BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Classification and Impairment Provisions for Loans/Financing

Issued on: 6 April 2015

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SECTION A

1. Introduction

1.1. This policy document sets out the minimum requirements on the classification of impaired loans/financing and impairment provisioning for loans/financing. A banking institution is expected to meet the requirements in this policy document and be able to demonstrate that internal policies and practices are consistent with the requirements.

1.2. This policy document shall be read together with the *Best Practices for the Management of Credit Risk* issued by Bank Negara Malaysia that are relevant to classification and provisioning practices. In particular, a banking institution shall refer to the best practices therein relating to the oversight functions of the board of directors, senior management and internal audit; maintenance of adequate policies and procedures; and maintenance of effective credit risk management processes.

1.3. Loans/financing for the purpose of this policy document includes all facilities[1] provided by a banking institution to a customer which give rise to credit exposure to the customer.

2. Applicability

2.1. This policy document is applicable to a licensed bank, a licensed Islamic bank, and a licensed investment bank (collectively referred to as ‘banking institution’).

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

3. Legal Provision

3.1. This policy document is issued pursuant to section 47 of the Financial Services Act 2013 and section 57 of the Islamic Financial Services Act 2013.

4. Effective Date

4.1. The requirements in this policy document are effective for financial years beginning on or after 1 January 2015, except for the following:

(i) the requirements in paragraph 12 shall apply to loans/financing that are rescheduled and restructured on or after 1 April 2015; and

(ii) the requirement in paragraph 15.2 shall be effective beginning 31 December 2015.

5. Documents Superseded

5.1. The following documents are superseded:

(i) *Classification and Impairment Provisions for Loans/Financing* dated 9 November 2011; and

(ii) *Classification and Impairment Provisions for Loans/Financing – Maintenance of Regulatory Reserves* dated 4 February 2014.

SECTION B

6. Compliance with the Malaysian Financial Reporting Standards (MFRS)

6.1. A banking institution shall ensure that the loan/financing impairment assessment and provisioning comply with the requirements specified under the MFRS on financial instruments.

7. Board and Senior Management Oversight

7.1. The board and senior management of a banking institution 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 banking institution's lending/financing operations. In particular, the credit risk assessment processes and controls should enable a banking institution to consistently determine impairment provisions for loans/financing in accordance with the banking institution's approved policies and procedures, applicable MFRS and the Bank's expectations in this policy document.

7.2. The board shall be satisfied that:

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

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

(iii) 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

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

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

7.3. In assessing the methods employed by the banking institution to calculate impairment provisions for loans/financing, the board shall be satisfied that:

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

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

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

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

(v) the banking institution is following policies and practices that are consistent with the expectations in this policy document.

7.4. 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 banking institution. The board may also consider requiring information on write-offs and recoveries of large loans/financing to be reported to the board.

7.5. 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:

(i) 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 banking institution's credit administration, financial reporting, internal audit and risk management functions;

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

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

7.6. The board and senior management shall take appropriate steps to obtain assurance that the expectations set out in this policy document are being met as intended. This includes ensuring that appropriate information about the credit quality of the loans/financing portfolio is maintained at a sufficiently granular level to enable a review to be undertaken for the purpose of ensuring that the classification of loans/financing is appropriate. In addition to information on individual loans/financing with credit quality problems (including rescheduled and restructured facilities), information on loans/financing for which modifications have been made to the original repayment terms and conditions but which are not driven by an increase in the credit risk or intended to mitigate the repayment risk associated with the loans/financing granted should also be maintained to test that such loans/financing are not impaired.

8. Credit Risk Grading

8.1. A banking institution 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, a banking institution 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 banking institution. The Bank 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.

8.2. 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 banking institution. 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.

8.3. A credit risk grading system should take into account a customer's current financial condition and paying capacity[2], 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[3] purposes, except in circumstances where regulatory requirements prescribe a more conservative treatment[4].

8.4. A banking institution 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 a customer. A banking institution 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[5].

