



NATIONAL BANK OF SERBIA

Guidelines For IAS 39

**Impairment and uncollectibility of financial assets
carried at amortised cost**

The National Bank of Serbia emphasises that the responsibility for the preparation of financial statements and the selection and application of appropriate accounting policies and estimates is exclusively and indisputably within the remit of the bank's management, while the external auditor gives an opinion on whether the bank's annual financial statements are prepared in compliance with International Financial Reporting Standards, and/or International Accounting Standards.

The National Bank of Serbia considers these Guidelines to represent good business practice, supports their implementation by banks and expects that banks will be able to document and explain any comportment which is not in accordance with this document. The National Bank of Serbia will continuously review the application of these Guidelines through the banking supervision process.

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DEFINITIONS OF TERMS

Exposures are all financial assets subsequently carried at amortized cost and they comprise loans (credits) and receivables, as well as held-to-maturity investments.

Loans (credits) and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:

- (a) those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss;
- (b) those that the entity upon initial recognition designates as available for sale; or
- (c) those for which the holder may not recover substantially all of its initial investment, other than because of credit rating deterioration, which shall be classified as available for sale.

An interest acquired in a pool of assets that are not loans (credits) or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan (credit) or receivable.

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity, other than:

- (a) those that the entity upon initial recognition designates as at fair value through profit or loss;
- (b) those that the entity designates as available for sale; and
- (c) those that meet the definition of loans and receivables.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

Non-performing exposures are exposures where the payment of the principal or interest is more than 90 days past due or where payments are less than 90 days overdue, but the bank has assessed that the borrower's repayment ability has deteriorated and doubts that the payments will be made in full.

Loss identification period spans the time between the occurrence of a loss event and the date that the loss event is identified.

LTV ratio is the ratio of the gross carrying amount of the exposure and the market value of the mortgaged property serving as security for the exposure.

1. INTRODUCTION

This document represents the National Bank of Serbia's guidelines for banks in the Republic of Serbia aimed at ensuring best practice in the application of the International Accounting Standard 39 Financial Instruments: Recognition and Measurement (hereinafter: IAS 39), related to impairment and uncollectibility of financial assets subsequently carried at amortized cost (hereinafter: exposures).

Often cited concerns about delayed loss recognition under IAS 39 ('too little and too late'), including the frequently cited shortcomings of the incurred loss model, prompted the International Accounting Standards Board (IASB) to issue a new standard (IFRS 9)¹ to replace IAS 39 in its entirety. In view of the above and the weaknesses in banks' provisioning practices highlighted by the Special Diagnostic Studies (SDS²), the National Bank of Serbia believes it is possible, within the context of IAS 39, to identify sooner the non-performing exposures and/or an increase in existing impairments on these exposures, so that they would better reflect the underlying economic reality.

The purpose of these Guidelines is to ensure prudential application of IAS 39 in order for the banks to:

- establish adequate procedures for assessing impairment losses on exposures, and
- recognize incurred losses in a timely manner within the context of IAS 39.

In line with IAS 39 and the incurred loss model, the National Bank of Serbia expects banks to: (i) prudently assess objective evidence of impairment, (ii) use conservative assessments and assumptions for determining the recoverable amount of exposures and (iii) use prudent assumptions when assessing the impairment amount of forborne exposures. It should be pointed out that IAS 39 recognizes the significance of experienced judgement in the process of determining the impairment amount and states that the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.³

The National Bank of Serbia considers that the approaches defined in these Guidelines represent examples of the best practice in the application of IAS 39

¹ During the financial crisis, the delayed recognition of credit losses on loans (and other financial instruments) was identified as a weakness in existing accounting standards. Specifically, because the existing model (an 'incurred loss' model) delays the recognition of credit losses until there is evidence of a credit loss event, the IASB has been exploring alternatives to the incurred loss model that would use more forward-looking information, which finally resulted in the publication of IFRS 9. Additionally, the complexity of the current accounting practices which use many different impairment models for financial instruments was also identified as a concern.

