بســـم الله الرحمن الرحيـــم

مؤسسة النقد العربي السعودي

المركـز الرئيسي

الإدارة العامة للرقابة على شركات التمويل

الرقـــم : ....

المرفقات : ......لا يوجد........

تعميم

السادة/ المحترمون

السلام عليكم ورحمة الله وبركاته،

الموضوع: قواعد تصنيف التعرض لمخاطر الائتمان والمخصصات لدى شركات التمويل.

إشارةً إلى الصلاحيات الممنوحة لمؤسسة النقد العربي السعودي بموجب نظام مراقبة شركات التمويل الصادر بالمرسوم الملكي رقم (م/٥١) وتاريخ ١٤٣٣/٨/١٣هـ. واستناداً إلى المادة الثالثة عشرة من نظام مراقبة شركات التمويل والتي نصت "على شركة التمويل أن تضع مخصصًا لمواجهة خسائر التشغيل المحتملة وفق المعايير التي تحددها اللائحة".

تجدون بطيّه نسخة من قواعد تصنيف التعرض لمخاطر الائتمان والمخصصات لدى شركات التمويل، حيث يسري العمل بهذه القواعد اعتباراً من تاريخ ٢٠٢١/٧/٠١م.

للإحاطة والعمل بموجبه.

وتقبلوا تحياتي،

فهد بن إبراهيم الشثري
وكيل المحافظ للرقابة

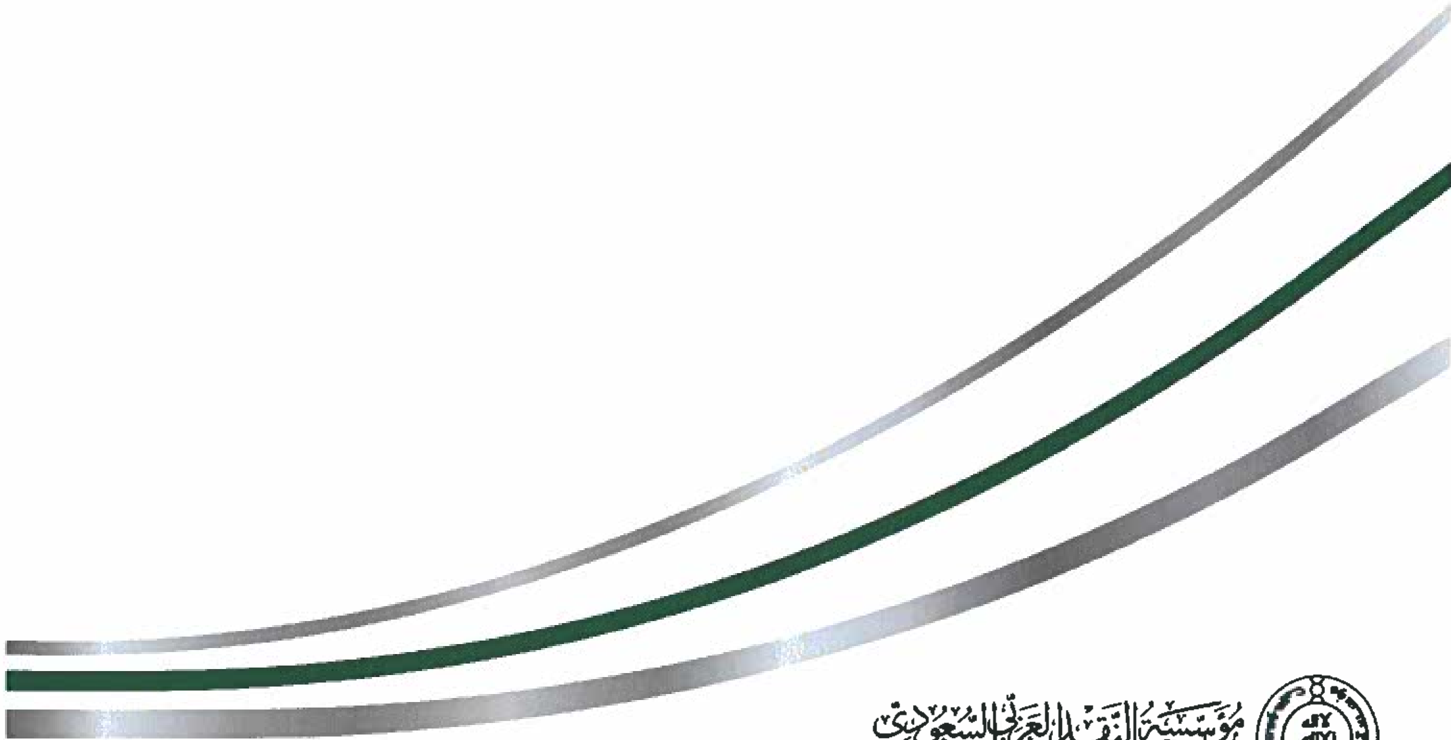
نطاق التوزيع

- شركات التمويل العاملة في المملكة.
- الشركة السعودية لإعادة التمويل العقاري.

ص.ب ٢٩٩٢ الرياض ١١١٦٩ ، هاتف : ٤٦٦٢٠٢٠ ١١ ٩٦٦+ ، فاكس ٤٦٦٢٤٨٨ ١١ ٩٦٦+

Rules Governing Credit Risk Exposure Classification and Provisioning

November 2020



مؤسسة النقد العربي السعودي

Saudi Arabian Monetary Authority

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Rules Governing Credit Risk Exposure Classification and Provisioning

1. General Requirements

1.1 Introduction

Saudi Arabian Monetary Authority (SAMA) issued these rules in exercise of the powers vested upon it under Finance Companies Control Law promulgated by the Royal Decree No. (M/51) on 13/08/1433H and in pursuance of the Implementing Regulation of Finance Companies Control Law promulgated by the resolution of the Governor No (2/M U T) dated 14/04/1434H.

