



March 2015

Statement of Guidance

Credit Risk Classification, Provisioning and Management



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1 Statement of Objectives

- 1.1 To provide guidance on the requirements imposed on Credit Risk Holders by the Rule on Management of Credit Risk and Problem Assets.
- 1.2 To provide guidance on adequate asset loss provision policies and procedures to recognise, measure and monitor asset impairment.
- 1.3 To provide guidance to Credit Risk Holders in assessing the inherent credit risk in both on and off-balance sheet interest bearing assets and using an appropriate grading system based on the Credit Risk Holders' asset quality.
- 1.4 The focus of this Statement of Guidance ("SOG") is on loss provision practices relating to the credit risk in problem assets. While the SOG does not specifically deal with provisions for other business activities (e.g., trading and derivatives activities), the Authority believes that Credit Risk Holders should ensure that the credit risk in these areas should also be prudently measured and managed.

2 Scope

- 2.1 This SOG applies to Credit Risk Holders as defined by the Rule.
- 2.2 The methods by which this SOG is implemented by Credit Risk Holders should reflect the scope and complexity of operations.

3 Terminology

- 3.1 For consistency, the following terminologies are applied:
 - 3.1.1 A 'credit' is a financial asset resulting from the delivery of cash or other assets by a lender to a borrower in return for an obligation to repay on a specified date or dates, or on demand, usually with interest. Credits comprise:
 - a. consumer instalments, overdrafts and credit card loans;
 - b. residential mortgages;
 - c. non-personal loans, such as commercial mortgages, project finance, and loans to businesses, financial institutions, governments and their agencies;
 - d. direct financing leases; and
 - e. other financing arrangements that are, in substance, loans or credits.
 - 3.1.2 The 'recorded investment' in a loan or group of loans is the face or principal amount, taking into account payments applied to reduce principal, and adjusted to reflect accrued but uncollected interest, charge-offs, unamortised premium or discount (i.e., a difference between acquisition cost and principal) and unamortised loan fees and



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costs.

- 3.1.3 The 'carrying amount' of a loan or a group of loans is the net amount reported for the loan or group of loans on the balance sheet, i.e., the recorded investment less any specific and general allowances.
- 3.1.4 A group of "Connected counterparties" means two or more individual counterparties whose exposures constitute a single exposure because the counterparties have:
- a) a group relationship; or
 - b) a business interdependency that is so close that it cannot be quickly unwound and in which financial problems of one counterparty is likely to cause repayment difficulties for another counterparty within the group."
- 3.1.5 Loan 'impairment'¹ represents deterioration in the credit quality of one or more loans such that it is probable that the Credit Risk Holder will be unable to collect, or there is no longer reasonable assurance that the Credit Risk Holder will collect, all amounts due according to the contractual terms of the loan agreement(s).
- 3.1.6 'Loan Loss provision' or 'allowance' for loan impairment is the amount that reduces the recorded investment in a loan or a group of loans to the carrying amount on the balance sheet.
- 3.1.7 A 'specific provision' is an allowance that is established against a loss that is identified in an individual loan. It is the accumulated provisions or charges made against operating earnings in the current and prior year, net of loss charge-offs.
- 3.1.8 A 'general provision' is an allowance that is established for latent losses that are known to exist, but cannot yet be ascribed to individual loans.
- 3.1.9 A 'charge-off' (or write-off) reduces the recorded investment in the loan and, if allowances previously have been established, the amount of allowances. A charge-off is made when all or part of a loan is deemed uncollectible or there is otherwise no realistic prospect of recovery.
- 3.1.10 A loan is a 'restructured troubled loan' when the lender, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider.
- 3.1.11 The 'effective interest rate' of a loan is calculated as the rate of interest required to discount the contractual cash flows over the term of the loan to equate to the acquisition cost of the loan.

4 Benefits of Asset Classification

¹ The term impaired loan is used synonymously with problem asset.



