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Credit portfolio manager of the year

A final flurry

Big portfolio disposals, baffling market moves, hedge funds making hay while others lost a fortune, balletic risk management, the recovery of eurozone fallen angels – for a year that was relatively quiet during its first nine months, 2014 eventually managed to generate a fair amount of drama.

Arguably the biggest story for risk managers, traders and investors was the huge intraday swing in US Treasuries on October 15, and the forces that provoked it. Press reports initially blamed it on electronic trading and thin dealer inventories, but *Risk* later pieced together a more complex tale of hedge fund crowding (*Risk* December 2014, *www.risk.net/2384515*).

At the time, confusion reined, but it was a defining moment for a number of this year's *Risk* award winners.

At Deutsche Bank, October 15 kicked off with an all-hands-on-deck meeting of senior traders and risk managers after a bank-wide value-at-risk limit was hit. A decision to slash exposure was taken quickly. The plan was communicated to Deutsche's board and the next day-and-a-half saw the bank shed roughly a third of its risk, as measured by VAR.

"In my 18 years at the bank, I have never seen such a single-minded approach to take risk down so dramatically when called to do so," says Stuart Lewis, the bank's chief risk officer.

Elsewhere, the burst of volatility and risk aversion became an opportunity. Napier Park Global Capital had been cautious for a while, viewing credit default swap (CDS) spreads as too narrow. The credit fund ventured into equity markets to execute a well-timed macro hedge in late August, and was positioned perfectly for the panic that would later hit CDS markets as spreads widened – October 14 was "one of our biggest buying days," says James O'Brien, the fund's chief executive.

In the old days, Napier Park would have had a lot more company, but O'Brien notes the field is now a lot thinner: "The banks can no longer arbitrage the mis-pricings during these sell-offs, and that's where we can take advantage." That highlights one of the themes of this year's awards – the retreat of dealers, and the corresponding advance of the buy side – with a number of the write-ups documenting the blurring, shifting boundary between the two.

But while banks certainly are retreating, that story can be overdone. In reality, dealers are part-way through deciding what they want to do, and focusing on it – take Citi's purchase of a $250 billion hedged portfolio of single-name CDSs from a European bank. Citi declined to reveal the seller, but enquiries by *Risk* journalists revealed it was Deutsche Bank.

While Deutsche wanted out of the non-cleared CDS market, Citi wanted in – sort of. The US bank acquired $450 billion of credit assets from various peers last year, but only because it believes it can use expertise gained while winding up its bad bank to recycle, compress or sell the assets at a gain. In the case of the Deutsche Bank portfolio, it has given itself six months to do so, and claims to be on track.

Societe Generale (SG) was also on the front foot, picking up four CDS portfolios worth €140 billion in notional from two European peers, taking on an inflation portfolio – not one of its traditional strengths – executing a big, creative longevity trade, and beginning the process of integrating Newedge into the bank. "SG has been consistent in doing what we are best at doing," says Didier Valet, head of SG Corporate & Investment Banking. The bank wins this year's derivatives house of the year award, and also gets the nod for equity derivatives and risk solutions.

It was not easy to pick winners. Where decisions were tight, client feedback often helped settle the issue. The *Risk* editorial team thanks all this year's participants for their time and help.

Banks were asked to submit information on their business in each of the asset class and product categories during 2014, and shortlisted companies underwent face-to-face and telephone interviews. *Risk* then gathered feedback from clients and other market participants.

The final decisions were made by *Risk*'s editors and journalists, weighing a number of factors, including risk management, creativity and innovation, liquidity provision, quality of service and engagement with regulatory issues. **R**

