

# UPDATED GUIDELINES ON SOUND CREDIT RISK MANAGEMENT PRACTICES

***Mr. Resty C. Cruz***  
Managing Director, BSP



BANGKO SENTRAL NG PILIPINAS

# OUTLINE

- **Rationale**
- **Existing BSP guidance**
- **What banks are doing (current practices)**
- **Where banks are going (changes/updates)**
- **How to operationalize changes**
- **What's the implication/effect**
- **Supervisory Expectations**



# RATIONALE

- **Provide minimum set of standards on credit risk management to ensure that:**
  - ❑ **exposures are appropriately identified, measured, monitored and controlled**
  - ❑ **Provisions are adequate relative to risks taken**
- **Further align existing BSP regulations with the Basel Core Principles and international best practices**



# EXISTING BSP GUIDANCE (MORB)

## ❖ Lending Policies - Section X301

- ✓ written policies to guide lending operations

## ❖ Grant of Loans – Section X304

- ✓ ascertain that borrower has the **financial capacity** to pay the loan

## ❖ Loan Review System – Sec. X302 & App. 18

- ✓ To maintain quality of loan portfolio
- ✓ For timely recognition of problem loans
- ✓ To ensure adequate level of allowance for credit losses



# PROPOSED UPDATED GUIDANCE

## Sound credit risk management system covering the following areas:

- Establishing an appropriate credit risk environment
- Operating under a sound credit granting process
- Maintaining an appropriate credit administration, measurement, and monitoring process
- Maintaining an appropriate credit control process



# WHAT RBs ARE DOING (CURRENT PRACTICES)

- Credit Granting

- Inadequate basis for evaluating financial capacity
- Heavy reliance on collateral
- Continuous renewal without re-establishing financial capacity



# WHAT RBs ARE DOING (CURRENT PRACTICES)

- Credit Review and Monitoring

- Provisioning is based on **aging of accounts**
  - ✓ Ok if tagging of past due is accurate
  - ✓ But, current loans with weaknesses are not considered in the classification/provisioning
- Relies on BSP for provisioning
- MIS not able to accurately report past due loans



# WHERE BANKS ARE GOING (CHANGES/UPDATES)

- Credit granting

- Primarily based on **cash flow**
- **Not limited to AFS/ITR\***, may use other sources but should be justified and documented
- For renewal/extension, creditworthiness should be re-established (**redo process**)

\* AFS/ITR shall only be required for borrowers with loan exposures of P3 million and up





# WHERE BANKS ARE GOING (CHANGES/UPDATES)

- Credit Measurement (All banks)

- ICRRS for large loans
- Credit scoring models for retail credits
- Validation and stress testing policies

- Credit Review, Monitoring & Control

- Adequate MIS
- Revised loan classification system
- Adopt revised Appendix 18 **OR**
- Development of own loan loss methodology for individually and **collectively** assessed loans;



# WHERE BANKS ARE GOING (CHANGES/UPDATES)

## • Revised Classification System

### Especially Mentioned

Existing Provision	Proposed Revision
<ul style="list-style-type: none"><li>✓ Loans with unlocated collateral folders and documents</li><li>✓ Loans to firms not supported by board resolutions authorizing the borrowings;</li><li>✓ Loans without credit investigation report/s;</li><li>✓ Loans not supported by AFS/ITR</li></ul>	<ul style="list-style-type: none"><li>✓ Loans with deficiencies in underwriting, documentation, structure and/or administration that can compromise the bank's ability to control credit relationship if events adversely affect the borrower</li></ul>
<ul style="list-style-type: none"><li>✓ Loans with other deficiencies were treated as "Miscellaneous Exceptions"</li></ul>	



# WHERE BANKS ARE GOING (CHANGES/UPDATES)

## • Revised Classification System

### Especially Mentioned

Existing Provision	Proposed Revision
	✓ Continuous renewal without reduction in principal, except when capacity to pay has been re-established.
	✓ Intermittent delays or inadequate repayment of principal, interest or periodic amortization



# WHERE BANKS ARE GOING (CHANGES/UPDATES)

## • Revised Classification System

### Substandard

Existing Provision	Proposed Revision
<ul style="list-style-type: none"><li>✓ Current loans with unfavorable results of operations for two (2) years or with impaired/negative net worth except for start-up firms (case-to-case evaluation)</li><li>✓ Renewed/extended loans with declining trend in operations, illiquidity, or increasing leverage trend in the F/S without at least 20% repayment of the principal before renewal or extension</li></ul>	<ul style="list-style-type: none"><li>✓ Weak financial condition and results of operations that leads to the borrower's inability to generate sufficient cash flow, except for start-up firms (case-to-case evaluation)</li></ul>



