

# **Regulation No. 9**

## **on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss**

(Issued by the Bulgarian National Bank on 19 December 2002; published in the State Gazette, issue 2 of 7 January 2003; amended; issue 71 of 2003; issue 11 of 2004, effective as of 1 April 2004)

### *Chapter One*

#### **General Provisions**

##### **Subject**

**Article 1.** This Regulation shall determine the criteria and manners of evaluating and classifying risk exposures of banks, the conditions, amounts and procedure for the allocation of provisions to cover impairment loss, as well as the supervision exercised by the Bulgarian National Bank on the compliance with these requirements.

##### **Risk Exposures**

**Article 2.** Within the meaning of this Regulation, risk exposures shall be:

1. all loans and other claims of a bank reported as balance-sheet items, regardless of the ground for their occurrence and the financial instrument used, for which there is a risk of reduction in their net value;
2. contingent liabilities of a bank, reported as off-balance sheet items, for which there is a probability to be paid by the bank.

##### **General Requirements**

**Article 3.** (1) Banks shall assess and classify their risk exposures where there exists objective evidence (proof) of deterioration. Banks shall report at least as of the date of preparation of each monthly balance sheet the allocated provisions to cover impairment loss.

(2) Where a bank has more than one exposure to persons who may be treated as presenting joint risk, these exposures shall be classified into the group of the person with the highest risk level.

(3) Banks may apply a more detailed and more stringent internal classification of their risk exposures.

(4) On each exposure, banks shall maintain comprehensive documentation, containing all material conditions and circumstances of the transaction, as well as the respective information about evaluation and classification and the manners of determining the amount of the provisions to cover impairment loss.

### **Risk Exposure Evaluation Policy and a Specialized Internal Body of a Bank**

**Article 4.** (1) Any bank shall develop a policy on risk exposure evaluation and shall establish a specialized internal body which shall monitor, evaluate, classify and provision the risk exposures to cover impairment loss.

(2) The structure and powers of the body under para. 1 shall be specified in the internal rules. Not eligible for participation therein shall be persons directly engaged in the approval of the loans and in maintaining relations with borrowers.

(3) In accordance with Article 57, para. 1 of the Law on Banks, both the policy on evaluation of risk exposures under para. 1 and the internal rules shall be submitted to the Banking Supervision Department of the Bulgarian National Bank within ten days after their adoption, or amendment respectively.

## *Chapter Two*

### **Classification and Provisioning of Risk Exposures to Cover Impairment Loss**

#### **Criteria for Risk Exposure Evaluation and Classification**

**Article 5.** (1) Risk exposures shall be evaluated and classified based on the credit risk level, the period of delay of amounts due, the assessment of the debtor's financial state and the main sources for repayment of the debtor's obligations.

(2) Assessment of the debtor's financial state shall be based on the information required from and made available by the debtor periodically in compliance with Article 44 of the Law on Banks, including financial statements and other documents. Assessment of the financial state shall include a qualitative and quantitative analysis reflecting all circumstances which may affect debt repayment, according to the clauses of the loan agreement.

(3) (amended; State Gazette, issue 11 of 2004) The bank's risk exposures shall be classified into four classification groups according to the criteria under Articles 8–11.

(4) Where the bank does not have sufficient information on the debtor's financial state and on the sources for repayment of his obligations, as well as other documentation relating to his activity, the risk exposure shall be classified into the next higher risk classification group.

(5) (amended; State Gazette, issue 71 of 2003) A group of standard loans and other claims with similar characteristics may be assessed on a portfolio basis.

(6) The system for monitoring of loans and claims shall allow for evaluation and classification individually, by separate group and for the overall portfolio.

### **Exposures to an Individual Country**

**Article 6.** (1) (amended; State Gazette, issue 71 of 2003) Banks shall allocate specific provisions on a portfolio basis on exposures to an individual country related to country risk, excluding the risk exposures for which there is an evidence (proof) for individual deterioration in the amounts specified in the risk exposure evaluation policy under Article 4.

(2) (amended; State Gazette, issue 71 of 2003) Exposures to nonresidents in Bulgaria with an original term (maturity) of up to six months, to foreign banks' branches in Bulgaria and to foreign banks with investment rating assigned by internationally recognized credit agencies shall not be provisioned to cover country risk.

