

Is a Loan all about Credit Risk?

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Disclaimer

The views expressed in this presentation are not necessarily those of Kuwait International Bank.

The presentation is based on research conducted for my thesis entitled
Examining the magnitude of Operational Risk in the Lending process in Banks.

The thesis was accepted by
Liverpool John Moores University in 2012.



AIB 'didn't check background' – fraud accused

A MAN accused of orchestrating a €920m fraud against AIB has claimed the bank never asked him for background information about himself when a series of loans were taken out to buy high-end UK properties.

Achilleas Kallakis, who denies a series of fraud charges, along with his business partner Alexander Williams, yesterday said that he met members of the bank's property team once a week over an intensive three-year period when deals were being done.

The businessman denies using falsified rent guarantees from a well-known [Hong Kong](#) property giant, [Sun Hung Kai Properties](#) (SHKP), to secure the loans from AIB between 2003 and 2008.

Mr Kallakis claims he was a negotiator in the property deals on behalf of the Hermitage Syndicated Trust, which benefited his children.

When asked yesterday whether he was aware the bank saw him as the principal in the deals, he said he was not, as the bank had details of his children as beneficiaries.

Mr Kallakis said he had told AIB that he had an "informal agreement" with SHKP.

When the bank wanted to meet with a member of SHKP in late 2007, a meeting occurred with a man called Jonathan Lee, who was said to be from the treasury department of the company. The prosecution allege him to be an imposter.

Quite obviously, credit procedures appear rather relaxed in this real life case.

The loan default of GBP 740 million is currently in a London court.

Source:

The Irish Independent
21 November 2012

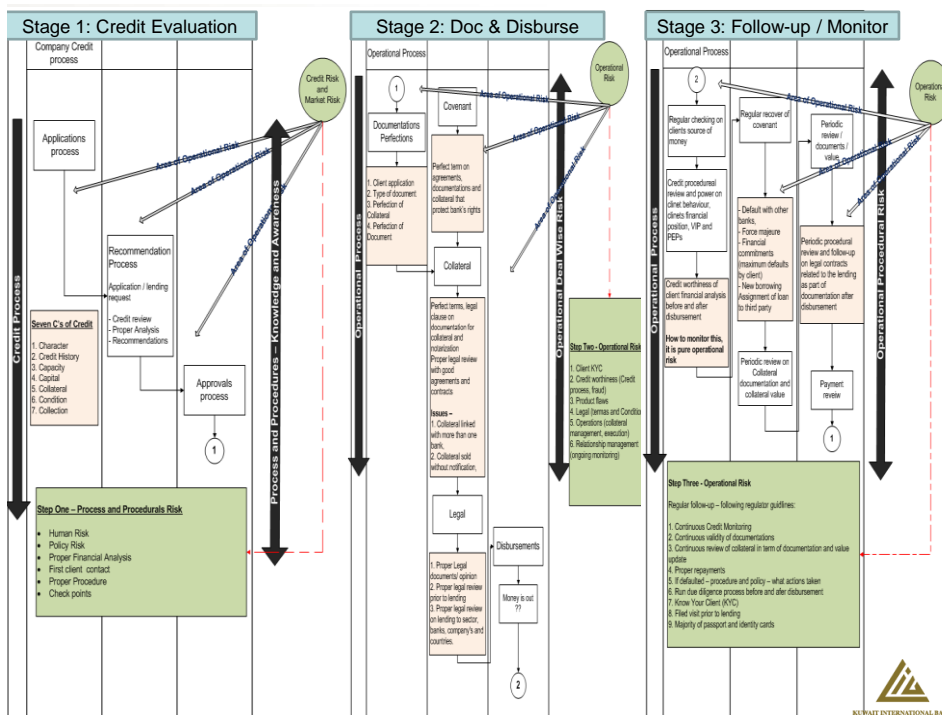
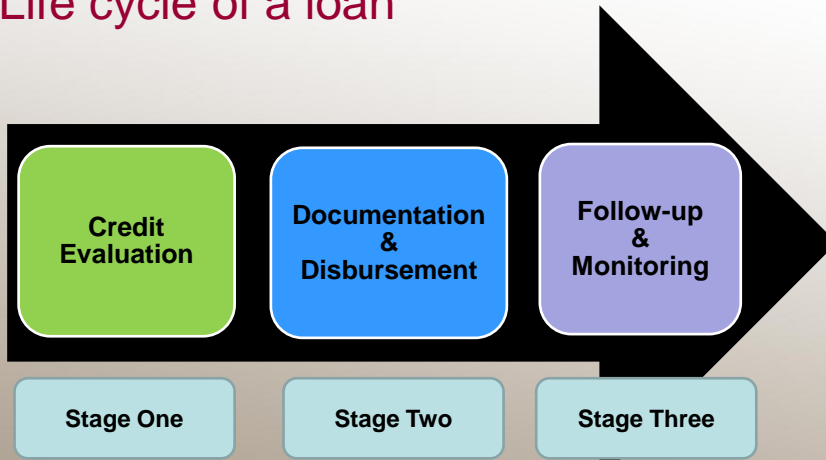


