**FINANCIAL SUPERVISORY COMMISSION
OF THE
COOK ISLANDS**

Banking Prudential Statement

BPS03

Credit Risk

Objective and key requirements of this Prudential Statement

This Prudential Statement aims to ensure that all banks control credit risk by adopting a prudent credit risk management framework, centered on comprehensive policies and procedures. These policies and procedures must particularly apply to the recognition, measurement, reporting of, and control of credit risk, including the provisioning for impaired facilities.

The key requirements of this Prudential Statement are that a bank must:

- have an effective credit risk framework that is supported by a robust system for the prompt identification, monitoring, measurement and control of its credit risk that is commensurate with the nature, scale and complexity of the institution;
- maintain a portfolio of high-quality assets (loans and advances) that are well diversified and does not present undue risk to capital;
- regularly review its credit risk management systems, taking account of changing operating circumstances, activities and risks;
- have systems to regularly review and grade assets in a consistent manner and report impaired facilities;
- ensure timely and adequate provisions and reserves are maintained to absorb credit losses; and
- ensure write-offs are taken to accurately reflect the capital and earnings performance of the bank.

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Authority

1. This Prudential Statement is issued by the Financial Supervisory Commission (FSC) pursuant to Section 65, of the Banking Act 2011 (the Act).

Application

2. This Prudential Statement is applicable to all financial institutions licensed under the Banking Act 2011.

Definitions

3. This Prudential Statement has used the following terms, which unless otherwise indicated, have the meanings specified below:

   3.1. **Accrued Interest -** means any earned but uncollected interest.

   3.2. **Bank** – an entity licensed under the Banking Act 2011.

   3.3. **Capitalised Interest -** means accrued interest which has been added to the principal balance at a payment date, maturity, or at any other time. It also includes unpaid interest which is refinanced or "rolled-over". For the purposes of this Prudential Statement, capitalised interest will not be permitted unless:

      3.3.1. the borrower has the ability to repay the entire loan (including both principal and interest) in the normal course of business;

      3.3.2. the capitalised interest was anticipated when the loan/obligation was originally made based on the borrower's planned temporary lack of cash flow;

      3.3.3. the loan is well-secured by the net realisable value of collateral security;

      3.3.4. repayment, including all capitalised interest, is based on a reasonably ascertainable future event; and

      3.3.5. the borrower can obtain funds from other sources at similar rates and terms.

   3.4. **Cash Deposit -** means credit balances on accounts in the books of the bank over which the depositor has given the bank a formal written letter of cession as security or collateral for a loan by the bank and which the bank can at its discretion transfer the amount from the depositor's account(s) to a specific or general cash collateral/security account(s).

   3.5. **Credit Risk Appetite** – a statement providing a clear direction from the Board and senior management of its expectations for the level of credit risk it is willing to accept in pursuit of its strategy and business objectives. A risk appetite is expressed

in the form of both high-level qualitative statements and, where appropriate, quantitative measures.

3.6. **Credit Risk Management Framework -** systems, structures, policies, processes and people within a Bank that identify, measure, monitor and control operational risk.

3.7. **Current -** as used in reference to "current" financial statement, "current" valuation, or similar uses, means information or documentation having an issuance date not more than 12 calendar months old.

3.8. **Current Loan** - means loans that are not past due using the definitions and criteria contained in this Prudential statement.

3.9. **Group of Borrowers -** means group of connected borrowers under the control of a particular person as defined under Section 42(3)(a) of the Act and immediate relatives of a particular borrower as defined in this Prudential Statement.

3.10. **Immediate Relatives -** means spouse, parents, children, brothers and sisters of a borrower from a bank.

3.11. **Large Exposure** - exposure to a counterparty or a group of related counterparties which is greater than or equal to 10% of a bank's capital base.

3.12. **Loans and Advances (loans) -** means any direct or indirect advances of funds and any credit facility including commitments to advance funds by a bank to a person or persons that are conditioned on the obligation of the person to repay the funds or that are repayable from specific property pledged by or on behalf of the person(s). The term includes a contractual liability of a bank to advance funds to or on behalf of a person(s), indebtedness evidenced by a lease financing transaction in which the bank is the lessor, and an overdraft funded by the bank on behalf of a person.

3.13. **Net Realisable Value -** means that amount which a bank can reasonably expect to realise after discounting the value of collateral to current market conditions and also after deducting the reasonable and estimable costs of recovery and sale. Costs of recovery and sale typically include but are not limited to: legal fees, costs of valuation, sales commissions and fees, insurance cover, maintenance, security, and any other expenses that may be necessary to put the collateral in a saleable condition.

3.14. **Non-accrual -** means interest is no longer accrued on the books of the bank for an asset nor is the interest taken into income unless otherwise provided for in this Prudential Statement.

3.15. **Non-performing** - loan is nonperforming when payments of interest and/or principal are past due by 90 days or more, or payments must be capitalised, refinanced, or delayed by agreement, due to inability to repay; or any loan that is current or past due that shows deterioration such that the likelihood of past due or default status is very high and warrants recognition of the deterioration. In addition, external events such as bankruptcy, debt defaults elsewhere and similar tangible

signs of financial distress would likely lead to nonperforming status recognition. And at any time where there is doubt that payments will be made in full.

3.16. **Overdraft -** means a deposit account on the books of the bank with a debit balance.

3.17. **Past Due or Overdue** means:

3.17.1. any asset, but excluding overdrafts, when:

3.17.1.1. principal and/or accrued interest is due and uncollected for 30 (thirty) days or more beyond the scheduled payment and/or maturity date; or

3.17.1.2. accrued interest equal to 30 (thirty) days or more has been capitalised to the outstanding principal balance of the obligation, refinanced, or rolled-over; provided, instalment loans requiring monthly payments will not be considered as past due until two (2) monthly payments or salary allotments have been missed, at which time the past due status will be measured from the date of the first missed payment;

3.17.2. overdrafts which carry a debit balance for 30 (thirty) consecutive days or more in excess of the agreed overdraft limit;

3.17.3. working capital loans that have breached their credit limit and remain over limit for 30 days or more, or meets any of the above criteria.

