TOPIC THREE: CREDIT POLICY IN BANKS

- Defining a Credit Policy of a Bank
- Objectives of a sound credit policy
- Credit policy as a Risk Management Tool
- Contents of a Typical Credit Policy
- Types of Credit Culture

❑ **What is a Credit Policy? – *"Tail Risk is the Culprit and Financing The Deal"***

- Credit policy is a set of guidelines that sets credit and payment terms for customers and establishes a clear course of action for late payments.
- It sets policies and procedures in treatment of delinquent loans, and the type of customer a bank wants as a borrower.
- This process of credit risk management is formalised in banks in a set of procedures referred to as a credit policy manual.

Control objectives of a Credit Policy;

a) Loan granted to bonafide applicants
b) Loan properly appraised and approved
c) Loan properly guaranteed and secured
d) Loan disbursed done per approved terms and conditions

- Turning a credit evaluation process into a functional activity requires a detailed set of guidelines, procedures and processes. Every firm that has a credit department like a bank needs to have a credit policy manual to formalize its decision processes regarding the day-to-day management of credit decisions and the resultant collection challenges when accounts are slow to pay, or fail to pay amounts when due.
- The thinking behind creating a manual, which is really a formalization of credit risk management procedures, is to be able to recognize and detail policy on important credit risk management issues, and to ensure consistent thinking and action on these issues by people engaged in credit risk management.
- As a document that formalizes the management of credit risk, a credit policy should provide decision rules and guidelines on important aspects of the credit-granting process being performed within the credit department and as discussed in earlier sections of this module.
- It is important to remember that, by formalizing the credit risk management process in a set of procedures, this will affect other elements of a bank's operations.
- Development of a credit policy is based on balanced assessment of credit risks and close cooperation with the client, the borrower. When determining priorities in lending, the bank assesses the ability of the borrower to develop and compete in its market.

- The Credit Committee plays a key role in implementing the bank's credit policy. It is authorized to make decisions regarding the risk appetite for the borrower and the project on behalf of the bank, and to ensure subsequent supervision.
- For the most part, credit policies will not change very often. However, as a matter of good practice, banks should review the manual annually, including in the review the views from senior management and affected departments to ensure that the procedures it details are up to date and reflect current thinking and practice- *refer to the banking trends for 2023 & generally changing financial sector discussed in Topic 1.* No banks will have the same set of credit risk management policies.

- The following list of components represents a typical set of policies that most banks would adopt to manage their credit exposures and regulatory frameworks in which they operate.

  - Within the scope of its credit policy, the bank seeks to generate profit with minimum risk and maximum protection for its clients and their funds.
  - Loans are targeted and are granted on the conditions of repayment, payment of interest and collateralization.
  - Loans may be granted on a one-time basis or as revolving credit instruments.
  - Usually, loans are secured by the borrower's property or other guarantees and insurance accepted in standard banking practice. The sufficiency and feasibility of such guarantees should be the basis of loan repayment and profitability.
  - The credit relationship between the bank and borrower are formalised in a written loan agreement. The loan agreement specifies the rights and obligations of the bank and borrower considering the nature of the loan, the amount and the procedure for payment of loan interest, the type of collateral, the procedure and term of loan repayment, and the liability of the parties for default of their obligations.

Types of Credit Policy

- One way to categorize credit policies is by how loose or stringent a policy is toward advancing credit and managing credit risk, no matter if the goal is credit sales or asset-based lending.
- The type of policy is based on firm-level goals and the business environment, so it should adjust dynamically. Banks use varying indices to determine the index that measures the general type of credit policy to use.

a) Loose credit

Represents a greater willingness to extend credit to grow the business; a strategy to take on higher credit risk and reap the rewards. Examples include granting credit to below-average

credit profiles with worse risk ratings, more limited access to capital, and weaker capacity.

b) Flexible credit

Represents a willingness to extend credit depending on circumstances. It is generally a neutral strategy that does not aggressively grow or restrict access to credit for clients. Examples include granting credit to a broader range of average credit profiles with a process for exceptional approval to policy for clients that may fall outside a diverse risk range.

c) Tight credit

Generally means less willingness to extend credit to support revenue growth. This is a strategy of restraint often implemented to limit credit losses and/or replenish capital. Examples include only granting credit to above-average credit risks, such as better risk ratings, greater access to capital, and more robust capacity.

d) No credit

This is an unwillingness to extend credit, as the bank is highly risk-averse or has no business case to support the cost/benefit of extending credit. Examples include "cash only" small-cash consumable goods or businesses with slim margins and insufficient capital to extend trade credit.

