Financial Institutions (Loan Portfolio Classification)

IN EXERCISE OF THE POWERS CONFERRED UPON THE COMMISSIONER OF FINANCIAL INSTITUTIONS BY SECTIONS 22(a), 71(2) (a),(b) and (c) OF THE FINANCIAL INSTITUTIONS ACT 1999 THE COMMISSIONER HERE MAKES THE FOLLOWING REGULATIONS -

PART Ⅰ

PRELIMINARY

Citation and commencement

1. These Regulations may be cited as the Financial Institutions (Loan Portfolio Classification) Regulations 1999 and shall come into operation on the date of publication in the Gazette.

Interpretation

2. In these Regulations, unless the context otherwise requires, words used have the same meanings assigned to them in the principal law.

Objectives

3. These Regulations are intended to ensure that -

(a) all loans and advances from financial institutions are regularly evaluated using objective classification criteria;

(b) the accounting treatment of accrued but uncollected interest on non-performing accounts of financial institutions is in accordance with internationally-accepted accounting principles; and

(c) the allowance for loan losses or provisioning is maintained at an adequate level at all times.

Application

4. These Regulations apply to all licensed financial institutions in Lesotho.

PART II

REGULATORY REQUIREMENT

Loan portfolio review

5. (1) A financial institution shall establish and adhere to adequate policies, practices and procedures for evaluating the quality of its loan portfolio and the adequacy of its provisions for probable losses.

(2) All financial institutions shall be required to conduct a qualitative appraisal of their loan portfolios comprising all loans, overdrafts, receivables, and other extensions of credit at least quarterly coinciding with the end of a calendar quarter.

(3) Notwithstanding sub-regulations (1) and (2), a summary of the consolidated (head or main office and branches) loan portfolio review as at 30 June and 31 December of each year shall be prepared and submitted to the Central Bank not later than the end of the following month in the prescribed form as setout in the Schedule and each review shall cover at least 70% of the loan portfolio and, shall include the following :-

(a) large loans to single borrowers or group of borrowers above 1% of the loan

portfolio;
(b) all past-due accounts;
(c) all non-performing accounts;
(d) all identified problem accounts; and
(e) large off-balance sheet commitments above 1% of the loan portfolio.

PART III

PAST-DUE AND NON-PERFORMING ACCOUNTS

Reports
6. (1) A financial institution shall report in its monthly banking statistics the outstanding balance of its loan portfolio considered to be past-due and those considered to be non-performing.
(2) The principal balance outstanding (and not the amount of delinquent payments) shall be used in calculating the aggregate amount of past-due and of non-performing accounts.
(3) If a financial institution has multiple loans and other credits outstanding to a single borrower and one account meets the criteria for non-performing status, then the financial institution shall evaluate every other exposure to that borrower and, if appropriate, place any other account in non-performing status also.
Past-due account
7. An account shall be reported as past-due when
(a) for a loan or an account with fixed repayment dates
(i) the principal or interest is due and unpaid for 1 month or more; or
(ii) the interest charges for 1 month or more have been capitalised, refinanced, or rolled-over;
(b) for an overdraft or an account without fixed repayment dates
(i) the approved limit has been exceeded for 1 month or more;
(ii) the credit line has expired for 1 month or more;
(iii) the interest charges for 1 month or more have not been covered by deposits; or
(iv) the account had turnovers which did not conform to the business cycle.
Non- performing account
8. An account shall be reported as non-performing when
(a) for a loan or an account with fixed repayments dates
(i) the principal or interest is due and unpaid for 3 months or more; or
(ii) the interest charges for 3 months or more have been capitalised, refinanced, or rolled-over;
(b) for an overdraft or an account without fixed repayment dates
(i) the approved limit has been exceeded for 3 months or more; or
(ii) the credit line has expired for 3 months or more; or
(iii) the interest charges for 3 months or more have not been covered by deposits; or
(iv) the account has developed a hardcore which was not converted into a term loan after 3 months or more.

Non-accrual status

9. (1) When an account is identified as non-performing a financial institution shall place it on a non-accrual status by either suspending the accrual of interest or continuing to accrue interest but setting aside a specific allowance for the full amount of interest being accrued.

(2) Uncollected interest that has been previously accrued shall be reversed or included in the account balance with an adequate specific allowance to offset the full amount which was previously accrued.

(3) Interest on loans to the Government and on any other loans or overdraft secured by cash, cash substitutes, government securities or government guarantees may be accrued up to the limit of the said collateral or government guarantee.

Cash basis accounting

10. (1) If an account has been placed on a non-accrual status and ultimate collectibility of the remaining principal balance is in doubt, then any cash payments received shall be applied only to reduce the principal.

