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# Guidance Note

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**Subject: Classification of Credit Risk**

**Date: November 2001**

This Note is intended to inform financial institutions of the credit risk rating categories that OSFI uses as part of its on-site credit risk asset review process. This Note may also assist institutions that are considering further granularity in their risk rating methodologies and in mapping between OSFI's risk classification system and their own.

OSFI's on-site credit review process classifies credit risk exposure using **five** categories of risk: Satisfactory, Especially Mentioned, Sub-Standard, Doubtful, and Loss. OSFI is not prescribing "Doubtful" as an additional category; however, financial institutions should be aware that OSFI uses the "Doubtful" category in its credit review process.

It is thus important to note that OSFI defines "Doubtful" as being a loan similar to "Sub-Standard," but in a situation where the prospect of turnaround is in serious question and there is a high probability of a partial or full loss. As a general rule, loans should not remain in the "Doubtful" category beyond one review cycle. They should be remediated such that they can be upgraded to "Sub-Standard" or better, or, alternatively, downgraded to "Loss" with the application of an appropriate specific provision, depending on the nature of the exposure and the risk of loss determined during the review cycle.

Furthermore, it is OSFI's practice to classify as "non-performing" all credit risk exposures risk rated as "Doubtful."

As an attachment to this Guidance Note, OSFI has appended the Risk Rating worksheet used as the basis of its on-site Risk Asset Review.

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Evaluation Category	Credit Risk Rating Category				
	Satisfactory	Especially Mentioned	Substandard	Doubtful	Loss
<b>Sales/revenues</b>	Sustained or improving	Deteriorating	Severe downturn	Severe downturn - prospects for turnaround in question	Prospects for turnaround in question
<b>Earnings</b>	Sustained	Losses or less than satisfactory profits with possibly a downward trend	Significant losses	Losses sustained for several periods	Losses sustained for several periods
<b>Capital Position</b>	Strong	Undercapitalized and overtrading	Significantly undercapitalized	Strongly undercapitalized	Strongly undercapitalized
<b>Cash flow from operations</b>	Stable	Deteriorating, although still able to meet debt service	Seriously affecting ability to service debt	Unable to service debt	Unable to service debt
<b>Debt servicing/ financing</b>	Undertaken easily	Unbalanced debt position and may have had or having difficulty obtaining financing	Little to no access	No access	No access
<b>Management</b>	Experienced	Inexperienced or weak	Poor	Poor	Poor
<b>Environmental risk</b>	Acceptable	Difficulty relating to environmental factors (e.g., many regulatory warnings/fines) that may impair security values	Serious liability identified	Serious liability identified	Serious liability identified
<b>Bank Supervision Required</b>	Normal	Close	Rigorous - to protect position	Likely a non-accrual advance	Ditto re balance sheet
<b>Security Position</b>	Not an issue	Good to strong	Continues to protect, according possible avenue for recovery	Does not fully protect - loss possible	Does not fully protect and a provision is required
<b>Sponsors</b>	Quality, reputation, and financial capacity strong	Commitment to support with known resources	Limited resources and commitment uncertain	Uncertain/unlikely	No outside resources
<b>Payment of principal and interest</b>	Assured	Not currently at risk	Potentially at risk due to well-defined weaknesses. (Note #2)	At risk. (Note #1)	Not supportable

Note 1: A doubtful rating on any advance should only exist for one examination. If any advance remains questionable at the next examination, loss provisions should be considered. The consultant and/or examiner must consider the extent of general provisions to support any allocation or advances in the doubtful category. Provisioning levels would be allocated according to the risk profile of the assets or contingent risk.

Note 2: Loans in Substandard category could be considered non-accrual depending on supporting documentation and judgement of the credit consultant.