**NATIONAL RESERVE BANK OF TONGA**

**Prudential Statement No.2 *Revised 2012***

**CREDIT RISK GRADING SYSTEM**

## Introduction

1. This statement is established under Section 15(3) of the Financial Institutions Act, 2004. This statement sets out the minimum standards which banks should adopt for grading credit risks. The guidelines contained in this statement form the basis for reporting on loans by credit risk classification in the FID 1_1 return.

2. The Reserve Bank believes that banks should have in place appropriate credit risk grading systems to help assess asset quality and credit exposures, including both performing and impaired facilities. This statement also establishes a set of minimum standards to be adopted by banks for provisioning and security valuation.

3. Credit risk grading systems offer a number of benefits. Analysis of a bank's entire book can reveal important insights to bank management (and the Reserve Bank) into the functioning and, ultimately, the health of a bank. Information on credit categories, and the spread of exposures across the grading system, provides a valuable snapshot of a bank's risk appetite. Time series data showing movements within grading categories provide insights into the changing nature and composition of a bank's book.

4. Credit risk grading systems provide the means for a more systematic assessment of asset quality. They are particularly useful in assisting in the early detection of asset quality problems within a bank 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.

5. Many banks use credit risk grading systems to develop more appropriate risk/reward pricing policies based on risk profiles. They can be used also as a portfolio management tool to recognise the degrees of risk associated with lending to various industries, areas, or types of borrower.

## Credit Risk Categories

6. Licensed financial institutions should classify loans, leases, other credits and similar assets or off balance sheet credit exposures (generally referred to as credit facilities) according to five categories as set out below.

   - **Standard**: Credit facilities where borrowers are meeting commitments and full repayment of interest and principal is not in doubt.

A Standard classification would generally be appropriate for any asset which is past due less than 30 days.

- **Special Mention**: Facilities which have a higher than normal degree of risk, or where borrowers are experiencing difficulties which, if they persisted could threaten the licenced financial institution's position. Special monitoring and remedial action is to be taken by the institution, to prevent such a deterioration occurring. A loss is not expected at this stage, but could occur if adverse conditions persist.

  A Special Mention classification would generally be appropriate for any asset which is past due 30 days or more but less than 90 days.

- **Substandard**: Facilities where borrowers display a definable credit weakness, which is likely to jeopardise repayment. If not corrected quickly, some loss is possible, particularly of interest. Cash flow generated by the borrower may not be considered sufficient to repay the debt at maturity. The licenced financial institution may be relying heavily on collateral security to ensure full collection.

  A Substandard classification would generally be appropriate for any asset which is past due 90 days or more but less than 180 days.

- **Doubtful**: Facilities classified as doubtful possess all the weaknesses of an account classified as Substandard but the creditworthiness of the borrower has deteriorated to such an extent that full collection on the facility is improbable. The licenced financial institution expects to sustain some loss of interest and/or principal, taking into account the market value of collateral.

  A Doubtful classification would generally be appropriate for any asset which is past due 180 days or more but less than 360 days (1 year).

- **Loss**: Facilities which are considered to be uncollectable or of minimal recoverable value, or are unable to be collected within a reasonable time frame after commencing legal proceedings,[1] or where all collection efforts such as realisation of collateral have been exhausted.

  A Loss classification would generally be appropriate for any asset which is past due 360 days (1 year) or more.

7. In allocating facilities to these classifications, the total balance outstanding on a credit facility (and not just the amount in arrears) is the amount, which is to be placed into respective category. Commitments and contingencies, which subject an institution to credit risk, are also classified in the same way to give a more complete picture of asset quality.

[1] Usually not more than 1 year after legal proceedings have commenced.

8. As a general rule, when one facility to a customer is classified, a bank should place all other facilities to that customer on the same grade.

9. Similarly, where a bank has exposures to a number of entities in a group, if an exposure to one of the borrowers is classified, banks should grade all other facilities to related parties under the same grade. However, this need not be the case if:

- the various facilities are not cross collateralised, and there are no cross guarantee arrangements between the entities; or
- there are cross collateral and guarantee arrangements but, in aggregate, there is sufficient security within the group to ensure ultimate collectability of all principal and interest.

