FINANCIAL SUPERVISION COMMISSION

DEPOSIT TAKING (BANKS)

THEMED VISIT PROGRAMME 2010-11:
CREDIT RISK MANAGEMENT – SUMMARY FINDINGS

DOCUMENT OVERVIEW

1. Introduction 1
2. Key findings 2
3. Action taken by the Commission 7
4. Our priorities for 2012-13 7

1. Introduction

- **Financial Services Rule Book ("Rule Book")**
- **Guidance Note for Deposit Takes – Credit Risk, Arrears and Provisions Management ("Credit GN")**
- **Guidance Note for Deposit Takers – Quarterly Prudential Returns ("Returns GN")**

The Commission has a regulatory objective to secure an appropriate degree of protection for the customers of persons carrying on a regulated activity. The Rule Book and Credit GN contain some important provisions in relation to the management of credit risk, arrears and provisions for bad and doubtful debts. Credit risk is also a core prudential risk that banks face and which supervisors must monitor. It is important that banks have robust credit processes to ensure the risk of loss from the granting of credit is appropriately managed and controlled, and that customers of banks are also treated in a fair way.

In order to fulfil our responsibilities the Commission carried out themed on-site reviews of certain banks' credit risk management processes with a particular focus on the identification and management of problem loans, and the use of early warning indicators (for both individual and sector specific exposures). The on-site reviews

did not include an assessment of the sanction process for new loans or the perfection of security.

The purpose of this feedback is to highlight the Commission's key findings from the credit risk on-site reviews that have taken place between October 2010 and May 2011.

2. Key findings

2.1 *Identification and reporting of arrears (including regulatory reporting)*

During the visits it became apparent that banks did not always have the capability to maintain a full arrears database (or databases depending on number of systems used). The lack of robust arrears databases, although not impairing the actual identification and management of loans in arrears, resulted in the potential for incorrect information being reported in the prudential returns made to the Commission. This was particularly the case in the following situations:

- Where a bank used credit grades as a proxy for arrears information (for example a certain credit grade would link to the number of payments in arrears but this would not be the only factor that could determine such a grade).

- Where a bank analysed its book based on the date of the last payment missed, rather than the actual number of months in arrears (for example a loan might have accumulated 6 months of arrears but an ad hoc payment could have been received within the last month resulting in the loan being classified as less than 1 month in arrears for regulatory reporting purposes. In these cases the loan was still recognised as a problem debt).

- Where multiple systems were in place, including transferring loans to other parts of the group to manage.

2.2 *Reporting to the board (and senior management for a branch)*

2.2.1 Large exposures (concentration risk)

Although it was observed that large loans (for example the top 10 or 20) were reported to boards, in some cases it was not evident to the reader of the credit information provided which of these loans were large exposures for regulatory purposes (exceeding 10% of a bank's capital resources). The Commission considers that it is important for boards to be made fully aware of the level of large exposures on a regular basis.

2.2.2 Arrears (trends)

Full information on arrears trends and positions by relevant segment was not always being reported to boards. Also, it was found that senior management of Isle of Man branches of overseas banks were not always receiving full information on the extent of arrears, and in some cases write offs / impairments, of parts of Isle of Man sited loan business, particularly where the customer relationship was managed outside of the Isle of Man.

The Commission considers it is important that boards of Isle of Man incorporated banks and senior management of Isle of Man branches of overseas banks receive regular and full information on all relevant parts of the loan books in respect of arrears and impairments.

2.3 *Credit grading and information systems*

All banks use a credit grading system in respect of identifying, managing and reporting problem / deteriorating loans. The grading systems used generally provided a range of ratings for a borrower from an early warning sign (e.g. an event or pattern of behaviour that may cause concern even though an account may not be out of order), to an account being classified as bad and doubtful.

2.3.1 Practice versus procedure

During review of the credit grades of accounts it was established that the actual grading did not always appear to correspond to the expected grade as outlined in documented procedures. This was particularly the case for loans in the more advanced stages of being problematic (bad and doubtful).

For example, some banks' procedures effectively stated that a loan should be classified as bad and doubtful where the relationship with the borrower is such that the bank is reliant on the sale or realisation of its security for the recovery of the debt. It was however noticed that this classification was not always used in practice for such cases, mainly arising when the bank was satisfied that the security would be sufficient to enable the debt (and charges) to be fully extinguished. The grading of accounts could also impact on the impairment charge (*see impairment methodologies below*).

The Commission considers that banks' practices should match documented procedures, and that the credit grading of accounts should be reviewed on a regular basis (including across multiple systems – see below). The Commission does however acknowledge that in some cases procedures need to be reviewed as much as the practice adopted.

2.3.2 Early warning / problem loan databases

From review and analysis of databases and records pertaining to problem loans (retail and corporate) the Commission identified some weaknesses / errors in information maintained (compared to core systems or loan strategy sheets). Some examples included:

- Differences in credit grades across systems / databases for a single borrower.
- Differences in information between individual strategy sheet data (e.g. value of security) and that held on a central database of problem loans.
- Differences in the facility amount held on the central database of problem loans versus actual (latest) facility granted.

The above issues arose from system constraints (some of which were known to management) and the manual nature of inputs into problem loan databases.

