

## Directive No. SBB/32/2002

### LICENSING AND SUPERVISION OF BANKING BUSINESS AMENDMENT OF PROVISIONS

#### 1. Issuing Authority

This Directive is issued by the National Bank of Ethiopia pursuant to the authority vested in it by Article 41 of the Monetary and Banking Proclamation No. 83/1994 and by Articles 15(1) and 36 of the Licensing and Supervision of Banking Business Proclamation No. 84/1994.

#### 2. Purpose of Directive

The purpose of this Directive is to provide uniform guidelines to banks to assure that:

- 2.1 Loans or advances are regularly reviewed and classified in a manner consistent with regulatory standards;
- 2.2 Loans or advances which are not performing in accordance with contractual repayment terms are recognized and reported as past due in a manner consistent with regulatory standards;
- 2.3 Accrued but uncollected interest on loans or advances is accounted for in accordance with international accounting and regulatory standards; and
- 2.4 Timely and adequate provisions are made to the Provisions for Loan Losses Account in order to accurately reflect the risk inherent in lending activities and to ensure that disclosed capital and earnings performance are accurately reflected.

#### 3. Definitions

- 3.1 "Affiliated Financial Institution" means a "company":
  - 3.1.1 In which a bank, directly or indirectly, owns or controls 10% (ten percent) or more of the voting shares or controls in any manner the election of a majority of its directors or other persons exercising similar functions;
  - 3.1.2 In which 50% (fifty percent) or more of the voting shares is held, or control is held, directly or indirectly, through stock ownership or in any other manner, by the shareholders of a bank who own or control 50% (fifty percent) or more of the voting shares of a bank;
  - 3.1.3 In which a majority of its directors, or other persons exercising similar functions, are directors of a bank; or
  - 3.1.4 Which owns or controls in any manner, directly or indirectly, 10% (ten percent) or more of the voting shares of a bank or controls in any manner the election of a majority of the directors, or persons exercising similar functions of a bank.

The term "company" as used in this definition means a bank or insurance company and "indirect ownership or control " refers to ownership or control exercised through ownership or control of entities that are shareholders in the same financial institution or through similar arrangements.

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

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

3.4 “Cash-substitutes” include:

3.4.1 A security issued by the Federal Government of Ethiopia;

3.4.2 An unconditional obligation or guaranty issued in writing by the Federal Government of Ethiopia or a non-affiliated domestic financial institution, where the beneficiary bank maintains a current written and well-documented evaluation evidencing that the non-affiliated financial institution is financially sound and capable of honoring the guaranty on demand with respect to repayment of both principal and interest, or a specific amount, and the lending bank has not been advised of any determination by the guarantor to deny payment under the terms of the obligation or guarantee; and

3.4.3 An unconditional obligation or guaranty issued in writing by a foreign bank with an A or above rating by Standard and Poor's Corporation and/or by Moody's Investor Services in their latest rating.

3.4.4 Other liquid and readily marketable securities approved in writing by the National Bank of Ethiopia and which are held in the vaults of the lending bank.

Provided, any loan or advance unconditionally guaranteed in writing by an affiliated financial institution as of the issuance of this Directive shall continue to be treated as a “cash-substitute” until the maturity of the loan or advance as stated in the loan contract/agreement, or the loan or advance is otherwise restructured, or has its terms or maturity modified, or the loan or advance is renewed. At which time, such affiliated financial institution guarantee shall no longer be considered a “cash-substitute” for purposes of this Directive.

3.5 “Current” as used in reference to “current written,” or similar uses, means information or documentation having an issuance date not more than 12 (twelve) calendar months old.

“In Process of Collection” means that the collection of loans or advances is proceeding in due course in a timely manner either through:

3.6.1 Enforcement of judgments against the borrower that is reasonably assured to result in full repayment of the loan or advance (principal plus accrued interest) within 360 (three-hundred-sixty) days from the date the loan or advance first became past due; or

3.6.2 Commencement of collection efforts not involving legal action but which are reasonably assured to result in full repayment of the loan or advance (principal plus accrued interest) within 180 (one-hundred-eighty) days from the date the loan or advance first became past due; or

3.6.3 Restoration of the loan or advance to a current status through payment, in cash, of all past due amounts within 180 (one-hundred-eighty) days from the date the loan or advance first became past due is reasonably assured.

3.7 "Loans" or "Advances" means any financial assets of a bank arising from a direct or indirect advance (i.e. unplanned overdrafts, participation in loan syndication, the purchase of loans from another lender, etc.) or commitment to advance funds by a bank 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 bank to advance funds to or on behalf of a person, claim evidenced by a lease financing transaction in which the bank is the lessor, and an overdraft facility to be funded by the bank on behalf of a person. The term does not include accrued but uncollected interest or discounted interest.

