# Extracted from IASB staff paper 1C, dated 1 December 2010

## How financial institutions manage and assess credit risk and the notion of 'good' book/'bad' book

4. The staff learnt from comment letters, outreach activities and the Expert Advisory Panel (EAP) that most financial institutions manage their lending business on a 'good' book / 'bad' book basis.

5. For most financial institutions, the loans in their 'good' book are usually those that management expects to be still collectible. For this reason, many respondents (as well as the EAP) who suggested (or support) the time-proportionate approach argue that the recognition of EL (both initial EL and subsequent changes) should follow the recognition of interest revenue and hence be allocated over the lifetime of the loan[2]. Allocation is directionally consistent with the objective of the ED given that credit losses need to be allocated because the compensation for credit losses that is implicit in the interest is also allocated over the life of the loan (as part of interest revenue in a decoupled approach). However, under the ED only the initial EL is allocated whereas subsequent changes are recognised immediately. As for loans in an entity's 'bad' book, these are usually considered by management to be 'non-performing' because they do not expect it to be collectible. Hence, for these loans respondents suggested to recognise all EL immediately.

6. The rest of this section describes how the notion of a 'good' book / 'bad' book is embedded in the structure of most financial institutions' credit risk management framework and their process for monitoring, assessing, measuring and managing credit risk. (Note: most financial institutions also use the terms 'good'/'bad' and 'performing'/'non-performing' interchangeably.)

7. As described in paragraph 4 above, the loans in the management's 'good' book are usually those that management expects to be collectible. EL on an entity's 'good' book is typically assessed collectively on a portfolio-by-portfolio basis (especially for high volume low value loans). In many financial institutions, loss rates based on past experience adjusted for changes in circumstances (ie the qualitative adjustment to a historical loss rate) are applied to loan portfolios on the portfolio level.[3]

8. Within their 'good' book, most financial institutions would assess differently the loans or the groups of loans where closer assessment or monitoring is required ('watch list' loans). These loans usually have a higher degree of risk of non-payment. However, many financial institutions still consider these loans to be 'performing' because they still expect the loans to be collectible (albeit with increased uncertainty). Hence, most

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2 Allocation is directionally consistent with the objective of the ED given that credit losses need to be allocated because the compensation for credit losses that is implicit in the interest is also allocated over the life of the loan (as part of interest revenue in a decoupled approach). However, under the ED only the initial EL is allocated whereas subsequent changes are recognised immediately.

3 The staff has learnt from outreach activities that internationally only a very few financial institutions apply the loss rates at the individual loan level (ie on a loan-by-loan basis).

financial institutions would not typically *manage* them differently from other loans in the entity's 'good' book.

9. As described in paragraph 4 above, loans that fall within the entity's 'bad' book are those loans that management expects to be uncollectible. The loans in the 'bad' book are typically managed on an individual basis and separately from the entity's 'good' book in specialised recovery units within the financial institution. In these specialised recovery units, loans are typically subject to intensified collection and recovery processes and credit risk exposure reduction.

10. For the loans in the entity's 'bad' book, credit risk is typically assessed on an individual basis or using limited aggregation. In most international financial institutions (eg financial institutions under the Basel II Advanced Internal Ratings Based (AIRB) approach), the amount of impairment on these loans can be quantified on a reasonably accurate basis due to the intensified level of detailed credit assessment and management.

11. We learnt from our outreach and the EAP that the criteria for determining when a loan is moved from the entity's 'good' book to the 'bad' book (and hence is managed differently), differ across financial institutions and are dependent on the specific credit risk management practices/framework of each financial institution. For example, the credit risk management criteria for moving a loan to the 'bad' book can be 1 day overdue for one financial institution and 120 days overdue for another financial institution. The credit risk management criteria can also differ for different products within a financial institution (eg one missed payment for credit card products, but three missed payments for mortgages).

