CENTRAL BANK OF SOLOMON ISLANDS
Financial Market Supervision Department

Prudential Guideline No. 2
On Asset Classification and Minimum Provision Requirements

Applicability

1. This Prudential Guideline is applicable to all financial institutions licensed by the Central Bank of Solomon Islands (CBSI).

Purpose of Prudential Guideline

2. This Prudential Guideline establishes uniform standards to be followed by financial institutions to ensure that: (i) loans are regularly evaluated using an objective grading system that is consistent with regulatory standards; (ii) the accounting treatment for non-performing assets is consistent with recognized accounting practices and regulatory requirements; and (iii) timely and adequate provisions are made and write-offs taken to reflect accurately the capital (or assigned capital in the case of branches of foreign financial institutions) and earnings performance of the financial institution. It is also intended to encourage the development of timely and effective work-out plans for problem assets and effective internal controls to manage such assets. This Prudential Guideline applies to all loans and assets carried on the balance sheet of a financial institution or reflected as off-balance sheet items.

3. It is the responsibility of the board of directors of each financial institution to adopt a written loan policy and to establish a loan review process which accurately identifies risk, ensures the adequacy of provisions for loan losses, and properly reflects the condition and operations of the financial institution in required financial returns.

Definitions

4. **"capitalized interest"** – means any accrued and uncollected interest which has been added to the principal balance at a payment date or maturity. It also includes unpaid interest which is refinanced or rolled-over into a new loan.

5. For overdrafts and other loans not having pre-established repayment programs or where interest is capitalized to the account as a normal practice, deposits to the account during a period of temporarily diminished cash flow should be at least sufficient to cover accrued interest for the period.

6. **"current"** – when referring to financial statements, asset appraisals or valuations, or in similar contexts, means the information or documentation is not more than one year old or such shorter period if specified herein.

7. **"in the process of collection"** – means that collection of a debt is proceeding in due course in a timely manner either through:
   a) legal action, including the enforcement of a judgment against the borrower; or
   b) by collection efforts not involving legal action but which are reasonably expected to result in full repayment of the debt (including principal and all

accrued interest) within 180 days, or in restoration of the debt to a current status through payment of all past due principal and accrued interest.

8. **“loan”** – means any direct or indirect advance of funds (including obligations as maker or endorser arising from discounting of commercial/business paper, lease financing arrangements, overdrafts, etc.) which are made to a person on the basis of an obligation to repay the funds, or which is repayable from specific property pledged by or on behalf of a person.

9. **“net realizable value”** – means that amount which a financial institution can reasonably expect to realize after (i) discounting the value of collateral to current market conditions and (ii) after deducting the reasonable and estimable costs of recovery and sale. Costs of recovery and sale typically include but are not limited to: legal fees, costs of valuation, selling expenses, insurance cover, maintenance of the collateral, security measures, and any other expenses that may be necessary to put the collateral in a saleable condition.

10. **“non-accrual”** – means that an asset has been place on a cash basis for financial reporting purposes. Interest is no longer accrued on the books of the financial institution or taken into income unless paid in cash by the borrower from his own funds. Non-accrual assets include all assets which are non-performing.

11. **“non-performing”** – means that a loan has been placed on non-accrual. Unless a loan is both well-secured and in the process of collection, it is considered non-performing when:
    a) any portion of principal or interest is due and unpaid for 90 days or more; or
    b) interest payments for 90 days or more have been capitalized, re-financed, or rolled-over into a new loan.

12. Overdrafts and other loans <u>not</u> 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 <u>consecutive</u> 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 deposits have been insufficient to cover the interest that was capitalized during the period.

13. The entire principal balance owing (<u>not</u> just the sum of delinquent payments) must be shown as non-performing when preparing and submitting financial returns to the CBSI.

14. **“past due” or “overdue”** – means any asset for which:
    a) any portion of principal or interest is due and unpaid for 30 days or more; or
    b) interest payments equal to 30 days interest or more have been capitalized, refinanced, or rolled-over.

15. Overdrafts and other loans <u>not</u> having pre-established repayment programs are considered past due when <u>any</u> of the following conditions exist:
    a) the debt exceeds the approved limit for 30 <u>consecutive</u> days or more;
    b) the borrowing line has expired for 30 days or more; or

c) the account has been inactive for 30 days, or deposits have been insufficient to cover the interest capitalized during the period.

