**NOTICE TO FINANCE COMPANIES**

**NOTICE NO. BU/N-8/2018/58**

**PRUDENTIAL TREATMENT OF PROBLEM ASSETS AND ACCOUNTING FOR EXPECTED CREDIT LOSSES**

## 1. INTRODUCTION

1.1. On 1 July 2014, the International Accounting Standards Board (IASB) issued International Financial Reporting Standards (IFRS) 9 which requires the recognition of expected credit losses (ECL), among others, to address the "too little, too late provisioning" concern of IAS 39. Under IFRS 9, provisions are booked for all credit exposures under its scope[1], including those with low credit risk. IFRS 9 also contends that significant[2] increases in credit risk are observable before delinquency occurs. Hence, all finance companies (FCs) should not wait for delinquency to occur before remedial measures are implemented and higher provisions are booked. IFRS 9, which became effective on 1 January 2018, is generally considered as the most significant change in accounting standards for the past two decades, and is expected to materially affect the capital and earnings of FCs in 2018.

1.2. The Basel Committee for Banking Supervision (BCBS) also issued on 4 April 2017 the Guidelines on the Prudential Treatment of Problem Assets – Definitions of Non-Performing Exposures and Forbearance (BCBS 403) to address the significant differences in how Non-Performing and Forborne exposures are defined and reported in various countries which made asset quality analysis difficult for supervisors.

1.3. In view thereof, this Notice is issued to integrate key features of IFRS 9 and BCBS 403 in the regulatory definitions of Non-Performing, Forborne, and classified exposures, which aim to result in the earlier identification of problem credits, timely execution of remedial measures, and recognition of appropriate level of loss allowance. This Notice also aims to harmonise the definitions and describe the interaction of Non-Performing, Forborne, impaired, defaulted, and classified exposures, to foster consistency in supervisory reporting and improve processes of Autoriti Monetari Brunei Darussalam ("AMBD") to monitor asset quality of FCs.

1.4. The revised definitions also provide benchmarks for use in the following contexts:

1.4.1. FCs' internal credit categorisation systems for credit risk management purposes; and

1.4.2. Dissemination of data for asset quality indicators and international assessments of financial systems.

[1] The IFRS 9 ECL Framework covers financial assets measured at amortised cost, financial assets measured at fair value through profit and loss, loan commitments and financial guarantee contracts not measured at fair value through profit and loss, trade receivables, contract assets under IFRS 15, and lease receivables under IAS 17. All financial assets measured at fair value through profit or loss and investments in equity investments are not subject to IFRS 9 ECL standards.

[2] See Appendix B for IFRS 9 guidelines on significant increase in credit risk.

1.5. The new definition of Non-Performing exposures introduces harmonised criteria for categorising loans and debt securities that are centered on the unlikeliness of full payment, impairment and the occurrence of default, even without any missed payment and without regard to the recovery value of the collateral, if any. However, as a regulatory backstop, all exposures are considered Non-Performing if past due for 90 days or more.

1.5.1. The definition focuses on a debtor basis, but allows categorisation of exposures as Non-Performing on a transaction basis for retail exposures.

1.5.2. It also introduces clear rules regarding the upgrading of a Non-Performing exposure to performing and the interaction between forbearance and Non-Performing status.

1.5.3. The definition of forbearance provides a harmonised view on the modification or refinancing of loans/financing and debt securities that result from a borrower's financial difficulty.

1.5.4. The definition allows Forborne exposures to be categorised as performing or Non-Performing exposures.

1.5.5. It also sets out criteria for the discontinuation of the forbearance categorisation and emphasises the need to ensure a borrower's financial soundness before the discontinuation.

1.6. All FCs shall comply fully with IFRS 9 in their audited financial statements starting in 2018 and set up adequate internal controls to ensure full compliance. Aside from adherence to IFRS issuances, FCs are also recommended to adopt guidelines issued by BCBS on the accounting of ECL, particularly the Guidance on Credit Risk and Accounting for Expected Credit Losses[3] (BCBS 350), issued in December 2015. The BCBS issuances on credit risk and ECL complement IFRS 9 and do not contradict ECL accounting standards issued by the IASB.

1.7. Consistent with BCBS guidelines, AMBD expects FCs operating in Brunei Darussalam to implement a high-quality, robust and consistent ECL accounting framework. While IFRS 9 does not prescribe a particular method in computing ECL, AMBD encourages FCs to use the PD/LGD[4] method in computing ECL to achieve high quality implementation of IFRS 9 and improve credit risk management. Such approach provides critical information to the Board, Senior Management, and AMBD, especially in the credit risk assessment of offshore investments.

1.8. This Notice is issued pursuant to Section 54 of the Autoriti Monetari Brunei Darussalam Order, 2010.

1.9. This Notice shall take immediate effect.

[3] The objective of this paper is to set out supervisory guidance on sound credit risk practices associated with the implementation and ongoing application of expected credit loss (ECL) accounting frameworks. The Committee expects a disciplined, high-quality approach to the assessment and measurement of ECL. The 8 supervisory principles for credit risk and accounting for ECL are attached in Appendix C.

[4] Probability of Default/Loss Given Default

## 2. PRUDENTIAL REPORTING

2.1. FCs shall report on a frequent basis to AMBD the levels of past due financial assets, Non-Performing exposures, and Forborne exposures, as defined in paragraphs 3, 4, and 5, respectively. For purposes of defining Non-Performing and Forborne exposures, the scope includes all financial assets, financial guarantees and loan/financing commitments under the scope of IFRS 9 ECL framework. Financial assets[5] include loans/financing, debt securities, claims from banks and other financial institutions, receivables, and related accrued interests/profit and fees.

## 3. PAST DUE FINANCIAL ASSETS

3.1. A financial asset shall be considered as past due if any amount due under the contract (interest/profit, principal, fee or other amount) has not been paid in full at the date when it was due. An exposure should be considered past due from the first day of missed payment, even when the amount of the exposure or the past due amount, as applicable, is not considered material.

## 4. NON-PERFORMING EXPOSURES

### 4.1. Definition

4.1.1. An exposure shall be considered Non-Performing, even without any missed contractual payments, if they meet any of the following criteria:

a. There is evidence that full repayment of principal, fees, and interest/profit based on the contractual terms, original or, when applicable, modified, is unlikely without the realisation of collateral or risk mitigants, if any;

b. It is considered credit-impaired[6] under IFRS 9;

c. It is considered “defaulted” under the Basel framework (paragraphs 452[7] and following the Basel II rules text and their subsequent amendments), where applicable;

d. It is classified as Substandard Non-performing, Doubtful, or Loss;

e. It is in litigation; or

f. Even if not considered impaired or defaulted, an exposure shall be considered Non-Performing if principal and/or interest/profit are unpaid for more than ninety (90) days, or accrued interest/profits for more than 90 days have been capitalized, refinanced, or delayed by agreement.

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[5] See Appendix A for definition of financial assets.

[6] See Appendix A for definition of credit-impaired financial asset under IFRS 9.

[7] Paragraph 452 of the Basel II framework: a default is considered to have occurred with regard to a particular obligor when either or both of the two following events have taken place.

- The FI considers that the obligor is unlikely to pay its credit obligations to the banking group in full, without recourse by the FI to actions such as realising security (if held).
- The obligor is past due more than 90 days on any material credit obligation to the banking group.
- Overdrafts will be considered as being past due once the customer has breached an advised limit or been advised of a limit smaller than current outstanding amount.

