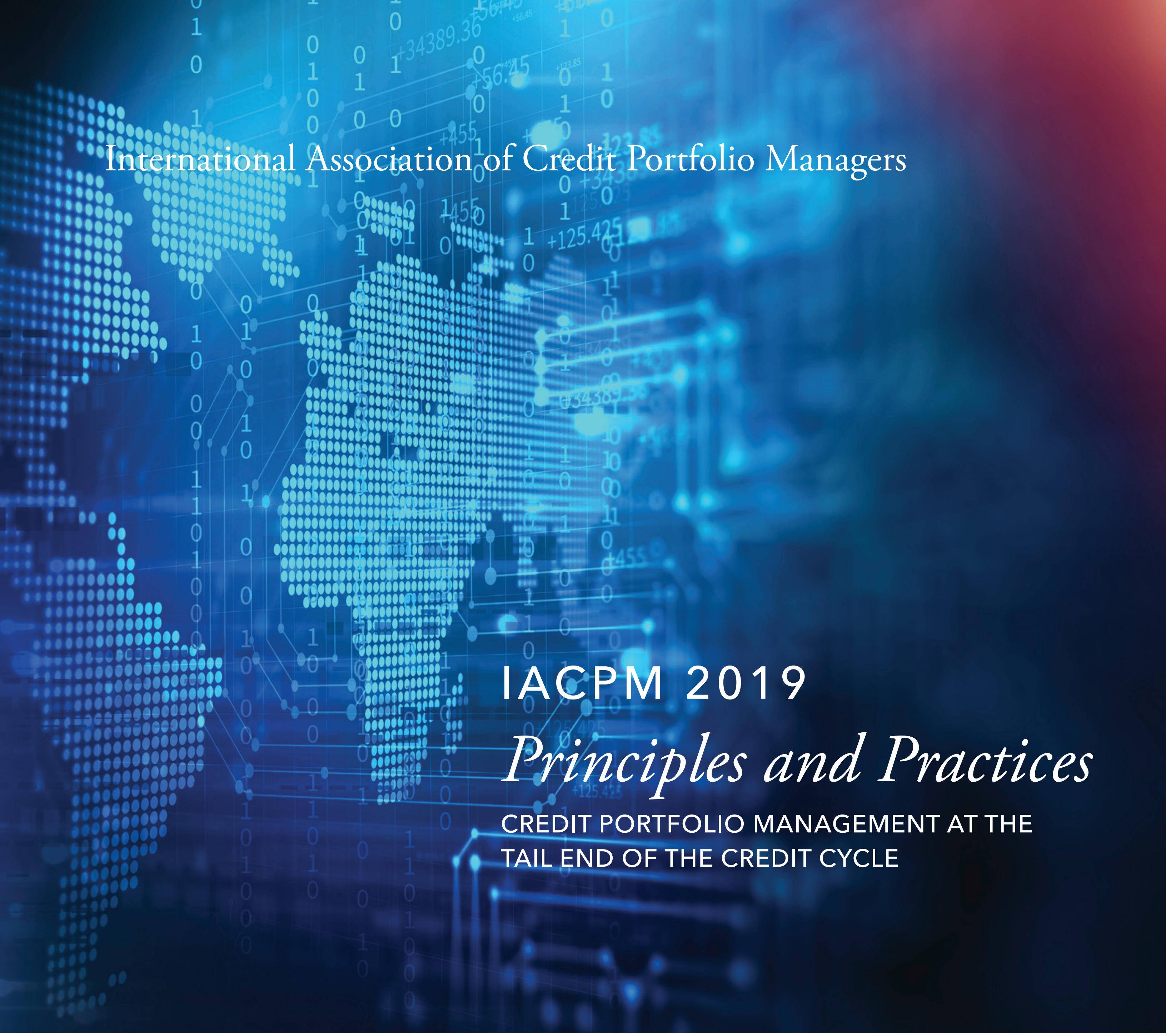


International Association of Credit Portfolio Managers

IACPM 2019

Principles and Practices

CREDIT PORTFOLIO MANAGEMENT AT THE TAIL END OF THE CREDIT CYCLE

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.

IACPM

Executive Summary

The International Association of Credit Portfolio Managers (IACPM) recently conducted its *2019 Principles and Practices Benchmarking Survey*. This Survey, conducted every other year, looks at the evolution of risk and credit portfolio management (CPM), organizational structures, mission and mandate, tools, and outlook for the future. The goal is to allow firms to benchmark their practices versus those of other leading financial firms. Sixty member firms globally participated. In addition, IACPM staff conducted interviews with a number of participating firms to help inform observations.

The 2019 data shows **a range of CPM business models and there is no "one size fits all" model**. Approaches reflect factors including organizational structure, nature of the portfolio, geographic location and culture. Individual firms' business models continue to evolve over time according to their specific objectives reflecting changing constraints and priorities.

The data shows a **high seniority of the CPM function within the firm which further increased between 2017 and 2019.** Some 50% of respondents cited reporting within two levels of the Chief Executive Officer (CEO) and 90% are within three levels. This compares to 40% at two levels and 76% within three levels in 2017.

KEY AREAS OF FOCUS FOR CPM

Late Stage of the Credit Cycle - Balancing Growth and Risk. The current stage of the credit cycle has heightened scrutiny on assessing risk/return and using capital efficiently, while still working to meet overall growth and new business targets.

Increasing Alignment with Line of Business. CPM functions cite closer alignment with line of business on portfolio and client strategy. The alignment takes a variety of forms, depending on the nature of the firm and of the role of the CPM function within it and can include organizational reporting structures within the first line of defense, roles in deal and capital committees, risk/return and pricing model alignment, etc.

Portfolio Risk Mitigation – Front-End vs. Back-End Tools. CPM functions use a range of risk mitigation strategies depending on the nature of the firm and the liquidity of the portfolio. Discipline at origination (i.e., credit onboarding policies at the front end of the transaction) remains the top area of focus. Market tools (i.e., risk mitigation in the markets post booking, or "back end tools") are used where available. Syndications/loan sales and insurance ranked most highly in this year's survey, along with CDS and securitisation. There are some meaningful differences in the application of tools depending on region/jurisdiction.

Strategy and Governance Roles, including ESG and Sustainability. In addition to roles in guiding origination, portfolio reporting and market execution, CPM functions are involved in risk governance and strategy. Among these areas are: concentration limits, emerging risk identification, stress testing and capital allocation. Notably, over 60% of responding firms indicated co-responsibility or advisory roles in addressing environmental risks and sustainability strategy for the portfolio.

Data Strategy. Data aggregation, reporting and information analysis as a category ranks among the top three priorities for CPM. Specific goals range from improving data quality to developing/refining dashboards for emerging risk identification as well as expanding machine learning capabilities and accessing external sources of data for risk assessment.

