CREDIT RISK MANAGEMENT GUIDELINE

1. INTRODUCTION

The Central Bank of Barbados (Bank), in furtherance of its responsibility for the regulation and supervision of licensees under the Financial Institutions Act, 1996-16 and the International Financial Services Act, 2002-5, has developed this Guideline to provide guidance to licensees on their obligations as it relates to the management of credit risk.

Credit risk is the current or prospective risk to earnings and capital arising from the failure of a counterparty to meet its contractual obligations. It occurs in both banking and trading book activities, encompassing loans and diverse financial instruments, including bonds, foreign exchange, derivatives, commitments and guarantees. Credit risk can result from either on- or off-balance sheet activities and is often the most significant risk some licensees face and therefore must be well managed. Credit risk cannot be managed in isolation from other risks and its management should therefore be conducted within the context of an enterprise risk management programme that seeks to promote the overall safety and soundness of the licensee and that is appropriate for the nature, complexity and sophistication of the business activities.

This Guideline focuses on sound practices in credit risk management, outlining licensees' responsibility for managing and controlling exposure to credit risk and setting out the Bank's expectations in relation to the minimum standards for sound credit risk management by all licensees. While the structure of the Guideline focuses on the credit risk associated with lending, some aspects of the Guideline may also be applicable to other sources of credit risk, including those incurred in investment management.

As part of its ongoing supervisory activities, the Bank will assess licensees' credit risk management processes i.e. strategies, policies, procedures and practices against the criteria set out in this Guideline. Licensees should be able to demonstrate that they have implemented adequate measures to manage credit risk. Licensees that have a credit risk process that is assessed as less than satisfactory will be required to take appropriate actions to promptly improve their credit risk management process.

2. APPLICATION

This Guideline applies to all entities that are licensed under the Financial Institutions Act, 1996-16 and the International Financial Services Act, 2002-5 that engage in business activities that give rise to credit risk. However, risk management practices will be influenced by factors such as the licensee's size and the nature and complexity of activities.

The Bank recognises that some licensees are part of larger banking groups and may delegate some functions to their Head Office as part of group-wide risk management strategy. However, responsibility for compliance with the requirements of this Guideline remains with the licensee.

Where a licensee controls a wider financial group or is the parent entity of a consolidated group, it must ensure that the required policies and procedures are in place to ensure that credit risk is managed in an appropriate and integrated manner across the group.

3. CREDIT RISK MANAGEMENT

Credit risk management is the process of controlling credit risk-related events. Credit risk largely arises in assets shown on the balance sheet, but it can also show up off balance sheet in a variety of contingent obligations. Lax loan supervision, ineffective control processes or the failure to identify fraud may increase the risk of loss. Licensees should therefore establish systems to identify, measure, monitor and control credit risk, to ensure that they hold adequate capital against credit risk and that they adequately mitigate the impact of the risks incurred.

A sound credit risk management framework should include:

a. Robust credit approval processes;
b. Appropriate credit administration, measurement and monitoring processes; and
c. Adequate controls over credit risk.

3.1 Board of Directors

The Board of Directors (Board) is responsible for establishing an appropriate credit risk environment by defining a viable long term risk management strategy and providing oversight of the credit risk management function. In formulating the strategy, the Board is expected to consider its target markets, its desired portfolio mix and the economic conditions in which it operates. To facilitate effective implementation of the strategy, the Board is responsible for, inter alia,

a. Approving documented policies and procedures for the prudent management of credit risk. These policies should, inter alia,

    i. Define the licensee's degree of risk tolerance i.e., how much and what types of risk the licensee is prepared to undertake.
    ii. Be consistent with the defined risk tolerance.
    iii. Provide for a risk management structure that effectively enables management oversight and execution of credit risk management and control processes.
    iv. Provide for credit approving authority to be delegated to senior management, a credit committee or individual credit officer(s) commensurate with their credit experience and expertise.
    v. Provide for internal controls and systems to control and monitor large exposures and other risk concentrations in accordance with legislation and internal policies.
    vi. Provide for new credit products to be reviewed and approved by the Board or its appropriate delegated committee.

