

**EESTI PANK
GOVERNOR'S DECREE**

Tallinn,

27 June 2000, No. 9

**Servicing of loans of credit institutions and
entering of uncollectible claims in expenses**

Based on Article 83 Clause 2 and Article 86 Clause 3 of the Credit Institutions Act
(RT I 1999, 23, 349; 2000, 35, 222; 40, 250)

Eesti Pank herewith resolves:

1. To approve 'Minimum requirements on loan servicing and procedure for entering uncollectible claims in expenses' pursuant to the Appendix to this Decree.
2. Credit institutions shall make their operations and documents comply with the requirements of this Decree by 01.10.2000.

/signature/
Vahur Kraft

Appendix 'Minimum requirements on loan servicing and procedure for entering uncollectible claims in expenses'

**Minimum requirements on loan servicing and procedure for entering
uncollectible claims in expenses**

1. General provisions

- 1.1. Herewith, minimum requirements set by a credit institution to loan servicing and entering of uncollectible claims in expenses are stipulated.
- 1.2. Loan servicing covers the operations of a credit institution on granting, analysing, monitoring and evaluating loans. Loan servicing shall be performed within the framework of the credit risk control and reporting system.
- 1.3. Internal rules for loan servicing and the respective credit risk control and reporting system shall be approved by the Management Board of the credit institution in compliance with general risk management principles set by the Supervisory Board of the credit institution and minimum requirements stipulated in this Procedure.
- 1.4. This Procedure shall not treat instruments of the trading portfolio of a credit institution and short-term receivables from and loans to credit and finance institutions. Section 8 of this Procedure 'Evaluation of claims and entering thereof in expenses' shall not treat evaluation of securities.
- 1.5. A credit institution shall guarantee the compliance of principles of loan servicing and entering of uncollectible claims in expenses applied at companies that are members of the same consolidated group with the requirements stipulated by this Procedure, unless the above-specified contradicts the legislation of the home country of any company which is a member of the consolidated group.

2. Definitions

- 2.1. The definitions used in this Procedures shall have the following meaning:
- 2.2. Loan – financial assets, deriving from granting money or other assets by the lender to the borrower in return for the obligation of the latter to repay or return such assets, usually with interest.
- 2.3. Loan file – aggregate of agreements, certificates, resolutions, analyses and other documents related to loan servicing.
- 2.4. Claim – loan and other receivables.
- 2.5. Security – assets and property rights to ensure the satisfaction of claims of a credit institution.
- 2.6. Creditworthiness – ability and readiness of the borrower to perform its liabilities to a credit institution pursuant to the loan agreement.

- 2.7. Claim restructured due to solvency problems – claim in respect of which the credit institution has agreed, due to solvency problems of the borrower or any other party to the transaction, to amend the terms and conditions of the loan agreement, to which it would normally not agree. The following shall be such amendments:
- 2.7.1. reduction of interest rate;
 - 2.7.2. waiving of the right of claim in part or in full;
 - 2.7.3. partial or full repayment of the debt on the account of the borrower's assets the value of which is less than the debt amount;
 - 2.7.4. replacement of the borrower or other party to the transaction by another person, or involvement of an additional new borrower within the framework of this transaction;
 - 2.7.5. any amendment of other terms and conditions of the agreement, which would not have been applied if there were no solvency problems of the borrower or other party to the transaction.

3. Loan analysis

- 3.1. The principles and respective internal procedure rules for loan analysis shall be approved by the Management Board of a credit institution or structural unit authorised by the Management Board of a credit institution.
- 3.2. Loan analysis shall primarily focus on the assessment of creditworthiness of the borrower. The assessment of creditworthiness shall be based on the qualitative and quantitative analysis considering any circumstances that might affect the probability of loan repayment.
- 3.3. The substance and extent of loan analysis shall depend on the amount of loan, loan product (instrument), borrower and on the circumstance how considerable an impact of the analysed loan or loan group or risk formed thereby is for the credit institution in its entirety.
- 3.4. Loan analysis shall include the following indicators:
 - 3.4.1. general data on the borrower, including owners of the borrower that is a legal person and related parties who comply with the definition provided in Article 85 Clause 3 of the Credit Institutions Act, and areas of activity of the borrower;
 - 3.4.2. data on the performance by the borrower of its previous liabilities;
 - 3.4.3. data in respect of financial indicators of the borrower for the last three years;
 - 3.4.4. management quality of the borrower that is a legal person;
 - 3.4.5. in case of enterprise-related loans, business efficiency of the borrower (in case of the borrower that is a legal person business efficiency of members of managing bodies of the borrower);
 - 3.4.6. reliability and business reputation of the borrower (owners and members of managing bodies of the borrower that is a legal person);
 - 3.4.7. borrower's self-financing share in the project financed;
 - 3.4.8. borrower's solvency within the entire loan period;
 - 3.4.9. major risk or risk arising from the loan product (instrument), loan terms and conditions and other liabilities of the borrower;
 - 3.4.10. country risk;

