



# **INSTITUTE OF CHARTERED ACCOUNTANTS OF ZIMBABWE SEMINAR**

**ON**

## **NON-PERFORMING LOANS – Enforcing Strict Compliance to Banking Regulations When Accounting for NPLs**

**Presented by:**

**Reserve Bank of Zimbabwe**

24-Feb-15

**24 February 2015**

# Outline

Introduction

Non-Performing Loans

Impact of Non-performing loans

NPLs status in Zimbabwe

RBZ Loan Classification System

Loan Provisioning Regimes

RBZ Observations on NPLs – Common Pitfalls

RBZ Expectations

# Introduction

- A well functioning banking system is the bedrock of a vibrant economy, as it helps to optimally distribute scarce financial resources among entrepreneurs.
- Disruption of this vital function usually leads to costly losses to the economy, particularly industry and households.
- Despite innovation in financial services sector more than 60% of the banks balance sheet generally relates to credit risk management.
- Therefore, credit risk management lies at the heart of the survival of a vast majority of banks.

# Introduction

- The quality of the bank's loans and advances commonly referred to as Asset quality and the adequacy of loan loss provision remain key issues for bankers and regulators.
- Credit quality inadequacies and their resultant losses have always been one of the primary causes of bank failures.
- Provisioning merits particular attention given its vital role in ensuring safety and soundness of the banking system.

# Non-Performing Loans

- Loans are known as non-performing when the loan ceases to “perform” or generate income for the bank.
- A loan is deemed non performing when the principal, interest or both is due and unpaid for 90 days or more; or interest payments equal to 90 days or more have been capitalized, refinanced or rolled over.
- The RBZ definition of NPLs is in tandem with other regional & international central banks and recommendations from other regulatory bodies such as the IMF and Basel Committee on Banking Supervision.

