

# Lessons from Credit Crisis

## Putting common Sense into Consumer Credit

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# Presentation Path

- The origins
- What went wrong ?
- Back to Basics : Putting common sense
- A year into the crisis – new paradigms

# The Origins

## Consumer debt has more than doubled in the last 10 years

Household\*, Consumer Credit & Credit Card Debt in the U.S. (\$Billions)

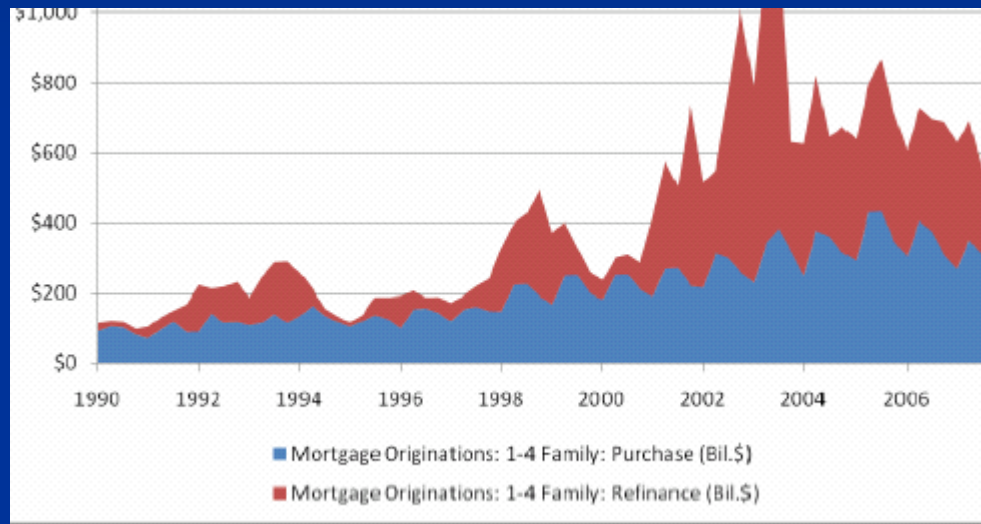
\* Includes mortgage related debt



	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
■ Credit Cards	\$545	\$610	\$680	\$718	\$763	\$961	\$961	\$961	\$961	\$961
■ Consumer Credit	\$1,441	\$1,554	\$1,741	\$1,892	\$2,000	\$2,104	\$2,219	\$2,314	\$2,418	\$2,551
■ Household Debt	\$5,919	\$6,414	\$7,009	\$7,680	\$8,514	\$9,497	\$10,575	\$11,754	\$12,948	\$13,825

