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Loan Classification, Average Recovery Rate and Provisioning Practices of Ethiopian Banks- Cross Country Comparison

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Abstract
The current classification and provisioning practice of Ethiopian banks has been framed by the National Bank of Ethiopia's directives. For loans with fixed repayment terms, the NBE's directive and the current practice of the banks are based on an objective indicator of collectibility i.e. the period that payments of interest and principal are past due. However, country's' experience lead us to conclude that the decision to classify loans should be largely judgmental based on assessment of the borrower's capacity to repay and on the degree of doubt about the collectibility of the principal or interest of a loan. Thus, payment in arrears is only one of a number of factors to be considered in classifying problem loans. In such respect, the NBE has also tried to integrate many factors into its classification system by providing the discretion to its onsite examiners. Most of the standards were related to financial factors, collateral factors, business risk factors and ownership and management factors. Therefore Banks need to revitalize their loan classification system by developing an internal workable guideline which provides coverage to the aforesaid standards. The guideline shall be framed in a way to incorporate criteria required by the regulator (objective standards) and subjective /judgmental criteria adopted from the international bank experiences and the National Bank of Ethiopia's (NBE's) on site practices. In addition, enhancements of internal system via ensuring independence of the classification and provision tasks, the MIS and the involvement of independent evaluators like internal auditors requires considerations from the Banks.
Keywords: Loan Classification, Average Recovery Rate, Provisioning, Ethiopia, Banks

Background of the Study

Banks need loan classification systems in order to monitor and manage the credit risk inherent in their loan portfolio (Adhikary, Bishnu Kumar,2003). In a number of countries, banking supervisors have introduced standardized requirements for classifying loans in specified categories based on the loans' credit quality. These classifications in turn are also used to quantify provisioning requirements. The experience of international banks and the NBE's on-site examination criteria pertaining to loan classification and provisioning indicated that loan classification and provisioning is often a matter of judgment than pure reliance on objectively set criteria in the directives. Thus, it appears natural that assessments may vary markedly between different assessors - such as banks, external auditors, and bank supervisors – and even across countries.

The regulations of the NBE were enacted within the past 10 years, reflecting a growing awareness among the Bank supervisor of the importance of a classification system as the foundation for proper asset quality monitoring. The directives have also recently been amended in order to add more stringent classification standards on loan without fixed repayment terms such as overdraft (O/D), tighten rules on average recovery rate and the treatment of restructured loans. However, both the past and the revised directives of the NBE have utilized objective criteria for classifying loan accounts but still provided the discretion to classify loan accounts relying on subjective judgments to its on-site examiners. Such practice has mainly created a difference in the loan classification and hence provisioning approaches of banks and the regulator. The aim of this study is also to evaluate the credit risk classification and provisioning approaches of the Ethiopian banking industry against the practice in various countries . This will assist to bridge the gap between the approach and assertion of regulators and Banks that prevailed over couple of years.

The study has tried to get a lesson on the experience of other countries and the industry regarding the system of loan classification and provisioning. However, the international banks experience with regard to average recovery rate appeared very different from our country's system. Some countries developed models (which doesn't incorporate the collateral aspect) to determine the average rate. In addition, on other countries the framework and implementation are different. Hence, the study (in respect of average recovery rate) appears to lack some better experiences from both the industry and international banks practices.

Methodology

In order to pursue the aforesaid objectives, the study has employed both primary and secondary data collection techniques. As part of the primary data collection techniques, the team has interviewed and made a discussion

with selected banks Credit Department staff especially with those personnel who directly engaged in loan classification, average rate computation and provisioning tasks. In addition, a careful observation of the current credit risk classification and provisioning approaches were made. The study also highly relied on secondary data sources while examining the general practices and countries experiences pertaining to the aforementioned topic. In such endeavor, it has consulted different websites of central and commercial banks and the NBE's directives. It has used various research reports of the world banks to review the experience of courtiers in both developed and developing nations. It mainly focused on the US system (developed countries) as it fits with the prevailing loan classification and provisioning system of the regulator and. In addition, a detail assessment of the practice in two countries (Uganda and Kenya) from developing nations was made to see the practice of countries comparable to our country's banking system. The practices of 119 countries including US, Kenya and Uganda were also scrutinized and important lesson derived from it.

