How much to lend? A new risk tool can help decide

IESE's Gilberto González García and Eduardo Martínez Abascal present a useful tool for risk managers, private bankers, consultants and credit managers.

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Given the increasing emphasis on risk management in financial organizations, a new corporate player has emerged: the risk manager.

In their technical note, "Risk Management: Lendable Amount Control in Private Banking," IESE's Gilberto González García and Eduardo Martínez Abascal present an approach to help risk managers evaluate and control the amount of money that lenders grant to borrowers, given that fluctuating investment portfolios are offered as collateral.

New, complex scenarios

In today's world, various groups of business interests, be they companies or individuals, may come together to provide each other financial support.

Take a group of investors who want to develop a start-up project in a different country. Since the start-up is not yet financially viable based on its statements, no credit would be granted.

In such case, a group of investors may decide to support the new venture by raising cash via loans, using part of their investment portfolio(s) as collateral.

Investment portfolios are dynamic, comprising a changing mix of different kinds of collateral — time deposits, bonds and other securities, for instance — at any point in time.

As such, having a common base is vital for a lender to be able to compare and evaluate the maximum credit risk exposure that a collateral portfolio or, as is more often the case, multiple portfolios can support at any given time.

Finding the lendable amount

For a lender, the maximum amount to lend based on collateral depends on financial factors such as liquidity, volatility, currency or the nature of the collateral itself, as well as factors related to the operational, legal, market or country risk involved. The authors approach this complex problem step by step.

The first step is to find the maximum lendable amount, or LendAm, for each individual collateral type in the investment portfolio(s) offered by the potential borrowers. An individual LendAm is generated for each collateral type.

The second step is to look at the LendAm of the collateral portfolio as a whole. This may include an added premium — or a subtracted penalty — based on the risk distribution of the portfolio as a whole.

The third step is to take currency exchange volatility into account. The LendAm may be decreased due to volatility. The lender also has to be cautious of the value that a collateral portfolio can lose through time spent trying to liquidate collateral.

This tool can enable a lender to monitor online how much money he or she can lend to a specific borrower with a certain collateral.

Besides monitoring and understanding clients' credit exposure, the tool has a commercial value. It can be used to identify, at any time, an investment portfolio's potential as collateral.

This could help ensure that a lender's clients are granted the maximum credit within the right level of risk.