Clarification and Guidelines Manual for Circular 28/2010

(Regulation for Classification of Loans and their Provisions)

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Introduction

The Central Bank of the United Arab Emirates has issued Circular No 28/2010 regarding loan classification and provisioning on 11 November 2010. The circular provides that the Banking Supervision and Examination Department will issue a manual to clarify how banks and financial institution should apply the terms of the above mentioned circular. In addition, we have received correspondence from a number of banks outlining various implementation issues and seeking further clarification.

In this context we are providing this manual to assist banks in applying the requirements of Circular No 28/2010 'Regulation for the Classification of Loans and their Provisions'.

1. Specific Provisions

The aggregate amount of specific provisions including interest in suspense should be adequate to absorb estimated credit losses for individually identified credit exposures.

The Central Bank of the U.A.E. will regularly review the position of individually identified and classified loans and the level of specific and general provisions held by each institution. It will discuss any concerns with the institution's senior management as well as the institution's external auditors and may formally direct that institution to make additional provisions where it considers that provisions held are inadequate in relation to the circumstances of that institution.

1.1 Classification of loans

Loans should be classified within levels 1 to 5 according to their conditions and the banks own assessment (see the table in 2 below). The onus will be on the bank to justify their assessment to the Central Bank's satisfaction. This requirement applies to all loans and advances.

The classification described in the circular does not preclude banks from developing their own more granular grading system which in all cases should be clearly mapped to the 5 categories below.

1.2 Determining provisioning amounts and collateral value

The circular specifies the following **minimum** provisions for **all** loans.

Classification	Criteria	Provision
Normal	All information available assures repayment as agreed	General Provision.
Watch-list	Some weakness in the borrower's financial position and credit	General Provision.

	worthiness that requires more than normal attention.	
Sub -standard loans	Payment of principal is in arrears beyond 90 days or some loss is possible due to adverse factors.	Specific Provision Minimum 25% of the net exposure amount
Doubtful loans	Full recovery seems doubtful based on the available information, leading to a loss or part of these loans.	Specific Provision Minimum 50% of the net exposure amount
Loss loans	Possibility of no recovery at all after the bank has exhausted all available courses of action	Specific Provision Minimum 100% of the net exposure amount

It should be noted that for corporate and commercial loans doubtful and loss categories should be determined on a principle basis and not necessarily on a rule, such as number of days delinquent. Provisions for retail exposures should be fully rule based.

1.3 Commercial and corporate facilities

For commercial and corporate facilities, the bank is required to use the above classification unless it can demonstrate, based on evidence and sound judgment, that the listed criteria for a specific facility is not the best indication of impairment. In this case, the bank can classify the loan to an alternate category (higher or lower).

This process needs to be well documented, based on the bank's board approved internal provisioning policy and follow a clear decision making criteria. Particular attention will be paid to restructured facilities or those where outstanding interest has been capitalized. The evidence should be presented to the Central Bank upon request.

If in doubt over the classification of a particular facility, please do not hesitate to contact your Supervisor at the Central Bank.

1.4 Retail and consumer loans

Specific provision percentages based on the number of days past due has to be followed for retail lending categories (including residential mortgages) as per the below table:

Days past due	**Personal Consumer Loan**	**Car Loans**	**Credit Card Loans**	**Residential Mortgages**
90 - 120 days(inclusive)	At least 25 %	At least 25 %	At least 25 %	At least 25 %
120 – 180 days (inclusive)	At least 50 %	At least 50 %	At least 50 %	At least 50 %
Over180 days	At least 100 %	At least 100 %	At least 100 %	At least 100 %

Note: the percentages in the table are of the net exposure amount (defined below)

1.5 Past due definition

Loans are considered past due if any part of the contractual interest and/or principal payment is not met on time. The number of days past due is non cumulative, where the most recent payment cures the earliest contractual breach.

For example if repayments are agreed to be made monthly, and the customer is 30 days late in making the repayment, his next repayment should cover 60 days to cure the arrears. However, If the customer only makes one month payment, the customer cures the past month arrears (30 days) but falls in arrears for the new month (i.e. in arrears for 1 day).

