ISLE OF MAN
FINANCIAL SERVICES AUTHORITY
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GUIDANCE NOTE FOR DEPOSIT TAKERS (Class 1(1) and Class 1(2))

Credit Risk, Arrears & Provisions Management

March 2017

STATUS OF GUIDANCE

The Isle of Man Financial Services Authority ("the Authority") issues guidance for various purposes including to illustrate best practice, to assist licenceholders to comply with legislation and to provide examples or illustrations. Guidance is, by its nature, not law, however it is persuasive. Where a person follows guidance this would tend to indicate compliance with the legislative provisions, and vice versa.

Version 1.1

Contents

Part 1 – Deposit takers incorporated in the Isle of Man

1. Rationale / Introduction

1.1 This guidance applies to deposit takers holding either a Class 1(1) or Class 1(2) licence, jointly referred to in this document as both 'deposit takers' and 'banks'.

1.2 Under the Financial Services Rule Book ("the Rule Book"), the Isle of Man Financial Services Authority ("the Authority") requires deposit takers to have a policy in relation to credit risk, arrears and provisioning management.

1.3 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. 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. 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 Authority 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.

1.4 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.

1.5 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 net interest income and bad debt provisions (loan impairments). This in turn can affect the underlying value of a bank's assets.

1.6 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 approval, granting, subsequent monitoring and any recovery procedures reflect the return received.

2. Overview of the Authority's Approach to Credit Risk

2.1 The Authority expects every bank to have a comprehensive statement of its credit policy appropriate to the nature of its business.

2.2 The Authority 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 Authority expects the bank to have a clear understanding of its exposure to concentrations of risk by (both economic & individual) customer and country / geographical sector.

2.4 The Authority requires banks to report all large exposures (those that exceed 10% of Large Exposure Capital Base “LECB”) on a quarterly basis (and at least the largest ten loans irrespective of whether they exceed 10% of LECB). There is also the need to provide the Authority with regular financial information including audited financial statements, quarterly prudential 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 Authority 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 note on Liquidity Risk Management issued by the Authority.

2.7 The Authority also expects banks to take into account the information contained in ***appendix 2***.

3. Credit Risk Management Policy

The Authority 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. The Authority also recognises that a bank’s credit policy may be part of a wider group or divisional policy. 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 specified in Rule 8.36. Further information is given below:

3.1 ***Key principles***

The credit policy should establish the key strategic aims including the attitude and sanctioning (approval) 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 country / geographical, economical or individual sectors.

3.2 ***Reputation risk***

Lending to certain individuals or sectors (either country / 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 the Authority's guidance note on Large Exposures.

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. Transactions should not be undertaken on more favourable terms than corresponding transactions with non-connected parties[1].

A bank should also ensure that its policy and processes enable it to identify exposures to, and transactions with, parties connected to it, and that appropriate limits are in place for such lending. A robust approval and monitoring process should also be in place, and persons who may benefit from the transaction (or be related to a person who may benefit) should be prevented from being part of the approval process.

[1] Exceptions may be appropriate for beneficial terms that are part of overall remuneration packages (e.g. staff receiving credit at favourable rates).

Definitions of parties connected to the bank are provided in the Authority's guidance note on Large Exposures.

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.

Classification and valuation methods for contingent liabilities should be clear and documented.

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

a) Allocation of responsibilities for credit granting, assessment and control

b) 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

c) 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

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.

e) Identification and monitoring of significant[2] exposures, including the process for valuation, classification, and provisioning on an individual basis.

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. *Also refer to section 3.5 above.*

Staff loans other than to senior management (as interpreted in the Rule Book), key persons, 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.

[2] Under Rule 8.37(3) a bank must set an appropriate threshold for significant exposures and review that threshold regularly. A threshold could, for example, be based on a percentage of capital, or as a percentage of the total loan book (at a portfolio level or total level), or as an absolute amount. Thresholds could differ for different portfolios taking into account security / collateral.

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 Authority 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. As for the main credit policy, the Authority also recognises that a bank's policy on arrears and provisioning may be part of a wider group or divisional policy.

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, including how different categories of problem loans should be treated and analysed for impairment. This should also extend to off balance sheet exposures. Significant exposures (*see section 5.1 above*) should be subject to assessment for provisioning on an individual exposure basis.

It is expected at a minimum that all loans that are 90 days in arrears (past due) 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 be 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 and 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.

6.4 *Reclassification*

Under Rule 8.36(3)(i), the credit policy must include restrictions preventing the reclassification of problem loans by increasing lending to enable interest to be paid.

Further, a loan should not be reclassified as performing until at least all arrears have been cleared.

