INTRODUCTION

This guideline sets out the minimum standards on classification of impaired loans and advances and provisioning requirements for such assets of development financial institutions (DFIs). The guideline promotes loan/financing accounting policies and practices which are consistent with sound risk management practices in order to ensure that the impaired assets and losses are identified and recognised in a timely manner and loan assets and income are fairly and prudently stated.

LEGAL PROVISION

2. This guideline is issued pursuant to section 41 of the Development Financial Institutions Act 2002 (DFIA) which requires a prescribed institution to meet such other prudential requirements, and within such time, as Bank Negara Malaysia may specify.

CLASSIFICATION OF IMPAIRED LOANS

3. DFIs are required to conduct regular reviews of all loans and other advances extended to their clients, with a view to classify impaired loans and to treat such loans accordingly. DFIs may formulate their own system of classifying impaired loans, subject to complying with the minimum categories of classification as follows:-

i. **Bad**

Credit facilities or portion thereof which are deemed to be uncollectible and worthless, on the basis of relevant circumstances.

ii. **Doubtful**

Credit facilities or portion thereof where collection in full is improbable and there is a high risk of ultimate default.

iii. **Sub-standard**

Credit facilities or portion thereof, which involve more than a normal risk of loss due to certain adverse factors, but which at this stage, not considered as doubtful or bad. The adverse factors could include delays in debt servicing, unfavourable financial condition, insufficient security or other factors which give rise to some doubts on the repayment capacity of the borrower.

As a general rule, impaired loans and credit facilities should be classified in the following manner:

Period of Default	**Classification**
6 months[1] but less than 9 months	Substandard, unless there is evidence to support a worse-off classification.
9 months but less than 12 months	Doubtful, unless there is evidence to support a worse-off classification.
12 months and above	Bad

[1] 3 months in the case of credit cards and trade financing instruments.

TREATMENT OF INTEREST INCOME ON IMPAIRED LOAN

4. All interest accrued from the date the account is classified as impaired loan shall forthwith be suspended. All uncollected interest that has been previously accrued and recognised as income need to be reversed out of income. DFIs are required to claw-back the interest to the first day of default. Interest earned on an

account which has been classified as impaired loan shall only be recognised as income as and when the interest has been collected by the DFIs i.e. cash basis.

5. In the case of Islamic banking, the unearned profit need not be reversed out of income given that the method of distribution of profit in Islamic banking is based on the concept of Mudharabah (profit-sharing), whereby the profit has already been distributed to the customer and hence it is not appropriate for the profit to be clawed-back from the first day of default. Therefore, the Islamic banking operations which are using the accrual basis are exempted from clawing-back the profit from the first day of default upon classification of the account as impaired. However, the DFIs are required to suspend the profit as and when the account is classified as impaired.

RECLASSIFICATION OF IMPAIRED LOAN AS UNIMPAIRED LOAN

6. An impaired loan can be reclassified as unimpaired loan when the principal and interest are deemed to be fully collectible in accordance with the terms of the loan agreement, indicating that the risk profile of the borrower has improved. As a general principle, this can take place when:

i. the DFI receives full repayment of the loan's past due principal and interest, and the DFI expects repayment of the remaining principal and interest as scheduled in the loan agreement;

ii. the borrower has resumed paying the full amount of the scheduled principal and interest payments for at least 6 months, and all the remaining payments (including full compensation for overdue payments) are deemed to be collectible in a timely manner; or

iii. the loan otherwise becomes well-secured and is in the process of collection.

7. The process for restoring an impaired loan to unimpaired status should be supported by a current, well documented credit evaluation of the borrower's financial condition and other factors affecting the prospects for repayment, including consideration of the borrower's repayment, government guarantees and other relevant factors. A mere rescheduling of repayment terms does not warrant reclassifying an impaired loan as an unimpaired loan.

PROVISIONING

8. DFIs are required to maintain an overall provision at a level that is adequate to absorb potential loan/financing losses. DFIs are required to review the adequacy of the specific and general provisions regularly at least every 6 months to ensure that the provisions set aside are consistent with current information about the collectibility of the loans. A specific provision is a provision that is established against a loss that is identified in an individual loan while general provision is a provision that is established for losses that are known to exist, but cannot yet to be directly addressed to individual loans.

9. The DFIs' assessment on the adequacy of the provisions should be performed in a systematic way, in a consistent manner over time, in conformity with objective criteria and prudent practice and be supported by adequate documentation.

10. DFIs are required to maintain **general provision** of at least 1.5% of total outstanding loans (including housing loans sold to Cagamas Berhad), net of interest-in-suspense and specific provision for substandard, bad and doubtful debts.

11. With regard to **specific provision**, the amount required is as follows:

Classification	**Specific provision on the shortfall in security value over the amount outstanding, net of unearned interest and interest suspended**
Substandard	10%
Doubtful	50%
Bad	100%

Credit card loans and trade financing instruments which are in arrears between 3 to 6 months should be classified as doubtful requiring 50% provisioning and those which are more than 6 months in arrears should be classified as bad requiring 100% provisioning.

12. In addition, DFIs are required to set aside provisions for off-balance sheet items where the DFIs face credit risk from failure of counterparties to fulfil their contractual obligations or else it should be disclosed as a contingent liability.

