Consultation Paper 2:
Changes to CBB Rulebook Module CM Concerning the Credit Grading/Classification System

CM-2.1 Overview

CM-2.1.1 A realistic assessment of credit quality is an essential feature of effective credit risk management. The starting point for a systematic review of credit quality is a comprehensive review of the bank's written credit policies and practices. These include, but are not limited to:

(a) Credit approval procedures;
(b) Credit assessment criteria; and
(c) Credit administration processes.

CM-2.1.2 Credit quality is a relative concept based on performance prospects and external variables. Trends in the economy and changes in markets and prices of goods affect the evaluation of loan repayment value. Assessing credit risk is a dynamic concept which needs to take into account the business cycle and the economic environment.

CM-2.1.3 The objectives of the credit assessment are to determine:

(a) Whether the applicant/customer will have sufficient future liquid resources to honour credit obligations according to the agreed terms;
(b) Whether the applicant's/customer's present and future prospects indicate that they will continue as a going concern in the foreseeable future;
(c) Is the applicant / customer of sufficient integrity; and
(d) To what extent does any collateral offered affect the risk inherent in the facility.

CM-2.1.4 To help improve prudential oversight of credit quality, the CBB, in this Module, seeks to establish a set of broad rules that are useful in identifying and containing the impact of non-performing credit facilities within banks.

CM-2.2 Credit Grading System

CM-2.2.1 **Banks must have in place appropriate credit grading systems (sometimes referred to as credit classification systems) to help assess the quality of credit facilities. The Rules and guidance in this Section (and CM-3) must be applied to the foreign branches and subsidiaries of locally incorporated banks. Where host supervisory rules are more stringent than these requirements, then the most stringent of the applicable standards must be followed. Branches of foreign retail banks in Bahrain must follow these requirements for credit facilities booked in Bahrain only. There is further guidance for branches of foreign banks in Bahrain in Chapter CM-4.**

CM-2.2.1A For the purpose of this Chapter, a credit facility is the outstanding amount of money advanced by a bank to a customer which is repayable on demand or by instalment, shown on the balance sheet of the bank. A credit facility is therefore narrower in its scope than the term "Providing Credit" which is used in Module LR to describe a regulated service.

CM-2.2.2 Credit grading systems offer a number of benefits. Analysis of a bank's entire book can reveal important insights to bank's management in the functioning and ultimately the health of the bank. Credit grading systems provide the means for a more systematic assessment of asset quality. They are particularly useful in assisting in the early detection of asset quality problems within a bank by highlighting non-performing facilities and exposures with above normal risks.

CM-2.2.3 **All locally incorporated banks and all retail branches of foreign banks e are hence required to provide to the CBB a statement of their policy in respect of its credit grading system (including definitions used to classify credit facilities) taking into account the requirements in this Module. The credit grading system to be used by a locally incorporated bank and all its subsidiaries and foreign branches must be approved by its Board. In the case of wholesale and retail branches of foreign banks licensed in Bahrain, the branch must provide its statement of its credit grading system as approved by its head office.**

CM-2.2 Credit Grading System (continued)

CM-2.2.4

All locally incorporated banks and all retail branches of foreign banks must consider the following points in their credit grading systems:

(a) The system should cover a broad range of the bank's credit portfolio, including off-balance sheet exposures;

(b) The system must cover performing, overdue, non-performing and impaired credit facilities;

(c) Banks must develop procedures for the determination and regular review of the credit risk grades;

(d) Banks must establish formal forums in the form of committees to review the compliance with the credit policy parameters and the concentration of exposure attributable to various economic and industrial sectors in accordance with the credit policy;

(e) Particular attention must be given to those credit facilities which are non-performing, or which are impaired (in some other way); and

(f) It is imperative that the policies relating to provisioning be clearly documented.

CM-2.2.5

Credit facilities must be classified by banks on an ongoing basis. The classification framework must, at a minimum, include the categories listed below for locally incorporated banks and retail branches of foreign banks. Banks are free to classify a credit facility in a category which requires a higher level of provisioning if the bank has information which gives doubt as to the collectability of the facility, even if the concerned credit facility is performing. These standards should also be applied in the case of the suspension of interest and the classification of other non-financing receivables (e.g. fees):

(a) 'Standard facilities' are those, which are 'performing' as the contract requires. These facilities are not past due and there is no reason to suspect that the customer's (or counterparty's) financial condition or the adequacy of collateral has deteriorated in any way.

