Risk Reward
riskupdate
The quarterly independent risk review for banks and financial institutions worldwide
Q2 – 2010

The Changing Face of Regulation

Also in this issue

CORPORATE LOAN PORTFOLIOS: AFTER THE CRISIS

Tracy E. Williams, former Managing Director at JPMorgan Chase, spent most of his 27 years there in a senior risk-manager role in the investment bank, says as the dust settles from the global economic crisis, even it stirs in certain pockets and regions around the world. Meanwhile, bank risk managers continue to patch up pummeled corporate loan portfolios by assessing loan-loss reserves, taking all the charge-offs they can stomach, restructuring bad loans, working out others, and using detective tactics to find out where the next collapse might occur.

It's the right time for self-reflection—the time to evaluate where loan portfolios got into trouble, what lessons can be learned from the past two years, and what banks can do going forward to insulate portfolios from the inevitable next crisis. It's the right time, too, to size up the benefits of diversification, redefine what that means, and deploy methods to ensure portfolios don't suffer substantial blows in the future because of imprudent concentration or careless risk management.

Corporate loan portfolios don't sit still; they aren't static. They grow, evolve, and change. They are reviewed, managed, hedged, argued over, pared down or allowed to blossom. Business managers focus on growth, hot industries, favorite client-borrowers and revenue possibilities. Risk managers focus on concentration, vulnerabilities, unforeseen risks, trends, and downturns. The dynamics between the two help shape the overall portfolio and explain why it evolves.

Nobody argues about the benefits of portfolio diversification. There are theory-based proponents, who can prove how diversified portfolios reduce overall risks. There are history-based proponents, who can show how banks without obvious concentration issues survived downturns or crises in the past. How is it, then, that time and again, when a crisis fades, banks are caught with enormous loan losses and portfolios that require a work-out, wind-down or sell-off, due in part to concentration?

Notwithstanding their awareness of the benefits of diversification, what gets banks in trouble? What got them in trouble this time when they winked and realized too late they had extraordinary levels of risks in loans tied to commercial real estate, leveraged buy-outs, or consumer companies?

Some of the reasons are the same from downturn to downturn, from crisis to crisis:

1. Banks succumb to aggressive business goals and pressures to

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generate increasing returns on equity within an organization where risk managers may not have authority, will power, or expertise to instill discipline.

2. Risk managers, who may have had authority and expertise, were blinded by business growth and profits, ignored creeping concentration and became careless about reviewing risks frequently and carefully.

3. Business and risk managers were too confident in their ability to hedge risks at any point in time or their ability to sell down loan assets in secondary markets when they thought they would need to. When they needed to, it was too costly or too late.

4. Risk managers established limits, benchmarks and guidelines, but may have been casual in allowing them to be ignored, broken or disrespected. They rationalized too many exceptions. And soon, exceptions-based approvals became the norm.

5. Risk managers, distracted by bustling business, gushing profits, or non-stop demands to approve new loans, may not have taken proper amounts of time to redefine risks in the portfolio. Nor did they allot time to review risks over and over and reformulate risk strategies.

6. Some risk managers may not have had the ability, information flow, or staff assistance to interpret vulnerability signs, downward trends, unexplained turning points, or risk correlation among industries or other factors.

7. Sometimes there was a tendency among risk managers to exaggerate the strengths of portfolio industries or geographies because they rode the momentum. What goes up will continue to rise indefinitely, they presumed. They may have allowed themselves to believe the positive tones of equity researchers or the investment-grade ratings from ratings agencies.

8. At some banks, risk managers may have had expertise, information, and perception, but were undermined by an organization structure where they had little voice and minimal authority. They might have felt threatened when they raised a hand that might slow business momentum.

9. And in many cases, there was a refusal among business and risk managers to understand, conceptualize, prepare for or assess worst-case scenarios, because history or statistics suggested that the probability of such was negligible.

Let's turn the page and go forward: From these portfolio experiences, shake-outs and upheavals, were there long-term lessons learned in managing corporate risk? What are ongoing issues and challenges that confront risk managers, who want to be shrewd the next time or at all times.

