GUIDELINE NO: 1/2010

(PURSUANT TO SECTION 25 OF THE ISLAMIC BANKING ORDER, 2008)

PROVISION FOR BAD AND DOUBTFUL FINANCING

1. It has been the supervisory experience that there has been no uniform practice observed by the licensed commercial Islamic banks with regard to the classification of advances for provisioning purposes. The objective of these guidelines is to establish a common standard for provisioning for bad and doubtful financing which would be in line with internationally accepted best regulatory practice.

2. These guidelines represent the minimum requirement that the licensed Islamic banks should observe in respect of provisioning for bad and doubtful debts. Any licensed commercial Islamic bank which chooses to adopt a more stringent standard is encouraged to do so.

3. **CLASSIFICATION OF NON-PERFORMING FINANCING (NPFs) FOR PROVISIONING PURPOSES**

3.1. NPFs shall be classified as follows:-

3.1.1. **Substandard Accounts**

Financing facilities of which the situation of the customer makes it uncertain that part, or the entirety of the facility, will be repaid, including those that are in arrears for three months or more, but less than six months, shall be classified substandard accounts. Characteristically, these are advances which involve more than normal risk of loss due to unsatisfactory repayment servicing record or financial condition of the customer, insufficiency of collateral or any other factors which give rise to some doubts as to the ability of the customer to comply with the present repayment terms. Consequently there is also the distinct possibility that the Islamic bank is likely to sustain some loss if these deficiencies are not corrected.

3.1.2. **Doubtful Accounts**

Financing facilities with a high risk of partial default including those that are in arrears for six to twelve months shall be classified as doubtful accounts. Usually these advances are accounts where full collection is improbable and there is a high risk of default.

3.1.3. **Loss Accounts**
Financing facilities where the situation of the customer makes it virtually certain that the facility will not be repaid including those that are in arrears for over twelve months shall be classified as loss accounts. These advances are deemed uncollectible and worthless.

Separate Control Accounts should be maintained for accounts classified in the above categories for identification and reporting purposes.

4. PROVISIONING FOR NPFs

4.1. Provision for classified NPFs shall be provided as follows:-

4.1.1. **Substandard Accounts**
In the case of substandard accounts, when the facility is in arrears for 3 months, the licensed commercial Islamic banks shall make a specific provision to cover the amount of the expected exposure. Such provisioning shall not be less than 20 percent of the amount outstanding, net of profit suspensed in the event such profit has been debited to the financing account. At this stage the value of collateral will not be considered.

4.1.2. **Doubtful Accounts**
In the case of doubtful accounts, when the facility is in arrears for 6-12 months, the licensed commercial Islamic banks shall make a specific provision to cover the amount of the expected exposure. Such provisioning shall not be less than 50 percent of the amount outstanding, net of realisable value of security and profit suspensed in the event such profit has been debited to the financing account.

4.1.3. **Loss Accounts**
In the case of loss accounts, when the facility is in arrears for more than 12 months, the licensed commercial Islamic banks shall make a specific provision equivalent to 100 percent of the amount outstanding net of realisable security value, if any, and profit suspensed in the event such profit has been debited to the financing account.

4.2. Public sector customers should be treated on an equal footing with private sector customers unless the facility extended is supported by a Government Guarantee. Where a facility is guaranteed by the Government, commercial banks, the World Bank, the Asian Development Bank or any other financial institution approved by the Authority, provision should be made only to the extent of the Islamic bank's exposure.

4.3. Financing obtain by a government department which is duly authorized with legal documentation in place which is valid, binding and enforceable and for which a clean legal opinion is available will be treated as a government risk and full value will be given.

5. GENERAL PROVISION FOR BAD & DOUBTFUL FINANCING

5.1. In addition to the specific provisions set out in paragraph 4 above, all licensed commercial Islamic banks are encouraged to maintain a general provision of any percentage of their total financing portfolio as a more prudential measure in the interests of good credit risk management.

6. WRITE-BACK OF SPECIFIC PROVISION

6.1. Write-back of specific provision will be permitted under the following circumstances:-

6.1.1. Where the financing account has been fully settled;

6.1.2. Where the status has changed with the full settlement of arrears, from NPF to current;

6.1.3. Where additional collateral, valued within the provisioning guidelines, has been taken to cover the net exposure of the Islamic bank;

6.1.4. Where there is enhancement in the value of collateral supported by documentary proof and a current valuation.

6.2. Write-back of specific provision is not allowed upon acquisition of properties in satisfaction of financing. The NPF status and the provision made will remain till the properties are actually sold and the sale proceeds applied in liquidation of the NPF.

6.3. The foreclosed properties held in lieu of NPF will be disclosed as such in the financial statements of the bank.

7. BOARD POLICY

7.1. All banks are required to establish a Board-approved policy for:-

7.1.1. Bad financing to be written off;

7.1.2. Financing to be restructured / rescheduled.

7.2. Such a policy should address the number of times a financing may be restructured, have appropriate controls to prevent 'ever-greening' of financing and a comprehensive provisioning policy for restructured financing. The criteria to be satisfied for restructuring/rescheduling should be clearly specified.

