LESSONS FROM THE BANKING INDUSTRY

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- Prologue
- Developing bank credit policy
- Extending and monitoring credit
- Corporate financial assessment
- External and internal ratings
- Setting the limit
- Risk protection
- Risk pricing
- Epilogue

Developing bank credit policy

- Policy limitations
  - acceptable markets and criteria for lending *(I.e. extending credit)* to them
  - unacceptable markets
  - acceptable products and approval of new products
- Limits and concentrations
  - Counterparties *(as % of capital)*; sectors; *target markets*; geography
- Exceptions to policy
- General policies, e.g. conflict of interest, money laundering, reputation risk, environmental risk
- Procedures for amending above

Extending and monitoring credit

- Credit approval process
  - lending authorities
  - credit process pre- and post- approval
- Control and monitoring
  - regular review of account
  - regular review of terms and conditions, including meeting covenants
- Action in the event of non-compliance should be prompt but proportionate. Most problems can be resolved if tackled early enough.
- ‘Banks and businesses: Working together when you borrow. A Statement of Principles.’

Corporate financial assessment

- Financial strength
  - Balance sheet (assets/liabilities), profitability, ratios and, most importantly,
- Cashflow and its sustainability.
- Scorecards
- Subsidiaries and parents
- Past history and experience
- Future projections and their certainty

Ratings VIP

- Ratings, *whether external or internal,* primarily assess the probability of default of the counterparty, rather than the transaction, over medium to long term. Grade migration may be of more value than default estimates *as a warning. Default is too late*.
- External ratings *have a value, but*
  - Quantitative *(recurrent earnings; risk profile)*, qualitative *(governance, management strategy)*, legal *context* and external *(operating environment, regulatory)* factors
  - their use and validity
  - the universe vs the specific transaction
- Internal ratings
  - can be qualitative and/or quantitative
  - validation and the need for volume data

Setting the limit

- Limit setting relates to the financial strength of the counterparty, and demands clarity about the purpose, term and certainty of repayment sources.
  - Too much or too little?
- Purpose - different purposes will demand differing structures. They may be mixed, in which case limits will be allocated for specific purposes.
- Term and Repayment sources – business/working capital; asset sale; asset or project cashflow

Follow the cash

but, in anticipation that things may not work out . . .

Risk protection

- Will usually relate to the transaction, including the worth of the counterparty, and the current and future value of assets, whether fixed (property, plant etc) or “floating” (stock, debtors, cashflow).
- May, in specialist areas such as certain bonds and guarantees, or where systemic risk is involved,involve cash or equivalent.
- Whether fully, partially or not specifically collateralised, the loan documentation will contain covenants, which will relate to risks identified in the credit assessment, protect against assumptions made and provide early warning of potential problems.

Note the power of competitive markets in negotiating the above, and in considering . . .

Risk pricing

- Risk/reward is a science which is distorted by the art of the competitive market.
- Price will be driven by the strength of the counterparty and the risks inherent in the transaction, including term and collateral.
- There is no direct correlation between credit rating and credit pricing, only a relative one.
- The price (margin and fees) may mitigate the risk, but rarely will it compensate for default in a bilateral transaction.

Epilogue

If, like an ill venture, it come unluckily home,
I break; and you, my gentle creditors, lose
. . . Bate me some, and I will pay you some,
and, as most debtors do, promise you
infinitely.