The Malawi Gazette Supplement, dated 26th September, 2014, containing Regulations, Rules, etc. (No. 17A)

GOVERNMENT NOTICE NO. 37

FINANCIAL SERVICES ACT, 2010

(NO. 26 OF 2010)

FINANCIAL SERVICES (ASSET CLASSIFICATION REQUIREMENTS FOR MICROFINANCE INSTITUTIONS) DIRECTIVE, 2014

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IN EXERCISE of the powers conferred by section 34 (2) (*u*) of the Financial Services Act, 2010, I, CHARLES S. R. CHUKA, the Registrar of Financial Institutions, issue the following Directive—

PART I— PRELIMINARY

Citation

1. This Directive may be cited as the Financial Services (Asset Classification Requirements for Microfinance Institutions) Directive, 2014.

Application

2. This Directive shall apply to—

(*a*) deposit taking microfinance institutions;

(*b*) prudentially regulated non-deposit taking microfinance institution; and

(*c*) microfinance portfolios of other licensed financial institutions engaged in microfinance services.

Interpretation

3. In this Directive, unless the context otherwise requires—

"book value" means—

(*a*) the value of an asset as stated on the books of account of an institution; or

(*b*) the amount of an investment less any specific provisions for loss;

"core capital" means the sum of—

(*a*) issued and fully-paid shares;

(*b*) share premium;

(*c*) retained earnings;

(*d*) 50% of current year to-date after tax profit or 100% of loss;

(*e*) capital grants; or

(*f*) any other distributable reserves, less investments in unconsolidated subsidiaries;

"credit facility or credit" means any asset or off-balance sheet item that contains credit risk, including loans, overdrafts, advances and all of the following—

(*a*) financing by means of factoring;

(*b*) leasing;

(*c*) hire purchase;

(*d*) accepting of trade and other bills;

(*e*) discounting of such bills and notes;

(*f*) the opening or confirming of documentary credit;

(*g*) the issue of other letters of standby, credit, guarantee or surety;

(*h*) the undertaking to pay on account of another person; and

(*i*) such other similar undertakings as may be prescribed by Registrar from time to time;

"collateral" means security on a credit facility that is sufficient to partly or fully protect the institution from loss;

"estimated recoverable amount" means the amount that an institution reasonably expects to recover on an asset, less costs of disposal or realization;

"exposure" means the amount of an institution's exposure to a person or group of inter-related persons which is calculated as the sum of the following—

(*a*) credits;

(*b*) investment in equities;

(*c*) debt securities;

(*d*) securitized assets and other transactions with recourse; and

(*e*) contingent liabilities, such as commitments to extend credit;

"institution" means a deposit taking microfinance institutions, a prudentially regulated non-deposit taking microfinance institution, or other licensed financial institutions engaged in offering microfinance services;

"large exposure" means an exposure, direct or indirect, of an institution to any person or group of inter-related persons which equals or exceeds ten per cent (10%) of the core capital of the institution;

"net unsecured credit balance" means the outstanding principal balance of a credit, less the estimated recoverable amount of eligible collateral, as long as the institution's interest is fully enforceable;

"non-performing loan" means any credit facility whose repayments are insufficient to meet principal, interest and other incidental charges due on it;

"provision for loan losses" means a charge in the income statement to reflect an increase in the probability of losses due to uncollected loans;

"Registrar" means the Registrar of Financial Institutions appointed under the Act; and

"value-impaired asset" means an asset with an estimated recoverable amount or market value that is less than the book value.

PART II—OBJECTIVES

Objectives

4. The objectives of this Directive are to ensure that institutions—

(*a*) manage their credit risk;

(*b*) properly identify and make provisions on non-performing assets; and

(*c*) present financial statements accurately.

PART III—BOARD OVERSIGHT

Board oversight

5. The board of directors of an institution shall—

(*a*) adopt and implement a written policy covering the following—

(i) classification of financial assets;

(ii) establishment of adequate provisions for loan losses;

(iii) types of lending that the institution may engage in; and

(iv) practices relating to various types of collateral that the institution may hold;

(*b*) adopt and implement sound risk management policies;

(*c*) ensure that credit policies include detailed write-off policies and procedures in order to minimize potential abuse; and

(*d*) review and approve policies as or when necessary or at least once every two (2) years.

