INSTRUCTION NO. 17/ 2021[1]
ON CREDIT CLASSIFICATION, REGULATORY PROVISIONS AND RESERVES

Banco Central de Timor-Leste (BCTL) has the responsibility to regulate and supervise financial institutions as prescribed by Art. 5 (j) of Law no. 5/2011 of 14 June, on the Organic Law of the BCTL

Section 16.2 of Regulation 2000/8 of 25 February determines that the Governing Board of a Bank shall be responsible for establishing the policies for the operations of the Bank and for supervision of their implementation.

Section 19.3 of Regulation 2000/8 of 25 February requires that each Bank shall establish a Risk Management Committee, responsible to establish and monitor implementation of procedures for credit appraisal, loan administration, and asset and liability management, including those prescribed by the BCTL, including such matters as requirements for collateral for credit, Classification of and provisioning for Value-Impaired Assets, pursuit of Borrowers and issuers in default, and monitor compliance with the laws and regulations applicable to credit and other risks.

Furthermore, Section 26.2 mandates that Banks shall observe the requirements concerning the Classification and evaluation of assets and provisions to be made on the basis of such Classification and evaluation against substandard and Non-Performing loans, and the time when earnings on Non-Performing loans may no longer be accounted for as income except as received in cash.

Section 46 of Regulation 2000/8 empowers the BCTL to issue instructions and guidelines, as deemed necessary or advisable to give effect to the provisions of that regulation.

The best international practices on banking supervision are defined by the Basel Committee on Banking Supervision (BCBS), and Principle 18 of the Core Principles for Effective Banking Supervision (Basel Core Principles) emphasizes that Banks must have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves, in accordance with the applicable accounting framework.

Taking into consideration the above referred best international practices and that the BCTL has required the adoption of International Financial Reporting Standards, and in the interests of protecting the Timorese banking system, the depositors and the institutions, enhancing a sound and safe financial and banking sector,

The Governing Board of Banco Central de Timor-Leste, in accordance with Section 46 of Regulation 2000/8 of 25 February and Article 31 paragraph 1 of Law no. 5/2011 of 15 June, hereby resolves to approve the following Instruction:

Article 1
Applicability

This Instruction governs credit Classification and regulatory provisioning, to ensure that Banks promptly identify and monitor their Non-Performing credit facilities and undertake adequate measures to manage Credit Risk in their portfolios.

Article 2
Definitions

In this Instruction the terms below shall have the following meaning:

a. "A credit decision on an arm's length terms" means that the terms of the contract are at least as

[1] Please refer to the Portuguese version for official use. This English version is prepared to facilitate the availability of information for the financial institutions.

favourable to the bank as could reasonably be obtained from an independent third party. The bank has not entered into a contract on less favourable terms and conditions than used for normal customers;

b. "Bank" means entities established under UNTAET Regulation 2000/8 on Bank Licensing and Supervision including Other Deposit Taking Institution established pursuant to Public Instruction 06/2010 of 29 December, and their agents;

c. "Borrower" means a natural person or a legal entity obtaining a credit from a Bank;

d. "Credit" is defined in Section 49(g) of the Regulation 2000/8 on Bank Licensing and Supervision;

e. "Credit Risk Mitigation" means the use of appropriate strategies to reduce adverse effect of the Credit Risk Exposure, including collateralization, guarantees and derivatives;

f. "Classification" means determination of the category of a Credit Facility using either subjective or objective criteria;

g. "Connected counterparties" means two or more individual counterparties whose Exposures constitute a single Exposure because the counterparties have a group relationship or a business interdependency in which the difficulties of one can affect another within the group;

h. "Credit Facility" means any asset or off-balance sheet item which contains Credit Risk, such as loans, Overdrafts, advances, finance leases, acceptances, bills discounted, guarantees and other assets or contingencies connected with Credit Risk;

i. "Credit Risk" means the risk of financial loss, despite realization of the main or secondary collateral, because of a debtor's inability to satisfy his obligations to a Bank;

