Unofficial Translation

PRAKAS
ON
ASSET CLASSIFICATION AND PROVISIONING IN BANKING AND FINANCIAL INSTITUTIONS

The Governor of the National Bank of Cambodia

- With reference to the Constitution of the Kingdom of Cambodia;
- With reference to the Royal Kram NS/RKM/0196/27 of January 26, 1996 promulgating the Law on the Organization and Functioning of the National Bank of Cambodia;
- With reference to the Royal Kram NS/RKM/1206/036 of December 29, 2006 promulgating the Law on the amendment of articles 14 and 57 of the Organization and Functioning of the National Bank of Cambodia;
- With reference to the Royal Kram NS/RKM/1199/13 of November 18, 1999 promulgating the Law on Banking and Financial Institutions;
- With reference to the Royal Decree NS/RKT/0508/526 of May 13, 2008 on the reappointment of His Excellency Chea Chanto as Governor General of the National Bank of Cambodia, equivalent to Senior Minister;
- Pursuant to the recommendation made by National Bank of Cambodia management during the February 23, 2009 meeting.

Decides:

Chapter I
General Provisions

Article 1: This Prakas is intended to ensure that all loans and assets of banking and financial institutions, hereinafter called "Institutions," are regularly evaluated using an objective and prudential grading system, and that timely and appropriate provisions and write-offs are made to the reserve for loan loss account in order to accurately reflect the true condition and operating results of the institutions.

This Prakas applies to all loans, advances and similar assets, including the ones extended to affiliates and related parties held or reflected in the Institution's balance sheet.

Given the potential impacts of non performing loans on the solvency, liquidity and income condition of the Institution, senior management and the board should exercise risk-based and forward looking judgment based on the observed trends of classified assets.

Article 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 Prakas, capitalization of interest will not be permitted unless:

- the borrower has the ability to repay the full debt (principal plus interest) in the normal course of business;
- the interest capitalization was anticipated upon approval of the initial loan based on the borrowers planned temporary lack of cash flow;
- repayment, including capitalized interest, is based on a reasonably ascertainable future event.

"In the process of collection" means that collection of a debt is proceeding in due course in a timely manner either through:

- legal action, including the enforcement of judgments against the borrower; or
- through collection efforts not involving legal action but which are reasonably expected to result in full repayment of the debt within 90 days or in restoration of the debt to a current status through payment of outstanding arrears.

"Loans" and "loans and advances" may be used interchangeably to include any loan, discount, advance, overdraft, export bills purchased, other bills receivable or purchased, import bills, a customer's liability on acceptances or any other credit facilities extended to the customer of an institution.

"Non-performing" means that an asset is no longer generating income. For purposes of this Prakas, "non-performing" assets are classified as substandard, doubtful or loss.

Current accounts used for overdraft purposes and other credit extensions not having pre-established repayment programs are considered "non-performing" when any of the following conditions exist:

- debt exceeds the customer's approved limit for 90 consecutive days or more;
- the customer's borrowing line has expired for 90 days or more;
- interest is due and unpaid for 90 days or more; or
- the current account has been inactive for 90 days, *or deposits are insufficient to cover the outstanding interest during the period.*

“Off balance sheet items” means all items not shown on the balance sheet but which constitute credit risk. Such risks include guarantees, acceptances, performance bonds, letters of credit, and all other off balance sheet items deemed to constitute credit risk by the National Bank of Cambodia.

“Past due" or "overdue” means any loan for which:

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

Current accounts use for overdrafts purposes and other credit extensions which do not have pre-established repayment schedules are considered "past due" when any of the conditions below exist:

- debt exceeds the customer’s approved limit for 30 consecutive days or more;
- the customer’s borrowing line has expired for 30 days or more;
- interest is due and unpaid for 30 days or more; or
- the current account has been inactive for 30 days, or deposits in the current account used are insufficient to cover the interest capitalized during the period.

“Provision for Loan Losses" or “Loan Loss Provision” means an income statement account used to increase or decrease the allowance for Loan Losses in order to maintain that account at a level adequate to absorb expected losses in the loan portfolio.

