

## Nine Elements of Credit Approval for Cash Portfolios A Behind the Scenes Look

### Abstract

*In this research commentary, we offer a behind the scenes look at the credit approval process for cash investment portfolios. We discuss nine essential components to help clarify a process that can sometimes seem mysterious and intimidating.*

1. *Beyond Ratings – What Makes Cash Unique*
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### Introduction

For some treasury practitioners, the credit approval process for cash investment portfolios can be mysterious and intimidating. In day-to-day operations, they often make credit decisions, directly or indirectly, about their investments solely based on credit ratings. In the post-2008 era, a deeper understanding of the credit process is essential for cash investments, even if one uses outside managers such as money market funds. In this research commentary, we explain nine essential elements in the credit approval process for a cash portfolio.

### 1. Beyond Ratings – What Makes Cash Unique

First, one needs to recognize that credit approval for a cash portfolio is rather different than that of other fixed income investments. In addition to minimum credit requirements such as ratings, fundamental credit features for cash credits include:

- *Minimum Loss Threshold:* In general and by design, cash portfolios have a very low threshold for principal loss. In money market funds, a \$0.01 loss on the net asset value can have grave consequences. Cash credit approval, thus, requires a higher degree of assurance.
- *Held to Maturity Bias:* Unlike trading portfolios, cash investments are often held to maturity. This means that the credits must be resilient in order to endure credit developments and market events until the maturity date.
- *Conservative Bias:* Because of the held-to-maturity bias, cash investments are income producing assets that often do not benefit from principal gains. The need for downside protection always outweighs any desire for upside potential.
- *Priority on Liquidity:* Due to the nature of cash accounts as sources of liquidity, the

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ease of converting into cash quickly and with minimum price concession is a key consideration.

- *Pre-Trade Compliance:* Because of higher demand on safety and liquidity, cash credits must typically be approved before they can be considered as candidates for a trade. Many firms maintain a list of pre-approved credits for this purpose, while non-cash credit departments typically do not.

## 2. The Credit Universe – It’s All About Supply

Another consideration is the availability of suitable investments for cash portfolios, as a strong name is of no use if it does not borrow in short-term markets. The liquidity marketplace naturally draws certain types of borrowers over others.

- *Types of Credits:* Short-term taxable credit instruments often include repurchase agreements, corporate and financial commercial paper (CP), asset-backed commercial paper, and large denomination certificates of deposit (CDs). In the U.S., the credit universe largely consists of non-U.S. banks and a few corporate issuers.
- *Sources of Credits:* The supply of credits typically includes CP dealers and direct CP issuers, CD brokers, dealer inventory of secondary note offerings, and limited new issues of corporate notes. Analysts and traders typically comb through this universe for approval candidates.

## 3. Preliminary Screening – Compliance and Common Sense

From the universe of available credits, credit analysts typically conduct a preliminary screening incorporating investment policy compliance and a common sense approach.

- *Ratings and Restricted Assets:* Most firms have a minimum ratings requirement, such as the single A ratings level (A- from S&P and A3 from Moody’s). Names below this threshold will be immediately disqualified. Firms may also screen out certain asset classes, industries, or countries of issuance to address unique risk preferences. Restrictions may include derivatives contracts, mortgage backed securities, airline credits, or exposure to southern Europe, for example.
- *Story Credits:* Screening also may remove candidates entangled with hot issues such as potential criminal conduct, shareholder litigation and product liability. These issues may be difficult to analyze through fundamental research. The severity of concerns will determine which credits to avoid.

## 4. Macro Analysis – The Panoramic View

Candidates that survive the preliminary screening are subject to further analysis, which may include a top-down macro look and a bottom-up fundamental scrub. The combined outcome from the two exercises may lead to a final credit determination.

- *Purpose of Macro Analysis:* Credit performance does not exist in a vacuum. Many external factors influence a borrower’s credit ratings and its ability to repay principal and interest on time. This is especially true with financial companies,

which tend to be highly sensitive to changes in interest rates, market conditions, and borrower credit statistics.

- *Elements of Macro Analysis:* Relevant macro factors may include economic resilience statistics, government fiscal health, monetary policies, maturity and stability of capital markets, the regulatory framework, interest rates, credit and business cycles, and government support assumptions, among others.

## 5. CAMELS – The Fundamental Process

Fundamental analysis is the meat and potatoes of credit approval. The bottom-up review allows the analyst to gain a more comprehensive understanding of the borrower's credit fundamentals to assess credit strength and ratings stability.