Review of General Credit Risk Classification and Provisioning Approaches

International Banks Experience

Valuations of portfolio of loans are done by classifying loans in to different categories, which reflect different risk profiles. However, even if there are some conventions, neither there exist a uniform loan classification technique, nor a standard procedure to assess loan risk on a worldwide basis. In some countries banks determine their own systems of classification. In other countries, like Ethiopia, the Bank regulatory agency (central banks) sets detailed rules on loan classification. Moreover, the criteria for classification range from repayment overdue to more forward-looking elements, involving where appropriate empirical data for loan default probabilities or repayment capacity and cash flow of the borrower that includes some subjective /judgmental judgments. However, as a minimum requirement supervisory authorities often find it useful to relay primarily on more standardized factors that can be applied routinely in the classification process. This is due to the belief that banks may be reluctant to use their own judgment to adversely classify loans. This study paper has separately considered the experience of USA (developed) and the Kenya and the Uganda system (from developing countries) of loan classification and provisioning approaches. In addition, it has provided a summary of loan classification and provisioning approach for 119 selected countries.

Developed Countries (US System)

Credit Risk Classification

The U.S guidelines are a good example of a relatively simple and transparent grid, the system includes five categories: standard/pass, special mention, substandard, doubtful and loss. The guideline uses multiple criteria than delinquency period to determine an appropriate classification. This includes; fall in value of collateral, changes in borrower's financial conditions, deficient documentation. In such system loans are considered as non-performing when, principal or interest is past due and unpaid for 90 days or more, or interest payment equal to 90 day interest or more have been capitalized, refinanced, or rolled over. In addition, judgmental factors got a power to relegate performing loans to classified loans. Accordingly, non-performing is often defined as loans in the three lowest categories (substandard, doubtful, loss). Nevertheless there is a difference between non-performing loans and classified loans, NPLs are classified on the basis of performance, while classified loans include NPLs and other reasons to expect losses associated with a loan.

Concerning restructured loans, generally, restructured loans remain non-performing and stay at the same classification as before, but after the borrower has serviced the loan for some periods (no definite time is set), the Bank could upgrade a restored loan. The discretion to treat the classification of multiple loan facilities was delegated to each Bank. Hence, there is no formal requirement to classify other loans of a multiple-loan customer as non-performing if one loan of the borrower appeared non-performing.

Loan Provisioning

There are two types of provision (specific and general); from prudential perspective an important distinction between general and specific provision is the former is for possible or latent losses not yet identified, whereas the latter is identified losses. Typically, specific provisions are applied on non-performing loans (substandard, doubtful and loss), it takes into consideration the value of recoverable collaterals and subtracted from the loan balance before the specific provision parameter is applied. The US banks are required to set aside 15%, 50% and 100% for substandard, doubtful and loss loans, respectively.

Developing Countries Experiences (Kenya and Uganda System)

Credit Risk Classification Criteria

The two countries system incorporates a distinction between subjective /judgmental and objective criteria for credit classification. In addition, the objective criteria were presented making segregation between credit

facilities with fixed repayment terms and those without fixed repayment terms (such as O/D, trade bills discounted). The Uganda system outlined the subjective /judgmental criteria as incorporating: the financial condition of the borrower, adequate documentation (current financial statement, cash flows, credit checks and evaluation report on collateral held) and collateral impairment. These criteria will be applied to all loan products irrespective of having/or not a fixed repayment terms. The Kenya system also used almost analogous approach in outlining the subjective /judgmental criteria. It considers trends in the financial condition of the borrower (repayment capacity), degree of ability to properly supervise the debt, condition or control of collateral, trend in the risk potential as compared to when the loan was originally granted.

