MONETARY BOARD
CENTRAL BANK OF SRI LANKA

04 **February 2020** **FINANCE BUSINESS ACT DIRECTIONS** **No. 01 of 2020**

CLASSIFICATION AND MEASUREMENT OF CREDIT FACILITIES

In terms of powers conferred by Section 12 of the Finance Business Act, No. 42 of 2011, the Monetary Board hereby determines the classification and measurement of credit facilities for Licensed Finance Companies (LFCs) as follows;

1. Applicability of the direction

1.1 These Directions set out the minimum requirements on the classification and measurement of all credit facilities granted by an LFC with the adoption of Sri Lanka Accounting Standard, 'SLFRS 9: Financial Instruments' issued by the Council of Chartered Accountants of Sri Lanka and prudential requirements of the Central Bank of Sri Lanka (CBSL).

1.2 The credit facilities shall include the following;

(a) All financial instruments measured at amortized cost as per SLFRS 9.

(b) Off-balance sheet credit facilities with a commitment to accept contingent liabilities, including guarantees, bonds, warranties, letters of credit and acceptances.

1.3 All LFC shall maintain basic information (including those set out in Appendix A, where applicable) on borrower, credit facility and periodic credit reviews to enable an objective evaluation of the quality of borrowers.

2. Effective date

2.1 These Directions are effective for financial years beginning on or after 1 April 2021.

3. Responsibility of the board of directors and senior management

3.1 The Board of Directors (BoD) and senior management of an LFC is responsible to establish credit risk management framework, including effective internal control system to consistently determine adequate impairment allowances in accordance with the LFC's Board approved policies, applicable accounting standards and regulatory requirements.

4. Classification of credit facilities

4.1 **Credit facilities**

4.1.1 An LFC shall classify the credit facilities as Performing loans (PLs) and non-performing loans (NPLs) in terms of Direction 4.1.2 and 4.1.3.

4.1.2 PLs shall mean all credit facilities other than NPLs classified in terms of Direction 4.1.4.

4.1.3 An LFCs shall classify credit facilities as NPLs based on the two criteria; i.e., based on period and/or on potential risk.

4.1.4 An LFC shall at minimum, classify every credit facility as NPL based on the period and / or on potential risk are given at Table 1 and 2, Appendix B.

4.2 **Rescheduled credit facilities**

4.2.1 When rescheduling, age should be considered in aggregate, the period of time the credit facility was in arrears before rescheduling and after rescheduling for the purpose of classification.

4.2.2 When rescheduling occurs before a credit facility is classified as NPL, LFCs may disregard aggregating the period of time the credit facility was in arrears, if the borrower continues to service the loan for periods specified in Table 3, Appendix B, applicable for Special mentioned category.

4.2.3 When rescheduling occurs after a credit facility is classified as NPL, the rescheduled credit facility shall be classified as NPL when, in aggregate, the period of time the credit facility was in arrears before rescheduling and after rescheduling exceeds the time period specified in Table 1, Appendix B, in respective credit facilities.

4.3 **Reclassification of credit facilities**

4.3.1 **Reclassification of NPLs to PLs**

An LFC shall reclassify NPLs as PLs, if such NPLs meet the following criteria;

(i) Principle and interest in arrears are fully paid by the borrower in relation to the classified NPLs or upon the confirmation to the satisfactory performance of the credit facilities classified as NPLs under potential risk, and after ensuring that the repayment of the remaining principle and interest are in accordance with the terms and conditions of the borrower.

(ii) A credit assessment of repayment capacity, cash flow and financial position of the borrower in line with the Direction 5 below shall be carried out prior to such reclassification of NPLs as PLs.

4.3.2 **Reclassification of rescheduled NPLs as PLs**

(i) LFCs shall reclassify rescheduled credit facilities as PLs only if the borrower has complied with the rescheduled terms fully and demonstrates the ability to repay under rescheduled terms and conditions in the future.

(ii) The NPLs which have been subjected to rescheduling, would be eligible to be upgraded to PLs only after ensuring satisfactory performance and subject to specified periods in Table 3, Appendix B in respective credit facilities.

