INSTRUCTION CPO/B-2001/4
ASSET CLASSIFICATION

I. AUTHORITY

This instruction is issued by the Central Payments Office of East Timor (hereinafter, "CPO") pursuant to Sections 19.3, 26.2 (c), and 31 of Regulation No. 2000/8 on Bank Licensing and Supervision (hereinafter, the "Regulation).

II. APPLICABILITY

This instruction applies to all assets of each licensed bank. Branches of foreign banks licensed to operate in East Timor pursuant to Section 2.4 of the Regulation may, upon written request to the CPO, be exempted in whole or in part from the application of this instruction; provided that, the parent foreign bank is subject to asset classification requirements by its home country supervisor which comply with the basel Committee on Banking Supervision's Sound Practices for Loan Accounting and Disclosure (July 1999)"and which are generally consistent with the requirements of this instruction.

III. DEFINITIONS

A. Adversely Classified Credits (or Assets) – Those credits or other assets which are classified as either Substandard, Doubtful, or Loss in accordance with subsection B.

B. Assets Classifications

1. **Standard**- Unless one of the following definitions applies, an asset is Standard if it (1) is current; (2) the obligor is complying, and is expected to continue to comply, with all term of the contract; and (3) there is no reason to believe that the bank is now, or will be, subject to risk of loss.

2. **Under Supervision**- An asset should be classified as Under Supervision if potential weaknesses exist in the obligor's financial position and/or the collateral pledged. Assets which are Under Supervision require the close attention of bank management, because if left unaddressed or uncorrected, these potential weaknesses could result in the deterioration of the repayment prospect for the asset or in the bank's position in the future.

3. **Substandard**- An asset should be classified as Substandard if the asset has one or more well-defined weaknesses that make the full collection of principal and interest questionable: (1) the obligor's financial condition (including net worth and/or repayment capacity) is unfavorable and is deterioration; (2) the pledged collateral (if any) is insufficient or is deteriorating; (3) other adverse factors exist which cause concern regarding the ability of the obligor to repay the credit in accordance with the existing repayment terms; and/or (4) there has been an actual breach of contract.

Assets classified as Substandard require management's active attention because there is a distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. While losses will be realized in the total amount of all assets classified as Substandard, a loss will not necessary be realized in each individual asset so classified.

Non performing assets, which are at least 90 days past due, are at a minimum classified Substandard.

4. **Doubtful** – An asset shall be classified as Doubtful when weaknesses exist which make collection or repayment in full highly questionable and improbable based upon currently existing circumstance, conditions, and the estimated recovered amount of the pledged collateral (if any). The possibility of losses very high; however, because of certain important and reasonably specific pending circumstances which could strengthen the asset, classification of the asset as Loss is deferred until its more exact status is determined.

   Non performing assets which are at least 180 days past due are classied Doubtful.

5. **Loss**- At the time of classification, the asset is deemed uncollectible and such little value that it should not be included on the accounts and financial statements of the bank. The classification of an asset as Loss does not defer writing off this basically worthless asset even though at least part of the value could be recovered in the future. Such classification does not cancel the obligor's obligation to repay, nor does it mean that the bank should not further exercise its full legal right to collection or repayment.

   Non performing assets which are least 270 days past due are classified as Loss.

C. **Credit** is defined in Section 49(g) of the Regulation.

D. **Estimated Recoverable Amount** – For a value-impaired credit or other asset, this is the amount that the bank reasonably estimates it will recover. Acceptable methods for determining the estimated recovered amount of an asset are:

1. The present value of expected future cash flow discounted at an appropriate interest rat, that is, the effective interest rate inherent in the original credit or other contract. The estimates future cash flow should be the bank's best estimate based on reasonable and supportable assumption and projections. Discounting is appropriate where the time value of money is material; it may not be necessary to discount the cash flows of short-term receivables.

2. The fair value of the pledged collateral to the extent that the asset is collateral-dependent, taking into consideration any significant estimated cost to sell the collateral. An asset is collateral-dependent if repayment or collectability of the asset is expected to be provided solely by the underlying collateral.

