September 25, 2004

CIRCULAR BM - 977

To: All Licensed Banks Operating in the Sultanate of Oman

After Compliments,

Sub: Master Circular on Risk Classification and Provisioning

1. Attached herewith please find a copy of the Regulation No. BM/REG/ 50/6/2004 of the Board of Governors of the Central Bank, published in the official Gazette No. 774 of September 1, 2004.

2. Pursuant to Article 14 of Regulation No. BM /REG/ 50/ 6/ 2004 dated September 1, 2004, the following consolidated and updated instructions are issued for strict compliance by the licensed banks.

3. Risk Classification

3.1 Asset quality is the key driver that determines the stability of the banking system. Accordingly, banks should have appropriate systems to grade the loans on the basis of well-defined credit weaknesses for providing useful insights into the nature and composition of the loan book. While banks have multiple tiers, consistent with their risk management policies, procedures and practices for risk classification, for the purpose of regulatory reporting and loan loss provisioning, banks should uniformly follow, for the present, a five-tiered risk classification system - Standard, Special Mention, Substandard, Doubtful and Loss. The parameters for risk classification will be a mix of quantitative and / or qualitative characteristics. Further, banks should follow a separate set of parameters for risk classification of retail and commercial loans.

Criteria for Classification of Retail Loans

3.2 The retail loans include all personal loans, consumer loans, auto loans and leases, educational loans, medical loans, instalment loans and credit card dues, irrespective of the size of the loan sanctioned.

3.3 Residential mortgages, small business facilities and any other exposures where the sanctioned limits do not exceed RO 50,000 shall also be treated as retail loans for the limited purpose of risk classification. Loans in excess of RO 50,000 from these categories should be treated as commercial loans for the purpose of risk classification.

3.4 Banks should use quantitative parameters for the risk classification of retail loans.

Sl. No	Category	Parameter
1	**Standard**	**Meeting all the payment obligations or remain past due for less than 60 days.**
2	**Special Mention**	**Remain past due for 60 days or more but less than 90 days**
3	**Substandard**	**Remain past due for 90 days or more but less than 180 days**
4	**Doubtful**	**Remain past due for 180 days or more but less than 365 days**
5	**Loss**	**Remain past due for 365 days and over**

Criteria for Classification of Commercial Loans

3.5 Commercial loans include all loans and advances, which are not categorized as retail loans. Such loans shall be classified into various risk categories on the basis of quantitative and / or qualitative parameters. The quantitative parameter i.e. payments past due for a specified number of days, should be considered only as a threshold and loans which exhibit early signs of defaults should appropriately be classified, notwithstanding the fact that the loans are not past due for the period specified under different categories of risk classification. Further, the characteristics listed out for risk classification of various categories are not exhaustive and banks should grade all loans meticulously to capture the downside risks and classify the loans proactively into the following appropriate risk categories.

(i) Standard

3.6 All loans and advances, where payment of the principal and / or interest are current and have no indications of financial, etc weaknesses and are not classified as Special Mention or Substandard or Doubtful or Loss, are categorized as Standard.

(ii) Special Mention

3.7 Special Mention loans are those which exhibit potential weaknesses that deserve bank's management's preemptive actions to enhance the present quality of the assets. The Special Mention loans are - ***potentially weak loans where, if left uncorrected, the weakness may result in deterioration of the repayment prospects for the loans or bank's credit position at some future date. Such loans are not adversely classified and do not expose a bank to sufficient risk to warrant adverse classification.*** The Special Mention category should not be used as a means of avoiding adverse risk classification of loans or for passing it without criticism.

The general characteristics of Special Mention loans are as follows: -

a) Early signs of cash flow / liquidity problems such as delay in servicing of trade creditors / loans.
b) Inadequate or unreliable financial and other information such as audited financial statements not obtained or are not available.
c) The condition of and control over collateral is unsatisfactory.
d) Frequent changes in senior levels of management.
e) Failure to obtain proper documentation or non-cooperation by the borrower.
f) Slowdown in business or adverse trend in the operations that signals a potential weakness in the financial strength of the borrower, which has not reached a point where servicing of the loan is jeopardized.
g) Intra-group transfer of funds without underlying transactions.
h) Exposures to related parties on favourable terms.
i) Volatility in the economic or market conditions which may, in future, affect the borrower adversely.
j) Poor performance in the industry in which the borrower operates.
k) Borrower is the subject of litigation by third parties that may have a significant impact on his financial position.
l) Remain past due for 60 days or more but less than 90 days.