Lessons Learned

Many risk officers agree portfolio benchmarks and standards worked, if they were astutely set and strictly adhered to. If there existed portfolio limits for certain industries or limits on long-term committed exposures or limits on unsecured risks, then they work and help minimize risk, if they are enforced.

Portfolio limits, standards and benchmarks are implemented for a reason and with an appreciation that the worst case can indeed happen. Nonetheless, in the middle of economic growth, soaring loan demand, profit waves, and strong loan performance, limits and standards begin to fade. They aren't ignored; business and risk managers find ways to justify exceeding them and approving exceptions. Suddenly a disciplined risk culture turns into an environment where bankers become confident that exceeding limits will be brushed over or swiftly rationalized.

Bank risk officers likely learned that while diversity minimizes overall risks, portfolio diversification needs to be tweaked, redefined, and realigned regularly. Not semi-annually. Not occasionally, but regularly (quarterly or perhaps monthly).

Just as quickly economic conditions, loan demand, and business forecasts change, the loan portfolio changes. Borrowers in some industries pay down; others turn to bank loans when other sources dry up. Rates and restrictive terms change the face of loan portfolios. Concentration and risks that didn't exist in a previous examination of the portfolio creep up. Suddenly they stand out sorely in subsequent reviews. A portfolio with 10% real-estate risk one week could have 15%

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the next. One with 30% unsecured exposure could have 35% the next. Or one with 25% long-term tenors (beyond five years, say) could have 30-40% the next week, as short-term borrowers pay down.

Risk managers, aware the portfolios they oversee can change materially from day to day, will need to anticipate those changes and prepare for downturns. They will need to be ready to redefine concentration risks to impose different limits or standards.

Banks learned they must define carefully and clearly what constitutes an "industry" and what factors impact ongoing borrowings. They learned they must understand when to combine sub-industry groups that on the surface may seem to have little in common, but are both susceptible to the same super-industry forces.

Furthermore, diversification and concentration risks don't apply just to industries. They apply to countries, currencies, corporate families, and loan structures: tenors, contractual commitments, collateral, and interest rates. The best benefits come from being able to implement portfolio diversification on all fronts.

It gets more complex. The bigger banks have an even broader array of risk exposures to a corporate family. They know it doesn't make sense to disregard exposures beyond loan portfolios. Thus, managing portfolios and concentration risks must include an awareness of non-loan exposures: counterparty-trading risks and operating and processing risks.

Banks learned it helped to have a well-defined, well-policed game plan for risk strategy for vulnerable segments of the portfolio. The game plan must be implemented early, revised as often as necessary, and articulated widely, loudly. The plan must include a program to reduce, hedge, phase out, collateralize or minimize exposures and potential risks.

Ongoing Issues and Challenges

As they go forward, risk managers understand there'll be ongoing challenges and issues in managing the corporate portfolio the right way.

Reporting, information updates, and systems have always been an issue and will continue to be, although improvements the past decade have been enormous. Most banks don't need several days to add up portfolio exposures, as they might have back in the 1990s. Updated data are not as much an issue as erroneous data or blatant bad information.

Another issue has been how to define exposure. If banks want to assess corporate loan portfolios and address industry and structural risks, then what constitutes loan exposure for risk-management purposes? Would it include the bank's purchases of the borrower's commercial paper or corporate bonds?

Banks use a variety of definitions of loan risk or "corporate credit risk." They may use definitions prescribed by regulators or accountants, or they may modify those and include other exposures that appear to be loans, but are not formally classified as such ("accounts receivable," "deposits," etc.). They may choose to include contingent and indirect exposures or exposures that are not outstanding, but fall under contractual commitments or will likely be drawn down in certain scenarios.

An examination of bank risks to other financial institutions shows the complexity of the exercise. FI portfolio exposure may include loans to other banks, broker/dealers, securities firms, and hedge funds—all of which have traditionally been large users of short-term loans to support activities. For large banks, this may also include banks' prime-brokerage or correspondent-clearing business or, for example, loans to hedge funds for "margin lending" purposes.

