Executive Briefing

Unit 1: Credit Risk Management
Welcome to the Credit Skills Academy.

There have been previous financial crises but this time it is the severity and global impacts that are very different from what we have seen before. Never have banks and lending bankers received greater criticism over the quality of their lending than at the present time.

Media comment suggests that prudent lending principles have been disregarded in the quest in recent years for increased lending volumes and enhanced short term profitability. Analysts suggest that many of the prudential canons of lending have been overlooked and many lending bankers would benefit from a reconsideration and review of well tested and accredited lending principles. It is against this background that the Credit Skills Academy has been developed.

The modules in this Academy have been prepared to allow you and your colleagues instant access via e-learning and may be accessed as individual topics in which you are interested. We believe that they will also make an excellent basis for discussion with colleagues for mutual benefit.

We do hope that the extensive range will help you in your everyday job and also as someone interested in self development in the important area of Credit Skills.

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Credit Risk Management

Key learning outcomes

- Define risk and outline the principles of risk assessment and risk management.
- Explain the system for compiling borrower ratings based on historical, current and anticipated levels of performance.
- List the factors that could be included in an evaluation of a company’s peer position.
- Monitor a business’s performance by analysing the potential danger signs under four main headings: weaknesses in management and proprietors, technical and commercial problems, financing problems, faulty accounting.
Introduction

As a starting point to techniques and templates on credit; in this unit we will first consider the wider perspective of the credit risk management function and then progress to examining the processes for business lending in detail as it applies to individual prospective borrowers.

Overview of risk management function

Risk may be defined as:

The exposure to present or future loss of profits and/or capital.

Risk arises from:

- Faulty analysis of current circumstances or probabilities
- Future change of a social, commercial, economic or environmental or political nature, the effect of which cannot be anticipated or hedged, or where reaction to such change is late or insufficient.

All banks have a need to spread overall lending risk as widely as possible to reduce exposure to any one trade or industry and thus reduce overall exposure risk and profit volatility.

Banks reduce portfolio risk by making advances to a wide variety of industries, spreading the risk among a broad client base. Being very aware of the risk of over concentration in any one sector, banks usually operate within industry thresholds, limiting credit exposure to achieve the best mix of individual and portfolio safety. Although loans concentrated in one particular industry may appear sound and profitable, external factors may substantially affect some industries. In recent years cyclical economic forces have been manifest in the property market, transportation, tourism, the defence industry and electronics, as have changes in industry life cycles. Banks may impose internal limits on lending to restrict exposure to any one sector. Economic influences may well be caused by government fiscal policy.

Loan Composition:

Over Concentration and Other Warning Signals - It is hard to generalise about the credit implications of particular categories of lending without reference to the historical and current experience in a specific country, in terms of local market conditions and the expertise that a specific bank has developed. Within particular markets, however, an analyst will soon gain some understanding of what sort of lending tends to be problematic. Probably the most salient consideration in evaluating the character of a bank’s loan portfolio is whether there is adequate diversification. One generalisation that can be made is that over-concentration brings dangers. Diversification is a key to minimising risk.

Over-Concentration by Industry - When too high a percentage of loans is made to a particular industry, the bank becomes vulnerable to a downturn in that industry.

Over-Concentration by Geography - A high percentage of loans made in a particular region within its franchise area makes a bank vulnerable to an economic downturn or a cataclysm affecting that locale.
Depending upon the size of the bank, over-concentration may be in one urban or rural district, city, province or even country.

**Over-Concentration by Individual Borrower** – Too high a percentage of loans made to a single individual or company holds a bank hostage to the fortunes of that borrower. The analyst should also beware of hidden over-concentration achieved through cross holdings and the use of nominee companies.

**Over-Concentration by Size** – A small number of large loans is intrinsically more risk than a large number of small loans

Substantial lending to cyclical or vulnerable industries or to related parties should be viewed as red flags. Some common warning signals include:

**Excessive Real Estate Lending** – The property market tends to be highly cyclical in nature. Long boom periods are followed by steep rapid busts. Over the decades, banks have demonstrated an attraction to property lending. There are several types of property-related exposure and both definitions and associated levels of risk vary. Lending to real estate developers is more risky than lending to purchase existing real estate for investment purposes, as developers may be subject to severe cash flow problems when the market turns negative. Mortgage lending to owner occupier housing should be comparatively low risk.

