BANK OF PAPUA NEW GUINEA

PRUDENTIAL STANDARD 2/2003

ASSET CLASSIFICATION, PROVISIONING AND SUSPENSION OF INTEREST

Arrangement of Paragraphs

PART I: PRELIMINARY

1: **Short Title** – Asset classification and provisioning.

2: **Authorization** – The Bank of Papua New Guinea (Bank) is authorized to issue prudential standards under Section 27 of the Banks and Financial Institutions Act 2000 (Act) in relation to prudential matters to be complied with by all Authorized Institutions.

3: **Application** – All banking institutions licensed by the Bank to conduct banking business in Papua New Guinea (PNG).

4: **Definitions** – Terms used within this prudential standard are as defined in the Act, as defined below, or as reasonably implied by contextual usage:

1) **"bank"** – means all banks and other licenced financial institutions authorized under the Act to carry on banking business.

2) **"capitalized interest"** – means any accrued and uncollected interest which has been added to the principal amount of a loan at a payment date or at maturity; capitalized interest also includes unpaid interest which is refinanced or rolled-over into a new loan; for purposes of this prudential standard, capitalization of interest will not be permitted unless:
a) the borrower has the ability to repay the full debt (including principal and interest) in the normal course of business;
b) the capitalization of interest was anticipated at approval of the initial loan based on the borrower's planned temporary lack of cash flow;
c) the debt is well-secured by the net realizable value of collateral security;
d) repayment, including all capitalized interest, is based on a reasonably ascertainable future event; and
e) the borrower can obtain funds from other sources at similar rates and terms.

For current accounts (overdrafts) and other loans or advances not having pre-established repayment programs or where interest is normally capitalized to the account, deposits to the account during a temporary period of diminished cash flow should be at least sufficient to cover accrued interest for the period.

3) **"in the process of collection"** – means that collection of an obligation is proceeding in due course in a timely manner either through:
a) legal action, including the enforcement of a judgment against the borrower; or
b) by collection efforts not involving legal action but which are reasonably expected to result in full repayment of the debt (including principal and all accrued interest) within 90 days, or in restoration of the debt to a current status through payment of all principal and interest which is due.

4) **"loans and advances"** – means any direct or indirect advance of funds (including obligations as maker or endorser arising from discounting of commercial/business paper) which are made to a person on the basis of an obligation to repay the funds, or which is repayable from specific property pledged by or on behalf of a person.

5) **"net realizable value"** – means that amount after discounting collateral held as security to current market conditions and also deducting the reasonable and estimable costs of recovery and sale including but not limited to: legal fees, valuation costs, estate agent fees,

insurance cover to date of sale, costs of maintenance, security, and expenses necessary to put the collateral in a saleable condition.

6) **"non-accrual"** – means that accrual of interest has been suspended and an asset has been placed on a cash basis for financial reporting purposes. Interest is no longer accrued on the books of the bank nor is it taken into income unless paid by the borrower in cash. Non-accrual assets include all assets which are non-performing unless an asset is both (i) well-secured and (ii) in the process of collection.

7) **"non-performing"** – means that an asset is no longer generating income. For purposes of this prudential standard, the entire outstanding balance of an asset is considered "non-performing" when:

a) any portion of principal or interest is due and unpaid for 90 days or more; or
b) interest payments for 90 days or more have been capitalized, re-financed, or rolled-over into a new loan.

Current accounts (overdrafts) and other loans not having pre-established repayment programs are considered "non-performing" when any of the following conditions exist:

a) the debt exceeds the approved limit for 90 consecutive days or more;
b) the borrowing line has expired for 90 days or more;
c) interest is due and unpaid for 90 days or more; or
d) the account has been inactive for 90 days, or deposits have been insufficient to cover the interest that was capitalized during the period.

The entire principal balance outstanding (not just the sum of delinquent payments) is to be shown as "non-performing" for purposes of this prudential standard and when preparing and submitting financial returns to the Bank.

8) **"past due" or "overdue"** – means any asset for which:

a) any portion of principal or interest is due and unpaid for 30 days or more; or
b) interest payments equal to 30 days interest or more have been capitalized, refinanced, or rolled-over.

