

International Association of Credit Portfolio Managers

Principles and Practices: 2015

Expanding Role of Credit Portfolio Management



Survey Goal

IACPM Members share their views on the state of CPM today, their priorities, goals and objectives, and how the practice is evolving and expanding in terms of structure, reporting, tools and its role in the enterprise.

EXECUTIVE SUMMARY

The International Association of Credit Portfolio Managers (IACPM) recently conducted its *2015 Principles and Practices Benchmarking Survey*. This Survey, conducted every other year, looks at the evolution of credit portfolio management (CPM), organizational structures, mission and mandate, tools, and outlook for the future. The goal of the Survey is to allow firms to benchmark their practices versus those of other leading financial firms. Sixty-one member firms located globally participated in the 2015 Survey.

KEY FINDINGS

While the credit cycle is fairly benign, firms are facing the ongoing challenges of integrating risk management across a widening array of risks and asset classes. Among the current challenges are: credit and market volatility in some geographies; changing global and local banking regulations; and increasing focus on enterprise risk management including capital and liquidity requirements.

Many firms are expanding the scope of their CPM models to include more strategic level functions, more linkages across the firm and more asset classes. The new CPM functions include advisory roles, and in some cases decision or co-decision making roles in: cascading risk appetite frameworks; limit setting and stress testing; liquidity management; and addressing regulatory changes. In addition, there are growing linkages between CPM and other areas of the firm such as liquidity and asset liability management, finance and balance sheet management, market and operational risks, and enterprise level risk and policy functions.

CPM is a senior function at most firms. Over half of responding firms have only one or two reporting levels between the head of CPM and the CEO. CPM reporting lines continue to evolve and are fairly evenly split between “Line of Business” and “Risk” (roughly 40% each) with smaller percentages reporting to Finance/Treasury and other areas.

Origination tools continue to have the highest importance. Of those tools, setting/managing concentration limits, participation in the deal decision making process (directly or indirectly via models) rank the highest. **Market tools also remain important** with loan sales and single name CDS in primary usage.

Capital measurement approaches continue to evolve between economic and regulatory capital. Responses show that two years ago economic capital was of highest importance by a slim margin. Today regulatory capital is of highest importance by a wide margin; and two years from now the expectation is that both economic and regulatory capital will be equally important by a wide margin.

Responding firms see continued expansion for CPM’s role looking forward – specifically in the strategic and enterprise level functions. Among the factors driving the continued change are: goals of implementing a holistic approach to risk management across the firm; the impact of new regulations; and broadening requirements to improve data and risk aggregation via stress testing, risk reporting and analysis.

The data continues to show **multiple organizational structures and mandates for CPM.** There is not one way of implementing the discipline. Specific approaches reflect the nature of the firm, its management, and its portfolio and seem likely to continue to evolve over time to adjust to the changing risk management, credit and regulatory environments.

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I. INTRODUCTION

“Risks should be identified, monitored and controlled on an ongoing bank-wide and individual entity basis. The sophistication of the bank’s risk management and internal control infrastructure should keep pace with changes to the bank’s risk profile, to the external risk landscape and in industry practice.”

-Principle 7, Corporate Governance Principles for Banks, Basel Committee on Banking Supervision, Consultative Document, October 2014

Credit Portfolio Management (CPM) has grown and deepened as a discipline over the past 20 years in response to financial institutions’ continuing efforts to measure credit risk more accurately and to manage it more effectively across the firm. The IACPM conducted the *2015 Principles and Practices in CPM Survey* to provide benchmarking on the evolution of firms’ credit risk management practices and CPM. The goal of the Survey is to provide a snapshot of current practices and issues for the future, and to allow firms to benchmark their organizational structure, mandate and tools against those of leading financial institutions globally.

Among the topics addressed in the *Survey* are:

- Defining the Portfolio
- Organizational Structure and Mandate
- CPM Objectives and Resource Time Allocation
- Implementing the CPM Mandate: Tools and Execution
- CPM in the Future: Evolution and Challenges

The *IACPM 2015 Principles and Practices in CPM Survey* results include responses from 61 participating firms globally. *See appendix for full demographics.*

