

**GUIDANCE NOTE FOR DEPOSIT TAKERS**  
**Credit Risk, Arrears & Provisions Management**

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Financial Supervision Commission Barrantee Oaseir's Arid

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## **Part 1 – Deposit takers incorporated in the Isle of Man**

### **1. Rationale / Introduction**

- 1.1 Under the Financial Services Rule Book (“the Rule Book”), the Commission requires deposit takers (hereinafter referred to as bank or banks as applicable) to have a policy in relation to credit risk, arrears and provisioning management.
- 1.2 Credit risk is one of the most important in terms of all banking risks and clear credit administration is a critical element in understanding the safety and soundness of a bank. It is important that banks have robust credit processes to ensure the risk of loss from the granting of credit is appropriately managed and controlled, and that customers of banks are also treated in a fair way. The default of a small number of important customers, or adverse factors affecting a particular segment of the business can generate large losses, potentially leading to insolvency. The overall objective of the Commission is to identify key risk areas in line with the Basel Core Principles for Effective Banking Supervision, and to minimise threats to its Core Objectives of Supervision.
- 1.3 The Basel Core Principles for Effective Banking Supervision require a bank to have effective systems in place to identify, measure, monitor and control credit risk as part of an overall approach to risk management. This includes best practice as dictated by international standards and the requirements of group regulators.
- 1.4 Credit risk is a normal part of banking. However, where the amount of risk is excessive or where this is not properly monitored and controlled, it can produce a significant threat to a bank and its earnings by fluctuations in net interest income and bad debt provisions (loan impairments). This in turn can affect the underlying value of a bank’s assets.
- 1.5 Lending activities also generate substantial costs relating to administration, funding and bad debts all of which impact strongly on profitability. It is therefore important that in all circumstances processes for the granting, subsequent monitoring and any recovery procedures reflect the return received.

### **2. Overview of the Commission’s Approach to Credit Risk**

- 2.1 The Commission expects every bank to have a comprehensive statement of its credit policy appropriate to the nature of its business.
- 2.2 The Commission expects relevant managers of banks to have a clear understanding of the risks and ensure that appropriate controls and monitoring procedures are in place. It is also expected that credit risk officers have the experience, knowledge and background to exercise prudent judgement in assessing, approving and managing credit risks

and that they are provided with the necessary training.

- 2.3 The Commission expects the bank to have a clear understanding of its exposure to concentrations of risk by (both economic & individual) customer and geographical sector.
- 2.4 The Commission requires banks to report all large exposures (those that exceed 10% of Large Exposure Capital Base “LECB”) on a quarterly basis. There is also the need to provide the Commission with regular financial information including audited financial statements, quarterly prudential returns and details of any internal audit and /or compliance reports.
- 2.5 The bank should have access to appropriate management information to monitor and exercise control to mitigate risk. This should include a formal process for provisioning where bad and doubtful debts have been identified.
- 2.6 The Commission expects banks to consider the impact on liquidity as part of the credit approval process and detailed guidance on this is contained within the separate guidance note on Liquidity Risk Management issued by the Commission.
- 2.7 The Commission also expects banks to take into account the key findings from the Commission’s on-site reviews conducted in 2010-2011 which are provided in **appendix 2**.

### **3. Credit Risk Management Policy**

The Commission requires banks to take reasonable steps to maintain appropriate systems for the management of credit risk and requires banks to have a formal credit policy. It is the responsibility of senior management to draw up the appropriate credit risk policy in the light of the particular circumstances of the bank. This should reflect the risk appetite of the bank and be approved by the Board. The Commission also recognises that a bank’s credit policy may be part of a wider group or divisional policy. In larger organisations it is recognised that formal implementation of many aspects of the policy may be delegated to a separate Credit or Risk Committee with referral to ALCO (or equivalent), where appropriate. The credit policy should be reviewed regularly, at least annually.

The purpose of a credit policy is to provide a framework that enables growth and competitiveness whilst maintaining acceptable levels of risk.

