
**PRUDENTIAL STANDARD FOR CREDIT RISK MANAGEMENT
AND CREDIT UNDERWRITING
FOR INSTITUTIONS LICENSED TO CONDUCT BANKING BUSINESS
UNDER THE BANKING ACT, 2015**



**AUGUST 2021
EASTERN CARIBBEAN CENTRAL BANK**

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LIST OF ACRONYMS

AML/CFT	Anti-Money Laundering/Counter-Financing of Terrorism
BOD	Board of Directors
DLA	Delegated Lending Authority
ECCB	Eastern Caribbean Central Bank
ECCU	Eastern Caribbean Currency Union
ERMF	Enterprise Risk Management Framework
GDSR	Gross Debt Service Ratio
ICAAP	Internal Capital Adequacy Assessment Process
LFI	Licensed Financial Institution
LTV	Loan-to-Value
NPL	Non Performing Loan
P & I	Principal and Interest
PLL	Provision for Loan Losses
TDSR	Total Debt Service Ratio

BANKING PRUDENTIAL STANDARD NO. 01 OF 2021

This standard is issued by the Eastern Caribbean Central Bank (Central Bank), in exercise of the powers conferred on it by Section 184 of the Banking Act, No....of 2015¹ (hereinafter referred to as the Act).

1 COMMENCEMENT

This Standard shall come into effect on 1 October 2021.

2 INTERPRETATION

The following terms are defined for the purpose of this Standard:

- (a) “**The Act**” refers to the Banking Act, 2015.
- (b) “**Appraiser**” an independent and objective person who performs valuation services and reports an opinion of value, and is a registered member of the Royal Institute of Chartered Surveyors or any other internationally recognised professional designation approved by the Eastern Caribbean Central Bank, and in good standing.
- (c) “**Appraisal Report**” a written statement prepared by an appraiser setting forth an opinion as to the market value of an adequately described property as of a specific date(s), supported by the presentation and analysis of the relevant market information.
- (d) “**Approved Collateral**” (or “**Collateral**”) refers to the property, property rights, cash or other forms of security upon which the residential mortgage loan is secured, in accordance with an institution’s established policy and best practices. Best practices take into consideration marketability, liquidity and transferability of the collateral, as well as the ability to ascertain its value.

¹ Section 183 of the Banking Act of Anguilla, No 6 of 2015

- (e) **“Balloon Payment”** the final payment of the outstanding principal sum that becomes due and payable at the end of a loan period.
- (f) **“Collateral Management”** means all tasks and processes within the credit underwriting process where collateral is involved, for example appraisal of collateral, the constitution of collateral, review of its legal existence and enforceability and entry of collateral-related data in the lender’s information technology systems.
- (g) **“Commercial Credit or Corporate Credit ”** is a pre-approved amount issued by an LFI to a company to help meet various financial obligations. It is credit approved for a business or corporation, rather than an individual.
- (h) **“Credit”** is the provision of funds on agreed terms and conditions to a borrower, who is obligated to repay the amount borrowed (together with interest thereon, unless specifically stated otherwise). Credit may be extended on a secured or unsecured basis by way of credit facilities.
- (i) **“Credit facilities”** means loans, mortgages, lines of credit, overdraft facilities, bonds, private placements, derivatives and leases.
- (j) **“Credit/Loan Administration Staff”** all personnel responsible for generating loan volume or approving loans, as well as their subordinates and supervisors.
- (k) **“Credit risk”** *means* the risk that a lender will suffer a financial loss as a result of a borrower’s failure to service a credit facility according to the terms and conditions of the agreement between the lender and borrower. **“Credit Risk”** arises from a counterparty’s potential inability or unwillingness to fully meet its on and/or off-balance sheet contractual obligations, such as loans, mortgages, lines of credit, overdraft facilities, bonds, private placements, derivatives and leases.
- (l) **“Credit Risk Management”** is the process of controlling the impact of credit risk-related events on the financial institution. This involves the identification, understanding, and

forward-looking quantification of the probability and degree of potential loss and the consequential implementation of appropriate measures to minimise the risk of loss to the financial institution.

- (m) **“Delegated Lending Authority” (DLA)** refers to the prescribed limits delegated to a body or group (example a lending officer or committee) with authority for the approval of a credit facility (based on product, amount, risk grade or other risk characteristics). The authority is usually linked to the seniority or experience of the officer or committee. Also known as delegated credit authority, credit discretions or similar.
- (n) **“Delinquency Rates”** the percentage of loans that are in default over their contractual payments.
- (o) **“Down Payment”** is an up-front payment from the borrower for a portion of the purchase price, which reduces the balance of the loan against the property.
- (p) **“Equity”** is the difference between the appraised value of the property and the total claims held against the property.
- (q) **“Expired accounts”** are accounts which remain on the books but which have passed their maturity dates.
- (r) **“Exposure”** means the amount at risk and includes:
 - (a) credit facilities, investments including equities, participations, guarantees and acceptance, or any other asset recognised by the Central Bank as an exposure;
 - (b) claims on a counterparty including actual and potential claims that would arise from the drawing down in full of undrawn advised facilities, whether on or off-balance sheet, revocable or irrevocable, conditional or unconditional, that the licensed financial institution has committed itself to provide, arrange, purchase or underwrite;