b. Reviewing at least annually, credit policies, procedures, controls and information systems to ensure continued adequacy, relevance and effectiveness;
c. Reviewing periodic reports that are timely and contain detailed information to allow for a clear understanding of the licensee's overall credit risk exposure and performance of the credit portfolio, including information on classification of credits, the level of provisioning and major problem assets and management's actions taken or contemplated for recovery;
d. Approving remuneration policies that are consistent with the credit risk strategy and that do not encourage officers to generate short-term profits by taking an unacceptable high level of credit risk; Approving credits to, or guaranteed by related parties[1], and review the licensee's policy related to such credits; and
e. Ensuring that there is a periodic independent internal assessment of the licensee's credit-granting and credit risk management functions.

[1] See definition of "related parties" in Section 3.5.4.

3.2 Senior Management

Senior Management is responsible for implementing the credit risk strategy approved by the Board of Directors. This includes:

a. Ensuring that written policies and procedures are developed and implemented and that credit approval and review responsibilities are clearly and properly assigned;
b. Disseminating the strategy and policy to all relevant staff and holding personnel accountable for compliance with established policies and procedures;
c. Establishing risk management and control functions such as limit setting, exposure and exception monitoring and reporting and custody and monitoring of documentation that are independent of the credit originating function;
d. Ensuring the implementation of a management information system that:

    i. Tracks the evolving circumstances of a credit, regularity of repayments, borrower's financial condition, value of the security, and other attributes of the credit; and
    ii. Tracks credits by portfolio characteristics, including single and associated groups of borrowers, types of credit facilities and industry sectors;

e. Developing systems for reporting and monitoring the credit portfolio, including:

    i. Large and/or overdue accounts;
    ii. Significant credit activities of the financial institution and composition and quality of the credit portfolio;
    iii. Significant impaired credits and collection prospects;
    iv. Credit transactions not in accordance with the credit risk management policies; and
    v. Trends in portfolio quality and the level of diversification, and an analysis of emerging problems and remedial actions taken or contemplated; and

f. Ensuring the implementation of an effective internal inspection/audit function to review and assess credit risk management activities.

3.3 Credit Policies

A properly documented credit policy is an essential element of the credit risk management process and provides the basis for effective portfolio management. It should set out the criteria and guidelines for the granting, maintenance, monitoring and management of credit at the individual and portfolio levels. In addressing all significant credit matters, the policy should include:

a. Types of facilities to be offered, with pricing policies, profitability targets, maximum maturities and maximum debt-servicing ratios for each type of lending;
b. Ceilings for the total loan portfolio in terms of, for example, loans-to-deposit ratio, un-drawn commitment ratio, a maximum dollar amount or percentage of capital base;
c. Limits on exposures by country, industry, category of borrower/counterparty, product type, groups of related parties and single borrowers etc. Licensees should also ensure that policies include a definition of “group” in line with Section 3 of FIA/Section 2 of IFSA;
d. Procedures for identifying when it is appropriate to classify a group of obligors as connected counterparties[2] and for aggregating exposures to individual customers across business activities:
e. Types of acceptable collateral, loan-to-value ratios and the criteria for accepting guarantees;
f. Delegation of credit authority to management and staff, including authority to approve exceptions;
g. Procedures for the review of loans including a grading/rating system;
h. Problem credit identification and administration and associated provisioning[3]; and
i. The minimum information required from loan applicants bearing in mind AML/CFT best practice and legal requirements.

3.4 Collateral and Guarantees

Licensees should not rely on collateral or guarantees as the primary source of repayment or a substitute for evaluating a borrower’s creditworthiness. Nevertheless, collateral and guarantees, if properly taken and managed, serve to mitigate credit risk by providing the licensee with a secondary source of repayment in the event of default by the borrower.

