WORLD BANK WORKING PAPER NO. 1

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Edited by
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FOREWORD

How banks account for credit losses in their loan portfolios is important for the presentation of banks' financial positions in their financial statements. Therefore accounting for credit losses is an area of significant interest for banking supervisors worldwide. Furthermore, banks need loan classification or grading systems to monitor and manage the credit risk in their loan portfolios. Many countries that do not belong to the Group of 10 also use such classifications to quantify provisioning requirements.

Despite its relevance, a well-recognized international standard to which national authorities and bank supervisors may refer is unavailable. The absence of international consensus is evident in the varying number of loan classification categories, the treatment of multiple loans when one loan is in default, the inclusion or exclusion of loan guarantees and collateral values when classifying a loan, the level of supervisory involvement in banks' loan review processes, the treatment of restructured loans, the number of days used to define past due loans, the tax treatment of loan loss provisions, the backward- or forward-looking nature of losses to be provisioned, and the often poor disclosure standards.

This report favors the development of a more homogeneous regulatory approach by presenting the findings of a World Bank survey of loan classification and provisioning practices in countries represented on the Basel Core Principles Liaison Group. The survey covers a broad spectrum of regulatory practices across countries of different sizes, locations, and levels of development.

While documenting the many differences among national regulatory approaches and practices, this report also clearly shows an increased awareness of the importance of proper loan classification and provisioning procedures in the participating countries, almost all of which have either introduced or updated their policies in the last decade. This awareness is an important precondition for defining a set of guiding principles for loan classification and provisioning that are more firmly grounded in sound risk management.

Cesare Calari
Vice President, Financial Sector
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ABSTRACT

This report reviews loan classification and provisioning practices in a broad sample of countries that differ in size, location, and level of financial development. The survey conducted for the report compares the regulatory approaches adopted by industrial and emerging economies, and is intended to complement other sources of information that focus exclusively on either industrial or developing countries.

The survey provides an overview of the systems prevailing in the 23 jurisdictions represented in the Basel Core Principles Liaison Group at the end of 2001. It covers a comprehensive list of features, including classification of individual and multiple loans, treatment of guarantees and collateral, bank loan review processes, restructured troubled loans, loan loss provisioning, tax treatment of loan loss provisions, disclosure standards, and external auditors' role. It makes no attempt to detect discrepancies between regulations and their enforcement, and therefore the effectiveness of rules may vary across countries.

Differences in provisioning and classification approaches have often made a comparison of bank and banking system weaknesses across regulatory regimes difficult, and such differences have made peer pressure and market discipline less effective. In some instances poor classification and provisioning practices have led to solvency ratios that gave a false sense of security, as occurred when seemingly adequately-capitalized financial systems failed in the 1990s.

Successful regulatory harmonization therefore requires a set of minimum standards for loan classification that is grounded in sound risk management practices, but that is also sufficiently general to recognize differences in national economic and legal environments. The evidence this survey provides is intended to contribute to this difficult task.

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This paper has been prepared by a World Bank team coordinated by Alain Laurin and Giovanni Majnoni and composed by Gabriella Ferencz, Samuel Munzele Maimbo, Rashmi Shankar, and Fatouma Toure Ibrahima Wane. The survey would not have been possible without the support and active cooperation of the Core Principle Liaison Group (CPLG) of the Basel Committee, of its chairman, Danièle Nouy, and of bank supervisors in all participating countries. Extensive reviews and comments were received from the CPLG's members and from IMF and World Bank colleagues as well as from the Accounting Task Force of the Basel Committee. The paper aims to provide an accurate representation of the systems prevailing in the participating countries as of December 2001. All remaining errors and omissions are the sole responsibility of the authors.

I

INTRODUCTION

Loan classification refers to the process banks use to review their loan portfolios and assign loans to categories or grades based on the perceived risk and other relevant characteristics of the loans. The process of continual review and classification of loans enables banks to monitor the quality of their loan portfolios and, when necessary, to take remedial action to counter deterioration in the credit quality of their portfolios. It is often necessary for banks to use more complex internal classification systems than the more standardized systems that bank regulators require for reporting purposes and that are intended to facilitate monitoring and interbank comparisons. Unless explicitly stated, this report discusses regulatory classification systems, not internal classification systems.

From an accounting perspective, loans should be recognized as being impaired, and necessary provisions should be made, if it is likely that the bank will not be able to collect all the amounts due—principal and interest—according to the contractual terms of the loan agreement(s). Loan loss provisioning is thus a method that banks use to recognize a reduction in the realizable value of their loans. Bank managers are expected to evaluate credit losses in their loan portfolios on the basis of available information—a process that involves a great deal of judgment and is subject to opposing incentives. Sometimes banks may be reluctant to account for the whole amount of incurred losses because of the negative effect of provisions on profits and on shareholders' dividends. In other cases, if provisions are tax-deductible, banks have an incentive to overstate their loss provisions and to smooth profits over time in order to reduce the amount of tax liability.

Both loan classification and provisioning present a number of conceptual and practical challenges, and diverse systems are used in different countries. Though similarities exist, there is a lack of internationally recognized definitions. For example, the terms *specific provisions* and *general provisions* are present in many regulatory frameworks, but their definitions and uses vary across countries. As a result of these differences, the definition of regulatory capital in different institutional frameworks varies and makes it difficult to interpret crucial financial ratios, especially when comparing banks' financial performance across countries. There are also differences in the amount of time that elapses before a loan is considered past due and in the extent of provisioning applied to impaired loans with the same characteristics and risk profile. Being aware of these differences is crucial to interpreting banks' financial and capital ratios correctly.

Regardless of prevailing rules, the provisioning and loan classification process is often a matter of judgment. Thus, assessments may vary markedly between different assessors—such as bank managers, external auditors, and bank supervisors—and across countries. Also, the national legal infrastructure affects the timely enforcement of the terms of loan contracts. For example, in countries with a strong legal infrastructure loans tend to be classified as past due relatively soon after the borrower misses a payment In countries where the quality of the legal infrastructure is weak, however, the period between an omitted payment and the revision of the loan classification may be longer.

Approaches also differ concerning whether and how collateral should be considered when classifying loans and determining the appropriate provisions. Not all regulatory frameworks recognize the same forms of collateral, and there is no consensus on the evaluation criteria of pledged assets, for example, according to their marketability. All these elements make it difficult to compare countries' rules on loan classification and provisioning.

Although the International Accounting Standards Board (IASB) has issued standards on asset valuation and disclosure, it has not yet provided detailed guidance on loan provisioning. As a result, countries that implement the International Accounting Standards still have different loan loss provisioning regulatory frameworks.

The Basel Committee is also paying increasing attention to accounting and auditing issues, as evidenced by the committee's analyses of and comments on important documents drafted by other bodies[1] and by its development of sound practices papers. Of particular interest in this context is the Basel Committee's paper "Sound Practices for Loan Accounting and Disclosure" (July 1999). That paper, which provides important guidance on loan accounting, accounting for credit losses and disclosure was drafted to be consistent with IAS 39, "Financial Instruments: Recognition and Measurement."

Even though the Basel Committee's paper provides sound principles, it is too early to determine the extent to which it will result in a more consistent approach to loan classification and provisioning across countries. As noted in the paper, there is neither a uniform loan classification technique, nor a standard procedure to assess loan risk. Furthermore, several concepts are susceptible to different interpretation. For example, the notion of "objective evidence" referenced in the paper involves mainly backward-looking criteria at a time when supervisors (such as those in Spain) envisage adopting a more forward-looking approach.

Despite the trend toward harmonization of bank regulations made possible by the Basel Committee's endeavors, and given the complexity of the desirable features of loan classification and provisioning policies, it may be difficult to develop a consensus on the most suitable type of regulation in these areas.

The Basel Committee is currently developing a new Capital Accord ("Basel II"). This effort is aimed at increasing the risk sensitivity of capital requirements and providing incentives for banks to improve risk management. The new Capital Accord is likely to be a factor of change toward better classification regimes, as banks will be required to implement systems that separate loans into categories based on the probability of default. Thus, it is expected that a greater homogeneity of classification systems will follow from the adoption of criteria that are less dependent on subjective judgment and more on objective quantitative factors.

1. The Basel Committee's comment letters on draft accounting and auditing standards, as well as its sound practices papers, are available on the BIS website at www.bis org

This paper presents the findings of a World Bank survey of loan classification and provisioning practices in countries represented on the Basel Core Principles Liaison Group (CPLG).[2] The survey conducted for the paper is not the first one to explore national loan classification and provisioning practices, but it does have the distinctive feature of comparing the regulatory approaches adopted by developed and developing economies. Thus, it is a useful complement to other sources of information that focus on either developed or developing countries. Although the sample—members of the Basel Core Principles Liaison Group—is limited in scope, it provides a broad representation of countries that differ in size, location, and level of financial development.

Differences in provisioning and classification approaches have often made it difficult to compare bank and banking system weaknesses across regulatory regimes, making peer pressure and market discipline less effective. In some instances, poor classification and provisioning practices have led to solvency ratios giving a false sense of security, as noted when apparently "adequately" capitalized financial systems failed in the 1990s. These differences, though, are not just the result of inadequate coordination among national supervisors At times, they address specific needs of financial systems at different levels of development. Successful regulatory harmonization therefore needs to recognize these conflicting features by defining a set of minimum standards for loan classification that are grounded in sound risk management practices but also sufficiently general to recognize differences in national economic and legal environments. The evidence provided by this survey is intended as a contribution to this difficult task.