Regulation, Accounting and Capital Efficiency. The new Basel requirements are a driver for capital efficiency as well as strategic portfolio assessments. This is especially the case for European participants for whom capital efficiency / RWA reduction ranks highest among their priorities, vs. third for North America and in a tie for top priority for Asia Pacific. The impact of the new credit loss accounting standards, IFRS 9 and CECL, is also a priority as firms and CPM functions continue to assess the business and strategic impacts, especially as a negative turn in the credit cycle will increase volatility.

Table of Contents

" There will be another financial crisis. This is almost a certainty with a fractional reserve banking system that relies on leverage and maturity mismatch. Our job as regulators and supervisors is not to prevent future crises, but to reduce their likelihood, and perhaps more importantly, their impact on the real economy. And whether the next crisis starts from within the banking system, the shadow banking system, central counterparty clearing houses or another part of the financial system, it will affect the banking system in one way or another…"

William Coen,
Secretary General of the Basel Committee on Banking Supervision
20th International Conference of Banking Supervisors
Abu Dhabi, 28 November 2018

I. *Introduction*

Credit risk measurement and portfolio management are evolving within financial institutions. The late stage of the credit cycle and concerns about credit outlook are heightening scrutiny of the credit portfolio and the focus on industry and concentration risks. Further, the evolving regulatory and market environment continues to drive changes in organizational approach and priorities.

Against this backdrop the International Association of Credit Portfolio Managers (IACPM) conducted its *2019 Principles and Practices Benchmarking Survey*. This *Survey*, conducted every other year, looks at the evolution of risk and credit portfolio management (CPM), organizational structures, mission and mandate, tools, and outlook for the future. The goal is to allow firms to benchmark their practices versus those of other leading financial firms. Sixty member firms globally participated.

Among the topics addressed are:

- Portfolio Definition and Coverage Responsibility
- Organizational Structure, Reporting Lines and Governance
- CPM Functions, Objectives and Key Performance Indicators (KPIs)
- Implementing the Mandate: Tools and Execution
- CPM in the Future: Evolution and Priorities

Note on the survey demographics:
The IACPM 2019 Principles and Practices in CPM Survey results include responses from 60 firms globally: 49 banks, as well as 11 re-insurance/insurance firms, multilateral development banks, and export credit agencies with a range of balance sheet sizes. Most observations on the survey results contained in this paper reflect the aggregate data across all respondents; in some instances, however, "bank only" data by size of balance sheet and geography provides specific insights on industry practices for those firms. The text distinguishes references to the "bank only" results, where applicable. See appendix for full demographics.

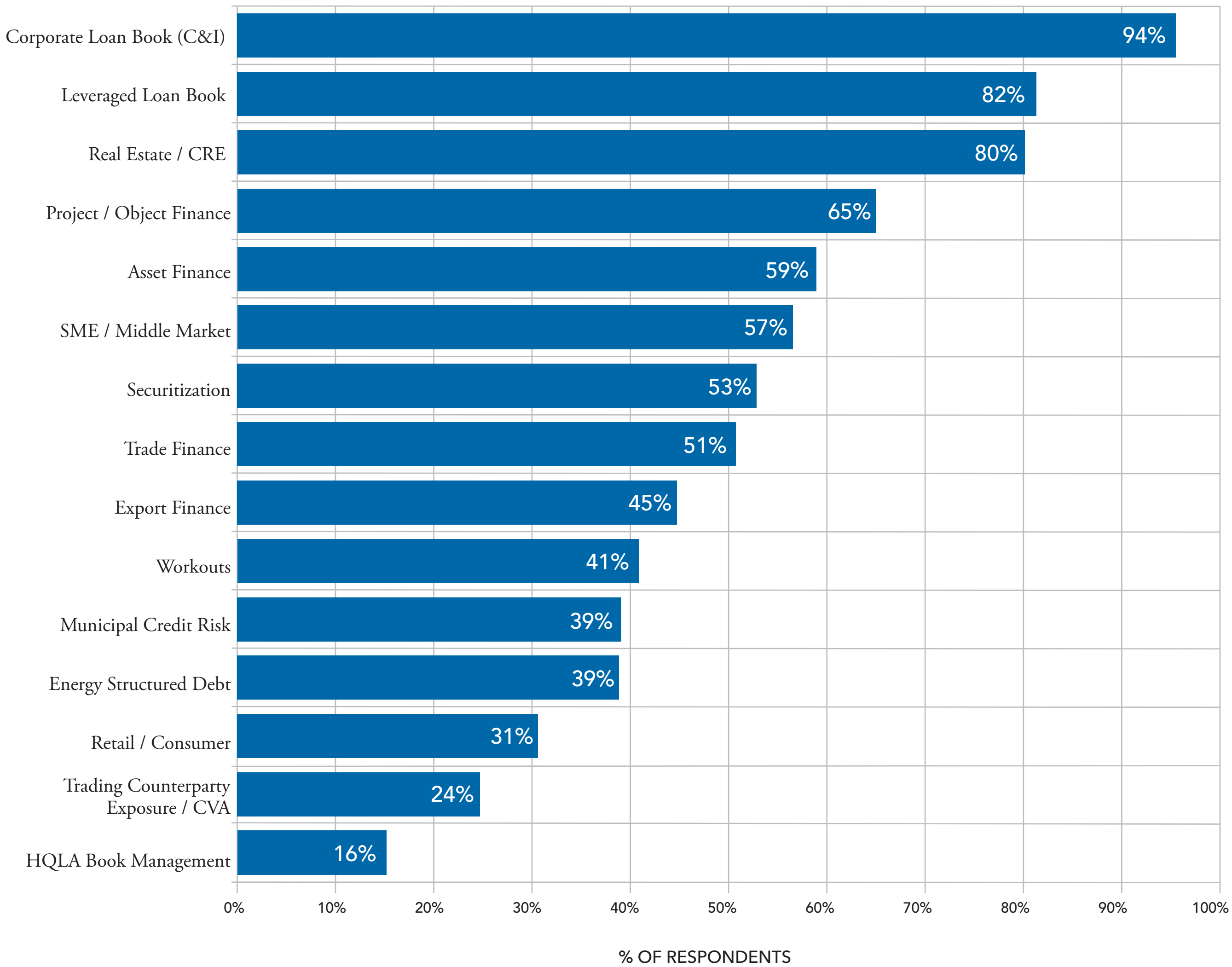
II. *Portfolio Definition and Coverage Responsibility*

One of the starting points for CPM and the nature of the function at the firm is "portfolio definition," i.e., what assets are in the firm's portfolio and what assets are included in the CPM remit. The nature of the assets (large corporate, SME, retail / consumer etc.), their risk profile and liquidity are key factors in determining priorities of the CPM unit and the tools available to measure and manage the risk.