16. The entire principal balance owing (not just the sum of delinquent payments) is to be shown as past due when preparing and submitting financial returns to the CBSI.

17. **“provisions for loan losses”** – means a balance sheet valuation account established through charges to provisions expense in the profit-and-loss statement and against which bad loans, or portions thereof, are written-off.

18. **“restructured”** or **“re-negotiated”** – means the terms and conditions of a loan have been modified, principally because of deterioration in the borrower’s financial condition, to provide for a reduction in interest rate or principal, or a capitalization of interest accrued. A rescheduled loan in which effective interest rates remain unchanged from original terms but principal repayment terms have been extended because of project delays is not considered a restructured loan as long as interest continues to be serviced on time, in cash, and without capitalization of interest. The following concessions would normally require a loan to be categorized as restructured:
    a) reduction in the principal amount of the facility;
    b) reduction in the amount payable at maturity;
    c) a below market rate of interest;
    d) forgiveness of accrued interest;
    e) a deferral or extension of interest payments;
    f) a deferral or extension of principal payments;
    g) capitalization of interest;
    h) extension of the maturity date or dates.

19. **“well-secured”** – means that a loan is secured by:
    a) collateral that can repay the full debt (principal plus accrued interest) through timely sale under an involuntary liquidation program, provided (i) proper legal documentation held, (ii) the collateral has a "net realizable value", as shown in a current written appraisal/valuation report, which covers principal, accrued interest, and costs of collection, and (iii) there are no prior liens which prevent the financial institution from foreclosing, repossessing or otherwise obtaining clear title to the collateral; or
    b) a written, irrevocable and unconditional guarantee issued by the Government of Solomon Island or the CBSI to repay in full the outstanding principal and interest of the loan.

Loan Review

20. **Frequency and Reporting:** The board of directors of each financial institution shall cause a review to be made of the quality of its loan portfolio on a regular basis but at least as of the end of each calendar quarter. Written reports of such reviews shall be made on a timely basis directly to the board of directors (or the parent/head office in the case of a foreign bank branch) and shall include enough information for the board to identify problems and require the officers of the financial institution to promptly correct the problems. Such written reports are to be made available to examining personnel of the CBSI upon request.

21. Financial institutions that have adopted policies and procedures for an internal loan review program, including the classification (grading) of loans and provisions for loan losses, that is different from the requirements of this Prudential Guideline, may continue to use their current system. However, for reporting purposes, financial institutions must report classification grades on loans and provisions for loan losses in accordance with the requirements, definitions and criteria as set forth in this Prudential Guideline.

22. **Objectives:** The loan review function shall ensure that: (i) the loan portfolio and lending function conform to a sound, written lending policy which has been adopted and approved by the board of directors; (ii) executive management (or senior management of the branch in the case of a branch of a foreign financial institution) and the board of directors are adequately informed regarding portfolio risk; (iii) problem loans are identified, classified, and placed on non-accrual in accordance with the requirements of this Prudential Guideline; (iv) fully adequate provisions are made to the provisions for loan losses account; and v) write-offs of identified losses are taken promptly.

23. **Review Requirements:** At a minimum, management of financial institutions should ensure the following loans are reviewed on a schedule that is sufficiently regular to ensure timely and accurate identification and reporting of loss exposure, including the maintenance of adequate provisions for loan losses: (i) loans that exceed 10% of Tier 1 capital (or assigned capital in the case of branches of foreign financial institutions) as defined from time to time by the CBSI; (ii) loans required to be placed on non-accrual or non-performing status in accordance with the requirements of this Prudential Guideline; and (iii) a sampling of all other loans appropriate to reach valid conclusions about the condition of loans on the books of the financial institution and the adequacy of provisions for losses on loans.

<u>Interest Suspension</u>

24. **Transfer to Non-Accrual Status:** A loan is to be placed on non-accrual if:
    a) it is maintained on a cash basis because of deterioration in the financial condition or paying ability of the borrower;
    b) payment in full of principal or interest is not expected or is otherwise in doubt; or
    c) it is non-performing unless it is <u>both</u> well-secured <u>and</u> in the process of collection.

