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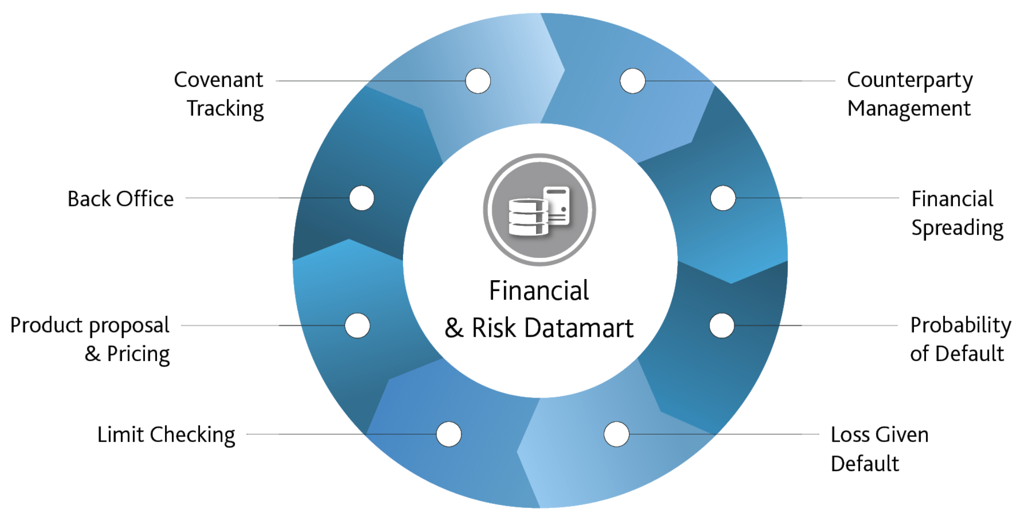
Credit Origination: An Integrated Approach

Few firms apply consistent risk management, origination and calibration methodologies across portfolios, business lines and regions

In the present economic landscape, risk management at the point of credit origination is not just tied to the spreading of risk data or selecting the correct product proposal and pricing. Effective and comprehensive risk management is a series of steps taken in a continuum that integrates covenant tracking, counterparty management, financial spreading, probability of default, loss given default (LGD), limits checking, product proposals and pricing and back-office activities.

THE BROADER SCOPE OF RISK MANAGEMENT



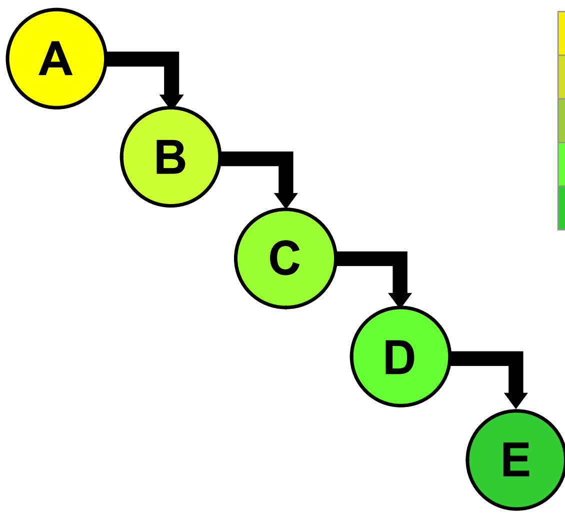
This new, broader scope of risk management includes stress testing; assessing risk appetites; calculating correlations and concentrations at both the portfolio and enterprise level; determining the impact of related parties; ensuring consistent underwriting and pricing methodologies; and, particularly of late, extensive regulatory compliance requirements from the FDIC, FINRA, OCC, SEC, CFTC and SIPC, to name a few.

Very few financial institutions adopt consistent risk management, origination and calibration methodologies across portfolios, business lines, products or regions. Instead, institutions frequently turn to quick fixes, overlays or "silver bullets," particularly at the edges of their businesses, to assess and manage risk or to produce a specific report.

The lack of integration between credit origination processes and firm-wide risk management and portfolio strategies makes it almost impossible to assess accurately the origination and holding of credit risk in a portfolio. This leaves institutions ill-prepared to conduct the detailed level of analysis and stress testing of their portfolios that both internal audit teams and external regulators (as well as the overall competitive environment) increasingly require.

To mitigate inaccurate measurement of risk and potential non-compliance with regulations, institutions are looking for an approach that minimizes the pain of implementing new IT systems and integrating these new systems with their legacy technology systems. The first origination priority, therefore, should be to maintain a single, richly detailed and internally consistent picture of the existing book of business.

A STEP-BY-STEP APPROACH TO ASSEMBLING A PICTURE OF TOTAL CREDIT RISK



A	Remove Equity
B	Remove US Treasuries
C	Remove Cash
D	Add in Subsidiary #1
E	Add in Derivatives Counterparties

For instance, in the accompanying figure, to assess the institution's total credit risk accurately, credit managers need to take a series of steps to make sure that they account for *all* of the risk exposures they are holding. Sequentially adding credit exposures (such as subsidiaries and derivatives counterparties) while removing those holdings that do not pose credit risk (e.g., equities, U.S. Treasuries and cash) produces this comprehensive, firmwide risk picture. This exercise typically involves collecting disparate, existing data feeds to arrive at a single data set that will be used in subsequent risk-management activities.

This centralized risk picture (typically a business-focused datamart that can be assembled quickly) reveals any data-collection gaps, and thus provides the institution with a clear plan for data improvement. Once this comprehensive view of risk is created, the next priority is to use it to affect credit origination activities.

Creating a centralized risk profile will offer immediate insights into the assumptions behind LGD models, which rating scales are used, and how overrides and pricing decisions are made. What's more, such a profile will yield data on month-over-month trends for key variables. An institution's origination and pricing activities, along with its portfolio and regulatory reporting, are directly improved by these efforts, ensuring a level of consistency in its activities while also highlighting areas that need improvement.

This picture of an institution's credit risk data, typically housed in a central financial and risk data warehouse, should next be linked to an institution's origination processes, as this will allow institutions to assess and price risk in the context of the entire portfolio and relationship hierarchies. This linkage between an institution's existing portfolio and its credit origination activities can range from portfolio strategy decisions to sector credit allocations to automated links between a loan decisioning system and an institution's existing book of business.

Institutions with these links will be in a better position to more effectively allocate their capital between different portfolio strategies, as well as to close any "backdoor" allocation of credit to a non-priority segment. Moreover, this approach enables coherent risk scales, automated limit monitoring, automated tracking of overrides and consistent pricing -- as well as the ability to target offers to existing counterparties of line increases and credit renewals. Armed with this comprehensive view of single obligor and group counterparty risks, institutions will be able to adopt obligor-specific strategies around retention, credit extension and pricing.

HOUSING CREDIT RISK DATA IN A CENTRAL DATAMART FOR CONSISTENT PICTURE

This data and risk integration effort can next be extended to include additional critical elements of the loan origination life cycle. Integrated decision management and well-structured workflow processes ultimately warrant the integration of covenant tracking, counterparty management, financial spreading, probability of default measures, LGD estimations, limits checking and back-office activities.

An integrated approach to credit origination allows institutions to benchmark their performance against different metrics and determine their overall credit origination consistency, or lack thereof, across portfolios. Enabled with diversified portfolios, well-allocated credit capital and a reduced operational burden, companies can now monetize their investment in origination systems with a higher ROC, ROA and ROI.

Since most of these processes are repeatable across new and existing customers, institutions have to make sure that they are taking the right steps forward to capture significant revenue savings and to allow for ongoing improvements.