RESERVE BANK OF VANUATU

DOMESTIC BANK
PRUDENTIAL GUIDELINE NO. 1

CREDIT RISK MANAGEMENT FOR LICENSED FINANCIAL INSTITUTIONS

A. PURPOSE

This document sets out the minimum policies and procedures that each bank needs to have in place and apply within its credit risk management programme, and the minimum criteria it should use, to prudently manage and control its credit portfolio and exposure to credit risk.

Experience indicates that credit quality goes hand in hand with financial soundness. Deterioration in credit quality is often a sign of problems in a bank. The major risk accompanying a weakening of the credit portfolio is the impairment of capital or liquidity.

For most banks, extending credit comprises the major portion of their business. To a great extent, therefore, the quality of the institution's credit portfolio determines the risk to depositors.

Credit risk management should be conducted within the context of a comprehensive business plan. Although this document focuses on a bank's responsibility for managing and controlling its credit portfolio and exposure to credit risk, it is not meant to imply that credit risk can be managed in isolation from asset/liability management considerations, such as the need to maintain adequate liquidity, or other risks.

B. DEFINITION

Credit is the provision of, or a commitment to provide funds or substitutes for funds (both on- and off-balance sheet), on a secured or unsecured basis, to a debtor who is obliged to repay, on demand or at a fixed or determinable future time, the amount borrowed together with fees and/or interest thereon.

Credit risk is the risk of financial loss resulting from the failure of a debtor, for any reason, to fully honour its financial or contractual obligations to the institution.

C. CREDIT RISK MANAGEMENT PROGRAMME

Managing credit risk is a fundamental component in the safe and sound management of all banks. Sound credit risk management involves prudently managing the risk/reward relationship and controlling and minimising credit risks across a variety of dimensions, such as quality, concentration, currency, maturity and security.

Although the particulars of credit risk management will differ among banks, depending upon the nature and complexity of their credit functions and portfolios, a comprehensive credit risk management programme requires:

- identifying existing or potential credit risks to which the institution is exposed in conducting its business activities and developing and implementing sound and prudent credit policies to effectively manage and control these risks;

- developing and implementing effective credit granting, documentation and collection processes; and

- developing and implementing comprehensive procedures to effectively monitor and control the nature, characteristics, and quality of the credit portfolio.

Credit Risk Identification and Risk Management Policies

The foundation of an effective credit risk management programme is the identification of the existing and potential risks inherent in the bank's credit products and credit activities, and the development and implementation of clearly defined policies, formally established in writing, that set out the credit risk philosophy of the institution and the parameters under which credit risk is to be controlled.

Pressure for increased profitability, marketing considerations and a vastly more complex financial environment have resulted in innovative credit instruments and approaches to credit. Measuring the risks attached to each credit activity permits the determination of aggregate exposures to counterparties for control and reporting purposes, concentration limits and risk/reward returns.

Credit policies establish the framework for lending and reflect the bank's credit culture and ethical standards. To be effective, policies must be communicated in a timely fashion, be implemented through all levels of the organization by appropriate procedures and revised periodically in light of changing circumstances.

Credit policies need to contain, at a minimum:

- a credit risk philosophy governing the extent to which the institution is willing to assume credit risk;

- general areas of credit in which the institution is prepared to engage or is restricted from engaging;

- clearly defined and appropriate levels of delegation of approval, and provision or write-off authorities; and

- sound and prudent portfolio concentration limits.

These policies need to be developed and implemented within the context of a credit risk management environment that ensures that all credit dealings are conducted in the highest possible standard of ethical behaviour.

i) Credit Risk Philosophy

The credit risk philosophy is a statement of principles and objectives that outlines the bank's willingness to assume credit risk and will vary with the nature and complexity of its business, the extent of other risks assumed, its ability to absorb losses and the minimum expected return acceptable for a specific level of risk.

ii) General Areas of Credit

The general areas of credit in which a bank is prepared to engage usually specify product lines, types of credit facilities, types of borrowers, or industries in which an institution may focus its marketing efforts or may establish constraints restricting an institution's activities.

iii) Approval Authorities

Clearly defined and appropriate levels of authorities for credit approval, provisions or write-offs help ensure that credit decisions are prudent and acceptable, that the integrity and credibility of the credit process is protected by fair, consistent and objective credit decisions, and that the risk is acceptable given the expected return.

