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PART A: OVERVIEW

1. INTRODUCTION

1.1 Credit risk continues to remain the largest source of risk for development financial institutions (DFIs) in Malaysia. This is due to the fact that a DFI's loan/financing portfolio is typically the largest asset and the major source of revenue.

1.2 Experience of prior years has shown that absence of proper management of such risk has resulted in significant losses for a number of DFIs. The consequence of such losses not only disrupts the intermediation function of the DFIs affected, but also imposes large financial burdens on the Government in recapitalising such DFIs. It is envisaged that as the size of the DFI's balance sheet increases over time, the potential financial burden will escalate proportionately. Effective credit risk management is therefore vital to ensure that a DFI's credit activities are conducted in a prudent manner and the risk of potential DFI failures reduced.

2. OBJECTIVE

2.1 These Guidelines set out the proposals on best practices for the management of credit risk for DFIs and intend to lay the initial foundation towards upgrading the prudent conduct of credit granting activities of DFIs in Malaysia.

2.2 The main body of the Guidelines are contained in four major chapters, based on the following principles:

- Appropriate overview by the board of directors and management;
- Adequate infrastructure for credit risk management;
- An integrated risk management process; and
- Comprehensive internal controls and audit procedures.

2.3 These Guidelines set the best practices which a DFI should adopt. In addition to these best practices, certain specific requirements are required by Bank Negara Malaysia. These requirements are directives which DFIs are required to implement in addition to the best practices.

2.4 These Guidelines prescribe the **minimum** level which DFIs should observe to ensure prudent conduct in the operations of credit granting activities. Similar with the banking institutions, DFIs are free to adopt more stringent standards in their risk management policies.

3. APPLICABILITY

3.1 These Guidelines are applicable to all DFIs prescribed under the Development Financial Institutions Act 2002 (DFIA).

4. EFFECTIVE DATE

4.1 These Guidelines shall take effect from 1 January 2010.

PART B: LEGAL PROVISIONS

5. LEGAL PROVISIONS

5.1 These Guidelines are issued pursuant to Section 41 of the DFIA.

PART C: POLICY

6. CHAPTER 1: ROLES AND RESPONSIBILITIES OF THE BOARD OF DIRECTORS AND MANAGEMENT

ROLES AND RESPONSIBILITIES OF THE BOARD OF DIRECTORS

6.1 It is the duty of the board of directors (Board) to be aware and ensure the proper oversight of the management of credit risk of the DFI.

6.2 The Board must set the minimum credit standards and approve all significant policies relating to the management of credit risk throughout the DFI. The Board should ensure that the credit risk policy is consistent with the DFI's capital strength, management expertise and risk appetite.

6.3 The Board must also ensure that the DFI's mandated roles, strategic focus, business strategies and lending/financing strategies are in line with the credit policies and standards set.

6.4 It is the responsibility of the Board to ensure that:

(i) sound credit culture is a corporate value within the DFI;

(ii) management is fully capable of managing the activities of the DFI and policies on credit risk management are effectively implemented (including having the necessary tools for monitoring credit risk);

(iii) mechanisms exist for the approval or review of any activity or product which results in the DFI assuming new or higher credit risk;

(iv) it is informed of the appropriate organisation structure for the management of credit risk within the institution and any changes to such structure thereof;

(v) it is regularly informed of the credit risk exposure and quality of the DFI's exposure and review the overall portfolio composition;

(vi) it regularly reviews credit risk management policies of the DFI to ensure that they are consistent with the DFI's credit standards and changes in the DFI's resources, overall financial strength and business conditions;

(vii) a competent team of audit personnel is available to verify the effectiveness of procedures and controls, as well as the reliability of information submitted; and

(viii) a competent team of personnel is available to audit and verify the compliance with all aspects of credit, in particular the credit granting process of the DFI.

6.5 **Specific Requirements by Bank Negara Malaysia: Roles and Responsibilities of the Board of Directors**

6.5.1 Review of credit policy by the Board

The Board should endorse major credit policy and business plan annually to ensure that they are consistent with each other and are within the DFI's level of tolerance for credit risk.

6.5.2 Duty of the Board to be aware of new credit risk activity

(i) The Board must ensure that they are duly informed of any new credit products or significant variations to existing credit products as specified in the "Guidelines on Introduction of New Products" issued on 18 May 2009.

(ii) The Board must make a decision on:

(a) whether the new activity is suitable from the business perspective and complies with its business plan, mandated roles, strategic focus and current regulations; and

(b) whether they are satisfied that the new activity will be adequately incorporated within the credit risk management process of the DFI and conducted according to the standards set by the Board.

6.5.3 Reports to be received by the Board

(i) At least every quarter, the Board should be briefed on the overall credit risk exposure (including off-balance sheet items) of the DFI and should review, at the very minimum, the following:

(a) the amount of exposures undertaken in credit activities, broken down by categories, for example, by types of exposures, products and level of credit grades;

(b) large concentrations of credit;

(c) problem loan/financing list which identifies problems or "watchlist" credits and the DFI's potential loss on each significant problem credit and past due account;

(d) status of significant credits under rehabilitation programs;

(e) credit areas with high rapid growth; and
[This is to alert the Board to review and ensure credit management standards in this area are adequately maintained and that there are no compromises made]

(f) significant credit exception reports.