What happened?

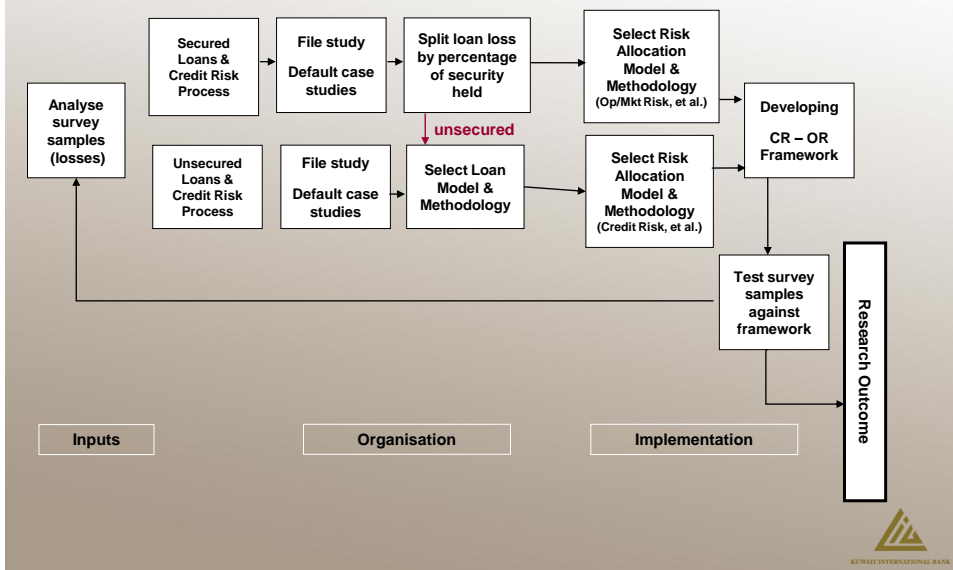
- Customer background not checked
- Falsified rent documents
- Conditions not clearly stated
- Informal agreement between client and guarantor accepted
- Imposter representing the alleged guarantor
- Which of the above 5 points refer to credit risk?
- We're talking about compliance failures, fraud, negligence and ignorance of credit procedures.
 - ↳ Operational risk all the way!



