MFSA

MALTA FINANCIAL SERVICES AUTHORITY

BANKING SUPERVISION UNIT

BANKING RULES

CREDIT RISK PROVISIONING BY CREDIT INSTITUTIONS AUTHORISED UNDER THE BANKING ACT 1994

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INTRODUCTION

1. In terms of Article 4(2) of the Banking Act 1994 ('the Act') the competent authority ('the authority') as defined in Article 2 (1) of the Act is empowered to make Banking Rules as may be required for carrying out any of the provisions of the Act. The authority may also amend or revoke such Banking Rules. The Banking Rules and any amendment or revocation thereof shall be officially communicated to credit institutions and the authority shall make copies thereof available to the public.

2. The Credit Provisioning of Credit Institutions Rule ('the Rule') is being made in relation to Article 17(A) of the Act which requires that:

   "The competent authority may issue a banking rule as it shall consider appropriate for the regulation of provisioning for bad and doubtful debts."

SCOPE AND APPLICATION

3. The authority regards that accurate valuation of assets and the establishment of adequate provisions is of fundamental importance. This Rule applies to loans and advances or other types of credit facilities and receivable financial assets (and held to maturity financial assets where applicable) - hereinafter referred to in this Rule interchangeably as 'loans' or 'credit facilities' - that are subject to impairment review in accordance with the requirements of International Accounting Standard 39 Financial Instruments: Recognition and Measurement ("IAS 39"). As the Rule is not intended to deal with each and every provision of IAS 39 pertaining to impairment and uncollectability of financial assets, credit institutions are advised to refer directly to International Financial Reporting Standards as adopted by the EU ("IFRS") for complete treatment of the subject.[1]

4. The authority considers it of utmost importance that a credit institution undertakes additional mitigation of the most prevalent risk on its balance sheet. Accordingly, the authority considers that this should be achieved through this Rule via a two-pronged technique:

   - the first approach is based on providing due direction to a credit institution to adopt a more conservative approach to accounting impairment provisioning as applicable through IFRS. This approach includes but is not limited to, the implementation of conservative triggers within IAS 39 to identify and recognise losses within the IFRS framework as early as possible, while

[1] IFRS as adopted by the EU are governed by the Commission Regulation (EC) No 1126/2008 and locally applied through Legal Notice 19 of 2009.

- the second approach mandates a credit institution to allocate funds to a Reserve for General Banking Risks (being an Own Funds item) on the basis of the application of the methodology laid down in this Rule to create an additional Pillar II capital buffer operating through Banking Rule BR/12.

Furthermore, the Rule also aims to ensure that a credit institution's Credit Risk Management Framework includes a provisioning policy appropriate to its operations and risk profile, adequate procedures and internal controls as per paragraph 8 of this Rule.

5. The Rule applies to all credit institutions authorised under the Banking Act 1994.

CREDIT RISK MANAGEMENT FRAMEWORK[2]

6. It is inevitable that, in the ordinary course of business, a credit institution may suffer losses on credit facilities as a result of these assets becoming partly or wholly uncollectible. The authority expects that the Board of Directors (the Board) and senior management of a credit institution implement a robust provisioning policy which should form part of its overall Credit Risk Policy. This Policy should as a minimum include appropriate credit risk assessment processes and effective internal controls to consistently determine provisions in accordance with the credit institution's stated policies and procedures through impairment allowances in accordance with IFRS (including the implementation of conservative triggers within IAS 39) and also deal as required and necessary with additional allocation of Pillar II capital buffers for credit risk in accordance with this Rule and Banking Rule BR/12. It is the responsibility of the Board to ensure that the requirements of the authority in terms of this Rule are reflected in the Credit Risk Policy.

Moreover, the authority requires a credit institution to regularly review and revise its key management judgements, assumptions and estimates in its provisioning framework:

- there should be appropriate disclosure through appropriate minutes (for perusal by the authority) of the key management judgements, estimates and assumptions underlying management decisions in this respect;

- the disclosures should include the key inputs and parameters used in credit institutions' provisioning models (if any) and an explanation of significant changes in the inputs used from the prior year;

[2] Developments in the local and international regulatory environment have highlighted the crucial importance of prudential management of credit risk for the continued soundness of credit institutions. Banking Notice No 1 – Notice on the Management of Credit Risk by Credit Institutions Authorised under the Banking Act 1994 – establishes best practice guidance which credit institutions are encouraged to apply in conjunction with the application of this Rule.

- if sensitivity analysis is used by a credit institution, the disclosures should include factors such as changes to assumptions concerning *inter alia* property price, GDP and unemployment rates.

7. Without prejudice to paragraph 26 of this Rule, the authority expects that a credit institution applies due conservatism in the interpretation of future cash flow estimates, discount factors and collateral value estimates used in IFRS impairment calculations and this should be supported by objective evidence, given current expected future economic conditions at the reporting date.

