

Credit Risk Management

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The bank is exposed to credit risk, the risk of not being able to recuperate the debtor claims as a result of the activity of granting loans to the clientele. Also, credit risk may manifest due to investments in other local and foreign credit institutions. Credit risk may be minimized through the careful evaluation of credit solicitors, through their monitoring along the duration of the loan and through the establishing of risk exposure limits, of significant risk margins as well as the acceptable balance between risk and profit.

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1. Introduction

The bank also monitors the selection of correspondent banks with ratings which express the lowest degree of risk. For this purpose, the bank sets limits for transactions with other banks referring to deposits and exchange rates.

Credit risk management implies: *risk prevention, risk measuring and risk management (per-se).*

Risk prevention regards two aspects: *risk dividing* – the goal of which is the dissipation of risks, such as the bank may reduce the possibility of registering significant losses and *building securities* – the goal of which is the possibility of the bank to recover its claims from the last chance at its disposal.

Risk measuring is a two-step process. The first step is the establishment of a maximum limit for risk assets from the proprietary funds of the bank by calculating the solvency ratio and which the bank must respect, being imposed by the National Bank. The second step is measuring the risks to which the bank is exposed through the periodic evaluation of the credit portfolio. Following the evaluation of the financial performances of the *clients* credits will be included in one of the following categories: **standard** – category A – include clients whose economic and financial performance are good and allow for due date payments of interests and installments.

From the conducted analysis the keeping into perspective of financial performance at a high level is being anticipated; **under observation** – category B – financial performance is good or very good but it is anticipated that they cannot maintain this level in the long run; **substandard** – category C – financial performance is satisfactory but have an obvious tendency to worsen; **doubtful** - category D – financial performance is low and there is an obvious cyclicity at short time intervals; **losses** – category E – financial performance show losses and it is not anticipated for either interests nor installments to be paid.

The ability of the economic *agent* to reimburse credits at their due date and to pay interest owed at their due date will be considered as:

-good- the situation in which interests and installments are paid at their due date with a maximum outstanding payment margin of 15 days;

-weak- the situation in which interests and installments are paid at their due date with a maximum outstanding payment margin of 30 days;

- inadequate- the situation in which interests and installments are paid at their due date with an outstanding payment margin of over 30 days.

For *private individuals*, the classification of the credit portfolio is made according to the debt service as follows:

- **category A – very good** –the client has accidentally incurred outstanding interest and/or installments up to a maximum of 15 days;

- **category B – good** - the client has accidentally incurred outstanding interest and/or installments up to a maximum of 30 days

- **category C – weak** –the client has two installments and their respective interests outstanding up to 60 days;

- **category D – very weak** –the client has three installments and their respective interests outstanding up to 90 days;

- **category E – inadequate** – the client has over three installments and their respective interests outstanding for over 90 days, and the sums corresponding to risk provisions are included in the expenses.

The third method in credit risk management implies *risk management per-se.*

The operational objective of risk management is the correct identifying, quantifying and balancing of financial risk elements, many of these being independent to some degree.⁷⁷

With a view to reduce or eliminate losses, banks monitor the quality of the credit portfolio through a periodic audit, respectively by detecting ahead of time the credits loans that may become problematic. The preferred solution for a problem loan is renegotiating the action plan with the client, in an attempt to save both the bank and the client from possible losses.

The action plan is actually an accord – a revised loan contract through which a new credit and interest reimbursement program is established which will be extended to bank authorities through their participation in the decision making process of the firm's management.

Credit revision is an operation which is dependent on the size of the bank. In large banks, a qualified staff must exist which to focus only on revision, under the leadership of the Risk Committee, in order to ensure its independence from the lending staff. In smaller banks, the revision operation comes as an additional task of the Loaning Department. Along the process of revision, the financial situation and reimbursement capacity of the client are followed, as well as the existence and state of securities.

