

# **BANKING GUIDANCE NOTE (BGN 3.0)**

## **Credit Risk, Arrears & Provisions Management**

**31<sup>st</sup> March 2006**



Financial Supervision Commission Barrantee Oaseirys

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**Appendix 1 - Glossary**

## **Part 1 – Banks incorporated in the Isle of Man**

### **1. Rationale / Introduction**

- 1.1 Under the Banking (General Practice) Regulatory Code 2005 the Commission requires banks to have a policy in relation to credit risk, arrears and provisioning management.
- 1.2 Credit risk is one of the most important in terms of all banking risks and clear credit administration is a critical element in understanding the safety and soundness of a bank. The default of a small number of important customers, or adverse factors affecting a particular segment of the business can generate large losses, potentially leading to insolvency. The overall objective of the Commission is to identify key risk areas in line with the Basel Core Principles for Effective Banking Supervision, and to minimise threats to its Core Objectives of Supervision.
- 1.3 The Basel Core Principles for Effective Banking Supervision require a bank to have effective systems in place to identify, measure, monitor and control credit risk as part of an overall approach to risk management. This includes best practice as dictated by international standards and the requirements of group regulators.
- 1.4 Credit risk is a normal part of banking. However, where the amount of risk is excessive or where this is not properly monitored and controlled, it can produce a significant threat to a bank and its earnings by fluctuations in:
  - a) the net interest income and bad debt provisions, which in turn can affect:
  - b) the underlying value of a bank's assets.
- 1.5 Lending activities also generate substantial costs relating to administration, funding and bad debts all of which impact strongly on profitability. It is therefore important that in all circumstances processes for the granting, subsequent monitoring and any recovery procedures reflect the return received.

### **2. Overview of the Commission's Approach to Credit Risk**

- 2.1 The Commission expects every bank to have a comprehensive statement of its credit policy appropriate to the nature of its business.
- 2.2 The Commission expects relevant managers of banks to have a clear understanding of the risks and ensure that appropriate controls and monitoring procedures are in place. It is also expected that credit risk officers have the experience, knowledge and background to exercise prudent judgement in assessing, approving and managing credit risks and that they are provided with the necessary training.
- 2.3 The Commission expects the bank to have a clear understanding of its

exposure to concentrations of risk by (both economic & individual) customer and geographical sector.

- 2.4 The Commission requires banks to report all large exposures that exceed 10% of Large Exposure Capital Base "LECB" on a quarterly basis. There is also the need to provide the Commission with regular financial information including audited financial statements, quarterly banking returns and details of any internal audit and /or compliance reports.
- 2.5 The bank should have access to appropriate management information to monitor and exercise control to mitigate risk. This should include a formal process for provisioning where bad and doubtful debts have been identified.
- 2.6 The Commission expects banks to consider the impact on liquidity as part of the credit approval process and detailed guidance on this is contained within the separate guidance notes on Liquidity Management issued by the Commission (see **Banking Guidance Note (BGN 5.0)**).

### **3. Credit Risk Management Policy**

The Commission requires banks to take reasonable steps to maintain appropriate systems for the management of credit risk and requires banks to have a formal credit policy. It is the responsibility of senior management to draw up the appropriate credit risk policy in the light of the particular circumstances of the bank. This should reflect the risk appetite of the bank and be approved by the Board. In larger organisations it is recognised that formal implementation of many aspects of the policy may be delegated to a separate Credit or Risk Committee with referral to ALCO (or equivalent), where appropriate. The credit policy should be reviewed regularly, at least annually.

The purpose of a credit policy is to provide a framework that enables growth and competitiveness whilst maintaining acceptable levels of risk.

The main points that need to be considered in drawing up a credit policy are given below:

#### **3.1 Key principles**

The credit policy should establish the key strategic aims including the attitude and sanctioning authorities in order to identify and manage, if applicable, any concentrations of risk. It should also set out the bank's attitude with regard to different types of lending, including geographical, economical or individual sector.

#### **3.2 Reputational risk**

Lending to certain individuals or sectors (either geographical or economic), or lending for a particular purpose can result in negative publicity and the bank should have a clearly defined policy in terms of what type and scope of lending is acceptable.

### 3.3 ***Discretionary power***

The credit policy must include details of the lending authority different people have within the organisation and the limit of this authority. If this is not specific within the credit policy there must be reference to how this is determined. This should also outline if any different procedures are necessary with regard to new business as this can present additional risk because there is no track record or behavioural patterns that can be assessed.

### 3.4 ***Related accounts / groupings***

An important element in considering lending is the recognition of facilities provided to a group of related customers. There should be appropriate guidance within the credit policy regarding the recognition and sanctioning of such exposures. Definitions of counterparties/customers related to each other are provided in ***Banking Guidance Note (BGN 4.0)***, Large Exposures for Banks.