3. The observable market prices, if it is a reliable indicator of the asset's estimated recoverable amount.

E. **Fair Value** - the amount for which an asset could be exchanged between knowledgeable willing parties in an arms-length transaction.

F. **Value-Impaired Asset** - An asset is considerable to be value-impaired when it is probable that the bank will be unable to collect, or there is no longer reasonable assurance that the bank will collect, all amounts due under the contractual terms of the asset.

IV. REQUIREMENTS

A. Assets Classification Policy

1. The Governing Board of each bank shall adopt, and ensure implementation of, a written policy covering the classification of assets and establishment of credit loss allowances which shall comply with the Basel Committee's "Sound Practices for Loan Accounting and Disclosure (July 1999)"and this instruction.

2. In accordance with Section 19.3(a) of the Regulation, the Risk Management Committee shall establish procedures for ensuring compliance with approved policy on Asset Classification, and shall monitor the implementation of the policy and procedures. Asset classification procedures should include the following: (1) three should be an approved and documented analytical framework for assessing loan quality, which is applied consistency over time; (2) estimates should be based on reasonable and supportable assumptions; and (3) assumption concerning the impact on obligors of changes in general economic activity should be realistic and conservative.

3. The Assets Classification policy shall be reviewed by the Risk management Committee and the Governing Board on at least an annual basis.

B. Classification of Credits

Banks shall review all credits, and relevant information available, for purposes of classification on at least a quarterly basis. Assessments should be performed in a systematic way and in accordance with the bank's policies and procedures. Based on such review, each credit shall be included into one of the classification categories of Section III.B. of this instruction. In the event that a credit may be classified differently based on these criteria, the bank shall apply the more severe classification. All value-impaired credits must be adversely classified. If, between formal quarterly reviews, the bank has knowledge of a significant deterioration in the quality of an individual credit or in a material part of the bank's credit portfolio, the bank must promptly assign the credit)s) to a new classification that accurately reflect the status of the credit (s).

C. Classification of Assets other than Credits

Each bank is required to review its assets on at least a quarterly basis for purpose of asset classification and for determining whether any asset has suffered an "other than temporary" decline in, or impairment to, value which should be recognized by the bank in accordance with this instruction. Assessments should be performed in a systematic way and in accordance with the bank's policies and procedures. When a bank adds an asset to its balance sheet or moves an asset to a different account on the balance sheet, the bank must ensure that its records and financial statements accurately reflect the quality and condition of that asset. If, between formal quarterly reviews, a bank obtains new information or otherwise determines the quality or condition of an asset has changed, the bank must promptly and accurately assign the asset to a new classification.

D. Loss Recognition on Value-Impaired Assets

1. Credits

(a) At the time of credit classification, any impairment to the value of a credit shall be recognized by reducing the carrying amount of the credit through an allowance for credit loss, or by charging of the credit, and in both cases charging the income statement in the period in which the impairment occurs.

(b) The bank shall determine the amount of the allowance for credit loss using one of the following two mutually exclusive methods:

(1) Standard percentage method – the minimum required amount for the allowance for credit loss shall be determined by applying the following percentage to the sum of credits in each classification category:

Standard	2%
Under Supervision	5%
Substandard	25%
Doubtful	50%
Loss	100%

(2) Estimated Recoverable amount method – alternatively, upon prior written approval by the CPO and in accordance with the bank' established policy, the bank may include in the allowance for credit loss the difference between the current carrying amount of the credit and its estimated recoverable amount.

(c) Once a bank has adopted the Estimated Recoverable Amount Method (with the prior written approval of the CPO), it may not revert to the use of the Standard percentage method except with the prior written approval of the CPO for good cause shown. The CPO, in its sole supervisory discretion, may require a bank to use the standard percentage method for purpose of establishing the allowance for credit loss.