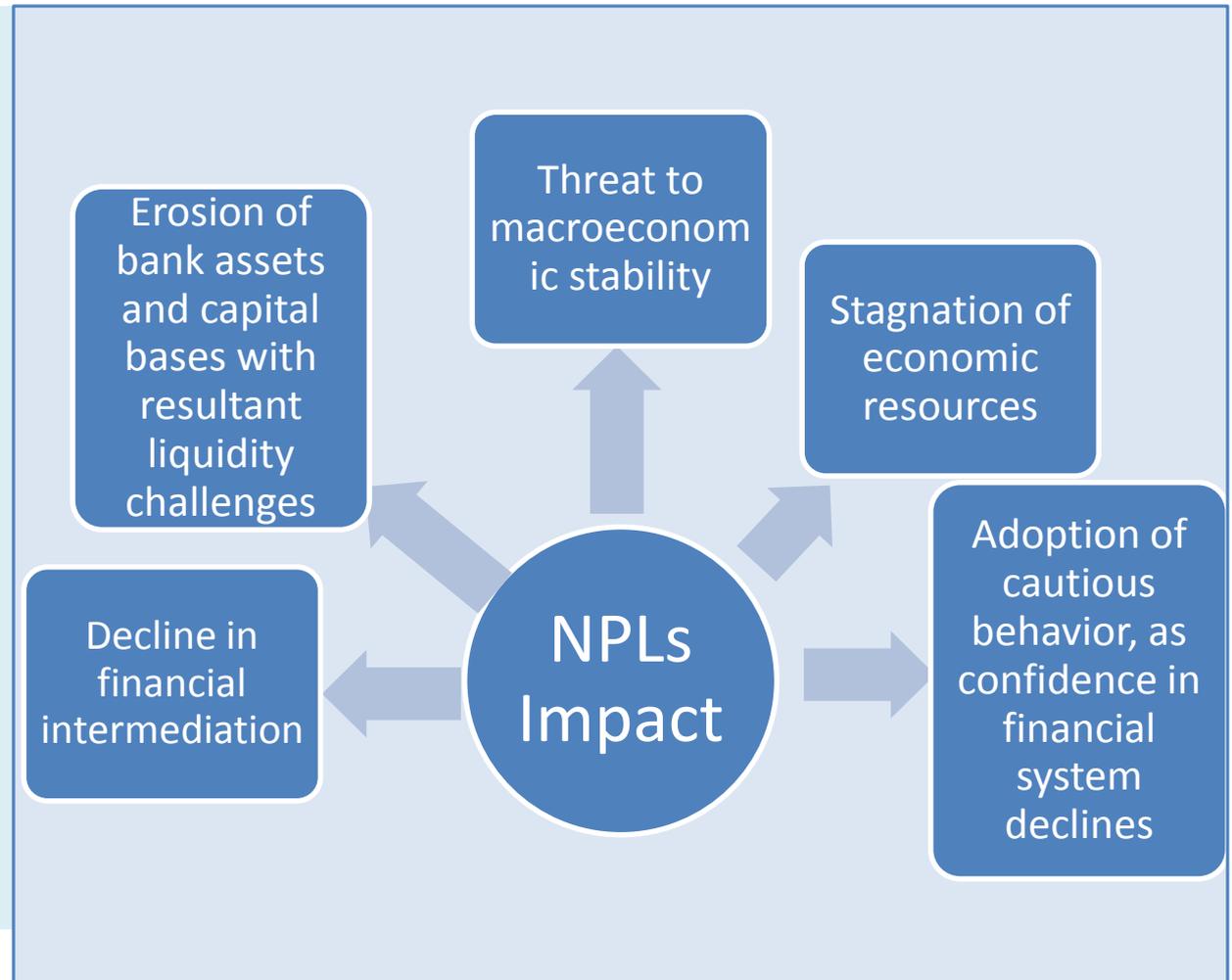
# Sources of Non-Performing Loans

- There are two main sources resulting in non-performing loans; **internal and external**

<b>Sources of Credit Risk</b>	<b>EXTERNAL SOURCES</b> <ul style="list-style-type: none"><li>• Macro-economic conditions;</li><li>• Correlated risk factors (the impact that risk factors in one market have on another market); and</li><li>• Competitive pressure among banks to lower underwriting standards.</li></ul>
	<b>INTERNAL SOURCES</b> <ul style="list-style-type: none"><li>• Poor underwriting standards;</li><li>• Excessive lending &amp; credit concentrations;</li><li>• Poor credit governance arrangements;</li><li>• Lack of technical competence in lending processes;</li><li>• Inadequate MIS resulting in untimely information on the credit worth of borrowers;</li><li>• Introduction of new financial products without thorough risk assessment;</li><li>• Subjective decision-making due to lack of adequate client information.</li></ul>

# Impact of NPLs

- High NPLs have adverse impact on banks.
- Any adverse developments in banks have an impact on the intermediary role of banking institutions, to the sector and economy as a whole.

