This module should be read in conjunction with the Introduction and with the Glossary, which contains an explanation of abbreviations and other terms used in this Manual. If reading on-line, click on blue underlined headings to activate hyperlinks to the relevant module.

Purpose

To provide a set of guidelines to AIs relating to credit approval, credit review and records to be maintained on credit files

Classification

A statutory guideline issued by the MA under the Banking Ordinance, §7(3)

Previous guidelines superseded

Guideline 5.1 "Loan Approvals, Records and Provisions" dated 20.08.87; Guideline 5.6 "Booking of loans" dated 20.04.94

Application

To all AIs

Structure

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1. Credit procedures and manual

1.1 This section should be read in conjunction with CR-G-1 "General Principles of Credit Risk Management".

1.2 AIs should have a written statement (credit manual) setting out the criteria and procedures for:

- granting new credits, renewing existing credits and approving exceptions;
- conducting periodic and independent reviews of credits granted; and
- covering the records that should be maintained for credits granted.

1.3 The credit manual should be considered a subsidiary document to the AI's credit risk strategy and policy statement and should be in conformity with it.

1.4 The manual should include statements setting out:

- credit authorities of individual officers, combinations of officers and committees;
- requirements for all new credits or renewal of existing credits to undergo thorough credit appraisals before approval and for justification of any decisions violating credit risk policy criteria and identifying the persons authorized to approve such decisions. The same criteria should be applied to both advised and unadvised facilities;

- information required for credit appraisal and documents in use, with a list of lawyers acceptable to the AI for drawing up such documents; and
- documentation to be maintained on credit files.

2. Credit approval system

2.1 Credit approval process

2.1.1 The credit approval process involves the evaluation and approval of credit applications. AIs should maintain prudent procedures for approving credits to ensure that credit facilities are granted only to credit-worthy customers meeting the prescribed credit acceptance criteria.

2.1.2 The Board of Directors is the ultimate source of credit authority. It may delegate all or part of its own credit authority to the Credit Committee, a specialised committee established to assist the Board in overseeing credit risk management. There should be written terms of reference for the Credit Committee specifying its duties and authorities.[1]

2.1.3 The Board should establish a clear limit structure for credit approval. Normally, the Credit Committee approves loans to large customers, e.g. those with total facilities in excess of 5% of the AI's capital base. Lower lending limits could then be delegated to other credit officers or committees according to their credit experience and expertise.

2.1.4 For AIs which do not have a Credit Committee, there should be adequate checks and balances to prevent undue reliance on the decisions of a single credit officer. For example, there should be a system requiring loans approved by an officer to be reviewed periodically by another officer or by an independent reviewer. In addition, loans over a certain amount should be

[1] Generally speaking, the Credit Committee has the role of monitoring credit quality and ensuring that there are adequate procedures to identify problems in time, recognise adverse trends, take appropriate corrective actions, maintain adequate loan loss provisions and monitor compliance with statutory lending limits. It may also participate in evaluating credit applications and making credit decisions.

reviewed by the Chief Executive and reported to the Board on a regular basis.

2.1.5 Generally speaking, account officers should not be delegated with any credit approval authority. If delegated, the assigned credit limit should not be significant and the approvals made by account officers should be subject to independent reviews or audits.

2.2 Credit appraisals

2.2.1 Credit appraisals require a detailed analysis of the borrowers' or counterparties' financial position and debt-servicing ability, a thorough understanding of their background and the purpose of the credit and an evaluation of the collateral pledged, if any.

2.2.2 Account officers should ensure that each credit proposal complies with credit risk policies before submitting it for approval. Management reports on new credits should highlight to recipients whether established credit criteria have been complied with.

2.2.3 Normal credit analysis should not be dispensed with even if comprehensive financial data are hard to get.

2.2.4 A sound credit appraisal process should disregard any intervention from shareholders, management or other interested parties to direct lending at particular sectors which are not in the AI's best interests.

2.2.5 The validity of methodology employed to evaluate credit risk, including credit scoring systems for retail customers, should be re-assessed periodically, bearing in mind changes to the products, market and the economy. New lending techniques should be tested and validated. When in doubt, conservatism is called for.

2.2.6 AIs should establish overall credit limits at the levels of:

- individual borrowers and counterparties; and
- groups of related borrowers and counterparties.

For this purpose, different types of exposure, both in the banking book and the trading book and on and off the balance sheet, should be aggregated.