Current accounts (overdrafts) and other loans and advances not having pre-established repayment programs are considered "past due" when any of the conditions below exist:

a) the debt exceeds the approved limit for 30 consecutive days or more;
b) the borrowing line has expired for 30 days or more;
c) interest is due and unpaid for 30 days or more; or
d) the account has been inactive for 30 days, or deposits have been insufficient to cover the interest capitalized during the period.

The entire principal balance outstanding (not just the sum of delinquent payments) is to be shown as "past due" for purposes of this prudential standard and when preparing and submitting financial returns to the Bank.

9) **"provisions for loan losses"** – means a balance sheet account established through charges to "provision expense" in the income statement and against which uncollectible assets, or portions thereof, are written-off. May also be referred to as the "allowance for loan losses". The account includes both "specific" and "general" provisions and is subtracted from gross loans for financial reporting purposes.

For purposes of this standard, provisions set aside for loans graded Substandard, Doubtful and Loss are considered "specific" provisions; provisions for loans graded Pass and Special Mention are considered “general” provisions.

10) **“well-secured”** – means that a loan or advance is secured by:

a) collateral that can repay the full debt (principal plus accrued interest) through timely sale under an involuntary liquidation program; also, (i) proper legal documentation must be held, (ii) the collateral must have a "net realizable value" which covers principal, accrued interest, and costs of collection, and (iii) there can be no prior liens which prevent the bank from obtaining clear title; or

b) a guarantee from a financially responsible party where the beneficiary bank has performed proper financial analysis and determined that the guarantor is financially sound, well-capitalized, and able to honour the guaranty on demand; such guarantees must be (i) irrevocable and unconditional, (ii) payable on default of the borrower, and (iii) independently confirmed by the guarantor.

PART II: STATEMENT OF POLICY

1: **Purpose** – This standard is intended to ensure that: (i) loans and advances are regularly evaluated using an objective grading system that is consistent with regulatory standards; (ii) the accounting treatment for accrued but uncollected interest on non-performing assets is consistent with international accounting standards and regulatory reporting requirements; and (iii) timely and appropriate provisions and write-offs are made to the loan loss provisions account in order to accurately reflect the condition and operations of the bank. It is also intended to promote well-reasoned, effective work-out plans for problem assets, and effective internal controls to manage the level of such assets.

2: **Scope** – This standard applies to all loans and advances reflected on a bank’s balance sheet or reflected as off-balance sheet items.

3: **Responsibility** – It is the responsibility of the board of directors of each bank to adopt a written loan policy and to establish a loan review process which accurately identifies risk, ensures the adequacy of provisions for loan losses, and properly reflects the condition and operations of the bank in required financial returns.

PART III: IMPLEMENTATION AND SPECIFIC REQUIREMENTS

1: **Loan Review - (a) Frequency and reporting.** The board of directors shall cause a review to be made of the quality of its loan book on a regular basis, at least at the end of each calendar quarter. Reports of such reviews shall be made on a timely basis directly to the board of directors and shall include enough information for the board to identify problems and require bank officers to correct the problems in a timely manner.

Banks that have adopted policies and procedures for an internal loan review program, including the classification (grading) of loans and provisioning, that is different from the requirements of this standard, may continue to use their current system. However, for reporting purposes, banks must report loan classifications and provisions in accordance with the requirements, definitions and criteria as set forth in this standard.

(b) Objectives. The loan review function shall ensure that: (i) the loan portfolio and lending function conform to a sound, written lending policy which has been adopted and approved by the board of directors; (ii) executive management and the board of directors are adequately informed regarding portfolio risk; (iii) problem credits are promptly identified, classified, and placed on non-accrual in accordance with this prudential standard; (iv) fully adequate provisions are made to the loan loss provisions account; and v) write-offs of identified losses are taken in a timely manner.

(c) Committee. The loan review function shall be performed by a committee of not less than three persons, at least one of whom shall not be an executive director or a principal shareholder of the bank.

