MFSA

MALTA FINANCIAL SERVICES AUTHORITY

BANKING UNIT

BANKING NOTICES

NOTICE ON THE MANAGEMENT OF CREDIT RISK
BY CREDIT INSTITUTIONS AUTHORISED
UNDER THE BANKING ACT 1994

Ref: BN/01/2002

NOTICE ON THE MANAGEMENT OF CREDIT RISK BY CREDIT INSTITUTIONS AUTHORISED UNDER THE BANKING ACT 1994

INTRODUCTION

1. The Malta Financial Services Authority as the competent authority ('the authority') appointed under Section 3(1) of the Banking Act 1994 ('the Act') considers that sound management of credit risks is essential to ensure the sound operations of credit institutions and to optimise their risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters.

2. It is not the purpose of this Banking Notice ('the Notice') to set specific rules on the management of credit risk for credit institutions. The Notice should be considered as being best practice guidelines on effective management of credit risk. The authority believes that the credit risk management approach adopted by a credit institution is to be commensurate with the scope and sophistication of the institution's activities.

3. The Notice however does address four specific areas and establish a number of best practice principles for the management of credit risk which should be considered for inclusion in any comprehensive credit risk management framework that credit institutions put in place. A summary of these best practice principles is included in the Annex to this Notice.

4. International developments on credit risk have highlighted the crucial importance that needs to be given to the management of credit risk as a major prudential tool in maintaining the soundness of credit institutions.

5. This Notice is modelled on the main requisites of the document dated September 2000 and entitled *'Principles for the Management of Credit Risk'* issued by the Basel Committee on Banking Supervision[1].

6. The authority considers the best practice guidelines established in this Notice as being complementary to the Credit and Country Risk Provisioning Banking Directive (BD/09) and the Large Exposures Banking Directive (BD/02). It should therefore assist credit institutions in their assessments of asset quality, the adequacy of provisions and reserves, and the disclosure of credit risk.

7. This Notice replaces Banking Notice (BN/01) on Provisions on Loans and Advances issued in 1994[2].

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1 A full reading of the Basle Document is recommended complementary to this Notice.

2 The 1994 Banking Notice was being replaced by this Notice and Banking Directive (BD/09) on loan loss provisioning.

PRINCIPLES FOR THE MANAGEMENT OF CREDIT RISK

8. The authority recognises that the major cause of serious 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 the economic or other circumstances can lead to a deterioration in the credit standing of counterparties.

9. Credit risk may be defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. Credit institutions need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits and transactions.

10. Although loans and other advances are the largest source of credit risk for most credit institutions, other sources of credit risk exist in their activities, including the banking and the trading book and both on- and off- balance sheet. The principles contained in this Notice are most clearly applicable to the business of lending. They should however be applied to all activities where credit risk is present. Hence, credit institutions must also address the increased credit risks in various financial instruments, including acceptances, interbank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitment and guarantees, and the settlement of transactions.

ESTABLISHING AN APPROPRIATE CREDIT RISK ENVIRONMENT

THE ROLE OF THE BOARD OF DIRECTORS

11. The board of directors[(3)] is expected to approve and periodically review, the credit risk strategy and significant credit risk policies of the credit institution. These should reflect the risk tolerance and the level of profitability the credit institution expects to achieve for incurring various credit risks. Also the board of directors[(4)] must recognise that the strategy and policies must cover the many activities of the credit institution in which credit exposure is a significant risk.

12. The credit risk strategy should give recognition to the goals of credit quality, earnings and growth. The authority believes that, amongst other features, a credit risk strategy would include:

- A statement of the credit institution's willingness to grant credit based on exposure type, (e.g. commercial, consumer, real estate);
- Economic sector;
- Geographical location;

[3] The authority is aware that there might be instances where the board of directors delegates this function to for example a senior management committee or executive body. The authority expects that in such cases the board of directors retains the exclusive function of supervising such committee or executive body as frequent as necessary but at least annually.

[4] Henceforth, the term "board of directors" throughout this Notice should be read within the context of note (3) unless otherwise specified.

- Currency;
- Maturity; and
- Anticipated profitability.

Credit institutions may wish to include other factors such as the identification of target markets and the overall characteristics that they want to achieve in their credit portfolio, including levels of diversification and concentration tolerances.

