

**On Approval of Policy On the
Procedure of Formation and Usage
of the Loan Loss Reserve by Banks**

APPROVED by NBU Board Resolution # 279 dated 07-06-2000

Registered with the Ministry of Justice of Ukraine on August 3, 2000 under # 474/4695

As amended by NBU Board Resolutions

#418 dated 10-24-00,
#151 dated 04-05-01,
#502 dated 12-07-01,
#119 dated 03-19-03,
#339 dated 08-15-03,
#411 dated 08-27-04,
#10 dated 01-17-05,
#210 dated 06-10-05,
#83 dated 03-19-07,
#248 dated 07-06-08,
#211 dated 07-23-08,
#406 dated 12-01-08

Additionally, see Letters of the National Bank of Ukraine
#43-111/5352-8352 dated 12-19-00 and # 40-511/442/919 dated 22-01-09

According to Article 59 of the Law of Ukraine On the National Bank of Ukraine and in order to improve the procedure of formation and usage of the loan loss reserve by banks, the Board **hereby RESOLVES**:

1. Approve the Procedure of Formation and Usage of Loan Loss Reserve by Banks (attached).
2. Recognize invalid Policy on the Procedure of Formation and Usage of Loan Loss Reserve by Commercial Banks approved by NBU Board Resolution #323 dated 09-29-97 (as amended).
3. Require that banks form lending risk reserve for cash kept on correspondent accounts at other banks and for over 30 days overdue accrued revenue from lending transactions, according to items 1.6, 1.7 and 8.2 of Policy on the Procedure for Formation and Usage of Loan Loss Reserves by Banks beginning January 1, 2001.
4. By January 1, 2001, the Department of Accounting shall make the relevant amendments in the Chart of Accounts of Commercial Banks of Ukraine concerning the procedure for accounting of accrued revenue from lending transactions overdue more than 30 days.
5. The Resolution shall come into effect in 10 days after registration with the Ministry of Justice of Ukraine.
6. Enforcement of this Resolution shall be the responsibility of Deputy Chairman Y. F. Soltys, Prudential Oversight Department (V. O. Zinchenko), Large Banks Supervision Division (Y. O. Herasymenko), Operations Division (V. D. Shchutskyi) and Heads of territorial divisions of the National Bank of Ukraine.

Chairman

V. S. Stelmakh

POLICY

On the procedure of formation and usage of the loan loss reserve by banks

1. General Provisions

1.1. With the objective of increasing the safety and soundness of the banking system and protecting the interests of bank creditors and depositors, the National Bank of Ukraine (hereinafter - the National Bank) establishes the procedure of formation and usage of the loan loss reserve by banks. The loan loss reserve (hereinafter – the reserve for credit risks) is a special reserve necessitated by credit risks inherent in banking activity. The formation of the reserve for credit risks is the recognition of losses to reflect the bank’s real performance taking into account the deterioration of its asset quality or increase in the risks of lending transactions.

The formation and usage of reserves is accounted for in accordance with the Guidelines of accounting for lending and deposit transactions and the formation and usage of lending risk reserves in the banks of Ukraine as approved by NBU Board Resolution #435 dated 09-15-04 and registered with the Ministry of Justice of Ukraine under #1302/9901 on 10-12-04. Tax accounting is regulated by the Law of Ukraine “On corporate profit taxation” as amended.

1.2. The Policy on the procedure of formation and usage of the loan loss reserve by banks (hereinafter – the Policy) has been developed on the basis of the Laws of Ukraine “On the National Bank of Ukraine”, “On banks and banking activity”, “On enterprises in Ukraine”, “On collateral”, “On business companies”, and NBU regulations.

1.3. In order to prevent losses from failure to repay debt because of borrowers’ (the bank’s counterparties’) insolvency, credit risks are assessed for all lending transactions and funds placed in the correspondent accounts opened with other banks both in national and foreign currencies.

Banks, on their own, identify the risk level of lending transactions, assess the financial condition of the borrowers (the bank’s counterparties) and appraise the value of collateral within the limits of the current law.

1.4. Debt on lending transactions constituting a bank’s loan portfolio includes:

term deposits placed with other banks and doubtful debt on them (balance sheet accounts #1502, 1510-1512, 1513, 1514, 1515, 1516, 1517, 1581);

loans extended to other banks and doubtful debt on them (#1520, 1521, 1522, 1523, 1524, 1525, 1536 KA, 1527, 1582, 1600 A);

requirements acquired in factoring transactions with business entities and doubtful debt on them (balance sheet accounts #2030, 2036 KA, 2037, 2093);

loans provided to business entities through “REPO” transactions (repurchase agreements) (balance sheet accounts #2010 and 2016 KA);

loans granted to business entities in the form of discounting bills of exchange and doubtful debt on them (balance sheet accounts # 2020, #2026 KA, 2027, 2092);

loans to business entities for current activities, for investment activities, and doubtful debt on them (balance sheet accounts #2062, 2063, 2065, 2066 KA, 2067, 2071, 2072, 2073, 2074, 2075, 2076 KA, 2077, 2096, 2097);

mortgage loans provided to business entities and doubtful debt on them (balance sheet accounts #2083, 2085, 2086 KA, 2087, 2095);

loans extended to central and local government authorities and doubtful debt on such loans (balance sheet accounts #2102, 2103, 2105, 2106 KA, 2107, 2112, 2113, 2115, 2116 KA, 2117, 2190, 2191, 2198, 2199);

mortgage loans extended to central and local government authorities and doubtful debt on them (balance sheet accounts #2122, 2123, 2125, 2126 KA, 2127, 2132, 2133, 2135, 2136 KA, 2137);

loans extended to individuals for current needs and investment activities and doubtful debt on them (balance sheet accounts #2202, 2203, 2205, 2206 KA, 2207, 2211, 2212, 2213, 2215, 2216, 2217, 2290, 2291);

mortgage loans extended to individuals and doubtful debt on them (balance sheet accounts #2232, 2233, 2235, 2236 KA, 2237, 2295);

loans granted to individuals in the form of discounting bills of exchange and doubtful debt on them (balance sheet accounts 2220, 2226 KA, 2227, 2292);

overdrafts granted to business entities and individuals (balance sheet accounts 2600A, 2605A, 2620A, 2625A, 2650 A, 2655 A);

guarantees, warrantees, confirmed letters of credit, acceptances and avals provided to banks (off-balance-sheet accounts #9000, 9001, 9002, 9003);

doubtful debt on paid guarantees issued to other banks (balance sheet account #1589);

guarantees and avals provided to clients other than banks (off-balance-sheet accounts #9020, 9023);

doubtful guarantees provided to banks and clients (off-balance-sheet accounts #9090, 9091);

doubtful debt on paid guarantees issued to business entities (balance sheet account #2099);

doubtful debt on paid guarantees issued to individuals (balance sheet account 2299);

lending commitments issued to banks and clients (off-balance-sheet accounts #9100, 9129). For the purpose of calculating the reserve, 50% is taken from the amount of lending commitments accounted for on off-balance-sheet accounts #9100, 9129.

- 1.5. In order to calculate the reserve for credit risks, banks have to classify their loan portfolio for each lending transaction depending on the financial condition of the borrower, status of loan debt servicing by the borrower, and taking into account the level of collateralization of the lending transaction. Loan portfolio classification results in the identification of the category of each lending transaction: standard, watch, substandard, doubtful, or loss.

Total debt on lending transactions constitutes gross credit risk for the creditor.

For the purposes of calculating loan loss reserves, net credit risk is identified (in absolute figures) by reducing the gross credit risk classified based on the degrees of risk by the value of the collateral accepted. Banks are required to create and form loan loss reserves for the entire amount of net credit risk of loan principal, adjusted for an appropriate provisioning ratio, for all types of lending transactions in national and foreign currencies.

No reserves are formed for budget loans¹; for lending transactions between institutions within the system of the same bank²; for finance lease transactions, if such transactions are carried out with real estate; for funds placed by the bank as subordinated debt; for off-balance-sheet lending commitments other than commitments provided by the bank under which the bank should not provide funds immediately on demand of the counterparty (that is, which bear no risk for the bank); and for funds in foreign currency transferred to the National Bank.

In case of consortium lending, the lead bank provides for only the part of the loan extended directly by this bank.

- 1.6. Item 1.6 with amendments as per NBU Board Resolution #151 dated 04-05-2001 was deleted according to NBU Board Resolution #502 dated 12-07-2001.

¹ Budget loans are budget funds, placed by a bank in the form of loans on the basis of an agreement with the manager of these funds, with regard to which the bank bears no credit risk.

² For banks with 100% foreign capital – for lending transactions with the parent company, provided this company has a credit rating not lower than “investment class”.

1.7. Banks shall form reserve for the entire amount of funds placed in the correspondent accounts both with resident and non-resident banks that are either recognized bankrupt or liquidated according to a decision of authorized bodies, or registered off-shore.