This simply suggests that industry sectors should capture all the exposure tied to that industry—no matter what the actual direct exposure is called from day to day ("corporate loans," "margin loans," "reverse-repo loan").

Whatever they choose, the definition of loan exposure within the portfolio should encompass:

1. a conservative assessment of exposures
2. a consistent, clear approach
3. exposures that are readily measurable and data easily accessed.

For loan portfolio-review purposes, "corporate credit risk" should at least incorporate the following set of risks:

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Uncommitted (discretionary and demand) loan outstandings: secured and unsecured

1. Committed loan outstandings: secured and unsecured legal commitments
2. Loan commitments not outstanding, but subject to drawdowns at any time
3. Letters of credit: standby, performance, secured, unsecured
4. Other similar contractual contingencies
5. Other

"Other" is a plug and serves to capture exposures and risks that may not be called "loans," but look, act, and feel like loan exposures. In crisis situations, they will certainly be lumped into creditor risk and treated as obligations from the problem borrower. Thus, for review purposes, they should be included or considered for inclusion.

They may include some of the risks in the categories below:

1. Overdrafts
2. Reverse-Repurchase agreements ("reverse-repos")
3. Receivables from securities-borrowing activity ("sec-lending")
4. Federal Funds sold (overnight loans to other banks)
5. Deposits
6. Accounts receivables
7. Pledged collateral
8. Unreimbursed payments (in trading or processing)
9. Commercial paper
10. Corporate bonds

Why combine corporate bonds with loan exposure? Bonds should be excluded, some might argue, because banks can sell off the exposure, hedge it, value it and price it. But in more recent years in advanced markets, they can do the same with certain loans. As well, major banks are engaged in both bond and lending activity and may in certain transactions be involved in both with a single borrower.

Bond and lending activities are, therefore, interrelated. Often the activities within a bank complement each other or go hand in hand. In many large, high-profile transactions over the past decade, deals will include a loan tranche and a bond tranche. The lending groups or investors and the documents all differ, but the exposure looks the same and often relies on the same payback sources. Or there are cases where bond-offering proceeds pay down loan outstandings, or vice-versa.

A prominent example is the prudence in including CMBS (commercial mortgage-backed securities) securities held with real-estate loan exposure to the same obligor.

Going forward: Allocation Principles

Nowadays, banks managing loan portfolios likely have an after-crisis game plan. Imbedded in that plan will be basic principles—which will help define allocations, concentrations, strategies, reviews, and routine portfolio tweaking.

1. Conduct thorough, frequent, and more disciplined reviews of industry allocations and industry risks.

2. Continue to work down exposures in over-exposed industries by selling off or reassigning exposures (if they can), allowing loans to expire, and not approving new loans for new business.

3. Acknowledge and consider non-loan exposures as much as possible in the overall assessment of industry risks, since banks' risk managers are also charged with managing all forms of risk, not just loan risk.

4. Evaluate portfolios within the context of industries, countries, currencies, geographies and structures (tenors, collateral).

5. Evaluate frequently hedging policies and procedures and methods to reduce, minimize, sell off or eliminate unwanted exposures.

6. Attempt to manage these risks and allocations within conditions and capital requirements that will be imposed by new regulation or closer scrutiny from equity analysts and shareholders.

Major corporate banks have substantial businesses beyond loans with corporate clients. Thus, all risk reviews (including industry allocations) should include a risk strategy for three major categories of risk:

1. Loan risk, as described above
2. Trading risk, including counterparty and market risk arising from FX, derivatives, and equity trading (collateralized and unsecured)
3. Intraday risk, including exposures arising from cash management, money-transfer, and securities-processing activities

This makes loan portfolio management complex. There could be times when it's necessary to reduce total loan risk or restrict loan growth, if risks in other categories can't be similarly contained or decreased. But including or addressing risks in the other categories is necessary. An overall assessment of

loan risk can't be divorced from an assessment of the other risks. The three categories of risk are not typically aggregated, because they arise in different ways and differ in scope. But banks will continue to evaluate all three when they set out to approve an incremental amount of risk for a particular client or for a particular industry.

