

FINANCIAL SUPERVISORY COMMISSION



Government of the Cook Islands

PRUDENTIAL STATEMENT

No. 03-2004

ASSET CLASSIFICATION, PROVISIONING and NON ACCRUAL OF INTEREST

1. Preamble

This Prudential Statement is issued by the Financial Supervisory Commission pursuant to the provisions of Section 14 (2)(e) of the Banking Act 2003 and shall be applicable to all bank licensees. Foreign licensees shall, for reporting purposes to the Financial Supervisory Commission, follow the criteria and computation set forth in this Prudential Statement for accounts held by its Cook Islands branch. Required provisions, however, may be determined and maintained on a consolidated basis by the foreign bank in a manner that is acceptable to its home country supervisor.

2. Purpose

The purpose of this Prudential Statement is to provide uniform guidelines to banks to assure that (i) assets are regularly reviewed and graded in a consistent manner; (ii) assets not performing in accordance with contractual repayment terms are reported and recognized as past due in a consistent manner; (iii) accrued but uncollected interest and other income on assets are accounted for in a consistent manner; and (iv) timely and adequate provisions are maintained for losses which accurately reflect the risk inherent in lending and investment activities to assure that disclosed capital and earnings performance are accurately reflected.

The focus of this Prudential Statement is on loan provisioning practices relating to the credit risk on lending and other types of credit extension. While the Prudential Statement does not deal with provisions for other assets, banks should ensure that risks pertinent to these exposures are prudentially measured and managed.

3. **Definitions**

As used in this Prudential Statement the following terms, unless otherwise clearly indicated by the context, have the meanings specified below:

“Accrued interest” means any accrued and uncollected interest, which has been added to the principal amount of a loan or asset at its payment date or maturity; it also includes uncollected interest which is refinanced or “rolled-over” into a new loan.

“Cash deposit” means credit balances on accounts in the books of the bank over which the depositor has given the bank a formal written letter of cession as security or collateral for a loan by the bank and which the bank at its discretion has transferred the amount of the cash deposit from the depositor’s account(s) to a specific or general cash collateral/security account(s).

“Current” as used in reference to “current” financial statement, “current” valuation, or similar uses, means information or documentation having an issuance date not more than 12 calendar months.

“Group of borrowers” means groups of bodies under the control of a particular person as defined under Section 36(2) of the Banking Act 2003 and immediate relatives of a particular borrower as defined in this Prudential Statement.

“Immediate relatives” means spouse, parents, children, brothers and sisters of a borrower from a bank.

“Loans” means advances and any credit facility including commitments to advance funds by a bank to a person that are conditioned on the obligation of the person to repay the funds or that are repayable from specific property pledged by or on behalf of the person. The term includes a contractual liability of a bank to advance funds to or on behalf of a person, indebtedness evidenced by a lease financing transaction in which the bank is the lessor, and an overdraft funded by the bank on behalf of a person

“Non accrual” means interest is no longer accrued on the books of the bank for an asset nor is the interest taken into income unless otherwise provided in this Prudential Statement.

“Overdraft” means a deposit account on the books of the bank with a debit balance.

“Past due or overdue” means:

- (1) any asset, but excluding overdrafts, when:
 - i. principal and/or accrued interest is due and uncollected for 30 (thirty) days or more beyond the scheduled payment and/or maturity date; or

- ii. accrued interest equal to 30 (thirty) days or more have been capitalized to the outstanding principal balance of the obligation, refinanced, or rolled-over;
provided, installment loans requiring monthly payments, including those with scheduled salary allotments, will not be considered as past due until two (2) monthly payments or salary allotments have been missed, at which time the past due status will be measured from the date of the first missed payment;
- (2) overdrafts which carry a debit balance for 30 (thirty) consecutive days or more in excess of the agreed overdraft limit.

“Provisions for bad loans account” means a balance sheet valuation account established through charges to provision expenses against which bad loans or portions thereof, are provided for and written off.