8.5. Credit risk grades should be reviewed and updated whenever relevant new information is obtained or received by a banking institution. 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 classified as problem credits should be reviewed more frequently and, as

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2 For rescheduled and restructured facilities, the assessment of the financial condition of the customer and the ability of the customer to repay shall be based on the rescheduled and restructured terms.

3 Applicable for a banking institution adopting the Internal Ratings-Based Approach for credit risk.

4 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 MFRS on financial instruments, such an event by itself may not provide sufficient evidence of impairment.

5 Excluding rescheduled and restructured loans/financing as set out in paragraph 9 of this policy document.

and when new information becomes available.

9. Rescheduled and Restructured Loans/Financing

9.1. A rescheduling and restructuring of a loan/financing facility involves any modification made to the original repayment terms and conditions[6,7] of the loan/financing facility following an increase in the credit risk of the customer. A banking institution 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:

(i) establish controls to avoid 'ever-greening' of loans/financing, including defining situations where loans/financing may be rescheduled or restructured more than once, and establish appropriate provisioning policies with respect to such loans/financing;

(ii) ensure compliance with Shariah rules and principles in respect of the rescheduling or restructuring of Islamic financing facilities. This may include administrative policies on the performance of a new agreement ('aqad) determination of new selling price and the treatment of charges (e.g. policy on non-capitalisation of compensation amounts in relation to the restructured financing); and

(iii) define a minimum 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. Such repayment period shall not be less than 6 months.

For the avoidance of doubt, any modification made to a loan/financing where

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6 This includes but is not limited to an extension of tenure and flexible repayment schedule including payment vacation, interest/profit-only payments, or capitalisation of principal or interest/profit or both.

7 Irrespective of whether the modification is carried out pursuant to a clause provided in the original repayment agreement.

the principal is scheduled to be paid at the end of the tenure in one lump sum payment shall be deemed to be indicative of an increase in the credit risk of the customer.

9.2. A banking institution 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.

9.3. The Bank 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 a moratorium on loan/financing repayments. As part of sound credit management practices, a banking institution is 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.

9.4. Where a moratorium on loan/financing repayments is granted under paragraph 9.3, the moratorium shall be for a period of **not** more than 6 months from the date of the customer's application for the moratorium.

9.5. Senior management (or 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 senior management's (or Credit Committee's) oversight of compliance with the banking institution'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 banking institution should be raised to the board's attention in a timely manner. A banking institution shall make available these reports for the Bank's review.

9.6. The Bank may direct the board of a banking institution 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.

10. Sound Loan/Financing Impairment Methodology

10.1. A banking institution 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.

10.2. 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 banking institution's methodology for determining amount of loan/financing loss provisions for financial reporting and capital adequacy purposes.

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

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

(ii) 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);

(iii) 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;

(iv) 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;

(v) 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;

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

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

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

10.4. 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.

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

11. Use of Experienced Credit Judgment

11.1. 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:

(i) a prudently limited scope for discretion;

(ii) 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;

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

(iv) 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

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

11.2. 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:

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

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

(iii) 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;

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

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

(vi) changes in the quality of the banking institution’s loan/financing review system and the degree of oversight by the banking institution’s board and senior management;

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

(viii) the effect of external factors such as competition and, legal and regulatory requirements on the level of estimated credit losses in the banking institution's current portfolio; and

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

11.3. Provisions for collective impairment should be sufficiently prudent to absorb the inherent credit losses in the loan/financing portfolio. The Bank expects a banking institution 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. A banking institution 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).

SECTION C

12. Classification of Loans/Financing as Rescheduled and Restructured in the Central Credit Reference Information System (CCRIS)

12.1. A banking institution shall classify a loan/financing described in paragraph 9 as a rescheduled and restructured loans/financing in CCRIS, except in the following circumstances:

(i) where a moratorium on loan/financing repayments granted is in line with paragraphs 9.3 and 9.4;

(ii) the loan/financing is rescheduled or restructured by *Agensi Kaunseling dan Pengurusan Kredit (AKPK)*; and

(iii) for retail loans/financing, where a banking institution elects not to increase the instalment amount following an increase in the base rate/base lending rate in cases where the increase is less than RM50 per month[8].

