LOAN POLICIES AND RISK RATING

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Organizational Structure and Commercial Lending

- Board of Directors
  - Set the credit and other policies that determine how the bank conducts its business, plus supervising the bank's affairs to ensure those policies are being implemented.
  - Constructs Risk Committee and Audit Committee to work closely with the Executive Officer to recommend to the Board various relevant issues
  - Approves loans beyond the authorities of the Loan Committee and other officers.
- Executive Officers
  - Responsible for implementing the policies set by the board.
  - Includes among others Chief Lending Officer, Chief Credit Officer and the CEO.
  - For high value loans, A loan committee comprising of executive officers and other senior managers can be formed.
  - Responsible for overviewing every aspect of lending.

Organizational Structure and Commercial Lending

- Business Bankers and other employees
  - **They can be divided into those employees whose duties involve direct public contact and those who work behind the scenes in a support capacity. In the lending area, both are critical to a successful and profitable lending function.**
  - **The business banker is, of course, an example of a bank employee who has extensive contact with the public and is responsible for obtaining all pertinent information required and analyzing them for making loan.**
  - **A Business Banker performs almost all the duties associated with evaluating and processing loan opportunities and has sole responsibility for all of the steps in the lending process.**
  - As the initiator of the loan, business banker's error or misrepresentation can lead to a huge cost to the bank and the business banker.

Bank's Loan Policy

- A bank has a written loan policy that sets forth the board of directors' lending philosophy, and provides a set of guidelines for carrying it out.
  - Detailed with procedures
  - Short with separate procedure manuals

  It is important is that employees involved in the lending function understand the provisions contained in the loan policy. It should be read, reread, and then continually referred to and understood by all business bankers.

  Because of the risks inherent in any significant deviation from bank loan policy, all commercial loans are reviewed for conformity with the policy.

  Justification of loan that does not meet the loan policy's definition of an acceptable loan should be documented in the credit file and then approved by the appropriate authority.

Loan Policy: A framework for lending

- Beyond the overall lending philosophy, the loan policy provides a framework for all lending practices. Working out of the frame may cause serious consequences including legal.
- Credit policies lay down the conditions and guidelines for the identification, measurement, evaluation, monitoring, reporting, control or mitigation of credit risk at both the individual transaction and portfolio levels. At a minimum, the policy documents the following elements:
  - the roles and responsibilities of units and staff involved in the granting, maintenance and management of credit;
  - the delegation of credit authority to various levels of management and staff (including authority to approve deviations and exceptions);

Loan Policy: A framework for lending

- the credit risk acceptance criteria;
- the general terms and conditions of the facility structure, such as pricing, tenure and quantum of financing;
- the acceptable types of collateral and security documents;
- the standards for credit review and monitoring; and
- the guidelines on management of concentration risk, including limits, portfolio monitoring and stress testing.

Compliance of Laws and Regulatory Requirements.

- Banks, being the custodian of public funds, are probably the most heavily regulated business in the world.
- Regulations may be in the form of Acts, Bye-laws, Directives, circulars and even the Policies, procedures and manuals.
- Non-compliance of these regulations may result in loss of reputation, loss of business, loss of job, penalties, fines and even imprisonment.

Compliance of Laws and Regulatory Requirements.

- In order to avoid non-compliance, a business banker must know and abide by the lending related provisions of following.
  - Banking and Financial Institutions Act
  - Directives of Nepal Rastra Bank (credit related)
  - Banking Offence and Punishment Act
  - Secured Transaction Act
  - Loan Recovery Act
  - Anti Money Laundering
  - Company Act
  - Bank's Loan Policy
  - Loan Procedures and Manuals
  - Foreign Exchange Regulation Act.

Compliance of Laws and Regulatory Requirements.

bafia provisions.docx

BAFIA.pdf

Banking Kasura Ain, 2064.pdf

Participant are suggested to study other Acts on their own.

Provisions of NRB Directives

- Loan Classification and Provisioning Requirement

  Performing Loans

  - Pass- Up to 3 months of overdue
    - Watch List
      - Past due over one month
      - Temporary renewal of WC/ST loan
      - Loan to borrower having graded loan at other bank
      - Company with loss for last 2 years, Company having negative net-worth
      - Loan to borrower having multiple bank borrowing and not under consortium
      - Loans to weak projects as determined by NRB

  Non-performing loans

  - Sub-standard- 3-6 months of overdue
  - Doubtful- 6 months to 1 year of overdue
  - Loss- Above 1 year of overdue

Provisions of NRB Directives

- **Additional arrangements on good loans**
- **Additional arrangements on bad loans**
- **Arrangements on term debt**
  - *Reclassification of entire loan when installment is overdue with the exception of given projects.*
- **Restriction on use of overdraft facility to pay installments and interest**
- **On grace period**
  - **Restricted to one year.**
  - **For longer period, one step higher authority to decide at the time of loan approval based on valid grounds.**
- **Rescheduling and restructuring**
  - **Can be done with proper plan business plan supported by various proofs in file.**
  - **25% of interest to be paid.**
  - **Provision at 12.5%**
  - **Other provisions.**

