

Results from the 2002 Survey of Credit Portfolio Management Practices

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In March 2002, with the sponsorship of the International Association of Credit Portfolio Mangers (IACPM), the International Association of Swaps and Derivatives Association (ISDA), and the Risk Management Association (RMA), Rutter Associates surveyed the state of credit portfolio management practices. The 2002 survey represents an expansion of the 2000 survey that was accomplished by Rutter Associates in cooperation with *Credit* magazine.*

The questionnaire was comprised of 34 questions. Twenty-four questions were answered by all of the respondents: Three questions dealt with the characteristics of the portfolio, three questions dealt with marking credit assets to market or model, including sources of data, seven questions dealt with modeling individual transactions (4 on the firms' internal rating systems and 3 on utilization and recovery rates), eleven questions dealt with portfolio management (11 questions). The remaining ten questions were answered only by those institutions indicating that they had a formal portfolio modeling process.

This article provides an overview of the survey and the results for 17 of the questions included in the survey. The actual survey results for the questions on which this article is based can be viewed at the websites of the sponsors (www.iacpm.org, www.isda.org, or www.rmahg.org) or at Rutter Associates website (www.rutterassociates.com).

Respondents and Characteristics of the Portfolios

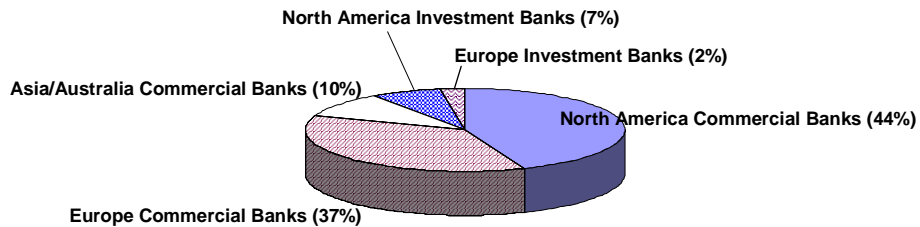
Questionnaires were distributed to the credit portfolio management area of 71 financial institutions. Responses were received from 41 of the 71 institutions. This high response rate (58%) was likely the consequence of the ground rules for the survey: *The only institutions that receive a full set of results are those who submitted a questionnaire.* Among the 41 firms who responded to this survey are

ABN-AMRO Bank	Credit Agricole Indosuez	PNC Financial Services Corp
Allied Irish Bank	CSFB	Provident Bank
Banca Commerciale Italiana	Deutsche Bank	Royal Bank Financial Group
Bank of America	DZ Bank	Scotiabank
Bear Stearns	Dresdner Bank	Standard Chartered
BMO Financial Group	EBRD	Sumitomo Mitsui Banking Corp.
Bank of New York	FleetBoston Financial	SunTrust Banks, Inc.
Barclays Capital	ING Bank	UFJ
BNP Paribas	JP Morgan Chase	Wells Fargo Bank
BNP Paribas - North America	Laurentian Bank of Canada	Westpac
CIBC World Markets	Lloyds TSB Group plc	
Citicorp	National City Corporation	

*Smithson, Charles "Managing Loans: The State of Play," *Credit*, December/January 2001, pp 26-31

As is illustrated in Exhibit 1, the bulk of the responses came from commercial banks headquartered in North America or Europe.

Exhibit 1
Distribution of Responding Institutions



Exhibits 2 and 3 characterize the type of portfolio on which the responses were based. Exhibit 2 illustrates that the majority of the responses apply to portfolios in which the obligors are large corporates.

Exhibit 2
Composition of the Portfolio By Type of Obligor

	Significant portion of exposures	Moderate portion of exposures	Minor portion (or none) of exposures
Large Corporates	66%	24%	5%
Middle-Market Corporates	37%	39%	22%
Banks	32%	39%	22%
Retail Customers	20%	17%	56%

Exhibit 3 indicates that bilateral banks loans, undrawn lines, and syndicated bank loans are the most common credit assets in the portfolios on which these survey results are based.