Concerning the objective standards, the Uganda system applies delinquency timing as a basis for classification of credit facilities with fixed repayment. In addition, more performance related standards were stated for classifying credit facilities without fixed repayment terms (such as O/D). It considers criteria as operating within approved limit, un-expired credit line, interest charge covered by deposits, hard-core level and turnover in comparison with the approved credit line plus interest charges. However, still time factor has been attached with those classification standards. For e.g. O/D will be classified as substandard if the facility exceeds borrower's approved limit for ninety days or more to 180 days, credit line expired for ninety consecutive days or more to 180 days, interest is due and unpaid for ninety or more days to 180 days the O/D or account is inactive (turnover is not equivalent to or greater than approved limit plus interest charges, the account developed hardcore)

The Kenya system also follows the same approach as Uganda for classifying loans with objective standards. It applied delinquency time to classify term loans. In addition, it considers separate criteria for the portion of interest: a delay in interest payment, refinanced or rolled over interest payments were subjected to reclassification depending on the delinquency period to repay the interest amount. For O/D facility, the objective standard take in to account comparison of the account balance with the approved limit, expired O/Ds, interest due and unpaid, inactive O/Ds and the period of administrative renewals.

In the Uganda system, (Non-Performing Loans) NPLs includes loans classified as substandard, doubtful and loss according to the above criteria's. And renegotiated NPLs stay as the same level before, until the borrower services the account properly for a year. Restructured credit facility shall not be reclassified upward for a minimum of one year following the new agreement; hence, the account shall not be restored to accrual status. In addition, Uganda Banks are prohibited from restructuring loans classified as doubtful or loss unless an up-front cash payments is made to cover at least unpaid interest, or an improvement in the security or collateral taken than make the account restructured

The Kenya system also classify substandard, doubtful and loss accounts as NPL. Besides, borrower's multiple facilities should join the same category. While that of renegotiated NPLs stay as the same level unless the borrower fully paid past due principal, interest or services the account for some periods as per the below guidelines. Concerning renegotiated loans, loans in the substandard category will normally continue to be classified substandard unless all past due principal and interest is repaid. In addition, a renegotiated loan in the doubtful category will normally continue to be classified Doubtful unless all past due principal and interest is repaid at the time of renegotiation. But the change in classification depends on the amount of payment. Full payment (principal and interest) would change substandard to pass and doubtful to special mention. Payment of past due interest only would change substandard loans to special mention and doubtful loans to substandard.

Loan Provisioning

Uganda banks are expected to hold specific provisions for substandard, doubtful and loss loan which shall be not less than 20%, 50% and 100%, of the outstanding balance of the credit facility, respectively. However, cash/cash substitute securities can be deducted from outstanding balances before applying specific provisions. Banks are expected to evaluate the status of security or collateral on any credit facility once repayment becomes irregular. In addition, general provisions are maintained at least 1% of outstanding loans. In general, central bank approves adequacy of provisions held.

In Kenya, a provision amount for non-performing loans i.e. substandard (20%), doubtful (100%) and loss (100%) is applied on net balances after deduction of realizable value of security determined from properties market. In addition, for performing loans a provision percentage of 1% and 3% for normal and watch loans, respectively are applied on gross outstanding balances.

The Loan Classification and Provisioning Approaches for other Selected Developed and Developing Countries

Loan Classification Systems

Most countries integrated the 5-grade loan classification framework (pass, special mention, substandard, doubtful, loss) in their system of loan classification. In addition, most of them have a formal definition for non performing loans i.e. they stated loans under substandard, doubtful, loss category as non-performing loans. Some countries incorporated special mention loans under the list and state them as 'criticized' loan. However, in such countries too, there is a distinction between 'criticized' loans (special mention, substandard, doubtful, loss) and non- performing loans (substandard, doubtful, loss).

