

RESERVE BANK OF VANUATU

DOMESTIC BANK PRUDENTIAL GUIDELINE NO. 2

GUIDELINES FOR LOAN CLASSIFICATION AND PROVISIONING FOR IMPAIRED ASSETS

INTRODUCTION

1. This paper sets out the Reserve Bank of Vanuatu's minimum requirements for the classification of assets quality, provisions for losses and suspension of interest to be used by financial institutions doing banking businesses in Vanuatu. These guidelines are part of the minimum rules that are being set out by the Reserve Bank for the conduct of banking business in a safe and sound manner.

MANAGEMENT OF RISK ASSETS

2. A realistic valuation of assets and prudent recognition of income and expenses are critical factors in evaluating the financial condition and performance of financial institutions. The majority of a bank's assets are loans and advances, thus, the process of assessing the quality of credit and its impact on solvency is absolutely important. In many developing countries, the failure of banks to identify problem assets is one of the most serious deficiencies and as a result balance sheets often do not reflect their true financial condition (especially in respect of solvency and capital adequacy) and income statements show overstated profits upon which dividends are paid. This overstatement originates from the failure to establish realistic provisions for potential losses, fully provide for actual losses, or suspend interest accrual on non-performing assets.
3. The Reserve Bank expects financial institutions to have in place a portfolio review system that ensures the evaluation of credit policies and identification and monitoring of existing or potential problem loans. The system should help ensure that timely and adequate provisions are taken to maintain the quality of the loan portfolio and that adequate provisions for losses are set-up and maintained. It is one of the Reserve Bank's objectives to ensure that financial institutions adopt prudent risk management and credit policies to minimise the extent, and likely impact, of such losses if they occur.
4. Where institutions operate in Vanuatu as branches and subsidiaries of international banks it is expected that they will already have in place systems adopted by the parent that may be compatible with the Reserve Bank's minimum approach. In such cases, financial institutions should provide the Reserve Bank with a "map" showing the links between their own categories of loan classification and the Reserve Bank's proposal, and highlight any differences in treatment of provisions and suspension of interest.
5. Where the situation noted in 4, does not apply, the Reserve Bank's minimum approach is proposed.

6. Foreign incorporated banks operating as branches would be expected to record in their Vanuatu accounts the provisions for loans classified as "Substandard", "Doubtful" and "Loss".

OBJECTIVES

7. These guidelines are intended to establish a prudent basis for :
- (a) the classification of assets quality;
 - (b) the determination of an adequate level of loan loss and other valuation reserves; and
 - (c) the accounting treatment of accrued, but uncollected interest on non-performing loans.

ASSET CLASSIFICATION

8. In general, financial institutions should classify all direct and indirect extensions of credit including loans and advances, accounts receivable, property acquired by the bank in settlement of loans, equity investments, equity participations, contingent items in the nature of direct credit substitutes and miscellaneous asset accounts.

Assets will be classified in the following categories:

- (a) "Standard": Assets in this category are not subject to criticism. In general, performing loans and other assets which are fully and formally collateralised, both as to principal and interest, by cash or by deposits with the lending institution or by securities issued by the Government or by the Reserve Bank, and full repayment of interest and principal is not in doubt, are included in this category regardless of arrears or other adverse credit factors.
- (b) "Substandard": Assets that are not protected by the current financial soundness and paying capacity of the obligor. In essence, substandard assets are those whose primary sources of repayment may be insufficient to fully service the debt and the lending institution may need to rely on secondary sources (for example, collateral, sale of fixed assets, refinancing or fresh capital) for the repayment of the loan. Substandard assets display well-defined credit weaknesses that are likely to jeopardise the full settlement of the debt.
- (c) "Doubtful": Assets that exhibit all the weaknesses inherent in assets classified as substandard with the added characteristics that the assets are not well-secured. These weaknesses make collection in full, on the basis of currently existing facts, conditions and values, improbable. The probability of some loss is expected, but because of certain reasonably specific factors which may strengthen the assets, classification as loss is not warranted at this stage. Non-performing assets that have been past due for more than 90 days are usually classified as doubtful unless they are well-secured, legal action has actually commenced and timely realisation of the collateral or successful enforcement of the guarantees can reasonably be expected.