8. VALUATION OF SECURITY FOR PROVISIONING PURPOSES

8.1. Primary Mortgage Over Property

8.1.1. The forced sale value (FSV) has to be taken provided that a current professional valuation report on property to that effect is available.

8.1.2. Where court proceedings are not yet instituted, FSV is used. The FSV should be based on the existing use of the land as valued by professional valuers.

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

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

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

8.1.6. At the time of first provisioning for a financing, only 75% of the forced sale value (FSV) of the property based on a current professional valuation report can be considered as the value of security (*i.e.* an initial haircut of 25% will be applied). After 2-3 years a new valuation is required.

8.1.7. When a financing is transferred to the 'Loss' category, the following progressive discounts will apply to the forced sale value of immovable property held as collateral, based on a current professional valuation report, depending on the time period for which it remains in the 'Loss' category:-

(a) **No. of years in 'Loss' category % of FSV of immovable property that can be counted as the value of security:-**

(i) 3-4 years = 60%
(ii) 4-5 years = 50%
(iii) 5 years and above = 40%

(b) All immovable property held as collateral, relating to financing in the 'Loss' category for more than 5 years should be reviewed on a regular basis, and discounted further at the discretion of the management.

(c) **'Current professional valuation report'** means, in respect of financing granted against residential property which is occupied by the customer for residential purposes, a report that is not more than 3 years old.

(d) **'Current professional valuation report'** means, in respect of financing granted for all other purposes, a report that is not more than 2 years old.

8.2. Deposit of Title Deeds with an Undertaking to Mortgage

8.2.1. No value should be assigned until a legal mortgage is executed.

8.3. Assignment Over Life Policies

8.3.1. 90% of the surrender value is to be used provided confirmation of surrender value from the insurer is available and the assignment in the Islamic bank's favour is duly registered.

8.4. **Lien Over Fixed Deposit / Savings Deposit**

8.4.1. Full amount of the deposit may be used provided the depositor has duly signed a lien in the Islamic bank's favour.

8.5. **Assignment of Shares**

8.5.1. **Quoted**

(a) Normally, 90% of the latest market price is to be taken. Appropriate discounts should be considered if the shares are either thinly traded and/or comprise a large block of shares. Premiums may only be considered where there is a valid offer at the highest price as evidenced by a firm commitment, such as, purchase contracts or undertaking letters provided by brokers.

(b) If trading has been suspended (other than temporary suspension), the net realisable tangible asset value, as per the latest audited financial statements (not more than 18 months old). If appropriate financial statements/certificates are not available, no value is to be given. In the case of shares where sales are temporarily suspended, the last quoted price prior to suspension may be used.

8.5.2. **Unquoted**

(a) Value may be given provided the shares are marketable. Appropriate value may be determined on the basis of 75% of the net tangible asset value per share as certified by the company's auditors. A higher valuation may be given only if there is a firm purchase commitment as evidenced by purchase contracts or undertaking letters provided by brokers.

8.6. **Mortgage**

8.6.1. **Mortgage Over Plant, Machinery and Equipment**

(a) In the absence of a professional valuation the net book value calculated by using a 25% depreciation rate on the straight line basis taking into account the date of acquisition and the acquisition price would be applicable.

8.6.2. **Mortgage Over Motor Vehicles;**

(a) **For Consumer Vehicles and Motor Cycles**
In the absence of a professional valuation the net book value calculated by using a 25% depreciation rate in year 1 and 20% on reducing balance subsequently over a period of 5 years, would be applicable.

(b) **For Passenger Cars and Commercial Vehicles**
In the absence of a professional valuation the net book value calculated by using a 25% depreciation rate on the straight line method.

(c) **For Airplanes and Shipping Vessels**
The open market value and forced sale value will be used.

8.7. **Pledge Over Stocks/Goods under the Islamic Bank's Control**

8.7.1. 50% of the market value determined on a case-by-case basis may be applicable.

8.8. **Hypothecation / Mortgage of Stock-in-Trade**

8.8.1. 30% of the current value of stocks provided that the level of stock-in-trade is closely monitored by the Islamic bank.

8.9. **Assignment of Book Debts**

8.9.1. Generally, no value may be assigned unless the Islamic bank is certain and can prove that the debtors are worth the value quoted.

8.10. **Debentures**

8.10.1. No value can be attached unless it is certified by a receiver / liquidator / auditor / professional valuer. Exceptions may be represented on a case-by-case basis.

8.11. Guarantees

8.11.1. Personal

(a) Generally, no value, if such guarantee is unsupported. If supported by security mentioned above, the relevant security valuation base may be applied.

(b) **Licensed Islamic Banks / Islamic Banks Abroad or Any Other Banking Institutions**
Full value.

(c) **Government Guarantee**
Full value.

(d) **Others**
To be considered on a case-by-case basis.

8.12. All Other Securities

8.12.1. To be considered on a case-by-case basis which should be documented in the relevant credit file.

ISLAMIC BANKING ORDER AUTHORITY

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