(ii) On an annual basis, the Board should be given a report containing a listing of all existing credit products. The report should contain, at the minimum, the target markets of the credit products, their performance and credit quality.

(iii) On an annual basis, or on a more frequent basis should the need arise, the Board should also be given a report on the potential amount of losses from deteriorating credits that could be incurred due to adverse changes in the economy and under stress situations.

ROLES AND RESPONSIBILITIES OF THE MANAGEMENT

6.6 Management at all levels are responsible for implementing the credit policies approved by the Board and for developing policies and procedures for identifying, measuring, monitoring and controlling credit risks at both the individual credit and portfolio level.

6.7 This responsibility includes ensuring that there are:

(i) clear delineation of lines of authority and responsibilities for managing credit risk;

(ii) policies and limit structures that clearly set the DFI’s credit risk tolerance;

(iii) proper channels of communication to ensure that the Board’s credit policies and credit risk tolerances are clearly communicated to and adhered to by all levels of the organisation;

(iv) adequate and effective operational procedures, internal controls and systems for identifying, measuring, monitoring and controlling credit risks are in place to implement the credit policies and standards approved by the Board;

(v) comprehensive credit risk reporting process;

(vi) effective management information systems to ensure timely, accurate and informative reporting of credit risk exposures;

(vii) sufficient resources and competent personnel are allocated to manage and control the daily operations and credit risk management functions effectively; and

(viii) periodic independent assessment of the DFI's credit granting functions.

6.8 Management should regularly review the procedures that have been put in place to manage credit risk in light of product innovation, changing business conditions and approve any changes to ensure that these changes are appropriate and sound.

CREDIT CULTURE

6.9 A DFI's credit culture is the unique combination of its credit values, beliefs, practices and management attitudes, which defines the lending/financing environment and determines the lending/financing behaviour acceptable to the DFI.

6.10 The following represent the best practices in developing a strong credit culture:

(i) Management should regularly assess the consistency of the credit practices with the DFI's risk appetite and credit policy;

(ii) Management should place high importance on credit quality, and this should be echoed throughout the organisation, both through communications and actions;

(iii) There should be strong management at the top of the credit function;

(iv) Management accepts responsibility for credit quality and encourages sound lending/financing practices from the credit officers;

(v) Clear accountability should be established for every personnel involved in the management of credit risk;

(vi) Management and officers involved in the credit process (including those in the front-line credit origination) should be rewarded for credit vigilance or penalised for credit negligence. This competency should be reflected in their performance evaluation. However, management should ensure that any form of reward is not excessive but commensurate with the level of competency;

(vii) Credit policies should be documented in a clear, concise written format and enforced by an authority who is independent of the business origination function;

(viii) The communication of credit standards, credit policy, business plan and incentive plan should be consistent to eliminate confusion and conflict of priorities;

(ix) Clear credit standards and objectives should be set for major credit areas;

(x) Credit policy exceptions seldom occur. If they should arise, they should be supported with proper justifications and documentation;

(xi) Strong credit systems and controls on credit approvals, rating and review, credit audit and portfolio management should be in place;

(xii) There should be regular training on the DFI's credit policy and credit analysis at all stages of a credit officer's development. There should be extensive indoctrination on how things are to be done and to ensure that the same credit vocabulary is used throughout the organisation; and

(xiii) New area of business should be selected in conformity with the portfolio risk guidelines.

7. CHAPTER 2: CREDIT RISK MANAGEMENT INFRASTRUCTURE

EXISTENCE OF INDEPENDENCE RISK MANAGEMENT FUNCTIONS

7.1 An example of a typical credit process would involve the following:

(a) Business origination
- (i) Credit origination
- (ii) Credit appraisal and review
- (iii) Credit approval

(b) Credit administration and monitoring
   (i) Documentation and security
   (ii) Disbursement and receipts

(c) Credit recovery

(d) Credit controls, review and analysis
   (i) Internal controls and audits
   (ii) Independent credit review and audit
   (iii) Portfolio review and trend analysis
   (iv) Credit policy and process review

7.2 The process of "credit administration" and "credit controls, review and analysis" should be performed independently of individuals involved in the "business origination" of credit.

7.3 The process of "credit recovery" should be performed independently of individuals involved in the other credit processes.

7.4 The functions of "credit administration" and "credit controls, review and analysis" should also report risk exposures and compliance with control procedures independently to management and the Board.

7.5 **Specific Requirements by Bank Negara Malaysia: Independent Credit Risk Management Committee**

7.5.1 DFIs should have an independent committee chaired by a director, either executive or non-executive, without powers to approve credit to assist the Board in its supervisory role on the management of credit risk of the institution. The committee should report directly to the Board and its composition should be approved by the Board.

7.5.2 The committee should comprise persons experienced in credit and risk management, preferably drawn from those having specialised skills in managing the various elements of the credit business. Such persons should be able to explain to the Board the issues and critical areas that a DFI should be concerned with and the methods available to handle such issues.

