MONETARY BOARD
CENTRAL BANK OF SRI LANKA

14 September 2021 **BANKING ACT DIRECTIONS** **No. 13 of 2021**

CLASSIFICATION, RECOGNITION AND MEASUREMENT OF CREDIT FACILITIES IN LICENSED BANKS

In the exercise of the powers conferred by Sections 46A, 46(1) and 76(J)(1) of the Banking Act, No. 30 of 1988, as amended, the Monetary Board of the Central Bank of Sri Lanka (CBSL) hereby issues the following Directions on Classification, Recognition and Measurement of credit facilities in licensed commercial banks and licensed specialised banks, hereinafter referred to as licensed banks, with a view to further strengthening and harmonising the regulatory framework on classification, recognition and measurement of credit facilities in licensed banks with the Sri Lanka Accounting Standard, 'SLFRS 9: Financial Instruments' (hereinafter referred to as SLFRS 9) and establishing consistent and prudent practices in the banking industry.

1. Empowerment

1.1 In terms of Section 46(1) of the Banking Act, in order to ensure the soundness of the banking system, the Monetary Board is empowered to issue Directions to all licensed commercial banks, regarding the manner in which any aspect of the business of such bank or banks is to be conducted.

1.2 In terms of Section 76J (1) of the Banking Act, the Monetary Board is empowered to give Directions to licensed specialised banks or to any category of licensed specialised banks, regarding the manner in which any aspect of the business of such banks is to be conducted.

2. Scope and Applicability

2.1 All requirements in these Directions shall be applicable to licensed banks in addition to the requirements of the Sri Lanka Accounting Standards.

3. Definitions

3.1 The following definitions shall be applicable for purposes of these Directions.

3.1.1 Credit facilities shall mean:

a. On balance sheet loans and advances which are measured under amortized cost or fair value through other comprehensive income and net investment in lease receivables; and

b. Off-balance sheet assets including commitment to accept contingent liabilities, and include guarantees, bonds, letters of credit, acceptances and undrawn commitment component of credit facilities such as credit cards and overdraft facilities etc.

3.1.2 Borrower shall include individuals, companies, the Government of Sri Lanka, public corporations, statutory bodies, firms, state owned entities (SOEs), associations of persons and any other entity.

3.1.3 Board of Directors shall mean the Board of Directors of locally incorporated licensed banks and in the case of foreign banks, the Head Office/ Regional Monitoring Office.

3.1.4 Chief Executive Officer (CEO) and Key Management Personnel (KMPs) shall mean CEO and Officers Performing Executive Functions of licensed banks as determined under the Banking Act.

4. Governance Framework for Credit Facilities

4.1 The Board of Directors, CEO and the respective KMPs are responsible for ensuring that the licensed bank has robust credit risk management policies and practices, including an effective system of internal controls, to manage the credit risk in the licensed bank in accordance with the policies and procedures, applicable Sri Lanka Accounting Standards and relevant regulatory and supervisory guidance.

4.2 The Board of Directors shall ensure that the credit policy of the licensed bank includes the following at a minimum in addition to requirements stipulated in Banking Act Directions on Integrated Risk Management Framework for licensed banks:

4.2.1 A policy on classification, measurement and recognition of credit facilities;

4.2.2 Adequate credit risk management policies and processes to identify, measure, monitor, report and mitigate credit risk on a timely basis covering the full credit life cycle. Such process shall be documented, while adhering to sound methodologies, procedures and controls for assessing and measuring the credit risk of loans and advances;

4.2.3 Adequate policies and processes in place for the timely identification of credit facilities and management of under-performing/non-performing assets and determining an adequate impairment allowance, and to strengthen the credit risk management process in accordance with the Sri Lanka Accounting Standards and the regulatory framework;

4.2.4 Ensure that clear guidelines are provided on;

(a) Staging of loans, including how to differentiate stage 2 and 3 loans based on potential risk criteria;

(b) Methodologies for determining the Probability of Default (PD), Loss Given Default (LGD), Economic Factor Adjustment etc. for impairment purposes ;

(c) Assessment thresholds and borrower-wise coverage of credit facilities to be assessed individually for impairment;

(d) Collateral to be considered for impairment along with valuation requirements on such collateral and specification of techniques and data to be used for such valuations in line with Direction 12 below;

(e) Use of overlays to impairment models to ensure expected loss computations reflect potential economic shocks, which are not captured otherwise; and

(f) On upgrading of credit facilities in line with Direction 11 below.

