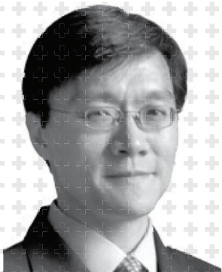
The Banker

How to run a bank 2013

The changing role of credit portfolio management



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Executive director of the International Association of Credit Portfolio Managers

REGULATION HAS SHIFTED THE FOCUS AWAY FROM HEDGING AND ONTO ORIGINATION AS A WAY OF CREATING A BALANCED PORTFOLIO.

Providing credit is an important, some would argue the most important, societal function of banks in their role as a driver of capital formation and economic growth. Banks that manage their credit portfolios well typically succeed, while banks that encounter problems almost always have those problems linked to credit, as evidenced by the recent financial crises centred on subprime and sovereign credit. Hence, credit portfolio management (CPM) remains a core competency for banks. Interestingly, the financial crisis has had a positive impact on many credit portfolio managers, as financial institutions refocus on the need to execute this core function well. At the same time, however, difficult post-crisis market conditions and regulatory changes have only served to make it more challenging to do so. While credit portfolio managers are well positioned to succeed, they will need to adapt to the changing environment to continue their success.

The evolution of CPM

The modern practice of CPM arose from the recognition that there are two fundamentally different economic activities behind the business of lending: originating credit assets and owning a portfolio of credit assets. For much of their history, the portfolio a bank held was simply the result (some would say victim) of the bank's origination function. This can be suboptimal, as the factors that lead to success in origination (expertise and specialisation in certain industries and geographies, the ability originate in volume) will lead to undesirable characteristics in the portfolio you hold (concentrations in those sectors where you originate successfully).

CPM functions developed to address this issue. For many banks that undertook this journey, the first step was to create a better understanding of portfolio dynamics. What constitutes concentration and diversification? What are the costs in terms of risk, capital, liquidity etc. of credit assets? How should we balance return relative to risk in the portfolio? A combination of analytics, judgment, and knowledge of markets and clients are the key tools to gain this understanding.

The next step is to take action to improve the portfolio's economics. On the 'front end' of the lending process, these actions encompass many traditional credit risk activities, such as setting a firm's risk appetite, developing limit structures and policies to implement that appetite, incorporating cost of risk and risk/return analytics into origination, and making portfolio considerations part of the credit approval process. On the 'back end', banks manage the portfolio through secondary loan trading, hedging through derivatives and insurance markets, and transferring risk through securitisations and other transactions.

Changing landscape

While the core tenets of the approach continue to hold, the post-crisis world is shifting the dynamics of CPM in important ways. There are three broad trends that are driving this shift.

The first is the inescapable weight of new regulation. Basel III, in particular, is changing the economics of providing credit to large corporate clients. Traditionally, managing credit costs have been a focus of this activity. Basel III's liquidity coverage ratio (LCR) greatly increases the liquidity costs of providing the credit products that large corporate clients demand of banks. (The LCR defines the amount of liquid assets that a bank must hold to underpin customer credit lines.) In fact, for the highest quality credits, the liquidity costs can now overwhelm the credit costs, greatly changing the economics of providing these products. In response, many CPM functions have started to work much more closely with their counterparts in finance and treasury to better manage these effects. In some firms, CPM has moved from risk or business divisions to treasury/finance. Even with the revised liquidity rules released by the Basel Committee in January 2013, which reduce the impact, the effects remain salient.

The second change is the relative importance of 'front end' versus 'back end' levers to manage the portfolio. A little more than 10 years ago, when the world saw a financial crisis centred on corporate accounting scandals (Enron, Worldcom and the such), many banks developed back end-oriented CPM processes to hedge large corporate risk. While using capital markets to manage portfolio concentrations remains an important aspect of CPM, markets and regulations have increased the costs of using these tools or made their execution much more difficult. As a result, there is a renewed focus on 'front end' steering of the portfolio by applying portfolio considerations in deal decisions, and using limits, policies and risk appetite