2: **Suspension of Interest - (a) Transfer to non-accrual status.** A loan or advance is to be placed on non-accrual if: (i) it is maintained on a cash basis because of deterioration in the financial condition or paying ability of the borrower; (ii) payment in full of principal or interest is not expected; or (iii) it is non-performing unless it is both well-secured and in the process of collection as defined in this prudential standard.

(b) Write-back of accrued interest. All interest which is accrued but is uncollected and still carried on the books shall be written-off by the end of the calendar quarter in which the loan is, or should have been, placed on non-accrual status, but in no event later than 90 days after being transferred to non-accrual status.

Interest which has already been taken into income and capitalized by increasing the principal amount of the loan or overdraft shall be reversed or written-off from the time the loan is, or should have been, placed in non-accrual status.

Interest which has accrued during the current calendar year shall be charged back against the current interest income account; interest accrued in prior calendar years shall be charged against the loan loss provisions account.

(c) Treatment of cash payments, and criteria for cash basis recognition of income. If a loan is on non-accrual and ultimate collection of the entire principal amount is in doubt, then any cash payments received shall be applied only to reduce principal. However, if the balance left on the books after a partial write-off of principal is considered fully collectible, then cash payments may be shown as interest income.

Where recognition of interest income on a cash basis is appropriate, the amount of income that may be shown is limited to the amount that would have been accrued on the book balance at the contractual rate. Any cash payments in excess of this amount (and not applied to the remaining book balance) shall be recorded as recoveries of prior write-offs until all such write-offs have been fully recovered.

In order to claim that a loan is fully recoverable, it must be supported by a current, properly-documented credit analysis, including evaluation of the borrower's historical repayment performance and any other relevant factors.

(d) Restoration to accrual status. A non-accrual loan may only be restored to accrual status when (i) no amount of principal or interest is past due and the bank expects repayment of all remaining contractual principal and interest, or (ii) when it becomes both well-secured and in the process of collection.

For purposes of (i) above, the bank must have received repayment in cash of all delinquent principal and interest unless the loan has been formally restructured and qualifies for accrual status. Until a loan is restored to accrual status, cash payments received shall be handled as required in paragraph (c) above. In addition, if a restructured loan deteriorates and qualifies again for non-accrual status, then the loan must be returned to non-accrual status and treated accordingly.

(e) Treatment of multiple loans to one borrower. If a bank has multiple loans to a single borrower, and one loan meets the criteria for placing on non-accrual status, then the bank shall evaluate every other loan to that borrower and place other loans on non-accrual status if circumstances so require.

3: **Classification of Assets –** All loans and other assets shall be classified into one of the five classification grades listed below based on the criteria provided. A bank may choose to use other classification groups so long as they can be correlated to the regulatory grades. A sample loan classification matrix is provided for reference as Appendix A.

Significant departure from the primary repayment source may justify adverse classification even when a loan is current or supported by apparent collateral value. Classification may also be warranted if the original repayment terms were too liberal or if a delinquency has been technically cured by modification of terms, refinancing, or additional advances.

In cases where different classification grades may be assigned based on subjective criteria, the more severe classification generally should apply. Moreover, nothing contained in the definitions below precludes assigning a more severe grade when analysis of a borrower's financial condition, ability, and willingness to repay justifies the more severe grade.

(a) Pass, or Acceptable. Loans, or other assets, in this category are fully protected by the current sound worth and paying capacity of the obligor or the collateral pledged, are performing in accordance with contractual terms, and are expected to continue doing so.

(b) Special Mention. Loans, or other assets, in this category are currently protected and repayment is not yet jeopardized but exhibit potential weaknesses which, if not corrected, may weaken the asset or the bank's position at some future date. Such loans may be current or may be in payment arrears or past maturity but for periods of less than 90 days. Examples of credit weaknesses include, but are not limited to: inability to properly supervise due to an inadequate loan agreement; deteriorating condition or control of collateral; deteriorating economic conditions or adverse trends in the obligor's financial position which may, if not checked, jeopardize repayment capacity. Risk potential is greater than when the loan was originally granted; but this category should not be used as a compromise between Pass and Substandard.

Any asset which is past due 60 days or more but less than 90 days shall be classified as Special Mention, at a minimum.

