



RESERVE BANK OF MALAWI

**DIRECTIVE**  
**NO.DO1-06/ASCL**

**ASSET CLASSIFICATION**

**Arrangement of Sections**

**PART I**  
**Preliminary**

SECTION

1. Short Title
2. Authorization
3. Application
4. Interpretations

**PART II**  
**Statement of Policy**

SECTION

1. Objectives
2. Rationale

**PART III**  
**Requirements**

SECTION

1. Asset Classification Policy
2. Classification of Credits
3. Classification of Credits other than Credits
4. Income Recognition
5. Loss Recognition
6. Acquisition of Assets in lieu of Repayments of Credits

**PART IV**  
**Restrictions**

**PART V**

**Supplemental Policy Statements**

**PART VI**

**Remedial Measures and Administrative Sanctions**

SECTION

1. Remedial Measures
2. Administrative Sanctions

**PART VII**

**Reporting**

PART VIII

**Effective Date & Supersedence**

## ASSET CLASSIFICATION

### PART 1: SHORT TITLE, AUTHORISATION, APPLICATION AND INTERPRETATION

#### Sec 1. Short Title- Asset Classification

#### Sec 2 Authorization

This Directive is issued by the Reserve Bank of Malaŵi pursuant to the authority granted in Sections 16(a)-(c), 21(1), and 26 of the Banking Act, 1989.

#### Sec 3 Application

This Directive applies to all banks and other financial institutions licensed under the Banking Act, 1989 (“licensed institutions”).

#### Sec 4 Interpretations : in this Directive unless the context otherwise require:

4.1 **‘Adversely Classified Credits (or Assets)’** means those credits or other assets which are classified as Substandard, Doubtful, or Loss in accordance with Section II.2. of this directive.

4.2 **‘Book Value’** means the value of an asset as stated on the books of account of the licensed institution; the amount of an investment less any specific and general provisions for loss.

#### 4.3 Classification Categories -

4.3.1. **Standard** – Unless one of the following definitions applies, an asset is Standard if: (a) it is current; (b) the obligor is complying, and is expected to continue to comply, with all terms of the contract; and (c) there is no reason to believe that the licensed institution is now, or will be, subject to risk of loss.

4.3.2. **Special Mention** – An asset should be classified as Special Mention if potential weaknesses exist in the obligor’s financial position and/or the collateral pledged. Assets which are Special Mention require the close attention of management, because if left unaddressed or uncorrected, these potential weaknesses could result in the deterioration of the repayment prospects for the asset or the future position of the licensed institution.

4.3.3. **Substandard** – An asset should be classified as Substandard if the asset has one or more well-defined weaknesses that make the full collection of principal and interest questionable: (a) the obligor’s financial condition, including net worth and/or repayment capacity, is unfavorable and is deteriorating; (b) the pledged collateral, if any, is insufficient or is deteriorating; (c) other adverse factors exist which cause concern regarding the ability of the obligor to repay the credit in accordance with

the existing repayment terms; and/or (d) an actual breach of contract has occurred. At a minimum, credits that are 90 days or more past-due shall be classified as Substandard.

Assets classified as Substandard require management's active attention because there is a distinct possibility that the licensed institution will sustain some loss if the deficiencies are not corrected. While losses will be realized in the portfolio of assets classified as Substandard, a loss will not necessarily be realized in each individual asset so classified.

4.3.4. **Doubtful** – An asset shall be classified as Doubtful when weaknesses exist which make collection or repayment in full highly questionable and improbable based upon currently existing circumstances, conditions, and the “estimated recoverable amount” of the pledged collateral, if any. The possibility of loss is very high; however, because of certain important and reasonably specific pending circumstances which could strengthen the asset, classification of the asset as Loss is deferred until its more exact status is determined. At a minimum, credits that are 180 days or more past-due shall be classified as Doubtful.

