Credit Portfolio Management in a downturn
- Toolkit and trade-offs to consider

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- Available tools and trade-offs to consider in the current cycle

Credit Portfolio Management vs business management: An analogy

Example: Idealised coffee business

Perfect cappuccino

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Perfect business strategy and management

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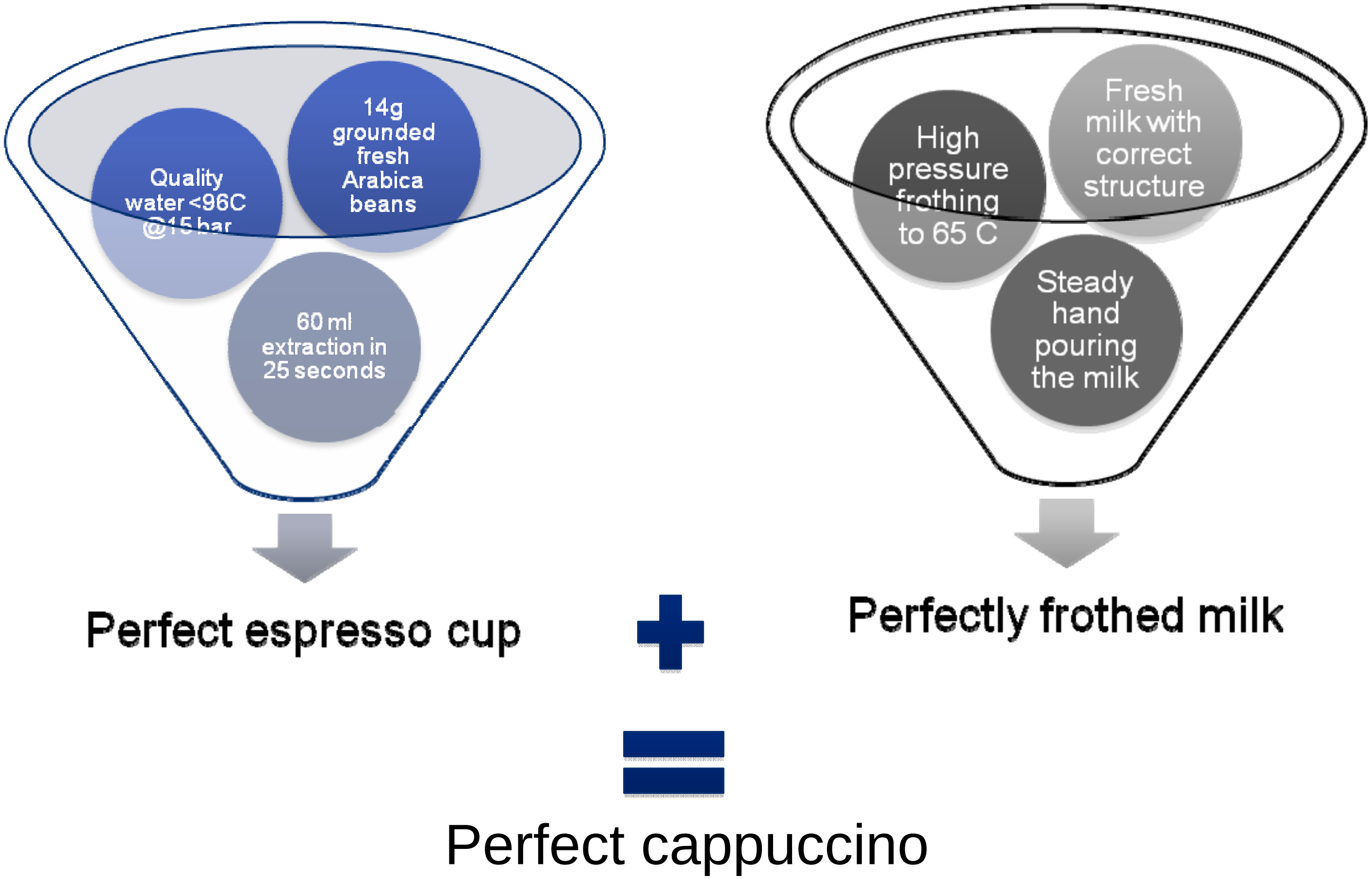
Profitable business