7.5.3 The committee should be responsible for at least the following:

(i) Evaluate and assess the adequacy of strategies to manage the overall credit risk associated with the DFI's activities;

(ii) Oversee the formal development of credit policies within the DFI, encompassing all products and businesses, and ensuring the development of policy manual and procedures;

(iii) Monitor, assess and advise on the credit risk portfolio composition of the DFI;

(iv) Evaluate risks under stress scenarios and the capacity of the DFI's capital to sustain such risk;

(v) Assess the risk-return trade-off;

(vi) Review reports of the credit review process, asset quality and ensure that corrective action is taken; and

(vii) Review and evaluate the various credit products engaged by the DFI to ensure that it is conducted within the standards and policies set by the Board.

AVAILABILITY OF COMPETENT PERSONNEL

7.6 Management must ensure that sufficient resources and personnel are allocated to manage and control credit risk within the DFI. These personnel should:

(i) have a complete understanding of the risks associated with the DFI's credit activities;

(ii) be able to understand the relevant factors and market conditions which can affect credit quality and assess the impact of changes in these factors on the DFI's risk profile and financial performance; and

(iii) report the risk profile of the DFI's credit portfolio to the appropriate lines of authority for information or consideration.

7.7 Adequate and consistent credit training should be given to these personnel to ensure that the above are satisfied. The training should conform to the DFI's credit culture and credit standards. The training should ensure that personnel have the same credit understanding and credit vocabulary.

7.8 **Specific Requirements of Bank Negara Malaysia: Accreditation of Credit Personnel**

7.8.1 Personnel involved in credit appraisal, credit approval and credit review (audit) are required to undergo a common training program and pass a common test, attain a minimum level of experience and receive accreditation from bodies or individuals acknowledged by the Board before they are eligible to sign off or approve a credit appraisal. A grace period of five years is given to meet this requirement. At the time being, DFIs should adhere to the "Circular on Accreditation Program for Credit Officers" issued to the DFIs on 5 July 2007.

(i) To assure attainment of minimum standards and quality, the common training program should be designed by competent senior credit officers of the DFI. To ensure consistency in standards across the industry, any examination syllabus developed in-house should be approved by IBBM as the industry standard setter.

(ii) There should also be broad criteria for the appropriate senior credit officer to follow before approving a trained personnel as a credit officer.

(iii) Existing personnel involved in credit appraisal, approval and credit review (audit) may be exempted from undergoing the training program and passing the common test subject to approval by the Board. However, no exemptions are permitted for new personnel.

***DFIs are required to submit a copy of the policy detailing the exemption criteria to Bank Negara Malaysia for information*.**

AVAILABILITY OF EFFECTIVE INFORMATION SYSTEM

7.9 The DFI must have in place effective management information system to enable management to be aware, measure, monitor and control the credit risk inherent in its activities.

7.10 The management information system should enable the DFI to:

(i) maintain a database for research and use of analytical techniques;
(ii) report exposures;
(iii) track quality and account performances; and
(iv) maintain limits.

MAINTENANCE OF ADEQUATE POLICIES AND PROCEDURES

7.11 The credit policy is the primary document by which the Board and management guide credit activities. It provides a framework for achieving asset quality, sets risk tolerance levels and guides the DFI's credit granting activities in a manner consistent with the DFI's credit standards.

7.12 The credit policy should be clearly defined, consistent with prudent banking practices and relevant regulatory requirements, and adequate for the nature and complexity of the DFI's activities.

7.13 Policies and procedures that are properly developed and implemented will enable the DFI to:

(i) maintain sound credit granting standards;
(ii) monitor and control credit risk;
(iii) properly evaluate new business opportunities; and
(iv) identify and administer problem credits.

7.14 Lending/financing policy

7.14.1 DFIs should maintain written policies and procedures that clearly outline its risk management policies for their lending/financing activities. The policy will establish the authority, rules and framework to operate and administer its loan/financing portfolio effectively.

7.14.2 The DFI's lending/financing policy should set basic standards and procedures to address the following:

(i) the composition of the loan/financing portfolio as a whole;

(ii) standards for individual credit decisions (including standard appraisal template and evaluation approach);

(iii) delineation of lines of authority and responsibilities to enable the management to monitor and control the lending/financing activities; and

(iv) procedures governing compliance with loan/financing related policies or other applicable laws or regulations.

7.15 Specific Requirements of Bank Negara Malaysia: Lending/financing Policy

7.15.1 The lending/financing policy should set parameters for at least the following:

(i) Credit authority – the personnel authorised to approve credit and the approval limits for credit approvers;

(ii) Acceptable markets or lending/financing areas – this should be based on the DFI's current strengths and weaknesses to indicate its customer and industry mix;

(iii) Limits on concentrations of credit. For example, this may include limits on credit exposures by:

(a) industries;

(b) geographic locations;

(c) borrower/customer groups;

(d) products; and

(e) risk grades.

(iv) Credits to related parties (in particular, the parameters of determining related parties).

