The Malawi Gazette Supplement, dated 11th May, 2018, containing Regulations, Rules, etc. (No. 11A)

GOVERNMENT NOTICE NO. 35

FINANCIAL SERVICES ACT

(CAP 44:05)

FINANCIAL SERVICES (FINANCIAL ASSET CLASSIFICATION FOR BANKS) DIRECTIVE, 2018

ARRANGEMENT OF PARAGRAPHS

PARAGRAPH

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IN EXERCISE of the powers conferred by section 34 of the Financial Services Act, I, DR. DALITSO KABAMBE, Registrar of Financial Institutions, make the following Directive—

PART 1—PRELIMINARY

Citation

1. This Directive may be cited as the Financial Services (Financial Asset Classification of Banks) Directive, 2018 and shall apply in addition to the Basel II Credit Risk Guidelines.

Interpretation

2. In this Directive, unless the context otherwise requires—

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"Act" means the Financial Services Act;

"adverse classification" means a classification in one of the following classification categories-substandard, doubtful or loss;

"Basel II Credit Risk Guidelines" means the Guidelines issued by the Registrar pursuant to section 96 of the Act to assist in calculation of capital charge for credit risk;

"book value" means the value of a financial asset as stated on the books of accounts of a bank, or the amount at which an asset is recognized in the statement of financial position;

"classification categories" means classification categories of—

(*a*) standard;

(*b*) special mention;

(*c*) sub standard;

(*d*) doubtful; and

(*e*) loss;

"credit impaired financial assets" means financial assets that have objective evidence of impairment at the reporting date or are non-performing assets;

"expected credit loss" means the probability-weighted estimate of credit losses or the present value of all cash shortfalls over the expected life of the financial instrument;

"financial asset" means any asset that is—

(*a*) cash;

(*b*) an equity instrument of another bank;

(*c*) a contractual right to receive cash or another financial asset from another bank, or to exchange financial instruments with another bank under conditions that are potentially favourable to the bank; and

(*d*) a contract that will or may be settled in the bank's own equity instruments and is—

(i) a non-derivative for which the bank is or may be obliged to receive a variable number of the bank's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the bank's own equity instruments";

"financial asset measured at amortized cost" means a financial asset which satisfies the following conditions—

(*a*) is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows; and

(*b*) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding;

"financial asset measured at fair value through comprehensive income" means a financial asset which satisfies the following conditions—

(*a*) is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and selling financial assets, and

(*b*) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding;

"financial instrument" means any contract that results in a financial asset of one bank and a financial liability or equity instrument of another bank;

"gross carrying amount" means the amortised cost of a financial asset, before adjusting for any loss provision;

"large exposure" means a direct or an indirect exposure, of a bank to any person or group of related parties equal to or exceeding ten percent (10%) of core capital of the bank;

"lifetime expected losses" means the expected credit losses that result from default events on a financial instrument that are possible during the expected life of the financial instrument;

"loan loss reserve" means a provision arising from differences in the amounts of specific provisions on identified losses from using prudential requirements and International Financial Reporting Standards;

"loss given default" means the percentage of the exposure at risk that is not expected to be recovered in an event of default;

"net carrying amount" means the amortised cost of a financial asset, after adjusting for any loss provision;

"non- performing credit" means a credit facility which is classified in one of the following asset categories—

(*a*) substandard;

(*b*) doubtful or

(*c*) loss;

"probability of default" means the risk that the borrower will be unable or unwilling to repay its debt to the bank in full, or in part, or on time or not in accordance with the contractual terms;

"provisioning categories" means categories of —

(*a*) stage one (1);

(*b*) stage two (2); and

(*c*) stage three (3) as outlined under paragraph 12 of this Directive;

"seasonal credit facility" means a credit facility where repayment is solely dependent on proceeds that are seasonal in nature or are expected within a predefined timeframe;

"sustained record of performance" means that all principal and interest payments are made according to the modified repayment schedule; and

"twelve month expected credit losses" means the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the twelve (12) months after the reporting date or a shorter period if the expected life of the financial instrument is less than twelve (12) months.

PART II—OBJECTIVES

Objectives

3. The objectives of this Directive are to set supervisory requirements which ensure that banks—

(*a*) properly identify and make provisions on expected credit loss in line with internationally recommended financial asset classification and provisioning standards;

(*b*) enhance their credit risk management practices;

(*c*) comply with the capital adequacy requirements provided for in sections 10, 11 and 23 of the Banking Act particularly with regard to—

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(i) valuation of assets and liabilities;

(ii) impairment of assets; and

(iii) recognition of income and expenses.

