



**Financial Services
Commission**

Banking Guidance Note No. 4 Provisioning Policy Statements

Date of Paper : 12 December 2001

Amended 16 march 2006

Version Number : 1.01



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Published by:

Financial Services Commission
PO Box 940, Suite 943, Europort, Gibraltar
Tel (+350) 40283
Fax (+350) 40282
E-Mail: info@fsc.gi
www.fsc.gi

1 Introduction

Context

- 1.1 This Guidance Note deals explicitly with provisioning policy statements and provisions in their generality, although general provisions are mentioned in the context of the definition of capital. The guidance note applies to banks formed or incorporated under the laws of Gibraltar and third country bank branches that are licensed under the Banking Ordinance 1992.

Legal sources

- 1.2 Section 23 (3)(d) of the Banking Ordinance 1992 requires a bank to have adequate provisions for bad and doubtful debts and also obligations of a contingent nature. This requires, therefore that provision should be made for depreciation or diminution in the value of an institution' s assets, for liabilities that will or are expected to fall to be discharged and for any losses which it will or expects to incur. Consequently provisions need to be made for a variety of reasons, for example, bad and doubtful debts, valuation uncertainties in long-term investment portfolios, contingent claims (for example, arising from guarantees or other off-balance sheet exposures), tax liabilities, etc.

Scope of obligations

- 1.3 The requirement to maintain adequate provisions applies to all licensed banks. A bank must provide the FSC with a copy of its provisioning policy statement. The statement should be reviewed by a bank on an annual basis and updates should be sent to the Banking Supervisor.
- a) For a Gibraltar incorporated bank it need not cover unconsolidated subsidiaries or undertakings supervised by other parts of the FSC.
 - b) A non-EEA bank with a Gibraltar branch presence should also submit a provisioning policy statement. Here, the FSC' s preference is for the statement to cover the whole bank. Such branches should contact the Banking Supervisor if they believe this to be inappropriate.
- 1.4 In assessing the adequacy of a bank' s provisions, the FSC looks at its provisioning policies, and the methods and systems for calculating provisions in accordance with those policies.

2 The FSC' S Basic Approach To Provisioning

- 2.1 The FSC regards the prudent valuation of assets and the establishment of provisions as of fundamental importance. The FSC expects contingent liabilities and anticipated losses to be recognised in accordance with accepted accounting standards (as embodied in the UK' s Statements of Standard Accounting Practice and Financial Reporting Standards).
- 2.2 The FSC' s overall approach is that a bank should hold an adequate level of provisions. The FSC accepts that what is ' adequate' will differ between banks, according to the precise nature and scale of the business(es) they undertake. These provisions may be in the form of general or specific provisions.
- 2.3 The objective of asking a bank to provide the FSC with a statement of their provisioning policies is to enable the FSC to understand more fully the procedures that a bank goes through when making provisions. The receipt of this information is a valuable tool of ongoing supervision and will be used in the context of the supervisory process.

- 2.4 Although more detailed guidance on what should be contained in the statement is provided below, as a general rule, it should clearly document the following key points:
- responsibility** for the policy (who owns it, implements it, reviews it, monitors it etc);
 - the **scope** of the policies (the areas of business/ activities that it covers, whether it encompasses all forms of provision, whether it is a high level framework or a set of rules set down in a procedures manual); and
 - reporting requirements**, (e. g. what should be reported to whom, by whom and when, and for what purpose? Which accounting standards/ practices are followed -this is particularly important for provisioning for liabilities).
- 2.5 The FSC has deliberately avoided setting down a prescribed style, format or length for a bank' s provisioning policy statements, as one format would not be appropriate for the range of banks authorised in Gibraltar.

3 The Provisioning Policy Statement

General

- 3.1 The guidance below indicates what a bank' s provisioning policy statement should contain. It is only an indicative list and by no means exhaustive. Statements do not have to follow the order below; a bank may find it more convenient to provide the information in a different format.
- 3.2 This section has been divided into three parts to reflect the fact that some issues relate only to credit exposures, some only to liabilities and some to both, issues relating to provisioning for credit exposures and other liabilities

Issues relating to provisioning for credit exposures and other liabilities

- 3.3 Who in the bank has responsibility for drawing up and monitoring the policy ?
- As with all aspects of a bank' s business, the board as a whole should have overall responsibility. A bank' s board, or a bank' s audit committee on behalf of the board, must approve the policies. It is important, however, that one of the executive directors has particular responsibility for the bank' s provisioning policies. For a non-EEA bank with a Gibraltar branch, a member of the branch' s senior management team, as well as a member of its board at head office, should have responsibility for the policy.
- As well as the above, a member of the bank' s senior management team should have responsibility for monitoring implementation of the policy on a day to day basis, and for ensuring that all the relevant members of staff are aware of the policy.
- 3.4 Who is responsible for reviewing and updating the policies and how often is this done? What are the review processes ?
- Once the policies are in place, they must be reviewed at least annually to ensure that they are still appropriate for the business the bank undertakes and the economic environment in which it operates. This should be undertaken by a member of the senior management team in the first instance, and reviewed and approved by the audit committee or the board.
- 3.5 Does the policy apply to all of a bank' s business ?