12.2. A banking institution shall only remove the rescheduled and restructured classification in CCRIS when the rescheduled and restructured loans/financing has been reclassified from impaired to non-impaired in accordance with paragraph 13.4.

13. Classification of Loans/Financing as Impaired

13.1. A banking institution shall classify a loan/financing as impaired:

(i) where the principal or interest/profit or both[9] of the loan/financing is past due for more than 90 days or 3 months. In the case of revolving facilities

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[8] Refer to the policy document on the *Reference Rate Framework* (including the FAQs) issued on 12 December 2014.

[9] In the case of credit card facilities, the amount past due refers to the minimum monthly repayments.

(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

(ii) 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[10] in accordance with the banking institution's credit risk grading framework; or

(iii) when the loan/financing is classified as rescheduled and restructured in CCRIS.

13.2. For the purpose of ascertaining the period in arrears:

(i) repayment on each of the instalment amount must be made in full. A partial repayment made on an instalment amount shall be deemed to be still in arrears; and

(ii) where a moratorium on loans/financing repayments is granted in relation to the rescheduling and restructuring exercise under paragraphs 9.3 and 9.4, the determination of period in arrears shall exclude the moratorium period granted.

13.3. Where repayments are scheduled on intervals of 3 months or longer, the loan/financing is classified as impaired as soon as a default[11] occurs, unless it does not exhibit any weakness that would render it classified according to the banking institution's credit risk grading framework.

13.4. For the purpose of paragraph 13.1(iii), the rescheduled and restructured loans/financing shall only be reclassified from impaired to non-impaired when repayments based on the revised and restructured terms have been observed continuously for a period of at least 6 months or a later period as determined

[10] A banking institution shall consider the loss events listed under the MFRS on financial instruments.

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

by the banking institution's policy on rescheduled and restructured facilities.

13.5. Notwithstanding paragraph 13.1, loans/financing rescheduled or restructured by AKPK may be immediately classified as non-impaired once the customer and the banking institution have agreed to the new terms and conditions. This treatment reflects the inherent controls built into AKPK's debt management programme, which among others, incorporates a rigorous assessment of the customers' debt repayment ability under the revised terms and conditions and precludes the affected customers from obtaining further loans/financing (i.e. different classification under CCRIS) as long as they are under AKPK's debt management programme. Classification of these loans/financing as impaired thereafter shall be in accordance with paragraphs 13.1 and 13.3 based on the new terms and conditions.

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

14. Individual Impairment Provisions

14.1. For the purpose of complying with MFRS 139 *Financial Instruments: Recognition and Measurement*, *objective evidence of impairment* is deemed to exist where the conditions under paragraphs 13.1 and 13.3 of this policy document have been met for loans/financing that are individually assessed for impairment.

14.2. 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 banking institution expects to recover on that loan/financing.

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

15. Maintenance of Regulatory Reserves

15.1. Where the Bank is satisfied that the banking institution has a loss estimation process[12] that is not sufficiently robust nor supported by adequate historical loan loss data, the Bank may require the banking institution to maintain additional regulatory reserves for a period and in a manner determined by the Bank.

15.2. Pursuant to paragraph 15.1, a banking institution is required to maintain, in aggregate, collective impairment allowances and regulatory reserves of no less than 1.2% of total outstanding loans/financing[13], net of individual impairment.

16. Capital Adequacy Ratio

16.1. For capital adequacy ratio purposes, the amount of collective impairment allowances and regulatory reserves attributable to the loans/financing classified as impaired shall be excluded from the provisions[14] recognised as eligible Tier 2 Capital.

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[12] Refer to the expectations as set out in paragraphs 8 to 11 of the policy document.
[13] Excluding loans/financing with an explicit guarantee from the Government of Malaysia.
[14] Refer to paragraph 12.1(iv) of the *Capital Adequacy Framework (Capital Components) and Capital Adequacy Framework for Islamic Banks (Capital Components)*.