(*d*) present statements of financial position and statements of comprehensive income that properly reflect the financial impact of expected credit loss; and

(*e*) promote consistency in the assessment and measurement of credit risk and development of expected credit loss models.

PART III—REQUIREMENTS

Financial asset classification policy

4. The board of directors of a bank shall—

(*a*) adopt and ensure implementation of a written policy covering the following—

(i) classification of financial assets;

(ii) establishment of adequate provisions for expected loan losses which comply with this Directive;

(iii) all types of lending the bank may be engaged in based on the business model adopted;

(iv) practices relating to various kinds of collateral that the bank may hold; and

(v) determination and approval of the bank's twelve (12) month expected loss and if relevant, the life time expected credit loss representative of portfolio risk and loss;

(*b*) determine, adopt and ensure implementation of sound risk management policies in respect of financial assets classification and provisioning;

(*c*) ensure that the bank's provisioning practices are anchored by credible management information system, high quality data and well trained and skilled personnel;

(*d*) review and approve policies on an annual basis or as and when there are applicable regulatory changes;

(*e*) ensure that Management identifies and documents the expected credit loss assessment and measurement methods such as a loss rate method, probability of default or loss-given-default method, to be applied to each exposure or portfolio; and

(*f*) ensure management communicates to the Registrar in writing the bank's twelve (12) month expected credit loss within thirty (30) days following year end and further ensure that any changes from twelve (12) month expected credit loss to life time expected credit loss are communicated immediately they are made in a similar manner.

Procedures on asset classification

5. A bank shall have written procedures to ensure consistent compliance with the approved policy on financial asset classification which shall include the following—

(*a*) an analytical framework for assessing credit quality;

(*b*) documented process for determining the annual provisioning factor consistent with the portfolio or sum of segments comprising the portfolio;

(*c*) appropriate valuation methods for determining fair value of collateral;

(*d*) periodic reporting procedures to senior management and the board about fair value and its impact on the financial capital and earnings of the bank;

(*e*) independent price valuation and verification functions; and (*f*) system of internal control reviewing policy and implementation mechanism behind establishment of twelve (12) month and life time expected loss.

Identification of non-performing credits

6. A bank shall categorize the following facilities as non-performing—

(*a*) overdrafts and other extensions not having pre-established repayment programs due to—

(i) an overdrawn balance which exceeds the customer's approved limit for ninety (90) days or more;

(ii) the customer's borrowing line which has expired for ninety (90) days or more ; or

(iii) an overdraft that is in excess at the review date which has not been renewed or renewed to a lower limit and remains in excess for ninety (90) days or more;

(*b*) a seasonal credit facility without a pre-established repayment program where—

(i) no repayment is made for ninety (90) days or more after the end of the proceeds period; or

(ii) repayments within ninety (90) days after the end of the proceeds period are insufficient to cover capital or accrued interest charged during the period of the credit facility;

(*c*) a credit facility with principal or interest which is due and unpaid for ninety (90) days or more;

(*d*) a credit facility with interest payments for ninety (90) days or more which has been re-financed, or rolled over into a new loan; or

(*e*) any of the qualitative conditions mentioned in the First Schedule which indicate that there is serious doubt about the repayment capacity of the borrower.

Classification categories of credits

7.—(1) A bank shall classify credit facilities in the following categories—

(*a*) Standard –An asset is Standard if—

(i) it is current;

(ii) the obligor is complying, and is expected to continue to comply, with all terms of the contract; and

(iii) there is no reason to believe that the bank is now, or will be, subject to risk of loss.

(*b*) Special Mention – An asset shall be classified as Special Mention if—

(i) potential weaknesses exist in the obligor's financial position; or

(ii) repayment installments are thirty (30) to ninety (90) days past-due.

(*c*) Substandard– An asset shall be classified as Sub-standard if—

(i) the obligor's financial condition, including net worth or repayment capacity, is unfavorable and is deteriorating;

(ii) other adverse factors exist which cause concern regarding the ability of the obligor to repay the credit in accordance with the existing repayment terms; or

(iii) repayment installments are ninety one (91) to one hundred eighty (180) days past their due date.

