Pursuant to Article 44 paragraph 2 point 3 of the Central Bank of Montenegro Law (OGM 40/10, 46/10) and Article 57 paragraph 2 of the Banking Law (OGM 17/08, 44/10), the Council of the Central Bank of Montenegro, at its meeting held on 12 April 2012, passed

DECISION
on Minimum Standards for Credit Risk Management in Banks

I. GENERAL PROVISION

Subject matter of the Decision

Article 1
This Decision shall regulate the minimum standards for identifying, measuring, monitoring and controlling credit risk (hereinafter: credit risk management) in banks, including also valuation and classification of banks' balance sheet assets and off-balance sheet items.

II. RISK MANAGEMENT

2.1. Risk identification, measurement, monitoring and control

Risk management framework

Article 2
A bank shall efficiently manage credit risk and maintain the level and the quality of its loan portfolio within frameworks set out in risk management strategy and credit policy.

Loan approval

Article 3
Before granting a loan and other bank placements, a bank shall evaluate debtor's credit capacity, taking into consideration the criteria laid down in its internal act as well as minimum requirements hereof.

Prior to loan approval, a bank shall assess the value and legal validity of collateral.

If the collateral value largely depends on credit capacity of collateral provider other than the loan beneficiary, the bank shall also assess credit capacity of such person.

The bank shall require the client, prior to the occurrence of individually significant receivable within the meaning of Article 19 paragraph 2 hereof, to submit information on the existence or non-existence of ownership, managerial or economic interconnections with other clients, and inform the bank during the exposure on all new connections or changes in the existing connections with other clients.

Economic interconnection referred to in paragraph 4 above shall be the connection between two or more persons within the meaning of Article 3 paragraph 8 indent 6 of the Banking Law (OGM 17/08, 44/10).

Loan file

Article 4

A bank shall ensure that every credit exposure is properly and correctly documented and that regular and complete loan file is created and kept for every loan, providing chronological evidence of the approval and the quality of loan granted, until its final repayment or regulation of debt in some other manner.

Loan file must contain, in addition to the loan application and loan agreement, as a minimum, other documents, data and information to provide the evidence of:

1) identity of loan beneficiary and its connected clients, as well as its guarantor;
2) legal capacity of loan beneficiary to take loans and/or borrow financial resources;
3) financial situation of loan beneficiary for the last three years, its ability to repay the loan, as well as the loan repayment dynamics and sources;
4) type and quality of collateral;
5) purpose of the loan granted and earmarked use of the funds, and
6) debt restructuring approved (request submitted by the loan beneficiary for debt restructuring and analysis of causes that led to debt restructuring and reasons for accepting debt restructuring).

Credit risk measurement

Article 5

A bank shall establish an adequate system and analytical methodologies, which enable the bank to measure credit risk by including all types of transactions and to pay sufficient attention to risks that cannot be quantified, and the relation between credit risk and other risks.

The bank shall measure exposures to credit risk taking into account the minimum requirements set forth in the provisions of this decision regulating valuation and classification of assets.

In the process of valuating individual exposures and the exposure to credit risk based on total portfolio, the bank shall also assess exposure to credit risk arising from an abrupt increase in balance sheet assets, as well as potential adverse business environment, including also changes in economic environment.

Loan monitoring process

Article 6

A bank shall establish a system of monitoring of the structure and the quality of different parts of the loan portfolio in accordance with the nature, size and complexity of its total portfolio.

The bank shall monitor the entire structure and quality of the loan portfolio, credit risk arising from the total portfolio, as well as risks related to individual loans and transactions, whereby loans classified under category “C” and lower (hereinafter: non-performing assets) shall be subject to separate consideration and monitoring.

The process of monitoring individual loans shall include the assessment of credit capacity of debtor as well as clients connected with the debtor, the quality of collateral and debtor’s regularity in repaying its obligations during the life of legal relationship representing bank exposure.

The process of monitoring individual loans must be established so as to enable taking of adequate measures in timely fashion for the purpose of reducing credit risk in case of deterioration of credit capacity of a debtor or collateral provider.

The bank shall ensure the monitoring of fulfilment of obligations under loan agreement, and in case of granted earmarked loans, it shall also ensure the monitoring of earmarked use of funds disbursed.

The bank shall establish early detection system for credit risk increase that enables timely identification of debtors with an increased risk, and which also includes determining adequate qualitative and quantitative indicators for early detection of credit risk increase.

The bank shall have procedures regulating the collection and monitoring of all relevant information that could point to the increase in the riskiness of loans and collaterals, and procedures for reporting on such information to all persons included in credit risk management so as to perform re-evaluation of placement risk.

The bank shall determine the criteria for determining problem loans and establish procedures for dealing with problem loans that should be subject to special monitoring due to the increased risk.

Credit risk control

Article 7

A bank shall prescribe in its internal acts the volume and the manner of controlling credit risk, as well as the volume and frequency of internal reporting on credit risk to bank management, board of directors and board of directors' bodies.

For the purpose of taking measures to reduce credit risk, the bank shall provide timely and effective analysis and monitoring of credit risk and informing relevant persons or bank's bodies in timely fashion on the exceptions in policies, procedures and credit limits.

The bank shall establish the procedures for taking activities in timely fashion to improve the condition of the loan portfolio and in particular, loans classified in the non-performing assets category, including also procedures for rescheduling, i.e. loan restructuring or taking other measures against loan beneficiary aimed at reducing losses of the bank to the minimum level possible, and the procedures for exercising and foreclosing the collateral.

Stress testing

Article 8

A bank shall perform stress testing in the assessment of risk of total loan portfolio.

The stress testing process shall include identification of potential events or future changes in economic conditions that could have adverse effect on bank's exposure to credit risk and assessment of bank's capacity to sustain such changes.

The bank shall define types, volume and frequency of stress testing (at least once a quarter), as well as the procedures and actions to be taken in case of unfavourable stress test results.

Treatment of large exposures

Article 9

A bank shall establish reliable administrative and accounting procedures and adequate internal control mechanisms for the purpose of identifying and recording all large exposures and their subsequent changes and monitoring those exposures, taking into account the bank's policies on exposures.

The bank shall analyse, to the extent possible, the concentration of exposures to collateral providers, unfunded credit protection providers and underlying assets with specific exposures (securitisation, open investment funds) and report to the Central Bank of Montenegro (hereinafter: the Central Bank) on all significant findings.

Determining large exposures

Article 10

A bank shall determine large exposures on solo and consolidated basis for all exposures in banking and trading book.

Large exposure shall be also determined in cases when it does not occur on the basis of the decision of a bank, but it occurs due to:

1) Reduction in bank's own funds;
2) Establishment of interconnection between clients to which bank's exposure already exists;
3) Change in market prices or other factors influencing the value of the existing exposures of the bank.

The manner of identifying connected clients for the purpose of determining large exposures is contained in Annex 1 which is enclosed and makes an integral part hereof.

Large exposures reporting

Article 11

A bank shall submit reports on large exposures to the Central Bank in accordance with the decision regulating the reports to be submitted by banks to the Central Bank and the Banking Law.

