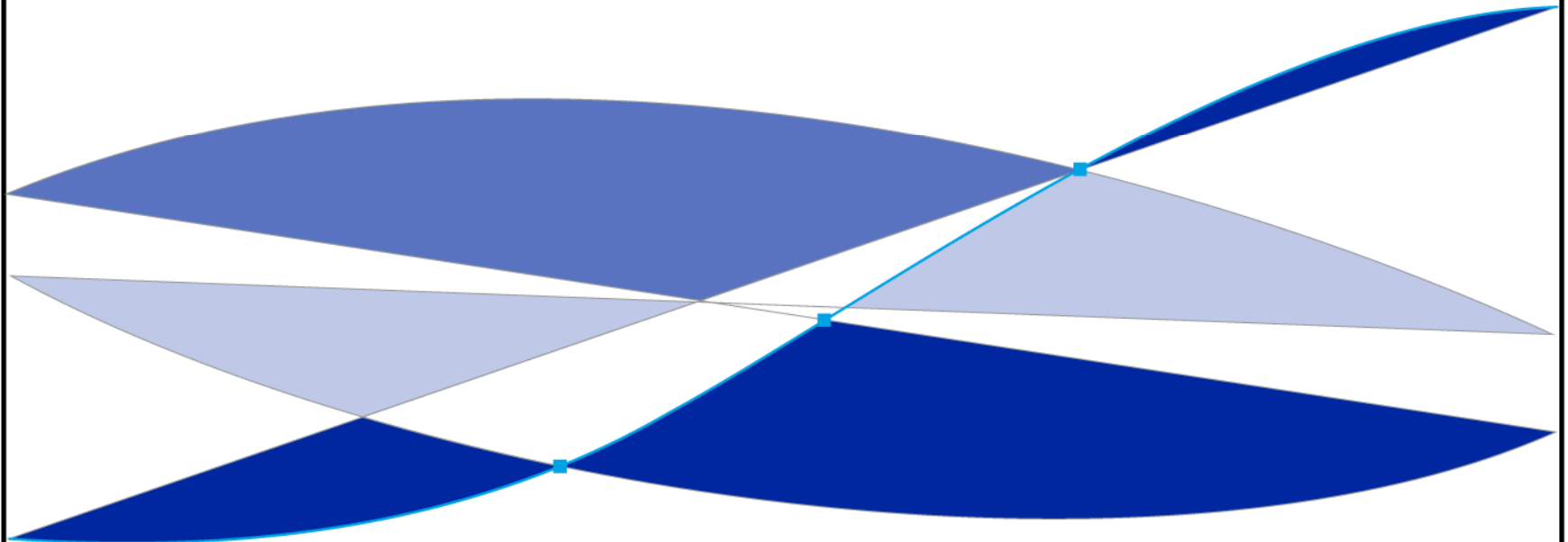


Managing Mid-Corporate Portfolios: Overcoming the Hurdles and Moving to Active Management



