GUIDANCE NOTE ON COMPUTATION OF CAPITAL CHARGE FOR CREDIT RISK FOR BANKS AND FINANCIAL INSTITUTIONS, 2023

BANK OF TANZANIA

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1. INTRODUCTION

1. These guidelines address determination of minimum capital requirements for credit risk in accordance with the standardised approach defined in the Basel III framework.

2. In determining risk-weighted assets for credit risk, banks and financial institutions shall multiply on-balance sheet exposures by the appropriate risk weights, while off-balance sheet exposures shall be multiplied by the appropriate credit conversion factor before applying the respective risk weights. Exposures should be risk-weighted net of specific provisions.

3. Under the Standardised approach for credit risk, banks and financial institutions exposures shall be risk weighted based on two broad methods:

    (a) External Credit Risk Assessment Approach (ECRA) – for exposures with external ratings that are allowable for regulatory purposes; and

    (b) Standardised Credit Risk Assessment Approach (SCRA) – for unrated exposures to banks and financial institutions incorporated in jurisdictions that allow the use of external ratings for regulatory purposes and exposures to banks and financial institutions incorporated in jurisdictions that do not allow the use of external ratings for regulatory purposes.

4. Banks and financial institutions shall use external ratings issued by recognised external credit assessment institutions (ECAIs) in determining the risk weights as provided in these guidelines.

5. External credit assessment institutions recognised by the Bank include Fitch Ratings, Standard and Poor's (S&P), and Moody's Investors Service and any other ECAIs that may be approved by the Bank.

6. External ratings are not used for determining the risk weights for residential mortgages, regulatory retail portfolios, non-performing loans and high risk exposures, instead specific risk weights prescribed by Basel Committee on Banking Supervision (BCBS) as provided in these guidelines shall be applied.

7. Banks and financial institutions shall perform due diligence to ensure that they have an adequate understanding, at origination and thereafter on a regular basis (at least annually), of the risk profile and characteristics of their counterparties. The sophistication of the due diligence should be appropriate to the size and complexity of bank's or financial institution's activities. Banks must take reasonable and adequate steps to assess the operating and financial performance levels and trends through internal credit analysis and/or other analytics outsourced to a third party, as appropriate for each counterparty.

8. Banks and financial institutions are expected to maintain a credit risk framework that allows for adequate analysis for any asset or group of assets with exposure to credit risk. The use of external ratings does not preclude the banks and financial institutions from performing due diligence on the risk of an exposure. Where the due diligence analysis reflects higher risk characteristics, the bank or financial institution is required to assign a risk weight that is consistent with the outcome of the due diligence and at least one bucket higher than the "Base" risk weight determined by the recognized external rating.

9. In the same way as for market risk and operational risk, the capital requirements for credit risk shall apply on solo and consolidated basis.

2. DEFINITION OF EXPOSURES

The following part defines the various categories of exposures and their corresponding risk weights under the standardised approach. The risk weights shall be applicable to all on-balance sheet and off-balance sheet exposures in the banking book. Exposures in the trading book shall be subject to the requirements under the market risk framework.

2.1 Exposures to sovereigns and Central Banks

2.1.1 Exposures to the Government of United Republic, Revolutionary Government of Zanzibar and the Bank, denominated and funded in Tanzania Shillings shall be accorded a risk weight of 0%. Any exposures where there is an explicit guarantee provided by the Government of United Republic, Revolutionary Government of Zanzibar and the Bank and such exposure is denominated and funded in Tanzania Shillings shall also be accorded a 0% risk weight.

2.1.2 Exposures to other sovereigns and their central banks shall be risk-weighted as follows:

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk weight	0%	20%	50%	100%	150%	100%

2.2 Exposures to to non-central government public sector entities (PSEs)

Exposures to domestic PSEs shall be risk-weighted as follows:

External rating of the PSE	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk weight under Option 1	20%	50%	100%	100%	150%	100%

2.3 Exposures to multilateral development banks (MDBs)

2.3.1 Highly-rated MDBs which meet criteria specified in the paragraph 2.3.2 shall be eligible for a preferential risk weight of 0%.

