



GUIDELINES ON CREDIT RISK MANAGEMENT

FOR BANKS

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I. PRINCIPLES FOR THE MANAGEMENT OF CREDIT RISK

- Principle 1 : The board of directors has ultimate responsibility for approving and periodically (at least annually) reviewing the credit risk strategy and significant credit risk policies of the bank. The strategy should reflect the bank's tolerance for risk and the level of profitability the bank expects to achieve for incurring various credit risks.
- Principle 2 : Senior management is responsible for implementing the credit risk strategy approved by the board of directors and for developing policies and procedures for identifying, measuring, monitoring and controlling credit risk. Such policies and procedures should address credit risk in all of the bank's activities and at both the individual credit and portfolio levels.
- Principle 3 : Banks should identify and manage credit risk inherent in all products and activities. Banks should ensure that the risks of products and activities new to them are subject to adequate risk management procedures and controls before being introduced or undertaken, and approved in advance by the board of directors or its appropriate committee.
- Principle 4 : Banks must operate within sound, well-defined credit-granting criteria. These criteria should include a clear indication of the bank's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.
- Principle 5 : Banks must establish overall credit limits at the level of individual borrowers and counterparties (and groups of connected counterparties) that aggregate different types of exposures in a comparable and meaningful manner, both in the banking and trading book and on and off the balance sheet.
- Principle 6 : Banks should have a clearly-established process in place for approving new credits as well as the amendment, renewal and re-financing of existing credits.
- Principle 7 : All extensions of credit must be made on an arm's-length basis. In particular, credits to related companies and individuals must be authorised on an exception basis, monitored with particular care and other appropriate steps taken to control or mitigate the risks of non-arm's length lending.
- Principle 8 : Banks should have in place a system for the ongoing administration of their various credit risk-bearing portfolios.
- Principle 9 : Banks must have in place a system for monitoring the condition of individual credits, including determining the adequacy of provisions and reserves.
- Principle 10 : Banks should develop and utilize an internal risk rating system appropriate to the nature, size and complexity of the bank's activities in order to help the board and senior management differentiate risks across the individual credits and groups and to facilitate informed decision making.

- Principle 11 : Banks must have in place a system for monitoring large exposures, and the overall composition and quality of the credit portfolio to manage concentration risks. Banks must have information systems and analytical techniques that enable management to measure the credit risk inherent in all on- and off-balance sheet activities. The management information system ('MIS') should provide adequate information on the composition of the credit portfolio, including identification of any concentrations of risk.
- Principle 12 : Banks should take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios, and should assess their credit risk exposures under stressed conditions.
- Principle 13 : Banks must establish a system of independent, ongoing assessment of their credit risk management processes and the results of such reviews should be communicated directly to the board of directors and senior management.
- Principle 14 : Banks must ensure that the credit-granting function is being properly managed and that credit exposures are within levels consistent with prudential standards and internal limits. Banks should establish and enforce internal controls and other practices to ensure that exceptions to policies, procedures and limits are reported in a timely manner to the appropriate level of management for action.
- Principle 15 : Banks must have a system in place for early remedial action on deteriorating credits, managing problem credits and similar workout situations.

II. DETAILED GUIDELINES FOR THE MANAGEMENT OF CREDIT RISK

A. ESTABLISHING AN APPROPRIATE CREDIT RISK ENVIRONMENT

1. Board Responsibilities

Principle 1: The board of directors has ultimate responsibility for approving and periodically (at least annually) reviewing the credit risk strategy and significant credit risk policies of the bank. The strategy should reflect the bank's tolerance for risk and the level of profitability the bank expects to achieve for incurring various credit risks.

Role of the Board

- 1.1 As with all other areas of a bank's activities, the board of directors has a critical role to play in overseeing the credit-granting and credit risk management functions of the bank. Each bank should develop a credit risk strategy or plan that establishes the objectives guiding the bank's credit-granting activities and adopt the necessary policies and procedures for conducting such activities. The credit risk strategy, as well as significant credit risk policies, should be approved and periodically (at least annually) reviewed by the board of directors. The board needs to recognise that the strategy and policies must cover the many activities of the bank in which credit exposure is a significant risk.
- 1.2 The board of directors should ensure that senior management is fully capable of managing the credit activities conducted by the bank and that such activities are undertaken within the risk strategy, policies and tolerances approved by the board. The board should also regularly (i.e. at least annually), either within the credit risk strategy or within a statement of credit policy, approve the bank's overall credit granting criteria (including general terms and conditions). In addition, it should approve the manner in which the bank will organise its credit-granting functions, including independent review of the credit granting and management function and the overall portfolio.
- 1.3 While members of the board of directors, particularly outside directors, can be important sources of new business for the bank, once a potential credit is introduced, the bank's established processes should determine how much and at what terms credit is granted. In order to avoid conflicts of interest, it is important that board members not override the bank's credit-granting and monitoring processes.
- 1.4 The board of directors should ensure that the bank's remuneration policies do not contradict its credit risk strategy. Remuneration policies that reward unacceptable behavior such as generating short-term profits while deviating from credit policies or exceeding set limits, weaken the bank's credit processes.
- 1.5 Foreign banks registered in Brunei Darussalam should explain briefly how the board of directors and senior management in the home country set the context for their operations in Brunei Darussalam. This also includes the extent to which local management can approve credit risk policy, if at all.

Credit Risk Strategy

- 1.6 The credit risk strategy must reflect the bank's profitability, credit quality, and portfolio growth targets, and must be consistent with the credit risk tolerance, diversification policy and overall corporate strategy and business goals of the bank.
- 1.7 The strategy should include a statement of the bank's willingness to grant credit based on exposure type (for example, commercial, consumer, real estate), economic sector, geographical location, currency, maturity and anticipated profitability. This also includes the identification of target markets and the overall characteristics that the bank would want to achieve in its credit portfolio (including levels of diversification and concentration tolerances).
- 1.8 Every bank, regardless of size, is in business to be profitable and, consequently, must determine the acceptable risk/reward trade-off for its activities, factoring in the cost of capital. A bank's board of directors should approve the bank's strategy for selecting risks and maximising profits. The board should periodically review the financial results of the bank and, based on these results, determine if changes need to be made to the strategy. The board must also determine that the bank's capital level is adequate for the risks assumed throughout the entire organisation.
- 1.9 The credit risk strategy of any bank should provide continuity in approach. Therefore, the strategy will need to take into account the cyclical aspects of any economy and the resulting shifts in the composition and quality of the overall credit portfolio. Although the strategy should be periodically assessed and amended, it should be viable in the long-run and through various economic cycles.
- 1.10 The credit risk strategy and policies should be effectively communicated throughout the bank. All relevant personnel should clearly understand the bank's approach to granting and managing credit and should be held accountable for complying with internal policies and procedures.