The top five asset classes for which banks responding to this survey have risk management responsibilities include: corporate loan book (94%), leveraged loan book (82%), real estate/CRE (80%), project/object finance (65%) and asset finance (59%). Middle Market/SME also is well represented (57%). Some CPM units have coverage of other assets in the firm such as retail/consumer, trading counterparty/CVA and HQLA book management but to a smaller degree. *(Figure 1)*

Figure 1

Percentage of Banks with Risk Management Responsibilities for the Following Asset Classes Including Commitments *(Banks Only)*



III. *Organizational Structure, Reporting Lines and Governance*

REPORTING LINES FOR CPM UNITS

The vast majority of CPM units report to either **Line of Business** or **Risk,** with a smaller percentage reporting to **Finance/Treasury.** Larger banks (greater than USD 500 billion) have a higher percentage who report to Line of Business vs smaller banks (less than USD 500 billion) which have a relatively higher percentage reporting to Risk. This is true for all geographies. Comments on the survey indicate that the nature of the firm's portfolio and its liquidity are one driver, while firms active in market focused risk mitigation are largely housed within the business unit. Smaller firms with less liquid portfolios seem to be more likely to report to risk. Interview comments indicated growing priorities for all firms to align with business objectives, i.e., assessing risk/return, determining appropriate portfolio allocation to industries and clients, and balancing business growth objectives and credit cycle concerns prudently. *(Figure 2)*

FIRST LINE AND SECOND LINE LOCATION WITHIN THE FIRM

Consistent with the above results on reporting line, some 67% of banks over USD 500 billion in size are located in the first line of defense while a roughly similar percentage, 64%, of banks below USD 500 billion are located in the second line of defense. *(Figure 3)*

In interviews, survey participants noted that the **differences in approach reflect both the size of the firm and the nature of its portfolio** (e.g., how concentrated, how liquid). CPM units often include a range of functions for which alignment may be split between first line and second line of defense. Additional benchmarking work may be useful to look at the specific functions (e.g., research and dashboards, working with origination, market execution, etc.) for location within lines of defense.

Figure 2
CPM Reporting Line *(Banks Only)*

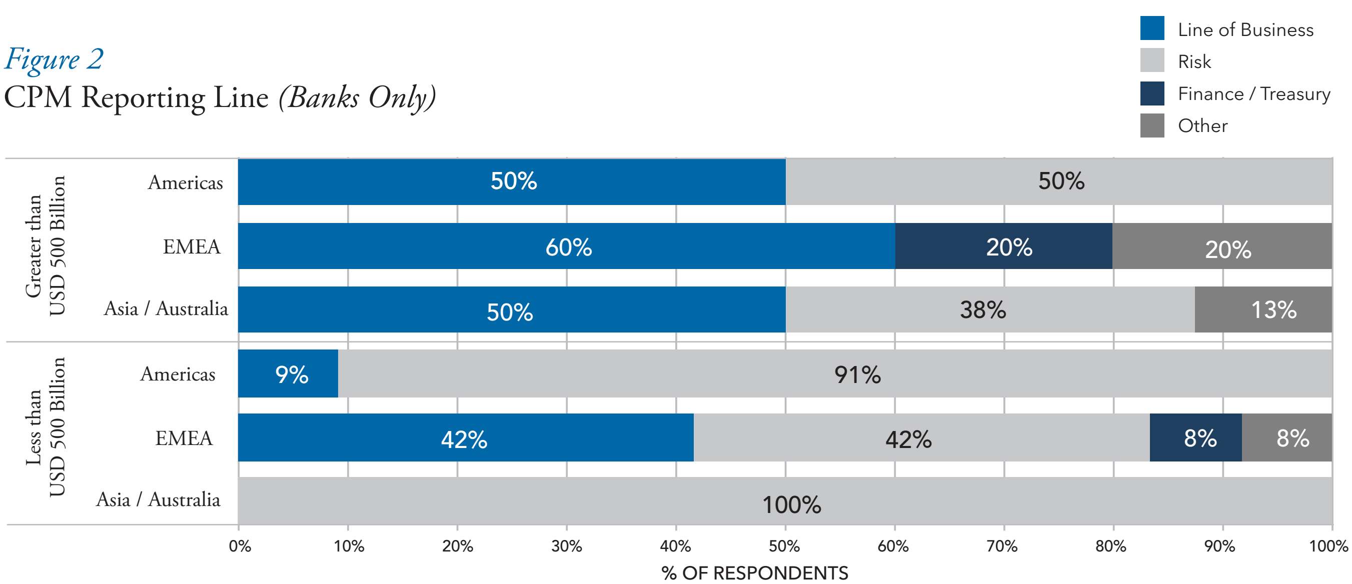
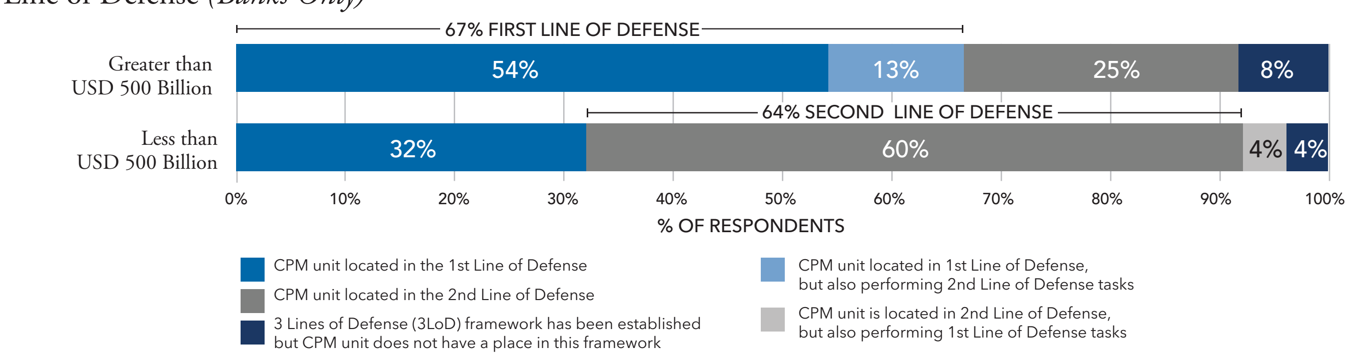