2.3.2 A 0% risk weight shall be applied to exposures to MDBs that fulfil the following eligibility criteria:

(i) very high quality long-term issuer ratings, ie a majority of an MDB's external assessments must be AAA;

(ii) MDBs with long-term issuer external ratings of AA- or better;

(iii) Either the shareholder structure comprises a significant proportion of sovereigns with long-term issuer external ratings of AA- or better, or the majority of the MDB´s fund-raising is in the form of paid-in equity/capital and there is little or no leverage;

(iv) Strong shareholder support demonstrated by the amount of paid-in capital contributed by the shareholders; the amount of further capital the MDBs have the right to call, if required, to repay their liabilities; and continued capital contributions and new pledges from sovereign shareholders;

(v) Adequate level of capital and liquidity (a case-by-case approach is necessary in order to assess whether each MDB´s capital and liquidity are adequate); and,

(vi) Strict statutory lending requirements and conservative financial policies, which would include, among other conditions, a structured approval process, internal creditworthiness and risk concentration limits (per country, sector, and individual exposures and credit category) large exposures approval by the board or a committee of the board, fixed repayment schedules, effective monitoring of use of proceeds, status review process, and rigorous assessment of risk and provisioning to loan loss reserve.

2.3.3 Banks and financial institutions shall risk weight exposures to all other MDBs as follows.

External rating of counterparty	AAA to AA–	A+ to A–	BBB+ to BBB–	BB+ to B–	Below B–	Unrated
“Base” risk weight	20%	30%	50%	100%	150%	50%

2.4 Exposures to banks and financial institutions

2.4.1 Banks and financial institutions shall apply the following risk weights for externally rated exposures to banks and financial institutions:

External rating of counterparty	**AAA to AA-**	**A+ to A-**	**BBB+ to BBB-**	**BB+ to B-**	**Below B-**
"Base" risk weight	20%	30%	50%	100%	150%
Risk weight for short-term exposures	20%	20%	20%	50%	150%

2.4.2 To reflect transfer and convertibility risk under the SCRA, a risk-weight floor based on the risk weight applicable to exposures to the sovereign of the country where the bank counterparty is incorporated shall be applied to the risk weight assigned to bank exposures. The sovereign floor applies when the exposure is not in the local currency of the jurisdiction of incorporation of the debtor bank and for a borrowing booked in a branch of the debtor bank in a foreign jurisdiction, when the exposure is not in the local currency of the jurisdiction in which the branch operates. The sovereign floor will not apply to short-term (i.e. with a maturity below one year) self-liquidating trade-related contingent items that arise from the movement of goods.

2.4.3 The use of external ratings does not exempt the banks and financial institutions from performing due diligence on the risk of an exposure. Where the due diligence analysis reflects higher risk characteristics, the bank or financial institution is required to assign a risk weight that is consistent with the due diligence and at least one bucket higher than the "Base" risk weight determined by the recognized external rating.

2.4.3.1 Unrated exposures to banks and financial institutions incorporated in jurisdictions that allow the use of external ratings for regulatory purposes and exposures to banks and financial institutions incorporated in jurisdictions that do not allow the use of external ratings for regulatory purposes shall be risk-weighted based on the Standardised Credit Risk Assessment Approach (SCRA) and shall apply the following risk weights.

Credit risk assessment of counterparty	Grade A	Grade B	Grade C
"Base" risk weight	40%[1]	75%	150%
Risk weight for short-term exposures	20%	50%	150%

- Grade A: refers to exposures to banks and financial institutions, where the counterparty bank or financial institution has adequate capacity to meet their financial commitments

[1] Under the Standardised Credit Risk Assessment Approach, exposures to banks without an external credit rating may receive a risk weight of 30%, provided that the counterparty bank has a Common Equity Tier 1 (CET1) ratio which meets or exceeds 14% and a Tier 1 leverage ratio which meets or exceeds 5%. The counterparty bank must also satisfy all the requirements for Grade A classification. This may include on-balance sheet exposures such as loans and off-balance sheet exposures such as self-liquidating trade-related contingent items.

(including repayments of principal and interest) in a timely manner, for the projected life of the assets or exposures and irrespective of the economic cycles and business conditions.

A counterparty bank or financial institution classified into Grade A must meet or exceed the published minimum regulatory requirements and buffers established by the supervisory authority as implemented in the jurisdiction where it is incorporated, except for bank-specific minimum regulatory requirements or buffers that may be imposed through supervisory actions (e.g. via Pillar 2) and not made public. If such minimum regulatory requirements and buffers (other than bank-specific minimum requirements or buffers) are not publicly disclosed or otherwise made available by the counterparty bank or financial institution, then the counterparty bank or financial institution shall be assessed as Grade B or lower.

