RESERVE BANK OF MALAWI

CREDIT RISK GUIDELINES

Bank Supervision Department

March 2013

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PART I- PRELIMINARY

1 MANDATE

These guidelines are issued pursuant to Section 96 of the Financial Services Act 2010 and implement Part III of the Financial Services (Capital Adequacy for Banks) Directive, 2012.

2 OBJECTIVE

The objectives of these guidelines are to:

(a) assist banks to appropriately calculate and measure the capital charge for credit risk under the Standardised Approach of Basel II.

(b) provide guidance on how to complete each section of the credit risk templates in the call report under Basel II.

(c) outline all the areas of supervisory national discretion decided by the Registrar pertaining to credit risk under Basel II.

3 SCOPE

These guidelines cover the calculation of capital charge for credit risk under the Standardised Approach.

4 APPLICABILITY OF CREDIT RISK GUIDELINES

The credit risk guidelines apply to all banks.

5 DEFINITIONS

'Standardised Approach' is a set of credit risk measurement techniques which uses external credit rating agencies to quantify required capital for credit risk.

'Total Capital' is as defined in the Directive on Capital Adequacy

'**Minimum Capital ratio**' is as prescribed in the Directive on Capital Adequacy

‘Past Due Exposures’ is as defined in the Asset Classification Directive

“Registrar” means Registrar of Financial Institutions as appointed under the Financial Services Act No. 26 of 2010.

PART II – MEASURING CREDIT RISK

6 APPROACHES

6.1 The Basel II Framework require that a bank's capital position be measured through a risk-based capital ratio calculated by dividing its capital base by total risk-weighted assets, as follows:

$$\textit{Capital Adequacy Ratio} = \frac{\textit{Total Capital}}{\textit{Credit RWA} + \textit{Operational Risk Equivalent Assets} + \textit{Market Risk Equivalent Assets}}$$

6.2 There are two methods for measuring credit risk namely: Standardized Approach and Internal Ratings Based (IRB) Approach.

6.3 All banks in Malawi are required to use the Standardized Approach for measuring credit risk and calculating the capital charge.

7 THE STANDARDISED APPROACH

7.1 The Standardised Approach is based on ratings assigned by eligible External Credit Assessment Institutions (ECAIs) or Export Credit Agencies (ECAs) to determine risk weights for a bank's exposures to counterparties in order to set regulatory capital for credit risk.

7.2 For an ECAI to be eligible for the purpose above, it has to meet the eligibility criteria and the Registrar is responsible for determining whether an ECAI meets the criteria.

7.3 An ECAI must satisfy each of the six criteria as follows:

(a) ***objectivity***: The methodology for assigning credit ratings must be rigorous, systematic, and subject to some form of validation based on historical experience. Moreover, assessments must be subject to ongoing review and responsive to changes in financial condition. Before being recognised, an assessment methodology for each market segment, including rigorous backtesting, must have been established for at least one year and preferably three years.

(b) ***independence***: an ECAI should be independent and should not be subject to political or economic pressures that may influence the rating. The assessment process should be as free as possible from any constraints that could arise in situations where the composition of the board of directors or the shareholder structure of the assessment institution may be seen as creating conflict of interest.

(c) ***international access/Transparency***: the individual assessments should be available to both domestic and foreign institutions with legitimate interests and at equivalent terms. In addition, the general methodology used by the ECAI should be publicly available.

(d) ***disclosure***: an ECAI should disclose the following information: its assessment methodologies, including the definition of default, the time horizon, and the meaning of each rating; the actual default rates experienced in each assessment category; and the transitions of the assessments, e.g. the likelihood of AA ratings becoming A over time.

(e) ***resources***: an ECAI should have sufficient resources to carry out high quality credit assessments. These resources should allow for substantial ongoing contact with senior and operational levels within the entities assessed in order to add value to the credit assessments. Such assessments should be based on methodologies combining qualitative and quantitative approaches.

