



Islamic Republic of Afghanistan  
Da Afghanistan Bank

## **Summary**

Da Afghanistan Bank (DAB) is issuing for public comment a regulation on asset classification and evaluation, provisioning and non-accrual status. The circulation of the regulation for comment is consistent with Article 3 of the Decree Law of Banking in Afghanistan (Banking Law), which requires that a regulation be published in the manner “best calculated to bring the regulation to the attention of the domestic banking industry.” If DAB determines that the delay in issuing a regulation that would be caused by circulating the regulation for public comment would be a “serious threat to the interests of the banking system” it may forego this requirement. In the case of this regulation, DAB chooses to circulate the regulation for public comment.

## **Purpose of rule**

The purpose is to detail the process by which banks’ own management must judge the quality of bank assets, for review by DAB inspectors. The regulation provides for different asset classifications (standard, watch, substandard, doubtful, loss) based on quality as judged by the performance of the borrower, as well as the underlying collateral, if any. Additionally the regulation addresses related issues, such as the expense provisions required to build a reserve for loan loss, and the placement of non-performing loans on non-accrual status. This regulation is generally in keeping with Principle 8 of the Basle Committee on Banking Supervision’s Core Principles Methodology.

## **Background and summary of rule**

Classification of assets is an important element of both the management and supervision of banks. Bank management must have current, accurate information on the likelihood that loans and other assets with credit risk will be repaid. DAB must collect reliable information on the quality of assets in order to properly calculate total capital and assets of the bank, used for calculating economic normatives regulating banking activities. Additionally, the calculation of provisions for loan losses must be properly calculated in determining the profitability of a bank.

The regulation defines the various classifications that must be used by bank management and verified by DAB in assessing asset quality: standard, watch, substandard, doubtful, loss. The process for evaluating assets and placing them into these various categories involves analyzing various subjective and objective factors. Minimum reserves for each of the categories are also included in the regulation. If deemed appropriate by DAB, classifications and reserves beyond the minimums noted in the regulation may be required. The regulation also details the process for placing non-performing loans that are

at least 90 days past due on non-accrual status. This involves the changeover for revenue recognition from a periodic accrual to what is essentially a cash basis for recognizing revenue due to the uncertainty of future collection of principal and interest.



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## BANKING REGULATIONS

### **Article Three: Asset Classifications and Evaluation, Provisioning and Non-Accrual Status**

#### **Part A — General.**

##### **§ 3.1.1. Authority**

This regulation on asset classifications and provisioning is pursuant to the authority granted to DAB by Article 35.2.4 of the Decree Law of Banking in Afghanistan (Bank Law).

##### **§ 3.1.2. Definitions.**

- a) *Capitalization of interest* - agreements, understandings or courses of conduct between a bank and its borrower under which unpaid interest due on an outstanding loan is added to the principal amount of such loan with the intention of paying it at a later date with the result that interest becomes due and payable on interest.
- b) *In the process of collection* - collection of a debt is proceeding through legal action against the borrower is reasonably expected to result in repayment of the debt or in its restoration to current status through payment of the principal and interest due.
- c) *Nonperforming loan* -- a loan on which principal or interest is due and unpaid for 90 days or more, or interest payments equal to 90 days or more have been capitalized, refinanced, or prolonged.

Credits without pre-established repayment schedules are considered nonperforming when any of the following conditions are met:

- (1) the amount advanced exceeds the customer's approved borrowing line for 90 consecutive days or more;

- (2) interest is due and unpaid for 90 days or more; or
- (3) the account has been inactive for 90 days and the customer's deposits are insufficient to cover the interest capitalized during that period.

d) *Past due* – an asset on which:

- (1) principal or interest payments are due and unpaid for 30 days or more, or
- (2) interest payments equal to a sum of 30 days interest or more have been capitalized, refinanced, or prolonged.

Assets without pre-established repayment schedules are considered past due when any of the following conditions are met:

- (1) the amount advanced exceeds the customer's approved borrowing line for 30 consecutive days or more;
- (2) interest is due and unpaid for 30 days or more; or
- (3) the account has been inactive for 30 days and the customer's deposits are insufficient to cover the interest capitalized during that period.

e) *Provision for loan loss* – an amount charged to earnings to fund the reserve for loan losses.

f) *Reserve for loan losses* – a contra asset account that is sufficient to absorb estimated losses in the bank's loan portfolio, plus all off-balance sheet credit instruments such as stand-by letters of credit and loan commitments.

### § 3.1.3. General.

a) This regulation aims at the following:

1. To collect reliable information on the total capital and assets of the bank, used for calculating economic normatives regulating banking activities.
2. For the purpose of calculating the amount of allowances to loan loss provisions to be deducted as an expense item in calculating profit.

b) The objectives of this regulation:

1. Banks shall form a general provision for standard assets, and a special provision for problem (watch, substandard, doubtful and loss) assets.