# WHERE BANKS ARE GOING (CHANGES/UPDATES)

## • Revised Classification System

### Substandard

Existing Provision	Proposed Revision
✓ Loans granted without requiring submission of the latest AFS/ITR to determine paying capacity of the borrower;	
✓ Loans with unsigned PNs or signed by unauthorized officers of the borrowing firm;	
	✓ Breach of any key financial covenants that will adversely affect the capacity to pay of borrower



# WHERE BANKS ARE GOING (CHANGES/UPDATES)

## • Revised Appendix 18

Existing Provision	Proposed Revision
<ul style="list-style-type: none"> <li>✓ Aging is <b>based on past due</b> as defined under Subsec X306.1</li> </ul>	<ul style="list-style-type: none"> <li>✓ Aging is <b>based on delinquency</b> in payment of <b>principal and interest</b>.</li> </ul>
<ul style="list-style-type: none"> <li>✓ Provisioning is <b>fixed</b>: <ul style="list-style-type: none"> <li>EM - 5%</li> <li>Substandard - 10% / 25%</li> <li>Doubtful - 50%</li> <li>Loss - 100%</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>✓ Provisioning <b>escalates</b> based on expected loss considering future cash flows and collateral.</li> </ul>
<ul style="list-style-type: none"> <li>✓ Secured loan – default classification is “Substandard”</li> </ul>	<ul style="list-style-type: none"> <li>✓ If collaterals are insufficient, weak or without recoverable values, loans shall be treated as unsecured</li> </ul>
<ul style="list-style-type: none"> <li>✓ Individual assessment even for retail and small denominated loans</li> </ul>	<ul style="list-style-type: none"> <li>✓ Collective assessment for retail and small-denominated loans .</li> </ul>



# Basis for Classification of loan account:

**Existing:** Basis is “*past due for more than 30 days*”

Mode of Payment	Min. # of Arrears	Reckoning Date of Classification (Past due + 30 +1)
Upon maturity	-	31 <sup>st</sup> day (30 + 1)
Monthly	3	121 <sup>st</sup> day (90 + 30 + 1)
Quarterly	1	121 <sup>st</sup> day (90 + 30 + 1)
Semestral	1	211 <sup>th</sup> day (180 + 30 + 1)
Annual	1	391 <sup>st</sup> day (360 + 30 + 1)

**Proposed :** *Missed payment on principal and interest*”

Individually assessed loans	30 days after missed payment
Collectively assessed	Day following missed payment



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# AGING OF ACCOUNTS (Individual assessment)

## For unsecured loans and advances:

No. of Days Unpaid/Delinquent	Classification	ACL
31 - 90 days	Substandard	10%
91 - 120 days	Substandard	25%
121 - 180 days	Doubtful	50%
Over 180 days	Loss	100%

## For secured loans and advances:

No. of Days Unpaid/Delinquent	Classification	ACL
31 - 120 days*	Substandard	10%
121 - 365 days	Substandard	25%
Over 1 year - 2 years	Doubtful	50%
Over 2 years	Loss	100%

\* When there is imminent possibility of foreclosure and expectation of loss, ACL shall be increased to 25%



# WHERE BANKS ARE GOING (CHANGES/UPDATES)

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# AGING OF ACCOUNTS (Collective assessment)

## For unsecured loans and advances:

No. of Days Unpaid/Delinquent*	Classification	ACL
1 - 30 days	EM	2%
31 - 60 days	Substandard	25%
61 - 90 days	Doubtful	50%
Over 90 days/ 2 <sup>nd</sup> Restructuring	Loss	100%

\* PAR for microfinance loans

## For secured loans and advances:

No. of Days Unpaid/ Delinquent	Classification	ACL (%)	
		Other types of collateral	Secured by real estate
31 – 90	Substandard	10	10
91 – 120	Substandard	25	15
121 – 360 days	Doubtful	50	25
361 days – 2 years	Loss	100	50
Over 2 years	Loss		100

# HOW TO OPERATIONALIZE

- **Loan Loss Methodology**

- Individually assessed loans

- Estimates should consider the facts and circumstances that affect the repayment of loans