If as part of its due diligence, a bank or financial institution assesses that a counterparty bank or financial institution does not meet the definition of Grade A above, exposures to the counterparty bank or financial institution shall be classified as Grade B or Grade C.

- Grade B: refers to exposures to banks and financial institutions, where the counterparty bank or financial institution is subject to substantial credit risk, such as repayment capacities that are dependent on stable or favorable economic or business conditions.

  A counterparty bank or financial institution classified into Grade B must meet or exceed the published minimum regulatory requirements (excluding buffers) established by the supervisory authority as implemented in the jurisdiction where it is incorporated, except for bank-specific minimum regulatory requirements that may be imposed through supervisory actions (e.g. via Pillar 2) and not made public. If such minimum regulatory requirements and buffers (other than bank-specific minimum requirements or buffers) are not publicly disclosed or otherwise made available by the counterparty bank or financial institution, then the counterparty bank or financial institution shall be assessed as Grade C.

  Banks and financial institutions shall classify all exposures that do not meet the requirements outlined in paragraph referred to Grade A into Grade B, unless the exposure falls within Grade C.

- Grade C: refers to higher credit risk exposures to banks and financial institutions, where the counterparty bank or financial institution has material default risks and limited margins of safety. For these counterparties, adverse business, financial, or economic conditions are very likely to lead, or have led, to an inability to meet their financial commitments.

  At a minimum, if any of the following triggers is breached, a bank or financial institution shall classify the exposure into Grade C:

  - The counterparty bank or financial institution does not meet the criteria for being classified as Grade B with respect to its published minimum regulatory requirements, as set out in the description of Grade B; or,

- Where audited financial statements are required, the external auditor has issued an adverse audit opinion or has expressed substantial doubt about the counterparty bank´s or financial institution's ability to continue as a going concern in its financial statements or audited reports within the previous 12 months.

Even if these triggers are not breached, a bank or financial institutions may assess that the counterparty bank meets the definition of Grade C. In that case, the exposure to such counterparty bank or financial institution must be classified into Grade C.

2.4.3.2 Short Term exposures mean exposures to banks and financial institutions with an original maturity of three months or less, as well as exposures to banks and financial institutions that arise from the movement of goods across national borders, with an original maturity of six months or less[2]. All other exposures to and financial institutions shall be assigned Base Risk Weights.

2.5 Exposures to securities firms and other financial institutions

Exposures to securities firms and other financial institutions not covered under the Banking and Financial Institutions, Act shall be treated as exposures to corporates.

2.6 Exposures to corporates

2.6.1 For the purposes of calculating capital requirements, exposures to corporates include exposures (loans, bonds, receivables, etc.) to incorporated entities, associations, partnerships, proprietorships, trusts funds and other entities with similar characteristics, except those which qualify for one of the other exposure classes. The corporate exposure class does not include exposures to individuals.

2.6.2 Banks and financial institutions shall apply the following "base" risk weights for exposures to corporates:

External rating of counterparty	AAA to AA–	A+ to A–	BBB+ to BBB–	BB+ to BB–	Below BB–	Unrated
"Base" risk weight	20%	50%	75%	100%	150%	100%

2.7 Retail Exposures

2.7.1 Retail exposures are exposures to an individual person or persons. All retail exposures shall be risk-weighted at 75%.

[2] This may include on-balance sheet exposures such as loans and off-balance sheet exposures such as self-liquidating trade-related contingrnt items.

2.8 Real estate exposure class

2.8.1 Exposures secured by residential real estate or commercial real estate must meet the following requirements:

- The exposure must be secured by the acquired, improved or constructed residential or commercial property.
- Legal enforceability: any claim on the property taken must be legally enforceable in all relevant jurisdictions.
- Claims over the property: the loan is a claim over the property where the lender bank holds a first lien over the property.
- Ability of the borrower to repay: the supervisory authority should ensure that banks put in place underwriting policies with respect to the granting of mortgage loans that include the assessment of the ability of the borrower to repay.
- Prudent value of property: the property must be valued according to the criteria for determining the value in the loan to value (LTV) ratio. This ratio is the amount of the loan divided by the value of the property. Moreover, the value of the property must not depend materially on the performance of the borrower. The value of the property will be maintained at the value measured at origination, and must be adjusted if an extraordinary idiosyncratic event occurs resulting in a permanent reduction of the property value. The value of the mortgage property shall be the purchase price or construction cost or improvement cost.
- Required documentation: all the information required at loan origination and for monitoring purposes shall be properly documented, including information on the ability of the borrower to repay and on the valuation of the property.

