NATIONAL BANK of ETHIOPIA
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<u>LICENSING AND SUPERVISION OF</u>
<u>BANKING BUSINESS</u>

Directives No. SBB/ 48/2010

ASSET CLASSIFICATION AND PROVISIONING
FOR DEVELOPMENT FINANCE INSTITUTIONS

1. Issuing Authority

These Directives are issued by the National Bank of Ethiopia pursuant to the authority vested in it by articles 21 and 22 of Banking Business Proclamation No. 592/2008.

2. Short Title

These Directives may be cited as “Asset Classification and Provisioning for Development Finance Institutions Directives No. SBB/ 48/2010”.

3. Purpose

The purpose of these Directives is to provide guidelines to development finance institutions to assure that:

3.1 loans are regularly reviewed and prudently classified in a manner that appropriately reflect credit risk;

3.2 loans which are not performing in accordance with contractual repayment terms are timely recognized and reported as past due ;

3.3 accrued but uncollected interest on loans is properly accounted for; and

3.4 timely and adequate provisions are made to the “Provisions for Loan Losses Account” in order to ensure that disclosed capital and earnings performance are accurately stated.

4. <u>Definitions</u>

4.1 “Capitalized Interest” means any accrued and uncollected interest that has been added to the principal amount of loans at a payment date or maturity; it also includes uncollected interest that is rolled-over into new loans.

4.2 “Cash Collateral” means credit balances on accounts in the books of the development finance institution over which customers have given the institution a formal letter of cession and which the institution at its discretion has transferred from the customer’s account(s) to a specific or general cash collateral account(s) or blocked.

4.3 “Cash-substitutes” include:

4.3.1 a security issued by the Federal Government of Ethiopia;

4.3.2 an unconditional obligation or guaranty issued in writing by the Federal Government of Ethiopia;

4.3.3 an unconditional obligation or guaranty issued in writing by a foreign bank with an **A** or above rating by Standard and Poor's Corporation, Moody's Investor Services or any other international rating agency, approved by the National Bank of Ethiopia, in its latest rating; and

4.3.4 other liquid and readily marketable securities approved in writing by the National Bank of Ethiopia and which are held in the vaults of the development finance institution.

4.4 “Development finance institution” means an institution which is engaged mainly in medium and long term project finance business, *with* the purpose of promoting development in the industrial, agricultural, construction, services, commercial or other economic sectors;

4.5 “Loans” means any financial assets of a development finance institution arising from a direct or indirect advance of funds (i.e. unplanned over drawings, participation in loan syndication, the purchase of loans from another lender, etc.) or commitment to advance funds by a development finance institution to a person that are conditioned on the obligation of the person to repay the funds, either on a specified date or dates or on demand, usually with interest. The term includes a contractual obligation of a development finance institution to advance funds to or on behalf of a person, claim evidenced by a lease financing transaction in which the development finance institution is the lessor, and line of credit to be funded by the development finance institutions on behalf of a person.

4.6 “Medium or long term loans” means loans with original repayment or maturity period of two years or more.

4.7 “Net Recoverable Value” means the most probable value of a loan which will be realized from the sale of collateral securing the loan in a competitive and open market. For the purposes of these Directives, the most probable value of a loan recoverable from the sale of collateral securing the loan shall be the outstanding principal balance of the loan or advance multiplied by the “average recovery rate” of a development finance institution for loans secured by the collateral, provided that such average recovery rate shall not be 15 (fifteen) percentage points greater than “industry average recovery rate”. If a development finance institution has no information on aggregate net cash receipts or total net market value of acquired properties to compute its own average recovery rate, it shall use industry average recovery rate to determine the most probable value of a loan.

4.7.1 The term “ average recovery rate” means aggregate net cash receipts from sale of collateral plus total net market value of acquired properties, divided by the aggregate outstanding principal balance of the loans backed by the collateral sold or otherwise acquired by a development finance institution calculated over the period of 18 consecutive months preceding the date of computing minimum provision requirement as laid down in these Directives. In case a loan or an advance is secured by more than one collateral, such loan or advance and the collateral securing it shall be excluded from computation of average recovery rate unless all properties backing the loan or advance are sold or otherwise acquired by the development finance institution.

4.7.2 “Aggregate net cash receipts” means net cash collection (after deduction of any expenses associated with the sale of the collateral which may have been necessary to place the collateral in a saleable condition), over 18 consecutive months preceding the date of calculating minimum provision requirement, of a development finance institution from the sale of collateral which have been seized or foreclosed by the institution in satisfaction of loans previously granted.

