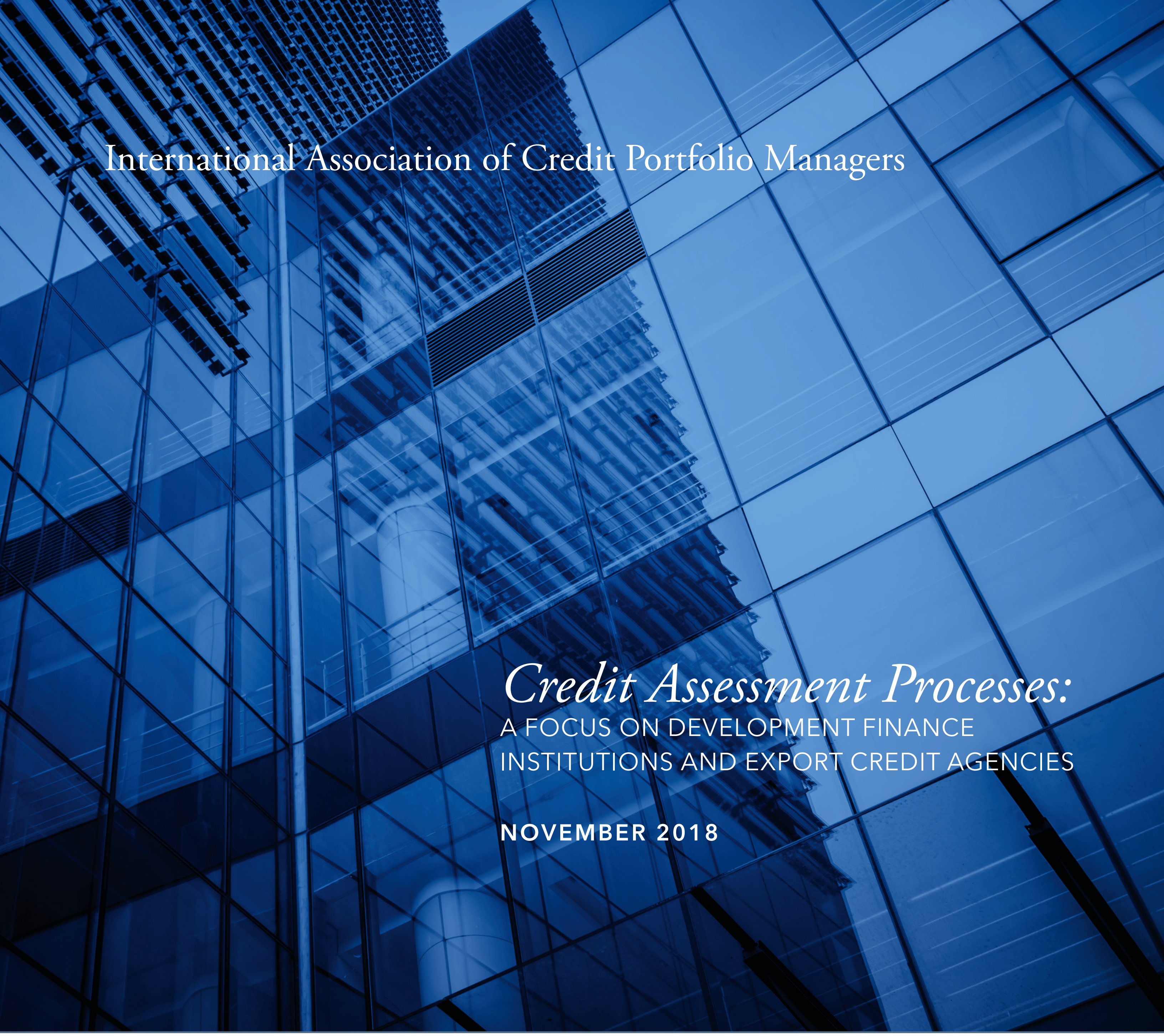

International Association of Credit Portfolio Managers

Credit Assessment Processes:
A FOCUS ON DEVELOPMENT FINANCE INSTITUTIONS AND EXPORT CREDIT AGENCIES

NOVEMBER 2018

IACPM

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Executive Summary

The International Association of Credit Portfolio Managers (IACPM) conducted a survey on Credit Assessment Processes in late 2018 with participants from Development Finance Institutions (DFIs) and Export Credit Agencies (ECAs). This sector-specific survey was designed by a group of the participants giving them the opportunity to focus on the issues that really mattered to them. There were 14 participants in the survey.

