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ব্যাংকিং প্রবিধি ও নীতি বিভাগ
বাংলাদেশ ব্যাংক
প্রধান কার্যালয়
ঢাকা।

২৫ ফাল্গুন, ১৪২২

বিআরপিডি সার্কুলার নং-০৪ **তারিখ ঃ ----------------**
০৮ মার্চ, ২০১৬

ব্যবস্থাপনা পরিচালক/প্রধান নির্বাহী কর্মকর্তা
বাংলাদেশে কার্যরত সকল তফসিলি ব্যাংক।

প্রিয় মহোদয়,

Guidelines on Credit Risk Management (CRM) for Banks পরিপালন প্রসঙ্গে।

উপরোক্ত বিষয়ে অত্র বিভাগের বিআরপিডি সার্কুলার নং-১৭, তারিখ অক্টোবর ০৭, ২০০৩ এর প্রতি দৃষ্টি আকর্ষণ করা যাচ্ছে।

ব্যাংক ব্যবসার সাথে সম্পৃক্ত ঝুঁকিসমূহ আরও কার্যকর ও ফলপ্রসূভাবে মোকাবেলা করার লক্ষ্যে ২০০৩ সালে প্রণীত **Credit Risk Management Guidelines** এ বাংলাদেশ ব্যাংক এবং বাংলাদেশে কার্যরত কতিপয় তফসিলি ব্যাংকের প্রতিনিধিদের সমন্বয়ে গঠিত কমিটির পর্যবেক্ষন ও স্টেকহোল্ডারদের মতামতের ভিত্তিতে সংশোধনী আনয়ন করা হয়েছে। সংশোধিত গাইডলাইন্সটি বাংলাদেশ ব্যাংকের ওয়েবসাইট (www.bb.org.bd) এ পাওয়া যাবে।

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আপনাদের বিশ্বস্ত,

(আবু ফরাহ মোঃ নাছের)
মহাব্যবস্থাপক
ফোন ঃ ৯৫৩০২৫২।

Guidelines on Credit Risk Management (CRM) for Banks

March 08, 2016

Preamble

To strengthen the risk management practices of banks, Bangladesh Bank issued “Industry Best Practices” in 2003 for ‘Managing Core Risks in Banking’ in five (5) areas. Inarguably, ‘Credit Risk Management’ was the most important among them. Since then, the banking sector in Bangladesh witnessed different changes and transformation which warrant the revision of the Credit Risk Management (CRM) Guideline to address the changes, owing to the significant time lag. Experience of prior years has shown that absence of proper management of such risk has resulted in significant losses or even crippling losses for a number of banking institutions. It is envisaged that as the size of the banking system’s balance sheet increases over time, the potential financial burden will escalate proportionately. Again, as a consequence of immense competition in the banking industry, the diversity and operational periphery of credit functions have extended which harbor new sources and dimension of credit risk. In these years, revolutionary changes have been incurred in the regulatory environment.

In this backdrop, Bangladesh Bank (BB) has felt the exigency to revisit the credit risk management guidelines. In continuation to that, this revised version of the guidelines titled “Guidelines on Credit Risk Management (CRM) for Banks” has been prepared. These guidelines are prepared on the basis of the first version of its kind, the Bank Company Act 1991 (Amended in 2013), Credit related Circulars and Instructions of BB, Risk Management Guidelines for Banks, and the Risk Based Capital Adequacy Framework in line with Basel II & III. These guidelines have been outlined by aligning with the Principle 17, 18, 19, 20 and 21 of Core Principles for Effective Banking Supervision i.e. BCP, issued by the Bank for International Settlements.

These guidelines provide broad-based policy on the core principles for identifying, measuring, managing and controlling credit risk in banks. The guideline will be applicable for all types of conventional and shariah-based mode of financing. These policies represent minimum standards for credit related functions and are not a substitute for experience and good judgment. The guideline will accommodate all instructions set out in the concerned acts and regulations of BB from time to time.

The purpose of this document is to provide directional guidelines to the banking sector that will improve the risk management culture, establish standards for segregation of duties and responsibilities, and assist in the ongoing improvement of the banking sector in Bangladesh. Banks are expected to go beyond the yardstick set out in these guidelines. In order to excel in credit risk management, banks themselves will devise, nurse and ensure compliance on core credit values to cultivate and drive behavior towards highly efficient and quality credit functions. The core credit values should include, but not be limited to, honesty (highest standard of professional and personal integrity), trust (faith and belief on each other in professional behavior), sincerity (intention to convey the truth to the best of knowledge and in action), equilibrium (balanced decision making through using open and unbiased processes of gathering and evaluating necessary information), diligence (act with due care which displays professional skills in conduct of any aspect of credit process) etc. Keeping in mind the credit values, banks will devise credit appraisal principles which should give an underlining broad guideline of credit risk management. This is the ultimate desired outcome of these guidelines.

Guidelines on
Credit Risk Management (CRM) for Banks

Chairman

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Member Secretary

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Acronyms

AoA	Article of Association
BB	Bangladesh Bank
BCP	Basel Core Principle
CET1	Common Equity Tier I
CIB	Credit Information Bureau
CP	Credit Policy
CRMP	Credit Risk Management Policy
EA	Early Alert Reporting
ECAI	External Credit Assessment Institution
ESRR	Environmental and Social Risk Rating
ICRRS	Internal Credit Risk Rating System
LTV	Loan-to-value
MAT	Management Action Trigger
MIS	Management Information Systems
MoA	Memorandum of Association
NBFIs	Non Bank Financial Institutions
NGOs	Non Government Organizations
NPLs	Non Performing Loans
NII	Net Interest Income
NFI	Net Fees Income
OBS	Off Balance Sheet
PD	Probability of Default
PNS	Personal Net-Worth Statement
RAS	Risk Appetite Statement
RAR	Risk Adjusted Return
RJSC	Registered Joint Stock Company
RM	Relationship Management
RMD	Risk Management Division
TP	Trading Profit
SMEs	Small & Medium-sized enterprises

Chapter 01: Overview on Credit Risk Management

1.1 Introduction

As a result of the global financial crisis, international standard-setting bodies and national authorities are reviewing and revising their expectations as to how banks identify, measure, monitor, and control their credit risk. These Guidelines have been prepared with these international standards in mind, most notably Principles 17, 18, 19, and 20 of the Core Principles for Effective Banking Supervision, issued in 2012 by the Basel Committee on Banking Supervision. The Board of Directors and senior executive officers of each bank are strongly advised to familiarize themselves with these Principles and apply them throughout their credit risk management activities.

1.2 Credit risk as range of possible outcomes

- Credit risk arises from the potential that a bank's borrower will fail to meet its obligations in accordance with agreed terms, resulting in a negative effect on the profitability and capital of the bank.
- Generally credits are the largest and most obvious source of credit risk. However, credit risk could stem from both on-balance sheet and off-balance sheet activities such as guarantees. It may arise from either an inability or an unwillingness to perform in the pre-committed contracted manner. Credit risk comes from a bank's dealing with households, small or medium-sized enterprises (SMEs), corporate clients, other banks and financial institutions, or a sovereign.
- In more technical terms, credit risk can be viewed as the existence of multiple possible outcomes when a bank makes a loan or other extension of credit. The possible outcomes range from full and timely payments according to the contract, all the way to a complete absence of any repayment (a total loss on the loan). Payments could be made in full but not in a timely manner, or payments could be made in a timely manner but not in full. Every possible outcome, and there are a great many possible outcomes, can be said to have a probability of occurrence, and the probabilities, as in any distribution, sum to 100 percent.
- In this and all the subsequent sections on credit risk management, "loan" is used as shorthand for all possible types of exposure to a single client or group of related clients. It is to be understood that many different types of transactions, including off-balance-sheet transactions, pose credit risk to the bank, and all such transactions are subject to these Guidelines as appropriate.

1.3 Indicators of high credit risk or poor credit risk management

Just as credit risk can be estimated for an individual loan, so too can the bank as a whole be said to have varying degrees of credit risk. Unlike measuring credit risk for a loan, however, measuring credit risk of an entire institution is a complicated assessment, involving many quantitative and qualitative factors, the most important of which are summarized below (some to be developed in more detail later in this document).

Moreover, whatever may be the overall level of credit risk, a bank may be said to have poor credit risk management. While these assessment factors are mostly qualitative in nature, they cannot be ignored, and BB will consider these lapses as evidence of mismanagement requiring corrective action.

Indicators of high credit risk (not an exhaustive list)

- The level of loans is high relative to total assets and equity capital.
- Loan growth rates significantly exceed national trends and the trends of similar banks.
- Growth was not planned or exceeds planned levels, and stretches management and staff expertise.
- The bank is highly dependent on interest and fees from loans and advances.
- Loan yields are high and reflect an imbalance between risk and return.
- The bank has one or more large concentrations. Concentrations have exceeded internal limits.
- Existing and/or new extensions of credit reflect liberal judgment and risk-selection standards.
- Practices have resulted in a large number of exceptions to the credit policy.
- The bank has a large volume and/or number of classified loans.
- Even among standard and special mention account loans, the portfolios are skewed toward lower internal ratings.
- Classified loans are skewed toward the less favorable categories (doubtful and bad/loss).
- Collateral requirements are liberal, or if conservative, there are substantial deviations from requirements.
- Collateral valuations are not always obtained, frequently unsupported, and/or reflect inadequate protection.
- Loan documentation exceptions are frequent, and exceptions are outstanding for long periods of time.
- The bank liberally reschedules and/or restructures loans in a manner that raises substantial concern about the accuracy or transparency of reported problem loan numbers.
- Quarterly loan losses, as a percentage of the total loan portfolio, are high and/or routinely exceed established provisions.

Indicators of poor credit risk management (not an exhaustive list)

- Credit culture is absent or materially flawed.
- Strategic and/or business plans encourage taking on liberal levels of risk.
- Anxiety for income dominates planning activities.
- The bank engages in new loan products or initiatives without conducting sufficient due diligence testing.
- Loan management and personnel may not possess sufficient expertise and/or experience.
- Responsibilities and accountabilities in the origination, administration, or problem loan management processes are unclear.
- The bank may not identify concentrated exposures, and/or identifies them but takes little or no actions to limit, reduce, or mitigate risk.
- Concentration limits, if any, are exceeded or raised frequently.
- Compensation structure is skewed toward volume of loans originated, rather than quality.

