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Credit Risk Management in Malta's Banks

Introduction

It is a priority for the ECB and MFSA to assess how banks are managing their credit risk profiles as economies emerge from the pandemic. This is because banks should be identifying where customers might be having trouble and putting in place appropriate management strategies to support them, but also to record the deterioration in credit risk that they observe as Covid pandemic support measures are gradually withdrawn.

The MFSA assessed credit risk management in a number of banks during 2021. We will assess others next year. There are areas we think boards and management should review to satisfy themselves they are operating in line with expected standards and ensuring their capital properly reflects the risks in their balance sheets, namely:

- Improving the quality of data used to support credit decisions. This is important as banks are more likely to be able to lend if the quality of financial reporting by their clients improves. It is also easier for banks to perform the required assessments of lending counterparties if their own reporting quality is good;
- Enhancing their systems to facilitate the identification of credit problems earlier on via the implementation of objective Early Warning Indictors (EWIs) and Unlikely-to-Pay (UTP) triggers. Banks are required to hold more capital where their systems cannot accurately identify the credit risk on their balance sheets or where their or UTP processes are not considered adequate;
- Recording the granting of concession/forbearance measures to borrowers correctly to ensure accurate information is available on the potential for credit deterioration. Boards and management will have a better understanding of balance sheet risk if they ensure these measures are reported.

The MFSA will continue its supervisory review work into 2022. This will include a review of the credit risk sections of ICAAPs to determine how Boards have ensured appropriate credit risk identification, management, mitigation, monitoring and reporting.

Managing a smooth exit from the economic stress of the pandemic as support measures are gradually withdrawn

After the COVID-19 pandemic hit last year, the government, MDB, ECB and MFSA introduced a range of support measures to ensure banks could support the real economy through the pandemic. The measures included but were not limited to:

- Guarantees to banks on lending to customers who needed financing through the economic stress that accompanied the pandemic;
- Interest rate subsidies to help firms access bank credit;
- Transitional arrangements for the implementation of IFRS 9 to alleviate its impact on bank capital;
- Dividend restrictions to avoid premature release of profits that could be used to support the banking system through the economic challenge;
- Loan moratoria to ensure those businesses that encountered liquidity shortage were not disadvantaged by regulatory rules.

These measures will gradually reduce as economic activity gradually returns to pre-pandemic levels. Banks have a role in supporting the recovery through the management of clients and credit risk during this period. It is important that banks have an IT system and trained staff to manage the recovery phase.

Training and development of staff and board members to ensure there is a good quality understanding of the credit risk environment and the regulatory and accounting regimes will help support this phase and the development of skills for assessing new business opportunities after the pandemic.

MFSA Observations

i. Recognition and treatment of forbearance

In line with definitions laid down in the CRR[1] (Article 47b), credit institutions should have sufficient internal controls in place to identify, assess, monitor and record forborne exposures supported by comprehensive forbearance and restructuring policies and procedures.

In many cases, we observed that procedures could be enhanced to take on board the following points:

1. Capture the rationale for exposure modification and forbearance. This means having sound processes to identify whether a modification of terms is granted to either i) maintain a client, ii) modify an inadequate debt structure, or iii) assist a client who is or is likely to exhibit financial difficulties;
2. Introducing a list of concessions within the Credit Risk Policy. This would help banks demonstrate how they are capturing forbearance measures, including short-term versus long-term solutions[2]; and
3. Performing a financial difficulty test at debtor level[3].

[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms.
[2] Section 3.5.3 in ECB Guidance to banks on NPLs - https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf
[3] Article 47b(4) of CRR and Section 5.3.1 of the ECB Guidance to banks on NPLs

Banks should be able to demonstrate to the regulator that they performed an affordability assessment where they have identified signs of distress at a client. This should help them show how they ensured a viable loan restructuring was granted. The MFSA observed that most of the banks were applying forbearance measures to exposures without performing an affordability assessment and thus were not in a position to do this.