[2] Connected counterparties may be a group of companies related financially or by common ownership, management, research and development, marketing or any combination thereof. Identification of connected counterparties requires a careful analysis of the impact of these factors on the financial interdependency of the parties involved.
[3] The minimum provisioning standards are set out in Appendix 1.

Licensees that rely on collateral to provide secondary protection in the event of default face the risks that:

a. They may be unable to establish a title to the collateral for disposal; and
b. The cash proceeds eventually realised by the disposal of the collateral may be less than its estimated value.

It is therefore essential that licensees set up appropriate systems and controls for the management of collateral and guarantees. In this regard, licensees should ensure that assets accepted as collateral satisfy, at minimum, the following criteria:

a. The licensee's right to repossess the asset is legally enforceable and without impediment;
b. The market value of the asset is readily determinable or can be reasonably established and verified;
c. The asset is marketable and there exists a readily available secondary market for disposing of the asset[4]; and
d. The licensee is able to secure control over the asset if necessary. In the case of a movable asset, the licensee should either have physical custody of the asset (e.g. security certificates) or have the means of locating its whereabouts (e.g. vehicle, machinery or equipment).

Collateral, which does not satisfy the above criteria, may still be accepted as additional comfort, but the facilities concerned should be regarded as unsecured. The legislation prohibits[5] the granting of any advance by a licensee against the security of its own shares or the shares of its holding company or subsidiary. Examples of acceptable collateral are referenced in Appendix 2.

Licensees should ensure that collateral valuations are up to date. The appropriate frequency of revaluation depends on the nature of the collateral and its current marketability. Licensees must also note that they will also be required to value collateral as often as the Bank may prescribe.

Licensees should not regard guarantees as collateral and the portion of the facilities covered by them should be regarded as unsecured. As an exception to this rule in the case of licenses under FIA, guarantees issued by the Barbados Government in support of any financial exposure to the Barbados Government or to a statutory corporation may be used as collateral. It should be highlighted that the Bank reserves the right to approve guarantees on a case-by-case basis based on their merits. Accordingly, licensees should ensure that these guarantees fulfil the following criteria:

[4] Disposal of collateral should be at arm's length and through a transparent process to avoid complaints by the original owner.
[5] Section 21 of FIA and Section 22 of IFSA.

a. The guarantee should represent a direct claim on the guarantor;
b. The guarantee should be unconditional and irrevocable;
c. The guarantee should be properly documented and legally enforceable;
d. The guarantee should remain continuously effective until the facility covered by the guarantee is fully repaid or settled; and
e. The financial strength of the guarantor should be thoroughly assessed and considered as adequate for discharging the obligation under the guarantee.

3.5 Credit Approval Process

The credit approval process involves the evaluation and approval of credit applications. Licensees should maintain prudent procedures for approving credits to ensure that credit facilities are granted only to credit-worthy customers meeting the prescribed credit acceptance criteria. To ensure a sound credit approval process, licensees should:

a. Operate within well-defined credit-granting criteria;
b. Establish overall credit limits at the level of individual borrowers and counterparties that aggregate in a comparable and meaningful manner different types of exposures; and
c. Have clearly established processes for approving credits.

3.5.1 Credit Granting Criteria

Criteria for granting new credit, for approving extensions to existing credits and exceptions should be documented, giving a clear indication of the licensee's target market and requiring a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.

3.5.2 Credit Granting Processes

Licensees must develop a core of credit risk officers who have the experience, knowledge and background to exercise prudent judgement in assessing, approving and managing credit risks. Key elements of the process include:

a. Analysis by competent credit analysts of the inherent risk factors of each transaction;
b. Approvals in accordance with the licensee's written policies and regulatory exposure limits and granted by the appropriate level of management;
c. Mechanisms to consolidate exposures to a borrower or group of borrowers where transactions may arise in one or more departments, branches or subsidiaries;
d. A clear audit trail documenting compliance with the approval process and identifying the individual(s) and/or committee(s) providing input as well as making the credit decision; and
e. Measures to minimise the possibility of loss through legal risk. See Section 3.4.

