BANKING COMMISSION

P.O. Box 1408

Majuro, Marshall Islands 96960

PHONE: (692) 625-6309 AND (692) 625-2310

DIRECTIVE 3

ASSET CLASSIFICATION AND RESERVE ADEQUACY

PURPOSE

---

1. Pursuant to Sections 133 and 156 of the Banking Act ("Act") the Commissioner of Banking has issued this Directive to enable banks to promptly recognize non-current and non-performing credits and to provide timely establishment of reserves that will adequately absorb loan losses.
2. A well-established system for classifying assets and maintaining adequate loan loss reserves represents an essential characteristic of a well-run bank. Classification of assets prompts management to implement appropriate collection measures and, by setting conservative provisioning standards, lessens the likelihood of overstating balance sheet values and profits. The early recognition of losses accordingly helps to lessen or prevent any impairment of capital.
3. The main purpose of this Directive is to clarify for the Board of Directors and bank senior management the methodology that the Commissioner of Banking has adopted for banks classification of assets and the determination of an adequate level of valuation reserves (Allowance for Loan Losses).

BACKGROUND

---

4. Three topics need to be addressed in order to trace the linkage of asset classification with the assessment of reserve adequacy. Hence, there needs to be:
    a. Well established and consistently applied accounting policies for the recognition of non-performing credits and for the recognition of income on such credits.

b. A well-defined credit classification system based on collectability considerations, where applicable including protection afforded by any security backing (collateral) or third-party guarantees.

c. An Objective provisioning process for setting minimum levels of loss provisions based on the credit classification system.

5. The ensuing Directive divides into three sections, namely by reference to the accounting policies for non-performing assets contained in Directive 2 and hence by providing objective classification and provisioning targets.

ACCOUNTING RULES AND DEFINITIONS

6. Directive 2 defines three asset categories, non-current, non-accrual and restructured, with the latter two combined being referred to as nonperforming assets. Further, it explains the accounting rules governing the recognition of income and provisioning for losses.

7. **Non-Current Credits**: Refer to loans and advances that are over 30 days past due on principal or interest, where they have not been placed on a non-accrual accounting basis as management is not in doubt as to prompt payment. Alternatively, the initial recognition of a past due credit signals the need for management to institute actions to strengthen or collect the credit, but does not in itself necessitate classification and attendant provisioning and income recognition rules.

8. **Non-Accrual Credits:** refer to loans and advances where interest is not being accrued to income due doubt as to ultimate collectability of principal and interest. Credits that are 90 days in arrears are automatically to be classified in the non-accrual category, whereby a specific provision is required and previously accrued but uncollected interest is reversed from income.

9. Accrual and capitalization of interest on non-performing credits is not permitted for purposes of booking income. Instead, the bank must record the unpaid interest due in a memoranda account (Interest in Suspense). Any debt servicing thereafter is first applied to principal and, only when the specific provisions and any write-offs have been recouped, then interest arrears.

10. **Restructured Credits:** Refer to loan and advances where the bank has modified the terms of a customer's debt and taken its losses, such that management believes the borrower can honor the terms of the restructured agreement. Pre-conditions for any such restructuring entail the customer clearing interest arrears and the bank writing off the pre-existing specific. Accordingly, specific provisions no longer apply and interest payments are recognized on a cash basis. If the debt subsequently becomes 90 days in arrears, however, it automatically reverts to the non-accrual classification, attendant provisioning, and income recognition rules.

CLASSIFICATION SYSTEM

11. Asset classifications apply for any credit where there is any doubt as to collectability of interest or principal according to the terms of the prevailing credit agreement that the bank has with its customer, which according to the above definitions includes all non-accrual credits.

