Directive on loan loss provisioning by virtue of Section 13, paragraph 1 of the State Ordinance on the Supervision of the Credit System (AB 1998 no. 16) (SOSCS) for credit institutions licensed by the Central Bank of Aruba (the Bank).

1. Introduction

The objective of this directive is to provide the credit institutions with guidelines for the establishment of effective policies and criteria for loan loss classification and provisioning. It deals with both the general (unallocated) and allocated loan loss provisions.

2. General (Unallocated) Loan Loss Provision

2.1 Purpose and definition

The unallocated loan loss provision should be considered as a special form of a dynamic determined provision related to the general risk a credit institution runs, directly or indirectly, originating from granting loans and conducting other banking activities. This provision serves as a buffer for losses, which cannot be foreseen and therefore cannot be quantified, (e.g. frauds, contingent liabilities and severe (loan) losses caused by a deterioration in the general economic situation).

2.2 Required minimum

Additions to the general provision have to be made systematically, thereby aiming at a minimum size, which stands in a reasonable relation to the possible risks involved. When deciding on this minimum management should take, amongst other things, into account:

- the domestic and international economic situation;
- (change in) character and composition of the balance sheet;
- past loss experience and relevant expectations;
- contingent liabilities.

Due to the one-sided structure of the Aruban economy and the ensuing modest opportunities for an adequate diversification of the loan portfolio and other bank activities, the Bank requires, for prudential reasons, that each bank should build up a general provision of at least 3% of the net loan portfolio plus other risk items on the asset side of the balance sheet. The net portfolio is calculated as gross loans minus allocated provisions.

2.3 Exceptions

Only in the case of local branches, whereby this provision is built up for the whole banking group by the parent company abroad, the absence of an unallocated loan loss provision may be justified.

3. Allocated Loan Loss Provision

3.1 Purpose and definition

The allocated loan loss provision is a specific provision for loans for which it is foreseen that full repayment will not take place. As part of its on-site examinations, the Bank performs credit reviews at the supervised institutions. These reviews result in the following classifications: good, special mention, substandard, doubtful and loss. Below an outline is provided of the Bank's loan classification and its provisioning policy. All credit institutions should review their own classification and provisioning policies and bring these in line with the policies mentioned below.

3.2 Loan classification

Good

The loan is sound and all principal and interest payments are current. Repayment difficulties are not foreseen under current circumstances and full repayment is expected.

Special mention

The loan is subject to conditions that, if left uncorrected, could raise concerns about full repayment. These loans require more than normal attention.

Substandard

Full repayment is in doubt due to inadequate protection (e.g. obligor net worth or collateral), and/ or interest or principal or both are more than 90 days but less than 180 over due. These loans show underlying, well-defined weaknesses that could lead to probable loss if not corrected and, thus, may become impaired assets. A specific provision of 10 - 20% of the uncollateralized amount is required.

Doubtful

Assets for which collection/ liquidation in full is determined by bank management to be improbable, due to current conditions, and/ or interest or principal or both are overdue more than 180 days but less than one year. Assets in this category are impaired, but are not yet considered total losses, because some pending factors may improve the asset's quality (via new financing or capital injection). A specific provision of at least 50% of the uncollateralized amount is required under these circumstances.

Loss

An asset is downgraded to loss when management considers the facility to be virtually uncollectible, and/ or when interest or principal or both are overdue more than one year. A specific provision of 100% of the uncollateralized amount is required under these circumstances.