(*d*) Doubtful – An asset shall be classified as Doubtful when—

(i) weaknesses exist which make collection or repayment in full highly questionable and improbable based upon currently existing circumstances, conditions, and the "estimated recoverable amount" of the pledged collateral, if any;

(ii) the possibility of loss is very high; however, because of certain important and reasonably specific pending circumstances which could strengthen the asset, classification of the asset as Loss is deferred until its more exact status is determined; or

(iii) repayment installments are one hundred and eighty one (181) to three hundred and sixty (360) days past their due date; or

(*e*) Loss – An asset shall be classified as loss if—

(i) the asset is considered uncollectible and of such little value that it should not be included on the books of account and financial statements of the bank; or

(ii) repayment installments are three hundred and sixty one days or more past their due date.

(2) The classification categories in subparagraph (1) fall into three (3) provisioning categories namely—

(*a*) stage one (1);

(*b*) stage two (2); and

(*c*) stage three (3)

Review of credit facilities

8.—(1) A bank shall review all credit facilities on a quarterly basis for purposes of asset classification and for determining whether the credit facility has suffered impairment or a significant increase in credit risk.

(2) In addition to the quarterly full review, the bank shall update the asset classification in between quarterly reviews, at least on a monthly basis according to the days that pass after its due date.

(3) If between formal quarterly reviews, the bank establishes a significant deterioration in the quality of an individual credit or in a material part of the credit portfolio, the bank shall—

(*a*) promptly assign the credit to a new classification category that accurately reflects the status of the credit; and

(*b*) make applicable provisions to the income statement.

(4) A bank shall review each large exposure on an individual item basis.

(5) In the event that a credit facility may be classified differently, the more severe classification shall be applied.

Reclassification of non-performing credits

9.—(1) A bank shall reclassify a credit in the Substandard or Doubtful category to the less adverse category of Special Mention if—

(*a*) all principal and interest which is due is repaid in full; and

(*b*) all other conditions that have led to this classification are removed.

(2) A credit which meets the condition in subparagraph (1) and has been classified as Special Mention may be reclassified Standard if a sustained record of performance is maintained for a period of three (3) months.

(3) A bank shall not have lifetime expected credit loss provisions which are written back unless the accounts have been upgraded strictly on the basis of the criteria under sub-paragraph (1).

Re-classification of re-negotiated credits

10.—(1) Credits of which the renegotiated terms are not on commercial conditions shall receive an adverse classification and shall not be reclassified according to the provisions of this paragraph.

(2) A renegotiated credit in the Standard category shall be reclassified at least to the Special Mention category, unless the credit shows no weaknesses.

(3) A renegotiated credit in the Special Mention category shall be reclassified at least to the Substandard category, unless the credit shows no weaknesses.

(4) Examples of possible weaknesses include—

(*a*) principal or interest are past their due date;

(*b*) inability to properly supervise the debt due to an inadequate loan agreement;

(*c*) deteriorating condition or control of collateral;

(*d*) deteriorating economic conditions or adverse trends in the borrower's financial position which may, if not checked, jeopardize repayment capacity; and

(*e*) risk potential is greater than when the loan was originally granted.

(5) A bank shall classfy a credit which exhibits weaknesses, before renegotiation as Substandard unless—

(*a*) all principal and interest which is due is repaid in full at the time of re-negotiation; and

(*b*) all other conditions that can lead to an adverse classification are removed, in which case it may revert to 'Special Mention' classification.

(6) A renegotiated credit which meets the conditions in subparagraphs (5) may be reclassified as Standard if a sustained record of performance is maintained for three (3) months from the date of renegotiation.

(7) For Standard and Special Mention credit categories to be renegotiated, the customer must provide sufficient justification and evidence that he or she has enough income to support the new repayment schedule.

(8) A bank shall continue to categorize a renegotiated credit in the Substandard category as Substandard unless—

(*a*) all principal and interest which is due is repaid in full at the time of renegotiation; and

(*b*) all other conditions that have led to this classification are removed, in which case it may revert to 'Special Mention' classification; or

(*c*) a sustained record of performance under a realistic repayment program has been maintained.

(9) A renegotiated credit which meets the conditions in subparagraph (8) (*a*) and (*b*) may be reclassified as Standard if a sustained record of performance is maintained for three (3) months from the date of re-negotiation.

(10) A renegotiated credit in the Substandard category, which meets condition in subparagraph 8 (*c*) may be classified as 'Special Mention' if the sustained record is maintained for at least six (6) months from the date of renegotiation.

(11) A renegotiated credit in the substandard category may however qualify for 'Standard' classification if the sustained record is maintained for at least twelve (12) months from the date of renegotiation.