- 3.4.11. primary and secondary sources of loan repayment;
 - 3.4.12. relation of the purpose of loan to repayment sources;
 - 3.4.13. existence of security and value thereof, incl. expenses, term and potential legal impediments related to the realisation of security.
- 3.5. In the loan analysis, special attention shall be paid inter alia to:
- 3.5.1. loans granted to companies starting their operations;
 - 3.5.2. loans with major risk concentration;
 - 3.5.3. loans to companies with nontransparent owners' structure;
 - 3.5.4. unsecured loans;
 - 3.5.5. financing of new areas of activity of the borrower;
 - 3.5.6. loans the repayment of which is directly related to the success of the financed project or transaction.
- 3.6. If the probability of loan repayment depends, in addition to the provisions specified in Clause 3.4, on any other major indicators, the loan analysis shall also comprise such respective indicators.
- 3.7. In the case of loans that considerably affect or form considerable risk for a credit institution, the loan analysis shall, in addition to the provisions specified in Clause 3.4, include the analysis of realisation of major risks of the financed project (stress scenario).

4. Decision of granting loans

- 4.1. Only a competent structural unit or competent person of a credit institution shall make loan decisions within the limits established by the Supervisory Board of the credit institution.
- 4.2. On making a loan decision, the principle of separation of functions of the person preparing the loan granting recommendation and the person resolving on granting the loan shall be observed; it shall not be the same person or structural unit. The principles for making exceptions shall be approved by the Supervisory Board of the credit institution.
- 4.3. Each loan decision shall be based on the previous loan analysis, which shall provide the person resolving on granting the loan sufficient proof as to the capability of the borrower to perform its obligations to the credit institution in good faith.
- 4.4. A decision on restructuring a loan in the part of the amendments specified in Clause 2.7 shall also be considered a loan decision.
- 4.5. Each loan decision shall specify, in writing, essential terms and conditions of the loan: loan amount, interest rate, terms of loan repayment and payment of interest. In the terms and conditions of the loan, risks assumed by the project financed by the credit institution, the borrower's person and its solvency as well as securities provided in favour of the credit institution shall be considered.

- 4.6. The terms and conditions of the loan stipulated in the loan decision and any other relevant information and conditions that may affect the loan repayment and satisfaction of claims of the credit institution, shall be specified in the loan agreement.
- 4.7. On granting a loan, a credit institution shall have proof to the fact that the reporting of the borrower during the loan period is sufficient for the assessment of the latter's creditworthiness and, if needed, stipulate the obligation of submitting respective reports in the loan agreement.
- 4.8. On granting an unsecured loan, a credit institution shall have proof to the fact that the creditworthiness of the loan applicant secures the repayment of loan pursuant to the terms and conditions of the loan agreement. Terms and conditions as well as limits of unsecured loans shall be approved by the Management Board of a credit institution.

5. Loan monitoring

- 5.1. A credit institution shall perform loan analysis pursuant to the requirements provided in Clause 3 and monitor the observance of the terms and conditions of the loan agreement by the borrower during the entire loan period.
- 5.2. For monitoring loans of each borrower and loans of borrowers who are related parties a responsible employee or structural unit shall be appointed.
- 5.3. A credit institution shall continuously monitor loans in order to determine the financial standing of the borrower, also, net realisation value of the security, country risk and other major risks, which may affect the borrower's creditworthiness or net realisation value of the security (if the bank intends to sell the given loan).
- 5.4. For the loans which considerably affect or form a major risk for credit institution in its entirety, loan monitoring requirements that are more detailed compared to the usual ones shall be set. Among others, such loans shall be considered loans with big risk concentration and loans the principal of which is repaid by a single amount at the end of the loan period.
- 5.5. In the course of loan monitoring a credit institution shall, applying the credit risk control and reporting system, receive sufficient information in order to:
 - 5.5.1. ensure immediate notification of competent persons or structural units of a credit institution of any considerable changes and events in the borrower's activity that may affect the probability of loan repayment;
 - 5.5.2. provide the Supervisory Board and Management Board of a credit institution with sufficient information on the structure of the loan portfolio by countries for the assessment of country and transfer risk;
 - 5.5.3. provide the Supervisory Board and Management Board of a credit institution with sufficient information on the structure of the loan portfolio, based on its quantitative distribution, for the adequate assessment of credit risk, also, for the analysis of credit risk strategy and internal procedure rules based thereupon, and, if required, for introducing amendments.

