Improve risk return with Credit risk management

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ZANDERS

TREASURY ▪ RISK ▪ FINANCE

Agenda

1. Brief introduction
2. Introduction to Credit Risk – a banking perspective
3. Improve risk return – Loan Origation
4. Improve risk return – Non performing exposures

Introduction

Zanders company profile

Zanders is a consultancy firm specialized in Treasury, Risk and Finance. We employ over 200 professionals in 8 countries. Powered by experience and driven by innovation, we have an extensive track record with corporate, financial and public sector clients.

Founded in 1994	200+ Professionals	8 Offices	500+ Clients	3,000+ Projects

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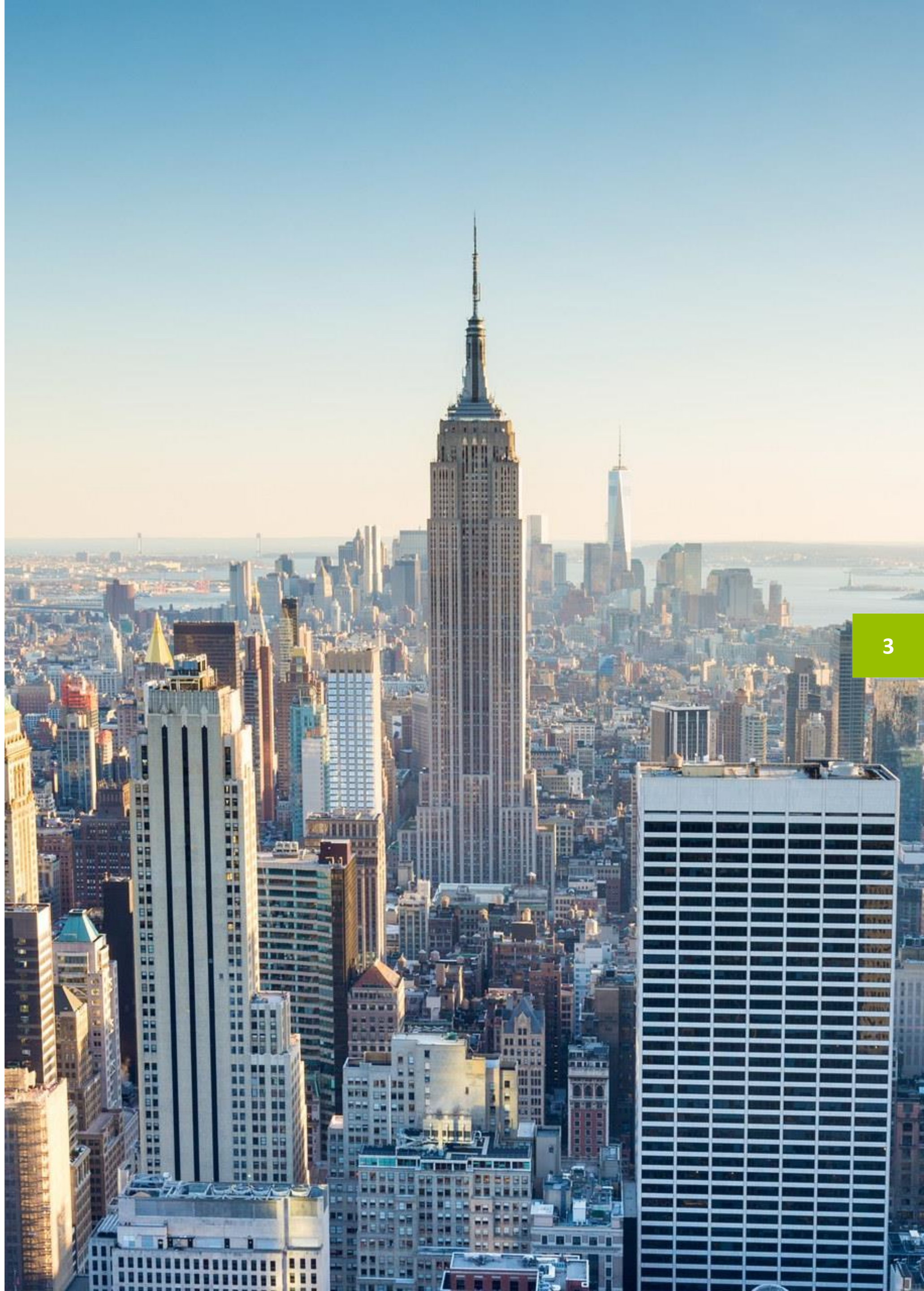
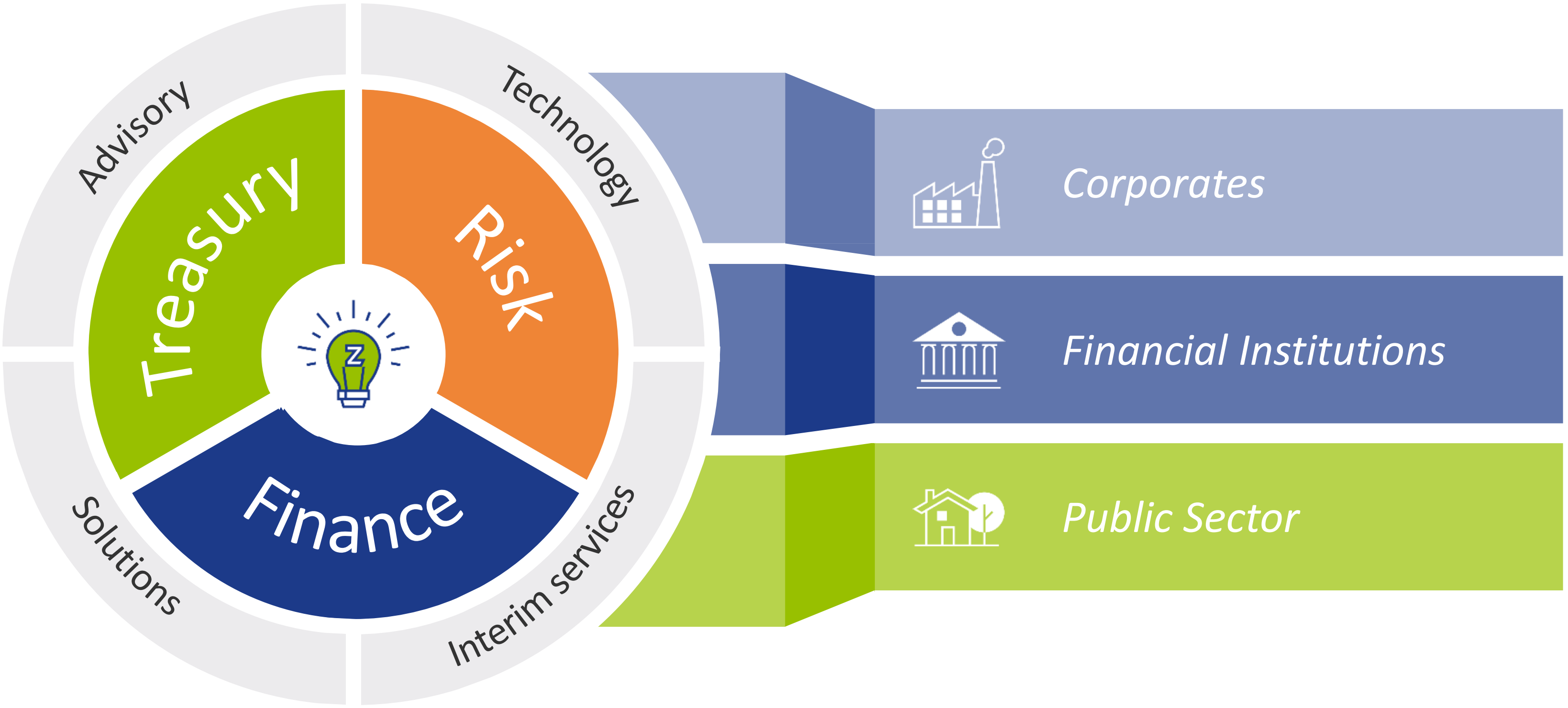


