SUPERVISORY AND REGULATORY GUIDELINES: 2005-04
Credit Risk
15th April, 2005

GUIDELINES FOR THE MEASUREMENT, MONITORING AND CONTROL OF IMPAIRED ASSETS

I. INTRODUCTION

The Central Bank of The Bahamas *("the Central Bank")* is responsible for the licensing, regulation and supervision of banks and trust companies operating in and from within The Bahamas pursuant to The Banks and Trust Companies Regulation Act, 2000 (Chapter 316) and The Central Bank of The Bahamas Act, 2000 (Chapter 351). Additionally, the Central Bank has the duty, in collaboration with financial institutions, to promote and maintain high standards of conduct and management in the provision of banking and trust services.

All licensees are expected to adhere to the Central Bank's licensing and prudential requirements, ongoing supervisory programmes and regulatory reporting requirements, and are subject to periodic onsite inspections. Licensees are expected to conduct their affairs in conformity with all other Bahamian legal requirements.

II. PURPOSE AND APPLICABILITY

These Guidelines outline the Central Bank's minimum requirements for the recognition and measurement of impaired assets. These Guidelines should be read along with the *Guidelines for the Management of Credit Risk.*

These Guidelines supplement, and do not replace, any requirements under relevant legislation or accounting standards necessary to show a true and fair view of the financial state or affairs of a licensee. Licensees are required to observe the requirements of the International Financial Reporting Standards related to impaired assets, in particular International Accounting Standards 18, 36 and 39.

These Guidelines apply to all Central Bank licensees.

III. RECOGNITION OF IMPAIRMENT

An ***impaired asset*** refers to an asset where there is no longer reasonable assurance of timely collection of the full amount of principal and interest due to a deterioration in the credit quality of the counterparty. An asset is impaired if the estimated recoverable amount of an asset is less than its carrying amount shown in the books of the licensee.

The overarching test of impairment of an asset is reasonable doubt over the ultimate collectibility of principal and/ or interest. The existence of any of the following conditions should be considered to indicate that the institution no longer has reasonable assurance of timely collection of the full amount of the principal and interest and the facility should be recognized as impaired:

- A payment on a deposit with a regulated financial institution or a restructured facility with any counterparty is contractually 90 days or more in arrears; or

- A payment on any other facility (excluding credit card loans) is contractually 90 days or more in arrears unless: The facility is fully secured, and the collection of the debt is in process and the collection efforts are reasonably expected to result in repayment of the debt or in restoring it to a current status within 180 days from the date a payment has become contractually in arrears; or

- A payment on any credit facility (i.e. "fully secured" or not) is contractually 180 days or more in arrears. Any credit card loan that has a payment 180 days or more in arrears should be written off.

The scope of impaired assets should cover the full range of a licensee's activities that give rise to problems associated with counterparty default. In classifying impaired assets, a licensee should not limit itself to only assessing assets arising out of its lending activities, but also for example, its investments and its off-balance sheet assets both in derivatives and contingent or committed undrawn facilities.

Licensees should treat counterparties as connected where they are linked by cross-guarantees, common ownership or management, ability to control, financial interdependency, or other connections which, in the licensee's assessment, would lead it to regard the assets as representing a common risk.

Where a licensee provides multiple facilities to a single counterparty and one of the facilities is impaired, the licensee may wish to classify all facilities to the counterparty as impaired where there is a reasonable expectation that the source of repayment has also been impaired. Similarly, if one party of a group of connected parties has an impaired facility with a licensee, the licensee may wish to treat all facilities to the related parties in the group as impaired where there is a reasonable expectation that the source of repayment has also been impaired.

Extension of the impairment classification is not required if:

(a) the various facilities are not cross-collateralised, and there are no cross guarantee arrangements between the related parties; or

(b) there are cross-collateral and guarantee arrangements but, in aggregate, there is sufficient security among the group of related parties to ensure ultimate collectibility of all principal and interest on both the impaired and performing exposures.

Licensees are not required to treat exposures to family members arising from retail relationships as related for the purposes of these Guidelines provided an independent relationship can be shown to exist.

A. Past Due Assets

An asset is 'past due' when a contracted payment (principal and interest) has not been met when due or it is otherwise outside contracted arrangements. Licensees are expected to have in place appropriate systems to adequately identify and manage past due assets with a view to minimising the migration to impaired asset status.

The extent that an asset is past due, the protection against loss provided by associated security and how the licensee manages the asset, determines whether non-accrual status is triggered.

B. Non Accrual Assets

Assets that are 90 days past due and not "fully secured" (if the net current market value of the security[1] is insufficient to cover outstanding payment of principal and accrued interest) **must be classified as non-accrual unless managed on a portfolio basis**.

