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

CM-3.1 Overview

CM-3.1.1 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 process.

CM-3.1.2 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 credit facility repayment value. Assessing credit risk is a dynamic concept which needs to take into account the business cycle and the economic environment.

CM-3.1.3 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-3.1.4 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-3.2 Credit Grading System

CM-3.2.1 **Banks must have in place appropriate credit grading systems (sometimes referred to as credit classification systems) to help assess credit quality.**

CM-3.2.2 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-3.2.3 **[This paragraph has been deleted.]**

CM-3.2.4 **Each 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 the licensee.**

CM-3.2.5 **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 facilities funded by unrestricted investment accounts, restricted investment accounts and other off-balance sheet exposures;

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

CM-3.2 Credit Grading System (continued)

(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 the provisioning for Islamic banks should be clearly laid down, fully identifying provisions relating to assets financed by own funds and those by the investment account holders.

CM-3.2.6

Credit facilities must be classified by banks on an ongoing basis. The classification framework must, at a minimum, include the categories listed below. 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 profit 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-3.2 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 regarding as overdue but not yet 'impaired' according to IFRS).

(c) 'Sub-standard facilities' are those where profit 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.

(d) 'Doubtful facilities' are those where profit 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 profit 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-3.2 Credit Grading System (continued)

CM-3.2.7

The following categories of credit facilities are defined as "Non-performing". Banks must apply the higher of the minimum specific provision levels outlined below or the amount of allowance required by IFRS or AAOIFI accounting standards 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, 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-3.2.8

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-3.3 Treatment of Profit in Suspense and Provisioning

Non-accrual of profit income

CM-3.3.1

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 profit 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 'profit in suspense account' and not to the profit and loss account.

CM-3.3.2

[This paragraph has been deleted.]

CM-3.3.3

For the purpose of this Module, The following 'non-performing' categories of assets must be considered as non-accrual items:

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

CM-3.3.4

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

(a) Profit 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-3.3.4A

Also banks are not allowed to capitalise profit 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-3.3 Treatment of Profit in Suspense and Provisioning (continued)

Treatment of Restructured and Rescheduled Facilities and Facilities Which Cease to be Non-performing

CM-3.3.5 **Any credit facility where principal or profit is 90 days or more overdue must be categorised as 'non-performing'. A facility becomes overdue from the first date that profit or principal is not received.**

CM-3.3.6 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-3.3.7 **A non-performing facility must not be considered 'performing' again until all arrears on profit 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-3.3.8 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-3.3.9 **Provisioning should be carried in the respective books including bank's own books, unrestricted investment account holders' books and restricted investment account holders' books.**

CM-3.3.10 [This paragraph has been deleted.]

CM-3.3.11 **The policy for provisioning should clearly contain provisions for segregating provisions relating to assets financed by own funds and those financed by investment account holders. In devising the policy, reference should be made to the Mudaraba contract.**

CM-3.3.12 [This paragraph has been deleted.]

CM-3.4 Provisions Against Sovereign Credit

[This section has been deleted as a result of the modifications to other parts of this Chapter.]

CM-3.5 Collateral

CM-3.5.1 **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-3.5.2 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-3.5.3 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-3.5.4 As a matter of principle, collateral should not replace a careful assessment of the borrower's ability to repay.

CM-3.6 Provisioning Policies of Branches of Foreign Banks in Bahrain

Retail branches of foreign banks

CM-3.6.1 Retail branches of foreign banks in Bahrain are required to follow the requirements of Chapter 3 of this Module where indicated with regard to the making and maintaining of provisions against non-performing credit facilities in their books in Bahrain.

All branches of foreign banks

CM-3.6.2 Specific provisions for the non-performing credit facilities (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-3.6.3 If the bank is not able to meet this requirement in Paragraph CM-3.6.2 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 credit facilities (and any other non-performing assets).

CM-3.6.4 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-3.6.5 Wholesale branches of foreign banks are required to follow the grading system outlined in paragraph CM-3.2.6 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-3.2.4. Therefore the other requirements of Chapter 3 are not obligatory but reflect the CBB's view of what is best practice.