**A Lending Portfolio Checklist:**

- What was the bank’s loan growth last year? What is projected in the current of forthcoming year?
- What is the bank’s lending strategy?
- Does the bank have written lending policies and strategies?
- What sectors or business segments, in management’s view, constitute the riskiest portions of the bank’s loan portfolio?
- What is the composition of the bank’s loan portfolio by borrower type, loan type and sector?
- Are there any types of borrowers, loans or sectors that the bank avoids?
- What is the bank’s largest problem loan?
- What is the bank’s largest commitment?
- How are loans approved? Is there a committee structure? How does it work?
- What are management’s policies on loan underwriting, review, collection, write-off and recovery? Have there been any recent changes? Are any planned?
- How does management control sector exposure and avoid over-concentration?
- How does the bank classify loans? How does it define a non-performing loan?
- What is the total volume and percentage of loans in each classification?
- What percentage is non-performing, restructured or foreclosed?
- How much discretion does the bank have in loan classification vis-à-vis regulatory requirements?
- What is the bank’s percentage of NPLs?
- Has the percentage of NPLs increased? Is so, why? What sectors or types of borrowers are responsible for a disproportionate volume of NPLs?
- What are the bank’s provisioning policies? What is the bank’s target NPL cover?
- Are there any disincentives (e.g. tax related) to full provisioning?
• What amount was set aside for loan loss provisioning last year? How was this determined?
• What was the amount of loans written off last year? What is projected for the current year?
• What is the bank’s policy on writing off loans? What time thresholds, if any, are employed? What are the bank’s policies on restructuring or foreclosing loans?
• What percentage of the bank’s total loans were restructured? What was the total number?
• What was the total amount of foreclosed assets on the bank’s balance sheet?
• What is the bank’s historical recovery rate on loss loans? How are recoveries accounted for?
• If a loan is restructured, what criteria, if any, must be met before that loan is deemed performing?
• What is the relapse rate on restructured loans?

Lending Portfolio Review

A qualitative review of the bank’s portfolio begins with an examination of the composition of the bank’s loan portfolio, which it should be noted encompasses, the use of some quantitative criteria. This includes:

• A review of the countries, geographic areas, industries and companies to which the bank is lending;
• A review of the type of customers to which a bank is lending and the tenor of the loans;
• Determining whether the bank is exposed to any foreign currency risk, as a result of lending;
• Ascertaining whether the bank is exposed to high sovereign or country risk as a result of cross-border lending activities.
• The fundamental concerns here are the degree of diversification and the level of foreign currency lending; or in other words, the avoidance of excessive concentrations of lending in any one sector or category.
• In conducting this review, the analyst is looking for signs of over-concentration within the loan portfolio (or preferably an adequate level of diversification).
• Over-concentration can be in respect of a particular industry (e.g. real estate), borrower (e.g. large amount lent to a single borrower) or geographic (e.g. a high proportion of loans extended to a particular foreign country).
• Qualitative review takes into account the relative financial health of the industry, borrower or geographic area in question.

The second major component of the qualitative review of asset quality concerns a bank’s credit policies and credit culture.

• Credit policies refer to whether the bank has in place adequate credit controls and credit risk management policies to avoid undue default risk, insider dealing as well as a potential lack of diversification in its loan book.
• Credit culture refers to less tangible elements that underlie those policies, including attitudes or management towards risk, incentives affecting the treatment of risk, the experience and training of credit personnel, and the character and competence of key management.
• Quantitative review includes an appraisal of the bank’s level of non-performing loans relative to its loan loss reserves, its equity and its ability to internally generate profits.
• It also involves a review of the bank’s reserve policy and cover of problem loans.
Lending Portfolio Duration

Loans may be classified by duration or tenor:

- Short term loans – term of one year of less
- Medium term loans – term of one to five years
- Long-term loans – term in excess of five years

A large proportion of bank loans will ordinarily be short-term. This is partly a function of the fact that the majority of bank funding is short-term. Banks rightly seek to avoid an excessive mismatch between their earning assets and funding liabilities, although some mismatch is inevitable. Whilst it is not always the case, short-term exposure is frequently regarded as being less risky.

Risk assessment and management

Risk assessment and management are the key skills of any successful banking operation. Most banks have some sort of risk rating system in place and the Basel Committee recommends this. The risk management process usually falls into a centralised or decentralised system. Such systems allow banks to evaluate and track risks on an industry, individual, or portfolio basis.

The principles underlying a risk rating system include:

- A common framework for assessing risk
- Uniformity throughout the bank
- Compatibility with regulatory requirements
- The ability to identify satisfactory levels of credit risk.

The principles underlying the risk rating process are:

- Common training through definition and risk rating assessment guides
- Introduction and continuity of levels of achievement on a continuing basis
- Regular reviews by senior bank officials to test for levels of accuracy and consistency.
The Importance of Credit Analysis

Many Financial Institutions have a significant proportion of their total assets within the lending portfolio. Prudent management of the bank is a reflection of its ability to balance successfully the risk in the portfolio with profit earned on it. The fundamental purpose of credit analysis is therefore; to develop ‘good’ business with:

- A known and acceptable level of risk
- Appropriate control to mitigate the risk
- An acceptable return

The primary vision when writing policy is to determine the institution’s tolerance for accepting financial risks and articulate it when defining the risk parameters of the policy.

