



Company Watch

ONLINE ARTICLE

CREDIT RISK MANAGEMENT – LESSONS LEARNT FROM THE RECESSION

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Credit Risk Management – Lessons Learnt From The Recession

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As the global recession slips into history, at least for most economies, attention is being focused not just on what caused the near catastrophe but also on what could have been done differently. The concern is not just to avoid such disasters in the future, but to examine how the process might better have been managed to mitigate the downside for stakeholders.

What is becoming clear is that credit risk management techniques were seriously lacking, with insufficient and inadequate information available to decision makers and action often not being taken until the situation was too far advanced for any significant mitigation of exposure to a failing business.

Excuses that the crisis developed too quickly are nonsense, because the early warning signs of an impending collapse are invariably contained in published information well before a commercial drama turns into a full blown financial crisis. Simply by examining a company's financial statements over a period of time, risk managers can tap into certain immutable realities of business life and judge the health of a company and the potential impact of certain eventualities. By doing so, they can make balanced judgements based on objective facts.

By monitoring the inner workings of a business and its performance, it is possible to predict the risk of failure with considerable accuracy. Tracking a combination of certain key ratios and trends, such as the effectiveness of asset management within the business or the control of funding sources is straight forward. Add in a close watch on changes in profitability through its key components of revenue, margins and cost control and a clear picture of risk emerges. This is hardly rocket science, more a matter of sophisticated statistical modelling driven by empirical assessment.

This is important not just for tracking the deterioration of a risk, so that exposure can be managed down to acceptable levels. It also matters when a business is being strangled by an out of date perception of a poor risk, which is in fact improving.

Of all those with a financial interest in a potential failure, none are more vulnerable than those holding equity positions, the very last in the financial queue. A classic illustration of this and of the imperfections of equity markets comes from the recent example of the Legion Group, which went into Administration in August 2010.

Our analysis shows clearly that in March 2008 there was a collapse in the company's risk profile: from a robust score of 83 out of 100 in September 2006, the March 2008 results plunged the company to a score of 8, deep into our 'Warning Area' of scores below 25. By March 2009, the score had further descended to only 2, a clear indication of serious and potentially fatal problems.

The reasons for this are relatively straightforward. Although profitability was robust, uncontrolled growth by acquisition was stretching working capital resources and increasing dependency on short term debt and creditors. No doubt management resources were also being tested to breaking point, as eventually was the patience of the lenders, but this is outside the scope of corporate health monitoring.

But what was happening in the allegedly sophisticated equity market? Share price movements between July 2006 and the eventual demise of the company late in 2010 show an apparently irrational level of strength in the share price and market capitalisation of Legion Group.

The market finally recognised the problem in March 2010, some two years after published information ought to have led it to downgrade the shares. Up to then, there was little in the share price to indicate just how serious the company's problems were. Our scores revealing the seriousness of Legion's risk profile were based on information taken direct from public domain data, all of which was also available to the market.

Shareholders lost out, but the good news is that any trading partner or creditor with the good fortune to have access to health monitoring data had plenty of advanced warning, giving them the time to limit their losses.

The stark reality is that 90 percent of all UK company failures fall into the 'Warning Area' prior to failure. The system's analysis of the fundamental financials picks up the underlying commercial malaise within these companies, a malaise which eventually brings the business down. Of course, not all companies in the Warning Area fail – in benign economies banks and suppliers will carry weak companies; also the management often take action to remedy the problems. But around one in four companies in the Warning Area either fail outright or need to undergo a major reconstruction to avoid failure, a statistic which should quite rightly prompt caution.

If nothing else, advance warning of potential problems allows stakeholders to engage in a constructive dialogue with management about risk issues while positive steps can be taken, rather than the dialogue of the deaf that is all too common when disaster is looming like a mid-Atlantic iceberg.

One regular complaint during the recession was that credit insurers overreacted to adverse information about the risks they were underwriting, pulling credit limits without notice and, according to some observers, without justification.

Inevitably, these accusations came from outraged managers and other stakeholders such as lenders. But they also came from turnaround and restructuring professionals, who either had well advanced rescue plans destroyed at a stroke or else found themselves parachuted into a cash flow and trading crisis caused by the loss of cover.

It may be that a risk is deteriorating and needs to be managed down, but as with most problems in business life, the sooner this is identified the greater the number of options available to manage down exposure and the less the chance that knee jerk decisions will unnecessarily destroy value for the insurer and other stakeholders.

The good news is that the credit insurance market has taken this on board and a number of key players are taking constructive steps to make the use of corporate health monitoring data mandatory for those seeking to benefit from the cover they provide. It seems that at least one part of the financial services market has learnt from the battering it took in the recession and is applying the wise maxim that timely and meaningful information is priceless in the risk management game.

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