4.4 **Multiple credit facilities**

An LFC shall classify for credit facilities based on the credit assessment of the borrower.

4.5 **New credit facilities**

LFCs shall not grant new credit facilities for repayment of NPL in the name of the same borrower or any other related party, unless such credit facility is also classified as NPL and categorized into the same category of the repaid credit facility as per categorization of non-performing credit facilities (Table 1, Appendix B). The reclassification of such NPL as a PL shall be subject to Direction 4.3.

5. Categorization of Non-performing credit facilities

5.1 An LFC at a minimum shall categorize the credit facilities into four credit grades as special mention, substandard, doubtful and loss given at Table 1, Appendix B.

6. Measurement for expected credit losses

6.1 An LFC shall recognize the loss allowance for expected credit losses for all the credit facilities as per Sri Lanka Accounting Standard, 'SLFRS 9: Financial Instruments', (as amended) as set out in Appendix C.

6.2 **Multiple credit facilities**

6.2.1 An LFC shall provide for credit facilities above a certain materiality threshold based on the credit assessment of the borrower, except for homogenous credit exposures (e.g. housing loans, consumer loans, credit card receivables) below a certain materiality threshold.

6.2.2 An LFC shall pool all homogenous credit exposures together except 6.2.1 above, and provide for collectively based on risk characteristics.

6.2.3 An LFC shall develop an internal rating if 6.2.1 and 6.2.2 above are combined and shall provide for based on the credit assessment of the borrower.

7. Regulatory requirement

7.1 **Minimum Level of Regulatory Loss Allowance**

7.1.1 Director may determine a Minimum Level of Regulatory Loss Allowance if there is significant difference between regulatory provision (i.e., provision and accrued interest in NPL) and loss allowances for expected credit losses for credit facilities for all financial instruments measured at amortized cost under purview of this Direction as per accounting standards from time to time.

7.1.2 LFC shall determine and recognize the loss allowances for expected credit loss on the credit exposures in accordance with the requirements of accounting standards. However, in line with the international best practices, the CBSL shall monitor the loss allowances for expected credit losses in comparison to the regulatory provision.

7.1.3 Where the loss allowances for expected credit loss falls below the regulatory provision, LFC shall maintain the additional loss allowance in a non-distributable regulatory loss allowance reserve (RLAR) through an appropriation of its retained earnings. The additional loss allowance shall be maintained in the RLAR at all times. When loss allowance for expected credit losses exceeds the Regulatory provision, the LFC may transfer the excess amount in the RLAR to its retained earnings.

7.1.4 Further, any shortfall in regulatory provision (i.e., provision and accrued interest in NPL) and loss allowances for expected credit loss as per accounting standards shall be adjusted in the Finance Business Act Directions No.03 of 2018 – Capital Adequacy Requirements or as amended.

7.1.5 LFCs shall submit all periodical information pertaining to regulatory provisioning on memorandum basis, based on statutory returns to CBSL in accordance with the Direction 7.2 below.

7.1.6 LFCs shall maintain adequate data/records and systems separately to identify, reconcile and report expected credit loss allowances under the Sri Lanka Accounting Standards and the regulatory provisioning requirements, in accordance with Direction 7.2 below.

7.2 **Regulatory Provisioning**

7.2.1 An LFC shall maintain specific provisions, as per the credit facilities categorized in Table 1 and 2, Appendix B on the amount outstanding, net of realizable security value of collaterals as specified in Appendix C and accrued interest on NPL specified in Direction 7.3 as per the following:

Categories of Non-performing Credit Facilities	Minimum Specific Provisioning Requirement
Special mention	5%
Substandard	20%
Doubtful	50%
Loss	100%

7.2.2 The amount of specific provision made earlier, in respective of rescheduled NPLs of the respective categories, could also be reversed only after the period specified in Table 3, Appendix B.

