



Effective Credit Risk Management

Effective credit risk management is a critical component of a bank's overall risk management strategy and is essential to the long-term success of any banking organization.

Overall, the components of effective credit risk management comprise active board and senior management oversight; sufficient policies, procedures and limits; adequate risk measurement, monitoring and management information systems; and comprehensive internal controls. Lepus, a U.K.-based investment banking management consultancy, sought the opinions of industry participants on the key components of effective credit risk management. The responses of the eight banks interviewed are summarized in the graph below:

■ **Robust technology and business processes**

Robust technology was mentioned as a critical component of effective credit risk management by 38 percent of the interviewees. It is thought to help banks identify, measure, manage and validate counterparty risk, although it is of little value without effective credit risk policies and business processes in place.

■ **Policies**

In 25 percent of the banks, having a comprehensive and strategic vision for credit policy is vital as it sets guidelines for businesses, giving rise to effective credit risk management. These guidelines include a set of general principles that apply to all credit risk situations, as well as specific principles applicable to some countries and types of counterparties and/or transactions.

■ **Exposures**

In 25 percent of the interviewed banks, the ability to measure, monitor and forecast potential credit risk exposures across the entire firm on both counterparty level and portfolio level is vital.

■ **Robust analytics**

A key component of an effective credit risk management strategy, as suggested by 13 percent of

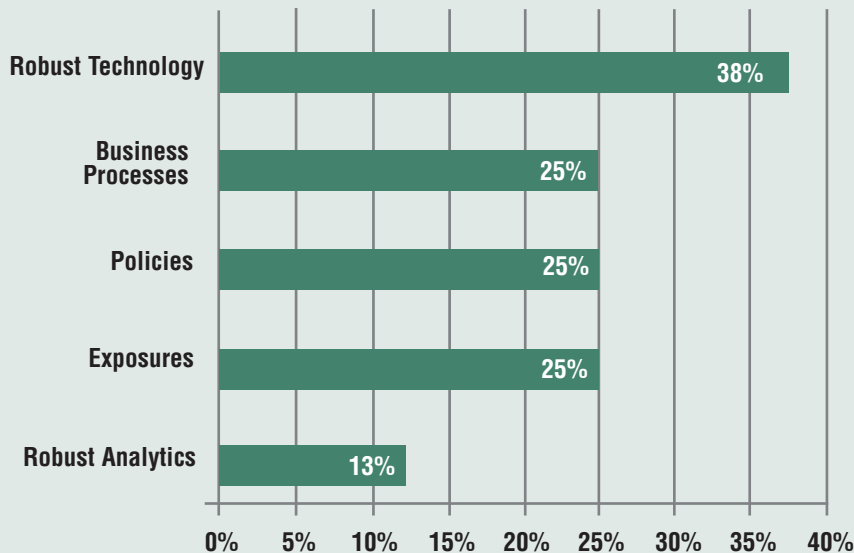


Figure 1: Key components of effective credit risk management (Source: Lepus)

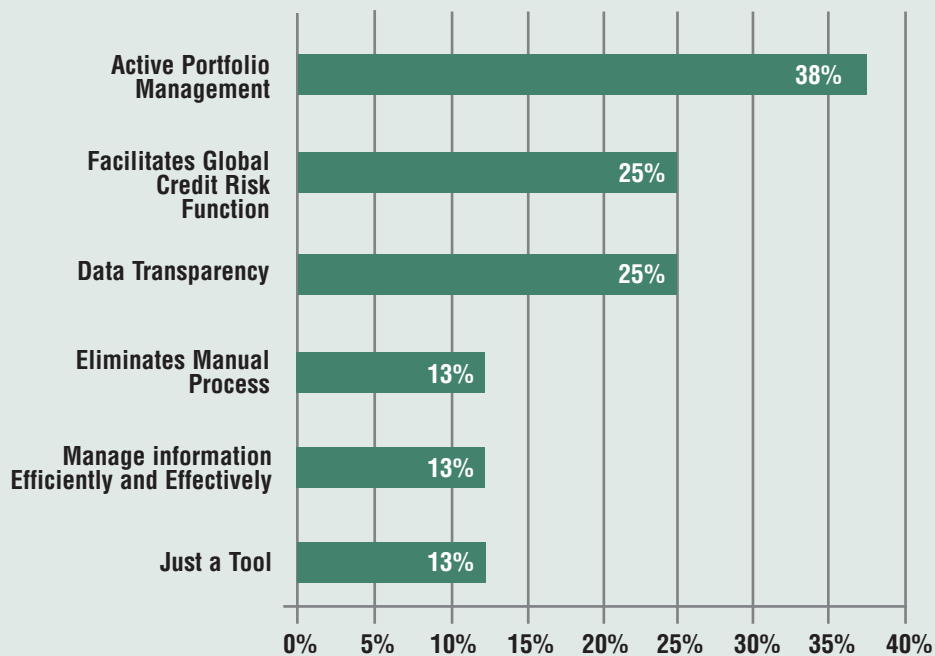


Figure 2: Role of technology in credit risk management (Source: Lepus)

