Standard Chartered – credit risk management

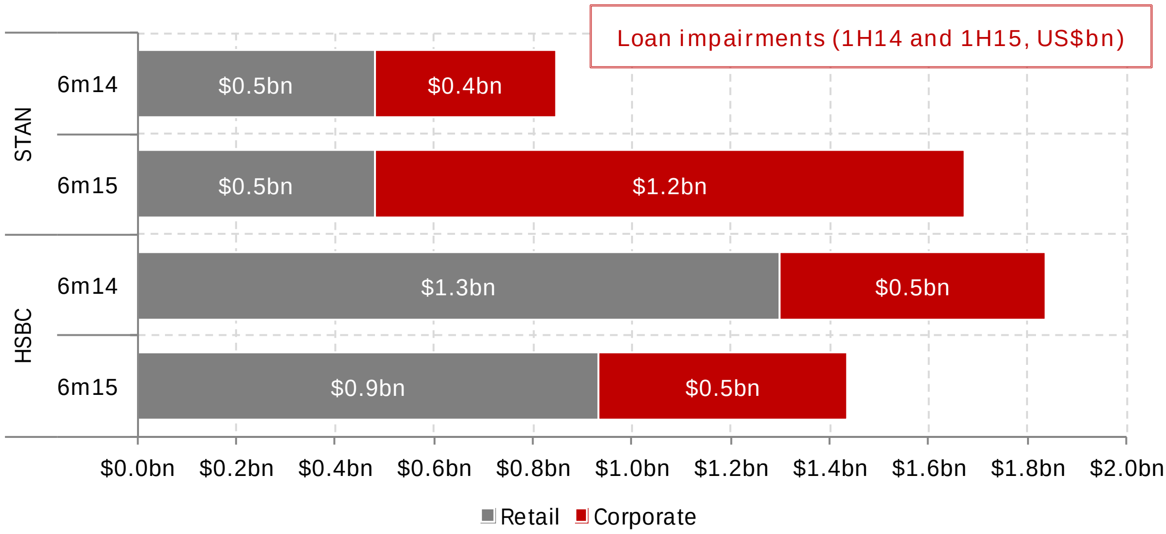
- The collapse of Standard Chartered's ROE over the past three years was largely caused by rising impairment costs. In our view, the growth in impairments suggests that there are issues with the bank's risk management, rather than with the underlying business proposition.
- The bank's current approach appears fragmented and lacks some of the dynamic techniques used to create a 'fortress balance sheet' of top-tier global universal banks.
- The new senior management team appears well placed to effect such changes. The bank is undergoing a major strategic review, the focus of which is its local corporate and commercial banking franchise in key markets.

Loan impairments surged ...

Some market commentators have suggested that there are inherent problems with Standard Chartered's business model. We disagree; while the bank faces cost management challenges in the retail segment and in parts of its corporate and commercial lending business, it also has a top-tier transaction banking division and solid trading and wealth management businesses.

Instead, the single most important reason for the bank's plummeting ROE (from 14% in FY10 to 3% in FY15E) has been a three-year growth in impairment costs, to the point where impairments equal 32% of the group's 6m15 operating revenue. In stark contrast, the impairment costs at HSBC group have fallen; they are also now smaller than those at Standard Chartered despite the fact that HSBC's 6m15 operating revenue is 8.3x higher.