² See [SDS Report](#), page 15.

³ IAS 39, 62.

and expects banks to apply them at the time of compiling financial statements in 2016.

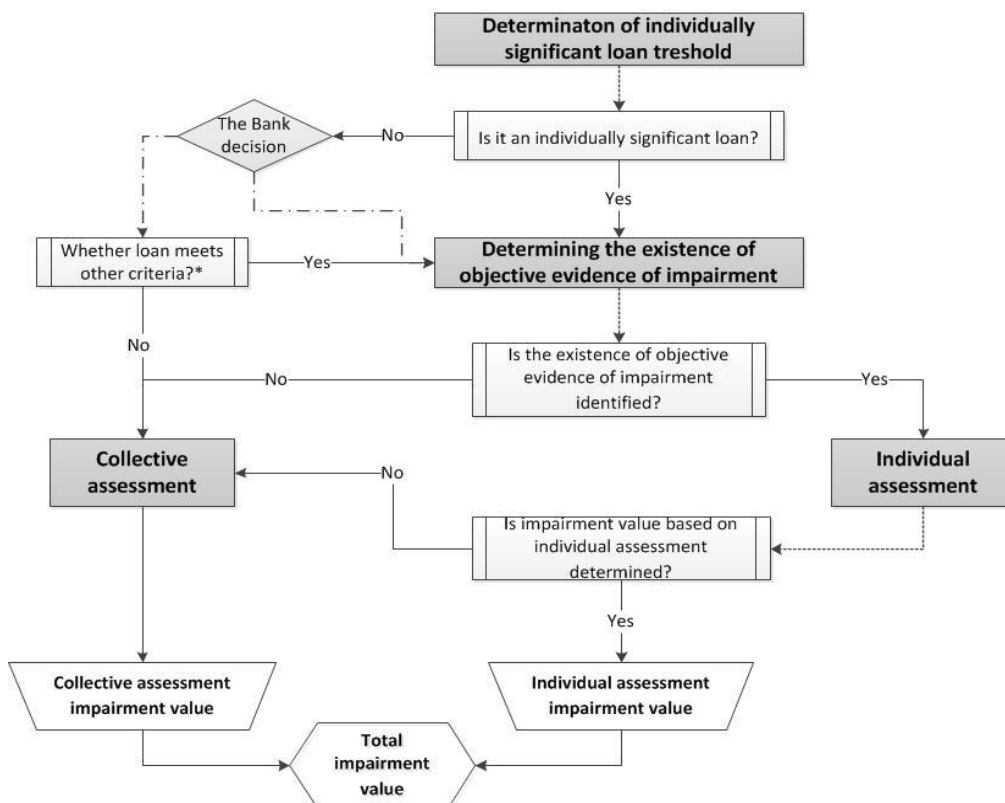
The National Bank of Serbia expects internal auditors of banks to independently assess the compliance of their respective banks with these Guidelines and to include this assessment in the Annual Report on the adequacy of risk management and internal controls, pursuant to Article 87 of the Law on Banks (RS Official Gazette, Nos 107/2005, 91/2010 and 14/2015).

The National Bank of Serbia expects the external auditor to include, in the part of the External Auditor's Report relating to analyses for the needs of the National Bank of Serbia (Decision on External Bank Audit, RS Official Gazette, Nos 41/2007, 59/2008, 67/2012 and 18/2015), an appropriate assessment of the bank's compliance with these Guidelines, as well as to provide a reasoned explanation for any departures by the bank from these Guidelines.

2. PROCEDURE FOR ASSESSING IMPAIRMENT AND UNCOLLECTIBILITY OF EXPOSURE

Banks are expected to establish, depending on the volume and complexity of their business model, a clearly defined methodology for assessing the impairment of exposures. This methodology should be reviewed at least once a year, amended as necessary, and its underlying assumptions adjusted. When developing methodologies and relevant procedures, banks should rely on these Guidelines. In fact, banks are expected to be able to provide a reasoned explanation for any materially significant departures of their methodologies from the elements defined in the Guidelines.