(2) However, if the remaining book balance after a partial write-off of principal is considered fully collectible, then cash payments received may be treated as interest income.

(3) When recognition of interest income on a cash basis is appropriate, the amount of income which may be recognised is limited to that which would have been accrued on the remaining book balance at the contractual rate.

(4) Any cash payments in excess of this amount (and not applied to the remaining book balance) shall be recorded as recoveries of prior write-offs until all such write-offs have been fully recovered.

(5) Any determination that an account is ultimately collectible must besupported by a current, properly-documented credit evaluation, including analysis of the borrowers historical repayment performance and any other relevant factors.

Restoration to accrual status

11. A non-performing account may be restored to accrual status when -

(a) all principal and interest in arrears have been paid and the borrower has resumed paying the full amount of the scheduled contractual principal and interest payments for at least 6 months and all contractual payments are deemed to be collectible in a timely manner; or

(b) when an account otherwise becomes well-secured and in the process of collection.

Well secured account

12. (1) A "well-secured account" means that the collateral is sufficient to protect the financial institution from loss of principal and interest through its timely disposition under a forced liquidation programme.

(2) "Sufficiency" implies the existence of proper legal documentation, a net realisable market value which is adequate to cover the amount of principal and interest outstanding as well as cost of collection, and the absence of prior liens on the collateral which would diminish its value or otherwise prevent

the bank from acquiring clear title.
(3) Collateral such as specialised manufacturing facilities and equipment for ongoing operations which involve large-scale employment of workers may not normally be considered well-secured because of the difficulties of actual fore closure or of disposing of the collateral in a timely manner at values sufficient toprotect the financial institution from loss.
(4) An account may also be considered as well-secured if the collateral includes irrevocable guarantees issued by first-class banks and other licensed financial institutions, multinational companies, and governments where the beneficiary or licensee has performed the financial analysis necessary to determine that the issuer is financially sound, well-capitalised, and able to pay the guarantee on demand.
(5) Such guarantees shall be unconditional and payable upon the default of the borrower and shall be properly acknowledged by the issuer through independent confirmation.

PART IV

CLASSIFICATION CRITERIA

Credit information
13. The loan portfolio shall be classified based on the review of the following information
(a) the original amount of the credit facility, terms, interest rate, current balance and status, and purpose of the credit facility;
(b) the business of the borrower, balance sheets, income statements, cash flows and other financial data both on the business and the guarantors;
(c) an evaluation of the project being financed;
(d) the collateral taken including up-to-date appraisals, legal assignments and insurances among others;
(e) track record of the borrower including the repayment history of previous borrowings; and
(f) if part of a group, the performance of credit accommodations to other members of the group.
Loan classification
14. (1) The loan portfolio shall be classified into the 5 categories listed in regulation 18 using the criteria stated in that regulation.
(2) The criteria shall be used by a financial institution for loan portfolio review as at 30th June and 31st December of each year and by the examiners of the Central Bank for loan classification purposes.
Basis
15. (1) In general, the evaluation of each account shall be based upon the creditworthiness of the particular borrower.
(2) The focus of the assessment shall be the ability of the borrower to repay the account.
(3) The assessment shall reflect all relevant factors as of the evaluation

date that affect the collectibility of principal and interest.
(4) Factors relevant to the assessment of the debtors ability to repay shall include the debtors payment record, overall financial condition and resources, debt service capacity, financial performance, net worth and future prospects.
(5) Significant departure from the primary source of repayment may warrant adverse classification even if a loan is current and supported by underlying collateral value or guarantees. Adverse classification may also be appropriate if repayment terms originally were too liberal or if a delinquency has been technically cured by modification of terms, refinancing or additional advances.

Collateral

16. (1) The loan classification exercise shall not depend on the amount or quality of collateral pledged.
(2) Collateral shall be regarded as a secondary source of repayment and therefore will only be considered in assessing the amount of provision required.

Hardcore

17. For purposes of classification, the hardcore of an overdraft facility shall refer to that portion of an overdraft which shows little or no turnover over a period of 12 consecutive months.

