Reserve Bank of Fiji

Banking Supervision Policy Statement No: 3 *Revised 2009*

GUIDELINES FOR LOAN CLASSIFICATION AND PROVISIONING FOR IMPAIRED ASSETS

1. Introduction

1.1 This policy notice is established under Section 14(3) of the Banking Act 1995 as part of the minimum rules for the conduct of banking business by licensed financial institutions and will take effect from 1 May 2009. The notice supersedes that which was implemented with effect from 1 April 2002. Revisions have been made to the earlier notice to simplify parts of the policy, take into account international financial reporting standards and other issues raised by licensed financial institutions and those arising from RBF on-site examinations. In addition, the recommendations of the *Core Principles for Effective Banking Supervision* set out by the Basle Committee on Banking Supervision were also referred to and incorporated.

1.2 It should be noted that the **basic responsibility** of the **board of directors and management** of each licensed financial institution ("institution") is to set policies and procedures to ensure that it maintains sound asset quality, ensure that there is an adequate level of provisions and general reserve for credit losses at all times, effective loan approval management and classification procedures, as well as an appropriate framework for dealing with problem loans. These guidelines are intended to be minimum standards in this regard.

2. Background and Outline of Approach

2.1 The extension of loans is a primary activity of banks and credit institutions. Lending requires financial institutions to make judgements on the credit worthiness of borrowers. Such judgements may not always be perfect. In fact, the credit worthiness of a borrower may deteriorate over time as a result of various factors. In banking, this risk is known as credit risk, and is defined as, the failure of a counterparty to perform according to a contractual arrangement. This risk applies not only to loans but also to other on- and off-balance sheet exposures such as guarantees, acceptances and other types of advances. Around the world, serious problems have risen from the failure of banks to effectively recognise bad assets, create provisions for or write off these assets, and suspend recognition of interest income whenever appropriate.

2.2 The maintenance of prudent written lending policies, loan approval and administration procedures, and adequate loan documentation are essential to a licensed financial institution's management of its lending function. An important part of the Reserve Bank of Fiji's (RBF's) function of supervising licensed financial institutions is to ensure that each institution's management and board of directors has fully recognised the extent to which the loan portfolio includes non-performing or 'Impaired' assets.[1] Each institution must take effective steps to identify, monitor and rectify those problem loans and to make adequate provisions for losses in respect of those loans.

2.3 In this regard, the Reserve Bank of Fiji's objective is to ensure that licensed financial institutions adopt prudent risk management and credit policies to minimise the extent, and likely impact, of such losses if they occur. Impaired assets, if not identified early and provided for, run the risk of undermining an institution's solvency if losses are recognised at a much later stage when they are likely to be much higher. Another important requirement is the need to know the true identity of counterparties to whom credit facilities are granted. The appropriate requirements to be met in this regard include any anti-money laundering laws and related guidelines issued by the Reserve Bank of Fiji as well as any requirements on "know your customer".

2.4 This Notice sets out minimum guidelines relating to loans classification, provisioning and other procedures that licensed financial institutions should have in place within each institution in relation to the management of their loans and advances portfolio as well as the associated quarterly reporting requirements which are set out in the return and reporting instructions attached Appendix 1. Compliance with the guidelines will be monitored by the Reserve Bank of Fiji and reviewed by the institution's external auditors at the Reserve Bank of Fiji's request.

Responsibilities of the Board of Directors and Management

3. Loan Classification Framework

3.1 Each institution's management should ensure that the institution has in place risk grading systems which should classify the quality of its portfolio of loans, leases, other credits and similar assets, and off-balance sheet credit exposures. (These are generally referred to as credit facilities). At a minimum, licensed financial institutions should classify their credit facilities according to five categories that are set out below.

---

1 Impaired Assets are those credit facilities and other assets 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 the need for a specific provision has been identified and allocated on a particular credit facility. Any income received is recognised on a cash basis only, or in the case of a Restructured credit facility, is accruing at the new rate, which is lower than the market rate at the time of restructuring. All Other Assets acquired through enforcement of security conditions are also to be classified as Impaired Assets. In general, a loan is classified as non performing when the principal or interest is due and unpaid for 3 months (90 days) or more from the first day of default.

3.2 **Standard:** Credit facilities where borrowers are meeting commitments and full repayment of interest and principal is not in doubt.

3.3 **Special Mention:** Facilities which have a higher than normal degree of risk, or where borrowers are experiencing difficulties which, if they persisted could threaten the institution's position. Special monitoring and remedial action is to be taken by the institution, to prevent a deterioration occurring. A loss is not expected at this stage, but could occur if adverse conditions persist.

3.4 **Substandard:** Facilities where borrowers display a definable credit weakness, which is likely to jeopardise repayment. If not corrected quickly, some loss is possible, particularly of interest. Cash flow generated by the borrower may not be considered sufficient to repay the debt at maturity. The institution may be relying heavily on the collateral pledged to ensure full collection.

3.5 **Doubtful:** Facilities classified as Doubtful possess all the essential weaknesses of an account classified as Substandard and where the creditworthiness of the borrower has deteriorated to such an extent that full collection on the facility is improbable. The institution expects to sustain some loss of principal and/or interest, after taking into account the market value of collateral.

3.6 **Loss:** Facilities which are considered to be uncollectable or of minimal recoverable value, or are unable to be collected within a reasonable time frame after commencing legal proceedings,[2] or where all collection efforts such as realisation of collateral have been exhausted, are to be classified as Loss.

3.7 In classifying credit facilities according the above categories, the total balance outstanding on a credit facility (and not just the amount in arrears) is the amount which is to be placed into the respective category. Commitments, contingencies and other off-balance sheet exposures which subject an institution to credit risk are also to be classified in the same way to give a more complete picture of asset quality.