The expected stages of the process of assessing the impairment and uncollectibility of exposures are presented below:



* Bank's estimate regarding the need for determining the existence of objective evidence of impairment for exposures to persons related to the bank as well as for all exposures to a borrower, where total exposures to such borrower exceeds the significance threshold.

IAS 39 recognizes that in the impairment assessment process all exposures in all credit grades⁴ should be considered (including those with good credit rating). The process for

⁴ IAS 39, AG 85.

estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the entity recognizes an impairment loss equal to the best estimate within the range taking into account all relevant information available before the financial statements are issued about conditions existing at the end of the reporting period.⁵

The bank's management should ensure a realistic estimation of future cash flows and the value of the collateral used in the impairment provision calculation, as well as to apply appropriate conservatism to impairment assessment of forborne loans and regularly review and revise the key judgements, assumptions and estimates used in the bank's impairment assessment methodology. In addition, the bank's management should ensure an appropriate level of disclosure regarding key management judgements, estimates and assumptions used by the bank in the process of impairment assessment.

Banks should apply the exposure impairment and uncollectibility assessment procedures as necessary, but no less than once every three months.

The National Bank of Serbia expects banks to set up an appropriate information system, which enables bank management and supervisors to have an insight during the supervision procedure into at least the following:

- **Individual exposure status** (performing/performing forborne/non-performing/ non-performing forborne),
- **Method for calculating individual exposure impairment** (individual impairment review/collective impairment review),
- **Method for calculating recoverable amount** (estimation of future cash flows without enforcing the collateral, estimation of future cash flows based on collateral realization or estimation of future operating cash flows with possible realization of non-core collateral),
- **Number of days past due**, in accordance with the Decision on the Classification of Bank Balance Sheet Assets and Off-balance Sheet Items and in accordance with the bank's internal calculation of days past due,
- **Type and value of the collateral underlying the exposure** (market value, liquidation value, value of higher priority claim and recoverable value), and
- **LTV** (loan-to-value) ratio of exposures.

⁵ IAS 39, AG 86.

2.1 DETERMINING INDIVIDUALLY SIGNIFICANT EXPOSURE

The National Bank of Serbia expects banks to clearly differentiate between individually significant exposures and those not considered individually significant (e.g. small exposures). When determining the significance thresholds, banks should take into account the level of portfolio diversification, as well as ensure compliance with limits defined in the credit approval process and the level of development and quality of the collective impairment review model.

In the absence of an appropriate collective impairment review model,⁶ a bank is expected to set the significance threshold lower, i.e. to set a lower significance threshold level in the initial stage of implementation of a new collective impairment review model, with the possibility of raising such threshold over time, if testing shows that the applied model is sound and reliable.

Banks are expected to clearly document the criteria underlying the thresholds for determining individually significant exposures.

⁶ A model consistent with these Guidelines and assessed by the external auditor to be fit for purpose.

2.2 DETERMINING OBJECTIVE EVIDENCE OF IMPAIRMENT AND UNCOLLECTIBILITY OF EXPOSURE

For individually significant exposures, as well as for all exposures which are not individually significant, where a bank determines impairment on an individual basis, it is necessary to establish whether there is objective evidence that the exposure is impaired. In addition, a bank is expected to assess the need for reviewing the existence of objective evidence for exposures to persons related to the bank, as well as for all exposures to a borrower, where total exposures to such borrower exceed the significance threshold.

In its internal acts, a bank is expected to define and regularly update the lists of objective evidence of exposure impairment for each relevant sub-portfolio ('impairment triggers') and to use them in the exposure assessment process. To facilitate appropriate use, banks should consider disclosing impairment triggers that are applicable to each sub-portfolio and define relevant internal thresholds that guide the application thereof.