Categories

18. (1) The following are the 5 categories for classifying accounts in the loan portfolio
(a) Pass;
(b) Special-Mention;
(c) Substandard;
(d) Doubtful; and
(e) Loss.
(2) When an account has more than one deficiency, the deficiency which attracts the lower classification category shall be considered.
(3) The Central Bank shall not be precluded from requiring a more severe classification for an account if such is warranted based upon any additional information.
(4) "Pass" category includes all of the following
(a) where the financial condition of the borrower is sound;
(b) where there is adequate documentation to support the granting of credit, such as current financial statements, cash flows, credit checks, and evaluation report on collateral held; and
(c) if the account is supported by collateral, such collateral shall be unimpaired.
(5) The classification in subregulation (4) be assigned to -
(a) a loan which is up-to-date in repayments; and
(b) an overdraft
(i) operating within the approved limit;
(ii) with unexpired credit line;

(iii) with interest charges covered by deposits; and
(iv) with no hardcore and showing turnovers which conform to the business cycle.
(6) "Special Mention (Potential Problem Credits)" includes any one or more of the following -
(a) an account which is currently up-to-date but evidence suggests that certain factors could in the future affect the borrowers ability to service the account properly or impair the collateral;
(b) where there is inadequate credit documentation or other deviations from prudent credit extension practices;
(c) where collateral is not fully in place;
(d) an account which may deteriorate because of current market conditions affecting the sector or industry;
(e) a renegotiated account which is up-to-date in repayments and adequately secured for a minimum of one year after rescheduling and during which period there would have been no inherent weaknesses affecting repayment;
(f) for a loan or an account with fixed repayment dates when
(i) the principal or interest is due and unpaid for 1 month to less than 3 months; or
(ii) the interest charges for 1 to 2 months have been capitalised, refinanced or rolled-over;
(g) for an overdraft or an account without fixed repayment dates when
(i) the approved limit has been exceeded for 1 month to less than 3 months; or
(iii) the credit line has expired for 1 month to less than 3 months; or
(iv) the interest charge for 1 to 2 months has not been covered by deposits; or
(iii) the account had turnovers which did not conform to the business cycle.
(7) "Substandard" includes any one or more of the following
(a) where there are well-defined credit weaknesses, such as, shortfalls in the borrowers cash flow and several renewals with capitalisation of interest;
(b) where the primary source of repayment is insufficient to service the debt and the financial institution may have to look at secondary sources, such as collateral or refinancing, for repayment;
(c) the well-secured portion of a loan or an overdraft which may otherwise have been classified as doubtful or loss;
(d) for a loan or an account with fixed repayment dates when
(i) the principal or interest is due and unpaid for 3 months to less than 6 months; or
(ii) the interest charges for 3 to 5 months have been capitalised, refinanced or rolled-over.
(e) for an overdraft or an account without fixed repayment dates when -
(i) the approved limit has been exceeded for 3 months to less than 6 months; or
(ii) the credit line has expired for 3 months to less than 6 months; or

(iii) the interest charges for 3 months to 5 months have not been covered by deposits; or
(iv) the account has developed a hardcore which was not converted into a term loan after 3 months to less than 6 months.
(8) "Doubtful" includes any one or more of the following
(a) where the collection of the debt in full is highly questionable or improbable;
(b) where there is the possibility of a loss, but some factors exist which could improve the situation;
(c) the unsecured portion of a loan or an account with fixed repayment dates when
(i) the principal or interest is due and unpaid for 6 months to less than 12 months; or
(v) the interest charges for 6 to 11 months have been capitalised, refinanced or rolled-over.
(d) the unsecured portion of an overdraft or an account without fixed repayment dates when
-(i) the approved limit has been exceeded for 6 months to less than 12 months; or
(iii) the credit line has expired for 6 months to less than 12 months; or
(vi) the interest charges for 6 months to 11 months have not been covered by deposits; or
(vii) the account has developed a hardcore which was not converted into a term loan after 6 months to less than 12 months.
(9) "Loss" includes any one or more of the following
(a) an account considered uncollectible;
(b) an account which may have some recovery value but it is not considered practical nor desirable to defer write off;
(c) an account classified as doubtful with little or no improvement over the 12-month period it has been classified as such;
(d) the unsecured portion of a loan or an account with fixed repayment dates when -
(i) the principal or interest is due and unpaid for 12 months or more; or
(ii) the interest charges for 12 months or more have been capitalised, refinanced or rolled-over
(e) the unsecured portion of an overdraft or an account without fixed repayment dates when
(i) the approved limit has been exceeded for 12 months or more; or
(ii) the credit line has expired for 12 months or more; or
(iv) the interest charges for 12 months or more have not been covered by deposits; or
(v) the account has developed a hardcore which was not converted into a term loan after 12 months or more.

PART V

PROVISIONING REQUIREMENT

Provision for probable loss

19. (1) All financial institutions shall at all times maintain an adequate level of provision for probable losses and failure to do so shall be considered an unsafe and unsound practice as it may result in misstatement of assets, earnings and capital.

(2) The loan portfolio classification exercise referred to in subregulation shall provide a basis for determining this level of provisioning which shall be created through charges to provision expense in the income statement and credited to reserve or allowance for probable losses which is a contra-asset account in the Balance Sheet.

