Credit Portfolio

An introduction to the challenges and opportunities

The growth in liquidity of credit markets and the active management of credit risk are among the most significant developments in commercial banking in the past 20 years. These developments hold the potential to permanently reduce the risk profile and improve the financial performance of commercial banks. Starting with this introduction and continuing through the next several articles, leading practitioners share some of the challenges and opportunities in this new field.

Credit portfolio management grew out of the need to improve the financial performance of the large corporate loan portfolios in commercial banks. It is paradoxical that these portfolios created the biggest problems for originators and investors in the marketplace. After all, large corporate loan portfolios typically are composed of loans, commitments, and other lending exposures to banks’ most creditworthy customers. Lending is the backbone of commercial banking, so lending is what banks should do best. Yet these portfolios proved to be the source of recurring problems and the cause of failure for many institutions. What caused these problems?

There are many answers to this question, but most can be grouped into three broad categories: 1) unmeasured risk; 2) misdirected incentives; and 3) aversion to change.

Unmeasured risk. When credit managers assume credit risk, they know there will be defaults, but they generally assume the defaults won’t occur in the positions they approve. This sense of denial exists because of the importance placed on personal judgment in the credit approval process.

Statistics and modeling techniques can be combined with personal judgment to create a stronger credit decision, but that still doesn’t eliminate the risk of default. We do not know the future with certainty, and defaults will happen.

Ultimately, the management of credit risk requires an objective, scientific measure of credit risk, and such an objective measure is available only at the portfolio level. Techniques for measuring credit risk in an objective manner became available only in the early 1990s.

Misdirected incentives. In the past, most banks compensated loan originators for the revenue streams they brought in, without proper regard for the associated risks. In benign credit environments, risks that were overlooked and allowed to accumulate came in many different forms, including single-name concentrations, sector concentrations, geographic concentrations, relaxed covenant protection, and less creditworthy obligors. Such risks remained largely unnoticed until there was a change in the market. When the market changed, the “booms” of the past became the “busts” of the present.

In short, there are strong forces within commercial banks that lead to the buildup of concentration risks. In benign credit environments, banks are lulled into a false sense of confidence and security. Historically, the traditional credit process was inadequately empowered to withstand these pressures.
Aversion to change. “You can’t teach an old dog new tricks”—or, at least, it’s difficult. The problem is not really one of age or species, but one of conditioning and status. After all, the old tricks were rewarded in the past, and these rewards included position and reputation. Resistance to change is especially problematic for an industry that views itself as rock-solid and impenetrable. Thus, it is not surprising that most credit portfolio management units were created with the statement “Just fix it! I don’t ever want to be in this situation again!”

Early attempts at credit portfolio management focused on influencing the loan approval process and selling loans. Loan originators considered these efforts a nuisance, and early practitioners frequently found themselves relegated to “geeky” research functions in their institutions.

Active management of the large corporate loan portfolio coincided with the introduction in the early 1990s of empirical measures of default probability and the development of tools for transacting credit risk in the market. Once banks employed the empirical measures to construct models that measure credit risk, they turned to transactional tools of credit derivatives and loan securitization to manage credit risk actively. In this way, banks could continue to originate loans and build relationships with customers, while avoiding the accumulation of concentration risk.

Credit derivatives and asset securitizations have enabled loans to be integrated into the broader market for credit risk. Increasing liquidity now enables credit portfolio managers to hedge and/or neutralize the default risk of their positions with relative ease. Credit portfolio managers in commercial banks find themselves transacting more and more with their nonbank counterparts at insurance companies, asset management firms, and hedge funds.

Significant diversity exists in the organizational structure and mandate given to credit portfolio

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<td>Credit Portfolio Management Strategies Vary by Institution</td>
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<td><strong>Strategy</strong></td>
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management units across institutions. These differences center on:

- Scope of the portfolio.
- Ownership of the assets.
- Authority to transact.
- Access to the market.
- P/L responsibility.

But each credit portfolio management unit features a common risk management focus, which includes:

- Responsibility to reduce/manage concentration risk.
- Responsibility to monitor/hedge default risk.
- Responsibility to reduce/manage total portfolio risk (economic and regulatory capital).

In short, credit portfolio management extends the traditional activities of credit risk management by assessing risk at the portfolio level and managing this risk through market transactions.

Obstacles to Risk/Return Objectives

While credit portfolio management was created for a defensive purpose (to reduce the losses in the loan portfolio), the rational management of economic capital is driving this function to embrace return and risk in its performance objectives. The continued progress toward rational asset management will require commercial banks to overcome formidable obstacles that impede or prevent them from fully integrating their activities into the market. These obstacles include 1) accounting practices; 2) regulatory practices; and 3) disclosure practices.

**Accounting practices.** If commercial banks are going to rationally manage credit risk, they must use market prices to 1) drive their decisions to originate, hold, hedge, or sell individual exposures; and 2) report the financial performance of their activities to investors.

**Regulatory practices.** Banks are subject to minimum capital standards. As long as the capital required by regulators differs from the true capital required to manage the business, banks will have to maintain two sets of books and manage to the constraints of both regulatory and economic rules.

**Disclosure practices.** Banks need to increase their disclosure of activities and adopt standard measures for describing these activities so investors can make comparisons across institutions.

Conclusion

Today, transactional capabilities enable us to unbundle financial products into their constituent “particles” and reassemble them to meet the needs of individual investors, including our own firms. In their never-ending search for returns, portfolio managers of all stripes are expected to move away from managing categories of financial instruments and move toward managing categories of financial risk. Nowhere is this practice applied more vigorously and with greater expectations for financial gain than in the field of credit portfolio management.

While credit portfolio management was developed to reduce losses in the large corporate loan portfolio in commercial banks, these practices have evolved to embrace return and risk in their performance objectives, and they have been embraced by insurance companies, asset managers, and hedge funds. If commercial banks want to realize the full benefit of these practices, they must overcome formidable obstacles. Overcoming these obstacles will require collaborative interaction with legislators, regulators, and standard setters. Failure to overcome these obstacles will cause commercial banks to focus increasingly on the origination and distribution of credit risk while passing the active management of credit risk to nonbank financial institutions.

It is difficult to teach an old dog new tricks. Are we up to the challenge?

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