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The implications of the new capital adequacy rules for portfolio management of credit assets

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Abstract

Over the past several years, there has been an extensive discussion among practitioners and academics about whether and how a portfolio management approach could help banks to better manage risk capital and create shareholder value. In this article, the authors argue that there are four key drivers which require banks to move from a transactional to a more portfolio management like approach when managing credit assets. These are: structural changes in the credit markets, inefficiencies of risk transfer in lending markets, ballooning debt levels in the US, and the proposed changes for capital adequacy. The authors see the latter not as a one-time change in capital adequacy rules, but more as a first step towards full convergence between risk capital and regulatory capital for credit risk. These changes require banks to accelerate their efforts to build first class portfolio management skills and capabilities. Achieving best practice credit portfolio management is rewarded with attractive opportunities for shareholder value creation and enables bank to successfully compete going forward. © 2001 Elsevier Science B.V. All rights reserved.

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1. Reasons to act: The need for building meaningful credit portfolio management capabilities

Credit risk management is undergoing major changes. These changes are likely to influence the competitive conduct in the credit markets, providing opportunities for banks that secure a first mover advantage.

One of the emerging opportunities is the area of credit portfolio management. While many banks have made first experiences with this new concept and have set up organizational responsibilities for implementing it, we do think that there is a strong need for accelerating these efforts. More specifically, we see four key drivers, which are likely to reward fast moving banks with a better competitive position.

2. Key driver No. 1: Structural changes in the credit markets

Over the past several years, the global credit markets have seen dramatic changes. They fundamentally changed conduct and competitiveness in the credit markets and required new strategies for sustaining competitiveness. We have identified four key structural changes:

Increasing competitiveness, particularly in lower grade lending markets. Overall, competitiveness in the credit markets has increased substantially. This is particularly true for lending to lower grade counterparties (e.g., leveraged financing, high yield debt). There are two trends responsible for this development. First, several investment banks entered the market for leveraged financing and non-investment-grade lending. Second, many commercial banks, in an effort to meet ROE-expectations of equity analysts and shareholders, expanded their lending activities to the lower part of the rating scale.

Trading credit risk. Over the past five years, the market for trading credit risk, either through credit derivatives or collateralized loan/debt obligations (CLOs/CDOs) has shown explosive growth. These new markets enabled the transformation of credit portfolio management from a rather academic measurement exercise into a powerful management tool that actively shapes the risk/reward profile of the portfolio.

Significant advancements in measuring credit risk. Preceding the emergence of credit risk trading was the rapid development of new credit risk measurement tools, such as JP Morgan's Creditmetrics, KMV's Creditmonitor, Credit Suisse's CreditRiskPlus or McKinsey's Credit Portfolio View. These new measurement tools deserve credit for two key accomplishments. First, they helped create transparency around the real risk of lending portfolios. Second, they helped quantify the value of alternative portfolio management approaches, such as portfolio swaps or the employment of credit derivatives.