For funds in the correspondent accounts opened with non-resident banks (balance sheet accounts 1500, 1580), banks shall form a reserve taking into account country risk as required in Chapter 8 hereof.

1.8. The reserve for credit risks is divided into reserves for standard and nonstandard debt for lending transactions. Reserves for nonstandard debt are formed for lending transactions classified as “watch”, “substandard”, “doubtful”, and “loss”.

The reserve for credit risks is formed in the currency, in which the underlying debt is recorded.

The reserve for credit risks is only used to cover losses of non-collectable loan principals not repaid by the borrowers.

1.9. Banks are required to calculate reserves for standard and nonstandard debt (taking into account the maturity of lending transactions) within the month when the lending transaction was carried out (or a contract to carry it out was concluded³). Banks are required to form reserves on a monthly basis in full irrespective of the size of their income by risk groups according to the amounts of debt on lending transactions (including provided lending commitments) as of the first day of the month following the reporting month before the established deadline for submission of the monthly balance sheet.

The size of the actually formed loan loss reserve is controlled based on the data of the monthly balance sheet⁴.

1.10. Loss loan debt is charged-off by the bank through the reserve for nonstandard debt based on a decision of the board of managers of the bank.

1.11. Banks are required to draft and approve based a decision of the appropriate body of the bank an internal policy on the procedure for carrying out lending transactions and a methodology for assessing the financial condition of a borrower (counterparty of the bank). These documents should be submitted at the request of authorized officers of the National Bank to review the accuracy of assessment of the financial condition of borrowers, correctness of their classification, and adequacy of reserves for credit risks. Lack of or failure to submit these documents for familiarization to authorized officers of the National Bank is considered as a basis for negative conclusions about the bank’s asset quality and management.

If a bank carries out long-term lending for investment projects, then the bank’s internal policies should contain rules on the procedure for granting such credit, a methodology for investment project evaluation, a methodology to analyze the business plan of the investment project and its profitability, a procedure for examining the borrower, a methodology for assessing its creditworthiness, a determination of schemes of lending for investment projects and a procedure for preparing decisions on granting investment credit.

1.12. Banks may classify debt by lending transactions and form a portfolio of similar consumer loans and reserve for the portfolio based on this classification.

1.13. A bank shall exercise control of proper usage of loans provided by it in line with the credit agreement.

2. Definition of Separate Terms Used in this Policy

Lending transactions (loans) are a type of active transactions involving providing funds to clients for temporary use or making commitments to provide funds for temporary use under certain conditions, as well as providing guarantees, warranties, avals, placing deposits, conducting factoring transactions, finance lease, issuing loans in the form of discounting bills of exchange, in the form of “REPO” transactions, any extension of debt repayment term provided in exchange for the borrower’s commitment to repay the debt and the commitment to pay interest and other charges on such amount (deferred

³ An agreement on provision of a guarantee, etc.

⁴ Control based on the data of the balance sheet means that the reserve is formed taking into account adjusting entries in accordance with the Procedure on formation of adjusting entries that are made by commercial banks of Ukraine approved by NBU Board Resolution #427 dated 10-09-01.

payment). Lending transactions are classified depending on the level of risk and are divided into “standard”, “watch”, “substandard”, “doubtful”, and “loss”.

Classification of lending transactions is an assessment of the level of risk of every lending transaction taking into account the financial condition of the borrower, the status of loan debt servicing by the borrower, and the level of collateralization of the lending transaction. The level of credit risk is assessed in accordance with the procedure as established in Chapters 4,5,6 and 7 of this Policy.

Credit risk is the risk of a borrower’s (a bank’s counterparty’s) failure to meet his obligations on lending transactions (that is, the risk that the borrower will pay interest and principal on lending transactions with a deviation from the terms and conditions of the loan agreement or will not pay at all).

“Standard” lending transactions are transactions, whose credit risk is insignificant and makes up one percent in net credit risk.

“Watch” transactions are lending transactions, whose credit risk is insignificant, but it may grow as a consequence of a situation unfavorable for the borrower, and makes up five percent in net credit risk.

“Substandard” lending transactions are transactions, whose credit risk is significant, may grow further, and makes up 20 percent in net credit risk, and there is also a probability of untimely repayment of the debt in full and on the dates as envisaged in the loan agreement.

“Doubtful” lending transactions are transactions, where the fulfillment of obligations by the borrower/counterparty of the bank in the full amount (taking into account the financial condition of the borrower and the level of collateralization) is under threat, the probability of full repayment of the loan debt is low and makes up 50 percent in net credit risk.

“Loss” lending transactions are transactions, where the probability of fulfillment of obligations by the borrower/counterparty of the bank (taking into account the financial condition of the borrower and the level of collateralization) is practically absent; the risk of such transactions is equal to the amount of debt on them.

Solvency is a borrower’s (a bank’s counterparty’s) ability to make timely payments on all types of his obligations.

Creditworthiness is the existence of preconditions for a borrower/counterparty of a bank to get a loan and his ability to repay loan principal and interest in full and on the dates as established in the contract.

Investment project is a project, which is implemented by borrowers (business entities) on a financial self-supporting basis and which calls for project co-funding by the borrower or other investors in the amount of at least 20% of the project value.

Lending for an investment project is long-term lending to investment projects against future revenues (which are to be received by the business created/restructured and which will secure loan repayment), which calls for both the bank’s assessment of the investment project in terms of its financial self-support and the practical implementation of the project (assessment of the business plan of the project). In doing a feasibility study of the project, the bank assesses the borrower’s ability to effectively implement the investment project and to achieve the results planned; the safety and soundness of the business run by the borrower over the time needed to finish the project and to repay the loan; consideration both by the borrower and the bank of all risks inherent in lending for the investment project.

Homogeneous consumer loans are loans for current needs extended to an individual borrower whose total amount under one or several loan agreements, irrespective of whether it is securitized or not, does not exceed UAH 20000.

Homogeneous consumer loan portfolio is total debt on homogeneous consumer loans (balance sheet accounts #2202, 2203, 2206, 2207, 2290, 2620A, 2625A) provided by the bank to individual borrowers for current needs. Loan agreements with them contain written consents of the borrower for collection, maintenance, usage and distribution of information about the borrower through the credit history bureau, as well as data on these agreements provided to the credit history bureau by the bank.

Concessional loan is a loan the bank extends to a borrower on terms more generous than those established by the bank bylaws that determine its lending and accounting policy.

3. Criteria of Classification of Lending Transactions

3.1. In order to calculate the amount of the reserve for credit risks and to determine net credit risk, a bank should analyze its loan portfolio.

Loan portfolio is analyzed and lending transactions are classified (gross credit risk) according to the following criteria:

- assessment of the financial condition of the borrower (counterparty of the bank⁵);
- the status of servicing loan principal and interest (commission fees and other payments to service the debt) by the borrower (counterparty of the bank) as broken down by each separate debt, and the borrower's ability to further service this debt;
- the level of collateralization of the lending transaction.

The debt on loans from homogeneous consumer loan portfolio is classified by the timeliness of repayment of principal debt and/or interest/fees on the loan by the borrower according to item 6.1 of Chapter 6 hereof.

4. Assessment of the Financial Condition of a Borrower

4.1. Criteria for the assessment of the financial condition of a borrower are established by every bank individually in its internal policies on conducting active transactions (lending) and in the methodology for the assessment of the financial condition of a borrower (counterparty of the bank) taking into account the requirements of this Policy⁶, which should define detailed, technically balanced criteria for the economic assessment of the financial activities of borrowers (counterparties of the bank) on the basis of analysis of their balance sheet and income statement trends, etc. The methodology for the assessment of the financial condition of a borrower (counterparty of a bank) developed by the bank constitutes an integral attachment to the bank's Policy on lending.

The bank must take into account key criteria listed in items 4.3 and 4.6 of this Chapter in assessing the financial condition of a borrower.

The bank may establish additional (subjective) criteria in assessing the financial condition of a borrower.

Additional (subjective) criteria established by the bank that are used to assess financial condition of a borrower – a legal or a natural entity entrepreneur – must take into account the specific features of economic activity undertaken by the above mentioned borrowers.

The financial condition of a borrower (counterparty of a bank) taking into account the current status of loan debt servicing by the borrower (counterparty of the bank) is assessed by the bank every time it concludes a contract on conducting a lending transaction, and further on:

- for banks – not less than once a month;
- for other legal entities – not less than once in three months;
- for individuals – the frequency of assessment of their condition is determined by banks individually taking into account the status of debt servicing and loan maturity, but not less than once a year (or based on the results of the fiscal year). If loan debt servicing is delayed or prolonged, then the financial condition of the individual borrower should be assessed on a regular basis (monthly or quarterly) during the period of untimely debt repayment – except for instances associated with good reasons (documented instances of business trips, sickness, etc).

The bank uses its own methodology to check creditworthiness of a borrower whose debt on loan is included in the homogeneous loan portfolio.

