



Principles and Practices in Credit Portfolio Management  
*Findings of the 2011 IACPM Survey*

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## I. INTRODUCTION

Every year, the International Association of Credit Portfolio Managers (IACPM) organizes a number of activities including conferences, training classes, regional meetings, research and surveys which allow practitioners of credit portfolio management to further develop their skills, stay abreast of the latest credit portfolio management techniques, and to exchange ideas with their peers at financial institutions, as well as academics, regulators and other risk experts.

This 2011 Annual Member Survey of Credit Portfolio Management Principles and Practices is the third in a series conducted by the IACPM. The survey was conducted in early 2011, and the institutions that participated account for a substantial portion of

corporate loans. The survey's primary objective is to provide IACPM member institutions with the ability to benchmark multiple aspects of their credit portfolio activities against baselines established by the survey.

It is also intended to provide information that will allow members and other financial institutions to understand the current trends and developments in the field of credit portfolio management. We hope that the survey's findings will provoke conversations and debates within financial institutions that will allow them to improve their credit portfolio management functions, enhance their risk management programs, and contribute to developing more transparency and stability in the financial markets overall.

### *Survey Results Overview*

Following are the key findings of the IACPM's 2011 Principles and Practices Member Survey:

- Senior managements have increased confidence in their credit portfolio management (CPM) functions and view them as integral to forming an enterprise view of risk.
- CPM groups' growing involvement with enterprise-level risk issues, particularly funding and liquidity management, was evident in survey responses.
- The key objectives of CPM are improving portfolio construction, reducing concentrations and improving origination quality.
- Optimizing portfolio risk/return, managing P&L volatility and managing regulatory change have increased in importance during the past year.
- CPM groups' involvement with enterprise-level risk issues, particularly funding and liquidity management, was highlighted in survey responses.
- CPM units primarily hedge based on concentration limits and their own views of potential credit deterioration.
- In the future, a common priority will be to improve discipline at origination from a portfolio management perspective.

## *Credit Portfolio Management Business Models*

While reducing portfolio concentrations and improving return on capital are the main goals of institutions practicing active credit portfolio management, there is not a singular business model employed by the various types of financial institutions who have developed credit portfolio management groups. To some extent this is explained by the length of time institutions have been managing their portfolio and the evolutionary path that has helped develop their organizational structure, reporting lines, assets they have chosen to manage, etc.

Another explanation for multiple business models is that financial institutions' businesses vary in many ways, e.g., wholesale vs. middle-market lending, international vs. regional business orientation, commercial bank vs. universal bank, commercial vs. consumer lending, etc. Regardless of the explanation, the fact is that credit portfolio management practices are being tailored to the needs of a variety of different financial institutions, and even to the specific needs of particular business lines within each institution. Readers of the survey should consider this when reviewing the survey responses.

## II. MAJOR THEMES

### *CPM is integral to risk governance at financial institutions*

Since its inception in the late 1990's, the practice of credit portfolio management (CPM) has evolved significantly. Today, at many institutions, CPM teams now focus on risk and return issues related to the entire firm. As risk management at financial institutions continues to evolve in reaction to market events and regulatory change, particular focus has been placed on optimizing capital and forming an enterprise view of risk. Identifying and measuring credit risks more accurately -- and introducing new methods of managing/hedging these risks -- are now the primary responsibilities of many CPM units.

Historically, many risk management activities were highly specialized and compartmentalized. Today, however, financial institutions are actively integrating formerly separate areas of risk management. CPM interacts with lines of business, senior management and other risk functions to define the firm's overall risk appetite. By helping to refine the credit business model CPM's goal is to maximize returns for appropriate risk taking. CPM has thereby become a catalyst for redefining the credit business model and for the integration of risk management activities within an organization.

### *CPM mandate and responsibilities continue to evolve*

During the recent financial crisis, the benefit of actively managing credit portfolios was validated. CPM units reported increased responsibilities across asset classes as well as the volume of assets for which they are responsible. Just over half of CPM units reported that they managed portfolios in excess of \$100 billion (Figure 1). Of the institutions participating in the survey, 83% reported that they hedged their loan portfolio (Figure 2).

Most CPM units were formed initially to manage corporate loan portfolios. This continues to be the dominant asset type managed: 96% of IACPM members report being responsible for risk management of their institution's C&I portfolio. Results also showed an increase in the number of CPM units responsible for managing their institution's leveraged loan book (66%), a reflection of increased M&A and leveraged loan financing activity. In addition, more members reported being involved with their institution's real estate and consumer finance portfolios and counterparty risk (Figure 3).

