# Webinar Keynote Executive: Credit Risk Management including Lending Portfolio

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# Session Format

- Part 1 KC introduction
- Part 2 HH Interactive case studies and PowerPoint presentation
- Part 3 Q&A session

# BIS Standards-17 Key Principles

Pre reading Summary –

**The main topics of the Basel Paper are:**

Establishing an Appropriate Credit Risk Environment

Operating under a Sound Credit Granting Process

Maintaining an Appropriate Credit Administration;

Measurement and Monitoring Process

Ensuring Adequate Controls over Credit Risk

# Document Extract:

- Principle 10: Banks are encouraged to develop and utilise an internal risk rating system in managing credit risk. The rating system should be consistent with the nature, size and complexity of a bank's activities.
- An important tool in monitoring the quality of individual credits, as well as the total portfolio, is the use of an internal risk rating system.
- A well-structured internal risk rating system is a good means of differentiating the degree of credit risk in the different credit exposures of a bank.

# Extract: continued

- This will allow more accurate determination of the overall characteristics of the credit portfolio, concentrations, problem credits, and the adequacy of loan loss reserves.
- More detailed and sophisticated internal risk rating systems, used primarily at larger banks, can also be used to determine internal capital allocation, pricing of credits, and profitability of transactions and relationships.

# Continued

## Example

**Five-category Loan Classification**

Unit: RMB million, except percentages

| Items | As at 31 December 2016 | | As at 31 December 2015 | |
|---|---|---|---|---|
| | **Amount** | **% of total** | Amount | % of total |
| **Group** | | | | |
| Pass | **9,516,729** | **95.43%** | 8,775,798 | 96.06% |
| Special-mention | **310,630** | **3.11%** | 229,165 | 2.51% |
| Substandard | **61,247** | **0.61%** | 58,741 | 0.64% |
| Doubtful | **36,817** | **0.37%** | 41,516 | 0.45% |
| Loss | **47,939** | **0.48%** | 30,640 | 0.34% |
| **Total** | **9,973,362** | **100.00%** | 9,135,860 | 100.00% |
| NPLs | **146,003** | **1.46%** | 130,897 | 1.43% |
| **Domestic** | | | | |
| Pass | **7,387,949** | **94.49%** | 6,854,159 | 95.21% |
| Special-mention | **289,101** | **3.70%** | 217,300 | 3.02% |
| Substandard | **58,763** | **0.75%** | 57,049 | 0.79% |
| Doubtful | **35,758** | **0.46%** | 40,612 | 0.56% |
| Loss | **46,937** | **0.60%** | 29,974 | 0.42% |
| **Total** | **7,818,508** | **100.00%** | 7,199,094 | 100.00% |
| NPLs | **141,458** | **1.81%** | 127,635 | 1.77% |

# Basel – Extract from Global Principles for the Management of Credit Risk

- While financial institutions have faced difficulties over the years for a multitude of reasons, the major cause of serious banking problems continues to be directly related to lax credit standards for borrowers and counterparties.
- Poor portfolio risk management, or a lack of attention to changes in economic or other circumstances that can lead to deterioration in the credit standing of a bank's counterparties.
- This experience is common in both so-called developing and developed countries.

# Continued

- The goal of credit risk management is to maximise a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters.
- *Banks need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions.*

# Continued

- The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organisation

# Continued

- All banks have a need to spread overall lending risk as widely as possible to reduce exposure to any one trade or industry and thus reduce overall exposure risk and profit volatility.
- Banks reduce portfolio risk by making advances to a wide variety of industries, spreading the risk among a broad client base.
- Being very aware of the risk of over concentration in any one sector, banks usually operate within industry thresholds, limiting credit exposure to achieve the best mix of individual and portfolio safety.