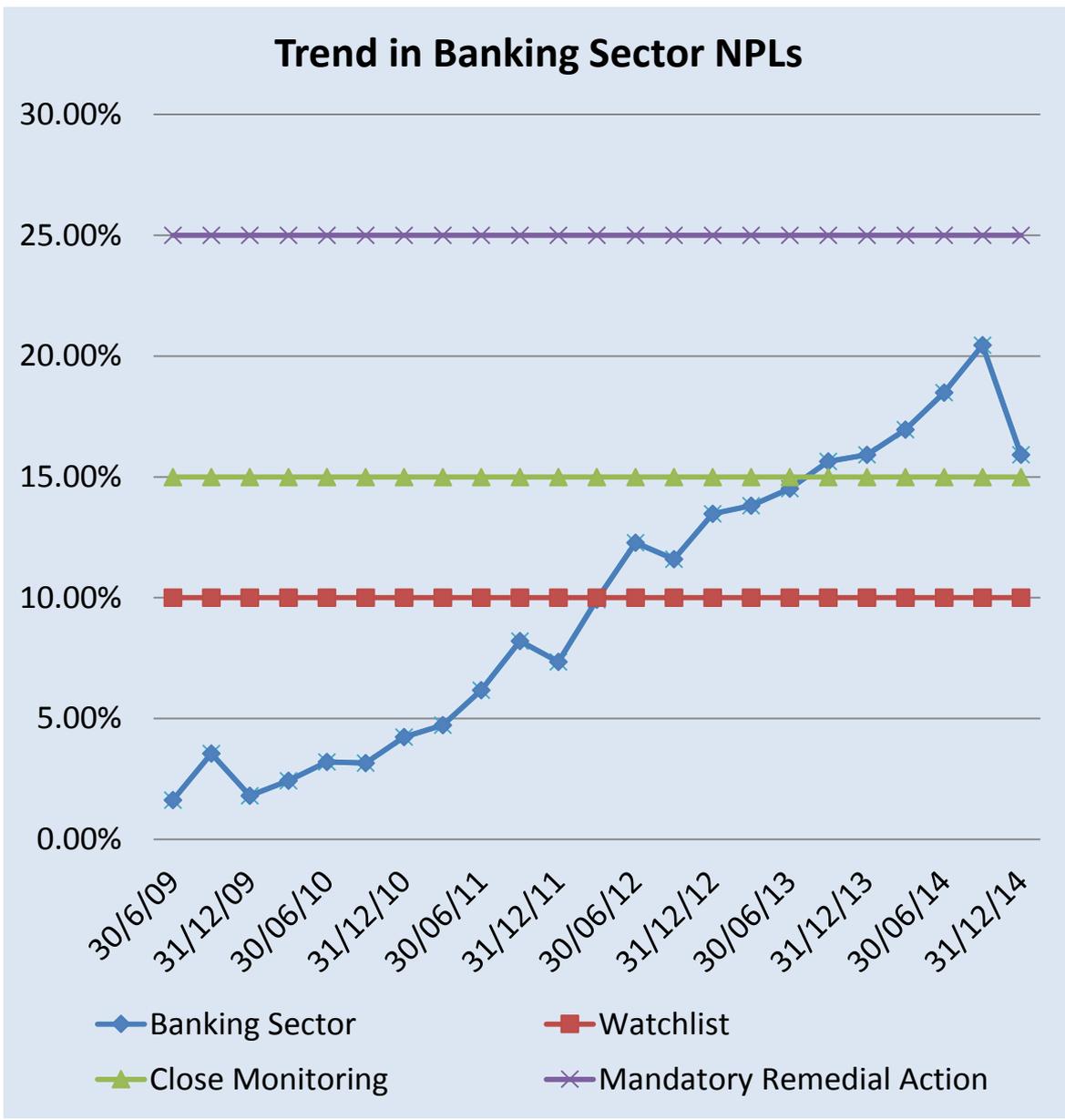


# NPLs – A Vicious Cycle

- **Credit crunch** may arise, as banks with high NPLs become increasingly reluctant to take up new risks and commit new loans.
- Unavailability of credit to finance working capital and investments might trigger the **second round business failure**.
- This in turn, exacerbates the quality of bank loans, resulting in a **re-emerging of banking failure**.

# NPLs Status in Zimbabwe

- A steady increase in the sector's average NPLs/TLs from **1.80%** as at 31 December 2009 to **15.91%** as at 31 December 2014.
- Asset quality deterioration can be attributed to the difficult operating environment and in some cases weak risk management within banks.



# NPLs Status in Zimbabwe

- The Troubled & Insolvent Banks Policy has categories depending on the level of NPLs in banking institutions:
- **“Watch List”** category - NPLs in excess of 10% but less than 15%.
- **“Close monitoring”** category - threshold is between 15% and 25%
- **“Mandatory Remedial action”** category relates to NPLs above 25%.

# Dealing with NPLs

## Bank Specific Measures

- Strengthening underwriting standards
- Enhancing credit governance arrangements
- Aggressive loan recovery strategies including constitution of specialised Recoveries Units
- Improve credit MIS

## System Wide Measures

- Holistic NPL resolution - ZAMCO
- Credit Reference System
- Resolution of Troubled Banks. These have distorted average NPLs
- Resumption of LOLR function
- Addressing some macro-economic challenges through ZimAsset

# ZAMCO

- The Reserve Bank of Zimbabwe set up the Zimbabwe Asset Management Corporation (Private) Limited (ZAMCO), in July 2014 as part of measures to deal with problem of rising non-performing loans (NPLs).
- ZAMCO's primary objective is the acquisition of non performing loans (NPLs) in a phased and orderly manner.
- To date ZAMCO has acquired NPLs amounting to \$65 million.
- The Reserve Bank is currently finalizing the accreditation of additional asset managers/investment advisors so that ZAMCO has a larger pool of institutions which it can utilize in raising of funds and manage acquired NPLs.

# Credit Reference System

- Complementary to ZAMCO, the Reserve Bank is implementing a credit reference system to bridge information asymmetry in the banking sector.
- The credit reference system will comprise a credit registry (databank) in the Reserve Bank and private credit reference bureaus (CRBs).
- Credit information will be collected from all banking institutions and microfinance institutions.
- The primary mandate of the credit registry is to promote efficient, timely and accurate credit information sharing, thereby enhancing credit risk management and fostering credit discipline in the market.
- The Reserve Bank has scheduled a number of activities for the implementation of the project