The main points that need to be considered in drawing up a credit policy are given below:

#### **3.1 Key principles**

The credit policy should establish the key strategic aims including the attitude and sanctioning authorities in order to identify and manage, if

applicable, any concentrations of risk. It should also set out the bank's attitude with regard to different types of lending, including geographical, economical or individual sectors.

### 3.2 ***Reputation risk***

Lending to certain individuals or sectors (either geographical or economic), or lending for a particular purpose can result in negative publicity and the bank should have a clearly defined policy in terms of what type and scope of lending is acceptable.

### 3.3 ***Discretionary power***

The credit policy must include details of the lending authority different people have within the organisation and the limit of this authority. If this is not specific within the credit policy there must be reference to how this is determined. This should also outline if any different procedures are necessary with regard to new business as this can present additional risk because there is no track record or behavioural patterns that can be assessed.

### 3.4 ***Related accounts / groupings***

An important element in considering lending is the recognition of facilities provided to a group of related customers. There should be appropriate guidance within the credit policy regarding the recognition and sanctioning of such exposures. Definitions of counterparties/customers related to each other are provided in the Commission's guidance note on Large Exposures.

### 3.5 ***Parties connected to the bank – arm's length lending***

When conducting business with a party connected to the bank appropriate controls should be in place to ensure business is conducted on an "arm's length" basis. Definitions of parties connected to the bank are provided in the Commission's guidance note on Large Exposures.

### 3.6 ***Facility grading / credit ratings***

Facility grading or credit ratings are a useful tool in the assessment of a lending proposition and if used guidance should be provided within credit policy. These ratings should be reviewed on a regular basis, at least annually.

### 3.7 ***Renewal process***

There should be clear guidelines on how to deal with the review and renewal of arrangements. These may include revisiting the original proposal to identify if any of the key information has changed and support this by a reassessment of current circumstances, in particular the financial performance and the value of security.

### 3.8 **Security**

Credit policy must state the different types of security that are acceptable and also information on the valuation parameters that should apply. Credit policy should be clear when security must be considered as part of an arrangement and how it may affect the approval of a facility. Security that includes assets that can regularly change in value must be regularly monitored and guidance given on how often this should be done. There must be appropriate procedures in place to ensure that security has been satisfactorily completed before funds are released. Where appropriate, insurance should also be considered in context with the circumstances of the security.

### 3.9 **Guarantees as security**

There should be a specific policy, when and under what circumstances it is appropriate to take guarantees as security.

### 3.10 **Environmental risk**

Consideration should be given to the threat of environmental risk in terms of credit risk and the risk to the bank's profile and reputation associated with taking a charge over land that might be contaminated.

### 3.11 **Documentation**

The quality of the documentation in respect of lending facilities is of prime importance in protecting the bank in the case of recovery proceedings. All lending facilities must be confirmed in writing in a format that has been approved by the bank's legal advisers and take into account any cross jurisdictional issues that might apply. The facility letter must accurately reflect all the terms and conditions of the arrangement.

### 3.12 **Bonds, indemnities and guarantees – contingent liabilities**

Where such an undertaking is entered into on behalf of a customer the liability should carry the same considerations as any lending facility. There should also be clear guidelines on the nature of the liabilities the bank is prepared to enter into and under what circumstances.

### 3.13 **Foreign exchange risk**

Where facilities have a potential foreign exchange risk this should be taken into consideration when reviewing/assessing any arrangement.

### 3.14 **Regulatory requirement**

Clear reference should be made to the different regulations that apply to the granting, managing and reporting of all credit exposures.

#### **4. Introduced Business**

Any third party introducer can pose an increased risk to a lending transaction if too great a reliance is placed on the information provided. This is particularly the case when the introducer has an interest, financial or otherwise, in the transaction and there must be a clear policy to deal with business of this nature to ensure that high standards are maintained. Introducer arrangements must be reviewed regularly, at least annually.

