# IRAQI MIDDLE EAST INVESTMENT BANK

# CREDIT RISK MANAGEMENT OBJECTIVES, STRATEGIES, POLICIES, PROCEDURES

Credit Risk Manual - 2012

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# 1.0 INTRODUCTION

Risk is defined as the potentiality of the bank facing unexpected and unplanned losses and/or fluctuation in expected revenues of a specific investment or operation. Such risks, if not controlled as well as their impact, may hinder the bank and lead to its insolvency.

There are two main types of risk facing the bank:

a) Systematic risks: These are the risks that cannot be avoided or abolished; however, they can be lived with and their negative impacts can be mitigated through diversifying the investment portfolio and preparing emergency plans to face them. These risks are related to the environment where the bank operates and include the risks of the market, credit risks, operating risks, and regional, political, legal, and environmental risks.
b) Non-systematic or internal risks: They are to do with the bank itself; they can be avoided or dealt with. They include bad management, bad investment, strategic and organizational risks, which can be avoided by setting up appropriate policies, controls and procedures that regulate the work as well as the selection of qualified and experienced managers, training the staff, improving internal auditing systems, and adhering to governance bases.

The risks that The Bank faces are divided into four key sections:

1. Financial risks including credit, market, and liquidity.
2. Operational risks
3. Business risks including strategy, organization and reputation
4. Regional and political Risks.

These risk areas will be addressed by the following Board committees, with participation of BOD:

1. Risk Management Committee
2. Investment Risk / Investment- Liability Committee

3. Credit Risk Committee
4. Internal Audit

At senior management level, and reporting to the Board, the following committees are in place:

- Risk Management
- Internal Audit

For all the committees detailed above, Scope of Operations documents will exist these fully detailing duties and responsibilities

For all the committees detailed above, scope of work and detailed work procedures should be clarified including detailed responsibilities and role in addition to detailed job descriptions for each department.
General Manager (GM) is responsible on submitting his own reports to the BOD accordingly determination and evaluation for all bank risks are recognized, GM is expected to receive reports from his / her subordinators:
1- Head of Credit ,
2- Operations Manager ,
3- IT Manager ,
4- Legal Dept. Manager

All senior management, department heads and branch managers should have a detailed job description, and this concept extends to all staff members.
In addition detailed written and documented policies and procedures for all bank's departments / Divisions are needed to clarify different roles for each department and clear the responsibilities for each one. Those Departments are:

1- Credit Division
2- IT and computer Center
3- Department of Finance ,
4- Branches and offices Division ,
5- Legal and contracting Division ,
6- Administrative Division ,
7- Branches

The task of risk manager is defined as the process of defining, measuring, monitoring risks, and mitigating the impact of the risks or the losses resulting from them. Also, the art of dealing with these risks and their good management, which ensure that the Bank avoids losses resulting from the different types of risks it faces in carrying out its business.

In general, risks have two sides, first, the potentiality of being subjected to a certain risk, and secondly the value or size of the potential losses resulting from being subjected to such risks.

Risks are not static, and impact on all business regardless of size. As such these objectives, strategies, policies and regulations are to be reviewed periodically to ensure they keep pace with banking development.

These Risk Management Objectives, Strategies, Policies, and Regulations should be read in conjunction with the Bank's various Department Scope of Operations, and Manuals.

Further, adherence to the following is required:

(1) Central Bank of Iraq Instructions.
(2) Regulatory requirements for banking sector.

# 2.0 BOARD AND SENIOR MANAGEMENT CONTROL

Board of Directors and senior managements plays a major role in controlling bank's credit risks, different responsibilities related for each level under bank's hierarchy

## 2.1 Board Of Directors Responsibilities :

The first and foremost responsibility for risk management is with the Board of Directors since it is responsible before the shareholders for the bank's practices. The Board is also responsible for appointing experienced and qualified management that is capable of understanding the risks faced by the Bank, and to ensure their efficient and effective management.

The Board should approve all significant policies relating to the management of risks throughout the bank. These policies should be consistent with the bank's broader business strategies, capital strength, management expertise and overall willingness to take risk. Accordingly, the Board should be informed regularly of the risk exposure of the bank and should regularly re-evaluate significant risk management policies and procedures. The Board of Directors should also conduct and encourage discussions between its members and senior management regarding the bank's risk management process and risk exposure.

The Board will review the progress of the policy at each of its scheduled Board meetings.

The following Board Committees consist of a minimum of three Directors:

- Risk Management
- Investment & Asset –Liability
- Credit
- Internal Audit

These Board Committees are tasked to supervise the management of risks inherent in Bank's operations.

