# Completion Instructions

## Quarterly Analysis of Loans and Advances and Provisions
## (Form MA(BS)2A)

### Introduction

1. This return analyses, by economic sector, an authorized institution's loans and advances for use in Hong Kong. It also analyses the performance of an institution's selected assets (mainly loans and advances) and off-balance sheet exposures according to the classification methods defined in these instructions. Information on provisions set aside for each category of classified assets is also included.

### Section A : General Instructions

2. This return consists of 2 parts and 3 supplementary items. It should be completed by authorized institutions in the following manner:

| | For Part I and Notes (1) & (2) | For Part II and Notes (3), (4), (5), (6) & (7) |
|---|---|---|
| Institutions incorporated in HK without overseas branches / institutions incorporated outside HK | Report the aggregate positions of HK offices | Report the aggregate positions of HK offices |
| Institutions incorporated in HK with overseas branches | Same as above | Report the combined position of HK offices and overseas branches unless otherwise indicated |

3. The return, showing the positions as at the last calendar day of each quarter, should be submitted no later than 14 days after the end of each quarter. In the case of an institution incorporated in Hong Kong with overseas branches, the information required under Part II and Notes (3), (4), (5), (6) & (7) of the return may be separately submitted within a period to be agreed with the Monetary Authority if that institution has difficulties in complying with the time limit. However, in no case should the information be submitted later than 6 weeks after the end of each quarter. If the submission deadline falls on a public holiday, it will be deferred to the next working day.

4. Amounts should be shown to the nearest thousands, in HK$ or HK$ equivalent in the case of foreign currency items. The closing middle market T/T rates prevailing at the reporting date should be used for conversion purposes.

5. Certain items reported under Parts I and II of this return should be reconciled with the amounts reported in relevant items in the Return of Assets and Liabilities (Form MA(BS)1 or MA(BS)1B) and the Return of Current Year's Profit & Loss Account (Form MA(BS)1C). Details are given in the specific instructions below and are summarised in Appendix 1.

6. As stipulated in our guidance note "Review on Impact of the New Hong Kong Accounting Standards on Authorized Institutions' Capital Base and Regulatory Reporting" issued to all AIs on 12 April 2005, locally incorporated AIs and overseas-incorporated AIs whose head offices have chosen to adopt IFRS or comparable standards shall neglect any reference made thereto in this return on "interest in suspense" and "country risk provision".

7. Specific provisions and general provisions mentioned in this completion instruction should follow the definitions of specific provisions and collective provisions defined in section 2(1) of the Banking (Capital) Rules respectively. The categorisation of accounting provisions into specific provisions or general provisions follows the treatment adopted in MA(BS)3.

## Section B: Specific Instructions

### 8. Part I - Classification of Loans and Advances by Economic Sectors

### 8.1 Items A to I - Loans and advances for use in Hong Kong

Report loans and advances for use in Hong Kong, according to each economic sector, under items A to H. A loan is regarded as for use in Hong Kong if it finances or has a direct impact on the level of economic activity in Hong Kong. For most of the cases, this can be determined by whether the loan is made available or disbursed in Hong Kong and by the principal place of business of the customer.

A loan should be classified according to its usage. For example, if a loan is granted to a textile manufacturer to purchase a factory building for enhancing productive capacity, it should be allocated to "textiles" (item A1) rather than to "property investment" (item B2). But if the loan is granted to the manufacturer to purchase a commercial complex for investment purpose, it should be classified under "investment in commercial properties" (item B2c). Similarly, if a loan is granted to a property developer for purposes which are clearly unrelated to its principal activities, such as the running of a hotel, such loan should not be reported under "property development" (item B1) or "property investment" (item B2).

In cases where the usage of a loan cannot be identified with reasonable certainty, it should be classified according to the principal business activity of the borrower. For example, a loan to a property developer for general working capital purposes should be reported under the relevant sub-item of item B1 - Property development.

In cases where it may not be possible to categorise a loan, including a finance lease and a hire purchase loan, by reference to the use of the loan proceeds or the use of the asset financed by the loan, it may be categorised by reference to the asset financed. For example, a mechanical digger can be categorised under the construction industry (item B3). Lorries and vans, where the principal activity of the end-user is uncertain may be classified under item G5 - Other transport and transport equipment.

The classification of loans by economic sectors should be made irrespective of whether the borrower is a corporate, firm or individual except for item H5. For example, a loan granted to an individual for purchasing a taxi should be reported under "taxis" (item G3) while a loan granted to an individual for purchasing residential property should be reported under "individuals - for the purchase of other residential properties" (item H5b).

