CENTRAL BANK OF SOMALIA

Financial Institution Law, 2012

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REGULATION ON ASSET CLASSIFICATION AND PROVISIONING, 2018

1. INTRODUCTION

1.1. Authority

This regulation is made by the Central Bank of Somalia ("Central Bank") pursuant to its authority set forth in Sections 34 and 120 of the Financial Institutions Law, 2012 ("FIL"), and Sections 38(1) and 52(1) of the Central Bank of Somalia Law, 2011, for the purpose of implementing the following sections of the FIL: 14(2)(e) – Minimum Capital Requirements, 15(1)(d) and 15(5) – Minimum Ongoing Capital Requirements, 19 – Accounts, and 119 – Maintenance of Adequate Provision for Bad and Doubtful Debts.

1.2. Applicability

1.2.1. This regulation applies to all persons licensed by the Central Bank to engage in banking business in Somalia including foreign financial institutions and subsidiaries and branches of foreign financial institutions.

1.2.2. The requirements of this regulation apply to each bank individually, and on a fully consolidated basis to each bank, its holding company, and members of its group, if applicable.

1.2.3. Branches and subsidiaries of foreign financial institutions may request in writing to the Central Bank for an exemption, in whole or in part, from the requirements of this regulation; provided that, the parent foreign financial institution is subject to asset classification requirements by its home country supervisor which are consistent with the Core Principle for Effective Banking Supervision on *Problem Assets, Provisions and Reserves* published by the Basel Committee on Banking Supervision.

1.3. Definition

"Credit Risk" refers to the risk that a Counterparty (borrower) may not repay the loan or may not meet the repayment obligations and that the bank may lose the principal (Cost) amount and the profit associated with it.

"General provision" means a loss reserve held against future and presently unidentified losses and which is thus available to meet losses which subsequently materialize.

"Profit in suspense" means that the profit on a non-performing credit facility is accrued or capitalized but the offsetting accounting entry is placed in a suspense account rather than taken into profit.

"Large exposure" means an exposure to a customer, or group of related customers, that meets or exceeds 10 percent of the bank's core capital.

"Net realizable value" means the estimated selling price of an asset in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to sell the asset.

"Non-accrual" means that a credit facility has been placed on a cash basis for accounting and financial reporting purposes, thus profit earned or due but unpaid is not credited to profit, but instead to profit in suspense.

"Non-performing credit" means credit that is classified as Substandard, Doubtful, or Loss in accordance with this regulation.

"Related person" has the meaning given in the FIL and the Regulation on Transactions with related persons, issued by the Central Bank.

"Specific provision" means a loss reserve held against presently identified losses or potential losses.

2. CLASSIFICATION AND PROVISIONING POLICY

2.1. The board of directors of each bank shall adopt, and ensure that senior officers implement, a written classification and provisioning policy that complies with the FIL and this regulation.

2.2. To be considered adequate, the classification and provisioning policy shall contain the following elements:

2.2.1. A credit risk classification system that is consistently applied, classifications accurately reflect differing levels of credit risk, changes in credit risk are identified on a timely basis, and prompt appropriate action is taken based on identified changes in credit risk.

2.2.2. The classification and provisioning process takes into account all relevant, reasonable, and supportable information including forward-looking information and macroeconomic indicators.

2.2.3. A process to validate models used for credit risk assessment and management.

2.2.4. A process to assess the overall adequacy of provisioning.

2.2.5. Procedures on write-offs and recoveries.

2.2.6. Internal controls and compliance reviews to ensure that the bank's credit-risk review process, classification, provisioning, monitoring, asset management, and reporting processes are performed in accordance with the bank's policy, this regulation, and the FIL.

2.2.7. An internal-audit function to independently evaluate the effectiveness of the bank's system.

3. CLASSIFICATION REQUIREMENTS

3.1. All of a bank's financing contracts and loans, including off-balance sheet credit equivalents, shall be reviewed for purposes of credit classification on at least a quarterly basis.

3.2. The review and classification shall be performed in accordance with this regulation and the bank's written board-approved written policy by persons who possess credit risk experience and judgment and are independent of the origination function.

