Since the introduction of the HKMA's loan classification system in 1994 the HKMA has conducted a large number of examinations of institutions' loan classification systems, together with the related issue of loan loss provisioning. This Supervisors' Memo provides further guidance to institutions on these areas, based on the experience gained so far.

Loan classification

An updated guideline on loan classification was issued in May 1999 (a summary is shown in the table). Many institutions which did not previously have a formal loan classification system in effect adopted the HKMA system wholesale when it was first introduced in 1994. In such cases there should be no definitional problems and hence little room for misunderstanding or misinterpretation. Other institutions, however, may have their own internal classification system which has to be mapped to the HKMA system. This throws up the possibility of misunderstandings and misinterpretation, particularly in the case of institutions which use terms such as "substandard" to mean something slightly different to the meaning afforded this term in the HKMA classification system.

Institutions should check that their loan classification definitions accord as closely as possible with the HKMA definitions. In the case of an institution which has its own system which has to be mapped to the HKMA system, the mapping should be reviewed carefully, so as not to be misled by the use of a familiar term such as "substandard", which may have a different meaning in different loan classification systems. Particular attention should be paid to differences at the margins, e.g. does the institution include as substandard some loans which the HKMA would regard as doubtful.

The guideline on loan classification stresses that the decision to classify loans should be largely judgmental based on assessment of the borrower's capacity to repay and on the degree of doubt about the collectibility of the principal or interest on a loan.

However, the guideline qualifies this by going on to say that an important indicator of collectibility is the period that payments of interest and/or principal have been overdue, and that loans on which payments of interest and/or principal have been overdue for more than three months and six months should generally be classified at least as substandard and doubtful respectively, unless there are good reasons for a better classification (such as the fact that the loan is fully secured by good quality collateral).

This qualification is important as it downplays to some extent the role of qualitative judgement in determining loan classification, and makes it clear that there must be sound justification why a loan is not classified as substandard once it has been overdue for more than three months and doubtful after more than six months. Effectively, unless a loan is fully secured (in which case it can continue to be classified as special mention until it is more than twelve months overdue) it should nearly always be classified as at least substandard when it is more than three months overdue, and at least doubtful when it is more that six months overdue (in this case it is important to establish that the collateral value reflects truly the current market value). This process should give rise to a steady migration of problem loans through the various categories of the loan classification system, unless the loans in question show signs of improvement.

Institutions should be wary of placing too much importance on subjective or judgmental factors as a reason for delaying classification. Downgrading to substandard/doubtful should be more or less automatic upon a loan becoming more than three/six months overdue. Exceptions to this "rule" should be few, and there should be a solid "good reason" for departing *from it. Reasons such as "good relationship with the borrower", "good prior account performance", "the account is just about to be restructured" are generally not acceptable.*

Having stressed above the primacy of the three/six months "rule" it is now necessary to step back from it a little. Although the "rule" means that a loan should nearly always be downgraded to substandard/doubtful when it is more than three/six months overdue, it does not mean that no loans should be downgraded to substandard/doubtful before they are three/six months overdue. This is stressed in the loan classification guideline, which makes it clear that even a loan which is current or overdue for less than three/six months may justify a rating of substandard or doubtful if there are reasons to doubt the borrower's ability to continue to service the loan.

In other words, institutions should not wait until a loan is overdue the requisite period before downgrading if there are other reasons for downgrading it earlier (see the list of reasons given in the loan classification guideline under item (c) under the "substandard" heading).

In addition to ensuring that loans are generally downgraded to substandard/doubtful when they are more than three/six months overdue, institutions should also have policies and procedures for reviewing loans to see whether they should be downgraded earlier (e.g. from special mention to substandard, or substandard to doubtful) and a clear idea of what factors should lead to an earlier downgrade.

If an institution's substandard loans as a proportion of total classified loans (i.e. substandard and worse) is very high, it may suggest that the institution is slow to downgrade.

Careful attention needs to be paid to the treatment of rescheduled loans. Generally, rescheduled loans where concessions have been made to the customer on interest or principal because of a deterioration in the customer's financial position should be classified at least as substandard. Such loans may, however, be upgraded to pass once they have been serviced according to the revised terms for six months in the case of monthly repayments[1] or 12 months in the case of quarterly or six-monthly repayments.

Institutions should ensure that loans have not been restructured or extended purely as a means of "window-dressing" asset quality, e.g. extending a new loan to pay off the overdue principal and interest, with no likelihood of the borrower being able to meet the new terms.

Institutions should review carefully the treatment of rescheduled loans and should ensure that they have proper policies, procedures and controls over the approval and reporting of rescheduled loans. These should ensure that proper assessment has been made of the borrower's ability to repay according to the new terms and that the loans are properly classified. In particular, there should be no "evergreening" of loans to understate problem loans.