j. "Expected Credit Losses" means the weighted average of credit losses with the respective risks of a default occurring as the weights;

k. "Exposure" means all types of credit including loans and advances, letters of credit, and similar forms of credits or credit commitments granted by a Bank to a client, as well as debt securities, shares and other types of investment in any other undertaking;

l. "Grading System" means tool to assess Credit Risk, differentiating the degree of Credit Risk of the credit Exposures of a Bank;

m. "IFRS" – International Financial Reporting Standards, as published by the International Accounting Standards Board (www.ifrs.org);

n. "Non-Accrual Asset" means asset that should be placed on a cash basis for prudential effects, thus interest earned or due but unpaid is not credited as interest income or, if accounted, required a proper reserve;

o. "Non-Performing Asset" means asset that is not generating income and meets the criteria specified in this Instruction;

p. "Overdraft" means Credit Facility under which a Bank allows funds withdrawn to exceed funds deposited in accordance with specified terms and conditions;

q. "Inactive Overdraft" means Overdraft where the turnovers or the volume of repayments on the account during the period under review are not equivalent to, or greater than the approved credit line plus interest charges;

r. "Adversely Classified Credits (or assets)" means those credits or other assets which are classified as either Substandard, Doubtful, or Loss in accordance with the definition of "Asset Classifications";

s. "Estimated Recoverable Amount" for a value impaired credit or other asset, this is the amount that the Bank reasonably estimates it will recover. Acceptable methods for determining the Estimated Recoverable Amount of an asset are:

   a) Deducting an allowance for Expected Credit Losses determined in accordance with applicable IFRS 9 and the Instruction on Credit Risk Management;

   b) The Fair Value of the pledged collateral to the extent that the asset is collateral-dependent, taking into consideration any significant estimated cost to sell the collateral. An asset is collateral-dependent if repayment or collectability of the asset is expected to be provided solely by the underlying collateral; and

c) The observable market prices; if it is a reliable indicator of the asset's Estimated Recoverable Amount.

t. "Fair Value" means the amount for which an asset could be exchanged between knowledgeable willing parties in an arms-length transaction;

u. "Value-Impaired Asset" or "Value-Impaired Credit" means a financial asset for which it is probable that the Bank will be unable to collect, or there is no longer reasonable assurance that the Bank will collect, all amounts due under the contractual terms of the asset.

Article 3
Bank's Responsibility

1. Banks shall formulate policies and processes for grading and classifying the assets in accordance with the Credit Risk, for identifying and managing problem assets and for establishing appropriate and robust provisioning levels.
2. The policies shall require regular review by Banks of their problem assets (at an individual level or at a portfolio level for assets with homogenous characteristics) and asset Classification, provisioning and write-offs.
3. Banks shall conduct review, by own decision or by determination of the BCTL, of the credit Classification and provisioning by external experts to determine the adequacy of the Bank's policies and processes.
4. The Bank's system for Classification and regulatory provisioning must consider the off-balance sheet Exposures.
5. Banks shall have appropriate policies and processes to ensure that provisions and write-offs are timely and reflect realistic repayment and recovery expectations, considering market and macroeconomic conditions.
6. Banks shall have appropriate policies and processes, and organizational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past due obligations.
7. Banks shall have adequate documentation to support their Classification and provisioning levels.

Article 4
Board of Directors Responsibilities

1. The Board of Directors of a Bank shall be responsible for adopting a policy and ensuring that the Bank has an effective loan Classification system, which accurately identifies Credit Risk and assures the maintenance of provisions at an appropriate level, and for overseeing and monitoring the Credit Risk assessment and provisioning processes.
2. The policy referred in the previous number shall comply with the instruction on Credit Risk Management and this Instruction.
3. The Board of Directors shall ensure that the Bank has appropriate Credit Risk assessment processes and internal controls to consistently calculate provisions for loan losses, in accordance with the policies and procedures established by the Bank, the accounting regulation and any applicable BCTL guidelines.

