GUIDELINES ON THE CLASSIFICATION AND IMPAIRMENT PROVISIONS FOR LOANS / FINANCING FOR LABUAN BANKS

1.0 Introduction

1.1 The Guidelines set out the minimum requirements on the classification of impaired loans/financing and provisioning for loan/financing impairment. Labuan banks are expected to meet the expectations in the Guidelines and be able to demonstrate that internal policies and practices are consistent with the expectations.

1.2 Loans/financing for the purpose of the Guidelines includes all facilities[1] provided by the Labuan banks to a customer which give rise to a credit exposure to the customer.

2.0 Applicability

2.1 The Guidelines is applicable to all Labuan banks licensed under LFSSA and LIFSSA under the following categories:-

(a) Labuan bank licensed under Part VI of the Labuan Financial Services and Securities Act 2010 (LFSSA);

(b) Labuan Islamic bank licensed under Part VI of the Labuan Islamic Financial Services and Securities Act 2010 (LIFSSA); and

(c) Labuan bank that has been given approval to undertake its business as a Labuan Islamic bank under Part VI of LIFSSA.

2.2 For avoidance of doubts, the requirements of the Guidelines are also applicable to Labuan banks operating as branches. Where policies and procedures as implemented by their head office are not comparable with the requirements of the Guidelines, the requirements prescribed herein shall prevail. Nevertheless, Labuan banks are encouraged to adopt any higher standards implemented by their head office.

[1] Including but not limited to advances, trade-related receivables, and block-discounting facilities.

3.0 Legal Provision

3.1 The Guidelines is issued pursuant to Section 4A of the Labuan Financial Services Authority Act 1996 (LFSAA) in respect of Labuan banking business, Labuan investment banking business, Labuan Islamic banking business or Labuan Islamic Investment banking business for the purpose of clarifying prudential requirements in relation to impairment provisions for loans/financing.

3.2 Any person who fails to comply with the Guidelines may be guilty of an offence punishable under Section 36B and 36G of the LFSAA.

4.0 Effective Date

4.1 The Guidelines is effective from **1 October 2012** and supersedes the Guidelines on Suspension of Interest and Provision for Bad and Doubtful Debts issued on 8 April 1997.

5.0 Compliance with Financial Reporting Standards

5.1 Labuan banks shall ensure that the loan/financing impairment assessment and provisioning comply with the requirements specified under the financial reporting standard on financial instruments issued by Malaysian Accounting Standards Board (MASB) or other recognized international financial reporting standards.

6.0 Board and Senior Management Oversight

6.1 The Board of Directors and senior management of a Labuan bank are responsible to ensure that appropriate credit risk assessment, control and provisioning processes are in place and operating effectively to maintain impairment provisions for loans/financing at an appropriate level. The Board must reasonably assure that the credit risk assessment processes and internal controls are appropriate to the size, nature and complexity of the Labuan bank's lending/financing operations. In particular, the credit risk assessment processes and controls should enable Labuan banks to consistently determine impairment provisions for loans/financing in accordance with the Labuan bank's approved policies and procedures, applicable financial reporting standards and Labuan FSA's expectations under the Guidelines.

6.2 The Board shall be satisfied that:

(a) the Labuan bank's internal control and loan/financing review function provides adequate assurance of internal compliance with the Labuan bank's internal policies and procedures on classification and provisioning for loans/financing;

(b) the Labuan bank's processes and systems for identifying, classifying, monitoring and addressing loans/financing with credit quality problems in a timely manner are adequate;

(c) appropriate information about the credit quality of the loan/financing portfolio and related provisions is provided to senior management and the Board on a regular and timely basis; and

(d) management judgment has been exercised in an appropriate manner and is reasonable.

The Board of Directors shall have policies that call for the review of the Labuan bank's lending/financing and credit risk assessment functions on a periodic basis, with recommendations for improvements, where appropriate.

