

Standard 4.4a

Management of credit risk

Regulations and guidelines



RAHOITUSTARKASTUS
FINANSINSPEKTIONEN
FINANCIAL SUPERVISION

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1 APPLICATION

Issued on 25 May 2004
Valid from 1 January 2005

(1) This standard comprises the core principles of credit risk management as well as provisions on the establishment and maintenance of the function. It concerns the following entities supervised by the Financial Supervision Authority (FSA):

- credit institutions
- investment firms
- financial holding companies
- central bodies as referred to in the Act on Cooperative Banks and Other Cooperative Credit Institutions
- parent companies of financial and insurance conglomerates primarily engaged in financial activities.

Issued on 25 May 2004
Valid from 1 January 2005

(2) The entities under the scope of this standard differ from each other with regard to the volume of their activities, their organisation, the range and complexity of their financial services and the profile of their customers. Therefore, specific credit risk management and control practices may differ among the entities depending on the focus and special characteristics of their credit activities.

Issued on 25 May 2004
Valid from 1 January 2005

(3) The core principles for risk management laid down in this standard are binding. Compliance as appropriate with the detailed rules supplementing the principles may be sufficient, if the supervised entity's organisation is small, if the level of risk taking specified in the entity's credit risk strategy is low, if the scale of the risk-exposed business is small and the business straightforward or otherwise transparent, or if the senior management itself actively participates in the detailed decision making of the everyday business. Compliance with binding rules only as appropriate always requires a specific decision by the board of directors. The supervised entities should at all times ensure that their internal control and risk management are adequate and commensurate with the risks involved in their activities.

Issued on 25 May 2004
Valid from 1 January 2005

(4) Entities that belong to the same consolidation group should apply uniform risk management principles. Parent companies of financial and insurance conglomerates primarily engaged in financial activities should ascertain that all companies included in the conglomerate have adequate risk management systems commensurate with their activities. In terms of credit risks taken in the conglomerate, the parent companies should also see to it that the core principles of credit risk management provided in this standard are applied throughout the conglomerate.

Issued on 25 May 2004
Valid from 1 January 2005

(5) In this standard, the general expression supervised entity is used of all entities under the scope of the standard.

Issued on 25 May 2004
Valid from 1 January 2005

(6) In establishing and maintaining credit risk management, the principles laid down in Standard 4.1 on the establishment and maintenance of internal control and risk management included in the section *Capital adequacy and risk management* of the FSA's set of regulations must also be observed.

Issued on 25 May 2004
Valid from 1 January 2005

(7) In addition, the principles laid down in Standard 4.4b on management of operational risk also included in the section *Capital adequacy and risk management* of the FSA's set of regulations must be observed in the establishment and maintenance of credit risk management.

2

OBJECTIVES

Issued on 25 May 2004
Valid from 1 January 2005

(1) For supervised entities engaged in banking activities, credit risk is the most significant risk. However, it should be recognised that credit risk also arises in other than banking activities, ie in the form of counterparty risk.

Issued on 25 May 2004
Valid from 1 January 2005

(2) Establishing and maintaining credit risk management and control as part of the internal control function constitutes a key task for the supervised entity's business management. Credit risk management and control is of crucial importance in ensuring that the supervised entity holds adequate capital against the risks involved in the business and the potential losses on incurred risks.

Issued on 25 May 2004
Valid from 1 January 2005

(3) The objective of the FSA's rules and regulations concerning credit risk management is

- to ensure that supervised entities and entities within their consolidation group have adequate and efficient functions commensurate with the nature and scale of their activities in order to identify, measure, mitigate, monitor and control credit risk as part of an overall approach to business risk management.
- to ensure that supervised entities and entities within their consolidation group in their lending or investment activities do not take on such credit risks that may jeopardise their profitability or capital adequacy
- to provide information on the topics that the FSA is focusing on and the demands it places on the supervised entities.

3

INTERNATIONAL FRAMEWORK

Issued on 25 May 2004
Valid from 1 January 2005

(1) This standard is based on the recommendations of the Basel Committee on Banking Supervision. The recommendation entitled *Core Principles for Effective Banking Supervision*¹, issued in September 1997, lists the following key requirements of credit risk management:

- sound procedures related to the granting of loans and making of investments and efficient management of loan and investment portfolios
- proper assessment of the quality of assets as well as adequacy of loan loss provisions and reserves
- identification of risk concentrations and prudential limits for groups of connected customers
- lending to related companies on an arm's-length basis
- monitoring and controlling country risk in international lending
- adequate risk management systems for the nature and scale of the business.