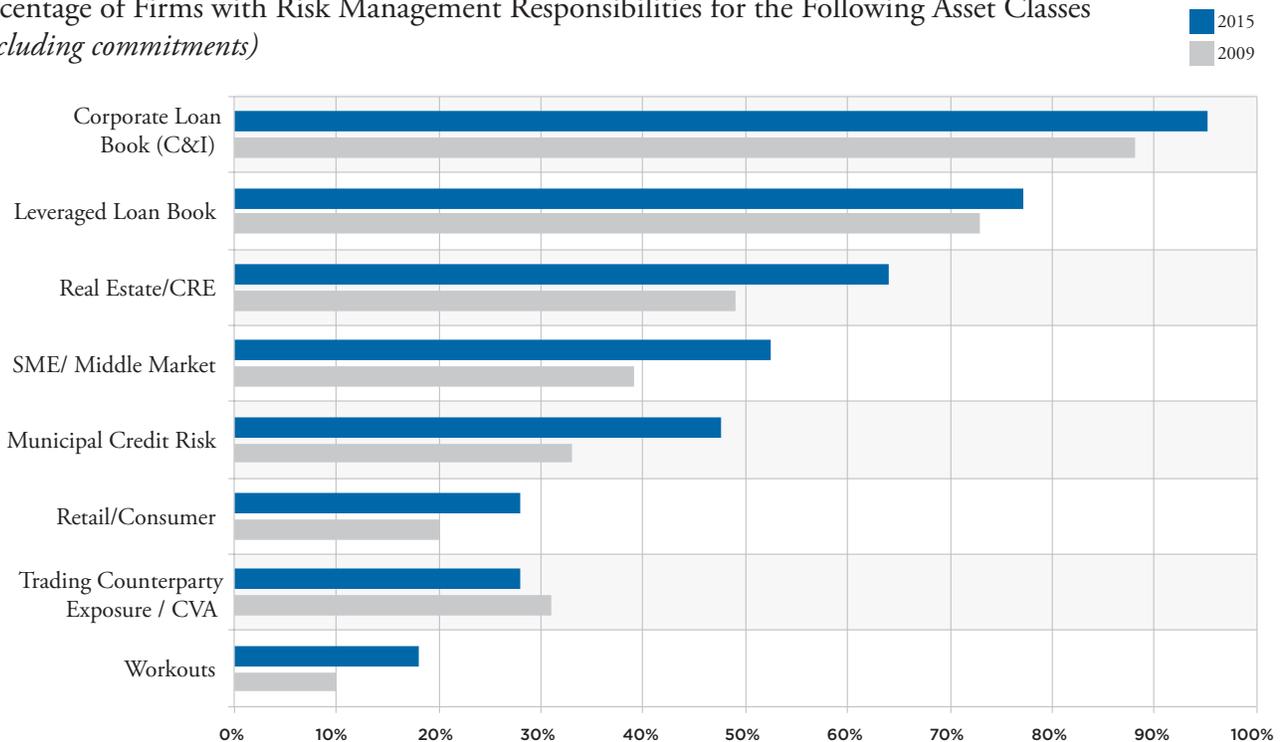
II. DEFINING THE PORTFOLIO

There are **many organizational models for types of credit assets** that are covered by CPM, and the approaches continue to evolve. Models show a range of coverage which seems to reflect the size of the firm, the nature of the firm, and types of portfolio assets, as well as factors such as management and the firm's organizational structure.

From 2009 to 2015, the vast majority of CPM units maintained responsibility for the corporate loan book (90% or more). Areas such as the leveraged loan books have been stable to slightly increasing in CPM coverage responsibility over the time period (73% in 2009 to 77% in 2015), and there have also been increases in CPM coverage for real estate/CRE (49% to 64%) and SME/middle market (39% to 52%). Other areas of increased coverage for CPM have been municipal risk and retail. (Figure 1)

Figure 1

Percentage of Firms with Risk Management Responsibilities for the Following Asset Classes (including commitments)



III. ORGANIZATIONAL STRUCTURE AND MANDATE

Expanding Functional Responsibilities

CPM functions expanded over the past two years along a number of dimensions. The Survey queried member firms on “sole responsibility”, “co-responsibility” and “advisory” functions (and “not involved” or “NA”). After adjusting for those who are not involved or for whom it does not apply, weighted rankings suggested that for many CPM functions the role is an advisory one or in some cases co-decision making. These roles seem consistent with the growing linkages within the firm cited by respondents and the increasing integration of risk management across assets and types of risk.

Core CPM functions – interface with **origination, portfolio reporting and analytics, and market tools** - remained at the top levels on the weighted scale, and included a range of co-decision making and advisory

roles. Portfolio market tools and origination moved slightly toward the advisory role and away from co-decision making.

Among the newer areas of focus are **linkages and responsibilities related to governance and strategy**: high and/or growing involvement – on an advisory/co-responsibility basis - in limits and concentration management; capital stress testing; cascading of the risk appetite frameworks; capital management; and managing regulatory changes. In all cases for these strategic or enterprise-level functions, responding firms showed growth in involvement over the past two years, with further growth in CPM’s role expected over the next two years. (Figure 2)

Figure 2

CPM’s Functional Responsibilities in 2015 and During the Past 12 to 24 Months



Weightings used in calculations:

1-Advisory Role, 2-Co-responsibility, 3-Full & Sole Responsibility & Decision Making

Weighted Average Involvement (for firms involved with the function only)

Reporting Lines

CPM units report primarily to **Risk and Line of Business** and, to a lesser extent, **Finance/Treasury**. Organizational reporting has shifted slightly toward both the “risk reporting” CPM model and to a lesser extent to Treasury/Finance in 2009 to 2015 and very slightly away from **Line of Business**. Some significant **regional differences** exist, with the majority of institutions in Europe reporting within the **Line of Business** and the majority in North America reporting within **Risk**. For Asia, most are reporting to Line of Business. (Figures 3 and 4)

Seniority

Within the organization, **CPM is a senior function**. Some 60% of CPM units are located organizationally within one to two levels of the CEO. (Figure 5)

Figure 3

CPM Reporting Line Over Time (2009 - 2015)