13. In determining the value of the various forms of collateral, DFIs are required to observe the guideline on the valuation of security as enumerated in the Appendix.

Write-Off of Impaired Loans

14. Accounts or portion thereof which are classified as bad or deemed uncollectible and worthless may be written-off. A loan account should only be written-off when they are genuinely uncollectible and worthless i.e. action for recovery has been exhausted or is no longer worthwhile in the foreseeable future.

15. Notwithstanding the above, partial write-offs of impaired loan accounts are allowed under the following circumstances:-

(i) the value of security is less than the balance outstanding (including principal, accrued interest and other charges) and topping up of the security deficiency is not forthcoming;

(ii) the shortfall in security value over the outstanding balance (including principal, accrued interest and other charges) is uncollectible and worthless;

(iii) the DFI is in the final stage of realising the security/collateral; or

(iv) the amount is written down to the value of security i.e. the shortfall in security value over the outstanding balance is written-off.

RESPONSIBILITIES OF THE BOARD OF DIRECTORS AND MANAGEMENT

16. The management should formulate and the Board of Directors should approve detailed policy on the classification of impaired loans and provisioning which are consistent with the minimum standards set out by Bank Negara Malaysia in this guideline. The policy should address the classification of various types of loans and financing facilities.

17. It is the responsibility of the Board of Directors and management to ensure that the DFI has an effective loan review system and controls (which include an effective credit classification system) that identify, monitor and address loan quality problems in an accurate and timely manner. To be effective, the DFI's loan review system and controls must be responsive to changes in internal and external factors affecting the level of credit risk in the portfolio.

18. The Board of Directors and management should also ensure the prompt identification of impaired loans and adequate provisioning for such loans.

19. The Board of Directors and management should ensure that the DFI's process for determining an adequate level of loan loss provisions is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan portfolio that considers all significant factors that affect the collectibility of the portfolio and supports the range of credit losses estimated by this process.

20. It is also the responsibility of the DFI's management to formulate adequate and clear policies and procedures for writing-off of impaired loans. The Board of Directors should approve these policies and procedures with particular reference to criteria, authorisation and limits of authority for loan write-offs. The approval for the writing-off of loans must be centralised in the head office of the DFIs.

APPENDIX

Guideline on the Valuation of Security

1. Charge/lienholder's caveat over property

   (i) Where court proceedings are not yet instituted, forced sale value (FSV) is used. The FSV should be based on the existing use of the land as valued by professional valuers. However, under exceptional circumstances, fair market value (FMV) may be used, for example, where the DFI feels strongly that the property charged is worth FMV and there is evidence to that effect.

   (ii) DFIs are required to use the current valuation reports to value the properties pledged as collateral. In the absence of current valuation reports, the full Property Market Report may be used. Current valuation reports are defined as not more than two years old.

   (iii) Where auction is pending and reserve price (RP) has been fixed, RP is to be used.

   (iv) Where auction has been aborted and FSV of the property is lower than RP, and in the absence of new RP, FSV is to be used.

   (v) Where aborted RP is based on FSV, and in the absence of new RP, a 10% discount should be made on the aborted RP.

Note : The FSV should be based on the existing use of the land as valued by professional valuers.

2. Deed of assignment

In circumstances where the issued document of title is not available, Deed of Assignment and Charge-in-Escrow may collectively be accepted as security. The basis of valuation should be as in paragraph 1 above. Private caveats have generally no value.

3. Debenture

No value can be attached unless it is certified by a receiver/ liquidator/auditor/professional valuer.

4. Assignment of book debts

No value unless the DFI can prove that the debtors are worth the value quoted.

5. Assignment of shares

(i) Quoted

Normally, the latest market price. Appropriate discounts should be considered if the shares are thinly traded and/or comprise a large block of shares. Premiums may only be considered where there is a valid offer at the higher price as evidenced by a firm commitment, such as purchase contracts or undertaking letters provided by solicitors or brokers.

If trading in that counter has been suspended (other than temporary suspension), the net realizable tangible asset value, as per the latest audited financial statements (not more than 18 months old and taking into account the content of interim announcement), would be used. If appropriate financial statements are not available, normally no value is given. In the case of shares which are temporarily suspended, the last quoted price prior to suspension will be used. The determination of ‘temporary’ will be inferred from the reasons for suspension, for instance, shares which are temporarily suspended pending a takeover scheme.

(ii) Unquoted

Value may be given provided the test of marketability is met. The condition of marketability would be considered based on the merit of each case. If it can be demonstrated that the shares are marketable, the basis of valuation applied should be the net tangible asset per share. Higher valuation may be considered if the DFI is able to provide detailed valuation of net assets in support of the higher valuation or if there is a purchase offer for the shares evidenced by firm commitments such as purchase contracts or undertaking letters provided by solicitors or brokers.

6. Plant, machinery and equipment

In the absence of professional valuation, the net book value would be applicable, using a 20% depreciation rate on a straight-line basis on the acquisition price.

7. Hire Purchase

The assets will have no value until these assets are repossessed. When the assets are repossessed, the market value is used.

8. Guarantees

(i) Personal	Generally no value
(ii) Banking institutions	Full value
(ii) Federal and State Government of Malaysia	Full value
(iv) Others	To be considered on a case-by-case basis

9. All other securities

To be considered on a case-by-case basis