



CENTRAL BANK OF
TRINIDAD & TOBAGO

Guideline on Credit Risk Management

for Institutions Licensed under the
Financial Institutions Act, 2008 and the
Insurance Act

Draft - July 2020

CONTENTS

1. Introduction	1
2. Purpose, Application and Scope.....	1
3. Definition of Key Terms	2
4. Establishment of a credit risk strategy and Policy	3
Credit Risk Strategy	3
Credit Risk Policy	3
5. Responsibilities of the Board and Senior management	5
Responsibilities of the Boards of Directors.....	5
Responsibilities of the Senior Management	6
6. Credit risk management process.....	8
Credit Processing and Appraisal.....	8
Credit Documentation	9
Credit Approval	9
Credit Administration.....	10
Disbursement	11
Monitoring Mechanisms	11
Managing Problem Credits	14
7. Role of the central bank.....	14
8. Effective Date	14

1. INTRODUCTION

- 1.1. The management of credit risk is a critical component of a financial institution's risk management strategy, particularly for financial institutions in which the issuance of credit constitutes a significant portion of the business.
- 1.2. This inherent risk not only poses a threat to individual credit transactions but to the entire credit portfolio, as mismanagement can jeopardize an institution's continued financial viability, with consequences for depositors, policyholders and other stakeholders.
- 1.3. Accordingly, the legislation governing financial institutions, as well as, several guidelines issued by the Central Bank of Trinidad and Tobago ("Central Bank"), have highlighted the importance of ensuring that credit risk is effectively identified, measured, monitored, and controlled:
 - 1.3.1. The Financial Institutions Act, 2008 ("FIA") and the Insurance Act, 2018 ("IA")¹ stipulate limits regarding large and connected party exposures²;
 - 1.3.2. The Guideline for the Monitoring, Management and Control of Impaired Assets outlines the Central Bank's minimum requirements for the recognition, monitoring and measurement of impaired assets; and
 - 1.3.3. The Corporate Governance Guideline ascribes, inter alia, specific responsibility to the Board of Directors and Senior Management to ensure the adequacy of risk management policies, systems and procedures, including those pertaining to credit risk.
- 1.4. This Credit Risk Management Guideline ("Guideline") supplements legislation, regulations and guidelines governing financial institutions. It leverages best practices on credit risk management as espoused by the Basel Committee for Banking Supervision ("BCBS")³ and the International Association of Insurance Supervisors ("IAIS").

2. PURPOSE, APPLICATION AND SCOPE

- 2.1. This Guideline provides guidance on the Central Bank's expectations for effective credit risk management and sets out inter alia, the responsibilities of the Board and Senior Management with respect to governance of credit risk.
- 2.2. The Guideline applies to financial institutions:
 - 2.2.1. licensed under the FIA; and

¹ From the date of proclamation of the Insurance Act, 2018.

² Reference to legislation in this Guideline includes subordinate legislation made under the relevant statute and any amendment, re-enactment or modification thereunder.

- 2.2.2. registered under the IA.
- 2.3. The Central Bank also recommends that the following financial institutions that have been **deemed** as systemically important, pursuant to section 123 of the FIA, also adhere to the principles in this Guideline, to the extent permitted by the provisions of their respective legislative frameworks:
 - 2.3.1. the Trinidad and Tobago Mortgage Finance Company Limited;
 - 2.3.2. the Home Mortgage Bank;
 - 2.3.3. The National Insurance Board of Trinidad and Tobago;
 - 2.3.4. the Trinidad and Tobago Unit Trust Corporation; and
 - 2.3.5. the Agricultural Development Bank.

3. DEFINITION OF KEY TERMS

“credit exposure”	has the meaning as defined in the FIA, IA and where applicable, legislation governing the financial institutions deemed systemically important.
“credit risk”	means the current or prospective risk to earnings and capital arising from an obligor’s failure to meet the terms of any contract with the financial institution or if an obligor otherwise fails to perform as agreed.
“credit risk management”	means the process of controlling the impact of credit risk related events on the financial institution. This management involves identification, understanding and quantification of the degree of potential loss and the consequent taking of appropriate measures to minimize the risk of loss to the financial institution.
“connected party”	has the meaning as defined in the FIA, IA and where applicable legislation governing the financial institutions deemed systemically important.
“country risk”	means the risk that an event occurring in a foreign country will negatively influence the willingness or ability of state-owned or privately owned borrowing companies in that country to pay their debts on time (e.g. Government restrictions, impact of policy measures, recession, foreign exchange restrictions and unavailability etc.).
“transfer risk”	means the risk that a Government will impose restrictions on the transfer of funds by debtors in the country in question to foreign creditors, either for financial or other reasons. This risk is almost exclusively related to foreign currency exposure.