2 The CPLG was established in 1996 so that Basel members as well as bank supervisors from non-G-10 countries could exchange views on universally applicable bank supervision standards This endeavor resulted in adoption of the Core Principles for Effective Supervision in 1997. Since then, the CPLG has met regularly to discuss bank supervision issues The CPLG includes Argentina, Australia, Brazil, Chile, China, the Czech Republic, France, Germany, Hong Kong, India, Italy, Japan, the Republic of Korea, Mexico, the Netherlands, the Russian Federation, Saudi Arabia, Singapore, South Africa, Spain, the United Kingdom, the United States, the West African Monetary Union, the European Commission, the Financial Stability Institute, the International Monetary Fund, and the World Bank

2

Regulatory and Supervisory Authority

With no international standard, national authorities and bank supervisors have designed their own regulations on loan classification and provisioning according to the specific nature of their regulatory environment.

In some countries, the rules are developed by private sector accounting standard-setting bodies; in others, the rules are issued by Parliament, the Ministry of Finance, or the banking regulator. In countries where the accounting rules for banks are not made by the banking regulators, regulators are normally consulted or offered an opportunity to comment on proposed changes in the rules (Table 1).

The banking regulator may act independently in issuing loan classification regulations, or may be required to obtain approval from the Minister of Finance (South Africa) or a committee representing both supervisors and the Ministry of Finance (Brazil, France). In addition, supervisors are often empowered to implement these regulations.

Most of today's classification regulations were enacted in the past 10 years, reflecting a growing awareness among banking supervisors of the importance of a classification system as the foundation for proper loan provisioning. Regulations have also recently been amended in order to add disclosure requirements (Brazil, China, Spain), tighten rules on collateral (Czech Republic), or update the regulation on classification and provisioning (India, Italy, Japan, Spain). Taken as a whole, these recent developments signal a growing awareness of the need to upgrade such regulations, in line with international best practices, in order to reduce the likelihood that inadequate loan classification and provisioning may result in bank failures.

TABLE 1. BANK SUPERVISORS' AUTHORITY TO ISSUE LOAN CLASSIFICATION RULES

Group/Country	Does the supervisory agency have the authority to issue a prudential regulation on loan classification?	Does a specific regulation exist for loan classification? When was it enacted?	Has there been a major overhaul since the regulation was enacted?
G-10			
France	No, but closely involved	1994	No, waiting for an international accord (Basel)
Germany	Yes	1994	No
Italy	Yes	1989	Yes; the categories "substandard" and "restructured" were added.
Japan	Yes	1989	No
Netherlands	Yes	No specific regulation[a]	-
United Kingdom	Yes	Yes[b]	No
United State	Yes[c]	1979[d]	No, but additional classification guidelines have been developed for troubled commercial real estate loans and for retail credit.
Non-G-10			
Argentina	Yes	1994	Yes, classification system amended
Australia	Yes	1995	Yes, in 2000, regulation was extended to nonbank deposittakers.
Brazil	Yes, but requires approvall by the National Monetary Council	1999	Amendments on disclosure policy
Chile	Yes	1982	Yes, in 1997
China	Yes	1988	1998 and 2002
Czech Republic	Yes	1994	Amendments on rules on collateral in 1998[e]
Hong Kong	Yes	1994	Yes, classification system amended
India	Yes	1993	Yes, new rules for classification of doubtful assets. A new regulation for a 90-day delinquency norm for asset classification becomes effective March 31, 2004.
Korea, Rep. of	Yes	1999	No
Mexico	Yes	2000	No
Russian Federation	Yes	1997	There have been several amendments.

TABLE 1. BANK SUPERVISORS' AUTHORITY TO ISSUE LOAN CLASSIFICATION RULES (*Continued*)

Group/Country	Does the supervisory agency have the authority to issue a prudential regulation on loan classification?	Does a specific regulation exist for loan classification? When was it enacted?	Has there been a major overhaul since the regulation was enacted?
Non-G-10 (*Continued*)			
Saudi Arabia	Yes	1994	Framework is currently reviewed.
Singapore	Yes	1983	Yes, on classification and provisioning
South Africa	Yes, but requires approval of the Ministry of Finance	2001	Yes, on provisioning
Spain	Yes	1981	No, but there have been several amendments. The "statistical provision" and the requirement of disclosure were added in 2000.
West African Monetary Union (WAMU)	No, this power rests with the regional central bank but the Banking Commission is closely involved.	1991	Yes (1996 and 1999)

Notes:

a. Banks are required by the supervisor to have in place procedures for identifying troubled credits on an ongoing basis. A classification of country risk exposures for prudential purposes is required.

b. In the UK, although there is no regulation on how firms should classify loans, supervisors expect firms to have a mechanism for identifying impaired assets and for determining the adequacy of their provisions.

c. The U S. banking agencies have issued loan classification standards as part of their examination procedures rather than as a regulation.

d. A revision of examination procedures was established in 1938 and revised in 1949.

e. A new regulation should be introduced in 2003.

3

LOAN CLASSIFICATION

Even a cursory review of classification systems reveals the absence of international consensus on loan classification approaches. The approaches used to classify loans are considered either a management responsibility or a regulatory matter. Among G-10 banking regulators, the United States and, to some extent, Germany use a classification approach. In countries with no detailed regulatory classification regime, bank managers are normally responsible for developing necessary internal policies and procedures to classify loans. A typical view in such countries is that in this area the role of external parties—including supervisors and external auditors—should be restricted to providing an opinion on whether banks' policies are adequate and if they are implemented in a satisfactory and consistent way.

In the United Kingdom, the supervisor does not require banks to adopt any particular form of loan classification. Nevertheless, supervisors do expect banks to have a proper risk management process, including prudent appraisal of loans, which should be updated regularly. There is no recommendation on the number of classification categories banks should use, but that does not preclude supervisors from instructing banks to revise their classification systems. A similar approach is taken in the Netherlands, except that in the Netherlands banks are required by the supervisor to have in place procedures and systems for identifying, measuring and monitoring troubled credits on an ongoing basis. The procedures and systems adopted by banks are subject to periodic review by the supervisor. France has enacted a system based on minimum requirements for loans to be considered impaired (doubtful) without issuing any prescriptive guidance on classification (loans are either normal or impaired). It is up to banks to work out internal classifications. A similar approach is used in Italy, where five types of loans are considered, but only general guidance is provided for implementation.

Though they also emphasize market discipline and managers' judgment, some G-10 countries have opted for a more prescriptive approach. For example, the U.S system classifies loans into five categories based on a set of criteria ranging from payment experience to the environment in which the debtor evolves. This system seeks to curb the risk of excessive bank discretion, even though some judgmental inputs play a crucial role.

The adoption of this system by many countries points to the usefulness of a structured approach that facilitates the supervisor's ability to analyze and compare banks' loan portfolios. Such a system could also provide an input for banks and supervisors when discussing whether adequate provisions have been made. However, the adoption of such systems has not resulted in identical frameworks because supervisors have customized their approaches to fit their environments. For example, German banks are expected to classify certain loans into four categories (loans with no discernible risk, loans with increased latent risk, nonperforming loans, and bad loans). Japan recently formulated new guidelines on loan classification to enhance inspection and supervision and, in turn, the credibility of the country's financial system.

Many non-G-10 countries have adopted loan classification systems of varying complexity (with the number of loan categories ranging from three to nine) to capture increasing risk and diminishing recovery prospects. Where inadequate classification is common, supervisors have tried to establish detailed rules to encourage prudent behavior and help level the playing field.

Brazil has adopted a nine-category system and established a list of factors that banks should consider when classifying their loans. The list includes both qualitative and quantitative factors related to each loan, the debtor, and the environment in which the debtor operates. The Czech Republic has adopted a five-category system based on the number of days in arrears and a qualitative assessment based on updated financial information on the debtor. A new regulation, which should be adopted in 2003, will allow banks to determine provisioning requirements for certain group of loans on a portfolio basis. China strongly encourages banks to adopt a refined loan classification system and use the supervisory five-category loan classification system as a minimum. Spain has adopted a six-category classification system that implies a multifaceted review. Mexico's system involves several steps. It starts with an assessment of the debtor, which determines the classification within seven categories Banks can then adjust their initial classification if adequate collateral can provide some comfort on the extent of the recovery. Singapore's classification system includes five grades. Several countries have enacted specific rules for residential mortgages (Chile, Mexico) and credit card loans (Mexico), given the peculiarities of these types of credit.

A term that is used in many loan classification regimes is "nonperforming loans" (NPL). However, this term has many different meanings. In some countries, nonperforming means that the loan is impaired. In other countries, it means that payments are past due, but there are significant differences among countries as to how many days a payment should be in arrears before past due status is triggered. Nevertheless, a rather common feature of nonperforming loans appears to be that a payment is "more than 90 days" past due, especially for retail loans. Where the criteria for designating a loan as nonperforming are largely discretionary for banks, the comparability of NPL over time may be affected by changes that individual banks make to their definition of the term.

Loan classification criteria generally appear to rely both on ex-ante and ex-post signals of loan quality, although the balance between the two is difficult to ascertain. Ex-post criteria include the number of days a loan is past due and, more broadly, the current condition of the debtor. In most of the countries surveyed, the number of days of past-due payments represents a minimum condition for loan classification purposes, but other criteria, some of which exhibit forward-looking features, are considered as well. A satisfactory forward-looking approach, though, requires an accurate assessment of the expected probability of default and is therefore still uncommon.

4

Classification of Multiple Loans

A bank's exposure to an individual customer or to related parties often involves different types of loans, including short-term facilities and overdrafts, with different risk profiles. Although it is not unusual to observe different performances for different loans granted to the same borrower, difficulties with one loan could be a harbinger of the debtor's deteriorating financial condition, which is likely to affect other loans. In such cases, it is important for supervisors to avoid creating regulatory loopholes and to provide banks with clear rules on how to deal with multiple loans.

Classification methods for multiple loans to the same client vary by country, and different methods generate differences in provisioning. At one end of the spectrum, several countries (such as Brazil, Czech Republic, France, India, and South Africa) believe that once a loan is classified as impaired, all other loans to the same customer should be classified in that same category (Table 2). Australia's stance is even stricter as all loans granted to related parties in the same group must be treated in the same manner. This provision, however, applies only to facilities that are cross-collateralized.

