Credit Risk Ratings

One recommended risk measurement and monitoring technique to be used for loans other than personal and mortgage loans, is the technique of credit risk ratings. Risk rating involves the categorization of individual loans, based on credit analysis and local market conditions, into a series of graduated categories of increasing risk. Risk ratings are most commonly applied to all loans other than personal and residential mortgage/bridge loans.

Risk ratings should be conducted:

- at the time of application for all new or increased loan facilities
- as part of the annual review process
- in situations where new information is considered that may materially affect the credit risk of the loan

A primary function of a risk rating model is to assist in the underwriting of new loans. As well, risk rating assists management in predicting changes to portfolio quality and the subsequent financial impact of such changes. Risk rating can also lead to earlier responses to potential portfolio problems, providing management with a wider choice of corrective options and decreased exposure to unexpected credit losses. Finally, risk ratings are useful for pricing loans and regulating the commercial portfolio exposure to maximum levels of risk. Board policy should optimally set the maximum credit risk allowable by credit classes and aggregate maximum portfolio credit risk. The extent of gradation (number of categories) of a risk rating system should be reflective of the size and complexity of the credit union's commercial and agricultural loan portfolio. Generally, a larger and more extensive a credit portfolio may require a more sophisticated risk rating system including a greater graduation of risk ratings.

In many situations, however, a system comprised of six risk levels of increasing credit risk is appropriate. Under this system, the lowest risk rating (1) is assigned to undoubted borrowers with vitually no risk. The highest risk rating (6) is assigned to borrowers where there is little or no likelihood of repayment. Loans should only be granted for risk ratings of 1, 2 (low risk) or 3 (normal risk). Ratings of 4, 5 and 6 are reserved for existing loans where the risk rating has deteriorated from the time of the original approval. Risk rating 4 is a "cautionary" rating assigned to higher risk loans. Loans in this category should be placed on a "watch list" for increased monitoring. Risk rating 5 is for "unsatisfactory" loans that are impaired in accordance with DICO By-law No. 6.

Schedule 1 below provides a more detailed overview of a risk rating model which has six risk rating categories combined with risk rating trends. The table also includes the types of assessment criteria or considerations which should be used to determine risk ratings. Compliance with the risk rating requirement as outlined in Schedule 1 satisfies the "credit rating band" requirement found in FSCO's *Lending and Investment Guideline* and meets DICO's expectations for an appropriate risk rating model.

Schedule 1: Sample Risk Rating Model			
Risk Rating		**Attributes**	
1	**Undoubted**	• Virtually no risk • Government borrower	• Full cash security • Strongly capitalized • Outstanding management
2	**Low**	• Minimal risk of any loss • Strong security/capitalization position	• Excellent financial history/trends • Strong management • Stable/strong industry
3	**Moderate**	• Good security margin/LTV • Demonstrable debt service capacity	• Sound management • Steady financial trends • Moderate capital level
4	**Cautionary**	• Deteriorating/lack of financials • Covenant breaches	• Potential security shortfalls • Potential debt service shortfalls • Significant adverse developments
5	**Unsatisfactory**	• Need for immediate action indicated • Security shortfall/capital crisis	• Cessation of operations • Adverse management change • Interest/principle arrears
6	**Unacceptable**	• Receivership or bankruptcy • Definite loss evident	• Disappearing assets/security • Fraud
Risk Rating Trend		**Attributes**	
I		Increasing risk	
S		Stable or Steady risk	
D		Decreasing risk	
Risk Component		**Assessment Criteria/Considerations**	
Financial		• Debt Service • Debt to Equity	• Quality of Financial Reporting • Working Capital • Financial Trends
Security		• Cash conversion • Quality of evaluation	• Asset coverage
Management		• Skill and tenure • Commitment • Infrastructure and support	• Succession planning • Quality and frequency of information
Environmental		• Issues, evaluation and insurance	• Industry risk • Competition

Risk ratings may be facilitated through the application of a standardized "points" credit analysis. Point analysis of borrowers' credit worthiness can be designed by the credit union, or reliance may be placed on external scoring systems.