

**Banking Regulation & Policy Department
Bangladesh Bank
Head Office
Dhaka**

September 23, 2012

BRPD Circular No. 14

Date: _____
Ashwin 8, 1419

**Chief Executives
All Scheduled Banks in Bangladesh**

Dear Sir,

Master Circular: Loan Classification and Provisioning

Please refer to BRPD Circular No.07 dated June 14, 2012 and attached CL formats on the captioned subject. Considering difficulties reported by banks and the business community, certain instructions of the circular have been reviewed; revised circular with the modifications is issued hereunder.

Bangladesh Bank has, over the last several years, positioned the banks on a path towards higher regulatory capital ratios and a more precise calculation of each individual bank's need for capital, through a gradual implementation of internationally recognized capital standards. The enforcement of a stricter regulatory capital regime also requires measures to improve the accuracy of financial data which are used internally, stated in the audited financial statements and reported to Bangladesh Bank as per rules. For both the bank's managerial and Bangladesh Bank's supervisory purposes, as well as for accurate valuation of a bank's capital in all of its financial reports is necessary.

An accurate valuation of capital relies, in turn, on an accurate valuation of assets. Loan-loss provisioning – the recognition that some or all of the required payments on a loan may never be made – is the single most important aspect of asset valuation to bankers and bank supervisors. It is important because loans typically make up 50% or more of the total assets of the bank. Basel II and Basel III devote a great deal of attention to the distinction between “expected losses” and “unexpected losses” on the bank's loan portfolio. The purpose of provisioning is to take into account expected losses. Expected losses can be assigned to loans based on a loan classification system, which has been utilized in Bangladesh for many years and is being updated with this circular.

Bangladesh Bank also wishes to stress that it is the responsibility of bank management to adopt and implement proper accounting and reporting, and that correct classification and provisioning is a part of that responsibility. Loan classification and provisioning must be a key component of a regular internal loan review process that looks at the current likelihood that the borrower will repay. The value of the formed allowance that results from the provisioning process should reflect all expected losses resulting from credit exposures.

Bangladesh Bank has established requirements for general loan loss provisions, in certain percentages, for certain categories of loans that are unclassified or in the Special Mention Account. As the name suggests, general provisions are assigned to take into account the expected losses on pools of loans that are thought to have similar characteristics. The characteristics of each individual loan are not analyzed. Put differently, it is not known or even assumed which loan or loans in the pool are going to result in loan losses; it is simply taken as given that in such large pools, even those currently unclassified, there will undoubtedly be individual loans that in the future will not be repaid. Ideally, the percentages of provision that are applied to each pool are determined based on historical loss experience of similar loan pools. Banks are encouraged to calculate these historical loss experiences on the loan pools for which Bangladesh Bank has indicated general provision percentages, and use these data if they result in higher provisions than are required in this circular. Because general provisions are not formed based on expectations of loss on any individual loan, they are allowed to be included in the calculation of Tier 2 capital, subject to some restrictions. In contrast, specific provisions (established on loans that are classified as Sub-standard, Doubtful or Bad/Loss) are set up on a loan-by-loan basis after careful analysis of each individual loan's probability of repayment. For loans placed into any of these classification categories, weaknesses have been identified that cast doubt on the borrower's ability or intent to make all contractual payments in a timely manner. For this reason, specific provisions are not allowed to be included in the calculation of Tier 2 capital.

1. Categories of Loans and Advances :

All loans and advances will be grouped into four (4) categories for the purpose of classification, namely- (a) Continuous Loan (b) Demand Loan (c) Fixed Term Loan and (d) Short-term Agricultural & Micro- Credit.

a) Continuous Loan: The loan accounts in which transactions may be made within certain limit and have an expiry date for full adjustment will be treated as Continuous Loan. Examples are: Cash Credit, Overdraft, etc.

b) Demand Loan: The loans that become repayable on demand by the bank will be treated as Demand Loan. If any contingent or any other liabilities are turned to forced loan (i.e. without any prior approval as regular loan) those too will be treated as Demand Loan. Such as: Forced Loan against Imported Merchandise, Payment against Document, Foreign Bill Purchased, and Inland Bill Purchased, etc.

c) Fixed Term Loan: The loans, which are repayable within a specific time period under a specific repayment schedule, will be treated as Fixed Term Loan.

d) Short-term Agricultural & Micro-Credit: Short-term Agricultural Credit will include the short-term credits as listed under the Annual Credit Programme issued by the Agricultural Credit and Financial Inclusion Department (ACFID) of Bangladesh Bank. Credits in the agricultural sector repayable within 12 (twelve) months will also be included herein. Short-term Micro-Credit will include any micro-credits not exceeding an amount determined by the ACFID of Bangladesh Bank from time to time and repayable within 12 (twelve) months, be those termed in any names such as Non-agricultural credit, Self-reliant Credit, Weaver's Credit or Bank's individual project credit.