- There is little evidence of accountability for loan quality in the origination and/or administration function.
- Staffing levels throughout the origination and/or administration function are low.
- Skills throughout the origination and/or administration function are low.
- Credit policies are deficient in one or more ways and require significant improvement in one or more areas. They may not be sufficiently clear or are too general to adequately communicate portfolio objectives, risk tolerance, and loan judgment and risk selection standards.
- The bank approves significant policy exceptions, but does not report them individually or in the aggregate and/or does not analyze their effect on portfolio quality. Policy exceptions do not receive appropriate approval.
- Credit analysis is deficient. Analysis is superficial and key risks are overlooked.
- Risk rating and problem loan review are deficient and require improvement. Problem loans and advances are not identified accurately or in a timely manner; as a result, portfolio risk is likely misstated.
- The bank's risk ratings (including the classification system) frequently deviate from BB's risk ratings or classifications.
- The graduating of internal risk ratings in the standard and special mention categories is insufficient to stratify risk for early warning or other purposes, such as loan pricing or capital allocation.
- Management information systems (MIS) have deficiencies requiring attention. The accuracy and/or timeliness of information is affected in a material way, and portfolio risk information is incomplete. As a result, the Board and senior management may not be receiving appropriate or sufficient information to analyze and understand the bank's credit risk profile.

1.4 Concentration risk

Even if a bank's origination and administration policies and procedures for individual loans are sound, a bank may have high credit risk and/or poor credit risk management if the loan book is concentrated. Concentration risk arises when any bank invests its most or all of the assets to single or few individuals or entities or sectors or instruments. Downturn in concentrated activities and/or areas may cause huge losses to a bank relative to its capital and can threaten the bank's health or ability to maintain its core operations. Banks need to pay attention to the following credit concentration risk areas:

- Sector wise exposure,
- Division wise exposure (Geographic Concentration),
- Group wise exposure (Outstanding amount more than),
- Single borrower wise exposure (Outstanding amount more than),
- Top borrower wise exposure (Top 10-50 borrowers will be counted)

Banks must establish internal limits to concentration across all the possible dimensions of concentration risk. It follows that if any part of a bank's loan portfolio is concentrated in any way, the bank must endeavor to reduce the volume of loans in that category, raise capital, or take a combination of both actions.

1.5 Robust credit risk management policy as an answer to high credit risk/poor credit risk management

Banks always have a "credit policy," but what is really needed is a high-quality "credit risk management policy" (CRMP). The CRMP in its expanded form contains all of the elements that a "credit policy" would contain, and goes beyond these. It must be updated at least annually, with Board approval for these annual updates.

i) Risk appetite statement

Risk appetite is the level and type of risk a bank is able and willing to assume in its exposures and business activities, given its business objectives and obligations to stakeholders (depositors, creditors, shareholders, borrowers, regulators).

A robust CRMP starts with a well-crafted risk appetite statement (RAS). In this regard, The Risk Appetite Statement shall be approved by board and embodied in risk policy and delegated authorities. . Risk appetite is generally expressed through both quantitative and qualitative means and should consider extreme conditions, events, and outcomes. It should be stated in terms of the potential impact on profitability, capital, and liquidity, and should be consistent with the bank's strategic and business plans. The credit RAS is an example of a bank's overall RAS being concretely expressed at the business line level. The RAS shall be approved by board and embodied in risk policy and delegated authorities.

For credit risk specifically, the RAS should quantify the maximum expected loss the bank is willing to endure across all credit products, including off-balance-sheet items such as letters of credit and guarantees. The maximum expected losses need to be specified so that the business lines that take on credit risk know where the bank wishes to be along the risk-return tradeoff. The bank should also specify the ***minimum*** expected losses, since it is possible for a bank to take on too little credit risk and face the consequence of weak earnings.

The RAS should also address the maximum and minimum allowable concentrations (expressed as a percentage of CET1) for all major types of credit products, borrowers, and sectors.

Contents of the Risk Appetite Statement shall be, but are not limited to, the following statements:

- Industry-wise sectoral concentration
- Product-wise funded loan concentration (composition of term loan, mid-term loan, demand loan, continuous loan etc)
- Product-wise non-funded loan (OBS) concentration (composition of bank guarantee, acceptance, etc.)
- Area wise/geographical, currency wise and maturity wise credit concentration
- Business segment-wise concentrations (corporate, MSMEs, Retail, Micro Credit, Card etc)
- Client concentration based on external/internal credit rating.
- Classification boundaries in terms of portfolio percentage, beyond which further growth may be halted.
- Maximum level of 'high' rated clients in terms of environmental and social due diligence.

ii) Limits on loan type, borrower type, rating grade, industry or economic sector

As stated above, it is an essential component of credit risk management to establish limits on concentrations across all possible dimensions of the credit portfolio. The first task in that effort is to establish a sensible disaggregation of the portfolio, along the following lines:

A Agriculture, Fishing, and Forestry

B Industry

Nature of Industry loan
a) Term loans
b) Working capital loans
(i) Secured by eligible securities
(ii) Secured by other than eligible securities
*Scale-wise distribution of industry portfolio
1. Large Industries
2.Small,medium,cottage & micro industries
3.Service industries

C Trade & Commerce:

a) Retail Trading
b)Wholesale Trading
c)Export Financing
d)Import Financing
e)Lease Finance
f)Others
(i) Secured by eligible securities
(ii) Secured by other than eligible securities

D Construction(commercial real estate, construction and land development loans):

a) Residential Real estate
b) Commercial Real estate
c) Infrastructure development
d) Others
(i) Secured by eligible securities
(ii) Secured by other than eligible securities

E Transport:

a) Road Transport
b) Water Transport
c) Air Transport

F Consumer financing

a) Loans for the purchase of flats or other single-family dwellings
b) Loans for the purchase of motorized personal transport
c) Loans for the purchase of durable consumption goods
d) Credit card loans
e) Other personal loans

G Loans to financial institutions

1) Loans to NBFIs
2) Loans to insurance companies
3) Loans to merchant banks and brokerage houses
4) Other, including loans to microfinance institutions and NGOs

H Miscellaneous

The above categorization, at its most disaggregated, contains 37 separate categories. Banks should establish concentration limits, expressed in terms of CET1, for all categories, at the lowest levels of disaggregation, and then rolling up to the highest.

In addition, Category B in the above scheme, “Industrial Loans,” can be disaggregated in a different way, focusing on the economic sectors rather than the type of enterprise and type of loan. The following breakdown is preferred:

- RMG
- Textile
- Food and allied industries
- Pharmaceutical industries
- Chemical, fertilizer, etc.
- Cement and ceramic industries
- Ship building industries
- Ship breaking industries
- Power and gas
- Other manufacturing or extractive industries
- Service industries
- Others

The combination of the type of borrower/type of loan breakdown and the sectoral breakdown of industrial loans would provide all the necessary data, plus allow the banks to monitor the all-important category of real estate lending and loans secured by real estate, the emphasis on which by the banks in recent years is a source of concern for financial stability.

iii) Other necessary components of an adequate credit risk management policy

Every bank has to develop a credit policy (CP) as a part of an overall credit risk management framework and get it approved by the Board. The CP should clearly outline the bank's view of business development priorities and the terms and conditions that should be applicable for credits to be approved. The CP should be periodically updated, taking into account changing internal and external circumstances. To make it effectual, CP should be communicated timely and implemented by all levels of the bank through appropriate procedures. It should be distributed to all lending authorities and credit officers. Significant deviations from the CP must be communicated to the senior management or Board and corrective measures should be taken. The CP should at least include:

1. Detailed and formalized credit evaluation/appraisal process;
2. Credit origination, administration and documentation procedures;
3. Formal credit approval process;
4. Approval procedure of credit extension beyond prescribed limits and other exceptions to the CP;
5. Risk identification, measurement, monitoring and control;
6. Internal rating (risk grading) systems including definition of each risk grade and clear demarcation for each risk grade in line with BB regulations and policies;
7. Risk acceptance criteria;

a. Credit approval authority at various levels including authority for approving exceptions and responsibilities of staffs involved in credit operations;

8. Roles and responsibilities of staffs involved in origination and management of credit;
9. Acceptable and unacceptable types of credit. These types can be on the basis of credit facilities, type of collateral security, types of borrowers, or geographic sectors on which the bank may focus;

10. Clear and specific policies for each of the various types of credits, including maximum loan-to-value (LTV) ratios where applicable;

11. Concentration limits on single party or group of connected parties, particular industries or economic sectors, geographic regions and specific products. Banks are allowed to set their own stringent internal exposure limits, as long as they are at least as strict as prudential limits or restrictions set by BB;

12. Pricing of credits, including whether loans will be granted on a fixed-rate or a floating-rate basis, and if floating, the frequency of rate changes and the reference rates that will be used for rate changes;

13. Policies for the frequency and thoroughness of collateral verification and valuation;

14. Review and approval authority of allowances for probable losses and write-offs;

15. Guidelines on regular monitoring and reporting systems, including borrower follow-up and mechanisms to ensure that loan proceeds are used for the stated purpose;

16. Guidelines on management of problem loans;

17. Policies on loan rescheduling and restructuring;

18. The process to ensure appropriate reporting and

19. Tolerance level of exceptions.

Chapter 02: Organizing Credit Risk Management

2.1 Role of the Board of Directors

The board has a vital role in granting credit as well as managing the credit risk of the bank. It is the overall responsibility of a bank's board to approve credit risk strategies and significant policies relating to credit risk and its management which should be based on the overall business strategy. Overall strategies as well as significant policies have to be reviewed by the board on regular basis.

The responsibilities of the board with regard to credit risk management shall include the following**:**

- Ensure that appropriate policies, plans and procedures for credit risk management are in place. Ensure that bank implements sound fundamental policies;
- Define the bank's overall risk appetite in relation to credit risk;
- Ensure that top management as well as staff responsible for credit risk management possess sound expertise and knowledge to accomplish the risk management function;
- Ensure that bank's significant credit risk exposure is maintained at prudent levels and consistent with the available capital.
- Review trends in portfolio quality and the adequacy of bank's provision for credit losses;
- Ensure that internal audit reviews the credit operations to assess whether or not the bank's policies and procedures are adequate and properly implemented;
- Review exposures to insiders and other related parties, including policies related thereto;
- Limit involvement in individual credit decisions to those powers specifically reserved to the Board by the bank's articles of association, by-laws, and credit risk management policy.
- Ratify exposures exceeding the level of the management authority delegated to management and be aware of exposures; and
- Outline the content and frequency of management reports to the board on credit risk management.

2.2 Role of Senior Management

The responsibility of senior management is to transform strategic directions set by the board in the shape of policies and procedures. Senior management has to ensure that the policies are embedded in the culture of the bank. Senior management is responsible for implementing the bank's credit risk management strategies and policies and ensuring that procedures are put in place to manage and control credit risk and the quality of credit portfolio in accordance with these policies.

