THE RECOGNITION OF INTEREST

1. This consultative paper sets out proposals to standardize the policy on recognition of interest by authorized institutions in Hong Kong. It is proposed that this policy would be adopted by all authorized institutions for the purposes of reporting to the Hong Kong Monetary Authority ("HKMA") and by locally incorporated institutions for the purposes of their published financial statements.

Background

2. The financial condition and performance of a bank depends critically on the realistic valuation of its assets and the prudent recognition of its income. The general rule is that interest earned on loans should be brought into the profit and loss account as it accrues, provided that its collectability is not subject to significant doubt. Doubtful interest should be excluded from the profit and loss account. This should be done by crediting the interest to a suspense account rather than the profit and loss account or by ceasing to accrue at all. If this is not done, the profits of the bank and its capital will be overstated. Loans on which interest is being placed in suspense or on which interest accrual has ceased are described for the purposes of this paper as "non-accrual loans".

3. The problem is to identify the point at which the collectability of interest becomes doubtful. To a large extent this must be a matter of judgment. However, it may be possible to use certain objective indicators such as the length of time that interest or principal is overdue to assist in arriving at the judgment.

Current practice in Hong Kong

4. Current practice on interest recognition in Hong Kong varies among different institutions. According to a survey conducted by the HKMA in 1997, a large proportion of locally incorporated banks will suspend accrual of interest on unsecured or partly secured loans which are overdue for 90 days or more. This is consistent with the approach in the US and in a number of other countries. Other banks use a more judgmental approach by suspending accrual of interest on loans which have been classified as "doubtful".

5. In view of this diversity of approach, the HKMA considers it necessary to standardize the approach towards the recognition of interest in Hong Kong. This would further enhance the transparency of the banking system in Hong Kong and help to reduce market uncertainty. It would enable market analysts to make more meaningful comparisons of the figures for non-accrual loans published by banks in their annual accounts. This would be consistent with the recommendation for more specific guidelines on income recognition which was made by the IMF during the 1997 Article IV Consultation on Hong Kong.

Criteria for determining non-accrual loans

6. The criteria set out below combine a mixture of subjective and objective factors. It is recognized that the decision to place loans on a non-accrual basis must be largely judgmental, based on whether there is reasonable doubt about the collectability of the interest. However, a number of objective criteria are proposed to assist in arriving at this judgment, relating in particular to the extent to which payments of principal and/or interest are in arrears. While the length of the period of arrears must inevitably be somewhat arbitrary, it is international best practice to use a period of 90 days for this purpose. In developing its proposals, the HKMA has also had particular regard to the position in the US and Australia. The latter provides a particularly appropriate model because Australian and Hong Kong banks both use overdrafts as a mean of lending.

7. Based on the above principles, the proposed criteria for determining non-accrual loans are as follows:

   (a) loans where there is reasonable doubt about the ultimate collectability of principal or interest;

   (b) loans against which a specific provision has been made;

   (c) loans where contractual payments of principal and/or interest are 90 days[1] or more in arrears and where the "net realizable value" of security is insufficient to cover payment of principal and accrued interest;

   (d) loans where contractual payments of principal and/or interest are 360 days[1] or more in arrears, irrespective of the net realizable value of collateral;

   (e) overdrafts which have remained continuously outside approved limits that were advised to the customer for 90 days or more, and where the net realizable value of security is insufficient to cover payment of principal and accrued interest[2];

   (f) overdrafts which have remained continuously outside approved limits that were advised to the customer for 360 days or more, irrespective of the net realizable value of collateral.

8. It should be noted that the first of these criteria establishes the overriding principle. This means, for example, that a decision may be made to place a loan on a non-accrual basis because there is reasonable doubt about the ultimate

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[1] Alternatively individual institutions may choose to adopt 3/12 months as the relevant periods provided that these are consistently applied.

[2] The same principle would apply to other types of flexible financing facilities without specific payment dates (such as bill lines).

collectability of principal or interest, even if it is not yet in breach of contractual requirements or if the period of arrears is less than 90 days.

9. There may be instances of trade finance facilities which are overdue for more than 90 days due purely to technical irregularities rather than because of the inability of the borrower to pay. In such cases, interest may continue to be accrued provided that the irregularities are expected to be resolved within a short period of time and the appropriate internal approval has been obtained.

10. Although the criteria in paragraph 7 have been expressed in terms of "loans", they are applicable to all assets on which interest is accrued (such as debt securities).