“Reserve for Loan Losses" or "Allowance for Loan Loses” means a balance sheet valuation account established through charges to "provision expense" in the income statement and against which uncollectible loans or portions thereof are written-off. The allowance for the loan losses account is offset by loans for financial reporting purposes.

“Renegotiated loan” or “**Restructured Loan**” means any loan that has been rescheduled or refinanced in accordance with an agreement setting forth a new repayment schedule on a periodic basis occasioned by weaknesses in the borrower’s financial condition and/or inability to repay the loan as originally agreed.

Chapter II
Classification of Loans and Assets

Article 3 - All loans and assets shall be classified according to the repayment capacity of the counterparty. This repayment capacity is assessed through the following criteria:

- Past payment experience,
- Financial condition of the borrower, both current and expected,
- Business prospective and cash-flow projections, based on realistic and prudent assumptions,
- Ability and willingness to repay of the borrower,

- Financial environment,
- Quality of documentation.

A significant departure from the primary source of repayment may warrant adverse classification even when a loan is current or appears to be supported by underlying collateral value. Reclassification may also be warranted if the counterparty could not meet the conditions of the contract and needed a modification of terms, refinancing, or additional advances.

In cases where different classification grades may be assigned based on subjective criteria, the more severe classification should apply. Moreover, nothing contained in the classification definitions indicated in Article 4 below shall preclude assigning a more severe grade when an analysis of a borrower's financial condition, ability, and willingness to repay justifies the more severe classification.

Article 4 - All assets shall be classified into five categories as follows:

(i) **Normal.** Assets in this category are fully protected by the current sound worth and paying capacity of the counterparty, are performing in accordance with contractual terms, and are expected to continue doing so.

(ii) **Special mention.** Assets in this category shall be currently protected and shall not be past due but exhibit potential weaknesses which shall, if not corrected, weaken the asset or inadequately protect the bank's position at some future date. Examples of such 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 borrower's financial position which shall, if not checked, jeopardize repayment capacity, potential risk is greater than when the loan was originally granted. This category should not be used as a compromise between Normal and Substandard.

Overdrafts must be classified as Special mention, if excess of the approval limit is more than 30 days but less than 90 days, or the current account has been inactive for 30 days, or deposits in the current account used are insufficient to cover the interest capitalized during the period.

Any loan which is past due 30 days or more but less than 90 days shall be classified as Special mention or worse.

When interest payments for 30 to 90 days have been capitalized, refinanced, or rolled over into a new loan, this loan shall be classified as Substandard or worse.

(iii) **Substandard.** Assets in this category are not adequately protected by the current sound worth and paying capacity of the counterparty. In essence, 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.

Overdrafts must be classified as Substandard if excess of the approval limit is more than 90 days, or if there are overdrafts with no significant amount in credit during 90 days or more, or the current account has been inactive for 90 days, or deposits in the current account used are insufficient to cover the interest capitalized during the period.

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

When interest payments for 90 to 180 days have been capitalized, refinanced, or rolled over into a new loan, this loan shall be classified as Substandard or worse.

(iv) **Doubtful**. Assets in this category have all the weaknesses inherent in a substandard asset plus the added characteristic that the asset is 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 that mitigate, the actual amount of loss cannot be fully determined. If pending events do not occur within 180 days and repayment must again be deferred pending further developments, a Loss classification is warranted upon realisation of securities held.

Overdrafts must be classified as Doubtful, if excess of the approval limit is more than 180 days, or if there are overdrafts with no significant amount in credit during 180 days or more, or the current account has been inactive for 180 days, or deposits in the current account used are insufficient to cover the interest capitalized during the period.

Any loan which is past due 180 days or more shall be classified as doubtful or worse.

When interest payments for 180 to 360 days have been capitalized, refinanced, or rolled over into a new loan, this loan shall be classified as Doubtful or worse.

(v) **Loss**. Assets that are considered uncollectible or of such little value that their continuance as bankable asset is not warranted shall be classified Loss. Losses shall be taken in the period in which they are identified, or should have been identified, as uncollectible.

