THE NEW APPROACH TOWARDS DEFINING THE RISK EXPOSITIONS OF COMMERCIAL BANKS THROUGH THE PRISM OF REGULATION № 575/2013 OF THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION

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Abstract

The recent financial crisis proved that losses in the banking system could be significant and offsetting them takes quite the time. The natural consequence is European financial institutions' striving for not allowing repeated loan expansion and bearing unreasonably high risks on behalf of banks. This striving is reflected in the new legal framework of the European Union.

Key words: *banks, credit risk, management*

1. INTRODUCTION

One of the most significant challenges the banking sector in Bulgaria is facing is the need for the Bulgarian banking legislation and banking practice to be aligned in conformity with the requirements of the new legal framework of the European Union that regulates the operations of the credit institutions. The new policies that are elaborated in Directive 2013/36 and enforced with Regulation 575/2013 (referred to as the "regulation" in the presentation) on one hand aim at ensuring stability and transparency of the banking environment and on the other hand improving the quality of bank capital and correspondingly – its relatedness to risks[1]. Credit risk is among these risks and if not managed effectively, it would cause new significant losses incurred by banks.

2. THE NEW REQUIREMENTS TOWARDS CREDIT PROCESS IN BANKS – BEING THE PREREQUISITE FOR EFFECTIVE MANAGEMENT OF RISK EXPOSITIONS THROUGH THE PRISM OF REGULATORY CHANGES ENFORCED BY THE EUROPEAN UNION

Aligning the Bulgarian banking legislation in the area of risk management in banks in conformity with the Regulation was initiated with modifications and supplementations in the Credit Institutions Act (State Gazette, edition 27, 35, 53, 2014) and it repels the following ordinances of the Bulgarian National Bank – Ordinance № 8 on credit institutions' capital adequacy, Ordinance № 7 on banks' high expositions, Ordinance № 9 on the assessment and classification of banks' risk expositions and on establishing specific provisions in view of credit risk. The new ordinance that regulates the organization and management of risks in banks is Ordinance № 7 (State Gazette, edition 40, 2014).

The loan issuing process should satisfy very important requirements of Ordinance № 7 (State Gazette, edition 40, 2014) in two directions:

- The bank should issue loans based on reasonable and clearly defined criteria;
- The process of approval, modification, renewal and refunding loans should be clearly defined and it ought to be duly observed correspondingly.

The clearly defined and reasonable criteria for issuing loans in a particular commercial bank should be established in its rules about credit operations. These criteria could be outlined in the following groups:

[1] Regulation 575/2013 defines the requirements and criteria on treating the following risk categories – credit risk and risk resulting from the contragent; residual risk, concentration risk, securitization risk and interest risk in the bank portfolio; market risk; operational risk and risk resulting from excessive leverage. See:

- In view of company's history – loan applicant – the year of company founding, the funding it started with, its owners and whether they participate in other enterprises, its business, are there threats presented by economic and legislative modifications, could the company business be referred to some branch that is experiencing decline;
- In view of its management – company's managers, their education, their experience in the area of company's business;
- In view of company's credit history – which are the banks it worked with and operates at present, has it received loan from other banks and with what purpose, does it have debts to banks at present and what is their amount, deadline and extinguishment plan;
- In view of company's market positions and competitiveness – the market share held by the company, the forecasts of this market's development, number of competitors, advantages and disadvantages of competitors and what makes the company better than them;
- In view of the product being manufactured with bank's funding – is it a product new to the market, what quantities could be marketed and at what price correspondingly;
- In view of suppliers and buyers – the main suppliers, the manner of delivering the commodities and company's mode of payment, does the company owe money to some of its suppliers, the way the company sells its products – wholesale, retail sale, deferred payment, the most important buyers and the total number of buyers, the payment terms;
- In view of company's assets – what are company's assets and most importantly the real estates, their location, its vehicles – tourist cars and vehicles that serve credit applicant's operations;
- In view of company's costs – what is the amount dedicated to employees' salaries, what are the taxes it pays, what are the advertisement costs, what are the costs incurred for premises rentals etc.;
- In view of the financial ratios it has chosen – concerning each indicator we should know the condition it signals and correspondingly – its reference value;
- In view of collateral on offer – whether the collateral is highly liquid;
- Miscellaneous.

For example, in recent years most commercial banks define criteria that refer to loan's maximum amount issued to a single client (in banking practice this is called client limit), as well as to the maximum amount of loans per a single branch (branch limit). Naturally, in view of branches that are experiencing decline, the limit should be cut down.

We should establish clearly defined and reasonable values of the financial ratios included in the ownership analysis, liquidity analysis, solvency analysis, capital turnover analysis etc. For example, the ownership ratio that is calculated as ratio of equity to assets actually being indicator of the financial stability enjoyed by the company loan applicant should have optimal value of 0.5, and the minimum one should not be lower than 0.2. Each increase of its value is perceived as positive trend in company loan applicant's development. Once again, in the light of company's equity it is not suitable for the amount of the requested loan to be greater than the amount of equity.

