Dynamic benchmarks

One of the biggest challenges in effective risk reporting is avoiding the trap of mind-numbing routine. David Rowe argues that dynamic benchmarks and exception highlighting are ways of keeping such reports relevant and useful, thereby maintaining management's attention

One of the biggest challenges in risk reporting is keeping the information fresh and relevant. Too often such reports become almost indistinguishable from month to month. A consequence is that they are reviewed in a cursory manner before being filed for future reference (or to demonstrate to regulators and auditors that they have been produced). Comparison of actual data with benchmarks is an essential means of providing relevant context for risk reports. Too often, however, such benchmarks are overly simplistic, often being warning levels that are held constant over time. Such an approach to defining benchmarks limits their contribution to the reports' effectiveness.

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A simple example

A simple example based on accounting variance reports illustrates my point. Through the course of a year, management accounting reports show actual-to-date versus budget-to-date, with a corresponding variance. The degree to which such reports are immediately informative depends on how thoughtfully the budget-to-date values are determined.

Too often the budget-to-date is simply based on the proportion of the fiscal year that has passed. Such a pattern is rarely appropriate for all or even most line items in the accounts. Both revenues and expenses are often subject to well-recognised peaks and troughs throughout the year. If these patterns are not incorporated into the year-to-date budget amounts, the variances become almost meaningless. Making the reports useful requires that the finance department supplement the reports with detailed commentary to explain why many of the variances are or are not worrisome.

For accounting reports, a fairly easy alternative can make a significant improvement. This alternative is to base the default definition for budget-to-date on the ratio of the prior year actual-to-date to prior year total. This effectively captures regularly recurring deviations from a straight linear realisation of both expenses and revenues. Even this, however, is not a complete answer. Known structural changes in the business, such as special one-time expenditures, can distort the month-to-month pattern and make it misleading if applied to the following year.

The ultimate answer is to have the finance department apply all available information in determining the appropriate year-to-date budget amounts. (Some explanatory notes are in order for line items with an especially peculiar pattern.) In this approach, constructing meaningful year-to-date variances, with implications for full-year deviations from budget, is the central goal.

Risk reporting is not as simple

Unfortunately, including context sensitivity in risk reports is a more complex challenge. There are undoubtedly some seasonal phenomena that can be captured, such as increased late payments on credit cards after the year-end holidays. Most factors of interest, however, tend to be cyclical and not seasonal. This is compounded by the fact that we don't know exactly where we are in a given business cycle as it is unfolding. Nevertheless, careful econometric analysis can provide useful insights.

Statistical analysis of a bank's experience relative to past business cycles can place the current situation in context. For example, an increase in the proportion of loans that are downgraded in the first year may be an indication of more lax credit standards. However, this increase must be viewed in the context of current business conditions. The proportion of first-year downgrades may be increasing by less than would be expected in a period of economic recession. In that case, implications for the credit culture are very different than might at first appear to be the case. Without the added context of a cyclically adjusted benchmark, it would be easy to jump to the wrong conclusion.

An answer to pro-cyclicality?

A much discussed issue is whether more risk-sensitive regulatory capital requirements will make bank lending more procyclical, thereby accentuating the business cycle itself. The Basel Committee's response to this has been to demand stress-tests of the capital requirement relative to simulations of adverse future economic conditions. In a sense, this is a way of introducing a dynamic element into the current benchmark for minimum capital.

The hope is that banks will be sufficiently forward-looking to begin to improve the quality and reduce the volume of their lending in the late stages of a boom. Needless to say, if a bank can get the timing right such a course is also in its own self-interest. One way for risk managers to encourage this would be to examine lending practices in past cycles. This would involve tracking the volume and quality of new loans relative to unemployment, GDP growth or, preferably, more specific indicators of economic activity in the markets of a bank's customers.

In retrospect, it may be clear that retrenchment did not occur soon enough or severely enough to avoid serious earnings effects during past downturns. That is, the actual cyclical response was less than the ideal cyclical response. This could be the basis for developing a modified relationship that tracks what would have been a more desirable response in the past. This relationship could then be used to generate a dynamic benchmark for new lending activity on current risk reports. By incorporating dynamic benchmarks into the numbers that drive ongoing decisions, it is more likely that banks will be able to muster the will to counter the prevailing mood in both expansions and contractions. If so, this would benefit both their own performance and that of the economy. ■