Where a loan is known to be raised by an immediate borrower to finance another party (the ultimate beneficiary), it should be classified according to the usage of the loan deployed by the ultimate beneficiary. An exception to this rule is where the principal business activity of the immediate borrower is that of lending money and it has financed the ultimate beneficiary in the ordinary course of business.

**8.2 Item B1 - Property development**

Report loans to finance property development, including those for building and construction, according to the type of properties being developed. In cases where a loan cannot be readily classified by type of properties, e.g. where a loan is extended to a property developer not specifically tied to a particular project or property or where the borrower is involved in more than one sector, such loans may be reported under item B1d - Other properties.

**8.3 Item B2 - Property investment**

Report loans to finance investments in properties, including uncompleted properties, according to the type of properties being invested in. These include loans to finance corporate customers purchasing residential properties for the use of their directors, shareholders or employees and also loans to shell companies through which individuals acquired properties. Loans to finance the purchase of residential properties by professional & private individuals should be reported under item H5a or H5b, as the case may be. Loans to finance the acquisition of properties, e.g. factories, for a borrower's own use should be classified according to the principal activities of that borrower rather than as a property investment in general.

**8.4 Item D – Recreational activities**

Report loans to companies engaging in motion picture, radio, television and other entertainment activities. The manufacturing of radios and televisions should, however, be reported under item A5 "Electrical & electronic".

**8.5 Item E1 - Telecommunications**

Report loans to companies that provide telecommunication services, such as residential or commercial telephone lines, mobile phone lines, pager, IDD, fax, data lines for data transmission and communication via satellite. Include loans to internet service providers and companies setting up networks/platforms for the provision of services as internet service providers. Loans to companies engaging in the manufacture of telecommunication equipment and other related accessories should be reported under item A5a "Telecommunication equipment".

**8.6 Item E2 - Information technology - Others**

These include loans to companies that engage in software or application development, data processing, system administration or maintenance and the provision of IT-related consultancy services. Loans to companies engaging in the manufacture of computer hardware and other peripherals should be reported under item A5 "Electrical and electronic". Loans to companies engaging in the wholesale or retail business of IT-related products should be reported under item F "Wholesale and Retail Trade".

**8.7 Item H2 - Financial concerns**

These include loans to investment companies, insurance companies, futures brokers, finance companies and any other persons in the financial sector not being authorized institutions or overseas banks. Investment companies include companies in the business of investment in commodity futures, foreign currencies, gold bullion, shares, funds and securities. They include also unit trusts, retirement funds and investment holding companies. Finance companies and others include companies in the business of leasing, factoring, bills discounting, hire purchase, mortgage, commercial and industrial finance. They include also gold bullion brokers, money-lenders, pawnshops and credit card companies.

**8.8 Item H3a/H4a - Margin lending for stockbrokers and non-stockbroking companies and individuals**

Margin lending is defined as lending for the purchase of shares against the market value of shares pledged, typically, the borrower of such lending is obliged to ensure, and the lending institution to monitor, that the amount of the loan would not exceed a predetermined ratio of the market value of the collateral pledged. In cases where a margin loan is secured partly by shares and partly by other securities, then only that part of the loan in excess of the value of the other securities should be reported as margin lending. For example, in respect of a loan of 10 which is secured by shares and other securities valued at 10 and 6 respectively, 4 being the part of the loan in excess of the value of other securities should be reported as margin lending. The remaining loan of 6 should be reported under item H3b or H4b, as the case may be. Loans for subscribing for new shares in initial public offerings (IPOs) should be included under items H3a and/or H4a, as the case may be. In addition, a breakdown of the amount of such loans included in items H3a and/or H4a should be reported under Note (2)(a). Non-stockbroking companies refer to companies other than investment companies.

**8.9 Item H5b - Purchase of residential properties by professional and private individuals**

Report loans to professional and private individuals for the purchase of residential properties, other than the purchase of flats under the Home Ownership Scheme (HOS), Private Sector Participation Scheme (PSPS) and Tenants Purchase Scheme (TPS), regardless of whether the properties are intended for occupation by the borrowers or for other purposes. As long as the loans for the purchase of flats under HOS, PSPS and TPS are covered by the guarantee issued by the Housing Authority, they should be reported under item H5a; otherwise, they should be reported under item H5b. This item includes refinancing loans and residential mortgage loans which have been transferred from other banks or companies.

8.10 **Item H6 – All others**

Report all loans and advances for use in Hong Kong that cannot be classified in the above economic sectors. Examples include "agriculture and fisheries" and "mining and quarrying".

8.11 **Item I - Loans and advances for use in Hong Kong**

Report the sum of entries under items A to H under columns (1) to (6).

8.12 **Item J - Trade financing**

These are loans reported under items 15.1 and 15.2 of Form MA(BS)1 covering finance of imports to Hong Kong, exports and re-exports from Hong Kong and merchandising trade.