Figure 3
Line of Defense *(Banks Only)*



SENIORITY OF THE FUNCTION WITHIN THE FIRM

Data from this year's survey versus that of 2017 clearly shows that the seniority of the CPM function within banks and financial institutions has been **growing steadily.** In 2019, some 50% of respondents report within two levels of the Chief Executive Officer (CEO) and 90% are within three levels. This was up from 2017 when 40% were at two levels and 76% within three levels. *(Figure 4)*

GOVERNANCE

Reflecting the growing seniority of the function, a significantly higher percentage of **CPM units are playing active roles on multiple committees** at their firms, either in a voting or advisory capacity. These include the Credit/Deal Committee (71% of banks represented with 53% in a voting role). In 2017, 61% of banks reported a voting or nonvoting role in this Committee. Additionally, CPM roles have expanded between 2017 and 2019 in the Capital Allocation Committee, the Asset-Liability Committee, and the Market Risk Committee. *(Figure 5)*

Figure 4
Reporting Levels Between Head of CPM and CEO

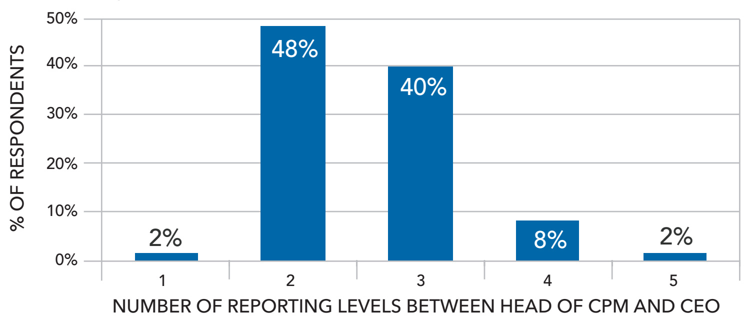
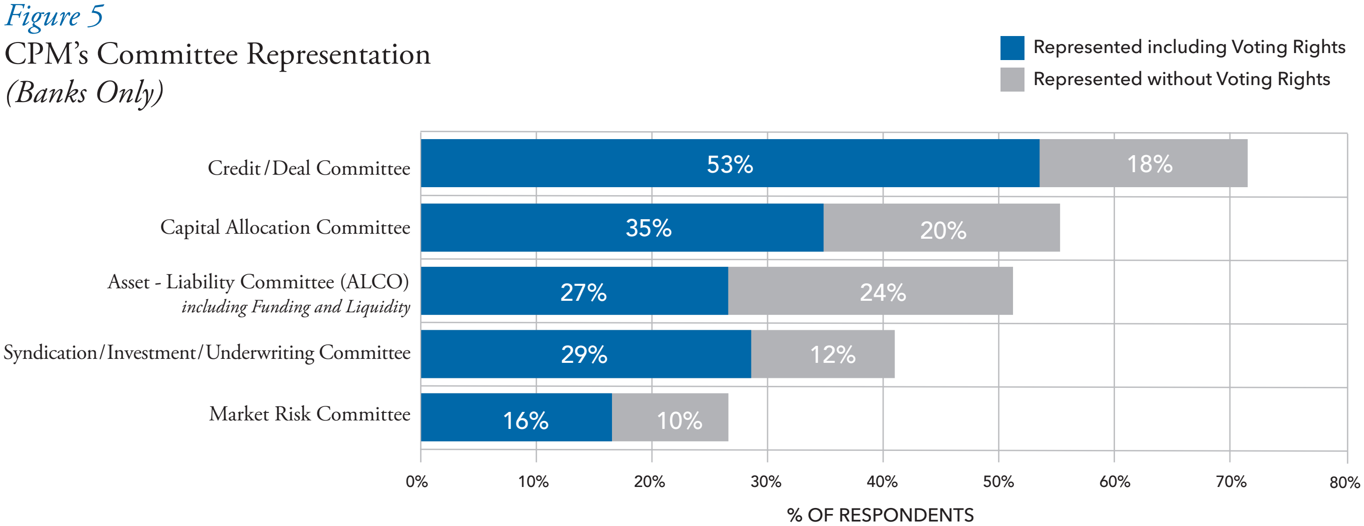


Figure 5
CPM's Committee Representation
(Banks Only)