The term "person" as used in this definition and elsewhere referenced in this Directive, includes individuals, groups of individuals, partnerships, and corporate entities or other similar business groups and companies.

3.8 "Net Recoverable Value" means the most probable value of a loan or advance which will be realized from the sale of collateral securing the loan or advance in a competitive and open market. For purposes of this Directive, the most probable value of a loan or advance recoverable from the sale of collateral securing a loan or advance shall be the outstanding principal balance of a loan multiplied by the "average recovery rate" of a bank for loans or advances secured by collateral.

3.8.1 For purposes of determining the outstanding principal balance of a loan, accrued interest (limited to 90 days) may be added to the outstanding principal balance.

The term "average recovery rate" as used in this definition means the ratio of (i) aggregate net cash receipts (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) of a bank over the preceding 12 (twelve) consecutive months from the sale of collateral which have been seized, foreclosed, repossessed or otherwise acquired by a bank in satisfaction of loans or advances previously granted to (ii) the aggregate outstanding principal balance of the loans or advances backed by the collateral at the time the collateral was seized, foreclosed, repossessed or otherwise acquired by the bank.

In determining the average recovery rate as set out under 3.8.2 herein above, the net cash receipt from the sale of collateral backing each outstanding non-performing loan that shall be used in the computation shall not exceed 100% of the outstanding non-performing loan.

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

3.10 "Non-performing" means loans or advances 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.

3.10.1 For purposes of this Directive, loans or advances with pre-established repayment programs are non-performing when principal and/or interest is due and uncollected for 90 (ninety) days or more beyond the scheduled payment date or maturity.

3.10.2 For purposes of this Directive, overdrafts and loans or advances that do not have a pre-established repayment program shall be considered as non-performing when:

The debt remains outstanding for 90 (ninety) consecutive days or more beyond the scheduled payment date or maturity;

The debt exceeds the borrower's approved limit for 90 (ninety) consecutive days or more;

Interest is due and uncollected for 90 (ninety) days or more; or

For overdrafts, the account has been inactive for 90 (ninety) consecutive days and/or deposits are insufficient to cover the interest capitalized during the period;

3.10.3 For purposes of this Directive, the entire principal balance of loans or advances outstanding exhibiting the characteristics described under 3.10.1 and 3.10.2 shall be considered as non-performing.

3.11 "Overdraft" means a deposit account on the books of the bank with a debit balance.

3.12 "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 loans or advances portfolio.

3.13 "Renegotiated Loans or Advances" means loans or advances 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.

"Suspended Interest Account" means an account where previously accrued but uncollected interest on loans or advances required to be placed on non-accrual status is reserved out of the income of the bank.

"Total capital" shall mean the paid up capital, legal reserve and any other unencumbered reserve acceptable to the National Bank of Ethiopia held by a bank

3.16 "Well-Secured" means that a loan or advance is secured by:

3.16.1 Cash collateral or cash-substitutes sufficient to repay the full debt (principal plus accrued interest); for purposes of this Directive, sufficiency shall include proper legal documentation evidencing the bank's claim on the collateral; and/or

3.16.2 A guaranty from a financially responsible third party where the beneficiary bank maintains a current written and well-documented evaluation evidencing that the guarantor is capable of honoring the guaranty on demand; for purposes of this Directive, a guaranty must be (i) independently confirmed in writing by the guarantor, (ii) unconditional, and (iii) payable on demand.

#### 4. Responsibility for Loan Review and Specific Requirements

4.1 The board of directors of each bank is responsible for establishing a loan review system which provides for the accurate and timely recognition of problem or deteriorating loans or advances, assuring the adequacy of the Provisions for Loan Losses Account, and assuring that accrued but uncollected interest reflected on the books of the bank are in accordance with the requirements laid out in this Directive.

4.2 The board of directors of each bank shall assure that a review is made of the quality of the bank's loans or advances 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 principal officer(s) of the bank to take appropriate measures in response to the findings of the loan review function to:

4.2.1 Accurately reflect earnings by assuring that all loans or advances categorized as non-performing in accordance with the requirements laid out in this Directive are placed on non-accrual status and accrued but uncollected interest has been reversed out of the bank's income;

4.2.2 Assure that the Provisions for Loan Losses Account is adequate to absorb potential losses in accordance with the requirements laid out in this Directive; and

4.2.3 Correct problems, either in individual loans or advances, 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.

4.3 The board of directors of each bank shall maintain adequate records supporting its evaluation of potential losses in the loans or advances 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.