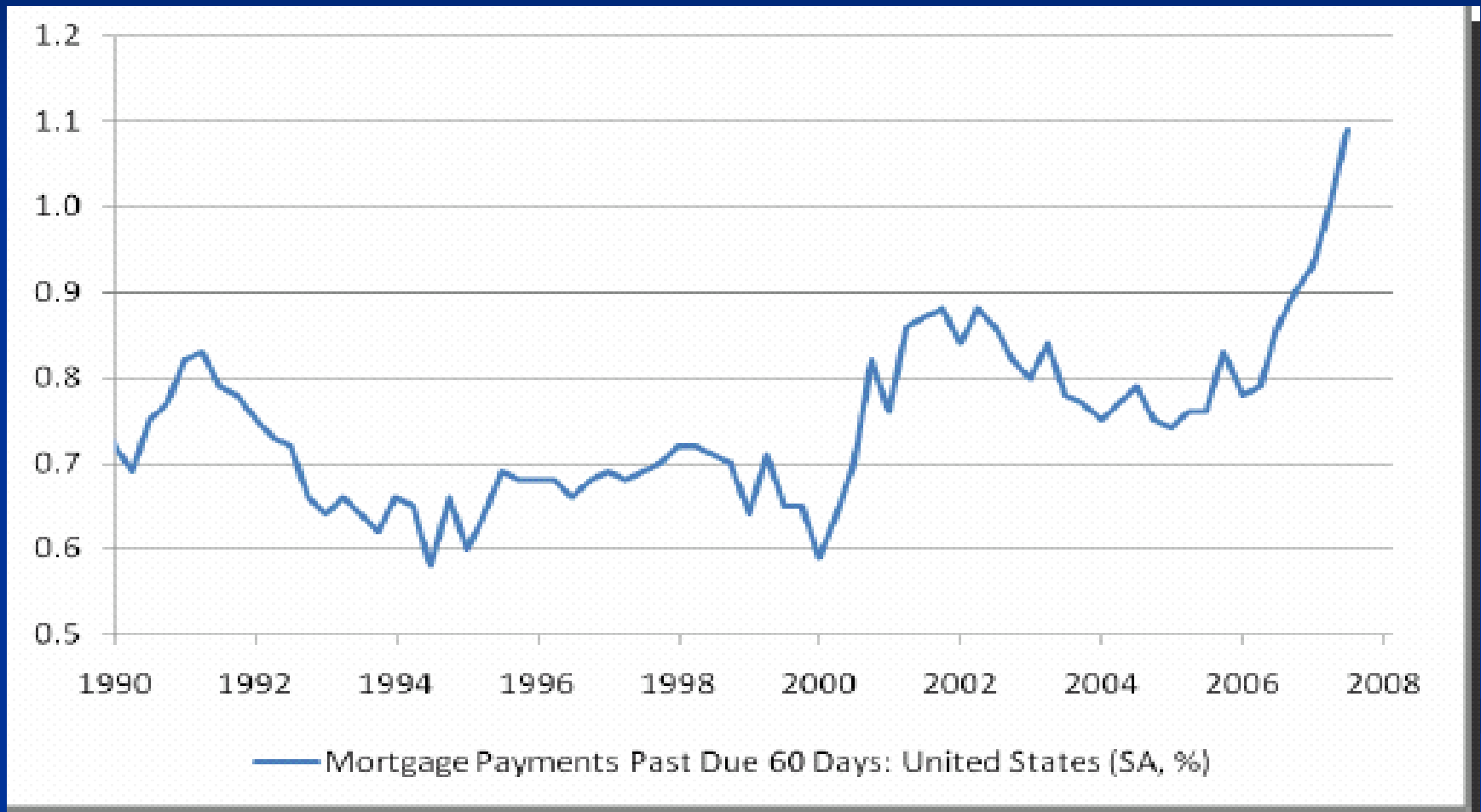
Sources: The Nilson Report, May 2008, EDC analysis

