

## Box 12

### CREDIT PORTFOLIO MANAGEMENT PRACTICES AND THEIR IMPLICATIONS

Financial institutions are increasingly measuring and managing the risk from their credit exposures at the portfolio level, in addition to the transaction level. A greater focus on so-called credit portfolio management (CPM) has occurred for a number of reasons. The first is a greater recognition of the fact that individual credit exposures can be highly correlated, leaving banks open to the possibility of facing multiple adverse credit events. CPM can help in lowering such undesirable credit risk concentrations. Additional driving factors have been greater emphasis on improving the risk/return profiles of credit portfolios, and making better use of regulatory capital. Furthermore, opportunities for managing credit exposures proactively, after they have been originated, have been facilitated by improved liquidity in the secondary loan market, the increased importance of syndicated lending, the availability of credit derivatives, and an increasing availability of sophisticated models for evaluating credit risk, as well as improved data, and information technologies that facilitate the management of credit risk on a portfolio basis. One implication of CPM is that banks are increasingly moving away from traditional buy-and-hold loan exposure management to an originate-and-distribute business model. This Box discusses recent advances in CPM practices and their implications.

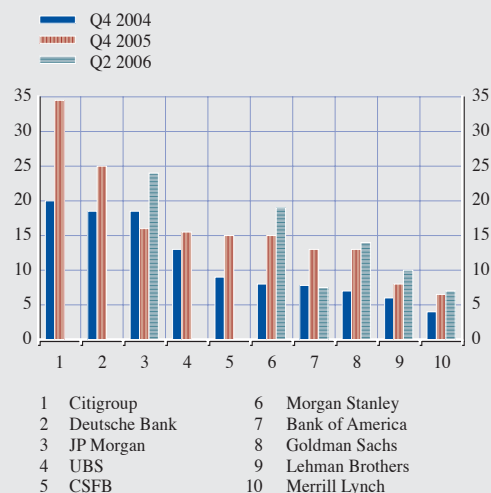
The main objective of modern CPM is to improve the ability of banks to identify risk-return optimal credit portfolios. Such identification is especially important in a market environment of intense competition which can leave banks exposed to greater risk and decreasing return margins. CPM provides banks with better tools for pricing and managing risks as well as for enhanced monitoring of the costs of their loan books. It also has the benefit that it promotes a more risk-adjusted and profit-focused culture in the loan origination business units of banks. It can also enhance the stability of banks' earnings and mitigate investor concerns on credit risk and profit drag from loan loss provisioning. Under active CPM, loan products are ultimately seen as strategic tools for optimising the risk/return trade-off in the banking book. CPM can also create capacity for new business by distributing credit risk more widely in the financial system and freeing up economic capital.

The implementation of CPM in banks is typically concentrated in specific business units that operate in-between the loan origination and loan portfolio hedging functions. The task of CPM business units is to create an internal "market" within the bank that marks loans to market and quotes internal transfer prices that match the shortfall between the revenues that the bank generates from a loan and the price it pays in the market to hedge that loan (for example in terms of the credit default swap (CDS) premium). These shortfalls are typically covered by the loan-originating business units, which receive partial ex post compensation out of the profits generated by the CPM unit from the transformation and sales of the credits. Given that the payment of this shortfall falls upon the loan originator, the pricing of loans at their origination should already take into account future hedging costs, thereby encouraging minimisation of the shortfall. In theory, loan origination will become an integral part of CPM, implying that all steps in the credit process are based on capital market prices.

Indications of growing CPM activity being undertaken by large global banks – where these activities tend to be concentrated – can be seen in increasing loan hedging via credit derivatives

**Chart B12.1 Credit default swap holdings by large international banks**

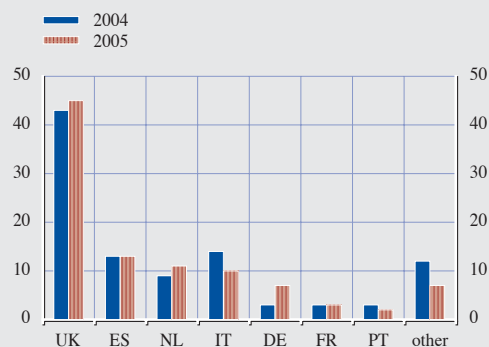
(EUR billions)



Source: Financial disclosures of banks.

**Chart B12.2 European securitisation issuance by country of collateral**

(% of total)



Source: European Securitisation Forum (ESF) Securitisation Data Report, Winter 2006.

(see Chart B12.1). Regarding the use of loan securitisation as a means of CPM, data available for EU banks shows substantial variation across Member States (see Chart B12.2).