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

4.4.1 Lending activities are in compliance with prudent written lending standards as approved and adopted by the board of directors;

4.4.2 The board of directors is adequately informed of the risks and potential loss exposure in outstanding loans or advances;

4.4.3 Problem or deteriorating loans or advances are properly and timely identified, classified, and placed on non-accrual status in accordance with the requirements laid out in this Directive;

Appropriate provisions are made to the Provisions for Loan Losses Account for loans or advances classified in accordance with the requirements laid out in this Directive; and

Uncollectible non-performing loans or advances are written off as appropriate.

4.5 The loan review function shall regularly and on an ongoing basis review all loans or advances which exceed 5% (five percent) of a bank's total capital to a single borrower, calculated in accordance with in the Single Borrower Loan Limit, all loans or advances required to be placed on non-accrual status in accordance with the requirements laid out in this Directive, and a sampling of the remaining loans or advances portfolio to determine that loans or advances reflected as performing on

the books of the bank are in fact performing pursuant to the requirements and definitions laid out in this Directive.

4.6 The loan review function shall be performed by the board of directors of each bank 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 bank. 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.

## 5. Placement of Loans or Advances on Non-accrual Status

5.1 All loans or advances categorized under 6.1.3, 6.1.4 and 6.1.5 in accordance with the requirements laid out in this Directive shall be placed on non-accrual status effective January 1, 2004 unless the loans or advances are (i) well-secured and (ii) in process of collection. Notwithstanding this provision a bank which has already placed its non-performing loans on non-accrual status shall continue to do so.

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

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

5.3.1 None of the outstanding principal and/or interest is past due; and,

5.3.2 For renegotiated loans or advances, 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 6.1.6. of this Directive; and

5.3.3 The bank expects full repayment of the remaining contractual principal and interest as evidenced by a current written and well-documented evaluation of the borrower's creditworthiness.

5.4 Banks shall report to the National Bank of Ethiopia on a quarterly basis loans or advances which exceed 5% (five percent) of the bank's capital that have been restored from non-accrual to accrual status.

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

## 6. Classification of Loans or Advances

For purposes of this Directive, banks shall classify all loans and advances, whether such loans or advances have pre-established repayment programs or not, into the following five classification categories using the criteria described below:

#### 6.1.1 Pass

Loans or advances in this category are fully protected by the current financial and paying capacity of the borrower and are not subject to criticism. In general, any loan or advance, or portion thereof, which is fully secured, both as to principal and interest, by cash or cash-substitutes, shall be classified under this category regardless of past due status or other adverse credit factors.

#### 6.1.2 Special Mention

Any loan or advance past due 30 (thirty) days or more, but less than 90(ninety) days shall be classified Special Mention.

#### 6.1.3 Substandard

Non-performing loans or advances past due 90 (ninety) days or more but less than 180 (one-hundred-eighty) days shall, at a minimum, be classified Substandard;

#### 6.1.4 Doubtful

Non-performing loans or advances past due 180 (one-hundred-eighty) days or more but less than 360 (three-hundred-sixty) days shall be classified, at a minimum, as Doubtful.

#### 6.1.5 Loss

Non-performing loans or advances past due 360 (three-hundred-sixty) days or more shall be classified Loss.

6.1.6 Without prejudice to the classification criteria used for the Sub-Standard category set out under 6.1.3 herein above, the following non-performing loans and advances shall be categorized as Substandard:

- a) Renegotiated term loans 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 or advance:
  - i) in the case of term loans with monthly installment repayments, at least 3 (three) consecutive repayments;
  - ii) in the case of term loans with quarterly installment repayments, at least 3 (three) consecutive repayments;
  - iii) in the case of loans with semi-annual installment repayments, at least 2 (two) consecutive repayments.

- b) Renegotiated non-performing overdraft facilities unless equivalent of all past due interest is paid by the borrower in cash at the time of renegotiation and the account shows at a minimum:
  - a nil balance at least once; or
  - a turnover rate of once the approved limit.

- c) Renegotiated non-performing merchandize loans unless physical inventory of the merchandize taken by the bank at the time of renegotiation shows that the outstanding principal loan and interest thereof are fully covered and the safety margin determined following the inventory is at least not lower than the margin stated in the loan contract entered into by the bank and the borrower at the time of initial extension of the loan.

6.2 Notwithstanding the classification criteria laid out under 6.1 herein above, loans or advances may be subject to more severe classification by examiners of the National Bank of Ethiopia if the actual condition of the loan or advance 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 advance, or advancing additional funds for the purpose of meeting repayment requirements on an existing loan or advance.