In reference to Article no. 13 of Finance Companies Control Law "The finance company shall allocate a provision for contingent operation losses in accordance with the criteria specified under the Regulations," and Article 62 of the Implementing Regulation of the Finance Companies Control Law "The finance company must set provisions for contingent losses and risks in accordance with international accounting standards. SAMA may require the finance company to make one or more additional provisions for such losses and risks."

These Rules set out the minimum requirements on Credit Risk Exposure Classification and Provisioning. A finance company's credit risk exposure classification and provisioning are components of its credit risk management framework. Credit Risk Management must be performed by finance companies through the use of appropriate policies, procedures, and controls that identify, measure, monitor, control and report the actual credit risk of the finance company. Finance companies will not be able to achieve compliance with these Rules unless there is an effective and robust Credit Risk Management Framework that is commensurate with the nature, size, complexity and level of their credit risk exposure. As a result, finance companies must first conduct an analysis of current risk management framework to determine what adjustments are necessary as a result of these Rules, and implement the necessary remediating actions to ensure full compliance by the effective date.

It should be noted that the Board of Directors and Management of the finance company are responsible to set adequate policies and procedures, maintaining sound asset quality, having an adequate level of provisions and general reserve for credit losses at all times, and having effective exposure approval management and classification procedures, as well as an appropriate framework for dealing with problem exposures.

1.2 Objective of the Rules

The main objectives of these Rules are to enable finance companies to:

i. Evaluate the degree of credit risk associated with exposures;

ii. Prudently value exposure portfolio;

iii. Determine and make adequate provisions for expected credit losses following robust governance; and

iv. Achieve uniformity and consistency in exposure classification and provisioning methodologies.

1.3 Scope of Implementation

These Rules shall be applicable to all finance companies licensed pursuant to Finance Companies Control Law.

1.4 Definitions

The following terms and phrases, where used in these Rules, should have the corresponding meanings, unless the context requires otherwise:

SAMA:	Saudi Arabian Monetary Authority
Rules:	Rules Governing Credit Risk Exposure Classification and Provisioning
Credit Exposure:	As prescribed by IFRS 9, this include loans and advances and other types of on- and off-balance sheet credit exposure (financial guarantees, bid and unutilized un-cancellable commitments and others), accrued commission / income receivable, commitments and contingent liabilities and any other commission / non-commission bearing credit-related instruments and arrangements. This will also include investments in non-trading debt securities (long-term/held-to-maturity investments) e.g. certificates of deposit, commercial papers and other negotiable debt instruments.
Restructured Exposure:	Any exposure arrangement in which the original terms and conditions have been changed or modified. Normal annual renewal of exposures should not be categorized as restructured exposure. Restructuring may occur in the form of either forbearance or renegotiation. Forborne Exposure and Renegotiated Exposure are defined as below: a. ***Forborne Exposure:*** Any exposure arrangement in which the original terms and conditions have been changed or modified such that the modified terms result in a concession to the borrower, and the modification, which would not have been otherwise granted, was granted as a result of the borrower's financial difficulty. ***b. Renegotiated and/or Refinanced and/or Rescheduled Exposure:*** Any exposure arrangement in which the original terms and conditions have been modified. However, the modification does not necessarily results in a concession to the borrower and the modification was not granted as a result of the borrower's financial difficulty. These 3 terms have the same interchangeable meanings and should be used accordingly, if needed. Any other new term should be discussed with SAMA before using in practice.

Probability of Default: Measures the estimated likelihood of default over a time horizon as prescribed by IFRS 9.

Exposure at Default: As prescribed by IFRS 9, it measures estimated risk exposure at the time of likely default taking into consideration any prepayments, repayments of principal and interest, and drawdowns. This includes both on and off-balance sheet exposure. No consideration is given to collateral when determining the exposure at default.

Loss Given Default: Measures the estimated risk of loss as prescribed by IFRS 9 i.e. the risk exposure adjusted for collateral and other recovery proceeds, fluctuation in market value and realization costs. Eligible collateral as elaborated in Annexure 1 should be included in the Loss Given Default calculation.

Financial Asset: As prescribed by IFRS 9, a financial asset is any asset that is cash, an equity instrument of another entity, a contractual right to receive cash or another financial asset from another entity or to exchange financial asset or financial liabilities with another entity under conditions that are potentially favorable to the entity. This includes derivative and non-derivative contracts.

Expected credit loss*:* As prescribed by IFRS 9, the estimated credit losses expected to be incurred from the occurrence of a credit event, e.g. default.

Lifetime expected credit loss*:* As prescribed by IFRS 9, the expected credit losses that result from all possible default events over the life of the financial asset.

12-month expected credit loss*:* As prescribed by IFRS 9, the expected credit losses that result from those default events on the financial asset that are possible within 12 months after the reporting date.

Stage 1 Exposure: As prescribed by IFRS 9, any exposure for which there is no significant increase in credit risk since origination or otherwise are considered high quality (i.e. rated of investment grade) or exhibit indicators of low credit risk. This exposure can be mapped to "Regular" Loans regulatory category (for the naming convention only) given in SAMA previous circular on Provisions Guidelines issued on 27/04/1438H.

Stage 2 Exposure: As prescribed by IFRS 9, any exposure for which there is a significant increase in credit risk since origination. This includes rebuttable presumption that the credit risk has increased significantly when contractual payments are more than 30 days past due. This exposure can be mapped to "Special Monitoring Accounts and Substandard" regulatory category (for the naming convention only keeping in view conservatism of

IFRS 9) given in SAMA previous circular on Provisions Guidelines issued on 27/04/1438H.