4.3.5. **Loss** – At the time of classification, the asset is deemed uncollectible and of such little value that it should not be included on the books of account and financial statements of the licensed institution. The classification of an asset as Loss does not mean that the asset has no recovery or salvage value, but that the licensed institution should not defer writing off this basically worthless asset even though at least part of the value could be recovered in the future. Such classification does not cancel the obligor's obligation to repay, nor does it mean that the licensed institution should not continue to exercise its full legal right to collection or payment. At a minimum, credits that are one year or more past-due shall be classified as Loss.

4.4 **‘Credit Facility or Credit’** means any asset or off-balance-sheet item that contains credit risk, including loans, overdrafts, advances and all of the following as listed in Section 2 of the Banking Act 1989: financing by means of factoring, leasing, hire purchase, accepting of trade and other bills, discounting of such bills and notes, the opening or confirming of documentary credit, the issue of other letters of standby, credit, guarantee or surety, the undertaking to pay on account of another person, and such other similar undertakings as may be prescribed from time to time.

4.5 **‘Estimated Recoverable Amount’** means the amount that the licensed institution reasonably expects to recover on an asset. The following three methods may be used to determine the estimated recoverable amount of an asset:

4.5.1. The present value of expected future cash flows discounted at the effective interest rate in the original credit or other contract, or other appropriate interest rate. The estimates of future cash flows should be based on reasonable and supportable assumptions. This method is appropriate in cases where the time value of money is material.

- 4.5.2. The “fair value” of the pledged collateral in cases where the repayment or collection of the asset is expected to be provided solely by the underlying collateral, less estimated costs to sell the collateral.
- 3.5.3. The observable market price, in cases where there is a developed and reasonably active market for the asset and if otherwise deemed to be a reliable indicator of the amount that the licensed institution expects to recover.
- 4.6** **‘Fair Value’** means the amount for which an asset could be exchanged between knowledgeable and willing parties in an arm’s-length transaction. A transaction is considered to be at arm’s-length if it is not on friendly or favorable terms.
- 4.7** **‘Home Country Supervisor’** means the competent authority that supervises banking business in the country in which the head office of a foreign bank is located.
- 4.8** **‘Licensed Institution’** means a bank or other financial institution holding a valid license, issued by the Reserve Bank, authorizing it to engage in deposit-taking business in Malaŵi.
- 4.9.** **‘Net Unsecured Credit Balance’** means the outstanding principal balance of a credit less the following:
- 4.9.1. The “fair value” of the following eligible collateral provided, however, that the licensed institution’s interest is fully enforceable:
- 4.9.1.1. Cash;
- 4.9.1.2. Cash deposits placed with the licensed institution;
- 4.9.1.3. Gold; or
- 4.9.1.4. Debt securities issued by: (1) The Government of Malawi; (2) A government of a member country of the Organization of Economic Cooperation and Development (“OECD”); or (3) A government of a country with a current “consensus country risk classification” of 1 or 2, as published by the OECD for Export Credit Agencies participating in its “Arrangement on Guidelines for Officially Supported Export Credits.”
- 4.9.2. The amount of an eligible guarantee issued by:
- 4.9.2.1. The Government of Malawi;
- 4.9.2.2. A government of a member country of the Organization of Economic Cooperation and Development (“OECD”);
- 4.9.2.3. A government of a country with a current “consensus country risk classification” of 1 or 2, as published by the OECD for Export Credit Agencies participating in its “Arrangement on Guidelines for Officially Supported Export Credits;” or
- 4.9.2.4. An international bank with an external credit assessment of AAA to AA- issued by an external credit assessment institution acceptable to the Reserve Bank.

