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Management of Credit Risk

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Abstract: . *While commercial banks have faced problems for many years for a number of reasons, the most fundamental cause of serious banking problems is directly related to lenient standards applied to credit granted to borrowers and counterparties, poor risk management of their portfolios, or failing to concentrate on changes in economic or other factors that lead to a decline in the creditworthiness of a bank's counterparties. This is a general trend for both G-10 and non-G-10 countries.*

Keywords: Credit risk.

I. INTRODUCTION

1. While commercial banks have faced problems for many years for a number of reasons, the most fundamental cause of serious banking problems is directly related to lenient standards applied to credit granted to borrowers and counterparties, poor risk management of their portfolios, or failing to concentrate on changes in economic or other factors that lead to a decline in the creditworthiness of a bank's counterparties. This is a general trend for both G-10 and non-G-10 countries.
2. Credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. The goal of credit risk management is to maximise a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Banks need to manage the credit risk inherent in the whole portfolio as well as in single credits or transactions. Banks must also take into account the interrelations between credit risk and other risks. The proper management of credit risk constitutes an element of integrated risk management policy and is crucial to the long-term prosperity of any banking entity.
3. For most banks, loans are the biggest source of credit risk; however, credit risk is but one of the sources of such risks, and it pervades all the operations of a bank, both on and off balance sheet, both in the banking book and in the trading book, to include acceptances, interbank transactions, trade financing, foreign exchange and other financial instruments such as financial futures, swaps, bonds, equities, and options and in the extension of commitments and guarantees, and the settlement of transactions.
4. As exposure to credit risk remains the number one source of problems in banks across the globe, there is much for banks and their supervisors to learn from past experiences. Banks should now be attuned with the realization that they must identify, measure, monitor and control credit risk as well as determine that they hold enough capital against such risks and that they receive adequate rewards for risks assumed. The Basel Committee is publishing this paper to encourage banking supervisors around the world to foster sound practices for managing credit risk. While the principles in this paper are of greatest relevance for banks and bank supervisors, others interested in the management of credit risk also will find value here. Clearly relevant to lending, they should be applied to every business activity where credit risk exists.
5. The sound practices contained in this paper relate to the following areas:

(i) establishing a suitable credit risk environment; (ii) operating under a sound process for granting credit; (iii) having a suitable process for credit administration, measurement and monitoring; and (iv) ensuring controls over credit risk are satisfactory. Although specific

Credit risk management practices differ among banks as a function of the type and complexity of their credit activities, a comprehensive credit risk management program will address these four areas. These practices should also be used in conjunction with other good practices directed toward the assessment of asset quality, the level of provisions and reserves, and the disclosure of credit risk, all of which are discussed in other recent documents from the Basel Committee.

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6. While the particular approach that any particular supervisor will take will depend in large part on a variety of factors, including their on-site and off-site supervisory techniques and the extent to which external auditors also are made part of the supervisory process, all of the members of the Basel Committee concur that the principles set out in this paper are to be used in assessing a bank's credit risk management system. Supervisory expectations concerning the credit risk
the management approach used by individual banks be commensurate with the scope and sophistication of the bank's activities. For smaller or less sophisticated banks, the supervisors should be assured that the approach used in managing credit risk is appropriate for their activities and that adequate risk-return discipline has been instilled in their credit risk management processes. The Committee prescribes in Sections II to VI of the paper, principles
for banking supervisory authorities to use in evaluating bank's systems for the management of credit risk. The annex also contains a general outline of credit problems that are often noted
by supervisors.

7. A settlement-related credit risk involves the settlement of financial transactions. When one side of the transaction is settled but the other is not, then a loss may be incurred that is equivalent to the principal amount of the transaction. Even if one party is only late in settling, then the other party may suffer a loss associated with lost investment opportunities.

Settlement risk (i.e. the risk that the completion or settlement of a financial transaction will fail to take place as expected) therefore encompasses aspects of liquidity, market, operational and credit and reputational risk. The inherent level of risk is determined by the particular arrangements for settlement. Factors in such arrangements which bear on credit risk include: the timing of the exchange of value; payment/settlement finality; and the role of intermediaries and clearing houses.

8. This paper was originally published for consultation in July 1999. The Committee is grateful to the central banks, supervisory authorities, banking associations, and institutions that wrote comments. These comments helped form this final version of the paper.

Principles for the Assessment of Banks' Management of Credit Risk

A. Building a Suitable Credit Risk Environment

Principle 1: The board of directors should be responsible for the approval and periodic review (at least on an annual basis) of the bank's credit risk strategy and major credit risk policies. Such strategy must reflect the bank's risk tolerance and the desired level of profitability the bank would expect to accomplish in taking on various forms of credit risk.

Principle 2: Senior management shall be responsible for the implementation of the credit risk strategy adopted by the board of directors and the development of policies and procedures that should ensure identification, measurement, monitoring, and control of credit risk. Such policies and procedures must cover credit risk through all the activities of the bank and at the two aggregate levels of individual and portfolio credit.

Principle 3: Banks must identify and manage credit risk inherent in all products and activities. Banks must subject the risks of products and activities new to them to adequate risk management procedures and controls before they are 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 shall operate within sound, well-defined credit-granting criteria.