There are 2 categories in Stage 2 exposures as defined in these rules **for regulatory reporting purposes only and not for accounting purposes,** i.e. Stage 2A and Stage 2B. **Stage 2A or Special Monitoring Account category** represents **lower levels of credit risk** within the stage 2 allocation while **Stage 2B or substandard category** represents **moderate levels of credit risk** within the stage 2 allocation.

Stage 3 Exposure: As prescribed by IFRS 9, any exposure which is assessed as impaired or otherwise is in default as determined in Section 8 of these Rules. This includes the fact that the credit risk has significantly increased when contractual payments are more than 90 days past due. This exposure can be mapped to "Doubtful and Loss" regulatory categories (for the naming convention only keeping in view conservatism of IFRS 9) given in SAMA previous circular on Provisions Guidelines issued on 27/04/1438H.

There are 2 categories in Stage 3 exposures as defined in these rules, **for regulatory reporting purposes only and not for accounting purposes,** i.e. Stage 3A and Stage 3B. **Stage 3A or Doubtful category** represents **higher levels of credit risk leading to impairment** within the stage 3 allocation and exposures currently in cure period while **Stage 3B or Loss category** represents **impaired/defaulted exposures** within the stage 3 allocation.

Past due: As prescribed by IFRS 9, an exposure where any amount due under the contract (interest, principal, fee or other amount) has not been paid in full at the date when it was due. An exposure should be considered past due from the first day of missed payment (scheduled payment date as per original or modified contract), even when the amount of the exposure or the past-due amount, as applicable, is not considered material (materiality means greater than 5% of total exposure).

Problem loans: Loans that display well-defined weaknesses or signs of potential problems. Problem loans should be classified by the company in accordance with accounting standards, and consistent with relevant regulations, as one or more of:

a. non-performing;
b. subject to restructuring on account of inability to service contractual payments;
c. IFRS 9 Stages 2; and exhibiting signs of significant credit deterioration or Stage 3;

d. under watch-list, early warning or enhanced monitoring measures; or

e. where concerns exist over the future stability of the borrower or on its ability to meet financial obligations as they fall due.

Net realizable amount: It is the amount the finance company is expected to receive in the ordinary course of business less the estimated costs of recovery. This should follow the same requirements as given in the Accounting Standards and practically followed by the finance companies i.e., the outstanding amount less the actual collateral held and recovery related costs.

2. Governance

It is the responsibility of the board of directors of finance companies to maintain ECL provisions at an adequate level and to oversee that the company has adopted appropriate credit risk practices for the assessment and measurement of ECL provisions, in accordance with the company's stated policies and procedures, the applicable accounting framework and relevant SAMA rules and guidance.

Establishing a strong governance and controls framework over ECL estimation and reporting, focusing on data integrity and model validation is a key focus area for those charged with governance. A robust framework for assessing credit risk and measuring the level of provisions should include, but not limited to the following:

i. Clearly define key terms related to the assessment and measurement of ECL (such as loss events or default, SICR, etc.);

ii. Identify and describe roles and responsibilities of functions and personnel involved;

iii. Include, for collectively evaluated exposures, a description of the basis for creating groups of portfolios of exposures with shared credit risk characteristics;

iv. Identify and document the ECL assessment and measurement methods (such as a loss rate method, probability of default (PD)/loss-given-default (LGD) method, or other) to be applied to each exposure or portfolio;

v. Document the inputs, data and assumptions used in the ECL estimation process (such as historical loss rates, PD/LGD estimates and economic forecasts), how the life of an exposure or portfolio is determined (including how expected prepayments have been considered), the historical time period over which loss experience is evaluated, and any qualitative adjustments. Examples of factors that may require qualitative adjustments are the existence of concentrations of credit risk and changes in the level of such concentrations, increased usage of exposure modifications, changes in expectations of macroeconomic trends and conditions, and/or the effects of changes in underwriting standards and lending policies;

vi. Include a process for evaluating the appropriateness of significant inputs and assumptions into the ECL measurement method chosen. It is expected that the basis for inputs and assumptions used in the estimation process will generally be consistent period to period. Where inputs and assumptions change, the rationale should be documented;

vii. Address how ECL rates are determined (e.g., historical loss rates or migration analysis as a starting point, adjusted for current conditions, forward-looking information and macroeconomic factors). A finance company should have a realistic view of its lending activities and consider forward-looking information that is reasonably available, macroeconomic factors, and the uncertainty and risks inherent in its lending activities when estimating ECL. To ensure alignment and consistency of macroeconomic factors used to

create ECL models, SAMA may require, at its discretion, finance companies to consider the possible effects of certain indexes and economic factors in a specific manner, from time to time.

viii. Consider the appropriateness of historical data/experience in relation to current conditions, forward-looking information and macroeconomic factors, and document how management's experienced judgment is used to assess and measure ECL;

ix. Determine the extent to which the value of collateral and other credit risk mitigants incorporated in the lending agreements affect ECL;

x. Include criteria for restructurings/modifications of lending exposures and their impact on ECL;

xi. Outline the company's policies and procedures on write-offs and recoveries;

xii. Document the methods used to validate models used for ECL measurement (e.g., back-tests) including model risk management;

xiii. Review, evaluate, update, and report on the adequacy of expected credit losses by Internal Auditors as a third line of defense on an annual basis. Where a finance company's Internal Auditor is unable to perform such reviews, the company may engage an independent third party to provide assurance to the Board of Directors and Senior Management on the quality and effectiveness of the internal controls, risk management and governance systems and processes set up under the IFRS 9 framework;

xiv. Providing relevant, timely, accurate and useful disclosures on expected credit losses in accordance with internal, regulatory, and accounting requirements; and

xv. Establish key performance indicators (KPIs) relating to ECL estimation and processes for regular reporting of those KPIs. For example, staging assessment KPIs might include how many credit exposures moved directly from Stage 1 to Stage 3 and how many credit exposures are moved to Stage 2 only because they are 30 days past due (and not flagged by other transfer criteria prior to delinquency) or operational performance KPI may include input data completeness, exposure reconciled, etc.