Similar to the findings in other IACPM surveys on banking, there are some areas where the participants are closely aligned in their practice, and at other times differences of approach and opinion. Nonetheless, the process of participating has enabled institutions to share ideas and discover other forms of best practice.

KEY FINDINGS

- The dominant operating model for initial credit assessments is one where the originator (1st line) proposes a rating that is subsequently confirmed by the risk function (2nd line).
- Authority to confirm an internal rating is mixed between individual powers and committee-based decisions.
- Initial credit ratings are mostly based upon the financials of the underlying credit risk but are sometimes supplemented with qualitative information.
- The determination of whether a credit has improved or deteriorated will generally be owned by either Risk or the Portfolio Management function.
- Decisions to upgrade/downgrade credits are primarily taken by a combination of Risk and Portfolio Management.
- There are differences in the reporting lines for the Portfolio Management function with some participants having the unit as 1st line and others preferring to have it as 2nd line reflecting the range of business and risk models at the firms and their portfolios.
- Timeliness of credit reviews is clearly the most used and valued measure applied to the ongoing credit assessment process.
- The governance process for credit assessment is characterised by risk reporting through the publication of key metrics, and then a response to issues by discussion or escalation.
- Half of the participants seek to mirror the regulatory norms and processes that a bank would follow in the private sector.
- There is a universal desire for more automation and systemisation.

I. *Introduction*

Development banks, export credit agencies and other similar financial institutions are an important and growing community in the IACPM membership. These institutions bear many similarities to commercial banks but do not have the same regulatory framework or commercial imperatives.

Conducting surveys specifically for this sector provides a useful lens through which to benchmark organisational structure and process. With this objective in mind, the IACPM conducted a survey on credit processes in the autumn of 2018.

The particular focus of the *Survey* was on:

- Credit Assessment: the mechanics of how exposures are assessed and managed
- Key Performance Indicators: methods of measuring performance, and
- Governance: how the organisation controls the credit process itself

Note on the survey demographics:
The Credit Assessment Processes survey included responses from 14 firms globally. *See appendix for full demographics.*

II. *Credit Assessment Processes*

The questions relating to credit assessment were split into three sections. By doing this it would be possible to form a view of how the dynamics of the credit process change given the external environment.

The three sections were:

- Determining the initial credit rating assigned to an asset
- Change in monitoring and responsibilities when an asset is downgraded
- Change in monitoring and responsibilities when an asset is upgraded

INITIAL ASSESSMENTS

The dominant operating model for initial credit assessments is one where the originator (1st line) proposes a rating that is subsequently confirmed by the risk function (2nd line). *Figures* 1 & 2. Although *Figure* 2 contains a significant response of 'other' this mostly referred to risk committees and other forums. The authority to confirm an internal rating is very mixed between the participants. Some clearly delegate powers to individuals, some work on a committee basis and others have a mixed approach of escalating exceptions to committees.

The rating itself is primarily built upon the financials of the underlying credit risk, although 50% of the participants supplement this with qualitative information. A small proportion of organisations look to external credit ratings, however given the countries in which the participants operate ratings are not always available. The minimum review period for ratings is annually with some participants operating a semi-annual process as standard. In the event of heightened awareness or special events, monitoring would become more frequent depending upon prevailing events (eg. quarterly).

For the majority of participants, the determination of whether a credit has improved or deteriorated, and whether to subject an asset to a higher level of scrutiny will generally be owned by either Risk or the Portfolio Management function, although involving the Originator.

CREDIT UPGRADES/DOWNGRADES

Half of the participants work to defined thresholds and limits for upgrading or downgrading a credit. The other half use a mixed system of limits and subjective measures to avoid being constrained on putting names on or off a watch list.

