GUIDELINES ON THE CLASSIFICATION AND IMPAIRMENT PROVISIONS FOR LOANS / FINANCING FOR LABUAN BANKS

1.0 Introduction

1.1 The *Guidelines on the Classification and Impairment Provisions for Loans/Financing for Labuan Banks* (the Guidelines) set out the minimum requirements on the classification of impaired loans/financing and provisioning for loan/financing impairment. Labuan banks are expected to meet the expectations in the Guidelines and be able to demonstrate that internal policies and practices are consistent with the expectations.

1.2 Loans/financing for the purpose of the Guidelines includes all credit facilities[1] provided by the Labuan banks to a customer which give rise to a credit exposure to the customer.

2.0 Applicability

2.1 The Guidelines is applicable to all Labuan banks as listed below:

(i) Labuan banks and Labuan investment banks licensed under Part VI of the Labuan Financial Services and Securities Act 2010 (LFSSA); and

(ii) Labuan Islamic banks and Labuan Islamic investment banks licensed under Part VI of the Labuan Islamic Financial Services and Securities Act 2010 (LIFSSA).

[1] Including but not limited to advances and trade-related receivables.

2.2 For Labuan banks operating as branches, they are expected to comply with the classification and impairment provisions requirements as per the recognised international accounting standards adopted by their head office level and/or other relevant requirements imposed by their home regulatory authorities.

2.3 The Guidelines should be read together with the following guidelines:

(i) Directive on Financial Reporting Standards for Labuan Financial Institutions;

(ii) Circular on Financial Reporting Standards for Labuan Financial Institutions;

(iii) Guidelines on Single Counterparty Exposure Limit for Labuan Banks;

(iv) Guidelines on Credit Transactions and Exposures with Connected Parties for Labuan Banks;

(v) Banking Capital Adequacy Framework: Guidelines on Capital Components; and

(vi) Banking Capital Adequacy Framework: Guidelines on Risk Weighted Assets.

3.0 Legal Provision

3.1 The Guidelines is issued pursuant to Section 4A of the Labuan Financial Services Authority Act 1996 (LFSAA) for the purpose of clarifying prudential requirements in relation to impairment provisions for loans/financing.

3.2 Any person who fails to comply with the Guidelines may be guilty of an administrative penalty under Section 36G of the LFSAA.

4.0 Effective Date

4.1 The Guidelines is effective from 1 October 2012 and remain effective and applicable unless amended or revoked.

4.2 In addition, the following new amendments as tabulated below shall come into effect on 1 January 2023.

No.	Scope	Paragraph
1.	Applicability	Paragraph 2.2
2.	Credit Risk Measurement	• Paragraph 7.1 – Paragraph 7.3 • Paragraph 7.7 – Paragraph 7.9
3.	Rescheduled and Restructured Loan/Financing	Paragraph 8.1 – Paragraph 8.2
4.	Sound Loan/Financing Impairment Methodology	Paragraph 9.2
5.	Classification of Loan/Financing as Impaired	Paragraph 11.3 – Paragraph 11.6

5.0 Compliance with Financial Reporting Standards

5.1 Labuan banks shall make reference to the *Directive on Financial Reporting Standards for Labuan Financial Institutions* issued by Labuan FSA on the internationally acceptable accounting standards for Labuan banks. In this regard, Labuan banks shall ensure that the loan/financing impairment assessment and provisioning comply with the requirements specified under the financial reporting standard on financial instruments adopted by them (i.e. Malaysia Financial Reporting Standards (MFRS), International Financial Reporting Standards (IFRS), UK Generally Accepted Accounting Practices (UK GAAP) and US Generally Accepted Accounting Practices (US GAAP).

6.0 Board and Senior Management Oversight

6.1 The Board and senior management of the Labuan bank are responsible to ensure that appropriate credit risk assessment, control and provisioning processes are in place and operating effectively to maintain impairment provisions for loans/financing at an appropriate level. The Board must reasonably assure that the credit risk assessment processes and internal controls are appropriate to the size, nature and complexity of the Labuan bank's lending/financing operations. In particular, the credit risk assessment processes and controls should enable Labuan banks to consistently determine impairment provisions for loans/financing in accordance with the Labuan bank's approved policies and procedures, adopted financial reporting standards and Labuan FSA's expectations under the Guidelines.

6.2 The Board shall be satisfied that:

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

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

(iii) appropriate information about the credit quality of the loan/financing portfolio and related provisions is provided to senior management and the Board on a regular and timely basis; and

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

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

6.4 The Board shall approve write-off policies for loans/financing and these policies shall include the circumstances, conditions and approving authority under which a loan/financing can be written-off. The policies should also address appropriate monitoring and reporting mechanisms on recovery efforts made and to be undertaken by the Labuan bank. The Board may also consider requiring information on write-offs and recoveries of large loans/financing to be reported to the Board.

