Keeping score

Evolving wholesale credit on a maturity model

Wholesale credit is a bright spot for financial institutions. It did not cause the financial crisis, it does not lend itself to systemic risk, and it remains a profitable area for banks. Regulators and governments are also supportive of commercial lending for its role in assisting economic growth.

Unfortunately, most banks do not have an adequate risk framework in place to fully take advantage of wholesale opportunities. Prior to the financial crisis when credit quality was good, wholesale lending generated enough profitability to mask inefficiencies in controls, data management, and systems. Today, with a renewed focus on increasing wholesale lending volumes while closely managing profitability, these shortcomings have become very visible, and banks need to correct them. The large number of stakeholders within a bank, the complexity of the problem, and the historic underinvestment in wholesale lending credit management can, however, make it challenging to know where to begin.

A wholesale credit risk maturity model is a methodological approach that helps banks solve this challenge. It allows a bank to assess where they are today, and where they might want to be in the future. A maturity model provides institutions with a scorecard to isolate and evaluate the various elements of wholesale credit management, take note of areas that need to be improved, and develop a view of the desired amount of improvement.

Using the maturity model gives banks a clear starting point: adapting a holistic view of credit, rather than trying to solve issues piecemeal. By looking at individual areas and coordinating them with overall corporate goals, banks can identify and target specific areas to increase efficiencies and effectiveness for the broadest group of stakeholders, and provide the optimum return on investment. Through this process, banks retain the ability to be selective about the risks they take, yet remain in a position to take risks, and ultimately achieve a greater volume of higher quality commercial loans.

Why keep score?

Credit risk management is based on a fear: that what goes out may never return. To hedge against this outcome, risk principles, best practices and procedures are applied to help banks make informed decisions and align risk with performance. However, beyond the worry of performance and returns lies another concern: what are my competitors doing?

The challenge of benchmarking credit risk performance is the large number of stakeholders within financial institutions. Each of these stakeholders has exposure to one part of the business, and for many organizations this is where acquiring a larger perspective stalls and a piecemeal view on the process is accepted. The funding process within banks complicates this fractured perspective. Departments are each assigned their own budget, and become incentivized to look at credit risk from their own, limited view of the world. This prevents stakeholders from acknowledging the substantial overlap among the needs of multiple departments.

Where the desire exists to increase wholesale credit lending, credit risk management needs to be increased as well. Enhancing this function, by department, highlights the absence of a holistic view. When risk management is focused only on risk, credit operations are focused only on efficiency, relationship managers are focused solely on sales, and financial management looks after compliance only, these divisions cannot add up to more than the sum of their parts.

The inner workings of a global financial institution can contain literally hundreds of systems in which credit risk is recorded. This risk may be managed with dozens of different systems, many of them disconnected from each other. Attempting to bring these disparate elements together can appear to be an overwhelming and resource-intensive process. This is where a maturity model comes into play. As a framework for financial institutions to examine their credit risk management from the perspective of a wide array of departments, a maturity model scorecard provides banks with a single point of reference to understand what they are, where they wish to go, some practical ideas about where to start, and how to do it most cost-effectively.

In the search for balance between efficiency and profitability, those banks that hold a holistic view of their credit controls will be better positioned to navigate opportunities.

Maturity in practice

A wholesale credit risk maturity model is first used to gauge a financial institution's existing risk management capabilities. The model provides a method for determining where the institution is on its journey to implementing best practices, as well as a roadmap for how far they may want to go.

Imagine this maturity model as an evolutionary chart of man, with primitive characteristics on one extreme, moving toward advanced characteristics on the other. Manual processes would be gathered on the primitive end of the spectrum, while those on the advanced end would be fully integrated capabilities that have evolved into strategic assets.

As an example, consider the various levels in which an institution can respond to regulatory requirements. An institution can quickly determine its placement in one of the model hierarchy's 5 categories, ranging from primitive to advanced:

- **Ad hoc:** Responding to regulatory requirements and fundamental risk management with a largely manual approach.
- **Foundation:** Introduction of additional automation. Organization focused on regulatory compliance and ad hoc risk management.
- **Competitive:** Significant amount of automation. Organization providing good regulatory compliance with standardized risk management.
- **Differentiating:** Organization is proactively managing risk and the profitability of various kinds of risks that are taken on.
- **Breakaway:** Organization is now proactively managing the future, by modeling future scenarios and closely managing the intake of new risk.

From a holistic approach and a department view, financial institutions can sub-divide and audit their maturity placement in a number of categories from information optimization (strategy, governance, infrastructure, integration), data (archiving, testing, management, privacy, metadata and master data management, warehousing, modeling), and business intelligence and performance management.

