Credit Risk Management - Loan Approval Process

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Abstract

The aim of this study is on understanding the international regulations issued by Basel I, Basel II and Basel III to best supervise and manage credit risk management policies. Part of paper will focus on the description and impacts of the regulations and the pivotal importance they play in providing a sound banking system.
Credit risk represents another important element that will be analysed considering that it lays the foundation during the loan consideration and approval process. The paper will also explain in detail procedures and responsibilities shared along the process of loan acceptance by a banker. To sum up, the overall process from application to loan approval or denial will be explained pointing out the implications that are faced along the way.

Keywords: Credit, Loan, Risk management, Basel regulations.

Introduction

The Committee of Basel I was established in 1974 by the governors of central banks from ten countries (France, Germany, Belgium, Italy, Japan, Holland, Sweden, United Kingdom, USA and Canada, and Swiss which had a minor role) aimed to improve supervising guidelines that central banks or similar authorities impose on banks. This committee provides banking policy guidelines for both sides of member states and non-member states and helps the authorities to implement their suggestions.
Basel I – The first agreement was reached in 1988 and mainly focused on credit risk, by creating a classification system of bank assets. This classification system grouped banks assets in five risk categories:

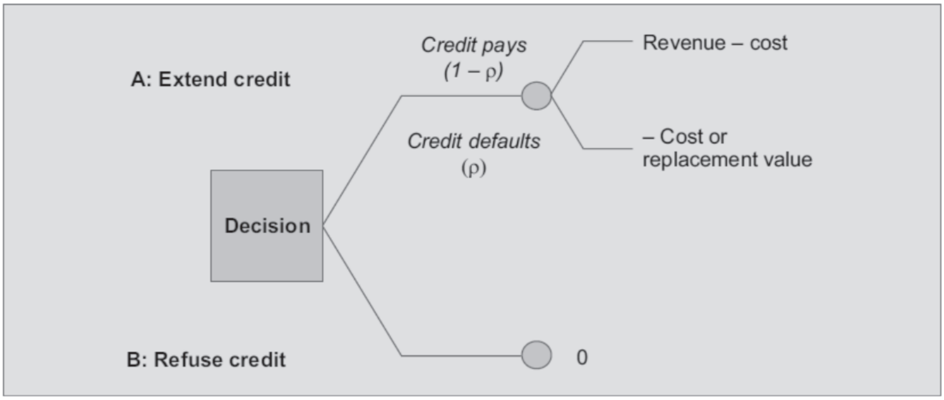
- 0% - Cash money in NCB, Government Debts;
- 0%, 10%, 20% or 50% - Debts to the public sector;
- 20% - Debts to development banks, OECD banks debts, debts of non-OECD countries (less than 1 year maturity);
- 50% - Residential mortgages;
- 100% - Private sector debt, debts from non - OECD banks (over 1 year maturity), etc.

Basel II

Basel II was published for the first time in June 2004 with the aim to change international standards on bank control. These rules were drafted with the goal to ensure the banks from the risks they were exposed to. Basel III (or Basel III Agreement) - is a global, voluntary regulatory framework on bank capital adequacy, which stresses testing and market liquidity risk. It was agreed by the members of the Basel Committee on Banking Supervision in 2010-11. It entered into force from 2013 until 2015; however, it changed from 1.4.2013 and the implementation is extended until 31.3.2018 and again extended until 31.3.2019.
Basel III was designed to strengthen the bank's capital requirements by increasing bank liquidity and reducing bank profits.

Credit risk management

What is credit risk? The easiest way of taking into account the credit risk is to imagine yourself in such a situation. Consider a situation in which someone you know either from school or from another occasion, demands a considerable amount of money from you, and if it doesn't give them back, effectively you will be without money. How will you react? Would you lend money to that individual? They might not return it. So, it's better to refuse it, though you might lose an opportunity to benefit.



Credit risk can be defined as an "opportunity when a contractual party will fail to fulfil its obligations in line with agreed conditions." Credit risk is also called as an inevitable risk, the risk of performance or the risk of the other party. All of these fundamentally refer to the same impact of adverse credit transactions of a company. In order to assess the credit risk, it is important to take a realistic view at economic and legal position of the borrower, as well as the relevant environment (industry, economic growth, etc.). The quality of loan approval process depends on two factors, i.e. transparent and comprehensive presentation of the credit risk on the one hand and the adequate assessment of these risks. Furthermore, effective level of loan

approval process is considered a significant element. Due to significant differences in the character of different borrowers (i.e. private individuals, companies, etc.) and the assets to be financed (i.e. residential real estate, manufacturing plans, machinery, etc.), as well as the large number of products and their complexity, there cannot be a process to assess the credit risk.
Therefore, it is necessary to make a distinction, and the following section describes the essential criteria which must be taken into account in determining this difference in terms of risk and efficiency.

Credit risk aspects

The quality of the credit approval process from the risk point of view is determined by identifying the best possible credit risk and its assessment. Credit risk can be distributed among four risk components who have found their way into Basel basic principles.

- Probability of default (PD);
- Loss given default (LGD);
- Exposure at default (EAD);
- Maturity (M).