- (s) “**Gross Debt Service Ratio (GDSR)** is the ratio of monthly housing costs (and includes costs such as mortgage payments, home insurance, and property costs) to monthly income.
- (t) “**Housing Costs**” includes all of the following costs – principal and interest payment, property insurance, fees, property tax and any other secondary financing payments for the property in question.
- (u) “**Loan-to-Value**” (LTV) the ratio of the amount of the loan outstanding to the appraised value of the residential property securing the loan.
- (v) “**Large Exposures**” means an exposure to a person or a borrower group, which amounts to ten per cent or more of tier I capital of a licensed financial institution.
- (w) “**Licensed Financial Institution**” means a person or incorporated entity licensed to carry on banking business and includes a former licensed financial institution. This includes all offices and branches of a financial institution operating in the ECCU, which shall be deemed to be one financial institution.
- (x) “**Market Value**” the estimated amount for which an asset or liability should be exchanged on the valuation date between a willing buyer and a willing seller in an arm’s length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.
- (y) “**Non-performing loans**” (NPLs) are exposures for which the ultimate collectability of principal and interest is compromised and there is no longer reasonable assurance that an institution will collect all amounts due, according to the contractual terms of the agreement. These would include loans that are past due 90 days and above, and overdrafts continuously operating in excess of the approved limit for a period of 30 days or more, overdrafts on which the contracted interest payment and or principal have not been paid for 90 days or more and this is not as a result of any special client arrangement, and overdrafts with inadequate fluctuations, and principal not being fully repaid at least once in the last 12 months.

- (z) **“Prime Properties”** prime properties are properties located in highly marketable areas and have broad appeal to potential buyers. The property must be located in areas with full access to services and in generally good condition.
- (aa) **“Permanent Resident”** an individual living in the country in which financing is being sought, with the right to permanently reside and work in that country, and the collateral being used to secure the facility is located in the same country.
- (bb) **“Residential Mortgage Loan”** includes any loan to an individual or group for the purpose of construction or purchase of property (land or building), primarily for personal, family or household use. This facility may be secured by residential property or any other form of approved collateral as outlined by policy.
- (cc) **“Risk Appetite”** is the articulation in written form of the aggregate level and types of risk that an LFI is willing to accept, or to avoid, in order to achieve its business objectives. It includes qualitative statements to address reputation and conduct risks, as well as money laundering and unethical practices. It also includes quantitative measures expressed relative to earnings, capital, risk measures, liquidity and other relevant measures as appropriate.
- (dd) **“Risk Tolerance/Limit”** is quantitative measures based on forward looking assumptions that allocate the financial institution’s aggregate risk appetite statement (example measure of loss or negative events) to business lines, legal entities as relevant, specific risk categories, concentrations, and as appropriate, other levels.
- (ee) **“Scenario Analysis”** assesses the potential outcome of various scenarios by setting up several possible situations and analysing the potential outcomes of each situation.

- (ff) **“Total Debt Service Ratio (TDSR)”** is the ratio of monthly housing costs plus other debt such as car payments and credit card borrowings to monthly income.
- (gg) **“Valuation”** includes both appraisals and evaluations conducted on behalf of an LFI.

3 OBJECTIVE

This Standard aims to promote the development and implementation of sound credit risk management frameworks at LFIs. This Standard represents the ECCB’s *minimum requirements* for credit risk management and should therefore not be viewed as all encompassing.

Similarly, the guidance provided on residential mortgage underwriting aims to:

- i. Provide a framework for sound residential mortgage underwriting for licensees;
- ii. Prescribe measures that LFIs must take to manage risk related to residential mortgage underwriting and ensure the adequacy of the management of associated risks; and
- iii. Provide the minimum acceptable underwriting standards with which the ECCB expects compliance for mitigating risk associated with residential mortgage underwriting.

Furthermore, the ECCB endorses and recommends the Basel Committee’s 17 Principles for Management of Credit Risk (September 2000).

4 APPLICATION

This Standard shall apply to all financial institutions licensed under the Act. Additionally, where applicable, this Standard is to be applied in conjunction with, and in due consideration of, other established guidelines and standards including (but not limited to) the Prudential Standard for the Treatment of Impaired Assets and the Prudential Valuation Standards.

The ECCB expects licensees to apply credit underwriting practices that ensure the safety and soundness of residential mortgage loans and adequate risk management of loan portfolios. This Standard also outlines supervisory requirements for residential mortgage underwriting and management, reporting, and risk management. The requirements outlined in this Standard are applicable to the direct underwriting of credit facilities, and credit facilities acquired as part of a portfolio.

Each LFI shall submit a copy of its board-approved credit risk management policies and procedures to the ECCB. These shall encompass the various types of credit facilities being offered, including residential mortgages and their associated underwriting procedures. The approved changes to these policies and procedures shall be submitted to the ECCB as they occur.

Approved minutes of meetings of the Committee responsible for credit risk management shall be forwarded to the ECCB as they occur.

5 REPEAL

The Guidelines On Credit Risk Management For Institutions Licensed To Conduct Banking Business Under The Banking Act, which came into effect on 15 May 2009, are hereby repealed.

6 OVERVIEW

A major cause of serious banking problems continues to be inadequate credit risk management. The provision of credit remains one of the primary roles of financial institutions licensed under the Banking Act, 2015 (licensees) operating within the Eastern Caribbean Currency Union (ECCU), and for this reason, credit quality is considered a primary indicator of financial soundness. It is therefore critical that a robust credit risk management framework be developed and effectively applied by all licensed financial institutions (LFIs).

The objective of credit risk management is to maximise an LFI's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Credit risk management should not only effectively address the credit risk inherent in the credit portfolio, but should also consider the relationships between credit risk and other risks. As an example, failure to effectively manage credit risk could lead to heightened reputational risk for the financial

institution. Additionally, deficiencies in credit risk management may be linked to failed operational processes, resulting in increased operational risk.

The effective management of credit risk is a critical component of a comprehensive Enterprise Risk Management Framework (ERMF), and is fundamental to the safety and soundness of LFIs. Appropriate policies, procedures and systems should be implemented at each LFI to effectively identify, measure, monitor and control credit risk.