Objective evidence that the exposure is impaired exists if there is one or more events that occurred after the previous assessment of impairment of an exposure which has or can have a negative impact on the ability of the borrower to regularly service its obligations to the bank, and has an impact on the estimated future cash flows of the exposure that can be reliably estimated.

A bank is expected to examine whether there is objective evidence that the exposure is impaired in at least the following situations:

- **where the borrower's financial position indicates significant problems in its business operations:**
 - borrower's internal rating indicates default,
 - the borrower is late in performing its obligations to the government, other creditors or employees, or irregularly meets its obligations in respect of taxes and employees' social security contributions, in a significant amount, as estimated by the bank;
 - there is a significant⁷ and continuous reduction in operating income over the previous two years, or over a shorter period of time as estimated by the bank (e.g. loss of a major customer);
 - borrower's capital has been significantly reduced due to losses in the course of the previous two reporting periods;

⁷ In the course of Special Diagnostic Studies conducted in 2015, the National Bank of Serbia defined a reduction of over 50% as significant.

- current indicator of debt servicing capacity determined by the bank is below the satisfactory level⁸ and shows a trend of continuous deterioration;
 - a material decrease in property value, where the sale of such property is required to repay the loan⁹;
 - a request from the borrower for forbearance and/or emergency funding.
- **where there are records of non-performance of obligations, frequent delays in the payment of interest and/or principal, or non-compliance with other contractual provisions:**
 - at the latest, when a borrower is 90 days past due on any of its exposures;
 - when exposure is non-performing in accordance with the Decision on Reporting Requirements for Banks (RS Official Gazette, Nos 125/2014 and 4/2015)¹⁰.
 - **where because of the borrower's financial difficulties the bank has significantly changed the terms of repayment of exposures compared with the initially agreed ones**, i.e. where the bank has approved benefits to the borrower which otherwise it would not have considered, the benefits being as follows:
 - change of the initially agreed terms of a single exposure due to the borrower's inability to meet the terms on account of financial difficulties, which would not have been approved if the borrower was not in financial difficulties (these changes include, but are not limited to: interest rate reduction, partial write-off of the principal, partial write-off of accrued interest and a change of maturity date of the principal and/or interest);
 - full or partial refinancing, which would not have been approved if the borrower was not in financial difficulties;
 - taking no action in relation to a borrower in financial difficulties, to which the bank is entitled under the contract.
 - **where the opening of bankruptcy proceedings against the borrower or other type of its financial reorganization seems highly likely**, which the bank can identify based on the following:
 - borrower's account is blocked for more than 60 days on the day of assessment;

⁸ In the course of Special Diagnostic Studies conducted in 2015, the National Bank of Serbia set the limit at 1.1.

⁹ For example, project financing.

¹⁰ Non-performing loan represents total outstanding debt under an individual loan (including the amount of arrears):

- where the payment of principal or interest is past due (within the meaning of the decision governing the classification of balance sheet assets and off-balance sheet items) over 90 days,
- where at least 90 days of interest payments have been added to the loan balance, capitalized, refinanced or delayed by agreement,
- where payments are less than 90 days overdue, but the bank has assessed that the borrower's repayment ability has deteriorated and doubts that the payments will be made in full.

- pre-bankruptcy proceedings have been opened against the borrower or bankruptcy proceedings are pending against any other strategically significant member of the economic unit to which the borrower belongs;
- conditions are met for opening bankruptcy proceedings against the borrower, as defined by the law governing bankruptcy;
 - the borrower is in the process of preparing a reorganization plan/creditors have accepted the proposed reorganization plan /borrower operates on the basis of an adopted reorganization plan;
 - the borrower is in the process of consensual financial restructuring in accordance with the relevant regulation.

Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of exposures, although the decrease cannot yet be identified by individual financial asset within the group, include:

- changes that have a negative effect on the ability of borrowers within a certain group to perform their obligations (e.g. higher incidence of delays in repayment, increased number of borrowers who have used up their credit card limit and are making minimum monthly repayments, etc.);
- economic circumstances that correlate with non-performance in respect of receivables within a certain group (e.g. increase in the unemployment rate in the geographic area where the borrower's business is located, reduction in the value of real estate taken as collateral, significant changes to interest rates or the exchange rate, adverse changes in industry conditions etc.).

An individual event is not in itself evidence of impairment, just as the absence of a loss event does not exclude possibility of impairment (such as the absence of days past due). In addition, the National Bank of Serbia considers loans which meet the definition of NPLs to have “objective evidence of impairment” and hence to necessitate an impairment assessment. Besides, it is important that the bank should rely on prior experience in specific cases when assessing objective evidence of impairment, also considering parameters that are not mentioned above.

If the bank identifies objective evidence of impairment of an exposure, it should document the type of such identified objective evidence. Conversely, if the bank identifies no objective evidence of impairment of an exposure, it must document the considerations underpinning this conclusion.

2.3 INDIVIDUAL IMPAIRMENT REVIEW

Individual assessment of impairment of exposures means establishing whether objective evidence of impairment exists, estimation of the present value of future cash

flows, and calculation of the value of impairment for each individual receivable from the borrower included in this assessment.

The National Bank of Serbia expects banks to determine, for each individual debtor, whether they expect to collect their receivables from expected future cash flows (going concern) or from collateral realization (gone concern). If a bank identifies objective evidence of impairment, the National Bank of Serbia expects the bank to indicate, at single debtor level, the most realistic sources of repayment (collection approach/strategy) based on all available information regarding such debtor's financial position and performances. In this context, the bank is expected to assess whether collection will be made from the debtor's expected future operating cash flows (debtor continues to perform business activities – going concern) or on the basis of collateral enforcement and realization (expectation that the debtor ceases to exist – gone concern). In both cases, banks should use conservative assumptions relating to the estimation of the expected cash flows, taking into account current economic conditions and the bank's own economic forecasts.

Assessments and assumptions regarding **expected future cash flows from exposures** should reflect the current economic situation and the expected economic trends and should be adjusted to each individual case, taking into account the borrower's business model and business strategy, amount and methods of financing, and the specificities of the industry in which the borrower operates.

When considering the likelihood of collection from cash flows, a bank may also consider collection from the realization of collaterals that are not vital for the borrower's business operations, if the realization of such collaterals would not influence the borrower's ability to generate future operating cash flows.

The National Bank of Serbia expects banks to regulate, by their internal acts, the process of identifying the recoverable amount by estimating expected future inflows in respect of contractual cash flows.

When estimating impairment based on collateral realization, the recoverable amount is the present value of the net inflow from collateral realization (taking into account the priority of claims), discounted by applying the original effective interest rate to the expected time to realization.

Collateral appraisal should be based on recognized international valuation standards and reflect current market circumstances¹¹. The National Bank of Serbia considers the following three methods of collateral valuation¹² to be acceptable:

- **Market-based approach,**
- **Income-based approach,**
- **Cost-based approach.**

The National Bank of Serbia expects that the market-based approach will be given priority in each case of collateral valuation. If this approach is impracticable or its use is not appropriate in a given case, income-based approach should be applied. Cost-based approach should only be used when the former two are not applicable. It should be noted that the National Bank of Serbia expects that a higher haircut will be applied when using the depreciated replacement cost method for collateral valuation than when using other methods.

In order to determine the recoverable amount, a bank should assess the **expected time to realization**. The bank will determine the expected time to the sale of collateral as of the moment it decides to expect collection from collateral realization and not from the expected future operating cash flows, based on prior experience and available data, but also taking into account current market circumstances as well as deadlines prescribed by the relevant legislation regulating mortgage and enforcement. When a bank determines impairment on the basis of expected future cash flows also taking into account collection from the realization of collaterals that are not vital for the borrower's business operations, the expected time to realization should be determined from the moment of default.

