Monetary Authority of Singapore

THEMATIC REVIEW OF CREDIT UNDERWRITING STANDARDS AND PRACTICES OF CORPORATE LENDING BUSINESS

MAS Information Paper

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1 Executive Summary

Introduction

1.1 The protracted low interest rate environment and increased level of liquidity over the past years have resulted in a very competitive market and compressed interest margins for banks. In this environment, some banks may relax loan structures and covenants, and under-price risks in their corporate lending activities. Against this backdrop, the Monetary Authority of Singapore (MAS) conducted a thematic inspection of several banks in Singapore to assess the credit underwriting standards and practices of their corporate lending business.

1.2 Overall, MAS did not observe any notable weakening of underwriting standards and practices by the banks from the thematic inspection, although there were areas for improvement and isolated cases of undesirable lending practices. Banks generally had sound underwriting policies and procedures in place to assess the creditworthiness and repayment capability of borrowers. Nevertheless, there were areas where some banks could strengthen their underwriting practices, such as by establishing clear risk acceptance criteria, improving credit assessments, and enhancing the monitoring of loans priced below hurdle rates and other credit policy deviations.

1.3 It is important that banks maintain sound credit underwriting standards, policies and processes as well as uphold prudent lending practices to avoid severe asset quality issues. Banks are expected to actively manage their credit risks to ensure that their credit portfolio remains resilient. Banks should also be watchful of emerging trends such as the substitution of trade finance facilities with working capital and other short term credit facilities, inappropriate granting of bullet loans, and loans priced below hurdle rates.

2 Credit Underwriting Framework

2.1 A sound credit underwriting framework is of paramount importance to a bank's corporate lending operations. It should set out the bank's lending strategies, risk assessment criteria, facility structuring guidelines and approving authority requirements in line with its risk appetite and tolerance.

Target markets and risk acceptance criteria

2.2 Most banks had clear corporate lending strategies that identified specific target markets to focus their marketing and expansion efforts. Target markets are customer segments identified by factors such as size, industry and geography.

2.3 However, not all banks performed robust analyses of the credit risks presented by their target markets to determine the appropriate risk acceptance criteria (RAC) to implement. RAC reflects the credit risk appetite of the banks' corporate lending business. It defines the characteristics of, and underwriting requirements for target customers. Banks with sound credit policies assessed prospective customers against the RAC as part of the credit evaluation process. In addition, credit facilities granted with deviations from RAC were actively monitored by the relevant management forums.

2.4 There were banks that only set RAC for new target markets or had general RAC that were not tailored to any specific customer segment. Their credit decisions were mainly based on the individual credit approvers' risk tolerance levels and experience which may result in inconsistent application of underwriting standards.

Credit approving authorities

2.5 Banks generally had appropriate approving authority frameworks and limits for the granting of new credit facilities. There were, however, instances where banks granted excessive powers to business units to approve credit exceptions such as temporary limit increases, limit excesses, and waivers of credit conditions and loan covenants. For example, some business heads were allowed to approve temporary limit excesses that formed a significant proportion of the initial loan limit granted.

2.6 For operational efficiency reasons, there may be a need for banks to grant business units with some credit exceptions approving powers. However, as business units have sales mandates, they may face conflicts of interest when exercising their approving authority. Appropriate limits and controls should therefore be established to mitigate such risks.

Policies and procedures

2.7 Most banks had credit policies and procedures that included underwriting standards on acceptable pricing, collateral, facility structures, covenants and conditions. Some banks' policies and procedures were more comprehensive as they covered specific areas such as collateral management and specialised industries.