1.6 Calculation of provision and collateral value

The minimum specific provisions for all loans should be calculated by multiplying the percentages provided in the above table by the net exposure amount. The net exposure amount is defined as the outstanding loan balance less the net realizable value of the collateral held. The collateral should be multiplied by the following discount factors to arrive at the net realizable value.

Collateral type	**Discount factor**	**Conditions**
Cash (or cash equivalent)	100%	Provided it is under legal right of set off
Federal Government (security or guarantee)	100%	
Local Government (security or guarantee)	100%	
Foreign sovereign government bonds rated BBB – or above	100%	
UAE licensed Bank (security or guarantee)	100%	
Foreign bank rated AA - or above (security or guarantee)	100%	
Foreign bank rated BBB- but below AA - (security or guarantee)	80%	
Listed Shares on a recognized stock exchange	70%	The previous 3 months average closing price should be used. Should be traded on a deep liquid and market.
Bonds or guarantees from corporations rated above BBB-	70%	The previous 3 months average closing price should be used. Should be traded on a deep and liquid market.
Residential Real Estate	70%	Valuation should be not more than 6 months old.

		The bank should have a registered first mortgage over the property. The bank has legal certainty over its ability to take control of security in a reasonable time frame. Interest should be immediately suspended where the time frame for taking over the security is uncertain and is expected to exceed 1 year.
Commercial Real Estate	50%	Valuation should be not more than 6 months old. The bank should have a registered first mortgage over the property. The bank has legal certainty over its ability to take control of security in a reasonable time frame. Interest should be immediately suspended where the time frame for taking over the security is uncertain and is expected to exceed 1 year
All other banks bonds or guarantees	50%	
Cars, Boats, Machinery and other movables	50%	Valuations should not be more than 3 months old The bank should have a legal and enforceable charge over the item
All other corporate bonds or guarantees (not including cross or personal guarantees)	40%	

Where the net collateral value exceeds the outstanding loan amount, the bank is not required to take any provisions. However, the bank is required to continually assess the need to raise a specific provision and raise one should the situation change (e.g. outstanding loan amount exceeds the net realizable collateral or the collateral value deteriorates).

1.7 Interest suspension on past due loans

It is a requirement under the circular that interest on loans that have been provisioned or loans where the interest is over due for 90 days or longer should be debited to the loan account and credited to a suspense account and not to the profit and loss account and this remains the default position. Any deviation from this must be substantiated by the bank to the satisfaction of the Central Bank.

The bank, however, can still take the interest to the profit and loss account where the net realizable value of collateral continues to exceed the outstanding balance of the loan. This assessment should be made at least quarterly. In any case, interest cannot be capitalized past 12 months overdue irrespective of the net realizable value of collateral. Any cash payments made by the customer can also be recognized in Profit and Loss Account only after the overdue principal amount has been satisfied.

Interest suspense account should be clearly documented with clear audit trails showing interest movement. The account will be examined by the Central Bank.

1.8 Interest suspension on overdraft facilities

Circular No 28/2010 highlights at least three situations where interest should be suspended on overdrafts. These are:

A – Where there is doubt regarding payment of interest and/or it has not been paid after 90 days of due date.

In this case a specific provision should be raised and interest suspended unless, as described in (1.7) above, the net realizable collateral value continues to exceed outstanding balance of the facility.

B – When due interest on other accounts of the same customer (or group) other than the overdraft account has been suspended.

Where interest is suspended on an account of a related entity or a member of the same group of entities, the default position is to suspend interest on all group accounts unless the outstanding balance is well covered by the net realizable collateral.

However, the bank can continue to credit the interest on over draft facility to the profit and loss account. Where: -

- The bank believes that there is low correlation between the entity and other group member(s) that have interest suspended, and
- All other facilities of the entity are in good standing,
- There is no guarantee between the borrower and the defaulted entity,

In this case, all group facilities that are not 90 day past due should be migrated to the “watch list” category.

C – When the outstanding balance is consistently in excess of the agreed upon limit or when the account is in debit although there is no sanctioned facility.

“Consistently” is defined as a period that exceeds 60 continuous days or a total of 60 days in any 6 months period.

2. General Provisions

These provisions are calculated as 1.5% multiplied by the ‘normal’ and ‘watch list’ Credit Risk Weighted Assets (CRWA). CRWA should be calculated using the Basel II standardized approach.