4.7.3 The term “total net market value of acquired properties” as used in these Directives means the average of ask or reserve price of acquired properties and the highest offer bid amount registered at the last auction in the market that preceded the acquisition by a development finance institution for properties which previously were offered by borrowers as collateral against loans. The highest offer bid amount for auctioned property in absence of a bidder at the last auction shall be zero.

4.7.4 “Ask or reserve price” means minimum price at which lending development finance institution is willing to sell foreclosed assets.

4.7.5 The term “ industry average recovery rate” means aggregate net cash receipts plus total net market value of acquired properties, divided by the aggregate outstanding principal balance of the loans backed by the collateral at the time the collateral was seized, foreclosed, repossessed or otherwise acquired by all banks, including development finance institutions, operating in Ethiopia calculated over the period of 18 consecutive months preceding the date of determining minimum provision requirement. In case a loan is secured by more than one collateral, such loan and the collateral backing it shall be excluded from computation of industry average recovery rate unless all properties held as collateral against the loan are sold or otherwise acquired by the banks. The National Bank of Ethiopia shall compute such industry average recovery rate every calendar quarter and distribute to development finance institutions.

4.7.6 In determining the average recovery rate as set out under 4.7.1 herein above, the net market value of acquired property and/or the net cash receipt from the sale of collateral shall not exceed 100% of each outstanding non-performing loan backed by the collateral and used in the calculation of the average recovery rate.

4.8 "Non-accrual Status" means that a loan has been placed on a cash basis for financial reporting purposes. Interest on such loans accrued on the books of the development finance institution, or for which a specific reserve (such as a suspended interest account) has been established by the development finance institution to offset the full amount of interest being accrued, shall not be taken into income unless as otherwise provided in these Directives.

4.9 "Non-performing loans " means loans whose credit quality has deteriorated such that full collection of principal and/or interest in accordance with the contractual repayment terms of the loan or advance is in question.

4.10 For purposes of these Directives,

4.10.1 short term loans are non-performing when principal and/or interest is due and uncollected for 90 (ninety) consecutive days or more beyond the scheduled payment date or maturity;

4.10.2 medium and long term loans are non-performing when principal and/or interest is due and uncollected for 180 (one hundred and eighty) consecutive days or more beyond the scheduled payment date or maturity;

4.10.3 the entire principal balance of loans outstanding exhibiting the characteristics described under articles 4.10.1 and 4.10.2 hereof shall be considered as non-performing.

4.11 "Person" means any judicial or natural person.

4.12 "Provisions for Loan Losses Account" means a balance sheet valuation account established through charges to provision expense in the income statement in respect of possible losses in the loan portfolio.

4.13 "Renegotiated Loans" means loans which have been refinanced, rescheduled, rolled-over, or otherwise modified at favorable terms and conditions for the borrower because of weaknesses in the borrower's financial condition and/or ability to repay. However, the term excludes loans held by projects under implementation.

4.14 "Short term loans" means loans with original repayment or maturity period of less than two years.

4.15 “Suspended Interest Account” means an account where previously accrued but uncollected interest on loans required to be placed on non-accrual status is reserved out of the income of the development finance institution.

4.16 “Total capital” means the paid up capital, legal reserve and any other unencumbered reserve acceptable to the National Bank of Ethiopia held by a development finance institution.

4.17 “Well-Secured” means that a loan is secured by cash collateral or cash-substitutes sufficient to repay the full debt (principal plus accrued interest); for purposes of these Directives, sufficiency shall include proper legal documentation evidencing the institution’s claim on the collateral.

5. Loan Review

5.1 The board of directors of each development finance institution is responsible for establishing a loan review system which provides for the accurate and timely recognition of problem or deteriorating loans, assuring the adequacy of the Provisions for Loan Losses Account, and assuring that accrued but uncollected interest reflected in the books of the institution are in accordance with the requirements laid out in these Directives.

5.2 The board of directors of each development finance institution shall assure that a review is made of the quality of the institution’s loan portfolio on a regular basis, but no less than once each calendar quarter. At the end of each calendar quarter, or more frequently if warranted, the board of directors shall require the executive officer(s) of the institution to take appropriate measures in response to the findings of the loan review function to:

5.2.1 accurately reflect earnings by assuring that all loans categorized as non-performing in accordance with the requirements laid out in these Directives are placed on non-accrual status and accrued but uncollected interest has been reversed out of the institution’s income;

5.2.2 assure that the Provisions for Loan Losses Account is adequate to absorb potential losses in accordance with the requirements laid out in these Directives; and

5.2.3 correct problems, either in individual loans, loan underwriting practices, compliance with prudent lending standards and the board-approved lending policy, or other credit administration weaknesses as may be identified by the loan review function, within a specified time frame.