## 2.2 Senior Management Responsibilities :

Senior Management will be responsible for ensuring that there are adequate policies and procedures for risk taking and monitoring on both a long-range and day-to-day basis. This responsibility includes ensuring that there are clear delineations of lines of responsibility for managing risk, adequate systems for measuring risk, appropriately structured limits on risk taking, effective internal controls, comprehensive risk reporting processes and a Management Information System. Additionally, records need to be protected and daily database back-ups secured off-site.

Essential to the successful control of risk management is the role played by the Risk Management and Compliance Department to make sure to focus on the following responsibilities:

1. Use this document as a work base, monitor conformity, ensure adequate policies and procedures are in place for all bank's activities, verify that a comprehensive risk reporting process is in place, and monitor the clear lines of responsibility and segregation of duties.
2. Regularly review existing techniques and tools to ensure all are up-to-date with current banking activities and threats.
3. Provide appropriate reports to the Board and their Risk Management and Audit committees.

Senior Management should also regularly evaluate the procedures in place to manage risk to ensure that these procedures are appropriate and sound. They should also foster and participate in active discussions with the Board, and with staff of risk management functions regarding procedures for measuring and managing risk.

Before engaging in any activity, senior management should ensure that all appropriate approvals are obtained and that adequate operational procedures and risk control systems are in place. These should include, where applicable:

(a) A description of the relevant financial products, markets and business strategies.

(b) The resources required to establish sound and efficient risk management systems.

(c) An analysis of the reasonableness of the proposed activities in relation to bank's overall financial condition, capital levels and, human resource capability.

(d) An analysis of the risks that may arise from the activities.

(e) The procedures used to define measure, mitigate and control risks.

(f) The relevant accounting guidelines.

(g) An analysis of any legal restrictions.

(h) Compliance with Central Bank regulations and instructions, and other regulatory requirements, to include bank's own internal rules and regulations.

(i) Compliance with other regulatory requirements, to include bank's own internal rules and regulations.

Line Committees are responsible for the day-to-day monitoring of the risk mechanism. It is their responsibility to ensure that Policy is followed, required periodic reports are provided, and the decisions of the Committee are executed.

## 2.3 RISK MEASURMENT AND MANAGEMENT

The first step in risk management is defining risks since this relates to each product or service provided by the bank. Therefore the defining of risks is continuous process in order to understand and be aware of the risks of each transaction or practice in the bank.

The measuring of the level of risks the bank may face follows the process of defining risks. In all cases measurement must take into consideration that each type of risk has three dimensions including the size of the risk, its duration, and the potentiality of its occurrence. The sound and timely measurement of risks is highly important in the process of risk management.

After defining and measuring risks, the setting up of appropriate standards to control the risks follows this including risk mitigation to avoid or reduce potential losses. This can be achieved in three main ways:

1. Avoid entering specific markets or products before doing the need evaluation and assessment.
2. Impose restrictions on specific practices such as credit limits, and restricting the mandates of managerial levels.
3. Eliminate the impact of risk through insurance and outsourcing.

A key step in risk control is an information system capable of accurately defining and measuring risks, and monitoring key changes in portfolios.

After identifying the Risk, it is needed to manage the risk in order to reduce the risk exposure to the Bank. This function is important and essential in determining the early warning systems that the bank should put in place to monitor risk. Continuous monitoring and risk analysis are an integral part of the early warning systems.

# 3.0 CREDIT RISK

Credit risks are the potential losses that may affect the profits and capital of the bank. They are the result of failure on behalf of the borrower to timely commit to the liabilities for personal reasons and/or general political and economic reasons. They are known in banking as credit risks.

Credit risk for banks consists not just of the amounts owed by borrowers on loans and overdrafts (for both interest payments and loan principal repayments) but also for customers' debts on other transactions, such as Letters of Credit, and Performance Bonds.

## 3.1 SIZE AND DURATION OF CREDIT RISK

The size of the Credit Risk is the amount that could be lost if the risks were to be realized, and non-payment or late payment occurred. The maximum potential loss is the full amount of the debt in the event of non-payment by the customer. A bad debt on a bank loan would create a loss of the unpaid debt principal, plus any overdue unpaid interest.

Late payments do not result in a direct loss only. There is however an indirect loss, which is the interest cost of having to finance debtors for longer than necessary, or the loss of interest that could have been earned from the money if it had been received sooner and invested elsewhere.

