Consultation Paper:
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 credit quality.**

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 **Each locally incorporated bank is hence required to provide to the CBB a statement of its policy in respect of its credit grading system (including definitions used to classify exposures) taking into account the requirements in this Module. The credit grading system must be approved by the Board of locally incorporated licensees. In the case of branches of foreign banks licensed in Bahrain, the branch must provide a statement of its credit grading system as set by its head office.**

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 asset portfolio, including off-balance sheet exposures;
(b) The system must cover performing, overdue, non-performing and impaired assets;
(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 facilities which are non-performing, or which are impaired (in some other way); and
(f) It is imperative that the policies relating to provisioning for should be clearly documented.

CM-2.2 Credit Grading System (continued)

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.

(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 regarding 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-3.2.7 for minimum required provisioning levels). 'Sub-standard facilities' also inludes 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.

CM-2.2 Credit Grading System (continued)

(d) 'Doubtful facilities' are those where interest or principal is 180 days or more overdue (see paragraph CM-3.2.7 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 3.2.7 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-2.2.6

The following categories of credit facilities are defined as "Non-performing". All retail bank licensees and all locally incorporated wholesale 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 must make a general provision for Standard and Watch Classification facilities (i.e. 'performing') and for the portion of non-performing credit facilities not covered by specific provisions equal to 1.0% of the book value of such facilities (i.e. the net book value). Credit facilities to GCC central government entities (including holdings of securities issued by GCC central governments) or credit facilities secured by GCC central government securities, 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 Credit Grading System (continued)

CM-2.2.7

Only cash or GCC Central Government securities may be recognized as collateral and allowed to be offset against the value of the credit facility for specific and general provisioning purposes. This means that other types of collateral such as real estate or equities may not be offset against the value of a credit facility for the purpose of calculating provisions.

CM-2.2A Treatment of Interest in Suspense and Provisioning

Non-accrual of interest income

CM-2.2A.1 All locally incorporated 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-3.3.3 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.

CM-2.2A.2 For the purpose of this Module, The following 'non-performing' categories of assets must be considered as non-accrual items for locally incorporated 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) Interest on other facilities has been put into suspense;
(b) When the outstanding amount has been in excess of the agreed upon limit for more than 90 days; and
(c) Where the 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 and 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 Therefore if an instalment is missed on 1st March 2010, but payment is made on 1st April 2010 (and the March instalment is not paid) then the credit facility will become over 90 days overdue by 1st June 2010, even if the April, May and June instalments are paid on time and in full, and a provision must be taken in respect of the overdue amount (but not necessarily the full outstanding amount of the credit facility if other payments were made on time).

CM-2.2A.7 **A non-performing 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 facility has been formally rescheduled or restructured, then payments must have been made on a timely basis for at least one year since the date of rescheduling or 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 starting 1st July, then it must be paid in full and on time for a period of at least 12 months from 1st July before it may be considered as 'standard' or 'watch' again.

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-3.1 Overview

CM-3.1.1 Credit culture is defined as the sum total of a bank's approach to managing credit risk, including business strategy, credit policy, shared assumptions about credit, the effectiveness of communications, and the composition and quality of the resulting loan portfolio.

CM-3.1.2 As a matter of best practice, all banks should periodically review their credit cultures in order to reduce future credit losses and also to minimise reputational risk and damage to their credit ratings.

CM-3.1.3 The CBB draws all licensed banks' attention to the September 2000 document issued by the Basel Committee entitled 'Principles for the Management of Credit Risk'. This document contains 17 principles which all banks should ensure are covered in their credit culture (i.e. policies, procedures, systems and controls) (see www.bis.org/publ/bcbs75.pdf).

CM-3.1.4 Effective from the date of the original circular (see Section CM-A.3), the CBB will use the Basel document mentioned above as a guideline in its evaluation of the credit cultures of banks operating in Bahrain. Evaluation will be implemented through prudential meetings, inspection and reviews by appointed experts.

CM-3.2 Elements of a Strong Credit Culture

CM-3.2.1 First, this Section is recommendatory in nature (except for the requirement in Paragraphs CM-3.2.2 (a) & (e) below), and the guidelines below under the five headings are indicative of best practice. Some of the guidelines may not be appropriate to all licensees. However, if a bank is not following these guidelines, it should consider why it is not doing so.

CM-3.2.2 Secondly, this Section is intended as a complement to the September 2000 Paper by the Basel Committee entitled 'Principles for the Management of Credit Risk' (see Section CM-B.2). This Section does not summarise the Basel Paper, but is intended to be read in conjunction with the above Paper.

(a) The Role of the Board of Directors

The Board of Directors must approve all the operating policies of a bank (see principle 1 of Basel Committee paper, 'Framework for Internal Control Systems in Banking Organisations' – Section CM-B.2).