10. In general, restructured facilities, which involve concessions to the borrower, should be classified in the Substandard classification or worse. These facilities may only be considered as Standard facilities once all due payments have been met and the new terms of the facility are comparable with the requirements for a new facility of comparable risk in the Standard risk category. The customer must be fully capable of meeting all obligations under the new terms of the facility, with a period of sustained performance of six consecutive months preceding the re-classification to a category above "Substandard".

11. Further details of the definitions and characteristics of each category are given in the completion instructions attached as Appendix I to this paper.

**Review and Risk Assessment of Credit Facilities**

12. The Reserve Bank believes that banks should have policies and appropriate systems in place for review and risk assessment of credit facilities on a regular basis.

13. All significant credit facilities should be reviewed on an individual basis at least annually. Licenced financial institutions may wish to treat some facilities on a 'portfolio' basis for convenience of analysis, for example all commercial loans with a relatively low principal value of say less than $5,000, or all personal loans or all housing loans, or all lease/hire purchase facilities, or all credit card facilities. However, once an individual Impaired facility in such a 'portfolio' becomes 6 months or more Past Due, the institution must then decide to treat the Impaired facility separate from the 'portfolio' or write the amount off in full, except to the extent that the facility is cash collateralised. The frequency of review should be linked to the size, nature, and/or risk grade of the facility. For example, impaired loans should be reviewed more frequently than once a year. Licenced financial institutions may assess provisions on an individual facility basis or on a portfolio (collective) basis. For the purposes of this Prudential Standard, collective provisions raised by an institution must be classified as either specific provisions or as part of the General Reserve for Credit Losses. Paragraph 30 of this Prudential Statement provides guidance on portfolio (collective) provisions.

14. In addition to the need for regular review of facilities there is the need for a formal, independent process for critical evaluation of the credit portfolio to reaffirm the creditworthiness of each customer and the expected losses on the portfolio. This process is commonly described as credit inspection or credit risk assessment and may be conducted in regular cycles, such as prior to each six-month and annual balance date, or may be part of a continuous credit inspection process.

15. Senior management must acknowledge the outcome of independent credit inspections or credit risk assessment and confirm the resulting amendments to provisions for loan losses carried by the institution. This inspection function should report direct to the Board Audit Committee (for locally incorporated institutions) or otherwise to a senior management position which is independent of the lending function.

## PROVISIONING AND SECURITY VALUATION

### Provisioning

16. Licenced financial institutions are required to maintain a prudent level of General Reserves for Credit Losses against losses not as yet identified and specific provisions against anticipated losses or specifically identified losses. Any under-assessment of the level of provisions required may result in an institution’s capital and profits being overstated and could lead to a lack of certainty about the institution’s on-going solvency. In determining levels of the General Reserve for Credit Losses, a licenced financial institution must have a realistic and comprehensive view of all of its business activities (including both on- and off-balance sheet exposures) and must adequately consider uncertainty and all relevant risks inherent in those activities.

17. Each licenced financial institution’s formal policies for establishing provisions will be required to be advised to the Reserve Bank and may be required to be modified after discussion with the Reserve Bank, where it considers that the policies or the resulting provisions established, are inadequate. Policies and procedures covering the reporting of the General Reserve for Credit Losses must provide for systematic assessments and be well documented, with clear explanations of supporting analysis and rationale. Such policies and procedures must, amongst other features, address the role and responsibilities of the Board and senior management in determining and monitoring the adequacy of specific provisions and the General Reserve for Credit Losses.

18. A licenced financial institution’s specific provisions and the General Reserve for Credit Losses must account for all significant factors as at the evaluation date that affect, as relevant, the collectability of the credit portfolio and estimated future credit losses. The levels of specific provisions and the General Reserve for Credit Losses must be reviewed regularly to ensure that they are consistent with identified and estimated losses.