7 PRUDENTIAL STANDARD REQUIREMENTS

7.1 Credit Risk Management Framework

To achieve and maintain effective credit risk management, an LFI should develop and implement a comprehensive credit risk management framework in accordance with its credit risk strategy. The board of directors, management and staff of the LFI should be aware of and understand their respective responsibilities within the credit risk management framework. As such, all policies and procedures formulated to guide the execution of this framework, should be circulated to all concerned staff throughout the LFI.

An effective credit risk management framework includes the implementation of clearly defined credit policies and procedures to facilitate the identification and quantification of risks inherent in an institution's lending and investment activities. The credit policy should be formally established in writing and approved by the board of directors, and should clearly set out the parameters under which credit risk is to be controlled. The policy document should be supported by procedures that clearly define how the roles, responsibilities and objectives outlined in the policy are to be executed.

7.2 Credit Policy

The credit policy establishes the authority, rules and framework for the effective operation and administration of the credit portfolio. The policy should be communicated throughout the organisation in a timely manner and effectively implemented through the use of clearly documented procedures. It is critical that the policy be reviewed periodically (at least annually) to ensure that it remains up to date and continues to reflect the current practices and stated

objectives of the institution. Changes in statutory and regulatory requirements should also be incorporated in the policy.

With the support of clearly articulated operational procedures, a comprehensive credit policy that is effectively implemented enables the financial institution to:

- (i) Maintain sound credit-underwriting standards;
- (ii) Assess, monitor and control credit risk;
- (iii) Properly evaluate new business opportunities; and
- (iv) Identify, administer and collect on problem credits.

The credit policy should specify, *inter alia*:

- (i) A credit risk philosophy governing the institution's credit risk appetite;
- (ii) Levels of authority to approve credits and their associated approval limits. Delegated credit authorities should be subject to timely reviews to ensure that they remain appropriate to current market conditions and the expertise of credit officers;
- (iii) Target markets;
- (iv) Types of facilities to be offered, along with ceilings, pricing, profitability, maximum maturities and acceptable debt-service ratios of borrowers for each type of lending;
- (v) Desired loan portfolio benchmarks (example total loans to deposits ratio, total loans as a percentage of capital base, etcetera);

- (vi) Loan portfolio limits for aggregate exposure by country, industry, category of borrower/counterparty, product, groups of related parties and single borrowers, et cetera. Consideration of relevant legislation and the ECCB standards should be given in establishing such limits. For example, Sections 49 to 51 of the Act² imposes restrictions on the aggregate amount of credit that can be extended to any person, group of borrowers or any member of a borrower group, related parties and employees;
- (vii) LFIs should also monitor and manage concentrations within loan portfolio sub-groups (example within the personal lending portfolio, concentrations of vehicle loans, other consumer durables, unsecured loans, etcetera).
- (viii) Criteria and procedures for granting all new credits and for credit restructuring and refinancing, and guidelines for approvals with exceptions;
- (ix) The minimum information required from loan applicants (considering Anti-Money Laundering and Know Your Customer best practices, and legal requirements), including financial information to adequately assess debt-servicing capacity;
- (x) Loan review procedures, including credit and risk grading/rating systems that take account of information initially gathered in (ix) above, as well as information obtained subsequently as part of an ongoing review process;
- (xi) Types of acceptable collateral, with a criterion for accepting intangible forms of security (example guarantees);
- (xii) Guidelines for credit classification, provisioning and write offs;

² Sections 48 to 50 of the Banking Act of Anguilla, 2015

- (xiii) Guidelines for obtaining and reviewing appraisals of real estate and other collateral; and
- (xiv) Guidelines for related party transactions including limits for exposure to a borrower or group of related borrowers.

7.3 Credit Risk Management Processes

7.3.1 Credit Assessment and Approval

Credit assessment is the stage where all required credit application information is collected, and applicants are screened. Credit application forms should be sufficiently detailed to permit gathering of all information needed for the credit assessment. For this reason, financial institutions should have a checklist to ensure that all required information is collected. The assessment criteria will vary between /commercial/corporate credit applicants and personal credit applicants. Loans to related parties should be appraised, and approved by the Board of Directors or its credit committee in accordance with applicable provisions of the Act.

For commercial/corporate credit applicants, LFIs should make every effort to obtain up to date audited financial statements, and management accounts, where necessary. This would facilitate an accurate assessment of the applicant's financial position and their capacity for servicing the requested credit facility. At a minimum, the assessment criteria for commercial credit applications should focus on:

- (i) Amount requested and purpose for credit;
- (ii) Sources of repayment;
- (iii) Applicant's integrity, as well as legal capacity to assume credit obligation;
- (iv) Risk profile of the applicant and the sensitivity of the applicable industry sector to economic fluctuations;

- (v) Performance of the applicant in any credit previously granted by the financial institution and other institutions;
- (vi) The applicant's capacity to repay based on:
 - ❖ assessments of the business plan;
 - ❖ current, as well as previous financial statements in order to analyse financial performance trends; and
 - ❖ projected cash flows.
- (vii) Cumulative exposure of the applicant to different institutions;
- (viii) Physical inspection of the applicant's business premises, as well as the asset that is the subject of the proposed financing;
- (ix) Applicant's business expertise and managerial capacity;
- (x) Adequacy, marketability and enforceability of collateral or guarantees, taking into account the existence of any previous charges of other institutions on the collateral;
- (xi) Current and forecast operating environment of the borrower; and
- (xii) Background information on shareholders, directors and beneficial owners.