Sound Practices

- *Banks analyse the credit risks presented by specific target markets and establish appropriate RAC for each target market. Credit facilities granted with deviations from RAC are monitored by the relevant management forums.*

- *Banks maintain comprehensive credit policies to ensure that policies are consistently implemented and industry specific risks are adequately addressed. For example, some banks have detailed policies on collateral management that include quantitative and qualitative guidelines to manage liquidation risk of physical collaterals, liquidity risk of financial collaterals, and foreign exchange risk when loans and collaterals were denominated in different currencies, etc. Some have specific policies for addressing risks in specialised industries such as shipping and commodities trading.*

Attention Areas

- *Where business units are vested with credit exceptions approving authorities, banks should establish appropriate limits and controls to mitigate potential conflicts of interest.*

3 Credit Risk Assessment

3.1 A comprehensive assessment of a customer's ability to repay a loan is an important aspect of sound credit underwriting. Such credit assessments include making assumptions on the relevant industry outlook, the customer's future plans and financial performance. It is critical that a bank adequately documents its assessments and assumptions in order to facilitate and support a proper credit review and decision-making process.

Credit assessment and documentation

3.2 In general, there is room for banks to improve the robustness and documentation of their credit assessments. There were instances where banks made inappropriate or erroneous assumptions when projecting borrowers' future cash flows for assessing repayment abilities. We also noted instances where banks did not adequately assess or document their analyses of the financial information of borrowers and guarantors, the experience and integrity of borrowers' key management staff, and the borrowers' business and industry outlook.

3.3 Inaccurate or inadequate credit assessment of relevant information could impair the ability of credit approvers to make sound credit decisions. The absence of adequate documentation could also hinder the ability of banks to perform effective independent reviews of credit decisions.

Credit risk rating models

3.4 Banks have developed internal credit risk rating models for assigning credit risk ratings to their customers. These ratings serve as important factors for determining the level of authority for approving credit facilities and the pricing required to cover the credit risks underwritten.

3.5 When applying their credit risk rating models, banks have to make various decisions on model selection, qualitative inputs needed and adjustments to model-generated ratings. There were instances where assumptions/decisions made by banks were inappropriate or inadequately justified. This could result in inaccurate credit ratings assigned to customers.

Sound Practices

- *Banks conduct comprehensive assessments of borrowers' creditworthiness including financial position and cash flows analyses, past repayment record, management quality and integrity, and relevant industry and macroeconomic data. Borrowers' repayment capabilities under various plausible and relevant stress scenarios are also assessed.*

Attention Areas

- *Banks could improve the robustness and documentation of their credit assessments.*

- *Banks should ensure that the assumptions/decisions made when using credit rating models are appropriate and adequately justified.*

4 Structuring of Credit Facilities

4.1 Appropriate structuring of credit facilities is an important element of sound credit underwriting practices. Among others, a bank should strive to structure credit facilities that suitably match the cash flow requirements and repayment sources of its customers, and include appropriate covenants to safeguard its interests.

Trade finance and working capital loans

4.2 There were increasing instances of banks granting general purpose working capital or short term loan facilities to companies, instead of trade finance facilities for borrowers' specific trading requirements. This trend could reflect the pressure on banks to accommodate the demands of borrowers to ease documentary requirements because of market competition.

4.3 Trade finance facilities allow banks to better control the cash flows of the transactions they are financing to reduce repayment risks. Such facilities are usually structured to match a borrower's trading cycles and cash flows. They tend to be short-term in nature and self-liquidating. In contrast, working capital loans are often granted on a clean basis with minimal covenants. Banks have no visibility of borrowers' use of the funds and have limited or no control over the cash flows. In this respect, working capital loans may carry relatively higher risks than trade finance loans.

4.4 Working capital loans are usually granted based on the strength of a borrower's financial position. It is thus important for banks to perform robust analyses of a borrower's financial position when granting such loans, particularly if a borrower's financial results are volatile. Banks should remain prudent and exercise sound underwriting practices even in the face of competitive pressures.

Bullet Loans

4.5 Several banks had stringent credit policies that only allowed the granting of bullet loans under certain circumstances, eg to match the cash flows from a borrower's source of repayment, and with adequate safeguards. However, some banks granted bullet loans without due consideration of the purpose of the loans and the adequacy of their borrowers' cash flows for supporting loan repayment. In most cases, the loans were granted with relatively long tenures of 3 years or more.

