International Association of Credit Portfolio Managers

Principles and Practices in Credit Portfolio Management

Findings of the 2013 Survey

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

KEY FINDINGS OF THE 2013 PRINCIPLES AND PRACTICES IN CPM SURVEY INCLUDE:

Most responding institutions now cite revenue generation as their top business priority for the firm looking forward over the next 12 to 24 months. CPM functions are being asked to support this growth through management of risk/return thresholds and working with the line of business to support growth in portfolio assets. Meeting capital objectives remains an important area of focus, but now ranks below revenue-focused goals for the firm.

CPM's top goals of improving portfolio structure and managing concentrations remain paramount. Also included among top goals are providing portfolio information and helping guide origination in support of business objectives as well as managing risk/return objectives (both regulatory and economic capital based).

The CPM discipline is expanding. At many firms, CPM now covers additional types of credit or assets such as Counterparty Risk and has linkages with Enterprise Risk and with Treasury/ALM among others.

CPM most frequently reports to Risk or the line of business and is generally a senior function within the firm. The majority of CPM units are located organizationally within one to two levels of the CEO.

Origination tools, including discipline at origination and limits, remain most important for CPM. Market tools such as CDS also continue to fill a vital role for more liquid portfolios.

The *Survey* data show some regional/geographic differences. There are also some differences in practices related to the institution's asset size.

As in prior years, the *2013 Survey* results indicate that there is no "one size fits all" approach to Credit Portfolio Management. Firms adapt CPM functions to provide for the prudent risk management of their specific portfolios and risks and to work effectively within their organizational structures. CPM functions are likely to evolve further as the discipline continues to expand.

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I. INTRODUCTION

"…The goal of credit risk management is to maximise a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Banks need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions. Banks should also consider the relationships between credit risk and other risks. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organisation."

-Principles for the Management of Credit Risk, Bank for International Settlements, September 2000

Credit Portfolio Management (CPM) has grown as a discipline over the past 15 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 2013 *Principles and Practices in CPM Survey* to provide benchmarking on the evolution of 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.

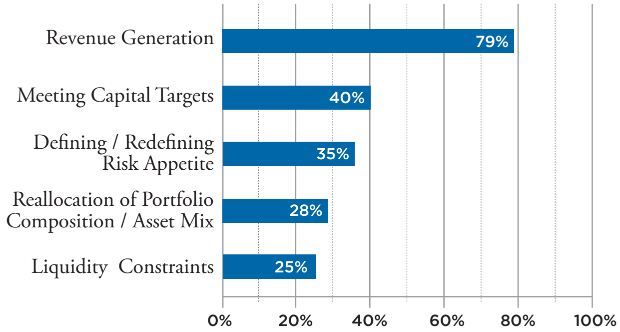
Among the topics addressed in the *Survey* are:

- CPM Evolution: Mission, Mandate and Business Priorities
- The CPM Portfolio
- Organizing CPM: Structure and Functions
- Implementing the CPM Mandate: Tools and Execution
- CPM in the Future: Evolution and Challenges

There were 66 firms, located in 16 countries, which participated in the 2013 *IACPM Principles and Practices in CPM Survey*.

Figure 1

Top CPM Business Priorities over the Next 12 - 24 Months



II. CPM EVOLUTION: MISSION, MANDATE AND BUSINESS PRIORITIES

The mandate of Risk and Credit Portfolio Management is expanding steadily within financial institutions worldwide. Credit and market changes after the 2007-2008 financial crisis and critical events in Europe have continued to underscore the increasing importance of Risk and Credit Portfolio Management within financial institutions. In addition, new global regulations have increased capital and liquidity requirements for the financial services industry. *IACPM's 2013 Survey* indicates that, increasingly, CPM is filling an important and growing role in integrating credit risk assessments across portfolios and businesses, in meeting new and evolving regulatory requirements, and in defining and maximizing ability to meet risk/return thresholds.

Over three quarters of survey respondents cited **revenue growth** as the top business priority for firms over the next 12-24 months. This is a shift in focus as in the years immediately following the financial crisis there was significant pressure to raise capital to meet regulatory thresholds, and primary objectives revolved around meeting capital targets. Responses to the *2013 Survey* indicated a smaller, but still significant, percentage (40%) of respondents are focused on meeting capital targets over the next 12 to 24 months. *(Figure 1)*

Given the shift toward revenue-focused objectives, firms are looking at strategies to boost revenues. Some 40% of respondents expect growth in portfolio size over the next 12 to 24 months; however, an even larger percentage- 57% - expects that portfolio size will remain about the same. This highlights one of the current challenges facing many firms and their CPM functions for achieving desired growth in revenues against expectations of limited or no portfolio growth and the continued constraints posed by risk appetite and capital requirements.