Approval limits may relate to size, security or other criteria, such as industry sector. Authorities may be absolute, incremental or a combination thereof and may also be individual, pooled, or shared within a committee.

The delegation of authority needs to be clearly documented, and must include as a minimum:

- the absolute and/or incremental credit approval authority being delegated;
- the provision or write-off authority being delegated;
- the officers, positions or committees to whom authority is being delegated;
- the ability of recipients to further delegate risk approval and write-off authority; and
- the restrictions, if any, placed on the use of delegated risk-approval and write-off authorities.

The degree of delegation of authority will depend on a number of variables including:

- the institution's risk philosophy and credit culture;
- the quality of the credit portfolio;
- the degree of market responsiveness required;
- the types of risks being assessed; and

- the experience of lending officers.

iv) Portfolio Concentration Limits

Concentration occurs when an institution's portfolio contains an excessive level of credits to:

- a single counterparty;
- a group of associated counterparties;
- an industry;
- one type of credit facility; or
- a class of security.

Excessive concentration renders an institution vulnerable to adverse changes in the area in which the credit is concentrated, and to security impairment.

Sound and prudent portfolio management and control involves the minimization of concentration risk by developing and implementing policies and procedures to ensure the diversification of the credit portfolio. At a minimum, credit diversification policies must be:

- stated clearly;
- include goals for portfolio mix; and
- place exposure limits on single counterparties and groups of associated counterparties and related entities, key industries or economic sectors and new or existing products.

The principal criteria in determining single counterparties are:

- the capability of the borrower to satisfy its commitments without support from external sources; and
- the independence of the borrower from the obligations (financial or otherwise) of others.

Associated counterparties may be a group of persons related financially or by common ownership, management, research and development, marketing or any combination thereof. Identification of associated counterparties requires analysis of the impact of these factors on the financial dependency of the parties involved.

To ensure that a bank is not excessively exposed to a single or associated counterparty, credit limits need to be established within the context of the bank's aggregate exposure to such counterparties, in terms of both the total credit extended and the total investment in security instruments issued by such counterparties.

Single counterparty and associated counterparty groupings need to be reviewed regularly to ensure that prior considerations have not changed to an extent that would warrant reclassification.

Credit Granting, Documentation and Collection Process

The most significant risk that a bank faces in the credit granting and collection process is default. Default occurs if a counterparty does not perform its obligations according to the terms of the credit agreement.

To minimize its exposure to loss through default, each bank must give proper consideration to, and conduct an assessment of, each credit (and the credit risks associated with each credit or type of credit) prior to the approval or the disbursement of funds, and ensure that credits are appropriately documented. These procedures to evaluate and document each credit proposal need to be accompanied by clearly defined procedures for collection and regular monitoring.

i) Evaluating Credit Proposals

Although some well constructed credits can deteriorate because of unforeseen circumstances, most credit problems stem from disregarding or inadequately assessing basic lending principles, including:

- the purpose of the credit and source of repayment;

- the character, integrity and reputation of the borrower to promptly and willingly repay debts or fulfil contractual obligations;

- the borrower's capacity to repay, based on historical financial trends and cash flow projections; and

- the adequacy of collateral.

For commercial credits, the borrower's business or management capability and the status of the borrower's industry and its position within that industry also need to be considered.

Major influences on the credit approval process are the bank's market share, growth or profitability. An overemphasis on any of these factors may expose the bank to undue risks resulting from:

- a relaxation in credit quality standards, including the assumption of borrowers' risks, the excessive granting of subordinated credit, or the provision of credit with overgenerous terms, conditions or amounts; or

- an adjustment of target market criteria or entrance into untested markets or products.