The documentation should clearly state to which areas of the bank's business the policies relate, i.e. whether they apply to the bank's business as a whole, or whether there are different policies for different areas of its business. If different policies exist, the key features of each should be outlined in the statement.

- 3.6 How often are the provisions reviewed? By whom? What is the system of review ?

As the status of the exposures/ potential losses changes, so the level of provisions held against them will need to be adjusted. The policy documentation should provide for regular reviews of provisions (both general and specific) to cater for sudden changes in conditions associated with the exposures.

- 3.7 What type of management reports/ other reports are generated and who sees them ?

As the bank's management has overall responsibility for ensuring that the level of provisions is adequate, they need to be able monitor this in some way using management information. The documentation should summarise the types of reports that are produced, how often, who sees them and what they are used for. It should also note any reports that are sent to overseas supervisors, head office, the parent bank or external auditors.

- 3.8 How is the implementation of the policy checked, and by whom ?

This is a crucial point in policy implementation. Is it done through, for example, management reports, internal audit checks, external audit reports, or Head Office examiners? Who within the bank is responsible for seeing that this is done? What measures are there in place if the policies are not adhered to?

Issues Relating To Provisioning For Credit Exposures Only

- 3.9 For the different types of business that the bank undertakes, what constitutes a non-performing exposure? How are they identified ?

Banks have different views as to what constitutes a non-performing exposure. Because of this the documentation should explain clearly and concisely the definition the bank uses. In addition, a bank needs to have a process for identifying such exposures and ensuring clarity as to who is responsible for doing so; for example, does the bank have a loan grading system to determine this and/ or does it operate a watch or problem list? If the bank has a loan grading system, details of how it operates should be included.

- 3.10 How does the bank identify watch list or other problem exposures? How are they defined ?

In order to identify problem exposures and have the opportunity to do something about them, the bank should monitor its loan portfolio on a regular basis. Such exposures can then be put on a watch or problem list and monitored more closely by management. Some common examples of potential problems are: late payment of interest; breaches of limits; failure to comply with covenants or other conditions; and problems emerging from a review of published financial information or management information.

- 3.11 At what stage are provisions on credit exposures raised ?

Is this simply a matter of when an exposure meets the non-performing criteria - or at a certain loan grading level -that the bank has laid down, or is it a matter of judgement for management, or a combination of the two?

- 3.12 How are specific provisions calculated? Is it the result of a formula, a loan grading policy or another method ?
How the level of specific provisions is calculated is important both for consistency and to ensure that there is an audit trail showing the methodology used.
- 3.13 Who decides whether the proposed level of specific provisions on an individual non-performing exposure is adequate?
Does an individual or a committee decide this?
- 3.14 What methodology determines the level of general provisions on credit exposures?
Does the bank make general provisions according to a formula or is it left to management or a committee to decide? Does the formula provide a methodology to determine latent impairment in the portfolio?
- 3.15 What are the bank' s policies for the revaluation of collateral, guarantees or insurance that it has in place ?
The value of any collateral in place will have a bearing on the need for and appropriate size of any provision to cover credit exposure. A bank needs to have systems for ensuring that the security or collateral it has in place is adequately and accurately valued.
- 3.16 How does the bank ensure the continuing enforceability of the collateral, guarantees or insurance that it has ?
So as to ensure that the collateral etc is in place when it is required, a bank needs to have a system for reviewing its enforceability periodically and replacing/ replenishing it if necessary.
- 3.17 At what point are exposures written down to the estimated net realisation value of any security and at what point are they finally written off ?
Does this occur when an exposure meets some non-performing criteria, or at a certain loan grading level that the bank has laid down, or is it a matter of judgement for management, or a combination of these?
- 3.18 What is the bank's arrears management and recovery policy ?
What procedures are in place for the bank to recover exposures that are in arrears or that have had provisions written against them? Is this the responsibility of a dedicated internal department, the customer relationship or credit departments or does the bank pass debts to an external collections company?
- 3.19 Does the bank review its write-off experience against provisions raised to identify whether its policies result in over or under provisioning across the cycle?
Such exercises are useful in contributing to the reviews of provisioning policies, and the design of loan grading systems and credit risk models, as well as risk pricing.
- 3.20 What is the bank' s policy on writing back provisions ?
The methodologies and procedures for identifying those exposures on which provisions are no longer deemed necessary should be described.

Issues Relating To Provisioning For Other Liabilities Only

- 3.21 *What is the bank's policy with regard to providing for other liabilities such as tax, contingent liabilities?*

Issues Relating To Country and Transfer Risk

- 3.22 *What is the bank's policy with regard to identification, monitoring and allocation of general or specific provisions on the control of country and transfer risk?*
- 3.23 *Does the bank monitor and evaluate developments in individual countries and develop appropriate countermeasures accordingly?*

Which accounting standards does the bank comply with in terms of providing for other liabilities?

- 3.22 *At what stage are such provisions raised, how are they calculated, who decides their proposed level, and how frequently are they reviewed?*

These are similar to issues relating to credit exposures mentioned above. This part of a bank's policy should cover all of these issues, as they are very likely to be dealt with in a different way and possibly by different people.