Islamic Republic of Afghanistan
Da Afghanistan Bank

BANKING REGULATIONS

Article Three: Asset Classifications, Monitoring of Problem Assets, Reserve for losses, 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 Law of Banking in Afghanistan (Banking Law).

§ 3.1.2. Definitions.

a) *Adversely-classified asset* – an asset or off-balance sheet item that has been classified as substandard, doubtful, or loss.

b) *Assets subject to classification and reserve for losses* -- claims on financial institutions, loans to non-financial institutions and other clients, unused commitments, commercial letters of credit, standby letters of credit, and other guarantees and credit substitutes. For permitted branches of foreign banks, only assets arising from transactions with unrelated parties and related non-depository institutions are subject to classification. Individual assets arising from transactions with related depository institutions, such as the home office or other branches of the same bank, are not subject to classification; nor is the calculated "net due from related depository institutions and head office" subject to classification.

c) *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 that the borrower will pay the full amount of the accumulated principal at a later date. The effect of capitalizing interest is that the borrower ends up paying interest on the accumulated (but unpaid) interest.

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d) *Fully secured* – a certain principal amount of credit is considered fully secured if all of the following characteristics are met and documented: the initial market value of the collateral is ascertained and recorded; the debtor has rights in the collateral; the debtor has authenticated a security agreement that contains a description of the collateral or the bank has possession of the collateral; a financing statement that contains the name of the debtor, the name of the bank, and the collateral to be covered has been filed in the appropriate jurisdiction according to the applicable laws of Afghanistan; no other secured creditor has a prior claim to the same collateral; and the collateral has a current market value equal to 100 percent or more of the principal amount of credit in question.

e) *In the process of collection* - collection of a debt is proceeding in due course either (1) through legal action against the borrower, including judgment enforcement procedures, or (2) in appropriate circumstances, through collection efforts not involving legal action, and 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.

f) *Nonperforming asset* -- a loan or other asset on which principal or interest is due and unpaid for 91 days or more or has been put on non-accrual status, or interest payments equal to 91 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:

i) the amount advanced exceeds the customer's approved borrowing line for 91 consecutive days or more;

ii) interest is due and unpaid for 91 days or more; or

iii) the account has been inactive for 91 days and the customer's deposits are insufficient to cover the interest capitalized during that period.

g) *Past due asset* – a loan or other asset on which:

i) principal or interest payments are due and unpaid for 31 to 90 days; or

ii) interest payments equal to a sum of 31 to 90 days interest or more have been capitalized, refinanced, or prolonged.

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

iii) the amount advanced exceeds the customer's approved borrowing line for 31-90 consecutive days;

iv) interest is due and unpaid for 31-90 days; or

v) the account has been inactive for 31-90 days and the customer's deposits are insufficient to cover the interest capitalized during that period.

h) *Provision for losses* – an item of expense that is debited in order to increase the reserve for losses.

i) *Readily marketable collateral* – to be considered readily marketable, the collateral must be salable under ordinary market conditions with reasonable promptness at a fair market value determined by quotations based upon actual transactions on an auction or similarly available daily bid and ask price market. Only the following types of collateral that meet the above characteristics are eligible to be considered readily marketable for the purposes of this regulation:

i) Currency, if it is in the possession of the lending bank and provided that the currency is either afghani or another currency that is denominated in the same currency as the principal amount of credit in question and freely convertible to afghani and issued by the monetary authority of a Category A country;
ii) Deposits by the obligor in the lending bank, if the deposit is denominated in the same currency as the principal amount of credit in question and, when the deposit is eligible for withdrawal before the secured amount matures, the bank has established internal procedures to prevent release of the security.
iii) Securities issued or unconditionally guaranteed by central governments or central banks;
iv) Securities issued by or guaranteed by multilateral lending institutions or global or regional development institutions subject to the prior approval of DAB.
v) Securities and other financial instruments issued by other parties that carry an investment grade rating by at least two internationally-recognized rating agencies.
vi) An unconditional guarantee, in writing, of the principal amount of the credit plus accrued interest, if any, by an international financial institution, multilateral development agency, central government agency of a Category A country, or bank licensed by a financial sector regulatory authority in a Category A country. In the case of an Afghanistan branch of a foreign bank, the home office may provide the guarantee, even if it is not licensed in a Category A country. In the case of an Afghanistan subsidiary of a foreign bank, the parent bank may provide the guarantee, even if it is not licensed in a Category A country. If the guarantee is provided by the home office or the parent bank, the guarantee must provide, in the event of default by the obligor, for the contribution of assets to the banking organization in Afghanistan that are considered by DAB to be assets resulting from transactions involving unrelated parties and related non-depository institutions. That is, the assets contributed must increase (in the case of a foreign branch) the net due to the home office and other branches of the same bank, or (in the case of a subsidiary) the capital of the subsidiary. The assets to be contributed must be assets that are

permissible for a banking organization licensed or permitted in Afghanistan to hold.

j) *Reserve for losses* – a contra asset account that is intended to absorb estimated losses in the bank's portfolio of assets subject to classification and reserve, or a liability account that is intended to absorb estimated losses in off-balance sheet items subject to classification and reserve.

