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# The evolving role of credit portfolio management

Banks can no longer manage loan books in isolation. A new survey reveals how portfolio managers are dealing with growing complexity.

Luis Nario, Tamara Pfister, Thomas Poppensieker, and Uwe Stegemann

Credit portfolio management (CPM) is a key function for banks (and other financial institutions, including insurers and institutional investors) with large, multifaceted portfolios of credit, often including illiquid loans. Historically, its role has been to understand the institution's aggregate credit risk, improve returns on those risks—sometimes by trading loans in the secondary market, and hedging—and identifying and managing concentrations of risk. In contrast to traditional origination and credit risk-management functions that look only at individual deals or borrowers, CPM looks across the entire credit book.

The financial crisis of 2007 changed the way most functions at these institutions operate, and CPM is no exception. The historical role of CPM remains. However, new regulatory requirements, especially

with respect to capital and liquidity, increasing cost and margin pressure, and changed market conditions have pushed CPM into a broader role with the need to align closely with other areas, such as finance, treasury, risk data and methodology, and business-origination functions.

To understand exactly how the role of CPM is evolving, McKinsey, in collaboration with the International Association of Credit Portfolio Managers (IACPM),<sup>1</sup> conducted a survey of 41 financial institutions around the world (see sidebar, “About the survey”). We asked what changes were afoot, what CPM's mandate should be, how it should be organized to deliver on that mandate, and what tools and analytics were required. We discovered that there is broad agreement on the need for change—and change is under way in many institutions. Just as there has

never been a unique template for the CPM function, there is no consensus on how it will evolve. Much will depend on the institution and its business model. The results point, though, to certain trends. And they highlight the choices that senior managers in banking, asset management, and insurance will have to make to adapt and shape their CPM functions for high performance.

### Why CPM's role is evolving

While several factors came to light, institutions identified three main reasons for the changes in CPM's role.

#### Capital and liquidity constraints

Some 85 percent of institutions surveyed said that regulations relating to the levels of capital and liquidity that banks must hold—and the prospect of even tighter regulation ahead—were the main reason. Institutions need to restructure their balance sheets to achieve required target ratios, optimize the use of capital, and help drive

profitability. As the largest component of the balance sheet is typically the credit book, they are looking to draw on CPM's unique portfolio-management expertise, and to encourage CPM to influence loan origination as well as asset sales.

McKinsey analysis shows that many of the world's top 150 banks by assets, especially in Europe, hold only a little more capital than the “fully loaded” minimum requirements of Basel III. In some cases, depending on the nature of their business, banks may face a significant capital shortfall under the provisions of the so-called Basel IV rules, driven by regulations currently under consultation, such as a changed credit risk standardized approach, new internal-ratings-based approaches, and potential capital floors. Another complication for CPM is the multiplication of different and sometimes contradictory requirements (such as the rules on risk-based capital minimums, which are at odds with the leverage-ratio rules). The thicket of rules requires institutions to keep an eye on many constraints simultaneously, and renders a single measure of return on capital misleading.

This is a significant change. Until recently, CPM teams could manage the loan portfolio largely independently from the rest of the balance sheet. Funding and leverage were not an issue for CPM. The team was free to manage for return on equity. Now, with all the multiple requirements in play (including rules on capital, funding, liquidity, and leverage), credit, the largest asset class on most balance sheets, is front and center in the new approach to integrated balance-sheet management.

#### Increasing cost and margin pressure

Weakening margins add to the pressure exerted by the regulatory demands and make optimization of scarce resources particularly urgent. Some 59 percent of surveyed institutions named the resulting cost and margin pressure as a motive for

## About the survey

- Participants included 39 banks and 2 insurance firms.
- North America accounted for 41 percent of the sample, Europe for 41 percent, Asia–Pacific for 13 percent, and South America for 5 percent.
- More than half of the 41 institutions have a total balance sheet greater than \$500 billion, while almost a fifth have balance sheets of less than \$100 billion. The remaining 30 percent are in between.
- Sixty-five percent of institutions use the internal-ratings-based (IRB) advanced approach, 10 percent the IRB-foundation approach, and 5 percent the standardized approach. Twenty percent of respondents are not subject to Basel requirements.