7.3.2 Credit Administration

An LFI's credit administration function should, at a minimum, ensure that:

- (i) Credit files, including electronic credit files, are organised in an orderly manner and cross-indexed, to facilitate ready retrieval of documents contained therein;
- (ii) Credit files are not removed from the institution's premises without the requisite approval;

- (iii) Insurance policies are properly assigned to the institution and premiums are current;
- (iv) Credit facilities are disbursed only after all contractual terms and conditions have been met and all required documents received;
- (v) Security documents are duly executed and held under dual control, and properly protected from fire, theft, etcetera;
- (vi) Collateral value is periodically ascertained and monitored in accordance with an LFI's approved credit policy, or other applicable document
- (vii) The borrower is making timely repayments on interest, principal and any agreed to fees and commissions;
- (viii) Information on credit provided to the LFI's management is accurate and timely;
- (ix) Credit administration responsibilities within the financial institution are adequately segregated;
- (x) Funds disbursed under the credit agreement are used for the purpose for which they were granted;
- (xi) Established policies and procedures, as well as relevant laws and regulations, are being complied with; and
- (xii) Assessments of borrower's business are conducted through regular inspections.

Each credit file, including electronic credit files, should contain, at a minimum, information that:

- (i) Identifies the borrower by name and occupation or type of business; identifies cosigners, endorsers, guarantors, beneficial owners and connected counter parties; and Know Your

Customer (KYC) information should be in accordance with the guidance notes issued by the AML/CFT supervisory authority;

- (ii) Provides evidence of the borrower's legal ability to borrow, financial condition, and ability to repay, including the timing and source(s) of repayment;
- (iii) Describes the terms of the credit obligation, including the purpose of the credit;
- (iv) Describes and evaluates the collateral;
- (v) Provides a history of the credit, including copies of the most recent credit authorisation and internal credit reviews, and evidence of the level of approval;
- (vi) Describes any relationship to owners, directors and management of the financial institution; and
- (vii) Reflects the full relationship of the borrower with the bank, such as deposit accounts, off-balance sheet transactions, credit history, et cetera.

7.3.3 Measuring and Monitoring of Credit Risk

Financial institutions should have in place comprehensive procedures and information systems to effectively monitor and control credit risk. These procedures should incorporate prudent criteria for identifying and reporting existing and potential problem accounts, ensuring that such accounts are sufficiently reviewed, adequately monitored and the relevant corrective action taken. The accurate classification of accounts and provisioning for loan losses should also form part of these procedures.

The feasibility and effectiveness of the various requirements of the credit risk management framework depend, in large measure, on the adequacy of management information systems. Financial institutions should have information systems and analytical techniques that are sufficiently flexible to help identify:

- (i) Risk concentrations, such as credits grouped by their various types, related borrowers, economic sector, geographic areas, et cetera;
- (ii) Degrees of delinquency and level of follow up;
- (iii) Volumes of loans secured versus unsecured;
- (iv) Volumes of new loans generated by officers;
- (v) Missing or inadequate information such as financial statements;
- (vi) Losses by officer/type of loan;
- (vii) Adequacy of loan loss reserves; and
- (viii) Restructured debts, expired and written-off accounts.

Financial institutions should have in place a credit rating system that defines risk rating criteria and rates credits according to these criteria. Each institution should have in place appropriate policies for classifying credits, recognising revenue and providing for loan loss.

Institutions should have a well-defined credit collection and arrears management process. For institutions that have a high level of non-performing credits, it is recommended that a dedicated unit be established to handle the workout and recovery of problem facilities, with appropriately-documented policies and procedures in place to guide the unit's operation.

7.4 ADEQUATE CREDIT RISK CONTROLS

7.4.1 Segregation of Duties

Financial institutions should establish internal controls and practices to ensure that the credit initiation, approval and collections functions are kept as separate as possible. Breaches of internal controls and practices should be reported to the appropriate level of management.

7.4.2 Credit Review

Financial institutions should establish an internal system of independent, ongoing assessment of its credit risk management processes. The results of such reviews should be communicated directly to the board of directors or committee thereof, and to senior management. The credit risk management programme of each institution must include procedures governing the formal review and rating of individual credits.

An independent review of credits should be conducted along with regular analysis and rating of credits by account officers. Accordingly, credit review systems should include the ongoing monitoring of credits and, where applicable, underlying security. Where credit reviews result in changes to the credit rating of a borrower, these should be documented on the borrower's file along with the rationale for said rating change.

Common objectives of an effective credit review system include:

- (i) Ensuring that the institution is aware of borrowers' current financial condition;
- (ii) Ensuring that collateral security is adequate and enforceable relative to borrowers' current circumstances;
- (iii) Ensuring that credits are in compliance with their covenants and margins;
- (iv) Providing early identification and classification of potential problem credits to protect the investment and ensure repayment of the loan before it becomes a complete loss;
- (v) Providing essential information to determine the adequacy of the provision for loan losses;

- (vi) Providing senior management and the board with an objective and timely assessment of the overall quality of the loan and investment portfolio; and
- (vii) Ensuring that proper accounting is maintained for all types of credits, for example, delinquent loans are put on a non-accrual basis and investments held for trading or available for sale are appropriately marked to market.
- (viii) Ensuring that the framework for the assessment of impaired assets is appropriate and adequate.

7.4.3 Independent Audit

Financial institutions should establish a system of regular credit and compliance audits. These audits should be performed as part of an annual audit plan, by the internal auditor and/or compliance officer, who should report directly to the board or its committees. The assessment should, at a minimum, periodically or at least annually) test all aspects of credit risk management in order to determine that:

- i. Credit policies and procedures are adequate;
- ii. Credit activities are in compliance with the institution's credit and accounting policies and procedures, and with the laws and regulations to which the activities are subject;
- iii. Credits are duly authorised and accurately recorded and classified;
- iv. Credits are appropriately rated;
- v. Credit files are complete and security is perfected and adequately secures the outstanding debt;
- vi. Potential problem credits are being identified in a timely manner and provision for credit losses is adequate;
- vii. Credit risk management information reports are prepared on a timely and regular basis, and are adequate and accurate;
- viii. Assessment of the overall quality of the loan and investment portfolios is timely and objective; and
- ix. The framework for the assessment of impaired assets is appropriate and adequate.