## US Mortgage Boom (2003-06) Triggered by historic low rates



Source : mortgage bankers association, USA

# US Mortgage Meltdown 18 to 24 months later triggered by unprecedented volumes

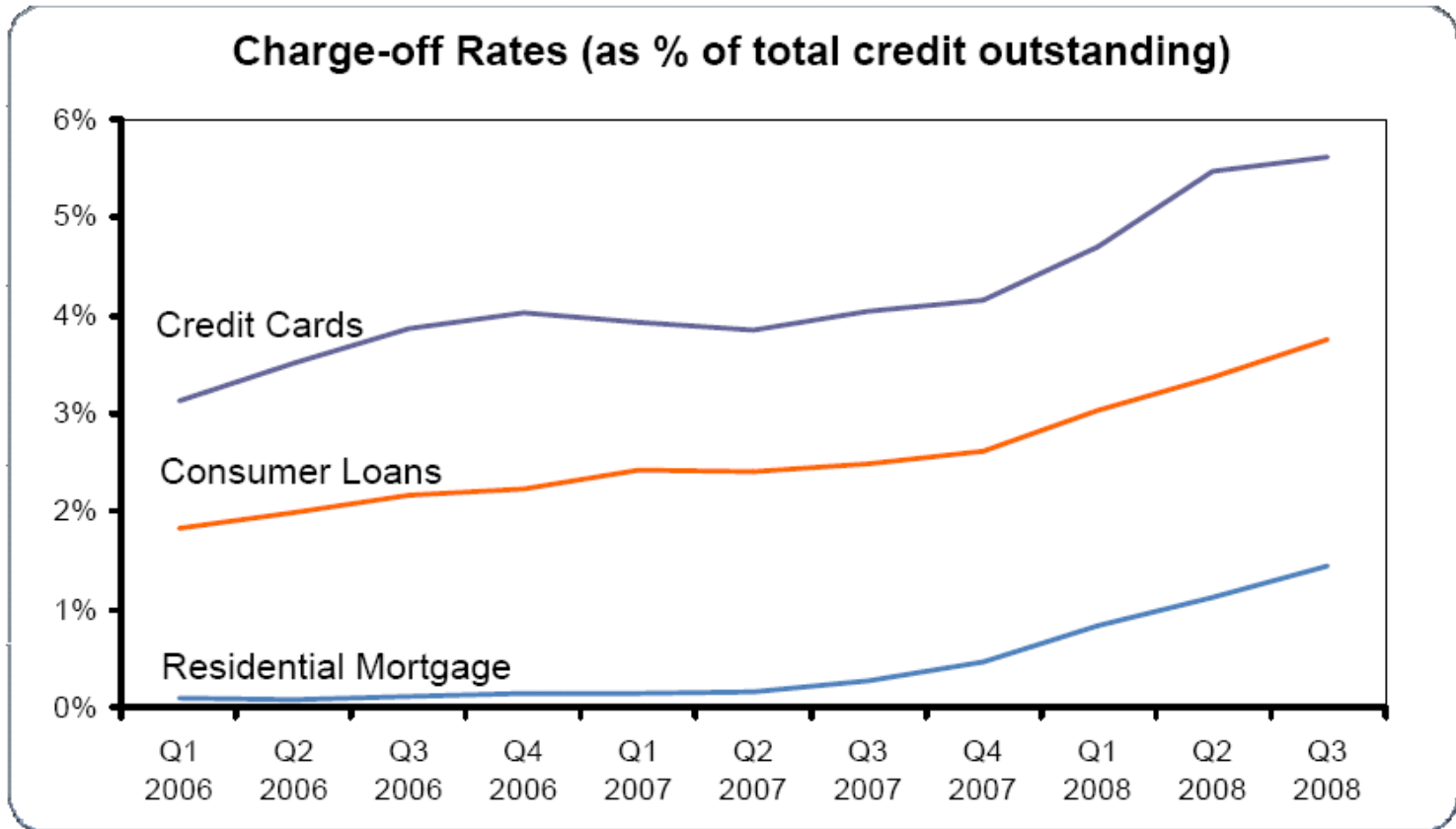


Source : mortgage bankers association, USA

# Problems were exacerbated also due to other important factors

- A highly well-oiled chain of broker-originator- servicer- investor which allowed new and refinancing volumes to be pumped into the “Trading book” as opposed to the “Banking Book”
- An enabling infrastructure and lax regulatory environment which supported securitization
- Exotic well packaged teaser products (Option ARM’s, Alt-A, SIVA, SISA etc) sold as RMBS & CLO’s- inappropriate for the customer and potentially toxic for the investor.
- Falling underwriting standards due volume pressures and misdirected incentives opened up the sub-prime segment
- Rapid rise in home prices and a booming stock market, a dangerous combine which further eroded equity in homes through 2<sup>nd</sup> and 3<sup>rd</sup> mortgages.
- US mortgage was one bubble, perhaps the biggest trigger of the many other smaller ones which blew up at the same time....and caused systemic failures.

# Problems not restricted to mortgages alone but to all consumer loan categories



Source: Federal Reserve Board

Fundamentally, at the root of the credit crisis was ineffective retail portfolio risk management where basic lending principles were ignored.

What went wrong ?

# Generic bank and industry level failures about which much has been said already

- Ineffective Risk Management governance
  - Robust risk culture
  - responsibility of CEO and Board for risk management
  - Independence of risk committees & seniority of CRO
  - Thorough understanding of risk appetite and strategy
- Improper Risk Management methodologies & procedures
  - External ratings not substitute for own due diligence
  - taking the macro-economic environment into account
  - identification of key risk factors and measures by portfolio
  - risk aggregation and concentrations

## Generic bank and industry level failures about which much has been said

- Absence of stress Testing
  - enterprise-wide covering broad array of risks and correlations
  - meaningful impact on business decisions & not academic exercises
- Improper Orientation of Compensation and incentive plans
  - should be long-term rather than short-term
  - payout alignment with timing of risk-adjusted profit
  - such that it does not encourage excessive risk-taking