"financial institution" has the meaning as defined in the FIA, IA and where applicable legislation governing the financial institutions deemed systemically important.

4. ESTABLISHMENT OF A CREDIT RISK STRATEGY AND POLICY

Credit Risk Strategy

- 4.1. Every financial institution should establish and document a **credit risk strategy** which:
 - 4.1.1. speaks to its appetite for credit risk;
 - 4.1.2. considers the activities which create credit risk; and
 - 4.1.3. can be effectively used in the development of its credit risk policy.
- 4.2. At a minimum, the credit risk strategy should outline the financial institution's willingness to grant credit based on:
 - 4.2.1. exposure type and limits;
 - 4.2.2. economic sector;
 - 4.2.3. geographical location;
 - 4.2.4. currency; and
 - 4.2.5. maturity.
- 4.3. Financial institutions should also ensure that the credit risk strategy is long-term in nature and is able to adapt to the volatility of many regional economies, if necessary.
- 4.4. It is also essential that a financial institution's credit strategy is effectively communicated and the relevant persons in the organization are aware of the established approach to credit risk management.

Credit Risk Policy

- 4.5. The development and establishment of a written **credit risk policy** will provide the financial institution with a framework for the granting and managing of its credit activities. In order to be effective, credit policies must also be communicated throughout the organization and implemented through appropriate procedures.
- 4.6. A financial institution's credit risk policy must be monitored and periodically revised to take into account changing internal and external circumstances. A well developed and implemented policy may also assist in the evaluation of new business opportunities.

4.7. At a minimum, the written credit policy should include:

- 4.7.1. a statement detailing the role, responsibility and level of accountability of the Board and the senior management;
- 4.7.2. a statement prohibiting inappropriate levels of remuneration which may act as an incentive for excessive risk taking;
- 4.7.3. the extent to which a financial institution is willing to accept credit risk against its portfolio, including concentration limits, with respect to, borrowers, individual credit products, industry sectors, geographic regions and classes of securities;
- 4.7.4. a process to deal with the granting of credit internationally. Financial institutions must have procedures for identifying, measuring, monitoring and controlling country and transfer risk. The monitoring of country risk should incorporate potential default of foreign borrowers due to country specific economic factors;
- 4.7.5. procedures for the granting of credit to related or connected parties taking into consideration relevant legislation;
- 4.7.6. types of credit activities in which the financial institution is allowed to engage;
- 4.7.7. details on the analysis to be conducted when introducing new products and initiatives;
- 4.7.8. a list of documentation required for each stage of the credit cycle;
- 4.7.9. details on internal controls to mitigate credit risk;
- 4.7.10. clearly defined credit approval authority levels and powers of delegation, taking into account the type and size of the credit, the types of risks to be assessed and the experience level and competence of the individuals approving the credit;
- 4.7.11. a communication standard that ensures the language used in credit documents is clear and customers understand the terms and conditions associated with the facilities approved;
- 4.7.12. details on how problem credits should be managed and who is responsible for managing this function; and
- 4.7.13. clear definitions of debt restructuring, rescheduling, refinancing and consolidation which adhere to local laws and guidelines, where relevant.