- *The Classical CAMELS System:* This analytical system was developed by U.S. banking authorities to assess a bank's financial condition. The acronym stands for *Capitalization, Asset Quality, Management, Earnings, Liquidity and Market Sensitivity*. Although the CAMELS 1 to 5 scoring system used by banking regulators is unavailable publically, the acronym today refers to the generally accepted method of evaluating financial firms throughout the world.
- *Quantitative and Qualitative Factors:* Assessing a borrower's ability to repay principal and interest is an involved process, guided by the established process of comparative analysis of its business, operating and financial factors against borrowers in similar situations. By definition, fundamental analysis differs from data analysis as it relies on an analyst's judgment, combining qualitative and quantitative factors. Factors under consideration often exceed the classical CAMELS framework.
- *A Dynamic Process:* The analyst may compile a credit model with relevant factors that helps to form credit decisions. Credit metrics may not be directly comparable across industries, countries, stages of a credit cycle, or even firms within a given domestic industry. This dynamic process requires individual examination and ongoing retooling of the methodology.

## 6. Internal Ratings Systems – A Scorecard Concept

The culmination of macro and fundamental research efforts allows the analyst to form a credit opinion. For some firms, the research process ends with an analyst recommendation for credit approval. More established firms may use internal ratings systems to better articulate the basis for credit recommendation.

- *Rationale for Internal Ratings:* Investment firms generally favor their own credit research capabilities over rating agency ratings. Financial regulators also encourage professional money managers to use credit criteria independent of agency ratings. An internal ratings system allows managers to explore opportunities from rating discrepancies.
- *Benefits of Scorecards:* Research firms, including rating agencies, may use a scorecard system to rate individual aspects of a credit. This system allows the user

to understand the strength of specific parts of the credit. It also allows relative strength comparisons among similar credits.

- *Types of Internal Ratings:* Some firms may keep their internal ratings format consistent with established rating agency convention, such as “AA-” or “Low Double-A”. Other prefers a numerical ranking system, such as scores 1 through 5. Others may use generic tier categories to indicate relative strength that include liquidity and maturity preferences.
- *Dynamic Ratings:* In recent years, more firms have incorporated market indicators into internal ratings to be more responsive to current events. These indicators may include benchmark credit default swap (CDS) spreads, bond yield implied ratings and stock price volatility. The dynamic nature of internal ratings may be an advantage over traditional bond ratings, which tend to respond more slowly to market developments.

## 7. Final Credit Approval – A Group Exercise

Finally, committee approval of credit decisions is often preferred over decisions by individual analysts. The formal process provides a platform for ideas to be debated and concerns heard before a credit is approved.

- *Members of a Credit Committee:* In addition to the principal analyst and the head of credit research, key members of portfolio management, trading, strategy, risk management, and executive management teams are likely to be on the credit committee. Because of sometimes conflicting performance objectives, portfolio managers and traders generally refrain from chairing the credit committee.
- *Approval Considerations:* In addition to fundamental credit factors, the credit committee may consider other factors before approving a credit. These may include issuance size and the breadth of the market, liquidity and capital structure, bond dealers’ involvement and general investor perception, price stability and secondary market liquidity during past market down cycles.
- *Forms of Approval:* Because of the unique nature of cash credits, the credit decision is not often a simple “yes” or “no”, but rather a question of approval for “how much”, “how long”, and “for what types of accounts”. The basic tenet is to ensure that, in the best judgment of the committee and over the holding period, the credit will not deteriorate below a set minimum credit and liquidity threshold.

## 8. Monitoring and Surveillance

- *Ongoing Monitoring:* As in many aspects of credit investments, monitoring and surveillance of credit metrics is an essential part of credit approval. Established firms have monitoring mechanisms to track business conditions, markets and products, regulatory actions, equity and bond prices, rating changes and other developments that may impact credit profiles.
- *Refreshed Recommendations:* In addition to ongoing monitoring, periodic reassessment, especially with the release of quarterly and annual financial results, is

important to reassess the original credit decisions. At these intervals, it helps to update credit metrics and refresh research recommendations to revalidate earlier credit decisions.

- *Useful Tools:* External research and technology may help improve effectiveness of credit monitoring. Rating agency reports, Wall Street research, third party research, subscriptions to databases, financial software and analytical packages, automatic alerts and delivery of key statistics are some of the tools that can improve credit monitoring.

### **9. Credit Event Response – Risk Mitigation**

Last but not least, an effective credit approval process must address risk mitigation. Even for credits perceived as safe for cash portfolios, the unexpected can happen and the credit department needs to stay prepared for these contingencies.

- *Tiered Approval Structure:* In our own experience, we find the tiered approval system to be effective in addressing credit surprises. By lengthening and reducing the maximum maturity limits in new purchases as credit conditions evolve, the economic exposure to potentially volatile credits can be significantly reduced.
- *Asymmetric Decision Tree:* Another practice often used by established firms is to give the principal analyst the discretion to tighten credit restrictions unilaterally but to require committee approval to relax them. This asymmetric credit decision tree may allow a firm to limit risk quickly and avoid being whipsawed by going back into credits on a downward spiral.
- *Credit Watch List:* Another useful tool is a credit watch list, which includes “developing” credits with negative implications. The firm may prohibit new purchases but continue to watch existing holdings for changes. Over time, watch-listed securities may reach maturity, be sold if more downside risk exists, or be removed from the watch list if the situation improves.

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