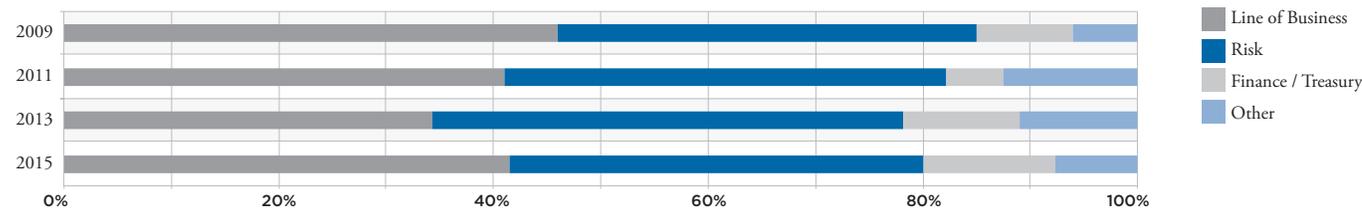


Figure 4

CPM Reporting Line by Geography

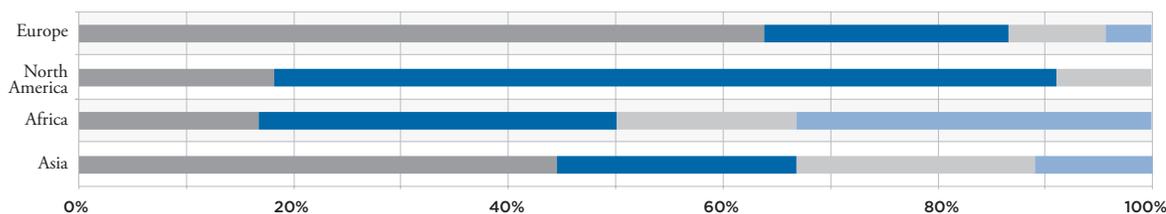
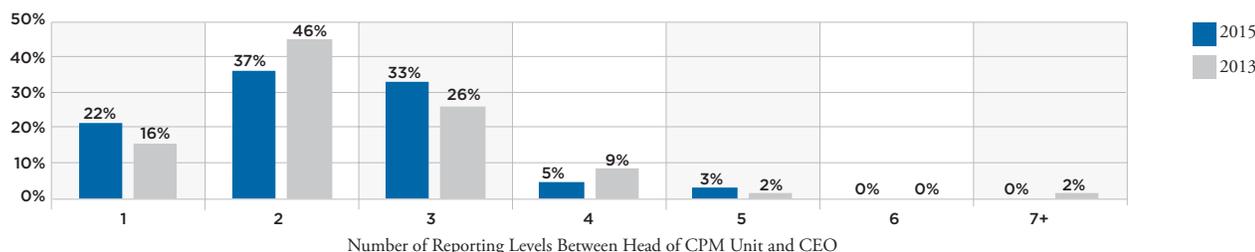


Figure 5

Number of Reporting Levels between Head of CPM and CEO



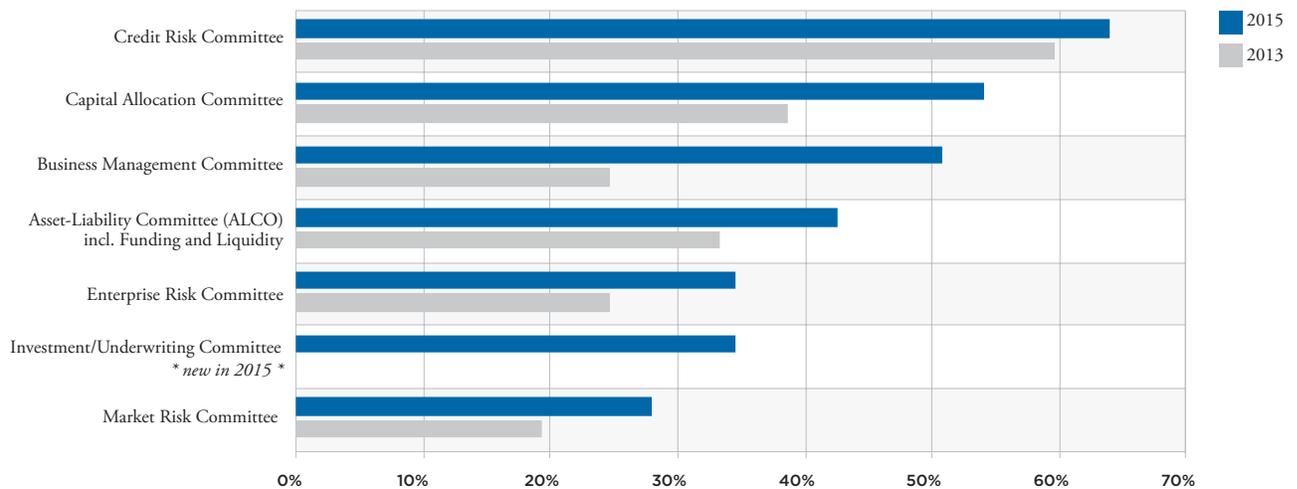
Expanding CPM Linkages within the Firm

CPM responsibilities and linkages within the organization continue to expand. While many of the Survey responses show the linkages in a number of ways, the data shows it clearly in Committee structures within the firm. The participation of CPM on committees – including voting and non-voting roles - increased between 2013 and 2015 for all committees for which there is survey data: Credit Risk, Capital Allocation,

Business Management, Asset Liability, Enterprise Risk Management, and Market Risk Management. It is also worth noting that roughly one-third or more of respondents indicated that they have a voting role on the Credit Risk Committee, the Capital Allocation Committee and the Business Management Committee. (Figure 6)

