PALAU FINANCIAL S**ERVICES AUTHORITY**

PRUDENTIAL REGULATION
PFSA-PR-02

ASSET CLASSIFICATION, PROVISIONING AND SUSPENSION OF INTEREST

Arrangement of Paragraphs

PART I: PRELIMINARY

1: **<u>Short Title</u>** – Asset classification and provisioning.

2: **<u>Authorization</u>** – The Financial Services Authority (the Commission) of the Republic of Palau (Palau) is authorized to promulgate regulations under Sections 12 and 80 of the Financial Institutions Act of 2001 (the Act) as amended. In addition, Section 54 of the Act provides that the Commission may establish specific requirements concerning classification and evaluation of assets, provisions to be made on the basis of such classification, and non-performing criteria.

3: **Application –** This regulation applies to all Palau banks and the branches of foreign banks licensed by the Commission to conduct financial activities in Palau (hereafter collectively referred to as a "bank").

4: **<u>Definitions</u> –** Terms used within this regulation are as defined in the Act, as defined below, or as reasonably implied by contextual usage:

1) **"capitalized interest" –** means any accrued and uncollected interest which has been added to the principal balance at a payment date or maturity; it also includes unpaid interest which is refinanced or rolled-over into a new loan; for purposes of this regulation, capitalization of interest will not be permitted unless:

a) the borrower has the ability to repay the entire debt (including both principal and interest) in the normal course of business;
b) the capitalization of interest was anticipated when the loan was originally made based on the borrower's planned temporary lack of cash flow;
c) the debt is well-secured by the net realizable value of collateral security;
d) repayment, including all capitalized interest, is based on a reasonably ascertainable future event; and
e) the borrower can obtain funds from other sources at similar rates and terms.

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

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

3) **"in the process of collection" –** means that collection of a debt is proceeding in due course in a timely manner either through:

a) legal action, including the enforcement of a judgment against the borrower; or
b) by collection efforts not involving legal action but which are reasonably expected to result in full repayment of the debt (including principal and all accrued interest) within 180 days, or in restoration of the debt to a current status through payment of all principal and interest which is due.

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

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

6) **“non-accrual”** – means that accrual of interest has been suspended and an asset has been placed on a cash basis for financial reporting purposes. Interest is no longer accrued on the books of the bank nor is it taken into income unless paid by the borrower in cash or otherwise provided in this regulation. Non-accrual assets include all assets which are non-performing unless an asset is both (i) well-secured and (ii) in the process of collection.

7) **“non-performing”** – means that an asset is no longer generating income. For purposes of this prudential regulation, the entire outstanding balance of an asset is considered non-performing when:
a) any portion of principal or interest is due and unpaid for 90 days or more; or
b) interest payments for 90 days or more have been capitalized, re-financed, or rolled-over into a new loan.

Overdrafts and other loans not having pre-established repayment programs are considered non-performing when any of the following conditions exist:
a) the debt exceeds the approved limit for 90 consecutive days or more;
b) the borrowing line has expired for 90 days or more;
c) interest is due and unpaid for 90 days or more; or
d) the account has been inactive for 90 days, or deposits have been insufficient to cover the interest that was capitalized during the period.

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

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

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

c) interest is due and unpaid for 30 days or more; or
d) the account has been inactive for 30 days, or deposits have been insufficient to cover the interest capitalized during the period.

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

9) **"provisions for loan losses" –** also referred to as "allowance for loan and lease losses"; means a balance sheet valuation account established through charges to provisions expense in the profit-and-loss statement and against which bad loans, or portions thereof, are written-off.

10) **"well-secured" –** means that a loan is secured by:
a) collateral that can repay the full debt (principal plus accrued interest) through timely sale under an involuntary liquidation program; also, (i) proper legal documentation must be held, (ii) the collateral must have a "net realizable value" which covers principal, accrued interest, and costs of collection, and (iii) there can be no prior liens which prevent the bank from obtaining clear title; or
b) a guarantee from a financially responsible party where the beneficiary bank has performed proper financial analysis and determined that the guarantor is financially sound, well-capitalized, and able to honor the guaranty on demand; such guarantees must be (i) irrevocable and unconditional, (ii) payable on default of the borrower, and (iii) independently confirmed by the guarantor.

