**<u>Appendix 2</u>**

# <u>Guideline on loan classification system</u>

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.

## <u>Background</u>

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 system was first introduced in 1994. Details of the loan classification framework were previously embodied in the completion instructions of the Quarterly Analysis of Loans and Advances and Provisions Return (MA(BS)2A). ***The classification framework outlined in this paper is largely the same as the one introduced in 1994. The only major change is the inclusion of investment debt securities in the loan classification system as they carry similar credit risk as loans and advances. The recommendations on the accrual of interest are deleted, as this area is now addressed by the HKMA's guideline on Recognition of Interest.*** In addition, the loan classification criteria have been further elaborated with a view to achieving greater consistency and accuracy in reporting by authorised institutions.

## <u>The loan classification framework</u>

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 expected 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).***

- **<u>Substandard</u>**

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 <u>where some loss of principal or interest is possible</u> after taking account of the "<u>net realisable value</u>" 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;

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

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

- unemployment of an individual borrower.

- **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 (long-term investment/held-to-maturity) debt securities is based on <u>credit risk</u>. Securities held for trading purposes 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".

## <u>Multiple extensions of credit to one borrower and loans to related companies</u>

10. The classification of individual <u>loans</u> should be based in the first instance on an assessment of the repayment capacity of the <u>borrower</u>. 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 authorised 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***

***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. 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.***

***13. Every authorised 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***

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

***provisions should normally be made 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 Loans and Advances and Provisions Return (MA(BS)2A).

Hong Kong Monetary Authority
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