Provisioning Policy

8. Accordingly, a credit institution's Credit Risk Policy should incorporate, but not be limited to, the following:

Procedures and Internal Controls

- The roles and responsibilities of a credit institution's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, and the Board) in relation to correctly implementing the Policy, determining impairment and measuring provisions and applicable additional capital buffers.
- A description of the procedures and internal controls a credit institution employs in determining impairment provisions. This should include, but not be limited to:
    a. an effective grading system that is consistently applied, identifies differing risk characteristics and quantifies problems accurately and in a timely manner, and prompts appropriate administrative actions;
    b. sufficient internal controls to ensure that all relevant information is appropriately considered in determining whether impairment has occurred and in estimating the impairment provision; and
    c. clear formal communication and coordination between a credit institution's credit administration function, collection and recovery functions, financial reporting function, management, the Board, and others involved in the determination or review of impairment provisions.
- A credit institution may need to implement changes to its management information system(s) in order to facilitate the gathering of information relating to forborne loans.
- A description of the independent credit review process indicating who is responsible for performing the review and how often it takes place.

Credit Risk Management

- A description of the methodology for assessing credit risk.
- A description of the credit risk management system. This should include disclosures of policies and procedures regarding:
    a. credit risk classification systems (internal loan grading systems);
    b. collateral and guarantees;
    c. periodic review of exposures and collateral;

d. internal credit quality reviews;
e. monitoring overdue credits;
f. limiting and controlling exposures; and
g. forbearance measures and the process for granting them;
h. where applicable,
   - reducing exposures through legally enforceable netting arrangements; and
   - the use of credit derivatives and credit insurance (including how these instruments affect the credit institution's recognition and measurement of losses).

Measuring Impairment

A credit institution shall document the following information in its written Credit Risk Policy:

- A description of the methodology for assessing exposures for objective evidence of impairment, and measuring impairment, on a *specific* basis. The methods used to identify exposures to be analysed individually should be disclosed.
- A description of the methodology for assessing exposures for objective evidence of impairment and measuring impairment, on a *collective* basis. A description of how information on historical loss experience has been gathered by the credit institution for different categories of exposures, current conditions, changes in portfolio composition and trends in delinquencies and recoveries should be disclosed. If using peer group experience, the credit institution should explain how this was sourced. The period used in accumulating the historical loss experience should be stated, along with the adjustments that were made to the results due to different conditions, and why these adjustments were necessary. The factors that were considered when establishing appropriate timeframes over which to evaluate loss experience should also be disclosed.
- Each policy should require that a description of the observable data that is used in the determination of impairment triggers and the measurement of the impairment of each portfolio is retained on file.
- The method of segmenting portfolios for collective evaluation should be disclosed, along with the types of exposures in each portfolio.

Actual Loss Review

- How often actual losses in the preceding period are compared to historical experience for each portfolio.
- How often actual losses are compared to the impairment provisions held against such losses.

9. The Credit Risk Policy shall be reviewed and approved by the Board on at least an annual basis to ensure its continued appropriateness to changing circumstances and economic conditions.

LOAN QUALITY ASSESSMENT AND ACCOUNTING IMPAIRMENT PROVISIONING

10. The measurement of impairment of credit facilities at amortized cost is governed by IAS 39 (58-65) and (AG84-AG93). IAS 39 requires the use of an incurred loss approach for the calculation of accounting impairment provisions.

11. In accordance with IAS 39, an exposure is deemed to be impaired when *"there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and the loss event (or events) has an impact on the estimated future cash flows."*[3] Impairment occurs if the estimated recoverable amount of an exposure is lower than its relevant carrying amount. An impairment provision should be created to decrease the carrying amount to the recoverable amount.

12. IAS 39 requires that a credit institution shall assess at each balance sheet date whether there is any objective evidence that a credit facility is impaired. However, every time the credit institution receives information indicating that quality of any credit facility has substantially deteriorated, it shall perform a review to assess whether one or more loss events referred to in paragraphs 13 to 15 has occurred.

OBJECTIVE EVIDENCE

13. *Objective evidence* provides the trigger point for assessment of the financial asset to determine the degree of its impairment (if any). IAS 39 lists the following loss events as being triggers of the objective evidence process:[3]

    - significant financial difficulty of the issuer or obligor;
    - a breach of contract, such as a default or delinquency in interest or principal payments;
    - the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrowers a concession that the lender would not otherwise consider;
    - it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
    - the disappearance of an active market for that financial asset because of financial difficulties; and
    - observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group.

14. The authority requires that when a borrower misses a contractual instalment payment on interest or principal by 90 days and over in line with the Doubtful definition as per paragraph 33, that loan is immediately designated for an individual assessment of the degree of impairment (if any). In the case of loans which are not individually

[3] Paragraph 59 of IAS 39.

significant and where the cost of individual evaluation is not proportionate to the amount of possible loss, these would then be evaluated on a loan group level in accordance with methodologies developed by the credit institution. This requirement should not limit the earlier recognition of impairment losses incurred in accordance with IAS 39.