Exposures that have received forbearance measures should be subject to enhanced monitoring, from the start of the forbearance period until its expiry. We noticed that oftentimes the flagging of forbearance did not correspond to more frequent monitoring; rather the 'regular' cycle still applies. Boards and management should document the monitoring cycle in the credit risk policy and consider whether any Pillar 2 capital should be held against the risk of not having a timely and effective review procedure in operation in their ICAAP.

Improper flagging of forbearance exposures may lead to inadequate monitoring and underestimation of risk and capital. It could also lead to banks having client management strategies which are not documented or not in line with the board's expectations.

ii. Exit criteria from non-performing and forborne categories

The Authority emphasises that non-performing forborne exposures can be moved to the performing-forborne category, only when **all** the following three conditions are met:

1. Exposures no longer meet the criteria for NPE classification;
2. One year has passed since the forbearance measure was granted or the exposure was classified as NPE, whichever is later; and
3. No past-due amounts are present and the credit institution is satisfied about the likelihood of full and timely repayment.

Similarly, all the following three conditions need to be met for a performing forborne exposure to exit probation:

1. 2 years have passed since the forborne exposure was reclassified as performing;
2. Regular and timely payments during at least half of the period the exposure would be under probation leading to the payment of substantial aggregate amount of principal or interest; and
3. None of the exposures of the obligor is more than 30 days past due.

We observed that banks are not able to demonstrate that all conditions are assessed when exposures are cured, particularly the conditions which require the exercise of professional judgement (conditions 3 and 2 in the two sections above respectively).

Credit institutions should document and retain on file all the assessments and analysis performed when granting, monitoring and exiting the forbearance status.

iii. Early Warning Indicators

Credit institutions should implement adequate internal procedures, including designing the necessary internal reports, to identify and manage potential non-performing obligors at a very early stage. Procedures should not be solely based on the number of days past due[4].

We have observed that following general weaknesses in this sphere that need to be addressed:

1. Early Warning Indicators should be tailored for each portfolio, e.g. we would not expect a bank to set the same EWIs for retail and corporate exposures;
2. EWIs should have a dual perspective, i.e. banks should have EWIs at the portfolio as well as borrower levels[5]; and
3. Banks should review key EWIs on a monthly basis[6] by the first line of defence and overseen independently by the second line of defence. Banks should document where they differentiate key indicators that are subject to monthly review from those that are not. Where banks have the IT capabilities to support it, they may introduce an automated alert system to expedite the identification of deterioration and limit manual intervention.

iv. Unlikely-to-pay triggers

We stress the importance of performing an UTP assessment in conjunction with the counting of days past due to appropriately classify exposures. In this respect, credit institutions are reminded to include a list of unlikely to pay triggers within their suite of credit policies, which should include '*pre-defined automatic events – wherever possible – and manual events in place*'[7].

We observed that banks might use phrases such as *'material decrease in turnover'* and '*clear and material danger to the permanence of the business'* as UTP criteria. Whilst this is good in so far as it goes, the MFSA would expect to see 'material' defined, and for corporate exposures, a calculation of the turnover and debt coverage that might be used to identify a specific customer deterioration. These triggers should be set prudently so the right alerts are raised to trigger a review of the credit file. Setting *unclear, ambiguous and unquantifiable* triggers should be avoided or kept to a minimum in order to limit individual discretion[8].

Loss of a major customer is also a good UTP criteria. The MFSA would like to understand the mechanisms banks have in place to identify whether this event has taken place – e.g. in the documentation of the client review or transcripts of informal interactions with clients or through client reporting. Where banks set this as a criterion, they should be able to explain to the MFSA how it is put into operation.

[4] S. 3.6.1 of the ECB Guidance to banks on NPLs
[5] Annex 4 and Section 3.6.1 of the ECB Guidance to banks on NPLs
[6] Section 3.6.2 and Annex 4 ECB Guidance to banks on NPLs
[7] Section 5.2.2. of the ECB Guidance to banks on NPLs
[8] Table 2 of the ECB Guidance to banks on NPLs

We observed that UTP triggers were not always designed according to the specificities of each loan portfolio, appropriately communicated to the personnel responsible for credit granting and on-going monitoring.

