Faced with huge increases in capital charges in the coming months, banks will turn to credit portfolio management to support business decisions on origination, capital allocation and risk transfer.
Introduction

The mandate of credit portfolio management (CPM) at banks is set to expand and play a more strategic role in the coming months as banks grapple with upcoming regulatory changes, increased market volatility and uncertainty in the global economy, say credit, finance and risk experts.

New rules governing banks’ capital requirements – part of a package designed to shore up Basel III – will be implemented across many jurisdictions in 2025. While there are currently delays in the US, implementation across the European Union and the UK is scheduled for January 1, 2025. The rules are likely to significantly increase the amount of capital that banks need to hold. Faced with additional capital charges – which could run into the billions – banks will need to review their capital allocations, portfolio management and risk transfer strategies to mitigate some of the impact of these rules. Credit and risk experts suggest CPM will play a key role in this, supporting businesses with decision-making and having greater input into origination and balance sheet optimisation in the coming months.

“Firms will be looking very carefully at the way they allocate capital going forward, and the CPM function is going to play a more important role than has been the case for the past few years,” says Alexis Hamar, head of banking client relationships at Moody’s Analytics.

Final Basel III reform is being implemented in the EU through the third capital requirements regulation (CRR III), which reached political agreement on June 27. It marks a much-discussed return to the use of the standardised approach (SA) – the method set out by the Basel Committee on Banking Supervision for calculating regulatory capital. Currently, most large banks use their own models under the internal ratings-based (IRB) approach. The new rules restrict the use of internal models and include an output floor that requires banks to hold capital equal to at least 72.5% of the amount indicated by the SA, regardless of what their internal models suggest.

“The new rules will bring a fresh dimension to the CPM mandate – at least for banks under the IRB approach,” says Thomas Alamalhoda, head of resource and portfolio management at BNP Paribas. “Post-implementation, they will have to manage capital under two different paradigms: the standardised and IRB approaches. This is one of the direct effects of the output floor.”

Changes to the SA – such as adding more tiers, categories and requirements – are also being brought in, which will make it more risk-sensitive. However, its simplified and standardised nature means it is significantly less risk-sensitive than banks’ own sophisticated models.

“The SA and the output floor will clearly make the assessment of the real risk more complex,” Alamahoda says.

The output floor will be phased in, not reaching 72.5% until 2028. By then, almost one-quarter of banks worldwide are set to be bound by it, up from just 6% at the end of 2021, according to the Basel Committee. The output floor is expected to increase the Tier 1 capital requirements of large European banks by 17.5% when compared with levels held at the end of 2021, Basel Committee figures suggest.

The final Basel III rules also introduce a leverage ratio buffer to further limit the leverage of global systemic institutions by requiring them to keep additional capital in reserve. This will also impact CPM.

“Management of the leverage ratio will require the expansion of the CPM role,” states Alamalhoda. “If you look at the balance sheet size or the leverage exposure used for the computation of the leverage ratio, the main contributors are businesses from typical global markets activities, namely fixed income, currencies, commodities and equities,” he says. “On the corporate banking side, tools to manage the leverage exposure are more limited – aside from asset sales, which have an obvious impact in terms of client relationships.”
One of the biggest impacts of final Basel III implementation is the introduction of changes to the methods and approaches used to calculate risk-weighted assets (RWAs) and capital ratios. All risk types will be affected, regardless of whether the standardised or IRB approach is being used. Major changes include reducing the use of the advanced IRB approach for financial institutions and replacing it with either the foundation IRB approach or the SA. Meanwhile, equity exposures will come out of IRB scope and only fall under the SA.

“Final Basel III implementation – or CRR III – is a potential game-changer for European banks, as current distribution of risk weights and profitability by facility or client could totally change,” says Alamalhoda. “This is a challenge for decision-making processes and drives the need for a double assessment in terms of economic and regulatory key performance indicators. The good news is that the portfolio will not be any riskier, as the risk profile will remain the same,” he adds.

As a result of these changes, affected IRB models will need to be recalibrated and, in some cases, new regulatory approval will need to be sought.

The end of the internal model?

The new emphasis of the SA under final Basel III reform raises the question of whether banks will still use internal economic models to calculate capital holdings.