(12) If after a formal restructuring a credit deteriorates, it must revert to a non-performing classification status and be classified accordingly.

(13) A renegotiated credit in the Doubtful category will normally continue to be classified Doubtful unless—

(*a*) all due principal and interest which is due is repaid in full at the time of renegotiation; and

(*b*) all other conditions that have led to this classification are removed, in which case it may revert to 'Special Mention' classification; or

(*c*) a sustained record of performance under a realistic repayment program has been maintained.

(14) A renegotiated credit which meets the conditions in subparagraph 13 (*a*) and (*b*) may be reclassified Standard if a sustained record of performance is maintained for a period of six (6) months from the date of renegotiation.

(15) A renegotiated credit in the 'Doubtful' category, which meets condition in subparagraph (13) (*c*) may be classified as 'Special Mention' if the sustained record of performance is maintained for at least six (6) months from the date of renegotiation.

(16) The renegotiated credit mentioned in subparagraph (13), may however qualify for 'Standard' classification if the sustained record of performance is maintained for at least twelve (12) months from the date of renegotiation.

(17) Credits that are renegotiated during their life time should be reported separately to the Registrar.

Loan loss provisions

11.—(1) A bank shall—

(*a*) determine the amount of provision for loan loss or loan impairment from expected credit losses expected credit loss calculated using the expected credit loss Model;

(*b*) follow methodologies for calculating expected credit loss as detailed in the Second Schedule; and

(*c*) recognize loan loss provisions for expected credit loss on all financial assets measured at amortised cost or fair value through other comprehensive income depending on the business model or strategy.

(2) Financial assets to be measured at amortized cost or fair value shall include a loan, a lease receivable, a contract asset, a loan commitment, a financial guarantee contract or a similar debt instrument.

(3) Loan loss provision recognized at sub-portfolio, sector, facility type or class shall equate to the expected credit loss of the entire financial asset (position) subject to measurement at the reporting date.

(4) The following facilities shall be expensed as specific charges or provisions—

(*a*) an overdraft and other extension not having pre-established repayment programs which exceeds the customer's approved limit for ninety (90) days or more;

(*b*) an overdraft that is in excess at the review date which has not been renewed or renewed to a lower limit and remains in excess for ninety (90) days or more;

(*c*) a clean overdraft which has expired for ninety (90) days or more; and

(*d*) a clean term loan falling past its due date for ninety (90) days or more.

Expected Credit Loss Model and Provisioning Categories

12.—(1) A bank shall classify credit exposures under the expected credit loss model into three provisioning categories, namely—

(*a*) stage one (1);

(*b*) stage two (2); and

(*c*) stage three (3).

(2) Stage one (1) category shall include newly booked and financially healthy financial assets that are expected to perform in line with their contractual terms and which have no signs of significant increase in credit risk. In this case—

(*a*) a twelve (12) month expected credit loss shall be recognized as an expense and a loss provision will be established;

(*b*) interest income shall be calculated on the gross carrying amount; and

(*c*) all financial assets classified as Standard shall be treated in the Stage one (1) category.

(3) Stage two (2) shall include financial assets which are not yet credit impaired but whose credit risk has significantly increased since their initial recognition. In this case—

(*a*) a lifetime expected credit loss shall be recognised as an expense and a loss provision shall be established;

(*b*) interest income shall be calculated on the gross carrying amount; and

(*c*) all financial assets classified as Special Mention shall be treated in the Stage two (2) category.

(4) Stage three (3) shall include all credit impaired financial assets. In this case—

(*a*) a lifetime expected credit loss shall be recognised as an expense and a loss provision shall be established;

(*b*) interest income shall be calculated on the net carrying amount; and

(*c*) all financial assets classified as Substandard, Doubtful and Loss shall be treated in the Stage three (3) category.

(5) Expected credit loss for all lending exposures shall be measured and nil provisions are expected to be rare but possible for fully collateralized loans because expected credit loss estimates shall be the probability weighted amount that should always reflect the possibility that a credit loss will occur.

(6) A bank shall group exposures with shared credit risk characteristics in a way that is sufficiently granular to be able to reasonably assess changes in credit risk and thus the impact on the estimate of the expected credit loss for these groups or indirectly the portfolio.

(7) A bank's methodology for grouping exposures to assess credit risk such as by instrument type, product terms and conditions, industry or market segment, geographical or location shall be documented and be subject to appropriate review and internal approval by appropriate governance structures of the bank.