In supporting business objectives, **CPM's top goals** of improving portfolio structure and managing concentrations remain paramount.

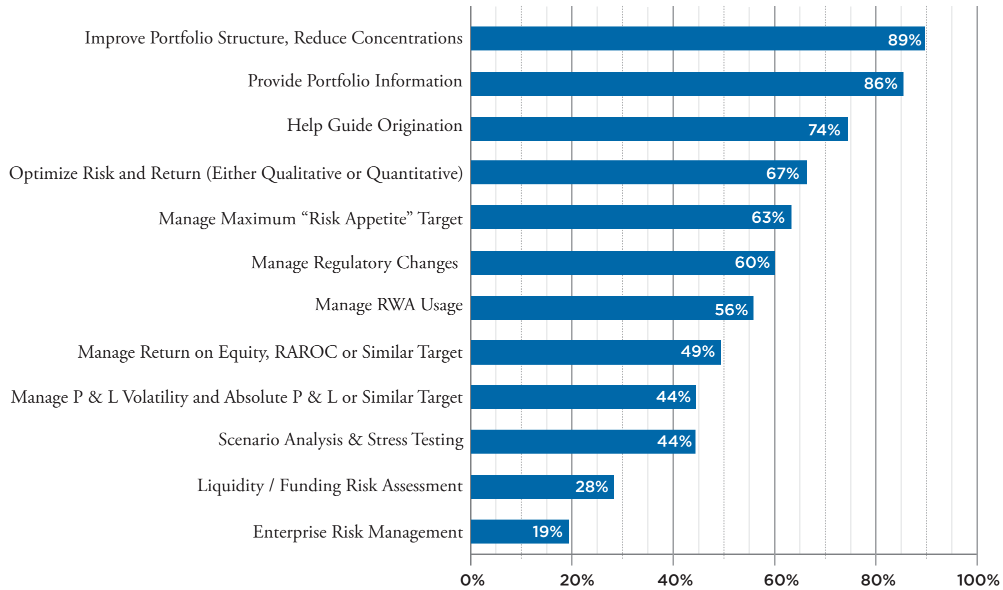
At least 75% of all CPM units are focusing on improving portfolio structures, reducing concentrations, providing portfolio information and helping guide origination in support of their institution's business objectives. More than 50% of all responding CPM units also cite as key objectives optimizing risk/return; managing a maximum risk appetite target; managing regulatory changes, and managing capital usage (including regulatory and economic). Managing maximum "risk appetite" target went from 57% in 2011 to 63% in 2013, while managing regulatory changes increased dramatically from 43% to 60% during the same period. There are some regional differences in goals. Liquidity/Funding risk assessment and management is more important in Europe, while managing enterprise risk and stress testing goals are more important in North America and Asia. *(Figure 2)*

Among other goals cited by respondents, there was definite growth in the importance of managing risk appetite and managing regulatory changes introduced from 2009 – 2013, highlighting the broadening of CPM's mandate into enterprise-wide credit and risk management at a number of firms.

