

IMPLEMENTATION OF THE GUIDELINES BY OVERSEAS INCORPORATED INSTITUTIONS

Application

1. The guidelines are intended to apply to all overseas incorporated institutions whose Hong Kong offices currently have total assets of HK\$10 billion or more or total customer deposits of HK\$2 billion or more. Any institution which meets either one of the size criteria should adopt the recommendations contained in the guidelines.

2. The HKMA intends to use the figures which the institutions report in respect of item 25 (Total assets less provisions) and item 6.4 (Total deposits from customers) of the "Return of Assets and Liabilities of an Authorized Institution" (MA(BS)1) to determine whether an institution meets the above size criteria. To ensure that institutions know in advance whether or not they should adopt the recommendations and to avoid the effects of one-off fluctuations at the end of financial year, the average of the relevant figures reported in the twelve month period up to end-August of each financial year will be adopted for this purpose.

Release, display and availability of Key Financial Information Disclosure Statement

3. The Key Financial Information Disclosure Statement (Disclosure Statement) should be issued in the form of a press release containing the relevant Disclosure Statement in both English and Chinese to newspapers circulating in Hong Kong within three months from the end of each financial period. A copy of the statement should also be displayed in a conspicuous position in the principal place of business of the institution in Hong Kong and in each local branch if applicable. The statement should also be made readily available to members of the public on request. Institutions should lodge a copy of the press release with the HKMA prior to release. The HKMA will keep such releases in its public registry maintained under section 20 of the Banking Ordinance.

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 months¹ 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 months¹ 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 more than 3 months, and where the net realizable value of security is insufficient to cover payment of principal and accrued interest²;
- (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.

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

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

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 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 and 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.

CURRENCY RISK

The following note illustrates disclosure of currency risk including exposures arising from options positions and structural positions. An individual currency should be reported if it constitutes more than 10% of the total net position in all foreign currencies. Similarly, for disclosure of the net structural position (assets less liabilities), an individual currency should be reported if it constitutes 10% or more of the total net structural position in all foreign currencies.

Equivalent in millions of HK\$	US\$	Euro	Japanese Yen	Total
Spot assets	200	150	500	850
Spot liabilities	(100)	(50)	(100)	(250)
Forward purchases	350	100	100	550
Forward sales	(550)	(400)	(350)	(1,300)
Net option position	(100)	(200)	(80)	(380)
Net long (short) position	(200)	(400)	70	(530)
Net structural position	US\$ 180	Can\$ (15)	Euro (40)	Total 125

GUIDANCE NOTE ON OVERDUE AND RESCHEDULED LOANS

1. Overdue advances can be broadly classified into the following types –
 - i. Loans with a specific expiry date e.g. a term loan, inward bill loan, advance against trust receipt, packing loan and other loans of similar nature - these loans should be treated as overdue where the principal or interest on it is overdue and remains unpaid as at the end of the financial period.
 - ii. Loans repayable by regular instalments e.g. residential mortgage loans, hire purchase loans and personal loans - these loans should be treated as overdue when an instalment payment is overdue and remains unpaid as at the end of the financial period.
 - iii. Loans repayable on demand e.g. demand loans and overdrafts - these loans should be treated as overdue where one or both of the following conditions are met:
 - a demand for repayment has been served on the borrower but repayment has not been made in accordance with the instruction; *or*
 - the loan has remained continuously outside the approved limit that was advised to the borrower for more than the period in question (e.g. three months or six months).
2. The period of overdue of a loan which has a determinable due date should be counted from the date following such due date.* The whole amount of a loan should be classified as overdue even if part of it is not yet due and the date used to determine whether it is overdue should be the earliest due date of such a loan. For example, if the longest overdue instalment of a loan repayable by monthly instalments has been overdue for more than six months as at the end of the financial period, the entire amount of the loan should be reported as overdue for more than six months.
3. Rescheduled advances refer to those that have been restructured or renegotiated because of a deterioration in the financial position of the borrower or of the inability of the borrower to meet the original repayment schedule and for which the revised repayment terms, either of interest or of repayment period, are ‘non-commercial’ to the institution. Rescheduled advances do not include the following:
 - Loans rescheduled in response to the changes in market conditions provided that at the time of rescheduling, the loans have been serviced normally, the ability of the borrowers to service the loans according to the revised repayment terms is not

* In the case of a loan repayable on demand, the period of overdue should be counted from the date following either the repayment date specified in the demand for repayment served on the borrower or the date on which the loan first exceeded, and thereafter remained continuously outside, the approved limit notified to the borrower, whichever is earlier.

in doubt and the rescheduled loans are priced at interest rates equal to the current market interest rates for new loans with similar risks.

- Rescheduled loans where there is reasonable assurance that the borrowers will be able to service all future principal and interest payments on the loans in accordance with the revised repayment terms and the borrowers have serviced all principal and interest payments on the loans 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.

4. Rescheduled advances which have been overdue for more than three months under the revised repayment terms should be included under overdue advances and not in rescheduled advances.

DISCLOSURE OF VALUE OF COLLATERAL HELD AGAINST OVERDUE LOANS

The following illustrates how an institution should disclose the collateral value of its overdue loans and the split between secured and unsecured amounts.

HK\$ million

Overdue loans	Outstanding loan amount	Market value of security	Secured amount	Unsecured amount
A	10	15	10	-
B	10	7	7	3
C	10	-	-	10
Total	30	22	17	13

Minimum information to be disclosed by the institution:

- Market value of security held against the secured overdue loans: HK\$22 million;
- Secured overdue loans: HK\$17 million; and
- Unsecured overdue loans: HK\$13 million.

Where multiple loans extended to one borrower are in aggregate secured partially by the same collateral, and one of the loans has been overdue for more than 3 months, the proportion of the value of the collateral held against the overdue loan disclosed should be the same as the proportion of the value of the collateral held against the different loans in aggregate. For example, if the different loans to one borrower are in aggregate 80% secured by the same collateral, it is assumed that each of the loans, including the overdue loans, should also be 80% secured. The institution should therefore disclose as the value of the collateral held against the overdue loan 80% of the outstanding amount of the overdue loan. If, however, the market value of the collateral has fallen to below 80% of the aggregate outstanding amount of the loans, the value of the collateral held against the overdue loan should also be adjusted accordingly.

Annex F

MAPPING THE PROFIT AND LOSS INFORMATION IN THE DISCLOSURE STATEMENT TO THE BANKING RETURN

Number

Name of return

MA(BS)1C

Return of Current Year's Profit and Loss Account

Disclosure statement		Banking return	
Item	Description	Return/Item	Description
(i)	Interest income	<i>MA(BS)1C</i> <i>I.1.1</i>	Interest income
(ii)	Interest expense	<i>MA(BS)1C</i> <i>I.1.2</i>	Interest expense
(iii)	Other operating income	<i>MA(BS)1C</i>	
	- Gains less losses arising from dealing in foreign currencies	<i>I.2.1A</i> <i>I.2.1B</i>	Gains less losses arising from trading in foreign currencies Gains less losses arising from non-trading activities in foreign currencies
	- Gains less losses on securities held for dealing purposes	<i>MA(BS)1C</i> <i>I.3.1</i>	Investments held for trading
	- Gains less losses from other dealing activities	<i>MA(BS)1C</i> <i>I.2.2</i> <i>I.2.3</i>	Gains less losses arising from trading in interest rate derivatives Gains less losses arising from trading in other derivatives
	- Others	<i>MA(BS)1C</i> <i>I.3.2</i> <i>I.3.3</i> <i>I.4</i> <i>I.6</i>	Dividend from subsidiary/associated companies and other investments Other investments Income from fees and commissions Other income
(iv)	Operating expenses	<i>MA(BS)1C</i> <i>I.8</i> <i>I.9</i> <i>I.11</i>	Staff and rental expenses Other expenses Net charge for other provisions
(v)	Charge for bad and doubtful debts	<i>MA(BS)1C</i> <i>I.10</i>	Net charge/(credit) for debt provision
(vi)	Gains less losses from disposal of tangible fixed assets	<i>MA(BS)1C</i> <i>I.5</i>	Profit/(loss) on sale of fixed assets
(vii)	Profit before taxation	<i>MA(BS)1C</i> <i>I.13</i>	Operating profit/(loss) before tax and exceptional items
(viii)	Taxation charge	<i>MA(BS)1C</i> <i>I.15</i>	Net charge for tax provision
(ix)	Profit after taxation	<i>MA(BS)1C</i> <i>I.18</i>	Profit/(loss) for the period