International Association of Credit Portfolio Managers

IACPM Research 2023

Principles and Practices in Credit Portfolio Management

Credit Matters: CPM's Critical Role Amid the Rising Credit Risk Environment

CPM's critical role is expanding amid a changing and uncertain economic and geopolitical environment that puts credit risk under heightened scrutiny at all firms.

IACPM

Executive Summary

The International Association of Credit Portfolio Managers (IACPM) recently completed its *2023 Principles and Practices in CPM* Survey. Sixty-five member firms globally participated in the 2023 Survey.

Conducted every other year, the Survey focuses on four key Risk and Credit Portfolio Management (CPM) areas and their evolution over time:

- Organizational structures
- Mandate and priorities
- Tools and execution
- Outlook for the future

Survey results enable firms to compare and benchmark their practices against those of other leading financial institutions. In preparing this white paper, the IACPM team conducted a number of interviews with participating firms to gather valuable insights into the survey findings.

The 2023 Survey was conducted amid a changing and uncertain economic and geopolitical environment. Conditions included rising inflation, tighter monetary policy, and signs of credit deterioration in certain sectors as well as geopolitical concerns (e.g., war in Ukraine, China/U.S. tensions, etc.).

As capital becomes more scarce and credit risk is under increased scrutiny at all firms, the role of CPM in shaping the credit portfolio is recognized as critical and expanding in banks and financial institutions throughout the world.

Accordingly, current **priority considerations for CPM** include capital efficiency, concentration management, as well as sector and asset strategies. To support these priorities, banks globally are expanding their skillsets in data analytics, data science, ESG and Climate. The integration of **ESG and Climate** metrics into risk and portfolio management is transforming origination and risk mitigation as new markets and standards develop. CPM continues to evolve to meet the needs and identify opportunities in the current rapidly changing risk environment.

Against this backdrop, the Survey results highlight that there is no "one-size fits all" for CPM organizational structures within line(s) of business, risk, finance/treasury or operating on a hybrid basis. The range of CPM business models reflects the nature of firms' portfolios, geographic locations, as well as culture. CPM frameworks and processes continue to evolve organizationally to most effectively address the changing environment.

In that context, **CPM's seniority** and its role within the firm increased during the COVID-19 crisis and its aftermath. This year's survey demonstrates that CPM continues to be a senior function with 40% of respondents reporting within two levels of the CEO, and 80% within three levels of the CEO. CPM is a hub for **linkages** across asset classes, industry sectors, and firms' functional areas (risk, line of business, capital policy, etc.).

Priorities for Credit Portfolio Managers

Capital optimization and RWA reduction

Given capital pressures by regulators, the regulatory capital ratio is now the top binding constraint at banks globally. These renewed capital constraints together with an increase in costs of capital have heightened the focus on RWA forecasts in the past months and made meeting capital targets one of the top CPM business priorities globally (behind revenue generation). Managing the efficient deployment of capital has become the top priority especially for banks domiciled in EMEA and the APAC regions.

While regulatory capital remains the capital measure with the highest importance at banks globally, larger firms in the Americas and APAC are expecting the importance of stressed capital to increase over the next two years. For one-third of smaller bank respondents, economic capital is the top binding constraint.

> ***"Stressed capital will matter for capital adequacy, regulatory capital matters when looking at RAROC and profitability, and economic capital matters most for concentration and risk-based optimization."***
>
> Survey Respondent

Supporting growth while balancing risk/return

The three most important regulations affecting CPM are the finalized Basel 3 rules (84%), followed by securitization and related issues (45%), and climate risk disclosure requirements (34%). Furthermore, in interviews survey respondents mentioned that the bank failures of Spring 2023 brought additional scrutiny on liquidity and counterparty risk and with it the prospect of new regulations.

Despite the tightening of credit and looming regulations, some 50% of respondents are expecting growth in their portfolios over the next 12 to 24 months. CPM is seen as a catalyst and will be expected to support revenue growth while meeting capital targets.

Concentration and limits frameworks, sector concerns and opportunities

Among key CPM mandates are origination frameworks, including concentrations and limits policies; risk measurement and monitoring of early warning metrics; and risk mitigation strategies involving expanded use of market tools where available. Integration of ESG and Climate metrics into risk and portfolio management is transforming origination and risk mitigation as markets and standards develop.

In the context of ESG and Climate and the current economic environment that accelerates credit concerns for some sectors like CRE, CPM functions are exploring emerging sector correlations as well as refining the granularity for select sector concentrations and limits frameworks.

CPM Tools

While discipline at origination (front-end) including concentration and limits frameworks, portfolio perspective in deal decision, and regulatory capital measurement tools continue to top the list of tools used to manage the credit portfolio, market tools (back-end) such as credit risk insurance, loan sales/purchases, financial guarantees, and funded synthetic securitizations have all increased in importance over the last two years for the active management of the credit portfolio, especially for banks using A-IRB. Globally, this is the first time in the survey history that credit risk insurance used for credit portfolio management is ranking highest, just above loan sales/purchases and financial guarantees.

Driven in part by jurisdictional differences in regulatory treatment, market tools show varying levels of use across different regions. For example, the increasing importance of credit risk insurance for risk mitigation in the credit portfolio can be mostly observed in EMEA and APAC, where the tool ranks highest, and its use is continuing to expand. Banks in the Americas prefer loan sales/purchases and single name CDS to manage the credit portfolio. Given differences in regulatory treatment, funded synthetic securitizations are still mainly used by banks under European jurisdiction. However, an increase in usage of this tool can be seen in North America.

Data and Analytics

CPM functions globally are expanding their data, data analytics, and data science skillsets. They are developing additional data sources (internal and external), non-traditional risk data, and new platforms to inform credit risk management decisions. For the Corporate and SME portfolio, these data sources include news, social media, and internal credit behavior data. Top challenges that are constraining the use of innovative data as well as advanced analytics are the cost and quality of available data, validation difficulties, and regulatory expectations. Forward-looking key risk indicators such as credit movements, P&L movements, and credit spread delta are evaluated at least monthly by some two-thirds of participating firms.