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- 4.1 Credit risk asset classification systems (CRACS) offer a number of benefits that provide for a more systematic assessment of a Credit Risk Holder's asset quality and credit strategy. The benefits include:
 - 4.1.1 the provision of insights into the quality of a Credit Risk Holder's credit portfolio and its risk appetite at a point in time;
 - 4.1.2 facilitation of migration analysis that can highlight changes in the risk profile and trends in asset quality;
 - 4.1.3 acting as an early warning system for the detection of asset quality problems by highlighting credits with above normal risks. This often allows for special monitoring of such facilities, and enables the development of strategies to eliminate any weaknesses;
 - 4.1.4 providing a foundation for risk-based pricing mechanisms; and
 - 4.1.5 improving portfolio management, especially when combined with applications that can identify degrees of risks associated with lending on an industry, geographic or counterparty basis.

5 Guidance on Credit Risk Asset Classification Systems

- 5.1 Credit Risk Holders should develop a CRACS that is consistent with the nature, size and complexity of the Credit Risk Holders' activities. The following factors should be considered when developing these systems: -
 - 5.1.1 Coverage should extend to as much of the portfolio as possible, including off-balance sheet exposures;
 - 5.1.2 For applicable exposures, the system should cover both performing and non-performing/value impaired assets to provide for the migration of an exposure from fully performing to loss status;
 - 5.1.3 Connected parties should be classified on a group basis;
 - 5.1.4 A regular independent review function to provide assurances about the integrity of the classification process should be established (i.e. an internal audit, risk management or compliance function, and in some instances the Credit Risk Holder may wish to engage the services of an independent external auditor to perform this function);
 - 5.1.5 Credit Risk Holders that rely on models to assess the classification of their assets should ensure that these models are validated periodically by an independent review function to ensure that it continues to deliver reliable information, and adequately distinguishes between exposures of varying credit quality;
 - 5.1.6 A sufficient number of risk grades to ensure that the system adequately captures



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gradation of risk; and

5.1.7 Poorer quality²facilities should at least include four categories along the lines indicated below; however, comparable ratings systems may also be used. Where the facility exhibits characteristics of two classification categories, the more conservative position should be used unless there are justifiable circumstances that would indicate otherwise. The Authority's asset classification for poorer quality facilities are as follows:

- i. **Special mention**, where clients are experiencing difficulties which, if they persisted, could result in losses – such clients should be subject to special monitoring, including frequent reviews and management scrutiny. Examples of credit weaknesses include, but are not limited to: (i) inability to properly supervise due to an inadequate loan agreement; (ii) deteriorating condition or control of collateral; (iii) deteriorating economic conditions or adverse trends in the obligor's financial position that may, if not checked, jeopardize repayment capacity; and (iv) the risk potential is greater than when the loan was originally granted, and this category should not be used as a compromise between Satisfactory and Substandard.
- ii. **Substandard**, where definable weaknesses are evident that could jeopardize repayment, particularly of interest – the Credit Risk Holder is relying heavily on available security. These assets may, or may not, be past due but carry more than a normal degree of risk due to the absence of current and satisfactory financial information or inadequate collateral documentation. There is also the distinct possibility that the Credit Risk Holder will sustain some loss if the deficiencies are not corrected. Renegotiated loans should continue to be classified as Substandard unless (i) all past due interest is paid in cash at the time of renegotiation, and (ii) a sustained record of performance under a realistic repayment program has been maintained for at least six months. A sustained record means that all principal and interest payments are made according to the modified repayment schedule from the renegotiation date. A renegotiated loan is a loan that has been refinanced, rescheduled, rolled-over, or otherwise modified because of weaknesses in the borrower's financial position or the non- repayment of the debt.
- iii. **Doubtful**, where the situation has deteriorated to such a degree that collection of the facility in full is improbable and the Credit Risk Holder expects a loss. The possibility of loss is high, but because of important and reasonable specific pending factors, that may mitigate, the actual amount of loss cannot be fully determined. Pending factors may include a

² Poorer quality facilities are those that are not categorized as Satisfactory.



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proposed merger, acquisition, or liquidation, a capital injection, perfecting liens on additional collateral, and refinancing plans. If pending events do not occur within 180 days and repayment must again be deferred pending further developments, a Loss classification is warranted.

- iv. **Loss**, where the credit facilities are considered uncollectible, and very little, or nothing can be done to recover the outstanding amount on any collateral or from the assets of the borrower (estimated recoverable amounts). This is however subject to realizing the asset within a time period that is reasonable for that asset to be normally sold. For example, marketable securities may be realized in a shorter time period compared to commercial real property that may be realized over a longer period (e.g. in excess of one year).