Given that credit risk is still the major risk that banks are exposed to in their business, particular scrutiny must be paid to credit policies, in terms of various limits as well as in terms of risk strategy. An essential function of the Board is to review and reassess the credit policies of the bank (including collateral, provisioning policies and concentration policies) on a periodic basis. The Board should also regularly review overdue and large facilities both in terms of performance, and also in relation to the capital (base) of the bank. The Board should insist upon periodic review/evaluation of internal systems and control weaknesses identified by external/internal auditors and management. Principle 1 of the Basel Committee paper 'Principles for the Management of Credit Risk' (see Section CM-B.2) also gives greater detail on the role of the Board in developing a sound credit culture.

CM-3.2 Elements of a Strong Credit Culture (continued)

(b) **The Role of the senior management**
Senior Management should be involved in regular reviews of outstanding facilities and overdue accounts as well as reviewing changes in activity, turnover or balances in clients' accounts. The role of senior management is covered in depth in Principle 2 of Basel Committee paper 'Principles for the Management of Credit Risk' – Section CM-B.2 (see also Principle 3 of Basel Committee paper 'Framework for Internal Controls Systems in Banking Organisations' – Section CM-B.2). However, Senior Management should be involved in the credit review process of (larger) existing facilities, visiting clients, requesting up to date financial statements and verifying collateral. Too often, a lack of direct contact by senior management with a problem client has been an identified factor in significant credit losses by banks, whether by way of fraud, or corporate failure.

(c) **Role of an Independent Risk Management Function**
Perhaps the key point to emphasise in Risk Management is that the function must be independent of the senior management and operational functions which are related to business acquisition. The Risk Management function should report to the Board or to senior management related to control functions. The Risk Management function must not only monitor risk, but also control it (i.e. review limits, excesses etc). It must also ensure that risk monitoring systems accurately measure risk in the first place, and that all risks where they occur are correctly identified (see also Principle 6 of Basel Committee paper, 'Framework for Internal Controls Systems in Banking Organisations' ' – Section CM-B.2).

(d) **Effective Internal Systems and Controls**
Well implemented sound policies and procedures maintain credit standards, enable monitoring and control of credit risk, and identify problem credits in a timely manner (see Principle 2 of Basel Committee paper 'Principles for the Management of Credit Risk' – Section CM-B.2 for more detail). Sound policy and administrative requirements also apply equally strongly to existing facilities as well as new ones (see Principle 8 of Basel Committee paper 'Principles for the Management of Credit Risk' – Section CM-B.2). Policies and procedures should allow a thorough understanding of the counterparty, the purpose of the credit facility and the source of repayment (Principle 4 of Basel Committee paper 'Principles for the Management of Credit Risk' – Section CM-B.2) to be gained by the Risk Management function in its assessment of the counterparty for risk profiling purposes, (see also Principle 6 of Basel Committee paper 'Framework for Internal Controls Systems in Banking Organisations' – Section CM-B.2 and Section E of the paper issued by the Counterparty Risk Management Policy Group - 'Improving Counterparty Risk Management' – see Section CM-B.2). Banks should seek to utilise internal rating systems to manage credit risk and to set adequate provisions on a timely basis (see Principle 10 of Basel Committee paper 'Framework for Internal Controls Systems in Banking Organisations' – Section CM-B.2 and also the Credit Ratings in Section CM-2.2).

CM-3.2 Elements of a Strong Credit Culture (continued)

(e) **The Role of Internal Audit**

The internal audit function must, on an on-going basis, monitor the system of internal controls because it provides an independent assessment of the adequacy of, and compliance with, the established policies and procedures. The internal audit function must report directly to the highest levels of the banking organisation, typically the Board of Directors or its audit committee, and to senior management. This allows for the proper functioning of corporate governance by giving the Board information that is not biased in any way by the levels of management that the reports cover.

CM-3.3 Name-lending

CM-3.3.1 Banks are exposed to credit risk when they provide large credit facilities on a 'clean' basis (i.e. without collateral or security). This risk is amplified, specifically, when such clean lending is made without adequate (up to date) financial information.

CM-3.3.2 In many banks there is a tendency to indulge in 'name-lending' without any credit analysis or understanding of the concerned counterparty's current borrowings from other banks. The CBB strongly discourages the banks to engage in such activities in order to minimise their credit risk and reputational risk.

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 2 of this Module where indicated with regard to the making and maintaining of provisions against non-performing debts in their books in Bahrain.

All branches of foreign banks

CM-4.3.2

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

CM-4.3.3

If the bank is not able to meet this requirement in Paragraph CM-4.3.2 above, then the bank's head office must advise the CBB, on an annual basis and in writing, of the amount of provisions set aside for the Bahrain branch(es)'s non-performing debts (and any other non-performing assets).

CM-4.3.4

In addition, the CBB may contact the bank's parent supervisor, on a regular or ad hoc basis, in order to obtain information about the adequacy of the provisioning for such assets.

Wholesale branches of foreign banks

CM-4.3.5

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 [This Section was deleted in January 2012].