The responsibilities of senior management with regard to credit risk management shall include:

- Developing credit policies and credit administration procedures for board approval;
- Implementing credit risk management policies to ensure an effective credit risk management process;
- Ensuring the development and implementation of appropriate reporting system;
- Monitoring and controlling the nature and composition of the bank's credit portfolio;

- Monitoring the quality of credit portfolio and ensuring that the portfolio is thoroughly and conservatively valued and probable losses are adequately provided for;
- Establishing internal controls and setting clear lines of accountability and authority; and
- Building lines of communication for the timely dissemination of credit risk management policies, procedures and other credit risk management information to all the credit staffs.

2.3 Role of the Credit Risk Management Committee

Each bank, depending upon its size, should constitute a credit risk management committee (CRMC), at least comprising of head of credit risk management Department and or credit department, head of recovery, head of RMD and treasury. The head of credit department/CRMD shall act as a member secretary of CRMC. This committee shall report to Board's risk committee and Board who shall be empowered to oversee credit risk taking activities and overall credit risk management function.

The CRMC should be mainly responsible for:

a) Implementation of the credit risk policy/strategy approved by the board.

b) Monitoring credit risk on a bank-wide basis and ensure compliance with limits approved by the board.

c) Makings recommendations to the board, for its approval, clear policies on standards for presentation of credit proposals, financial covenants, rating standards and benchmarks.

d) Deciding delegation of credit approving powers, prudential limits on large credit exposures, standards for loan collateral, portfolio management, loan review mechanism, risk concentrations, risk monitoring and evaluation, pricing of loans, provisioning, regulatory/legal compliance, etc.

Chapter 03: Managing Credit Risk in the Origination Process

Many avoidable mistakes are made in the origination process, leading to higher credit risk. In addition to the following analysis, an inventory of the most common mistakes that banks must avoid is contained in Annexure 2.

3.1 Borrower evaluation

The first step in the management of credit risks happens when the borrower walks through the door and goes through the application process. The basic question that any bank has to ask is: does the credit history (if any) and repayment capacity of the borrower provide sufficient probability of repayment, so that that the bank will earn an adequate risk-adjusted rate of return on the loan, without charging an excessive interest rate that may be unacceptable to the borrower or requiring credit enhancements that may be impossible for the borrower to provide?

i) Internal credit risk rating system[1]

An internal credit risk rating system (ICRRS) should categorize all credits into various classes on the basis of underlying credit quality. Banks should develop an internal credit risk rating system in line with regulatory authority's prescription for its credits in consistent with the nature, size and complexity of the bank's activities. All credit facilities should be assigned a risk grade. If any deterioration in risk is observed, the risk grade assigned to a borrower and its facilities should be immediately changed. The rating system must be endorsed by the board and should have at least the following parameters:

- covers a broad range of the bank's credit exposure, including off-balance sheet exposures;
- covers both performing and non-performing assets;
- has several grades covering exposures, with the lowest rating accorded to those where losses are expected;
- has risk ratings for "performing" credits with several grades (including the grade corresponding to "special mention");
- has regulatory classifications (standard, special mention, sub-standard, doubtful & bad/loss) should be incorporated within the risk rating systems; and
- has the credit risk rating system detailed in the credit policy and procedures developed for the determination and periodic review of the credit grades.

Using the language of Basel II/III, borrowers can be graded by their estimated probability of default (PD). The following sample table is an illustration of an actual bank's ICRRS, which is, in principle, an expanded version of the simplified Pass, Special Mention, Substandard, Doubtful, and Loss classification system utilized by banks and BB to establish loan-loss provisions. There should be several rating categories corresponding to Pass, and one or two corresponding to each of the other categories. In the following sample table, the rating categories 1-5 roughly correspond to the Pass classification category, 6 and 7 to Special Mention, 8 and 9 to substandard, 10 to Doubtful, and 11 to Loss. Simultaneously

[1] Banks shall comply with existing Credit Risk Grading (CRG) process and start preparation (including capacity building) for ICRRS as per this guidelines simultaneously. Banks shall be required to conduct ICRRS to manage credit risk in origination process mandatorily after the implementation of Internal Rating based Approach (IRB) in line with Basel III.

RATING CATEGORY BREAKDOWN

At 31 December Rating category	PD scale (%)		Net credit exposure (DKK billions)	
	Upper	Lower	2014	2013
1	0.00	0.01	69	99
2	0.01	0.03	185	147
3	0.03	0.06	394	393
4	0.06	0.14	447	405
5	0.14	0.31	510	457
6	0.31	0.63	289	296
7	0.63	1.90	213	210
8	1.90	7.98	82	80
9	7.98	25.70	22	30
10	25.70	99.99	38	38
11	100.00	100.00	18	17
Total			2,268	2,173

The rating grade is assigned to each individual obligor for wholesale credit, and either by obligor or at a pool level for retail exposures.

The ICRRS should be used for several purposes. First, it should be used in the setting of interest rates and other terms on the loan. Second, it should be used in determining approval authorities and limits. Approval authorities should be escalated to higher levels of the bank for fresh loans to lower-rated borrowers. Limits should also be established for fresh loans to borrowers across the various rating categories.

Next, the ratings should be used in determining if provisions (based on expected loss) and capital (based on unexpected loss) are adequate. As the above table illustrates, it should also be used to manage the portfolio and report on exposures, so that the Board and senior management know the overall exposure to borrowers across the rating categories are acceptable and within the risk appetite. The ICRRS can also be used for migration analysis and stress testing: for example, in determining what further loan loss provisions would be needed if all borrowers currently in category 7 migrated to category 8.

In designing the ICRRS, the bank must include both quantitative risk drivers (such as financial and income statement ratios, sources and uses of funds, cash flow coverage, past performance history, etc.) and qualitative risk drivers (financial projections, resiliency of payment sources, quality of management, macroeconomic and industry conditions, etc.). For every borrower, the ICRRS must estimate the PD through-the-cycle, that is, over a long assessment horizon that reflects the borrower's entire credit cycle and takes into account the possibility that the financial condition of the borrower may change over time, given cycles in the overall economy or the borrower's particular industry.

Reliance on entirely statistical models (also known as "credit scoring") is appropriate only for retail borrowers (such as individuals and small/medium-sized enterprises or SMEs) whose loans can be grouped into relatively homogeneous portfolios. For all other borrowers, default behavior depends more on idiosyncratic factors to each borrower. Some statistical modeling can be used, but must be supplemented by expert judgment. If, in turn, expert judgment is used, it must be documented transparently and be free from the raters' own biases.

The ratings must be reviewed at least annually, with more frequent reviews for new borrowers, large borrowers, and borrowers with more complex credits and/or multiple facilities.

Responsibilities and authorities to make changes to the rating category for any borrower must be clearly spelled out.

ii) The role of external credit assessment institutions (ECAIs)

The analysis of a potential borrower's creditworthiness by an ECAI may provide useful input and assist the bank's credit analysts in organizing thinking and forming an opinion about the potential borrower in question.
Banks may make reference to ECAI ratings (registered by Bangladesh Securities and Exchange Commission as well as recognized by Bangladesh Bank) in their credit risk management policies and loan underwriting practices, but they must rely on their own assessments of the creditworthiness of their borrowers as the primary determinants of the decision.

iii) Analysis of specific borrower repayment capacity

In order to make good credit decisions, lenders must know how to analyze financial statements submitted by loan applicants. Lenders are expected to follow sound risk management practices in the context of commercial credit analysis activities. A review of the company's current position with respect to the existing authorized level of commercial lending activities, capital adequacy position and compliance with commercial credit analysis regulations, guidelines and rulings is essential in determining the creditworthiness of an applicant.

Analyzing the Financial Statements

There is no substitute for thorough and rigorous analysis of a borrower's financial statements when attempting to determine a borrower's creditworthiness. The balance sheet, income statement, cash flow statement, and financial projections all provide critical information about the borrower's creditworthiness and capacity to repay

However, despite the importance of financial statement analysis in determining creditworthiness, the final credit decision is subjective because the most important factor in the decision is management of the borrower. An evaluation of management is based on both objective and subjective factors but is, in the end, subjective because there is no ratio or number that will inform the banker of management's intention or willingness to repay a loan. Therefore, the credit officer should make a serious effort to determine the competence, honesty and integrity of borrower management in each case. This effort should include what is called "due diligence," that is, the attempt to "know your customer" through contacting customers, suppliers and others in the industry who have experience with the borrower and its management.

Where possible and legal, in the case of smaller companies with single owners where personal guarantees will be required, a credit history should be obtained to determine the owner's record of fulfilling his/her financial obligations. Court records should be reviewed to determine if there have been any court proceedings against the borrower and/or borrower management. The question is whether or not borrower management, or the business owner, will honor its obligations to the lender in the best case and worst case. If the borrower encounters difficulties in repaying its obligation(s) to the bank, will management, or the owner, be willing to collaborate with the bank to "work out" repayment, however long it requires.

Limits on total exposure should be set for each individual borrower or group of related borrowers (related to each other, not to the bank), that are at least as stringent as those set by law or BB regulation. The size of credit limits should be based on the credit strength of the borrower, genuine purpose of credit, economic conditions and the bank's risk appetite. Limits should also be set for respective products, activities, specific industry, economic sectors and/or geographic regions to avoid concentration risk. Credit limits should be reviewed periodically at least semi-annually or more frequently if borrower's credit quality deteriorates. All requests for increase in credit limits should be authenticated by appropriate authority.

Sometimes, the borrower may want to share its facility limits with its related companies. Banks should review such arrangements and impose necessary limits if the transactions are frequent and significant.

Five Key Components of Financial Analysis

The lender should always use five key components of analysis. These are;

- Income statement,
- Balance sheet,
- Net worth and fixed asset reconciliation,
- Key ratios, and
- Cash flow statement.

When using accrual basis financial statements, cash flow analysis ties together the income statement and balance sheet to provide the analyst with a more complete financial picture of the borrower. Cash flow analysis "looks behind" the accrual basis numbers to identify the actual cash inflows and outflows over a certain period of time. Since cash flow is the first source of repayment, this exercise is critical.

iv) Required loan documentation- (See Annexure 1.)