4.2. **Analysis on Likelihood of Repayment**

4.2.1. The likelihood of repayment should be assessed through a comprehensive analysis of the financial situation of the counterparty, using all inputs available, including but not limited to:

a. patterns of payment behaviours in past circumstances;
b. new facts that change the counterparty's situation; and
c. financial analysis.

4.2.2. Financial analysis of non-retail counterparties may include, as appropriate, the following ratios: leverage ratio; debt/EBITDA ratio; interest coverage ratio[8]; current liquidity ratio; or ratio of the sum of operating cash flow and interest expenses[9] divided by interest expenses[9]; loan-to-value ratio or financing-to-value ratio; and any other relevant indicators.

4.2.3. For retail counterparties, this analysis may include consideration of total debt service ratio (TDSR), loan-to-value (LTV) or financing-to-value ratio, credit scores and any other relevant indicators.

4.2.4. In the case of business loans/financing, a situation of partially or totally missed payment for more than 30 days should trigger a specific assessment of the counterparty's creditworthiness. When the assessment evidences a situation where the full repayment of the loan/financing is unlikely without the realisation of collateral, the loan/financing will be considered as Non-Performing regardless of the number of days it is past due.

4.2.5. Paragraph 453 of Basel II provides examples of "unlikely-to-pay" (UTP) indicators, as follows:

a. the financial institution puts the credit obligation on non-accrued status;

b. the financial institution makes a charge-off or account-specific provision resulting from a significant perceived decline in credit quality subsequent to the bank taking on the exposure;

c. the financial institution sells other credit obligations from the same counterparty at a material credit-related economic loss;

d. the financial institution consents to a distressed restructuring of the credit obligation where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest/profit or (where relevant) fees;

e. the financial institution has filed for the obligor's bankruptcy or a similar order in respect of the obligor's credit obligation to the banking group; and

f. the obligor has sought or has been placed in bankruptcy or similar protection where this would avoid or delay repayment of the credit obligation to the financial institution.

[8] profit coverage ratio for Islamic FC
[9] profit expenses for Islamic FC

## 4.3. Level of Application

4.3.1. Non-Performing exposures should always be categorised for the whole exposure, including when non-performance relates to only a part of the exposure, for instance, unpaid interest/profit. For off-balance sheet exposures, such as loan/financing commitments or financial guarantees, the whole exposure is the entire uncancellable nominal amount.

4.3.2. In the case of exposures to a non-retail counterparty[10] where the FC has more than one exposure to that counterparty, the FC must consider all exposures to that counterparty as Non-Performing when any one of the material[11] exposures **(in terms of aggregate exposure)** is Non-Performing. In other words, Non-Performing status should be applied at the level of the counterparty.

4.3.3. In the case of exposures to a retail counterparty, the Non-Performing status can be applied at the transaction level. In the case of a retail counterparty with more than one exposure from an FC, the FC should consider the Non-Performing or performing status of the other exposures when deciding about the status of a given exposure.

4.3.4. In the case of exposures to a group, Non-Performing status may be applied at the counterparty level if the entities are not economically interdependent[12]. Designating an exposure to one entity belonging to a group as Non-Performing does not mandatorily lead to designating all exposures to the other entities from the same group as such. However, designating the exposure to one of the group entities as Non-Performing should be one of the inputs, along with the respective financial situation of other entities from the same group, when assessing the creditworthiness and determining the performing or Non-Performing status of exposures to the other entities in the group.

4.3.5. At the same time, the FC should consider the Non-Performing or performing status of the other group entities when deciding about the status of any of the group entities.

## 4.4. Effect of Collaterals and Guarantees

4.4.1. Collaterals or received guarantees should have no direct influence on the categorisation of an exposure as Non-Performing. However, the FC may consider the collateral when assessing a borrower's economic incentive (both positive and negative) to repay under the unlikeliness to repay criteria. Any recourse by the FC shall not be considered in this judgment. The collateralisation or guarantee status does not influence the past-due status, including the counting of past-due days and the determination of the exposure as Non-Performing, once the materiality and overdue days threshold have been met. When the relevant criteria in **paragraph 4.1** are met, an exposure should be categorised as Non-Performing even if the collateral value exceeds the amount of the past-due exposure.

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[10] A counterparty is a natural or legal person to which a finance company has exposure.
[11] For non-retail borrowers with multiple exposures, an exposure is material if it represents at least 10 percent of the aggregate exposure to the counterparty.
[12] Economic interdependence is defined in AMBD's Guidelines on Credit Risk Management as may be amended from time to time.

### 4.5. Recategorisation of Non-Performing exposures as performing

4.5.1. An exposure ceases to be Non-Performing and can be recategorised as performing when all the following criteria are simultaneously met:

a. the counterparty's situation has improved so that the full repayment of the exposure is likely, according to the original or, when applicable, modified conditions;

b. the exposure is not "defaulted" according to the Basel II standard or "credit-impaired" under IFRS 9; and

c. repayments have been made when due over a continuous repayment period **of at least six months**.

4.5.2. The following situations will not lead to the recategorisation of a Non-Performing exposure as performing:

a. partial write-off of an existing Non-Performing exposure, (i.e. when a FC writes off part of a Non-Performing exposure that it deems to be uncollectible);

b. repossession of collateral on a Non-Performing exposure, until the collateral is actually disposed of and the FC realises the proceeds (when the exposure is kept on balance sheet, it is deemed Non-Performing); or

c. extension or granting of forbearance measures to an exposure that is already identified as Non-Performing subject to the relevant exit criteria for Non-Performing exposures.

4.5.3. The recategorisation of a Non-Performing exposure as performing should be made on the same level (i.e. debtor or transaction approach) as when the exposure was originally categorised as Non-Performing.

## 5. <u>FORBORNE EXPOSURES</u>

### 5.1. Definition

5.1.1. Forbearance occurs when:

a. a counterparty is experiencing **financial difficulty** in meeting its financial commitments; and
b. a finance company grants a **concession** that it would not otherwise consider.

5.1.2. Forbearance is identified at the individual exposure level to which concessions are granted due to financial difficulty of the counterparty.

## 5.2. Explanation of terms

5.2.1. **Financial difficulty**: in order to identify cases of forbearance, FCs should first determine if the counterparty is experiencing financial difficulty at the time when the forbearance is granted.

5.2.1.1. The following list provides examples of possible indicators of financial difficulty, but is not intended to constitute an exhaustive enumeration of financial difficulty indicators with respect to forbearance:

a. On the basis of actual performance, estimates and projections that encompass the counterparty's current capabilities, the FC forecasts that all the counterparty's committed/available cash flows will be insufficient to service all of its loans/financing or debt;

b. A counterparty is currently past due on any of its material exposures;

c. A counterparty is not currently past due, but it is probable that the counterparty will be past due on any of its material exposures in the foreseeable future without the concession, for instance, when there has been a pattern of delinquency in payments on its material exposures (aggregate exposure);

d. A counterparty's outstanding securities have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange due to noncompliance with the listing requirements or for financial reasons;

e. A counterparty's existing exposures are categorised as exposures that have already evidenced difficulty in the counterparty's ability to repay in accordance with a FC's internal credit risk rating system;

f. A counterparty is in Non-Performing status or would be categorised as Non-Performing without the concessions;

g. The counterparty cannot obtain funds from sources other than the existing FCs at an effective interest/profit rate equal to the current market interest/profit rate for similar loans/financing or debt securities for a non-troubled counterparty.

