
EASTERN CARIBBEAN CENTRAL BANK



**GUIDELINES ON CREDIT RISK MANAGEMENT
FOR INSTITUTIONS LICENSED
TO CONDUCT BANKING BUSINESS UNDER THE BANKING ACT**

Prepared by the

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INTRODUCTION

I OVERVIEW

The major cause of serious banking problems continues to be ineffective credit risk management. The provision of credit remains the primary business of financial institutions operating within the ECCU. For this reason, credit quality is considered a primary indicator of the financial soundness of these institutions.

The objective of credit risk management is to maximize a financial institution's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Credit risk management should not only effectively address the credit risk inherent in the credit portfolio, but should also consider the relationships between credit risks and other risks. The effective management of credit risk is a critical component of a comprehensive approach to total risk management and is fundamental to the safety and soundness of financial institutions. Appropriate policies, procedures and systems should be implemented at each financial institution to effectively identify, measure, monitor and control credit risk.

The Eastern Caribbean Central Bank (ECCB) has issued these guidelines in an effort to promote the implementation of sound credit risk management at licensed financial institutions. These guidelines represent the ECCB's minimum requirements for credit risk management and are not be viewed as all encompassing. The ECCB endorses and recommends the Basel Committee's 17 Principles for Management of Credit Risk (September 2000).

II INTERPRETATION

The following terms are defined for the purpose of these guidelines:

- a) **“Financial Institution”** includes any person doing banking business and all offices and branches of the financial institution in () shall be deemed to be one financial institution.
- b) **“Credit”** is the provision of funds on agreed terms and conditions to a borrower, who is obliged to repay the amount borrowed (together with interest thereon). Credit may be extended on a secured or unsecured basis by way of loans, mortgages, bonds, private placements, derivatives and leases.
- c) **“Credit risk”** is the risk that a lender will suffer a financial loss as a result of a borrower’s failure to perform according to the terms and conditions of the credit or loan agreement.
- d) **“Credit Risk Management”** Credit Risk Management is the process of controlling the impact of credit risk-related events on the financial institution and involves the identification, understanding, and quantification of the degree of potential loss and the consequential implementation of appropriate measures to minimize the risk of loss to the financial institution.
- e) **“Exposure”** includes advances, credit facilities, guarantees, repurchase agreements, swap agreements and equity investments.
- f) **“Insider”** has the meaning assigned to it under the Securities Act, 2001.
- g) **“Non-performing loans”** include loans and advances
 - (a) that are not earning income;
 - (b) on which
 - (i) full payment can no longer be expected;
 - (ii) payments are more than 90 days delinquent;
 - (c) total credits to the accounts are insufficient to cover interest charges over a three-month period;

accounts are insufficient to cover interest charges over a three-month period, or the maturity date has passed and payment has not been made.

h) Expired accounts

Accounts which remain on the books but which have passed their maturity dates.

III AUTHORITY

These guidelines are issued by the Eastern Caribbean Central Bank (ECCB) pursuant to the authority contained in section 36 of the Banking Act.

IV APPLICATION

These guidelines apply to all financial institutions licensed under the Banking Act.

V REGULATORY REPORTING REQUIREMENTS

- a) Each institution shall submit a copy of its credit risk management policies and procedures to the ECCB. Changes to these policies and procedures shall be submitted to the ECCB as they occur.

- b) Minutes of meetings of the Committee responsible for credit risk management shall be forwarded to the ECCB on a quarterly basis.

VI COMMENCEMENT

These guidelines shall come into effect on 15 May 2009.

1.0 CREDIT RISK MANAGEMENT PROGRAMME

To achieve and maintain effective credit risk management, a financial institution should develop and implement a comprehensive credit risk management programme in accordance with its credit risk strategy. The credit risk strategy should reflect the institution's tolerance for risk and the desired level of profitability for incurring various credit risks. The board of directors, management and staff of the financial institution should be aware of and understand their respective responsibilities within the credit risk management programme.

An effective credit risk management programme includes the implementation of clearly defined credit policy and processes to facilitate the identification and quantification of risks inherent in an institution's lending and investment activities. The credit policy should be formally established in writing and approved by the board of directors, and should clearly set out the parameters under which credit risk is to be controlled.

Credit Policy

The credit policy establishes the authority, rules and framework for the effective operation and administration of the credit portfolio. The policy should be communicated throughout the organization in a timely manner and effectively implemented through the use of appropriate procedures. It is critical that the policy be reviewed periodically (at least annually) to ensure that it remains effective and flexible, and continues to meet the institution's objectives. Changes in statutory and regulatory requirements should also be incorporated in the policy.