Treatment of collateral

11. Given the efficiency and transparency of the asset markets in Hong Kong and the existence of a legal system which enables lenders to take possession of, and realize, security within a reasonable time-frame, it is appropriate to take the value of security into account in determining whether to place loans on a non-accrual basis. However, the longer the loan is in arrears, the more "collateral dependent" it will become. That is, it will become increasingly clear that repayment of the debt will depend solely on realization of the underlying collateral. Moreover, to maintain non-performing loans on accrual status for too long could progressively overstate the revenue of the institution. It is proposed therefore that there should be a cut-off point of 360 days of arrears at which loans should be placed on a non-accrual basis, regardless of the value of the security held.

12. In determining whether the value of tangible security is sufficient to cover payment of principal and accrued interest, reference should be made to the "net realizable value" of the security concerned. This is the current market value less any realization costs. Market value should be measured on the basis of up-to-date valuations 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;

(d) the asset was freely exposed to the market.

13. Other forms of collateral (e.g., guarantees) may be taken into account for the purpose of determining whether interest accrual should continue provided that the value of such collateral can be determined with reasonable certainty.

Treatment of overdrafts and similar facilities

14. It is recognized that it is difficult to apply the "90 day rule" to flexible financing facilities such as overdrafts and bill lines without specified payment dates. To cater for this, it is proposed that institutions should apply a test similar to the "90 day rule" to exposures which are in breach of agreed limits for a continuous period of 90 days or more (see paragraph 7(e)). However, banks will have the option to increase overdraft limits (or limits on similar facilities) to accommodate the increased financing needs of sound customers. This should only be done on the basis of a well-documented credit evaluation and after the appropriate internal approval has been obtained. An increase in the overdraft limit should not be sanctioned simply to avoid placing the loan on a non-accrual basis. Similarly, as a matter of principle, an institution should not extend short-term financing to borrowers solely to provide them with liquidity to service longer term debts and thus circumvent the criteria set out in paragraph 7.

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

15. As a general principle, whether an individual loan is placed on a non-accrual basis or not will depend on the application of the criteria set out in paragraph 7 to that particular loan. Thus, even if one or more loans to a particular borrower are placed in non-accrual status, 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 interest accrual 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 placed in non-accrual status (at least not until it is in arrears for 360 days or more).

Loans managed on a portfolio basis

16. It is recognized that certain types of loan (e.g. credit cards) are managed on a portfolio basis. Such loans are typically high volume and relatively low value items which it may be impractical to analyse on an individual basis for interest recognition purposes.

17. For such loans which are 90 days or more in arrears or which have remained continuously outside approved limits for 90 days or more, it is proposed that institutions should have two options (but institutions are required to make their decisions at the outset):

    (a) continue to accrue interest in the same manner as the performing loans in the portfolio, but establish a specific provision against the pool of loans that are overdue for 90 days or more to cover a suitably conservative amount of principal and interest. The outstanding balance of the loans in

arrears should be fully provided for or written off when they are 180 days or more in arrears; or

(b) subject the individual loans in the portfolio concerned to separate review on the basis of the criteria for non-accrual in paragraph 7.

18. Institutions which wish to use option (a) should establish written policies for the treatment of loans on a portfolio basis and should submit these to the HKMA for its approval. Such loans should nonetheless be regarded as non-accrual loans for reporting and disclosure purposes. This is because interest income has only been accrued on a conditional basis. That is, such loans would have normally been classified as non-accrual loans under the criteria set out in paragraph 7, but interest accrual has been allowed to continue because of the practical issues mentioned above.

Suspension of interest accrual versus cessation of accrual

19. As noted in paragraph 2, non-accrual loans comprise loans on which interest is being placed in suspense or on which interest accrual has ceased. Which treatment is adopted will depend on the severity of the case. Where the collectability of the interest is simply "doubtful", the normal practice will be to continue to accrue but to place the interest in suspense. However, when it becomes clear that there is no longer any realistic prospect of collecting the interest, it should cease to be accrued.

Restoring non-accrual loans to accrual status

20. A non-accrual loan may be restored to accrual status if all arrears of principal and interest from the borrower have been cleared and it is probable that the customer is capable of fully servicing his obligations under the terms of the loan for the foreseeable future. This should be supported by a well-documented credit evaluation of the borrower's financial position and prospects for repayment. A loan which has been restructured may be restored to accrual status where it is probable that it will be serviced in accordance with the revised terms. Receipt of additional security should not, by itself, be sufficient to restore a loan to accrual status since, in the absence of payment of arrears, it would subsequently slip back to non-accrual status by virtue of the "360 day rule" (see paragraph 7(d)).

Implementation of the guideline

21. This guideline will be incorporated into the relevant parts of the completion instructions for the relevant Banking Returns (including the "Return of Loans and Advances and Provisions" (MA(BS)2A)) and the "Best Practice Guide on Financial Disclosure by Authorized Institutions". Authorized institutions are

expected to apply the criteria set out in this guideline for identification of non-accrual loans with effect on and from 30 June 1998.

Hong Kong Monetary Authority
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