By definition all exposures receiving 0% Risk Weight are excluded from General Provisions.

2.1 Build up of the General Provision

The Circular allows banks a period of 4 years to reach the minimum general provisions prescribed as 1.5% of CRWA. It is our expectation that banks build up the deficiency in their General Provisions in equal installments over the 4 year period. Banks are encouraged to achieve the minimum requirement of General Provisions in a shorter duration if possible.

No bank is allowed to fall below its current level of General Provisioning during the 4 years transition period unless its general provisions exceeds the minimum requirement of 1.5% of CRWA.

The Central Bank will be assessing the progress towards building up the general provisions by the banks and will issue individual guidance to banks if required.

3. Provisioning for Off Balance sheet items

Some off balance sheet exposures such as bank guarantees, letters of credit, irrevocable commitments to lend and unused overdraft limits should be treated as impaired and adequate provisions raised against them if the bank believes it is likely they will be called upon and the financial position of the customer has deteriorated.

In this case the exposures should be converted to on balance sheet using 100% credit conversion factor (CCF) then assigned to the one of the three defaulted categories (3 to 5) as mentioned in 1 and 2 above and specific provision allocated against as appropriate.

Where the off balance sheet exposure is in the form of a derivative contract and there is doubt that all contractual future cash flows will be received from the counterparty, the bank should assess the net marked to market exposure to the counterparty taking into account any enforceable netting arrangements in place. The net position (if due from) should then be converted to on balance sheet asset using 100% CCF and assigned to one of the three defaulted categories (3 to 5) as mentioned in 1 and 2 above and specific provision allocated as appropriate.

Please note that under Basel II, all off balance sheet exposures are converted to on balance sheet exposures using Credit Conversion Factors “CCF” and Risk Weights are then assigned in order to arrive at the Credit Risk Weighted Assets which are then multiplied by 1.5% to arrive at the General provision.

4. Share values and investment values

The circular requires the use of the International Accounting Standard in recognizing losses or a decline in the value of the investment asset.

In particular IAS 39 requires the bank to recognize losses either directly through P&L (Fair value option) or periodically asses the asset for impairment depending on the initial designation of the asset.

If uncertain, please discus with your external auditor the accounting treatment applied to the specific assets.

5. Write backs of provisions and reclassification of loans

A loan can be reclassified to a higher category and the specific provision reversed if the arrears have been fully satisfied and the bank has sufficient information to indicate that the borrower is able to deliver on his contractual obligations going forward.

The reclassified loan should be initially assigned to the watch list category for a period of at least 12 months and be subject to close monitoring. The expectation is that banks will immediately downgrade the loan and raise appropriate provisions if early signs of deterioration reappear.

Where the bank has agreed to restructure a facility, the facility should only be upgraded after the new arrangement has been fully adhered to by the customer for at least 90 days and should remain on the watch list for at least a 12 months period.

After at least 90 days, the difference between the present value of the original facility and the present value of the restructured facility should be written off against the provision assigned. The remainder of the provision can then be released with the appropriate approval from the relevant internal credit committee.

6. Write-Off Loans and Advances

All credit policies should adequately detail the write-off procedures and periodical review of written off loans in order to minimize potential abuse. The ultimate authority for approval of write-offs rests with the board of directors or any designated body duly formed by the board of directors (National Banks may refer to Circular No. 23/2000 dated 22/07/2000 – Required Administrative Structure in Banks).A memoranda accounts should be maintained for written off loans. All recoveries made from the accounts earlier written off should be credited to the income account. A summarized record of such recoveries should be maintained for Central Bank’s examiner’s review.

7. Frequency of Review and Internal Reporting

The management of each institution shall ensure that a review of its loan portfolio is made at least on quarterly basis and a complete report is provided to the relevant committee. Such reports shall provide sufficient information that will enable the committee to deliberate and direct management to take timely and necessary remedial action within a specified time frame.

8. Supervisory Reporting Requirements

- The institution shall submit to the Central Bank on monthly basis the following statements as per the attached Forms:

- Classification of loans and advances and provisioning and movement in provisions and interest in suspense
- Classification of loans and advances by economic activity
- Classification of loans and advances by segments
- Statement of overdue and rescheduled loans and advances and performing and non-performing loans and advances
- Security wise distribution of loans and advances