Advisory Letter 2006-3 **11 May 2006**

Minimum Standards for Credit Risk Management

1. PURPOSE

This letter is intended to provide in a single document the guidelines for minimum standards of credit risk management. In the course of performing its supervisory activities, BPK has noted that credit risk management is a systemic issue that needs the attention of banks' governing bodies. BPK is in the process of revising Banking Rule No. IX on Classification and Provisioning, and will be issuing Rules on Accrual/Non accrual of Interest and on Restructuring of Troubled Credits. This letter supplements those Rules. BPK recognizes that each bank may have different systems and policies regarding the management of its credit risk. The contents of this letter should be viewed as guidance. It incorporates those facets or overriding principles of credit risk management that BPK Supervision views as essential. It represents the standards that BPK will use in evaluating how well each bank manages its credit risk exposure. BPK expects that banks will develop or revise their credit risk management policies, practices and systems in order to substantively conform to these standards.

2. CREDIT RISK MANAGEMENT STANDARDS

Each bank should have an organization structure with risk management systems that are adequate to identify, measure, monitor and control credit risk in all its banking operations. Exposures that carry credit risk include loans, advances, overdraft facilities, investment securities, deposit accounts with other banks, loans to other banks, suspense accounts, guarantees, letters of credit, forward contracts and similar transactions where the debtor/counter party has or may have a contingent or direct obligation to the bank.

A. ORGANIZATIONAL AND ADMINISTRATIVE STANDARDS

1. Role and Responsibilities of the Board of Directors

BPK considers the board to be responsible for the organization and overall supervision of the credit function. To properly organize and supervise a bank's lending activities, the board, at a minimum, is responsible for the following:

a. Establishing a formal written credit policy. The policy should define risks that are acceptable and unacceptable to the bank, and should provide guidelines and standards to properly administer the acceptance and ongoing management of portfolio risk. The board is further responsible for reviewing the policy periodically and revising it in response to changing internal and external factors.

b. Ensuring compliance with the established policy through periodic review of reports provided by management, internal and external auditors, and the BPK Banking Supervision Directorate.

c. Establishing credit-granting authorities and limits for the bank's officers and credit committees. The board is responsible for approving large requests for credit that are over officers' or a management credit committee's authorities and those that do not conform to the bank's policies/strategy. The board, or a designated committee of board members, also should give prior review/approval and continued monitoring to insider credits, actions with problem credits, large commitments to lend, and any other exposures that may present significant risk to the bank.

d. Approving loss provisioning against credit exposures and write-offs of those exposures.

e. Reviewing reports on different aspects of the credit portfolio and other banking activities that carry credit risk in order to evaluate the condition of the loan/asset portfolio, management's lending practices, and compliance with regulations and BPK Rules.

f. Being knowledgeable of laws and Rules that relate to lending. If there are legal concerns regarding any credit transactions, the board should retain an attorney and when necessary, discuss the transaction with the Banking Supervision Directorate of BPK, <u>before</u> completing the transaction.

g. Ensuring the appointment of qualified credit officers and staff and providing adequate professional training for their continued development.

2. Responsibilities of Officers and Managers

BPK expects that the personnel responsible for making daily business judgments that affect the credit portfolio will be qualified and knowledgeable. The credit officers and senior credit management are responsible for implementing the credit policies of the bank and ensuring compliance with them. BPK evaluates the ability of these individuals to:

a. Accurately identify, measure and manage risk in the portfolio.

b. Evaluate business opportunities and lend in accordance with the credit policy and their lending authorities.

c. Communicate and maintain relationships with borrowers.

d. Ensure that credit files contain adequate and updated information.

e. Review and monitor the exposures/clients for which they are responsible.

f. Understand and follow applicable regulations and BPK Rules and implement the internal lending policy.

g. Collect loans when necessary.