To identify which loans are individually significant, the credit institution shall take into account, as may be required, factors such as relative size of the loan to assets, loan portfolio or own funds as well as qualitative information, e.g. a loan forming part of a group of loans (loans to related parties with the credit institution, loans with heightened country risk, loans to the borrowers in distressed industries, or loans for which up-dated financial information on the borrower/guarantor is missing or where collateral has not been perfected or is not available).

15. A credit institution shall assess all credit exposures for objective evidence of impairment based on current information and events at the date of assessment. The general principle underlying this Rule is that impairment triggers should be conservative and appropriate for each loan asset class. The authority expects that as a minimum a credit institution takes into consideration the following triggers in the determination of applicable impairments:

Macroeconomic triggers

- economic conditions that indicate a measureable decrease in estimated future cash flows of the loan asset class
- an increase in the unemployment rate
- a decrease in prices of property pledged as collateral
- an adverse change in industry conditions
- Country risk

Other triggers:

- a request for a forbearance measure from the borrower.
- a deterioration in the debt service capacity.
- a material decrease in rents received on a buy-to-let property.
- a material decrease in the property value.
- a material decrease in estimated future cash flows.
- the lack of an active market for the assets concerned.
- the absence of a market for refinancing options.
- a significant decline in the credit institution’s own credit score/rating of the borrower
- a significant decline in a rating agency credit rating of the borrower
- diversion of cash flows from earning assets to support non-earning assets.
- a material decrease in turnover or the loss of a major customer.

- a default or breach of contract.
- deterioration in a borrower's financial performance;
- deterioration in a borrower's net worth and future prospects;
- negative prospects for support from any financially responsible guarantors;
- deterioration in the nature and degree of protection provided by the current and stabilised cash flow and value of any underlying collateral;
- defaults on obligations by a counterparty to a borrower, which affects the borrower's capability to meet its liabilities to the credit institution;
- decrease in the value of the collateral in cases when repayment of the loan is directly dependent on the collateral value;
- the borrower belongs to a group of entities that has credits outstanding from the credit institution or other credit institutions and one or more members of the group have defaulted;
- use of loaned funds for the purpose different from that provided in the loan contract;
- there is a loss of confidence in the borrower's integrity;
- in case of overdraft, the customer exceeding the approved limit frequently;

ASSESSMENT OF INDIVIDUALLY SIGNIFICANT LOANS

16. If there is objective evidence that an impairment of a credit facility exists, where one or more loss events indicated in paragraphs 13 and 15 occurred, a credit institution shall calculate the decrease in value according to the methodology laid down in IAS 39. If the recoverable amount is less than the carrying amount, a credit institution shall recognise the loss in the income statement. A credit institution shall calculate the decrease in value as the difference between the carrying amount of the credit facility and the value of future cash flows, which has been discounted using the original effective interest rate.[4]

17. Future cash flows should include the value of applicable collateral less cost for obtaining it. The authority expects that the value of applicable collateral shall be subject to paragraphs 25 and 26 of this Rule when determining the recoverable amount of an impaired credit facility.

18. Without prejudice to paragraph 47, where several credit facilities have been supplied to the same borrower and one loan loss event has occurred, the credit institution shall assess the impairment of all loans granted to this borrower.

COLLECTIVE ASSESSMENT OF LOANS

19. The collective assessment of loans undertaken in line with IAS 39 requires that when collective provisioning is used, financial assets shall be grouped on the basis of similar credit characteristics which indicate the borrower's ability to pay in accordance with the contractually agreed terms. Future cash flows in the

[4] Paragraph 63 IAS 39.

collective assessment of a group of credit facilities are estimated on the basis of historical loss experience for loans with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience are required to use peer group experience for comparable groups of credit facilities.[5]

20. A credit institution should adjust the historical loss rate on the basis of current observable data to reflect the effects of current conditions and to remove the effect of conditions in the historical period that do not exist currently. Current factors include:

- changes in international, national and local economic and business environment;
- the presence of any credit concentration and changes in the level of concentration;
- variation in the size of loan portfolio, risk profile and loan agreement conditions;
- changes in the amount of past due loans, the share of increased risk loans, the number of rescheduled loans (forbearance) and other loans with modified loan agreement conditions; and
- the effect of external factors such as competition, legal and regulatory requirements on the estimated credit institution’s current portfolio.

21. Changes in the estimates of future cash flows shall reflect and shall be directly consistent with changes in related market data such as changes in unemployment rate, property prices, commodity prices, loan payment status or any other statistics required to determine impairment losses in a group of loans.

22. A credit institution shall document the estimated impact of changes in the factors on historical loss experience, when adjustments in impairment provisions take place. Also, the methodology and assumptions used for estimating cash flows should be reviewed regularly to reduce any difference between loss estimates and actual loss experience. These should also be documented.

