



Supervisory Policy Manual

CR-S-2

Syndicated Lending

V.1 – 29.06.01

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 guidance to AIs on the management of risks associated with syndicated lending

Classification

A non-statutory guideline issued by the MA as a guidance note

Previous guidelines superseded

This is a new guideline.

Application

To all AIs

Structure

1. Introduction
 - 1.1 Background
 - 1.2 Features
 - 1.3 Multiple parties
 - 1.4 Risk implications
2. Risks in syndicated lending
 - 2.1 Credit risk
 - 2.2 Market risk
 - 2.3 Interest rate risk
 - 2.4 Liquidity risk
 - 2.5 Operational risk
 - 2.6 Legal risk



Supervisory Policy Manual

CR-S-2

Syndicated Lending

V.1 – 29.06.01

- 2.7 Reputation risk
 - 2.8 Strategic risk
 - 3. Controls over syndicated lending
 - 3.1 Policies and procedures
 - 3.2 Credit appraisals, review and monitoring
 - 3.3 Documentation
 - 3.4 Monitoring compliance with covenants
 - 3.5 Problem credit management
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1. Introduction

1.1 Background

- 1.1.1 Syndicated lending constitutes a significant type of business for some AIs. The participation of multiple lenders and other parties adds a layer of complexity to such activity. Syndicated loans, which are often sizeable in amount, tend to attract a higher level of publicity from the market.
- 1.1.2 Syndicated loans are not necessarily riskier than other types of lending. Indeed, the distribution of lending among participants is designed to reduce risk by sharing it. In the syndicated loan market, lenders can manage their risk exposures through various means such as secondary loan sales and credit derivatives. Furthermore, the presence of multiple lenders strengthens their negotiating power with borrowers by harnessing the collective wisdom and experience of the participants and enables risk mitigating measures such as protective covenants to be put in place. Nevertheless particular types of risk may be incurred, depending on what role an AI plays in a syndicated loan.
- 1.1.3 For this reason the HKMA considers it beneficial to offer general guidance to AIs on the risks associated with such business, on how to manage them and on the types of safeguards, processes and procedures which it would expect to find in place in AIs engaging in such business.



Supervisory Policy Manual

CR-S-2

Syndicated Lending

V.1 – 29.06.01

This does not represent an exhaustive checklist but rather is intended to indicate the types of measures AIs should consider.

1.2 Features

1.2.1 The term "syndicated lending" in this module refers to arrangements whereby multiple lenders advance funds jointly to one or more borrowers (e.g. in the case of lending to different funding vehicles within a borrowing group)¹.

1.2.2 While the structure, pricing, repayment schedule and other terms of syndicated loans can vary, the following common characteristics are usually present:

- syndicated loans are normally governed by one set of documentation describing the rights and obligations of the signatories - the borrower and all the lenders (or syndicate members). The latter's obligation to lend is usually several;
- one or more lenders are mandated by the borrower to arrange credit facilities on terms agreed between the arranger and the borrower. The arranger may underwrite (i.e. undertake to provide) all or part of the facility amount;
- typically, the total amount of a syndicated deal is relatively significant, even though the credit extended by each participant does not generally exceed what it would be prepared to lend on a bilateral basis;
- the tenor may well be medium- or long-term, although short-term (under one year) facilities are also common, particularly for trade-related transactions;
- the credit facility typically takes the form of a term loan, a revolving credit or a standby letter of credit; and

¹ References to the borrower in the remainder of this module should be read as including multiple borrowers. Likewise, other parties such as the arranger may be multiple.



Supervisory Policy Manual

CR-S-2

Syndicated Lending

V.1 – 29.06.01

- syndicated lending involves multiple parties (also see subsection 1.3 below), e.g., arrangers, underwriters, sub-underwriters, agents (facility and security), legal counsel and participating lenders. There is no standard terminology, however. Titles such as co-arranger, lead manager and co-lead manager are also found. Such titles do not necessarily correspond to or define the tasks carried out by the parties bearing such titles.

