MFSA

MALTA FINANCIAL SERVICES AUTHORITY

BANKING RULES

MEASURES ADDRESSING CREDIT RISKS ARISING FROM THE ASSESSMENT OF THE QUALITY OF ASSET PORTFOLIOS OF CREDIT INSTITUTIONS AUTHORISED UNDER THE BANKING ACT 1994

Ref: BR/09/2016

INTRODUCTION

1. In terms of Article 4(2) of the Banking Act 1994 ('the Act') the competent authority ('the authority') as defined in Article 2 (1) of the Act is empowered to make Banking Rules as may be required for carrying out any of the provisions of the Act. The authority may also amend or revoke such Banking Rules. The Banking Rules and any amendment or revocation thereof shall be officially communicated to credit institutions and the authority shall make copies thereof available to the public.

2. The Measures Addressing Credit Risks arising from the Assessment of the Quality of Asset Portfolios of credit institutions Rule ('the Rule') is being made in relation to Article 17A of the Act which requires that:

> *"The competent authority may issue a banking rule as it considers appropriate for the implementation of measures aimed to address credit risks arising from the assessment of the quality of a credit institution's asset portfolio."*

SCOPE AND APPLICATION

3. The authority regards that fair valuation of assets and the allocation of adequate capital to cover risks associated with such exposures is of fundamental importance. This Rule applies to loans and receivables (held to maturity financial assets where applicable) and off-balance sheet exposures which comprise the following revocable and irrevocable items: loan commitments given, financial guarantees given, and other commitments given - hereinafter referred to in this Rule interchangeably as 'loans' (that are subject to impairment review in accordance with requirements of International Financial Reporting Standards as adopted by the EU ("IFRSs")[1] or 'credit facilities'. As a Rule, credit institutions are to comply with the provisions of IAS 39 and are expected to refer directly to IFRSs. Furthermore, this Rule should be read in conjunction with the Commission Implementing Regulation (EU) 2015/227 of 9 January 2015 amending Implementing Regulation (EU) No 680/2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council.

4. The authority considers it of utmost importance that a credit institution undertakes appropriate mitigation of the risks on its balance sheet, inter alia those arising from a

[1] IFRS as adopted by the EU are governed by the Commission Regulation (EC) No 1126/2008 and locally applied through Legal Notice 19 of 2009.

heightened level of non-performing loans. Accordingly, the authority considers that this should be achieved by this Rule through:

- the provision of due direction to a credit institution to recognise its incurred loan losses as early as possible within the context of IFRSs and ensuring that a credit institution's Credit Risk Management Framework includes a robust Credit Risk Policy commensurate with its operational risk profile, procedures and internal controls.

- the allocation of funds to a Reserve for "General Banking Risks" (being an Own Funds item) on the basis of the application of the methodology laid down in this Rule to create an additional Pillar II capital buffer operating through Banking Rule BR/12.

- the setting of a medium to long term target for non-performing loan ratios[2] not to exceed the threshold of 6%. In the event of such threshold being exceeded, a credit institution shall draw up a multi-year non-performing loans reduction plan in accordance with paragraphs 45 to 60 of this Rule.

- the allocation of funds to a separate Reserve for "Excessive Non-Performing Loans"[3], where the credit institution deviates from any phase of the non-performing loans reduction plan.

5. The Rule applies to all credit institutions authorised under the Banking Act 1994 on a solo basis.

CREDIT RISK MANAGEMENT FRAMEWORK

6. It is inevitable that, in the ordinary course of business, a credit institution may suffer losses on credit facilities as a result of these assets becoming partly or wholly uncollectible. The authority requires the Board of Directors (the Board) and senior management of a credit institution to implement a robust Impairment Loss Measurement Policy and Collateral Valuation Policy as part of its overall Credit Risk Policy.

[2] FINREP calculation of NPL ratio: Non-performing loans and advances (A) / Total gross loans and advances (B) – Data Point A from template Sheet F18.00 Row 070 & Column 060 + Row 250 & Column 060; Data Point B from template Sheet F18.00 Row 070 & Column 010 + Row 250 & Column 010.

[3] This Reserve is distinct from the Reserve for "General Banking Risk" and is governed by paragraphs 45-60 of this Rule.

CREDIT RISK POLICY

7. This Policy shall, as a minimum, include appropriate credit risk assessment processes and effective internal controls to consistently determine that impairments are in accordance with the credit institution's stated policies and procedures. Such Policy shall encompass the impairment allowances created in accordance with IFRSs and also deal with the additional allocation of Pillar II capital buffers for credit risk in accordance with this Rule and Banking Rule BR/12. It is the responsibility of the Board to ensure that the requirements of the authority in terms of this Rule are reflected in the Credit Risk Policy.

   Moreover, the authority requires a credit institution to regularly review and revise its key management risk judgements, assumptions and estimates in its Credit Risk Policy:

   - there should be disclosure through appropriate minutes (for perusal by the authority) of the key management judgements, estimates and assumptions underlying management decisions in this respect;

   - the disclosures should include the key inputs and parameters used in credit institutions' impairment models (if any) and an explanation of significant changes in the inputs used from the prior year;

   - if sensitivity analysis is used by a credit institution in assessing prospective risk quality and evaluating actual deterioration, the disclosures should include factors such as changes to assumptions concerning *inter alia* property price, GDP and unemployment rates.