25. **Write-back of Accrued Interest:** Any interest which is accrued but not collected and still carried on the books shall be written-off by the end of the calendar quarter in which a loan is, or should have been, placed on non-accrual status, but in no event later than 90 days after being transferred to non-accrual status.

26. Interest which has already been taken into profits shall be reversed from when the loan is, or should have been, placed in non-accrual status. Interest accrued during the <u>current</u> year shall be charged back against the interest income account; interest accrued in <u>prior years</u> shall be charged against the provisions for loan losses account.

27. **Treatment of Cash Payments and Criteria For Cash Basis Recognition of Income:** If a loan is on non-accrual and ultimate collection of all principal is in doubt, then any cash payments received shall be applied only to reduce principal. However, if the principal balance remaining after a partial write-off is regarded as collectible, then cash payments may be applied to interest income.

28. Where recognition of interest income is appropriate for an asset held on a cash basis, the income that may be recognized is limited to the amount which would have accrued at the contractual rate if the asset had been on an accrual basis. Any cash payments in excess of this amount (and not applied to the remaining book balance) shall be recorded as recoveries of prior write-offs until all such write-offs have been fully recovered. For a loan to be considered fully recoverable, it must be supported by current financial information which demonstrates the repayment capacity of the borrower.

29. **Return to Accrual Status:** A non-accrual loan may be returned to accrual status only when (i) no principal or interest is past due and full repayment of all remaining contractual principal and interest is reasonably expected or (ii) when the loan is both well-secured and in the process of collection. To satisfy condition (i), a financial institution must have received payment in cash from the borrower for all delinquent principal and interest unless the loan has been formally restructured and qualifies for accrual status. Until a loan is restored to accrual status, cash payments received shall be handled as required in paragraph (28) above.

30. **Treatment of Multiple Loans to One Borrower:** If a financial institution has multiple loans to a single borrower or group of related borrowers, and one loan meets the criteria for non-accrual status, then the financial institution shall evaluate every other loan to that borrower and place any other loans on non-accrual status if circumstances so require. Written reports of such evaluations shall be maintained by the financial institution and made available to examining personnel of the CBSI upon request.

Classification of Assets

31. All loans shall be classified using the classification grades below, provided, a loan may be assigned a split classification, whereby two or more portions of the same loan are given separate classifications if appropriate. For example, a financial institution has an unsecured loan to a non performing borrower. The collecting attorney/loan officer has indicated a minimum and maximum disbursement to unsecured creditors of 40% and 65%, respectively. In this example, the proper classification of the loan would be 40% Substandard, 25% Doubtful and 35% Loss.

32. Significant departure from the primary source of repayment on a loan may justify an adverse classification grade even if a loan is current or appears supported by collateral. Classification also may be appropriate if original repayment terms were too liberal or past due payments have been cured by refinancing or additional advances.

Restructured or Re-negotiated Items

33. For each restructured loan the following documents shall be maintained by the financial institution and made available to examining personnel of the CBSI upon request:

a) if the borrower is a corporation or the loan is to an individual for business purposes, 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;
b) current financial and cash flow information on the borrower;
c) a written analysis, prepared by the financial institution, of the borrower's current financial condition which clearly and unquestionably indicates the borrower's ability to service the restructured terms of the loan from its projected cash flow;
e) a written agreement on the restructured terms signed by the borrower and accepted by the financial institution;

34. Any restructured loan which subsequently becomes overdue for the payment of principle or interest, in full or in part, for 90 days or more according to the terms of the restructured loan agreement shall be placed in non-accrual status and shall remain in non-accrual status until the borrower pays from his own funds all overdue principal and interest.

Regulatory Classification Grades

35. **Pass.** Loans or assets in this category are fully protected by the current sound worth and paying capacity of the obligor or the collateral pledged, are performing in accordance with contractual terms, and are expected to continue doing so.

36. **Special Mention.** Loans or assets in this category are secured and repayment is not yet jeopardized but deficiencies exist which may, if not corrected, weaken the asset or the financial institution's position at some future date. Deficiencies may include: inability to properly supervise the loan due to an inadequate loan agreement; deteriorating condition or control of collateral; deteriorating economic conditions or adverse trends in obligor's financial position which jeopardize repayment capacity. This grade should not be used if a Substandard grade is warranted.

37. Any asset which is past due 60 days or more but less than 90 days shall be classified as Special Mention, at a minimum.

