

# NATIONAL RESERVE BANK OF TONGA

## Prudential Statement No.10

### LENDING LIMITS

#### Introduction

1. This statement is issued in terms of Section 15(3) of the Financial Institutions Act 2004 (the “Act”).
2. The Act imposes restrictions on a licenced financial institution (LFI) or its subsidiaries in relation to:
  - a. Exposures greater than 25 percent of capital as defined by the Reserve Bank (Section 28(2)(a)) of the Act;
  - b. Unsecured exposures greater than 10 percent of capital as defined by the Reserve Bank (Section 28(2)(b)) of the Act; and
  - c. The aggregate of all exposures to all of a LFI’s connected parties<sup>1</sup> should not exceed the LFI’s capital base as defined by the Reserve Bank.
3. Section 29 of the Act provides limited exemptions from the lending restrictions in the case of certain transactions, for example for transactions between LFIs in Tonga and overseas and transactions guaranteed by the Government of Tonga.
4. The Reserve Bank expects LFIs to implement prudent measures and limits to monitor and control the risk of credit concentrations in respect of large exposures to individual counterparties or groups of related counterparties on a consolidated basis.
5. Notwithstanding the limits on lending specified in the Act, the Reserve Bank may use its powers under section 33 of the Act, to set specific limits on a LFI’s exposures to particular counterparties, groups of counterparties, industry sectors, countries or types of asset on a case-by-case basis, having regard to the bank’s individual circumstances.

#### Risk Management of Credit Concentrations

6. The credit risk exposure of a LFI is increased where it is concentrated in a few counterparties. A LFI should maintain and implement appropriate policies, systems and internal controls to monitor and manage the risk of credit concentrations on a consolidated group basis to ensure that it is not unduly

---

<sup>1</sup> A definition of a LFI’s “connected parties” is given in section 28(1)(a)(i) & (ii) of the Act.

exposed to a single or small number of counterparties such that their default would adversely affect the LFI's financial position.

7. The board and management of a LFI should ensure that, as part of their responsibilities to maintain and implement an effective credit risk management system for monitoring credit risk exposures, adequate policies and procedures are in place to identify, measure, monitor and report large credit exposures of the consolidated group to individual counterparties or groups of related counterparties. The policy should place a limit on the size of individual exposures relative to the capital base of the consolidated group, and should provide for credit exposures to be kept under regular review (at least annually).
8. A LFI's lending policy should, as a minimum, cover the following:
  - a. exposure<sup>2</sup> limits for:
    - i. various types of counterparties (e.g. governments, banks and foreign equivalents, corporate and individual borrowers);
    - ii. a group of related counterparties;
    - iii. individual industry sectors (where applicable);
    - iv. individual countries (where applicable); and
    - v. various types of investment (e.g. holdings of securities, property, etc.)

that are commensurate with the LFI's capital base, balance sheet size and risk appetite;

- b. the circumstances in which the above exposure limits may be exceeded and the authority required for approving such excesses (e.g. by the LFI's Board or a board committee); and
    - c. the procedures for identifying, reviewing, controlling and reporting large exposures of the LFI.
9. Annex 1 of this Statement provides further guidance on credit risk management and outlines minimum principles that the Reserve Bank expects LFIs to implement. These principles should be read in conjunction with Prudential Statements 1 – Asset Quality and Prudential Statement 2 – Credit Risk Grading System.

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

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

---

<sup>2</sup> Exposures include claims and commitments recorded both on and off the balance sheet of a LFI on a consolidated group basis.

- b. large exposures of the bank are kept under regular review.
11. A LFI must inform the Reserve Bank immediately where it has concerns that its credit risk concentrations have the potential to impact materially upon its capital adequacy.

### **Related parties**

12. A LFI should treat counterparties as related where they are linked by cross guarantees, common ownership, ability to control, financial interdependency, or other connections which, in the LFI's assessment, identify the counterparties as representing a single risk.