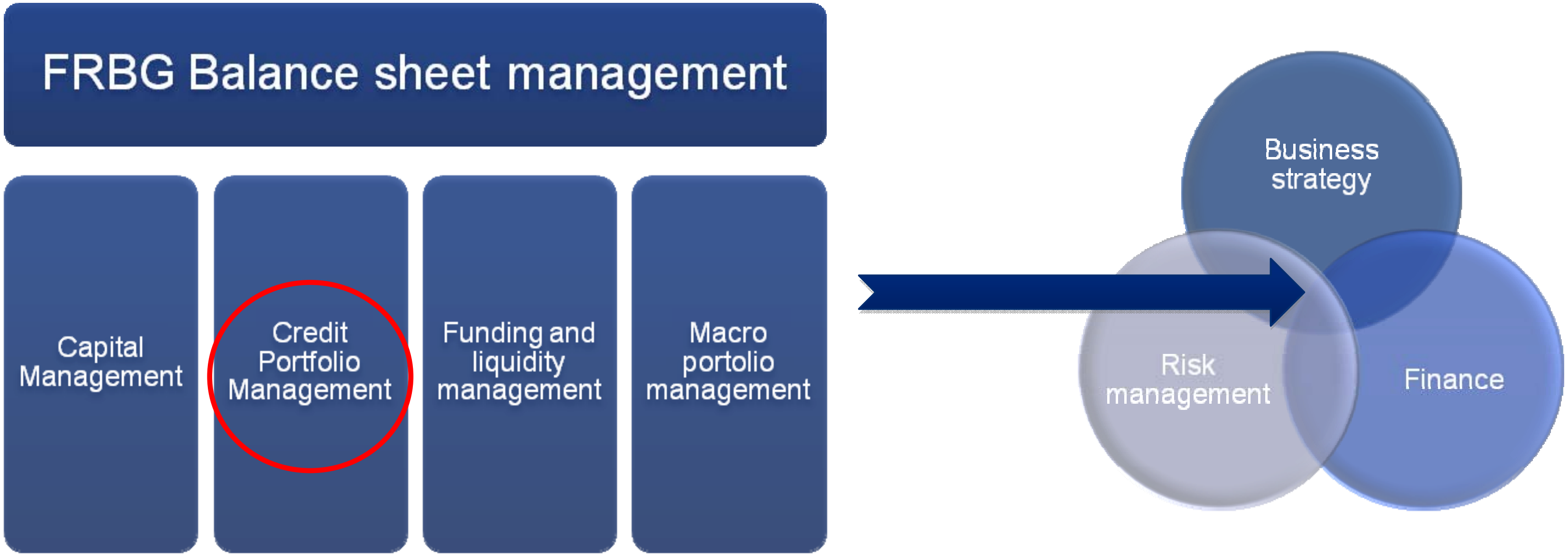
The toolkit for a perfect cappuccino contains a series of interrelated elements



Various trade-offs exist between the coffee making process and broader business strategy. Processes are interdependent and needs to be aligned

Active credit portfolio management approach at FRBG

Positioning of CPM in FRBG…is to actively management the balance sheet…and be the link between business strategy and risk management / finance



CPM forms part of a broader Balance Sheet Management function, with responsibility for capital, funding, CPM and macro hedging

A number of structural issues in South Africa influence the strategy for CPM

Structural features of SA Bank credit portfolios

- Mainly illiquid held to maturity portfolios
- Inherent geographic, sectoral and single name concentrations

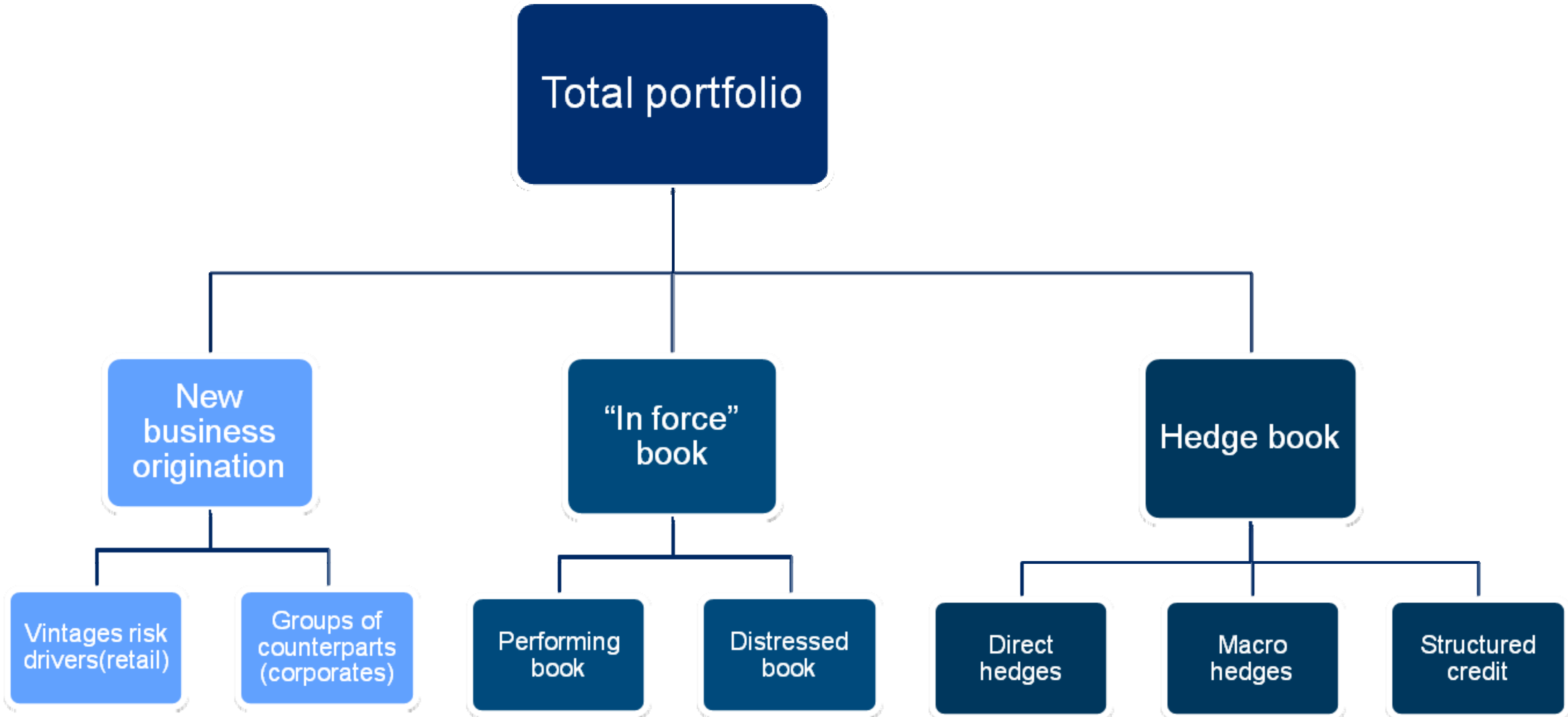
Structural features of SA domestic capital markets