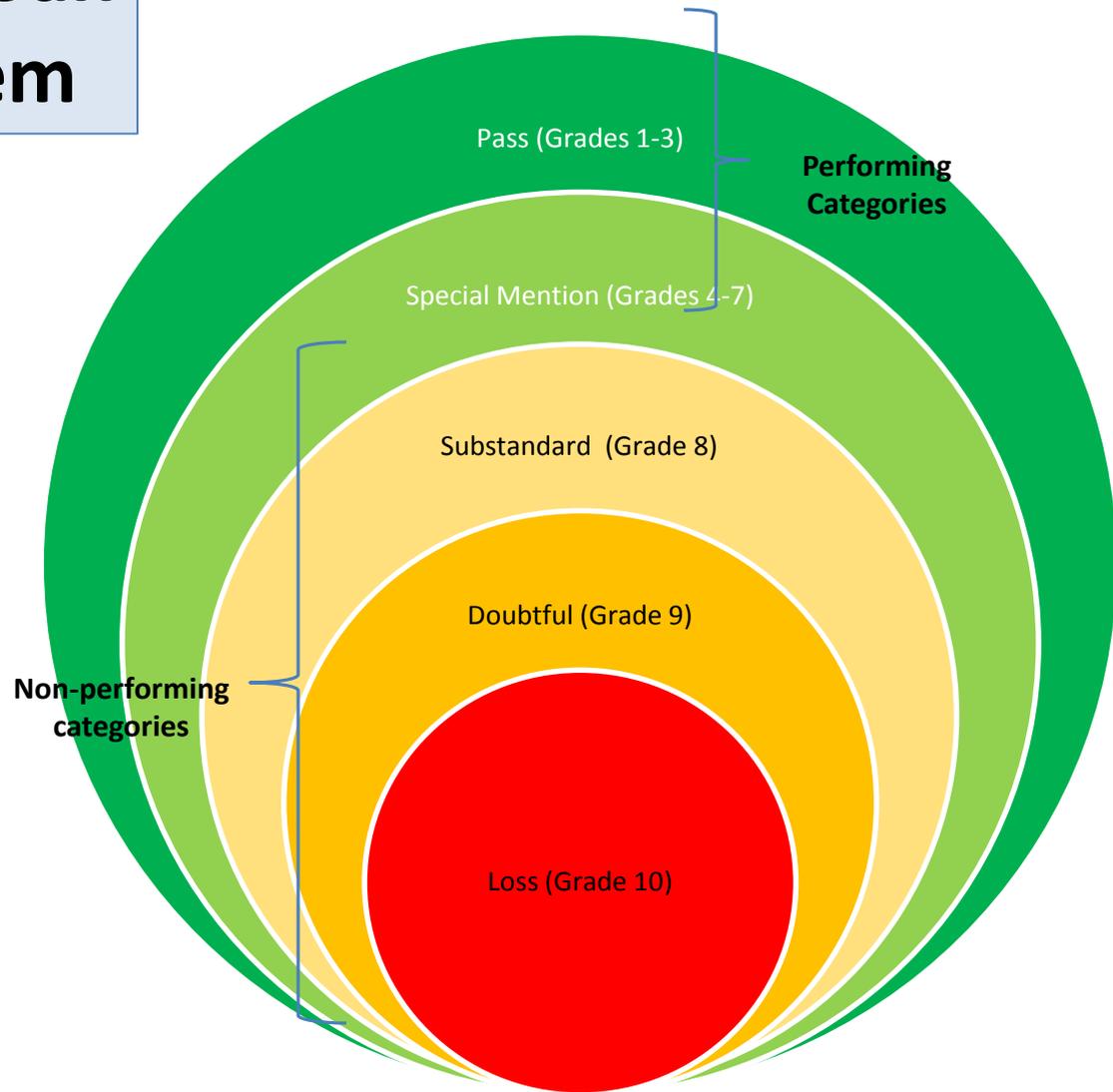
# **RBZ LOAN CLASSIFICATION SYSTEM**

# LOAN CLASSIFICATION

- The process banks use to review their loan portfolios and assign loans to categories or grades based on the perceived risk and other relevant characteristics of the loans.
- The primary consideration in Supervisory authorities' credit risk assessment is the strength of the primary repayment source.
- Primary repayment source should represent a sustainable source of cash.
- In general, as the primary repayment source weakens and default probability increases, **collateral** and other protective structural elements have a greater bearing on the rating

# Overview of RBZ Loan Classification System

- Banking Regulations SI 205 of 2000, Part IV: Asset Classification , Provisioning & Non-Accrual of interest outline the Reserve Bank loan classification and provisioning.
- Provides for five (5) categories, each denotes the performance of the asset.
- Loans in the substandard, doubtful and loss categories are collectively known as “non-performing” or “adversely classified” loans.