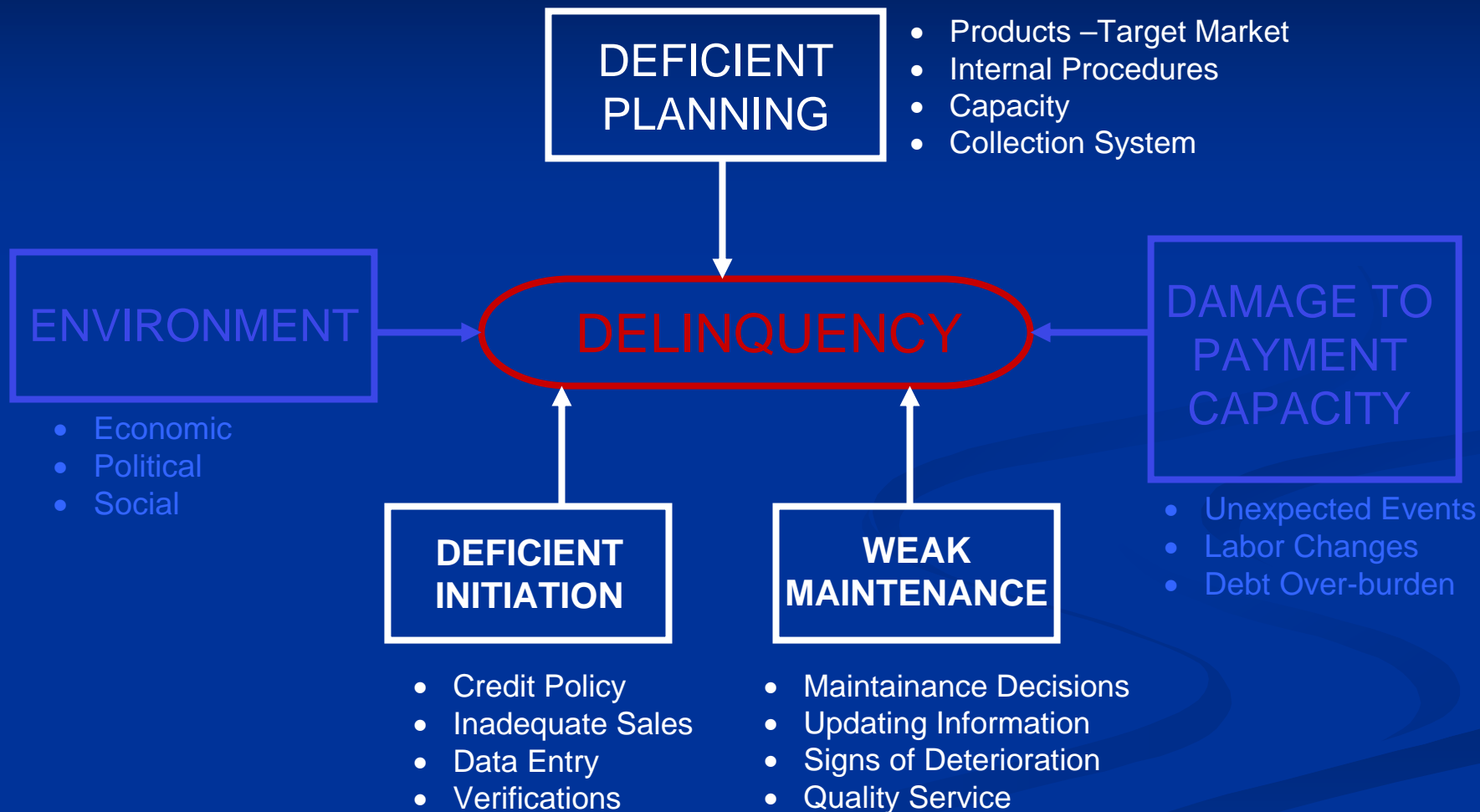
# Specific to Retail risk management there were some fundamental failures

- The 5 C's of Credit were ignored in underwriting  
( To recap they are – Capacity, character, cash-flow, creditworthiness and collateral)... more importantly a sixth C was ignored too- Common sense !
- “Originate to sell” lending followed completely different ( less conservative) rules than “originate to hold” lending.
- Product design , pricing & target segments were out-of-synch.
- Failure to set limits or caps on overall volume of lending and risky sub-portfolios ( SIVA, SISA, Alt-A, Sub-Prime)
- Failure to understand vintage curves & credit waves.
- Inability to forecast and provision for losses adequately
- Lack of sensitivity to changes in key leading indicators and act on trends.
- Ill-prepared & inadequate collections set ups , grossly inadequate for the credit wave that was to come.
- Deal based opportunistic lending as opposed to a portfolio approach

While there was failure at multiple levels it can be argued that it would have been easiest to identify and control it at the front-end of the chain which was retail lending. The key failure within retail lending was an absence of Risk Appetite management