- Credit markets not deep enough for comprehensive name level hedging
- Interest rate and equity market deep enough for macro hedging
- Structured credit markets globally suffered severe credibility damage

Strategic implications for CPM

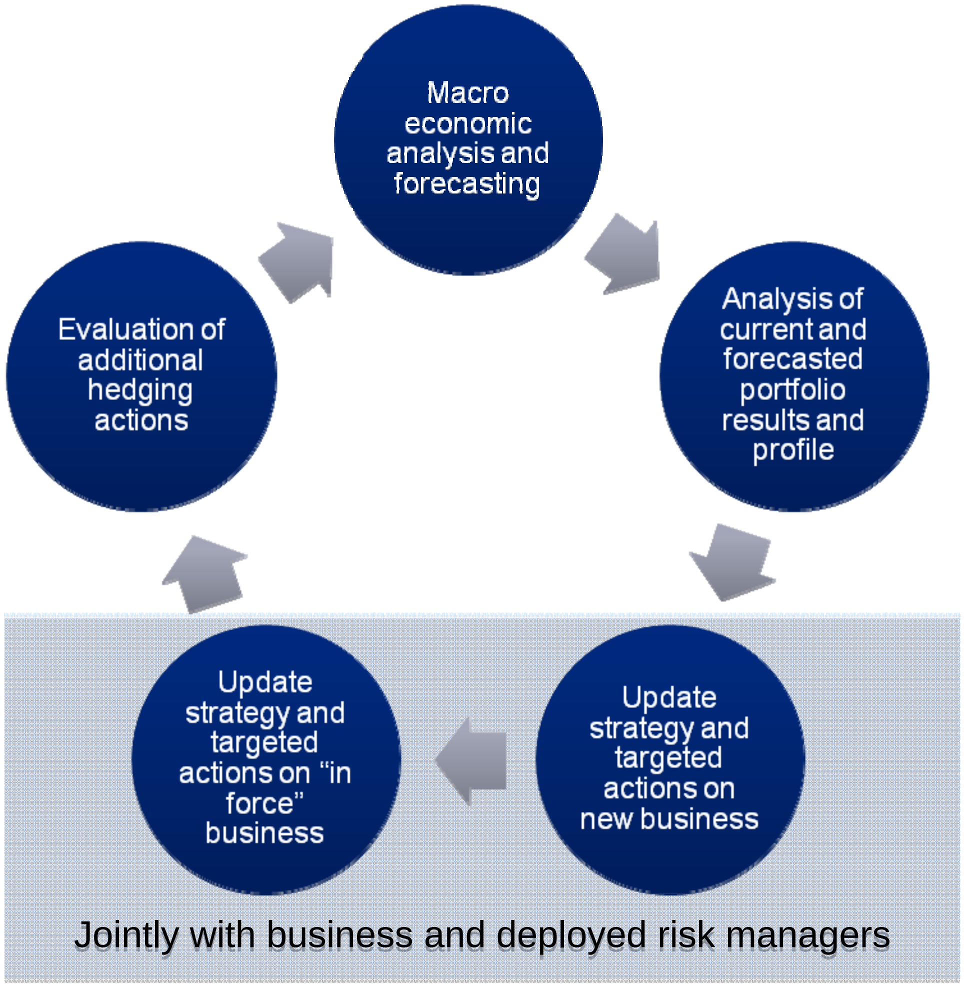
- Most powerful tool is to focus on new business inflows to steer overall portfolio
- Complement with macro hedging programme

