BOARD OF THE CENTRAL BANK OF THE REPUBLIC OF ARMENIA

RESOLUTION

On Amending the "Order on Classification of Loans and Accounts Receivable, and Loan Loss Provisioning in Banks Operating in the Territory of the Republic of Armenia" Jointly Approved by the Central Bank and the Ministry of Finance and Economy of Armenia

On the basis of Article 20 of the RA Law on the Central Bank of the RA, the Board of the Central Bank of the RA decides:

1. To approve the modified version (attached) of "Order on Classification of Loans and Accounts Receivable, and Loan Loss Provisioning in Banks Operating in the Territory of the Republic of Armenia" jointly approved by the Central Bank and the Ministry of Finance and Economy of Armenia.

2. To order the Banking Supervision Department of the Central Bank of the RA to submit the aforementioned amended Order to the approval of the Ministry of Finance and Economy of the RA within ten days.

3. After the amended Order has been approved by the Ministry of Finance and Economy, to propose to the banks operating in Armenia to incorporate the amendments in the internal orders that they develop in accordance with Paragraph 7.2 hereof, and to submit their amended internal orders (approved by the authorized body of management of the bank) to the CBA within a period of three months.

4. The present resolution comes into effect from the moment it is passed.

Chairman T. Sargsyan

Policy on Classification of Loans and Accounts Receivable,
and Loan Loss Provisioning in Banks Operating in the Territory of the Republic of Armenia

TABLE OF CONTENTS

1. GENERAL PROVISIONS

1.1. This Policy is defined in accordance with Article 57 of the RA Law "On Banks and Banking" and Article 30 of the RA Law "On Profit Tax", and regulates the issues regarding classification of loans and accounts receivable (assets), general and special provisioning against possible loan losses, and writing off bad assets.

1.2. This Policy aims at the following:
   a) For the purpose of calculating the profit tax, to define reductions of gross income at the amount of allowances to loan loss provisions.
   b) To collect reliable information on the total capital and assets of the bank, used for calculating economic normatives regulating banking activities.

1.3. Banks shall be responsible for assets classification and loan loss provisioning.

1.4. Deriving from the objectives of this Policy:
   a) Banks shall form a general provision for standard assets, and a special provision for substandard, doubtful and bad assets.
   b) Loans loss provisions shall be formed on the basis of criteria for assets classification.
   c) Objective and subjective criteria for asset classification shall be defined.

1.5. In the result of examinations, the supervisory service of the RA Central Bank can oblige the bank to adjust its assets classification under this Policy, as well as its provisioning in accordance with Clause 4.2 hereof.

2. DEFINITIONS

In the context of this Policy:

2.1. Loans and receivables (hereinafter assets) are loans (including overdraft, loan cards, deposits in banks (with the exception of those in the Central Bank of the RA) (including deposits in bank gold), claims on factoring, financial leasing, banking guarantees, and letters of credit, receivables from asset transactions (for securities, only IOU transactions), and/or other claims to third parties, as well as post-balance sheet items involving credit risk.

2.2. In accordance with paragraph 3.11 of this Policy, asset classification is the grouping of assets into the following five classes:

   1) standard, 2)substandard, 3) doubtful, 4) loss.

2.3 General reserve shall be recorded in the balance sheet as a counterbalance to assets section. It shall be formed for standard assets from the allowances (withdrawals) to the general reserve. The latter shall be recognized (booked) as expenses in the bank's income statement, arising from the possibility of the future non-apparent (unrevealed) losses.

2.4 Special provision shall be booked in the balance sheet as a counterbalance of the assets section. It shall be formed in respect with assets classified as substandard, doubtful and loss, from the allowances (withdrawals) to the general provision. The latter shall be recognized (booked) as expense in the bank's income statement, arising from the possibility of the apparent (revealed) losses.

2.5 Unrecognized interest income (and/or penalties) is the generated (accrued) but not actually collected interest (and/or penalties). Unrecognized interest income (and/or penalties) shall be recorded in the balance sheet as a counterbalance to the assets section, and the account used when the assets are classified as non-performing assets. Accounting entries into the account of "Unrecognized Interest Income (and/or Penalties)" shall be made instead of entries into the account "Interest Income (Received Penalties)".