Credit risk can be avoided by refusing to give credit; this concept is contradictory to the nature of the commercial bank. However, banks have to give credit in order to make profit from earnings of interest. The decision to grant credit should depend on a balance between the expected profits and the potential risk of a bad debt.

## 3.2 CREDIT MANAGEMENT

The Board of Directors is the only authorized entity details who grants limits, size, and to whom. Various flexible powers are delegated to the Board Credit Committee who in turn devolves similar but reduced flexible authorities to the Credit Committee.

In addition to the Credit Committee yet further flexible authorities are devolved in the Branch Committees, General Manager and Credit Manager.

Details of any lending in excess of these flexible limits are to be submitted immediately to the relevant authority.

The Credit Committee is tasked with coordinating, and carrying out, the credit responsibilities devolving from the Credit Policy.

The minutes of each Credit Committee meeting are to be presented to the Board Risk Committee for review, recommendation, and approval.

The aim of the bank's credit committee is to limit credit risk within the Bank's overall policy guidelines. All those involved with credit should identify high risk customers and either refuse to give credit (or to lend) or restrict the customer's credit limit..

The danger of a high credit risk is not always evident when the original lending decision is made, but warning signs could be evident from the beginning. There are seven main reasons for bad lending decisions for banks:

**(a) Over-trading by the borrower:**

This is a situation where the borrower relies heavily on short-term credit to finance a required growth in business. Symptoms of over-trading are a rising bank overdraft and increasing amounts of unpaid creditors. Such a borrower is a high credit risk.

**(b) Adverse trading for the borrower:**

Projects might have unstable sales turnover and a high proportion of expenditures that are fixed costs. These projects are a risk from a downturn in sales, which would cut income sharply but leave expenditures largely unchanged. They should be regarded as high-risk borrowers.

**(c) Liquidity runs on the borrower's business:**

A project may suffer a large drop in cash income or a sharp rise in spending. The lender should consider whether the borrower has sufficient financial flexibility, i.e. access to emergency funds should a run in liquidity occur.

**(d) Excessive capital spending commitments:**

Projects with excessive capital spending commitments are a high credit risk. Lending banks and suppliers of credit are often unable to control a project's excessive spending, but can try to monitor it by looking at the most recent published accounts of the project, for example, where capital expenditure commitments must be disclosed.

**(e) Faulty credit analysis by the lender:**

A lender's decision/judgment based on the information available can sometimes be at fault. There is always some risk of bad decisions on the basis of information available but the frequency of bad loans can be contained by means of a structured approach to lending by trained staff.

**(f) Creative accounting by the borrower, masking the true financial position**:

This is the use of policies which make the reported financial position misleading. It is important for lending staff to be aware that many projects will take advantage of opportunities for creative accounting if they exist.

**(g) Dishonesty by the borrower:**

A dishonest customer can deceive a prospective lender into making a bad lending decision, thus creating a bad debt. Lenders need to be wary of this possibility and try to make a judgment from objective information, about the borrower's character.

## 3.3 CREDIT ASSESSMENT

Credit assessment provides the basis for a decision about whether credit should be granted. Continuing assessment will help monitor the customer's account.

### 3.3.1 Techniques:

1. Collecting any available published information about the borrower's business and its management.

2. Keeping an eye on such customer's stock market performance.

3. Analyzing the company's business risk – its strengths and weaknesses in resources and management, and the threats and opportunities in its industry and markets.

4. Analyzing the company's financial position as disclosed in up to date audited accounts and current financial management information. Tools include financial ratio analysis, to assess whether the organization's profits will be sufficient to cover priority expenditures (fixed charges) such as interest costs. Analysis will also consider the size of the organization's net cash flows relative to the volume of its debts.

5. Obtaining status report of the borrower from other banks.

The role of all those involved in credit is to pursue a compatible minimization of credit risk. Since repayment risk is the critical concern of loan portfolio management, the following should be affected:

(a) Accurate selection of borrowers by collecting quality information and processing the information collected, adopting standardized procedures.

(b) Accurate loans follow up and review to reinforce a "Credit Culture" within potential clients. A review of all loans disbursed is to be carried out every year to include the repayment ability of the borrower, completeness of documentation, consistency with loan policy, perfection of security, interest on collateral, and legal and regulatory compliance (including a classification/provision review).

(c) Ensure implementation of a lending strategy to cover both quantitative aspects (change in loan volumes) and qualitative aspects (composition of loan portfolios) in respect of a return against costs.

(d) Review loan mix, liquidity and maturity structure and the size of the current and projected portfolio.

