BANKING COMMISSION
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DIRECTIVE 2

ACCOUNTING FOR NON-PERFORMING CREDITS

PURPOSE

1. Directive 2 sets uniform accounting standards for establishing, provisioning and income recognition on non-performing loans related credits. The classifications and associated accounting rules are based on objective time-bound criteria for prompt recognition of unsatisfactory performance of individual credits.

BACKGROUND

2. A realistic valuation of assets and prudent recognition of income and expense are critical factors for evaluating the financial condition and operating performance of financial institutions. Uniform accounting standards are accordingly intended to ensure that non-performing credits are recognized in the financial statements on a timely basis, and thus prevent income recognition on any such credits. This paper does not set provisioning or reserve (Allowance for Loan Losses) adequacy standards per se.

RELEVANT DEFINITIONS

3. Specific loss provisions, sometimes referred to as "specific provisions" or "specifics", are established on a loan-by-loan basis on advances that are:

   i. Past due on interest and/or principal payments, or

   ii. Where there is evidence of well defined credit weaknesses causing doubt as to ultimate payment of interest and/or principal according to the contractual terms of the credit.

4. The appropriate level of specific loss provisions on individual credits is determined by management on the basis of the internal credit review process, which is periodically subject to assessment by examiners in the Office of the Commissioner of Banking and audit by external accountants.

5. A general provision, as distinct from a specific, refers to provisions established on portfolio basis in anticipation of future losses not yet detected, thus to compensate for expected losses on residual credit exposures where specific provisions have not been recognized including fully performing loans.

6. Write-offs are usually recorded when standard collection procedures that reasonably can be expected to result in repayment of the debt have failed, such that management has decided that a loan is uncollectible and turned the account over to a collection agency and or commenced legal proceedings, in which case the asset should be written off and removed from the books. Write-offs are also required in course of restructuring a non-accrual credit based on the estimated loss to the bank that the restructuring agreement will entail.

7. Loans and advances contractually past due 30 days on principal or interest, which are not in doubt as to payment, are referred to as non-current loans. If such loans become past due 90 days, they are automatically classified as non-accrual.

8. In the case of overdrafts, deposits to the account by the customer should be sufficient to cover interest due and payable. Where interest payments equal to 30 days or more have been capitalized, the overdraft is categorized in the non-current category and after 90 days among non-accrual credits.

NON-PERFORMING CREDITS

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9. Non-performing credits for purposes of this paper refer to all direct and indirect extensions of credit including, but not limited to, loans and overdrafts, contingent accounts and miscellaneous other exposures where the credits have been classified either "Non-Accrual" (See paras. 10 and 11) or "Restructured" (See para. 18) per the ensuing accounting rules.

10. The value attributed to security, collateral or third-party guarantees is not recognized for purposes of postponing a non-performing classification, on account of legal and other delays that can arise and/or due to uncertainty concerning future market values under a forced liquidation program. Consequently, realized recoveries on credits previously provisioned against, or where write-offs have been taken, represent the primary means by which security backing non-performing credits is recognized in the accounts.

11. Accrual and capitalization of interest on non-performing credits is not permitted for financial reporting purposes. In the case of non-accrual credits subsequent interest payments are applied to reduce principal and interest arrears; and on

restructured credits, interest income is recognized on a cash basis, namely on receipt of cash payments from the borrower.

NON-ACCRUAL DEFINITION AND PROVISIONING PROCEDURES

12. Non-accrual credits are defined as loans and advances on which interest is not being accrued due to the existence of reasonable doubt as to the ultimate collectability of principal or interest. Credit where interest is contractually past due 90 days are automatically to be accounted for on a non-accrual basis.

13. Current account overdrafts and other credits that lack pre-established repayment programs are subject to similar standards, namely being classified as non-accrual credits when interest is past-due 90 days, including dormant accounts, where outstandings exceed the customer's borrowing limit for 90 days or if the borrowing line has expired for 90 days.

14. When a credit has been designated non-accrual, a specific loss provision is required in recognition of the deterioration in financial performance by the debtor. The amount of the specific loss provision should be sufficient to cover the estimated ultimate loss or principal and interest on the credit, based on managements' assessment of the financial condition of the debtor, and near-term prospects for realizing on any security held or third-party guarantees (See Note).

    Note: Where the credit exposure is well secured with readily marketable securities or similar collateral, the bank's estimate of ultimate loss may initially be a negligible amount or no loss. If, however, the initial specific provision is small, in order to avoid a subsequent escalation in the provision, a prompt disposition of security will be necessary.