In addition to the reports under paragraph 1 above, the bank shall:

1) inform the Central Bank of the occurrence of large exposure to individual clients, within ten days following that of passing the decision resulting in large exposure;

2) inform the Central Bank of the occurrence of large exposure under Article 10 paragraph 2 hereof, within ten days following that of determining large exposure;
3) immediately inform the Central Bank, when the exposure limit has been exceeded, on the amount of and the reasons for exceeding the prescribed limits.

Sale and purchase of receivables

Article 12

A bank that intends to purchase or sell loan or other receivable which amount exceeds EUR 50.000, shall first obtain the opinion of the Central Bank on the justification of the planned sale and/or purchase of such a receivable.

The bank that intends to sell and/or purchase loan receivable shall submit to the Central Bank the following:

1) proposal on repurchase agreement;
2) Information on reasons for the purchase and/or sale of receivables;
3) Data on the quality of the receivable and collateral and the assessment of debtor's credit capacity;
4) Information on the manner of determining the selling and/or purchase price;
5) Assessment of effects of sale and/or purchase on the financial position and bank's performance indicators.

In addition to documents under paragraph 2 above, the Central Bank may require a bank to submit additional data and information.

The Central Bank shall, within eight working days following that of the receipt of documents under paragraph 2 above and/or following that of the receipt of the additional data and information under paragraph 3 above, provide the bank with the opinion on justification of then sale and/or purchase of receivables.

2.2. Valuation and classification of asset items

Obligation for valuing and classifying

Article 13

A bank shall, in accordance with this decision, perform impairment assessment (for balance sheet items) and/or assessment of probable loss (for off-balance sheet items) for balance sheet assets and off-balance sheet items based on which it is exposed to credit risk and classify them into appropriate classification categories.

Risk-Bearing and Risk-Free Items

Article 14

Balance sheet assets and off-balance sheet items under Article 13 hereof shall be considered balance sheet asset items exposing bank to default risk and off-balance sheet items representing contingent liabilities of bank such as:

1) Loans and receivables from banks (including due from banks, interest rates and fees);
2) Loans and receivables from clients (including interest rates and fees, receivables based on lease, forfeiting and factoring);
3) Financial assets shown at fair value through profit and loss (debt and equity securities not included in trading book or included in trading book but for which the bank does not calculate capital requirement for market risks within the meaning of decisions regulating banks' capital adequacy);
4) Investment securities (securities held to maturity and available for sale securities);
5) equity participations in other legal persons, excluding equity participations, which in accordance with the decision governing banks' capital adequacy, represent a deductible item from bank's own funds;
6) Guarantees issued;
7) Credit obligations given (granted and unused loans);
8) Bill of exchange security and bill of exchange acceptance;
9) other sureties;
10) uncovered letter of credits.

Balance sheet assets and off-balance sheet items not exposing the bank to credit risk shall be considered the following:

1) cash and deposits with central banks (cash and cash equivalents, including cash and other short-term highly liquid instruments with original maturity up to three months or less, for which low level of risk from change in value exists);
2) derivative instruments used as hedging instruments;
3) investment immovable properties, properties, plant and equipment and intangible assets;
4) equity participations in other legal persons, which in accordance with the decision governing banks' capital adequacy, represent a deductible item from bank's own funds;
5) Financial assets included in trading book and for which the bank calculates capital requirement for market risks in accordance with the decision governing banks' capital adequacy;
6) Guarantees received;
7) Credit obligations received;
8) Loans written off;
9) Collateral received;
10) Assets held for custody.

For every balance sheet assets and off-balance sheet items not defined under paragraphs 1 and 2 above, the bank shall proceed as follows:

1) determine whether those items expose the bank to credit risk;
2) classify every balance sheet asset and off-balance sheet item exposing the bank to credit risk under proper classification category in accordance with the provisions hereof.

2.2.1. Valuation of asset items

IAS/IFRS application

Article 15

A bank shall value asset and off-balance sheet items in accordance with the International Accounting Standards and/or International Financial Reporting Standards.

Methodology

Article 16

A bank shall determine methodology for the assessment of impairment of balance sheet assets and probable losses related to off-balance sheet items.

The following shall be determined by the methodology under paragraph 1 above:

1) criteria for identification of receivables where the assessment of impairment of balance sheet assets and probable losses related to off-balance sheet items is made on individual basis,
2) procedures for the assessment of impairment of balance sheet assets and probable losses related to off-balance sheet items, as well as obligations and responsibilities in this process;
3) methods and techniques the bank uses for individual and collective assessments;
4) criteria for classifying receivables into categories with similar characteristics for the purpose of collective assessment.

The application of methodology under paragraph 1 above shall ensure that:

1) all analyses, assessments and other procedures in the process of impairment assessment of balance sheet assets and probable losses related to off-balance sheet items are explained and documented in detail;
2) impairment assessment of balance sheet assets and probable losses related to off-balance sheet items is based on accurate and updated information and it takes into account all significant internal and external factors that may influence the collectability of receivables.

The bank shall consistently apply the methodology referred to in paragraph 1 above, review it at least once a year and adjust it, as needed, to the results of the review and adjust the assumptions on which the methodology is based.

Frequency of valuation

Article 17

A bank shall, at least quarterly, assess asset quality, determine if there is an objective evidence of impairment of balance sheet assets and/or probable losses related to off-balance sheet items and calculate adequate amount of such impairment and/or probable losses.

The objective evidence on the impairment of balance sheet assets and/or probable losses related to off-balance sheet items shall be information on one or more events that adversely affect the ability of debtor to regularly meet its obligations to the bank.

Treatment of collateral

Article 18

A bank may also take into account cash flows based on collateral when calculating impairment of balance sheet assets and probable losses related to off-balance sheet items.

The methodology under Article 16 paragraph 1 hereof shall also determine the manner of valuation of collateral for which the bank estimates cash flows and expected period for exercising such collateral.

Individual assessment

Article 19

A bank shall perform individual assessment of impairment of balance sheet assets and probable losses related to off-balance sheet items in respect of individually significant receivables.

Individually significant receivable, within the meaning of paragraph 1 above, shall be total gross exposure of the bank to a single client or a group of connected clients exceeding EUR 50.000.

Notwithstanding paragraph 2 above, a bank may, in its internal acts, determine lower amount of total exposure to a single client or a group of connected clients as a threshold beyond which the exposure is considered an individually significant receivable.

The individual assessment of balance sheet assets for impairment shall include determining the existence of objective evidence of impairment, estimation of the present value of future cash flows and calculation of the amount of impairment for every individual receivable included in this assessment.

It is considered that there is objective evidence on the impairment of balance sheet assets on individual basis, if:

1) debtor's financial condition indicates significant problems in its operations;
2) there is information on default, and on frequent delay in principal and/or interest repayment, or non-compliance with other contractual obligations;
3) due to debtor's financial difficulties, the bank changes significantly the terms of repayment in relation to those originally agreed, or
4) it becomes certain that bankruptcy proceedings, reorganisation or other similar procedures will be initiated against the debtor.

Determining impairment amount

Article 20

The amount of impairment of balance sheet assets shall be determined as a difference between carrying amount of a receivable and present value of expected future cash flows of such receivable.