PART IV—ASSET CLASSIFICATION

Asset classification policy

6.—(1) An institution shall have written procedures to ensure consistent compliance with the approved policy on asset classification which include the following—

(*a*) an analytical framework for assessing credit quality;

(*b*) appropriate valuation methods for determining fair value of a collateral;

(*c*) realistic and conservative assumptions concerning the impact on obligors of potential future changes in general economic conditions; and

(*d*) periodic reporting procedures to senior management staff and the board of directors about credit risks and its impact on the financial capital and earnings of the institution.

(2) An institution shall—

(*a*) promptly identify and classify problem assets in accordance with the classification criteria specified in this Directive;

(*b*) make adequate provisions for potential losses;

(*c*) where the institution has granted multiple loans to a single borrower, and any one of such loans is non- performing, evaluate every other loan to that borrower and place such loans on non-performing status accordingly; and

(*d*) classify a group loan as past-due in its entirety, where any one of the members of the group defaults,

but if the amount due is guaranteed by the members of the group, only theportion in arrears shall be accounted for as past-due until the group members pay up the guarantee.

Classification of credits

7.—(1) The following facilities shall be categorized as non-performing in line with classification categories as stipulated in paragraph 8 of this Directive—

(*a*) overdrafts and other extensions not having pre-established repayment programmes due to—

(i) an overdrawn balance which exceeds the customer's approved limit for sixty (60) days or more;

(ii) a customer's borrowing line which has expired for more than sixty (60) days; and

(iii) an overdraft that is in excess at the review date, which has not been renewed or which has been renewed to a lower limit but remains in excess for more than sixty (60) days;

(*b*) a seasonal credit facility without a pre-established repayment programme where—

(i) no repayment is made for sixty (60) days or more after the end of the sales period; and

(ii) repayments within sixty (60) days after the end of the sales period are insufficient to cover capital or accrued interest charged during the period of the credit facility;

(*c*) a credit facility with principal or interest which is due and unpaid for sixty (60) days or more; and

(*d*) a credit facility with interest payments which is due and unpaid for sixty (60) days or more which has been re-financed, or rolled over into a new loan.

(2) In determing whether a financial asset or a group of financial assets is impaired under this Directive, the Registrar shall be guided by the international financial reporting standards.

Classification categories

8.—(1) An institution shall classify credit facilities into the following categories—

(*a*) standard, where—

(i) it is current;

(ii) the obligor is complying, and is expected to continue to comply, with all terms of the contract; and

(iii) there is no reason to believe that the institution is being, or will be, subject to risk of loss;

(*b*) special mention, where—

(i) potential weaknesses exist in the obligor's financial position; or

(ii) repayment installments are 30 days or more past-due;

(*c*) substandard, where—

(i) the obligor's financial condition, including net worth or repayment capacity, is unfavourable and is deteriorating;

(ii) other adverse factors exist which cause concern regarding

the ability of the obligor to repay the credit in accordance with the existing repayment terms; or

(iii) repayment installments are sixty (60) days or more past-due;

(*d*) doubtful, where—

(i) weaknesses exist which make collection or repayment in full highly questionable and improbable based upon currently existing circumstances, conditions, and the estimated recoverable amount of the pledged collateral, if any;

(ii) the possibility of loss is very high, however, because of certain important and reasonably specific pending circumstances which could strengthen the asset, classification of the asset as loss is deferred until its exact status is determined; or

(iii) repayment installments are ninety (90) days or more past-due;

(*e*) loss, where—

(i) the asset is deemed uncollectible and of such little value that it should not be included on the books of account and financial statements of the institution; or

(ii) repayment installments are one hundred and eighty days or more past-due.

(2) An institution shall closely monitor all assets which are special mention to minimize deterioration of the repayment prospects for the asset or the future position of the institution.

(3) Where an asset is classified as loss, such classification does not cancel the obligor's obligation to repay and the institution shall continue to exercise its full legal right to collection or payment.

Review of credit facilities

9.—(1) An institution shall review all credit facilities on a quarterly basis for purposes of asset classification and for determining whether the credit facility has suffered a decline in, or impairment to value that is not expected to be temporary.

(2) In addition to the quarterly review, an institution shall update the asset classification in between quarterly reviews on a monthly basis according to the days past due.

(3) If between formal quarterly reviews, an institution establishes a significant deterioration in the quality of an individual credit or in a material part of the credit portfolio, the institution shall—

(*a*) promptly assign the credit to a new classification category that accurately reflects the status of the credit; and

(*b*) make applicable provisions to its income statement.

(4) An institution shall review each large exposure on an individual item basis.

(5) Where a credit facility is capable of being classified into two categories, the more severe classification of the two shall be applied.

(6) When an institution adds an asset to its books of account or moves an asset to a different account, the institution shall ensure that the quality and condition of that asset is accurately reflected.

Classification of restructured facilities

10.—(1) An institution shall classify a renegotiated or restructured nonperforming loan in the substandard category unless, all past due principal and interest is repaid in full at the time of the renegotiation, or restructuring in which case it may revert to special mention classification.

(2) A renegotiated or restructured loan classified as doubtful or loss shall continue to be classified as doubtful or loss unless—

(*a*) all past due principal and interest is repaid in full at the time of renegotiation, in which case it may revert to special mention classification;

(*b*) all past due interest is repaid in full at the time of renegotiation in which case it may revert to substandard classification; or

(*c*) all past due principal and interest is repaid in full at the time of renegotiation and there has be consistent repayment of three (3) installments in which case it may revert to standard classification.

(3) Any loan or credit facility restructured for the second time shall be classified as substandard if all past due principal and interest is repaid in full at the time of renegotiation.

Classification of assets other than credits

11.—(1) An institution shall review all other financial assets, other than credits on a quarterly basis for purposes of classification and for determining whether a financial asset has suffered impairment in, or impairment to value that is not expected to be temporary.

(2) In the event of impairment to the book value of a noncredit asset that is not expected to be temporary, an institution shall—

(*a*) reduce the book value of the asset to its estimated recoverable amount; and

(*b*) classify the loss in value as an expense and charge it against income in the current period.

(3) If, between formal quarterly reviews, an institution obtains new information or otherwise determines that the quality or condition of an asset has been impaired, the institution must promptly and accurately reduce the book value of the asset to its estimated recoverable amount.

Income recognition

12—(1) An institution shall place all value impaired assets, including assets that are adversely classified, on non accrual status and the institution shall—

(*a*) cease to reflect in its income statement the accrual of interest;

(*b*) reverse uncollected interest which has previously accrued; and

(*c*) not classify interest as income except when received in cash.

(2) An institution shall place an asset on non accrual status regardless of any collateral held against it.

(3) An institution shall restore an asset which has been placed on a non accrual status to an accrual status when the contractual amount of the principal and interest is deemed to be fully collectible in accordance with the terms of the contract where—

(*a*) the borrower has made all payments of past-due principal and interest, the principal and interest payments are current and the institution expects repayment of the remaining contractual principal and interest as scheduled in the contract; or

(*b*) the borrower has resumed paying the full amount of the scheduled contractual principal and interest and all remaining contractual payments, including compensation for past-due payments are deemed to be collectible in a timely manner.

(4) An institution shall ensure that a determination to restore an asset to an accrual status is supported by a current and well documented evaluation of the obligor's financial condition and other factors affecting the prospects for repayment, including the obligor's repayment performance for the past three (3) months.

PART V—PROVISION FOR LOAN LOSSES

Provision for loan losses

13.—(1) An institution shall determine the amount of provision for loan losses using the standard percentage method.

(2) An institution shall apply the following percentages to the sum of the classified net unsecured credit balances in each classification category—

(*a*) special mention, twenty per cent (20%) of the sum;

(*b*) substandard, fifty per cent (50%) of the sum;

(*c*) doubtful, seventy five per cent (75%) of the sum; and

(*d*) loss, one hundred per cent (100%) of the sum.

Write-offs of credit facilities

14.—(1) An institution shall write off a loan or a portion of a loan from its balance sheet when—

(*a*) the institution loses control of the contractual rights that comprise all or part of the loan, as determined by a court of law;

(*b*) the institution is unable to collect, or there is no longer any reasonable assurance that the institution will be able to collect all amounts due;

(*c*) the borrower declares or is declared bankrupt;

(*d*) efforts to collect debt are abandoned for any other reason; or

(*e*) the loan has been non-performing for one hundred and eighty (180) consecutive days .

(2) Any recoveries made from an account that was previously written off shall be credited to the provisions account in the income and expenditure statement.

Acquisition of assets in lieu of repayment of credit

15.—(1) If an institution acquires an asset in lieu of repayment of a credit, the book value of the asset acquired shall be the lower of the net unpaid balance of the credit or the estimated recoverable amount of the asset acquired.

(2) If the estimated recoverable amount of the asset acquired is less than the book value of the credit, then the institution shall write off the difference when the asset is added to the books of account.

PART VI—RESTRICTIONS

Restrictions

16.—(1) An institution shall not—

(*a*) renegotiate, roll-over, or modify the terms of a credit in order to avoid an adverse classification; or

(*b*) advance additional funds to enable an obligor to meet existing payment obligations to the institution.

Prior approval for large credits

17. An institution shall apply for approval from the Registrar for any credit facility in excess of ten per cent (10%) of core capital.

PART VII—REPORTING REQUIREMENTS

Reporting requirements

18.—(1) An institution shall—

(*a*) submit to the Registrar an asset quality report within fifteen (15) days of the end of each month, in the format prescribed as Form 1 of the Schedule to this Directive; and

(*b*) submit to the Registrar a quarterly portfolio quality report within fifteen (15) days of the end of each quarter, in the format prescribed as Form 2 of the Schedule to this Directive.

PART VIII—ENFORCEMENT

Monetary Penalties

19.—(1) The Registrar shall impose the following monetary penalties for violation of this Directive—

(*a*) for an institution, up to fifty million Kwacha (K50,000,000); and

(*b*) for a natural person who are members of the board of directors or management, up to ten million Kwacha (K10,000,000).

(2) An institution or natural person shall pay the respective penalties imposed under subparagraph (1) through a bank certified cheque payable to the Reserve Bank of Malawi within ten (10) working days after being notified of the violation.

(3) In addition to the monetary penalty imposed in subparagraph (1), the Registrar may impose directions and administrative penalties as provided for under the Act and the Microfinance Act, 2010.

SCHEDULE

FORM 1:—ASSET CLASSIFICATION REPORT (para. 18 (1) (*a*))

Name of Institution:.....

Month Ending:.....

CLASSIFIED ASSETS

Asset	*Standard*	*Special Mention*	*Substandard*	*Doubtful*	*Loss*	*Total*
	0%	20%	50%	75%	100%	
Credit facilities	—	—	—	—	—	—
Securities	—	—	—	—	—	—
Real Estate Owned	—	—	—	—	—	—
Other Assets	—	—	—	—	—	—
Total Assets						
Loan Loss	—	—	—	—	—	—
Provisioning for	—	—	—	—	—	—
Net Assets	—	—	—	—	—	—

PAST-DUE ASSETS: REPORT THE TOTAL AMOUNT OUTSTANDING FOR EACH ASSET CLASS.

Asset	*Past Due 8-30 days (memo item) (1)*	*Past Due 30-59*	*Past Due 60-89 days (3) days (2)*	*Past Due 90* or more	*Total Past Due (2)+(3)+(4)) days (4)*
Credit Facilities					
Other Assets					
Total					

CHARGE-OFFS AND RECOVERIES

Asset	Charge-Offs	Recoveries	Net Position
Credit Facilities			
Other Assets			
Total	—	—	—

CHANGES IN ALLOWANCE FOR LOAN LOSS

	Amount K'000
Balance from previous report	—
Recoveries	—
Charge-offs	—
Current provisions for losses	—
Prior period adjustments	—
Ending balance	—

FORM 2:—PORTFOLIO QUALITY REPORT (para. 18 (1) (*b*))

Name of Institution:.....

Month Quarter Ending:.....