At the other end of the spectrum, other countries (for example, Korea, Mexico, and Saudi Arabia) take a more flexible approach. Banks' decisions are based on their reviews of each loan's performance, regardless of how the customer's other loans are rated. In Hong Kong, the decision to classify multiple loans to the same borrower is made on a loan-by-loan basis, depending on how each of them is collateralized and guaranteed. Still, a loan can be downgraded—say, by one notch—to account for the impairment of related loans. In Spain, all loans to the same customer are considered doubtful if accrued arrears on all the loans exceed 25 percent of the outstanding exposure. In Germany, while banks are expected to focus on borrower circumstances, not all loans are classified homogeneously.

TABLE 2. CLASSIFICATION APPROACHES TO MULTIPLE LOANS TO THE SAME BORROWER

Group/Country	If a debtor with multiple loans has one nonperforming loan, what effect does it have on the other loans?
G-10	
France	The other loans are similarly reclassified.
Germany	Such decisions are at the discretion of individual banks
Italy	The other loans are similarly reclassified unless the nonperforming loan is small relative to the overall exposure or has been restructured.
Japan	The other loans are not necessarily reclassified.
Netherlands	The effect on other loans is assessed on a case by case.[a]
United Kingdom	No supervisory guidance
United States	The other loans should be evaluated to determine whether one or more should be similarly classified. This determination should be based on an assessment of each individual loan's collectibility and the debtor's payment ability and performance with respect to that loan.
Non-G-10	
Argentina	All loans to the same customer are classified in the same category
Australia	The other loans are similarly reclassified.
Brazil	The other loans are similarly reclassified.[b]
Chile	The other loans are similarly reclassified.
China	Left at banks' discretion
Czech Republic	The other loans are similarly reclassified.
Hong Kong	Such decisions are at the discretion of individual banks, but downgrading is recommended.
India	The other loans are similarly reclassified.
Korea, Rep. of	The other loans are similarly reclassified. Exceptions are specified for high-quality loans.
Mexico	The other loans are not necessarily reclassified, but they cannot be classified in the three top categories.
Russian Federation	The other loans are similarly reclassified.
Saudi Arabia	The other loans are similarly reclassified.
Singapore	The other loans are similarly reclassified for customers who are the principal borrowers. There may be exceptions when the customer is a joint borrower and repayment depends on the other borrower, who has demonstrated an ability to repay the loan.
South Africa	No effect except for retail loans.
Spain	All loans to the same customer are considered doubtful if accrued arrears on the same customer exceed 25 percent of the outstanding exposure.
WAMU	The other loans are similarly reclassified.

Notes

a. There is a presumption that the other loans to the same borrower or to a group of connected borrowers would be reclassified to a higher risk category, as credit worthiness of the debtor is the basis for the judgment.

b. There may be exceptions depending on the loan's nature, and volume and on the value and liquidity of the collateral.

5

GUARANTEES AND COLLATERAL

Determining the appropriate value of collateral is a common problem when provisioning for losses on impaired loans. If the collateral is assigned too high a value, the provision will be insufficient. Although collateral is potentially marketable, banks and, to some extent, supervisors may underestimate or ignore the obstacles caused by weak legal systems and cultural factors in the effective disposal of collateral.

Countries take varying approaches to the treatment of collateral and guarantees in the classification process (Table 3). Several jurisdictions (Czech Republic, France, Spain, and West African Monetary Union (WAMU)) do not take collateral and guarantees into account for classification purposes. As a result, classifications reflect the quality of loans regardless of the prospects for recovery deriving from collateral. Far more countries explicitly factor in the value of collateral, in various ways, when classifying loans. The focus seems to be on estimating the amount of recovery In Australia, loans with interest or principal 90 days past due must be recorded as nonaccrual if the market value of the security is insufficient to cover payment of principal and accrued interest. When the market value is sufficient, the loan should be classified as past due. In Mexico, the initial credit rating is upgraded by one notch if certain conditions are met, one of which is that the guarantor's rating must be higher than that of the debtor. In Singapore, the secured portion of a nonperforming loan is considered substandard, while the unsecured portion is graded as doubtful or a loss. In China, the declining value of collateral or the deterioration of the guarantor's financial condition is a trigger point that results in normal loans being downgraded, and different portions of a loan with an eligible guarantee can be classified differently based on the degree of protection that the underlying guarantee provides. In Japan, only assets secured by the safest collateral (those deemed to be of superior value) will not be reclassified, even when customers experience problems, on the assumption that banks are unlikely to incur any loss.

In many countries, collateral and guarantees are assessed and considered in making loan loss provisions. This is relevant to the extent that banks are able to seize and dispose of collateral within a reasonable period. It is not uncommon, however, for a collateral value to be used without any discount being applied over time—even when the results of banks' recovery attempts are uncertain.

Table 3. Guidelines for Valuing Collateral for Loan Classification and Provisioning

Group/Country	Guidelines
G-10	
France[a]	Collateral does not play a role in classification, but it does play a role in provisioning. Detailed guidance is provided for real estate valuations.
Germany	General guidance is provided for valuing collateral in provisioning.
Italy	Collateral does not play a role in classification, but it does in the measurement of loan provisions.
Japan	Collateral plays a role in loan classification and in provisioning. General guidance is provided for valuation.
Netherlands	Collateral is considered in provisioning.[b]
United Kingdom	Collateral is considered in provisioning.
United States	Banks should value collateral at its fair market value minus the costs of selling it. Banks should consider all guarantees and collateral when determining a loan classification However, a guarantor's performance history and expected future performance should also be considered.
Non-G-10	
Argentina	Collateral does not play a role in classification, but it does play a role in provisioning.
Australia	General guidance is provided for valuation; classification depends on collateral.[c]
Brazil	General guidance is provided for valuation; provisions depend only on classification.
Chile	Not available.
China	The role of collateral and guarantee in reducing the risk of the borrower is recognized. Banks are asked to have adequate policies and procedures on recognition and assessment of collateral.
Czech Republic	Banks have discretion on valuations; as for loss loans, real estate collateral is not taken into account if interest is past due for more than a year on any obligation of the borrower.
Hong Kong	Specific rules exist on valuation; banks set discount margins on collateral depending on its characteristics
India	Collateral plays a role in provisioning. Valuation permitted only by approved valuers.
Korea, Rep. of	General guidance is provided for valuation; the collateralized portion of a loan may be classified as substandard if the loan is doubtful or a loss.
Mexico	The collateralized portion of a loan is upgraded one notch if collateralized with real estate or property, two notches if it is in the form of securities; it is classified as standard if it is in the form of government debt.
Russian Federation	Formal criteria indicate that collateral should be taken into account in loan classification and provisioning. In addition, if bank managers decide to do so, unsecured and insufficiently secured loans may be classified as secured.
Saudi Arabia	General guidance is provided for valuation, which is used in provisioning but not classification. A nonperforming loan may be considered low risk if its net realizable value exceeds the loan's value.
Singapore	General guidance is provided for valuation and nonperforming loans.
South Africa	General guidance is provided for valuation.
Spain	Specific rules are provided for estimating the provisions of collateralized loans.
WAMU	Collateral does not play a role in loan classification; for provisioning, only collateral in the form of liquid financial assets and real estate is considered. The value of physical collateral is discounted by 50 percent after two years and fully discounted after the third year.

Notes:

a. Commission Bancaire has not issued specific guidance.

b. Legal enforceability and liquidity also determine the extent to which credit risk mitigants can lower the level of the provision required.

c. A loan with interest or principal payments 90 days in arrears must be recorded as a nonaccrual item if the net current market value of the collateral is insufficient to cover the overdue principal and interest. Where the market value of the collateral is sufficient, the loan should be classified as a past-due item.

Key issues for collateral include the enforceability of foreclosure provisions and the likelihood of collateral collection. Australia's regulation mentions the enforceability of guarantees as a feature to take into account when setting provisioning levels. To offset the negative impact that collateral collection constraints may have on bank soundness, the Czech Republic requires banks to rapidly depreciate the value of real estate posted as collateral as past-due payments increase, lowering the value of real estate posted as collateral to zero after a year of past-due payments Meanwhile, India requires a higher volume of provisions as past-due payments increase, raising the provision requirements for a doubtful loan from 20 to 50 percent in the first three years. In the WAMU, banks are exempt from provisioning the portion of a loan covered by physical collateral in the form of real estate for the first two years, but required to reach full provisioning, regardless of its valuation, at the end of the fourth year, with a minimum of 50 percent in the third year.

6

Loan Reviews by Banks

The timely review of loan quality for both classification and provisioning purposes is key to keeping management up to date on a loan portfolio's quality. In countries where accounting regulation requires loan review only for the preparation of the yearly financial statements, supervisors may find it necessary to require banks to review their loans more frequently.

All G-10 supervisors (except those in the United Kingdom) have issued rules on how and when banks are expected to review their loan portfolios (Table 4). In France, banks are expected to review every loan at least every quarter so that they can, at least for the largest exposures, regularly reassess their risk profiles. German banks must review all loans once a year. UK banks are required to outline their review process for different business lines in their provisioning policy statement. That way, supervisors can assess the frequency and depth of reviews for each type of lending. In the Netherlands, banks have to report their provisioning levels twice a year. In addition to this reporting requirement, banks are required by the supervisor to perform an analysis of the credit risks to which they are exposed on a systematic basis and to have in place procedures for monitoring troubled credits on an ongoing basis.

Most non-G-10 countries have similarly prescriptive provisions. For Brazilian banks, the review depends on loan delinquency. A monthly review is required for the most impaired loans, and an annual review for other exposures. In China and in the Czech Republic, loans are to be reviewed on a quarterly basis. Hong Kong requires an annual review for all but large exposures, which must be analyzed at least quarterly. Russian supervisors require monthly reviews for loan portfolios, while the WAMU recommends a semi-annual review. In Australia, as in the UK, there is no formal banking regulatory requirement for the periodic review of individual loans, but individual bank practices are documented and assessed as part of the off-site and on-site review processes.