5. RESPONSIBILITIES OF THE BOARD AND SENIOR MANAGEMENT

Responsibilities of the Boards of Directors

- 5.1. The Board plays a crucial role in overseeing the credit risk management function of a financial institution. The Board's responsibilities should include at a minimum:
 - 5.1.1. developing a documented credit risk strategy that establishes objectives guiding the investment, lending and any other activities of the financial institution, in which credit risk exposure is significant. This strategy should be reflective of the size of the institution and be cognizant of the nature and complexity of risk generating activities undertaken;
 - 5.1.2. approving the appointment of qualified and competent senior managers to administer the credit risk management function;
 - 5.1.3. ensuring that sound, written and comprehensive risk management policies and procedures are developed and maintained by the senior management;
 - 5.1.4. approving the credit risk policy developed by senior management, ensuring that it takes into account the overall credit risk strategy and risk tolerances approved by the Board and also includes (inter alia) procedures for transactions between the financial institution and connected parties, connected party groups and employees who are not connected parties;
 - 5.1.5. reviewing the relevant policies and procedures in accordance with established timeframes;
 - 5.1.6. reviewing, where applicable, large or complex transactions to ensure compliance with the risk tolerance levels approved by the board~~reviewing the relevant transactions on an ongoing basis to ensure compliance;~~
 - 5.1.7. ensuring that adequate controls, including management reporting and internal audits, are in place to monitor that the risks being taken are in accordance with agreed upon internal policies;
 - 5.1.8. monitoring of adherence to regulatory, supervisory and other legal requirements;
 - 5.1.9. reviewing all significant problem credits and the actions taken by management to ensure their recovery;
 - 5.1.10. evaluating significant credits granted in conflict with the written credit risk policy and deciding on the action to be taken to ensure future compliance; and

- 5.1.11. reviewing trend analyses and stress tests conducted by the financial institution in order to identify emerging credit risk problems and the making of recommendations to deal with the problems.

Responsibilities of the Senior Management

5.2. The Senior Management, like the Board, also plays a vital role in the credit risk management process. At a minimum, their responsibilities should include:

- 5.2.1. adopting the credit risk strategy set out by the Board. The senior management must ensure that the lending and investing activities of the financial institution conform to the established strategy, risk tolerances and limits identified;
- 5.2.2. developing and implementing written policies and procedures in keeping with the credit risk strategy. These policies should establish a clear lending and investing framework which should guide such activities in the financial institution;
- 5.2.3. establishing a communication system that disseminates the credit risk strategy, policies and procedures to the employees engaged in the credit risk management process. This communication should ensure that all relevant employees understand clearly the financial institution's approach to lending and investing, thereby holding them accountable for complying with the established and approved policies and procedures;
- 5.2.4. establishing and implementing credit documentation policies;
- 5.2.5. developing adequate internal controls, which at a minimum should include:
 - (i) an internal risk rating system;
 - (ii) an appropriate internal valuation methodology for the appraisal of asset and collateral; and
 - (iii) segregation of activities between persons responsible for authorization of credit transactions and those responsible for their monitoring.
- 5.2.6. implementing an internal audit function to review and assess *inter alia* the credit risk management activities. The internal auditor should report directly to the Board or the Audit Committee. This internal audit review should be conducted by persons independent of the business function and ensure that:
 - (i) credit activities are in compliance with the credit risk policy;
 - (ii) credits are duly authorized, accurately recorded, and appropriately valued;

- (iii) credits are appropriately rated according to the internal rating system in place;
 - (iv) credit files are properly maintained and complete;
 - (v) potential problem credits are identified on a timely basis and a determination can be made whether provision for credit losses are adequate in accordance with the policy and relevant legislation; and
 - (vi) the Board receives regular reports on the audits conducted.
- 5.2.7. submitting a written report to the Board, no less than quarterly in the case of systemically important financial institutions, and no less than semi-annually in the case of other financial institutions. At a minimum, the report should identify:
- (i) significant credit activities of the financial institution and the composition and quality of the credit portfolio;
 - (ii) significant credit exposures outstanding;
 - (iii) significantly impaired credits, their current status and collection prospects;
 - (iv) credit transactions undertaken that are not in accordance with the credit risk management policy and the reasons for the deviation from the policy; and
 - (v) credits granted, or guaranteed by the licensee, to connected parties and connected party groups.
- 5.2.8. ensuring that there is a periodic independent assessment of the financial institution's credit granting functions; and
- 5.2.9. the development of appropriate Management Information Systems (MIS) which will track:
- (i) the evolving circumstances of credit exposures, repayments regularity, borrower's financial condition, continuing value of security; and
 - (ii) credit by portfolio characteristics, including single and associated groups of borrowers, types of credit facilities, industry sectors and geographical regions.