Issued on 25 May 2004
Valid from 1 January 2005

(2) The recommendation *Principles for the Management of Credit Risk*², issued by the Basel Committee in September 2000, states that, although specific credit risk management may differ among credit institutions depending on the scale and type of their activities, the following four sub-areas should be included in a comprehensive credit risk management:

- establishing appropriate principles and methods of credit risk management
- operating under a sound credit-granting process
- maintaining an appropriate credit management, measurement and monitoring process

¹ *Core Principles for Effective Banking Supervision, Basel Committee on Banking Supervision, Basel September 1997*

² *Principles for the Management of Credit Risk, Basel Committee on Banking Supervision, Basel September 2000*

- ensuring adequate controls over credit risk.

Issued on 25 May 2004
Valid from 1 January 2005

(3) In a recommendation issued in January 1999³, the Basel Committee lists specific principles that credit institutions, besides general credit risk management principles, should apply in their interactions with highly leveraged institutions.

Issued on 25 May 2004
Valid from 1 January 2005

(4) These recommendations should be applied together with the Basel Committee's recommendations on valuation of assets, credit loss reporting and credit risk disclosure⁴.

³ *Sound Practices for Banks' Interactions with Highly Leveraged Institutions, Basel Committee on Banking Supervision, January 1999*

⁴ *Sound Practices for Loan Accounting and Disclosure, Basel Committee for Banking Supervision, Basel July 1999 and Best Practices for Credit Risk Disclosure, Basel Committee for Banking Supervision, Basel September 2000*

4

LEGAL BASIS

Issued on 25 May 2004
Valid from 1 January 2005

(1) The FSA's rules and regulations on the management of credit risk are based on section 68, subsection 3 of the Credit Institutions Act (1607/1993) and section 29, subsection 3 of the Investment Firms Act (579/1996). These rules also itemise the requirements of establishing and maintaining internal control and risk management applicable to parent companies of conglomerates as referred to in section 13 of the Act on the Supervision of Financial and Insurance Conglomerates (44/2002).

Issued on 25 May 2004
Valid from 1 January 2005

(2) The rules applying to large exposures are based on sections 69-71 of the Credit Institutions Act, section 31 of the Investment Firms Act and sections 6-7 of the Act on Cooperative Banks and Other Cooperative Credit Institutions. Pursuant to section 14 of the Act on the Supervision of Financial and Insurance Conglomerates, risk concentrations in the conglomerates shall be reported to the coordinating supervisory authority.

Issued on 25 May 2004
Valid from 1 January 2005

(3) Customer identification data shall be retained in compliance with section 8 of the Act on the Prevention and Detection of Money Laundering (68/1998). The retention periods for accounting books and records are laid down in chapter 2, section 10 of the Accounting Act (1336/1997).

Issued on 25 May 2004
Valid from 1 January 2005

(4) In preparing these rules and regulations, account has been taken of Directive 2000/12/EC (32000L0012) of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions (OJ L 126 of 26 May 2000, p. 1) and of Council Directive 93/22/EEC (31993L0022) on investment services in the securities field (OJ L 141 of 11 June 1993, p 27).

5

CORE PRINCIPLES OF CREDIT RISK MANAGEMENT

5.1 Definition of credit risk

Justifications

Issued on 25 May 2004
Valid from 1 January 2005

(1) *Credit risk* is defined as the potential failure of a counterparty to meet its contractual obligations. This standard should be applied to all activities posing a credit risk to the supervised entity.

Justifications

Issued on 25 May 2004
Valid from 1 January 2005

(2) Loans are the largest source of credit risk, but credit risk (counterparty risk) may also be inherent in other types of assets, such as bonds, short-term debt securities and derivatives, and in off balance-sheet commitments, such as unused credit lines or limits, guarantees and documentary credit. Country risk and settlement risk are also regarded as credit risks.

Justifications

Issued on 25 May 2004
Valid from 1 January 2005

(3) In this standard, *credit* refers to a legal relationship that results in or may result in a claim on a second party.