38. **Substandard.** Loans or assets in this category are not adequately protected by the current sound worth and paying capacity of the obligor. The primary source of repayment is not sufficient to service the debt, and the financial institution must rely on secondary sources such as realizing on collateral, sale of fixed assets, refinancing, or capital injections from external sources. Substandard assets have well-defined weaknesses that jeopardize the orderly repayment of the debt. These assets may, or may not, be past due but have a higher than normal risk due to absence of current credit documentation. There is a distinct possibility that the financial institution will sustain loss if deficiencies are not corrected.

39. Any asset which is past due 90 days or more but less than 180 days shall be classified as Substandard, at a minimum.

40. Re-negotiated and restructured loans shall be graded Substandard unless (i) all past due interest is paid in cash at the time of restructuring, (ii) all principal and interest payments have been made according to the modified repayment schedule for at least six

consecutive months from the date the loan was re-structured, and (iii) the terms and conditions of the restructured loan comply with the loan policy.

41. **Doubtful.** Loans and assets in this category have all the weaknesses inherent in Substandard assets but the loans are not well-secured. Weaknesses make collection in full highly questionable and improbable on the basis of existing facts, conditions, and value. The possibility of loss is high, but the actual amount of loss cannot be fully determined because specific pending factors may mitigate. Pending factors may include a merger, acquisition, or liquidation; a capital injection; obtaining additional collateral; or refinancing. If pending events do not occur within 180 days and repayment must again be deferred, Loss classification is warranted.

42. Any asset which is past due 180 days or more but less than 360 days shall be classified as Doubtful, unless (i) the asset is well-secured, (ii) legal action has commenced, and (iii) the time to realize on collateral or on a guarantee does not exceed 180 days.

43. **Loss.** Loans and assets in this category are deemed uncollectible or of such little value that carrying on the books is no longer warranted. Loss classification does not mean there will never be a recovery, but rather that it is no longer appropriate to defer writing off the asset. Losses shall be taken when identified as uncollectible and shall not remain on the books while pursuing long-term recovery efforts.

44. Any asset which is past due 360 days or more shall be classified as Loss, unless (i) the asset is well-secured, (ii) legal action has commenced, and (iii) the time to realize on collateral or on a guarantee does not exceed 180 days. In some cases, a reduced carrying value or partial write-down is justified. If a partial write-down is taken, the remaining book value must be supported by tangible facts**.**

45. Loans classified Loss shall be written off by a charge against provisions for loan losses; in no event should loan write-offs be taken directly to capital accounts. When a loan or portion of a loan is written-off, all accrued but unpaid interest should also be written off or reversed. Current period interest should be reversed and prior period interest that was taken into income should be charged against the provisions account.

Classification Downgrades

46. If, at an on-site examination or otherwise, a loan or asset is graded lower by the CBSI than by the financial institution, the financial institution shall (i) re-classify the asset to the lower grade assigned by the CBSI, and (ii) make provisions as required. Subsequent upgrades, or further downgrades, shall be made if circumstances justify.

Provisioning Requirements

47. **Provision Account:** All financial institutions shall maintain an account on the balance sheet entitled "provisions for loan losses" (also called “allowance for loan losses and reserve for doubtful debts) which shall include both specific and general provisions. The provisions account shall be created by charges to provision expense in the income statement and shall be maintained at a level that is adequate to absorb potential losses in the loan portfolio.

48. At the end of each calendar quarter, or more frequently if warranted, the board of directors shall cause management to evaluate the collectibility of all loans, including any accrued and unpaid interest, and shall require that appropriate entries be made to (i) accurately report earnings, and (ii) ensure that the provision for loan losses account is fully adequate to absorb identified and potential losses. Management must maintain records to support their evaluations and shall make them available for inspection by examiners as requested.

49. **Additions/reductions to the provisions account:** Additions to the provisions account shall be made by charges to provision expense in the income statement. Write-offs and recoveries shall be charged to the provisions account; loans must <u>not</u> be written off or recovered directly to current year earnings or to other capital accounts.