(iii) Substandard

3.8 The Substandard loans are - ***loans, which have well defined credit weaknesses, where the current sound worth and paying capacity of the borrower is not assured and that timely repayment of the obligations is in jeopardy. They are characterized by the distinct possibility that the bank will sustain some loss unless the deficiencies are corrected***.

Loans possessing any of the following characteristics shall be classified as Substandard.

a) Inadequate cash flows and / or defects in loan documentation.
b) Inadequate and / or unhealthy operations in the account.
c) Imminent probability of foreclosure or acquisition of collateral.
d) Failure to clear temporary or short-term facilities.
e) Frequent rollovers and / or renewals without definite source/s of repayment.
f) Adjusting delinquency by creating fresh facilities and / or allowing excess drawings in other related concerns' or individual accounts.
g) Significant negative trends in financial statements – deterioration in account receivables, declines in net worth and profitability, build-up of inventories, liquidity problem, etc.
h) Loans under dispute and recovery measures are being contemplated.
i) Remain past due for 90 days or more but less than 270 days.

(iv) Doubtful

3.9 Doubtful loans are - ***loans that exhibit all the weaknesses inherent in substandard loans with the added characteristic that collection or liquidation, in full, on the basis of currently known facts, conditions and values, is highly questionable and improbable.***

Loans possessing any of the following characteristics shall be classified as Doubtful.

a) All or most of the weaknesses of loans classified as substandard.
b) A loss exposure that cannot be readily defined with present circumstances and conditions.
c) The weaknesses, on the basis of existing facts, conditions and value, have rendered the collection or liquidation in full highly questionable and improbable.
d) Legal action initiated.
e) Remain past due for 270 days or more but less than 630 days.

(v) Loss

3.10 Loss loans are - ***loans that are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable***

to defer full provision or writing off this basically worthless loan even though partial recovery may be effected in future.

Loans possessing any of the following characteristics shall be classified as Loss.

a) Severe delinquency.
b) The borrower's whereabouts is unknown, or he is insolvent, or his earning power is permanently impaired and the guarantees are not financially supported (not collateralized).
c) The collateral is worthless or undetermined value of collateral.
d) Loans considered by the management of the bank as absolutely uncollectible.
e) Remain past due for 630 days or more.

4. Non-Performing Loans (NPLs)

4.1 All loans and advances, which are classified as Substandard, Doubtful and Loss, should be categorized as Non-Performing Loans (NPLs).

4.2 A loan, where repayments of principal and interest are pre-determined, shall be considered as past due, when it has not been paid on the due date fixed by the bank, as per the terms of sanction.

4.3 Credit facilities like overdrafts, lines of credit, etc where no definite repayments are pre-determined shall be treated as past due (out of order), if the outstanding balance remains continuously in excess of 10% of the sanctioned / authorized limit or in cases where the outstanding balance in the principal operating account is less than the sanctioned / authorized limit, but there are not enough credits in the account to cover the interest charged or unauthorized drawings have frequently been allowed.

4.4 Bills, which remain unpaid on due dates, shall be considered as past due.

5. Risk Classification and Collateral Support

The risk classification system is designed to assess the underlying quality of the loans. Thus, the collateral support or other risk mitigation techniques should not influence the risk classification of loans. The classification should be carried out with reference to the credit weaknesses, financial status of the guarantors, etc.

6. Classification of Off-Balance Sheet Exposures

6.1 Off-balance sheet exposures- loan commitments, guarantees, letters of credit, stand-by letters of credit, etc also involve credit risk arising from the possibility that the creditworthiness of the borrowers could deteriorate after the original commitment is made. Thus, off-balance sheet exposures shall also be treated the same way as loans for risk classification. When apparent signs of weaknesses that jeopardize repayment are visible, such exposures shall be classified accordingly. The exposures shall be separated into two components – the direct amount (the amount that has already been advanced) and the indirect amount (the amount that might be advanced in the future).

6.2 In the case of derivatives, like swaps, options, futures, forward contracts, etc where the credit risk is limited to the replacement cost, the maximum loss is only the cost of replacing the contracts. In such cases, banks can classify the credit equivalent of off-balance sheet exposures by using the credit conversion factors used for computing the BIS capital ratio.

7. Restructured Loans

7.1 Restructured or rescheduled loans are loans that have been modified at favourable terms and conditions for the borrower, after establishing the borrower's financial condition or ability to repay. Restructuring shall also include modification of terms, such as reduction in interest rate or principal amount, transfer of collateral and acquisition of equity interest, in full or partial satisfaction of the loan, etc.

7.2 Restructuring or rescheduling does not entitle a bank to upgrade the existing risk classification status of the loans automatically. Such loans shall be upgraded only after satisfactory performance of one year from the date of the first payment of interest or principal, whichever is earlier, under the rescheduled / renegotiated terms.