Exhibit 3
Composition of the Portfolio By Type of Credit Asset

	Comprises 5% or less of portfolio	Comprises 5-25% of portfolio	Comprises 25-50% of portfolio	Comprises 50% or more of portfolio
Bilateral Bank Loans	7%	29%	34%	22%
Syndicated Bank Loans	20%	39%	27%	10%
Bonds	66%	27%	2%	0%
Undrawn Lines	0%	29%	49%	17%
Credit Protection Sold via Credit Derivatives	83%	12%	0%	0%
Counterparty Credit Risk	51%	34%	7%	2%
Senior or Subordinated CDO Securities	71%	25%	0%	0%

Internal Ratings and Probability of Default

We asked how many ratings grades the firm uses. The responses are summarized in Exhibit. 4. Note that the results showed no differentiation by type of counterparty – large corporates, middle-market corporates, or banks.

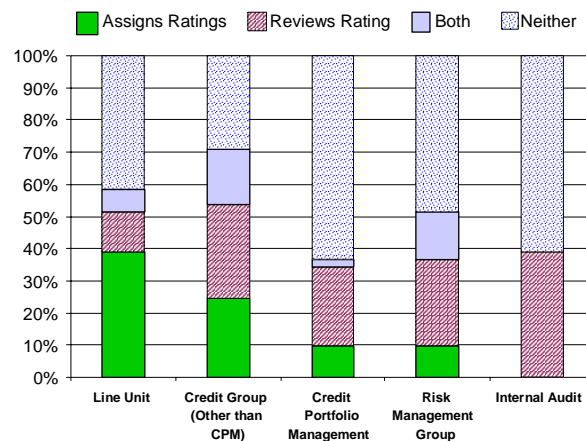
Exhibit 4
Number of Ratings Grades

Non-defaulted entities	
Range	5 - 22
Median	12
Mean	13
Defaulted entities	
Range	1 - 7
Median	2
Mean	3

Sixty six percent (66%) of the respondents indicated that they employ facility ratings that are separate from the obligor rating. The number of facility ratings used by those institutions ranged from a low of 4 to a high of 25, with a median of 10 and an average of 10.6. Of those indicating that they used a separate facility rating, 63% indicated that they explicitly link LGD estimates to specific facility ratings.

We asked who in the institution has the responsibility for assigning and reviewing the ratings. The survey results are summarized in Exhibit 5

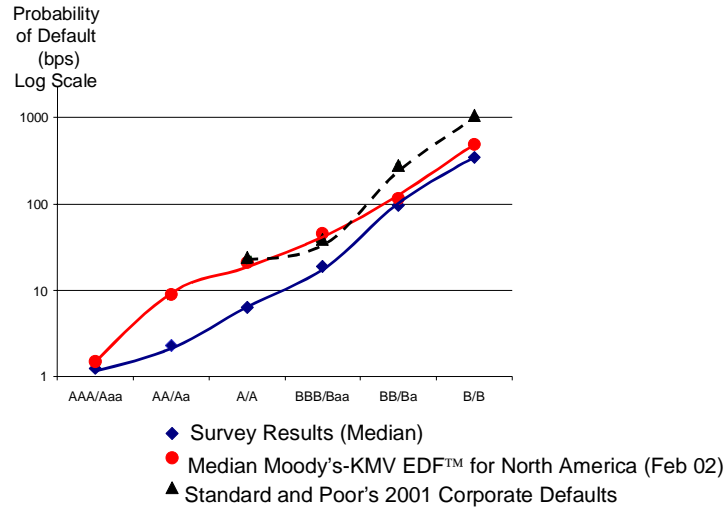
Exhibit 5
Responsibility for Assigning and Reviewing Ratings



We identified five borrower grades (using S&P and Moody's ratings) and asked the respondents to tell us the probability of default that the firm was using for that grade in their credit portfolio modeling. Exhibit 6 summarizes the median probabilities of default

reported by the respondents to the survey and compares these probabilities of default to the EDFTM that would have been obtained from KMV's *CreditMonitor*TM at the same

Exhibit 6
Comparison of Survey Results with Other Probability of Default Measures



time and also with actual default rates reported by Standard & Poor's in 2001.

Portfolio Management

Only one-fourth of the respondents described the “style” of their credit portfolio management as “offensive” – i.e., maximizing return for a given level of risk. Three-fourths of the respondents described their style as “defensive.”