The overall book is managed by decomposing it into manageable subcomponents



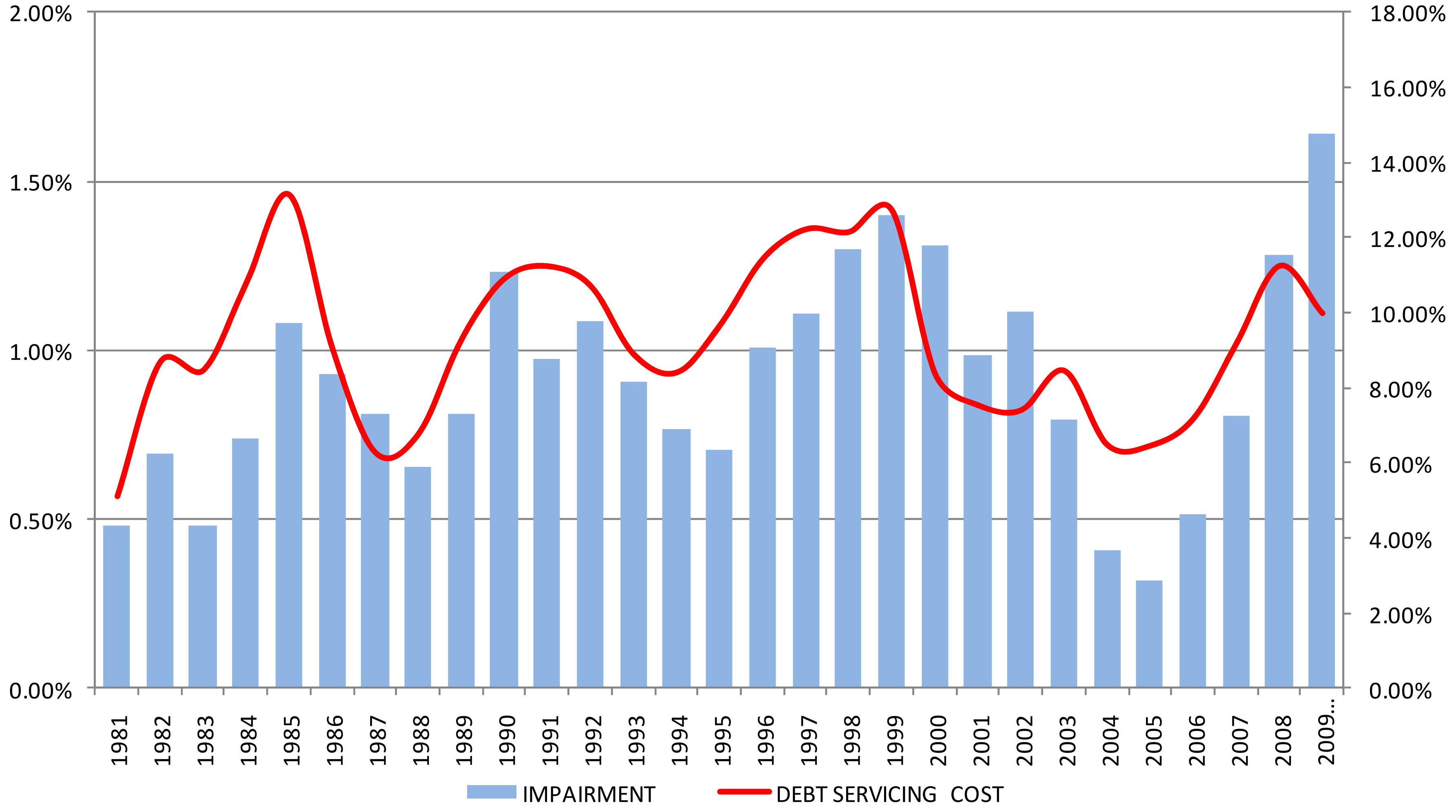
Perform decomposition for each major portfolio subsegment
(Corporate/SME, Mortgages, Asset finance, Unsecured credit etc.)

FRBG credit portfolio management process



CPM tools and trade-offs in the current cycle

The relationship between debt payment to income (DSC) and impairments has broken down in the current cycle