7.3 Restructuring or rescheduling should not be used as a means for preempting the classification of loans into adverse risk categories. The credit decisions to restructuring or rescheduling of loans shall be backed by thorough risk appraisal for clearly establishing the paying capacity, duly supported by adequate cash flows of the borrowers under the revised terms. Any restructuring or rescheduling, which is not supported by proper credit risk assessments would have to be classified according to the underlying risk profile of the loans. Frequent restructuring or rescheduling of loans, which is

not backed by rigorous credit risk appraisal shall straightaway be classified into high risk categories, at least one grade lower than the category as prior to restructuring or rescheduling.

8. Responsibility for Classification

8.1 The onus of appropriate and instant risk classification of loans rests with the banks. The banks shall design appropriate loan review mechanism for spotting and classification of problem loans, to recognize deterioration in asset quality well in time through out the financial year.

8.2 Loan accounts above a cut-off point, internally decided by the banks, shall be evaluated on a continuous basis. The loans, which are basically retail, shall be classified at monthly intervals. However, all the loans are to be evaluated atleast once in every quarter for proper risk classification.

8.3 The responsibility for proper risk classification of loans and validation thereof shall be clearly delineated and the framework shall ensure that any doubts in loan classification are settled through specified internal channels, within one month from the date on which the account would have been classified, as per the extant norms. The banks shall lay down well-defined administrative procedures for classification of loans, subject to the condition that a clean break is established between the sanctioning authority, which had approved the credit facility/ies, and the authority, which is responsible for confirming the risk classification.

8.4 Risk classification of loans should also be validated by the internal and external auditors of the banks.

9. Asset Classification – Borrower –wise or Facility –wise

In normal situations, it is difficult to visualize a scenario where only one exposure of the borrower becomes a problem credit and not others. Thus, banks should evaluate all exposures of a borrower, in terms of financials – cash flow, net worth, profitability, liquidity, etc, whose account has been classified in a high risk category and if the banks anticipate, given the circumstances and downside risks, problems in recoveries, should proactively classify other exposures as well to recognize the latent risks.

10. Split Classification

Where a bank has already decided to write-off a part of its exposures in certain cases, split classification of a single exposure is allowed on the basis of underlying risks. However, the banks should evaluate the downside risks before effecting split classification of single exposures.

11. Declassification of Loans

Loans, other than rescheduled or restructured, which are categorized as Special Mention or Substandard or Doubtful or Loss could be upgraded upon realizing in cash, in full, the past due principal and / or interest. The banks have the discretion to declassify/upgrade such loans. The internal and external auditors should validate the declassification/upgradation. However, the declassification/upgradation of loans by the banks shall be subjected to validation and modifications, if necessary, by the Central Bank.

12. Income Recognition on NPLs

Recognition of income on loans should be objective and based on the record of recovery. Prudential standards mandate that income on NPLs be recognized only on a cash basis. The entire interest income or commission accruing on NPLs may be debited to the borrowers accounts and shall simultaneously be credited to reserve interest account. Upon recovery, in cash, the reserved interest or commission could be released and recognized in the income account. Banks should not also directly transfer balances in the reserve interest account to provisions or any other reserves accounts.

13. Loan Loss Provision

13.1 Sound loan loss provisioning policy is an important indicator of solvency and stability of the banking system. The banks should, therefore, assess credit risk proactively when they book loans and should seek to protect themselves from potential losses – expected and unexpected. Banks generally cover the expected losses by creating general loan loss provisions at the front end, while the unexpected losses are covered by capital. However, the probability of defaults by borrowers changes over time, particularly in response to changes in economic conditions. During boom period, the borrowers' ability to repay tend to increase and as a result loan defaults are likely to fall and vice versa. The current practice is that banks place more weight on the current economic environment and too little on the possibility of changes in economic conditions in the future. Since provisions

are a deduction from income, the cyclicality in provisions may contribute to procyclicality in banks’ earning and capital.

13.2 Banks are, therefore, encouraged to build capital cushion by retaining more profits earned during periods when provision requirements are low, which could be drawn down when large provisions are required to be made. Thus, banks should assess the impact of future macroeconomic conditions on their loan quality and build the necessary reserves in boom periods to provide a cushion against higher realized losses in economic downturns. In principle, the approach for provisions should be dynamic and / or forward-looking.

General Loan Loss Provisions

13.3 The banks should, over a period of time, build adequate expertise in estimating the expected and unexpected losses, with the data on past loss experiences, spanning multiple credit cycles. The general loan loss provisions should ideally be determined on the basis of credit ratings and the associated default probabilities, loss given defaults, rating migrations, current macro-economic environment and other pertinent indicators.

