This module should be read in conjunction with the Introduction and with the Glossary, which contains an explanation of abbreviations and other terms used in this Manual. If reading on-line, click on blue underlined headings to activate hyperlinks to the relevant module.

Purpose

To lay down the guidelines that AIs should follow for determining those loans or other assets on which interest should be suspended or cease to be accrued to the profit and loss account

Classification

A statutory guideline issued by the MA under the Banking Ordinance, §7(3)

Previous guidelines superseded

Guideline 11.3 "Guideline on recognition of interest" dated 19.05.98

Application

To all AIs

Structure

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1. Introduction

1.1 The financial condition and performance of an AI depend on whether its assets are realistically valued and whether its income is prudently recognised. Generally, interest earned on loans should be brought into the profit and loss account as it accrues, provided that its collectibility is not significantly in doubt.

1.2 The problem is to identify the point at which the collectibility of interest or principal becomes doubtful. In most cases, this is a highly judgemental process. Therefore, there is a need for a standardised approach to interest recognition in order to:

- narrow the diversity of practices adopted by different AIs;
- enhance the transparency of the banking industry by allowing market analysts and other users to make more meaningful comparisons of AIs' published financial statements; and
- align with international best practices.

2. General principles

2.1 Interest on loans where there is no prospect of eventual recovery should cease to be accrued. Otherwise, the AI's profits and capital will be overstated.

2.2 If there is still some prospect of ultimate recovery of the loan interest, it should normally be credited to a suspense account in the balance sheet rather than being recognised as income. Cash interest payments, if any, from a non-performing account should follow the priority of settlement stipulated in the loan

agreement. If this is not specified in the agreement, such payments may be recognised as interest income provided that the collectibility of the loan principal, net of any specific provision, is not in doubt. Otherwise, such payments should be applied against the outstanding principal first.

2.3 Uncollected interest previously accrued to the profit and loss account on loans whose collectibility subsequently becomes doubtful should either be reversed from interest income or provided against to the extent necessary.

2.4 Any decision to cease interest accrual from an accounting perspective does not preclude interest from continuing to be accrued on a memorandum basis for legal enforcement purposes.

3. Criteria for suspending or ceasing interest accrual

3.1 Criteria

3.1.1 AIs should suspend or cease to accrue interest on a loan where:

- there is reasonable doubt about the ultimate collectibility of the loan principal or interest;
- a specific provision (including any country debt provision associated with the loan) has been made;
- contractual repayments of principal and/or interest are more than three months[1] in arrears and where the net realisable value of collateral (see subsection 4.3 below and also section 6 of CR-G-7 "Collateral and Guarantees") is insufficient to cover repayment of principal and accrued interest;
- contractual repayments of principal and/or interest are more than 12 months[1] in arrears, irrespective of the net realisable value of collateral;
- in the case of an overdraft, it has remained continuously outside the approved limit that was

[1] Alternatively, individual AIs may choose to adopt 90/360 days as the relevant periods provided that these are consistently applied.

advised to the customer for more than three months, and where the net realisable value of collateral is insufficient to cover repayment of principal and accrued interest[2]; or

- in the case of an overdraft, it has remained continuously outside the approved limit that was advised to the customer for more than 12 months, irrespective of the net realisable value of collateral[2].

3.1.2 The first criterion is the overriding principle. Therefore, for example, where there is reasonable doubt about the ultimate collectibility of the loan principal or interest, even if the borrower is not yet in breach of contractual requirements or if the period of arrears is not more than three months, interest should still be suspended or cease to be accrued.

3.2 Application

3.2.1 Although the criteria above have been expressed in terms of "loans", they are applicable to all assets (such as debt securities) and off-balance sheet instruments (e.g. interest rate swaps) on which interest is accrued (except those held for trading purposes).

3.2.2 AIs are free to adopt more stringent policies for interest recognition if they consider it appropriate, e.g. in terms of the choice of time period and treatment of collateral.

3.2.3 There may be instances where repayments of credit facilities are overdue for more than three months due purely to technical reasons (e.g. minor technical irregularities in documentation under trade finance facilities) rather than because of the inability of the borrower to pay. In such cases, interest may continue to be accrued to the profit and loss account provided that the irregularities are expected to be resolved within a short period of time and the appropriate internal approval has been obtained.

[2] The same principle applies to other types of flexible financing facilities without specific payment dates (such as bill lines).

4. Treatment of collateral

4.1 Effect on interest accrual

4.1.1 Given the efficiency and transparency of asset markets in Hong Kong and the existence of a legal system that enables lenders to take possession of, and realise, collateral within a reasonable time-frame, it is appropriate to take the net realisable value of collateral into account when determining whether to place interest in suspense or cease to accrue it, subject to the criteria mentioned below.

4.2 Long overdue loans

4.2.1 The longer a loan is in arrears, the clearer it becomes that repayment will depend solely on realisation of the underlying collateral. Normally, AIs will continue accruing interest on a problem loan if the net realisable value of the underlying collateral can cover both the principal and accrued interest.

4.2.2 Taking interest arising from problem loans to the profit and loss account for too long, however, is not a prudent practice because it could progressively overstate an AI's revenue. Therefore, interest should be placed in suspense or cease to be accrued if repayments are more than 12 months in arrears, regardless of the net realisable value of the collateral held.

