MASTERING BASIC CREDIT

The Professional Credit Coaching Program

Reading Material & Resource Guide

RISK ISSUES IN CREDIT

Control And Monitoring Notes

Collateral Types And Considerations

Mortgages

- Most widely used form of security by banks and other corporate organizations.
- Created when an interest in a property is conveyed by way of security from a borrower to the lender for the payment of a debt or for the discharge of some other obligations.
- This property of interest could be land, building, stocks, shares, and life policies.
- The borrower is the mortgagor while the bank (lender) is the mortgagee.
- Until full discharge of the loan, the legal title as opposed to possession of the property, remains with the mortgagees.
- On default, the mortgage can exercise his right over the mortgaged property either by way of sale or foreclosure.
- A mortgage can be legal or equitable.

Legal Mortgages

- Operates when the mortgagor (borrower) takes steps to convey his legal interest to the mortgagee (bank) by registering an instrument of transfer in favour of the mortgagee in an office designated for it.
- This is a good title and it does not require the consent of the court before selling.
- Types of Legal Mortgages also includes Tripartite Legal Mortgage otherwise called 3rd party Legal Mortgage

Equitable Mortgages

- Operates where the mortgagor (borrower) merely deposits his title documents with the mortgagee, with the intention to give a security, the mortgagor may or may not

sign a memorandum of deposit form, indicating the deposit.

- It is a very weak security when compared to the legal mortgage. In the event of default, the cooperation of the mortgagor is required or the mortgagee has to obtain an order of the court to sell.
- Any other registered creditor takes precedence.

Various Land Title Documentation

- Certificate of Occupancy (C of O)
- Registered deeds of
  - Assignment
  - Lease
  - Sub-lease
- Power of attorney
- Letter of administration (when it covers land)
- Right of Occupancy by local government
- A certificate of occupancy is evidence of title to land sold by the government (State & Federal)
- A registered deed is used is used when the property is bought from any other person/s than the government and states the nature of the transfer.
- A registered power of attorney states the terms of holding the title.
- Letters of administration are used when land is transferred from one to another by reason of death, where there is no last will & testament.
- Right of Occupancy - Issued by local governments for rural lands within their area.

Importance Of Title To Land

- It gives the final right of ownership to a landed property.
- It is usually required when selling a home or refinancing a mortgage.
- Banks will typically deny mortgage applications for properties that do not have valid title documentation.

Debentures

- S650 (1) of CAMA 1990 defines a debenture as "a written acknowledgement of indebtedness by the company; setting the terms and conditions of indebtedness, and include debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not"

Types of Debentures

- **Fixed Charge Debenture:** A charge on the specific listed IMMOVABLE assets of the borrower. The listed assets cannot be sold without the consent of the bank being sought
  & obtained. The registration of the fixed charge gives a ranking position to the bank relative to other lenders.
- **Floating Charge Debenture:** A charge on the current assets or stock-in- trade of the borrower. The listed assets can, prior to default, be sold without the bank's consent being sought or obtained. Again, registration of the floating is crucial for ranking purposes.
  NOTE: This charge is subject to the rights of preferential creditors e.g. fixed charge holders

Pledges

- Created when the borrower makes a physical or constructive transfer of his/her property to the lender as security until the loan is repaired.
- The lender keeps possession of the property, the borrower keeps the legal title.
- It is the earliest form of security in commerce and widely practiced in Nigeria.
- It serves as security to the lender, as it gives the lender the right to sell off the security to offset the loan in the case of default.

A Mortgage Debenture

- It is a charge over the fixed and floating asset including Legal Mortgage.
- This is different from All Asset Debenture which is a charge over fixed and floating asset excluding landed properties.

Guarantees And Indemnities

- A guarantee operates when a 3rd party (guarantor) holds himself out as the one liable to pay the loan should the borrower fail to pay. The guarantor is the secondary obligor. This is indirect exposure.
- An indemnity operates when an indemnor undertakes to repay the facility from inception, which makes him/her the primary obligor. This is a direct exposure.
- When obtaining a third party guarantee or indemnity from an individual, the bank must also obtain a statement of net worth signed as an affidavit.
- The idea of an affidavit is because a false statement made under oath constitutes the crime of 'perjury' which is punishable by a term of imprisonment.

Negative Pledge

- It does not constitute a security interest in the true sense of the world.
- It is a commitment by the REPUTABLE borrower not to encumber its assets in favour of a third party by way of creating a security which has priority over, or ranks parripassu with any of the assets of the borrower without the knowledge of the other existing lender in question
- It does not confer rights on any asset of the borrower but merely restricts its ability to give security to others.
- Third parties do not have notice of a negative pledges as it is not registerable.
- It however gives the right to bring legal action for breach of a contractual obligation and use for damages.
- The basis of accepting a negative pledge is the under faulting integrity of the borrower and its strong asset base.
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Right Of Set-off

- A security made possible where the borrower has more than one account in his/her name or business name with the lending bank, with the authority to use the credit balance in one to offset the debit balance in the other.
- Not a very good security because the bank's negligence may lead to all the accounts of the customer being drawn to a level whereby funds available are insufficient to off-set the liability in the other.
- Useful for early payment default.

Letter Of Comfort

- This is a quasi-security because no liability is attached to such letters.
- Usually issued by reputable companies or individuals, stating that the obligor is fit and proper as a prospective borrower.
- For this "security" to be accepted, it is advised that it be accompanied by a tangible security as a back-up.

Lien On Account

- The customer charges as security for banking facilities his/her credit balance which could be in fixed or short-term deposit account, current account, savings account or domiciliary account

Domiciliation Of Payment

- A tripartite agreement between the borrower, the third party liable to pay and the bank which is advancing the facilities to the customer. It involves the express request of the borrower to a third party to pay amounts due to him to the lender.

- It is usually taken for short term credit facilities to retail/commercial clients or against salary of an employee on a loan facility granted to such an employee.

Letter Of Hypothecation

- It is an equitable charge.
- Operates where it is impracticable to give possession of the goods or document of title to the goods to the bank. E.g. a customer applies for a banking facility to import goods, which are charged to the bank as security or to manufacture goods.
- It confers a right in preference to other creditors to have the goods satisfy the liabilities secured.