CPM's evolution. The issue is most significant in Europe, where 71 percent of participants named cost pressure as a factor. From 2010 to 2015 the cost-income ratio of the 150 largest institutions in Europe increased from 59.1 percent to 65.6 percent, while the income-asset ratio was essentially unchanged.

### Changing market conditions

Postcrisis market conditions are a third dimension in the evolution of CPM, though less important than rising capital needs and cost pressures: only about 40 percent of surveyed institutions felt that this is a key driver for change. Significantly reduced opportunities for hedging and secondary trading, low risk appetite for going long credit in secondary markets, and lack of acceptance of going short credit exposure generally have led to a shift of focus toward portfolio management at the point of origination.

For example, activity in securitization markets and single-name credit-default swaps (CDS), CPM's main hedging tool, have declined significantly because of higher costs and stricter rules for CDS. According to the Bank for International Settlements, single-name CDS outstanding had a global notional value of \$18.1 trillion in the second half of 2010. By the second half of 2015, this had more than halved to \$7.2 trillion.<sup>2</sup> Multiname CDS, a useful tool for managing portfolios and correlations, have also been hard hit by changing bank-capital rules. Here too, volume more than halved over the same time period, from \$11.8 trillion to \$5.1 trillion. To get rid of unwanted exposures, CPM units often look to bundle similar assets. But securitizations in Europe declined by more than 50 percent since 2010 and are still below 2007 levels.<sup>3</sup> In the United States, securitization volumes have rebounded slightly, starting in 2010.

In this context, CPM has had to rethink its main job, of mitigating risk within the portfolio and maximizing risk returns.

### How the role of CPM is evolving

Together, these three factors are altering CPM's mandate, the tools it needs to carry out that mandate, the way in which it works with the rest of the organization, and its data requirements. Most banks and other institutions are good at originating, structuring, and pricing risk, but not as good at holding volume on their balance sheet. That has to change—even as banks wrestle with an urgent challenge to substitute interest income with fee income. CPM has to revamp its offering for banks' changed circumstances.

### A broader role in balance-sheet management

Once largely focused on the loan book, in many institutions CPM is now managing the entire range of credit exposures and their effect on the balance sheet. With that, CPM functions are also conducting new activities. For example, 54 percent of respondents said they already observed a change in the scope of the function and the tasks it was conducting, with an increasing focus on loan origination, expanded analytics (for example, on deposits and client profitability), use of additional metrics (such as the leverage ratio), more explicit alignment with risk appetite, and additional legal entity reporting.

There is, however, no single template for that extended role. In Europe and Asia-Pacific, most institutions (up to 80 percent) expect CPM to assume an active, first-line role in managing the portfolio, taking responsibility for reducing credit risk and optimizing the balance-sheet structure to secure the highest return on equity or return per risk within the constraints of regulation. This might include, for example, a closer alignment of the credit portfolio with the particular funding strategy (asset-backed funding, securitization, syndication, and so on).

In North America, an advisory, second-line role is more common, in which CPM ensures compliance with risk limits and risk-appetite constraints, assesses market opportunities and capital requirements, offers a perspective on stress testing and its strategic implications for the lending portfolio, and recommends actions to business leaders. An essential component of CPM's contribution is a superior market perspective and the capability to identify business opportunities. Seventy-six percent of North American respondents foresee the role in this way.

The design choice appears to be driven by historical precedents, market context, management priorities and regulatory emphasis; the size of the institution is also a factor. In the United States, for example, we think that the Comprehensive Capital Analysis and Review might push CPM into an advisory role because of the expertise required for stress testing. In Europe, where liquidity is tighter, more active portfolio management might be required. In addition, the survey shows that smaller institutions tend to favor a second-line CPM function, while larger ones often choose a more active role for the function, with direct market access.