4. Responsibility of Board of Directors

- (a) It is the responsibility of the board of directors of each bank to ensure that appropriate systems and procedures are established to accurately and timely recognize problem or deteriorating assets, assume adequacy of provisions for bad loans and to comply with the requirements of this Prudential Statement. The Financial Supervisory Commission may require a bank to maintain higher provisions for bad loans after considering a bank’s historical loan loss experience, current economic conditions, delinquency trends, the effectiveness of policies on the granting, monitoring and collection of loans as well as the timeliness and accuracy of its loan review function.
- (b) The board of directors of each bank shall assure that a review is made of the quality of the bank’s loan portfolio on a regular basis, but no less than once each calendar quarter. At the end of each calendar quarter, or more frequently if warranted, the board of directors shall require the officer(s) of the bank to take appropriate measures in response to the findings of the loan review function to:
 - (1) accurately reflect earnings by assuring that all loans categorized as non-performing in accordance with the requirements contained in this Prudential Statement are placed on non-accrual status and accrued but uncollected interest has been reversed out of the bank’s income;
 - (2) assure that the provisions for bad loans account is adequate to absorb potential losses in accordance with the requirements contained in this Prudential Statement; and
 - (3) correct problems, either in individual loans, loan underwriting practices, compliance with prudent lending standards and the board-approved lending policy, or other credit administration weaknesses as may be identified by the loan review function, within a specified time frame.

5. Purpose and Function of Loan Review

- (a) The loan review function shall assure on an on-going basis, at a minimum, that:
- (1) lending activities are in compliance with prudent written lending standards as approved and adopted by the board of directors of the bank;
 - (2) the board of directors is adequately informed of the risks and potential loss exposure in outstanding loans and assets;
 - (3) problem or deteriorating loans and assets are properly and timely identified, classified, and placed on non-accrual status in accordance with the requirements contained in this Prudential Statement;
 - (4) appropriate provisions are made to the provisions for bad loans account in accordance with the requirements contained in this Prudential Statement;
 - (5) loans and assets classified Loss are promptly written off in accordance with the requirements contained in this Prudential Statement.
- (b) The loan review function shall regularly and on an ongoing basis review:
- (1) all loans which exceed ten percent (10%) or more of a bank's Tier-1 capital,
 - (2) all loans not included above but classified among the top twenty (20) loans individually or as a group of borrowers,
 - (3) all loans required to be placed on non accrual status in accordance with this Prudential Statement,
 - (4) a sampling of the remaining loan portfolio to assure that loans reflected as performing on the books of the bank are in fact performing pursuant to the definitions of this Prudential Statement.

6. Requirements for the Placement of Loans on Non accrual Status

Assets shall be categorized as non-performing and shall be placed on non accrual status if any of the following conditions exist:

- (1) any asset, but excluding overdrafts, when:
 - i. principal, including instalments due, and/or accrued interest is due and uncollected for 90 (ninety) days or more beyond the scheduled payment and/or maturity date; or
 - ii. accrued interest equal to 90 (ninety) days or more has been capitalized to the outstanding principal balance of the obligation, refinanced, or rolled-over, and full repayment of principal and/or accrued interest is not expected as evidenced by a well-documented written analysis and evaluation of the obligor's current financial condition; or

- iii. payment of principal or interest in full is not expected based upon either an analysis of current financial information on the obligor or other reliable information or facts:
- (2) overdrafts which carry a debit balance for 90 (ninety) consecutive days or more in excess of the agreed overdraft limit;
- (3) the asset is classified Doubtful or Loss.

7. Treatment of Multiple Loans to One Borrower

If a bank has multiple loans outstanding to a single borrower or related group of borrowers, and one loan meets the criteria for non accrual status, then the bank shall prepare a written evaluation of the borrower's current financial condition and other relevant factors to evidence that repayment prospects for the other loans is reasonably assured. Should such written evaluation suggest that repayment prospects for the other loans are in question or otherwise uncertain, then all such loans to the borrower shall be placed on non accrual status regardless of any guidelines contained in this Prudential Statement to the contrary.

8. Treatment of Accrued but Uncollected Interest

- (a) Accrued but uncollected interest being carried on the books for a loan which is required to be placed on non accrual status in accordance with the requirements contained within this Prudential Statement shall be eliminated by the end of the calendar quarter in which the loan is placed on non accrual status, but in no event later than the fiscal year-end date of the bank, whichever is sooner.
- (b) Interest which has been taken into income and capitalized by increasing the principal amount of a loan shall be written-off or placed in a suspended interest account from the time the loan is, or should have been, placed on non accrual status. Interest which has been accrued during the current calendar quarter shall be charged against the interest income account, and interest accrued in prior calendar quarters shall be charged against the provisions for bad loans account.

9. Treatment of Cash Payments and Criteria for Cash Basis Recognition of Income

- (a) The placement of a loan on non accrual status does not require an automatic write-off in whole or in part of the outstanding principal balance. An identifiable Loss, however, must be written-off at the time a loan is placed on non accrual status.
- (b) When a loan is placed on non accrual status and full collection of the outstanding principal and interest is uncertain, any cash payments received must first be applied to reduce the outstanding principal balance until the outstanding principal balance is reduced to a level where collection in full is reasonably certain.

