THE IMPORTANCE OF CREDIT CONTROL *

Poor asset quality, attributable to over-concentration, specialisation and poor risk selection, remains the main cause of problems in banks. In maintaining sound credit controls, a clear credit philosophy, and ongoing management of the loan portfolio with a view to identifying early warning signs of deteriorating asset quality, are also helpful. Whilst local institutions are well capitalised, they should ensure that the increasingly competitive environment does not tempt them to sacrifice their credit standards or pricing as a means of winning new business.

I am pleased to have been invited by Arthur Andersen to address you today on the importance of credit control. This, of course, is a subject which is very dear to a banking supervisor's heart. It is also one which remains as topical as ever.

On the face of it, this seems somewhat surprising. Surely bankers have learned their lesson once and for all, and would never repeat the mistakes of the past, when poor lending decisions, exacerbated by economic downturn, led to banks suffering debilitating credit losses? Surely attention would more gainfully be focused on more topical, and less well understood, areas of risk, such as market risk or the risks associated with dealing in derivatives?

The Threat Posed by Poor Asset Quality

Well, there is no doubt that it is quite appropriate for bankers and, for that matter, supervisors, to focus on "new" areas of risk, or areas that may have been neglected in the past. However, that is not the same thing as saying that "old" areas of risk can be ignored, and that the systems for assessing and controlling these risks can be taken for granted. Because the fact is that credit risk has never gone away. Certainly, there have been a number of recent high profile cases of banks getting into difficulties because of trading losses. But it is still poor asset quality that is the main cause of problems in banks.

A recent study by the Bank of England bears this out[1]. This showed that of 22 cases of banks in the United Kingdom which failed or got into severe difficulties since 1984, poor asset quality was a factor in 16 of the 22 cases. Dealing losses, incidentally, was a factor in only two, one of which, of course, was Barings.

The Bank study identified three main causes of these asset quality problems, some of which were present in more than one case. One was over-concentration – where the failure of one loan, or a small number of loans, placed the bank in jeopardy. Another was specialisation – where there was a concentration of the loan book in one sector, region, or to a group of individuals. The third was poor risk selection – where the bank made loans without correctly pricing the risk. The Bank study also noted that in a number of cases the macroeconomic environment was an important factor. Lending strategies which had seemed safe when the economy was booming – such as lending to the property sector – rebounded on the bank when the economy dipped and asset prices fell away sharply.

The truth of this latter point has been demonstrated by the recent economic slowdown in the Asia region which has uncovered problems in a number of banks which had lent too freely to the property sector or to over-geared borrowers. This has highlighted once again how vital it is that banks should maintain sound credit controls at all stages of the economic cycle.

The Key Elements of Credit Control

I do not think there is any mystery about what constitutes good credit control. Clearly the starting point is for the institution to get its strategy clear and to determine how much risk, and what types of risk, it is prepared to take. This then needs to be translated into policies, procedures,

* This is the text of a speech given by David T R Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, at the Arthur Andersen Seminar on "Hong Kong Financial Markets Towards 2000" held in Hong Kong on 9 May 1997.

1 Patricia Jackson (1996) : "Deposit Protection and Bank Failures in the UK" in Financial Stability review, Issue One, Autumn 1996.

and limits which will put these strategic objectives into practice. For example, policies need to be set on the types of facilities the institution will offer, what security will be acceptable, what country, industry and single borrower limits will apply, and how loans will be approved and administered. All these policies and procedures need to be communicated clearly to the staff of the institution, and checks put in place to ensure they are adhered to.

I do not propose to go into these processes in any great detail, as my colleague Mr Y K Choi will be speaking on this later this morning. However, there are a couple of points I would like to highlight.

First, one cannot overestimate the importance of establishing the right credit culture. Having a neat set of policies and procedures is a good start, but the application of these policies and procedures is far more likely to be successful if the institution has a clear credit philosophy which is well understood by staff, and to which staff are committed. It is also important to ensure that the message is consistent. For example, what are staff to make of a situation where the management espouses the importance of asset quality, but lending staff are remunerated for the volume of new business they bring in, seemingly irrespective of its credit quality?