Article 5
Risk Management Committee Responsibilities

1. In accordance with Subsection 19.3(a) of the Regulation 2000/8 on Bank Licensing and Supervision, the Risk Management Committee shall establish procedures for ensuring compliance with approved policy on Asset Classification and shall monitor the implementation of the policy and procedures.
2. Asset Classification procedures should include the following:

a) there should be an approved and documented analytical framework for assessing loan quality, which is applied consistently over time;

b) estimates should be based on reasonable and supportable assumptions; and

c) assumption concerning the impact on obligors of changes in general economic activity should be realistic and conservative.

3. The Risk Management Committee must ensure that the Board of Directors obtains timely and appropriate information on the condition of the Bank's asset portfolio, including Classification of assets, the level of provisions and reserves and major problem assets. The information includes, at a minimum, summary results of the latest asset review process, comparative trends in the overall quality of problem assets, and measurements of existing or anticipated deterioration in asset quality and losses expected valuation. Classification and provisioning, at least for significant Exposures, are conducted on an individual item basis. For this purpose, BCTL requires Banks to set an appropriate threshold for the purpose of identifying significant Exposures and to regularly review the level of the threshold.

4. The Assets Classification policy shall be reviewed by the Risk Management Committee and the Board of Director on at least an annual basis.

Article 6
Classification of Credits

1. Banks shall review all credits and relevant information available for purposes of Classification on at least a quarterly basis.

2. Assessments should be performed in a systematic way and in accordance with the Bank's policies and procedures.

3. A sufficient number of risk grades must be set to ensure that the system captures gradation of risk.

4. The Grading System can be more complex but shall be consistent with the system defined on paragraph 10.

5. Based on such review, each credit shall be included into one of the Classification categories mentioned on paragraph 10.

6. In the event that a credit may be classified differently based on these criteria, the Bank shall apply the more severe Classification.

7. All Value-Impaired Credits must be Adversely Classified.

8. If, between formal quarterly reviews, the Bank has knowledge of a significant deterioration in the quality of an individual credit or in a material part of the Bank's credit portfolio, the Bank must promptly assign the credit(s) to a new Classification that accurately reflect the status of the credit (s).

9. Banks shall have appropriate mechanisms in place for regularly assessing the value of Credit Risk mitigators, including guarantees, credit derivatives and collateral. The valuation of collateral reflects the net realizable value, taking into account prevailing market conditions.

10. Assets Classifications for prudential reasons require that the assets shall be grouped in the following categories:

    a) **Standard** - Unless one of the following definitions applies, an asset is Standard if it: 1) is current; 2) the obligor is complying and is expected to continue to comply with all terms of the contract; and 3) there is no reason to believe that the Bank is now, or will be, subject to risk of loss.

    b) **Under Supervision** - An asset should be classified as Under Supervision if potential weaknesses exist in the obligor's financial position and/or the collateral pledged. Assets which are Under Supervision require the close attention of Bank management, because if left unaddressed or uncorrected, these potential weaknesses could result in the deterioration of the repayment prospect for the asset or in the Bank's position in the future. Assets which are at least 60 days past due, are at a minimum classified as Under Supervision.

    c) **Substandard** - An asset should be classified as Substandard if the asset has one or more well-defined weaknesses that make the full collection of principal and interest questionable: (1) the obligor's financial condition (including net worth and/or repayment capacity) is unfavourable and is deterioration; (2) the pledged collateral (if any) is insufficient or is deteriorating; (3) other adverse factors exist which cause concern regarding the ability of the obligor to repay the credit in accordance with the existing repayment terms; and/or (4) there has been an actual breach of contract. Assets classified as Substandard require management's active attention because there is a distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. While losses will be realized in the total amount of all assets classified as Substandard, a loss will not necessary be realized in each individual asset so classified. Non-Performing Assets, which are at least 90 days past due, are at a minimum classified Substandard.