The framework must be reviewed at least annually, or more frequently when the need arises especially when new information becomes available during the quarterly expected credit loss assessment process.

3. Credit Risk Classification

Finance companies will be required to classify exposures on an individual or collective basis in one of three stages or regulatory categories based on their original credit risk at origination and the change in credit risk at reporting date since origination. SAMA encourages finance companies to adopt General Approach for measuring expected credit losses (ECL).

SAMA has provided mapping of IFRS 9 stages to regulatory categories (for the naming convention only keeping in view conservatism of IFRS 9) i.e. Regular, Special Monitoring Accounts, Substandard, Doubtful and Loss categories. The definitions given in SAMA previous circular on Provisions Guidelines (Circular No. 381000046342 dated 27/04/1438H) for these regulatory categories should no longer be used while applying the requirements of this new circular.

3.1 Stage 1 or Regular category

Any exposure for which there is no significant increase in credit risk since origination (SICR) or otherwise are considered high quality or exhibit indicators of low credit risk. Indicators of low credit risk include, but are not limited to:

i. The borrower has a low risk of default;
ii. The payments are not past due by more than 30 days;
iii. The borrower has a strong capacity to meet contractual cash flow obligations in the near term; and
iv. Adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil contractual cash flow obligations.

3.2 Stage 2 or Special Monitoring Accounts / Substandard category

Any exposure for which there is significant increase in credit risk since origination. Each finance company must clearly define what it considers to be significant increase in credit risk. Such indicators may include, but are not limited to:

i. The borrower has a moderate risk of default;
ii. The payments are past due by more than 30 days; this is rebuttable only for direct exposures to the Government, Government Agencies or Ministries (or equivalent entities including contractors working directly for a governmental entity in cases where the delay is not due to performance issues);
iii. The borrower has a weak or deficient capacity to meet its contractual cash flow obligations in the near term; and
iv. Adverse changes in economic and business conditions in the longer term are more likely than not to reduce the borrower's ability to fulfil its obligations.

Finance companies should continuously monitor stage 2 exposures to identify improvements in credit quality and determine eligibility for re-staging stage 2 exposures to stage 1. Finance companies should document the minimum eligibility requirement for re-staging stage 2 exposures into stage 1 exposures, which should at least include the following conditions:

i. The borrower does not have any exposure more than 30 days past due;
ii. Exposure repayments have been made when due over a continuous repayment period (cure period excluding grace period, if any) of 90 days for those non-retail customers that have moved from stage 1 to stage 2 due to overdue principal and/or interest for more than 30 days (but less than 90 days) or extended due to credit risk reasons;
iii. The borrower's situation has improved so that the full repayment of the exposure is likely (tested over 90 days as part of cure period), according to the original or modified terms and conditions; and
iv. The indicators which has contributed to the significant increase in credit risk no longer existed (tested over 90 days as part of cure period) to threaten the full repayment of the exposure under the original or modified terms and conditions.
v. The cure period requirements as stated above (90 days) do not apply to retail customers. For retail customers that have moved from stage 1 to stage 2B (as detailed below), they should be allowed to be moved back to stage 1 after a cure period of 60 days.

SAMA recognizes the added value of having discrete tiers of credit risk exposures within Stage 2 allocation. As a result, SAMA is establishing, **for regulatory reporting purposes only and not for accounting purposes,** a bifurcation of Stage 2 totals to be reported in the quarterly prudential returns. It is expected that finance companies will have robust internal risk rating processes and mappings, which can identify and categorize discrete levels of borrower performance characteristics and the resulting credit risk.

Stage 2 exposures segregation into Stage 2A and Stage 2B categories are explained as follows:

Stage 2A or Special monitoring accounts category represents **lower levels of credit risk** within the stage 2 allocation. It represents borrowers with some or all of the following qualitative and quantitative indicators:

Qualitative indicators include, but are not limited to:

i. Lower but increasing levels of credit risk;
ii. Expected change in credit risk to remain low and currently manageable;
iii. Demonstrates current capacity to repay the financial commitment but this capacity is declining or diminishing from the original approval standards and warrants greater attention;
iv. Demonstrates periodic ability of addressing past due levels within reasonable time frames without significant finance company intervention; and
v. Close monitoring and intervention generally required.

Quantitative indicator:

i. Past due more than 30 days and up to 60 days.

Stage 2B or substandard category represents **moderate levels** of credit risk within the stage 2 allocation. It represents borrowers with some or all of the following qualitative and quantitative indicators:

Qualitative indicators include, but are not limited to:

i. Obvious cash flow deficiencies;
ii. Higher probability of default;
iii. Higher increase in credit risk is clearly identified;
iv. Financial statements do not demonstrate additional financial resources necessary to reduce credit risk to the finance company or demonstrating additional sources of repayment ability;
v. Monitoring and intervention is done on a continuing basis whether past due or not; and
vi. Finance company is considering or is in the process of providing concessionary terms under a modified exposure arrangement due to financial difficulties of the borrower.

Quantitative indicator:

i. Past due more than 60 days and up to 90 days.

Finance Companies may apply other limited discretionary measures to designate exposures as Stage 2B. Such measures must be well documented as this can be subject to thematic review by SAMA in future, if needed.