Deferrals & Waivers

Deferrals

- Postponing the fulfillment of a condition for a stated period in order to give the borrower more time to meet the condition.

Waivers

- It is agreed that certain conditions should not be enforced.
- The customer is therefore under no obligation to fulfill the condition.
- These should only be granted after careful review of its implications by the legal department.
- It is advisable that deferrals and waivers are approved as set out in the bank's credit policy.
- They should be used only on a need basis.
- Where deferrals are given, there should be adequate tracking to ensure that the conditions are indeed met by the time specified.

Dangers Of Not Perfecting

- The risks associated with not perfecting security documents include:
  - A charge on a company's assets not registered at the CAC within 90 days of creation, is void. The bank will need a court order after 90 days to revive the charge.
  - The bank would lose priority.
  - The documentation provided by the customer could have expired where land is involved e.g. a lease.
  - Should there be default before perfection, the bank will be in the position of an unsecured creditor.
  - Should there be reason for the bank to resort to the courts in respect of a facility, the document may be inadmissible. This can be cured by stamping the document out of time but it involves a cost as the bank will have to pay a penalty for late stamping.
  - If recovery proceedings are instituted under FBRF, bank's officers can be held liable if he/she failed to perfect the security.

Security/Collateral Documentation

- Title documents
- Shares certificates
- Guarantees
- Fixed charge
- Floating charge
- Guarantee/indemnity

NB: This list is not exhaustive

Conditions And Covenants

Conditions & covenants may be:

- **Financial:** These are clauses that ensure that the borrower's profit are converted into enough cash to meet the borrower's obligations. They usually focus on the

borrower's cash-flow, leverage, liquidity or net worth. For example, a bank could insist that certain ratios do not go above or below agreed limits.

- **Non - Financial:** These are usually imposed to protect the assets of the borrower from depletion and ensure that the lender receives timely and relevant information about the borrower's financial condition. For example, the banker could include a clause that the borrower should not sell more than 10% of his assets without the prior consent of the bank.

Examples Of Covenants

- Financial
  - ❖ Leverage should not exceed an agreed level
  - ❖ Current asset ratio should not fall below 1
  - ❖ Minimum sales or Net income
- Non-financial
  - Maintenance of an external credit rating above a set level, typically investment staff without advising the bank

Other Examples Of Covenants (contd.)

- Affirmative:
  - ❖ Ensuring adequate insurance cover over assets
  - ❖ Bank being made insurance loss payee
  - ❖ Submission of quarterly financial statements to the bank within 30 days after the end of the quarter
  - ❖ Relationship of equity to debt of at least 1:3
- Negative:
  - ❖ Borrower cannot pledge his assets to a third party during the tenor of the facility
  - ❖ Borrower cannot take on additional debt
  - ❖ Dividends must not exceed a specified level

Condition Precedent

- Board resolution of corporate borrower
- Board resolution of corporate guarantor
- Receipt of security, guaranty and collateral agreements and notes
- Evidence of no substantial changes in the financial condition of an adverse nature since (date)
- Evidence that collateral is free of liens
- Commitment fee
- Subordination agreement provided

Major Documentation Errors/Pitfalls

- Failure to perfect security
- Acceptance of forged or cloned documentation
- Inadequate insurance cover
- Failure to ensure listing of the bank as 'loss payee'
- Inadvertently taking an inferior position relative to other lenders.
- Improperly executed loan agreements
- Absence of properly executed security documents
- Poor financial statements that reveal little or nothing about the viability of project

Loan Management: Monitoring Perspective

Together with business development, loan management is one of the most important responsibilities of the risk officer. Once loans are disbursed, the monitoring process begins. The purpose of loan monitoring is to identify as soon as possible any changes in the borrower's financial condition or performance that impact, or may impact, the borrower's capacity to repay the outstanding loan(s) to the bank as agreed. The primary monitoring tool is the loan agreement. The purpose of loan monitoring is to make sure that the customer returns borrowed money to the bank with interest—in full and on time.

Strategy

Your loan monitoring strategy is implied by the analyses you have already completed. If you did your analysis thoughtfully, you already have the core of your loan monitoring strategy:

- You identified the risks associated with the borrower's industry
- You identified the risks associated with the borrower's company and approach to its business
- You assessed management's ability to manage risks.
  - You did this by Analysing financial statement trends
  - Evaluating how the borrower's business actually works
- You prepared projection assumptions covering the life of the loan
- You structured the loan to include terms and covenants to protect the bank against the risks identified

The projection assumptions are the most important part of the loan management strategy. They are your game plan. If the company's performance starts to vary significantly from projected performance, you need to reassess the situation.

You know management's strengths and weaknesses, and you know the important risks. Set up a system to:

- Monitor actual performance
- Compare actual performance with expected performance
- Determine whether variations from expected performance are good or bad
- Understand the reasons for a variance and if unfavourable obtain a 'game plan' to address the danger
- React. You can:
  - Do nothing
  - Demand immediate repayment (if your loan agreement permits)
  - Renegotiate, that is, change the terms of the agreement to meet the new situations

- Work with customer to develop opportunities where performance is better than expected or where bank products can help the customer to manage risks more effectively

The loan documentation which you put in place at the outset should contain covenants which give you a right to take action if performance deteriorates to levels that increase risk to a level to warrant taking action. If not you need to be even more vigilant and you need more to act.

Well Structured loan documentation should help you in the next stage—routine monitoring of performance—and it should give you a right of action. The documentation you produce must relate to the risks that you have identified and be appropriate to assist in monitoring changes in circumstances. The key however, is what is happening to the customer, the documentation is only your protection. If you don't see what is happening, you won't buy yourself maximum time to take action.

Routine Monitoring

The key to successful loan management is a routine that you do every day, every week, every month, or every quarter for each loan. Monitoring includes the review of internal reports but must not stop here.

The best performing bankers will pose five questions to be asked in assessing loan risks:

Which risks are critical to successful performance?

- Is management responding to these risks to mitigate them?
- How quickly could the situation change, requiring a new response?
- What would be the impact of the potential changes?
- Can you set up an early-warning system to help you anticipate risks and events that might affect the borrower's ability to repay?