#### **5. Procedures and Systems**

The assessment of a lending proposition should always be undertaken in accordance with the bank's procedures and referred for sanction to the appropriate authority if outside discretionary powers. Detailed procedures should cover the approval process and the assessment should identify the source of repayment and outline when security is to be taken. Security should be revalued periodically to ensure that any covenants continue to be observed.

##### **5.1 General**

The Commission requires banks to monitor their credit risks on a frequent and timely basis. A bank must therefore have adequate procedures and systems covering:

- b) Allocation of responsibilities for credit granting, assessment and control
- c) Reliable systems that can produce accurate reports promptly. Reports should follow the principles of good management information and be clear and highlight all relevant information
- d) Active senior management involvement in clearly allocated responsibilities for credit reporting and monitoring – this should include regular independent checks by an internal control function, and
- e) Staff training that enables credit risk officers to have the experience, knowledge and background to exercise prudent judgement in assessing, approving and managing credit risks.

##### **5.2 Conflict of interest**

Conflicts of interest may arise where personal or outside interests exist which could affect the judgement of a member of staff in the management of a customer relationship. There should be guidance provided to deal with this type of situation.

Staff loans other than to senior management (as interpreted in the Rule Book), key persons, controllers or directors are normally treated as

exempt when considering if a conflict of interest applies.

### 5.3 **Pricing**

Formal arrangements for the agreement for pricing of lending should be in place. This should take into consideration the need to remain competitive within chosen markets and also reflect the maturity and risk of a proposition.

### 5.4 **Credit scoring**

Where credit scoring is utilised as part of a credit strategy approval process there should be clear guidelines when and under what circumstances this should be used.

## 6. **Arrears and Provisioning**

The Commission requires that the bank shall have a policy on arrears and provisioning for bad and doubtful debts that is appropriate to the nature and scale of its business. The Board and / or Audit Committee as well as senior management are responsible for ensuring that internal reviews of those documented policies are performed periodically.

The bank's Board must approve the written policy and changes thereafter. This should be reviewed at least annually to ensure it remains appropriate. As for the main credit policy the Commission also recognises that a bank's policy on arrears and provisioning may be part of a wider group or divisional policy.

### 6.1 **Management information**

Management information systems should be able to identify any deteriorating position at an early stage. There should be detailed procedures on how these are dealt with which should include a timescale and follow up action.

### 6.2 **Arrears /Bad Debt provision**

There should be a clear definition of what are considered to be non-performing exposures and the provisioning process. It is expected at a minimum that all loans that are 90 days in arrears are automatically subject to default procedures and the action to be taken in respect of these must be contained within the arrears policy. However there may be exceptions or circumstances where certain types of lending require a more conservative approach and procedures in respect of these should be documented.

The arrears policy must also outline the procedures that should be followed in respect of accounts that fail to cover interest or where security has deteriorated in value and have become in breach of the original terms of approval. There must be clear procedures to follow should any of these events occur. This should also include details on

how both general/collective & specific/individual provisions are raised and calculated, by whom and when they should be reviewed.

The Arrears Policy should detail who has the authority to make / release provisions and the procedures that should be followed.

### 6.3 ***Monitoring & control of lending***

Appropriate monitoring must be undertaken to ensure the bank is protected at all times and that risks are identified and acted upon at the earliest opportunity. There should be clearly defined procedures to ensure that monitoring, reporting and controls are applied in line with the bank's policies, procedures and terms of sanction.

## 7. **Other**

### 7.1 ***Breaches***

An appropriate record of any breach should be maintained and brought to the attention of the Board / senior management in a timely manner.

### 7.2 ***Contingency or crisis planning***

A bank is expected to have a contingency plan which includes the recovery and operation of the credit risk functions in the event of it being unable to operate from its normal place of business.

