LOAN CLASSIFICATION SYSTEM

1. Introduction

This paper sets out a system for the classification and reporting of loans and other specified exposures by authorized institutions. The system will be supplemented by regular reporting on provisions set aside for each category of classified assets and for different sectors in Hong Kong. With such information, the Hong Kong Monetary Authority (HKMA) will be able to monitor more closely the asset quality and adequacy of provisions of institutions.

2. Background

2.1 Inferior asset quality is a major cause of bank failures. It may be caused by imprudent lending or by a downturn in the economy. Asset quality and adequacy of provisions are therefore the major areas to which banking supervisors should pay particular attention. They need to be fully aware of the asset quality of individual banks and to be satisfied that adequate provisions have been maintained for problem assets.

2.2 Hitherto, statistics collected by the HKMA have not included information on the amount of non-performing assets of institutions. It is not therefore in a position fully to monitor asset quality and assess the adequacy of bad debt provisions off-site. This can be done only through periodic on-site examinations by its staff and through annual audits by the external auditors. While this is, and will remain, the principal means of assessing asset quality, a standard loan classification system will help provide the HKMA with a clearer picture on the asset quality of individual institutions on a regular basis. With such information, the HKMA will be able to act more swiftly on detection of any deterioration in the asset quality of an institution. The validity of institutions' loan classifications will be checked during the course of on-site examinations.

2.3 Various banking regulatory bodies in the region such as Singapore, Malaysia, Korea, Philippines, Indonesia and Australia have adopted some form of loan or asset classification system. Most of such systems are modelled after the system adopted by the supervisory authorities of the United States. The system outlined in this paper will bring Hong Kong in line with the practices adopted by the supervisory bodies of the countries mentioned above.

3. The loan classification framework

3.1 Under the system, loans and advances will be classified into the following categories:-

(a) Performing - loans where borrowers are current in meeting commitments and full repayment of interest and principal is not in doubt.

(b) 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. Such borrowers should be subject to special monitoring.

(c) Substandard - loans where borrowers are displaying a definable weakness which is likely to jeopardise repayment. The institution is relying heavily on available security. Some loss is possible, particularly of interest.

(d) Doubtful - collection of the loan in full is improbable and the institution expects to sustain a loss of principal and/or interest, taking into account the market value of collateral.

(e) Loss - loans which are considered uncollectible after exhausting all collection efforts such as realisation of collateral and legal proceedings etc.

3.2 Details of the definitions and characteristics of each category of loans are given in the completion instructions included in Annex 1. In addition to loans, balances due from banks, acceptances and bills of exchange held, as well as commitments and contingent liabilities which subject an institution to credit risk are also classified in the same way in order to give a better picture on asset quality.

3.3 Although some countries have gone one step further to stipulate the loan loss provisioning level required for different category of loans, e.g. 25% for substandard loans, 50% for doubtful loans and 100% for loss loans, the HKMA does not propose to do so in Hong Kong. The objective of the framework is to help identify potential and problem assets that may have an adverse bearing on the financial position of an institution. That said, institutions are expected to have their own internal guidelines on the provisioning level appropriate to each category of loans. They should also develop action plans appropriate to each category of loans with a view to recovering as much as possible of the debts owed and reducing the possible loss to the minimum. The HKMA will wish to discuss with individual institutions their internal guidelines and action plans.

4. Sectoral provisioning

4.1 In addition to a loan classification system, information on provisions against various sectors of loans for use in Hong Kong will give the HKMA a better knowledge about how the institutions view the condition of individual sectors and enable it to assess the adequacy of provisions set aside by individual institutions from another perspective. This would help to identify those institutions whose provisions against lending to a particular sector seemed to be out of line with their peers. Furthermore, if the level of provisions set aside by the banking industry as a whole for a particular sector is very high or is increasing, the HKMA would be able to issue warnings to the industry regarding the risk of lending to this sector.

4.2 Institutions are therefore required to provide information on provisions against various sectors of loans for use in Hong Kong, trade financing and other loans.

5. The reporting structure

5.1 To facilitate the collection of the relevant statistics on the value of classified assets, the amounts of provisions set aside against them and sectoral provisions, a new quarterly return on “Analysis of loans and advances and provisions *(MA(BS)2A(Rev.94))*” has been established to replace the existing quarterly return on “Analysis of loans and advances for use in Hong Kong *(MA(BS)2A)*”. A copy of the new return and the completion instructions are attached in Annex 1.

5.2 Apart from the inclusion of information on sectoral provisioning and loan classification, the HKMA has taken this opportunity to split item C1 of Part I of the existing return into two separate items namely “Property development” and “Property investment”. In addition, further information on loans to companies which are property-developer-connected is also required. These changes to the existing return will enable the HKMA to better monitor property-related lending.

5.3 Also included in Note (3) of the new return is information on overdue and rescheduled assets of authorized institutions. Such information is presently required under the Return of Profit and Loss *(MA(BS)IC)* but it is considered more appropriate to include it in the new return instead.

The Hong Kong Monetary Authority
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