3.18. **Provisions for Bad Loans Account -** means a balance sheet valuation account established through charges to provision expenses in the profit-and-loss statement against which bad loans or portions thereof, are provided for and written off.

Key Principles

4. Credit risk – the risk of counterparty default – usually represents the single largest risk facing banks. The presence of a well-functioning credit risk management system is, therefore fundamental to the safety and soundness of banks.

5. It is the responsibility of the Board of Directors (Board) and senior management of a bank to oversee the nature and level of credit risk within the bank. This responsibility includes ensuring that a bank has in place:

5.1. credit risk management policies, procedures and controls appropriate to the complexity, scope and scale of its business;

5.2. appropriate controls to ensure adequate provisions in compliance with the bank's stated policies and procedures, applicable accounting framework and the requirements of this Prudential Statement; and

5.3. a realistic assessment of asset quality.

Board and Senior Management Responsibilities

6. It is the responsibility of the Board to ensure that appropriate systems are in place for the sound management of the bank's credit risk. They must ensure the bank has a robust credit risk management framework to manage this risk accordingly.

7. The Board must establish a credit risk management framework, and risk strategy commensurate with the credit risk appetite.

8. The Board and management must have a sound credit approval process that is properly communicated throughout the organisation. Approval and authorisations must be well developed, and provide the necessary controls to mitigate risk.

9. The Board and management must establish a system of independent ongoing credit review that provides the Board with regular information about the credit risk, asset quality, trends in individual credits, portfolio segments, and the portfolio in aggregate.

10. A bank's senior management must, at a minimum:

    10.1. develop the credit management strategy, policies and processes in accordance with the Board-approved risk appetite;

    10.2. ensure that the bank maintains sufficient credit quality at all times;

    10.3. determine the structure, responsibilities and controls for managing credit risk and for overseeing the credit portfolio;

    10.4. ensure that the bank has adequate internal controls to safeguard the integrity of its credit risk management processes;

    10.5. establish a set of reporting criteria specifying the scope, manner and frequency of reporting for various recipients (such as the Board, senior management and the risk and credit committees) and the parties responsible for preparing the reports;

    10.6. establish the specific procedures and approvals necessary for exceptions to policies and limits, including the escalation procedures and follow-up actions to be taken for breaches of policy limits;

    10.7. closely monitor current trends and potential market developments that may present challenges for managing credit risk, so that appropriate and timely changes to the credit risk management strategy can be made as needed; and

11. A bank must identify and manage credit risk inherent in all products and activities. The bank must ensure that the risks of new products and activities are subject to adequate procedures and controls before being introduced or undertaken, and approved in advance by the Board or its appropriate committee.

12. The Board and senior management must be able to demonstrate a thorough understanding of the links between credit risk and other risks within the bank including liquidity, market, operational and reputation risks.

Credit Risk Management Framework

13. The bank's credit risk management framework must include, at a minimum:

    13.1. a statement of the bank's credit risk appetite, representing the amount of credit risk that the Board is willing to accept in the bank to meet its strategic objectives;

    13.2. a robust management information system that produces data and other information required for adequately assessing the credit risk exposure of the institution, including levels of impairment, accounting for asset impairment and reporting to FSC;

    13.3. a defined organisational structure;

    13.4. the credit management strategy and policy;

    13.5. operating standards in the form of policies, procedures and controls, for identifying, measuring, monitoring and controlling its credit risk in accordance with its credit risk appetite;

    13.6. senior management and other relevant personnel that have the necessary experience to manage credit risk;

    13.7. regular reporting on the existing credit risk of the bank and, information on new or emerging credit risks; and

    13.8. annual review and approval by the Board.

14. A bank's credit risk management framework must include comprehensive documented policies, procedures and controls addressing at a minimum the following:

    14.1. board and senior management responsibilities;

    14.2. credit policies;

    14.3. credit approval;

    14.4. credit administration;

    14.5. concentrations;

    14.6. credit risk monitoring;

    14.7. internal credit risk rating system;

    14.8. portfolio review system;

    14.9. collateral role, purpose and valuation;

    14.10. asset classification including the write-off of uncollectible facilities;

14.11. provisions for loans losses and the adequacy of reserves for current and future losses;

14.12. interest suspension;

14.13. renegotiated or restructured loans; and

14.14. managing problem credits.

15. A bank's credit risk management framework must clearly set out the organisational structure as it relates to credit for the bank, and define the roles and responsibilities of management and staff involved in managing credit risk. It must be well integrated into the bank's overall risk management process.

16. A bank's credit risk management function must be staffed with personnel who have the skills and authority to challenge the bank's credit risk management practices.

17. The credit management strategy must be appropriate for the nature, scale and complexity of the bank. In formulating this strategy, the bank's must consider its legal structure, key business lines, the breadth and diversity of markets, products and jurisdictions in which it operates, and regulatory requirements.

18. The credit management strategy, key policies for implementing the strategy, and the credit risk management structure must be communicated throughout the organisation by senior management.

19. A bank must have adequate policies, procedures and controls in place to ensure that the Board and senior management are informed immediately of new and emerging credit concerns. These include a significant decline in the quality of underwriting, high or increasing exceptions to policy, noncompliance with policy, material or persistent breaches of limits, or changes in external market conditions that could signal future difficulties.