3. Credit Committee

Bank credit activity should be organized through a credit committee that may be at the board or management level. BPK has found that board-level credit committees have tended to be self-serving or overly involved in day-to-day credit decisions that are the responsibility of management. For these reasons, any board-level credit committee should have specifically defined oversight responsibilities, rather than operational ones. The board-level committee should review and ratify the actions of management and any management credit committee. The management credit committee should be comprised of the most senior credit officers. The committee should meet regularly. BPK considers the following to be basic duties and responsibilities of such a committee:

- To approve or decline requests for credit within specified limits. The committee usually is responsible for reviewing loan requests that are above the lending authority of most or all of the account officers.
- To review activity reports of new loans/facilities, payments and renewals.
- To review maturing loans and expiring facilities.
- To review credit and collateral documentation exceptions.
- To review past due and problem exposures.
- To review the portfolio and off-balance sheet commitments and contingent obligations to determine large credit exposures.
- To report issues to the executive management or the board which require their awareness, approval or action.

4. Credit Information Systems

Banks must have an adequate credit information system in order to monitor and control credit risk adequately. The credit information system is part of, and should be integrated with, the bank's broader management information system (MIS). The credit information system must provide information on the credit portfolio necessary for bank management and the board to make prudent and reasonable business decisions. The credit information system may be either a manual or an automated system or a combination of each. The system should be sufficient to meet the bank's particular business objectives, and should be accessible to and useable by all appropriate personnel and levels in the bank. BPK will evaluate the system to determine if it provides management and the board with adequate and accurate information to guide credit operations and enable timely decision-making, and whether it helps management to monitor risk and progress toward reaching the bank's goals. The system must be capable of generating the information concerning credit portfolios that is required for onsite examination purposes. It also must be capable of generating the information that must be reported to BPK on a periodic basis, e.g. the credit related reports specified in BPK Banking Rule No. XI.

BPK will evaluate how well the credit information system achieves the following objectives:

- Enhancing communication about the credit portfolio among the lending staff, officers, management and board.
- Providing an objective system for recording and aggregating credit portfolio information.
- Reducing expenses by increasing effectiveness and efficiency of recording and obtaining information.
- Supporting the bank's strategic goals and direction.
- Facilitating risk management by providing timely and relevant portfolio information

The system must enable management and the board to recognize, monitor, measure, and control risks in the portfolio. It should help management measure performance, manage resources and facilitate compliance with regulatory requirements, such as compliance with legal lending limits and credit exposures to insiders. The following management reports, in addition to trial balances and daily activity journals, are considered to be minima for bank management and directors for decision-making, monitoring and planning:

Past Due/Non-Performing Loan report that shows basic information on all past due and non-performing loans and expired facilities, the number of days delinquent/since expired and their status – i.e. on or not on an accrual basis.

Aging report that aggregates and groups delinquencies by time bands

Temporary Overdraft report that shows all exposures not operating under formal agreements and their date of origination

Credit Facilities Overline report that shows all facilities such as revolving credit and overdraft lines, that are operating in excess of their approved limits.

Credit History report that would show payment performance since inception or over a defined historical period.

Credit Exposures to Insiders and their Related Interests report with information on all credit to insiders and related parties.

Portfolio Composition report with aggregate information on the mix of the entire credit portfolio by type, and the variance in composition since the last reporting period.

Sectoral Distribution report that shows the aggregate of credit exposures in different economic, industrial and/or geographic sectors

Problem (Classified) Exposures report with information on problem loans, their classifications, attendant specific provisions, and overdue interest.

Renewed and Restructured Credits report that would enable management or the board to monitor progress in restructured credits

Large Exposures report with information on aggregate amount of credit to one borrower or a group of related borrowers above a certain cutoff amount or percentage of capital and reserves.

Officer/Branch Status report that shows, by account officer and/or by branch, the size, type, status and total volume of the credits for which the officer/branch is responsible.

Commitments and Contingent Obligations Reports to provide adequate detail on credit lines, letters of credit, guarantees and other off-balance sheet items.

New Business Activity report with information on new loans originated.

These reports from the system must be clear, meaningful, accurate and timely.