Most important components in credit approval process are PD, LGD, and EAD, while maturity (M) is needed to calculate required capital. Maturity plays a small role during exposure review.

a) Probability of default (PD)

This assessment should take into account diverse characteristics of the borrowers (private or legal person). Depending on this distinction the change of the loan approval process is made, in line with the borrowers. Moreover, it should be taken into account that the interest and principal repayments must be financed exclusively by cash flow of the object that will be financed without borrowers' opportunity to change assets.

b) Loss given default (LGD)

It deals with collateralized part and the collateral sale cost. Therefore, the calculated value and the type of collateral must also be taken into account during the loan approval processing.

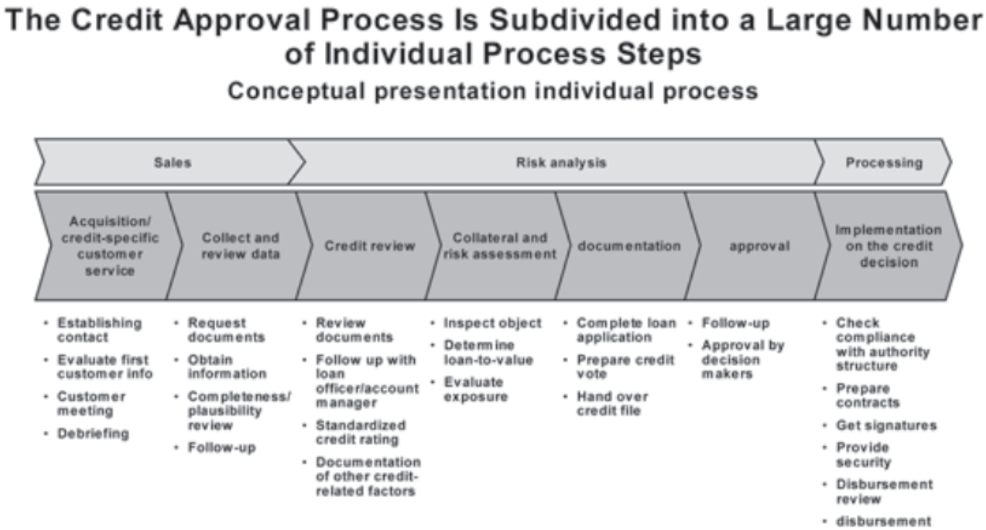
c) Exposure at default (EAD)

This is the total amount of exposure at the time when the exposure is delayed. An EAD value is given to any banking exposure and is identified within the bank's internal system. The use of Internal Review Board (IRB), financial institutions will often use their models to manage their Exposure at Default (EAD) risk - regarding the request type, the amount of the claim which is another important element during the loan approval processing.

Loan approval processing

The way the following paragraphs are listed below reflects the sequence of steps in the credit approval processing, which is the framework of loan approval processing for new users. Credit approval processing for existing customers will be addressed explicitly if they contain the process steps that are not applied during the processing of granting loans to new customers at least in a similar form.
This chapter shows a structured presentation of criteria that should form the basis for designing credit approval processes. The definition of segments of exposure is an important prerequisite to handle credit approval processes in a way that is specific to the involved and efficient risk.

Figure 1 summarizes individual steps in during the process



Data collection

The Evaluation of a loan application is based on data sources and different types of data in accordance with the type of borrower. In any case, banks should always be interested in having accurate and updated data on the economic and individual position of the borrower. Before a loan approval, the application is subject to a comprehensive analysis; the employee in charge must first conduct a reliability audit and preliminary review of the application. This control should assess the completeness and consistency of the submitted documents by the borrower to minimize any lack of application and the need for further investigation about the client. In addition, unit sales should perform an initial substantial check on the basis of some relevant criteria.

Analysis of exposure, loan review and collateral assessment

The exposure assessment includes credit review and a collateral assessment based on data provided by the loan applicant. These steps are aimed at avoiding the exposure risk. Standardized credit review (rating) is based in two main components:
- Financial assessment (or quantitative assessment);
- Quality assessment

Financial assessment includes an analysis of available financial data on the loan applicant. The analysis of annual financial state has a central position in this context. However, analysis of business planning (forward-looking approach) is being excessively included in the process of request reviewing. Usually, automated programs are used to calculate indicators of annual financial state or business plan. In most of cases, financial assessment is conducted by credit analysts who are not related to sales department in terms of organisational structure.

Processing procedure mainly deals with contracts' preparation, which means that it should be in accordance in line with the conditions of committee's decision. Then, the bank must ensure that the loan is in compliance with the rules stipulated by the regulator (CBK). Disbursement happens at this stage (loan allowing) and reporting to the loans registry.

Allowing the use of the loan funds must be in accordance with the proposed investment plan submitted by the client in accordance with the investment's timeline.

Recommendations

- Regarding the system of credit risk management the bank needs to use even more specific policies to have a continuous and timely loan assesment, specialy at the initial phase of the loan request. This would enable to set the appropriate reserve for the possible loses that may occure in the future.
- Banks credit risk departments worldwilde should monitor and control more often the loan assesment evaluation of all loans, in order to avoid loan clasification in different non-performing categories.

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