- 5.2 Additional guidance on the four classification categories described above is available in Annex 1. The factors listed in Annex 1 are intended to help Credit Risk Holders determine the most appropriate classification for facilities using all the factors listed therein. It is important to note that it is not necessary for all factors to be present for a particular classification to be selected. Most deteriorating facilities may exhibit characteristics of more than one classification category. As such, Credit Risk Holders should take a holistic view of all the factors in determining the most appropriate classification category.
- 5.3 Within the framework of generally accepted accounting principles, impairment loss is defined as the amount by which the carrying amount of the loan/ or other asset exceeds the asset's fair value (i.e. estimated recoverable amount). Any loan or other asset that is classified as Loss should be written-off against the provisions for loan losses account.

6 Internal Reporting and Reporting to the Authority

- 6.1 The Credit Risk Holder's internal management and Board should ensure that appropriate reports are generated regularly to reflect the Credit Risk Holder's CRACS.
 - 6.1.1 Credit Risk Holders should also provide details on the amount of provisions held against the various categories of poorer quality facilities.
 - 6.1.2 Information on Credit Risk Holders' asset classification should be provided to the Authority on regular returns as required.

7 Board and Senior Management

- 7.1 The Board and senior management are responsible for understanding and determining the nature and level of risk being taken by the Credit Risk Holder and how these risks



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- relate to the level of general and specific allowances. A Credit Risk Holder's board of directors should approve the loan loss provision policies and procedures to recognise, measure, monitor and control loan impairment. The board should be informed regularly of the loan loss provision and loan impairment.
- 7.2 The Board is also responsible for ensuring the formality and sophistication of the risk management processes are appropriate in the light of the Credit Risk Holder's risk profile and business plan.
- 7.3 The Board has responsibility for setting the Credit Risk Holder's risk tolerance levels. It should also ensure that management establishes a measurement system for assessing risk, develops a system to relate risk to the Credit Risk Holder's provision (allowance) levels, and establishes a method of monitoring compliance with internal policies.
- 7.4 Management responsibilities for managing risk in the context of loan impairment and loan loss provision (allowances) should include among other things:
- 7.4.1 Monitoring and managing the loan quality;
 - 7.4.2 Ensuring that loans are appropriately valued, uncollectable credits written off, and expected or probable losses adequately provided for;
 - 7.4.3 Exercising appropriate judgment to recognize the impression in valuation estimates;
 - 7.4.4 Maintaining effective systems and controls for identifying, measuring, monitoring, and addressing loan quality problems in a timely manner;
 - 7.4.5 Establishing documented policies and procedures for the determining and maintaining of general allowances;
 - 7.4.6 Providing appropriate disclosure; and
 - 7.4.7 Documenting its process for vetting both quantitative and qualitative methods used in the determining its general allowance.
- 7.5 To fulfil these responsibilities, Boards of directors are to instruct senior management to develop and maintain an appropriate, systematic and consistently applied process to determine provisions for loan losses. As new or additional information of relevance about the collectability of loans becomes available, a consistently applied process should allow for the capturing of such information in determining loan loss provisions. Senior management should create, implement and update suitable policies and procedures to communicate the provisioning process internally to all applicable personnel.
- 7.6 An internal control system for credit risk assessment and the provisioning process should, among others:
- 7.6.1 Include measures to provide assurance regarding the reliability and integrity of information and compliance with laws, regulations, and internal policies and



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procedures;

7.6.2 Reasonably ensure that the Credit Risk Holder's financial statements and its supervisory reports are prepared in accordance with the applicable accounting framework and relevant prudential provisioning supervisory guidance; and

7.6.3 Include a well-defined loan review process that is independent from the lending function containing:

- a. An effective credit risk grading system that is consistently applied, identifies and accurately grades differing credit risk characteristics and loan quality problems in a timely manner, and prompts appropriate administrative actions;
- b. Sufficient internal controls to reasonably assure that all relevant loan review information is appropriately considered in estimating losses (including maintaining appropriate reports, details of reviews performed, and identification of personnel involved); and
- c. Clear formal communication and coordination among a Credit Risk Holder's credit administration function, financial reporting staff, internal auditors, senior management, board of directors and others who are involved in the credit risk assessment and measurement process, as applicable (e.g. written policies and procedures, management reports, audit programs, and committee minutes).