But whatever the design choice, an essential component of the evolving function—if it is to fulfill its value potential—is the aggregation of risk and

funding information from across the organization in order to make strategic decisions or proffer strategic advice while providing oversight and control.

#### [An enhanced management framework and tool set](#)

To carry out its new mandate and earn the right to participate in strategic decisions—an important component of the potential value CPM can contribute to an institution today—will require superior analytics and a new management framework. Survey respondents identified tools for measuring regulatory capital and capital allocation (that is, discipline at origination) as the most important for the CPM function, and growing in importance; 88 percent plan to use regulatory capital-allocation mechanisms. Sophisticated tools and analytics will allow them to earn credibility, participate in the primary market, and be a strategic partner to the business.

In the secondary market, survey participants see wholesale loan purchases and sales as the most important CPM tool. Their use is growing. Some 60 percent already use them, and 71 percent expect to do so in the near future. In contrast, tools such as index options and single-name CDS hedges are losing influence. In addition, the survey showed a likely shift in the way CPM makes hedging and sale decisions. Only 5 percent of respondents said CPM currently has the capabilities to consider a holistic

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view of the portfolio, including stress outlook and capital and liquidity usage. But 39 percent said they aim to develop these capabilities in the future. Exhibit 1 shows how other considerations are also changing.

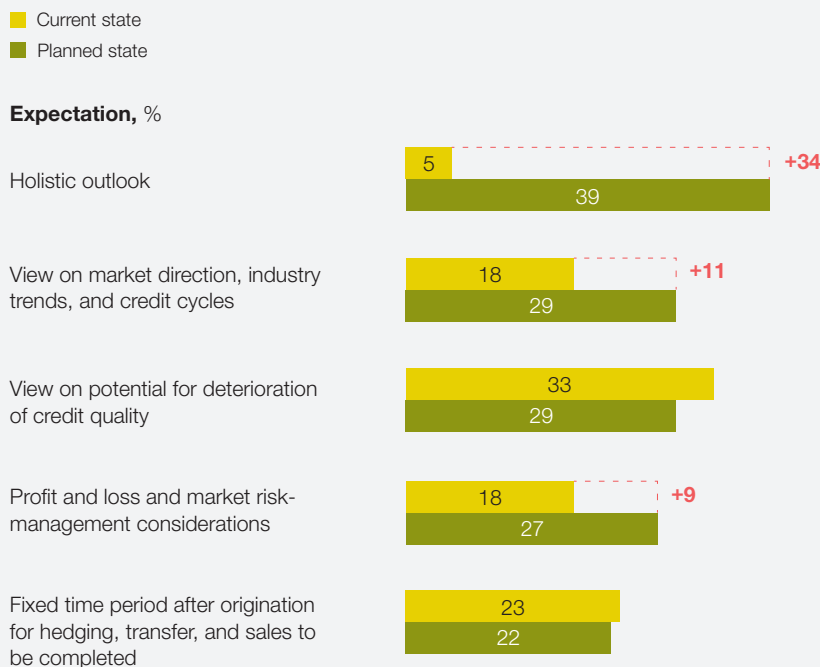
To steer business decisions, CPM will also need to use a granular and rigorous limit framework and evolving optimization tools. The new limit system needs to be in line with overall targets and limits for the balance sheet, reflecting the multitude of key performance indicators the institution has to optimize for. Before the crisis, CPM units often used transfer pricing to create effective internal markets. But this tool is losing its importance. With a host of new regulatory constraints to consider, transfer pricing would need to include so many components that it becomes increasingly misleading and opaque, and hence loses its power of influence.