These criteria should include clear indication of the bank's target market and a adequate knowledge of the credit or counterparty, and the goal and composition of the credit and mechanism of repayment.

Principle 5: Banks should have general credit limits at the group level of individual borrowers and counterparties, as well as groups of related counterparties that aggregate in a similar and meaningful way various types of exposures, both on and off the balance sheet and in the banking book.

Principle 6: Credit institutions shall have a well-defined procedure for granting new credits, as well as the amendment, renewal and refinancing of existing credits.

Principle 7: All extensions of credit must be granted at arm's-length. In this connection, credits to related companies and individuals shall be authorized on an exception basis, with special care taken for monitoring, as well as other appropriate action to control or mitigate risks of non-arm's length lending.

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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 credit risk management. The rating system should be appropriate to 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 should have a process for controlling the overall composition and quality of the credit portfolio.

Principle 13: Banks should factor into their evaluation of individual credits and their credit portfolios any future economic conditions that may differ from current conditions, and should review their credit risk exposures under stress conditions.

D. Credit Risk Control

Principle 14: Banks should establish an independent, continuing process for monitoring the The bank's credit risk management process and outcomes of such reviews should be communicated directly to the board of directors and senior management.

Principle 15: Banks should be able to demonstrate that the credit granting function is being adequately managed and that credit exposures are at levels consistent with prudential standards and limits. Banks should establish internal controls and other practices to ensure exceptions to policies, procedures, and limits are being reported:

in time to the appropriate level of management for action.

Principle 16: Banks should have a system where early remedial action on deteriorating credits, problem credits and similar workout situations can be managed.

E. The role of supervisors

Principle 17: Supervisors should insist that banks have an effective system for identifying, measuring, monitoring and controlling credit risk as part of overall approach to risk.

management. Supervisors should require that a bank conduct, on an independent basis, reviews of its strategies, policies, procedures and practices associated with the granting of credit and the ongoing management of its portfolio. The supervisors should take into account the setting of prudent limits to limit exposures by a bank to a single borrower or a group of connected counterparties.

II. BUILDING A SOUND CREDIT RISK ENVIRONMENT

Principle 1: The board of directors should have oversight responsibility for the approval and periodically reviewing the bank's credit risk strategy and significant credit risk policies. The strategy should have to reflect the tolerance of the risk of the bank and profit level the bank expects to obtain for taking various types of credit risk. 9. Just as in all other areas of a bank's activities, the board of directors3 has a very important part to play in overseeing the credit-granting and credit risk management function of the bank.

3 This paper takes a management structure to comprise a board of directors and senior management. The Committee is aware that there are significant differences in legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management. In some countries, the board has the main, if not exclusive, supervising the executive body (senior management, general management) so as to make sure that the latter fulfils its tasks. For this reason, in some cases, it is known as a supervisory board. This means that the board has no executive functions. In other countries, by contrast, the board has a broader competence in that it lays down the general framework for the management of the bank. Due to these differences, the concepts of the board of directors and senior management are used in this paper not to define legal entities but to denote two decision-making roles within a bank.

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Every bank should develop a credit risk strategy or program that defines the objectives driving the bank's credit-granting operations and adopt the necessary policies and procedures for conducting such activities. The credit risk strategy, as well as significant credit risk policies, should be approved and periodically (at least annually) reviewed by the board of directors.

The board should realise that the strategy and policies must address the many activities of the bank in which credit exposure is a major risk.

10. The strategy should include a statement of the bank's willingness to grant credit eged on exposure type (for example, commercial, consumer, real estate), economic sector, geographical location, currency, maturity and expected profitability. This might also include the identification of target markets and the overall characteristics that the bank would want to achieve in its credit portfolio (including levels of diversification and concentration tolerances).

11. The credit risk strategy should acknowledge the objectives of credit quality, earnings and growth. Any bank, small, medium, or large, exists to make a profit and, therefore, must decide on an acceptable risk/reward trade-off for its operations, taking into account the cost of capital. A bank's board of directors should approve the bank's strategy in terms of choosing its risks and maximizing profits. The board should review from time to time the financial results of the bank and, on the basis of these results, whether change is required to the strategy. The board must also conclude that the level of capital of the bank is sufficient with regard to the risk taken all over the group.

12. Any bank's credit risk strategy should be consistent and coherent. Hence, the strategy must, therefore be designed to the periodic nature of any economy and the consequent changes in the balance and mix and quality of the entire credit portfolio. Despite the fact that the strategy must be reviewed and updated from time to time and should be sustainable in the long-term and across business cycles.

13. The credit risk strategy and policy should be clearly communicated throughout the banking organization. All affected staff should have a clear understanding of the bank's practice of granting and managing credit and should be made accountable for adherence to policies and procedures put in place.

14. The board should ensure that the top management is adequately equipped and capable of managing the Credit activities carried out by the bank and that such activities are conducted within the risk strategy, policies, and tolerances approved by the board. The board should also, from time to time (at least annually), either within the credit risk strategy or within a statement of credit policy, approve the bank's overall criteria for granting credit including general terms and conditions. In in addition, it should approve the manner in which the bank structures its credit granting functions, including separate audit of the credit granting and management function and the aggregate portfolio.