With regard to corporate loan portfolios, the CPM units surveyed reported having primary or co-responsibility for activities that helped shape the structure of the portfolio: hedging (70%), securitization (68%), research (64%) and secondary sales (59%) being the most important. Influencing the quality of the portfolio at origination has also become more important: 52% of CPM units reported acting in an advisory role to originators. Recent changes also include a decline in the number of institutions investing via a long book for diversification (Figure 4).

*Figure 1*

Portfolio size covered by CPM unit  
(total amount including commitments)

Less than \$50 billion	11 %
\$50 billion to \$100 billion	34 %
\$100 billion to \$200 billion	25 %
\$200 billion to \$300 billion	9 %
\$300 billion to \$500 billion	12 %
Greater than \$500 billion	9 %
<b>Total</b>	<b>100%</b>

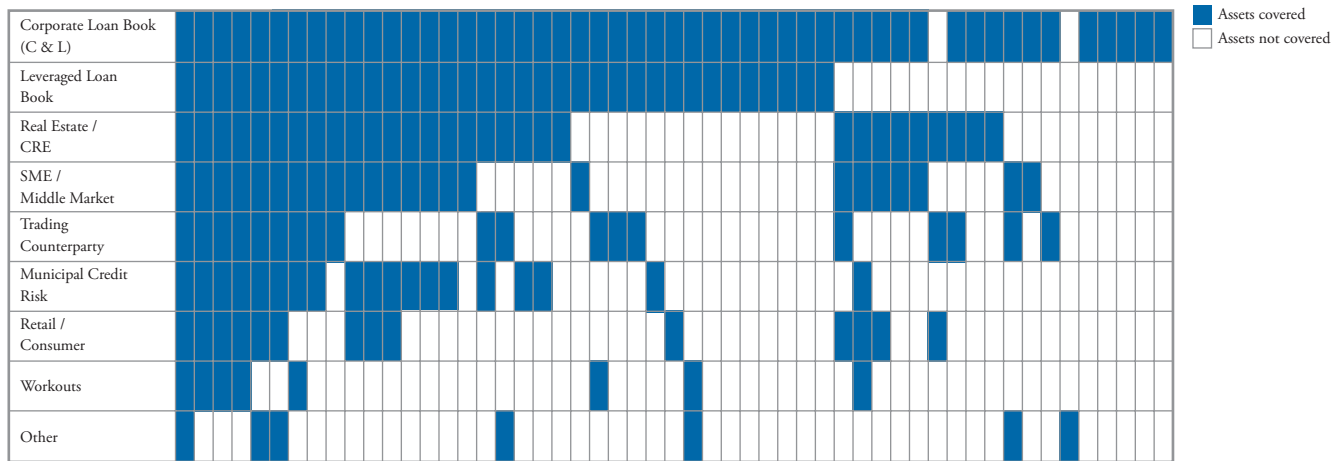
*Figure 2*

Derivative hedge book relative to  
loan portfolio (*notional terms*)