5.2 Credit risk strategy and credit risk management procedures

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(4) A credit risk strategy and procedures for identifying, measuring, monitoring and controlling credit risk are the cornerstones of sound credit risk management. The credit risk strategy must be consistent with the credit institution's general business plan.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(5) At a minimum, a supervised entity's credit risk strategy shall define its

- preferred customer profile in granting credit and its allocation of

credit based on exposure type, industry or economic sector, geographical location, currency and maturity

- target markets
- risk-taking level based on its risk-bearing capacity and principles for diversification of and protection against risks
- quality, yield and growth targets for the credit portfolio.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(6) The credit risk strategy shall be reviewed periodically (at least annually). It shall also be viable in the long run and through various economic cycles.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(7) The credit risk management shall cover all products and activities of the supervised entity in which credit exposure poses a risk. Supervised entities shall ensure that they have risk management procedures in place for new products and activities before these are being introduced or undertaken and that the procedures have been approved in advance by the board of directors. Special attention shall be paid to products that involve unfamiliar markets, pricing, contract law, risk management or accounting principles.

5.3 Organisation and responsibilities

5.3.1 Board of directors responsible for establishing sound credit risk management

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(8) The board of directors shall have responsibility for approving and periodically reviewing the credit risk strategy and significant credit risk policies and procedures of the supervised entity.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(9) The board of directors shall ensure that all relevant personnel clearly understand the credit risk strategy and significant credit risk policies and procedures approved by the board and that it observes them and the written instructions based thereon.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(10) The board shall ensure that the senior management is fully capable of managing the credit granting activities conducted by the supervised entity and that those activities are performed within a risk strategy, policies and limits approved by the board.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(11) The board of directors shall ensure that the supervised entity's remuneration policies do not contradict its credit strategy.

5.3.2 Senior management responsible for implementing sound credit risk management

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(12) The senior management shall have the responsibility for implementing the credit risk strategy approved by the board of directors and for developing policies and procedures for identifying, measuring, mitigating, monitoring and controlling credit risk.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(13) The senior management shall as a minimum requirement see to it that

- the supervised entity's credit granting activities conform to the adopted strategy
- the supervised entity's personnel have the sufficient expertise to implement the adopted strategy
- the credit granting policies are communicated throughout the organisation and implemented through appropriate procedures
- written operating and credit granting instructions exist and the operating instructions are revised to take into account changing internal and external circumstances
- approval and control authorisations have been duly designated
- an independent assessment of the credit granting and risk management functions has been organised
- the credit portfolio is adequately diversified pursuant to the credit strategy approved by the board
- the supervised entity has established targets for portfolio mix and set exposure limits on single customers and groups of connected customers, particular industries or economic sectors, geographic regions and specific products
- sound credit granting standards are maintained.

5.3.3 Assessment of credit risk management

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(14) The supervised entity shall have a separate, independent function for assessment of its credit risk management processes conducted by individuals who have no dealings with customer, product and business functions. This will enable the board of directors and senior management to ensure that the adopted principles for credit risk management are appropriate and complied with.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(15) The independent risk management assessment function shall ensure

- that the credit granting function is being properly managed and that credit exposures are consistent with official standards and the internal limits of the supervised entity
- that the management information systems provide correct and adequate data on the supervised entity's aggregate credit exposures

- and changes in these over time
- that internal controls have been designed in such a way that exceptions to policies, procedures and limits are reported in a timely manner to the appropriate level of management for action
 - that the supervised entity has adopted procedures for changing over to more frequent customer monitoring in case of impaired payment capacity as well as procedures for managing problem credits.

Binding
Issued on 25 May 2004
Valid from 1 January 2005

(16) The independent risk management assessment function shall report directly to the board of directors and senior management.

5.4 Credit granting criteria and credit granting process

Binding
Issued on 25 May 2004
Valid from 1 January 2005

(17) Supervised entities shall define and operate within certain credit granting criteria. These criteria shall contain a clear indication of the supervised entity's target market, based on the supervised entity's credit risk strategy, and credit decision and credit granting procedures concerning the customer, the purpose of the credit, the repayment and the management of collateral or guarantees.

5.4.1 Credit analysis

Binding
Issued on 25 May 2004
Valid from 1 January 2005

(18) Each credit decision shall be based on a credit analysis. The credit analysis shall give a sufficiently accurate picture of the borrower applying for credit and of the project to be financed.

Binding
Issued on 25 May 2004
Valid from 1 January 2005

(19) The supervised entity shall clearly define what kind of information and documentation it needs for handling applications for new credits as well as for renewal and amendment of existing credits.