In terms of classification criteria, most of them apply delinquency period as a standard to classify loan. But, the delinquency period (the time that the loans were in arrears) varies across countries. Most of them categorize loans having arrears beyond 90 days in to NPL. Some of them (like Aruba, Bulgaria, Georgia, Macedonia, Malta, Peru, Salvador, El) use unpaid loans over 60 days as benchmark to classify in to NPL, some (like Bahrain, Botswana, Brazil, Cambodia, Chile, Guatemala, Honduras, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Poland, Russia, Tajikistan, Turkmenistan, Vanatu) use the 30 days threshold, some (like India) apply over 210 days, others like (Jordan, Sri Lanka, Vietnam) use over 180 days, Nepal uses 720 days to classify loans into NPL , Seychelles and Yugoslavia apply 120 days . Exceptionally, Romania classifies loans in arrears for 7 days into NPL Category. The country (Romania) uses a special matrix for loan classification. In Switzerland, classification and provisioning of loans in arrears are done on a case by case basis. So the delinquency factor cannot be considered as a major factor for loan classification.

Countries also have different experience pertaining to the classification of multiple loans. Out of the 119 countries, only 39 of them classify loans of a multiple-loan customer in to NPL if one loan in the category is non -performing. However, the data attached in annex 3 could not clearly explicate to which category the loan would fall. To check countries (in fact few) experience with regard to the specific category of loan for multiple loan-loan customer, refer annex 1 As per the table, if a debtor with multiple loans has one nonperforming loan, all loans to the same customer are classified in the same category (France, Argentina, Australia, Brazil, Chile, Czech Republic, India, Korea, Rep. of, Russian Federation, Saudi Arabia, and Italy). In 76 countries, banks are not required to apply the multiple loan classification standard and the rest 4 countries consider the performance of loan and borrower's repayment ability before applying the standard. Hence, such decisions are at the discretion of individual banks.

There is also variation among countries in taking collateral into account when classifying credit. Countries like Japan, the US and the Russian Federation consider collateral for loan classification. In contras, collateral plays no role in the classification of credits in France, Italy, Argentina, India or Saudi Arabia.

Loan Provisioning

Supervisory bodies in the countries considered, require banks to set aside a provision for NPLs. The variation lies on the percentage of provision and the balance of the loan from which the provision is calculated. Regarding the percentage, countries use two type of system: percentage basis and range systems. The percentage basis (like Ethiopia) requires banks to set aside some portion (%) of the outstanding balance of the loan or the unpaid (arrears part) of the loan (there is a variation among countries in this regard too) as a provision. In contrast, the range basis require banks to set aside a provision amount starting from a certain minimum percentage increasing up to the highest percentage irrespective of the loans stay in a certain category. For example, Bulgaria banks are required to maintain a provision amounting 30%-50 % , 50%-75 % and 100% for loans under substandard, doubtful and loss category, respectively. This seems reasonable as loans stay more time within a certain category, their level of risk will increase. This requires setting more provision than the minimum amount held during the initial change in category of the loan. Concerning the variation on the loan balance on which provision is computed, countries use three approaches: total outstanding balance (including interest), the unpaid (arrears part) of the loan, the unsecured part of the loan.

The Regulator's Requirement (The National Bank of Ethiopia)

Loan Classification Basis

The NBE Directive No SBB/43/2008 laid down the framework for the loan classification system for all banks operating in the Ethiopian banking industry. The directive is applied to all banks irrespective of their ownership and purpose of establishment (i.e. development and commercial banks as well as government and private banks). The NBE's guideline utilized a 5-grade (pass, special mention, substandard, doubtful and loss) loan classification framework to classify loan accounts. In addition, it highly relied on delinquencies (measured as the numbers of

days or month's loan repayment are past due) as main benchmark to classify loans. Thus, loans with pre-established repayment programs are classified as non-performing loans when principal and/or interest is unpaid for 90 days or more. In addition, for loans without repayment terms when the account remain outstanding, exceeded its limit, interest due uncollectible and inactive for 90 consecutive days or more. Besides, the directive has established criteria to classify overdraft facilities based on their lowest debit performance. This can give an indication that the regulator directive has set objective criteria for classifying loans providing the discretion of subjective judgment to its on-site examiners. The directives have also established a framework for the treatment of renegotiated loans and advances and multiple loans and advances despite ambiguities on some of the standards.