3.5.3 Large Exposures and Risk Concentrations

Licensees should establish internal controls and systems, endorsed by the Board of Directors, to control and monitor large exposures and other risk concentrations, in accordance with Section 21 of FIA and Section 22 of IFSA.

Risk concentration can be viewed as any exposure with the potential to produce losses that are substantial enough to threaten a licensee's capital strength or earnings or otherwise undermine the licensee. It can take many forms, as such licensees should ensure that they carefully manage and avoid excessive risk concentrations of various kinds. These include exposure to:

a. Individual borrowers or a group of borrowers (in particular exposure exceeding 10% of the licensee's capital base);
b. Groups of borrowers with similar characteristics, economic and geographical sectors; and
c. Types of lending with similar characteristics.

3.5.4 Related Parties

Related party exposures (both on-balance sheet and off-balance sheet) arise from lending to:

a. The holding company, subsidiaries or affiliates of the licensee;
b. Any party that the licensee exerts control over or that exerts control over the licensee;
c. Any firm in which any director or officer or the immediate relative[6] of such officer or director of the licensee, has an interest or controls 20% or more of the voting shares,
d. Any person who controls 20% or more of the licensee's shares;
e. Associated entities in which the licensee owns at least 20% but less than half of the voting shares;
f. The licensee's directors, controlling and/or major shareholders, executive officers, senior staff or any business partner or immediate relative of such individuals;
g. Corresponding persons referred to in f. of the holding company, subsidiaries and affiliates of the licensee; and
h. Any company of which any persons referred to in f. is a director, controlling shareholder, senior officer or exercises control.

[6] An "immediate relative", in respect of any person, means the spouse, parent, brother, sister, child or step-child of that person or the spouse of that person's parent, brother, sister, child or step-child.

In addition, the Bank may exercise discretion in applying this definition on a case-by-case basis.

Attention is drawn to Section 21 of the FIA and Section 22 of the IFSA which set out governance procedures for granting facilities[7] to related parties.

To minimise the risk of improper and excessive lending and to protect third party depositors, the Bank expects licensees to establish internal limits on:

a. Aggregate unsecured lending to related parties;
b. Secured lending to individual related parties; and
c. Aggregate secured lending to related parties.

Licensees must ensure that:

a. All credits to related companies and individuals are granted on an arm's-length basis;
b. The amount of credit granted is monitored carefully;
c. Notwithstanding delegated credit limits, material transactions with related parties and write-offs of related parties exposures exceeding specified amounts are subject to Board approval; and
d. All related party exposures are reported to the Bank as required.

Exposures to related parties will be closely monitored. Where a licensee is funded by third party deposits, the Bank will deduct such exposures from the capital base of the licensee if it is of the opinion that the exposure was:

a. Used to fund investments in unconsolidated subsidiaries or affiliates; or
b. Made on concessionary terms such as low or no interest rate and/or no final maturity; and
c. In excess of the permissible limits for related party transactions.

3.6 Credit Administration

Good credit administration is critical if a licensee is to manage credit risk exposure. Once a credit is granted, it is the responsibility of the unit charged with credit administration, often in conjunction with a credit support team, to ensure that the credit is properly maintained. It is expected that an adequately functioning credit administration function would:

[7] For non-credit services/contracts provided by related parties kindly refer to the Corporate Governance Guideline and Outsourcing Guideline.