ESG, Climate, and Sustainability

ESG and climate concerns hold significant importance for all firms at the organizational level. CPM is actively working to integrate factors pertaining to both potential challenges and advantages into portfolio structures, analytical processes, and choices. CPM's seniority and expanding linkages within financial institutions make the practice an effective platform.

Especially at larger institutions domiciled in EMEA and APAC, client transition management and finance, which includes supporting clients in their transition to a low carbon economy, are one of the top three business priorities. This focus on transition finance is affecting CPM's role and mandate. CPM functions have an increasing responsibility for ESG and climate risk management frameworks within Corporate and SME portfolios and continue the development of ESG and climate risk analytics to support clients' transition and, with that, banks' balance sheet optimization and growth.

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Introduction

The conditions of a persistently uncertain economic and geopolitical environment, including rising inflation and therefore tighter monetary policy, are causing credit deterioration in some industry sectors. As a result, credit risk is under heightened scrutiny at all firms.

Against this backdrop, the International Association of Credit Portfolio Managers (IACPM) launched its *2023 Principles and Practices in CPM* Survey. Conducted every other year, the Survey focuses on key areas of interest to IACPM members: the **evolution** of risk and credit portfolio management (CPM), **organizational** structures, **mandate** and **priorities, tools** used to manage the credit portfolio, and **outlook** for the future.

Results provide insights into the current state of CPM across an array of firms and an opportunity for IACPM members to confidentially benchmark their CPM practice with those of other leading financial firms. Sixty-five member firms globally participated in the 2023 Survey.

Among the topics addressed are:

- Portfolio definition and coverage
- Organizational structure, reporting lines and seniority
- CPM mandate, priorities, and key performance indicators (KPIs)
- Tools and execution (front-end versus back-end)
- Challenges and future path

Note on the survey demographics

The *IACPM 2023 Principles and Practices in CPM* Survey collected responses from 65 firms globally consisting of: 54 banks, as well as nine development banks and export credit agencies, and two reinsurance firms. More than half of the participating banks have a total balance sheet size above USD 500 billion.

The observations on the survey results contained in this paper reflect responses for the 54 banks and two reinsurance companies. For the purposes of comparison and to examine trends, parts of the analysis look at different sizes of responding firms. For ease of reference, 'large banks' are defined as those with assets greater than USD 500 billion and 'small banks' as those with assets below USD 500 billion.

For this survey, the term 'Credit Portfolio Management' or 'CPM' refers to a division/unit or a function.

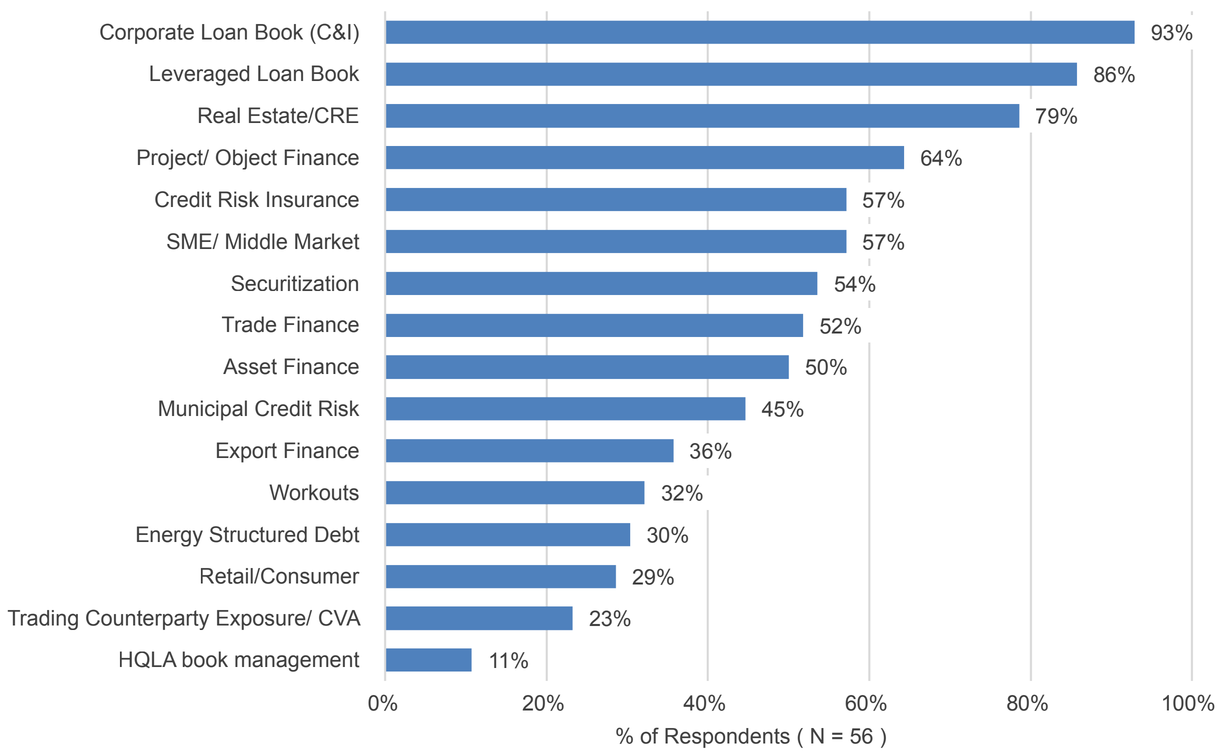
Portfolio Definition and Coverage

Portfolio definition and asset coverage are among the most important organizational items for risk and credit portfolio management. The definition, and the liquidity and nature of the assets, in many ways then determine the appropriate organizational structure as well as the mission and mandate of the function.

At almost all responding banks, CPM has risk management responsibility for the corporate loan book and the leveraged loan book, and three-quarters of respondents also cover the real estate/CRE book as well as project/object finance. At larger banks, this is followed by securitization, credit risk insurance, and SME/middle market portfolios. At smaller institutions, the next tier includes municipal credit risk, SME/middle market, credit risk insurance, and trade finance portfolios.