Our Services

Zanders offers Treasury, Risk and Finance services across markets



Our Track Record

Zanders has an extensive track record with international clients

35+
Countries

500+
Clients

3,000+
Projects

Legend

- Zanders locations
- Project countries
- Project locations

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Introduction to credit risk – a banking perspective

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Introduction to credit risk – a banking perspective

Credit risk is the risk of a party incurring losses due to failure of a counterparty to meet its financial obligations

CREDIT RISK TYPES

Default risk

STANDARD & POOR'S

Downgrade risk

Settlement risk

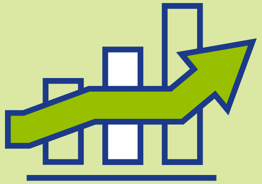
Introduction to credit risk – a banking perspective

Credit risk materialisation differs per investment strategy

INVESTMENT STRATEGY

Hold to collect

e.g. loans and mortgages



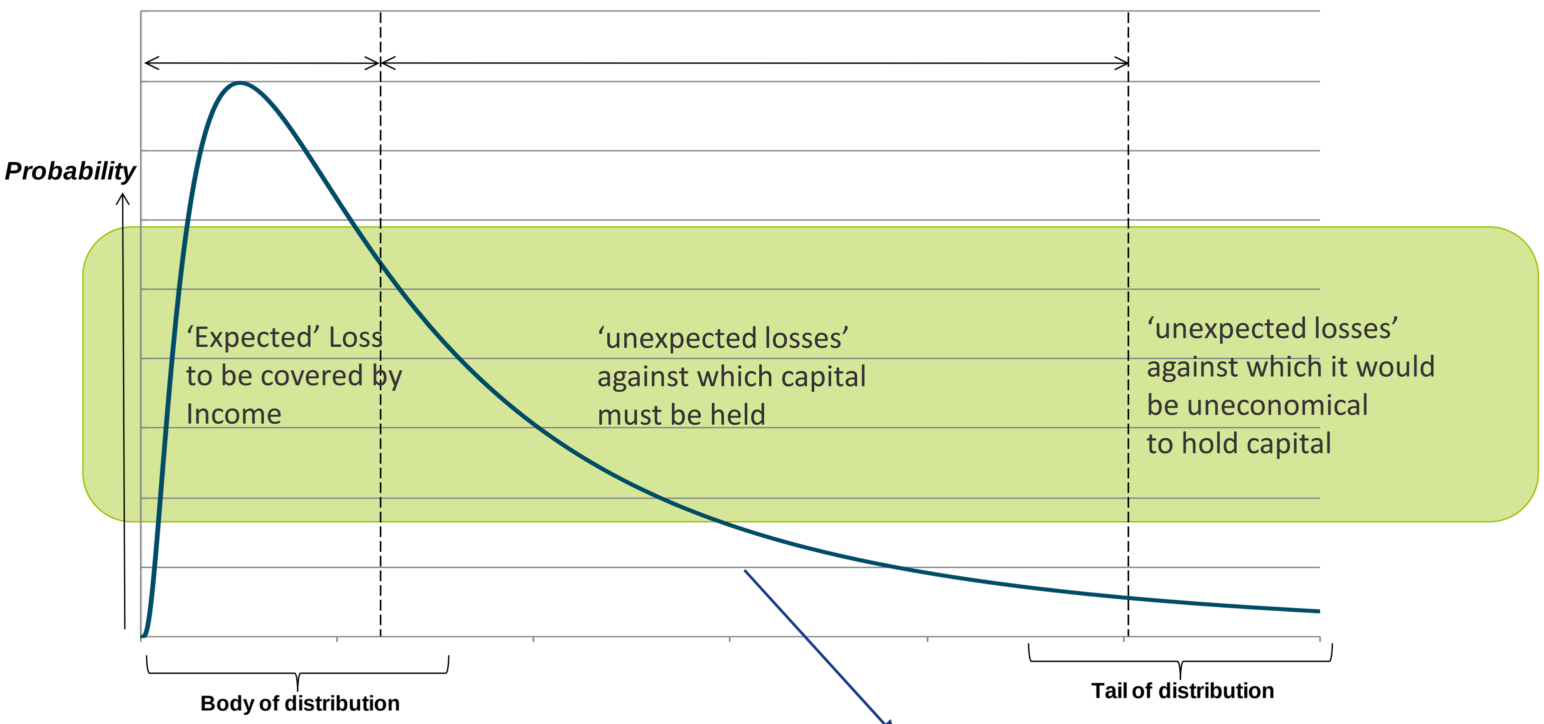
Buy and sell

e.g. bonds

Introduction to credit risk – a banking perspective

Many investments will not generate losses, expectation is that only a small percentage will default. On portfolio level this will result in a loss distribution function, with a peak around the small losses.

A bank perspective



Banks and insurance companies are required to hold sufficient capital on their balance sheet for unexpected losses