The bank's credit information system should provide a trial balance of all accounts and an activity journal for each department having credit-related responsibilities. The system should provide adequate information for the bank officer, auditor or BPK examiner to be able to review the history of a particular credit from inception to the current point in time. Together with the credit file, the information should provide a complete picture of the exposure.

5. Workout Department

Large banks or banks with a significant amount of problem credits should have a workout, or problem loan, department. The department should be responsible for handling problem credit exposures when the normal collection process is unsuccessful. The workout staff should develop strategies with the borrowers to attempt to receive payment in full at terms that the borrower is able to meet. They may restructure the terms of the credit and attempt to obtain additional collateral or support. This department should take action to liquidate collateral or negotiate with other creditors, if either of these actions becomes necessary. The workout department also works on the recovery of previous write-offs.

6. The Credit Department

Large banks should have a credit department to collect, analyze and maintain borrower information that is maintained in the credit files for each borrower. The credit department should be responsible for maintaining credit files and ensuring that current financial information is on file. This department is responsible for preparing credit reviews and analyses on new borrowers, and credit renewals and extensions. The credit department provides reports to senior credit management and the board, and may classify credits, acting as an internal loan review. In smaller institutions or in institutions with a small credit portfolio, these responsibilities may be assigned to one or a few individuals who are not part of the credit decision-making process.

B. CREDIT RISK MANAGEMENT POLICIES AND PROCEDURES

1. Credit Policies

The establishment of a written credit policy by the bank provides the foundation for sound portfolio management. BPK places considerable emphasis on the establishment of formal written policies by the board. The board, in discharging their duties to both the depositors and shareholders, must ensure that exposures in the bank's portfolio are made with the following three basic objectives:

- To grant credit on a sound and collectible basis.
- To invest the bank's funds profitably for the benefit of shareholders and the protection of depositors.
- To serve the legitimate credit needs of the community in which the bank is located.

A credit policy differs from credit procedures. Banks need both types of documents to adequately address all areas of lending and credit administration. The policy should contain a general outline of the scope of the bank's credit activity and the manner in which credit exposures are originated, serviced and collected. The policy should be broad in nature and not overly restrictive. The policy should provide for the presentation, to the board or a committee thereof, of credits that officers believe are fundamentally sound and worthy of consideration, even though they may not conform to certain aspects of the bank's written policy. Flexibility must exist to allow for adaptation to changing conditions in the bank's earning assets mix and within its service area.

In developing the credit policy, consideration must be given to the bank's available financial resources, personnel, facilities, and future growth potential. The policy should be established by the bank's board and administered by senior credit management. The policy should be clearly communicated to the bank's management and lending staff. It should be reviewed at least annually by the board and credit management, and updated as necessary to reflect the actual situation of the bank and its lending objectives. The complexity and scope of credit policies and procedures should be appropriate to the size of the bank and the nature of the bank's activities, and should be consistent with prudent banking practices and relevant BPK regulatory requirements.

BPK examiners will evaluate a bank's credit policy to determine its adequacy in relation to the bank's size and lending activities, and whether the policy is implemented and followed. Examiners will compare the policies and processes that are stated or written to those that are actually practiced by management and staff.

Elements of a Credit Policy
The credit policy should include a mission statement, lending guidelines and internal control guidelines. An adequate lending policy is composed of the following components (to the extent that they are applicable to a bank's operations):

a. **Mission statement** -- This is the bank's lending philosophy. The statement should define the bank's risk tolerance, which is the level of risk that is acceptable for the bank. The risk tolerance depends on the bank's capital, economic environment, management experience and the shareholders' risk desire. The statement outlines the strategies by which the bank identifies, measures, controls and monitors risk and accomplishes its objectives. It sets the standards for the bank's lending decisions and procedures.

b. **Definition of acceptable and unacceptable types of credit exposures** -- The lending policy should state the types of credits that the bank will assume and should set forth guidelines to follow in originating specific types of credits. The decision about the types of credit to be granted should be based on a consideration of the expertise of the credit officers, the deposit structure of the bank, and anticipated credit demands of the community. Credits involving complex structures or those that are secured by collateral which require more than normal policing should be avoided unless or until the bank obtains the necessary personnel, policies, controls, and systems to properly administer such loans. Types of credits that have resulted in an abnormal loss to the bank should be identified, scrutinized, and controlled within the framework of the stated policy. A bank should consider its overall lending exposure relative to its stable funds.