15. There are three reclassification routes that a non-accrual credit can take. It can:

    i. Be returned to performing status if all payments are brought to a fully current basis so long as management remains of the view that there is no reasonable doubt as to the ultimate collectability of interest and principal according to the terms of the existing credit agreement.

    ii. Be classified in restructured status, where the terms of the credit have been modified to accommodate the weakened financial condition of the borrower or

    iii. Be written off as a loss. If on the basis of predominant facts, conditions and values, management decides that the debtor's prospects for meeting future contractual payments remain highly improbable, the bank will declare the credit a loss. Uncollectible debts should be written off as soon as possible and, notwithstanding any delays protracting the collection process, must be recognized in the accounts within one year of the credit being placed in non-accrual status.

16. In the event that collection endeavors on credits previously written off are successful, the amount of the recovery proceeds is added to the allowance for loan losses.

NON-ACCRUAL INCOME RECOGNITION

17. Accrued and uncollected interest is to be reversed against interest income in the quarter in which a credit is classified as non-accrual. Where applicable, a corresponding reversal of recorded but unpaid interest for the prior period (s) is also required in the current period.

18. In the case of current account overdrafts, where interest has been capitalized to the account by adding uncollected interest to the principal, corresponding interest reversal rules apply. Accordingly, any accrued and uncollected interest on a non-accrual overdraft that deposit to the account is to be reversed against current interest income.

19. Payments received subsequent to a credit being classified in non-accrual status are to be applied in the accounts in the following sequence:

    i. When a write-off has been recorded credit principal (loan loss recovery) up to the amount of the write-off.

    ii. When a specific loss provision remains on the books, credit principal (specific reversal) up to the amount of the specific provision.

    iii. When the pre-existing loss (write-offs plus specific provisions) attributable to the non-accrual credit has been fully extinguished, credit income on a cash basis until the indebtedness is current and eligible to be returned to performing status.

RESTRUCTURED CREDIT DEFINITION AND PROVISIONING PROCEDURES

18. Restructured credits are defined as loans and other advances, where due to the weakened financial condition of the debtor, the bank has refinanced, rescheduled or otherwise modified the terms of the customer's debt. Concessions associated with restructured credits are:

    i. Reduced interest rates to below market rates to meet the borrower's debt service abilities

    ii. Extension of the borrower's repayment schedule because of inability to meet payments under the existing terms and/or

    iii. A reduction in principal payable from the amount indicated in the original debt agreement.

19. Restructured credits will frequently have previously been classified as non-accrual credits/overdrafts, based on the premise that the concessionary terms provided by the bank in the restructuring process are intended and can reasonably be expected to be met by the debtor. As a pre-condition for reclassifying from non-accrual to restructured status, therefore, interest arrears must be brought current from payments by the customer, or from payments by third party guarantors or from disposition of collateral. Accordingly, where the applicable specific provision is only partially covered by such payments, a write-off will be required to cover the residual amount owing on the debt before it can be restructured.

20. A restructured credit may return to performing status when it has fully met the debt service requirements of the restructured credit agreement on a timely basis for a period of one year, so long as management determines that there is no reasonable doubt as to the ultimate collectability of principal and interest according to the prevailing terms of the credit agreement.

21. When interest payments on a restructured credit become contractually past due 90 days, it will automatically revert to non-accrual status and thus require a new specific provision. Subsequent to a restructured credit being reclassified to non-accrual status, therefore, it remains subject to the provisioning and write-off rules prescribed for non-accrual credits until it is eligible for either reclassification to performing status or is written-off.

RESTRUCTURED INCOME RECOGNITION

22. The absence of specific provisions on restructured credits attests to managements' expectation that the debtor can meet the contractual terms of the revised debt servicing requirements. For this reason, interest payments on restructured credits are recorded in the accounts as follows:

    i. In the first year, credit income on a cash basis. This precludes accrual of interest in discreet accounting periods in the event of late payments, and is to ensure restructured credits are kept under close management scrutiny.

    ii. When the debt servicing requirements on a restructured credit have been honored on a timely basis for a year or longer, the credit may revert to performing status with interest accrued to income. If management prefers, however, the credit can remain in restructured status with recognition of interest payments continuing on a cash basis.

    iii. Where interest payments are contractually past due 90 days, the credit is automatically reclassified to non-accrual status and is subject to the attendant income recognition rules.

23. Front-end fees on restructured credits are to be credited to "other" income to the extent that they offset identifiable front-end costs associated with renegotiating the terms of the credit. Front-end fees in whole or in part, are otherwise amortized to income over the remaining term of the restructured indebtedness.

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FINAL VERSION

Signature Date

Sultan T. Korean
Banking Commissioner

6/30/17

Date Signed