20. The credit risk management framework must be subject to effective and comprehensive independent review on an ongoing basis. In most cases, the independent reviews could be facilitated by a bank's internal audit function but may require the engagement of independent parties outside of this function.

Credit Policies

21. The Board must adopt credit policies that clearly outline the bank's' view of business development priorities and the terms and conditions that are necessary for loans to be approved.

22. The credit policies must be updated at a regular interval to reflect changes in the economic outlook and the evolution of the bank's loan portfolio.

23. The credit policies must be communicated timely and be implemented by all levels of the bank. It should be distributed to all lending authorities and credit officers.

24. At a minimum, credit policies must include:

24.1. the identification of credit risk, both on and off the balance sheet, by products, sectors, and geographic segments;

24.2. areas of credit in which the bank plans to lend and not lend (acceptable and unacceptable types of credit);

24.3. target market within each lending segment and level of diversification/concentration;

24.4. clear guidelines for each of the various types of credits, including (but not limited to) loans, overdrafts, mortgages and leases;

24.5. terms and conditions under which it will consider an application for each type of credit facility that the bank will provide, including acceptable loan tenor, type of acceptable collateral security, maximum loan to value ratio, and types of borrowers, currencies, geographies, industries and sectors;

24.6. specified acceptable and unacceptable financial quality and repayment performance measures, such a debt service coverage ratio, cash flow, liquidity, and debt to worth ratios for each different type of loan product;

24.7. the bank’s' formal credit approval process - detailed and formalised credit evaluation and appraisal process, administration and documentation;

24.8. credit approval authority;

24.9. concentration and diversification limits for connected counterparties, industries or economic sectors, geographic regions, and products;

24.10. credit pricing strategy;

24.11. roles and responsibilities of staff involved in credit;

24.12. guidelines on monitoring and reporting system;

24.13. internal risk grading criteria;

24.14. criteria for past due, non-accrual, and restructuring of loans;

24.15. guidelines on management of problem loans;

24.16. authority for approval of allowance for losses and write-offs;

24.17. identification, reporting, and approvals of exceptions to policy and procedures,

24.18. internal control systems for disbursement of funds that require completion of all legal and required actions and conditions be met prior to authorisation to disburse funds; and

24.19. quantitative and qualitative targets.

Credit Approval

25. A bank must have a well-defined credit approval strategy, in line with its stated credit risk appetite, and well-defined criteria for approval of credit.

26. Before approving credit, a bank must receive sufficient information to enable a comprehensive assessment of the true risk profile of the counterparty, including up to date financial information.

27. At a minimum, the factors to be considered and documented in approving credits must include:

    27.1. the purpose of the credit, the source of repayment and the consistency between these two elements;

    27.2. the integrity and reputation of the counterparty;

    27.3. the current risk profile (including the nature and aggregate amounts of risks) of the counterparty and its sensitivity to economic and market developments;

    27.4. the counterparty's repayment history and consistency, financial trends, current capacity to repay, the stated source of repayment, and financial and cash flow projections;

    27.5. a forward-looking analysis of the capacity to repay based on various scenarios;

    27.6. the legal capacity of the counterparty to assume the liability;

    27.7. for commercial credits, the counterparty's business expertise and the status of its economic sector and position within that sector;

    27.8. the proposed terms and conditions of the credit, including covenants designed to identify early signs of deterioration and allow the bank to take preemptive action to protect its loan; and

    27.9. the adequacy and enforceability of collateral or guarantees.

28. The assessment of a borrower's ability to repay must include at a minimum analysis of common financial ratios of current and historical financial condition along with full analysis of financial position or net worth of the borrower, and financial performance or income and expenditure of the borrower.

29. For non-retail counterparties the following minimal financial ratios should be analysed: leverage ratio; debt/EBITDA ratio; interest coverage ratio; current liquidity ratio; ratio of (operating cash flow + interest expenses)/interest expenses; debt service coverage ratio, loan-to-value ratio; and any other relevant indicators.

30. For non-retail large and complex counterparties additional financial analysis is necessary and should additionally include at a minimum an analysis of bank and total debt to free cash flow.

31. For retail counterparties, this analysis should include at a minimum consideration of debt service coverage ratio, loan-to-value ratio and credit scores.

32. A bank must not substitute collateral for a comprehensive assessment of the counterparty's capacity to repay the facility, nor can it compensate for insufficient information. A bank may utilise collateral and guarantees to help mitigate risks inherent in individual credits but transactions should be entered primarily on the strength of the counterparty's repayment capacity.

33. A bank must have policies covering the acceptability of various forms of collateral, procedures for the ongoing valuation of such collateral, and a process to ensure that collateral is, and continues to be, enforceable and realisable.

34. Regarding guarantees, banks must evaluate the level of coverage being provided in relation to the credit-quality and legal capacity of the guarantor.

35. The bank must have ongoing access to borrower's financial information, including the submission of financial statements where applicable. For non-retail borrowers, this requirement should include the audited financial statements for the last financial year, cash flow statements and any other relevant reports that provide information on repayment capacity.

Credit Administration

36. Credit administration is a critical function in maintaining the safety and soundness of a bank. The credit administration function provides the physical aspects of approving and maintaining credit.

37. A typical credit administration unit should perform the functions of credit documentation, disbursement and monitoring; loan repayment; and maintenance of credit files, collateral and security documents. Once a credit is granted, it is the responsibility of Credit Administration to ensure that the credit is properly maintained.

38. Credit administration must ensure completeness of documentation (loan agreements, guarantees, transfer of title of collaterals etc.) in accordance with approved terms and conditions. This includes keeping the credit file up to date, obtaining current financial information, sending out renewal notices and preparing various documents such as loan agreements.