- (d) **"Loss":** Assets that are considered to be uncollectable, or to have minimal recovery value, or are unable to be collected within a reasonable time after commencement of legal proceedings for recovery. This classification does not mean that the asset has no recovery or salvage value. Rather, that it is neither practical nor desirable to defer writing off the asset even though it is possible that partial recovery may be effected in the future. Such assets should not be retained on the books while attempting long-term recoveries. Losses should be taken in the period in which they are identified as uncollectable. Non-performing assets which have been past due for at least 90 days or more should also be classified loss unless such assets are well-secured, legal action has actually commenced and timely realisation of the collateral or successful enforcement of the guarantees can be expected.
9. There is, of course, no objection to a more conservative classification if such is warranted, based upon the analysis of the borrower's financial condition, ability and willingness to repay.
10. As a general rule, where more than one facility has been opened for a borrower or to other entities in a group of related companies which is under the control or influence of the same person or company, all facilities outstanding to that borrower or group should be placed in the worst appropriate classification if one of the facilities meets that criteria. However where there are exposures to related entities which are still fully performing and the nature and value of the collateral and the cash flows which have been consistently generated on the fully performing facilities leaves no doubt that full repayment of principal and interest can be maintained on such facilities, those facilities can be classified on their own merits provided that:
- (a) The related classified facilities are not cross collateralised and there are no cross guarantees between the related entities; or
- (b) If there are cross collateral or guarantee arrangements, there is, in aggregate, sufficient readily realisable security available within the group to ensure that all principal and interest due will be collected in full.

Renegotiated or Restructured loans

11. These are loans where the original terms have been modified by formal agreement to provide some concession to the borrower in respect of payment of principal and/or interest, because of financial difficulties of the borrower. The modification may include lengthening of repayment term and adjustment of interest rate to conform to changes in the borrower's debt service capacity.
12. If the modified terms do not increase risk, and are expected to be met in full with no loss of principal or interest, an adverse classification need not be recorded solely based on the modification. If these conditions are not met, consideration of the appropriate classification for the renegotiated loan should form part of the renegotiation process.

13. In general, it would be expected that any overdue interest should be brought up-to-date by the borrower from his own funds before a loan is renegotiated or restructured. If this is not done then this should be taken into account when considering classification of the renegotiated or restructured loan.

INTEREST SUSPENSION

14. Another important aspect in evaluating asset quality is a bank's policy on suspending interest on problem loans. Most banks operate on an accrual basis, i.e. interest on loans is taken into income when it is earned. However, interest must cease to be accrued from the time a facility is classified doubtful or loss. It is emphasised that:-
- (a) Interest should not continue to be accrued when there is reasonable doubt about the collection of principal and interest as scheduled or within a reasonable time thereafter. All "non-performing", "doubtful" or "loss" assets are to be placed on a non-accrual basis, and the institutions should cease to recognise as income any interest earned but not yet received.
 - (b) Where a loan is placed on non-accrual status, any interest accrued but unpaid in the current accounting period should be reversed from income. Unpaid interest relating to prior accounting periods, and already taken to profit & loss, should be reviewed to determine the amount of specific loss provisions required.
 - (c) A loan designated non-accrual may be restored to accrual status if principal and interest arrears have been met in full by payments from the borrower, other than from the extension of a new loan, and it is reasonably expected that the borrower is capable of servicing the loan in compliance with its terms.
 - (d) Where subsequent payments or collections received by the institution results in a reduction in the remaining estimated recoverable amount, the proceeds should be applied first to the principal and then to the interest.

PROVISIONING

15. Institutions are required to maintain a prudent level of general provisions against losses not as yet identified on the good quality part of the portfolio, and specific provisions against reasonably anticipated losses on poor quality assets and all specifically identified losses on impaired assets. 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.
16. As a general rule, where there is doubt about full collectability of the facility, and readily realisable security exists which can be realised within a reasonable time frame (usually not more than one year), 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 is not expected to be realisable within one year of legal action commencing, impaired assets must be rigorously examined to determine whether it is prudent to provide for the full amount of the asset 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, for example, 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.