12. Collectability considerations like the borrower's current paying capacity and readily accessible funds due to collateral and/or guarantees can influence the severity of classifications applied for non-accrual credits, and hence the level of provisions considered adequate. The ensuing Paragraphs provide three applicable classification severities, namely for Substandard, Doubtful and Loss exposures

13. **SUBSTANDARD:** A substandard credit is inadequately protected by the current paying capacity and/or sound worth of the obligor. Assets so classified have a well-defined weakness or potential weaknesses that jeopardizes liquidation of the debt. It is characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Non-accrual assets, which are at least 90 days past due are at a minimum classified substandard.

14. Substandard assets may also include assets, which carry more than a normal degree of risk due to the absence of current and satisfactory financial information or inadequate collateral documentation.

15. **DOUBTFUL:** Doubtful credits exhibit all the weaknesses inherent in assets classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and collateral values highly questionable and improbable. The possibility of loss is high, but because of certain important and special pending circumstances (results of liquidation process, additional collateral or enforcement of a guarantee are soon expected), which may strengthen the credit, its classification as a "loss" exposure is being deferred until a more, exact reading can be made. Non-accrual assets, which are at least 180 days past due are classified doubtful.

16. **LOSS:** Assets classified as loss are considered as uncollectible or such little value their continuance as bankable assets is no longer warranted. This does not mean that the asset has no recovery value, but rather that it is no longer prudent or desirable to defer write-offs pending the outcome of foreclosure and collection proceedings. Non-Accrual assets which are at least one year past due are to be classified as a Loss.

PROVISIONING CRITERIA & RESERVE ADEQUACY

17. Assessment of a financial institution's reserve adequacy and provisioning policies is the main task for examiners conducting on-site examinations. The asset classification process also provides an objective framework for monitoring the adequacy of the valuation reserve (Allowance for Credit Losses).

18. Reflecting the relatively short-term lending by domestic banks, stringent provisioning levels are needed for purposes of setting reserve adequacy standards. In conformity with Directive 2, charges to the provision expense for non-accrual credits are specific provisions, and provisions established for the remaining credits are general provisions. On this basis, the minimum provisioning criteria for supervisory purposes are as follows:

    a. Substandard credits in arrears more than 3 months and up to 6 months on interest or principal payments, except for any such credits already classified as "Doubtful" or "Loss" based on the foregoing asset classification definitions. The provision applied is 30% of the balance outstanding, which includes interest arrears added to principal.

    b. Doubtful credits that have been in arrears more than 6 months and less than 1 year are classified doubtful, expect for those already classified "loss". The provision is 50% on the outstanding balance plus interest arrears.

    c. Loss credits in arrears over 1 year are classified as loss and the provision is 100%

19. Loans and advances classified as a loss should be written off and removed from the bank's books as soon as management decides they are unclollectible. This is to foster conservative accounting practices. The prompt write-off does not signify any easing off the collection process per se which, to the extent that such actions are successful, will result in recoveries being credited to the valuation reserve. In any event, Directive 2 provides for loss credits remaining on the books for up to one year after they are classified as non-accrual, at which time they become a write-off.

20. The calculation for reserve adequacy purposes also requires a 5% provision to cover potential but unforeseen losses on renegotiated credit exposures and 1.5% on the remaining exposures, which include all performing plus non-current exposures up to 89 days past due.

REPORTING ARRANGEMENTS

21. All licensed banks are required to submit or any additional returns that will be issued by the Banking Commission within 14 days after the last business day of each calendar quarter.

CERTIFICATION OF COMPLETENESS AND ACCURACY

22. The "Certification and Submission Form" attached to this Directive is required for all regulatory returns and shall be used as the standard cover page for all statutory submissions. It is the ultimate responsibility of the Chief Financial Officer or designee from the Accounting/Finance function complete the financial return and ensure the accuracy and completeness of all information contained in the financial return. The Internal Audit or an appointed Auditor of the bank shall provide the final verification on the accuracy and completeness of the information in the financial return prior to submission to the Banking Commission.

23. Any late, inaccurate and/or incomplete financial return submissions will not be accepted and may be subject regulatory fines until the correct information is furnished to the satisfaction of the Commissioner.