7.2.3 An LFC shall provide for multiple credit facilities based on the credit assessment of the borrower.

7.3 **Accrued interest on NPLs**

On a memorandum basis, an LFC shall report the accrued interest but uncollected from the date a credit facility is classified as NPL.

7.4 **Write off/write down of non-performing credit facilities**

An LFC shall have a well-designed write off/write down policy approved by the BoD.

8. Transitional provisions	8.1	As a transitional provision in classifying for Special mention category, LFCs shall adopt 120 past due date with effect from 01.04.2021 for 12 months and required to adopt 90 past due date for classifications with effect from 01.04.2022.
9. Definition	9.1	"Director" means the Director of the Department of Supervision of Non-Bank Financial Institutions of the Central Bank of Sri Lanka.
10. Revocation of Previous Direction	10.1	The Finance Companies (Provision for Bad and Doubtful Debts) Direction No. 03 of 2006 and the Finance Companies (Accrued Interest) Direction No. 15 of 1991 will be revoked from effective date of these Directions.

Prof. W D Lakshman
Chairman of the Monetary Board and
Governor of the Central Bank of Sri Lanka

Appendix A

Minimum Information to be maintained in Credit Files

(I) Information on borrower

(i) Natural Persons – Occupation, Employer, Salary/Income, Financial position/net worth and any other relevant information.

(ii) Others – Constitution (proprietorship, partnership, private company, public company, society, club, co-operative, statutory board), Business background and history, Organization structure, Management team/Directors, Shareholders/proprietor/ partners, Financial position and performance, and any other relevant information.

(II) Information on credit facility

(i) Description of facility type

(ii) Purpose of facility

(iii) Terms of facility – limits, interest rates, repayment schedules, expiry dates

(iv) Collateral – types, valuation amount, valuation date and where applicable, name of the valuer.

(v) Guarantors – names, financial position and net worth

(vi) Business Sector in which the loan is given (i.e., agriculture, manufacture, retail…etc.)

(III) Information on appraisal of credit application

(Certain information would not be applicable for borrowers who are natural persons.)

(i) Assessment and recommendations of account officer/manager

(ii) Approval and basis of approval by management/credit committee

(iii) Qualitative analyses based on:

a. Borrower information
b. History of relationship with customer
c. Information on the finance company relationship of other related groups of the borrower with the LFC
d. Information obtained on the borrower from other institutions and sources, including related offices of the LFC

e. Analysis of industry and business risk

f. Single customer concentration (if appropriate)

(iv) Quantitative analyses based on:

a. Financial position and performance (previous, current and projected)

b. Business plans, sources and cash flow forecast for meeting repayment requirements

(v) Capital resources

(vi) Other commitments

(vii) Collateral appraisal and value

(IV) Information on periodic credit review

(Certain information would not be applicable for borrowers who are natural persons.)

(i) Assessment and recommendations of credit review officer, including:

a. Credit grading/rating accorded

b. Provision for losses

c. Suspension of interest

(ii) Approval and basis of approval for renewals; revision in terms and conditions; and changes in credit grading

(iii) Latest available information on:-

a. Outstanding facilities utilized, including contingent liabilities, commitments and other off-balance sheet transactions

b. Conduct and servicing of account

c. Correspondences and call reports from meetings with borrowers and site visits

d. Current qualitative analyses based on latest updated information on borrower, including review comments from internal and external auditors, where available

(iv) Current quantitative analyses based on latest updated financial information, appraisals and valuations

(v) Information on the account conduct of other related groups of the borrower

(vi) Analysis of industry and business risk

(vii) Assessment of credit report obtained from Credit Information Bureau of Sri Lanka.