a. Keep credit files up to date, obtain current financial information, send out renewal notices and prepare various documents such as loan agreements;
b. Ensure adequate segregation of duties between origination and disbursement;
c. Verify that the terms and conditions (interest rate, maturity/settlement date, payment amount) of credits are accurate;
d. Review all facilities, at least annually, to ensure that the terms and conditions continue to be met;
e. Keep regular contact with the borrowers/counterparties. In doing this, a licensee should address any documentation deficiencies that prevent it from ascertaining the current financial condition of the borrower or counterparty. Licensees should request items such as audited financial statements, bank statements or other proof of income in an attempt to determine the borrower's on-going ability to service the facility;
f. Assign credit ratings to individual credits in accordance with the internally developed rating system and ensure that ratings are consistent across the loan portfolio. Licensees must ensure that internal risk ratings can be mapped to the 5 grade classification under the Financial Institutions Act (Asset Classification and Provisioning) Regulations, 1998 SI 107;
g. Provide management with timely information to allow for adequate assessment of the asset quality of the loan portfolio;
h. Ensure safe custody of important legal documents (e.g. first legal mortgage, bill of sale);
i. Comply with prescribed management policies and procedures and applicable laws and regulations; and
j. Ensure collateral valuations are up to date.

3.7 Measurement of Credit Risk

The measurement methodology employed by the licensee should be aligned with the nature and complexity of its activities. In general, this will require:

a. An adequate accounting/management information system; and
b. The development of an internal risk ratings model.

In measuring its credit risk, the licensee should take into account the current exposure as well as the potential future exposure, i.e. what would be the loss should a borrower or counterparty default at any stage of the transaction's life.

3.7.1 Management Information Systems

Licensees should have in place information systems and analytical techniques that enable management to:

a. Measure the credit risk inherent in all on- and off-balance sheet activities including guarantees and credit derivatives;
b. Quantify periodically and efficiently the credit risk of individual customers as well as the overall portfolio;
c. Obtain reliable and timely information for the adequate measurement of the licensee's credit risk;
d. Aggregate information in various ways so as to facilitate different types of analysis. Generally, the information system should allow for detailed analysis of individual credits and the portfolio as a whole. For example, it should:

    i. Provide at a minimum a breakdown of the loan portfolio such as by loan type, maturity, sector/industry, geographic location, counterparty, collateral type, currency or any other breakdown applicable to the nature of the licensee's business activity;
    ii. Detail the terms of the loan (interest rates, repayment schedule), type of security, collateral or guarantee assigned as well as provide a report of the payment history of a given loan facility;
    iii. Permit aggregation of individual loan facilities for instance by group, related party, sector/industry, geographic location, currency or maturity to allow for analysis on concentrations;
    iv. Allow for a determination of large exposures both on an individual and aggregated basis;
    v. Facilitate the use of an internal rating system (see Section 3.7.2) to classify loans and assist in the determination of the level of provisioning of the loan portfolio;
    vi. Provide a breakdown of the loan portfolio based on the classification assigned;
    vii. Provide suspension of interest accruals for non-performing loans in accordance with the statutory regulations[8]; and
    viii. Facilitate exception reporting for breaches to internal policies and statutory regulations.

3.7.2 Internal Risk Rating Systems

A well-structured internal risk rating system will allow for determination of:

a. The overall characteristics of the credit portfolio;
b. Concentrations;

[8] A summary of the statutory requirement is captured in Appendix 3.

c. Problem credits;
d. Classifications; and
e. The adequacy of loan loss provisions.

Risk rating systems must, at a minimum, reflect the five-grade classification system employed for regulatory reporting as set out in the Financial Institutions Act (Asset Classification and Provisioning) Regulations, 1998 SI 107 and captured in Appendix 1. Licensees must ensure that internal risk grades can be mapped to the 5 grade classification under the FIA Regulations. Additionally, the system should allow the licensee to track the migration of individual credits in loan portfolios, facilitate the early identification of deteriorating credits, and thus allow for the implementation of corrective actions to minimise potential credit losses. Licensees should ensure that assigned risk grades cover both on and off balance sheet credit exposures of customers.