19. As a general rule, where there is doubt about full collectability of a facility a specific provision should be made for the difference between the book value of the loan and the

net realisable value of the security after deducting collection and selling expenses. Where real security does not exist, or where realisability of securities is uncertain, then a rigorous assessment must be made to determine whether it is prudent to provide for the full amount or whether there is some readily identifiable residual value. The residual value should be an objective assessment (which may be based on the recovery experience of similar asset sales eg distress sale value of the business) of the realisable value of assets, which are freely and legally available to support the exposure, and which would reduce the level of specific provision otherwise required. (See Section on "Security Valuation" below)

20. It is essential that licenced financial institutions do not overestimate collectability of a loan. Unless exceptional circumstances exist where the realistic value of realisable security is unquestionably sufficient to cover the remaining outstanding amount (ie after deducting specific provisions or write off to date) of all principal and present and future interest due, any facility which has been impaired for 1 year or more should be classified as Loss and provided for in full or written off, regardless of whether or not legal action has commenced to realise any security held against the facility. An independent valuation of security would be essential in material cases where write off or specific provision for the total amount of the loan is not to be made at that time.

21. **General Reserve for Loan Losses**: General reserves for loan losses inherent in the loan portfolio, but which are not associated with an identifiable asset or amount, should be maintained at prudent levels by each licenced financial institution. General Reserves for Loan Losses must be maintained in respect of all credit facilities outstanding net of specific provision requirements below. (General Reserves for Loan Losses are trying to cover current unanticipated losses – therefore some of the general reserve may relate to facilities against which there is (inadequate) specific provision). The Reserve Bank will require written details of the licenced financial institution's policy in relation to the setting of General Reserves for Loan Losses.

22. The General Reserve for Credit Losses must not act as a substitute for the establishment of adequate specific provisions or the recording of an appropriate write-off for bad debts. As soon as adequate information is available to identify losses or to estimate losses on individual facilities, a suitable specific provision must be reported or a write-off for bad debts must occur as appropriate.

23. The General Reserve for Credit Losses can be determined by using one or several different methodologies, outlined below, which provide guidance as to the intrinsic risk which might be estimated to exist in an institution's credit profile. The application of these methodologies to the credit portfolio must be consistent with the nature and scale of a licenced financial institution's credit operations and management information systems.

- applying a formula to a portfolio that takes into account factors such as past loss experience;
- migration analysis;

- the use of statistical applications; and
- estimating losses having regard to an institutions judgment of the impact of recent events and changes in economic conditions on credit activities.

24. Prudent institutions should take into consideration the relatively higher risk associated with certain types of lending such as credit card facilities, hire purchase and leasing contracts and unsecured personal loans in setting the level of general reserve for credit losses held by the institution.

25. In the case of branches of foreign institutions, the Reserve Bank will require written confirmation from the head office, where an institution has advised that the general reserve for credit losses is maintained in the head office books to cover the Tonga operations.

26. **Specific Provisions held against Substandard, Doubtful and Loss facilities**: Apart from the General reserves for credit losses maintained under Paragraph 21, the Reserve Bank expects that each institution will maintain **in Tonga**, a total amount of additional provisions which is not less than the sum of the following:[2]

    - **20%** of the outstanding balance of all facilities classified as **Substandard**, (which may be established as an unallocated specific provision);[3]

    - **50%** of the outstanding balance of all facilities classified as **Doubtful**, as an allocated specific provision;

    - **100%** of the outstanding balance of all facilities classified as **Loss** (unless already written off in full) as an allocated specific provision;

27. These levels of provisions represent the minimum average levels of provisions expected by the Reserve Bank. In establishing the appropriate level of provisions, each institution must consider not only historical loan performance and asset quality information but must also conservatively evaluate the possibility of future circumstances causing a deterioration in the credit portfolio. Institutions with a relatively high-risk loan portfolio or clearly identifiable and potentially serious asset quality problems (for example where the total outstanding balance of all facilities classified as Substandard, Doubtful and Loss exceeds 10 to 15% of the total loan portfolio) will be expected to maintain an average level of provisions above these minimum levels.

[2] Calculated as a proportion of the full amount of classified credit facilities after deducting the value of security held against each facility.

[3] This does not mean that all Substandard assets are Impaired or that a specific amount of loss must be identified for each Substandard asset but rather that historical patterns indicate that, on average, a proportion of each category of assets will decline into the next lowest classification over time. It is therefore prudent to recognise a minimum provision equal to an average of at least 20% of the uncollateralised balance of all Substandard assets, as an unallocated specific provision, at the time the loan review and classification as Substandard is made.