A comprehensive credit policy that is effectively implemented enables the financial institution to:

- (i) Maintain sound credit-underwriting standards;
- (ii) Assess, monitor and control credit risk;
- (iii) Properly evaluate new business opportunities; and
- (iv) Identify, administer and collect problem credits.

The credit policy should specify, *inter alia*:

- (i) A credit risk philosophy governing the extent to which the institution is willing to accept credit risk;
- (ii) Levels of authority to approve credits. Delegated credit authority should be subject to timely review to ensure that it remains appropriate to current market conditions and expertise of credit officers;
- (iii) Target markets;
- (iv) Types of facilities to be offered, along with ceilings, pricing, profitability, maximum maturities and debt-service ratios of borrowers for each type of lending;
- (v) Loan portfolio ratios (e.g. total loans to deposit ratio, total loans as a percentage of capital base);
- (vi) Loan portfolio limits for aggregate exposure by country, industry, category of borrower/counterparty, product, groups of related parties and single borrowers etc. Consideration of relevant legislation and ECCB guidelines should be made in establishing such limits. For example, Section 16 of the Banking Act imposes restrictions on the aggregate amount of credit that can be extended to a person or group of related persons;
- (vii) Criteria and procedures for granting new credits, unsecured credits and for credit restructuring and refinancing;
- (viii) The minimum information required from loan applicants (considering Anti-Money Laundering and Know Your Customer best practices, and legal requirements);
- (ix) Loan review procedures, including a grading/rating system;

- (x) Types of acceptable collateral and the criteria for accepting guarantees;
- (xi) Guidelines for classification, provisioning and write offs;
- (xii) Guidelines for obtaining and reviewing appraisals of real estate and other collateral;
- (xiii) Guidelines for related party transactions including limits for exposure to a borrower or group of related borrowers.

Credit Risk Management Processes

Credit Appraisal and Approval

Credit appraisal is the stage where all required information on the credit is gathered and credit applicants are screened. Credit application forms should be sufficiently detailed to permit gathering of all information needed for credit assessment. For this reason, financial institutions should have a checklist to ensure that all required information is collected. The appraisal criteria will of necessity vary between corporate credit applicants and personal credit applicants. Loans to insiders should be appraised and approved by the Board or its committee in accordance with applicable provisions of the Banking Act.

Corporate credit applicants should be required to provide up to date audited financial statements, and management accounts where necessary, in support of their applications. At a minimum, the appraisal criteria for corporate credit should focus on:

- (i) Amount requested and purpose for credit;
- (ii) Sources of repayment;
- (iii) Applicant's integrity as well as legal capacity to assume credit obligation;
- (iv) Risk profile of the applicant and the sensitivity of the applicable industry sector to economic fluctuations;
- (v) Performance of the applicant in any credit previously granted by the financial institution and other institutions;

- (vi) The applicant's capacity to repay based on the business plan and projected cash flows;
- (vii) Cumulative exposure of the applicant to different institutions;
- (viii) Physical inspection of the applicant's business premises as well as the asset that is the subject of the proposed financing;
- (ix) Applicant's business expertise and managerial capacity;
- (x) Adequacy, marketability and enforceability of collateral or guarantees, taking into account the existence of any previous charges of other institutions on the collateral;
- (xi) Current and forecast operating environment of the borrower; and
- (xii) Background information on shareholders, directors and beneficial owners.

Credit Administration

A financial institution's credit administration function should, at a minimum, ensure that:

- (i) Credit files are neatly organized and cross-indexed;
- (ii) Credit files should not be removed from the institution's premises without the requisite approval;
- (iii) Insurance policies are properly assigned to the institution and premiums are current;
- (iv) Credit facilities are disbursed only after all contractual terms and conditions have been met and all required documents received;
- (v) Security documents are duly executed and properly protected from fire, theft etc;
- (vi) Collateral value is periodically ascertained and monitored;
- (vii) The borrower is making timely repayments on interest, principal and any agreed to fees and commissions;
- (viii) Information on credit provided to the financial institution's management is accurate and timely;
- (ix) Credit administration responsibilities within the financial institution are adequately segregated;
- (x) Funds disbursed under the credit agreement are used for the purpose for which they were granted;

- (xi) Established policies and procedures, as well as relevant laws and regulations, are being complied with; and
- (xii) Assessments of borrower's business are conducted through regular inspections.