ACKNOWLEDGEMENT OF RECEIPT OF RETURN

24. The licensed bank shall submit financial returns through hand delivery of hard copies to the authorized Banking Commission officer who has been assigned for receiving the return.

25. All financial returns are to be hand-delivered to the Administrative Officer situated in the Banking Commission Administration Office located on the 2nd Floor of Andrew Bing Building Complex. During the absence of the Administrative Officer the bank officer may submit the financial returns to Financial Institutions Supervision department staff for acknowledgement of receipt.

26. Bank officers delivering the returns should not leave the Banking Commission until he/she had obtained the Commission's stamped receipt and signed copy of the Certification and Submission Form, which becomes the official "receipt" acknowledging that the report has been successfully submitted.

27. All inquiries regarding the provisions outlined in this Directive should be addressed to the Commissioner or the Financial Institution Supervision Manager.

Reviewed by the Regulation and Policy Review Committee ("RPRC") on 6/21/17

Sultan T. Korean
Commissioner of Banking

6/30/17

Date Signed

REPORTING INSTRUCTIONS 4

This Report consolidates the information previously required to be submitted by banks under Instructions and Reporting Forms 3, 3(A) and 4. The revised Report also reduces the regulatory burden on banks by extending the reporting frequency for past due loans from monthly to quarterly. The revised Report, however, maintains the quarterly reporting requirement on changes in the composition of the Allowance for Loan Losses (ALL).

While banks will be reporting to the Banking Commission on a less frequent basis, the Board of Directors and management should continue to monitor the level and severity of past due loans and the adequacy of the Allowance for Loan Losses (ALL) account on a regular and frequent basis.

In classifying assets and assessing the adequacy of the ALL account, banks may use more stringent standards for recognizing non-performing credits than those set forth in Directive 3, but there is little if any scope for delaying classifications. Any credit past due 90 days or more for the payment of principal or interest must be placed on non-accrual in accordance with Directive 2, Accounting for Non-Performing Credits. Banks, however, are reminded that the minimum provision requirements outlined in Directive 3 are applicable to the sum total of a bank's exposure, which in the case of non-accrual loans includes principal plus accrued interest arrears to date.

All amounts reported in this Quarterly Report on Classified Loans and Reserve Adequacy are to be reported in thousands of U.S. Dollars (US$ 000).

PART A: CLASSIFICATION OF LOANS

Column Heads:

(a) Item

- Loans categories listed in Lines 1. Through 5. And 7. Through 13 are the same as those defined in Instruction and Reporting Form 1, Statement of Assets and Liabilities.

(b) Current Less Than 30 Days Past Due

- Report in the appropriate lines all loans as categorized in Instruction 1, monthly Statement of Assets and Liabilities, Lines 13 through 24, which are performing in accordance with their contractual repayment terms or on which the payment of principal or interest is in arrears for less than 30 days.

(c) Non-Current 30 to 89 days Past-Due

- Report in the appropriate lines all loans which are past due for the payment of principal or interest 30 days or more but less than 90 days.

(d) Restructured

- Report in the appropriate lines all loans which have had their terms modified by the bank due to the weakened financial condition of the borrower and which do not yet qualify for return to performing status in accordance with Directive 2, Accounting for Non-Performing Credits.

(e) Substandard 90 to 179 Days Past-Due

- Report in the appropriate lines all loans classified Substandard in accordance with Directive 3, Asset Classification and Reserve Adequacy, paragraph 9, or on which principal or interest is past due for 90 days or more but less than 180 days.

(f) Doubtful 180 to 360 Days Past-Due

- Report in the appropriate lines all loans classified Doubtful in accordance with Directive 3, Asset Classification and Reserve Adequacy, paragraph 10, or on which principal or interest is past due for 180 days or more but less than one year.

(g) Loss Over 360 days Past-Due

- Report in the appropriate lines all loans classified Substandard in accordance with Directive 3, Asset Classification and Reserve Adequacy, paragraph 11, or on which principal or interest is past due for one year or more.