(8) Exposures shall not be grouped in such a way that an increase in the credit risk of particular exposures is obscured by performance of the group as a whole, or obscure timely identification of significant increases in credit risk.

(9) A bank shall adopt an active approach to assessing and measuring twelve (12) month expected credit loss that enables significant changes in credit risk to be identified in a timely manner and hence, timely recognition of changes in expected credit loss.

(10) An estimate of the amount equal to twelve (12) month expected credit loss, shall consider reasonable and supportable information as explained in the Third Schedule that affect credit risk, especially forward looking information including macroeconomic factors.

(11) A bank shall not undertake an exhaustive search for information when measuring an amount equal to twelve (12) months expected losses.

(12) Notwithstanding Subparagraph (1), a bank shall actively incorporate information that may affect the estimate of expected losses and shall not exclude or ignore relevant information that is reasonably available.

(13) Estimates and timing of twelve (12) month expected credit loss shall reflect senior management's experienced credit judgment, and represent an unbiased probability-weighted estimate of expected credit loss by considering a range of possible outcomes.

(14) In developing the approach to determine significant increase in credit risk for transfer of financial assets from Stage one (1) to Stage two (2) or to Stage three (3), a bank shall consider the factors outlined in the Fourth Schedule.

Governance of the Expected Credit Loss Model

13.—(1) Management shall develop and seek Board approval of a documented process for determining Probability of Default, Loss Rates and Loss Given Default as inputs to the calculation of expected credit loss.

(2) A bank's Internal Audit function shall provide general oversight on the inputs, processes and outputs in the calculation of expected credit loss.

(3) Management shall use experienced credit judgment, especially in the consideration of whether reasonable and supportable forward-looking information as explained in the Third Schedule, including macroeconomic factors, is essential to the assessment of credit risk and measurement of expected credit loss.

(4) The Board shall put in place processes and management information systems to enable timely determination of whether there has been a significant increase in credit risk subsequent to the initial recognition of a lending exposure so that an individual exposure, or a group of exposures with similar credit risk characteristics, is transferred to lifetime expected credit loss measurement as soon as credit risk has increased significantly.

(5) Management shall develop and seek board approval of robust policies and procedures to appropriately validate models used to measure expected credit loss.

(6) Model validation shall be performed independently of the model development process by staff with the necessary experience and expertise.

(7) Further, review of the model validation process shall be conducted by internal or external auditors to evaluate the overall effectiveness of the model validation process and independence of the model validation process from the development process.

Accounting treatment for provisioning of losses

14.—(1) If provisions required under this Directive are higher than impairment charges computed under International Financial Reporting Standard (IFRS) the excess in provisions shall be treated as an appropriation of retained earnings to loan loss reserve.

(2) The loan loss reserve in sub paragraph (1) shall not be treated as core capital as it is not available to meet unidentified losses which may subsequently arise elsewhere in the credit portfolio.

(3) A bank shall report loan loss reserves separately on the call report as

prescribed by the Registrar under the Financial Services (Submission of Information by Banks) Directive.

(4) The loan reserve in sub paragraph (1) shall be credited back to retained earnings after recoveries have been made on non-performing credit facilities or with prior approval of the Registrar.

Adequacy of provisions for loss

15. The aggregate amount of the provision for loss, regardless of whether the provisions are determined on a collective or an individual basis, must be adequate to absorb the estimated expected credit loss associated with the entire asset portfolio.

Adjustment of provisions where provisions are lower than expected

16. The Registrar shall require a bank to adjust provisions or the provisioning factor until a revised and correct ratio is set by the Board, if it is determined that the provisions of the bank are lower than expected and are imprudent.

Acquisition of assets in lieu of repayment of credits

17.—(1) A bank shall not acquire or accept an asset in lieu of repayment of a credit unless approved by the Registrar.

(2) The book value of the asset acquired in subparagraph (1) shall be the lower of the net unpaid balance of the credit or the estimated recoverable amount of the asset acquired.

(3) Assets acquired in terms of subparagraph (1) shall be disposed off not later than twelve (12) months after their acquisition or acceptance.

(4) If the estimated recoverable amount of the asset acquired is less than the book value of the credit, then the bank shall write off the difference when the asset is added to the book of accounts.

(5) A bank shall ensure that full provisions have been made on all non-performing credits in subparagraph (1) prior to acquiring or accepting repayment through an asset;

(6) The provisions in subparagraph (4) shall only be reversed after the acquired asset has been disposed in line with subparagraph (3).