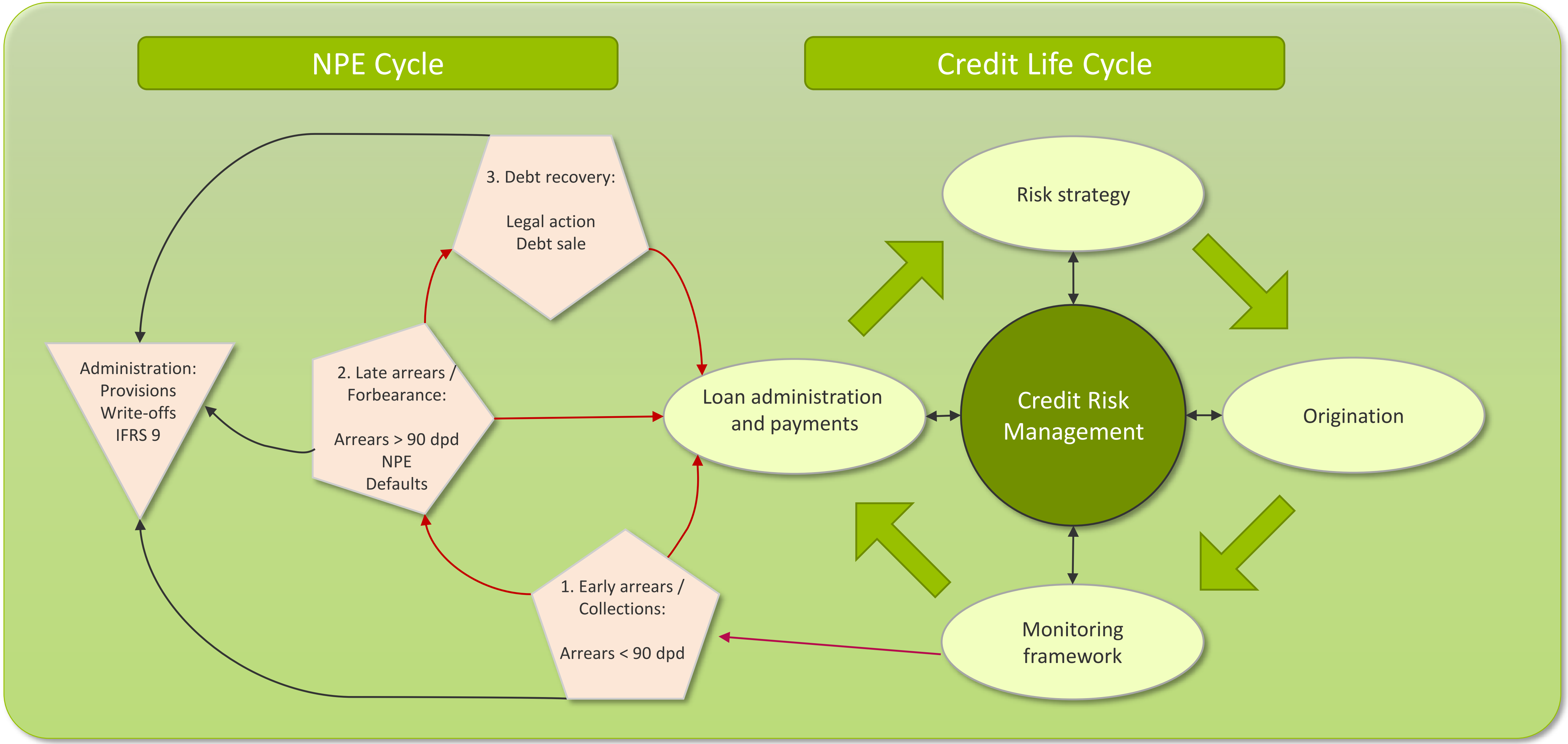
The loss distribution function shows the necessity to anticipate for a number of defaults.

On portfolio level, the credit margin in the loan coupon should cover for the realised losses.

Credit risk management aims at:

- Onboarding the targeted amount of credit risk
- Properly pricing for the amount of credit risk
- Manage the portfolio and defaults to keep losses limited

Introduction to credit risk – a banking perspective



Discussion 1

Credit risk has material impact on performance

- How to properly assess performance from credit risk in single names, industries and country risk?
- Do illiquid investments that are hold to collect the interest also have upward potential or only downside risk?
- What is the impact of long maturities in illiquid investments such as loans eg:
    - Corporate/SME lending
    - Project finance
    - Retail mortgages
- What is the impact of illiquidity on non-performing investments?