28. Whether a particular licenced financial institution's average provision levels should be higher than the above minimums will also depend on other factors, including:

- The effectiveness of the institution's credit policies, internal and external audit, loan reviews and credit inspections in maintaining a high quality asset portfolio;
- The recent experience of loan losses, its success in realising security on problem loans in a timely manner without incurring substantial loss, and the expected future outlook for recoveries;
- The quality of financial information and credit files maintained on each borrower; and
- The present economic conditions within the industry sectors where the portfolio is concentrated and the expected impact of political, financial, economic and climatic circumstances on the collectability of the loan portfolio in the foreseeable futures.

29. The Reserve Bank will regularly review the level of general and specific provisions held by each licenced financial institution. It will discuss any concerns with the institution's senior management and may formally direct that institution to make additional provisions where it considers that the provisioning is inadequate in relation to the circumstances of that institution, or that a higher than average risk of losses exists in the portfolio which warrants more prudent levels of provisions, or where it considers that the institution has not been sufficiently rigorous in identifying Impaired Assets in its portfolio. Such concerns may arise from the various reports made by the institution or by its external auditor to the Reserve Bank, or from an on-site examination of the institution's credit portfolio conducted by the Reserve Bank.

30. **Portfolio (Collective) Provisions:** For the purposes of this Prudential Statement, a licenced financial institution must classify its portfolio (collective) provisions into specific provisions or a General Reserve for Credit Losses. Depending on the form of collective provisions raised, all, some, or none of such provisions may be included in the General Reserve for Credit Losses. A licenced financial institution's policies and procedures must address how such classification is to be undertaken.

31. A collective provision raised by an institution under international accounting standards that is not eligible to be included in the General Reserve for Credit Losses must be reported as a specific provision. The remaining eligible portion of an institution's collective provisions raised in accordance with international accounting standards must be included in the institution's General Reserve for Credit Losses.

32. That portion of collective provisions covering facilities where any assessment of probability of default or loss would give rise to a reasonable expectation that the facilities in question will need in the short term to be subject to:

- a write-down or write-off; or
- assessment for impairment on an individual facility basis

must be treated as specific provisions for the purposes of this Prudential Statement. Where an individual facility included in a group of facilities is subject to collective assessment and the facility is individually assessed as impaired, the individual facility must be removed from the group. Following this, any collective provisions incorporating the individual facility concerned must be re-determined prior to an institution assessing what portion of its collective provisions are eligible to be included in a General Reserve for Credit Losses.

33. Where a collective provision relates to possible losses from facilities in a group of facilities and
    (a) the losses are expected but not certain to arise; and
    (b) the facilities are currently meeting their contractual terms (e.g. they are not past due more than 90 days)

the provision is eligible to form part of the General Reserve for Credit Losses.

**Security Valuation**

34. All decisions to grant a credit facility to a customer should be primarily based on the licenced financial institution's assessment of the borrower's present and expected ability to repay from expected cash flows, rather than on the strength of collateral offered as security for the facility. Excessive reliance on security offered at the commencement of a loan has often led to larger than anticipated losses in environments such as Tonga, where true market values are often difficult to establish, and the processes of foreclosure, mortgagee sale or redress through the legal system can be drawn out and expensive.

35. Establishing a realistic 'Fair'[4] or net current market value for any security held is critical at the time when assessment of the appropriate level of provisions is to be made. The temptation for loan review officers to overestimate security values (and thereby reduce provisions required) must be combated by training staff in prudent assessment policies and oversight or hindsight review by experienced senior credit personnel.

36. While a first mortgage charge over real property may generally be acceptable a bank must be clear on its position given the provisions under the Land Act of Tonga. Debenture over business assets or stock may turn out to be less than fully realisable. Such securities must therefore be recognised only at a substantial discount to face value, particularly at the time that decisions are made on the appropriate level of provisions.

37. Valuation of security in the form of mortgage charge over real estate, plant and equipment or business assets should be established on the basis of their current use, rather than any prospective future value after redevelopment or possible improvement in economic or financial circumstances.

[4] "Fair value" is defined as the amount, which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. The "fair value" of an asset should equate to the "net current market value" of the asset.

