Using Portfolio Management to Steer Your Way through Foggy Market Conditions

Portfolio analytics, and the metrics and methodologies portfolio analysts use, have evolved very rapidly over the past three or four years. As a general trend, we have seen that as institutions get larger and more sophisticated, they have moved from understanding and managing risk only at the level of individual assets to managing them also in the context of the entire portfolio at the enterprise level and in terms of concentration risk.

Until recently, portfolio-level risk was used mainly for reporting purposes, to understand and communicate an institution's overall risk. Regulatory capital and stress testing were used as the means of risk assessment, especially by small to mid-sized institutions whose portfolio compositions were relatively straightforward.

As part of the movement towards more comprehensive risk assessment, the provisional accounting standards (CECL and IFRS9) were implemented to account for the lifetime loss in the reserve calculation under various economic assumptions. The implementation and governance of these new provision standards offered an opportunity for institutions to recalibrate internal ratings and credit models and also to consider reductions in risk-weighted assets, resulting in a more quantitative and sophisticated risk assessment than before.

With the more competitive marketplace, many institutions are looking at ways to leverage various risk analytics to uncover practical business growth opportunities. However, limits are set by the existing regulatory capital, stress testing or CECL/IFRS9, which are universally prescribed across asset types and sizes.

Positive trends in portfolio management:

- Institutions are making further progress in seeking a better understanding of risk based on their own portfolios rather than a one-size-fits-all regulatory framework. Knowing the real risk within the portfolio using correlation-based concentration risk, rather than concentration based on holding amount or expected loss, provides a different view of market opportunities.
- There is greater integration across multifunctional teams, as opposed to risk, finance and portfolio management working in silos. This provides a consistent view of risk and a more solid basis for driving the institution's growth.
- Progress is further supported by the trend away from siloed onsite technology implementations to cloud-based computing, which provides an opportunity to harmonize and share data across functions.

What's keeping portfolio managers awake at night?

So far so good, but the current market conditions impose a few worries on portfolio risk managers:

- First, margin compression is something we cannot directly influence, and institutions are reevaluating their product offerings to look for other sources of profit.
- Second, market consolidation in Americas and growth through portfolio steering to target new asset classes continues (for instance, there are now approximately 5,000 FDIC-insured institutions compared with more than 7,000 a decade ago). As they consolidate through mergers, the need for a consistent portfolio-level view of risk becomes even more important, along with the ability to assess any additional risks coming in while maximizing the synergies within the expanded portfolio.
- Third, another challenge posed by mergers is concentration analysis. Is there more room to grow in the segment in which the institution has been doing well. but has a high holding amount? What is the best way to quantify the true concentration risk that regulators are questioning?

- Fourth, competition is growing with more and more fintechs entering the market with innovative ideas for lower rates and the ability to execute very fast transactions. Consequently banks and financial institutions are challenged to match or improve on these offers.
- And fifth, institutions are hitting some technical and process challenges in their efforts to achieve an integrated risk-based view of operations, in other words, to improve siloed operations from reserve to downstream.

In summary, market conditions are rather foggy at the moment and portfolio managers are having trouble steering their way to greater profitability. Territorial expansion is an option, but how can you decide which are the right markets to move into? Typically, a bank that is in one state/region and is looking at the best options in new ones will consider factors such as population growth, size of the market, demographic profile, average household income, real estate development and of course, the competition from existing lenders in the market.

Your options for expansion are obviously limited, so what happens if you then identify several areas with a similarly beneficial profile? The next stage in this quantitative approach should be to look at the risk profiles of the various markets to find the ones that are less correlated with your own, and then find the appropriate rate based on the combined portfolio.

Your focus must be on managing risk

Let's now get back to basics: profitability is return on risk. With margins being squeezed, the game today is therefore more about how to reduce risk, or manage it better, rather than chasing after elusive profits. The competitors that manage risk most effectively are the ones best placed to succeed in the current period. The way to do this is to review and understand the overall risk in the portfolio and make informed decisions to avoid areas of concentration risk and to minimize marginal concentration risk being added by any new business.

Data insights and transparent portfolio management are needed here. A consistent view of return metrics combined with strategic planning will help manage business growth opportunities and:

- Incorporate credit risk into business planning and enable business teams to plan/review business strategy needs
- Rebalance portfolio to achieve the desired profitability
- Plan for uncertain economic conditions and consistently apply forward-looking strategies that support business resilience and profitability

A checklist

To assess if your current approach is fit for purpose in the current environment, you need to answer the following questions:

» Which are your best products and customers from a risk/return perspective?

» Which are your worst, adding more correlated concentration risk?

» Are you able to combine your current CECL view with overall risk management and volatility?

» Where does it make sense to focus for growth in terms of geographies and industry segments?

» How can you align your growth strategy with your risk appetite?

» How much more business should you do with your best customers/products within an appropriate overall risk appetite?

» Given your current portfolio, what types of products should you be offering to the market top optimize risk/return?

In conclusion, we have entered an interesting period for portfolio managers, who are challenged to identify opportunities to grow in uncertain market conditions and a fairly tight regulatory framework. Achieving the optimum balance at portfolio level will not be easy, but with the right insights based on today's sophisticated modeling and analytics, it is within their grasp.

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