

THE NEW LOAN CLASSIFICATION SYSTEM

The Monetary Authority introduced in December 1994 a new measure which requires authorised institutions to report on a quarterly basis their assets according to a standardised loan classification system and provisions made against the specified categories. The first report indicated that the quality of Hong Kong banks' assets was generally high by international standards.

Importance of asset quality and adequate provisions

Poor asset quality is a common cause of bank failures. It can be caused by imprudent lending or by a downturn in the economy. Bad and doubtful loans can seriously damage a bank's financial position by eroding its earnings and capital. The problem of deterioration in asset quality can be made much more serious if there is no mechanism to ensure timely recognition of the problem. The losses will be hidden resulting in a significant shortfall in provisions and overstatement of the bank's capital. Instead of taking remedial measures to rebuild capital and to tighten lending policies, the bank may compound the problem, e.g. by overtrading, and/or by making excessive dividend payments.

An effective loan classification system is therefore an essential tool to achieve the twin objectives of continuous monitoring of banks' asset quality and ensuring that they maintain adequate provisions at all times. Both require an accurate measure of potential or expected losses in respect of the banks' various assets.

New Loan Classification System

The HKMA introduced in December 1994 a new loan classification system which is modelled after the system adopted by the supervisory authorities in the United States and in other countries. The initiative brings Hong Kong in line with international best practice. The new system serves three important objectives:

- (a) to monitor continuously individual institutions' asset quality and the adequacy of their level of provisioning;
- (b) to identify outliers through peer group analysis made possible by the common classification system; and
- (c) to detect deterioration of asset quality in specific sectors through monitoring

the aggregate level of provisioning of individual sectors.

Features of the new system

The new loan classification system covers loans and other assets which subject banks to credit risks. The latter include balances due from banks, acceptances and bills of exchange held and commitments and contingent liabilities. Investments in equities and debt securities are not included for the time being. It is intended that their treatment will be reviewed after the new system has settled down.

Loan classifications are expressions of different degrees of a common factor i.e. the risk of non-repayment. All loans involve some risk but the degree varies. The severity of classification is influenced by the following key factors:

- (a) the repayment ability of the borrower i.e. the borrower's ability to generate cash flow to service the debt;
- (b) the income-producing potential and the market value of the assigned collateral;
- (c) the prospect of support from other sources e.g. guarantors, endorsers or cosigners; and
- (d) the extent to which payments are overdue, which reflects the ability and willingness of the borrower to repay the debt.

In accordance with the above, the new loan classification system requires authorised institutions to classify their loans and relevant assets into five categories:

- Performing
- Special Mention
- Substandard
- Doubtful
- Loss

The Loan Classification System

Performing

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. Such borrowers should be subject to special monitoring. It is not envisaged that specific provisions will be required for these loans at this stage but a certain amount of general provisions may be necessary. Interest may continue to be accrued to the profit and loss account.

Substandard

This refers to loans where borrowers are displaying a definable weakness which is likely to jeopardise repayment. The institution is relying heavily on available security. This would include:

- (i) loans where some loss, either of principal or interest, (including future interest), is possible after taking account of the market value of security;
- (ii) 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;

Some amount of specific provisions may have to be set aside for accounts included in this category and a certain amount of general provisions will usually be appropriate, taking into account the value of collateral, if any. Banks should consider accruing interest to suspense account rather than profit and loss account or, if interest has been overdue for a significant period of time, not accruing interest at all.

Doubtful

This refers to loans where collection in full is improbable and the institution *expects to sustain a loss of principal and/or interest*, taking account of the market value of security. Specific provisions should be made against any expected loss. Accrual of interest on such loans should cease or be taken to the suspense account.

Loss

This refers to loans which are considered uncollectible after exhausting all collection efforts such as realisation of collateral and institution of legal proceedings etc. All outstanding principal and interest which are not covered by the value of collateral should be fully provided for or written off. Interest on accounts included in this category should cease to be accrued.

Loans classified as substandard, doubtful or loss are collectively regarded as non-performing loans that exhibit actual (not potential) weaknesses and distinct possibility that loss will result for the bank.

