



## Introduction

Over the past 18 months, financial organizations and investors have been working overtime at their capital buffers to stabilize their capital requirements. The pandemic has brought several regulatory adaptations that are now ending, cancelling the need for additional capital buffers.

Many market participants see it as an opportunity to address credit portfolio management challenges and grow the business. This can be achieved by looking holistically at the risk and finance eco-system and making the most out of the next generation technology. As a result, we see credit portfolio management become the central driver for capital deployment that supports growth with a responsible risk-taker approach.

## Portfolio Management in a low interest rate environment

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The perfect investment delivers the highest possible returns at the lowest possible risk. But as we all know, there is really no such thing. You need to diversify to generate the best possible returns for your risk appetite. That's the basis for portfolio management. Some assets may fall in value, but that will be compensated by those that rise, and over time, the portfolio's overall value will increase in line with the markets.

This approach works especially well insofar as there is an inverse relationship between certain asset classes. For example, if equity prices fall, government bond prices are most likely to rise and vice versa. High-quality government bonds traditionally provide predictable returns, but they also offer a reasonable prospect of compensating for weak equity markets: central banks respond to weak equity markets by lowering interest rates, pushing up the price of government bonds.

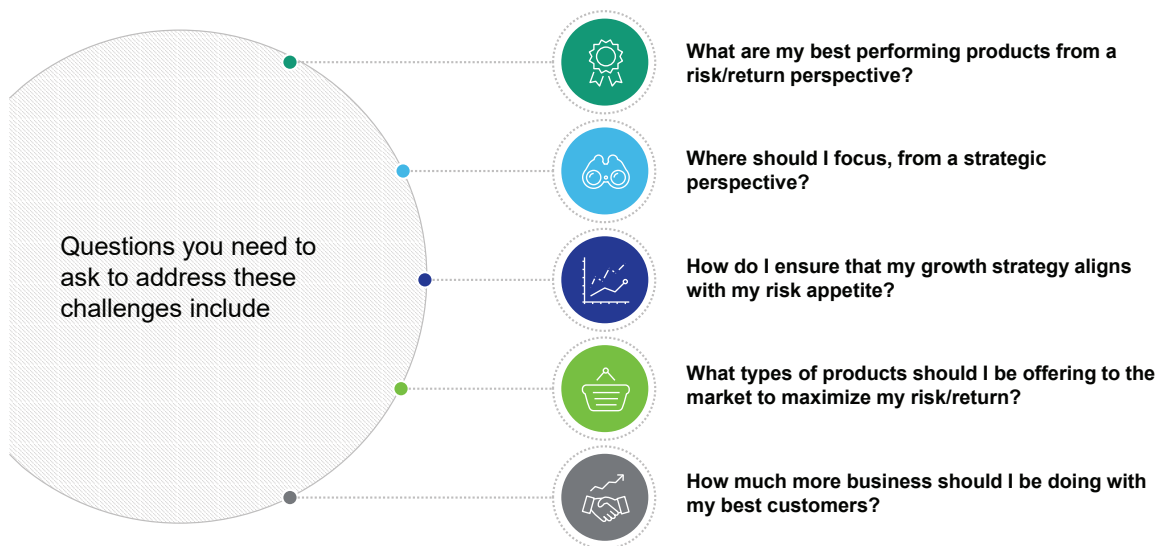
This has put credit portfolio managers in a tight spot. They need to investigate a range of potential sources of interest income from many assets, including term loans with prepayment options and grid pricing, revolving lines of credit, bonds with put and call options, commercial real estate loans, and structured instruments.

Banks might also try to compensate for declining interest yields by increasing fees, but here too, the scope is limited by market competition – and the competition is getting even more intense, with fintech, asset managers and insurance companies entering the market.

Harry M. Markowitz was one of the most brilliant economists of the last century. His paper, "Portfolio Selection", published in the *Journal of Finance* in 1952, laid the foundations for modern portfolio theory. It describes how risk-averse investors can construct portfolios to maximize expected return based on a given level of market risk.

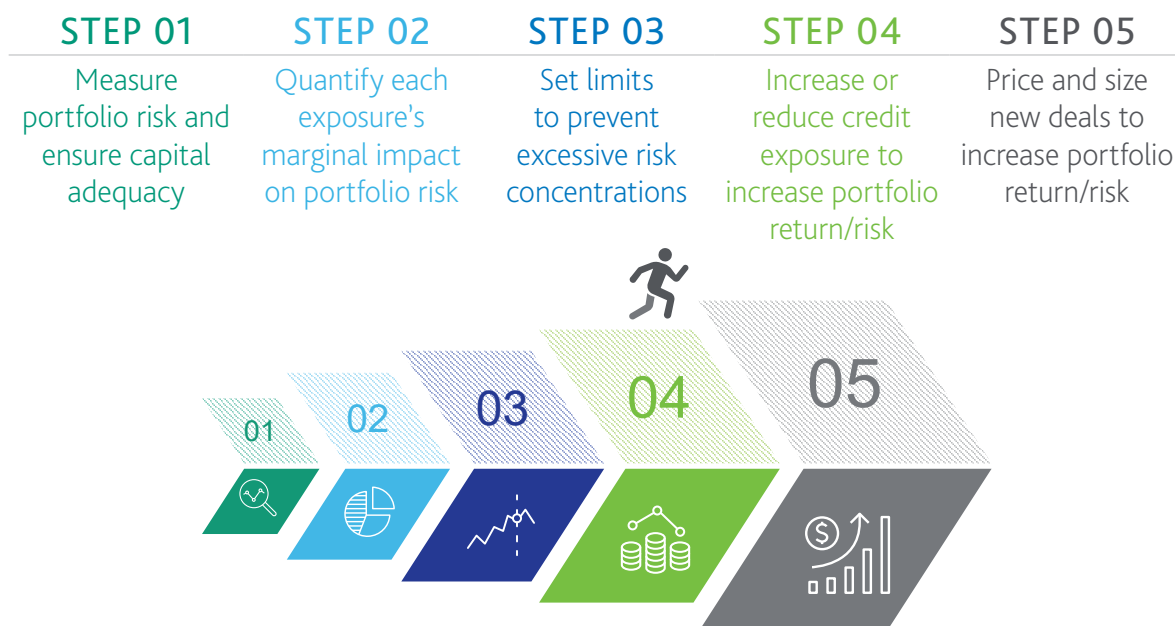
But the approach is far from easy when interest rates are already at rock bottom and debt securities are trading at very low yields. (Added to which, equity markets are in record territory and may be due for a correction.) In 2009 European interest rates on 10-year government bonds were around 6%. Today they are edging towards zero. A joint committee report from the European Supervisory Authorities pointed out in 2019 that "Net interest income (NII) is the most important source of bank income but has decreased by 6.2% from March 2015 to March 2019 (EUR 347 bn) during the prolonged low interest rate environment, and in spite of growing lending volumes".

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## Risk appetite is growing

The search for increased yield in a low interest environment will, in general, create pressure to increase risk appetite and this could lead to a misalignment between the risk and reward on various assets. More than ever, diversification is key, but risk managers are likely to push back on the increasing complexity in investment strategies with higher risk profiles, which would weaken resilience in the event of a downturn. Investing in higher-yield assets, in infrastructure, hedge funds, private equity, derivatives, and commodities, as well as providing direct credit in the form of mortgage loans, therefore requires access to unprecedented analytical tools and expertise. Institutions can increase stakeholder value by increasing portfolio return/risk while ensuring capital adequacy by taking a structured approach, which means following these five steps:



It is also advisable to implement and test your lending and hedging strategies by segment, name and product mix; and plan for a variety of scenarios such as new opportunities, improving or worsening macroeconomic outlooks, and changing consumer behavior post-Covid.

## Active credit portfolio management

Credit models have been designed to provide the industry with transparent and reliable credit risk measurement, both at the standalone level and at the portfolio level, to steer portfolios in the right direction.

As a response to the latest accounting and prudential regulatory framework changes, financial institutions need to rethink their strategies and be ready for apparent but often unpredictable risks (the so-called “gray rhino” attitude). The use of credit models puts portfolio managers in a better position to anticipate those risks and form strategies that can be tested to assess impacts and adjust specific actions accordingly.

In parallel, organizations should put in place management incentives that are truly aligned with shareholder value creation as opposed to revenue production irrespective of risk. Return strategies have to be developed in accordance with risk identification to improve return on equity and increase capital rate. Internal capital is then more efficiently deployed to do more business and to improve returns on risk and capital.

## Better risk-based pricing

In the current low interest rates environment, it is important to anticipate in which markets and sectors inflation has already started or will soon start to materialize; it is also important to note the respective state of economic growth or recession.

Robust multi-period scenario analysis based on plausibility and tolerance assessment will allow organizations to:

- » Screen those emerging risks more effectively
- » Prepare for the next stress test requirements and its new additions (climate-transition, cyber and political risks etc.)
- » Anticipate change in consumer demands and cascading impacts on financial organizations
- » Capture client behaviors (e.g., deposits dynamics) and long-term liquidity requirements

In the context of increased market competition, more granular risk-based pricing practices are evolving, where loans and other credit portfolios are marked and modelled for a variety of purposes. This includes proactive credit pricing and decisioning at origination and loan transfer pricing, as well as understanding value when taking active credit portfolio management actions, including loan sales, hedging, and securitizations.

Portfolio output needs to be disclosed in a form that is easy to be interpreted to support business decisions. Portfolio managers must communicate how they are navigating market challenges on a regular basis with metrics that enable a clear understanding of risks and returns, and the capital being used, to be able to explain their strategy to the management, the board, and the shareholders.

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### Clarity to act in a changing landscape

Many financial institutions have continued to pursue revenue growth in the face of low interest rates, increased competition, and regulatory changes.

Clarity to act in these complex times requires a pro-active portfolio management strategy. One that is centered on driving the efficient use of capital by supporting the business with the latest innovations in cloud technology to promote transparency and portfolio actions that support sustainable growth.

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