### 3.5 ***Parties connected to the bank – arm's length lending***

When conducting business with a party connected to the bank appropriate controls should be in place to ensure business is conducted on an "arm's length" basis. Definitions of parties connected to the bank are provided in ***Banking Guidance Note (BGN 4.0)***, Large Exposures for Banks.

### 3.6 ***Facility grading / credit ratings***

Facility grading or credit ratings are a useful tool in the assessment of a lending proposition and if used guidance should be provided within credit policy. These ratings should be reviewed on a regular basis, at least annually.

### 3.7 ***Renewal process***

There should be clear guidelines on how to deal with the review and renewal of arrangements. These may include revisiting the original proposal to identify if any of the key information has changed and support this by a reassessment of current circumstances, in particular the financial performance and the value of security.

### 3.8 ***Security***

Credit policy must state the different types of security that are acceptable and also information on the valuation parameters that should apply. Credit policy should be clear when security must be considered as part of an arrangement and how it may affect the approval of a facility. Security that includes assets that can regularly change in value must be regularly monitored and guidance given on how often this should be done. There must be appropriate procedures in place to ensure that security has been satisfactorily completed before funds are released. Where appropriate, insurance should also be considered in context with the circumstances of the security.

### 3.9 ***Guarantees as security***

There should be a specific policy, when and under what circumstances it is appropriate to take guarantees as security.

### 3.10 ***Environmental risk***

Consideration should be given to the threat of environmental risk in terms of credit risk and the risk to the bank's profile and reputation associated with taking a charge over land that might be contaminated.

### 3.11 ***Documentation***

The quality of the documentation in respect of lending facilities is of prime importance in protecting the bank in the case of recovery proceedings. All lending facilities must be confirmed in writing in a format that has been approved by the bank's legal advisers and take into account any cross jurisdictional issues that might apply. The facility letter must accurately reflect all the terms and conditions of the arrangement.

### 3.12 ***Bonds, indemnities and guarantees – contingent liabilities***

Where such an undertaking is entered into on behalf of a customer the liability should carry the same considerations as any lending facility. There should also be clear guidelines on the nature of the liabilities the bank is prepared to enter into and under what circumstances.

### 3.13 ***Foreign exchange risk***

Where facilities have a potential foreign exchange risk this should be taken into consideration when reviewing/assessing any arrangement.

### 3.14 ***Regulatory requirement***

Clear reference should be made to the different regulations that apply to the granting, managing and reporting of all credit exposures.

## 4. **Introduced Business**

Any third party introducer can pose an increased risk to a lending transaction if too great a reliance is placed on the information provided. This is particularly the case when the introducer has an interest, financial or otherwise, in the transaction and there must be a clear policy to deal with business of this nature to ensure that high standards are maintained. Introducer arrangements must be reviewed regularly, at least annually.

## 5. **Procedures and Systems**

The assessment of a lending proposition should always be undertaken in accordance with the bank's procedures and referred for sanction to the

appropriate authority if outside discretionary powers. Detailed procedures should cover the approval process and the assessment should identify the source of repayment and outline when security is to be taken. Security should be revalued periodically to ensure that any covenants continue to be observed.

## 5.1 **General**

The Commission requires banks to monitor their credit risks on a frequent and timely basis. A bank must therefore have adequate procedures and systems covering:

- b) Allocation of responsibilities for credit granting, assessment and control
- c) Reliable systems that can produce accurate reports promptly. Reports should follow the principles of good management information and be clear and highlight all relevant information
- d) Active senior management involvement in clearly allocated responsibilities for credit reporting and monitoring – this should include regular independent checks by an internal control function, and
- e) Staff training that enables credit risk officers to have the experience, knowledge and background to exercise prudent judgement in assessing, approving and managing credit risks.

## 5.2 **Conflict of interest**

Conflicts of interest may arise where personal or outside interests exist which could affect the judgement of a member of staff in the management of a customer relationship. There should be guidance provided to deal with this type of situation.

Staff loans other than to managers, controllers or directors are normally treated as exempt when considering if a conflict of interest applies.

## 5.3 **Pricing**

Formal arrangements for the agreement for pricing of lending should be in place. This should take into consideration the need to remain competitive within chosen markets and also reflect the maturity and risk of a proposition.

## 5.4 **Credit scoring**

Where credit scoring is utilised as part of a credit strategy approval process there should be clear guidelines when and under what circumstances this should be used.

## 6. **Arrears and Provisioning**

The Commission requires that the bank shall have a policy on arrears and provisioning for bad and doubtful debts that is appropriate to the nature and

scale of its business. The Board and / or Audit Committee as well as senior management are responsible for ensuring that internal reviews of those documented policies are performed periodically.

The bank's Board must approve the written policy and changes thereafter. This should be reviewed at least annually to ensure it remains appropriate.