8.13 **Item K - Other loans and advances**

These are loans reported under items 15.4, 15.5 and 15.6 of Form MA(BS)1.

8.14 **Item L - Total loans and advances**

Report the sum of entries under items I, J, and K, columns (1) to (5). Entries under columns (1) to (4) should correspond to those reported under item 15.7g of Form MA(BS)1. The entry under column (4) should also correspond to that reported under item A1, column (6) in Part II.

8.15 **Columns (1) to (3)**

Report the principal amount of all loans which are outstanding as at the reporting date in the appropriate columns according to the currency in which they are denominated. Accrued interest which has been capitalised as loans should be included net of any interest in suspense. Accrued interest which has not been capitalised should be reported net of any interest in suspense under E1 in Part II. Interest in suspense refers to the interest that has been accrued to a suspense account instead of the profit and loss account.

8.16 **Column (5)**

Report the amount of specific provisions, other than country risk provisions, that have been set aside for each item. In the case of institutions incorporated in Hong Kong without overseas branches or institutions incorporated overseas, the total of this column as reported under item L should correspond to the entry under item A5, column (6) in Part II.

**8.17** **<u>Column (6)</u>**

Report the amount of general provisions, if any, that have been set aside for the various economic sectors under items A to H.

## 9. <u>Part II - Asset Quality and Provisions</u>

**9.1** For <u>items A1, A2, A4, B1, C1, C2, D1, D2, F1 and F2</u>, classify and report loans and advances, balances due from banks, acceptances and bills of exchange held, investment debt securities and commitments and contingent liabilities of similar nature into the categories as listed out in this part according to the guidelines on Loan Classification System in <u>Appendix 2</u>. For item A4, licensed banks incorporated in Hong Kong should report the position of loans and advances of their banking subsidiary incorporated in Mainland China.

Any financial assets which are classified as fair value through profit or loss under HKFRS9 or equivalent accounting standards should **<u>NOT</u>** be included in this part except Item A.

**9.2** **<u>Item B1 - Balances due from banks</u>**

This item refers to placements with authorized institutions in Hong Kong and other banks abroad (excluding overseas head office and branches of the reporting institution).

**9.3** **<u>Item C - Acceptances and bills of exchange held</u>**

This item refers to acceptances and bills of exchange held (i.e. excluding those held as collateral for a loan or advance) by the institution.

**9.4** **<u>Item D – Investment debt securities</u>**

Report the holding of debt securities in items D1 to D2 according to the type of issuer and the category of classification.

**9.5** **<u>Item E1 - Accrued interest</u>**

Report interest that has been accrued but not capitalised for those exposures classified as either <u>substandard</u>, <u>doubtful</u> or <u>loss</u> under items A3, B1, C3 and D3. Accrued interest should be reported net of any interest in suspense (i.e. any interest which has been accrued to a suspense account instead of the profit and loss account).

**9.6** **<u>Items F1 and F2 - Commitments and contingent liabilities</u>**

Report commitments and contingent liabilities which subject the reporting institution to credit risk. These include direct credit substitutes (such as guarantees and standby letters of credit), trade-related contingent items (such as letters of credit and liabilities under acceptances) and irrevocable loan commitments. Guarantees and standby letters of credit are usually converted into on-balance sheet exposures if the counterparty they are supporting fails but there may be circumstances when the bank is reasonably certain that such instruments will be called upon at a future date because of uncertainty about the client. Loan commitments which are irrevocable should also be classified as impaired assets if the creditworthiness of the client has deteriorated to an extent that makes repayment of any loan drawdown (or associated interest payments) doubtful.

The definitions of direct credit substitutes and trade-related contingent items are the same as those defined in section 2 of the Banking (Capital) Rules. Commitments and contingent liabilities to overseas head office and branches of the reporting institution are excluded for the purposes of this item.

**9.7 Items A5 to A7, B2 to B4, C4 to C6, D4 to D5, E2, F4 to F6 - Provisions**

Provisions should be reported and classified according to their nature, i.e. for general, specific or country risk, and the categories of exposures (where appropriate) for which the provisions are set aside.

**9.8 Item G - Value of security**

Report in item G1 the value of security held by the reporting institution to support those exposures classified as either substandard, doubtful or loss under item A3, and in item G2 the value of security for those classified exposures under items B1, C3, D3, E1 and F3. However, for each counterparty, the aggregate value of the security reported here should not exceed the aggregate of all relevant principals and accrued interest (i.e. for each counterparty, the lower of the value of the total exposure and the value of the total security should be reported here). If a security is held in support of different types of exposures to the same counterparty, the value should first apply to loans and advances. The following illustrates how value of security should be reported by institutions.