Provisions of NRB Directives

- On credit sale, purchase, repurchase and takeover
- On loan to cooperatives and against FD
- On Bank guarantee
- Loan to be given within limited territory
- On TR loans
- On check purchase
- On loans to risk taker
- On environment analysis for industry
- On agriculture loan payment schedule
- On personal guarantee
- On working capital loan.docx
- Single borrower limits
  - Exceptional limits
  - Limit waiver

Provisions of NRB Directives

- Related party definition
- Provision on Sectorial limits
- On real estate loans
- On consortium loan
- On Blacklisting
  - 100% provisioning
  - Fine if loan is given to a person in blacklist
- On base rate
- On Deprived an Productive sector lending

Non compliance attracts fines and actions as per the provisions of NRB Act.

Risk Rating of Loans

- Risk rating involves the categorization of individual credit facilities based on credit analysis into a series of graduating categories based on risk. It is the determination of the place of a particular loan on a predetermined scale of risk.
- Identifying and rating credit risk is the essential first step in managing it effectively.
- Well-managed credit risk rating systems promote bank safety and soundness by facilitating informed decision making.
- Rating systems measure credit risk and differentiate individual credits and groups of credits by the risk they pose.
- Risk Rating can be Internal or External.

Functions of Risk Rating

- A primary function of a risk rating is to assist in the underwriting of new loans. As well, risk ratings assist management in predicting changes in portfolio quality and the subsequent financial impact.
- Risk rating can lead to timely response to potential deteriorating trends and a wider choice of corrective action to decrease exposure to unexpected loan losses.
- Risk rating is useful for loan pricing and regulating the commercial portfolio exposure to maximum acceptable levels of risk as established in board policy.
- Risk ratings can be used to determine or influence who is authorized to approve a credit, how much credit will be extended or held, and the structure of the credit facility (collateral, repayment terms, guarantor, etc.).

Functions of Risk Rating

- A credit's risk rating determines how the relationship should be administered. Higher risk credits are reviewed and analyzed more frequently, and higher risk borrowers normally are contacted more frequently.
- Risk ratings of individual credits underpin the provisioning. Every credit's inherent loss is factored into its assigned risk rating with an allowance provided. The provisioning is directly correlated with the level of risk indicated by risk ratings.
- Risk rating reports that aggregate and stratify risk and describe risk's trends within the portfolio are critical to credit risk management and strategic decision making.

Risk Rating Sample

- The regulator prescribed five-point risk rating (pass, watch list, sub-standard, doubtful and loss) does not differentiate various levels of acceptable risks.
- Different banks may adopt different modalities of risk rating.
- In our example, each acceptable loan is graded on the scale of 1 to 4, with loans of lowest risk being grade 1. When loans becomes ‘special attention’ or ‘watch list’ they are graded 5. Grade 6,7,8 correspond to the regulators sub-standard, doubtful, and loss loans.

Sample Risk Rating Grid.docx

Risk grading sample 1.xls

CUSTOMER CREDIT GRADING sample 2.docx

Summarizing Risk Ratings

- **Risk-rated 1**—These are substantially risk-free loans to borrowers at the highest levels of credit quality, usually including national governments and central banks, a few major world-class banks, a few multinational corporations, and the government guaranteed portions of loans and cash secured loans.
- Financial statements of the borrowing businesses typically are audited with an unqualified opinion.
- Management depth is excellent, with substantial industry experience.
- This category also can include portions of loans to weaker borrowers, where the portion is backed by government support.
- Another type of loan that can be placed into this category is a loan to a weaker borrower where the loan principal and interest are fully supported by cash collateral (certificates of deposit or cash accounts held at the lending bank).
- In some cases, where only principal is supported by the cash collateral, the risk rating may be at a "2."

Summarizing Risk Ratings

- **Risk-rated 2**—These loans are to borrowers of high credit quality, presently and prospectively.
- Cash flows over at least three to five years demonstrate exceptionally large and/or stable net profit margins of protection. Balance sheets are very conservative and strong with liquid assets.
- Projected cash flows, including anticipated credit extensions, exhibit strong trends in net profit margins, liquidity, and debt service coverage.
- There is excellent asset quality and management, and the borrowers are typically large companies in stable industries. Generally audited financial statements with strong reliability, and access to capital markets.