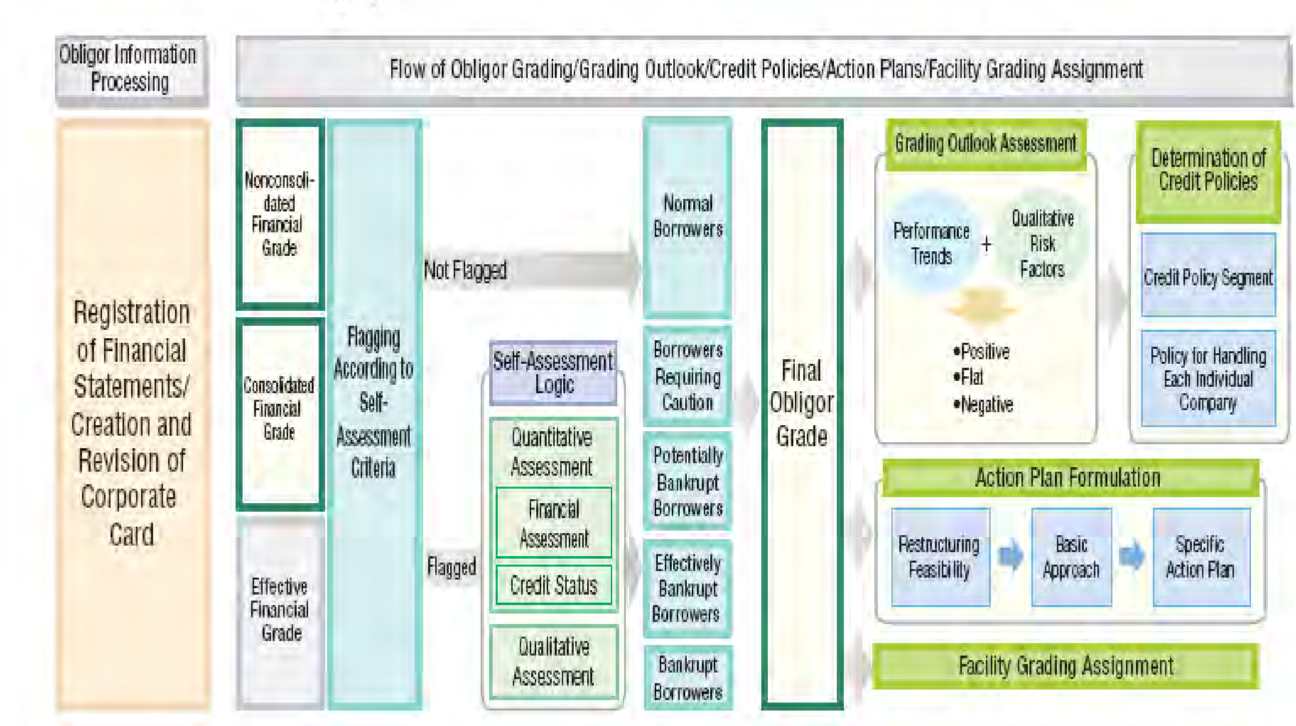
12. Furthermore, we learnt from the EAP and outreach activities that the credit risk management criteria for moving loans from the 'good' book to the 'bad' book are typically more objective and involve less judgement for large volume low value products that are typical of consumer lending (eg number of days overdue). For large wholesale products (eg high value corporate loans), there is usually more management judgement and subjectivity involved in assessing whether the loan should be transferred to the 'bad' book. The facts and circumstances are often assessed on a case-by-case basis (eg cash flows analysis, industry trends etc).

13. We also learnt from outreach activities and the EAP that there is a spectrum of different ratings within an entity's 'good' book. Within an entity's 'bad' book there are also different grades of 'bad' before the borrower is declared legally bankrupt. The grades used for assessing and quantifying credit risk form grade rating scales ranging from 3 to 14 internationally[4]. These grade ratings are also not standardised across different financial institutions or jurisdictions. However, the staff note that these grades would typically be grouped into two main distinct groups (ie 'good'/'bad' book) for credit risk management purposes.

14. We also learnt from outreach activities and the EAP that in most financial institutions, to ensure integrity of the credit risk management framework and policies, the grade ratings and the criteria and processes for defining when loans are moved into the entity's 'bad' book are subject to stringent and rigorous oversight by risk committees. These processes are also subject to internal and external audits.

4 Some financial institutions further sub-classify some grades into sub-grades.

15. In our outreach, the staff and Board members spoke with many financial institutions. Following is a diagram of how loans are monitored, assessed and managed in one of the large international financial institutions that we reached out to[5].




16. For this particular financial institution 'potentially bankrupt borrowers', 'effectively bankrupt borrowers' and 'bankrupt borrowers' are more actively managed in its 'bad' book. For this particular financial institution, specific/individual provisions for EL are created for borrowers in the ''bad' book. For 'normal borrowers' and 'borrowers requiring caution', EL are provided for on a collective basis (ie at the portfolio level). Further details on the borrower categories and the write-off and provision policy for each borrower category are set out in Appendix A.

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## Appendix A

A1. Appendix A sets out extracts from an annual report of a large international financial institution.