PART I—PORTFOLIO AT RISK

	Current month	*Previous month*
CLIENT POPULATION		
1. Number of new borrowers		
2. Number of existing borrowers		
3. Total number of borrowers		
DEPOSITORS		
4. Number of Savings Accounts		
5. Number of Time Deposit Accounts		
Total		
PORTFOLIO STATUS		
6. Number of loans disbursed		
7. Value of loans disbursed (K'000)		
8. Number of loans outstanding		
9. Value of outstanding loan portfolio (K'000)		
10. Average loan amount		
11. Average loan term (in weeks)		
13. Loans written off (K '000)		
14. Loans recovered (K '000)		
15. Portfolio at risk *(K'000)		

*Portfolio at risk is calculated as the amount due not repaid for over sixty (60) days or more divided by value of loans outstanding.

PART II—AGING REPORT

	Number of Loans	*Outstanding Balance*	*Minimum Provision (%)*	*Provision Amount (Kwacha)*	*Compulsory Savings/LIF*	*Required Provision*
Current	—	—	0%	—		
Overdue for 30 days or more but less than 60 days	—	—	20%	—	—	—
Overdue for 60 days but less than 90 days	—	—	50%	—	—	—

	Number of Loans	*Outstanding Balance*	*Minimum Provision (%)*	*Provision Amount (Kwacha)*	*Compulsory Savings/LIF*	*Required Provision*
Overdue for 90 days but less than 180 days	—	—	75%	—	—	—
Overdue for 180 days and above	—	—	100%	—	—	—
Rescheduled loans						
Overdue for 30 - 59 days	—	—	20%	—	—	—
Overdue 60 - 89 days	—	—	50%	—	—	—
Overdue 90 - 179 days	—	—	75%	—	—	—
Overdue 180 days and above	—	—	100%	—	—	—
Total	—	—	—	—	—	—

PART III—PROVISIONS

SPECIFIC PROVISIONS

A provision is established against a presently identified loan or probable loss. Should the loan improve in status, its provision may be eliminated or reduced. If the loan remains classified as a loss it shall be written off from the books of the institution.

	Year to Date	*Corresponding Quarter*	*Prior Year*
Beginning balance			
Transfer to provisions			
Gross charge-offs (loan losses)			
Recoveries on prior charge-offs			
Other entries (describe)			
Ending balance			

PART IV—INTEREST IN SUSPENSE

For all value-impaired assets, including assets that are adversely-classified and assets that are 60 days or more past-due

	Year to Date	*Corresponding Quarter*	*Prior Year*
Opening Balance			
Add: Current interest in suspense			
Less: Write-Offs			
Ending balance			

PART V—CHARGE OFFS AND RECOVERIES BY SECTOR

Show, in the schedule below, gross amounts charged off and gross recoveries on such charge-offs by sector, for the year-to-date in the current financial year. The totals must agree with gross provisions established in the period and reductions due to improved status, again in the year-to-date column of the Specific Provisions in Part I of this Schedule.
Year-to-date for the current financial year (K'000)

Sector	*Charge-off*	*Recoveries*	*Net Position*
1. Agriculture	—	—	—
2. Manufacturing	—	—	—
3. Trade and Commerce	—	—	—
4. Transport and Utilities	—	—	—
5. Building and Construction	—	—	—
6. Others	—	—	—
7. Total	—	—	—

PART VI— SUPPLEMENTARY DATA ON NON PERFOMING ADVANCES (K '000)

Sector	*Total Outstanding*	*Non-performing as per definition*	*Percentage of Non-Performing*
1. Agriculture	—	—	—
2. Manufacturing	—	—	—
3. Trade and Commerce	—	—	—
4. Transport and Utilities	—	—	—
5. Building and Construction	—	—	—
6. Others	—	—	—
7. Total	—	—	—

We have reviewed the above return, and we certify that the figures stated therein are in accordance with the institution's books and records.

Chief Executive Officer

Name:.....

Date:.....

Signature:.....

Chief Financial Officer

Name:.....

Date:.....

Signature:.....

Made this 21st day of July, 2014.

C. S. R. CHUKA
Registrar of Financial Institutions

(FILE NO.ST/2/120)