6.5 Senior management is responsible for the development and effective implementation of the impairment provisions framework and policies on the write-off of loans/financing approved by the Board. This includes ensuring that:

(i) internal policies, procedures, and processes on provisioning are clearly communicated to all relevant personnel. There should be formal channels for communication and coordination among those involved in the credit risk assessment, measurement and control process, including the Labuan bank's credit administration, financial reporting, internal audit and risk management functions;

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

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

7.0 Credit Risk Measurement

7.1 A robust approach to credit risk measurement is key to provide the Labuan bank with a complete and accurate understanding of the credit risk profile of its portfolio, thereby strengthening the feedback loop of information for more effective planning and decision-making.

7.2 Labuan banks must establish an approach for measuring the risks in all credit exposures, with the capability to aggregate and appropriately segment different credit exposures based on shared credit risk characteristics[2].

7.3 The credit risk measurement outputs must also be duly considered by Labuan bank in developing the credit risk strategy and credit risk policy, particularly in areas of credit approval, pricing, limit-setting, identification of problem credits, provisioning and compensation design.

Credit Risk Grading

7.4 Labuan banks shall have in place a systematic and consistently applied process to reliably classify loans/financing on the basis of credit risk. This should support the prudent valuation of loans/financing and determination of appropriate impairment provisions for loans/financing. For this purpose, Labuan banks may adopt a credit risk grading system or categorisation based on repayment conduct (e.g. payment delinquency status) which must appropriately reflect the risks associated with loans/financing granted by the Labuan bank. Labuan FSA expects that larger loans/financing would be classified on the basis of a credit risk grading system, while other smaller loans/financing or loans/financing with homogeneous characteristics and managed on a portfolio basis may be classified on the basis of either a credit risk grading system or repayment conduct.

[2] For example, by groups of connected counterparties, product type and risk characteristics.

7.5 The credit risk grading system should be able to differentiate at a sufficiently granular level, the degree of credit risk inherent in the various credit exposures of a Labuan bank. The level of granularity should facilitate a more accurate determination of the overall characteristics of the loan/financing portfolio, probability of default and ultimately the adequacy of impairment provisions for loans/financing. The grading system should address the definitions of each credit risk grade. The delineation of responsibilities for the design, implementation, operation and performance of the system should also be clearly defined and documented.

7.6 A credit risk grading system should take into account a customer's current financial condition and paying capacity, and other customer and facility specific characteristics (which may include the current value and realisability of collateral) that affect the prospects for collection of outstanding debt/financing (including interest/profit). In general, the credit risk grading system should be consistently applied for credit risk assessment, financial reporting and capital adequacy purposes, except in circumstances where regulatory requirements prescribe a more conservative treatment[3].

7.7 Labuan banks must establish an appropriate number of rating grades to facilitate meaningful differentiation of credit exposures and consistent loss estimation practices across credit exposures. The rating grades must include sufficiently granular triggers or factors to enable the identification of both migration of credit risk and significant changes in credit risk that result in a change in rating grades of credit exposures.

7.8 In respect of paragraph 7.7, as an example, Labuan banks may assess whether there is a significant concentration of counterparties within a particular rating grade, which indicates a lack of granularity in the design of the credit risk measurement methodology.

[3] For example, Basel II allows a single event (i.e. 90 days past due) to determine the classification of 'non- performing' which then warrants a higher risk weight. Under the financial reporting standard on financial instruments, such an event by itself may not provide sufficient evidence of impairment.

7.9 Labuan banks must exercise prudence in adjusting the rating grade for a particular credit by applying more stringent criteria for upgrades compared to downgrades to reflect changes in the level of credit risk. In particular, rating upgrades must be supported by evidence of a sustained improvement in the repayment capacity, gearing, associated cash flows and financial position of a counterparty, over a specified period. In contrast, a shorter specified period must be considered when demonstrating a sustained deterioration in credit quality to effect a rating downgrade. A Labuan bank or other institutions in the same group should not grant new credit to a defaulting customer for the settlement of arrears in order to justify an improved credit risk grading[4].

7.10 Credit risk grades should be reviewed periodically and updated whenever relevant new information is obtained or received by Labuan banks. Loans/financing to which credit risk grades are assigned should receive a periodic formal review to reasonably assure that those grades are accurate and up-to-date. Credit risk grades for individually assessed loans/financing shall be reviewed at least annually. Loans/financing that are either large, complex, higher risk or which are problem credits should be reviewed more frequently and as and when new information becomes available.