### **Specific Provisions to Cover Impairment Loss and on Off-Balance Sheet Items**

**Article 7.** (1) Specific provisions to cover impairment loss shall reduce the value of balance-sheet assets by the estimated loss to the amount of their recovery.

(2) (amended; State Gazette, issue 71 of 2003, issue 11 of 2004) Specific provisions to cover impairment loss shall be allocated against particular exposures classified as watch, substandard and nonperforming.

(3) (amended; State Gazette, issue 71 of 2003, issue 11 of 2004) Specific provisions to cover impairment loss may be allocated also on a portfolio basis and classified as standard to cover existing loss and risks which may not be specifically determined for each individual exposure in the amounts specified in the risk exposure evaluation policy under Article 4.

(4) (amended; State Gazette, issue 71 of 2003) Specific provisions shall be an element of the accounting expenses and shall be reported in the income statement.

(5) Specific provisions to cover contingent liabilities reported as off-balance sheet items shall be an element of the accounting expenses and shall be reported as liabilities in the balance sheet with the portion of the liability which is likely to be repaid by the bank

### **Standard Exposures**

**Article 8.** (1) Standard risk exposures on loans and other claims shall be those risk exposures which are serviced and information on the debtor's financial state gives no ground to assume that the debtor will not repay in full his debts.

(2) A risk exposure shall be classified as standard, provided that all of the following conditions obtain:

1. principal and interest are repaid in accordance with the contractual agreement terms, or payments on them have been past-due up to 30 days, provided the delay is justified or accidental;

2. the debtor uses the loan for the purposes stipulated in the loan agreement;
3. the bank has sufficient updated information on the debtor's financial state and on the sources for repayment of his liabilities, as well as other documents relating to his activity.

(3) Banks may not classify as standard exposures which have arisen from the performance of off-balance sheet commitments.

### **Watch Exposures**

**Article 9.** (1) Watch exposures shall be the risk exposures on loans and other claims where insignificant weaknesses exist with respect to their servicing or there is a possibility of deterioration in the debtor's financial state, which may question the full repayment of the obligation.

(2) A risk exposure shall be classified as watch, provided that it satisfies the general conditions under para. 1 or one of the following conditions obtains:

1. principal or interest arrears payments have been past-due 31 to 60 days;
2. the debtor uses the loan for purposes other than those specified in the loan agreement.

### **Substandard Exposures**

**Article 10.** (1) Substandard exposures shall be the risk exposures on loans and other claims where significant weaknesses exist with respect to their servicing, or the available information points to the debtor's unstable financial state, current and anticipated proceeds are insufficient for the full repayment of his obligations to the bank and to other creditors, as well as where weaknesses have been found with the distinct possibility that the bank will sustain some loss.

(2) A risk exposure shall be classified as substandard, provided that it satisfies the general conditions under para. 1 or one of the following conditions obtains:

1. principal or interest arrears payments have been past-due 61 to 90 days;
2. the debtor's financial state has substantially deteriorated and may result in inability to repay his obligations.

### **Nonperforming Exposures**

(title amended; State Gazette, issue 11 of 2004)

**Article 11.** (1) (amended; State Gazette, issue 11 of 2004) Nonperforming exposures shall be those risk exposures where grave weaknesses exist with respect to their servicing or as a result of the debtor's deteriorated financial state his obligations are deemed uncollectable, even though they have partial recovery value that may be realized in the future.

(2) (amended; State Gazette, issue 71 of 2003, issue 11 of 2004) A risk exposure shall be classified as nonperforming, provided it satisfies the general conditions under para. 1 or one of the following conditions:

1. principal or interest arrears payments have been past-due over 90 days;

2. the debtor suffers a permanent shortage of money;
3. the debtor has been declared bankrupt or is in a liquidation procedure, and there is a risk of leaving creditors unsatisfied;
4. the claim reported as a balance-sheet item is subject to court proceedings or the court has awarded it to the bank but it has not been collected;
5. other conditions providing grounds to consider that the risk exposure is jeopardized by nonrepayment.

