PREFACE

Title

Guideline on Classification of Non-Performing Loans and Provision for Substandard, Bad and Doubtful Debts (BNM/GP3)

Effective Date

1 January 1998 unless indicated otherwise in the Guideline. Amendments to Part 6 of the Guideline shall be applied prospectively from financial years beginning 1 November 2007.

Applicability

This Guideline is applicable to all banking institutions (commercial banks and investment banks) licensed under the Banking and Financial Institutions Act 1989 (BAFIA).

Summary

This Guideline sets out the minimum standards on the classification of non-performing loans and the treatment of interest accrued when a loan turns non-performing. It also establishes the minimum loan loss provisioning for the respective loan classifications, including a general provision of 1.5%, and requires additional provisions for impaired loans.

Highlights

Part 6 of the Guideline has been amended to: -

(i) remove the requirement to obtain prior approval from Bank Negara Malaysia to reschedule a loan at more frequent intervals (i.e. more than once in two years), subject to enhanced minimum credit risk management standards that must be observed by banking institutions for rescheduled and restructured credit facilities; and

(ii) simplify and rationalize the parameters for the classification of rescheduled and restructured loans.

Issuing Department

Prudential Financial Policy Department

PART 1 INTRODUCTION

1.1 This Guideline sets out the minimum standards on the classification of non-performing loans and provision for substandard, bad and doubtful debts. This Guideline applies to loans offered under conventional banking principles only. Banking institutions should refer to Guidelines on Interest-Free Banking Scheme for treatment of accrued income and provision for bad and doubtful debts for interest-free financing.

1.2 The objective of this Guideline is to establish minimum standards for the classification of accounts, income recognition and loan loss provisioning aimed at realistic valuation of loan assets of banking institutions and prudent recognition of income.

PART 2 APPLICABILITY

2.1 This Guideline is applicable to all banking institutions (commercial banks and investment banks[1]) licensed under the Banking and Financial Institutions Act 1989 (BAFIA).

PART 3 LEGAL PROVISION

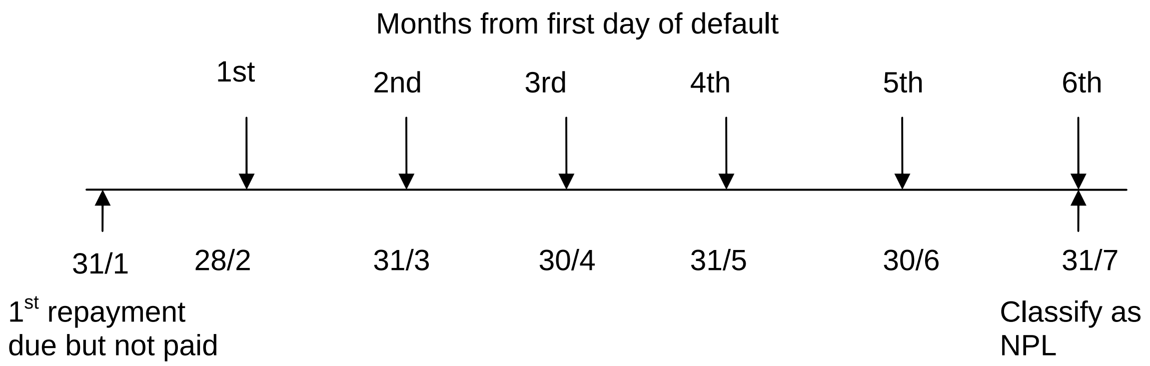
3.1 This Guideline is issued pursuant to section 126 of the BAFIA.

---

[1] An 'investment bank' is an entity which holds a merchant bank licence under the BAFIA and a dealer's licence under the Securities Industry Act 1983.

PART 4 MINIMUM STANDARDS FOR CLASSIFICATION OF LOANS AS NON-PERFORMING

4.1 In general, a loan is classified as non-performing when the principal or interest is due and unpaid for six months or more from the first day of default. This is illustrated as follows:-



4.2 The various categories of credit facilities shall be classified as non-performing in the following manner:-

(i) Overdrafts

- When accounts have been dormant[2] for six months or more and the outstanding amount is in excess of the approved limit.
- For an active account which has breached the approved limit, the account shall be classified as non-performing only when the amount in excess of the approved limit is not fully settled within six months from the date the approved limit was breached.
- Where the overdraft facility has been recalled, the account shall be classified as non-performing immediately. Subsequently, if the account is reinstated, without full settlement of the amount outstanding, the facility shall be regarded as a rescheduled facility.
- For the purpose of this Guideline, 'approved limit' refers to the current approved line of credit granted to the borrower. A reduction in the limit would lower the 'approved limit' accordingly. An