3.3 Stage 3 or Doubtful/Loss category

Any exposure (including purchased originated exposures) which is assessed as impaired or otherwise is in default as determined in Section 8 of these Rules. In addition to Section 8 of these Rules, such indicators may include, but are not limited to:

i. The borrower has a high risk of default or has defaulted;
ii. Past due more than 90 days;
iii. The borrower has an inadequate capacity to meet contractual cash flow obligations due to financial difficulty in the near term;
iv. The collection of principal, commission income highly questionable and improbable; and
v. Adverse changes in economic and business conditions in the near and longer term will only further negatively impact borrower's ability to fulfil obligations.

Finance companies should consistently monitor stage 3 exposures to identify improvements in credit quality and determine eligibility for re-staging stage 3 exposures to stage 2 or stage 1. Finance companies should document

the minimum eligibility requirement for re-staging stage 3 exposures, which should include, at minimum, all of the following conditions:

i. The borrower does not have any material exposure (greater than 95% of total exposures) more than 90 days past due;
ii. Exposure repayments have been made when due over a continuous repayment period (cure period excluding grace period, if any) of 12 months (9 months for restaging from Stage 3A to Stage 2B and 3 months for restaging from Stage 2B to Stage 1);
iii. If a forborne exposure becomes non-performing during the 12-month probation/cure period, the probation/cure period starts again.
iv. Restructuring agreements and its conditions should consider the following:
   - For the first time restructuring agreement with non-retail customers, 100% repayment of overdue interest and satisfactory compliance with the terms and conditions of the restructuring agreement.
v. For the second time restructuring agreement with non-retail customers, at least 7% of the funded outstanding amount should be settled within the 12 months cure period;
vi. The borrower's situation has improved (the borrower has resolved its financial difficulty) so that the full repayment of the exposure is likely, according to the original or modified terms and conditions;
vii. The exposure is not in default as defined in Section 8 of these Rules or impaired according to the accounting framework - IFRS 9; and
viii. The cure period requirements as stated above (12 months) do not apply to retail customers. For retail customers, cure period for moving stage 3 exposures into stage 1 exposures is 6 months (4 months for restaging from Stage 3A to Stage 2B and 2 months for restaging from Stage 2B to Stage 1).

SAMA recognizes the added value of having discrete tiers of credit risk exposures within Stage 3 allocation. As a result, SAMA is establishing, **for regulatory reporting purposes only and not for accounting purposes**, a bifurcation of Stage 3 totals to be reported in the quarterly prudential returns.

Stage 3A or Doubtful category within the stage 3 allocation. It represents borrowers with some or all of the following qualitative and quantitative indicators:

Qualitative indicators include, but are not limited to:

i. The borrower has a high risk of default or has defaulted;
ii. A restructuring arrangement is in advanced stages of negotiation, expected to finalize before the loan is past due by more than 120 days.
iii. Stage 3 loans which are in cure period.

Quantitative indicator:

i. Past due more than 90 days and up to 120 days.

Stage 3B or Loss category within the stage 3 allocation. It represents borrowers with some or all of the following qualitative and quantitative indicators:

Qualitative indicators include, but are not limited to:

i. The borrower has defaulted;
ii. The loan is uncollectible

Quantitative indicator:

i. Past due more than 90 days.
ii. Stage 3A exposures past due more than 120 days

3.4 Additional Consideration for Stage Allocation

i. A single exposure to a borrower should not be split between stages. The total balance outstanding (including any overdue amount) must be staged in the higher credit risk stage. Thus, staging of such exposures must occur at the counterparty level instead of at the transactional level.

ii. Multiple exposures to the same borrower should be allocated in the same stage if each individual exposure is greater than 5% of total exposures to the customer. The aggregate of the exposures (including any overdue amounts) should be staged in the highest credit risk stage. Thus, staging of such exposures must occur at the counterparty level instead of at the transactional level.

4. Expected Credit Loss Provisioning

All finance companies are required to develop and document a robust methodology for estimating the expected credit losses inherent in its exposures and establish adequate provisioning to offset the realization of such expected credit losses.

SAMA may request additional provisions, if based on its own assessment, the ECL provision is not considered to be adequate. SAMA may issue additional rules specifying regulatory provision requirements for finance companies.

5. Interest Recognition

Interest is recognized on Stage 1 and Stage 2 exposures based on the interest revenue calculated on the gross carrying amount (i.e. without deducting expected credit losses) on Stage 1 and Stage 2 exposures. Interest income on Stage 3 loans is calculated on the net carrying amount (i.e. after deducting expected credit losses).

Forborne exposures for which the concession granted was the capitalization of accrued interest previously booked to income should result in a reversal of the accrued interest income capitalized from the income recognized.

Where the interest income to be reversed spans more than one financial period, the interest income recognized in the current financial period should be reversed from current interest income. Interest income recognized in the prior financial period should be offset against the provisions for expected credit losses account. This treatment should follow requirements of the IFRS 9.

6. Macroeconomic factors

Finance companies should benchmark economic data published by SAMA and Other Governmental Agencies on an annual basis as part of their economic modelling process. Economic scenarios should be compared with macroeconomic drivers that are relevant to finance company portfolio. Macroeconomic factors may include the following:

- GDP and GDP forecast
- Brent oil prices (actual and forecast)
- Expectations of government spending
- Credit growth and availability
- Employment indicator (for finance companies active in retail lending)

A finance company should use at-least two macroeconomic factors in determining expected credit losses based on their relevance.

Finance companies should annually assess whether their approach for macroeconomic factors (based on single model or multiple models) continues to be appropriate in the light of changes in business circumstances i.e. growth in balance sheet, new and complicated products.

<u>Forward looking macro-economic scenarios:</u>

A moderate stress testing scenario as required under IFRS 9 should be used for upside and downside assumptions i.e. Upside and downside scenarios may each be given maximum 30% weight while the base case scenario may ideally be given 40% weightage. This may be subject to change depending on economic cycles in future.