Ultimately, whether or not an institution's loan classification accords closely with the guideline will depend to a considerable degree on the people implementing it. It is important, therefore, to ensure that the institution has the right sort of culture as regards classification, particularly in respect of downgrading (in some institutions staff may be loath to downgrade for fear that it will be seen as some sort of personal failure, while in others the institution positively encourages downgrading for the reason of extreme prudence).

Institutions should practice "self-assessment" on their loan classification culture. This assessment should disregard the institution's own notions of how "conservative" or "prudent" it may be and should instead focus on hard evidence, e.g. whether they promptly downgrade to substandard/doubtful after three/six months overdue and also how many loans they downgrade before they reach these overdue periods. They should also look at how the loan classification process is organised within the institution. Is it left mainly in the hands of the account managers who may be reluctant to classify loans which they themselves put

1 This represents a change in the HKMA's previous policies which required all rescheduled loans to have been serviced according to the revised terms for at least 12 months before they can be upgraded to pass.

on? Or is there some form of centralised loan review process (which should be more objective)?

One final point - Remember that the guideline applies not only to loans but also to investment debt securities. Institutions should check that they have incorporated this in their classification system.

Provisioning

It is an authorisation criterion that each institution should maintain adequate provisions. However, in contrast to areas such as liquidity and capital, where hard limits are set down in the Banking Ordinance or in guidelines issued by the HKMA, the HKMA (unlike certain other regulators) has never issued formal guidelines on provisioning levels. However, internally the HKMA has adopted certain benchmark provisioning levels against the various loan classifications (substandard 20%, doubtful 50% and loss 100%, of the unsecured portion of an exposure) as a means of enabling us to cross-check whether the aggregate amount of an institution's loan loss reserve looks adequate (irrespective of how the institution itself actually arrives at the aggregate figure). These benchmark levels have to some extent become generally known, and many institutions have adopted them (or similar) as a formula for calculating their provisions.

However, while the use of benchmark provisioning levels implies that the level of provision should be closely linked with the loan classification, it is in fact far preferable for provisions to be determined on a loan-by-loan basis, with full provision being made for the likely loss (i.e. the irrecoverable amount). It is only because in practice it may be difficult to reliably estimate the likely loss (particularly at the comparatively early stage of a loan being downgraded to substandard) that the "shorthand" of relating the level of provisions in respect of individual loans to their loan classification tends to be used.

It follows from this that, although the HKMA might apply the standard percentages to the aggregate for each classification category when cross-checking the aggregate amount of provisions, this should not be the way that institutions calculate their provisions. What they should do is to review each loan individually and assess the loss, and then only apply the "benchmark" provisioning level to the unsecured portion of those loans on which they are unable to assess the likely loss reliably.

An exception to this is the case of portfolios of loans with similar characteristics (e.g. credit cards), on which it is quite acceptable to base the provision level on past loan loss experience in respect of that type of loan.

Specific provisions should normally be made as soon as a loan is classified as substandard, unless there are good reasons to the contrary. An institution will typically provide 20-25% against the unsecured portion of those loans that it is unable to assess on a loan-by-loan basis.

Typically, loans will be reclassified from substandard to doubtful when the overdue period increases to more than 6 months. With this passage of time the position of the borrower and therefore the position as regards the degree of recoverability of the loan may become clearer, and it may be possible to more accurately assess the likely loss on a loan-by-loan basis. Consequently a range of provisioning levels is possible. Typically, however, provisions are likely to be in the range of 50-75% against the unsecured portion. Provisions at the higher end of this range (and perhaps as high as 100%) may be appropriate where there has been no sign of progress/improvement over time (e.g. further provision (75%-100%) should be considered against doubtful loans which show no improvement from one review period to the next or in cases where the loan has been classified as doubtful for more than six months).

To recap, provisions should ideally be assessed on a loan-by-loan basis, with full provision being made for the likely loss. However, if it is not possible to reliably estimate the loss, then it is prudent for the institution to set aside an amount of provision determined by a formula related to the loan classification. For substandard, 20% is acceptable. For doubtful, 50% is acceptable initially, but this may have to be increased further to 75% or even 100% over time. For this approach to be acceptable, it is crucial that the institution's loan classification should be reliable. If it is slow to downgrade its provisioning may look reasonable in relation to its reported asset quality, but it may not in fact be as reasonable in relation to its actual asset quality. Equally important is that collateral should be properly valued, otherwise the unsecured portion against which the provision is calculated may be understated, leading to a lower provision than is merited. In this connection, it may be sensible for institutions to apply a haircut to the estimated market value of collateral to provide a more realistic indication of the amount that would actually be realised should the collateral be sold.