1.3 Multiple parties

1.3.1 Although the functions of the arranger in syndicated lending vary according to the set-up of each deal, they normally include:

- structuring and negotiating the terms of the transaction with the borrower;
- preparing the information memorandum or package for potential lenders;
- if applicable, forming the underwriting group;
- developing a syndication strategy, including the strategy for soliciting participants and securing their commitments;
- coordinating the drafting of documentation by legal professionals; and
- handling signing of the facility and any publicity.

1.3.2 Co-arrangers may support the arrangers in carrying out the above functions, or may simply be accorded their titles by virtue of the scale of their participation.

1.3.3 As the term indicates, underwriters undertake to provide all or part of the syndicated loan if any portion remains unsold, subject to satisfactory documentation. Sub-underwriters underwrite up to the limit of their sub-underwriting. Underwriters and sub-underwriters may also be arrangers, lead managers, co-arrangers or co-lead managers.



Supervisory Policy Manual

CR-S-2

Syndicated Lending

V.1 – 29.06.01

- 1.3.4 The functions and obligations of the agent² are outlined in the facility agreement. They normally include:
- obtaining and perfecting any collateral (see para. 1.3.5 below);
 - verifying compliance with pre-conditions by the borrower (and guarantor, if appropriate) based on guidance given by legal counsel and issuing confirmation thereof to the lenders;
 - vetting any drawdown notices from the borrower and informing the lenders;
 - coordinating payments by the lenders and re-routing the funds to the borrower;
 - distributing repayments by the borrower to the lenders; and
 - advising the lenders of any default, actual or potential, by the borrower of which it becomes aware as regards repayments and compliance with covenants and other terms of the loan agreement. Lenders becoming aware of any default should also inform the agent so that the latter can inform the other lenders.
- 1.3.5 The agent usually performs the function of obtaining and perfecting any collateral with the assistance and confirmation of legal counsel appointed on behalf of the arranger and lenders. A security agent may be appointed to hold or administer collateral on behalf of the lenders.
- 1.3.6 The lenders will require the borrower's auditors, whose appointment must be satisfactory to them, to monitor compliance with financial covenants and to examine compliance certificates.
- 1.3.7 A syndicate member which is not engaged in the above functions will mainly be a participating lender. The member may employ its own legal and financial advisors to give professional advice on the deal, in addition to those appointed to advise the syndicate. A syndicate may also appoint other professional advisors such as valuation, insurance and engineering companies.

² Unless otherwise specified, the term “agent” in this module refers to the facility agent.



Supervisory Policy Manual

CR-S-2

Syndicated Lending

V.1 – 29.06.01

1.4 Risk implications

1.4.1 Given the above characteristics, Als engaging in syndicated lending business may be exposed not only to credit risk but also to market risk, interest rate risk, liquidity risk, operational risk, legal risk, reputation risk and strategic risk (also see section 2 below). These risks are not specific to syndicated lending (see para. 1.1.2 above) but the nature or degree of risks assumed may be affected by the special features of syndicated lending.

1.4.2 Als' risk exposures in a syndicated deal will vary, depending on their particular role in the transaction and the extent of their participation. Als should therefore understand the risks arising from these roles and have systems in place to manage and mitigate such risks.

2. Risks in syndicated lending

2.1 Credit risk

2.1.1 Credit risk is incurred by Als lending under a syndicated transaction. Although the creditworthiness of the borrower may be good - usually only the more creditworthy borrowers have access to the syndicated loan market - the inherent credit risk will tend to be higher where the tenor of the obligations is longer and the total size of the credit extended to the borrower is relatively large³. This is particularly true in cases where the deal amount goes up simply because of over-subscription for the syndicated transaction.

2.1.2 Regardless of their extent of participation, syndicate members (i.e. lenders) should not rely solely on the credit appraisal prepared by the arranger. Each member should perform its own independent analysis with respect to the credit quality of the borrower and the suitability of the deal in relation to its own risk appetite.