Restrictions on interest accrual and capitalization

18. (1) A bank shall cease charging interest on a credit facility upon foreclosure of the collateral pledged:

Provided however that this provision shall not apply where the borrower or obligor obtains a court order stopping the bank's exercise of its right of foreclosure.

(2) The Registrar may prescribe additional circumstances under which the provisions of subparagraph (1) of this paragraph may not apply.

PART IV—RESTRICTION

Restrictions

19.—(1) A bank shall not renegotiate, roll-over or modify the terms of a large exposure unless approved by the board of directors.

(2) Where a bank has collateral and it has applied the collateral in determining the loss given default, loss rate or reducing provisions on non-performing loans—

(*a*) the collateral shall cease to have this effect if after eighteen (18) months from date of default, the bank has not realized its monetary or exchange value; and

(*b*) the non-performing loan shall be provided for as if the bank had no collateral.

(3) Except for cash and similar liquid collateral held by the bank, illiquid collateral value shall be reduced taking into account time value to realization and cost of disposal or realization.

PART V—COLLATERAL REQUIREMENTS

Collateral for credit risk management

20.—(1) The list of acceptable collateral by a bank, for its credit risk management is shown in the Fifth Schedule to this Directive.

(2) For risk management purposes, the list of acceptable collateral by a bank is not exhaustive and banks may accept other forms of unencumbered collateral in line with their credit risk management policies.

(3) Eligible collateral for capital relief purposes shall however only be restricted to those as outlined in the Basel II Credit Risk Guidelines.

PART VI—ENFORCEMENT

Monetary penalties

21.—(1) The Registrar may impose the following monetary penalties for non-compliance with any provision of this Directive—

(*a*) for banks, up to fifty million kwacha (K50,000,000); and

(*b*) for natural persons who are members of the board of directors, or senior management up to ten million kwacha (K10,000,000).

(2) With respect to banks, the Registrar shall—

(*a*) debit the penalty in subparagraph (1) (*a*) from the main account of the bank maintained at the Reserve Bank; and

(*b*) notify the bank in writing prior to debiting the account.

(3) With respect to natural persons or where the bank does not maintain an account with the Reserve Bank of Malawi, the natural person or the bank shall pay the penalty through a bank certified cheque or electronic transfer payable to the Reserve Bank of Malawi within ten (10) working days after being notified by the Registrar.

Administrative penalties

22.—(1) A bank that fails to comply with the provisions of this Directive shall have its financial statements qualified by its external auditor.

(2) In addition to the monetary penalty imposed in subparagraph (1), the Registrar may impose directions, administrative penalties and enforcement action as provided for under the Act and the Banking Act.

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PART VII—REPORTING

Reporting

23.—(1) A bank shall submit to the Registrar a report in the format and frequency as prescribed by the Registrar, showing the classification of assets in accordance with this Directive.

(2) Under specific circumstances the Registrar may require bank to increase the frequency of the reporting to a monthly, weekly or daily basis.

Revocation of G. N. 17/2014

24. The Financial Services (Financial Asset Classification for Banks) Directive, 2014 is hereby revoked.

FIRST SCHEDULE (para. 6 (*e*))

INDICATORS OF NON-PERFORMANCE OR CREDIT IMPAIRMENT

The Registrar lists the following as some of the factors that should compel bank management to classify credit facilities as non-performing or credit impaired—

1. Significant financial difficulty of the issuer, borrower, or counterparty.
2. Breach of contract such as default in principal or interest.
3. The lender, for economic or legal reasons relating to the borrower's financial hardship, grants the borrower a concession that a lender would otherwise not consider in the normal course of business.
4. The borrower has gone or will go into bankruptcy, financial reorganization or compromise arrangement with creditors.
5. Death of the borrower.
6. Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of similar borrowers or financial assets including adverse changes in the payment status of borrowers in a group (e. g increased number of delayed payments of credit card borrowers or micro credit borrowers).
7. National or local economic conditions that correlate with defaults on the assets in the group, (e. g increase in unemployment rate in a geographical area of borrowers, decrease in property or asset values that are the major or sole source of repayment or changes in industry conditions that affect borrowers).

SECOND SCHEDULE (para. 11 (1))

MEASUREMENT APPROCHES FOR EXPECTED CREDIT LOSS

There are a variety of measurement approaches that a bank may use to calculate expected credit loss. Furthermore, a bank need not apply the same approach for all financial instruments.