2. Loan loss provisions shall be formed on the basis of criteria for asset classifications
  3. Objective and subjective criteria for asset classification shall be defined.
- c) Based on the results of supervision, DAB can require banks to adjust its assets classification under this Policy, as well as its provisioning in accordance with Section 3.2.2 herein.
- d) The following procedures apply to all direct and indirect extensions of credit, including loans and advances, accounts receivable, overdrafts, letters of credit, bank guarantees, and contingent liabilities. These same procedures also apply to the evaluation of non-loan assets, such as property acquired by banks in satisfaction of debts (repossessed or foreclosed property), investments, equity participations, and miscellaneous asset accounts.

## Part B — Asset Classifications

### **§ 3.2.1. Asset classifications-General.**

- a). On a quarterly basis, all banks shall self-classify each of their loan assets within one of the five categories set forth below.
- b). In making the decision to classify a loan asset within one of the five classification categories listed below, a bank shall use its informed judgment but shall be guided by the standards and components set forth below with respect to each such category.
- c). Self-classifications of loan assets by banks shall be subject to classification decisions of DAB. Differences between classification decisions of DAB with respect to any asset and that of the classifying bank shall be subject to negotiation between them but the classification decision of DAB shall be final for all purposes.
  - i. Standard - An asset classified as Standard is paying in a current manner and is supported by sound net worth and paying capability of the borrower. The loan was made with sound standards of credit analysis. Standard assets are sufficiently secured with respect to both the principal amount and interest, and only a general provision shall be formed for standard assets in the amount of 1%.
  - ii. Watch-List – An asset classified as Watch List is adequately protected, but is potentially weak. Such an asset constitutes an unwarranted credit risk, but not to the point of requiring a classification of Substandard. The credit risk may be minor, and in most instances, bank management can correct

the noted deficiencies with increased attention. Yet such risk is considered undue and unwarranted in light of the particular circumstances surrounding the asset.

- A. Examples of Watch-List assets are those which may, if not corrected, become weakened by imprudent lending practices including but not limited to the bank loan officer's inability to properly supervise them due to lack of expertise; the loan was not made in compliance with the bank's internal policies; failure to maintain adequate and enforceable documentation; or poor control over collateral.
  - B. Watch-List assets require a minimum credit provision of 5%.
  - C. Under no circumstances should a Watch List category be utilized as a compromise between the classification categories of Standard and Substandard.
- iii. Substandard – An asset classified as Substandard is inadequately protected by current sound net worth and paying capacity of the borrower or by the collateral, if any, supporting it. Such an asset has at least one well-defined weakness that jeopardizes the full repayment of the debt. It is characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Assets that are past due 61-90 days for principal or interest payments must be classified as substandard at a minimum. Substandard assets require a minimum credit provision of 25%.

Examples of substandard assets include the following:

- A. Primary sources of repayment are insufficient to service the debt and the bank must look to secondary sources of repayment, including collateral.
  - B. The borrower's current financial capability or cash flow is not sufficient to meet currently maturing debt.
  - C. The borrower's business is significantly undercapitalized.
- iv. Doubtful – An asset classified as Doubtful has all the weaknesses inherent in one classified as Substandard with the added characteristic that these weaknesses make collection or liquidation in full, on the basis of current circumstances and values, highly questionable and improbable. Although the possibility of loss is thus extremely high, because of significant pending factors, reasonably specific, which could be expected to work to the advantage and strengthening of the asset, its classification as an estimated loss is deferred until its more exact status may be determined. Examples of such pending factors include but are not limited to mergers, acquisitions, capital restructuring, and the furnishing of new collateral or realistic refinancing plans. Assets that are past due 91-180 days for principal or interest payments

must be classified as doubtful at a minimum. Doubtful assets require a minimum credit provision of 50%.

- v. Loss -An asset classified as a loss is considered not collectible and of such little value that its continuance as a bankable asset is not warranted. A loss classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future. An asset that is past due over 180 days for principal or interest payments must be classified as loss. Loss assets require a credit provision of 100%.

Asset classification criteria are summarized below:

<b>Asset classification</b>	<b>Objective criteria</b>	<b>Provision required</b>
Standard	A performing asset which is being repaid in accordance with the contract.	1 percent
Watch	Up to 60 days past due status	5 percent
Substandard	With 61 to 90 days past due status	25 percent
Doubtful	With a 91 to 180 days past due status	50 percent
Loss	With a 181 days and more past due status	100 percent

### § 3.2.2. Split classifications.

An asset may be classified in more than one category . A problem loan which is secured by collateral whose value is less than the outstanding balance, is classified as follows:

- a) the portion of the outstanding balance equal to the market value of the collateral (as determined in accordance with International Valuation Standards and International Accounting Standards) is classified substandard;
- b) the remaining portion is classified doubtful or loss, consistent with the subjective criteria used for classification under these categories.