PART II: STATEMENT OF POLICY

1: **Purpose** – This regulation establishes uniform regulations to be followed by banks to ensure that: (i) loans are regularly evaluated using an objective grading system that is consistent with regulatory requirements; (ii) the accounting treatment for non-performing assets is consistent with recognized accounting regulations and regulatory reporting requirements; and (iii) timely and adequate provisions are made and write-offs taken to reflect accurately the capital and earnings performance of the bank. It is also intended to encourage the development of effective work-out plans for problem assets and effective internal controls to manage such assets.

2: **Scope** – This regulation applies to all loans and advances carried on or off the balance sheet of a bank.

A Palau foreign bank branch, with the prior written approval of the Commission, may use and follow the policies and procedures adopted by the foreign bank's board of directors for the classification (grading) of loans and maintenance of provisions for loan losses provided (i) the deposits of the foreign bank, including the deposits of the Palau foreign bank branch are insured in accordance with a government sponsored depository insurance program, and (ii) the policies and procedures for the classification (grading) of loans and the maintenance of provisions for loan losses comply in all material respects with the requirements of the foreign bank's home country supervisory authority and those of its deposit insurer.

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

PART III: IMPLEMENTATION AND SPECIFIC REQUIREMENTS

1: **Loan Review - (a) Frequency and reporting.** The board of directors shall cause a review to be made of the quality of its loans and advances on a regular basis, at least at the end of each calendar quarter. Reports of such reviews shall be made on a timely basis directly to the board of directors and shall include enough information for the board to identify problems and require bank officers to promptly correct the problems.

(b) Objectives. The loan review function shall ensure that: (i) the loan portfolio and lending function conform to a sound, written lending policy which has been adopted and approved by the board of directors; (ii) executive management and the board of directors are adequately informed regarding portfolio risk; (iii) problem credits are identified, classified, and placed on non-accrual in accordance with this regulation; (iv) fully adequate provisions are made to the provisions account; and v) write-offs of identified losses are taken promptly.

(c) Review. At a minimum, the following loans or classes of loans shall be reviewed on a schedule that is sufficiently regular to ensure timely and accurate identification and reporting: (i) credits that exceed 10% of capital; (ii) credits that are or should be shown as non-accrual or non-performing under this regulation; (iii) a sampling of all other loans as appropriate to reach valid conclusions about the condition of the loan portfolio and the adequacy of loan loss provisions; and loans previously classified Doubtful either by the bank's internal loan review program, the Commission, or the bank's home country supervisory authority.

2: **Suspension of Interest - (a) Transfer to non-accrual status.** A loan is to be placed on non-accrual if: (i) it is maintained on a cash basis because of deterioration in the financial condition or paying ability of the borrower; (ii) payment in full of principal or interest is not expected; or (iii) it is non-performing unless it is both well-secured and in the process of collection as defined in this regulation.

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

Interest which has already been taken into profits and capitalized by increasing the principal balance of the loan shall be reversed from when the loan is, or should have been, placed in non-accrual status. Interest accrued during the current year shall be charged back against the interest income account; interest accrued in prior years shall be charged against the loan loss provisions account.

(c) Treatment of cash payments, and criteria for cash basis recognition of income. If a loan is on non-accrual and ultimate collection of all principal is in doubt, then any cash payments received shall be applied only to reduce principal. However, if the principal balance remaining after a partial write-off is regarded as collectible, then cash payments may be applied to interest income.

Where recognition of interest income is appropriate for an asset held on a cash basis, the income that may be shown is limited to the amount accrued at the contractual rate. Any cash payments in excess of this amount (and not applied to the remaining book balance) shall be recorded as recoveries of prior write-offs until all such write-offs have been fully recovered. For a loan to be considered fully recoverable, it must be supported by a current credit documentation as defined in the Act.

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

(e) Treatment of multiple loans to one borrower. If a bank has multiple loans to a single borrower or group of related borrowers, and one loan meets the criteria for non-accrual status, then the bank shall evaluate every other loan to that borrower and place any other loans on non-accrual status if circumstances so require.

3: **<u>Classification of Assets</u> –** All loans and other assets shall be classified using the classification grades below, provided, a loan may be assigned a split classification, whereby two or more portions of the same loan are given separate classifications if appropriate. For example, a bank has an unsecured loan to a borrower in bankruptcy. The bankruptcy trustee has indicated a minimum and maximum disbursement to unsecured creditors of 40% and 65%, respectively. In this example, the proper classification of the loan would be 40% Substandard, 25% Doubtful and 35% Loss.