(v) Limit on credit growth – a maximum trigger threshold on the rate of credit extension should be set to alert the DFI of the potentiality of expanding beyond the current capability of its existing resources. This rate may be pegged as a percentage of capital, total assets, total deposits or other bases;

(vi) Acceptable credit maturity tenure – the maturity period within which the DFI is willing to carry the risk. This should be related to the anticipated source of repayment, the purpose of the credits and the useful life of the security;

(vii) List of unacceptable credits;

(viii) Risk rating of credits; and

(ix) Collections and charge-offs – criteria and rating used for delinquent credits, procedures for reporting credits that are in arrears to management and clearly defined guidelines and authority for charge-offs.

7.15.2 The credit policy should also address credit requests from creditworthy borrowers/customers whose credit needs do not fit within the DFI's general lending/financing policy, i.e. credit exceptions. Such provisions should normally demand a higher level of credit standard and vigilance compared to those acceptable under normal circumstances.

7.16 Collateral policy

7.16.1 DFIs should have in place clear policies for the establishment of acceptable collateral arrangements.

7.16.2 In assessing the acceptability of collateral, DFIs should take into consideration the following:

(i) the value of the collateral;

(ii) the ease of disposal of the collateral, namely its marketability (e.g. for securities, whether it is actively traded, over-the-counter, or closely held); and

(iii) the aggregate size of the particular collateral that the DFI holds.

7.16.3 Both the lending/financing and collateral policies should be reviewed regularly and be flexible to accommodate innovation and to respond to changes in the DFI's strategic direction, risk tolerance, market and business conditions.

7.17 **Specific Requirements by Bank Negara Malaysia: Collateral Policy**

7.17.1 The collateral policy should set parameters for the following:

(i) Limits on the concentration of collateral. (Nevertheless, limit excesses, where reasonable, can be justified as an exception item);

(ii) The approach used for the valuation and frequency of review of collateral;

(iii) Approved panel of solicitors, property valuers and insurance companies;

(iv) For secured facilities, the maximum margin of advance that may be granted against each type of collateral; and

(v) Collateral documentation requirements.

EVALUATION PROCESS FOR CREDIT ACTIVITIES

7.18 DFIs should identify and manage credit risk inherent in all products and activities.

7.19 DFIs should conduct a product approval program to assess the risks inherent in any new product or area of business. DFIs should ensure that the risks of products and activities new to them are subject to adequate procedures and controls before being introduced or undertaken. These products/activities should be approved by the Board or an appropriate committee. Where this function is being carried out by a committee, the Board should be informed at the nearest Board meeting as required in Chapter 1. Industry specialists should be engaged to assist the DFI in its risk assessment, where necessary.

7.20 For existing products, a regular evaluation program should be conducted. The Board or the appropriate committee should set a policy on review interval or date.

7.21 Each product approval/evaluation program should be signed off by the various management in charge of the following risks:

(i) credit risk;

(ii) market risk (if any);

(iii) liquidity risk (if any);

(iv) legal risk;

(v) accounting and financial reporting; and

(vi) audit and internal control

to ascertain that the relevant issues surrounding the product pertaining to their area have been properly examined and that they are satisfied with being able to assimilate them properly into their respective scope of responsibility.

8. CHAPTER 3: THE CREDIT RISK MANAGEMENT PROCESS

8.1 The primary components of a sound credit risk management process are:

(i) a sound, well-defined **credit granting criteria;**

(ii) a comprehensive **risk measurement and evaluation** approach;

(iii) a detailed **structure of limits,** guidelines and other parameters used to govern risk taking;

(iv) a strong **management information system** for controlling, monitoring and reporting risks; and

(v) an effective problem credit management process.

CREDIT GRANTING CRITERIA

8.2 DFIs must operate under sound, well-defined credit granting criteria. These should set out the qualifying criteria for:

(i) the eligibility of credit and the amount qualified for;
(ii) the types of credit to be given; and
(iii) the terms and conditions to be applied on the credits granted.

8.3 DFIs should have a clearly established formal evaluation and approval process for new credits and the extension of existing credits.

8.4 Evaluation of credits

8.4.1 Each credit proposal should be subject to careful analysis by a credit analyst with expertise which commensurate with the size and complexity of the transaction. Where necessary, the establishment of specialist credit groups to analyse and approve credits relating to significant product line, types of credit facilities, industry or geographic sectors are recommended.

8.4.2 Standard documented formats for appraisal and standard approach in analysis should be in place. The evaluation should include a thorough understanding of the borrower/customer, purpose and structure of credit and its sources of repayment.

8.4.3 An effective evaluation process should establish minimum requirements for the information on which the analysis is to be based and minimum financial performance standards or benchmarks in appraising loans/financing for each product or type of industry.

8.4.4 There should be written policies in place regarding the information and documentation needed to approve new credits, renew existing credits and/or change the terms and conditions of previously approved credits. The information received will be the basis for any internal evaluation or rating assigned to the credit and its accuracy and adequacy is critical to management making appropriate judgements about the acceptability of the credit. The DFI should verify the accuracy of such information.