(h) Total

- Horizontally sum the amounts reported for each Line in Columns (b) through (g).

Line Items:

1. **Central government** - The payment status of loans categorized as Central Government and reported in Columns (b) through (g) report in the appropriate Columns (b) through (g) the payment status of loans categorized as Central Government. The total loans categorized as Central Government and reported in Column (h) of this Form must equal the amount reported in Form 1, Monthly Statement of Assets and Liabilities, Line 13.

2. **Local Government** – report in the appropriate Columns (b) through (g) the payment status of all loans categorized as Local Government. The total loans categorized as Local Government and reported in Column (h) of this Form must equal the amount reported in Form 1, Monthly Statement of Assets and Liabilities, Line 14.

3. **MIDB** – report in the appropriate Columns (b) through (g) the payment status of all loans categorized as Marshall Islands Development Bank. The total loans categorized as Marshall Islands Development Bank and reported in Column (h) of this Form must equal the amount reported in Form 1, Monthly Statement of Assets and Liabilities, Line 15.

4. **Non-Financial Public Enterprises** - report in the appropriate Columns (b) through (g) the payment status of all loans categorized as Non-Financial Public Enterprises. The total loans categorized as Non-Financial Public Enterprises and reported in Column (h) of this Form must equal the amount reported in Form 1, Monthly Statement of Assets and Liabilities, Line 16.

5. **Sub-total – Public Sector** – Sub-total vertically the amounts reported in lines 1. through 4. for Columns (b) through (h)

6. **Businesses – Non-Bank Financial** – report in the appropriate Columns (b) through (g) the payment status of all loans categorized as Businesses – Non-Bank Financial. The total loans categorized as Businesses – Non-Bank Financial and reported in Column (h) of this Form must equal the amount reported in Form 1, Monthly Statement of Assets and Liabilities, Line 18.

7. **Businesses – Commercial** - report in the appropriate Columns (b) through (g) the payment status of all loans categorized as Business – Commercial. The total loans categorized as Non-Financial Public Enterprises and reported in Column (h) of this Form must equal the amount reported in Form 1, Monthly Statement of Assets and Liabilities, Line 19.

8. **Nonprofit Institutions** - report in the appropriate Columns (b) through (g) the payment status of all loans categorized as Nonprofit Institutions. The total loans categorized as Nonprofit Institutions and reported in Column (h) of this Form must equal the amount reported in Form 1, Monthly Statement of Assets and Liabilities, Line 20.

9. **Individuals – Installment Credit** - report in the appropriate Columns (b) through (g) the payment status of all loans categorized as Individuals – Installment Credit. The total loans categorized as Individuals – Installment Credit and reported in Column (h) of this Form must equal the amount reported in Form 1, Monthly Statement of Assets and Liabilities, Line 21.

10. **Individuals – Residential Mortgages** - report in the appropriate Columns (b) through (g) the payment status of all loans categorized as Individuals – Residential Mortgages. The total loans categorized as Individuals – Residential Mortgages and reported in Column (h) of this Form must equal the amount reported in Form 1, Monthly Statement of Assets and Liabilities, Line 22.

11. **Individuals – Other** - report in the appropriate Columns (b) through (g) the payment status of all loans categorized as Individuals - Other. The total loans categorized as Individual Other and reported in Column (h) of this Form must equal the amount reported in Form 1, Monthly Statement of Assets and Liabilities, Line 23.

12. **Overdrafts** - report in the appropriate Columns (b) through (g) the payment status of all Overdrafts. The total Overdrafts and reported in Column (h) of this Form must equal the amount reported in Form 1, Monthly Statement of Assets and Liabilities, Line 19.

13. **Sub-total Private Sector** - Sub-total vertically the amounts reported in lines 6. through 12. for Columns (b) through (h)

14. **Total** – Total vertically the amounts reported in lines 5. and 13. for Columns (b) through (h).

