

**DISCUSSION PAPER**  
**“RISK MANAGEMENT STRATEGY/Framework”**  
**For ACCs**

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The purpose of this paper is to stimulate discussion regarding the establishment of an overall Risk Management Strategy/Framework for ACCs, which would encourage them to further promote, encourage, and support their Developmental Lending activities. I am also using this paper as a forum to be a devil's advocate by tabling a number of suggestions / recommendations that initially go beyond the scope of the topic, however I believe must be considered if the ACC's goals are to be achieved.

“Developmental Lending” refers to lending in the higher risk sector where both equity and debt capital is not available from “traditional” (bank) sources. In this paper and in our discussions for the most part the focus is on small enterprises with little equity and no track record.

The meeting on February 20<sup>th</sup> is to discuss the implementation of a Credit Risk Rating System and assess the pros and cons of various Credit Enhancement or Risk-Offset Mechanisms that will assist ACCs in providing increased level of developmental lending. The developmental lending by ACCs should be complimentary and gap filling and not necessarily competitive to the private sector.

There has been a lot of excellent work done by various ACCs, NACCA and INAC providing detailed analysis with ample information and statistics regarding ACCs. I will not attempt to restate all of the facts, however I will summarize major points extracted from recent reports and provide an overall commentary.

The increased risk of developmental lending, cannot be mitigated by a Risk Rating System or a Credit Enhancement Mechanism on their own. Providing Guarantees or Interest Rate Buy-Downs should initially stimulate Developmental Lending, however it will not eliminate the overall challenges that the ACCs have experienced, i.e. not fully utilizing their capital to fulfill their original mandate as a developmental lender, losses, shrinking lending pool and depletion of capital.

The following are recommendations and suggestions, which are not necessarily in order of importance.

## RECOMMENDATIONS

### **I) Adopt / Implement a Credit Risk Rating System**

For discussion purposes we are strictly interpreting “credit risk” to mean, “default risk”. It is the risk of financial loss resulting from the inability of a debtor to meet their financial obligations.

A Risk Rating System or Model will be required regardless of the Credit Enhancement Mechanism utilized and it is recommended that a risk Rating System be implemented as part of an overall formal “Lending Policies, Standards and Procedures”.

A Risk Rating system is a methodology for calculating the probability of default, default time and the severity of default and it is used to formally differentiate credits or clients. This differentiation is required in order to quantify risk, at the contributory level (client level) and more importantly the portfolio level, so as an economic link or price differential can be made between a default contingent loan and a loan carrying little or no default risk. This is the first step in determining the extra compensation, or risk premium required for assuming the increased risk of loss.

I will not attempt to outline or recommend, at this point, in detail a model or system to be implemented by ACCs. The discussions on Feb 20<sup>th</sup> will lead to specific recommendations as to the complexity of a Risk Rating System required and choice of an Offset Mechanism. I will however outline the minimum components that are required.

According to regulatory and rating agencies a Risk Rating System, which should be formalized in a Lending Policy, must classify loans in a minimum of three categories, as follows:

- a) Satisfactory or Acceptable (e.g. from low risk to higher risk).
- b) Watch Category (e.g. deterioration or risk increasing)
- c) Classified (e.g. unsatisfactory accrual, unsatisfactory non accrual, bad & doubtful, etc).

Each category can have as few as 3 to as many as 10 or more increments. Also there could be numerous variables or subsections such as trending. The exercise of quantifying risk should also include a list of “High Risk” industries. This list along with other non-financial criteria should be included in a formal Lending Policy.

There is a proliferation of risk models and risk rating systems, however I believe that we should initially use a system that is simple, uncomplicated and most importantly user friendly. It is very important to have a system that initially is not subject to a great deal of subjectivity or discretion on the part of a loan officer. The system should start out fairly simple and then evolve, as both training and experience increases.

We can adopt and modify a Risk Rating System used by any one of the Financial Institutions in Canada. For comparison purposes, in addition to models used by Canadian financial institutions we can look at “CreditRisk+” a model developed by Credit Suisse/First Boston. The model is publicly available (at no cost) in a spreadsheet format (Excel) that is fast and easy to use. It employs an analytic method (not a simulation) so calculations take seconds with minimal data requirements.

I would like to stress that adopting and implementing a Credit Rating System, in my opinion, is only one of the fundamental operational issues that have to be addressed.

Following is an example of a simple Risk Rating and Pricing Grid.