- 4.9.3. In order to be eligible, the guarantee must:
- 4.9.3.1. Represent a direct claim on the guarantor;
  - 4.9.3.2. Be denominated in the same, domestic currency the same as the credit or a strong convertible currency.
  - 4.9.3.3. Clearly and incontrovertibly define the extent of the guarantee's cover of a specific credit;
  - 4.9.3.4. Be irrevocable and non-cancelable by the guarantor, except for non-payment of the credit protection contract;
  - 4.9.3.5. Have no clause in the contract that would allow the guarantor unilaterally to cancel the guarantee, increase the effective cost of the guarantee, or delay payment under the guarantee for any reason including the need to be funded in the budget;
  - 4.9.3.6. Have as the only condition for its enforcement the obligor's failure to meet his/her obligation to the licensed institution; and
  - 4.9.3.7. Be executed so that neither the guarantor nor any other person is in a position to challenge the legal rights of the licensed institution in calling the guarantee.
- 4.10.** **'Reserve Bank'** means the Reserve Bank of Malaŵi established under the reserve Bank of Malaŵi Act, 1989.
- 4.11.** **'Value-Impaired Asset'** means an asset is considered to be value-impaired when it is probable that the licensed institution will be unable to collect, or there is no longer reasonable assurance that the licensed institution will collect, all amounts due under the contractual terms of the asset.
- 4.12.** **'Well-Secured'** means a credit facility that has sufficient collateral to protect the licensed institution from loss, specifically:
- 4.12.1. All documentation is binding on all parties and is legally enforceable as determined by sufficient legal review by the bank to verify this legal certainty;
  - 4.12.2. The bank has the right to liquidate or take legal possession of the collateral in a timely manner in the event of default, insolvency or bankruptcy;
  - 4.12.3. The bank has taken all necessary steps to perfect and maintain the bank's security interest in the collateral; and
  - 4.12.4. The "estimated recoverable amount" of the collateral exceeds the amount of the credit exposure including the costs of liquidation.

## **PART II: STATEMENT OF POLICY**

### **Sec. 1: Objectives**

- 1.1 To ensure that banks are in proper compliance with capital adequacy requirements as called for in Section 16 of the Banking Act of 1989, especially: sub-section a) valuation of assets, b) depreciation of assets, and c) provision for bad and doubtful debts;

- 1.2 To ensure banks are quantitatively identifying their non-performing credit facilities in line with internationally recommended asset classification and provisioning standards;
- 1.3 To ensure banks present balance sheets and income statements that properly reflect the financial impact of non-performing credit facilities.

## **Sec. 2: Rationale**

- 2.1 Banks need to, in an accounting sense, recognize problem assets using a quantitative definition of non-performing and then properly treat such assets with regard to accrual of interest, classification according to ultimate collectibility, and to make adequate provisions based on such classification;
- 2.2 The recognition of such non-performing assets stimulates collection efforts and thus helps reduce the possibility of loss on such assets;
- 2.3 Supervisory authorities worldwide have recognized that their effectiveness is dependent on the integrity of balance sheets and income statements resulting from proper identification and accounting treatment of non-performing assets; failure to set such standards can lead to fictitious profits and misleading balance sheets to the supervisory authority and other interested parties.

## **PART III REQUIREMENTS**

### **Sec 1: Asset Classification Policy**

- 1.1. The board of directors of each licensed institution shall adopt, and ensure implementation of, a written policy covering the classification of assets and establishment of adequate provisions for loss which shall comply with this directive.
- 1.2. Each licensed institution shall have written procedures to ensure consistent compliance with the approved policy on asset classification which, at a minimum, shall include the following:
  - 1.2.1. An analytical framework for assessing credit quality;
  - 1.2.2. Estimates based on reasonable and supportable assumptions; and
  - 1.2.3. Realistic and conservative assumptions concerning the impact on obligors of potential future changes in general economic conditions.
- 1.3. The asset classification policy shall be reviewed and approved by the board of directors on at least an annual basis.

### **Sec 2: Classification of Credits**

All credits shall be reviewed for purposes of classification on at least a quarterly basis. Reviews should be performed in a systematic way and in accordance with

the licensed institution's written policies and procedures. Each "large exposure" shall be reviewed on an individual item basis. Based on the review, each credit shall be included into one of the classification categories of Section I.3.3 of this directive. In the event that a credit may be classified differently based on these criteria, the more severe classification shall be applied. All value-impaired credits must be adversely classified. If, between formal quarterly reviews, the licensed institution gains knowledge of a significant deterioration in the quality of an individual credit or in a material part of the credit portfolio, the credit(s) must promptly be assigned to a new classification category that accurately reflects the status of the credit(s).

