BANKING TECHNIQUE

LECTURE 11. Credit risk management

Objectives

- Policies for Managing Credit Risk
- Regulatory Policies to Limit Exposures
- Management Policies to Reduce Credit
- Analyzing Credit Risk
- Asset Classification and Loan Loss Provisioning
- Assessing Credit Risk Management Capacity

11.1. Policies for Managing Credit Risk

There are typically three kinds of policies related to credit risk management:

- One set aims to ***limit or reduce credit risk***
  - These include policies on concentration and large exposures, diversification, lending to connected parties, and overexposure.
- The second set aims to ***classify assets***
  - These mandate periodic evaluation of the collectability of the portfolio of credit instruments.
- The third set aims to ***provision loss*** *or* ***make allowances*** at a level adequate to absorb anticipated loss.

11.2. Regulatory Policies to Limit Exposures

To reduce or limit credit risk, regulators pay close attention to three issues:

- **exposure to a single customer**
  - the maximum permitted exposure to a single client, connected group, or sector of economic activity (for example, agriculture, steel, or textiles). This is especially important for small, regionally oriented or specialized banks.
- **related party financing**
  - typically include a bank's parent, major shareholders, subsidiaries, affiliate companies, directors, and executive officers. Such parties are in a position to exert control over or influence a bank's policies and decision making, especially concerning credit decisions.
- **overexposure to a geographic area or economic sector**

11.3. Management Policies to Reduce Credit

- **Lending Authority**
  - Lending authority is often determined by the size of a bank. In smaller banks, it is typically centralized. To avoid delays in the lending process, larger banks tend to decentralize according to geographical area, lending products, and types of customers.
- **Type of Loans and Distribution by Category**
  - Decisions about types of credit instruments should be based on the expertise of lending officers, the deposit structure of a bank, and anticipated credit demand.
- **Loan Pricing**
  - Rates on various loan types must be sufficient to cover the costs of funds, loan supervision, administration (including general overhead), and probable losses. Rates should provide a reasonable margin of profit.
- **Maturities**
  - A lending policy should establish the maximum maturity for each type of credit, and loans should be granted with a realistic repayment schedule.

11.4. Analyzing Credit Risk

Contents of a Loan Review File

- ☆ Borrower's name and line of business
- ☆ Use of proceeds
- ☆ Date credit was granted
- ☆ Loan maturity date, amount, currency, and interest rate
- ☆ Principal source of repayment
- ☆ Nature and value of collateral/security (or valuation basis, if a fixed asset)
- ☆ Total outstanding liabilities, including loan principal and interest due and all other real and contingent liabilities, in cases where the bank is absorbing the credit risk
- ☆ Delinquency or nonperformance, if any
- ☆ Description of monitoring activities undertaken for the loan
- ☆ Financial information, including current financial statements and other pertinent information
- ☆ Specific provisions that are required and available

11.5. Asset Classification and Loan Loss Provisioning

Asset Classification Categories

- **Standard, or pass.** When debt service capacity is considered to be beyond any doubt.
- **Specially mentioned, or watch.** Assets with potential weaknesses that may, if not checked or corrected, weaken the asset as a whole or potentially jeopardize a borrower's repayment capacity in the future.
- **Substandard.** This classification indicates credit weaknesses that jeopardize debt service capacity, in particular when the primary sources of repayment are insufficient and the bank must look to secondary sources for repayment, such as collateral, the sale of a fixed asset, refinancing, or fresh capital.
- **Doubtful.** Such assets have the same weaknesses as substandard assets, but their collection in full is questionable on the basis of existing facts.
- **Loss.** Certain assets are considered uncollectible and of such little value that the continued definition as bankable assets is not warranted.

11.5. Asset Classification and Loan Loss Provisioning

Nonperforming Loans

- Nonperforming assets are those not generating income.
- As a first step, loans are often considered to be nonperforming when principal or interest on them is due and left un paid for 90 days or more.

Loan Loss Provisioning

- Asset classification provides a basis for determining an adequate level of provisions for possible loan losses.
- It forms the basis for establishing a bank's capacity to absorb losses.