8. The Credit Risk Policy shall as a minimum incorporate:

   - A description of the methodology for assessing credit risk.

   - A description of the credit risk management system. This shall include disclosures of policies and procedures regarding:

     a. credit risk classification systems (internal loan grading systems);
     b. collateral and guarantees;
     c. periodic review of exposures and collateral;
     d. internal credit quality reviews;
     e. monitoring overdue credits;
     f. limiting and controlling exposures;
     g. forbearance measures and the process for granting them;
     h. risk approval authorities within the credit institution including those authorised to approve risk policy exceptions, if any; and

i. where applicable,
   - reducing exposures through legally enforceable netting arrangements; and
   - the use of credit derivatives and credit insurance (including how these instruments affect the credit institution's recognition and measurement of exposure and losses).

Impairment Loss Measurement Policy

9. A credit institution's Impairment Loss Measurement Policy should incorporate, but not be limited to, the following:

Procedures and Internal Controls

- The roles and responsibilities of a credit institution's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, recoveries, debt management and the Board) involved in relation to correctly implementing the Policy, determining impairment and any applicable additional capital buffers.

- A description of the procedures and internal controls a credit institution employs in determining impairments. This should include, but not be limited to:
  a. an effective grading system that is consistently applied, identifies differing risk characteristics and quantifies problems accurately in a timely manner and prompts appropriate administrative and risk mitigation actions;

  b. sufficient internal controls to ensure that all relevant impairment indicators are appropriately considered in determining whether impairment has occurred and if so, in estimating the impairment loss; and

  c. clear formal communication and coordination between a credit institution's credit administration function, collection and recovery functions, financial reporting function, management, the Board, and others involved in the determination or review of impairments.

- Sufficient flexibility in the operation of a credit institution's changes to its management information system(s) through the collation of information relating to forborne loans, to clearly identify those facilities that have been fully restored to commercial terms following forbearance, and those supported by economic concessions.

- A description of the independent credit review process, as well as the officials responsible for performing reviews, the content and frequency of review assessments.

Impairment Loss Measurement

10. A credit institution shall document the following information in its written Impairment Policy:

  - A description of the methodology for assessing exposures for objective evidence of impairment and measuring impairment on a *specific* basis. The methods used to identify exposures to be analysed individually should be disclosed.

  - A description of the methodology for assessing exposures for objective evidence of impairment and measuring impairment, on a *collective* basis. A description of how information on historical loss experience has been gathered by the credit institution for different categories of exposures, current conditions, changes in portfolio composition and trends in delinquencies and recoveries should be disclosed. If using peer group experience, the credit institution should explain how this was sourced. The period used in accumulating the historical loss experience should be stated, along with the adjustments that were made to the results due to different conditions, and why these adjustments were necessary. The factors that were considered when establishing appropriate timeframes over which to evaluate loss experience should also be disclosed.

  - Each Policy should require that a description of the observable data that is used in the determination of impairment triggers and the measurement of the impairment of each portfolio is retained on file.

  - The method of segmenting portfolios for collective evaluation should be disclosed, along with the types of exposures in each portfolio.

Actual Loss Review

- The Policy should include how often actual losses in the preceding period are compared to historical experience for each portfolio and how often actual losses are compared to the impairment allowances held against such losses.

Collateral Valuation Policy

11. Collateral is a determining factor in establishing the extent of impairment that needs to be created whenever recovery of a credit facility is in serious doubt. Indeed, the projected cash flows from the enforcement of any lien on collateral are taken into consideration in the calculation of the impairment charges of a credit facility.

12. The Collateral Valuation Policy, without prejudice to paragraph 14, should incorporate but not be limited to the following:

    - the expertise and independence of the appraiser. The appraiser shall be a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process. "Necessary qualifications" need not be solely professional qualifications, but a credit institution should be able to demonstrate that the appraiser has the necessary ability and experience to undertake an independent review. The credit institution should request appraisers to disclose any material involvement in a property, if any;

    - how to determine the fair value, including the use of appraisals, valuation assumptions and calculations;

    - the supporting rationale for adjustments to appraised values, if any;

    - the determination of costs to sell, if applicable;

    - the assumed time line to recover;

    - clear instructions to appraisers for the evaluations;

    - the allocation of fees should follow the provisions of paragraph 14.

13. The Credit Risk Policy shall be reviewed and approved by the Board on at least an annual basis to ensure its continued appropriateness to changing circumstances and economic conditions.

Collateral Valuation

14. The types of assets that are generally considered acceptable by a credit institution to be pledged by the borrower in its favour as collateral are to be specified in the credit institution's Credit Risk Policy. For the purposes of this Rule, the authority requires that as a minimum, a credit institution shall:

- establish a programme to monitor on a frequent basis and at a minimum, once every year, the value of commercial real estate and once every three years, the value of residential real estate. Such monitoring may lead to amendments to the values assigned to properties. For individually significant loans, including but not limited to those exceeding EUR 3 million or 5% of the own funds of the credit institution, a credit institution shall review the value of the property securing such loans by an independent appraiser at least every three years. Such review may need to be undertaken at more frequent intervals, depending on a credit institution's particular circumstances at a point in time, for example, where there is lack of substantial capital buffers to take losses due to borrowing customers' default. Review of property valuations may lead to an amendment of the values assigned to the collateral;

- require that if the market is subject to significant changes in conditions where information indicates that the value of the property may have declined materially relative to general market prices, a revaluation of the collateral shall be deemed required. In general, collateral will need to be revalued regularly and consistent with stated policy to ensure that the original purchase price does not overstate the degree of security provided by the said collateral;

- make management accountable to review each appraiser assumptions and conclusions to ensure timeliness, reasonableness, prudence and conservatism in the exercise of appropriate judgement to recognise the inherent subjectivity of valuation estimates. These should be based on the most prudent estimate of the collateral's ability to generate timely cash flows at the time of loan approval and subsequent assessment.