Figure 6

CPM's Committee Representation



IV. CPM OBJECTIVES AND RESOURCE TIME ALLOCATION

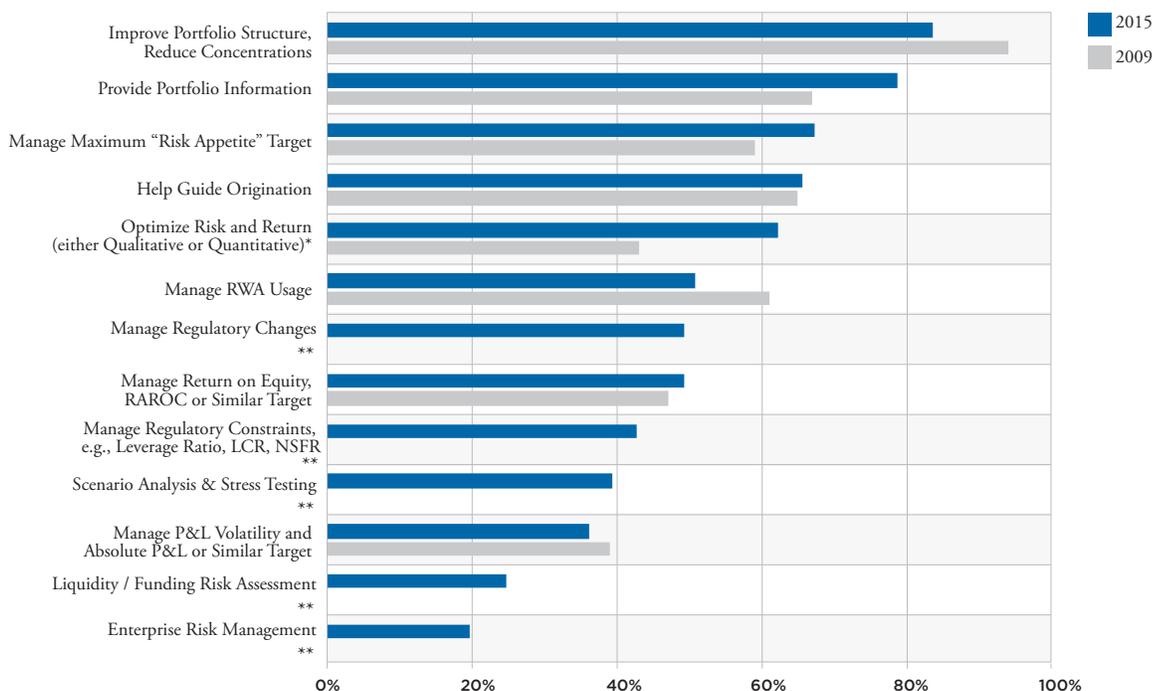
CPM Objectives

Over half of responding firms indicated eight primary objectives for their CPM function. Of these objectives, those increasing in importance in the period 2009 to 2015 are: providing portfolio information; managing maximum risk appetite; and optimizing risk /return. There was a decline registered in improving portfolio structure (from 94% in 2009 to 84% in 2015), possibly reflecting the more benign credit environment. There was also a decline in Managing RWA (from 61% to 51%), though it is possible that RWA is now being

addressed more from the standpoint of risk/return management which increased over the time frame as noted above. The other 50%+ key objectives remained roughly unchanged in their high degree of importance over the time frame, including helping guide origination (65%) and managing regulatory changes/regulatory constraints (50%). Additionally, there were other objectives cited as important at material but lesser percentages including, stress testing, liquidity/funding risk assessment, and enterprise risk management. (Figure 7)

Figure 7

CPM Key Objectives Over Time



*In 2009 this option read: "Optimize Risk and Return (i.e., manage to Sharpe ratio or similar target)"