6.3 In assessing the methods employed by the Labuan bank to calculate impairment provisions for loans/financing, the Board shall be satisfied that:

(a) the procedures used by the Labuan bank to establish impairment provisions on individually impaired loans/financing are prudent and based on cash flow projections that take into account economic conditions;

(b) the framework for establishing collectively assessed impairment provisions is adequate and that the methodology used is reasonable;

(c) aggregate (individual and collective) impairment provisions are appropriate in relation to total credit risk exposure in the loan/financing portfolio;

(d) loans/financing (or portions thereof) determined to be uncollectible have been recognised in a timely and appropriate manner through provisions or write-offs; and

(e) the Labuan bank is following policies and practices that are consistent with the expectations of these Guidelines.

6.4 The Board shall approve write-off policies for loans/financing and these policies shall include the circumstances, conditions and approving authority under which a loan/financing can be written-off. The policies should also address appropriate monitoring and reporting mechanisms on recovery efforts made and to be undertaken by the Labuan bank. The Board may also consider requiring information on write-offs and recoveries of large loans/financing to be reported to the Board.

6.5 Senior management is responsible for the development and effective implementation of the impairment provisions framework and policies on the write-off of loans/financing approved by the Board. This includes ensuring that:

(a) internal policies, procedures, and processes on provisioning are clearly communicated to all relevant personnel. There should be formal channels for communication and coordination among those involved in the credit risk assessment, measurement and control process, including the Labuan bank's credit administration, financial reporting, internal audit and risk management functions;

(b) an appropriate, systematic and consistently applied process is adopted to determine impairment provisions for loans/financing. Such a process should facilitate the timely capturing of new or additional information about the collectability of loans/financing for the purpose of determining impairment provisions when such information becomes available; and

(c) prudent and proper monitoring of impaired loans/financing including the recovery of written-off loans/financing is enforced.

7.0 Credit Risk Grading

7.1 Labuan banks shall have in place a systematic and consistently applied process to reliably classify loans/financing on the basis of credit risk. This should support the prudent valuation of loans/financing and determination of appropriate impairment provisions for loans/financing. For this purpose, Labuan banks may adopt a credit risk grading system or categorisation based on repayment conduct (e.g. payment delinquency status) which must appropriately reflect the risks associated with loans/financing granted by the Labuan bank. Labuan FSA expects that larger loans/financing would be classified on the basis of a credit risk grading system, while other smaller loans/financing or loans/financing with homogeneous characteristics and managed on a portfolio basis may be classified on the basis of either a credit risk grading system or repayment conduct.

7.2 The credit risk grading system should be able to differentiate at a sufficiently granular level, the degree of credit risk inherent in the various credit exposures of a Labuan bank. The level of granularity should facilitate a more accurate determination of the overall characteristics of the loan/financing portfolio, probability of default and ultimately the adequacy of impairment provisions for loans/financing. The grading system should address the definitions of each credit risk grade. The delineation of responsibilities for the design, implementation, operation and performance of the system should also be clearly defined and documented.

7.3 A credit risk grading system should take into account a customer's current financial condition and paying capacity, and other customer and facility specific characteristics (which may include the current value and realisability of collateral) that affect the prospects for collection of outstanding debt/financing (including interest/profit). In general, the credit risk grading system should be consistently applied for credit risk assessment, financial reporting and capital adequacy purposes, except in circumstances where regulatory requirements prescribe a more conservative treatment[2].

[2] For example, Basel II allows a single event (i.e. 90 days past due) to determine the classification of 'non- performing' which then warrants a higher risk weight. Under the financial reporting standard on financial instruments, such an event by itself may not provide sufficient evidence of impairment.

7.4 Labuan banks shall exercise prudence in the upgrading of the status of any loans/financing. The upgrading of the status of any loans/financing should be supported by a clear demonstration of a sustained trend of improvement in the repayment capability, gearing, associated cash flows and financial position of the customer. A Labuan bank or other institutions in the same group should not grant new credit to a defaulting customer for the settlement of arrears in order to justify an improved credit risk grading[3].