The bank is expected to define the **haircut** as a reduction of the estimated market value of collateral down to the value expected to be collected through the sale of collateral at a certain future point in time, taking into consideration the identified volatility of such market value as well as the possibility of realization of such collateral. In addition to the **haircut**, the bank should also take into account the costs of activation and realization of collateral (estimated legal costs, tax expenses payable by the seller, consultant fees, advertising costs and other costs), expected decrease in market value from the time of appraisal until the moment of planned realization, as well as uncertainty regarding value assessment inherent to the appraisal process¹³, etc.

¹¹ The Ministry of Finance is in the process of drafting the law governing requirements for and performance of property valuation, professional qualifications of valuers and other relevant issues, along with national valuation standards.

¹² It is expected that the market value of collateral is based on current use of such collateral. When collateral is valued on the basis of its alternative use, it is necessary to assess appropriate reductions of its value (e.g. costs of demolition, renovation, restoration, upgrade...)

¹³ In practice, appraisals of the same collateral by different appraisers may differ materially (even when done in accordance with international valuation standards) – e.g. when the market is illiquid, or appraisers have different views regarding key parameters. In that sense, additional conservatism is necessary (appraiser haircut).

If, in the process of determining the recoverable amount, a bank takes into account cash flows expected on the basis of realization of movable property (vehicles, equipment, goods etc.), the National Bank of Serbia expects the bank to apply conservative haircuts reflecting the characteristics, volatility, expected percentage of collection as well as probability and possibility of realization of the movable property, and to clearly document the underlying considerations. Generally speaking, the National Bank of Serbia expects haircuts on movable property to exceed those applied to immovable property.

In the absence of detailed, relevant, experience-based data on time to realization for certain types of collateral, collateral realization costs, and haircuts in the collection process, the National Bank of Serbia expects banks to adopt a conservative approach of adjusting all key input parameters for determining the recoverable amount.

The National Bank of Serbia expects banks to identify, in their internal acts, the types of collateral which can be taken into consideration for the purpose of determining the amount of impairment¹⁴, and to regulate the process of determining the recoverable amount, the method for determining expected time to realization, assessment of the collateral realization process, haircuts, and the assessment of realization costs. Also, the National Bank of Serbia expects that, at the time of determining the recoverable amount, the bank should take into account only the collateral enforceable in accordance with the applicable law and registered in the land registry, real estate cadastre or other appropriate register.

The National Bank of Serbia expects banks to clearly define, in their internal acts, the process and frequency of collateral valuation, consistent with statutory and prudential requirements, and to review relevant internal acts at least once a year and amend them as necessary. The frequency of collateral valuation should reflect its size, marketability and complexity, as well as the riskiness of the exposure which such collateral underlies. Taking into account the importance of the value of collateral for prudential assessment of impairment of exposures, the National Bank of Serbia expects a sufficient degree of conservativeness to be applied in collateral valuation.

As regards performing exposures which are secured by collateral, banks are expected to have their collaterals revalued by a licensed appraiser at least once every three years. For exposures secured by commercial real-estate and for non-performing exposures where banks expect to collect their receivables based on collateral realization, the monitoring of the value of collateral should be done at least annually. If an exposure is secured by a complex collateral instrument, it is advisable for a bank to be prudent and request valuation of such collateral by two different licensed appraisers from its own list of appraisers. Additionally, the bank is expected to assess the need for establishing a system of continuous monitoring of movements in the value of conducted collateral valuations.

¹⁴ Taking into account its characteristics and uncertainty of realization.

Regarding the pledge on movable property, banks are expected to be able to establish adequate monitoring, including verification of the existence of the pledged property (quantitatively and qualitatively) on a regular basis, as well as to have monitoring reports confirming the existence of such pledged property. In the absence thereof, the bank should not take this type of collateral into account for the purpose of determining the amount of impairment.