2.2.7 Prior to the finalisation of a credit application, care should be taken to ensure that various internal portfolio limits or statutory restrictions would not be breached as a result of the new facilities granted (see subsection 3.2 in CR-G-1 "General Principles of Credit Risk Management" for further guidance). Any excess over internal limits should be justified, properly approved and documented.

2.2.8 For credit applications identified as having weaknesses in the credit appraisal, justifications for granting credit (e.g. by means of ways to mitigate credit risks) should be adequately documented on file for future reference.

2.2.9 In syndicated lending, participating AIs should carry out their own assessment and not simply rely on that of the lead managers.

2.2.10 AIs should exercise due caution when entering into transactions (e.g. lending and trading in cash or derivative instruments) with highly leveraged institutions[2] (HLIs). Before doing business with HLIs, AIs should take into account the specific risk characteristics of such institutions and:

- establish clear policies and procedures for their involvement with HLIs;
- perform a thorough credit analysis of HLIs' activities, risks and operations;
- develop accurate measures of credit exposure resulting from trading and derivatives transactions with HLIs;
- set meaningful overall credit limits for HLIs;
- obtain credit enhancement where necessary, including collateral and early termination provisions; and
- monitor credit exposures vis-à-vis HLIs, including their trading activities, risk concentration, degree of

[2] Highly leveraged institutions (HLIs), including hedge funds, are characterised by a lack of transparency, heavy use of leverage and trading positions which can change dynamically. Effectively they are financial institutions that are subject to very little or no direct regulatory oversight and hence do not need to observe regulatory restrictions on leverage or capital requirements. They are highly exposed to market price movements and to the impact of stressed market conditions.

leverage and risk management processes.

2.2.11 For market-sensitive transactions such as those involving financial derivatives, AIs should:

- ensure that, in order to avoid disputes in future, customers with little knowledge of such instruments fully understand the potential risks they may incur before the transaction is concluded; and
- stress-test volatility assumptions as changes in volatility could increase AIs' exposures considerably and the chance of default by the borrower/counterparty. For example, if the securities market takes a downward trend in response to rising interest rates, a private banking customer who has written an American put option on shares to an AI may be unable to meet his or her obligation when the option is exercised.

2.3 Information to be analysed

2.3.1 Credit decisions should be based on rigorous analysis rather than on subjective decisions by senior management. Credit appraisals should entail a careful consideration of the following information where applicable:

- integrity of the borrower/counterparty;
- borrower's/counterparty's authority to borrow;
- purpose of credit;
- viability of business being financed and management capabilities in running the business;
- the employment of borrowing individuals or the business expertise of corporate customers;
- outlook of industry in which the borrower is engaged;
- repayment terms;
- source of repayment;
- cash flow forecast and debt-servicing ability in both normal and stressful conditions during various stages of the economic cycle. In

calculating the debt-servicing ratio, consideration should be given to the service payments due on the borrower's indebtedness to other lenders;

- current credit and financial information on the borrower and relevant group members – AIs need to make cross-reference to related borrowers and guarantors to facilitate the assessment and approval of credit facilities on a group basis;
- other credit facilities to the same or related parties;
- valuation and validity of collateral;
- validity of guarantee; and
- expected return, preferably on a risk-adjusted basis, on facility to be granted.

2.4 Know your customer

2.4.1 AIs should verify the identity of their customers[3] and gain a thorough understanding of their background and businesses. They should not lend purely on name and relationship without a firm understanding of the borrower.

2.4.2 AIs should only deal with customers who are considered to be able to meet their obligations and who carry on business in a lawful and ethical manner. There should be appropriate criteria and standards for establishing account relationship with customers.

2.4.3 Virtual banks or AIs offering facilities through the internet should ensure that the requirement to know their customers is strictly followed for their internet banking customers. They should normally try to establish face-to-face contact with their customers but if this is not possible they should ensure that there are other arrangements to achieve the objective. They will need inter alia to obtain proof of a potential customer's income and identity.

[3] By, for example, asking to see and noting the details of (in the case of individuals) a valid identity card, passport or other identification document or (in the case of corporate customers) the certificate of incorporation and ascertaining beneficial ownership.

2.5 Application of funds

2.5.1 AIs should find out what their lending is actually being used for and the sources of repayment. Sometimes borrowers re-direct funds from core businesses into incautious diversification or into speculation in the stock or property markets. Short-term trade finance may also be used as part of a company's general working capital.

