Corporate CPM strategy in a down turn

Investec corporate impairments seminar

FIRSTRAND
Banking Group

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20 November 2009

Agenda

- Setting the scene for the South African market
- Understanding what has happened previously and resulting CPM reaction
- What can happen in the near future and how does CPM react?
- Conclusion

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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 program

2009

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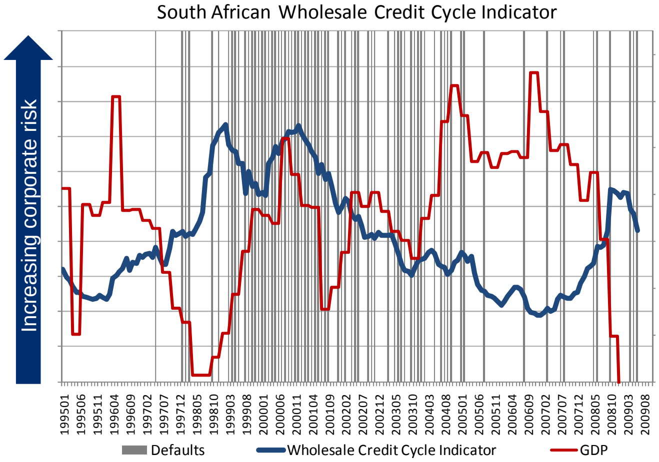
2009

Looking at what has happened and where we are

South African Wholesale Credit Cycle Indicator



2009

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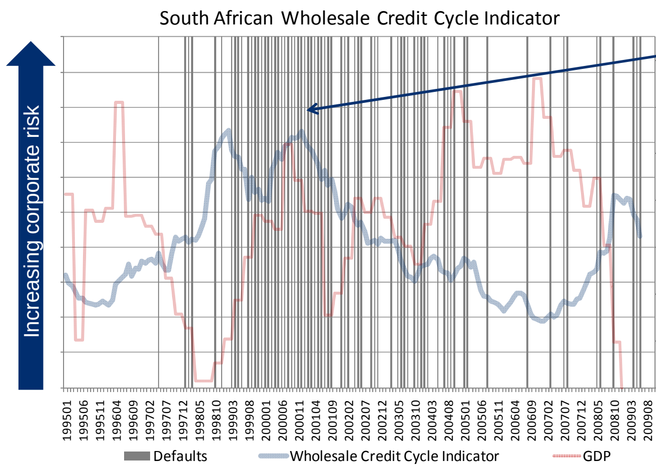
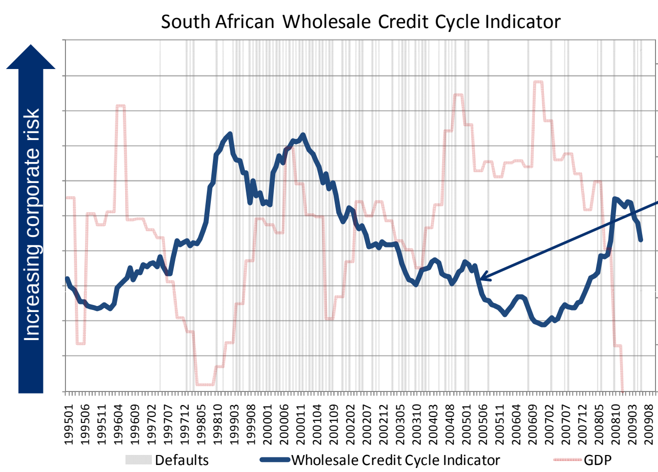


Understanding what has happened previously

- Defaults were more concentrated in smaller size counters and specific industries
- Increased risk evident in both market data and fundamentals more than 12 months before default

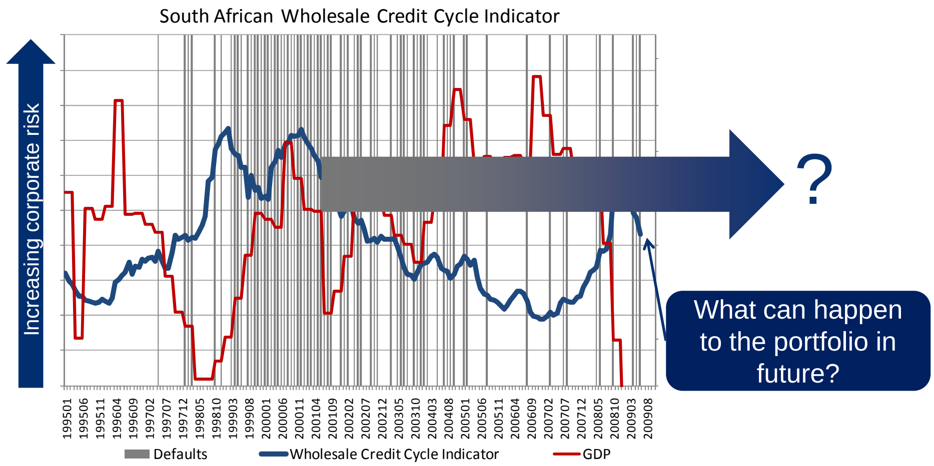
Looking at what has happened and where we are