Banks should also have arrangements to react to events that impact their customers. This means, they should not rely only on an annual review of a customer file to identify whether a deterioration in credit quality has occurred. They should be able to evidence how they gather intelligence on market events, analyse macroeconomic trends which may put pressure on their clients' operations or use periodic client reporting (including through the monitoring of contractual covenants). Measures such as these are important to identify and manage credit risk. The earlier the issue is identified, the earlier its management and the higher the likelihood that suitable measures are provided to the client to achieve a turnaround at an individual level and at portfolio level, a possible change in risk appetite may be deemed necessary. In the long run, prompt identification of early signs of deterioration is likely to reduce the overall risk level.

Moreover, we emphasise that the assessment of UTP triggers should not be solely restricted to a regular cycle but this assessment should occur when a trigger event materialises. To facilitate this, the credit institution should also have in place pre-defined automatic events, as mentioned earlier, whereby the exposure can be classified as non-performing exposure without the need of further manual intervention[9].

Furthermore, banks should include any triggers in the Proposal Form or Review Sheets to ensure that each trigger is assessed as part of the routine credit monitoring reviews. The review of UTP triggers should be formalised to ensure that the First Line of Defense is assessing all the relevant triggers and not relying solely on the 90 days past due criterion to downgrade an obligor to the non-performing category.

v. IT Systems

We have identified that some banks are still integrating IT systems to implement their forbearance policy which will allow them to identify, assess, monitor and record exposures subject to forbearance measures appropriately. IT systems should allow for the identification of concessions, thereby prompting the user to assess whether the obligor is experiencing distress and subsequently, ensure that the forbearance measure will lead to a sustainable repayment (i.e. perform an affordability assessment).

It is helpful where banks can show their IT system includes automated alerts at obligor level with clear escalation-procedures, which should be aligned with the early warning policies.

[9] Section 5.2.2. of the ECB Guidance to banks on NPL

vi. Maintenance of Credit Files

When inspecting credit files, we observed a need for a more robust and coherent set of corporate client documentation to enable a quality analysis of a client's current and expected financial performance and ensure appropriate classification. The following is a non-exhaustive list of documentation that should be retained on file:

1. Up to date audited accounts and periodical management accounts should be sought on a regular basis;
2. Information on privileged creditors should also be kept up to date;
3. Formal documentation of clients' meetings and site visits;
4. Credit files should not only have historical information, but credit institutions should also have forward looking information, such as updated business plans and cashflow forecasts.

ICAAP Considerations

Banks should consider how to document their assessment of the issues highlighted in this circular in their ICAAP. Some areas that they might consider are:

- The extent to which data quality issues are an impediment to the proper assessment of unlikely to pay or credit deterioration in their client base and the measures they are taking to improve the situation;
- Any measures taken to update their policies on EWIs and UTP to ensure compliance with regulatory expectations;
- The process for identifying and recording forbearance and the amount of loans subject to forbearance;
- The way in which they have integrated unlikely to pay triggers and affordability assessments into their credit risk reviews;
- The evidence they have to show that the stresses used to calculate the lifetime expected losses appropriately reflect the level of uncertainty as the economy returns to a normalized pattern;
- Their assessment for Pillar 2 capital for credit risk where additional capital to cover the points made in this circular might be required. This should be alongside other credit risk related Pillar 2 assessments (e.g. concentration, large exposures, geographic profile);
- Their processes for valuing collateral including the extent to which they use independent estimates and factor in the recoverability of collateral and its realistic realisable value; and
- An assessment of overall balance sheet resilience factoring in the gross exposure level mitigated by collateral, capital and provisions.

Concluding Remarks

The MFSA expects boards of banks in Malta to benchmark themselves against the findings and recommendations set out in this publication and take action where appropriate. This should accompany any specific actions set out in supervisory feedback to individual credit institutions. The Authority will engage with, and assess, the approach taken by boards as part of its supervisory assessments in 2022. The outcomes of these assessments will be incorporated in the SREP letters and ongoing supervisory dialogues.

Triq l-Imdina, Zone 1 Central Business District, Birkirkara CBD 1010
+356 2144 1155
communications@mfsa.mt
www.mfsa.mt