2. Senior Management Responsibilities

Principle 2: Senior management is responsible for implementing the credit risk strategy approved by the board of directors and for developing policies and procedures for identifying, measuring, monitoring and controlling credit risk. Such policies and procedures should address credit risk in all of the bank's activities and at both the individual credit and portfolio levels.

Role of Senior Management

- 2.1 Senior management is responsible for ensuring that the credit risk-taking activities of a bank are aligned with the credit risk strategy approved by the board of directors. It is also responsible for developing and implementing credit policies and procedures that lay down the conditions and guidelines for an effective credit risk management process, as well as proper channels of communication to ensure that these policies are clearly communicated and adhered to by all levels of the organization.
- 2.2 A senior management committee should be formed to establish and oversee the credit risk management framework. The framework should cover areas such as approval of business and credit risk strategy, review of the credit portfolio and profile, approval of credit policy, delegation of credit approving authority and evaluation of the credit processes. This committee should comprise senior management from the business line and control functions.

Credit Risk Management Structure

- 2.3 Senior Management should implement a board-approved credit risk management structure that clearly delineates lines of authority, establish accountabilities and responsibilities of individuals involved in the different phases of the credit risk management process.
- 2.4 Depending on the size, complexity and scope of credit activities, and in addition to the roles and responsibilities of the board and senior management, a bank's credit risk management organization may be broadly classified into three functional lines of activities: the front, back and middle offices, to properly segregate accountabilities, ensure that no individual is assigned conflicting responsibilities, and effectively monitor and control the risks being taken.
- 2.5 The front office function performs credit originating; recommends internal credit ratings, classifications and allowances for losses including changes thereon, when necessary; and the on-going monitoring of credit exposures of borrowers on a day-to-day basis.
- 2.6 The back office provides support in the overall credit administration, including, among others: ensuring complete documentation, credit disbursement and recording of payments received; maintenance of credit and collateral files; and compilation of management information reports.

- 2.7 The middle office performs risk management and control functions that are independent from the credit originating and administration functions. The risk management function provides meaningful inputs in policy formulation and limits setting; designs and implements the bank's internal credit risk rating system; and performs periodic exposure and exception monitoring. The risk management function should report directly to the Risk Management Committee (RMC) or appropriate board-level committee or the board.
- 2.8 An independent credit review is a function within the middle office that performs an unbiased assessment of the quality of individual credits and the aggregate credit portfolio, including appropriateness of credit risk rating, classification and adequacy of allowance for loan losses. In the case of simple banks, such independent credit review function may be concurrently performed by qualified personnel fulfilling other independent control oversight functions (e.g. compliance, internal audit).
- 2.9 The workout or problem loan management is another function within the middle office that is independent from the credit originating function to ensure that problem loans are managed effectively to minimize potential losses. For simple banks, however, the function may still be performed by the credit originating function and/or unit responsible for monitoring the quality of such credit.
- 2.10 The structure should likewise provide for independent audits, i.e., internal audit and compliance, to conduct independent credit and compliance audits of the credit risk management system of the bank. The scope of internal audit should include the evaluation of the independence and overall effectiveness of the credit review function.
- 2.11 Regardless of the organizational structure that a bank adopts, the board and senior management must ensure that the aforementioned key functions are considered, and independence and control oversight functions are effective to avoid or address any potential conflict of interest.
- 2.12 Personnel or staff involved in all phases of the credit risk management process should be qualified, competent and have the necessary training and experience to exercise prudent judgment in assessing, managing and/or controlling credit risk, and a solid understanding of the bank's strategic direction, policies, procedures, risk tolerance and limits. Their qualification standards, roles and responsibilities should be clearly defined in the credit operating policies and procedures manual. The board and senior management must ensure that adequate resources and appropriate level of staffing are allocated to execute all kinds of credit activities.

Credit Policies, Processes, and Procedures

- 2.13 Banks should have in place sound, comprehensive and clearly defined credit policies, processes and procedures consistent with prudent standards, practices, and relevant regulatory requirements adequate for the size, complexity and scope of a bank's operations. The board-approved policies, processes and procedures should cover all phases of the credit risk management system.

- 2.14 The credit culture, which reflects the bank's credit values, beliefs and behaviours, should be articulated in the credit policy and communicated to credit officers and staff at all levels through the strategic plan. The credit practices should be assessed periodically to ensure that the officers and staff conform to the desired standard and value.
- 2.15 Banks should establish appropriate processes and procedures to implement the credit policy and strategy. These processes and procedures, as well as the credit policy, should be documented in sufficient detail, effectively communicated throughout the organization to provide guidance to staff, and periodically reviewed and updated to take into account new activities and products, as well as new lending approaches. Subsequent major changes must be approved by the board.
- 2.16 The credit policy should likewise provide for the maintenance of an audit trail documenting that the credit risk management process was properly observed and identifying the unit, individual(s) and/or committee(s) providing input into the process.

3. Review And Approval Of Credit Products

Principle 3: Banks should identify and manage credit risk inherent in all products and activities. Banks should ensure that the risks of products and activities new to them are subject to adequate risk management procedures and controls before being introduced or undertaken, and approved in advance by the board of directors or its appropriate committee.