7.5 Credit risk grades should be reviewed and updated whenever relevant new information is obtained or received by Labuan banks. Loans/financing to which credit risk grades are assigned should receive a periodic formal review to reasonably assure that those grades are accurate and up-to-date. Credit risk grades for individually assessed loans/financing shall be reviewed at least annually. Loans/financing that are either large, complex, higher risk or which are problem credits should be reviewed more frequently and as and when new information becomes available.

8.0 Rescheduled and Restructured Loans/Financing

8.1 Labuan banks must have in place policies approved by the Board which define the circumstances and conditions under which a loan/financing may be rescheduled or restructured. The policies should address the following:

(a) controls to avoid ‘ever-greening’ of loans/financing, including situations where loans/financing may be rescheduled or restructured more than once, and provisioning policies with respect to such loans/financing;

(b) compliance with Shariah rules and principles in rescheduling or restructuring of financing for Labuan Islamic banks. This may include administrative policies on the performance of a new agreement (‘aqad) and the treatment of charges i.e. capitalisation of compensation amounts in relation to the restructured financing; and

(c) a repayment period (based on the revised and restructured term) to be continuously observed before the rescheduled and restructured facilities can be reclassified as non-impaired.

8.2 Labuan banks must reassess the customer’s financial position, having regard to all relevant circumstances surrounding the customer’s financial condition and prospects for repayment, before a loan/financing can be rescheduled or restructured. In addition, adequate resources must be allocated to closely monitor and follow up on the performance of rescheduled and restructured loans/financing.

[3] Excluding rescheduled and restructured loans/financing, which are subject to the requirements specified under paragraph 8 of the Guidelines.

8.3 A Labuan bank shall appropriately classify the rescheduled and restructured facilities based on the assessment of the financial condition of the customer and the ability of the customer to repay based on the restructured terms. In principle and consistent with paragraph 8.1(c), loans/financing that have been rescheduled and restructured shall not lead to improved classification immediately upon perfection of the relevant documentation in relation to the rescheduling and restructuring exercise.

8.4 Labuan FSA acknowledges that in specific and exceptional circumstances, such as when customers are affected by natural disasters, rescheduling and restructuring exercises may involve the granting of moratorium on loan/financing repayments. As part of sound credit management practices, Labuan banks are expected to establish clear parameters and internal processes for the consideration of moratorium on loan/financing repayments, including proper authority for the approval of the moratorium. These processes should also be subject to adequate monitoring and review by an independent function.

8.5 Where moratorium on loan/financing repayments is granted under paragraph 8.4, the moratorium shall be for a period of **not** more than 6 months from the date of the customers' application for the moratorium.

8.6 Senior management (or the Credit Committee) should receive periodic reports on the performance of rescheduled and restructured credit facilities. The reports should provide adequate information, including default status and the frequency of rescheduling or restructuring for the same customer, to facilitate management's (or the Committee's) oversight of compliance with the Labuan bank's internal policies on rescheduling and restructuring and assessment of risks associated with the loan/financing portfolio. Any material impact on the risk profile of the Labuan bank should be raised to the Board's attention in a timely manner.

8.7 Labuan FSA may direct the Board of a Labuan bank to take appropriate remedial actions to address any deficiencies in controls or provisions for rescheduled and/or restructured loans/financing if there is evidence of restructuring or rescheduling for the purpose of 'ever-greening' loans/financing.

9.0 Sound Loan/Financing Impairment Methodology

9.1 Labuan banks shall develop and implement a sound loan/financing impairment methodology to identify, monitor, measure and report the quality of the loan/financing portfolio. The methodology should be supported by sound analysis, procedures and information systems, and should include criteria for the early identification and reporting of potential problem loans/financing to ensure that they are appropriately monitored, administered and provided for when required.

9.2 The loan/financing impairment methodologies employed must be systematic, applied consistently from period to period and incorporate a sufficient level of prudence. The methodologies must also be reviewed at regular intervals and any changes in the methodologies employed must be justified and approved at the appropriate management level. The same information should be utilised by management to monitor the condition of the loan/financing portfolio and in the Labuan bank's methodology for determining amount of loan/financing loss provisions for financial reporting and capital adequacy purposes.