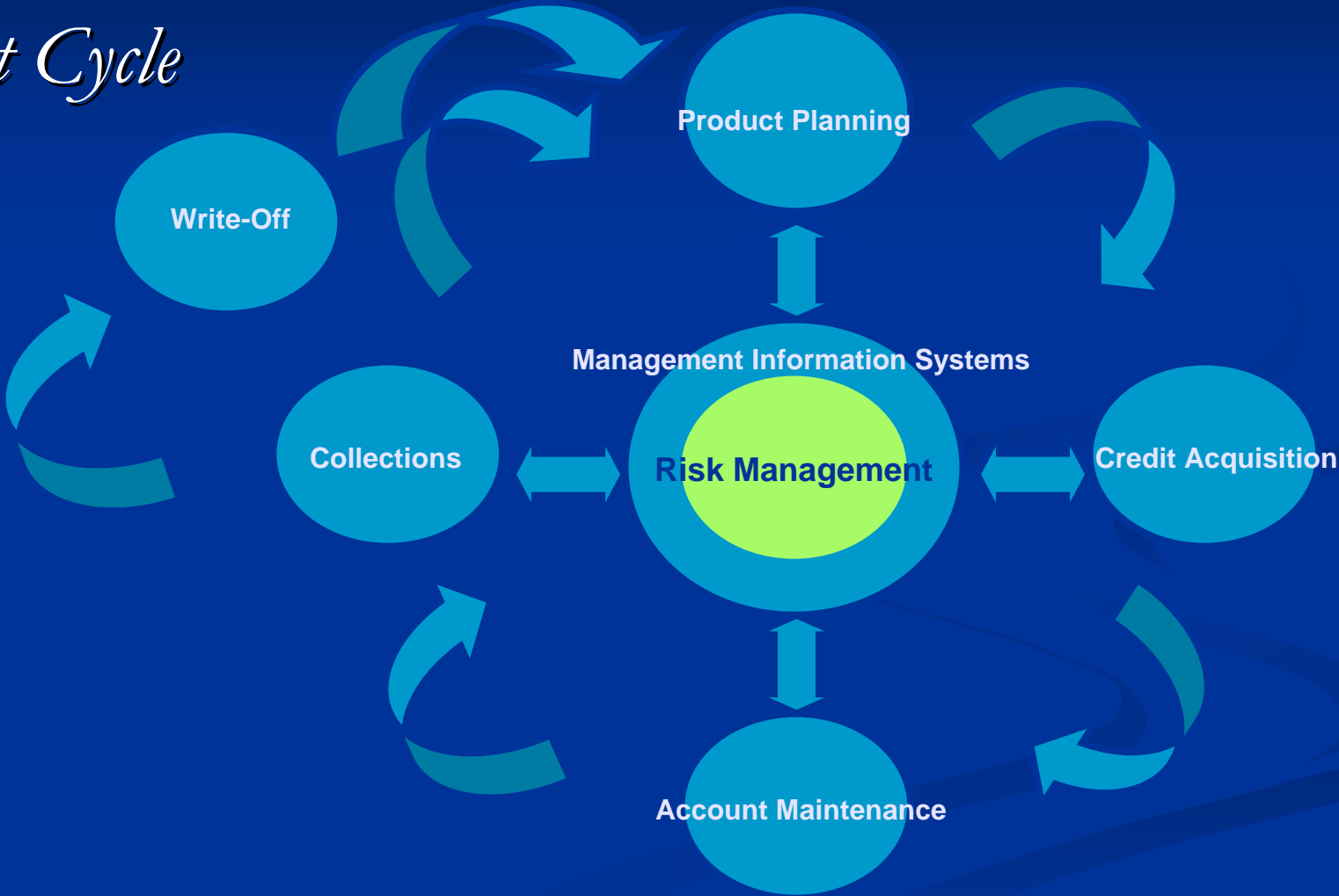
Back to Basics -  
Putting Common Sense  
into consumer credit

*There are many moving parts in Retail lending  
...working in silos inevitably results in higher  
delinquency and losses*



# *Back to Basics ... really*

## *Credit Cycle*



*An integrated credit risk management process is fundamental*

# *A Product Program Integrated Portfolio Tool*

- A standardized set of rules of credit extension/ maintenance and collections for a group of customer with similar characteristics or product needs which culminate in setting up a risk appetite for the portfolio and key benchmarks.
- A sign-off on a Product Program is considered an approval of the complete risk/reward characteristics of the product and the credit cycle process
- Demonstrates that portfolio performance will be predictable in terms of profitability, revenues, costs, delinquencies, and losses as well as capital usage

# *The Product Program contains ...*

## Product Description

- Target Market & Portfolio growth and health strategy
- Economic and Competitive Environment
- Eligibility Criteria (Terms and Conditions)
- Account Initiation
- Account Maintenance
- Collection and Write-Off Policy
- Treasury, Funding, and Pricing Considerations
- Support Systems ( IT, infrastructure, resources, compliance)
- Product Profitability and Stress Testing
- Analysis of RWA, Economic Capital consumption

Portfolio MI is the heart & soul of a program..