4.2.5 A comprehensive validation policy in respect of models used for classification, recognition and measurement of credit facilities in the licensed bank including clear roles & responsibilities, validation frequency and procedures & methodologies to be used by the bank;

4.2.6 Establish a mechanism to segregate non-performing credit facilities from other credit facilities to ensure close follow-up action and to monitor and streamline the recovery process;

4.2.7 A well-designed write-off/write down policy established by the Board of Directors delineating the approach, authority, accountability for negligence and inappropriate follow-up, independent review and audit, continuous monitoring, reporting, etc. Such policy shall also aim to recover the maximum salvage value through enforcement of collateral / guarantees, etc; and

4.2.8 Ensure transparency and comparability by establishing mechanisms to provide timely, relevant, accurate and useful information of the licensed bank through public disclosures and maintaining adequate data/records and systems to identify, reconcile and report the requirements under the Sri Lanka Accounting Standards and the existing regulatory framework.

4.3 CEO and KMPs of the licensed bank shall ensure that Board approved policies, procedures and processes on credit facilities are implemented as intended, and adequate internal controls and validation processes are established to ensure same.

4.4 Licensed Bank shall not fund the recovery of any credit facility provided to any borrower by the same bank.

5. Classification of Credit Facilities

5.1 Licensed bank shall classify all credit facilities for the purpose of impairment assessment, risk mitigation and monitoring into performing and non-performing loans and advances as follows:

5.1.1 Performing credit facilities shall mean:

(a) All the credit facilities classified as Stage 1 under SLFRS 9; and

(b) All credit facilities identified as significantly increased credit risk facilities and classified as Stage 2 under SLFRS 9 (under-performing credit facilities).

5.1.2 Non-performing credit facilities (NPCF) shall mean all credit facilities where contractual payments of a customer are past due for more than 90 days (the number of days past due shall be calculated starting from the contractual due date of the payment) or has remained in excess of the sanctioned limit for more than 90 days, and any other credit facilities classified as Stage 3 credit facility under SLFRS 9 (facilities classified as NPCF based on potential risk and impaired assets at origination).

5.2 A licensed bank shall not consider the value and type of security obtained by the bank against their credit facilities when determining the classification status of a credit facility.

5.3 In cases where a borrower has several current accounts with overdraft limits with the bank, the aggregate sanctioned limit and the daily outstanding aggregate balance on all such accounts shall be considered for the purposes of classification of Overdrafts.

6. Sub-Categorisation of non-performing Credit Facilities

6.1 Licensed bank shall sub-categorise NPCF into the following categories based on the criteria mentioned below:

6.1.1 Special mention

(a) Based on days past due: All credit facilities where contractual payments are past due or have remained in excess of the sanctioned limit for more than 90 days but less than or equal to 180 days.

(b) Based on potential risk: All credit facilities that exhibit potential weaknesses where, if not corrected in a timely manner, may adversely affect repayment by the borrower at a future date, and those that warrant close attention by the licensed bank.

6.1.2 Substandard

(a) Based on days past due: All credit facilities where contractual payments are past due or have remained in excess of the sanctioned limit for more than 180 days but less than or equal to 270 days.

(b) Based on potential risk: All credit facilities that exhibit definable weaknesses, either in respect of the business, cash flow or financial position of the borrower, that may jeopardise repayment on existing terms and where there is uncertainty that part or the entire facility will be repaid and involves more than normal risk of loss due to unsatisfactory debt servicing record/financial condition of the borrower, insufficiency of collateral or any other factors which give rise to some doubts as to the ability of the borrower to comply with the present repayment terms.

