Credit Approval & Limits Management Survey

BY FRANCIS GARRITT

Overview of Findings

A total of 41 institutions participated in RMA's latest market risk survey. The results are particularly meaningful because they represent best practices in the area of credit approval and limits management with regard to both trading and non-trading assets. Most of the surveyed institutions operate principally in North America, Europe, and Asia, with several in Australia. Five respondents operate in South America and one in Africa.

The 61-question survey, conducted between September 27 and October 26, 2007, focused on practices for credit approval and limits-management processes with regard to both trading and non-trading businesses. In addition, the survey asked about institutions' integration of Basel II methodologies into their approaches to risk management of credit and limits.

This survey inventories the current industry best practices with regard to credit approval and limits management. The most revealing aspect of the survey, with the inclusion of leading practitioners, reveals the direction in which the industry is now headed, providing a road map for those institutions currently not following industry best practices.

Key Findings

- A majority of institutions allow the reallocation of exposure limits, with 67% permitting reallocation between trading products for the same counterparty.
- Approximately 60% of respondents use an electronic system for at least part of their approval processes.
- Key variables that differentiate approval processes are exposure (67%), product (64%), risk rating (61%), and counterparty type (56%).
- In-house product and combination in-house/vendor were chosen over 82% of the time to build limits management systems.

"With such a strong response from institutions, this survey serves as a good benchmark of industry practices in credit approval and limits-management processes. The survey showed that credit approval and effective limits management are key elements within the overall credit risk management strategy. All the institutions to varying degrees are monitoring and approving counterparties, exposures, collateral, and limits at an enterprise-wide level across all business lines and at all different levels of consolidation," said Curtis Knight, RMA director of Market Risk.

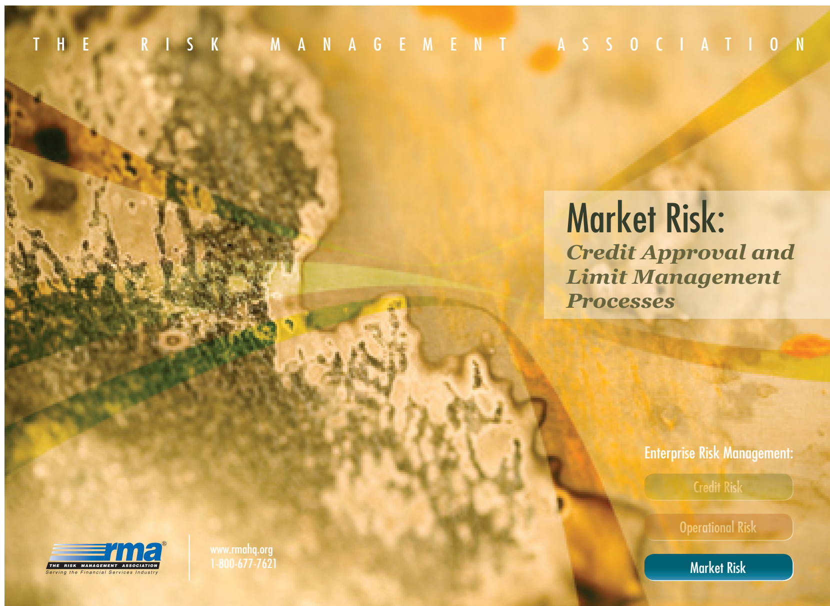
RMA President and CEO Kevin Blakely agreed. "The response to our research effort has been global, making these studies especially valuable to the industry, particularly in the current credit environment," said Blakely. "The landscape surrounding credit and limits approvals for all bank businesses has grown increasingly complex over the past few years, as institutions have embraced additional credit-based products, such as structured finance vehicles and derivatives.

"In addition, technological means of aggregating and distributing data have grown more sophisticated. Looming in the background are the requirements of Basel II that will bring about fundamental changes for many institutions in the way their business lines are viewed."

Summary of Results

Organizational Structure

This section inquired about the structure of credit and limits approval processes in the responding institutions, and there are some clear-cut best practices when it comes to organizational structure.



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—Curtis Knight, RMA

The market risk studies *were initiated by RMA's Market Risk Council, whose members are as follows: Chairman* **Bryan Osmar**, *Royal Bank of Canada, Toronto;* **Geoffrey J. Craddock**, *CIBC, New York;* **Edward B. Dumas**, *State Street, Boston;* **David M. Griffith**, *Washington Mutual Bank, Seattle, Washington.;* **Murray McIntosh**, *BMO Financial Group, Toronto; and* **Dennis P. Wierzba**, *SunTrust Banks, Inc., Atlanta, Georgia.*

RMA and the Market Risk Council would also like to specifically thank **Jim Benninger**, *vice president and senior director of credit infrastructure at State Street, for assistance with crafting and editing of the survey and guidance in writing the final report.*

The results clearly state that best practices with regard to organizational structure are that the signature chain should be involved in final credit approvals, that risk management should be involved in the analysis for credit approval, and that final credit approval authority should reside within the independent risk management function. The results also show that the independent risk management function, especially among leading practitioners, should be responsible for the limits management function.