(f) ***credibility***: to some extent, credibility is derived from the criteria above. In addition, the reliance on an ECAI's external credit assessments by independent parties (investors, insurers, trading partners) is evidence of the credibility of the assessments of an ECAI.

The credibility of an ECAI is also underpinned by the existence of internal procedures to prevent the misuse of confidential information. An ECAI does not have to assess firms in more than one country in order to be eligible.

8 CREDIT RISK WEIGHTED ASSETS

8.1 All exposures (on and off balance sheet) should be risk weighted net of specific provisions;

8.2 A bank's total credit risk-weighted assets should be equal to the sum of the risk-weighted amount of each on- and off-balance sheet exposures it holds;

8.3 The risk-weighted amount of an on-balance sheet exposure is determined by multiplying its current book value (net of specific provisions) by the relevant risk-weight;

8.4 The risk-weighted amount of an off-balance sheet asset is determined by first multiplying its current book value (net of specific provisions) by a credit conversion factor (CCF) and then the relevant risk-weight;

8.5 Both, on and off-balance sheet exposures are netted by the appropriate credit risk mitigations (CRMs) to determine the net exposure before applying the risk weights;

8.6 All non-performing loans (past dues) for each category should be reported on a separate line. The exposure amounts to be risk weighted therefore should be net of non-performing loans to avoid double counting.

9 CLASSIFICATION OF EXPOSURES

In terms of the Standardized Approach, a bank should classify its credit exposures into the following asset classes, for risk weighting purposes:

(a) exposures to sovereigns and central banks;

(b) exposures to public sector entities;

(c) exposures to multilateral development banks;

(d) exposures to other banks;

(e) exposures to Security firms;

(f) exposures to Corporate;

(g) claims included in retail portfolios;

(h) exposures secured by residential mortgage properties

(i) claims secured by commercial real estate

(j) other assets

(k) higher risk categories

(l) off-balance sheet items

10 RISK WEIGHTS FOR EXPOSURES

The following tables outline the specific risk weights for the various exposures as classified above.

10.1 Portfolio I: Exposures to Sovereigns or Central Banks

The risk weights applicable to sovereigns and central banks exposures are as follows:

Risk Weight	Narration
0%	i. Exposures to Malawi Government ii. Exposures to Reserve Bank of Malawi
100%	i. Past due exposures to Malawi Government, Reserve Bank of Malawi and rated sovereigns.

NOTE:

- In case of advances to Governments/RBM through purchase of securities, the bank should only report exposures held to maturity under Credit Risk; any exposures held for sale, should be reported under market risk in the bank's trading book.

- Exposures to rated sovereigns include all exposures to foreign sovereigns according to that sovereign's credit rating. However, the rating must be recognised by the Registrar.

- For the purpose of risk weighting claims on sovereigns, the Registrar may recognise the country risk scores assigned by ECAs. To qualify, an ECA must publish its scores and subscribe to the Organisation for Economic Co-operation and Development (OECD) agreed methodology. The OECD methodology establishes eight risk score categories associated with minimum export insurance premiums. These ECA risk scores will correspond to risk weight categories as detailed below:

Export Credit Assessment Rating (ECA)	**0-1**	**2**	**3**	**4 to 6**	**7**
Risk Weight	**0%**	**20%**	**50%**	**100%**	**150%**

10.2 Portfolio II: Exposures to Public Sector Entities (PSEs)

Risk Weight	**Narration**
0%	i. Exposures to Central Government Departments or Ministries[1]
100%	i. Exposures to Parastatals and Statutory Corporations[2] ii. Exposures to Local Assemblies (district, town, municipal or city assemblies) iii. Exposures to Other Government related entities not listed in i and ii. iv. Past due exposures to i-iii

[1] See Appendix I for a List of Central Government Departments and Ministries provided by the Ministry of Finance as at January 2012

[2] See Appendix II for a List of Parastatals and Appendix III for Statutory Corporation provided by the Ministry of Finance as at January 2012.