c. **Limitation on total outstanding credit exposures** -- As a guide in limiting the total amount of credit outstanding, relationships to other balance sheet accounts should be established. Controls over the credit portfolio should be expressed relative to deposits, capital, or total assets. In setting such limitations, various factors, such as the credit demands of the bank's market area, the volatility of deposits and the credit risks involved must be considered.

d. **Desired portfolio mix** -- Distribution of credit by category should be specified. Limitations should be based on desired percentages of total credits in commercial, real estate, consumer, or other categories (such as geographic or industrial sectors). Such policies are beneficial, but should allow for deviations with the approval by senior management and/or the board or a committee thereof to allow credit to be distributed in relation to the changing needs of the market area.

e. **Desired portfolio maturity distribution --** Maturity dates of loans and expiration dates for other types of credit facilities should be established in recognition of the characteristics of the bank's funding base, the type of credit, and the purpose of the credit.

f. **Market segment defined—** The policy should define the targets for building the core of the credit portfolio. These should be consistent with the expertise of credit officers and the characteristics of the trade area.

g. **Trade area and geographic limitations** -- Including limitations on lending outside of specified areas. The bank's trade area should be clearly delineated, and credit officers and the board should be fully aware of specific geographic limitations for lending purposes. The bank's defined trade area should not be so large that, given its resources, proper and adequate monitoring and administration of the bank's credits cannot be reasonably determined. Such a policy avoids loan approval for customers outside the trade area in opposition to primary bank objectives. The bank's primary trade area should be distinguished from any secondary trade area so that emphasis may be properly placed; this is especially important for new banks. Specific restrictions or exceptions should be listed separately.

h. **Lending terms** – should be specified for each type/category of credit in the portfolio:

- Pricing -- Many factors will influence rates, including the market and competitive conditions, the bank's business goals, and the maturity and risk level of the credit. Rates on various types of credit established by the policy must be sufficient to, among other things, cover the costs of the funds, of servicing (including general overhead), and of probable losses, while providing for a reasonable margin of profit. Policymakers must know those costs before establishing rates. Periodic review should be made to adjust rates to reflect changes in costs, competitive factors, and the risks associated with the type of credit.

- Maturity -- Credits should be granted with realistic repayment plans. Maturity/facility expiration dates must be related to the anticipated source of repayment, the purpose of the credit and the useful life of the collateral. The policy should state the maximum number of months over which loans may be amortized and overdraft facilities liquidated. Specific procedures should be developed for situations requiring balloon payments and modification of the original terms of the credit. Maximum maturity periods and periodic cleanup requirements for lines of credit should be specified to reduce funding risk.

- Down payment/capital requirements -- The bank's policy should define the maximum ratio of the amount of the credit to the value of the collateral. The policy should also contain a schedule listing the down payment requirements for different kinds of property to be financed.

i. **Financial information requirements** -- Extension of credit on a safe and sound basis depends upon complete and accurate information of the borrower's financial condition and credit standing. An exception would be for loans predicated on readily marketable collateral, the disposition of which was originally designated as the source of repayment for the advance. Current and complete financial information is necessary not only at the inception of the credit, but also throughout the term of the advance. The policy should define the frequency of receipt of financial statement information for various types of credit extended by the bank. In addition, the policy should define the financial statement requirements for businesses and individuals at various borrowing levels and should include requirements for audited, annual, interim, balance sheets, income, cash flow, changes in capital, and other statements and supporting notes, schedules, and management analyses. Financial statement requirements should include external credit checks required at the time of periodic updates. BPK considers this element to be a mandatory documentation requirement for all credit exposures.

j. **Definition of a qualified borrower –** The policy should outline minimum personal and financial criteria for each type of borrower in order to establish the borrower's character and capacity.