- 3.1 The basis for an effective credit risk management process is the identification and analysis of existing and potential risks inherent in any product or activity. Consequently, it is important that banks identify all credit risk inherent in the products they offer and the activities in which they engage. Such identification stems from a careful review of the existing and potential credit risk characteristics of the product or activity.
- 3.2 Banks must develop a clear understanding of the credit risks involved in more complex credit-granting activities (for example, loans to sectors such as oil or aviation, asset securitisation, customer-written options, credit derivatives, credit-linked notes). This is particularly important because the credit risk involved, while not new to banking, may be less obvious and require more analysis than the risk of more traditional credit-granting activities. Although more complex credit-granting activities may require tailored procedures and controls, the basic principles of credit risk management still apply.
- 3.3 New ventures require significant planning and careful oversight to ensure the risks are appropriately identified and managed. Banks should ensure that the risks of new products and activities are subject to adequate procedures and controls before being introduced or undertaken. Any major new activity should be approved in advance by the board of directors or its appropriate delegated committee.
- 3.4 It is critical that senior management determine that the staff involved in any activity where there is borrower or counterparty credit risk, whether established or new, basic or more complex, be fully capable of conducting the activity to the highest standards and in compliance with the bank's policies and procedures.

B. OPERATING UNDER A SOUND CREDIT GRANTING PROCESS

4. Sound And Well-Defined Credit Criteria

Principle 4: Banks must operate within sound, well-defined credit-granting criteria. These criteria should include a clear indication of the bank's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.

- 4.1 Establishing sound, well-defined credit-granting criteria is essential to approving credit in a safe and sound manner. The criteria should set out who is eligible for credit and for how much, what types of credit are available, and under what terms and conditions the credits should be granted.
- 4.2 Banks must receive sufficient information to enable a comprehensive assessment of the true risk profile of the borrower or counterparty. Depending on the type of credit exposure and the nature of the credit relationship, the factors to be considered and documented in approving credits include:
- (a) the purpose of the credit and sources of repayment;
 - (b) the current risk profile (including the nature and aggregate amounts of risks) of the borrower or counterparty and collateral and its sensitivity to economic and market developments;
 - (c) the borrower's repayment history and current capacity to repay, based on historical financial trends and future cash flow projections, under various scenarios;
 - (d) for commercial credits, the borrower's business expertise and the status of the borrower's economic sector and its position within that sector;
 - (e) the proposed terms and conditions of the credit, including covenants designed to limit changes in the future risk profile of the borrower; and
 - (f) where applicable, the adequacy and enforceability of collateral or guarantees, including under various scenarios.
- 4.3 In performing the financial analysis, banks should use, to the extent available, credible audited financial statements and other relevant documents and sources. Banks may opt to use financial information/data from other sources provided that the process for arriving at such disposition and an evaluation of how much reliance or value was attached into the financial information used is clearly articulated and documented.

- 4.4 When granting consumer credits, a bank should conduct its credit assessment in a holistic and prudent manner, taking into account all relevant factors that could influence the prospect for the loan to be repaid according to its terms and conditions. This should include an appropriate consideration of the potential obligor's other debt obligations and repayment history and an assessment of whether the loan can be expected to be repaid from the potential obligor's own resources without causing undue hardship and over-indebtedness. Adequate credit checking, including with relevant credit bureaus, should be made to verify the obligor's outstanding balance, credit applications, repayment records, and total debt service coverage ratio, as defined under relevant AMBD regulations.
- 4.5 In approving borrowers or counterparties for the first time, consideration should be given to the integrity and reputation of the borrower or counterparty as well as their legal capacity to assume the liability. Once credit-granting criteria have been established, it is essential for the bank to ensure that the information it receives is sufficient to make proper credit-granting decisions. This information will also serve as the basis for rating the credit under the bank's internal rating system.
- 4.6 Banks need to understand to whom they are granting credit. Therefore, prior to entering into any new credit relationship, a bank must become familiar with the borrower or counterparty and be confident that they are dealing with an individual or organisation of sound repute and creditworthiness. In particular, strict policies must be in place to avoid association with individuals involved in fraudulent activities and other crimes. This can be achieved through a number of ways, including asking for references from known parties, accessing credit registries, and becoming familiar with individuals responsible for managing a company and checking their personal references and financial condition. However, a bank should not grant credit simply because the borrower or counterparty is familiar to the bank or is perceived to be highly reputable.
- 4.7 Banks should have procedures to identify situations where, in considering credits, it is appropriate to classify a group of obligors as connected counterparties and, thus, as a single obligor. This would include aggregating exposures to groups of accounts exhibiting financial interdependence, including corporate or non-corporate, where they are under common ownership or control or with strong connecting links (for example, common management, familial ties). Banks should also have procedures for aggregating exposures to individual clients across business activities.
- 4.8 Many banks participate in loan syndications or other such loan consortia. Some institutions place undue reliance on the credit risk analysis done by the lead underwriter or on external commercial loan credit ratings. All syndicate participants should perform their own due diligence, including independent credit risk analysis and review of syndicate terms prior to committing to the syndication. Each bank should analyse the risk and return on syndicated loans in the same manner as directly sourced loans.
- 4.9 Granting credit involves accepting risks as well as producing profits. Banks should assess the risk/reward relationship in any credit as well as the overall profitability of the account relationship. In evaluating whether, and on what terms, to grant credit, banks also need to factor in 'non-price' risks (e.g. restrictive covenants) against expected return to the greatest extent possible. In evaluating risk, banks should also assess likely downside scenarios and their possible impact on borrowers or counterparties. A common problem among banks is the tendency not to take 'non-price' factors into account and therefore not receive adequate compensation for the risks incurred.

- 4.10 In considering potential credits, banks must recognise the necessity of establishing provisions for identified and expected losses and holding adequate capital to absorb unexpected losses. The bank should factor expected loss provisioning into credit-granting decisions, as well as into the overall portfolio risk management process.
- 4.11 Banks can utilise transaction structure, collateral and guarantees to help mitigate risks (both identified and inherent) in individual credits but transactions should be entered into primarily on the strength of the borrower's repayment capacity. Collateral cannot be a substitute for a comprehensive assessment of the borrower or counterparty, nor can it compensate for insufficient information. It should be recognised that any credit enforcement actions (e.g. foreclosure proceedings) can eliminate the profit margin on the transaction. In addition, banks need to be mindful that the value of collateral may well be impaired by the same factors that have led to the diminished recoverability of the credit. Banks should have policies covering the acceptability of various forms of collateral, procedures for the ongoing valuation of such collateral, and a process to ensure that collateral is, and continues to be, enforceable and realisable. With regard to guarantees, banks should evaluate the level of coverage being provided in relation to the credit-quality and legal capacity of the guarantor. Banks should exercise extreme caution when assessing implied support from third parties such as the government.
- 4.12 Netting agreements are an important way to reduce credit risks, especially in interbank transactions. In order to actually reduce risk, such agreements must be sound and legally enforceable.
- 4.13 Where actual or potential conflicts of interest exist within the bank, internal confidentiality arrangements (e.g. "Chinese walls") should be established to ensure that there is no hindrance to the bank obtaining all relevant information from the customer.