(d) The aggregate amount of the allowances for credits loss must be adequate to absorb estimated credit losses associated with the bank's credit portfolio.

2. Assets other than Credits

In the event of another than temporary" impairment to the carrying amount of an asset (other than credits), then the net carrying amount of the asset shall be reduced to the estimated recoverable amount, and the loss in value shall be recognized as an expense and charged against income in the current period. The new carrying amount shall not be changed for subsequent recoveries in value.

E. Income Recognition

1. Assets which are impaired and/or adversely classified, and assets with payments which are contractually 90 days or more in arrears, shall be placed on non-accrual.

2. For non-accrual assets, the bank shall cease reflecting in its net income the accrual of interest; that is, interest shall no longer be accounted for as income except as received in cash.

3. When an asset is placed on non-accrual, uncollected interest which has previously been accrued shall be reversed.

F. Restoring an Asset to Unimpaired Status

An impaired and/or adversely classified asset shall only be restored to unimpaired status when the contractual amount of principal and interest is deemed to be fully collectible in accordance with the terms of the contract. Specifically,

1. The bank has received repayment of the past due principal and interest, none of the principal and interest is due unpaid, and the bank expected repayment of the remaining contractual principal and interest as schedule in the contract;

2. The obligor has resumed paying the full amount of the schedule contractual principal and interest payments for at least six months, and all remaining

contractual payments (including compensation for overdue payments) are deemed to be collectible in a timely manner; or

3. The asset otherwise becomes well-secured and is in the process of collection.

G. Acquisition of Equity Interest, Real Property, or Other Assets in Lieu of Repayment of Credits Granted by the Bank.

If the bank acquires either an equity interest (in accordance with Section 13.5(a) of the Regulation), real property, or other assets in lieu of repayment of a credit granted by the bank, the carrying amount of the asset shall be the lower of the net unpaid principal balance of the credit or the estimated recoverable amount of the asset. If the estimated recoverable amount of the asset acquired is less than the amount of the net unpaid principal balance of the credit, then the deficient amount shall be charged off when the asset is added to the books of the bank.

V. RESTRICTIONS

A. A bank shall not renegotiate, roll-over, or modify the terms of a credit in order to avoid an adverse classification.

B. A bank shall not advance additional funds to enable an obligor to meet current payment obligations to the bank.

VI. SUPPLEMENTAL POLICY STATEMENTS

From time to time, the CPO may issue policy statements to supplement this instruction in order to elaborate proper classification of assets in certain special instances.

VII. REPORTING

Each bank shall submit to the CPO a report as of each quarter-end, in the format prescribed by the CPO, showing the classification of the bank's assets in accordance with this instruction.

11 April 2001

Fernando De Peralto, General Manager

REPORT

Name of Bank:
CPO Identification Number:
Report for Quarter Ended:

ASSET CLASSIFICATION AND ALLOWANCEFOR LOSSES

Assets	Standard	Under Supervision	Substandard	Doubtful	Loss	Total
Credits/Leases (broken down by sector)						
Securities						
Other Real Estate Owned						
Other Assets						
Total						
Provisioning for Credit losses (%)						
Amount of Required Provisioning						

PAST-DUE AND NON-ACCRUAL ASSETS

Each item on this schedule should be reported net of interest. Reportable assets should be reported in either column 2 or 3, but not both.

(1) Assets	(2) Assets Past-Due 30 – 90 Days	(3) Assets 90+Days Past-Due and Non-Accrual Assets	(4) Total Past-Due and Non-Accrual Assets
Credits (broken down by sector)			
Assets Other Than Credits			
Total			

CHARGE-OFFS AND RECOVERIES

Asset	Charges-Offs	Recoveries
Credits (broken down by sector)		
Assets other than credits		
Total		

CHANGES IN ALLOWANCE FOR LOSSES

	Amount
Balance from previous report	
Recoveries	
Charges-Offs	
Current provision for losses	
Prior Period adjustments	
Ending Balance	

Signature of Authorized Officer / Date;