

Modelling the Survival of Financial and Industrial Enterprises

Advantages, Challenges and Problems with the
Internal Ratings-Based (IRB) Method

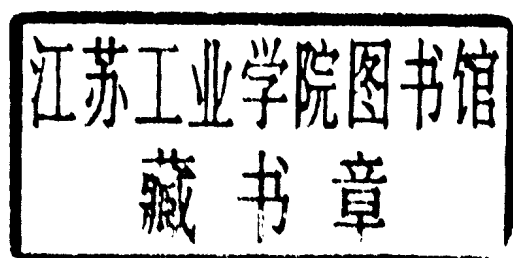
Dimitris N. Chorafas

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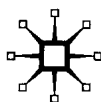
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Preface

Mathematical models offer opportunities for better management of our company, particularly in the domain of risk control. But they also pose questions that are of interest to us all: How should they be developed, tested and implemented? How their deliverables should be validated in terms of accuracy and usefulness? Are the results they provide useful over a longer period of time or their dependability changes?

These queries are not of an academic nature. They are practical and an answer to them is both important and urgent. Models are an indispensable part of modern finance, which has become so technical that at least theoretically only a small number of specialists are able to master its mathematics. Practically, however, basic ideas about the development and use of models can be understood by everyone. This is the purpose the present book puts to itself.

This book is written for non-mathematicians, commercial bankers, treasurers, investment officers, stock brokers, fund managers, portfolio managers, financial analysts, auditors, actuaries and risk controllers. It requires no deep mathematical background because its goal is not to teach how to write algorithms but to help the reader understand and appreciate what is behind the mathematical model and its usage: What are the opportunities, challenges and pitfalls?

This understanding is at a level above the model's mathematics, and it has its own prerequisites. Foremost is to explain models without complex equations, in a form that people without a degree in science can comprehend. This is what I have tried to do in this book. The reader must judge whether this effort of explaining without cluttering the text with detailed complex equations, algorithms and probability theory has indeed been successful.

There are two reasons for abstaining from complex formulae. One is the readership to which this text addresses itself. This involves business people in finance, banking, treasury operations and other industrial sectors. Till recently business education has not included much mathematical analysis apart from some elementary statistics. This is currently changing.

A second basic reason for keeping complex algorithms out of the confines of this text is that the intention has been to present my experience in the *methodology* of financial analysis rather than the details of its tools. The tools are, of course, most important, but sometimes they are like the trees hiding the forest. Vital in this text is the thesis and the antithesis concerning financial models and their usage.

* * *

The book is divided into five parts and thirteen chapters. Chapter 1 offers a perspective in science and philosophy, by way of discussing why philosophy and science have a common origin, what underpins science and how the scientific method can contribute to the solution of real-life business problems. Based on this background Chapter 2 focuses on the work the analyst is expected to perform, and on whether this work worth the cost and the effort.

The theme of Chapter 3 is what models can and cannot really contribute to modern business; a similar query is posed and answered in connection to experimentation done through models through the implementation of the scientific method. This sets the stage for practical applications presented in Chapter 4, whose central theme is the assessment of creditworthiness: past, present and future.

The assessment of the counterparty's creditworthiness is a challenge as old as banking. The tools, however, are evolving. The latest is the Internal Rating-Based (IRB) method of the New Capital Adequacy Framework of the Basle Committee on Banking Supervision. The position taken by the American Bankers' Association (ABA) in regard to IRB is that:

- every bank should be encouraged to develop its own model; and
- it should definitely test to see if its model works well in real life applications.

But ABA also thinks that smaller and medium-sized banks may find difficulties in adopting IRB, and many might choose the so-called standard method, which is less sophisticated and eventually more onerous in terms of capital requirements. For this reason the introductory text on IRB in Chapter 4 is expanded in Chapter 5. This is done in two ways: through practical examples and by means of showing the vast domain where IRB may be applicable. Credit derivatives have been chosen as a reference.