6.1.3 Doubtful

(a) Based on days past due: All credit facilities where contractual payments are past due or have remained in excess of the sanctioned limit for more than 270 days but less than or equal to 360 days.

(b) Based on potential risk: All credit facilities that exhibit a high risk of partial default or where full collection is improbable and there is a high risk of default and where the outstanding credit facility exhibits more severe weaknesses than those in a substandard category.

6.1.4 Loss

(a) Based on days past due: All credit facilities where contractual payments are past due or have remained in excess of the sanctioned limit for more than 360 days.

(b) Based on potential risk: All credit facilities that are deemed to be uncollectable or are almost certain that such will not be repaid and which are categorised as NPCF but not included under special mention, substandard and doubtful categories.

7. Significant Increase in Credit Risk / Default Facilities

7.1 For the purpose of calculating life-time expected losses under SLFRS 9, at a minimum, if one or more of the following factors/conditions are met, it shall be considered as significant increase in credit risk or as defaulted facilities.

7.1.1 Contractual payments of a borrower are past due for more than 30 days (subject to the rebuttable presumption under SLFRS 9).

7.1.2 Credit rating of a borrower has been subsequently downgraded to B+ or below under the Sri Lankan National Rating Scale by an External Credit Assessment Institution (ECAI).

7.1.3 A two-notch downgrade under the internal rating of the licensed bank. Licensed banks are required to map their internal credit risk ratings with the ratings issued by ECAI. For this purpose, licensed banks are required to refer the mapping of external credit ratings given in Banking Act Directions on capital requirements;

7.1.4 Reasonable and supportable forecasts of future economic conditions show a direct negative impact on the performance of a customer/group of customers;

7.1.5 A significant change in the geographical locations or natural catastrophes that directly impact the performance of a customer/group of customers;

7.1.6 The value of collateral is significantly reduced and/or realisability of collateral is doubtful. Licensed banks shall define relevant thresholds/limits and document the same;

7.1.7 The borrower is subject to litigation that significantly affects the performance of the credit facility;

7.1.8 Frequent changes in the Board of Directors and Senior Management of an institutional customer;

7.1.9 Delay in commencement of business operations/projects by more than two years from the originally agreed date;

7.1.10 Modification of terms resulting in concessions, including extensions, deferment of payments, waiver of covenants etc.;

7.1.11 The borrower is deceased/insolvent;

7.1.12 Licensed bank is unable to contact or find the borrower; and

7.1.13 A fall of 50% or more in the turnover and/or profit before tax of the borrower when compared to the previous year for two consecutive years and/or erosion of net-worth of the borrower by more than 25% (other than due to changes in equity structure and dividend policy) when compared to the previous financial year.

7.1.14 Restructure and rescheduled credit facilities as per guidance provided in Direction 10 below.

7.2 Licensed banks may rebut one or more criteria listed from 7.1.2 to 7.1.14 when determining significant increase of credit risk, subject to the following:

7.1.1 The KMP heading the Risk Management Function shall recommend such rebuttal criteria to the Board of Directors providing valid rationale and justifications to ensure that such criteria do not result in significant increase of credit risk to the bank, and Board of Directors shall grant approval or reject the proposal after considering the information provided.

7.1.2 Disclose the rebutted criteria if any and the estimated impact of such rebuttal on the respective bank's impairment provisions and profitability in their audited annual financial statements.

8. Impairment Charges for Credit Facilities

8.1 Licensed banks shall measure the impairment charges for credit facilities as per the Sri Lanka Accounting Standards and Directions/Guidelines issued by CBSL in this regard from time to time.

8.2 The measurement of impairment charges should build upon robust methodologies and result in the appropriate and timely recognition of expected credit losses in accordance with the applicable Sri Lanka Accounting Standards.

8.3 At each reporting date, licensed banks shall measure the loss allowance for credit facilities at an amount equal to life-time expected losses, if the credit risk of loans and advances has increased significantly since initial recognition (except for the credit facilities purchased and/or originated as credit-impaired credit facilities).