The amount of impairment of exposures is determined as the difference between the carrying amount of the exposure and the present value of expected future cash flows deriving from such exposure, discounted at the exposure's original effective interest rate. If the terms of an exposure are renegotiated or otherwise modified because of the financial difficulties of the borrower or the issuer, the impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of such discounting is immaterial. If an exposure has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.

2.4 COLLECTIVE IMPAIRMENT REVIEW

A bank makes a collective assessment of impairment for all exposures that are not deemed to be individually significant and are therefore not assessed for impairment on an individual basis. Collective assessment of impairment will also be made for exposures where individual assessment revealed no objective evidence of impairment (including exposures with the highest credit grade/quality) and where no amount of impairment of exposure has been determined at individual level.

The National Bank of Serbia expects banks to develop a methodology to define assumptions and parameters used in assessing impairment for a group of exposures with similar credit risk characteristics, as well as to revise this methodology on a regular basis, but at least once a year, in order to minimize differences between estimated and actually incurred losses.

Banks are expected to group exposures according to similar credit risk characteristics that are indicative of the borrowers' ability to pay all amounts due according to the contractual terms (for example: type of exposure, borrower's current and previous internal rating (status), number of days past due, industry in which the borrower operates, geographical location in which the borrower operates, currency of indexation of the exposure, type of collateral, LTV ratio value, forbearance measures applied to borrowers in financial difficulties, employment status, other relevant factors).

The recoverable amount of individual exposures classified into groups of exposures is assessed based on historical loss experience for exposures with similar credit risk characteristics.

Banks are expected to adjust historical loss experience on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based in order to emphasize the effects of current data. When determining deviation from historical loss experience the bank may consider observable relevant factors¹⁵, such as:

- changes in lending policies and procedures, including underwriting standards and collection, the extension of forbearance measures, write-offs, and recovery practices;
- changes in international, national and local economic and business conditions and developments, including the conditions in various market segments;
- changes in the trend, volume and severity of past due and adversely classified exposures, as well as trends in the volume of impaired exposures and restructurings;

¹⁵ BSCBS, <http://www.bis.org/publ/bcbs126.pdf>

- the existence and effect of any concentrations of credit, and changes in the level of such concentrations;
- the effect of external factors such as competition, legal and regulatory requirements on the level of estimated credit losses in the bank's current portfolio; and
- changes in the risk profile of the portfolio as a whole.

Additionally, banks should also remove the effect of conditions in the historical period that do not exist currently.

Deviations from historical loss data should be clearly documented and signed by banks' senior management.

The National Bank of Serbia expects banks to adhere to a sufficiently conservative approach with regard to assessments and data used in the process of collective impairment review regardless of the model used for the purposes of calculating the collective impairment amount¹⁶. Estimations should reflect, among other things, conservative assumptions in collateral appraisals, time to realization and costs of collateral realization process, as well as probability of default (PD), loss given default (LGD), recovery rate, cure rate and loss identification period (LIP) that are reflective of the credit characteristics of each stratified pool.

Banks are expected to create a database for determining the PD and LGD for each group of exposures, assigning higher weight to current phase of economic cycle of the economy as a whole when determining those parameters. When it is not possible to create such database in a short period of time, for example due to the absence of reliable historical loss data, it is recommended to use the experience of a similar group for comparable groups of exposures. Representative data from third parties (e.g. ratings agencies) can also be used.

It should be noted that the probability of default is greater for exposures which are less than 90 days past due (e.g. 30 or 60 days) than for exposures which are not past due. Taking that into account, banks are expected to use a higher PD, and lower cure rates for groups of exposures with a higher number of days past due. Additionally, PD is expected to be significantly higher and cure rates significantly lower for groups of exposures that were non-performing (cured), compared to exposures for which no problems in repayment are expected.