The process of approval, modification, renewal and refunding loans should also be regulated in the credit operations' rules of each commercial bank.

The approval of a particular loan starts with answering the question: is the loan applicant in conformity with the criteria and requirements of the particular bank. The credit experts of the bank branches or in the head office start collecting the necessary information. The first meeting held with the loan applicant is essential since during it the credit expert receives information about the business history, the credit history, the funding need, the purpose, amount and term of the requested loan and the sources for extinguishing it correspondingly. During this first meeting the credit expert should on the basis of assessing some of the abovementioned criteria make a decision on whether to continue

working with the credit applicant. In the case of positive answer, the work on loan approval continues with filling a set of documents[2]. The information provided by the loan applicant should be reviewed and analysed in detail, and if necessary additional information is to be requested. Naturally, if it turns out that false data was furnished or the loan applicant does not wish to provide additional documents, the credit expert should give up on furthering the transaction approval.

A very important step in approving each loan irrespective of whether it is to be issued to physical person or legal entity, is paying a visit on the spot. The purpose of this step is to provide answers to questions about company's operations and the way it is organized, about the business project and the requested loan, the suppliers and clients, the inventories, the sales, the assets, the condition of the collateral on offer etc. In other words, the visit on the spot provides us with the opportunity to decide whether the requested funding is prospective. It is important to highlight on something – this visit on the spot should be performed by the credit expert that is accompanied by the director of the bank branch or by his/her direct manager, if he/she comes from bank's head office. In all cases this contributes for risk mitigation.

The elaboration of opinion on the credit transaction is the next step of the process on approving a requested loan. Of course, when it comes to requesting turnover funding, the principles to be conformed with differ from those that are applicable in the cases of funding investment projects.

When it comes to issuing loans for turnover funding we should analyse the following aspects:

- Historically speaking – the need of turnover funding in previous years;
- The net turnover capital – it actually creates buffer that will serve as banks' protection when issuing short-term loans. That is why turnover capital should be sufficient to ensure bank's adequate protection.
- The rate of turnover capital turn-over;
- Is the manufacturing process of seasonal character or not;
- Comparison of obligations' term to receivables' term;
- Comparison of the period during which the loan funding would be invested in the business project and the quantity of ready products it will manufacture etc.

We should establish different principles in investment funding and these are about the following:

- taking the economic situation of the country and the region into consideration and reviewing the development forecasts throughout the years of requested credit's "life";
- detailed review of the investment project, including via visit on the spot;
- assessing the feasibility of investment's commissioning period;
- assessing business cycle's duration;
- assessing the probability of additional unforeseen costs etc.

The elaboration of credit opinion includes financial analysis. The purpose each bank targets via its financial analysis is on the basis of selected financial indicators to assess loan applicant's capabilities to extinguish its debt in conformity with the terms and conditions defined in the loan agreement – principal and interest – basically, as well as fees and commissions, entries made for the collaterals, insurances and the addenda to these. This kind of detailed financial analysis requires calculating many financial ratio that will help analyse ownership, liquidity, profitability, financial equilibrium, capital turnover, operations, return, effectiveness, cash flows. We should specify that the resulting values of the individual indicators do not answer the question about loan applicant's creditworthiness. The bank

[2] The document set contains documents according to the provided template of each commercial bank and usually this includes application for loan issuing, statement on economically related parties, statement on business relatedness, statement on civil and economic condition, statement on lawsuits initiated by and against the commercial entity.

should follow up and analyse the changes of their values throughout various periods back in time, as well as the reasons behind these, especially if it is about negative trend.

An important moment about the credit operations of each commercial bank is the decision making on whether to issue the loan or not. Bank's credit board plays key role in this. It is specialized bank body and its obligations are about reviewing the credit opinions and decision-making on issuing, modifications or refusing a request for loan. In the case of positive decision we proceed to a very important stage – the preparation of the documents related to the credit transaction.

The principles to be conformed with refer to:

- the accurate writing down the loan agreement and all appendices to it (in order to minimize the risk of errors the banks use typical agreements);
- agreements' sealing by the authorized bank employees – credit expert, legal advisor;
- agreements' entering by bank and client representatives;
- entering the collaterals established in bank's interest in the statutory manner and having certificates issued on the absence of burdens on the collaterals established in the interest of other persons;
- payment of the due fees and commissions; entering the loan agreement in bank's accounting system.

What comes next is loan utilization and correspondingly – the last stage of the credit process – the loan agreement is being performed on behalf of the borrower. In the case of full extinguishment of the issued loan, the bank could hold discussions with the client about new loan. Client's regularity suggests walking the abovementioned steps in faster manner, such as visit on the spot, analysis, assessment and approval.