5.2.2. **Concession**: concessions are special contractual terms and conditions provided by a lender to a counterparty facing financial difficulty so that the counterparty can sufficiently service its debt. The main characteristic of these concessions is that a lender would not extend loans/financing or grant commitments to the counterparty, or purchase its debt securities, on such terms and conditions under normal market conditions. Concessions may be at the discretion of the FC and/or the counterparty. A concession is at the discretion of the counterparty (debtor) when the initial contract allows the counterparty (debtor) to change the terms of the contract in its own favour (embedded forbearance clauses) due to financial difficulty.

5.2.2.1. Concessions can be triggered by:

a. changes in the conditions of the existing contract, giving considerably more favourable terms for the counterparty;

b. a supplementary agreement, or a new contract to refinance the current transaction; or

c. the exercise of clauses embedded in the contract that enable the counterparty to change the terms and conditions of its contract or to take on additional loans/financing, debt securities or off-balance sheet items at its own discretion. These actions should only be treated as concessions if the FC assesses that the counterparty is in financial difficulty.

5.2.2.2 There are many types of concession granted by lenders, or exercised by counterparties in existing contracts, that could be considered as forbearance. Not all concessions lead to a reduction in the net present value of the loan/financing, and therefore a concession does not necessarily lead to the recognition of a loss by the lender. **There is no concession when the borrower is not in financial difficulty.** When a borrower is assessed as experiencing financial difficulty, examples of potential concessions are:

a. extending the loan/financing term;
b. rescheduling the dates of principal or interest/profit payments;
c. granting new or additional periods of non-payment (grace period);
d. reducing the interest/profit rate, resulting in an effective interest/profit rate below the current interest/profit rate that counterparties with similar risk characteristics could obtain from the same or other institutions in the market;
e. capitalising arrears;
f. forgiving, deferring or postponing principal, interest/profit or relevant fees;
g. changing an amortising loan/financing to an interest/profit payment only;
h. releasing collateral or accepting lower levels of collateralisation;
i. allowing the conversion of debt to equity of the counterparty;
j. deferring recovery/collection actions for extended periods of time; and
k. easing of covenants.

5.2.2.3. Refinancing an existing exposure with a new contract due to the financial difficulty of a counterparty should still qualify as a concession, even if the terms of the new contract are no more favourable for the counterparty than those of the existing transaction.

5.2.3. **Repackaged Exposures**: When terms are modified for reasons other than financial difficulty and the counterparty is expected to fully pay its obligations, then the exposure is just considered as "repackaged" and it will not be reported as Forborne exposure, but only as repackaged exposure.

5.2.4 **Modified Exposures:** Forborne and repackaged exposures are collectively called modified exposures.

## 5.3. Restructured terms of payment

5.3.1. As a general rule, restructured terms of payment should match the projected cash flows of borrowers to improve probability of collection and to lessen the debt burden of the borrowers, particularly distressed borrowers. Restructured terms that include balloon, bullet, and/or step-up payments[13] should be not be used unless considered viable in exceptional circumstances and when the FC can duly demonstrate future cash flow availability by the borrower to meet the balloon, bullet, or step-up payments. In assessing whether these structures are viable, special emphasis should be placed on the availability of refinancing/roll-over options for such customers, which will depend to a large degree on the financial strength of the customer and the collateralisation of the loan/financing. In addition, the FC should also consider the economic lifetime of the underlying projects and the ability of the counterparty to repay the exposure within this lifetime.

## 5.4. Accounting of Modified Exposures

5.4.1. Under IFRS 9 paragraph 5.4.3, when the contractual cash flows of a financial asset are renegotiated or otherwise modified and the renegotiation or modification does not result in the derecognition of that financial asset in accordance with IFRS 9, an entity shall recalculate the gross carrying amount of the financial asset and shall recognise a *modification gain or loss*[14] in profit or loss. The gross carrying amount of the financial asset shall be recalculated as the present value of the renegotiated or modified contractual cash flows that are discounted at the financial asset's original effective interest/profit rate (or credit-adjusted effective interest/profit rate for purchased or originated credit-impaired financial assets). Any costs or fees incurred adjust the carrying amount of the modified financial asset and are amortised over the remaining term of the modified financial asset.

## 5.5. Criteria for exit from the forborne exposures category

5.5.1. A Forborne exposure will be identified as such until it meets both of the following exit criteria:

a. When all payments, as per the revised contractual terms, have been made in a timely manner over a continuous repayment period of not less than one year (probation period for reporting). The starting date of the probation period should be the scheduled start of payments under the revised terms,

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[13] Balloon, bullet, or step-up payments are large one-time or multiple payments of principal and/or interest/profit, typically at maturity, or in certain specified dates during the term of the loan/financing or debt security.

[14] The account "Modification Gain or Loss" is included in the Statement of Income and Expenses Prudential Return.

regardless of the performing or Non-Performing status of the exposure at the time that forbearance was granted; and

b. The counterparty has resolved its financial difficulty, and there is sufficient evidence that the exposure will be recovered in full.

5.5.2. For Forborne exposures which have balloon, bullet, and/or step-up payments, the mere continuous payment by the counterparty of the interest/profit amounts due, even for more than a year, is not enough to assume that the counterparty will pay the final bullet/balloon/step-up payment due. Hence, an exposure with this payment structure shall remain categorised as Forborne and Non-Performing until all balloon, bullet, and/or step-up payments are fully paid.

### 5.6. Interaction of forbearance with Non-Performing and credit-impaired exposures

5.6.1. Forborne exposures should be identified as Non-Performing when they meet the specific criteria provided under paragraph 4.1.

5.6.2. Under paragraph 4.1, all credit-impaired[15] financial assets are considered as Non-Performing.

5.6.3. Forbearance may be granted on performing or Non-Performing exposures. When forbearance is applied to a Non-Performing exposure, the exposure should remain Non-Performing. When forbearance is applied to a performing exposure, the FC then needs to assess whether the exposure meets the Non-Performing criteria, even if the forbearance resulted in a new exposure. When the original exposure would have been categorised as Non-Performing at the time of granting forbearance, had the forbearance not been granted, the new exposure should be categorised as Non-Performing.

5.6.4. A financial asset is considered credit-impaired if one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred (see Appendix A). One of such events considered under IFRS 9 is when there is observable data that the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, granted to the borrower a concession(s) that the lender(s) would not otherwise consider. In view of the foregoing, Forborne exposures are generally considered as credit-impaired and Non-Performing at the time of granting forbearance. FCs that do not consider certain Forborne exposures as credit-impaired and Non-Performing at the time of granting forbearance should develop sound policies for the approval of these exceptions.

5.6.5. FCs should pay particular attention to the appropriate categorisation of exposures on which forbearance has been granted more than once. When a Forborne exposure under the probation period is granted new forbearance, this should trigger a re-start of the probation period, and FCs should consider whether the exposure should be categorised as Non-Performing.

[15] See Appendix A for definition of credit-impaired financial asset

5.6.6. The continuous repayment period for Non-Performing and the probation period for forbearance can run concurrently. All Non-Performing Forborne exposures should remain Non-Performing until they meet the criteria in **paragraph 4.5**. Thereafter, the remaining probation period for forbearance exit in **paragraph 5.5** shall apply and the exposure should be identified as a performing Forborne exposure.