d) **Doubtful** – An asset shall be classified as Doubtful when weaknesses exist which make collection or repayment in full highly questionable and improbable based upon currently existing circumstance, conditions, and the Estimated Recoverable Amount of the pledged collateral (if any). The possibility of losses is very high; however, because of certain important and reasonably specific pending circumstances which could strengthen the asset, Classification of the asset as Loss is deferred until its more exact status is determined. Non-Performing Assets which are at least 180 days past due are classified Doubtful.

e) **Loss** - At the time of Classification, the asset is deemed uncollectible and such little value that it should not be included on the accounts and financial statements of the Bank. The Classification of an asset as Loss does not defer writing off of this basically worthless asset, even though at least part of the value could be recovered in the future. Such Classification does not cancel the obligor's obligation to repay, nor does it mean that the Bank should not further exercise its full legal right to collection or repayment. Non-Performing Assets which are least 360 days past due are classified as Loss.

Article 7
Regulatory Loan Loss Allowances

1. Banks shall determine a regulatory and prudential loan loss allowance using the standard percentage method.
2. Using this approach, the minimum required amount for the allowance for credit loss shall be determined by applying the following percentage to the sum of credits in each Classification category mentioned on Article 6:

Standard	1%
Under Supervision	3%
Substandard	25%
Doubtful	50%
Loss	100%

3. A Bank shall review its regulatory provisioning level at least on a quarterly basis and shall report to the BCTL quarterly basis using relevant forms as defined by the BCTL.

Article 8
Loss Allowance for Expected Credit Losses

1. According to the IFRS 9, an entity shall recognize a loss allowance for Expected Credit Losses on a financial asset that is measured at amortized cost, as most loans in Timor-Leste, or at Fair Value through other comprehensive income, a lease receivable, a contract asset or a loan commitment and a financial guarantee contract to which the impairment requirements apply.

2. At the time of credit Classification, any impairment to the value of a credit shall be recognized by reducing the carrying amount of the credit through an allowance for credit loss, or by charging of the credit, and in both cases charging the income statement in the period in which the impairment occurs.

3. The Bank shall determine the amount of the loss allowance based on Expected Credit Losses using the requirements of IFRS 9 and the Instruction 15/2021 on Credit Risk management.

4. The allowance for loan losses must be estimated on an individual basis if a Bank considers the asset to be significant or it represents at least 5% of the Bank's primary capital. Also, if the asset do not belong to a homogeneous risk group.

5. Collective estimation shall be applied for all loans for which an individualised estimate does not have to be made, and the methods for collective estimation must comply with the IFRS 9 and Instruction 15/2021 on Credit Risk management.

6. If the Bank's loss allowance based on Expected Credit Losses is less than the regulatory amount determined using the standard percentage method, described on Article 7, then the Bank's allowance shall be considered to be inadequate, and the difference shall be treated as an appropriation of retained earnings and placed in a non-distributable regulatory loan loss reserve, not charging the income statement.

7. The appropriation shall occur even if the Bank is accounting for losses. If necessary, the BCTL can determine the strengthening of the Bank's capital.

8. Where the loan loss allowances determined under IFRS 9 are higher than the regulatory amount determined using standard percentage method, mentioned on Article 7, they will be considered as the minimum required for the purpose of this Instruction.

9. The regulatory reserve for loan losses referred on paragraph 8 of this Article, for capital adequacy purposes, cannot be included as part of regulatory capital.

10. When determining the value-impaired of a credit for compliance with this Instruction, the Bank shall consider the lifetime Expected Credit Losses.

11. Other assets shall be valued in accordance with IFRS.

Article 9
Classification of Assets other than Credits

1. Each Bank is required to review its assets not recorded at Fair Value on at least a quarterly basis for purpose of asset Classification and for determining whether any asset has suffered an "other than temporary" decline in, or impairment to, value which should be recognized by the Bank in accordance with this Instruction.

2. Assessments should be performed in a systematic way and in accordance with the Bank's policies and procedures. When a Bank adds an asset to its balance sheet or moves an asset to a different account on the balance sheet, the Bank must ensure that its records and financial statements accurately reflect the quality and condition of that asset.