13. The board of directors is to approve the institution's strategy for the selection of risks and maximising profits and must also determine the capital level sufficient for the risks assumed by the credit institution. The authority deems it appropriate that the board of directors periodically reviews, *at least on an annual basis,* the following:

    - the institution's financial results and, on the basis of results, determine the changes that need to be made to the strategy; and
    - either within the credit risk strategy or within a statement of credit policy, approve the credit institution's overall credit granting criteria (including general terms and conditions).

    The board of directors has also to approve the manner in which the institution will organise its credit-granting functions, including independent review of the credit granting and management function and the overall portfolio.

14. The board of directors must avoid:

    - Conflicts of interest leading to the overriding of the credit-granting and monitoring processes in instances of potential credits introduced by members of the board; and
    - Remuneration policies that contradict the institution's credit risk strategy.

    Therefore the authority would not expect the board of directors to reward unacceptable behaviour such as the generation of short-term profits through the deviation from credit policies or the exceeding of established limits which would weaken the monitoring processes of the institution.

15. The authority believes that credit risk strategies of credit institutions need to provide continuity in approach, and thus will need to take into account the cyclical aspects of the economy and the resulting shifts in the composition and quality of the overall credit portfolio.

16. The authority considers that the effective communication of the credit institution's credit risk strategy and policies to all the relevant personnel is essential. Not only are personnel to clearly understand the established policies and procedures but they are also to be held accountable for compliance.

THE ROLE OF SENIOR MANAGEMENT

17. The authority expects senior management to be responsible 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 are to address credit risk in all of the credit institution's activities and at both the individual credit and portfolio levels.

18. Amongst other factors, senior management must ensure that:

- the credit institution's credit-granting activities conform to the established strategy;

- written procedures are developed and implemented;

- loan approval and review responsibilities are clearly and properly assigned; and

- there is periodic independent internal assessment of the credit institution's credit-granting and management functions.

19. The authority considers the design and implementation of written policies and procedures related to identifying, measuring, monitoring and controlling credit as essential. Credit policies are to establish the framework for lending and guide the credit-granting activities of the bank. Hence these are to address items such as target markets, portfolio mix, price and non-price terms, the structure of limits, approval authorities, and exception processing and reporting. These policies must be clearly defined, consistent with prudent banking practices and relevant regulatory requirements, and adequate for the nature and complexity of the credit institution's activity.

20. Credit institutions must ensure that the credit portfolio is adequately diversified given the institution's target markets and overall credit strategy. These policies are to establish targets for portfolio mix as well as set exposure limits on single counterparties and groups of connected counterparties(5), particular industries or economic sectors, and specific products.

21. When credit institutions grant credit internationally, apart from the standard credit risk, they take over other risks such as country/sovereign risk and transfer risk. Credit institutions need to understand the globalisation of financial markets and the potential for spillover effects from one country to another or contagion effects for an entire region. Credit institutions must therefore have adequate policies and procedures to identify, measure, monitor and control country and transfer risk in their lending and investment activities incorporating any potential default of foreign private sector counterparties arising from country specific economic factors, the enforceability of loan agreements and the timing and ability to realise collateral under the national legal framework.

[5] Such limits should respect and comply with the provisions of the Large Exposures Directive (BD/02).

IDENTIFICATION AND MANAGEMENT OF CREDIT RISK IN PRODUCTS AND ACTIVITIES

22. The authority considers that the basis for an effective risk management process is the identification and analysis of existing and potential risks inherent in any product and activity.

23. Credit institutions are expected to identify such risks and to develop a clear understanding of the credit risks involved in more complex credit-granting activities. New ventures require significant planning and careful oversight to ensure that risks are appropriately identified and managed. Therefore new products and activities should be subjected to adequate risk assessment procedures and controls before being introduced or undertaken.

24. The authority emphasis the importance of the quality of the credit institution's staff allocated in any activity where there is borrower or counterparty credit risk. Senior management should be responsible to ensure that such staff is fully capable of conducting the activity to the highest standards and in compliance with the institution's policies and procedures.

THE CRITERIA FOR A SOUND CREDIT GRANTING PROCESS

CREDIT-GRANTING CRITERIA

25. Credit institutions should operate within a sound, well-defined credit-granting criteria, which is to include a clear indication of the institution's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment. Hence credit institutions need to ensure that they have sufficient information on borrowers or counterparty to enable them to make a comprehensive assessment of their true risk profile. In instances where actual or potential conflicts of interest are deemed to exist within an institution, internal confidentiality arrangements are to be established to ensure that there is no hindrance to the credit institution obtaining all the relevant information from the borrower.

