

NATIONAL RESERVE BANK OF TONGA

Prudential Statement No.1 Revised 2012

ASSET QUALITY

Introduction

1. This statement is established under Section 15(3) of the Financial Institutions Act, 2004. This statement sets out the minimum standards which banks should adopt for the identification and reporting of impaired assets. The guidelines contained in this statement form the basis for reporting on the Impaired Assets section in the FID 1_1 return.
2. The maintenance of sound asset quality is a fundamental aspect of banking. In its approach to the supervision of banks, the Reserve Bank takes the view that it is the prime responsibility of each bank's management to set policies and procedures to ensure that the bank maintains sound asset quality, strong portfolio management, prudent risk controls, effective credit review and classification procedures, and an appropriate methodology for dealing with problem exposures.
3. The maintenance of prudent written lending policies, loan approval and administration procedures, and adequate loan documentation are essential to a licenced financial institution's management of its lending function. An important part of the Reserve Bank's function of supervising licenced 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. 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.
4. In this regard, the Reserve Bank's objective is to ensure that licenced financial institutions adopt prudent risk management and credit policies to minimise the extent, and likely impact, of such losses if they occur. The earlier Impaired assets are identified and remedial action taken the greater the likelihood of minimising losses.
5. 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 as well as any requirements on "know your customer".
6. To help improve prudential oversight of asset quality, the Reserve Bank establishes minimum standards as well as a common language and methodology, for identifying impaired assets within banks. The guidelines on the measurement and reporting of impaired assets are designed to improve the quality and consistency of data received from banks.

IDENTIFICATION AND MEASUREMENT OF IMPAIRED ASSETS

Scope

7. This statement applies to all problem assets, which banks hold, and is not limited to problem loans. In addition to loans, it also captures off-balance sheet exposures (detailed guidance on the treatment of off-balance sheet exposures is outlined in Appendix I). These are referred to collectively throughout this paper as "impaired assets".
8. The statement covers all banks' lending activities, including retail facilities such as housing loans, personal loans, credit cards and personal finance leases/hire purchase agreements. It is recognised, however, that it may not be practical for banks to analyse some smaller facilities on an individual basis. Accordingly, banks can choose to treat facilities with a principal balance of up to \$5,000 on a portfolio basis¹, rather than subject them to individual review². Any impaired facilities treated on a portfolio basis can remain on an accrual basis for up to 180 days. At that time banks must decide whether they are prepared to subject the accounts to individual review or to write them off. If they choose to conduct individual reviews, then the facilities can remain on an accrual basis, if the bank is satisfied, because of the existence of adequate security, that it will receive payment of interest and principal in full within 12 months; if security is inadequate, the bank should immediately create the appropriate provision and move the facility to a non-accrual basis.

Classification of Impaired Assets

9. Impaired assets should be classified into one of the following categories:
 - non-accrual items;
 - restructured items; or
 - other assets acquired through security enforcement, including "other real estate owned".

Non-Accrual Items

10. The term "non-accrual items" applies to those facilities on which income may no longer be accrued ahead of its receipt. The following definition of non-accrual items should be used:
 - (i) facilities where there is reasonable doubt about the ultimate collectability of principal and interest within a time frame established by the bank, but in any case not significantly longer than the term of the original facility. Non-accruals would include all facilities against which a specific provision has been established, or a write-off taken (except in the case of restructured facilities, and assets acquired through security enforcement) even if the facility is not in breach of contractual requirements;

¹ Banks can choose to apply a lower threshold for individual review, consistent with their scale of operations or current provisioning policy.

² Accounts treated on a portfolio basis should be classified according to their arrears status. Banks should identify arrears at an early stage and have adequate systems in place to monitor the arrears position of accounts on a regular basis.

- (ii) facilities, not included in (i), where contractual payments of principal and/or interest are 90 or more days in arrears³, and where the "fair value"⁴ of security is insufficient to cover payment of principal and accrued interest. In line with the principles outlined above, a facility should be classified as non-accruing 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;
- (iii) overdrafts, not included in (i), which have remained continuously outside approved limits (including unadvised internally authorised excesses or extensions approved as part of the initial credit extension process) for 90 or more days, and where security is insufficient to cover the bank's exposure (including accrued interest).
- (iv) Overdrafts and other loans not having pre-established repayment programs are considered non-performing when any of the following conditions exist:
 - a) the debt exceeds the approved limit for 90 consecutive days or more;
 - b) the borrowing line has expired for 90 days or more;
 - c) interest is due and unpaid for 90 days or more; or
 - d) the account has been inactive for 90 days, or loan repayments have been insufficient to cover the interest that was capitalized during the period.