Decisions to upgrade/downgrade are primarily taken by a combination of Risk and Portfolio Management although a quarter of participants cite the Origination team as playing the lead role. There is a slight difference in emphasis for upgrades where Portfolio Management on average plays a larger role in contrast to downgrades where Risk plays a marginally larger role.

There are still differences in the reporting lines for the Portfolio Management function with some participants having the unit as 1st line and others preferring to have it as 2nd line. There is universally a desire for more automation and systemisation.

Figure 1
Which Part of the Organization *Proposes* the Initial Rating?

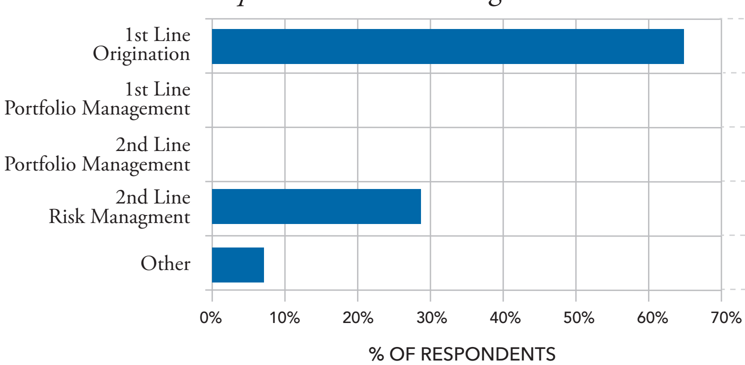
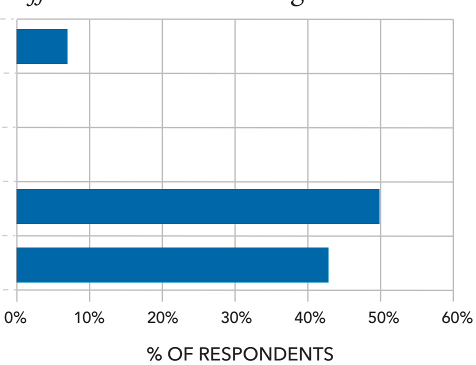


Figure 2
Which Part of the Organization *Affirms* the Initial Rating?



III. *Key Performance Indicators*

Figure 3 shows the sources of information that participants use to monitor performing assets and compares this to the frequency of use.

A clear pattern is evident that a wide range of sources are used on a frequent basis to monitor asset performance. The lesser-used monitoring methods by half of the participants are either event-related (Identification & Escalation of Issues, Restructuring etc.) or less directly tied to a specific client (Data Aggregation). Feedback to Origination from Portfolio Management is not widely or frequently used, which contrasts with the relative importance of the role of the Portfolio Management in credit upgrade/downgrades (see section 2). “Other” in this context relates to sourcing market data and alerts.

Figure 3

Sources of Information and Monitoring

N = *14 for each source*	*Which sources of information are used to monitor assets that are performing?*				*Of the monitoring methods available, how frequently does your organization use them?*			
	Not Measured	Quantitative	Qualitative	N/A	Used Frequently	Sometimes Used	Rarely Used	Do Not Use
Client Contact and Visits		2	12		10	3	1	
Client Reporting, Information Sourcing and Processing		12	2		13	1		
Regular Written Reviews (Monitoring and / or Visiting Banker)		8	6		12	2		
Identification and Escalation of Issues (Exceptional / Event Driven)	2	1	8	3	6	7		1
Credit Scoring (PD or Other)		11	1	2	10	2		2
Covenants Compliance Monitoring	1	12	1		11	3		
Waivers and Amendments Processing		5	9		10	4		
Restructuring, Renegotiation or Remedial Work	1	4	8	1	6	7	1	
Data Aggregation and Analysis (Client Financials / Covenants)	3	9	1		11	1	2	
Data Aggregation and Analysis (Macroeconomic / Sectoral)	3	8	3		7	6	1	
Input from Internal Strategy Formulation	4		2	8		2	7	4
Feedback to Origination from Portfolio Management	5		8	1	3	7	3	1
Other			1	4				2

IV. Governance

Governance and oversight of the credit process was of great importance to all participants. *Figure* 4 shows a map of how the participants use different metrics to ensure that the credit process is functioning as expected, and highlights what each participant considers to be the most important metric.