2.2 Market risk

2.2.1 The level of market risk in syndicated lending depends on the level of the Al's involvement in a deal. Als acting as

³ In relation to individual lenders the size of the credit extended will not necessarily be any larger than for direct loans to the particular borrower.



Supervisory Policy Manual

CR-S-2

Syndicated Lending

V.1 – 29.06.01

underwriters are subject to market risk because, although they intend to sell all or part of their participations, they may end up with an unsold portion on their books for a period of time pending eventual sale, particularly if:

- due to unforeseen circumstances, the borrower's financial condition deteriorates to such an extent as to affect an underwriter's ability to distribute the unsold portion; or
- market interest rates move adversely. As the majority of syndicated loans are priced on a floating-rate basis, this would be relevant in respect of:
 - fixed-rate deals; or
 - situations where market spreads widen after a syndicated transaction is concluded. This would render the deal unattractive to potential lenders.

2.2.2 It is usually the case that the period between underwriting and completion of syndication is relatively short and the extent of the risk is therefore limited. Nevertheless it is customary to cater for this risk by "material adverse change" or "force majeure" clauses in the documentation, covering market disruption or deteriorating credit circumstances, which would enable underwriters to restructure or cancel a deal.

2.2.3 Als should have policies and procedures to cater for such situations, including documentation standards, hedging for interest rate and credit risks (e.g. by use of derivative instruments), if appropriate, and reporting to senior management on any significant unsold sticks.

2.3 Interest rate risk

2.3.1 Depending on how a deal is priced and funded there may be different degrees of interest rate risk. It is incurred by Als which have provided lending commitments under legally binding documentation. Als should ensure that such risk arising from syndicated lending activities is properly managed at the product level or integrated into their overall interest rate risk management process. The handling of such risk is usually the responsibility of the Treasury Department.



Supervisory Policy Manual

CR-S-2

Syndicated Lending

V.1 – 29.06.01

- 2.3.2 In general, Als should limit the extent to which floating-rate deals are funded from fixed-rate sources and vice versa in order to minimise their interest rate risk.
- 2.3.3 Even if Als use floating-rate money to fund their floating-rate lending, they should still limit the extent to which they run any basis risk that may arise if their lending and funding are not priced using precisely the same indices.
- 2.3.4 Als should not let competitive pressures tempt them to underwrite syndicated lending at spreads which leave them no safety margin to absorb interest rate and other associated risks.
- 2.3.5 Subject to negotiation with the borrower, Als may make use of prepayment clauses as a safeguard against any loss incurred in the redeployment of funds. Standard documentation normally provides for prepayment to be made only on interest payment dates and subject to 30 or 60 days' prior written notice which generally give Als adequate time to redeploy funds. Als may also incorporate a provision that allows them to claim for losses resulting from the prepayment of funds before the end of a given interest period, i.e. where the prepayment does not correspond to a rollover or repayment date.
- 2.3.6 Als may consider balancing cash flows and managing the interest rate risk through hedging, e.g. using swaps or other derivative instruments.

2.4 Liquidity risk

- 2.4.1 As a matter of prudent management, Als should manage their liquidity positions as a whole by limiting the amount of longer term syndicated lending and other types of long-term lending (e.g. residential mortgage loans) to a conservative percentage of their stable funds⁴ so as to avoid creating significant maturity mismatches.
- 2.4.2 Als can reduce their exposure under syndicated transactions and better manage their liquidity positions through subsequent loan sales in the secondary market. To facilitate this, Als should ensure that the

⁴ Stable funds usually refer to core deposits (mainly demand and saving deposits which, based on internal analysis by the AI, can be considered permanent), medium and long term certificates of deposit and the capital base.



Supervisory Policy Manual

CR-S-2

Syndicated Lending

V.1 – 29.06.01

documentation contains transferability provisions enabling them to assign their rights by such sales.