2.6 Assets shall be recognized as non-performing in the following cases:

a) full or partial repayment of principal amount or its interests is 90 days or more past due, or
b) b) the payment of 90 days and more past due interests is capitalized (added to the amount of the unsettled loan), or the repayment terms are adjusted (refinanced) or transferred to the amount of new loan.

The assets without preliminarily defined (envisaged) repayment terms (overdrafts and other instruments) shall be acknowledged non-performing assets in case the repayments are not made within 90 days, and the funds, available on the account are not sufficient for repaying the capitalized (accrued) interests during the corresponding period.

The calculation of the non-working assets for the purpose of ceasing the interest accrual shall be based on the non-repaid portion of the borrower's principal loan amount, and not its past-due amount.

The calculation of non-performing assets for the purpose of classification (See Clause 3.11 of this Policy) shall be based only on the past due part of the borrower's principal loan amount, and not its non-repaid portion.

The first-class secured assets are the ones which are fully secured by:

a) letters of guarantee (budget guarantees) of the government of the Republic of Armenia;
b) guarantees and securities of the Central Bank of the Republic of Armenia;
c) upon the approval of the Central Bank of the Republic of Armenia, letters of guarantee and guarantees of leading banks or policies of leading insurance companies;
d) collateral in the Armenian dram and freely convertible foreign currencies (including deposits in these currencies) defined under the relevant rule of Regulation 2 "On Bank Performance Economic Normatives"
e) Collateral in non-freely convertible foreign currency (including deposits in these currencies) provided the said collateral is the security of the asset, expressed in the same FX;
f) Collateral in the government securities of the Republic of Armenia;
g) Collateral in standard bullions of precious metals (including accounts in gold).

This classification shall apply to both the total asset amount and its parts.

Capitalization of interests is the procedure of adding the non-paid interests to the unsettled amount of the asset on the interest or loan repayment date, specified in the contract.

Assets with adjusted terms are the ones which have been refunded in accordance with the contract , or restructured through changing their repayment terms or other conditions, the amounts transferred to new asset (credit) instruments , or conditions otherwise more favorably revised for the borrower conditioned by its difficult financial situation and/or its ability to repay the debt.

Refinanced assets are the ones repaid from the newly undertaken liabilities.

3. CLASSIFICATION OF ASSETS

3.1. Banks shall at least once every 30 days (better on the last bank day of the reporting month) classify its assets in compliance with paragraph 7.3 of this Policy and the internal regulation, defined by the bank.

3.2. Each asset shall be classified as standard, substandard, doubtful, or loss.

3.3. Asset classification shall be based on the objective and subjective criteria defined in this Policy (see the table of Clause 3.11).

3.4. In case of differences arising in the process of asset classification on the basis of objective and subjective criteria, the bank shall primarily base on the stricter criteria.

3.5. Objective criteria shall be based on the past due days and level of security defined in this Policy

3.6. Subjective criteria shall be based on the judgement and professional opinion of the supervisory service of the banks and CBA. These judgements shall be in line with the definitions of standard, substandard, doubtful and loss, specified in this Policy

3.7. The portfolio of **Standard** assets represents the difference of gross and classified assets. Standard classification shall be given to those assets, which are serviced in compliance with the contract and are not problematic, including the assets with up to 90 days past due status. As a rule, standard assets have the following characteristics :

a) The financial condition of the borrower is not doubtful, and

b) The borrower has sufficient capacity to repay (service) the debt.

Normally, standard assets are sufficiently secured in respect with both the principal amount and interest debt, and only a general provision is formed for standard assets.

