Moody's Releases New Version of RiskCalc for Measuring Default Risk of Private Firms

First Quantitative Risk Assessment Model Native to Middle Market Private Firms

New York, June 14, 2000 -- Moody's Risk Management Services announced today the release of a version of RiskCalc, its proprietary web-based model, for estimating default risk on obligations of private companies. The version is designed for middle market, private firms with assets between $100,000 and $100 million and with no traded equity, which covers more than 2 million companies in the U.S. RiskCalc is the next generation of Moody's existing RiskScore model and contains improvements in power, comprehensiveness, simplification of data requirements, and calibration to default probabilities.

This new RiskCalc release for private firms is designed to help financial institutions make loans, structure securitizations, and determine adequate levels of capital allocation under the new proposed Basel directives. It helps directly answer questions such as whether the current spread on loans is sufficient to add shareholder value, whether bank loans should be kept on or off balance sheet, and the appropriate capital attribution levels.

"The main problem facing credit analysts today is how to integrate hundreds of inputs into lending decisions," says Lea Carty, Managing Director, of Moody's Risk Management Services. "RiskCalc provides the analyst with a succinct and informative summary of all relevant financial ratios, and ties them directly to the probability of default. It takes risk management beyond why certain portfolios underperformed and into making decisions affecting a company's future revenues," Carty says.

This version of RiskCalc joins the Moody's RiskCalc family of quantitative credit risk models which includes Moody's proprietary quantitative credit model for firms with publicly traded equity.

Need for credit models driven by changing bank regulation

Credit models like RiskCalc are becoming increasingly important in meeting new regulatory demands. The advent of new supervisory practices in the U.S. are giving emphasis to the usefulness of a bank's internal rating system in assigning internal capital against measured risks. In September, 1998, the Federal Reserve issued a letter (SR 98-25), stating that bank examiners should be critical of a system that does not "meaningfully distinguish among the strata of risk with the loans in the portfolio." Many of the internal rating systems in use by banks today tend to lump credits into one or two pass grades. By enabling a ranking of credits by their Estimated Default Frequency (EDF), they can be arrayed into risk grade categories with finer granularity, enabling banks to achieve greater precision and accuracy in the internal rating process.

Only model specifically calibrated for private firms

This version of RiskCalc is the most statistically powerful model currently available for private firm default modeling because it has been specifically calibrated using Moody's unique Credit Research Database (CRD) comprised of 28,000 private firm financial statements and over 1,500 private firm defaults. "To create the CRD, Moody's formed a consortium of 16 large US and Canadian lenders who realized they could maximize the value of their default data by pooling it, and the associated financial conditions of those borrowers, with other institutions" says James Herrity, Director of Credit Research Data Base Initiatives. This approach stands in stark contrast to, and represents a meaningful step forward from the common approach, which is to use publicly traded or agency-rated companies to derive and test a model. Some lenders are skeptical about inferring private firm default probabilities from capital market firms. Daniel Gelinas, Portfolio Manager at the National Bank of Canada in Montreal, Quebec, Canada notes, "We have supported the CRD initiative because we believe there are many differences between public and private firm default drivers."

"While models fit to public companies can be useful when applied to private firms, the relationship between certain ratios and default probability displays markedly different behavior between the two groups," says Eric Falkenstein, Vice President and Senior Analyst at Moody's Risk Management Services. "For instance, cash-to-total assets is one of the most important predictors of default for private firms, whereas among public companies it is a much less important variable. This reflects the difference that a public firm's access to the commercial paper and other capital market makes in avoiding a liquidity crisis if cash on hand is insufficient to meet short-term obligations."

Large dataset allows leap forward in commercial credit modeling

There are currently no widely accepted benchmarks for commercial loan portfolio evaluation. As a consequence, loan liquidity,

loan securitization and loan portfolio management have suffered. The CRD and RiskCalc change this by establishing the data and benchmark models needed for the risk assessment of private firms.

"Consumer credit modeling has surpassed commercial credit modeling as a science because hundreds of thousands of bad credit card debts and millions of good ones make for confident inference," says Falkenstein. "In contrast, if one examines 30 major academic papers on commercial defaults over the past 30 years, the median number of companies used is 40." The CRD which RiskCalc draws upon contains over 1,500 private firm defaults and 1,400 nonfinancial public firm defaults providing for a high degree of model accuracy and reliability.

RiskCalc is a nonstructural model that uses ten financial ratios to reflect a firm's size, profitability, leverage, liquidity, activity levels and sales growth. The ratios for each category were chosen based both on their stand-alone ability to predict default and how they function within a multivariate model. The transformed variables are run through a probit regression model that produces one and five-year expected default frequencies that are also mapped to a Moody's rating of a comparable default rate.

The model also produces contribution scores, which allows the lender to see which factors are the most important drivers of the final score for each individual credit. The report: RiskCalc Private Model: Moody's Default Model for Private Firms, A Rating Methodology is available at www.moodysrms.com.

Moody's Risk Management Services (MRMS) is a leading financial software, credit training and quantitative risk assessment company. Its client base ranges from community bank to large credit-granting institutions. MRMS has offices in New York, New York; London, U.K.; Dublin, Ireland; Reigate, U.K.; Walnut Creek, California; and South Bend, Indiana. MRMS also has associates in other major U.S. cities as well as Cyprus, Latin America, Rome, and Sydney. Additional information about Moody's Risk Management Services and its RiskCalc line of products are available through its web site, www.moodysrms.com.

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