The internal risk rating system should be reviewed periodically to ensure that it is still appropriate given the nature of the licensee's portfolio and risk appetite. This review would entail assessing the validity and consistency of the criteria used to assign ratings.

3.7.3 Stress Testing

The development of a stress-testing program should form an integral part of a licensee's risk management processes. It provides an avenue that allows licensees to estimate their risk exposures under stressed conditions and develop appropriate strategies to mitigate the risks. Licensees should refer to the Stress Testing Guideline for further details on the overall stress testing process and its applicability to credit risk management.

3.8 Monitoring of Credit Risk

Licensees should monitor credits on an individual basis so that they can:

a. Understand the current financial condition of the borrower or counterparty;
b. Monitor compliance with existing covenants;
c. Assess collateral coverage relative to the borrower's current condition;
d. Identify contractual delinquencies and classify potential problem credits on a timely basis;
e. Review the adequacy of the provisions for individual credits; and
f. Direct problems promptly for remedial action.

The frequency of monitoring depends on the particular procedure being performed and the complexity of the portfolio. However, licensees are required to conduct, at a minimum, annual reviews of their loan portfolios and other assets. The following must be reviewed:

a. All large credit and significant asset items, including large off-balance sheet credit commitments;
b. All past due loans, non-performing loans and other loans identified as problem loans, and;
c. A sample of the remaining portfolio.

The loan portfolio review should cover at least 70% of the total amount of outstanding loans and advances. The information reviewed would include:

a. The original amount of the loan or advance, the terms, the interest rate, the current balance and status and the purpose of the loan or advance;
b. The business of the borrower, balance sheets, cash flows and other financial data both on the business and guarantors;
c. The evaluation of the project financed;
d. The security taken, including up-to-date appraisals, legal assignments, and insurances; and
e. The track record of the borrower including the servicing of previous borrowings.

Internal risk ratings as well as the volatility of the operating environment and other market conditions should drive the frequency of reviews assigned to any given credit. Certain types of credits may require quarterly or monthly monitoring due to their nature. Additionally, credits identified as potential problem credits, should be monitored at an interval that allows for remedial actions to be put in place to minimise any projected loss.

An effective monitoring system at the portfolio level should, at a minimum, entail:

a. Reviewing the performance of the loan portfolio by loan type, sector/industry, currency, geographic locations or other groupings. This would include performance trends and ratio analysis;
c. Reviewing of the loan portfolio based on the internal risk ratings. This allows licensees to assess gradation of the loan portfolio;
d. Assessing the level of concentration (type, maturity, sector etc) in the portfolio and compliance with internal and statutory large exposure limits;
e. Monitoring exposures to group or connected party lending as well as related party exposures;
f. Assessing the asset quality and adequacy of provisioning for the loan portfolio; and
g. Conducting stress testing and contingency planning.

A summary of the reviews should be reported to senior management in a timely manner to enable them to adequately assess the overall composition and quality of the loan portfolio. These reports should form an integral part of the monitoring of the overall loan portfolio. Senior management or other delegated staff should also have procedures in place to monitor the overall quality of the portfolio and take corrective actions to address any deficiencies.

3.9 Ensuring Adequate Controls Over Credit Risk

Licensees should ensure that the credit risk function is properly managed, that credit exposures are within statutory and internal limits and that problem credits are effectively managed. Aspects of the control process include:

a. Segregation of Duties
b. Exception Reporting
c. Risk Mitigation
d. Managing Problem Credits
e. Independent Reviews

3.9.1 Segregation of Duties

Licensees should keep as separate as possible, the functions of credit initiation, approval, review, administration, payments and credit work-outs on weak credits.

3.9.2 Exception Reporting

Licensees should establish and enforce internal controls and practices so that deviations from policies, procedures, limits and prudential guidelines are promptly reported to the appropriate level of management.