Alamalhoda believes they will. “The new regulatory framework – while aiming at harmonising and simplifying RWA computation approaches – is not the end of internal models,” he says.

Nick Silitch, former chief risk officer at Prudential, believes the 72.5% output floor still gives large firms an incentive to model their own portfolios, especially as today’s technology makes it “really not expensive or time-consuming”.

He says dropping the internal economic model altogether would be a loss for the industry. “Hopefully there is still room for that economic model because, once you get away from having the economic model drive your decision-making, you’ve lost a lot.”

For firms still operating internal models, the challenge will be bridging the gap between the output of economic models and the SA – and, here again, CPM will play an important role, say credit experts.

“We see it as an important opportunity for CPM to help the institution reduce the gap, when relevant,” says Alamalhoda. “We are seeing a growing trend of CPM facilitating internal capital reallocation, with savings redeployed into growth plans. Those institutions that have the proper framework for implementing capital active management strategies will obviously be better placed to tap into this trend,” he says, adding that BNP Paribas has “extensively invested” in this area.

He adds that it’s important to note the output floor is not applied at asset level, but at institution level: “This means you can benefit from mutualisation effects.”

This may also add complexity, suggests Hamar. “Because of the output floor, banks will now have to manage and steer their portfolios at a more aggregated level than before.”

“Previously, banks could adopt a granular loan-by-loan approach to achieve the most optimal capital allocation treatment. They will now be required to assess the impact of new loans at portfolio level and consider how to optimise the existing balance sheet,” he adds.
The changing face of credit portfolio management at banks

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Market volatility

Increased market volatility and margin call hikes in recent months have made hedging trickier and more expensive, putting extra emphasis on the role of CPM, say credit experts. While derivatives valuation adjustment (XVA) desks can take on and hedge some credit risk, the expense of dynamic hedging strategies can be prohibitive. These days, the credit function may need to be more strategic, says Malcolm Hibbert, managing director and head of XVA trading at Crédit Agricole CIB.

“You might need to look at how your portfolio is diversified, as opposed to only the dynamic rebalancing of hedges. It’s not just about the capacity to hedge – it’s also about understanding and managing concentration risks and diversifying.”

Certain concentrations tend to occur naturally in banks’ portfolios. For example, a regional bank in Houston, Texas, is very likely to be heavy on loans to the oil industry, while a large bank may have a concentration of assets in the country in which it is headquartered. As credit portfolio managers look at various portfolio diversification strategies that deal with concentration risk, they also need to consider new RWAs and increased capital charges. Hamar expects to see a move towards capital steering strategies such as ‘risk parity’ type strategies, which involve selecting a relatively even spread of medium-risk assets within the portfolio, in line with risk appetite allocation constraints.

“Another possible strategy is to polarise risks, opting for both light RWA assets – overweighted in relation to what the institution deems necessary in terms of capital – and high-risk, underweighted assets,” Hamar adds.

Risk transfer

As well as portfolio diversification, credit portfolio managers will be looking to implement new asset allocation strategies using optimal risk transfer solutions, say credit experts. “If, as a CPM, you actively manage back-book capital, you will need to reassess your positions to ensure that significant risk transfer [SRT], credit insurance or credit default swap [CDS] positions remain efficient,” says Alamalhoda. “This could therefore require unwinding some positions and putting on new ones.”

SRT transactions will be key here, says Som-lok Leung, executive director at the International Association of Credit Portfolio Managers (IACPM).

In the EU, these trades are usually conducted via synthetic securitisations, where a special-purpose vehicle buys tranched credit protection from investors, referencing an underlying portfolio of the bank’s loans. SRT deals may be used by banks to reduce exposure to specific sectors, or to obtain more general capital relief, because the synthetic securitisation will cut the credit RWAs of the underlying pool.
“While CDS have diminished in importance since the financial crisis [that began in 2007–08], in Europe, synthetic securitisation is very important as a source of capital relief so that banks can recycle capital to lend to the real economy,” says Leung. It is gaining importance in North America – particularly Canada – he notes.