8.5 Approval of credits

8.5.1 Credit approvals should be made in accordance with the DFI's written guidelines and granted by the appropriate level of management.

8.5.2 A formal underwriting standard document which lays down the risk acceptance criteria should be established as a foundation for which the whole credit approval process is based.

8.5.3 The credit approval process should establish accountability for decisions taken and designate who has the authority to approve credits or changes in credit terms and what the authorised limit would be.

8.5.4 There should be a clear audit trail documenting that all aspects of the approval process was complied with and identifying the individual(s) and/or committee(s) providing input, as well as making the credit decision.

8.5.5 Approval authorities should commensurate with the expertise of the individuals involved.

8.6 Specific Requirement by Bank Negara Malaysia: Credit Granting Criteria

Credit Approval by the Board

8.6.1 The credit approving function should be performed by full-time executive personnel or a committee comprising as such. Although not involved in the approval process, the Board has the veto power to reject credits or modify the terms of credits which have been approved by the DFI's executive body/credit personnel should the majority of the Board be of the opinion that the loan/financing would expose the DFI to undue excessive risk.
[This requirement affects only the role of the Board and the EXCO (where it represents the Board). Individual directors who are also full-time executive personnel with the responsibility to approve loans/financing would not be affected by this prohibition.]

8.6.2 The Board may however, continue to approve "policy loans/financing" and loans/financing which are required by statute to be approved by the Board, provided that the initial filter of approval is conducted by the full-time executive credit personnel.

8.6.3 To encourage greater accountability, where approving committees are involved, individual reservations and dissensions should be recorded in the minutes or loan/financing papers.

Credit Appraisal Requirement

8.6.4 At the minimum, the factors to be considered and documented in approving credits must include:

(i) the purpose of the credit and source of repayment;

(ii) the integrity and reputation of the borrower/customer;

(iii) the current risk profile (including the nature and aggregate amounts of exposure) of the borrower/customer and its sensitivity to economic and market developments;

(iv) the borrower's/customer's repayment history and current capacity to repay, based on historical financial trends and cash flow projections;
[For retail-based loans/financing, historical financial trends and cash flow projections may not be practically feasible.]

(v) a forward looking analysis of the capacity to repay based on various scenarios, in particular, on likely downside scenarios;

(vi) the appropriateness of the term structure of credit to be given based on the borrower's/customer's cash flow profile;

(vii) the legal capacity of the borrower/customer to assume the liability;

(viii) for business loans/financing, the borrower's/customer's business expertise, the status of the borrower's/customer's economic sector and the borrower's/customer's position within that sector;

(ix) the proposed terms and conditions of the credit, including covenants designed to limit changes in the future risk profile of the borrower/customer; and

(x) where applicable, the adequacy, marketability and enforceability of collateral or guarantees.

8.6.5 DFIs should assess credits based primarily on the strength of the borrower's/customer's repayment capacity (cash flow) but can utilise collateral and guarantees to help mitigate risk inherent in individual credits. Collateral should not be a substitute for a comprehensive assessment of the borrower/customer, nor should it compensate for insufficient information.

8.6.6 DFIs should also not grant credit simply because the borrower/customer is familiar to the DFI or is perceived to be highly reputable.

8.6.7 When assessing collateral, DFIs also need to be mindful that the value of collateral may well be impaired by the same factors that have led to the diminished recoverability of the credit. The cost of recovery actions will also reduce the final recoverability value. With regard to guarantees, DFIs should evaluate the level of coverage being provided in relation to the credit quality and legal capacity of the guarantor. Only explicit guarantees should be factored into the credit decision and not those that might be considered implicit such as anticipated support from the authorities.

8.6.8 For participation in loan/financing syndications, DFIs should perform independent credit analysis and review of syndicated terms prior to committing to the syndication. Each DFI should analyse the risk and return on syndicated loans/financing in the same manners for other loans/financing.

8.7 Appropriate risk-return relationship

8.7.1 Granting credit involves accepting risk as well as producing profits. DFIs should assess the risk-return relationship in any credit, as well as the overall profitability of the account relationship. Credits should be priced in such a way that, together with other revenues earned, would cover all of the associated costs and compensate the DFI for the risks incurred.

RISK MEASUREMENT

8.8 Scope of measurement

8.8.1 A DFI's system for measuring credit exposure should:

(i) be comprehensive and accurate; and

(ii) enable risks to be aggregated and assessed on an institution-wide basis across all the various DFI products, including off-balance sheet activities, and, for those operating as a group, on a group-wide basis.

8.8.2 DFIs should have procedures to identify situations where, in considering credits, it is appropriate to classify a group of borrowers/customers as connected parties and, thus as a single borrower/customer. This would include aggregating exposures to groups of accounts, corporate or non-corporate, under common ownership or control or with strong connecting links (e.g. common management, family ties).

8.8.3 DFIs should also have procedures for aggregating exposures to individual clients across various product lines.

8.9 Measurement methods

8.9.1 Risk measurement methods must be understood by relevant personnel at all levels of the DFI, from individual officers to the board of directors, and should provide a common framework for limiting and monitoring risk.