3.2 Risk-based loan pricing

i) Building blocks of loan pricing

Banks must price loans to cover all costs, including a certain number of basis points over the life of the loan to account for each of the following:

- *Cost of funds*- The rate at which the bank is able to attract funds of equivalent tenor to the loan in question. In banks that apply funds transfer pricing, this rate is a wholesale rate, usually the swap rate (fixed or floating, depending on whether the loan is fixed or floating) of an equivalent tenor.
- *Expected loss*- The number of basis points that corresponds to the expected loss on the loan, which will be higher on loans with more credit risk and lower on loans with less credit risk. Although banks do not make loans with the expectation of suffering any loss, this amount is not zero for any loan, no matter how well collateralized or guaranteed.
- *Cost of allocated capital*- The cost of allocated capital is the amount of capital the bank has allocated to the loan as coverage for unexpected loss, multiplied by the target return on equity for the bank as a whole, and expressed in terms of basis points. As a simplification, banks often use the risk-based capital requirement as a proxy for the amount of capital that should be allocated to the loan.

- *Term cost of liquidity*- The number of basis points that captures the cost arising from the fact that loans of longer and longer tenor require stable funding of longer and longer tenor, which will be costly for the bank above and beyond any interest-rate risk considerations (which will be captured in the swap rate).
- *Cost of liquid asset buffer*- Banks rarely "maturity-match" a loan with a specific source of funding of equivalent tenor. They rightly know that a mix of current accounts, savings accounts, and fixed deposits will render a stable source of funds under most circumstances. However, in extremely adverse and rare circumstances, a run on deposits may occur and the bank may be forced to sell assets quickly at low prices or seek additional deposits or other funds at high rates. For this reason, a liquid asset buffer must be held for these unexpected situations. Since these assets either earn no interest at all, or very little interest for the bank, there is an opportunity cost for holding the assets that must be expressed in terms of basis points and included in the determination of the loan rate.
- *Loan administration costs*- For any loan, big or small, there are staff costs involved in origination and monitoring. Some of these costs are up-front and some are ongoing, but they all must be expressed in terms of basis points over the life of the loan.
- *Competitive margin*- Finally, after all other costs have been included in the rate, the bank will add on a certain number of basis points to earn a margin. This component is the only one that is fully at the discretion of the bank, given its funding and expense structure. This margin may even be negative, if the bank desires to gain a temporary competitive advantage. However, it should not be negative on any kind of loan product for an extended period of time.

Banks should be able to show to BB at all times that they have priced their recently-originated loans to cover all of these costs.

ii) Determination of selected components of risk-based loan pricing

Some of the various components like swap rate, wholesale rate, liquidity premium, senior debts issued by banks may be difficult to estimate in practice. However, banks are expected to exert every effort in estimating these necessary components and documenting their assumptions and results.

3.3 Approval authority

i) Basic approval authority principles

The authority to sanction/approve loans must be clearly delegated to senior credit executives by the Board, based on the executive's knowledge and experience. Approval authority should be delegated to individual executives and not to committees to ensure accountability in the approval process.

Banks are expected to develop credit risk officers who have adequate and proper experience, knowledge and background to exercise prudent judgment in assessing, approving and managing credit risks. A bank's credit-granting approval process should also establish accountability for decisions taken and designate who has the absolute authority to approve credits or changes in credit terms. Approval authorities should be commensurate with the expertise of the individuals involved. A preferred approach is to develop a risk-based authority structure where lending power is tied to the risk ratings of the obligor (that is, progressively higher levels of credit risk, holding constant the loan amount, should be approved by progressively higher levels of authority).

The following guidelines should apply in the approval/sanctioning of loans:

- Credit approval authority must be delegated in writing from the MD/CEO and Board (as appropriate), acknowledged by recipients, and records of all delegation retained in the CRM.
- Delegated approval authorities must be reviewed annually by the Board.
- The credit approval function should be separate from the marketing/relationship management (RM) function. Credit approval authority cannot be delegated to a person assigned with marketing functions.
- The role of the Credit Committee may be restricted to only the review of proposals and making recommendations within the context of the bank's overall loan portfolios. They may also review the compliance with regulatory requirements.
- Approvals must be evidenced in writing, or by electronic signature. Approval records must be kept on file with the Credit Applications.
- All credit risks must be approved by executives within the authority limits delegated to them. The "pooling" or combining of authority limits should not be permitted.
- The credit approval process should be centralized as a core CRM function. Considering the volume of operations, Regional Credit Centers may be necessary. However, all large loans must be recommended by the Credit Committee and Managing Director and approved by the Board.
- The aggregate exposure to any borrower or borrowing group must be used to determine the approval authority required.
- Any credit proposal that does not comply with the Bank's Lending Policy, regardless of amount, should be referred to Board of Directors for approval
- A definite process is to be adopted to review, approve and monitor cross border exposure risks.
- Any breaches of lending authority should be reported to MD/CEO and Head of Internal Control. There should be consequences for such breaches, to deter future violations.
- It is essential that executives assigned delegated with approving loans possess relevant training and experience to carry out their responsibilities effectively. As a minimum, approving executives should have:

  - At least 5 years' experience working in corporate/commercial banking as a relationship manager or as a credit analyst or account executive.
  - Training and experience in financial statement, cash flow and risk analysis with a critical eye.
  - A thorough working knowledge of the fundamentals of accounting, finance and risk management.
  - A good understanding of the local industry/market dynamics.
  - Successful completion of an assessment test demonstrating adequate knowledge in areas including introduction of accrual accounting, industry/business risk assessment, borrowing causes, financial reporting and full disclosure, financial statement analysis, asset conversion/trade cycle, cash flow analysis, projections, loan structure and documentation, loan management, etc.

A separate register (hard copy/electronic copy) is to be maintained for proposals received, approvals accorded, and proposals declined. A monthly summary of all new facilities approved, renewed, or enhanced; and a list of proposals declined, stating reasons thereof, should be reported by the CRM to the MD and related Senior Management.

Credit delegations are to be as specific as possible in terms of amount, tenor, deal, business segment etc. The following areas may be considered as a guide for credit delegation.

a. New/fresh limits (secured and unsecured)
b. Renewal of credit limits
c. Renewal, renewal of enhancement, renewal with reduction, restructuring and rescheduling of limits
d. Compromise Settlement under Alternate Dispute Resolution (ADR) [Sec 24 of Money Loan Court Act – 2003]
e. Consumer/Retail and Personal Advance to each individual :
f. Emergency Short-Term Enhancements
g. Documentation deferrals
h. Change of terms and conditions
i. Collateral exceptions
j. Pricing, policy, exceptions

The bank's internal audit department must review the functioning of the authority delegations at least annually, to ensure that there are no breaches.

ii) Approval authority for large or complex exposures

The approval level for large loans and loans to be restructured must be escalated to the Board. It is also best practice for any complex or unusually high-risk loan to be escalated to the Board for approval.

iii) Exceptions

In certain, limited circumstances, exceptions may be granted to the approval authority policy on a case-by-case basis. However, such exceptions should be rare, and the reason for the exception should be stated in the loan file. A compilation of the exceptions should be provided to the Audit Committee of the Board on a regular basis.

3.4 Disbursement

The credit administration should ensure that the credit application has proper approval before entering facility limits into computer systems. Disbursement should be effected only after execution of charge documents and completion of covenants and creating charge on primary securities and collaterals (an indicative documentation checklist is given in Annexure 1). In case of exceptions, necessary approval should be obtained from competent authorities. In no case should any of the loan proceeds be disbursed before all necessary approvals have been granted.

In disbursing the loan, it is imperative that the borrower understand and acknowledge the purpose of the loan. It is also imperative for the bank to design and implement checks, such as the submission of invoices, to ensure that the proceeds are spent on the designated purpose and for no other purpose, and for the borrower to understand and comply with these checks.

3.5 Special case of related person lending

Banks must exercise a heightened level of caution in lending to bank-related persons, as that term is defined in section 26 (Ga) of Bank Company Act as well as BRPD Circular No. 4 of 23 February 2014 and any amendment thereafter. A potential area of exploitation arises from granting credit to related persons, whether companies or individuals. Related parties typically include a bank's promoters, major shareholders, subsidiaries, affiliate companies, directors, and executives. The relationship includes the ability to exert control over or influence a bank's policies and decision-making, especially concerning credit decisions. It is crucial for a bank to systematically identify and track extensions of credit to related persons. The issue is whether credit granting decisions are made rationally and according to approved policies and procedures.

Under no circumstances should a loan be made to a related person on terms and conditions more favorable to that person than to any unrelated client. In this context, "more favorable" means a lower interest rate, lower upfront fee, less collateral, lower-quality collateral, longer tenor, or less frequent interest payment. Any loan or other extension of credit to a related person must be approved by the Board, and the aggregate amount of all loans and other extensions of credit to bank-related persons cannot exceed 10% of the bank's Tier 1 capital.

i) Avoidance of undue influence on credit decision

The Board and senior management must set the proper "tone from the top" in not pushing through loans to related persons that violate laws, BB guidelines and circulars, the bank's own credit risk management policy, and best banking practice. Ability to repay must be the primary criterion for approval. Banks must have policies and processes to prevent related persons from participating in the proposal and approval discussions.

ii) Avoidance of "daisy chains" and other devices to evade rules and sound practices in related person lending

The Board and senior management will be held responsible for ensuring that the bank does not enter into so-called "daisy chains" or other reciprocal arrangements that are designed to evade the rules, aggregate limits, and sound practices in lending to related persons. A daisy chain is created when Bank A lends to a related person or persons of Bank B, Bank B lends to a related person or persons of Bank C, and Bank C lends to a related person or persons of Bank A. (Chains often have even more than three links, to further disguise the coordinated violation.) A reciprocal arrangement is created when Bank A lends to a related person or persons of Bank B, and Bank B lends to a related person or persons of Bank A.

BB will closely inspect and monitor for the existence of these daisy chains and reciprocal arrangements, and those that are entered into without any independent business justification except for the purpose of evading the rules, limitations, and sound practices, shall be considered as violations of the relevant laws, guidelines, and circulars, and subject the bank(s) to measures to take corrective action.

Chapter 04: Credit Risk Mitigation Strategies

4.1 Credit Risk Mitigation

Banks may use different strategies such as collateral and guarantees etc. to mitigate credit risks. Credit Risk Mitigation strategies can be of agreements made between the bank and the borrower, or between the bank and a third party, which lower the credit risk to the bank. The existence of credit risk mitigation is no substitute for proper loan underwriting and loan administration. They are correctly viewed only as secondary sources of loan repayment, never primary sources.

Given the often lengthy, arduous, and costly process of realizing the collateral or invoking the guarantee, banks are strongly cautioned against making their loans collateral- or guarantee-dependent. A loan is considered collateral-dependent when repayment is expected to be provided solely by the seizure and sale of the collateral, the continued operation of the collateral, or, sometimes, both together.