HK$'000

| Counterparty | Net realisable value of security | Exposures | | Value of security to be reported under | |
|---|---|---|---|---|---|
| | | Loans | Others | Item G(1) | Item G(2) |
| A | 1,000 | 700 | 0 | 700 | 0 |
| B | 1,000 | 1,500 | 0 | 1,000 | 0 |
| C | 1,000 | 500 | 200 | 500 | 200 |
| D | 1,000 | 900 | 500 | 900 | 100 |
| E | 1,000 | 1,300 | 500 | 1,000 | 0 |

**9.9 Item H - Assets acquired through security enforcement**

Report in column (6) the net book value of any asset (e.g. shares, debt securities or real properties) the ownership of which has been transferred to the institution in settlement of all or part of a claim (e.g. by way of foreclosure). Such assets usually indicate a lack of demand which contributes to uncertainty about their actual value. They should therefore be closely monitored until sold.

This item does not include those assets, such as mortgaged properties, which have been taken possession of by the reporting institution but the ownership of which has yet to be transferred to the institution.

**10.** **<u>Note (1) - Loans to group companies of property developers</u>**

Indicate the amount of loans reported under items H2a (to investment companies) and H2d (to finance companies) in Part I the borrowers of which are connected with property developers (where the use of such loans is known to be related to property development or property investment activities, it should be reported under item B in accordance with the purpose explained above). A borrower is regarded as property-developer-connected if it is the holding company, sister company, subsidiary or associate of any property developer.

**11.** **<u>Note (2) - Margin lending</u>**

Provide the breakdown of margin lending reported under items H3a and H4a in Part I as follows:

(a) loans for subscribing new shares in IPOs; and

(b) other margin lending.

The breakdown relating to item H4a is required to be split further into loans to non-stockbroking companies and loans to individuals.

For other margin lending reported under Note (2)(b), provide the following supplementary information:

(i) closing market value of the shares which are pledged with the institution to support these loans; and

(ii) aggregate amount of any individual loans which are in excess of 50% of the closing market value of the underlying shares pledged as security.

**12.** **<u>Note (3) - Overdue and rescheduled assets</u>**

**12.1** Report the book value (net of accrued interest that has been capitalised but accrued to a suspense account) of overdue or rescheduled assets under items (a) to (d) and (f). "Loans" include loans and advances to customers, and "other assets" include balances due from banks, acceptances & bills of exchange held and debt securities. Institutions incorporated in Hong Kong with overseas branches should report separately the aggregate positions of the Hong Kong Offices and overseas branches. Information on each individual country of the overseas branches should also be provided by completing pages 14 (for overdue and rescheduled loans) and 15 (for other overdue and rescheduled assets) of the return form. Supplementary sheets are to be used when necessary.

**12.2** **Sub-items (a) to (d)**

The criteria for determining the overdue status of an asset are included in a separate guideline in <u>Appendix 2.1</u>.

All assets should be reported as and when they have been overdue for more than 1 month. However, consumer loans repayable by regular monthly instalments should be treated differently and <u>should not be reported unless they have been overdue for more</u>

than three months. When such consumer loans qualify for reporting as overdue, the period overdue should be determined by reference to the earliest due date of any of the instalments. Similarly, demand loans (including overdrafts) which have exceeded the approved limit advised to the customer should not be reported unless they have remained continuously above the limit for more than three months. When such demand loans qualify for reporting as overdue, the overdue period should be determined by reference to the whole of the period that the limits were exceeded.

**12.3 Sub-item (f)**

All rescheduled assets (including those which have been reported under (a) - (d) above should be reported in item (f), except those specified under paragraph 9 of the "Guidelines on overdue and rescheduled assets" in Appendix 2.1.

The amount of those rescheduled assets which have also been reported as overdue under item (a) should be reported in item (f)(i) and those rescheduled assets which have been reported as overdue in items (b) to (d) should be reported in item (f)(ii).

The reporting treatment of a rescheduled asset taken up by a new obligor and the circumstances under which a rescheduled asset may be upgraded to "special mention" are provided under paragraphs 10 and 11 of Appendix 2.1.

**13. Note (4) - Assets on which interest no longer accrues to profit and loss**

Assets on which interest no longer accrues to the profit and loss refer to those assets in respect of which the interest has not been taken to the profit and loss account but credited to a suspense account or where the interest has ceased to be accrued. Report under item (a) the amount of loans and advances reported in Part II. Report under item (b) all those assets not included under item (a) above. The criteria on which institutions should cease to accrue interest on an asset to the profit and loss account are set out in CR-G-6 "Interest Recognition" of the Supervisory Policy Manual.