Nearly half of the respondents indicate their credit approval process includes both a signature chain and credit committee. But what is most revealing is that 83% have the signature chain involved in the final approval process. Respondents are divided when asked where the analysis support for credit approval resides, with nearly 40% pointing to risk management and an equal number selecting a combination of risk management and the business unit. However, a majority of respondents state that final credit approval authority resides with independent risk management, either by itself or combined with the business unit. For leading practitioners, that figure jumps to 90%.

Approval Processes

This section addresses credit and limit approvals from the perspective of scope and differentiation of process based on certain variables. The knowledge needed to address the questions in this section would likely come from risk approvers in the participating institutions.

When it comes to what roles or positions at the institution are key in the approval process, it is clear that the line-of-business head, the risk management approver, the senior risk management approver if different from the head, and/or the risk management head are involved. What the results also show, which is not surprising, is that institutions should have a different approval process based on whether the counterparty transaction is a higher risk to the organization.

The one difference between leading practitioners and all institutions with regard to exposure characteristics subject to limits approval is that, by a slight margin, leading practitioners include assets classes such as CDO and CLO exposures. Given the current market environment, one would expect the remaining institutions to incorporate these into the limits management process.

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Whether the approval system is a vendor-based or in-house solution, the survey unquestionably shows that an institution's approval system should be electronic based. Only one leading practitioner still incorporates a paper-based system. And when it comes to the workflow activities included in the approval process, the one activity included by leading practitioners more often than all respondents is modification.

The approval process is not without its challenges, however. Leading practitioners indicate a number of significant challenges, including:

- Depth of experience with respect to complex structured transactions.
- Documenting verbal approvals and follow-up on limit excesses where approval was given but not yet documented.
- Speed versus not compromising the risk standard.

Other respondents feel there are challenges as well, including:

- Credibility of the credit rating model/statistical model.
- Identifying total counterparty exposure across all lines of business in the bank.
- Timely response to requests and lack of straight-through processing.
- Credit system that is currently an end-of-day batch system, not accounting for intraday trading electronically, so credit limits have to be adjusted manually during the day to track all intraday trades.

Limits Management

The focus of this section was on various facets of limits management, including scope and structure of approach, with an emphasis on netting and collateral considerations. Appropriate respondents would likely come from an institution's trading risk management, though some answers may need input from internal legal or risk analytics functions.

To further the importance of the limits management system, more than 85% of respondents indicate their organizations use an independent limits management system as the system of record for limits management. However, among leading practitioners, this level increases to 100%.

Respondents were asked how their organizations manage limits in three areas: non-trading products, derivatives and repos, and equities and fixed income. Real-time would be the best practice but the most difficult to achieve, especially for non-trading products.

The results clearly show, especially among leading practitioners, that the independent limits management system, either by itself or in tandem with a transaction/trading application, generates an institution's limits exceptions. Also, leading practitioners lead the way with every institution at least in using an in-house solution exclusively (80%) or in combination with a vendor solution (100%).

One best practice with regard to counterparty credit risk is that more than 80% of respondents employ netting in limits management assessment; indeed, all leading institutions do so. In recognizing netting enforceability for credit risk and capital adequacy, respondents indicate they would use several legal steps, most notably in-house legal analysis with an external industry or privately commissioned legal opinion. The external industry opinion would come from an ISDA or BMA/ISMA.

Another counterparty credit risk best practice is that the majority of respondents say their institutions recognize collateral in their limits management measurement. Where collateral is deemed to be enforceable, nearly 44% of respondents say collateral is netted and potential future exposure (PFE) is calculated on either a shortened or time-to-maturity, time-to-liquidation (TTL) basis.

Once again, respondents indicate they would use several legal steps, most notably in-house legal analysis with an external industry or privately commissioned legal opinion. The external industry opinion would, again, come from an ISDA or BMA/ISMA. Leading practitioners show that when assessing collateral enforceability, institutions should consider counterparty jurisdiction, the branch location of the counterparty, the legal entity type of the counterparty, and the type of collateral and the documentation.

Executing a collateral support annex (CSA) is now a common practice in counterparty risk management; it still does not (in a majority of institutions) facilitate a bigger limit with that counterparty. Currently, the CSA only qualifies weaker-rated counterparties and permits longer transactions with them.

