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Practical Applications: the Assessment of Creditworthiness

4.1 Introduction

Credit risk that concerns the dependability and solvency of a counterparty is the earliest type of risk known in finance and banking. Credit risk is part of the broader concept of risk, which is not alien to people even in the sciences. Max Plank, the physicist, once said: ‘Without occasional venture or risk, no genuine inventions can be accomplished even in the most exact science.’

Everything we do has a risk, but we also hope that it has a return that exceeds the exposure by a margin. The question is which transactions present the best return for risk being taken as well as how many risks are involved. There are credit risks, market risks, operational risks, legal risks, technology risks, and many others. Therefore, we need a comprehensive, portfolio oriented approach to risk control:

- understanding component risks;
- measuring them in a uniform manner; and
- assigning appropriate capital to support them.

In principle, we can make more profit by taking credit risk than market risk, but credit risk is seldom well-managed. Banks are often too eager to bend their own rules in order to give loans, without really accounting for the counterparty’s creditworthiness. One way to do so is through credit rating either by independent rating agencies or through resources internal to the institution.

In the past, many banks kept an internal credit rating system, fairly similar to that of independent agencies but less detailed. This is changing. The best managed (and larger) credit institutions are significantly
increasing the detail of their rating approach, employ OC curves in their evaluation of credit worthiness, and are active in the use of models:

- Taken together, these steps form the foundation of the IRB approach.
- IRB is one of the pillars of the New Capital Adequacy Framework (Basle II), which replaces the 1988 Capital Accord by the Basle Committee.

The reader is warned, however, that all on its own the knowledge on how to implement credit rating and credit models in banking is not synonymous to well-managed risk, though it is its basic ingredient. Without such knowledge we will not find a solution in controlling exposure in a reliable way, unless we stumble on it. There are also, however, other important ingredients in credit risk management, one of them being the absence of conflicts of interest.

Take the risk council at one of the major and better known credit institutions, and its conflicting duties, as an example. In late 1996, this bank instituted a risk council with four members: the director of treasury and trading (later chairman of the bank), the chief credit officer, the assistant director of trading, and the chief risk manager who was reporting to the director of trading. This violated two cardinal rules at the same time:

- that traders and loans officers in exercise of such duties should never be entrusted with risk control; and
- the functions of the front desk and the back office should be separated by a thick, impenetrable wall.

Eventually the inevitable happened: huge financial losses. Post-mortem analysts who looked into this case of conflicting duties also said that the creation of another risk control function, under trading, diluted rather than strengthened the bank’s central risk management system. The result has been a torrent of red ink. This and many other failures in the assessment of exposure should serve as lessons; otherwise, we are condemned to repeat the same errors time and again.

4.2 Notions underpinning the control of credit risk

Counterparties to a given transaction, even AAA rated, can fail. Based on statistics on rated parties by Standard & Poor’s, Table 4.1 documents this statement. No trade and no contract is ever free of credit risk. Some transactions, however, involve much more credit risk than others.