2.4 *Management of problem loans*

In most cases it was evident that banks had adequate procedures and processes for dealing with problem loans, including appropriate segregation of functions. Banks generally utilised strategy sheets to keep track of developments and diarise actions, and used formal letters of demand when required, which can help in ensuring the customer communicates with the bank. The Commission considers the use of strategy sheets or equivalent to record actions and progress is good practice.

Different approaches were used when managing retail, mortgage and corporate loans. More complex cases were also often referred to specialist teams outside the Isle of Man.

The Commission also observed that loan books could be segmented and analysed in a number of ways and information on arrears levels, impairments and LTV could be provided for relevant portfolios (e.g. residential mortgages, personal loans, corporate loans etc).

2.5 *Impairment methodologies*

Most banks had a well documented impairment methodology that linked through to the automated allocation of impairments to problem loans (with manual override capable of being made when required). Different levels of impairment would apply

depending on the grading of the account, length of time in arrears and nature and value of security.

However, where impairments were automatically linked to the grading of loans, it was not always clear that the grading applied matched documented procedures, which in some cases could lead to an underestimation of impairments (*see also credit grading and information systems above*). The impairments applied to more complex corporate arrangements would often be assessed separately.

In relation to the assessment of security in determining the level of impairment it was evident that most banks applied discount factors (depending on the type of security) to the last valuation held (some banks also utilised indexation). If a property was on the market at a sale price, that would however also be taken into account.

The Commission encourages the use of a clear documented impairment methodology that takes into account the severity of the problem (including length of time in arrears) and nature and (discounted) value of the security. Impairments applied to loans, including cases which are problems loans where no impairment has been applied, should be reviewed regularly by management.

2.6 *Interest only mortgages (including re-financing and collateral values)*

2.6.1 Consumer protection: disclosure

The matter of the provision of interest only mortgages being provided for the purchase or refinancing of residential property (whether for owner occupied or rented property) has been researched and commented upon in some detail in the United Kingdom. From a consumer protection perspective the Commission focused on how banks' standard letters and facilities were worded, and how explicit they were in informing the borrower of the risks involved.

The Commission found that mortgage offer letters (and similar documentation) issued to customers contained warnings regarding the adequacy of the repayment vehicle which will ultimately repay the loan and that the capital will be outstanding at the end of the loan period. However, in some cases the warnings were not sufficiently upfront or explicit within the documentation. Examples of good practice seen, with information provided explicitly and upfront, including the following:-

- A requirement for a customer to explicitly state in writing how they intend to repay the mortgage loan capital (sum borrowed) at the end of (or during) the term of loan.

- A standard paragraph covering confirmation that the customer understands the following:-

    - That repayments to an interest only loan only cover the interest charged and do not reduce the capital.

    - That the responsibility to check the performance or value of an investment vehicle, endowment, pension plan or any other form of repayment is theirs.

    - That they fully understand that their home will be at risk if they fail to have sufficient funds to repay the capital sum at the end of the mortgage term, which could result in them having to sell their home to repay the mortgage.

The Commission considers it is important that warnings such as the above are explicit and are not hidden within documentation, especially where such mortgages are provided on a non advised basis.

The Commission also examined banks' policies in relation to the provision of such loans now. It was evident that sole reliance on the security as a means of repayment is no longer considered acceptable practice.

2.6.2 Managing back books

Some banks have material interest only portfolios where the terms of the mortgage expire within the shorter term. Due to past practices the repayment of the capital amount was also partly or mostly due to be made from the sale of the property mortgaged, or another property within a customer's portfolio. There is the potential that banks face situations where performing mortgages become non-performing upon expiry of the term and that the value of security has dropped below the loan outstanding.

The Commission observed that banks were cognisant of the above risks and were taking steps to manage these and also contact customers at appropriate times. Analysis of potential security shortfalls were also made or being made. In some cases the strategy required to deal with the risks needed to be completed and relevant information reported to the appropriate level within the business, including where applicable to the board.

2.7 *Repossessions of owner occupied properties*

It was evident from discussions and a review of cases that banks would only repossess a property owned and occupied by an individual when all other avenues

had been completely exhausted. This follows the general principles of forbearance that have been promulgated in the United Kingdom.

3. Action taken by the Commission

The Commission does not consider that there have been any major issues identified that would cause a significant threat to its core objectives, and that the Rule Book and Credit GN remain appropriate. Individual banks have been required to take action where applicable. The Commission provided feedback to banks in 2011 and expects banks to take note of the findings and good practice points explained above.

The Commission found it useful to observe data held by banks in relation to problem loans, including analysis of portfolios and arrears / impairments relating thereto, which helped with its understanding of banks' credit portfolios and risks. The Commission found, however, that the regulatory reporting of arrears and impairment information may not be fully accurate.

In respect of the above the Commission is proposing to review its reporting forms and Returns GN to enable better information to be received to assist in desk top supervisory work of credit risk.

4. Our priorities for 2012 / 2013

The Commission wishes to receive better and more regular information on the quality of banks' credit portfolios (rather than through ad-hoc visits and questionnaires) to assist in its regular monitoring process at an individual bank and sector level. In this respect the Commission has commenced a review of the existing reporting forms and Returns GN in relation to credit portfolios, and is due to provide proposals to the industry in the latter part of 2012, for implementation in 2013.