Second, lending very rarely goes bad overnight. There are invariably warning signs of deterioration in a borrower's creditworthiness or repayment ability, and a prudent banker knows what these signs are and keeps his eyes open for them. In other words, once an asset is on the balance sheet it should not be forgotten. The quality of the portfolio needs to be monitored on an ongoing basis so that appropriate action can be taken to head off problems before they get any worse.

The Approach of the Monetary Authority

Perhaps I should say a few words now about what the Monetary Authority, as banking supervisor, does to ensure that banks' credit controls are prudent.

First I should mention the principal statutory limitations on advances in the Banking Ordinance. There are two key ones. First, under Section 81 of the Ordinance, authorised institutions which are locally incorporated may not lend an amount equivalent to more than 25% of their capital base to a single customer or group of connected customers. In practice, however, while 25% is the statutory limit, we would normally expect institutions to subject any loans of more than 10% of their capital base to particularly close scrutiny. Second, under Section 83 of the Ordinance, locally incorporated institutions may not lend unsecured an amount equivalent to more than 5% of their capital base to any single director or other party "connected" to the institution, and not more than 10% to all such persons in aggregate. Moreover, we would expect any such lending to be approved at arm's length, and for the "connected" director not to be involved in the approval process, so as to avoid a conflict of interest.

You will find provisions such as these in just about every supervisory system around the globe, the objective being to avoid concentrations of risk to individual customers, and to prevent dubious lending to "connected" parties, both of which have historically been the cause of bank failure, including in Hong Kong.

In addition to these statutory limitations, institutions are also required to follow guidelines issued from time to time by the Monetary Authority. We issued a guideline on loan approvals – or at least our predecessor the Office of the Commissioner of Banking did – in 1987, setting out the basic principles for establishing a lending policy and loan approval and loan review systems. The content of this still holds good. We also issued a guideline, in 1994, on loan classification, the objective being to encourage institutions to assess their asset quality and level of provisioning on an ongoing basis, and also to provide us with a means of monitoring the asset quality of the sector as a whole, so that we can be alerted to any deterioration in asset quality.

So, there are statutory limitations, and we have issued guidelines on loan approvals and loan classification. But how do we monitor institutions' credit controls and asset quality on an ongoing basis? To start with, we get a number of regular quarterly returns. One shows the institution's largest exposures, enabling us to confirm compliance with the relevant provisions of the Ordinance and to monitor the institution's "lumpiest" exposures. Another shows the institution's loans and advances

broken down by industry type, enabling a check to be made on concentrations to particular sectors of the economy. Another is on loan classification, breaking down the institution's book into pass, special mention, substandard, doubtful and loss categories. From this we can monitor how the institution's asset quality is holding up.

In addition to this off-site monitoring, each locally incorporated institution is the subject of an on-site examination each year. During examination of an institution's credit controls, we will examine the institution's policies and procedures, assess how well they are being applied, and offer recommendations on how they could be improved. Although a sample of loans is usually reviewed as a means of checking that approval procedures are being followed and that loans are being classified correctly, the focus of the examination is more on the controls angle, the emphasis being on identifying weaknesses which, if uncorrected, could lead to problems in the future.

The Current Position of Local Institutions

So where do local institutions currently stand as regards credit risk? The first thing to note is that they are very well capitalised – the average capital adequacy ratio is 17.8% – and this provides a good buffer against credit losses. Second, they are prudently provisioned. Third, their asset quality remains relatively good. Although the bad debt charge for locally incorporated institutions more than doubled in 1996 from 0.08% of total assets to 0.18%, and of course any deterioration is unwelcome, this is still quite good by any standards. Moreover, the ratio of overdue loans to total loans actually improved in 1996, to 2.44%, as did the ratio of classified loans net of specific provisions to total loans, to 1.71%. These figures suggest that most banks are managing their credit risk pretty well, although admittedly it is easier to do this when property, and therefore collateral, values are rising as they did in 1996.