## **Part 2 – Deposit takers operating in or from the Isle of Man which are incorporated outside the Isle of Man (“branches”)**

### **1. Rationale / Introduction**

- 1.1 Under the Rule Book, the Commission requires branches to have a policy in relation to credit risk, arrears and provisioning management. This may be part of Head Office policy, with local requirements taken into account.
- 1.2 Credit risk is one of the most important in terms of all banking risks and clear credit administration is a critical element in understanding the safety and soundness of a bank. It is important that banks have robust credit processes to ensure the risk of loss from the granting of credit is appropriately managed and controlled, and that customers of banks are also treated in a fair way. The default of a small number of important customers, or adverse factors affecting a particular segment of the business can generate large losses, potentially leading to insolvency (of the bank of which the branch is a part). The overall objective of the Commission is to identify key risk areas in line with the Basel Core Principles for Effective Banking Supervision, and to minimise threats to its Core Objectives of Supervision.
- 1.3 The Basel Core Principles for Effective Banking Supervision require a bank to have effective systems in place to identify, measure, monitor and control credit risk as part of an overall approach to risk management. This includes best practice as dictated by international standards and the requirements of group regulators. A branch would be part of such requirements.
- 1.4 Credit risk is a normal part of banking. However, where the amount of risk is excessive or where this is not properly monitored and controlled, it can produce a significant threat to a bank (in relation to business booked in the branch) and its earnings by fluctuations in net interest income and bad debt provisions (loan impairments). This in turn can affect the underlying value of a bank's assets.
- 1.5 Lending activities also generate substantial costs relating to administration, funding and bad debts all of which impact strongly on profitability. It is therefore important that in all circumstances processes for the granting, subsequent monitoring and any recovery procedures reflect the return received.

### **2. Overview of the Commission's Approach to Credit Risk**

- 2.1 The Commission expects every branch to have a comprehensive statement of its credit policy appropriate to the nature of its business. This may be part of the Head Office policy of the bank, with local requirements taken into account.

- 2.2 The Commission expects relevant managers of branches to have a clear understanding of the risks and ensure that appropriate controls and monitoring procedures are in place. It is also expected that credit risk officers have the experience, knowledge and background to exercise prudent judgement in assessing, approving and managing credit risks and that they are provided with the necessary training.
- 2.3 The Commission expects the branch to have a clear understanding of its exposure to concentrations of risk by (both economic & individual) customer and geographical sector, which may form part of concentration limits applied by the bank.
- 2.4 The branch should have access to appropriate management information to monitor and exercise control to mitigate risk. This should include a formal process for provisioning where bad and doubtful debts have been identified.
- 2.5 The Commission also expects banks to take into account the key findings from the Commission's on-site reviews conducted in 2010-2011 which are provided in **appendix 2**.

### **3. Credit Risk Management Policy**

The Commission requires branches to take reasonable steps to maintain appropriate systems for the management of credit risk and requires branches to have a formal credit policy (which can be part of the branch's head office policy taking into account local requirements). It is the responsibility of senior management to draw up the appropriate credit risk policy in the light of the particular circumstances of the branch. This should reflect the risk appetite of the bank of which the branch is a part. In larger organisations it is recognised that formal implementation of many aspects of the policy may be delegated to a separate Credit or Risk Committee with referral to ALCO (or equivalent), where appropriate. The credit policy should be reviewed regularly, at least annually.

The purpose of a credit policy is to provide a framework that enables growth and competitiveness whilst maintaining acceptable levels of risk.

The main points that need to be considered in drawing up a credit policy are given below:

#### **3.1 Key principles**

The credit policy should establish the key strategic aims including the attitude and sanctioning authorities in order to identify and manage, if applicable, any concentrations of risk. It should also set out the branch's attitude (which is likely to be driven by the bank of which it is a part) with regard to different types of lending, including geographical, economical or individual sectors.

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An important element in considering lending is the recognition of facilities provided to a group of related customers. There should be appropriate guidance within the credit policy regarding the recognition and sanctioning of such exposures. Definitions of counterparties/customers related to each other are provided in the Commission's guidance note on Large Exposures.

### 3.5 ***Parties connected to the bank – arm's length lending***

When conducting business with a party connected to the bank appropriate controls should be in place (at branch level) to ensure business is conducted on an "arm's length" basis. Definitions of parties connected to the bank are provided in the Commission's guidance note on Large Exposures.