§ 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 provision for losses to be deducted as an expense item in calculating profit.

b) The objectives of this regulation:
   1. Banks are encouraged to form a general reserve for losses on standard loans to non-financial institutions and other clients.
   2. Banks must form a specific reserve for losses on watch, substandard, and doubtful assets.
   3. Banks must immediately charge off assets classified loss.
   4. Reserve for losses must be formed in sufficient amounts, based on the classification process and other relevant information.
   5. Objective and subjective criteria for asset classification must be defined.

c) Based on the results of supervision, DAB can require banks to adjust its asset classification as well as its reserve for losses in accordance with Part B herein.

d) The following procedures apply to all assets subject to classification and reserve for losses.

e) Other assets that can experience a decline in value are not classified, but banking organizations must follow prudent valuation rules issued in other regulations and policy statements of DAB. These assets include claims on securities repurchase agreements, trading account assets, investment account assets, repossessed assets, investments in unconsolidated subsidiaries and other associated companies, accounts receivable, intangible assets, and premises and other fixed assets. ***This last paragraph requires discussion – how can we apply the classification rules to other types of assets? Should we simply insist on prudent valuation (to be spelled out in other***

regulations or policy statements) or is there additional value in putting them in a classification category?

Part B — Asset Classifications

§ 3.2.1. Asset classifications-General.

a). On a quarterly basis, all banks must self-classify each of their assets subject to classification and reserve for losses within one of the five categories set forth below. These self-classifications must be documented, with justifications given for the classifications, in the bank's files, and the classification documents must be signed by the individual responsible for performing the classifications and the individual responsible for reviewing their accuracy.

b). In making the decision to classify an asset within one of the five classification categories listed below, a bank shall use its informed judgment but must be guided by the standards and components set forth below with respect to each such category.

c). Self-classifications of assets by banks shall be subject to review by 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, profitability, liquidity, and cash flow of the obligor. The obligor's management is highly regarded, and the obligor is a strong competitor in a stable industry and has ready access to alternative financing. Standard assets are sufficiently secured with respect to the repayment of both the principal amount and interest.

ii. Watch – An asset classified as Watch 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.

1. Assets must be classified no higher than Watch if any of the following deficiencies of bank management are present: 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.
2. Assets must be classified no higher than Watch if any of the following deficiencies of the obligor are present: occasional overdrafts within the past year, below-average or declining

profitability; barely acceptable liquidity; problems in strategic planning.

3. Assets that are past due 31-60 days for principal or interest payments must be classified no higher than Watch.

Under no circumstances should a Watch classification be utilized as a compromise between 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.

1. Assets must be classified no higher than Substandard if any of the following deficiencies of the obligor are present: recurrent overdrafts, 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.
2. Assets must be classified no higher than Substandard if the primary sources of repayment are insufficient to service the debt and the bank must look to secondary sources of repayment, including collateral.
3. Assets must be classified no higher than Substandard 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.
4. Assets that are past due 61-90 days for principal or interest payments must be classified no higher than Substandard.

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.

1. Assets must be classified no higher than Doubtful if any of the following deficiencies of the obligor are present: permanent overdrafts; 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; uncooperative or hostile management; serious doubts of the integrity of management; doubts about true ownership; complete absence of faith in financial statements
2. Assets that are past due by 91-180 days for principal or interest payments must be classified no higher than Doubtful.

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.

1. Assets must be classified no higher than 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; cashflow less than production costs; no repayment source except liquidation; presence of money laundering, fraud, embezzlement, or other criminal activity; no further support by owners.
2. Assets that are past due by 181 days or more for principal or interest payments must be classified no higher than Loss.

Asset classification criteria are summarized below:

Asset classification	**Objective criteria**	**Reserve for loss required**
Standard	A performing asset which is being repaid in accordance with the contract.	None; general loss reserve encouraged on loans to NFIs and other clients
Watch	31- 60 days past due status (most favorable classification – could be lower	5 percent

	based on subjective criteria)	
Substandard	61 to 90 days past due status (most favorable classification – could be lower based on subjective criteria)	25 percent
Doubtful	91 to 180 days past due status (most favorable classification – could be lower based on subjective criteria)	50 percent
Loss	181 days or more past due status	Immediate chargeoff against the reserve for losses

§ 3.2.2. Asset classifications – treatment of collateral.

A loan that is secured by collateral is classified as follows:

a) the portion of the outstanding balance that is equal to or greater than the market value of the collateral (as determined in accordance with International Valuation Standards and International Accounting Standards) is classified in the category that is one category higher than the combination of objective/subjective criteria would imply;

b) the remaining portion of the outstanding balance, if any, is classified in the category consistent with the combination of objective/subjective criteria used for that category.

c) If all or a portion of the outstanding balance is fully secured by readily-marketable collateral, that portion may be classified as Standard, and the remaining portion is classified in the category consistent with the combination of objective/subjective criteria used for that category.