11. The following observations serve to elaborate on this definition:

- the key element of the definition requires that banks place on a non-accrual basis any facility where there is reasonable doubt about the collectability of principal and/or interest, irrespective of whether the customer concerned is currently in arrears or not. This element of the definition acknowledges the reality that recognition of impaired assets will always have a high degree of subjectivity attached to it. The definition covers the range of flexible financing facilities common in the Tongan banking system, which may not be amenable to more prescriptive rules. It would, for example, encompass doubtful loans where repayment of principal and interest occur only as a single payment at maturity; or money market transactions where doubt about collectability arises immediately settlement does not eventuate;
- such a definition might also be expected to capture agricultural facilities where repayment is dependent on returns from crop or livestock sales where failure to sell would immediately place loan repayments in doubt. However, it would not include agricultural facilities where capitalisation or approved deferral of interest and/or further advances for working capital purposes during a bad season have been pre-arranged and approved through the normal credit approval process;

³ Loans are considered to be 90 days in arrears when the outstanding arrears is the dollar equivalent of 90 days past due (for a typical loan where repayments are made monthly this is considered to be equivalent to 3 months payments). The calculation begins on the day on which the client who has a contractual obligation fails to make a payment to the bank.

⁴ "Fair value" is defined as the amount, which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. The "fair value" of an asset should equate to the "net current market value" of the asset.

- the **creation of a specific provision** against an individually identified exposure gives rise to a sufficient degree of doubt about collectability to warrant placing such a facility on a non-accrual basis. A bank is expected to continue to raise specific provisions against exposures on which it is still receiving interest and other payments but where the bank may ultimately suffer a loss. However, in such circumstances, it would generally be appropriate that income received on such facilities should be taken to profit on a cash basis (the treatment of income received on non-accrual items is discussed in a later section of this paper). This requirement does not extend to provisions created on a formula or portfolio basis against particular categories of facilities;
- once contractual payments are in arrears for a period of 90 or more days, such facilities should, in principle, be placed on a non-accrual basis. However, if it is a bank's best judgement that the value of security (using the concept of "fair value")⁵ is sufficient to ensure that the bank will recover the principal and interest due, AND the debt is **“in the process of collection”**⁶ then such a facility need not be placed on a non-accrual basis. Security will include any arrangement, which protects the bank from losing partially or fully the principal, and/or interest on a facility. It may include legal rights of set-off, guarantees, and interest servicing arrangements. Where the facility is unsecured, however, it should be placed in the non-accrual category;
- the existence of a range of flexible facilities, such as overdraft and bill lines, makes it difficult in practice to apply a "90 day rule" in all cases. To ensure that such facilities are brought within the framework of the return, banks should apply a test similar to the "90 day rule" to exposures, which are in breach of agreed limits for a continuous period of 90 days or more. For control purposes banks often operate overdraft facilities with both advised and higher unadvised/unarranged limits. The 90 day threshold can be applied to unadvised/unarranged limits approved as part of the normal credit extension process;
- banks should provide a disaggregation of non-accrual facilities on the basis of whether or not a specific provision has been raised against the facility concerned.

Restoring Non-Accrual Items to Accrual Status

12. A non-accrual item may be restored to accrual status **once all** arrears have been met by payments from the customer and the bank judges that the customer is capable of fully servicing its future obligations under the facility, **and** becomes well secured. In each case, the underlying evidence should support the view that there is no reasonable doubt about ultimate collectability of principal or interest.

⁵ "Fair value" as defined under footnote 4.

⁶ The debt is in the process of collection if collection is proceeding through actions that are reasonably expected to result in repayment of the debt in full or its restoration to current status. The commencement of collection efforts, plans to liquidate collateral, ongoing workouts, restructuring or settlement do not, in and of themselves, allow a loan to meet the definition. There must be evidence that collection in full of amounts due and unpaid or its restoration to current status will occur within a period not exceeding 12 months of the credit facility becoming past due.