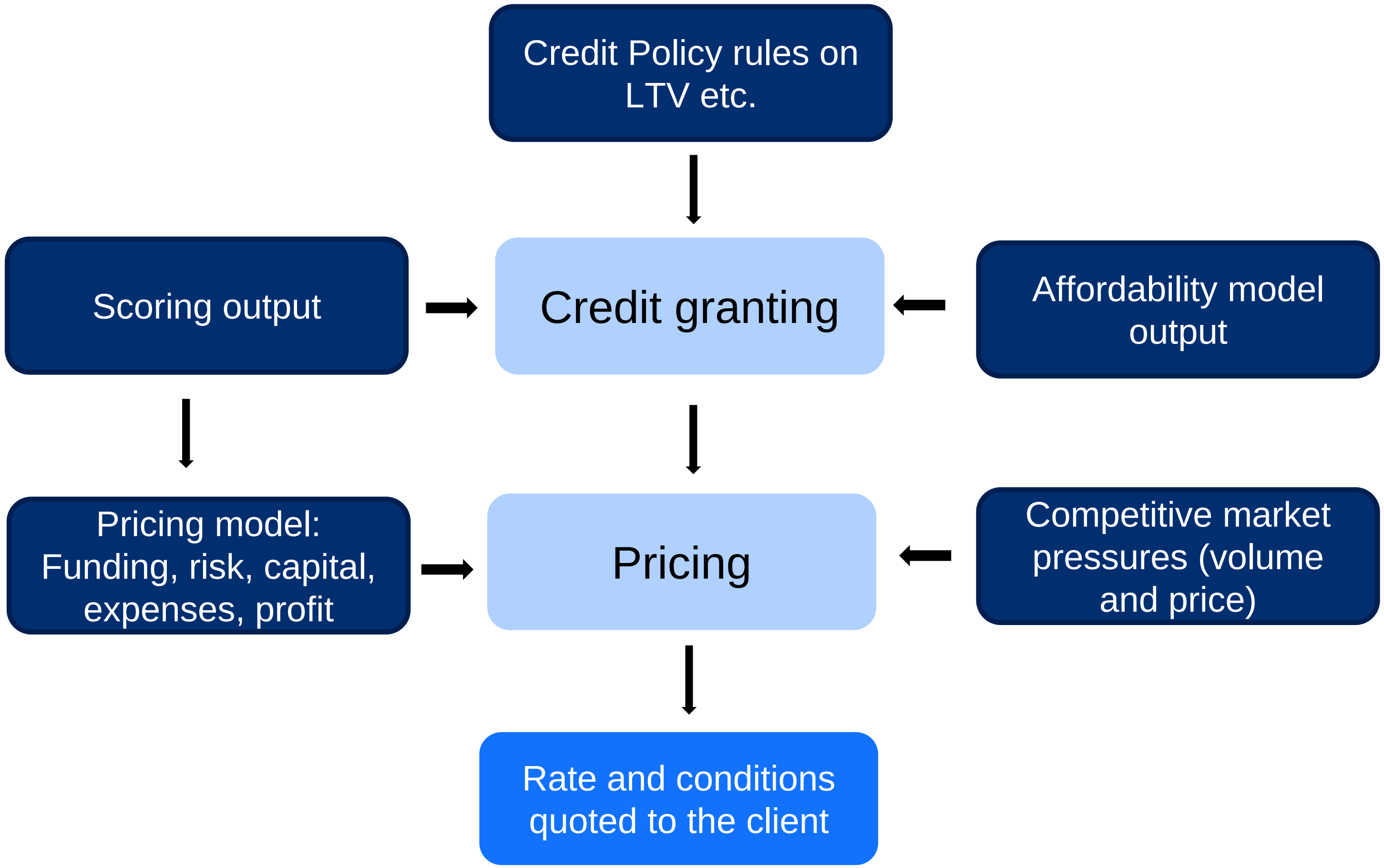
CPM tools to change the portfolio structure

Retail	Corporate
• Pre-screening changes • Scoring cut-offs • Affordability rules • Collateral rules • Pricing • Targeted Portfolio limits • Special arrangements • Macro hedges • Structured credit	• Pre-syndications • Ratings cut-offs • Cash flow stress testing • Collateral rules • Pricing • Targeted portfolio limits • Restructuring • Macro hedges • Structured credit • Single name hedges

CPM tools are used to change portfolio in line with risk appetite

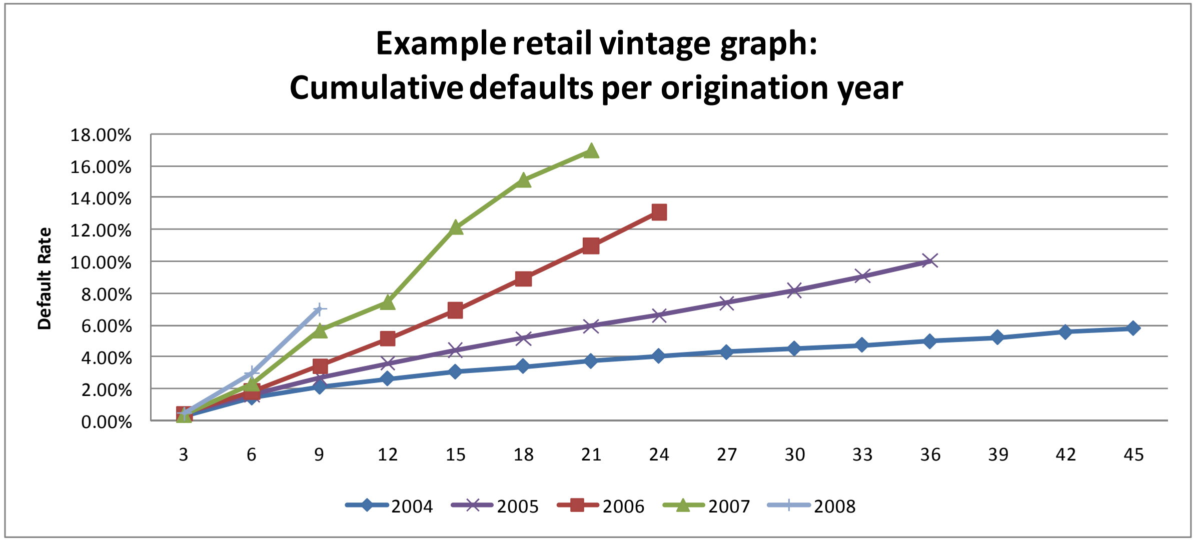
Scoring, affordability assessment, collateral rules