The bank individually establishes the frequency for revision of creditworthiness of a borrower whose debt is included in the homogeneous consumer loan portfolio.

⁵ Except for counterparties on factoring transactions.

⁶ Footnote 6 was deleted

The results of assessment of the financial condition of a bank's borrowers/counterparties should be stored at the bank according to the time of storage of lending documents as set by the law of Ukraine, especially with regard to large loans, loans to related parties (insiders).

The requirements to the assessment of the financial condition of a borrower stated in this Policy are minimally necessary. Individual banks have the right to establish additional criteria for the assessment of the financial condition of a borrower, which would raise the requirements to performance indicators in order to adequately assess credit risks and to exercise proper control over them.

- 4.2. Banks individually establish normative indicators and appropriate scores for each indicator depending on its significance among other indicators, which can indicate the highest probability of fulfillment by a borrower (counterparty of the bank) of obligations on lending transactions.

The significance of each indicator is identified individually for each group of borrowers (counterparties of the bank) depending on the bank's lending policy, the client's features (industry, seasonal production, turnover of funds, etc.), liquidity, market situation, etc.

The bank determines the class of a borrower (counterparty of the bank) based on the results of assessment of its financial condition and its total score by key and additional (subjective) indicators. The score by additional (subjective) indicators must not exceed 30% of the total score determined by the bank on the basis of the result of assessment of the borrower's financial condition.

- 4.3. In order to assess the financial condition of a legal entity borrower, the bank should take into account the following key performance indicators:

solvency (quick, current and general liquidity ratios);

financial stability (ratios of maneuverability of own funds, debt-to-equity ratio);

sales;

turnovers in accounts (ratio of proceeds to the borrower's accounts to the amount of credit, existence of accounts with other banks, existence of a card index of non-payments - in terms of trends);

composition and trends of accounts receivable and payable (for the last reporting and current years);

production costs (trends);

profits and losses (trends);

profitability (trends);

credit history (repayment of loan debt in the past, existence of current loans).

Banks must determine solvency indicators of a borrower and its financial stability taking into account statistics of the industry where it operates and information on the results of its activity.

- 4.3.1. A borrower's solvency is determined based on the following indicators:

Quick liquidity ratio (LR1) that characterizes how quickly short-term liabilities can be repaid with highly liquid assets:

$$LR1 = HLA/CL,$$

where HLA is highly liquid assets that include cash, cash equivalents and current financial investments,

CL is current (short-term) liabilities that are comprised of short-term loans and settlements with creditors.

Current liquidity ratio (LR2) that characterizes the possibility of repayment of short-term liabilities within established timeframes:

$$LR2 = LA/CL,$$

where LA is liquid assets that are comprised of highly liquid assets, accounts receivable, and bills of exchange received,

CL is current (short-term) liabilities that are comprised of short-term loans and settlements with creditors.

General liquidity ratio (GLR) that characterizes to which extent the amount of short-term liabilities and settlements can be repaid at the expense of all liquid assets:

$$GLR = CA/CL,$$

where CA is current assets,

CL is current (short-term) liabilities that are comprised of short-term loans and settlements with creditors.

4.3.2. The financial stability of a borrower is determined based on the following indicators: maneuverability ratio of own funds (MR) that characterizes the degree of mobility of usage of own funds:

$$MR = (EC - FA)/EC,$$

where EC is equity capital,

FA is fixed assets.

Independence ratio (IR) that characterizes the degree of financial risk:

$$IR = AF/EC,$$

where AF is attracted funds (long-term and current liabilities),

EC is equity capital.

4.3.3. The profitability of a borrower is determined based on the following indicators:

Return on assets:

$$ROA = NP/A,$$

where NP is net profit,

A is assets.

Profitability of sales:

$$POS = NP/S,$$

where NP is net profit,

S is sales (net of VAT).

4.3.4. An analysis of a borrower's cash flows has to be conducted taking into account the following indicator:

The ratio of net proceeds to all of the borrower's accounts (including those opened with other banks) to the principal and interest on the lending transaction taking into account the effective term of the loan agreement for short-term loans, and the change of currency rate for business entities that received the loan in foreign currency :

$$P = ((AMP \times n) - (ML \times n) - OL) / P\&I,$$

where AMP is average monthly proceeds to the borrower's accounts over the past three months (with the exception of loan funds),

P&I is principal and interest (for loans in foreign currency, this amount is included in the calculation taking into account the change of currency rate),

n is the effective term of the loan agreement in months,

ML is monthly nominally permanent liabilities of the borrower (administrative and overhead expenses, etc.),

OL is tax payments and other liabilities to creditors, which have to be paid from the borrower's account, except for liabilities whose maturities exceed the effective term of the loan agreement (based on the data of the recent balance sheet).

For business entities whose activity is associated with seasonal production, the average monthly amount of proceeds is determined for 12 months.

The optimal theoretical value of indicator P is not less than 1.5.

4.3.5. Also, there may be taken into account subjective factors that are characterized by the following indicators:

the market position of the borrower and its dependence on cyclical and structural changes in the economy and industry;

existence of government orders and government support for the borrower;

the borrower's management effectiveness;

professionalism of management and their business reputation;

other information.

4.4. The financial condition of a borrowing bank is assessed not less than once a month using methods used in domestic and international banking practices taking into account the following:

information of the borrowing bank on compliance with economic normatives and mandatory reserve requirements;

analysis of the quality of assets and liabilities;

analysis of profits and losses;

information on the bank's fulfillment of liabilities in the past;

information on interbank loans extended and received;

annual auditors' opinion.

4.5. Legal entity borrowers (including banks) are classified based on the results of assessment of their financial condition:

Class "A" – financial activity is good, which indicates the possibility of timely fulfillment of liabilities on lending transactions, in particular, repayment of principal and interest in accordance with the terms and conditions of the loan agreement; economic indicators are within established limits (according to the methodology for assessing the financial condition of a borrower approved by the bank's internal documents); senior management of the borrower has an excellent business reputation; the borrower's credit history is perfect; in addition, borrowing banks (residents) and nonresident banks registered in CIS member countries are compliant with economic normatives. It can be concluded that financial activity will continue at a high level. This class may include other borrowing banks (nonresidents) that have a credit rating not lower than A confirmed in the bulletin of one of the world's leading rating companies (Fitch IBCA, Standard & Poor's, Moody's, etc.).

Class "B" – the financial activity of a borrower in this category is close by characteristics to Class "A", but the probability of its maintenance at this level for a continuous period of time is low. A bank's borrowers/counterparties, which belong to this class, require a greater deal of attention because of potential deficiencies that pose a threat to the adequacy of proceeds of funds to service the debt and the stability of achievement of a positive financial result of activity; in addition, borrowing banks (residents) and nonresident banks, which are registered in CIS member states, are compliant with economic normatives. An analysis of the borrower's financial condition indicators may demonstrate negative trends in the borrower's activity. Deficiencies in the activity of borrowers, which belong to Class "B", should only be potential. If there are real deficiencies, the borrower's class should be downgraded. This class may include other borrowing banks (nonresident) that have a credit rating not lower than "investment class" confirmed in the bulletin of one of the world's leading rating companies (Fitch IBCA, Standard & Poor's, Moody's, etc.).

Class "C" – financial activity is satisfactory and requires more detailed control. In addition, borrowing banks (residents) and banks of CIS member countries are compliant with economic normatives. The proceeds of funds and solvency of the borrower indicate the probability of untimely repayment of the loan debt in full and on the dates agreed, unless the deficiencies are removed. Simultaneously, there is a possibility to remedy the situation and to improve the financial condition of the borrower. The collateral for the lending transaction should be liquid and cause no doubt as to its value appraisal, the correctness of the format of the collateral agreement, etc. This class may include borrowing banks (nonresident) that have a credit rating not lower than B confirmed in the

bulletin of one of the world's leading rating companies (Fitch IBCA, Standard & Poor's, Moody's, etc.).

Class "D" – financial activity is unsatisfactory (economic indicators do not meet the established values) and has been unstable for a year; there is a high risk of considerable losses; the probability of full repayment of loan principal and interest is low; problems may exist in the status of the collateral for the loan and the collateral documentation. If, when conducting the next classification, there are no undoubted confirmations to improve the financial condition of the borrower or the level of collateralization for the lending transaction within one month, the borrower should be classified a class lower (Class "E"). This class includes a bank's borrowers/counterparties, against which a bankruptcy lawsuit has been filed.

Class "E" – financial activity is unsatisfactory and loss-making; the performance indicators do not meet the established values, the lending transaction is not secured with liquid collateral (or an unconditional guarantee), the probability of fulfillment of obligations by the borrower/ counterparty of the bank is virtually null. This class includes a bank's borrowers/counterparties, which have been recognized as bankrupt under the procedure as established by the current law.

Based on the assessment of its financial condition, a borrower is referred to a respective class.