Appendix B

Table 1: Non-Performing Loans - Based on Period

Facility type	Classification criteria	Categorization of NPLs			
		Special Mention	Substandard	Doubtful	Loss
Credit facilities repayable in daily basis	Principle or interest or both past due for more than 7 days from the due date	Payment due and unpaid for more than 7 days but less than or equal 30 days from the due date	Payment due and unpaid for more than 30 days but less than or equal 60 days from the due date	Payment due and unpaid for more than 60 days but less than or equal 90 days from the due date	Payment due and unpaid for more than 90 days from the due date
Credit facilities repayable in weekly and bi-weekly basis	Principle or interest or both past due for more than 30 days from the due date	Payment due and unpaid for more than 30 days but less than or equal 90 days from the due date	Payment due and unpaid for more than 90 days but less than or equal 180 days from the due date	Payment due and unpaid for more than 180 days but less than 270 days from the due date	Payment due and unpaid for more than 270 days from the due date
Credit facilities repayable on monthly basis or more	principle or interest or both past due for more than 90 days from the due date In the case of credit card, minimum payment is in arrears for more than 90 days from due date	Payment due and unpaid for more than 90 days but less than or equal 180 days from the due date In case of credit card, minimum payment arrears for more than 90 days but less than or equal 180 days from due date	Payment due and unpaid for more than 180 days but less than or equal 270 days from the due date In case of credit card, minimum payment arrears for more 180 days but less than or equal 270 days from due date	Payment due and unpaid for more than 270 days but less than or equal 360 days from the due date In case of credit card, minimum payment arrears for more than 270 days but less than or equal 360 days from due date	Payment due and unpaid for more than 360 days from the due date In case of credit card, minimum payment arrears for more than 360 days from due date
Credit facilities repayable in one	Installment (fully /partly) past due for	Payment due and unpaid for more than 90	Payment due and unpaid for more than	Payment due and unpaid for more than 270 days but	Payment due and unpaid for more than

Facility type	Classification criteria	Categorization of NPLs			
		Special Mention	Substandard	Doubtful	Loss
installment at the end of specific period or on a due date (bullet payments)	more than 90 days from the end of agreed period or the due date	days but less than or equal 180 days from the end of agreed period or the due date	180 days but less than or equal 270 days from the end of agreed period or the due date	less than or equal 360 days from the end of agreed period or the due date	360 days from the end of agreed period or the due date

Table 2: Non-Performing Loans - Based on Potential Risk

Facility type	Classification criteria	Categorization of NPLs			
		Special Mention	Substandard	Doubtful	Loss
	Any triggered criteria stated under potential risk in this table.	(i) A declining trend in the operations of the borrower that signals a potential weakness in the financial position of the borrower, but not to the point that repayment is jeopardized; or (ii) Any economic and market conditions that may unfavorably affect the profitability and business of the	(i) Inability of the borrower to meet contractual repayment terms of the credit facility; (ii) Weak financial condition or the inability of the borrower to generate sufficient cash flow to service the payments; (iii) Difficulties experienced by the borrower in	(i) The borrower exhibits more severe weaknesses than those in a 'substandard' credit facility, such that the prospect of full recovery of the outstanding credit facilities are questionable; or (ii) The probability of a loss is high, but the exact amount remains undeterminable as yet. (iii) Unfavorable economic and market conditions or operating problems	(i) Breach of any key financial covenants by the borrower; (ii) The borrower is in a weak financial position or the ability of the customer to earn income is low, which indicates that the customer may not be able to service the debt; (iii) The business of the borrower has become uncertain or the borrower has used the funds obtained for the purposes other than

Facility type	Classification criteria	Categorization of NPLs			
		Special Mention	Substandard	Doubtful	Loss
		borrower in the future.	repaying other credit facilities granted by the same LFC, or by any other financial institutions (where such information is available); or (iv) Unfavorable economic and market conditions or operating problems that would affect the repayment capacity of the borrower in the future.	that already affected the repayment capacity of the borrower.	for which they were meant; (iv) The borrower is deceased and there are no assets to repay the debt; (v) The borrower has ceased or dissolved his business and is in debt to other creditors with preferential rights over the whole of the borrower's assets, where the said creditors' total claims exceed the value of the borrower's assets; (vi) The LFC has filed a bankruptcy suit against the borrower or has applied for participation in property with other creditors who have filed for bankruptcy, where the parties have agreed to restructure the debt

Facility type	Classification criteria	Categorization of NPLs			
		Special Mention	Substandard	Doubtful	Loss
					with approval from the Court; (vii) The LFC has applied for participation in property with other creditors who have sued the debtor; or (viii) The LFC is unable to contact or find the borrower.