8 ROLE OF BOARD OF DIRECTORS AND SENIOR MANAGEMENT

The board of directors of each licensed financial institution is responsible for approving and periodically (at least annually) reviewing the institution's credit risk strategy and subsequently amending its significant credit risk policies where required. Comprehensive reviews of the aforementioned policies may be undertaken annually, or with greater frequency if deemed necessary.

The board should establish a credit committee, consisting of a cross section of directors of the board and at least one member of senior management. Documented terms of reference should include the approval of new loans over a predetermined limit, related party loans, restructured/refinanced loans above a predetermined limit, and the review of regular reports on the financial institution's credit activity. Reports should include information on credit types, concentration levels and credit risk, as well as problem accounts and loss provisioning levels.

The **Credit Committee** should at a minimum:

- (i) Recommend the credit risk policy for the board's approval;
- (ii) Review, at least annually, credit policies, procedures, controls and information systems to ensure continued adequacy and effectiveness;
- (iii) Ensure, through an independent inspection/audit function, adherence to policies, controls, procedures, and information systems;
- (iv) Ensure that qualified and competent management is appointed to administer the credit risk management function;
- (v) Require the submission of comprehensive written reports to the committee on the management of exposures to credit risk, at least quarterly;

- (vi) Approve credits to, or guaranteed by, directors or management personnel or to entities in which directors or management personnel are partners, directors or officers, and review the institution's policy related to such credits;
- (vii) Approve all large credit exposures, in relation to the institution's capital base;
- (viii) Review all significant delinquent credits, as defined by the board, and management's actions taken or contemplated for their recovery;
- (ix) Review any credits granted in conflict with credit policies, and take action to ensure attainment and maintenance of compliance; and
- (x) Review the trends in the volume and nature of policy exceptions in addition to trends in the quality of, and concentration in, the financial institution's overall credit portfolio, to identify emerging problems and take appropriate mitigating action.

The **senior management** of the financial institution should at a minimum:

- (i) Develop the credit risk management policy for approval by the board of directors;
- (ii) Ensure that the credit approval process is not unduly influenced by market share or growth targets;
- (iii) Establish and utilise a system to monitor and control the nature, composition, and quality of the credit portfolio, and to ensure that the portfolio is conservatively valued and that the ECCB's guidance on classification and provisioning for non-performing assets are fully complied with;
- (iv) Ensure implementation of a credit risk management information system that:
 - tracks the evolving circumstances of a credit, regularity of repayments, borrower's financial condition, value of the security, and other attributes of the credit; and

- tracks credits by portfolio characteristics, including single and associated groups of borrowers, types of credit facilities and industry sectors;
- (v) Ensure implementation of an appropriate management reporting system for credit;
- (vi) Establish a communication system for effective dissemination of credit risk management policies and procedures to employees engaged in the credit risk management process;
- (vii) Submit comprehensive written reports to the board of directors and/or a committee thereof, dealing with:
 - Significant credit activities of the financial institution and composition and quality of the credit portfolio;
 - Significant impaired credits and collection prospects;
 - Credit transactions not in accordance with the credit risk management policies; and
 - Trends in portfolio quality and the level of diversification, and an analysis of emerging problems and remedial actions taken or contemplated.
- (viii) Implement adequate internal controls over the credit risk function; and
- (ix) Ensure implementation of an effective internal inspection/audit function to review and assess credit risk management activities.

9 LOAN SYNDICATIONS

Each financial institution participating in syndicated lending arrangements should perform their own due diligence, including independent credit risk analysis and review of syndicate terms prior to committing to the syndication. Each financial institution should analyse the risk and return on syndicated loans in the same manner normal lending is analysed.

10 RESIDENTIAL MORTGAGE UNDERWRITING PRACTICES AND PROCEDURES

Mortgage loan facilities occupy a significant portion of credit portfolios. As such, these accounts contribute greatly to elevated credit risk and are a notable component of non-performing credits. As part of the Credit Risk Management Standards, these mortgage underwriting standards were developed in consideration of the foregoing, in an effort to ensure that particular attention is given to this type of credit facility.

10.1 Verification of Income

In granting residential mortgage loans, licensees are required to assess the borrower's income, repayment history, and the affordability of the loan to minimise the risk of default. A borrower's underlying income capacity is a key input into effective mortgage underwriting. While income verification is a key factor in measuring a borrower's "*ability to repay*", other financial information can also help to measure, substantiate or infer a borrower's historical "*propensity to repay*" (*i.e. credit history*). Licensees should demonstrate rigour in the verification of a borrower's income to detect and deter fraud or misrepresentation. The borrower's underlying income should be verified through an employment letter or another reliable and documented source, along with reliable and documented income history. This includes:

- (i) Verification of a borrower's employment status through independent means from a source that is difficult to falsify;
- (ii) Requesting documentation that matches the amount of income used by the licensee in its assessment of the borrower's debt service capacity, and does not contradict other information provided during the underwriting process; and
- (iii) Obtaining sufficient income history on the borrower and making appropriate efforts to capture any variability in the borrower's income by collecting and analysing sufficient income history.

Licensees are required to appropriately value and, if necessary, suitably discount inconsistent income. Sound practice includes undertaking additional due diligence through third-party

verification of historical income in cases of the self-employed, or borrowers with irregular sources of income. Such borrowers may require unique repayment arrangements tailored to their income patterns. For example, in the case of borrowers employed in the hospitality sector, it may be necessary for payments to vary in conjunction with both the high and low seasons of the industry. For rental income, documentation should be provided to substantiate income, such as a lease/tenant agreement.