2.6 Pricing

2.6.1 AIs' pricing of their products should reflect the underlying risk and provide an adequate return on capital, after covering the cost of funds, operating expenses and anticipated bad debts, to maintain the confidence of shareholders and other interested parties.

2.6.2 AIs should have established policies for determining the cost of funds for individual products and services and factor these into their pricing.

2.7 Collateral and guarantees

2.7.1 AIs should not over-rely on collateral or guarantees as the cost of enforcement often significantly reduces the profit in a transaction and the collateral may fall in value. Collateral and guarantees can provide secondary protection to the lender if the borrower defaults but the primary consideration should be the borrower's debt-servicing capacity.

2.7.2 Where collateral is taken, AIs should adopt appropriate loan-to-value ratios depending on the nature of the collateral. AIs should be aware that collateral values may be linked to the financial condition of the borrower - the same factors that cause a customer financial difficulties may drive down the value of the collateral. For example, the facilities of a customer producing woollen garments may be collateralised by a charge on the customer's manufacturing machinery. A slump in demand for woollen garments may reduce not only the customer's income but also the market value of the collateral.

2.7.3 The customer should be required to take out adequate insurance for the collateral pledged.

2.7.4 Where a guarantee is accepted, the financial strength of the guarantor and the enforceability of the guarantee should be thoroughly assessed.

2.8 Acceptance of credit facilities

2.8.1 Customers' acceptance of all credit facilities should be evidenced in writing.

2.9 Large exposures

2.9.1 Notwithstanding the 25% limit on large exposures under §81 of the Banking Ordinance, AIs should exercise particular care in relation to facilities exceeding 10% of capital base.

2.10 Central liability records

2.10.1 AIs should maintain a central liability record for each borrower or group of related borrowers to facilitate credit control and ensure compliance with statutory limits under the Banking Ordinance. It is recognised that this may be impractical in some cases, e.g. in the case of retail or small customers. However, even in such cases, AIs should ensure that information about the total exposure to the customer in question is readily available.

2.10.2 The central liability record should be updated promptly whenever there is an increase or change in risk exposure.

2.11 Advances to related parties

2.11.1 Each AI should maintain procedures to identify credits to related parties of borrowers or guarantors and to parties connected with the AI (e.g. its controllers, directors, and officers) in order to ensure compliance with §§81 and 83 of the Banking Ordinance and the disclosure requirements of the Companies Ordinance (e.g. loans to directors under §161B).

2.11.2 All credits should be granted at arm's length, particularly in the context of connected lending.

2.11.3 Where AIs are part of wider groups or conglomerates, any finance provided to other group entities or shareholders should be subject to the same standards of credit assessment applicable to unrelated borrowers.

2.12 Legal advice

2.12.1 AIs should seek legal advice on the enforceability of loan agreements and other legal documentation. In some cases, e.g. for facilities above a stated threshold, this may require AIs to seek advice from an external firm of lawyers.

2.13 Booking of offshore credits

2.13.1 The Hong Kong branch of overseas incorporated AIs should not be used as the depository for loans originally booked in other overseas branches which have become non-performing or unacceptable to the overseas banking supervisors concerned.

2.13.2 Overseas incorporated AIs should inform the HKMA in advance of any proposal to transfer to Hong Kong any non-performing loan as a result of the requirement or pressure of an overseas banking supervisor, or as an alternative to making provisions requested by such supervisor. Generally speaking, the HKMA would not wish to see such loans placed on the balance sheet of a Hong Kong branch unless a very strong case for the transfer can be made.

3. Credit review system

3.1 Credit review process

3.1 1 Each AI should have a system to ensure that, in addition to the on-going monitoring of the performance of credits (see CR-G-3 "Credit Administration, Measurement and Monitoring"), periodic credit reviews, of individual accounts or accounts managed on a portfolio basis (e.g. credit cards), are also carried out independently by the middle office[4] to:

- update the AI's understanding of the affairs, financial position and needs of its existing customers and other counterparties;
- consider whether, based on the credit appraisals prepared by the front office[4], a new facility should

[4] Please see Diagram 1 of CR-G-1 "General Principles of Credit Risk Management" for an illustration of functions typically performed by the front, middle and back offices.

be granted or facilities granted should be renewed, increased, extended, curtailed or cancelled. The recommendation should be made to the Credit Committee or relevant credit officer for consideration;

- ascertain changes in the credit quality of individual customers or other counterparties as well as the overall portfolio and detect unusual developments;
- review whether changes to the classification of loans are necessary and provisions are adequate;
- identify opportunities and threats through the new information collected and the changes to the quality of the portfolio;
- confirm the appropriateness of the credit risk strategy and policy or formulate necessary revisions in response to changes/trends identified; and
- trigger remedial actions to protect the interests of the AI, if appropriate (e.g. in relation to deteriorated credits).