### Greater collaboration with the rest of the organization

CPM’s new work at the point of origination, and its multifaceted challenge with capital constraints, liquidity ratios, and other regulatory demands, means the group has to work more closely with the range of functions governing the balance sheet. Eighty-three percent of executives describe an increased need for coordination between CPM and the rest of the organization during the past few years, particularly with finance and risk, and more than a quarter of respondents said they saw the need for significant change in the current interaction model.

Geography made almost no difference to respondents’ views on this issue. Wherever they were located, the vast majority felt CPM should be engrained in the organization if it is to fulfill its new mandate. “Collaboration across the

## Exhibit 1 Expectations of credit portfolio management are changing.



**What credit portfolio management leaders said:**

“We should move from ‘do the deal’ to influence and shape the balance sheet, define the strategy, and bring it to business.”

“We need to understand the macro perspective better, and give a robust outlook in order to mitigate on the macro level and through the cycle.”

“Tools are not applied mechanically anymore but with a more holistic view.”

Source: International Association of Credit Portfolio Managers/McKinsey 2015 survey

organization—covering risk and finance—is key to developing a capital-efficient business,” was the view expressed by one respondent.

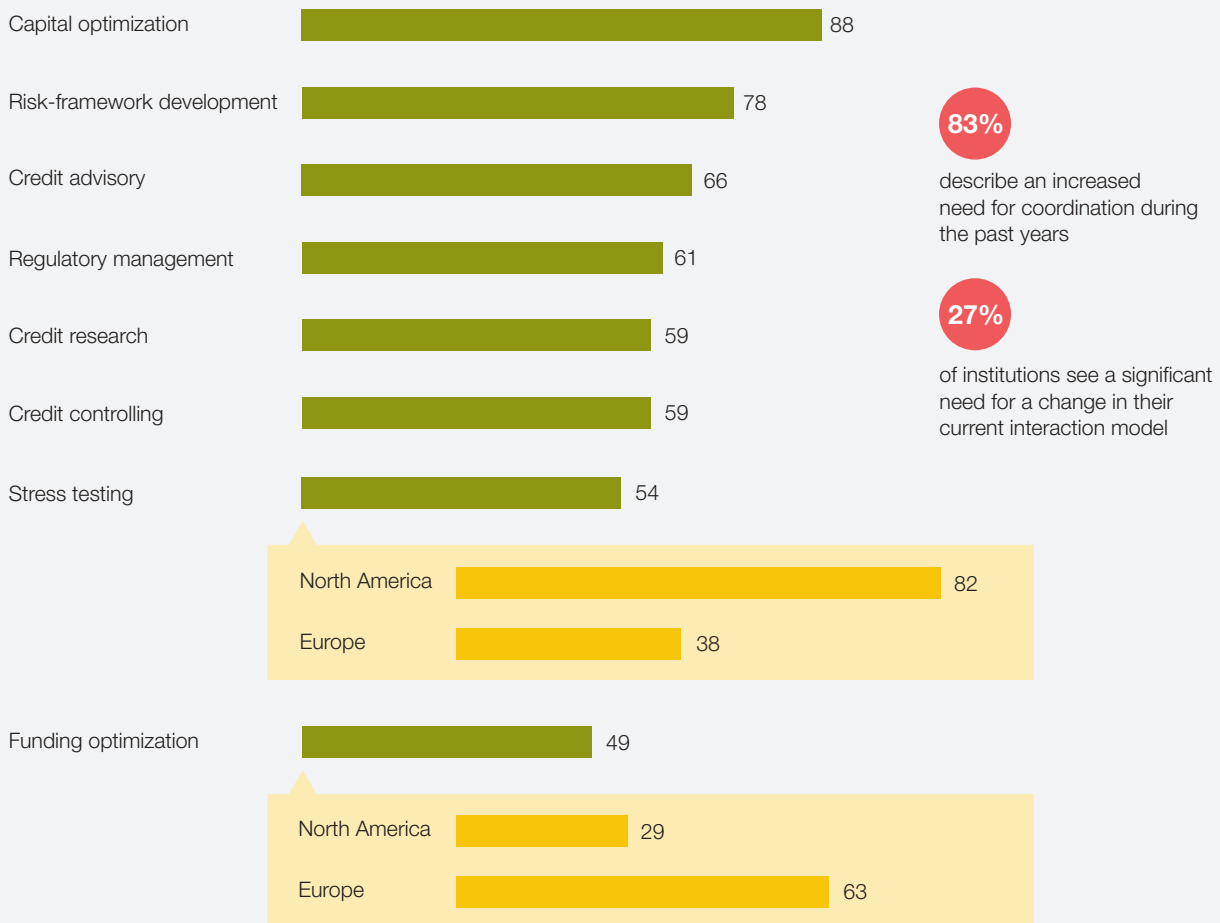
Exhibit 2 shows respondents’ views on where CPM needs to be more closely involved. Capital optimization (88 percent) and the development of risk frameworks top the list.