> 10%	15 %
1 - 10 %	68 %
0 % (we do not hedge)	17 %

Figure 3

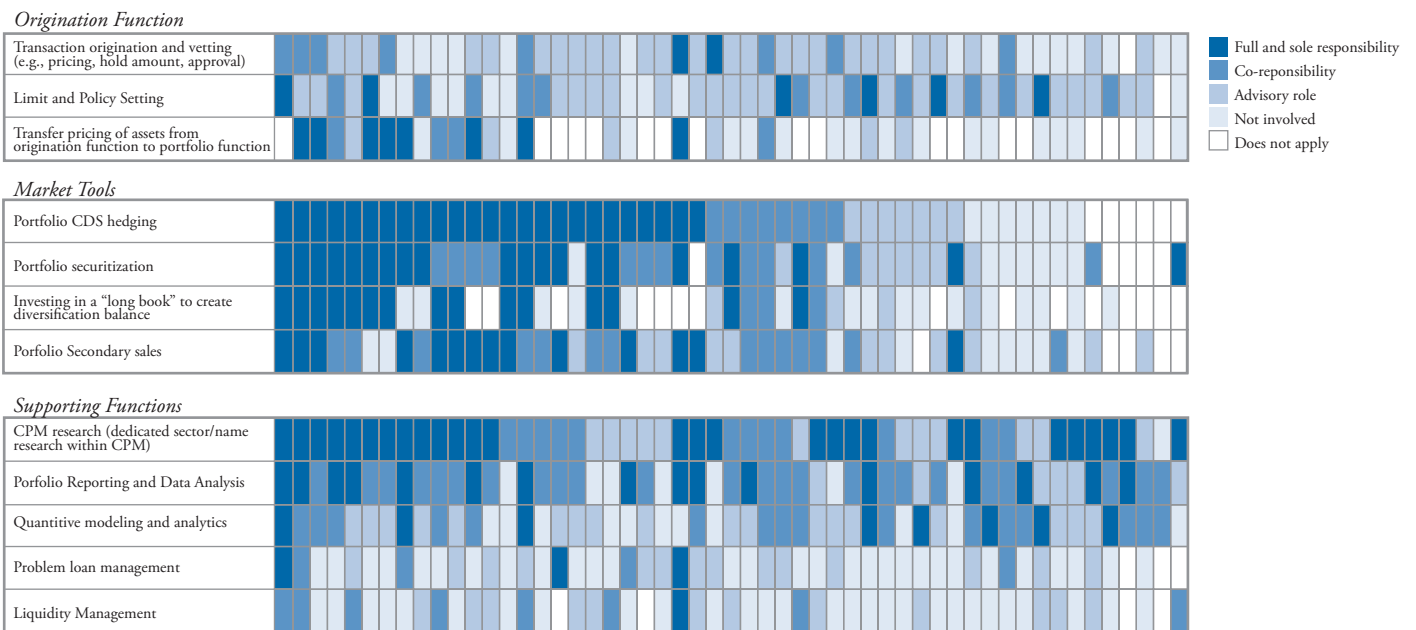
Overview of CPM unit’s risk management responsibilities



Note: Each column represents the response of one participating bank.

Figure 4

CPM unit’s degree of functional involvement (for the Corporate Loan Book only)



Note: Each column represents the response of one participating bank; shaded cells indicate degree of involvement (see legend top right corner).

According to this year's survey respondents, the primary objectives of their CPM units include (Figure 5):

- Improve portfolio structure and reduce concentrations
- Provide portfolio information
- Help guide origination
- Manage maximum risk appetite
- Support management of capital and returns

These objectives are consistent with the institutional goals of refining their credit business models, more accurately measuring credit risks, and optimizing capital. Most CPM units reported that they influence loan pricing at the time of origination via a capital pricing model, transfer pricing or specific loan pricing at origination (Figure 6).

In keeping with the overall trend reflected in the prior surveys, the CPM concept continues to expand from corporate loans to other assets. Interestingly, 43% of members responded that there were multiple CPM units within their firm. Firms with multiple CPM units reported that regional offices and lines of business/asset types were responsible for this growth.

Over time, CPM groups have become involved with a broader range of assets. Commercial real estate (57%) and the middle market (47%) exposures were the most significant areas beyond C&I and leveraged loans. In addition, roughly one-third of members work on trading counterparty exposure and municipal credit risk, and 26% manage consumer assets (Figure 3).

Many of the skills developed in the original corporate loan CPM units are being utilized to manage these other assets. When CPM units reported being involved with trading counterparty exposure, middle-market loans and commercial real estate, the activities they were most involved with included portfolio reporting and analysis, modeling and analytics, limits and research.

More recent changes to the CPM mandate include involvement with other balance sheet assets (e.g., investment portfolio), and balance sheet management (e.g., asset liability management and funding).

*Figure 5*

Key objectives for CPM units in 2011  
(multiple selections are possible)

Improve portfolio structure, reduce concentrations	77 %
Provide portfolio information	74 %
Help guide origination	70 %
Manage return on Equity, RAROC or similar target	60 %
Optimize Risk and Return (either quantitative or qualitative)	58 %
Manage maximum "risk appetite" target	57 %
Manage P & L volatility and absolute P & L or similar target	53 %
Manage RWA usage	51 %
Managing Regulatory Changes	43 %

*Figure 6*

CPM's influence on loan pricing at time of origination (multiple selections are possible)

Directly, via specific loan pricing input to origination	13 %
Indirectly, via specific RAROC or other capital approach pricing model	53 %
Indirectly, via market based transfer pricing	26 %
No influence on loan pricing at the time of origination	21 %

## *CPM focuses on risk and return activities*

Survey findings indicated greater involvement by CPM groups across the entire spectrum of risk management activities, from increased involvement as assets are originated, to the ability to affect the risk content and structure of the portfolio over time.