(c) Substandard. Loans, or other assets, in this category are not adequately protected by the current sound worth and paying capacity of the obligor. The primary source(s) of repayment is not sufficient to service the debt, and the bank must look to secondary sources such as collateral, sale of fixed assets, refinancing, or additional capital injections for repayment. Substandard assets have well-defined weaknesses that jeopardize the orderly repayment of the debt. These assets may, or may not, be past due but carry more than a normal degree of risk due to the absence of current and satisfactory financial information or inadequate collateral documentation. There is also the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

Any asset which is past due 90 days or more but less than 180 days shall be classified as Substandard, at a minimum.

Renegotiated loans shall continue to be classified Substandard unless (i) all past due interest is paid in cash at the time of renegotiation, and (ii) a sustained record of performance under a realistic repayment program has been maintained for at least six months. A sustained record means that all principal and interest payments are made according to the modified repayment schedule from the renegotiation date.

(d) Doubtful. Loans, or other assets, in this category have all the weaknesses inherent in Substandard assets plus the added characteristic that the assets are not well-secured. These weaknesses make collection in full, on the basis of currently existing facts, conditions, and value, highly questionable and improbable. The possibility of loss is high, but because of important and reasonably specific pending factors which may mitigate, the actual amount of loss cannot be fully determined. Pending factors may include a proposed merger, acquisition, or liquidation, a capital injection, perfecting liens on additional collateral, and refinancing plans. If pending events do not occur within 180 days and repayment must again be deferred pending further developments, a Loss classification is warranted.

Any asset which is past due 180 days or more but less than 360 days shall be classified as Doubtful, at a minimum, unless (i) the asset is well-secured, (ii) legal action has actually commenced, and (iii) the time needed to realize collateral does not exceed one year. Guarantees must be honoured within 90 days of call to preclude a Doubtful classification.

(e) Loss. Loans, or other assets, which are considered uncollectible or of such little value that their continuance as bankable assets are not warranted shall be classified Loss. Loss classification does not mean there is no recovery or salvage value; rather it is not practical or appropriate to defer writing off the asset even though partial recovery may be realized in the future. Losses shall be taken when identified as uncollectible and shall not remain on the books while pursuing long-term recovery efforts.

In some cases, a reduced carrying value for a distressed asset may require a partial write-down. Partial write-downs shall be made by a charge to the provision for loan losses account, and the remaining book value must be supported by tangible facts and reported in writing to the board of directors**.**

Any asset which is past due 360 days or more shall be classified as Loss and written-off against the provisions for loan losses account unless the loan is: (i) well-secured; (ii) legal action has commenced; and (iii) the time to realize collateral is less than one year. Guarantees must be honored within 90 days of call to preclude Loss classification.

Loans classified Loss shall be written off by crediting “loans” and debiting the balance sheet account “provisions for loan losses”. In no event should loan write-offs be taken directly to capital accounts or expensed in the income statement. (In the case of other assets, a credit should be made to the other asset account and a debit to "other operating expense".)

Loan write-offs shall include all interest that is accrued but unpaid. Current period interest which has accrued but is uncollected shall be reversed from the income account. Prior period accrued interest which has already been taken into income shall be written-off by crediting accrued interest and debiting the provisions for loan losses account. Ordinarily, loans classified as Loss and to be written off would have already been placed on nonaccrual for interest with all accrued and unpaid interest reversed from income and credited to the "Interest in Suspense" account.

4: **Provisioning Requirements - (a) Provisions for loan losses account.** All banks shall maintain a provisions for loan losses account (also referred to as "allowance for loan losses) which shall include both specific and general provisions. The provisions account shall be created by charges to provision expense in the income statement and shall be maintained at a level that is adequate to absorb potential losses in the loan portfolio.

At the end of each calendar quarter, or more frequently if warranted, the board of directors shall cause management to evaluate the collectibility of all loans, including any accrued and unpaid interest, and shall require that appropriate entries be made to (i) accurately report earnings, and (ii) ensure that the provision for loan losses account is fully adequate to absorb potential losses. Management must maintain records to support their evaluations and shall make them available for inspection by examiners as requested.