Figure 1

Portfolio Management Coverage by Asset Class (including commitments and LCs)



Organizational Structure, Reporting Lines and Seniority

CPM is a team of subject matter experts that provides guidance to senior management in the active management of the credit portfolio to optimize risk/return efficiency. The team has three main objectives:

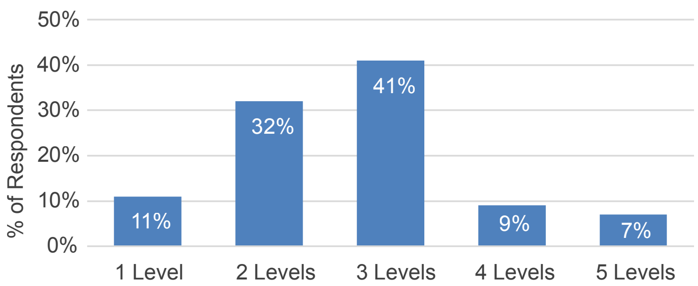
1. ***Ensure that the [bank's] credit risk profile remains within its established risk appetite limits.***
2. ***Manage portfolio concentrations to mitigate the potential impact of correlated losses.***
3. ***[...] Publish research to identify emerging risks and opportunities that can be used to drive portfolio shaping recommendations.***

Example of a CPM Business Model as described by a survey respondent.

CPM is a **senior function** at virtually all the participating firms, and the trend is toward higher levels of seniority. Some 80% report within three levels of the CEO and some 40% within two. In interviews, survey participants noted that the focus on capital and a refocus on credit risk, combined with the need for new data and analytical approaches, continue to elevate and expand CPM's role and responsibilities, and **increase visibility** of the CPM function within institutions.

Figure 2

Reporting Levels between Head of CPM and CEO

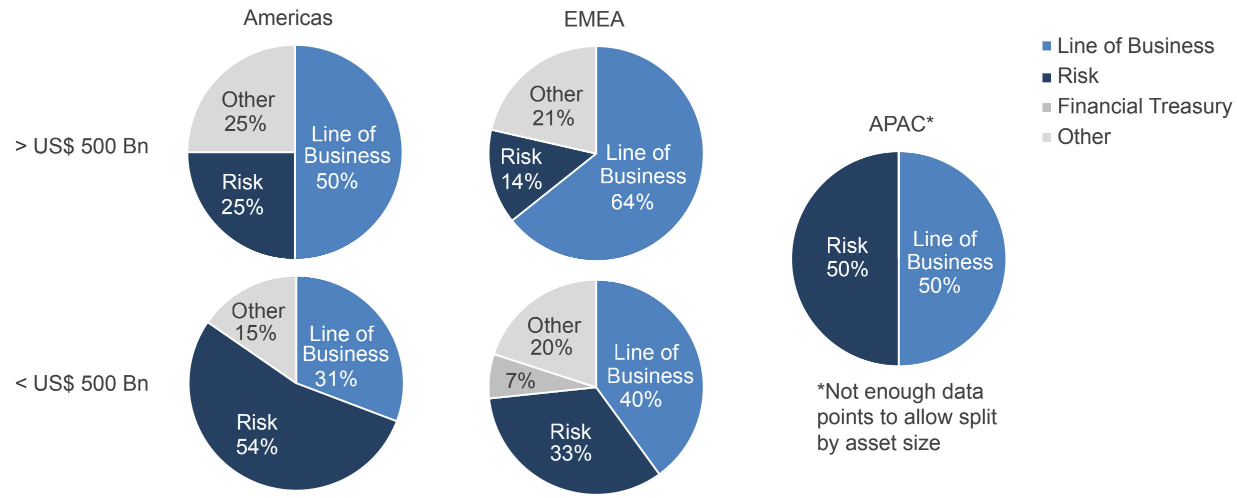


CPM generally reports to one of two functional areas: **Risk or Line(s) of Business**. A few participants note reporting to finance/ treasury and/or operating on a hybrid basis with dual reporting lines to more than one functional area.

Reporting lines differ according to firms' size and geography. Larger firms globally tend to report to the Line of Business, while smaller firms in the Americas more often report to Risk. APAC is evenly split. These variances might reflect a firm's portfolio composition. For example, larger firms tend to have both origination policy tools and market risk mitigation tools available for the portfolio allowing them functionally to align more with the Line of Business, while smaller, more regional firms may have portfolios with fewer public, liquid names and therefore align CPM with Risk.

Figure 3

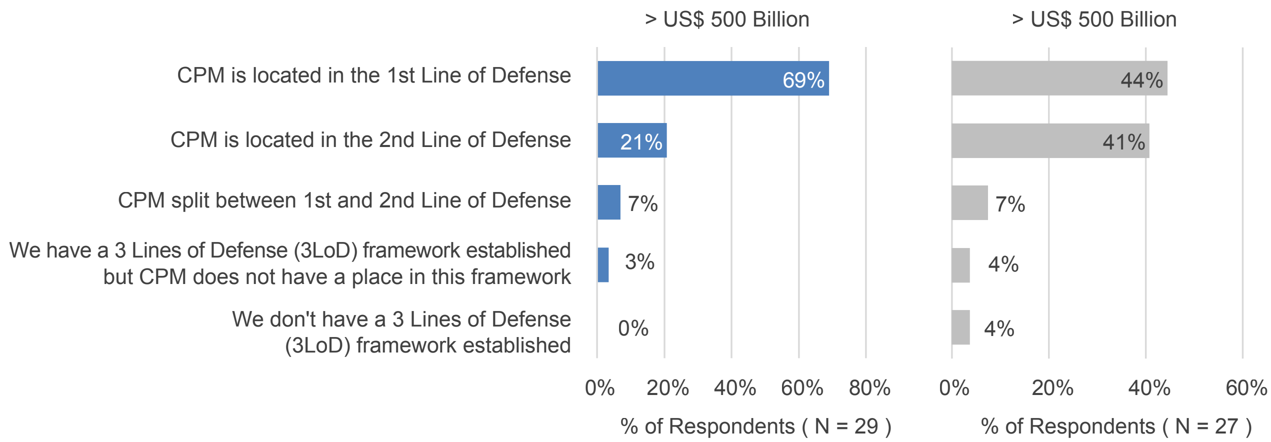
Credit Risk and Portfolio Management Reporting Line by Region of Domicile and Asset Size



Lines of defense approaches differ depending on bank size and region of domicile. Two-thirds of larger banks reported their CPM location in the first line of defense, compared with smaller banks that have CPM more evenly split between first and second line. Regionally, at almost three-quarters of banks in EMEA (regardless of size) CPM is located in the first line of defense.