Timeliness of reviews is clearly the most used and valued by the participants but there are some different points of view regarding the best way to judge the integrity of the credit process. Criticisms of review timeliness included the issue that it might be too late for a given credit. Limit breaches are not always viewed to be a useful indicator of a weak credit process (in particular if caused by an exogenous event such as an FX market move).

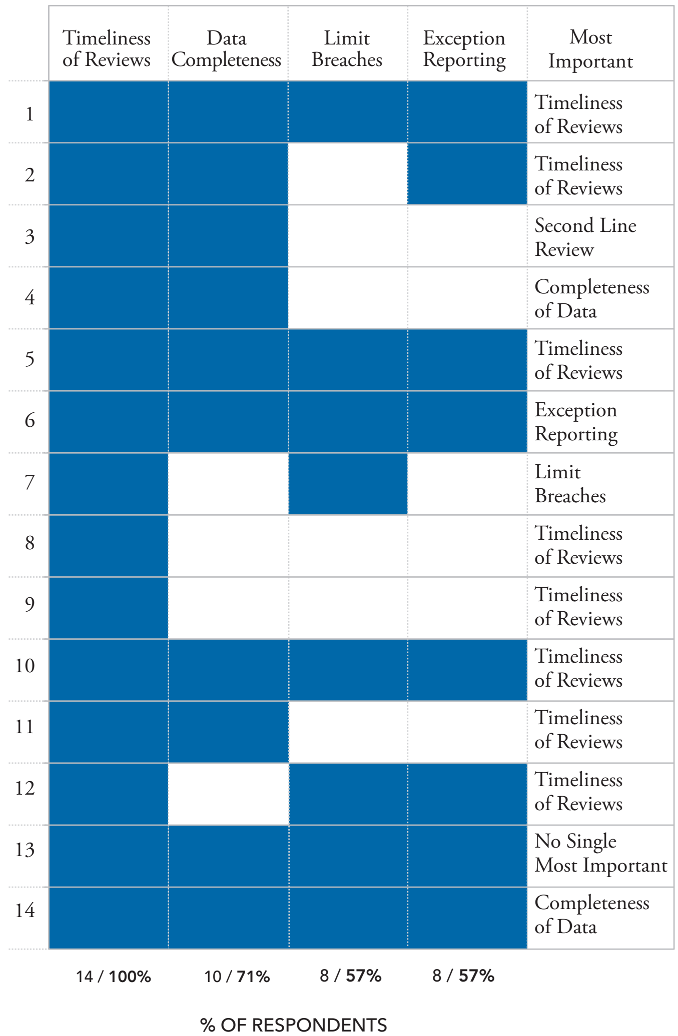
The stated consequences of not completing a review on time split into two broad categories. For about half of the participants the primary response was an organisational penalty such as a capital requirement increase, the expiry of a credit limit or an audit point against the business. For other participants the response was more to do with information reporting such as escalation to higher levels in the organisation or a recognised limit breach.

A disagreement between business functions about the credit standing of an asset followed a similar split in response. For half of the participants the reaction was 'vertical' – meaning that the issue would be passed up the organisation to a higher committee or an individual with the power to arbitrate. The other half of the responses suggested a more 'horizontal' response meaning that a decision might be subject to further negotiation/discussion or that a specific function (ie. typically Risk in the 2nd line) has the final say on a decision.

As a group, although mostly not tied to a formal regulatory structure, about half of the participants seek to mirror the regulatory norms and processes that a bank would follow in the private sector. The majority view with regard to future developments is to seek more automation and streamlining. Organisational change remains an ongoing challenge as it does for the banks in the private sector.

Figure 4

Governance Matrix



V. *Concluding Thoughts*

At first glance the overall survey results do not offer a conclusive answer to the best way to manage credit assessment processes. However, all the respondents follow the same underlying operating model for credit risk by initiating, rating and continuously monitoring risk. All the respondents also wrap a governance process around this model to test that it is working effectively. The differences appear to arise from the choices made in organisational structure and also from the measurement methods applied.

It is difficult with such a survey to interpret why different organisations map responsibilities in different ways. Examples of this would include the reporting lines for the portfolio management function, or perhaps the responsibility for proposing initial ratings. In large organisations there is a 'path-dependency' to change management and risk processes take time to evolve. It is possible that as the respondents operate in different jurisdictions and with different mandates, their internal structures are already the best solutions for each institution.