- Each financial institution is unique and this must be reflected in its policy. The policy must reflect the collective risk tolerance of senior managers and boards of directors, which may vary from extremely conservative to very aggressive.
- The Credit Risk Committee policy must also address the responsibility for managing the institution’s capital position. If Credit risk wants to establish strong control of the risk position, it should include a description of its minimum default expectations within the policy.
- When developing controls the Credit Committee will need to set sectoral and business exposure limits to mitigate economic downturn sectorial risks
- The frequency that accounts will be monitored and the establishment of credit grade guidelines to manage the mix of lending will enhance portfolio management.

Much of the value of the banking process is created by managing credit risk within the loan portfolio. There are, however, several factors that can cause loans to become delinquent, among them are poor underwriting procedures and credit judgement.

The most common cause of borrowers becoming unable to repay their loans is change in the economic environment. During periods of expansion, the robust business climate will mask all but the most extreme credit mismanagement. However, when the economy turns into recession, banks will experience an increase in loan delinquencies and those with a weak credit management process will encounter the most problems.

When the collateral (if any) is sold for less than the balance. The highly leveraged position of many financial institutions makes them very vulnerable to credit risk susceptibility due to the low capital base relative to total assets.

An institution’s risk exposure is not solely confined to loss that may occur on the loan. Before the loan is liquidated, it becomes an non-earning asset, which reduces the overall return on assets and causes the net interest margin to compress.

The loan Credit committee need to know that effective credit management processes are in place:

- Credit review and approval procedures should be clearly described in policy procedures and must be checked for compliance during audits.
- Policies that restricts the percent of the loan portfolio that can be in any one area or industry and that restricts lending to an individual borrower or associated group.

By using current data in conjunction with historical data, analysts can discern trends of deteriorating or improving credit conditions in an institution’s balance sheet by using various ratios. To be effective in managing the balance sheet, the Credit committee must be aware of the institution’s total and sectorial credit risk exposure.

**Ratios** that can be used to determine asset quality:
Asset quality

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned and other assets, as well as off-balance sheet transactions. The ability of management to identify, measure, monitor and control credit risk is also reflected here.

The evaluation of asset quality should consider the adequacy of the allowance for loan and lease losses and weigh the exposure to counterparty, issuer or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution’s assets, including, but not limited to, operating, market, reputation, strategic or compliance risks should also be considered.

The asset quality of a financial institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

1. The adequacy of underwriting standards, soundness of credit administration practices and appropriateness of risk identification practices. A suitable generic model for credit evaluation is shown below:

![Diagnostic Credit Evaluation Model](image)

*Ref: Checkley “Lending” Published by London CIOB 1997*

2. The level, distribution, severity and trend of problems, classified, non-accrual, restructured, delinquent and non-performing assets for both on and off-balance sheet transactions
3. The adequacy of the allowance for loan and lease losses and other asset valuation reserves
4. The credit risk arising from or reduced by off-balance sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit and lines of credit
5. The diversification and quality of the loan and investment portfolios
6. The extent of securities underwriting activities and exposure to counterparties in trading activities
7. Existence of asset concentrations
8. The adequacy of loan and investment policies, procedures and practices
9. The ability of management to properly administer its assets, including the timely identification and collection of problem assets
10. The adequacy of internal controls and management information systems
11. The volume and nature of credit documentation exceptions.

Management

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor and control the risks of an institution’s activities and to ensure a financial institution’s safe, sound and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures and practices have been established. Senior management is responsible for developing and implementing policies, procedures and practices that translate the board’s goals, objectives and risk limits into prudent operating standards.

Depending on the nature and scope of an institution’s activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity and other risks.

Sound management practices are demonstrated by:
   a. Active oversight by the board of directors and management
   b. Competent personnel
   c. Adequate policies, processes and controls taking into consideration the size and sophistication of the institution
   d. Maintenance of an appropriate audit programme and internal control environment
   e. Effective risk monitoring and management information systems.

This rating should reflect the board’s and management’s ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved. Further considerations to take into account are:

   a. The level and quality of oversight and support of all institution activities by the board of directors and management
   b. The ability of the board of directors and management to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products
   c. The adequacy of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities
   d. The accuracy, timeliness and effectiveness of management information and risk monitoring systems appropriate for the institution’s size, complexity and risk profile
   e. The adequacy of audits and internal controls to:
      i. promote effective operations and reliable financial and regulatory reporting
Many guidelines as to how we manage risk are within the Basel Committee documents and publications.

**Basel II – The Big Picture**

The Over-arching goals of the Committee are to ensure the adequate capitalisation of Financial Institutions and to encourage best-practice risk management.