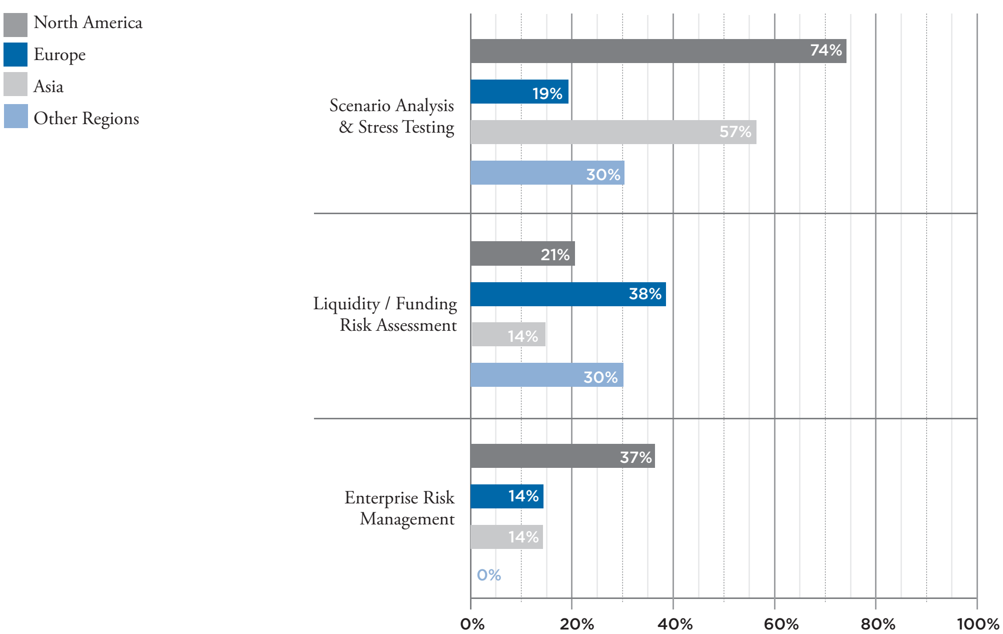
Also reflecting the widening array of important goals, **CPM is expanding** as a function in a number of ways. Over 50% of respondents indicated that the CPM mandate for their firm has expanded over the past 12-24 months. Among the areas of expansion specifically mentioned were enterprise level functions such as asset allocation responsibilities, linkages with liquidity management, addition of assets covered to include counterparty risk and retail portfolio risk, and involvement with and/or responsibility for regulatory- and business-driven stress testing.

Figure 2

CPM Key Objectives in 2013



Selected CPM Key Objectives in 2013 *by Region of Domicile*



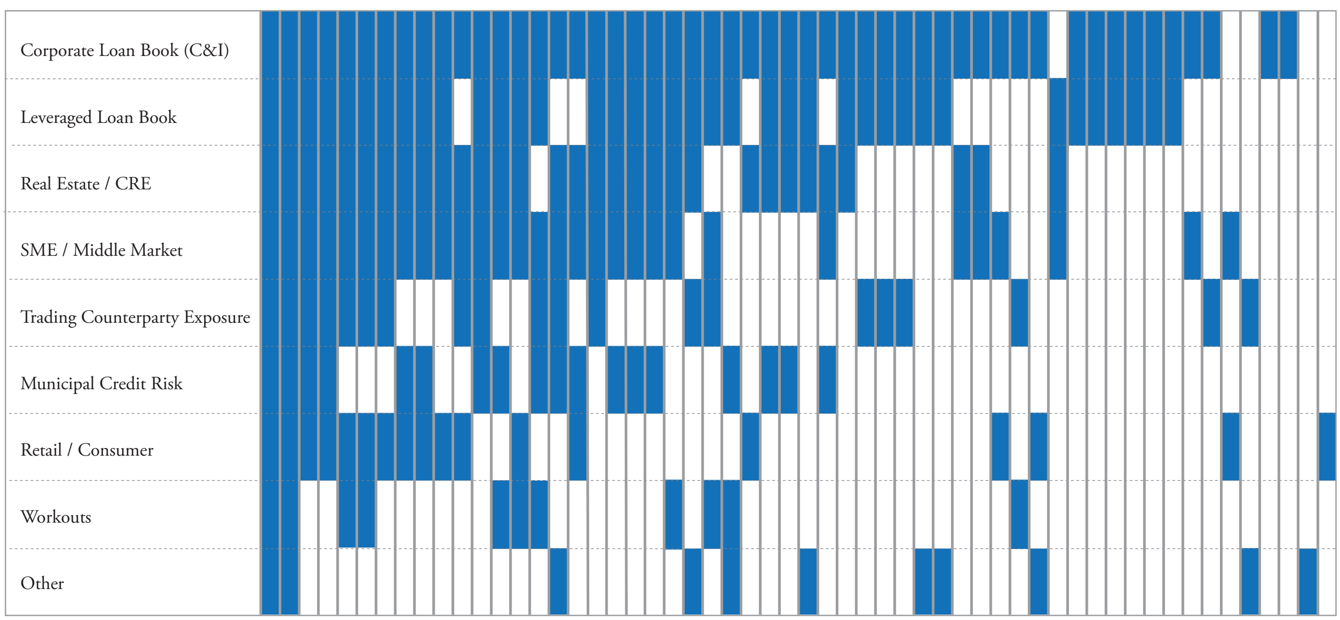
III. THE CPM PORTFOLIO

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

The vast majority (70% or more) of CPM units have responsibility for the corporate loan book and the leveraged loan book, and a majority also cover real estate/CRE and SME/middle market. CPM responsibilities continue to expand and, although still in a minority, a growing number of firms now report coverage of assets such as counterparty exposure, retail, and enterprise-wide exposures. *(Figure 3)*