7.7 The Credit Risk Holder's strategy must have an enterprise-wide view.

8 Loan Impairment – recognition and measurement

8.1 Recognition of impairment should be considered whenever circumstances cause uncertainty about a borrower's ability to repay all amounts due according to the contractual terms of the loan agreement. Management should use both internal and external information. Evidence of impairment includes:

- 8.1.1 information about significant financial difficulties of the borrower (e.g., as indicated by liquidity or cash flow projections),
- 8.1.2 an actual breach of contract (e.g., the borrower's delay in making principal or interest payments),
- 8.1.3 a high probability of bankruptcy or other financial re-organization of the borrower (e.g., as indicated by a downgrading of credit status by a credit rating agency),
- 8.1.4 the granting by the lender to the borrower, for economic or legal reasons relating to the borrower's financial difficulties, of a concession that the lender would not otherwise consider.

8.2 To ensure that impairment in loans is identified in a timely manner, loans should be reviewed for impairment in credit quality on at least an annual basis. The evaluation of each loan or group of related loans should be based upon the creditworthiness of the particular borrower and the creditworthiness of the group to which the borrower



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belongs. Factors to consider include:

- 8.2.1 the ability of the borrower to repay all amounts due according to the contractual terms of the loan agreement;
 - 8.2.2 the debtor's payment record, overall financial condition and resources, debt service capacity, financial performance, net worth and future prospects;
 - 8.2.3 the prospects for support from any financially responsible guarantors;
 - 8.2.4 the nature and degree of protection provided by the current and stabilized cash flow and value of any underlying collateral; and
 - 8.2.5 sector and country risk.
- 8.3 One factor that generally indicates that there has been a deterioration in the credit quality of a loan is that the borrower has defaulted in making interest or principal payments when due on the loan. As a starting point, loans generally should be identified as impaired when payments are contractually a minimum number of days in arrears reflecting payment practices for the type of loan in question.
- 8.4 Credit Risk Holders are required to classify loans and other interest-bearing assets that are in arrears in principal or interest for 90 days or more as "non-performing". In the case of overdrafts, revolving lines and other extensions of credit with no pre-established repayment terms, they are to be considered as "90 Days & Over Past Due" when they have been inactive for a period of at least 90 days, and deposits are insufficient to cover the interest capitalised during such period.

9 Loan Provisioning Methodology

- 9.1 The credit risk monitoring system provides the relevant information for senior management to make its experienced judgments about the credit quality of the loan portfolio and provides the foundation upon which a Credit Risk Holder's loan loss or provisioning methodology is built. That is, the same information should be utilized by senior management to monitor the condition of the loan portfolio and in the Credit Risk Holder's methodology for determining amounts of loan loss provisions for credit risk assessment, accounting and capital adequacy purposes.
- 9.2 A Credit Risk Holder's loan loss methodology is influenced by many factors, such as an institution's sophistication, business environment and strategy, loan portfolio characteristics, loan administration procedures and management information systems. However, there are common elements a Credit Risk Holder should incorporate in its loan loss methodology, many of which are elements of the Credit Risk Holder's credit risk monitoring system. A Credit Risk Holder's loan loss methodology should:
- 9.2.1 Include written policies and procedures for the credit risk systems and controls inherent in the methodology, including roles and responsibilities of the Credit Risk Holder's board of directors and senior management;