“One of the reasons why Canadian and US banks are now looking at it is because they can see what is coming in terms of potential pressure on regulatory capital and they know how long it takes to get into this market,” says Leung. “It’s not like going out and buying a credit insurance policy or buying a CDS and hedging it. It involves setting up an entire team and developing a programme.”

It had been feared that CRR III would strangle the SRT market with regulatory treatment that would render most transactions uneconomical. However, the June 27, 2023 political agreement of CRR III offered some relief by amending the ‘P factor’.

Under the final Basel III securitisation rules, banks using the SA have to apply a fixed multiplier known as the P factor, so securitisation carries a higher risk weight than the underlying asset. Although this is targeted specifically to the SA, it hits banks deploying the IRB approach due to the 72.5% output floor. Under EU securitisation rules, the originating bank must retain 5% of the synthetic transaction to protect against conflicts of interest. The design of the output floor in the original draft of CRR III, published in October 2021, would have made it prohibitively expensive to hold a retained senior tranche. As the vast majority of synthetic securitisation deals have regulatory capital relief, constraining that would have had a huge impact, says Leung.

To address this, the latest agreement included a proposal – known as the Boyer amendment – to halve the P factor when it is applied to the output floor. This significantly reduces the amount of capital that IRB banks – by far the biggest issuers of SRT – need to hold against retained SRT senior tranches.

For the minority of SRT issuers that use the SA, however, the Boyer amendment provides no relief, and SRTs may still be uneconomical unless the issuing banks’ cost of equity is very high. Capital requirements for retained securitised assets, under the SA, work out between four and seven times higher than simply keeping the same assets on a balance sheet, according to one industry source.

This runs counter to the goals that European regulators and European Parliament had for securitisation, suggests Leung. “The idea behind the simple, transparent and standardised framework to SRT was to try and promote more lending to the real economy – especially for small and medium-sized enterprises (SMEs). But, as far as the SA goes, SMEs – especially high-quality SMEs – will be one of the things hit first. In the current economy, that’s not necessarily what you want to curtail.”

Again, CPM will be required here to optimise risk and profitability within portfolios, taking into account not just regulatory capital charges, but also today’s new economic paradigms, say credit and risk experts.
New economic cycle

Silitch believes more work needs to be done on economic modelling so credit models more closely reflect the new economic cycle of rising interest rates. “For the past 40 years, interest rates have been pretty much falling the entire time, while asset values have been rising,” he says. “All of our default and recovery metrics are calibrated using data where that tailwind was in existence.”

This means that, even though the data is plentiful and robust, it is flawed in terms of calibrating what a distribution of outcomes might look like when interest rates are flat or rising. “It is useful for understanding what the shape of a distribution might look like, but it doesn’t do a good job of defining the tails. Firms should think about putting a conservative overlay on their credit modelling to compensate for the inherent biases in the historic data,” he says. “I don’t see much being done on that front yet.”

Another challenge for CPM units is the low correlation between market conditions and regulatory capital consumption,” says Alamalhoda. “This is [particularly] true for the assessment of profitability at origination, where margins or liquidity cost variations are not generally correlated to the regulatory capital charge.”

Taken as a whole, it is expected that final Basel III reform could speed up the disintermediation strategy across the banking system in Europe. “One can expect some banks may exit certain markets, or at least accelerate their distribution strategy to decrease their final take,” says Alamalhoda.

This could accelerate the growth of shadow banking. Lightly regulated financial institutions – such as pension funds – are already at a competitive advantage over banks with large regulatory capital charges. Shadow banking is also likely to be able to take on certain assets that banks would struggle with under Basel III.

Long-term and emerging risk

As the role of CPM widens, many credit portfolio managers are considering how they will be impacted by emerging and longer-term risks, such as those related to climate.

“Climate risk has already changed business models and, increasingly, it’s going to redefine how the world works,” says Silitch. “It needs to be considered as firms estimate cashflows.”

In the coming years, firms and assets deemed high climate risk – or that are not compliant with environmental, social and governance (ESG) factors – are likely to receive shorter-term loans at higher rates, say credit experts.

“From a pure credit risk management perspective, companies that are not compliant will see their access to market and funding potentially reduced,” says Alamalhoda. “As a result, beyond the positive impact on a society of banks financing ESG complaint actors, there is also a benefit in terms of risk management.”