2. Basis for Loan Classification:

a) Objective Criteria:

(1) Past Due/Over Due:

(i) Any Continuous Loan if not repaid/renewed within the fixed expiry date for repayment or after the demand by the bank will be treated as past due/overdue from the following day of the expiry date.

(ii) Any Demand Loan if not repaid within the fixed expiry date for repayment or after the demand by the bank will be treated as past due/overdue from the following day of the expiry date.

(iii) In case of any installment(s) or part of installment(s) of a Fixed Term Loan is not repaid within the fixed expiry date, the amount of unpaid installment(s) will be treated as past due/overdue from the following day of the expiry date.

(iv) The Short-term Agricultural and Micro-Credit if not repaid within the fixed expiry date for repayment will be considered past due/overdue after six months of the expiry date.

(2) All unclassified loans other than Special Mention Account (SMA) will be treated as Standard.

(3) A Continuous loan, Demand loan or a Term Loan which will remain overdue for a period of 02 (two) months or more, will be put into the "Special Mention Account(SMA)". This will help banks to look at accounts with potential problems in a focused manner and it will capture early warning signals for accounts showing first sign of weakness. Loans in the "Special Mention Account (SMA)" will have to be reported to the Credit Information Bureau (CIB) of Bangladesh Bank.

(4) Loans except Short-term Agricultural & Micro-Credit in the "Special Mention Account" and "Sub-Standard" will not be treated as defaulted loan for the purpose of section 27KaKa(3) [read with section 5(GaGa)] of the Banking Companies Act, 1991.

(5) Any continuous loan will be classified as:

- i. *'Sub-standard'* if it is past due/overdue for 03 (three) months or beyond but less than 06 (six) months.
- ii. *'Doubtful'* if it is past due/overdue for 06 (six) months or beyond but less than 09 (nine) months
- iii. *'Bad/Loss'* if it is past due/overdue for 09 (nine) months or beyond.

(6) Any Demand Loan will be classified as:

- i. *'Sub-standard'* if it remains past due/overdue for 03 (three) months or beyond but not over 06 (six) months from the date of expiry or claim by the bank or from the date of creation of forced loan.
- ii. *'Doubtful'* if it remains past due/overdue for 06 (six) months or beyond but not over 09 (nine) months from the date of expiry or claim by the bank or from the date of creation of forced loan.
- iii. *'Bad/Loss'* if it remains past due/overdue for 09 (nine) months or beyond from the date of expiry or claim by the bank or from the date of creation of forced loan.

(7) In case of any installment(s) or part of installment(s) of a Fixed Term Loan is not repaid within the due date, the amount of unpaid installment(s) will be termed as 'past due or overdue installment'. In case of Fixed Term Loans: -

- i. If the amount of past due installment is equal to or more than the amount of installment(s) due within 03 (three) months, the entire loan will be classified as "Sub-standard".
- ii. If the amount of past due installment is equal to or more than the amount of installment(s) due within 06 (six) months, the entire loan will be classified as "Doubtful".
- iii. If the amount of 'past due installment is equal to or more than the amount of installment(s) due within 09 (nine) months, the entire loan will be classified as "Bad/Loss".

Explanation: If any Fixed Term Loan is repayable on monthly installment basis, the amount of installment(s) due within 06 (six) months will be equal to the sum of 06 monthly installments. Similarly, if the loan is repayable on quarterly installment basis, the amount of installment(s) due within 06 (six) months will be equal to the sum of 2 quarterly installments.