Notwithstanding paragraph 1 above, if deadline for specific receivable in which future cash flows are expected is shorter than one year, a bank shall not calculate present value of expected future cash flows but it may determine the amount of impairment of those assets items as a difference between carrying value of receivable and expected future cash flows on such receivable.

Assessment of probable loss

Article 21

The assessment of probable loss related to off-balance sheet items on individual basis includes the assessment of recoverability of future cash outflows for each of the assumed off-balance sheet commitments and the calculation of the amount of probable loss for each individual off-balance sheet item included in this assessment.

Irrecoverable future cash outflows shall be the nominal amount of expected cash outflows related to off-balance sheet obligations less the amount reasonably estimated to be recovered by counterparty or through exercising the collateral.

Determining probable loss

Article 22

The amount of probable loss related to off-balance sheet items shall be equal to the present value of expected irrecoverable future cash outflows under those items.

By way of derogation from paragraph 1 above, if it is estimated that cash outflows will occur within a year following the calculation date of probable loss related to off-balance sheet items, a bank may determine the amount of cash outflows to equal those outflows.

Collective assessment

Article 23

A bank shall perform collective assessment of balance sheet assets for impairment or probable losses related to off-balance sheet items for all receivables where the impairment or losses may not be directly linked to those receivables, but which may be estimated, based on experience, to exist in the loan portfolio.

The bank shall perform collective assessment for the following receivables:

1) for which individual assessment showed no objective evidence of impairment of balance sheet assets or probable losses on off-balance sheet items, and/or if no amount of impairment of balance sheet assets and probable losses on off-balance sheet items has been determined at individual level
2) which do not represent individually significant receivables referred to Article 19 paragraph 2 hereof.

The bank may perform assessment of impairment of balance sheet assets and probable losses related to off-balance sheet items for receivables that do not represent individually significant receivables on individual basis.

In performing collective assessment, a bank shall group receivables based on similar characteristics of credit risk that reflect the debtor’s ability to meet its obligations in accordance with the agreed terms by applying one or more criteria, such as: type of products, regularity in meeting the obligations, credit rating, geographical areas, economic sector, type of collateral, and the like.

Accounting treatment

Article 24

A bank shall debit the amount of impairment loss calculated on balance sheet assets as expense and credit it to the allowances for the impairment.

A bank shall debit the calculated amount of probable losses related to off-balance sheet items and credit it to the provisions for losses on off-balance sheet items.

2.2.2. Classification of asset items

Article 25

A bank shall classify, at least once a month, balance sheet asset and off-balance sheet items exposing the bank to credit risk and calculate loan loss provisions.

Classification criteria

Article 26

The criteria for asset classification shall be:

1) debtor's credit capacity;
2) debtor's regularity in meeting its obligations;
3) collateral quality;
4) other relevant factors.

Assessment of debtor's credit capacity

Article 27

The assessment of debtor's credit capacity is based on the assessment of capacity and readiness of a debtor to completely and timely meet their obligations to the bank from primary sources of debt repayment.

Primary sources of debt repayment shall be considered, in particular, cash from debtor's operating and other activities.

In assessing debtor's credit capacity, the bank shall analyse, in particular, performance indicators that refer to:

1) maturity structure of specific elements of assets and liabilities showing liquidity level of debtor, matching of sources of financing and placements and net working assets, including also information on turnover on customers' accounts with the bank and in the system, and information on account freezes;
2) cash flows, in respect of the fulfilment of obligations, cash flows incurred in the previous period, and adequacy of projected cash flows;

3) level of indebtedness of loan beneficiary, loan maturity, influence of newly granted loan on maturity structure, cash flows, interest expenses and indicators of capitalisation;
4) total operating income and extraordinary income and expenses of loan beneficiaries influencing the profitability and attainment of financial result.

Assessment of collateral quality

Article 28

The value of collateral shall be calculated as its net value which implies market value of the collateral reduced by all expenses relative to the exercising of the collateral.

Market value of collateral shall be the estimated cash for which collateral may be sold as of the day of determining its value, provided that the buyer and the seller act in a voluntary, informative, prudent and unenforced manner, where this value must be transparently and clearly documented.

Prime collateral

Article 29

Prime collateral, within the meaning of this decision, shall be:

1) cash deposit with bank, if it is agreed that it serves as a security for specific bank receivables, the maturity of which is not shorter than the maturity of receivables and only the bank may dispose of it;
2) pledge on gold;
3) debt securities, as well as guarantees, counter guarantees, other forms of sureties and other similar instruments of unfunded credit protection, issued by central governments and central banks which receive a 0% credit risk weight pursuant to the decision governing banks' capital adequacy;
4) debt securities, as well as guarantees, counter guarantees, other forms of sureties and other similar instruments of unfunded credit protection issued by the regional and self-government units which receive a 0% credit risk weight pursuant to the decision governing banks' capital adequacy;
5) debt securities, as well as guarantees, counter guarantees, other forms of sureties and other similar instruments of unfunded credit protection issued by public authorities which receive a 0% credit risk weight pursuant to the decision governing banks' capital adequacy
6) debt securities, as well as guarantees, counter guarantees, other forms of sureties and other similar instruments of unfunded credit protection issued by international development banks and international organisations which receive a 0% credit risk weight pursuant to the decision governing banks' capital adequacy;

7) debt securities, as well as guarantees, counter guarantees, other forms of sureties and other similar instruments of unfunded credit protection issued by a member of the banking group to which the bank – collateral taker belongs (superior bank in the group, subordinate bank to this bank or bank that is subordinated to a bank – the collateral taker), if the bank is subject to supervision on consolidated basis in accordance with the applicable regulations in the European Union or equivalent supervisory standards on consolidated basis applicable in third country;
8) debt securities, as well as guarantees, counter guarantees, other forms of sureties and other similar instruments of unfunded credit protection issued by banks which would qualify for credit quality step 3 or better in accordance with the decision governing banks' capital adequacy;
9) debt securities, as well as guarantees, counter guarantees, other forms of sureties and other similar instruments of unfunded credit protection issued by the banks supervised by the Central Bank.

