Rescheduled Loans

by the Banking Policy Department

"Rescheduled loans" refer to loans: (i) that have been restructured and re-negotiated between authorized institutions (AIs) and borrowers 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 (ii) for which the revised repayment terms, either of interest or the repayment period, are non-commercial to the AI.

This memo aims to provide a more interpretative guidance to AIs on the definition of "rescheduled loans". Set out below are some questions that have arisen when considering whether a loan with revised repayment terms should be treated as a rescheduled loan:

Q1. What reliable criteria can an AI use to ascertain whether the financial position of a borrower has deteriorated or the borrower is unable to meet the original repayment schedule?

A1. The most objective and simplest way for AIs to determine whether the financial position of a borrower has deteriorated, or the borrower is unable to meet the original repayment schedule, is the current status of the loan (i.e. whether it is still performing). In most cases, a bank will not regard a borrower as being in financial difficulty if there is no default in repayment.

However, factors such as a borrower's employment status, debt-to-income ratio, estimated net worth and cash flow projection are also relevant for assessing the borrower's financial position and ability to repay. Therefore, if a borrower seeks rescheduling, AIs should take account of all relevant factors to decide whether the request is a result of the borrower being in financial difficulty.

Q2. What factors can an AI rely on to determine whether the revised repayment terms of a loan are non-commercial?

A2. There is no standard formula. AIs will have to exercise judgement, on a case-by-case basis, to determine whether the revised repayment terms of a loan are commercial. In determining this, AIs are expected to consider their lending strategy, risk appetite, customer risk profile and current market conditions. Under normal circumstances, AIs should treat a loan as being rescheduled on non-commercial terms if one of the following conditions exists:

(a) a reduction (i.e. haircut) in the principal amount of the loan;

(b) a reduction of accrued interest (i.e. forgiveness of interest);

(c) a reduction of interest rate to a level that is lower than the current market rate for a new loan with a similar risk. A mere reduction of interest rates to current market rates is not enough to justify that the loan is on normal commercial terms. AIs should also take account of the risk factor. For instance, if a borrower approaches an AI for rescheduling because of financial difficulties, technically the customer is of a higher than normal risk. It follows, therefore, that an AI would normally price such loans at a rate higher than current market rates. However, if an AI is prepared to grant current market rates for such a loan, this loan should be considered as being on non-commercial terms given the concession granted, unless the AI has taken steps to reduce the risk, for example, through partial repayment which helps to reduce the borrower's repayment burden;

(d) modification of terms that are not normally offered to customers, such as extending the loan tenor to a level the AI will not provide to its normal customers (e.g. a 30-year mortgage loan) or the temporary suspension of principal and interest repayment; or

(e) deterioration in a borrower's financial position (e.g. debt-to-income ratio higher than 50% for residential mortgage lending or negative cash flow projection for corporate lending) to the extent that the AI will not provide any new credit in accordance with its lending policies.

Q3. Are there any exclusions from the definition of "rescheduled loans"?

A3. Yes. The following loans are not regarded as rescheduled even if their repayment terms have been revised:

(a) loans rescheduled in response to changes in market conditions provided that at the time of rescheduling:

- the loans have been serviced normally;
- the ability of borrowers to service the loans according to the revised repayment terms is not in doubt; <u>and</u>
- the rescheduled loans are priced at interest rates equal to or higher than the current market interest rates for new loans with <u>similar</u> risks.

(b) rescheduled loans where:

- there is reasonable assurance that the borrowers will be able to service all future principal and interest payments on the loans in accordance with the revised repayment terms; <u>and</u>
- the borrowers have serviced all principal and interest payments on the loans in accordance with the revised repayment terms continuously for a reasonable period. The reasonable period of continuing repayments for rescheduled loans with monthly payments (including both interest and principal) is six months. For other rescheduled loans, a period of continuing repayment of 12 months is considered reasonable.

Q4. As a result of changes in market conditions (e.g. continuous fall in mortgage rates due to competition), the revised terms of a loan, which were previously regarded non-commercial, may now become commercial, or even better than the current market rate offered to a loan with similar risk. In this situation, should AIs continue to treat it as a rescheduled loan?

A4. Taking into account the fact that the borrower has recently rescheduled the loan due to financial difficulty, a mere change in market conditions should not be a reason to bring the status of the loan back to "normal". It is therefore more prudent for AIs to keep these loans in the portfolio of rescheduled loans until they qualify for the exemption provided under (b) of A3 above.

Q5. AIs may sometimes act on a customer's request to convert a loan from one type to another and revise the terms accordingly (e.g. from a trust receipt loan to a 1-year term loan). Should the new loan be regarded as a rescheduled loan?

A5. In determining whether the new loan should be regarded as a rescheduled loan, AIs should consider two fundamental principles:

(a) whether the borrower is in financial difficulty. For example, if a trust receipt loan has already been overdue for more than three months and the borrower requests to convert it into, say, a one-year term loan, it may be reasonable for an AI to assume the borrower is in financial difficulty. However, if the borrower has good commercial reasons to want to convert a trust receipt loan into a one-year term loan, the AI does not have to assume the borrower is in financial difficulty unless there is evidence to prove otherwise.

(b) whether the terms of the new loan are commercial to the AI. For example, if the interest rate of the new loan is lower than the current market rate, which the AI will offer for a new loan with a similar risk, the loan should be regarded as non-commercial. However, if the interest rate of the new loan is in line with the current market rate or even higher than that, to take into account the risk premium, the loan may be regarded as commercial.

Any decision made on the above should be fully justified, properly approved and well documented.

Q6. If a doubtful loan is taken up by a new obligor with revised repayment terms, should AIs regard it as a rescheduled loan?

A6. AIs may treat the loan as a new loan (i.e. no longer a rescheduled loan) provided that:

(a) it is restructured with the new obligor on commercial terms;

(b) the agreed haircut, if any, has been fully written off upon completion of restructuring; and

(c) it is a genuine restructuring and not merely a transfer of an overdue loan among the borrower's group or related companies. AIs must be satisfied with the creditworthiness and repayment ability of the new obligor (e.g. the new obligor must have sufficient assets that can generate adequate funds to repay the outstanding loan) before entering into the restructuring.