#### 6.1 ***Management information***

Management information systems should be able to identify any deteriorating position at an early stage. There should be detailed procedures on how these are dealt with which should include a timescale and follow up action.

#### 6.2 ***Arrears /Bad Debt provision***

There should be a clear definition of what are considered to be non-performing exposures and the provisioning process. It is expected at a minimum that all loans that are 90 days in arrears are automatically subject to default procedures and the action to be taken in respect of these must be contained within the arrears policy. However there may exceptions or circumstances where certain types of lending require a more conservative approach and procedures in respect of these should be documented.

The arrears policy must also outline the procedures that should be followed in respect of accounts that fail to cover interest or where security has deteriorated in value and have become in breach of the original terms of approval. There must be clear procedures to follow should any of these events occur. This should also include details on how both general/collective & specific/individual provisions are raised and calculated, by whom and when they should be reviewed.

The Arrears Policy should detail who has the authority to make / release provisions and the procedures that should be followed.

#### 6.3 ***Monitoring & control of lending***

Appropriate monitoring must be undertaken to ensure the bank is protected at all times and that risks are identified and acted upon at the earliest opportunity. There should be clearly defined procedures to ensure that monitoring, reporting and controls are applied in line with the bank's policies, procedures and terms of sanction.

### 7. **Other**

#### 7.1 ***Breaches***

An appropriate record of any breach should be maintained and brought to the attention of the Board / senior management in a timely manner.

## 7.2 ***Contingency or crisis planning***

A bank is expected to have a contingency plan which includes the recovery and operation of the credit risk functions in the event of it being unable to operate from its normal place of business.

## **Part 2 – Banks operating in or from the Isle of Man which are incorporated outside the Isle of Man (“branches”)**

### **1. Rationale / Introduction**

- 1.1 Under the Banking (General Practice) Regulatory Code 2005 the Commission requires branches to have a policy in relation to credit risk, arrears and provisioning management. This may be part of Head Office policy, with local requirements taken into account.
- 1.2 Credit risk is one of the most important in terms of all banking risks and clear credit administration is a critical element in understanding the safety and soundness of a bank. The default of a small number of important customers, or adverse factors affecting a particular segment of the business can generate large losses, potentially leading to insolvency (of the bank of which the branch is a part). The overall objective of the Commission is to identify key risk areas in line with the Basel Core Principles for Effective Banking Supervision, and to minimise threats to its Core Objectives of Supervision.
- 1.3 The Basel Core Principles for Effective Banking Supervision require a bank to have effective systems in place to identify, measure, monitor and control credit risk as part of an overall approach to risk management. This includes best practice as dictated by international standards and the requirements of group regulators. A branch would be part of such requirements.
- 1.4 Credit risk is a normal part of banking. However, where the amount of risk is excessive or where this is not properly monitored and controlled, it can produce a significant threat to a bank (in relation to business booked in the branch) and its earnings by fluctuations in:
  - a) the net interest income and bad debt provisions, which in turn can affect:
  - b) the underlying value of a bank's assets.
- 1.5 Lending activities also generate substantial costs relating to administration, funding and bad debts all of which impact strongly on profitability. It is therefore important that in all circumstances processes for the granting, subsequent monitoring and any recovery procedures reflect the return received.

### **2. Overview of the Commission's Approach to Credit Risk**

- 2.1 The Commission expects every branch to have a comprehensive statement of its credit policy appropriate to the nature of its business. This may be part of the Head Office policy of the bank, with local requirements taken into account.
- 2.2 The Commission expects relevant managers of branches to have a clear understanding of the risks and ensure that appropriate controls and monitoring procedures are in place. It is also expected that credit risk officers have the experience, knowledge and background to exercise prudent judgement in assessing, approving and managing credit risks and that they are provided with

the necessary training.

- 2.3 The Commission expects the branch to have a clear understanding of its exposure to concentrations of risk by (both economic & individual) customer and geographical sector, which may form part of concentration limits applied by the bank.
- 2.4 The branch should have access to appropriate management information to monitor and exercise control to mitigate risk. This should include a formal process for provisioning where bad and doubtful debts have been identified.

### **3. Credit Risk Management Policy**

The Commission requires branches to take reasonable steps to maintain appropriate systems for the management of credit risk and requires branches to have a formal credit policy (which can be part of the branch's head office policy taking into account local requirements). It is the responsibility of senior management to draw up the appropriate credit risk policy in the light of the particular circumstances of the branch. This should reflect the risk appetite of the bank of which the branch is a part. In larger organisations it is recognised that formal implementation of many aspects of the policy may be delegated to a separate Credit or Risk Committee with referral to ALCO (or equivalent), where appropriate. The credit policy should be reviewed regularly, at least annually.