A bank may use classification grades different from the regulatory classification grades contained in this regulation so long as the~~y~~ bank maintains written documentation which correlates the bank's classification grades to the regulatory classification grades. If different classification grades may be assigned due to interpretation of subjective criteria, the more severe grade should apply.

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

Regulatory Classification Grades:

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

(b) Special Mention. Loans or assets in this category are secured and repayment is not yet jeopardized but deficiencies exist which may, if not corrected, weaken the asset or the bank's position at some future date. Such loans may be current or may be delinquent for up to 90 days. Deficiencies may include: inability to properly supervise the loan due to an inadequate loan agreement; deteriorating condition or control of collateral; deteriorating economic conditions or adverse trends in obligor's financial position which jeopardize repayment capacity. This grade should not be used if a Substandard grade is warranted.

A Special Mention classification would generally be appropriate for any asset which is past due 60 days or more but less than 90 days.

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

A Substandard classification would generally be appropriate for any asset which is past due 90 days or more but less than 180 days.

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

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

A Doubtful classification would generally be appropriate for any asset which is past due 180 days or more up to 360 days, unless (i) the asset is well-secured, (ii) legal action has commenced, and (iii) the time to realize on collateral or on a guarantee does not exceed 180 days.

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

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

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

4: **<u>Classification downgrades</u> –** If, at an on-site examination or otherwise, a loan or asset is graded lower by the Commission than by the bank, the bank shall (i) re-classify the asset to the lower grade assigned by the Commission, and (ii) make provisions as required. Subsequent upgrades, or further downgrades, shall be made if circumstances justify.

5: **<u>Provisioning Requirements</u> - (a) Provisions account.** All banks, including branches of foreign banks licensed by the Commission to conduct financial activities in Palau, shall maintain an account on the balance sheet called "provisions for loan losses" or "allowance for loan and lease losses". The account shall be created by charges to provision expense in the profit and loss statement and shall be maintained at a level that is adequate to absorb estimated losses.

At the end of each calendar quarter, or more frequently if warranted, an evaluation shall be made of the loan portfolio and based thereon, appropriate entries shall be made to the provisions account in the profit and loss statement to ensure that (i) the provisions account is fully funded, and (ii) earnings are accurately reported.

(b) Additions/reductions to the provisions account. Additions to the provisions account shall be made by charges to provision expense in the income statement. Write-offs and recoveries shall be charged to the provisions account; loans must not be written off or recovered directly to current year earnings or to capital accounts.

(c) Provisioning for small loans. In cases where a bank has numerous smaller loans, a bank can apply the provisioning percentages in paragraph (d) below to the aggregate total of a pool of loans.

(d) Provisioning amounts. In determining the potential loss for individual loans or for pools of smaller loans, all relevant factors shall be considered including, but not limited to current economic conditions, loss experience, delinquency trends, quality of under-writing practices, accuracy of loan review, and effectiveness of loan recovery efforts.

At a minimum, the following provisioning amounts are to be maintained:

i)	for loans graded **"Pass"** or **"Acceptable"**	1%
ii)	for loans graded **"Special Mention"**	5%
iii)	for loans graded **"Substandard "**	20%
iv)	for loans graded **"Doubtful"**	50%
v)	for loans graded **"Loss"**	100%

(i) More or less: If reliable factors indicate higher loss potential, then provisions greater than the above shall be maintained. If a bank demonstrates to the satisfaction of the Commission that lower provisions are justified, then lower amounts may be used.

(ii) Gross vs. net balance: The provisioning percentages above shall be applied against the gross loan balance for loans graded Pass, Special Mention or Substandard. For loans graded Doubtful or Loss, the provisioning percentage shall be applied to the net exposure after deducting the "net realisable value" of collateral. (Refer to paragraph (e) below.) In no event shall the provision amount be less than the amount that would be required if a loan is graded in the next higher category.

(iii) Cash-secured: Any loan, or portion thereof, secured by cash, by a segregated deposit in the lending bank, by a security issued by the Republic of Palau national government (Government), or by an unconditional and irrevocable obligation or guaranty of Government, is exempt from classification and the provisioning requirements of this regulation.

(iv) Write-off vs. full provisioning: Any loan, or portion of, that is, or should be, classified "Loss" may be fully provisioned for and charge-off deferred to the end of the current calendar quarter but not later than 90 days after being classified Loss.