# What should Portfolio MI deliver ?

- Help establish “Risk Appetite” levels and continuously enable adjustments based on portfolio behavior and market conditions to deliver :

Risk-Return Trade-Off  
&  
Optimal Capital Management

- Serve as a basis for effective credit cycle and portfolio management : tools for mitigating risks and evaluating opportunities

# *Risk Appetite Management is in the Core of Program Lending*

- Based on portfolio MIS, identify credit risk and devise a way of controlling that risk by establishing
  - portfolio peak outstanding limits
  - concentration exposure limits (i.e. industry, geographical, dealer, etc.)
  - caps on deviation approvals
  - portfolio delinquency and loss benchmarks
  - EL, EC and RAROC targetsand monitor the portfolio accordingly.
  
- Establish risk-based pricing to ensure that the customer price is appropriate given the degree of risk taken
  - higher-than-average rates for sub-prime customers
  - lower-than-average rates for prime customers
  - Customer rates based on score bands

# *Risk Appetite Management is in the Core of Program Lending*

- **When portfolio delinquency and loss rates exceed pre-set benchmarks, pre-defined risk management actions are triggered:**

<u>Portfolio</u>	<u>Benchmarks</u>		<u>Action Plan</u>
	<u>30+dpd</u>	<u>NCL%</u>	
Mortgage	2%	3%	Review portfolio MIS, underwriting parameters (minimum income, maximum loan-to-value, debt burden, etc...) and collection strategy

- ◆ Evaluate loss absorption capacity of portfolio by performing portfolio stress testing and develop action plans for risk control:

<u>Stress Factor</u>	<u>Action Plan</u>
Foreign exchange depreciating over 10% in 2 months	Review performance of customer segment from import sector and adjust underwriting policy and collection strategy, accordingly

# *The Program Lending Approach offers value*

- Aligns credit policies and processes with business strategy and Line Management
- Ensures clear articulation of risk appetite and benchmarks
- Formal delegated approval authorities can be linked to program materiality and/or program performance ensuring proper due diligence
- Has an inbuilt review/check mechanism to safe guard portfolio quality
- Enhances portfolio profitability and predictability through constant tracking of actuals against projections & pre-set triggers
- Ensures pro active portfolio management
- Process highly sensitive/ responsive to environmental / internal factors
- Lends itself easily to Modelling and Basel II Compliance

# To Recap : Credit Crisis - Key Lessons Learnt

- Imbalance between desire for business and appetite for risk
- Failure to discuss emerging risks until it was too difficult
- Failure to discuss risks at a “broader” level , no holistic assessment of risks (deal based approach as opposed to a portfolio approach)
- Insufficient challenge of risk / reward to business plans
- Poor underwriting standards which did not get tightened even as environment changed
- Failure to provide adequate and timely disclosure
- Incentives aligned to short-term performance rather than Long term
- Absence of Stress Testing.

# Does Program Lending make the cut ?

- A clearly articulated risk-appetite is fundamental to a Program
- A program approach has an in-built disciplined review mechanism – annual review or review when triggers are tested
- Program assessment holistic and requires sign-off from multiple stakeholders across business, risk, finance, audit, compliance
- Multiple levels of challenge & escalation during review process
- Tracking Actual Metrics against program limits is at least monthly
- High level Portfolio approach , encourages 3-5 year plan horizon and therefore permits re-orienting compensation to sustained program performance over time
- Stress Testing & forecasting woven into annual review process
- Inbuilt capital discipline and targets optimal allocation across portfolios

# “A Year through the Crisis, some new Paradigms are emerging

- Understanding affordability & vulnerability of Target (& existing) customers & segments is key to portfolio health.
- Payment hierarchy : behaviors are changing.
- Old models need revamping as old assumptions are being challenged, strong need for “local knowledge/behavior” – decentralization?
- New models are needed for new behaviors & dilemmas (propensity to skip, propensity to restructure, to foreclose or not).
- Key challenge: New types of consumer data.
- Pricing higher for higher risk: Does it really work?

.....BUT THE 6 C's STILL HOLD”

I rest my case.

Thank You