Loan Provisioning

The directive required the computation of provisions to be based on a fixed percentage in line with the category of loans. Hence, banks are required to maintain 1%, 3%, 20%, 50% and 100% for loans with pass, special mention, substandard, doubtful and loss categories, respectively. However, the minimum percentage maintained by banks for each non performing loan or advance shall not be less than 3(three) percent of the outstanding loan or advance. The directives also clearly pointed out that the minimum provision requirements for each classification category shall be applied against the total outstanding principal balance.

Average Recovery Rate

The NBE directives defined the term average recovery rate as aggregate net cash receipts from sales of collateral plus total net market value of acquired propertied, divided by the aggregate outstanding principal balance of loans or advances backed by the collateral sold or otherwise acquired by a bank calculated over the period of 18 consecutive months preceding the date of computing minimum provision requirements. The NBE Directive also restricted the recovery rate to be applied by a bank during computing net recoverable value of a loan shall not be 15(fifteen) percentages points greater than 'industry average recovery rate'. In addition, in case a bank has no information on aggregated net cash receipts or the total net market value of acquired properties to compute its own average recovery rate, it shall use the industry average recovery rate.

Analysis on the Ethiopian Banks Experience on Loan Classification and Provisioning

Structure and System of Loan Classification and Provisioning

In most banks the role of loan classification and provisioning is handled by an individual. In addition, there appears no standardized procedure on how to handle the classification task. Banks are just dependent on the NBE's directives. However, the study identified that loan classification has its own informal path of accomplishment as shown below:

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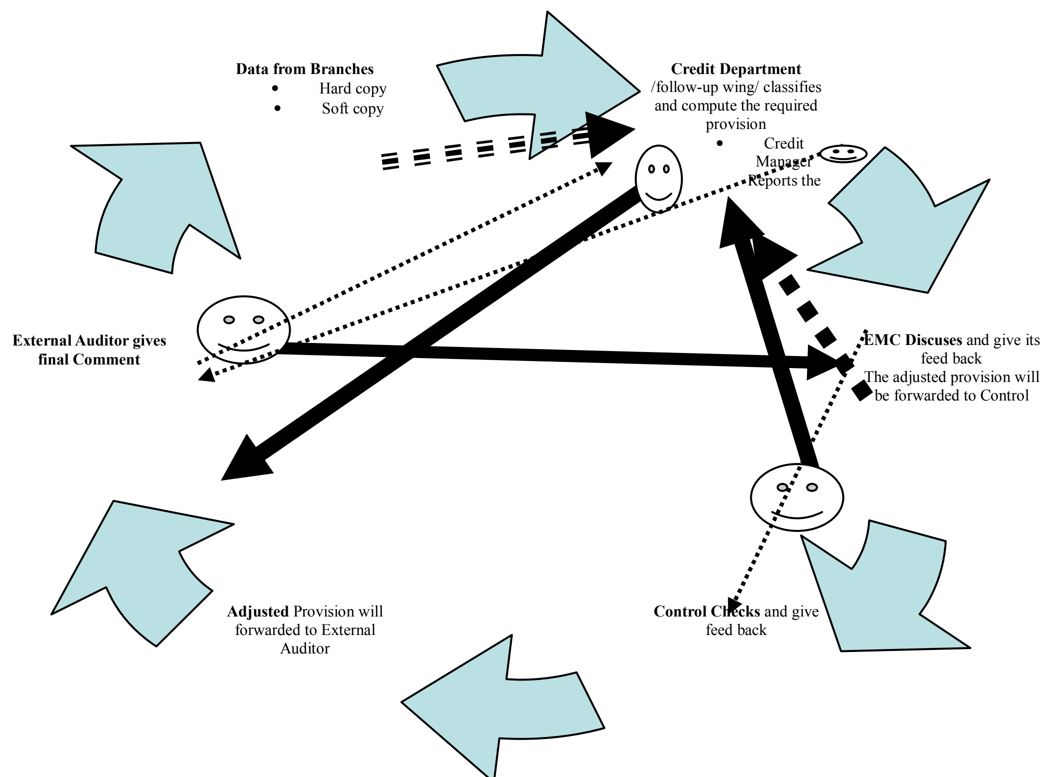
Chart 1:Pictorial Presentation of Current/Customary Practice for Classifying and Provisioning Loans