A borrower/counterparty of a bank against which bankruptcy case has been initiated, as well as banks whose banking licenses have been revoked, may not refer to a class higher than "D".

4.6. For assessing the financial condition of an individual borrower, banks establish indicators and their optimal values depending on the type of the loan (to purchase or build housing, to purchase motor vehicles, durable goods, and for other needs), its volume and maturity, and the type of collateral for the loan. In determining the class of a borrower for financial lease transactions no such criterion of lending transaction classification as "the level of collateralization of a lending transaction" is taken into account.

The assessment of a borrower's financial condition should take into account quantitative and qualitative indicators (factors), which may, to a certain extent, affect the fulfillment of the loan obligations by the borrower, together with identifying the level of their probable impact on adherence to the terms and conditions of the loan agreement by establishing optimal values optimal values and appropriate scores for each of the indicators (factors) and the assessment should take into account the type and maturity of the loan.

In determining the creditworthiness of an individual borrower, when considering granting a loan to him and assessing his financial condition during the time of loan debt servicing, both the quantitative indicators (economic creditworthiness) and qualitative characteristics (personal creditworthiness) of the borrower should be taken into consideration and confirmed with reliable documents issued by a third party (statement from the work place, income statement, account cash flows statement from the bank and credit history of a borrower if available backed by credit reports of the credit history bureau).

The qualitative characteristics of a borrower include, in particular:

the general welfare of the client (existence of property and properly certified copies of the respective documents confirming title to the property);

the social stability of the client (a permanent job, business reputation, marital status, etc.);

the age of the client;

credit history (intensity of usage of bank loans/guarantees in the past and timeliness of their repayment and payment of interest/fees) including one received from the credit history bureau.

The key quantitative indicators for assessing the financial condition of an individual borrower include, in particular:

total net income (expected total monthly revenues reduced by total expenses and liabilities);

savings in bank accounts (information is provided if the borrower wishes to);

ratios characterizing the current paying capacity of the borrower and his financial capacity to meet the obligations under the loan agreement (in particular, the ratio of the borrower's total income to his expenses/liabilities, the ratio of net monthly income to a monthly loan principal and interest payment);

loan collateral (pledge of personal and real property, its insurance, transfer of title to the object of lending (housing, vehicles, etc.) and its liquidity.

In calculating key quantitative indicators for assessment of the financial condition of an individual borrower, a bank takes into account revenues whose receipt throughout the term of the credit agreement is confirmed by reliable documents issued by a third party (statement from the work place, income statement, and account cash flow statement from the bank).

In determining the creditworthiness and assessing the financial condition of individual borrowers who get a loan as entrepreneurs, there also need to be considered the respective indicators established for legal entities, including the following qualitative and quantitative indicators:

management (level of management, business reputation and connections in the business community, the customer's willingness and ability to bear personal responsibility for fulfilling the loan obligations, etc.);

risk factors (type of industry, assessment of the attractiveness of goods/services produced/made by the customer; market for such goods/services, level of competition in the customer's industry, time of activity in a specific market, etc.);

cash flow forecast (ratio of equity capital to the size of the loan, ratio of monthly cash turnovers to the amount of the loan, etc.).

The classification of individual borrowers based on the identification of their creditworthiness (financial condition) is done taking into account the collateralization level of lending transactions:

Class A – the borrower's total net income greatly exceeds loan principal and interest payments, it is highly likely that such relationship will remain over the effective term of the loan agreement; the volume, quality and liquidity of collateral for loans, which are extended for more than one year, are sufficient, or the borrower has high personal creditworthiness (documentarily confirmed) and is absolutely credible; there is no indication of a possible delay in loan principal and interest repayment in accordance with the terms and conditions of the loan agreement.

Class B – key characteristics are identical or close to Class A, however, the likelihood of their maintenance at the same level is low, or there is a trend (or information) towards the possibility of their decrease. The volume, quality and liquidity of collateral for loans granted for more than one year are sufficient for loan principal and interest to be repaid in full.

Class C – the borrower's total income and expenses indicate the reaching of a boundary limit in ensuring debt repayment, change of job (with a deterioration of conditions), growth in the borrower's liabilities, which indicates an increase in the likelihood of untimely and/or incomplete loan principal and interest repayment. The volume, quality and liquidity of collateral for loans granted for more than one year are sufficient for loan principal and interest to be repaid in full.

Class D – the borrower's financial condition is unstable. There is a tendency and periodical problems with timely principal and interest/fee repayment because of the instability of the borrower's revenues or an increase in expenses and/or liabilities. The borrower's net income during certain periods does not support the payment of loan principal and interest/fees. There are problems with loan collateral (low liquidity and size, etc.)

Class E – the borrower's financial condition is unsatisfactory. Income does not support loan principal and interest/fee payment. The loan is not secured with liquid collateral. There is virtually no ability to pay loan principal and interest/fees, including at the expense of loan collateral.

- 4.7. In the event of unavailability of reliable financial statements confirming the assessment of the financial condition of a legal entity borrower or appropriate documents and information on the assessment of the financial condition of an individual borrower, as well as duly executed documents on the basis of which the lending transaction was conducted, such borrowers have to be classified not higher than Class "D".

The borrowers, both natural and legal entities, whose credit agreements with the bank do not contain written consents for collection, maintenance, usage and distribution of information about the borrowers through credit history bureau, must be classified not higher than Class "D" by the bank.

4.8. If at the time of concluding an agreement on prolongation of a lending transaction with a creditworthy and reliable legal entity borrower assigned to Class A or B there is no deterioration in its financial condition and interest has been paid on time (provided that the agreement calls for interest payment not less frequently than once a quarter), then such a transaction is considered as current, that is, prolonged without reducing the class of the borrower. In addition, proceeds (except for loan funds) to the borrower's (the bank's counterparty's) accounts over the initial term of utilization of loan funds under the loan agreement should exceed the amount of loan debt at least twofold and should be documented.

Prolonged loans granted to individual borrowers to acquire and improve real estate, motor vehicles and durable goods are considered as prolonged without reducing the class of the borrower, if at the time of concluding an agreement on prolongation of the loan agreement the individual borrowers are assigned to Class A or B and interest (fees and other payments) have been paid on time. Prolongation of loans under other conditions is considered as prolongation with reducing the class of the borrower.

5. Determination of the Group of Lending Transactions Based on the Status of Debt Servicing by the Borrower

5.1. Banks are required to assess the status of debt servicing on a monthly basis: a. Based on the status of repayment by a legal entity borrower/counterparty of loan principal (including "REPO" transactions) and interest/fees and on the basis of the borrower's credit history and relationships with the bank, debt servicing is:

"good": if loan principal and interest/fees have been paid on established dates or with a maximum delay of up to seven calendar days;
or the loan has been prolonged without reducing the class of the borrower, and loan interest/fees have been paid on established dates or with a maximum delay of up to seven calendar days;
or the loan has been prolonged with reducing the class of the borrower for up to 90 days, and loan interest/fees have been paid on established dates or with a maximum delay of up to seven calendar days;

"weak": if loan debt has been overdue for 8 to 90 days, and loan interest/fees have been paid with a maximum delay of 8 to 30 days;
or the loan has been prolonged with reducing the class of the borrower for a term of 91 to 180 days, but interest/fees have been paid on time or with a maximum delay of up to 30 days;

"unsatisfactory": if loan debt has been overdue for more than 90 days;
or the loan has been prolonged with reducing the class of the borrower for more than 180 days.

b. Based on the status of repayment by an individual borrower of loan principal and interest/fees, debt servicing is:

"good": if loan principal and interest/fees have been paid on established terms or with a maximum delay of up to seven calendar days (or with a maximum delay of up to 30 days in case of documentary evidence of a business trip, sickness, etc.);

or the loan has been prolonged without reducing the class of the borrower and loan interest/fees have been paid on established days or with a maximum delay of up to seven calendar days (or with a maximum delay of up to 30 days in case of documentary evidence of a business trip, sickness, etc.);

or the loan has been prolonged with reducing the class of the borrower for a term of up to 90 days and loan interest/fees have been paid on established terms or with a maximum delay of up to seven calendar days (or with a maximum delay of up to 30 days in case of documentary evidence of a business trip, sickness, etc.);

"weak":

if loan debt is past due 8 to 90 days and loan interest/fees are paid with a delay of 8 to 30 days (or with a maximum delay of 31 to 120 days in case of documentary evidence of a business trip, sickness, etc.);

or the loan has been prolonged with reducing the class of the borrower for a term of 91 to 180 days, but interest/fees have been paid on time or with a maximum delay of up to seven calendar days (or with a maximum delay of up to 30 days in case of documentary evidence of a business trip, sickness, etc.);

“unsatisfactory”:

if loan debt is past due over 90 days (or with a maximum delay of 120 days in case of documentary evidence of a business trip, sickness, etc.);

or the loan has been prolonged with reducing the class of the borrower for over 180 days.