38. Valuations should be undertaken using internationally recognised valuation principles. They should be on the basis of an arms length transaction, between a willing buyer and a willing seller, after proper marketing[5] and where all the parties involved had each acted with sound knowledge of the circumstances, without compulsion, and in the best interests of their principals.

39. In many circumstances in Tonga, it will not be easy to readily establish a true market value for security held. Licenced financial institutions are therefore advised to adopt a prudent approach to discounting the estimated market value, and adopting loan to valuation ratios, which are comfortably below 100 percent when loans are granted. This also allows for the possibility of decline in estimated security values and the contingencies and delays, which commonly arise in liquidating security.

**Compliance with Prudential Statement No. 2**

40. This statement is effective from 1 May 2012. Non-compliance with the requirements of this Prudential Statement will be subject to corrective actions as provided under section 33 of the Financial Institutions Act 2004 and the administrative penalties outlined in Prudential Statement No.3 Administrative Penalties.

National Reserve Bank of Tonga
March 2012

[5] As a general rule banks should view this period as 12 months, although a longer period can be assumed for specialised or unusual properties.

**Appendix I**

# REPORTING INSTRUCTIONS FOR NRBT MONTHLY FORM FID1_1

## General Instructions

1. The report, showing the position at the last business day of each calendar quarter, should be furnished to the Reserve Bank within 15 business days of the quarter end. Figures reported should be after any related adjustments have been completed in the financial accounts for the reporting date.

2. Certain items in the report should reconcile to amounts reported in other relevant returns at the same date. Reference will be made in the instructions for those returns where appropriate, when revised by the Reserve Bank.

## Specific Reporting Instructions

For the purpose of reporting to the Reserve Bank, the following definitions should be observed, consistent with Prudential Statement No. 2 *Revised 2011* 'CREDIT RISK GRADING SYSTEM' dated November 2011.

1. "Credit Facilities" includes Loans and Advances, Leases, all other on balance sheet credit exposures to customers, acceptances and bills of exchange, and off balance sheet commitments contingencies and other transactions which have the potential to expose the licenced financial institution to a loss if the counterparty fails.

   Guarantees and standby letters of credit are usually converted into on-balance sheet exposures (at full value) if the counterparty they are supporting fails. There may also be circumstances where the licenced financial institution is reasonably certain that the instrument will be called upon at a future date because of uncertainty about the customer. Loan commitments, which are irrevocable, should also be classified as Impaired Assets if the creditworthiness of the customer has deteriorated to such an extent that full repayment of any drawdown (or interest payments thereon) is considered uncertain. Interest rate and exchange rate contracts should be reported at their credit equivalent amount as in the 'Capital' Return (FID 1_10).

2. "Classification of Credit Facilities". Each licenced financial institution is to classify and report all credit facilities (as defined above), into the following categories: -
   - Standard
   - Special Mention
   - Substandard
   - Doubtful
   - Loss

The definition and examples of expected characteristics of each of these categories of exposures are given below.  While references are mainly made to loans, the factors given are also applicable to exposures arising from other items specified in the definition of credit facilities.

**Standard**

This refers to loans where borrowers are current in meeting commitments and full repayment of interest and principal is not is doubt.

**Special Mention**

This refers to loans where borrowers are experiencing difficulties, which may threaten the licenced financial institution's position. Ultimate loss is not expected at this stage but could occur if adverse conditions persist. Such borrowers should be subject to special monitoring.

It is not envisaged that specific provisions will be required for these loans at this stage. Interest may continue to be accrued to the Profit and Loss account.

These loans exhibit one or more of the following characteristics.

(a) Early signs of liquidity problems such as delay in servicing loans.

(b) Inadequate loan information such as annual audited financial statements not obtained or not available within a reasonable time.

(c) The condition of, and control over, collateral is questionable.

(d) Failure to provide proper documentation or non-cooperation by the borrower or difficulty in keeping contact with him.

(e) Slowdown in business or adverse trends in the borrower's operations that signal a potential weakness in the financial strength of the borrower but which has not reached a point where a servicing of the loan is jeopardised.

(f) Volatility in the economic or market conditions which may in the future affect the borrower negatively.