Focus your monitoring on the key success variables. Monitor each loan according to how fast the situation could change: probably monthly for short-term loans, probably quarterly for long-term facilities. The three major information sources are the bank, external sources (suppliers, other financial institutions, etc.) and the borrower.

Information From The Bank

- Loan Activity
- Exception and Turnover Reports
- Maturing Loans
- Past Due Loans
- Loans with Exceptions
- Extension requests
- Current Account Activity
- Overdrafts and Drawings against uncleared effects
- Account activity analysis
- Contingent Liabilities

Loans with Exceptions

In some cases, you are notified that one of your loans requires your attention before it is due for renewal or before it is paid. This may occur for a number of reasons:

- Insurance coverage on fixed assets pledged as security has been cancelled or has expired or a request for a second charge has been made by a third party
- The company has not conformed to the loan covenants in the loan agreement.
- The level of the company's account is in excess of the approved overdraft limit.
- The loan warrants or has been given a deteriorating credit grade, is sub-standard or non- performing or has been given another, similar status by the bank.

- There has been a request for additional funds, an extension of maturity or other change in terms.

External Sources of Information

- Trade enquiries through other banks for companies that supply your customers.
- Credit enquiries from other financial institutions.
- News that may affect your customers and their ability to repay their loans.
- News of any legal actions —by the government, other companies, or private citizens
- Major economic issues that may affect your customers and their industries.
- Reading the financial press and relevant industry trade press is critical to developing appropriate market intelligence.

Information From The Borrower

Much of the information you receive about your borrowers will come from the borrowers themselves.

- Informal visits with the borrower
- Visiting the plant or company
- Analysing financial statements

Build Bridges of Trust

- If you gain the borrower's confidence and trust, you'll be able to encourage the borrower to talk openly about the business —its problems and success. You'll be able to anticipate problems because the borrower has shared concerns with you in a relaxed setting. You'll be able to get a clear picture of management responses to problems by listening to the borrower talk about how things are going.
- A request for additional funds, material extension of maturity date or

substantial change in terms and conditions should be treated as a completely new loan. In other words, you should identify loan purpose and repayment sources, just as you would for a new customer.

- Prepare projections and use them to manage your loans. If you have a clear projection, with well – documented hypotheses, you can quickly look it over, compare it with the actual results in the most recent financial statements, and react to any differences between actual and expected performance.

Identifying Trouble

Signs **Overview**

Trouble signs, or red flags, are not always easy to spot. As you gain experience in loan management, you'll learn to identify the more subtle indications of trouble. The trouble signs, and what they imply, are arranged by source of information.

Information From The Bank

- Loan Activity
- Special Clearances
- Unexpectedly prolonged borrowing
- Account activity – Excesses against overdrafts or withdrawals against uncollected effects
- Returned cheques deposited
- Unexpected cash balance decline
- Decline in loan activity or account turnover
- Unusual activity

Information From Other Sources

Occasionally you may see trouble signs in information that you receive from outside sources.

- Trade enquires
- Customer stops taking advantage of trade discounts
- Credit enquiries
- Discounting accounts receivable
- Failure to meet other financial obligations
- Legal actions Lawsuits
- New mortgages and lines
- Official Management or Liquidation
- Economic News – News about the industry
- Labour unrest

Information From The Customer

- Contact with the Customer
- Large or unexpected borrowing requests or renewals
- Diversification
- Inability to meet commitments on schedule
- Recurrence of problems presumed solved
- Lack of functional planning
- Poor financial housekeeping
- Change in personal habits of key people
- Changes in Management, ownership or key personnel
- Financial Statements
- Late or incomplete statements
- Change in auditors or accounting Practices
- Adverse information
- Non-compliance with terms of loan agreement
- Low cash balance
- Slowdown in accounts receivable

- Excessive inventory
- Increase in speculative assets or outside investments
- Increase in borrowing
- Increase in borrowing

Plant or company visit

A visit to the customer's plant or company offices may provide you with some indication of trouble that you could not obtain from other sources. Some of these factors are:

- Deteriorating Appearance
- Discouraged or demoralized employees
- Overstocking
- Damaged or obsolete inventory
- Excessive downtime or repairs

A Strategy For Problem Loans

- Review The Loan
- Contact the Customer
- Confer with the Customer
- Restructure the Loan

Summary

The loan management process consists of four basic steps. You need to:

❖ Do a good credit analysis before you make the loan

- Identify the risks, particularly those that could happen quickly or be disastrous
- Prepare a projection

- Monitor company activity
    - Gather information from the customer, from bank sources, and from other sources
    - Compare actual performance with projected performance
- Identify trouble signs and determine whether the condition is temporary
- Take action: renegotiate or restructure loan as needed

Food for thought - Loan covenants.

A breach of a loan covenant usually triggers a default of the loan. However, most banks prefer to negotiate a fee-based waiver of the default so long as the ultimate repayment of the loan is relatively assured. How many of you have seen loan covenants in a loan agreement? Have you seen any of these common covenants?

- *Cash flow (earnings before interest, taxes, depreciation and amortization, and capital expenditures - so called EBITDA) must cover debt service by 1.2x or more.*
- *Leverage as measured by debt/equity cannot exceed a pre-set number, such as 100%. In addition, some banks require their pre-approval before the borrower can incur additional debt of any kind.*
- *Maintenance of minimum current or quick asset ratios at no less than 1.00 and 0.70 respectively.*
- *Minimum sales or net income.*
- *Maintenance of an external credit rating above a set level, typically investment grade.*

Monitoring And Post Disbursement Considerations

Post-Disbursement considerations

- **Facility Monitoring Considerations**
    - Once loans are disbursed, the monitoring process begins. The purpose of this is to identify as soon as possible any changes in the borrower's financial condition or performance that may impact the borrower's capacity to repay

the outstanding loan(s) as agreed.

- ❖ The primary monitoring tool is the loan agreement.

- The first area which monitoring focuses on are the weaknesses identified during the credit initiation and analysis phase.
- Additionally, there may be weaknesses in the borrower's industry, financial condition or performance, changes which could impact the borrower's capacity to repay the loan in accordance with the credit agreement.
- The greater the weaknesses identified, the more frequent monitoring required. If new or worsening weakness are identified, monitoring frequency should be increased.
- Note that the aim of facility monitoring is to prevent delinquencies in the repayment dates as agreed.