### **Concentrations of Large Exposures**

13. Where a LFI intends to enter into an exposure in excess of 20 per cent of its consolidated capital base, it should first consult with the Reserve Bank before committing to the exposure. The LFI must be able to satisfy the Reserve Bank that the proposed exposure does not constitute an excessive risk to the consolidated group.
14. A LFI which has, on a consolidated group basis, a significant number of large exposures must be able to satisfy the Reserve Bank that excessive risks are not being undertaken. A LFI with a high volume of large exposures is likely to be required to maintain a higher capital ratio.

### **Reporting**

15. LFI's are required to submit on a quarterly basis to the Reserve Bank:
- a. Form FID 6A (covering the LFI's largest exposures, regardless of whether they are secured or unsecured facilities) and form FID 6B (which covers the LFI's largest unsecured exposures) and:
  - b. Form FID 8 – Exposures to Connected Parties.

### **Compliance with Prudential Statement No. 10**

16. This statement is effective from 1 June 2009.

**CREDIT RISK MANAGEMENT FOR LICENSED FINANCIAL INSTITUTIONS**

**A. PURPOSE**

This document sets out the minimum policies and procedures that each LFI needs to have in place and apply within its credit risk management programme, and the minimum criteria it should use, to prudently manage and control its credit portfolio and exposure to credit risk.

Experience indicates that credit quality goes hand in hand with financial soundness. Deterioration in credit quality is often a sign of problems in a LFI. The major risk accompanying a weakening of the credit portfolio is the impairment of capital or liquidity.

For most LFIs, extending credit comprises the major portion of their business. To a great extent, therefore, the quality of the institution's credit portfolio determines the risk to depositors.

Credit risk management should be conducted within the context of a comprehensive business plan. Although this document focuses on a LFI's responsibility for managing and controlling its credit portfolio and exposure to credit risk, it is not meant to imply that credit risk can be managed in isolation from asset/liability management considerations, such as the need to maintain adequate liquidity, or other risks.

**B. DEFINITION**

Credit is the provision of, or a commitment to provide funds or substitutes for funds (both on- and off-balance sheet), on a secured or unsecured basis, to a debtor who is obliged to repay, on demand or at a fixed or determinable future time, the amount borrowed together with fees and/or interest thereon.

Credit risk is the risk of financial loss resulting from the failure of a debtor, for any reason, to fully honour its financial or contractual obligations to the institution.

**C. CREDIT RISK MANAGEMENT PROGRAMME**

Managing credit risk is a fundamental component in the safe and sound management of all LFIs. Sound credit risk management involves prudently managing the risk/reward relationship and controlling and minimising credit risks across a variety of dimensions, such as quality, concentration, currency, maturity and security.

Although the particulars of credit risk management will differ among LFIs, depending upon the nature and complexity of their credit functions and portfolios, a comprehensive credit risk management programme requires:

- Identifying existing or potential credit risks to which the institution is exposed in conducting its business activities and developing and implementing sound and prudent credit policies to effectively manage and control these risks;
- Developing and implementing effective credit granting, documentation and collection processes; and
- Developing and implementing comprehensive procedures to effectively monitor and control the nature, characteristics, and quality of the credit portfolio.

### **Credit Risk Identification and Risk Management Policies**

The foundation of an effective credit risk management programme is the identification of the existing and potential risks inherent in the LFI's credit products and credit activities, and the development and implementation of clearly defined policies, formally established in writing, that set out the credit risk philosophy of the institution and the parameters under which credit risk is to be controlled.

Pressure for increased profitability, marketing considerations and a vastly more complex financial environment have resulted in innovative credit instruments and approaches to credit. Measuring the risks attached to each credit activity permits the determination of aggregate exposures to counterparties for control and reporting purposes, concentration limits and risk/reward returns.

Credit policies establish the framework for lending and reflect the LFI's credit culture and ethical standards. To be effective, policies must be communicated in a timely fashion, be implemented through all levels of the organization by appropriate procedures and revised periodically in light of changing circumstances.