Scoring, affordability and collateral rules are three of the main pillars to control new retail business

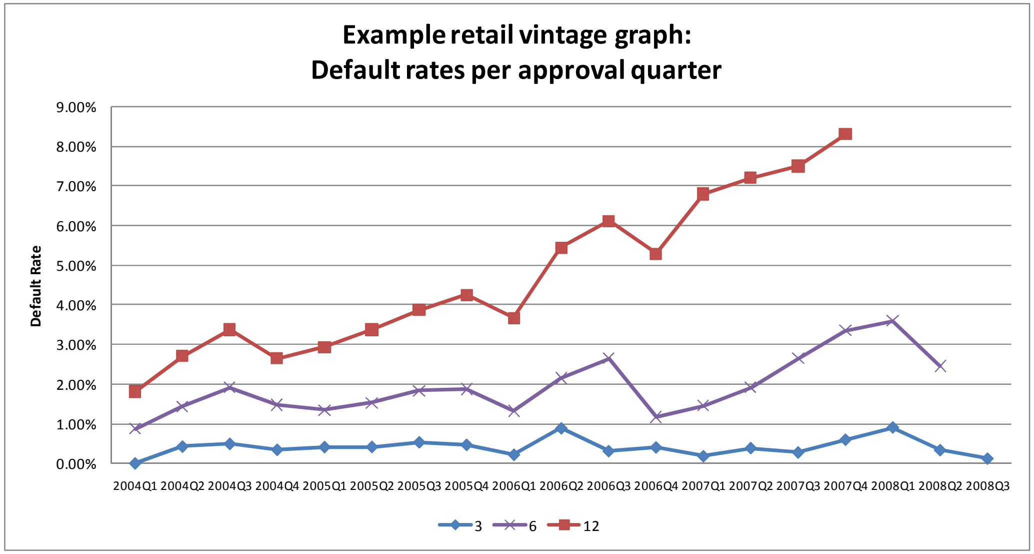


Processes are interlinked – aim to balance accuracy vs efficiency

Various types of vintage graphs are used to track effectiveness of origination credit actions



Note: Vintage graphs are illustrations only and are not based on the actual results of FRB's portfolio vintages.