Figure 4

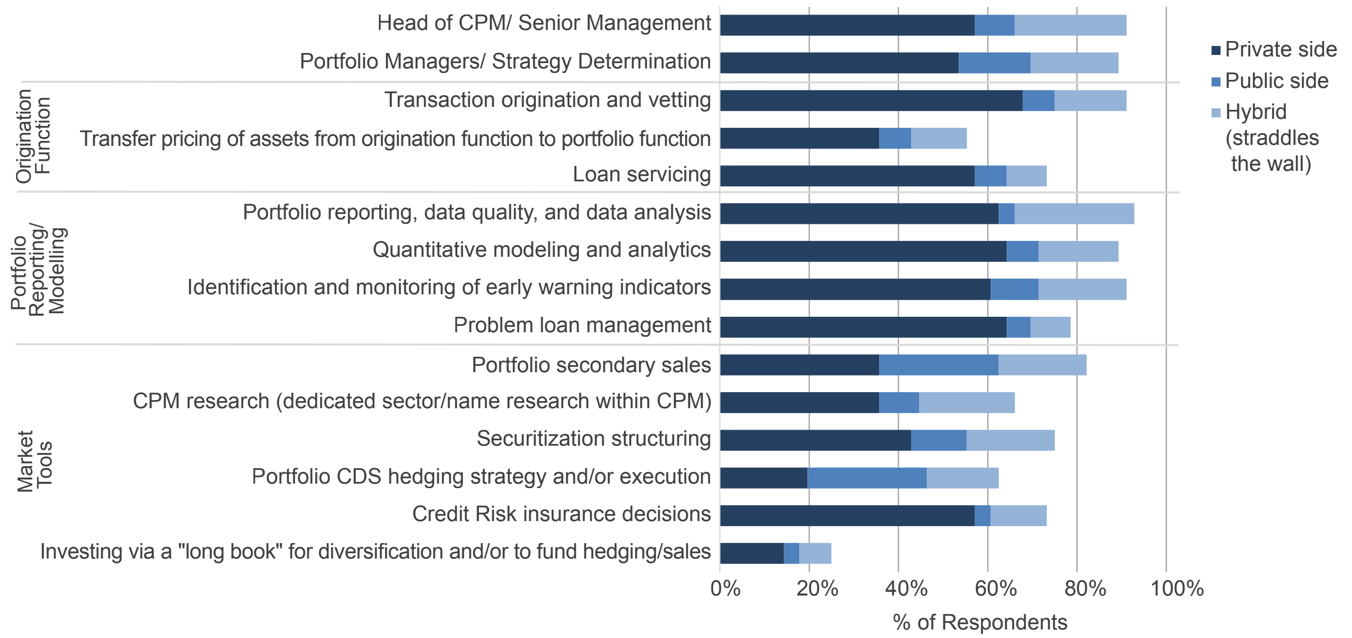
CPM Location in 3 Lines of Defense Framework by Asset Size



CPM models vary on **private versus public side organizational approaches**, reflecting the nature of the firm and its lines of business and assets. Most firms operate CPM organizationally on the private side or in a hybrid structure with some housed on the public side. For example, CPM can operate wholly on the public side and, as such, will have no linkage to credit origination. If so, CPM often includes public side portfolio research and has a focus on market risk mitigation functions. Other firms place CPM fully on the private side or utilize hybrid structures. For these, CPM may actively advise on the origination and on-boarding of assets but may have more limited back-end risk mitigation functions which might operate under a hybrid approach.

Figure 5

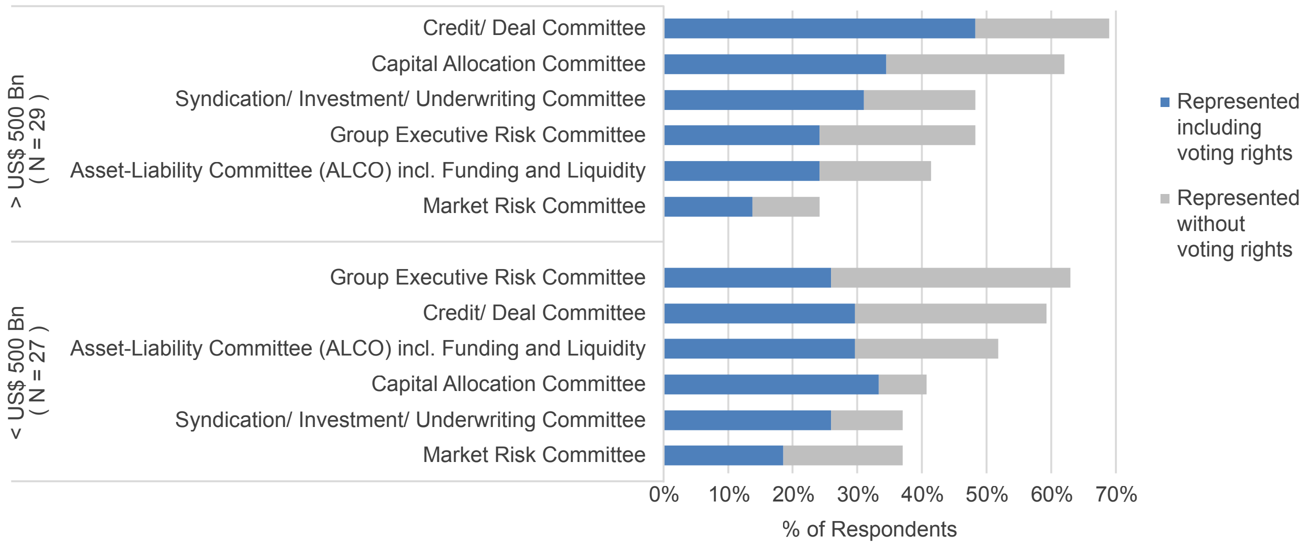
CPM Functions on the Public/Private Side



To effectively fulfill their functions, CPM is represented across various **governing committees**, thereby further enhancing linkages throughout their institutions. The top three include the Credit/Deal Committee, the Group Executive Risk Committee, and the Capital Allocation Committee where CPM is either represented with voting rights or with an advisory role. Other committees with CPM representation include Syndication/ Investment/Underwriting, ALCO/Funding and, to a lesser extent, Market Risk.