**14. Note (5) - Interest in suspense**

Interest in suspense refers to the accrued interest that has not been taken to the profit & loss account but credited to a suspense account. Report under (a) the amount that has been capitalised as the principal exposure and under (b) the amount that accrued to the interest receivable account. Accrued interest is deemed to be "capitalised" if it is treated indistinguishably from the principal exposure, rather than included within a suspense accrued interest account.

**15. Note (6) – Non-bank China exposures**

Note (6) has been replaced by Return of Mainland Activities MA(BS)20.

**16. Note (7) - Ten largest criticised assets**

Criticised assets refer to those that have been reported by the institution in Part II of this return as "special mention", "substandard", "doubtful" or "loss". For the purpose of reporting under this Note, assets include on-balance sheet exposures such as loans and advances to non-bank customers, balances due from banks, acceptances and bills of exchange held, investment debt securities and accrued interest as reported under

Items A3, B1, C3, D3 and E1 of Part II respectively. They also include commitments and contingent liabilities as reported under Item F3 of the same part of the return.

Criticised assets should be reported on a gross basis before provisions and in descending order by size. Specific provisions made against these assets, which include those made for country risk, should be reported under a separate column of the return.

Each reported item should be the aggregate of exposures to an individual counterparty or a group of related counterparties. In the latter case, the aggregate should be reported as one exposure and shown in the name(s) of the principal counterparty(ies). For the definition of "a group of related counterparties", reference should be made to the completion instructions of the Return of Large Exposures. The full name of each counterparty or the principal counterparty in the case of a group of related parties should be reported.

Hong Kong Monetary Authority
January 2018

## Appendix 1

### Reconciliation with other returns

| Item in this return | Return of Assets and Liabilities: Form MA(BS)1 (For position of HK offices) | Return of Assets and Liabilities: Form MA(BS)1B (For combined position) | Return of Profit and Loss: Form MA(BS)1C (For both cases) |
|---|---|---|---|
| Part I, columns (1),(2),(3) and (4) | | | |
| I | Part II 15.3 | N.A. | N.A. |
| J | Part II 15.1 + 15.2 | N.A. | N.A. |
| K | Part II 15.4 + 15.5 + 15.6 | N.A. | N.A. |
| L | Part II 15.7g | N.A. | N.A. |
| Part II, column (6) | | | |
| A1 | Part II 15.7g | N.A. | N.A. |
| A3 | N.A. | Part II 15 | N.A. |
| A5+B2+C4 | N.A. | N.A. | ≤ Part II 1.9 (b) |
| A6+B3+C5 | N.A. | N.A. | ≤ Part II 1.9 (a) |
| A7+B4+C6 | N.A. | N.A. | ≤ Part II 1.9 (c) |
| B1 | Part II 17.1 +17.2 + 17.4 | Part II 17.3 | N.A. |
| C1 | Part II 19.2b(1+2) ) | ≤ Part II 18.2 | N.A. |
| C2 | Part II 19.2a(1+2) ) | | |
| F3 | ≤ Part VIII(a) + (c) + (f)[@] | N.A. | N.A. |
| A8+B5+C7+D6 +E2 (col.3+4+5) + F7 | ≤ Part II 24 | ≤ Part II 23 | ≤ Part II 3 |

Notes:

[@] apply to institutions incorporated outside HK only. For institutions incorporated in Hong Kong, the amount reported should be equal to or less than the sum of the principal amounts for items 1, 3 and 9 in Table 10 (Standardized), Table 14 (BSC) and Table 20 (IRB) of the Banking (Capital) Rules.

**Appendix 2**

## Guideline on loan classification system

1. This guideline sets out the loan classification framework adopted by the Hong Kong Monetary Authority ("HKMA") for monitoring the asset quality and provisioning adequacy of authorized institutions.

### Background

2. The purpose of a loan classification system is to enable institutions to prudently value loans and to act as a guide to appropriate provisions. The HKMA's 5-grade loan classification framework was first introduced in 1994 and has been regularly updated since the first issue. The framework covers loans and advances and other types of on- and off-balance sheet exposures, including balances due from banks, investment debt securities, acceptances and bills of exchange held, accrued interest receivable and commitments and contingent liabilities.

### The loan classification framework

3. Under the HKMA's loan classification system, loans and advances are to be classified into the following categories: Pass, Special Mention, Substandard, Doubtful, and Loss. Loans in the substandard, doubtful and loss categories are collectively known as "classified loans". Classified loans together with loans in the special mention category are collectively referred to as "criticised loans". The definition and characteristics of each of the categories are given below. In general, 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 of a loan. An important indicator of collectibility is the period that payments of interest and principal are overdue. Thus, loans on which payments of interest and/or principal are 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). However, the existence of payment arrears is only one of a number of factors to be considered in classifying problem loans and even a loan which is current or overdue for less than three 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.