26. Strict and efficient *know-your-customer* policies applied to borrowers or counterparties are considered of extreme importance for credit institutions to be confident that they are dealing with individuals or organisations of sound repute and creditworthiness thus avoiding association with individuals involved in fraudulent activities and other crimes.

27. The Large Exposures Banking Directive (BD/02) establishes what constitutes a group of connected customers. Apart from complying with the provisions of this Banking Directive, credit institutions also need to have procedures for aggregating and monitoring exposures to individual clients across business activities. Furthermore, in the case of syndicated loans, the authority considers it appropriate that all syndicate participants perform their own due diligence, including independent credit risk analysis and review of the syndicate terms prior to committing to the syndication.

28. The appropriate pricing of a credit as well as the overall profitability of the account relationship is conducive for credit institutions to assess the return of adequate compensation for the risks incurred. Collateral cannot be a substitute for a

comprehensive assessment of the borrower or counterparty, nor can it compensate for insufficient information for appropriate pricing.

29. The authority attaches great importance on the necessity of establishing provisions for identified and expected losses[6] and the holding of adequate capital to absorb losses. Credit institutions therefore need to factor these considerations into their credit-granting decisions and their overall portfolio risk management process.

CRITERIA FOR ESTABLISHMENT OF CREDIT LIMITS

30. The authority considers that, despite the parameters on limits set by the Large Exposures Banking Directive (BD/02), an important element of credit risk management is the establishment of exposure limits on single counterparties and groups of connected counterparties in all areas of activities of the credit institution that involve credit risk. Such limits are normally to be partly based on the internal risk rating assigned to the borrower or counterparty. However, it might also be appropriate for credit institutions to consider limits for particular industries or economic sectors and specific products.

31. The establishment of credit limits needs to factor in the recognition of the risks associated with the near term liquidation of position in the event of counterparty default. The authority therefore recognises the importance of stress-testing taking into consideration economic cycles, interest rates and other market movements and liquidity conditions.

PROCESS FOR APPROVING NEW CREDITS

32. The authority believes that the coordinating of a credit institution's credit granting process between the various units related to the credit approval function is of paramount importance to ensure that sound credit decisions are made. Therefore there must be policies in place regarding the information and documentation needed to approve new credits, renew existing credits and/or change the terms and conditions of previously approved credits. Moreover the granting approval process must establish accountability for decisions taken and designate who has the absolute authority to approve credits or changes in credit terms. Approval authorities should be commensurate with the expertise of the individuals involved.

33. The authority stresses that directors, senior management or other influential parties such as shareholders must not seek to override the established credit-granting and monitoring processes of the bank. A potential area of abuse may arise from granting credit to non-arms-length and related parties, whether counterparties or individuals[7]. It is important that credit institutions grant credit to such parties on an *arm's-length basis* and that the amount of credit granted is suitably monitored. Moreover the terms

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6 Refer to Banking Directive (BD/09) on loan loss provisioning.

7 Without prejudice to the provisions of the Banking Act 1994, related parties can include a credit institution's subsidiaries and affiliates, its major shareholders, directors and senior management and their direct and related interests, as well as any party that the institution exerts control over or that exerts control over the bank.

and conditions of such credits must not be more favourable than those granted to non-related borrowers under similar circumstances whilst imposing strict absolute limits on such credits[8].

MAINTAINING AN APPROPRIATE CREDIT ADMINISTRATION, MEASUREMENT AND MONITORING PROCESS

ONGOING ADMINISTRATION OF CREDIT RISK-BEARING PORTFOLIOS

34. The authority considers credit administration as being a critical element in the maintenance of the safety and soundness of a credit institution. Senior management of credit institutions must understand and demonstrate that it recognises the importance of this element of monitoring and controlling credit risk.

35. The wide range of responsibilities of the credit administration function normally dictates the organisational structure which varies with the size and sophistication of the institution. The development of credit administration areas within this structure calls for the consideration of the efficiency and effectiveness of operations with adequate segregation of duties and controls complemented by accurate and timely information to management and supported by a process of compliance with prescribed management policies and procedures as well as applicable laws and regulations.