Results of a bank's self-assessment can be grouped into 3 points of measurement:

- First capabilities – where am I today?
- Best practice capabilities – where is the industry today?
- Goal capabilities – where do I want to be?

This process enables banks to see where they are at a micro level for each item on the maturity model, while also producing a bottom line snapshot of where the organization is holistically. Financial institutions also gain something they have not had before: a way to compare themselves to best practice institutions, and an opportunity to choose an informed starting point on enhancing their credit risk capabilities.

Institutions also face pressure to lend more, more aggressively, and to a broader commercial base.

Setting goals

The more complex an organization is, the more opportunities for operational gains exist, and the more stakeholders will be impacted by policies and procedures. Institution size, geographic dispersion and intricacy of risk are the main drivers of these complexities.

Because it incorporates a wide range of categories, a maturity model does not require a bank to evolve all its capabilities at once. Typically a financial institution will focus their efforts on specific projects, with a pre-determined goal at a specific point on the scorecard. Not all institutions will find it cost-effective or desirable to develop top-end capabilities in every area or at the same time.

A wholesale credit risk maturity model is a non-invasive way to identify business value through improved information, automation and processes. Institutions can use the model to chart a course toward desired priorities, such as; achieving a holistic vision of risk; optimizing risk-adjusted returns; maximizing the efficient use of capital; and enabling quicker regulatory responsiveness to changes. Current capabilities can be moved toward best practice standards to help maximize the efficient use of capital through improved use of risk information, reducing the costs and complexity of managing information for risk and compliance.

A maturity model helps banks avoid the tendency to overcompensate on efficiencies or effectiveness. If resources are thrown into upgrading systems and data management, effectiveness might suffer, as performance improvements could still conceal outdated controls. On the other hand, if controls are enhanced, but systems are not upgraded, the benefits and cost efficiencies of automation might be lost. The maturity model acts as a reminder of the holistic picture. The intricate, connected elements of credit risk management must be considered together to extract the promise of greater profitability from commercial loans.

Pressure and perceptions

Competition for new customers and the retention of current customers are extremely aggressive among banks. These institutions also face pressure from governments and commentators who are calling on banks to lend more, more aggressively, and to a broader commercial base.

In the UK, driven by the perception that banks are not supporting enough loans, some columnists have called for a new government-backed business bank to focus specifically on commercial lending. A number of commentators have suggested that the creditworthiness of applicants and the burden of holding additional regulatory capital are not significant issues, and that new players are required to jumpstart lending opportunities.

Credit risk management is based on a fear: That what goes out may never return

In the US, a similar public perception exists. Ironically, there is not an unwillingness of banks to commit to lending: rather there is growing pressure on larger banks to expand their client base. In an Economic Letter of August 27, 2012,[1] the Federal Reserve Bank of San Francisco observed that the lending to SMBs by community banks had dropped substantially. Although stronger lenders had increased commercial lending to the SMB segment, growth in this area did not compensate for the larger reduction in lending by weaker, smaller banks. There is particular pressure to provide funding to SMBs, who are noted to create jobs and stimulate the economy, but they may have fewer available assets or assets that are difficult to use as collateral compared to enterprise-level clients.

In the increasingly competitive wholesale space, smart investments in credit risk management are required so that efficiency and effectiveness can be realized together.

These pressures and perceptions reflect the realities of our times. Prior to 2007 when the economy was doing so well, a loan might be issued to almost anyone. By 2008, when banks around the world simultaneously increased their lending standards, commercial lending fell off a cliff. In the search for balance between efficiency and profitability, those banks that hold a holistic view of their credit controls will be better positioned to navigate opportunities in the face of pressure, and the oversight of regulators and governments.

Final score

Banks need to make profitable lending decisions. In the increasingly competitive wholesale space, smart investments in credit risk management are required so that efficiency and effectiveness can be realized together. A maturity model scorecard shows banks how to achieve this goal and enhance profitability by aligning risk with performance.

The maturity model offers decision makers a common language to identify and achieve objectives. By providing a holistic framework, the maturity model's self-assessment process enables C-level stakeholders to understand how big the problem is, and how to balance out the needs of various stakeholders across the organization.

Financial institutions want to know where they fit into the marketplace. Like the best roadmaps, the maturity model helps banks assess their current place in the industry, where they want to be in the future, and what steps will be required to reach their ultimate destination.

Where the desire exists to increase wholesale credit risk lending, credit risk management needs to be increased as well.

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Produced in the United States of America
March 2013

1 Elizabeth Laderman, FRBSF Economic Letter, Economic Research, August 27, 2012

YTW03322-USEN-00