13.4 In the meanwhile, banks should create general loan loss provisions, latest by December 31, 2006, at least equivalent to 1% of their loans, categorized as Standard and Special Mention for meeting the latent loan losses. However, considering the heightened risk inherent in personal loans, a minimum general loss provision of 2% of the Standard and Special Mention personal loans should be created, latest by December 31, 2006. Banks are also encouraged to create such provisions in excess of the thresholds.

13.5 Banks, which have their own systems in estimating the expected losses, might be permitted, subject to validation of the models by the Central Bank, to create general loan loss provisions, on the basis of historical experiences.

13.6 Such provisions contribute towards mitigating pro-cyclicality of earnings, besides improving the financials of banks. The general loan loss provisions shall be recognized as an expense in the income account and the banks could reckon such provisions as well within the maximum limit of 1.25% of the total risk - weighted assets, as Tier 2 capital for BIS capital adequacy purposes.

Specific Loan Loss Provisions

13.7 Once the risk classification of loans has been determined on the basis of specific characteristics, the banks shall make adequate specific loan loss provisions to cover the realized credit risk. The banks are required to make adequate specific loan loss provisions on the direct or contingent obligations of their customers. The minimum provisioning levels are indicated below:

Classification	Provision	Procedure for provisioning
Substandard	25%	To be fully provided in cash, without reckoning the value of collaterals.
Doubtful	50%	25% of the provision is required to be made in cash. The balance 25% of the provision could be covered by recourse to the "determined value" of real estate (lower of 100% of the forced sale value or 50% of the estimated market value, valued by a recognized / reputed estate agent within the last three years and properly and legally mortgaged to the bank. In case the valuation report is more than three years old, the value of the real estate shall not be reckoned for determining the provisions) and shares listed in the Muscat Securities Market (MSM), held as security (50% of the latest market value). If the determined value of these collaterals is not sufficient to cover the balance provision of 25%, the banks have to arrange for cash provision for the residual amount.

Loss	100%	25% of the provision is required to be made in cash. The balance 75% of the provision could be covered by recourse to the "determined value" of real estate (lower of 100% of the forced sale value or 50% of the estimated market value, valued by a recognized / reputed estate agent within the last three years and properly and legally mortgaged to the bank. In case the valuation report is more than three years old, the value of the real estate shall not be reckoned for determining the provisions) and shares listed in the Muscat Securities Market (MSM), held as security (50% of the latest market value). If the determined value of these collaterals is not sufficient to cover the balance provision of 75%, the banks have to arrange for cash provision for the residual amount.

13.8 In cases of loans that are fully backed by bank deposits (with proper discharge), commercial pre-payments (margin) or securities issued and / or guaranteed or confirmed receivables from the Government of Oman, guarantees from local banks including the branches of foreign banks licensed by the Central Bank and overseas banks with a minimum long-term foreign currency credit rating of 'A' from international rating agencies, there is no need to make specific provisions. However, when the value of these collaterals and / or the guarantees does not cover the classified amount fully, banks shall make cash provisions for the uncovered amount, on the basis of the underlying risk classification of the loans. Banks shall enforce such collaterals and / or guarantees, in the event of default of the obligations, expeditiously for enhancing the asset quality. In cases where the banks take unduly long period in enforcing the collaterals or guarantees, adequate provisions, on the basis of the risk classification, should back such loans.

13.9 Given the market conditions and liquidity, it is necessary that a conservative approach be followed in the manner of reckoning the type and value of collaterals. Recognizing the constraints involved in the disposal of mortgaged properties, susceptibility to market fluctuations and liquidity, banks should assume only conservative periods, based on historical experiences for

discounting the cash flows that might arise out of the sale of real estates, under the International Financial Reporting Standards (IFRS). Further, banks should estimate the provisions, independently on a two-track approach i.e. the Central Bank's norms and under IFRS and create provisions on a portfolio-wide basis, subject to the condition that the provisions, determined under either of the methods, whichever is higher is made.

14. Acquisition of Real Estate and Personal Property under Article 66 (b) of the Banking Law.

Banks are allowed to acquire real estate and personal property in satisfaction of debts previously contracted within the normal course of banking business, subject to the condition that such property shall be sold or otherwise disposed of within 12 months of the date of acquisition, unless an extension is granted by the Central Bank. Until such property is finally sold or disposed of, banks should not release the specific provisions that backed such loans, to the income account.