[2] For the purpose of this Guideline, 'dormant' account refers to an account which has not been utilised by the customer. It also includes accounts which have only a few transactions of insignificant amount for the stated period.

unadvised line of credit shall not be regarded as the 'approved limit'. In the case of overdrafts secured by shares, the 'approved limit' would be the original approved pre-set limit and not the drawing limit (which fluctuates depending on the value of shares deposited).

(ii) Bankers acceptances, trust receipts, bills of exchange, other trade-related bills and other instruments of similar nature.

- When the instrument is due and unpaid for three months or more from the first day of default.

(iii) Credit cards

- When the credit card holder fails to settle his minimum monthly repayments for three months or more from first day of default.

(iv) Term loans, revolving credit facilities, leasing loans, block-discounting facilities, hire-purchase loans and other loans.

- When principal or interest is due and unpaid for six months or more from the first day of default.

(v) Rescheduled and restructured loans

- As stipulated in Part 6.

Treatment of loans with quarterly, semi-annually, annual or bullet repayments

4.3 Where repayments are scheduled on intervals of three months or longer, the loan is classified as non-performing when a repayment is due and unpaid for three months or more from the first day of default.

Treatment of loans secured by cash or cash substitutes

4.4 If a loan is fully secured (all as to principal and interest and cost of collection) by cash or cash substitutes, the loan will be classified as non-performing if it is due and unpaid for 12 months or more from the first day of default. Cash or cash substitutes are defined as below:-

(i) Fixed deposits or sinking funds with set-off rights;

(ii) Securities issued by the Federal Government; or

(iii) Irrevocable guarantees or step-in rights by the Federal Government.

4.5 Where loans are partially secured by cash or cash substitutes, split classification applies whereby the secured portion is subject to the conditions in paragraph 4.4 whilst the unsecured portion will be subject to the normal classification rules as stipulated in paragraphs 4.1 and 4.2.

Treatment of partial repayments of loans

4.6 For purposes of ascertaining the period in arrears, each repayment must be made in full. If the borrower settles his monthly repayment partially, the repayment is still deemed to be in arrears.

Treatment of interest and penalty interest on non-performing loans

4.7 Interest accrued and recognised as income prior to the date a loan is classified as non-performing shall be reversed out of income (by debiting the ‘interest income’ in the income statement and crediting the ‘accrued interest receivable account’ in the balance sheet). Subsequently, interest earned on non-performing loans shall only be recognised as income on a cash basis. Ceasing interest accrual from an accounting perspective does not preclude interest from continuing to be accrued for legal enforcement purposes[3].

4.8 Penalty interest should be treated in the same manner as normal interest.

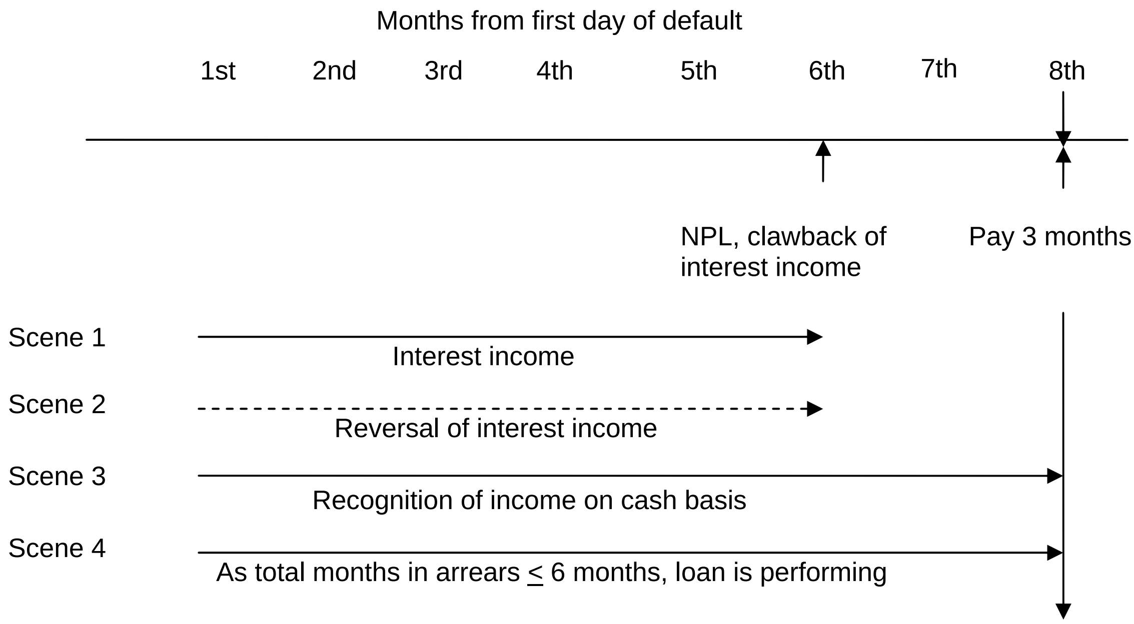
Reclassification of non-performing loans as performing