10.3 Portfolio III: Exposures to Multilateral Development Banks (MDBs)

Risk Weight	Narration
0%	Exposures to Multilateral Development Banks[3]
100%	Past due exposures to Multilateral Development Banks

NOTE:

- The following are the qualifying characteristics for a 0% risk weight for a Multilateral Development Bank:

  (a) it has very high long-term issuer ratings;

  (b) It has a shareholder structure comprised of a significant proportion of high quality sovereigns with long term issuer credit assessments of AA or better;

  (c) Must have a strong shareholder support demonstrated by the amount of paid-in capital contributed by the shareholders;

  (d) Must have adequate level of capital and liquidity; and

[3] See Appendix IV for a list of Multilateral Development Banks

(e) It has strict statutory lending requirements and conservative financial policies.

10.4 Exposures to Other Banks

There are two options for calculating risk exposures to other banks.

10.4.1 Under the first option, all banks incorporated in a given country are assigned a risk weight, one category less favourable than that assigned to the exposures to the sovereign of that country; or

10.4.2 The second option is based on the risk weight of the external credit assessment of the bank itself, with exposures to unrated banks being risk weighted at 50%. Under this option, a preferential risk weight that is one category more favourable may be applied to exposures with an original maturity of three months or less, subject to a floor of 20%.

10.4.3 The Registrar has exercised discretion to use option two, because all the banks in Malawi are not rated. The following are the rules for compiling the template under this category:

Risk Weight	**Narration**
0%	Excess funds placed as a deposit with Reserve Bank of Malawi
20%	i. Interbank loans to local banks with original contractual maturity of three months or less ii. Excess funds placed as a deposit in another bank
50%	I. Interbank loans with original contractual maturity of more than three months II. Excess funds placed as a deposit with another bank maturing in more than three months
100%	Past due exposures to local banks

NOTE*:*

- Exposures to rated banks must be risk weighted in line with the ratings of those banks. However, the ratings must be recognised by the Registrar.

10.5 Portfolio V: Exposures to Securities Firms

Exposures to ***prudentially regulated*** securities firms shall be treated as exposures to banks as follows:

Risk Weight	Narration
50%	Claims on locally prudentially regulated securities firms[4]
100%	i. Exposure to securities firm not on the list provided in Appendix V ii. Past due exposures

10.6 Portfolio VI: Exposures to Corporates

10.6.1 All exposures to corporates in Malawi shall be risk weighted at 100% or in line with their external ratings. The ratings must be recognised by the Registrar.

Credit assessment	**AAA to AA-**	**A+ to A-**	**BBB+ to BB-**	**Below BB-**	**Unrated**
Risk weight	20%	50%	100%	150%	100%

10.6.2 Past due exposures must be risk weighted at 100%.

[4] See Appendix V for a list of Security Firms

10.7 Portfolio VII: Claims Included in Retail Portfolios

10.7.1 All retail exposures except overdrafts shall be risk weighted at 75%.

10.7.2 All overdrafts actual drawn amounts should be risk weighted at 100%. The undrawn amount should be reported under off balance sheet items, but will have a conversion factor of 100% and risk weighted at 100% as well;

10.7.3 Retail exposures should meet the following criteria:

(a) Orientation criterion - The exposure is to an individual person or persons or to a small business enterprise (SMEs);

(b) Low value of individual exposures - Maximum aggregated retail exposure to one counterparty shall not exceed MK30 million;

(c) Product criterion - The exposure takes the form of the following: revolving credits and lines of credit (including credit cards and overdrafts); personal/consumer loans; student loans; education loans, and leases to individuals.

(d) Granularity criterion – the portfolio must be sufficiently diversified to a degree that reduces risk in the portfolio. For purposes of this condition, no aggregate exposure to one counterparty should exceed 0.2% of the overall retail portfolio. In other words, if an exposure (on aggregate basis) exceeds this limit, that exposure should be assigned a risk weight of 100% under the line “exposures greater than MK30 million”.

10.7.4 All forex loans to individual persons or small and medium enterprises should be included under Retail Portfolio.

10.7.5 Personal residential mortgage loans should be excluded from the retail portfolio. These should be reported under Portfolio VIII – Exposures to Residential Mortgages.