Credit policies need to contain, at a minimum:

- i. A credit risk philosophy governing the extent to which the institution is willing to assume credit risk;
- ii. General areas of credit in which the institution is prepared to engage or is restricted from engaging;
- iii. Clearly defined and appropriate levels of delegation of approval, and provision or write-off authorities; and
- iv. Sound and prudent portfolio concentration limits.

These policies need to be developed and implemented within the context of a credit risk management environment that ensures that all credit dealings are conducted in the highest possible standard of ethical behaviour.

### **i) Credit Risk Philosophy**

The credit risk philosophy is a statement of principles and objectives that outlines the LFI's willingness to assume credit risk and will vary with the nature and complexity of its business, the extent of other risks assumed, its ability to absorb losses and the minimum expected return acceptable for a specific level of risk.

### **ii) General Areas of Credit**

The general areas of credit in which a LFI is prepared to engage usually specify product lines, types of credit facilities, types of borrowers, or industries in which an institution may focus its marketing efforts or may establish constraints restricting an institution's activities.

### **iii) Approval Authorities**

Clearly defined and appropriate levels of authorities for credit approval, provisions or write-offs help ensure that credit decisions are prudent and acceptable, that the integrity and credibility of the credit process is protected by fair, consistent and objective credit decisions, and that the risk is acceptable given the LFI's capacity, collectability and the expected rate of return.

Approval limits may relate to size, security or other criteria, such as industry sector. Authorities may be absolute, incremental or a combination thereof and may also be individual, pooled, or shared within a committee.

The delegation of authority needs to be clearly documented, and should include as a minimum:

- The absolute and/or incremental credit approval authority being delegated;
- The provision or write-off authority being delegated;
- The officers, positions or committees to whom authority is being delegated;
- The ability of recipients to further delegate risk approval and write-off authority; and
- The restrictions, if any, placed on the use of delegated risk-approval and write-off authorities.

The degree of delegation of authority will depend on a number of variables including:

- The institution's risk philosophy and credit culture;
- The quality of the credit portfolio;
- The degree of market responsiveness required;

- The types of risks being assessed; and
- The experience of lending officers.

#### **iv) Portfolio Concentration Limits**

Concentration occurs when an institution's portfolio contains an excessive level (for example, 25 percent of capital or total lending assets) of credits to:

- A single counterparty;
- A group of associated counterparties;
- An industry;
- One type of credit facility; or
- A class of security.

Excessive concentration renders an institution vulnerable to adverse changes in the area in which the credit is concentrated, and to security impairment.

Sound and prudent portfolio management and control involves the minimization of concentration risk by developing and implementing policies and procedures to ensure the diversification of the credit portfolio. At a minimum, credit diversification policies must be:

- Stated clearly;
- Include goals for portfolio mix; and
- Place exposure limits on single counterparties and groups of associated counterparties and related entities, key industries or economic sectors and new or existing products.

The principal criteria in determining single counterparties are:

- The capability of the borrower to satisfy its commitments without support from external sources; and
- The independence of the borrower from the obligations (financial or otherwise) of others.

Associated counterparties may be a group of persons related financially or by common ownership, management, research and development, marketing or any combination thereof.

Identification of associated counterparties requires analysis of the impact of these factors on the financial dependency of the parties involved.

To ensure that a LFI is not excessively exposed to a single or associated counterparty, credit limits need to be established within the context of the LFI's aggregate exposure to such counterparties, in terms of both the total credit extended and the total investment in security instruments (e.g. holdings of commercial paper issued) issued by such counterparties.

Single counterparty and associated counterparty groupings need to be reviewed regularly to ensure that prior considerations have not changed to an extent that would warrant reclassification.

### **Credit Granting, Documentation and Collection Process**

The most significant risk that a LFI faces in the credit granting and collection process is default. Default occurs if a counterparty does not pay according to the terms of the credit agreement.

To minimize its exposure to loss through default, each LFI must give proper consideration to, and conduct an assessment of, each credit (and the credit risks associated with each credit or type of credit) prior to the approval or the disbursement of funds, and ensure that credits are appropriately documented. These procedures to evaluate and document each credit proposal need to be accompanied by clearly defined procedures for collection and regular monitoring.