	<u>Rating</u>	<u>Target Rate</u>	<u>Default Premium</u>
<b>Satisfactory Categories</b>	1 – Very Low Risk	Prime	.25%
	2 – Low Risk	Prime + 1.00%	.75%
	3 – Normal Risk	Prime + 3.00%	2.25%
	4 – High Risk	Prime + 5.00%	4.25%
<b>Watch Category</b>	5 – Watch		
<b>Classified Categories</b>	6 – Unsatisfactory Accrual (Interest only)		
	7 – Bad and Doubtful		

The risk rating grids could be condensed to fewer categories or expanded to more categories, with an additional parameter added for “Trending”.

Every loan should have a default premium built into the pricing. The pricing and risk premium is normally calculated using a RAROC (Risk-Adjusted Return On Capital) model. In a RAROC model, for a normal risk or non-developmental lending, a default rate of .75% is standard. In our example above we have used a minimum premium of .25% (Government Risk) moving to 4.25% for a high-risk loan. The exact default premium would be determined by utilizing a combination of Risk Rating and RAROC models.

True Developmental Loans should be considered “high risk” from inception and carry the highest risk rating, regardless of geographic location or proximity to urban centres. The risk rating is determined at the inception of the loan and the level of risk will be solely based on the underlying fundamental ability to repay. It is also important, for portfolio management purposes, on an ongoing basis, to monitor a loan for deterioration. However, it may be that a loan although developmental may not carry the highest risk rating due to either an underlying guarantee or security which would provide a secondary source of repayment.

The amount of default premium should be theoretically used as a reserve for bad debts, either directly or indirectly.

## **II) Adopt / Implement a Credit Enhancement or Risk Mitigation Mechanism**

There are basically four-credit enhancement or risk mitigation mechanisms utilized by financial institutions. They are 1) third-party guarantees, 2) margin arrangements (interest buy-down, etc.), 3) posted collateral and 4) netting. Credit enhancement or risk mitigation mechanisms are not a substitute for credit analysis. These mechanisms are only one element of an overall credit risk management program and should not be regarded as a replacement for, sound credit analysis.

In the recent reports, papers and discussions only two of the mechanisms, Loan Guarantee programs and Interest Buy-Down programs have been discussed. I will synopsise the aforementioned two programs; however, in this exercise we should seriously consider posted collateral (Reserve Account), which I believe is a viable and preferred alternative, which I am recommending.

### **1) Third-Party Guarantees**

Third-party guarantees are the most common Credit Enhancement mechanism used to bolster creditworthiness. The guarantees can take the form of direct guarantees, letters of credit or credit insurance.

Credit Guarantees are designed to enable small businesses that do not qualify for conventional bank financing to access credit. An example of a guarantee program is the Canada Small Business Financing program, where the federal government will guarantee 85% of the lender’s losses in the event of default. Percentage of guarantee can be variable and on a sliding scale directly correlated to the level of risk underwritten.

**Pros**

- Eliminates Risk
- Manages the exceptions
- Targeted support mechanism (specific losses)
- Would restore capital as losses incurred
- Can be simpler to administer
- Encourages advancing of riskier loans
- Borrower could receive lower interest in light of decreased risk

**Cons**

- Incentive to write-off all bad and doubtful loans immediately
- Potential to accept unreasonable risk
- Permanent “guarantee” organization created
- Fee would cover only part of the cost
- Nearly all guarantee programs are not self funded and must be continuously subsidized
- No market discipline
- Fixed exposure limits do not recognize the relationship between risk and return
- Can reward poor performance

**2) Margin Requirements (Interest Rate Subsidies, etc.)**

There are numerous variations of interest rate buy-down programs.

One of the forms is the direct subsidy of the borrower where the fund or program subsidizes the portion of the interest rate representing the increased default premium paid. The premise or justification is based on the fact that the borrower would pay a reduced rate, which would be more commensurate with his ability to repay and therefore this would reduce the chances of default. The premise is also to recognize the increase of developmental lending and motivate the ACC's to lend.

Another form provides indirect support, i.e. interest buy-down (or no interest) on capital borrowed from the market or public sector. The premise or justification is based on the fact that there will be more funds available at the end of the day, to absorb losses, because the cost of borrowing or capital is reduced. Amount of buy-down or support can be directly correlated to level of risk underwritten.

**Pros**

- Helps manage risk

- Recognizes the relationship between risk and return
- No stigmas of guarantees
- No negative reinforcement (do not have to pay)
- Increased revenues up front

**Cons**

- Client may pay higher interest rates
- Can be more difficult to administer
- Can require more due diligence

**3) Posted Collateral (Reserve Account)**

Collateralization has been the fastest growing credit risk mitigation technique in use within the financial industry. A Collateral or Reserve Account would provide a highly effective protection against default risk. It would not nor is it intended to eliminate all exposure.