Assets subject to a regular repayment schedule are regarded as 90 days past due when:

- At least 90 calendar days have elapsed since the due date of a contractual payment; and

- The total amount outstanding outside contractual arrangements remaining is equivalent to at least 90 days worth of contractual payments (e.g. where less than full payment is being made).

Additionally, classification of non-accrual assets should include, at a minimum, all assets against which a specific provision has been established, or a write-off taken (except in the case of restructured assets, and assets acquired through security enforcements) even if the facility is not in breach of contractual requirements. The creation of a specific provision against an individually identified asset gives rise to a sufficient degree of doubt about

[1] Net current market value is defined as the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arms length transaction after proper marketing of the asset and deduction of all disposal costs.

collectibility to warrant placing such a facility on a non-accrual basis. Licensees are expected to continue to raise specific provisions against assets on which they are still receiving interest and other payments but where the licensee may ultimately suffer a loss.

An asset should be classified as non-accrual earlier than 90 days where it is evident that full or partial recovery of the debt, including interest, is unlikely even though the full extent of the loss cannot be clearly determined.

A ***"fully secured"*** asset may be excluded from the definition of non-accrual assets.[2] In determining whether the coverage provided by the security will enable the licensee to recoup all principal and interest on the asset the licensee should take into account any additional interest that is likely to accrue until the asset is settled. Security should include any arrangement that protects the licensee from losing, partially or fully, the principal and/or interest on an asset. This will include, for example, mortgage insurance. It may also include cash collateral, guarantees, put options and interest servicing arrangements. Licensees will need to demonstrate to the Central Bank that any value ascribed to these enhancements is reliable in a recovery situation.

C. Restructured Assets

A restructured asset is defined as one in which the original contractual terms have been modified to provide for concessions of interest or principal for reasons related to the financial difficulties of a counterparty.

Where concessions are made to a counterparty that renders the asset "non-commercial" to the licensee, that asset shall be classified as a restructured asset. However, if the asset is restructured so that it is fully expected that the customer will perform on terms that are considered by the licensee as similar to those for new debt with similar risk, and no specific provisions are currently held against the asset, then it may not be considered as a restructured asset.

The following concessions can lead to an asset being classified as "restructured":

- A reduction in the principal amount of the asset, or the amount payable at maturity, as set down in the original facility agreement;

- A below market rate of interest;

- A reduction of interest payable by the counterparty, including forgiveness of interest (whether or how interest is accrued, is up to the licensee. The counterparty may be unaware of any changes in accrual of interest – the counterparty only knows about paid, payable, and overdue/ penalties);

[2] A fully secured facility is defined as one where the licensee judges that the net current market value of the associated securities or collateral is sufficient to ensure that the licensee will recover the principal and any accrued interest due.

- A deferral or extension of interest and/or principal payments, including interest capitalization; or

- An extension of the original maturity date (or dates) at a stated interest rate lower than the current market rate for new debt with a similar risk.

If, after a restructuring, there still remains considerable doubt about recovery of principal and/or interest, and the asset is not "fully-secured", it should be regarded as a non-accrual item. If specific provisions are raised subsequent to the restructure, the asset should also be classified as non-accrual.

D. Foreclosed Assets

These include assets acquired by a licensee in full or partial settlement of a loan or similar facility through enforcement of security arrangements. When the licensee forecloses on the facility, the licensee may take title, directly or indirectly, to the assets, and hence the indebtedness of the borrower would be replaced by title to the underlying security. Assets reported in this category should be recorded in accordance with their net current market values.

IV. MEASUREMENT OF IMPAIRMENT

When assets are identified as impaired, their carrying amounts should be reduced to their estimated recoverable amounts. Estimated recoverable amounts should be measured by discounting the expected future cash flows at the effective interest rate inherent in the asset. When the amounts and timing of future cash flows cannot be estimated with reasonable reliability, estimated recoverable amounts may be measured at either:

(a) The fair value of any security underlying the assets, net of expected costs of recovery and any amounts legally required to be paid to the borrowers; or

(b) Observable market prices for the assets.

All assets valued using the observable market price should be valued on an individualized basis.

Discounting should be applied on an individual basis to each asset that is significant to the institution, including those assets measured under option (a) above. Under option (a), the estimated recoverable amount should be measured by discounting the fair value of the underlying security from the most probable date of sale (unless that time period has already been taken into account in the determination of the fair value of the security).

The aggregate value of all assets where discounting has been applied on an individual basis should constitute a significant proportion of the total recorded investment of all impaired assets measured by discounting.