5.6.7. When a Forborne exposure becomes Non-Performing during the 12-month probation period, the probation period starts again.

## 6. ACCRUAL OF INTEREST/PROFIT INCOME (EFFECTIVE INTEREST/PROFIT METHOD)

6.1. Interest/profit revenue on financial assets shall be calculated using the effective interest/profit method[16] under IFRS 9. The use of this method means that interest/profit revenue is recognised for all financial assets, including Non-Performing financial assets with future expected cash flows. However, for prudential reasons, all accrued interest/profit income on Non-Performing financial assets are not distributable as dividends until they are collected.

6.2. An amount equal to the accrued interest/profit income on Non-Performing financial assets shall be reflected in a non-distributable reserve account in the equity section of the balance sheet, called Prudential Reserve for Credit Losses (PRCL) in both the audited financial statements and prudential returns via an appropriation of retained earnings.

## 7. REGULATORY CLASSIFICATION

7.1. FCs shall have in place a reliable credit classification system to promptly identify deteriorating credit exposures. For material exposures[17], the supervisory expectation is that FCs should be able to identify and appropriately classify deteriorating large exposures before they become delinquent to enable Management to institute timely remedial actions and provide appropriate allowance for credit losses (ACL) earlier. Hence, FCs should have robust processes and early warning indicators in place to identify counterparties who are having financial difficulty and/or manifesting adverse trends that may jeopardise repayment. As provided under IFRS 9, credit risk usually increases significantly before an exposure becomes past due or other lagging borrower-specific factors (for example, a concession or modification) are observed. Consequently, when reasonable and supportable information that is more forward-looking than past due information is available without undue cost or effort, it must be used to assess changes in credit risk.

[16] See Appendix A and B for definition of effective interest/profit method and other related concepts on the recognition of interest revenue under IFRS 9, such as the credit-adjusted effective interest/profit rate used for purchased or originated credit-impaired financial asset.

[17] For purposes of regulatory classification, material exposures are those exposures that are subjected to individual credit risk review. FCs are expected to define what is considered as material depending on the level of capital, expected credit losses, risk tolerances, and the complexity of the credit risk management system. As a minimum, all exposures that represent at least 5 percent of qualifying capital should be considered as material.

7.2. For retail loans/financing and other exposures wherein it is impractical to perform individual credit review, classification may be done based on delinquency status.

7.3. ***Definition of Regulatory Classifications.*** The regulatory classifications and their definitions are described below. The definitions represent the minimum criteria and FCs are encouraged to expand the criteria to identify material problem credits earlier.

7.3.1. ***Pass.*** These are credit exposures that do not have a greater-than-normal credit risk. Repayment is prompt and the credit facility does not exhibit any potential weakness in repayment capability, business, cash flow or financial position. The borrower has the apparent ability and willingness to satisfy his obligations in full and therefore no loss in ultimate collection is anticipated. In exceptional cases, past due exposures may be classified as Pass if there are no significant structural deficiencies in the credit facility and the delay in payment is properly justified, considered temporary, and delinquency does not exceed 30 days.

***Adverse Classifications/Classified Exposures:***

7.3.2. ***Special Mention (SM).*** These are exposures to counterparties that exhibit early signs of financial difficulty[18]. These also include credit facilities with structural weaknesses, that if not corrected in a timely manner, may potentially affect repayment by the counterparty at a future date, and warrant close attention by Management. Exposures that meet the criteria[19] for significant increase in credit risk criteria under IFRS 9 shall have a minimum classification of Special Mention.

a. Special Mention credit facilities typically exhibit the following:

- declining trend in operations, profitability, and liquidity that signals potential weakness in capacity to pay; and/or
- deterioration in the economic and market conditions of the industry in which the counterparty operates that may unfavourably affect the profitability and business of the counterparty in the future.

b. Some degree of structural weakness may be found in virtually any aspect of a credit facility, and the presence of one or more need not be indicative of an overall credit weakness deserving adverse classification. Instead, the FC's credit reviewers must evaluate the relative importance of such factors in the context of the counterparty's overall financial strength, the condition of the borrower's industry or market, and the borrower's total relationship with the finance company. Examples of structural weaknesses are attached in **Appendix D**.

[18] As defined in paragraph 5.2.1.

[19] IFRS 9 paragraph B5.5.17, which is reproduced in Appendix B, provides a non-exhaustive list of information that may be relevant in assessing changes in credit risk.

c. Generally, Special Mention exposures are classified as such before they become past due. However, depending on the nature of the exposure and the credit risk information available for particular groups of exposures, a finance company may not be able to identify deterioration in credit before they become past due. This may be the case for retail loans/financing for which there is little or no updated credit risk information that is routinely obtained and monitored on an individual basis until a customer breaches the contractual terms. Hence, for retail loans/financing, Special Mention classification may be defined in terms of delinquency which should not exceed 30 days past due. Nevertheless, FCs are encouraged to use other qualitative and forward looking information in identifying Special Mention retail exposures.

d. In exceptional cases, past due exposures may remain in the Special Mention classification for up to 60 days, if there is sufficient proof that the exposure can still be fully collected, including all interest/profit and fees, within a reasonable period of time and there is no significant increase in credit risk despite the delinquency.

***Technical Exceptions***

e. Exposures that have structural weaknesses and/or material documentary deficiencies but are not adversely classified due to the overall financial strength of the counterparty, and/or they do not meet the criteria for significant increase in credit risk under IFRS 9, should be reported by credit reviewers to Management as Exposures with Technical Exceptions. Management should determine and address the root causes of the technical exceptions noted and regularly monitor updates on the status of the corrective actions. FCs are also expected to book additional ACL for exposures with technical exceptions if historical loss rates for these exposures are collectively above the average for Pass exposures.

7.3.3. ***Substandard*.** These are exposures that have well-defined weakness/(es) in profitability, cash flows, and/or operations, that may jeopardise repayment in full. Structural weaknesses noted are more severe compared to Special Mention loans/financing and delays in payment are more frequent and longer. Basic characteristics include any of the following:

a. Weak financial condition and results of operation that leads to the borrower’s inability to generate sufficient cash flow for debt servicing, except for start-up firms which should be evaluated on a case-to-case basis;

b. Past due secured loans/financing and other credit accommodations where properties offered as collateral have been found with defects as to ownership or with other adverse information; or

c. Breach of any key financial covenants/agreements that will adversely affect the capacity to pay of the counterparty.

7.3.3.1. There is a rebuttable presumption that a loan/financing is Substandard Underperforming if it is past due for more than 30 days. For business loans/financing, a comprehensive risk assessment of the creditworthiness of the counterparty must be conducted if the exposure is past due for 30 days, at the latest. FCs should have clear guidelines on when loans/financing that are past due for more than 30 days are not considered as Substandard Underperforming. Such guidelines should include the appropriate approval authority for these exceptions, depending on the type, amount, and complexity of the transactions. Loans/financing that are past due for more than 60 days shall have a minimum classification of Substandard Underperforming regardless of the justifications of the credit officer.

7.3.3.2. For purposes of prudential reporting, Substandard loans/financing are divided into the following:

a. Substandard Underperforming (UP) – Substandard loans/financing that are not considered Non-Performing under paragraph 4.1; and

b. Substandard Non-performing (NP) – Substandard loans/financing that are considered Non-Performing under paragraph 4.1. All loans/financing considered impaired under IFRS 9 shall have a minimum classification of Substandard NP.