2.4.3 Als should avoid relying excessively on short-term deposits to fund long-term loans.

2.5 Operational risk

2.5.1 Operational risk in syndicated lending is incurred by the lenders but it also affects the agent as the latter is responsible for handling certain aspects of credit administration. Errors due to oversight or negligence, e.g. in giving timely advice to syndicate members, in arranging drawdowns, in refixing interest rates or in effecting interest and principal payments to syndicate members, can be costly in terms of both monetary compensation and reputation.

2.5.2 Als taking on the role of agent should ensure that their systems are adequate and their staff are capable of carrying out their role efficiently. They may be required to compensate syndicate members if, for example, funds are disbursed late or to the wrong parties. They should also cater for counterparty risk on settlement of payments.

2.6 Legal risk

2.6.1 Legal risk is incurred by underwriters, lenders and the agent once the documentation is signed.

2.6.2 Because of the scale, term and complexity of syndicated lending, with multiple parties involved, legal arrangements need to be as watertight as possible. Experienced staff of the arranger should work closely with legal counsel to ensure that the interests of lenders are adequately protected. This should be by negotiating with the borrower to ensure that appropriate and enforceable covenants are included in the information memorandum and that they are reflected in the syndicated loan agreement along with suitable protective clauses.

2.6.3 All relevant documentation should be circulated to syndicate members for review and comment before such documentation is signed. It is up to prospective lenders to decide whether those covenants are adequate and in



Supervisory Policy Manual

CR-S-2

Syndicated Lending

V.1 – 29.06.01

general to decide whether the deal is consistent with their risk appetite.

2.7 Reputation risk

2.7.1 If a high profile deal encounters problems, it is primarily the reputation of the arranger of the deal that suffers. There may also, however, be some effect on the reputation of ordinary syndicate members. Syndicated lending tends to have a higher public profile and it is more difficult to control the information flow when there are multiple lenders. Als, whatever their role or level of involvement in a deal, should have arrangements in place and experienced staff assigned to handle corporate communications in relation to syndicated lending. There will need to be a degree of coordination among various syndicate members so that media relations can be handled effectively.

2.7.2 As it is also in the borrower's interest that media relations are handled effectively, Als acting as arrangers should coordinate with the borrower to ensure that there is a mutually satisfactory approach for dealing with media inquiries.

2.8 Strategic risk

2.8.1 Als should consider whether the projected extent of their involvement in syndicated lending is compatible with the overall strategic goals of the organisation and whether they have the requisite resources to achieve targets set for this activity.

3. Controls over syndicated lending

3.1 Policies and procedures

3.1.1 Every AI involved in syndicated lending should have adequate policies and procedures for conducting such business.

3.1.2 The policies should set out the AI's strategy for such business, its risk appetite and tolerances and the parameters under which such business is done. These would normally include:



Supervisory Policy Manual

CR-S-2

Syndicated Lending

V.1 – 29.06.01

- the type of role the AI may take on in syndicated lending (see subsection 1.3 above);
- within its overall credit limits, limits for syndicated lending with sub-limits according to different criteria, e.g. underwriting and sub-underwriting;
- the parties or committees authorized to approve such lending and ancillary matters such as documentation, pricing and other terms;
- requirements for and acceptable types of collateral;
- lists of lawyers acceptable for drawing up documentation;
- minimum standard provisions (e.g. protective clauses and covenants) required in documentation;
- guidance on pricing (e.g. minimum acceptable level of spread over funding costs and the level of authority required to approve a spread lower than the minimum);
- policies and procedures for managing the eight risks described in section 2 above; and
- requirements for monitoring, reporting and independent reviews of syndicated lending activity.

3.1.3 Als engaged in syndicated lending mainly as ordinary members may have the above policies incorporated into their general credit policies which are subject to periodic review and approval as required in subsection 3.1 of CR-G-1 “General Principles of Credit Risk Management”.

