Foreword

> "My ventures are not in one bottom trusted, nor to one place; nor is my whole estate upon the fortune of this present year."
> *Shakespeare, The Merchant of Venice, 1596–97*

Credit Portfolio Management – an old topic? In the many centuries of bank history and even before the introduction of institutional lending activities, the basic principles of credit portfolio management remained unchanged. Careful selection of credit risks to avoid losses, and diversification ("Don't put all your eggs in one basket") were the major principles of risk management. However, until the end of the second millennium, the implementation of these principles had been a challenging task.

If the credit quality of an issuer deteriorated, possible reactions were limited to challenging negotiations with the borrower to reduce risk, for example, by reducing lending exposure or by demanding additional collateral. An early recognition of declining quality was a prerequisite to sell credit risk to other market participants. Reducing idiosyncratic risk was only possible through denying additional lending, while regional diversification required the expansion of infrastructure, for instance, enlarging the branch network.

This situation changed dramatically in the last five to ten years. It is not an exaggeration to describe this period as a revolution in capital markets. Credit risk has developed into an asset class of its own, and is well on its way to being on the same level as fixed income, foreign exchange, and equity markets. This is true with respect to turnover as well as the variety of tradable instruments.

The major impulse for this development was the creation of the market for synthetic credit risk, which awakened the credit market from the sleepy phase when syndicated loans, corporate bonds, and collateralized debt dominated. The beginning of this development was characterized by the emergence of asset backed securities (ABS), which allow the transfer of receivables from smaller-sized clients to financial markets. In addition, new investors were encouraged to participate in a market previously dominated by banks.

The most important innovation, however, for the development of credit markets in the last few years was the emergence of credit derivatives, which made credit risk tradable in a very efficient way. The structure of credit derivatives is simple and standardized: very liquid for a huge variety of names and the pricing is rather transparent.

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A special feature of credit derivatives is their suitability as an underlying for more complex structures, so-called derivatives squared, such as CDOs or indices which allow investors to construct exactly the risk profile that perfectly matches their portfolio and strategy. The rapid growth of the synthetic market was accompanied by the trend towards specialized market participants, like credit hedge funds or credit asset managers, which significantly contributed to the further development of credit markets. As the valuation of credits is rather complex in comparison with other asset classes, the credit market provides an interesting platform for quantitative approaches, for example, to identify arbitrage opportunities. This is due to the asymmetrical risk profile of credits. In line with equity markets, correlation in credit markets has a significant impact on the risk and return profile of a credit portfolio. Analyzing credit correlation is far more complex than is the case for equities. It is both exciting and challenging that the credit market is far from being as efficient as equity markets, which offers interesting opportunities but, at the same time, also contains huge risks.

Last but not least, secondary markets have a massive influence on primary markets, as the pricing of credit risk is becoming more transparent, which also affects traditional lending business. This also has an impact on the efficiency of financial markets and in the end on the behavior of companies. The turnover in the synthetic credit market already exceeds corporate debt.

Where do we go from here? It is obvious that this dynamic development will continue, with volumes increasing further, as there is still a huge number of potential market participants who will enter or even increase their activities in credit markets. The variety of instruments and therefore the complexity will increase. Efficiency will rise on the back of an accelerating number of market participants. It will be interesting to see how credit markets will react to a crisis. Indeed, we have already experienced several crises (among others, the General Motors and Ford downgrades to junk status in May 2005), with the credit market demonstrating remarkable stability. However, we have yet to experience a truly major crisis, such as a more pronounced economic downturn or the surprising default of a large, well-known obligor. In such a scenario, we will see whether credit derivatives will reduce systematic risk via diversification, or if they contribute to a domino effect and aggravate the crisis.

This book comes at exactly the right point in time. It presents a broad and comprehensive description of existing instruments and strategies in the field of credit portfolio management.

It is suitable for everyone involved in trading credit-risky instruments, as well as for asset managers and credit portfolio managers in banks.

Credit Portfolio Management – an old topic? This book as well as current developments in credit markets demonstrate the opposite: Credits are currently the hottest topic in the market place!

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