6. CREDIT RISK MANAGEMENT PROCESS

- 6.1. Effective credit risk management includes the identification and assessment of potential risks inherent in any product or activity.
- 6.2. The credit risk management process should cover the entire credit cycle starting from the origination of the credit in the financial institution's books to the point the credit is removed from the books. At a minimum, this process should formalize the financial institution's approach to the following:
 - 6.2.1. credit processing and appraisal;
 - 6.2.2. credit documentation;
 - 6.2.3. credit approval;
 - 6.2.4. credit administration;
 - 6.2.5. disbursement;
 - 6.2.6. monitoring mechanisms; and
 - 6.2.7. managing problem credits.

Credit Processing and Appraisal

- 6.3. The goal of the credit processing and appraisal stage of the credit cycle is to gather information to enable an assessment of the borrower's risk profile.
- 6.4. In order to ensure that extending credit for a particular facility is prudent and complies with the financial institution's risk policy, credit application forms need to be detailed and accurately completed.
- 6.5. Financial institutions should create comprehensive pre-qualification criteria which should inform the questions presented on the application form. A well-developed application form will aid institutions in avoiding processing and screening applications that would be later rejected.
- 6.6. A key aspect of credit processing and appraisal is assessing the borrower's ability to repay. Establishing and implementing credit appraisal criteria would assist in the evaluation of the borrower's creditworthiness. The criteria should establish eligibility for each level and type of credit, the borrower's risk profile and repayment history, as well as consider disqualification criteria (for example, rejecting applications from customers who have been identified or suspected of being involved in money laundering).
- 6.7. Financial institutions must also establish procedures, processes and systems to identify when persons applying for credit are connected parties and such persons should be classified and dealt with as a connected party group. In assessing risk, the exposure to the connected party group must be evaluated and monitored to ensure that regulatory limits or thresholds are not breached.

- 6.8. The terms and conditions of any exposures incurred by the financial institution to any of its connected parties or connected party groups should not be more favorable than the terms and conditions offered to the public and the credit exposure should be subject to the approval of the Board before it is granted.
- 6.9. A financial institution usually requires collateral or guarantees in order to mitigate the risks associated with the issuance of credit. It would be prudent for financial institutions to have a policy established to value this collateral. However, it should be noted, that over-reliance on collateral or guarantees may be a risky practice.
- 6.10. While collateral and guarantees may provide secondary protection to the lender if the borrower defaults, the primary consideration should be the borrower's debt-servicing capacity.

Credit Documentation

- 6.11. Proper documentation is vital for the effective management of credit risk and is required at every stage of the credit cycle.
- 6.12. Documentation establishes the relationship between the financial institution and the borrower and will also form the basis for any legal action. In this regard, financial institutions should create and implement policies stipulating the information to be documented at each stage of the credit cycle and ensure that it is obtained, maintained and held safely. The retention period for such documents should also be established.
- 6.13. Credit documentation policies should outline information required for compliance with Know-Your-Customer and Anti-Money Laundering regulatory requirements set out in law, regulations and guidelines.
- 6.14. A standardized format should be employed for all lending and investment documents and files. A separate credit file should be maintained for each customer with an appropriate system of cross-indexing. This will facilitate complete reviews and follow-up of credit facilities.

Credit Approval

- 6.15. Financial institutions must have a documented credit approval policy for the granting of credits. The policy should identify the documentation required and criteria to be met in order to approve new credits and renew or change the terms of existing credits.
- 6.16. At a minimum, in assessing a borrower the following criteria should be considered:
 - 6.16.1 the purpose of the credit and source of repayment;
 - 6.16.2 the current risk profile of the borrower;
 - 6.16.3 the borrower's repayment history;