Table 3 - Reclassification of rescheduled NPL as PL

Upgrade to PL	Special Mention	Substandard and Doubtful	Loss
Credit facilities repayable in daily basis	Period of 4 days after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms.	Period of 7 days after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms.	Period of 15 days after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms.
Credit facilities repayable in weekly and bi-weekly basis	Period of 15 days after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms.	Period of 30 days after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms.	Period of 60 days after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms.
Credit facilities repayable on monthly basis or more including bullet payments	Period of 90 days after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms.	Period of 180 days after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms.	Period of 360 days after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms.

Appendix C

Guidelines to LFCs on adoption of Sri Lanka Accounting Standards - SLFRS 9 – Financial Instruments within the scope of the Direction on Classification and Measurement of Credit Facilities for LFCs.

1. Principles for Sound Credit Risk Management

1.1 BoD and the senior management are responsible for ensuring that the LFCs have appropriate credit risk practices, including an effective system of internal control, to consistently determine adequate impairment allowances in accordance with the policies and procedures of LFCs, the applicable Sri Lanka Accounting Standards and applicable prudential Directions.

1.2 LFC shall document and adhere to sound methodologies that address policies, procedures and controls for assessing and measuring credit risk on all financial assets. The measurement of impairment allowances should build upon those robust methodologies and result in the appropriate and timely recognition of expected credit losses in accordance with the applicable Sri Lanka Accounting Standards and applicable prudential Directions.

1.3 The aggregate amount of impairment allowances of LFCs, regardless of whether allowance components are determined on a collective or an individual basis, should be adequate and consistent with the objectives of the applicable Sri Lanka Accounting Standards and applicable prudential Directions.

1.4 LFC shall have policies and procedures in place to validate models used to assess and measure expected credit losses.

1.5 LFC shall use experienced credit judgment, especially in the robust consideration of reasonable and supportable forward-looking information, including macro-economic factors, to measure the expected credit losses.

1.6 LFC should have a sound credit risk assessment and measurement process with the support of adequate systems, tools and data to assess credit risk and to account for expected credit losses.

1.7 LFC's public disclosures should promote transparency and comparability by providing timely, relevant and useful information.

2. Classification and Measurement of Financial Assets

Business models approved by BoD shall be in place to facilitate classification of financial assets. For this purpose, sufficient documentation on objectives, definitions, characteristics, criteria and operating policies along with adequate procedures and systems for assessing the business models on an on-going basis shall be in place.

3. Reclassification

3.1 If the objective of the business model of the LFC for its financial assets changes and its previous model assessment would no longer apply, reclassification is required between financial assets under the provisions of SLFRS 9.

3.2 In line with the requirements of SLFRS 9, such changes in business models and reclassifications shall be pre- approved by the BoD and shall be notified to the Director of Supervision of Non-Bank Financial Institutions within 7 working days of the date of such approval.

4. Impairment of Financial Assets

4.1 General

(a) The impairment model under SLFRS 9 is forward-looking and changes the way loan loss provisions are recognized and measured.

(b) At the initial recognition, at a minimum of 12 months Expected Credit Losses (ECL) is recognized in profit or loss for financial assets measured at amortized cost or Fair value through Other Comprehensive Income (FVTOCI).

(c) After initial recognition, Lifetime Expected Credit Losses (LECL) will be recognized on assets for which there is a significant increase in credit risk (except for the purchased or originated credit impaired financial assets.

4.2 Life-time Expected Credit Losses and 12 Month Expected Credit Losses

(a) At each reporting date, LFCs shall measure the loss allowance for financial instruments at an amount equal to life-time expected losses, if the credit risk of a financial instrument has increased significantly since initial recognition (except for the purchased or originated credit-impaired financial assets).

(b) For purchased or originated credit impaired financial assets, lifetime expected credit losses shall be measured.