Life cycle of a loan



Data analysis framework



Approach

Deal Process Cycle		Type	Weight %	Grade	Score	Max score		Case 1
Stage One - LENDING								
1. Pre-approval stage								
1.1	Review criteria on borrowers application	C	4%	5	0.20	0.20	C	x
1.2	Complete the credit application	C	3%	5	NA	-	NA	x
1.3	KYC procedure	O	6%	5	0.30	0.30	O	x
1.4	Customer grading	C	1%	5	0.05	0.05	C	x
1.5	Credit reference bureau check	O	3%	5	0.15	0.15	O	x
1.6	Evaluation of collateral	O	6%	5	0.30	0.30	O	x
1.7	Review of credit proposal	C	3%	5	0.15	0.15	C	x
1.8	Credit recommendation	C	5%	5	0.25	0.25	C	x
1.9	Risk review and recommendation	C	5%	5	0.25	0.25	C	x
1.10	Authority approval	C	5%	5	0.25	0.25	C	x
Stage Two - PROCESS AND PROCEDURE								
2. Post-approval and pre-disbursement stage								
2.1	Follow up on missing/additional documentation vs requ	O	3%	5	0.15	0.15	O	x
2.2	Complete missing documentation	O	4%	5	NA	-	NA	x
2.3	Complete necessary procedures related to collateral	O	5%	5	0.25	0.25	O	x
2.4	Internal valuation of collateral	O	5%	5	0.25	0.25	O	x
2.5	Perfection of legal documentation	O	5%	5	0.25	0.25	O	x
2.6	Facility pricing	O	5%	5	0.25	0.25	O	x
Stage Three - FOLLOW UP AND MONITORING								
3. Post disbursement stage								
3.1	Regular check on borrower source of payments	O	3%	2	0.06	0.15	O	x
3.2	Regular check on o borrowers behaviour position	C	3%	5	NA	-	NA	x
3.3	Monitoring on borrowers financial position	C	5%	3	0.15	0.25	C	x
3.4	Regular update of borrower documentations (address / i	C	3%	1	0.03	0.15	C	x
3.5	Regular review of collateral (valuation / documentation)	O	4%	1	0.04	0.20	O	x
3.6	Follow-up on clients repayment	O	3%	1	0.03	0.15	O	x
3.7	Communication with collection unit if borrow deferred ;	O	4%	4	0.16	0.20	O	x
3.8	Regular review on borrowers legal agreements and cont	C	4%	5	0.20	0.20	C	x
3.9	Run on field visit after lending	O	3%	3	0.09	0.15	O	x
			100%	4.31	3.81	4.50		

Total score	85%
Total Operational Risk	60%
Total Credit Risk	40%
Total number of activities	25
Total number of applicable activities	22
Total possible score	



Approach – cont'd

Total score	70%		
Total Operational Risk	51%		
Total Credit Risk	49%		
Total number of activities	25		
Total number of applicable activities	22		
Total possible score			
GRADE			
1	the activity was conducted perfectly		
2			
3			
4			
5	The activity was not conducted at all		
Proposed Weight %			
1%	Lower activity rate		
2%			
3%			
4%			
5%	higher activity rate		



Data collection

- Data collection done in three stages:
 - Survey questionnaire to collect default cases,
 - One questions on risk allocation to risk professional
 - One-to-one interview with professional
- **Focus of questions** – Segregation of the two risks (Operational and Credit) and allocation of risk type to loan size and loan type in loan process cycle
- One-to-one interviews with 3 professionals in the filed, Risk Manager, Operational Risk Manager and External Consultant / Advisor, to support wrap-up of the findings.
- Collected 120 loss cases (Bahrain, China, Japan, India, Qatar, UAE)



Default case submission validation

Cases	N	%
Valid	120	100.0
Excluded	0	0.0
Total	120	100.0

Default case submission validation

Cronbach's Alpha	N of items
0.835	8

An alpha of 0.835 describes the consistency between responses of respondents. Thus, through this result it is assumed that the responses are all reliable.

Actually, estimating internal consistency (reliability) from the average correlation, the formula for alpha also takes into account the number of items on the theory that the more items considered, the more reliable a scale will be.



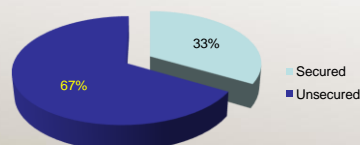
The results

- There was no material difference between wholesale and retail bank responses.
 - Conclusion: Large transactions do not necessarily command more careful procedural handling (see opening case).
- Workout chances are viewed with scepticism as to recovery success.
 - Conclusion: Once you are in trouble, it's hard to recover.



Secured vs. unsecured loans

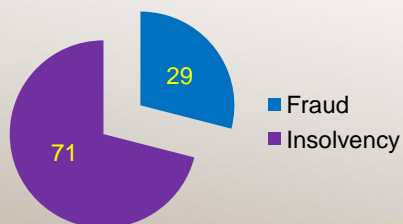
- The 120 cases received consisted of
 - 33% secured loans and
 - 67% unsecured credits.