Table 4: Loan Review Procedures

Group/Country	How frequently are loans reviewed?
G-10	
France	Quarterly
Germany	Annually[a]
Italy	Bi-annually for measurement purposes; monthly for classification purposes
Japan	Bi-annually
Netherlands	Continually
United Kingdom	Annually[b]
United States	At least annually for loans subject to individual review; quarterly for the loan portfolio as a whole
Non-G-10	
Argentina	At least annually
Australia	Annually
Brazil	Monthly[c]
Chile	At least annually
China	Quarterly
Czech Republic	Quarterly
Hong Kong	Quarterly
India	Quarterly
Korea, Rep. of	Quarterly
Mexico	Quarterly
Russian Federation	Monthly
Saudi Arabia	Quarterly for classification purposes
Singapore	Regularly. Banks review loans at least annually.
South Africa	Continually; monthly for classification purposes
Spain	Continually; monthly for classification purposes and quarterly for provisioning
WAMU	Bi-annually; monthly for classification purposes

Notes:

a. Assessments must be made quarterly for large exposures.

b. Loans managed individually are expected to be reviewed at least annually, with problem exposures to be reviewed more frequently. However, there is no regulatory requirement to do so

c. Monthly for delinquent loans. For credit operations with a single client or single economic group whose sum exceeds 5 percent of the bank's capital base, assessments should be made semi-annually if possible and, in all cases, annually.

7

CLASSIFICATION OF RESTRUCTURED TROUBLED LOANS

According to the definition in the Basel Committee's 1999 Loan Accounting Paper, a loan is "a restructured troubled loan when the lender, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider " Restructuring the terms of a loan may result in an impaired loan being upgraded even though an upgrade might not be justified. Without adequate safeguards, the extent of impairment could be concealed, since the improvement in quality expected from a bank's restructuring efforts could be unrealistic or even false. Thus, it is worthwhile that regulatory classification regimes provide guidance in this regard—particularly in countries where banks often reschedule loans

Because banks often must modify the initial conditions of a loan—for example, when the debtor is unable to service the debt according to the loan agreement—banks should know how these actions are to be accounted for. Since a lower interest rate or extended repayment schedule (or both) may help the debtor repay the debt, banks often offer these mechanisms to safeguard their assets. This phenomenon can also occur when banks renegotiate the terms of a loan as a result of improved market conditions for customers. Such renegotiations may not raise difficulties for prudential treatment, though thorny issues may still arise—such as whether it is necessary for banks to account for the losses. However, the issue of problem loans being restructured is far more complex Banks may offer new terms to customers who can no longer pay their debt. In such a case, the new terms may provide only temporary relief to the debtor and lead the way to additional concessions In doing so, banks may try to conceal the extent of impairment. Such "evergreening" practices, which include extending the credit facility without amending the contractual interest rate, are difficult to track unless bank supervisors implement proper reporting systems or investigate this issue during on-site examinations.

Most supervisors in G-10 countries do not provide any definition of restructured troubled loans, and they have not issued guidance on how such loans should be classified (Table 5). Italian supervisors define restructured loans as those for which a borrower who was granted a moratorium on repayment in the previous 12 months renegotiates the debt at a below-market rate. If more than a year has

Table 5. Classification Rules for Restructured Troubled Loans		
Group/Country	**Are restructured troubled loans defined by regulation?**	**Classification rules for restructured troubled loans**
G-10		
France	No	
Germany	No	
Italy	Yes	Any loan for which a moratorium was granted on repayment and interest was renegotiated at a below-market rate
Japan	Yes	If lending conditions have been relaxed or modified, then it is classified as a "special attention" loan.
Netherlands	No	
United Kingdom	No	
United States	No[a]	Same rules as for classifying other loans
Non-G-10		
Argentina	No	
Australia	Yes	If the loan's yield is less than average cost of funds, the loan should be classified as nonaccrual.
Brazil	Yes	Same risk level or higher
Chile	Yes	Separate analysis with specific rules
China	Yes	Restructured loans are classified as substandard or worse. If the borrower fails to service the loan after restructuring, it must be classified as doubtful or worse.
Czech Republic	Yes	Restructured loans are classified as substandard or worse if restructuring has occurred in the last 6 months; special mention, between 6 months and 3 years; standard over three years.
Hong Kong	Yes	Restructured loans are classified as substandard or worse.
India	Yes	Losses incurred on restructured loans must be fully provisioned.
Korea, Rep. of	Yes	Restructured loans are classified based on their present value discounted by the adjusted interest rate and full consideration of the revised contract terms.
Mexico	Yes	If restructured loans are considered past due, banks must grant an initial rating, which can be changed when payments become regular.
Russian Federation	Yes	The loan must be classified in a risk group from 1 to 4 depending on the number of extensions and the quantity of collateral.
Saudi Arabia	No	
Singapore	No	Restructured loans are classified as substandard, doubtful, or loss, but may be upgraded to unimpaired if they comply with their new terms for at least one year.
South Africa	Yes	Restructured loans are classified in the two top categories only if all principal and interest are paid continually for a reasonable period.
Spain	Yes	Must remain as doubtful, except in the case of additional acceptable collateral and payment of interest.
WAMU	Yes	Restructured loans involving all major financial creditors are considered substandard, if the terms of the restructuring agreement with the bank are respected, or doubtful otherwise.

Notes.

a. Defined in accounting standards and in regulatory reporting instructions.

elapsed, banks are required to determine whether the loan should be reclassified as substandard or bad debt. U.S. supervisors rely on the definition of a restructured loan provided by generally accepted accounting principles. Under that definition, debt is considered a troubled restructuring if the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider.

Supervisors in non-G-10 countries, by contrast, provide specific criteria for banks to classify loans as restructured. Definitions often focus on loan rescheduling, whether it involves extending the loan's maturity or lowering its interest rate (or both). Either way, the goal is to enhance borrowers' ability to meet their obligations. Australian supervisors consider a loan to be restructured if there has been a reduction in its principal, in the amount due at maturity, in the interest rate (to below-market levels), or in accrued interest (including interest capitalization), or if it involves an extension of the maturity date or dates at an interest rate lower than the current market rate for new debt with similar risk. In the Czech Republic, a loan is also considered restructured if the bank grants a new loan so that the customer can repay an impaired loan; after more than two years have elapsed from restructuring a loan can be rated as standard. In Australia, a restructured loan must be classified as nonaccrual if it does not yield interest equal to the bank's average cost of funding. In Brazil, restructured loans are also classified as nonaccrual or in a higher risk category, and a better grading cannot be granted until a significant amortization of the outstanding loan is achieved and sufficient evidence is provided to justify that decision. In WAMU, restructured loans are assumed to be doubtful unless the debtor is engaged in a restructuring agreement with all his major financial creditors and the terms of the agreement are respected. In the Russian Federation, all loans that have been restructured more than once—regardless of whether the initial loan agreement has been revised—are classified as substandard or risky (doubtful for loans rescheduled twice with amendments of the initial contract). In Singapore, restructured loans are initially rated substandard at best but can be upgraded to unimpaired if they comply with the restructured terms for at least a year. Except in the Russian Federation, where the number of reschedulings is explicitly referred to, the number of times a loan is restructured does not affect its classification. Assessments are based on loans' performance and prospects for recovery.

8

PROVISIONING ISSUES

In many countries, the rules for loan loss provisioning do not aim to capture losses at an early stage, but rather to consider "objective" factors that could be taken into account by the fiscal authority. Some countries provide principle-based rules, with only general guidance on how to determine adequate provisioning. This approach is common in the European Union (Table 6). In contrast, countries that issue detailed regulations on loan classification often define quantitative minimum provisioning requirements. Most emerging markets take this approach. The rationale behind issuing detailed regulatory parameters could be to level the playing field or make bank regulations more easily enforceable Among non-G-10 economies, provisioning requirements are usually defined in four or five categories, though Brazil (nine) and Mexico (seven) use more categories.

Australia takes an intermediate stance Banks are allowed to set provisions based on their "internal model," while nonbank deposit-taking institutions are required to use parameters prescribed by the supervisor. Although banks may consider applying the supervisory parameters, it is generally expected that they have in place systems and procedures for assessing provisioning levels in line with the supervisor's prudential requirements.

Provisioning requirements may differ significantly for several reasons. One initial factor is, of course, the conceptual basis for provisioning requirements: Do they aim at addressing only losses that follow from visible and identifiable events, or do they aim at establishing provisions for probable losses? A related aspect is if only specific provisions are used or if general provisions are also permitted or required. Furthermore, the approaches differ as to whether the impairment is measured on the basis of discounted cash flows or undiscounted cash flows. One important aspect is if and how banks are expected to factor in the value of collateral. In many countries, the value of collateral is then subtracted from the required provisions to determine the level of the actual provisions to be established.

Under a second approach, collateral is taken into account when classifying a loan—allocating it, for example, to a more favorable category than that reflecting its own risk—and determining the level of provisions accordingly. No evident convergence toward one of the two approaches has emerged from the survey. Countries that have defined specific provisioning requirements for collateralized assets include Argentina, Hong Kong, India, and Spain.