17. 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 (that is after deducting specific provisions or write offs to date) of all principal and present and future interest due, any facility which has been impaired for one year or more should be classified as loss and written off or provided for the full amount of possible loss, 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 being made at that time.

General Provisions

18. 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. For this purpose, the Reserve Bank may require 1% of the outstanding balance of all facilities classified as standard as an allocated general provision.
19. Prudent institutions may 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 provisions held by the institution.
20. In the case of branches of foreign financial institutions, the Reserve Bank may require written confirmation from the head office, where an institution has advised that the general provision is maintained in the head office's books to cover the Vanuatu operations.

Specific Provisions held against Substandard, Doubtful and Loss facilities

21. The Reserve Bank may expect that each institution will maintain in Vanuatu, a total amount of additional provisions which is not less than the sum of the following:
- (a) 20% of the outstanding balance of all facilities classified as substandard, (which may be established as an unallocated specific provision);
 - (b) 50% of the outstanding balance of all facilities classified as doubtful, as an allocated specific provision;
 - (c) 100% of the outstanding balance of all facilities classified as loss (unless already written off in full) as an allocated specific provision;
22. Whether a particular institution's average provision levels should be higher than the above minimum will also depend on other factors, including:
- (a) The effectiveness of the institution's credit policies, internal and external audit, loan reviews and credit inspections in maintaining a high quality asset portfolio;
 - (b) 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;
 - (c) The quality of financial information and credit files maintained on each borrower; and
 - (d) 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 future.

GLOSSARY OF TERMS

Accrual

Assets where interest is accrued in the institution's income statement.

Facility

Includes loans and advances, leases, all other on balance sheet credit exposures to customers, acceptances and bills of exchange, and other off balance sheet commitments and contingencies which have the potential to expose the institution to a loss if the counterparty fails.

Impaired Assets

These are facilities which are not fully performing, for example, where the full amount of originally contracted interest is not being accrued in the institution's income statement or where a need for a specific provision has been identified.

Non-Accrual

Asset has been placed on a cash basis for financial reporting purposes. Interest is no longer accrued on the books of the bank nor taken into income unless paid by the borrower in cash. All non-performing assets should be placed on non-accrual and previously accrued but uncollected interest reversed from income; or interest should be placed in suspense. The level of non-accrual loans is a useful piece of information in assessing the creditworthiness of the loan portfolio and the future drain of poor quality loans on interest income.

Non-performing assets

Assets are considered to be past due when, without prior arrangement, principal or interest or an amortisation (when loan is payable by instalment) is unpaid 90 days past its due repayment date or when, in the case of overdrafts, the account has remained unpaid 90 days or more after the expiry date of the credit line. The principal balance outstanding (and not the amount of delinquent payments) is used in calculating the aggregate amount of past due obligations.

The initial recognition of credits as past due does not, in itself, provide sufficient cause for classification, loan loss provision, or suspension of interest unless such credit also exhibits well-defined credit weaknesses. Past due status does signal the need for bank management to institute actions to strengthen or collect the credits so affected. To the extent that management is not successful in its collection efforts and the credits become non-performing, there is a presumption that well-defined credit weaknesses exist. This action results in interest suspension and might cause the bank to raise a loan loss provision.

Renegotiated Loans and Advances

These are extension of credit which have been refinanced, rescheduled, roll-over, or otherwise modified at favorable terms and conditions for the borrower because of weaknesses in the borrower's financial condition and/or ability to repay.

Well-secured

Assets with sufficient collateral to protect the lending institution from any loss of principal or interest through timely disposition under a forced liquidation program. Sufficiency implies the existence of proper legal documentation, a net realisable market value which is adequate to cover the amount of principal and interest outstanding, as well as costs of collection, and the absence of prior liens on the collateral which could diminish its value or otherwise prevent the acquiring of clear title. Collateral such as specialised manufacturing facilities and equipment for ongoing operations would not normally be considered "well-secured" because of the difficulties of actual foreclosure or of disposing of the collateral in a timely manner at values sufficient to ensure that no loss is sustained.