10.7.6 Past due exposures must be risk weighted at 100%.

10.8 Portfolio VIII: Exposures Secured by Residential Mortgage Property

Risk Weight	**Narration**
35%	Mortgages on residential property which are fully secured, whether or not occupied by the owner[5]
100%	i. Mortgage exposures where a bank is not the holder of the first mortgage bond or portion of mortgage bond that has been consolidated with other facilities, whether ranking *pari pasu* or not. ii. Past due exposures secured by Residential Mortgage Property must be risk weighted at 100%.

NOTE:

- Mortgages on residences in support of business or corporate loans are not included in the definition of residential mortgages.

[5] This risk weight may be reviewed by the Registrar depending on available data on mortgage default rates in the industry.

10.9 Portfolio IX: Claims Secured by Commercial Real Estate

Risk Weight	Narration
100%	Mortgages on residential property which are fully secured, whether or not occupied by the owner[6]
100%	i. Commercial real estate lending ii. Past due exposures for claims secured by commercial real estate.

10.10 Portfolio X: Other Assets

List any remaining claims under the following asset categories:

Risk Weight	Narration
0%	Cash, gold, coins, bullion, foreign notes & coins, balances with the Reserve Bank of Malawi
20%	Cheques in course of collection
100%	Other assets

[6] This risk weight may be reviewed by the Registrar depending on available data on mortgage default rates in the industry.

10.11 Portfolio XI: Higher Risk Categories

Risk Weight	Narration
150%	i. High risk category exposures (venture capital, project finance, private equity). ii. Exposures to sovereigns, PSEs, banks, and securities firms that are risk weighted below B- and all exposures to corporates that are risk weighted below BB-. iii. Past due exposures

11 OFF BALANCE SHEET ITEMS

11.1 Off balance sheet items are subject to a "Credit Conversion Factor" to recognize what is in many cases lower risk.

11.2 In principle, the risk weight of an off balance items is determined by the following calculation:

Nominal Amount x Credit Conversion Factor x Risk Weight as set out above = Capital Requirement. The off balance sheet items outlined in the template are as follows:

(i) Claims to or Guaranteed by Government

(ii) Claims with Cash Collateral

(iii) Direct Credit Substitutes (Guarantees, Acceptances etc)

(iv) Transaction Related Contingency (Performance or Bid Bonds, Stand By L/Cs etc) related to specific transactions (but not as credit guarantee)

(v) Documentary Credit (Trade Related and Self Liquidating)

(vi) Other Commitments with maturity of over 1 year

(vii) Similar Other Commitments of up to 1 year or which can be conditionally cancelled

(viii) Bank should report any off balance sheet items not included in the list in separate note and consult the Registrar on how to convert and risk weight them.

Off Balance Sheet Exposures	**Credit Conversion Factors**
Claims to or Guaranteed by Government	0%
Claims with Cash Collateral	0%
Direct Credit Substitutes (Guarantees, Acceptances etc)	100%
Transaction Related Contingency (Performance or Bid Bonds, Stand By L/Cs etc) related to specific transactions (but not as credit guarantee)	50%
Undrawn Commitments with original maturity of less than one year Undrawn commitment with original maturity of more than one year	20% 50%
Documentary Credit (Trade Related and Self Liquidating)	20%
Other Commitments with maturity of over 1 year	50%

Similar Other Commitments of up to 1 year or which can be conditionally cancelled	0%

11.3 After converting off balance sheet items, the appropriate risk weight must be chosen depending on category of exposures which ranges from 0% to 150% in line with risk weights for normal credit exposures.

12 CREDIT RISK MITIGATION TECHNIQUES

12.1 A number of risk mitigation techniques, such as cash collateral, may be used to reduce risk weighting and hence the capital requirements.