Justifications
Issued on 25 May 2004
Valid from 1 January 2005

(20) A sound credit granting process entails careful examination by the supervised entity of each credit applicant's ability to meet his obligations. To analyse the financial status and creditworthiness, sufficient information must be obtained about the borrower. Where corporate borrowers are concerned, an analysis of financial reporting and credit register details is likely to assist the supervised entity in making the right credit decisions.

Binding
Issued on 25 May 2004
Valid from 1 January 2005

(21) At a minimum, the factors to be considered in the credit analysis shall include:

- the borrower's current, historical and future repayment capacity
- the purpose of the credit and sources of repayment
- the proportion of the borrower's own funding for the project concerned
- for commercial credit, the status of the borrower's industry or

- economic sector and the borrower's position within this sector as well as the business expertise of the business management
- commitments of groups of connected customers
 - coverage and realisability of collateral or guarantees
 - assessment of risks posed by macro-economic developments.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(22) In their credit decisions, supervised entities need to assess the risks against expected return both in pricing individual credits and in making an overall assessment of their customer relationships. In keeping with its risk-related goals, the supervised entity shall take into consideration potential future macro-economic changes and their effects on borrowers and contract parties.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(23) Particular attention need to be paid to the identification procedures used for new customers. The identification shall be documented and filed to make it possible to establish later on how the customer relationship was formed and what information it was based on.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(24) The supervised entity shall have information systems in place for the collection and updating of customer data as well as established procedures for the identification of connections between single customers, counterparties and entities related to them and the calculation of risk concentrations.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(25) The supervised entity shall have information barriers between different functions, units and departments in order to prevent sensitive customer information to spread to unauthorised personnel. These arrangements must not, however, prevent units or persons dealing with internal control and risk management from obtaining necessary data.

5.4.2 Collateral management

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(26) The credit decision shall primarily be based on the creditworthiness of the borrower, but the collateral offered as coverage for credit risk is also of significance. In considering an application for commercial credit, the supervised entity shall pay adequate attention to the company's business idea, the project to be financed, the company's cash flow and profit-earning capacity, and not only be content with adequate collateral. As a rule, credit shall not be granted if the customer lacks credit repayment potential apart from realisation of collateral.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(27) In financing arrangements where the repayment of credit is based on the realisation of collateral, the supervised entity shall monitor yield prospects and market values of the collateral in order to ascertain that the repayment is guaranteed.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(28) Supervised entities shall have policies and procedures for

- accepting different types of collateral
- classifying collateral
- regularly monitoring and assessing collateral values
- ensuring that collateral is binding, adequate and realisable
- identifying and managing any concentrations of risk arising from collateral.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(29) The supervised entity shall establish a collateral value for each type of acceptable collateral, expressed as a percentage of its market value. The percentage shall be consistent with a prudential maximum limit for the relevant type of collateral. Collateral values shall always be set on a case-to-case basis. Particular care shall be taken if the market value of the collateral is not deemed stable.

5.4.3 Credit granting process

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(30) Supervised entities shall have established procedures in place for processing credit applications and decisions and for amending and renewing existing credits.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(31) Credit decisions shall be made in accordance with written instructions approved by the senior management. There shall be a clear audit trail documenting the whole process, from credit application to credit decision, and it shall be approved by the appropriate level of management. The credit decision or the documents appended thereto shall give a detailed account of the contents of the decision, the grounds for granting or turning down the application and an indication of the decision makers. The entire credit granting process must be verifiable after the event.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(32) The supervised entity's written instructions on credit granting shall indicate that the duties and responsibilities of those who have the authority to approve credit be clearly designated. The instructions shall also specify who has the authority to grant credit and the limit of the authority. Only authorised persons or decision-making units may make credit decisions.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(33) The processing of credit applications and the credit decisions shall be segregated so that the person preparing the decision cannot make the credit decision on his own.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(34) Credit must not be disbursed to the customer until the supervised entity has received all the necessary documents. Credit documents and collateral must be retained at least until the credit has been repaid. The Act on the Prevention and Detection of Money Laundering contains provisions on the retention of customer identification data. The retention periods for accounting

books and records are laid down in the Accounting Act.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(35) The granting of all new credit and changes of terms and conditions of credit previously granted must be provided on an arm's-length basis. All credit or comparable finance to related individuals, companies or foundations must be extended on the same terms and conditions as to non-related borrowers. The board of directors shall adopt general terms and conditions for credit to related parties and all credit extended to related parties requires the approval of the board.

