Appendix B

GUIDELINE ON RECOGNITION OF INTEREST

1. This guideline aims to achieve greater standardization of the policy on recognition of interest by authorized institutions in Hong Kong. This policy should 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 collectibility is not subject to significant doubt. Doubtful interest should be excluded from the profit and loss account. For loans where there is still some prospect of ultimate recovery of interest, this is normally done by crediting the interest to a suspense account in the balance sheet rather than recognising it as income. For loans where it is considered that there is no prospect of ultimate recovery of interest, interest should cease to be accrued altogether. If such action is not taken, the profits of the bank and its capital will be overstated. Accrued interest previously credited to the profit and loss account on loans whose collectibility subsequently becomes doubtful should either be reversed from interest income or provided against to the extent necessary. Loans on which interest is no longer being taken to profit are termed either "Loans on which interest is being placed in suspense" or "Loans on which accrual has ceased". Any decision to cease interest accrual from an accounting perspective does not preclude continuing to accrue interest on a memorandum basis for legal enforcement purposes.

3. The problem is to identify the point at which the collectibility 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 3 months or more. This is consistent with the approach in the United States 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 achieve greater standardization in the approach towards the recognition of interest in Hong Kong. This will further enhance the transparency of the banking system in Hong Kong and help to reduce market uncertainty. It will enable market analysts to make more meaningful comparisons of the published figures for loans on which interest is being placed in suspense or on which accrual has ceased. This will 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.

6. It should be noted that these guidelines are not intended to prevent individual institutions from adopting more stringent policies for income recognition if they consider that to be appropriate, e.g. in terms of the choice of time period and treatment of collateral.

Criteria for determining loans on which interest no longer accrues to the profit and loss account

7. The criteria set out below combine a mixture of subjective and objective factors. It is recognized that the decision to place interest in suspense or cease to accrue it must be largely judgmental, based on whether there is reasonable doubt about the collectibility of the interest. However, there are a number of objective criteria that can 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 or 3 months for this purpose. In developing these criteria, 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.

8. Based on the above principles, the criteria for determining when interest should be placed in suspense or cease to be accrued are as follows:

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

   (b) loans against which specific provisions has been made;

   (c) loans where contractual payments of principal and/or interest are more than 3 months[1] 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 more than 12 months[1] in arrears, irrespective of the net realizable value of collateral;

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[1] Alternatively individual institutions may choose to adopt 90/360 days as the relevant periods provided that these are consistently applied.

(e) overdrafts which have remained continuously outside approved limits that were advised to the customer for more than 3 months, 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 more than 12 months, irrespective of the net realizable value of collateral.

9. 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 the interest on a loan in suspense or cease to accrue it because there is reasonable doubt about the ultimate collectibility of principal or interest, even if it is not yet in breach of contractual requirements or if the period of arrears is not more than 3 months.

10. There may be instances of trade finance facilities which are overdue for more than 3 months 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 to the profit and loss account provided that the irregularities are expected to be resolved within a short period of time and the appropriate internal approval has been obtained.

11. Although the criteria in paragraph 8 have been expressed in terms of "loans", they are applicable to all assets on which interest is accrued (such as debt securities, except those held for trading purposes).

Treatment of collateral

12. 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 interest in suspense or cease to accrue it. 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 take to profit interest on non-performing loans for too long could progressively overstate the revenue of the institution. This is why there is a cut-off point of 12 months of arrears beyond which interest should be placed in suspense or cease to be accrued, regardless of the value of the collateral held.

13. In determining whether the value of tangible collateral is sufficient to cover payment of principal and accrued interest, reference should be made to the "net realizable value" of the collateral concerned. This is the current market value

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

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.

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

Treatment of overdrafts and similar facilities

15. It is recognized that it is difficult to apply the "3 month rule" to flexible financing facilities such as overdrafts and bill lines without specified payment dates. To cater for this, institutions should apply a test similar to the "3 month rule" to exposures which are in breach of agreed limits for a continuous period of more than 3 months (see paragraph 8(e)). However, institutions 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 interest in suspense or ceasing to accrue it. 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 with the aim of circumventing the criteria set out in paragraph 8.

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

16. As a general principle, whether interest on an individual loan is placed in suspense or ceases to be accrued will depend on the application of the criteria set out in paragraph 8 to that particular loan. Thus, even if interest on one or more loans to a particular borrower is no longer accrued to the profit and loss account, 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, the interest may continue to be accrued to the profit and loss account (subject to the criteria in paragraph 8).

Loans managed on a portfolio basis

17. 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.

18. For such loans which are more than 3 months in arrears or which have remained continuously outside approved limits for more than 3 months, institutions 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 more than 3 months 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 at the latest when they are more than 6 months in arrears; or

    (b) subject the individual loans in the portfolio concerned to separate review on the basis of the criteria in paragraph 8.

19. 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. For reporting and disclosure purposes such loans should be regarded in the same manner as other loans on which interest is no longer accrued to the profit and loss account. This is because interest income has only been accrued on a conditional basis. That is, such loans would have normally met the criteria for ceasing to accrue interest to the profit and loss account set out in paragraph 8, but interest accrual has been allowed to continue because of the practical issues mentioned above.

Resuming accrual in the profit and loss account

20. Where interest has been placed in suspense or has ceased to be accrued, accrual of interest to the profit and loss account may be resumed 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 ***rescheduled*** may be restored to accrual status ***if there is reasonable assurance that the borrower will be able to service all future principal and interest payments on the loan in accordance with the revised repayment terms <u>and</u> the borrower has serviced all principal and interest payments on the loan in accordance with the revised repayment terms continuously for a reasonable period. The reasonable period of continuing repayments for rescheduled loans with monthly payments (including both interest and principal) is 6 months. For other rescheduled loans, a period of continuing repayments of 12 months would be considered as reasonable.*** Receipt of additional collateral should not, by itself, be sufficient to restore a loan

to accrual status since, in the absence of payment of arrears, interest accrual to the profit and loss account would again cease by virtue of the "12 month rule" (see paragraph 8(d)).

Implementation of the guideline

21. This guideline should be adopted by authorized institutions for the purpose of reporting in the relevant Banking Returns (for example, "Return of Loans and Advances and Provisions" (MA(BS)2A)) and for financial disclosure purposes in compliance with 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 loans on which interest should be placed in suspense or cease to be accrued no later than 31 December 1998. However, authorized institutions that opt for early adoption of this guideline are encouraged to do so.