IV. *CPM Functions, Objectives and Key Performance Indicators*

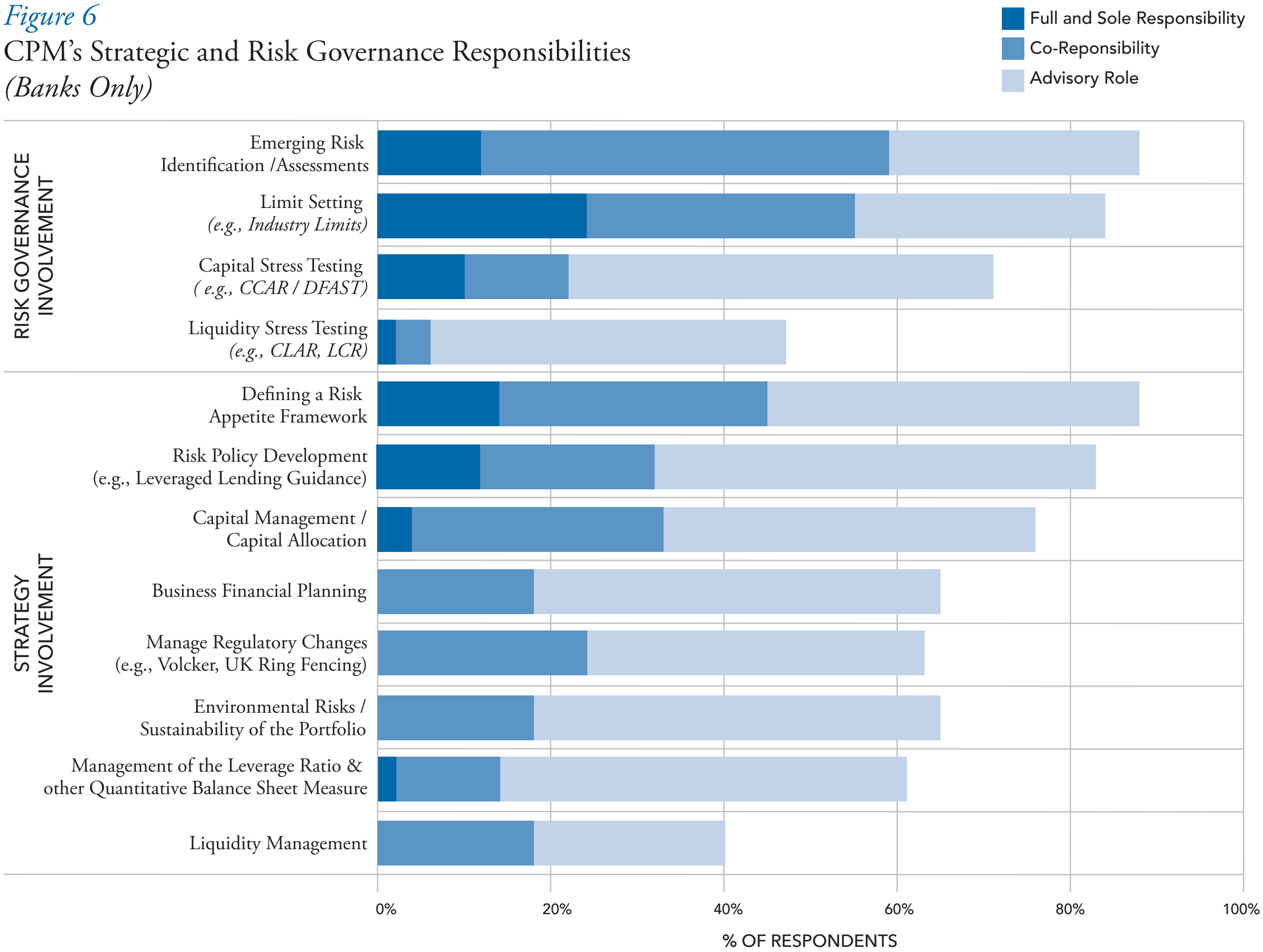
CPM FUNCTIONS: EXPANDING ROLES

CPM units are engaged in an **expanding range of functions within the firm**, with growth coming primarily related to strategic and risk governance responsibilities. The majority of CPM units have a role in Portfolio Reporting/Modeling and Market Tools Execution. To a lesser extent, respondents also indicated roles in origination, primarily in transaction vetting. These roles, which have historically been "core" for CPM, remained fairly stable between 2017 and 2019.

CPM units have also assumed roles in Strategic and Risk Governance. Specific areas of responsibility include defining a risk appetite framework, emerging risk identification, and risk policy development (e.g., for leveraged lending strategy, etc.). *(Figure 6)*

Figure 6

CPM's Strategic and Risk Governance Responsibilities
(Banks Only)



CPM OBJECTIVES

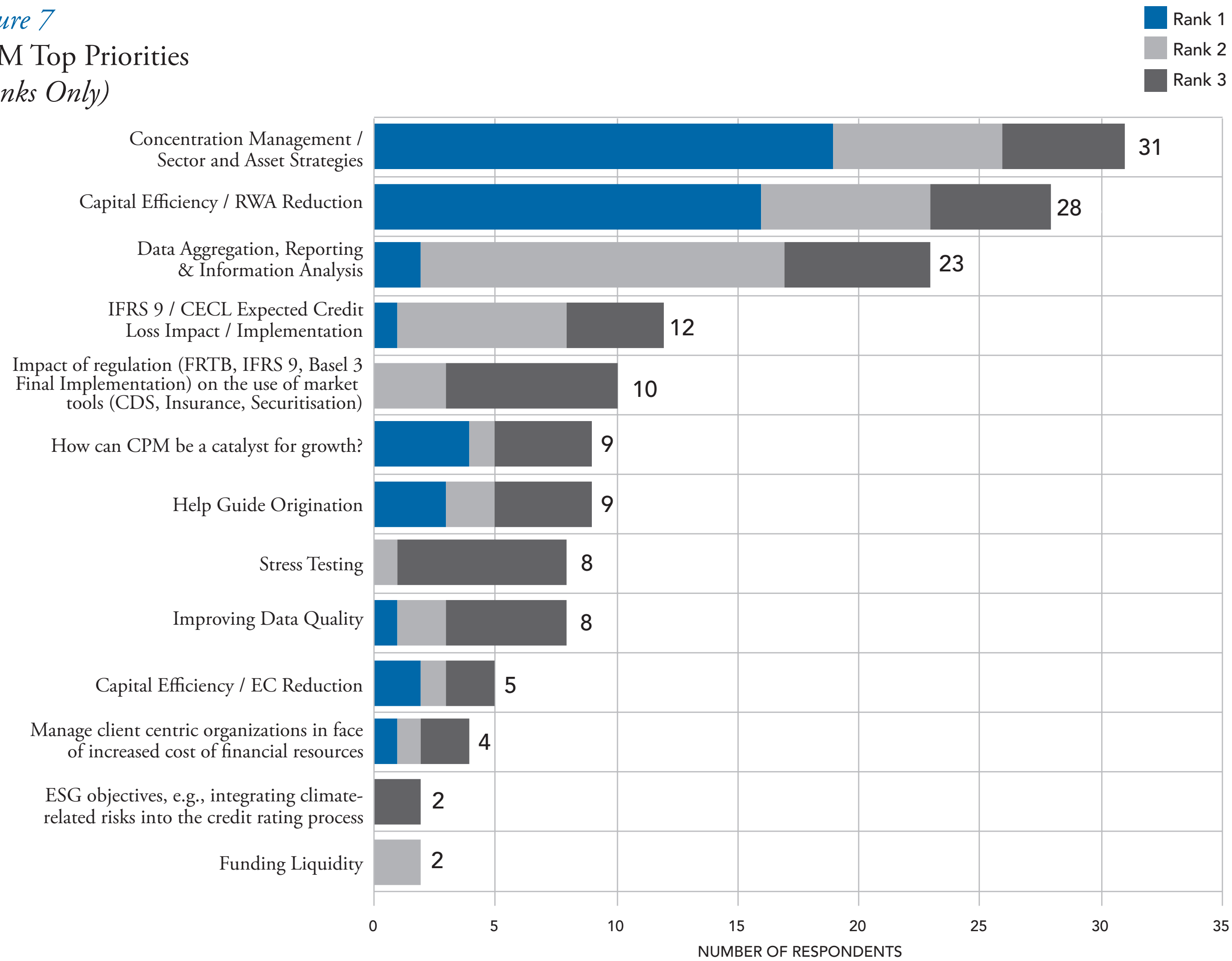
Concentration Management / Sector and Asset Strategies and Capital Efficiency / RWA Reduction are the top two priorities for CPM. These are closely tied to current concerns about the credit cycle and the **intensive focus on aligning business growth objectives with efficient use of capital**. There are, however, some differences in top objectives by region. For European participants, Capital Efficiency / RWA Reduction ranks highest among their priorities vs third in importance for North America and in a tie for top priority with concentration management for Asia Pacific. *(Figure 7)*

Data aggregation, reporting and information analysis as the third ranked priority is also worthy of comment. Interviews with respondents indicated that portfolio reporting and information are, of course, critical to all CPM functions, and to risk and business management within the firm.

Additionally, data-driven solutions for better risk identification are high priorities for continued development and eventual application. This includes a range of considerations such as machine learning, external data capture for risk assessment and the technology to support these tools.