A new quarterly return on "Analysis of loans and advances and provisions", which was developed on the basis of the former return on "Quarterly analysis of loans and advances for use in Hong Kong", has been introduced to collect the relevant data. Apart from reporting the relevant assets according to the five categories, institutions are also required to report provisions (including specific provisions, general provisions and country debt provisions) made against each loan category, provisions made against each major economic sector, the value of security held against non-performing loans and the size of overdue loans.

Classifying loans into the different categories involves a fair amount of subjective judgement, in particular in assessing possible recovery in light of the repayment ability of the borrower or the likely impact of an adverse event on such ability. Quantitative elements however can be used to provide some degree of consistency in the classification. Two important indicators for this purpose are the extent to which principal and

interest of the outstanding amount of a loan are secured and the degree of delinquency in loan repayments. The matrix in Table I below sets out the basic loan classification and interest treatment under various collateralisation and delinquency scenarios. The principle is rather straightforward: the less secured the loan and the longer the period overdue, the more conservative should be the classification. These classifications are recommended as minimum standards. Where serious deficiencies are detected with respect to a particular loan, it may be necessary for institutions to classify it into a more conservative category.

It should be emphasised that the responsibility for prudent and accurate identification of weak assets rests with the management of authorised institutions. The HKMA expects authorised institutions in their evaluation of asset quality to recognise the extent of loan losses on a prudent and realistic basis, based on the best available information on borrowers, including the present state of their affairs and past payment record.

Provision for non-performing loans

The HKMA does not endorse or require a particular method for evaluating the adequacy of provision for the non-performing loans of authorised

Table I:
Loan Classification and Interest Treatment

Scenario	Principal	Accrued interest	Future interest	Period of Overdue							
				within 3M		>3 - 6M		>6 - 12M		over 12M	
				Class	Int	Class	Int	Class	Int	Class	Int
1	F	F	F	SM	a	SM	a	SM	a	SS	a
2	F	F	P	SM	a	SS	a	SS	b	SS	c
3	F	P	U	SM	a	SS	b	SS/D	c	D	c
4	F	U	U	SM	a	SS	b	D	c	D	c
5	P	U	U	SM	a	SS	b	D/L	c	D/L	c
6	U	U	U	SM/SS	a	SS/D	c	D/L	c	L	c

Key:

Class	= loan classification	SM	= special mention
Int	= interest treatment	SS	= substandard
F	= fully secured	D	= doubtful
P	= partially secured	L	= loss
U	= unsecured		
a	= interest may continue to be accrued to the profit and loss a/c		
b	= accrued interest should be transferred to a suspense a/c		
c	= cease accruing interest		

institutions. It is the responsibility of bank management to develop, monitor, and maintain provisions at an adequate level. While the new system does not stipulate the loan loss provisioning level required for different categories of loans, institutions are expected to have their own internal guidelines on the provisioning level appropriate to each category. They should also develop sound action plans for each loan category with a view to maximising their eventual recovery or minimising the possible loss from troubled loans.

Mapping of institutions' existing systems with the HKMA framework

In implementing the new loan classification system, the HKMA has advised a small number of institutions which had not hitherto established a formal loan classification system to adopt the new system. For institutions with existing loan classification systems which needed to "map" their own loan categories into the five HKMA categories, the HKMA adopted an approach which aimed to minimise as far as possible the need for changes to institutions' established systems or the running of two systems. It turned out that for most institutions

it was possible to fit the whole of their own categories, or the whole of particular classes of loans within those categories, into those on the HKMA's return without conducting a separate reclassification of individual loans. There was only one bank which needed to make minor reclassification and this was resolved through discussion with the bank concerned.

Experience of the first reporting by authorised institutions

The first reporting under the new loan classification system was based on authorised institutions' positions as at end-December 1994. As a normal feature of new reporting, some adjustments needed to be made to the data submitted by institutions to correct reporting errors. The common reporting errors include:

- (a) institutions which have not established general provisions against individual economic sectors reported such data on a pro-rata basis (institutions are required to report such data only if they have set aside general provisions against specific