- 6.16.4 the proposed terms of the credit;
 - 6.16.5 the borrower's expertise;
 - 6.16.6 the type and value of collateral;
 - 6.16.7 the reputation of the borrower; and
 - 6.16.8 whether the borrower is a connected party or part of a group of connected parties.
- 6.17. In order to absorb additional risks, financial institutions should ensure that appropriate risk mitigation measures are utilised, for example, insurance on loans, and requiring additional collateral including cash, fixed deposits and/ or property as appropriate in the circumstances.
- 6.18. Financial institutions must apply stronger criteria for borrowers with high loan to value ratios. In addition to the risk mitigation measures identified above, financial institutions should consider applying appropriate margins or haircuts of the security depending on its liquidity.
- 6.19. The credit approval policy should establish accountability for decisions taken and designate the absolute authority to approve credits.
- 6.20. It is also important that there is separation of duties between persons with credit approval authority and customer relationship authority.
- 6.21. The evaluation of credit applications from connected parties must be monitored to ensure that the transactions are carried out in accordance with the financial institution's written policy. The policy must stipulate that all extensions of credit to connected parties are done on an arm's length basis and the terms of the contracts are no more favorable than the terms offered to other parties or individuals.
- 6.22. The documentation required and obtained should then be evaluated by a qualified credit officer or analyst to ensure compliance with the financial institution's written policies.
- 6.23. It is essential that the credit officer or analyst has the necessary skill and expertise to properly evaluate all transactions, including complex and/or large transactions. Financial institutions should ensure that the provisions outlined in the relevant credit policies are utilised in all cases.

Credit Administration

- 6.24. Ongoing administration of the credit portfolio is an essential part of the credit management process. The credit administration function supports the extension and maintenance of credit.
- 6.25. At a minimum, a financial institution's credit administration function should ensure that:

- 6.25.1 controls over 'back office' procedures are adequate;
 - 6.25.5 documentation is complete and in compliance with the approved terms and conditions;
 - 6.25.3 there is adequate segregation of duties;
 - 6.25.4 the borrower's compliance with credit terms is monitored and early signs of repayment irregularity are identified;
 - 6.25.5 credit files are maintained and prohibited from being removed from the premises. These files should have current financial statements, financial analysis and a document specifying an internal rating;
 - 6.25.6 credit facilities are disbursed only after all relevant contractual terms including but not limited to insurance coverage have been met and required documents received;
 - 6.25.7 funds issued are used for the stated purpose; and
 - 6.25.8 contractual requirements, legal covenants and collateral values are monitored.
- 6.26. Due to the sensitive nature of the credit administration function, officers carrying out this responsibility should not report to a manager who is also responsible for the approval of credits.

Disbursement

- 6.27. Once the credit is approved, a letter in duplicate explaining the terms of the credit facility should be sent to the borrower. This letter must be written in plain language to ensure the customer understands the relevant terms and conditions.
- 6.28. The financial institution should request that a signed copy of the letter be returned, at which time it will be placed in the corresponding credit file. The disbursement of the funds should not begin before the signed copy of the letter is received.

Monitoring Mechanisms

- 6.29. Financial institutions need to develop and implement a comprehensive system that enables them to monitor and assess the credit risk involved in exposures to individual borrowers or counterparties, as well as, at the portfolio level.
- 6.30. At a minimum, the monitoring system should include the utilization of MIS, internal risk ratings and stress testing.
- 6.31. An effective monitoring system will ensure the following:
 - 6.31.1 an accurate picture of the current financial condition of the borrower is understood;

- 6.31.2 early detection of late or non-receipt of agreed payments and follow up of these payments;
 - 6.31.3 compliance with existing contractual agreements is monitored;
 - 6.31.4 as far as possible, funds advanced are only used for the stated purpose;
 - 6.31.5 the financial institution's internal risk ratings reflect the current condition of the borrower; and
 - 6.31.6 concentrations within the credit portfolio(s) are continuously monitored and evaluated.
- 6.32. A high level of concentration may expose financial institutions to adverse changes in the area in which the credits are concentrated. However, it may be difficult for financial institutions to reduce their concentration to particular sectors, borrowers, borrower groups, connected parties or connected party groups.
- 6.33. In order to mitigate against this risk, financial institutions can:
- 6.33.1 consider pricing for the additional risk;
 - 6.33.2 increase their holding of capital to compensate for the additional risks³; and
 - 6.33.3 make use of loan participations in order to reduce dependency on a particular sector of the economy or group of related borrowers.
- 6.34. Financial institutions must also remain mindful of the statutory exposure limits they are required to comply with and should set internal limits utilizing their internal risk rating system, which will help ensure that exposures nearing the statutory limit are identified quickly and the necessary action taken.