- **Pass**

  This refers to loans where borrowers are current in meeting commitments and full repayment of interest and principal is not in doubt.

- **Special Mention**

  This refers to loans where borrowers are experiencing difficulties which may threaten the institution's position. Ultimate loss is not identified at this stage but could occur if adverse conditions persist. These loans exhibit one or more of the following characteristics:

  a) early signs of liquidity problems such as delay in servicing loans;

  b) inadequate loan information such as annual audited financial statements not obtained or available;

  c) the condition of and control over collateral is questionable;

  d) failure to obtain proper documentation or non-cooperation by the borrower or difficulty in keeping contact with him;

  e) slowdown in business or adverse trend in the borrower's operations that signals a potential weakness in the financial strength of the borrower but which has not reached a point where servicing of the loan is jeopardised;

  f) volatility in economic or market conditions which may in the future affect the borrower negatively;

  g) poor performance in the industry in which the borrower operates;

  h) the borrower or in the case of corporate borrowers, a key executive, is in ill health;

  i) borrower is the subject of litigation which may have a significant impact on his financial position; and/or

  j) even if the loan in question is current, the borrower is having difficulty in servicing other loans (either from the institution concerned or from other institutions).

- **Substandard**

  This refers to loans where borrowers are displaying a definable weakness that is likely to jeopardise repayment. The institution is relying heavily on available security. This would include loans where some loss of principal or interest is possible after taking account of the "net realisable value" of security, and rescheduled loans* where concessions have been made to a customer on interest or principal such as to render the loan "non-commercial" to the bank.

  These loans exhibit one or more of the following characteristics:

  a) repayment of principal and/or interest has been overdue* for more than three months and the net realisable value of security is insufficient to cover the payment of principal and accrued interest;

  b) even where principal and accrued interest are fully secured, a "substandard" classification will usually be justified where repayment of principal and/or interest is overdue* for more than 12 months;

  c) in the case of unsecured or partially secured loans, a "substandard" classification may also be justified, even if the overdue period is less than three months, where other significant deficiencies are present which threaten the borrower's business, cash flow and payment capability. These include:

     - credit history or performance record is not satisfactory;

     - labour disputes or unresolved management problems which may affect the business, production or profitability of the borrower;

     - increased borrowings not in proportion with the borrower's business;

     - the borrower experiencing difficulties in repaying obligations to other creditors;

     - construction delays or other unplanned adverse events resulting in cost overruns that may require loan restructuring; and/ or

     - unemployment of an individual borrower.

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* Guidelines in relation to overdue and rescheduled loans are set out in Appendix 2.1.

- **Doubtful**

  This refers to loans where collection in full is improbable and the institution expects to sustain a loss of principal and/or interest after taking account of the net realisable value of security. Doubtful loans exhibit one or more of the following characteristics:

  a) repayment of principal and/or interest has been overdue for more than six months and the net realisable value of security is insufficient to cover the payment of principal and accrued interest; and/or

  b) in the case of unsecured or partially secured loans, a shorter overdue period may also justify a "doubtful" classification if other serious deficiencies, such as default, death, bankruptcy or liquidation of the borrower, are detected or if the borrower's whereabouts are unknown.

- **Loss**

  This refers to loans which are considered uncollectible after exhausting all collection efforts such as realisation of collateral, institution of legal proceedings, etc.

4. Individual loans should not be split between categories. This means, where only part of a loan has become overdue, the total loan outstanding should be considered as overdue and classified under the most appropriate category.

5. Although references are made to "loans" in this guideline, the classification criteria are also applicable to exposures arising from:

- balances due from banks;
- investment debt securities;
- acceptances and bills of exchange held; and
- credit commitments and contingent liabilities.

6. Debt securities include certificates of deposit, floating rate notes, commercial paper and other negotiable debt instruments. These securities carry credit risk and should be included in the institution's loan classification system. A decline in the market value of a security simply due to interest rate fluctuations is not a basis for adverse classification. Classification of investment debt securities is based on credit risk. However, debt securities which are measured at fair value through profit or loss under HKFRS 9 or equivalent accounting standards are not required to be included in the loan classification system.

7. The ultimate and conclusive test of investment quality is the actual credit soundness of the issuers. The principles underlying analysis of the credit soundness of issuers are essentially the same as those applicable to loan analysis. However, debt

securities for which payments are in default should generally be classified as "doubtful". Institutions should maintain adequate records in support of their investment decisions and current credit information relating to the securities.

8. Many debt securities are rated by credit rating agencies (e.g. S&P's and Moody's). In such cases, the ratings assigned by the agencies will be useful guides for institutions to classify debt securities. This, however, should not replace the institution's own judgement on the credit soundness of the issuers.