Adequate collateral

Article 30

Adequate collateral, within the meaning of this decision, shall be:

1) mortgage or fiduciary of immovable properties provided that the following conditions have been met:
   - a bank has adopted and implements an internal document which regulates types of immovable properties accepted as collateral during loan approvals and other exposures,
   - mortgage or fiduciary on immovable properties enables the bank to exercise rights laid down in the agreement, in the legal system within which those rights have been exercised,
   - all legal conditions for establishing a mortgage or transferring fiduciary rights on immovable property have been met and adequate registration of lien have been made in cadastre and other registers,
   - legal actions for mortgage and/or fiduciary foreclosure enable settlement of receivables from immovable property in reasonable timeframe,
   - bank verifies the value of immovable property using statistical and other methods, at least once a year, and if market conditions are subject to significant changes, the bank shall make verifications even more frequently,
   - If it has been determined based on the verification of the value of immovable property that significant reduction in value of immovable property has occurred or might have occurred relative to usual market prices, the bank shall re-evaluate the immovable property,
   - for individual exposure representing 5% or more of bank's own funds or exceeding EUR 300.000 (whichever is lower), an independent

- bank has adopted and implemented procedures containing provisions based on which it monitors and determines if immovable property used as collateral is adequately insured in case of loss occurrence;

2) Pledge on movables, provided that the following conditions have been met:
   - bank has adopted and implements an internal document which regulates types of movables that are accepted as collateral in the loan approval process and approval of other exposures, taking into account that unsuitable movables are not accepted as collateral (perishable goods, movables with date of expiry, which is shorter than the life of loan, and the like);
   - pledge on movables that enables the bank to exercise rights determined in the contract within the legal system where those rights have been exercised,
   - all legal conditions for establishing pledge have been met and proper registration of lien has been made at competent authority;
   - liquid market exists that enables fast enforcement of pledge,
   - market value of pledge is known,
   - pledge contract enables settlement of claims from a pledge in an acceptable period;
   - priority right in the collection of pledge exists in relation to other creditors,
   - bank verifies at least once a year the value of pledge and in case of significant changes in market prices, even more frequently;
3) Debt securities of institutions without credit rating determined by recognised external credit assessment institutions, provided that the following conditions have been met:
   - securities are listed at a recognised stock exchange;
   - securities are considered senior receivable;
   - all other issues of securities of the issuer institution ranked the same have credit rating of recognised external credit assessment institution that would qualify for credit quality step 3 pursuant to the rules for assigning weights to the exposures to institutions or rules for assigning weights to short-term exposures;
   - securities are easily marketable;
4) equity securities and convertible bonds included in main stock exchange index;
5) credit derivatives that meet funded credit protection recognition criteria laid down in the decision regulating banks’ capital adequacy;
6) life insurance policies that meet funded credit protection recognition criteria laid down in the decision regulating banks’ capital adequacy.

Assessment of other relevant factors

Article 31

In the procedure of classification of assets items, the assessment of other relevant factors for classifying asset items shall include, in particular:

1) information on general economic cycle;
2) information on the condition and prospects of economic sector to which a debtor belongs;
3) information on loan concentration per economic sectors and certain group of loan beneficiaries;
4) debtor's market position;
5) debtor's ownership and status changes;
6) corporate governance and management's capacity to implement the programme subject to financial support from the bank;
7) loan structure;
8) compatibility of the loan purpose with debtor's activity, and
9) compliance of loan approval with the bank policies and procedures.

Classification categories

Article 32

Bank shall, depending on probability of incurring losses, classify asset items into one of the following classification categories:

1) category A – "pass";
2) category B – "special mention" with subcategories B1 and B2;
3) category C – "substandard" with subcategories C1 and C2;
4) category D – "doubtful";
5) category E – "loss".

Classification category A

Article 33

Loans and other receivables (hereinafter the loan) shall be classified into the classification category A where highly documented evidence exist that it will be collected in full in accordance with the agreed terms and conditions.

The following shall be classified into the classification category A:

1) loan granted to central governments, central banks, public authorities, multilateral development banks and international organisations which receive a 0% risk weight pursuant to the decision regulating banks' capital adequacy;
2) loan which has the following characteristics:
   - loan is granted in accordance with the criteria laid down in bank's internal documents;

- loan beneficiary is financially sound;
- loan repayment is regular (as at maturity date or with small delay);
- information and data on the fulfilment of obligations in prior period indicate that loan beneficiary met regularly its obligations; and
- loan is secured by collateral, which in combination with debtor's financial condition minimises risk of loan collection; and

3) loan which is fully secured by prime collateral under Article 29 hereof, provided that the conditions under Article 38 paragraph 1 hereof have been met.

Classification category B

Article 34

A loan shall be classified into the classification category B (subcategories B1 and B2) if there is a small probability of incurring losses. However, such loan must be subject to special watch of a bank, as the potential risk, if not adequately monitored, might result in poor perspective for its repayment.

A loan classified into the classification category B (subcategory B1 or B2) shall have some of the following characteristics:

1) financial information on loan beneficiary are incomplete;
2) loan has not been granted in accordance with the internal policies of the bank;
3) the assessment of financial value of collateral is incomplete or inadequately documented;
4) connected loan beneficiaries are not included in the loan analysis;
5) debtor's financial situation is stable but it has some features that point to possible difficulties in future loan repayment;
6) debtor is over 30 days past due.

A loan that is over 30 days past due may not be classified in higher classification category and/or subcategory other than subcategory B1. A loan that is over 60 days past due may not be classified in higher classification category and/or subcategory other than subcategory B2.

Classification category C

Article 35

A loan shall be classified into the classification category C if there is high probability of incurring losses due to clearly disclosed weaknesses jeopardising their repayment.

A loan classified into the classification category C (subcategory C1 or C2) shall have some of the following characteristics:

1) primary sources of repayment are insufficient to repay debt and bank must use secondary sources to collect debt, i.e. to foreclose the collateral, restructure debt, and the like;
2) current financial possibilities of the loan beneficiary or cash flows are insufficient for the repayment of maturing debt (customer is insufficiently liquid, significantly indebted or not well capitalised, it has critically low level of profitability or operates with loss);
3) negative trend in debtor's operations exists;
4) there is an indication in short-term loans that loan beneficiary will not be able to convert assets into cash which will result in an inability of the borrower to repay debt when it becomes due;
5) bank does not have required and updated financial information to determine financial ability of customer to repay the debt;
6) loan is over 90 days past due.

A loan that is over 90 days past due may not be classified in higher classification category and/or subcategory other than subcategory C1. A loan that is over 150 days past due may not be classified in higher classification category and/or subcategory other than subcategory C2.

Classification category D

Article 36

A loan shall be classified into classification category D if there is a low probability of the collection of loan in full, taking into consideration debtor's credit capacity, value and possibility of collateral enforcement.

A loan classified into classification category D shall have some of the following characteristics:

1) legal person who is loan beneficiary is illiquid with insufficient amount of capital, highly leveraged, non-profitable, has difficulties or shows permanent non-competitiveness without any perspective for further development;
2) bankruptcy proceedings have been initiated;
3) there is significant credit risk, thus it is quite uncertain if the loan will be collected in full, but there are facts that indicate that there is real expectation for at least partial collection in near future (loan is in the process of collection, loan beneficiary has initiated the procedure of providing additional collateral which will fully secure the loan in case of its enforcement, the bank initiated foreclosure of additional instruments of security, and the like);
4) loan is over 270 days past due.

A loan that is over 270 days past due may not be classified in higher classification category and/or subcategory other than subcategory D.

Classification category E

Article 37

A loan shall be classified into classification category E if it is fully uncollectible or if it will be collected in an insignificant amount.

A loan shall be classified into classification category E if:

1) regardless of default, it contains at least one characteristic of doubtful assets, it is not fully secured and no facts exist indicating that there is real expectation for at least partial collection in near future;
2) loan is over 365 days past due.