The key objectives are:

- Promote the safety & soundness of the financial system
- Enhance competitive equality
- Apply a more comprehensive approach to risk
- Create a framework of three mutually-reinforcing pillars

(Ref: BIS.org  July 2004)  [http://www.bis.org/publ/bcbs107.htm](http://www.bis.org/publ/bcbs107.htm)

The Committee also seeks to continue to engage the banking industry in a discussion of prevailing risk management practices, including those practices aiming to produce quantified measures or risk and economic capital. Over the last decade, a number of banking organisations have invested resources in modelling the credit risk arising from their significant business operations. Such models are intended to assist banks in quantifying, aggregating and managing credit risk across geographic and product lines. While the framework stops short of allowing the results of such credit risk models to be used for regulatory capital purposes, the Committee recognises the importance of continuing active dialogue regarding both the performance of such models and their comparability across banks.
**Basel II - Capital Strategy - Pillar I:**

### The First Pillar – Choices in calculation

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<tr>
<th>Credit Risk</th>
<th>Basic</th>
<th>Intermediate</th>
<th>Advanced</th>
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<tr>
<td></td>
<td>‘Standardised’</td>
<td>‘Foundation’ – internal rating based approach</td>
<td>‘Advanced’ – internal rating-based approach</td>
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<td></td>
<td>Successor to the 1988 Accord with some additional sensitivities</td>
<td>Portfolio split by category of exposure – input from institution and regulator</td>
<td>As for Foundation but all parameters calculated by institution.</td>
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<th>Market Risk</th>
<th>No major change in current approach</th>
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<tr>
<td>Operational Risk*</td>
<td>‘Basic Indicator Approach’</td>
<td>‘Standardised Approach’</td>
<td>‘Advanced Measurement Approach’</td>
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<td></td>
<td>Capital charge based on single risk indicator</td>
<td>Capital charge based on sum of 8 Business Line risk indicators, each calculated by defined industry standards</td>
<td>Capital charge by Business Line, internally calculated and variable on level of risk</td>
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* Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

As you can see from the chart, a significant innovation within Basel II is the greater use of the assessments of risk provided by an Institution’s own internal risk assessment systems as inputs to capital calculations.

In taking this step, the Committee is also putting forward a detailed set of minimum requirements designed to ensure the integrity of these internal risk assessments.
Basel II - Overall Summary Diagram:

Basel II Strategies

Pillar 1 (Capital Strategy)

Pillar 2 (Regulation)

Pillar 3 (Disclosure)

Create "Risk Culture"

Risk Management

Risk Event Handling

Risk Event Data Base

- Human Resources
- Communications
- Reporting
- Training
- Approved persons
- Procedures Manuals

- Regulatory Compliance
- Organisational Structure
- Risk Categorisation
- Assessment
- Process improvement

- Monitoring
- Event Recording
- Event Management
- Statistics

Credit Risk Management
Towards Basel III – The Big Picture

- Basel Press release:
  - Reference 35/2010 dated 12th September 2010
  - Overall objective is to ensure the adequate capitalisation of Financial Institutions

- At its 12 September 2010 meeting, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, announced a substantial strengthening of existing capital requirements and improving liquidity management.


- Also Summary diagram below

For more detailed reading see:

http://www.bis.org/bcbs/basel3.htm?ql=1

As evidenced by recent Global volatility, where not only general commercial businesses, but also many banks in the US’ UK and Europe have come under liquidity management pressures due in part to numerous bad loans. Pillar I now stipulates a more thorough approach to Liquidity Management.
The Credit Analysis Process

A Framework for Assessment

- It is vitally important to remember that a business, no matter how strong the balance sheet, cannot carry a debt burden greater than can be serviced by the income generating capacity of the business.
- It is for this reason that great emphasis should be placed on understanding the trading profile of the business. This is displayed in the trading profit/loss account and in the projected profit and cashflow budgets.

Testing the ability to repay out of cash earnings

- “The going-concern test” - Debt/Profit
- Ability to repay out of asset liquidation
- “The gone-concern test” - Debt/break up value of assets

Commercial lending therefore exposes a bank to two major types of risk:

- Borrower risks
- Operating/transactional risks.

Borrower Risks

- Industry economic risk – covering inflation and foreign exchange risk exposure.
- Industry structure risk - embracing the risk inherent in a company’s business environment, including entry and exit barriers, the power of suppliers or customers, the impact of technology, regulatory requirements and capital requirements.

Operating Risks

- Inactivity to repay, receivership or liquidation, error or fraud.

Transaction Risks

- Including the risk inherent in the lending itself. Embraces terms and conditions, tenor and maturity, the security/collateral implications.

Borrower ratings

Banks may give borrowers ratings based on historical, current and anticipated levels of performance.

A borrower rating is likely to be based on the following criteria:

- Industry and operating environment
  - Does the borrower operate in a strong and growing industry?
  - Does the borrower hold a significant share of the market?
  - Are legal and regulatory climates favourable?