3.3. The bank's financing contracts, loans and other assets with credit risk may be divided into groups with similar characteristics for review and classification on a collective basis; however, the following assets shall be reviewed and classified on an individual basis:

3.3.1. Large exposures;

3.3.2. Exposures to related persons of the bank;

3.3.3. Exposures that are deemed complex, out of the bank's normal expertise, or otherwise of greater credit risk;

3.3.4. Exposures that have previously been classified other than Pass;

3.3.5. All other exposures to a counterparty or group of closely-related counterparties, when the bank classifies one such exposure other than Pass;

3.3.6. A sample of exposures from each group with the portfolio of financing contracts and loans.

3.4. Between quarterly reviews, if a bank gains knowledge of an adverse change in the quality of an individual financing contract or a group of financing contracts, then the asset must be promptly assigned to the new classification category that properly reflects its status.

4. CLASSIFICATION CATEGORIES

4.1. A bank may use its own internal risk-grading system; however, the internal risk grades must be reconciled to the five classification categories of this regulation for purposes of reporting to the Central Bank.

4.2. A bank's financing credits and other assets subject to credit-risk are classified into the following five categories using the stated criteria.

4.2.1. **PASS**. Financing contracts and loans that meet *all* of the following criteria should be classified as Pass.

a) The financing contract/loan is performing, and is expected to continue to perform, in accordance with the financing contract.

b) Documentation includes current financial statements, cash flow projections, evidence of the bank's perfected interest in any collateral held, and evidence that the net realizable value of the collateral is sufficient to support the outstanding balance.

c) The financial condition of the counterparty is sound and is expected to remain sound.

d) Financing contracts/loans are current and overdrafts are operating within their approved limits.

4.2.2. **SPECIAL MENTION.** Financing contracts/loans, including those that are currently performing and/or secured by unimpaired collateral, that meet *one or more* of the following criteria should be classified as Special Mention.

a) Documentation is insufficient to support the outstanding balance, evidence the bank's perfected interest in collateral, or permit the bank to properly supervise the financing contract or collateral.

b) Certain factors are known which could, in the future, impinge on the performance of the financing contract or impair the value of the collateral. Such factors include deteriorating general economic or sector conditions and adverse trends in the counterparty's financial condition.

c) The financing contract/loan has been previously re-negotiated with the counterparty and, for at least one year subsequent to re-negotiation, has remained up-to-date on payments and there is no evidence of collateral impairment or any other inherent weakness.

d) A financing contract/loan is 60 - 89 days past-due or is not in compliance with any other term or condition of the contract.

e) An overdraft has surpassed the approved limits for 60 - 89 days without the bank's prior approval.

4.2.3. **SUBSTANDARD.** Financing contracts/loans, including those that are currently performing and/or secured by unimpaired collateral, that possess *one or more* of the following deficiencies should be classified as Substandard.

a) The financing contract/loan is inadequately protected by the current financial condition and paying capacity of the counterparty (such as one or more renewals or evidence of the counterparty's inadequate cash flow).

b) The primary source of payment of the financing contract/loan is insufficient to service the payment and the bank is relying on one or more secondary sources of repayment (such as liquidation of collateral, sale of fixed assets, or restructuring).

c) A financing contract/Loan is 90 – 179 days past-due or is not in compliance with any other term or condition of the credit contract.

d) An overdraft, while adequately secured, continuously exceeds the approved limits for 90 – 179 days or has fluctuations that do not follow the business cycle.

4.2.4. **DOUBTFUL.** Financing contracts/loans that, in addition to meeting the previously-listed criteria for a classification of Substandard, have *one or more* of the following characteristics should be classified as Doubtful.

a) Collection of the financing contract/loan in full is highly questionable or unlikely.

b) There is a likelihood of loss on the financing contract/loan; however, the situation could improve due to near-term important and reasonably specific pending factors such as a proposed merger, acquisition, liquidation, capital injection, perfection of liens, additional collateral, or other arrangements.

c) A financing contract/loan is 180 – 364 days past-due.

d) An overdraft continuously exceeds the approved limits for 180 - 364 days and has had minimum activity in the account.

4.2.5. **LOSS**. A financing contract/loan which meets *one or more* of the following criteria should be classified as Loss.

a) The financing contract/loan is regarded as uncollectible or of such little value that its continuance on the bank's books of account is not warranted.

b) The financing contract/loan may have some recovery value; however, the bank deems it to be neither sensible nor desirable to postpone removing the asset from its books while it pursues long-term recovery efforts.

c) The financing contract/loan is 365 days or more past-due.

d) The financing contract/loan has been classified "Doubtful" for at least 180 days during which time the pending resolving events have not been consummated.

5. RENEGOTIATED CREDITS

5.1 The classification of a credit which has been renegotiated to modify one or more of its terms shall remain in the specific category and only be improved to Special Mention, if repayment of amounts due, in accordance with the credit contract, has been made for at least a six months.

6. ASSIGNING A CLASSIFICATION

A transaction's credit risk usually increases significantly *prior* to its underlying financing contract/loan becoming past-due or being modified or restructured. In addition, a counterparty may exhibit a significant increase in credit risk prior to the bank's exposure to that counterparty showing impairment.

Therefore, both historical and forward-looking factors should be considered in the classification process including:

a) Original principal amount of the financing contract/loan, purpose, terms, current balance and status;

b) Counterparty’s financial condition, performance, and payment capacity: income, sales, cash flow, working capital, leverage, net worth;

c) Trends in, and future prospects for, the counterparty’s financial condition, performance, and payment capacity;

d) The counterparty’s payment record to date;

e) Evidence of financial difficulties of the counterparty or the counterparty’s source of funds inflow;

f) Resources available to the counterparty;

g) General economic conditions: global, regional, local;

h) Industry-specific conditions;

i) Country risk; Security risk;

j) Forbearance or restructuring of the financing contract/loan is expected, requested, and/or received; and

k) Action has been taken or is expected to be taken by senior officers to strengthen contract requirements including collateral.

6. MINIMUM PROVISIONING REQUIREMENTS

6.1. At least quarterly and based upon the bank’s assessment and classification process, any impairment to the value of a financing contract/loan or group of financing contracts/loans must be recognized by reducing the book value of the financing contract(s) and charging the income statement in the period in which the impairment occurred:

6.1.1. Through the General Provisions for Bad and Doubtful Debts account for financing contracts/loans classified as Pass.

6.1.2. Through the Specific Provisions for Bad and Doubtful Debts account for financing contracts/loans classified as non-performing credit.

6.2. The aggregate amount in the provisioning accounts must be adequate to absorb estimated losses associated with the entire portfolio and approved by the Risk Committee of the board of directors at least quarterly.

6.3. Each bank shall determine the amount of provisioning to be made by applying the following Standard Percentages to the sum of the outstanding balances in each classification category.

Special Mention	5%
Substandard	20%
Doubtful	50%
Loss	100%

6.4. The following requirement shall apply to banks reporting under International Financial Reporting Standard (IFRS):

(a) Banks are required to calculate their provisions in accordance with the requirements of both lFRS 9 and this regulation;

(b) Should the provisions computed under IFRS 9 be less than what is required under this regulation, the bank shall assign the difference to a non-distributable equity reserve created through an appropriation of reserve;

(c) Where IFRS 9 requires a higher provisioning than prescribed by this regulation, the bank shall provide for the greater amount.

6.5. The Central Bank may direct a bank to increase the amount of its provisioning.

7. SUSPENSION OF PROFIT

7.1 All categories of non-performing credit facilities shall be placed on a non-accrual basis, that is profit due but uncollected, should not be accrued as profit, but instead should be shown as a suspense account.

7.2 All profit on non-performing credit facilities previously accrued into profit but uncollected shall be reversed and credited into a suspense account until paid in cash by the borrower.

7.3 Only when all outstanding due and unpaid obligations of a non-performing credit facility have been paid up to date, may the credit facility be returned to an accrual basis.

8. WRITE-OFFS

All credit policies should adequately detail the write-off procedures and periodical review of written off loans in order to minimize potential abuse. The ultimate authority for approval of write-offs rests with the board of directors or as delegated by the board of directors. All recoveries made from the accounts earlier written off should be credited to the profit account.

9. REPORTING

Banks shall submit to the central bank as a part of each quarterly report a schedule which shows a breakdown by category which meets all the requirements of this regulation.