Credit and Compliance Audits

- 6.35. Financial institutions must also ensure that there is a system in place to ensure that regular independent credit and compliance audits are conducted.
- 6.36. These audits should be conducted by either the internal auditor or compliance officer. The review should randomly test all the aspects of the credit risk management programme to ensure that, at a minimum:
- 6.36.1 the level of provisions are adequate (provisions made should be in accordance with international accounting standards);
 - 6.36.2 collateral coverage is sufficient and regularly assessed and related to the borrower's financial health;

³ Financial institutions licensed under the FIA will be required to develop an Internal Capital Adequacy Assessment Process (ICAAP), which demonstrates how it has calculated the optimal capital required for its operations at the licensee and group level, incorporating the capital conservation buffer, the leverage ratio and the capital add-on for domestic systemically important banks

- 6.36.3 Internal valuations of collateral held are performed on an annual basis;
- 6.36.4 problem credits are identified and classified in accordance with International Financial Reporting Standard (IFRS) 9.

Management Information System (MIS)

- 6.37. Ensuring that an effective MIS is implemented will assist financial institutions to comprehensively monitor their credit portfolio(s) and any associated credit risk.
- 6.38. The quality and timeliness of information generated from the MIS is vital because it is used to inform decisions made by the Board and senior management and facilitate the on-going assessment of credit risk.
- 6.39. Financial institutions should also utilise internal risk rating systems to assist in monitoring the quality of the credit portfolio.
- 6.40. Internal risk rating systems should categorize credits based on their level of risk and facilitate a more accurate determination of the overall characteristics of the credit portfolio including: concentrations, problem credits, adequacy of loan reserves, internal capital allocation, pricing of credits and profitability of transactions and relationships. In developing this type of rating system financial institutions should ensure that it is responsive to indicators of potential or actual deterioration in the credit.
- 6.41. In order to assess the impact that potential adverse changes in economic conditions may have on the credit portfolio, stress testing should be incorporated in the financial institution's overall monitoring of credit risk. The following should be noted in relation to stress testing:
 - 6.41.1. potential changes in the financial landscape may include economic or industry downturns, market risk events, pandemics, natural disasters, and/or liquidity conditions;
 - 6.41.2. the determination of whether or not a particular concentration is excessive should be benchmarked against industry norms and regulatory requirements.
 - 6.41.3. stress testing can range from relatively simple alterations in assumptions about one economic variable to the use of highly sophisticated financial models.
 - 6.41.4. the analysis should include contingency plans regarding management action given certain scenarios.
 - 6.41.5. the sophistication of the stress tests should align with the nature and complexity of operations of the financial institution.
- 6.42. Specific individuals should be assigned responsibility for monitoring credit quality and any underlying collateral and guarantees. In assigning these responsibilities management should be cognizant of the potential for conflicts of interest, especially

for personnel who are rewarded for performance based on loan volume, portfolio quality or the financial institution's short-term profitability.

Managing Problem Credits

- 6.43. A financial institution's credit risk policy should stipulate how problem credits should be managed and who should be responsible for overseeing this function. The positioning of this responsibility should be dependent on the size and complexity of the credit operations of the financial institution.
- 6.44. In the case of a large, complex or systemic financial institution, it may be prudent to establish an independent credit 'work-out' unit to monitor and manage all aspects of the problem credit, including rehabilitation of the borrower, restructuring of the credit, monitoring the value of applicable collateral and dealing with the receiver/manager until the recovery matters are finalized. Establishing a work out unit will also facilitate the segregation of the management of problem credits from the unit that originated the credit.
- 6.45. Documentation of all the steps the financial institution took to pursue claims against delinquent borrowers should be placed on file. This file may need to be presented in any legal proceedings arising from the problem credit.

7. ROLE OF THE CENTRAL BANK

- 7.1. The Central Bank assesses routinely the financial institutions' credit risk exposure and management through a mix of off-site analyses of reported financial and other information, on-site examinations and meetings with the institution's to assess governance of that risk.
- 7.2. Where the Central Bank determines that weaknesses or gaps in the financial institution's credit risk management, including the level of provisioning and capital relative to its credit risk, the Central Bank will take such regulatory action as is necessary and allowed under law to ensure that the gaps are addressed in a timely manner.

8. EFFECTIVE DATE

- 8.1. This Guideline comes into effect on the date of its issuance.
- 8.2. Financial institutions are required to review this Guideline and institute appropriate measures to ensure compliance within six months of the date of issuance.