5.3 The board of directors of each institution shall maintain adequate records supporting its evaluation of potential losses in the loans portfolio and the entries made to reflect earnings and the adequacy of the Provisions for

Loan Losses Account; such records shall be made available to examining personnel of the National Bank of Ethiopia upon request.

5.4 The loan review function shall assure on an on-going basis, at a minimum, that:

5.4.1 lending activities are in compliance with prudent written lending standards as approved and adopted by the board of directors;
5.4.2 the board of directors is adequately informed of the risks and potential loss exposure in outstanding loans;
5.4.3 problem or deteriorating loans are properly and timely identified, classified, and placed on non-accrual status in accordance with the requirements laid out in these Directives;
5.4.4 appropriate provisions are made to the Provisions for Loan Losses Account for loans classified in accordance with the requirements laid out in these Directives; and
5.4.5 uncollectible non-performing loans are written off as appropriate.

5.5 The loan review function shall regularly and on an ongoing basis review all loans which exceed 5% (five percent) of a development finance institution's total capital to a single borrower, calculated in accordance with the Single Borrower Loan Limit Directives of the National Bank of Ethiopia, all loans required to be placed on non-accrual status in accordance with the requirements laid out in these Directives, and a sampling of the remaining loan portfolio to determine that loans reflected as performing on the books of the institution are in fact performing pursuant to the requirements and definitions laid out in these Directives.

5.6 The loan review function shall be performed by the board of directors of each development finance institution or a group of individuals to be designated by the board of directors, who are knowledgeable in credit analysis methodologies and who are not involved in the lending activities of the institution. In the latter case, the group shall on a regular basis, but not less than once each calendar quarter, report its findings directly to the board of directors in writing.

6. <u>Placement of Loans on Non-accrual Status</u>

6.1 All non performing loans shall be placed on non-accrual status, unless the loans are well-secured.

6.2 Accrued but uncollected interest being carried on the books for loans which are required to be placed on non-accrual status in accordance with the requirements laid out in these Directives shall be eliminated by the end of the calendar quarter in which the loans are required to be placed on non-accrual status, but in no event later than the fiscal year-end date of the institution, whichever is sooner.

6.3 A non-performing loan or advance placed on non-accrual status may be restored to accrual status only when:

6.3.1 none of the outstanding principal and/or interest is past due; and

6.3.2 for renegotiated loans , where all past due interest is paid by the borrower in cash at the time of renegotiation and the loan or advance is not classified as “Substandard” in accordance with article 7.1.6. of these Directives.

6.4 Development finance institutions shall report to the National Bank of Ethiopia on a quarterly basis loans which exceed 5% (five percent) of the institution 's capital that have been restored from non-accrual to accrual status.

6.5 If a development finance institution has multiple loans outstanding to a single borrower as calculated in accordance with the Single Borrower Loan Limit Directives of the National Bank of Ethiopia, and one loan or advance meets the criteria for non-accrual status, then the institution shall prepare a current written evaluation of the borrower’s creditworthiness evidencing that repayment prospects for the other loans are reasonably assured; should such written creditworthiness evaluation suggest that repayment prospects for the other loans are in question or otherwise uncertain, then all such loans to the borrower shall be placed on non-accrual status regardless of any requirements laid out in these Directives.

7. <u>Classification of Loans</u>

7.1 For the purpose of these Directives, development finance institutions shall classify all their loans, into the following five classification categories using the criteria described below:

7.1.1 Pass

Loans in this category are fully protected by the current financial and paying capacity of the borrower and are not subject to any criticism. Notwithstanding the generality of this statement, the following loans shall be classified pass:

a) short term loans past due for less than 30 (thirty) days,
b) medium and long term loans past due for less than 90 (ninety) days; and
c) any loan, or portion thereof, which is fully secured, both as to principal and interest, by cash or cash-substitutes, regardless of past due status or other adverse credit factors.