The roll of honour

Derivatives house of the year
Societe Generale

Lifetime achievement award
Andrew Feldstein

Interest rate derivatives house of the year
Deutsche Bank

Currency derivatives house of the year
BNP Paribas

Equity derivatives house of the year
Societe Generale

Credit derivatives house of the year
Citi

Inflation derivatives house of the year
HSBC

Structured products house of the year
Bank of America Merrill Lynch

Risk solutions house of the year
Societe Generale

OTC client clearer of the year
Citi

Deal of the year
Blackstone/Morgan Stanley

Quant of the year
Mats Kjaer/Christoph Burgard

Bank risk manager of the year
Deutsche Bank

Credit portfolio manager of the year
Credit Agricole

Clearing house of the year
LCH.Clearnet

Exchange of the year
Eurex

OTC infrastructure service of the year
TriOptima

Sovereign risk manager of the year
IGCP

Asset manager of the year
DoubleLine Capital

Hedge fund of the year
Napier Park Global Capital

Pension fund risk manager of the year
PKA

Corporate risk manager of the year
Electricity Supply Board of Ireland

Sef of the year
MarketAxess

OTC trading platform of the year
UBS Neo

Single-dealer platform of the year
Deutsche Bank

Law firm of the year
Linklaters

In-house system of the year
Danske Bank

Trading technology product of the year (bank)
Morgan Stanley

Trading technology product of the year (vendor)
Algomi

Risk management technology product of the year
IBM Risk Analytics

Back-office technology product of the year
KPMG

Risk Awards 2015

Credit portfolio manager of the year

Crédit Agricole

Trade finance is a tricky product for credit portfolio managers to deal with – loan maturities may be relatively short, but the portfolios can still be large, and very few borrowers are covered by the credit default swap (CDS) market. This can make it difficult for banks to transfer credit risk to third parties, which is one of the ways a credit portfolio management (CPM) function earns its keep.

In June last year, Crédit Agricole Corporate and Investment Banking (CA CIB) showed it can be done, teaming up with an unusual investor – an arm of the World Bank – to share credit exposure related to trade finance and other emerging market loans via an innovative synthetic securitisation-like structure, dubbed Marco Polo in a nod to its globe-trotting, trade-focused collateral. The resulting $350 million reduction in risk-weighted assets (RWAs) – against which regulatory capital is held – allowed the bank to take on additional trade finance business as the year went on.

On top of that, the CPM function has taken on the job of managing the French bank's liquidity buffer – an investment role – and has helped analyse the repayment characteristics of the group's loan book to optimise funding costs. Those skills are new to most CPM teams.

"Our activities last year significantly evolved, on top of carrying out the historical mandate of CPM, which is to hedge the risk of the bank. Although we already had the relevant knowledge in our CPM team, it's been an important change, because we had a lot to set up to start the investment activity and to invest in the best way we can," says Olivier Jouy, head of CPM at CA CIB in Paris.

The CPM team's work on trade finance exposures started in 2012, when the bank decided to re-emphasise its 'real economy' activities. The bank allocated more resources to growing trade finance as a result, but simultaneously challenged the CPM team to use the capital more efficiently.

At the same time, the World Bank's International Finance Corporation (IFC) was becoming increasingly worried a combination of regulatory change and the struggling global economy could affect trade finance in emerging markets.

The two parties got together, and in 2014 worked out a deal in which IFC would take the credit risk of a portion of CA CIB's exposures.

The bank identified a portfolio of trade finance, corporate and commodity loans, and took a 20% slice of each individual asset to keep separately on its balance sheet. The remaining portfolio, valued at $2 billion and consisting of 80% trade finance loans, 15% corporate loans, and 5% commodities-related loans, was then separated into senior, mezzanine and subordinated tranches.

IFC provided credit protection on the $88 million mezzanine tranche, which covers losses from $12 million to $100 million and represents around $350 million in RWAs, via a financial guarantee. As CA CIB held a 20% slice of every loan on its balance sheet, and also held the

Crédit Agricole's CPM team (left to right): François-Edouard Hétier, Martial Ribette, Olivier Jouy, Pascale Olivié, Antoine Biais

$1.9 billion senior and $12 million subordinated tranches, its interests were aligned with IFC.

"The idea at the very beginning was to use securitisation to release some capital, but obviously, with the crisis, the international markets began to be very, very difficult. We thought that if we were able to help our trade finance activity that would be good, and at the same time IFC was looking for something to help trade finance, especially with emerging markets," says Jouy.

"This was a significant deal for IFC, and the first time we have guaranteed a tranche of on-balance sheet credit risk across a variety of asset classes and borrower groups related to emerging markets. It demonstrates how credit risk transfer can support more emerging markets-related business at international banks,including in priority developmental areas such as small- and medium-sized enterprises and infrastructure," says Georgina Baker, director of trade and supply chain at IFC.

This synthetic credit risk transfer provided significant capital benefits: "This allowed us to release 50% of the risk weight of the original portfolio. With a $2 billion portfolio, there's about $700 million of risk-weighted assets on that, and transferring this mezzanine tranche synthetically to IFC releases half of it. We did not transfer all of it, but the piece we did transfer is the most RWA-intensive," says Pascale Olivié, head of structuring, research and asset allocation at CA CIB in Paris.

IFC provides a financial guarantee on the mezzanine tranche for four years but, as the assets are short dated, the loans need to be regularly replenished. For the first two years, the loans are automatically replaced monthly via an algorithm, while the portfolio amortises over the remaining two years.

IFC has an option to extend the credit protection for a further year,

which would result in a three-year period where the loans are being replenished monthly, and a two-year amortisation period. This extension is vital, as the transaction is less economical with a four-year maturity, says CA CIB. As a result, interests between the two parties are further aligned.