### Changing data needs

However the future role of CPM shapes up, it will need excellent data to fulfill its tasks and comply with regulations. Highly detailed finance and risk information is essential to risk-return models, and high-quality market information will be necessary to gain superior industry insights. Yet despite all the investment in data management and digitization,

## Exhibit 2 Credit portfolio management is moving from independence to collaboration.

Survey respondents describe a need for greater collaboration on various tasks, %



Source: International Association of Credit Portfolio Managers/McKinsey 2015 survey

largely in response to regulations such as Basel Committee of Banking Supervision (BCBS) 239, as well as digitization, results are lackluster. Sixty-six percent of respondents saw poor data as the single most important constraint preventing the function from performing its new mandate well (Exhibit 3). The transformation of data systems and data governance currently under way at many banks could provide the ideal opportunity for CPM to influence future investments and systems development. With its unique position at the center and in between many related functions, CPM can be in the optimal spot to define business requirements, with an overarching perspective on business, finance, and risk data and system needs.

### What senior leaders should consider

The need for CPM to play a different and wider role is clear. CPM's focus on portfolio dynamics puts it in a particularly advantageous position to steer balance-sheet construction, as compared with finance functions focused on measurement, credit

risk functions focused on individual assessment and limits, and originators focused on individual deals and clients. Such a role is needed without delay, given the balance-sheet constraints that institutions already face, and the prospects of further tightening. Institutions should take five actions that will serve as building blocks for CPM to assume its elevated role.

### Define the new mandate

How the new role of the CPM function takes shape will vary by institution, ranging from advisory to active portfolio management. For example, an investment bank that uses corporate credit lines as a loss leader to build relationships is likely to have a very different CPM function from a regional bank that generates core profits from its middle-market and small-and-medium-size-enterprise portfolios. The former will need a global overview and advice on risk positions and improving cross-selling, while the latter might benefit more from active portfolio management at a sector level.

Exhibit 3

## The biggest hurdle for credit portfolio management is data management.

■ Room for improvement ■ Issues

Areas with most room for improvement, 2015, %



Most common owner today

Risk
Business
Risk
Business
Credit portfolio management

Source: International Association of Credit Portfolio Managers/McKinsey 2015 survey

Institutions with active trading operations should also consider the scope of responsibility for the function across loan books, securities portfolios subject to default risk, and trading counterparty risk. A comprehensive approach may be needed but presents additional complications. A thorough cost-benefit analysis and careful implementation of expanded scope is critical.

Whichever role is chosen, the change needs to proceed quickly and with a clear mandate that defines how the function will add value to the institution. This will help focus efforts to drive the change, which in many cases is already under way. Senior managers must ask whether this change is taking place in a way that suits the institution. And if CPM is not taking on an expanded role, who will be responsible for integrating balance-sheet optimization, stress testing, and ongoing management of the credit books?