**3.3.2 Basic Rules of Lending**

All involved with providing credit must adhere to the following basic rules of lending:

1. Always have a secondary source of repayment by obtaining security. With the exception of personal loans, unsecured credit accommodation should generally not be granted.

2. Character is important.

3. There are no substitutes for equity, experience.

4. There are no substitutes for going out to your customer's place of business, and, understanding the business you are lending to.

5. Know the market you are lending to.

6. Do not be too shy to ask questions.

7. Up to date financial information on long-time customers just as you would on new customers.

8. Quality financial information is essential for both the business owner and lender.

## 3.4 CREDIT POLICIES, PROCEDURES AND LIMITS

All credits should be sanctioned as per the guidelines and procedures prescribed in the credit policy of the bank.

The Policy for Corporate and Retail contains the powers and limits for authorization of loans and temporary overdrafts. These authorized procedures should be observed and respected.

## 3.5 MONITORING CREDIT

Credit limits, once set, should be monitored to ensure that they are not breached. Relevant departments should also monitor individual credit transactions for overdue payments, and watch for signs of credit deterioration.

Continuous monitoring of credit includes:

1. Overdue payments must be chased. This is routine credit management.

2. The payment record of individual customers should be used to reevaluate their credit rating and credit limit.

3. At some stage, a decision might have to be taken about writing off a debt as uncollectable. The Bank's bad debts should be a factor in the regular reassessment of credit policy.

4. Writing off loans doesn't mean freezing follow up procedures, written off clients should be followed through different techniques (Courts, Guarantors..) which strengthen the banks image in front of current clients.

Effective monitoring means that all involved with credit should be aware of the following warning signs of possible portfolio deterioration:

- Inadequate financial information
- Frequent checking overdrafts
- Business growth greater than 20% per year
- Increase in receivables collection time frame.
- Deteriorating debtor and stock turnovers
- Increased expense to sales relationships
- When there are ownership changes
- When the owner borrows on a short-term basis for long-term needs.
- When the owner gets involved in other ventures, and fails to focus on the primary activities of the business
- When the customer borrows from several banks in town

## 3.6 INTERNAL GUIDELINES ON IDENTIFICATION AND MEASUREMENT

1. The Credit Manual contains a staged recovery process for defaulting customers.

2. Continuous risk analysis will include reports and monthly reviews to be submitted to the relevant line manager.

3. Site visits will be undertaken by relationship managers and reports filed in the respective credit files.

4. Subsequent sanctioned limits should be set on the basis of risk analysis generated.

5. Qualitative and quantitative analysis to be completed for each client. Risk analysis to be derived after the analyses has been completed.

6. Disbursements will not be effected until the legal documents are signed.

7. Exposure to one industry will not exceed the ceilings prescribed in the Credit Policy of the bank excluding cash collateral loans.

## 3.7 INDEPENDENT REVIEW

The Internal Auditor reports to the Board, should include the results of the audit process including any serious violation.

The Internal Auditor should allocate a sufficient number of days for the audit of the credit portfolio including risk management functions.

The External Auditors Report should be presented to the Board Audit Committee, alongside management replies, for their review, remarks, recommendations, and censure where required.

## 3.8 LOANS COLLECTION

While the aggregate amount of loans, overdrafts or advances are permanent accounts that could be found in the Balance Sheet of a bank (owing to the very nature of the function of a bank), the individual accounts that include each one of them should be subjected to collection at maturity. If that is not possible, full liquidation must be attainable within reasonable time. Distressed accounts should be litigated, or a remedial restructuring be immediately worked out as soon as possible.

Foremost in the public responsibility of a Bank is its obligation to honor the withdrawals of the depositing public. The key to upholding this responsibility is for a bank to have a continuous cash flow.

## 3.9 INTERNAL CONTROLS:

For efficient and effective internal control, the following guidelines are to be followed at all times.

1. All the credit files are to be kept safely under lock and key, and properly arranged for easy references.

2. All the insurable collaterals should be insured with bank's interest noted and should be renewed on due dates.

3. All the legal agreements should be properly executed and stamped and kept in the safe. Copies are to be held, for easy reference, in the relevant credit file.

4. Legal documents should be recorded in a security logbook.

5. Loan disbursements should only be allowed once the agreed security has been taken and perfected. This will be certified by the Legal Department.

## 3.10 MANAGEMENT INFORMATION SYSTEM:

1. All accounts in arrears are to be reported to the relevant line manager.

2. All accounts which are subject to a normal credit review but these have been delayed by 30 days should be reported to the relevant line manager.