(3) Write-downs, charge-offs and recoveries in the loan portfolio shall only be made to the reserve or allowance for probable losses account and not directly to a capital account such as retained earnings or undivided profits.

(4) Management shall maintain adequate records in support of their evaluations and entries and shall make them available for examination by the Central Bank.

Minimum levels

20. (1) The minimum levels of specific provisioning set out in sub-regulation (4) for each of the classification categories shall be regarded as a minimum.

(2) A general provision equivalent to 1% of gross loan portfolio shall likewise be maintained.

(3) Where the Central Bank is of opinion that losses are likely to be more than these minimum percentages, the Central Bank may require a financial institution to provide a higher amount against estimated credit losses.

(4) The minimum levels of required provisioning are as follows:-

(a) Specific Provision Level of Provision

(i) Pass 0%

(ii) Special Mention 10%

(iii) Substandard 20%

(iv) Doubtful 50%

(v) Loss 100%

(b) General Provision 1%

(3) For groups of homogenous loans of small amounts where it is often not practicable to investigate the credit worthiness of each individual borrower on a regular basis, the provisioning levelshould be determined on a portfolio basis by applying formulae that take into consideration factors such as an analysis of arrears, ageing of balances, past loss experience, current economic conditions and other relevant circumstances.

Net realisable value

21. (1) An underlying collaterals net realisable value which refers to that amount left after deducting from the market value all reasonable and estimable cost of recoveries and sale, shall be considered for the purpose of determining the appropriateness of provision amounts.

(2) For accounts classified as "Special Mention", "Substandard", "Doubtful" or "Loss" the net realisable value of the collateral may be deducted from the

outstanding balance before applying the provisioning percentages.
(3) Collateral in the form of hold-outs on deposits or other funds with the financial institution may be deducted in full.
Deduction from provision
22. (1) The net realisable value of real estate held as collateral may be allowed to be deducted before applying the provisioning percentages only where there is a fully perfected lien and when there is an active market for such property.
(2) The net realisable value to be deducted shall be based on an appropriate appraisal or other documentation of verifiable value.
Guarantee
23. For a guarantee to be deductible it shall be affirmed, irrevocable and unconditional and shall be issued by-
(a) the Government of Lesotho;
(b) a bank rated not lower than the three highest grades by an internationally recognised bank rating agency; or
(c) a third party who has pledged notes, bonds, treasury bills, and other similar debt instruments issued by the Government of Lesotho and which are in the possession of the lending financial institution.

PART VI

OTHER REQUIREMENTS

Overdraft facilities
24. (1) The hardcore of an overdraft facility shall be converted into a term loan which specifies a fixed repayment programme.
(2) To facilitate review of overdraft facilities, a financial institution shall maintain an analysis sheet for each account showing monthly balances and a summary of movements indicating the total amount and number of deposits and withdrawals, and the accruals and repayments of interest charges.
Restructured loan
25. A restructured loan is a loan which has been refinanced, rescheduled, rolled-over, or otherwise modified because of weaknesses in the borrowers financial position or the non-payment of the debt as arranged and shall be subject to the following conditions
(a) the existing financial position of the borrower can service the debt under the new conditions;
(b) an account classified as doubtful or loss shall not be restructured unless an up-front cash payment is made to cover, at the least, unpaid interest, or there is an improvement in the collateral taken which will make the restructured account, including unpaid interest, a well-secured account;
(c) a commercial loan shall not be restructured more than twice over the life of the original loan; a mortgage or personal loan not more than twice in a five-year period;
(d) a restructured loan shall not be reclassified upward for a minimum of one year following the new arrangements; and

(e) a restructured loan shall not be restored to accrual status unless there is evidence of a relative improvement in the borrowers condition and debt service capacity and only after a one year period of sustained payment performance.

Write-offs

26. (1) An account shall be written-off 3 months after being classified as a "Loss" unless it shows a definite and significant improvement which indicates recovery within the next 6 months.

(2) A record of bad debts written-off shall be maintained in a memorandum account for monitoring purposes.

PART VI

SUPERVISORY ACTION

Failure to comply

27. If a financial institution fails to comply with these Regulations in a flagrant manner which results or threatens to result in an unsafe and unsound financial condition, the Central Bank may pursue any remedial measures at its disposal, including requiring the financial institution to take any or all of the following measures

(a) require the infusion of additional capital to absorb probable losses in the loan portfolio;

(b) suspend lending, investment or other credit extension operations;

(c) restrict declaration or payment of dividends or remittance of profits;

(d) stop establishment of new branches or facilities; and

(e) prohibit payment of bonuses, salary incentives, management fees or other discretionary compensation to directors or officers.

S. M. SWARAY

GOVERNOR- CENTRAL BANK OF LESOTHO

NOTE

1. Act No. 3 of 1999