5. Internal Credit Limits

Principle 5: Banks must establish overall credit limits at the level of individual borrowers and counterparties (and groups of connected counterparties) that aggregate different types of exposures in a comparable and meaningful manner, both in the banking and trading book and on and off the balance sheet.

- 5.1 An important element of credit risk management is the establishment of exposure limits on single counterparties and groups of connected counterparties. Such limits should be based on the internal risk rating assigned to the borrower or counterparty, with counterparties assigned better risk ratings having potentially higher exposure limits. Internal limits should also be established for particular industries or economic sectors, geographic regions and specific products.
- 5.2 Exposure limits are needed in all areas of the bank's activities that involve credit risk. These limits help to ensure that the bank's credit-granting activities are adequately diversified. As mentioned earlier, much of the credit exposure faced by some banks comes from activities and instruments in the trading book and off the balance sheet. Limits on such transactions are particularly effective in managing the overall credit risk profile or counterparty risk of a bank. In order to be effective, limits should generally be binding and not driven by customer demand.
- 5.3 Effective measures of potential future exposure are essential for the establishment of meaningful limits, placing an upper bound on the overall scale of activity with, and exposure to, a given counterparty, based on a comparable measure of exposure across a bank's various activities (both on and off-balance-sheet).
- 5.4 Banks should consider the results of stress testing in the overall limit setting and monitoring process. Such stress testing should take into consideration economic cycles, interest rate and other market movements, and liquidity conditions.
- 5.5 Bank's credit limits should recognise and reflect the risks associated with the near term liquidation of positions in the event of counterparty default. Where a bank has several transactions with a counterparty, its potential exposure to that counterparty is likely to vary significantly and discontinuously over the maturity over which it is calculated. Potential future exposures should therefore be calculated over multiple time horizons. Limits should also factor in any unsecured exposure in a liquidation scenario.

6. Credit Approval And Renewal

Principle 6: Banks should have a clearly-established process in place for approving new credits as well as the amendment, renewal and re-financing of existing credits.

- 6.1 Many individuals within a bank are involved in the credit-granting process. These include individuals from the business origination function, the credit analysis function and the credit approval function. In addition, the same counterparty may be approaching several different areas of the bank for various forms of credit. It is therefore important that the credit granting process coordinate the efforts of all of the various individuals in order to ensure that sound credit decisions are made.
- 6.2 In order to maintain a sound credit portfolio, a bank must have an established formal transaction evaluation and approval process for the granting of credits. Approvals should be made in accordance with the bank's written guidelines and granted by the appropriate level of management. There should be a clear audit trail documenting that the approval process was complied with and identifying the individual(s) and/or committee(s) providing input as well as making the credit decision. Banks should establish specialist credit groups to analyse and approve credits related to significant product lines, types of credit facilities and industrial and geographic sectors. Banks should review the adequacy of credit decision resources to ensure that they are able to make sound credit decisions consistent with their credit strategy and meet competitive time, pricing and structuring pressures.
- 6.3 Each credit proposal should be subject to careful analysis by a qualified credit analyst with expertise commensurate with the size and complexity of the transaction. An effective evaluation process establishes minimum requirements for the information on which the analysis is to be based (see 'Credit Criteria'). There should be policies in place regarding the information and documentation needed to approve new credits, renew existing credits and/or change the terms and conditions of previously approved credits. The information received will be the basis for any internal evaluation or rating assigned to the credit and its accuracy and adequacy is critical to management making appropriate judgements about the acceptability of the credit.
- 6.4 Banks must develop a body of credit risk officers who have the experience, knowledge and background to exercise prudent judgement in assessing, approving and managing credit risks. A bank's credit-granting approval process should establish accountability for decisions taken and designate who has the absolute authority to approve credits or changes in credit terms. Banks' policies should clearly outline when to utilise individual signature authority, dual or joint authorities, or a credit committee, depending upon the size and nature of the credit. Approval authorities should be commensurate with the expertise of the individuals involved.

- 6.5 Banks must adopt and adhere to the following explicit standards that control the use of renewals and extensions of maturity date of credits:
- (a) Credits and other accommodations should only be renewed or its maturity date extended:
 - (i) Upon re-establishment of the creditworthiness of the obligor using the same credit-granting criteria for the evaluation and approval of new loans; and
 - (ii) When the corresponding accrued interest receivable has been paid.
 - (b) A policy on clean-up of principal, either partial or full, should be established and appropriate controls put in place to prevent continuous renewal or extension of watchlisted and problem credits without reduction in principal; otherwise, such credits and other accommodations will be subject to adverse classification and increase in allowance for credit losses.
 - (c) Specific and reasonable standards should be provided for renewals or extensions of certain types of credit exposures that take into consideration the following factors:
 - (i) Borrower's normal operating, trade or production cycle, in the case of credit exposures for working capital, trade financing, production, and/or other similar purposes to ensure a realistic repayment schedule;
 - (ii) Transaction history such as frequency of renewal or extension, rate of utilization of facilities granted, and business requirements;
 - (iii) Status of collateral and other guarantees in the case of secured credit exposures, including requiring the bank to re-appraise the property especially when there is a material change in market conditions or in the physical aspects of the property that threatens the collateral protection; and
 - (iv) Age of the account, utilization rate, average balance carried, delinquency status, payment history, and account profitability.
 - (d) For retail credits, banks may use separate credit scoring models, such as behavioural models, to evaluate application for renewals.

7. Credit Extension To Related Parties

Principle 7: All extensions of credit must be made on an arm's-length basis. In particular, credits to related companies and individuals must only be authorized on an exceptions basis, monitored with particular care and other appropriate steps taken to control or mitigate the risks of non-arm's length lending.