3. If, between formal quarterly reviews, a Bank obtains new information or otherwise determines that the quality or condition of an asset has changed, the Bank must promptly and accurately assign the asset to a new Classification.

Article 10
Income Recognition

1. An entity shall recognize all items of income in a period in profit or loss unless an IFRS requires or permits otherwise.

2. Assets which are impaired and/or Adversely Classified, and assets with payments which are contractually 90 days or more in arrears, shall be placed on non-accrual.

3. For Non-Accrual Assets, the Bank shall cease reflecting in its net income the accrual of interest; that is,

interest shall no longer be accounted for as income except as received in cash.

4. When an asset is placed on non-accrual, uncollected interest which has previously been accrued should be reversed.

5. Only when all outstanding due and unpaid obligations of a Non-Performing Asset have been paid up to date, may the asset be returned to an accrual basis.

6. When the IFRS requires or permits the recognition of income, in conflict with paragraph 2 to 4 above, the amount of interest accounted shall be treated as an appropriation from retained earnings and placed in a non-distributable reserve.

Article 11
Non-performing Assets

1. An asset with a pre-established repayment schedule shall be considered as non-performing if:
    a). the payment of principal or interest is due and unpaid for at least ninety days; or
    b). the payment of principal or interest for at least ninety days have been capitalized, refinanced, renegotiated or restructured.
2. An asset without a fixed repayment program, such as Overdrafts or other forms of open credit, shall be considered non-performing when any one of the following exists:
    a) the Credit Facility exceeds the customer's established borrowing limit for at least ninety days;
    b) the customer's borrowing line has expired for at least ninety consecutive days;
    c) principal or interest are due and unpaid for at least ninety days; or
    d) the Overdraft or account is inactive.
3. The criterion for Non-Performing Assets applies regardless of what security is held on the facility and, even cash-backed security will not change the Non-Performing status of an asset, although can mitigate the expected loan losses and the provisioning.
4. Where a Bank has granted more than one Credit Facility to a Borrower and any of the facilities becomes non-performing, the Bank shall consider all other outstanding credit facilities to the Borrower and to his Connected Counterparties as non-performing.
5. In case a Credit Facility of a Borrower or of its Connected Counterparties becomes non-performing in one Bank, other Banks shall downgrade the credit facilities of that Borrower and of its interconnected parties to a non-performing category.
6. Upon meeting the non-performing criteria, Overdrafts and other credit facilities without a pre-established repayment schedule must be converted to a reasonable amortization schedule consistent with the Borrower's financial situation.
7. The conversion of Overdrafts and other credit facilities without pre-established repayment schedules into term loans shall not change the Classification category and the corresponding level of provisions for an observation period of 3 months subject to which the account can be upgraded based on performance.

Article 12
Restoring an Asset to Unimpaired Status

1. Any Credit Facility can be refinanced, rescheduled, rolled-over, or otherwise modified because of weaknesses in the Borrower's financial position or the non-payment of the debt as arranged if:
    a) there is clear evidence that the financial position of the Borrower can service the debt under the new condition;
    b) a Credit Facility other than Overdraft will not be restructured more than twice over the life of the original facility;

c) not be reclassified upward before a period of 3 months minimum following the new arrangements.

2. An impaired and/or Adversely Classified asset shall only be restored to unimpaired status when the contractual amount of principal and interest is deemed to be fully collectible in accordance with the terms of the contract. Specifically, if the Bank has received repayment of the past due principal and interest, none of the principal and interest is due unpaid, and the Bank expects repayment of the remaining contractual principal and interest as schedule in the contract.

3. The credit can also be restored to unimpaired status when the obligor has resumed paying the full amount of the schedule contractual principal and interest payments for at least 6 months, and all remaining contractual payments, including compensation for overdue payments, are deemed to be collectible in a timely manner.

4. When the asset can be restructured because there is an improvement in the security or collateral taken, the facility can be reclassified upward for one category only.