Table 6. Loan Classifications and Provisions for Domestic Loans

Group/Country	Discretionary	Number of loan categories	Pass	Special mention: Provisions (%)	Special mention: Months overdue	Substandard: Provisions (%)	Substandard: Months overdue	Doubtful: Provisions (%)	Doubtful: Months overdue	Loss: Provisions (%)	Loss: Months overdue
G-10											
France[a]	Yes	3	-	-	Up to 3	-	-	0–100	Over 3	-	-
Germany[b]	Yes	4	-	-	-	-	-	-	-	-	-
Italy	Yes	5[c]	-	-	-	-	-	-	-	-	-
Japan	Yes	5	-	-[d]	Up to 3	15	Up to 6[e]	70[d]	-	100	-
Netherlands	Yes	-	-	-	-	-	-	-	-	-	-
United Kingdom	Yes	-	-	-	-	-	-	-	-	-	-
United States	Yes	5[f]	-	-	-	-	-	-	-	-	-
Non-G-10											
Argentina[g]											
With collateral	No	5	1	3	-	12	-	25	-	50	-
Without collateral	No	5	1	5	-	25	-	50	-	100	-
Australia	Yes	-[h]	-	-	-	-	-	-	-	-	-
Brazil	No	9[i]	-	-	-	-	-	-	-	-	-
Chile	No	5	-	0–5	-	5–39	-	40–79	-	80–100	-
China	Yes[j]	5	1	3		25	3	75	6	100	
Czech Republic	No	5	1	5	1–3	20	3–6	50	6–12	100	Over 12
Hong Kong											
Fully secured	Yes	5	-	-	Up to 12	-	Over 12	-	-	-	-
Partly secured/ unsecured	Yes	5	-	-	Up to 3	20–25[k]	3–6	50–75[k]	Over 6	100	-
India											
With collateral	No	4	0.25	-	-	10	6–18	20–50[l]	Over 18	100	n.a.
Without collateral	No	-	-	-	-	-	-	100	-	-	-
Korea, Rep. of	No	5	0.5	2	-	20	-	50	-	100	-
Mexico	No	7[m]	-	-	-	-	-	-	-	-	-
Russian Federation	No	4	1	-	-	20	-	50	-	100	-
Saudi Arabia[n]	Yes	-	-	-	-	-	-	-	-	-	-

Singapore[o]	No	5	-	-	-	At least 10	3 months or more	At least 50	3 months or more	100	3 months or more
South Africa	No	5	0.5	2	-	20	-	50	-	100	-
Spain	No	6	0.5–1.0[q]	-	Up to 3	10	3 to 6	25–100[p]	Over 6[r]	100	Over 36
WAMU[s]	No	3	-	-	-	-	1–6	100	Over 6	-	-

Notes: For classification purposes, "with collateral" means fully secured and "without collateral" means partly secured or unsecured.

a. Loans can also be classified as doubtful if a bank decides that there is a probable risk of default or the loan is the subject of legal proceedings. Special mention loans are called past-due loans.

b. Loans with no discernible risks, loans with increased latent risk, loan categorized as nonperforming, bad debt (i.e., losses).

c. Nonperforming loans are grouped by decreasing order of risk into bad debts, substandard loans, loans being restructured, and restructured loans. Unsecured loans to borrowers from high-risk countries are treated as nonperforming. Bad debts are claims on insolvent borrowers. Substandard loans are claims on borrowers in temporary difficulty where at least 20 percent of the exposure is more than 6–12 months past due. Loans being restructured are loans where the debtor is indebted to several banks and has applied for consolidation in the previous year. Restructured loans are loans granted a moratorium on repayment and renegotiated at below-market rates.

d. Based on the actual losses over the past three years of each category.

e. The use of classification is not a legally binding requirement but rather a supervisory recommendation.

f. At a minimum, banks must use these five classification categories, but are encouraged to use a larger number, particularly in the pass category.

g. Excludes public sector loans. Banks classify debtors, not loans.

h. Impaired assets are grouped into nonaccrual items, restructured items. In addition, loans that are 90 days in arrears (on principal or interest) but that are well secured are classified as past-due items.

i The nine categories are AA (0 percent), A (0.5 percent), B (1 percent), C (3 percent), D (10 percent), E (30 percent), F (50 percent), G (70 percent), and H (100 percent)

j. At present, from 1 percent up to 100 percent decided by banks. The supervisor require that banks set aside provisions based on the loan classification system in accordance with sound accounting principles. The numbers provided are to be introduced according to the new supervisory guidelines.

k. Specific provision is made against the unsecured portion of the classified loans.

l. Provisions for the secured portion of a loan are 20 percent if it is doubtful for up to one year, 30 percent if it is doubtful for one to three years, and 50 percent beyond three years.

m. The seven categories are based on country risk, financial risk, industry risk, and payment experience. Uncollateralized A-1 loans require 0.5 percent provisions; A-2, 0 99 percent; B, 1–20 percent; C-1, 20–40 percent; C-2, 40–60 percent; D, 60–90 percent; and E, 100 percent.

n. Banks are allowed to determine their provisioning policy in consultation with external auditors.

o. Banks are required to classify accounts based on the borrower's financials, credit worthiness, and/or repayment capability. Loans have to be classified as non-performing once principal or interest is past due for three months or more.

p The entire asset, not just the late payments, is considered doubtful when it becomes 12 months overdue.

q The 0.5–1.0 percent "generic" provision is complemented by a "statistical provision for insolvency."

r. Provisions on doubtful assets must equal 10 percent for payments more than 3 months overdue, 25 percent for more than 6 months, 50 percent for more than 12 months, 75 percent for more than 18 months, and 100 percent for more than 21 months. Late payments on mortgages are subject to a longer schedule.

s. Doubtful loans include, in particular, the whole amount of each loan with at least one payment overdue for more than six months. The uncollateralized portion must be fully provision-immediately and the remaining, according to the rules mentioned in Table 3.

The Basel Capital Accord accepts, under certain conditions, that general provisions be included in Tier II capital. Among the European countries surveyed, France and the UK accept general provisions in capital; Italy and the Netherlands do not (Table 7). Most non-G-10 countries—except Argentina, Australia, Brazil, and Korea—accept recognized general provisions in Tier II capital. Some countries set minimum (Argentina, Korea) or benchmark (Australia) provisioning requirements for standard loans—that is, a de facto regulation on general provisions.

TABLE 7. GENERAL PROVISIONS FOR LOAN LOSSES

Group/Country	Are general provisions tax-deductible?	Are general provisions accepted in regulatory capital?	Minimum provisions required
G-10			
France[a]	No	Yes	None
Germany	Yes[b]	Yes	None
Italy	Yes[c]	No	1 percent of qualifying loans
Japan	Yes	Yes	Based on actual loss over the past three years
Netherlands	No	No	None
United Kingdom	No	Yes	None
United States	No[d]	Yes	Bank must maintain a provision that is adequate to absorb estimated credit losses associated with its loan portfolio.
Non-G-10			
Argentina	No	Yes	1 percent of normal (standard) loans
Australia	Yes	Yes	0.5 percent of risk-weighted credit risk assets is considered a benchmark against which the adequacy of a bank's general provision for credit risk is assessed.
Brazil	No	No	None
Chile	Yes	No	None
China	Yes, only when bad loans are written off.		1 percent of the loan outstanding
Czech Republic	Yes	Yes	None
Hong Kong	No	Yes	1 percent of pass loans and 2 percent of special mention loans
India[e]	Yes	Yes	0.25 percent of standard loans
Korea, Rep. of	No	Yes	0.5 percent of normal (standard) loans and 2 percent of precautionary (special-mention) loans
Mexico	No	Yes	0.5 percent of standard loans
Russian Federation	No	Yes	1 percent of standard loans

TABLE 7. GENERAL PROVISIONS FOR LOAN LOSSES (*Continued*)

Group/Country	Are general provisions tax-deductible?	Are general provisions accepted in regulatory capital?	Minimum provisions required
Non-G-10 (*Continued*)			
Saudi Arabia	Yes	Yes	Not available
Singapore	Yes	Yes	For tax purposes banks are encouraged to make general provisions for up to 3 percent of their qualifying loans and investments.
South Africa	No	Yes	0.5 percent of normal loans
Spain	Partly[f]	Yes	A 0.5–1.0 percent "generic" provision is complemented by a "statistical provision for insolvency"
WAMU	Yes	Yes	Left at the discretion of the banks

Notes

a. Except for general provisions for country risk.

b. Only for actual losses, provided they do not exceed the specific provision. Forty percent of actual losses are netted out, and the balance is compared with the specific provision against the loan or the part of the loan that is written off.

c. General and specific provisions can be deducted within the annual limit of 0.6 percent of the loan portfolio up to a cumulative amount of 5 percent.

d. Small banks, as defined in tax law, can choose to use a "reserve method" under which additions to the tax bad debt reserve are tax-deductible The size of the tax bad debt reserve is based on a six-year moving average of loan write-offs as a percentage of loans. Banks not using the "reserve method" may deduct only their actual write-offs of specific individual loans.

e. Provisions can be no greater than 5 percent of total income and 10 percent of average advances by rural banks. The regulatory framework does not consider general provisions, but the Act on Accountancy and the Tax Act make a distinction between specific and general provisions.

f. Only 1 percent "generic" is deductible.

General provisions are in several countries set at compulsory levels—as in Hong Kong, India, Mexico, Russia, South Africa, and Spain. In general, these provisions are not intended to reflect the quality problems of the loan portfolio deriving from realized events but rather aim at cushioning against future events.

The importance of loan loss classification and loan loss provisioning was heightened with the introduction of the 1988 Basel Capital Accord. The Accord allowed the inclusion of general provisions as part of Tier II capital. However, most of the countries surveyed adopted a more restrictive approach than that specified in the Capital Accord. For instance, Brazil, the Netherlands, and Spain do not allow general provisions to be counted as part of Tier II capital (Table 8). Where general provisions are permitted in Tier II capital, the limit is generally set at 1.25 percent of risk-weighted assets, as defined by the Capital Accord. Only Argentina specifies that not more than half the amount of provisions set aside for normal or standardized assets can be counted as a component of regulatory capital.