An important distinction between the responsibilities of current credit portfolio groups and other specialized risk management functions is the execution capability of CPM. With the focus on managing risk in the context of expected returns, CPM can impact the overall portfolio return in a number of ways: distributing risk by selling it, hedging risk with CDS, and diversifying by buying assets not naturally generated by the underlying business.

Before actively managing risk, CPM groups invest considerable time and effort in identifying and measuring credit risks and modeling and analyzing the results. Improving analytic rigor and providing high quality data is key to developing strategies to manage the portfolio. Fully 78% of IACPM members report complete or co-responsibility for decision-making on portfolio reporting and data analysis activities, and another 12% act in an advisory role. A total of 80% report direct/indirect involvement with quantitative modeling and analytics with regard to the portfolio (Figure 4).

Another building block of active credit portfolio management is the degree of responsibility for the credit portfolio P&L. While 79% reported CPM as being a cost center, 50% of cost center CPM units noted that the P&L is considered when assessing the performance of the CPM unit. In addition, a small proportion (21%) of survey respondents reported being a profit center. There is also a noticeable shift away from a centrally allocated budget for hedging activities: 47% responded that they are charging all or some portion of hedging costs to business units (Figure 7).

When managing the credit portfolio, members reported that the most important tools they applied were discipline at origination (e.g., the use of concentration limits), 88%; single name hedges (CDS), 70%; and loan sales/purchases, 53%, while securitization and CDS index products usage declined (Figure 8).

CPM units are involved with shaping the portfolio at different stages. This is a key ingredient to the role that CPM plays in bringing the market to other parts of the organization. A total of 70% of CPM groups cited helping guide origination as a primary objective (Figure 5).

Origination practices have evolved to incorporate more refined limit and concentration policies, pricing tools and a portfolio management perspective. Today's origination process asks the question "Does adding this asset make sense from an overall portfolio perspective?" instead of considering individual transactions solely on their own merits. Strategies to guide pricing -- either through market-based transfer pricing or capital related mechanisms -- are mentioned as important tools to influence loan pricing at origination.

Hedging is the key execution capability of CPM units and a distinguishing characteristic of CPM relative to historical risk management operations. As for the timing of hedging, virtually half of CPM units (49%) responding indicated that they have the flexibility to make hedging decisions when necessary to hedge potentially deteriorating situations in a cost-efficient manner, reflecting a shift away from a fixed time period after origination (Figure 9).

Managing the mark-to-market volatility of hedges continues to be a challenging area for CPM managers: 30% of CPM units report investments in offsetting hedges as their mechanism for managing mark-to-market volatility, and 30% report not managing the mark-to-market volatility (Figure 10).



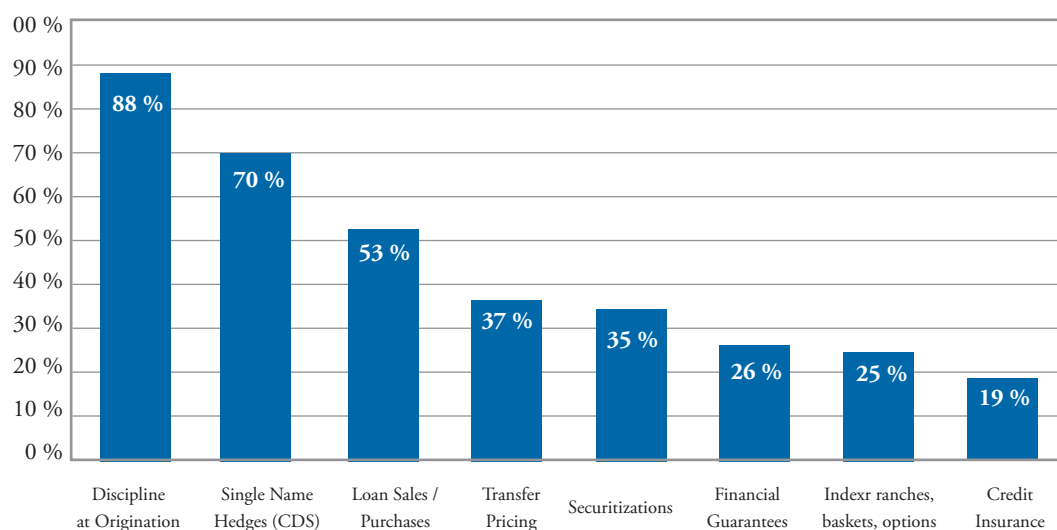
Figure 7

## Funding of CPM hedging activities

Centrally allocated budget	40 %
Charge the business line the accrual cost (and bear the mark-to-market volatility)	30 %
Mark-to-market / model shortfall payments charged to business units	17 %
Risk taking (e.g., writing protection)	19 %