Most (56%) of the respondents use a single hurdle rate for the combined earnings from lending and non-lending activities with a customer. Twenty percent (20%) indicated that hurdle rates are set on the basis of earnings from lending activities only, 56% indicated that they use the combined earnings from lending and non-lending activities with a customer, and 22% indicated that they employ separate hurdle rates for earnings from lending activities and for combined earnings from lending and non-lending activities

We were interested in how far the idea of portfolio management has evolved in these financial institutions. To get at this, we asked what happens in internal discussions if a transaction is proposed that has a return from lending activities only that is below the hurdle rate. 5% responded that such transactions were always rejected. Only 10%, indicated that the business sponsor pays the portfolio manager directly. The majority – 63% indicated that the business sponsor (e.g., relationship management or investment

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banking) decides. 15% indicated a middle ground -- the business sponsor creates an internal IOU

Tools Used to Manage the Portfolio

We asked the respondents to rank four tools in order of their importance to credit portfolio management. (We asked them to use a rank of "1" to denote the most important and a rank of "4" for the least important.) The resulting "importance ranks" are reported in Exhibit 7 (both means and medians).

Exhibit 7		
	Importance Rank (Mean)	Importance Rank (Median)
Approval/disapproval of new business and renewals/nonrenewal of existing business	1.10	1.0
Loan sales and trading	2.74	3.0
Credit derivatives	2.97	3.0
Securitizations	3.15	3.0

We also asked the respondents to rank credit derivative structures with respect to their importance to credit portfolio management. (We asked them to use a rank of "1" to denote the most important and a rank of "3" for the least important) The resulting "importance ranks" are reported in Exhibit 8 (both means and medians).

Exhibit 8		
	Importance Rank (Mean)	Importance Rank (Median)
Total return swaps	2.69	3.00
Credit default swaps	1.09	1.00
Credit linked notes	2.25	2.00

We were interested in whether the institutions had used CLOs as a means of transferring credit risk from the portfolio and/or as a means of acquiring credit risk.

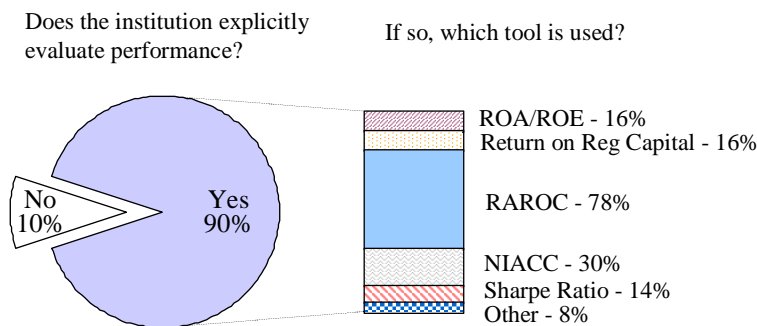
- 73% of the respondents indicated that they had issued a CLO in order to transfer loans **from** the institution. (20% cash CLO, 24% synthetic CLO, and 29% both Cash and Synthetic CLOs)
We asked the respondents indicating that they had issued a CLO to transfer credit risk from the institution about their primary motivation. "Regulatory capital" was ranked the most important (mean rank 1.7), followed by "freeing lines" (mean rank 2.1) and by "economic capital" (mean rank 2.2).
- Only 41% of the respondents indicated that they had used a CLO in order to transfer loans **into** the institution. (10% cash CLO, 13% synthetic CLO, and 18% both Cash and Synthetic CLOs)

Formal Credit Portfolio Management

The institutions that responded to the survey indicated overwhelmingly that their institution has a formal Credit Portfolio Management function (80% indicated that they did). However, there was much less consensus about the ownership of the portfolio of credit assets? Of the firms indicating that they have a formal Credit Portfolio Management function, 14% indicated that the credit assets are "owned" by Credit Portfolio Management exclusively, 30% indicated that the credit assets are "owned" by Line Units exclusively, and 35% "owned" by Line Units/Credit Portfolio Management exclusively

As is illustrated in Exhibit 9, 90% of the firms that responded indicated that the institution explicitly evaluates the performance of their portfolios of credit assets. The dominant tool used to perform this evaluation is RAROC.

Exhibit 9
Evaluation of Performance of Credit Portfolio



We asked whether the institution uses a credit portfolio model. As summarized in Exhibit 10, 85% of the respondents indicated that they did use a credit portfolio model. And, the dominant model was KMV's *Portfolio Manager*.

Exhibit 10

Credit Portfolio Models

Does the institution uses a
credit portfolio model?

If so, which is the primary model?