3.8 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 (see definitions in Section 24 of the Banking Act 1995 and Banking Supervision Policy Statement Notice No 2, *Large Exposures Policy*), all facilities outstanding to that borrower or group should be placed into the worst appropriate category if one of the facilities meet that criteria. Exceptions to this approach may be justifiable where there are exposures to some of the related entities which are still fully performing and the nature and value of the security and the cash flows have been consistently generated on the fully performing facilities and leave no doubt that full repayment of

2 Usually not more than 1 year after legal proceedings have commenced.

principal and interest can be maintained on the fully performing facilities. Facilities need not be classified as impaired where:

- the related impaired facilities are not cross collateralised and there are no cross guarantees between the related entities; or
- there are cross collateral or guarantee arrangements but, in aggregate, there is sufficient readily realisable security available within the group to ensure that all principal and interest due will be collected in full.

3.9 In general, a facility which has been classified as Doubtful or Loss or has otherwise been restructured in relation to a concession of either principal or interest may only be restored to fully performing status once all payments due have been met and the new terms of the facility are comparable with the requirements for a new facility of comparable risk in the Standard risk category. The customer must be fully capable of meeting all the obligations under the new terms of the facility, with a period of sustained satisfactory performance preceding the re-classification to a category above Substandard, in the case of a restructured facility. In the interim, such restructured facilities should remain in the Substandard classification or worse, as appropriate.

3.10 Further details on the definitions and characteristics of each category are given in the instructions for completion of the quarterly report attached as Appendix 1 to this paper.

4. Review of Credit Facilities

4.1 Each institution's management should ensure that it has a stringent in-house system for continually assessing the credit worthiness of its customers. In this regard, at least 70% by value of all loans and advances and other credit facilities, and off-balance sheet exposures (including guarantees, letters of credit, undrawn borrowing facilities and foreign currency exposures) should be assessed on an annual basis. All significant credit facilities[3] should be assessed individually, at least annually.

4.2 As an exception to Paragraph 6.1 below, all credit card facilities whether treated on a portfolio basis or individually must be classified as Doubtful (or provided for or written off in full) when one or more payments is 90 days or more Past Due, unless the facility is fully collateralised by cash or adequately secured by first registered mortgage over real property.

4.3 Senior management must sign off the credit risk assessment and confirm the resulting amendments to provisions for loan losses carried by the institution. The credit risk assessment or inspection function should report directly to a Board Audit committee or to a senior management position which is independent of the lending function.

---

3 Credit facilities with a total exposure or approved credit limits of $250,000 and over. A licensed financial institution, particularly smaller sized ones, may take a lower value given their circumstances.

4.4 The review referred to in paragraph 4.1 above should also include assessing the adequacy of the general framework for dealing with problem institutions. This review and the management of problem facilities should be delegated to a separate unit[4] of the licensed financial institution. This specialised unit should continuously appraise the status of such advances as to whether they are either worked down or are rehabilitated. At all times, the unit should ensure that appropriate levels of provisions are maintained for loans under its management.

4.5 In managing its loan and advances portfolio, a licensed financial institution should ensure that proper credit files are maintained for each borrower. Credit files should include all of the information necessary to ascertain the current financial condition of the borrower as well as to track the decisions made on the account and its history. For example, credit files should include current financial statements, financial analyses, reference letters and appraisals. The loan review function should determine that the credit files are complete and that all loan approvals and other necessary documentation have been obtained and kept.

4.6 In order to ensure an effective credit risk assessment of the loan portfolio, certain prerequisites are necessary. These include :

- standards for loan file documentation (see Appendix 2 for information to be included in credit files of licensed financial institutions) which all credit files must follow;
- clearly established approved limits for each customer and facility, so that excesses can be readily identified;
- clearly designated loan approval limits for lending officers and management, well documented procedures for granting and reviewing credit facilities, and a credit committee which may comprise senior management and/or directors to grant and review substantial credit facilities;
- selection criteria for loans to be assessed by the credit inspection function, which may combine a risk-based assessment and a sample of a set proportion of other loan files;
- clear allocation of authority and responsibility to properly trained credit risk assessment of inspection staff with access to all files, and senior management which are independent of the normal credit management function to oversee the assessment; and
- a credit risk grading or classification system to group the portfolio into segments which require a greater (or lesser) degree of attention from management depending on the risk of losses arising on the facility.

[4] Unless otherwise stated, for the purposes of Paragraph 4.4, a separate unit may not necessarily mean a separate department (Recoveries/Collections Unit/Department) but can be extended to refer to delegation/appointment of officers carrying out similar duties usually carried out in a Recoveries or Collections Unit/Department which is independent of the lending function.

5. Provisioning and General Reserves for Credit Losses

5.1 Each institution's management is required to ensure that the institution maintains a prudent level of general reserves for credit losses against losses not certain to arise on the good part of the portfolio, as well as specific provisions against reasonably anticipated losses on poor quality assets and all specifically identified losses on impaired assets. Any understatement of the level of provisions required may result in an institution's capital and profits being overstated which could lead to a lack of certainty of the institution's on-going solvency.

5.2 Each institution will be required to advise the Reserve Bank of Fiji of its formal policies for establishing provisions which may be required to be modified after discussion with the Reserve Bank of Fiji, where the Reserve Bank considers that those policies or the resulting provisions established are inadequate.

5.3 As a general rule, where there is doubt about full collectability of a facility and readily realisable security exists which can be realised within a reasonable timeframe, specific provisions 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.

5.4 Where real security does not exist, or is not expected to be realisable within 1 year of legal action commencing, impaired assets must be examined to determine whether it is prudent to provide for some readily identifiable residual value of the collateral held. The residual value should be an objective assessment (which may be based on the recovery experience of similar asset sales e.g. 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 provisions otherwise required. See part 7 below for valuation of security.

5.5 It is essential that licensed financial institutions do not overestimate the collectability of a loan. Unless exceptional circumstances exist where the realistic value of realisable security is unquestionably sufficient to cover the remaining outstanding amount (i.e. after deducting specific provisions or write off to date) of all principal and present and future interest due, any facility which has been Impaired for 2 years 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 provisions for the total amount of the loan is not to be made at that time. See part 7 below for further details.