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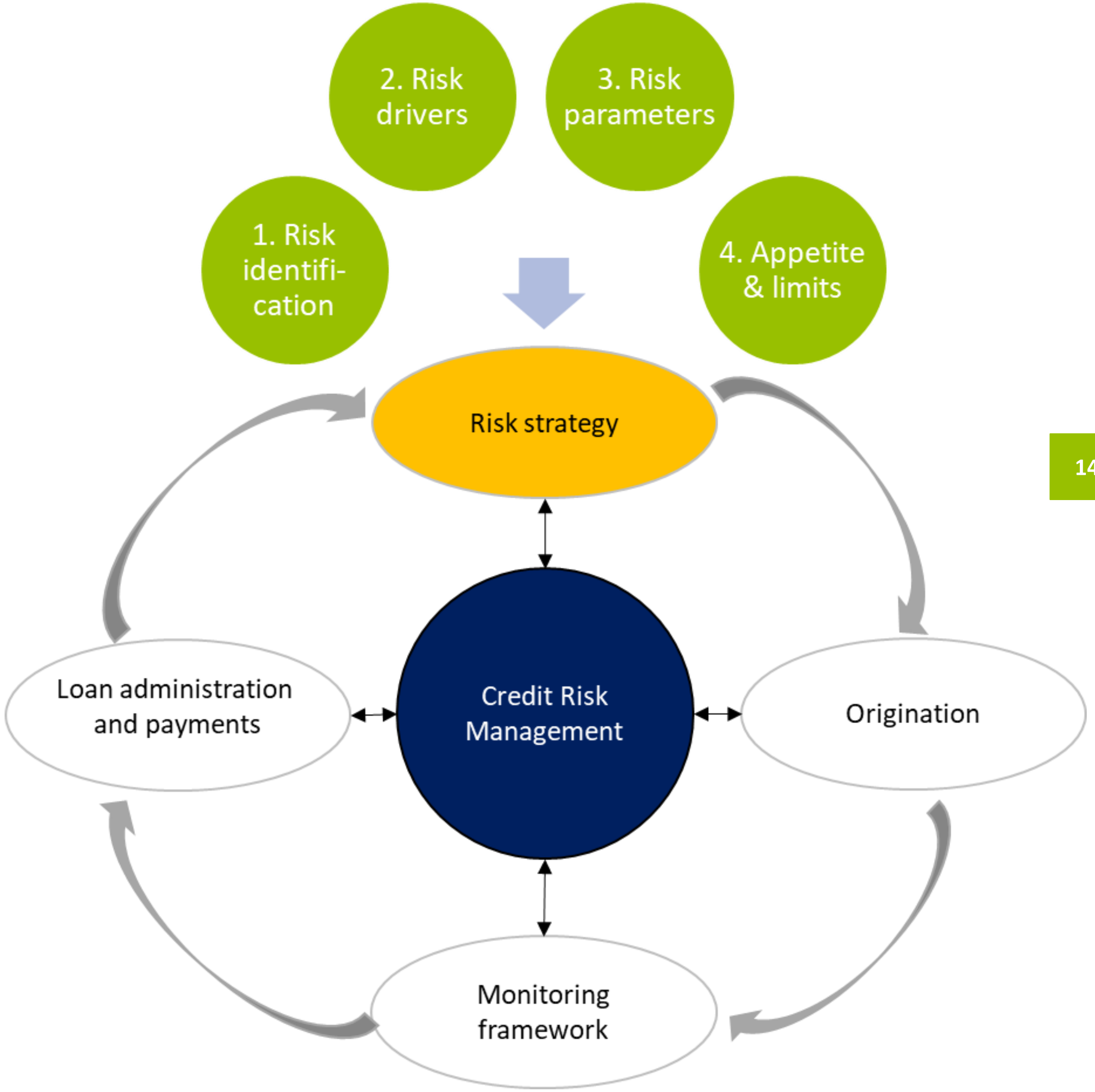
Credit life cycle | Origination

Credit life cycle | Risk strategy

Clear understanding and strategy of the risks in the business is key for proper credit risk management:

1. Identification of all material risks
2. Understanding of the drivers of the risks
3. Definition of risk parameters that give insight in the level of credit risk
4. Appetite for risk and limits



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Credit life cycle | Origination

1. Investment criteria

- Acceptance criteria, e.g.:
  - Loan size below certain threshold EUR 2 million)
  - External credit score above certain threshold
  - P&L or equity above certain figure (EUR 0)
  - Debt service coverage ratio (DSCR) above a certain level (100%)
  - LtV $\leq$ 100%