Treatment of collateral in classification

Article 38

A bank may classify loan that is fully secured by prime collateral under Article 29 hereof into classification category A, if:

1) all conditions for recognising credit protection, which are laid down in the decision regulating banks' capital adequacy that refer to such type of collateral, have been met;
2) debtor meets its loan obligations without any delay or with delay that does not exceed 180 days; and
3) bankruptcy proceedings have not been initiated against a debtor or a reorganisation plan of the debtor has been adopted after the initiation of bankruptcy proceedings in accordance with the regulations governing bankruptcy proceedings of business organisations.

If debtor defaults on loan repayment more than 180 days or other conditions under paragraph 1 above have no longer been met, a bank may treat prime collateral during asset classification only as adequate collateral.

The bank may classify loan that is fully secured by adequate collateral under Article 30 hereof directly into higher classification category and/or subcategory other than the category and/or subcategory in which such loan would be classified applying other classification criteria.

By way of derogation from paragraph 3 above, a bank may classify loan that meets classification criteria for category E and which is fully secured by adequate collateral into the classification category D and keep it within this classification category no longer than 90 days.

Impact of other relevant factors on classification

Article 39

Should it prove that the factors set out under Article 31 hereof, either individually or as combined, affect the increase in debtor's probability of default, the bank shall classify such a loan into the classification category and/or subcategory that is at least one grade lower than the classification category and/or subcategory under which such a loan would be classified based on the assessment of debtor's credit capacity.

Classification of small loans

Article 40

A bank may classify loan that does not belong to a category of individually significant receivable under Article 19 paragraph 2 hereof into appropriate classification category based on the information on debtor's regularity in meeting its obligations to the bank.

When there is default, loan under paragraph 1 above shall not be classified into higher into classification category and/or subcategory other than:

1) subcategory B1, if the debtor is over 30 days past due,
2) subcategory B2, if the debtor is over 60 days past due,
3) subcategory C1,if the debtor is over 90 days past due,
4) subcategory C2,if the debtor is over 150 days past due,
5) subcategory D, if the debtor is over 270 days past due,
6) subcategory E, if the debtor is over 365 days past due.

Default in repayment shall be calculated only for matured receivables exceeding EUR 20 for natural persons, and/or EUR 200 for other debtors.

Assessment of credit capacity of loan beneficiary for investment projects

Article 41

In the procedure of classification of a loan granted for the investment project, a bank may base its assessment of debtor's credit capacity on the analysis of profitability of such investment project.

Profitability analysis of the investment project shall include, as a minimum, the following:

1) assessment of reality of business plan and financial projections;
2) assessment of period required for return on funds invested in the project;
3) project risk sensitivity;

4) assessment if cash flows arising from the project implementation ensure regular fulfilment of debtor's obligations in accordance with the agreed loan repayment dynamics.

Investment project, within the meaning of this Article, shall be the project from the production or services sectors aimed at promoting the existing activity of the loan applicant, introduction of new products and services, and the like.

Classification of loan under paragraph 1 above may be performed only by a bank that has adequate methodology for the assessment of business plans set forth in its internal document.

A bank shall regularly monitor projected implementation of the investment project, and based on the analysis of compliance of actual and projected implementation of the investment project and other criteria for asset classification, it shall classify loan into adequate classification category and/or subcategory.

Multiple loan holder

Article 42

If one person holds more loans with a bank, and one or more of those loans are classified into category of non-performing assets, a bank shall classify all receivables to such a person into the lowest classification category and/or subcategory.

Notwithstanding paragraph 1 above:

1) a bank may classify individual loan into a higher classification category and/or subcategory if:
    - such loan is secured by prime or adequate collateral, and loan classified into the lowest classification category and/or subcategory is not secured by such type of collateral, or
    - the bank may prove that the loan, based on its characteristics or sources of repayment, is clearly separated from other loans granted to the same beneficiary and that the assessment of loan showed that there is not uncertainty in respect of the debtor's capacity to repay the debt, where the assessment must include estimation of probability of repayment as well as cash flows and reliability of primary sources of repayment of such loan, and the bank continuously monitors and controls repayment of such loan and may adequately document reasons for such classification;
2) if more than 90% of total carrying value (including outstanding interest) of all loans under paragraph 1 above has been classified into the

Classification of restructured loans

Article 43

A bank is deemed to have restructured a loan if, due to deterioration in the borrower’s credit capacity, it has:

1) extended principal or interest repayment dates;
2) reduced the interest rate on the granted loan;
3) acquired the debtor’s liabilities to a third party, either against full or partial repayment of its loan;
4) reduced the amount of debt, principal or interest;
5) capitalised interest on the loan granted to the debtor;
6) replaced the existing loan with a new loan (loan renewal), or
7) made other similar arrangements that alleviate the debtor’s financial position.

The following shall not be considered to be loan restructuring:

1) change in conditions for principal repayment due to contingencies that are out of the debtor’s control (for instance, delays in project completion), provided that the effective interest rate remains the same as agreed, as long as the interest is paid on time;
2) reduction of interest rate or capitalisation of interest which are not the result of deterioration in the debtor’s credit capacity.

In the procedure of loan restructuring, a bank shall:

1) analyse the debtor’s financial position in order to assess whether the debtor will record cash flows sufficient for principal and interest repayment after the loan restructuring;
2) provide adequate information on the results of restructuring in accordance with the International Accounting Standards and/or the International Financial Reporting Standards, that is:
    - define and determine the fair value at which the bank will account for assets obtained in the process of loan restructuring and precisely recognise any loss associated with the loan restructuring, and
    - provide up-to-date accounting of all elements of transactions performed in the process of loan restructuring;
3) apply the concept of fair value assessment for assets acquired against debt collection, provided that:
    - if there is a stable market, the fair value assessment of assets shall be equal to their market value,

- when the market is unstable or the value of acquired assets cannot be determined, a bank shall ensure the fair value assessment of such assets in accordance with professional standards.

The bank shall classify new receivables that are the result of loan restructuring into adequate classification categories and/or sub-categories and establish proper reserves in line with the provisions set out in this Decision.

The bank may not classify the restructured loan of the same debtor into a higher classification category until regular payment of principal and interest have been received for at least three months after the loan restructuring.

Multiple classifications

Article 44

A loan may be classified into more than one classification category and/or subcategory.

A loan belonging to non-performing assets and which net value of collateral is lower than the outstanding loan amount shall be classified as follows:

1) rules laid down in this decision for the classification of loans that are fully secured by prime or adequate collateral shall be applied to a part of the outstanding amount of loan fully secured by prime or adequate collateral, whereby this part of loan cannot be classified into higher classification category other than subcategory C1;
2) the remaining portion of the loan shall be classified into categories D or E by applying the following criteria:
   - a part of the outstanding amount of loan which collection is expected shall be classified into category D,
   - the remaining part of the loan which collection is not expected shall be classified into category E.

Classification of other balance sheet items

Article 45

The classification of balance sheet asset items which are not loans shall be performed in line with the criteria applicable under Article 26 hereof, as well as based on other facts that are important for establishing the level of potential risk of loss arising from these asset items.

Classification of off-balance sheet items

Article 46

The classification of off-balance sheet items that expose bank to credit risk shall be performed in line with the loan classification criteria set out in this decision by applying those criteria on potential debtor of a bank.

The classification of agreed but undrawn loan shall be made if bank was irrevocably obliged to meet outstanding liabilities for that loan arrangement.