7. Restructuring

Restructuring occurs when there is a change or modification of the terms and conditions of the original exposure contract. Restructuring may only occur in the form of either forbearance or renegotiation and/or refinancing and/or rescheduling. The determination of whether restructuring results in forbearance or renegotiation is based on whether the modified terms of the original exposure contract is concessionary and whether the modification (which otherwise would not have been granted) was in fact granted as a result of the financial difficulty of the borrower.

7.1 Forbearance

7.1.1 Identification of forbearance

Forbearance includes all exposures regardless of the measurement method for accounting purposes. Forbearance occurs when:

i. The borrower is experiencing **financial difficulty** in meeting the financial commitments specified under the initial credit contract; and

ii. The finance company grants a **concession** that it would not otherwise consider whether or not the concession is at the discretion of the finance company and/or the counterparty. A concession is at the discretion of the borrower when the initial contract allows the borrower to change the terms and conditions of the contract in its own favor due to financial difficulty.

Forbearance is identified at the individual exposure level to which concessions are granted due to financial difficulty of the counterparty. For regulatory classification purposes, these exposures should only be reported in Stage 2B, 3A or 3B.

7.1.2 Identification of Financial Difficulty

Finance companies should first determine if the borrower is experiencing financial difficulty at the time when the forbearance is granted. The following list provides examples of possible indicators of financial difficulty, but is not intended to constitute an exhaustive list of financial difficulty indicators with respect to forbearance.

i. A borrower is currently past due on any of its material exposures (more than 5% of total exposures);

ii. A borrower is not currently past due, but it is probable that the counterparty will be past due on any of its material exposures (more than 5% of total exposures) in the foreseeable future without the concession, for instance, when there has been a pattern of delinquency in payments on its material exposures;

iii. A borrower's outstanding securities have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange due to noncompliance with the listing requirements or for financial reasons;
iv. The borrower is unwilling to pay;
v. The finance company forecasts that all the borrower's committed/available cash flows will be insufficient to service all of its exposures or debt based on actual performance, estimates and projections that encompass the borrower's current capabilities;
vi. A borrower's existing exposures are categorized as exposures that have already evidenced difficulty in the counterparty's ability to repay in accordance with the SAMA categorization scheme in force or the credit categorization scheme within a finance company's internal credit rating system;
vii. A borrower is in non-performing status or would be categorized as non- performing without the concessions;
viii. The borrower cannot obtain funds from sources other than the existing finance companies at an effective interest rate equal to the current market interest rate for similar exposures or debt securities for a non-troubled counterparty;
ix. Customer is unable to provide promised security/collateral (while the exposure is disbursed) past 180 days and is deemed material to credit; and
x. For retail customers, the potential incidents would be customers with job loss, retirement with no income, reduced salary, discontinued salary transfers etc.

7.1.3 Identification of Concession

Concessions are special contractual terms and conditions provided by the finance company to a borrower facing financial difficulty so that the borrower can sufficiently service its financial commitment. The main characteristic of these concessions is that the finance company would not extend exposures or grant commitments to the borrower on such modified terms and conditions under normal market conditions.

Concessions can be triggered by:

i. Changes in the terms and conditions of the existing exposure contract by giving considerably more favorable terms to the borrower that otherwise would not be considered;
ii. A supplementary agreement, or a new contract to refinance on concessionary terms, the current transaction; or
iii. The exercise of clauses embedded in the contract that enable the borrower to change the terms and conditions of the exposure contract or to take on additional exposures or commitments at its own discretion. These actions should only be treated as concessions if the finance company assesses that the counterparty is in financial difficulty.

There are many types of concession granted to borrowers. However, not all concessions will cause a reduction in the net present value of the exposure and such concessions do not lead to the recognition of a loss by the finance company. Such concessions would cause a stage 2B forborne exposure to retain its stage 2B status and not migrate to stage 3 as a credit impaired exposure. A concession is granted only when the borrower is experiencing financial difficulty. Examples of potential concessions (not complete exhaustive list) include the following:

i. Extending or rolling over the exposure term over 1 year and easing covenants; also includes if rolled over for more than 2 times;
ii. Supplementary agreement or new contract to refinance current transaction. Rescheduling the dates of principal or interest payments i.e. changes in conditions of existing contract, giving considerably more favorable terms to obligor;
iii. Granting new or additional periods of non-payment (grace period/moratorium);
iv. Reducing the interest rate, concession in interest rate, resulting in an effective interest rate below the current interest rate that borrowers with similar risk characteristics could obtain from the same or other institutions in the market;
v. Capitalizing arrears;
vi. Forgiving, deferring or postponing principal, interest or relevant fees;
vii. Changing an amortizing exposure to an interest payment only;
viii. Releasing collateral or accepting lower levels of collateralization;
ix. Repayments linked to disposal of assets or non-operating events;
x. Allowing the conversion of debt to equity of the counterparty;
xi. Deferring recovery/collection actions for extended periods of time; and
xii. Exercise of clauses in agreement that enables obligor to change terms and conditions.

Refinancing an existing exposure with a new contract due to the financial difficulty of a borrower should qualify as a concession, even if the terms of the new contract are no more favorable for the counterparty than those of the existing transaction. Such arrangement is treated as forbearance and the Rules specified in this Section are applicable.

7.1.4 Stage Allocation for Forborne Exposures

A forborne exposure will likely affect its stage allocation. A forborne exposure categorized as stage 2B may likely retain its categorization if the cash flow characteristics do not warrant migration to stage 3 or result in impairment (only exceptional circumstances). Generally, forbearance would warrant changes in the ECL model inputs to account for the increase in credit risk. Where this is automatic if forbearance causes exposure migration from stage

2B to stage 3, the finance company must consider similar changes in model inputs when computing ECL for forborne exposures.