- **Collateral Review:**
  One way of monitoring loans is to periodically re - evaluate the collateral and determine if it is still sufficient security for the loan. If not, the borrower is required to update the security irrespective of his performance. A typical method for the review is:
- Post-disbursement Considerations

- **Comparable weight Analysis**
  This analysis focuses on sales comparison and checks the reasonability of an appraisal's value estimate. The comparables are scored and value weighted for the subject calculated.
- The spread between the appraised value and the weighted value either provides support for or identifies a skewed value estimate. The results are clarified by a program- generated graph which displays the relationships between the values and scores.
- Loan monitoring and control is a key part of the bank's risk management system which is defined as all of the mechanisms concerning the process of standard-setting,

reporting, verifying the compliance with standards, decision-making and implementing, which are established by the board of directors in order to monitor, to keep under control and, if necessary, to change the risk/return structure of the future cash flows of the bank and, accordingly, the quality and the extend of the activities

- Loan monitoring and control is the bank's established and defined system for monitoring and controlling credit risk: The risk of loss that the bank faces the situation when the counter party fails to fulfill wholly or partly of his obligations in a timely manner by breaching of contractual obligations.
- For most banks, loans are the largest and most obvious source of credit risk; however, other sources of credit risk exist throughout the activities of a bank, including in the banking book and in the trading book, and both on and off the balance sheet.
- Banks are increasingly facing credit risk (or counterparty risk) in various financial instruments other than loans, including acceptances, interbank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitments and guarantees, and the settlement of transactions.

Loan Monitoring Process

- The loan monitoring process starts with the Credit Control Desk of the Bank before the disbursement by Credit Administration Unit.
- The Credit Control Desk checks through the approved credit and ensures it is in line with the stipulations of the Bank's Credit Policy Guide as per target market, risk acceptance criteria, security, lending approval limits, minimum risk adjusted return, satisfactory account operation, etc.
- Emphasis is also placed on Completeness of Documentation and Security. The Legal Department sees to this.
- Once the loan is disbursed, it forms part of the portfolio of loans being monitored by the Loan Monitoring Department.

- The loan monitoring process is not universal among the Banks but the ultimate objective is to be able to promptly and proactively identify and mitigate credit risks and loss of money.
- Internally, the Bank structures its Credit Risk Management Departments into Credit Assessment, Credit Administration, Credit Control, Credit Monitoring, etc. to ensure checks and balances.
- Credit Monitoring Department ensures that:
  - Borrower is in compliance with all terms e.g. equity contribution
  - Documentation is adequate
  - Repayment is made as scheduled
  - Early identification of any omission or commission
- Regular examination and review of account activity and security status. Through this, Officers check for Overtrading, Cheque- Kiting, Window Dressing, Turnover Trend, Repayment Trend, Interest Servicing Trend, Sensitivity Analysis for Projects, etc.
- Visits to Project Sites, and Appointment of Project Consultants for construction-related facilities
- Look out for all areas identified under Early Warning Signals, including frequent and irregular request for excesses, and frequent discounting of clearing cheques.
- Marking to Market (MTM) all equity, fixed income and FX related securities and ensuring adequate collateral coverage as approved.
- Follow-up and confirm with Legal Department that the pledged security is duly perfected. Check for amount stamped, the exact security, location, insurance, etc. At the Portfolio Level, the Loan Management Officers have tools to generate reports that include the following:
  - Unapproved Credits
  - Expired Limits with Outstanding Balances
  - Loans and Leases with Repayment of Principal and Interest in Arrears
  - Facilities Disbursed before Conditions Precedents are met

- Facilities with Deferrals, and Uncured Deferrals
- Future Maturities Report

- Unfunded Accounts for Clearing Cheques. With this report, the Loan Officer can direct the Clearing Department to return a Cheque unpaid with or without the consent of the Relationship Manager.
- Deal Booked Daily to know who, which and what credits have been booked. Booking Limit Breaches can be sanctioned with this report
- Future Schedule of Due Rentals on Leases
- Turnover Report to check for performance on liquidity, yield and repayment

Who should monitor?

Points to ponder....

- The key issue in the banking crisis revolves around governance around credits and reporting of loan exposures on the balance sheets.
- Who failed to do their duty that resulted in the crisis-the regulator or the banks?
- If we agree that governance is the key issue, then the banks failed to do their duty and the regulator intervened to correct the problems (yes/no)
- Ok, who in the bank failed, if we can answer this question, then we can agree on who should monitor and control?
- Risk Management, Relationship Officers hm...but recall that in the problem banks, the CBN removed CEOs, directors and in some cases, entire boards,

Who failed to do their duty in the banks?

- Chief Risk Officer, Relationship Officers, Group Heads hm...but recall that in the problem banks, the CBN removed CEOs, directors and in some cases, entire boards.
- No mention of RMs or Group Heads or CROs
- So who is responsible for loan monitoring and control

Board of Directors

CBN thinks so hence in 2009, it held them accountable for the crisis in the individual problem banks. BASEL Committee thinks so… "Principle 1: The board of directors should have responsibility for approving and periodically (at least annually) reviewing the credit risk strategy and significant credit risk policies of the bank. The strategy should reflect the bank's tolerance for risk and the level of profitability the bank expects to achieve for incurring various credit risks"

Who else?

Senior Management

Principle 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-BASEL COMMITTEE.

Frontline Staff

The credit risk strategy and policies should be effectively communicated throughout the banking organization. All relevant personnel should clearly understand the bank's approach to granting and managing credit and should be held accountable for complying with established policies and procedures-BASEL COMMITTEE

Who Is Responsible?