5.6 **General Reserves for Credit Losses:** General reserves for credit losses should be established at prudent levels by each licensed financial institution for possible losses inherent in the loan portfolio which are not associated with any individual facility or amount. These must be maintained in respect of all credit facilities outstanding which are not subject to the specific provision requirements below. As soon as adequate information is available to identify losses on individually impaired facilities, a suitable specific provision or charge-off for bad debts should be made. General reserve for credit losses is required to be held as an equity reserve through an appropriation of retained profits.

5.7 In the case of branches of foreign licensed financial institutions, the Reserve Bank of Fiji will require written confirmation from the head office, where an institution has advised that general reserves for credit losses to cover the Fiji operations is maintained in books of its head office overseas. It should be noted that such general reserves for credit losses maintained offshore will not be an eligible component of the institution's total capital in Fiji for capital adequacy purposes.

5.8 Specific Provisions will be reported in two categories:

- Individually assessed provisions: Held on loans and advances individually assessed for impairment and not included in a group of assets that are collectively assessed for impairment;
- Collectively assessed provisions: Held on groups of loans and advances with similar risk characteristics, collectively assessed for impairment and not included in assets individually assessed for impairment.

5.9 **Specific Provisions held against Substandard, Doubtful and Loss facilities:** Apart from the General reserves for credit losses maintained under paragraph 5.6, the Reserve Bank of Fiji expects that each institution will maintain **in Fiji**, a total amount of provisions which is not less than the sum of the following:

- **20 %** of the shortfall in the net realisable security value over the outstanding balance of all facilities classified as **Substandard** as an unallocated collectively assessed provision, net of unearned interest and interest suspended;
- **50 %** of the shortfall in the net realisable security value over the outstanding balance all facilities classified as **Doubtful** as an allocated individually assessed provision, net of unearned interest and interest suspended;
- **100 %** of all facilities classified as **Loss** (unless already written off in full) as an allocated individually assessed provision calculated as the difference between the book value of the loan and the net realisable value of the security after deducting collection and selling expenses.
- An unallocated collective provision may also be provided for accounts classified as special mention.

5.10 For the purposes of paragraph 5.9, where facilities classified as Doubtful or Loss are secured[5] by a first[6] registered mortgage against a residential property (as defined in Annex II under the 50% weight in the Banking Supervision Policy Statement No.1, *Capital Adequacy Requirements for Licensed Financial Institutions*) a licensed financial institution may at a minimum maintain specific provisions equivalent to the difference between the book value of the loan and the net realisable value of the residential property. If the exposure is in arrears for a period of more than 180 days, the licensed financial institution is expected to consider only 65% of the value[7] of the residential property.

5.11 The level of collectively assessed provisions should be based on a comprehensive, well-documented, and consistently applied analysis of the loan portfolio.

5.12 Overall holdings of general reserve for credit losses together with specific provisions should take into consideration all available information existing as of the financial statement date, including environmental factors such as industry, geographical, economic, and political factors. Combined levels of general reserve for credit losses and specific provisions must prudently be able to cover for expected as well as unexpected losses in the loan portfolios.

5.13 The levels of provisions required in the above paragraphs represent the minimum average levels of provisions expected by the Reserve Bank of Fiji. In establishing an appropriate level of provisions, each institution must consider not only historical loan performance and asset quality information but must also conservatively evaluate the possibility of future circumstances causing a deterioration in the loans and advances portfolio. 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 provisions that they should hold.

5.14 Licensed financial institutions with a relatively high-risk loan portfolio or clearly identifiable and potentially serious asset quality problems (for example where the total outstanding balance of all facilities classified as Substandard, Doubtful and Loss exceeds 10 to 15% of the total loan

---

5 Refer to section 7 on valuation of security for other acceptable forms of security.

6 Where a facility is secured by a registered mortgage against a residential property other than a first registered mortgage licensed financial institutions may on consultation with the Reserve Bank of Fiji seek to have the provisions adjusted to reflect the value of the residential property that is realisable.

7 Except where otherwise stated, property shall, for the purpose of paragraph 5.10 be valued at the net realizable value in accordance with paragraph 7 of this policy statement and the date of valuation must not be any older than 1 year.

portfolio) are expected to maintain an average level of provisions above the minimum levels recommended in the above paragraphs.

5.15 Whether a particular institution's average provision levels should be higher than the recommended minimums noted above will also depend on other factors, including:

- the effectiveness of the institution's credit policies, internal and external audit, loan reviews and credit inspections;
- the recent experience of loan losses, the institution's success in realising security on problem loans in a timely manner without incurring substantial loss, and the expected future outlook for recoveries;
- the quality of financial information and credit files maintained for each borrower;
- the types of products offered by each institution and the risks that they pertain; and
- 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.

5.16 The Reserve Bank of Fiji will regularly review the level of general reserve for credit losses and specific provisions held by each institution. It will discuss any concerns with the institution's senior management and may formally direct that the institution make additional provisions where it considers that provisions held are inadequate in relation to the circumstances of that institution. This may also be required where the circumstances of an institution indicate a higher than average risk of loss in the portfolio thus necessitating more prudent levels of provisions. It may also be required where the Reserve Bank of Fiji considers that the institution has not been sufficiently rigorous in identifying Impaired Assets. See part 8 below for further details on oversight by the Reserve Bank of Fiji.

6. Recognition of Interest Income

6.1 A facility should be considered Non-accrual if there is reasonable doubt about the ultimate collectability of principal or interest as scheduled within a time frame not significantly longer than the original term of the facility. Non-accrual facilities also includes all facilities where a specific provision or write-off has been made even if that facility is not currently in breach of contractual requirements.

6.2 Interest must cease to be accrued from the time a facility is classified Doubtful or Loss. Interest should also generally cease to be accrued as soon as a facility which is classified as Substandard has become more than 90 days past due, unless the collateral pledged for the facilities is sufficient to cover the outstanding value of the principal, interest and all charges on the facility.