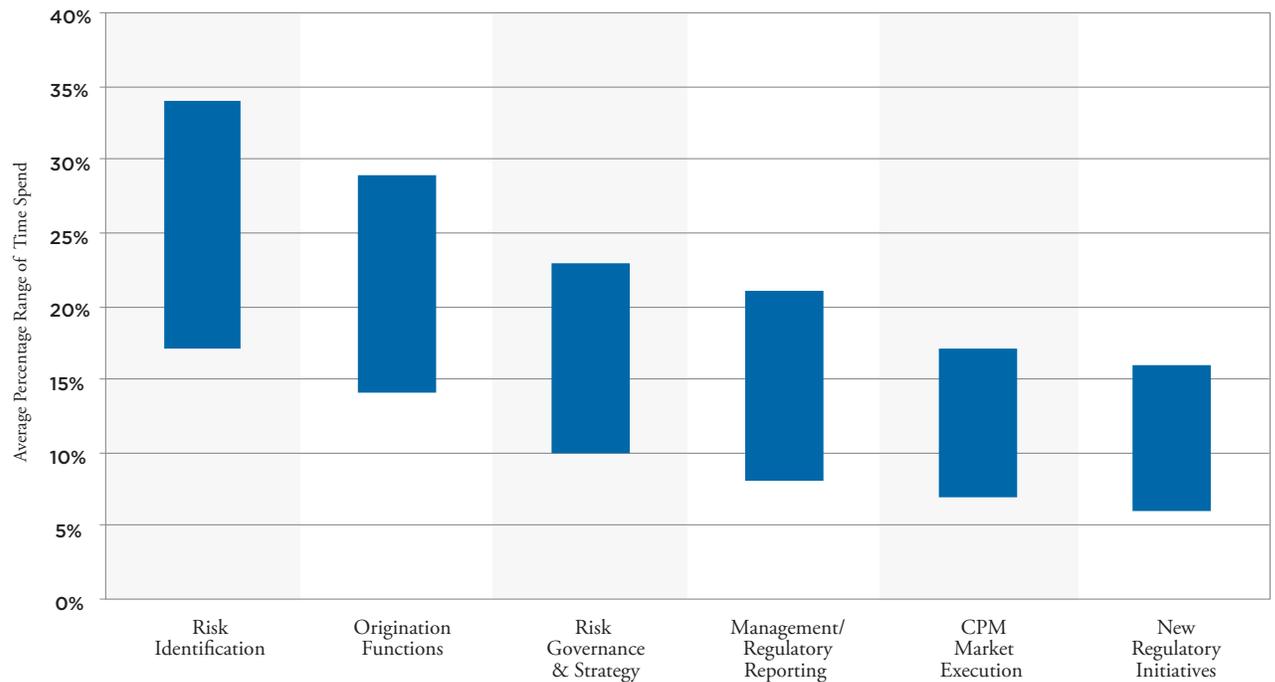
** Option added after 2009

Resource Time Allocation

To meet their objectives, CPM units allocate time resources in a range of ways. Among the top functions are: 1) risk identification and portfolio data management/analysis; 2) origination functions with line of business; 3) risk governance and strategy; and 4) management of regulatory initiatives and reporting. Smaller time percentages were reported for market execution and assessing/managing new regulatory initiatives. (Figure 8)

Figure 8

CPM Resource Allocation



V. IMPLEMENTING THE CPM MANDATE: TOOLS AND EXECUTION

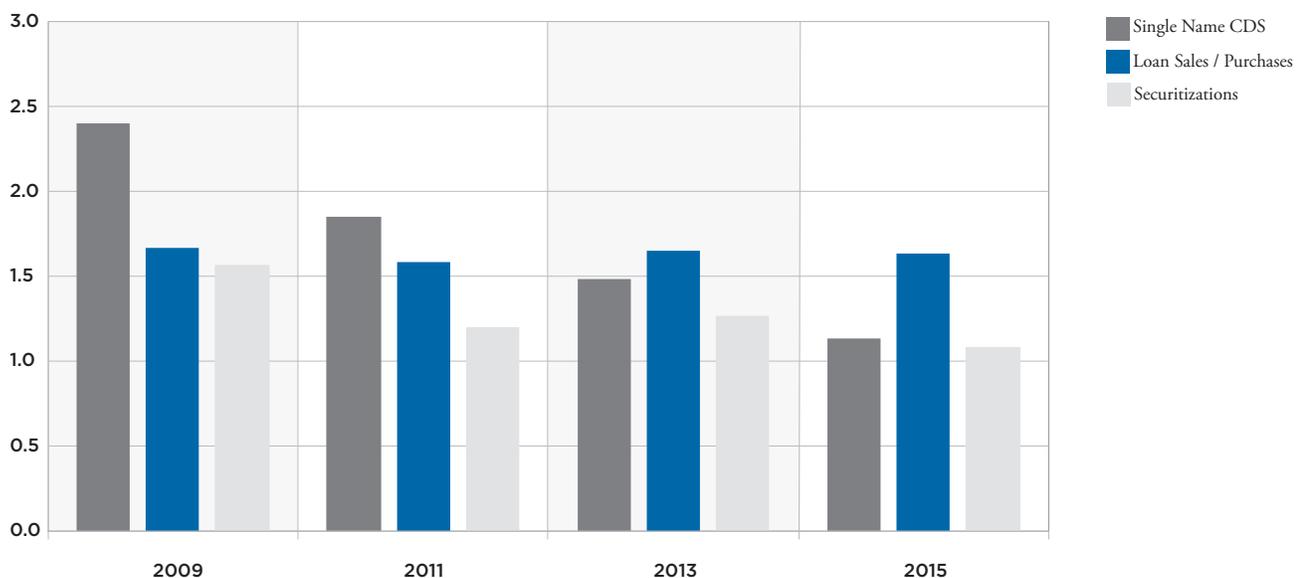
Origination-focused tools remain the most important in CPM's toolkit. Weighted by importance, CPM units reported that **discipline at origination** and **concentration limits** ranked highest (2.3 average importance weighting) as they work to achieve their portfolio goals and objectives. In addition, other origination-focused tools - including the **discipline of portfolio perspective in the deal decision process** and the **management of regulatory and economic capital thresholds** - were at the top of CPM tools. **Market tools** also are important for CPM units, ranking just behind **origination tools**. Among **market tools**, **loan sales** are ranked "most important" or "somewhat important" by about 60% of respondents. Single name **CDS** are ranked

"most important" or "somewhat important" by about 50%. It is worth noting that, given the changes and evolution in market and regulation, CDS has declined sharply in ranking since 2009, falling from over 80% ranking the tool as "most important" or "somewhat important" to about 35% percent in 2015. Concurrently **loan sales** have risen slightly to exceed CDS in importance, but still rank well below **origination focused tools**. Other tools such as **credit insurance** and **financial guarantees** have increased slightly in importance ("most important" or "somewhat important" ranking) over the time period while **securitizations** and **index tranches** have declined slightly. (Figure 9)

Figure 9

Relative Importance of Selected CPM Tools Over Time

(Weighted by Importance with 3 = Most Important)



In terms of **portfolio hedging activity**, there is a difference in hedging behavior between banks with balance sheet assets larger than \$500 billion and those below that number. Roughly one third of the smaller institutions do not hedge, while among larger institutions only 8% indicated no hedging activity. Single name hedging percentages have declined markedly, however, with 33% of larger institutions indicating that up to 10% of their portfolios is hedged, down from 80% of larger institutions indicating an up to 10% hedge percentage in 2013. Generally, responses regarding hedging activity seem to reflect the nature of the firm's assets and their liquidity and the evolving liquidity status for single names in the CDS market. (Figure 10)