- All personnel in the loan process including and especially the Relationship manager - front line staff
- The RM is the critical actor in three lines of defense model. He/ She is the first line of defense in the loan granting and monitoring process
- If client engagement is frequent and intense, in line with a pre-agreed ongoing call plan, a competent RM is able to spot early signals that a borrower might experience difficulty with meeting its loan obligations

- Competence to assess loan viability in line with the bank's credit strategy, policies and procedures.
- Integrity to recommend only viable loans and to halt disbursement if developments pre-disbursement suggest so.
- Competence to understand loan covenants and to monitor same such as clean up clauses, OD efficiency ratios, material changes in product, markets or management or industry, events of default clause
- Competence and Commitment to monitor changes, developments in the individual borrower's condition, its industry, experiences of other players with lending to the relevant industry, collateral.
- Integrity to revise recommendation to approving authorities if approval was obtained under different conditions, prior to advising the customer of approved facility.
- Integrity and confidence to advise Risk Management of adverse developments that might impair the borrower's capacity to perform as expected.
- Integrity and confidence to propose to Risk Management that based on adverse developments that might impair the borrower's capacity to perform as expected, a downgrade in risk rating is appropriate.
- Confidence to propose to Risk Mgt. a remedial course of action to support the borrower through the period and/or to commence enhanced monitoring of borrower and originally agreed "Ways Out"
- All personnel in the loan process; key dependence on the second line of defense-risk management staff.
- Relied on by Board of Directors and Senior Management to provide oversight of frontline activities in the loan process
- Together with Legal, responsible for ensuring that security and loan documentation is adequate throughout the life of the facility
- In order to be effective, credit policies must be communicated throughout the organization, implemented through appropriate procedures, monitored and

periodically revised to take into account changing internal and external circumstances. They should be applied, where appropriate, on a consolidated bank basis and at the level of individual affiliates. In addition, the policies should address equally the important functions of reviewing credits on an individual basis and ensuring appropriate diversification at the portfolio level.

Risk Management must ensure that:

- facilities are reviewed as and when due
- Pledged Collateral on a portfolio basis and for individually assessed high risk credits, is checked for adequacy as a way out of the facility on a pre-determined frequencies, which may or may not coincide with the scheduled review of the credit.
- Stress testing on a portfolio basis is undertaken periodically, the effect on capital adequacy, liquidity, asset quality is recorded and Senior Mgt. advised on possible remedial actions
- Based on industry specialization, frontline staff can and should provide industry reviews highlighting risks and Mitigants over a pre-agreed period and on ad-hoc basis depending on the bank's exposure to that sector.
- Risk Management must be competent to independently check reports from frontline staff so as to provide re-assurance to the Board and Senior Management
- Risk Management must report accurately and promptly on movements in the loan book, concentrations, deviations from agreed credit strategy and proposed remedial action (working with the RMs) plus the success or otherwise of these proposals
- Boards typically meet four times a year and so need assurance that credit strategy is being applied as approved.
- Reliance is therefore on Internal Audit to check the checkers and provide that reassurance to the Board.
- Most Internal Auditors have a direct reporting line to the board and a dotted one to the CEO.

Summary

- Who should monitor? - everyone in the loan process.
- Board of Directors has ultimate responsibility for setting credit strategy and tone and ensuring that the communication is dispersed throughout the relevant parts of the organization
- Senior Management is responsible for the design of policies, procedure that implement the board approved credit strategy
- Internal Audit (IA) provides third level assurance to the board on these issues
- Risk Mgt. has responsibility as the second line of defense
- Frontline staff is the critical actor in the chain-
- Themes…..Training, Effective Communication, Testing, Integrity, Competence and Commitment, Checks, Accurate Reporting

Control of Credit Risk - 1

Risk selection is the foundation for effective risk management. Integrated approach to risk management entails a four-step process, viz:

- Establishing corporate priorities
- Choosing the credit culture
- Determining credit risk strategy
- Implementing risk control

Taken together these steps help in reducing the volatility of a bank's credit portfolio and performance. The strategic credit risk management process provides a framework to integrate priorities, credit culture, risk strategy, and risk controls to maximize financial performance while monitoring credit ensures performance within an acceptable range of

volatility. Each step in the process must be defined, communicated and monitored.

1. Corporate Priorities:

Corporate priorities establish the framework for a bank's credit culture and credit performance. Successful credit risk management of individual loan portfolios or a bank's loan portfolio is measured by consistent and predictable earnings and credit quality over the business cycle. Successful credit risk management must therefore balance priorities for:

- ❖ Asset quality and soundness.
- ❖ Profitability
- ❖ Growth and market share

Priorities define what is most important to top management and describe how management intends to maximize shareholders value. Priorities also define the institution's tolerance for risk. Priorities that focus on growth and immediate earning imply a greater tolerance for risk than priorities that emphasis credit quality.

Financial institutions post great emphasis on one of the following three priorities to assure consistent increase in earnings and to enhance shareholders value.

a) Asset Quality

Quality is emphasized above anything else, shareholders value will be maximized by conservatively managing transaction, intrinsic and concentration risks. Band of volatility will be narrow.

b) Immediate Earnings

Emphasis is place on a "mixture" of growth and credit quality to achieve immediate earnings. The problem here is when earning goals become difficult to achieve, credit

quality will be compromised.

c) Growth and/or Market Domination

Corporate priorities are asset growth or increasing market share and expanding market presence. Shareholder value is maximized by increasing the market value of the franchise. An institution must take higher level of risk to achieve market share goals.

Management's choice of priorities defines the institution's:

- Credit Culture
- Risk Strategy
- Rewarded Behaviour
- Selection and growth of line of business
- Credit Process

Care should always be taken by management to avoid the usual problem of espousing asset quality as the number one priority but defines a profit plan with profitability objectives and market goals that can be achieved if credit is compromised. The resulting confusion will compromise corporate performance and may result in greater credit volatility and erratic earning.

Banks that design credit risk management systems but underestimate the importance of a conservative philosophy find credit quality elusive. The challenges presented by external environment often force management to compromise priorities. But the test of portfolio quality is credit performance over the business cycle.

It is easy to compromise credit quality in good time to achieve superior growth and earning. The results of aggressive lending often do not manifest themselves for two or three years after the loan is made when the portfolio is stressed by a downturn in the economic environment.