As CA CIB doesn't disclose the actual assets included in the portfolio to IFC, it also had to come up with a default settlement procedure that could confirm a default had occurred on a particular loan without revealing details about the individual debtor. In addition, a clause was inserted in the contract that would allow the deal to be renegotiated should future capital requirements for retained securitisation tranches prove punitive.

The deal has a simple enough outcome, but was very complex to put together, requiring the CPM team to collaborate with 24 other groups within the bank, from legal and compliance to commercial banking. It was completed in June 2014.

The bank declines to provide details on the amount of extra financing Marco Polo has facilitated, but Jouy says trade finance lending has increased as a direct result of the deal.

Elsewhere, the 20-strong CPM team is now playing a key part in managing the bank's medium- and long-term liquidity resources, having been given the mandate by the asset and liability management department in 2013. This involves choosing which high-quality liquid assets (HQLAs) to invest in for the purposes of Basel III's liquidity coverage ratio (LCR), which requires banks to hold enough HQLAs to cover outflows over a 30-day period of stress.

The team focuses on assets with a maturity of more than about two years, with the treasury department handling shorter-term investments.

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Olivier Jouy, CA CIB

François-Edouard Hétier, the Paris-based head of active portfolio management, says the rationale is that the portfolio management function has a lot of expertise in credit risk analysis, regulation and the management of scarce resources.

"We specialise in dealing with regulatory-related issues, whether that's economic capital, risk-weighted assets for CDS activity or the liquidity buffer. As we are used to hedging the loan portfolio of the bank, we have strong knowledge of the CDS market and of the credit quality of these bonds, and that's why we've been given this mandate," says Hétier.

The portfolio the CPM team manages is made up primarily of sovereign debt – this accounts for 60% of the buffer – as they are a level one asset in the LCR and therefore free from haircuts if issued by a member state or a highly-rated non-EU country. As a result, the majority of buffer assets are in European debt, with the rest in the US and Japan. Around 35% of the portfolio is made up of supra-nationals, and the remaining 5% is in corporate debt.

To maintain the optimal balance of assets – meaning the bank complies with the LCR while still holding a portfolio that is as high-yielding as possible – bonds have to be bought and sold as the market moves. To help manage this, the CPM team built an optimisation tool that locates assets with better returns and longer maturities that still qualify as HQLA. The tool was first used in mid-2014 and Jouy says it runs on a regular basis, helping identify good investment ideas for the buffer.

Separately, the portfolio management function has also started playing a part earlier in the lifecycle of the bank's lending – an evolutionary step that has been seen at other leading banks. Traditionally, CPM teams do their work once loans are on the bank's books, shaping and sculpting the exposure through loan trading, CDS purchases and securitisation, for example. This work continues at CA CIB, but the portfolio management function also now plays a gatekeeper role, assessing new loans in terms of the capital and funding costs they represent and calculating what the bank needs to earn in order to be profitable.

The team has the right to reject prospective loans that are value destroying, but the more common approach is to charge other businesses with recouping any shortfall through ancillary business with the client.

On the funding side, CPM looks at every single loan application to assess the potential funding shortfall or excess. If a loan to a client is matched with equal-term financing but the loan repays early, the result is a funding mismatch, in which the lending business has borrowed for longer than it needs to.

In November last year, the CPM team completed an in-depth study of the bank's various loan segments – from corporate and financial institution borrowers to structured credit finance – to see how reliably the actual maturity of lending could be forecast, and how different it was to the contractual maturity.

"The outcome of that study was the bank should not refinance itself at legal maturity, but at the average expected maturity of the loans. The gap in terms of actual cost was very substantial – we're talking about tens of millions of euros in additional funding costs if we don't take that into account. The results of the study showed the expected shortfall is 80 basis points for a trade with an average maturity of three-and-a-half years," says Antoine Biais, head of CPM advisory in Paris.

Clients are not just borrowers, of course, so the team also calculates what it calls the net gap – which includes the income that can be made from cross-selling. Even a trade with a higher-than-average shortfall can play a part in a profitable relationship, says Jouy.

"Tens of millions of euros for all trades are in shortfall at the beginning, but we know cross-selling largely covers this shortfall. We follow our shortfalls for four years, and after two years we are even, and after four years we have seen historically a two-and-a-half times return on the initial investment," he says.

Given the intensity of the calculations required, a loan can reach an advanced stage of origination before being rejected due to shortfall concerns, but Jouy says this is relatively rare. "We've said no to less than five trades in the past two years. There is less commercial damage if you reject a loan at the start, rather than waiting until the very last moment. The idea is that if the process is very well done, no-one will speak out at the last minute," he says. **R**