### **Loss**

**Article 12.** (amended; State Gazette, issue 71 of 2003; repealed, issue 11 of 2004).

### *Chapter Three*

### **Allocation of Provisions to Cover Impairment Loss**

**Article 13.** (1) Banks shall allocate specific provisions to cover impairment loss for individually significant exposures on the difference between the book value of prior reporting period of the risk exposure and its recoverable amount as of the reporting period.

(2) The recoverable amount of the risk exposure shall be determined by:

1. reducing the contractually agreed cash flows by the loss risk percent depending on the classification group of the exposure:

- a) for watch exposures not less than 10 percent;
- b) (amended; State Gazette, issue 11 of 2004) for substandard exposures not less than 50 percent;
- c) (amended; State Gazette, issue 11 of 2004) for nonperforming exposures not less than 100 percent;
- d) (repealed; State Gazette, issue 11 of 2004);

2. discounting the estimated cash flows under item 1 by applying the corresponding effective interest rate.

(3) (amended; State Gazette, issue 71 of 2003) The size of the specific provision to cover impairment loss on a risk exposure which has a high liquid collateral (of best quality) shall be equal to the difference between the book value and the recoverable amount of the risk exposure as of the reporting period that remains uncovered by the net realizable value of the collateral, and for the collateral under § 1, item 1, 'f' of the Additional Provision a half of the net realizable value.

(4) (amended; State Gazette, issue 11 of 2004) The size of the specific provisions on contingent liabilities reported as off-balance sheet commitments shall be determined under the procedure specified in para. 2, item 1, 'c', where the contingent off-balance sheet commitments meet the general conditions of the provision under Article 11, para. 1.

*Chapter Four*  
**Interest Accrual Regime**

**General Provision**

**Article 14.** Balance-sheet accrued interest, including capitalized interest, shall be reported as income for the relevant period as of the date of its accrual, regardless of the time of its actual repayment.

**Ban on Accruing Interest upon Interest**

**Article 15.** (1) Banks may not accrue interest on interest, except for the cases of interest capitalization under Article 16.

**Interest Capitalization**

**Article 16.** (1) Banks may negotiate interest capitalization with their customers, provided that all of the following conditions obtain:

1. the debtor is in a position to repay his debts from the proceeds of his activities;
  2. the possibility of capitalization is provided for in the original agreement and is based on the debtor's planned temporary money deficiency;
  3. the repayment of the total liability, including capitalized interest, is based on a planned and reasonably estimated future event;
  4. the overall exposure, including capitalized interest, is secured.
- (2) Banks shall not capitalize interest arrears.

*Chapter Five*

**Restructuring of Risk Exposures, Off-Balance Sheet  
Accounting of Risk Exposures Classified as Nonperforming  
and Posting (Reintegrating) into Profit of Provisions to  
Cover Impairment Loss**

(title amended; State Gazette, issue 11 of 2004)

**Restructuring of Risk Exposures**

**Article 17.** (1) An exposure shall be considered restructured where the original agreement terms are amended by the bank to alleviate terms for the debtor due to deterioration of debtor's financial state that led to debt repayment impossibility and which allowances would not have been given by the bank under other circumstances.

(2) An exposure shall not be restructured where it is not identified as deteriorated, it is fully secured and there is a ground to assume that the bank will collect both the principal and the interest.

(3) Restructuring shall be made at the expense of allocated provisions to cover impairment loss, respectively reclassification in other classification group and further allocation of provisions to cover impairment loss.

(4) (amended; State Gazette, issue 11 of 2004) A restructured exposure may not be reclassified into a lower-risk classification group than the one as of the moment of the restructuring prior to elimination of the circumstances which led to this classification. Where the grounds for reclassification are overdue payments, elimination is deemed effected provided all payments due prior to restructuring of this exposure are redeemed.

(5) A bank may restructure a claim only on the basis of a motivated written proposal of the specialized internal body under Article 4.

### **Balance-Sheet Accounting of Risk Exposures Classified as Nonperforming**

(title amended; State Gazette, issue 11 of 2004)

**Article 18.** (amended; State Gazette, issue 11 of 2004) Banks shall discontinue balance-sheet accounting of risk exposures classified as nonperforming, and fully provisioned to cover impairment loss, by a motivated decision of the bank's managing body empowered by the Articles of Association on a written proposal by the specialized internal body under Article 4. The claim shall be written-off against allocated provisions for impairment loss.

