Early Warning Signals (EWS) in Banking Advances

March - 2023

Early Warning Signs (EWS)?

- An early warning signal is a warning or an indication that the stock, financial statements, or news reports of business pose a possible issue or a threat.

- Early warning signals can be any undesirable characteristic which makes an analyst or investor stand out.

- There is no universal norm for red flag recognition. The methodology could involve reviewing financial statements, economic indicators, or historical information.

- Rising debt-to-equity (D/E) ratios, steadily declining sales, and fluctuating cash flows are some common early warning signs that suggest trouble for businesses.

- Early warning signs can be found in the details and comments of a financial report. A pending class action litigation against the company, which may jeopardize potential performance, is one red flag that is frequently included in a financial statement's notice segment.

Early Warning Signs (EWS) in Banking Advances?

- An ideal early warning system identifies possible risks in advance and helps the bank's management forecast default before it is too late.
- It enables them to take necessary measures to ensure that loans are recovered timely, thus maintaining the asset quality of the bank.
- EWS can be quantitative or qualitative indicators, based on asset quality, capital, liquidity, profitability, market and macroeconomic metrics.

Benefits of Early Warning Signs (EWS) in Banking Advances

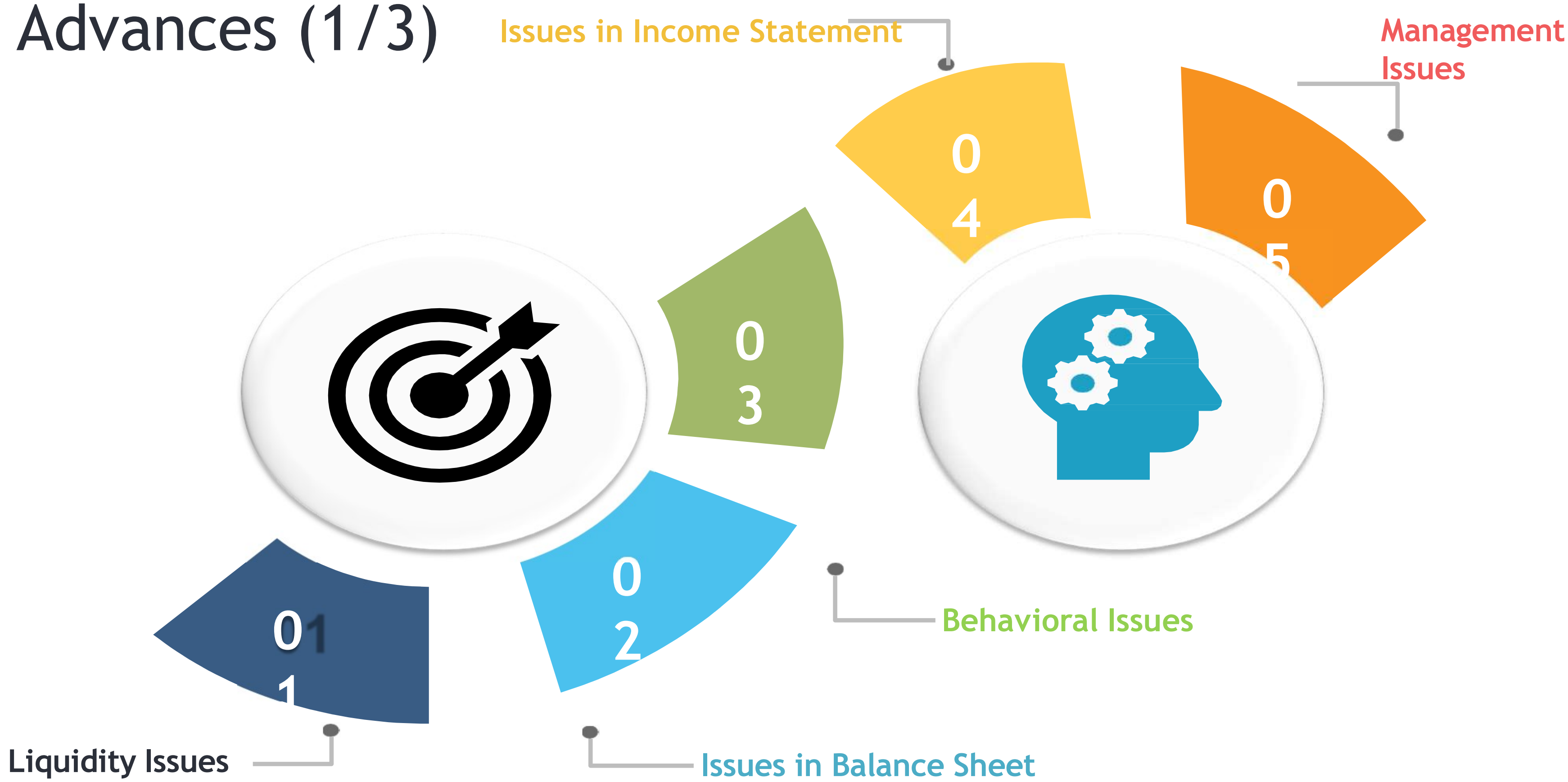
- Reduce the possibility of future NPAs
- Help make effective decisions to limit exposure in default-prone segments
- Minimise defaults through regular evaluation of customer portfolios
- Utilize capital effectively
- Limit piling up of NPA stocks

Key Indicators of Early Warning Signs (EWS) in Banking Advances

- Banking institutions should develop, maintain and regularly evaluate relevant quantitative and qualitative EWS that are supported by an appropriate IT and data infrastructure that would allow the timely detection of increased credit risk in their aggregate portfolio as well as in portfolios, sub-portfolios, industries, geographies and individual exposures.

- The EWIs should have defined trigger levels set with regard to the levels specified in credit risk appetite, strategy and credit risk policies, and have assigned escalation procedures, including assigned responsibilities for the follow-up actions.

Categories of Early Warning Signs (EWS) in Banking Advances (1/3)



Categories of Early Warning Signs (EWS) in Banking Advances (2/3)

Liquidity Issues

- Returned items from deposits made by the client
- Operating loans fully utilized for extended periods
- Operating loans over their limit, for example, a sudden unrequested overdraft
- Increased litigation against the client
- Frequent and sudden requests for a temporary bulge or loan accommodation

Issues in Balance Sheet

- Failure to submit financial statements in a timely fashion
- Slowdown in the collection period for receivables
- Deterioration in customer's cash position
- Slowdown in inventory turnover
- Decline in current assets as a percentage of total assets
- High concentration of assets in intangibles
- Substantial increases in long-term debt
- Change of accountants

Issues in Income Statement

- Declining sales/rapidly expanding sales
- Major gap between gross and net sales
- Rising cost percentages/narrowing margins
- Rising sales and falling profits
- Rising levels of bad debt losses
- Disproportionate increases in overhead, relative to sales
- Rising levels of total assets, relative to sales/profits

Categories of Early Warning Signs (EWS) in Banking Advances (3

Behavioral Issues

- A reluctance or unwillingness to communicate
- Absence of key personnel from crucial planning or strategic sessions
- Too much change in accounting personnel or procedure
- Changing external accounting firms too often

Management Issues

- Change in behavior/personal habits of key people
- Lack of visible management succession
- Labor problems
- Changes in management, ownership, or key personnel Illness or death of key personnel

Thank You