- ensure that the collateral values used to determine the present value of estimated future cash flows are based on the value obtained in accordance with the credit institution's valuation policy. The determination of conservative values is particularly relevant and important where the characteristics of the collateral used render it 'unique' and thus may potentially result in limited marketability. In such cases, the value of the collateral may be determined almost exclusively on the basis of technical expert advice through estimates by an independent appraiser, rather than on the basis of an appropriate comprehensive track record of realisation in the market and therefore, the collateral valuation should be particularly prudent to reflect the singularity of such instances.

- require, where the authority deems it necessary, a credit institution to carry out an appraisal, at its expense, by another independent appraiser. Instructions to appraiser for property valuation on collateral security should come from the credit institution in accordance with its clearly defined terms of engagement. Fees should only be discharged by the credit institution. It is for the credit institution to decide as to how it will allocate such costs;

- assess whether the 'market value' of the collateral is indeed the best estimate of the net realisable value of the said asset. The credit institution should assess valuation in the context of the market impact of liquidation of the said collateral on liquidity, buy-sell spread and market float of the same class of assets. For immovable property, the Policy is expected to advocate adjustments such as forced sale discounts to reflect the idiosyncratic characteristics and conditions of the local market (e.g. type of property, time factor to realise collateral and location) so as to arrive at the best prudent estimate of the realisable value of the collateral;

- specify that any material expenses related to the potential sale of collateral shall be netted off against the cash flows that are estimated to occur as a result of the realisation of such collateral safeguarding a credit facility. Accordingly, any such cash flows shall take into consideration matters such as the following:

    a. expenses relating to legal procedures also taking into account any other offsetting aspects in such estimates, including as an example, the impact of duration of retention (of said collateral) on such selling expenses;

    b. the impact in monetary terms of the liquidity of the collateral itself;

    c. the price volatility of such collateral and concomitant market price dynamics (if available);

    d. the impact of the useful life of the collateral compared with maturity of the loan;

    e. the credit institution's priority ranking in the right to sale proceeds and the existence of insurance on the collateral.

- ensure that when the observable market price or fair value is used to assess the recoverable amount of the exposure, the amount, source and date of the observable market price is formally documented;

When using the fair value of collateral in assessing the recoverable amount of the exposure, the following items shall be documented:

a. how the fair value was determined, including the use of appraisals, valuation assumptions, comparable sale evaluations and other calculations;

b. the supporting rationale for adjustments to appraised values, if any;

c. the determination of costs to sell, if applicable;

d. the expertise and independence of the appraiser; and

e. the assumed timeline to recover;

f. Any valuation techniques and/or methodologies together with the institution's policies dealing with retention of evidence in the respect.

A credit institution shall ensure that this procedure is also adopted by its subsidiaries (if any).

LOAN QUALITY ASSESSMENT AND IMPAIRMENT LOSS QUANTIFICATION

15. Impairment occurs where there is objective evidence that the estimated recoverable amount of an exposure is lower than its relevant carrying amount. An impairment allowance should be created to decrease the carrying amount to the recoverable amount.

16. Every time a credit institution receives information indicating that quality of any credit facility has substantially deteriorated, it shall perform a review to assess whether one or more loss events referred to in paragraphs 17 to 19 has occurred.

OBJECTIVE EVIDENCE

17. *"Objective evidence"* provides the trigger point for assessment of the financial asset or a group of financial assets measured at amortised cost to determine the degree of its impairment (if any).

18. IAS 39 specifies that a breach of contract, such as a default or delinquency in interest or principal payments is considered as a loss event. The authority considers that there is a rebuttable presumption of objective evidence of impairment when a borrower misses a

contractual instalment payment on interest or principal by 90 days and over in line with the Non-Performing Exposure definition as per paragraphs 28 to 30. Consequently, such financial assets or group of assets should be considered for specific assessment as appropriate. In the case of loans which are not individually significant and where the cost of individual evaluation is not proportionate to the amount of possible loss, these would then be evaluated on a loan group level in accordance with methodologies developed by the credit institution. This requirement should not limit the earlier recognition of impairment losses incurred in accordance with IAS 39.

To identify which loans are individually significant, the credit institution shall take into account, as may be required, factors such as relative size of the loan to assets, loan portfolio or own funds as well as qualitative information, e.g. a loan forming part of a group of loans (loans to related parties with the credit institution, loans with heightened country risk, loans to the borrowers in distressed industries, or loans for which up-dated financial information on the borrower/guarantor is missing or where collateral has not been perfected or is not available).