3.9.3 Risk Mitigation

In controlling credit risk, licensees can utilise certain mitigation techniques including:

a. Accepting collateral, standby letters of credit and guarantees;
b. Entering into netting arrangements;
c. Setting strict loan covenants; and
d. Using credit derivatives and other hedging instruments.

While mitigation through collateral and guarantee is usually dealt with at the time of granting credits, credit derivatives and netting are often employed after the credit is in place, or used to manage the overall portfolio risk.

When mitigation arrangements are in place they should be controlled. Licensees should have written policies, procedures and controls for the use of credit mitigation techniques.

Licensees should revalue their collateral and mitigation instruments on a regular basis. The method and frequency of revaluation depend on the nature of the mitigation and the products involved.

3.9.4 Managing Problem Credits

Problem credits can adversely affect the profitability of licensees due to increased provisioning or write-offs. Additionally, they can impact the licensee's liquidity and result in an ineffective use of management resources. Therefore, it is critical that licensees implement well-defined active credit collection and arrears management processes.

Licensees should establish dedicated units/functions to handle the recovery and workout of problem loans. These units/functions may be independent units or may be housed within the credit department. The precise nature of the unit/function should reflect the size and complexity of the licensee's loan portfolio and its available resources.

The unit should be adequately staffed with officer(s) who have the requisite skills and experience to facilitate speedy resolutions to both current and potential problem credits. Irrespective of the structure of the unit, its staff should be independent of the marketing and credit approval processes.

Licensees should develop and implement clearly defined policies and procedures for the management of problem credits. The policy should at a minimum address:

a. The delegation of authority and responsibilities for the handling of problem credits;
b. Criteria and trigger points for identifying and transferring credits to the unit, including a description of the procedures to be taken for the various types of credit such as retail, business etc.;
c. Procedures for the handling of restructuring and work-outs for problem credits;
d. Procedures for the management of repossessed collateral;
e. The documentation to be produced and submitted to the Board and management;
f. The process by which feedback on the licensee's experiences in problem credit management is provided to other credit functions; and
g. Independent review of the problem credit management process.

Early identification of problem credits allows for prompt corrective action to be taken before the credits can deteriorate further. Credits flagged as potential problem credits should be subjected to more frequent reviews and, based on the characteristics of the loan portfolio, a summary of these credits should be reported to senior management on a monthly basis or more frequently.

Licensees may renegotiate loans and advances i.e. refinance, reschedule, roll over or otherwise modify credits because of weaknesses in the borrower's financial position or the non repayment of the debt as arranged. Loans should only be renegotiated if:

a. The existing financial position of the borrower can service the debt under new conditions;

b. Loans classified as doubtful or loss receive an up-front cash payment or if there is an improvement in the security taken; and
d. The security for renegotiated loans, inclusive of capitalised interest, covers the full amount of the renegotiated loan.

Loans should not:

a. Be renegotiated more than twice over the life of the original loan (commercial loans) or more than twice in a five-year period (mortgage and personal loans); and
b. Be classified upward for a minimum of 1 year following renegotiation

3.9.5 Independent Reviews

Licensees should establish a system of regular independent credit and compliance audits. These should be done by independent parties (Internal Audit and Compliance), which report to the Board or Audit Committee.

Credit audits should be conducted to assess individual credits on a sample basis and the overall quality of the portfolio. Such audits are useful in evaluating the performance of account officers and the effectiveness of the credit process.

Compliance audits should be performed to test compliance with established policies and procedures, in particular credit approval, internal credit risk grading, the appropriateness of pricing, adequacy of provisioning and adherence to limits, statutory restrictions and operating procedures.

The findings of these audits should be reported to the Board or the Audit Committee on a timely basis, and appropriate remedial actions taken to address any concerns.