Figure 8

## Tools Used to Manage the Credit Portfolio by Importance



Note: Percentage of survey participants that are using any given tool to manage their Credit Portfolio

Figure 9

## Timing of hedging or sales decisions

(multiple selections are possible)

When CPM has a view that credit quality of a name will deteriorate	49 %
View on market direction	32 %
Fixed time period after origination for hedging / sales to be completed	25 %
P&L market risk management considerations	23 %

Figure 10

## Management of mark-to-market volatility of hedges

Through investments offsetting hedges	30 %
Through fair value accounting for loans	17 %
Through hedge accounting	13 %
Not managed but disclosed to investors	11 %
Not managed or separately disclosed	19 %
Other	10 %

### *Strong internal support*

The worldwide financial crisis created a number of challenges for the institutions surveyed: substantial staff cuts and organizational changes were the most commonly cited effects of the crisis. Much thought was also given to revising risk management practices.

Answers to several survey questions suggest that senior managements regard their CPM functions highly and as a critical component of their risk management enterprise. Senior managements' overall confidence in CPM was viewed as "improving" by 70% of the responding institutions.

Members reported increasing involvement in activities beyond their traditional scope. It can be inferred from the responses that during the recent stressful credit environment CPM units' range of skills and communication/partnership with businesses were viewed favorably, and is resulting in expanding mandates for the credit portfolio management function.

### *Developing issues*

The survey asked IACPM members what changes they have been dealing with, and what their top priorities for the next 12 months were likely to be. Responses tended to reflect the particular stage the evolution of the CPM function was at each institution.

For example, early adopters of credit portfolio management focused on extending their platforms to new products, improving pricing discipline, managing P&L volatility, managing counterparty risk and focusing on capital issues. More recent CPM units noted building distribution capability, building modeling skills and improving portfolio data and analysis. Improving discipline at the time of origination and liquidity management were also noted as key issues going forward.

### III. CONCLUSION

The IACPM's 2011 *Annual Member Survey of Credit Portfolio Management Principles and Practices* highlights the continuing growth and evolution of active credit portfolio management by large financial intermediaries. In reaction to the financial crisis, banks have re-engineered various aspects of their risk management organizations with one major outcome being an expansion of the range of assets and activities with which CPM groups are involved.

From a demographic perspective, the trends highlighted by the survey are not only present in institutions operating in cross-border financial markets, but are increasingly being adopted by financial institutions operating regionally. Managements are seeking to enhance their risk organizations' capabilities to reduce future potential credit losses, and the skills developed by CPM groups are being applied more widely to accomplish this goal.

### IV. ABOUT THE IACPM

The International Association of Credit Portfolio Managers (IACPM) is an industry association established in 2001 to further the practice of credit portfolio management by providing an active forum for its member institutions to exchange ideas and act collectively. The Association holds conferences and regional meetings, conducts research in the credit portfolio management field, engages in other activities relating to the measurement and management of credit exposures and represents its members before legislative and administrative bodies in the United States and internationally. More information about the IACPM may be found at [www.iacpm.org](http://www.iacpm.org).

While IACPM's member firms comprise the world's largest financial institutions, the IACPM represents a very specific constituency within those firms. IACPM members are the teams that have responsibility for managing credit portfolios. At a bank, for example, our members would be the group responsible for managing the bank's loan portfolio. Their primary objective is to strategically manage the return of the portfolio relative to the risk assumed. They do this by actively controlling concentrations and diversifying the portfolio, as well as applying other risk management techniques. At many institutions, our members also manage counterparty risk related to derivatives exposure.

In carrying out these responsibilities, credit portfolio managers contribute to the overall risk management of the enterprise. Importantly, this also allows them to make credit more available to their clients, which is vitally important in the current environment.

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