§ 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 unused loan commitments, commercial letters of credit, standby letters of credit, and other guarantees and credit substitutes).

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 reserve for losses on off-balance sheet items, which is reported as an "other liability" rather than as a contra-asset, must adequately reflect the associated risks.

Part C — Provisioning, Adjustment of Classifications, Interest Accruals, Capitalization of Interest

§ 3.3.1. Provisioning.

a) Banks must make provisions for losses and establish reserves for losses in the minimum amounts as set forth in this Regulation. Banking organizations may establish reserves in amounts higher than the minimums required, if the facts warrant. The classification of assets and the concomitant determination of the sufficiency of the reserve must be reviewed not less than quarterly.

b) All adjustments to classifications and the reserve for losses, and all accrued provisions and reintegrated provisions necessary to make these adjustments to the reserve, must be made in the same reporting period. In no case shall a bank adjust its classifications during one period (month or quarter) and make the necessary provisions in a subsequent period.

c) The amount of the reserve must be based on facts and circumstances as of the evaluation date, and after charge-off of all assets or portions of assets classified Loss.

d) For standard loans to non-financial institutions and other clients, banking organizations are encouraged, but not required, to form a general reserve for losses. The size of this general reserve, which is includable as a component of Tier 2 capital in the calculation of regulatory capital (subject to certain limitations), should be based on a methodical prediction (making reference to past experience with similar kinds of loans) of the percentage of existing standard loans that will ultimately result in a chargeoff. The general reserve is formed in the same manner as the specific reserve on non-standard loans; that is, via a credit to the reserve on the balance sheet and a debit to accrued provisions on the profit-and-loss statement.

e) For substandard and doubtful assets, all estimated losses over the remaining life of the asset must be included in the bank's reserve, even if that results in higher reserves than the minimum percentages outlined in the matrix in §3.2.1 above.

f) Assets classified Loss must be charged off (via a credit to the asset balance on the balance sheet), and the reserve for losses reduced (via a debit) immediately upon determination of Loss status.

g) A banking organization must continue to make reasonable efforts to collect on assets that are charged off. The act of charging off does not eliminate the obligor's responsibility to fully repay the principal balance and accrued but unpaid interest on the asset.

h) Any new loan to a given borrower must be initially classified under the same category as the most adversely-classified previous loan to the same borrower, unless it is fully secured by readily-marketable collateral.

i) A bank may move an asset to a more favorable classification category, and reintegrate the provision and reduce the reserve for losses, only if the bank can satisfactorily demonstrate that the asset's quality has improved significantly, and an explicit, written decision of the bank's Credit Committee outlining the justifications for the more favorable classification is placed in the asset's file.

§ 3.3.2. Interest accruals.

a) A bank must accrue interest on interest-earning assets on a monthly basis if the frequency of actual payment by the obligor is less than monthly.

b) Banks must suspend the accrual of interest on all interest-earning assets where principal or interest payments have been past due for periods exceeding 90 days. The loan is then placed on "non-accrual status," and interest income will be recognized only upon payment in cash. The only exception to this rule is when such an asset is both well-secured and in process of collection.

c) Banks may place an asset on non-accrual status where principal or interest payments have been past due for periods of 90 days or less, if there has been a deterioration in the financial condition of the borrower.

d) When an asset is placed on non-accrual status, all accrued but unpaid interest must be reversed via a debit to interest income and a credit to accrued interest.

e) Banks may restore a non-accrual asset to accrual status only on full repayment of all past-due principal and interest.

§ 3.3.3 Capitalization of Interest.

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.

Part D — Monitoring of adversely-classified, past-due, and non-performing assets

§ 3.4.1. Mandatory monitoring of adversely-classified, past-due, and non-performing assets.

A banking organization must strictly monitor and keep accurate records of its adversely-classified, past-due, and non-performing assets, in the aggregate and by type of asset, and submit to its Board of Supervisors (or, for a permitted branch of a foreign bank, to the next-higher level of authority outside of Afghanistan) for each of their regularly-scheduled meetings, and anytime upon their request, detailed information and analysis concerning these trends.

§ 3.4.2. Mandatory monitoring of chargeoffs.

A banking organization must also monitor and keep accurate records of assets that are charged off, in the aggregate and by type of asset. For each type of asset, the banking organization must on a quarterly and annual basis report to its Board of Supervisors (or, for a permitted branch of a foreign bank ,to the next-higher level of authority outside of Afghanistan) the annualized rate of chargeoff. After the banking organization has accumulated a sufficient number of years of data on the annualized rates of chargeoff of different types of assets, that information will be incorporated into the calculation of the required reserves for losses.

Part E — Effective date of regulation.

§ 3.5.1. Regulation immediately effective upon adoption by DAB Supreme Council.

This regulation is effective immediately upon adoption by the Supreme Council of DAB.

This regulation approved by the supreme council of DAB on 14-15 October 2006