Justifications

*Issued on 25 May 2004
Valid from 1 January 2005*

(36) The supervised entity shall ensure that credit is not extended to related parties at terms and conditions that could jeopardise the supervised entity's financial status or otherwise the confidence in its operations. Operating on market terms requires well-functioning markets and adequate disclosure and transparency of information.

5.5 Measurement of credit risk and the management information systems

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(37) The supervised entity must be able to measure the credit risk inherent in all balance sheet items and off-balance sheet commitments. It must have information systems and analytical techniques that provide the management with adequate information on the composition of the credit portfolio, including identification of any concentrations of risk.

Justifications

*Issued on 25 May 2004
Valid from 1 January 2005*

(38) The information generated from the management information systems enables the board and senior management to fulfil their respective monitoring, including determining the adequate level of capital that the supervised entity should be holding. The information should also enable the board to assess, quickly and reliably, the credit risk exposure of the supervised entity in its various activities and to determine whether the supervised entity's operations comply with its credit risk strategy. Therefore, the quality, detail and timeliness of the credit risk information are critical.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(39) The supervised entity shall use credit risk measurement techniques that are sufficiently advanced for the nature of its activities and have procedures in place for establishing and monitoring limits.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(40) The measurement of credit risk shall take account of the specific nature of the claims, their contract terms, the existence of collateral, the probability of payment default and possible market movements affecting the value of the claims.

5.6 Mitigation of credit risk

5.6.1 Limits

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(41) The board of directors must ensure that the credit granting activities and other activities involving credit risk in the supervised entity are adequately diversified. For this purpose, the supervised entity shall establish the claims and groups of claims that are significant from the viewpoint of risk management and therefore require exposure limits. When necessary, limits shall be established for specific products, certain counterparties, particular industries or economic sectors, individual foreign countries or groups of countries.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(42) The supervised entity shall monitor the actual utilisation of established limits on an ongoing basis and all credit granting in excess of predetermined levels shall be documented, analysed and reported in accordance with set procedures. In the monitoring, it is important that attention is paid to claims approaching risk limits. Clear procedures must be established for monitoring exceptions to credit limits. Established limits shall be evaluated in relation to the chosen approach and prevailing market conditions.

5.6.2 Risk concentrations

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(43) The supervised entity must have established procedures for identification and management of risk concentrations within the credit portfolio. Limits for different types of concentrations shall be established in accordance with the supervised entity's credit risk strategy.

Justifications

Issued on 25 May 2004
Valid from 1 January 2005

(44) Concentrations occur when, among other things, a supervised entity's credit portfolio contains credits in large amounts involving

- a single counterparty
- a group of single counterparties and entities related to them
- a particular industry or economic sector
- a counterparty located in a certain geographic region
- an individual foreign country or a group of countries whose economies are strongly interrelated
- a certain type of collateral
- the same maturity
- the same product/instrument.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(45) The supervised entity must also identify such indirect risk concentrations that may arise in situations where the performance of different business lines react in the same way to external, primarily macro-economic factors, such as changes in interest rate.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(46) If the avoidance of certain risk concentrations is difficult or the concentrations are justifiable from a business point of view, the increased credit risk thus arising shall be considered in the pricing and calculation of capital adequacy.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(47) In managing risk concentrations or mitigating their effects, supervised entities may use such mechanisms as loan sales, credit derivatives, securitisation programmes and other arrangements in the secondary loan markets. When a supervised entity decides to utilise these mechanisms, it needs to have separate policies and procedures, as well as adequate controls, in place for identifying and managing also the risks that these mechanisms involve.

5.6.3 Large exposures

Justifications

Issued on 25 May 2004
Valid from 1 January 2005

(48) Risk concentrations arising from exposures to single counterparties or groups of single counterparties and entities related to them are subject to legal restrictions.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(49) Exposures to a customer refer to a supervised entity's total claims, investments and off-balance sheet commitments vis-à-vis any one natural or legal person (customer) or vis-à-vis any one natural or legal person sharing substantial economic interests with the said person (group of connected customers).

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(50) A large exposure is at issue when the exposure to a customer equals or exceeds 10% of the supervised entity's own funds.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(51) Details on the restrictions and reporting procedures applicable to large exposures are provided in FSA standard [RA4.1](#) Reporting of large exposures and risk concentrations.