Licensees may have a number of individually identified, but relatively small, impaired assets where it may not be practical to apply discounting on an individual basis. A licensee's approach to identifying the types of impaired assets where it is not practical to apply discounting on an individual basis should be reasonable in the circumstance of the particular institution, and be consistently applied. The licensee's approach should be documented. Where the expected future cash flows of smaller valued assets have not been discounted on an individual basis, institutions should aggregate those smaller valued assets which share common characteristics, such as exposure to the same industry, into groups and apply a discount factor to each group which is representative of the group's expected recovery pattern. The institution's experience with larger individually discounted assets sharing similar characteristics would be one factor to be taken into account in developing appropriate discount factors.

In reviewing the adequacy of provisions for impaired assets, in each case where the estimated recoverable amounts have been measured by discounting the expected future cash flows, the Central Bank will want to be able to easily identify the following components of the provisions (or allowance for impairment):-

(a) the shortfall between the undiscounted expected future cash flow and the recorded investment; and

(b) the amount resulting from discounting the expected cash flows at the effective interest rate inherent in the asset.

Estimating the timing of the future cash flows associated with an impaired asset is an integral component of discounting. Changes in the timing of estimated cash flows may have a significant impact on the overall general provisions maintained by an institution, and consequently the assumptions used by an institution with respect to the timing of the anticipated cash flows must be conservative and supportable (e.g. by past performance). While the timing of near-term cash flows may be projected with reasonable precision, simplifying assumptions such as receipt at mid-year may be required by longer-term cash flows. Where used, such simplifying assumptions should be applied to all impaired assets measured on a discounted cash flow basis and applied consistently from period to period.

V. INCOME RECOGNITION FOR IMPAIRED ASSETS

When an asset becomes impaired, recognition of interest income in accordance with the terms of the original contractual agreement should cease until the asset has been written down to its estimated recoverable amount. Interest income thereafter may be recognized.

When an impaired asset is measured on the basis of expected future cash flow discounted at the asset's effective interest rate, changes in the estimated recoverable amount arising subsequent to initial recognition of impairment should be reflected in the income statement in the current period. The reductions in the carrying amount of the impaired asset should be recognized as a charge in the statement of income in the period in which the impairment is identified.

When an impaired asset is measured on the basis of the fair value of security underlying the asset or an observable market price for the asset, changes in the estimated recoverable amount arising subsequent to initial recognition of impairment should be reflected in the income statement in the current period as a charge or credit for asset impairment.

To maintain a complete record of write-offs and recoveries in the allowance for loan impairment account, write-offs and recoveries related to impaired assets should be recorded through this account rather than being recorded directly as a charge or credit for asset impairment in the income statement. Write-offs and recoveries, that are charged or credited to the allowance account during an accounting period, are reflected as a charge or credit for asset impairment in the income statement at the end of the period when the ending balance in the allowance account is established.

Subsequent payments (whether designated as interest or principal) received on an impaired facility should be recorded as a reduction of the recorded investment in the facility. When the recorded investment in the facility is completely written off, the subsequent payments should be credited to the allowance for impaired assets.

A. Past Due Assets

Interest on assets that are past due but fully-secured should be accrued to income. Portfolio-managed past due assets may continue to accrue interest until they have reached an equivalent of 180 days worth of contractual payments past due.

B. Non-Accrual Assets

Income taken to profit and loss on a cash basis for non-accrual assets should be disaggregated according to whether an immaterial, or partial and full payment of interest has occurred under the relevant item. For non-accrual items that continue to fully perform but on which a specific provision has been raised, the income on these items should also be taken to profit on a cash basis.

C. Restructured Assets

Income on restructured assets may be taken to income on an accrual basis. Given that interest charged or received on an accrual basis may be at a rate that is below market rates, and in order to determine the "income drag" for such assets, the licensee should separately disclose the amount of income accrued over the reporting period on the aggregate of restructured assets as at balance sheet date.

D. Foreclosed Asset

Write offs and recoveries related to foreclosed assets held for sale should be recorded through the allowance for impaired assets account rather than being recorded directly as a charge or credit for impairment (provision) in the income statement.

Write-offs resulting from the initial measurement of foreclosed assets held for the production of income should be recorded through the allowance for impairment account rather than being recorded directly as a charge for impairment in the income statement.

F. Cash Receipt Priority

Where relevant documentation stipulates the order of priority in which cash receipts are to be treated, the licensee should follow that treatment, unless agreement has been reached with the client to vary the priority of repayment in the facility documentation. Where the documentation is silent, then in the absence of any legislation, court orders, 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;

(e) Principal.

VI. RESTORATION TO ACCRUAL STATUS

A. Non Accrual Assets

Assets classified as non-accrual due to their being 90 days past due may be restored to accrual status when:

(a) All payments in arrears have been brought up to date (where the payment of arrears has not resulted from a further advance by the licensee); and

(b) the licensee judges that the customer is capable of fully servicing its future obligations under the facility;

A facility may also be restored to accrual status if it becomes full secured. Loans which are impaired but are “fully secured” should be disclosed.