2. Counterparty information

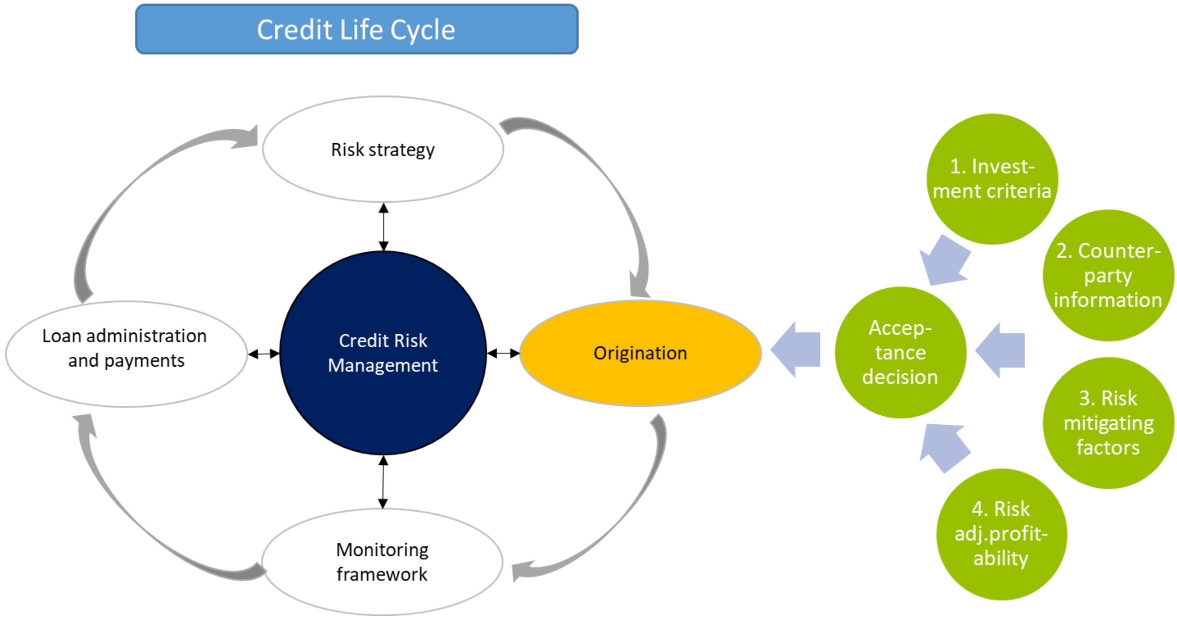
- **Counterparty and loan details**: purpose of the loan, source of repayment capacity
- **Small, Medium and Large enterprises**: also business plans supported by financial projections
- **External Credit bureaus:** e.g. BKR, Risk navigator score, FICO score, Delphi score, Credit Safe, Experian

3. Risk mitigating factors

- Guarantees
- Collateral
- Credit structure: (un)subordinated
- Legal documentation: contingencies

4. Risk adjusted profitability

- Return
- Risk adjusted return on economic capital (RAROC)
- Return on Risk weighted assets (RoRWA)
- Capital
- Provisions



Discussion 2

In the origination process you balance between mandate, risks and pricing

- Are investment criteria sufficiently set from credit risk perspective?
- Is sufficient amount of counterparty information available?
- Are mitigating factors really risk based?
- Is risk adjusted performance properly assessed?

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NPE Cycle | Pre-/Early arrears

Payment processing and managing arrears is an important part of credit risk management. Material difference in the process is applied for the various stages in the NPE cycle:

Pre-arrears: A borrower is not in arrears, but there are early warning signals (e.g. Debit card cancellation, adverse movement in the sector).

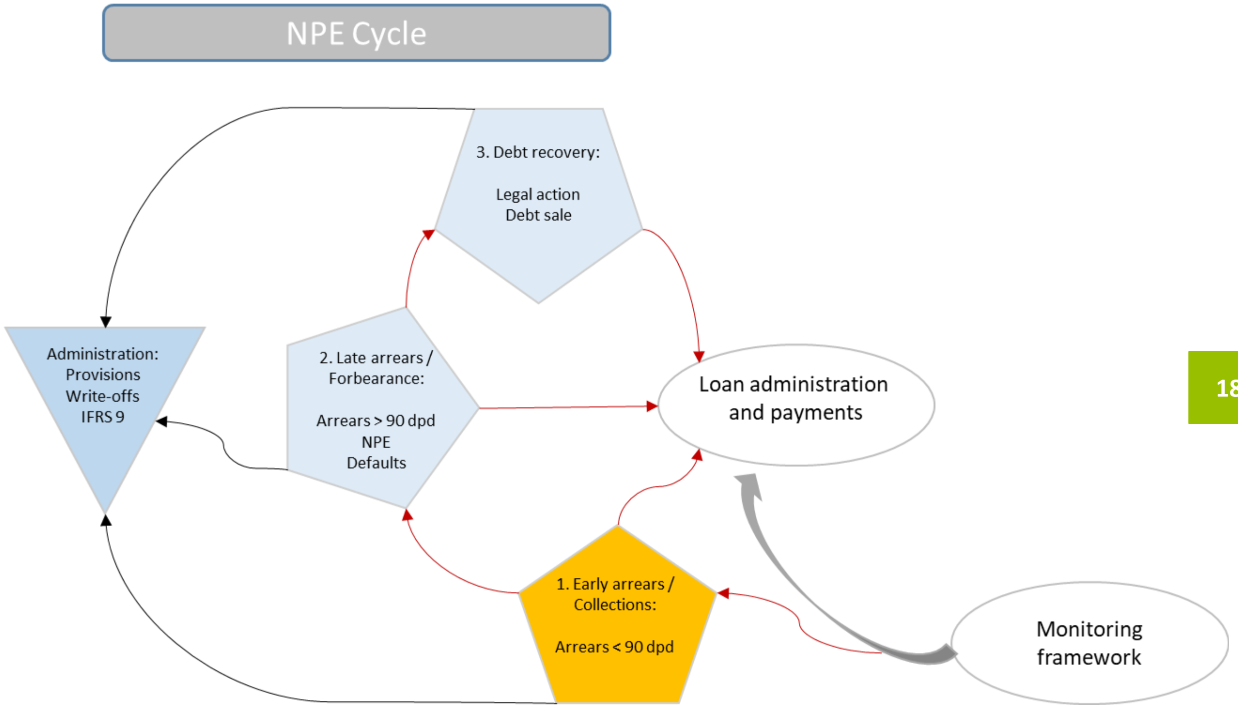
Actions:

- gather overview of borrower's financial situation;
- encouraging the borrower to work towards a solution for its issues;
- offering the borrower short-term forbearance measures.

Early arrears: the borrower is in arrears and the days-past-due counting has started.

Actions:

- engaging the borrower for early recoveries;
- collecting information to enable a detailed assessment of the borrower its circumstances (e.g. financial position, status of loan documentation, status of collateral, level of cooperation);
- offering short-term forbearance measures



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NPE Cycle | Late arrears / Forbearance

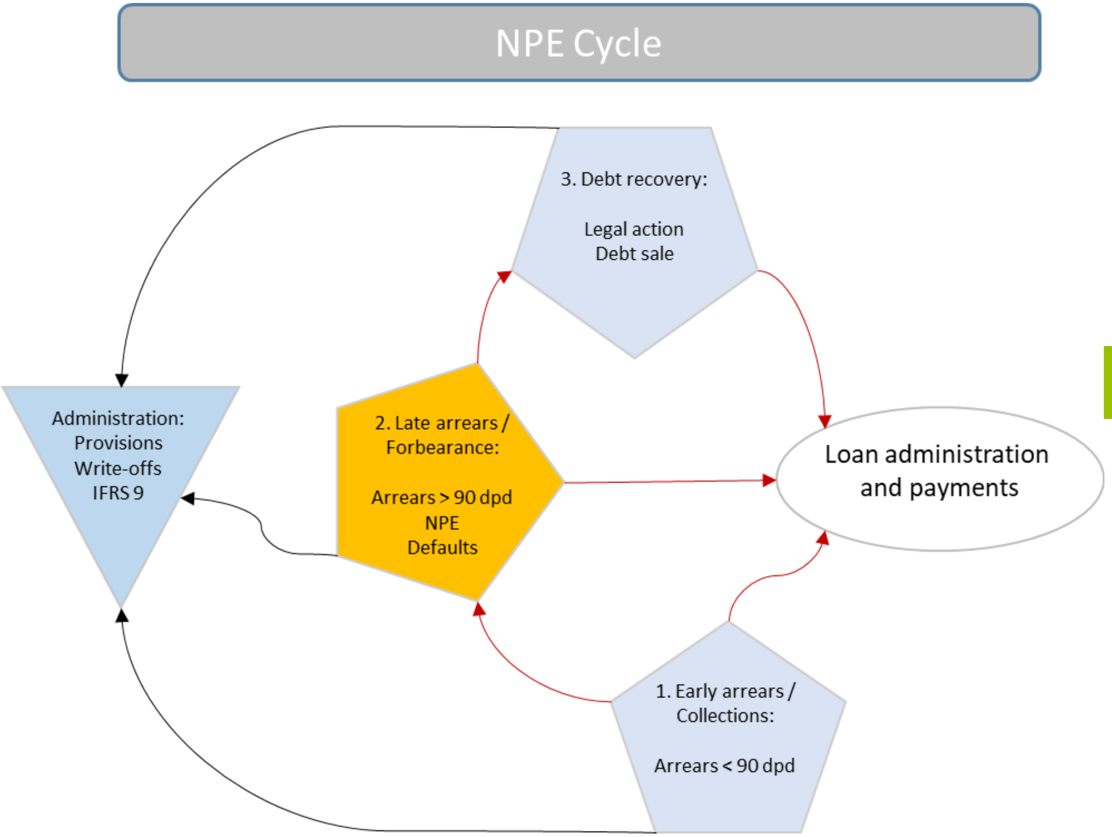
Late arrears / forbearance: A borrower is classified as NPE, and in most cases more than 90 days-past-due.

Actions:

- Initiate recoveries;
- assessing the financial position of the borrower based on new information;
- offering short/long-term forbearance measures.