9.3 The loan/financing impairment methodology should include, among others, the following:

(a) written policies and procedures for the credit risk systems and controls inherent in the methodology, including roles and responsibilities of the Board of Directors and senior management;

(b) a detailed analysis of the entire loan/financing portfolio, performed on a regular basis. This should be based on all available and reliable data, incorporate management's experienced judgment about the credit quality of the loan/financing portfolio and consider all known relevant internal and external factors that may affect loan/financing collectability (such as industry, geographical, economic, and political factors);

(c) the identification of loans/financing to be evaluated for impairment on an individual basis and the basis for segmentation of the remainder of the portfolio into groups of loans/financing with similar credit risk characteristics (such as loan/financing type, product type, market segment, credit risk grading and classification, collateral type, geographical location and past-due status) for evaluation and analysis on a collective basis;

(d) for individually assessed loans/financing that are impaired, the process for determining and measuring the amount of any impairment, including procedures on the appropriate impairment measurement techniques to be applied in a given situation;

(e) how loss rates are determined (e.g. historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience;

(f) the consideration of recoverable collateral values (less disposition costs associated with obtaining and selling collateral) and other credit risk mitigants, where applicable;

(g) policies and procedures for loan/financing write-offs and recoveries; and

(h) the methods used to validate models used for credit risk assessment and management (e.g. stress tests and back tests).

9.4 Functions associated with implementing the loan/financing impairment methodology should be performed by competent and well-trained personnel and properly documented, with clear explanations of the supporting analyses, assumptions used and rationale.

9.5 Reviews of the loan/financing loss methodologies and application should be performed by an independent function (either an internal unit of the Labuan bank or external party) at regular intervals. The results of such reviews shall be reported to senior management and the Board to provide reasonable assurance that the loan/financing loss provisions are reliable. The appropriateness of a Labuan bank's loan/financing methodologies, including any deficiencies identified by the independent function, shall also be subject to periodic reviews by internal audit. Labuan banks shall promptly address any deficiencies identified by the independent function and/or internal audit and report on remedial actions to the Board.

10.0 Use of Experienced Credit Judgment

10.1 Credit judgment used to complement historical loss experience or observable data in assessing the loan/financing impairment provisions shall be exercised by an appropriate level of management. Where experienced credit judgment is used, it shall be subject to:

(a) a prudently limited scope for discretion;

(b) appropriate parameters established and approved by the Board for the use of experienced credit judgment to enable an understanding and validation of the basis for the judgments made. Any deviation from these parameters, must be well justified and documented;

(c) the consistent application of an approved and documented analytical framework for assessing loan/financing quality to support the experienced judgment;

(d) the use of reasonable and supportable assumptions that are adequately documented. Assumptions concerning the impact on customers of changes in general economic activity, both favourable and unfavourable, should be made with sufficient prudence; and

(e) the consistent use of a broad range of available and relevant data.

10.2 The method of determining impairment provisions for loans/financing should provide reasonable assurance of the timely recognition of loan/financing losses. Management shall consider all relevant factors that are likely to cause loan/financing losses to differ from historical loss experience. The factors include:

(a) changes in credit/financing policies and procedures, including underwriting standards and collection, write-off, and recovery practices;

(b) changes in international, national and local economic and business conditions and developments, including the condition of various market segments;

(c) changes in the trend, volume and severity of past due loans/financing and loans/financing graded as low quality. This should include observations of trends in the volume of impaired loans/financing, troubled debt restructurings and other loan/financing modifications;

(d) changes in the experience, ability, and depth of management and staff involved in the credit/financing function;

(e) changes related to new market segments and products;

(f) changes in the quality of the Labuan bank's loan/financing review system and the degree of oversight by the Labuan bank's Board of Directors and senior management;

(g) the existence and effect of any concentrations of credit, and changes in the level of such concentrations;

(h) the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the Labuan bank's current portfolio; and

(i) changes in the credit risk profile of the loan/financing portfolio as a whole.