23. As information becomes available to a credit institution indicating impairment of a loan included in the loan group, that loan shall be excluded from the group and shall be assessed individually or included in other loan group in accordance with credit risk characteristics.

COLLATERAL VALUATION

24. Collateral is a determining factor in establishing the extent of impairments that needs to be created whenever recovery of a credit facility is in serious doubt. Indeed, the projected cash flows from the enforcement of any lien on collateral are taken into consideration in the calculation of the impairment charges of a credit facility.[6]

25. The types of assets that are generally considered acceptable by a credit institution to be pledged by the borrower in its favour as collateral are to be specified in the credit

[5] Paragraph AG 89 IAS 39.
[6] Paragraph AG84 IAS 39.

institution's Credit Risk Policy. For the purposes of this Rule the authority expects that as a minimum, credit institutions should:

- establish a programme to **monitor** on a frequent basis and at a minimum, once every year, the value of commercial real estate and once every three years, the value of residential real estate. Such monitoring may lead to amendments to the values assigned to properties. For individually significant loans, including but **not limited** to those exceeding EUR 3 million or 5% of the own funds of the credit institution, a credit institution shall review the value of the property securing such loans by an independent valuer[7] **at least** every three years. Such review may need to be undertaken at more frequent intervals, depending on a credit institution's particular circumstances at a point in time, for example, where there is lack of substantial capital buffers to take losses due to borrowing customers' default. Review of property valuations may lead to an amendment of the values assigned to the collateral;
- require that if the market is subject to significant changes in conditions where information indicates that the value of the property may have declined materially relative to general market prices, a revaluation of the collateral shall be deemed required. In general, collateral will need to be revalued over time to ensure that the original purchase price does not overstate the degree of security provided by the said collateral;
- responsibilise management to review each valuer's assumptions and conclusions to ensure timeliness and reasonableness, prudence and conservatism in the exercise of appropriate judgement to recognise the inherent subjectivity of valuation estimates. These should be based on the most prudent estimate of the collateral at the time of loan assessment and take into account the fact that the said collateral could enable the generation of income over time based on reasonable and supportive assumptions reduced, as may be necessary, through any adverse movements resulting from the on-going monitoring process;
- ensure that the collateral values used to determine the present value of estimated future cash flows shall be **conservative.** This means that collateral values used should be supported by objective evidence based on current economic conditions and where possible, take into account expected future market conditions. Conservative values are especially relevant and important where the characteristics of the collateral used render it 'unique' and thus may potentially result in limited marketability. In such cases, the value of the collateral may be determined almost exclusively on the basis of technical expert *advice* through estimates by the independent valuer, rather than on the basis of an appropriate comprehensive track record of realisation in the market and therefore, the collateral valuation should be particularly prudent to reflect the singularity of such instances. Where the authority deems it necessary, it may require that credit institution to have the appraisal carried out, at the expense of the credit institution, by another independent appraiser.

[7] An independent valuer shall be a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process. "Necessary qualifications" need not be solely professional qualifications, but the credit institutions should be able to demonstrate that the valuer has the necessary ability and experience to undertake the review.

- assess whether the ‘market value’ of the collateral is indeed the best estimate of the **realisable value** of the said asset. Should this not be the case, it is thus expected that for collateral taking the form of immovable property, the Policy advocates adjustments such as forced sale discounts to reflect the idiosyncratic characteristics and conditions of the local market (e.g. type of property, time factor to realise collateral and location) so as to arrive at the best prudent estimate of the realisable value of the collateral;
- Specify that any material expenses related to the potential sale of collateral shall be netted off against the cash flows that are estimated to occur as a result of the realisation of such collateral safeguarding a credit facility. Accordingly, any such cash flows shall take into consideration matters such as the following:
  - expenses relating to legal procedures also taking into account any other offsetting aspects in such estimates such as the impact of duration of retention (of said collateral) on such selling expenses;
  - the impact in monetary terms of the liquidity of the collateral itself;
  - the price volatility of such collateral and concomitant market price dynamics (if available);
  - the impact of the useful life of the collateral compared with maturity of the loan;
  - the credit institution’s priority ranking in the right to sale proceeds and the existence of insurance on the collateral;
- ensure that when the observable market price or fair value is used to assess the recoverable amount of the exposure, the amount, source and date of the observable market price is formally documented on file. For the purposes of this Rule, the authority requires that when using the fair value of collateral in assessing the recoverable amount of the exposure, the following items shall be documented:
  - how the fair value was determined, including the use of appraisals, valuation assumptions, and calculations;
  - the supporting rationale for adjustments to appraised values, if any;
  - the determination of costs to sell, if applicable;
  - the expertise and independence of the appraiser; and
  - the assumed timeline to recover.

  A credit institution shall ensure that this procedure is also adopted by its subsidiaries (if any).