3.8 The assets in respect of which the borrower, due to its financial situation and repayability, fails to discharge its obligations under the contract, are **substandard** assets. Substandard assets include:

a) Term assets, which cannot be timely settled because of the insufficient cash flow of the borrower.

b) Those loans, advances and other claims of the borrower that have an insufficient ratio of equity capital to the attracted funds, defined under the internal regulation of the bank in compliance with Clause 7.3 of this Policy.

c) Those assets, which cannot be repaid by the borrower in accordance with the preliminary arrangement , and which are to be adjusted and negotiated due to the deteriorated financial condition of the borrower. This means that the primary sources of the asset settlement are insufficient, and the bank needs to apply to secondary repayment sources, such as sale of collateral and property, adjustment of terms (refinancing), or identification of new sources of capital, etc.

Substandard assets have obvious deficiencies which impede the full repayment of the debt.

Non-standard classification applies also to those assets, which involve more than a normal level of risk connected with the absence of proper documentation on the borrower's current financial information or collateral.

In order to clarify the relevant classification of any substandard asset, the following factors shall be considered:

a) On-going adjustments of the asset servicing terms (restructuring) without any significant repayments.

b) Borrower's application on defining more favorable asset repayment conditions, due to the latter's financial situation.

c) Inadequate collateral.

3.10. **Doubtful assets** have all the peculiarities of substandard assets, but are more problematic, which makes the collectability of these assets more difficult or even impossible. The likelihood of losses in case of doubtful assets increases, while their size still remains indefinite mainly due to a number of important and special

factors, which can improve the asset condition. Thus, these assets are not classified as a loss until all the relevant circumstances are clarified. .

3.11. **Loss assets** are non-collectable and low -value assets, which cease to represent any significance for the bank to be booked in its balance sheet. This classification does not imply that the asset cannot be recovered in the future, still at the given moment it should be recognized as a devaluated asset in the accounting records.

3.12. Asset classification criteria are summarized below:

Asset class	Objective criteria	Subjective criteria
Standard asset	**A performing asset which is being repaid.** **In case of a primary secured asset – with an up to 90 days past due status**	**Corresponds to the definition of standard assets set in Clause 3.7 of this Policy.**
Substandard asset	**With an up to 90 days past due status – in case the asset is without a primary security.** **With 91 to 180 days past due status in case the asset has a primary security.**	**Corresponds to the definition of substandard assets presented in Clause 3.8 of this Policy.**
Doubtful asset	**With a 91-180 days past due status in case the asset is not backed with a primary security.** **With a 181 to one year past due status in case of a primary security.**	**Corresponds to the definition of doubtful assets presented in Clause 3.9 of this Policy.**
Loss	**With a 181 days and more past due status in case the asset is not backed with a primary security.** **With a one-year and more past due status in case the asset has a primary security.**	**Corresponds to the definition of loss assets presented in Clause 3.11 of this Policy.**

3.13. The calculation of past due days specified in Clause 3.11 of this Policy shall start in accordance with Clause 2.6.

4. General and Special Provisioning

4.1. Each bank shall maintain individual accounts for general and special provisions for covering possible asset losses. The size of the provisions shall be adjusted on every date of asset classification, in accordance with Clause 3.1 of this Policy.

4.2. Banks shall form special provisions in the amount of 20% for each substandard asset, 50% - doubtful asset, and 100% - losses.

4.3. Banks shall form a general provision in the amount of 1% of standard assets.

4.4. Based on the internal regulation, drafted in accordance with Clause 7.3 of this Policy, banks may at their own discretion, without any interference of the CBA Bank Supervision Service, increase the allowances to the general provision by 2% for standard assets, and for special provision: a) substandard assets - up to 25%; b) doubtful assets - up to 70%.

4.5. An asset shall be credited from the bank's balance sheet to the "Special Provision" Account at the date it has been recognized as a loss, and the bank shall continue recording it in the corresponding Memorandum accounts of the balance sheet.

5. Cessation of Interest (and/or Penalties) Accrual

5.1. The non-performing assets, defined in accordance with this Policy, shall be accounted through the accrual method since the moment these assets are classified as such, i.e., the accumulated but not collected interest (and/or fine) shall not be recorded as an interest income (and/or penalties). Interests (and/or penalties) accrued on those assets shall be recorded on the "Non- recognized Interest Income" Account. The accrual of interests (and/or penalties) shall be continued, but not booked as interest income before it is paid.