8.9.2 An important tool in monitoring the quality of individual credits, as well as the total portfolio, is the use of an internal risk rating system. An internal risk rating system categorises credits into various classes designed to take into account the gradations in risk.

8.9.3 A well-structured internal risk rating system provides a good means of differentiating the degree of credit risk in the credit portfolio of a DFI. This will allow more accurate determination of the overall characteristics of the credit portfolio, quality distributions, problem credits, and the adequacy of loan/financing loss reserves.

8.9.4 Meaningful system will have numerous gradations for credits considered satisfactory in order to differentiate the relative credit risk they pose. More detailed and sophisticated internal risk rating systems can also be used to determine internal capital allocation, pricing of credits, and profitability of transaction and relationships.

8.9.5 For mass retail loans/financing, evaluating risk on a portfolio basis and applying credit scoring techniques can be adopted.

8.10 Specific Requirement by Bank Negara Malaysia: Internal Credit Rating System

8.10.1 DFIs should develop an internal credit risk rating system for corporate and business loans/financing. The rating system should be consistent with the nature, size and complexity of a DFI's activities and should have at least the following parameters:

(i) covers a broad range of the DFI's credit exposure, including off-balance sheet exposures;

(ii) covers both performing and non-performing assets;

(iii) has at least seven grades covering exposures, with the lowest rating accorded to those where losses are expected;

(iv) risk ratings for "performing" credits should have a minimum of four grades (including the grade(s) for "watchlist" or "special mention");

(v) regulatory classifications (performing, substandard, doubtful & bad) should be incorporated within the risk rating systems; and

(vi) the credit risk rating system should be detailed in the credit policy and procedures developed for the determination and periodic review of the credit grades.

8.10.2 The rating system, which has been endorsed by the Board, has to be submitted to Bank Negara Malaysia. For DFIs which have yet to implement the rating system, a plan, endorsed by the Board, must be submitted to Bank Negara Malaysia specifying the project scope, timeframe, persons responsible and milestones on the implementation of a credit grading system. ***Such plans must be submitted to Bank Negara Malaysia no later than 31 December 2009.***

8.10.3 DFIs should regularly monitor and evaluate the actual default or loss experience of credits in each risk grade as one means to assess the consistency and reliability of the ratings being used.

8.11 Monitoring and review

8.11.1 The process of evaluating and reviewing credit exposures regularly is fundamental to measuring and reporting exposures accurately.

Individual credits

8.11.2 DFIs need to develop and implement comprehensive procedures and information systems to monitor the condition of individual credits and related single borrowers/customers across the DFI's various portfolios.

8.11.3 Reviews of individual credits must be performed at least once a year. However, problem credits and credits where there are indications of deterioration in credit quality should be reviewed at more frequent intervals.

8.11.4 As individual credits for mass retail loans/financing may be voluminous, DFIs may confine the review of credits to those exceeding certain parameters.

8.11.5 Monitoring procedures need to define criteria for identifying and reporting potential problem credits and other transactions to ensure that they are subject to more frequent monitoring as well as possible corrective action, classification and/or provisioning.

8.11.6 An effective credit monitoring system should include measures to:

(i) ensure that the DFI understands the current financial condition of the borrower/customer;

(ii) endure all credits are in compliance with existing covenants;

(iii) monitor the usage of approved credit lines by borrowers/customers;

(iv) ensure that the projected cash flow by major credits meet debt servicing requirements;

(v) ensure that, where applicable, collateral provides adequate coverage; and

(vi) identify and classify potential problem credits on a timely basis.

Independent portfolio review

8.11.7 DFIs need to have a process to review independently credits on an aggregate basis for each portfolio segment (e.g. by loan/financing types, industry, risk grades). The review should cover the following:

(i) monitor composition and concentration of risk;

(ii) review significant shifts in the portfolio composition;

(iii) migration of risk levels within the portfolio segment that could lead to increased risk levels or a review of credit granting standards;

(iv) monitor changing economic environment, trends and events that could create new risk or increase the existing risk profile of the portfolio;

(v) adequacy of provisioning levels of each portfolio; and

(vi) adequacy of earnings in relation to the risk in the portfolio.

8.11.8 The review should be reported to the Board and/or the committee that oversees the management of credit risk.

Credit evaluations to be reviewed (audited) by independent parties

8.11.9 Credit officers can be responsible for ongoing credit analysis and the prompt identification of emerging problems. Their contact with borrowers/customers will usually permit identification of potential problems before they become apparent to others. However, DFIs should be careful to avoid over reliance on credit officers.

8.11.10 Internal credit reviews (audit) conducted by individuals independent from the business unit provide an important unbiased assessment of individual credits and the overall quality of the portfolio.

8.11.11 Such a review (audit) function helps to evaluate the overall credit approval and appraisal process, determine the accuracy of internal ratings and judge whether the account officer is properly monitoring individual credits.