5 Extract from annual report of a large international financial institution.
= 'bad' book (highlighted by staff)

A2. The following table sets out the obligor grading system for each loan.

| Obligor Grade Domestic (C&I), etc. | Obligor Grade Overseas (C&I), etc. | Definition | Borrower Category | Financial Reconstruction Law Based Disclosure Category (Domestic) |
|---|---|---|---|---|
| J1 | G1 | Very high certainty of debt repayment | Normal Borrowers | Normal Assets |
| J2 | G2 | High certainty of debt repayment | | |
| J3 | G3 | Satisfactory certainty of debt repayment | | |
| J4 | G4 | Debt repayment is likely but this could change in cases of significant changes in economic trends or business environment | | |
| J5 | G5 | No problem with debt repayment over the short term, but not satisfactory over the mid to long term and the situation could change in cases of significant changes in economic trends or business environment | | |
| J6 | G6 | Currently no problem with debt repayment, but there are unstable business and financial factors that could lead to debt repayment problems | | |
| J7 | G7 | Close monitoring is required due to problems in meeting loan terms and conditions, sluggish/unstable business, or financial problems | Borrowers Requiring Caution | |
| J7R | G7R | (Of which Substandard Borrowers) | Substandard Borrowers | Substandard Loans |
| J8 | G8 | Currently not bankrupt, but experiencing business difficulties, making insufficient progress in restructuring, and highly likely to go bankrupt | Potentially Bankrupt Borrowers | Doubtful Assets |
| J9 | G9 | Though not yet legally or formally bankrupt, has serious business difficulties and rehabilitation is unlikely; thus, effectively bankrupt | Effectively Bankrupt Borrowers | Bankrupt and Quasi-Bankrupt Assets |
| J10 | G10 | Legally or formally bankrupt | Bankrupt Borrowers | |

A3. The following tables sets out the definitions of each borrower category and asset classifications.

| Borrower Categories, Defined | |
|---|---|
| Normal Borrowers | Borrowers with good earnings performances and no significant financial problems |
| Borrowers Requiring Caution | Borrowers identified for close monitoring |
| Potentially Bankrupt Borrowers | Borrowers perceived to have a high risk of falling into bankruptcy |
| Effectively Bankrupt Borrowers | Borrowers that may not have legally or formally declared bankruptcy but are essentially bankrupt |
| Bankrupt Borrowers | Borrowers that have been legally or formally declared bankrupt |

| Asset Classifications, Defined | |
|---|---|
| Classification I | Assets not classified under Classifications II, III, or IV |
| Classification II | Assets perceived to have an above-average risk of uncollectibility |
| Classification III | Assets for which final collection or asset value is very doubtful and which pose a high risk of incurring a loss |
| Classification IV | Assets assessed as uncollectible or worthless |

A4. The following table sets out the write-off and provision criteria for each borrower category.

| Self-Assessment Borrower Categories | | Standards for Write-Offs and Provisions |
|---|---|---|
| Normal Borrowers | | The expected loss amount for the next 12 months is calculated for each grade based on the grade's historical bankruptcy rate, and the total amount is recorded as "provision for the general reserve for possible loan losses." |
| Borrowers Requiring Caution | | These assets are divided into groups according to the level of default risk. Amounts are recorded as provisions for the general reserve in proportion to the expected losses based on the historical bankruptcy rate of each group. The groups are "claims on Substandard Borrowers" and "claims on other Borrowers Requiring Caution." The latter group is further subdivided according to the borrower's financial position, credit situation, and other factors. Further, when cash flows can be estimated reasonably accurately, the discounted cash flow (DCF) method is applied mainly to large claims for calculating the provision amount. |
| Potentially Bankrupt Borrowers | | A provision for the specific reserve for possible loan losses is made for the portion of Classification III assets (calculated for each borrower) not secured by collateral, guarantee, or other means. Further, when cash flows can be estimated reasonably accurately, the DCF method is applied mainly to large claims for calculating the provision amount. |
| Effectively Bankrupt/ Bankrupt Borrowers | | Classification III asset and Classification IV asset amounts for each borrower are calculated, and the full amount of Classification IV assets (deemed to be uncollectible or of no value) is written off in principle and provision for the specific reserve is made for the full amount of Classification III assets. |
| Notes | General reserve | Provisions made in accordance with general inherent default risk of loans, unrelated to specific individual loans or other claims |
| | Specific reserve | Provisions made for claims that have been found uncollectible in part or in total (individually evaluated claims) |