Applying the corporate priority concept

The following will help establish corporate priorities:

- Define in writing the organization priorities.
- Correlate corporate priorities with market strategy.
- Verify that the profit plan supports the priorities.
- Establish credit standard to communicate the institution's risk tolerance and to define acceptable bands of volatility.
- Ensure that priorities, strategies and standards are consistent throughout all subunits.
- Clearly and consistently communicate the institutions priorities through oral and written Directives, executive actions, the profit plan, policies, procedures, incentives and Enforcement.
- Put in place tools to monitor achievement and priorities and to ensure continuing consistency.

Corporate Priorities and Culture

Culture

"Systems and controls are only as good as the credit culture that nurtures them."

If priorities define "what is important" then the credit culture defines "how we do things around here". It is the embodiment of the banks approach to underwriting, managing and monitoring credit risk. Credit culture is the glue that binds credit process and forms the foundation for credit discipline.

Every bank has a credit culture, may be formally defined or evolved informally

overtime. The culture may be unified or diverse.

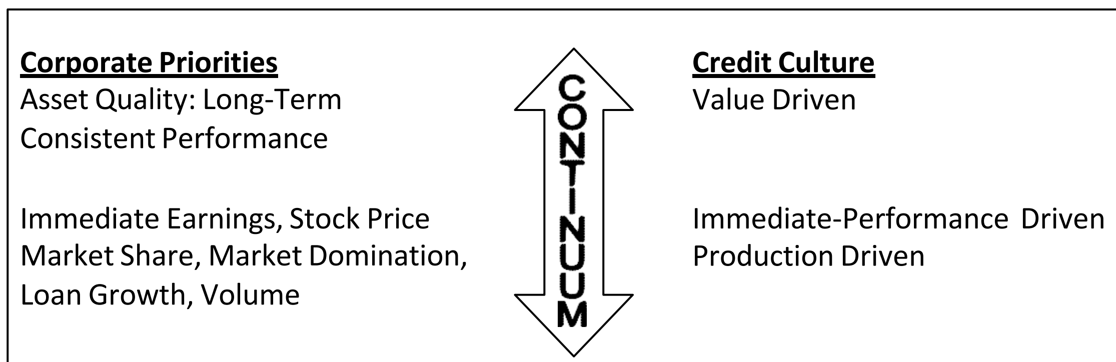
In some banks, diverse cultures evolved from loan approval and loan management processes that were built around transaction management. Thus, the credit culture developed – unplanned – from the bottom up instead of the other way round. To build a credit culture, management must ensure congruence between the culture and corporate priorities.

Credit culture may embody formalized policies, procedures and systems and controls, but these are not enough to ensure good credit culture, especially if the policies and procedures are not consistent with senior management's priorities and strategies.

Types of credit culture

- Values driven
- Immediate-performance driven
- Production driven
- Unfocused (current priority driven)

Corporate Priority/ Credit Culture Continuum



Abbreviated Credit Culture

Descriptions:

1. Value- Driven

- **Top Priority:** Long-term, consistent performance
- **Driving Force:** Corporate values and market consistency
- **Credit Environment:** Strong credit organization with few policy exceptions and excellent communication.
- **Hidden Policy:** Not a factor; consistent with written policy
- **Success Factor:** strikes a balance with credit quality and revenue generation; avoid tendency to over control lending function.

2. Immediate-Performance Driven

- **Top Priority:** Current earnings, stock price
- **Driving Force:** Annual Profit Plan.
- **Credit Environment:** Generally strong emphasis on credit quality; shift in priority becomes evident only during periods of soft loan demand, in strong markets; discerning difference between value-driven and immediate performance-driven cultures can be difficult. Tendency to enter and/or increase riskier lines of business when loan demand is weak.
- **Hidden Policy:** Conflicts with written policy during soft market demand periods; stems from lender confusion over management priorities.
- **Success Factor:** Must resist temptation to overreach in down cycle; credit administration must be strong enough to influence lending behaviour.

3. Production Driven

- **Top Priority:** Market share, loan growth, loan volume.
- **Driving Force:** Commitment to be the largest; market plan
- **Credit Environment:** Well-managed, market-driven banks have strong systems controls, and good credit leadership. However, effectiveness is tested by pressure on lenders to produce. Credit staff and line management may have conflicts over priorities. In every aggressive banks, credit administration will have limited influence on the loan approval process.
- **Hidden Policy:** Generally dominates written policy; lenders understand that their primary role is to produce.
- **Success Factor:** Loan approval largely controlled by the credit organization; low individual lending authorities exist; requires strong credit management to resist production pressures.

4. Unfocused (Current-Priority Driven)

- **Top priority:** Uncertain; tends to change with the prevailing winds; priority of the month culture.
- **Driving force:** Varies; often search for self (what do we want to be?): could be survival, problem avoidance, or desire to be competitive; changes as priorities change; management is reactive.
- **Credit Environment:** Varies; depends on strength of credit management or on current priorities; each line lending unit may have its own unique attitude toward credit quality.
- **Hidden policy:** Lack of consistency and tendency to shift priorities leave lenders confused; they don’t know what behaviour is desired.
- **Success factor:** Dominant leadership provides clear direction; credit quality may be okay if credit management policies and systems are strong. In the absence of

strong leadership, a management change will be required or merger or sale to a stronger institution will most likely occur.

Determinants of Credit Culture

The key determinants of a bank's credit culture are:

- Commitment
- Credit discipline
- Incented behaviour
- Selection and growth of lines of business
- Communication

Commitment

"Senior management must walk the talk"

- Top management must be committed
- Top' management's action must be consistent with priorities
- The CEO must not be a lender because he will be tempted to cut corners
- Where the CEO lends, he must set right examples

Discipline

"Commitment is the foundation for discipline"

Strong credit discipline ensures participation and supports from all levels of the organization. Discipline integrates:

- Policies
- Risk-rating system
- Credit administration
- Loan review
- Lender accountability

Behaviour incented

"The primary determinant of lending behaviour in most banks is the profit plan supported by incentives"

- Incentive must reinforce the priorities
- Credit quality will be for naught if pay raises, promotions and bonuses reward aggressive lending.
- Incentive should be tied to priorities and to define performance standards to credit quality and portfolio profitability

Lines of business

"Uncontrolled growth of risky lines of business was the primary cause of credit quality deterioration in the 1990s."