Figure 3

In 2013 CPM has Responsibility for the Following Asset Classes *(including commitments)*



NOTE: Each column represents the response of one participating bank

Assets Covered
Assets Not Covered

IV. ORGANIZING CPM: STRUCTURE AND FUNCTION

Organizational Structure and Reporting

CPM units report primarily to Risk and line of business and, to a lesser extent, finance. Organizational reporting has shifted slightly toward the "risk reporting" CPM model in 2009 – 2013, including a range of risk functions such as Chief Risk Officer, Enterprise Risk Management and Credit Risk Management. *(Figure 4)* Some **regional differences** also 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, 50% are reporting to Risk and 25% to line of business.

Seniority

Within the organization, **CPM is a senior function.** The majority of CPM units are located organizationally within one to two levels of the CEO. It is also worth noting that the percentage of firms reporting within one to two levels of the CEO is higher for CPM units who report to risk (68 %) vs. those who report to the line of business (55 %).

Expanding Functional Responsibilities

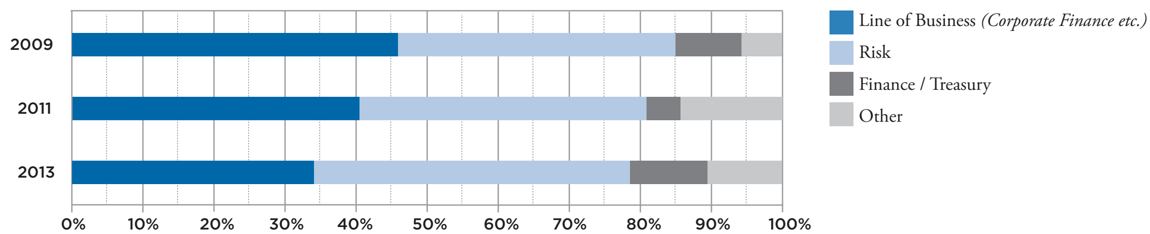
There remain many models of functional responsibilities for CPM, including origination-focused, market and execution, and policies. These functional responsibilities also continue to evolve. *(Figure 5)* The time series of data shows that CPM remains responsible for market and execution functions such as CDS hedging and secondary loan sales. Responsibility for the latter has grown over the time period with about three quarters reporting full or co-responsibility in 2013 vs. roughly half in 2009. In addition, CPM maintains a strong role in quantitative modeling and analytics with about one third of respondents indicating co-responsibility within their firms for these functions and about one third of respondents indicating an advisory role within their firms for modeling and analytics functions throughout the time period.

Growing CPM Linkages Within the Firm

CPM responsibilities and linkages within the organization have expanded in a number of ways. Co-responsibility for decisions increased in Origination (23% in 2010 to 34% in 2013) and in Limit and Policy Setting (20% in 2010 to 34% in 2013). CPM's responsibility for liquidity management also grew in an advisory capacity over the time frame (from 25% in 2011 to 42% in 2013).