It is noted that a bank may enter into a new contractual arrangement with an existing borrower to enable a debt to be repaid and that existing arrears may be rolled up into the new facility / debt. In such circumstances, although arrears may have been technically cleared (as a new loan is in place), the loan should only be reclassified as performing if repayments are being made in a timely manner and that continued collection, in accordance with the contractual terms, is expected.

7. Reporting to the board

The board should receive timely information on the condition of a bank's loan portfolio. This should include the following information:-

a) Classification of loans (e.g. showing performing, impaired, past due but not impaired, by portfolio group)
b) Levels of provisions (impairments) to date for the year, comparative trends, and forecasts where relevant: this should be at a portfolio level (e.g. residential mortgages, retail loans, corporate / commercial loans)
c) Information on arrears trends
d) Analysis / commentary on major problem loans
e) Information in respect of large loans (including large exposures and significant exposures)
f) Any other information that may be relevant (such as the results of asset reviews, internal audits, credit reviews, stress testing of loan portfolios)

8. Other

8.1 ***Breaches***

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

8.2 ***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 – Deposit takers operating in or from the Isle of Man which are incorporated outside the Isle of Man (“branches”)

1. Rationale / Introduction

1.1 This guidance applies to deposit takers holding either a Class 1(1) or Class 1(2) licence, jointly referred to in this document as both ‘deposit takers’ and ‘banks’.

1.2 Under the Rule Book, the Authority 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.

1.3 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. 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. 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 Authority 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.

1.4 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.

1.5 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 net interest income and bad debt provisions (loan impairments). This in turn can affect the underlying value of a bank’s assets.

1.6 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 approval, granting, subsequent monitoring and any recovery procedures reflect the return received.

2. Overview of the Authority’s Approach to Credit Risk

2.1 The Authority 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 Authority 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 Authority expects the branch to have a clear understanding of its exposure to concentrations of risk by (both economic & individual) customer and country / 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.

2.5 The Authority also expects banks to take into account the information contained in ***appendix 2***.

3. Credit Risk Management Policy

The Authority 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.

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 specified in Rule 8.49. Further information is given below:

3.1 *Key principles*

The credit policy should establish the key strategic aims including the attitude and sanctioning (approval) 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 country / geographical, economical or individual sectors. The licenceholder should review the policy annually and evidence that review.

3.2 ***Reputation risk***

Lending to certain individuals or sectors (either country / 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. 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 the Authority's guidance note on Large Exposures.

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. Transactions should not be undertaken on more favourable terms than corresponding transactions with non-connected parties[3].

A bank should also ensure that its policy and processes enable it to identify exposures to, and transactions with, parties connected to it, and that appropriate limits are in place for such lending. A robust approval and monitoring process should also be in place, and persons who may benefit from the transaction (or be related to a person who may benefit) should be prevented from being part of the approval process.

Definitions of parties connected to the bank are provided in the Authority's guidance note on Large Exposures.

[3] Exceptions may be appropriate for beneficial terms that are part of overall remuneration packages (e.g. staff receiving credit at favourable rates).

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 branch'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 branch in the case of recovery proceedings. All lending facilities must be confirmed in writing in a format that has been approved by the branch/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 branch is prepared to enter into and under what circumstances.

Classification and valuation methods for contingent liabilities should be clear and documented.

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 branch’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 Authority requires branches to monitor their credit risks on a frequent and timely basis. A branch must therefore have adequate procedures and systems covering:

a) Allocation of responsibilities for credit granting, assessment and control

b) 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

c) 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

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. *Also refer to section 3.5 above.*

Staff loans other than to senior management (as interpreted in the Rule Book), other key persons, 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 Authority 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, including how different categories of problem loans should be treated and analysed for impairment. This should also extend to off balance sheet exposures.

It is expected at a minimum that all loans that are 90 days in arrears (past due) 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 be 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.

6.4 *Reclassification*

Under Rule 8.49(3)(i), the credit policy must include restrictions preventing the reclassification of problem loans by increasing lending to enable interest to be paid.

Further, a loan should not be reclassified as performing until at least all arrears have been cleared.

It is noted that a bank may enter into a new contractual arrangement with an existing borrower to enable a debt to be repaid and that existing arrears may be rolled up into the new facility / debt. In such circumstances, although arrears may have been technically cleared (as a new loan is in place), the loan should only be reclassified as performing if repayments are being made in a timely manner and that continued collection, in accordance with the contractual terms, is expected.

7. Overview by responsible officers

The responsible officers should receive timely information on the condition of a bank's loan portfolio. This should include the following information:-

a) Classification of loans (e.g. showing performing, impaired, past due but not impaired, by portfolio group)
b) Levels of provisions (impairments) to date for the year, comparative trends, and forecasts where relevant: this should be at a portfolio level (e.g. residential mortgages, retail loans, corporate / commercial loans)
c) Information on arrears trends
d) Analysis / commentary on major problem loans
e) Information in respect of large loans (for example the top 10 or 20 exposures)
f) Any other information that may be relevant (such as the results of asset reviews, internal audits, credit reviews, stress testing of loan portfolios)

8. Other

8.1 *Breaches*

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

8.2 *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 1 – Glossary

"ALCO" means an Asset and Liability Committee.