Environmental, Social and Governance (ESG) and Climate Risk rank low on the CPM priority list, but in discussions with practitioners these issues are viewed as an emerging area of importance for CPM as firms work to integrate their strategic views of Climate Risk as well as ESG and associated reputational risks into more quantitative measures. In interviews, a number of respondents cited their assessments of a range of transition risks in front-end client decisions and in associated portfolio risk assessment.

Figure 7
CPM Top Priorities
(Banks Only)



KEY PERFORMANCE INDICATORS (KPIs)

KPIs for assessing CPM performance include a range of metrics, with material differences by size of bank. For banks with greater than USD 500 billion in assets, RWA Reduction/optimization and Return on Risk Weighted Assets (RORWA) rank most highly. *(Figure 8a)* For banks with assets below USD 500 billion, the focus is on Concentration Reductions and Risk Adjusted Return on Capital (RAROC) as well as Return on Equity (ROE). There was also a material percentage of smaller banks that cited KPIs as "under development". *(Figure 8b)* In interviews, respondents in both size categories observed that performance assessment for CPM includes qualitative as well as quantitative factors.

Figure 8a
Key Performance Indicators
(Banks Only - Greater than USD 500 Billion Asset Size)

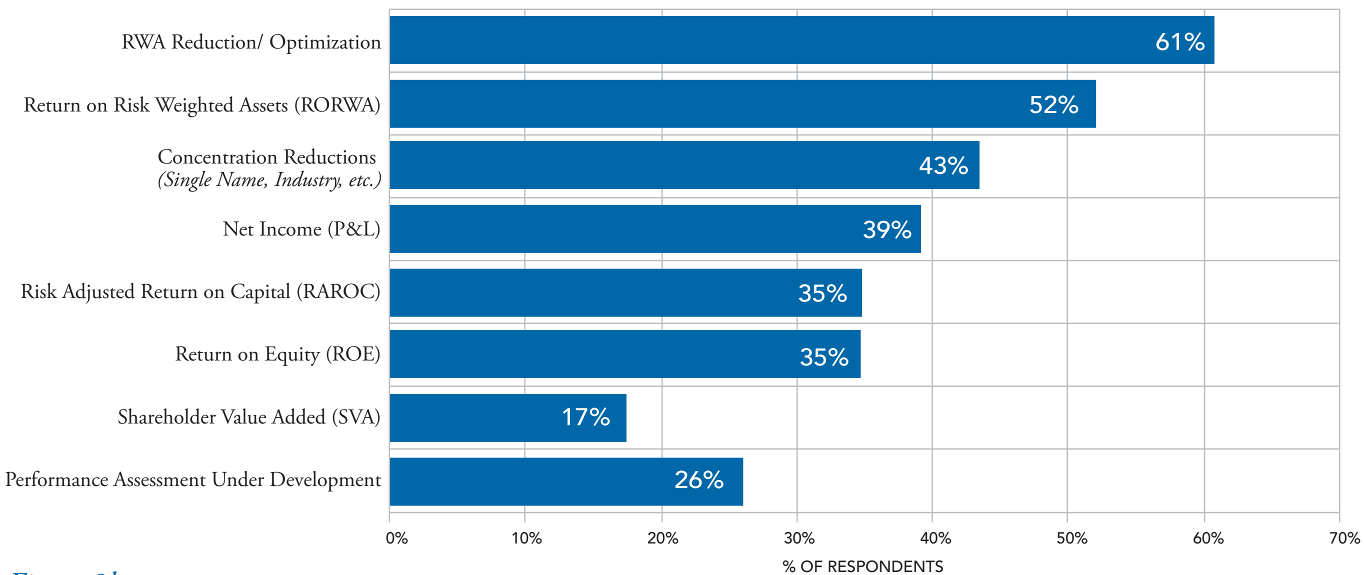
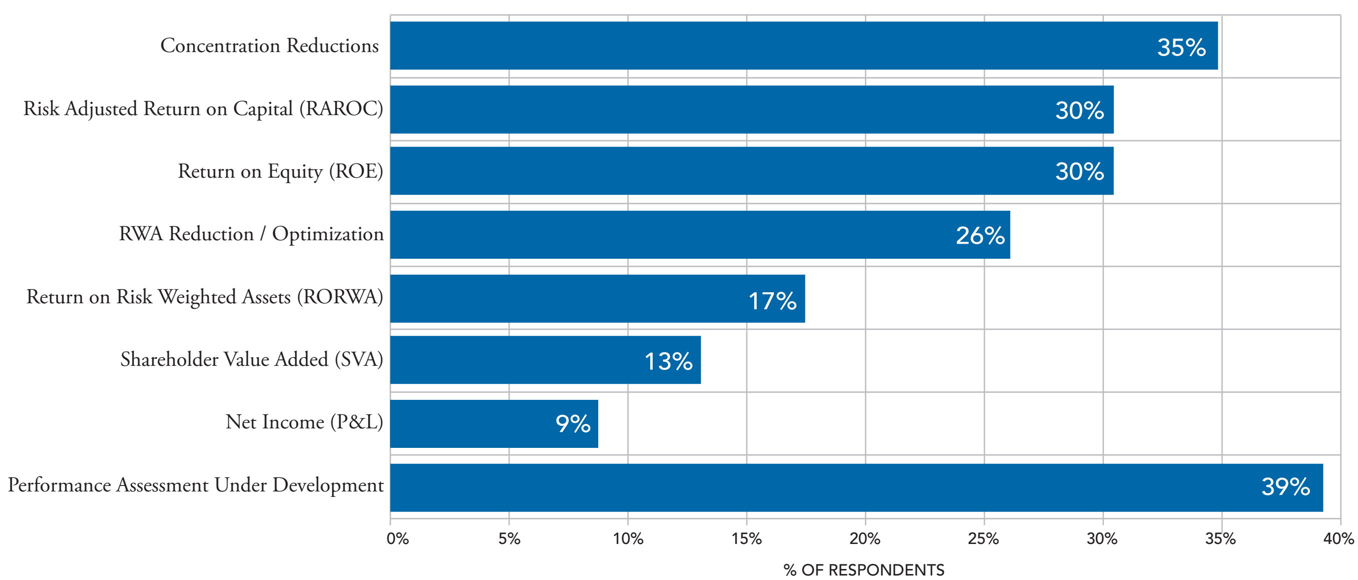


Figure 8b
Key Performance Indicators
(Banks Only - Less than USD 500 Billion Asset Size)



V. *Implementing the Mandate: Tools and Execution*

TOOLS AND EXECUTION

CPM units reported using both discipline at origination (i.e., credit onboarding policies and other "front end" risk mitigation techniques) and market tools (i.e., risk mitigation in the markets post booking or "back end tools") to execute portfolio strategies. The weighting of which tools are applied in specific situations is linked to size of the firm and liquidity of the portfolio and availability of market tools for the assets in the geographic region.