6.3 Non–accrual facilities may be restored to Accrual status when:

- principal and interest arrears have been met in full by payments from the customer and it is reasonably expected that the customer is capable of fully servicing all future obligations under the facility;
- for restructured facilities, where a specific provision has been made prior to restructuring, the facility and interest is now being charged at a rate higher than the institution's average cost of funds and the facility is considered likely to continue as fully performing on the basis of currently agreed arrangements;
- for assets acquired through enforcement of security, where a partial write-off has been made and the facility is considered likely to continue as fully performing on the basis of currently agreed arrangements; and
- the facility is "well secured", i.e. if interest has been capitalised, the licensed financial institution should ensure that there is a reasonable margin of comfort that would prevent facilities from slipping back to Non-accrual status in the foreseeable future.

6.4 In order to restore Non-accrual facilities back to their accrual status in the cases above, there should be evidence in the form of a written assessment addressing the current credit evaluation of the borrower's financial condition and other factors affecting prospects for repayment. However, in the case of revolving facilities, the clearance of excesses shall be sufficient to restore an item back to Accrual status provided the institution is of the view that the customer is capable of fully servicing its future obligations under the exposure.

6.5 When a facility meets the definition for Non-accrual status, the licensed financial institution must cease to recognise as income any interest earned but not yet received. In certain limited circumstances, at the institution's discretion, interest may be taken direct to a suspense account but not to income until received in cash.

6.6 Income received from Non-accrual facilities should be taken to the profit and loss account on a cash basis and should be categorised according to whether partial or full payment of interest has occurred under the respective item. If a licensed financial institution has calculated the recoverable amount by estimating future expected cash receipts from the customer, and the cash received was anticipated in that calculation and its receipt results in a reduction in the remaining estimated recoverable amount of the facility, the balance outstanding on the facility should be reduced by the amount of the cash received. However, where the cash received does not alter the previously determined estimated future recoverable amount of the facility, the cash receipt should be brought to account as income.

6.7 Any accrued but unpaid interest on facilities designated as Non-accrual should generally be reversed back to the date of the institution's most recent six month or annual balance date, or the date when interest was last paid, whichever is later. Unpaid interest dating back prior to the last six month or annual balance date should be reviewed to determine its ultimate collectability, and provisions made for loss where appropriate.

6.8 Each licensed financial institution's lending documentation should stipulate the order of priority in which cash received on facilities classified as Impaired should be applied. However, if the loan documentation is silent, and in the absence of any legislation, common law decisions, or regulations governing priority, cash received should be applied in the following priority:

(a) statutory charges;

(b) penalty interest and fees;

(c) overdue interest and fees;

(d) current interest and fees; and

(e) principal.

6.9 Licensed financial institutions are also required to disclose separately the following in their reporting of Impaired assets:

(a) interest and fees brought to account during the period on Non-accrual items;

(b) income taken to account on Restructured items;

(c) income earned from Assets Acquired through Security Enforcement; and

(d) income earned from Other Real Estate Owned.

6.10 The Reserve Bank of Fiji will require details of each institution's policy on the treatment of suspended interest and interest previously capitalised on loans designated as Non-accrual, to ensure that reported loan portfolio amount does not continue to increase from those sources.

7. Valuation of Security

7.1 It has been seen that excessive reliance on security at the commencement of a loan has often led to larger than anticipated losses in various countries such as Fiji, where true market values are often difficult to establish, and the processes of foreclosure, mortgagee sale or redress through the legal system can be long drawn out and expensive. Licensed financial institutions should have in place mechanisms for continually assessing the worth of collateral. This is particularly important for large value loans and advances.

7.2 Valuation of security should be done, wherever possible, on the basis of their net realisable value. Establishing a realistic 'fair' or net realisable value[8] for any security held is critical at the time when assessment of the appropriate level of provisions is to be made on Impaired assets.

7.3 The net realisable value is the estimated amount for which an asset could be exchanged on the date of valuation:

(a) in an arm's length transaction;

(b) between a willing buyer and willing seller;

(c) after proper marketing; and

(d) wherein the parties had each acted knowledgeably, prudently and without compulsion.

7.4 Valuation techniques used by licensed financial institutions should be consistent with the procedures adopted by The Fiji Institute of Valuers and Land Management. Independent valuations should be obtained in relation to real estate security supporting the granting or review of credit facilities with a total exposure of $250,000 or more.

7.5 While a first mortgage charge over real property may generally be acceptable security at a level of 65% of valuation, a second or subsequent mortgage, or debenture over business assets or stock may turn out to be much less than fully collectable. Where security takes the form of a charge over non-property assets, licensed financial institutions should ensure that all relevant financial accounts are properly examined, particularly at the time when decisions are made on the appropriate level of provisions on Impaired assets. For instance:

- Debentures – No value will be recognised unless it is certified by a receiver/ liquidator/ auditor/ professional valuer.
- Assignment of book debts – No value will be recognised unless the licensed financial institution can prove that the debtors are worth the value quoted.
- Assignment of shares

  (i) <u>Quoted</u>

  Normally, the latest stock market price. Appropriate discounts should be considered if the shares are thinly traded and/or comprise a large block of shares. Premiums may only be considered where there is a valid offer at the higher price evidenced by a firm commitment, such as purchase contracts or undertaking letters provided by solicitors or brokers.

  If trading over a counter has been suspended (other than temporary suspension), the net realisable asset value, as per the latest audited financial statements (not more than 18 months old and taking into account the content of interim announcement), would be used. If appropriate financial statements are not

[8] i.e. the value expected to be received by the institution from the sale of the security on the open market within a period of not more than 1 year, after deducting all costs expected to be incurred in the disposal of the asset.

available, normally no value is to be considered. In the case of shares which are temporarily suspended, the last quoted price prior to suspension will be used. The determination of 'temporary' will be inferred from the reasons for suspension, for instance, shares which are temporarily suspended pending a take-over scheme.

(ii) Unquoted

An appropriate value may be considered provided the test of marketability is met. The condition of marketability would be considered based on the merit of each case. If it can be demonstrated that the shares are marketable, the basis of valuation applied should be the net tangible asset per share. A higher valuation may be considered if the licensed financial institution is able to provide a detailed valuation of net assets in support of the higher valuation or if there is a purchase offer for the shares evidenced by firm commitments such as purchase contracts or undertaking letters provided by solicitors or brokers.