26. Loans with long overdue repayments of interest and/or capital attach a heightened level of uncertainty in the estimation of the future cash flows and collateral values. The authority expects that for loans that have capital repayments and/or interest past due by 24 months, and where no proper legal action in the court for the realisation of collateral in the form of immovable property has been commenced, the value to be considered in determining the recoverable amount of an impaired credit facility shall not exceed 65% of the appraised value of the collateral. In case where a loan with capital repayments and/or interest past due by 36 months and over, and where no proper legal action in the court for the realisation of collateral in the form of immovable property has been commenced, the value to be considered in determining the recoverable amount of an impaired credit facility shall not exceed 50% of the

appraised value of the collateral. These percentages shall be without prejudice to the credit institution's decisions to apply lower percentages to determine the recoverable amount of an impaired credit facility where it is deemed appropriate under certain circumstances.

FORBEARANCE MEASURES

27. Forbearance measures occur in circumstances where the borrower is considered to be unable to meet the terms and conditions of the contract due to *financial difficulties* so that the credit institution decides either to modify the terms and conditions of the contract to enable the debtor to service the debt or to refinance, totally or partially, the contract. Modifications of terms and conditions may include, but may not be limited to, reduction of the interest rate, principal, accrued interest or rescheduling of the dates of payment of principals and/or interests.[8]

28. Forbearance based on sound conduct principles provides for sound prudential management. Thus, a credit institution is expected to have in place a formal policy relating to forbearance practices, which policy should assess to what extent forborne assets are expected to be recovered and set a realistic time-frame for the recovery process to be concluded. A credit institution is expected to ensure that the period of forbearance for such loans on its books is limited.

29. The conditions (e.g. interest rate, term, grace period) shall be based on realistic payment arrangements in accordance with expectations as to the borrower's ability to pay and the general economic situation. Thus, loans shall preferably be structured through regular instalments consistent with the borrower's generation of income or, alternatively, through financially equivalent arrangements.

30. A credit institution should distinguish between those forborne facilities which are non-performing and those which, following forbearance measures, have adhered to the new repayment arrangements and can consequently be considered as performing. A forborne facility cannot be considered as performing (i.e. regular) unless monthly repayments have been effected for 12 consecutive months (or 4 quarterly or 1 annual repayment, as the case may be).
Following the granting of forbearance measures by the credit institution, the latter cannot change the facility rating immediately. As such, the credit institution can only start to upgrade the relative facility gradually if there is clear evidence that customer had started to adhere to the new repayment programme. As a general rule, the new repayment conditions need to be adhered to for a given period (a minimum of 6 monthly repayments or 2 quarterly repayments) before the first upgrade can be effected. Further upgrades can be effected if repayments continue to be regularly maintained.

[8] EBA Draft Implementing Technical Standard (ITS) on Supervisory Reporting (Forbearance and non-performing exposures)

A credit institution has to report all its forborne facilities as follows:

- All non-performing forborne facilities have to be reported on an appropriate schedule, including the credit grading of the facilities and the number of times that forbearance measures have been applied (number of times that they have been rescheduled);
- Those forborne facilities which are graded as 4-Doubtful at time of reporting have also to be reported in the schedule of Doubtful facilities and marked accordingly as rescheduled;
- Those facilities which, at reporting date, have adhered to the new repayment arrangements for more than 12 months (4 quarterly or 1 annual repayment) as referred to above and which can therefore be termed as performing forborne facilities, should not continue to be reported in the schedule of rescheduled facilities;

Nevertheless, such facilities still have to be reported separately and the credit institution is required to follow up on these closely. As such, these facilities have to be marked accordingly on the credit institution's IT system so that it will remain clear that such facilities had been rescheduled at some time or other following initial sanction.

31. The authority considers that credit facilities which have received forbearance measures more than twice should attract a 4 - Doubtful grading in accordance with paragraph 33.

CREDIT GRADING

32. The foundation of any loan review system is an accurate and timely credit grading, which involves an independent assessment of credit quality that should lead to the identification of problematic loans. An effective credit grading system provides important information for the determination of an adequate level for provisioning.

33. For the purposes of this Rule the loans and advances portfolio should be graded under four categories namely: *1 - Regular; 2 - Watch; 3 - Substandard; 4 - Doubtful;*

(1) Regular

Loans and advances which attract a *1 - Regular* grading are those which do not possess any weaknesses and are therefore adequately protected, all the significant conditions outlined in the sanction letter are met, all collateral required is held and registered, and repayments are up-to-date or, in case of an overdraft, the account is revolving satisfactorily with no unauthorised excesses.

(2) Watch

Loans and advances which attract a *2 - Watch* grading are those which are receiving the close attention of the credit institution's management and are being reviewed periodically in order to determine whether such advances should be reclassified to either the *regular* or the *substandard* classification.