7. Provisioning Requirements for Loans or Advances

7.1 All banks 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 or advances portfolio. In determining the adequacy of the Provisions for Loan Losses Account, provisions may be attributed to individual loans or advances or groups of loans or advances.

7.2 The Provisions for Loan Losses Account shall always have a credit balance. Additions to or reductions of the Provisions for Loan Losses Account shall be made only through charges to provisions in the income statement

7.3 Banks 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 or advances as laid out under 6.1 herein above:

Classification Category:	Minimum Provision:
7.3.1. "Pass" (in accordance with the following build	up in minimum required provisions)
0.5%	(a) by December 31, 2002
0.75%	(b) by June 30, 2003
1%	(c) Effective January 2004
7.3.2. "Special Mention" (in accordance with the following build	up in minimum required provisions)
1%	(a) by December 31, 2002
2%	(b) by June 30, 2003
3%	(c) Effective January 2004
7.3.3. "Substandard"	(a) Until December 31,
2003	25%

(b) Effective January 2004

20%	
7.3.4. "Doubtful"	50%
7.3.5. "Loss"	100%

7.4 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, banks may be required to maintain larger provisions.

7.5 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.

7.6 Before applying the minimum provision percentages laid out under 7.3.3, 7.3.4 and 7.3.5 herein above, banks may deduct from the outstanding non-performing loans or advances:

7.6.1 any accrued but uncollected interest held in a suspended interest account (by debiting this account), cash collateral and cash substitutes held as collateral; and

7.6.2 in the case of loans secured by physical collateral:

a) Until 31 December 2003, 67% (sixty-seven percent) of the estimated value of the collateral backing the non-performing loan, provided the estimated value of the collateral used for this purpose shall not exceed 100% (one hundred percent) of the outstanding non-performing loan;

b) starting from 1 January 2004, net recoverable value.

7.7 Required provisions computed in accordance with 7.6.2.a. herein above shall be set aside in the following manner:

7.7.1 at least 50% (fifty percent) of the required provisions by June 30, 2002;

7.7.2 at least 70% (seventy percent) of the required provisions by December 31, 2002;

at least 85% (eighty five percent) of required provisions by June 30, 2003; and 100% (hundred percent) of the required provisions by December 31, 2003.

Notwithstanding the percentages set under items 7.7.1, 7.7.2 and 7.7.3 herein above, the provisions to be set aside shall not be lower than those held prior to the coming into force of this Directive.

7.8 Provisions required to be maintained against non-performing loans or advances

classified in accordance with the requirements of this Directive may only be reduced by a bank when:

Cash payments on the loan or advance are received in full; or

A current written and well-documented evaluation of the borrower's

creditworthiness clearly and unquestionably demonstrates that repayment prospects have improved and are reasonably assured; and repayment terms on the loan or advance are consistent with other loans or advances being made by the bank and in accordance with guidelines laid out in the board-approved loan policy; or

The loan is not classified as Substandard in accordance with article 6.1.6. of this Directive.

## 8. Examiner Review

8.1 Each bank shall maintain adequate records in support of its evaluation of potential loss exposure in the loans or advances 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 bank's loss estimation procedures, the reliability of the information on which estimates are based, and the adequacy of the Provisions for Loan Losses Account.

8.2 Should examining personnel in applying the requirements of this Directive and after discussions with the principal officer(s) of the bank 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 principal 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.

8.3 In the event of material disagreements between examining personnel of the National Bank of Ethiopia and the principal officer(s) of the bank 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 principal officer(s) of the bank 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 or advances.

## 9. Other Provisioning Requirements

9.1 Provision for depreciation of fixed assets shall be made out of the annual income of a bank in accordance with the law.

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

9.3 The value of any assets lodged or pledged to secure a liability, as indicated under Article 15(1)(d) of Proclamation No. 84/1994, shall be fully provided for upon the lodging or pledging of any asset.

9.4 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 5 (five) years.

9.5 Any uncollectible claims, other than loans or advances, shall be written off as other operating expense of the bank as they are identified.

## 10. Application and Interpretation of Directive

All loans or advances held by a bank must be accounted for and categorized in accordance with the requirements laid out in this Directive. No interpretation of this Directive 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 this Directive, a bank shall make a written request to the National Bank of Ethiopia to confirm the proper application of the requirements laid out in this Directive.

11. Reporting

Banks shall submit to the Supervision Department of the National Bank of Ethiopia a quarterly report on loan classification and provisioning in accordance with the table attached with this Directive which shall be part of the Directive.

12. Repeal

Directive No. SBB/28/2002 is hereby repealed and replaced by this Directive.

13. Effective Date

This Directive shall enter into force as of the 1st day of September 2002.