Article 13
Collateral and Guarantees

1. A Bank shall evaluate the status of security or collateral on any Credit Facility for the expected loan losses and, especially once payment of principal or interest falls into arrears or becomes irregular.

2. A Bank may initiate procedures which could include the realization of any security or collateral once a Credit Facility becomes non- performing.

3. Collateral that can be taken into account for the purpose of determining levels of provisioning shall be:

    a) supported by proper legal documentation;

    b) appropriately charged and registered;

    c) adequately insured;

    d) valued by an accredited valuer;

    e) actively traded in the market, in the case of securities;

    f) free of prior liens which could reduce its value or prevent the Bank from obtaining clear title;

    g) characterized by no foreseeable difficulties in actual foreclosure or disposing;

    h) perfect in all other ways as specified in the credit policy.

4. Notwithstanding any valuation of a security undertaken by a Bank, the BCTL may require another valuation to be undertaken by a valuer of its choice.

Article 14
Collateral and Guarantees for Provisioning Purposes

The outstanding balance of a Credit Facility must be deducted from its collateral and guarantee value, or other Credit Risk Mitigation, before determining the required provisions. However, the BCTL may require Banks not to consider collaterals and guarantees when determining the provisions for a particular class of Non-Performing loans.

Article 15
Acquisition of Assets in Lieu of Repayment of Credits Granted by the Bank

1. If the Bank acquires either an equity interest, real property, or other assets in lieu of repayment of a credit granted by the Bank, the asset will be recognized at its Fair Value in accordance with IFRS.

2. If the Estimated Recoverable Amount of the asset acquired is less than the amount of the net unpaid principal balance of the credit, then the deficient amount shall be charged off when the asset is added to the books of the Bank.

Article 16
Restrictions

1. A Bank shall not renegotiate, roll-over, or modify the terms of a credit in order to avoid an Adverse Classification.
2. A Bank shall not advance additional funds to enable an obligor to meet current payment obligations to the Bank.
3. A Bank shall not grant a credit to a Borrower whose loan facility was classified "Substandard", "Doubtful", or "Loss" unless it is a restructured loan.
4. A Bank shall not grant a credit to a Borrower whose Credit Facility was written off unless he/she has repaid all outstanding facilities including interest.

Article 17
Loans Writing Off

1. According to the IFRSs, an entity shall directly reduce the gross carrying amount of a financial asset when the entity has no reasonable expectations of recovering a financial asset in its entirety or a portion thereof, which constitutes a derecognition event.
2. A Bank must write off loans that have been classified "Loss" for more than 360 days unless the Bank has entered into the court for collection and the prospect of success is significant.
3. Even though the above paragraph, a Bank may continue the recovery process after writing off the loan in line with other applicable laws.
4. Write-offs can relate to a financial asset in its entirety or to a portion of it if the Bank expects to recover part of the asset.
5. Prior approval of BCTL is required before writing off loans to a Bank related party.

Article 18
Off-balance Sheet Provisioning

The provisioning for expected losses on off-balance sheet items shall be recognized as a liability.

Article 19
Implementation

The effective implementation shall be within six (6) months after the entry into force of this instruction.

Article 20
Administrative Penalty

1. Any bank or ODTI failure to comply with any provisions of this instruction, will be subject to an administrative penalty in an amount up to US$5,000 (US$ five thousand dollar) and it will be debited directly from the settlement account of the relevant entity held at BCTL.
2. For the entities that do not have a settlement account, the BCTL will notify the relevant entity and require the payment to be made by transfer to to BCTL's account held at a commercial bank, within 3 days.
3. Notwithstanding with the previous paragraphs, the BCTL may take additional remedial measures for any continues infraction in accordance with Article 36.3 of Regulation 2000/8 on Bank Licensing and Regulation.

Article 21
Repealing and Entry into Force

1. Instruction 2001/4 on Asset Classification is hereby repealed.
2. This Instruction shall enter into force on the day of its publication in the Jornal da República.

Approved on 25 November 2021

The Governor,

Abraão de Vasconselos