10.3 Provisions for collective impairment should be sufficiently prudent to absorb the inherent credit losses in the loan/financing portfolio. Labuan FSA expects Labuan banks to maintain sufficient loss data to support loan/financing loss estimates for the purpose of establishing the level of collective impairment provisions for groups of loan/financing with similar credit risk characteristics. Labuan banks shall ensure that the period for maintaining data is appropriate to yield reliable loss rates for a particular group of loans/financing. When using the historical loss rates to estimate the expected cash flows for groups of loan/financing, the historical loss experience shall be adjusted to reflect the current economic conditions (i.e. remove the effects of conditions in the historical period that do not exist currently on the basis of current observable data and developments).

11.0 Classification of Loans/Financing as Impaired

11.1 In addition to the disclosure requirements under the applicable financial reporting standards, Labuan banks shall classify a loan/financing as impaired based on repayment conduct:

(a) where the principal or interest/profit or both is past due for more than 90 days or 3 months. In the case of revolving facilities (e.g. overdraft facilities), the facility shall be classified as impaired where the outstanding amount has remained in excess of the approved limit for a period of more than 90 days or 3 months; or

(b) where the amount is past due or the outstanding amount has been in excess of the approved limit for 90 days or 3 months or less, the loan/financing exhibits weaknesses[4] that render a classification appropriate according to the Labuan bank's credit risk grading framework.

11.2 Where repayments are scheduled on intervals of 3 months or longer, the loan/financing is classified as impaired as soon as a default[5] occurs, unless it does not exhibit any weakness that would render it classified according to the Labuan bank's credit risk grading framework.

11.3 Where moratorium on loan/financing repayments is granted in relation to the rescheduling and restructuring exercise under paragraph 8.4:

(a) classification of a loan/financing as impaired under paragraphs 11.1 and 11.2 shall exclude the moratorium period granted; and

(b) Labuan banks are required to maintain appropriate information on these customers for Labuan FSA's review as and when required.

11.4 Rescheduled and restructured facilities can only be reclassified as non-impaired when repayments based on the revised or restructured terms have been observed continuously for a period as determined by the Labuan bank's policy on rescheduled and restructured facilities. For rescheduling and restructuring of facilities where the amount is past due for 90 days or 3 months or less, these accounts shall be classified as impaired if they exhibit any weaknesses that render such classification as appropriate according to the Labuan bank's credit risk grading framework.

11.5 Impairment provisions for loans/financing classified as impaired shall be determined in accordance with the financial reporting standard on financial instruments.

12.0 Individual Impairment Provisions

12.1 For the purpose of complying with the financial reporting standard on financial instruments, *objective evidence of impairment* is deemed to exist where the conditions under paragraphs 11.1 and 11.2 of these Guidelines have been met for loans/financing that are individually assessed for impairment.

12.2 Impairment provisions for a loan/financing that is individually assessed for impairment shall be based on reasonable and well-documented estimates of the net present value of the future cash flows that the Labuan bank expects to recover on that loan/financing.

[4] Labuan banks shall consider the loss events listed under financial reporting standard on financial instruments.

[5] A default is defined as the inability to meet the contractual repayment terms.

12.3 Where a loan/financing that is individually assessed for impairment does not result in impairment provisions, the Labuan bank shall include the loan/financing in a group of loans/financing that has similar credit characteristics for collective assessment of impairment.

13.0 Maintenance of Regulatory Reserves

13.1 Where Labuan FSA is satisfied that the Labuan bank has a loss estimation process[6] that is not sufficiently robust nor supported by adequate historical loan loss data, Labuan FSA may require the Labuan bank to maintain additional regulatory reserves for a period and in a manner determined by Labuan FSA.

14.0 Risk-Weighted Capital Ratio

14.1 For Risk-Weighted Capital Ratio (RWCR) purposes, the amount of collective impairment provisions and regulatory reserves attributable to the loans classified as impaired shall be excluded from the provisions recognised as eligible Tier-2 capital.

Labuan Financial Services Authority
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[6] Expectations as set out in paragraphs 8 to 10 of these Guidelines.