11.5. Asset Classification and Loan Loss Provisioning

Recommended Loan Loss Provisions

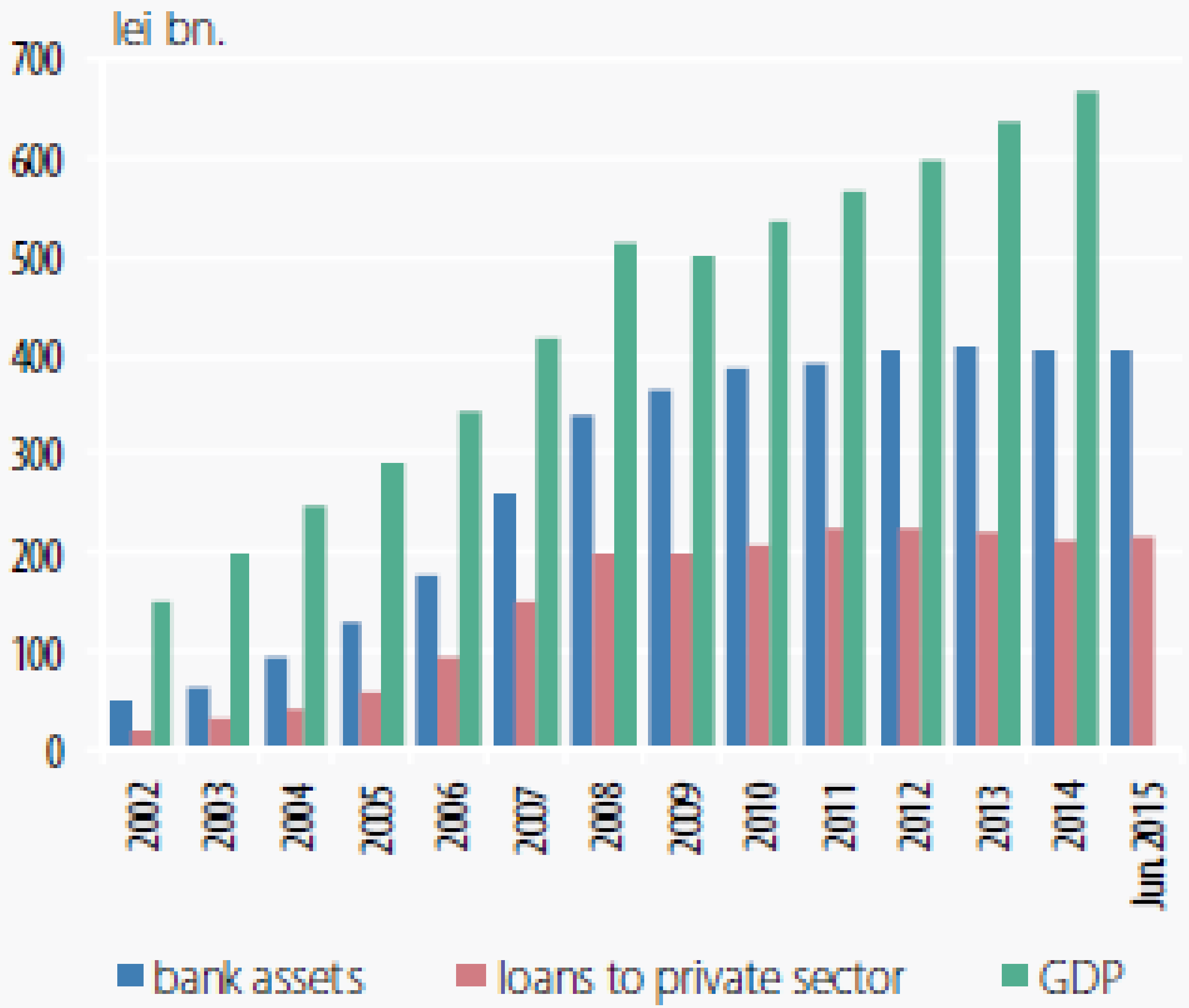
Classification	Recommended Provision	Qualification
Pass	1–2 percent	General loss reserve
Watch	5–10 percent	Specific provision
Substandard	10–30 percent	Specific provision
Doubtful	50–75 percent	Specific provision
Loss	100 percent	Specific provision