Restructured Items

13. A restructured item is defined as one in which the original contractual terms have been modified to provide **concessions** of interest, principal or term for reasons related to the financial difficulties of a customer. Where concessions are made to a customer, which render the facility "non-commercial" to the bank, that facility should be classified as a restructured item. However, if the item is restructured so that it is fully expected that the customer will perform on terms, which are considered by the bank as similar to those for new debt with similar risk, and no provisions are currently held against the exposure, then it should not be considered as restructured debt.
14. For a facility to be classified as restructured, the bank and customer must formally agree to the new terms. Facilities which are "partially performing" but which are not the subject of a formal agreement should be classified as non-accrual.
15. 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 minimum documentation requirements expected of a bank for a restructured facility are:
 - A written request by the borrower for restructuring;
 - A written restructuring or business plan showing how the operational or management changes the borrower intends to make will improve the borrower's debt servicing capacity;
 - Current financial information on the borrower, including cash flow projections (current means dated not more than 12 months from the restructuring);
 - A written analysis of the borrower's current financial condition and projected cash flow prepared by the bank which clearly and unquestionably indicated the borrower's ability to service the restructured terms of the debts;
 - A written agreement on the restructured terms co-signed by the borrower and the bank (i.e. new loan).
16. The following concessions would lead to a loan being classified as restructured:
 - a reduction in the principal amount of the facility as set down in the original loan agreement;
 - a reduction in the amount payable at maturity,
 - a below market rate of interest;
 - a reduction of accrued interest;
 - forgiveness of accrued interest;
 - a deferral or extension of interest payments;
 - a deferral or extension of principal payments;
 - capitalisation of interest;
 - extension of the maturity date or dates.

17. Any facility, which is placed on restructured terms for a limited period, perhaps because of temporary financial difficulty being experienced by the customer, but where it is fully expected that the customer will be able to perform, need not be classified as a restructured item. A typical example might be a retail type facility (such as suspension of principal repayments on housing loans), provided the suspension is for a limited period of time (not exceeding 12 months) and the full amount is still repayable, and no loss of principal or the originally contracted amount of interest is likely.
18. The effective interest rate being earned on restructured 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, which is equal to or greater than the bank's average cost of funds at the date of the restructuring. Otherwise, it should be classified as non-accrual.
19. If, after a restructuring, there still remains considerable doubt about recovery of principal and/or interest, consideration should be given to placing the facility on a non-accrual basis. If provisions are raised subsequent to the restructure, the facility should be classified as non-accrual.
20. A single facility cannot be split into a performing and non-performing part in the absence of a formal loan restructuring. If the facility cannot support accrual of all interest due under its terms and conditions, then it must be placed on a non-accrual status. As discussed in the section "Income on Non-Accrual Items" below, this does not completely exclude the recording of income but it is not considered prudent to record income until it is actually received in cash.

Restoring a Restructured Item to Performing Status

21. A restructured item may be returned to fully performing status when:
 - (i) A facility which has 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 terms of the restructured facility are comparable with the market terms required for a facility of comparable risk in the standard risk category.
 - (ii) The customer pays the outstanding accrued interest at the time of the restructuring or after six consecutive months of principal and interest payments.
 - (iii) The customer is capable of fully servicing its future obligations under the facility. A period of sustained performance, whether prior to or subsequent to the date of the restructuring, is an important factor in determining whether there is reasonable assurance of repayment and performance according to the item's modified terms. In certain circumstances, evidence may exist regarding other characteristics of the customer that may be sufficient to demonstrate relative improvement in its condition and debt service capacity apart from performance to date, which would warrant

return to accrual status. This might include the signing of lease or rental contracts, or an equity injection.

22. A restructured item that has been re-classified to non-accrual status may revert to restructured status when all payments become fully current in terms of the restructured terms and conditions, and senior credit management has determined that there is no reasonable doubt as to the ultimate collectability of principal and interest.