To develop and maintain a sound credit portfolio, each bank must have a prudent and effective formal evaluation process that provides for an independent and objective assessment of credit

proposals. In this context, where circumstances warrant, consideration should be given to the formation and use of specialist credit groups for significant product lines, types of credit facilities, and the sectors in which the institution is engaged.

A strong credit process independent of the marketing function is an effective means of ensuring that credit risks are appropriately analyzed and reviewed, and are within the parameters of the bank's credit policies. The details of the analysis, however, will vary with the areas of credit the institution is engaging in. Commercial credits require extensive analysis; a retail portfolio may not require the same degree of assessment. In all cases, sufficient analysis must be made to properly assess the integrity of the borrower, the borrower's ability to repay, and, where applicable, the value of collateral pledged.

ii) Credit Documentation

In developing and maintaining a sound portfolio, the terms of each credit must be adequately and accurately documented. Inadequate, incomplete, or unenforceable documentation could lead to non-recovery of funds, particularly in instances where lenders are obliged to resort to litigation for credit recovery.

For a bank to conduct meaningful credit reviews and ensure that assets are soundly and conservatively valued, it must maintain credit files supporting the credit granting and review process.

Each credit file needs to contain, at a minimum, information that:

- identifies the borrower by name and occupation or type of business, and identifies consigners, endorsers, guarantors and connected counterparties;

- provides evidence of the borrower's legal ability to borrow, financial condition, and ability to repay including, the timing and source of repayment;

- describes the terms of the credit obligation, including the purpose of the credit;

- describes and evaluates the collateral, indicating the marketability and/or condition thereof;

- provides a history of the credit, including copies of the most recent credit authorization and internal credit reviews, and evidence of the level of approval; and

- where applicable, describes the relationship of the borrower to owners, directors and management of the bank..

iii) Credit Collection Process

All banks need to have in place procedures governing the collection of principal, interest and fees to ensure that such payments are received on a timely basis, in accordance with the terms of repayment, and are appropriately recorded.

Although most credits are ultimately repaid in full, it is recognized that all banks are exposed to risk of default and, therefore, some credit write-offs may be expected.

A reduction in credit quality needs to be recognized at an early stage when there are still a number of strategic options open to the institution in managing its default risk. These options include referral to an internal credit workout group, where values suggest the need for renegotiation of the terms of the credit, and reorganization or liquidation of the borrower in order to minimize potential loss to the bank. Renegotiation must not, however, be used to disguise serious weaknesses in a credit. Recovery efforts require a well conceived strategy and timetable.

Credit Portfolio Monitoring and Control

Failure to establish adequate procedures to effectively monitor and control the credit function within established guidelines has resulted in credit problems for many banks. Compromising credit policies and procedures has been another major cause of credit problems.

Accordingly, each bank needs to develop and implement comprehensive procedures and information systems to effectively monitor and control the characteristics and quality of its credit portfolio. These procedures need to define prudent criteria for identifying and reporting potential problem accounts to ensure that such accounts are identified for more frequent review, followed up with appropriate corrective action, classified as unsatisfactory where appropriate, and that provisions are made where necessary.

Categorization of the credit portfolio by credit characteristic, risk rating and regular review of individual and groups of credits within the portfolio, and independent internal credit inspections or audits are integral elements of effective and prudent portfolio monitoring and control.

i) Portfolio Characteristics

In order to track portfolio diversification characteristics, each bank needs to have in place a system to enable credits to be grouped by single and associated groups of counterparties, types of credit facilities, and industries.

ii) Credit Rating Systems

Each institution needs to have a credit rating system that defines risk-rating criteria and rates credits according to those criteria.

Internal credit ratings provide an effective tool for monitoring the level and trends in the quality of individual credits and the credit portfolio by highlighting credits or segments of the portfolio that warrant special attention.

At a minimum, a rating system should permit credits to be classified as:

- satisfactory or acceptable risk;

- below standard risk (or substandard); and
- unsatisfactory risk or doubtful (for example, credits in which payments are contractually past due, credits in which partial or complete provisions for loss have been made, or credits not adequately supported by collateral, where appropriate).