Figure 6

CPM's Committee Representation



CPM Mandate and Priorities

Responses demonstrate that **CPM's functional responsibilities** include a wide range of areas, reflecting CPM's mandate and the nature of the firm. Among key areas are:

- Origination Decisions and Advisory
- Portfolio Reporting, Modeling, and Analytics, including the identification and monitoring of early warning indicators, stress testing and risk/return
- Risk Mitigation Strategy, Decisions and Execution for the portfolio, including for credit risk insurance and CDS
- Risk Governance such as limit setting and monitoring of breaches
- Strategic functions such as capital management and the management of regulatory changes

"Innovative data availability is a key concern although there is an active focus on integrating more innovative data points. Additionally, prior experience with AI applications has not been favorable but will continue to be evaluated given ongoing developments."

Survey Respondent

CPM functions globally are expanding data, data analytics, and data science skillsets. Furthermore, CPM functions are developing additional data sources (internal and external), non-traditional risk data, and new platforms to inform credit risk management decisions. For the Corporate and SME portfolio, these data sources include news, social media, and internal credit behavior data. Top challenges that are constraining the use of innovative data as well as advanced analytics are the cost and quality of available data, validation difficulties, and regulatory expectations.

Within risk governance, CPM typically advises on Risk Appetite frameworks, often holds responsibility for limit setting, calibration and monitoring, the mitigation of breaches, as well as the identification of emerging risks.

"Expansion of existing responsibilities to drive increased returns on capital."

Survey Respondent

CPM functions are closely involved in Capital Management and Allocation decisioning as well as the management of regulatory changes, like the upcoming finalization of Basel 3. The identification, monitoring, and management of **environmental risks** within the credit portfolio are growing in importance and CPM has a critical and central role to play by increasing useful linkages across departments, asset classes, and industries thereby increasing the role of the function on an enterprise level.

Consistent with previous observations in this survey series, **CPM mandates continue to expand** at half of banks with domicile in APAC and EMEA, and especially at larger EMEA domiciled institutions (67%). The important role of many CPM functions during the COVID period led at some institutions to an increase in responsibility and at others to an expansion of the role to include liquidity risk and funding cost management. The focus on credit risk, including ESG, counterparty risk, and early warning indicators, triggers additional expansion of the CPM mandate.

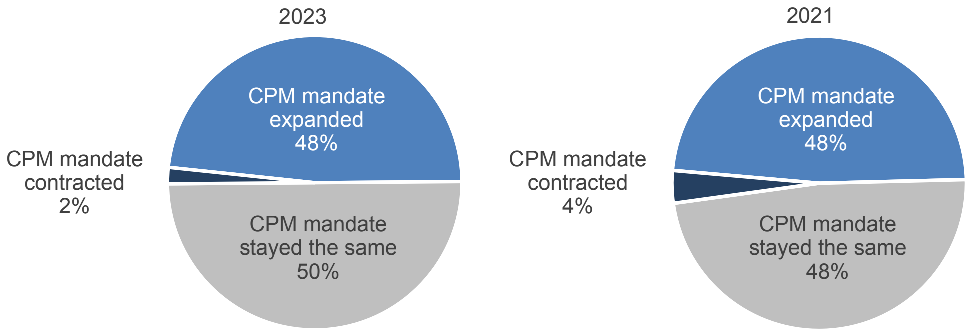
Examples of an expanding CPM role as cited by survey participants include the involvement in liquidity risk and ESG risk management along with additional data, data analytics, and reporting requirements.

"Expansion of current roles to increasingly include considerations of liquidity and funding costs, as counterparty or credit risk management is increasingly influenced by MTM movements and collateral management capabilities, especially for Non-Bank Financial Institutions (NBFIs)."

Survey Respondent

Figure 7

CPM Mandate Expanding or Contracting



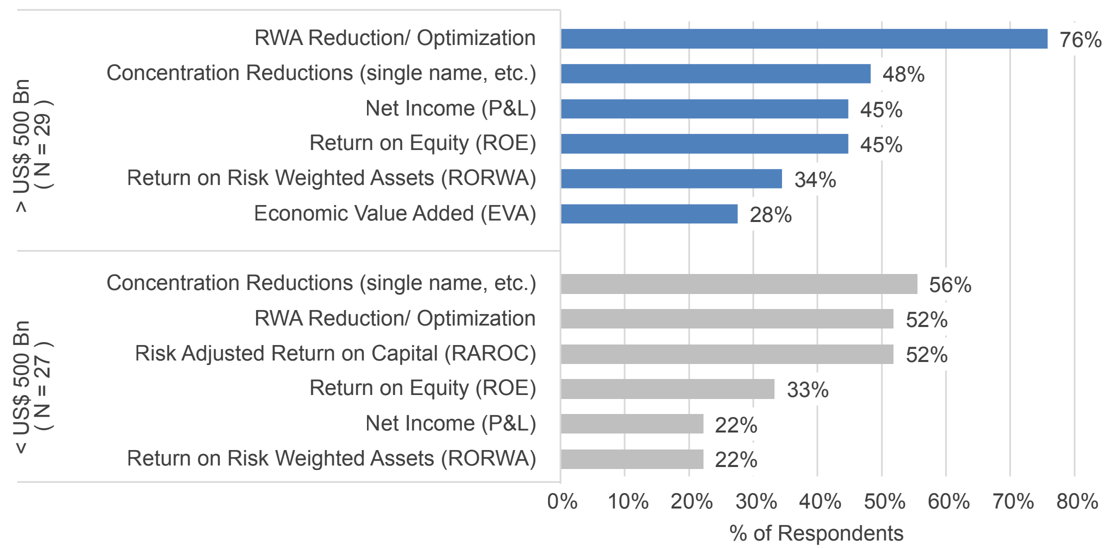
Key performance indicators (KPIs) for CPM show some variance depending on firm size and the nature of assets. Given CPM's linkages across many areas of the firm, KPIs often include both quantitative and qualitative measures. Quantitatively, larger firms predominantly use RWA reduction/optimization to assess the economic value of CPM, followed by concentration reduction, net income measures, and return on equity. Smaller firms are equally focused on concentration reductions, RWA reduction/optimization, and RAROC measures, which rank much higher at smaller banks than at their larger counterparts. It is worth noting that, during this changing period of the credit crisis, one quarter of the smaller banks indicated (re)defining or developing CPM performance assessment.