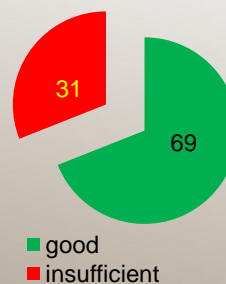
- The unsecured percentage is high!
This may have geographical and socio-economic reasons as the majority of cases came from the Gulf. It should be interesting to see the results from a similar study in another part of the world.



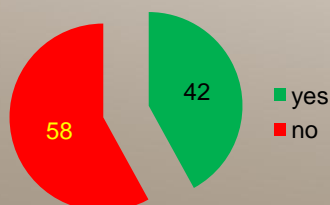
Primary cause for default



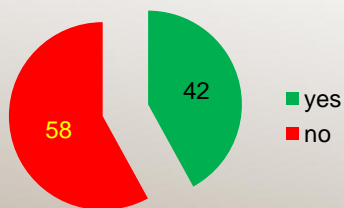
Adequacy of procedures



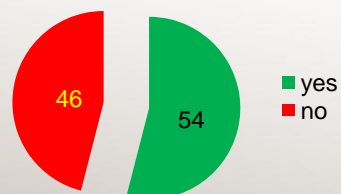
Procedures followed



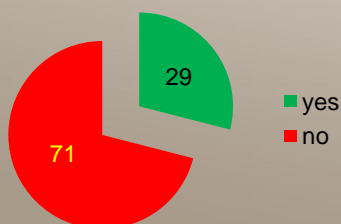
Credit agreement reviewed by Legal



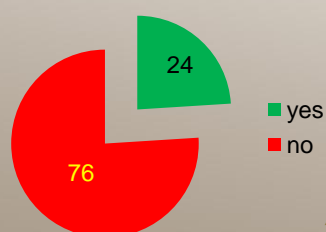
Documentation in place at time of disbursement



Collateral secured prior to disbursement



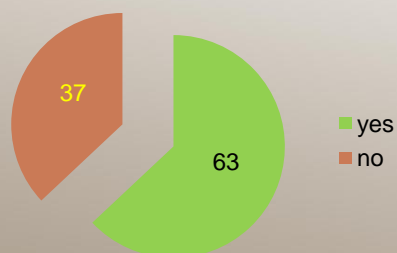
Collateral periodically reviewed



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The most important question

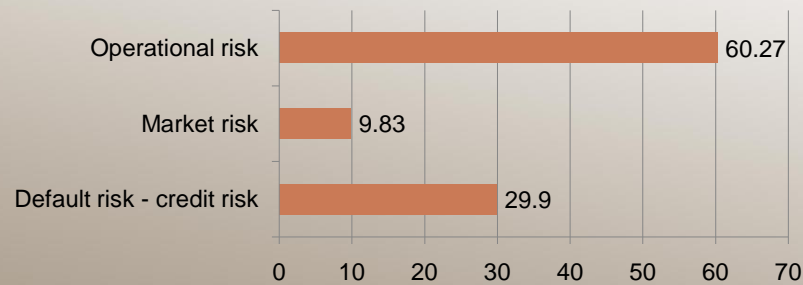
- Could the loss have been prevented?
- In the opinion of responding risk managers:



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Causal breakdown summary

- Respondents broke down reasons for the default into the corresponding risk categories.



Conclusions

- Through proper process risk management, a lender can increase competency and reduce operational failures.
- The bank's operational risk function can contribute to sustainable growth by promoting sound financial discipline and application of strategies.
- Although a majority of loan losses are no longer fully recoverable, lenders are still making efforts towards recovery which might end in additional costs when the recovery effort is badly managed.



Conclusions – cont'd

- Lenders need to do proper due diligence on the borrower and his social and economic environment.
- Credit risk is by far not confined to a poor assessment of the borrower's potential to repay; risk begins in the lender's own operational process.
- Lending procedures should periodically be reviewed.
- Prior to financing a project, lenders should assess their own operational capabilities.



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