Credit Risk Management

Policy paper on Credit Risk Management by virtue of Section 15, paragraph 1 of the State Ordinance on the Supervision of the Credit System (AB 1998 no. 16) (SOSCS) for credit institutions licensed by the Central Bank of Aruba.

1. Introduction

Over the years weak credit risk management practices and poor credit quality continue to be the major cause for bank failures and banking crises worldwide. In view of this, the Bank has decided to issue a policy paper to provide credit institutions with detailed guidelines to formulate their policies and procedures for effective credit risk management, which are essentially based on the Principles for the Management of Credit Risk as issued by the Basle Committee on Banking Supervision in September 2000. The Bank will evaluate the credit institutions' policy against there standards.

Credit risk is defined as the existing or potential threat to the equity and income of a credit institution, due to the failure of a borrower or counterparty to meet its financial or other obligations towards the institution. The purpose of credit risk management is to maintain credit risk exposure within acceptable parameters.

This policy paper provides guidelines on the following four major areas of Credit Risk Management:

1. credit risk environment;
2. credit granting process;
3. credit administration, measurement and monitoring process;
4. controls over credit risk.

2. Credit risk environment

In order to establish an appropriate credit risk environment the institution should have a clear credit risk strategy and adequate credit risk policies. The strategy and policies should reflect the institution's tolerance for risk and the level of profitability it expects to reach by incurring various credit risks. Furthermore, it should address the identification, measurement, monitoring and control of credit risk in all the institution's activities and at both the individual credit and aggregated portfolio levels. The strategy and policies should be communicated in writing to all employees involved in activities where borrower or counter party credit risks exist. These employees should be held accountable for complying with the established policies and procedures.

The development and implementation of the credit risk strategy and policies is the responsibility of senior management. The board of directors is responsible for the approval and periodical (at least annually) review of the documents concerned. The board should ensure that the institution's capital level is adequate for the risks assumed throughout the organization. Furthermore, the board should ensure that senior management is fully capable of managing the credit activities and that such activities are done within the risk strategy, policies and tolerances approved by the board. In addition, the board should approve the manner in which the bank will organize its credit-granting functions, including an independent review of the credit granting and management function and the overall portfolio.

3. Credit granting process

The institution should have a sound credit granting process with well-defined criteria for the approval of new credits, as well as the amendment, renewal and re-financing of existing credits. This credit granting process should be delineated in a handbook, which should be approved by the Board of Directors. Important aspects of this process are:

- requirement that account officers perform a comprehensive assessment of the true risk profile of the borrower/ counter party. The following factors should be considered in approving credits:

  - the purpose and structure of the credit and the source of repayment;
  - the current risk profile of the borrower/ counter party and collateral, and its sensitivity to economic and market developments;
  - the borrower's repayment history and current capacity to repay, based on historical financial trends and future cash flow projections under various scenarios;
  - for commercial credits, the borrower's business expertise and the status of the borrower's economic sector and its position within that sector;
  - the proposed terms and conditions of the credit, including covenants designed to limit changes in the future risk profile of the borrower; and
  - where applicable, the adequacy and enforceability of collateral or guarantees, under various scenarios;
  - integrity and reputation of the borrower/ counter party, as well as their legal capacity to assume liability.

- Establishment of a Credit Committee that ensures that the lending policies are adequate and adhered to and comply with applicable laws and regulations regarding credit extensions;
- Establishment of overall credit limits at the level of individual borrowers and counter parties, groups of connected counter parties and credits to related companies and individuals. These limits should be in compliance with the supervisory directives on "Large exposures to a group of connected clients" and "Credit extensions to Insiders";
- Establishment of exposure limits for particular industries or economic sectors, geographic regions and specific products;
- Requirement that all extensions of credit are made at arm's length, especially credits to related companies and individuals;
- Adequate documentation.

The institution must bear in mind that although collateral and guarantees may help to mitigate risks in individual credits, the granting of credits should be based primarily on the strength of the borrower's repayment capacity. The institution should establish policies covering the acceptability of various forms of collateral and procedures for the ongoing valuation thereof.

The institution should ensure that the credit risk officers have sufficient experience, knowledge and background to exercise prudent judgement in assessing, approving and managing risks. The credit-granting approval process should establish accountability for decisions taken and designate who has the final authority to approve credit or changes in credit terms.

4. Credit administration, measurement and monitoring process

The institution should maintain an appropriate credit administration, measurement and monitoring process. This process consists of the following 6 important aspects:

1. Development of a system for the ongoing administration of the credit risk-bearing portfolios. This includes keeping the credit files up to date, obtaining current financial information, sending out renewal notices and preparing various documents such as loan agreements.

