

NATIONAL RESERVE BANK OF TONGA

Prudential Statement No.2 *Revised 2007*

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 the revised Credit Risk Grading Return (FID4) attached as Appendix I. These guidelines will take effect from 24 December 2007 and will supersede that which was implemented with effect from 1 November 2002.
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.
 - **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 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.

- **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 institution may be relying heavily on collateral security to ensure full collection.
 - **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 institution expects to sustain some loss of interest and/or principal, taking into account the market value of collateral.
 - **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.
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.
 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 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 included with the quarterly form FID 4 attached as Appendix II to this paper.

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

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. 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.
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. Institutions are required to maintain a prudent level of general provisions 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.
17. Each 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.
18. 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)
19. It is essential that 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.
20. **General Provisions:** General provisions for possible 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 institution. General Provisions must be maintained in respect of all credit facilities outstanding net of specific provision requirements below. (general provisions are trying to cover current unanticipated losses – therefore some of the general provision may relate to facilities against which there is (inadequate) specific provision) The Reserve Bank will require written details of the institution's policy in relation to the setting of General provisions.
21. 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 provision held by the institution.
22. In the case of branches of foreign licensed financial institutions, the Reserve Bank will require written confirmation from the head office, where an institution has advised that the general provision is maintained in the head office books to cover the Tonga operations.

23. **Specific Provisions held against Substandard, Doubtful and Loss facilities:** Apart from the General provisions maintained under Paragraph 20, 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;
24. 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.
25. Whether a particular 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.
26. The Reserve Bank will regularly review the level of general and specific provisions held by each 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

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.

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.

Security Valuation

27. All decisions to grant a credit facility to a customer should be primarily based on the 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.
28. 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.
29. 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.
30. 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.
31. 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 marketing⁵ 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.
32. In many circumstances in Tonga, it will not be easy to readily establish a true market value for security held. 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.

National Reserve Bank of Tonga
24 December 2007

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.

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.