CM-2.2 Credit Grading System (continued)

(b) Watch-list facilities' are those which show some weaknesses in the customer's (or counterparty's) financial condition or creditworthiness, requiring more than normal attention but not necessarily requiring the allocation of specific provisions (or impairment allowances). 'Watch' could include 'performing' facilities which are not regular in repayment or are regular but there is minor deterioration in the financial position of the customer or counterparty or the underlying collateral. 'Watch' must include any facilities which are less than 90 days overdue and which are not (yet) included in 'sub-standard', 'doubtful' or 'loss' (i.e. the facility can be regarded as overdue but not yet 'impaired' according to IFRS).

(c) 'Sub-standard facilities' are those where interest or principal is 90 days or more overdue (see paragraph CM-2.2.6 for minimum required provisioning levels). 'Sub-standard facilities' also inlude those where full repayment (collectability) is in doubt due to inadequate protection by the impaired paying capacity of the customer (or counterparty) or by impairment of the collateral pledged. Sub-standard facilities are characterised by the distinct possibility of loss if observed weaknesses are not corrected and may therefore be viewed as, 'impaired' or non-performing. Sub-standard may therefore include facilities that are not yet overdue, or are less than 90 days overdue.

(d) 'Doubtful facilities' are those where interest or principal is 180 days or more overdue (see paragraph CM-2.2.6 for minimum required provisioning levels). 'Doubtful facilities" have all the weaknesses inherent in a facility classified as 'substandard' with the added characteristic that observed weaknesses make full collection (or liquidation), on the bases of currently existing facts and valuations highly questionable or improbable. The probability of loss is extremely high, but total loss may not necessarily occur because some pending factors may strengthen the asset quality.

(e) 'Loss facilities' are those where interest or principal is 360 days or more overdue (see paragraph CM 2.2.6 for minimum required provisioning levels). 'Loss facilities' are considered uncollectible or of such little value that their continuance at any material value is not warranted. The category 'loss' means that it is not considered practical or desirable to give a positive valuation to this facility, even though partial recovery may be effected in the future.

CM-2.2 Credit Grading System (continued)

CM-2.2.5A The requirements in paragraph CM-2.2.5 apply at the facility level and not at customer level. It is therefore possible that for a given customer there may be some facilities that are 'performing' and some which are 'non-performing'. However, banks must take into account the non-performing nature of a facility and decide whether to extend provisioning to all facilities. This is particularly relevant in the case of cross-default clauses or if an obligor has announced a standstill of payments.

CM-2.2.6 **The following categories of credit facilities are defined as "Non-performing". All locally incorporated banks and all retail branches of foreign banks must apply the higher of the minimum specific provision levels outlined below or the amount of allowance required by IFRS against the book value of such credit facilities. Banks are therefore allowed to apply higher provisioning levels for substandard and doubtful as they wish.**

Substandard	**:**	**20%**
Doubtful	**:**	**50%**
Loss	**:**	**100%**

In addition to the above minimum provisioning levels for non-performing credit facilities, All locally incorporated banks and all retail branches of foreign banks must make a general provision for Standard and Watch Classification (i.e. 'performing') credit facilities equal to 1.0% of the book value of such facilities (i.e. the net book value). Performing credit facilities to GCC central government entities and to GCC governments wholly owned Public Sector Entities that do not operate on a commercial basis , or credit facilities guaranteed by GCC central governments, or credit facilities secured by cash collateral do not require the above general provision of 1.0%.