Chapter 6 introduces to the reader the basics of actuarial science. The background reason is to impress upon the reader the importance of appreciating the cost of money. I see discounted cash flow as one of the basic tools in connection to IRB. The modelling of cash flow systems is a good exercise, and is also relevant to all financial issues confronting business and industry.

Since it has been a deliberate choice to limit to a bare minimum the mathematical formulae included in this book, emphasis has been placed on scenarios. Chapter 7 looks into scenario analysis and its contribution, taking as an example practical applications with the Delphi Method.

Chapter 8 elaborates on the use of scenarios in forecasting, and it explains why the use of undocumented hypotheses is behind many model failures. Chapter 9 underlines the fact that even the best model will be powerless without reliable financial reporting. If the data that we use is not reliable it would hardly worth our time to look at the output of the model or the scenario.

Since Chapters 4 and 5 have centred on credit risk, Chapters 10 and 11 look into models for market risk. Chapter 10 covers value-at-risk (VAR) and the Monte Carlo Method. Chapter 11 concentrates on limits and brings the reader's attention to the fact that the substitution of limits by VAR (as some banks are recently doing) is a very bad practice.

The subject of the last two chapters is model risk and its management. Chapter 12 explains why errors are made in prognostication, and it suggests ways and means for correcting these errors. Chapter 13 looks at model risk as being part of operational risk. It then presents to the reader a policy centred on internal control and on auditing, which can help to reduce operational risk.

A fundamental understanding of what models are and are not, as well as what they might contribute to the modern enterprise, is essential to all executives and professionals. Today computers, communications and an increasingly more sophisticated software, are the pillars on which rests a great deal of our company's profitability. In the years to come model-illiteracy will be synonymous with lack of professional skills, and therefore will be interpreted as a personal weakness. Yet, as this book demonstrates, it does not take much to become model-literate.

I am indebted to many knowledgeable people, and organisations, for their contribution to the research that made this book feasible – also to several senior executives and experts for constructive criticism during the preparation of the manuscript.

Let me take this opportunity to thank Stephen Rutt, Zelah Pengilley and Caitlin Cornish, for suggesting this project and seeing it all the way

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Valmer and Vitznau
3 April 2002

DIMITRIS N. CHORAFAS

Contents

<i>List of Tables</i>	ix
<i>List of Figures</i>	x
<i>Preface</i>	xiii

Part One Understanding the Contribution of Science and of Models

1 Science and the Solution of Real-life Business Problems	3
1.1 Introduction	3
1.2 Thinking is the common ground between science and philosophy	5
1.3 Principles underlying scientific thought	8
1.4 What is meant by the scientific method?	12
1.5 Models and the internal rating-based solution	16
1.6 Natural death and oblivion of models, products, factories, companies and people	20
2 Is the Work of Financial Analysts Worth the Cost and the Effort?	24
2.1 Introduction	24
2.2 The role of financial analysts	25
2.3 Metaknowledge is a basic concept of science and technology	29
2.4 Metaphors, real world problems and their solution	32
2.5 Characteristics of an internally consistent analysis	36
2.6 Financial studies and the methodology of physicists and inventors	39
2.7 Management based on research and analysis	42
3 The Contribution of Modelling and Experimentation in Modern Business	45
3.1 Introduction	45
3.2 The multiple role of analysis in the financial industry	46
3.3 Can models help in improving business leadership?	48
3.4 Non-traditional financial analysis and qualitative criteria	54

3.5 Models become more important in conjunction to internal control	57
3.6 Human factors in organisation and modelling	60