Capital measurement tools continue to evolve, with balance shifting between economic capital and regulatory capital. Survey responses show that two years ago economic capital was ranked as the most important by a slim margin (36%) and that many considered both **economic capital** and **regulatory capital** equally important (32%) at that time. Today **regulatory capital** outweighs **economic capital** as having highest importance within the firm (50%+). Looking forward two years, the expectation is that the two will be equally important again – and by a wider margin: both equally important (53%) vs. **regulatory capital** (32%) and **economic capital** (15%). (Figure 11)

Figure 10

Size of Credit Derivative Hedge Book Relative to Credit Portfolio in Notional Terms
(by Balance Sheet Asset Size)

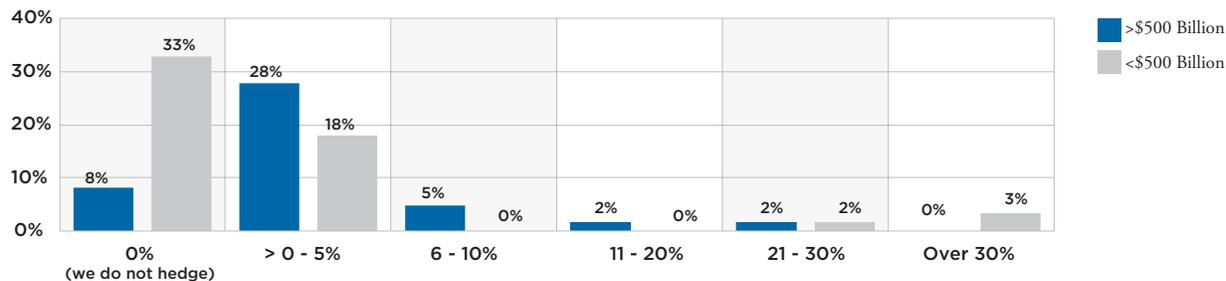
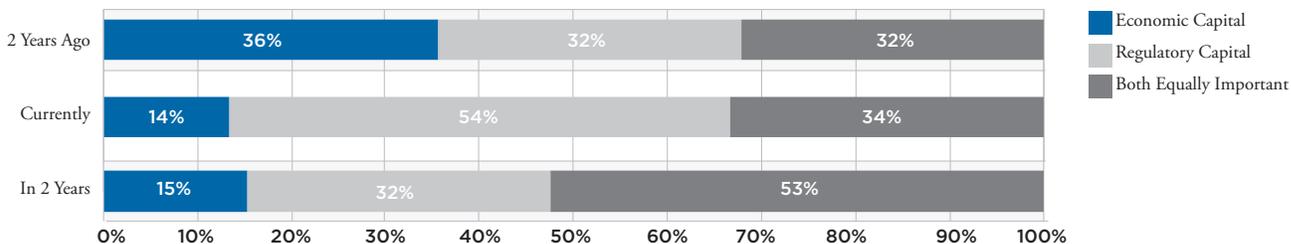


Figure 11

Evolution of Capital Management Tools



VI. CPM IN THE FUTURE: EVOLUTION AND CHALLENGES

The 2015 Survey highlights that over the past six years CPM has continued to evolve and expand in a number of material ways. Looking ahead over the next 12 to 24 months a number of challenges remain, including the following:

Facilitating Portfolio Origination and Revenue Generation

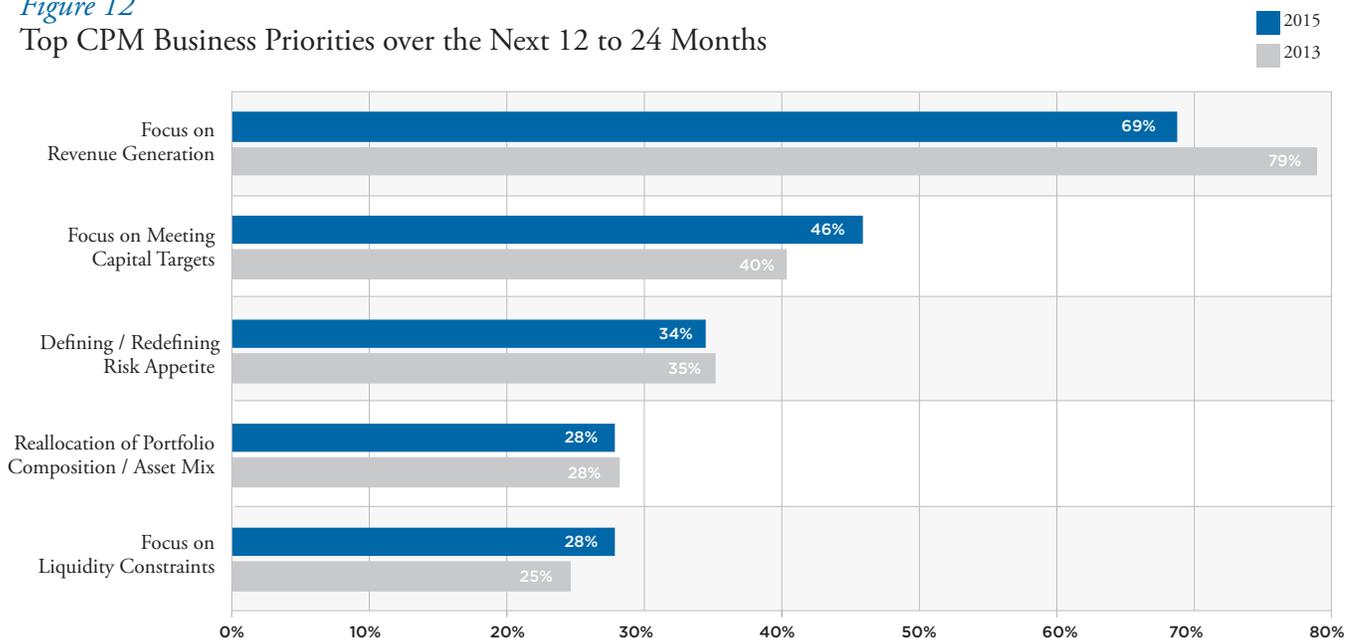
The 2015 Survey shows continued emphasis on revenue generation as the firm-level business objective and brings ongoing pressures to grow, and moreover, to grow in ways that meet desired return thresholds. (Figure 12) CPM will continue to have a prominent role to play in facilitating revenue growth, balancing revenues vs. returns against evolving capital measures, as well as working with lines of business regarding client exposure strategies. CPM will continue to face the dual challenges of managing concentrations in core businesses and industries where portfolio origination is targeted – both at the time of front-end origination as well as via market distribution strategies where/as available and appropriate.