4.2 Collateral

For proper credit risk management, banks must keep track of which loans are collateralized by which types of collateral. "Concentrations of collateral" are nearly as dangerous as concentrations by type of loan or industry. The following scheme for categorizing loans by collateral type is recommended:

1) Shares and securities
2) Commodities/export documents
   a) Export documents
   b) Commodities
      i) Export commodities
      ii) Import commodities
      iii) Other commodities pledged or hypothecated
3) Machinery/fixed assets (excluding land, building/flat)
4) Real estate
   a) Residential Real estate
   b) Commercial Real estate
5) Financial obligations
6) Guarantee of individuals (personal guarantee)
7) Guarantee of institutions (corporate guarantee)
   a) Guarantee of bank or NBFI
   b) Other corporate guarantee
8) Miscellaneous
   a) Hypothecation of crops
   b) Other
9) Unsecured loans

i) Amount and type required

It is imperative that the bank, when extending credit, demand the type and amount of collateral as stated in its credit risk management policy. The loan-to-value ratio must be low enough to absorb declines in the value of the collateral that may occur with a small, though not insignificant probability.

The most valuable collateral is cash and easily en-cashable financial collateral stipulated in Risk Based Capital Adequacy Guidelines (in line with Basel III). Other collateral in order of its quality and marketability would be marketable securities, real estate and a personal guarantee. The order of collateral mentioned is the same as the operating cycle of the company. The farther away from cash, the more tenuous the value becomes. Real estate, taken as collateral, is less liquid and marketable in the short run but is controllable and dependable in value.

ii) Initial and ongoing valuation

Collateral is only as good as the lender's ability to locate, identify, and legally claim the collateral and eventually sell the collateral for enough to recover the principal, interest, plus all liquidation costs. When collateral is taken as security, consideration must be given to the dependability of the value, its marketability, the liquidity and the ability of the bank to control the collateral when in the possession of the debtor and when the bank must liquidate.

Cash flow is the primary source of repayment and the collateral taken should be valued on a liquidation basis. The bank is unlikely to be more successful with the collateral than the borrower has been.

Determining value of collateral at the time of the inception of the loan is essential. Continuous updated valuations are needed, depending on the length of the loan, particularly if the loan becomes a problem loan. The techniques of valuing include the cost, or replacement value, market, income as a going concern or liquidation, and the liquidation value. It is essential the bank uses outside appraisers or companies familiar with auctions and liquidation experience. If a borrower gets into trouble, the good collateral will be the first to be used by the borrower to satisfy other debtors or suppliers. The bank should consider the costs to liquidate, which includes foreclosure, holding the collateral for sale, and the costs of selling.

To reiterate, banks need to reassess the value of collateral on a periodic basis. Appropriate inspection should be conducted to verify the existence and valuation of the collateral. The frequency of such valuation is very subjective and depends upon the nature of the collateral. For instance, credits granted against shares need revaluation on almost a daily basis, whereas if there is mortgage of a residential property the revaluation may not be needed as frequently

4.3 Third-party guarantees

The bank must understand that the credit risk on a loan is not eliminated by the existence of a third-party guarantee. The bank merely substitutes the credit risk of the guarantor for that of its own client. With regard to guarantees, banks should evaluate the level of coverage being provided in relation to the credit-quality and legal capacity of the guarantor. Additional credit-enhancing steps are the following:

- The corporate guarantee must be supported by a Memorandum of Association (MoA) and Articles of Association (AoA) of the company giving the corporate guarantee. Additionally, the corporate guarantee to be approved in the board meeting of the corporate guarantor.

- The guarantor company must be rated in any of the investment grade categories by at least one ECAI.
- The balance sheet of the third party giving a corporate guarantee is to be analyzed. Net worth, total assets, profitability, existing credit lines, and security arrangements of the company giving the corporate guarantee to be analyzed to ensure that the company is not exposed to financial obligation beyond its capability.
- Once the financial stability of the corporate guarantor has deteriorated in terms of the above, the bank shall ask for remedial measures from the borrower (replacement/new collateral).
- Reciprocal guarantee arrangements between two banks will be disregarded. For example, if Bank A guarantees loans made by Bank B to certain client(s), and Bank B guarantees loans made by Bank A to certain client(s), only the difference between the two guaranteed amounts will be considered as a credit enhancement for the purposes of determining the overall level of credit risk at the bank whose borrowers benefitted from the higher amount.

Chapter 05: Managing Credit Risk in the Administration Process

5.1 Borrower follow-up and corrective action

Conducting customer calls and site visits to obtain key data is a critical and continuous process. For this reason it is important for the lender to be out in the field as often as possible because:

- Problems are often evident here first.
- Problems are often disguised in financial statements.
- The loan proceeds may have been diverted to some other purpose.

Depending on the size of loan and risk rating of the customer the lender should conduct a customer call quarterly. To do this the lender should:

- Develop a call schedule plan.
- Plan other necessary data gathering.
- Determine the frequency of site visits by utilizing the loan classification. The less favorable the classification, the more frequent the visits should be.

In addition, banks need to watch carefully the financial standing of the borrowers. The key financial performance indicators on profitability, equity, leverage and liquidity should be analyzed. While making such analysis due consideration should be given to business/industry risk, borrowers' position within the industry and external factors such as economic condition, government policies and regulations. For companies whose financial position is dependent on key management personnel and/or shareholders, for example, in small and medium enterprises, institutions would need to pay particular attention to the assessment of the capability and capacity of the management/ shareholder(s).

In case of an existing borrower, banks should monitor the borrower's account activity, repayment history and instances of excesses over credit limits. For trade financing, banks should monitor cases of repeat in extensions of due dates for trust receipts and bills.

Banks should regularly review the credit in terms of the borrower's ability to adhere to financial covenants stated in the credit agreement, and any breach detected should be addressed promptly.

5.2 Independent internal loan review and changes to the credit risk rating

The concept of an independent, internal loan review is absolutely critical to proper credit risk management.

a) Loan Review vs. Loan Monitoring

Loan Review is a strategic process, a staff function:

- Accomplished by an objective third party (not the loan officer)
- Includes assessment and evaluation of individual loans, loan portfolio components
- Attempts to assess the loan portfolio as a whole
- May make recommendations for achieving corporate strategic objectives through the loan portfolio

Loan Monitoring is a tactical process, a line function:

- Accomplished by loan officer
- Tracking of a borrower, watching for loan deterioration, with the emphasis on loan repayment

b) Objectives of Loan Review

- Evaluate credit quality of the loan portfolio through an independent assessment of risk ratings assigned to individual loans
- Assess adequacy of the loan loss reserve with conclusions based on:
  - Historical loan loss and recovery experience,
  - Projected loan losses and recoveries,
  - Review of problem loans,
  - Overall portfolio quality,
  - Current and anticipated economic conditions, and
  - Ability of the bank to replenish (loan loss) reserves through earnings.

  Perspective adopted by loan review should be that of a potential purchaser of the loan portfolio on a **non-recourse** basis.
- Determine Trends
  - Loan review should attempt to extrapolate trends and identify potential problem areas and/or unique opportunities, after examination of such factors as the quality of loan administration and personnel, credit concentrations, and vulnerability to economic conditions.
  - A review of current conditions alone is not sufficient because banking is a dynamic business, never static.
- Identify Problems
  - Credit concentrations may pose a problem, e.g.
  - Once identified, examination of the source of the problem is important.
    - Perhaps loan administration/monitoring is weak, e.g.
- Evaluate adherence to loan policy, laws, and regulations
  - Are individual loans in compliance with policy, laws and regulations?
  - Why are the violations occurring?
  - Is there a pattern to non-compliance?
    - Perhaps the bank's loan policy is unrealistic or should be altered
    - Perhaps additional training of loan officers is needed
- Assess portfolio in relation to profitability and funds management objectives
  - Evaluate profitability of individual credits.
  - Evaluate the profitability of the portfolio as a whole.
- Evaluate effectiveness of loan administration and personnel by focusing on the effectiveness of:
  - Loan policy,
  - Loan approval systems,
  - Ongoing loan monitoring,
  - Problem loan administration, and
  - Loan review itself.

If warranted, make recommendations for improvement.

Loan review should assess the loan management process, credit quality, and the results/ profitability of the loan portfolio, **not** credit quality alone. External inspection by BB is not a substitute for a strong loan review function within the bank.

c) Chief Elements of Loan Review

- Senior Management Support
  - Objectivity
  - Credibility

Loan review should report to the board of directors and receive *strong support from senior management.*

Objectivity is critical. Senior management sets the example; it must be willing to accept unfavorable/undesired information without recriminations.

Credibility is vital. A good loan review team acts as a consultant, identifying problems and recommending solutions. Loan review staff should be competent and experienced. Loan review can provide excellent training for potential loan managers.

d) Organizational and Reporting Considerations

Loan review is usually an independent function or part of the overall independent auditing function of the bank. Ideally, it reports to a committee of the board of directors of the bank.

The purpose of an independent loan review function is the pursuit of **objectivity**. It is of critical importance, however, that loan review personnel be competent and have lending experience, in order to maintain credibility and communication with the lending function. If the loan review department has no credibility and/or poor communication with the lending function, it cannot perform its function well.

e) How Loan Review Performs Its Function

- Determine what is to be reviewed and when, given time and resource limitations.
- Loans reviewed should be representative of the portfolio as a whole.
- Establish a minimum loan amount for review.
- Employ random sampling on a statistical basis.
- (Suspected) Industry concentrations must be detected and examined.
- Borrowers with certain financial characteristics should be scrutinized, e.g., erratic earnings, interest-sensitive leverage which exceeds industry standards.
- Examine credits of a particular branch or officer where weakness or incompetence is suspected.
- Frequency of loan review is based on risk rating – the higher the risk the more frequent the review.
- Monitor situations where corrective action has been recommended.
- Be present at loan department meetings to review loan activity for conformity with original repayment programs, pricing, funds management goals, appropriate monitoring.

f) Content of Loan Review

Five specific issues should be addressed when examining individual credits:

- Credit Quality
- Documentation

- Liquidation of Collateral
- Pricing and Funds Management Objectives
- Compliance With Loan Policy, Laws and Regulations

g) Credit Quality

Three fundamental questions:

- Is the risk different from that perceived by the lender?
- What is the probability of repayment in accordance with terms?
- Is current monitoring adequate?