19. A credit institution shall assess all credit exposures for objective evidence of impairment based on current information and events at the date of assessment. The general principle underlying this Rule is that impairment triggers should recognise incurred losses as early as possible and appropriate for each loan asset class. As a minimum a credit institution shall take into consideration the following triggers in the determination of applicable impairments:

Macroeconomic triggers

- economic conditions that indicate a measureable decrease in estimated future cash flows of the loan asset class
- increase in the unemployment rate
- decrease in prices of property pledged as collateral
- adverse change in industry conditions
- deteriorating country risk

Other triggers

- credit facility meets the definition of a non-performing loan
- request for a forbearance measure from the borrower
- actual deterioration in the debt service capacity
- material decrease in rents received on a buy-to-let property
- material decrease in the property value
- material decrease in estimated future cash flows
- material weakening or lack of an active market for the assets concerned
- the absence of a market for refinancing options
- rapid or significant decline in the credit institution’s own credit score/ rating of the borrower

- significant decline in a rating agency's credit rating or outlook assessment of the borrower
- diversion of cash flows from earning assets to support non-earning assets
- material decrease in turnover or the loss of a major customer
- default or breach of contract
- deterioration in a borrower's financial performance
- deterioration in a borrower's net worth and future prospects
- negative prospects for support from any financially responsible guarantors
- deterioration in the nature and degree of protection provided by the current and stabilised cash flow and value of any underlying collateral
- defaults on obligations by a counterparty to a borrower, which affects the borrower's capability to meet its liabilities to the credit institution
- decrease in the value of the collateral in cases when repayment of the loan is directly dependent on the collateral value
- the borrower belongs to a group of entities that has credits outstanding from the credit institution or other credit institutions and one or more members of the group have defaulted
- use of loaned funds for the purpose different from that provided in the loan contract
- there is a loss of confidence in the borrower's integrity
- in case of overdraft, the customer exceeding the approved limit frequently.

ASSESSMENT OF INDIVIDUALLY SIGNIFICANT LOANS

20. If there is objective evidence that an impairment of a credit facility exists, where one or more loss events indicated in paragraphs 17 to 19 occurred, a credit institution shall calculate the decrease in value according to the methodology laid down in IAS 39. If the recoverable amount is less than the carrying amount, a credit institution shall recognise the loss in the income statement. A credit institution shall calculate the decrease in value as the difference between the carrying amount of the credit facility and the value of future cash flows, which has been discounted using the original effective interest rate.

21. Future cash flows should include the value of applicable collateral less cost for obtaining it. The value of applicable collateral shall be subject to paragraphs 11 and 14 of this Rule when determining the recoverable amount of an impaired credit facility.

22. Without prejudice to paragraph 63, where several credit facilities have been supplied to the same borrower and one loan loss event has occurred, the credit institution shall assess the impairment of all loans granted to this borrower.

COLLECTIVE ASSESSMENT OF LOANS

23. Financial assets that are not individually identified as impaired shall be grouped on the basis of similar credit characteristics which indicate the borrower's ability to pay in accordance with the contractually agreed terms. Credit risk characteristics include location, collateral type, loan to value ratios, past-due status (age of arrears), asset type, forbearance measures applied and other relevant factors. Future cash flows in the collective assessment of a group of credit facilities are estimated on the basis of historical loss experience for loans with credit risk characteristics similar to those in the group. A number of factors could be taken into consideration, when determining historical loss rate such as ageing of balances, past loss experience, forbearance measures applied and current economic conditions. A credit institution that does not have the necessary historical loss experience is required to use peer group experience for comparable groups of credit facilities, (for example it could be obtained from peer group information published by rating agencies).

24. A credit institution should adjust the historical loss rate on the basis of its assessment of current observable data to reflect the effects of current conditions and to remove the effect of conditions in the historical period that no longer exist. Such factors include, but are not limited to:

    - changes in international, national and local economic and business environment;
    - the presence of any credit concentration and changes in the level of concentration;
    - variation in the size of loan portfolio, risk profile and loan agreement conditions;
    - changes in the amount of past due loans, the share of increased risk loans, the number of forborne loans and other loans with modified loan agreement conditions; and
    - the effect of external factors such as competition, legal and regulatory requirements on the estimated credit institution's current portfolio.

25. Changes in the estimates of future cash flows shall reflect and shall be directly consistent with changes in related market data such as changes in unemployment rate, property prices, commodity prices, loan payment status or any other statistics required to determine impairment losses in a group of loans.

    The authority considers that ageing of arrears and the numbers of repayments in arrears are key indicators of asset quality and may also be important inputs in recognising collective impairments.

26. A credit institution shall document the estimated impact of changes in the factors on historical loss experience, when adjustments in impairment allowances take place. Also, the methodology and assumptions used for estimating cash flows should be reviewed regularly to reduce any difference between loss estimates and actual loss experience. These shall also be documented.

27. As information becomes available to a credit institution indicating impairment of a loan included in the loan group, that loan shall be excluded from the group and shall be assessed individually or included in another loan group in accordance with credit risk characteristics.

PERFORMING AND NON-PERFORMING LOANS

28. The foundation of any loan review system is an accurate and timely credit grading, which involves an independent assessment of credit quality that should lead to the identification of problematic loans. An effective credit grading system provides important information for the determination of an adequate level of impairment allowances. A credit institution shall have a robust credit grading system based on qualitative and quantitative criteria.