8.4 In respect of purchased or originated credit impaired credit facilities, lifetime expected credit losses shall be measured unless upgraded in line with Direction 11 below.

8.5 In principle, lifetime expected credit losses and/or credit impaired credit facilities shall be assessed on an individual basis. However, the licensed bank may perform the assessment on appropriate groups or portfolios on a collective basis for their portfolios.

8.6 The aggregate amount of impairment allowances of the licensed bank, regardless of whether such allowancesare determined on a collective or an individual basis, should be adequate and consistent with the objectives of the applicable Sri Lanka Accounting Standards.

8.7 Impairment of Stage 1 credit facilities

8.7.1 From 01.01.2022, licensed banks shall maintain a minimum Stage 1 impairment ratio of 0.5% as a percentage of total Stage 1 credit facilities i.e., Stage 1 Impairment / Stage 1 credit facilities.

8.7.2 In instances where a licensed bank does not maintain a minimum Stage 1 impairment ratio of 0.5% as a percentage of total Stage 1 credit facilities such deficit shall be required to be maintained in a special reserve account against equity.

8.7.3 Such reserve shall not be used to declare dividends by licensed banks.

8.7.4 However, this shall only be used as a minimum value for Stage 1 impairment and licensed banks shall ensure the adequacy of Stage 1 impairment as per the relevant Sri Lanka Accounting Standards and internal policies.

8.8 Further Directions on impairment of credit facilities in licensed banks are provided in Annex I.

9. Models for Calculation of Impairment

9.1 The CEO and relevant KMPs of the licensed bank under the guidance provided by the Board of Directors, shall ensure that the licensed bank:

9.1.1 Develops robust models to determine expected credit losses as per the Sri Lanka Accounting Standards, which should be in line with the licensed bank's business model and risk profile;

9.1.2 Considers all available and relevant internal and external data when estimating expected credit losses, ensuring that the estimates are robust, unbiased and reflective of current exposures;

9.1.3 Consists relevant officers who are well trained, competent and have a thorough understanding of the models adopted by the bank;

9.1.4 Adheres to rigorous governance and internal control procedures, when obtaining support from external vendors/consultants in respect of model development.

9.1.5 Documents the reasons for selecting a specific model as the appropriate mode, if different models are used for different portfolios and instruments and ensure that all credit models are reviewed at least annually;

9.1.6 Establishes an effective model validation process to ensure that the credit risk assessment and measurement methods are capable of generating accurate, consistent and unbiased predictive estimates on an ongoing basis; and

9.1.7 Desists from making changes in the parameters, inputs and assumptions used for the purpose of profit smoothening. However, if any changes in the credit models are required, the rationale and justification for such change shall be evaluated by the Chief Risk Officer, Integrated Risk Management Committee and approved by the Board of Directors.

9.2 In cases where licensed banks incorporated outside Sri Lanka use models developed by their head office or regional offices, such licensed banks shall assess the appropriateness of the credit models in the Sri Lankan context and a local team headed by a KMP shall carry out appropriate validation procedures.

10. Re-structured and Re-scheduled Credit Facilities

10.1 **Restructured credit facilities**

10.1.1 Restructured credit facilities are where the original repayment terms have been amended due to a deterioration in credit quality, while the respective credit facilities remain as performing facilities as defined under Direction 5.1.1 above.

10.1.2 Credit facilities which are restructured up to two times other than upgraded credit facilities as defined under Direction 11 below, shall be classified as Stage 2 credit facilities under SLFRS 9.

10.1.3 Credit facilities restructured more than two times other than upgraded credit facilities as defined under Direction 11 below, shall be considered as Stage 3 credit facilities under SLFRS 9.

10.2 **Rescheduled credit facilities**

10.2.1 Rescheduled credit facilities are where the original repayment terms have been amended while the respective credit facilities remain as NPCFs as defined under Direction 5.1.2 above.