Loss identification period (LIP) is of great importance for impairment assessment. That period depends on the frequency of assessment of a borrower's creditworthiness. Banks are expected to determine the correlation between certain macroeconomic variables and the probability of loss, which could result in earlier identification of

¹⁶ For example, when $PD < 100\%$, impairment amount = $E * PD * LGD * LIP$, E – exposure.

incurred losses. The National Bank of Serbia expects banks to apply a sufficiently conservative approach when assessing the time required for identification of incurred losses and to document the manner in which such period was determined, followed by an appropriate explanation. If a bank is not able to document the above, it should recognize minimum 12 months as the incurred loss identification period (LIP=1).

In case of significant departures of estimated from realized losses, banks are expected to assess the adequacy of borrower segmentation and the assumptions used in determining the parameters, and to define what is considered a significant departure of estimated from realized losses. Banks should back-test the parameters used for collective provisioning against actual loss data on an annual basis, and make changes to their collective provisioning approach as needed.

Regardless of whether they apply the recommended or another approach for estimating collective impairment, the National Bank of Serbia expects banks to provide the following documentation at supervisor's request:

- criteria for classifying exposures into different groups of exposures;
- data, calculations and results supporting each category of assumptions for each group of exposures;
- reasons for applying the given assumptions,
- documentation on reliability and accuracy of the applied parameters obtained through back-testing, i.e. checking assumptions against actual values, with testing done at least once a year.

3. INTEREST RECOGNITION ON IMPAIRED EXPOSURE

Once an exposure has been written down as a result of an impairment loss, interest income is thereafter recognized by applying the effective interest rate to the carrying amount of the exposure (i.e. net of impairments)¹⁷.

The National Bank of Serbia recognizes that certain banks, due to insufficient technical capacity or for other objective reasons, apply an accounting policy which implies derecognition of interest income on impaired exposures. In the context of the precautionary balancing principle and in view of deviation of this approach from IAS 39, special attention should be paid to impaired exposures with a higher number of days past due (e.g., more than 180 days past due). The National Bank of Serbia will determine, in communication with the bank, the reasons and causes for applying such accounting policy and its effects on the financial position, capital and performance indicators of the bank.

When a bank applies the policy of derecognition of interest income on impaired exposures, the National Bank of Serbia expects the external auditor to assess with due diligence, in accordance with international auditing standards, the effects of such derecognition and to acquire audit evidence in order to determine whether such practice has a materially significant impact on the truthfulness and objectivity of the financial position and business results of the bank stated in such annual financial statements, as well as whether the bank's annual financial statements contain appropriate disclosures on interest recognition of impaired exposures.

¹⁷ IAS 39, AG 93.

4. WRITE-OFF OF UNCOLLECTIBLE EXPOSURE

The National Bank of Serbia expects banks to manage the collection of receivables in an appropriate manner for as long as they assess that collection-related activities are justified from an economic point of view. If a bank estimates that the exposure will not be collected, such bank is expected to remove the exposure from its balance sheet, without relinquishing its legal rights vis-à-vis the borrower.

Emphasizing that the National Bank of Serbia does not consider direct write-off of receivables, i.e. the derecognition of an exposure or a part of an exposure, to imply a loss of rights or bank's withdrawal from the collection process, when determining the appropriateness of the write-off of exposures that are deemed uncollectible, and with the aim to ensure timely loss recognition, banks are expected to take into account exposures with the following characteristics:

- unsecured exposure, if the debtor has been in bankruptcy proceedings for more than one year,
- unsecured exposure, if the debtor is more than three years in arrears,
- exposure secured by real estate collateral where the debtor is more than three years in arrears, if the bank has not started the procedure of collection from collateral or made collection from the underwriter or co-debtor,
- other exposures having elements that indicate difficulties in collection (for example, exposure to a debtor deleted from the business entities register that has not continued to operate through status change of merger by acquisition, merger by formation of new company or division; exposure to a deceased person).