- Guarantees

(i)	Personal	Generally no value
(ii)	Banking institutions	Full value
(iii)	Government of the Republic of Fiji Islands	Full value
(iv)	Others	To be considered on a case-by-case basis

- Charge/lienholder's caveat over property

(i) Where court proceedings are not yet instituted, forced sale value (FSV) is used. The FSV should be based on the existing use of the land as estimated by professional valuers. However, under exceptional circumstances, fair market value (FMV) may be used, for example, where the licensed financial institution feels strongly that the property charged is worth the FMV and there is evidence to that effect.

(ii) Where an auction is pending and a reserve price (RP) has been fixed, the RP is to be used.

(iii) Where an auction has been aborted and FSV of the property is lower than RP, and in the absence of new RP, FSV is to be used.

(iv) Where aborted RP is based on FSV, and in the absence of new RP, a 10% discount should be made on the aborted RP.

Note: The FSV should be based on the existing use of the land as valued by registered valuers.

- Plant, machinery and equipment – In the absence of a professional valuation, the net book value would be applicable, using a 20% depreciation rate on a straight-line basis on the acquisition price.

- All other securities

To be considered on a case-by-case basis.

7.6 In many circumstances, it will not be easy to readily establish a true market value for security held. Licensed financial institutions are therefore advised to adopt a prudent approach to discounting the estimated market value, and adopting loan-to-valuation ratios which are comfortably below 100 percent. This also allows for the possibility of a decline in estimated security values and the contingencies and delays which commonly arise in liquidating security.

8. Oversight by the Reserve Bank and External Auditors

8.1 Oversight by the Reserve Bank of Fiji will include on-site examinations of licensed financial institutions to ensure compliance with the requirements of this Notice and that each institution holds adequate provisions against their level of Impaired assets. In ascertaining the adequacy of licensed financial institution's policies, the Reserve Bank of Fiji will establish whether such policies are appropriate and whether they reflect realistic repayment expectations.

8.2 The Reserve Bank of Fiji will also determine whether the licensed financial institution has appropriate procedures and organisational resources for ongoing oversight of problem facilities and for collecting past due loans and advances.

8.3 The Reserve Bank of Fiji may request external auditors of the licensed financial institutions to review the loans classification and provisioning systems, procedures and reports submitted by licensed financial institutions to the Reserve Bank of Fiji.

9. Non-Compliance with the Guidelines

9.1 If the level of Impaired assets of an institution is deemed to be of concern, or if as a result of an examination the Reserve Bank of Fiji determines that the institution's policies, procedures, provisioning, or supervisory reporting is inadequate in relation to the guidelines or imprudent in the circumstances of the institution, the Reserve Bank of Fiji will require remedial action to be taken within a specified time or may use the various sanctions or powers contained in the Banking Act 1995.

9.2 Sanctions imposed by the Reserve Bank of Fiji for non–compliance by a licensed financial institution with this Notice may include issuing a directive to the institution requiring compliance or attaching conditions of licence to the institution as provided under Section 11 of the Banking Act 1995.

9.3 Where the requirements of this policy are expected to conflict with international financial reporting standards (IFRS), the requirements of this policy will continue to be applicable to licensed financial institutions. The Reserve Bank will discuss any concerns with the institutions senior management on IFRS requirements contrary to this policy.

9.4 The actions that the Reserve Bank of Fiji may take with regard to a licensed financial institution not complying with the requirements of this Notice may include a directive to strengthen the institution's lending practices or loans approval standards to raise the institution's level of provisions and its overall financial strength.

Reserve Bank of Fiji
Revised March 2009

Attachments:

1. **Appendix 1 : Asset Quality Return with Reporting Instructions and Definitions**

2. **Appendix 2 : Information to be included in the Credit Files**

CONFIDENTIAL RESERVE BANK OF FIJI RBF FORM M-AQ

PRIVATE MAIL BAG, SUVA

MONTHLY RETURN ON

LOAN CLASSIFICATION AND PROVISIONING FOR IMPAIRED ASSETS

AS AT: ____________________

NAME OF INSTITUTION: ___________________________

PART I: FULLY PERFORMING PROBLEM CREDIT FACILITIES (Balance Outstanding before deducting Specific Provisions) F$000	SPECIAL MENTION (a)	SUBSTANDARD (b)	DOUBTFUL (c)	LOSS (d)	TOTAL (before deducting provisions) (a)+(b)+(c)+(d)	TOTAL SPECIFIC PROVISIONS HELD
1. Fully Performing Credit Facilities Past Due > 90 days (well secured)						
2. Other Fully Performing Problem Credit Facilities						
3. TOTAL FULLY PERFORMING PROBLEM CREDIT FACILITIES (1+2)						

PART II: IMPAIRED CREDIT FACILITIES (Balance Outstanding before deducting Specific Provisions)	SPECIAL MENTION (a)	SUBSTANDARD (b)	DOUBTFUL (c)	LOSS (d)	TOTAL (before deducting provisions) (a)+(b)+(c)+(d)	TOTAL SPECIFIC PROVISIONS HELD	INCOME TAKEN TO PROFIT AND LOSS (year to date)	INCOME TRANSFERRED TO SUSPENSE ACCOUNT (year to date)
4. Total Non-Accrual Credit Facilities								
5. Total Restructured Credit Facilities								
6. TOTAL IMPAIRED CREDIT FACILITIES (4+5)								

PART III: OTHER IMPAIRED ASSETS					TOTAL (book value)		INCOME TAKEN TO PROFIT AND LOSS (year to date)	PROVISION OR WRITE DOWN CHARGED TO PROFIT AND LOSS (year to date)
7. Other Assets Acquired Through Security Enforcement								
8. TOTAL IMPAIRED ASSETS (6+7)						NUMBER		
9. New Restructured Credit Facilities During the Month								
10. Restructured Credit Facilities								
11. Demand Notices Issued During the Month								
12. Mortgage Sales Initiated During the Month								
13. Mortgage Sales In-process								
14. Completed Mortgage Sales During the Month								