4.9 A non-performing loan can be reclassified as performing once total instalment in arrears falls below six months.

For example, if a loan is eight months in arrears and the borrower pays three monthly instalments, the non-performing loan can be reclassified as performing

[3] Effective from financial year beginning 1 January 2005.

as the total period in arrears is below six months. When the loan is reclassified as performing, interest can be recognised as income on an accrual basis. If the loan remains at all times below six months in arrears, the loan can be classified as performing and interest income can be recognised or accrued accordingly.



PART 5 PROVISION FOR SUBSTANDARD, BAD AND DOUBTFUL DEBTS

5.1 Banking institutions are required to review the adequacy of the general and specific provisions for substandard, bad and doubtful debts at all times to ensure that the provisions set aside are reflective of their potential losses.

5.2 Banking institutions are required to maintain general provisions of at least 1.5% of total outstanding loans (including housing loans sold to Cagamas Berhad), net of unearned interest, specific provisions for substandard, bad and doubtful debts and additional provisions made for impaired loans under paragraph 5.9.

5.3 In general, banking institutions are required to observe the following minimum parameters in respect of specific provisions:

Period of Default	**Classification**	**Specific Provision on the shortfall in collateral value over the amount outstanding, net of unearned interest**
6 months from the first day of default but less than 9 months	Substandard, unless there is evidence to support a worse-off classification	20% provisioning, unless overall loan loss provisions are adequate
9 months from the first day of default but less than 12 months	Doubtful, unless there is evidence to support a worse-off classification	50%
12 months and above	Bad	100%

5.4 Credit card loans, trade-related bills[4] and other instruments of similar nature:

Period of Default	**Classification**	**Specific Provision on the shortfall in collateral value over the amount outstanding, net of unearned interest**
3 months from the first day of default but less than 6 months	Doubtful, unless there is evidence to support a worse-off classification	50%
6 months and above from the first day of default	Bad	100%

[4] Effective from financial year beginning 1 January 1999.

5.5 For loans with repayments scheduled on intervals of 3 months or longer, the minimum requirements are as follows:

Period of Default	**Classification**	**Specific Provision on the shortfall in collateral value over the amount outstanding, net of unearned interest**
3 months from the first day of default but less than 6 months	Substandard, unless there is evidence to support a worse-off classification	20% provisioning unless overall loan loss provisions are adequate
6 months from the first day of default but less than 9 months	Doubtful, unless there is evidence to support a worse-off classification	50%
9 months and above from the first day of default	Bad	100%

5.6 Notwithstanding the above, banking institutions should be further guided by the general principles enumerated below for purposes of determining the level of provisioning required:-

(i) **Substandard accounts**

Credit facilities or portion thereof, which involve more than a normal risk of loss due to certain adverse factors, but which are at this stage, not considered as doubtful or bad. These adverse factors could include delays in debt-servicing, unfavourable financial condition, insufficient collateral or other factors which give rise to some doubts on the repayment capacity of the borrower.

(ii) **Doubtful accounts**

Credit facilities or portion thereof where collection in full is improbable and there is a high risk of ultimate default.

(iii) **Bad accounts**

Credit facilities or portion thereof which are deemed uncollectible and worthless, on the basis of relevant circumstances.

5.7 In determining the value of the various forms of collateral, banking institutions are required to observe the Guidelines on the Valuation of Collateral as enumerated in Appendix I.