Ordering stricter classification

Article 47

The Central Bank may order a bank to apply stricter classification of asset items and/or off-balance sheet items, if it estimates that the bank did not perform the classification in accordance with the provisions of this Decision.

When the Central Bank orders stricter classification of asset items and/or off-balance sheet items, a bank shall perform the requested correction immediately upon receiving such an order and inform the Central Bank thereof.

With a view to ensuring quality documentation base for bank supervision and analysis of the bank's condition, the Central Bank may order the bank to disclose the new classification performed in accordance with paragraph 2 above in the reports for the prior reporting periods.

Provisioning

Article 48

Bank shall calculate loan loss provisions for on-balance sheet and off-balance sheet asset items by applying the percentages under the table below:

No.	Classification categories and subcategories	Provisions in percentages
1.	Category A – “Pass”	0%
2.	Category B – “Special mention” - subcategory B1 - subcategory B2	 2% 7%
3.	Category C – “Substandard”: - subcategory C1 - subcategory C2	 20% 40%
4.	Category D – “Doubtful”	70%
5.	Category E – “Loss”	100 %

The base for calculating loan loss provisions shall be carrying amount of receivables without deducting allowances for impairment.

2.2.3. Treatment of provisions and allowances for impairment

Article 49

A bank shall determine the difference between the amount of loan loss provisions calculated in accordance with Article 48 hereof and the sum of the amount of allowances for impairment and provisioning for off-balance sheet items calculated in accordance with the provisions of this decision regulating the manner of valuation of asset items by applying International Accounting Standards.

The positive difference between the amount of calculated loan loss provisions and the sum of the amount of allowances for impairment and provisioning for off-balance sheet items shall be deductible item from the bank's own funds.

The bank shall submit reports to the Central Bank on the classification of balance sheet assets and off-balance sheet items, and on the amount of loan loss provisions calculated in accordance with the decision regulating banks' reporting to the Central Bank and the Banking Law.

III TRANSITIONAL AND CLOSING PROVISIONS

Article 50

Banks shall align their internal acts with the provisions hereof within six months following the effective date of this decision.

Article 51

Until the commencement of the implementation of this decision, the Central Bank shall regulate in more details in its Instructions the accounting of loan loss provisions and allowances for impairment, as well as the accounting of written off items of the balance sheet assets when determining the opening balance in the banks' business books for 2013.

Article 52

The Decision on Minimum Standards for Credit Risk Management in Banks (OGM 60/08, 41/09) and Decision on Temporary Measures for Credit Risk Management in Banks (OGM 64/09, 87/09, 66/10, 70/10, 02/12) shall be repealed as of the day of entry into force of this Decision.

Article 53

This Decision shall enter into force on the eighth day following that of its publication in the Official Gazette of Montenegro, and it shall be applied from 1 January 2013.

THE COUNCIL OF THE CENTRAL BANK OF MONTENEGRO

CHAIRMAN
VICE-GOVERNOR,

Decision number: 0101-4014/29-6
Podgorica, 12 April 2012

Milojica Dakic, m.p.

ANNEX 1

IDENTIFICATION OF CONNECTED CLIENTS

The identification of connected clients for the purpose of calculating large exposures is aimed at identifying bank's so closely linked by ownership connectedness or economic dependence that pose idiosyncratic risk to the bank, therefore, when calculating bank's exposure, such group of connected clients is treated as a single person.

1. Connected clients

The definition of connected clients for the purpose of determining large exposures is contained in the definition under Article 3 point 8 of the Banking Law, which stipulates that the connected clients mean two or more parties that are connected in at least one of the following forms:

- one party controls or has direct or indirect participation in capital or voting rights of other party of at least 20%,
- two or more parties are controlled by a third party,
- the same persons represent the majority members of the board or another governing body in two or more legal persons,
- two or more parties are family members (a spouse, a person who lives in community equal to matrimony pursuant to the law, and children and other persons who live in household of that party),
- two or more parties, pursuant to a contract, an agreement or informally, jointly performing business activities of a significant volume;
- if a deterioration or improvement in financial situation of one party may lead to deterioration or improvement in financial situation of the other party or other parties, or there is a possibility of loss, profit or creditworthiness transmission among these parties.

The definition refers to interconnections arising from one of the following:

- one client has control or significant participation in capital over the other;
- the clients are interconnected by some form of material economic dependency (e.g. direct economic dependencies such as supply chain links or dependence on large customers, or the clients have main common source of funding in the form of credit support, potential funding or direct, indirect or reciprocal financial assistance).

In addition to ownership connectedness, the definition of connected clients includes also interconnectedness arising from other basis such as economic connection of bank's clients.

2. Interpretation of control

Banking Law defines that the control relationship exists where a client owns independently or mutually with other related party, direct or indirect participation in capital or voting rights in legal person of at least of 50%, or controls means the possibility of incurring dominant influence over decision making, business policy and strategy of a legal person, independently or mutually with other parties, without regard to the percentage of participation in capital.

During the procedure of determining if a client has possibility of incurring dominant influence over decision making, business policy and strategy of a legal person, the following is verified:

- if it may direct the activities of the other entity so as to obtain benefits from its activities;
- if it may decide on crucial transactions such as the transfer of profit or loss;
- if it may appoint or remove the majority of directors, the supervisory board, the members of the board of directors or equivalent governing body where control of the entity is exercised by that board or body;
- if it may cast the majority of votes at meetings of the board of directors, general assembly or equivalent governing body where control of the entity is exercised by that board or body; and/or
- if it may co-ordinate the management of an undertaking with that of other undertakings in pursuit of a common objective, for instance, in the case where the same natural persons are involved in the management or board of two or more undertakings.

In cases where the bank needs to make a discretionary judgement, these indicators, along with other relevant indicators used for accounting purposes, could be used in order to identify a control relationship.

Control exists also where:

- in the case of an entity in which two persons/companies hold 50:50 participations if they exercise equal control on the entity, but are not otherwise
- a client has entered into a “shareholders’ agreement” with other shareholders so as to obtain the majority of the voting power of an entity and this implies that all of the shareholders involved have control over the entity.
- a natural or legal person that is a partner in one or more (limited) partnerships also exercises control over these (limited) partnerships. The controlled entities are to be included in the group of connected clients of every one of their partners.

The entire exposure to a connected client must be included in the calculation of the exposure to a group of connected clients; it is not limited to, nor proportional to, the formal percentage of ownership.

The definition of connected clients indicates that companies, which draw up consolidated accounts and a consolidated annual report, are to be grouped as connected clients. This is the case if an undertaking is related to one or more other undertakings because they all have the same parent or are managed on a unified basis.

The control criterion indicates that exposures to entities within the same group as the reporting institution are to be regarded as a single risk. All entities within the same group are connected clients, although exposures to some or all of them may be exempted from the large exposures regime in accordance with the decision regulating the manner of calculation of bank exposures.

The control situation is not just for a transitional period but it should be in a reasonably stable state. If the bank is able to demonstrate that what seems to be a control relationship truly is not, then, there is no requirement to group the clients. However, in cases where control exists, and the client, does not actually exercise its potential control. This does not exclude the need to consider such clients as connected.