10. Restoration of Accrued Status

- (a) A loan placed on non accrual status in accordance with the guidelines contained in this Prudential Statement may only be restored to accrual status when:
- (1) none of the outstanding principal and/or interest is past due; and,
 - (2) payments have been made on a consistent and timely basis for at least six (6) consecutive months in accordance with the original contractual terms; or
 - (3) where a loan which has had its terms formally restructured with accrued interest prior to the restructuring being capitalized into the restructured loan, and where the terms of the restructured loan agreement are consistent with other loans being made by the bank and in accordance with guidelines as outlined in the board-approved loan policy, when loan payments have been made on a consistent and timely basis for at least six (6) consecutive months; and
 - (4) the bank expects full repayment of the remaining contractual principal and interest as evidenced by a well documented written credit evaluation of the borrower's current financial condition.
- (b) If, after a formal restructuring, a loan deteriorates again and meets the criteria for placement on non accrual status as required by the guidelines contained in this Prudential Statement, the loan must be returned to non accrual status until such time as it again qualifies for accrual status.

11. Classification of Assets

- (a) For purposes of this Prudential Statement, every bank shall classify all assets according to the following categories and criteria detailed below. Banks may develop their own internal risk grading system to indicate various levels of risk exposure in assets, however such risk grades must be reconciled to the five regulatory categories detailed below.
- (1) **“Pass”** if the asset is fully protected by the current sound worth and paying capacity of the obligor, is performing in accordance with contractual terms and is expected to continue to do so;
 - (2) **“Special Mention”** if the asset:
 - i. is past due for more than 30 (thirty) days but less than 90 (ninety) days;
 - ii. although currently protected, exhibits potential weaknesses which may, if not corrected, weaken the asset or inadequately protect the bank's position at some future date, for example –

- the asset in question cannot be properly supervised due to an inadequate loan agreement; or
- the condition or control of the collateral for the asset in question is deteriorating; or
- the repayment capacity of the obligor is jeopardized because of deteriorating economic conditions or adverse trends in the obligor's financial position; or
- there is an unreasonably long absence of current and satisfactory financial information or inadequate collateral documentation in regard to the asset:

provided that, generally an asset shall be classified Special Mention only if its risk potential is greater than that under which is was originally granted;

(3) **“Substandard”** if the asset:

- i. is past due for more than 90 (ninety) days but less than 180 (one hundred eighty) days; or
- ii. is required to be placed on non accrual status in accordance with the requirements contained in this Prudential Statement;
- iii. is a renegotiated loan which has had its terms or interest rate modified because of weaknesses or deterioration in the obligor's financial condition or ability to repay, unless all past due interest is paid by the obligor in cash at the time of renegotiation and a sustained record of timely repayment of principal and interest under a repayment program, where such repayment terms and rate of interest are consistent with other loans being made by the bank at the time of renegotiation and in accordance with guidelines as outlined in the board-approved loan policy, has been demonstrated for a period of not less than six (6) months; or
- iv. whether or not it is past due, is inadequately protected by the current sound worth and paying capacity of the obligor by reason of the fact that:
 - the primary source of repayment is insufficient to service the debt and the bank must look to secondary sources such as collateral, sale of fixed assets, refinancing or additional capital injections; or
 - there is an unduly long absence of current and satisfactory financial information or inadequate collateral documentation in regard to the asset; or
 - generally, there is more than a normal degree of risk attaching to the asset due to the obligor's unsatisfactory financial condition;

(4) **“Doubtful”** if the asset:

- i. is past due for more than 180 (one hundred eighty) days but less than 360 (three hundred sixty) days; or
- ii. exhibits all the weaknesses of a substandard asset and, in addition, is not well-secured by reason of the fact that

collection in full, on the basis of currently existing facts, is highly improbable, but the actual amount of the loss is indeterminable due to pending events that have a more than reasonable prospect of mitigating the loss, such as a proposed merger, acquisitions or liquidation, a capital injection, perfecting liens on additional collateral, refinancing plans, new projects or asset disposal;

(5) **“Loss”** if the asset:

- i. is past due for more than 360 (three hundred sixty) days, unless such asset is well secured and legal action has actually commenced which is expected to result in the timely realization of the collateral or enforcement of any guarantee relating to the asset; or
- ii. had been characterized as Doubtful on account of any pending event referred to in subparagraph (d)(ii) above, and the event concerned did not occur within 360 (three hundred sixty) days, whether or not the event is still pending thereafter; or
- iii. is otherwise considered uncollectible or of such little value that its continuance as an asset on the books of the bank is not warranted:

provided that a Loss classification shall not preclude the possibility of recovering the asset or securing a salvage value for it.