Several jurisdictions—Australia, the Czech Republic, France, Hong Kong, and the WAMU—explicitly mention that specific provisions reduce the amount of risk-weighed assets in the denominator of solvency ratios. It is not clear how many other economies allow specific provisions to be deducted from outstanding assets when computing capital requirements.

A central feature of provisioning systems is typically to refer to losses that have already been incurred or are anticipated with a high degree of confidence. The general orientation of a

TABLE 8. LIMITS ON THE INCLUSION OF GENERAL PROVISIONS IN TIER I AND TIER II CAPITAL

Group/Country	Can general provisions be included in Tier I capital?	Can general provisions be included in Tier II capital?	Is the inclusion of general provisions in Tier II capital limited to 1.25 percent of risk-weighted assets, as provided in the Basel Capital Accord?
G-10			
France	No	Yes	Yes
Germany	No	Yes	Yes
Italy	No	Yes	Yes
Japan	No	Yes	Yes
Netherlands	No	No	Not applicable
United Kingdom	No	Yes	Yes
United States	No.	Yes	Yes
Non-G-10			
Argentina	No	Yes	No
Australia	No	Yes	Yes
Brazil	No	No	Not applicable
Chile	No	Yes	Yes
China	No	Yes	No
Czech Republic	No	Yes	Yes
Hong Kong	No	Yes	Yes
India	No	Yes	Yes
Korea, Rep. of	No	Yes	Yes
Mexico	No	Yes	Yes
Russian Federation	No	Yes	Yes
Saudi Arabia	No	Yes	Yes
Singapore	No	Yes	Yes
South Africa	No	Yes	Yes
Spain	No	No	Not applicable
WAMU	Yes	No	Not applicable

provisioning practice is often hard to determine. For instance, although there might not be any explicit reference to general loan loss provisions, bankers can follow a forward-looking approach if bank supervisors support it or if there are fiscal or accounting incentives to do so. In general, though, a minimum requirement for standard loans (which amounts to a de facto general provision) can be considered a minimum requirement of a forward-looking system in that it requires, other things being equal, that more resources be set aside during periods of economic and loan growth than during downturns. To date, an explicit forward-looking approach has been adopted only by Spain, which has introduced a "statistical" provisioning requirement in addition to a minimum level of general provisions. Statistical provisions allow Spanish banks to set aside provisions—up to a ceiling consistent with EU regulation—that can be depleted when loan portfolio quality deteriorates.

Although many jurisdictions (Australia, Brazil, China, India, Germany, the Netherlands, the United Kingdom) do not allow banks to spread provisions over long periods, several countries allow for regulatory discretion in the case of a banking crisis (Spain), ongoing bank restructurings, mergers, or takeovers (Argentina). Some countries have legal provisions for such exceptions, while others (the Netherlands) have specific provisions preventing them.

Specific provisioning requirements are often designed for certain portfolio segments, such as small loans (consumer and credit card lending) or loans exposed to sovereign risk. Several countries (Australia, France, Korea, the Netherlands, Saudi Arabia, Singapore) do not require small loans to be classified and provisioned on an individual basis but allow them to be assessed on a pooled basis (Table 9). In Australia, for example, management is allowed to deal with small consumer loans on a portfolio basis. The general current practice is for the write-off to occur at 180 days past due; therefore, the loans do not go through the "specific provision" stage. A few countries (Argentina, France, Germany, Italy, the Netherlands, Spain) also have separate provision requirements for country risk. In the Netherlands, country risk is dealt with through a combination of specific provisions and capital requirements

TABLE 9. SOVEREIGN AND RETAIL LENDING RISK

Group/ Country	Are there ad hoc criteria for sovereign or retail lending?	Nature of the criteria	Other portfolio segments
G-10			
France	Yes	Discretionary since 1995; provision is set as a percentage of country risks.	Consumer and small loans are reviewed on a pooled basis.
Germany	Yes	Special standardized risk provision to account for sovereign risk	Standardized provision set on a pooled basis for similar consumer loans.
Italy	Yes	Two methods are used to estimate the value of country risk to be deducted from regulatory capital. The simplified method applies to banks with small exposures to risky countries and calls for a reduction equal to a standard percentage of the face value of all unsecured on- and off-balance sheet exposures to counterparts in risky countries. The analytical method divides countries into seven categories based on a scoring procedure, and each category is assigned a value adjustment percentage.	
Japan	Yes	Provisions will be calculated based on the expected loan loss.	Loans are individually classified.
Netherlands	Yes	Countries are classified into four risk categories and provisions are set for the high-risk category.	Retail loans are assessed on a pooled basis; commercial loans are assessed individually.
United Kingdom	No		
United States	Yes	When a country is experiencing political, social, or economic conditions leading to an interruption in debt servicing by obligors within the country, or when an interruption in payments appears imminent, the U.S. banking agencies will designate credits within the country as Other Transfer Risk Problems or will classified them substandard, value-impaired, or loss. The agencies determine whether an Allocated Transfer Risk Reserve is required for particular international loans, and, if so, the amount of the reserve, based on whether the loans have been impaired by a protracted inability of obligors in a foreign country to make payments on their external indebtedness or whether no definite prospects exist for the orderly restoration of debt service.	Retail loans (including consumer loans, credit cards, and loans secured by residential real estate) are classified based on delinquency status.
Non-G-10			
Argentina	Yes	100 percent capital requirement for noninvestment grade countries; usual rule for investment grade countries.	All financing is classified individually; no treatment on a pooled basis.
Australia	No		
Brazil	No		
Chile	Yes		Specific rules for consumer loans and mortgages
China	Yes		

TABLE 9. SOVEREIGN AND RETAIL LENDING RISK (*Continued*)

Group/ Country	Are there ad hoc criteria for sovereign or retail lending?	Nature of the criteria	Other portfolio segments
Non-G-10 (*Continued*)			
Czech Republic	No	Banks have to consider external political and economic factors when classifying a loan; sovereign risk is also reflected in risk weights for capital requirements	
Hong Kong	No		Banks may use the pooled approach for consumer loans, e.g., credit cards
India	No		No provisions made for loans guaranteed by the central government.
Korea, Rep. of	No		Small loans (consumer and developed) are treated on a pooled basis.[a]
Mexico	No		Mortgage and consumer loans are treated on a pooled basis
Russian Federation	Yes	No specific requirements on sovereign risk	For syndicated loans, provisions are as in for the unguaranteed portion; 20 percent for the guaranteed portion (see Table 6).
Saudi Arabia	No		Some banks may take the pooled approach for retail and consumer loans, including credit cards.
Singapore	No	Local banks have made provisions to counter the potential risks from their exposure to the region's economies. For foreign banks that operate in Singapore, provisions for country risk are usually subject to the policies of their head offices.	Banks generally make general provisions for retail loans on a pooled basis.
South Africa	No		
Spain	Yes	For countries classified as highly doubtful, provisions should reach no less than 50 percent in the first year, 75 percent in the second, and 90 percent in the third For countries classified as doubtful, provisions should reach no less than 20 percent in the first year and 35 percent in the second year. For risks with countries in temporary difficulties, a provision of not less than 15 percent shall be applied.	
WAMU	Yes	Domestic sovereign risk provisioning is optional, but recommended under certain circumstances. Other country risk provisioning criteria are left to the banks, but more than three months' overdue accrued interest must be fully provisioned.	Outstanding off-balance sheet commitments on doubtful clients must also be provisioned.

Note:

a. Boans to central and local governments, call loans, bonds under repurchase agreements, and interbank loans are classified as normal.

9

MONITORING AND ENFORCEMENT

This section discusses the enforcement of regulations as reported by the surveyed supervisory authorities and therefore does not represent a third-party assessment. In general, the enforcement of rules and regulations is a sensitive issue that supervisors confront daily. Supervision requires considerable competence and judgment by bank supervisors and is not just the implementation of administrative rules. Efficient supervision depends on the right combination of supervisory powers, including sanctions and penalties, and moral suasion. However, when supervisors have flexibility in enforcing prudential rules, it can result in supervisory forbearance—with negative effects on their credibility and on market discipline.

In most countries loan classification and provisioning involve substantial subjective judgment, requiring difficult assessments under considerable uncertainty. The room for subjective judgment further increases if banks are allowed to use their own classification and provisioning criteria or if they are given several regulatory options. Such flexibility may contribute to the limited use of penalties and sanctions that could be justified in view of inappropriate classification and provisioning. Instead, supervisors appear to rely more on moral suasion and the threat of sanctions rather than specific penalties and sanctions to enforce classification and provisioning regulations.

In most countries, supervisory authorities have mechanisms for monitoring and assessing loan classifications and the adequacy of provisions. While many supervisors conduct monthly and quarterly off-site monitoring, there appears to be greater reliance on on-site inspections. While some jurisdictions carryout annual on-site inspections, most jurisdictions offer some flexibility depending on the size of the bank or the circumstances of the economy.

In other countries such as the United Kingdom, while supervisory authorities periodically review banks' manuals, internal controls, operational polices, and credit control and monitoring systems, they may contract with third parties for on-site assessments. A common approach is to incorporate the work of external auditors into the assessment process—as in the Czech Republic, Germany, and the United Kingdom.

An interesting approach taken in Argentina, Brazil, France and Spain, for example, is the use of credit registers to provide ongoing monitoring and surveillance of loan portfolios. For example, Argentine banks must file monthly reports with the credit register on the composition and evolution of their loan portfolios. In Brazil, the central bank uses a credit risk center to gather monthly data on the credit operations of banks for clients with total liabilities of at least US$2,500. In Spain, the central bank uses a credit risk register to gather monthly data on the credit operations of banks for clients with total exposures of at least ¢76.000. In France and Italy, data from the credit registers are commonly used as a supervisory tool in both on-site and off-site supervision.

Improper loan classification and provisioning are reflected in disclosure of inaccurate or misleading information to supervisory authorities, shareholders, and the market in general. Most jurisdictions lack specific sanctions for such breaches of loan classification and provisioning regulations. Therefore, supervisors issue reprimands or enforce corrective action or sanctions on the basis of general or targeted requirements given in corporate law or in banking and financial sector legislation.

Corporate law gives directors and auditors certain rights and obligations to ensure that financial statements provide a fair statement of a bank's financial position, complying with adequate provisioning practices. Banking and financial legislation often provides specific penalties for violations of prudential regulations in general and of the banking and financial services act specifically (Table 10). In Hong Kong, as in most other jurisdictions, the penalty for violating any provision of the Banking Ordinance could be a fine, imprisonment, or both. In France, the underestimation of provisions constitutes an offense to the extent that it affects the fairness and accuracy of the information provided to the public as defined in the 1966 Commercial Company Law. Similar interpretations of commercial and banking laws are used in Mexico, Russia, Saudi Arabia, Spain, and the WAMU

The penalties available to supervisors include a variety of disciplinary measures enforceable in accordance with the severity of the offense. If the offense is considered minor, a warning or reprimand is issued. If it is of great importance—especially if it threatens the bank's financial viability—then the bank's license could be revoked. Other penalties include fines, excluding the bank's general provisions from the capital computation (France), ordering revised financial statements to be issued, increasing the required regulatory capital, suspending the bank's license, and placing the bank under conservatorship.

In some countries, penalties are applicable to bank directors and managers. In such cases, penalties include fines, temporary disqualification, demotion, dismissal, and imprisonment. Moreover, when a violation affects the preparation of the final financial statements, it infringes on the auditor's obligations (as in Germany). In such cases, the penalties include paying fines and barring auditors from future engagements with banks.

TABLE 10. ENFORCEMENT POWERS

Group/economy	What types of legal penalties are imposed on banks for inaccurate classification of loans or underestimation of provisions?[a]	Do such breaches of law bring about financial penalties? The dismissal of managers? Other penalties?	Have any such penalties been imposed in the past five years?
G-10			
France[b]	General	Yes	Yes
Germany	Targeted	Yes	No
Italy	General	Yes (only financial penalties)	Yes
Japan	General	Yes	No
Netherlands	General	Yes	No
United Kingdom	Targeted[c]	No	No financial fines
United States	General	Yes, if the breaches are significant enough to constitute an unsafe or unsound practice	Yes
Non-G-10			
Argentina	General	Yes	n.a.
Australia	General	Yes	No
Brazil	General	Yes	Yes
Chile	General	Yes	No
China	General	Yes	Yes
Czech Republic	Targeted	Yes	Yes
Hong Kong	General	Yes	No
India	None[d]	n.a.	n.a.
Korea, Rep	None	n.a.	n.a.
Mexico	General	Yes	Yes
Russian Federation	General	Yes	Yes
Saudi Arabia	General	Yes	Yes
Singapore	Targeted	Yes	No
South Africa	General	Yes	No
Spain	Targeted	Yes	No
WAMU	General	Yes	Yes

Notes.

a. General penalties address any misleading information. Targeted penalties specifically address classification and provisioning failures.

b. In France, the supervisor may at first ask a bank to rectify classification and provisioning if deemed necessary. Should the bank be reluctant, the Banking Commission is empowered to impose disciplinary sanctions (range of five sanctions), as in any case of breach of the rules of sound banking practices.

c. In the UK, inaccurate classifications are subject to financial fines effective December 1, 2001.

d. Banks have been advised that from June 2001, monetary penalties may be imposed by the Reserve Bank of India under the provisions of the Banking Regulation Act for failure to adhere to prudential guidelines including inaccurate classification or underestimation of provisions.

10

The Tax Treatment of Loan Loss Provisions

The tax deductibility of loan losses provides a strong incentive to set aside adequate loan loss provisions. Thus, the tax treatment of loan provisions needs to strike a delicate balance between tax deductions that boost provisions (at the cost of lower tax revenues) and over-restrictive tax rules that result in inadequate loan loss reserves, which can raise fiscal costs subsequently in the event of a banking crisis. Increasing international convergence on the criteria underlying the risk classification of bank loans for capital regulation provides a useful basis for more efficient accounting and fiscal treatment of loan provisions. The common interest of bank supervisors and fiscal authorities in properly assessing the deterioration of a bank's loan portfolio can inspire the convergence of prudential and fiscal regulation on loan loss valuation.

Three broad approaches can be used to describe the tax deductibility of loan losses·

- Under the *write-off approach,* loans are tax-deductible only when they are declared uncollectible and are written off the bank's books
- Under the *specific provisions approach,* specific provisions are fully or partly tax-deductible.
- Under the *general provisions approach,* banks can take a deduction for general provisions up to a predefined percentage of eligible loans.

The write-off approach is over-restrictive if regulation does not allow banks to writeoff loans before all means of collection and all legal actions to execute the collateral have been exhausted. In many countries, inefficiencies in the judicial system unduly postpone the accounting recognition of losses in income statements relative to the period when they were effectively incurred. If partial write-offs are allowed, this approach is more like the specific provisions approach.

The write-off approach and the specific provisions approach are the most common. The write-off approach is used by Australia, Korea, and the United States (Table 11). The specific provisions approach is used by almost all the other economies surveyed. Apart from a few countries that have set limits on deductible provisions, there is flexibility in the amount of provisions. Among countries that

TABLE 11. TAX DEDUCTIBILITY OF SPECIFIC AND GENERAL PROVISIONS

Group/Country	Are specific provisions deductible?	Are there limits on such deductions?	Are general provisions deductible?	Are there limits on such deductions?	Are other provisions deductible?
G-10					
France	Yes	No	No, except for country risk		Yes
Germany	Yes	No	Yes	Average ratio of credit losses to loans reduced by 40 percent over the past five years.	Yes, if additional specific provisions required
Italy	Yes, but only for highly certain losses	No	Yes	Deductions on provisions cannot exceed 0.6 percent of the loan portfolio each year. Amounts over that can be deducted over the next nine years within a 5 percent ceiling.	
Japan	Yes	Yes	Yes	Calculated from actual losses over the past three years.	Yes
Netherlands	Yes, but only for highly unlikely recoveries	No	No		No
United Kingdom	Yes	No[d]	No	n.a	n.a
United States[a]	n a	n.a.	n.a.	n.a	n.a.
Non-G-10					
Argentina	Yes	Yes	No		No
Australia	Yes, but only for write-offs	No	No		No
Brazil	Yes, but only if legal action for collection has been taken and is in progress	Provisions on unsecured loans are deductible based on historical past-due levels. Provisions on secured loans are deductible once they are two years past due	No		Yes
Chile	n.a.	n.a	n a	n.a	n.a
China	Only when loans are written off New policies are under consideration.				

Czech Republic	Yes	Specific provisions on special mention loans are deductible in the tax period up to 1 percent for special mention loans, 5 percent for substandard loans, 10 percent for doubtful loans, and 20 percent for loss loans. Total specific provisions are deductible up to 2% of total loans.	Yes	Up to 2 percent of loans and loan guarantees	No
Hong Kong	Yes	No	No	-	No
India	Yes	Up to 5 percent of income and 3 percent of assets	No		Yes, subject to limits
Korea, Rep.	Yes	Up to the minimum regulatory ratio	No		No
Mexico	Yes	Annual limit of 2 5 percent of average loan portfolio. Excess provisions can be deducted over the next 10 fiscal years.	No		Yes
Russian Federation	Yes[b]	No	No[c]		Subject to tax laws
Saudi Arabia	Yes	No	Yes		Yes
Singapore	Yes	No	Yes	Up to 3 percent of qualifying loans and investments	No
South Africa	Yes	Up to 25 percent of doubtful loans, including interest and capital	No		Yes
Spain	Yes	No	Partly	Statistical provisions are not tax-deductible, and generic provisions face restrictions.	n.a
WAMU	Yes	No, subject to the control of tax authorities	On a case-by-case basis	Limits on general provisions	Yes, if additional specific provisions are required by the banking commission.

Notes.

a. Small banks, as defined in tax law, can choose to use a "reserve method" under which additions to the tax bad debt reserve are tax deductible. The size of the tax bad debt reserve is based on six-year moving average of loan write-offs as a percentage of loans. Banks not using the "reserve method" may deduct only their actual write-offs of specific individual loans.

b. Loan loss provisions in risk categories 2, 3, and 4 are tax deductible.

c. Provisions in group 1 (general provisions), provisions on promissory notes, loans guaranteed by the government, Ministry of Finance, the subject of the Russian Federation, local authorities, and unsecured loans (except interbank loans and deposits) are not tax deductible.

d Provided not excessive.

set limits on tax deductibility, India allows deductibility up to 5 percent of annual income and 5 percent of assets deemed losses or doubtful by the Reserve Bank of India; Korea up to the minimum regulatory ratio; Mexico up to 2.5 percent of the loan portfolio; and South Africa up to 25 percent of the sum of capital and interest of doubtful loans. China's limit, 1 percent of outstanding loans, is being reconsidered.

The general provisions approach is less common. This approach is used by the Czech Republic, Germany, Italy, and Singapore. Limits are always defined for the deductibility of general provisions and often for specific provisions as well. Germany sets no limits for specific provisions but requires general provisions not to exceed 60 percent of average loan losses over the past five years. Italy has a cumulative limit on the tax deductibility of specific and general provisions equal to 0.5 percent of outstanding loans on an annual basis, provided that loan loss reserves are less than 5 percent of outstanding loans. In France, provisions on loans to foreign borrowers that fall into the category of country risk are granted tax deductibility, but general provisions are not. It is also generally understood that revenues on nonaccrual assets are not taxed.

Among non-G-10 countries, the Czech Republic has used a scale of allowed deductibility for specific provisions related to loan classifications, with a ceiling of two per cent of the total amount of loans and loan guarantee; no deductions are allowed for general provisions (see Table 11). Singapore has a tax-deductible limit for general provisions of up to 3 percent of banks' loan and investment portfolio while specific provisions are fully deductible. Saudi Arabia and Spain do not have limits on the specific and general provisions allowed by bank supervisors.