PART IV: PROVISIONS HELD (IN FIJI)	STANDARD (a)	SPECIAL MENTION (b)	SUBSTANDARD (c)	DOUBTFUL (d)	LOSS (e)	TOTAL PROVISIONS HELD (a)+(b)+(c)+(d)+(e)	PROVISIONS CHARGED TO PROFIT AND LOSS (year to date)
15. General Reserves for Credit Losses							
16. Collectively Assessed Provisions							
17. Individually Assessed Provisions							
18. Interest in Suspense							

PART V: PAST DUE STATUS OF PROBLEM CREDIT FACILITIES AND IMPAIRED CREDIT FACILITIES (In respect of Items reported in Part I and Part II)	PAST DUE > 1 MONTH & UP TO 3 MONTHS (a)	PAST DUE > 3 MONTHS & UP TO 6 MONTHS (b)	PAST DUE > 6 MONTHS & UP TO 1 YEAR (c)	PAST DUE > 1 YEAR & UP TO 2 YEARS (d)	PAST DUE OVER 2 YEARS (e)	TOTAL PAST DUE (a)+(b)+(c)+(d)+(e)
19. TOTAL PAST DUE CREDIT FACILITIES						

REPORTING INSTRUCTIONS FOR MONTHLY REPORT ON
LOAN CLASSIFICATION AND PROVISIONING FOR IMPAIRED ASSETS”
(Form M-AQ)

General Instructions

1. The report, showing the position at the last day of each calendar month, should be furnished to the Reserve Bank of Fiji within 10 working days of the month end. Figures reported should be after any related adjustments have been completed in the financial accounts for the reporting date.

2. Certain items in the report should reconcile to amounts reported in other relevant returns at the same date. Reference will be made in the instructions for those returns where appropriate, when revised by the Reserve Bank.

3. The completed monthly report and any inquiries regarding completion of this report should be addressed to

The Chief Manager
Financial Institutions
Reserve Bank of Fiji

Specific Reporting Instructions

For the purpose of reporting to the Reserve Bank of Fiji, the following definitions should be observed, consistent with the Banking Supervision Policy Statement No. 3; ‘Guidelines for Loan Classification and Provisioning for Impaired Assets’ revised in March 2009.

1. **“Credit Facilities”** 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.

Guarantees and standby letters of credit are usually converted into on-balance sheet exposures (at full value) if the counterparty they are supporting fails. There may also be circumstances where the institution is reasonably certain that the instrument will be called upon at a future date because of uncertainty about the customer. Loan commitments which are irrevocable should also be classified as Impaired Assets if the creditworthiness of the customer has deteriorated to such an extent that full repayment of any drawdown (or interest payments thereon) is considered uncertain. Interest rate and exchange rate contracts should be reported at their credit equivalent amount as in the ‘Capital Ratio Return’.

2. **"Classification of Credit Facilities"** Each institution is to classify and report all credit facilities (as defined above), into the following categories:-

- **Standard**
- **Special Mention**
- **Substandard**
- **Doubtful**
- **Loss**

The definition and examples of expected characteristics of each of these categories of exposures are given below. While references are mainly made to loans, the factors given are also applicable to exposures arising from other items specified in the definition of credit facilities.

Standard

This refers to loans where borrowers are current in meeting commitments and full repayment of interest and principal is not in doubt.

Special Mention

This refers to loans where borrowers are experiencing difficulties which may threaten the institution's position. Ultimate loss is not expected at this stage but could occur if adverse conditions persist. Such borrowers should be subject to special monitoring.

It is not envisaged that individually assessed provisions will be required for these loans at this stage. Interest may continue to be accrued to the Profit and Loss account.

These loans exhibit one or more of the following characteristics.

(a) early signs of liquidity problems such as delay in servicing loans.

(b) inadequate loan information such as annual audited financial statements not obtained or not available within a reasonable time.

(c) the condition of and control over collateral is questionable.

(d) failure to obtain proper documentation or non-cooperation by the borrower or difficulty in keeping contact with him.

(e) slowdown in business or adverse trend in the borrower's operations that signals a potential weakness in the financial strength of the borrower but which has not reached a point where a servicing of the loan is jeopardised.

(f) volatility in the economic or market conditions which may in the future affect the borrower negatively.

(g) poor performance in the industry in which the borrower operates.

(h) some management weakness is evident, or the borrower or in the case of corporate borrowers, a key executive, is in ill health.

(i) the borrower is the subject of a litigation which may have a significant impact on his financial position.

(j) repayment of principal or interest on a fully secured loan or facility (or period continually in excess of limits or authorised excesses in the case of overdrafts, etc) is Past Due by more than 30 days and up to 90 days past due.

(k) for acceptances and bills of exchange held, a bill which is overdue should at least be classified as Special Mention.

Substandard

This refers to loans where borrowers are displaying a definable weakness which is likely to jeopardise repayment. The institution is relying heavily on available security. This would include:

(i) loans where some loss, either of principal or interest, (including future interest), is possible after taking account of the market value of security;

(ii) restructured loans - where concessions have formally been agreed with a customer on interest or principal such as to render the loan "non-commercial" to the financial institution;

Collectively assessed provisions (which may be maintained on a portfolio basis for all substandard facilities and not allocated to individual loans) should be set aside at an average of at least 20% of the shortfall in security value over the outstanding balance for accounts included in this category. Where for example security is not considered sufficient to recover both principal and accrued interest, the lending institution should consider accruing interest to suspense account rather than Profit and Loss account, or if interest has been overdue for a significant period of time, not accruing interest at all.

These loans exhibit one or more of the following characteristics:-

(a) repayment of principal and/or of interest has been overdue for more than one month and principal, accrued interest and/or future interest is unsecured or only partially secured by the current market value of collateral, or other serious deficiencies are observed.