12.2 The following requirements must be taken into a count when using credit risk mitigation techniques:

(i) The CRM is applied only up to the exposure amount;

(ii) No transaction in which CRM techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used;

(iii) The effects of the CRM should not be double counted. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on exposures for which an issue specific rating (i.e. it is possible to have credit rating on an institution as well as the specific debt instruments it issues) has been used that already reflects that CRM;

(iv) All banks shall use the ***Simple Approach*** for credit risk mitigation which substitutes the risk weighting of the collateral for the risk weighting of the counterparty for the collaterised portion of the exposure;

(v) The CRM must meet the following legal requirements: (1) all documentation used in collaterised transactions and for documenting on balance sheet netting and guarantees must be binding on all parties and legally enforceable; and (2) banks must have conducted sufficient legal review to verify requirement (1) above and undertake such further review as necessary to ensure continuing enforceability.

12.3 CRM techniques reduce or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks. Where these risks are not adequately controlled, the Registrar may impose additional capital charges or take other supervisory actions under Pillar 2.

12.4 The following collateral instruments are eligible for recognition as CRMs under the Simple Approach:

	Type of Collateral	**Notes/Treatment**
1	Cash (including Gold)	Full value of cash collateral or Gold. For cash, the bank must have the right of set off and must be held by the bank. *Mere holding of deposits by the bank of an obligor does not meet the criteria for mitigating credit exposure for capital relief.*
2	Government Securities such as Treasury Bills; RBM Bills; Local	Apply face value of the paper.

	Registered Stocks; Government Bonds etc	
3	Guarantees provided by Malawi Government	Full recognition up to the amount of Guarantee.
4	Guarantees provided by other sovereigns	Based on the credit rating of the sovereign. The ratings of the sovereign must be recognized by the Registrar. If sovereign is not rated, the Guarantee is not recognised.
5	Guarantee provided by a bank	For local banks, only 50% is recognized as credit mitigation. Where the bank is rated, in line with rating of that bank. *However, rating must be recognized by the Registrar.*
6	Guarantee by a parent company/non bank	Only qualifies if the Guarantor is rated and its rating replaces that of the counter party. The rating must be recognized by the Registrar. Guarantees by unrated companies are not recognised. Where the parent is another bank or regulated financial institution in Malawi, only 50% of Guarantee will be recognized.
7	Guarantee by a Multilateral Development	The rating of the MDB replaces that of the original obligor. For

	Bank (MDBs)	MDBs outlined in this Note, full recognition up to the amount of Guarantee.
9	Commercial Paper issued by banking institutions licensed under the FSA	Will qualify but scaled down by a 50% risk factor applicable to banks. Commercial Paper issued by any unrated corporate does not meet eligibility criteria and cannot be used for capital relief purposes.
10	Shares of listed companies	Will qualify but scaled down by a 40% risk factor. i.e. only 60% of the market value of the share will be recognized as CRM.
11	Credit Insurance	Will qualify with a risk weight of 50% or depending upon the risk weight of the insurer.

13 CAPITAL CHARGE FOR CREDIT RISK

The capital charge for credit risk will be determined by summing all credit risk weighted assets (both, on and off-balance sheet) and then multiplying the sum with the regulatory minimum prescribed ratio.

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APPENDIX I

LIST OF CENTRAL GOVERNMENT DEPARTMENTS AND MINISTRIES

1. The Presidency;
2. Pensions and Gratuities;
3. State Residences;
4. National Audit Office;
5. The Judiciary;
6. National Assembly;
7. Office of President and Cabinet;
8. Public Services Management;
9. Nutrition;
10. HIV and National AIDS Commission;
11. Public Services Commission;
12. Directorate of Public Procurement;
13. Ministry of Defence;
14. Malawi Defence Force;
15. Ministry of Development planning and Cooperation;
16. National Statistics Office;
17. Local Government and Rural Development;
18. Local Government Finance Committee;
19. Ministry of Lands and Natural Resources;
20. Ministry of Youth Development and Sports;
21. Ministry of Agriculture and Food Security;
22. Ministry of Persons with Disabilities and Elderly;
23. Ministry of Irrigation and Water Development;
24. Office of the Vice President;
25. Ministry of Education, Science and Technology;
26. Ministry of Foreign Affairs;