Overdrafts must be classified as Loss, if excess of the approval limit is more than 360 days, or if there are overdrafts with no significant amount in credit during 360 days or more, or the current account has been inactive for 360 days, or deposits in the current account used are insufficient to cover the interest capitalized during the period.

Any loan which is past due 360 days or more shall be classified as Loss.
When interest payments for 360 days or more have been capitalized, refinanced, or rolled over into a new loan, this loan shall be classified as Loss.

Article 5 - Overdrafts, whatever their maturity, must be used only to fund short term needs. Overdrafts shall be classified as short term loans.

Article 6 - If a bank has multiple loans or assets outstanding with a single counterparty or group of counterparties and one loan or another asset meets the criteria for being adversely classified, then the bank shall evaluate every other loan to that borrower shall, classify them in the same category. This includes off balance sheet commitments, except where the nature of these commitments makes it unlikely that the bank will have to make any disbursement. However, commercial paper, including documentary credit, accepted by the drawee and where timely payment is likely can be maintained in the Normal category.

Chapter III
Restructured Loans

Article 7 - Debt Restructuring may only be undertaken towards debtors that still have good business prospects and have or are expected to experience **temporary** difficulties in repayment of credit principal and/or interest.

Article 8 - Banks are prohibited from conducting Debt Restructuring merely for the purpose of avoiding:

- downgrading in classification of credit; or
- formation of increased Allowance for Earning Assets Losses; or
- **Discontinued** recognition of interest income on an accrual basis.

Article 9 - Credit to be restructured shall be analyzed on the basis of the business prospects and repayment capacity of the debtor according to **new** cash flow projections supported by updated business perspectives and overall market conditions being based on realistic and prudent assumptions.

Article 10 - Debt Restructuring shall be carried out by a work-out unit which shall be separate from the units responsible for the lending process. In the case that involvement of officers or employees involved in the lending process is unavoidable; the Board of Directors of the Institution shall conduct direct and strict monitoring of the implementation of Debt Restructuring.

Article 11 - Following the completion of Debt Restructuring, the credit shall be classified as follows:

- not better than Substandard, for credit originally classified as doubtful or loss;
- unchanged, for credit originally classified as normal, special mention or substandard.

This classification shall not be improved unless there are no arrears in repayment of principal and interest within three (3) installment periods and within a period of not less than three (3) months. After that period, the restructured credit may be classified according to article 11 of this Prakas.

Chapter IV
Provisioning Requirements

Article 12 - All institutions shall maintain an Allowance for Loan Losses at a level adequate to absorb expected losses in the loan portfolio.

1- Twice a year, or more frequently if warranted, the board of directors shall require 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) assure that the Provision for Loan Losses is adequate to absorb potential losses. Management must maintain reasonable records in support of their evaluations and entries and shall make them available for on-site inspection by NBC examiners, external auditors and Internal Audit.

2- Increases and decreases in the Allowance for Loan Losses account shall be made through charges to the Provision for Loan Losses in the income statement.

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

Article 13 - The following minimum percentage amounts for provisioning are to be maintained according to assigned classifications. Where reliable information suggests that losses are likely to be more than these minimum amounts, larger provisions shall be made.

(i)	General provision	
	- for loans graded "**Normal**"	1% of gross loan
(ii)	Specific provision	
	- for loans graded **"Special mention"**	3% of gross loan
	- for loans graded "**Substandard**"	20% of gross loan
	- for loans graded "**Doubtful**"	50% of gross loan
	- for loans graded "**Loss**"	100% of gross loan.

Article 14- Institutions shall maintain adequate records supporting their evaluations of potential loan losses and the entries made to ensure adequacy of the Provision for Loan Losses.

The specific provision shall be recorded in the Institution's accounts and charged to the profit and loss account in the month in which the need is identified. It shall not be spread over future periods. Insofar as the customer account balance includes an amount of interest the counterpart of which has been recoded as interest in suspense, this amount shall not be taken into account in calculating the specific provision.