(b) Additions or reductions to provision for loan losses account. Additions to the provisions for loan losses account shall be made through charges to provision expense in the income statement. All loan write-offs shall be debited to the provision for loan losses account, and recoveries on loans previously written-off shall be credited to the same account. At no time shall any loan loss be written off (or recovery credited) directly to "current year profits" or "retained earnings" or to any other capital account.

(c) Specific Provisions for small loans. Banks may comply with the minimum specific provisioning requirements as provided in (d) below for small loans classified as either Substandard, Doubtful or Loss by grouping, or pooling, such loans by classification grade and applying the minimum provisioning percentage to the aggregate balances. The level of specific provisions for such groups of loans should be increased or decreased, as the case may be, not less than quarterly as the aggregate balances of such loan groups change.

For commercial banks, a small loan is deemed to be a loan of K10,000 or smaller. For finance companies, a small loan is deemed to be a loan of K5,000 or smaller.

(d) Provisioning amounts. In determining the potential loss in specific loans, groups of loans, or in the aggregate loan portfolio, all relevant factors shall be considered including, but not limited to: current economic conditions, historical loss experience, delinquency trends, the effectiveness of the bank's lending policies and collection procedures, and the timeliness and accuracy of its loan review function.

The following minimum provisioning amounts are to be maintained:

i) for loans graded **"Pass"** or **"Acceptable"**	1% - General
ii) for loans graded **"Special Mention"**	5% - General
iii) for loans graded **"Substandard"**	25% - Specific
iv) for loans graded **"Doubtful"**	50% - Specific
v) for loans graded **"Loss"**	100% - Specific

If reliable data suggests that loss potential is higher and larger provisions are warranted, then the larger provisions shall be maintained. Correspondingly, if a bank demonstrates to the satisfaction of the Bank that historical loss experience justifies a lower provision amount for the different classes of loans, then the Bank may allow the lower provisions.

The above percentages shall be applied against the gross loan balance for all loans graded Pass, Special Mention and Substandard regardless whether the loan is analysed separately or as part of a pool of loans. For loans graded Doubtful or Loss, the provisioning percentage shall be applied to the net exposure after subtracting the net realisable value of collateral security. Collateral shall be treated as provided in paragraph (e) below. In all cases, suspended interest, if any, shall be deducted first.

Any loan, or portion thereof, fully secured by cash, a segregated deposit in the lending bank, a security issued by Govt., or an unconditional and irrevocable obligation or guaranty by Govt. to repay both principal and interest, is exempt from the provisioning amounts.

Any loan, or portion thereof, which is, or should be, classified "Loss" may be fully provisioned when the classification is, or should have been, assigned and shall be written-off at the end of the current calendar quarter but not later than 90 days after being classified Loss.

(e Treatment of Collateral. Collateral is a secondary source of repayment, and classification grades do not depend on the amount or quality of collateral pledged. Therefore, collateral is only used in determining the amount of provision for loans graded Doubtful or Loss. This is especially true where the validity, value and ability to realize collateral are questionable.

For loans graded Doubtful or Loss, the net realizable value of collateral shall be deducted from the loan balance before applying the provisioning percentages. In the case of real property collateral, the net realizable value may be deducted only if transferability of title is certain and an active market for the property exists. An "active market" means that a willing buyer and willing seller exist and a sale can reasonably be achieved within a period not exceeding one year.

In no event, however, should provisions by the bank for any loan classified Doubtful or Loss, irrespective of the net realizable value of collateral, be less than the amount of provisions required as if the loan were subject to the next higher classification level. For example, provisions for a loan classified as Doubtful must equal or exceed 25% of the gross loan balance; and for a loan classified as Loss, a minimum provision of 50% of the gross loan balance is required.

(f) Examiner review. The board of directors shall maintain adequate records supporting its evaluation of potential loan losses and the entries made to ensure adequacy of the provision for loan losses account. Such records shall be available for examiners to assess management's loss estimation procedures, the reliability of the information on which estimates are based, and the adequacy of the provision for loan losses account. During the course of loan reviews by examiners, whether conducted on-site or off-site, higher levels of provisions with respect to particular loans may be determined appropriate. In such cases, the bank will be advised of the determinations and increases in its specific provisioning will be required. Generally, if the provision for loan losses account is determined to be inadequate by more than 5%, adjusting entries will be required.