Measurement of risk is also being done in different ways, but that is something where convergence might be more likely. There ought to be a good answer to the question of the most effective ways to manage credit risk. Differences of opinion about the most useful methods to monitor credit risk might actually be driven by informational and organisational constraints. It could also be from operational limitations where the data that can be gathered in one market is either not available or of poorer quality than in another.

Good governance will be tailored to each institution and ties in with the choices made about organisational responsibilities. While there are some objective monitoring criteria such as the timeliness of reviews, there are some criteria that have a subjective component. Data completeness is objective on the surface, but underlying that there are choices being made about what data is required.

The next steps in developing these ideas might involve mapping organisational responsibilities, or taking a closer look at the relative value of different credit risk KPIs and governance metrics.

Appendix

DEMOGRAPHICS & SURVEY PARTICIPATION

For the IACPM Credit Assessment Processes survey globally a total of 14 institutions participated. The majority of participants were development banks or export credit agencies with the other participants very closely aligned to that activity. (*Figure* 5)

In terms of size, the participants represented a broad range of balance sheet sizes. (*Figure* 6)

Figure 5
Survey Participants by Activity

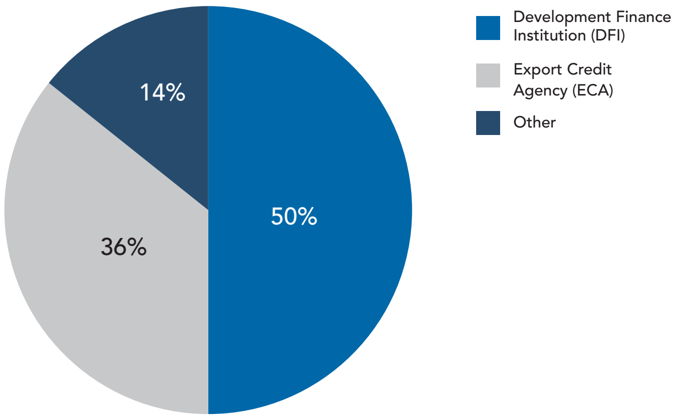
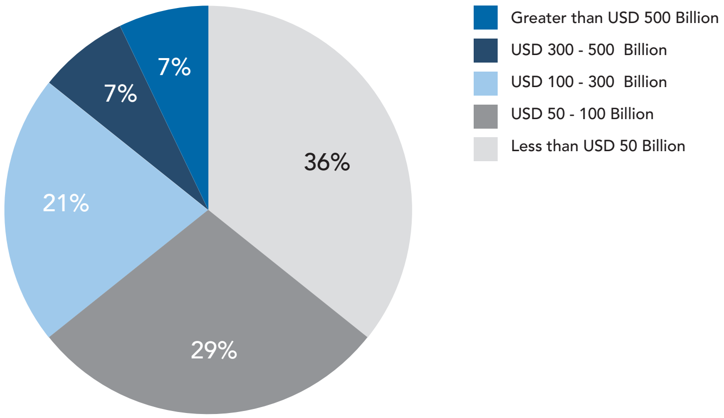


Figure 6
Survey Participants by Total Balance Sheet Assets



This report has been prepared by Chris McHugh, senior adviser to the IACPM. He is on the faculty at The London Institute of Banking & Finance and is a PhD researcher at the University of Portsmouth.

About the IACPM

The IACPM is an industry association established to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest. Membership of the IACPM is open to all financial institutions that manage portfolios of corporate loans, bonds or similar credit-sensitive financial instruments. The IACPM represents its members before regulatory and administrative bodies around the world, holds conferences and regional meetings, conducts research on the credit portfolio management field, and works with other organizations on issues of mutual interest relating to the measurement and management of portfolio risk. Currently there are more than 100 financial institutions worldwide that are members of the IACPM. These institutions are based in 23 countries and include many of the world's largest commercial wholesale banks, investment banks, development finance institutions, export credit agencies, insurance companies and asset managers. More information about the IACPM may be found on our website: www.iapcm.org.

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