"The function is measured according to its capacity to properly monitor and early detect any deterioration of the portfolio through the rating reviews, the early warning signals, and the event management."

Survey Respondent

Figure 8

Key performance indicators for assessing CPM performance



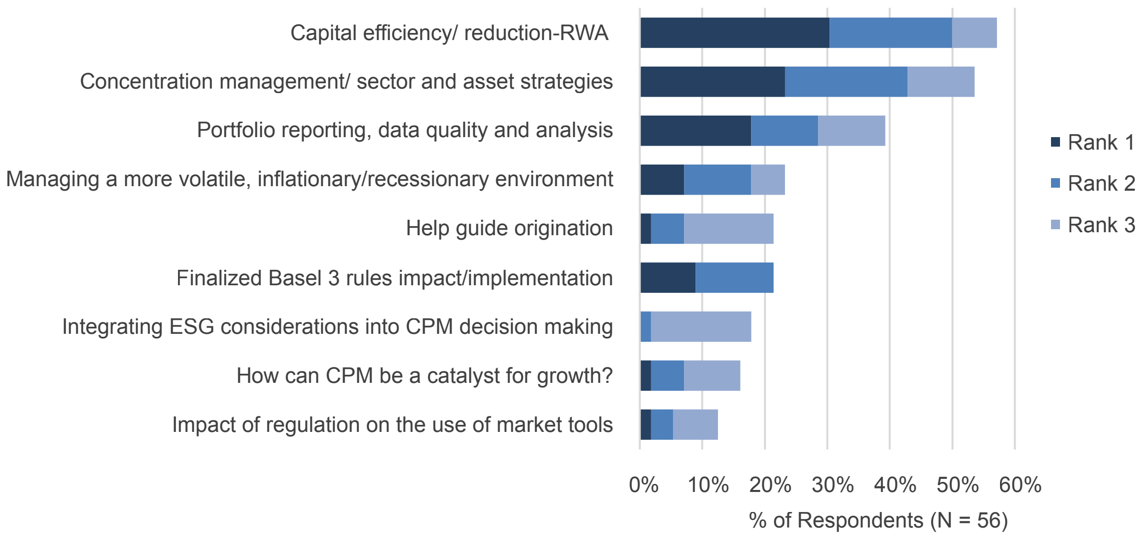
CPM priorities include:

- Capital efficiency, reduction and RWA
- Concentration management, including sector and asset strategies
- Portfolio Reporting, data, and data analytics

While these three objectives have been consistently topping the priority list, the management of capital and RWA is now the top priority, especially for banks domiciled in EMEA and APAC. In the prevailing uncertain economic and geopolitical environment, banks domiciled in the Americas have a higher focus on concentration management, including sector and asset strategies. In interviews, survey participants pointed to a currently increasing focus on sectors like commercial real estate as well as non-bank lending and emphasized the need for diversification in the credit portfolio.

Figure 9

Credit Risk and Portfolio Management Top Priorities



Tools and Execution

To achieve portfolio objectives, CPM uses a range of front-end tools at origination (concentration limits, etc.) **and back-end market tools post-origination** (loan sales, credit risk insurance, etc.).

- **"Front-end" function of credit origination into the portfolio:**
  Policies related to risk appetite and concentration limits framework, risk and risk/return assessment and pricing, loan documentation, and promotion of sustainable finance.
- **"Back-end" function of loan portfolio management:**
  Aims at facilitating lending growth by creating more lending capacity, mitigating concentrations, and reducing capital requirements, using risk transfer solutions like loan sales, credit risk insurance, credit default swaps, funded and unfunded securitizations.

(Source : http://iacpm.org/wp-content/uploads/2022/02/IACPMRisk-Mitigation-Techniques-White-Paper.pdf)

Discipline at origination remains the top priority when managing a credit portfolio, with **concentration limits** the overall **most important tool** in CPM's tool kit supported by maintaining a portfolio perspective when making deal decisions and regulatory capital measurement tools to ensure capital optimization.

On the back end, the use of market tools continued to increase over the last two years for almost all tools except loan sales/purchases and single name CDS. Market tools are often used for significant risk transfer (SRT) and to free up capital for redeployment in support of the real economy.

Globally, this is the first time credit risk insurance is ranking highest, just before loan sales/purchases and financial guarantees. Driven at least in part by jurisdictional differences in regulatory treatment, market tools continue to show varying levels of employment across different regions. While for firms domiciled in EMEA credit risk insurance and synthetic securitizations (funded and unfunded) are important tools in their toolkit to mitigate risk in the credit portfolio, their counterparts in the Americas assign the relative highest importance to loan sales/purchases and single name CDS contracts.

In the APAC region, especially for Australian banks, credit risk insurance is the relative most important market tool to mitigate credit risk on the back end, followed by financial guarantees.

Looking forward, smaller banks are expecting to increase their usage of credit risk insurance, unfunded synthetic securitization, and financial guarantees, while large institutions are expecting loan sales/purchases, funded synthetic securitizations (issuing CLNs), and CDS (single name as well as indices) to increase relatively more in importance.