Figure 4

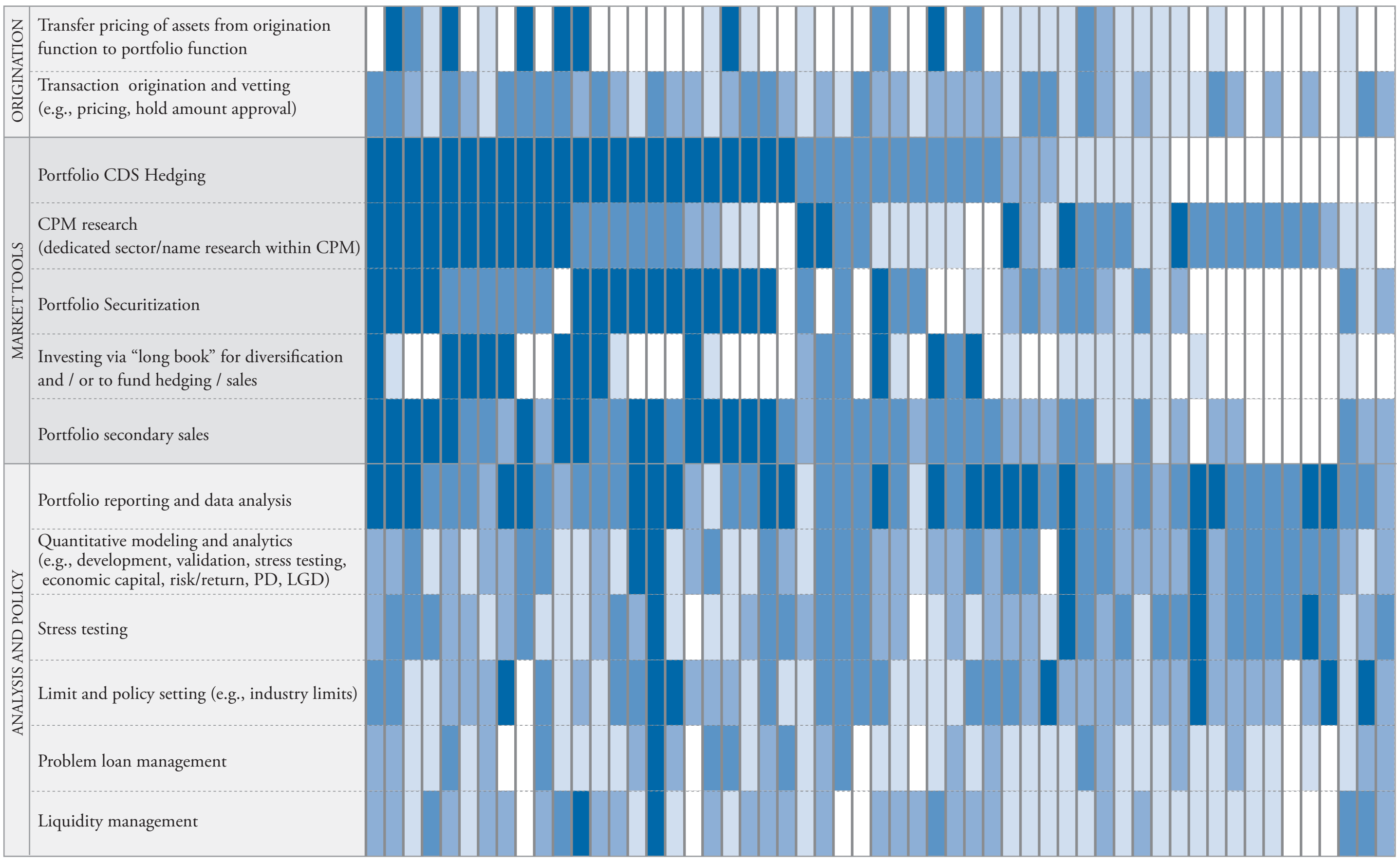
CPM Reporting Line



Full and Sole Responsibility
Co-Responsibility
Advisory Role
Not Involved
Does Not Apply

Figure 5

CPM's Functional Responsibilities for the Corporate Loan Book in 2013

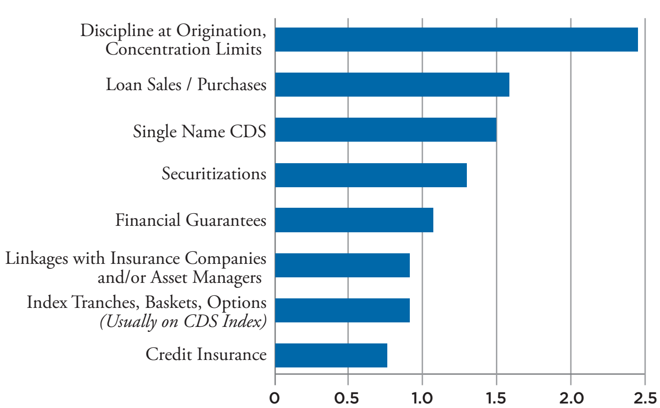


NOTE: Each column represents the response of one participating bank; shaded cells indicate degree of involvement