8.0 Rescheduled and Restructured Loan/Financing

8.1 A rescheduling and restructuring of a loan/financing facility involves any modification made to the original repayment terms and conditions[5,6] of the loan/financing facility following an increase in the credit risk of a customer.

8.2 In respect of rescheduled and restructured credits, Labuan banks must establish controls to avoid 'ever-greening' of credits. In addition, Labuan banks must have

[4] Excluding rescheduled and restructured loans/financing, which are subject to the requirements specified under paragraph 8 of the Guidelines

[5] This includes but is not limited to an extension of loan/financing term and flexible repayment schedule including payment vacation, interest/profit-only payments, or capitalisation or deferring of principal or interest/profit or both.

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

in place policies approved by the Board which define the circumstances and conditions under which a loan/financing may be rescheduled or restructured. The policies should address the following:

(i) define the circumstances and conditions where a loan/financing facility may be rescheduled or restructured, including the appropriate credit grade classification and staging policies under IFRS9/MFRS9 or the equivalent requirement under other recognised international financial reporting standards;

(ii) set out situations where a loans/financing may be rescheduled or restructured more than once, and establish appropriate controls governing such loans/financing facility;

(iii) in addition to paragraph 7.9, define additional considerations under which a rescheduling and restructuring could result in the loan/financing to be upgraded. For the avoidance of doubt, the Labuan bank must not automatically consider a rescheduled and restructured loan/financing facility to have lower credit risk without performing appropriate analysis, demonstrating a sustained trend of improvement to justify the improved credit grading;

(iv) ensure information on the credit quality of rescheduled and restructured loan/financing facilities is maintained at a sufficiently granular level to enable a separate review and monitoring of such facilities;

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

(vi) for credit-impaired loan/financing facilities that are a rescheduled and restructured, define a minimum repayment period (based on the revised and restructured terms and conditions) to be continuously observed before facilities can be reclassified as non-impaired. For avoidance of doubt, such repayment shall not be less than 6 months.

8.3 Labuan banks must reassess the customer's financial position, having regard to all relevant circumstances surrounding the customer's financial condition and prospects for repayment, before a loan/financing can be rescheduled or restructured. In addition, adequate resources must be allocated to closely monitor and follow up on the performance of rescheduled and restructured loans/financing.

8.4 A Labuan bank shall appropriately classify the rescheduled and restructured facilities based on the assessment of the financial condition of the customer and the ability of the customer to repay based on the restructured terms. In principle and consistent with paragraph 8.2(vi), loans/financing that have been rescheduled and restructured shall not lead to improved classification immediately upon perfection of the relevant documentation in relation to the rescheduling and restructuring exercise.

8.5 Labuan FSA acknowledges that in specific and exceptional circumstances, such as when customers are affected by natural disasters, the rescheduling and restructuring exercises may involve the granting of moratorium on loan/financing repayments. As part of sound credit management practices, Labuan banks are expected to establish clear parameters and internal processes for the consideration of moratorium on loan/financing repayments, including clear authority structure for the approval of the moratorium. These processes should also be subject to adequate monitoring and review by an independent party.

8.6 Where moratorium on loan/financing repayments is granted under paragraph 8.5 above, the moratorium shall be for a period of not more than 6 months from the date of the customers' application for the moratorium.

8.7 Senior management (or the Credit Committee) should receive periodic reports on the performance of rescheduled and restructured credit facilities. The reports should provide adequate information, including default status and the frequency of rescheduling or restructuring for the same customer, to facilitate management's (or the Committee's) oversight of compliance with the Labuan bank's internal policies on rescheduling and restructuring and assessment of risks associated with the loan/financing portfolio. Any material impact on the risk profile of the Labuan bank should be raised to the Board's attention in a timely manner.

8.8 Labuan FSA may direct the Board of a Labuan bank to take appropriate remedial actions to address any deficiencies in controls or provisions for rescheduled and/or restructured loans/financing if there is evidence of restructuring or rescheduling for the purpose of 'ever-greening' loans/financing.

9.0 Sound Loan/Financing Impairment Methodology

9.1 Labuan banks shall develop and implement a sound loan/financing impairment methodology to identify, monitor, measure and report the quality of the loan/financing portfolio. The methodology should be supported by sound analysis, procedures and information systems, and should include criteria for the early identification and reporting of potential problem loans/financing to ensure that they are appropriately monitored, administered and provided for when required.

9.2 The loan/financing impairment methodologies employed must be systematic, applied consistently from period to period and incorporate a sufficient level of prudence and that the aggregate amount of loss allowance must be adequate to absorb inherent losses in the credit portfolio. The methodologies must also be reviewed at regular intervals and any changes in the methodologies employed must be justified and approved at the appropriate management level. The same information should be utilised by management to monitor the condition of the loan/financing portfolio and in the Labuan bank's methodology for determining amount of loan/financing loss provisions for financial reporting and capital adequacy purposes.