Leading indicator of cycle impact on risk

- Quantitative model using market data and fundamentals
- Leading indicator of portfolio risk
- Used actively as CPM tool

Looking at what has happened and where we are



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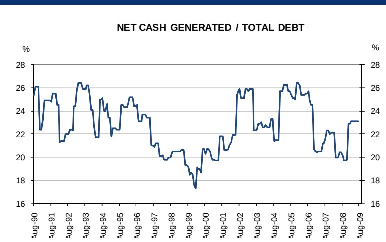
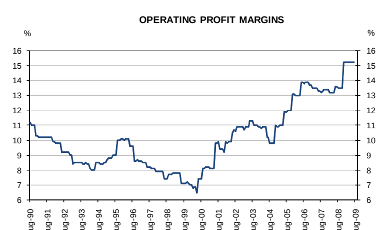
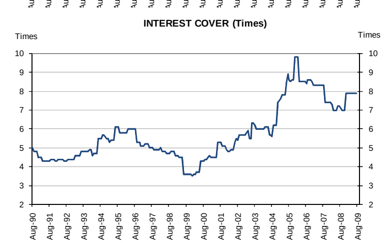
Most corporates still acceptable health status vs previous cycles

Key Financial ratios of JSE Industrial Companies







- Ratios remain at reasonable levels
- Stress testing of cashflows/earnings required given lag effect

Source: Inet Bridge

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Rating models as risk/ default predictor

Rating model inputs	SEP 05 Percentile rank	SEP 06 Percentile rank	SEP 07 Percentile rank	SEP 08 Percentile rank	SEP 09 Percentile rank	SEP 09 Ratio or value
Size (Turnover 'm)	98%	98%	98%	99%	98%	129,943
Size (Market Cap 'm)	99%	99%	98%	99%	98%	180,101
Real turnover growth	1%	3%	2%	5%	6%	26%
Debtors / Turnover	53%	36%	50%	61%	61%	19%
Cash from Operations / Net Liabilities	86%	86%	82%	88%	92%	92%
Cash from Operating Activities / Net Liabilities	83%	83%	82%	84%	88%	88%
Cash from Operating Activities - Depr / Net Liabilities	84%	86%	84%	85%	89%	89%
Net liabilities / Tangible assets	33%	40%	42%	44%	33%	35%
Market leverage	25%	30%	33%	32%	34%	20%
Excess return	86%	32%	41%	80%	36%	-20%
Share Price Volatility / Share Price	50%	14%	11%	50%	12%	7%
Three year high/low Shareprice	37%	41%	33%	23%	18%	139%
Model rating	BBB	BBB+	BBB+	BBB+	BBB+	

Good Ratio | Average Ratio | Weak Ratio

- Financial ratios are significant building blocks of predicting distress over longer term
- Market Data (more significant over short term as predictor)- rating mover report
- Models key tool in pricing, rating migration, ORM

Fundamental industry analysis: industry classification

Fundamental analysis methodology

- S&P's view for industries
- Confirmed with internal credit experts
- Confirmed by wholesale credit cycle indicator
- Historical default & migration matrices confirm

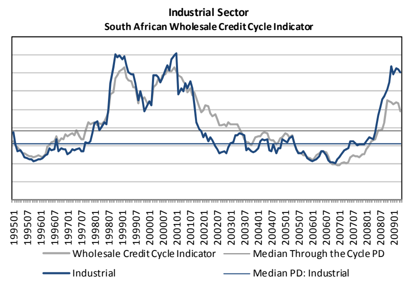
Inherent industry risks

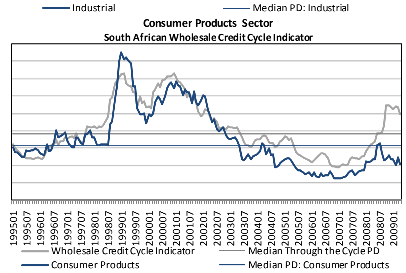
- Industry Dynamics & Competitive Environment
- Industry cyclicality
- Competition
- Growth & Profitability
- Growth outlook
- Earnings volatility
- Operating Considerations & Cost
- Technological risk / change
- Energy cost sensitivity
- Capital & Financing Characteristics
- Etc…

Fundamental industry analysis: industry classification example

More Volatile Industries				
Risk Factor	**Cyclicality**	**Competition**	**Capital intensity**	**Energy sensitivity**
Industry A	H	H	H	H
Industry B	H	H	H	M
Industry C	H	H	H	M
Industry D	M	M/H	L/M	L
Industry E	H	H	H	L
Industry F	H	H	M	L
Industry G	H	H	M/H	M
Industry H	H	M/H	M	L/M
Industry I	H	H	M	L/M

