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Negotiating turbulent times

By Christian Thun in the special April edition of Gulf News

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Rising Credit Risk in Middle East: The Importance of Stronger Risk Management Processes.

The globalisation of markets that began in the late 1980s has propelled the economic development of many countries and regions around the world. However, during the current economic downturn, this much-praised globalisation has now shown its unpleasant side and has undermined booming economies and significantly weakened formerly leading industries.

Even regions that were previously considered to be quasi low-default environments may now see an increase in the number of insolvencies. The US has seen an almost tenfold increase in expected default rates over the past 12 months, according to Moody's analysis of Expected Default Frequencies. But this phenomenon was not limited to the US - indeed, even regions like the Middle East have shown a significant increase in credit risk. While the average expected default rate for firms in the Middle East region was around 0.3 per cent in summer 2008, it had quadrupled to more than 1.2 per cent by March 2009.

These numbers will affect Middle Eastern firms that are exposed to credit risk via their clients and suppliers, primarily financial institutions but also corporates. The speed and scope of the global economic downturn has caught many by surprise and has highlighted the need for market players to strengthen existing risk management systems to manage current and future events.

Recent surveys indicate that half of all interviewed risk managers at FTSE 100 companies believe they have insufficient influence to manage risk properly at their organisation. Observers noted that the organisation is at fault and not their risk managers - as many companies see risk management as a mere 'tick-in-the-box' corporate governance exercise.

These issues as well as the impact of the current crisis on the loan decision-making process for banks and the issue of regulatory capital were discussed during two recent events by Moody's Analytics, called Credit Risk Best Practice: Weathering the Storm. The events, which took place in Dubai and Kuwait, discussed advanced stress-testing techniques as one way for banks and corporates to strengthen internal risk management processes. Stress tests can take the form of a single-factor/sensitivity analysis or a multi-factor/scenario analysis. A single-factor analysis could, for instance, focus on assessing the impact of a large shift in one risk factor, such as a 10 per cent increase in the probability of default.

The events by Moody's Analytics concluded by reiterating the key principles of prudent loan portfolio management, which are to (1) hold credit only when in receipt of payment for the marginal risk that a loan is adding to the overall portfolio risk; (2) reduce concentration on single companies, industries or countries; and (3) apply a rigid stress-testing framework to assess the potential need for additional capital.

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