This calculation applies to any problem loan that is uncollateralized, or to the portion of a collateralized problem loan that exceeds the collateralized portion.

### **§ 3.2.3. Classification of Off Balance Sheet Items.**

The factors analyzed in evaluating a direct loan (financial performance, ability and willingness to pay, collateral protection, and future prospects) are applicable to the review of off-balance sheet lending arrangements (such as loan commitments, commercial letters of credit, and standby letters of credit).

When evaluating off-balance-sheet credit transactions for determining a credit-quality rating, consideration must be first given to whether the bank is irrevocably committed to advance additional funds under the credit arrangement. The appropriate classification must be determined and applied if the bank must continue to fund the commitment and:

- a) a potential weakness exists that, if left uncorrected, may at some future date result in the deterioration of repayment prospects or the bank's credit position,  
or
- b) there is a well-defined weakness that jeopardizes repayment of a commitment.

The Loan Loss Reserve must adequately reflect, through proper provisioning, the associated risks.

## Part C — Provisioning, Interest Accruals, Capitalization of Interest

### **§ 3.3.1. Provisioning.**

- a) Banks must make provisions for loan losses and establish loss reserves as set forth in this Decision. The sufficiency of the reserve must be reviewed not less than quarterly.
- b) The amount of the reserve must be based on facts and circumstances as of the evaluation date, and after charge-off of all loans or portions of loans classified Loss.
- c) For substandard and doubtful assets, all estimated losses over the remaining life of the loan must be included in the bank's reserve.
- d) For assets classified as pass or special mention, all estimated credit losses over the upcoming 12 months must be included in the reserve.
- e) If such facts and circumstances dictate that estimated losses are likely to be greater than the required minimums, then the larger amounts should be used.

- f) Loans classified loss must be charged-off (credited), and the reserve for loan losses reduced (debited) immediately. Losses must be taken in the period in which they are identified as uncollectible.
- g) The bank shall calculate the minimum provisioning requirements for all asset classifications by using the book value of the debt, multiplied by the determined classification provisioning percentage. However, a bank may first deduct the following collateral and guarantees as provided below:
  - (1) cash and cash deposit collateral are deductible by 100% of its value;
  - (2) readily marketable publicly-traded government securities with an easily determinable market value, subject to a deduction of 10% of their market value;
  - (3) In case of any classified debtor for which the government is the guarantor, or for which the government has set aside its budget for, or for which there is evidence of certain repayment from a government bureau, the amount of the debtor's loan covered by such a guarantee or repayment may be deducted from the book value of the debt when calculating provisioning requirements.
- h) Any new credit to a given borrower must be classified under the same category as previous credit to same borrower which was classified other than Pass, unless it is fully secured by cash or equivalent collateral which is in the possession of the bank.

i) A bank may reverse a provision and charge-off and rebook the pertinent asset only in the following circumstances:

- A. where the bank can satisfactorily demonstrate that the asset's quality has improved significantly; and
- B. where the Governing Board of the bank, or its Credit Risk Management Committee, has approved the reversal and rebooking in advance and has recorded in the minutes of the meeting giving such approval the improved facts and circumstances which serve as the bases for the approval.

- j). Rebooked assets shall be assessed by supervisors on a case by case basis and shall:

- A. meet the criteria used in granting new loans contained in the bank's lending policies;
- B. not be granted on more favorable terms than those prevailing for comparable borrowers in good-credit standing with the bank; and
- C. not be subject to classification.

If the above conditions are not met, the asset shall not be rebooked.

§ **3.3.2. Interest accruals.**

- a. Accrued interest on balance-sheet items of a bank shall be recognized as income for the relevant period as of the date on which it is due, regardless of the time of its actual repayment.
- b. Banks shall suspend the accrual of interest on all non-performing loans where principal or interest payments have been past due for periods exceeding 90 days. The only exception to this rule is when a non-performing loan is both well-secured and in process of collection. The loan will then be accounted for on a cash basis with income recognized only upon payment in cash.
- c. Banks shall account for interest due for periods exceeding 90 days by recording them as off-balance sheet items. The only exception to this rule is when a non-performing loan is both well-secured and in process of collection.
- d. Banks may restore the status of accrual of interest on loans where accrual has been suspended only upon full repayment of all arrears of the loan.
- e. When a bank places a loan in a non-accrual status, previously accrued but uncollected interest should be reversed against appropriate income and balance sheet accounts.

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**§ .3.3.3 Capitalization of Interest.**

a.

No bank shall engage in any capitalization of interest arrangement unless it can demonstrate to the satisfaction of DAB that:

- a) the debtor will be in a position to repay the loan out of its cash flow within a reasonable time;
- b) the possibility of interest compounding is provided for in the original agreement or was always understood by both parties to be available;
- c) the repayment of the total indebtedness is based upon a planned and reasonably likely future event; and
- d) any other condition(s) or circumstance(s) deemed appropriate by DAB.