7.3.4. ***Doubtful.*** These are exposures that exhibit more severe weaknesses than those classified as “Substandard”, whose characteristics on the basis of currently known facts, conditions and values make collection or liquidation highly improbable. Doubtful is just a transitory classification and FCs should only use this classification when there are specific pending factors and information that justify deferral classification of the exposure as “Loss”. Some basic characteristics include any of the following:

a. Secured exposures where properties offered as collateral are either subject to an adverse claim rendering settlement of the loan/financing through foreclosure doubtful or whose values have materially declined without the borrower offering additional collateral for the loan/s to cover the deficiency; or

b. Exposures wherein the possibility of loss is extremely high but because of certain important and reasonable pending factors (i.e., merger, acquisition, or liquidation procedures, capital infusion, perfecting liens on additional collateral, and refinancing plans) that may work to the advantage and strengthening of the asset, its classification as an estimated loss is deferred until the next credit review.

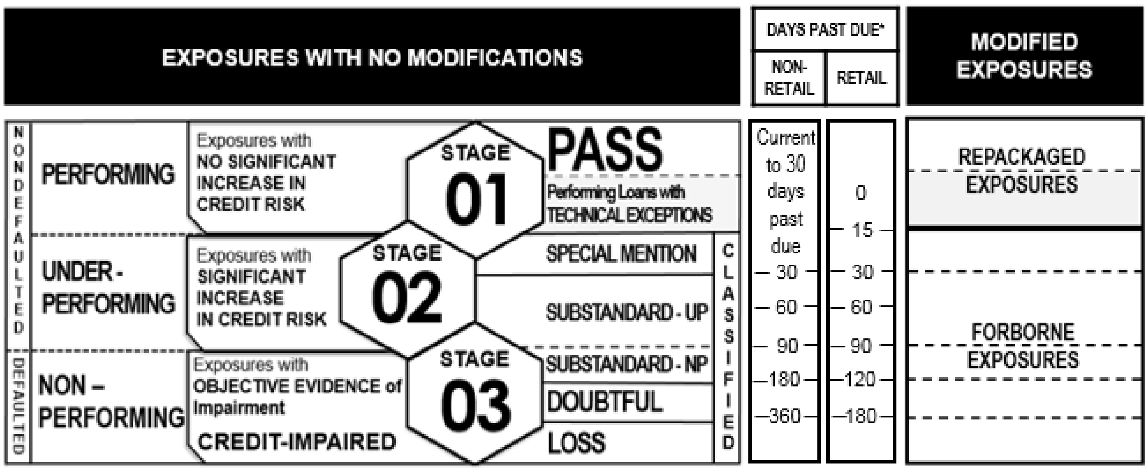
7.3.5. ***Loss.*** These are exposures which are considered uncollectible or worthless, after exhausting all collection efforts such as realisation of collateral and institution of legal proceedings, although the loans/financing may have some recovery or salvage value. All unsecured retail loans/financing must be classified as Loss if past due for more than 180 days. All unsecured non-retail exposures must be considered as Loss if past due for more than 360 days. All secured exposures should be classified as Loss if still uncollected after 5 years since they became Non-Performing.

7.3.6. FCs must split the classification of secured Non-Performing exposures if the recoverable amount of the collateral is not sufficient to cover the carrying amount of the exposure. The secured portion may be classified as “Substandard” or “Doubtful”, as appropriate, while the unsecured portion should be classified “Loss” if there is no other source of payment other than the collateral. The valuation of collaterals is further discussed in paragraphs 10.4 and 10.5.

## 7.4. Interaction of IFRS 9 staging with prudential measures of asset quality

7.4.1 The integration of IFRS 9 staging concepts in the regulatory classification framework, and the harmonisation of the definitions of Non-Performing exposures, default, forbearance, and impairment are illustrated below.

**Table 7.4.1.1**




** The number of days past due in the table are backstops for purposes of consistent regulatory classification of unsecured exposures and represent the latest point to adversely classify, categorise, or downgrade the classifications of problem credits. Secured exposures are classified in accordance with the qualitative description of classifications under Paragraph 7. All secured exposures should be classified as Loss if still uncollected after 5 years since they became Non-Performing .*

7.4.2. Except in cases wherein forward-looking information is not available without undue cost or effort, delinquency matrices should not be used as the primary basis for classification and provisioning, especially for material exposures. As explained in paragraph 7.1, material exposures should be classified, even without any missed payments, if they meet the criteria for regulatory classification. For example, an unsecured loan/financing to a counterparty, whose business has already closed and has no other material sources of cash flow, should be classified as Loss and provided with 100 percent ACL, even if the loan/financing is current and the next amortisation due is still months away from reporting date.

7.4.3. All exposures with significant increase in credit risk since initial recognition, as defined under IFRS 9, shall have a minimum classification of Special Mention. All credit-impaired assets shall be categorised as Non-Performing and shall have a minimum classification of Substandard Non-Performing.

7.4.4. All Forborne and/or Non-Performing exposures should be adversely classified. Forborne exposures shall have a minimum classification of Special Mention while Non-Performing exposures shall have a minimum classification of Substandard Non-Performing . Forborne exposures that meet the exit criteria under paragraph 5.5 may be restored to Pass rating. Non-Performing exposures that meet the criteria for recategorisation to performing exposures under paragraph 4.5, may also be restored to Pass rating but it may still be classified as Special Mention or at worst, Substandard Underperforming, if noted structural weaknesses remain substantially uncorrected.

## 7.5 Mapping of regulatory classification to internal credit risk rating system

7.5.1. The classification process may be integrated in the FC's internal credit risk rating system. In which case, the finance company should document the mapping of regulatory classifications, as defined in Paragraph 7.3, to their internal credit risk rating system.

## 7.6. Upgrading of Classification

7.6.1. FCs shall have clear policies that set the criteria in the upgrading of classification and the approval process of such upgrades. Such criteria should consider the exit criteria for Non-Performing (Paragraph 4.5) and Forborne exposures (Paragraph 5.5); and the interaction of IFRS 9 staging with prudential measures of asset quality (paragraph 7.4). Upgrading of any credit facility shall be supported by a comprehensive analysis of the repayment capability, cash flows and financial strength of the counterparty, and the corrective actions on the structural weaknesses noted. FCs shall exercise prudence in the upgrading of any credit facility and be satisfied that the credit facility that it intends to upgrade has exhibited a sustained trend of improvement to justify the improved classification.

7.6.2. For Substandard Underperforming and Special Mention exposures that were not previously categorised as Non-Performing or Forborne, and as such, are not subject to the exit criteria prescribed in Paragraphs 4.5 and 5.5, respectively, upgrading to Pass may be supported by the following developments:

a. All arrears or missed payments on principal and interest/profit including penalties have been paid; and

b. There is sufficient proof on the counterparty's ability and willingness to fully pay all outstanding obligations to all creditors in a timely manner.

## 8. MAINTENANCE OF CREDIT FILES

8.1. All FCs shall maintain credit files whether in electronic, print or other form, on all its counterparties which shall contain adequate and timely information on the creditworthiness of the counterparties: (a) to enable the proper and effective monitoring of credit facilities; and (b) to enable credit reviewers, internal auditors, risk managers and AMBD examiners, to have immediate and complete factual information from which they can form an objective appraisal of the quality of the credit facilities.