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

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

(ii) a detailed analysis of the entire loan/financing portfolio, performed on a regular basis. This should be based on all available and reliable data, incorporate management's experienced judgment about the credit quality of the loan/financing portfolio and consider all known relevant internal and external factors that may affect loan/financing collectability (such as industry, geographical, economic, and political factors);

(iii) the identification of loans/financing to be evaluated for impairment on an individual basis and the basis for segmentation of the remainder of the portfolio into groups of loans/financing with similar credit risk characteristics (such as loan/financing type, product type, market segment, credit risk grading and classification, collateral type, geographical location and past-due status) for evaluation and analysis on a collective basis;

(iv) for individually assessed loans/financing that are impaired, the process for determining and measuring the amount of any impairment, including procedures on the appropriate impairment measurement techniques to be applied in a given situation;

(v) how loss rates are determined (e.g. historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience;

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

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

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

9.4 Functions associated with implementing the loan/financing impairment methodology should be performed by competent and well-trained personnel and properly documented, with clear explanations of the supporting analyses, assumptions used and rationale.

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

10.0 Use of Experienced Credit Judgment

10.1 Credit judgment used to complement historical loss experience, current conditions and forecast information or observable data in assessing the loan/financing impairment provisions shall be exercised by an appropriate level of management. Where experienced credit judgment is used, it shall be subject to:

(i) a prudently limited scope for discretion;

(ii) appropriate parameters established and approved by the Board for the use of experienced credit judgment to enable an understanding and validation of the basis for the judgments made. Any deviation from these parameters, must be well justified and documented;

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

(iv) the use of reasonable and supportable assumptions that are adequately documented. Assumptions concerning the impact on customers of changes in general economic activity, both favourable and unfavourable, should be made with sufficient prudence; and

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

10.2 The method of determining impairment provisions for loans/financing should provide reasonable assurance of the timely recognition of loan/financing losses. Management shall consider all relevant factors that are likely to cause loan/financing losses to differ from historical loss experience. The factors include:

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

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

(iii) changes in the trend, volume and severity of past due loans/financing and loans/financing graded as low quality. This should include observations of trends in the volume of impaired loans/financing, troubled debt restructurings and other loan/financing modifications;

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

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

(vi) changes in the quality of the Labuan bank’s loan/financing review system and the degree of oversight by the Labuan bank’s Board and senior management;

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

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

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

11.0 Classification of Loans/Financing as Impaired

11.1 Labuan banks shall classify a credit facility as impaired:

(i) where the principal or interest/profit or both of the credit facility is past due for more than 90 days or 3 months;

(ii) In the case of revolving credit facilities (e.g. overdraft facilities), where the outstanding amount has remained in excess of the approved limit for a period of more than 90 days or 3 months;

(iii) where the amount is past due or the outstanding amount has been in excess of the approved limit for 90 days or 3 months or less, and the credit facility exhibits weaknesses[7] in accordance with the Labuan bank's credit risk measurement framework; or

(iv) as soon as default[8] occurs where the principal and/or interest/profit repayments are scheduled on intervals of 3 months or longer.

11.2 Where moratorium on loan/financing repayments is granted in relation to the rescheduling and restructuring exercise under paragraph 8.5:

(i) classification of a loan/financing as impaired under paragraphs 11.1 shall exclude the moratorium period granted; and

(ii) Labuan banks are required to maintain appropriate information on these customers for Labuan FSA's review as and when required.

[7] Labuan banks shall consider the loss events listed under financial reporting standard on financial instruments.
[8] A default is defined as the inability to meet the contractual repayment terms.

11.3 Where a credit-impaired facility is rescheduled and restructured, such facility shall remain classified as credit-impaired. Labuan bank shall only reclassify this facility to non-credit-impaired when repayments based on the revised terms have been observed continuously for a period of at least 6 months or a later period as determined by the Labuan bank's policy on rescheduled and restructured facilities.

11.4 For rescheduling and restructuring of facilities where the amount is past due for 90 days or 3 months or less, these accounts shall be classified as impaired if they exhibit any weaknesses that render such classification as appropriate according to the Labuan bank's credit risk measurement framework.

11.5 For the purpose of ascertaining the period in arrears in paragraph 11.1:

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

(ii) Where a moratorium on credit facilities is granted in relation to the rescheduling and restructuring exercise, the determination of period in arrears shall exclude the moratorium period granted.

11.6 Impairment provisions for loans/financing classified as impaired shall be determined in accordance with the requirements under IFRS 9/MFRS 9 or the equivalent requirement under other recognised international financial reporting standards.

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