Furthermore, each bank needs to develop and implement appropriate policies for classifying credits as non-accrual and conservative accounting policies for recognizing revenue related to such accounts. Usually, credits are classified non-accrual whenever there is serious doubt as to the ultimate collectibility of principal or interest, whenever a provision for loss has been recorded against the account, or where interest owing remains uncollected 90 days following its contracted or scheduled date for payment. Normally, revenue should not be recognized through the capitalization of interest in any manner, except where this was specifically agreed upon with the client and formed part of the original terms of the credit and the loan continues to be adequately collateralized or is otherwise in good standing.

Usually, commercial credit needs to be rated individually. Retail portfolios, however, consisting of relatively smaller credits of a similar nature, may permit the adoption of procedures that rate all credits as satisfactory, unless there are indications to the contrary, with only unsatisfactory credits requiring individual attention.

iii) Credit Review

Most outstanding credits and commitments to extend credit are contingent upon borrowers maintaining specific credit standards. Consequently, banks need to regularly monitor the status of borrowers and re-evaluate individual credits and commitments, and their ratings, particularly credit to owners and directors. Reliance on unreviewed credits and optimistic economic forecasts can lead to a serious undetected deterioration of the credit portfolio. Accordingly, the credit risk management programme of each bank must include procedures governing the regular formal review and, where applicable, the re-rating of individual credits.

An effective internal credit review system should include as a minimum an independent review, with regular analysis, and a re-rating of credits by account officers. Because of their frequent contact with borrowers, account officers are in a position to detect changes in a borrower's operations or financial condition. This permits these officers to identify potential problems before they may be discovered by independent credit reviewers. Accordingly, credit review systems must ensure that an account officer is monitoring credit quality and, where applicable, underlying security on an on-going basis.

The nature, complexity and degree of analysis and the quantity of credits re-evaluated under a credit review process will vary with the type and sophistication of credits in the portfolio. Each commercial credit should be reviewed at least annually; retail credits, however, may need less frequent individual review. Credits on the security of real estate may require more frequent review.

Common objectives of effective credit review systems include:

- ensuring that the bank is aware of the borrowers' current financial condition;
- ensuring that collateral security is adequate and enforceable relative to the borrowers' current circumstances;
- ensuring that credits are in compliance with their covenants and margins;
- providing early identification and classification of potential problem credits; and
- providing current information regarding the quality of the loan portfolio.

iv) Internal Credit Inspection/Audit

Internal credit inspections/audits verify the continuing adequacy and applicability of credit risk management policies and procedures, provide an independent assessment of the credit portfolios' existence, quality and value, the integrity of the credit process, and promotes detection of problems relating thereto. Assessments should, at a minimum, randomly test all aspects of credit risk management in order to determine that:

- credit activities are in compliance with the bank's credit and accounting policies and procedures, and with the laws and regulations to which these credit activities are subject;
- credits exist, are duly authorized, and are accurately recorded and appropriately valued on the books of the bank;
- credits are appropriately rated;
- credit files are complete;
- potential problem accounts are being identified on a timely basis and determine whether the bank's provision for credit losses is adequate; and
- credit risk management information reports are adequate and accurate.

Assessments of the credit risk management activities should be presented to the bank's board of directors on a timely basis for review.

Conflict of Interest and Confidentiality

Each bank needs to have in place procedures to prevent conflicts of interest and preserve confidentiality.

Conflict of interest in the credit process occurs if persons use their connections or influence to obtain funds for themselves or their interests. Conflict of interest may lead to the extension of credit on an unsound basis -- because individuals within the credit process may be subject to

influence by such persons and, therefore, may not be in a position to evaluate and reject credit applications on the same basis as credit requests from other persons dealing with the bank at arm's length.

Releasing confidential information without a client's prior consent may adversely impact upon the reputation and stature of the bank and may bring the institution into disrepute.