- Data (Loan returns) on loans and advances is collected from Branches through both hardcopy and softcopy formats (Information Technology(IT) Department also receives softcopy data from Branches). The data utilized for average recovery rate was compiled from the Bank's Legal Service Department;
- Based on the data obtained from Branches, the Legal Service Department and the Credit Department, a person in relatively higher position (in the Follow up and Monitoring wing) will classify loans; compute the Average Recovery Rate (ARR); and calculate the required provision;
- The Credit Department Manager validate the task done by the follow-up and monitoring officer;
- The Credit Manger submit the loan classification, average recovery rate and provisioning report to the Vice President;
- The Executive Management will have a discussion on the report and provides feedback to the Credit Department on the appropriateness of the approach for computing the average recovery rate, classifying and provisioning loans;
- The Credit Department will amend its approach on loan classification ,average recovery rate and provisioning as per EMC's comment and will forward the updated data to the Control Department for scrutiny;
- The Control Department checks the report and forwards its feedback to the Credit Department which ultimately communicates with the Bank's Senior Management. The report checking is done by the Control Department before the final report is examined by the External Auditors, often on annual basis; and
- Finally, the external auditor gives its final comment.

However, this system has suffered from the following drawbacks:

- Practically, the task of loan classification and provisioning has no explicit owner or a responsible organ that separately handles such task is not identified.
- The consistent , direct and indirect involvement of the Bank's management on the issues of NPLs, collateral, and related issues has an impact on the independence of the person/ organ responsible to classify loans and compute provision;
- The Classification and Provisioning of loans and advances are carried-out by the Credit Department

without effective check and balance. Due to the vast number of loan accounts, it will be far from reality to expect that an individual person will identify all the relation between borrowers, check accuracy of the data, prepare independent assessment on a borrowers with multiple loans etc;

MIS for Loan Classification and Provisioning

Technology facilitates for the elimination of manual processes and allows information to be managed in an efficient and effective way. However, in most banks interviewed the manner in which the Credit Department receives information from Branches at times is untimely and inefficient. The information is submitted in both hard copy and in soft copy formats but sometimes takes more time to reach the Department after the submission cutoff date. In sum, the credit database of banks exhibits the following deficiencies: report inconsistencies, delay in reporting, not supported by latest information technologies and statistical software, unable to accurately classify loans and advances in terms of different categories: geography, sectors, in terms of product, term, etc, doesn't identify term loans in arrears, the recent value of collateral, in accurate in indicating collections and disbursements, inaccurate in indicating due dates of loans, total inability to indicate rescheduled loans.

The implication is that the individual assigned in the task is obliged to process the raw data received from Branches to meaningful information such as loans (by product, geography, term etc).This appeared very tiresome and prone the information produced to inaccuracies.

'The June 30 Syndrome'

Interviewed banks also expressed that the end of the fiscal year appear to be the time when a critical focus on loan classification and hence provisioning is provided. Hence, there's a deep rooted attitude towards considering June as the time warranting proper classification. This is for obvious reason that classification affects provision requirement which have direct implication on the profitability status of the Bank at the end of the fiscal year. Therefore, undertaking proper loan classification and provision system as a reflection of the quality of the credit portfolio has been compromised due to managers focus on short-term profit performance.

Management Involvement

Independence is tremendously vital in loan classification and provisioning activities; however management involvement on the area appear on the high side. This consistent, direct and indirect involvement of the Bank's management on the issues of NPLs, collateral, and related issues has an impact on the independence of the person/ organ responsible to classify loans and compute provision. It seems difficult to totally eradicate such attitude of the management and the involvement level because:

Loans appear to be the largest earning asset base of banks; hence any problem in the asset quality could have significant implication on the profit performance. Management is very sensitive to issues which affect profit as the main purpose of banks is directed towards maximizing shareholders wealth.

Strict application of loan classification standards could also escalate the level of NPLs and sometimes beyond the limit set by the NBE. This will result in compromising the compliance level of banks, hence is not an easy matter to be out of the management attention.