Part Two Elements of the Internal Rating-based Method

4 Practical Applications: the Assessment of Creditworthiness	67
4.1 Introduction	67
4.2 Notions underpinning the control of credit risk	68
4.3 RAROC as a strategic tool	74
4.4 Standardised approach and IRB method of Basle II	78
4.5 Amount of leverage, loss threshold and counterparty risk	81
4.6 Risk factors help in better appreciation of exposure	84
4.7 Has the Westdeutsche Landesbank Girozentrale (West LB) an AA+ or a D rating?	88
5 Debts and the Use of Models in Evaluating Credit Risk	91
5.1 Introduction	91
5.2 Contribution of information technology (IT) to the control of credit exposure	94
5.3 Credit risk, rating and exposure: examples with credit derivatives	97
5.4 Rules by Banque de France on securitisation of corporate debt	101
5.5 Credit derivatives with non-performing loans: Banca di Roma and Thai Farmers' Bank	106
5.6 Don't use market risk models for credit risk	108
6 Models for Actuarial Science and the Cost of Money	113
6.1 Introduction	113
6.2 Basic principles underpinning actuarial science	114
6.3 The stochastic nature of actuarial models	120
6.4 Interest rates, present value and discounting	123
6.5 Modelling a cash flow system	126
6.6 Actuarial reserves and collective models	129

Part Three Forecasting, Reporting, Evaluating and Exercising Market Discipline

7 Scenario Analysis and the Delphi Method	137
7.1 Introduction	137
7.2 Why expert opinion is not available matter-of-course	139

7.3	The delphi method helps management avoid tunnel vision	141
7.4	Scenarios and the pattern of expert advice	146
7.5	Extending the scope of analytics and the planning horizon	151
7.6	Making effective use of informed intuitive judgement	154
8	Financial Forecasting and Economic Predictions	157
8.1	Introduction	157
8.2	The art of prognostication and its pitfalls	158
8.3	Predictive trends, evolutionary concepts and rocket scientists	162
8.4	A prediction theory based on the underlying simplicity of systems	166
8.5	Undocumented hypotheses are in the background of many model failures	171
8.6	Investment horizon and the arrow of time	174
9	Reliable Financial Reporting and Market Discipline	179
9.1	Introduction	179
9.2	Committee of Sponsoring Organisations (COSO) of the Treadway Commission and implementation of COSO	181
9.3	Qualitative and quantitative disclosures by financial institutions	184
9.4	Proactive regulation and the use of an accounting metalanguage	188
9.5	Defining the territory where new regulations must apply	191
9.6	Measurement practices, reporting guidelines and management intent	194
9.7	Why fair value in financial reporting is a superior method	198

Part Four What to do and not to do with Models

10	The Model's Contribution: Examples with Value at Risk and the Monte Carlo Method	203
10.1	Introduction	203
10.2	Concepts underpinning value at risk and its usage	204
10.3	What VAR is and what it is not	209
10.4	Historical correlation and simulation with VAR models	213
10.5	The bootstrapping method and backtesting	215
10.6	Levels of confidence with models and operating characteristics curves	218

11	Is Value at Risk an Alternative to Setting Limits?	224
11.1	Introduction	224
11.2	Establishing a policy of prudential limits	226
11.3	Limits, VAR and market risk	230
11.4	The impact of level of confidence on the usability of VAR	233
11.5	Can we use eigenmodels for precommitment?	237
11.6	Using the warning signals given by value at risk	240
 Part Five Facing the Challenge of Model Risk		
12	Errors in Prognostication	247
12.1	Introduction	247
12.2	'For' and 'against' the use of models for forecasting	249
12.3	Faulty assumptions by famous people and their models	252
12.4	The detection of extreme events	257
12.5	Costly errors in option pricing and volatility smiles	261
12.6	Imperfections with modelling and simulation	265
13	Model Risk is Part of Operational Risk	268
13.1	Introduction	268
13.2	The risk you took is the risk you got	270
13.3	Model risk whose origin is in low technology	272
13.4	The downside may also be in overall operational risk	275
13.5	Operational risk in the evaluation of investment factors	278
13.6	How far can internal control reduce operational risk?	281
13.7	The contribution that is expected from auditing	285
	<i>Notes</i>	288
	<i>Index</i>	292

List of Tables

3.1	Banking problems studied through models and simulation since the 1960s	49
4.1	Increasing probabilities of average cumulative default rates over a 15-year timespan (%)	69
4.2	Risk factors for swaps trades worked out by the Federal Reserve and the Bank of England	86
6.1	The top eight telecoms debt defaults in the first half of 2001	130
6.2	Consolidated statements of cash flows	131
9.1	Three types of risk to which the board and senior management must pay attention	190
10.1	The time schedule of major regulatory measures by the Basle Committee on banking supervision	204