For entities where the majority of the shares are directly owned by the central government, and where exposures to the central government receive a 0% risk weight under the decision regulating banks' capital adequacy, there is no requirement to group these entities as a group of connected clients. This also applies to entities controlled by regional or local authorities treated as a central government which receives a 0% risk weight. This exemption, however, does not apply to further sub-structures of these entities. In such cases, these entities and their subsidiaries are to be included in a group of connected clients. This also applies to other cases of interconnections.

3. Identification of economic interconnection

Geographic and sectoral concentration risks fall outside the scope of the large exposures regime. Sectoral concentration is a common risk affecting all entities in the same industry; geographic risk is a risk affecting all entities in the same region, whereas economic interconnection is an idiosyncratic risk that arises in addition to sectoral and geographic risk. Idiosyncratic risk is where, in a bilateral interrelationship, financial problems of one entity are transferred via this interrelationship to another entity which otherwise would not be concerned.

Even if the issue of control of one client over another does not apply, an institution is obliged to determine whether there exists a relationship of economic dependence between clients. If it is likely that the financial problems of one client would cause difficulties for the other(s) in terms of full and timely repayment of liabilities, there exists a single risk that needs to be addressed. An economic dependence between clients may be mutual or only one way. Dependence might arise in the context of business interconnections (such as supply chain links, dependence on large customers or counterparty exposures, financial dependency) and suggests that the clients involved are exposed to the same idiosyncratic risk factor. The fact that the existence of common idiosyncratic risk factors may lead to default contagion for otherwise independent clients, is the core of the concept of economic interconnection.

Legal basis for identifying economic interconnection is contained in Article 3 point 8 indent 6 of the Banking Law, which defines that the connection exists between one or more persons if a deterioration or improvement in financial situation of one party may lead to deterioration or improvement in financial situation of the other party or other parties, or there is a possibility of loss, profit or creditworthiness transmission among these parties.

Economic dependence should be identified, which implies that a client cannot overcome problem without experiencing repayment difficulties. However, even if a client is depending on another client through, for instance, a business relationship, it could still be possible for the client to find a replacement for this business partner (in case of his default). The client could also compensate for such a loss by other means, for example, through reduction of costs, concentration on other sectors etc. If the bank comes to the conclusion that the client will be able to experience such a situation without facing substantial, existence-threatening repayment difficulties, there is no requirement to consider such clients to be interconnected.

It is not possible to determine a comprehensive list of possible cases of economic interconnection as each case has special characteristics. Therefore, the identification of connected clients requires thorough knowledge of the customer. The following examples are illustrative of possible economic dependence between clients, where banks should carry out further investigations regarding the need to group these clients:

- when one counterparty has guaranteed fully or partly the exposure of the other counterparty, or is liable by other means and the exposure is so significant for the issuer that the issuer is likely to default if a claim occurs. If the exposure is not significant, meaning that the potential liability, if it materializes, would not threaten the issuer’s solvency, then such relationships are covered through the credit risk mitigation rules or counterparty substitution;
- the owner of a residential/commercial property and the tenant who pays the majority of the rent;
- significant part of production/output is for one single customer;
- significant part of receivables or liabilities of the client is to one counterparty;

- a producer and vendor that this producer is depending on and which it would take time to replace;
- undertakings that have an identical customer base, consisting of a very small number of customers and where the potential for finding new customers is limited;
- if the bank becomes aware that clients have been considered as interconnected by another institution; and
- for the retail market:
  - the debtor and his/her co-borrower;
  - the debtor and a collateral provider or guarantor, provided that the collateral or guarantee is so substantial for the issuer to the extent that his/her/its ability to service the liabilities will be affected if the guarantee or collateral is claimed by the institution.

The banks should identify clients that are connected because of funding relationships. This means that funding problems of one entity are likely to spread to another due to dependence on the same funding source. Dependency in this context means that the source of funding is not easily replaceable and that the clients in this case are not able to overcome their funding dependence on this entity even by taking on practical inconvenience or higher costs. Furthermore, it should be noted, that it is a basic principle of the large exposures regime, that in the determination of interconnections, the quality of management or the credit quality of the entities concerned is not taken into account.

A single risk shall be assumed if there is risk of contagion or synchronic risk between the respective entities. Synchronic risk means that the connected clients could all be affected because they rely on a common source of funding. Synchronic risk can emerge from, for example:

- use of one funding entity;
- same investment advisor (e.g. investment committee);
- similar structures;
- similar underlying assets.

The requirement to connect clients due to a common source of funding is not dependent on either the type of entity being funded nor the form of funding used, but rather it is dependent on entities receiving all or the majority of their funding from a common source which cannot easily be replaced. As in general, for the concept of interconnection, it requires a case by case assessment.

Interconnections arising through control and interconnections arising through economic interconnection are two different concepts and a mandatory requirement to interlink them could lead to far reaching grouping requirements. Therefore it is not always the practice to link these two concepts together. See the following example:

4. Treatment of exposures to schemes with underlying assets

Exposures can arise not only through direct investments of banks but also through investments in schemes (open investment funds and structured finance/structured finance vehicles e.g. securitisations) which themselves invest in underlying assets. Consequently, when an institution invests in a scheme it is exposed on the one hand to the risk associated with the scheme manager and on the other hand to the credit and market risk linked to the underlying assets of the scheme. Therefore, ideally, the underlying assets of a scheme should always be taken into account when calculating exposures for large exposure purposes.

Banks are required to assess whether the scheme itself, its underlying assets or both are interconnected with the bank's clients (including other schemes) and, therefore, should be grouped together with such connected clients for the purpose of the large exposure requirements. The regime however, specify under what circumstances the scheme or the underlying exposures or both have to be assessed. It does not provide an option for bank to choose between these three approaches, but requires bank to decide on the basis of "the economic substance and the risks inherent in the structures" which approach is the most suitable for a scheme.

When analysing schemes with underlying assets, bank should adhere the following principles:

- the look-through approach is considered to be the most risk-sensitive approach for determining interconnections of the underlying assets with the bank's clients, as it provides the most prudent treatment from a large exposures' perspective;
- because it is not always possible or feasible to look-through, the guidelines provide prudent alternative approaches that adequately deal with such cases. In these approaches, greater uncertainty should be reflected in a more conservative treatment;
- the bank should appropriately take into account the granularity of schemes, significance of exposures and situations where banks can positively assess whether unknown clients are different and not connected with other clients in a bank's portfolio;
- regardless of the question of interconnections of the underlying assets to other schemes or direct exposures to clients, risk arising from schemes themselves should be recognized.

Potential losses stemming from schemes with underlying assets can arise from two sources: the risk associated with the scheme itself and the risk associated with the underlying assets of the scheme. These two sources of risk need to be taken into account in the determination of the existence of a group of connected clients. The different nature of the two sources implies that different factors should be taken into account when assessing the materiality of the risks stemming from each source, and therefore the need to apply look-through to cope with the risk stemming from the underlying assets or to limit the investment in a specific scheme to cope with the risk stemming from the scheme itself. In the case of the risk stemming from the underlying assets one important factor would be the degree of diversification in the scheme. While in the case of the risk stemming from the scheme itself the legal framework applicable to the fund managers would be an important factor to take into account.