15. As members of the board of directors, but particularly as outside directors, can be significant sources of new business for the bank, after a potential credit is presented to the bank, its established procedures must determine how much and on what terms of credit is granted.

Therefore, the credit-granting and monitoring processes of the bank should not be overridden by the board members to avoid conflicts of interest.

16. The board of directors should ensure that the remuneration policies of the bank do not contradict its credit risk strategy. Such remuneration policies that encourage unacceptable behaviour such as accumulation of profits over the short term by violation of credit policies or achieving that by exceeding established limits weaken the credit processes of the bank.

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.

17. Senior management of a bank is responsible for implementing the credit risk strategy approved by the board of directors. This includes ensuring that the bank's credit-granting activities conform to the established strategy, that written procedures are developed and implemented, and that loan approval and review responsibilities are clearly and properly assigned. Senior management must also ensure that there is a periodic independent internal assessment of the bank's credit-granting and management functions.

18. A cornerstone of safe and sound banking is the design and implementation of written These include identifying, measuring, monitoring, and controlling credit risk. Credit policies define the framework of a credit agreement, hence

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guiding credit-granting activities of a bank. Therefore, credit policies should address the targets selected and the portfolios; mix and price and non-price terms that will be adopted in granting credits; structure of limits, authority to approve, exception processing/reporting, etc. Such policies should, accordingly be well-articulated, just about aligned with prudent banking practices and relevant regulatory expectations, and appropriately reasonable for the nature and complexity of a bank's operations.
This may be challenging to smaller banks; however, there must be satisfactory controls and checks in place to encourage sound credit decisions.

Credit management

complexity of the bank's operations. The policies should be framed and implemented considering the internal and external factors like the market position of the bank, trading area, staff capabilities, and technology. Policies and procedures that are well developed and of these allow the bank to: (i) ensure sound credit-granting standards; (ii) monitor and control credit risk; (iii) appraise new business propositions properly; and (iv) detect and administer problem credits.
19. As discussed further in paragraphs 30 and 37 through 41 below, banks should formulate and adopt policies and procedures to ensure that the credit portfolio is diversified enough based on the bank's target markets and overall credit strategy. In particular, such policies should set targets for portfolio mix as well as set exposure limits on single counterparties and groups of connected counterparties, particular industries or economic sectors, geographic regions and specific products. Banks should ensure that their own internal exposure limits comply with any prudential limits or restrictions set by the banking supervisors.
20. In order to be effective, credit policies must be communicated throughout the organisation, implemented through appropriate procedures, monitored and periodically revised to reflect changes in internal and external conditions. They should be applied, where applicable, on a consolidated basis with respect to a bank and at the level of the individual subsidiaries. Moreover, the policies should treat equally the two key roles of examining credit on an individual basis and obtaining proper diversification at the portfolio level.
21. When banks become engaged in extending credit abroad, they accept, in addition to Standard credit risk, risk associated with conditions in the home country of a foreign borrower or counterparty. Country or sovereign risk encompasses the entire spectrum of risks arising from the economic, political and social environments of a foreign country that may have potential consequences for foreigners' debt and equity investments in that country. Transfer
risk focuses more specifically on a borrower's capacity to obtain the foreign exchange required to service its cross-border debt and other contractual obligations. In all cases of cross-border transactions, banks are compelled to appreciate the globalization of financial markets and the possible spillover impact from one country to another or contagion impact for a whole region.
22. Banks that are involved in extending credit across borders must therefore have proper policies and procedures for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities. The monitoring of country risk factors should consider the potential default of foreign private sector counterparties due to country-specific economic factors and the enforceability of loan agreements as well as the timing and ability to realize collateral under the national legal framework. This function is often performed by a specialist team that knows the specific issues.
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 subjected 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.
23. The basis for an effective credit risk management process is the identification and assessment of latent and potential risks associated with any product or activity. Thus, it is essential that banks identify all inherent credit risk associated with products available and activities undertaken by them. Such identification arises from a detailed analysis of the latent and potential credit risk characteristics of the product or activity.
24. Banks need to establish a well-defined comprehension of the credit risks associated with more Complex credit granting activities (such as loans to specific industry sectors, asset securitisation, customer-written options, credit derivatives, credit-linked notes) This is particularly relevant because the credit risk considered here, although not new

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to banking, is less obvious and perhaps more analytical than that of more conventional credit granting activities. Although complex credit granting activities may entail procedures and controls tailored to specific needs, the underlying principles of credit risk management are not abrogated.

25. New ventures need a great deal of planning and careful monitoring to ensure risks are appropriately identified and controlled. The banks must have proper procedures and controls applied to new products and activities before introducing or engaging in them. Any major new activity shall require advance approval by the board of directors or its appropriate delegated committee.

26 Senior management should ensure that the staff at any operation where there is a borrower's credit risk or a counterparty's credit risk, whether established or new, whether plain or more complex, are fully qualified and capable of performing the operation to the best standards possible and consistent with the policies and procedures of the bank.