Impairments compared to HSBC



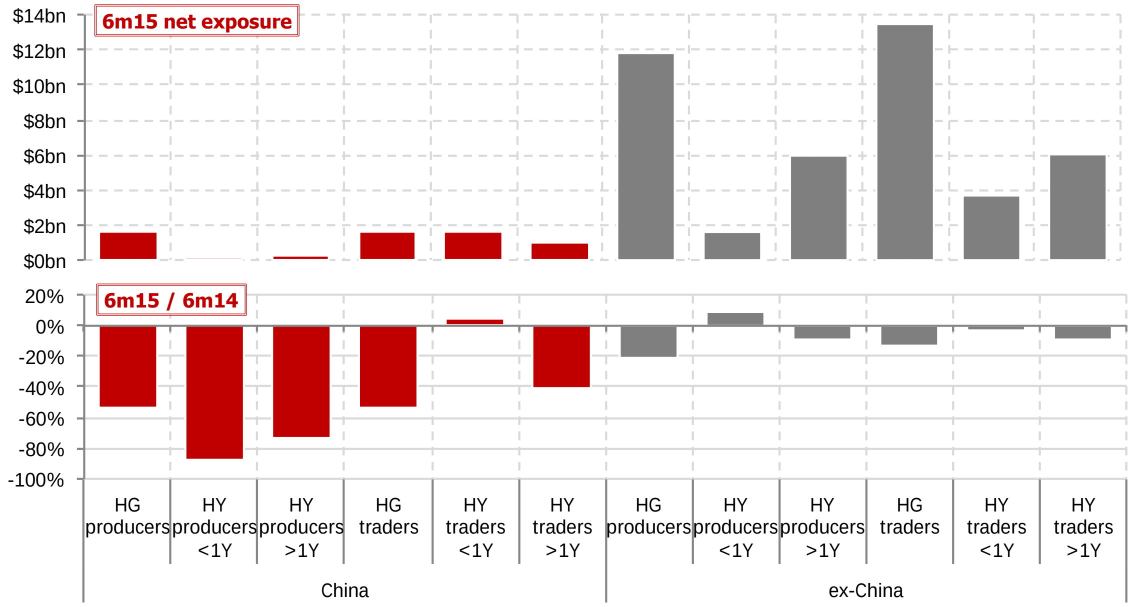
Source: Standard Chartered, HSBC, Tricumen analysis.

... but that's only partly due to the exposure to commodities ...

Many have looked to Standard Chartered's exposure to commodity markets as the key cause for the surge in loan impairments. This is not surprising, as the bank focuses on trade corridors between Asia, Europe and Africa, where commodities represent significant flows.

That said, Standard Chartered has made significant reductions to its exposure to commodity producers and traders, both in China and the rest of the world. Indeed, the bank's main remaining exposure - totalling approximately US$25bn - is to high grade producers and traders outside of China where the credit arrangements are more than one year in duration.

STAN reduced commodities exposure from $62bn in 2H13 to $43bn in 3Q15 ...



Source: Standard Chartered, Tricumen analysis.

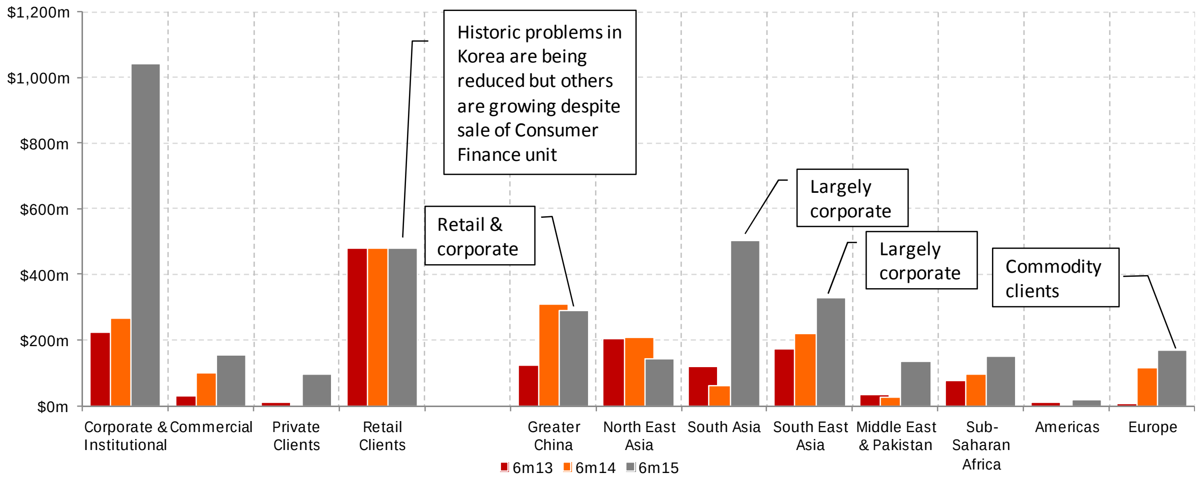
... as impairments are actually widespread

The real story is that the bank's impairments have grown across many regions. India, for example, is one area of concern; 6m15 impairments surged eightfold between 6m14 and 6m15. The bank attributed much of the blame on regulatory changes and a shift in local banks' approach to refinancing, which has 'reduced the likelihood for success of certain of Standard Chartered's corporate debt recoveries'. The bank has, however, reduced its corporate and commercial credit exposure in India, from US$42bn in 2012 to $35bn at the end of 1H15.