### **Off-balance Sheet Accounting of Risk Exposures Classified as Nonperforming**

(title amended; State Gazette, issue 11 of 2004)

**Article 19.** (1) Banks shall keep off-balance sheet accounting of risk exposures under Article 18 and of those lost by limitation.

(2) Off-balance sheet accounting of exposures under para. 1 shall be discontinued by a decision of the bank's managing body empowered by the Articles of Association where the debtor:

1. is a legal entity deleted from the Commercial Register or any other public register and has no legal successor;
2. is a deceased physical entity with no heirs, or the heirs have renounced their inheritance;
3. has lodged a claim on limitation.

### **Posting to Profit (Reintegration) of Provisions to Cover Impairment Loss**

**Article 20.** Banks shall post to their current year revenues (reintegrate) the amounts released due to partial or full collection of the classified exposure that had been provisioned to cover impairment loss, as well as upon reclassification into lower-risk classification group.

## *Chapter Six*

### **Supervision over Evaluation and Classification of Risk Exposures and Provisioning to Cover Impairment Loss**

#### **Reports on Classified Risk Exposures and Allocation of Provisions to Cover Impairment Loss**

**Article 21.** (1) Banks shall prepare and submit to the Bulgarian National Bank, prior to the 15th day of the month following the reported quarter, a report on the classified risk exposures and allocated provisions to cover impairment loss drawn up on the basis of the balance sheet in a format approved by the Deputy Governor of the BNB heading the Banking Supervision Department.

(2) Banks shall also submit to the Bulgarian National Bank an annual report on the classified risk exposures and allocated provisions to cover impairment loss as an integral part of their annual supervisory reports.

(3) Banks shall disclose in their annual public statements methods used for evaluation of the risk exposures, the collateral and their impact on allocated specific provisions to cover impairment loss, as well as the share of classified and restructured exposures in their portfolios.

#### **Consolidated Report of a Bank Group**

**Article 22.** The parent bank shall prepare and submit to the BNB Banking Supervision Department, under this Regulation, a consolidated report of a bank group pursuant to Article 13 of BNB Regulation No. 12 on the Supervision on a Consolidated Basis.

#### **Instructions**

**Article 23.** The Deputy Governor of the BNB heading the Banking Supervision Department shall issue mandatory instructions on enactment of this Regulation.

#### **Additional Information**

**Article 24.** The Deputy Governor of the BNB heading the Banking Supervision Department may require from banks additional information and analytical breakdown of each item in the reports, including by individual risk exposure.

#### **Verification of the Information**

**Article 25.** (1) The banking supervision authorities of the Bulgarian National Bank shall conduct examinations to verify the authenticity of the reports drawn up under Articles 21 and 22, including on-site inspections.

(2) Auditors under Article 61, para. 2 of the Law on Banks shall conduct an examination and give an opinion on the compliance of the report drawn up by the bank under Article 21, para. 2 and Article 22 with the requirements of the Law on Banks, the Law on the Accountancy and this Regulation.



## Supervisory Reclassification of Risk Exposures

**Article 26.** (amended; State Gazette, issue 11 of 2004) Banking supervision authorities may reclassify risk exposures where the latter have not been evaluated and classified by the banks according to the provisions of this Regulation and shall require from the banks implementation of more stringent evaluation, classification and impairment of the risk exposures. In such cases the banks shall make adjustment accounting entries as of the date of reclassification.

## Measures and Sanctions

**Article 27.** Where an individual bank violates the provisions of this Regulation, the Deputy Governor heading the Banking Supervision Department shall enforce the sanctions and enforcement administrative measures stipulated in Article 65, para. 2 and Article 99 of the Law on Banks.

