

# **CREDIT DERIVATIVES: How Flexible Risk Management Is Changing the Business of Banking\***

by

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## **Introduction**

In most discussions about credit derivatives, the focus is on risk. Not the ability of these instruments to reduce risk in the financial system, but the inherent risk of this class of financial instruments, and how less knowledgeable buyers may unwittingly be increasing their risk exposure. More recent discussions have gone even further. Now, we are worried about the risk to the clearing system associated with a broad based credit event and the systemic risk that these assets may cause.

These are important issues, but not the issue we wish to address here. Rather, we would like to turn the focus of the discussion of credit derivatives back to the reason they were created. Lest we forget, credit derivatives were created to trade and allocate credit risk across the large class of investors that actively participate in the debt markets and to expand that list of participants. The benefits that these derivatives have brought to the credit markets are both numerous and significant.

Three are most noteworthy:

- Credit derivatives promote more complete financial markets, which leads to more efficient risk-sharing and a lower cost of financial intermediation,
- Credit derivatives allow dispersion of credit risk among a greater number of institutions, therefore limiting the systemic impact of the default of any single name.
- And last but not least, credit derivatives make risk management more flexible and efficient for the institutional investors and banks that hold these credits.

It is worthwhile to focus on these beneficial aspects to remind investors and policymakers that despite some potential concerns, credit derivatives are clearly making a significantly positive contribution to the financial structure.

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The growth in the credit derivative market is directly related to the importance of these benefits. Therefore, the current contribution will focus on that growth and how it has changed the business and organization of banking.

### **The evolving corporate debt market**

The business of banking has undergone significant changes over the past two or three decades and is still evolving today. Traditionally, banks had to hold the loans they made until maturity, thereby assuming substantial credit and interest rate risk. In addition, most banks restricted their lending activities to their geographical markets and had access only to the bond market as an alternative investment. As a result, they had little control over the composition of their loan portfolios. This is no longer the case.

Banks now have access to deeper and more liquid markets for their loans. The whole loan market has come of age. And, loan syndication and participation have both played an increasing role in funding corporate credit. At the same time, credit derivatives have become a progressively more important part of the debt market and are now a key ingredient in the trend toward converting credit risk into a marketable, that is to say tradable, economic commodity.

One beneficial consequence of this trend is that banks can now move away from the traditional “buy and hold” model of lending. Individual banks can now select a loan portfolio of a chosen risk level and an efficient risk-return profile from the set of opportunities available in the market.

Today they can buy or sell loans or portions of loans. They can join syndicated loan groups, or they can buy or sell credit derivatives to decrease specific name or industry exposure. Active Credit Portfolio Management (ACPM), as loan management is now called, has replaced the passive accumulation of all originated loans.

In addition, institutions now have a wide choice of operating models in managing their credit portfolio. They may accept loan applications presented to them by their geographically or industry specific franchise and then alter the characteristics of their portfolio through the use of credit derivatives. Or, they may synthetically create such a portfolio through the purchase of whole loans, participations, and various types of credit derivatives in the wholesale market. Banks are no longer prevented from obtaining their desired credit portfolio that is, an efficient collection of credit instruments, by the lending opportunities available to the institution. This is a great achievement.

### **The effect of credit derivatives on organizations**

A consequence of the maturation of the credit derivatives market is that the internal organizational structure of banks is changing to respond to the new market reality. The increased power and flexibility of ACPM allows the value chain in corporate lending to be segmented into at least two separate businesses: *origination and servicing* on the one

hand, and *credit portfolio management* on the other. Specialized units within the institution run each business.

Breaking the once-integrated process into separate components creates benefits, but also poses challenges. There are two main benefits of separation, namely it increases transparency and allows each business to be held accountable for its own contribution to bank profitability.

On the origination and servicing side of the business, each transaction can now be valued at market prices. This results in more disciplined credit selection, more rigorous pricing strategies, and improved distribution. It also adds clarity to the value added from this activity, forcing loan originators to increase their focus on high value businesses.

On the portfolio management side, separation can result in improved diversification, improved capital allocation and potentially reduced capital costs. Portfolio management can be motivated to search for greater risk using these instruments but it can also be encouraged to more aggressively seek natural hedging opportunities in secondary markets. The latter can free up capital that can be reallocated to further growth opportunities. And, a properly motivated portfolio management desk will innovate and develop products that respond to investors' needs in their effort to construct their optimal portfolio, an activity made much easier by the use of credit derivatives.