39. The bank must ensure:

    39.1. the efficiency and effectiveness of credit administration operations, including monitoring documentation, contractual requirements, legal covenants, collateral recordation;

    39.2. the accuracy and timeliness of information provided by management information systems;

    39.3. the adequacy of controls over all credit administration procedures; and

    39.4. compliance with prescribed management policies and procedures as well as applicable laws and regulations.

40. Senior management must understand and demonstrate that it recognises the importance of this element of monitoring and controlling credit risk, to help ensure the various components of credit administration to function appropriately.

Control of Concentrations of Credit

41. A bank must incorporate the management of risk concentrations to counterparties, industries, countries and asset classes into its risk management framework. The Board is responsible for establishing and monitoring compliance with policies governing large exposures and risk concentrations of the bank.

42. The Board and senior management of a bank should ensure that:

    42.1. adequate systems and controls are in place to identify, measure, monitor, and control large exposures and risk concentrations of the bank in a timely manner; and

    42.2. large exposures and risk concentrations of the bank are kept under regular review.

43. The Board must ensure that these policies are reviewed regularly (at least annually) and that they remain adequate and appropriate for the bank. Any material changes to established policies must be approved by the Board.

44. A bank's large exposures and concentrations policy must, at a minimum, cover the following:

    44.1. cover specific exposure limits to capital for various types of exposures including but not limited to:

        44.1.1. concentrations arising from common sources of repayment
        44.1.2. individual industry sectors
        44.1.3. various asset classes
        44.1.4. collateral types
        44.1.5. various types of counterparties (e.g. governments, banks and foreign equivalents, corporate and individual borrowers);
        44.1.6. a group or groups of related counterparties; and
        44.1.7. individual countries (where applicable);

    44.2. be commensurate with the bank's capital base and balance sheet size;

    44.3. cover the circumstances in which the above exposure limits may be exceeded and the authority required for approving such excesses; and

    44.4. cover the procedures for identifying, measuring, monitoring and reporting large exposures of the bank.

45. A bank must, where appropriate, conduct stress testing and scenario analysis of its large exposures and risk concentrations to assess the impact of changes in market conditions or key risk factors (e.g. economic cycles, interest rates, liquidity conditions or other market movements) on its risk profile and earnings.

Credit Risk Monitoring

46. A bank's credit risk management framework must provide for the systematic and regular monitoring of credit risk, to assist the Board and senior management in obtaining, on a regular basis, a view of trends and other changes in the overall nature and levels of credit risk, and in assessing the adequacy of provisions and capital.

47. A bank's credit risk monitoring must include measures that:

    47.1. enable the Board and senior management to readily understand the current (and changing) financial condition of its borrowers, individually and in aggregate;

    47.2. ensure that all credits are in compliance with existing covenants;

    47.3. allow management to view customer credit lines usage and to take timely action when these lines are not used as approved;

    47.4. ensure that the projected source of repayment, including cash flow and sale of assets, meet debt servicing requirements on an ongoing basis;

    47.5. ensure that, where applicable, collateral provides adequate coverage relative to the obligor's current condition;

    47.6. an internal credit risk rating system that stratifies the loan portfolio by loan quality;

    47.7. classifies potential problem credits on a timely basis;

    47.8. ensure the accuracy of the information submitted to the Board and management.

48. A bank's credit risk monitoring must comprise a full suite of asset quality indicators including qualitative and quantitative reports. Examples of minimum quantitative credit risk ratios are listed in attachment A.

Internal Credit Risk Rating System

49. A bank must ensure that appropriate systems and procedures are established to accurately and promptly recognise the quality of its loan and other asset portfolios. Appropriate activities include the emphasis on the early detection and management of problem or deteriorating assets.

50. A bank must develop an internal credit risk rating system for its credit risk assets. The risk rating should categorise all credits into various classes on the basis of underlying credit quality and ability to repay.

51. All facilities should be assigned a risk rating. When deterioration in repayment ability is noted, the risk rating should be changed within the earlier of 30 calendar days or quarter end.

52. The risk rating system must have the following parameters at a minimum:

52.1. covers a broad range of the bank credit exposure, including on and off-balance sheet exposures and other credit exposure assets;

52.2. covers both performing and non-performing assets;

52.3. has several grades covering exposures, with the lowest rating accorded to those where losses are expected;

52.4. has more than one risk grade for performing credits;

52.5. can be readily mapped to the regulatory classifications ("pass", "special mention", "substandard", "doubtful" and "loss") which are discussed and defined in this prudential statement;

52.6. is consistent with the nature, size and complexity of the bank's activities;

52.7. provides ongoing updated risk ratings at renewals; and

52.8. provides a process for updating risk ratings through the life of the asset, using an ongoing loan review process and when borrower financial condition changes.

Purpose and Function of Loan Review

53. A bank shall ensure that a review is made of the quality of the bank's loan portfolio on a regular basis. Ongoing review activities should be performed no less than once each calendar quarter. At the end of each calendar quarter, or more frequently if warranted, the Board shall require the officers of the bank to take appropriate measures in response to the findings of the loan review function to:

53.1. accurately reflect earnings by assuring that all loans categorised as non-performing in accordance with the requirements contained in this Prudential Statement are placed on non-accrual status and accrued but uncollected interest has been reversed out of the bank's income;

53.2. ensure that the provisions for bad loans account is adequate to absorb potential losses in accordance with the requirements contained in this Prudential Statement; and

53.3. correct problems, whether in individual loans, loan underwriting practices, compliance with prudent lending standards and the board-approved lending policy, and/or other credit administration weaknesses as may be identified by the loan review function, within a specified time frame.