50. **Specific Provisions for small loans:** Financial institutions may comply with the minimum <u>specific</u> provisioning requirements provided in (d) below for small loans (SBD25,000 or less) classified as Substandard, Doubtful or Loss by pooling such loans according to classification grade and applying the minimum provisioning percentage to the aggregate total balances. The level of specific provisions for pooled loans shall be increased or decreased, as the case may be, not less than quarterly as the aggregate balances of the pools change.

51. **Provisioning amounts:** In determining the potential loss in specific (individual) loans, groups of loans, or the aggregate loan portfolio, all relevant factors shall be considered including, but not limited to: current economic conditions, historical loss experience, delinquency trends, the effectiveness of the financial institution's lending policies and collection procedures, and the timeliness and accuracy of its loan review function.

52. At a minimum, the following provisioning amounts are to be maintained:
    a) for loans graded **"Pass"** or **"Acceptable"** 1%
    b) for loans graded **"Special Mention"**............................... 5%
    c) for loans graded **"Substandard"**.................................. 20%
    d) for loans graded **"Doubtful"** 50%
    e) for loans graded **"Loss"**... 100%

53. Provisions for loans, whether on an individual, group, pool or portfolio basis graded Substandard, Doubtful and Loss are Specific Provisions. Provisions established for remaining assets and not allocated to specific assets are general provisions

54. If reliable factors indicate higher loss potential, then provisions greater than the above shall be maintained. If a financial institution demonstrates to the satisfaction of the CBSI that lower provisions are justified, then lower amounts may be used.

55. The provisioning percentages above shall be applied against the <u>gross</u> loan balance for loans graded Pass, Special Mention or Substandard. For loans graded Doubtful or Loss, the "net realizable value", as shown in a current written appraisal/valuation report, of collateral may be deducted from the balance of the loan before applying the provisioning percentages providing the resulting provision is not less than 20% of the gross loan balance. For example, a SBD100,000 loan graded Doubtful must have a minimum provision of at least SBD20,000 (SBD100,000 x 20% minimum Substandard

provision requirement) after deducting the "net realizable value" of collateral securing the loan.

56. Any loan, or portion thereof, if fully secured by cash held by the lending financial institution or a written, irrevocable and unconditional guarantee issued by the Government of Solomon Island or the CBSI is exempt from the classification and provisioning requirements of this Prudential Guideline.

57. Any loan, or portion thereof, that is, or should be, classified "Loss" may be fully provisioned for and write-off deferred to the end of the current calendar quarter but not later than 90 days after being classified Loss.

58. **Treatment of Collateral:** Classification grades for loans should be based on an assessment of the primary repayment source – generally being an assessment of the financial capacity and/or cash flow of the borrower to repay the debt. Collateral is a secondary source of repayment and should therefore be considered in determining the severity of the classification grade. For example, whether a loan should be classified Substandard because it is well-secured by collateral in the process of collection, or whether it should be classified Doubtful or Loss because the value of the collateral does not provide adequate protection to the financial institution from loss. Because collateral is generally illiquid, costly to acquire control of and to maintain pending its sale, and difficult and costly to value during periods of financial distress, the provisioning percentages required in this Prudential Guideline shall be applied against the gross outstanding balance of loans graded Pass, Special Mention or Substandard.

Review by CBSI

59. Each financial institution shall maintain adequate records to support its determination of loan loss potential and provisions and make such records available to the CBSI for inspection on request. If a review by the CBSI concludes that additional provisions are required for individual loans or for the loan portfolio in aggregate, the financial institution will be instructed to make the necessary adjusting entries.

Reporting Requirements

60. Each financial institution shall submit to the CBSI returns as may be required and in the form and frequency as the CBSI may prescribe.

Enforcement and Corrective Measures

61. A financial institution which fails to comply with the requirements contained in this Prudential Guideline or submits reports to the CBSI which are materially inaccurate will be considered as following unsound and unsafe practices as provided in Section 16 (1) (a) of the Financial Institutions Act 1998.

62. The CBSI may pursue any or all corrective measures as provided in Section 16 of the Financial Institutions Act 1998 to enforce the provisions of this Prudential Guideline including:
    (a) issuance of an order to cease and desist from the unsound and unsafe practices and
    (b) action to replace or strengthen the management of the financial institution.

Effective Date

63. The effective date of this Prudential Guideline is 1 January 2010.

Issued this ***4th*** day of ***September***, 2009

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Governor Denton Rarawa
Central Bank of Solomon Islands