The purpose of the revision of lending operations is to evaluate if the process follows the criteria within which the Management Council must ensure that the lending function of the bank fulfills three fundamental objectives, as follows: - loans must be granted on a healthy basis, so as they may be reimbursed; - funds must be profitably invested in the benefit of shareholders and for the protection of depositors; - the legitimate loan necessities of the economic agents and private individuals must be satisfied.

Risk management is the operation of saving a loan, and is constituted by the recovery of claims by the bank by taking them over by another firm which finances the buying of debt claims. The operation is particularly advantageous for the bank because, aside from the fact that it may "get rid" of problem debts, they recover them at their book value.

Another loan saving technique is the selling of claims by the bank to a specialized bank that deals with forfeiting debts, transforming them into currency, in exchange for a commission. The operation allows for the partial recovery of debt claims by the bank, the unrecovered amount being covered by the bank through its constituted provisions.

Human resources analysis is an evaluation that must identify the personnel involved in the initiation, evaluation, surveillance of loans and in the processes of credit risk management. The following must be identified: the number, level of training, age, experience and responsibilities specific to each employee. The organization, abilities and qualifications of the staff must be analyzed alongside policies and procedures. The professional training programs for the bank's loaning staff must be reviewed and their degree of adequacy must be evaluated. The quality and frequency of staff training gives important clues regarding the level of loaning abilities.⁷⁸

The bank is exposed to credit risk both through its loaning, trading and investing activities as well as security issuing. Credit risk associated with trading and investment activities is reduced by selecting those trade-offs with solid credit ratings, by monitoring their activity, by using exposure limits and, where necessary, by demanding securities.

A bank's greatest exposure to credit risk is given by granting loans and credits to the clients. In this case, exposure is represented by the book value of assets from the individual situation of the financial position.

2. Credit risk concentrations

Credit risk is correlated to reinvestment risk, the bank registering losses also due to the fact that the sums it was due to receive were not reinvested in due time.

Banca Transilvania is exposed to credit risk through different other financial assets, including derivatives and debt instruments, exposure in the case of these instruments being equal to their book value from the individual situation of financial position. The loaning institution is exposed to off balance sheet credit risk, through financial agreements and securities issuing.

The concentration of credit risk pertaining to financial instruments exists for groups of clients or third parties which present similar economic characteristics and whose loan reimbursement capacity is similarly affected by the changes in the economic environment.

⁷⁷ Hennie van Greuning and Sonja Brajovic Bratanovic, "Analiza și Managementul riscului bancar – Evaluarea guvernantei corporatiste și a riscului financiar" Editura Irecson 2004, pag. 53

⁷⁸ Doinița Simona Badiu Popa, "Banking și Performanța Bancară" Metodologii Manageriale Moderne Ed. Europlus Galați 2010, pag. 137

The main concentration of credit risk is derived from individual exposure and that based on categories of clients, in reference to loans and credits given by the bank, facility extension commitments, and securities issued. On 31st of December, 2011, total balance sheet and off balance sheet exposure were of 19.453.950 thousand lei (31st December 2010: 15.228.472). The sums represent the maximum accounting loss which would be admitted at the date of the report if the clients were to stop respecting the contractual obligations and any security would be worthless.

The bank withdraws from accounting books a credit/a financial instrument (and the respective depreciation provisions) at the moment when it considers that the asset is irrecoverable. This conclusion is reached after the evaluation of the significant changes that took place in the financial position of the loaner/issuer, changes which have determined the impossibility of paying the bond or the insufficiency of the sums from the recovering of securities to cover the whole exposure.

3. Exposure to credit risk for loans and advances to customers

The bank uses ratings associated to financial performance both for individually tested credits as well as for those collectively evaluated. According to the policies applied by the bank, to each degree of risk may be associated a corresponding rating, from the lowest to the category of loans for which judicial debt recovery procedures have been launched.