**Sec 3: Classification of Assets other than Credits**

All assets other than credits shall be reviewed on at least quarterly basis for purposes of asset classification and for determining whether any asset has suffered a decline in, or impairment to, value that is not expected to be temporary. Assessments should be performed in a systematic way and in accordance with written policies and procedures. When a licensed institution adds an asset to its books of account or moves an asset to a different account, the licensed institution must ensure that the quality and condition of that asset is being accurately reflected. If, between formal quarterly reviews, the licensed institution obtains new information or otherwise determines that the quality or condition of an asset has changed, then the asset must promptly and accurately be assigned to a new classification category.

**Sec 4: Income Recognition**

- 4.1. All value-impaired assets, including assets that are adversely-classified and assets that are 90 days or more past-due, shall be promptly placed on non-accrual status:
  - 4.1.1. The licensed institution shall cease reflecting in its net income the accrual of interest;
  - 4.1.2. Uncollected interest which has previously been accrued shall be reversed; and
  - 4.1.3. Interest shall no longer be accounted for as income except as received in cash.
- 4.2. The decision to place an asset on non-accrual status shall be made regardless of any collateral held against it.
- 4.3. An asset which has been placed on non-accrual status shall only be restored to accrual status when the contractual amount of principal and interest is deemed to be fully collectible in accordance with the terms of the contract by one of the following methods:
  - 4.3.1. The obligor has made all payments of past-due principal and interest, the principal and interest payments are now current and not past-due, and the

licensed institution expects repayment of the remaining contractual principal and interest as scheduled in the contract;

- 4.3.2. The obligor has resumed paying the full amount of the scheduled contractual principal and interest payments for at least six months, and all remaining contractual payments (including compensation for past-due payments) are deemed to be collectible in a timely manner; or
- 4.4. The determination to restore an asset to accrual status pursuant to Section 4.3 must be supported by a current, written, and well-documented evaluation of the obligor's financial condition and other factors affecting the prospects for repayment, including the obligor's repayment performance.

## Sec 5: Loss Recognition

### 5.1. Credits

- 5.1.1. At the time of credit classification, impairment to the value of a credit shall be recognized by reducing the book value of the credit through the provision for loan loss or by charging off the credit, and in both cases charging the income statement in the period in which the impairment occurs.
- 5.1.2. The licensed institution shall determine the amount of the provision for loan loss using the Standard Percentages Method and the decision to establish provisions against non performing assets shall be made regardless of collateral held.

#### 5.1.2.1. *Standard Percentage Method*

The minimum required amount for the specific provision for loan loss shall be determined by applying the following percentages to the sum of the classified credit balances in each classification category.

#### Specific Provisions:

Special Mention	10 %
Substandard	20 %
Doubtful	50 %
Loss	100 %

General Provision	
Standard	1%

A general provision of at least 1% shall be made on outstanding credit balances less specific provision and interest in suspense.

### 5.1.2.2. *Estimated Recoverable Amount Method*

Alternatively, upon prior written approval of the Reserve Bank and in accordance with the licensed institution's established policy, the licensed institution may include in the provision for loss the difference between the current book value of the asset and its "estimated recoverable amount." Once a licensed institution has adopted the Estimated Recoverable Amount Method (with the prior written approval of the Reserve Bank), it may not revert back to the Standard Percentages Method except with the prior written approval of the Reserve Bank for good cause shown.

- 5.1.3. The aggregate amount of the provision for loss must be adequate to absorb estimated losses associated with the entire asset portfolio.

## 5.2. Assets other than Credits

In the event of an impairment to the book value of a non-credit asset that is not expected to be temporary, the book value of the asset shall be reduced to its "estimated recoverable amount," and the loss in value shall be recognized as an expense and charged against income in the current period. The new book value should not be changed for any future recovery in value.

## **Sec 6: Acquisition of Assets in Lieu of Repayment of Credits**

If a licensed institution acquires an asset in lieu of repayment of a credit, then the book value of the asset acquired shall be the lower of the net unpaid principal balance of the credit or the "estimated recoverable amount" of the asset acquired. If the "estimated recoverable amount" of the asset acquired is less than the book value of the credit, then the difference should be charged off through the provision for loan loss when the asset is added to the book of accounts.