36. The credit files are to include all the information necessary to ascertain the current financial condition of the borrower or counterparty as well as sufficient information to track the decisions made and the history of the credit. Well kept credit files should be of assistance not only for the administration of credits but also for internal/external audit and the authority itself.

MONITORING OF CREDITS

37. Credit institutions should develop and implement comprehensive procedures and information systems to monitor the condition and quality of individual credits and single obligors across the institution's various portfolios thus being able to assign internal risk ratings to the credit. This process should lead to the identification and reporting of potential problem credits and other transactions to ensure that they are subject to more frequent monitoring as well as possible corrective action and/or provisioning.

38. Monitoring on an ongoing basis of the underlying collateral and guarantees must be undertaken to assist the credit institution in making the necessary changes to contractual arrangements as well as maintaining adequate reserves and provisions for credit losses.

8 Refer to Article 21 of the Large Exposures Directive (BD/02).

INTERNAL RISK RATING SYSTEM

39. The authority considers the use of an internal risk rating system as an important tool in the monitoring of the quality of individual credits as well as the total portfolio. A well-structured internal risk rating system is a good means of differentiating the degree of credit risk in the different credit exposures. This allows a more accurate determination of the overall characteristics of the credit portfolio, concentrations, problem credits, and the adequacy of the loan loss reserves.

40. Normally, risk-rating systems categorise credits into various classes designed to take into account gradations in risk. In developing their systems credit institutions have to decide whether to rate the riskiness of the borrower or counterparty, the risks associated with a specific transaction, or both. Internal risk ratings are an important tool in monitoring and controlling credit risk.

41. To facilitate the early identification of changes in risk profiles, the credit internal risk rating system has to be responsive to indicators of potential or actual deterioration in credit risk. The initial ratings assigned to individual borrowers or counterparties must be reviewed periodically whilst credits with deteriorating ratings must be subject to additional oversight and monitoring.

42. To ensure that internal ratings are consistent and accurately reflect the quality of individual credits, the credit review function must preferably be independent of that which originated the credit concerned and periodically examined by an independent review group.

MANAGEMENT INFORMATION SYSTEMS

43. Methodologies that enable credit institutions to quantify the risks involved in exposures to individual borrowers or counterparties and to analyse credit risk at the product and portfolio level in order to identify particular sensitivities or concentrations should be established. The analysis of the credit risk data has to be undertaken at an appropriate frequency with the results reviewed against relevant limits. Measurement techniques used should be appropriate to the complexity and level of the risks involved in all credit activities, based on robust data, and subject to periodic validation.

44. The authority considers that the effectiveness of a credit institution's measurement process is highly dependent on the quality and timeliness of management information systems. Such systems must be able to aggregate credit exposures to individual borrowers and counterparties and report on exceptions to credit risk limits on a meaningful and timely basis. Management should therefore be able to identify any concentrations of risk within the credit portfolio whilst periodically reviewing the adequacy of the scope of information.

MONITORING OF THE CREDIT PORTFOLIO

45. Concentrations within credit portfolios is an ongoing source of credit risk requiring the implementation of systems for monitoring the composition and quality of an institution's portfolios. A high level of concentration may expose a credit institution to

adverse changes in the areas in which credits are concentrated. Concentrations to single or connected counterparties are partly mitigated by the Large Exposures Banking Directive (BD/02). Furthermore, although in the local context economic sectors are possibly the main source of concentration, credit institutions should monitor concentrations in other areas (industry, country and types of facilities and collateral) since concentration of risk applies to the whole range of activities that involve a counterparty risk and not to the granting of loans only.

46. The authority recognises that credit institutions may want to capitalise on their expertise in a particular industry or economic sector whilst being satisfied with the compensation of incurring certain concentrations of risk. Therefore, although credit institutions may not necessarily have to decline from taking sound loans solely on the basis of concentration they should take measures, including pricing or increased capital holdings for the additional risks, to reduce or mitigate concentrations. The engaging in credit activities that are not fully understood simply for the sake of diversification poses additional risks which credit institutions might not be in a position to measure, monitor and manage.

POTENTIAL FUTURE CHANGES AND STRESS TESTING

47. The identification of what may potentially go wrong in individual credits and the various credit portfolios of credit institutions and the factoring of this information within the analyses of the adequacy of capital and provisions is an important element of sound credit risk management. Scenario analysis and stress testing are useful ways of assessing areas of potential problems.

