



For Better, for Worse – Our Relationship with Economic Change

Introduction

The past few years have been a gruelling time for the Credit Industry. The major banks have been shaken to their foundations and continue to be lambasted in the media for their role in the 'Crunch'. Many organisations have disappeared entirely or have been swallowed by competitors, including once-venerated examples of the industry's strength and diversity. Many businesses continue to struggle with difficult market conditions, liquidity constraints and changes in consumer behaviour.

This turbulent period underlines one key fact: our industry is highly susceptible to economic change. Right now this seems like a statement of the obvious, but it is important to remember how little focus was given to economic change only a few years ago. In the period of stability prior to the events of 2007, the wider economy became an unchanging backdrop, unheeded in the vast majority of decision making processes. Only as the scenery changed did we realise that the economy was not just a backdrop but a vital foundation for a large number of our processes and assumptions.

Now is an opportune time for us to reflect on how we think about the economy in our businesses and how this can be altered and improved to provide greater flexibility and resilience in the future. While few individuals involved in risk and portfolio management will look back on this period fondly, the one thing it certainly has done is to underline just how critical economic change is to the performance of credit businesses.

Leaving the Stable Door Open after the Horse has Bolted...

So, in the aftermath of our harsh lesson in the vagaries of economic change, are we more prepared to face such difficulties in the future? Surely we have emerged older and wiser from our traumatic experiences during the Crunch?

The sad truth is that many businesses would be in no better shape to face the Credit Crunch now than they were in 2007. With the fires of the immediate aftermath of the recession under control, focus is returning to continuing business as usual. The importance of economic considerations is now recognised, but decisive and positive steps to incorporate this into our decision making often fail to materialise. With our fingers so badly burnt, why would we fall back on the deficient practices of the past?



Many argue that there is little point locking the stable door after the horse has bolted. The Credit Crunch is in the past and there is nothing to be gained from focussing attention backwards. The sensible thing to do now is to make the best of the new environment and move the business forward in the best way possible. Of course the fallacy here is the assumption that economic change is a rare event; something to be endured until the next period of calm ensues. The length of the golden period before the latest downturn was unprecedented, but there is no reason to think the future brings such extensive periods of economic stability.

For others the recent economic changes have not been so hard to bear. After the initial shocks, many mortgage lenders may have found that historically low interest rates are helping control arrears and deliver excellent margins. Specialist lenders may be revelling in the sudden growth in the UK 'under-banked' population that now have need for their products. With the sting associated with the downturn removed, there is little incentive for these businesses to worry unduly about economic change. But while these business models have proved buoyant in the current environment, there is no guarantee that they will fare so well in future. While the dice have fallen favourably for them this time, underestimating the potentially negative impact of future changes could be disastrous.

A Herculean Task?

However, one of the overriding reasons why our businesses and processes have not been refined to anticipate and respond to economic variation is the perceived magnitude and complexity of the task. In the current climate it is difficult enough to carry out BAU operations successfully and profitably, without having to consider how to future-proof the business against economic volatility. And even if time and resources were available, is it even clear how to carry out such a task?

Those of us who have worked within the Basel II framework may already have expended significant efforts on incorporating economic models and scenarios into our monitoring, forecasting and decision-making. Regulatory requirements for stress testing meant that most large institutions had processes in place before the downturn hit. Sadly, these processes proved to be almost universally flawed; there are few who would claim that the efforts exerted in ticking the regulatory stress testing boxes provided a significantly clearer view through the recession!

The truth is that while the recession has underlined the importance of the economy to our industry, it has also severely dented the reputations of economic forecasting and stress-testing. Very few predicted the troubles in advance, and when they did arrive the stress-test models proved woefully inadequate. So while it is more apparent than ever that we need to build defences against such events, we have less faith than ever before in the tools we have available. For a further Euristix analysis on the perceived failure of stress-testing, see [this paper](#).