The exposures to credit risk for loans and advances issued to the clients at Dec. 31st 2011 and 2010 is presented in *table 1 and table 2, respectively*:

Table 1 - Loans and advances issued to customers

Thousand lei (RON)

Specific provisioned loans and delays	December 31st 2011	Debts and Impaired without reserves	December 31st 2011
4 th Degree - with specific reserves	820.865	1 st Degree – 2 nd Degree	1.706.786
5 th Degree - with specific reserves	315.086	3 rd Degree	670.461
6 th Degree – over 90 days outstanding debts and litigation	1.520.911	4 th Degree	367.714
		5 th Degree	65.623
Gross value	2.656.862	Gross value	2.810.584
Depreciation Allowance	- 1.479.450	Depreciation Allowance	- 135.592
Net book value	1.177.412	Net book value	2.675.192
Current loans and without reserves	December 31st 2011	Stratification by outstanding days	December 31st 2011
1 st Degree – 2 nd Degree	9.607.890	15-30 days	2.029.878
3 rd Degree	619.306	30-60 days	388.383
Gross value	10.227.196		
Depreciation reserve	- 44.510	60-90 days	334.078
Net book value	10.182.686	90-180 days	58.244
		180 days +	0
Total net book value	14.035.290	Gross value	2.810.583

Source: developed by the author according to the financial standings of Banca Transilvania

Table 2 - Loans and advances issued to customers

Thousand lei (RON)

Specific provisioned loans and delays	December 31st 2010	Debts and Impaired without reserves	December 31st 2010
4 th Degree - with specific reserves	2.509.382	1 st Degree – 2 nd Degree	792.246
5 th Degree - with specific reserves	653.060	3 rd Degree	466.491

6 th Degree – over 90 days outstanding debts and litigation	1.204.565	4 th Degree	0
		5 th Degree	0
Gross value	4.367.007	Gross value	1.258.737
Depreciation Allowance	- 1.050.830	Depreciation Allowance	- 45.700
Net book value	3.316.177	Net book value	1.213.037

Current loans and without reserves	December 31 st 2010	Stratification by outstanding days	December 31 st 2010
1 st Degree – 2 nd Degree	7.453.418	15-30 days	1.059.414
3 rd Degree	463.509	30-60 days	84.712
Gross value	7.916.927	60-90 days	114.611
Depreciation reserve	- 181.336	90-180 days	-
Net book value	7.735.591		
	-	180 days +	-
Total net book value	12.264.805	Gross value	1.258.737

Source: developed by the author according to the financial standings of Banca Transilvania

The bank has loaning commitments on December 31st 2011 to the sum of 3.759.309 thousand lei (December 31st 2012: 2.963.667 thousand lei), closed mainly with trade-offs with 1st to 3rd Degree risks.

Investments in banks and stock deposits were neither outstanding nor provisioned.

The analysis of held securities according to the categories of loans issued to clients

Banca Transilvania holds securities for credits and advances issued to clients in the form of collaterals, mortgages on real estate, assets used as collateral in secured loans and other equipment pledges or future earnings. The estimations take into account the value of the security evaluated at the date of the loan and, where applicable, the values estimated at the date of subsequent analyses.

The securities held according to the categories of loans issued to clients are presented below, in table 3.

Table 3 - Security interests according to loan types

<i>Pertaining to provisioned loans and those over 90 days overdue</i>		
	2011	2010
Real estate	1.704.588	4.204.122
Personal securities	358.258	677.242
Other securities	58.905	158.000
	2.121.751	5.039.364
<i>Pertaining to outstanding loans and without specific provision</i>		
Real estate	2.603.650	1.128.030
Personal securities	309.397	197.908
Other securities	178.752	79.299
	3.091.799	1.405.237
<i>Pertaining to current loans and without specific provision</i>		
Real estate	9.610.772	8.869.531
Personal securities	1.618.578	1.517.087
Other securities	545.480	598.210
	11.774.830	10.984.828
Total	16.988.380	17.429.429