CM-2.2.7 **Cash,GCC Central Government securities and debt securities listed on a recognized exchange which are rated at least BBB- may be recognized as collateral and allowed to be offset against the value of the credit facility for specific provisioning purposes. The haircuts to be used are shown in Section CA-4.3 of the Rulebook. Real estate may be offset against the value of a credit facility for the purpose of calculating specific provisions in certain cases as outlined in paragraph CM-2.2.8.**

CM-2.2 Credit Grading System (continued)

CM-2.2.8 Certain commercial real estate may be recognized as collateral and allowed to be offset against the value of a credit facility for specific provisioning purposes when the valuation has been carried out by a member of the Royal Institute of Chartered Surveyors in accordance with RICS "Red Book" Valuation Standards. Generally, only completed and occupied real estate may be recognized. Only the net realizable land value may be recognized for partially or uncompleted projects. To be valid on an ongoing basis, the valuation must be carried out at least annually. In the case of real estate which is valued in excess of BD 1 million, a minimum of two valuations from two separate valuers are required per annum (the bank should take the average of the two). A 'haircut' of 30% will be applied to all valuations to arrive at the value to be allowed against the outstanding credit facility.

CM-2.2.8A For residential real estate, if the bank can justify foreclosure or repossession for a claim and obtain a satisfactory legal opinion that foreclosure or repossession is possible without any impediment, such real estate may be recognized as collateral and allowed to be offset against the value of a credit facility for specific provisioning purposes subject to the additional requirements mentioned in CM-2.2.8 above.

CM-2.2A Treatment of Interest in Suspense and Provisioning

Non-accrual of interest income

CM-2.2A.1

All locally incorporated banks and all retail branches of foreign banks are required to place on a non-accrual basis any facility where there is reasonable doubt about the collectability of the receivable irrespective of whether the facility is overdue or not. All accrued interest for non-accrual assets identified in CM-2.2A.2 below must be credited to a special account in the bank's records under the name 'interest in suspense account' and not to the profit and loss account, and any interest amount that was recognized as income previously but not received for such accounts must be provided against.

CM-2.2A.2

For the purpose of this Module, The following 'non-performing' categories of credit facilities must be considered as non-accrual items for locally incorporated banks and retail branches of foreign banks :

(a) Substandard;
(b) Doubtful; and
(c) Loss.

CM-2.2A.3

In the case of credit card balances and overdrafts, interest must be put into suspense where:

(a)
(b) When the outstanding amount has been in excess of the agreed upon limit for more than 90 days; and
(c) Where a current account is overdrawn and there is no sanctioned overdraft facility.

CM-2.2A.4

Also banks are not allowed to capitalise interest on overdrafts or credit card balances, or to provide a new credit facility to artificially show that an overdraft or credit card facility is performing.

CM-2.2A Treatment of Interest in Suspense and Provisioning (continued)

Treatment of Restructured/ Rescheduled Facilities and Facilities which cease to be Non-performing

CM-2.2A.5 **Any credit facility where principal or interest is 90 days or more overdue must be categorised as 'non-performing'. A facility becomes overdue from the first date that interest or principal is not received.**

CM-2.2A.6 Once a borrower misses a scheduled instalment, his credit becomes irregular/overdue. Any subsequent repayment/instalment made after the default shall be adjusted against the unpaid instalments or arrears. The credit facility will continue to remain in default until all its overdue amount along with the current instalment are paid in full. Therefore, if an instalment is missed on 1st March 2010, the credit facility will become 30 days overdue by 1st April 2010. Subsequently, if a payment is made on 1st April 2010 it should be adjusted against the overdue of March 2010, while instalment for April 2010 will remain unpaid. Similarly, repayment received in May 2010 shall be adjusted against the arrears of April 2010 while instalment for May 2010 will remain unpaid. In this instance, the facility will become up to date only after all the arrears along with current instalment is paid in full. Such facilities must always remain at least at 'watch' category until brought back up to date.

CM-2.2A.7 **A non-performing credit facility must not be considered 'performing' again until all arrears on interest and principal have been repaid in full and due instalments/payments have been paid for a period of at least one year after such arrears have been repaid. If a non-performing credit facility has been formally rescheduled/ restructured, then payments must have been made on a timely basis for at least one year since the date of rescheduling/ restructuring before it may be considered 'performing'.**

CM-2.2A.8 Therefore if an instalment is missed on 1st March 2010, and the credit facility is formally rescheduled/ restructured starting 1st July, then the rescheduled/ restructured credit facility must be performing and repaid on time as per the rescheduling/ restructuring arrangement for a period of at least 12 months from 1st July before it may be considered as 'standard' or 'watch' again. The rescheduled/ restructured credit facility will remain for 12 months in its last NPL category at the time of rescheduling/ restructuring but will not be required to be further downgraded unless further non-payments occur.