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The main points that need to be considered in drawing up a credit policy are given below:

#### **3.1 *Key principles***

The credit policy should establish the key strategic aims including the attitude and sanctioning authorities in order to identify and manage, if applicable, any concentrations of risk. It should also set out the branch's attitude (which is likely to be driven by the bank of which it is a part) with regard to different types of lending, including geographical, economical or individual sector.

#### **3.2 *Reputational risk***

Lending to certain individuals or sectors (either geographical or economic), or lending for a particular purpose can result in negative publicity and the branch should have a clearly defined policy in terms of what type and scope of lending is acceptable.

#### **3.3 *Discretionary power***

The credit policy must include details of the lending authority different people have within the organisation and the limit of this authority. If this is not specific within the credit policy there must be reference to how this is determined.

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#### 3.4 ***Related accounts / groupings***

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#### 3.5 ***Parties connected to the bank – arm’s length lending***

When conducting business with a party connected to the bank appropriate controls should be in place (at branch level) to ensure business is conducted on an “arm’s length” basis. Definitions of parties connected to the bank are provided in ***Banking Guidance Note BGN (4.0)***, Large Exposures for Banks.

#### 3.6 ***Facility grading / credit ratings***

Facility grading or credit ratings are a useful tool in the assessment of a lending proposition and if used guidance should be provided within credit policy. These ratings should be reviewed on a regular basis, at least annually.

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- d) Staff training that enables credit risk officers to have the experience, knowledge and background to exercise prudent judgement in assessing, approving and managing credit risks.

## 5.2 **Conflict of interest**

Conflicts of interest may arise where personal or outside interests exist which could affect the judgement of a member of staff in the management of a customer relationship. There should be guidance provided to deal with this type of situation.

Staff loans other than to managers, controllers or directors are normally treated as exempt when considering if a conflict of interest applies.

## 5.3 **Pricing**

Formal arrangements for the agreement for pricing of lending should be in place. This should take into consideration the need to remain competitive within chosen markets and also reflect the maturity and risk of a proposition.

## 5.4 **Credit scoring**

Where credit scoring is utilised as part of a credit strategy approval process there should be clear guidelines when and under what circumstances this should be used.

## 6. **Arrears and Provisioning**

The Commission requires that the branch shall have a policy on arrears and provisioning for bad and doubtful debts that is appropriate to the nature and scale of its business (which can be part of the branch's head office policy taking into account local requirements). Senior management are responsible for ensuring that internal reviews of those documented policies are performed periodically.

In the case of a branch senior management must approve the written policy and changes thereafter. This should be reviewed on a regular basis and at least annually to ensure it remains appropriate.

#### 6.1 ***Management information***

Management information systems should be able to identify any deteriorating position at an early stage. There should be detailed procedures on how these are dealt with which should include a timescale and follow up action.

#### 6.2 ***Arrears /Bad Debt provision***

There should be a clear definition of what are considered to be non-performing exposures and the provisioning process. It is expected at a minimum that all loans that are 90 days in arrears are automatically subject to default procedures and the action to be taken in respect of these must be contained within the arrears policy. However there may exceptions or circumstances where certain types of lending require a more conservative approach and procedures in respect of these should be documented.

The arrears policy must also outline the procedures that should be followed in respect of accounts that fail to cover interest or where security has deteriorated in value and have become in breach of the original terms of approval. There must be clear procedures to follow should any of these events occur. This should also include details on how both general/collective & specific/individual provisions are raised and calculated, by whom and when they should be reviewed.

The Arrears Policy should detail who has the authority to make / release provisions and the procedures that should be followed.

#### 6.3 ***Monitoring & control of lending***

Appropriate monitoring must be undertaken to ensure the branch is protected at all times and that risks are identified and acted upon at the earliest opportunity. There should be clearly defined procedures to ensure that monitoring, reporting and controls are applied in line with the policies, procedures and terms of sanction applicable to the branch.

### 7. **Other**

#### 7.1 ***Breaches***

An appropriate record of any breach should be maintained and brought to the attention of senior management in a timely manner.

#### 7.2 ***Contingency or crisis planning***

A branch is expected to have a contingency plan which includes the recovery and operation of the credit risk functions in the event of it being unable to operate from its normal place of business.

## **Appendix I – Glossary**

**“ALCO”** means an Asset and Liability Committee.

**“bank”** is the Isle of Man incorporated bank (part 1), or the head office, or otherwise as applicable, of the branch (part 2).

**“branch”** means a branch in the Isle of Man of a bank incorporated outside the Isle of Man.

**“large exposures capital base”** (“LECB”) is equivalent to Adjusted Capital Base as calculated on form SR-2A and is the sum of allowable Tier 1 and Tier 2 capital, less appropriate deductions. The calculation is usually performed annually and is based on the previous year’s audited financial statements and should be agreed with the Commission for the next financial year.