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Article

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Filters for Today's Higher Risk Environment: Business Credit Article by Joe Boland

NACM ARTICLE–TACTICAL FILTERS

"Tactical Filters for Today's Higher Risk Environment"

By Joseph N. Boland

We now recognize that poor risk underwriting in the sub-prime mortgage market has had a catastrophic impact on that segment, and similar problems have surfaced in the credit card and leveraged debt markets, and will certainly affect all segments of the financing markets. So far, financial institutions have recognized over $100 billion in write-downs, with more bad news almost daily, while the market sharply re-adjusts its risk/reward balance–e.g., increasing credit spreads, particularly for weaker credits and tightening financial covenants.

Given these conditions, many of The Alta Group´s clients, from financing companies to trade creditors, have asked how to adjust their risk management approach in response to today's economic and credit conditions. A weakening economy, a reduction in credit availability from traditional sources, increased credit spread premiums with tighter conditions, and the severely weakened dollar have degraded the risk landscape for our clients as they deal with their customer sets.

Beyond considering process and structural changes such as adjusting pricing and terms, changing delegation to include more senior management review and involvement, and strengthening internal risk resources and capabilities, in the short term our clients are also attempting to filter more clearly which customers and prospects are most likely, in today's environment, to become problematic credits.

To supplement their normal assessment process, Alta is advising clients to also screen their existing and potential customers with additional tactical "filters" to put focus on credit requesters who are at greater risk in current conditions. Credit requesters identified in these filters should be subject to supplemental evaluation, either by adjusting the general methodology to do a more detailed financial analysis and/or requiring a higher level of review by management to assure experienced judgment is being applied to these potentially more sensitive names. The specific approach will vary by your type of business and the level of development of your risk infrastructure, but in some appropriate way, additional scrutiny should apply to higher risk sets.

General Characteristics Filter:

In economic downturns and periods of disruption in the credit markets, many companies will typically exhibit increased credit risk (and more so at the low end of the rating scale).However, with today's unique combination of factors, companies with particularly increased exposure may exhibit the following characteristics:

1. Low-margin, high- turnover companies such as retail and distribution: especially vulnerable to volume slowdown coupled with increased financing costs
2. Companies with high levels of floating rate debt, particularly at lower end of the rating scale: increased credit spreads are exceeding base rate reductions (prime, LIBOR, etc.)
3. Companies with expiring credit commitments from the banks, or with need to regularly access the capital markets: both sources are pulling back on availability, and in all cases demanding higher spreads and tighter conditions, reducing the company's flexibility
4. Companies with significant dependence on vendor financing programs to move product: credit availability tightening (credit crunch) is likely to impact some vendor financing organizations' continued commitment to the business
5. Low-margin businesses dependent on credit insurance backstop to support sales: credit insurers likely to be increasing prices to reflect new market risk paradigm
6. Any low-rated company (e.g., <BBB): highly dependent on banks': refinancing risk
7. Companies in the midst of a large project or transition to a new business model dependent on longer-term financing commitments: much evidence in the market of lenders/underwriters backing off commitments wherever possible
8. Companies with high energy components in their variable cost(e.g. airlines and their suppliers)
9. Companies highly dependent on exports to the U.S.: impacted by slowing economy and weakening dollar;
10. Conversely, companies dependent on increasingly higher-priced imports for components or finished product

Industry Groups Filter:

Certain industry groups will also likely reflect weakness in current conditions:

1. Banks and financing companies: already well publicized, but many in this segment highly dependent on credit funding and asset quality are suffering. Be wary especially of marginal players in the financing business vulnerable to bank/capital market pullback
2. Companies selling to the banking industry, e.g., specialized software companies, certain consultants/training companies
3. Retail and distribution: as noted, low-margin businesses vulnerable to economic slowdown, higher rates, and credit availability
4. Construction/real estate businesses in the U.S. and Western Europe, and those dependent on robust real estate sales
5. Domestic U.S. airline industry and major suppliers: usually impacted by economic slowdown, but further impacted now by higher fuel costs driven, in part, by weaker dollar
6. Mortgage brokers
7. Certain credit insurers
8. Small and mid-sized businesses/enterprises (SMB/SME): while not an "industry group," generally have a tough time in this type of environment; tend to be exposed to a narrower client base in their own business (high concentration), rely heavily on bank financing, and may be especially vulnerable to tightening repayment conditions. If your company relies on standard application scoring for parts of this segment, then we recommend:

1. Analyzing the portfolio performance for each change in credit underwriting policies for the past three years.
2. Analyzing performance of industries and equipment types added in the past three years with remaining portfolio.
3. Revalidating scoring model predictability traits for transactions added in the past three years.

Problem Indicators/Warnings Filter

An increased emphasis on using the standard tools for identifying problem accounts (delinquency tracking, follow-up, portfolio rescoring, etc.) is critical today. In addition, watch out for the following indicators of potential trouble in your account set:

1. Requests for increased lines and /or extended terms from your customers and distributors: may reflect reduction of bank or other vendor credit availability
2. Increase in "disputed" accounts receivable: many actual credit-related delinquencies and write-offs start out as dispute claims
3. Lower take-up by your customers on offered early payment incentives: may reflect efforts to conserve cash at expense of financial return
4. Delays in submitting financial statements or agreed-upon financial submissions
5. Key management changes in your customer's organization
6. Oblique inquiries from other suppliers/financers to your client about performance
7. Industry patterns in your accounts receivable performance: e.g., if all of your retail business customers are slowing
8. Banks and finance companies declaring exits from certain sectors: indicates a risk/return pattern not favorable in that segment
9. Lower Paydex or other market indicator scores related to your market
10. Reduced risk appetite/higher pricing from your vendor financing partners for your customers
11. On credit insurance, lower limits and /or higher specific prices for segments or particular accounts
12. Rating agency downgrades, specific to your customer, or even for companies in the same industry segment: indicates perhaps some general problem affecting the segment

Special Note: Fraud

Now is also the time, unfortunately, to be especially diligent about fraudulent activity. "Good times" tend to make obtaining credit by false statements less tempting, but worsening credit conditions make such activities as misrepresentation of financial statements, bogus business plans, and phantom guarantors more likely. "Know your customer" (and by extension, know the guy introducing you to your customer) continues to be the best advice for avoiding fraud. Educating your field and risk staff on potentially fraudulent situations, and reviewing your current processes for fraud prevention, are worthwhile activities in today's uncertain climate.

The Alta Group (www.thealtagroup.com) is a global consulting firm that advises clients on effective ways to manage their own risk/reward equation by building a robust risk-management infrastructure. From policy development to process design, portfolio management to systems, controls, and executive training, Alta's objective is to increase shareholder value by making risk management an integral part of business.

BOLAND BIO

Mr. Boland is responsible for The Alta Group's risk management practice and has 38 years of experience in financing and risk management. He has spent 20 years in the banking industry, at the Bank of New York and then UBS, and more recently spent 16 years at IBM Corporation as chief credit officer for the company and its financing subsidiary, IBM Global Financing. Contact him at 914-533-7007 or**jnboland@thealtagroup.com**.