5.8 Banking institutions are also required to set aside provisions for off-balance sheet items where the banking institution faces credit risk from failure of counterparties to fulfil their contractual obligations.

5.9 Impaired credit facilities should be measured at their estimated recoverable amount. Banking institutions should set aside additional provisions if the recoverable amount (present value of estimated future cash flows discounted at original effective interest rate) is lower than the net book value of the loans (outstanding amount of loans, advances and financing, net of specific provisions)[5].

PART 6 RESCHEDULED AND RESTRUCTED CREDIT FACILITIES

6.1 A rescheduled credit facility is one whose repayment terms have been modified but the principal terms and conditions of the contract have not changed significantly. This includes, amongst others, lengthening the repayment tenor of the facility. A change in the form of the credit facility for example conversion from a trade-related facility to an overdraft facility does not constitute a rescheduled facility as the principal terms of the contract have changed significantly.

6.2 A restructured credit facility is one whose terms and conditions have been modified principally. This may include a change in the type or structure of facilities or changes to other facility terms to assist the borrower overcome its shorter term financial difficulties particularly where the longer term prospect of

[5] Effective from financial year beginning 1 January 2005.

the business or project is deemed to be viable. When the borrower enters into Schemes of Arrangement, the new facility will constitute a restructured facility.

6.3 Where the banking institution incurs a loss as a result of the rescheduling or restructuring, the difference in value of the loan prior to and after rescheduling/restructuring must be written off immediately.

6.4 Subject to paragraph 6.5, the period in arrears in respect of a rescheduled and restructured loan may be zerorised upon completion of the relevant documentation in relation to the rescheduled and restructured exercise. Thereafter, the rescheduled or restructured account shall be classified as non-performing when the borrower fails to settle his repayments under the new terms for six months or more. Where a banking institution adopts more stringent terms for the classification of non-performing loans (e.g. three months in arrears), then such terms shall be applied consistently for the classification of a rescheduled or restructured loan as non-performing under the new rescheduled or restructured terms.

Credit risk management for rescheduled and restructured credit facilities

6.5 Banking institutions must have in place clear and comprehensive policies, approved by the Board, which define the circumstances and conditions under which a loan may be rescheduled or restructured. The policies should specifically address situations where loans may be rescheduled or restructured more than once, controls to avoid ‘ever-greening’ of loans, and provisioning policies with respect to such loans.

6.6 Banking institutions must reassess the borrower’s financial position and make a full credit evaluation of the borrower’s financial condition and prospects for repayments before the loan 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. Notwithstanding the application of paragraph 6.4, additional provisions should be made promptly where there is objective evidence of impairment of the loans in accordance with paragraph 5.9.

6.7 Banking institutions should prepare periodic reports to the Board (or the Credit Committee or Executive Committee as appropriate) on the performance of rescheduled and restructured credit facilities. These reports should provide adequate information, including default status and the frequency of rescheduling or restructuring for the same borrower, to facilitate the Board’s (or relevant Committee’s) oversight of compliance with the institution’s internal policies on rescheduling and restructuring of loans.

6.8 The Bank may direct the Board of a banking institution to take appropriate remedial actions to address any deficiencies in controls or provisions for rescheduled and/or restructured loans if there is evidence of restructuring or rescheduling for the purpose of “ever-greening” loans.

Treatment of capitalised interest and specific provisions

6.9 When an account is rescheduled or restructured, all prior interest owed to the banking institution (i.e. interest accrued for performing loans and interest-in-suspense accrued for non-performing loans for legal enforcement purposes) may be capitalised to form the new principal loan base. Interest-in-suspense which has been capitalised should not be credited as interest income upon rescheduling or restructuring, but reversed out only upon receipt of cash. Similarly, specific provisions on rescheduled or restructured loans, if any, shall not be written back unless the conditions under paragraphs 7.6 and 7.7 of this Guideline have been met.

PART 7 OTHER ISSUES

Granting of new loan to a borrower with a non-performing account

7.1 Where a banking institution grants a loan and the loan subsequently turns non-performing, the banking institution or other institutions in the same group is not allowed to grant new credit, by way of a loan or debt instrument, to the defaulting borrower to settle the arrears. If the business of the borrower is still deemed to be viable, the banking institution should reschedule or restructure the loan.