#### Rethink the organizational setup

The new CPM mandate may entail some changes in organizational structure. Large institutions often want CPM to have direct market access, which would place it on the first line and hence anchored in the business. For some banks, that will mean moving the group out of the second line. Many respondents cited business proximity and alignment as important design principles for the CPM function.

In some cases, however, where the function is split into separate teams within each business unit, it may lose a centralized overview, making it harder to interact consistently with risk and finance. That's a problem: as an example, when profit optimization was carried out centrally, only 35 percent of survey respondents said significant improvement was required. In decentralized instances, the figure was 75 percent. An option to address this challenge might be to establish a thin central "layer" that combines the information from decentralized teams.

On the other hand, a setup as part of the second line of defense bears the risk of less credibility with the business side. A second-line CPM might also be seen as a team that only wants to "hit the brakes" instead of a function supporting the business. One survey participant suggested that job rotation between CPM, finance, and risk works well to address this challenge.

Another option might be to split the CPM function in two—a decentralized first-line team and a centralized second-line team, typically anchored in the risk function. In our experience, CPM functions at European banks tend to be anchored in finance or treasury, especially when newly established. This simplifies their mandate to optimize risk returns on the balance sheet as they naturally consider funding and liquidity needs. Exhibit 4 shows the current distribution of the various options.

In addition, each institution should consider whether its CPM function has the right proximity to senior stakeholders. Even though most institutions recognize the growing importance of CPM and the strategic role it will have to play in steering the balance sheet, it still sits at the third or fourth level of management in two-thirds of the institutions in our survey. And if it is to take a more strategic role in managing the balance sheet, a closer interaction with the board can help to address strategic topics effectively.

#### Redefine the functional position and promote greater integration

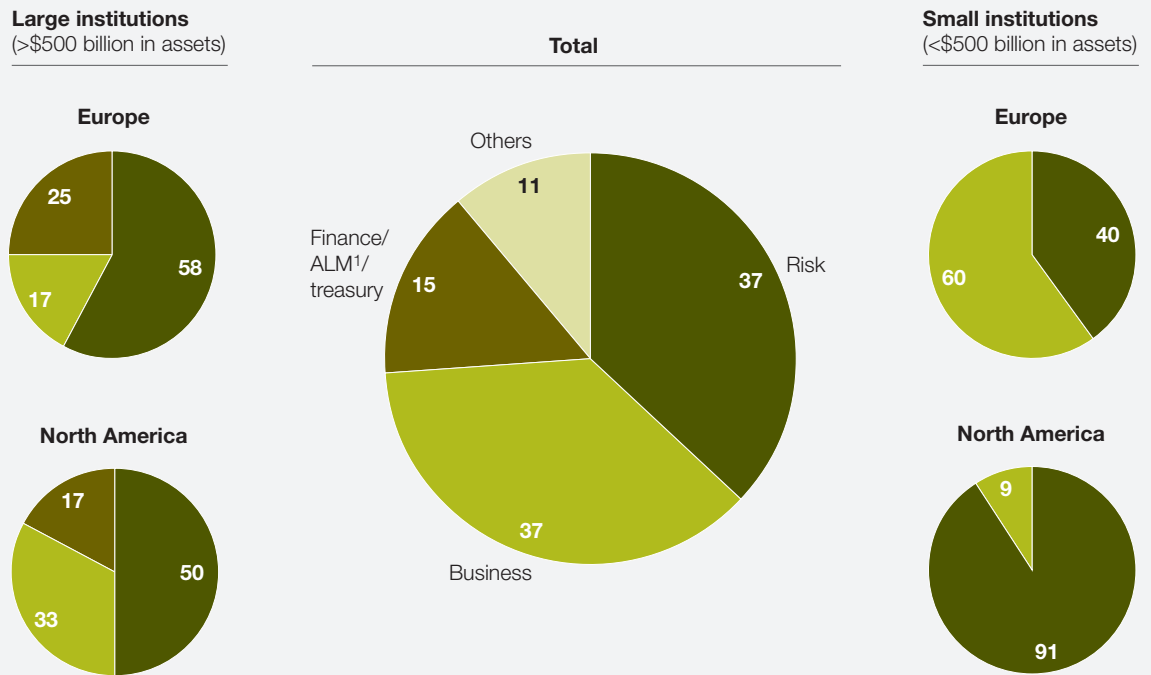
To be successful, CPM will need to work closely with the businesses and the risk and finance functions. As a starting point, senior managers should ask themselves whether roles and responsibilities are clear, and they should also factor in cultural considerations. What is CPM's functional fit with risk, finance, treasury, and the business?