- ❑ **A good policy will generally do four things:**

    - Determine which customers are extended credit and billed
    - Set the payment terms for parties to whom credit is extended
    - Define the limits to be set on outstanding credit accounts
    - Outline the steps or procedures used to deal with delinquent accounts

- ❑ **Importance of Lending/Credit Policy**
    - Credit concentration failure to diversify
    - Protect the institutions against effects of risky practices
    - Ensure monitoring of activities
    - Integration to the global economy
    - Interest rates variations
    - Competition in the financial sector
    - Regulatory requirement

- ❑ **Overriding objective of credit policy**
    - Healthy Balance between

- Credit Volumes, Earnings & Asset Quality

- Within the framework of;
    - Regulatory prescriptions,

- Corporate goals - social responsibilities

- **Deciding on a credit policy**

Once the bank decides to formalize their credit policy, the question is: **How d**oes the Bank make a credit policy a good one? The end goal of all credit policies is to maximize the company revenue/business while minimizing the risk generated by extending credit.

- **Factors to consider**

While it is true that the end goal of all credit policies is to maximize the revenue while minimizing the risk generated by extending credit – the ways to get there can vary depending on a number of factors;

- The size of the business
- The specific cash flow of the business
- The industry of which the business is a part
- The overall economic climate

The credit department plays a huge role in controlling the flow of sales through the pipeline. Clearly, the easier it is to get credit, the more customers are able to purchase, and sales go up. A restrictive credit policy can reduce credit sales, since fewer borrowers would qualify for a credit line. However, as we have seen more than enough of recently, making credit too easy to obtain can result in more failures to pay as more of the customers default on the obligations. The bank must create a balance between very restrictive and very lenient credit terms.

- **Principles of Sound Lending**
  - Safety
  - Profitability
  - Liquidity
  - Risk diversification
- **Ingredients of a good loan policy**
  - Board & Management Oversight
  - Portfolio Management
  - Management Information Systems
  - Market Analysis
  - Credit Underwriting Standards
  - Portfolio Stress Testing & Sensitivity Analysis

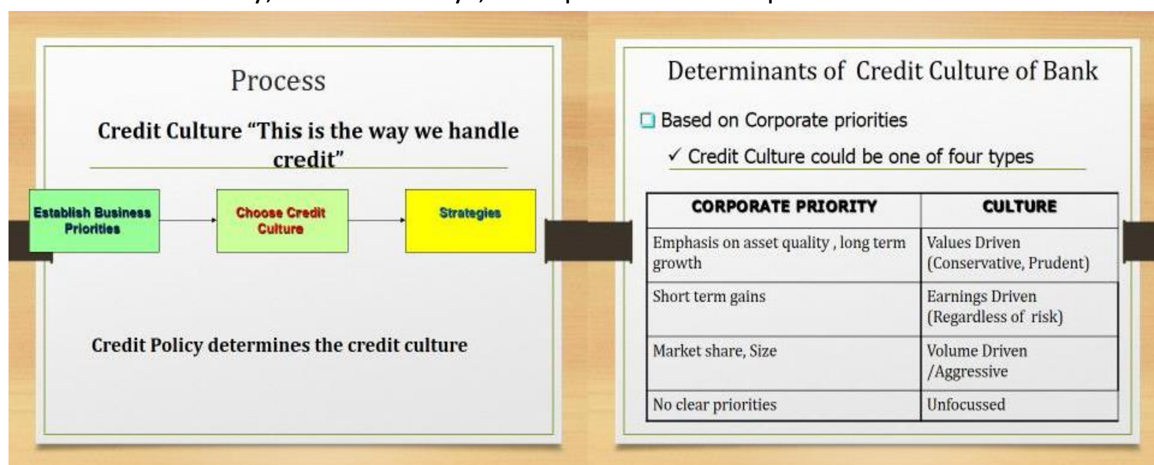
- Credit Risk Review Function

- **Establishing A Written Credit Policy**

- Define principal trade area
- Goals in terms of types, maturity, sizes, quality, and diversification by type, product and customer
- Lending authority and loan limits for each officer in the decision making process
- Operating procedures and required documentation
- Procedures for setting loan rates, fees, and restrictions or covenants Guidelines for evaluating, perfecting liens, and taking loan collateral in defaults
- Maintaining and reviewing loans and loan files to detect problems
- Working out problem loans

❑ **Perspectives that explain a Typical loan policy**

1. **Theory**
   a. Broadly defining the credit culture
   b. Broadly laying out the external-internal environment
2. **Regulatory Expectations**
   a. Statutory issues & Regulatory
   b. Market, present environment
3. **Empirical Studies**
   a. Industry, market surveys, bank performance reports



CORPORATE PRIORITY	CULTURE
Emphasis on asset quality , long term growth	Values Driven (Conservative, Prudent)
Short term gains	Earnings Driven (Regardless of risk)
Market share, Size	Volume Driven /Aggressive
No clear priorities	Unfocussed

❑ **Credit Policy As a Risk Management Tool**

- Credit Policy serves a 'Gate Keeping' function
- Defines thrust areas in relation to credit culture, profit objectives and regulatory directions
- Defines acceptable levels of risk by identifying industry segments for fresh exposures
- Prevents risk concentrations and ensures diversification by setting limits on sectors and individual transactions
- It provides pricing strategies through the use of Credit Risk Rating framework

- **An Ideal loan policy should;**

- Create business growth
- Maintain quality of assets
- Provide platform for good procedures/process
- Ensure regulatory and statutory compliances
- Be the platform for Credit Risk Management