Figure 10

Relative importance of CPM tools 2023 vs 2021

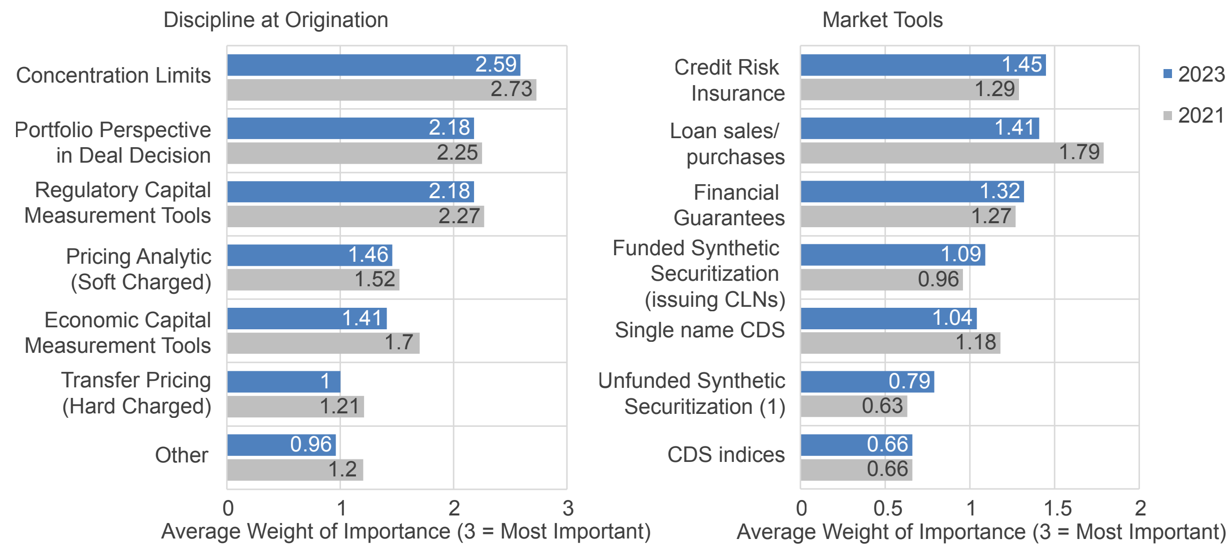
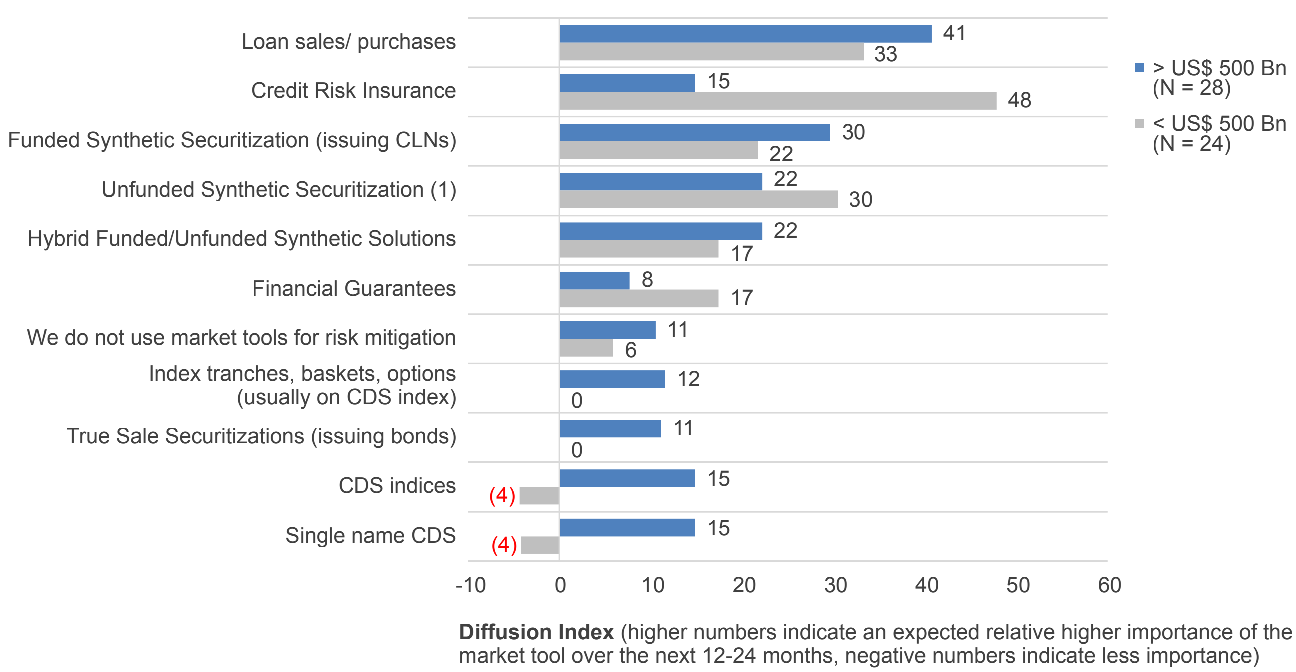


Figure 11

Relative Importance of Market Tools over the next 12-24 Months – by asset size

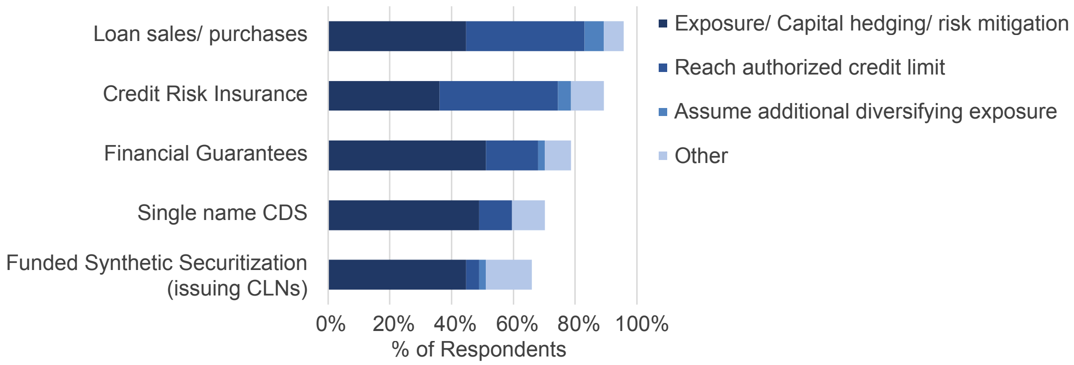


(1) split between CDSs, credit risk insurance policies, and hybrid solutions

The **primary goals** when using market tools to mitigate risk in the credit portfolio include exposure/capital hedging to free up capital for redeployment and reaching authorized credit limits. Some firms use risk mitigation tools to assume additional diversifying exposures.