7.2 This rule does not apply where a banking institution, in realising the collateral charged to it for the non-performing loan, grants a loan to an 'independent party[6]' wishing to purchase the collateral. Banking institutions must assess the credit-worthiness of the 'independent party' based on its normal credit evaluation criteria. When a loan to purchase the collateral is granted to a party which is related to the borrower, such loan will remain classified as non-performing until repayments have been complied with for a continuous period of six months.

Write-off of non-performing loans

7.3 Accounts or portions thereof which are classified as bad or deemed uncollectible and worthless should be written-off. To ensure that the health of the institution is not distorted by writing off loan accounts which are deemed still collectible as a guise to suppress the true level of non-performing loans, it is the management's responsibility to ensure that prudent and proper monitoring of loans is enforced.

7.4 Before a loan can be written off, the banking institution should seek the approval of the Board of Directors. However, where necessary, such powers subject to specified limit, may be delegated by the Board to a management committee comprising senior management staff.

7.5 Partial write-offs are permitted under the following circumstances:-

(i) the value of collateral is less than the balance outstanding (including principal, accrued interest and other charges) and topping up of the collateral deficiency is not forthcoming;

(ii) the shortfall in collateral value over the outstanding balance (including

[6] For the purposes of this Guideline, 'independent party' refers to any non-related third party.

principal, accrued interest and other charges) is uncollectible and worthless;

(iii) the banking institution is now in the final stage of realising the collateral; or

(iv) the amount is written down to the value of collateral i.e. the shortfall in collateral value over the outstanding balance is written off.

Write-back of specific provision

7.6 Write-back of specific provision is permitted under the following circumstances:-

(i) where the loan account has been fully settled;

(ii) where there is cash inflow*;*

(iii) where additional collateral which is readily marketable is provided;

(iv) where there is a firm contractual agreement to dispose of the collateral at a price higher than valuation used by the banking institution;

(v) where there is enhancement in the value of collateral arising from actual conversion of land use on the property charged e.g. from agriculture land to residential/industrial/commercial land;

(vi) where there is appreciation in the value of quoted shares held as collateral, subject to the conditions in Appendix I[7]; or

(vii) where there is concrete evidence to support a reclassification of the account to a better category subject to loan review conducted by the Bank for purposes of approval of accounts.

7.7 Write-back of specific provision is not allowed upon acquisition of properties in satisfaction of debts. All outstanding specific provisions pertaining to a

[7] Effective from 1 March 2000.

foreclosed account shall be transferred to the "Provision for diminution in value of foreclosed properties" account which shall be netted off from "Foreclosed Properties" in the annual financial statements. Write-back of the "Provision for diminution in value of foreclosed properties" is allowed under the following circumstances:-

(i) Where the property acquired in satisfaction of debt is disposed off at a price higher than the net book value;

(ii) Where there is a firm contractual agreement to dispose off the foreclosed property at a price higher than the net book value; or

(iii) Where there is enhancement in the value of the foreclosed property arising from actual conversion of land use, e.g. from agriculture land to residential/industrial/commercial land.

PART 8 EFFECTIVE DATE AND TRANSITIONAL PROVISIONS

8.1 This Guideline is effective from financial years beginning 1 January 1998 unless indicated otherwise.

8.2 Amendments to Part 6 of the Guideline shall be applied prospectively from financial years beginning 1 November 2007.

PART 9 GUIDELINES AND CIRCULARS SUPERSEDED

9.1 This Guideline supersedes:

(i) Guidelines on Classification of Non-Performing Loans and Provisions for Substandard, Doubtful and Bad Debts (BNM/GP3) dated 24 September 1998;

(ii) Circular entitled ’Pindaan kepada Garis Panduan Mengenai Pengkelasan Pinjaman Tak Berbayar dan Peruntukan Hutang Ragu dan Lapuk’ dated 24 March 1999;

(iii) Circular entitled ‘Guidelines on Classification of Non-performing Loans and Provisions for Substandard, Doubtful and Bad Debts’ dated 9 August 1999;

(iv) Circular entitled ‘Write-back of Specific Provisions on Loans Secured by Quoted Shares’ dated 3 March 2000; and

(v) Paragraph 4 of Appendix A of the Revised Guidelines on Financial Reporting for Licensed Institutions (BNM/GP8) dated 5 October 2004.

APPENDIX I GUIDELINES ON THE VALUATION OF COLLATERAL

1. Charge or lienholder's caveat over property

   (i) Where court proceedings are not yet instituted, forced sale value (FSV) is used. The FSV should be based on the existing use of the land as valued by professional valuers. However, under exceptional circumstances, fair market value (FMV) may be used, for example, where the banking institution feels strongly that the property charged is worth FMV and there is evidence to that effect.