Less Volatile Industries				
Risk Factor	**Cyclicality**	**Competition**	**Capital intensity**	**Energy sensitivity**
Industry J	L/M	M	M	M
Industry K	L/M	M	M	M
Industry L	L	L/M	M/H	L
Industry M	L/M	M	M/H	M
Industry N	L	M/H	H	L
Industry O	L/M	L	M/H	M





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CPM toolkit derived from lessons learned during previous cycles

CPM strategies for the in force book: immediate effect

- Credit cycle indicator (portfolio level leading risk indicator)
- Rating mover reports (exposure level leading risk indicator)
- Ongoing risk management & covenant monitoring
- Collateral audits
- Assessing provisioning levels
- Ensuring workout and restructuring capacity/resources

CPM strategies used thereafter

- Monitoring of risk capacity and appetite
- Monitoring of portfolio composition
- Stress testing & hedging
- New business origination

CPM example: risk appetite drivers and targeted portfolio process

Portfolio drivers

- Weighted average portfolio rating
- Maximum % of portfolio rated below B+
- Single Name Event Risk
- Manage Size Concentration risk
- Manage Industry Concentrations

Levers that influence portfolio credit quality

Loss appetite levels

- Turbulent
- Average
- Benign

Loss tolerance rates for market scenarios

Target levels

- Not below BB
- Max Exposure % = 30%
- Limits per rating grade (Measured in terms of LIED)
- Allocate marginal capital to names exceeding thresholds
- 3 Largest Industries < ??%

Outcome of loss levels and business impact

Rigorous asset selection process

Hypothetical risk appetite summary

Wholesale Lending Portfolio - Credit Risk Appetite and Capacity (Example)	
Portfolio Summary	**R'million**
Credit Portfolio Exposure Value	1,000
Average net income from credit related business	40
Credit Capital on Performing Exposures	100
Concentration risk Capital	10
Portfolio Credit Reserves	15

Credit Capacity	%	R'million	R'million
Credit Risk Capacity Estimation			
Average net income from credit related business before credit losses and loan impairments			40
Add - Portfolio Credit Reserves available			15
Less - Shareholder min required annual return on Economic capital and Portfolio Provisions	10%	100	10
Estimated credit risk capacity			45
Credit Appetite at Normal Downturn Conditions			
Credit income volatility (Earnings buffer)	25%	40	10
Credit losses (Downturn)			20
Concentration Risk Capital contribution			10
Credit Capacity utilised			38
Available (excess) utilisation of credit capacity			7

CPM tools for pro-actively analysing possible future outcomes on portfolio

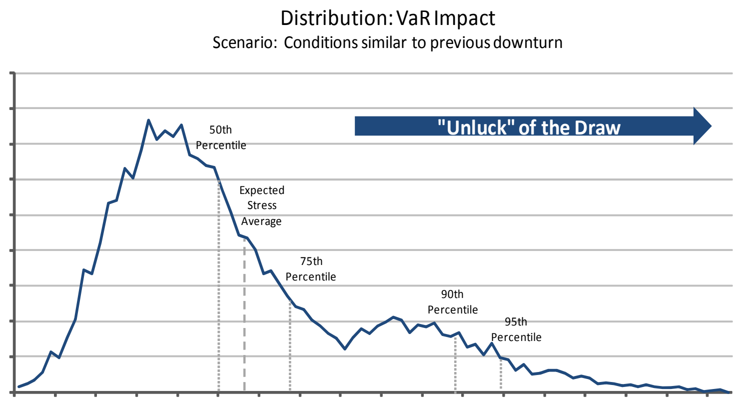
Assessing the impact of future scenarios: stress testing

- Stress testing must be conducted pro-actively and continuously
- Measure & identify portfolio vulnerabilities to extreme but plausible events
- Defining stress scenarios
- Assess impact of scenarios on i.e. capital adequacy, earnings and provisions

Doing something about it: hedging & origination strategies

- Translate industry risk to macro economic factors
- Investigate and enact possible hedges to reduce risk
- Change origination strategies already during benign times
- Build earnings and provision buffers

Assessing the impact on provisions



Stress testing done to indicate possible loss scenarios given economic downturn conditions - used to assess adequacy of provisions

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- Most large corporate counters indeed in better state of financial health vs previous downturn, but understand industry specific earnings/ cash flow volatility not yet in numbers

- Improved CPM allows for better understanding of and early reaction to the implications of downturns

- Illiquid held to maturity portfolios require long-term investor approach
  - Pro-active setting of through-the-cycle risk appetite and portfolio returns
  - Rigorous asset selection process (what you allow into portfolio)

- But specific alignment of strategy to point-in-time issues also required
  - Industry origination strategy including pricing for credit
  - Importance of the “non sexy stuff” –covenants, collateral, ORM and restructuring