10.2.2 All rescheduled credit facilities, other than upgraded credit facilities as defined under Direction 11 below, shall be considered as Stage 3 credit facilities under SLFRS 9.

10.3 Licensed banks shall consider the factors listed under Direction 7.1 above in assessing any deterioration in credit quality. However, such assessment shall not be limited to factors specified in Direction 7.1 and shall ensure adequate provisions are made in respect of restructured and rescheduled credit facilities to commensurate with the significant increase in the credit risk.

10.4 Licensed banks shall not grant new credit facilities for repayment of NPCF to the same borrower unless the new credit facility is also classified as NPCF.

11. Upgrading of Credit Facilities

11.1 Licensed banks may upgrade credit facilities from a higher stage (Stage 3 or 2) to a lower stage (Stage 2 or 1) subject to the following:

11.1.1 Upgrading of credit facilities shall be in accordance with a policy approved by the Board of Directors, and the rationale for such upgrading shall be properly documented. Such policy at a minimum shall ensure the following:

(a) Settlement of the due payment

(i) Credit facilities other than the restructured credit facilities in stage 3 and rescheduled credit facilities shall be upgraded, if due payments are fully settled by the customer and bank is satisfied that the customer is able to service debt service obligations up to a foreseeable future:

(b) Restructured credit facilities upgrading from stage 3 and rescheduled credit facilities

(i) Licensed bank exercises prudence in upgrading NPCFs/ under-performing credit facilities; and

(ii) Upgraded credit facility has exhibited a sustained trend/status/ of improvement to justify the improved classification status.

11.1.2 Upgrading of re-scheduled and re-structured credit facilities shall only be carried out by the Risk Management Department and shall be independent from the credit facility review mechanism.

12. Valuation of Collateral for Impairment Purposes

12.1 Licensed bank shall consider the valuation of assets in a prudent manner considering the available reliable market valuations in assessing LGD / cash flow. Such valuations shall appropriately reflect the inherent uncertainty associated with distressed property liquidation (including the time taken for such realisation).

12.2 Licensed bank shall substantiate any increase in the valuation with appropriate evidence that such increases are sustainable.

12.3 Licensed bank shall estimate the net realisable value of the credit risk mitigants or use the forced sale value of the collateral to provide more realistic estimates. Impairment charges shall take into account the updated and realistic valuations of such credit risk mitigants.

12.4 Assets that can be considered as collateral shall be limited to cash, deposits, property mortgage, guarantees by the Government, CBSL and licensed banks, assignment of life insurance policies, gold articles, assignment of shares, mortgage over motor vehicles, plant, machinery and equipment, debt mortgages quoted debentures, equity shares and any other types of security as specifically approved by the Director of Bank Supervision on a case-by-case basis.

12.5 Licensed bank shall comply with the following in relation to valuation of collateral:

12.5.1 Banking Act Directions issued by CBSL from time to time, on Regulatory Framework on Valuation of Immovable Properties of Licensed Banks.

12.5.2 Guidelines issued by the CA Sri Lanka on Valuation of Property, Plant and Equipment, Investment Property and Biological Assets for the purpose of Financial Reporting.

13. Recognition of Interest Income

13.1 Licensed bank shall recognise the interest income for credit facilities based on the Sri Lanka Accounting Standards.

14. Role of Internal Audit

14.1 The Internal audit function shall independently evaluate the effectiveness of the credit risk assessment, measurement systems and processes of the licensed bank and shall ensure the acceptability of credit judgments.

14.2 The Internal audit function shall at least annually, validate and evaluate all credit risk assessment models, inputs and assumptions used along with data smoothening, if any.

14.3 The Internal audit function shall provide an assurance on the adequacy and effectiveness of back testing in order to ensure that the key drivers have been captured and calibrated accurately.

15. Regulatory Reporting

15.1 Licensed bank are required to submit the statutory returns introduced for these Directions, as stipulated below, or as stipulated otherwise by the Director of Bank Supervision.