Use of a **risk rating system,** as described in 3)1)i)[2] above, is essential in order to reduce the element of subjectivity as much as possible. In examining a credit, loan review must either confirm the risk rating assigned by the lender or change it and substantiate the change.

h) Documentation

Documentation is either correct or incorrect. Loan review should point out errors with the aim of improving protection for the bank, strengthening the position of the bank in the event of a problem. Additional protection may well be recommended in the case of deteriorating credits. Loan review should be concerned both with identifying existing problems and eliminating future problems.

i) Liquidation Value of Collateral

The only relevant value to apply to collateral is its liquidation value, because collateral is needed only in the event that it must be liquidated to repay a loan. Book values are meaningless.

Loan review personnel must be experienced in working with collateral, in identifying liquidation values, in knowing what is involved in liquidations. It is the responsibility of loan review to provide an objective third-party opinion so that realistic loan-to-collateral relationships are maintained by lenders.

5.3 Timely identification of problem assets

The standard practice of "looking back" at past due status, presence or absence of collateral, and other factors resulted in provisions that turned out to be grossly inadequate on both an aggregate and individual credit basis. A more "forward-looking" approach to the identification of problem loans and the establishment of adequate provisions was clearly needed, and international standards such as International Financial Reporting Standard 9 on the classification and measurement of financial assets are being adopted to provide this forward-looking approach. The independent, internal loan review described in the previous section is the appropriate framework through which to apply this forward-looking approach.

As mentioned in the previous section on loan review, banks, in reviewing and classifying their loans, should be on the alert for developments in the macroeconomic, industry, and competitive environment that could lead to financial problems for those borrowers in the future. The subjective factors given in BRPD's Circular No. 14 of 23 September 2012, "Master Circular: Loan Classification and Provisioning" and any change thereafter must be taken into account in

[2] Before implementation of Internal Rating based Approach (IRB) in line with Basel III, banks are required to conduct existing Credit Risk Grading (CRG) process instead of ICRRS.

determining the classification category, and banks must avoid taking a mechanistic approach to identifying and classifying their problem loans.

More specifically, the following warning signs are to be considered by banks in predicting that a loan will become a problem loan:

a) Documentation Weakness

- Failing to file collateral agreements/security agreements with appropriate public departments
- Transferring the collateral to another country/state
- Guaranties with expired dates
- Changes in legal status
- Unauthorized corporate/partner signatures

b) Collateral Deterioration

- Changes of value in the marketplace
- Rising interest rates decrease real estate and investments
- Technological advances
- Rapid depreciation of equipment or inventory
- Tax law changes (real estate)
- Natural disasters
- Spoilage or mishandling of collateral

c) Extended Credit and High Use of Lines of Credit

- Borrower is at the top of line each month
- Failure to meet financial covenants in loan agreement
- Delays in payment of principal and interest
- Use of overdrafts/low balances in current account
- Credit inquiries from other lenders
- Change of accountants

d) Other Indications of Problem Loans

- Delay in receipt of financial statements
- Delay in management promises or returning telephone calls
- Change in senior management

5.4 The role of provisioning in managing credit risk

Provisions for loan losses (alternatively known as loan loss reserves, loan loss allowances, valuation allowances, etc.) are more than just an accounting entry on the liability side of a bank's balance sheet. In the aggregate, the level of provisions must reflect the expected loss on each loan. General provisions are applied to portions of the portfolio (currently, on unclassified loans and loans in the Special Mention Account) on a portfolio basis, based on the expectation that some of the loans (without knowing which) will be downgraded in the future and require specific provisions. Specific provisions are applied to individual classified loans as an estimation of expected losses on these individual loans.

These balance sheet provisions, formed by debiting expense accounts on the profit and loss statement also known as “provisions,” play an essential role in managing credit risk. Without accurate provisions, the Board and senior management do not know completely whether or not certain types of lending are profitable on a risk-adjusted basis. Funds could then flow to these unprofitable lending activities at the expense of more profitable activities. Moreover, if loans are overvalued on the balance sheet, then capital will also be overvalued, leading to misallocation of the bank’s scarce financial resources and interfering with all activities of risk management that are tied to the level of capital.

The Board and senior management should recognize that loan losses are inherent in their portfolios, and provisioning policy does not alter the timing and magnitude of these losses. Higher or lower provisions only alter the timing of recognition of these losses. Accordingly, the bank’s long-run profitability is unaffected by the bank’s stance on provisioning.

Chapter 06: Managing Credit Risk with Appropriate Management Information Systems (MIS)

A Management Information System (MIS) must provide quality data to the Board and senior management on the segmented portfolio on a timely basis that will enable the analysis of the current and future risk, and exposure by both the business areas responsible for its management. The business must have and maintain an accurate database containing all application information for both approved and declined applications, collateral and security information. Data retention specifications must be incorporated in the Credit Instruction Manual. Data archiving procedures and MIS must be adequate to facilitate the development of credit scores and models when required.

The following indicators (both number and amount where relevant) must be traced and tracked on a monthly basis at the each business level for Single Products and Multi products:

6.1 Booking MIS

- Applications received, Processed
- Applications Approved, Declined
- Approval rate, Average credit score of approved limits
- High side overrides/ Low side overrides, Policy Overrides
- New Business Booked in 'Amount' and 'Number'
- Bank Directors' Loan Information
- Rejection Reason Analysis

6.2 Portfolio MIS

- Limit Increases, Limit Decreases, Renewals
- Unutilized and Undrawn amounts
- Attrition (voluntary and involuntary)
- Net Interest Income (NII) %, Net Fees Income (NFI) %, Operating Profit %, Trading Profit (TP)%, Risk Adjusted Return (RAR) % [Note: These ratios and percentages seem to apply to the entire bank, not to the credit function or individual portfolios of credits.]
- Delinquency (30+DPD, 60+DPD, 90+DPD, 120+ DPD, 150+ DPD, 180+ DPD or more)
- First Installment Default (FID) or First Payment Defaults
- Risk grading of customer exposures
- Early Alert Reporting (EA Code wise), Classified Account Reporting, Loss Given Default, Collateral Values, Deviations.
- Overdue Annual Reviews (aged) and Extended Accounts
- Gross Write-offs, New Provisions, Releases, Recoveries, Net Bad Debt, Provisioning Balance
- Repossessions/foreclosures - initiated, in progress, Inventory
- Expenses associated with foreclosure process
- Foreclosure Assets sold, Write-downs taken periodic and on sale
- Expenses incurred in maintaining and selling repossessed property
- Database of Non-Performing Loans (NPLs) that are due to environmental reasons

- Clients' Classification based on Environmental and Social Risk Rating (ESRR)
- Environmental and Social Risk Rating (ESRR) wise portfolio MIS
- Monthly Loan Set off data and reason analysis report
- DLA wise loan performance report

6.3 Segmentation MIS

The business must have the ability to generate reports for the above indictors for single and multiple products (on an as needed basis and, where relevant) by:

- Original loan amount or credit line
- Debt burden
- Risk Score range
- Customer profile
- Collateral Profile (fully secured/ partly secured etc), Breakdown of collaterals held
- Loan purpose
- Loan Size and Tenor
- LTV and geographic location
- Customer Relationship based on Turnover
- Industry according to SBS code.
- Segment / industry-wise / product-wise loan sanctioned vs. utilization vs. outstanding
- Utilization of approved limits (TL / WC)
- Risk based pricing performance monitoring
- Loans under "different customer group" performance report
- Credit Test report if any test is undertaken
- Product wise campaign reports

All indicators must be compared and reviewed with historical performance, expected results and competitive benchmarks where available. Forecasts for future periods must be updated based on actual performance and revised expectations.

6.4 Sufficient data to disaggregate loan portfolio by loan type, borrower type, rating grade, industry or sector, type of collateral, etc.; with concentrations highlighted

If they have not already done so, banks must begin immediately to disaggregate their loan portfolios according to the schemes shown above in 1.5-iii. Portfolios must also be disaggregated by collateral type, as shown in 4.2 above.

6.5 Sufficient data to track loss experience on loans disaggregated by above factors

Once the disaggregation of the loan portfolio is in place, banks must begin immediately to record loss experience by type of loan, disaggregated across all the categories. The reason for this database development and maintenance is threefold: first, to provide, over time, better estimates of "expected loss" to be used in the setting of loan-loss provisions and loan pricing; second, to steer the Board and senior management away from types of lending that have historically been unprofitable; and third, to allow the eventual construction of probability distributions, both at the level of the individual bank and the banking system as a whole, that are used in the calculation of economic capital and in the Internal Ratings Based approach to the determination of risk weights in the Basel III capital requirement calculation.

For each type of loan (disaggregated data) and for the breakdown of industrial loans, the bank must collect the following data on a quarterly basis:

- Outstanding principal balance of loans written off during the quarter (excluding accrued interest receivable)
- Estimated market value of collateral related to loans written off during the quarter, subdivided into:
- Collateral already repossessed by the bank
- Collateral not yet repossessed by the bank
- Specific provisions related to loans written off, debited at the time of write-off
- Cash recoveries related to loans written off during the quarter
- Gain or loss on sale of collateral repossessed by the bank

The net credit loss related to these write-offs, then, would be the outstanding principal balance minus the value of collateral already repossessed, minus specific provisions, minus any cash recoveries on these loans, minus or plus any gain or loss on the sale of the repossessed collateral. (It is to be understood that as the quarters proceed, the quarterly net credit losses on various types of loans will not be a smooth data set, but will be subject to sharp fluctuations. Over time, however, the quarterly figures can be smoothed into a measure of "typical" quarterly losses on each segment of the portfolio.)

6.6 Sufficient data to quantify embedded losses in the loan portfolio that have not yet been recognized

Particularly on loans that have been rescheduled or restructured, there may be a degree of regulatory forbearance concerning provisioning of problem loans from time to time. Notwithstanding any such regulatory or accounting forbearance, it is imperative that management quantify "embedded" losses in the loan portfolio that have not yet been recognized in the audited financial statements or in regulatory reports to BB.

6.7 Periodic stress testing

An important element of sound credit risk management is analyzing what could potentially go wrong with individual credits and the overall credit portfolio if conditions/environment, in which borrowers operate, change significantly. The results of this analysis should then be factored into the assessment of the adequacy of provisioning and capital of the bank. Such stress analysis can reveal previously undetected areas of potential credit risk exposure that could arise in times of crisis.

Possible scenarios that banks should consider in carrying out stress testing include:

- Significant economic or industry sector downturns;
- Adverse market-risk events; and
- Unfavorable liquidity conditions.