## **PART IV RESTRICTIONS**

1. A licensed institution shall not renegotiate, roll-over, or modify the terms of a credit in order to avoid an adverse classification.
2. A licensed institution shall not advance additional funds to enable an obligor to meet existing payment obligations to the licensed institution.

## **PART V SUPPLEMENTAL POLICY STATEMENTS**

The Reserve Bank's policy regarding the proper classification of assets in certain special instances is included in an Annex to this directive. From time to time, the Reserve Bank may issue additional policy statements in order to elaborate proper classification of assets in certain special circumstances.

## **PART VI REMEDIAL MEASURES AND ADMINISTRATIVE SANCTIONS**

### **Sec. 1: Remedial Measures**

- 1) When the Reserve Bank determines that a bank is not in compliance with this directive, it may impose remedial measures as specified under Section 31 of the Banking Act, 1989.
- 2) When the Reserve Bank determines that a bank's non-compliance with this directive has resulted in such undue risk that its capital is impaired or solvency is otherwise threatened, it may petition the High Court to sanction procedures as called for under Section 32 of the Banking Act, 1989.

### **Sec. 2: Administrative Sanctions**

In addition to the remedial measures available to it as given above in Part IV Section 1, the Reserve Bank may impose any or all of the following administrative sanctions with regards to a bank that fails to comply with this directive:

- 1) Prohibition from declaring and/or paying dividends;
- 2) Suspension of the establishment of new branches and/or expansion into new banking or financial activities;
- 3) Suspension of access to Reserve Bank credit facilities;
- 4) Suspension of lending operations;
- 5) Suspension of the opening of letters of credit;
- 6) Suspension of the acceptance of new deposits;
- 7) Suspension of the acquisition of fixed assets.

## **PART VII REPORTING**

Each licensed institution shall submit to the Reserve Bank a report as of each quarter-end, in the format prescribed by the Reserve Bank, showing the classification of assets in accordance with this directive.

## **PART VIII EFFECTIVE DATE & SUPERSEDEENCE**

### **Sec 1: Effective Date**

The Effective Date of this Directive shall be 13<sup>th</sup> March 2006.

### **Sec 2: Supersedence**

This Directive shall supersede and replace Prudential Guidelines on Asset Quality Directive for Banks of 1993.

**Questions relating to this Directive should be addressed to the Bank Supervision Department of the Reserve Bank of Malawi**

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**Victor Mbewe**  
**GOVERNOR**

**REPORT ON CLASSIFIED ASSETS AND ALLOWANCE FOR LOAN AND LEASE LOSS**

Name of Licensed Institution:

Reserve Bank Identification Number:

Report for Quarter Ended:

**Classified Assets**

<b>Assets</b>	<b>Standard 1 %</b>	<b>Special Mention 10 %</b>	<b>Substandard 20 %</b>	<b>Doubtful 50 %</b>	<b>Loss 100 %</b>	<b>Total</b>
Credit facilities (broken down by sector)						
Securities						
Other Real Estate Owned						
Other Assets						
Total						
Provisioning for Loan Loss						

**Past-Due and Non-Accrual Assets**

Report the principal amount of each asset.

<b>Assets</b>	<b>(1) Past-Due 30 – 90 days (memo item)</b>	<b>(2) Past-Due 90-179 days and non- accrual assets</b>	<b>(3) Past-Due 180-364 days</b>	<b>(4) Past-Due 1 year or more</b>	<b>(5) Total past- due and non-accrual [(2)+(3)+(4)]</b>
Credit Facilities (by sector)					
Other Assets (by type)					
Total					

**Charge-offs and Recoveries**

<b>Asset</b>	<b>Charge-Offs</b>	<b>Recoveries</b>
Credit Facilities (by sector)		
Other Assets (by type)		
Total		

**Changes in Allowance for Loan Loss**

	<b>Amount K'000</b>
Balance from previous report	
Recoveries	
Charge-offs	
Current provisions for losses	
Prior period adjustments	
Ending balance	