3.1.2 The results of credit reviews should be properly documented and reported to the appropriate level of management. Where deterioration is detected, the review report should be submitted to a senior officer for review and follow-up.

3.1.3 As a general rule, all facilities, except those managed on a portfolio basis, should be individually reviewed at least yearly. Where facilities are irregular, larger or more risky, more frequent reviews would be necessary. In the case of facilities managed on a portfolio basis (e.g. credit cards or residential mortgages), a portfolio review should be conducted at least annually to assess the performance of the portfolio (e.g. return on assets, delinquency ratio, credit write-offs) against established targets or norms.

3.1.4 There should be a system to diarise and bring up accounts due for review. Overdue credit reviews should be identified and reported in time to the appropriate level of management. This should be performed by staff

independent of the credit review function, e.g. credit administration staff in the back office[4].

3.2 Credit review procedures

3.2.1 Procedures for credit reviews should cover inter alia:

- which officers (and, in large AIs, committees) are in charge of credit review. They should, where possible, be independent of those initiating, approving, funding or recording the credit;
- frequency of review (at least annually for normal accounts and more frequently, say monthly, for classified accounts);
- requirement for collateral valuations to be checked and site visits to be reported;
- assessment of any change in the borrower's capacity to repay;
- requirement for a recommendation by the reviewing officer (to renew, cancel, increase or decrease) and for justification to be documented where the approving officer or the Credit Committee diverges from the recommendation;
- requirement for the progress of any remedial action to be reported to the Credit Committee or senior management; and
- reporting to the Credit Committee, senior management or the Board of Directors of credits or exceptions over a certain amount.

3.2.2 The relevant procedures should be formally documented.

4. Records

4.1 AIs should ideally maintain a centralised credit file for each borrower or other counterparty. If this is not feasible in some cases (e.g. separate filing of different types of facilities handled by different departments), AIs should ensure that all relevant credit information on each borrower or counterparty is properly kept and readily available to credit managers and other parties such as auditors and examiners.

4.2 It is recommended that the following information be maintained in the credit file in respect of any credit facilities outstanding:

4.2.1 Background on the borrower:

- name and address;
- organisation, history, principal activities;
- certificate of incorporation (or identity card/passport details for personal banking customers);
- memorandum and articles of association;
- borrower's authority to borrow;
- third party references;
- experience or expertise in the trade;
- past three years' financial performance (including audited accounts and information on facilities obtained from other AIs if applicable); and
- for personal banking customers, if appropriate, a copy of the life insurance certificate naming the AI as the beneficiary;

4.2.2 Purpose of the credit and facilities requested;

4.2.3 Terms of repayment and interest;

4.2.4 Details of collateral, its current valuation and evidence that the collateral's existence has been verified and a copy of the certificate for the insurance of the collateral;

4.2.5 Nature and details of any guarantees together with an assessment of the net worth of the guarantor;

4.2.6 Assessment of credit application, including:

- the borrower's financial position at time of drawing, prospects, projected cash flows, capital resources, and other commitments;
- details of other exposure to the borrower or other related borrowers (cross-referenced to the central liability record);

- details of verification of information provided by the borrower, e.g. reference taken, valuation required;
- result of stress-test; and
- internal credit rating accorded;

4.2.7 Approval:

- name(s), rank(s) and signature(s) of approving officer(s);
- facilities approved;
- expected rate of return, preferably on a risk-adjusted basis, on the facility; and
- copy of credit documentation (agreement, facility letter, guarantee, pledge of securities, etc. - the originals should be kept in a fire-proof safe);

4.2.8 Updating of records:

- movement of funds or periodic balance of facilities;
- movement or periodic balance of collateral;
- current financial information on the borrower;
- meeting notes; and
- correspondence;

4.2.9 Assessment of internal credit rating and provisions:

- details of assessment and justifications;
- movement of internal credit rating;
- movement of provisions made; and
- current interest accrual status;

4.2.10 Review:

- incidental intelligence concerning the borrower;
- copies of exception reports arising from regular monitoring; and
- copies of the reports produced for the periodic review.

4.3 The information on a credit file should be updated regularly. Credit files should be subject to annual vetting to ensure the adequacy and proper filing of information maintained.

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