- Earnings and operating cash flow
  - Are earnings of high quality and growing?
  - Are margins in line with others operating in the industry?
  - Is cash flow strong in relation to current and anticipated debt?
- **Asset and liability structure**
  - Are asset values realistic?
  - Are assets and liabilities matched?
  - Have intangibles been discounted?
  - Are the assets available as security/collateral?
  - Is the bank avoiding a subordinated lending position?

- **Debt capacity**
  - Is gearing/leverage at acceptable levels?
  - What alternative sources of debt and capital exist?

**Debt Management and controls**
  - How competent is the management?
  - Are good reporting lines in place?

**Financial reporting**
  - Are the auditors reputable?
  - Is financial information produced on time?
  - Is it accurate and complete?
Risk rating

The risk rating is an index of risk intended to reflect the collectability of a specific advance in accordance with its terms. Each advance carries its own risk rating.

The risk rating is the risk of the particular advance or transaction to a particular borrower. There can be possible positive and negative variables that may impact on an advance or credit facility. Some of the common factors include security/collateral, ownership, terms, subordinated position and country risk.

There is a need for banks’ internal audit departments to test for accuracy, consistency and appropriateness. Such a rating system is helpful in setting fee guidelines appropriate to the degree of risk involved.

Industry tier position

A company’s tier position should reflect a company’s competitive position relative to its peers. The factors used to determine peer position may be qualitative or quantitative. Factors that could be included in an evaluation of a company’s peer position may include:

- **Market share**
- **Pricing**
  - Price leadership
  - Product differentiation/premium pricing
- **Cost structure**
  - Labour cost
  - Material costs
  - Capital intensity
  - Economies of scale
  - Technological advantages/disadvantages
  - Operating gearing/leverage
- **Managerial skills**
  - Industry reputation, expertise
  - Marketing ability
  - Long term strategic focus
- **Financial aspects**
  - Cash flow measures
  - Debt levels
  - Profitability measures
  - Comparable performance ratios
- **Miscellaneous**
  - Diversification
  - Acquisitions
  - Contingent Liabilities/off-balance sheet obligations
  - Diversification/concentration
  - Divestiture/acquisitions
  - Contingent liabilities and other off-balance sheet obligations
Credit Administration

Credit administration

It is often important for a bank’s credit management function to maintain an independent viewpoint.

Senior management must:
• Ensure that credit policy is fully understood throughout the organisation
• Develop the training programmes needed to ensure that lenders have appropriate skills
• Track credit documentation and decisions
• Review policy decisions.

Statements on advances policies

Such a statement may include:
• Advances should have a sound funding capability and be predicted on sound lending principles
• Advances pricing should adequately reflect bank policy and requirements
• Rewards sought should be in line with risk assumed
• Advances must comply with laws and regulations
• Advances not to be of a speculative nature where the bank could be placed at risk
• All advances to be reviewed on an annual basis
• Credit decisions to be made as quickly as possible bearing in mind complexity and risk.

Credit review

Lenders involved with the review and sanctioning of advances applications have a primary goal of minimising loss. When reviewing advances applications, amongst the most important areas will be:
• Business background, nature of business, management and control
• Macroeconomic sensitivities/company problems
• Quality of management
• Product/service, market and trading outlook
• Premises, machinery/vehicles – age and suitability
• Trading performance
• Conduct of account
• Requirements
• Ability to repay and source of repayment
• Projections for the future and assumptions underlying
• Security/collateral available
• Remuneration
• Other business creative opportunities.
Anticipatory limits

The bank may agree that lending managers have authority to allow customers to anticipate their income streams to a limited degree. To reduce the workload on lenders, many banks set up a system whereby the computer is programmed to allow an automatic anticipatory limit to be recorded on creditworthy accounts. It is crucial that such limits are set at appropriate and realistic levels. In a perfect system the limit should be linked to the customer’s ability to repay.

Credit scoring

Some banks allow loan applications to be assessed by a credit scoring process, set in accordance with bank policy. Banks using the system have application forms for completion. Information submitted by customers may be checked against bank records. Non-customer applicants should be asked for proof of statements made. Banks often provide for a manual override of decisions made by computerised credit scoring techniques.

Monitoring and control – spotting the warning signs of trouble

Accountants often tell banks that they are between six and nine months too late in identifying problem lending. Part of the difficulty may be the anxiety of bankers to support a company as far as is possible through a difficult trading period, often maintaining that support longer than they should. However, there are warning signs of business failure to look out for and which should not be ignored. Too often the monitoring of progress and the telltale signs of a downturn in the affairs of a customer are overlooked. In many cases the decline is gradual and an alert lender will see danger signals long before the situation becomes critical.