Therefore management will choose to involve on the issues especially during times of problems in quality of assets. The involvement might take the following forms:

- **Using some of the NBE's subjective criteria as advantage**- for instances banks might refrain from classifying multiple loans of a single borrower to NPL category on the pretext that the creditworthiness of borrowers is ascertained.
- **Hiding any material relationship among borrowers:** banks prefer to hide the list of interconnected borrowers. Therefore business with obvious relationship will only be considered for categorization of loans. In some banks this issue remained to be main cause for the controversy and difference in loan classification among banks and the regulatory organ.
- Other involvement includes- hiding the proper past due date, rescheduling without adequate justifications, sticking to the minimum requirements of the directives even if it's obvious that the borrower will default the day after year end book is closed, providing additional fiancé to the borrower which sometimes is used to repay the old loan,

Internally developed Loan classification Guideline

Almost all banks in the industry have no internally developed formal loan classification guideline in effect. They adopted the National Bank of Ethiopia's directives for classifying loan accounts. Despite attempt by very few

banks in such direction, it was reported that the standards are not different from the regulator's requirement (NBE's directives). That means the internal guideline is a broad explanation for the NBE's directives than the expected comprehensive documents consisting both objective and subjective factors for classifying loans. .

Issues on Average Recovery Rate Computation

Most of the issues in the computation of the average recovery rate were related to ambiguous clauses of the NBE directives. The interview has shown that the following issues are concerns related to ARR:

- The data for average recovery rate was obtained from Legal Service Department and there is no adequate data maintained to establish a proper framework for the computation of ARR;
- In case where gradual foreclosure of a group of assets was made by the Bank for a single loan outstanding and some of the collateral were foreclosed before 18 months (but the foreclosure of the final lies within the 18 months) , the directives have no mention which outstanding balance of the loan and collateral amount shall be taken during computation of the average recovery rate;
- The directives have a confusing presentation with regard to the amount of outstanding balance to be taken whenever only part of the loan was secured by collateral. The choice is between the total outstanding balance and only that portion of the loan which was secured by the collateral during the initial granting of the loan. In such respect, the Bank is working by following the later approach, but subsequent challenges were arising from the external auditors of the Bank;
- The directives has not stipulated clear cut procedures on how to treat the proceeds collected from insurance companies, from arrangement sales and from sources other than sales proceeds during the computation of ARR;
- In addition, the directives lack presentations with regard to the treatment of collateral which cannot be foreclosed due to their worse condition (damaged properties, out of service collateral or collateral with some defects). This situation becomes more confusing in case of loans backed by two or more collateral .This is when the majority of the collateral was sold but the rest couldn't be foreclosed or cannot be possible to attach value for foreclosure. In such cases, there is a confusion on whether to ignore the total sales from the computation of the ARR or not and on what amount to acquire the unsold collateral.

Assurance System

The role of internal control department emerges at the end of the loan classification and provisioning cycle. The Department conducts checking on the classification made by the Credit Department after it was assessed and commented by the Senior Management. However, the task of the Control Department is far from being exhaustive owing to the inadequacy of reliable and readily available data. In addition, in most banks the internal audit unit has no a specialized unit in the review of loan classification and provisioning. Therefore assurance seems in adequate and infrequent.

Additional Classification Standards used by the regulator

From the interview with the banks personnel, it was suggested that the NBE's examiners use additional standards which are not clearly stipulated in the directives. Most of the standards were related to financial factors, collateral factors, business risk factors and ownership and management factors. For instance they raised that, the regulatory on-site examiners use:

- **Account Performance-**In addition to the lowest debit standard set in the directives, the NBE's examiners consider the turnover of overdraft facility during classifying loan accounts;
- **Borrowers Performance**- Borrower's financial condition is also one area that get focus by the NBE to classify loan accounts. The examiners critically evaluate the financial performance of borrowers providing a significant weight to erosion in paid up capital due to accumulated losses;
- **Documentation**- Submission of proper financial statements (cash flow, Income Statement and Balance Sheet) by borrowers during new credit request, renewing facilities, restructuring loans etc also has got power to classify loan accounts in the NBE's examiners loan classification practice;
- **Collateral-** Collateral coverage is another criteria used by the examiners for loan classification;
- **Management Risk-** Risks pertaining to ownership or management also served a basis for loan classification.