The following situations will not lead to the re-categorization of a forborne exposure as performing:

i. Partial write-off of an existing forborne exposure, (i.e. when a finance company writes off part of a forborne exposure that it deems to be uncollectible);

ii. Repossession of collateral on a forborne exposure, until the collateral is actually disposed of and the finance company realizes the proceeds (when the exposure is kept on balance sheet, it is deemed forborne); or

iii. Extension or granting of forbearance measures to an exposure that is already identified as forborne subject to the relevant exit criteria for forborne exposures.

The re-categorization of a forborne exposure as performing should be made on the same level (i.e. debtor or transaction approach) as when the exposure was originally categorized as forborne.

7.2 Renegotiated and/or Refinanced and/or Rescheduled Exposures

Renegotiated and/or Refinanced and/or Rescheduled exposures represent a change in exposure terms, conditions, and/or timing of repayment performed for the convenience of the borrower, where no financial deterioration coexists with the transaction now or in the foreseeable future. For example, a borrower may seek to change repayment terms from monthly to quarterly due to changes in the timing of incoming payment streams but not due to any deterioration in overall cash flows.

Transactions within this definition must not lead to a reduction in the present value of the exposure. The borrower must not be in financial difficulty during the renegotiation. Otherwise, the transaction would qualify as forbearance instead of renegotiation.

It is expected that finance companies will maintain exposure documentation that demonstrate that the financial repayment capacity and credit risk of the borrower has not changed and that the act of renegotiation is not consistent with the forbearance Rules specified in Section 7.1.

The mere act of renegotiation does not qualify for a downgrade in the stage allocation of renegotiated exposures. Instead, the staging allocation of renegotiated exposure follows the rules outlined in Section 3.

For Retail exposures, renegotiation should only be permitted for personal finance and for residential exposures on an exceptional basis. This renegotiation should only be maximum once in a year and 3 times in the lifecycle of the exposure. If this renegotiation exceeds 3 times, that should be considered as forbearance.

8. Default

Finance companies are required to adopt SAMA's regulatory definition of default and apply it consistently for both, regulatory and financial reporting purposes, or document good reasons why not. Finance companies should use both the quantitative and qualitative indicators of default that finance companies should use to determine the existence of a default. A default event occurs when either (or both) of the qualitative and quantitative criteria are met. Such indicators include, but are not limited to:

i. ***A qualitative criterion*** - by which "the finance company considers that the obligor is unlikely to pay its credit obligations to the finance company in full, without recourse by the finance company to actions such as liquidating collateral (if secured)" ("unlikeliness to pay" events) including:

   a. The finance company allocates the credit exposure to Stage 3B status;
   b. The finance company makes a charge-off or account-specific provision resulting from credit impairment;
   c. The finance company sells the credit exposure at a material credit-related economic loss;
   d. The finance company consents to granting concessionary terms under a modified exposure agreement that would likely result in a diminished financial obligation caused by material forgiveness, or postponement, of principal, interest or fees;
   e. Bankruptcy protection has been filed for the borrower in respect of its credit obligation to the finance company;
   f. Finance company have taken borrowers to Enforcement Court; and
   g. The borrower has sought or has been placed in bankruptcy or similar protection where this would avoid or delay repayment of the credit obligation to the finance companies.

ii. ***A quantitative criterion*** - where "the borrower is past due more than 90 days on any material credit obligation to the finance company and classified in Stage 3", equivalent to the rebuttable presumption in IFRS 9. In certain circumstances, finance companies may be able to justify the use of an objective indicator of default exceeding 90 days subject to prior approval by SAMA on a case by case basis. However, finance companies would need to support using a -threshold exceeding 90 days with reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate.

A default event occurs when either (or both) of the qualitative and quantitative criteria are met.

9. Write-off

A finance company shall directly reduce the gross carrying amount of a financial asset when the company has no reasonable expectations of recovering a financial asset in its entirety or a portion thereof in a timely manner. Finance companies should ensure that they initiate timely collection efforts consistent with the requirements of their delinquency management and collections policy. Finance companies should follow through on their

collection efforts, where required, until they have reasonably exhausted all options for collections and recovery. Finance companies should then initiate write off once it has exhausted all options for collections and recovery along with review by Internal Auditor. While a write-off constitutes de-recognition of a financial asset for accounting purposes but it does not eliminate the finance company's right to continue its recovery proceedings against the collateral or the borrower.

Write offs should not be delayed in the hopes of an otherwise unknown reversal of fortune by the borrower. Even when there is a possibility of repayment/recovery in a later but uncertain time period, the uncertainty, timing, and amount preclude the finance company from maintaining the asset on its books and demand a proactive and timely de-recognition. Multiple exposures to the same counterparty should follow the same treatment for write off purposes at the counterparty level. Finance companies should adhere to the following time period rules for writing off retail and corporate (including micro, small and medium enterprises) exposures unless the finance company has a more conservative write-off policy.

- Unsecured exposures (including retail, micro and small enterprises and excluding mortgages) should be written off within 360 days once they are classified as stage 3 exposures.
- Secured exposures (including retail, micro and small enterprises and excluding mortgages) should be written off within 720 days once they are classified as stage 3 exposure.
- Mortgages (including retail, micro and small enterprises mortgages) and corporate exposures (including medium corporates as per MSME definition by SAMA) should be written off before 1,080 days from the date they are classified as stage 3 exposure.

In case, the above-mentioned time period of the write off is not followed, SAMA prior approval should be obtained on a case by case basis.

Reversal of write off should be treated in accordance with the requirements of Accounting Standard.