Increases in loan loss provisions requested by bank supervisors are not always tax-deductible. Given the nature of coordination between supervisors and fiscal authorities, there is no general rule on the tax deductibility of additional provisioning that bank supervisors require above what has been recorded in a bank's income statement and balance sheet. Limits on tax deductibility generally apply to provisions regardless of whether bank supervisors have required additional provisions.

11

DISCLOSURE

It is generally expected that banks will act more prudently if they are required to publicly disclose information on their appetite for risk, on the results of their activities, and on their future prospects. However, the extent of disclosure and market discipline depends on the economy's sophistication and its openness to market forces. Given the differences this paper has highlighted in rules for loan classification and provisioning, there is a strong case for requiring banks to publicly disclose comprehensive information on their accounting policies, risk management policies, and exposures.[3]

The countries surveyed have diverse requirements for the disclosure of credit quality. In most G-10 countries banks are not required to provide the public with detailed information on the quality of their loan portfolios. Usually, when specific classifications are required, supervisors do not expect banks to disclose them (Table 12). Banks in the United States and Japan are required to disclose the amount of loans classified as nonaccrual. Detailed information on the quality of loans is considered confidential—unless market discipline (such as for listed banks) compels banks to divulge more information to investors and to the market. Many countries will have to significantly improve their disclosure rules to fulfill the aforementioned Basel Committee recommendations.

In non-G10 countries, the extent of disclosure imposed on banks for loan quality varies. Still, it is common for banks to be required to make public some information on the loan portfolio's breakdown, even though this information is not as comprehensive as that received by supervisors. For example, the Czech Republic requires banks to disclose the distribution of their loan portfolios

3 The Basel Committee has paid significant attention to this issue and has provided banks and supervisors with recommendations on disclosure that are included in several papers ("Enhancing Bank Transparency," September 1998, "Best Practices for Credit Risk Disclosure," September 2000, Pillar III of the proposed revised framework on capital, 2001, "Sound Practices for Loan Accounting and Disclosure," June 2001) The committee has identified four areas in which banks' annual financial statements should be required to provide clear, concise information on the credit risk in their loan portfolios· accounting policies, credit risk management, credit exposure, and credit quality.

TABLE 12. PUBLIC DISCLOSURE OF LOAN CLASSIFICATIONS

Group/Country	Is public disclosure of loan classifications required?	If so, how often?
G-10		
France	Yes	Annually
Germany	No	-
Italy	Yes	Semi-annually
Japan	Yes	Semi-annually
Netherlands	No	-
United Kingdom	No	-
United States	No	n.a.
Non-G-10		
Argentina	Yes	Monthly
Australia	Yes	Semi-annually
Brazil	Yes	Semi-annually
Chile	No	-
China	Yes, on selective basis. Strong encouragement for disclosure	-
Czech Republic	Yes	Quarterly
Hong Kong	No	-
India	Yes	Quarterly
Korea, Rep. of	Yes	Quarterly
Mexico	Yes	n.a.
Russian Federation	No	-
Saudi Arabia	Yes	Quarterly
Singapore	Yes	Varies[a]
South Africa	Yes	Annually
Spain	Yes	Annually
WAMU	Yes	Annually

Note:

a. Locally incorporated banks report such information twice a year, while foreign bank branches do so on an annual basis. In addition, the aggregate exposure to regional countries and nonperforming loan ratios of locally incorporated banks are disclosed on a quarterly basis.

between standard and classified loans and the amounts of provisions on a quarterly basis. India and Saudi Arabia require disclosure of the amount of nonperforming loans. In Singapore, banks disclose information on their classified loans which include non-performing loans as well as loans which are performing but are classified due to weaknesses in the borrowers' financial standing and cashflows. Recently, Spain added requirements of disclosure on loan classification and provisioning in the annual accounts in 2000. Other jurisdictions (Russian Federation, WAMU) do not call for any disclosure. Australian accounting standards require that banks publicly disclose a breakdown of their loan portfolios; Korean banks must do the same. In general, the complete information held by supervisors on loan portfolios is not shared with the market at large.

Requirements on disclosure for provisions tend to be much more uniform. In most countries, banks are required to provide information on the amount of provisions and the amount accrued in the year under review. Banks may also be asked to disclose details of loans being written off and the amount of recoveries on write-offs from previous years. South Africa's accounting standard on disclosure—which all companies including banks must comply with—requires in-depth disclosure on accounting policies and loan quality.

Although bank supervisors may not be empowered to regulate bank disclosure, they are often involved in reviewing the adequacy of disclosure, including the accuracy of information on loan quality. Notwithstanding the role external auditors play in forming an opinion on banks' financial statements, supervisors ensure that banks do not provide a distorted view of their financial condition. Among G-10 countries, only French, U.S. and Japan regulators are empowered to ensure that banks publish timely information. France's regulator can also instruct banks to publish amended statements if material omissions or inaccuracies have been detected. In the Czech Republic and Spain, bank supervisors not only check banks' compliance with accounting standards, they also regulate disclosure requirements.

Under several banking laws (Korea, Mexico, Russian Federation), supervisors can impose penalties for inaccurate disclosures. In practice most G-10 and non-G-10 supervisors do not impose penalties on banks that breach disclosure requirements. In principle, other legal authorities can prosecute banks for not observing the requirements.

12

The Role of External Auditors

In most of the countries surveyed, external auditors are legally required to examine loan portfolios and to ascertain the adequacy of provisions established by banks for impaired assets, including loans. In most cases, an external party reviews banks' accounts and policies at least once a year, regardless of whether bank supervisors conduct on-site examinations.

Despite almost universal recognition among supervisors that external audits are a crucial element of any regulatory system, in many countries there is still widespread mistrust of the quality and reliability of the work performed by external auditors. It is argued that, because of the remuneration they receive from their customers, external auditors lack the required independence of judgment. Vested interests may impinge upon external auditor' ability to require clients to enforce prudent loan classification and loan loss provisions, especially during a banking crisis.

In view of the likelihood of improper auditing practices, one might expect that penalties would have been applied in most countries. In the past five years, though, only a few countries (Brazil, the Czech Republic, France, Germany, WAMU) have penalized external auditors for improper auditing of loan classifications (Table 13). Yet, most countries indicate that external auditors could be penalized if evidence emerges that their reviews of loan classification and provisioning were not performed properly (that is, not in line with external auditing standards). Some countries have a greater degree of trust in the work of external auditors, believing that professional standards and the commercial imperative of maintaining trust in their brand will generally result in work of high quality Such countries, such as the UK, may substantially rely on accounting and auditing rules as opposed to setting specific supervisory rules and requirements for provisioning.

TABLE 13. ROLES, RESPONSIBILITIES, AND PENALTIES FOR EXTERNAL AUDITORS

Group/Country	Are external auditors legally required to assess the adequacy of loan loss provisions?	Can external auditors be penalized for improper auditing of provisions?	Have any external auditors been penalized for improper auditing of provisions in the past five years?
G-10			
France	Yes	Yes	Yes
Germany	Yes	Yes	No
Italy	No[a]	Yes	n.a.
Japan	Yes[c]	Yes[d]	No
Netherlands	No[a]	Yes	No
United Kingdom	No[a]	Yes[b]	n.a.
United States	No[a]	Yes[b]	n.a.
Non-G-10			
Argentina	Yes	Unclear	n.a.
Australia	Yes[b]	Yes	No
Brazil	Yes	Yes	Yes
Chile	-	-	-
China	No	Unclear	No
Czech Republic	Yes	Yes	Yes
Hong Kong	Yes	Yes	No
India	Yes	Unclear	n.a
Korea, Rep.	No	n.a.	n.a.
Mexico	Yes	Unclear	No
Russia	Yes	Yes	n.a
Saudi Arabia	Yes	Yes	No
Singapore	Yes	Yes	Yes
South Africa	Yes	Yes	No
Spain	Yes	Yes	n.a.
WAMU	Yes	Yes	Yes—Rejection of Approval

Notes:

a. Not prescribed by the law but considered an integral part of external auditing.

b. Professional auditors are required to use due professional care. Their peers can penalize auditors if they fail to abide by established standards.

c. Though the relevant laws do not mention specifically the role of external auditors a correct assessment of the adequacy of the loan loss provision is considered a general requirement of the law.

d. External auditors can be penalized in certain cases (e.g., a misleading opinion is issued intentionally).

13

Conclusion

Although most of the countries surveyed have improved their regulatory frameworks over the past decade, there has been little convergence toward a common loan classification model—though U.S.-like systems have been adopted by many developing and transition economies.

The absence of international consensus is evident in the varying number of loan classification categories; the treatment of multiple loans when one loan is in default; the inclusion or exclusion of loan guarantees and collateral values when classifying a loan; the level of supervisory involvement in the bank loan review processes; the treatment of restructured loans; the number of days used in defining past-due loans; the tax treatment of loan loss provisions; the backward- or forward-looking nature of losses to be provisioned for; and the often poor disclosure standards.

Notwithstanding the observed differences among national regulatory approaches the survey has clearly shown an increased awareness of the importance of proper loan classification and provisioning procedures among the participating countries, almost all of which have either introduced or updated their policies in the last decade. It is to be expected that a streamlining of provisioning approaches, more firmly grounded in sound risk management practices, will result from a more systematic reference to empirical measures of credit risk and from an integrated approach to expected and unexpected losses in the framework of the forthcoming Capital Accord.

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Differences in provisioning and classification approaches have often made difficult a comparison of bank and banking system weaknesses across regulatory regimes. Such differences have made peer pressure and market discipline less effective. Poor classification and provisioning practices have led to solvency ratios that gave a false sense of security, as occurred as financial systems failed in the 1990s.

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