Credit facilities that attract this category include those where:

a. the lending officer may be unable to properly supervise the credit because of an inadequate loan or advance credit agreement;

b. questions exist regarding the condition of and/or control over collateral;

c. adequate review could not be undertaken owing to lack of up-to-date audited financial statements;

d. economic or market conditions may unfavourably affect the borrower in the future;

e. a declining trend in the borrower's operations or an imbalanced position in the balance sheet exists including failure of the borrower to meet financial projections, but not to the point that repayment is jeopardised;

f. other deviations from prudent lending practices are present; and/or

g. the payment of interest and/or capital becomes overdue by 30 days and over but not exceeding 60 days.

(3) Substandard

Loans and advances which attract a *3 - Substandard* grading are those having the weaknesses inherent in those loans and advances classified as *2 – Watch* with the added characteristic that repayment is inadequately protected by the current sound worth and paying capacity of the borrower. Loans and advances so graded have a well-defined weakness or weaknesses that could jeopardise the repayment of the debt. They are characterised by the distinct possibility that the credit institution will sustain some loss if the deficiencies are not corrected. Examples of well-defined weaknesses include the lack of credible support for full repayment from reliable sources; a significant departure from the intended source of repayment and the inability to generate sufficient cash flow to service the debt.

Credit facilities with payments of interest and/or capital overdue by 60 days and over but not exceeding 90 days should also attract this grading.

(4) Doubtful

Loans and advances which attract a *4 - Doubtful* grading are those facilities where the credit institution deems the recoverability of principal to be remote as a result of worsening conditions of loans and advances classified as *3 - Substandard*.

Furthermore, credit facilities with payments of interest and/or capital overdue by 90 days and over should attract a *4 – Doubtful* grading. Interest on facilities graded *4 – Doubtful* which is overdue shall be immediately taken to *Interest in Suspense*.

Circumstances may arise through which, irrespective of the repayment not being overdue by 90 days, the credit institution has reasons to doubt the eventual recoverability of funds. In such instances, credit institutions are expected to immediately grade facilities as *4 – Doubtful* and take interest to suspense accordingly.

34. For the purposes of overdrafts and other debts payable on demand without an agreed maturity date the *"past due"* period shall be measured from the date of the first demand for repayment of either the principal or interest or from the date that the facility carries an unauthorised excess that remains unpaid or unauthorised.

    Nevertheless, if during a period of 180 days, the unpaid or unauthorised excess is regularised only for a brief period and subsequently the credit facility reverts to delinquency, the "*past due*" period should not be interrupted and the credit facility should continue to attract the same grading before it was temporarily regularised.

35. The authority acknowledges that credit institutions may wish to create subdivisions of the above gradings for their internal reporting purposes. In such circumstances the authority still expects credit institutions to apply a grading as established by this Rule both for the purposes of this Rule and for statutory reporting to the authority.

NOTIONAL SPECIFIC REGULATORY PROVISIONS

36. Where a review of the individual credit facility reveals that the creditworthiness of a borrower has undergone a significant deterioration through the application of the credit grading system stated above and that, as a result, recovery of a credit facility may be in doubt, such loans and advances are described in this Rule as *'Doubtful'*. For the purposes of this Rule, Doubtful facilities shall be net of any applicable specific provisions and/or interest in suspense. The authority thus requires that a *notional specific regulatory provision* shall be made by a credit institution against that facility according to this Rule.

37. Thus, the authority expects that credit facilities categorised as 4 - Doubtful according to paragraph 33 to be fully eligible for the purposes of a *notional specific regulatory provision*. This means that for the purposes of the methodology of this Rule, the *notional specific regulatory provisions* shall be equal to a credit institution's level of Doubtful facilities i.e. collateral (of whatever nature) shall NOT be taken into account.

38. This Rule provides for the minimum levels of *notional specific regulatory provisions* for the purposes of bridging the 'gap' with impairments arising from IAS 39 and facilities categorised within the 4-Doubtful according to paragraph 33. However, the authority expects that credit institutions undertake their own assessment and reasoned judgment on the possibility of timely recovery of funds and provide *additional*

notional specific regulatory provisions as may be required and merited in such circumstances.

METHODOLOGY FOR ALLOCATION OF FUNDS TO THE RESERVE FOR GENERAL BANKING RISKS

39. With the magnitude of *notional specific regulatory provisions* calculated in terms of paragraphs 36 to 38 above, a credit institution shall at the end of each financial year[9] appropriate the calculated amount out of its Retained Earnings, to a non-distributable "Reserve for General Banking Risks". The authority considers the allocation of funds via this capital buffer as a Pillar II measure.

    The authority reserves the right to restrict or prohibit distributions by a credit institution to its shareholders if the appropriation to the "Reserve for General Banking Risks" is not undertaken from the amount attributable to the said shareholders.