54. The loan review function shall ensure on an on-going basis, at a minimum, that:

54.1. lending activities are in compliance with prudent written lending standards as approved and adopted by the Board;

54.2. the Board is adequately informed of the risks and potential loss exposure in outstanding loans and assets;

54.3. problem or deteriorating loans and assets are properly and timely identified, risk rated, and placed on non-accrual status in accordance with the requirements contained in this Prudential Statement;

54.4. appropriate provisions are made to the provisions for bad loans account in accordance with the requirements contained in this Prudential Statement; and

54.5. loans and assets classified Loss are promptly written off in accordance with the requirements contained in this Prudential Statement.

55. The loan review function shall regularly and on an ongoing basis review:

55.1. all loans which exceed ten percent (10%) or more of a bank's total capital;

55.2. all loans not included above but classified among the top twenty (20) loans individually or as a group of borrowers,

55.3. all loans required to be placed on non-accrual status in accordance with this Prudential Statement; and

55.4. a risk-based sampling of the remaining loan portfolio to ensure that loans reflected as performing on the books of the bank are in fact performing pursuant to the definitions of this Prudential Statement.

56. Notwithstanding the above minimum standards, the bank must have a system that is risk based and adequate in scope and coverage to ensure over the course of its fiscal year that the loan portfolio quality, provisions for loan losses, and capital are accurately reflected throughout the year.

Portfolio Review System

57. A bank must have an established portfolio review system that is aimed at identifying credit quality in the portfolio by risk rating the individual credits and reviewing the accuracy of those ratings over time.

58. A bank portfolio review system should ensure that timely and adequate management action is taken to maintain the quality of the loan portfolio and adequate provisions for losses are established and maintained.

59. A bank must recognise that maintaining loss provisions is a stabilising factor and that failure to make adequate provisions may result in misrepresentation of a bank's financial condition

60. The portfolio review system should include an annual risk-based review of portfolio quality and condition, including a reassessment of the internal credit rating of individual exposures, with a minimum sample review ratio of sixty percent (60%) of outstanding loan volume.

61. The portfolio review system is to include a summary report presented to the Board (at least annually) that contains the scope and results of the review, risk rating downgrades and upgrades, conclusions regarding documentation, policy and procedure compliance, and adequacy of provisioning.

62. The portfolio review system must sample various portfolio segments, sectors, and types of loans, as well as size of loan.

63. The portfolio review and asset classification is predicated on the ability of bank staff (or as necessary external service providers) to perform appropriate financial analysis of the counterparty's ability to repay the debt as structured. The analysis must include assessments in compliance with this Prudential Statement.

Non-accrual Status

64. Assets shall be categorised as non-performing and shall be placed on non-accrual status if any of the following conditions exist:

    64.1. any asset, but excluding overdrafts, when:

        64.1.1. principal, including instalments due, and/or accrued interest is due and uncollected for 90 (ninety) days or more beyond the scheduled payment and/or maturity date; or accrued interest equal to 90 (ninety) days or more has been capitalised to the outstanding principal balance of the obligation, refinanced, or rolled-over, and full repayment of principal and/or accrued interest is not expected as evidenced by a well-documented written analysis and evaluation of the borrower's current financial condition; or

        64.1.2. payment of principal or interest in full is not expected based upon either an analysis of current financial information of the borrower or other reliable information or facts;

    64.2. customer deposit accounts (overdrafts) which carry a debit balance for 90 (ninety) consecutive days or more in excess of the agreed overdraft limit;

    64.3. the asset is classified Doubtful or Loss by the bank's internal loan review function or the FSC;

    64.4. the asset is maintained on a cash basis because of deterioration in the financial condition or paying capacity of the borrower; or

    64.5. payment in full of principal and interest according to the contractual repayment terms of the loan is not expected.

Treatment of Multiple Loans to One Borrower

65. If a bank has multiple loans outstanding to a single borrower or related group of borrowers, and one loan meets the criteria for non-accrual status, then the bank shall prepare a written evaluation of the borrower's current financial condition and other relevant factors to evidence that repayment prospects for the other loans is reasonably

assured. Should such written evaluation suggest that repayment prospects for the other loans are in question or otherwise uncertain, then all such loans to the borrower shall be placed on non-accrual status regardless of any guidelines contained in this Prudential Statement to the contrary.

Treatment of Accrued Interest

66. Accrued interest being carried on the books for a loan which is required to be placed on non-accrual status in accordance with the requirements contained in this Prudential Statement shall be reversed by the end of the calendar quarter in which the loan is placed on non-accrual status, but in no event later than the fiscal year-end date of the bank, whichever is sooner.

67. Interest which has been taken into income and capitalised (increasing the principal amount of a loan) shall be written-off or placed in a suspended interest account from the time the loan is, or should have been, placed on non-accrual status. Interest which has been accrued during the current calendar year shall be charged against the interest income account, and interest accrued in prior calendar years shall be charged against the provisions for bad loans account.

Treatment of Cash Payments and Criteria for Cash Basis Recognition of Income

68. The placement of a loan on non-accrual status does not require an automatic write-off in whole or in part of the outstanding principal balance. An identifiable Loss, however, must be written-off no later than the end of the calendar quarter in which it is identified.

69. When a loan is placed on non-accrual status and full collection of the outstanding principal and interest is uncertain, any cash payments received must first be applied to reduce the outstanding principal balance until the outstanding principal balance is reduced to a level where collection in full is reasonably certain. However, if the principal balance remaining after a partial write-off is regarded as collectible, then cash payments may be applied to interest income.

70. Where recognition of interest income is appropriate for an asset held on a cash basis, the income that may be shown is limited to the amount accrued at the contractual rate. Any cash payments in excess of this amount (and not applied to the remaining book balance) shall be recorded as recoveries of prior write-offs until all such write-offs have been fully recovered. For a loan to be considered fully recoverable, it must be supported by a well-documented written analysis of the borrower's current financial statements.