(8) The Short-term Agricultural and Micro-Credit will be considered irregular if not repaid within the due date as stipulated in the loan agreement. If the said irregular status continues, the credit will be classified as 'Substandard' after a period of 12 months, as 'Doubtful' after a period of 36 months and as 'Bad/Loss' after a period of 60 months from the stipulated due date as per the loan agreement.

b) Qualitative Judgement:

If any uncertainty or doubt arises in respect of recovery of any Continuous Loan, Demand Loan or Fixed Term Loan, the same will have to be classified on the basis of qualitative judgement be it classifiable or not on the basis of objective criteria. If any situational changes occur in the stipulations in terms of which the loan was extended or if the capital of the borrower is impaired due to adverse conditions or if the value of the collateral decreases or if the recovery of the loan becomes uncertain due to any other unfavourable situation, the loan will have to be classified on the basis of qualitative judgement .

Despite the probability of any loan being affected due to the reasons stated above or for any other reasons, if there is any hope for change of the existing condition by resorting to proper steps, the loan, on the basis of qualitative judgement, will be classified as 'Sub-standard '. But even after resorting to proper steps, there exists no certainty of total recovery of the loan, it will be classified as ' Doubtful ' and even after exerting the all-out efforts, there exists no chance of recovery, it will be classified as ' Bad/Loss ' on the basis of qualitative judgement.

For incorporating qualitative judgment, banks must focus on the likelihood that the borrower will repay all amounts due in a timely manner, using their own judgment and the following assessment factors:

(1) Special Mention

i. Assets must be classified no higher than Special Mention if any of the following deficiencies of bank management is present: 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.

ii. Assets must be classified no higher than Special Mention if any of the following deficiencies of the obligor is present: occasional overdrawn within the past year, below-average or declining profitability; barely acceptable liquidity; problems in strategic planning.

(2) Sub-standard

i. Assets must be classified no higher than Sub-standard if any of the following deficiencies of the obligor is present: recurrent overdrawn, low account turnover, competitive difficulties, location in a volatile industry with an acute drop in demand; very low profitability that is also declining; inadequate liquidity; cash flow less than repayment of principal and interest; weak management; doubts about integrity of management; conflict in corporate governance; unjustifiable lack of external audit; pending litigation of a significant nature.

ii. Assets must be classified no higher than Sub-standard if the primary sources of repayment are insufficient to service the debt and the bank must look to secondary sources of repayment, including collateral.

iii. Assets must be classified no higher than Sub-standard if the banking organization has acquired the asset without the types of adequate documentation of the obligor's net worth, profitability, liquidity, and cash flow that are required in the banking organization's lending policy, or there are doubts about the validity of that documentation.

(3) Doubtful

Assets must be classified no higher than Doubtful if any of the following deficiencies of the obligor is present: permanent overdrawn; location in an industry with poor aggregate earnings or loss of markets; serious competitive problems; failure of key products; operational losses; illiquidity, including the necessity to sell assets to meet operating expenses; cash flow less than required interest payments; very poor management; non-cooperative or hostile management; serious doubts of the integrity of management; doubts about true ownership; complete absence of faith in financial statements.

(4) Bad/Loss

Assets must be classified no higher than Bad/Loss if any of the following deficiencies of the obligor are present: the obligor seeks new loans to finance operational losses; location in an industry that is disappearing; location in the bottom quartile of its industry in terms of profitability; technological obsolescence; very high losses; asset sales at a loss to meet operational expenses; cash flow less than production costs; no repayment source except liquidation; presence of money laundering, fraud, embezzlement, or other criminal activity; no further support by owners.

c) Improvement in Classification:

From time to time, in the judgment of the bank, the condition of a loan may improve and it may be justified to move it to a more favorable classification category. The decision to move a loan to a more favorable classification category must be accompanied by analysis showing that there has been improvement in the payment performance of the loan and/or in the financial condition of the borrower. The decision to move a loan from Bad/Loss to Doubtful or Substandard, or from Doubtful to Substandard, may, with appropriate justification, be taken by the Chief Credit Officer, with the concurrence of the Chief Financial Officer. The decision to move a loan from Substandard, Doubtful, or Bad/Loss to Special Mention Account or to declassify it completely must be taken by the Board of Directors, with appropriate justification presented by the branch manager who originated the loan in question and the Managing Director.