#### **i) Evaluating Credit Proposals**

Although some well constructed credits can deteriorate because of unforeseen circumstances, most credit problems stem from disregarding or inadequately assessing basic lending principles, including:

- The purpose of the credit and source of repayment;
- The character, integrity and reputation of the borrower to promptly and willingly repay debts or fulfil contractual obligations;
- The borrower's capacity to repay, based on historical financial trends and cash flow projections; and
- The adequacy of collateral.

For commercial credits, the borrower's business or management capability and the status of the borrower's industry and its position within that industry also need to be considered.

Major influences on the credit approval process are the LFI's market share, growth or profitability. An overemphasis on any of these factors may expose the LFI to undue risks resulting from:

- A relaxation in credit quality standards, including the assumption of borrowers' risks, the excessive granting of subordinated credit, or the provision of credit with overgenerous terms, conditions or amounts; or
- An adjustment of target market criteria or entrance into untested markets or products.

To develop and maintain a sound credit portfolio, each LFI must have a prudent and effective formal evaluation process that provides for an independent and objective assessment of credit proposals. In this context, where circumstances warrant, consideration should be given to the formation and use of specialist credit groups for significant product lines, types of credit facilities, and the sectors in which the institution is engaged.

A strong credit process independent of the marketing function is an effective means of ensuring that credit risks are appropriately analyzed and reviewed and, are within the parameters of the LFI's credit policies. The details of the analysis, however, will vary with the areas of credit the institution is engaging in. Commercial credits require extensive analysis; a retail portfolio may not require the same degree of assessment. In all cases, sufficient analysis must be made to properly assess the integrity of the borrower, the borrower's ability to repay, and, where applicable, the value of collateral pledged.

## **ii) Credit Documentation**

In developing and maintaining a sound portfolio, the terms of each credit must be adequately and accurately documented. Inadequate, incomplete, or unenforceable documentation could lead to non-recovery of funds, particularly in instances where lenders are obliged to resort to litigation for credit recovery.

For a LFI to conduct meaningful credit reviews and ensure that assets are soundly and conservatively valued, it must maintain credit files supporting the credit granting and review process.

Each credit file needs to contain, at a minimum, information that:

- Identifies the borrower by name and occupation or type of business, and identifies consigners, endorsers, guarantors and connected counterparties;
- Provides evidence of the borrower's legal ability to borrow, financial condition, and ability to repay including, the timing and source of repayment;
- Describes the terms of the credit obligation, including the purpose of the credit;

- Describes and evaluates the collateral, indicating the marketability and/or condition thereof;
- Provides a history of the credit, including copies of the most recent credit authorization and internal credit reviews, and evidence of the level of approval; and
- Where applicable, describes the relationship of the borrower to owners, directors and management of the LFI.

### **iii) Credit Collection Process**

All LFIs need to have in place procedures governing the collection of principal, interest and fees to ensure that such payments are received on a timely basis, in accordance with the terms of repayment, and are appropriately recorded.

Although most credits are ultimately repaid in full, it is recognized that all LFIs are exposed to risk of default and, therefore, some credit write-offs may be expected.

A reduction in credit quality needs to be recognized at an early stage when there are still a number of strategic options open to the institution in managing its default risk. These options include referral to an internal credit workout group, where values suggest the need for renegotiation of the terms of the credit, and reorganization or liquidation of the borrower in order to minimize potential loss to the LFI. Renegotiation must not, however, be used to disguise serious weaknesses in a credit. Recovery efforts require a well conceived strategy and timetable.

### **Credit Portfolio Monitoring and Control**

Failure to establish adequate procedures to effectively monitor and control the credit function within established guidelines has resulted in credit problems for many LFIs. Compromising credit policies and procedures has been another major cause of credit problems.

Accordingly, each LFI needs to develop and implement comprehensive procedures and information systems to effectively monitor and control the characteristics and quality of its credit portfolio (e.g. maturities, delinquencies, concentrations, exposures to related parties, interest rates and cash flows). These procedures need to define prudent criteria for identifying and reporting potential problem accounts to ensure that such accounts are identified for more frequent review, followed up with appropriate corrective action, classified as unsatisfactory where appropriate, and that provisions are made where necessary.

