Credit Risk in Banking

On 1–2 May 1997, the Bank convened a conference entitled, 'Credit Risk in Banking'. The following excerpt is the introductory chapter of the conference volume.

For the past five or more years, banks in many countries have been involved in a process of upgrading their risk management capabilities. An important focus of those efforts has been the development of methodologies, and the introduction of more rigorous practices, to measure and manage traded market risk. The rapid growth and increasing complexity of financial market activity, together with increasing competition, have been important catalysts to those developments. The actions of bank supervisors in encouraging better risk management practices have provided additional impetus to market initiatives.

As significant as these developments have been, the reality is that for the vast bulk of banks, exposures arising from traded market products have not been especially large to date. In contrast, other forms of risk, such as interest rate risk in the banking book and operational risk, represent far more significant on-going threats to banks and other financial institutions.

By far the biggest risk facing banks and financial intermediaries, however, remains credit risk, the risk of customer or counterparty default. Between the late 1980s and early 1990s, Australian banks experienced aggregate loan losses of around $25 billion. In 1992, banks as a group experienced the first negative return on equity in living memory. Similar episodes occurred around the same period in a range of other industrial countries, with bank losses and failures reaching unprecedented levels in some of them. In Australia, the upturn and continued growth in the economy from 1992 has been translated into a sharp reduction in the incidence of problem loans. Bank profitability, although under threat from strong competitive forces in the market, has rebounded to levels last seen in the early to mid 1980s. Yet, despite the improved health of the banking sector, the longer-term inevitability of economic cycles and thus credit cycles in banking remains, and points to the need for continuing close examination and analysis of credit risk.

Main Themes

Within the diverse range of subjects and issues canvassed during the conference, four main themes emerged.

The first concerned the rapid evolution of credit risk management techniques over recent years. In part, the speed of advance can be viewed as a response to the events in the banking and financial sector, described above, between the late 1980s and the early 1990s.

In part, the pace of evolution can also be linked to the realisation that theories and techniques developed mainly for the measurement of traded market risk could, in principle, also be applied to the measurement of credit risk. Technological developments, particularly the increasing availability of low cost computing power and communications, have played an important supporting role in facilitating the adoption of more rigorous credit risk management techniques. Despite advances in thinking and analysis in relation to credit risk, implementation of some of these new approaches still has a long way to go for the bulk of banks. However, there is a strong sense from the papers, and from the subsequent discussion amongst conference participants, that the pace of change in credit risk management in banks is likely to accelerate. This is viewed as an inevitable response to an environment where competition in the provision of financial services is increasing and, thus, the need for banks and financial institutions to identify new and profitable business opportunities, and properly measure the associated risks, is growing.

The second and related theme to emerge was that the ability to better measure and manage risk in financial institutions is likely to carry implications for the way financial institutions develop in the future. For example, widespread cross-subsidisation has long been a feature within banks and other financial institutions, with profitable businesses supporting otherwise unprofitable activities. To some extent, the presence of cross-subsidisation has been a conscious business decision on the part of institutions. However, it has also reflected an inability on their part to disentangle the cash flows, and accurately measure the risk and return, associated with different banking activities and functions. Inevitably, as banks improve their ability to assess risk and return associated with their various activities, the nature and relative sizes of the implicit internal subsidies will become more transparent. The potential benefits of altering the mix of financial activities carried out by an institution, or restructuring or disassembling the institution to better reflect comparative advantages, will become more obvious. One outcome is likely to be an improvement in shareholder value through gains in efficiency. Another is that the face of banking is likely to change significantly over time.

A third theme related to the interaction between improved risk measurement and management systems in banks and the possible use of alternative risk measurement techniques in the regulatory sphere. The issues which emerged under this broad heading included: the role of bank supervision in a more competitive and sophisticated financial environment; the extent to which existing supervisory practices and policies are keeping pace with market initiatives and developments; and the scope and urgency for supervisory methodologies to be aligned more closely with newly emerging risk measurement practices. On the last of these issues, there was a sense of optimism that alignment between the approaches being used within the regulatory community and within the financial sector could occur over time. However, there remain some important obstacles to be overcome before that objective is likely to be achieved in relation to credit risk. At the simplest level, banks would need to demonstrate convincingly that they have rigorous and well-tested models in place to generate plausible risk estimates and that these models are integrated fully into their organisational frameworks.

The fourth and final theme was the need for a firm commitment, at the highest levels within banks, to the effective management of risk in all its forms and the development of strong risk-oriented cultures within institutions. Without that commitment, better approaches to risk measurement can be of only limited value. Where that commitment exists, however, an improved risk measurement capability becomes critical in achieving broader bank objectives (including improved shareholder returns) within a lower overall risk environment. Very importantly, the presence of accurate measures of risk (and associated return) has the potential to alter risk-taking behaviour both at the individual and institutional level within banks, permitting activities to be better aligned with strategic objectives. Improved measurement technique does not, of course, reduce the need for good judgment and experience to be applied where credit and other forms of risk are present. Rather, improved measurement practice permits subjective risk assessment to be viewed against more objective benchmarks than has been possible in the past. This may be one of the greatest advantages to flow from the new credit risk developments discussed in detail in the volume.