10.2 Affordability

In all instances, a robust and effective assessment of individual affordability must underpin any sustainable lending assessment. A licensee must determine a borrower's capacity to repay in order to minimise defaults and losses to the institution and to minimise the likelihood of borrower over-indebtedness. Where a loan is offered to a borrower on an exception to policy basis, the borrower should be made aware, and the particulars of the exception and its approval should be clearly documented and accessible on the borrower's credit file.

In determining a borrower's capacity licensees should:

- (i) Determine the borrower's debt service ratio:
 - a. The debt service calculations should consider any existing and ongoing financial commitments (living expenses, debt repayments, marital and family contractual obligations). The calculations should not rely on long term discounted introductory rates; and
 - b. Ensure that appropriate adjustments are in place to account for potential changes in interest rates, increases in the borrower's living expenses and/or decreases in the borrower's income available to service the debt.

- (ii) Calculate the LTV ratio with an appropriate level of down payment sourced from the borrower's own resources and identify any other resources available as a secondary source of recovery;

- (iii) Undertake appropriate due diligence on guarantors or co-signors as prescribed by documented policies and/or prevailing legislation, where there is a guarantor or co-signor supporting the residential mortgage; and
- (iv) Determine an amortisation relative to LTV ratio such that the principal portion of the monthly payments is reasonably reducing the licensee's exposure to the underlying collateral security.

Licenses are required to document any amortisation beyond the prescribed number of years as an exception to policy that is approved, monitored, and reported in accordance with the requirements within the licensee's residential mortgage underwriting or credit policy. This would apply in the case of approval from the inception of the mortgage, and/or in cases of review or modification of existing facilities. If the loan term extends past normal retirement age, licenses should take appropriate account of the adequacy of the borrower's likely income and repayment capacity in retirement.

10.3 Credit History

Licenses should make independent enquiries into a borrower's credit history (through credit reporting agencies and other financial entities, where possible). The use of a borrower's credit bureau score is one indicator of a borrower's reliability of repayment. However, credit bureau scores should not be the sole assessment tool used to determine reliability as they do not provide an indication of future behavior, but rather only the borrower's past and/or current financial condition.

In their assessment of a borrower's credit history and reliability to repay, licenses should consider the borrower's stage in his/her financial lifecycle³. A borrower's financial lifecycle indicates the borrower's current and future stage of financial life. By considering the stage of the borrower's financial lifecycle, a licensee can assess whether the residential mortgage fits the

³ There are four stages to an individual's financial life cycle. There is the accumulation of wealth, growing or managing wealth, preserving and protecting wealth, and transferring wealth.

current and future financial conditions of the borrower and, the probability of repayment. In doing so, an appropriate amortisation period can be determined.

10.4 Documentation

Maintaining prudent loan documentation is an important administrative function for licensees. It provides a clear record of the reasons for a credit-granting decision, supports compliance with a licensee's policies, and permits independent audit and/or review by a licensee's risk oversight functions. In addition, it allows for more efficient retrieval of information and facilitates information sharing with competent authorities, for example on occasions where a need for greater AML/CFT scrutiny arises. Documentation is also necessary to demonstrate compliance with mortgage insurance requirements.

Complete documentation of a residential mortgage approval includes, but is not limited to:

- a) A description of the purpose of the loan;
- b) Verification of income and employment status;
- c) Verification of the source of down payment;
- d) Debt service ratio calculations, including verification documents;
- e) LTV ratio and confirmation that the LTV is confirmed as the aggregate lending exposure to one collateral security;
- f) Property valuation/appraisal;
- g) Credit bureau reports and any other credit enquiries;
- h) Purchase and sale agreements, and other collateral supporting documents;
- i) An explanation of any mitigating criteria for higher credit risk factors;
- j) A clearly stated rationale for the decision (including exceptions);
- k) A record of approval for an exception; and
- l) Where required, a record from the mortgage insurer validating approval to insure the residential mortgage.

10.5 Debt Service Ratio

Licensees are required to appropriately assess borrowers' ability to service and fully repay their loans without causing the borrower undue hardship and over-indebtedness. As part of this

assessment, licensees should establish debt serviceability metrics (inclusive of the method to calculate these metrics), set prudent measures for debt serviceability (as articulated in relevant policies) and calculate each borrower's debt serviceability ratios for the purposes of assessing affordability.

Two commonly used ratios are the Gross Debt Service Ratio (GDSR) and the Total Debt Service Ratio (TDSR). The ECCB expects the average GDSR and TDSR scores for all mortgages underwritten and/or acquired to be less than the licensee's stated maximums, as articulated in its policies, and reflect a reasonable distribution across the portfolio. Licensees should have clear policies with respect to the contributing factors for the calculation of the GDSR and TDSR, including, but not limited to:

- Principal and interest payments on the mortgage loan;
- Primary and other sources of income;
- Property taxes;
- Fees (example strata/condominium fees or other fees, where applicable); and
- Payments for all other credit facilities (example unsecured personal loan, second mortgage loan, credit cards et cetera); and
- Utilities, where applicable.

GDS and TDS ratios should be calculated conservatively (that is, appropriately stressed for varied financial and economic conditions and/or higher interest rates).

10.6 Loan-to-Value Ratio

For residential mortgage loans, LFIs should establish and adhere to LTV ratios that are in accordance with their policies, risk appetite and/or any other guiding document. The LTV ratio may be determined by law or may be established by an LFI, based on risk factors and other considerations, including the current and expected market conditions, the type of loan, as well as other factors that may impact borrowers' ability to service their debt and/or lenders' ability to realise on the security. The ECCB expects LFIs framework for the LTV ratio to be based on prudent credit risk management practices and procedures.

The LTV ratio should be re-calculated upon any refinancing, and whenever deemed prudent, given changes to a borrower's risk profile or delinquency status. Additionally, LFIs should use an appropriate valuation methodology that does not circumvent the licensee's maximum LTV ratio or other limits in its relevant policies, or any requirements established by the Banking Act or applicable prudential standards.