- 7.1 Extensions of credit should be made subject to the criteria and processes described above. These create a system of checks and balances that promote sound credit decisions. Therefore, directors, senior management and other influential parties (e.g. shareholders) should not seek to override the established credit-granting and monitoring processes of the bank.
- 7.2 A potential area of abuse arises from granting credit to non-arms-length and related parties, whether companies or individuals. Consequently, it is important that banks grant credit to such parties on an arm's-length basis and that the amount of credit granted is suitably monitored. Such controls are most easily implemented by requiring that the terms and conditions of such credits not be more favourable than credit granted to non-related borrowers under similar circumstances and by imposing strict absolute limits on such credits. The bank's credit-granting criteria should not be altered to accommodate related companies and individuals.
- 7.3 Material transactions with related parties should be subject to the approval of the board of directors (excluding board members with conflicts of interest), and where required by the Banking Order, 2006 and Islamic Banking Order, 2008 or other Notices reported to the AMBD for prior approval.

C. MAINTAINING AN APPROPRIATE CREDIT ADMINISTRATION, MEASUREMENT AND MONITORING PROCESS

8. Credit Administration

Principle 8: Banks should have in place a system for the ongoing administration of their various credit risk-bearing portfolios.

- 8.1 Credit administration is a critical element in maintaining the safety and soundness of a bank. Once a credit is granted, it is the responsibility of the business unit, often in conjunction with a credit administration support team, to ensure that the credit is properly maintained. This includes keeping the credit file up to date, obtaining current financial information, sending out renewal notices and ensuring collateral is taken and loan covenants are followed.
- 8.2 Given the wide range of responsibilities of the credit administration function, its organisational structure varies with the size and sophistication of the bank. In larger banks, responsibilities for the various components of credit administration are usually assigned to different departments. In smaller banks, a few individuals might handle several of the functional areas. Where individuals perform such sensitive functions as custody of key documents, wiring out funds, or entering limits into the computer database, they should report to managers who are independent of the business origination and credit approval processes.
- 8.3 In developing their credit administration areas, banks should ensure:
- (a) the efficiency and effectiveness of credit administration operations, including monitoring documentation, contractual requirements, legal covenants, collateral, etc.;
 - (b) the accuracy and timeliness of information provided to management information systems;
 - (c) adequate segregation of duties;
 - (d) the adequacy of controls over all “back office” procedures; and
 - (e) compliance with prescribed management policies and procedures as well as applicable laws and regulations.
- 8.4 For the various components of credit administration to function appropriately, senior management must understand and demonstrate that it recognises the importance of this element of monitoring and controlling credit risk.

The credit files should include all of the information necessary to ascertain the current financial condition of the borrower or counterparty as well as sufficient information to track the decisions made and the history of the credit. For example, the credit files should include current financial statements, financial analyses and internal rating documentation, internal memoranda, reference letters, and appraisals. The loan review function should determine that the credit files are complete and that all loan approvals and other necessary documents have been obtained.

9. Credit Monitoring, Classification, And Provisioning

Principle 9: Banks must have in place a system for monitoring the condition of individual credits, including determining the adequacy of provisions and reserves.

9.1 Banks need to develop and implement comprehensive procedures and information systems to monitor the condition of individual credits and single obligors across the bank's various portfolios. These procedures need to define criteria for identifying and reporting potential problem credits and other transactions to ensure that they are subject to more frequent monitoring as well as possible corrective/remedial action, classification, and provisioning.

Credit Monitoring

9.2 An effective credit monitoring system will include measures to:

- (a) Regularly assess the current financial condition and results of operations of the borrower or counterparty;
- (b) monitor compliance with existing covenants;
- (c) assess, where applicable, collateral coverage relative to the obligor's current condition;
- (d) identify contractual payment delinquencies and classify potential problem credits on a timely basis; and
- (e) direct problems promptly for remedial management.

Regulatory measures of problem credits, particularly non-performing, forbore, and classified exposures are defined in separate Notice.

9.3 Specific individuals should be responsible for monitoring credit quality, including ensuring that relevant information is passed to those responsible for assigning internal risk ratings to the credit. In addition, individuals should be made responsible for monitoring on an ongoing basis any underlying collateral and guarantees. Such monitoring will assist the bank in making necessary changes to contractual arrangements as well as maintaining adequate allowance for credit losses. In assigning these responsibilities, management should recognise the potential for conflicts of interest, especially for personnel who are judged and rewarded on such indicators as loan volume, portfolio quality or short-term profitability.

Credit Classification

9.4 Banks should have in place a reliable credit classification system to promptly identify deteriorating credit exposures to enable management to implement prompt remedial measures and recognize timely and adequate allowance for credit losses.

Credit Provisioning

- 9.5 Banks should adopt, document and adhere to sound methodologies that address policies, procedures, and controls for assessing and measuring credit risk on all lending exposures. The measurement of allowances should build upon those robust methodologies and result in the appropriate and timely recognition of expected credit losses (ECL) in accordance with the International Financial Reporting Standard (IFRS) 9 and other guidelines on the accounting of ECL issued by the International Accounting Standards Board (IASB) and the Basel Committee on Banking Supervision, particularly the “Guidance on Credit Risk and Accounting for Expected Credit Losses”, issued on December 2015.

Prudential Treatment of Problem Assets and Accounting for Allowance for Credit Losses

- 9.6 Detailed prudential guidelines on credit classification and provisioning are provided under a separate Notice as titled above.

10. Internal Risk Rating System

Principle 10: Banks should develop and utilize an internal risk rating system appropriate to the nature, size and complexity of the bank's activities in order to help the board and senior management differentiate risks across the individual credits and groups and to facilitate informed decision making.

