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CREDIT PRACTICE

CCP

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This paper is intended to equip the candidate with the knowledge, skills and attitudes required for the application of various credit management concepts in a practical scenario.

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CHAPTER ONE

CREDIT PORTFOLIO RISK MANAGEMENT

Introduction to Credit Risk Management

Financial institutions use a variety of different concepts to manage credit portfolio risk. A general overview of concepts, methodologies, procedures, systems and standards of credit risk modelling is presented in accordance with the definitions and requirements of the revised capital adequacy framework set forth by the Basel Committee (BCBS (2006a).

General Framework of Credit Risk Management

The implementation of an appropriate and reliable credit risk management framework is the prerequisite of a reliable credit risk measurement. In the following, best practice procedural and organizational standards in the credit risk management of banks are presented. These standards represent the basis for the modelling, estimation and backtesting of portfolio credit risk models in subsequent chapters. The following delineation is based on the requirements defined by the Basel Committee.

The Basel Committee on Banking Supervision requires banks to maintain appropriate information systems and processes to identify, measure, monitor and control credit risk exposures in size, quality and composition. By definition, credit exposures comprise all contractual arrangements on and off the balance sheet that involve deterministic or contingent future payments to be received from a contractual partner, such as bonds, loan arrangements, credit facilities, credit card obligations and contingent claims with counterparty risk arising from OTC derivative contracts in the trading book.

A credit risk strategy of a bank is set and approved by the board of directors and implemented by senior management. Credit risk strategies, policies, processes and limits should be documented, regularly reviewed, updated and communicated throughout the bank. Credit risk systems provide timely and accurate information for the analysis,

accounting, provisioning and capital requirements of credit exposures.
The credit risk management of a bank covers the ongoing identification, origination, administration, measurement and monitoring of all on- and off-balance sheet credit exposures. An effective credit management involves lending controls and limits as well as a comprehensive reporting process. Credit risk management implements an adequate diversification of credit portfolios and ensures that exposure limits to single counterparties, groups of connected counterparties, particular industries or economic sectors, geographic regions and specific products are set and complied with. Concentrations of credit risk are managed by means of concentrations limits and risk mitigation techniques such as collateralization, third-party guarantees, credit derivatives, securitization programmes and secondary credit markets. All credit-risk- related processes are performed in a timely, periodical and consistent way. Risk assessment, monitoring and control functions are clearly separated from risk-taking functions of the bank.

Credit origination includes the analysis, granting and approval of credit exposures. A formal process to decide on and approve the origination or the renewal of credit exposures on an arm's length basis is defined. Policies for the origination of credit exposures determine functional and personal responsibilities in terms of amount and product type. Senior management approves large credit involvements that exceed a certain amount or percentage of banks' capital.

The main objective of credit analysis is to assess the risk-reward profile of prospective and current credit engagements to foreclose that loans are granted or extended on a subjective basis or non-risk-adequate credit pricing due to personal or commercial affiliations to borrowers takes place. The effectiveness of credit analysis is based on the quality, detail and timeliness information is recorded and processed. Often, a comprehensive initial credit analysis is limited by time constraints caused by competitive pressure. An ongoing credit re-assessment implements the early identification of deteriorating assets, is used to determine loan loss provisions in a timely manner, and monitors problem assets and collections on past-due obligations.

Credit analysis accounts for business-cycle effects using stress tests and scenario analysis, that examine economic or industry downturns, market-risk events and liquidity conditions. The counterparty risk of market-risk sensitive exposures, particularly of derivatives that do not constitute original credit exposures, are analyzed for the counterparties' willingness and ability to pay. Third-party guarantees or credit facilities

that are sensitive to the liquidity of credit markets are analyzed for the borrower's vulnerability to financial stress,
which may threaten its debt-serving capabilities as well as its financing needs.
Credit policies specify the information and methodologies used to assess the credit risk of exposures. Methodologies such as internal rating systems quantify and classify the credit risk of individual exposures. The valuation, classification and provisioning of large credit risk exposures is conducted on an individual basis considering all available information on the obligor and the engagement itself, including credit covenants and means of credit risk mitigation. Periodical re-assessments of credit involvements ensure that specific and general loan loss provisions and write-offs adequately absorb expected credit losses and reflect realistic repayment and recovery expectations.
Internal credit risk rating systems support the origination, risk measurement, monitoring and administration of individual credit exposures by assessing the ability and willingness of borrowers to meet contractual financial obligations. Rating systems differentiate the degree of credit risk of exposures and allow for a more accurate control of problem exposures, risk concentrations, capital allocation, pricing of credit exposures and determine risk-adjusted performance of exposures, adequacy and loan loss provisions. Typically, credit exposures are categorized into classes of different risk levels considering all relevant indicators of an actual or a potential deterioration of the credit risk of the exposure and the borrower. For each risk class estimates of he probability of default (PD), the exposure-at-default (EAD) and the percentage loss-given-default (LGD) of exposures are provided and reviewed at least annually. Rating migration, default and loss experience of the bank's own credit portfolio and credit market data from rating agencies as well as market observed credit spread data are used to estimate these parameters. Rating systems provide historical information on credit exposures and information that indicate the solvency of borrowers for a time period of several years, ideally spanning a complete economic cycle. If pooled data is used, methodological differences in the definition of data is taken into account. Structural changes in credit markets and the time-inhomogeneity of market-derived parameters are addressed by a frequent updating of the estimates of the relevant parameters. Means of credit risk mitigation including guarantees and collateral is re-assessed periodically.

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