k. **Acceptable collateral and margins** -- The policy should address the quality and frequency of appraisal or valuation. The policy should outline where the responsibility for appraisals or internal evaluations lies and should define formal standard appraisal and evaluation procedures, including regulatory compliance, and procedures for possible re-appraisals or re-evaluations in the case of renewals or extensions. Acceptable types of appraisals or evaluations and limits on the amount and type of collateral bank personnel are authorized to appraise should be outlined. Circumstances requiring the use of in-house staff appraisers versus a fee appraiser should be identified.

l. **Lending authorities and approval process** -- There should be a documented approval process for exceptions to the lending policy, including the need for approval of exceptions by the senior management, board or committee of the board. Management reporting systems should report and highlight exceptions to management and/or the board.

The lending policy should establish limits for all credit officers. Limits also should be set for group authority, allowing a combination of officers or a committee to approve larger amounts than the members would be permitted to approve individually. The policy also should define situations when an application must go to a higher level for approval. The policy should include procedures for situations involving an increase in debt to one borrower, related interests, and documentation waivers. The reporting procedures and the frequency of committee meetings should be defined.

m. **Limitations on large exposures --** The lending policy should strive to develop diversification within the portfolio and to obtain a balance between maximum yield and minimum risk. Large exposures of credit often depend heavily on one key factor, and when weaknesses develop in that key factor, every individual loan within the large exposure is affected. The policy should define large exposures and establish limits on exposures to one borrower, a related group of borrowers, an industry, etc., in light of legal and regulatory limits and the bank's capacity. Senior management and/or the board should evaluate the additional risk involved in various large exposures and determine which large exposures should be avoided or limited. The policy should also require that all large exposures be reviewed and reported frequently to the board. BPK Banking Rule No II contains specific rules and guidelines concerning large exposures. These must be considered in the drafting of any credit policy.

Banks that have in place effective controls to manage and reduce undue large exposures over time need not refuse credit to sound borrowers simply because of the borrower's industry or geographic location.

n. **Exposures to insiders and their related interests --** Lending to insiders and their related interests may pose additional risks to the bank. The policy should define insiders and their related interests in light of current legal and regulatory definitions and requirements and should include reporting these exposures to the board. UNMIK Regulation 1999/21 and BPK Banking Rule No. XX contain specific rules and guidelines concerning exposures to insiders and their interests. These must be considered in the drafting of any credit policy.

o. **Application and review procedures –** The policy should set forth requirements for initial information to be obtained from borrowers of different types and for different levels of credit, and the process for verifying such information, prior to granting or submitting for approval

p. **Procedural and accounting guidelines for non-performing credits, credits in process of collection, write-offs and recoveries --** The policy should define delinquent/non-performing obligations of all types and should dictate the appropriate reports to be submitted to senior management and/or the board. The reports should include sufficient detail to allow for the determination of the risk factor, loss potential and alternative courses of action. The policy should require a follow-up collection notice procedure that is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by the senior management and/or board for provisioning and write-off at a stated period of delinquency.

q. **Guidelines for restructuring credits**—Banks should have strict standards on which to judge whether a credit should be renewed/restructured. Policy should enumerate those factors or considerations that would be applicable. Additionally, this policy element should comply with the requirements for restructured loans that are established by BPK. Please Refer to BPK Banking Rule No. IX.

r. **Reports** -- The policy should detail the types of reports to be generated, the frequency of these reports, and the purpose and use of such reports. Please refer to a preceding section of this Advisory Letter for the types of reports that BPK considers essential for proper portfolio risk management.

s. **Organization of the credit function** -- The policy should include the organizational structure and responsibilities of the various lending departments, and the establishment and functions of loan committees. Please refer to organizational and administrative elements outlined in a prior section of this Advisory Letter.

t. **Guidelines for purchases and sales of participations/syndications --** The policy should state the limits for the aggregate amount of loans/credits to be purchased from and sold to any single outside source, and all loans/credits purchased and sold. Limits should also be established for the aggregate amount of loans/credits to particular types of industries that may be purchased. In addition, the policy should require that loans/credits purchased from another source be evaluated in the same manner as those originated by the bank itself. Guidelines should be established for the type and frequency of information that should be obtained from the originating bank to keep the bank continually updated on the status of the credit. Because of the inherent reliance on the originating bank to administer and collect participated loans/credits, the purchasing bank should analyze the lead bank's ability to properly carry out these responsibilities. On the other hand, guidelines also should be established for supplying complete and regularly updated credit information to the purchasers of loans/credits originated and sold by the bank.