# **RBZ Loan Classification System**

## **Pass...**

- Asset exhibits no evidence of weaknesses;
- Is fully protected by the current sound worth and paying capacity of the borrower;
- Is performing in accordance with contractual terms and is expected to continue to do so; and
- Repayments are up to date.

**NB : borrowers are current in meeting commitments and full repayment of interest and principal is not in doubt**

# RBZ Loan Classification System

## Special mention...

- past due 31-90 days;
- Although largely sound and adequately secured, possesses some potentially detrimental factors which may increase the risk profile of the asset in future such as.
  - inadequate loan documentation;
  - Deteriorating condition or control of the collaterals
  - a marked deterioration in financials;
  - An unreasonably long absence of current and satisfactory financials or in adequate collateral documentation; and
  - evidence of difficulties in meeting commitments e.g. excesses, requests for limit increases, repayments being met from secondary sources.

# RBZ Loan Classification System

## Substandard...

- Past due 91 days but less than 180 days;
- Renegotiated loan - unless all past due interest is paid.
- Whether or not past due, inadequately protected by sound worth e.g.
  - **primary** source of repayment is insufficient to service debt and institution must look at secondary sources;
  - Unduly long absence of current and satisfactory financial information;
  - Inadequate collateral documentation; and
  - More than normal degree of risk due to borrower's unsatisfactory financial condition.

# RBZ Loan Classification System

- **Doubtful...**
- past due 180 days but less than 360 days.
- Exhibits all weaknesses of S/S.
- collection in full based on current existing facts is highly improbable but actual amount of loss is indeterminable due to pending events e.g. capital injection, asset disposal, liquidation, litigation.
- If other serious deficiencies, such as, death, bankruptcy or liquidation of the borrower, are detected or if the borrower's whereabouts are unknown assets can be classified doubtful notwithstanding the shorter overdue period.

# RBZ Loan Classification System

## ❖ **Doubtful Cont...**

- Doubtful is normally a transitional classification pending the occurrence of an event.
- One year is considered reasonable time for a pending event to have taken place.
- An asset can not be classified doubtful in two successive years but should be graded up or down
- A doubtful asset can only remain doubtful in the second year if there are special circumstances which warrant such action; and
- collection in full based on current existing facts is highly improbable but actual amount of loss is indeterminable due to pending events e.g. capital injection, asset disposal, liquidation, litigation.

# RBZ Loan Classification System

## Loss...

- past due more than 360 days unless well secured and legal action has commenced;
- The legal action will be expected to result in timely realization of collateral or enforcement of a guarantee;
- Has been classified doubtful, but the pending event has not occurred within 360 days; and
- Otherwise considered uncollectible or of such little value that continuance as an asset is not warranted. Whatever collateral is held must be liquidated to pay off the debt. The outstanding portion must be written off.
- Full recovery may be possible after write off. As such, even after write off, the bank must, where possible continue with efforts to collect.

# **PROVISIONING REGIMES FOR BANK LOANS**

# Loan Loss Provisioning

- Loan loss provisioning is a method of recognizing and covering loan losses by setting aside a reserve for the loan portfolio and other assets.
- Accounting practices and supervisory guidance require loans to be reported in a bank's financial statements at their true or realizable value
- The Reserve bank concern relating to provisioning include the need :
  - I. to ensure that a bank's net worth is neither over- nor understated as a result of incorrect loan values - Balance sheet not reflecting actual condition and income statement overstated
  - II. to eliminate the probability of banking institution not setting aside adequate provision on timely basis;

# Provisioning Regimes Affecting Banking Institutions

- Elements in the universe of loan loss provisions include banks, professional accounting bodies, external auditors and bank supervisors .
- In a number of countries, loan loss provisioning by banks is influenced by two set of approaches namely Accounting and the Basel regime/regulatory regime

	ACCOUNTING	RBZ/REGULATORY
Current	IAS 39 incurred loss approach	Basel II – Modified Standardized Approach. This regime favours “expected loss’ approach.
Future	IFRS 9 – expected loss approach (12 months time bucket & life time bucket).	Basel II Credit Risk - the proposed revisions to the Standardised Approach for credit risk.