the banks, is having robust risk analytics. Efficient and accurate credit analytics enable risk managers in banks to make better and more informed decisions. The availability of better information, combined with timeliness in its delivery, leads to more effective balancing of risk and reward, and the possibility of higher long-term profitability.

■ **Other**

The other ingredients of effective credit risk management were thought to include credit risk transparency, defined credit decision process, sophisticated risk measurement methodologies, stress testing, timeliness and accuracy of risk calculations as well as efficient credit risk reporting.

Role of technology in credit risk management

As mentioned, technology is widely acknowledged to

be a key component of effective credit risk management. Lepus thus sought industry opinions on how important IT is for achieving best practice in credit risk management. Thirty-eight percent of the interviewees stated that technology plays a significant role in enabling active portfolio management and assessment. This is followed by data transparency (25 percent) and facilitation of global credit risk function (25 percent). Subsequently, technology facilitates elimination of manual processes and allows information to be managed in an efficient and effective way.

Furthermore, one bank stated that while technology can help banks facilitate innovative credit risk management procedures, it is simply a tool and is useless if misused. Another opinion expressed by one of the interviewees is that technology plays a bigger role in the trading book than in the lending book as it enables

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This is an excerpt from the white paper “Best Practices in Strategic Credit Risk Management” produced by SAS and Lepus, a UK-based investment banking management consultancy. The information presented in this paper has been compiled from interviews with eight senior risk managers at leading global banks and from Lepus’ extensive industry experience. To download the entire white paper, visit www.sas.com/creditriskwp.

key questions to be answered, such as the cost of credit risk.

Drivers of effective credit risk management

Basel II was highlighted as one of the main drivers in shaping the banks’ approach to credit risk management. It imposes disciplinary capital charges for procedural errors, limit violations and other operational risks. It also creates new pressures to ensure that effective credit risk management controls are in place.

A leading investment bank, for example, commented that regulations drive its credit risk management procedures. The bank is forced to provide more detailed disclosures in its annual reports. These may include information on its strategies, nature of credit risk in its activities and how credit risk arises in those activities, as well as information on how it manages credit risk.

Basel II will affect a number of key elements in another European bank, including a more rigorous assessment of the bank’s credit risk appetite, more technical approach toward its counterparties and better portfolio risk management. Another bank mentioned that the impact of Basel II is largely dependent on the environment it is regulated under, as it is different for each region.

In one U.S. bank, regulatory pressures raise the status of the risk group, while in another, these pressures can distract from strategic business projects.

While regulatory compliance is indeed a significant driver, most banks’ credit risk management aspirations span beyond this. Key players also seek to gain competitive advantage through effective credit risk management.

The objective of best practices in credit risk management is to provide comprehensive guidance to better address credit risk management. The findings from Lepus’ survey illustrate that credit risk management practices differ among banks, as they are dependent upon the nature and complexity of an individual bank’s credit activities. Sound practices should generally address the following areas:

- 1 Establishing an appropriate credit risk environment.
- 2 Operating under a sound credit-granting process.
- 3 Maintaining an appropriate credit administration, measurement and monitoring process.
- 4 Ensuring adequate controls over credit risk.

The feedback from banks demonstrates that centralization, standardization, consolidation, timeliness, active portfolio management and efficient tools for

exposures are the key best practice in credit risk management. A Tier One American bank is considering having more efficient tools for “what if” analysis and tools to provide transparency to the business. This is particularly important for counterparty exposure at a firmwide level. Another U.S. institution is focusing on stress testing, concentration risk, macrohedged and capital risk market management. Moreover, the firm has consolidated market risk and credit risk.

In 25 percent of the interviewed banks, achieving best practice involves having an active portfolio management in the lending book along with real-time credit risk management. A leading investment bank identifies best practice as having good quality data, for example, identifying processes that induce data errors. Timeliness is another contributing factor. Real-time pre-deal checking, effective credit limits management and country risk management are key to good credit risk practice at another bank. However, this is largely dependent on the market the bank is targeting.