2. The Lending Process

BPK considers the following procedures to be essential elements of the credit process. Banks should ensure that their credit procedures manuals or guidelines address these elements.

a. <u>*Application.*</u> The process for a new loan or facility must begin with the completion of a credit application form by the applicant. The applicant must provide sufficient information for the bank officer to evaluate the request. The applicant should provide financial statements, information on current and past creditors, and, if the credit will be secured, evidence of claim on collateral and value of collateral to be pledged. The bank officer must obtain adequate information to determine: the purpose of the credit, the source of repayment, and the creditworthiness of the applicant. Similar information must be gathered to evaluate an existing borrower's request for additional funds or the restructuring of a credit.

b. *Review and Analysis.* The bank must perform a review and analysis of the applicant's potential willingness and capacity to repay the credit. The bank officer should perform credit inquiries with a credit bureau/the Credit Registry of Kosovo and the applicant's present or previous lenders to determine the applicant's credit status and history. If the applicant has previous or existing credit exposures within the bank, past experience with the applicant should be reviewed.

A responsible bank officer should review the financial statements of the borrower to determine the *capacity* of the borrower to repay the credit from a reliable source of funds. For an individual, this is demonstrated by the quality and quantity of earnings; for a business, this is demonstrated by sufficient cash flow and net worth. To obtain a clear picture of the borrower's capacity, the bank officer must obtain current and sufficiently detailed financial statements. Regardless of whether the credit is secured or unsecured, the officer must analyze the applicant's financial condition to ascertain the probability of the applicant maintaining sufficient cash flow for debt obligations.

If a credit is to be secured, the bank officer should evaluate the collateral. Credits should not be made solely on the basis of collateral value. The collateral coverage should be adequate to protect the bank against loss, thereby mitigating credit risk. The credit policy guidelines, described in a prior section of this Advisory Letter, should indicate acceptable types and levels of collateral for each category of credit. Collateral appraisals should be a realistic estimate of the value of the collateral if liquidated under adverse circumstances such as repossession/foreclosure.

c. *Approval or disapproval of the credit*. All necessary approvals should be obtained in accordance with the lending authorities and approval procedures outlined in the credit policy. If the approved credit is an exception to the bank's policy in any way, the exception should be noted, and the reasons for making it should be clearly documented in the credit file of the borrower. BPK examiners will review the number of exceptions to policy to identify whether policy is appropriate, and whether it is being followed.

d. *Documentation of the credit*. All credit exposures should be properly documented with a legally binding promissory note/credit agreement. Large, complex loans or facilities often are documented with a credit agreement. The note or credit agreement should be secured in the bank's vault. An agreement documenting a large credit should include the following information:

- Purpose of the credit/use of the funds
- Amount of credit
- Source and timing of repayment
- Maturity/payment dates

- Interest rate
- Collateral, guarantees
- Dates on which funds are available to the borrower
- Covenants concerning maintenance of certain financial aspects, such as minimum capital, minimum current ratio, minimum debt to worth ratio, etc

e. *Disbursal of the proceeds.* Proceeds are normally transferred or made available to the borrower's account. Funds should be disbursed only after all necessary approvals have been made, the agreement has been completed, documentation has been collected, collateral documents are completed, and any legal processes related to acquiring a lien on collateral have been properly executed. The secured party (the bank) must go through the process of "perfecting" its claim in order to protect its interest in the collateral against other claims by other creditors of the borrower. The collateral file should contain evidence that the bank's claim has been perfected in the manner prescribed by laws and custom. Proceeds in amounts greater than Euro 10,000 should not be permitted to be withdrawn directly by the borrower. Instead, these funds should be transferred upon valid invoices or other appropriate documentation.

f. *Establish the record keeping for the credit.* The information and documentation pertaining to a credit exposure is kept in a credit file to facilitate monitoring the performance and status of the exposure and the condition of the borrower.