11.6. Assessing Credit Risk Management Capacity

Lending Processes

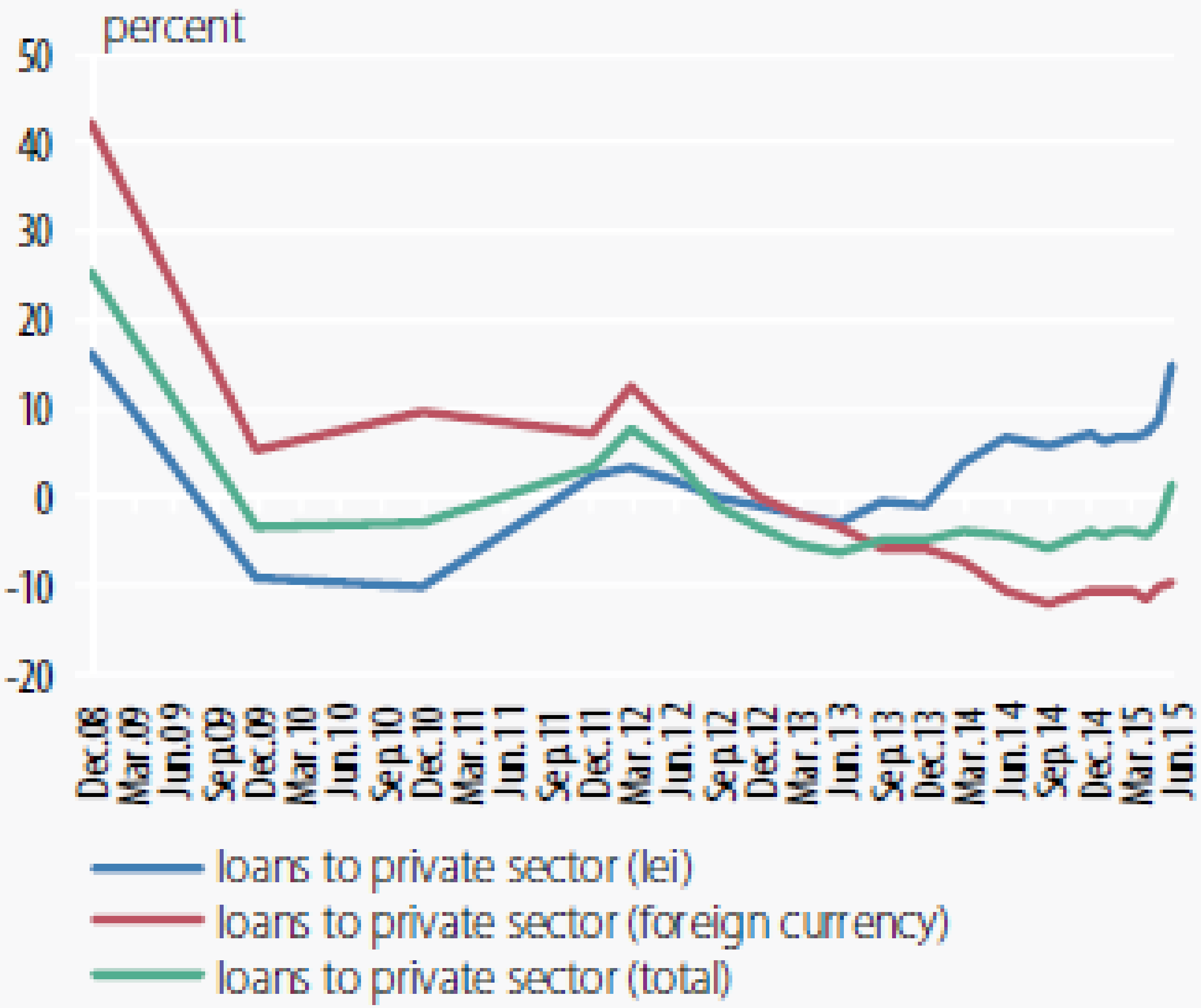
- A detailed **credit analysis** and **approval process**, including samples of loan application forms, internal credit summary forms, internal credit manuals, and loan files
- **Criteria for approving loans**, determining **loan pricing policy** and **lending limits** at various levels of the bank's management, and for making arrangements for lending through the branch network
- **Collateral policy** for all types of loans, including the actual methods and practices concerning revaluation of collateral and files related to collateral
- **Administration and monitoring** procedures, including responsibilities, compliance, and controls