Effective credit risk management as a value-enhancing activity

If deployed correctly and effectively, credit risk management can be a value-enhancing activity that goes beyond regulatory compliance and can provide a competitive advantage to institutions that execute it appropriately. Some of the examples demonstrating the statement above include consolidating credit lines for customers in order to achieve greater business activity, efficient use of capital risk adjusted return

through Basel II implementation and International Swap Derivatives Association’s (ISDA) Credit Support Annex (CSA) allowing banks to deal with lower rated entities.

■ **Consolidating credit lines**

Consolidating credit lines allows one of the responding banks to manage capital adequacy more efficiently. For instance, all of the bank’s global customers, such as Ford Motor Company, have consolidated global credit lines across multiple countries, including the UK, Germany and Singapore. By deploying global credit lines, total credit is reduced thus allowing for more business activity.

■ **Efficient use of economic and regulatory capital**

Having consistent, comprehensive risk architecture will make it easier for banks to calculate and manage capital. Banks mainly in the U.S. and Europe use economic capital for the following reasons:

- ❖ To ensure that the bank has a safe level of capital to guard against risks and to meet regulatory requirements.
- ❖ To price loans to earn attractive risk-adjusted profits.
- ❖ To apply economic capital’s trio of core decision-making criteria (risk, capital requirements and returns) in strategic business planning and to measure return on equity (ROE) by line of business, product or customer to ensure that capital is effectively allocated among different activities in a bank to maximize shareholders’ value.

Once the economic capital is computed across the bank, the bank's actual equity capital is allocated to individual business units on the basis of risks so that shareholders' wealth can be maximized. There are two ways to ensure that the amount of capital is appropriate to the risks it faces. The first is to ensure that the risks are not excessive, given the capital. The second is to ensure that capital is adequate, given the risk. If the economic capital exceeds the regulatory capital, there is no problem. If the regulatory capital exceeds economic capital, the excess can be treated as a cost (regulatory overhead), leading to an increase in the hurdle rate of the bank. This cost can be allocated on a pro rata basis to all elements of economic capital so that every unit of the bank is equally sharing the burden of regulatory requirements.

■ **CSA**

ISDA's CSAs are used extensively in several of the interviewed banks (with most of their counterparties) since it adds significant value to the firms. These banks have signed CSAs with a large majority of their counterparties in order to call for daily cash collateral cover of all outstanding positions. The major benefits gained from daily collateralization are the reduction in risk amounts and capital usage, and the significant shortening of the potential future exposure risk window. Many of the banks monitor the number of overdue master agreements and overdue trade



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confirmations, as they could affect the banks' ability to net collateral against the gross exposure. Late payments or disputed calls are other potential indicators of operational problems, which could impact the effectiveness of credit management.

■ Use of derivatives to reshape credit profile

Credit portfolio management is a value-enhancing activity; some of the interviewed banks use credit derivatives to reshape their credit profiles. The use of credit derivatives in one Tier One bank has significantly reduced its financial markets' credit risk from 70-75 percent to 40-45 percent.

Credit derivatives create new possibilities for risk transformation through innovative structures such as credit default swaps, basket swaps and debt obligations. Further derivative structures may involve the indexing or reinsuring of illiquid middle market and the creation of short positions in credit risk. This will greatly increase the power and flexibility of portfolio strategies. Hedging decisions are largely made by banks' separate portfolio management groups and senior management teams.

Some of the interviewed banks use credit derivatives for active portfolio management to offset exposures such as inventory and loans, to examine the industry's portfolio and concentration

portfolio across the institutions, and to mitigate exposures. The benefits gained from using this activity typically lead to reduced regulatory capital and freed up credit lines, allowing firms to effectively manage credit exposures.

■ **Technology**

Along with credit derivatives, technology can also contribute to reshaping banks' credit profile by allowing banks to know the type of exposures and price transactions they are dealing with. These elements are required to hedge exposures.

Today, the focus for many banks is to adopt an enterprise credit risk management approach to achieve an integrated view of risk. Best practice in credit risk management should demonstrate centralization, standardization, timeliness, active portfolio management and efficient tools for managing exposures. This is encouraged by the pressure from regulatory requirements such as Basel II. By constantly enhancing existing tools and methods, banks are able to work toward achieving best practice. Furthermore, consistent, accurate and reliable data is required to achieve best practice in credit risk management. ■