8.2. FCs shall maintain basic information on: (a) the borrower; (b) the credit facility; (c) the appraisal of the credit application; and (d) the conduct of the account, to enable an objective evaluation of the quality of each facility.

8.3. FCs shall also maintain in its credit files, documents which support such basic information. For consumer loans/financing where credit risk is managed on a portfolio basis, a finance company shall maintain information on at least the borrower, credit facility and its appraisal of the credit application.

8.4. In the case of syndicated loans/financing, each participating financial institution shall maintain credit information on the borrower, and classify and make provision for its portion of the syndicated loan/financing in accordance with the requirements of this Notice. The lead financial institution shall provide the credit information on the borrower upon request by the participating FCs and inform the latter if the loan/financing will be classified so as to achieve uniform classification of the syndicated loan/financing.

8.5. The information in the credit files shall be made available in English.

## 9. ACCOUNTABILITIES AND FREQUENCY OF CREDIT REVIEW

9.1. Since credit officers/frontliners have more access to client information, they are primarily accountable in ensuring that credit facilities are appropriately classified at all times. However, there has to be an independent credit review function that verifies the propriety of the classifications and has the authority to override the classifications made by the credit officers, when necessary.

9.2. FCs should have a formal policy in place regarding the frequency of individual credit reviews which considers materiality and credit quality of the exposures. Watchlisted and classified loans/financing should be reviewed at least quarterly.

## 10. EXPECTED CREDIT LOSS METHODOLOGY

10.1. All FCs are expected to develop and document a sound expected credit loss (ECL) methodology in accordance with IFRS 9 and other guidelines on the accounting of ECL issued by the IASB and the BCBS, particularly the “Guidance on Credit Risk and Accounting for Expected Credit Losses”, issued in December 2015. The BCBS issuances on credit risk and ECL complement IFRS 9, and do not contradict ECL accounting standards issued by the IFSB.

10.2. Consistent with BCBS guidelines, AMBD expects FCs operating in Brunei Darussalam to implement a high-quality, robust and consistent ECL accounting framework. While IFRS 9 does not prescribe a particular method in computing ECL, AMBD encourages FCs to use the PD/LGD[20] method in computing ECL to achieve high quality implementation of IFRS 9 and improve credit risk management. Such approach provides critical information to the Board, Senior Management, and AMBD, especially in the credit risk assessment of offshore investments.

***Eligibility for Inclusion as Tier 2 capital***

10.3. Stage 1 IFRS 9 ECL is considered as general credit loss reserve that qualify for inclusion in Tier 2 capital in the computation of the Capital Adequacy Ratio[21] up to 1.25% of credit risk-weighted assets (RWA). FCs should endeavour to ensure that assets or groups of assets with identified deterioration in values should be excluded in the computation of general provisions.

***Eligible Collaterals***

10.4. FCs may deduct the recoverable amount of the collateral in the computation of ACL, if the following criteria are met:

a. The market value of the collateral is readily determinable or can be reasonably established and verified;

b. The collateral is readily marketable and there exists a secondary market for disposing of the collateral;

c. The FC's right to repossess the collateral is legally enforceable and without impediment;

d. The FC is able to secure control over the collateral if necessary. In the case of movable collateral, the FC must either have physical custody of the collateral (e.g. gold, precious metal or taxi medallion) or have the means of readily (say, within one month) locating its whereabouts (e.g. vehicle, machinery or equipment); and

e. The FC has the expertise and adequate processes to manage the collateral concerned.

[20] Probability of Default/Loss Given Default

[21] Paragraph 49 (vii) of Basel II states: General provisions or general loan-loss reserves are created against the possibility of losses not yet identified. Where they do not reflect a known deterioration in the valuation of particular assets, these reserves qualify for inclusion in Tier 2 capital. Where, however, provisions or reserves have been created against identified losses or in respect of an identified deterioration in the value of any asset or group of subsets of assets, they are not freely available to meet unidentified losses which may subsequently arise elsewhere in the portfolio and do not possess an essential characteristic of capital. Such provisions or reserves should therefore not be included in the capital base.

***Valuation of Eligible Collaterals***

10.5. The valuation of eligible collaterals for purposes of determining the secured portion of classified exposures and computing ACL shall be done in accordance with applicable guidelines under IFRS 9, IFRS 13, and IAS 36. Hence, the expected cash flows from the collateral should be discounted using the effective interest/profit rate determined at initial recognition, and consider the following factors in the valuation: historical recovery rates of collateral, costs and length of time to obtain control over and sell the collateral, and other reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

10.6. For secured Non-Performing exposures, FCs must secure independent full appraisal of the collateral/s within one year since they became Non-Performing . The valuation should be updated every three years.

## 11. PROVISIONS REPEALED

11.1. Notice No. BU/N-5/2017/40 on Classification of Impaired Credit/Financing Facilities and Financial Assets for Provisioning Purposes issued to licensees on 15 March 2017 is hereby repealed.

11.2. The provisions of any other notices, directives and policy documents issued by AMBD prior to this Notice and which are inconsistent with it are hereby repealed.

**MANAGING DIRECTOR**

**AUTORITI MONETARI BRUNEI DARUSSALAM**

Date: 19 Rabiulakhir 1440H / 27 December 2018

## APPENDIX A

### DEFINITION OF TERMS

**Based on IFRS 9**
*(all paragraph number references pertain to IFRS 9)*

**amortised cost of a financial asset or financial liability -** The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**.

**Credit-impaired financial asset -** A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events:

(a) Significant financial difficulty of the issuer or the borrower;
(b) A breach of contract, such as a default or past due event;
(c) The lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;
(d) It is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
(e) The disappearance of an active market for that financial asset because of financial difficulties; or
(f) The purchase or origination of a financial asset at a deep discount that reflects the incurred **credit losses**.

It may not be possible to identify a single discrete event—instead, the combined effect of several events may have caused financial assets to become credit-impaired.

**Credit loss -** The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls), discounted at the original **effective interest rate** (or **credit-adjusted effective interest rate** for **purchased or originated credit-impaired financial assets**). An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.

**Credit-adjusted effective interest rate -** The rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial asset to the **amortised cost of a financial asset** that is a **purchased or originated credit-impaired financial asset**. When calculating the credit-adjusted effective interest rate, an entity shall estimate the expected cash flows by considering all contractual terms of the financial asset (for example, prepayment, extension, call and similar options) and **expected credit losses**. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1–B5.4.3 of Appendix B), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the remaining life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

**Dividends -** Distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital.

**Effective interest method -** The method that is used in the calculation of the **amortised cost of a financial asset or a financial liability** and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.

**Effective interest rate -** The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the **gross carrying amount of a financial asset** or to the **amortised cost of a financial liability**. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the **expected credit losses**. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1–B5.4.3 of Appendix B), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

**Expected credit losses -** The weighted average of **credit losses** with the respective risks of a default occurring as the weights.

**Financial Asset –** Cash or the contractual right to receive cash or another financial asset, or the contractual right to exchange financial instruments at a potential gain or an equity instrument of another entity. Financial assets also include contracts in which an entity receives a variable number of its own shares.

**Financial Instrument –** A contract that creates a financial asset for one entity and a financial liability or equity instrument for another entity. Examples include cash, deposits, commercial bills, notes, loans and accounts receivable and payable.

**gross carrying amount of a financial asset -** The **amortised cost of a financial asset**, before adjusting for any **loss allowance**.

**Lifetime expected - credit losses -** The **expected credit losses** that result from all possible default events over the expected life of a financial instrument.