In each case, the underlying evidence should support the view that there is no reasonable doubt about the ultimate collectibility of principal or interest. This should be appropriately documented in a written assessment that addresses the current credit evaluation of the borrower’s financial condition and other factors affecting prospects for repayment and maintained on the credit file.

For revolving facilities, the clearance of excesses should be sufficient to remove an item from the non-accrual category, provided the licensee judges that the customer is capable of fully servicing its future obligations under the exposure. Clearance should not be artificial, that is undertaken merely to “reset” past due status. As above, the rationale employed should be clearly documented in the credit file.

B. Restructured Assets

A restructured asset may be returned to fully performing status when:

(a) The terms of the restructured asset are comparable with the current market terms applicable for a facility of comparable risk; and

(b) The restructured asset has operated in accordance with non-concessional terms and conditions for a period of at least six months; or

(c) Where, in limited or exceptional circumstances, there is sufficient evidence to demonstrate relative improvement in the financial condition and debt service capacity of counterparty, apart from performance to date, which would warrant return to accrual status prior to the six months threshold.

A restructured asset that has been re-classified as non-accrual may revert to restructured status when all outstanding payments become fully current in terms of the restructured terms and conditions, and the appropriate level of management has determined that there is no reasonable doubt as to the ultimate collectibility of principal and interest.

VII. TREATMENT OF OFF-BALANCE SHEET EXPOSURES

The principal off-balance sheet exposures to be captured by these Guidelines are likely to be direct credit substitutes and commitments. Direct credit substitutes (e.g. guarantees and standby letters of credit) are usually converted into on-balance sheet items when called. However, there may be circumstances when the licensee is reasonably certain that such instruments will be called upon at a future date because of uncertainty about the counterparty. In such cases, the off-balance sheet exposure should be regarded as impaired. Loan commitments that are irrevocable should be classified as impaired if the credit worthiness of the client has deteriorated to an extent that makes full repayment of any loan (or associated interest payments) doubtful.

The recorded value of exposures arising from derivative instruments, especially long-term derivative instruments, can be susceptible to a decline in the credit standing of the counterparty over time. If a licensee has doubts regarding the receipt of cash flow entitlements from a counterparty to a derivative instrument, it should treat such an exposure as impaired. Licensees should calculate their derivative instrument exposures to counterparties using the current exposure or mark-to-market method. Any other method must be approved in advance by the Central Bank. Potential exposure add-ons should reflect the nature of the individual exposure involved. Derivative instrument exposures should be re-valued regularly so as to maintain reasonably current assessments of the extent of credit risk attaching to those transactions. As a general rule, licensees should create a provision or take a charge against profit, equal to the full amount of the current credit exposure and potential credit exposure, unless satisfied that a lesser amount is appropriate.

VIII. DISCLOSURE

In addition to the disclosure requirements of International Financial Reporting Standards, the following information should be disclosed in the financial statements:

(a) The total recorded investment in individual assets identified as impaired and the amount of the related allowance for impairment, analyzed by groups of facilities with similar characteristics;

(b) The total recorded investment in foreclosed assets held for sale and the amount of the related allowance for asset impairment;

(c) The recorded investment in each group of assets against which an allowance for asset impairment has been established collectively and the provisions for the current period;

(d) The net charge or credit to income in respect of asset impairment, identifying separately recoveries of assets written off in previous periods; and

(e) Write offs of assets during the reporting period, identifying separately amounts related to facilities restructured during the reporting period;

(f) The amount of restructured assets, analysed by groups of facilities with similar characteristics.

The basis of determining the amount of the allowance for impaired assets as well as the events and conditions considered in determining the charge to income for the period in respect of the provisions should be disclosed.

A continuity schedule of the allowance for impairment, identifying separately the total amount of allowances against individual assets and groups of assets, should be disclosed in the financial statements.

A facility cannot be split into unimpaired and impaired portions for the purpose of reducing the recorded investment in impaired assets that is required to be disclosed unless this is done to reflect a change in the underlying legal agreements. The existence of a guarantee or insurance (irrespective of the status of the guarantor or provider of insurance) does not preclude a facility from being disclosed as an impaired asset when reasonable assurance does not exist of the timely collection of the full amount of principal and interest.

Although not necessarily regarded as impaired assets, licensees are required to disclose the amount of past due facilities as a routine part of their quarterly reporting requirements to the Central Bank.

When reporting impaired assets to the Central Bank, licensees should include provisions for off-balance sheet exposures under the heading of specific provisions.

Exemption from these disclosure requirements may be granted in circumstances where the Central Bank has agreed, in writing, with the licensee that the cost of disclosure is disproportionately greater than the benefit it provides.

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