   The credit files should include all information necessary to ascertain the current financial condition of the borrower or counter party, as well as sufficient information to track the decisions made and the history of the credit e.g. current financial statements, financial analyses, internal rating documentation and appraisals.

2. Monitoring the condition of individual credits and determining the adequacy of provisions and reserves. An effective credit monitoring system includes measures to:

- ensure that the credit institution understands the current financial condition of the borrower or counter party;
- monitor compliance with existing covenants;
- assess, where applicable, collateral coverage relative to the obligor's current condition;
- identify contractual payment delinquencies and classify potential problem credits on a timely basis;
- direct problems promptly for remedial management.

3. Development and utilization of an internal credit risk rating system. The ratings assigned to individual borrowers or counter parties at the time the credit is granted should be reviewed at least on an annual basis and individual credits should be assigned a new rating when conditions either improve or deteriorate. The Bank recommends to categorise credits into the following 5 classes:

Good
The loan is sound and all principal and interest payments are current. Repayment difficulties are not foreseen under current circumstances and full repayment is expected.

Special mention
The loan is subject to conditions that, if left uncorrected, could raise concerns about full repayment. These type of loans require more than normal attention.

Substandard
Full repayment is in doubt due to inadequate protection (e.g. obligor net worth or collateral), and/ or interest or principal or both are more than 90 days over due. These loans show underlying, well-defined weaknesses that could lead to probable losses if not corrected, and thus risk becoming impaired assets. A specific provision of 10-20% of the uncollateralized amount is required.

Doubtful
Assets for which collection/ liquidation in full is determined by bank management to be improbable due to current conditions, and/ or interest or principal or both are overdue more than 180 days. Assets in this category are considered impaired, but are not yet considered total losses, because some pending factors may improve the assets' quality (via new financing or capital injection). A specific provision of at least 50% of the uncollateralized amount is required.

Loss
An asset is downgraded to loss when management considers the facility to be virtually uncollectible, and/ or when interest or principal or both are overdue more than one year. A specific provision of 100% of the uncollateralized amount is required.

4. Establishment of adequate management information systems (MIS) and analytical techniques that enable management to measure the credit risk inherent in all on- and off-balance sheet activities, and to identify (potential) concentrations of risk and/ or particular sensitivities. Also, the MIS should ensure that exposures approaching risk limits are brought to the attention of senior management. The measurement of credit risk should take into account:

- the specific nature of the credit (loan, derivative, facility, etc.) and its contractual and financial conditions;
- the exposure profile until maturity in relation to potential market movements;
- the existence of collateral or guarantees;
- the potential for default based on the internal risk rating;
- monitoring of actual exposures against established limits;
- perform (stress testing and scenario) analyses to identify potential areas of credit risk exposure.

5. Development of a system for the assessment and monitoring of the overall composition and quality of the credit portfolio, including the identification of any concentrations of risk. Concentration is present when the portfolio of a credit institution contains a high level of direct or indirect credits:

- to a single counter party;
- to a group of connected counter parties;
- to a particular industry or economic sector;
- to an individual foreign country or a group of countries whose economies are strongly interrelated;
- with the same maturity.

   This system should also identify the measures to reduce or mitigate concentrations, e.g. pricing for additional risk, increased holdings of capital, loan participations, loan sales, credit derivatives, etc. Risks involved in these measures should also be identified and adequately managed.

6. Assessment of impact of potential future changes in economic conditions on the credit portfolio, and thus on the credit risk exposure of the institution. The credit institution should perform (stress-test) analyses of the types of situations, such as economic downturns both in the whole economy or in particular sectors, higher than expected levels of delinquencies and defaults, or the combinations of credit and market events that could produce substantial losses or liquidity problems.

5. Controls over credit risk

The institution should establish a system of independent, ongoing review of the institution’s credit risk management processes and the results of such reviews should be communicated directly to the board of directors and senior management. Important functions of such independent credit reviews are:

- evaluation of the overall credit administration processes;
- assessment of overall quality of credit portfolio;
- determination of the accuracy of internal risk ratings;
- assessment of adequacy of monitoring of individual credits by account officers.

Credit institutions should ensure that the credit granting function is being properly managed, and that credit exposures are within levels consistent with prudential standards and internal limits. The institutions 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.

The institutions should have a system in place for early remedial action on deteriorating credits and managing problem credits. Credit institutions with significant problem credits are recommended to establish a specialized workout section responsible for developing effective strategies to rehabilitate troubled credits or to increase the amount of repayment ultimately collected.