One measurement approach is the probability of default approach, as presented in the example below.

Another example of a measurement approach is a loss rate approach. The loss rate approach may only be used if the bank cannot separately identify changes in the various inputs driving the expected credit loss (e.g. probability of default, collateral, etc.).

Example of Probability of Default Approach

Mortgage Investment Company Y (MICY) provided a 10 year residential mortgage for K2,000,000.

At initial recognition of the mortgage, MICY determines the following on the basis of the most relevant and supportable information available—

1. A 12 month Probability of Default of 0.75% when considering historical results and current expectations of similar financial instruments, the borrower's financial condition and economic forecasts for the next 12 months.
2. It has been determined that the changes in the Probability of Default reasonably approximate the lifetime when assessing if there has been significant increase in credit risk.
3. The Loss Given Default is 25% i.e., the estimated loss amount of the gross carrying amount of the loan if it were to default.

There has been no change in the 12-month Probability of Default nor a significant increase in credit risk since initial recognition. Therefore, the mortgage falls in Stage 1. Mortage Investments Company y calculates the twelve (12) month expected credit loss provision as K3,750 (K2, 000,000 x 0.75% Probability of Default x 25% Loss Given Default).

The following factors should also be considered when making the impairment assessment—

1. The change in the probability of default since initial recognition;
2. The expected life of the financial instrument;
3. Reasonable and supportable information that is available without undue cost or effort.

Example of Loss Rate Approach

Lender X has a portfolio of 200 loans with a total gross carrying amount of K250,000. At initial recognition, the portfolio is separated into two borrower groups (Group A and B) on the basis of shared credit characteristics.

1. Group A has 100 loans at K1, 000 per client for a total gross carrying amount of K100, 000.
2. Group B has 100 loans of K1, 500 per client for a total gross carrying amount of K150,000.
3. For simplicity, the loans have no transaction costs and include no options, premiums or discounts, points paid, or other fees associated.
4. Historical loss rates for Group A loans are 4.5% based on 5 past defaults and Group B loans are 2% based on 3 past defaults.

Example of Loss Rate Approach

Expected credit loss are measured using the loss rate approach for Groups A and B based on Lender X's historical default and loss experience.

	Number of Clients in Sample	Estimated per Client Gross Carrying Amount at Default	Total Estimated Gross Carrying Amount at Default	Expected Defaults	Total Estimated Gross Carrying Amount of Expected Defaulted Loan	Present Value of Observed Loss	Loss Rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C x 100
A	100	K1,000	K100,000	5	K5,000	K4,500	4.5%
B	100	K1,500	K150,000	3	K4,500	K3,000	2.0%

Based on current and forecast economic conditions, Lender X expects an increase in defaults over the next 12 months compared to the historical rate at the reporting date. Lender X estimates 6 defaults in Group A and 4 defaults in Group B in the next 12 months. It estimates the present value of the observed credit loss per client will remain the same as the historical loss per client (i.e., K900 for Group A and K1, 000 for Group B). Lender X determines that the expected increase in defaults does not represent a significant increase in credit risk since initial recognition for the portfolios based on the expected life of the loans.

As the expected increase in defaults does not represent a significant increase in credit risk since initial recognition, the loss provision is measured at an amount equal to the 12-month expected credit loss on the 100 loans in Group A and B at K5, 400 and K4, 000, respectively. This represents a loss rate in the first year of 5.4% for Group A and 2.67% for Group B.

	Number of Clients in Sample	Estimated per Client Gross Carrying Amount at Default	Total Estimated Gross Carrying Amount at Default	Expected Defaults	Total Estimated Gross Carrying Amount of Expected Defaulted Loan	Present Value of Observed Loss	Loss Rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C x 100
A	100	K1, 000	K100, 000	6	K6, 000	K5, 400	5.4%
B	100	K1, 500	K150, 000	4	K6, 000	K4, 000	2.67%

Lender X uses the loss rates of 5.4% and 2.67% to estimate 12 month expected credit loss on new loans originated during the year in Group A and B, respectively, and for which credit risk has not increased significantly since initial recognition.

Therefore, if K100,000 new loans were originated during the year in each group the 12-month expected credit loss provision for these new loans would be K100, 000 × 5.4% + K100, 000 × 2.67% = K5, 400 + K2, 670 = K8, 070.