Summarizing Risk Ratings

- **Risk-rated 3**—For these loans, borrowers are middle range of credit quality, and have good prospects for future financial performance.
- The borrowers have very good asset quality and liquidity with consistently adequate debt capacity and coverage.
- They represent very good management with reasonable industry experience and depth.
- The credit extension is considered definitely sound; however, elements are present that suggest the borrower typically does experience temporary impairments.
- Reasonable access to bank financing at similar terms and conditions is present, though not likely to be able to access capital markets.
- **Risk-rated 4**—These loans are at the lower end of acceptable credit quality.
- The borrowers are definitely sound, but with some minor to moderate risk characteristics.
- The margin of protection is adequate, with adequate liquidity, stability of profit margins and cash flows, diversity of assets, and good operating systems

Summarizing Risk Ratings

- **Risk-rated 5 loans**—These borrowers exhibit potential credit weaknesses or downward financial trends deserving bank management's close attention.
- These are pass loans that are currently performing as agreed, but with above-average risk due to potential weaknesses such as severe or adverse industry, market or management conditions, operating problems, pending litigation of a significant nature, or declining collateral quality and adequacy.
- If not checked or corrected, these trends will weaken the bank's asset position. Although weak, these borrowers are currently marginally acceptable, but no loss of principal or interest is envisioned. As a result, these loans do not expose a bank to sufficient risk to warrant adverse classification, although they still are considered "watch list."
- The borrowers generally have limited additional debt capacity, weak cash flow coverage, and average or below average asset quality, margins, and market share. Some industry, market and management weaknesses likely exist.

Summarizing Risk Ratings

- Most customer in the 5 risk rating need turnaround. These loan at 3 0r 4 have shown deterioration, for whatever reason, thereby indicating a downgrading from the better categories. The borrower in this circumstance needs to "turn around" whatever caused the weakness. Typically, these companies may be in deteriorating industries or with a poor and declining market share in an average or declining industry. The following are examples of what might need to be turned around:
  - Poor operating margins
  - Excessive or unnecessary fixed costs
  - Deteriorating collateral value
  - Management and owners with limited skills and depth
- This category should also include those borrowers who are prescribed by the regulators to be watch list.

Summarizing Risk Ratings

- **Risk-rated 6 loans**—These loans display a definite weakness that jeopardizes the orderly liquidation of debt, although loss is unlikely.
- This usually matches the regulatory category of "substandard" for a loan not adequately protected by the current net worth and paying capacity of the obligor or by the collateral pledged, if any.
- Normal repayment from the borrower is in jeopardy, although, again, no loss of principal is envisioned.
- If the deficiencies are not corrected, there is a distinct possibility that a partial loss of interest and/or principal will occur.
- Potential loss, although it may exist in the aggregate amount of substandard assets, does not necessarily exist in individual assets classified "substandard."
- As per regulatory classification, a loan is classified "substandard" if the loan is not served beyond 3 months of maturity.

Summarizing Risk Ratings

- **Risk-rated 7 loans**—These loans indicate probable partial loss. Borrowers are classified as "doubtful" and have the weaknesses found in other substandard borrowers with the added provision that the weaknesses make the complete collection highly questionable and improbable.
- Serious problems exist to the point where partial loss of principal is likely. The possibility of loss is extremely high, but because of certain important, reasonably specific pending factors that may work to strengthen the assets; this classification's "estimated losses" are deferred until a more exact status may be determined.
- Pending uncertain factors include proposed merger, acquisition, or liquidation procedures; capital injection; perfecting liens on additional collateral; and refinancing plans. Loan loss reserves for each individual substandard loan generally are established to provide for these uncertainties. Management has demonstrated a history of failing to live up to agreements, unethical or dishonest business practices, bankruptcy, and/or conviction on criminal charges.
- As per regulatory classification, a loan is classified "doubtful" if the loan has been overdue beyond 6 months of maturity.

Summarizing Risk Ratings

- **Risk-rated 8 loans**—These assets are definite losses. Borrowers are deemed incapable of repayment of what essentially is unsecured debt. Loans to such borrowers are considered uncollectible and of such little value that continuance as active assets of the bank is not warranted. This classification does not mean that the loans have absolutely no recovery or salvage value. Rather, it is not practical or desirable to defer writing off these assets even though partial recovery may be possible.
- Regulators classify loans that are overdue for more than a year as bad loans and ask for 100% provisioning but do not expect to write it off immediately.

Summarizing Risk Ratings

- Most banks establish procedures to identify how frequently to review commercial loans for the accuracy of the risk grade.
- Commercial loans should be evaluated on roughly an annual basis, at a minimum, either through renewals and loan originations involving a particular loan or borrower, or a related loan that is adequately analyzed as part of the credit decision.
- Loans that do not have such opportunities for adequate analysis over the prior twelve months should have an annual review performed by the business banker. Using the risk rating, loans rated 1-4 should meet this annual benchmark.
- Loans rated 5 should shift to more frequent monitoring on at least a quarterly basis, with 7 or 8 ratings monitored even more frequently, such as monthly.
- Beyond a schedule of frequency of review based on risk grade, business bankers should re-assess risk grades as market or industry conditions change, or as the borrower's condition materially improves or deteriorates. Keeping risk grades updated is perhaps the single most important job of lenders and their support staff.

Thank you