48. Stress testing is to involve the identification of possible events or future changes in economic conditions, such as economic or industry downturns, market-risk events and liquidity conditions, that may have unfavourable effects on credit institutions' credit exposures and assessment of their ability to withstand changes.

ENSURING ADEQUATE CONTROLS OVER CREDIT RISK

INDEPENDENT ASSESSMENT OF THE CREDIT RISK MANAGEMENT PROCESS

49. Credit institutions need to have in place an efficient internal review and reporting system in order to manage effectively the institution's various portfolios. This review function may assist in the evaluation of the overall credit administration process, determine the accuracy of internal risk ratings and also judge whether the account officer is monitoring individual credits properly. The authority attaches great importance to the independence of the credit review function, preferably reporting directly to the board of directors or a committee with audit responsibilities, or to senior management without lending authority.

MANAGEMENT OF THE CREDIT-GRANTING FUNCTION

50. The establishment and enforcement of internal controls, operating limits and other practices is considered important for credit institutions to ensure that their credit risk

exposures and the credit-granting function itself are within the set policies and credit risk objectives.

51. Internal audits on the credit risk processes are to be conducted periodically to determine that credit activities are in compliance with the credit institution's credit policies and procedures. Audits should help to identify areas of weaknesses in the credit risk management process, policies and procedures as well as any exceptions to policies, procedures and limits.

SYSTEMS FOR REMEDIAL ACTION

52. Systematic credit review processes should be able to identify a reduction of credit quality at an early stage, when more options are likely to be available for improving the credit. Credit institutions must therefore have a disciplined and vigorous remedial management process, triggered by specific events and that is administered through the credit administration and problem recognition systems.

53. A credit institution's credit risk policies must clearly lay down how it intends to manage problem credits. The authority considers it best that such responsibility be assigned to a specialised section, although this depends on the size and nature of the institution itself, the credit and the reasons for its problems.

CONCLUSION

54. The authority recommends that credit institutions establish sound and effective systems to identify, measure, monitor and control credit risk as part of an overall approach to risk management. Efficient internal review systems for assessing the overall quality of the credit portfolio are conducive for the board of directors and senior management, who bear the ultimate responsibility for credit risk management, to establish the adequacy of provisions and reserves.

55. The authority would expect the credit risk management approach used by the individual credit institutions to be commensurate with the scope and sophistication of their activity.

ANNEX[1]

PRINCIPLES FOR THE ASSESSMENT OF BANKS' MANAGEMENT OF CREDIT RISK

A. Establishing an appropriate credit risk environment

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.

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.

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

B. Operating under a sound credit granting process

Principle 4: Banks must operate within sound, well-defined credit-granting criteria. These criteria should include a clear indication of the bank's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.

Principle 5: Banks should establish overall credit limits at the level of individual borrowers and counterparties, and groups of connected counterparties that aggregate in a comparable and meaningful manner different types of exposures, both in the banking and trading book and on and off the balance sheet.

Principle 6: Banks should have a clearly established process in place for approving new credits as well as the amendment, renewal and re-financing of existing credits.

Principle 7: All extensions of credit must be made on an arm's-length basis. In particular, credits to related companies and individuals must be authorised on an exception basis, monitored with particular care and other appropriate steps taken to control or mitigate the risks of non-arm's length lending.

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1 *Source: Basle Committee on Banking Supervision Principles for the Management of Credit Risk, September 2000.*

C. Maintaining an appropriate credit administration, measurement and monitoring process

Principle 8: Banks should have in place a system for the ongoing administration of their various credit risk-bearing portfolios.

Principle 9: Banks must have in place a system for monitoring the condition of individual credits, including determining the adequacy of provisions and reserves.

Principle 10: 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.

Principle 11: 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 concentrations of risk.

Principle 12: Banks must have in place a system for monitoring the overall composition and quality of the credit portfolio.

Principle 13: Banks should take into consideration potential 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

Principle 14: Banks must establish a system of independent, ongoing assessment of the bank's credit risk management processes and the results of such reviews should be communicated directly to the board of directors and senior management.

Principle 15: Banks must ensure that the credit-granting function is being properly managed and that 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.

Principle 16: Banks must have a system in place for early remedial action on deteriorating credits, managing problem credits and similar workout situations.