9. In classifying acceptances and bills of exchange held, references to "borrower" as in the case of loans and advances should normally apply to the party who is expected to pay the bill (i.e. the acceptor or the drawee). However, they may also apply to the customer of the institution from whom the institution has purchased the bill on a recourse basis. The classification should generally be based on whether or not the bill is current except where the institution has doubt about the relevant payment or the financial condition of the parties involved. Accordingly, a bill which is overdue should at least be classified as "special mention". A bill which has been overdue for more than 3 months should at least be classified as "substandard".

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

10. The classification of individual loans should be based in the first instance on an assessment of the repayment capacity of the borrower. However, even if one or more loans to the same borrower have been classified in a particular category, 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. In particular, whether individual loans should be treated separately or collectively for classification purposes will depend on how they are collateralised or guaranteed. If it is clear that there is sufficient security dedicated to a particular loan to cover payments of principal and interest on that loan, it need not be classified in the same way as other loans to the same borrower which are not similarly secured. It will however usually be appropriate to classify the loan as at least "special mention" to reflect the known financial difficulties of the borrower. Where a number of loans are supported by a pool of collateral or are cross-collateralised, they should all be classified in the same category.

**Value of security**

11. For the purposes of the HKMA's loan classification system, security refers to (i) tangible assets such as cash, properties and securities and (ii) guarantees issued by a central government or central bank of a country without payment difficulties, an authorized institution or an overseas bank which is under adequate supervision. The value of tangible security means its net realisable value, being the current market value of the security less any realisation costs. Market value should be measured on the basis of up-to-date valuation and is defined in terms of the price at which an asset might be sold at the valuation date assuming:

a) a willing buyer and seller;

b) transaction is at arm's length;
c) a reasonable period has been allowed for the sale; and
d) the asset is freely exposed to the market.

## Loan loss provisioning[1]

12. Loan loss provisions should be established and maintained at a level that is adequate to absorb estimated inherent losses in the institution's loan portfolio, binding commitments and contingent liabilities. In general, provisions established to absorb unidentified losses inherent in an institution's loan portfolio are referred to as general provisions, and provisions established to absorb losses identified for specific loans are referred to as specific provisions. Country risk provisions generally refer to provisions set aside by authorized institutions to absorb potential losses arising from their country risk exposures. If institutions reflect country risk in provisions earmarked against their aggregate exposures to a particular country after accounting for risk transfers and specific provision made against credit risk (i.e. on a country basis), such provision should be referred to as country risk provisions. If institutions do not separately set aside country risk provisions but factor in an element of provision for country risk into specific provisioning for each individual exposure (i.e. on an individual obligor basis), such provision should be referred to as "specific provisions".

13. Every authorized institution should have a system for the establishment of adequate provisions. There is not a single method that is suitable for all institutions. However, provisioning decisions should be based primarily on an assessment of the recoverability of individual loans or portfolios of loans with similar characteristics (such as credit card receivables). Therefore, recognising problem loans is a necessary step and an effective loan classification system is essential for the establishment of an adequate level of provisions. The level of specific provisions in respect of a particular loan should normally be related to its loan classification, with higher provisions being required when loans are downgraded into a lower category (e.g. from substandard to doubtful). Specific provisions should normally be made

[1] The recommendations in this section also apply to other assets to which the loan classification framework applies (see paragraph 5 above).

as soon as a loan is classified as substandard, unless there are good reasons to the contrary. Provisions against substandard loans may not be necessary where the policy of the institution is to classify loans promptly as doubtful and to provision accordingly.

## Implementation

14. The HKMA expects every institution to have a formal loan classification system in place for internal monitoring of its asset quality. Institutions whose internal systems are different from that of the HKMA are required to agree with the HKMA the methodology for mapping their system onto the HKMA's system for the purposes of reporting the Quarterly Analysis of Loans and Advances and Provisions (MA(BS)2A).

Hong Kong Monetary Authority
January 2018

**Appendix 2.1**

## Guidelines on overdue and rescheduled assets

1. This paper sets out the criteria which are to be applied in determining overdue and rescheduled assets for the purposes of classification under the loan classification framework and for reporting in the Quarterly Analysis of Loans and Advances and Provisions (MA(BS)2A).