8.11.12 The credit review (audit) function should report to the Board and/or a committee with audit responsibilities.

8.12 Specific Requirements by Bank Negara Malaysia: Independent Credit Review (Audit) System

8.12.1 DFIs should establish a separate credit review (audit) department staffed by experienced independent credit analysts to conduct post-review on credits which have been approved and provide an independent judgement on both the quality of credit appraisal and the quality of the credit portfolio of the DFI. Where cost and volume considerations may not justify such a department, a unit within the internal auditors department with the necessary skills to specialise in this function can fill this role.

Qualification of credit review (audit) personnel

8.12.2 Personnel involved in the credit review (audit) function should be qualified based on level of education, experience and extent of formal training. They should be knowledgeable in both sound lending/financing practices and their DFI's specific credit guidelines. In addition, they should be aware of pertinent laws and regulations that affect credit activities.

Scope of reviews

8.12.3 Reviews (audit) can be done on a sampling basis. Nevertheless, reviews should cover at least all credits that are considered significant. In addition, smaller credits that present elevated risks characteristics such as classified credits or restructured accounts should also be reviewed regularly. The percentage of the portfolio selected for review should provide reasonable assurance that all major credit risk has been identified.

Frequency of reviews

8.12.4 The credit review (audit) function should provide feedback on the effectiveness of the credit process in identifying emerging problems. Reviews should be performed annually on significant credits or more frequently where weaknesses in the credit appraisal/approval process are found. A system of periodic review is particularly important to the specific and general loan/financing loss provisioning process.

Depth of reviews

8.12.5 Credit reviews (audit) should analyse a number of important credit evaluation factors, including:

(i) quality of appraisals;
(ii) the accuracy and timeliness of credit grades assigned by credit officers;
(iii) proper credit approval;
(iv) level of risk – migration, direction; and
(v) sufficiency of collateral valuation.

Review findings and follow-up

8.12.6 Credit review (audit) findings should be discussed with appropriate credit officers, departmental managers and management. Corrective action(s) (including estimated time frames) should be obtained for all noted deficiencies.

8.12.7 Review findings should be submitted to the Board or committee that oversees the management of credit risk. Deficiencies that remain unresolved should also be reported to management and the Board or the committee.

8.13 Stress analysis

8.13.1 Unexpected turn of events can throw even the best forecast and projections awry. Hence, analysing performance under "worst case" scenario is an important aspect of risk measurement.

8.13.2 Sound risk management involves consideration of what could potentially go wrong with individual credits and the various portfolios, and factoring this information in analysing the adequacy of capital and provisions. DFIs should therefore consciously conduct "what if" exercise in order to reveal previously undetected areas of potential credit risk exposure and linkages between different categories of risk that are likely to emerge in times of crisis.

8.13.3 Stress testing should include identifying possible events or future changes in economic conditions that have unfavourable effects on the DFI's credit exposures and assessing the DFI's ability to withstand such effects. Three areas the DFI should examine are:

(i) economic or industry downturns;
(ii) market-risk events; and
(iii) liquidity conditions.

8.13.4 Stress tests should be conducted by DFIs at least semi-annually or at any other interval as may be prescribed by Bank Negara Malaysia.

8.13.5 The results of the tests should be tabled at the Board meetings and appropriate action taken in cases where the results exceed tolerant limits. The results should be incorporated into the process for assigning and updating policies and limits.

LIMITING RISK

8.14 Scope of limits

8.14.1 A sound system of limits and risk taking guidelines are an essential component of the credit risk management process. Such a system should:

(i) set boundaries for organisational risk-taking;

(ii) be consistent with the institution's overall risk measurement approach;

(iii) be applied on an institution-wide basis where credit risks also arise in other activities of the DFI;

(iv) permit management to control exposures and to monitor actual risk taking against predetermined tolerances, as set by the Board or committee that oversees credit risk management; and

(v) ensure that exposures which exceed certain predetermined levels receive prompt management attention.

8.14.2 The limits should be consistent with the DFI's risk management process and commensurate with its capital position.

Individual Credit Limits

8.14.3 DFIs should establish overall credit limits at the level of individual borrowers/customers and groups of connected borrowers/customers that aggregate in a comparable and meaningful manner, different types of exposures, both in the banking, trading book and on and off the balance sheet.

8.14.4 Limits can be based on the internal risk rating assigned to the borrower/customer.

8.14.5 DFIs are also required to establish sub-limits arising from credit exposure from activities and instruments in the trading book and off the balance sheet. In order to be effective, limits should generally be binding and not driven by borrower/customer demand.

Portfolio Concentration

8.14.6 Concentration of risks can take many forms and arise whenever a significant number of credits have similar risk characteristics. Concentrations occur when, among other things, a DFI's portfolio contains a high level of direct or indirect credits to:

(i) a particular industry or sector;
(ii) a geographic region;
(iii) a type of credit facility or product group;
(iv) a foreign country or a group of countries with strongly interrelated economies;
(v) a type of security; or
(vi) credits with same maturity.

8.14.7 To ensure that the DFI's credit granting activities are adequately diversified, limits should also be established for particular industry sector, geographic regions and/or specific products. However, DFIs should be careful not to enter into transactions with borrowers/customers they do not know or engage in credit activities they do not fully understand simply for the sake of diversification.