7.1.2 Special Mention

The following loans at a minimum shall be classified special mention:

a) short term loans past due for 30 (thirty) days or more, but less than 90 (ninety) days;

b) medium and long term loans past due 90 (ninety) days or more, but less than 180 (one-hundred-eighty) days;

7.1.3 Substandard

The following non-performing loans at a minimum shall be classified substandard:

a) short term loans past due 90 (ninety) days or more, but less than 180 (one-hundred-eighty) days;
b) medium and long term loans past due 180 (one-hundred-eighty) days or more, but less than 360 (three-hundred-sixty) days;

7.1.4 Doubtful

The following non-performing loans at a minimum shall be classified doubtful:
a) short term loans past due 180 (one-hundred-eighty) days or more, but less than 360 (three-hundred-sixty) days;
b) medium and long term loans past due 360 (three-hundred-sixty) days, but less than 3 (three) years;

7.1.5 Loss

The following non-performing loans at a minimum shall be classified loss:

a) short term loans past due 360 (three-hundred-sixty) days or more;

b) medium and long term loans past due 3 (three) years or more;

7.1.6 Without prejudice to the classification criteria used for the Sub-Standard category set out under article 7.1.3 herein above, renegotiated non-performing loans shall be categorized as “Substandard” unless equivalent of all past due interest is paid by the borrower in cash at the time of renegotiation and the following payments are made by the borrower on a consistent and timely basis in accordance with the restructured terms of the loan :

a) in the case of loans with monthly or quarterly installment repayments, at least 3 (three) consecutive repayments;
b) in the case of loans with semi-annual installment repayments, at least 2 (two) consecutive repayments;
c) in the case of loans with annual installment repayments, at least one repayment.

7.1.7 If a development finance institution has multiple loans outstanding to a single borrower as calculated in accordance with the Single Borrower Loan Limit Directives of the National bank of Ethiopia, and one loan or advance meets the criteria for non performing, then the institution shall prepare a current written evaluation of the borrower's creditworthiness evidencing that repayment prospects for the other loans are reasonably assured; should such written creditworthiness evaluation suggest that repayment prospects for the other loans are in question or otherwise uncertain, then all such loans to the borrower shall at a minimum be classified as substandard regardless of any requirements laid out in these Directives.

7.1.8 A development finance institution shall not reschedule, restructure or renegotiate a short term loan to a borrower for more than three iterations.

7.1.9 Before rescheduling, restructuring or renegotiating a short term loan, a development finance institution shall collect in cash full amount of interest in arrears thereof and the following principal amounts:

a) a minimum of 25% of outstanding principal balance in case of rescheduling, restructuring or renegotiating for the second time.

b) a minimum of 50% of outstanding principal balance in case of rescheduling, restructuring or renegotiating for the third time.

7.2 Notwithstanding the classification criteria laid out under article 7.1 herein above, a loan may be subject to more severe classification by examiners of the National Bank of Ethiopia if the actual condition of the loan warrants such classification. Conditions that warrant more severe classification may include, but are not limited to: (i) significant departure from the primary source of repayment; (ii) repayment terms which are too liberal or inconsistent with the purpose and nature of the loan or advance and/or collateral held; (iii) delinquencies which have been technically cured by modifying the repayment terms, refinancing or renewing the loan, or advancing additional funds for the purpose of meeting repayment requirements on an existing loan or advance.

8. Provisioning Requirements for Loans

8.1 Development finance institutions shall maintain a "Provisions for Loan Losses Account" which shall be created by charges to provision expense in the income statement and shall be maintained at a level adequate to absorb potential losses in the loans portfolio. In determining the adequacy of the Provisions for Loan Losses Account, provisions may be attributed to individual or groups of loans.

8.2 The Provisions for Loan Losses Account shall always have a credit balance. Additions to or reductions from this account shall be made only through charges to provisions in the income statement at least every calendar quarter.

8.3 Development finance institutions shall maintain the following minimum provision percentages against the outstanding principal amount of each loan or advance classified in accordance with the criteria for the classification of loans as laid out under article 7 herein above:

Article	**Classification Category**	**Minimum Provision for Short, medium and long term loans**
8.3.1	Pass	**1%**
8.3.2	Special Mention	**3%**
8.3.3	Substandard	**20%**
8.3.4	Doubtful	**65%**
8.3.5	Loss	**100%**

8.4 Where reliable information, such as (i) historical loan loss experience, (ii) current economic conditions, (iii) delinquency trends, (iv) ineffectiveness of lending policies and/or collection procedures, or (v) lack of timeliness and accuracy in the loan review function, suggests that losses are likely to be more than the above minimum provision percentages, development finance institutions may be required to maintain larger provisions.

8.5 The minimum provision requirements for each classification category here in above shall be applied against the total outstanding principal balance, not against the amount of past due payments, for each loan or advance, or portion thereof, classified regardless of whether the loan or advance is analyzed and provided for individually or as part of a group.