40. Specific and collective impairment allowances within the IFRS accounting framework are based on the concept of *accrual accounting* i.e. losses are to be recognised when they are actually incurred. However, the underlying principle of this Rule is based on the prudence concept thus giving rise to differences in assessing the amount of *notional specific loan loss provisions* for regulatory purposes as opposed to accounting impairment allowances according to IAS 39.

41. When *notional specific regulatory provisions* calculated in terms of this Rule exceed specific impairment allowances calculated in accordance with IFRSs as adopted by the EU (IAS 39), a credit institution shall, at the end of the financial year[9], appropriate an amount equivalent to 2.5% of the difference out of its Retained Earnings, to the said non-distributable "Reserve for General Banking Risks". As the allocation of funds via this capital buffer is a Pillar II measure, the authority reserves the right to increase the applicable metric i.e. currently 2.5%, for any particular credit institution as may be required according to that credit institution's risk profile as set out in its ICAAP and as assessed by the authority through the applicable Supervisory Review and Evaluation Process.

42. A credit institution shall, on an *annual basis*, appropriate on an aggregate basis the allocation of funds to the Reserve for General Banking Risks as described above in paragraph 39 for its pool of individually significant loans. However, should the difference between the *notional specific regulatory provision* and relevant accounting impairment allowance for such loan change materially within the interim period through further deterioration of a facility, the authority expects credit institutions to

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9 Credit institution which include interim net profit for Own Funds purposes shall make this appropriation on an interim basis (*vide* Banking Rule BR/03 Appendix 2 para 1.1.7)

adjust the applicable capital buffer accordingly to reflect the possibility of incremental risk.

43. The authority expects that, as a minimum, credit institutions adequately allocate *notional specific regulatory provisions* for those loans and advances graded as *4 – Doubtful* in accordance with the criteria established by this Rule. The authority reserves the right to require a credit institution to ultimately increase its allocation of funds for general banking risks i.e. to increase its Pillar II allocation if, in its opinion, circumstances so warrant following an examination of that credit institution's loans and advances portfolio *or* in situations where, in its considered opinion, impairments made by a credit institution may not be sufficient. In doing so, the authority may also consider the opinion of the credit institution's external auditors.

44. A credit institution is expected to maintain a record of credit facilities falling within *4 – Doubtful* for supervisory purposes. This record shall include the outstanding amount of the exposure, the date when facility was initially classified as *Doubtful*, the updated market valuation of any underlying collateral, any prior charges over such collateral, interest in suspense, accounting impairment allowances and any notional specific provisioning amounts and any other data or information which the authority may require from time to time.

45. The authority expects a credit institution to ensure that for those credit facilities for which impairments under relevant accounting rules, and *notional specific regulatory provisions* under paragraphs 36 to 38, to implement appropriate practical and timely measures to recover funds in line with the credit institutions' established Credit Risk Policy. Such measures should include, amongst others, the taking of legal action to safeguard that credit institution's interests in cases involving prolonged unsatisfactory conduct of facilities and the possibility of writing-off such assets (see paragraphs 48 and 49 below).

REVIEW SYSTEM

46. In order to determine the level of adequate provisions, the authority requires a credit institution to implement an appropriate and robust asset review system in place. The nature of this system should be proportionate to the credit institution's nature, size and complexity. Accurate and timely credit grading is considered to be a critical component of an effective loans and advances review system. Therefore, each credit institution is required to ensure that, as a minimum, its loan and advances review system includes the following attributes:

- a prompt identification of assets having potential credit weaknesses and appropriate classification of facilities or other assets with well-defined credit weaknesses that jeopardise repayment so that timely action can be taken and credit losses can be minimised.

- a formal credit grading system that can be reconciled with the framework set in paragraphs 6 to 8 of this Rule.

- an identification or grouping of loans and advances that warrant the special attention of the credit institution’s management.

- documentation supporting the reason(s) why a particular loan or advance merits special attention.

- an independent evaluation of the activities of lending personnel and the furnishing of essential information to determine the adequacy of provisions.

- a mechanism for direct, periodic and timely reporting to senior management and the Board on the status of loans identified as meriting special attention and the action(s) taken by management.

- information based on relevant trends that affect the collectability of any asset portfolio and the isolation of potential problem areas.

- assessment of the adequacy of and adherence to internal credit policies and asset administration procedures and monitoring of compliance with relevant laws and regulations.

- appropriate documentation of the credit institution's loss experience for various components of its loans and advances portfolio.

- regular comparison of assumptions and parameters used to create the portfolio provision against experience. This should involve testing or verifying on an annual basis through:
  - comparison of actual losses to provisions held for major categories of exposures;
  - analysis of recent experience that considers recent economic conditions; and
  - consistent review over portfolios and over time periods. When new methods are introduced, the rationale should be documented and results on both the new and old methodology compiled over one year.

A credit institution shall perform stress testing of the exposures (particularly loans) at regular intervals. These tests should incorporate both normal and extreme conditions, and immediate and long-term horizons. The results of the stress tests should be appropriately documented and reported to senior management, and appropriate action taken if results exceed agreed tolerances.

