

Loan Loss Provision

The core business of banks and financial institutions is to provide loans to individuals and institutions. The loans may not be recovered on time which may hamper the banking industry and economy. To protect the banking industry and economy from such risks, NRB has directed banks to calculate loan loss provisions by classifying loans. Loan loss provision is an accounting practice that involves setting aside funds by a bank or financial institution to cover potential losses from loans that are at risk of default.

A. Classification of loans as per NRB directive

As per NRB, the total loans of banks and financial should be categorized into two types:

Performing loan	Non-performing loan
Pass Loan	Substandard
Watchlist	Doubtful
	Bad/Loss

B. Calculation of Provisions required by NRB.

After classifying loans, the banks are required to calculate the loan loss provision in all types of loans as specified in the unified directive of NRB. The following table shows the calculation of the minimum requirement of loan loss provision.

Classification of loans and calculation of loan loss provision			
Loans	Value	Provisions %	Loan Loss Provision
A Good	80.00	1.3%	1.04
B Watch list	10.00	5.0%	0.50
1 Performing(A+B)	90.00		1.54
C Substandard	5.00	25.0%	1.25
D Doubtful	3.00	50.0%	1.50
E Bad/Loss	2.00	100.0%	2.00
2 Non-Performing(C+D+E)	10.00		4.75
Total(1+2)	100.00		6.29

C. Impact of Provisions on Income Statement

After calculating the loan loss provision, the bank must charge the loan loss provision in the income statement. According to the above table, Rs. 6.29 will be charged as impairment charges to the income statement.

The bank follows a similar process in the next year. If the loan loss provision is Rs. 7 in the next year, the bank will charge an additional impairment of Rs. 0.71 (7 - 6.29) in the income statement of next year. Similarly, if the loan loss provision is Rs 6 in the next year, it will reverse the impairment charge of Rs. 0.29 (6.29 – 6) in the next year's income statement.