2.9 Exposures secured by residential real estate

2.9.1 A residential real estate exposure is a loan granted to a borrower for the purposes of acquiring, improving or constructing a residential property and is secured by the acquired, improved or constructed residential property.

2.9.2 The risk weight assigned to the residential real estate exposure shall be determined based on the following exposure´s LTV ratio:

	LTV ≤ 50%	50% < LTV ≤ 60%	60% < LTV ≤ 80%	80% < LTV ≤ 90%	90% < LTV ≤ 100%	LTV > 100%
Risk weight	20%	25%	30%	40%	50%	70%

2.10 Exposures secured by commercial real estate

2.10.1 A commercial real estate exposure is a loan granted to a borrower for the purposes of acquiring, improving or constructing a commercial property and is secured by the acquired, improved or constructed commercial property.

2.10.2 The risk weight assigned to the commercial real estate exposure shall be determined based on the following exposure´s LTV ratio:

	LTV ≤ 60%	LTV > 60%
Risk weight	Min (60%, RW of counterparty)	RW of counterparty

The risk weight of the counterparty refers to 75% for exposures to individuals, and for exposures to other counterparties, the risk weight applied is the risk weight that would be assigned to the counterparty.

2.11 Off-balance sheet items

2.11.1 Off-balance sheet items shall be converted into credit exposures equivalents through the use of credit conversion factors (CCF) as follows:

(a) A 100% CCF shall be applied to the following Off-balance sheet exposures:

- Direct credit substitutes, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities and acceptances (including endorsements with the character of acceptances)
- Sale and repurchase agreements and asset sales with recourse where the credit risk remains with the bank
- The lending of banks´securities or the posting of securities as collateral by banks, including instances where these arise out of repo-style transactions
- Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain drawdown.
- Off-balance sheet items that are credit substitutes not explicitly included in any other category.

(b) A 50% CCF shall be applied to the following Off-balance sheet exposures:

- Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs) regardless of the maturity of the underlying facility
- Certain transactions-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions).

(c) A 40% CCF shall be applied to the following Off-balance sheet exposures:

- Commitments, regardless of the maturity of the underlying facility unless they qualify for a lower CCF.

(d) A 20% CCF shall be applied to the following Off-balance sheet exposures:

- The issuing and confirming banks of short-term self-liquidating trade letters of credit arising from the movement of goods (e.g. documentary credits collateralized by the underlying shipment).

(e) A 10% CCF shall be applied to the following Off-balance sheet exposures:

- Commitments that are unconditionally cancellable at any time by the bank without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower´s creditworthiness.

2.12 Defaulted exposures

2.12.1 A defaulted exposure is a non-performing exposure as determined by criteria prescribed in the Banking and Financial Institutions (Management of Risk Assets) Regulations:

2.12.2 A defaulted exposure shall be risk-weighted net of specific provisions as follows:

- 150% risk weight when specific provisions are less than 20% of the outstanding amount of the loan; and

- 100% risk weight when specific provisions are equal or greater than 20% of the outstanding amount of the loan.

2.13 Other assets

2.13.1 The standard risk weight for all other assets shall be 100%, with the exception of the following exposures:

- A 0% risk weight shall apply to gold position, cash owned and held at the bank or financial institution or in transit.

- A 20% risk weight shall apply to cash items in the process of collection (Cheques and items for clearing) and float balance from Mobile Network Operators (MNOs).

3. CREDIT RISK MITIGATION (CRM) TECHNIQUES

3.1 Banks and financial institutions shall use simple approach to mitigate credit risks to which they are exposed.

3.2 Under the simple approach, the risk weight of the counterparty is replaced by the risk weight of the collateral instrument collateralizing or partially collateralizing the exposure.

3.3 The following collateral instruments shall be eligible for recognition in the simple approach:

(a) Guarantee of the Government of the United Republic;

(b) Guarantee of the Revolutionary Government of Zanzibar;

(c) Guarantee of the Bank of Tanzania;

(d) Cash, fixed deposit, treasury bills, notes or bonds, or other instruments as the Bank may approve;

(e) Unconditional and irrevocable guarantee of a first class international bank or a first class international financial institution[3];

(f) Government securities of an A rated sovereign; and

(g) Unconditional and irrevocable guarantee of an A rated sovereign.

[3] "first class international bank or financial institution" means an international bank or financial institution that has a minimum long-term rating by internationally recognized rating agencies of "A" or above;