- 10.1 Large banks are expected to have comprehensive rating systems involving sufficiently granular rating grades. Simple banks may adopt simpler systems. In all cases, however, banks should demonstrate the influence of the internal risk rating system in the following important functions: i) credit approval and underwriting; ii) loan pricing; iii) relationship management and credit administration; iv) allowance for credit losses and capital adequacy; and v) portfolio management and board reporting.
- 10.2 Internal risk rating systems for non-retail exposures, particularly large corporate exposures, should generally observe the following standards:
- (a) It must be operationally integrated into the bank's internal credit risk management process. Its output should accordingly be an integral part of the process of evaluation and review of prospective and existing exposures. Credit underwriting criteria should become progressively more stringent as credit rating declines;
 - (b) It must be fully documented and should address topics such as coverage, rating criteria, responsibilities of parties involved in the ratings process, definition of what constitutes a rating exception, parties that have authority to approve exceptions, frequency of rating reviews, and management oversight of the rating process. In addition, banks must document the rationale for its choice of rating criteria and must be able to provide analyses demonstrating that the rating criteria and procedures are likely to result in ratings that meaningfully differentiate risk;
 - (c) All credit exposures should be rated for risk. Where individual credit risk ratings are not assigned, e.g., small-denomination performing loans, banks should assign the portfolio of such exposures a composite credit risk rating that adequately defines its risk, i.e., repayment capacity and/or loss potential;
 - (d) The board should receive sufficient information to oversee management's implementation of the process. Migration analysis/transition matrix of ratings should be regularly reported to show the actual performance of the rating system over time;
 - (e) The risk rating system should encompass an adequate number of ratings. Banks should ensure that "pass" credits are sufficiently differentiated and more precisely defined. There should be a proper process to map the internal rating system to regulatory classification. The bank should readjust the mapping after every review of its internal risk rating methodology;
 - (f) Risk ratings must be reasonable, timely and dynamic. Ratings should be reviewed at least annually and should be modified whenever the borrower's creditworthiness changes;
 - (g) The rating criteria should reflect an established blend of qualitative (e.g., the quality of management, willingness to repay, etc.) and quantitative (e.g., cash flow,

profitability, and leverage) factors. The criteria for assigning each rating should be clearly defined;

- (h) The rating policy should indicate a time horizon for the risk rating. Generally, the time horizon used for probability of default estimation is one year. However, banks may use a different time horizon to cover one business cycle;
- (i) Ratings should reflect the risks posed by both the borrower's expected performance and the transaction's structure. The ratings output of internal credit risk rating systems must contain both a borrower and a facility dimension. The borrower dimension should focus on factors that affect the inherent credit quality of each borrower. The facility dimension, on the other hand, should focus on security/collateral arrangements and other similar risk influencing factors of each transaction;
- (j) The rating assigned to a credit should be well supported and documented in the credit file; and
- (k) Rating histories on individual accounts should be maintained, which should include the ratings of the account, the dates the ratings were assigned, the methodology and key data used to derive the ratings and the analyst who gave the ratings. The identity of borrowers and facilities that default, and the timing and circumstances of such defaults, must be retained. Banks must also retain data on the realized default rates associated with rating grades and ratings migration in order to eventually track the predictive power of the risk rating system.

10.3 For retail exposures, banks may use credit risk scoring models for credit evaluation of credit applicants, monitoring, and provisioning purposes.

Validation of Internal Rating Systems

10.4 Validation is a process to assess the performance of risk component measurement systems consistently and meaningfully, to ensure that the realized risk measures are within an expected range. It not only increases the reliability of a model, but also promotes improvements and a clearer understanding of a model's strengths and weaknesses among management and user groups.

10.5 Banks must establish comprehensive policies and procedures on effective validation of the rating system (i.e. review of model design/developmental evidence, backtesting, benchmarking and assessment of the discriminatory power of the ratings) and rating process (i.e. review of data quality, internal reporting, problem handling and how the rating system issued by the credit officers). This should be adequately documented and results reported to appropriate levels of the bank. The process should likewise be subject to periodic review by qualified, independent individuals.

10.6 Moreover, banks should periodically conduct back-testing in evaluating the quality of their credit risk assessment models and establish internal tolerance limits for differences between expected and actual outcomes and processes for updating limits as conditions warrant. The policy should also include remedial actions to be taken when risk tolerances are exceeded.

11. Credit Portfolio Risk Management

Principle 11: Banks must have in place a system for monitoring large exposures, and the overall composition and quality of the credit portfolio to manage concentration risks. Banks must have information systems and analytical techniques that enable management to measure the credit risk inherent in all on- and off-balance sheet activities. The management information system ('MIS') should provide adequate information on the composition of the credit portfolio, including identification of any concentrations of risk.

Credit Risk Measurement

11.1 Banks should have methodologies that enable them to quantify the risk involved in exposures to individual borrowers or counterparties. Banks should also be able to analyse credit risk at the product and portfolio level in order to identify any particular sensitivities or concentrations. The measurement of credit risk should take account of the following:-

- (a) the specific nature of the credit (loan, derivative, facility, etc.) and its contractual and financial conditions (maturity, reference rate, etc.);
- (b) the exposure profile until maturity in relation to potential market movements;
- (c) the existence of collateral or guarantees; and
- (d) the potential for default based on the internal risk rating.

The analysis of credit risk data should be undertaken at an appropriate frequency with the results reviewed against relevant limits. Banks should use measurement techniques that are appropriate to the complexity and level of the risks involved in their activities, based on robust data, and subject to periodic validation.

Management of Large Exposures¹ and Concentration Risks

11.2 A bank is exposed to various forms of credit risk concentration which if not properly managed, monitored and controlled may cause significant losses that could threaten its financial strength and undermine public confidence in the bank. Concentration risk can arise from excessive exposures to individual obligors, groups of connected counterparties¹ and groups of counterparties with similar characteristics (e.g., counterparties in specific geographical locations, economic or industry sectors) or entities in a foreign country or a group of countries with strongly interrelated economies.

11.3 While concentration of credit risks is inherent in banking and cannot be totally eliminated, this can be mitigated by adopting policies and processes that would limit and control credit exposures and employing portfolio diversification strategies. Policies and procedures may include, but are not limited to the following:

- (a) Policies and procedures for identifying, reviewing, managing and reporting large exposures and concentration risks of the bank.

¹ Large exposures and connected counterparties are defined in the Glossary.