# Provisioning Regimes Affecting Banking Institutions

- Banking institutions should **comply with both** regulatory requirements and the accounting principles (IFRS).
- The focus of the accounting impairment loss is to ensure that Balance Sheets, Income Statements and Capital Schedules are fairly stated.
- Under-provisioning is the single greatest distortion in calculation of capital and capital adequacy computation.

# Provisioning Regimes Affecting Banking Institutions

- It has been noted that prudential requirements tend to produce more provisions than the accounting regime.
- This is largely due to several factors including:
  - a) the different ranges of information allowed under the two approaches;
  - b) different judgments used by banks in applying IAS 39, and
  - c) In few cases inadequate loan quality assessments by auditors

# Accounting Regime - IAS 39 Approach

- IAS 39 is **principle based**, leaves substantial room for judgment, which may result in insufficient provisions.
- **Paragraph 54** specifies a series of observable data that can serve to support the objective evidence, such as what constitutes objective evidence or trigger events and how best to estimate future cash flows, especially when there is limited data.
- Banks have thus, a wide latitude in selecting relevant objective evidence.

# Accounting Regime - IAS 39 Approach

- IAS 39 assesses and measures impairment, both on an individual and portfolio basis. The measurement of impairment losses uses the **discounted cash flow method**.
- For individual assets, the amount of impairment losses is measured as the difference between the asset's carrying amount and the present value of estimated cash flows discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition).
- ***Banking institutions have in some instances failed to use the correct discount rate.***

# Accounting Regime - IAS 39 Approach

- In contrast to regulatory requirements which require that credit losses expected as a result of future events be adjusted for through **loan classification and subsequently through provisions**, the IAS 39 approach does not impact on the Income Statement, despite the highly likely possibility.
- The carrying amount of the loan on the Statement of Financial Position is reduced either directly or through the use of an “allowance account.”

# Accounting Regime - IFRS 9 Approach

- IFRS 9 Effective 2018. It is expected to align supervisory & accounting requirements by recognising credit losses in a more timely manner.
- BCBS contributed to the changes

## **Box 1. Guiding Principles for the Replacement of IAS 39**

*On provisioning and impairment:* The new provisioning standard should:

- reflect expected losses over the life of the portfolio, considering the loss experience over the complete economic cycle;
- allow early identification and recognition of losses;
- incorporate a broader range of available credit information;
- allow for the use of professional judgment while using leading economic indicators, changes in underwriting standards and collection practices, and other relevant information; and
- allow for provisions for groups of loans with similar risk characteristics.

# Accounting Regime - IFRS 9 Approach

- Expected changes include:
  - ✓ credit loss recognition will be forward-looking rather than dependent upon the occurrence of objective evidence;
  - ✓ expected loss model will provide users of financial statements with information about expected credit losses and changes in expectations about credit losses.
  - ✓ permit a wider range of information, including on expectations of future credit losses.
  - ✓ credit losses are measured at different stages, **marked by 12-month and life-time expected credit loss** recognitions.

# Regulatory Regime

- Regulatory provisioning anchored on “**expected loss**” approach in provisioning for credit losses.
- Provisions include:
  - ✓ identified losses (**specific provisions**) – based on identified loan losses and deterioration; and
  - ✓ unidentified losses that are expected to occur (**general provisions**) - losses that have not arisen yet but expected to emerge, based on an evaluation of economic and financial factors and the borrower’s ability to pay

# RBZ Provisioning Requirements

- Section 17 of Banking Act [Chapter 24:20] – “ *every banking institution shall conduct its banking business and other operations in accordance with sound administrative and accounting practices and procedures...*”
- Paragraph 23 to the Third Schedule, Part IV of the Banking Regulations S.I. 205 of 2000; requires that “*...every banking institution establishes a provision for loan losses account consisting of specific and general provisions created through charges to provision expense in the income statement and maintained at a level adequate to absorb expected losses in the loan portfolio and in respect of other assets...*”

# RBZ Provisioning Requirements

- Banks are expected to have detailed provisioning policies and procedures covering:
  - ✓ criteria for setting provisions
  - ✓ methodology for estimating provisions
  - ✓ procedures for collateral valuation
  - ✓ procedures for review of adequacy of provisions
  - ✓ mechanism for reporting information to management on a periodic basis

# Regulatory Regime – Computation of Loan loss provisions

- **General provisions** are for possible or latent losses that are not yet identified. Such provisions are calculated as a percentage of total loans.
- Computation of general provisions **does not take into account collateral held.**

$$\text{Provision} = (\text{Gross Loan Amount}) \times \text{grade provisioning level (\%)}$$