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- 9.2.2 Include a detailed analysis of the entire loan portfolio, performed on a regular basis;
 - 9.2.3 Identify loans to be evaluated for impairment on an individual basis and segment the remainder of the portfolio into groups of loans with similar credit risk characteristics (such as loan type, product type, market segment, credit risk grading and classification, collateral type, geographical location and past-due status) for evaluation and analysis on a collective basis;
 - 9.2.4 Identify, for individually assessed loans that are impaired, how the amount of any impairment is determined and measured, including procedures describing the impairment measurement techniques available and steps performed to determine which technique is most appropriate in a given situation;
 - 9.2.5 Address the methods used to determine whether and how loans individually evaluated, but not considered to be individually impaired, should be grouped with other loans (excluding individually assessed loans that are impaired) that share similar credit risk characteristics for collective impairment evaluation;
 - 9.2.6 Be based on current and reliable data, incorporate management's experienced judgments about the credit quality of the loan portfolio and consider all known relevant internal and external factors that may affect loan collectability (such as industry, geographical, economic, and political factors);
 - 9.2.7 Address how loss rates are determined (e.g. historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience;
 - 9.2.8 Consider current collateral values (less disposition costs from obtaining and selling collateral) and other credit risk mitigants incorporated in the loan agreement, where applicable;
 - 9.2.9 Address the Credit Risk Holder's policies and procedures for loan charge-offs and recoveries;
 - 9.2.10 Require that analyses, estimates, reviews and other provisioning methodology functions be performed by competent and well-trained personnel and be well documented, in writing, with clear explanations of the supporting analyses and rationale; and
 - 9.2.11 Include a systematic and logical method to consolidate the loan loss estimates and reasonably assure the loan loss provision balance is in accordance with the applicable accounting framework (e.g. IFRS) and relevant prudential requirements.
- 9.3 A Credit Risk Holder should have a realistic view of its lending activities and adequately consider uncertainty and risks inherent in those activities in preparing accounting information.
- 9.4 Loan accounting policies and practices should be selected and applied in a consistent way that reasonably assures that loan and loan loss provision information is reliable and verifiable.



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- 9.5 A Credit Risk Holder should use consistent credit risk assessment and valuation policies and procedures from period to period, and consistent measurement concepts and procedures for related items.
- 9.6 Sound practices for recognition and measurement of loan impairment should consider:
- 9.6.1 whether the level of loan loss allowances is sufficient to cover probable losses associated with the total loan portfolio. In such cases, all or the bulk of a Credit Risk Holder's allowances are general allowances and identified losses are charged off at an early stage.
 - 9.6.2 whether specific allowances are sufficient to cover all ascertained and expected losses inherent in individual loans. In such cases, identified but not yet finally determined losses are often recognised through specific allowances.
- 9.7 For groups of loans that are collectively assessed for impairment, estimated credit losses should reflect consideration of the Credit Risk Holder's historical net charge-off rate of the groups, adjusted upward or downward for changes in trends, conditions and other relevant factors that affect repayment of the loans in these groups as of the evaluation date. Methodologies for the determination of the historical net charge-off rate on a group of loans can range from a simple average of an Credit Risk Holder's net charge-off experience over a relevant credit cycle, coupled with appropriate adjustments as noted above for factors that affect repayment, to more complex techniques, such as migration analysis or models that estimate credit losses.
- 9.8 Capital adequacy standards and accounting frameworks require the use of historical data adjusted for current trends and conditions when collectively assessing groups of loans with similar credit risk characteristics. While methodologies for the determination of historical net charge-off rates, as adjusted for current conditions, vary depending on the sophistication and complexity of the institution, a Credit Risk Holder should utilize consistent methodologies for determining loan losses for credit risk assessment, accounting and capital adequacy purposes.

10 Management's Judgment

- 10.1 Assessment and valuation of loan impairment should not be based solely on prescriptive rules or formulae but must be enhanced with judgment by the appropriate levels of management. Historical loss experience or observable data may be limited or not fully relevant to current circumstances; therefore, management may be required to use its experienced credit judgment to estimate the amount of any loan loss. The capital and accounting frameworks provide for the use of experienced credit judgment in assessing probability of default, loss given default and loan loss provisioning. While experienced credit judgments may be necessary, the scope for actual discretion should be prudently limited and documentation should be in place to



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enable an understanding of the procedures performed and judgments made by management, particularly within the following constraints:

- 10.1.1 Experienced credit judgments should be subject to established policies and procedures;
 - 10.1.2 There should be an approved and documented analytical framework for assessing loan quality, which is applied consistently over time;
 - 10.1.3 Estimates should be based on reasonable and supportable assumptions and should be supported by adequate documentation; and
 - 10.1.4 Assumptions concerning the impact on borrowers of changes in general economic activity, both favorable and unfavorable, should be made with sufficient prudence.
- 10.2 The method of determining loan loss provisions should reasonably assure the timely recognition of loan losses. While historical loss experience and recent economic conditions are a reasonable starting point for the Credit Risk Holder's analysis, these factors are not, by themselves, a sufficient basis to determine the appropriate level for the aggregate loan loss provisions. Management should also consider any current factors that are likely to cause loan losses associated with the Credit Risk Holder's loan portfolio to differ from historical loss experience, including:
- 10.2.1 Changes in lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices;
 - 10.2.2 Changes in international, national and local economic and business conditions and developments, including the condition of various market segments;
 - 10.2.3 Changes in the trend, volume and severity of past due loans and loans graded as low quality, as well as trends in the volume of impaired loans, troubled debt restructurings and other loan modifications;
 - 10.2.4 Changes in the experience, ability, and depth of lending management and staff;
 - 10.2.5 Changes related to new market segments and products;
 - 10.2.6 Changes in the quality of the Credit Risk Holder's loan review system and the degree of oversight by the Credit Risk Holder's senior management and board of directors;
 - 10.2.7 The existence and effect of any concentrations of credit, and changes in the level of such concentrations;
 - 10.2.8 The effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's current portfolio; and
 - 10.2.9 Changes in the credit risk profile of the loan portfolio as a whole.
- 10.3 Experienced credit judgment should also be used to determine an acceptable period that will yield reliable historical loss rates as loss rate periods should not be restricted to a fixed time period to determine the average historical loss experience for any group of loans with similar credit risk characteristics. A Credit Risk Holder should



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maintain sufficient historical loss data over a full credit cycle to provide robust and meaningful statistical loan loss estimates for establishing the level of collective impairment losses for each group of loans with similar credit risk characteristics. When applying experienced credit judgment, a Credit Risk Holder should provide a sound rationale for excluding any historical loss data that is deemed not representative of the performance of the portfolio.

- 10.4 In estimating probability of defaults, loss given defaults and loan losses under both capital and accounting frameworks, Credit Risk Holders may determine either a single amount or a range of possible amounts. In the latter case, a Credit Risk Holder should recognize an impairment loss equal to the best estimate within the range after considering all relevant information about conditions existing at the measurement date that is available before it completes its prudential reports or financial statements. When determining an amount of an impairment loss within a range, Credit Risk Holders will rely upon factors that are consistent with credit risk characteristics evaluated under the Basel II framework.
- 10.5 Notwithstanding management' discretion, non-performing loans and other interest-bearing assets, which have been placed on a cash basis for accounting and reporting purposes should be considered as Non-accruing Loans. Interest should no longer be accrued on the books of the Credit Risk Holder as income unless paid by the borrower in cash. Previously accrued but uncollected interest should be reversed from income at the time these accounts are placed on non-performing/non-accrual status.
- 10.6 When management adjusts allowance estimates for these factors, there must be documentation that clearly demonstrates the estimated impact of the changes in the factors on the historical loss experience.

11 General Provisions

- 11.1 General provisions are often considered to represent an interim step pending the identification of losses on individual loans. The occurrence of a loss event on an individual loan might not be immediately known to the Credit Risk Holder. However, the effect of those events should ordinarily become apparent within a reasonable time frame through delinquency or the receipt of new financial statements or other information that triggers the classification of the loan. As soon as adequate information is available to identify losses on individually impaired loans, the general provisions would be replaced by specific provisions (or charge-offs).
- 11.2 General allowances should be determined by using one or several of a number of different methodologies including:
- 11.2.1 Applying a formula to the group that takes into account the analysis of arrears, ageing of balances, past loss experience, current economic conditions and other relevant circumstances;



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- 11.2.2 Migration analysis;
- 11.2.3 Various statistical methodologies;
- 11.2.4 Estimating impairment in the group based on the Credit Risk Holder's judgment of the impact of recent events and changes in economic conditions that indicate the existence of impairment.



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12 Specific Provisions

- 12.1 Credit Risk Holders should provide specifically for credits where losses are certain or likely. The percentages to be provided will depend on the particular circumstances.³
- 12.2 Whilst the level of provisions is normally a matter for a Credit Risk Holder to determine in consultation with its external auditors, the Authority may exercise its discretion to intervene where in its opinion the Credit Risk Holder is being insufficiently prudent in its approach to its own provisioning policies or is seriously out of line with industry best practice provisioning policies.