### 3.6 ***Facility grading / credit ratings***

Facility grading or credit ratings are a useful tool in the assessment of a lending proposition and if used guidance should be provided within credit policy. These ratings should be reviewed on a regular basis, at least annually.

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### 3.12 ***Bonds, indemnities and guarantees – contingent liabilities***

Where such an undertaking is entered into on behalf of a customer the liability should carry the same considerations as any lending facility. There should also be clear guidelines on the nature of the liabilities the branch is prepared to enter into and under what circumstances.

### 3.13 ***Foreign exchange risk***

Where facilities have a potential foreign exchange risk this should be taken into consideration when reviewing/assessing any arrangement.

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## 4. **Introduced Business**

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This is particularly the case when the introducer has an interest, financial or otherwise, in the transaction and there must be a clear policy to deal with business of this nature to ensure that high standards are maintained. Introducer arrangements must be reviewed regularly, at least annually.

## **5. Procedures and Systems**

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### **5.2 Conflict of interest**

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### **5.3 Pricing**

Formal arrangements for the agreement for pricing of lending should be

in place. This should take into consideration the need to remain competitive within chosen markets and also reflect the maturity and risk of a proposition.

#### 5.4 ***Credit scoring***

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### 6. **Arrears and Provisioning**

The Commission requires that the branch shall have a policy on arrears and provisioning for bad and doubtful debts that is appropriate to the nature and scale of its business (which can be part of the branch's head office policy taking into account local requirements). Senior management are responsible for ensuring that internal reviews of those documented policies are performed periodically.

In the case of a branch senior management must approve the written policy and changes thereafter. This should be reviewed on a regular basis and at least annually to ensure it remains appropriate.

#### 6.1 ***Management information***

Management information systems should be able to identify any deteriorating position at an early stage. There should be detailed procedures on how these are dealt with which should include a timescale and follow up action.

#### 6.2 ***Arrears /Bad Debt provision***

There should be a clear definition of what are considered to be non-performing exposures and the provisioning process. It is expected at a minimum that all loans that are 90 days in arrears are automatically subject to default procedures and the action to be taken in respect of these must be contained within the arrears policy. However there may be exceptions or circumstances where certain types of lending require a more conservative approach and procedures in respect of these should be documented.

The arrears policy must also outline the procedures that should be followed in respect of accounts that fail to cover interest or where security has deteriorated in value and have become in breach of the original terms of approval. There must be clear procedures to follow should any of these events occur. This should also include details on how both general/collective & specific/individual provisions are raised and calculated, by whom and when they should be reviewed.

The Arrears Policy should detail who has the authority to make / release provisions and the procedures that should be followed.

### 6.3 ***Monitoring & control of lending***

Appropriate monitoring must be undertaken to ensure the branch is protected at all times and that risks are identified and acted upon at the earliest opportunity. There should be clearly defined procedures to ensure that monitoring, reporting and controls are applied in line with the policies, procedures and terms of sanction applicable to the branch.

## 7. **Other**

### 7.1 ***Breaches***

An appropriate record of any breach should be maintained and brought to the attention of senior management in a timely manner.

### 7.2 ***Contingency or crisis planning***

A branch is expected to have a contingency plan which includes the recovery and operation of the credit risk functions in the event of it being unable to operate from its normal place of business.

## Appendix I – Glossary

“**ALCO**” means an Asset and Liability Committee.

“**bank**” is the Isle of Man incorporated deposit taker (part 1), or the head office, or otherwise as applicable, of the branch (part 2).

“**branch**” means a branch in the Isle of Man of a deposit taker incorporated outside the Isle of Man.

“**large exposures capital base**” (“LECB”) is interpreted in accordance with the Rule Book. In addition to this, if there is any material alteration in the LECB during the year resulting from a change to tier 1 or tier 2 capital (e.g. through the payment of a dividend, interim profits verified by the auditor, an injection of subordinated debt or repayment of capital), the revised figure should also be agreed with the Commission.