# Regulatory Regime - Computation of Loan loss provisions

- **Specific provisions** are explicitly tied to the exposures they cover.
- These are not included in capital because they are established for expected losses for specific exposures.
- Computation of specific provisions take into account **collateral held** and **interest in suspense**.

$$\text{Provision} = (\text{Gross Loan Amount} - \text{Interest in Suspense} - \text{**Collateral held}) \text{ grade provisioning level (\%)}$$

**\*\* NB:** Acceptable collateral is defined as land, buildings, cash, quoted securities, subject regulatory haircuts. Other securities e.g. NGCG, guarantees, cessions excluded for prudential purposes

# RBZ Provisioning Requirements – Basel II

- The adoption of **Basel II** ushered in a more granular grading system.
- To operationalize the Modified Standardized Approach, in the absence of External Credit Rating Agencies, RBZ has expanded the supervisory loan classification system from a five-tier to a 10-tier classification system in line with Basel II Supervisory Rating Scale (SRS)
- The provisions stipulated for each category are to be maintained as provision against the outstanding balance on loans or assets (after deducting any suspended interest accruals).

## Basel II 10-tier Supervisory Rating System

Grade	Loan Classification	Provisioning Percentage (of Exposure)
<b>1 to 2</b>	Pass	1%
<b>3</b>		2%
<b>4</b>	Special Mention	3%
<b>5</b>		4%
<b>6</b>		5%
<b>7</b>		10%
<b>8</b>	Substandard	20%
<b>9</b>	Doubtful	50%
<b>10</b>	Loss	100%

# RBZ Provisioning Requirements

- Banks shall make larger provisions than provided for where it is reliably informed that expected losses will exceed the minimum provisions.
- Provisioning should be done **on a timely basis** and the same should be reported in the bank's balance sheet and the income statement.
- Sound provisioning by a bank relies on the adequacy and effectiveness of its processes relating to monitoring credit quality and provisioning. These include having in place:
  - an effective loan grading system;
  - consistent review and monitoring of loans; and
  - detailed policies and procedures for provisioning.

# Loan Loss Provisioning - Collateral

- Acceptable collateral includes land, buildings, cash, quoted securities, subject to regulatory haircuts
- In considering collateral for provisioning purposes, the following factors should be taken into account:
  - ✓ is it liquid and marketable?
  - ✓ if so, how much can be collected?
  - ✓ is the amount sufficient to cover payments in arrears?
- There is increasing trend to rely on desktop collateral valuations, which tend to over-value the security held. Need for professional valuations.

# Treatment of Regulatory Provisions

- Direct deduction from core capital through income statement (retained income)
- Cumulative general provisions allowed as part of Tier 2 capital, subject to a ceiling of up to 1.25% of Risk Weighted Assets (RWA) computed under standardized approach.

# **Proposed Changes to Regulatory Credit Risk Measurement**

# Proposed Changes to Credit Risk Standardized Approach

- The aim of the revision is to address weaknesses in the current approach, including:
  - over-reliance on external credit ratings;
  - lack of granularity and risk sensitivity;
  - out-of-date calibration;
  - lack of comparability across different banks and jurisdictions; and
  - misalignment of treatment between the current standardised approach and exposures risk weighted under the internal ratings based (IRB) approach.
- The proposals are in consultative period (consultations close **31 March 2015**)

# Proposed Changes to Credit Risk Drivers

Exposure Class	Risk Driver	
Banks	CET1 ratio	Net NPA ratio
Senior Corporate Debt Exposures	Revenue	Leverage
Regulatory Retail	<ul style="list-style-type: none"> <li>i. The extent to which the loan is secured by durable good;</li> <li>ii. The percentage of the borrower income available to service the loan;</li> <li>iii. The maturity of the exposure;</li> <li>iv. Whether there is already an established relationship between the borrower and the bank.</li> </ul>	
Claims secured by Real Estate – Residential real estate	Loan-to-value (LTV) ratio	Debt service coverage (DSC) ratio
Claims secured by Real Estate – Commercial Real Estate	Two options: A. No recognition of the real estate collateral and treatment of exposure as unsecured B. RW based on LTV ratio	

# Proposed Changes to Credit Risk Weights

Current Risk Weights under CRR		
Institutions		20% - 150%
Corporates		20% - 150%
Equity Exposures		100% - 250%
Retail		75%
Secured by mortgages on imm. property	Residential	35%
	Commercial	50%
Off-balance sheet		0% - 100%
Exposures in Default		100% - 150%
MDBs		0% - 150%
Other Items		0% - 250%