29. The Commission Implementing Regulation (EU) 2015/227 of 9 January 2015 amending Implementing Regulation (EU) No 680/2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council aim to provide consistency of asset quality assessment across the EU, particularly regarding the line drawn in the different jurisdictions between performing and non-performing categories. For the purpose of this Rule, non-performing exposures as defined in the ITS, are those that satisfy either or both of the following criteria:

    a. material exposures which are more than 90 days past-due;

    b. the debtor is assessed as unlikely to pay its credit obligation(s) in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due.

30. For the purposes of this Rule, a credit institution shall apply Commission Implementing Regulation (EU) 2015/227 of 9 January 2015 in its entirety for reporting purposes in the determination of the institution’s performing and non-performing exposures.

FORBEARANCE MEASURES

31. Forbearance based on sound conduct principles provides for sound prudential management. Thus, a credit institution shall have in place a formal policy relating to forbearance practices, which policy should assess to what extent forborne assets are expected to be recovered and set a realistic time-frame for the recovery process to be concluded. A credit institution is expected to ensure that the period of forbearance for such loans on its books is limited.

32. The conditions (e.g. interest rate, term, grace period) shall be based on realistic payment arrangements in accordance with expectations as to the borrower's ability to pay and the general economic situation. Thus, loans shall preferably be structured through regular instalments consistent with the borrower's generation of income or, alternatively, through financially equivalent arrangements.

33. With respect to forbearance activities a credit institution should apply the Commission Implementing Regulation (EU) 2015/227 of 9 January 2015. Through this Regulation, the EU implements the EBA ITS, which includes a comprehensive and harmonised definition of forbearance and non-performing exposure. The definition of forbearance focuses on concessions extended to debtors who face, or may face, difficulties in meeting payments. Forborne exposures can be identified in both the non-performing and the performing portfolios.

REGULATORY ALLOCATION

34. Specific and collective impairment allowances within the IFRS accounting framework are based on the concept of *accrual accounting* i.e. losses are to be recognised when they are actually incurred. However, the underlying principle of this Rule is based on the prudence concept, thus giving rise to differences in assessing the amount of the *regulatory allocation* for regulatory purposes as opposed to impairment allowances according to IFRSs.

35. The authority requires that a *regulatory allocation* shall be made by a credit institution against the level of its non-performing loans. Thus, the authority expects that credit facilities categorised as non-performing according to paragraph 29 to be fully eligible for the purposes of a *regulatory allocation* in terms of this Rule. This means that for the purposes of the methodology of this Rule, the *regulatory allocation* shall be equal to a credit institution's level of non-performing exposures i.e. collateral (of whatever nature) <u>shall not</u> be taken into account, *less* the specific impairment allowance calculated in accordance with IFRSs as adopted by the EU. For the purposes of this Rule, non-performing facilities shall be net of interest in suspense.

36. This Rule provides for the minimum level of the *regulatory allocation* for the purposes of bridging the 'gap' with impairments arising from IFRSs and facilities categorised as non performing according to paragraph 29. However, the authority expects a credit institution to undertake its own assessment and reasoned judgement on the possibility of timely recovery of funds and provide an enhanced level of regulatory allocation as may be required and merited in such circumstances.

METHODOLOGY FOR ALLOCATION OF FUNDS TO THE RESERVE FORGENERAL BANKING RISKS

37. A credit institution shall, at the end of each financial year[4], appropriate an amount equivalent to a minimum of 2.5% of the *regulatory allocation* calculated in terms of this Rule, to the said "Reserve for General Banking Risks". However for all those non-performing facilities with capital and/or interest past due by more than 12 months and over, the 2.5% metric shall, as a minimum, in this case increase to 5%.

38. The authority considers the allocation of funds as a capital buffer via this methodology as a Pillar II measure. The appropriation to the "Reserve for General Banking Risks" shall be effected from the profits for the year. Where a credit institution has total Common Equity Tier 1 capital (CET 1) as per Regulation (EU) No 575/2013 (CRR) which exceeds a threshold determined by the authority, only half (50%) of the appropriation shall be allocated to the "Reserve for General Banking Risks" from the profits for the year .

    The balance shall be aggregated with the capital allocations made to cover all other Pillar II risks in the credit institution's ICAAP. Thus this capital allocation may be satisfied by surplus CET 1 capital already held by the credit institution which is not utilised to cover any other risks to which the credit institution is exposed.

    In the event that an institution's total CET 1 capital does not exceed the threshold referred to above, the appropriation to the "Reserve for General Banking Risks" shall be fully undertaken from the profits for the year.

    The above actions are without prejudice to the authority invoking its power to restrict or prohibit distributions (in general) by a credit institution to its shareholders.

39. As the allocation of funds via this capital buffer is a Pillar II measure, the authority reserves the right to increase the applicable metrics for any particular credit institution as

[4] Credit institution which include interim net profit for Own Funds purposes shall make this appropriation on an interim basis (*vide* Article 26(2) of the Regulation (EU) No 575/2013).

may be required according to that credit institution's risk profile as set out in its ICAAP and as assessed by the authority through the applicable Supervisory Review and Evaluation Process.

40. A credit institution shall, on an *annual basis,* appropriate funds to the "Reserve for General Banking Risks" as described above in paragraphs 37 and 38 for its pool of individually significant loans. However, should the *regulatory allocation* for such loans change materially within the interim period through further deterioration of a facility, a credit institution shall adjust the applicable capital buffer accordingly to reflect the possibility of incremental risk.

41. The authority reserves the right to require a credit institution to ultimately increase its allocation of funds to the reserve for "General Banking Risks" i.e. to increase its Pillar II allocation if, in its opinion, circumstances so warrant following an examination of that credit institution's loans and advances portfolio. In doing so, the authority may also consider the opinion of the credit institution's external auditors.

42. A credit institution shall not distribute or reduce the "Reserve for General Banking Risks" as referred to in paragraph 37, without the formal consent of the authority. The authority shall be immediately notified if a credit institution does not have sufficient funds to allocate the required amount to the "Reserve for General Banking Risks".

43. A credit institution is required to maintain a record of credit facilities falling within non-performing exposures for supervisory purposes. This record shall include the outstanding amount of the exposure, the date when facility was initially classified as non-performing, the updated market valuation of any underlying collateral, any prior charges over such collateral, interest in suspense, specific impairment allowances and any *regulatory allocation* and any other data or information which the authority may require from time to time.

44. The authority requires a credit institution to ensure that for those credit facilities for which impairments under IFRS and *regulatory allocation* under paragraphs 35 and 36 apply, to implement appropriate practical and timely measures to recover funds in line with the credit institutions' established Credit Risk Policy. Such measures may include, amongst others, the taking of timely legal action to safeguard that credit institution's interests and the possibility of writing-off such assets (see paragraphs 64 and 65 below).

NON-PERFORMING LOANS REDUCTION PLAN

45. A credit institution shall maintain an NPL ratio[5] which does not exceed 6% at any point in time.

46. A credit institution with a two year average NPL ratio exceeding 6% on the date of publication of this rule, shall submit to the authority, a multi-year NPL Reduction Plan targeting the decrease in these exposures to the set target. If it transpires, from the most recent data point, that the bank's NPL ratio is lower than the said threshold and hence diverges from the 2-year average ratio, the Authority would use its discretion, following an in-depth analysis of the trends and developments in the bank's stock of NPLs to exempt or suspend that institution from submitting the NPL reduction plan. The plan shall be endorsed by the credit institution's Board of Directors and subject to an external audit. The plan will be submitted to the Authority for review.

47. The NPL reduction plan shall be submitted along with the upcoming financial statements for the year ending 2016, or the years thereafter as applicable by the eligibility criteria for this Rule. Reference is made to reporting schedules as stipulated in Banking Rule 7[6].

48. When setting up and executing this plan, credit institutions shall be guided to the extent possible by the ECB Draft Guidance to banks on non-performing loans, particularly Chapters 2 and 3, and Annexes 2, 3 and 7. The credit institution shall include within the NPL Reduction Plan, annual milestones linked to tangible Key Performance Indicators (KPIs), which as a minimum shall include:

- a multi-year plan not exceeding five years showing clearly when the target of 6% NPL ratio (based on a static denominator[7]) is to be reached, including the motivation/main drivers of the timeline chosen;

- an accompanying overall strategy on how the plan is expected to be implemented and executed, as well as how this would be integrated in the bank's ICAAPs;

[5] The NPL ratio refers to the ratio of non-performing loans and advances to total gross loans and advances [FINREP tables http://www.eba.europa.eu/regulation-and-policy/supervisory-reporting/implementing-technical-standard-on-supervisory-reporting].

[6] Publication of Annual Report and Audited Financial Statements of Credit Institutions Authorised under the Banking Act 1994.

[7] The static denominator refers to the latest available figure for the denominator indicated in footnote 2 of this rule. This shall be maintained static throughout the NPL reduction plan.

- information on any internal governance and/or operational structures being set-up or changed in order to support the implementation of the said NPL reduction plan;

- yearly target NPL ratios (see also footnote 7);

- yearly target 'cure'[8] rates;

- specific details of the loans to be targeted and how these address the riskier areas and/or concentration of the portfolio, as well as the instruments used for NPLs reduction, including expected cash flows from collateral monetization;

- disclosure of any forbearance to the current stock of NPLs (as at the date of the coming into force of these amendments) featured in the reduction plan;

- if foreclosure is to form part of the strategy underpinning the reduction plan, appropriate detailed information for monitoring purposes is to be disclosed, including amongst others details on the stock of existing exposures that are undergoing court proceedings, any additions in such exposures in line with the plan, as well as their fair valuations.

For the purpose of paragraph 45, any forbearance given to any of the loans entering the plan shall follow Commission Implementing Regulation (EU) 2015/227 of 9 January 2015 for the calculation of the NPL KPIs.

49. In the case where a credit institution can objectively justify that the reduction plan cannot be concluded within the set five year period due to a significantly high starting level of NPLs, the institution is to notify the authority accordingly and submit an alternative proposed timeframe for approval. The authority reserves the right to reject or request further changes to the proposed alternative timeframe based on the evidence submitted by the credit institution.

50. Following the submission of the NPLs reduction plan, the credit institution shall report to the authority on a six-monthly basis the following:

- actual NPL stock;
- actual 'cure' rate;

[8] Cure rate: A default should be counted as cure if all of the following conditions are met: (a) the respective obligor or facility shows no default trigger anymore at one point in time between the date of default and end of reference date; (b) none of the collaterals has been realised; (c) the obligor or facility was not treated in the workout or recoveries [EBA – Instructions for EBA data collection exercise on the proposed regulatory changes of the Definition of Default, 26 October 2015] .

- actual new NPLs;
- information on any forbearance to the NPL stock; and
- any divergences from the Credit Risk Management Framework set out in the Rule.

51. Within a month following each year-end of the plan, the credit institution shall conduct a yearly self-assessment of its performance against the set milestones within the reduction plan.

52. The authority shall conduct an annual review of the level of adherence of the credit institution to the NPL Reduction Plan.

53. The authority reserves the right to review the mentioned 6% threshold and/or the standard timeframe (currently capped at 5 years) of the NPL Reduction Plan based on objective reasons and following consultation with the Central Bank of Malta as the macro-prudential authority. The authority shall also consult with credit institutions on the proposed changes.

METHODOLOGY FOR THE ACCUMULATION OF A RESERVE FOR EXCESSIVE NPLs

54. If a credit institution deviates from any phase of the NPL Reduction Plan, it shall accumulate a reserve for excessive NPLs to strengthen its resiliency to the risks associated with high NPLs. The duration of the accumulation of this reserve shall run annually until the NPL Reduction Plan is back on track. Notwithstanding the requirements to accumulate the reserve, the authority reserves the right to require a credit institution to draw up a new reduction plan.

55. The appropriation to the Reserve for Excessive NPLs shall be governed by the scheme and buckets featured in the table below:

	% of NPLs Past due by less than and equal to 12 months	**% of NPLs Past due by more than 12 months**
Bucket 3 (NPL Ratio>15%)	3.5%	7%
Bucket 2 (NPL Ratio 8% - 15%)	2.25%	4.5%
Bucket 1 (NPL Ratio 6% - 8%)	1.5%	3%

56. The appropriation to the ‘Reserve for excessive NPLs’ shall be based on the weighted average of the applicable rates for NPLs past due by less than and equal to 12 months and those past due by more than 12 months respectively, and charged on the stock of NPLs net of provisions and the Reserve for General Banking Risks. This appropriation is to be effected from the profits for the year (Reference is made to Appendix I which is being attached to this Rule).

57. Where a credit institution has total Common Equity Tier 1 capital (CET 1) as per Regulation (EU) No 575/2013 (CRR) which exceeds a threshold determined by the authority, only half (50%) of the appropriation shall be allocated to the “Reserve for excessive NPLs” from the profits for the year. This is without prejudice to the authority invoking its power to restrict or prohibit distributions (in general) by a credit institution to its shareholders.

58. The authority reserves the right to increase the applicable metrics for any particular credit institution as may be required according to that credit institution’s risk profile as set out in the ICAAP and as assessed by the authority through the applicable Supervisory Review and Evaluation Process.

59. A credit institution shall not distribute or reduce the ‘Reserve for excessive NPLs’ as referred to in paragraph 54, without the formal consent of the authority. The authority shall be immediately notified if a credit institution does not have sufficient funds to be allocated to the required amount to the ‘Reserve for excessive NPLs’.

60. In the case that a credit institution expects, and can objectively demonstrate, that the impact of the accumulation of this reserve to be in excess of 100% of the projected earnings after tax, it is to notify the authority. The authority shall exercise its discretion to amend the requirements for the said reserve accumulation in line with its prudential principles.

REVIEW SYSTEM

61. In order to determine the level of adequate impairment allowances, the authority requires a credit institution to implement an appropriate and robust asset review system. The nature of this system should be proportionate to the credit institution's nature, size and complexity. Accurate and timely credit grading is considered to be a critical component of an effective loans and advances review system. Therefore, each credit institution is required to ensure that, as a minimum, its loan and advances review system includes the following attributes:

- a prompt identification of assets having potential credit weaknesses and appropriate classification of facilities or other assets with well-defined credit weaknesses that jeopardise repayment so that timely action can be taken and credit losses can be minimised.

- an understanding of the current and possible future external operating environment. Related developments should be closely followed by banks and NPL strategies updated accordingly.

- a formal credit grading system that can be reconciled with the definitions of the Commission Implementing Regulation (EU) 2015/227 of 9 January 2015.

- an identification or grouping of loans and advances that warrant the special attention of the credit institution's management.

- documentation supporting the reason(s) why a particular loan or advance merits special attention.

- an independent evaluation of the activities by lending personnel and the furnishing of essential information to determine the adequacy of impairment allowances.

- a mechanism for direct, periodic and timely reporting to senior management and the Board on the status of loans identified as meriting special attention and the action(s) taken by management.

- information based on relevant trends that affect the collectability of any asset portfolio and the isolation of potential problem areas.

- assessment of the adequacy of and adherence to internal credit policies and asset administration procedures and monitoring of compliance with relevant laws and regulations.

- appropriate documentation of the credit institution's loss experience for various components of its loans and advances portfolio.

- regular comparison of assumptions and parameters used in the allocation of the portfolio's impairment allowances against experience. This should involve testing (including back-testing) or verifying on an annual basis through:

    - comparison of actual losses to impairment allowances held for major categories of exposures;

- analysis of recent experience that considers recent economic conditions; and
- consistent review over portfolios and over time periods. When new methods are introduced, the rationale should be documented and results on both the new and old methodology compiled over one year.

