

Our Ref : CB/POL/41911

2 September 1994

The Chief Executive
All authorized institutions

Dear Sir/Madam,

Loan Classification System

In October 1993, the Hong Kong Monetary Authority ("HKMA") circulated to the two industry Associations a Consultation Paper setting out its proposals for a loan classification system for supervisory purposes.

Under the proposed system, institutions would be required to report their loans and advances according to five categories (i.e. Performing, Special Mention, Substandard, Doubtful and Loss), provisions made against each category and the value of security held against the non-performing loans. The proposal would serve the important supervisory objectives of :

- (a) continuous monitoring of individual institutions' asset quality and the adequacy of their level of provisioning;
- (b) identifying the outliers through peer group analysis made possible by the common classification system; and
- (c) early detection of deterioration of asset quality in specific sectors through monitoring the aggregate level of provisioning of individual sectors.

The industry Associations have indicated general support for the proposals. They emphasized the need for HKMA to discuss with individual

institutions on how to map their existing loan categories into those under HKMA's proposed system. Reservations were also expressed on the proposed inclusion of equities and debt securities held by institutions on the grounds that they are of a different nature to commercial lending.

The HKMA has discussed with all authorised institutions their internal loan classification systems and the issue of mapping with HKMA's proposed system. The discussions revealed that institutions generally fall into three situations:

- (a) a small number who have not hitherto established a formal loan classification system;
- (b) the majority who have already established a formal system which is generally compatible with the proposed system; and
- (c) only one institution whose loan classification system is substantially different from the one proposed.

The HKMA expects institutions which have not yet established a formal loan classification system to adopt the proposed system. For those institutions which need to map their loan categories into the five proposed categories, the HKMA will adopt a flexible approach which aims to minimise as far as possible the need for changes to institutions' established systems or running two systems.

For most institutions, it should be 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. Where this is not possible because of major definitional differences, institutions should contact the HKMA well in advance of the submission of the first return to discuss the appropriate basis of reporting.

To ensure consistency in reporting by individual institutions, all institutions which have existing systems of loan classification should provide the HKMA on or before 15 November a brief description of their systems, the method which they intend to use to map their loan categories onto the HKMA return and any significant differences in definitions and approach between the HKMA system and their own. The HKMA will confirm in writing in due course the agreed methodology for mapping.

As regards investments in equities and debt securities, we have decided not to include them for reporting at this stage. The treatment of these items will be reviewed after the new loan classification system has settled down.

A Policy Paper setting out the new loan classification framework is attached. Annex 1 of the Paper is a copy of the new return on "Quarterly analysis of loans and advances and provisions" which will replace the existing return on "Quarterly analysis of loans and advances for use in Hong Kong".

Pursuant to section 63(2) of the Banking Ordinance, all authorized institutions are required to submit, on a quarterly basis, the new return to the Monetary Authority not later than fourteen days after the end of each quarter. The first return will cover the position of your institution at 31 December 1994. Printed copies of the return will be sent to authorized institutions when they are available. The HKMA does not intend to require auditors' certificate in respect of the new return at this stage. The need for this requirement will be reviewed after the new loan classification system has settled down.

The new return covers the information on overdue and rescheduled assets which institutions are currently required to report under Form MA(BS)1C. As from the first reporting of the new return at end December 1994, institutions should stop reporting such information on Form MA(BS)1C. Printed copies of the revised Form MA(BS)1C will be sent to all authorized institutions in due course.

The basis for reporting loans and advances by economic sectors under Part I of the new return has not changed (although property lending has been broken down into those for development and investment purposes). The reporting instructions have however been expanded in certain areas and this may lead some institutions to re-classify some of their existing loans. To ensure an orderly adjustment to HKMA's statistics, institutions are requested not to make any re-classifications until the first submission of the new return and to provide at the time of submission a written explanation of any re-classifications made and to provide the amount of the affected items on the old as well as the new basis so that the overall effect of any changes can be quantified.

Should you have any queries regarding the Policy Paper and the reporting requirements, please feel free to contact Ms Brenda Tao (878 1622) or Ms Irene Sy (878 8210).

Yours faithfully,

D T R Carse
Deputy Chief Executive (Banking)

c.c. The Chairman, HKAB
 The Chairman, DTC Association
 President, Hong Kong Society of Accountants
 Auditors of Authorised Institutions
 The Chairman, Securities & Futures Commission