- (b) Segmenting its portfolio into the following diverse categories or such other segmentations consistent with the bank's credit strategy.
- Various types of borrowers/counterparties or loan category (e.g., government, banks and other banks, corporate and individual borrowers, including exchanges, and clearing houses);
 - A group of connected borrowers/counterparties (includes aggregating exposures to groups of accounts exhibiting financial or economic interdependence, including corporate or non-corporate, where they are under common ownership or control or with strong connecting links, e.g. common management, familial ties);
 - Individual industry sectors;
 - Geographic regions or countries;
 - Loan structure, collateral, and tenor; and
 - Various types of investments, including other credit instruments in the trading books and off-balance sheet transactions.
- (c) Defining limit structure on each of the foregoing categories. Limits should meaningfully aggregate credit exposures, both in the banking, trading book and on and off the balance sheet and should be reasonable in relation to the bank's level of risk tolerance, historical loss experience, capital and resources. Such limits can be based in part on the internal risk rating assigned to the obligor or counterparty.
- (d) Procedures should ensure that limits are not exceeded and are clearly communicated, periodically reviewed and modified, as appropriate. Should exceptions to policy be allowed, the circumstances under which limits may be exceeded and the party authorized to approve such excesses should be clearly articulated in the credit policy.

11.4 In many instances, due to a bank's trade area, geographic location or lack of access to economically diverse borrowers or counterparties, avoiding or reducing concentrations may be extremely difficult. In addition, banks may want to capitalise on their expertise in a particular industry or economic sector. A bank may also determine that it is being adequately compensated for incurring certain concentrations of risk. Consequently, banks should not necessarily forego booking sound credits solely on the basis of concentration. Banks may need to make use of alternatives to reduce or mitigate concentrations. Such measures can include pricing for the additional risk, increased holdings of capital to compensate for the additional risks and making use of syndications in order to reduce dependency on a particular sector of the economy or group of related borrowers. Banks must be careful not to enter into transactions with borrowers or counterparties they do not know or engage in credit activities they do not fully understand simply for the sake of diversification.

11.5 Banks can also manage credit concentrations and other portfolio issues by mechanisms such as loan sales, credit derivatives, securitization programs and other secondary loan markets. However, mechanisms to deal with portfolio concentration issues involve risks that must also be identified and managed. Consequently, when banks decide to utilise these mechanisms, they need to first have policies and procedures, as well as adequate controls, in place.

Country and Transfer Risks

- 11.6 Country risk is the risk of exposure to loss arising from adverse economic, social and political conditions/events of a foreign country which may cause obligors in that country to default on their obligations. The concept is broader than sovereign risk as all forms of lending or investment activity whether to/with individuals, corporate, banks or governments are covered. Transfer risk is the risk that a borrower will not be able to convert local currency into foreign currency and so will be unable to make debt service payments in foreign currency. The risk normally arises from exchange restrictions imposed by the government in the borrower's country.
- 11.7 Banks that have cross-border credit risk exposures should have adequate internal capacity for identifying, measuring, monitoring and controlling country and transfer risks in its international lending and investment activities, and should not place undue reliance on external ratings. A bank should consider the following:
- (a) In establishing credit-granting criteria, banks should consider country risk factors that should include the potential for default of foreign private sector obligors arising from country-specific economic, social and political factors, the enforceability of loan agreements, and the timing and ability to realise collateral under the national legal framework. The results of the country risk analysis must be integrated into the internal credit risk rating of the obligor. These country risk factors should be regularly monitored. A bank should also assess an obligor's ability to obtain foreign exchange to service cross-currency debt and honor contracts across jurisdictions.
 - (b) Country risk limits should be put in place and regularly reviewed to determine that approved limits still reflect the bank's business strategy in line with the changing market conditions. Banks should ensure that country exposures are reported and monitored against these limits. Significant country risks should be assessed and highlighted in credit proposals submitted to management for approval.
 - (c) Credit policy should clearly articulate appropriate countermeasures that a bank should take in the event of an adverse development in a particular country where it has exposures. These measures should include closer analysis of the obligor's capacity to repay, provisioning and preparation of contingency plans if country risk continues to deteriorate. It should consider in its monitoring and evaluation of country and transfer risks, the internal and external country risk rating transitions and economic social and political developments of the relevant countries. Any significant changes to the conditions of a country should also be elevated to the board promptly particularly if the bank has substantial exposure to that country.

Credit Risk Management Information System

- 11.8 The effectiveness of a bank's credit risk measurement process is highly dependent on the quality of the MIS. The information generated from the MIS enables the board of directors and all levels of management to fulfil their respective oversight roles, including determining the adequate level of capital of the bank. Therefore, the quality, detail and timeliness of information are critical. In particular, information on the composition and quality of the various portfolios, including on a consolidated bank basis, should permit management to assess quickly and accurately the level of credit risk that the bank has incurred through its various activities and determine whether the bank's performance is meeting the credit risk strategy.
- 11.9 Banks should monitor actual exposures against established limits. It is important that the MIS reports exposures which are approaching risk limits to senior management. All exposures should be included in a risk limit measurement system. The bank's MIS should be able to aggregate credit exposures to individual borrowers and counterparties and report on exceptions to credit risk limits on a meaningful and timely basis. Risk limits are specific quantitative measures or limits based on, for example, forward-looking assumptions that allocate the bank's aggregate risk to business lines, legal entities as relevant, specific risk categories, concentrations and, as appropriate, other measures.
- 11.10 The MIS should identify any concentrations of risk within the credit portfolio. The adequacy of scope of information should be reviewed on a periodic basis by business line managers and senior management to ensure that it is sufficient to the complexity of the business. The MIS should permit additional analysis of the credit portfolio, particularly stress testing.

12. Stress Testing

Principle 12: Banks should take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios, and should assess their credit risk exposures under stressed conditions.