If one of the requirements of each subparagraph characterizing a group of lending transactions based on the status of debt servicing by borrowers/counterparties (legal entities and individuals) is not met, then such a transaction is to be included in the group one level lower.

5.2. Debt servicing cannot be considered as “good”, if debt on the lending transaction includes a balance of refinanced debt, that is, if the old debt has been repaid through the issuance of a new loan caused by the worsening financial condition of a borrower and/or problems related to debt servicing.

In determining the group of a lending transaction there also have to be taken into account changes in the initial terms and conditions of the loan agreement with regard to the amounts and maturities of principal and interest (if such changes have taken place with a deterioration of the terms and conditions for the creditor).

If a borrower has debt on several loans simultaneously, debt servicing by the borrower is assessed based on the loan debt assigned to the lower group.

5.3. Obligations on provided guarantees, warranties and avals are considered as “good” in terms of the status of debt servicing up to the time of their fulfillment provided that the counterparties pay interest/fees on them on time and in compliance with the agreement terms.

6. Classification of Loan Portfolio

6.1. In accordance with the criteria as listed in Chapters 4 and 5 of this Policy, loan portfolio is classified by risk degree, and the category of a lending transaction is determined as follows:

Financial condition of the borrower (class)	Debt servicing by the borrower (group)		
	“good”	“weak”	“unsatisfactory”
“A”	“standard”	“watch”	“substandard”
“B”	“watch”	“substandard”	“substandard”
“C”	“substandard”	“substandard”	“doubtful”
“D”	“doubtful”	“doubtful”	“loss”
“E”	“doubtful”	“loss”	“loss”

The category of debt on loans included in the homogeneous consumer loan portfolio is determined by the bank every month depending on the number of days the principal debt and/or interest/fees on it are past due.

Calendar days past due	Category of debt	Provisioning ratio for homogeneous consumer loans	
		UAH	In foreign currency
0	“standard”	2%	50%
Up to 30	“watch”	10%	100%
31-60	“sub-standard”	40%	100%
61-90	“doubtful”	80%	100%
91 and over	“loss”	100%	100%

Banks may individually establish tougher criteria for referring this loan to a certain category.

6.2. A bank may refer a lending transaction under which the status of debt servicing by the borrower has been identified as “good” over the previous six months to the category of “watch” (if the borrower is in Class “C”) or “substandard” (if the borrower is in Class “D”) provided that, by the moment of credit agreement classification, the credit agreement has been in effect for at least six months and provided for interest to be paid at least once a month.

A bank cannot apply the provisions of paragraph one of this item in classifying a lending transaction if a borrower does not have credit history or if the bank classified financial condition of a borrower based on item 4.7 of Chapter 4 hereof.

A bank may move a lending transaction one category up for long-term lending of an investment project whose estimated effectiveness (including return expected from the implementation thereof) guarantees repayment of the loan and interest/fees on it according to the terms of the credit agreement provided that the business plan of the investment project implementation is carried out.

A bank cannot apply the provisions of paragraph one and three of this item in classifying a lending transaction performed on the basis of the credit agreement that is changed so as to make the terms worse for the lender, and on the basis of a prolonged credit agreement.

A bank cannot apply the provisions of paragraph one and three of this item simultaneously.

A bank cannot refer privileged loans to categories “standard” and “watch”.

6.3. In classifying transactions with discounted bills of exchange, in addition to assessing the financial condition of the obligor identified by the bank, the maturity of the debt is also taken into account.

If debt on past due bills of exchange is not more than 30 days past due, then such a lending transaction cannot be classified higher than “doubtful”.

Debt on past due bills of exchange with a past due period of more than 30 days should belong to the “loss” category.

In determining the size of a reserve for discounted bills of exchange, the amount subject to provisioning is determined based on the discounted value of the bill of exchange and discount amortization.

For lending transactions in the form of discounting bills under which cash is extended to one person and debt is repaid by another person, analytical accounting is kept with respect to the person expected to pay accounts payable under the terms of the agreement.

6.4. The quality of a lending transaction is assessed before the time when the borrower/counterparty fulfills the obligation under it (arrival of funds) irrespective of the type of the obligation (or its replacement with another type).

6.5. In classifying lending transactions by risk degree and assigning them to the groups, according to which reserves for factoring, commitments granted (aval), guarantees and warranties fulfilled are calculated, the maturity date of the debt is taken into account as follows:

“standard” – debt whose maturity date envisaged by the contractual terms and conditions (bill of exchange) has not come yet, or commitments⁷ (including avals) whose date of fulfillment has not come yet;

“doubtful” – debt on factoring transactions (principal or regular payment) and on guarantees and warranties⁸ (including avals) fulfilled (paid) by the bank is up to 90 days from the date of fulfillment of the commitment (payment) envisaged by the contractual terms and conditions (bill of exchange);

⁷ With regard to commitments granted (guarantees, warranties, avals), if based on financial condition assessment the borrower has been assigned to Class “B” and lower, the category of the transaction is determined according to the class of the borrower (taking into account Paragraph 5.3 hereof).

⁸ If at the time of fulfillment by a bank of an commitment on provided guarantees and warranties such a commitment was classified taking into account the financial condition of the counterparty as “loss”, then after the fulfillment by the bank of the commitment on provided guarantees and warranties such loan debt is classified also as “loss”, unless the financial activity of the counterparty has improved.

“loss” – debt on factoring transactions (principal or regular payment) and on guarantees and warranties (including avals) fulfilled (paid) by the bank, under which the client has not fulfilled its obligations for more than 90 days after the date of payment envisaged by the contractual terms and conditions (bill of exchange).

7. Criteria of Acceptance of Collateral for Lending Transactions in Calculating Reserves

7.1. In identifying net credit risk for reserve calculation, the amount of gross credit risk on each lending transaction separately may be reduced by the value of the collateral accepted specified in this item or an object of financial lease (movable property).

In calculating reserve for debt on the homogeneous consumer loan portfolio the collateral under such loans is not taken into account.

7.1.1. Unconditional guarantees, which are taken for calculating the reserve for credit risks:

- of the Cabinet of Ministers of Ukraine;

- of banks that have an official credit rating not lower than “investment class”⁹;

- of the governments of Category “A” countries (Attachment 1);

- of international multilateral banks (International Bank for Reconstruction and Development, European Bank for Reconstruction and Development);

- secured guarantees of banks of Ukraine.

7.1.2. Collateral items (property, and ownership rights of the borrower or third parties – ownership guarantors), which are taken for calculating the reserve for credit risks:

- ownership rights for money deposits placed with a bank that has an official credit rating not lower than “investment class”;

- registered savings certificates issued by the creditor bank or ownership rights for money of the borrower or ownership guarantor deposited with the creditor bank, provided there is absolute contractual control and access of the creditor bank to this money, if the borrower fails to meet its loan obligations. Reserve calculation does not accept ownership rights for money of a bank, which simultaneously is a borrower and a creditor and whose funds are placed with the creditor bank on the terms and conditions (amount, maturity, and type of currency) similar to the terms and conditions for the loan received from it or the deposit attracted;

- precious metals, which belong to the borrower and are stored with the creditor bank, provided that the creditor bank has the absolute contractual right to repossess these metals, in case the borrower fails to meet its loan obligations;

- government securities;

- non-government securities – corporate shares and bonds having an active market, bearer savings certificates issued by the creditor bank, savings certificates of other banks, investment certificates;

- registered real estate (located on the territory of Ukraine);

- movable property (property in material form that is not real estate);

- mortgage bonds and mortgage certificates;

- ownership rights for real estate that is part of the housing stock, - ownership rights for the object of unfinished construction or other real estate belonging to the housing stock which will become the ownership of a borrower after conclusion of the mortgage agreement, provided that a borrower has confirmed with documents his/her rights to become the owner of the respective real estate in the future, - are taken into account for two years after receipt of the loan;

- other ownership rights.

In case of lending transactions with non-residents (other than banks and individuals that hold permissions to be employed in Ukraine or are employed in foreign diplomatic, consular, trade and other official missions, international organizations and their branches that have diplomatic immunity or privileges and are located in Ukraine) the only items taken into account for calculation of the reserve for credit risks include ownership rights for cash deposits or registered deposit certificates and real estate located on the territory of Ukraine which is owned by this non-resident or resident guarantor; guarantees

⁹ Investment class is a credit rating confirmed in the bulletin of one of the leading international rating companies (Fitch IBCA, Standard & Poor’s, Moody’s, etc.)

of banks with the official credit rating no lower than “investment class”. This requirement does not cover lending transactions performed by foreign branches of Ukrainian banks.

In calculating the reserve for credit risks for transactions of placing and obtaining cash between two banks performed in different currencies, equivalent amount and for identical terms (established at the time of the agreement conclusion), ownership rights for such cash are taken into account provided that a collateral agreement is closed for the entire amount of the cash.

7.1.3. The amount of collateral is taken for calculating reserves for credit risks taking into account the ratios depending on the category of the lending transaction.

