



## Lessons From Current Credit Crisis

By Joseph N. Boland, The Alta Group

**T**he current crisis in the credit markets should remind all of us in the equipment financing business that certain business fundamentals don't change.

We now recognize that poor risk underwriting in the sub-prime mortgage market has had a catastrophic impact on that segment, and similar problems are surfacing in the credit card and leveraged debt markets and will certainly affect equipment financing as well. Aspects of today's crisis are reminiscent of factors analyzed in Alta's 2001 study of leasing industry problems in the late 1990s, "The Perfect Storm." So far, financial institutions have recognized \$100 billion in write-downs, with more to come, while the market sharply re-adjusts its risk/reward balance—e.g., credit spreads for BB risks stand at 520 basis points (bp) over treasuries, up 310 bp since the end of 2006, and financial covenants are tightening. Recognizing the source of the problem—poor credit underwriting—is the first step toward effecting a solution: a re-adjustment toward a more balanced risk/reward equation.

First, some perspective: approximately every five or six years, a significant "event" occurs in the credit markets. Whether it was the REITs and "Lesser Developed Countries" (LDCs) in the 1970s or the S&Ls and LBO/MBOs of the 1980s and 1990s, credit crises have surfaced regularly. Over the last decade, we've witnessed Long-Term Capital Management, the Enron failure, and the Telecom Bubble burst.

So, it should come as no surprise that another problem is upon us.

But if one looks closely at each credit event and its unique contributing factors, one common characteristic becomes clear: *the gradual discounting of basic risk management*, leading to severe underestimation of potential losses, which drove down risk pricing and conditions.

In the current turmoil, key drivers for this degradation of risk management include:

1. *The financial industry's drive for growth and share.* This drive was abetted by liquidity growth (fed in part by inflated real estate values) and had a parallel focus on E/R measures, resulting in non-revenue-producing

areas like risk management feeling expense pressure and diminished capabilities;

2. *Complacency.* Declining loss rates from 2002 through 2006 convinced many that new tools, liquidity pools, and asset values warranted a new, more positive, risk paradigm—i.e., that "things are different now" and "the old rules no longer apply";
3. *Allowing outsiders to drive internal risk/reward decisions.* External assessments, such as those by lead banks/sponsors and rating agencies, have partly replaced internal analysis;
4. *The conflict between evaluating credit risk and marketability.* Conflict between basic credit risk-assessment activities and activities related to determining marketability of a deal and its related packaging/syndication means capital markets are often making *retention* of risk subordinate to the *marketing* of risk;
5. *Lack of adequate experienced management involvement in the risk management process.* The increasing complexity of markets, mitigation instruments, and highly structured financings, coupled with growing volume and demand for speed, tended to reduce the level of experienced senior management input to the deal flow.

These factors caused many institutions to reduce the role of risk management in their business: minimizing risk-oriented input into the strategic direction process, under-investing in risk tools, reducing staff and executive development, and isolating senior management from the risk-assessment process.

The results: *big surprises and big losses!*

How can we handle risk better in the next cycle?

First, view risk management as an integral partner in the business, not just a necessary control function to be adjusted as the market changes. Successful financing companies tend to keep risk management a high priority, providing credit with consistent organizational support.

Second, involve senior management directly

in the design and operation of the credit function, not just in the normal adjudication between credit and sales. A reasonable percentage of deals should be reviewed or signed by senior managers to ensure they are in touch with, and understand, the deal flow.

Senior management also should regularly step back and look at market conditions, pricing, and terms and make an experienced judgment on whether risk/reward balance is still favorable. Financing executives with 15 to 25 years experience—veterans who have lived through previous downturns—might make a different judgment than a less-experienced deal manager. Experience *is* invaluable—but only to the extent that it is utilized.

Third, insist that your team take full responsibility for the risks it assumes. Remember that a lead bank/sponsor or agency rating is simply input to what should be your own organization's analysis, understanding, and decision regarding risk, not a substitute for them.

The Alta Group successfully advises clients on effective ways to manage their own risk/reward equation by building a robust risk-management infrastructure. Through policy development, process design, portfolio management, systems, controls, and executive training, our objective is to increase shareholder value by making risk management an integral part of your business.



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