Root causes and the danger signs can be analysed under four main headings:

- Weaknesses in management and proprietors
- Technical and commercial problems
- Financing problems
- Faulty accounting

Weaknesses in management

Bad management is the most common cause of business failure and a proper appreciation of the capabilities of the company’s management is therefore essential in any customer monitoring exercise. In a family business the management of the company is frequently handed down from one generation to the next, irrespective of whether management skills have been successfully inbred.

Equally dangerous is the situation where a company’s management is concentrated in the hands of a single executive. There is a limit as to what one person can do, but a dominant chief executive can be dangerous in many respects, not least when he/she dies. It is a common failing in such cases to find no management succession. There is also more likelihood of financial impropriety where there is a dominant chief executive.
A further situation that can give rise to problems is where the size or nature of a business is undergoing rapid change. An entrepreneur may be well suited to running a small, expanding business, but there comes a time when there is a requirement for other skills within the management team such as delegation and team building; such skills are not always inherent in the initial pioneer of a business. A well-run company will thrive on collective decisions and collective responsibility. If there is a lack of middle management, it is hard to see how decisions can be implemented.

Apart from being alert to the factors described above, there are other indications of management weakness that the banker should look out for in monitoring customers:

- A high turnover rate among key employees may indicate that management is unable to motivate staff with a real sense of purpose.

- Extravagant spending on travel, entertainment and office accommodation may be an indication of irresponsible management. A reluctance to inject capital into the business indicates a management team lacking confidence in the business and may lead to a lack of commitment to it.

- Perhaps most important, a failure to take advantage of financial information (for example, by attending to variances) may indicate insufficient attention to planning and control which are so essential to good management.

**Technical and commercial problems**

While weak management is still the prime cause of corporate failure, increasingly the pace of technical and political change is wrong footing even generally competent management as it becomes more difficult to respond quickly to the changing environment.

The banker needs to be alert to the implications of the environment in which the customer operates and to the implications of commercial decisions. A business with volatile products or markets, susceptible to changes in cost, fashion, technology, social attitudes, overseas competition or exchange rates is clearly vulnerable. Such changes may be near impossible to foresee, yet their impact can spread far beyond a particular business – they can spell doom for entire industries.

A business where sales are concentrated in a small number of customers may go into a rapid decline if one of its customers goes out of business or switches to another brand. Equally, a business whose prosperity depends on one large contract has a big question mark hanging over its future. A business with sales volumes susceptible to sharp fluctuations is necessarily insecure unless its overheads can be easily controlled and flexed. If the business has a high level of fixed costs, there is an obvious cause for concern. A business which bases its prices on marginal costing techniques can very easily get into trouble and the effect can multiply rapidly in the struggling company that seeks to “buy” volume by paring its margins.

**Financing problems**

Other possible indications that a business is heading for trouble lie in its financing.

If the accounting system is inadequate, proper and corrective decisions cannot be made. Progress cannot be monitored if management has no information on which to work. Creative
accounting almost invariably is associated with corporate failure. It is seen, for example, in the revaluing of assets, changes in the bases of stock valuations and in expenditure being carried forward. Creative accounting improves profits and liquidity ratios, but remember that profit is merely an opinion whilst cash is fact.

Another sign of trouble is a deteriorating debt collection record, which may be caused by customer dissatisfaction with goods supplied or by more favourable credit terms offered so as to revive flagging sales. As regards payments to creditors and collections from debtors, a successful company will demonstrate a reasonably steady pattern. As a company moves towards failure, this pattern will begin to deteriorate since the company will not release cash in the same regular way as before. Equally, it may simply be the result of poor credit control. The easiest debts to collect will be pressed for and difficult ones may be ignored. This symptom occurs late on the failure path.

A banker should be wary of a business that is overgeared or with a capital structure weighted to short term maturities. Other danger signs include the payment of dividends in the face of losses and the granting of increasing security interests to obtain credit. A business which decides to diversify or expand its existing operations without sufficient capital to finance the high costs associated with such plans is courting trouble.

Uncontrolled capital expenditure can give rise to serious problems in the short term, if the company’s cash flow position cannot bear the cost, or in the longer term, if the return from the capital investment is inadequate. Equally, a failure to invest in the development of the production system can result in the business becoming uncompetitive. An increase in the flow of status enquiries may give the observant banker advance warning that facilities are inadequate.

Faulty accounting

No company can monitor its progress (or lack of it) effectively without accurate financial information. A qualified audit report is often an early warning. Other warnings may be changes in accounting policy (perhaps to mask losses) such as capitalising research and development or advertising costs. Even accurate information is of little value unless it is current and produced on a timely basis; late accounting should give as much cause for concern as faulty accounting. It is often the first telltale sign of trouble.

Without current and accurate financial information decisions are apt to be based on wrong assumptions while both favourable and unfavourable trends can go undetected. Hence, a lack of financial information or, equally, irrelevant or even excessive financial information, should be regarded as indicative of problems and as a possible root cause of them. In a company which incorporates several different operations, the significance of this point is amplified – it may be possible to establish that problems exist but accurate and relevant reports are essential if the problem areas are to be isolated. Current financial information is essential to management.