Unbundling the lending process also brings new challenges. The most obvious are that it requires the institution to clearly define the specific mandate of each business, and correctly measure each unit's individual contribution. Here, performance evaluation and incentive systems must also resolve complex coordination issues between the two units. This is not easy.

In addition, banks must resolve conflicts of interest that may arise between origination and portfolio management. In particular, the diversification objectives of the portfolio manager may sometimes conflict with the origination and servicing unit's ability to forge privileged relationships with borrowers. Further, through the imposition of terms and conditions, the initial quality of the loans that the origination unit underwrites determines portfolio management's ability to mitigate losses. This can be a source of conflict unless incentives are properly aligned.

The new loan transfer mechanism between the origination unit and the portfolio management unit can play a key role in determining the credit portfolio's ultimate performance. To achieve the best possible ex post outcome, banks must promote the flow of information between the two units. Portfolio management's ability to successfully manage the portfolio depends on the information it has on the individual loans. The origination unit is the one that is actually involved in managing the borrower relationships. It ought to be better informed concerning the borrowers present status and must be provided with the incentives to share any relevant information. Unlike the case in many parts of consumer loan servicing, this is not a passive part of the process.

## **Where do we go from here?**

That said, unbundling the lending process potentially allows the bank to design a more flexible and targeted incentive system. However, this process may also be more complex. Therefore, it is not surprising that, in a recent McKinsey survey of 33 American and European banks, we found that standardized performance metrics to differentiate performance and allocate profits to different business units are still a work in progress.

The same survey suggests that banks are still looking for the appropriate response to other challenges they are facing in the credit market. In particular, banks are still struggling with exactly how to structure their credit portfolio, and how to think of their role in their local market. These are two important questions.

Two approaches are emerging in the global banking market. The first model embraces the separation of portfolio management from origination. According to this view, the mandate of portfolio management is to focus exclusively on carrying out the appropriate market transactions to achieve the bank's optimal portfolio risk-return profile given its risk appetite. The origination function is viewed as a totally separate business unit and its activities are seen as having little relevance to the credit portfolio team. Originated loans are treated as arm's length transactions, and there is no obligation or expectation that they will be purchased by the bank itself. This model is sometimes referred to as *Credit Treasury* and seems to be most popular among European institutions.

The second approach resists distancing origination from funding. Banks that embrace this position see portfolio management and origination as two complementary efforts and allow portfolio management to influence origination decisions. According to this view, the mandate of portfolio management is to accept all loans that are generated by the origination unit and to focus exclusively on carrying out the appropriate market transactions to alter the portfolio's risk-return profile. Here, derivative transactions are a way to alter the risk return trade off of local market loans so as to achieve a preferred overall portfolio risk profile. Interestingly, this model seems to be most popular among American banks.

As current practice continues to evolve, the relative merits of each paradigm are being debated. The choice may well depend upon a bank's franchise and special information advantage it possesses about its clients

## **So where does this leave us?**

Thanks in large part to credit derivatives the ability of the financial sector to finance the capital needs of the corporate sector has increased significantly. Bank debt is now freely traded, and attributes can be disaggregated and traded separately in increasingly liquid markets. This has led to the emergence of active portfolio management, ACPM, at all major institutions. This has also led to the separation of portfolio management from origination and servicing with the associated transparency benefits and coordination challenges.

Looking ahead, the opportunity facing lending institutions is to extend the reach of ACPM beyond the large corporate market to mid-market commercial lending, which constitutes the bulk of the typical bank's loan portfolio. Innovative markets will no doubt find ways to make the attributes of these assets more liquid as well. It would not be surprising if this process involved the development of new and even more complex types of credit derivatives.

This is, as Martha Stewart would say, "a good thing." Credit derivatives are now an integral part of the fabric of banking that has transformed the way credit markets operate. They have increased liquidity, improved bank portfolios and reduced the risk of banks seeking to achieve greater efficiency in their credit absorption function in the capital market.

As we focus on the risk that credit derivatives may or may not add to the structure of capital markets, let us remember these beneficial aspects of their use. Changes in the availability of these instruments or restrictions on their use would greatly affect the business and organization of banking – and, not necessarily for the better.