Figure 6

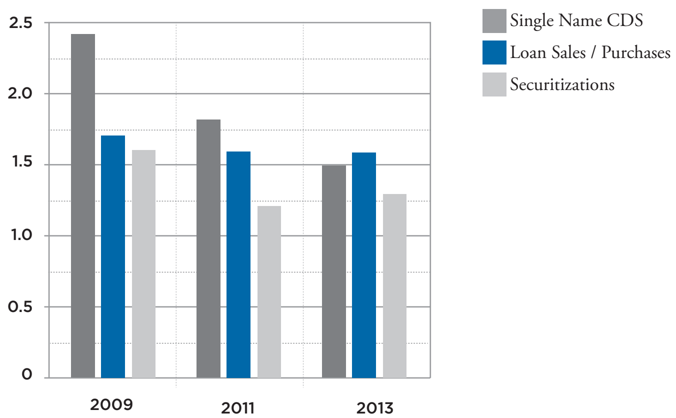
Relative Importance of CPM Tools in 2013

(Weighted by Importance with 3 = Most Important)



Relative Importance of Selected CPM Tools over Time

(Weighted by Importance with 3 = Most Important)



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 (2.4 average importance weighting) as they work to achieve their portfolio goals and objectives. *(Figure 6)* 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, single name CDS and loan sales are most widely used. It is worth noting that, given the changes and evolution in market and regulation, CDS has declined in ranking since 2009, falling from about two thirds ranking the tool as most important to about one quarter giving it that ranking in 2013. Concurrently loan sales have risen very slightly in importance to match or slightly exceed CDS in importance, but still rank well below origination focused tools. Other tools such as securitizations and index tranches have declined slightly in overall importance over the time frame.

In terms of **portfolio hedging activity**, there is a significant difference in hedging behavior between banks with balance sheet assets larger than $500 billion and those below that number. Almost half of the smaller institutions do not hedge, while among larger institutions only 14% indicated no hedging activity. Also among larger institutions, over 70% indicated that 1-10% of their portfolio is hedged. Responses seem largely to reflect the nature of the firm's assets and liquidity of the portfolio in the CDS market. *(Figure 7)*

VI. CPM IN THE FUTURE: EVOLUTION AND CHALLENGES

The *2013 Survey* highlights that over the past five years CPM has continued to evolve and expand in a number of material ways; however, looking ahead over the next 12 to 24 months a number of challenges remain, including the following:

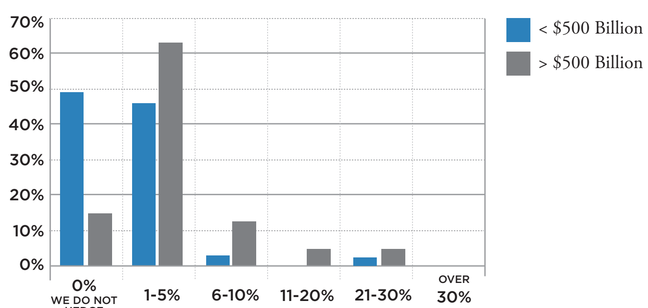
Facilitating Growth and Revenue Generation

The 2013 shift in business priority to revenue generation brings increasing pressure on firms to grow, and moreover, to grow in ways that meet desired return thresholds. CPM will have a prominent role to play in facilitating revenue growth, balancing revenues vs. returns, and working with lines of business regarding client exposure strategies. As a number of firms are seeking to increase revenues via portfolio growth, CPM will also face the challenges of managing concentrations in core businesses and industries where growth is likely to be targeted.

Figure 7

Size of Derivative Hedge Book Relative to Loan Portfolio in 2013

(By Balance Sheet Asset Size)



Enterprise Risk and Stress Testing

As a result of both business and regulatory requirements, institutions are undertaking a wide range of stress tests and analyses of portfolio and business risks across the firm. CPM is often the central repository of portfolio data and history and is also in a key position to assess expected portfolio funding and performance looking forward. In many firms, CPM is now contributing to, or has growing responsibility for, stress test scenario development and analyses of portfolio behavior.

Balance Sheet Management, Liquidity and Capital Allocation Strategy

Most institutions are 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 these enterprise level resource allocations and in executing the strategies set by the firm. These roles will entail increased coordination and partnership with 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.

VII. CONCLUSION

Looking forward, the current dynamic credit, regulatory and market environment suggests that CPM will continue to evolve and expand in a number of ways. 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 and its 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 the institution's goals and objectives given the nature of its business and portfolio.

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