- 12.1 Scenario analysis and stress testing are useful ways of assessing areas of what could potentially go wrong with individual credits and with various credit portfolios, and factoring this information into the analysis of the adequacy of capital and provisions. Such “what if” exercises can reveal previously undetected areas of potential credit risk exposure for the bank. The linkages between different categories of risk that are likely to emerge in times of crisis should be fully understood. In case of adverse circumstances, there may be a substantial correlation of various risks, especially credit and market risk.
- 12.2 Stress testing should involve identifying possible events or future changes in economic conditions that could have unfavourable effects on a bank’s credit exposures and assessing the bank’s ability to withstand such changes. Three areas that banks could usefully examine are: (i) economic or industry downturns; (ii) market-risk events; and (iii) liquidity conditions. Stress testing can range from relatively simple alterations in assumptions about one or more financial, structural or economic variables to the use of highly sophisticated financial models.
- 12.3 Whatever the method of stress testing used, the output of the tests should be reviewed periodically by senior management and appropriate action taken in cases where the results exceed agreed tolerances. The output should also be incorporated into the process for assigning and updating policies and limits.
- 12.4 The bank should attempt to identify the types of situations, such as economic downturns, both in the whole economy or in particular sectors, higher than expected levels of delinquencies and defaults, or the combinations of credit and market events, that could produce substantial losses or liquidity problems. Such an analysis should be done on a consolidated bank basis. Stress-test analyses should also include contingency plans regarding actions management might take given certain scenarios. These can include such techniques as hedging against the outcome or reducing the size of the exposure.

D. ENSURING ADEQUATE CONTROLS OVER CREDIT RISK

13. Independent Assessment of Credit Risk Processes

Principle 13: Banks must establish a system of independent, ongoing assessment of their credit risk management processes and the results of such reviews should be communicated directly to the banks' board of directors and senior management.

- 13.1 As various individuals throughout a bank have the authority to grant credit, the bank should have an efficient internal review and reporting system in order to manage effectively the bank's various portfolios. This system should provide the board of directors and senior management with sufficient information to evaluate the performance of account officers and the condition of the credit portfolio.
- 13.2 Internal credit reviews conducted by individuals independent from the business function provide an important assessment of individual credits and the overall quality of the credit portfolio. Such a credit review function can help evaluate the overall credit administration process, determine the accuracy of internal risk ratings and judge whether the account officer is properly monitoring individual credits. The credit review function should report directly to the board of directors, a committee with audit responsibilities, or senior management within the risk control function.

14. Compliance with Limits

Principle 14: Banks must ensure that the credit-granting function is being properly managed and that credit exposures are within levels consistent with prudential standards and internal limits. Banks should establish and enforce internal controls and other practices to ensure that exceptions to policies, procedures and limits are reported in a timely manner to the appropriate level of management for action.

- 14.1 The goal of credit risk management is to maintain a bank's credit risk exposure within parameters set by the board of directors and senior management. The establishment and enforcement of internal controls, operating limits and other practices will help ensure that credit risk exposures do not exceed levels acceptable to the individual bank. Such a system will enable management to monitor adherence to the established credit risk objectives.
- 14.2 Limit systems should ensure that granting of credit exceeding certain predetermined levels receive prompt management attention. An appropriate limit system should assist management in controlling credit risk exposures, initiating discussion about opportunities and risks, and monitoring actual risk taking against predetermined credit risk tolerances.
- 14.3 Internal audits of the credit risk processes should be conducted on a periodic basis to determine that credit activities are in compliance with the bank's credit policies and procedures, that credits are authorised within the guidelines established by the bank's board of directors and that the existence, quality and value of individual credits are accurately being reported to senior management. Such audits should also be used to identify areas of weakness in the credit risk management process, policies and procedures as well as any exceptions to policies, procedures and limits.

15. Remedial Management

Principle 15: Banks must have a system in place for early remedial action on deteriorating credits, managing problem credits and similar workout situations.

- 15.1 One reason for establishing a systematic credit review process is to identify weakened or problem credits. A reduction in credit quality should be recognised at an early stage when there may be more options available for improving the credit. Banks must have a disciplined and vigorous remedial management process, triggered by specific events, that is administered through the credit administration and problem recognition systems.
- 15.2 A bank's credit risk policies should clearly set out how the bank will manage problem credits. Responsibility for such problem credits may be assigned to the originating business function, a specialised workout section, or a combination of the two, depending upon the size and nature of the credit and the reason for its problems.
- 15.3 Effective workout programs are critical to managing risk in the portfolio. When a bank has significant credit-related problems, it is important to segregate the workout function from the area that originated the credit. The additional resources, expertise and more concentrated focus of a specialised workout section normally improve collection results. A workout section can help develop an effective strategy to rehabilitate a troubled credit or to increase the amount of repayment ultimately collected. An experienced workout section can also provide valuable input into any credit restructurings organised by the business function.

III. GLOSSARY

The following terms, unless the context require otherwise, have the following meanings:

Term	Meaning
“AMBD”	: Autoriti Monetari Brunei Darussalam as defined by the Autoriti Monetari Brunei Darussalam Order, 2010 [S 103/10]
“bank”	: A company which carries on banking business and holds a licence granted under section 4 or section 23 of the Banking Order 2006, or the Islamic Banking Order, 2008 or any other company considered by the AMBD to be the parent of a banking group.
“Connected counterparties”	: Refer to a group of counterparties that are connected through (a) direct or indirect control of one of the counterparties over the other(s) or (b) economic interdependencies, and must be treated as a single counterparty.
“Economic interdependence”	: Refers to a situation where counterparties are reliant on each other, such that if one of the counterparties experiences financial problems in repaying its obligations, the creditworthiness of the other(s) would also likely deteriorate. Banks should define in their credit policy criteria in determining connectedness based on economic interdependence, which shall consider, among others, significant dealings or transactions of one or more counterpart(y/ies) that impact the financial capacity or ability to repay the obligations of the other counterpart(y/ies). In cases where significant dealings do not automatically imply an economic interdependence that results in two or more counterparties being connected, the bank should provide evidence to AMBD that a counterparty which is economically connected to another, still can pay its liabilities even if the latter’s financial condition weakens.
“large exposures”	: Refer to exposures to a counterparty or a group of connected counterparties equal or greater than five percent (5%) of the bank’s qualifying capital

- “risk management” : The processes established to ensure that all material risks and associated risk concentrations are identified, measured, limited, controlled, mitigated and reported on a timely and comprehensive basis.
- “risk profile” : Point-in-time assessment of a bank’s gross risk exposures (ie before the application of any mitigants) or, as appropriate, net risk exposures (ie after taking into account mitigants) aggregated within and across each relevant risk category based on current or forward-looking assumptions.
- “Senior Management” : The chief executive officer and other persons having authority and responsibility for planning, directing and controlling the activities of the bank.

- END -