Systems issues seem to be the more significant challenges facing the industry with regard to limits management. Such issues include:

- Data integration.
- System shortcomings (what they are and how to identify them).
- Inability to aggregate/allocate limits across variables.
- Multiple limit-monitoring systems, which can create an inefficient use of the approved limit.

- Identifying excesses caused by MTM or new transactions.
- Ongoing change in business activities undertaken with associated booking and risk methodology problems relating to the more complex new activities (i.e., RPI swaps), leading to trades being misrepresented or not represented in the automated limits-management systems.
- The critical need for a timely reporting system that allows an institution to cut the data in multiple ways (e.g., by industry, product, counterparty, etc.).
- Multiple legacy counterparty/issuer hierarchies to be reconciled.

Other significant challenges to limits management are:

- Limit structure is unnecessarily complex, and demand-driven limits setting is inappropriate, particularly for market professional counterparties.
- Ensuring that the limit assigned is appropriate for the hedging/business needs.
- Application of risk mitigants and exposure calculation of structured products.
- Constant change in exposure and corresponding limits while pursuing causes of excesses and violations.
- Identification of "wrong-way exposures" under stress scenarios and consistent representation of credit trading books in a counterparty-limits framework.
- Arbitrary or subjective basis for limits setting and exception authority.

Basel II Deployment

The purpose of this section was to canvass participating institutions about the status of their efforts to meet Basel II requirements as well as determine current and future plans to integrate Basel II metrics in their risk management practices. Knowledge to fill out these questions comes from an institution's Basel II implementation team, though the risk management area may need to be consulted. As part of the process for determining leading practitioners, all must have already implemented Basel II regulations or (at the time of the survey) planned to have implemented Basel II by January 1, 2008.

Nearly 72% of respondents say their institutions are required to adopt Basel II regulations, and 15% plan to implement Basel II. However, among those with no plans to implement at all, over half say they plan to use some other type of economic capital allocation as a proxy for risk. Most institutions not required to adopt Basel II say their institutions are incorporating some of the proposed Basel II methodologies into their day-to-day risk management processes.

Finally, respondents were asked if they experienced or anticipated any difficulties implementing proposed Basel II methodologies in their risk management processes. There was no one outstanding problem, but several institutions thought that information technology development, probability of default/loss given default model integrity and testing, data integrity, user acceptance, and user education would be hurdles to overcome.

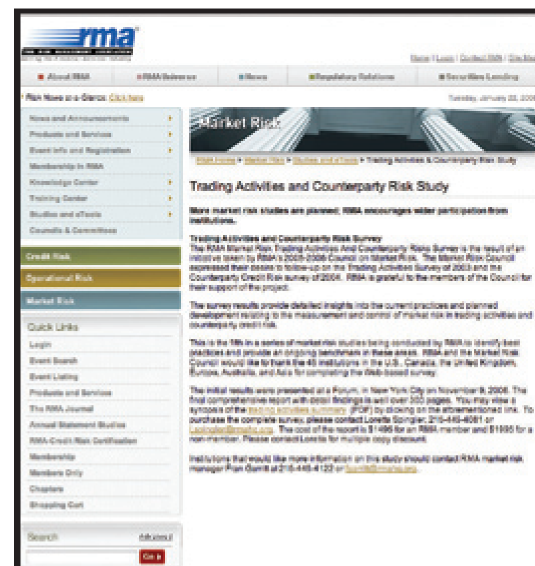
Why RMA Conducted This Study

This Web-based survey, the sixth such survey RMA has conducted since 2000, is part of a long-term effort to identify best practices and provide an ongoing benchmark to help members understand the evolving nature of their market and counterparty risk exposures. The results of this study will provide the basis for further exchanges of information.

Past studies have included:

1. Trading Activities and Counterparty Risk, released January 2007.
2. Technology – Vendor/Service Provider, released 2005.
3. Counterparty Risk, released 2004.
4. Trading Activities, released 2003.

Curtis Knight, RMA's director of Market Risk and Securities Lending, said the market risk surveys produce valuable information for the industry. "The survey results provide useful insights into trends and patterns in the continuing evolution of risk management best practices, covering a wide scope of activities in practical detail," he said. "They are most valuable when practitioners can benchmark their institutions to current industry best practices. This is most helpful when discussing areas of need with management for strategic planning and budgeting purposes and to show regulators where the institution stands in relation to the industry."



The detailed final report for Credit Approval and Limits Management, issued in January 2008 to survey participants, describes the current state of credit approval and limits management processes. It clearly details the most prevalent methods, tools, and decision processes used to determine leading practices. The report is now available for purchase by interested institutions. For more information about this or any of the past studies, or to take part in a future study, contact Loretta Spingler at RMA, 215-446-4122 or lspingler@rmahq.org. ❖

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