## Additional Provision

§ 1. Within the meaning of this Regulation:

1. 'high liquid collateral' (of best quality) shall be collateral easily convertible into money and carrying an insignificant loss risk. High liquid collateral shall be:

a) cash and deposits with the bank in levs or foreign currency for which the Bulgarian National Bank quotes exchange rates on a daily basis;

b) gold in bullion and plates with weights approved in gold markets;

c) securities and guarantees issued by the government of the Republic of Bulgaria;

d) securities and guarantees issued by governments, central banks and international organizations specified in Appendices 1 and 2 to BNB Regulation No. 8 of 1997 on the Capital Adequacy of Banks;

e) (amended; State Gazette, issue 71 of 2003) bank guarantees issued by domestic banks, as well as by foreign banks with investment rating assigned by internationally recognized credit agencies;

f) (amended; State Gazette, issue 71 of 2003) fully insured real estate in Bulgaria on which first mortgage has been established and which is located in a residential, administrative, trade or hotel building, provided the real estate may be sold within six months at its net realizable value; the realization term starts running at exposure past-due over 90 days;

g) insurance policies up to the amount of the insurance cover, signed at the expense of the government under the Law on Export Insurance, where the bank is the insured person or the third-person beneficiary;

2. 'capitalization' shall be the increase of the undue principal at the expense of adding nondelinquent due interest;

3. 'own funds (capital base)' shall be the capital under Articles 9–11 of Regulation No. 8 on the Capital Adequacy of Banks;

4. 'deterioration' shall be the decrease in the quality of one or more claims on which a bank is unlikely to collect all amounts due under the contractual terms;

5. 'country risk' shall be a possibility of nonpayment of obligations or impeding transfer of funds on claims of individuals of specific country due to economic, political or other reasons;

6. 'exposure to a country' shall be the exposure of an individual bank or banking group comprising of all its claims on individuals from the respective country;

7. 'parent bank' shall be a bank within the meaning of § 1, item 1 of the Additional Provision of BNB Regulation No. 12 on the Supervision on a Consolidated Basis;

8. 'net realizable amount of collateral' shall be the selling price of the asset in a secondary liquid market reduced by the additional expenses that are directly related to the release (sale) of the respective asset.

9. 'individually significant exposure' shall be the exposure exceeding one percent of the own funds (capital base) of the bank and which is evaluated and classified individually. For foreign banks' branches, an individually significant exposure shall be the exposure that exceeds BGN 100,000. An individually significant exposure shall be the exposure that besides the specified amounts shows objective deterioration evidence (proof);

10. 'effective interest rate' shall be the rate of precise discount of expected future cash flows at maturity or on a following date of market change to the net present balance-sheet amount of a financial asset or financial liability;

11. 'portfolio basis' shall be a group of similar financial assets that are not individually identified as deteriorated (impaired);

12. 'nonresident' shall be a legal entity not registered in the Republic of Bulgaria or a physical entity permanently residing abroad (over six months);

13. (amended; State Gazette, issue 71 of 2003) 'entities presenting joint risk' shall be:

- a) spouses and relatives in a direct lineage;
- b) entities, one of whom exercises control over the other;
- c) entities whose activities are controlled by a third party or its subsidiary company;
- d) entities who jointly control a third party or its subsidiary company;
- e) entities related financially (economically) to each other in such a way that in case of financial problems with one of them, another entity or all other entities may suffer difficulties in repaying their obligations.

### **Transitional and Final Provisions**

§ 2. This Regulation is issued on the grounds of Article 27 in connection with § 19 of the Transitional and Final Provisions of the Law on Banks, and is adopted by Resolution No. 100 of 19 December 2002 of the Managing Board of the Bulgarian National Bank.

§ 3. This Regulation shall come into force on 1 January 2003 and shall repeal Regulation No. 9 of 1997 of the Bulgarian National Bank on the Evaluation of Risk Exposures of Banks and the Allocation of Provisions to Cover the Risk Related Thereto (State Gazette, issue 73 of 1997).

### **Amendments**

#### **to Regulation No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss**

(Published in the State Gazette, issue 71 of 12 August 2003)

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### **Transitional and Final Provisions**

§ 8. Provisions under Article 11, para. 2, item 1 and Article 12, para. 2, item 1 shall further apply to incumbent cases as of 30 September 2003.

§ 9. These Amendments are issued on the grounds of Article 27 in connection with § 19 of the Transitional and Final Provisions of the Law on Banks, and are adopted by Resolution No. 69 of 24 July 2003 of the Managing Board of the Bulgarian National Bank.

### **Amendments**

#### **to Regulation No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss**

(Published in the State Gazette, issue 11 of 10 February 2004)

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§ 11. These Amendments are adopted by Resolution No. 13 of 22 January 2004 of the Managing Board of the Bulgarian National Bank and shall come into force on 1 April 2004.