(b) even where principal, accrued interest and future interest appear to be fully secured, a "substandard" classification should be made where repayment of principal and/or of interest is overdue for more than 3 months.

(c) inadequate collateral.

(d) credit history or performance record is not satisfactory.

(e) labour disputes which may affect business and production of borrower.

(f) unresolved management problems which clearly affect borrower's profitability.

(g) material documentation exceptions, such as valuation of properties and collateral not properly supported in writing.

(h) increased borrowings not in proportion with the borrower's business.

(i) borrower experiencing difficulties in repaying obligations to other creditors.

(j) construction delays or other unplanned adverse events resulting in cost overruns that may require loan restructuring.

(k) unemployment of the borrower.

(l) deteriorating financial condition of the borrower.

(m) for acceptances and bills of exchange held, a bill which is past due by more than 3 months should at least be classified as Substandard

<u>Doubtful</u>

This refers to loans where collection of principal and interest in full is improbable and the institution <u>expects to sustain a loss of principal and/or interest</u>, taking account of the market value of security. Individually assessed provisions should be made against any expected loss. Accrual of interest on such loans should cease.

In addition to the characteristics mentioned for substandard loans, doubtful loans may have one or more of the following characteristics:-

(a) a prolonged overdue period of more than 6 months; but in the case of unsecured or partially secured loans or where serious deficiencies, such as death or bankruptcy of borrower, are detected, they should be classified as 'doubtful' if the overdue period exceeds 3 months. Loans for which all principal, accrued interest and future interest for an extended period is considered to be fully secured by the current market value of collateral should be regularly reviewed, but may not need to be classified as Doubtful until Past due by 2 years or more.

(b) borrower's operations have ceased or are about to cease because of poor business results.

(c) borrower's whereabouts unknown.

(d) borrower in liquidation.

Loss

This refers to loans which are considered uncollectable or of minimal recoverable value, or are unable to be collected within a reasonable timeframe (usually not more than 1 year) after commencing legal proceedings; or where all collection efforts such as realisation of collateral and institution of legal proceedings etc have been exhausted. All outstanding principal and interest which are not covered by the value of collateral should be fully provided for or written off. Interest on accounts included in this category should cease to be accrued. Loans which are unsecured or only partially secured may be classified as Loss once the loan becomes Past Due by more than 6 months, and other than in exceptional circumstances, such loans must be classified as Loss when Past Due by 1 year or more.

3. **"Problem Credit Facilities"** includes all credit facilities falling within the definition of Special Mention or worse, under the above definitions .

4. **"Fully Performing Credit Facilities Past Due by More Than 90 Days (Well Secured)"** includes those facilities where the fair value of collateral is sufficient to cover all principal and interest due plus at least six months additional interest. Such facilities are classified as Substandard, but may remain on accrual status until 2 or more years past due, provided they are regularly reviewed and no loss of Principal or Interest is expected. (Also commonly referred to as "Other Items Past due 90 days or more).

   Eligible security in relation to well secured (or fully secured) facilities will include guarantees (which cover both principal and interest payments in full) from central governments, central banks and supervised banks of good standing, providing there is no impairment to the guarantee or to the expectation of recovery under the guarantee.

5. **"Other Fully Performing Problem Credit Facilities"** - refers to those facilities which are continuing to accrue Interest at the original contractual rate, but which are classified as Special Mention or Substandard under the above definitions.

6. **"Non-Accrual Credit Facilities"**
   Facilities where interest is not being accrued to Profits but is only recognised as Income when received in cash. This category also includes all "Substandard" facilities where interest is not taken to profits but is transferred directly to Interest in Suspense, and all facilities classified as Doubtful or Loss.

   Partially performing facilities where the full amount of payments due is not being received in cash, and the facility is not well secured, or there is some likelihood of loss of either principal or interest due, should also be treated as Non-Accrual. Interest due but not received on partially performing facilities may be transferred to Suspense Account in appropriate circumstances.

Institutions may wish to classify a particular facility into a more severe category than would be derived from the above guidelines, where there are serious problems associated with the facility. It is not expected that a less severe classification should be adopted than is suggested here unless there are sound reasons for doing so. In material cases, such less severe classifications should be approved by the institution's Board and separately notified in writing to the Reserve Bank setting out the attendant circumstances and classification adopted.

All Non-Accrual credit facilities are regarded as Impaired assets.

7. "Restructured Credit Facilities"

Restructured Credit Facilities are those where the original terms have been modified by the lending institution to provide some concession of principal or interest because of the financial difficulties of the borrower, so as to render the facility 'non-commercial' to the lender. The borrower and lender must formally agree to the new terms. Facilities which are partially performing but have not been subject to a formal restructuring agreement should be regarded as Non-Accrual.

If the modified terms of the facility are substantially the same as new debt with similar risk, the facility need not be regarded as Restructured if it is expected that the new terms will be met in full and there has been no specific provision or write-off made against the loan. A short term (less than 12 months) arrangement to bide the borrower over a temporary difficulty need not be regarded as Restructured if the full amount is still repayable and no loss of principal or interest is expected.

The effective interest rate being earned on restructured debt items should be calculated by reference to the principal outstanding following restructuring,(i.e. after write-off, provisions or repayments in the form of assets or equity). A Restructured facility must be yielding a rate of interest at least equal to the institution's average cost of funds at the date of restructuring. Otherwise it should be classified as Non-Accrual rather than Restructured.

If after restructuring, there is still considerable doubt about the ability to recover principal and/or interest in full, it may be appropriate to place the facility on a Non-Accrual basis. Also, if a facility requires individually assessed provisions to be raised against it subsequent to the restructure, the facility should be regarded as Non-Accrual.

A Restructured facility may be returned to fully performing status when:

(i) the terms of the Restructured facility are comparable with the market rate required for a facility of comparable risk; and

(ii) the customer is regarded as strong and capable of fully servicing its future obligations under the facility. A sustained period of strong performance (at least 12 months) and/or improvement in other characteristics such as equity injection should be evident to demonstrate a relative, permanent improvement in the borrower's condition and debt servicing capacity.