Source: developed by the author according to the financial standings of Banca Transilvania

The evaluation of the credit risk to which the bank is exposed is determined through the following indicators:

$$\text{Outstanding loan ratio} = \frac{\text{Outstanding loans}}{\text{Total loans}} \times 100$$

$$\text{Degree of credit risk coverage} = \frac{\text{Current credit risk provisions}}{\text{Necessary credit risk provisions}}$$

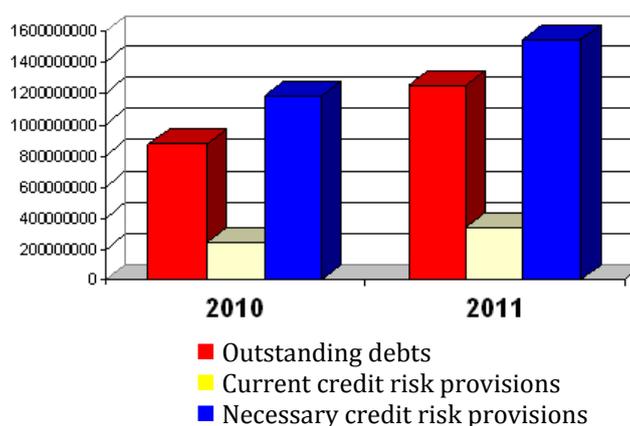
In order to analyze these indicators the elements from *table 4* are necessary:

Table 4 - Elements necessary for credit risk

	Year 2010	Year 2011
Outstanding debts	878.853.529	1.246.312.301
Total debts	13.028.004.771	14.140.233.409
Current credit risk provisions	243.000.000	345.000.000
Necessary credit risk provisions	1.180.649.581	1.545.222.956

Source: developed by the author according to the financial standings of Banca Transilvania

Figure no.1 - The graphic representation of indicators used in calculating credit risk



Source: developed by the author according to the financial standings of Banca Transilvania

Outstanding loan ratio:

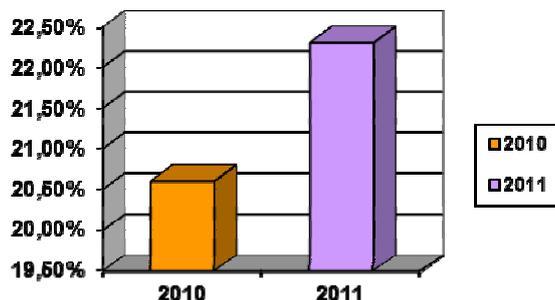
- ◆ For the year 2010 is 6,7 %
- ◆ For the year 2011 is 8,8 %

The outstanding loan ratio outlines the quality of the bank’s credit portfolio; the higher the value of the indicator, the more the bank is exposed to credit risk. The maximum admissible limit of this indicator is 6%.

From the analysis we observe a bank’s exposure to credit risk which is much larger in 2011 as compared to 2010.

Degree of credit risk coverage

- ◆ For the year 2010 is 20,6%
- ◆ For the year 2011 is 22,3%

Figure 2 – The graphic representation of the degree of credit risk coverage 2010/2011

Source: developed by the author according to the financial standings of Banca Transilvania

The degree of credit risk coverage outlines the foresight of management to cover its credit losses with provisions. Normally, this ratio should be within 1%.

Credit risk management implies the use of techniques through which the bank can eliminate losses or save the loan. With a view to reduce or eliminate losses, banks monitor the quality of the credit portfolio through a permanent revision. In banking activity, taking risks can be researched for its possible future advantages, such as speculative operations on financial or exchange markets but also for possible unpredictable losses.

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*** Regulamentul nr. 3/2007 din 12/03/2007 privind limitarea riscului de credit.

Web Resources:

<http://www.bnr.ro/>

<http://www.capital.ro/>

<http://www.bacatransilvania.ro/>