(e) Treatment of Collateral. Loan classification grades should be based on an assessment of the primary repayment source – being an assessment of the financial capacity and/or cash flow of the borrower. Collateral should then be considered in determining the severity of the classification grade. For example, whether a loan should be classified Substandard because it is well-secured by collateral in the process of collection, or whether it should be classified Doubtful or Loss because the value of the collateral does not provide adequate protection to the bank from loss. Because collateral is generally illiquid, costly to acquire and maintain, and difficult to value during periods of financial distress, provisioning percentages shall be applied against the gross outstanding balance of loans graded Pass, Special Mention or Substandard. For loans graded Doubtful or Loss, the net realizable value of collateral may be deducted from the loan balance before applying the provisioning percentages. In the case of real property collateral, the net realizable value may be deducted only if transferability of title is certain and an active market for the property exists. An "active market" means that a willing buyer and willing seller exist and a sale is reasonably expected within one year.

In no event shall provisions for a loan graded Doubtful or Loss be less than the amount required if the loan were graded in the next higher grade. For example, provisions for a loan graded Doubtful must be at least 20% of the gross outstanding loan balance.

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

7: **Reporting Requirements.** Each bank shall submit to the Commission returns as may be required and in the form and frequency as the Commission may prescribe.

PART IV: CORRECTIVE MEASURES

1: **Remedial measures and sanctions –** If a bank, or any director or administrator of a bank, violates any provision of this regulation in a willful, negligent or flagrant manner which results, or is likely to result, in an unsafe or unsound condition for the bank or that threatens the interests of depositors, creditors or the general public, or if a bank, or any director or administrator of a bank, fails to comply with the instructions and reporting requirements in this regulation, the Commission may impose any one or more of the remedial measures or penalties provided in the Act.

PART V: EFFECTIVE DATE

1: **Effective date** – The effective date of this regulation shall be 1st September 2008.

Questions relating to this regulation may be addressed to the Financial Services Authority of the Republic of Palau.

Adopted _________________________, 2008

____
Governing Board
Financial Services Authority
Republic of Palau

Approved _________________________, 2008

____
Honorable President
Tommy E. Remengesau, Jr.

LOAN CLASSIFICATION (GRADING) MATRIX APPENDIX A

A combined assessment of financial condition and repayment history of a borrower should be used to arrive at an initial classification grade for a loan. Adjustments to the initial grade should then be made based on mitigating or unique circumstances. The Loan Classification Matrix below provides criteria for assigning a preliminary classification grade.

LOAN CLASSIFICATION MATRIX			
	Repayment History		
Financial Condition	***Strong***	***Fair***	***Unsatisfactory***
Strong	Pass	Special Mention	Substandard
Satisfactory	Special Mention	Substandard	Substandard
Fair	Substandard	Substandard	Doubtful
Marginal	Substandard	Doubtful	Loss
Unsatisfactory	Doubtful	Loss	Loss

Definitions: The definitions below are used in the Matrix above.

FINANCIAL CONDITION	
Strong	Borrower's financial condition is of highest quality based on detailed, current financial statements; normal indicators of financial health indicate borrower is readily able to repay both principal and interest according to original terms of loan agreement.
Satisfactory	Borrower is financially stable but various aspects exist regarding the financial condition of the borrower that are less than first-rate, though generally minor in nature.
Fair	Borrower is financially stable but various unsatisfactory aspects exist regarding the financial condition of the borrower, some of which may be significant.
Marginal	Borrower is not financially stable and unsatisfactory aspects which are significant exist regarding the financial condition of the borrower.
Unsatisfactory	Borrower's financial condition is highly unsatisfactory; liquidation or formal insolvency proceedings have begun or likely will commence shortly.

REPAYMENT HISTORY	
Strong....................................	Interest and principal are current (i.e., not past due) and there is no evidence that the current loan balance includes any capitalized amounts of either principal or interest from previous loan roll-overs. A grace period of no more than 7 days may be allowed before payments are considered past due to allow for administrative errors on the part of borrower or the bank.
Fair..	Interest or principal has historically been past due for more than 7 days but less than 30 days, or there is evidence of interest or principal capitalization.
Unsatisfactory	Interest or principal has been past due for more than 30 days, or there is evidence of equivalent rescheduling of payments or capitalization of interest.