## **Appendix 2 – Key findings from on-site reviews 2010-2011**

In 2010-2011 the Commission carried out themed on-site reviews of certain banks' credit risk management processes with a particular focus on the identification and management of problem loans, and the use of early warning indicators (for both individual and sector specific exposures). The on-site reviews did not include an assessment of the sanction process for new loans or the perfection of security.

### *Identification and reporting of arrears (including regulatory reporting)*

Banks did not always have the capability to maintain a full arrears database (or databases depending on number of systems used). The lack of robust arrears databases, although not impairing the actual identification and management of loans in arrears, resulted in the potential for incorrect information being reported in the prudential returns made to the Commission. This was particularly the case in the following situations:

- Where a bank used credit grades as a proxy for arrears information (for example a certain credit grade would link to the number of payments in arrears but this would not be the only factor that could determine such a grade).
- Where a bank analysed its book based on the date of the last payment missed, rather than the actual number of months in arrears (for example a loan might have accumulated 6 months of arrears but an ad hoc payment could have been received within the last month resulting in the loan being classified as less than 1 month in arrears for regulatory reporting purposes. In these cases the loan was still recognised as a problem debt).
- Where multiple systems were in place, including transferring loans to other parts of the group to manage.

### *Reporting to the board (and senior management for a branch)*

#### *Large exposures (concentration risk)*

Although it was observed that large loans (for example the top 10 or 20) were reported to boards, in some cases it was not evident to the reader of the credit information provided which of these loans were large exposures for regulatory purposes (exceeding 10% of a bank's capital resources). The Commission considers that it is important for boards to be made fully aware of the level of large exposures on a regular basis.

#### *Arrears (trends)*

Full information on arrears trends and positions by relevant segment was not always being reported to boards. Also, it was found that senior management of Isle of Man branches of overseas banks were not always receiving full information on the extent of arrears, and in some cases write offs / impairments, of parts of Isle of Man sited loan business, particularly where the

customer relationship was managed outside of the Isle of Man.

The Commission considers it is important that boards of Isle of Man incorporated banks and senior management of Isle of Man branches of overseas banks receive regular and full information on all relevant parts of the loan books in respect of arrears and impairments.

### Credit grading and information systems

All banks use a credit grading system in respect of identifying, managing and reporting problem / deteriorating loans. The grading systems used generally provided a range of ratings for a borrower from an early warning sign (e.g. an event or pattern of behaviour that may cause concern even though an account may not be out of order), to an account being classified as bad and doubtful.

### *Practice versus procedure*

During review of the credit grades of accounts it was established that the actual grading did not always appear to correspond to the expected grade as outlined in documented procedures. This was particularly the case for loans in the more advanced stages of being problematic (bad and doubtful).

For example, some banks' procedures effectively stated that a loan should be classified as bad and doubtful where the relationship with the borrower is such that the bank is reliant on the sale or realisation of its security for the recovery of the debt. It was however noticed that this classification was not always used in practice for such cases, mainly arising when the bank was satisfied that the security would be sufficient to enable the debt (and charges) to be fully extinguished. The grading of accounts could also impact on the impairment charge (*see impairment methodologies below*).

The Commission considers that banks' practices should match documented procedures, and that the credit grading of accounts should be reviewed on a regular basis (including across multiple systems – see below). The Commission does however acknowledge that in some cases procedures need to be reviewed as much as the practice adopted.

### *Early warning / problem loan databases*

From review and analysis of databases and records pertaining to problem loans (retail and corporate) the Commission identified some weaknesses / errors in information maintained (compared to core systems or loan strategy sheets). Some examples included:

- Differences in credit grades across systems / databases for a single borrower.
- Differences in information between individual strategy sheet data (e.g. value of security) and that held on a central database of problem loans.
- Differences in the facility amount held on the central database of problem loans versus actual (latest) facility granted.

The above issues arose from system constraints (some of which were known to management) and the manual nature of inputs into problem loan databases.