Banks should have industry profiles in respect of all industries where they have significant exposures. Such profiles must be reviewed/updated on a regular basis. Each stress test should be followed by a contingency plan as regards recommended corrective actions. Senior management must regularly review the results of stress tests and contingency plans. The results must serve as an important input into a review of credit risk management framework and setting limits and provisioning levels.

6.8 The role of loss control limits (“management action triggers”) in adjusting credit policies, authorities, limits, required credit enhancements, etc.

Although they were developed primarily to manage market risk, loss control limits (also known as management action triggers) are usefully applied to credit risk management as well. A loss control limit is a type of limit that requires specific management action if it is approached or breached. When tracking the loss experience on the disaggregated portfolio, the MIS should warn the Board and senior management when the loss experience on a particular type of loan is approaching the established limit (which must also be clearly indicated in the documentation) so that management can make an informed decision about whether or not to cease or scale back on that type of lending.

Chapter 07: Managing Credit Risk of Problem Assets

Problem loans are an inevitable consequence of lending. Any time a loan is funded, unforeseen events could arise and make it difficult for the borrower to live up to the terms of the loan agreement. Problem loans often begin with commercial loan officer errors – for example, inaccurately assessing the character of the borrower, misinterpreting the figures on a spread sheet, or simply not saying no to the loan request. These causes of problem loans should and can be minimized.

7.1 Interaction with borrower

Once a potential problem loan has been identified, the banker needs to follow following steps:

- Develop a preliminary plan before meeting with the borrower.
- Schedule a meeting with the borrower soon after learning about the problem loan.
  - Discuss the problem, explore available alternatives to solve the problem, and establish what actions are acceptable and not acceptable.
  - The lender decides what additional information, such as monthly financial statements, the borrower should supply, so that the bank can more closely track the situation.
  - The borrowers also outline interim steps to resolve the problem.

It is not enough to send a letter pointing out how the borrower is in violation of various terms of the loan documents. The response, if one comes at all, likely will be unsatisfactory; most borrowers deny the problem or believe that if anything is wrong it will correct itself over time. Instead, call the borrower, inform him of the bank's concerns, and schedule a meeting. The lender thus impresses on the borrower the bank's desire to cooperate, with out downplaying the bank's resolve to get to the bottom of the problem quickly. A meeting helps to further define the best course of action – whether to continue working with the borrower, ask for repayment, or move to liquidate the collateral. For example, an evasive or extremely uncooperative borrower quickly enables the lender to narrow the bank's options.

What action a lender takes depends on a thorough analysis of the causes of the loan and the likelihood of their resolution. However, regardless of whether the bank ultimately decides to continue working with the borrower or to liquidate, a cooperative effort is important. Avoiding unnecessary animosity is good customer relations and helps resolve the problem with a minimum of stress for both the bank and borrower. If the borrower is made to feel that the situation is hopeless, he or she may act precipitously. It is important, therefore, that the lender understands the borrower's emotional state and knows how to deal with him so that the bank's objective of debt repayment is realized.

7.2 Appropriateness of rescheduling as a means to manage credit risk

In certain rare situations, the borrower may find itself in a period of temporary financial distress. Loan rescheduling – the stretching out over a longer time period of required payments of principal and/or interest – may be an appropriate way of handling the problem loan situation, but only if the bank is fairly certain that the borrower can fulfill the rescheduled terms of the contract. In no way must rescheduling be used if the bank has significant doubt concerning the borrower's willingness or ability to repay over the long term.

7.3 Appropriateness of restructuring as a means to manage credit risk

If the borrower's financial distress is more permanent rather than temporary, restructuring may be appropriate in order to maximize the present value of the future cash flows that can reasonably be expected from the borrower.

As with rescheduling, banks should not restructure any loan unless the bank is fairly certain that the borrower can fulfill the restructured terms. In all cases, restructuring must be conducted only in accordance with BB directives from time to time, including the formation of necessary provisions. (Additional provisions to capture all expected losses from the restructuring activity may also be established, and, at the very least, the tracking of these embedded losses should be part of MIS reports to the Board and senior management.)

7.4 Credit Recovery

Banks will put in place systems to ensure that management is kept advised on a regular basis on all developments in the recovery process. The following issues shall be addressed while conduction credit recovery functions:

- Determine Account Action Plan/Recovery Strategy
- Pursue all options to maximize recovery, including placing customers into receivership or liquidation as appropriate.
- Ensure adequate and timely loan loss provisions are made based on actual and expected losses.
- Regular review of non performing or worse accounts

The management of problem loans (NPLs) must be a dynamic process, and the associated strategy together with the adequacy of provisions must be regularly reviewed. A process should be established to share the lessons learned from the experience of credit losses in order to update the lending guidelines.

7.5 Write-off, repossession, and disposition of collateral

When the bank considers an account to be no longer collectable, it will "write off' the account (i.e. the amount is removed from the asset portion of a balance sheet and recorded as an expense item on the income statement or adjusted against provision). Depending on the product, the point at which this occurs may vary, but at a minimum, banks are to follow the loan write off policies issued by BB from time to time..

When all security has been realized and all recovery possibility have been exhausted, a decision may be made to write off, applying the provision in place for this purpose or debiting profit & loss account. This shall be approved by the Board of Directors.

It is not an appropriate policy for a bank to "nurse" or warehouse repossessed properties until the market picks up, but to dispose them into the market quickly and at the best price. Disposal methods should be reviewed continuously to ensure the most effective method is being used. The asset disposal policy must conform to the Transfer of Property Act, and all other applicable laws related thereto. A Designated Division shall be responsible for repossessed asset disposal with assistance of Legal Division and other concerned divisions of the bank.

While repossessed assets are awaiting disposal, the bank should make sure that proper administration is undertaken on these assets to protect their value. Asset disposal should start immediately when the asset becomes ready for sale. This is specifically defined as the time when:

- The client surrenders voluntarily the asset or has agreed for the bank to sell the property.
- The bank is awarded possession of the property by legal or other means. As the case may be, titles and ownership documents have been transferred to the bank's name and registered with the appropriate Land Registry.

Basic principles to guide the bank in its efforts for asset disposal include:

- Assets acquired have to be disposed of at the earliest time possible within a reasonable time frame from acquisition / repossession.
- Until disposition occurs, the bank should endeavor to keep costs relative to the upkeep and maintenance of the assets to a minimum.
- Converting / Liquidating the assets in the bank's possession at the earliest possible date is a lower-risk strategy than holding the assets for a projected upturn in market prices in the future, which often do not materialize, and in the meantime the Bank is saddled with a non-earning asset.

Banks are not in the business of asset and property trading or management, and thus are ill-equipped to take positions on the market trends.

"Documentation" should be viewed as a process of ensuring shield against risk of non-repayment of loan comprehensively in 03 (three) dimensions:

- i) The Type of Borrower
- ii) The Type of Loan or credit facilities &
- iii) The Type of Security Arrangement

General Documents: In general, required papers and documents to be obtained/maintained irrespective of type of borrower, loan and security are:

1. Demand Promissory Note
2. Letter of Authority
3. Letter of Arrangement
4. Letter of Disbursement
5. Letter of Revival
6. Personal Net Worth statement
7. Copy of National ID
8. Credit Approach in Business Pad of the Borrower
9. Credit Application in prescribed format duly filled in
10. Photograph of the Borrower
11. Photograph of the business/inventory
12. Photograph of the mortgaged property
13. Up to date CIB Report
14. Credit report of the Borrower/Supplier
15. Liability Declaration of the borrower along with an Undertaking that they have no liability with any bank or financial institution except as declared.
16. Undertaking stating that, they will not avail any credit facility from any other bank or financial institution without prior consent of the bank.
17. Undertaking stating that customer does not have any relationship as Director or Sponsor with the bank.
18. Undertaking stating that customer shall not sell or transfer the ownership of the business/factory/shop until all amounts due to the bank bank are fully paid or without NOC of the bank.
19. Credit Risk Grading Score Sheet (CRGS)
20. Post-dated cheque covering the credit facility
21. Acceptance by the Borrower of the Sanction Letter
22. Proper Stamping

Specific Charge Documents and Papers to be obtained:

A. As per type of Borrower:

SL	Type of Borrower	Document
1.	Individual Borrower	• Letter of Guarantee of a Third Person • Personal Net-Worth Statement (PNS) of Guarantor • Personal Net-Worth Statement (PNS) of the Borrower • Letter of Guarantee of the Spouse of the Borrower
2.	Proprietorship Firm	• Trade License (up to date) • Personal Net-Worth Statement (PNS) of Proprietor
3.	Partnership Firm	• Trade License (up to date) • Partnership Deed (Registered) • Letter of Guarantee of the partners • Personal Net-Worth Statement (PNS) of Partners • Letter of Partnership. • Partnership Account Agreement.
4.	Limited Company	• Trade License (up to date) • Memorandum and Articles of Association (Certified by RJSC) • List/Personal profile of the Directors • Certificate of Incorporation • Form XII Certified by RJSC (Particulars of Directors) • Board Resolution in respect of availing loans and execution of document with Bank • Letter of Guarantee of the Directors • Personal Net-Worth Statement (PNS) of Directors • Deed of Mortgage and Hypothecation for creation of Charge on fixed & floating assets (existing & future) with RJSC • Modification of charge with RJSC through form 19. • Certified copy of charge creation certificate from RJSC • Undertaking stating that the borrower shall not make any amendment or alteration in Memorandum and Article of Association without prior approval of Bank. • Approval of the Bank for any inclusion or exclusion of Directors in and from the company • Certificate of Commencement (In case of Public Limited Company) • Joint venture Agreement (In case of Joint Venture company) • BOI Permission (In case of Joint venture company)

B. As per type of Loan / Credit facility:

SL	Type of Loan	Document
1.	CC (Hypo)	• Letter of Hypothecation of stock in Trade • Supplementary Letter of Hypothecation • IGPA *[spell out acronym]* to sell Hypothecated goods • Letter of Continuity • Periodical Stock Report • Letter of Disclaimer form the owner of rented Warehouse • Insurance Policy cover note
2.	CC (Pledge)	• Letter of Pledge • IGPA to sell Pledged goods • Letter of Continuity • Periodical Stock Report • Letter of Disclaimer form the owner of rented Warehouse • Insurance Policy cover note
3.	Overdraft (General)	• Letter of Continuity • Insurance Policy cover note
4.	SOD (Work Order)	• Bid Document/ Tender Notice • Letter of Awarding • Assignment of Bills against work order
5.	SOD (FO)	• The Financial Instrument duly discharged on the Back • Lien on the Financial Instrument • Letter of Continuity
6.	SOD (Scheme Deposit)	• Lien on the Scheme Deposit • Letter of Continuity
7.	Term Loan	• Term Loan Agreement • Letter of Installment • Letter of Undertaking • Amortization Schedule • Insurance Policy cover note
8.	Home Loan for purchase of Flat or Floor Space	• Power of attorney for developing the property • Letter of Installment • Letter of Undertaking • Amortization Schedule • Letter of Allotment of Flat or Floor Space • Tripartite Agreement among Purchaser, Developer and Bank (If under construction) • Undertaking of the borrower to the effect that he will mortgage the flat/floor space favoringg the Bank at the moment the same is registered in his name by the seller.(If Under construction) • Agreement between Land Owner and Developer • Sharing Agreement between Land Owner and Developer • Copy of approved plan of construction from concerned authority.
9.	Consumers' loan/ Personal Loan	• PNS of the Borrower • PNS of the Guarantor • Letter of Guarantee of the Guarantor • Letter of Guarantee of the Spouse of the Borrower • Insurance Policy cover note