# Implementing an effective Loan Portfolio Policy

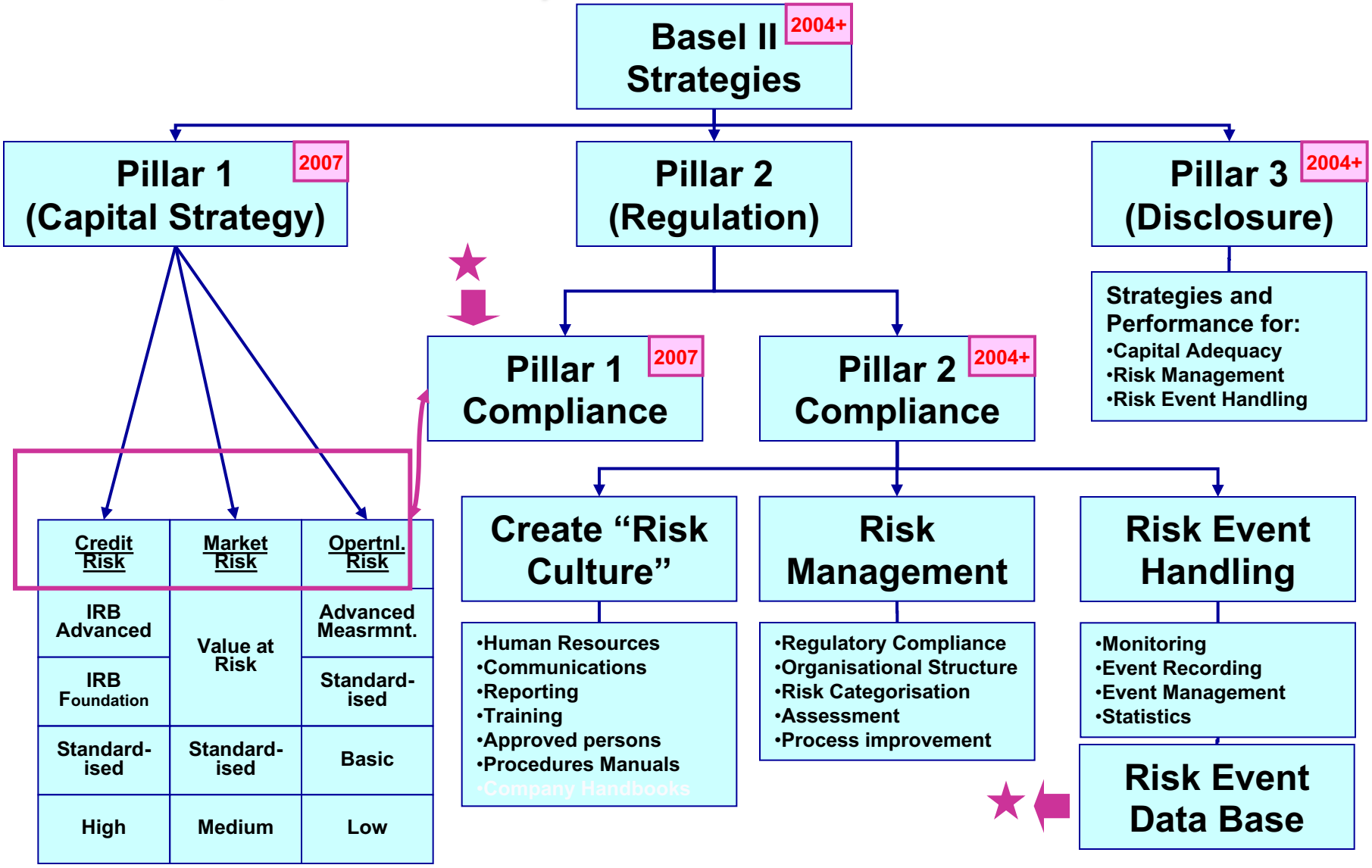
- Each financial institution is unique and this must be reflected in its policy.
- *The policy must reflect the collective risk tolerance of senior managers and boards of directors, which may vary from extremely conservative to very aggressive.*

# Basel II – The Big Picture

- A significant innovation is the greater use of the assessments of risk provided by the institution' internal systems as inputs to capital calculations.
- In taking this step, the Committee is also putting forward a detailed set of minimum requirements designed to ensure the integrity of these internal risk assessments.