The ECCB reserves the discretion to implement a ceiling for the LTV ratio, if deemed necessary to maintain financial stability.

10.7 Amortisation

Licensees should have a stated maximum amortisation period for all residential mortgage loans that are underwritten. The ECCB expects the average amortisation period for mortgages underwritten to be less than the licensee's stated maximum, as articulated in its relevant policies.

10.8 Credit Score

For residential mortgage adjudication, a custom credit score is useful to assist in manual adjudication. Licensees are strongly encouraged to utilise borrower's credit scores, where available.

10.9 Guarantors

Where a licensee obtains a guarantee supporting a residential mortgage, it should also undertake a sufficiently rigorous credit assessment of the guarantor. This assessment should be commensurate with the degree to which the guarantor's support is relied upon. The LFI should ensure that the guarantor fully understands his/her legal obligations.

10.10 Co-borrowers and Joint Borrowers

Licensees' should not approve applicants as co-borrowers/joint borrowers unless:

- a) Reasonable steps have been taken to ensure that the co-borrower/joint-borrower understands the risks associated with entering into the loan and understand the difference between being a co-borrower/joint-borrower and a guarantor;

- b) The licensee has taken into account the reasons why the applicant wants to be a co-borrower/joint-borrower; and
- c) Satisfied that the co-borrower/joint-borrower is not experiencing any coercion or financial abuse.

10.11 Additional Assessment Criteria

In addition to income and debt service coverage, licensees are required to consider, as appropriate, other factors that are relevant for assessing credit risk, such as the borrower's assets and liabilities (net worth), other living expenses, recurring payment obligations, and alternate sources for loan repayment.

10.12 Property Valuation

Licensees should have sound collateral management processes for their underlying mortgage properties, supported by clear and transparent valuation policies and procedures that are consistent, at minimum, with the ECCB's Prudential Valuation Standard.

For all credit applications secured by real estate, a property valuation that has been objectively and independently determined is required. The following property valuation method should be used for real estate-secured credit applications:

- **A full valuation** - in general, LFIs should conduct an on-site inspection on the underlying property, to be performed by either a qualified employee or an accredited professional appraiser, depending on the nature of the property or transaction, with a written report independently and impartially prepared thereafter. The report should provide "*an opinion*" with supporting justification as to the market value of the property. Its purpose is to establish a value for lending purposes.

Licensees that use third-party valuers should ensure that they possess the appropriate professional appraisal skill and diligence, and that they are designated, or certified, and meet minimum qualification standards⁴. In addition, valuers should be independent of the mortgage

⁴ Refer to the ECCB's Prudential Valuation Standard

acquisition, loan processing and loan decision process. Licensees should also maintain and implement a framework for critically reviewing and, where appropriate, effectively challenging the assumptions and methodologies underlying property valuations. Realistic, substantiated and supportable valuations should be established to reflect the current price level and the property's function as collateral over the term of the mortgage.

10.13 Mortgage Insurance

Mortgage insurance should not be used as a substitute for sound underwriting practices, particularly the risk mitigation provided by sound borrower due diligence. Licensees are required to conduct their own due diligence including comprehensive and independent assessment of the borrower's capacity to repay, verification of minimum initial equity by borrowers, reasonable debt service coverage, and an assessment of equity requirements.

The effectiveness of mortgage insurance depends on the financial strength of the provider and a clear understanding of the policy coverage, which should be periodically monitored and assessed by licensees commensurate with its level of exposure to the insurer. Licenses are required to use reputable insurance companies and conduct proper due diligence on insurers. For insured mortgages, licensees should meet any underwriting, valuation, or other information requirements set out by the mortgage insurer to ensure the validity of insurance on its loans.

10.14 Collateral Management

In assessing the value of property, LFIs are expected to take a risk-based approach using various tools and processes, to protect against unexpected loss, and undertake on-going monitoring of the collateral. Sound collateral management and valuation practices are essential to the residential mortgage risk management process. A combination of valuation tools and appraisal processes should include:

- (i) Third party appraisal by a certified professional appraiser who is independent of the residential mortgage originator and underwriting process; and valuation tools that monitor the on-going market value of the property;
- (ii) Property tax assessments; and

- (iii) On-site inspection by a qualified employee or appraiser that determines existence, occupancy, and condition of the property.

It is important that loan security documents are complete in order to substantiate a borrower's commitment to the residential mortgage loan and register a claim against the collateral property. Loan security documentation deficiencies can lead to unexpected losses. An LFI is expected to establish policies and procedures to ensure loan security documents are kept safe and enforceable.

10.15 RISK MANAGEMENT

Licenseses must ensure that risk management policies and practices are in place, enabling operational staff and oversight functions to:

- (i) Identify, assess and analyse the key risks with respect to residential mortgages;
- (ii) Ensure that residential mortgage underwriting, other credit policies and credit limits are being followed, particularly on exceptions to policy;
- (iii) Monitor risk exposures against their Risk Appetite Framework;
- (iv) Ensure that risk management policies, processes and limits are being adhered to;
- (v) Ensure that risks are appropriately controlled and mitigated, and provide assurance to the board and senior management;
- (vi) Provide regular risk reporting;
- (vii) Provide exception reporting, including the identification of patterns, trends or systemic issues within the residential mortgage portfolio that may impair loan quality or risk mitigation factors; and
- (viii) Report on the effectiveness and performance of underwriting practices.

Risk management requires a continuous process of identifying risks that are subject to quick and volatile changes. The identification of risks can result in opportunities for portfolio growth or mitigate unacceptable exposures to licensees. In order to properly assess its risks, licensees must maintain quality data and information on their residential mortgage loan portfolio. The ECCB

also recognises that risk management practices will vary according to the size, scope, and complexity of LFI's.