PART B: MINIMUM RESERVE ADEQUACY

General Instructions for completing Line 16 – ALL Target this Quarter

- For Columns (b) though (g), multiply the amount reported in Line 14 by the respective percentage listed in Line 15.

PART C: CHANGES IN THE ALLOWANCE FOR LOAN LOSSES

The balance of the Allowance for Loan Losses account should be sufficient to absorb all identified and potential but unidentified losses associated with a bank's on and off-balance sheet risk exposures.

In order to accurately record the results of a bank for any given reporting period, management must decide what or how much "Provision for Loan Losses" will be charged against current earnings. In considering how much, if any, charge is needed to current earnings, the balance of the Allowance for Credit Losses should be compared with the minimum provision requirements as reflected in Line 16 of this Report.

On this basis, the "Provision for Loan Losses" charged to earnings is a residual and significant adjustment necessary for the appropriate reporting of a bank's operating results.

Column Heads:

- This part of the return is designed to be updated as of the end of each calendar quarter commencing with the calendar quarter ending 31 March. As such, the Year-to-Date Column will represent the accumulation of information submitted for each calendar quarter end.

Line Items:

17. Balance at Prior Quarter End

- Report the balance of the Allowance for Credit Losses as of the end of the last calendar quarter end. For the calendar quarter ending 31 March, the balance at prior quarter end will be derived from the immediately preceding calendar year end.

18. New Provisions the Quarter

- Report the amount of Provisions for Loan Losses charged to earnings during the current calendar quarter.

19. Recoveries this Quarter

- Report the amount of loans written off in previous reporting periods but collected during the current calendar quarter.

20. Write –offs this Quarter

- Report the amount of loans written off in the current calendar quarter.

21. Other Increases (Decreases)

- Report all other increases and (decreases) to the Allowance for Credit Losses accounts which cannot otherwise be reported in lines 18., 19. or 20.

22. Ending Balance

- For each calendar quarter, add amounts reported in Lines 17., 18., 19. and 21 less amounts reported in line 20.

Bank/Branch

Quarter Ending

LOAN CLASSIFICATION AND RESERVE ADEQUACY

(Report all amounts in thousands of U.S. Dollars)

Item (a)	Payment Status						
				Non-Accural			
	Current Less than 30 Days Past Due (b)	Non-Current 30 to 89 Days Past Due (c)	Restructured (d)	Substandard 90 to 179 Days Past Due (e)	Doubtful 180 to 360 Days Past Due (f)	Loss Over 360 Days Past Due (g)	Total (h)
PART A: Loans Classifications							
1. Central Government							0
2. Local Government							0
3. MIDB							0
4. Non-Financial Public Enterprises							0
5. **Sub-total Public Sector** (Lines 1 throuh 4)	0	0	0	0	0	0	0
6. Business - NonBank Financial							0
7. Business - Commercial							0
8. Nonprofit Institutions							0
9. Individuals - Installment Credit							0
10. Individuals - Residential Mortgage							0
11. Individuals - Other							0
12. Overdrafts							0
13. **Sub-total Private Sector** (Lines 6 through 12)	0	0	0	0	0	0	0
14. **Total** (Lines 5 plus 13)	0	0	0	0	0	0	0
PART B: Minimum Reserve Adeqaucy							
15. Minimum Provision Rate	1.50%	1.50%	5%	30%	50%	100%	
16. **AFCL Target this Quarter** (Line 15 x Line 14)	0	0	0	0	0	0	0

Item (a)	Quarter 1 Ending 31-Mar (b)	Quarter 2 Ending 30-Jun (c)	Quarter 3 Ending 30-Sep (d)	Quarter 4 Ending 31-Dec (e)	Year-to-Date Total (f)
PART C: Changes in the AFCL					
17. Balance at Prior Quarter End					
18. Plus: New Provisions this Quarter					0
19. Plus: Recoveries this Quarter					0
20. Less: Write-offs this Quarter					0
21. Plus: Other Increases (Descreases)					0
22. **Ending Balance**	0	0	0	0	0