Categorization of the credit portfolio by credit characteristic, risk rating and regular review of individual and groups of credits within the portfolio, and independent internal credit inspections or audits are integral elements of effective and prudent portfolio monitoring and control.

### **i) Portfolio Characteristics**

In order to track portfolio diversification characteristics, each LFI needs to have in place a system to enable credits to be grouped by single and associated groups of counterparties, types of credit facilities, and industries.

### **ii) Credit Rating Systems**

Each institution needs to have a credit rating system that defines risk-rating criteria and rates credits according to those criteria.

Internal credit ratings provide an effective tool for monitoring the level and trends in the quality of individual credits and the credit portfolio by highlighting credits or segments of the portfolio that warrant special attention.

At a minimum, a rating system should permit credits to be classified as:

- Satisfactory or acceptable risk;
- Below standard risk (or substandard); and
- Unsatisfactory risk or doubtful (for example, credits in which payments are contractually past due, credits in which partial or complete provisions for loss have been made, or credits not adequately supported by collateral, where appropriate).

Furthermore, each LFI needs to develop and implement appropriate policies for classifying credits as non-accrual and conservative accounting policies for recognizing revenue related to such accounts. Usually, credits are classified non-accrual whenever there is serious doubt as to the ultimate collectability of principal or interest, whenever a provision for loss has been recorded against the account, or where interest owing remains uncollected 90 days following its contracted or scheduled date for payment. Normally, revenue should not be recognized through the capitalization of interest in any manner, except where this was specifically agreed upon with the client and formed part of the original terms of the credit and the loan continues to be adequately collateralized or is otherwise in good standing.

Usually, commercial credit needs to be rated individually. Retail portfolios, however, consisting of relatively smaller credits of a similar nature, may permit the adoption of procedures that rate all credits as satisfactory, unless there are indications to the contrary, with only unsatisfactory credits requiring individual attention.

### **iii) Credit Review**

Most outstanding credits and commitments to extend credit are contingent upon borrowers maintaining specific credit standards. Consequently, LFIs need to regularly monitor the status of borrowers and re-evaluate individual credits and commitments, and their ratings,

particularly credit to owners and directors. Reliance on un-reviewed credits and optimistic economic forecasts can lead to a serious undetected deterioration of the credit portfolio. Accordingly, the credit risk management programme of each LFI must include procedures governing the regular formal review and, where applicable, the re-rating of individual credits.

An effective internal credit review system should include as a minimum an independent review, with regular analysis, and a re-rating of credits by account officers. Because of their frequent contact with borrowers, account officers are in a position to detect changes in a borrower's operations or financial condition. This permits these officers to identify potential problems before they may be discovered by independent credit reviewers. Accordingly, credit review systems must ensure that an account officer is monitoring credit quality and, where applicable, underlying security on an on-going basis.

The nature, complexity and degree of analysis and the quantity of credits re-evaluated under a credit review process will vary with the type and sophistication of credits in the portfolio. Each commercial credit should be reviewed at least annually; retail credits, however, may need less frequent individual review. Credits on the security of real estate may require more frequent review.

Common objectives of effective credit review systems include:

- Ensuring that the LFI is aware of the borrowers' current financial condition;
- Ensuring that collateral security is adequate and enforceable relative to the borrowers' current circumstances;
- Ensuring that credits are in compliance with their covenants and margins;
- Providing early identification and classification of potential problem credits; and
- Providing current information regarding the quality of the loan portfolio.