Restoration of Accrued Status

71. A loan placed on non-accrual status in accordance with the guidelines contained in this Prudential Statement may only be restored to accrual status when:

    71.1. no principal or interest is past due; and

    71.2. principal and interest payments have been made on a consistent and timely basis for at least six (6) consecutive months in accordance with the original contractual terms; or

71.3. where a loan which has had its terms formally restructured with accrued interest prior to the restructuring being capitalised into the restructured loan, and where the terms of the restructured loan agreement are consistent with other loans being made by the bank and in accordance with guidelines as outlined in the board-approved loan policy, when loan payments have been made on a consistent and timely basis for at least six (6) consecutive months; and

71.4. the bank expects full repayment of the remaining contractual principal and interest as evidenced by a well-documented written credit evaluation of the borrower's current financial condition.

72. If, after a formal restructuring, a loan deteriorates again and meets the criteria for placement on non-accrual status as required by the guidelines contained in this Prudential Statement, the loan must be returned to non-accrual status until such time as it again qualifies for accrual status

Classification of Assets

73. For purposes of this Prudential Statement, every bank shall classify loans according to the following categories and criteria detailed below. Banks may develop their own internal risk grading system to indicate various levels of risk exposure in assets, however such risk grades must be reconciled to the five regulatory categories detailed below.

73.1. "**Pass**" if the asset is fully protected by the current sound worth and paying capacity of the borrower and the borrower is performing in accordance with contractual terms and is expected to continue to do so.

Assets in this category are not subject to criticism. In general, this includes only performing loans, and other assets. Such assets are fully supported by demonstrated past, current, and future capacity to repay under contractual terms. This may include assets that do not meet the above criteria but are formally and legally collateralised, both as to principal and interest, by cash or deposits with the lending bank or by securities issued by the Cook Islands Government. As such they are exempted from other classifications regardless of arrears or other adverse credit factors.

Banks should have a grading system with multiple “pass” ratings based upon capacity to repay, level and liquidity of collateral support, tenor, and other financial metrics. When pricing loans these same attributes are used to determine the necessary risk premiums required of an approved loan. The grading system is complementary to the pricing system of the bank.

73.2. "**Special Mention**" if the asset:

73.2.1. is past due for the payment of principal or interest for more than 30 (thirty) days but less than 90 (ninety) days; or

73.2.2. although currently protected, exhibits potential weaknesses which may, if not corrected, weaken the asset or inadequately protect the bank's position at some future date, for example:

73.2.2.1. the asset in question cannot be properly supervised due to an inadequate loan agreement; or

73.2.2.2. the condition or control of the collateral for the asset in question is deteriorating; or

73.2.2.3. the repayment capacity of the obligor is jeopardised because of deteriorating economic conditions or adverse trends in the obligor's financial position; or

73.2.2.4. there is an unreasonably long absence of current and satisfactory financial information or inadequate collateral documentation in regard to the asset;

provided that generally an asset shall be classified Special Mention only if its risk potential is greater than that under which it was originally granted.

73.3. "**Substandard**" if the asset:

73.3.1. is past due for the payment of principal or interest for more than 90 (ninety) days but less than 180 (one hundred eighty) days; or

73.3.2. is required to be placed on non-accrual status in accordance with the requirements contained in this Prudential Statement; or

73.3.3. is a renegotiated loan which has had its terms or interest rate modified because of weaknesses or deterioration in the obligor's financial condition or ability to repay, unless all past due interest is paid by the borrower in cash at the time of renegotiation and a sustained record of timely repayment of principal and interest under a repayment programme, where such repayment terms and rate of interest are consistent with other loans being made by the bank at the time of renegotiation and in accordance with guidelines as outlined in the board-approved loan policy, has been demonstrated for a period of not less than six (6) months; or

73.3.4. whether or not it is past due, is inadequately protected by the current sound worth and paying capacity of the obligor by reason of the fact that:

73.3.4.1. the primary source of repayment is insufficient to service the debt and the bank must look to secondary sources such as collateral, sale of fixed assets, refinancing or additional capital injections; or

73.3.4.2. there is an unduly long absence of current and satisfactory financial information or inadequate collateral documentation in regard to the asset; or

73.3.4.3. generally, there is more than a normal degree of risk attaching to the asset due to the borrower's unsatisfactory financial condition.

73.4. "**Doubtful**" if the asset:

73.4.1. is past due for the payment of principal or interest for more than 180 (one hundred eighty) days but less than 360 (three hundred sixty) days; or

73.4.2. exhibits all the weaknesses of a substandard asset and, in addition, is not well-secured these weaknesses make collection in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. The possibility of loss is high, but because of certain important, reasonably and timely specific pending factors which may strengthen the asset, its classification as an estimated loss is deferred until a more precise status is obtained. such factors include but are not limited to a proposed merger, acquisitions or liquidation, a capital injection, perfecting liens on additional collateral, refinancing plans, new projects or asset disposal.

73.5. "**Loss**" if the asset:

73.5.1. is past due for the payment of principal or interest for more than 360 (three hundred sixty) days, unless such asset is well secured and legal action has actually commenced and the time to realise on collateral or on a guarantee relating to the asset does not exceed 180 (one hundred eighty) days in which case the asset is to be classified as Doubtful; or

73.5.2. had been characterised as Doubtful on account of any pending event referred to in subparagraph 70(4)(ii) above, and the event concerned has not occurred and the asset is now past due for the payment of principal or interest for more than 540 (five hundred forty) days, whether or not the event is still pending; or

73.5.3. regardless of its past due status it is otherwise considered uncollectible or considered to be of such little value that its continuance as an asset on the books of the bank is not warranted provided that a Loss classification shall not preclude the possibility of recovering the asset or securing a salvage value for it.

74. Nothing contained in this Prudential Statement, however, shall preclude examining personnel of the FSC from assigning a more severe classification where circumstances are supportable based on an analysis of a borrower's current financial condition, commitment, capacity, and willingness to repay.