Regarding the risk of the underlying assets, taking into account the burden that a compulsory full look-through approach could impose in some cases, thus, the decision on the most appropriate approach for a specific scheme is left to the bank.

However, banks should, whenever feasible, use the more risk sensitive approaches and should be able to demonstrate that freedom of choice have not influenced their choice. Bank's decision should be justified in terms of the relative risk that the scheme could pose in terms of breaching the large exposure limits and the cost to mitigate that risk by the look-through. For example, if a bank makes an investment, that represents 5% in terms of its own funds, in a fund with a very granular and dynamic portfolio, the marginal contribution of this scheme to the "unexpected idiosyncratic credit risk" of the bank may be low, while the cost of a full look-through of this portfolio may be high. On the other hand, if a bank makes an investment in non-granular and static portfolio, the contribution of this scheme to idiosyncratic credit risk of the bank may be materially high. Therefore, in this case, it is expected that bank focuses on comprehensive analysis of the scheme and fully justifies its decision if it opts for different approach.

Where the bank cannot ensure that there are no interconnections between the bank's clients and the underlying assets of a scheme, prudential treatment cannot allow for such exposures and schemes to be considered as independent counterparts. Therefore, all unknown exposures from schemes should be considered as belonging to one single group of connected clients.

An important issue in the context of look-through is the question of changes in the underlying assets of a scheme. For static portfolios where the underlying assets do not change over time, an assessment can be made once and does not need to be monitored in the future. For dynamic portfolios the treatment is more complicated as the relative portions of underlying assets as well as the composition of the scheme itself can change. In these cases a look-through or partial look-through approach must always be accompanied by on-going monitoring of the composition of the scheme. On-going monitoring in this context means that the monitoring frequency must be appropriate to the frequency and materiality of the changes in the underlying assets of the scheme.

The bank shall apply the following approach or their combination for the purpose of determining the interconnections of the underlying assets in the scheme with other clients:

- Full look-through: The bank may identify and monitor over time all exposures in a scheme and assign them to the corresponding client(s) or group(s) of connected clients.
- Partial look-through approach: The bank may look-through some of the underlying exposures in a scheme and assign them to the corresponding client(s) or group(s) of connected clients. The remaining exposures shall be treated as unknown exposures in accordance with (c) below.
- Unknown exposures: All unknown exposures (including schemes where the bank does not look-through by any of the methods described above and which are not sufficiently granular) are to be regarded as a single risk and shall, therefore, be considered as one unknown client. A scheme may be considered as sufficiently granular if its largest exposure is smaller than 5% of the total scheme.
- Structure-based approach: If a bank can ensure (e.g. by means of a CIU's mandate) that the underlying assets of the scheme are not connected with any other direct or indirect exposure in the bank's portfolio (including other schemes) that is higher than 2% of the banks own funds, it may treat these schemes as separate unconnected clients.

In addition to the risk stemming from the underlying assets, banks shall consider the risk arising from the scheme itself separately. Therefore, investments in single schemes (including the group of unknown exposures referred to in c)) shall be limited to 25% of own funds.

The banks should adhere to the following principles when applying the approaches above:

- For resources of funds, the granularity criterion may be applied on the level of the underlying assets of the underlying funds.
- Monitoring shall be carried out on an ongoing basis, but at least once a year.
- If the bank is aware of interconnections between the underlying assets of a scheme, they shall be recognised for the purposes of establishing the existence of a "group of connected clients". However, there is no requirement to intensively analyse interconnections between those underlying assets.
- The respective exposure amounts only need to be included in proportion to the banks' share of interests in the scheme.

5. Treatment of tranched products (securitization)

In cases of non-structured finance exposures, the losses derived from the default of counterparty in the scheme is proportionate to a direct investment in the underlying assets. In the case of structured products, the calculation of the losses also depends on the credit enhancements linked with the specific tranches. The proposed treatment recognises the credit risk mitigation that subordination of tranches provides to the structure, which is consistent with the general requirement for banks to use the most risk sensitive approach feasible.

For any given position that an investor may hold in a securitisation, there is a protection stemming from subordinated tranches equal to the size of this subordination. No matter which underlying exposure defaults first, a given position will always be protected by the junior tranches, by an amount equal to their size. Thus, the initial exposure to a given name should be “adjusted” and reduced by an amount equal to the size of all junior tranches. The adjustment will, of course, also depend on the share that is invested in the tranche.

6. Control and management procedures

Identification of possible connections between clients should be an integral part of a bank’s lending policy and supervisory process. It is in the interests of the bank to identify all possible connections in order that it has a clear understanding of its cluster risk. Banks should increase their efforts to identify connections as exposures grow or reach a certain threshold. While a bank should in general examine interconnections for all exposures, it is recommended that banks intensively investigate possible economic connections with appropriate documentation for all exposures that exceed 2% of own funds at a solo or consolidated level.

In this regard, banks should use all available information to identify connections; this includes publicly available information. The data that needs to be collected may go beyond the bank’s client and include legal or natural persons connected to the client. The information about business links or economic dependencies is not usually captured by the existing information systems of banks. The necessary inputs require utilising “soft information” that typically exists at the level of individual loan officers and relationship managers. Banks should take reasonable steps to acquire this information.

In relation to the identification of interconnected clients, every bank should have in place a robust process for determining connected clients. Notwithstanding this, the bank must be in a position to demonstrate to its supervisor that its process is commensurate to its business. In addition, the process should be subject to on-going review by the bank to ensure its appropriateness. It will rarely be possible to implement automated procedures for identifying economic interconnections; therefore, case by case analysis and judgement will be required. Consequently, for the identification of economic interconnections, banks need to rely primarily on the expertise of their loan officers and risk managers. Furthermore, banks should also monitor changes in interconnections, at least in the context of their normal periodic loan reviews and when substantial expansions of the loan are planned.

A crucial point in the process is the first time an exposure is granted to the client, or the first time an exposure reaches a level that requires individual handling from the bank. At this point, there is normally a loan officer involved and personal contact between the loan officer and the client. This opportunity to collect information relevant to disclosure of connected clients should be utilised. Normally, the bank's largest exposures will be allocated to loan officers dedicated to following the client on a regular basis. This includes personal contact as well as scrutinizing accounts and reports. The occasions to develop a deeper understanding of the client's business and possible dependencies are there and the collection of such information is a normal part of conducting prudent banking.

The bank has to assess for example the diversity of the client's customer base. In cases where the bank has identified interconnection, it has to acquire information on the other entities in the group of connected clients if this is necessary to form a view on the creditworthiness of its customer. The bank, however, is not obliged to investigate, whether the other entity, to which its client is interconnected, itself is part of other groups of connected clients, as long as the other entity is not a client of the institution.

Notwithstanding the above, all interconnections to the knowledge of a bank should be recognized, independently of the size of the exposure. As the determination of interconnection is dependent on the one hand on economic judgment, and on the other hand on the information available to, or gathered on a best effort basis by the reporting bank, it is possible that different banks will arrive at different results when analysing the same entities.