5.2. The interests (and/or penalties) accumulated but not collected during the same reporting period shall be transferred from "Interest income (and/or penalties)" Account to "Non-recognized Interest Income (and/or Penalties)" Account.

5.3. The interests (and/or penalties) accrued during the previous period, but not collected, shall be recognized as expense and booked in "unrecognized interest income (and/or penalties)" account.

5.4. As a rule, the accrual method can be applied to a non-performing asset only in case the overdue principal amount, as well as penalties are repaid in full. penalties

5.5. The accrued, but not yet collected interests (and/or penalties penalties), which are booked in the "unrecognized interest income" account, shall be credited from the balance sheet at the moment the relevant asset is classified as a loss and booked in the Memorandum accounts. The bank may continue the accrual of interests (and/or penalties).

5.6.

6. Writing off Assets and Interest Booked in Memorandum Accounts

6.1. In case of receiving payments (compensation) on assets recorded in Memorandum accounts:

6.1.1. the written off asset shall be fully or partially recovered in the balance sheet, offsetting with the “Special Provision” account,

6.1.2. the recovered asset shall be repaid, offsetting with the “Monetary Items” account or other respective account in the asset section.

6.2. During the regular classification of assets and adjustment of provisions, the bank shall book the surplus balance amounts of the general and special provisions in the income account.

6.3. In case of receiving payments (compensation) on interests booked in Memorandum accounts:

6.3.1. the written off interest shall be fully or partially recovered, offsetting with the “Interest Income” account,

6.3.2. the recovered interest shall be repaid, offsetting with the “Monetary Items” Account or any other respective account in the asset section.

6.4. Assets and interests (or parts thereof), booked in the Memorandum Accounts shall be written off from the Memorandum Accounts in the following cases:

6.4.1. the assets and interests are forgiven by the bank in full or partially, or

6.4.2. the term, set by the RA legislation for the right to claims on assets and interests (or parts thereof), is due.

6.5. If the assets and interests are fully or partially forgiven by the bank prior to recognizing them as a loss and/or writing off from the balance sheet, they shall not be considered as gross income reductions, made for the purpose of profit calculation.

6.6. In cases, specified in Clauses 6.4. and 6.5. of this Policy, the bank shall within 7 days notify the RA Ministry of State Revenues about the latter.

7. Transitional Provisions and Effectiveness of This Policy

7.1. To consider void the Procedures “On Formation of Loan Loss Provisions by Banks Operating in the Territory of the RA and Writing off Bad Debts” and “On Formation of Provisions for Receivables Losses of Banks Operating in the Territory of the RA, and Classification of Receivables as Losses and Their Writing Off”, jointly approved by the RA Central Bank and Ministry of Finance on 19.02.1997 and 20.05.1998 respectively.

7.2. Within three months following the effective date of this Policy, banks shall develop an internal regulation on classification of loans and receivables (assets) and formation of provisions for asset losses in accordance with the provisions of this Policy.

4.3 During the period covering the effective date of this Policy and the end of the reporting period (month) banks shall compute the size of the provision, required for the classified assets (substandard, doubtful and loss) after the classification of assets. Prior to the date when this Policy comes into force banks shall fully transfer the formed provision to the special provision, and create a general provision for standard assets. In the event the amounts, allocated to the special provision exceed the required size, the surplus funds shall be transferred to the general provision. In the event the general provision exceeds the required amount, the surplus funds shall be added to the bank's revenues.

At the date this Policy comes into force, not only assets booked in the balance sheet, but also the ones, recorded in the Memorandum accounts, shall be subject to classification.

7.4 This Policy is drafted exclusively for the purpose of regulating banking activity and keeping track of the bank's tax obligations, and none of its provisions or concepts may be interpreted, quoted or applied by the court, state management bodies, the bank, its customers or its shareholders or any other person as a document, regulating or defining the legal relations between the bank and customer (borrower) in respect with conclusion or implementation of contracts, prolongation of terms, calculation of interests and penalties, as well as collateral and other issues.