D. ROLE OF THE BOARD OF DIRECTORS

The board of directors of each bank is ultimately responsible for the integrity of the institution's credit risk management function. In discharging its responsibility, the board usually charges management with developing credit policies for the board's approval, and developing and implementing procedures to manage and control the structure and quality of the bank's credit portfolio, and the level of credit risk assumed, within these policies, and ensuring that such policies remain adequate, comprehensive and prudent.

The board needs to have a means of ensuring compliance with the credit risk management program. The board generally ensures compliance through periodic reporting by management and internal inspectors/auditors. The reports must provide sufficient information to satisfy the board that the bank is complying with its credit risk management policies.

At a minimum, the board should:

- review and approve credit risk management policies recommended by the institution's management;
- review periodically, but at least once a year, the credit risk management programme;
- ensure the selection and appointment of qualified and competent management to administer the credit risk function;
- ensure that an internal inspection/audit function reviews the credit operations to assess whether or not the institution's policies and procedures are being adhered to, and whether the policies effectively contribute to the achievement of corporate objectives;
- review credits to, or guaranteed by, officers of the institution, including policies related thereto;
- review credits to directors or firms in which they are partners, directors or officers, including policies related thereto;
- review credits to corporations controlled by the bank, or their officers or directors, including policies related thereto;
- ratify credits exceeding the level of authority delegated to management;
- review significant credit exposures;

- review trends in portfolio quality and the adequacy of the institution's provision for credit losses; and

- outline the content and frequency of management reports to the board on credit risk management.

E. ROLE OF MANAGEMENT

The management of each bank is responsible for implementing the institution's credit risk management policies and ensuring that procedures are put in place to manage and control credit risk and the quality of the credit portfolio in accordance with these policies.

Although specific credit risk management responsibilities will vary from one bank to another, management at each institution is responsible for:

- developing and recommending credit risk management policies for approval by the board of directors;

- implementing the credit risk management policies;

- ensuring that credit risk is managed and controlled within the credit risk management programme;

- ensuring the development and implementation of appropriate reporting systems with respect to the content, format and frequency of information concerning the credit portfolio and credit risk, to permit the effective analysis and the sound and prudent management and control of existing and potential credit risk exposure;

- monitoring and controlling the nature and composition of the institution's credit portfolio;

- monitoring the quality of the credit portfolio and ensuring that the portfolio is soundly and conservatively valued, uncollectible credits written off, and probable losses adequately provided for;

- ensuring that an internal inspection/audit function reviews and assesses the credit portfolio and credit risk management programme;

- developing lines of communication to ensure the timely dissemination of credit risk management policies and procedures and other credit risk management information to all individuals involved in the credit process; and

- reporting comprehensively on significant credit activities, the composition and quality of the credit portfolio, and the credit risk management program to the board of directors at least once a year.

GLOSSARY

Associated Counterparties

A group of persons related financially or by common ownership, management, research and development, marketing or any combination thereof. Identification of associated counterparties requires analysis of the impact of these factors on the financial dependency of the parties involved. Associated counterparties may either be at arms-length from a licensee or maybe associated with a licensee.

Concentrated Lending

Occurs when an institution's credit portfolio contains an excessive level of exposure to a single counterparty, a group of associated counterparties, an industry, one type of credit facility, or a class of security.

Credit

The provision of, or a commitment to provide funds or substitutes for funds (both on- and off-balance sheet), on a secured or unsecured basis, to a debtor who is obliged to repay, on demand or at a fixed or determinable future time, the amount borrowed together with fees and/or interest thereon.

Credit Risk

The risk of financial loss resulting from the failure of a debtor, for any reason, to fully honour financial or contractual obligations to an institution.

Risk Management

The process of controlling the impact of risk-related events on the institution.

Risk Philosophy

A statement of principles and objectives that outlines an institution's willingness to assume risk. An institution's risk philosophy will vary with the nature and complexity of its business, the extent of other risks assumed, its ability to absorb losses and the minimum expected return acceptable for a specific level of risk.

Risk Position

The amount of an institution's exposure to a particular risk.

Single Counterparty

A borrower that is capable of satisfying its commitments without support from external sources and is independent from the obligations (financial or otherwise) of others.