75. A bank must assign credit classifications to all direct and indirect extensions of credit including loans and advances, accounts receivable, property acquired in settlement of

loans, contingent items in the nature of direct credit substitutes and miscellaneous asset accounts.

76. When applying the risk grading to a counterparty that has more than one credit facility, the bank must apply the rating consistently to all loans that are subject to the same source of repayment, obligor financial strength (or lack thereof) or other factors unless the bank can prove that one or more of the other loans has a well-defined separate source of repayment that is not jeopardised.

Provisioning Requirements

77. All banks shall maintain a provision account created through charges to provision expense in the income statement and maintained at a level adequate to absorb potential and expected losses in the loan portfolio and in respect of other assets.

78. Every loan classified Loss shall be written off by debiting the provisions for bad loans account and every recovery of loans previously written off shall be credited to the provisions for bad loans account. At no time shall a loan be written off as a direct debit, or a loan recovery be recorded as a direct credit to retained earnings or any other capital account of a bank.

79. The following minimum percentage amounts are to be maintained as provisions against the outstanding balance of loans classified in accordance with the requirements of Classification of Assets in this prudential statement.

Asset Grades/Classifications:	Minimum Provision:
"Pass"	1%
"Special Mention"	5%
"Substandard"	20%
"Doubtful"	50%
"Loss"	100%

80. The FSC recognises: -

80.1. that foreign licensees which belong to banking groups may have different provisioning requirements as specified for their group wide credit risk management. When this is the case, foreign licensees aggregate provisions must exceed the total of the minimum provision for asset grades/classifications as provided for in this Prudential Statement; or

80.2. banks that have adopted IFRS 9 will have a more dynamic provisioning model and therefore will not be required to comply with the provisioning requirements of this Prudential Statement.

81. That portion of a loan or asset secured by the following shall be exempt from the classification and provisioning requirements of this Prudential Statement:

81.1. a cash deposit; or

81.2. a security issued by the Cook Islands Government or central governments and central banks with an external credit assessment rating of AAA to AA-[1], the current market value of which has been determined by a qualified, independent, third party in writing; or

81.3. an unconditional obligation or guarantee[2] issued in writing by the Cook Islands Government or central governments and central banks with an external credit assessment rating of AAA to AA- to repay both principal and interest, or a specific amount, and the lending bank has not been advised in writing of any determination by the guarantor to deny payment under the terms of the obligation or guarantee; or

81.4. other liquid and readily marketable collateral as may be approved in writing by the FSC.

82. The FSC may require a bank to maintain higher provisions for bad loans after considering a bank's historical loan loss experience, current economic conditions, delinquency trends, the effectiveness of policies on the approving, monitoring and collection of loans as well as the timeliness and accuracy of its loan review function

Treatment of Collateral for Purposes of Determining Provisions

83. Because collateral is generally illiquid, costly and often time consuming to acquire control of, costly to maintain pending its sale, and difficult to value during periods of financial distress, provisioning percentages outlined in paragraph 79 above are to be applied against the gross outstanding balance of assets classified Pass, Special Mention or Substandard by the bank's internal loan review or the FSC. For loans classified Doubtful or Loss by the bank's internal loan review or the FSC, the provisioning percentage is to be applied to the net exposure after deducting the current net realisable value of any real property pledged as security from the outstanding principal balance and accrued but uncollected interest on the assets. However, in no event should the provision amount after deducting the net realisable value of any real property pledged as security be less than the amount that would be required if the asset were classified Substandard (that is to say an asset classified Doubtful or Loss must have provisions of at least 20% of the outstanding principal balance unless otherwise exempted as provided in paragraph 81 above). In the case of real property security collateral, the net realisable value may be deducted only if transferability of title is certain and an active market for the property exists.

Record-keeping Requirements

84. Each bank shall maintain adequate records in support of its evaluation of potential loss exposure in the loan portfolio and of the entries made to ensure an adequate provision for bad loans account is maintained at all times.

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[1]This external credit assessment rating follows the methodology used by Standard & Poor's. Equivalent ratings by other internationally recognised external credit assessment institutions (i.e. Moody's, Fitch, etc.) may be used with the prior written approval of the FSC

[2] The guarantee must be affirmed in writing and be unconditional as to the payment of principal and interest

85. Such records shall be made available to the FSC and its examining personnel upon request to assess the reasonableness of the bank's loss estimation procedures, the reliability of the information on which estimates are based, and the adequacy of the provisions for bad loans account.

Review by FSC

86. Should the FSC or its examining personnel in applying the requirements of this Prudential Statement and after discussions with the executive officer(s) of the bank find the provisions for bad loans account to be inadequate, the chief executive officer shall immediately record the appropriate entries in the books of the bank to increase the amount of the provisions for bad loans account to the amount determined by the FSC.

87. In the event of material disagreements regarding the appropriateness of additional provisions needed to the provisions for bad loans account, the board of directors of a bank may appeal in writing to the Board of the FSC. The written appeal should outline the basis for the board's disagreement with the application of this Prudential Statement by the FSC or examining personnel in determining the amount of the provisions for bad loans account, and provide additional financial and other information as is necessary.

88. The written appeal must be received at the office of the FSC within 30 days of written notice via letter to the bank by the FSC. The FSC may at its option delay the requirement of an additional provision or may require the provision be accounted for on the bank's books during the appeal process if the FSC finds such action is in the best interest of the banking system, in their sole judgement.

Renegotiated or Restructured Loans

89. A bank must have policies and procedures that address restructured or renegotiated loans. The restructured loan designation applies to loans which, because of weaknesses in the counterparty's financial condition or ability to pay, have been refinanced, rescheduled, rolled-over or otherwise modified at favourable terms and conditions for the borrower. The modification may include lengthening of repayment schedules or lowering interest rates to meet the borrower's debt service abilities.