Unconditional guarantees are taken for calculating the reserve for credit risks according to the following ratios:

Classified lending transactions	Percentage of the value of collateral (guarantee), which is taken for calculating net credit risk for a given lending transaction			
	Of the Cabinet of Ministers of Ukraine	Of the governments of Category “A” countries	Of international multilateral banks	Of banks with a rating not lower than “investment class”, secured guarantees of Ukrainian banks
“Standard”	100	100	100	100
“Watch”	100	100	100	100
“Substandard”	50	100	100	100
“Doubtful”	20	20	20	20
“Loss”	0	0	0	0

Collateral items are taken for calculating the reserve for credit risks according to the following ratios:

Category of lending transaction	Percentage of the value of collateral (guarantee), which is taken for calculating net credit risk for a given lending transaction										
	Ownership rights for cash deposits, registered deposit certificates issued by the lending bank, ownership rights for cash under transactions of placing/obtaining cash between two banks performed in different currencies		Bank metals	Government securities	Non-government securities	Real estate from the housing stock; mortgage bonds and mortgage certificates		Other real estate	Ownership rights for real estate from the housing stock	Movable property, precious metals	Other ownership rights
In the currency corresponding to the currency of extended loan or FCC	In the currency different from the currency of the extended loan	On loans in UAH				On loans in foreign currencies					
“Standard”	100	90	80	100	40	70	50	50	50	50	30
“Watch”	100	90	80	80	20	70	50	50	40	40	20
“Substandard”	100	90	60	50	10	40	40	40	20	20	10
“Doubtful”	100	90	20	20	0	20	20	20	10	10	5
“Loss”	0	0	0	0	0	0	0	0	0	0	0

In calculating the reserve for financial lease transactions with movable property as the item of such transactions, the value of the financial lease item is taken into account subject to the term for which the leaseholder has had the item (from the date of the object transfer to him) based on the following ratios:

Classified lending transactions	Percent of the financial lease object value taken in calculating net credit risk by an individual lending transaction subject to the term for which the leaseholder has had the object		
	<u>Up to 1 year</u>	<u>1-2 years</u>	<u>Over 2 years</u>
“Standard”	80	65	50
“Watch”	80	65	50
“Substandard”	60	50	35
“Doubtful”	20	10	5
“Loss”	0	0	0

7.2. In case of lending, the value of a collateral item is determined by the bank at its market value¹¹. Collateral is to be documented with a collateral agreement in accordance with the Law of Ukraine “On collateral”. In cases where the collateral item is securities a bank must calculate the value of such item according to Chapter 3 of Policy on the Procedure for Formation of Reserve for Transactions with Securities by Banks of Ukraine as approved by NBU Board Resolution #31 as of 02.02.2007 and registered with the Ministry of Justice of Ukraine at #189/13456 as of 03.05.2007 (as amended).

The general requirement to the size of collateral for a lending transaction is that its market value should exceed loan principal and interest taking into account the amount of possible expenses to sell the collateral, in case the borrower fails to meet its obligations.

Collateral is taken into account in calculating credit risk reserve in the amount proportionate to the amount of each loan if the item is used as collateral for two or several loans.

If one of such loans is more than 30 days overdue, the collateral item is not taken into account in calculating reserve for all other loans.

If the overdue debt on the loan is paid, the procedure of taking into account this collateral item for other loans is restored in calculating the reserve.

7.3. In calculating net credit risk, collateral consisting of shares issued by the creditor bank is not taken into account.

In calculating net credit risk, a bank has no right to take into account collateral if the rights of the collateral provider for the pledged property are appealed in court or the item of collateral is property that is already a collateral behind another liability of a borrower/property guarantor, or a borrower/property guarantor appeals the right of a creditor bank to exercise its right of foreclosure of the collateral item in court.

In calculating net credit risk, a bank has no right to take into account collateral provided by a borrower/guarantor against which a bankruptcy case has been initiated or which has been recognized bankrupt under the procedure established by law.

In calculating net credit risk for loans extended against ownership rights for money deposits of the borrower or the guarantor, the collateral value is taken into account in the amount specified in sub-item 7.1.3 of item 7.3 of this Chapter, provided that these funds have been transferred to the bank for management for the effective term of the loan agreement.

In calculating the reserve, the indebtedness accounted for in guarantee deposits and cash collateral accounts at other banks (balance sheet account 1502) must be decreased by the amount of coverage under the respective letter of credit accounted for in “Funds in settlements of business entities” (balance sheet account 2602) and “Funds in settlements of individuals” (balance sheet account 2622) provided that an applicant of the letter of credit undertakes all risks related to the selection of banks that participate in settlements under the letter of credit while guarantee deposits meet the terms and amounts of the respective letter of credit and are accounted for on separate analytic accounts.

The amount of gross credit risk for a consortium loan is reduced in the lead bank by the amount of the credit resources attracted from the banks participating in the banking consortium.

For loans classified as “loss” the bank forms a reserve for total loan debt irrespective of availability of collateral.

¹¹ Note 11 was deleted.

7.4. Considering changes in market conditions, banks are recommended, on a quarterly basis and in case of each prolongation of a loan agreement, to review the condition of pledged property and, if necessary, to revise its value.

If a bank does not review the condition of pledged property, and there are no documents evidencing the availability and condition of collateral, then the bank is required to form a reserve for credit risks for the entire loan principal.

The frequency and procedure for reviewing the condition of pledged property are determined in the bank's internal documents depending on the type and quality of the collateral taken to cover the risk of lending transactions and the possibility of its safeguarding.

8. Procedure of calculation of the reserve for credit risks

8.1. On the basis of classification of gross credit risk and taking into account the collateral accepted, the bank determines net credit risk of indebtedness for each lending transaction (other than indebtedness on lending transactions included in the homogeneous consumer loan portfolio) and adjusts it for the established provisioning ratio.

For indebtedness included in the homogeneous consumer loan portfolio, total credit risk is weighted against the established provisioning ratio for a category to which the indebtedness is referred.

Category of a lending transaction	Provisioning ratio (based on risk degree) for lending transactions			
	In UAH		In foreign currency	
	For homogeneous consumer loans	For other loans	With borrowers that have sources of currency earnings	With borrowers that have no sources of currency earnings
"Standard"	2%	1%	2%	50%
"Watch"	10%	5%	7%	100%
"Sub-standard"	40%	20%	25%	100%
"Doubtful"	80%	50%	60%	100%
"Loss"	100%	100%	100%	100%

Credit risk reserve for transactions in foreign currency carried out on the interbank market is formed on the basis of 1%, 5%, 20%, 50% and 100% provisioning ratios according to the category of every individual transaction without additional assessment of the borrower's revenues in foreign currency.

In calculating the reserve for lending transactions in foreign currency, the revenues that exceed principal debt and interest thereon are considered sufficient currency revenues. The sufficiency of currency revenues is calculated for the period that meets the term of the concluded credit agreement.

8.2. When forming reserves for lending transactions conducted in the international market, banks should take into account the country risk, which arises in connection with lending to borrowers from other countries and depends on an unstable political situation, economic crisis, restrictive government policy with regard to foreign loans, investments, transfers, etc.

When calculating a reserve taking into account country risk, net credit risk is adjusted for one of the two provisioning ratios, whichever is bigger:

the provisioning ratio based on the risk degree depending on the category of the lending transaction, which is established in paragraph 8.1 hereof;

or the provisioning ratio based on the risk of the borrower's country, which is established in paragraph 8.3 hereof.

If the guarantor of debt repayment for such a lending transaction is a resident of a country whose risk belongs to a higher group than the risk of the borrower's country, then the ratio established for the country of this guarantor is taken for comparison.

If, based on the assessment of the financial condition and the status of debt servicing, a lending transaction is referred to the "standard" category by its risk degree while the borrower's country is

referred to the third or lower risk group by its risk degree, such lending transaction is considered “non standard”.

“Watch” lending transactions include transactions referred to group 3 by the country rate.

“Sub-standard” lending transactions include transactions referred to groups 4-5 by the country rate.

“Doubtful” lending transactions include transactions referred to groups 6-7 by the country rate.

“Loss” lending transactions include transactions referred to group 8 by the country rate.

If a lending transaction in foreign currency is carried out by a non-resident that is not a banking institution or an individual (other than banks and individuals that hold permissions to be employed in Ukraine or are employed in foreign diplomatic, consular, trade and other official missions, international organizations and their branches that have diplomatic immunity or privileges and are located in Ukraine), such transaction may not be referred to a category higher than “sub-standard”. This requirement does not cover lending transactions carried out by foreign branched of Ukrainian banks.

8.3 In order to take into account country risk in calculating a reserve for funds in the correspondent accounts opened with other banks, demand deposits with other banks, and doubtful debt on these funds, ratings established by international rating agencies confirmed in the bulletin of one of the leading rating companies (Fitch IBCA, Moody’s, Standard & Poor’s, etc.) are used.