6. Loan file

- 6.1. A credit institution shall ensure the existence of the required information and documents in the loan file within the entire loan period.
- 6.2. A loan file shall be maintained for each borrower.
- 6.3. A loan file shall provide the person or structural unit responsible for granting the loan, also the Internal Audit Department and auditors as well as the Banking Supervision Department sufficient information for the performance of loan analysis.
- 6.4. As a rule, a loan file shall contain the following certificates and documents:
 - 6.4.1. general information on the borrower;
 - 6.4.2. loan application or applications;
 - 6.4.3. resolution or resolutions on granting the loan or refusal thereof;
 - 6.4.4. documents and reports submitted within the period of applying for the loan and loan period, including audited and not audited accounting records and financial statements;
 - 6.4.5. results of the analysis of the borrower's solvency;
 - 6.4.6. loan and security agreement or agreements;
 - 6.4.7. correspondence maintained with the borrower during the loan period;
 - 6.4.8. loan reports containing information on the assessment and classification of the loan;
 - 6.4.9. documents in respect of the checking, insurance and assessment of the security, including opinions of independent experts on the value of the security.
- 6.5. The requirements set to the certificates and documents contained in the loan file as well as substance and extent thereof may be different depending on the loan product (instrument), borrower and loan amount.
- 6.6. The information contained in the loan file may be located in the information and document administration system at random, but the credit institution shall secure availability thereof at any moment of time.

7. Loan classification

- 7.1. For loan monitoring, a credit institution shall apply the loan classification system, which shall enable to differentiate loans according to their risk level, based on the repayment probability and considering the borrower's financial standing, creditworthiness, security value and realisability, and other circumstances that may affect the performance of the borrower's obligations to the credit institution. The credit rating system may serve as the basis for the loan classification system.
- 7.2. The loan classification system shall enable to monitor and analyse any loan individually, single loan groups and the entire loan portfolio.

- 7.3. Loans of insignificant value can be grouped prior to classification based on common features.
- 7.4. The loan classification system shall enable to differentiate loans,
- 7.4.1. in respect of which no circumstances have arisen that might cause non-repayment of the loan pursuant to the terms and conditions of the loan agreement, i.e. standard loans;
 - 7.4.2. which contain potential weaknesses that require more attention and that, if unremoved, may in the future affect the borrower's creditworthiness, i.e. watch loans;
 - 7.4.3. which are insufficiently secured by the borrower's creditworthiness or security and contain explicitly identifiable drawbacks or weaknesses based on which the credit institution has a reason to believe that the full repayment of the loan is questionable and the credit institution will probably sustain a loss, if the specified drawbacks or weaknesses are not removed, i.e. doubtful loans;
 - 7.4.4. which contain all the drawbacks and weaknesses specified in Clause 7.4.3, based on which the credit institution has a reason to believe that the repayment of the loan in full is improbable if the given situation does not change considerably, but the repayment of the loan in part is possible, under certain circumstances, i.e. insecure loans;
 - 7.4.5. in the case of which it is impossible or economically unreasonable for the credit institution to apply measures for their recovery, i.e. uncollectible loans.
- 7.5. A credit institution shall identify the classification criteria of a loan or part thereof based on the general principles stipulated in Clause 7.4 and in compliance with the requirements of loan analysis provided in Clause 3 of this Procedure. If conditions for different parts of a loan are different, they shall be classified individually.
- 7.6. The frequency of loan classification shall depend on the amount of loan, loan product (instrument), borrower, loan type and on the circumstance how considerable is the impact made or risk formed by the analysed loan for the credit institution in its entirety.
- 7.7. Loans differentiated pursuant to the principle stipulated in Clause 7.4.1 shall be classified at least once a year and each time the credit institution has a reason to believe that the borrower's creditworthiness has decreased or the probability of loan repayment has reduced.
- 7.8. Loans with a lower repayment probability compared to the loans differentiated pursuant to the principle stipulated in Clause 7.4.1 shall be classified at least once a quarter and each time the credit institution has a reason to believe that the borrower's creditworthiness has decreased or the loan repayment probability has reduced.
- 7.9. A loan that failed to comply with the loans differentiated pursuant to the principle stipulated on Clause 7.4.1 may be re-considered a standard loan if interest payments and principal repayments of such loan are received according to the terms and conditions of the loan agreement and the

circumstances, which have caused the decrease of creditworthiness, have been removed.

- 7.10. Loans of related parties shall not be classified standard loans if at least one of the loans of related parties has been classified doubtful, insecure or uncollectible, and if the deterioration of the solvency of such person affects the solvency of other related parties.
- 7.11. A loan restructured due to solvency problems shall not be considered a standard loan pursuant to the principle stipulated in Clause 7.4.1 until the circumstances that have caused the decrease of the borrower's creditworthiness have been removed.
- 7.12. On classifying and evaluating loans, a credit institution shall be governed by the principle that interest is overdue if refinancing or adding of interest to the principle amount was not stipulated in the initial terms and conditions of the agreement or interest payments are not sufficiently secured by the borrower's creditworthiness.