4.6 Bullet loans have higher credit risks because the principal is only repayable at maturity. Regular payments by a borrower consist of only interest payments and consequently the credit exposure remains significant throughout the loan tenure. In addition, we noted that most bullet loans had to be refinanced or rolled over at maturity. It is critical that banks appropriately price such loans to take into account the borrowers' refinancing risks and/or the expected actual tenure of the credit exposure.

Sound Practices

- *Banks grant bullet loans only when they are appropriate for the purpose of the loan, and the repayment structure is aligned with the borrower's cash flow and source of repayment. Banks also implement measures to ensure that their credit risks are adequately mitigated.*

Attention Areas

- *Banks should give due consideration to the purpose of the loans and the cash flows from the borrower's source of repayment when granting bullet loans.*

5 Other Areas

Deviations from credit policies and underwriting standards

5.1 Banks required their business units to justify deviations from established credit policies and underwriting standards. However, some banks did not have adequate procedures to manage the risks from such deviations.

5.2 There were instances where banks deviated from their credit policies and underwriting standards without appropriate explanation. For example, some banks had reduced the frequency of collateral valuation performed or waived certain standard credit conditions. While such easing of underwriting standards could be appropriate, banks should carefully assess and document the bases for accepting such deviations and implement appropriate mitigating measures.

5.3 Some banks managed such deviations on a case-by-case basis as part of the credit approval or review process. While risks arising from the deviations were assessed for specific borrowers, these banks did not have a view of the aggregate impact of such deviations on their credit risk exposures. Banks with sound risk management practices monitored such deviations on a portfolio basis separately from the credit approval or review process. Having a portfolio view of credit underwriting deviations allowed these banks to manage their overall credit risks more effectively. They were able to observe trends in their overall underwriting practices and any resulting incremental risk to their credit portfolio.

Risk-adjusted returns from loans

5.4 Most banks had internal thresholds for minimum risk-adjusted returns on loans (internal hurdle rates). However, banks occasionally priced loans below their internal hurdle rates for strategic reasons or with the expectation that projected fee incomes from borrowers would compensate for the lower interest income. While banks performed some level of review of the overall returns earned from borrowers during annual credit reviews, some banks did not systematically track the expected fee incomes to ensure that they were adequately compensated for the risks underwritten on an overall basis. Only a few banks actively managed borrowers with risk-adjusted returns below their internal hurdle rates to either improve the returns or exit the relationships.

Undrawn credit lines

5.5 Some corporate borrowers have significant undrawn committed credit lines with various banks. If these borrowers utilise all their undrawn facilities during periods of stress, there could be significant impact on their leverage and financials. Banks should be cognisant of the potential impact on their credit risk exposures if these undrawn committed credit lines are fully utilised.

Key performance indicators

5.6 Most banks recognised that their business units formed the first line of defence in risk management. For this reason, the business units were appraised based on balanced key performance indicators (KPIs) that included marketing, compliance and risk management goals. The balanced KPIs aimed to increase the business units' risk awareness and compliance consciousness with regulations and internal requirements. However, a few banks did not give sufficient emphasis to compliance and risk management KPIs, resulting in credit decisions that did not fully consider potential risks.

Sound Practices

- *Banks actively manage borrowers with risk-adjusted returns below their internal hurdle rates.*

- *Banks include compliance and risk management KPIs for business unit staff.*

Attention Areas

- *Banks should carefully assess and adequately document the bases for allowing deviations from credit policies and underwriting standards.*

- *Banks should monitor deviations from their credit policies and underwriting standards on a portfolio basis in addition to monitoring such deviations on an individual borrower basis during the credit approval or review process. This will allow banks to monitor the incremental impact of such deviations on their credit risk exposures.*

- *Banks, especially those with large loan portfolios, should give due attention to borrowers with risk-adjusted returns below their internal hurdle rates. Banks should proactively monitor and review the sustainability of their exposures to these borrowers, and adopt the necessary measures to ensure that they are adequately compensated for the risks underwritten.*

- *Banks should be cognisant of the potential impact on their credit risk exposures if borrowers utilise all their undrawn committed credit lines.*