Chart 3.18. Bank assets and loans to private sector



Source: NBR, NIS

Chart 3.19. Annual real growth rate of loans to private sector



Source: NBR, NIS

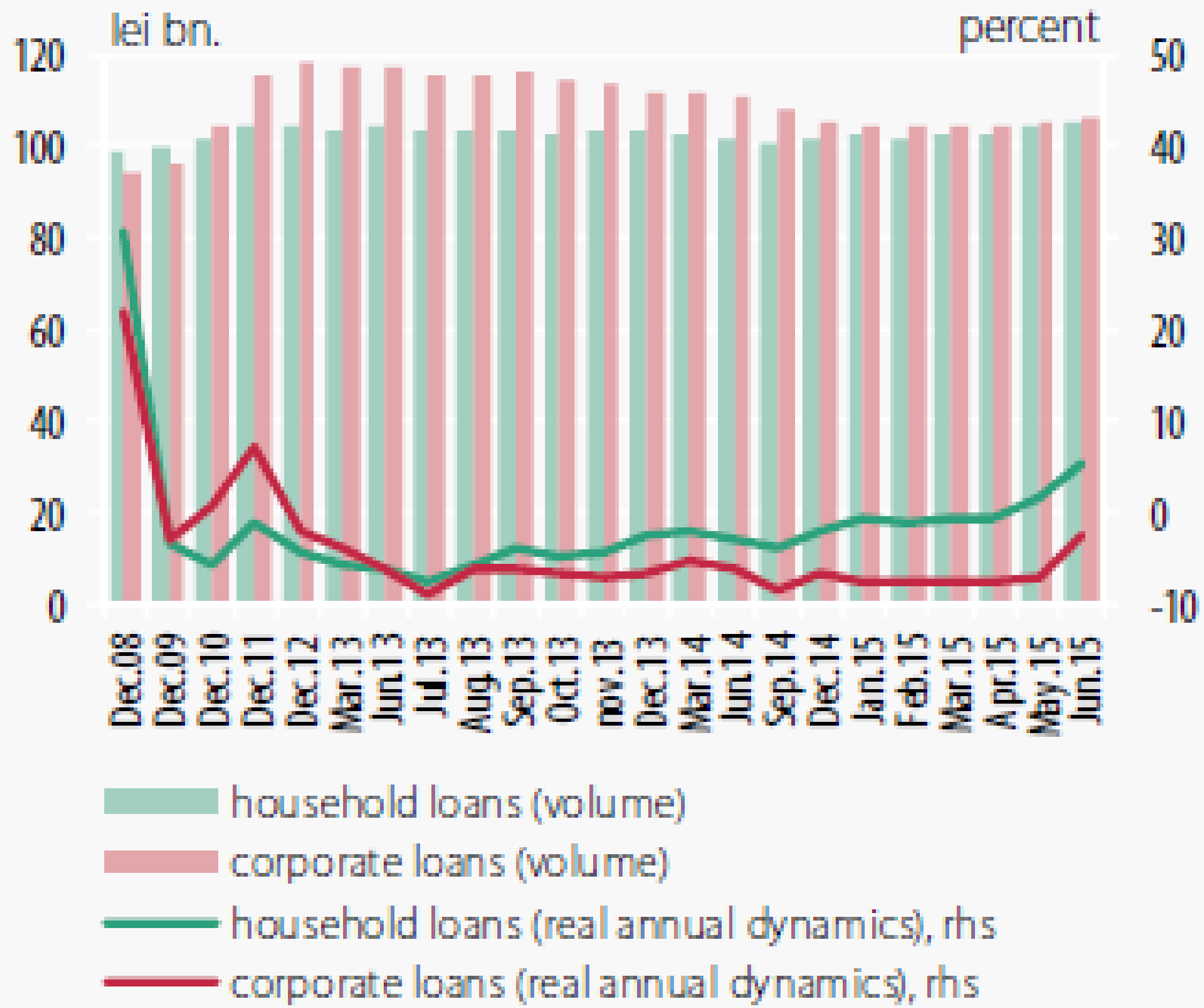
Table 3.4. The main components of loans to the private sector

lei bn.