- Collectively assessed loans

- Use of **historical net charge-off rate** adjusted for relevant factors that affect repayment of loans

- Use of **experienced credit judgment**

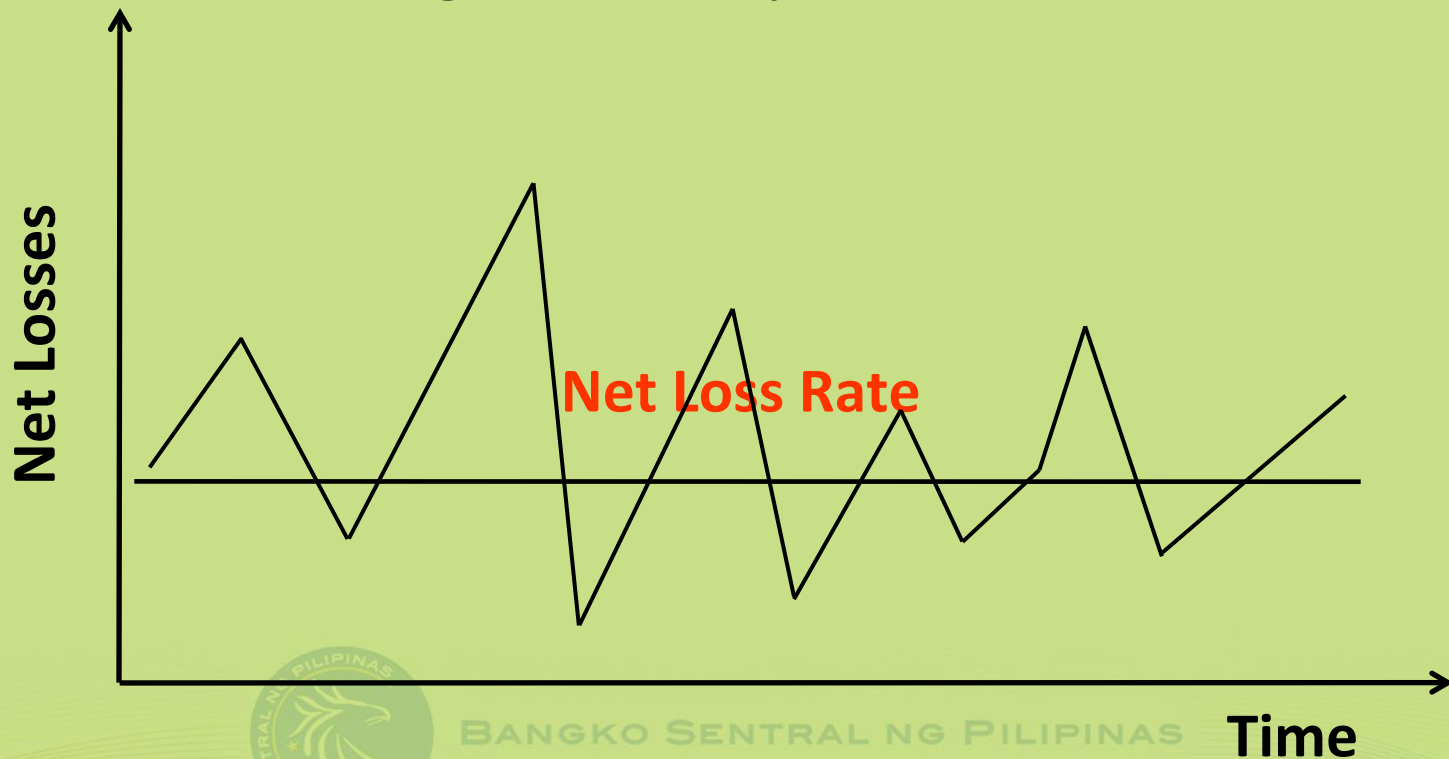
- Clearly articulated in the policies and procedures
- Estimates should be based on reasonable and supportable assumptions and adequately documented



# Historical Loss Rate

- Represents a bank's experience of losses with a particular group of loans (often used for retail credits)

Historical net loss rate = loan losses less recoveries  
(averaged over a period of time)



# Example of Historical Loss Rate Calculation

– Assuming a salary loan portfolio of P5,000,000

Quarter	Loan Losses (a)	Recoveries (b)	Net (a-b) = (c)	Historical LR (C)/P5 million
1	200,000	75,000	125,000	2.5%
2	100,000	30,000	70,000	1.4%
3	300,000	120,000	180,000	3.6%
4	200,000	90,000	110,000	2.2%
Total				9.7%