Suggested Risk Weights by BCBS		
Banks		30% - 300%
Corporates - Senior Debt		60% - 300%
Corporates - Specialised Lending		120% - 300%
Sub. Dept, Equity and Other		250% - 400%
Regulatory Retail		75%
Other Retail		100%
Secured by real estate	Residential	35%
	Commercial	50%
Off-balance sheet		10% - 100%
Past due loans		Under analysis
MDBs		0% - 300%
Other Assets		100%

# **RBZ OBSERVATIONS**

# RBZ Observations on Loan Grading & Provisioning

- Supervisory activities over the years have revealed a number of challenges relating to the computation and levels of provisions.
- When banks are under stress they are more likely to have incentives to underestimate credit risk.
- Tendency for inaccuracies and misreporting with regards asset quality.
- These range from deliberate falsification of records, conveniently misclassifying credit to misinterpretation of legislation/guidelines.
- Finance department passing less provisions than those computed and recommended by Risk management Department

# RBZ Observations on Loan Grading & Provisioning

- Mis-classification of impaired assets which have glaring credit weaknesses.  
Ever-greening of loans to mask credit weaknesses.
- Re-negotiated or restructured facilities classified as performing, contrary to **Paragraph 22 (c) part (ii) of the Third Schedule of the Banking Regulations, 2000** which requires that all re-negotiated loans be classified as substandard unless all past due interest is repaid at the time of renegotiation;
- Upgrading of NPLs before the 6 months period lapses as stipulated by banking regulations
- Failure to immediately write off loans in line with **Paragraph 24 of Part (iv) the Third Schedule of the Banking Regulations, 2000;**

# **RBZ Observations on Loan Grading & Provisioning**

## **Inappropriate Governance Arrangements...**

- Risk management involvement in credit granting / approval, compromising independence of risk function.
- Loan classification and provisioning not being carried out independently – Some members of Loans Review Committee also members of Credit Committee.
- Inadequate board oversight of loan classification and provisioning – boards not interrogating management provisioning levels.

# RBZ Observations on Loan Grading & Provisioning

- Use of 5-tier provisioning requirements instead of 10-tier provisioning levels.
- Weak ICT systems with extensive manual processes. – inability to produce comprehensive reports such as arrears reports.
- A failure to improve collateral position as credits deteriorate. Collateral not perfected.

# **RBZ Observations on Loan Grading & Provisioning**

## **Related Party Transactions ...**

- Non-disclosure of related party transactions and misclassification of the same.
- Insider or related party exposures should still be deducted from capital, in line with banking regulations.

# **RBZ Observations on Loan Grading & Provisioning**

## **Breach of own policies...**

- Instances of inadequate loan documentation and assessment of applications have been noted.
- Some banking institutions are granting unsecured or inadequately secured facilities to borrowers with adverse ratings and over-borrowed clients.

# **Reserve Bank Expectations**

# Reserve Bank Expectations

- Detailed credit policies and procedures and adherence thereof.
- Board and senior management bear ultimate responsibility for the adequacy of its provisions.
- Board and senior management to ensure that financial statements are a true reflection of the financial position of a bank.
- ***Failure to correctly disclose financial information constitutes an offence in terms of section 75 of the Banking Act.***
- Need for effective method of identifying and monitoring poor credits by reviewing the outstanding credits regularly

# Reserve Bank Expectations

- Strict adherence to banking regulations and applicable accounting standards;
- Regular reviews of quality of loan portfolio – SI 2015 of 2000 *“not less frequently than each quarter”*
- Role of Loans Review Committees should play a more central role in oversight of credit performance – reports to be made directly and timeously to the board ( paragraph 20(3) of SI 205 Of 2000)
- Ensure segregation of duties;
- Robust MIS that effectively support the credit risk management process.

# Reserve Bank Expectations

- External auditors are expected to ensure compliance with both IFRS and regulatory guidance.
- This will include inter alia:
  - appropriateness of loan classification and provisioning;
  - reasonableness of cashflow computations and the choice of discount rate used;
  - ensure correct and consistent treatment of collateral; and
  - valuation practices consistent with IFRS
- External auditors are expected to report promptly to regulators all instances of material misstatement.

# Conclusion

- Collaboration and dialoguing between regulatory authorities and accounting profession promotes adoption of sound accounting and reporting practices.
- Consistent implementation and compliance to accounting and regulatory requirements contribute to the financial stability of the banking sector.

**THANK YOU**