(g) Poor performance in the industry in which the borrower operates.

(h) Some management weakness is evident, or the borrower, or in the case of corporate borrowers, a key executive, is in ill health.

(i) The borrower is the subject of a litigation, which may have a significant impact on his financial position.

(j) Repayment of principal or interest on a fully secured loan or facility (or period continually in excess of limits or authorised excesses in the case of overdrafts, etc) is Past Due by more than 30 days and up to 90 days past due.

(k) For acceptances and bills of exchange held, a bill, which is overdue, should at least be classified as Special Mention.

**<u>Substandard</u>**

This refers to loans where borrowers are displaying a definable weakness, which is likely to jeopardise repayment. The licenced financial institution is relying heavily on available security. This would include:

(i) loans where some loss, either of principal or interest, (including future interest), is <u>possible</u> after taking account of the market value of security;

(ii) restructured loans – where concessions have formally been agreed with a customer on interest or principal such as to render the loan "non-commercial" to the bank;

Specific provisions (which may be maintained on a portfolio basis for all substandard facilities and not allocated to individual loans) should be set-aside at an average of at least 20% of the uncollateralised balance for accounts included in this category. Where for example security is not considered sufficient to recover both principal and accrued interest, the lending institution should consider accruing interest to suspense account rather than Profit and Loss account, or if interest has been overdue for a significant period of time, not accruing interest at all.

These loans exhibit one or more of the following characteristics: -

(a) Repayment of principal and/or of interest has been overdue for more than one month and principal, accrued interest and/or future interest is unsecured or only partially secured by the current market value of collateral, or other serious deficiencies are observed.

(b) Even where principal, accrued interest and future interest appear to be fully secured, a "substandard" classification should be made where repayment of principal and/or interest is overdue for more than 3 months.

(c) Inadequate collateral.

(d) Credit history or performance record is not satisfactory

(e) Material documentation exceptions, such as valuation of properties and collateral not properly supported in writing.

(f) Increased borrowings not in proportion with the borrower's business.

(g) Borrower experiencing difficulties in repaying obligations to other creditors.

(h) Construction delays or other unplanned adverse events resulting in cost overruns that may require loan restructuring.

(i) Unemployment of the borrower.

(j) Deteriorating financial condition of the borrower.

(k) For acceptances and bills of exchange held, a bill, which is past due by more than 3 months, should at least be classified as Substandard.

**Doubtful**

This refers to loans where collection of principal and interest in full is improbable and the licenced financial institution expects to sustain a loss of principal and/or interest, taking account of the market value of security. Specific provisions should be made against any expected loss. Accrual of interest on such loans should cease.

In addition to the characteristics mentioned for substandard loans, doubtful loans may have one or more of the following characteristics: -

(a) A prolonged overdue period of more than 6 months; but in the case of unsecured or partially secured loans or where serious deficiencies, such as death or bankruptcy of borrower, are detected, they should be classified as 'doubtful' if the overdue period exceeds 3 months. Loans for which all principal, accrued interest and future interest for an extended period is considered to be fully secured by the current market value of collateral should be regularly reviewed, but may not need to be classified as Doubtful until Past due by 2 years or more.

(b) Borrower's operations have ceased or are about to cease because of poor business results.

(c) Borrower's whereabouts unknown.

(d) Borrower in liquidation.

**Loss**

This refers to loans, which are considered uncollectable, or of minimal recoverable value, or are unable to be collected within a reasonable timeframe (usually not more than 1 year) after commencing legal proceedings; or where all collection efforts such as realisation of collateral and institution of legal proceedings etc have been exhausted. All outstanding principal and interest, which are not covered by the fair value of collateral, should be fully provided for or written off. Interest on accounts included in this category should cease to be accrued. Loans which are unsecured or only partially secured may be classified as Loss once the loan becomes Past Due by more than 6 months, and other than in exceptional circumstances, such loans must be classified as Loss when Past Due 1 year or more.

**3. “Classified Credit Facilities”**

Where reference is made to Classified credit facilities, it refers to those facilities falling within the definitions of Substandard, Doubtful or Loss as set out above and in the Guidelines for Credit Risk Grading Systems.