### Management of problem loans

In most cases it was evident that banks had adequate procedures and processes for dealing with problem loans, including appropriate segregation of functions. Banks generally utilised strategy sheets to keep track of developments and diarise actions, and used formal letters of demand when required, which can help in ensuring the customer communicates with the bank. The Commission considers the use of strategy sheets or equivalent to record actions and progress is good practice.

Different approaches were used when managing retail, mortgage and corporate loans. More complex cases were also often referred to specialist teams outside the Isle of Man.

The Commission also observed that loan books could be segmented and analysed in a number of ways and information on arrears levels, impairments and LTV could be provided for relevant portfolios (e.g. residential mortgages, personal loans, corporate loans etc).

### Impairment methodologies

Most banks had a well documented impairment methodology that linked through to the automated allocation of impairments to problem loans (with manual override capable of being made when required). Different levels of impairment would apply depending on the grading of the account, length of time in arrears and nature and value of security.

However, where impairments were automatically linked to the grading of loans, it was not always clear that the grading applied matched documented procedures, which in some cases could lead to an underestimation of impairments (*see also credit grading and information systems above*). The impairments applied to more complex corporate arrangements would often be assessed separately.

In relation to the assessment of security in determining the level of impairment it was evident that most banks applied discount factors (depending on the type of security) to the last valuation held (some banks also utilised indexation). If a property was on the market at a sale price, that would however also be taken into account.

The Commission encourages the use of a clear documented impairment methodology that takes into account the severity of the problem (including length of time in arrears) and nature and (discounted) value of the security. Impairments applied to loans, including cases which are problems loans where no impairment has been applied, should be reviewed regularly by management.

### Interest only mortgages (including re-financing and collateral values)

#### *Consumer protection: disclosure*

The matter of the provision of interest only mortgages being provided for the purchase or refinancing of residential property (whether for owner occupied or rented property) has been researched and commented upon in some detail in the United Kingdom. From a consumer protection perspective the Commission focused on how banks' standard letters and facilities were worded, and how explicit they were in informing the borrower of the risks involved.

The Commission found that mortgage offer letters (and similar documentation) issued to customers contained warnings regarding the adequacy of the repayment vehicle which will ultimately repay the loan and that the capital will be outstanding at the end of the loan period. However, in some cases the warnings were not sufficiently upfront or explicit within the documentation. Examples of good practice seen, with information provided explicitly and upfront, including the following:-

- A requirement for a customer to explicitly state in writing how they intend to repay the mortgage loan capital (sum borrowed) at the end of (or during) the term of loan.
- A standard paragraph covering confirmation that the customer understands the following:-
  - That repayments to an interest only loan only cover the interest charged and do not reduce the capital.
  - That the responsibility to check the performance or value of an investment vehicle, endowment, pension plan or any other form of repayment is theirs.
  - That they fully understand that their home will be at risk if they fail to have sufficient funds to repay the capital sum at the end of the mortgage term, which could result in them having to sell their home to repay the mortgage.

The Commission considers it is important that warnings such as the above are explicit and are not hidden within documentation, especially where such mortgages are provided on a non advised basis.

The Commission also examined banks' policies in relation to the provision of such loans now. It was evident that sole reliance on the security as a means of repayment is no longer considered acceptable practice.

#### *Managing back books*

Some banks have material interest only portfolios where the terms of the mortgage expire within the shorter term. Due to past practices the repayment of the capital amount was also partly or mostly due to be made from the sale of the property mortgaged, or another property within a customer's portfolio.

There is the potential that banks face situations where performing mortgages become non-performing upon expiry of the term and that the value of security has dropped below the loan outstanding.

The Commission observed that banks were cognisant of the above risks and were taking steps to manage these and also contact customers at appropriate times. Analysis of potential security shortfalls were also made or being made. In some cases the strategy required to deal with the risks needed to be completed and relevant information reported to the appropriate level within the business, including where applicable to the board.

*Repossessions of owner occupied properties*

It was evident from discussions and a review of cases that banks would only repossess a property owned and occupied by an individual when all other avenues had been completely exhausted. This follows the general principles of forbearance that have been promulgated in the United Kingdom.