Forbearance measures:

- Forbearance measures must support the borrower in repaying the financial commitment;
- After granting the forbearance measure, full repayment – including outstanding arrears – must be expected;
- Consumer protection and fair treatment of customers are taken into account;
- Forbearance measures cannot be extended indefinitely.



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NPE Cycle | Debt recovery

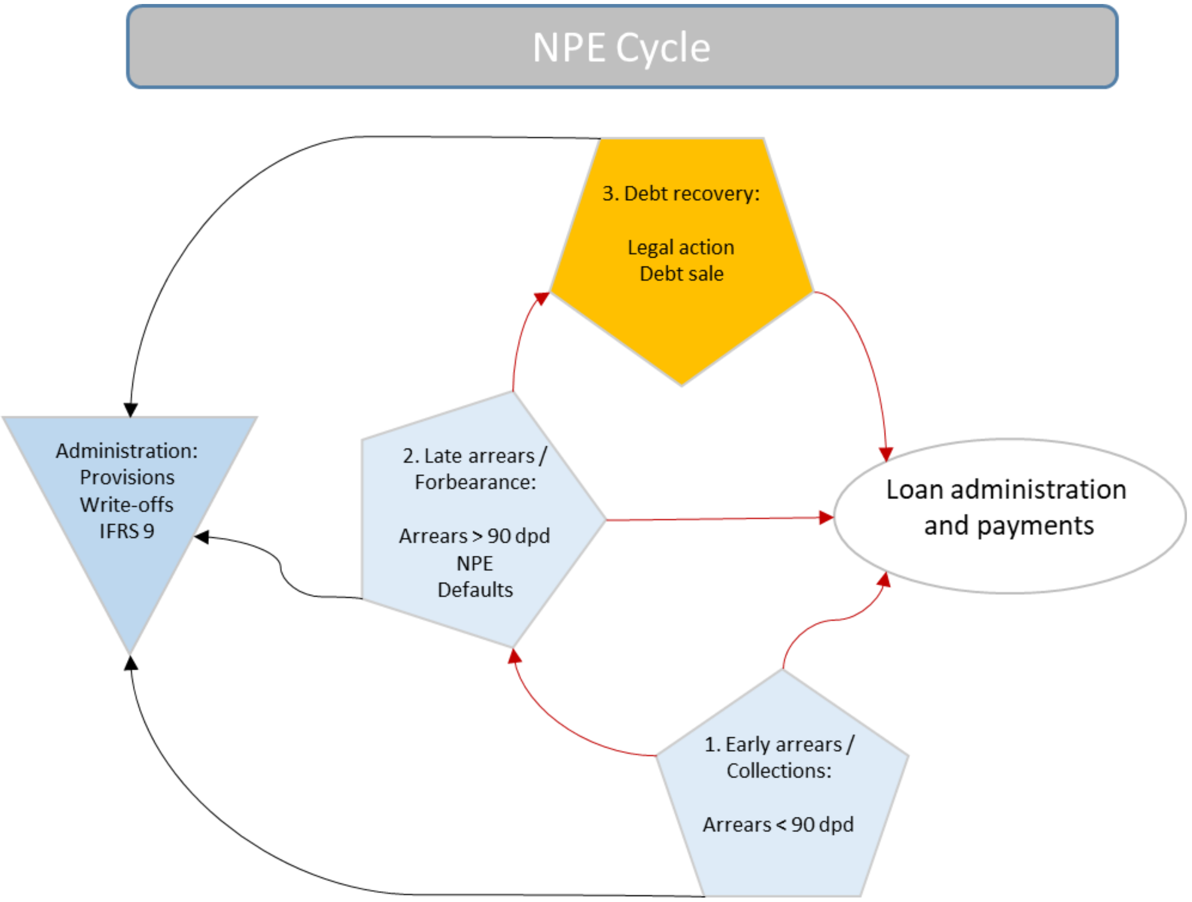
<u>Debt recovery</u>: A borrower is classified as NPE and forbearance measures are not considered anymore. The most cost-efficient way of collecting the highest number of recoveries is assessed, taking the fair treatment of borrowers into account.

Actions:

- performing a cost-benefit analysis of different debt recovery options;
- commencing formal legal or insolvency proceedings;
- taking additional security from guarantors, where necessary;
- selling the NPEs;
- monitoring and reporting on performance of debt recovery activities.

Typically, processes are tailored for:

- Deceased borrower (e.g. make claim for estate, from personal guarantor or other liable parties)
- Bankruptcy (loan is written-off)



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Discussion 3

Managing the NPE cycle reduces your losses

- Where to put your energy:
  - Pre-arrears/early arrears
  - Late arrears/forbearance
  - Debt recovery

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