Exhibit 4

**Credit portfolio management is usually placed with the risk function in North America and with the business function in Europe.**

Organizational group that includes credit-portfolio-management team, 2015, %



<sup>1</sup> Asset-liability management.

Source: International Association of Credit Portfolio Managers/McKinsey 2015 survey

There are then various measures, including job rotation, that can promote better integration. Institutions can give businesses and CPM joint responsibilities, such as ownership of models for pricing or industry analysis. They can make CPM the advocate of business in its dealings with finance and risk. And they can align incentives. Clearly, interaction is naturally supported if CPM has a representative within each business unit.

[Build the analytic capabilities needed to restructure the credit book](#)

Whatever the function’s mandate and the way it is organized, it will need outstanding analytic capabilities. External factors such as market liquidity, the

cost of funding, and regulatory scrutiny will require continual adjustments to the institution’s credit book. CPM will need to understand these balance-sheet constraints, how they might change, and their interdependencies. Only with a trusted tool kit that provides the business superior insights from a portfolio perspective, which they cannot gain without CPM’s support, will the CPM function be able to earn the right to be part of strategic discussions and business decisions.

Increasingly, CPM teams will need analytics to meet needs such as advanced pricing, an improved combination of risk and finance data (for better capital optimization), a more detailed and solid link

from the risk strategy and appetite to origination, and macro and industry insights (to aid mitigation at the macro level and through the business cycle).

### Ensure adequate data, system governance, and infrastructure

Fundamental to successful CPM is the availability, analysis, and interpretation of information. Sixty-six percent of institutions named data constraints as the main hurdle for filling their expanded mandate. Senior managers must ask themselves whether the quality and availability of data is sufficient to enable CPM to form insights of value to the business. Current initiatives, like those begun in response to BCBS 239, can be an opportunity to ensure a clear data and system governance. To steer the business, CPM will need sufficient detail for portfolio analysis. To optimize the portfolio within current and future constraints, risk and finance data needs to be integrated. CPM functions have an opportunity to step in and take a vital role in the definition of business requirements, combining the perspectives of business, risk, and finance together with those of the IT department.



The survey reveals broad agreement on the need to evolve the role of CPM, and to do so promptly to respond to the current industry environment. That said, the role is evolving in different ways, depending on geography, business mix, and institutional idiosyncrasies. Senior managers cannot rely on a single template. The survey sheds light on the different choices being made about the function's mandate, the way it is organized, and the tools it is using, as well as what is driving those choices. We hope it will help others make their own choices wisely—and without delay. ■

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<sup>1</sup> The IACPM ([iacpm.org](http://iacpm.org)) is an industry association established to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest. Currently, 95 financial institutions in 19 countries are members.

<sup>2</sup> *Semiannual OTC derivatives statistics*, Bank for International Settlements, May 4, 2016, [bis.org](http://bis.org).

<sup>3</sup> *Securitisation data report, fourth quarter 2015*, a joint report from the Association for Financial Markets in Europe (AFME) and the Security Industry and Financial Markets Association (SIFMA), March 17, 2016, [sifma.org](http://sifma.org).

**Luis Nario** is a partner in McKinsey's New York office; **Tamara Pfister** is an associate principal in the Munich office, where **Thomas Poppensieker** is a senior partner; **Uwe Stegemann** is a senior partner in the Cologne office.

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