	2011 Dec.	2012 Dec.	2013 Dec.	2014 Jun.	2014 Dec.	2015 Jun.
Total loans to the private sector,	223.0	225.8	218.5	215.4	211.2	215.1
of which:						
Leu-denominated loans,	81.7	84.7	85.3	90.4	92.1	102.4
of which:						
– short-term	30.1	33.4	29.3	30.2	27.5	28.8
– medium-term	19.5	22.1	27.9	31.7	33.5	37.9
– long-term	32.0	29.2	28.1	28.6	31.1	35.6
Foreign currency-denominated loans,	141.4	141.1	133.1	124.9	119.1	112.7
of which:						
– short-term	22.6	21.3	17.9	15.8	13.7	12.4
– medium-term	24.8	24.8	23.3	22.8	21.3	19.6
– long-term	93.9	95.0	91.9	86.4	84.1	80.6

Source: NBR

Chart 3.20. The annual dynamics of private sector loan components



Source: NBR

Table 3.5. The average bank interest rates on outstanding loans and deposits

percent

	2011 Dec.	2012 Dec.	2013 Dec.	2014 Jun.	2014 Dec.	2015 Jun.
Lending rates in lei – households	14.00	13.26	11.32	10.47	9.47	8.22
Lending rates in lei – companies	10.45	10.11	7.36	7.04	5.93	5.30
Lending rates in euro – households	7.11	5.65	5.38	5.36	5.13	5.08
Lending rates in euro – companies	5.73	4.77	4.76	4.76	4.32	4.50
Deposit rates in lei – households	6.24	5.31	4.03	3.32	2.92	2.11
Deposit rates in lei – companies	5.59	4.94	2.69	2.26	1.61	1.13
Deposit rates in euro – households	3.29	3.12	2.25	1.92	1.66	1.18
Deposit rates in euro – companies	2.74	2.43	1.78	1.46	1.10	0.72

Source: NBR

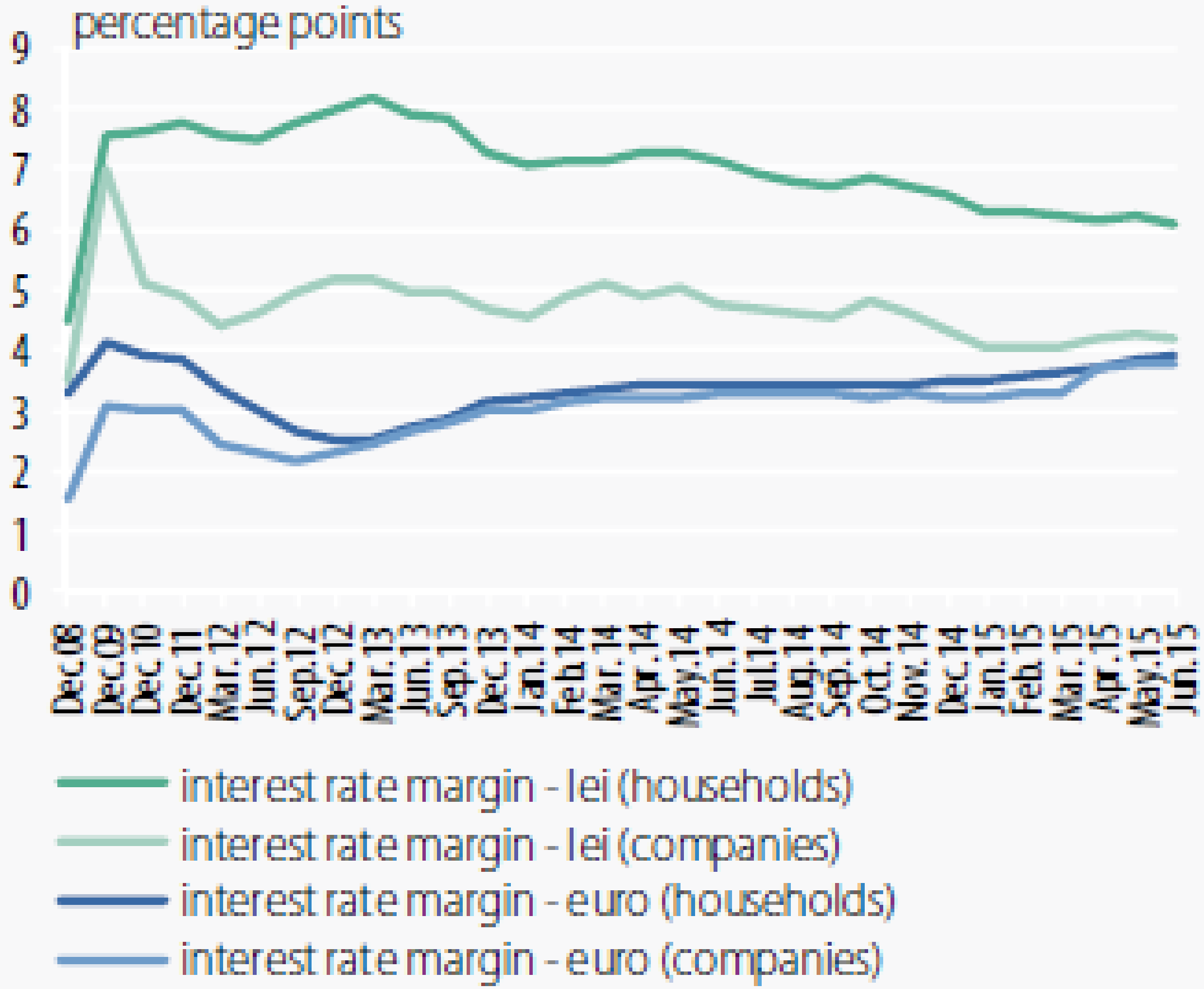
Table 3.6. The average bank interest rates on new loans and deposits