- ❖ Lines of business are broad class of loans.
- ❖ Choice of lines of business and growth rate determines the risk profile of a bank.
- ❖ Pursuit of risky lines of business leads to concentration of high-risk loans exceeding prudent level
- ❖ Lines of business must be consistent with stated priorities and the desired credit culture.

Communications

"Communications are good when all leaders understand corporate priorities and describe them with the same words."

Communication entails:

- ❖ Continual and positive reinforcement of the desired culture using common language and relentless communication of priorities.
- ❖ The bank's credit culture vocabulary should consist of words and phrases that have universal meaning, because it conveys the bank's lending philosophy and its tolerance for risk.

Lending Philosophy

Our priorities in order of importance are:

1. Quality assets
2. Profitable relationships
3. Prudent growth

Optimal Credit Culture

Optimal culture is not one that minimizes loss; rather it is one that provides best credit quality consistent within acceptable parameters. The strongest cultures have the following characteristics in common.

- ❖ Credit quality is a corporate priority, and senior management supports it through words and deeds.
- ❖ Line management supports credit quality objectives.
- ❖ There is strong management at the top of the credit function.
- ❖ Lending policies exceptions are infrequent and difficult to obtain.
- ❖ There is a commitment to lender training, moreover, lenders receives regular training on the bank's lending policy; they understand it and adhere to it.
- ❖ Strong credit systems and control exists.
- ❖ Major lending areas have clear and demanding credit standards and objectives. Managers and lenders are rewarded or penalized based on performance.
- ❖ There are credit heroes in the bank.
- ❖ Credit standards, credit policy, business plans, incentive plans, and credit communications are harmonious.
- ❖ Lenders share a common credit vocabulary, and new lenders receive extensive documentation on "how things are done around here."
- ❖ There are communicators in the bank who persistently repeat the credit message.
- ❖ New line of business and markets are carefully selected to conform with portfolio risk guidelines, lines of business growth are managed prudently.

There are however, barriers to achieve the optimal credit culture. The notable barriers are:

- Obtaining the unwavering commitment of the CEO
- Time frame required to establish a culture. The time frame is particularly long for the values driven culture.
- Pressure on interim earnings.
- Failure to integrate priorities, credit culture, risk strategy, and control.

Applying The Culture Choice Concept

The following suggestions will help choose the culture.

- Identify and analyze the existing culture. Is it consistent with corporate priorities?
- Determine the optimal culture consistent with corporate priorities.
- Ensure CEO commitment to the desired culture.
- Design/refine the element of credit discipline.
- Focus, enhance, and reward behaviour that is consistent with corporate priorities and the desired culture.
- Improve communication at all levels of the organization.
- Review lines of business and the strategic plan to ensure consistency with the desired culture and corporate priorities.
- Implementing the changes required to achieve the desired culture and to ensure consistency with corporate priorities.

Source: Bank Management: Text and Case, George H. Hampel, 1990

Control of Credit Risk - 2

Risk Asset Process / Management

Basic credit controls include:

- ❖ Check the counterpart's public and other financial information, including off-

balance sheet positions if possible;

- Check the strategic objectives of the counterparty and understand its overall risk profile;
- Check management quality of the counterparty;
- Check the counterparty's profitability;
- Check the counterparty's standing among its creditors;
- Check the size of the counterparty's positions compared with other market users of similar profile

This is what is done under Evaluation in the Risk Asset Process Flow and counterparty and Customer Assessment in the Credit Management.

Documentation

This is a critical step in credit risk management. The usual question is "Documentation as Risk Management?" To get deals done, we're led by the business not by the documents. Documentation can, therefore, get left till the last minute and it is all too easy to reach for a precedent, fill in the blanks and have done with it. The purpose of a document is to manage the risks.

Collateral

The objective of taking collateral is to convert credit risk (right to receive money) into market risk (right to sell property). The techniques available for effective rights over collateral depend on the asset. The following is a list based on our law rights:

- Charge of mortgage (Fixed /Floating)
- Lien
- Pledge
- Outright transfer and set-off other relevant concepts
- Recharacterisation
- Rehypothecation

- Substitution
- Enforcement
- Negative pledge

After-The-Fact

After-the-fact credit risk management control is Portfolio Management, i.e. the admin Administration of the credit which may be followed by Workout. We are essentially talking about credit review and monitoring, collateral management, collection and enforcement of covenants.

Financial

- Ensure the credit is used for the stated purpose.
- Obtain both current and past financial statements and related supporting data. Be conversant with accounting treatment. Auditor's management letter should be available for examination.
- Pay close attention to the basic ratios of credit, including the trends in profitability, turnover and liquidity.
- Understand the borrower's trade cycle and how cash is derived. Review receivable quality, inventory composition and true value. The continuing ability to generate cash from operations is essential.
- Check trade reactions.
- Test validity of all assumptions; false assumptions lead to wrong decisions.
- Review capital structure. Make sure that borrower has access to all the financial resources it requires to grow and succeed. Is the ability to withstand shock there?
- Ensure, in reviewing the borrower's insurance practices, that insurance of risks by third parties is included.
- Include in your analysis other classes of creditors that have the potential of jeopardizing the bank's position

Source: Bank Management, Text and Cases: George H. Hampel et al, 1990

Credit Infractions and Sanctions

Introduction

Every bank should have a policy document on Discipline that provides a process for identifying and addressing infractions by staff. Most bank document however categorizes credit-related infractions under broad terms. In order to remove ambiguity, and attach great importance to the seriousness of credit-type infractions, some banks have approved the list of infractions and corresponding sanctions, as highlighted below.