Looking ahead, there are at least two reasons to expect that CPM will become an increasingly integral part of banks' credit activities. First, the development of instruments for credit risk transfer has substantially improved the ability of CPM business units to quote internal prices for hedging credits. For larger corporate clients, corporate bond spreads or CDS prices can be used as a reference price, while new product innovations such as collateralised loan obligations (CLOs) and loan credit default swaps (LCDSs) now allow banks to obtain prices for hedging loans to entities with no corporate debt outstanding (such as SMEs). However, considerable challenges still exist in the management of credit risks at the portfolio level. For example, the models commonly used for risk-adjusted pricing still rest on rather strong assumptions about the basic risk components of the credit portfolio, such as correlations between individual obligors' probabilities of default or banks' losses and exposures in the event of the default of an obligor. Second, because they will bind regulatory capital to credit quality and because of the recognition of risk mitigation, the new rules for calculating risk weighted assets (RWAs) under Pillar I of Basel II are likely to provide additional impetus for developing tools for CPM. This is because under the RWA rules, banks either need to support the riskier parts of their loan books with additional capital, or transfer the risk off their balance sheets by means of securitisation, in which case exposures can be deducted from RWA calculations.<sup>1</sup>

Notwithstanding the potential benefits of CPM, some risks for financial stability can be identified. First, as with all credit risk transfer (CRT) activity, CPM implies that banks will face agency problems. On one hand, increasing competitive pressure on loan pricing could contribute to adverse selection and a dilution of banks' credit standards. On the other hand, the fact that credit risks are being transferred off banks' balance sheets creates a moral hazard problem in that it can reduce banks' incentives to monitor their obligors. Although retaining the first-loss tranches of securitised loans, as well as the contractual arrangements of credit derivatives and potential reputational risks should in principle mitigate this possibility, it cannot be excluded that the quality of banks' loan books could deteriorate, particularly if the end-holders of credit exposures do not have the ability to monitor obligors as well as banks can.

Second, the broadening of the investor base for credit instruments, reflecting greater investor appetite for securitised assets, means that credit risk can increasingly be transferred outside the banking system. The growing presence of unregulated financial institutions such as hedge funds in the securitisation markets has been driven by the high yields offered by riskier loan tranches and because default rates have reached unprecedented lows. A key financial stability question that arises from the activity of such investors who take on credit risk via the securitisation market is their ability to absorb losses during periods of high market volatility, and the implications for the CRT process should these institutions fail, particularly if their investor lock-up periods are insufficiently long.<sup>2</sup>

1 In terms of risk transfer it is important to distinguish between "synthetic risk transfer" – whereby only the credit risk is transferred by a bank through the purchase of CDSs while the loans remain on the banks' balance sheets – and "true-sale risk transfer", which involves securitisation and the sale of loans out of banks' balance sheets.

2 In addition, given that banks can have sizeable financing or investment exposures to hedge funds – either via their prime brokerage arms or via their fund-of-funds businesses – it cannot be ruled out that credit risks could "migrate" back to banks via their counterparty exposures.

Third, as a result of CPM activity, and also with the move to IFRS, increasing numbers of instruments purchased to provide credit risk protection are being placed in the banks' trading books as they are often unlikely to be held until maturity. The increasing concentration of instruments that carry credit risk into banks' trading books could gradually raise the correlation of returns between banking and trading books, thereby lowering overall income diversification. In addition, concerns have been expressed about the adequacy of existing risk management methods for monitoring such new instruments in the trading books, as these typically assume that positions can be liquidated at short notice. Although liquidity in credit derivatives markets has improved substantially in recent years, the market has not yet endured a situation where liquidity has dried up.

Finally, it is important to recall that recent advances in CPM have taken place in an environment of exceptionally benign credit and liquidity conditions. A gradual reduction of liquidity in the financial system and/or an adverse turn of the credit cycle could therefore constitute a challenge for banks with active credit portfolio management and loan securitisation processes. In particular, those banks that have become more dependent on the additional funding they have been able to gather from securitisation could see their funding costs increase if the functioning of the securitisation market was adversely affected.

All in all, from a financial system stability viewpoint, improved credit risk management should be seen as a positive development as it provides the banks the potential for additional funding and better diversification of their loan portfolios and for an optimal use of the capital in their balance sheets. Moreover, with the investor base for securitised credits widening, as institutional investors have been developing a greater appetite for high-yielding credit products, this should lead to a broadening and deepening of capital markets and a greater spread of credit risk through the financial system to those most willing to bear it. Nevertheless, there are some risks which will require monitoring in the period ahead.