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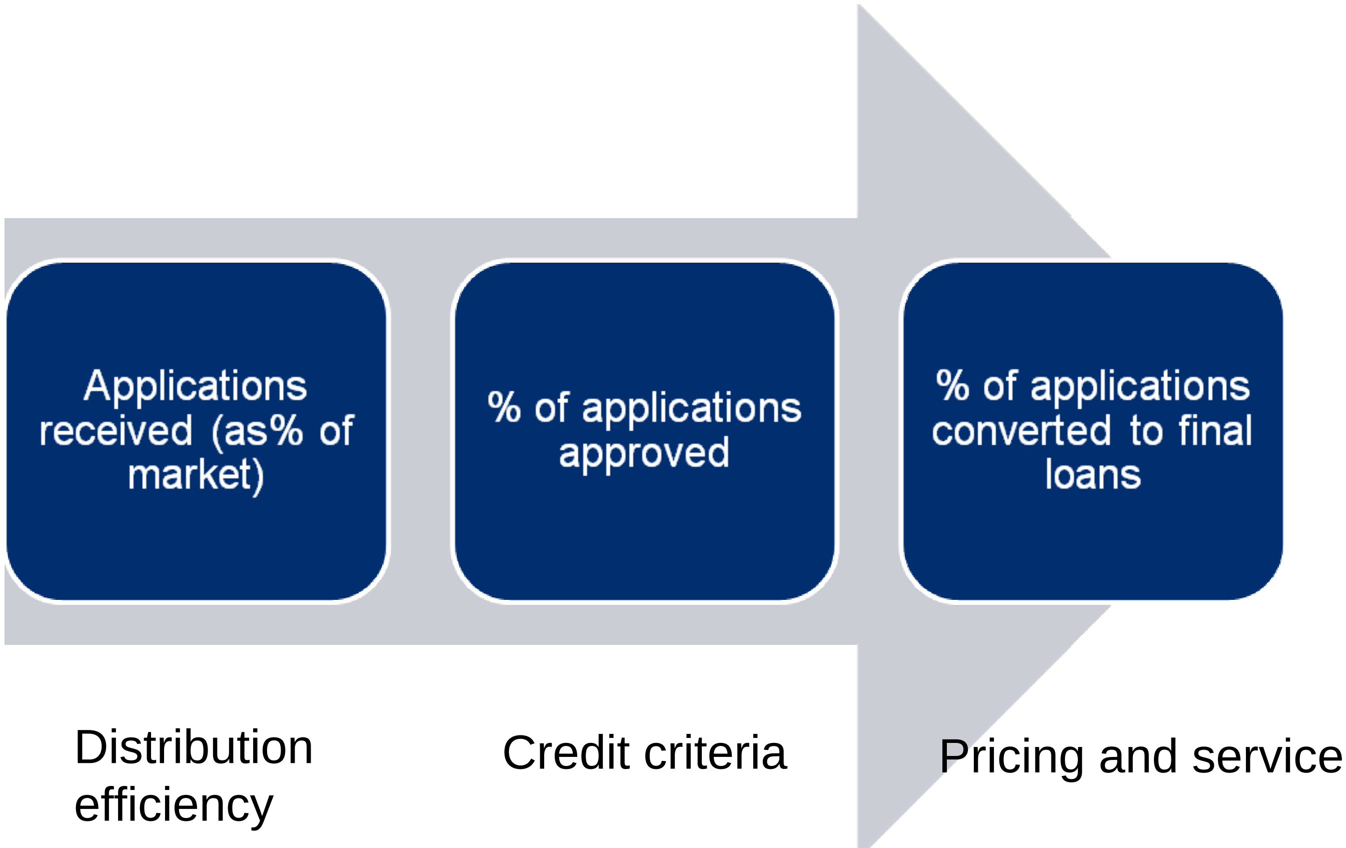
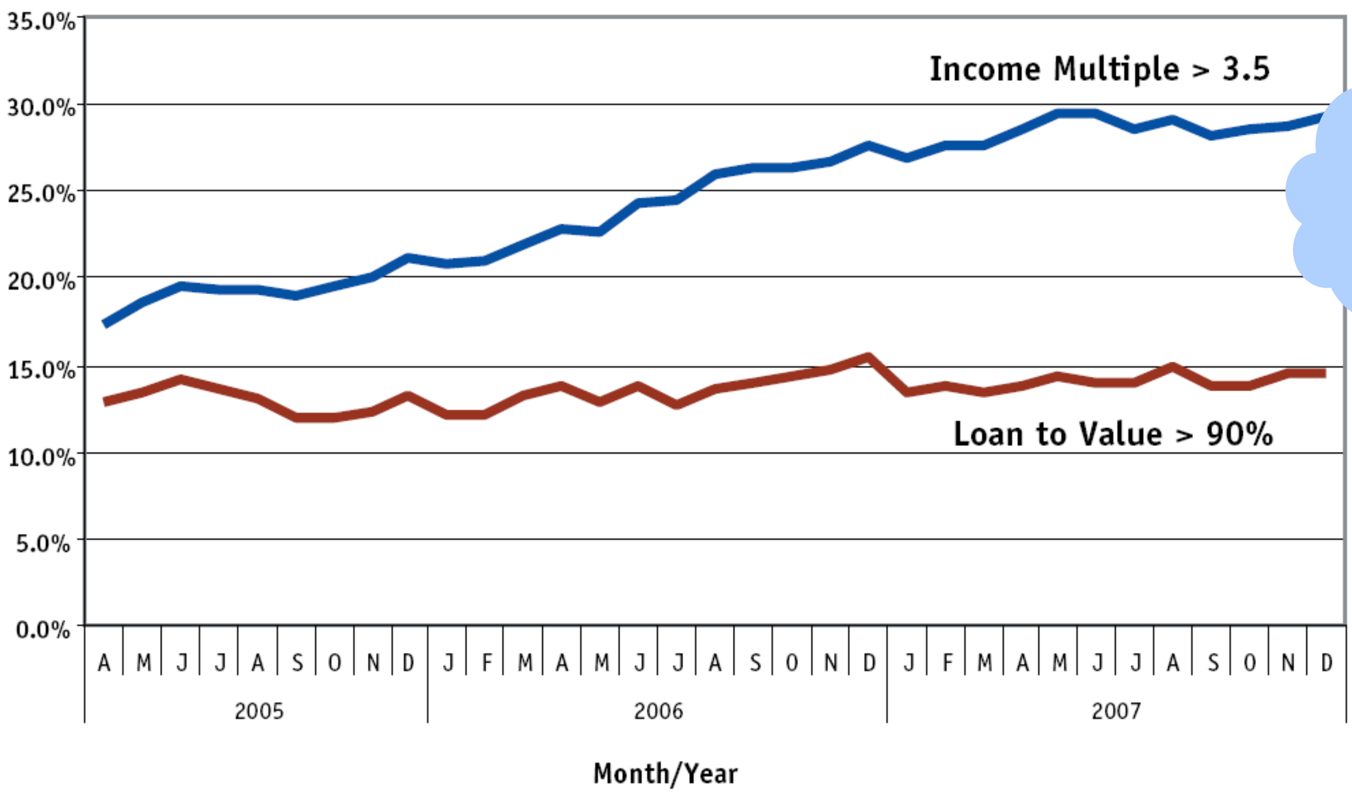
Pipeline efficiency analysis is used to assess competitiveness of broader process