#### **iv) Internal Credit Inspection/Audit**

Internal credit inspections/audits verify the continuing adequacy and applicability of credit risk management policies and procedures, provide an independent assessment of the credit portfolios' existence, quality and value, the integrity of the credit process, and promotes detection of problems relating thereto. Assessments should, at a minimum, randomly test all aspects of credit risk management in order to determine that:

- Credit activities are in compliance with the LFI's credit and accounting policies and procedures, and with the laws and regulations to which these credit activities are subject;

- Credits exist, are duly authorized, and are accurately recorded and appropriately valued on the books of the LFI;
- Credits are appropriately rated;
- Credit files are complete;
- Potential problem accounts are being identified on a timely basis and determine whether the LFI's provision for credit losses is adequate; and
- Credit risk management information reports are adequate and accurate.

Assessments of the credit risk management activities should be presented to the LFI's board of directors on a timely basis for review.

### **Conflict of Interest and Confidentiality**

Each LFI needs to have in place procedures to prevent conflicts of interest and preserve confidentiality.

Conflict of interest in the credit process occurs if persons use their connections or influence to obtain funds for themselves or their interests. Conflict of interest may lead to the extension of credit on an unsound basis -- because individuals within the credit process may be subject to influence by such persons and, therefore, may not be in a position to evaluate and reject credit applications on the same basis as credit requests from other persons dealing with the LFI at arm's length.

Releasing confidential information without a client's prior consent may adversely impact upon the reputation and stature of the LFI and may bring the LFI into disrepute.

### **D. ROLE OF THE BOARD OF DIRECTORS**

The board of directors of each LFI is ultimately responsible for the integrity of the institution's credit risk management function. In discharging its responsibility, the board usually charges management with developing credit policies for the board's approval, and developing and implementing procedures to manage and control the structure and quality of the LFI's credit portfolio, and the level of credit risk assumed, within these policies, and ensuring that such policies remain adequate, comprehensive and prudent.

The board needs to have a means of ensuring compliance with the credit risk management program. The board generally ensures compliance through periodic reporting by management and internal inspectors/auditors. The reports must provide sufficient information to satisfy the board that the LFI is complying with its credit risk management policies.

At a minimum, the board should:

- Review and approve credit risk management policies recommended by the LFI's management;
- Review periodically, but at least once a year, the credit risk management programme;
- Ensure the selection and appointment of qualified and competent management to administer the credit risk function;
- Ensure that an internal inspection/audit function reviews the credit operations to assess whether or not the LFI's policies and procedures are being adhered to, and whether the policies effectively contribute to the achievement of corporate objectives;
- Review credits to, or guaranteed by, officers of the LFI, including policies related thereto;
- Review credits to directors or firms in which they are partners, directors or officers, including policies related thereto;
- Review credits to corporations controlled by the LFI, or their officers or directors, including policies related thereto;
- Ratify credits exceeding the level of authority delegated to management;
- Review significant credit exposures;
- Review trends in portfolio quality and the adequacy of the institution's provision for credit losses; and
- Outline the content and frequency of management reports to the board on credit risk management.

## **E. ROLE OF MANAGEMENT**

The management of each LFI is responsible for implementing the institution's credit risk management policies and ensuring that procedures are put in place to manage and control credit risk and the quality of the credit portfolio in accordance with these policies.

Although specific credit risk management responsibilities will vary from one LFI to another, management at each LFI is responsible for:

- Developing and recommending credit risk management policies for approval by the board of directors;

- Implementing the credit risk management policies;
- Ensuring that credit risk is managed and controlled within the credit risk management programme;
- Ensuring the development and implementation of appropriate reporting systems with respect to the content, format and frequency of information concerning the credit portfolio and credit risk, to permit the effective analysis and the sound and prudent management and control of existing and potential credit risk exposure;
- Monitoring and controlling the nature and composition of the institution's credit portfolio;
- Monitoring the quality of the credit portfolio and ensuring that the portfolio is soundly and conservatively valued, uncollectible credits written off, and probable losses adequately provided for;
- Ensuring that an internal inspection/audit function reviews and assesses the credit portfolio and credit risk management programme;
- Developing lines of communication to ensure the timely dissemination of credit risk management policies and procedures and other credit risk management information to all individuals involved in the credit process; and
- Reporting comprehensively on significant credit activities, the composition and quality of the credit portfolio, and the credit risk management program to the board of directors at least once a year.