The Credit Process

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Overview

Overview

Learning Objectives

- Describe the basic elements of the credit process.
- Explain the importance of each component of the process.
- Explain the importance of the evaluation of the credit risk.
- Evaluate the quality of the process.

Lending is the primary function of a Bank

The Credit Department has a major role in the Banking System

- Lending is the main source of creation of assets, but it involves risks for potential losses, which quickly erode the assets of the bank and result in the loss of confidence of the depositors, who are the main source of funds.

Prudence in lending

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The bank must be guided by high standards of safety in lending.

- The bank must adopt prudent lending policies and enforce them.
- The credit department of the bank must have sound banking practices and abide by its policies.
- The bank must have full confidence in the ability of the clients to repay their loans.

Role of the Examiners

Examiners are responsible for evaluating the quality of banks' loan portfolios and their compliance with the lending policies.

- They must understand:
  - The credit administration process.
  - The classification process.
  - The lending process.
- They must also know:
  - The existing banking laws.
  - The external and internal lending procedures and policies.

Credit Process

Credit Process

The credit process begins with an in depth analysis of the borrower's creditworthiness. (People, purpose, payment, protection, plan).

- Current and expected financial condition of the borrower.
- Ability by the borrower to withstand adverse conditions.
- Management, industry, economic environment.
- Credit history.
- Risk mitigation: underwriting, loan agreement, covenants, reporting, insurance.
- Security: Collateral, guarantees.

Credit Initiation

The objective of the credit initiation and analysis process is to ensure that loans meet:

- The credit policies and procedures approved by the bank.
- The safety standards and guidelines of the bank.
- An acceptable level of risk assumed by the bank.

Credit Initiation

Process

- Screen prospective customers.
- Collect data.
- Analyze risks..
- Prepare credit analysis and assessment.
- Structure the loan.

Credit Initiation

There are four main foundations of creditworthiness

- Industry and its environment.
- Financial condition of the borrower.
- Quality and reputation of the of the management.
- Security given to the bank (guarantees, collateral).

Credit Underwriting

Credit underwriting is the process that banks undertake to structure a credit facility. It includes:

- The terms and conditions of the loan.
- The amortization schedule of the loan (Match the repayments with cash inflow).
- The covenants in the loan agreement.
- The reporting requirements to respective parties.
- The security provided to the bank.

Lending Decision

Lending decision must be done according to the recommendations presented by the credit department to the lending authority.

Delegation of authority.

- Authority to approve a loan can be given to senior members of the credit department in order to avoid delays in the lending decision.

Credit Committee.

- Large or difficult loans should be presented to the Credit Committee of the bank and (or to the Board of Directors) for final approval.

Loan Monitoring

Loan monitoring starts when a loan has been approved.

- Purpose
  - Monitor the changes in the industry's environment, the borrower's financial conditions, changes in the management, and any problems that may impact the loan performance.
- Sources of information
  - The covenants of the loan and collateral agreements require the borrower to submit financial and other information on specified dates.
  - The bank should contact the borrower regularly, in person or by phone, as a mean of following up the evolution of his business
  - The best indicator is the timely repayment of principal and interest.

Risk Rating

Why is risk rating important?

- Loans represent an important part of the bank's assets.
- Ratings are critical to determine the quality of the assets.
- Ratings will determine the allowance for loan losses.
- The allowance impacts the bank's level of capital.

Problem Loans

Credit workout should be covered in detail in the bank's credit policy.

- Who should be in charge of workout?
- How does a bank decide when a loan is a problem loan?
- Early detection of weaknesses or deterioration of the loan.
- Actions to be taken to rehabilitate a problem loan or to recover the assets.

Causes of problem loans

Problems loans can arise from different causes:

- Competition.
- Changes in the economic situation.
- Changes in management.
- Lack of proper monitoring.
- Incomplete credit analysis.
- Inadequate loan documentation.
- Failure to enforce terms and conditions and covenants of the loan agreement.
- Reliance on the collateral.

Evaluation of the Credit Process

The Examiners need to ascertain and understand the lending activities of the bank.

- What are the lending activities of the bank?
- Interview the loan officers and the senior Management.
- Review the bank's policies and procedures in order to determine:
  - The standards applied to the lending activity of the bank.
  - The adequacy of the credit process and its implementation.
  - The soundness of the lending decision.

Evaluation of the Credit Process

The Examiners will discuss their findings and conclusions with the management of the bank and write a detailed report.

- Focus on weak points.
- Recommend improvements in policies.
- Insist on proper monitoring and appropriate loan classification.