10. Credit Risk Management

Finance Companies should adopt and adhere to written policies and procedures detailing the credit risk systems and controls and the roles and responsibilities of the company's board and senior management. The Board and Management must review the finance company's credit risk management framework to comply with the requirements set out in these Rules including, but not limited to:

i. Updating the governance and risk frameworks in accordance with these rules;
ii. Reviewing, revising and approving sound credit risk management policies and strategies, and implementing credit risk management practices to facilitate effective identification (including internal credit risk rating and collective assessments), and adequate measurement and reporting of expected credit losses.

iii. Adopting, documenting and approving sound expected credit loss methodologies to facilitate appropriate, consistent, and timely recognition of expected credit losses. Finance Companies' expected credit loss methodologies must be reviewed annually, or more frequently when the need arises especially when new information becomes available during the quarterly expected credit loss assessment process.

iv. Review, evaluate, update, and report to the Board or Board delegated committees on the adequacy of its exposure and expected credit losses at least quarterly.

v. Include requirements for internal audit function to independently evaluate the effectiveness of the Finance Company's credit risk assessment and measurement systems and processes, including the credit risk rating system on an annual basis.

vi. The management of assets in default should be governed by a comprehensive policy that at a minimum has the following characteristics:

   a. Determining account action plans or recovery strategies;
   b. Monitoring compliance with the action plan, adjusting the plan as necessary;
   c. Updating collateral valuations;
   d. Pursuit of all options to maximize recovery, including placing customers into legal proceedings or liquidation as appropriate;
   e. Ensuring adequate and timely write offs; and
   f. Regular reporting to the Board or Board delegated committees on the overall problem exposure portfolio and in particular, the large and complex credits.

11. Implementation

These Rules shall come into force with effect from 1 July 2021. On implementation of these Rules from the above effective date, the Provisioning Guidelines previously issued via Circular No. 381000046342 dated 27/04/1438H shall cease to apply.

Finance companies must adjust internal credit risk classification, exposure loss provisioning, and regulatory reporting systems to satisfy the requirements specified in these Rules.

12. Annexures

Annexure 1 – List of eligible collaterals and Valuation Frequency

Eligible Collaterals

Collateral is an efficient tool for reducing credit risk. The fundamental role of any collateral is to mitigate the loss which may occur if the counterparty defaults on its obligation. The following list includes examples of eligible collateral (not comprehensive or exhaustive list) used for calculation of provisions and should be subject to the finance company's policy.

- Cash
- Gold
- Realizable amount of bank deposits
- Certificate of deposits
- Government securities, treasury bills, Government bonds and SUKUKs
- Shares of listed companies and government related corporates
- Corporate bonds/sukuk with a minimum of investment grade rating
- Receivables
- Financial guarantees e.g., Sovereign guarantees, Bank guarantees and Kafalah guarantees;
- Immovable collateral - immovable object, an item of property that cannot be moved without destroying or altering it – a property that is fixed to the earth, such as land or a house.
- Other physical collateral - physical collateral other than immovable property.
- Treating lease exposures as collateralized - exposure arising from leasing transactions as collateralized by the type of property/asset leased.

Finance companies should clearly document in collateral policies and procedures the frequency of collateral valuations. The policies and procedures should also provide for the following:

a. Companies monitor the value of each type of collateral on a defined frequent basis.
b. More frequent valuations where the market is subject to significant negative changes and/or where there are signs of a significant decline in the value of an individual collateral.
c. Defined criteria for determining that a significant decline in collateral value has taken place. These will include quantitative thresholds for each type of collateral established, based on the observed empirical data and qualitative experience, taking into consideration relevant factors such as market price trends or the opinion of independent appraisers or valuers.

d. Appropriate haircuts to cover, at a high level of confidence, the maximum expected decline in the market price of the collateral asset, over a conservative liquidation horizon before a transaction can be closed out, in order to cover potential declines in collateral values during liquidation. The haircut adjusted collateral values should be considered for the purpose of calculating Loss Given Default (LGD).
e. Stress-tests and scenario analysis on finance companies portfolio of collateral in order to assess the impact under unusual market conditions (e.g. a significant decline in property or vehicle prices).

Valuation Frequency

Immovable Collateral

Immovable collateral relating to Stage 3 or Default Exposures should be re-valued once every year such that the collateral value used in the calculation of Loss Given Default (LGD) for Stage 3 exposures should not be more than 12 months old at the reporting date. The valuation should be carried out by licensed and approved appraisers or valuers fulfilling requirements of commercial pledge law. The valuation report should clearly indicate therein, amongst others, the present market value and the forced sale value. In cases, where judgement is used in the valuation of collateral, valuations should be carried out by more than one external appraisers and lower of the two values should be taken into consideration.

Finance Companies should continuously monitor general trends in markets (e.g. property price) and take into account any deterioration or obsolescence of the collateral. For exposure classified as Stage 1 and Stage 2, finance companies should assess on annual basis whether the immovable collateral needs to be assessed by approved appraisers, e.g., where the collateral coverage is low and there is an indication of significant decline in the value of the asset. The assessment and related conclusions should be documented and endorsed by the Audit Committee of the company. A more conservative approach should be adopted while considering collateral values for the purpose of LGD calculations where up to date or recent collateral valuations are not available.

Other Physical Collateral Including Leased Assets

Finance companies should re-value other physical collateral including leased assets (other than immovable collateral) at least on an annual basis. Collateral should be valued, at net realizable amount, being the current market value less any potential realization costs (e.g. carrying costs of the repossessed collateral, legal fees or other charges associated with disposing of the collateral in the event of foreclosure). Finance companies may use a combination of external (market values from independent appraisers or Price Quotes from Seller/ manufacturer for specialized assets) and internal valuation methods (e.g., written down value). The valuation methods used should be based on assumptions that are both reasonable and prudent and clearly documented. A more conservative approach should be adopted for valuing collateral relating to Stage 3 or Default exposures and an appropriate haircut to the estimated market value should be applied where appropriate.