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Agenda

1. Setting The Scene
2. The Journey



Setting The Scene

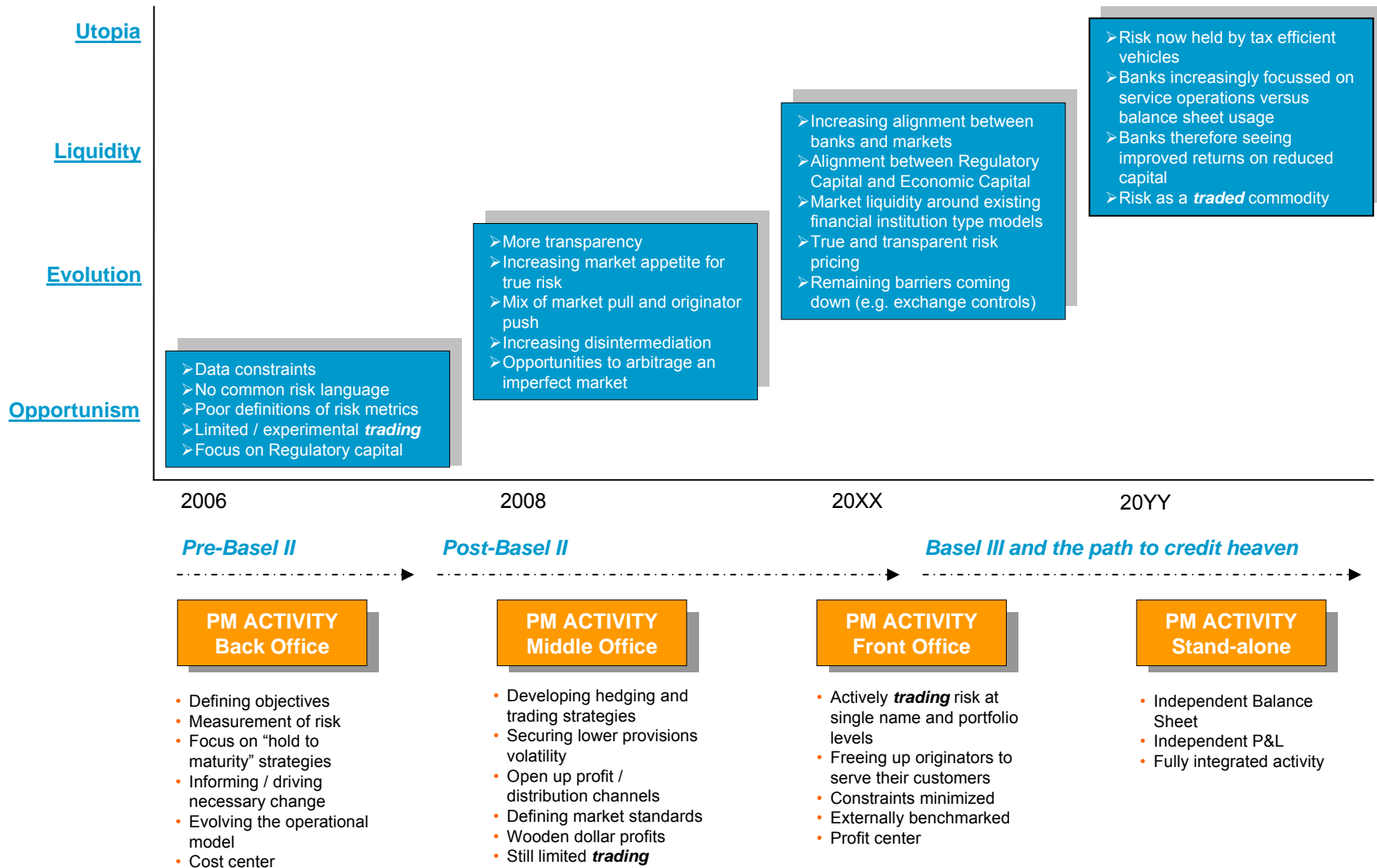
Definitions

- Mid-Corporate = Mid-Cap = Middle Market
- Mid-Corporate sits between:
 - Wholesale (well established, liquid and transparent markets)
and
 - Retail (homogenous, liquid and also well established)
- Mid-Corporate may include Large, Medium or Small businesses (SMEs)
- i.e. Mid-Corporate is
 - defined by local circumstances
 - at an early stage in its evolution as a liquid asset class

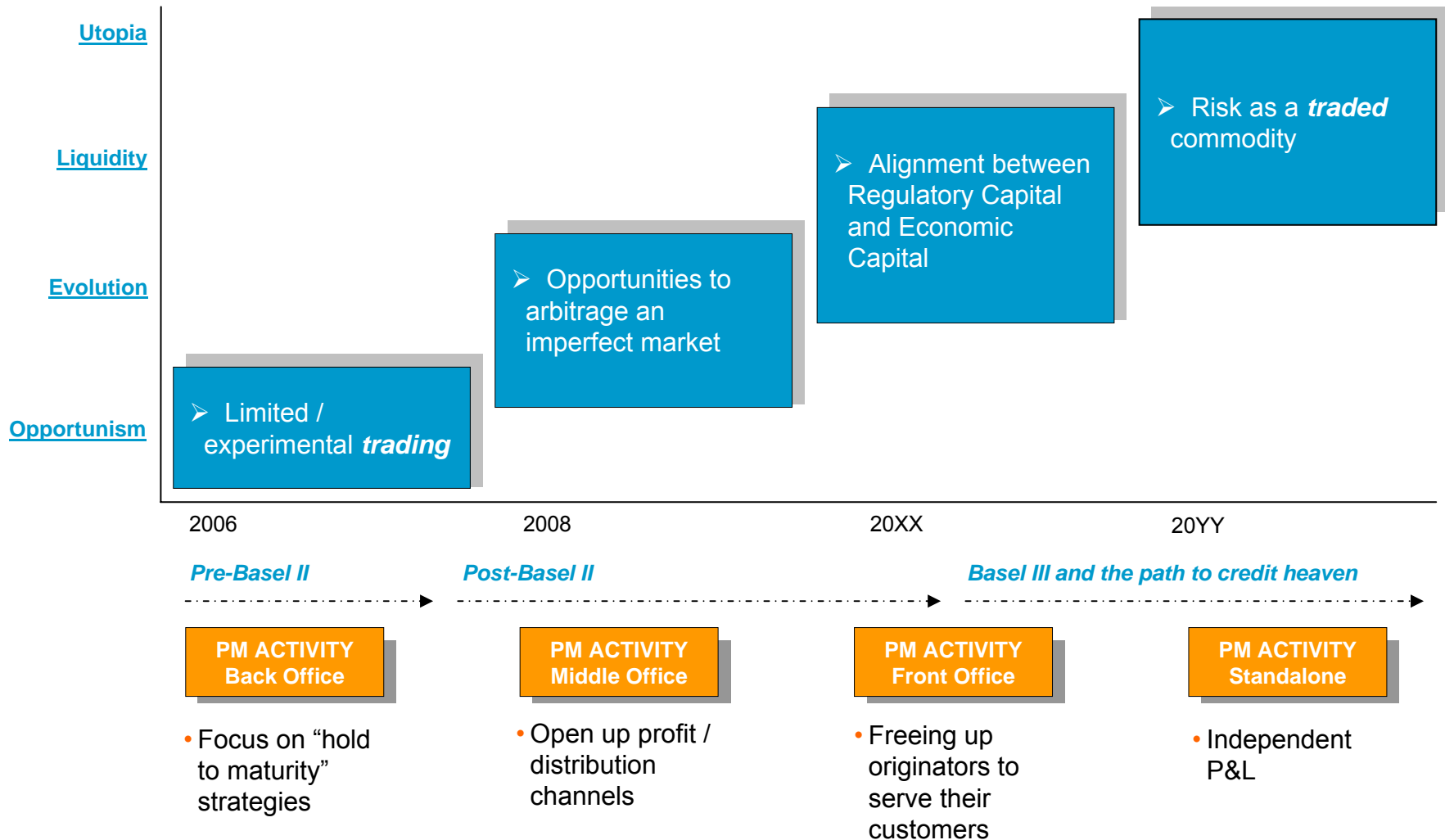
Context

- Basel II - a driver for change
- Regulators increasingly interested in economic risk
 - Pillar II of increasing significance
- But Regulatory Capital \neq Economic Capital
- Meanwhile
 - Bankers [sometimes] learn from experience
 - There are other drivers for / opportunities arising from a different approach
 - Market for risk is advancing
 - Continuing pace of change

Setting a Vision: A Liquid Market Utopia



Setting a Vision: A Liquid Market Utopia



A few questions the CEO ponders every day...

1. Who are the bank's 10 best customers?
.....or the best [three] industries?
2. Who are the bank's 10 worst customers?
.....or the worst [three] industries?
3. What is our risk distribution by industry and geography?
4. What is the state of our diversification?
5. How much risk capital are we consuming?
6. How can I use risk capital in business strategy?

To answer these questions, banks need a common risk metric for the loan portfolio. Economic Capital is a catch-all risk metric reflecting stand-alone risk, concentration risk, correlation risk and migration risk

What is Economic Capital?

- The aggregate amount of equity capital required as a cushion for Unexpected Losses due to credit risks, given the institution's target financial strength
- Risk is measured *objectively* in terms of economic reality using modeling techniques
- Provides a *common yardstick* to measure, evaluate, manage, and price a wide range of risks

- Required economic capital has become the language of risk at leading banks
- An accurate, granular credit portfolio model is essential for making good credit origination, pricing, and portfolio decisions

What might be done to manage the portfolio?

Active management of the portfolio can be achieved in many ways:

Portfolio Level:

- Industry limits
- Sector limits
- Credit policy
- Conditions of sanction
- Pricing strategies
- Retention strategies
- Exit strategies
- Third-party transactions (e.g. ABS, CDOs, insurance, portfolio sales, partnerships, portfolio swaps, etc.)

Asset Level:

- Single name credit approval
- Sell down, syndication and hedging strategies for single names (top end)
- Conditions of sanction
- Pricing strategies
- Retention strategies
- Exit strategies

Strategic:

- Recruitment strategies
- Acquisitions
- Divestments
- Third-party transactions (e.g. ABS, CDOs, insurance, [portfolio] sales, partnerships, [portfolio] swaps, etc.)

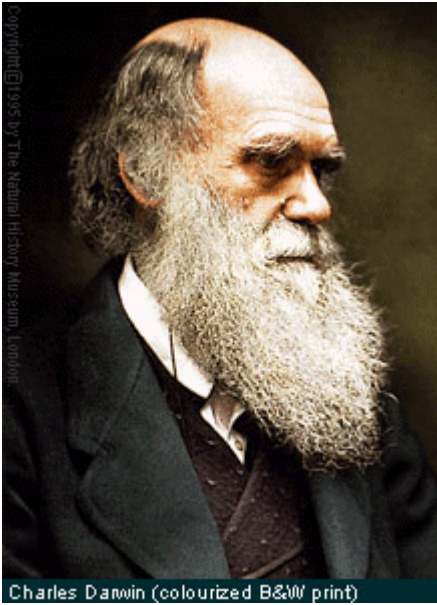
Prerequisites for Active Credit Portfolio Management

- Executive sponsorship
- Clearly defined objectives
- Governance
- Stakeholder management
- Measurement capability
- Monitoring infrastructure
- Fit with strategy development

2

The Journey

Why a Journey?



Versus



Prerequisites for Active Credit Portfolio Management

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Sponsorship

THE
pre-condition:

Board level ownership and support

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ACPM – What Are You Trying to Achieve?

RISK MANAGEMENT

Balance Sheet Management

- Capital freed up
- Rapid growth
- Enable higher single name origination / hold levels
- Enable concentration management and industry exposure capacity creation

P & L Management

- Enhanced Economic Profit
- Reduced volatility in profits
- New profit streams

Operational Management

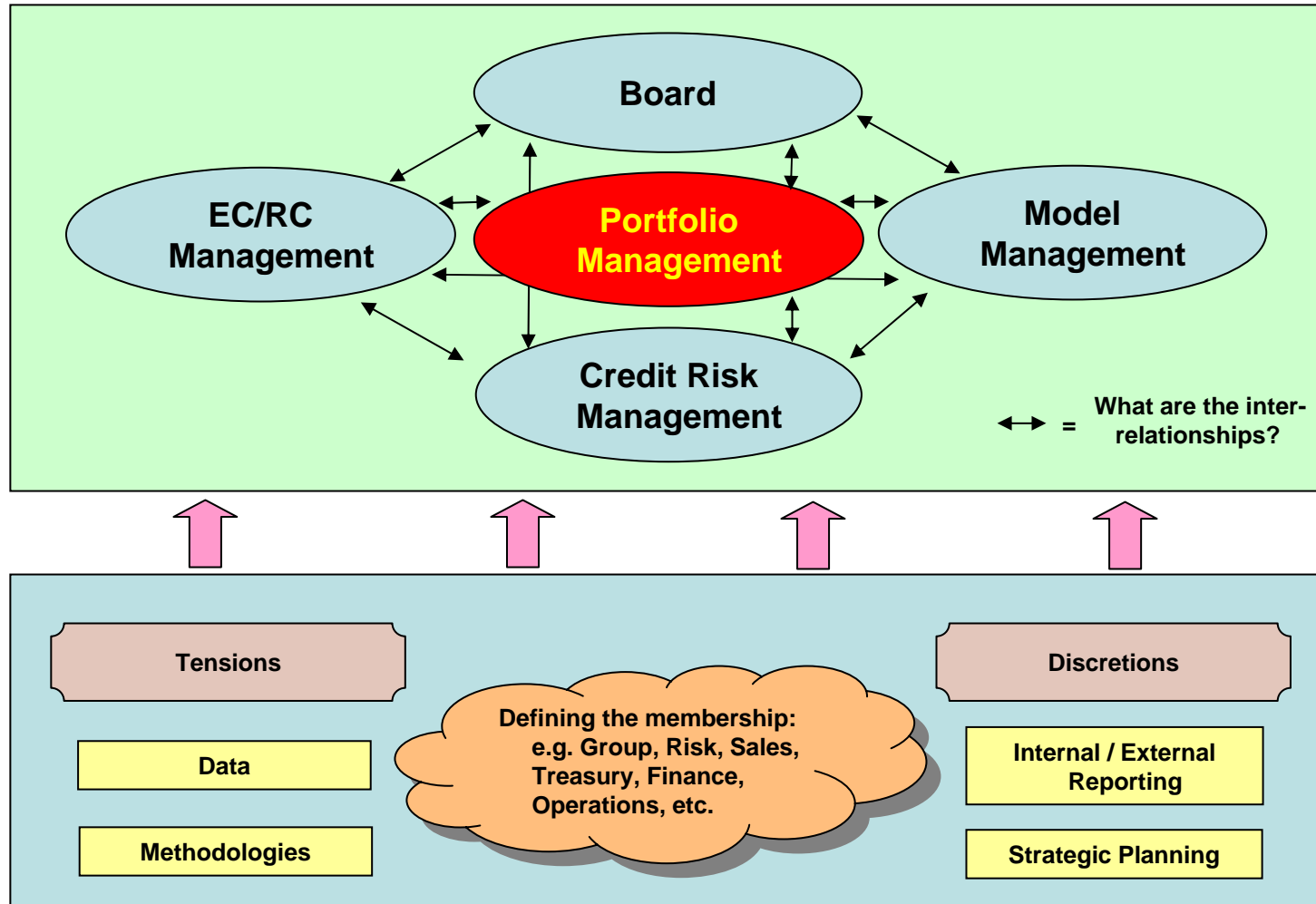
- Explore and develop capital market capacity for an asset class
- Benchmarking
- Enable wider liquidity for the bank (name-in-market presence)

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- **Governance**
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Governance

What is the governance structure?



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Manage Stakeholders

What value would they like to see from the Portfolio Management function?

Customers	
Internal Customers	External Customers
<ul style="list-style-type: none"> • Maximised Economic Profit • Less profit volatility (provisions) • New profit avenues • Choices • Options 	<ul style="list-style-type: none"> • Competitive products • Appetite for new business • Quick and consistent decision • Supportive and informing

Employees
<ul style="list-style-type: none"> • Reward for good performance • Clear line of sight • To be proud of their team • To be in a place where others want to work • Career enhancement and opportunity

Shareholders
<ul style="list-style-type: none"> • Increasing returns • Stable returns • No surprises • Efficient use of capital • Good governance • Out-performance

Regulators
<ul style="list-style-type: none"> • Compliance • Transparency • High standards • Pro-activity and contribution

Wider Community
<ul style="list-style-type: none"> • Knowledge transfer • Inspiration • Something to respect • A source of talent

Prerequisites for Active Credit Portfolio Management

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- **Measurement capability**
- Monitoring infrastructure
- Fit with strategy development

Measurement

Without the means (e.g. the right tools) to measure progress / success there is no point in even starting

- Single customer / asset measures
 - Exposure, maturity, limits, balances, industry, product type, maturity, collateral, grade, severity, etc.
- Portfolio / sub-portfolio perspectives
 - EP, concentrations, correlations, grade migration, geographic & industry perspectives, etc.
- Operational volumes / statistics

Prerequisites for Active Credit Portfolio Management

- Executive sponsorship
- Clearly defined objectives
- Governance
- Stakeholder management
- Measurement capability
- **Monitoring infrastructure**
- Fit with strategy development

Monitoring

WHAT

- Historical trends, grade migration, default histories, recovery and workout information, prepayment profiles, franchise periods

HOW

- Processes / infrastructure for analysis, reporting, archive or data history retrieval, etc.

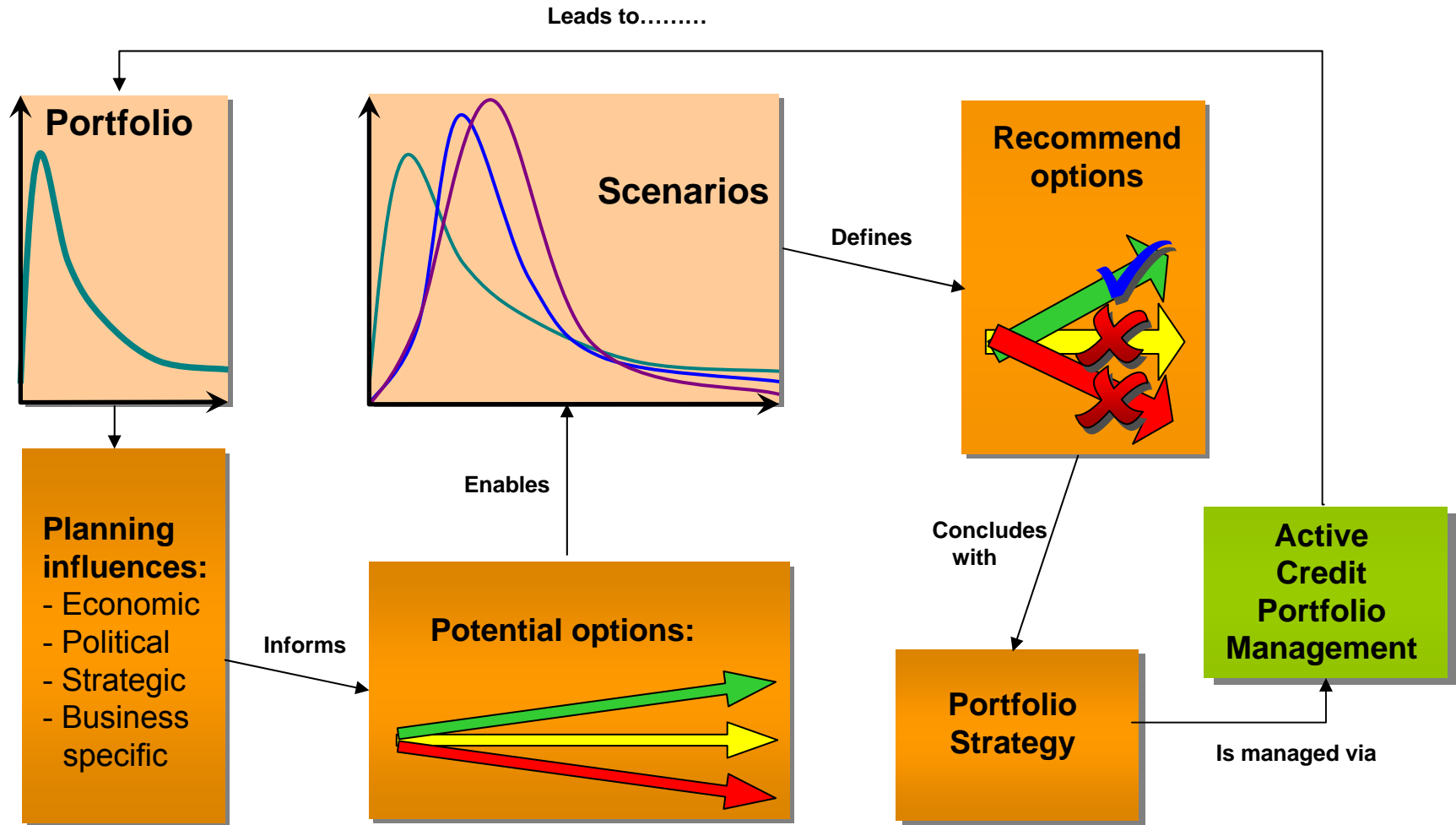
WHO

- Who will report what to whom, and how often

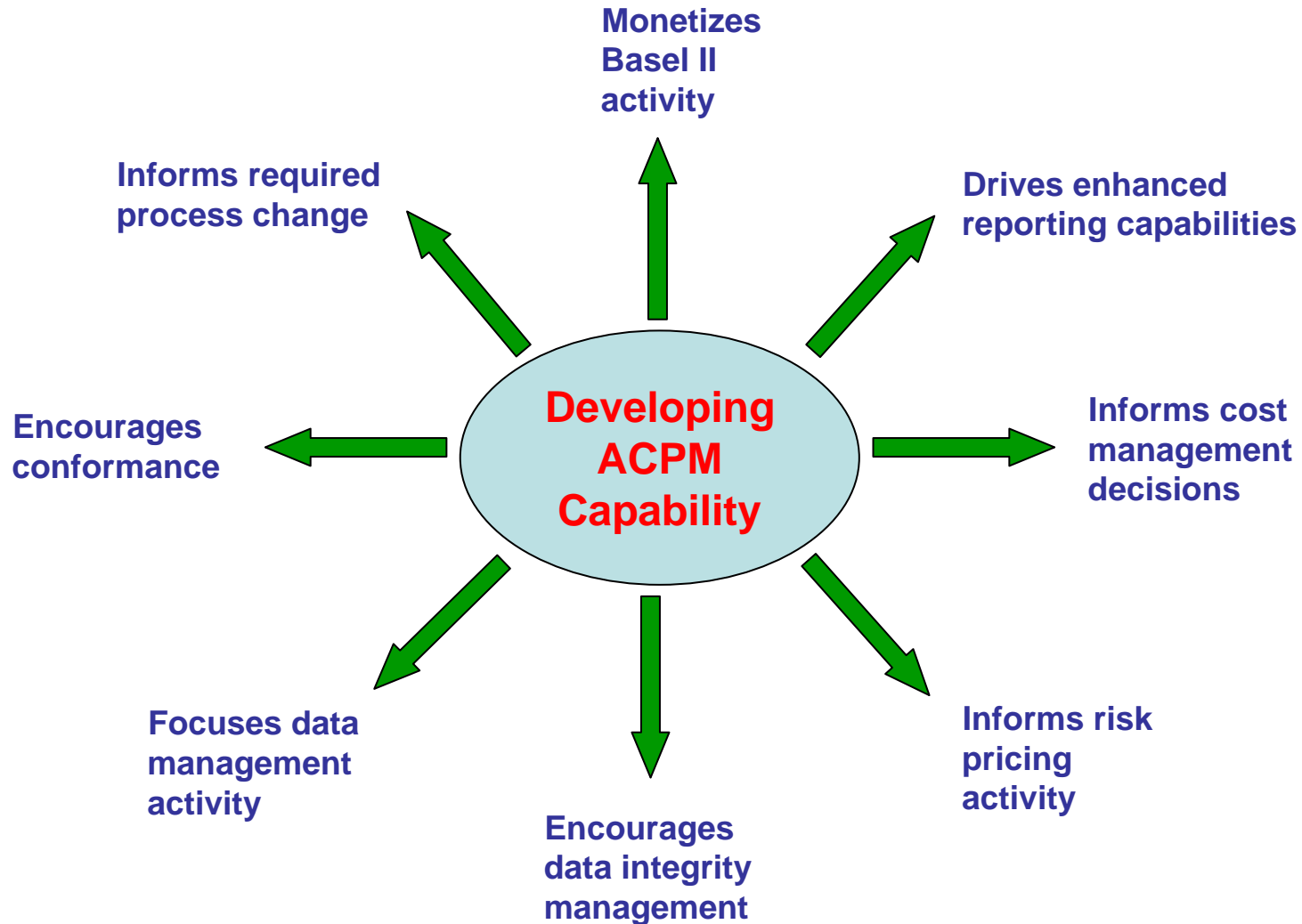
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Development of Portfolio Strategy



Selling the Benefits: Fit with Business Design



Other Considerations / Issues

- Data, data, data
 - Data capture, data integrity, 'information', good book and bad book, cross collateralization

- Organizational / operational issues
 - Platform tools, changing organizational design, conformance, measurement & recognition of benefits, moral hazard

- Customer impact
 - Disclosure issues / maintaining customer confidentiality, loan documentation (e.g. constraints)

- Third Party transaction issues

Conclusions

An ACPM approach to risk management is a different way of operating:

- Ensure Executive sponsorship and keep stakeholders informed
- It requires a changed approach to data and process
- Leverage whatever else in the organization drives the case for change
- Don't await a need or driver

Questions?