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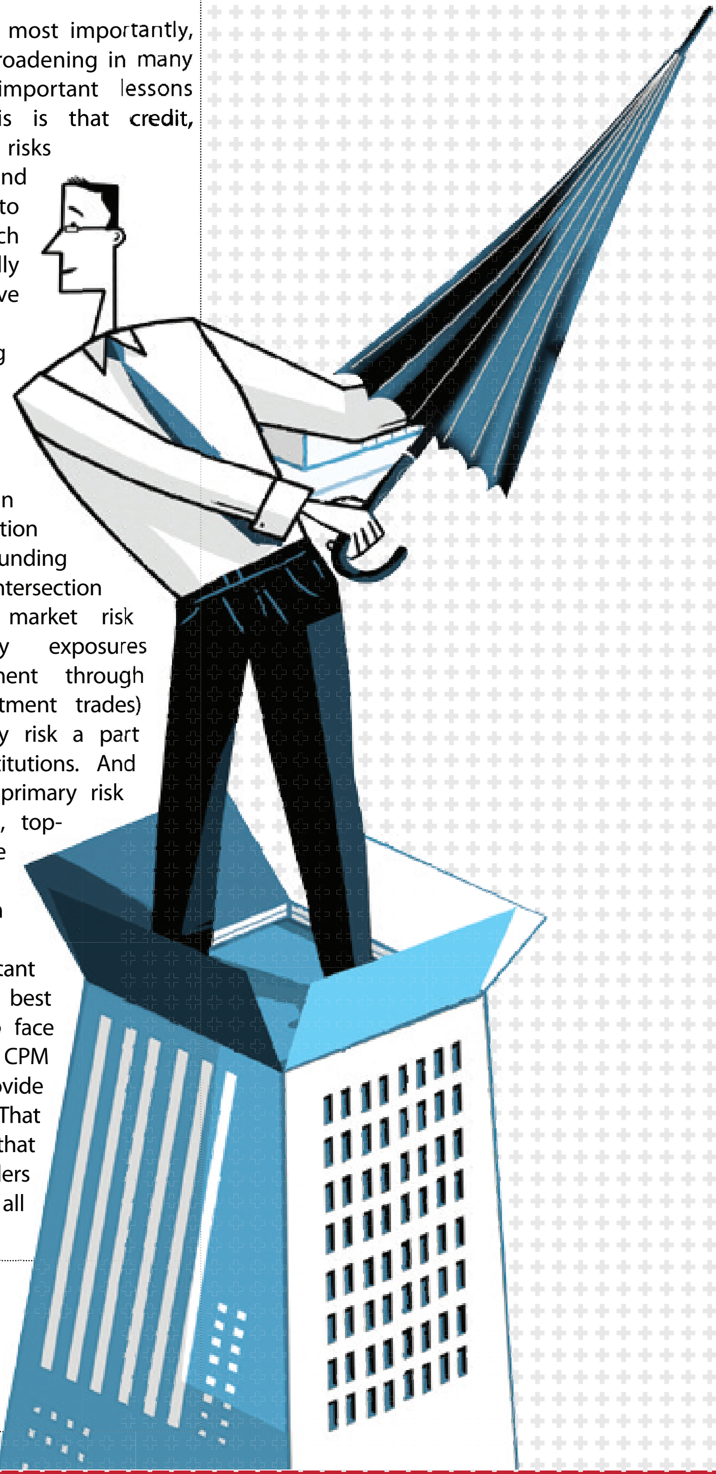
to manage the portfolio through better control of origination.

Finally, and perhaps most importantly, the CPM function is broadening in many ways. One of the important lessons of the financial crisis is that credit, markets and other risks can intertwine, and putting these risks into separate 'silos', which while organisationally convenient, can leave banks vulnerable.



Credit risk is being thought of in the broader framework of enterprise risk, in a much more holistic fashion. In addition to the integration with liquidity and funding discussed above, the intersection of credit risk with market risk through counterparty exposures (and their management through credit valuation adjustment trades) is making counterparty risk a part of CPM in more institutions. And because credit is the primary risk borne by most banks, top-of-house risk appetite discussions rely on significant input from CPM.

These are significant challenges and the best banks are adjusting to face them. The success of CPM will allow banks to provide credit more effectively. That is surely something that bankers, shareholders and regulators can all enthusiastically support.

biography

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