Country Risks

For banks with cross-border activities, country risks must be incorporated. Many major financial institutions have special risk-management groups that assess the risk of doing business in different countries. They will have set "country limits" for loan exposures and for total risks.

Those limits will be based an ongoing review of substantive country-related

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risks: economics, politics, regulation, currency, legal, etc. The review may be enhanced by ratings from external rating organizations.

All loan activity booked in that country would presumably fall within pre-established country limits. Or if they exceed limits, they would have been specially approved by senior managers.

Industry Allocations: Approaches
After having gone through some turmoil and large-scale efforts to clean up balance sheets, banks have likely gone through extensive reviews of industry risks and have reallocated portfolio allocations (among those industries), based on losses, defaults, non-performing loans and risks in recent years. This would be similar to banks scaling down technology exposures substantially after the dot-com crisis in the early 2000's or Asia exposures after the 1998 crisis (or oil-industry exposures and international sovereign exposures in the 1980's).

With 2009 a year of expunging risks and banks surviving write-downs, raising capital, and cleaning up balance sheets, 2009 yearend portfolios may not necessarily be indicative of banks' risk posture going forward.

On the other hand, risk managers are mindful that business managers will still want to have input. For some banks, allocations within the portfolio are based entirely on risk perception, risk strategy and risk tolerance. At most banks, allocations also reflect a bank's client penetration in that industry.

Banks with a big presence and strategy for technology industries will likely allocate more for technology; banks with a known competence and substantial energy business will likely commit more (allocations via capital or absolute loan amounts) for energy. They would commit, of course, all within the scope and guidelines of proper portfolio management.

There is always a stinging, lingering memory of write-downs and defaults from a particular industry: technology companies in the early 2000's, commercial real-estate exposures in many an era. These memories will influence risk behavior going forward. Banks suffering large losses in a single industry, in a single country, or from a particular loan structure (unsecured, long-term risks) will initially hesitate to permit significant allocations in these segments going forward. Memories, indeed, sometimes fade away when potential profits rebound in magnitude. That's why real-estate loans revive or loans to technology start-ups return.

Let's review a basic approach to loan-portfolio allocations, which might be unfair or inappropriate for complex portfolio management at large banks. But it helps to show the discipline necessary to set allocations, limits and benchmarks and demonstrate the perseverance necessary to review them, revise them, and adjust them.

A general approach to industry allocation is summarized in the table below.

Industry	Risk Rating	Bank Risk Capital	1 year Loan Equivalent	Loan Category 1 (3 year limit)	Loan Category 2 (5 year limit)	Loan Category 3 (7 year limit)	Loan Category 4 Committed limit	Loan Category 5 Unsecured limit
Financial Institutions								
Technology								
Energy								
Consumer								
Real Estate								
Healthcare								
Autos								
Other								

1. Industry categories must be defined carefully and explicitly. Guidelines must be set for companies (with risk exposures) that overlap several industries or could be interpreted differently by different people. (Is Apple a technology company or a consumer-products/retail enterprise?)

2. Some industries should include sub-categories. Financial institutions include such subsets as banks, hedge funds, insurance companies, and asset-management companies.

3. Risk ratings (for these purposes) are based on a traditional 1-10 scale (1 being negligible risk, 10 being bankruptcy risk).

   External ratings agency ratings can be used as input, but should not determine the rating. Ratings agencies historically are slow to reflect downgrades in a deteriorating environment. Although ratings agencies will refine and improve their practices going forward, downgrades will continue to be slower than what markets and creditors expect.

   Banks' industry ratings here would be a weighted-average obligor risk rating from all borrower ratings within the industry. Years ago, that would have been a week-long chore to compile and compute. Bank systems should be able to compute that swiftly today.