8.6 Before applying the minimum provision percentages laid out under articles 8.3.3, 8.3.4 and 8.3.5 herein above, development finance institutions may deduct from the outstanding non-performing loans :

8.6.1 any accrued but uncollected interest held in a suspended interest account (by debiting this account); and

8.6.2 in the case of loans secured by physical collateral net recoverable value, provided that such net recoverable value to be deducted shall not exceed 97% (ninety seven percent)) of the outstanding non performing loan, or estimated collateral value backing the non performing loan; whichever is lower.

9. Prohibition and Review of Financial Statements of Borrowers

9.1 Development finance institutions are prohibited from extending overdraft loans to their borrowers. For the purpose of these Directives “Overdraft loan” means a deposit account on the books of the development finance institution with a debit balance.

9.2 Development finance institutions shall review financial statements for the latest financial year of a borrower, who has been in business for a year or above, audited by external auditors before granting loans of Birr 5 million or above.

10. Loan repayment schedule

Development finance institutions shall base periodic loan collections from their borrowers on cash generating capacity of the business financed by the loan. Without limiting the generality of the statement hereof, they shall collect medium and long term loans at least:

10.1 monthly from business that regularly generates cash daily;

10.2 quarterly from business that regularly generate cash in two to 30 days;

10.3 semi annually from business that regularly generate cash in 31 to 180 days;

10.4 annually from business that generate cash in 181 to 360 days; and,

10.5 as shall be determined by board of directors of each institution in all other cases.

11. **<u>Examiner Review</u>**

11.1. Each development finance institution shall maintain adequate records in support of its evaluation of potential loss exposure in the loans portfolio and of the entries made to ensure an adequate Provisions for Loan Losses Account which shall be made available to examining personnel of the National Bank of Ethiopia upon request to assess the reasonableness of the institution’s loss estimation procedures, the reliability of the information on which estimates are based, and the adequacy of the Provisions for Loan Losses Account.

11.2. Should examining personnel in applying the requirements of these Directives and after discussions with the executive officer(s) of the institution find the Provisions for Loan Losses Account to be inadequate by more than 10% (ten percent) when compared to the findings of an on-site examination, the board of directors shall within 30 (thirty) days of such notice by the National Bank of Ethiopia of any deficiency in the Provisions for Loan Losses Account require the executive officer(s) to record the appropriate entries to increase the balance of the Provisions for Loan Losses Account to a level which is within 10% (ten percent) of the estimated amount of the Provisions for Loan Losses Account determined by examining personnel of the National Bank of Ethiopia.

11.3. In the event of material disagreements between examining personnel of the National Bank of Ethiopia and the executive officer(s) of the institution regarding the appropriateness of additional provisions needed to the Provisions for Loan Losses Account, the board of directors may appeal to the National Bank of Ethiopia. Notwithstanding this appeal, it is incumbent on the executive officer(s) of the institution to attend all loan discussions and meetings during on-site inspections in order to be fully apprised of examiner concerns with respect to all classified loans.

12. Other Provisioning Requirements

12.1. Provision for depreciation of fixed assets shall be made out of the annual income of a development finance institution in accordance with the law.

12.2. Operating and accumulated losses shall be provided for from the annual net profit until such losses are fully covered.

12.3. The value of any assets lodged or pledged to secure a liability, as indicated under Article 21(1)(b) of Proclamation No. 592/2008, shall be fully provided for upon the lodging or pledging of any asset.

12.4. Preliminary expenses representing expenses relating to organization or extension or the purchase of business or good will and including share underwriting commission shall be fully provided for within a maximum of 5 (five) years.

12.5. Any uncollectible claims, other than loans, shall be classified and provided for in the same manner and method laid down in these Directives for loans with monthly repayment program or otherwise written off as other operating expense of the institution as they are identified.

13. Interpretation of the Directives

All loans held by a development finance institution must be accounted for and categorized in accordance with the requirements laid out in these Directives. No interpretation of these Directives shall be permitted unless confirmed in writing by the National Bank of Ethiopia. In recording a loan or advance not covered in principle by the requirements laid out in these Directives, a development finance institution shall make a written request to the National Bank of Ethiopia to confirm the proper application of the requirements laid out in these Directives.

14. Reporting

Development finance institutions shall submit to the Banking Supervision Directorate of the National Bank of Ethiopia a quarterly report on loan classification and provisioning in accordance with the table attached with these Directives which shall be part thereof.

15. Effective Date

These Directives shall enter into force as of the **5th day of August 2010.**