Banks where a correspondent account is opened are divided into groups according to the country rating¹². The amount of reserve is determined through adjusting the funds recorded in the correspondent account of a given bank for the appropriate provisioning ratio:

Group #	Provisioning ratio (%)
1	0
2	2
3	10
4	20
5	30
6	40
7	50
8	100

Banks and other borrowers located in the countries whose rating is not confirmed by one of the leading international companies are referred to group 7.

Group 8 includes banks (resident and nonresident) and other borrowers that are recognized as bankrupt or are under liquidation according to a decision of authorized bodies, as well as banks registered in offshore zones.

Risks related to funds placed in the correspondent accounts opened with other banks assigned to Groups 1 - 2 are considered as “standard”, but assigned Groups 3 – 8 – “nonstandard”.

8.3. The reserve for credit risks is calculated and formed by the head office of a bank and its branches in accordance with Paragraph 1.9 of this Policy. The head office bears responsibility for the completeness of reserve formation.

9. Requirements to lending documentation and reporting

9.1. The criteria used by banks in analyzing their loan portfolio, as well as in the procedures of taking and fulfilling decisions on the formation and usage of the reserve for credit risks, have to be reflected in the appropriate documents of the bank, which define its lending policy.

Banks are required to store the minutes of meetings of their lending committees (lending commissions), information on conducting lending transactions, classification of the loan portfolio

¹² The NBU informs the banks about country ratings determined by international rating agencies.

and formation of reserves for not less than five years from the expiry date of the loan agreement, and to provide these documents to authorized officers of the NBU at their request.

- 9.2. Reports on classification of lending transactions and formation and usage of reserves, which are prepared according to form #302 “Report on classified lending transactions by form of ownership” and form #604 “Report on calculation of the loan loss reserve of banks” are submitted by the head offices of the banks (summary data – taking into account the branches located in Ukraine and abroad) to the regional offices of the NBU.
- 9.3. For the monthly calculation of reserves, banks classify lending transactions through inventorying them and analyzing their quality. The results of analysis of loan portfolio quality have to be documented according to the form as established by the bank (the recommended form is in Attachment 2). This form has also to be kept in electronic form. In addition, the bank has to maintain a database of this form as of the first day of each month. The form is completed on the basis of work papers related to each lending transaction, which are kept by the lending officer for each borrower (counterparty) individually.
- 9.4. Work papers (credit file) on each borrower (counterparty) must contain the following:
 - name of the client, his location (place of residence);
 - numbers of the primary current, additional current accounts and loan accounts;
 - loan application and feasibility study of the loan;
 - loan agreement and amendments to it;
 - collateral agreement and amendments to it;
 - date of issuance and maturity of the loan (according to the agreement);
 - original amount of the loan in hryvnias or hryvnia equivalent and the currency code (in case the loan was issued in foreign currency);
 - interest rate and all of its changes as of the reporting date;
 - financial statements of the borrower (counterparty), which are submitted to the creditor bank;

information about the results of assessment of the financial condition of the borrower (counterparty), as established by this Policy and the bank’s internal policies on lending and the methodology for assessing the financial condition (as of the date of conducting the lending transaction and all the following dates of conducting assessments, including as of the date of transfer of the debt to the accounts of prolonged, overdue, and doubtful debt or recognition of it as loss);

documents that confirm the transfer of the debt on the lending transaction to the accounts of prolonged (with the indication of account numbers, amounts and periods of each prolongation), overdue or doubtful debt (with the indication of account numbers, dates, and amounts);

date of taking a decision to recognize the debt as loss with the indication of the amount of loan principal and interest, a relevant abstract from the minutes of the meeting of the bank’s lending committee;

information about the status of debt repayment with the indication of dates and amounts; balance of loan debt as of the reporting date (in hryvnias or in hryvnia equivalent in case of a foreign currency loan), the number of the account where the debt is recorded as of the reporting date;

type and amount of collateral under the agreement;

documents indicating the condition of collateral under the loan agreement;

amount of collateral taken for calculating the reserve;

class of the borrower as of every reporting date and supporting documents;

risk category (“standard”, “watch”, “substandard”, “doubtful”, “loss”) of the lending transaction;

estimated amount of net risk of the lending transaction;

information about the measures taken by the bank to collect the debt (documents or their copies that evidence the procedure of debt collection). The recommended format of work papers is provided in Attachments 3 and 4. Work papers are completed upon submission by a potential borrower (counterparty) of a loan application and are mandatory for the lending committee to review in making a decision to conduct a lending transaction. In future, if there are changes in the financial condition of the borrower or collateral for the loan, the lending officer completes new forms of work papers, based on which the lending transaction is classified and a reserve is calculated. Work papers are kept in the credit files of borrowers (counterparties). By the first date of each month, information is grouped into one document as broken down by each borrower and by each lending transaction with the indication of interim and

consolidated results, wherever possible. General information based on the results of loan portfolio classification includes all of the bank's lending transactions, which are subject to classification and provisioning in accordance with this Policy. A bank is required to submit credit files to authorized officers of the NBU at their request.

- 9.5. Subdivisions of the bank supervision system of the NBU systematically review the reports of the banks and their branches in terms of adequacy of the classification of lending transactions and the banks' compliance with the procedure of reserve formation and usage. In case there are discrepancies found between the data of a bank and the data in the report of examination, the NBU is entitled to require the bank to reclassify the loan portfolio and to correct the reports and, if necessary, to adjust the reserve size for the amount of the difference revealed during the examination.
- 9.6. In case a bank violates the procedure of formation and usage of the reserve for credit risk, it is subject to enforcement actions in accordance with Article 73 of the Law of Ukraine "On banks and banking activity" and NBU regulations on enforcement actions.

10. Procedure of formation and usage of reserves for overdue and doubtful accrued income on active operations of banks

10.1. For the purpose of real income estimation and determination of the size of a bank's regulatory capital, there has been established a procedure of formation and usage of the reserve for overdue and doubtful accrued income on active operations of banks. Accrued income on active operations of banks is considered as doubtful, if a payment of principal is over 180 days overdue or interest on it is over 60 days overdue. Banks are required to form reserves regardless of their financial condition (profitable or loss-making activity) for the entire amount of over 31-day overdue and doubtful accrued income, which is recorded in the following on-balance-sheet accounts:

- 1509 "Overdue accrued income on demand funds with other banks";
 - 1519 "Overdue accrued income on term deposits placed with other banks";
 - 1529 "Overdue accrued income on loans granted to other banks";
 - 1780 "Doubtful debt on accrued income on interbank operations";
 - 2029 "Overdue accrued income on loans provided under discounted bills of exchange to business entities";
 - 2039 "Overdue accrued income on claims acquired under factoring transactions with business entities";
 - 2069 "Overdue accrued income on other loans for current activity, which have been granted to business entities";
 - 2079 "Overdue accrued income on loans for investment activity, which have been granted to business entities";
 - 2089 "Overdue accrued income on mortgage loans which have been granted to business entities";
 - 2109 "Overdue accrued income on loans, which have been granted to central government authorities";
 - 2119 "Overdue accrued income on loans, which have been granted to local government authorities";
 - 2129 "Overdue accrued income on mortgage loans granted to central government authorities";
 - 2139 "Overdue accrued income on mortgage loans granted to local government authorities";
 - 2209 "Overdue accrued income on loans for current needs granted to individuals";
 - 2219 "Overdue accrued income on loans for investment activity, which have been granted to individuals";
 - 2229 "Overdue accrued income on loans granted under discounted bills to individuals";
 - 2239 "Overdue accrued income on mortgage loans granted to individuals";
 - 2480 "Doubtful debt on accrued income on operations with clients";
 - 3579 "Other overdue accrued income";
 - 3589 "Doubtful debt on other accrued income".
- 10.2. Debt on over 31-day overdue and doubtful accrued income belongs to nonstandard debt.

- 10.3. Banks form a reserve for overdue and doubtful accrued income on a monthly basis in the amount of actual debt on over 31-day overdue and doubtful accrued income as of the first day of the month following the reporting month.
Control over the completeness of the reserve formed is exercised based on the data of the monthly balance sheet.
- 10.4. Banks are required to monthly inventory overdue and doubtful accrued income and, in case of repayment by the borrower (counterparty) of his debt on accrued income, to adjust the amount of the reserve in line with the total amount of over 31-day overdue and doubtful accrued income, which is recorded in the balance sheet accounts of Classes 1,2,3.
- 10.5. Accrued income, which has been recognized in accordance with the current law as loss, is charged-off under a decision of the Board of Managers of the bank through the reserve.

V. O. Zinchenko

Director

Prudential Supervision Department

Annex 1
to the Policy on the Procedure for Formation
and Usage of Loan Loss Reserve by Banks

THE LIST OF COUNTRIES RATED AS “A” CATEGORY BY INTERNATIONAL RATING AGENCIES

Australia, Austria, Belgium, Great Britain, Greece, Denmark, Ireland, Iceland, Italy, Canada, Luxemburg, Netherlands, Germany, New Zealand, Norway, Portugal, the United States of America, Turkey, Finland, France, Switzerland, Sweden, Japan.