Discipline at origination, highest ranked in the CPM toolkit, includes a number of policy approaches. Concentrations Limits and Regulatory Capital Measurement tools ranked ahead of others such as portfolio perspective in the deal decision, setting capital allocations and economic capital measurement tools.

Market tools also include a range of options. Loan sales / purchases rank highest and credit insurance second. Others include single name CDS, financial guarantees and synthetic securitisations. For banks over USD 500 billion in asset size, loan sales ranked highest, while other market tools such as single name CDS, credit insurance and securitisation were about evenly split.

There are some notable changes in importance for market tools in 2019 vs 2017. **Credit insurance** has increased to 1.24 in weighted importance vs 1.05 in 2017, while **securitisation** is lower at 1.02 in 2019 vs 1.23 in 2017. Interviews with participants confirmed expanding use of credit insurance but noted some of the regulatory uncertainties about securitisation affecting current usage. Participants indicated that there is keen interest to resolve these uncertainties and increase securitisation looking forward. *(Figure 9)*

As CPM units evaluate tools for managing risk under the new IFRS 9 / CECL and Basel standards, loan sales were ranked by far most efficient followed by credit insurance, single name CDS, and synthetic securitisation.

CAPITAL

Some 71% of banks reported in 2019 that regulatory capital is the most important measure. Economic capital was ranked by only 29% of banks as either of more, or at least of equal, importance. However, the data does show a **slight shift away from regulatory capital and toward economic capital** over the past two years. In 2017, 81% of banks reported that regulatory capital was most important and only 19% ranked economic capital either of more or at least equal importance. Furthermore, the outlook for two years from now indicates the expectation that this modest shift toward economic capital will continue. *(Figure 10)*

Figure 9

Relative Importance of CPM Tools

(Banks Only)

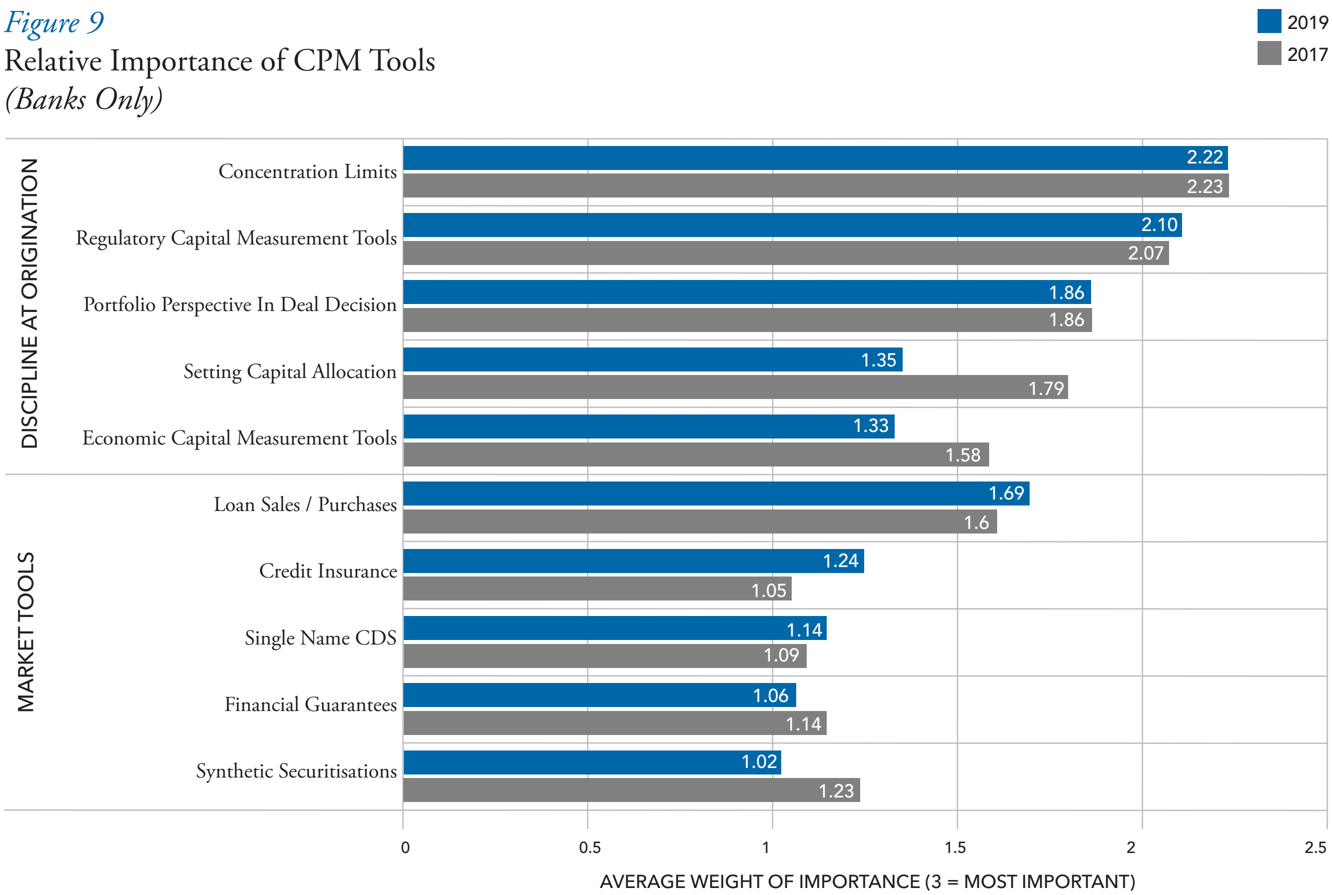
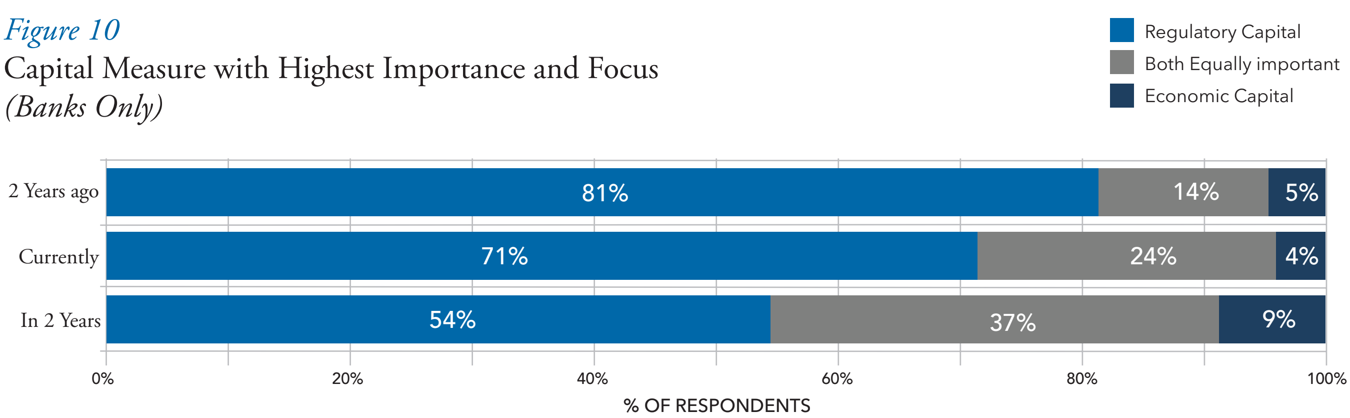