Each credit file, including electronic credit files, should contain, at a minimum, information that:

- (i) Identifies the borrower by name and occupation or type of business, and identifies cosigners, endorsers, guarantors and connected counter parties; Know your customer information should be in accordance with the guidance notes issued by the money laundering supervisory authority;
- (ii) Provides evidence of the borrower's legal ability to borrow, financial condition, and ability to repay, including the timing and source(s) of repayment;
- (iii) Describes the terms of the credit obligation, including the purpose of the credit;
- (iv) Describes and evaluates the collateral;
- (v) 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;
- (vi) Describes any relationship to owners, directors and management of the financial institution; and
- (vii) Reflects the full relationship of the borrower with the bank, such as deposit accounts, off-balance sheet transactions, credit history etc.

Measuring and Monitoring of Credit Risk

Financial institutions should have in place comprehensive procedures and information systems to effectively monitor and control credit risk. These procedures should incorporate prudent criteria for identifying and reporting existing and potential problem accounts, ensuring that such accounts are sufficiently reviewed, adequately monitored and the relevant corrective action taken. The accurate classification of accounts and provisioning for loan losses should also form part of these procedures.

The feasibility and effectiveness of the various requirements of the credit risk management framework depend, in large measure, on the adequacy of management information systems. Financial institutions should have information systems and analytical techniques that are sufficiently flexible to help identify:

- (i) Risk concentrations, such as, credits grouped by related borrowers, economic sector, geographic areas etc;
- (ii) Degrees of delinquency and level of follow up;
- (iii) Volumes of loans secured versus unsecured;
- (iv) Volumes of new loans generated by officers;
- (v) Missing or inadequate information such as financial statements;
- (vi) Losses by officer/type of loan;
- (vii) Adequacy of loan loss reserves; and
- (viii) Restructured debts, expired and written-off accounts.

Financial institutions should have in place a credit rating system that defines risk rating criteria and rates credits according to these criteria. Each institution should have in place appropriate policies for classifying credits, recognizing revenue and providing for loan loss.

Institutions should have a well-defined credit collection and arrears management process. For institutions that have a high level of nonperforming loans, it is recommended that a unit be established to handle the workout and recovery of problem loans with appropriate policies in place.

2.0 Adequate Credit Risk Controls

Segregation of Duties

Financial institutions should establish internal controls and practices to ensure that the credit initiation, approval, review, administration, payments and work-out functions are kept as separate as possible. Breaches of internal controls and practices should be reported to the appropriate level of management.

Credit Review

Financial institutions should establish a system of independent, ongoing assessment of its credit risk management processes and the results of such reviews should be communicated directly to the board of directors or committee thereof, and to senior management. The credit risk management programme of each institution must include procedures governing the formal review and rating of individual credits.

An independent review of credits should be conducted along with regular analysis and 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. Accordingly, these officers should be able to identify potential problems before they may be discovered by independent credit reviewers. Accordingly, credit review systems should include the ongoing monitoring of credits and, where applicable, underlying security.

Common objectives of effective credit review system include:

- (i) Ensuring that the institution is aware of borrowers' current financial condition;
- (ii) Ensuring that collateral security is adequate and enforceable relative to borrowers' current circumstances;
- (iii) Ensuring that credits are in compliance with their covenants and margins;
- (iv) Providing early identification, classification of potential problem credits to protect the investment and ensure repayment of the loan before it becomes a complete loss;

- (v) Providing essential information to determine the adequacy of the provision for loan losses;
- (vi) Providing senior management and the board with an objective and timely assessment of the overall quality of the loan and investment portfolio; and
- (vii) Ensuring that proper accounting is maintained for all types of credits, for example, delinquent loans are put on a non-accrual basis and investments held for trading or available for sale are appropriately marked to market.

Independent Audit

Financial institutions should establish a system of regular independent credit and compliance audits. These audits should be performed by an independent party, that is, internal auditor and or compliance officer, who should report directly to the board or its committees. The assessment should, at a minimum, randomly test all aspects of credit risk management in order to determine that:

- (i) Credit policies are adequate;
- (ii) Credit activities are in compliance with the institution's credit and accounting policies and procedures, and with the laws and regulations to which the activities are subject;
- (iii) Credits are duly authorized and accurately recorded;
- (iv) Credits are appropriately rated;
- (v) Credit files are complete and security perfected;
- (vi) Potential problem credits are being identified in a timely manner and provision for credit losses is adequate; and
- (vii) Credit risk management information reports are adequate and accurate.