Assets Acquired Through Security Enforcement
(including Other Real Estate owned or OREO)

23. Where an asset has been acquired through security enforcement or where a bank assumes ownership of an asset in settlement of all or part of a debt, it falls within the category of impaired assets. Although under accepted accounting standards, banks should record these assets in their accounts at their "fair value", the holding of an asset acquired through foreclosure usually indicates a lack of demand, which contributes to uncertainty about the actual value of such assets. It is also the case that banks can lose money in liquidating other real estate owned despite the apparent adequacy of the appraised value. This category does not include "mortgagee in possession" assets.
24. If the income streams received on such assets are doubtful they should be taken to P&L only on a cash basis. However, if income streams are virtually certain, they may be treated on an accrual basis; examples would be dividends declared by public companies, and lease rental income (after payment of outgoings) which is considered certain (such as rents payable by quality tenants on longer term leases).
25. Assets acquired through security enforcement should remain classified as impaired assets until sold.
26. This category of impaired assets is not intended to capture buildings acquired for occupation by bank staff.

Impaired Assets

27. Impaired Assets are those credit facilities and other assets which are not fully performing, eg 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.
28. 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.

Income Recognition

Income on non-accrual items

29. When a facility is classified as non-accrual, a bank should cease to recognise any interest earned but not yet received.
30. When a facility is placed on non-accrual, any accrued but unpaid interest should generally be reversed back to the last reporting date or the date when the interest was last paid, whichever is more recent. Unpaid interest dating back prior to the last reporting date should be reviewed to establish ultimate collectability and a provision against loss should be raised as appropriate.
31. Where a bank's documentation stipulates the order of priority in which cash receipts are to be treated, the bank should follow that treatment, unless agreement can be reached with the client to vary the requirements of the documentation. If 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:
 - statutory charges;
 - penalty interest and fees;
 - overdue interest and fees;
 - current interest and fees; and
 - principal.
32. Where a bank has calculated the recoverable amount of a facility 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 (eg. because it represents proceeds from the sale of security) the balance outstanding on the facility should be reduced by the amount of the cash receipt.
33. However, where the cash receipt does not alter the previously determined estimated future recoverable amount of the facility, the cash receipt should be brought to account as income. To do otherwise would result in the facility being written down to below its recoverable amount.

Past Due Items

34. Items, which are 90 or more days in arrears, are not classified as impaired assets if they are well secured (using the concept of “fair value”⁷ and no provisions are held against them but are in the process of collection⁸. However, because they are considered more at risk than items, which are being maintained in accordance with their contractually agreed terms, data on such exposures will continue to be collected (as a memorandum item on the Impaired Assets Return).

⁷ “Fair value” as defined under footnote 4.

⁸ “in the process of collection” as defined under footnote 6.

35. Interest on past due items should be accrued to income.
36. An item should cease to be classified as past due when arrears have been reduced below the 90-day threshold by payments from the customer.

Compliance with Prudential Statement No. 1

37. This statement is effective from 1 May 2012. Non-compliance with the requirements of this Prudential Statement will be subject to corrective actions as provided under section 33 of the Financial Institutions Act 2004 and the administrative penalties outlined in Prudential Statement No.3 Administrative Penalties.

National Reserve Bank of Tonga
March 2012

Treatment of Off-Balance Sheet Exposures

This Statement is intended to capture off-balance sheet as well as on-balance sheet exposures. The principal off-balance sheet credit transactions are likely to be direct credit substitutes and commitments. Guarantees and standby letters of credit are usually converted into on-balance sheet exposures if the counterparty they are supporting fails but there may be circumstances when the bank is reasonably certain that such instruments will be called upon at a future date because of uncertainty about the client. Loan commitments, which are irrevocable, should also be classified as impaired assets if the creditworthiness of the client has deteriorated to an extent that makes repayment of any loan drawdown (or associated interest payments) doubtful. Any foreign exchange transactions, which expose a bank to credit risk, are also captured by this statement. If doubt arises as to whether the bank will receive cash flow entitlements from foreign exchange transactions, banks should treat such an exposure as an impaired asset. Banks should take into account current exposures and potential exposures, which could arise from movements in exchange rates.

Provisions for off-balance sheet exposures do not generally appear in the totals of either specific or general reserve for credit losses disclosed in a bank's financial statements but are often included in "other liabilities" and are disclosed as part of the notes to the accounts. For the purposes of the Impaired Assets Return these should be reported under the heading of specific provisions.