

Arguments Against Six Sigma for Credit Risk

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Jumping to conclusions

It is human nature to jump to conclusions and to find solutions before the problem is adequately identified. This is just as true for Risk Managers who may think they are working on the critical projects and analysis, but are not. Six Sigma ensures that the right problem is addressed, the root cause is identified and the best solution is found and implemented.

Understanding where you are in the process can eliminate unnecessary reporting and focus the analysis on the critical factors and drivers that matter. It can also ensure that challenger strategies are appropriate – ones that will deliver the benefits rather than tweak insignificant edges.

Be wary however, of the Six Sigma project that has in fact been worked backwards. Someone has a solution and obtains the problem to solve. This happens because of the certification and qualification programme that often accompanies Six Sigma. Green Belt and Black Belt programmes require projects and

Arguments against the methodology in Risk

Even in organisations that embrace Six Sigma, there can be resistance by the Risk Management function. It's a science based function that you would expect to accept Six Sigma with open arms. Let's look at six of the main complaints about the philosophy.

1. Six Sigma adds work to our projects:

It is easy to assume that a project is required and so the Six Sigma methodology must be followed. Not every decision is a Six Sigma project. If a decision has to be made, for example changes required to the credit bureau link due to regulatory changes. If there is only one option then there is no point in going through the methodology to arrive at the conclusion you had to make. So if there is no problem to be solved, don't let the apparent bureaucracy of the methodology get in the way.

2. There's enough analysis going on:

But is there paralysis of analysis? Credit Risk analysis has never been better. However, much of what is produced is data rather than information. It is natural to want to measure as much as possible. Most times, less is more. Six Sigma helps us think about what we need: the critical metrics. We'll look at this in more detail later when we ask where Six Sigma fits in what the Risk department does.

3. There isn't a problem:

Don't wait for a problem, find one. GE use the term 'entitlement': in principle it means that you shouldn't accept the way things are you should consider how they could be. For example, Collections performance may be acceptable, however it can always be improved. This is like the old "if it aint broke, break it" principle. The challenge is to find the processes and problems that will have the biggest impact on the bottom line.

4. Six Sigma requires a cumbersome project team:

Companies that have a Six Sigma program have a Quality team that comprises of Six Sigma experts known as Black Belts and Master Black Belts. Sometimes companies can become more wrapped up in the structure rather than the methodology. The philosophy can be applied to everything Risk Managers do without the need for a formal structure involving Quality experts outside the function.

It is important to remember that most people are not statisticians. Credit Risk people should have a scientific rigour to what they do and so the principles of Six Sigma should be a natural part of their work.

5. The concepts of Defects and DPMO don't apply to Credit Risk:

The term Six Sigma, is derived from six standard deviations (sigma) from the mean. The Normal probability of being further from the mean than six sigma is 0.0003%. In other words, the chance of an occurrence beyond this point is 300 times in a million outcomes, or in Six Sigma terminology, 3.4 Defects Per Million Opportunities (DPMO).

Not every problem involves errors and hence DPMO. However, it would be a mistake to assume that Six Sigma did not apply because of this. For example if the challenge was to reduce the number of customers defaulting it would be a mistake to assume that default was equivalent to defect.

6. Six Sigma is about improving quality:

Whilst Six Sigma is primarily about improving the quality perceived by a customer from a process, this does not mean that the principles cannot be applied to improving credit quality or profitability. More generally we could relabel this to be "critical to achieving our goal". Rather than get hung up about terms like *Critical to Quality*, think of them as mere labels that give us a common language.