3.0 ROLE OF BOARD OF DIRECTORS AND SENIOR MANAGEMENT

The board of directors of each financial institution is responsible for approving and periodically (at least annually) reviewing the institution's credit risk strategy and significant credit risk policies.

The board should establish a credit sub-committee, consisting of a cross section of the members of the board and at least one member of senior management. Documented terms of reference should include the approval of new loans over a predetermined limit, insider loans, restructured/refinanced loans above a predetermined limit, and the review of regular reports on the financial institution's credit activity, including problem accounts.

The Committee should at a minimum:

- (i) Recommend the credit risk policy for the board's approval;
- (ii) Review, at least annually, credit policies, procedures, controls and information systems to ensure continued adequacy and effectiveness;
- (iii) Ensure through an independent inspection/audit function adherence to policies, controls, procedures, and information systems;
- (iv) Ensure that qualified and competent management is appointed to administer the credit risk management function;
- (v) Require the submission of comprehensive written reports to the committee on the management of exposures to credit risk, at least quarterly;
- (vi) Approve credits to, or guaranteed by, directors or management personnel or to entities in which directors or management personnel are partners, directors or officers, and review the institution's policy related to such credits;
- (vii) Approve all large credit exposures, as defined by the board, in relation to the institution's capital base;
- (viii) Review all significant delinquent credits, as defined by the board, and management's actions taken or contemplated for their recovery;
- (ix) Review any credits granted in conflict with credit policies, and take action to ensure attainment and maintenance of compliance; and
- (x) Review trends in the quality of, and concentration in, the financial institution's credit portfolio, to identify emerging problems and take action to deal with the problems.

The senior management of the financial institution should at a minimum:

- (i) Develop the credit risk management policy for approval by the board of directors;
- (ii) Ensure that the credit approval process is not unduly influenced by market share or growth targets;
- (iii) Establish and utilize a system to monitor and control the nature, composition, and quality of the credit portfolio, and to ensure that the portfolio is conservatively valued and that ECCB's guidelines on classification and provisioning for nonperforming assets are fully complied with;
- (iv) Ensure implementation of a credit risk management information system that :
 - tracks the evolving circumstances of a credit, regularity of repayments, borrower's financial condition, value of the security, and other attributes of the credit; and
 - tracks credits by portfolio characteristics, including single and associated groups of borrowers, types of credit facilities and industry sectors;
- (v) Ensure implementation of an appropriate management reporting system for credit;
- (vi) Establish a communication system for effective dissemination of credit risk management policies and procedures to employees engaged in the credit risk management process;
- (vii) Submit comprehensive written reports to the board of directors and/or a committee thereof, dealing with:
 - Significant credit activities of the financial institution and composition and quality of the credit portfolio;
 - Significant impaired credits and collection prospects;
 - Credit transactions not in accordance with the credit risk management policies; and
 - Trends in portfolio quality and the level of diversification, and an analysis of emerging problems and remedial actions taken or contemplated.
- (viii) Implement adequate internal controls over the credit risk function; and
- (ix) Ensure implementation of an effective internal inspection/audit function to review and assess credit risk management activities.

4.0 LOAN SYNDICATIONS

Each financial institution participating in syndicated lending arrangements should perform their own due diligence, including independent credit risk analysis and review of syndicate terms prior to committing to the syndication. Each financial institution should analyse the risk and return on syndicated loans in the same manner normal lending is analysed.

5.0 OTHER

The following ratios may be used to assist a financial institution in its measurement of credit risk:

RATIO	INTERPRETATIONS
NPL ratio – that is loans 90 days and more in arrears plus nonperforming overdrafts as a percentage of total loans and advances. The prudential benchmark for this ratio is 5%.	Level and severity of non-performing loans and advances. An assessment of the portfolio quality, credit analysis and management and level of potential future write-offs. This ratio also gives an indication of the quantum of non-income generating loans.
NPL minus provision for loan losses/ tier one capital	Gives an indication of the impairment to capital
Provisions for loan losses / Non-performing loans	Level and adequacy of provision made for portfolio losses
Past due loans/NPL	Level of unsatisfactory assets past maturity date; indicates severity of delinquency.
Total delinquency - all loans in arrears and nonperforming overdrafts compared to total loans and advances	Gives an indication of the total risk in the credit portfolio
Amount outstanding by sector/Total Loans	Portfolio concentration by sector. It is an indication of the bank's vulnerability to the performance of a sector.
Amount outstanding by largest borrowers (group)/Total Loans	Portfolio concentration by individual or borrower group. It is an indication of the bank's vulnerability to the performance of a small group of customers.