Figure 12

Primary Goals when Using Risk Mitigation Tools



Environmental, Social and Governance (ESG) and Climate

The integration of ESG and Climate metrics into risk and portfolio management is transforming origination and risk mitigation as markets and standards develop.

CPM remains a hub for important and growing **linkages** within the firm (risk, line of business, capital policy, etc.) but also across industry sectors which is an indispensable characteristic for the identification and management of ESG and climate risks as well as opportunities.

ESG and climate concerns hold significant importance for all firms at the organizational level. CPM is actively working to integrate factors pertaining to both potential challenges and advantages into portfolio structures, analytical processes, and choices.

Especially at larger institutions domiciled in EMEA and APAC, client transition management and finance, which includes supporting clients in their transition to a low carbon economy, is one of the top three business priorities. This focus on transition finance affects CPM's role and mandate. CPM functions have an increasing responsibility for ESG and climate risk management frameworks within Corporate and SME portfolios and continue the development of ESG and climate risk analytics to support clients' transition and with that banks' balance sheet optimization and growth.

"Continued development of ESG capability to support clients' transition to a low carbon economy."

Survey Respondent

"We will [...] need to implement a number of top-down climate initiatives at the portfolio level."

Survey Respondent

"Assisting in climate balance sheet optimization."

Survey Respondent

Challenges and the Path Forward

Geopolitical conflicts, a persistent inflationary environment and the resulting economic and market volatility have **significantly heightened the focus on credit risk and the need for early warning indicators.** As a result, CPM is increasingly involved in enterprise-level, strategic decision-making at many financial institutions globally. As simply stated by one CPM professional: "Credit matters."

As credit concerns and **capital requirements** continue to rise, CPM's role in the efficient use of capital through the active management of credit portfolios is even more critical and expanding. Finalized Basel rules with the transition to a Foundation – Internal Ratings Based Approach (FIRB) will bring additional capital pressures that will need to get managed. At many firms the role of CPM is seen as a catalyst to support revenue growth while also meeting capital targets.

The transverse nature of ESG and climate risks make CPM linkages across departments, asset classes, and industries an effective platform for the identification, monitoring, and management of environmental risks within the credit portfolio and for the integration of these risks into credit risk assessment processes, therefore increasing visibility of CPM within the organization.

To support these priorities, CPM functions globally are expanding their **skillsets** in data analytics, data science, as well as ESG and climate within their organizations as finding the right talent elsewhere continues to be a challenge with growing demand.

The increased attention on credit and counterparty risk due to geopolitical and economic uncertainty, the amplified focus on ESG and climate risk effects on counterparties, together with rising capital costs are making CPM a central, often enterprise level role at many firms.

CPMs' organizational structures are evolving, as appropriate at their firms (no "one size fits all"), to meet the new challenges and opportunities that are confronting the industry in this rapidly changing and demanding environment. The right building blocks are already in place.

Demographics

Figure 13

Survey Participants by Approximate Total Balance Sheet Assets

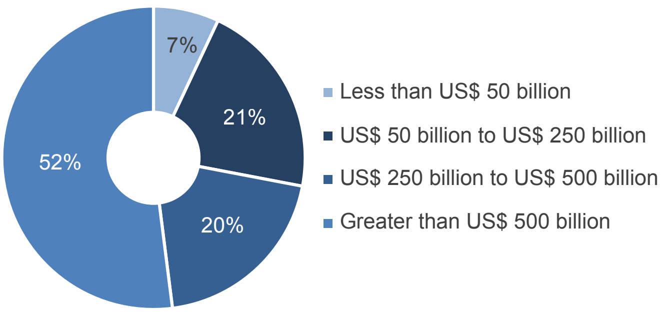
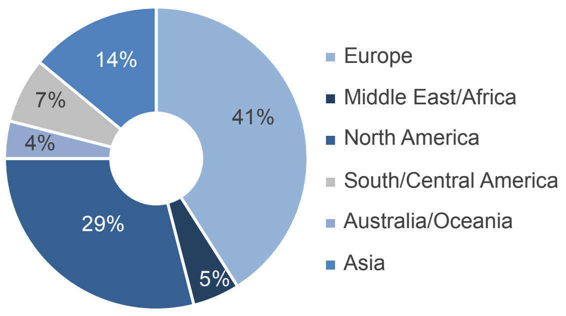


Figure 14

Survey Participants by Region of Domicile



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About the IACPM

The Association represents its members before regulators around the world, holds bi-annual 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.

There are over 135 financial institutions worldwide that are members of the IACPM. These institutions are based in 30 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

Today credit market conditions, and new regulations, are shaping the financial services industry. The discipline of credit portfolio management is evolving within firms to include the measurement and management of credit risk at the enterprise level, in addition to execution of risk mitigation strategies in credit markets.

CPM has increasing linkages with: front-end credit originators; the setting of risk appetite and limit structures; funding and liquidity for the firm; and management of counterparty risk. CPM is also expanding coverage of credit assets beyond investment grade and leveraged to include middle market and retail, as well as in some cases bonds and other credit-sensitive instruments.

The IACPM recognizes the unique and evolving role of credit portfolio managers in today's financial environment, and offers an excellent forum through which these issues can be identified, understood and addressed.