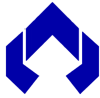

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# Guideline

**Subject:** **Standards of Sound Business and Financial Practices -- Credit Risk Management**

**No:** **F-3** **Date:** **February 1998**

## A. PURPOSE

This guideline sets out the minimum policies and procedures that each company needs to have in place and apply within its credit risk management program. This document also defines the minimum criteria each company should use to prudently manage and control its credit portfolio and exposure to credit risk.

Experience indicates that adherence to sound credit granting policies and procedures goes hand in hand with financial soundness. Failure to adhere to these policies and procedures is often a source of weakness in any financial institution. The major risk which arises from a weakening of the credit portfolio is the impairment of capital or liquidity.

For most companies, extending credit through investment and lending activities comprises an important portion of their business. Therefore, the quality of an institution's credit portfolio contributes to the risks borne by policyholders and shareholders.

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

## B. DEFINITIONS

Credit, in the context of a company's investment and lending activities, is the provision of funds on agreed terms and conditions to a debtor 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 instruments such as mortgages, bonds, private placements, derivatives, and leases.

Credit risk is the risk of financial loss, despite realization of collateral security or property, resulting from the failure of a debtor to honour its obligations to the company.



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Credit risk management is the process of controlling the impact of credit risk-related events on the company. This management involves identification, understanding, and quantification of the degree of risk of loss and the consequent taking of appropriate measures.

## C. CREDIT RISK MANAGEMENT PROGRAM

Managing credit risk is a fundamental component in the safe and sound management of companies. Sound credit risk management involves establishing a credit risk philosophy, policies and procedures for prudently managing the risk/reward relationship across a variety of dimensions, such as quality, concentration, currency, maturity, collateral security or property and type of credit facility.

Although credit risk management will differ among companies, a comprehensive credit risk management program requires:

- identifying existing or potential credit risks to which the company is exposed, on or off balance sheet, in conducting its investment and lending 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 procedures;

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

- developing processes for managing problem accounts.

Credit risk management standards should be maintained notwithstanding pressure for increased profitability, marketing considerations and a vastly more complex financial environment.

### Credit Risk Philosophy

The foundation of an effective credit risk management program is the establishment of a credit risk philosophy. A credit risk philosophy is a statement of principles and objectives that outlines a company's tolerance of 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.

## Credit Risk Management Policies

An effective credit risk management program requires the identification and quantification of the risks inherent in a company's investment and lending activities, and the development and implementation of clearly defined policies. These policies should be formally established in writing and set out the parameters under which credit risk is to be controlled.

### (i) Credit Risk Measurement

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. The establishment of a system for the rating of credit forms a fundamental part of the measurement process.

In developing a credit risk management program, the company should consider the extent to which credit risk in any part of a company's operations could impact the company as a whole.

Credit policies establish the framework for the making of investment and lending decisions and reflect a company's tolerance for credit risk. To be effective, policies (as revised from time to time in light of changing circumstances) should be communicated in a timely fashion, and should be implemented through all levels of the organization by appropriate procedures.

Credit policies need to contain:

- a description of general areas of credit-related activities;
- clearly defined and appropriate levels of delegation of decision-making approval authority; and
- portfolio concentration limits.

These policies need to be developed and implemented within the context of credit risk management procedures that ensure that all credit dealings are conducted in accordance with prudent business practices.

### ii) General Areas of Credit

The general areas of credit in which a company is prepared to engage usually specify the type of credit activity, type of collateral security or property, types of borrowers, or geographic sectors on which a company may focus.

### iii) Approval Authorities

Clearly defined and appropriate levels of authorities for approval help ensure that credit decisions are prudent, that the integrity and credibility of the credit process is maintained, and that the risk is acceptable given the expected return.

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

- the company's risk philosophy;
- the qualifications of lending officers;
- the quality of the credit portfolio;
- the types of risks being assessed; and
- the timeliness of market responsiveness required.

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 should include:

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

Approval limits should relate to some combination of:

- type of credit activity;
- credit rating;
- size;
- credit concentration;
- type of collateral security or property;

- liquidity of investment; and
- quality of the covenant package.

### iv) Portfolio Concentration Limits

Credit concentration may occur when a company's portfolio contains an exposure to, amongst other things:

- a single counterparty or associated counterparties;
- an industry;
- type of collateral security or property; or
- a geographic region.

Excessive credit concentration is contrary to sound principles as it exposes a company to adverse changes in the area in which the credit is concentrated, and to collateral security or property impairment.

Sound and prudent portfolio management and control involve the management of concentration risk by developing and implementing policies and procedures to ensure the diversification of the credit portfolio. Credit exposure limits should:

- be stated clearly;
- include goals for portfolio mix; and
- place exposure limits on single counterparties and associated counterparties, key industries or economic sectors, geographic regions, etc.

Determination of whether or not concentration is excessive is a matter of judgement. In circumstances where a company's investment or loan portfolio is excessively concentrated, a company should take steps to diversify its credit portfolio.

To ensure that a company is not excessively exposed to these credit concentrations, credit exposure limits need to be established within the context of the company's exposure to such concentrations.

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

Credit risk is the risk of financial loss, despite realization of collateral security or property, resulting from the failure of a debtor to honour its obligations to the company.