Nevertheless, we have a totally different situation when throughout the "life" of a particular loan debts are not being extinguished in the term and at the amount defined in the loan agreement. The presence of significant problems that render even loan re-negotiating impossible and unsuitable makes the bank undertake the following actions after analysing the situation in depth: forwards invitation for voluntary extinguishment or proceeds to compulsory debt repayment.

This situation may be present since banks' credit operations are accompanied by various risks, the most important one being the credit risk. The lessons learnt by the banking world and the consequences from the resulting economic and financial crisis brought about significant changes in managing bank risks. The successful management of credit risk is essential not only to each and every bank's stability and profitability, but to its reputation in the banking sector and its future. This could be achieved if the bank (State Gazette, edition 40, 2014, article 2) :

- Has in place internal rules and procedures for assessing credit risk that nevertheless are not solely and mechanically based on external credit ratings;
- Uses effective systems for current administering and monitoring of the various portfolios and expositions to credit risk;
- Uses systems for establishing and managing the problematic loans;
- Applies systems for making adequate corrections of the value of each exposition;
- Maintains exhaustive documentation related to each exposition, which contains the terms, conditions and circumstances inherent to transactions, information about assessment and establishment of corrections in view of credit risk.

Additionally, article 9, paragraph 1 of Ordinance №7 regulates the requirements towards the internal rules and procedures of credit risk management and these are aimed at:

- Defining the cases where there is general risk for the bank because of the credit concentration increase as a result of newly occurred relatedness;

- Introducing limitations on expositions' concentration to certain economic sector and/or geographic region.

The Regulation defines the irregular expositions as expositions in default. In order to be defined as such, the following two prerequisites or at least one should be conformed (REGULATION (EU) № 575/2013, article 178, paragraph 1, letters "a" and 'b"):

- The bank is of the opinion that there is not great chance for the debtor to fully pay its obligations towards it without having to undertake additional actions, such as exercising the collateral;
- If the debtor has been in delay for more than 90 days under significant part of its obligation towards the bank. The term of 90 days for retail expositions and expositions to subjects of the public sector could be extended to 180 days for expositions secured with residential real estate or business real estate in the case of small- and medium-sized enterprises.

The elements defined by the Regulation as indicators for the occurrence of default in relation to a particular debtor include the following events (REGULATION (EU) № 575/2013, article 178, paragraph 3, letters a) - f):

- The bank suspended the current interest accruals;
- The bank performs specific credit correction as a result of established significant deteriorating of credit quality;
- The bank sells the credit obligation and incurs significant economic loss related to this loan;
- The bank agrees to accept the compulsory restructuring of the loan debt that would most probably result in cutting down the amount of the financial debt;
- The bank requested opening a procedure for declaring the debtor insolvent or similar procedure in relation to credit debt of the debtor towards it;
- The debtor requested to be or was declared insolvent and this would result in delaying the extinguishment or in default under the credit debt towards the bank.

The early detection of indicators for default under the terms and conditions of the loan agreement is of paramount importance to each bank. This requires continuing monitoring over the loans that includes on one hand searching for and identifying the reasons behind turning one loan in exposition into default and finding a solution to cope with the problem.

Credit risk minimization requires that the banks operate actively in another direction: there should be operating internal bodies in place for risk identifying, monitoring and managing, including the credit risk. Hence the Supervisory Board of the bank is the one that approves and performs regular review of the passed strategies and policies for undertaking, managing, monitoring and reducing the risks the bank is exposed to or could be exposed to, ….(State Gazette, edition 40, 2014, article 2). The other internal body, that in conformity with the Regulation and Ordinance № 7 of the Bulgarian National Bank actively participates and ensures sufficient resources for managing all these significant risks, including for the processes involved in assessing the assets, as well as the use of external credit ratings and internal models related to these risks, is the Board of Directors/the Management Board….(State Gazette, edition 40, 2014, article 2) .

The Risk Committee (in some banks it is called Assets and Liabilities Management Committee) plays key role in achieving effective credit risk management. In conformity with the Regulation it is assigned with the following essential tasks (Regulation № 575/2013, article 190, paragraph 2):

- Categories and groups testing and monitoring;
- Elaborating and analysing summary reports based on institutions' rating systems;
- Introducing procedures for checking the consistent implementation of the definitions of categories and groups in view of the structural divisions and geographic regions;

- Reviewing and documenting the changes in the rating process, including the reasons behind the changes;
- Review of the forecasting capacity of rating criteria. The changes in the rating process, criteria or individual rating parameters are documented and stored;
- Actively participating in elaborating or electing, introducing and establishing the models used throughout the rating process;
- Controlling and monitoring the models being used in the rating process;
- Continuously reviewing and changing the models being used in the rating process.

3. CONCLUSIONS

The issues we discussed above do not cover all the range of problems concerning credit risk management in the banking sector in view of satisfying the requirements of Regulation 575/2013.

Banks in our country keep operating in the circumstances of unstable economic environment that inevitably requires quality management of the credit risk that results from issuing loans to business and citizens.

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