But commodities and India only account for 16% of the bank's credit exposure. From 1H13, impairments have grown progressively in almost every other region. Most impairments were caused by corporate/commercial exposures; indeed, only in China is there any significant problem on the retail side of the business. In Southeast Asia, loan impairments tripled, from $171m in 1H13 and 1H14 to $329m at end-1H15, mostly due to a surge in corporate loan impairments. In Europe, loan impairments are modest - $168m at end-1H15 - but have jumped by 46% versus 1H14.

In our view, the challenge lies not in Standard Chartered's business and client focus, but in its credit portfolio risk management in corporate and commercial banking.

Impairments by business and region (6m13 - 6m15)



Source: Standard Chartered, HSBC, Tricumen analysis.

Credit portfolio risk management is fragmented and in need of an update

Our analysis suggests that Standard Chartered's credit practices lag behind best-in-class peers in two key areas:

- Standard Chartered's credit portfolio management organisation is fragmented, with much of the effort centred at country level. Further, local portfolio managers are often charged with 'maintaining business risk at acceptable levels while maximizing revenue'. This seems to place the portfolio manager in the unenviable position of having to take the perspectives of both a 'credit officer' and a 'business originator'.
- We have seen indications that the bank's culture for credit risk management is more akin to that of a traditional commercial bank rather than a modern universal bank. For example, the bank's 6m15 financial report states that:

  > Approximately 80 per cent of the loan impairment in India relates to the existing NPLs. A significant part of this impairment is due to the restructuring of a small number of the most vulnerable accounts in the telecom, infrastructure-related and commodity sectors. These clients have underperformed due to macroeconomic or structural issues resulting in delays in refinancing through the sale of assets or through access to capital markets.

We do not yet have the full detail, but we wonder if Standard Chartered's sector exposures could have been hedged (the CDS market in India has been in existence since Oct-11; energy and infrastructure/telcos constitute 31% of the total exposure); and whether the bank could have sold or securitised some of its loans, including some of the 80% that had become non-performing loans as a number of firms are actively sourcing such product in Asia.

We contrast the above with HSBC who have shifted their business model from an 'originate and hold' to more of an 'originate and distribute' model. In 2013, HSBC distributed only a quarter of loans made by its global banking and markets division, but now distributes around half of them. HSBC has also been running a risk weighted asset reduction project, with staff from the FIG Banking Group working with the Portfolio Management Group to find solutions to reduce exposures across infrastructure, project & export finance, acquisition finance, real estate, aircraft & shipping, leveraged and distressed loans across various sectors.

Innovation can come in many guises. In 2014, Credit Agricole worked with the World Bank's International Finance Corporation (IFC) in a deal where Credit Agricole 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. The IFC provided credit protection on the $88m mezzanine tranche, while Credit Agricole held the senior and subordinate tranches.

Our thoughts on the need for a more progressive approach appear to be borne out by comments made by the new management team in the Nov-15 Strategic Review where the presentation referred to the need for 'tightened risk tolerance' and plans for a 'fundamental overhaul of Commercial Banking' under the headings of 'Secure the Foundations' and 'Get Lean and Focused'.

Aside from a shift in approach to credit portfolio management, we suggest that there are organizational changes that the bank could make. While Standard Chartered's credit officer footprint is the envy of many (the bank has more than 400 credit officers in Asia alone), the bank could do more to centralise its credit portfolio management teams, and develop a P&L-driven credit portfolio trading group to manage the retained credit risk in the wholesale banking operation, covering both loan portfolios and derivatives transactions.

Given that the new CEO has a pedigree from J.P.Morgan (which pioneered credit portfolio management) and at Renshaw Bay (which focuses on structured finance and credit markets investments), we expect the bank will choose a path along these lines.

About Tricumen

Tricumen was founded in 2008. It quickly became a strong provider of diversified market intelligence across the capital markets and has since expanded into transaction and corporate banking coverage. Tricumen's data has been used by many of the world's leading investment banks as well as strategy consulting firms, investment managers and 'blue chip' corporations.

Situated near Cambridge in the UK, Tricumen is almost exclusively staffed with senior individuals with an extensive track record of either working for or analysing banks; and boasts what we believe is the largest capital markets-focused research network of its peer group.

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