CONNECTED LENDING

47. Credit institutions are expected to have systems and procedures in place to identify exposures to connected customers and determine whether such exposures constitute a single risk. Where exposures are deemed to constitute a single risk, the authority expects that the requirements of paragraph 33 (grading) are applied to each exposure in a consistent manner.

For the purpose of determining connectivity of customers, reference and adherence is to be made to BR/02 Large Exposures paragraphs 13 to 16.

IRRECOVERABLE LOANS AND ADVANCES

48. When a credit facility has been identified as 'Doubtful' and subject to a *notional specific regulatory provision* in line with the process outlined above in this Rule, such facility should be regularly reviewed, at least annually. In the case of those credit facilities identified as Doubtful, such facilities may be required to be written off as per accounting framework, either partially or in full, when there is no realistic prospect of recovery. Where such facilities are secured, this is generally after receipt of any proceeds from the realisation of security. The timing and extent of write-offs involves the combination of a series of events and could entail an element of subjective judgement. Nevertheless, a write-off will often be prompted following a specific event, such as the fact that insolvency proceedings or other formal recovery action has been concluded.

49. Where forbearance measures fail, the authority expects a credit institution to take appropriate timely actions to recover those facilities which have been long overdue[10] including facilities whose performance have been 'mostly unsatisfactory'[11] over a period of time, irrespective of whether it is covered by collateral. In this context, a credit institution shall endeavour to reduce the level of long-outstanding doubtful loans in its portfolio to the lowest possible. Therefore, the decision not to take legal action should be adequately documented and approved by senior management and any other extant relevant governance structures.

ALLOCATION OF ADDITIONAL CAPITAL UNDER PILLAR II

50. The allocation of funds to a non-distributable "Reserve for General Banking Risks" according to the methodology laid down in this Rule augments a credit institution's capital buffers for Pillar 2 risks – particularly any expected or potential future credit losses as may be indicated by rising levels of *Doubtful* loans through application of this Rule - within the context of Banking Rule BR/12.

51. The difference between *notional specific regulatory provisions* and accounting impairment allowances can be deemed as being purely a quantitative measure of a credit institution's contingent credit risk. Thus, credit institutions may be required to take further pre-emptive quantitative and qualitative Pillar II measures to mitigate any potential credit losses in times of stress.

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[10] The authority would expect that a credit institution would take tangible and specific enforcement action commensurate with relevant accounting principles and IFRS as adopted by the EU on those loans and advances which have been in default for at least the past 5 years.

[11] Facilities are considered as having "*mostly unsatisfactory*" performance if repayments of capital instalments have only been few and far between. There have to be at least twelve monthly consecutive payments of capital instalments (or equivalent for loans with other repayment terms) for the period of "mostly unsatisfactory" performance to be broken.

52. According to paragraph ___ of BR/12, the authority may, through the SREP process, assess on a case-by-case basis whether a credit institution's allocation of additional Pillar II capital as per paragraphs 39, 41 and 43 of this Rule is sufficiently robust to cater for the risk profile of that particular credit institution.

BRANCHES OF OVERSEAS CREDIT INSTITUTIONS

53. Paragraph 29 of the Application Procedures for Authorisation of Licences for Banking Activities Rule (BR/01) states that a licence issued to a credit institution incorporated outside Malta to carry on its business of banking through a branch in Malta is deemed to having been granted to that credit institution as a whole.

54. Consequently, the authority expects that the overseas credit institution maintains an adequate level of provisions. If necessary the authority may, in consultation with the foreign supervisory authority, require that the provisions on credit facilities of the branch in Malta be in accordance with the provisions of this Rule.

OFFENCES AND PENALTIES

55. Any person who commits an offence in terms of the Rule as provided for under Article 35 of the Act shall be liable to such penalties as may be prescribed pursuant to the said article.[12]

FUTURE DEVELOPMENTS REGARDING FORBEARANCE

56. The provisions in this Rule are without prejudice to future EBA Implementing Technical Standard (ITS) on Supervisory Reporting relating to Forbearance and non-performing exposures.

TRANSITORY PROVISIONS

57. This Rule replaces the current BR/09/2008 Credit and Country Risk Provisioning of Credit Institutions Licenced under the Banking Act 1994 and shall come into force on 30 September 2013. The authority recognises the impact that certain provisions of the Rule could have on credit institutions' capital planning measures and in view of this the authority is hereby granting a transitory period of [*X*] years with regards to the compliance with paragraph 26 of this Rule. Accordingly, the authority considers that the extent of additional provisions resulting through the application of the relevant haircuts in terms of the said paragraph, may be staggered equally over [*X*] financial years as of the commencement date of the Rule.

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[12] Legal Notice 155 of 1999 on "Penalties for Offences Regulation, 1999".