Ref: BIS.org July 2004

# Basel II, in Summary



# *Case Study: Balance sheet summary*

**Table 1**

| | 2001 (£bn) | 2008 (£bn) | *CAGR (%)* |
|---|---|---|---|
| **Group** | | | |
| Customer Loans | 201.0 | 435.2 | *12.6* |
| Customer Deposits | 140.5 | 222.3 | *7.8* |
| Total Assets | 274.7 | 630.9 | *12.6* |
| Tangible Shareholders Equity (£m) | 9,823 | 17,792 | *10.4* |
| Loans/Deposits Ratio (%) | 143 | 196 | |
| Wholesale funding < 1 year | 89.8 | 119.4 | |
| Leverage (Assets/TSE) (x) | 28 | 35 | |
| **Retail** | | | |
| Customer Loans | 132.1 | 255.3 | *9.9* |
| Customer Deposits | 102.0 | 143.7 | *5.0* |
| **Corporate (including Business Banking in 2001)** | | | |
| Customer Loans | 55.1 | 123.0 | *14.4* |
| Customer Deposits | 22.2 | 38.5 | *10.5* |
| **International** | | | |
| Customer Loans | 14.4 | 61.0 | *29.5* |
| Customer Deposits | 3.7 | 6.6 | *29.6* |
| **Treasury** | | | |
| Deposits | 12.6 | 33.5 | *15.0* |
| **Insurance & Investment** | | | |
| General Insurance (Gross Written Premiums) (£m) | 1,064 | 1,799 | *7.8* |
| Investment Sales | 7.79 | 11.2 | *5.3* |

The total estimated cost to bail out HBOS during the 2008 financial crisis was close to **£30 billion**

HBOS Extract from UK Parliament enquiry:

- An Accident waiting to happen

- 19. The strategy set by the Board from the creation of the new Group sowed the seeds of its destruction. HBOS set a strategy for aggressive, asset-led growth across divisions over a sustained period. This involved accepting more risk across all divisions of the Group.
- Although many of the strengths of the two brands within HBOS largely persisted at branch level, the strategy created a new culture in the higher echelons of the bank. This culture was brash, underpinned by a belief that the growing market share was due to a special set of skills which HBOS possessed and which its competitors lacked.
- The effects of the culture were all the more corrosive when coupled with a lack of corporate self-knowledge at the top of the organisation, enabling the bank's leaders to persist in the belief, in some cases to this day, that HBOS was a conservative institution when in fact it was the very opposite.

# Towards Basel III

BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

## Press release

Press enquiries: +41 61 280 8188
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Ref no: 35/2010

12 September 2010

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**Group of Governors and Heads of Supervision announces higher global minimum capital standards**

## Annex 2: Phase-in arrangements (shading indicates transition periods)

### (all dates are as of 1 January)

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | As of 1 January 2019 |
|---|---|---|---|---|---|---|---|---|---|
| Leverage Ratio | Supervisory monitoring | | Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015 | | | | | Migration to Pillar 1 | |
| Minimum Common Equity Capital Ratio | | | 3.5% | 4.0% | 4.5% | 4.5% | 4.5% | 4.5% | 4.5% |
| Capital Conservation Buffer | | | | | | 0.625% | 1.25% | 1.875% | 2.50% |
| Minimum common equity plus capital conservation buffer | | | 3.5% | 4.0% | 4.5% | 5.125% | 5.75% | 6.375% | 7.0% |
| Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials ) | | | | 20% | 40% | 60% | 80% | 100% | 100% |
| Minimum Tier 1 Capital | | | 4.5% | 5.5% | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% |
| Minimum Total Capital | | | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% |
| Minimum Total Capital plus conservation buffer | | | 8.0% | 8.0% | 8.0% | 8.625% | 9.25% | 9.875% | 10.5% |
| Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital | | | Phased out over 10 year horizon beginning 2013 | | | | | | |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Liquidity coverage ratio | Observation period begins | | | | Introduce minimum standard | | | | |
| Net stable funding ratio | | Observation period begins | | | | | | Introduce minimum standard | |

