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EBS/86/93
Correction 1

CONFIDENTIAL

April 25, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Somalia - Review Under Stand-By Arrangement and Request for Waiver of Performance Criteria

The attached page 2 of EBS/86/93 (4/24/86) is reissued to add the last five lines which were inadvertently omitted.

Att: (1)

The Practice of Provisioning in Financial Organizations

The factors that influence the management of an organization in making judgments regarding the probability of a loss, and hence the possible need to make provision against a loss, are in part associated with the type, nature and purpose of business making the loans; the types of loans actually made and the maturity of the loans; past experience regarding doubtful or bad debts, including the length of time debts have been outstanding; the number of individual loans involved; and the economic and financial data available that bear on the financial position of the borrower. However, such factors have to be looked at within the operational context of the organization, and in particular, within the context of its relation with its clients and its general financial policies. A brief summary of the practices followed by some of the main types of financial institutions would seem helpful in clarifying some of the issues that relate to provisioning by the Fund. But this does not mean that these factors provide, in any way, conclusive guidance for the Fund.

1. Depository institutions

Financial institutions engaged in commercial lending operations have a long standing practice of provisioning for doubtful or bad debts in view of the risks normally associated with commercial lending. Banks and other depository institutions usually establish provisions in anticipation, and usually by quantitative estimation of loan losses, in order to protect their equity capital from erosion. Such institutions recognize that it is preferable to provision over time starting with the first signs of perception of loss, rather than when no further recovery is feasible and the entire loss has to be charged against earnings or reserves in one accounting period. The portion of estimated loan losses that is not covered by effectively realizable collateral is normally provided for by using various techniques of general and specific provisioning or by combining them.

Banks normally establish specific provisions by reviewing individual loans above a certain minimum amount and by ranking them according to risk category as good, substandard, doubtful or loss loans. Specific provisions are then made up to a specified percentage of the loan, amounting to 5 to 20 percent for "substandard loans", 50 percent for "doubtful loans" and 100 percent for "loss category loans." 1/

1/ "Substandard loans" are those loans with well-defined weaknesses that disrupt or jeopardize orderly repayment and that are inadequately protected by the current net worth and paying capacity of the obligor, while "doubtful loans" have the additional characteristic of making complete collection or liquidation improbable based on existing facts, conditions and collateral values. "Loss loans" are considered uncollectible and of such little value that their continuation as a bankable asset is unwarranted. The classification as a "loss loan" does not mean that the asset has absolutely no recovery or salvage value, but it is not considered practical and desirable to defer full loss recognition.