   The industry rating should be based partly on historical default rates in the industry (information provided by ratings agencies and called "estimated default frequency") and partly based on inherent characteristics of an industry (both qualitative and quantitative) (growth prospects, regulation, balance-sheet leverage, profitability dynamics, globalization, etc.). Most of all, it must be forward-looking.

4. The rating of the industry determines the priority of allocating risk capital to that industry (as a proportion of total capital a bank allocates to the loan business).

   The better-rated industries might arguably attract the most capital allocated. But here is where discipline and restraint come into play: There should still be concentration limits. For example,

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an industry rated "2" may deserve 50% of the total, but the bank should still impose lower limits for concentration, regardless of what it may deserve on a credit-rating basis.

5. A risk-rating for an industry is dynamic and can be subject to change from quarter to quarter. Hence, ratings and allocations must be reviewed quarterly and assessed carefully.

6. The risk-capital amount is "translated" into a total one-year loan equivalent, the total amount of loans for that industry group, if all loans were one-year, unsecured, committed arrangements. Capital-allocation methodology, used by most banks and required in the current regulatory environment everywhere, can expedite those translations.

7. The risk amounts above would also be subject to limits and thresholds set on geographical basis by country ("country limits").

8. Systems and technology improvements over the past decade—including banks' willingness to devote resources to risk systems—make it possible for banks to monitor exposures, limits, and thresholds substantially better—if the data are right.

Thus, if banks want to have disciplined allocation approaches, they can do so. At large banks, exposure information is available either in real time or on an overnight basis. Banks also use systems to ensure that those with proper authority approve incremental risk exposures.

Since all loans are not one-year loans, the one-year loan equivalent will subsequently need to be "translated" into limits for several categories (tenors, collateral, legal commitments to lend) of loans. Loans exist in different forms and structures all with varying risks. For risk-equivalent purposes, a U.S. Dollar 10 million one-year, unsecured loan limit might translate, for example, into a U.S. Dollar 100 million secured, overnight loan limit or a U.S. Dollar 1 million five-year limit.

(Banks acknowledge the fact that a borrower may default, but the loan risk can be minimized or salvaged if there is (a) sufficient collateral, (b) a senior claim (in a liquidation scenario), (c) short tenor, and/or (d) no legal commitment to lend. This salvaging effort is sometimes linked to banks' "loss-given-default" calculations.)

Ideally, in sum, industry limits would be set for:

- Total Loans Outstandings
- Total Unsecured Loan Outstandings (Committed, Uncommitted)
- Total Committed Term Loans (Outstandings and Undrawn Amounts, R/C, T/L)
- Total Secured, Uncommitted Outstandings
- Total Letters of Credit Outstanding
- Total Loan Outstandings and Commitments with a tenor < 1 year
- Total Loan Outstandings and Commitments with a tenor 1-3 years
- Total Loan Outstandings and Commitments with a tenor 3-5 years
- Total Loan Outstandings and Commitments with a tenor 5-10 years
- Total Revolving Credit Commitments with "Term-outs"
- Total Subordinate Loans Outstandings and Commitments
- All limits would be subject to country-risk limits.

The basic approach now seems complex. It can be done, and it provides a way to manage industry risks, as well as structural risks and country risks. And banks are better off when a looming downturn approaches.

Thresholds, Industry Limits, and Policing

Banks should enhance the allocation process by setting overall portfolio policies for thresholds and industry limits before establishing them. For example:

1. No industry should comprise more than a certain amount of the total at all times (say, 25%)
2. There may be times when exposures will exceed thresholds because of reductions in other industry groups or when there is a sufficient business rationale
3. Exposures that exceed thresholds should be specially approved and reported
4. Exposures that exceed thresholds should be subject to higher pricing (risk vs. reward)
5. Exposures that exceed thresholds should be subject to a well-delineated reduction plan (sell off or reassign loan exposure, reduce outstandings, require collateral, etc.)

Process and Review: Getting it right

After establishing allocation methodology, guidelines, and limits based on ratings, statistics, history, intuition and judgment, how do we make it work and get it right?