4. ROLE OF THE BANK

As part of its ongoing supervisory activities, the Bank will assess licensees' credit risk management against the criteria set out in this Guideline and through the continuous review of credit risk related prudential reports. This will include an evaluation of any measurement tool (such as internal ratings and credit risk models) used by the licensee.

The Bank will determine if the Board of Directors effectively oversees the credit risk management process and if management monitors risk positions, compliance with and appropriateness of policies.

Licensees that have a credit risk process that is assessed as less than satisfactory will be required to take appropriate actions to promptly improve their credit risk management processes.

Appendix 1

PROVISIONING

Licensees are required to review their on-balance sheet assets and off-balance sheet exposures annually and, where relevant, make appropriate provisions against potential losses. Licensees should:

a. Assign at a minimum the levels of provisions set out in the table below for each of the asset classification categories;
b. Make a provision of at least 1% for the balance of loan portfolios not reviewed in the past 12 months;
c. Make larger provisions for loan and investment losses, if this is considered warranted by the Bank. Factors which can influence the Bank include a review of a licensee's loan portfolio by the Bank, economic trends, changes in lending practices, the loss experience of the licensee and the quality of its risk management; and
d. Write off to a memorandum account loans classified as a loss three months after assigning the classification.

Classification	Provision (%)
Pass	0
Special mention	0
Substandard loans and advances fully secured by cash or government securities or guarantees	0
Substandard residential mortgage loans up to a maximum of six months past due	0
Other Substandard Assets	10
Doubtful	50
Loss	100

Where an asset that is not marked to market become impaired, licensees shall immediately write down its value.

Licensees should also set aside provisions to absorb potential losses from exposure to country risk[9]. Licensees, however, need not make additional provisions solely for country risk if they are satisfied that their current level of general and specific provisioning is sufficient to absorb potential losses from both credit and country risks.

[9] For further discussion, see Country Risk Management Guideline.

In the cases where a licensee's provision requirements based on International Financial Reporting Standards (IFRS) are below those based on Financial Institutions Act (Asset Classification and Provisioning) Regulations, 1998 the licensee is required to account for the residual balance which would ensure regulatory compliance, through an additional reserve account. Licensees should also prepare a report which reconciles the IFRS based provisions with those based on FIA regulations for submission to the Bank upon the Bank's request.

Appendix 2

Examples of Acceptable Forms of Collateral / Security for Loan Exposures

1. Cash
2. Bill of Sale
3. Debenture over the Fixed and Floating assets
4. First Legal Mortgage
5. Second Legal Mortgage
6. Further Charge
7. Chattel Mortgage
8. Guarantee, which is supported by Assignment of Assets
9. Central Government Guarantee
10. Credit Insurance Guarantee provided by the Central Bank
11. Security such as publicly traded shares, bonds and commercial paper may be considered collateral, provided that appropriate haircuts are applied.

Appendix 3

SUSPENSION OF INTEREST

Licensees' accounting systems should take account of the requirements of SI 107, which indicates that:

a. Interest shall not be accrued on loans classified as non-performing (i.e. where principal and interest have not been paid for ninety days or more, except in the case of residential mortgage loans where the period shall be extended to one hundred and twenty days) unless such loans are adequately secured and full collection is expected within three months;
b. Interest shall not be accrued on overdrafts when the approved limit has been reached or when credits to the account are insufficient to cover interest accruals for at least a three-month period; and
c. Interest on loans to approved Governments and loans guaranteed by such Governments, would continue to accrue up to the limit of the guarantee.

Loans for which partial payments have been are received but are cumulatively 90 days or more in arrears shall have their interest suspended.

A non-accrual loan may be restored to accrual status when all arrears of principal and interest have been paid or when it otherwise becomes well secured and in the process of collection. In the case of overdrafts, accrual status is restored when the account is operating within the limit and all interest arrears have been cleared or when it otherwise becomes well secured and in the process of collection.

Accrued, uncollected interest should be reflected in an "interest in suspense" account on the balance sheet.