All Restructured credit facilities are regarded as Impaired assets.

8. "Other Assets Acquired through Security Enforcement"

This category refers to acquisition or ownership of an asset in settlement of part or all of a debt and includes 'other real estate owned' by the lending institution (but does not include 'mortgagee in possession' loans which will normally still be recorded as Non-Accrual credit facilities). Real assets acquired under this category are to be recorded in the accounts at their 'fair' or net realisable value and any writedown in value taken as a charge through the income statement.

If the income streams on these assets are doubtful, they should only be taken to profit on a cash basis, otherwise, certain income streams may be treated on an accrual basis.

Assets acquired through security enforcement should remain as Impaired Assets until sold.

9. "Impaired Assets"

Impaired Assets are those credit facilities and other assets which are not fully performing, e.g. where the full amount of originally contracted interest is not being accrued in the institution's Income statement or where the need for an individually assessed provision has been identified and allocated on a particular credit facility. Any income received is recognised on a cash basis only, or in the case of a Restructured credit facility, is accruing at the new rate which is lower than the market rate at the time of restructuring.

All credit facilities which fall within the definitions of Non Accrual or Restructured (including those Substandard facilities where interest is taken to suspense account, and all facilities classified as Doubtful or Loss), and all "Other Assets Acquired through Security Enforcement" are to be regarded as Impaired Assets.

10. "Demand Notices Issued During the Month"

Any written formal notification to the reporting financial institution's clients requesting for immediate payment of a loan account that is not up to date with repayments.

11. "Mortgage Sale"

The sale of property that is used as security for debt to the financial institution.

12. "Past Due Status"

All assets with an identifiable maturity date or due date for contractual or periodic repayments of interest or principal should be reported as Past Due when any of those payments is in arrears or overdue or due and unpaid for a period of over 30 days. In the case of overdrafts etc, Past Due refers to where the outstanding balance has remained continuously outside the authorised limits or approved excesses for a stated number of consecutive days and is usually first identified where the outstanding balance has remained continuously outside the authorised limits for a period of 30 or more consecutive days. (At that point, the overdraft is regarded as 30 days or more past due.)

Bankers Acceptances, bills of exchange, bonds and other debt instruments are regarded as Past Due when either principal or interest on the instrument is in arrears after the due dates or maturity dates. In the case of sight bills, a grace period of 1 month is reasonable for processing and effecting payment. These bills will therefore be regarded as past due if payment is not made within one month after presentation, (or of arrival of the carrying vessel if the overseas buyer is not obliged to pay prior to arrival of the goods). For such sight bills, the period past due is thereafter measured from the day following presentation (or of arrival of the carrying vessel).

13. "Classified Credit Facilities"

Where reference is made to classified credit facilities, it refers to those facilities falling within the definitions of Substandard, Doubtful or Loss as set out above and in the Guidelines for Loan Classification and Provisioning for Impaired Assets.

Appendix 2 (i)

Information in Credit Files
(Private Individuals)

The credit file should contain the following basic information on the borrower:-

1. Name of account;
2. Address;
3. Occupation;
4. Position;
5. Name of Employer;
6. Years of Service;
7. Salary;
8. Other income;
9. History of relationship of bank with customer;
10. Financial Position and reported worth;
11. Details of credit facilities granted and when originally approved;
12. Details of limits at present available and dates of expiry of each limit;
13. Purpose of credit facilities;
14. Securities, including types and valuation;
15. Names of guarantors, their financial position and net worth;
16. Rates of interest charged, and plans and sources for repayment;
17. Brief report obtained on the borrower from other banks and sources;
18. Nature and extent of credit facilities already enjoyed by the borrower at different branches of the bank and also, if possible, at other banks. Give the names of branches and the banks, the types of facilities, the approved limits, and remarks.
19. Comments and recommendations by interviewing officer and manager;
20. Comments of bank's internal and external auditors on the facilities granted to the borrower;
21. Report on periodic reviews:
    - Extent of facilities utilised.
    - Appraisal of security, if any.
    - Financial standing of customer (economic status)
    - Customer's performance towards financial obligation.
    - Is account active or dormant?
    - Is interest serviced regularly?

Appendix 2 (ii)

Information in Credit Files
(Sole Proprietorship, Partnership and Company Accounts)

The credit file should contain the following basic information on the borrower:-

1. Name of account;
2. Address;
3. Constitution (state whether sole proprietorship, partnership, private or public company);
4. History and conduct of business;
5. Experience, ability and reputation of the borrower;
6. History of bank's relationship with borrower;
7. Names of proprietor, partners or directors (state the relationship of the partners or directors with each other, if any);
8. Names of guarantors and their financial position and net worth;
9. Particulars of branches or connected entities (names of firms and places of business);
10. Details of credit facilities granted and when originally approved;
11. Details of limits at present available and dates of expiry of each limit;
12. Purpose of credit facilities;
13. Securities, including types and valuation;
14. Rates of interest charged, and plans and sources for repayment;
15. Comparative analysis of balance sheet – give details of assets and liabilities and net worth;
16. Analysis of profit and loss statements;
17. Brief report obtained on the borrower from other banks and sources;
18. Nature and extent of credit facilities already enjoyed by the borrower at different branches of the bank and also, if possible, at other banks. Give the names of branches and the banks, the types of facilities, the approved limits, and remarks.
19. Comments and recommendations by interviewing officer and manager;
20. Reports of external auditor of the borrower;
21. Comments of bank's internal and external auditors on the facilities granted to the borrower;
22. Report on periodic reviews:
    - Extent of facilities utilised.
    - Appraisal of security, if any.
    - Financial standing of customer (economic status).
    - Customer's performance towards financial obligation.
    - Is account active or dormant?
    - Is interest serviced regularly?
    - Number and amounts of L/Cs opened.
    - Number and amounts of trust receipts granted.
    - Amount of import bills under L/C.
    - Amount of export bills under L/C.
    - Inward bills for collection.
    - Outward bills for collection.