8. Evaluation and entering in expenses of claims

- 8.1. Claims shall be evaluated individually, considering the information within as well as outside the credit institution, incl. circumstances related to the solvency and securities of the party to the transaction (incl. guarantors' creditworthiness, security value).
- 8.2. If a claim is evaluated as doubtful in part or in full, such claim shall be considered nonperforming.
- 8.3. The circumstances indicating that a claim is doubtful shall be the following:
 - 8.3.1. solvency problems of the party to transaction affecting the repayment of claim;
 - 8.3.2. violation of the terms and conditions of the agreement, incl. violation of the repayment schedule in the part of interest or principal payments;
 - 8.3.3. probability of permanent insolvency or danger of any other financial reorganisation of the party to the transaction;
 - 8.3.4. support of the party to the transaction by the credit institution by way of making concessions to which the credit institution would not have agreed if no solvency problems occurred to the party to transaction.
- 8.4. A claim shall always be considered nonperforming if the party to transaction delays the payment of interest or principal over 90 calendar days, unless the claim is restructured due to solvency problems of the party to transaction and the security value exceeds the principal amount of the claim including accrued interest and late penalties.
- 8.5. The calculation of accrued interest on nonperforming claims shall be suspended.

- 8.6. A nonperforming claim shall be discounted. The amount of discount shall be the difference of the book value of the claim and present value of future expected cash flows discounted at the interest rate fixed in the agreement (on discounting cash flows of claims restructured due to solvency problems the interest rate specified in the agreement prior to restructuring shall be applied). A credit institution shall be able to prove that prerequisites and projections on the basis of which future expected cash flows are estimated are realistic and justified in the given situation.
- 8.7. If a credit institution has no assurance that a claim should be discounted based on cash flows, on discounting such loan the security or claim net realisation value shall serve as the basis. In such case the amount of discount shall be the difference between the book value of the claim and security or claim net realisation value.
- 8.8. On finding the net realisation value of security or claim, the conservatism principle shall be observed and secondary market prices taken as the basis, if it is possible to realise the security or claim in the liquid secondary market. If no liquid secondary market exists for the realisation of the security or claim, the present value of expected cash flows on realising the security or claim discounted at the interest rate specified in the loan agreement shall serve as the basis and the term required for the realisation of such security or claim shall be considered.
- 8.9. The requirement of individual evaluation specified in Clause 8.1 shall not apply in case of homogeneous claims of inconsiderable value, which may be grouped based on their common features. The grouping principles shall be stipulated in the internal procedure rules for claim evaluation. Evaluation of homogeneous claims of inconsiderable value by groups may be applied if the credit institution has been continuously applying the same evaluation methods.
- 8.10. On evaluating grouped homogeneous claims of inconsiderable value the previous practice of the credit institution on evaluating the given claim groups and statistical data on changes within groups shall serve as the basis.
- 8.11. If there is a reason to believe that the value of claims of a credit institution is lower than book value thereof, and the decrease of the given value cannot be linked to any particular claim or contingent liability, general discount shall be applied.
- 8.12. Credit institutions shall develop principles of calculating general discount approved by a competent managing body. On calculating general discount, the following shall serve as the basis: discount applied during the previous period and actual loss, qualitative and quantitative changes in the classes or groups of claims occurred, general economic situation, changes in credit policy and other factors affecting the value of claims. The principles of calculating general discount shall inter alia contain country risk calculation by countries.
- 8.13. Individual as well as general discount shall be applied based on the conservatism principle. A credit institution shall be able to prove that discount

is applied based on the consistency and comparison principle and the reporting and information that serve as the basis for discount enables to objectively assess the value of claims. The discount applied shall be sufficient to cover potential losses in the part of claims. No discount shall be applied with the aim of gaining a certain amount of profit/loss.

- 8.14. If circumstances arise based on which a credit institution has a reason to believe that it will probably incur a loss from contingent liabilities and it is possible to reliably evaluate the amount of such loss, it shall be entered in the balance sheet.
- 8.15. A credit institution shall regularly review discount principles and adjust them if needed.
- 8.16. The discount amount shall be entered in the balance sheet in the entry 'Uncollectible claims.'
- 8.17. A credit institution shall write off the balance sheet claims in respect of which the credit institution is unable, or it is economically unreasonable, to apply measures for recovery thereof, i.e. uncollectible claims. If an uncollectible claim is recovered later, it shall be entered as income.

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22.06.2000