THIRD SCHEDULE (par. 12 (10))

REASONABLE AND SUPPORTABLE INFORMATION

Expected credit loss are estimated using reasonable and supportable information that is available without undue cost or effort. It is not expected that an extensive search be performed nor that the information cover the entire expected life of the financial asset. However, a bank must consider all information that is reasonably attainable pertaining to the borrower, past events, and general current and future economic conditions. Any projections regarding future economic conditions may be extrapolated when detailed information is not available for the entire expected life of the instrument. Information available for financial reporting purposes must be analyzed when calculating expected credit loss for a financial asset.

Reasonable and supportable information may be obtained from a variety of internal (bank-specific) and external sources, including—

1. Historical credit loss experience of the bank or its peers;
2. Internal credit risk ratings or forecasts;
3. External ratings, reports and statistics; and
4. Peer group experience for comparable financial instruments (or groups of financial instruments) where insufficient sources of bank-specific data exist.

Historical information, such as credit loss experience, is an important starting point to which a bank makes adjustments on the basis of reasonable and supportable information that incorporates both current conditions and its forecasts of future conditions. In some cases, adjustments are made to remove effects of conditions in the historical period that are not relevant to future contractual cash flows. In other cases, unadjusted historical information may be the best reasonable and supportable information.

FOURTH SCHEDULE (par. 12 (14))

INFORMATION THAT MAY BE RELEVANT IN ASSESSING SIGNIFICANT CHANGE IN CREDIT RISK

The following non-exhaustive list of information may be relevant in assessing significant change in credit risk—

1. Significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date.
2. Other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the financial instrument since initial recognition.
3. Significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life. Changes in market indicators of credit risk include, but are not limited to—

(*a*) the credit spread;

(*b*) the credit default swap prices for the borrower;

(*c*) the length of time or the extent to which the fair value of a financial asset has been less than its amortized cost; and

(*d*) other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments.

4. An actual or expected significant change in the financial instrument's external credit rating.

5. An actual or expected internal credit rating downgrade for the borrower or decrease in behavioral scoring used to assess credit risk internally. Internal credit ratings and internal behavioral scoring are more reliable when they are mapped to external ratings or supported by default studies.

6. Existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates.

7. An actual or expected significant change in the operating results of the borrower. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organizational structure (such as the discontinuance of a segment of the business) that results in a significant change in the borrower's ability to meet its debt obligations.

8. Significant increases in credit risk on other financial instruments of the same borrower.

9. An actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower that results in a significant change in the borrower's ability to meet its debt obligations, such as a decline in the demand for the borrower's sales product because of a shift in technology.

10. Significant changes in the value of the collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments or to otherwise have an effect on the probability of a default occurring. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages.

11. A significant change in the quality of the guarantee provided by a shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion.

12. Significant changes, such as reductions in financial support from a parent bank or other affiliate or an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the borrower's economic incentive to make scheduled contractual payments. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in securitizations, whether subordinated interests are expected to be capable of absorbing Expected credit loss (for example, on the loans underlying the security).

13. Expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument.

14. Significant changes in the expected performance and behavior of the borrower, including changes in the payment status of borrowers in the group (for example, an increase in the expected number or extent of delayed contractual payments or significant increases in the expected number of credit card borrowers who are expected to approach or exceed their credit limit or who are expected to be paying the minimum monthly amount).

15. Changes in the bank's credit management approach in relation to the financial instrument; i.e., based on emerging indicators of changes in the credit risk of the financial instrument, the bank's credit risk management practice is expected to become more active or to be focused on managing the instrument, including the instrument becoming more closely monitored or controlled, or the bank specifically intervening with the borrower.

16. Past due information, including the rebuttable presumption that assumes credit risk has increased significantly if more than 30 days past due.

FIFTH SCHEDULE (para. 20 (1))

LIST OF ACCEPTABLE COLLATERAL FOR BANKS

1. Collateral for Credit Risk Management—
   (*a*) cash (including gold);
   (*b*) Government Paper (Treasury Bills, Reserve Bank of Malawi Bills, Government Bonds and Promissory Notes);
   (*c*) guarantees;
   (*d*) other debt securities such as commercial paper;
   (*e*) shares of listed entities;
   (*f*) real property (land and building);
   (*g*) commercial property;
   (*h*) plant and machinery;
   (*i*) vehicles; and
   (*j*) moveable property; and
   (*k*) any other collateral acceptable to the bank in line with its credit policy.

Made this 3rd day of April, 2018.

DR. DALISO KABAMBE
Registrar of Financial Institutions

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