15.1.1 Monthly Returns - on or before the 15th day of the following month.

15.1.2 Quarterly Returns - on or before the 15th day from the end of a quarter.

15.2 Licensed bank shall publish the following Key Performance Indicators based on SLFRS information in quarterly and annual financial statements.

15.2.1 Stage 3 Loans (net of Stage 3 impairment) to Total Loans.

15.2.2 Stage 3 Impairment to Stage 3 Loans.

16. Effective Date

16.1 These Directions shall be in effect from 01 January 2022.

17. Revocation of Directions

17.1 The following Directions/Circulars will be revoked from 01 January 2022:

17.1.1 Banking Act Direction Nos. 3 and 4 of 2008 on Classification of Loans and Advances, Income Recognition and Provisioning dated 08 May 2008.

17.1.2 Banking Act Direction Nos. 3 and 4 of 2010 - Amendments to Directions on Classification of Loans and Advances, Income Recognition and Provisioning dated 27 September 2010.

17.1.3 Circular No. 04 of 2018 - Guidelines to Licensed Banks on Adoption of Sri Lanka Accounting Standard - SLFRS 9: Financial Instruments dated 31 December 2018. The one-time permission to stagger first day audited additional credit loss provisions from adoption of SLFRS 9, net of any other adjustment on first day impact to retained earnings and net of tax effects, will continue to be in effect until 31 December2021.

17.1.4 Circular No. 06 of 2019 - Supplement to Circular No. 04 of 2018 on the Adoption of Sri Lanka Accounting Standards - SLFRS 9: Financial Instruments in Licensed Banks dated 26 April 2019.

Prof. W D Lakshman

Chairman of the Monetary Board and

Governor of the Central Bank of Sri Lanka

Annex I

Guidance on Impairment Computation for Licensed Banks

1. **Computation of the Probability of Default (PD) and Loss Given Default (LGD)**
   (i) Licensed bank shall, at a minimum, use five years of data, unless a shorter time horizon provides better estimations and is better suited when calculating PDs and LGDs. Any smoothening of data or inputs must be validated by the Risk Management Department.
   (ii) Licensed bank shall not use proxies to compute PDs and LGDs, unless the bank is a newly incorporated bank, or the product category was newly introduced by the bank and has a credit history of less than 5 years.
   (iii) When the licensed bank are unable to compute LGDs due to lack of data or inputs, licensed banks shall use a minimum LGD of 45 per cent for such exposures.
   (iv) When required to calculate LGD for exposures guaranteed by the Government of Sri Lanka:
      (a) An LGD of zero may be applied to exposures with a guarantee of the Government provided that the guarantee fully covers the principal and interest and is reported as a liability of the Government.
      (b) LGD for any other form of assurance provided by the Government other than in item (a) above, shall be computed instead of using an LGD of zero percent.
      (c) A minimum LGD of 20 per cent shall be applied for Government guarantees denominated in foreign currency.

2. **Economic Factor Adjustment**
   (i) Licensed bank shall use forecasts and projections published by CBSL when adjusting credit provisioning models to reflect the economic conditions and forecasts, on a consistent basis.
   (ii) If CBSL forecasts are not available, licensed bank shall use credible alternative sources on a consistent basis and shall maintain relevant documentary evidence.
   (iii) Board approved policies shall specify the sources to be used and licensed bank shall not cherry pick sources in their favor.

3. Use of Banks Internal Credit Rating (ICR) for Impairment Computation

(i) A licensed bank may use ICR information as the main basis for expected credit loss calculations only if they comply with the following requirements:

(a) Pricing mechanism and operational decision-making process shall be mapped with ICR information;

(b) Shall have at least five years of ICR based historical data subject to (i) (a) above; and

(c) Board of Directors approved policies shall be in place and ICR inputs and models shall be reviewed and endorsed annually by the Risk Management Department and/or an independent 3rd party.

4. Off-Balance Sheet Exposures

(i) When converting off-balance sheet exposures for expected credit loss calculations, if historical data is not available, licensed bank shall use the values as per the credit conversion factors specified in the Banking Act Direction on Capital Requirements.