However, there are warning signs from the increase in the bad debt charge in 1996, which should not be ignored. Most of the increase related to a small number of listed companies which got into financial difficulties. In some cases the deterioration in the financial condition of the borrower was fairly rapid, but in other cases it is possible that closer monitoring of the borrower, including a better understanding of the business of the borrower and what the borrowed funds were actually being used for, could have led to problems being identified earlier. Another lesson of these cases may be that better control is achieved by lending directly to the operating unit that will actually utilise the funding rather than to a group holding company. Another lesson is that a Stock Exchange listing is not in itself a guarantee of financial strength, and certainly does not mean that lenders can relax on their initial assessment of listed companies and on their ongoing monitoring. The same point could be made about banks which participate in syndicated loans originated by other lenders. They should certainly undertake sufficient due diligence to know what they are getting into. The final lesson is that with over-extended borrowers it is actual cash flow that matters rather than accounting profits.

The Outlook for Asset Quality

Moving on now to the bad debt position this year, the first thing to note is that the macro-economic environment is rather better now than it was last year. And given the clear link between the business and economic cycle and credit losses, this bodes well for this year's performance on bad debts. This does not mean, however, that banks can relax their guard. In particular, they need to ensure that the increasingly competitive environment in Hong Kong does not tempt them to sacrifice their credit standards as a means of winning new business. For example, as has already been seen in other countries, there may be pressure to relax loan covenants, or to extend maturities imprudently. From the bank's point of view this may be expedient, and it may feel that it can justify to itself each deviation from its normal credit policies. However, as history has shown, it is just storing up trouble for the future.

Similarly, banks need to ensure that their pricing gives them an adequate return for the risk they take on. We have seen competition forcing down margins on mortgage loans, personal loans, and corporate loans, including in the syndicated credits market. While banks cannot, of course, ignore competitive pressures, they need to ensure that the return is commensurate with the risk – otherwise, again, they are just storing up trouble for the future.

The Importance of Portfolio Management

A particularly difficult question for banks to grapple with is the extent to which they should seek to diversify their business. As I noted earlier, concentrations of various types – to particular borrowers, particular industries, and particular sectors of the economy – have been the downfall of many a bank. However, while this suggests that banks should place great importance on diversifying their portfolio, in practice this is rarely straightforward.

Take as an example banks' property lending. Clearly, many local banks have a heavy concentration on the property sector, mostly in the form of residential mortgages. Mortgage lending is something they know well, are good at, and it is profitable. Their lending criteria, such as the loan to value ratio and debt service ratio, are prudent, and the loan loss record so far has been very good. Why, then, should they diversify into areas of business with which they have less familiarity and which seem more risky? For example, does it really make sense for them to diversify away from mortgage lending towards unsecured personal loans?

This is a very difficult question. I think that we would all agree that over-concentration in lending for property development and for speculative property investment is something that should definitely be avoided – historically this has been shown to be a major cause of banking problems. Residential mortgage lending seems to be more innocuous, as indeed it is. However, the fact remains that mortgage lending is long-term, and has to be financed mainly by short-term deposits. So there is a liquidity risk that must be managed. Moreover, the higher property prices rise, the greater the possibility that the boom will be followed by bust. So there is a market risk which banks have to handle. This risk increases as interest rates rise which is a factor beyond the control of individual banks. Rising interest rates also put strain on the repayment capacity of borrowers, particularly those which have acquired residential properties for "investment" rather than end-use reasons. So there is also a credit risk, though this will probably only arise in somewhat extreme market circumstances. Finally, there is what might be termed a "business risk" for banks of being too heavily dependent on one particular source of income, with the possibility that that source may diminish if market conditions change.

We must be careful not to overplay these risks. It is certainly not in the interests of either the banks or their supervisors for them to diversify blindly for its own sake. Logically, however, there must come a point where concentration to a particular sector – however "low risk" that lending may be – starts to become a bit of a liability. Judging where that point may be is no easy matter. But that is what banks should try to do, taking into account their own particular circumstances. The amount of mortgage lending – and of other types of loans – that banks are prepared to put on should be part of a conscious and well-considered portfolio management strategy. What they should try to avoid is simply chasing more lending volume because they feel that they have no other option. This can lead to a vicious circle where more and more volume is required to offset the effects of a decline in margins which has been caused by the chase for volume in the first place.

Conclusion

I hope these comments have given you some food for thought. To stress again the point I made at the beginning, prudent management of credit risk is still the key to success for most banks. Arthur Andersen are to be congratulated for putting this seminar together and I hope that you will find it useful. Thank you. ❁