10.	SME/Small Loan	• As per type of borrower and nature of security
11.	Lease Finance	• Lease Agreement • Lease Execution Certificate • Quotation / Price Offer duly accepted by borrower • BRTA Registration Slip (In case of Motor Vehicle) • Insurance Policy cover note
12.	Hire Purchase Loan	• Hire Purchase Agreement • Quotation / Price Offer duly accepted by borrower • BRTA Registration Slip (In case of Motor Vehicle) • Insurance Policy cover note
13.	House Building Loan	• Letter of Installment • Letter of Undertaking • Amortization Schedule • Approved Plan form the competent authority
14.	House Building Loan(To Developer)	• Power of Attorney for development of property • Agreement between Land owner and Developer • Sharing Agreement between Land owner and Developer • Copy of approved plan of construction from concerned authority • Letter of Installment • Letter of Undertaking • Amortization schedule • Copy of Title deed of the property on which construction will be made • Copy of Bia *[spell out acronym]* deed (previous deed in support of Title deed)
15.	IDBP *[spell out acronym]*	• Acceptance of L/C issuing Bank (duly verified) • Letter of Indemnity
16.	Guarantee Facility	• Counter Guarantee • Bid Document or the document where requirement of Guarantee stated
17.	Syndicated Loan	• *Pari passu* Sharing Agreement • Facility Agreement • Escrow Account Agreement • Creation of *Pari passu* Sharing charge with RJSC • Participation Letter • Subordination Agreement • Deed of Floating charge on the Balance for Escrow Account • Accepted Mandate Letter • Information Memorandum • Participant’s Commitment Letter
18.	LTR	• Letter of Trust Receipt • Insurance Policy Cover note

C. As per Type of Security *[collateral may be a better word here]***:**

SL	Type of Security	Document
1.	Corporate Guarantee	• Corporate Guarantee of Guarantor Company on Non-Judicial Stamp • Resolution of the Board of the Guarantor Company (Memorandum of the Guarantor company must permit to do so.) regarding Guarantee.
2.	Hypothecation of Stock/Receivables	• Letter of Hypothecation • IGPA to sell hypothecated Stock / Receivables • Letter of disclaimer form the owner of Rented Warehouse
3.	Pledge of goods in Trade	• Letter of Pledge • IGPA to sell pledged goods • Letter of disclaimer form the owner of rented Warehouse
4.	Assignment of Bill	• Assignment of Bill by the beneficiary through IGPA • Letter of Acceptance of Assignment by the work giving authority • Original Work Order
5.	Lien on Financial Instrument like FDR etc.	• The Instrument duly discharged on the back of it. • Letter of Lien ('1st Party Lien' - if the Borrower is the owner of the Instrument, '3rd Party Lien'- if the Owner of the Instrument is one other than Borrower) • Letter of Authority to encash the instrument as and when needed by the Bank • Confirmation of Lien (Marking of Lien) from the issuing Bank.
6.	Lien on Demated Stock/Shares	• NOC of the Company in case of Sponsor's Share • Confiscate Request Form (Form19-1) duly signed by the pledgor. • Pledge Request form (By Law 11.9.3) duly signed by the holder of the share. • Pledge setup Acknowledgement from Brokerage House • CDBL *[spell out acronym]* generated copy of Pledge Setup
7.	*Pari-Passu* Security	• *Pari Passu* Security Sharing Agreement among lenders. • NOC from existing lenders if the property/assets are already under *pari passu* sharing. • Certificate of RJSC on creation of charge on Fixed and floating assets of the company. • Form XIX for modification of charge on Fixed and floating assets with RJSC
8.	Mortgage of Landed Property	• Original Title Deed of the property • Certified copy of Purchase Deed along with Deed - Delivery receipt duly endorsed (In absence of original Title Deed) • Registered Partition Deed among the Co-owners (if required) • Mortgage Deed duly Registered along with Registration Receipt duly discharged • Registered IGPA favoring Bank to sell the property • Bia Deeds of the mortgaged property • Certified Mutation Khatian along with DCR *[spell out acronym]* • Record of Rights i.e. CS, SA, RS Parcha, Mohanagar Jorip parcha (if within Mohannagar Area)

		• B.S. Khatian • Affidavit to be sworn by the owner of the property before 1st class Magistrate that he has valid title in the property and not encumbered otherwise • Up-to-date Rent Receipt • Up-to-date Municipal Tax Payment Receipt (if property within Municipal Area) • Up-to-date Union Parishad Tax Payment Receipt (if property within UP) • Approved Plan of Construction from concerned authority (if there is any construction upon the land) • Original Lease Deed (In case of Lease hold property) • Allotment Letter favoring Lessee (in case of Leasehold Property) • Mutation letter favoring Lessee (in case of Leasehold Property) • NOC of the competent Authority for Mortgage. • NEC *[spell out acronym]* along with search fee paid receipt • Board Resolution of the Mortgagor company duly supported by the provision of Memorandum and Article of Association (when one company mortgagse on behalf of the loan of other company) • Photograph of the Mortgaged Property • Location Map • Survey Report from professional Surveyors • Physical Visit Report by Bank Officials • Lawyer's opinion in respect of acceptability of the property as collateral security • Lawyer's satisfaction certificate regarding appropriateness of mortgage formalities

<u>Documentation relating to Bank-to-Bank Loan takeover process :</u>

1. Photocopies of security documents such as mortgaged property documents, Corporate Guarantee, etc.
2. Lawyer's Opinion regarding acceptance of the securities
3. Liability position of the borrower to the disposing bank
4. Confirmation Letter of the disposing bank about redemption of mortgage and handing over of all original security deeds and documents directly after adjustment of loan through Pay Order.
5. Undertaking of the owner of the property that they will mortgage the property after being redeemed by disposing bank.

Avoidable Reasons for Problematic Credits

The causes of problem loans range from poor plant management or increasing raw materials costs in the case of a manufacturer to poor accounts receivable collection policies or a rise in the price of products in the case of a wholesale company. Most often, a problem loan is the result of not one, but several, factors.

Poor Loan Interview

A poor interview most often occurs when the lender is dealing with a friend or when the business owner has leverage. Rather than ask tough, probing questions about the company's financial situation, the lender opts for friendly banter instead. Sometimes the lender may be intimidated or conned. The lender may be reluctant to ask questions for fear of sounding dumb or appearing to lack basic knowledge of the company or industry. For whatever reason, he or she may allow a loan request that should have been rejected during the initial interview to proceed to financial analysis and beyond. With each subsequent step, it becomes increasingly more difficult to reject the request.

Inadequate Financial Analysis

Many loans become problems when a lender considers the financial analysis unimportant and believes that, instead, the true test of whether a loan will be repaid lies in a handshake, the eyes, or some of the subjective measure of the client. Although some characteristics, such as the ability to overcome adversity, do not appear on financial statements, there is no substitute for a complete analysis of income statements, balance sheets, ratios, and cash flow. Together, they present an objective measure of performance that can be compared with those of similar companies.

Improper Loan Structuring

Another cause of problem loans is the failure of the lender to structure the loan properly. Problems often arise when the lender fails to understand the client's business and the cash flow cycle. Without this knowledge, it is difficult to anticipate future financing needs and to choose the appropriate loan type, amount, and repayment terms. Most borrowers, regardless of financial health, find it difficult to repay debts that do not coincide with their cash flow cycle.

Improper Loan Support

Another leading cause of loan loss is improper collateralization. Accepting collateral not properly evaluated for ownership, value, or marketability can leave the bank unprotected in a default situation.

Inadequate Loan Documentation

Failure to completely and accurately document the obligations of the bank and borrower in the lending arrangement also contributes to problem loans.

Inadequate Loan Monitoring

Many problem loans can be avoided if they were more closely followed.

Adverse Business Owner Decisions

Problem loans due to poor business practices include a lack of management depth, product deterioration, poor marketing, and poor financial controls.

Adverse External Developments

Changes in the environment, economy, regulations, competition, technology, and other adverse developments affect a business. However, mature businesses can anticipate and adapt to changing external circumstances.

Intervention from Board

Sometimes Board of Directors intervenes in the loan origination process to make loan to bad borrower which unless otherwise should have been rejected.

Below is a long but not exhaustive list of mistakes that bankers can make that eventually lead to the bank having a problem loan.

Common Banking Mistakes That Can Lead to Problem Loans

In the Beginning

- Allowing customer to intimidate, coerce into, or sell the banker on making the loan
- Failure to ask pertinent questions for fear of angering or losing the customer
- Making difficult loans that should be handled by a more experienced officer
- Basing the lending decision on pressure from other parties, especially the competition
- Trying to be an entrepreneur/businessman through the customer using the bank's money
- Inadequate analysis of the borrower
- Inadequate analysis of financial statements
- Inadequate analysis of loan purpose, source of repayment, and excess cash flow
- Improper loan structure—amount, source of repayment, timing of repayment (terms)
- Improper collateralization
- Failure to properly identify entity bank is dealing with
- Failure to supervise utilization of loan proceeds
- Failure to obtain and perfect valid security interest

After the Loan Was Made

- Did not effectively follow loan
  - Request and review financial information
  - Make periodic visits to company
  - Perform periodic trade and industry checks
  - Monitor impact of changing economic conditions on company
- Did not control expansion
- Let customer borrow in small amounts until he/she had too much debt or bank placed in forced lending situation
- Inappropriate management of the lending function

When the Problem is Recognized

- Afraid to look into credit—ask tough questions
- Afraid to admit made a mistake or have a problem
- Cut off communication with customer, resort to pressure/threats to collect loan
- Inaction—hoping situation will improve—"miracle approach"