List of Figures

1.1	The top five business topics chosen by 1296 business executives	4
1.2	Frame of reference of the analytical study of time series	10
1.3	Both analytics and rapid project development use prototyping as a stepping stone	14
1.4	Solutions to real-world problems can be helped through simulation	18
2.1	More effective communication is key target of scientific disciplines	29
2.2	Metaknowledge exists in all processes and it contrasts to the more visible object knowledge	30
2.3	In a quality control chart by variables the control limits should be within the tolerances	34
2.4	Radar chart for off-balance sheet risk management to keep top management alert	37
3.1	Pareto's Law is widely applicable to business and industry	52
3.2	A practical application of Pareto's Law versus equal payoff	53
3.3	Problem definition is only the starting point of modelling	59
4.1	A simple model for evaluation of credit risk	71
4.2	A more complex model for evaluation of credit risk	72
4.3	A sequential sampling plan allows computation of interest rates commensurate to risks being assumed	75
4.4	Cumulative default probabilities for AAA, AA, A, BBB, BB, B and CC rated companies	87
5.1	The best credit risk models are those that focus at events at the tail of the distribution	92
5.2	A finer definition of capital at risk must be done in a 3-dimensional space	93
5.3	The rapid growth in derivatives versus the slow growth in assets, loans, equity and reserves	99
5.4	Other assets and other liabilities reported to the authorities over a 6-year timeframe by one of the credit institutions	103
6.1	Probability distribution of default rates in a relatively normal business environment	116

6.2	Yield curves for interest rate swaps in US\$ and Euro	118
6.3	Bell-shaped normal distribution and leptokyrctic distribution	121
7.1	A linear plot of answers given by experts to the first round of a Delphi procedure	144
7.2	The opinions of participating experts can be presented as a pattern with corresponding frequencies	145
7.3	A 3-dimensional frame of reference for calculating the premium rate in connection to country risk	147
7.4	The value derived by the degree of satisfaction of an action C_1 might be represented by an ogive curve	150
8.1	Interest rates impact the way investors value equities	161
8.2	A lognormal distribution for option pricing reflecting volatility and maturity	167
8.3	Between fine grain and coarse grain financial data the difference is orders of magnitude	168
8.4	From low yield stability through chaos to higher yield stability	170
8.5	A procedure for online generation of hypotheses regarding intraday currency exchange rates	172
8.6	Intrinsic time can be shorter or much longer than clock time	176
9.1	The reliable reporting structure created by COSO	182
9.2	The viewpoint of SEC and of the Austrian National Bank	183
9.3	The areas covered by accounting, auditing, risk management and internal control overlap: each also has its own sphere of interest	186
9.4	Measuring derivatives at current value and reporting gains and losses	194
10.1	The money at risk increases as the level of confidence increases	206
10.2	According to the majority of banks, even for market risk, the concept of VAR alone is not a sufficient measure	210
10.3	The operating characteristics curve of a statistical distribution	219
10.4	The use of Monte Carlo simulation in connection with income from interest rate instruments	222
11.1	Establishing limits: top-down or bottom-up?	226
11.2	Establishing limits and testing procedures for all main types of risk	229
11.3	Intraday changes in equity index, therefore, in market risk, may totally upset equity limits	231

11.4	The correlation between marking-to-market and marking-to-model is not perfect, but it can be revealing	232
11.5	Characteristic behaviour of a nonlinear system	239
12.1	A comparison between VAR estimates and trading losses at Crédit Suisse First Boston	253
12.2	Schedule of research and development: real-world computing	256
12.3	Volatility in daily gold prices: a short-lived spike	260
12.4	Volatility smile and volatility valley with interest rate products	262
13.1	A feedback mechanism is fundamental to any process in engineering, accounting, management and internal control	278
13.2	The common frontier between internal control and operational risk management	283

Part One

Understanding the Contribution of Science and of Models