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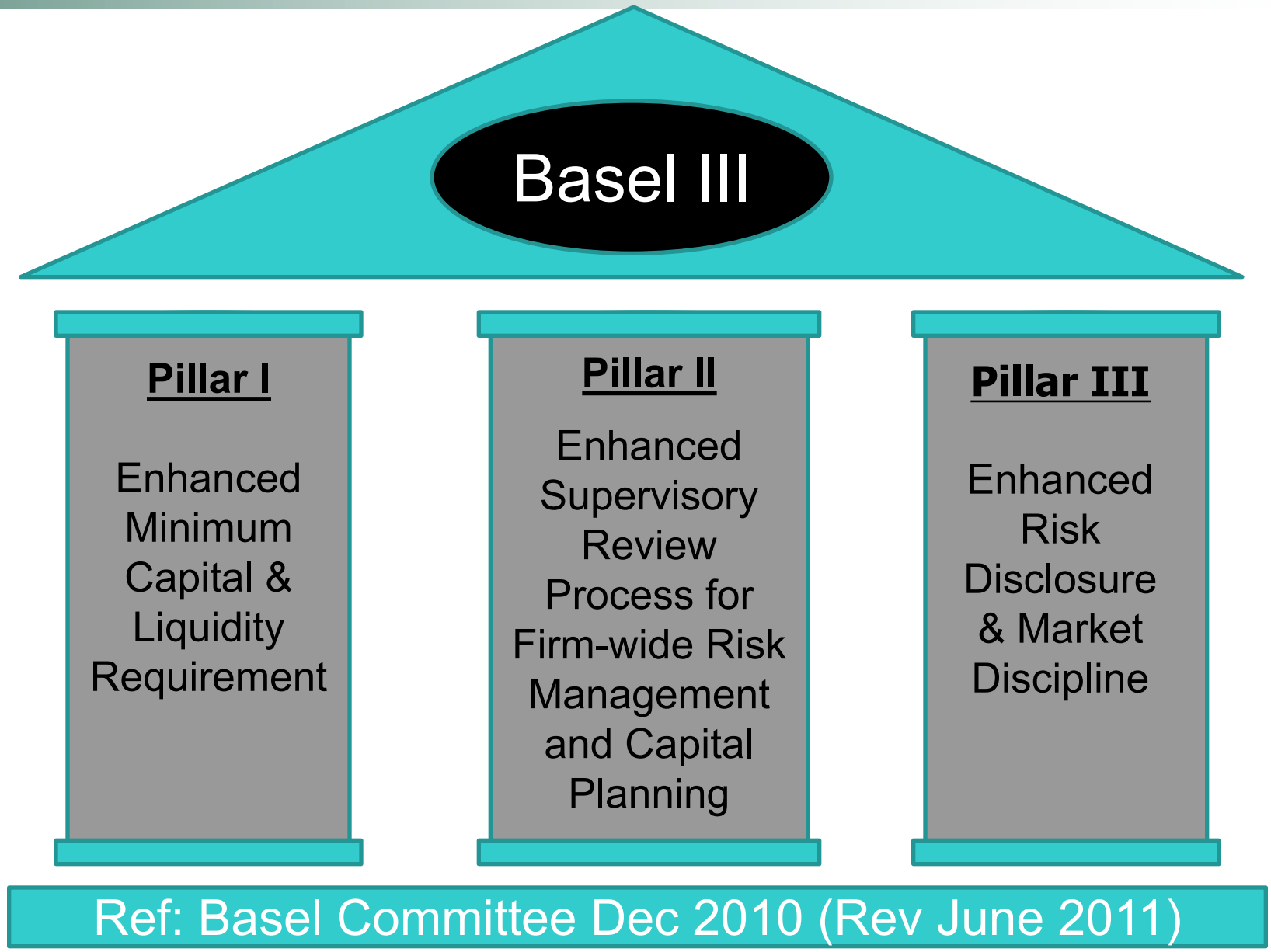
DTAs – Deferred Tax Assets

MSRs – Mortgage Servicing Rights


Basel III
Pillar I
Enhanced Minimum Capital & Liquidity Requirement
Pillar II
Enhanced Supervisory Review Process for Firm-wide Risk Management and Capital Planning
Pillar III
Enhanced Risk Disclosure & Market Discipline
Ref: Basel Committee Dec 2010 (Rev June 2011)