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Hello

Happy New Year! Welcome to 2010's first edition of Euristix Insight, our newsletter which seeks to deliver unique commentary and information in the changing world of credit and portfolio management.

In this edition's lead article we present a review of some of the factors that undermined the performance of stress testing solutions in the latest economic downturn. We hope it will provide interesting food for thought! The fallout from the Christmas excess will undoubtedly bring a new raft of defaults, and we take this opportunity to ask some key questions about the cost-income considerations in collections. This issue closes by considering the difficulties of maintaining leading-edge risk management in a changing world, with some interesting options on how this can be achieved.

Euristix wish you all the best for 2010 and continuing success in all your portfolio and risk management endeavours. As ever, please contact us with any questions or feedback.

Kind regards,

Chris Kemp



In this edition...

The Failure of Economic Stress Testing? - Many view the recent financial crisis as proof that economic stress testing failed in its remit. But the desire of management teams to understand economic impacts is greater than ever. We look at what went wrong and why.

Questions Corner - The new year shows little sign of bringing easier conditions for collections teams. Managing the cost-income ratio is ever more important. Take a moment to consider the questions presented here and assess whether you have all bases covered.

Building Risk Management Capability - In a changing world maintaining a cutting edge internal risk team is complex and expensive. Here we consider some of the alternative options available to organisations who desire better risk management without the associated cost.

The Failure of Economic Stress Testing?



The credit industry finds itself in an interesting position regarding economic stress testing. Never before has the importance of robust and accurate stress tests been so apparent, and this topic is high up on the agenda for many portfolio management teams. Yet at the same time it is clear that past methodologies have failed, giving wildly misleading results in the latest downturn.

This issue's lead article looks at what has gone wrong, highlighting some of the common pitfalls and difficulties involved in the stress testing process. It is clear that previous common methodologies have been seriously flawed and some new approaches are needed. Please see the [full article here...](#)

Questions Corner - Collections Cost-Income Ratio

As pressure on collections performance continues unappeased it is vital that management decisions are firmly based on accurate cost-income considerations. Those teams who react swiftly and effectively to improve the cost-income ratio will survive and thrive; those who do not face extinction. Consider the following simple questions:

- Do you feel that your collections operation has changed flexibly and quickly to meet new conditions and requirements? Or is there an element of inertia?
- To what extent are changes driven by a true understanding of the resulting cost and income impact on the business?
- How do you measure the effectiveness of the strategies you

currently have in place? Is there careful trade off between the cost of activities and the cash received?

- At what level of granularity do you track costs? How does this compare with the level at which you forecast cost?
- How do you determine the level of effort to expend on each debt segment? How accurate and granular do you think this is?

In a future edition of Euristix Insight we will expand on some common areas of the collections process that are having a detrimental effect on the cost income equation. In the meantime, please direct any questions to vincent.bordes@euristix.com

Achieving Best Practice - Risk Management Capability

Problem - Risk management practices and requirements are constantly evolving, driven by fresh developments, new regulation and a changing marketplace. Maintaining class-leading capability is a difficult, time consuming and expensive task, but can be vital to ensure continued success.

Many organizations find their internal risk teams lacking either the time or the skills to implement all the initiatives on their risk management 'wish list'. Some are not even in a position to develop this 'wish list' in the first place. The result is that key improvements are delayed or scrapped, leading to sub-optimal processes, slowed progress and a long-term erosion of business value.

Approaches - For risk managers in charge of strong risk teams there is a tendency to over-estimate capacity and to misjudge the time requirement for 'business-as-usual' tasks. Resource availability is eroded by the requirements of data processing, MI production, scorecard monitoring, and so on. On top of this there is a need to factor in the ad-hoc analysis and reporting required when responding to exogenous factors such as economic or regulatory change.

While key individuals may keep abreast of all the latest developments and be capable of undertaking the work needed to advance the risk management tools, they often find that they simply do not have the time. The result is that the well-crafted plans fail to come to fruition, or are implemented later than planned at the expense of significant value to the business.

For other organisations the issue is a skills gap. Risk management is a fast moving discipline and 'cutting edge' becomes 'old hat' very quickly. Maintaining a best practice framework requires a detailed knowledge of regulation, the market, statistics, business strategy, long-term goals, third-party solutions, consumer trends, fraud risks, bureau data and so on. Many businesses simply cannot support a team large enough to contain this level of knowledge. While their teams may be comfortable with the day to day requirements of reporting and MI production, the business as a whole suffers from the need to take the risk management to the next level.

One solution to these problems is to engage with external firms such as consultancies or contractors. Indeed, this approach has a lot to recommend it; consultancies often have specialist tools or knowledge that can be leveraged and they are normally capable of producing results quickly and efficiently. It is a good way to access skill sets not present within the internal team and allows key pieces of work to be ring-fenced and unaffected by BAU distractions.

The risk with piecemeal consultancy engagements is inadequate knowledge transfer in both directions. Within the limited timeframes of a one-off project, it can be difficult for the consultancy firm to develop a deep understanding of the business; a situation that can be exacerbated by disclosure concerns on the part of the engaging firm. Conversely, the consultancy team will produce significant deliverables but will not be there to oversee the long term integration of these into the business. The onus falls back on the over-stretched risk team to understand and take ownership of whatever output the project produces. Unless there is very effective handover, full understanding and resource availability within the risk team, there is a danger that the solution will be under-utilised, poorly maintained or, at worse, left to gather dust with no material benefit to the business.

Best of Breed - So how is it possible to attain significantly increased risk management capability without the prohibitive expense and risks of heavy internal recruitment? One option that is gaining popularity throughout the industry, and showing high levels of success in driving business growth, is that of a long-term external relationship. Leveraging the skills and experience of an external team while limiting the risks inherent in short-term consultancy can prove a cost effective solution to drive the business forward.



Where the key issue restricting advancement is time and the internal team already have the cutting edge capability, it is possible to outsource standard but time-consuming tasks. Removing the burden of MI production, reporting, or scorecard development and monitoring for example, could enable the risk team to focus on new initiatives that will move the business towards 'best in class'. Not only will this directly improve the business, it will help lead to a motivated and driven internal team. The added advantage is the commentary and insight available from receiving a fresh, external view of the business.

If the issue is a skills gap, then it is possible to situate the engagement at the other end of the spectrum. The external team can help to deliver some of the more advanced initiatives which lie outside the expertise of the internal team. Not only does this advance the risk management framework of the organisation, but it allows for the training and development of internal resources allowing them to deliver greater future value. The long term nature of the engagement ensures a deep understanding of the needs of the business, the development of solutions that really fit the business problem, and guaranteed embedding of the deliverables into the risk structure.

While outsourced solutions do not suit every organisation, those that can take advantage of such arrangements find it an effective and cost-efficient way to develop their businesses. A well-respected external view can help reassure investors and deliver a quantum leap in risk management capability. The difference this can make in today's difficult environment should not be under-estimated and such arrangements will help define the difference between failure and success in the coming years. If you have any questions or would like more information on the Euristix offerings in this area, please contact chris.kemp@euristix.com

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