**Loss allowance or allowance for credit losses (ACL) -** The allowance for **expected credit losses** on financial assets measured at amortised cost or fair value though other comprehensive income, lease receivables, loan commitments and **financial guarantee contracts**.

## APPENDIX B

### EXCERPTS FROM IFRS 9 ON SIGNIFICANT INCREASE IN CREDIT RISK

***Recognition of Lifetime Expected Credit Losses***

**5.5.3** At each reporting date, an entity shall measure the loss allowance for a financial instrument at an amount equal to the *lifetime expected credit losses* if the credit risk on that financial instrument has increased significantly since initial recognition.

**5.5.4** The objective of the impairment requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition — whether assessed on an individual or collective basis —considering all reasonable and supportable information, including that which is forward-looking.

***Determining significant increases in credit risk***

**5.5.9** At each reporting date, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition. When making the assessment, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses. To make that assessment, an entity shall compare the risk of a default occurring on the financial instrument as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition and consider reasonable and supportable information, that is available without undue cost or effort, that is indicative of significant increases in credit risk since initial recognition.

**5.5.10** An entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low credit risk at the reporting date (see paragraphs B5.5.22–B5.5.24 below).

**5.5.11** If reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on *past due* information when determining whether credit risk has increased significantly since initial recognition. However, when information that is more forward-looking than past due status (either on an individual or a collective basis) is not available without undue cost or effort, an entity may use past due information to determine whether there have been significant increases in credit risk since initial recognition. Regardless of the way in which an entity assesses significant increases in credit risk, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due. An entity can rebut this presumption if the entity has reasonable and supportable information that is available without undue cost or effort, that demonstrates that the credit risk has not increased significantly since initial recognition even though the contractual payments are more than 30 days past due. When an entity determines that there have been significant increases in credit risk before contractual payments are more than 30 days past due, the rebuttable presumption does not apply.

**B5.5.17** The following non-exhaustive list of information may be relevant in assessing changes in credit risk:

(a) 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.

(b) 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.

(c) 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:

(i) the credit spread;
(ii) the credit default swap prices for the borrower;
(iii) the length of time or the extent to which the fair value of a financial asset has been less than its amortised cost; and
(iv) other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments.

(d) an actual or expected significant change in the financial instrument's external credit rating.

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

(f) 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.

(g) 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 organisational 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.

(h) significant increases in credit risk on other financial instruments of the same borrower.

(i) 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.

(j) 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.

(k) 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.

(l) significant changes, such as reductions in financial support from a parent entity 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 securitisations, whether subordinated interests are expected to be capable of absorbing expected credit losses (for example, on the loans underlying the security).

(m) 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.

(n) significant changes in the expected performance and behaviour 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).

(o) changes in the entity's credit management approach in relation to the financial instrument; ie based on emerging indicators of changes in the credit risk of the financial instrument, the entity'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 entity specifically intervening with the borrower.

(p) past due information, including the rebuttable presumption as set out in paragraph 5.5.11 above.

**B5.5.18** In some cases, the qualitative and non-statistical quantitative information available may be sufficient to determine that a financial instrument has met the criterion for the recognition of a loss allowance at an amount equal to lifetime expected credit losses. That is, the information does not need to flow through a statistical model or credit ratings process in order to determine whether there has been a significant increase in the credit risk of the financial instrument. In other cases, an entity may need to consider other information, including information from its statistical models or credit ratings processes. Alternatively, the entity may base the assessment on both types of information, i.e. qualitative factors that are not captured through the internal ratings process and a specific internal rating category at the reporting date, taking into consideration the credit risk characteristics at initial recognition, if both types of information are relevant.

***More than 30 days past due rebuttable presumption***

**B5.5.19** The rebuttable presumption in paragraph 5.5.11 above is not an absolute indicator that lifetime expected credit losses should be recognised, but is presumed to be the latest point at which lifetime expected credit losses should be recognised even when using forward-looking information (including macroeconomic factors on a portfolio level).

**B5.5.20** An entity can rebut this presumption. However, it can do so only when it has reasonable and supportable information available that demonstrates that even if contractual payments become more than 30 days past due, this does not represent a significant increase in the credit risk of a financial instrument. For example, when non-payment was an administrative oversight, instead of resulting from financial difficulty of the borrower, or the entity has access to historical evidence that demonstrates that there is no correlation between significant increases in the risk of a default occurring and financial assets on which payments are more than 30 days past due, but that evidence does identify such a correlation when payments are more than 60 days past due.

**B5.5.21** An entity **cannot** align the timing of significant increases in credit risk and the recognition of lifetime expected credit losses to when a financial asset is regarded as credit-impaired or an entity's internal definition of default.

***Financial instruments that have low credit risk at the reporting date***

**B5.5.22** The credit risk on a financial instrument is considered low for the purposes of paragraph 5.5.10 above, if the financial instrument has a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations. Financial instruments are not considered to have low credit risk when they are regarded as having a low risk of loss simply because of the value of collateral and the financial instrument without that collateral would not be considered low credit risk. Financial instruments are also not considered to have low credit risk simply because they have a lower risk of default than the entity's other financial instruments or relative to the credit risk of the jurisdiction within which an entity operates.

**B5.5.23** To determine whether a financial instrument has low credit risk, an entity may use its internal credit risk ratings or other methodologies that are consistent with a globally understood definition of low credit risk and that consider the risks and the type of financial instruments that are being assessed. An external rating of ‘investment grade’ is an example of a financial instrument that may be considered as having low credit risk. However, financial instruments are not required to be externally rated to be considered to have low credit risk. They should, however, be considered to have low credit risk from a market participant perspective taking into account all of the terms and conditions of the financial instrument.

**B5.5.24** Lifetime expected credit losses are not recognised on a financial instrument simply because it was considered to have low credit risk in the previous reporting period and is not considered to have low credit risk at the reporting date. In such a case, an entity shall determine whether there has been a significant increase in credit risk since initial recognition and thus whether lifetime expected credit losses are required to be recognised in accordance with paragraph 5.5.3 above.

***Definition of default***

**B5.5.36** Paragraph 5.5.9 above requires that when determining whether the credit risk on a financial instrument has increased significantly, an entity shall consider the change in the risk of a default occurring since initial recognition.

**B5.5.37** When defining default for the purposes of determining the risk of a default occurring, an entity shall apply a default definition that is consistent with the definition used for internal credit risk management purposes for the relevant financial instrument and consider qualitative indicators (for example, financial covenants) when appropriate. However, there is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate. The definition of default used for these purposes shall be applied consistently to all financial instruments unless information becomes available that demonstrates that another default definition is more appropriate for a particular financial instrument.

***Effective interest method***

**B5.4.1** In applying the effective interest method, an entity identifies fees that are an integral part of the effective interest rate of a financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value, with the change in fair value being recognised in profit or loss. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised.

**B5.4.2** Fees that are an integral part of the effective interest rate of a financial instrument include:

(a) origination fees received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument.

(b) commitment fees received by the entity to originate a loan when the loan commitment is not measured at fair value through profit or loss and it is probable that the entity will enter into a specific lending arrangement. These fees are regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry.

(c) origination fees paid on issuing financial liabilities measured at amortised cost. These fees are an integral part of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.