90. While loan restructuring can be considered a management tool to maintain or improve asset quality or the soundness of lending operations, troubled restructurings should be carefully analysed to ensure that the modification is not delaying or avoiding recognition of necessary risk rating classification, provisioning, non-accrual, non-performing, or write downs associated with the concessions. In this process, it is expected that the bank will take all action to enhance the creditworthiness of the facility, including obtaining additional collateral, guarantors, control over borrower cash flows, ongoing interim and annual financial information submissions, and the implementation of loan covenants.

91. If the restructuring occurs after the counterparty has been graded as Substandard or worse, the supporting documentation for restructuring must be robust given the presumption that a substandard borrower exhibits well-defined weaknesses and financial difficulties. The bank's analysis must reflect why this restructuring is in its best interest.

92. For restructurings that reflect a concession by the bank to the counterparty, such as reduced interest rate, extended amortisation schedules, and other similar concession criteria, the bank must revalue the loan as if granted at current interest rates and

repayment terms. The result may be a discount of the loan value and would require a write down in the bank’s accounts.

93. Restructured loans should be classified as Substandard until a sustained and satisfactory record of repayment performance has been achieved, for a minimum period of six months, under the new repayment program. Upon satisfactory completion of the minimum period the bank can return the credit to accrual status.

94. Repeat loan restructuring should be avoided. If a second restructuring is approved the repayment history required before returning the credit to performing status and removal from substandard is increased to 12 months.

95. The restructuring of loans to “connected borrowers” (See the *Example Draft Prudential Statement – Connected Lending and Activities, and Direct Ownership Interests*) must be on terms not less favourable to the bank than those offered to other clients.

Managing Problem Credits

96. The credit risk policy must define the bank’s system of managing their problem assets. Once a loan is identified as a problem, it should be managed under a dedicated remedial process.

97. Responsibility for such credits may be assigned to the originating business function, a specialised workout section, or a combination of both, depending upon the size and nature of the credit and the reason for its problems.

98. When a bank has significant credit-related problems, it is important to segregate the workout function from the credit origination function. The additional resources, expertise and more concentrated focus of a specialised workout section normally improve collection results. In such case, the “Recovery Unit”, shall manage accounts with sustained deterioration (a risk rating of Substandard or worse).

99. Whether the management of problem assets is through a designated recovery unit or by other part of the bank, the primary functions should be to:

    99.1. determine account action plans or recovery strategies;

    99.2. monitor compliance with the action plan, adjusting the plan as necessary;

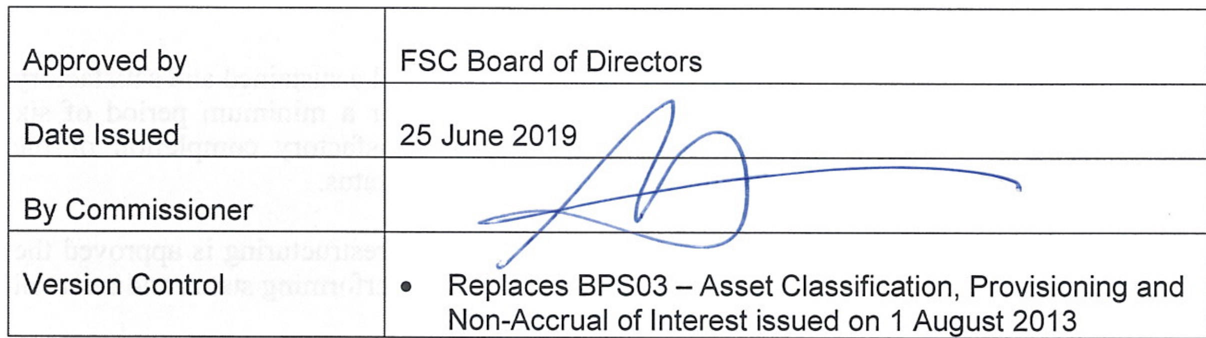
    99.3. pursue all options to maximise recovery, including placing customers into legal proceedings or liquidation as appropriate;

    99.4. ensure adequate and timely loan loss provisions are made based on actual and expected losses;

    99.5. regular review of substandard or worse accounts; and

    99.6. regular reporting to the Board on the overall problem loan portfolio and in particular, the large and complex credits.

Issuance Details



Approved by	FSC Board of Directors
Date Issued	25 June 2019
By Commissioner	
Version Control	• Replaces BPS03 – Asset Classification, Provisioning and Non-Accrual of Interest issued on 1 August 2013

Attachment A

RATIO	INTERPRETATIONS
NPL ratio –nonperforming as a percentage of total loans and advances.	Level and severity of non-performing loans and advances. An assessment of the portfolio quality, credit analysis and management and level of potential future write-offs. This ratio also gives an indication of the quantum of non-income generating loans.
NPL minus provision for loan losses/ tier one capital	Gives an indication of the risk of impairment to capital
Provisions for loan losses / NPL	Level and adequacy of provision made for portfolio losses
Past due loans/NPL	Level of unsatisfactory assets past maturity date - indicates severity of delinquency.
Total delinquency - all loans in arrears and nonperforming overdrafts compared to total loans and advances	Gives an indication of the total risk in the credit portfolio
Amount outstanding by sector/Total Loans	Reflects key sector concentrations
Sector concentrations /total capital	Portfolio concentration showing amount of capital at risk. It is an indication of the bank's vulnerability to the performance of a sector.
Amount outstanding by largest borrower (group)/Total Loans	Portfolio concentration by individual or borrower group. It is an indication of the bank's vulnerability to the performance of a small group of customers.