In accordance with accrual basis accounting, interest accrued on a customer account shall be recorded as income in the profit and loss account. However, such a procedure is not followed for assets once they have been classified as Substandard, Doubtful or Loss. In these circumstances, interest accrued shall be credited to an account for interest in suspense.

Chapter V
Write-off of Loans/Advances

Article 15 - An institution should remove a loan/advance or a portion of a loan from its balance sheet when the bank loses control of the contractual rights over the loan or when all or part of a loan is deemed uncollectable; or there is no realistic prospect of recovery. This is normally evident at a stage where-a- The bank has lost control over the contractual rights that comprise the loan or part of the loan as determined by a court of law.

b- All forms of securities or collateral have been called, realized but proceeds failed to cover the entire facility outstanding.

c- The bank is unable to collect or there is no longer reasonable assurance that the bank will collect all amounts due according to the contractual terms of the loan/advances agreement.

d- The borrower becomes bankrupt or is undergoing other forms of financial restructuring and is having difficulty in servicing the facility.

e- The loan is classified under loss category.

All credit policies should adequately detail the write-off procedures in order to minimize potential abuse.

Chapter VI
Loans Control

Article 16 When performing an on-site examination, NBC will review asset classification processes and policies and may classify assets in accordance with the provisions set under this Prakas. The assets classified during such a process shall remain in the categories assessed by the NBC until all the conditions for re-classification are met. The Board of Directors and Senior Management should swiftly take all measures to be fully compliant with the regulatory requirements, including possible revision of policies, procedures and processes.

Article 17 The External Auditors (Certified Public Accountants) are required to review the asset classification policies, procedures and processes in the course of their periodic due diligences. They shall assess, based on their investigations, internal compliance with the policies and rules set by the Board of Directors and Senior Management as well as the overall quality of the asset classification performed at the banks.
Based on their investigations, External Auditors shall make a judgment on accuracy of recognized income, on adequacy of provisioning performed, on quality and independence of collateral appraisals performed externally and internally. They should document any material element that has an impact on recognized income and on the solvency condition of the bank. Special attention shall be paid to asset classification related to loans and facilities extended to related parties and affiliates; those should lead to specific comments in the reports issued and sent to the NBC / Banking Regulatory Authority.

Article 18 The Internal Audit shall perform periodic reviews of the overall portfolio. Such reviews shall be carried out at least once a year in a comprehensive manner. Where such reviews are performed more frequently, they might then be performed by making use of sampling techniques. However, the bigger exposures shall be systematically reviewed.

Internal Audit shall assess, based on its own independent investigations, internal compliance with the policies and rules set by the Board of Directors and Senior Management as well as the overall quality of the asset classification performed at the bank.

Based on its investigations, Internal Audit shall make a judgment of the accuracy of recognized income, on adequacy of provisioning performed, on quality, the selection and the effectiveness of institution's rights on pledged assets for collateral accepted as a credit risk mitigation element. Any significant issue shall be immediately brought to the Board's attention and lead to a recommendation of corrective actions to be taken to rapidly solve the raised issues.

Ultimately, Internal Audit shall also judge the quality of the Management Information System designed for credit risk monitoring and decision making purposes as well as the accuracy and timely delivery of data provided to Bank Management.

Chapter VII
Final Provisions

Article 19 - The following regulations:

Prakas B7-00-51 on the Classification of and provisions for bad and doubtful debts, including interests in suspense, dated February 17, 2000,

Prakas B7-02-145 on the Classification of and provisions for bad and doubtful debts, including interests in suspense, dated June 7, 2002,

are hereby repealed.

Article 20 - The General Directorate, the General Secretariat, the General Inspection, the General Cashier and all Departments of the National Bank of Cambodia, and all Banking and Financial Institutions under the NBC's supervisory authority shall strictly implement this Prakas.

Article 21 - This Prakas shall take effect from the signing date.

Phnom Penh, February 25, 2009
The Governor
Signed and Sealed

cc:
- All members of the Board of Directors
- The parties concerned as stated in Article 20
- File
- CM "for info"
- Administration Department of CM
  "for publication in the National Gazette"