**B5.4.3** Fees that are not an integral part of the effective interest rate of a financial instrument and are accounted for in accordance with IFRS 15 include:

(a) fees charged for servicing a loan;

(b) commitment fees to originate a loan when the loan commitment is not measured at fair value through profit or loss and it is unlikely that a specific lending arrangement will be entered into; and

(c) loan syndication fees received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).

## APPENDIX C

**GUIDANCE ON CREDIT RISK AND ACCOUNTING FOR EXPECTED CREDIT LOSSES (BCBS 350, DECEMBER 2015)**

**Principle 1**: A bank's board of directors (or equivalent) and senior management are responsible for ensuring that the bank has appropriate credit risk practices, including an effective system of internal control, to consistently determine adequate allowances in accordance with the bank's stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.

**Principle 2**: A bank should adopt, document and adhere to sound methodologies that address policies, procedures and controls for assessing and measuring credit risk on all lending exposures. The measurement of allowances should build upon those robust methodologies and result in the appropriate and timely recognition of expected credit losses in accordance with the applicable accounting framework.

**Principle 3**: A bank should have a credit risk rating process in place to appropriately group lending exposures on the basis of shared credit risk characteristics.

**Principle 4**: A bank's aggregate amount of allowances, regardless of whether allowance components are determined on a collective or an individual basis, should be adequate and consistent with the objectives of the applicable accounting framework.

**Principle 5**: A bank should have policies and procedures in place to appropriately validate models used to assess and measure expected credit losses.

**Principle 6**: A bank's use of experienced credit judgment, especially in the robust consideration of reasonable and supportable forward-looking information, including macroeconomic factors, is essential to the assessment and measurement of expected credit losses.

**Principle 7**: A bank should have a sound credit risk assessment and measurement process that provides it with a strong basis for common systems, tools and data to assess credit risk and to account for expected credit losses.

**Principle 8**: A bank's public disclosures should promote transparency and comparability by providing timely, relevant and decision-useful information.

## APPENDIX D

**Structural Weaknesses**[22]

Structural weaknesses are underwriting deficiencies that can compromise a financial institution's ability to control a credit relationship if economic or other events adversely affect the borrower. Some degree of structural weakness may be found in virtually any aspect of a loan arrangement or type of loan, and the presence of one (or more) need not be indicative of an overall credit weakness deserving criticism. Instead, the financial institution's credit reviewers must evaluate the relative importance of such factors in the context of the borrower's overall financial strength, the condition of the borrower's industry or market, and the borrower's total relationship with the financial institution.

Some of the most prevalent structural weaknesses are:

- Indefinite or speculative purpose — The loan purpose should clearly reflect the intended use of the proceeds. Loans for ambiguous or speculative purposes deserve extra scrutiny.

- Indefinite or overly liberal repayment program/evergreen loans — Loans that lack a clear and reasonable repayment program (source and timing) present extra risk, regardless of their nominal maturity. This includes "evergreen loans" or those that revolve continually where the financial institution is essentially providing debt capital. Typical indicators of unrealistic repayment terms include: bullet maturities unrelated to the actual source of repayment funds, rewrites or renewals for the purpose of simply deferring a maturity, loans used to finance asset purchases with a repayment plan significantly in excess of the useful life of the asset, and advances to fund interest payments.

- Non existent, weak, or waived covenants — In large and medium-sized financial institutions, covenants are generally required for medium and longer term credits and can be an effective control mechanism. Effective covenants typically provide the lending financial institution with an opportunity to trigger protective action if a defined aspect of the borrower's operation or financial condition falls below prescribed standards. Credit reviewers should be alert for covenants that have been waived or renegotiated by the business units to accommodate a borrower's failure to maintain the original standards.

- Inadequate debt service coverage — The initial underwriting of loans that are intended to be repaid from operating cash flow should provide for an acceptable margin to repay both principal and interest in a reasonable time based on historical performance. If repayment is predicated on new revenues that are expected to be enabled by the loan, then anticipated future cash flows should be reasonable and well documented.

- Elevated leverage ratio — Acceptable leverage ratios vary based on industry, loan purpose, covenant definition, capital expenditure restrictions, and dividend payouts. Credit reviewers should consider both the reasonableness of the leverage ratio and how it is defined. Leverage ratios may be calculated as debt to net worth or debt to cash flow; industry standards prescribe which methodology is most appropriate.

[22] Adopted from Annex F of Rating Credit Risk by the Office of the Comptroller of the Currency.

- Inadequate net worth/capital — Companies need tangible net worth to sustain them during unforeseen, adverse situations. Consider both the absolute amount of tangible net worth and its amount relative to debt.

- Inadequate financial analysis — The level of analysis should be commensurate with the level of risk. If the loan approval documentation lacks sufficient analysis of financial trends, primary and secondary repayment sources, industry trends, and risk mitigants, the loan may fit this category. More complex credits normally should also require sensitivity analysis (base case, break even case, etc.) and risk/reward analysis.

- Insufficient collateral support — This occurs when the borrower is not deserving of unsecured credit, but is either unwilling or unable to provide a satisfactory margin of collateral value.

- Inadequate collateral documentation and valuation — Collateral should be documented by evidence of perfected liens and current appraisals reports.

- Overly aggressive loan-to-value (LTV)— LTV should reflect the useful life of the collateral pledged, depreciation rates, vulnerability to obsolescence, and market volatility.

- Inadequate guarantor support— Guarantors may serve a variety of purposes in the credit process, including as an "abundance of caution." Therefore, it is important that guarantor support be analysed in the context of the financial institution's actual expectations of the guarantor, as well as the guarantor's willingness to support the credit, if called upon to do so. Inadequate guarantor support may result when the financial institution relies on a guarantor's presumed financial strength, but has not fully analysed the guarantor's financial information, including contingent liabilities and liquidity. Inadequate guarantor support may also occur when a guarantor, whose support was critical to the original credit decision, is subsequently released from the obligation without other offsetting support.

  The repayment of all loans depends, to some degree, on projected future events. For example, repayment depends on the borrower continuing to operate profitably, asset values remaining within a certain range, etc. However, the word "projected," as used in the following four elements, identifies loans whose repayment is predicated on future events that appear to deviate materially from the historical performance of the borrower, trends within the industry, or general economic trends.

- Repayment highly dependent on projected cash flows — This category includes loans whose repayment relies heavily on optimistic increases in sales volumes, or savings from increased productivity or business consolidation. It may also include loans whose projections do not adequately support debt service over the duration of the loan or whose projections rely on an unfunded revolver or other external sources of capital or liquidity. Real estate loans with limited or no pre-leasing or sales should be considered for this category.

- Repayment highly dependent on projected asset values — This category includes loans that are projected to be repaid from the conversion of assets at a value that exceeds current value when the projected appreciation is not well supported. It may also include loans for which the LTV is too thin to weather a decline in value resulting from normal economic cycles.

- Repayment highly dependent on projected equity values — Loans that are predicated on the projected increasing value of the business as a going concern fit this category. These loans typically have all the business assets, including goodwill and stock of the borrowing entity, pledged as collateral.

- Repayment highly dependent on projected refinancing or recapitalization — Loans in this category are made based on the expectation that proceeds from the issuance of new debt or equity will repay the loan. These are not bridge loans pending a closing; rather, the future debt or equity event is uncommitted or has other elements of uncertainty. They may rely on optimistic assumptions about the future direction or performance of debt markets, equity markets, or interest rates.

- High interest rates – relatively higher interest rates imply high risk premium.

**- END -**