Leung has also seen CPM at many banks becoming one of the main hubs for looking at ESG and climate issues as part of the onboarding process. “Climate issues – both risk and financed emissions – have basically become another dimension for the credit decision,” he says.

Despite challenges around data and the lack of standardisation in corporate climate risk disclosures, banks are taking early steps in assessing climate risk from a credit perspective. “Firms are starting to incorporate climate risk factors into strategic planning, credit origination and insurance underwriting, in addition to CPM and stress-testing scenarios,” says Leung, noting that different firms have different practices. “Some may try to incorporate climate risk into the credit risk assessment using something like a credit climate risk scorecard, while other firms take a much more subjective approach.”
In time, the integration of climate risk factors into credit decisions will produce internal risk ratings, which will evolve into climate risk-adjusted ratings. These will allow credit risk to be structured, priced and managed at an individual borrower level and an aggregated portfolio level, says Leung.

As well as climate risk, Silitch believes firms should keep an eye on the rising level of US debt. Sitting at around $32 trillion today, US debt is up from $5.7 trillion in 2000, according to US Treasury figures. The country’s debt-to-GDP ratio has risen from 55% in 2000 to 123% in 2022, putting it way above the 77% mark the World Bank believes is a tipping point for debt slowing economic growth.

“Debt has grown hugely over that time and, at some point, people may start questioning the safety and soundness of fiat currencies,” says Silitch. “I don’t think the dollar will ever lose [its status as] a reserve currency, but I think it might lose its exclusive stature.” If that were to happen, volatility would almost certainly increase and things could move quickly. “It’s worth thinking about what could upset that apple cart,” he says.

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**New tools**

The Covid-19 pandemic and the war in Ukraine have provided salutary lessons in how quickly and profoundly the global economy can be impacted by an event. As a result, many firms are now putting greater emphasis on early warning indicators, says Hamar.

“Early warning indicators for increased risk in credit positions are being developed to model loan lifecycles, as well as capturing specific counterparties’ behaviours in a portfolio context,” he says.

These fast-emerging risks also highlighted the importance of banks having near real-time visibility into the credit risk in their portfolios. As a result, credit portfolio managers now want to understand sensitivities and concentration risk in real-time and to run sophisticated ‘what-if’ scenarios. Not surprisingly, they are keen to harness the latest technologies for portfolio optimisation.

For several years, cloud computing has allowed firms to tap into vastly greater stores of data and carry out computationally intensive calculations. More recently, data-intensive techniques such as machine learning are being used to pull in, organise and analyse reams of data. For CPM, this data consists of internal sources (such as automated client financials and client credit behaviour) and external sources (such as economic forecasts, rating agency data, newsfeeds and even social media).

*A December 2022 survey by the IACPM and McKinsey & Company* found that firms tend to use external data sources for credit analysis on the corporate segments of portfolios and internal ones for SMEs. In SME portfolios, machine learning models are being used in credit scoring, early-warning-indicator development and credit pricing, the survey found. In corporate asset classes, their usage is largely confined to early-warning-indicator development.
When it comes to automating decisions on portfolios, the survey found that only 11% of SME portfolios and 4% of mid-market portfolios at banks have fully automated decisioning that covers more than 50% of the portfolio.

Elsewhere, automation technology is helping standardise data and processes across departments, allowing greater connections between CPM and other departments such as risk, treasury and balance sheet management. This is helping move it closer to the business and to take on a more strategic role.

The combination of tighter regulation, market volatility and economic uncertainty are putting the spotlight on CPM, increasing its strategic importance and redefining its mandate. With the final Basel III reforms reducing the sensitivity of RWAs, credit portfolio managers will need to review portfolios and devise strategies for optimising risk and return. This could range from unwinding some trades to completely reorganising portfolios to minimise regulatory capital charges.

Meanwhile, changes in the rates cycle and market volatility are increasing credit risk, further triggering the need for a review of portfolios. However, advances in technology and data-intensive analytics can support more sophisticated CPM strategies than ever before. Carrying out this analysis, backed up by new technologies such as machine learning, will take the CPM function to the next level. This will ensure its readiness for the next big event while, at the same time, raise the profile of CPM within the entire organisation.