5.6.4 Interactions with Highly Leveraged Institutions (HLIs)

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(52) Before taking up business with HLIs or similar institutions, a supervised entity shall, in addition to its general guidelines on credit risk management, have instructions in place on the pursuit of financial and investment activities involving additional risk.

Justifications

Issued on 25 May 2004
Valid from 1 January 2005

(53) An active use of derivatives and a high proportion of debt-financed capital are characteristic of the HLIs' business activities. HLIs are subject to very little or no direct oversight, their investments are unrestricted by regulations and the disclosure required of them is very limited compared to supervised entities and/or listed companies.

5.7 Ongoing credit risk management and segregation of duties

5.7.1 Credit management

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(54) Supervised entities shall have procedures in place for the ongoing management of their various credit risk bearing portfolios.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(55) A supervised entity must have an independent function, segregated from the credit granting process, to ensure that credits are granted properly and relevant documents duly prepared. The credit documents shall include information to track the history of the credit as well as information on the credit decision process, the staff involved in the credit process and credit decision and information on the current financial status of the borrower or counterparty.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(56) The credit management shall fulfil the following requirements:

- It shall provide accurate and timely information to the management information systems.
- It shall ensure adequate segregation of duties and appropriate controls over back office procedures.
- It shall ensure compliance with policies and procedures established by the management and with applicable laws and regulations.

Justifications

Issued on 25 May 2004
Valid from 1 January 2005

(57) The guidance and support of the board of directors is a key factor in ensuring that the credit management is recognised as a significant sub-area of the supervised entity's credit risk monitoring and control.

5.7.2 Customer monitoring

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(58) The supervised entity shall have procedures in place for monitoring the status of single credits and borrowers in different credit portfolios. The supervised entity shall also ensure that possible problem credits or other deteriorating business activities are detected and monitored in order to establish the need for corrective action, change of rating and/or loan loss reporting.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(59) The supervised entity shall establish principles for the monitoring of customers, collateral and guarantees. The principles shall comprise separate procedures to be complied with in the monitoring of problem customers. If covenants are used in the credit granting, the supervised entity shall have capacity for the customer monitoring required.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(60) The supervised entity shall appoint the persons that are to be responsible for the monitoring of credits and collateral. These persons shall ensure that the persons responsible for the internal risk rating are provided with the updated information they need for their work. When delegating the monitoring responsibilities, the management shall consider possible conflicts of interest in situations where staff is rewarded on the basis of different criteria, such as credit volume, quality of credit portfolio or profitability.

5.7.3 Internal risk rating system

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(61) The board of directors shall establish procedures for differentiating various credit risks through an internal risk rating system or some other method considered sufficient by the board.

Justifications

*Issued on 25 May 2004
Valid from 1 January 2005*

(62) An important tool in monitoring the quality of individual credits, as well as the total portfolio, is the use of an internal risk rating system. A well-structured internal risk rating system is a good means of differentiating the degree of credit risk in the different credit exposures of the bank. This enables a detailed analysis of the characteristics, concentrations, problem credits and adequacy of loan loss provisions pertaining to the credit portfolio. The risk rating system can also be used in capital allocation, credit pricing and measuring of the profitability of a customer relationship or business activity.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(63) The risk rating system shall hold so many categories that it can separate both different credit risks in well-managed credits and credit risks in problem credits.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(64) The risk rating system shall reflect changes in the credit risks. Deterioration of a customer's payment capacity shall lead to an adjustment of its risk category and a thorough review of its credits as well as an inclusion of the credits on a separate watch list. The regular reports to the management on the condition of the supervised entity's entire credit portfolio shall be based on internal ratings.

Justifications

*Issued on 25 May 2004
Valid from 1 January 2005*

(65) Through the risk rating system the managers of the different business lines get a picture of the composition of the credit portfolio and thus they can contribute to the preparation of potential amendments to the credit strategy.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(66) The internal ratings must continuously provide a true picture of the status of the credits. The credit rating given to a single claim/counterparty when the credit was granted must be updated regularly. A function that is independent of the credit granting shall be responsible for making the rating decisions. This independent function shall also regularly ensure that the rating reflects the actual, prevailing conditions.

5.7.4 Stress tests

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(67) The supervised entity must always consider possible changes in the financial situation in its assessment of single credits and entire credit portfolios.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(68) The supervised entity shall make various assessments of how the credit risk would be affected in rare but difficult situations. Large market price fluctuations, bankruptcies of large market participants, unexpected changes in liquidity, realisation of significant country risks and corresponding situations are typical examples of such situations.