13 Adequacy of the Overall Provisions

- 13.1 A Credit Risk Holder should maintain an overall allowance at a level that is adequate to absorb estimated credit losses associated with the loan portfolio. The adequacy of specific and general allowances should be reviewed in the preparation of annual and interim reports or more frequently, if warranted, to ensure that the aggregate amount of allowances is consistent with current information about the collectability of the loan portfolio. When establishing allowances, the Credit Risk Holder should not understate or overstate loan losses in order to achieve a desired level of earnings in current or future reporting periods.

14 Re-classification of Impaired Loan

- 14.1 An impaired loan should only be restored to satisfactory status when the contractual amount of principal and interest is deemed to be fully collectible in accordance with the terms of the loan agreement. As a general principle, this should take place when:
- 14.1.1 the Credit Risk Holder has received repayment of the loan's past due principal and interest, none of the loan's principal and interest is due and unpaid, and the Credit Risk Holder expects repayment of the remaining contractual principal and interest as scheduled in the loan agreement,
 - 14.1.2 the borrower has resumed paying the full amount of the scheduled contractual principal and interest payments for 6 months period, and all remaining contractual payments (including full compensation for overdue payments) are deemed to be collectible in a timely manner, or
 - 14.1.3 the loan otherwise becomes well secured and is in the process of collection.

³ 1 The following is an example of a common provisioning benchmark system:-

- (a) **Satisfactory – 0**
 - (b) **Special mention – 0%**
 - (c) **Substandard – 15-25%**
 - (d) **Doubtful – 50-75%**
 - (e) **Loss – 100%**
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- 14.2 Acceptable methods for calculating the estimated recoverable amount of an individual impaired loan are:
- 14.2.1 The present value of expected future cash flows discounted at an appropriate interest rate, i.e., the effective interest rate inherent in the original loan agreement. The estimates of future cash flows should be the Credit Risk Holder's best estimate based on reasonable and supportable assumptions and projections;
 - 14.2.2 The fair value of the collateral to the extent the loan is collateral-dependent. A loan is collateral-dependent if repayment of the loan is expected to be provided solely by the underlying collateral;
 - 14.2.3 The observable market price, if it is a reliable indicator of the loan's estimated recoverable amount.
- 14.3 A Credit Risk Holder should measure the estimated recoverable amount of a restructured troubled loan taking into account the cost of all concessions at the date of restructuring. The restructuring may include the acceptance of property in partial satisfaction of the loan. In such a case, the recorded investment in the loan is reduced by the fair value of the property received less cost to sell.
- 14.4 Evidence of impairment includes a troubled loan restructuring, i.e., where the lender has granted a concession to the borrower due to a deterioration of the borrower's financial condition or other financial difficulties. Concessions granted in a troubled loan restructuring may include, but are not necessarily limited to, the following situations:
- 14.4.1 a modification of terms, e.g., a reduction in the interest from that originally agreed or a reduction in the principal amount.
 - 14.4.2 the transfer from the borrower to the Credit Risk Holder of real estate, receivables from third parties, other assets, or equity interest in the borrower in full or partial satisfaction of the loan.
- 14.5 A restructuring may also involve the substitution of a new debtor for the original borrower or the addition of a new debtor.

15 Income recognition

- 15.1 A Credit Risk Holder should recognise interest income on an unimpaired loan on an accrual basis using the effective interest rate method. Interest earned on unimpaired loans should be recognised in the income statement on a level-yield basis as it accrues using the effective interest rate method, and not as it is received in cash or becomes due. The effective interest is calculated as the rate of interest required to discount the contractual cash flows over the term of the loan to an amount that equals the cost of the loan. Interest revenue is then allocated to periods over the term of the loan by applying the effective interest rate so as to achieve interest being reported at a



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constant yield on the recorded investment. Thus, under the effective interest rate method, interest includes the amount of amortisation of any discount or premium between the cost of a loan and its amount at maturity and the amortisation of any loan fees and costs.