percent

	2011 Dec.	2012 Dec.	2013 Dec.	2014 Jun.	2014 Dec.	2015 Jun.
Lending rates in lei – households	12.66	12.41	9.05	8.44	7.27	6.48
Lending rates in lei – companies	9.74	9.76	6.84	6.01	5.87	4.86
Lending rates in euro – households	5.90	4.33	4.81	5.63	4.42	5.08
Lending rates in euro – companies	5.64	4.62	4.89	4.38	3.93	3.76
Deposit rates in lei – households	6.59	5.64	3.92	3.17	2.78	1.79
Deposit rates in lei – companies	5.78	5.15	2.19	1.88	1.11	0.79
Deposit rates in euro – households	3.47	3.39	2.13	1.85	1.58	0.94
Deposit rates in euro – companies	2.38	1.97	1.47	1.06	0.71	0.42

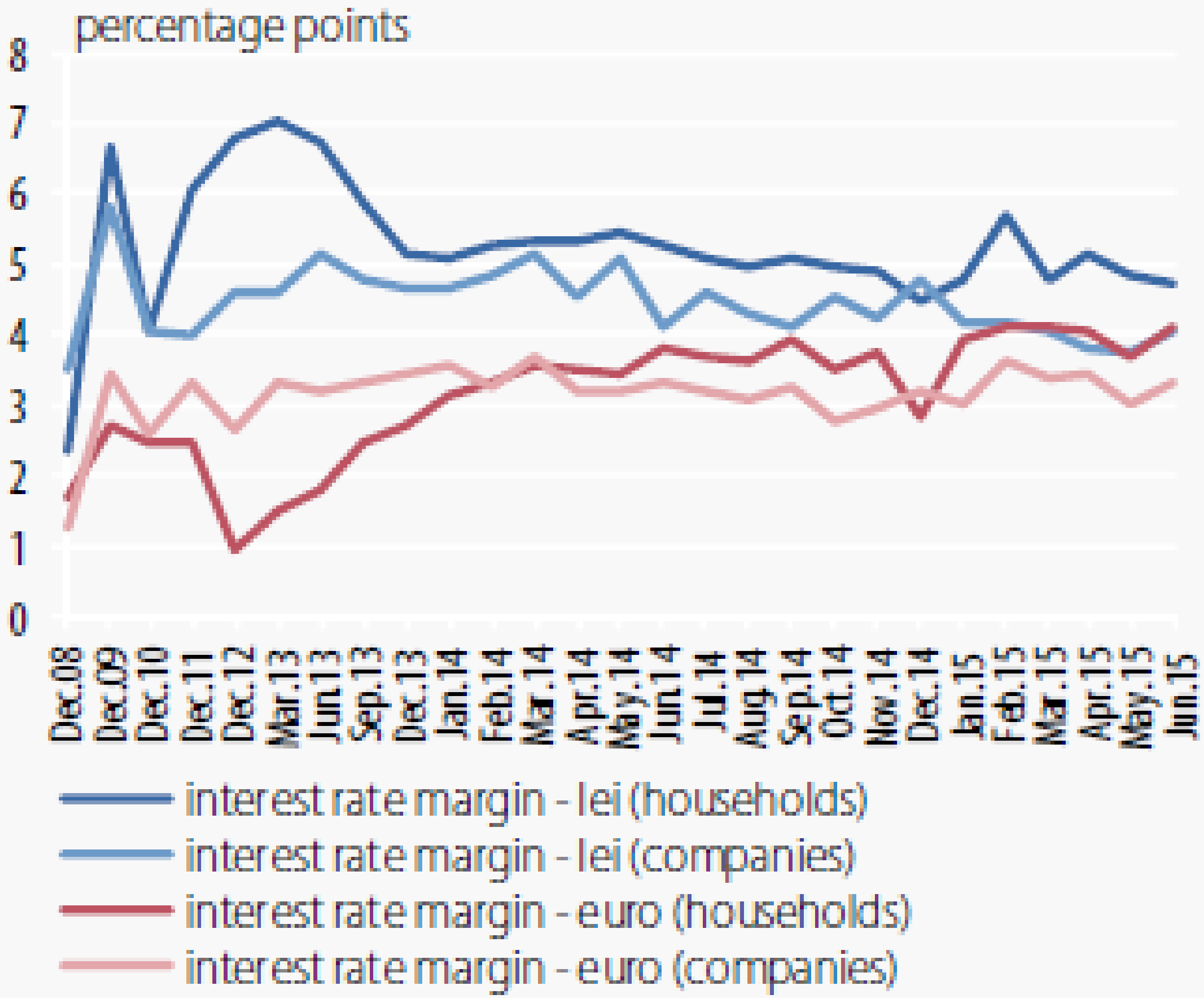
Source: NBR

Chart 3.21. Interest rate margins on outstanding loans and deposits



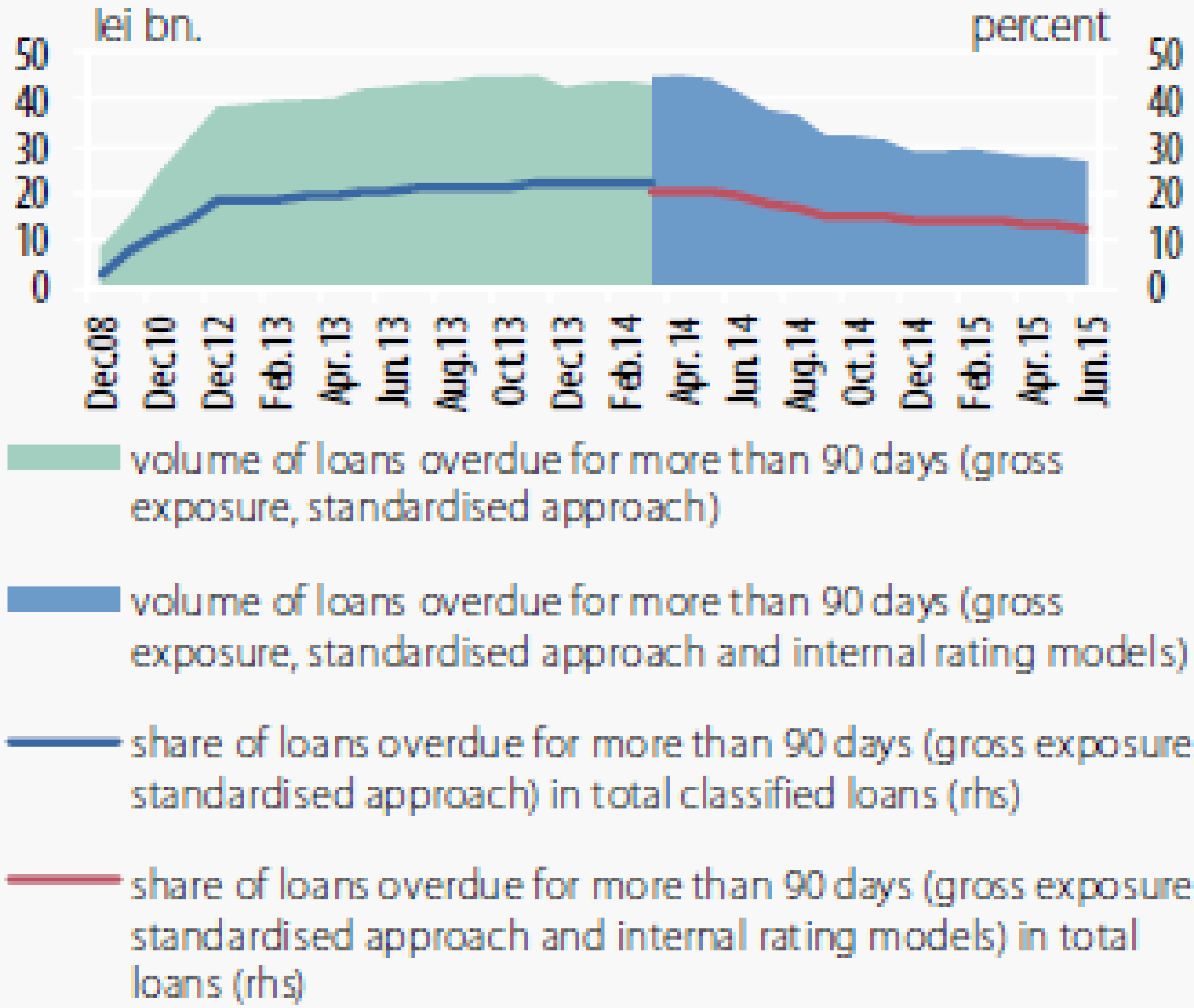
Source: NBR