Table 2:
Asset Classification

	Performing %	Special Mention %	Substandard %	Doubtful %	Loss %
Loans & advances					
(a) all authorised institutions	97.63	1.36	0.34	0.58	0.09
(b) all local banks	94.04	2.61	0.95	2.33	0.07
Balances due from banks					
(a) all authorised institutions	99.94	0.02	0.01	0.02	0.01
(b) all local banks	99.96	0.00	0.00	0.04	0.00
Acceptances and bills of exchange held					
(a) all authorised institutions	97.41	1.49	0.52	0.45	0.13
(b) all local banks	97.54	1.31	0.74	0.38	0.03
Commitments and contingent liabilities					
(a) all authorised institutions	99.19	0.58	0.11	0.12	0.00
(b) all local banks	99.23	0.37	0.15	0.25	0.00
Total Credit exposures					
(a) all authorised institutions	98.44	0.90	0.23	0.37	0.06
(b) all local banks	97.26	1.21	0.45	1.05	0.03

- economic sectors);
- (b) balances with overseas offices of the reporting institution, which are excluded from reporting, were reported as balances due from banks;
 - (c) some reported figures did not match equivalent items in another part of the same return or other returns.

Institutions have been informed of our observations and the correct treatment of the above items.

Asset quality and adequacy of provisioning

Asset quality

The aggregate results based on the returns submitted by authorised institutions in respect of their position at end-December 1994 indicate that

the quality of authorised institutions' assets is generally high by international standards (Table 2). This is consistent with other measures of asset quality, including the amount of overdue loans and the fall in the amount of provisions for bad debts in 1994. It reflects the relatively benign conditions under which banks in Hong Kong have operated in recent years. It cannot be assumed however that this will continue in the future.

Provisioning

Taking into account the amount of specific provisions and the value of security held against the non-performing assets, the uncovered portion of the Substandard, Doubtful and Loss categories of the banking sector were 50%, 22% and 12% respectively (Table 3). By comparison, local banks as a whole had a higher security cover in respect of their non-performing loans. The uncovered portions

Table 3:
Uncovered position of non-performing exposures

	Substandard %	Doubtful %	Loss %
Proportion of non-performing exposures covered by:			
(A) Specific provisions*			
(a) all authorised institutions	5.31	56.62	70.51
(b) all local banks	2.92	58.13	62.86
(B) Value of security			
(a) all authorised institutions	44.68	21.25	17.40
(b) all local banks	51.80	22.34	29.27
Uncovered non-performing exposures [1-(A+B)]:			
(a) all authorised institutions	50.01	22.13	12.09
(b) all local banks	45.28	19.53	7.87

* Including Country Debt Provisions

Table 4:
General provisions as % of loans and advances

	Average ratio	Highest ratio	Lowest ratio	Ratio reported by the majority
All authorised institutions	0.41%	110.18%	0.00%	0.00%
Local banks	0.87%	27.61%	0.13%	>0.8%

for the Substandard, Doubtful and Loss categories were 45%, 20% and 8% respectively.

Table 4 shows the aggregate levels of general provision held by the banking sector and local banks as at end-December 1994. The average level of general provision for the sector as a whole was 0.41% of the total loans to non-bank customers. Local banks maintained a much higher average level at 0.87%. The majority of the local banks maintained general provisions at above 0.8%.

Some 190 institutions have not made any general provisions against their loan book. They are mainly foreign bank branches and subsidiary deposit-taking institutions of foreign banks. The position reflects that:

- (a) some 30 institutions do not have any loans and advances;
- (b) some institutions have adopted the policy of direct charge off after a loan has been overdue for a certain period; and
- (c) general provisions are made at the Head Office or parent bank level.

Information on provisions made against domestic loans in respect of key economic sectors

is available for the first time. Only eight institutions adopted the practice of setting aside general provisions against individual sectors. Most of these provisions were made against consumer lending. Specific provisions made against individual sectors were generally below 1%, with the exceptions in the sub-sectors of Cotton Textiles (3.9%), Other Textiles (1.2%) and Shipbuilding and Repair (1.4%).

Follow-up action

The data collected under the new loan classification system provide useful information for the HKMA to monitor authorised institutions' asset quality on an on-going basis and to provide a benchmark for conducting on-site examinations of loan books. The standardised classification system is particularly useful for conducting peer group analysis to help to identify institutions with below-average asset quality and provisions maintained at levels below their peers. The HKMA will discuss with these institutions the need for improvements, in particular whether the position reflects weaknesses in their credit underwriting and review processes. The classification system and the reporting requirements will be kept under regular review in the light of experience. ㉞

– Prepared by the Banking Policy Department