A bank may request the concerned Department of Banking Inspection of Bangladesh Bank to review the classification of any loan for which there is a disagreement on classification that is not resolved during the on-site inspection. Bangladesh Bank will respond to the bank within 15 days of receiving such request. However, in any case where there is a lingering disagreement between the classification determined by bank management and the classification determined by Bangladesh Bank, the judgment of Bangladesh Bank will prevail. Any loan classified during Bangladesh Bank's on-site inspection on the basis of qualitative judgement cannot be declassified without the consent of Bangladesh Bank.

3. Accounting of the Interest of Classified Loans:

If any loan or advance is classified as 'Sub-standard' and 'Doubtful', interest accrued on such loan will be credited to Interest Suspense Account, instead of crediting the same to Income Account. In case of rescheduled loans the unrealized interest, if any, will be credited to Interest Suspense Account, instead of crediting the same to Income Account.

As soon as any loan or advance is classified as 'Bad/Loss', charging of interest in the same account will cease. In case of filing a law-suit for recovery of such loan, interest for the period till filing of the suit can be charged in the loan account in order to file the same for the amount of principal plus interest. But interest thus charged in the loan account has to be preserved in the 'Interest Suspense' account. If any interest is charged on any 'Bad/Loss' account for any other special reason, the same will be preserved in the 'Interest Suspense' account. If classified loan or part of it is recovered i.e., real deposit is effected in the loan account, first the interest charged and accrued but not charged is to be recovered from the said deposit and the principal to be adjusted afterwards.

4. Maintenance of Provision:

a) General Provision: Banks will be required to maintain General Provision in the following way :

(1) @ 0.25% against all unclassified loans of Small and Medium Enterprise (SME) as defined by the SME & Special Programmes Department of Bangladesh Bank from time to time and @ 1% against all unclassified loans (other than loans under Consumer Financing, Loans to Brokerage House, Merchant Banks, Stock dealers etc., Special Mention Account as well as SME Financing.)

(2) @ 5% on the unclassified amount for Consumer Financing whereas it has to be maintained @ 2% on the unclassified amount for (i) Housing Finance and (ii) Loans for Professionals to set up business under Consumer Financing Scheme.

(3) @ 2% on the unclassified amount for Loans to Brokerage House, Merchant Banks, Stock dealers, etc.

(4) @ 5% on the outstanding amount of loans kept in the 'Special Mention Account'.

(5) @1% on the off-balance sheet exposures. (Provision will be on the total exposure and amount of cash margin or value of eligible collateral will not be deducted while computing Off-balance sheet exposure.)

b) Specific Provision: Banks will maintain provision at the following rates in respect of classified Continuous, Demand and Fixed Term Loans:

(1) Sub-standard : 20%

(2) Doubtful : 50%

(3) Bad/Loss : 100%

c) Provision for Short-term Agricultural and Micro-Credits:

- (1) All credits except 'Bad/Loss' (i.e. 'Doubtful', 'Sub-standard', irregular and regular credit accounts) : 5%
- (2) 'Bad/Loss' : 100%

5. Provisions to Cover All Expected Losses:

The expressed minimum percentages of provisions in Paragraph 4 for exposures in each classification category are absolute minimums, and banks are encouraged to set aside higher provisions if expected losses on the loan pools (for general provisions) or individual loans (for specific provisions) warrant.

6. Base for Provision:

For eligible collaterals of the following types, provision will be maintained at the stated rates in Para 4 on the outstanding balance of the classified loans less the amount of Interest Suspense and the value of eligible collateral:

- a. Deposit with the same bank under lien against the loan,
- b. Government bond/savings certificate under lien,
- c. Guarantee given by Government or Bangladesh Bank.

For all other eligible collaterals, the provision will be maintained at the stated rates in Para 4 on the balance calculated as the greater of the following two amounts:

- i. outstanding balance of the classified loan less the amount of Interest Suspense and the value of eligible collateral; and
- ii. 15% of the outstanding balance of the loan.

However, the base for provision shall be further reviewed towards closer convergence with international best practice standards.

7. Eligible Collateral :

In the definition of 'Eligible Collateral' as mentioned in the above paragraph the following collateral will be included as eligible collateral in determining base for provision:

- 100% of deposit under lien against the loan
- 100% of the value of government bond/savings certificate under lien
- 100% of the value of guarantee given by Government or Bangladesh Bank
- 100% of the market value of gold or gold ornaments pledged with the bank.
- 50% of the market value of easily marketable commodities kept under control of the bank
- Maximum 50% of the market value of land and building mortgaged with the bank
- 50% of the average market value for last 06 months or 50% of the face value, whichever is less, of the shares traded in stock exchange.

Determination of Market Value of Eligible Collateral :

In determining market value of easily marketable commodities, land and building, banks are advised to follow the instructions mentioned below:

(a) Easily marketable goods will mean pledged, easily encashable/saleable goods that remain under full control of the bank. However, while the concerned bank branch official will conduct periodic inspection to verify as to whether requirements have been met such as the suitability of goods for use, expiry period, appropriateness of documentary evidences, and up to date insurance cover, the same will have to be assessed by the professional assessor from time to time.

(b) For land and building, banks will have to ensure whether title documents are in order and concerned land and building will have to be valued by the professional valuation firm along with completion of proper documentation in favour of the bank. In the absence of a professional valuation firm, a certificate in favour of such valuation will have to be collected from a specialized engineer. Nevertheless, temporary houses including tin-shed structure shall not be shown as building.

(c) In order to facilitate the on-site inspection by Bangladesh Bank's Department of Banking Inspection, banks are also advised to maintain a complete statement of eligible collateral on a separate sheet in the concerned loan file. Information such as a description of eligible collateral, their assessment by a recognized firm, marketability of the commodity, control of the bank, and reasons for considering eligible collateral etc. will have to be included in that sheet.

8. In terms of the above policies, the banks will conduct their classification- activities on quarterly basis. These activities must include periodic revaluations of collateral, no less frequently than one year for movables and no less frequently than three years for immovables. The classification of each individual loan must be justified in writing and the documentation must contain the signatures of both the persons assigning the classification and the person reviewing it. These written justifications must be maintained in the loan files and be available for viewing by the Bangladesh Bank inspection teams. In this connection revised forms for loan classification, provisioning and interest suspense i.e CL-1 to CL-5 have been enclosed herewith which will replace the existing ones.

- (i) CL-1 is the compilation/summary of 4 other forms. This form is for showing summary of classification status for different loan categories mentioned earlier along with staff loan.
- (ii) CL-2 is for reporting loan classification of Continuous Loan
- (iii) CL-3 is for reporting loan classification of Demand Loan
- (iv) CL-4 is for reporting loan classification of Term Loan
- (v) CL-5 is for reporting loan classification of Short-term Agricultural and Micro-Credit.

Bank branches shall send the completed forms (CL-1 to CL-5) to their Head Office. The Head Offices of banks should make arrangements for scrutiny of all the forms prepared by the branches. Where necessary, they should carry out corrections and ensure maintenance of the corrected forms in the records of the branch. After scrutiny of all forms (CL-1, CL-2, CL-3, CL-4 and CL-5) prepared by branches and being satisfied with the results, they should prepare a consolidated position of classification, provisions and interest suspense using form CL-1 and send the same to the Banking Regulation and Policy Department of Bangladesh Bank and upload in Enterprise Data Warehouse (EDW) of Bangladesh Bank. Banks are also advised to preserve the CL statements in both their Head Offices and branches for inspection by the Bangladesh Bank inspection team.

9. Banks having Offshore Banking Unit (OBU) will report to Bangladesh Bank in similar way in a separate CL-1 named OBU SUMMARY OF LOAN CLASSIFICATION AND PROVISION (enclosed herewith). In this regard, concerned banks will prepare and send data on OBU transactions for A, B and C type in separate worksheets along with the consolidated statement through the said separate CL-1 named OBU SUMMARY OF LOAN CLASSIFICATION AND PROVISION to the Banking Regulation and Policy Department and Credit Information Bureau (CIB) of Bangladesh Bank.

10. Banks are advised to submit detailed statements through CL-1 in respect of classification, provision and interest suspense accounts within 25 days from the reference date and ensure correct and timely submission of CL-1 failing to which penalty may be imposed on the concerned non compliant bank.

11. Audited financial statements of banks for year ending 2012 will have to be drawn up in full compliance with instructions laid out in this revised circular. The position of classification and provisioning (Consolidated CL-1 format) as of quarter ending September 30, 2012 will have to be submitted by October 31, 2012 for Bangladesh Bank's review.

Instructions of BRPD Circular No. 07 dated June 14, 2012 hereby stand superseded by this circular.

Please acknowledge receipt.

Yours sincerely,

(Md. Anwarul Islam)
Deputy General Manager
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