CM-2.3 Collateral

CM-2.3.1 **The extension of credit is often supported by collateral provided by the customer or third parties. When a credit facility includes collateral, independent timely appraisals of the collateral must be obtained by the bank. In the case of a credit facility supported by a guarantee, an assessment of the guarantor must be made by the bank on at least an annual basis.**

CM-2.3.2 In principle, collateral can improve the credit grading of a customer, but experience suggests that over-reliance on collateral is unsound because very often when a credit facility goes sour the collateral turns out to have less value than estimated or is, at worst, illusory.

CM-2.3.3 Misjudgements about collectability are frequently the cause; collateral is often illiquid, difficult to value during periods of financial distress and costly to realise through foreclosure or other legal means. Particular concern may be appropriate in the case of collateral in the form of real estate, as it involves additional uncertainties and the costs of maintaining the property.

CM-2.3.4 As a matter of principle, collateral should not replace a careful assessment of the borrower's ability to repay.

CM-4.1 [This Section was deleted in January 2012].

CM-4.2 [This Section was deleted in January 2012].

CM-4.3 Provisioning Policies of Branches of Foreign Banks in Bahrain

Retail branches of foreign banks

CM-4.3.1 Retail branches of foreign banks in Bahrain are required to follow the requirements of Chapter CM-2 of this Module with regard to the making and maintaining of provisions against non-performing credit facilities in their books in Bahrain.

CM-4.3.2 Specific provisions for the non-performing credit facilities (as well as any other non-performing assets) of retail branch(es) of foreign banks in Bahrain are expected to be maintained in the books of Bahrain branch(es).

Wholesale branches of foreign banks

CM-4.3.3 Wholesale branches of foreign banks are required to follow the grading system outlined in paragraph CM-2.2.5 and report their facilities accordingly but will be allowed to follow their head office policies and procedures in respect of provisioning unless directed specifically by the CBB to do otherwise. Wholesale branches must also observe the requirements of paragraph CM-2.2.3. Therefore the other requirements of Chapter 2 are not obligatory but reflect the CBB's view of what is best practice.

CM-4.4 Provisions against Sovereign Debt

CM-4.4.1 The CBB has consistently encouraged banks to maintain adequate provisions against credit facilities to borrowers experiencing difficulties and against credit facilities for countries with current or potential debt servicing difficulties.

CM-4.4.2 In all cases the assessment of credit facilities – and decisions regarding adequate provisions – are assisted by the categorization of credit facilities as defined by the CBB in Section CM-2.2. In addition, with regard to 'sovereign debt' it is particularly important that the size of the provisions made should be based on the identification and objective assessment of the nature and extent of difficulties being experienced by particular countries and reflect as near as possible deterioration in the prospects for recovering debts. With these objectives in mind, the Sovereign Debt Provisioning Matrix (see Appendix CM-1) contains a list of measurements which have been designed to help identify those borrowers and countries with payment difficulties and to decide what would constitute adequate provisions.

CM-4.4.3 It is emphasized that this Section and the Sovereign Debt Provisioning Matrix (see Appendix CM-1) are merely a general framework for assessing degrees of provisions. They should not be regarded as an exhaustive or definitive framework. Nevertheless, the CBB does intend to include the results of banks' calculations in its discussions with them, and to establish that adequate provisions are being made.

Implications of International Accounting Standard (IAS) no. 39 on the Provisions Assessed through Sovereign Debt Provisioning Matrix

CM-4.4.4 **The banks must continue to apply the Sovereign Debt Provisioning Matrix (see Appendix CM-1) as a benchmark for estimating future recoverable cash receipts. However, if a lower provisioning amount is determined, i.e. lower than the amount identified through the matrix, and the bank intends to book the lower amount, then a meeting must be arranged with the CBB to discuss the issues before booking such provisions.**