Targeted portfolio parameters / limits

Spot the build-up of the (UK) problem…

Exhibit 3.1: Affordability indicators for mortgages sold in the UK, 2005-2007



Mortgages > 100% LTV doubled from 4-8%

Source: Turner review

Portfolio limits aim to limit the build-up of concentrations

- Target portfolio parameters/limits are articulated for each major portfolio / asset class
  - Sets the outer boundary of the desired targeted portfolio
  - Approved by Retail Credit Committee
- Items typically covered
  - % of new business with Loan to Value > specified levels (e.g. 100%)
  - % of new business with repayment to income > specified levels
  - % of portfolios with ratings lower than specified boundary levels
  - Targeted aggregate profile

Main focus of joint CPM/Business/Credit meetings is to determine tactical responses to the macro environment given the desired target portfolio and limits

Hedging existing exposures (single name, macro hedge, structured credit)

Structured credit: FRESCO II example

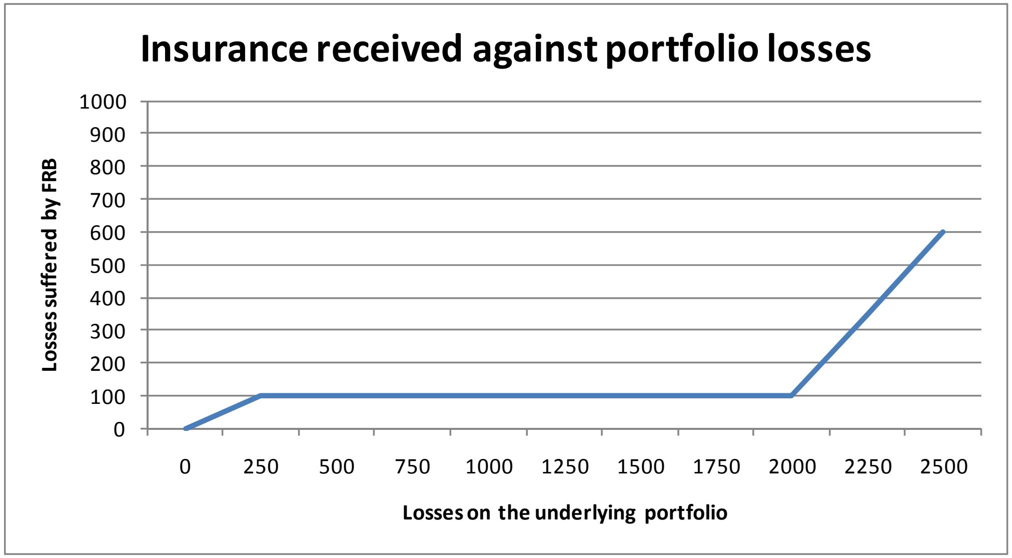
Underlying portfolio of 200+ investment grade corporate or FI exposures

Obtain insurance

R2bn notes issued into the market.
FRB retains first loss and super senior.

Note: Exposures are still shown on balance sheet for disclosure purposes, with normal provisioning practices still applied.

Insurance profile



Broader linkages: Capital, funding, ALM

CPM cannot be conducted in isolation…need to consider broader linkages

- Credit portfolio strategy vs funding strategy
- Credit portfolio strategy vs capital strategy
- ALM hedging strategy vs credit hedging strategy
  - Consideration of natural hedges
- Local vs international strategy differences
- Bank Lending vs Capital markets lending differences
- Technical linkages
  - Rating models vs IFRS provisions vs Basel II capital estimation and expected loss vs IFRS capital impairments
  - Recovery processes vs downturn LGD estimation
  - Others

Concluding remarks

Conclusion

- CPM approach complements traditional credit risk management
  - Explicitly considers the portfolio view and macro linkages
  - Focus on broader linkages, e.g. capital, funding, hedging

- A variety of tools are available to manage the portfolio
  - Trade-offs always exist between risk and business strategy
  - Combination of science and judgement

- Current cycle poses particular challenges
  - De-linkages of historical relationships
  - Trade-offs between capital, funding, credit more pronounced

- CPM and wider BSM approach provides key building blocks to effectively manage these challenges