It is (or should be) just as important to the banker for the purpose of any effective monitoring exercise. Too often the banker monitors the customer with last year’s balance sheet rather than the projection of next year’s profit and loss account.

Bankers are busy people, but attention to the customer’s current management accounts and future projections and an understanding of the commercial problems and assumptions which underlie them, may save time in the long run.

Perhaps the most important overall feature is profitability. It may sound obvious to say that a company with a history of continuing losses is a serious risk but, especially where large and prestigious companies are concerned, this is sometimes overlooked. Lack of profitability soon turns into adverse cash flow and soon erodes the balance sheet. Obviously profit alone is not enough unless it can be turned into cash flow, but in reviewing financial projections it is worth
remembering that a business without prospects of profit has lost its raison d'être.
The BIS Standards

As we mentioned earlier; the Bank for International Settlements (BIS) provides guidelines to commercial banks and bank regulators worldwide on the effective operation of banking institutions. Its sub-committee, Basel Committee on Banking Supervision, is one which encourages banking supervisors globally to promote sound practices for managing risk. Their consultative document “Principles for the Management of Credit Risk” discusses 17 principles applicable to the business of lending and should be applied to all activities where credit risk is present.

http://www.bis.org/publ/bcbs75.htm

The Committee recognises that “the major cause of banking problems continues to be directly related to lax credit standards for borrowers and counterparties, poor portfolio risk management, or a lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of a bank’s counterparties”.

Credit Process Issues

Many credit problems reveal basic weaknesses in the credit granting and monitoring processes. While shortcomings in underwriting and management of market-related credit exposures represent important sources of losses at banks, many credit problems would have been avoided or mitigated by a strong internal credit process.

Many banks find carrying out a thorough credit assessment (or basic due diligence) a substantial challenge. For traditional bank lending, competitive pressures and the growth of loan syndication techniques create time constraints that interfere with basic due diligence. Globalisation of credit markets increases the need for financial information based on sound accounting standards and timely macroeconomic and flow of funds data. When this information is not available or reliable, banks may dispense with financial and economic analysis and support credit decisions with simple indicators of credit quality, especially if they perceive a need to gain a competitive foothold in a rapidly growing foreign market. Finally, banks may need new types of information, such as risk measurements, and more frequent financial information, to assess relatively newer counterparties, such as institutional investors and highly leveraged institutions.

The absence of testing and validation of new lending techniques is another important problem. Adoption of untested lending techniques in new or innovative areas of the market, especially techniques that dispense with sound principles of due diligence or traditional benchmarks for leverage, have led to serious problems at many banks. Sound practice calls for the application of basic principles to new types of credit activity.

Credit Risk

The Committee define credit risk as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms and point out that the objective of credit risk management is to maximise a bank’s risk-adjusted rate of return by maintaining credit risk exposure within acceptable levels. They suggest that banks will need to manage the credit risk inherent in the entire portfolio, as well as the risk in individual loans. According to Basel, “The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organisation”.
Many banks that experience asset quality problems lacked an effective credit review process (and indeed, many banks had no credit review function). Credit review at larger banks usually is a department made up of analysts, independent of the lending officers, who make an independent assessment of the quality of a credit or a credit relationship based on documentation such as financial statements, credit analysis provided by the account officer and collateral appraisals. At smaller banks, this function may be more limited and performed by internal or external auditors. The purpose of credit review is to provide appropriate checks and balances to ensure that credits are made in accordance with bank policy and to provide an independent judgment of asset quality, uninfluenced by relationships with the borrower. Effective credit review not only helps to detect poorly underwritten credits, it also helps prevent weak credits from being granted, since credit officers are likely to be more diligent if they know their work will be subject to review.

More generally, many underwriting problems reflect the absence of a thoughtful consideration of downside scenarios. In addition to the business cycle, borrowers may be vulnerable to changes in risk factors such as specific commodity prices, shifts in the competitive landscape and the uncertainty of success in business strategy or management direction. Many lenders fail to “stress test” or analyse the credit using sufficiently adverse assumptions and thus fail to detect vulnerabilities.

The sound practices set out in the Basel document represent internationally acceptable standards which should be instilled in all banks’ credit risk management processes.

The principles fall under five main headings:

A Establishing an Appropriate Credit Risk Environment

1 The Board of Directors should have responsibility for approving and periodically (at least annually) reviewing the credit risk strategy and significant credit risk principles of the bank. The strategy should reflect the bank’s tolerance and the level of profitability the bank expects to achieve for incurring various credit risks.

2 Senior management should have responsibility for implementing the credit risk strategy approved by the Board of Directors and for developing policies and procedures for identifying, measuring, monitoring and controlling credit risk. Such policies and procedures should address credit risk in all of the bank’s activities and at both the individual credit and portfolio levels.