Binding

*Issued on 25 May 2004
Valid from 1 January 2005*

(69) The board of directors shall see to it that the above-mentioned stress tests are performed regularly and that necessary measures are taken on the basis of the test results.

6

REPORTING TO THE FSA

Justifications

Issued on 25 May 2004
Valid from 1 January 2005

(1) No separate obligation of regular reporting to the FSA adheres to the establishment and maintenance of the credit risk management. However, the supervised entity must submit the information on credit risk required in the following regulations in the way specified in each relevant regulation.

Binding

Issued on 25 May 2004
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(2) The reporting procedures applicable to large exposures are provided in FSA standard [RA4.1](#) Reporting of large exposures and risk concentrations.

Binding

Issued on 25 May 2004
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(3) The reporting of country risk is regulated in FSA standard RA4.4.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(4) Non-performing and other zero-interest assets shall be reported in accordance with FSA regulation 105.8.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(5) The data collected in the joint data collection of Statistics Finland, the Bank of Finland and the FSA shall be submitted to the FSA according to the detailed provisions in regulation 106.8a.

Binding

Issued on 25 May 2004
Valid from 1 January 2005

(6) In addition, the supervised entity shall provide regular information in its financial statements on the credit risk management. The contents of the information to be provided in the financial statements are detailed in the section *Accounting and financial statements*.

7

DEFINITIONS

*Issued on 25 May 2004
Valid from 1 January 2005*

(1) In this standard the word **document** applies to both electronic documents and paper copies.

*Issued on 25 May 2004
Valid from 1 January 2005*

(2) A **sound credit granting process** is due to the relations between the supervised entities and their customers and the supervised entity's operating principles. These relations and principles are subject to an ongoing development and they also supplement existing laws and regulations. At the same time they form a basis for the decision making in practical situations not regulated by law.

*Issued on 25 May 2004
Valid from 1 January 2005*

(3) **Management information systems** refer to a tool required for the generation and utilisation of appropriate information for the decision making. The information systems used for collecting, processing and searching the information required for the decision making do not necessarily have to be automated.

*Issued on 25 May 2004
Valid from 1 January 2005*

(4) **Highly leveraged institutions** refer to large financial institutions which are subject to very little or no direct oversight and very limited disclosure requirements and have a high proportion of debt-financed capital⁵. They are not financial institutions of the type referred to in the Credit Institutions Act.

*Issued on 25 May 2004
Valid from 1 January 2005*

(5) In this standard, **credit** refers to a legal relationship that results in or may result in a claim on a second party.

*Issued on 25 May 2004
Valid from 1 January 2005*

(6) Counterparties are considered **related parties**, if one party has control or dominant influence over the other in decisions on matters of economy or business activities. Typical related parties are companies within the same group as the supervised entity as well as the entity's owners, board of directors, senior management, auditors and their relatives and companies and foundations controlled by the above-mentioned parties.

⁵ *Sound Practices for Banks' Interactions with Highly Leveraged Institutions, Basel Committee on Banking Supervision, January 1999, page 3*

Issued on 25 May 2004
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(7) **Senior management** refers to a body that is responsible for the daily operative management of the supervised entity and the execution of the decisions made by the board of directors. The senior management consists of the managing director and a possible management group.

Issued on 25 May 2004
Valid from 1 January 2005

(8) The **board of directors** refers to a body that sets the supervised entity's general operational framework and bears ultimate responsibility for the organisation's operations, for its decisions on business plans and objectives and for the functioning of its internal control. If the supervised entity has both a board of directors and a supervisory board, they are here together referred to as the board of directors. In that case the supervised entity's internal instructions shall contain detailed specifications on which duties shall be the responsibility of the supervisory board and which shall be the responsibility of the subordinated board of directors.

8

FURTHER INFORMATION

Please find the necessary contact information in the list of [Persons responsible](#) for standards provided on the FSA website. For further information, please contact:

- Credit Risk, tel. +358 10 831 5207

9

OBSOLETE GUIDELINES AND REGULATIONS

Issued on 25 May 2004
Valid from 1 January 2005

(1) This standard renders the following guidelines obsolete:

General guideline on credit risk management (105.13)
Guideline on the margin requirement related to the use of securities as collateral (103.3).