5: **Reporting Requirements.** Each bank shall submit to the Bank such returns as the Bank may require and in the form and frequency as the Bank may prescribe.

PART IV: CORRECTIVE MEASURES

1: **Remedial measures and sanctions** - If a bank breaches any provision of this prudential standard in a flagrant manner which results, or threatens to result, in an unsafe or unsound condition, or fails to comply with the instructions and reporting requirements, or if there is risk that the existing capital funds will be impaired and result in a condition that threatens the interests of depositors or the general public, the Bank may pursue appropriate corrective actions and sanctions by imposing or varying conditions on the bank's licence as provided in Section 14 of the Act.

Such conditions imposed on a bank's licence under Section 14 may include, but are not limited to, the following –

a) Require the bank to take certain steps or to refrain from adopting or pursuing a particular course of action or to restrict the scope of its business in a particular way, including a prohibition from engaging in any further foreign exchange activities for a specified period of time;
b) Impose limitations on the acceptance of deposits, the borrowing of money, the granting of credit or the making of investments;
c) Prohibit the bank from soliciting deposits, either generally or from persons who are not already depositors;
d) Prohibit the bank from entering into any other transaction or class of transactions;
e) Suspend access to the credit facilities of the Bank; or
f) Suspend or require the removal of any directors, managers or chief executives.

PART V: EFFECTIVE DATE

1: **Effective date** - The effective date of this prudential standard shall be **1st October 2003**.

2: **Supersedence** - This prudential standard supersedes and replaces Prudential Standard 1/2000 which was effective in September 2000.

Questions relating to this prudential standard should be addressed to The Manager, Financial System Supervision Department, Bank of PNG, Tel: 322-7200.

LOAN CLASSIFICATION (RATING) MATRIX APPENDIX A

A combined assessment of financial condition and repayment history of a borrower should be used to arrive at an initial classification grade for a loan. Adjustments to the initial grade should then be made based on mitigating or unique circumstances. The Loan Classification Matrix below provides criteria for assigning a preliminary classification grade.

LOAN CLASSIFICATION MATRIX			
	Repayment History		
Financial Condition	***Strong***	***Fair***	***Unsatisfactory***
Strong	Pass	Special Mention	Substandard
Satisfactory	Special Mention	Substandard	Substandard
Fair	Substandard	Substandard	Doubtful
Marginal	Substandard	Doubtful	Loss
Unsatisfactory	Doubtful	Loss	Loss

Definitions: The definitions below are used in the Matrix above.

FINANCIAL CONDITION	
Strong.................................	Borrower's financial condition is of highest quality; normal indicators of financial health show that borrower is clearly able to repay both principal and interest according to original terms of loan agreement.
Satisfactory.........................	Borrower is financially stable but various aspects exist regarding the financial condition of the borrower that are less than first-rate, though generally minor in nature.
Fair.....................................	Borrower is financial stable but various unsatisfactory aspects exist regarding the financial condition of the borrower, some of which may be significant.
Marginal.............................	Borrower is financially unstable and significant unsatisfactory aspects exist regarding the financial condition of the borrower.
Unsatisfactory.....................	Borrower's financial condition is highly unsatisfactory; it is likely that liquidation or other formal insolvency proceedings have begun or will commence shortly.

REPAYMENT HISTORY	
Strong................................	Interest and principal are current (i.e., not past due) and there is no evidence that the current loan balance includes any capitalized amounts of either principal or interest from previous loan roll-overs. A grace period of no more than 7 days may be allowed before payments are considered past due to allow for administrative errors on the part of borrower or the bank.
Fair.....................................	Interest or principal has historically been past due for more than 7 days but less than 30 days, or there is evidence of interest or principal capitalization.
Unsatisfactory....................	Interest or principal has been past due for more than 30 days, or there is evidence of equivalent rescheduling of payments or capitalization of interest.