   (ii) Where auction is pending and a reserve price (RP) has been fixed, RP is to be used.

   (iii) Where auction has been aborted and FSV of the property is lower than RP, and in the absence of new RP, FSV is to be used.

   (iv) Where aborted RP is based on FSV, and in the absence of new RP**,** a 10% discount should be made on the aborted RP.

   (v) Banking institutions are required to use current valuation reports to value properties pledged as collateral. In the absence of current valuation reports, the full Property Market Report (PMR) may be used. Current valuation reports are defined as not more than two years old.

<u>Note</u>: The FSV should be based on the existing use of the land as valued by professional valuers.

2. Deed of Assignment

   In circumstances where the issued document of title is not available, Deed of Assignment and Charge-in-Escrow may collectively be accepted as collateral. The basis of valuation should be as in paragraph 1 of this Appendix. Private caveats generally have no value.

3. Debenture

No value can be attached unless it is certified by a receiver/ liquidator/ auditor/ professional valuer.

4. Assignment of book debts

No value unless the banking institution can prove that the debtors are worth the value quoted.

5. Assignment of shares

(i) <u>Quoted</u>

Normally, the latest market price. Appropriate discounts should be considered if the shares are thinly traded and/or comprise a large block of shares. Premiums may only be considered where there is a valid offer at the higher price as evidenced by a firm commitment, such as purchase contracts or undertaking letters provided by solicitors or brokers.

If trading in that counter has been suspended (other than temporary suspension), the net realisable tangible asset value, as per the latest audited financial statements (not more than 18 months old and taking into account the content of interim announcement), would be used. If appropriate financial statements are not available, normally no value is given. In the case of shares which are temporarily suspended, the last quoted price prior to suspension will be used. The determination of ‘temporary’ will be inferred from the reasons for suspension, for instance, shares which are temporarily suspended pending a takeover scheme.

Banking institutions are only allowed to recognise up to 50% of the appreciation in the value of the quoted shares for purposes of writing-back specific provisions previously charged against the loan account. Any depreciation in the value of the quoted shares should, however, be fully recognised for purposes of specific provisions. In addition, given the volatility of share prices, banking institutions are required to value the quoted shares at the end of each month, at the minimum**.** This is to ensure that the value of the quoted shares used for provisioning purposes is consistently updated to reflect the latest market prices. An illustration of this is attached in Appendix II.

(ii) Unquoted

Value may be given provided the test of marketability is met. The condition of marketability would be considered based on the merit of each case. If it can be demonstrated that the shares are marketable, the basis of valuation applied should be the net tangible asset per share. Higher valuation may be considered if the financial institution is able to provide detailed valuation of net assets in support of the higher valuation or if there is a purchase offer for the shares evidenced by firm commitments such as purchase contracts or undertaking letters provided by solicitors or brokers.

6. Plant, machinery and equipment

In the absence of professional valuation, the net book value would be applicable, using a 20% depreciation rate on a straight line basis on the acquisition price.

7. Guarantees

(i)	Personal	Generally no value
(ii)	Banking institutions	Full value
(iii)	Federal and State Government of Malaysia	Full value
(iv)	Others	To be considered on a case-by-case basis

8. All other securities

To be considered on a case-by-case basis.

APPENDIX II ILLUSTRATION ON WRITE BACK OF SPECIFIC PROVISIONS

Scenario	**RM million**
Outstanding loan (net of unearned interest)	12
Value of quoted shares pledged as collateral (Month 1)	6
Assuming loan account is classified as bad	
Specific provision (SP) charged in Month 1	6
Value of quoted shares pledged as collateral appreciated (Month 2)	10
Value of quoted shares pledged as collateral depreciated (Month 3)	4

Calculation of SP Movement	**RM million**
Month 2	
Value of quoted shares for provisioning purposes in Month 2	
(Only allowed to recognise 50% of increase in value of shares)	8
Opening balance of SP	6
SP required on loan 100%X (12-8)	4
:. Write-back of SP	2
Closing balance of SP	4
Month 3	
Value of quoted shares for provisioning purposes in Month 3	4
Opening balance of SP	4
SP required on loan 100% X (12-4)	8
:. Additional charge to profit and loss account	4
Closing balance of SP	8