Licenses are expected to record and aggregate the following data (where applicable) from each residential mortgage loan at origination, and update as available, through its Management Information System: Amortisation (initial and remaining); GDSR/TDSR; location of collateral, insured/uninsured; number of days delinquent; product type, unique member identifier; credit bureau; LTV; approved amount; exception to policy; origination date; outstanding balance and purpose.

To manage credit risk, licenses should focus on the oversight of individual residential mortgage loans and the loan portfolio, particularly in balancing the risk of both mortgage loans and the loan portfolio in five key risk areas:

- i. LTV;
- ii. Credit score;
- iii. GDSR/TDSR;
- iv. Amortisation; and
- v. Exceptions to policy.

The data collected should provide the licensee with insight into the loan portfolio's attributes, including exposure (dollar value of loans), distribution (percentage) and the number of loans in each risk area.

10.16 Concentration Risk

The composition and level of risk in the loan portfolio should reflect the risk appetite and limits, strategy, and policies set by the LFI's board. A high volume of loans, near or at policy limits in key risk areas generates concentration risk to the portfolio. It is expected that licenses perform concentration analysis, at a minimum, segmenting the residential mortgage loan portfolio amongst the key credit risk areas of LTV, credit, GDSR/TDSR, amortisation, and exceptions to policy in order to identify concentration risk. Each area of concentration risk should be evaluated individually and as part of the whole portfolio.

Licenses should continuously assess whether adequate controls are in place to properly monitor concentration risk exposure. As part of its risk management practices, a licensee should periodically stress test its portfolio's capacity to absorb expected and unexpected losses.

10.17 Exceptions to Policy

Where a high volume of exceptions is identified, the board of directors is required to review its risk limits and residential mortgage underwriting policy and either revise the licensee's strategy or institute new policy limits.

Licenses are required to document any loan above policy limit as an exception to policy with clear direction on how the exception to policy is approved, monitored and reported. An appropriate exception to policy portfolio concentration tolerance should be documented in a licensee's residential mortgage underwriting or credit policy, with its board receiving semi-annual reporting on this segment of the loan portfolio.

10.18 Reporting

The residential mortgage loan portfolio should be reviewed monthly by senior management and semi-annually by the board or board-designated sub-committee. The frequency of reporting on the portfolio must be written into the licensee's residential mortgage underwriting or credit policy.

Semi-annual reporting to the board or board sub-committee must include, at a minimum:

- (i) Portfolio concentration of levels of LTV, debt service ratios, amortisation, credit scores, and exceptions to policy;
- (ii) Layered analysis of portfolio concentrations of levels of *LTV and amortisation, TDSR and amortisation*;
- (iii) All non-performing residential mortgages and associated provisioning; and
- (iv) Any other combinations deemed appropriate in identifying risk.

10.19 Stress Testing

Licenses are required to have a stress-testing framework that considers unlikely, but plausible, scenarios and their potential impact on the residential mortgage portfolio. The results of such stress testing should be substantially reflected in a licensee's Internal Capital Adequacy Assessment Process (ICAAP).

10.20 Outsourcing

Where an LFI outsources any part of the residential mortgage underwriting process, it remains responsible for ensuring that underwriting standards of the third party are consistent with the policies and procedures of the LFI, this Standard, and other standards issued by the ECCB. An LFI should not rely solely on the attestation of the third party. In case of borrower default, an LFI is expected to have procedures in place to determine the best course of action, identifying the parties for recourse and plans for pursuing recourse.

11 ANTI-MONEY LAUNDERING/COUNTER-FINANCING OF TERRORISM

As part of an LFI's borrower assessment, if the licensee is aware or has reasonable grounds to suspect that any credit facility will be used for illicit purposes, then the licensee should decline the credit application and consider filing a suspicious transaction report to the competent authority with respect to the attempted transaction. Similarly, in the course of a periodic review of an existing credit facility, if illicit activity is now being suspected, a suspicious transaction report filing should likewise be considered.

For all types of credit facilities, licensees are required to ensure compliance with the customer identification and record keeping requirements of the relevant legislation, and ensure that they obtain sufficient information about the borrower to facilitate an adequate assessment of the associated ML/TF risks, and the subsequent assignment of an appropriate risk rating.

Further, all Customer Due Diligence (CDD) and Know Your Customer (KYC) documents should be stored in a manner that facilitates ready retrieval, and in accordance with established Document Retention policies and prevailing AML/CFT legislation.

12 OTHER

The following ratios may be used to assist a licensed financial institution in its measurement of credit risk:

RATIO	INTERPRETATIONS
NPL ratio – loans 90 days or more in arrears plus non-performing overdrafts as a percentage of total loans and advances. The prudential benchmark for this ratio is 5%.	Provides an indication of the level and severity of non-performing loans and advances. An assessment of the portfolio quality, credit analysis and management and level of potential future write-offs. This ratio also gives an indication of the quantum of non-income generating loans.
NPLs minus provision for loan losses/Tier 1 capital	Gives an indication of the impairment to core capital.

Provisions for loan losses/NPLs	Level and adequacy of provision made for portfolio losses.
Past due loans/NPLs	Level of unsatisfactory assets past maturity date, as a proportion of all non-performing loans; indicates severity of delinquency.
Total delinquency - all loans in arrears and non-performing overdrafts compared to total loans and advances	Gives an indication of the total risk in the credit portfolio
Amount outstanding by sector/Total Loans and Advances	Portfolio concentrations by sector. It is an indication of the bank's vulnerability to the performance of a sector.
Amount outstanding by largest borrowers (group)/Total Loans and Advances	Portfolio concentration by individual or borrower group. It is an indication of the bank's vulnerability to the performance of a small group of customers.