Figure 10

Capital Measure with Highest Importance and Focus

(Banks Only)



VI. CPM in the Future: Evolution and Priorities in Late Stage Credit Cycle

"The enemy is forgetting…"

Ben Bernanke
Former Federal Reserve Chair
Marketplace, March 13, 2018

Joint interview with Henry Paulson, former Treasury Secretary and Timothy Geithner, former president of the New York Federal Reserve and former Treasury Secretary.

Results of the *IACPM's 2019 Principles and Practices Survey* show clearly that CPM has continued to grow as a discipline, and in material ways. This growth reflects the changing objectives and requirements within the firm in the evolving credit, market and regulatory environments.

PRIORITY AREAS OF FOCUS REMAIN

- Late stage of the credit cycle and impact
- Enhancing alignment with line of business and balancing risk/return while many firms are still seeking growth
- Risk mitigation as appropriate

ADDITIONAL PRIORITIES ARE EMERGING

- Data Strategy, Emerging Risk Identification and Digitization – the continuing need to enhance emerging risk identification and integrate portfolio data across the enterprise and maximize use of additional sources of data (e.g., machine learning)
- ESG and Sustainability – the focus on transition risks and linking reputational considerations into business decision making, financial metrics and portfolio strategy
- Regulation and Capital Efficiency – the implementation of IFRS 9/CECL and the impact of new Basel requirements on business and strategy

Appendix

DEMOGRAPHICS & SURVEY PARTICIPATION

For the *2019 Principles and Practices Benchmarking Survey*, globally a total of 60 member firms participated, comprised of mainly banks and investment banks. One-fifth of all respondents are development banks, export credit agencies or insurer/re-insurer respectively. *(Figure 11)*

In terms of size, 40% of respondents have Approximate Total Balance Sheet Assets greater than USD 500 billion and 33% have balance sheet assets of USD 50 to 250 billion. *(Figure 12)* Geographically by country of domicile, participants were in Europe (43%), North America (30%), Asia Pacific (20%) and rest of world. *(Figure 13)*

Figure 11
Survey Participants by Nature of Firm

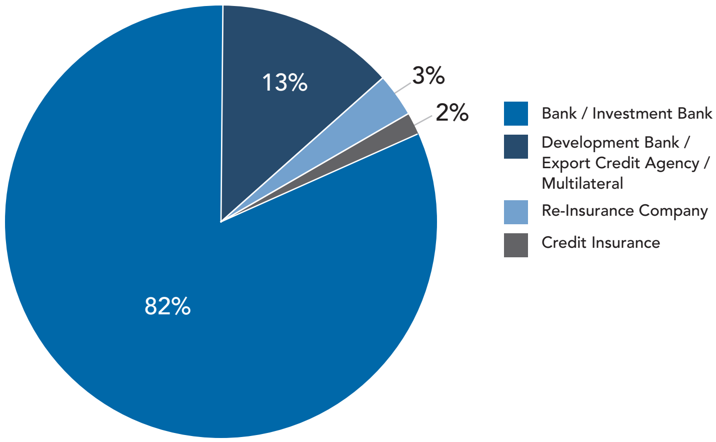


Figure 12
Survey Participants by Approximate Total Balance Sheet Assets

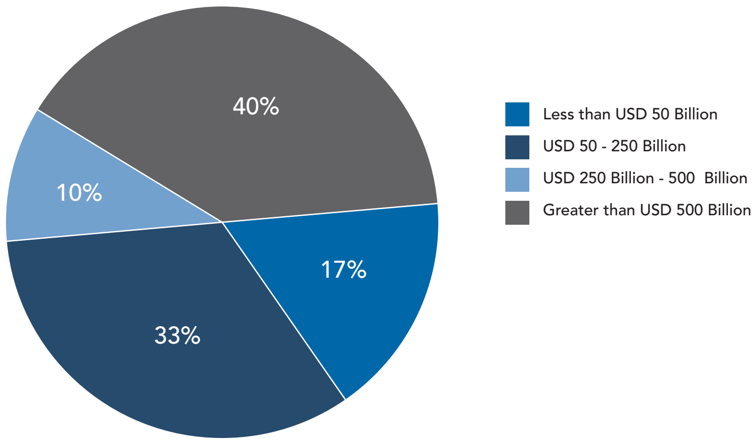
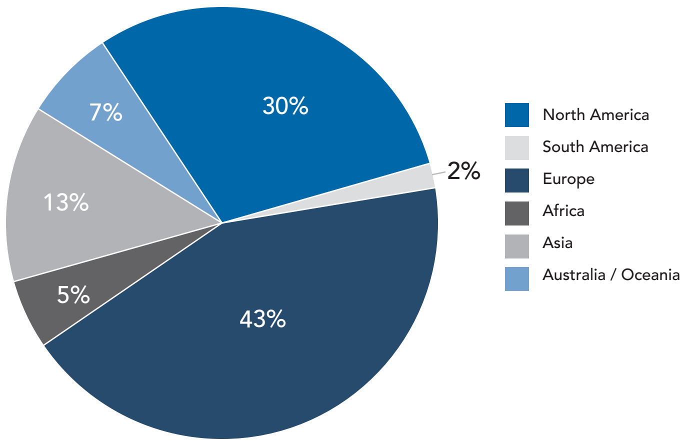


Figure 13
Survey Participants by Region of Domicile



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 23 countries and include many of the world's largest commercial wholesale banks, investment banks, development finance institutions, export credit agencies, insurance companies and asset managers.

Som-lok Leung
Executive Director
somlok@iacpm.org

Marcia Banks
Deputy Director
marcia@iacpm.org

Juliane Saary-Littman
Director, Research
juliane@iacpm.org

www.iacpm.org