- 15.2 When a loan is identified as impaired, a Credit Risk Holder should cease accruing interest in accordance with the terms of the contract. Impaired loans should be measured at their estimated recoverable amount. Interest on impaired loans should not contribute to net income if doubt exists concerning the collectability of loan principal or interest.
- 15.3 Uncollected interest that has been previously accrued should be reversed or included in the loan balance with an adequate specific allowance established against it. In some Credit Risk Holders, when an impaired loan is carried at the present value of expected future cash flows, interest may be accrued and reported in net income to reflect updated present values based on the effective interest rate inherent in the original loan agreement. An institution that applies a present value approach, but does not accrue interest to reflect updated present values, may include the changes in present values in the adjustment to allowances that is reported in the income statement.
- 15.4 Some or all of the cash interest payments received on an impaired loan for which the accrual of interest has ceased may be reported as interest income on a cash basis as long as the recorded investment in the loan less any specific allowance is deemed fully collectible in a timely manner.
- 15.5 A loan on which a Credit Risk Holder has ceased to accrue interest should only be restored to accrual status when the loan has returned to unimpaired status as discussed in section 14 unless (1) the loan has been formally restructured (as discussed below) or (2) the loan has been acquired at a discount that relates to its credit quality and the discount that is considered collectible is accreted in accordance with sound principles.

16 Restructured Loan

- 16.1 An impaired loan that has been restructured so as to be reasonably assured of repayment and performance according to its modified terms may be returned to accrual status. Circumstances that may provide evidence of a relative improvement in the borrower's condition and debt service capacity include substantial and reliable sales; lease or rental contracts obtained by the borrower or other developments that are expected to significantly increase the borrower's cash flow and debt service capacity and the borrower's commitment to repay. Also, a reasonable period of demonstrated payment performance in accordance with the modified terms is an important factor in determining whether there is reasonable assurance of repayment



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and performance according to the loan's modified terms.

- 16.2 A Credit Risk Holder's determination of the ultimate collectability of a loan for purposes of reporting interest income on a cash basis or restoring the loan to accrual status should be supported by a current, well documented credit evaluation of the borrower's financial condition and other factors affecting the prospects for repayment, including consideration of the borrower's repayment performance and other relevant factors.

17 Further Guidance

This Statement of Guidance has been developed using *Sound credit risk assessment and valuation for loans*, June 2006 and *Principles for the management of credit risk*, September 2000.) issued by The Basel Committee on Banking Supervision. Institutions should consult the aforementioned papers for further guidance on the establishment and maintenance of a Credit Risk Management System.



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Annex 1

Credit Risk Asset Classification Considerations					
Evaluation Category	Satisfactory	Special Mention	Substandard	Doubtful	Loss
Sales/ Revenues	Sustained or improving	Deteriorating	Severe downturn	Severe downturn – prospects for turnaround in question	Prospects for turnaround unlikely
Earnings	Sustained	Losses or less than satisfactory profits with possibly a downward trend	Significant losses	Losses sustained for several periods	Losses sustained for several periods
Capital Position	Strong	Undercapitalized and overtrading or deteriorating capital position	Significantly undercapitalized	Strongly undercapitalized	Strongly undercapitalized
Cash flow from operations	Stable	Deteriorating, although still able to meet debt service	Seriously affecting ability to service debt	Unable to service debt	Unable to service debt
Debt servicing / financing	Undertaken easily	Unbalanced debt position and may have had or having difficulty obtaining financing	Little to no access to information about position. Renegotiated loans are classified as Substandard unless (i) all past due interest is paid in cash at the time of renegotiation, and (ii) a sustained record of performance under a realistic repayment program has been maintained for at least six months.	No access to information	No access to information
Management	Experienced	Inexperienced or weak or under scrutiny	Poor	Poor	Poor
Environmental Risk	Acceptable	Difficulty relating to environmental factors, economic conditions or adverse trends that may impair security values or jeopardize repayment capacity	Definable weakness identified	Serious liability identified	Serious liability identified
Credit Risk Holder Supervision Required	Normal	Close	Rigorous – to protect position	Likely a non-accrual advance	Likely a non-accrual advance



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Security / Collateral Position	Not an issue	Good to strong but condition or control of collateral is deteriorating	Continues to protect, according possible avenue for recovery	Does not fully protect – loss possible	Does not full protect and a provision is required
Sponsors / Guarantors	Quality, reputation and financial capacity strong	Commitment to support with known resources	Limited resources and commitment uncertain	Uncertain / Unlikely	No outside resources
Payment of Principal and Interest	Assured	Not currently at risk but the potential risk is greater than when the loan was originally granted	Repayment of principal and/or interest potentially at risk due to well defined weaknesses	At risk. Collection of the facility in full is improbable.	Not supportable