4.3 Collateral valuation

4.3.1 In determining whether the value of tangible collateral is sufficient to cover repayments of principal and accrued interest, reference should be made to the net realisable value of the collateral concerned. This is the current market value less any potential realisation costs. Market value should be measured on the basis of up-to-date valuations and is defined as the price at which an asset might be sold at the valuation date assuming:

- a willing buyer and seller;
- the transaction is at arm's length;
- a reasonable period has been allowed for the sale; and

- the asset is freely exposed to the market.

See also section 6 of CR-G-7 "Collateral and Guarantees" for more detailed guidance.

4.3.2 Other forms of collateral (e.g. bank guarantees) may be taken into account for the purpose of determining whether interest should continue to be accrued to the profit and loss account, provided that the value of such collateral can be determined with reasonable certainty.

5. Treatment of special types of assets

5.1 Overdrafts and similar facilities

5.1.1 It is difficult to apply the "three-month rule" to flexible financing facilities such as overdrafts and bill lines without specified repayment dates. To cater for this, AIs should apply a test similar to the "three-month rule" to exposures which are in breach of agreed limits for a continuous period of more than three months.

5.1.2 AIs have the option, however, to increase overdraft limits, or limits on similar facilities, to accommodate increased financing needs of sound customers. This should only be done on the basis of a well-documented credit appraisal and after the appropriate internal approval has been obtained. An increase in the overdraft limit should not be sanctioned simply to avoid placing interest in suspense or ceasing to accrue it.

5.1.3 Similarly, an AI should not extend short-term financing solely to provide borrowers with liquidity to service longer-term debts with the aim of circumventing the criteria set out in subsection 3.1 above.

5.2 Multiple extensions of credit to one borrower and loans to related companies

5.2.1 As a general principle, whether interest on a loan is placed in suspense or ceases to be accrued will depend on the application of the criteria set out in subsection 3.1 to the loan. Even if interest on one or more loans to a particular borrower is no longer accrued, this does not necessarily mean that all other outstanding loans to that borrower or to other related companies should be treated in the same manner.

5.2.2 Whether individual loans should be treated separately or collectively for interest accrual purposes will depend on how they are collateralised or guaranteed. If there is clearly sufficient collateral to cover repayments of principal and interest of a particular loan, the interest may continue to be accrued to the profit and loss account, subject to the 12-month criterion stipulated in paras. 3.1.1 and 4.2.2.

5.3 Loans managed on a portfolio basis

5.3.1 Certain types of loans such as credit cards are managed on a portfolio basis. Such loans are typically high-volume and relatively low-value items which it may be impractical to analyse on an individual basis for interest recognition purposes.

5.3.2 For such loans which are more than three months in arrears or which have remained continuously outside approved limits for more than three months, AIs have two options but should make their decision clear at the outset:

- continue to accrue interest as for performing loans in the portfolio but establish a specific provision against the pool of loans that are overdue for more than three months to cover a suitably conservative amount of principal and interest. The outstanding balance of the loans in arrears should be fully provided for or written off at the latest when they are more than six months in arrears; or
- subject the individual loans in the portfolio concerned to separate review on the basis of the criteria in subsection 3.1.

5.3.3 AIs which wish to use the first option should establish written policies for the treatment of loans on a portfolio basis and should submit these to the HKMA for approval.

5.3.4 For reporting and disclosure purposes such loans should be regarded in the same manner as other loans on which interest is no longer accrued to the profit and loss account. This is because interest income has only been accrued on a conditional basis. That is, such loans would have normally met the criteria for ceasing to accrue interest to the profit and loss account, but interest accrual has been allowed to continue because of practical issues

mentioned above.

6. Resuming accrual in the profit and loss account

6.1 Where interest has been placed in suspense or has ceased to be accrued, accrual of interest to the profit and loss account may be resumed if all arrears of principal and interest from the borrower have been cleared and it is probable that the customer is capable of fully servicing all obligations under the terms of the loan for the foreseeable future. This should be supported by a thorough credit evaluation of the borrower's financial position and prospects for repayment.

6.2 A loan which has been rescheduled[3] may be restored to accrual status if:

- there is reasonable assurance that the borrower will be able to service all future principal and interest repayments on the loan in accordance with the revised repayment terms; and
- the borrower has serviced all principal and interest repayments on the loan in accordance with the revised repayment terms continuously for a reasonable period.

6.3 The reasonable period of continuing repayments for rescheduled loans with monthly repayments (including both interest and principal) is six months. For other rescheduled loans with less frequent repayments, a period of continuing repayments of 12 months would be considered as reasonable.

6.4 Prior to being restored to accrual status, interest on rescheduled loans should only be recognised in the profit and loss account on a cash basis.

6.5 Receipt of additional collateral should not, by itself, be sufficient to restore a loan to accrual status since, in the absence of repayment of arrears, interest accrual to the profit and loss account would again cease by virtue of the "12-month rule" (see paras. 3.1.1 and 4.2.2).

[3] A rescheduled loan refers to a loan that has been restructured and renegotiated between an AI and its borrower because of a deterioration in the financial position of the borrower or of the inability of the borrower to meet the original repayment schedule and for which the revised repayment terms, either of interest or of repayment period, are “non-commercial” to the AI.

7. Reporting and financial disclosure

7.1 AIs should adopt the guidelines in this module for the purposes of reporting in the relevant prudential returns, e.g. "Return of Loans and Advances and Provisions – MA(BS)2A", and for complying with the HKMA's financial disclosure requirements on non-performing loans.