### Overdue assets

2. The overdue status of the following assets are to be determined as follows:-

   a) Loans with a specific expiry date (e.g. a term loan, inward bill loan, advance against trust receipt, packing loan and other loans of similar nature) - these loans should be treated as overdue where the principal or interest is overdue and remains unpaid as at the reporting date. (For multiple loans to a single borrower, e.g. where there are more than one trust receipt loans, report only the one overdue according to its overdue period.)

   b) Consumer loans repayable by regular instalments (e.g. residential mortgage loans, hire purchase loans and personal loans) - these loans should be treated as overdue when an instalment payment is overdue and remains unpaid as at the reporting date.

   c) Loans repayable on demand (e.g. demand loans and overdrafts) - these loans should be treated as overdue where one or both of the following conditions are met:

      i) a demand for repayment has been served on the borrower but repayment has not been made in accordance with the instruction; or

      ii) the loan has remained continuously outside the approved limit that was advised to the borrower for more than the period in question (e.g. three months or six months).

   d) Bankers acceptances are to be treated as overdue where either the principal or interest of the instruments are still in arrears after the due dates or maturity dates.

   e) A bill payable at a determinable date (i.e. usance bill) should be treated as overdue if it remains in arrears after the maturity date. Sight bills/drafts in respect of goods exported from Hong Kong should normally be paid within one week from the date of presentation (or the arrival of carrying vessel if the buyer is not obliged to pay before the arrival of goods). However, to allow for unforeseeable delays in processing the documents or effecting payments, a grace period of one month will be allowed. These bills should therefore be regarded as overdue if payment is not made within one month after presentation or the arrival of carrying vessel, as the case may be.

3. The period of overdue of a loan which has a determinable due date should commence from the date following such due date. The <u>whole amount</u> of a loan is regarded as overdue even if part of it is not yet due and assessment should be made by reference to the earliest due date of such a loan. For example, if the longest overdue instalment of a loan repayable by monthly instalments has been overdue for six months as at the reporting date, the entire amount of the loan should be considered as overdue for six months.

4. Where partial repayment of an overdue loan repayable by monthly instalments is made, to the extent that it is not financed by a new loan extended by the reporting institution for the purpose of repaying the overdue loan, the repayment should be offset against the earliest instalments due. In the previous example, if the borrower makes a partial repayment reducing the longest overdue instalment to five months, the entire loan may be considered as overdue for five months.

5. If an overdue loan is scheduled to be repaid by a lump sum payment, a partial repayment will not change the overdue status of the remaining loan balance, i.e. the outstanding balance should continue to be treated as overdue with reference to the original due date.

6. An institution should not extend a new loan to a borrower solely for the purpose of repaying an existing overdue loan with the institution. Where the repayment whether partial or whole is financed by a new loan extended by the institution, the overdue status of the initial loan should be considered as unchanged, i.e. as if the new loan and partial repayment had never been made.

7. It is recognised that institutions may decide to increase overdraft limits (or limits of similar facilities) to accommodate the increased financing needs of sound customers. In such cases, the loan would not be regarded as overdue under paragraph 2(c)(ii) above. However, this should only be done on the basis of a well-documented credit evaluation and after the appropriate internal approval have been obtained. An increase in the overdraft limit should not be sanctioned simply to avoid classifying the loan as overdue.

## Rescheduled assets

8. Rescheduled assets refer to loans and other assets that have been restructured and renegotiated between the reporting institution and the 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 bank. A rescheduled asset will normally require an adverse classification under the loan classification system (i.e. substandard or doubtful).

9. The following assets are not regarded as rescheduled even if their repayment terms have been revised:

    a) Assets rescheduled in response to the changes in market conditions provided that at the time of rescheduling, the assets have been serviced normally, the ability of borrowers to service the assets according to the revised repayment terms is not in doubt and the rescheduled assets are priced at interest rates equal to the current market interest rates for new assets with similar risks.

    b) Rescheduled assets whose revised repayment terms are, or become, commercial to the institution and where there is reasonable assurance that the borrowers will be able to service all future principal and interest payments on the assets in accordance with the revised repayment terms and the borrowers have serviced all principal and interest payments on the assets in accordance with the revised repayment terms continuously for a reasonable period. The reasonable period of continuing repayments for rescheduled assets with monthly payments (including both interest and principal) is 6 months. For other rescheduled assets, a period of continuing repayment of 12 months would be considered as reasonable.

10. If a rescheduled asset is taken up by a new obligor, the reporting institution may regard it as a new asset (i.e. no longer a rescheduled asset) and classify it according to the creditworthiness of the new obligor 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 companies. The reporting institution 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 debt) before entering into the restructuring.

11. A rescheduled asset may be upgraded to "special mention" if : i) the agreed haircut has been fully written off and all the potential losses have been fully provided upon completion of restructuring; and ii) the reporting institution is satisfied that the borrower will be able to service all future principal and interest payments in accordance with the revised repayment terms. Such asset will however continue to be regarded as rescheduled until the borrowers have serviced all principal and interest payments on the assets in accordance with the revised repayment terms continuously for a reasonable period (see paragraph 9 above).

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