To minimize its exposure to loss through default or failure to obtain adequate collateral security or property, each company should give proper consideration to, and conduct an assessment of, each 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

To develop and maintain a sound credit portfolio, each company should have a prudent and effective formal evaluation process that provides for an independent and objective assessment of credit proposals. Sufficient analysis should be made to properly assess the borrower's ongoing financial viability and willingness to repay, and, where applicable, the adequacy and liquidity of collateral security or property pledged.

A sound credit process is an effective means of ensuring that credit risks are appropriately analyzed and reviewed, and are within the parameters of the company's credit policies. The details of the analysis, however, will vary with the type of credit activity the company engages in.

### ii) Credit Documentation

To assist a company in conducting credit evaluations and reviews and ensuring that assets are soundly and appropriately valued, each company should maintain credit files. Each credit file should contain the following:

- an underwriting file which identifies and assesses the borrower, and includes a signed authorization and the rationale for granting the credit;
- up-to-date financial statements;
- evidence of the borrower's financial condition and ability to repay;
- the terms and conditions of the credit, including the use of proceeds;

- a description and evaluation of the collateral;
- the history of the credit; and
- evidence as to the method of pricing of the credit.

### iii) Legal Documentation

In developing and maintaining a sound credit portfolio, the terms of each credit should be adequately and accurately documented. Inadequate, incomplete, or unenforceable legal documentation could lead to non-recovery of funds. Enforceability documents should conform to the credit authorized and should include, where appropriate, such legal documents as:

- prospectuses or offering memoranda;
- instruments evidencing indebtedness;
- collateral security or property registration documents; and
- opinions on enforceability.

### iv) Credit Collection Process

Companies should establish 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.

### v) Arrears Management

Although most credits are ultimately repaid in full, it is recognized that companies are exposed to risk of default and, therefore, some credit losses 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 company in managing its default risk. These options may include renegotiation of the terms of the credit, reorganization or liquidation of the borrower, or realization of collateral security or property, in order to minimize potential loss to the company. Recovery efforts require a well conceived strategy and timetable.

Each company should establish appropriate procedures that are not under the sole control of the credit-granting function for recognition of income and impairment and to ensure that the credit portfolio is properly valued and probable losses are adequately accounted for.

## Credit Portfolio Monitoring and Control

Failure to establish adequate procedures to effectively monitor and control the credit function within established guidelines can result in significant other costs, in addition to credit losses. Compromising credit policies and procedures is another major cause of servicing costs and credit losses.

Accordingly, each company needs to develop and implement procedures to identify, monitor and control the characteristics and quality of its credit portfolio. These procedures need to define prudent criteria for identifying and reporting potential problem credit exposures to ensure that they are identified for more frequent review, followed up with appropriate corrective action, classified as below standard where appropriate, and that provisions are made where necessary.

Categorization of the credit portfolio by type of credit activity, credit rating, regular review of individual and groups of credits within the portfolio, and internal credit audits are integral elements of effective and prudent portfolio monitoring and control and should include current relevant information about all borrowers.

Regular review of ratings provides 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.

### i) Portfolio Characteristics

In order to track portfolio diversification characteristics, each company needs to have a system to enable credits to be grouped by characteristics such as type of credit activity, ranking by size of counterparty credit exposures, credit ratings, type of collateral security or property, type of industry, and geographic regions.

### ii) Credit Rating Systems

Credit ratings provide an effective tool for pricing risk and return, monitoring overall portfolio creditworthiness, determining minimum credit standards, and determining conformity with minimum company credit standards.

Each company needs to have a credit rating system that uses objective measures and rates credits accordingly. Each credit exposure should have a credit rating attached at the time the credit is granted. All credit ratings should be reviewed systematically and changed when appropriate.

Internal credit rating systems should be based on best industry practice and should be broadly consistent with public rating systems.

The credit rating system will enable the company to classify each credit exposure as follows (see Glossary for definitions):

- satisfactory;
- especially mentioned;
- below standard; and
- loss,

or such other classification systems as may be prescribed from time to time by OSFI.

### iii) Credit Review and Reclassification

Companies need to regularly monitor the status of borrowers and re-evaluate individual credits and commitments, and their credit ratings. Failure to do so can result in an undetected deterioration of the credit portfolio. Accordingly, the credit risk management program of each company should include procedures governing the regular formal review and, where applicable, the re-rating of credits. In addition, credit review systems should ensure that credit quality and, where applicable, underlying collateral security or property are being monitored 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 of credits in the portfolio. Each credit should be reviewed regularly, with the frequency of review reflecting the perceived risk.

Common objectives of effective credit review systems include:

- ensuring that the company is aware of borrowers' current financial condition;
- ensuring that collateral security or property is adequate and enforceable relative to 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 credit portfolio.

### iv) Credit Audits

Credit audits will be conducted to review the company's compliance with credit risk management policies and procedures. Assessments should randomly test all aspects of credit risk management in order to determine that:

- credit activities are in compliance with the company's credit and accounting policies and procedures;
- credits exist, are duly authorized, and are accurately recorded on the books of the company;
- credits are rated in accordance with the company's policies;
- credit files are complete;
- potential problem accounts are being identified on a timely basis; and
- credit risk management information reports are adequate and accurate.

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

### Conflict of Interest, Self-Dealing and Confidentiality

Each company needs to have in place procedures to address conflicts of interest and self-dealing and to preserve confidentiality.

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