The biggest challenges or the factors that most frequently undermine meeting portfolio objectives? A lack of or slippage in the following:

1. Frequent, disciplined review of company and industry ratings.

2. Frequent, disciplined review and revisions of allocations including business input from loan-product experts, syndicated market bankers, and client bankers.

3. Realistic, conservative outlook of specific industries.

4. Keen observation and measurement of factors that signal decline, downturns, or vulnerability.

5. Management of exposures within defined limits.

6. Strict special approvals of exposure beyond thresholds or limits.

What can banks and risk managers (especially those who have been granted proper and adequate authority to act) do?

1. Review the portfolio, allocations, and limits regularly. And when doing so, focus on 3-5 important topics, objectives, issues, or vulnerabilities.

2. Be willing and ready to make changes, adjustments and revisions in portfolio allocations.

3. Enforce limits, guidelines, allocations, and benchmarks. Make them mean something. Approve exceptions rarely.

4. Review, update and alter, as necessary, definitions of industries, overlapping industries, and corporate credit risks.

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5. Understand how industries tie to each other. Recognize interdependence or correlation (past or in anticipation), between/among industries, regions, geographies. Understand when it's necessary to combine industries for allocation purposes or separate larger ones into smaller sectors.

6. Perform and be pragmatic about stress tests applied to the portfolio. Analyze worst-case, what-if scenarios. Let the stress tests be guides on how to act before the crisis overwhelms.

   If certain industries incur an unforeseen downturn or collapse, what will happen to the portfolio? Where will losses occur first? What will the likely losses be if no action is taken? What action must be taken now?

7. Manage, discuss and debate the ongoing tension between business goals vs. risk-management objectives. Use risk-reward methods, guidelines and principles as tools to manage these discussions and make the right decisions.

8. Conduct formal industry portfolio reviews, as appropriate (quarterly for low-rated, vulnerable industries). Design the reviews to be based more on scenarios, based less on routine review of old data.

9. At all portfolio-review sessions, articulate, define and communicate broadly an overall risk strategy, one that will be understood and heard by business managers and client relationship managers, who in fact should be willing participants in the sessions.

10. Go through scenarios (growth, decline, unforeseen deterioration). But don't disregard extreme risks and worst cases.

11. Highlight, measure and observe potential domino effects and ripples. Something that occurs in one industry could send waves of impact into another.

12. At all portfolio sessions, always ask the following:

    a. How high is high?
    b. How much is too much?
    c. What can be done to reduce, minimize, hedge or eliminate?
    d. What can be done to sell off or re-assign exposure within rules?
    e. What doesn't make sense?
    f. Is it right? What would be the regulatory view?
    g. Would the maximum loss be debilitating to the business, to shareholders?
    h. Where can unsecured exposures be collateralized? What are acceptable forms of collateral in a downturn?
    i. What would restructuring, recovery, and exposure reduction entail? What is that impact on capital and employees, and what are opportunity costs?
    j. What is the probability of loss? What is loss given default? What is the worst case?
    k. What is the tolerance for loss?
    l. When is it okay to avoid risks (where reward = 0) to avoid worst loss (where reward = max gain or reward = max loss)?

13. Develop meaningful, useful and serious "credit watch" lists—for specific borrowers, regions, and for specific industries or sub-industries. Accompany them with practical, clear risk strategies

14. For limits, allocations and benchmarks, watch out for potential loopholes that can be exploited by others outside risk-management circles.
    a. Secured vs. unsecured
    b. Interpreting industry exposures
    c. Overlapping industries
    d. Companies with diversified interests
    e. New industries outside existing industry segments

15. Update portfolio data, and keep an eye on errors, misinformation, incomplete data, or discrepancies.

16. Update limits and allocations at all times.

In the end, use history, past defaults, non-performing loan trends, and analysis as tools to set limits and define strategy. But rely on judgment, insight and an informed view of future risks. Acknowledge crudely that the worst can happen.

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