Chart 3.22. Interest rate margins on new loans and deposits



Source: NBR

Chart 3.23. Non-performing loans at aggregate level (national definition)



Source: NBR

Chart 3.25. Loan portfolio quality in selected EU Member States (share of non-performing loans in total loans)

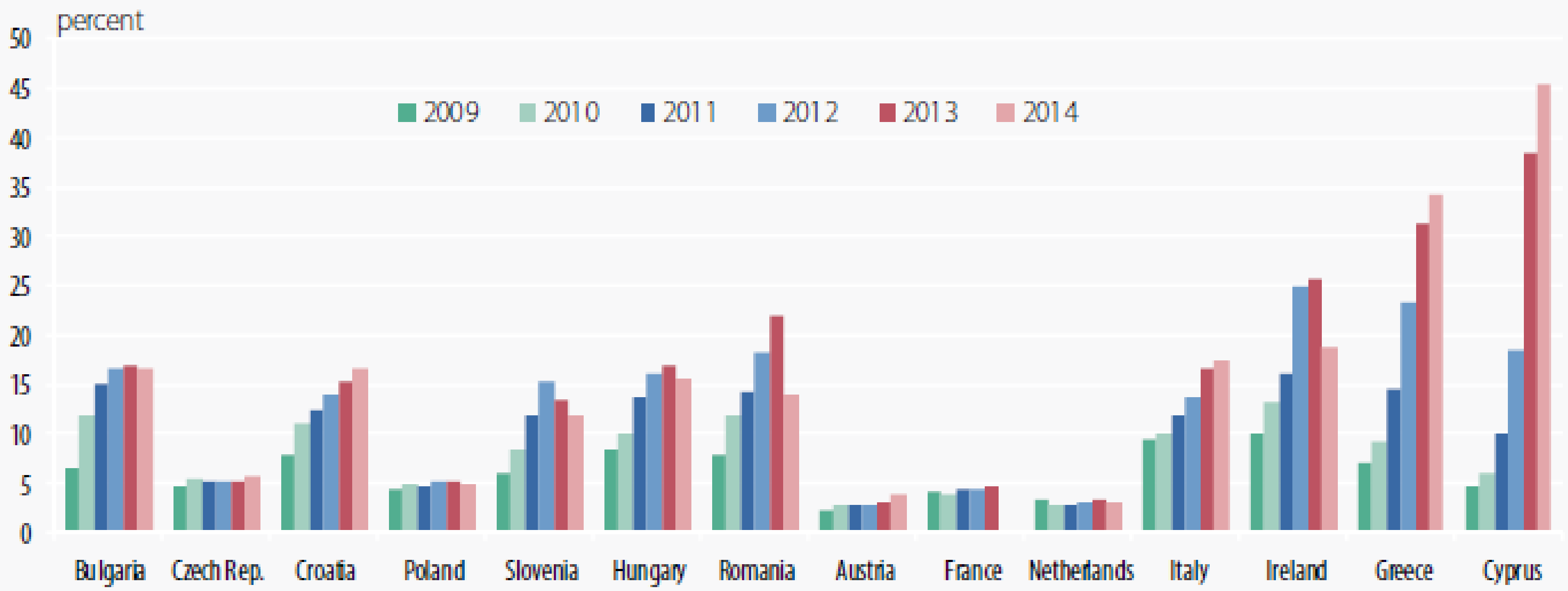


Chart 3.26. Coverage of non-performing loans in selected EU Member States