LETTER AND SPIRIT: WILL CREDIT RISK GET A "C" FOR CHARACTER?

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How will financial firms survive upcoming market upheavals? Amid sputtering economic growth, markets face unchecked risks. Many large firms still carry the stigma of distress, and global interconnectedness may vaporize their liquidity instantly. As a bitter remedy, the whole industry will have to come to grips with the heavy cost of increased regulatory burdens.

Meanwhile, less constrained energy markets may inflate expectations of future demand and put pressure on the price of energy commodities. Back to the future, financial markets in the U.S. and Europe seem to rejoice in the valuation hype of Social Media companies. And riding on the short memories of major financial scandals, ***another risk factor seems to keep running amok: Character***.

To sustain their credibility, credit risk models both in consumer and corporate banking will need to improve the extent, depth, granularity, and quality of customer data that gets pumped into them. Models may remain oblivious to unexpected factors that will threaten the validity of scenario analyses and stress testing exercises. Despite some progress in monitoring financial and non-financial customer transaction behaviors, credit analytics must address the full importance of character.

Opposite the sophistication of credit models, successful implementations of microcredit in emerging markets hinge on simple principles of knowledge and trust. Microlending focuses on productive and visible endeavors. Borrowers must meet their loan obligations, and are also accountable to their people for putting the monies to work. Peer realities would readily weed out any failed or rogue borrowers.

Relationship managers have been keen on gauging the moral fiber of their clients. In corporate banking, ***savvy relationship management has always been a core competency***. However, some firms may need to dodge the credit management trap. Heavy doses of credit analytics, sheer speculation on the potential of overhyped companies, liquid cash-flows of unclear sources, and the fleeting thrill of financial bubbles may numb the use of common sense in the relationship.

Credit models and regulations must wake up to the fact that questionable behaviors will ultimately show their grimaces. When the music stops, the morals of financial firms and their clients who are left standing on shaky business will become apparent to all. Investor sentiment will penalize reputational damages for a very long time. So above and beyond credit policies and management systems, sound corporate governance in financial firms must ensure that character and morals never get compromised.

Boards of Directors of financial firms must take charge responsibly and ***review how character plays out in the credit management process***, customer relationships, and management ranks. As financial complexity increases, corporate governance must reach beyond the customary personal rapport and experience the power of advanced information systems. Customer intelligence systems will strengthen the overall credit process. Besides providing better data, smarter information about customers would restore the missing link. ***A broader and deeper tracking of customer behaviors and credit decisions by financial firms will bring much needed transparency to the character dimension.***