"bank" is the Isle of Man incorporated deposit taker (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 deposit taker incorporated outside the Isle of Man.

"large exposures capital base" ("LECB") is interpreted in accordance with the Rule Book.

Appendix 2 – Other relevant information

The additional information contained here is designed to support the main body of the guidance note. It includes findings from Authority on-site reviews, and other best practice points.

Identification and reporting of arrears (including regulatory reporting)

Banks need to have, or be working towards, maintaining 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, can result in the potential for incorrect information being reported in the prudential returns made to the Authority. This can particularly be the case in the following situations:

- Where a bank uses credit grades as a proxy for arrears information (for example a certain credit grade will 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 analyses 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 is still recognised as a problem debt).

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

Credit grading and information systems

A well-structured credit risk grading system can be an important tool to enable banks to differentiate the degree of credit risk in the various exposures it has. Such a system may typically take into account a borrower's current financial condition and paying capacity, current and realisable value of collateral and other specific characteristics of the borrower and facility that could affect the collection of principal and interest. It can allow a more accurate determination of the characteristics of the loan portfolio, probability of default and ultimately the adequacy of provisions (impairment).

Credit risk grading should be used for larger loans whereas smaller loans may be classified using such a system, or just based on payment delinquency (e.g. arrears). Credit grades can also be used for groups of loans.

Banks should use a credit grading system in respect of identifying, managing and reporting problem / deteriorating loans. The grading systems used should include 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.

Practice versus procedure

Banks should ensure that the actual grading used for an account corresponds to the expected grade as outlined in documented procedures. This is particularly important in the case for loans in the more advanced stages of being problematic (bad and doubtful).

Risk ratings / grades should be reviewed and updated whenever relevant new information is received, and loans to which credit risk grades are assigned should be reviewed formally periodically (e.g. annually) to ensure risk grades are up to date and accurate. More frequent review of risk grades for large, complex, higher risk or problem credits should be undertaken.

For example, the Authority has previously seen examples where procedures have 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. However, 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 Authority considers that banks' practices should match documented procedures for credit grading. The Authority does however acknowledge that in some cases procedures may need to be reviewed as much as the practice adopted.

Early warning / problem loan databases

From review and analysis of databases and records pertaining to problem loans (retail and corporate) the Authority has previously identified some weaknesses / errors in information maintained (compared to core systems or loan strategy sheets). Some examples have 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 often arise from system constraints and the manual nature of inputs into problem loan databases.

<u>Management of problem loans</u>

As part of the management and monitoring of problem loans, banks may utilise strategy sheets to keep track of developments and diarise actions, and use formal letters of demand when required, which can help in ensuring the customer communicates with the bank. The Authority considers the use of strategy sheets or equivalent to record actions and progress is good practice.

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

Systems should also be capable of enabling loan books to be segmented and analysed in a number of ways and information on arrears levels, impairments and LTV should be provided for relevant portfolios (e.g. residential mortgages, personal loans, corporate loans etc).

Impairment methodologies

Banks normally have a documented impairment methodology that links the automated allocation of impairments to problem loans (with manual override capable of being made when required). Different levels of impairment will apply depending on the grading of the account, length of time in arrears and nature and value of security.

However, where impairments are automatically linked to the grading of loans, banks should ensure that the grading applied matches documented procedures; if not, an underestimation of impairments may occur (*see also credit grading and information systems above*). The impairments applied to more complex corporate arrangements will often be assessed separately.

In relation to the assessment of security in determining the level of impairment banks normally apply discount factors (depending on the type of security) to the last valuation held (some banks also utilised indexation). This practice is encouraged. If a property is on the market at a realistic sale price, that can however also be taken into account.

The Authority 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.

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

Consumer protection: disclosure

Mortgage offer letters (and similar documentation) issued to customers should contain 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. Warnings need to be sufficiently upfront or explicit within the documentation. Examples of good practice seen, with information provided explicitly and upfront, includes 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 Authority 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.

Finally, sole reliance on the security as a means of repayment is not considered to be acceptable practice.

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.

Banks need to be cognisant of the above risks and take steps to manage these and also contact customers at appropriate times. Analysis of potential security shortfalls should also be undertaken. In some cases the strategy required to deal with the risks will need to be developed further and relevant information reported to the appropriate level within the business, including where applicable to the board.

Repossessions of owner occupied properties

Banks should have a clear policy on repossession (and therefore forbearance) for owner occupied properties and should exhaust all other avenues for repayment of the debt before taking such action.