- a thorough self-assessment to determine strengths, significant gaps and any areas of improvement required for banks to reach their NPL reduction targets.

62. A credit institution shall perform stress testing of the exposures (particularly loans) at regular intervals. These tests should incorporate both normal and extreme conditions, and immediate and long-term horizons. The results of the stress tests should be appropriately documented and reported to senior management and appropriate action taken if results exceed agreed tolerances.

CONNECTED LENDING

63. Credit institutions are required to have systems and procedures in place to identify exposures to connected customers and determine whether such exposures constitute a single risk. Where exposures are deemed to constitute a single risk, the authority requires that the requirements of paragraph 155 of the ITS The EBA FINAL draft Implementing Technical Standards on Supervisory Reporting on Forbearance and Non-Performing Exposures under article 99(4) of Regulation (UE) 575/2013[EBA/ITS/2013/03/rev1] are applied to each exposure in a consistent manner.

    For the purpose of determining connectivity of customers, reference and adherence is to be made to Regulation (EU) 575/2013.

IRRECOVERABLE LOANS AND ADVANCES

64. When a credit facility has been identified as non-performing' and subject to a *regulatory allocation* in line with the process outlined above in this Rule, such facility should be reviewed regularly, at least on an annual basis. Such facilities may be required to be written off as per accounting framework, either partially or in full, when there is no realistic prospect of recovery. Where such facilities are secured, this is generally after receipt of any proceeds from the realisation of security. The timing and extent of write-offs involves the combination of a series of events and could entail an element of

subjective judgement. Nevertheless, a write-off may often be prompted following a specific event, such as the fact that insolvency proceedings or other formal recovery action has been concluded.

65. Where forbearance measures fail, the authority expects a credit institution to take appropriate timely actions to recover those facilities which have been long overdue[9] including facilities whose performance have been "mostly unsatisfactory"[10] over a period of time, irrespective of whether these are covered by collateral. In this context, a credit institution shall endeavour to reduce the level of long-outstanding non-performing loans in its portfolio to the lowest possible. Therefore, the decision not to take legal action should be adequately documented and approved by a relevant Board committee and senior management and any other extant relevant governance structures.

ALLOCATION OF ADDITIONAL CAPITAL UNDER PILLAR II

66. The allocation of funds to a "Reserve for General Banking Risks" and to the "Reserve for excessive NPLs" according to the methodology laid down in this Rule augments a credit institution's capital buffers for Pillar 2 risks – particularly those arising from any expected or potential future credit losses as may be indicated by rising levels of non-performing loans through application of this Rule - within the context of Banking Rule BR/12.

67. The *regulatory allocation* can be deemed as being purely a quantitative measure of a credit institution's contingent credit risk. Thus, credit institutions may be required to take further pre-emptive quantitative and qualitative Pillar II measures to mitigate any potential credit losses in times of stress.

68. According to paragraph 27a. of BR/12, the authority may, through the SREP process, assess on a case-by-case basis whether a credit institution's allocation of additional Pillar II capital as per paragraphs 37 – 44, and 54 - 60 of this Rule is sufficiently robust to cater for the risk profile of that particular credit institution and may determine that further allocations are appropriate.

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9 The authority expects that a credit institution takes tangible and specific enforcement action commensurate with relevant accounting principles and IFRS as adopted by the EU on those loans and advances which have been in default for at least the past 5 years

10 For the purposes of this Rule, facilities are considered as having "*mostly unsatisfactory*" performance if repayments of capital instalments have only been few and far between. There have to be at least twelve monthly consecutive payments of capital instalments (or equivalent for loans with other repayment terms) for the period of "mostly unsatisfactory" performance to be broken.

BRANCHES OF OVERSEAS CREDIT INSTITUTIONS

69. Paragraph 29 of the Application Procedures for Authorisation of Licences for Banking Activities Rule (BR/01) states that a licence issued to a credit institution incorporated outside Malta to carry on its business of banking through a branch in Malta is deemed to having been granted to that credit institution as a group.

70. Consequently, the authority expects that the overseas credit institution maintains an adequate level of impairment allowances. If necessary the authority may, in consultation with the foreign supervisory authority, require that the impairment allowances on credit facilities of the branch in Malta be allocated in accordance with the provisions of this Rule.

APPLICATION OF THE RULE

71. The amendments to this Rule shall be applicable upon publication of the Rule.

OFFENCES AND PENALTIES

72. Any person who commits an offence in terms of the Rule as provided for under Article 35 of the Act shall be liable to such penalties as may be prescribed pursuant to the said article.[11]

[11] Legal Notice 155 of 1999 on "Penalties for Offences Regulation, 1999".

Appendix I

Methodology for the accumulation of 'Reserve for excessive NPLs':

NPLs			Applicable Rate for Reserve Accumulation (%)			Provisions on Non-Performing Loans			Reserve for General Banking Risks	Reserve
past due < 12 months	past due >12 months	Total	past due <12 months	past due >12 Months	Weighted	Individually Estimated (F7.00 Row 120 & Col 080)	Collectively Estimated (F7.00 Row 120 & Col 090)	Collective Allowances* (F7.00 Row 120 & Col 100)		
A	B	C=A+B	D	E	F = D*(A/C) + E *(B/C)	G	H	I	J	**K =(C-G-H-I-J)*F**

* Collective allowances for incurred but not reported losses