Toward Holistic Risk Management

Most institutions indicate that priorities include **integrating risk assessments across the firm** through risk appetite statements, **enterprise level allocations** of capital to lines of business, and **linkages of liquidity and funding with other market and credit risks**. For many firms, CPM expects to have an expanding role – formally or informally – in establishing and executing these governance and strategic resource decisions. These roles will entail increased coordination and partnership with enterprise risk management, Treasury/ALM and with lines of business that are originating assets, in addition to execution of market strategies that may be needed to add, hedge or reduce exposures.

Figure 12

Top CPM Business Priorities over the Next 12 to 24 Months



VII. CONCLUSION

Looking forward, the current dynamic credit, regulatory and market environment suggests that CPM will continue to evolve and expand. It remains clear from the survey data that there are multiple CPM business models and that expansion is taking place along a number of different dimensions depending on the firm's risk structure and portfolio. Commonality of CPM purpose exists on the mission and mandate of the measurement and management of credit risk, as it is being integrated into risk assessment across the firm. The specifics of **organizational structure, breadth of functions** and **linkages with enterprise risk, liquidity, etc.**, are customized and adapted to achieve each institution's goals and objectives given the nature of its business and portfolio.

ABOUT THE IACPM

The IACPM is an industry association established to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest. Membership of the IACPM is open to all financial institutions that manage portfolios of corporate loans, bonds or similar credit-sensitive financial instruments. The IACPM represents its members before regulatory and administrative bodies around the world, holds conferences and regional meetings, conducts research on the credit portfolio management field, and works with other organizations on issues of mutual interest relating to the measurement and management of portfolio risk. Currently there are more than 100 financial institutions worldwide that are members of the IACPM. These institutions are based in 19 countries and include many of the world's largest commercial wholesale banks, investment banks and insurance companies, as well as a number of asset managers. More information about the IACPM may be found on our website: www.iapcm.org.

APPENDIX

Demographics and Survey Participation

For the 2015 Principles and Practices Benchmarking Survey, there were 61 participating member firms globally. (Figure 13)

In terms of size, the largest percentage of participating firms ranged from greater than \$500 billion (44%) with others ranging from less than \$500 billion to less than \$50 billion. (Figure 14)