(c) In principle, life time expected credit losses and credit impaired loans are provided on an individual basis. However, due to lack of borrower-specific information, LFCs may perform the assessment on appropriate groups or portfolios on a collective basis.

(d) At the reporting date, if the credit risk of a financial instrument has not increased significantly since the initial recognition, LFCs shall measure the loss allowance for that financial instrument at an amount equal to 12 month expected credit loss.

4.3 Economic Factor Adjustment

(a) LFCs shall use the forecasts and projections published by independent institutions such as Central Bank of Sri Lanka(CBSL), International Monetary Fund, Asian Development Bank and/or World Bank in all instances where such projections are available when adjusting credit provisioning models to reflect the economic conditions and forecasts.

(b) If the required information is not available through above sources, LFCs shall use credible alternative sources and shall maintain documentary evidence.

(c) BoD approved policies shall be available to specify the sources to be used and LFCs shall not cherry pick sources in their favour.

4.4 Significant Increase in Credit Risk

For the purpose of calculating life-time expected credit losses, as a minimum, if one or more of the following factors/conditions are met, it shall be considered as a significant increase in credit risk:

(a) When contractual payments of a customer are more than 30 days (transitional provision) past due[1] (not relevant for daily, weekly and bi weekly).

(b) When the risk rating of the customer of LFC that has been obtained within one year, has been downgraded to B+ by an external credit rating agency from the origination of credit facility and/or when there is a two-notch downgrade in the LFCs internal rating system. In the event no external credit rating is available, LFCs are required to map their internal credit risk ratings with the ratings issued by the External Credit Assessment Institutions (ECAI). For this purpose, LFCs are required to refer the mapping of external credit

[1] Days past due shall be calculated from contractual due date of the payment.

ratings given in Finance Business Act Direction No.03 of 2018 – Capital Adequacy Requirements or as amended.

(c) When reasonable and supportable forecasts of future economic conditions directly affect the performance of a customer/group of customers or portfolios.

(d) When there is a significant change in the geographical locations or natural catastrophes that directly impact the performance of a customer/group of customers.

(e) When the value of collateral is significantly reduced and/or realisibility of collateral is doubtful. Limits shall be set and documented by LFCs.

(f) When a customer is subject to litigation that significantly affects the performance of the credit facility.

(g) Delay in the commencement of business operations/projects by more than two years from the originally agreed date.

(h) Modification of terms resulting in concessions, including extensions, deferment of payments, waiver of covenants etc.

(i) When the customer is deceased/insolvent.

(j) When the LFC is unable to contact or find the customer.

4.5 Models for Calculation of Expected Credit Losses

(a) LFCs shall consider 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.

(b) LFCs shall calculate the expected credit losses for structured products based on the credit assessment of the borrower and Board approved policy. Further, credit evaluation and assessment shall be done at least half yearly.

(c) LFCs shall develop robust models to determine expected credit losses under SLFRS 9. Such models shall be tailored to reflect the LFC's risk profile.

(d) LFCs shall ensure that the relevant officers are well trained and competent on understanding the models adopted by them for this purpose.

(e) When obtaining support from external vendors/consultants in respect of model development, rigorous governance and internal control processes shall be adhered.

(f) In respect of models are used for different portfolios and instruments, LFCs are required to document the reasons why the selected model is appropriate and all credit models must be reviewed at least annually.

(g) An effective model validation process shall be established to ensure that the credit risk assessment and measurement methods are able to generate accurate, consistent and unbiased predictive estimates on an ongoing basis.

(h) LFCs are required to desist from making changes in the parameters, inputs and assumptions used for the purpose of profit smoothening. The rationale and justification for any changes in the expected loss models shall be documented and justified by the Chief Risk Officer and approved by the BoD.

(i) Assumptions concerning the impact of changes in general economic developments on borrower's repayment capacity, shall be made with reasonable and supportable information as well as the need to consider all possible scenarios.

(j) For certain events, the above conditions may not result in a significant increase of credit risk. In such events, the BoD should make such assessment and notify CBSL in the next reporting period.

4.6 Minimum criteria on impairment of financial instruments

(a) Minimum criteria to be met by LFC

(i) **Stage 1:** All credit facilities, which are not categorized under Stages 2 or 3 below.

(ii) **Stage 2:** Based on the past due days given below:

Facility type	2021/22	2022/23
Credit facilities repayable in daily	07	04
Credit facilities repayable in weekly or bi-weekly basis	30	15
Credit facilities repayable monthly or more	60	30

a. All rescheduled credit facilities, in aggregate, the period of time the credit facilities was in arrears before rescheduling and after rescheduling based on above table, other than credit facilities/exposures mentioned in 4.6(c)(ii) below.

b. Under-performing credit facilities/exposures as identified in paragraph 4.4 of the "Guidelines to LFCs on adoption of Sri Lanka Accounting Standards - SLFRS 9 – Financial Instruments within the scope of the Direction on Classification and Measurement of Credit Facilities for LFCs".

(iii) **Stage 3:** Based on the past due days given below:

Facility type	**2021/22**	**2022/23**
Credit facilities repayable in daily	15	07
Credit facilities repayable in weekly or bi-weekly basis	60	30
Credit facilities repayable monthly or more	120	90

a. All rescheduled credit facilities, in aggregate, the period of time the credit facilities was in arrears before rescheduling and after rescheduling based on above table, other than credit facilities/exposures mentioned in 4.6(c)(ii) below.

b. All credit facilities/customers classified as NPLs as per proposed new Direction.

c. Non-performing credit facilities/customers as identified in the paragraph 4.4 of the "Guidelines to LFCs on adoption of Sri Lanka Accounting Standards - Financial Instruments within the scope of the Direction on Classification and Measurement of Credit Facilities for LFCs".

d. Unrecovered amount of an exposure where the asset financed under a lease/hire purchase agreement has been repossessed and sold or where the asset taken as collateral has been sold by the LFC.

(b) Guidance for computation of the Probability of Default (PD) and Loss Given Default (LGD) to be used as a minimum for the calculation of expected credit losses is as follows.

(i) LFCs shall use at least 4 years data when calculating PDs and any smoothing of data or inputs must be validated by the Risk Management Department or an independent party.

(ii) LFCs shall not use proxies to compute PDs and LGDs, unless the LFC is a newly incorporated LFC with inadequate credit history of less than 4 years.

(iii) When the LFC is unable to compute LGDs due to lack of data or inputs, such LFC is required to use a minimum LGD of 45 per cent for such exposures.

(iv) When calculating LGD for exposures guaranteed by the Government of Sri Lanka:

a. An LGD of zero can be applied to exposures with the guarantee of the Government provided that the guarantee is fully covered with the interest and reported as liabilities of the Government.

b. A minimum LGD of 20 per cent shall be applied for Government guarantees denominated in foreign currency.

c. LGD for any other form of assurance other than in item 4.6(b)(iv)a. above shall be computed instead of using a zero LGD.

(c) Other Guidance

(i) Off-balance sheet exposures: When converting off-balance sheet exposures for expected credit loss calculations, LFCs may use the values as per the credit conversion factors specified in the Finance Business Act Direction No.03 of 2018 – Capital Adequacy Requirements or as amended.

(ii) Upgrading of credit facilities: when upgrading credit facilities from a higher stage to a lower stage (e.g., from stage 3 to stage 2)

a. The upgrading of credit facilities shall only be carried out by Risk Management Department or an independent party and be independent from the loan review mechanism.

b. Such upgrading shall be supported with a Board approved policy, rationale and with adequate documentation.

c. With respect to upgrading rescheduled facilities, LFCs must comply with Finance Business Act Direction No. 01 of 2020 - Classification and Measurement of Credit Facilities.

5. Collateral Valuation

5.1. Expected cash flows from collateral realization shall be based on latest observed reliable market valuations and shall appropriately reflect the inherent uncertainty associated with distressed property liquidation (including the time taken for such realization).

5.2. Any increase in valuations shall be substantiated by solid evidence that such increases are sustainable.

5.3. In addition, the minimum criteria for valuation of security for the purpose of Finance Business Act Direction No. 01 of 2020 - Classification and Measurement of Credit Facilities are given below:

(a) Secured on Gold - The market price of gold, subject to an adequate insurance cover.

(b) Assignment of Shares - Quoted - 90 percent of the latest market price.

(c) Repossessed vehicles and Machinery - With regard to vehicles and machinery that have been repossessed by the LFC, 80 per cent of the valuation (forced sale value) obtained during the preceding 6 months from an acceptable valuer.

(d) Quoted Debentures - 90 percent of the latest market price.

(e) Guarantees:

(i) Licensed Banks – incorporated locally or outside Sri Lanka

Eligible value of guarantee is based on a rating given by an eligible credit rating agency as given below:

Bank's credit rating	Value of security
AAA to AA- or equivalent	80%
A+ to A- or equivalent	50%

(ii) Government Guarantee of Sri Lanka - Full value

(f) Sri Lanka Government Securities, free from any lien or charge.

(g) Central Bank of Sri Lanka securities, free from any lien or charge.

(h) Time deposits in a licensed commercial bank, licensed specialised bank or a licensed finance company, with an external rating of BB+ and free from any lien or charge.

(i) Primary mortgage over immovable property

(i) Valuation of the immovable property shall be in compliance with the Finance Business Act Direction No. 4 of 2018 - Valuation of Immovable Properties or as amended.

(ii) The value of security is based on progressive discounts on the forced sale value (FSV) of immovable property and on a current valuation report as per the cited Direction.

(iii) The progressive discounts shall be as follows:

Item	% of FSV of immovable property that can be considered as the value of security
At the first time of classifying credit facility as NPL	75
Period in the loss category	
Less than 12 months	65

Item	% of FSV of immovable property that can be considered as the value of security
More than 12 but less than 24 months	60
More than 24 but less than 36 months	50
More than 36 but less than 48 months	40
More than 48 months	Property should be reviewed on a regular basis, and discounted further based on the Board approved policy

(j) Mortgages other than Primary Mortgages

Mortgages other than primary mortgages over immovable property will qualify for the above purpose subject to complying with the conditions in Section (i) (iii) above and if such property is mortgaged to the same LFC.

Provided that in the case of an occupied residential property taken as collateral without an agreement to hand over vacant possession in the event of sale for the recovery of dues, the value of such property shall not be considered.

6. Role of Internal Audit

6.1. The Internal Audit function shall independently evaluate the effectiveness of the credit risk assessment, measurement systems and processes of LFCs and shall ensure the acceptability of credit judgments.

6.2. Internal Audit function shall validate and evaluate all credit risk assessment models, inputs and assumptions used.

6.3. Internal audit function shall provide assurance over the adequacy and effectiveness of back testing, in order to ensure that the key drivers have been captured and calibrated accurately.

7. LFCs are required to report the information set out in Tables 1 and 2 below to the Department of Supervision of Non-Bank Financial Institutions through dsnbfi@cbsl.lk within 30 days after the end of each quarter, commencing from quarter ending 30.06.2021.

Table 1 – Probability of Defaults (PD) and Loss Given Defaults (LGD) on Collective Impairment as at ....

Business Segment/Product/ Category or any Other Basis	PD			LGD		
	Stage 1	Stage 2	Stage 3	Stage 1	Stage 2	Stage 3

Table 2 - Upgrading of Credit Facilities/Exposures for the Computation of Expected Credit Losses for the Quarter Ended as at ....

Number of Facilities upgraded From stage 2 to stage 1 From stage 3 to stage 1 From stage 3 to stage 2	
Value of Total Facilities Upgraded From stage 2 to stage 1 (Rs.mn) From stage 3 to stage 1 (Rs.mn) From stage 3 to stage 2 (Rs.mn)	
Total of interest income re-recognised to the income statement on upgrading to Stages 2 and 1. (Rs.mn)	