15. Write-off of NPLs

15.1 Banks should have clearly articulated write-off/waiver policies established by the Board of Directors, delineating the approach, authority, accountability for negligence and inappropriate follow-up, independent review and audit, continuous monitoring, reporting, etc. The policies should aim at recovering maximum salvage value through enforcement of collateral / guarantees, etc. The banks should also be extremely prudent in entering into compromise proposals / waiving any part of the claims with the borrowers and guarantors and all such decisions should have the approval of the appropriate authorities. Further, the decisions to compromise the banks' claims should be pursued only when all available remedies including legal actions against the borrowers and guarantors have been fully exhausted. Where the write-off / waiver is considered before exhausting all the recourses, the justifications therefor should be clearly established and the cases duly approved by the full Board of Directors.

15.2 Where the claims have been written-off only for recognizing the status of asset quality, steps towards recovery of the dues should be pursued vigorously. Banks should also subject all write-offs / waivers to independent review and internal audit and maintain all the relevant records for ex-post scrutiny of the external auditors / Central Bank.

15.3 In normal course, no proposals for write-off / waiver in respect of claims on senior members and their related parties of any of the licensed financial institutions should be considered. However, in respect of exceptionally genuine cases, the proposals, duly endorsed by the full Board of Directors, should be referred in the format (Attachment-I) to the Central Bank and that only in cases where the Central Bank do not raise any objections within 30 days from the dates of reference, banks can write-off or enter into agreement with such borrowers and guarantors for waiver or write-off. The details of such cases should also be disclosed in the financial statements.

15.4 Banks should disclose their policies on waiver of claims / write-offs and the amounts actually waived or written-off, in a particular year, in the respective annual financial statements, to ensure greater transparency. Banks should also report on quarterly basis (number of accounts, total amount involved and manner of write-off) of Non Performing Assets waived or written-off, separately along with the Quarterly Monitoring Reports. Further, all write-offs or waivers involving compromises of RO 100,000/- and over should be reported individually in the format (Attachment-II).

Best regards,

Hamood Sangour Al-Zadjali
The Executive President

Attachment I

Proposal for Waiver / Write-off of Non Performing Assets (NPAs) in respect of claims on Senior Members and their Related Parties

1.	Name of the Bank	
2.	Name of the Borrower/s	
a.	Relationship with the Bank	
3.	Legal Status of the Borrower/s	
4.	ID No. or CR No. or Passport No. & Issue Date (as applicable)	
5.	Name of the Guarantor/s, if any	
6.	Legal Status of the Guarantor/s	
7.	ID No. or CR No. or Passport No. & Issue Date (as applicable)	
8.	Date of Original Sanction	
9.	Date of Latest Renewal / Review	
10.	Balance Outstanding	
11.	Current Classification Status	
12.	Date of placing the accounts on non-accrual basis	
13.	Amount to be waived / written -off	
14.	Reserve Interest	
15.	Provisions	
16.	Amount to be met from Current Year's Profit	
17.	Details of Collaterals:	
	a) Cash Collaterals	
	b) Real Estate • Forced Sale Value • Market Value	
	c) MSM Securities – Market Value	
	d) Others (please specify)	
18.	Latest financial position of the Borrower/s	
19.	Latest financial position of the Guarantor/s	
20.	Steps taken by the bank in recovering the dues	
21.	Reason/s for waiver / write-off	
22.	Authority approving the waiver / write-off	
23.	Summary of the proposed agreements with the borrowers / guarantors	

Authorized Signatory Date:

Attachment II

Reporting of Waiver / Write-off of Non Performing Assets (NPAs) with a compromise of RO.100,000 and above

1.	Name of the Bank	
2.	Name of the Borrower/s	
3.	Legal Status of the Borrower/s	
4.	ID No. or CR No. or Passport No. & Issue Date (as applicable)	
5.	Name of the Guarantor/s, if any	
6.	Legal Status of the Guarantor/s	
7.	ID No. or CR No. or Passport No. & Issue Date (as applicable)	
8.	Date of Original Sanction	
9.	Date of Latest Renewal / Review	
10.	Balance Outstanding	
11.	Classification Status at the time of waiver / write-off	
12.	Date of placing the accounts on non-accrual basis	
13.	Amount waived / written -off	
	a) From Reserve Interest	
	b) From Provisions	
	c) From Current Year's Profit	
14.	Details of Collaterals:	
	a) Cash Collaterals	
	b) Real Estate • Forced Sale Value • Market Value	
	c) MSM Securities – Market Value	
	d) Others (please specify)	
15.	Latest financial position of the Borrower/s	
16.	Latest financial position of the Guarantor/s	
17.	Steps taken by the bank in recovering the dues	
18.	Justifications for waiver / write-off	
19.	Authority approving the waiver / write-off	

Authorized Signatory   Date: