Asia Focus

COUNTRY ANALYSIS UNIT FEDERAL RESERVE BANK OF SAN FRANCISCO JUNE 2009

A Comparison of Loan Loss Allowance Practices in Asia

The financial crisis has ignited worldwide debates about numerous policy issues in the financial services industry; among them is the treatment of loan loss allowance. Historically, the determination of loan loss allowance has been controversial at times because of its subjective nature and the need to balance the transparency emphasis of financial statements with the prudential focus of regulatory expectations. The ongoing challenge of balancing transparency and prudence has been amplified by the current global economic downturn. This *Asia Focus* provides a brief background on loan loss allowance and the associated supervisory guidance in the United States and compares different applications of loan loss allowance regulatory and accounting standards in some Asian economies. The report also highlights proposed alternatives for reconciling the varying goals of loan loss allowance practices and provides a brief assessment of their potential impact on Asia.

Loan Loss Allowance: Background and Purpose

A bank's loan loss allowance is a contra-asset valuation account maintained to cover credit losses that are both *probable* and *reasonably estimable* on the date of evaluation. The loan loss allowance is not a cushion against future losses; such protection is provided by the bank's capital base. Determining the loan loss allowance requires a great deal of judgment and, therefore, the process is inevitably imprecise. The process is not only *quantitative* but also *qualitative*. For example, factors influencing an appropriate loan loss allowance include historic loss data on a portfolio of loans as well as environmental considerations such as geographical and economic conditions.

Banks must follow relevant accounting principles when determining their loan loss allowance levels. Both U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standard (IFRS) address probable losses that are inherent in a bank's loan portfolio, reflecting the concept of "incurred loss" (meaning losses that have already been incurred as of a financial statement date). However, neither accounting framework addresses the concept of "expected losses," which include losses that are probable based on events expected *after* the financial statement date.

Why the controversy?

Loan loss allowance has historically been controversial because its dual goals of transparency and prudence are not always complementary. Market participants that tend to emphasize transparency—including securities regulators and investors—are often concerned primarily with the accuracy of reported earnings. They frequently point out that excessive or inadequate loan loss allowance can obscure the transparency of financial statements, making it difficult for users of the statements to determine the true financial condition of a banking institution. These market participants also contend that the high degree of judgment used in establishing a loan loss allowance may result in earnings manipulation. In contrast, although other market participants such as bank regulators and central bankers also value transparency, their primary focus is on the safety and soundness of the banking system and protection of the deposit insurance funds. From this prudential perspective, lessons learned from past banking crises provide support for higher allowance levels which include significant cushions for "expected losses" that are not addressed by current accounting standards. These more conservative allowance levels can help reduce volatility not only in the performance of individual banks but also in overall banking and financial markets.

Regulatory Approach in the United States

U.S. regulators require banks to follow accounting principles and to adopt a sound methodology when determining the loan loss allowance. Under the U.S. regulatory system, loans are classified into five categories: pass, special mention, substandard, doubtful, and loss.[i] In the past, some banks relied solely on so-called "regulatory benchmarks" to gauge their allowance level; they would apply assigned percentages against loans in each category to calculate their allowance amount. To reiterate the need to follow relevant GAAP[ii] standards, U.S. banking agencies issued an Interagency Policy Statement in 2006 which removed references to regulatory benchmarks and highlighted the importance of developing and applying sound allowance methodologies[iii] when estimating the amount of loan loss allowances. In addition, the U.S. banking agencies attempted to strike a balance between transparency and prudence by indicating that the allowance level should be "prudent, conservative, and not overly excessive."

Asia

In Asia, many jurisdictions have converged or have announced their intention to converge with IFRS.[iv] Consistent with U.S. GAAP, *International Accounting Standard 39* (IAS 39) states that the assessment of credit losses should be based on the use of individual and collective impairment approaches. IAS 39 also articulates the concept of incurred loss. However, several Asian economies complement these international standards with guidance that requires the application of reserve percentages based on a locally defined set of loan classification terms. Their loan classification systems are generally comparable across jurisdictions and similar to those in the United States – i.e., they use some variation on the loan grade categories of pass, special mention, substandard, doubtful, and loss. Therefore, differences across economies lie primarily in the percentages assigned to each category. Table 1 below compares the current loan loss allowance guidelines and reserve factors assigned for each loan grade category in Hong Kong, South Korea, the Philippines, and Taiwan.

Hong Kong

Since 2005, Hong Kong has formally incorporated IFRS into its accounting framework. Hong Kong adopted IAS 39 and renamed it Hong Kong Accounting Standard (HKAS) 39. However, supervisory guidance published by the Hong Kong Monetary Authority (HKMA) still permits provisioning based on certain established benchmarks and loan classifications if loan losses cannot be reliably estimated *(see Table 1)*.[v] Above and beyond what is already required under HKAS 39 or determined using established benchmarks, the Hong Kong Banking Ordinance also requires all supervised institutions to consider "future economic trends in the markets in which they operate," thereby applying the expected loss concept to their provisioning practices.[vi] This "future" portion is referred to as "regulatory reserve" and included as part of equity for financial reporting. There are no established minimum benchmarks as financial institutions must consult with the HKMA when determining this "future" amount but regulatory guidance stated that HKMA's indicated figure for the "regulatory reserve" is between 0.5 and 1 percent of total loans.[vii]

South Korea

Since the 1997-1998 Asian Financial Crisis, South Korean authorities have made significant strides in bringing domestic accounting standards in line with IFRS, with implementation of standards scheduled to be completed by 2011. IAS 39 will be adopted through Korea *International Financial Reporting Standard 1039* (K-IFRS 1039), which becomes effective for banks in 2011. Currently, South Korean banks are required to apply a set of "forward-looking criteria" (FLC) when determining the loan classification and loan loss allowance for a corporate borrower.[viii] The FLC determines credit risk by evaluating factors such as a borrower's financial condition and management capacity as well as *future* cash flow projections in relation to a borrower's debt, placing less emphasis on collateral value and bankruptcy status. Supervisory guidance then requires banks to maintain minimum loan loss allowance levels based on the grades they assign to each loan and the associated benchmark percentages designated by South Korea's Financial Services Commission *(see Table 1)*.

Table 1: Loan Loss Allowance Minimum/Benchmark Percentages by Loan Grade Category

Loan Grade Category†	Hong Kong††	South Korea‡	Philippines	Taiwan
Pass	None	0.9%	1%†††	None
Special Mention	None	7%	5%	2%
Substandard	20% - 25%	20%	10 - 25%	10%
Doubtful	50% - 75%	50%	50%	50%
Loss	100%	100%	100%	100%

† Categories are consistent with loan grade terms used in the United States.

†† These percentages are for unsecured portion and are only used when loss estimates are unreliable. A "regulatory reserve" with no minimum benchmarks assigned (HKMA has an indicated figure between 0.5 and 1 percent of total loans) may be reported as part of equity.

††† This is the "general" allowance, and has a subcategory designated as restructured unclassified loans that has been assigned five percent instead of one percent.

‡ For large corporate and small-to-medium loans only.

Philippines

Effective January 1, 2005, the Philippines adopted all IFRS standards with slight modifications described as "transition relief." Therefore, accounting for provisioning in the Philippines largely follows guidelines outlined in IAS 39 and considers both individual and collective impairment. However, for prudential reporting purposes, the central bank, Bangko Sentral ng Pilipinas (BSP), requires supervised institutions to report the *higher* of IAS-based provisioning and BSP-recommended provisioning *(see Table 1)*. The latter is the sum of the "specific" and "general" allowance; the specific allowance is determined by applying a benchmark percentage to the outstanding balance of each loan based on its grade category, and the general allowance is the sum of one percent of total unclassified loans and five percent of restructured unclassified loans.[ix]

Taiwan

Taiwan has also made significant efforts to align local accounting standards with international practices. Taiwan's *Statement of Financial Accounting Standard 34* (SFAS 34) discusses the individual and collective approaches but amendments made to better align with IAS 39 do not apply until January 1, 2011. As outlined in a regulation dated July 2005, the local supervisory authority currently requires minimum allowance levels using certain percentages based on designated loan grades *(see Table 1)*.[x] In addition, Taiwanese banks are required to set aside between 10 and 30 percent of net earnings as a legal reserve.[xi] While not explicitly designated for loan losses, the legal reserve is similar to the "regulatory reserve" in Hong Kong.

Observations

While Asian economies are gradually moving toward adopting IFRS, regional regulatory expectations continue to demonstrate a distinct perspective. Across Asia, the emphasis on regulatory benchmarks remains strong and the imposition of additional reserve requirements tend to reflect a generally conservative approach used by the region's regulators in supervising local banks. From a more global perspective, the differences among regulatory guidelines highlight an ongoing debate about how to balance the needs of two important, yet sometimes competing, goals: transparency and prudence.

The Impact of the Global Financial Crisis

To some observers, the global financial crisis has amplified the somewhat "lagged" aspects of following the incurred loss approach toward loan loss provisioning, while highlighting the positive benefits from more "proactive" approaches, such as the expected loss approach. In an April 2 Communiqué issued from the London Summit, G-20 leaders laid out various plans for financial supervision and regulation, including a call for "accounting standard setters to work *urgently* with supervisors and regulators to improve standards on valuation and provisioning." In June, the U.S. Treasury's Financial Regulatory Reform proposal called for the accounting standard setters to "improve accounting standards for loan loss provisioning by the end of 2009 that would make it more forward looking, as long as the transparency of financial statements is not compromised." In response to critics, the International Accounting Standards Board (IASB) committed itself to revising IAS 39 "in months and not years."[xii] Undoubtedly, changes are on the horizon.

The following table presents a brief summary of two approaches that have been widely discussed:

Methodology	Overview
Expected Loss	Loan loss allowance is based on the expected loss of the loan portfolio at the balance sheet date each year. This is similar to the more forward-looking models used in Hong Kong and South Korea. While this approach aims to promote stability by being more forward looking, it is not IAS-compliant at this time.
Dynamic Provisioning	Primarily based on concepts introduced by Spain's central bank, dynamic provisioning aims to be counter-cyclical and to promote stability by making provisions more evenly over an economic cycle ("through-the-cycle"). To some degree, provision would be based on hypothetical losses and include "allowance against loans not yet booked at the balance sheet date."[xiii] However, this approach is not fully IAS-compliant and relies on substantial historical data over economic cycles to develop a sound model; thus, data collection and model development will be challenging. Other issues would include potential earnings manipulation, consistency and comparability across institutions and economies, and the appropriate role of bank regulators in this process.

In addition to loan loss allowance methodologies, other alternatives have been discussed to address concerns over prudence. One suggestion has been to raise the minimum capital ratio requirements. This approach, however, could have a pro-cyclical effect, thereby exacerbating or creating a credit crunch during a financial crisis. To offset this effect, some analysts have suggested having higher capital requirements during economic peaks and lower requirements during economic troughs. This idea may be difficult to implement mainly due to its unconventional approach of continuously resetting capital requirements. Another alternative has been to allocate separate special reserves apart from retained earnings as part of equity. Special reserves are already common in Asia, with Hong Kong having a "regulatory reserve" designated specifically for expected credit losses. However, a consistent methodology for determining a reserve is needed for comparability.

Implications for Asia

The overall impact on Asia of these potential alternatives depends on many factors, including model assumptions derived from past and forecasted economic data as determined by individual jurisdictions. However, based on current practices and loan loss allowance measures of the four economies reviewed, Hong Kong and South Korea are likely to be least affected by potential changes to provisioning rules. In addition to adopting IFRS, Hong Kong has an approach that already considers two of the four alternatives listed above and includes relatively higher reserve percentages compared to those assigned by the other economies. In aggregate, South Korean banks historically have maintained allowance levels that cover nonperforming loans by a factor of more than 1.5, primarily because of the conservative reserve factors assigned to the "pass" and "special mention" portfolios. Also, South Korean banks already consider FLC as part of the current methodology used to assign loan grades. In contrast, the Philippines and Taiwan are likely to be more impacted by potential changes to standards on provisioning. While financial institutions in both regions have demonstrated improving asset quality trends during the last decade, the elevated level of nonperforming loans in the Philippines and the relatively low nonperforming loan coverage in Taiwan leave both economies open to a more significant impact *(see Table 2)*.

Conclusion

With financial leaders and market participants advocating for a more unified approach to determining loan loss allowance, more changes are on the horizon. Due to the sensitive and evolving nature of the subject, it is difficult to predict how loan loss allowance approaches will change in the coming months and how Asia will be affected by such changes. What is certain is that both accounting standard-setters and regulatory bodies around the world will be taking a closer look at new approaches and alternatives to minimize future volatility while upholding transparency.

[i] Commercial Bank Examination Manual, The Federal Reserve System Board of Governors,
[ii] Key accounting guidance: SFAS 5 discusses loss estimates for groups of loans with similar risk characteristics and SFAS 114 addresses individual loans identified for evaluation.
[iii] Supervisory and Regulation Letter 06-17, *Interagency Policy Statement on the Allowance for Loan and Lease Losses*
[iv] March 2008 *Asia Focus:* "Implementing IFRS in Asia: Bringing Greater Transparency and Comparability to Asian Banks' Financial Statements."
[v] General Principles of Credit Risk Management and Credit Administration, Measurement and Monitoring
[vi] Hong Kong Banking Ordinance, Schedule 7, section 9 requires authorized institutions to maintain adequate provisions for devaluation of assets (including provisions for bad debts) and for losses which *will* or *may occur*.
[vii] Impact of the New Hong Kong Accounting Standards on AI's Capital Base and Regulatory Reporting
[viii] *Financial Supervisory System in Korea (2007),* Financial Supervisory Service (South Korea), August 12, 2008
[ix] BSP, Manual of Regulations for Banks, Part III Loans and Appendix 18, updated as of December 2007
[x] *Regulations Governing the Procedures for Banking Institutions to Evaluate Assets and Deal with Non-performing/Non-accrual Loans*
[xi] Article 50 of The Banking Act (Amendments approved in December 2008 authorized the competent authority to set out the standards for financial soundness, which could exempt a bank from the 30 percent legal reserve requirement. However, the rule settings have not been finalized.)
[xii] At the IASCF Trustees' meeting on April 2, 2009, the Chairman of the IASB (Sir David Tweedie) promised that proposals to replace existing financial instrument standards would be published within six months. These include impairment loss models, such as the "incurred model."
[xiii] "Can accounting standards save the G20?" by Iain Martin, Accountancy Age, April 2, 2009
[xiv] Data gathered from the Financial Supervisory Service (South Korea), Bangko Sentral ng Pilipinas (the Philippines), Financial Services Commission (Taiwan)

Table 2: Common Loan Loss Allowance Measures and Asset Quality Indicators[xiv]

December 31, 2008[‡]	South Korea	Philippines	Taiwan
Nonperforming Loans (NPL) / Total Loans (%)	1.16	3.52	1.52
Loan Loss Allowance / Total Loans (%)	1.69	3.52	1.16
NPL Coverage Ratio (X)	1.45	1.00	0.70
Number of Institutions Included	14	38	37

[‡] Data were not available for Hong Kong.

Contacts: Walter Yao (walter.yao@sf.frb.org) and Nkechi Carroll (nkechi.carroll@sf.frb.org)
Written by: Grace Li and Walter Yao