

Financial institutions must pull out all the stops to meet the more stringent requirements for risk management. Having a solid credit ratings and portfolio management framework is crucially important. But how *consciously* are they tackling the task? Do they really know how appropriate and consistent the rating models are on which they base and control risks? And do financial institutions know what is going on *behind* the figures on their dashboards?

How solid is your credit ratings framework?

Zanders associate Evert de Vries likes to keep things simple. When the credit ratings and portfolio management specialist talks about the use of the universally popular dashboards for risk management, he uses a car analogy to illustrate how he approaches the issue: “When you’re in a car, you drive according to lamps and clocks. You know the difference between ‘no windscreen wiper liquid’ and ‘no petrol’. You know how – and

numbers and how reliable they are. “Ratings have their own indicators and limitations,” warns de Vries, “if for no other reason than because of how they are established.” He explains that at one end of the spectrum you have ‘Through-the-Cycle’ models in which ratings move relatively stably through the economic cycle. In contrast, ‘Point-in-Time’ models are based more on current information, so the ratings move with greater volatility in step

how quickly – you must respond to such a warning. You rely on engineering and your knowledge, but also on your own insight. If the petrol indicator doesn’t light up after a certain number of kilometres, you at least wonder whether the lamp is broken. You might also ask yourself whether your driving style has changed or whether it’s due to a new type of petrol.”

Taken for granted?

Whereas the motorist conscientiously interprets his dashboard, some financial institutions conduct their risk management with scant awareness. “The financial crisis is indication enough,” says De Vries. “Entire institutions had to pull over and stop because they’d run out of petrol, so to speak. Apparently their dashboards lacked the essential lamps or they failed to light up when they should have done. Or they went unnoticed or were interpreted wrongly. No matter what the scenario, it underscores how important it is to conduct risk management consciously, consistently and integrally.”

Figure blindness

One of the pitfalls in risk management is to rely blindly on dashboard figures, without asking yourself what lurks behind the

with the economy. De Vries says: “The reality is not as black and white as this, of course, because there is a more hybrid situation. Some asset classes merit evaluation more according to current information than others and vice versa. It’s all about understanding these concepts if you run your risk management using these models, to say nothing of the results of the model validations.” The volatility of ratings exerts a great influence on the interpretation of the data and on such matters as solvency obligations, economic capital and the pricing of credit products.

From external to internal ratings

Awareness is the key word according to De Vries. He predicts that external ratings will lose some of their significance in internal risk management, asking: “How much value can you still attach to them? You need look no further than what happened to asset securitization, with entire packages wrongly being assigned a triple-A status.” In fact De Vries is convinced that it is no longer possible to hide behind external ratings. “As a financial institution you must be able to evaluate, calculate and control your risks yourself. You must also understand the internal models. Among other things you need to be aware of how and when ratings migrate.” The Zanders associate believes that internal rating models will become more and more important. “You can always look at the external ratings, but it’s better to base your decisions on your own ability to form a critical opinion.”

Rating philosophy

De Vries has been developing credit ratings frameworks for different types of financial institutions for more than a decade.

“Your own rating philosophy is indispensable for conducting risk management consciously, consistently and integrally.”



Evert de Vries, associate at Zanders: "Even large corporations can no longer regard risk management as a task that somebody like a treasurer can do on the side. You can now rely less on external ratings. Good risk management requires a structural, integral approach and awareness."

Profile of Evert de Vries

Evert de Vries has been an associate at Zanders since February 2009. He earned his spurs mainly in banking. In 1987 he joined AMRO Bank as a macroeconomist and among other things he established 'Financial Institutions Netherlands'. In 2001, De Vries became responsible for developing and implementing ABN AMRO's group-wide rating models and policies. Later, he was assigned to work worldwide as a senior credit ratings and modelling adviser for various other banks in countries including the Netherlands, Russia, Saudi Arabia and Taiwan. When ABN AMRO was sold in 2008, his Risk Advisory Services (RAS) department was closed down. "At Zanders I have been able to continue where I left off. The content of the work is truly fascinating – not just for me, but for everybody who takes risk management seriously."

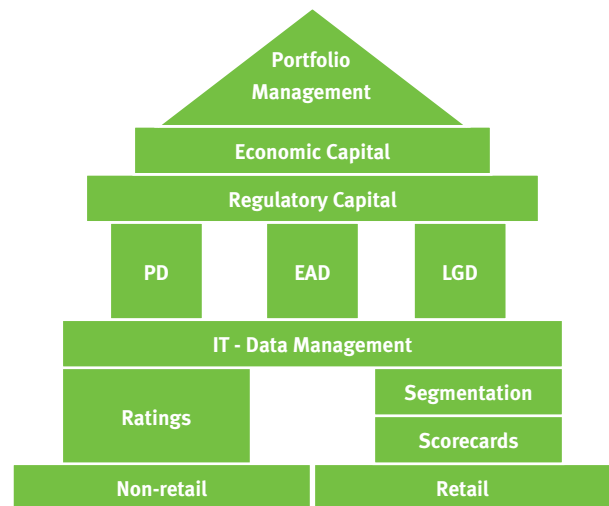
Besides the technique - using the right models and systems - he devotes a lot of attention to developing a solid rating philosophy, as outlined above. "Your own rating philosophy is indispensable for conducting risk management consciously, consistently and integrally. It helps you to improve your interpretation and management of risk metrics and portfolios. You learn to recognise the internal strength of the rating model, identify defaults early and make a better determination of calculated and uncalculated losses. In short, the philosophy determines your 'driving style' in risk management. It helps you to develop suitable forward-looking models."

Ongoing process

Zanders advises and supports financial institutions in developing and implementing tailor-made rating models and rating policies such as PD calibrations and model governance. Additionally, Zanders performs impartial model validations. According to De Vries, "The real work starts after you have determined the ratings. Will the metrics still be right a year from now? By then how reliable will the rating models be? Will you still be following the same course based on the same values? These are just some of the questions. Risk management is an ongoing process. The secret is to be and to remain aware. That is possible with our concepts for credit ratings and portfolio management frameworks. <



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According to De Vries, a solid framework consists of three independent elements (see illustration). The different rating models and evaluation systems for non-retail and retail counterparties form the foundations for PD (Probability of Default), LGD (Loss Given Default) and EAD (Exposure at Default). These result in solvency obligations and economic capital. The way the models and ratings are classified and configured depends very much on the overarching rating philosophy.