27. Ministry of Finance;
28. Department of Accountant General;
29. Malawi Revenue Authority;
30. Roads Fund Administration;
31. Financial Intelligence Unit;
32. Ministry of Health;
33. Ministry of Women and Child Development;
34. Ministry of Information and Civic Education;
35. Ministry of Home Affairs and Home Security;
36. Malawi Police Services;
37. Malawi Prison Services;
38. Immigration Department;
39. Ministry of Justice and Constitutional Affairs;
40. Directorate of Public Prosecutions and State Advocacy;
41. Department of Registrar General;
42. Department of Administrator General;
43. Legal Aid Department;
44. Ministry of Tourism, Wildlife and Culture;
45. Ministry of Labour;
46. Ministry of Industry and Trade;
47. Ministry of Transport, Public Works and Infrastructure Development;
48. Human Rights Commission;
49. Electoral Commission;
50. Ministry of Natural Resources, Energy and Environment;
51. Department of Geological Surveys;
52. Department of Mines;
53. Anti-Corruption Bureau;
54. Office of Ombudsman; and
55. Law Commission.

APPENDIX II

LIST OF PARASTATALS

1. University of Malawi;
2. Malawi College of Health Sciences;
3. Malawi Institute of Education;
4. National Library Services;
5. National UNESCO Commission;
6. Malawi National Examination Board;
7. Malawi Council for the Handicapped;
8. Malawi National Council of Sports;
9. Small and Medium Enterprise Board;
10. Development of Malawi Traders Trust;
11. Small Enterprise Development of Malawi;
12. Malawi Entrepreneurship Development Institute;
13. Health Service Regulatory Authority;
14. Pharmacy, Medicines and Poisons Board;
15. Nurses and Midwives Council;
16. Medical Council of Malawi;
17. National Herbarium and Botanic Gardens;
18. Scholarship Fund;
19. National Youth Council of Malawi;
20. Mzuzu University, Library Books;
21. Kachere Rehabilitation Center;
22. Malawi Investment and Trade Center;
23. Malawi Investment Promotion Agency;
24. Malawi Export Promotion Council;
25. Malawi Broadcasting Corporation (including Television Malawi);
26. National Commission of Science and Technology;
27. Support to CHAM and MCHS for Heath Officers;

28. Lilongwe University of Agriculture and Natural Resources (including Natural Resources College Trust);
29. Malawi University of Science and Technology; and
30. Malawi Industrial Research and Technology.

APPENDIX III

LIST OF STATUTORY CORPORATIONS

1 Blantyre Water Board;

2 Northern Region Water Board;

3 Lilongwe Water Board;

4 Southern Region Water Board;

5 Central Region Water Board;

6 Malawi Housing Corporation;

7 Air Malawi;

8 Electricity Supply Corporation of Malawi;

9 Agricultural Development and Marketing Corporation;

10 Malawi Posts Corporation;

11 Malawi Communications Regulatory Authority; and

12 Airport Development Limited.

APPENDIX IV

LIST OF MULTILATERAL DEVELOPMENT BANKS

1 International Monetary Fund (IMF);

2 World Bank Group (International Bank for Reconstruction and Development – IBRD & the International Finance Corporation – IFC);

3 Asian Development Bank, African Development Bank;

4 European Investment Bank, European Investment Fund;

5 European Central Bank, the Bank for International Settlement;

6 Nordic Investment Bank, Caribbean Development Bank;

7 Islamic Development bank;

8 Council of Europe Development Bank;

9 Preferential Trade Bank – PTA.

APPENDIX V

LIST OF SECURITY FIRMS

1 Malawi Stock Exchange
2 Stockbrokers/dealers
3 African Alliance
4 CDH Stockbrokers
5 FDH Stockbrokers
6 Stockbrokers Malawi Ltd
7 CDH Asset Management
8 NBM Financial Management Services
9 FMB Asset Management Division
10 Old Mutual Life Assurance
11 Alliance Capital Ltd
12 Indetrust
13 NICO Asset Managers

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