All of these complexities conspire to engender paralysis. Even when the need is fully accepted it is not clear how to approach the task. In an industry that has prided itself on automation, analytics and decisioning, where is the magic formula or methodology for protecting against economic risk? How do we factor these considerations into our carefully constructed business tools?

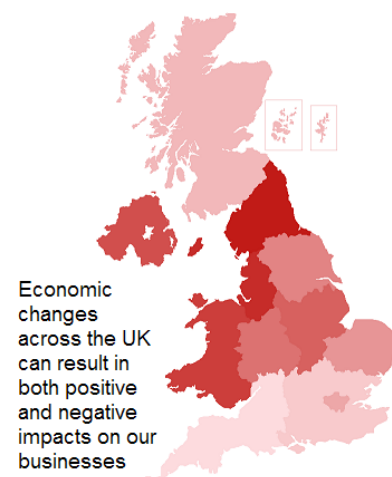
Whilst Euristix have had some considerable success with innovative approaches to economic modelling (see [here](#)), the truth is that there is no silver bullet. Analytics and intelligent modelling can take us on part of the journey, but the real changes that need to be made are in the fundamentals of how we approach the running of our businesses. Analytics and scenario analysis can only begin to be truly helpful if we ensure that this work is embedded successfully within our decision-making processes. Combating future uncertainty requires us to integrate economic considerations as a fundamental aspect of our businesses, to allow expert management decision-making supported by the correct tools and models.

For Richer, for Poorer

One of the least healthy aspects of our relationship with the economy is to consider only the negative. Mention the phrase 'economic change' to most risk management professionals and you will see them suppress a shudder! Few, if any, will begin their thought process with a consideration of the possible opportunities such a change might bring. Even within this article we have tended to focus on how to 'protect' our businesses from economic change.

As business performance stalled in the wake of the Crunch, we were quick to apportion blame to the faltering economy. However, it is less easy to recall the beneficial economy being credited with the responsibility for the growth and prosperity in the industry during the first half of this decade. The issue with economic change is that it is only brought into focus when it is negative. To really embed economic considerations within our businesses we need to begin considering it in all its forms; as a source of opportunity as well as a source of stress.

While our considerations of the economy should of course be used to protect our businesses against negative impacts, we should equally be prepared to exploit positive movements too. From product design through to growth plans and collections strategy, our relationship with the economy will be more rounded if we understand that economic cycles will bring good as well as bad. It will seem less arduous to embed economic discussions throughout the business if these discussions include the upsides as well as the downsides.





A Paradigm Shift

Successfully building businesses which respond and adapt smoothly to economic change requires a re-evaluation of the way we think about economic evolution. The solution cannot be delivered by the implementation of a few statistical models or stress tests sitting outside of our BAU operations. From board level discussions and strategic direction down to forecasting models, risk decisioning and marketing, the potential impact of economic change should become part of the day to day considerations within the business.

The key is not to start by looking for answers but to begin by asking the right questions. What is the current view of the short, medium and long-term economic outlook? Is everyone in the business aware of this? Does management buy in to these economic expectations or are there additional concerns, such as an interest rate spike or further unemployment? What do these changes mean for the business and where are the opportunities and risks?

Incorporating this type of thinking into the way we approach our day to day business problems and decisions will help us create an environment where the economy is embedded in what we do. As the tools and forecasts develop, so too will the mindset to be able to exploit and use these tools. No longer will economic considerations be a secondary consideration or backroom process to tick a box - it will become a fundamental part of the way our businesses work.

Once we achieve this, the economy will transform from being an unheeded, benign entity that occasionally rears its ugly head to confound and undo us. Instead it will become our constant companion, continually in our thoughts, bringing with it both highs and lows, opportunities and pitfalls. And, as with any close relationship that stays the course, the economy will eventually lose its ability to shock and surprise us!

If you would like to discuss any of the points above, or if you would like any further information on the research carried out by Euristix, then please contact Paul Matthews at paul.matthews@euristix.com