Annex 2*
to the Policy on the Procedure for Formation and Usage of Loan
Loss Reserve by Banks

Lending transactions of a bank and the status of forming reserves for them

Item	Client/ account	# of account	Date as in contract		Initial amount		Area of the economy	Region (oblast)	Currency code	Interest rate (%)		Remaining amount as of the reporting date		Transfer to accounts:			Class of asset as of the reporting date	Security of agreements		Category of risk (amount)					Security taken for estimation	Estimated amount of reserve	Formed actually (the amount)	Deviation of the amount of settlement and actually formed reserve (+/- amount)	Notes	
			Of issuance	Of redemption	In UAH	In foreign currency				initial	as of the reporting date	In UAH	In foreign currency	prolonged date	amount	Overdue, date		Doubtful, date	type	amount	standard	watch	Substandard	doubtful						loss
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30	31
Total	x	x	x	x	Total	Total	x	x	x	x	x	Total	Total	x	x	x	x	x	x	Total	Total	Total	Total	Total	Total	Total	Total	Total	Total	x

* Information is divided in groups by each account, each group of accounts, the classes and types of transactions, and institutions. Interim and consolidated total sums (including columns) must be listed where possible.

The table is broken down into analytical accounts and contains all transactions of a bank that are subject to classification and provisioning of funds in line with this Regulation.

Annex 3
to the Policy on the Procedure for Formation
and Usage of Loan Loss Reserve by Banks

Borrower: _____(1)* _____

Loan documents of the borrower

Form 1

Date	Document	
(2)	Loan request application (3) Technical and economic justification (4) Contract (5)	
	If the borrower is a client or a borrower of another bank (6)	Card with sample signatures of Director and Senior Accountant (6.1) Account statement (account balance statement) (6.2) Accounts payable statement (6.3)
	Statutory documents (7) - Individuals authorized to obtain a loan on behalf of the company (8)	
	Loan agreement (9) - Requirement on filing financial and accounting statements (9.1) - Liabilities of a borrower before the bank (9.2) _____ _____ _____	Fulfilled note <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> (9.3) <input type="checkbox"/> <input type="checkbox"/>
	Collateral agreement (10)	
	Collateral. The item of collateral (10.1)	_____
	The cost of collateral, UAH (10.2)	_____
	Guarantee agreement (11)	
	Warranty agreement (12)	Insurance agreement (13)

* The number specified in the Procedure for filling in form 1.

Annex 3 to the Policy on the Procedure for
Formation and Usage of Loan Loss Reserve by
Banks continued

Procedure for filling out form 1 “Loan Documents of the borrower”

1. Name of the borrowing legal entity or last name of an individual.
2. The date of signing the documents about loan issuance included in the credit file of the borrower. The date put there means that the inspector has looked at the loan documents. If the loan document lacks the date it is considered to be a violation of lending rules.

- 3.** Loan request on which basis decision is taken to extend the loan, and last names of individuals signing the request, the date of compiling the request, the amount of requested loan, the term of loan usage, the aim of loan and collateral of the loan if available.
- 4.** Technical and economic justification of the loan, especially for new or expanding companies.
- 5.** A contract between a borrower and its suppliers.
- 6.** If a borrower is serviced at another bank or is a borrower of another bank, the credit file must contain the following documents that are properly certified:
 - 6.1.** a card with sample signatures of the Director and Senior Accountant of a bank (with listed individuals that have the first and second signature rights);
 - 6.2.** a statement of balance on a borrower's current account as of the date of loan issuance;
 - 6.3.** information about the amount of accounts payable before other banks as of the date of filling out the loan request.
- 7.** Provide information about statutory documents of a borrower and key founders (for legal entities, last names of their directors additionally) and managers of a company.
- 8.** A copy of the document confirming the right of an authorized person to conclude financial agreements to obtain a loan on behalf of the borrower.
- 9.** Information on the loan agreement (list last names of the signatories).
 - 9.1.** Specify frequency and list financial statements to be submitted by the borrower under the loan agreement terms.
 - 9.2.** Specify key terms of the loan agreement concerning liabilities of the borrower before the bank.
 - 9.3.** Provide the record of the borrower's fulfillment of liabilities (yes or no, since when).
- 10.** Collateral agreement.
 - 10.1.** List collateral items by types.
 - 10.2.** Provide the value of collateral.
- 11.** Guarantee agreement. List all guarantors and amounts of guarantees.
- 12.** Warranty agreement. List all warrantors and amounts of warranties.
- 13.** Insurance contract. Give the name of the insurance company, the term of insurance contract, and the amount of insurance coverage.

CREDIT HISTORY OF THE BORROWER

Form 2

Borrower/relations with the bank _____ (1)* _____

Activity _____ (4) _____

Address _____ (2) _____ Credit specialist _____ (5) _____

Loans to individuals related to the borrower _____ (3) _____ Managers of the borrowing company _____ (6) _____

Date of contract/loan issuance (7)	Redemption term (8)	Initial amount (9)	The amount outstanding as of the reporting date (10)	Interest rate (11)	Security (2)	Status of the loan (term, prolonged, overdue, registered, suspended)** (13)	_/_/ (20)	Maximum (21)	_/_/ (22)	Minimum (23)	Date of amendments introduction, date of inspection (24)

Purpose (14)	Preliminary information of the loan (25)
Terms (15)	Evaluation of financial condition (26)
Source of redemption (16)	Date (27)
Category (17)	Income (28)
Classification (18)	Надходження на рахунки (обороти за рахунками) (29)
Estimated amount of reserve (19)	Solvency indicators (30)
	Financial stability indicators (31)
	Conclusions (32)
	Violations (33)

* The number specified in the Procedure for filling out form 2.

** suspended means suspended accrual of interest.

Procedure for filling out form 2
“Credit history of the borrower”

1. Name of the borrower and his/her relations with the bank (client, insider etc.).
2. Address of the company (legal and actual).
3. Companies and individuals that are not related directly to the borrower but are in indirect relations which may affect loan payment by the borrower, the name and amount of loans (deposits), etc.
4. Type of the company (type of the business entity, industry, the statutory activity).
5. First, second and last name of the credit department specialist directly responsible for the loan.
6. First, second and last names of the borrowing company managers.
7. The date of signing the loan agreement and the date of actual issuance of the loan.
8. The date of loan repayment.
9. The initial amount of the extended loan.
10. Outstanding remainder of accounts payable.
11. Specify: interest rate at the moment of loan issuance, current interest rate, and penalty rate if necessary.
12. Specify: the type and amount of loan securitization (collateral, guarantee or warranty).
13. Specify whether the loan is a term, prolonged, overdue, restructured loan or a loan with suspended accrual of interest (underline the correct abbreviation with a pencil).
14. Specify the purpose of the loan.
15. Specify the terms for loan repayment (how and when principal debt and interest thereon are paid).
16. Specify the main and additional sources for payment of accounts payable.
17. Specify the category of a borrower.
18. Specify classification of the loan.
19. Specify the amount of reserve to cover possible loss on the loan. A credit controller/internal auditor must state if this amount meets the category of credit risk.

- 20.** Specify the date at which accounts payable were the highest over the previous 12 months for short-term loans and lines of credit.
- 21.** Specify the date at which outstanding accounts payable were the highest over the previous 12 months for short-term loans and lines of credit.
- 22.** Specify the date at which accounts payable were the lowest over the previous 12 months for short-term loans and lines of credit.
- 23.** Specify the date at which outstanding accounts payable were the lowest over the previous 12 months for short-term loans and lines of credit.
- 24.** Specify: the date of introduction of the latest amendments and the date of inspection by the credit controller/internal auditor.
- 25.** Analyze the data on previous relations between the bank and the borrower with regard to extended loans: how often were loans referred to overdue categories for this borrower, how many loans were prolonged for this borrower, and analyze information about re-documentation of the debt with a new loan agreement.
- 26.** Assess financial condition.
- 27.** The date of the latest financial report of the borrower filed with the bank.
- 28.** Analyze proceeds of the borrower, provide information about an increase of its product sales, profitability of its business and other indicators.
- 29.** Provide data on the sufficiency of cash proceeds to the borrower's accounts for repayment of its debts, especially for term loans where the amount of loan and interest for its usage are paid gradually throughout the term of the loan agreement rather than with a lump sum, i.e. the full amount at the date of repayment.
- 30.** Specify evaluated solvency indicators of the borrower.
- 31.** Specify evaluated financial stability indicators.
- 32.** Specify classification of the loan with justified conclusions based on the evaluation of the borrower's financial condition and the status of debt servicing by the borrower.
- 33.** Give the list of revealed violations including the lack of financial reports, breaches of the bank's bylaws and legal acts etc. (to be filled out by the credit controller and internal auditor).