- (b) Nothing contained in this Prudential Statement, however, shall preclude examining personnel of the Financial Supervisory Commission from assigning a more severe classification where circumstances are supportable based on an analysis of an obligor's current financial condition, commitment, capacity, and willingness to repay.

12. **Provisioning Requirements**

- (a) All banks shall maintain provisions for bad loans account created through charges to provision expense in the income statement and maintained at a level adequate to absorb potential and expected losses in the loan portfolio and in respect of other assets.
- (b) Every loan classified Loss shall be written off by debiting the provisions for bad loans account and every recovery of loans previously written off shall be credited to the provisions for bad loans account. At no time shall a loan ever be written off as a direct debit, or a loan recovery ever be recorded as a direct credit to retained earnings or any other capital account of a bank.
- (c) The following minimum percentage amounts are to be maintained as

provisions against the outstanding balance of loans classified in accordance with the requirements of Paragraph 11, Classification of Assets.

<u>Asset Grades/Classifications:</u>	<u>Minimum Provision:</u>
“Pass”	0%
“Special Mention”	5%
“Substandard”	20%
“Doubtful”	50%
“Loss”	100%

- (d) That portion of a loan or asset secured by the following shall be exempt from the classification and provisioning requirements of this Prudential Statement:
- (1) a cash deposit; or
 - (2) a security issued by the Cook Islands Government, OECD central governments and central banks, the current market value of which has been determined by a qualified, independent, third party in writing; or
 - (3) an unconditional obligation or guaranty issued in writing by the Cook Islands Government or an OECD central government or central bank to repay both principal and interest, or a specific amount, and the lending bank has not been advised in writing of any determination by the guarantor to deny payment under the terms of the obligation or guaranty; or
 - (4) other liquid and readily marketable collateral as may be approved in writing by the Financial Supervisory Commission.

13. Record-keeping Requirements

- (a) Each bank shall maintain adequate records in support of its evaluation of potential loss exposure in the loan portfolio and of the entries made to ensure adequate provisions for bad loans account.
- (b) Such records shall be made available to the Financial Supervisory Commission and its examining personnel upon request to assess the reasonableness of the bank’s loss estimation procedures, the reliability of the information on which estimates are based, and the adequacy of the provisions for bad loans account.

14. Review by Financial Supervisory Commission

- (a) Should the Financial Supervisory Commission or its examining personnel in applying the requirements of this Prudential Statement and after discussions with the executive officer(s) of the bank find the provisions for bad loans account to be inadequate, the board of directors shall instruct and require the chief executive officer to

immediately record the appropriate entries to increase the amount of the provisions for bad loans account to the amount determined by the Financial Supervisory Commission.

- (b) In the event of material disagreements regarding the appropriateness of additional provisions needed to the provisions for bad loans account, the board of directors of a bank may appeal in writing to the Board of the Financial Institutions Commission. The written appeal should outline the basis for the board's disagreement with the amount of provisions required by the Financial Supervisory Commission or examining personnel.

15. Transition Period

Each bank shall have until 30 June 2004 to bring itself into compliance with the requirements of this Prudential Statement. Any deficiency in required provisions must therefore be booked in full during the transition period, unless otherwise approved by the Financial Supervisory Commission.

16. Enforcement and Corrective Measures

If a bank fails to comply with the requirements contained in this Prudential Statement in a flagrant manner which results, or threatens to result, in an unsafe or unsound condition, or submits statistical or other reports to the Financial Supervisory Commission which are materially inaccurate, the Financial Supervisory Commission may pursue any or all corrective actions as provided under pertinent sections of the Banking Act 2003 or as may be prescribed by subsequent regulations or issuances of the Financial Supervisory Commission. Directives or conditions that may also be imposed by the Financial Supervisory Commission on the operation of the bank may include but need not be limited to:

- i. prohibition from engaging in new activities or from expanding existing activities;
- ii. suspension of lending, investment and credit extension activities;
- iii. prohibition from acquiring, through purchase or lease, additional fixed assets;
- iv. prohibition from accepting further deposits or other liabilities for borrowed money;
- v. prohibition from declaring or paying dividends or bonuses, salary incentives, severance packages, management fees or other discretionary compensation to directors, managers and officers.