HKMA LOAN CLASSIFICATION SYSTEM

Category	Definition	Typical Overdue Period *	Provisioning
Pass	Loans where borrowers are current in meeting commitments & full repayment of interest & principal is not in doubt.		A general provision of at least 1% across-the-board should be established. Alternatively, the provision may be calculated according to a formula based on past loan loss experience in respect of different categories of loans (e .g. 1/2% on residential mortgages, 2% on taxi loans, etc.).
Special mention	Loans where borrowers are experiencing difficulties which may threaten the institution's position. Ultimate loss is not expected at this stage but could occur if adverse conditions persist.	Unsecured or partially-secured : Up to 3 months [N.B. downgrading to substandard may be justified, even if the loan has not been overdue for more than 3 months, where other significant deficiencies are present which threaten the borrower's business, cash flow & payment capability.] Fully secured : Up to 12 months [N.B. fully secured loans need not be downgraded to substandard until they are over 12 months overdue]	No specific provision is necessary against loans classified as special mention, but it may be appropriate to increase the general provision against such loans to, say, 2% (whether secured or unsecured). For taxi loans a specific provision of 2% on top of a general provision of 2% is recommended.
Substandard	Loans where borrowers are displaying a definable weakness that is likely to jeopardise repayment. Includes loans where some loss of principal or interest is <u>possible</u> after taking account of the "net realisable value" of security, & rescheduled loans where concessions have been made to the customer on interest or principal (i.e. which have been made on non-commercial terms). N.B. Such loans may be upgraded to pass once they have been serviced according to the revised terms for 6 months (monthly repayments) / 12 months (other than monthly repayments).	Unsecured or partially-secured : Generally more than 3 months up to 6 months [N.B. downgrading to doubtful may be justified, even if the loan has not been overdue for more than 6 months, where other significant deficiencies are present which threaten the borrower's business, cash flow & payment capability.] Fully secured : Over 12 months	Specific provisions should normally be made as soon as a loan is classified as substandard, unless there are good reasons to the contrary (however, provisions against substandard loans may not be necessary where the policy of the AI is to classify loans promptly as doubtful & to provision accordingly). Provisions should be determined on a loan-by-loan basis, with full provision being made for the likely loss (i.e. the irrecoverable amount). However, in practice it may be difficult to reliably estimate the likely loss (particularly at the comparatively early stage of a loan being downgraded to substandard). Generally speaking, therefore, the level of provisions in respect of individual loans tends to be related to the loan classification. In the case of substandard loans, an AI may typically provide 20-25% against the unsecured portion of those loans that it is unable to assess on a loan-by-loan basis. In the case of portfolios of loans with similar characteristics (e.g. credit cards) the provision may be based on past loan loss experience.

Category	Definition	Typical Overdue Period *	Provisioning
Doubtful	Loans where collection in full is improbable & the institution expects to sustain a loss of principal &/or interest after taking account of the net relisable value of security.	Unsecured or partially-secured : Generally more than 6 months	Given that, generally speaking, the level of provisions in respect of individual loans tends to be related to the loan classification, higher provisions will generally be required when loans are downgraded into a lower category (e.g. from substandard to doubtful). Typically, loans will be reclassified from substandard to doubtful when the overdue period increases to more than 6 months. With this passage of time the position of the borrower & therefore the position as regards the degree of recoverability of the loan may become clearer, & it may be possible to more accurately assess the likely loss on a loan-by-loan basis. Consequently a range of provisioning levels is possible. Typically, however, provisions are likely to be in the range of 50-75% against the unsecured portion. Provisions at the higher end of this range (& perhaps as high as 100%) may be appropriate where there has been no sign of progress/improvement over time (e.g. further provision should be considered against loans which show no improvement from one review period to the next). If it is still not possible to reliably estimate the likely loss on some loans, it is prudent for an AI to provide at least 50% against those doubtful loans that it is unable to assess on a loan-by-loan basis.
Loss	Loans which are considered uncollectible after exhausting all collection efforts such as realisation of collateral, institution of legal proceedings, etc.		All outstanding principal & interest which are not covered by the value of collateral should be fully provided for or written off (e.g. 100% provision)

* In the case of loans under restructuring, the overdue period should be measured from the time the loan first went overdue [no "grace period" should be given because the loan is under restructuring].

Interest accrual

Interest should be placed in suspense or cease to be accrued in respect of (1) loans where there is reasonable doubt about the ultimate collectibility of principal &/or interest (irrespective of whether the contractual terms of the loan have been breached or if the period of arrears is not more than 3 months); (2) loans on which contractual repayments of principal &/or interest are more than 3 months in arrears & the net realizable value of security is insufficient to cover the payment of principal & accrued interest, & (3) loans on which principal &/or interest is more than 12 months in arrears, irrespective of the net realizable value of collateral.