Can the consideration of qualitative factors as data inputs in our default assessments improve predictability and early warning signals ?

Dr.Shikha Bagai
Managing Director-India & Mauritius
Vistra ITCL (India) Ltd.

For long, early warning signals models and default predictors have mostly stayed in the academic world of Researchers and Academicians or within Risk teams of financial institutions. The academic literature on probability of default works aggregate to many thousands of pages. And yet, many defaults in our markets come unprepared and as accidents. The conversations after a default then turn to punitive actions and the role that stakeholders could have played in preempting them.

Use of data – both quantitative and qualitative for sense making on different stages of credit deterioration and to get to some meaningful insights on early warning signals is not the most talked about subject. Rating transitions remain the most heavily depended measure. Is there a need to increase the respect for data and information and the analysis on a more widespread basis in order to catch the trends of deterioration early enough – for both unlisted and listed credit ? As per our research and conversations with Market Participants on surprise element in defaults and credit deterioration, Information asymmetry came out as one of the most significant factors. And then there are cases where the market has an informal sense, the credit is a subject matter of some closed door conversations, but professional skepticism alerts on wider scale do not find their way into the credit models early enough.

Another dimension that is a food for thought is the opportunity that lies unused in the Academic works of Researchers and its use by Practitioners. Effectiveness of assessment and dissemination of early warning signals and their use in framing interventions can provide significant support to reducing damage early enough. In some cases, it may even benefit credit issuers/borrowers as a professional skepticism intervention by other stakeholders to ultimately save the credit. The Academic Papers on the subject run into hundreds and maybe more. All we need is the bridge between what Academicians produce as research and what industry absorbs in its day to day assessment of credit exposures.

Why should we not move the benchmark beyond regulatory compliances to a level where our own assessments basis data and information triggers professional skepticism alerts, the sense making emanating from alerts are discussed with a certain respect for professional skepticism and we frame interventions that can help stakeholders and prevent damage.

A well working system would entail –

- availability of data and information. This is mostly available post regulatory frameworks
- Use of basic models that factor in quantitative and qualitative assessments in order to figure out a comprehensive picture of the credit. Use of qualitative themes here would represent themes that do not find their way in the modular format of financial ratios and give completeness to the assessment of a particular credit situation of a particular borrower. This leads to the conviction to run interventions. Interventions could range from the assessment that no action is required to the assessment that a serious lender action is an urgent requirement
- One of the requirements of a well functioning system of early warnings is our ability to become comfortable with uncomfortable tough conversations

In terms of categories of information, we can keep it simple. Analysis of Academic Papers over last many years reveals two broad categories of models – market based and accounting based. I'm taking the liberty to add a category of Qualitative/ informal information category to the quantitative information that is used for models. This is information category that everyone talks about in the informal space but which does not get tested for its correctness, significance in a form and manner that can lend some objectivity to the assessments of credit. This category can be extremely important for interventions to prevent further deterioration or in the period of distance to a possible default.

A subtle factor that comes into play as we deal with a sense of credit deterioration is the strength of conviction to insist on interventions when some parameters are throwing some alerts here and there. A simple breach of an asset cover or security cover may mean little from perspective of sense making of whether the breach is relevant or not. But if an asset cover breach is read together with qualitative factors like say, KMP resignations, rating transitions, the same information could mean very different. The limitation of pure quantitative based traditional assessments is that it does not stitch a story that can talk. Added to this is the data point that privately placed credit is a significant proportion of the total credit. Simple indicators like Altaman Z-scores are not available for a lot of these credits. However, if information available in public domain, both quantitative and qualitative can be used together for sense making, it could give very different picture.

Regulators have done significant work in bringing accountability for early warning signals for corporate credit defaults. Trustees, Rating Agencies, Issuers and other intermediaries have been scoped with being signal generators for any trouble brewing on a credit like Debentures or Bonds. DLT platform, a blockchain based system is positioned to be the central database for information on debt along the way.

If we could upgrade our assessments of information to looking at different dimensions of information including qualitative factors and happenings that are being discussed to look at the aggregate picture of professional skepticism alerts, our early warning signal work could be boosted further. If information analysis leads to no other benefit, it would surely add substance to lender situations wherein there is lack of clarity in how strong the intervention should be.. A comprehensive framework that outlines remedial steps based on early warning signals constructs that have the ability to consider multiple themes at one go and analyse a credit from perspective of multiple dimensions including market specific factors. The resulting framework has an independent variable representing qualitative themes and is statistically significant.

Alertness would mean we do not ignore the informal conversations, the qualitative signals and use appropriate level of professional skepticism to get to a place of assessment of actual position of the specific credit.

Conclusion : To summarize, I'm urging a view of a world where we create a benchmark of an upgraded level of sense making and alertness of credit assessments beyond regulatory compliances. This is a world where we consolidate quantitative and qualitative information that is relevant, look at the triggers with professional skepticism and have the openness to engage in tough conversations that aim to minimize or prevent damage. This world has alertness as a fundamental approach and the alertness is anchored in data and information. In this world, we will have the resolve to prevent accidents on account of factors within control of different stakeholders.