Breaches in limits

8.14.8 DFIs should monitor actual exposures against established limits and have in place procedures for increased monitoring and taking appropriate action as such limits are approached.

8.14.9 If limits are exceeded, such occurrences should be made known immediately to management. The management, committee or the Board should also be informed of frequent breaches as well as corrective actions undertaken to ensure non-recurrence of such breaches. Exceptions should be approved only by authorised personnel. The seriousness of limit exceptions depends largely upon the conservativeness of management's attitude towards setting limits and on the actual size of individual and organisational limits relative to the DFI's capacity to take risk.

REPORTING

8.15 An accurate, informative and timely management information system is essential to the prudent operation of credit risk management. Hence, the quality of the management information system is an important factor in the overall effectiveness of the risk management process.

8.16 The credit risk management function should monitor and report its measures of risk to appropriate levels of management, the committee that oversees the management of credit risk and the Board.

8.17 The reporting system should be able to provide adequate information on:

(i) the composition of the portfolio;

(ii) concentrations of credit risk;

(iii) quality of various portfolios; and

(iv) rehabilitated and "watchlist" accounts both on an entity and on a consolidated basis across various products (including off-balance sheet activities), that will permit management to assess quickly and accurately the level of credit risk that the DFI has incurred and determine whether the DFI's performance meets the credit standards.

8.18 The reporting system should ensure that exposures approaching risk limits are brought to the attention of management. All exposures should be included in a risk limit measurement system.

8.19 The adequacy of scope of information should be reviewed on a periodic basis by management and the Board or the committee that oversees the management of credit risk.

8.20 Reports should be prepared by persons who are independent of the business unit.

MANAGING PROBLEM CREDITS

8.21 A reduction in credit quality should be recognised at an early stage when there may be more options available for improving the credit.

8.22 Effective workout programmes are critical to managing risk in the portfolio. The DFI should clearly set out how it will manage problem credits.

8.23 When the DFI has significant credit-related problems, the workout function should be segregated from the area that originated the credit as well as persons involved in the credit organisation.

8.24 The DFI should recognise that additional resources, expertise and more concentrated focus of a specialised workout section normally improve collection results. This is because a workout section can help to develop an effective strategy to rehabilitate a troubled credit or increase the amount of repayment ultimately collected. An experienced workout team should also be used to provide valuable input into any credit restructuring organised by the business function.

8.25 A post-mortem review should be carried out on significant cases. The review should enable the DFI to understand better how problem credits and losses develop and identify weaknesses in the DFI's existing credit granting process and monitoring process. The review should:

(i) compare the credit's terms and characteristics with lending/financing guidelines;
(ii) reassess the borrower's/customer's condition at the time of approval;
(iii) assess the timeliness of problem identification;
(iv) assess the accuracy of collateral evaluation;
(v) assess documentation adequacy; and
(vi) assess the effectiveness of credit conditions imposed.

8.26 The results of the review should be reported to the Board and/or the committee that oversees the management of credit risk.

9. CHAPTER 4: INTERNAL AUDITS

9.1 The internal audit function should provide an on-going focus on the internal control systems and periodic reviews of the credit risk management processes. It should also review compliance with approved policies, as well as applicable laws and regulations. It should be read together with the "Guidelines on Minimum Audit Standards for Internal Auditors of Development Financial Institutions" issued to DFIs on 18 December 2006.

ROLE OF INTERNAL AUDITORS

9.2 Internal auditors must evaluate the independence and overall effectiveness of the credit risk management systems.

9.3 The internal auditor's assessment on the adequacy of internal controls will involve understanding, documenting, evaluating and testing a DFI's internal control system and follow-up of corrective actions and review of management's action to address material weaknesses.

SCOPE OF INTERNAL AUDITORS

9.4 A DFI should have internal controls and information systems that are appropriate to the size of the DFI and the nature, scope and risk of its activities. The internal audit is required to evaluate the following:

(i) the existence of adequate internal controls for each stage of the credit process;

(ii) systems of internal controls are appropriate and effective to the level of risk posed by the nature and scope of the DFI's credit granting operations;

(iii) reliability and timeliness of information reported to the DFI's management, committee and the Board;

(iv) adequate segregation of incompatible credit functions to promote checks and balances. Organisational structure reflects actual reporting practices and there are clear lines of authority and responsibilities for monitoring adherence to approved credit policies, procedures and limits;

(v) compliance with risk limits;

(vi) adequacy of written policies and procedures;

(vii) adequate procedures exist for compliance with applicable laws, regulations and policies, and policies are adhered to;

(viii) review the legal documentation process to ensure that all legal procedures are followed; and

(ix) weaknesses in the credit approval and monitoring systems are given proper and timely high level attention, and management action to address these weaknesses are objectively verified and reviewed.

INDEPENDENCE OF INTERNAL AUDITORS

9.5 The internal auditors should have direct access to the chief executive officer, the Board and the audit committee. Findings and recommendations of the auditors should not be watered down by line management.

9.6 To preserve the effectiveness of credit risk management, the selection, retention, evaluation, and compensation of the heads of department that perform the audit and reviews should be decided by the Board, and not by the management.