3. Credit Documentation

Credit documentation is a collection of documents that demonstrate that the borrower has the willingness and ability to repay the credit. These documents should indicate that the bank has adhered to sound credit policies, acted prudently to safeguard the bank's funds and ensure repayment by all reasonable means.

In general, these documents should provide the following:

- Identity of the borrower and related interests/affiliates, principals, owners
- The location, nature and type of business of the borrower
- The purpose of the credit.
- The primary and secondary sources of repayment. (If guarantees are involved, the bank must have sufficient information on the guarantor's financial condition, income, liquidity, cash flows, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation.)
- Analysis of the borrower's financial condition.
- Projections for the borrower's future financial performance

- Experience of the bank with the borrower on other credit obligations

- Documentation of the collateral for the credit; its location, value and condition.

This documentation should be kept in the borrower's credit file. BPK considers it essential that banks establish an effective system to obtain and maintain complete and current credit information and documentation as a necessary component of sound lending. BPK examiners will review the adequacy of credit documentation during onsite examinations.

4. Standards for Internal Review and Classification Systems

Each bank must have in place a process to review and classify credit risk exposures. The review process should be prescribed by written policies and procedures and should be performed by individuals who are independent from the day-to-day operational activities of the areas reviewed. BPK, through its program of onsite examinations, will review the adequacy of a bank's internal review and classification processes. BPK examiners will use the following characteristics/standards to evaluate adequacy and effectiveness:

- The existence of a policy that clearly states the responsibilities of the review function.

- Whether the policy explicitly defines the bank's classification/risk-grading system.

- Whether the risk-grading definitions are understood by all concerned staff.

- Whether the risk-grading system is consistent with BPK classification requirements.

- The ability of the review function to communicate directly to senior management and the board.

- Whether qualified personnel with credit analysis skills and knowledge of the bank's lending operation perform the review.

- The degree of support and responsiveness from the board and executive management.

In particular, the credit risk review function is expected to be able to perform the following:

- Provide timely reports of portfolio risk to management and the board, including internal controls assessments, objective appraisals of portfolio asset quality, and evaluations of the potential impact of problem exposures.

- Review material exposures continually or periodically on a regular, predetermined basis (no less frequently than quarterly).

- Review internal controls pertaining to the lending, investment or other banking function being reviewed.

- Ensure that problems and potential problems are identified at the earliest possible time.

- Classify problem credit exposures as their risks become evident.

- Ensure that problem exposures are placed under additional scrutiny or workout.

- Ensure that any documentation deficiencies are identified and corrected.

- Assess the adequacy of provisions and recommend provisioning amounts.

- Cite violations and non-compliance with established laws, BPK Rules and the bank's internal policy.

- Provide reports on corrective actions taken on problem exposures and recommendations for follow-up.

- Assist in the development and revision of the pertinent policies governing credit risk exposures.

- Evaluate trends in the loan, investment and/or correspondent bank portfolios.

BPK guidelines for credit review are that the credit portfolio and off-balance sheet commitments and contingent liabilities (e.g. unused portions of legally binding credit facilities, letters of credit, guarantees) should be reviewed on an ongoing basis:

- at least quarterly for credit exposures to one or a related group of borrowers whose aggregate exceeds 0.5% of the bank's capital and reserves;

- at least semiannually for credit exposures to one or a related group of borrowers whose aggregate exposure is equal to or less than 0.5% of the bank's capital and reserves.

- Groups of small credits with homogeneous characteristics, such as consumer instalment portfolios, that are approved according to a fixed methodology and have standard amortization requirements, can be reviewed in terms of aggregate characteristics, such as days delinquent, and classified/provisioned accordingly. See BPK Banking Rule No. IX.