Figure 13

Survey Participants *by Region of Domicile*

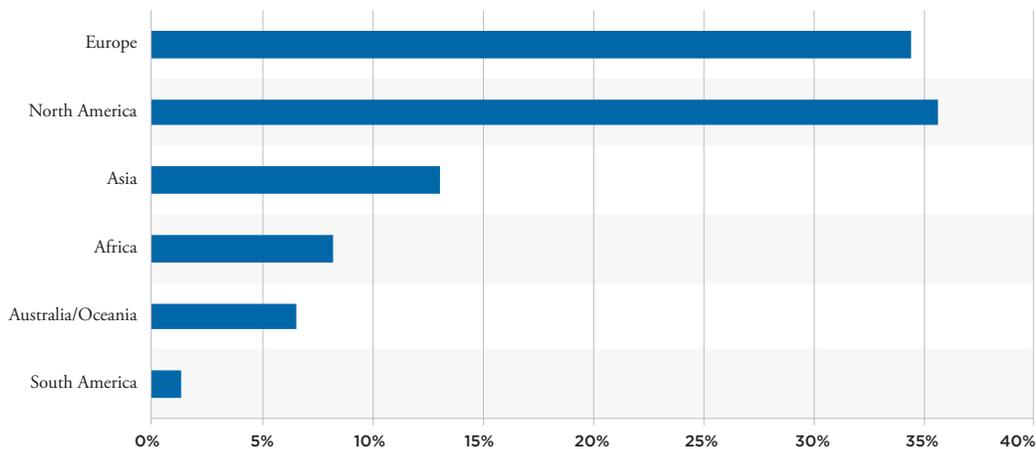
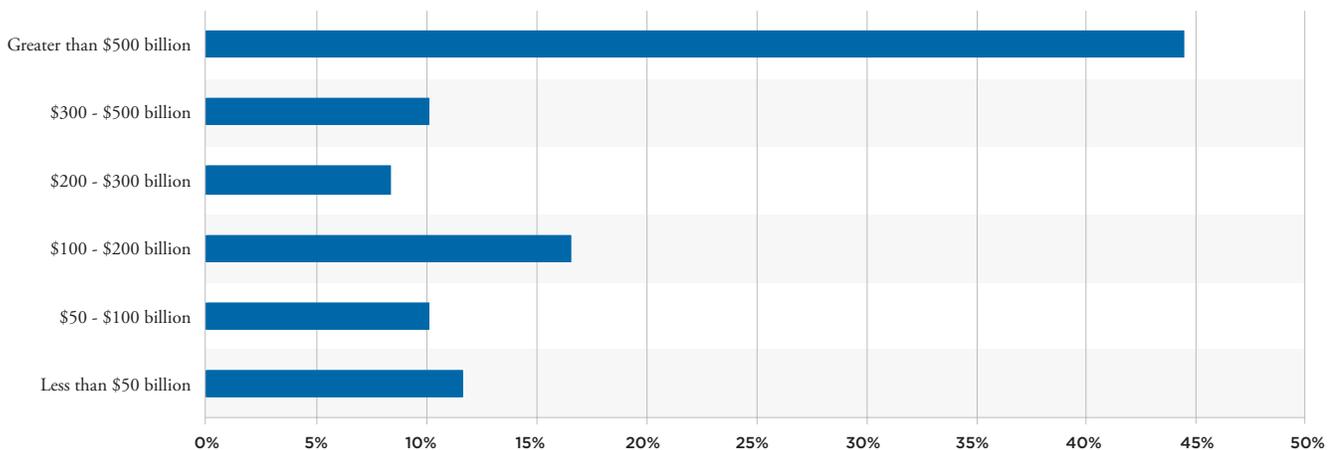
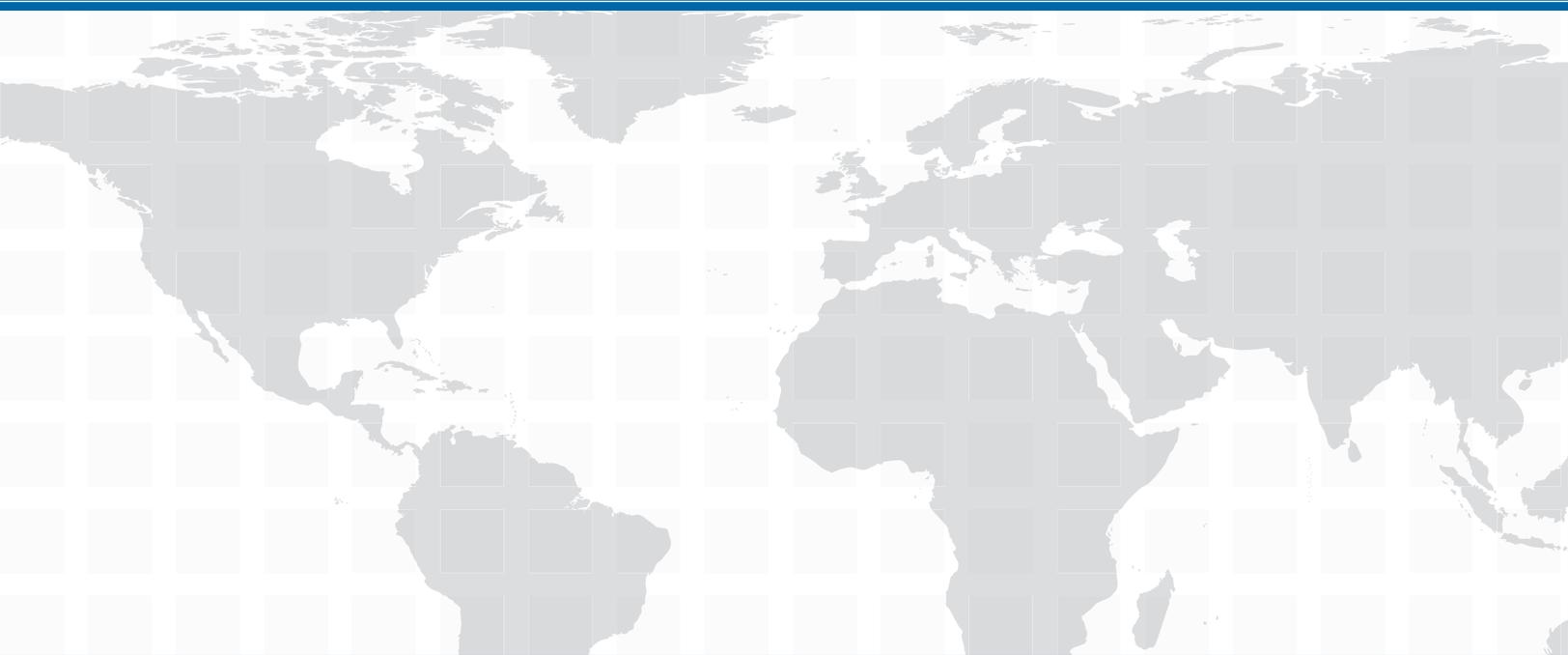


Figure 14

Survey Participants *by Approximate Total Balance Sheet Assets*





International Association of Credit Portfolio Managers

360 Madison Avenue, 17th Floor

New York, NY 10017

www.iacpm.org

Som-lok Leung

Executive Director

+1-646-289-5434

somlok@iacpm.org

Marcia Banks

Deputy Director

+1-646-289-5432

marcia@iacpm.org