Categorization of Credit Infractions

The offences in the credit process are classified along the following lines:

1. Customer Identification
2. Credit Processing & Approval
3. Credit Control Process
4. Credit Disbursement
5. Credit Monitoring
6. Credit Administration
7. Credit Recovery

Sanctions

Credit Control Process

S/N	Offences	Category	Adjudication	Range of Sanctions
1	Availment of credits not duly approved	Fraud & other acts of dishonesty	Disciplinary committee	Caution letter -Termination
2	Availment of credits with incomplete pre-disbursement conditions and without an approved deferral	Fraud & other acts of dishonesty	Disciplinary committee	Caution letter -Termination
3	Availment of approved credits without receipt of positive credit bureau report or a deferral	Fraud & other acts of dishonesty	Disciplinary committee	Caution letter -Warning
4	Failure to review, observe, or escalate breaches of the Credit Policy	Dereliction of duty/ negligence	Disciplinary Panel	Caution letter -Suspension

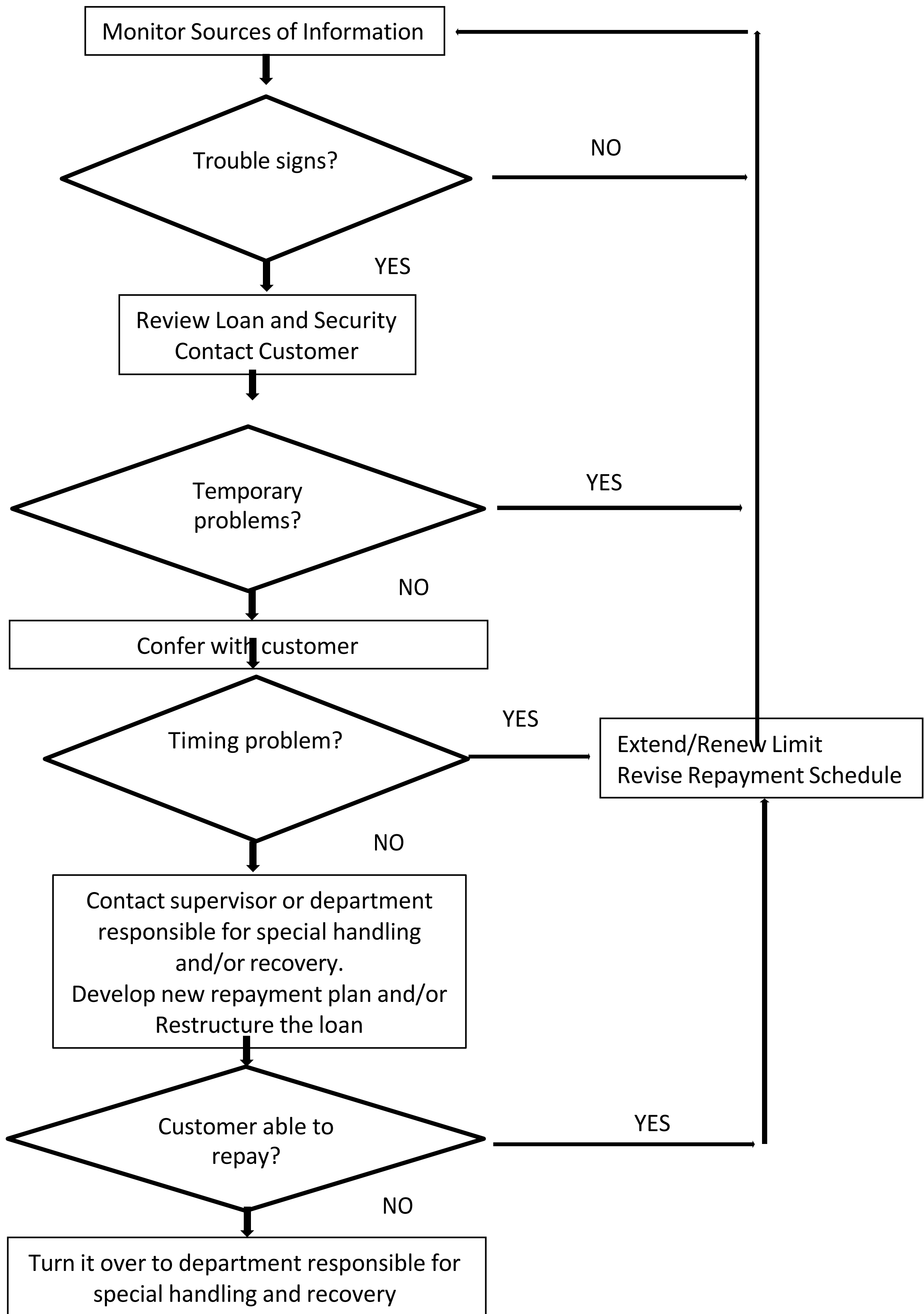
Credit Monitoring Process

These offences are mostly committed by Credit Monitoring Staff, Relationship Managers and Account Officers

S/N	Offences	Category	Adjudication	Range of Sanctions
1	Availment of credits not duly approved	Dereliction of duty/ negligence	Disciplinary Panel	Caution letter – Suspension
2	Availment of credits with incomplete pre-disbursement conditions and without an approved deferral	Dereliction of duty/ negligence	Disciplinary Panel	Letter of Displeasure – Warning
3	Availment of approved credits without receipt of positive credit bureau report or a deferral	Dereliction of duty/ negligence	Disciplinary Panel	Letter of Displeasure – Warning

4	Failure to review, observe, or escalate breaches of the Credit Policy	Fraud & Other acts of dishonesty	Disciplinary committee	Letter of Displeasure – Warning
5	Failure to promptly identify weak and impaired assets and advise required provision	Dereliction of duty/ negligence	Disciplinary Panel	Letter of Displeasure – Warning
6	Complicity in covering up credit breaches	Fraud & Other acts of dishonesty	Disciplinary committee	Termination – dismissal
7	Failure to escalate breaches of credit policy	Dereliction of duty/ negligence	Disciplinary Panel	Letter of Displeasure – Warning

Job Aid: **Loan Management Strategy**



Appendix

Appendix 1: Loan Risk Grading

Risk Rating	**Grade**
Superior – Low Risk	1
Good – Satisfactory Risk	2
Acceptable – Fair Risk	3
Marginal – Watch List	4
Special Mention	5
Substandard	6
Doubtful and Bad (Non-Performing)	7
Loss (Non-Performing)	8

Appendix 2:

Perception About Risk In Banking (Banking Banana Skins Report 2019)

1.	Macro-economic environment
2.	Criminality
3.	Regulation
4.	Technology risk
5.	Political interference (
6.	Quality of risk management
7.	Credit risk
8.	Conduct practices
9.	Pricing of risk
10.	Business model

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