Historical net loss rate =  $9.7\% / 4 \text{ quarters} = 2.4\%$



# Sample Computation for Collective Provisioning

**Given:**

Salary Loan Portfolio	P 5.0 million	Past Due (PDL)	P 2.0 million
Booked Allowance for Credit Losses	P 0.6 million	PDL Ratio	40%
3-Year Historical Loss Rate Data			

Days Past Due	Outstanding Balance	% that slides to over 180 days Based on Historical Data			
		2010	2011	2012	Ave.
		Current to 30 days	3,000,000	3%	2%
31 to 60 days	700,000	25%	28%	25%	26%
61 to 90 days	300,000	30%	32%	28%	30%
91 to 120 days	200,000	32%	34%	33%	33%
121 to 150 days	200,000	55%	59%	60%	58%
151 to 180 days	300,000	85%	87%	89%	87%
Over 180 days	300,000	89%	91%	90%	90%
Total	5,000,000				



# Sample Computation for Collective Provisioning

## Computation using Basic Guidelines (Appendix 18)

Days Past Due	Classification	Provisions	Outstanding Balance	Required Allowance
1 to 30 days	EM	2%	3,000,000	60,000
31 to 60 days	Substandard	25%	700,000	175,000
61 to 90 days	Doubtful	50%	300,000	150,000
Over 90 days	Loss	100%	1,000,000	1,000,000
Total			5,000,000	<b>1,385,000</b>
Booked Allowance				600,000
Proposed Additional Allow.				<b>785,000</b>





# Sample Computation for Collective Provisioning

## Computation using historical net charge off rate

Days Past Due	Outstanding Balance	Average Historical Loss Rate	Estimated Losses Over 180 Days (O/S Bal. x Ave.)	Loss Rate	Expected Losses
Current to 30 days	3,000,000	3%	90,000	90%	81,000
31 to 60 days	700,000	26%	182,000	90%	163,800
61 to 90 days	300,000	30%	90,000	90%	81,000
91 to 120 days	200,000	33%	66,000	90%	59,400
121 to 150 days	200,000	58%	116,000	90%	104,400
151 to 180 days	300,000	87%	261,000	90%	234,900
Over 180 days	300,000	90%	270,000	90%	270,000
Total	5,000,000				994,500
Booked Allowance					600,000
Proposed Additional Allowance					<b>394,500</b>



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## Basic Guidelines (Appendix 18)

Days Past Due	Class'n	Provisions	Outstanding Balance	Required Allowance
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Over 90 days	Loss	100%	1,000,000	1,000,000
<b>Total</b>			<b>5,000,000</b>	<b>1,385,000</b>
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<b>Total</b>	<b>5,000,000</b>				<b>994,500</b>
Booked Allowance					600,000
Proposed Additional Allowance					<b>394,500</b>

- Collectively assessed loans shall be provided with a minimum provision of 1% (GLLP)



# Implication/Effect:

- Application of historical net charge off rate **may result to higher or lower provisions** compared to prudential minimum, but, will be able to capture a realistic or reasonable estimate of loan-losses, including current loans that manifest weaknesses
- Adjustment in the MIS
  - for purposes of aging of delinquent accounts (basis is changed from past due to number of days of missed payment)
  - Adoption of a credit risk rating system



# Implication/Effect:

- For a bank that opts to adopt App. 18, it should ensure the **accuracy of tagging** of delinquent loan accounts. Otherwise, the required allowance for credit losses shall be **grossed up** based on the BSP's examination of sampled accounts.



# Supervisory Expectations:

- **Adequate** credit policies and procedures aligned with the requirements of the proposed updated guidelines
- A sound credit granting process that primarily considers **cash flow** and other relevant factors in determining capacity to pay
- A credit risk rating/measurement system that provides a framework for effective monitoring and control of the quality of individual credit as well as total loan portfolio



# Supervisory Expectations:

- An effective credit review process that:
  - ✓ ensures that credits are granted in accordance with policies
  - ✓ Assesses the overall quality of assets, including appropriateness of classification and adequacy of loan-loss provisions
- A sound loan loss methodology that produces a **reasonable** and **prudent** measurement of estimated credit losses in the loan portfolio that are recognized in a **timely** manner
- MIS that is accurate, reliable and timely.

**Thank You!**



**BANGKO SENTRAL NG PILIPINAS**

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Over 2 years	Loss		100