3 Banks should identify and manage credit risk inherent in all products and activities new to them are subject to adequate risk management procedures and controls before being introduced and undertaken, and approved in advance by the Board of Directors or its appropriate committee.

B Operating Under a Sound Credit Granting Process

4 Banks must operate within sound, well-defined credit granting criteria. These criteria should

5 include a clear indication of the bank’s target market and thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit and its source of repayment.
Banks should establish overall credit limits at the level of individual borrowers and counterparties, and groups of connected parties that aggregate in a comparable and meaningful manner, different types of exposure, both in the banking and trading book and on and off the balance sheet. Banks should have a clearly established process in place for approving new credits as well as the amendment, renewal and refinancing of existing credits.

All extentions of credit must be made on an arm’s length basis. In particular, credits related to companies and individuals must be authorised on an exceptional basis, monitored with particular care and other appropriate steps taken to control or mitigate the risks of non-arm’s length lending.

C Maintaining an Appropriate Credit Administration, Measurement and Monitoring Process

Banks should have in place a system for the on-going administration of their various credit risk-bearing portfolios.

Banks must have in place a system for monitoring the condition of individual credits, including determining the adequacy of provisions and reserves.

Banks are encouraged to develop and utilise an internal risk rating system in managing credit risk. The rating system should be consistent with the nature, size and complexity of a bank’s activities.

Banks must have information systems and analytical techniques that enable management to measure the credit risk inherent in all on- and off-balance sheet activities. The management information system should provide adequate information on the composition of the credit portfolio, including identification of any concentration risks.

Banks must have in place a system for monitoring the overall composition and quality of the credit portfolio.

Banks should take into consideration future changes in economic conditions when assessing individual credits and their credit portfolios, and should assess their credit risk exposures under stressful conditions.

D Ensuring Adequate Controls over Credit Risk

Banks must establish a system of independent on-going assessment of the bank’s credit risk management process and the results of such reviews should be communicated directly to the Board of Directors and senior management.

Banks must ensure that the credit granting function is being properly managed and the credit exposures are within levels consistent with prudential standards and internal limits. Banks should establish and enforce internal controls and other practices to ensure that exceptions to policies procedures and limits are reported in a timely manner to the appropriate level of management for action.

Banks must have a system in place for early remedial action on deteriorating credits, managing problem credits and similar workout stations.
E Role of Supervisors

17 Supervisors should require that banks have an effective system in place to identify, measure, monitor and control credit risk as part of an overall approach to risk management. Supervisors should conduct an independent evaluation of a bank’s strategies, policies, procedures and practices related to the granting of credit and the on-going management of the portfolio. Supervisors should consider setting prudential limits to restrict bank exposures to single borrowers or groups of connected counterparties.

Basel, however, makes the point that the above-mentioned principles should be applied in conjunction with sound practices related to the assessment of asset quality, the adequacy of provisions and reserves and the disclosure of credit risk, all of which have been addressed in other Committee documents.

Ref: Basel Committee on Banking Supervision, Principles for the Management of Credit Risk, publication No. 75 (2000)
Credit Risk Management

Review

The main points introduced here are:

- Risk may be defined as the exposure to present or future loss of profits and/or capital.

- Risk arises from faulty analysis of current circumstances or probabilities and future change of a social, commercial, economic or environmental or political nature, the effect of which cannot be anticipated or hedged, or where reaction to such change is late or insufficient.

- The principles underlying a risk rating system include:
  - a common framework for assessing risk
  - uniformity throughout the bank
  - compatibility with regulatory requirements
  - the ability to identify satisfactory levels of credit risk.

- A borrower rating is likely to be based on:
  - industry and operating environment
  - earnings and operating cash flow
  - asset and liability structure
  - debt capacity
  - management and controls
  - financial reporting.

- The root causes and the danger signs can be analysed under four main headings: weaknesses in management and proprietors, technical and commercial problems, financing problems and faulty accounting.

- The sound practices set out in the Basel Committee on Banking Supervision’s “Principles for the Management of Credit Risk” represent internationally acceptable standards which should be instilled in all banks’ credit risk management processes.
CSA Member Activity 1

Review the 17 principles document in detail and compare with your Bank’s procedures.

Ref: Basel Committee on Banking Supervision, Principles for the Management of Credit Risk, publication No.75 (2000)

http://www.bis.org/publ/bcbs75.htm

Record your opinions for discussion with a senior colleague.

CSA Member Activity 2

Review the UK Parliamentary enquiry into the collapse of HBOS entitled “an accident waiting to happen”


What lessons about Credit risk management can we learn from this debacle?
Make notes for later submission to the CSA Director of Studies.
Credit Skills Academy

This is one in a series of topics about credit, designed for easy access by banking professionals with a special interest in this field.