3.1.4 Als actively involved in syndicated lending as arrangers or underwriters should have specific policies and procedures covering such business, documented in writing and approved by the Board of Directors, the Credit Committee or senior management with delegated authority. They should also set up dedicated teams responsible for managing the syndication process and associated underwriting risks.

3.2 Credit appraisals, review and monitoring



Supervisory Policy Manual

CR-S-2

Syndicated Lending

V.1 – 29.06.01

3.2.1 In addition to conducting its own due diligence as mentioned in para. 2.1.2 above, each syndicate member should perform its own periodic credit review and monitoring to identify unusual developments and, if appropriate, initiate necessary actions to protect its interest. See [CR-G-2](#) “Credit Approval, Review and Records” and [CR-G-3](#) “Credit Administration, Measurement and Monitoring” for further guidance.

3.3 Documentation

3.3.1 Due to the multiple parties associated with syndicated lending it is customary for such deals to be tightly documented. In addition to agreements between the participating AIs and the borrower (and guarantor, if any), the respective roles and responsibilities of all participating AIs, e.g. the agreement between the agent and other syndicate members, should be carefully drafted.

3.3.2 It is up to individual AIs to decide what provisions are required to be included in the agreements. It is, however, customary for emphasis to be placed on covenants to protect the interests of lenders.

3.3.3 Documentation should also cover provisions dealing with issues such as:

- tax gross-ups (the obligation of the borrower to increase any payment on which withholding tax or other deductions are levied so that lenders receive the amount they were originally due under the terms of the documentation);
- increased costs (the obligation of the borrower to indemnify lenders where market circumstances make it more expensive for lenders to maintain their participations); and
- illegality (where any provisions of the documentation become illegal or unenforceable, the survival of the remaining terms).

3.3.4 In the evolution of the syndicated lending market since its inception documentation has gradually become more standardised. Parties active in the market are encouraging this process through participation in market



Supervisory Policy Manual

CR-S-2

Syndicated Lending

V.1 – 29.06.01

associations. The HKMA sees this as a development which is beneficial to AIs.

3.4 Monitoring compliance with covenants

3.4.1 Covenants may be affirmative or negative. The former relates to pledges to satisfy certain requirements, e.g. undertakings to keep key assets adequately insured and to effect repayments on time. Negative (or restrictive) covenants prohibit or require the borrower to refrain from certain practices such as selling or transferring key assets, from committing any default under other terms of the agreement, from falling below a minimum gearing ratio, from committing actions that diminish the value of the collateral or endanger the financial stability of the business, etc.

3.4.2 Violations of covenants may constitute events of default and accelerate repayment under the agreement. AIs should not relax covenants without careful considerations.

3.4.3 All syndicate members should have proper systems in place to monitor for themselves the compliance by the borrower with the covenants of a syndicated loan agreement. For example, they may set out their own schedules for regular follow-up of information from borrowers. If any syndicate member is aware of any breach of the covenants, it should report the breach promptly to the agent for relaying to other members. The breach should be investigated with appropriate actions taken, e.g. top-up of collateral, to protect the interests of syndicate members.

3.4.4 If the task of monitoring compliance with covenants is delegated to the agent, other syndicate members should satisfy themselves that the agent is capable of performing this important task and they should also carry out their own periodic verifications to spot check whether the agent is monitoring properly.

3.5 Problem credit management

3.5.1 As with any lending, syndicated loans may go into default. With the presence of multiple lenders, it is particularly important that they react responsibly in such situations so that the interests of lenders, borrowers and other parties are properly safeguarded. In this regard, AIs are



Supervisory Policy Manual

CR-S-2

Syndicated Lending

V.1 – 29.06.01

encouraged to observe the guidelines jointly issued by the Hong Kong Association of Banks and the HKMA titled "Hong Kong Approach to Corporate Difficulties".

Contents	Glossary	Home	Introduction
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