There are basically three ways to establish or build a basis of a pool for a Loan Loss Reserve Account. One is to use existing subsidy buy-down or contribution programs, the second is to develop a default premium funding mechanism and the third is utilizing a combination of the two mechanisms.

The “default premium” funding mechanism would be funded by or come from the pricing premium, which would be built into every loan. The pricing premium would be linked, to the risk or credit rating model-pricing gradient and paid into the reserve fund by either taking all or part of the default premium (depending on the program chosen).

Collateral levels may be fixed or vary over time to reflect the market value of the portfolio as it is paid down. It is then conceivable that a rebate (reward) of a portion of the risk premiums collected can be refunded to the individual ACCs based on their individual performance.

The Collateral or Reserve Account should be part of a centralized function. This is necessary for reasons of operational efficiency and also a key factor in overall risk management control.

**Pros**

- Recognizes the relationship between risk and reward
- Tied to a specific pricing model
- Targeted support mechanism
- Process is transparent

- Totally market driven (no stigma of guarantees)
- Specific pool of funds available to help offset losses
- Collective mechanism based on shared risk
- All loans can contribute to a default pool
- Over time can be self funding
- Can be stand-alone to outside support

#### **Cons**

- 1) Centralized function
- 2) Client pays a higher interest rate
- 3) Collective mechanism based on shared risk

#### 4) **Netting**

Netting would not be applicable for use by ACCs. This mechanism is mainly used for exchange traded products and over-the-counter derivative transactions. The mechanism provides right of offset under qualified financial contracts entered into under a netting agreement.

### **OBSERVATIONS / ADDITIONAL RECOMMENDATIONS**

There are major structural and procedural issues that have to be addressed in order to ensure a permanent fix. I believe that the solution, in addition to implementing a Risk Rating System and adopting a Credit Enhancement Mechanism, must include a major change of how the ACCs operate. If these changes are not made, the existing situation will temporarily improve but in the long-term the structure will remain fundamentally flawed.

#### **Recommendations**

- **Use higher Loan Loss figures. In a number of the reports produced for the ACCs a Loan Loss of between 5 to 10% is mentioned. Realistic loan loss rates for Developmental Lending should be closer to 12%. Due to the nature and circumstances of the ACC's markets, and factoring in Section 89 of the Indian Act, realistic loss rates would be closer to a range of 15%, if Development Lending was increased to its full capacity.**
- Review, update and expand (if necessary) the Loan Policy.
- Centralize or Pool the Loan Portfolios. Due to the higher risk of Developmental Lending critical mass is necessary. Specifically there should be a pooling of risk

amongst all of the ACCs in order to obtain critical mass and diversify risk both from industry exposure but also geographic concentration. A downturn in a single sector or geographic area could devastate the local ACC. With pooling everyone shares in each other's success' and risks. Pooling would also bring with it internal pressure to perform.

- Adopt Centralized Portfolio Management. The primary reason to have a quantitative portfolio approach to credit risk management is so that the ACCs can more systematically address default risk and concentration risk. Concentration risk refers to additional portfolio risk resulting from increased exposure to one borrower or groups of connected borrowers (e.g., by industry, location, etc.).
- Centralize Loan Adjudication to ensure uniformity of assessing risk and exposure. Also this will remove the political pressure from the local ACC.
- Business Services should be introduced. ACCs should offer advisory services such as pre-loan and aftercare for their clients. Support should also extend to the development of business planning, financial management and loan application training programs.
- Business Case should be required for every new loan. Decisions should be based on viable business plans that demonstrate adequate level of repayment ability, equity and security.
- Loans should be adjudicated on a "Free Cash Flow" basis and not traditional asset or security basis. Security and assets are important, however as back-up or secondary source of exit only.
- Centralize Loan Accounting, Monitoring and Collection.
- Consider outsourcing Loan Accounting and Administration.
- Centralize and implement an Audit or Inspection Group that would ensure compliance and monitoring
- Recommend a RAROC model be used to review the loan pricing. There has been mention in a number of the papers that the ACC's pricing model is outdated and has to be re-visited. RAROC is a risk-adjusted profitability measurement and management framework for measuring financial performance and it would, firstly provide the financial framework to understand and evaluate performance and secondly assist in actively managing the portfolio and sustainable growth. The

process would assist in achieving controlled growth and returns commensurate with risk taken.