Conclusions and Recommendations

Even if there exist neither a uniform loan classification technique, nor a standard procedure to assess credit risk on a worldwide basis, the following lessons can be grasped from the experiences of countries:

- The countries experience revealed that banks shall be encouraged to timely evaluate the credit risk of a borrower via applying both subjective /judgmental and objective criteria;
- The framework of some international banks comprised of multiple criteria than delinquency period to

determine an appropriate classification. The criteria provided a power to judgmental factors to relegate performing loans to NPLs. The judgmental (subjective /judgmental) factors include: value of collateral, changes in borrower's financial conditions, deficient documentation. The National Bank of Ethiopia also considers such factors during its on-site examination, however integrating the standards in its loan classification and provisioning is not formalized.

- Most countries apply a 5-grade (pass, special mention, substandard, doubtful, loss) loan classification framework to classify loan accounts. This appeared more consistent with the current credit categorization framework of our country;
- Credit risk classification can be also separately adapted for loans without fixed repayment programs such as merchandise loans and trade bills discounted based on the nature of the loan performances ;
- Restructured loans can't be up-graded unless both principal and interests in arrears are fully cleared by the borrowers, otherwise until the borrower services the loan for some periods (some countries one year) under the new contract depending on the risk level/grade the borrower was before renegotiation. Such practice is also implemented in our country system;
- Some countries supervisors prohibited Banks from restructuring loans classified as doubtful or loss unless an up-front cash payments is made to cover at least unpaid interest, or an improvement in the security or collateral taken than make the account restructured;
- Some countries banks are enforced to re-estimate their collateral when loans were categorized as non-performing. The study also acknowledges this as a good experience;
- Some countries incorporated special mention loans under the list of 'criticized' loans (special mention, substandard, doubtful and loss) making a segregation from NPLs (substandard, doubtful and loss). This also appeared as a good experience which enables banks to see the prospects of there loan portfolio via incorporating watched listed loans ;
- Some banks classify multiple loan to the same customer in the same category as the status of the non performing loan;
- Some countries also introduced a range system which set aside a provision amount starting from a certain minimum percentage increasing up to the highest percentage irrespective of the loans stay in a certain category. This seems reasonable as a loan stay within a certain category for an extended period of time could give an indication on the high level of credit risk. This requires backing the loan with more provision amount than the minimum provision balance held during the initial (time 0) timing in the existing category of the loan;
- Countries also take collateral into account during classifying loan accounts. The experience could be applied with our country system where collateral based credit granting practice is prevailed;

In sum, the current classification and provisioning practice of Ethiopian banks has been framed by the National Bank of Ethiopia's directives. For loans with fixed repayment terms, the NBE's directive and the current practice of the banks are based on an objective indicator of collectibility i.e. the period that payments of interest and principal are past due. However, country's' experience lead us to conclude that the decision to classify loans should be largely judgmental based on assessment of the borrower's capacity to repay and on the degree of doubt about the collectibility of the principal or interest of a loan. Thus, payment in arrears is only one of a number of factors to be considered in classifying problem loans. In such respect, the NBE has also tried to integrate many factors into its classification system by providing the discretion to its onsite examiners. Most of the standards were related to financial factors, collateral factors, business risk factors and ownership and management factors. Therefore Banks need to revitalize their loan classification system by developing an internal workable guideline which provides coverage to the aforesaid standards. The guideline shall be framed in a way to incorporate criteria required by the regulator (objective standards) and subjective /judgmental criteria adopted from the international bank experiences and the NBE's on site practices. In addition, enhancements of internal system via ensuring independence of the classification and provision tasks, the MIS and the involvement of independent evaluators like internal auditors requires considerations from the Banks

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Loan Classification and Provisioning Directives of the National Bank of Ethiopia

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