



## Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

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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.

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### Purpose

To provide guidelines to AIs on credit risk mitigation in the form of collateral or guarantee

### Classification

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

### Previous guidelines superseded

CR-G-7 “Collateral and Guarantee” (v.1) dated 29.06.01

### Application

To all AIs

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### 1. Introduction

#### 1.1 Terminology

For the purposes of this module—

1.1.1 **collateral** means any financial collateral or physical collateral;

1.1.2 **credit protection provider** means the guarantor of a guarantee (see paragraph 1.1.5), including the insurer of any insurance policy that falls within the meaning of “guarantee” given by paragraph 1.1.5;

1.1.3 **credit risk mitigant** (CRM), in relation to a credit exposure (whether existing or proposed)—

(a) means any collateral or guarantee obtained or intended to be obtained by an AI to mitigate the credit risk of the credit exposure; and

(b) excludes any collateral or guarantee—

(i) that does not have or is not expected to have any meaningful credit risk mitigation effect for the credit exposure; and

(ii) that has been or is intended to be obtained simply as additional comfort;

1.1.4 **financial collateral** means collateral in the form of a financial instrument or financial asset, such as cash, bank deposits, debt securities, investment funds, equities, paper gold, life insurance policies, residential mortgage loans, trade receivables, etc.;

1.1.5 **guarantee**, in relation to an AI—

(a) means a legal agreement, other than a credit derivative contract, that allows one party (beneficiary) to transfer the credit risk of one or more specific credit exposures to another party; and

(b) includes any legal agreement falling within paragraph (a) that is in the form of indemnity, letter of credit, risk



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participation, mortgage insurance, export credit insurance or other credit risk insurance;

- 1.1.6 **physical collateral** means tangible collateral other than financial collateral, such as real estate, machinery, inventories, equipment, automobile, aircraft, gold bullion, taxi medallion, etc..

### 1.2 Scope of application

- 1.2.1 The guidance set out in this module is applicable to CRM used for mitigating credit risk arising from credit exposures, including lending commitments and contingent liabilities (such as those arising from shipping guarantees or performance bonds issued by AIs), and margin lending that is neither a margin lending transaction as defined in section 2(1) of the Banking (Capital) Rules (BCR) nor share margin financing as defined in [CR-S-4](#) “New Share Subscription and Share Margin Financing”.

- 1.2.2 Regarding CRM used for mitigating counterparty credit risk (CCR)<sup>1</sup> and credit risk arising from share margin financing (within the meaning given by [CR-S-4](#)), apart from the general principles set out in this module (e.g. Sections [2](#), [3](#) and [4](#)), AIs should also refer to the following SPM modules for more specific guidance—

- (a) [CR-G-13](#) “Counterparty Credit Risk Management” for guidance on the use of collateral, central clearing and netting in mitigating CCR arising from derivative contracts and securities financing transactions;
- (b) [CR-G-14](#) “Non-centrally cleared OTC derivatives transactions – Margin and other risk mitigation standards” for requirements on the use of margins for mitigating CCR arising from non-centrally cleared OTC derivative contracts; and

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<sup>1</sup> Please see [CR-G-13](#) “Counterparty Credit Risk Management” for the definition of “counterparty credit risk”. Such risk arises mainly from derivative contracts and securities financing transactions (e.g. repo transactions) where the AI is exposed to the risk of default of the other party to the contract or transaction and that other party is also exposed to the risk of default of the AI. This is different from a loan granted by the AI to a borrower because the loan does not expose the borrower to the risk of default of the AI.



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- (c) [CR-S-4](#) “New Share Subscription and Share Margin Financing” for specific guidance on the acceptance and management of share collateral.

1.2.3 Als should refer to [CR-G-12](#) “Credit Risk Transfer Activities” for guidance on the use of credit risk transfer techniques in the form of credit derivative contracts and securitization.

1.2.4 To avoid doubt, this module is intended to provide guidance on the use of collateral and guarantees for credit risk management purposes. It does not seek to introduce any new requirements into, or replace or modify any requirements specified in, the rules made by the MA under the Banking Ordinance, e.g. the eligibility criteria for recognised credit risk mitigation set out in the BCR<sup>2</sup>.

### 1.3 Nature of risks associated with CRM

1.3.1 Als’ primary consideration when approving credits should always be the financial strength and debt-servicing capacity of the borrower, [transacting party or obligor concerned](#) (collectively referred to as “borrower” in this module). Als should not rely solely on [the proceeds from the enforcement of CRM](#) as the primary source of repayment<sup>3</sup>, as a substitute for their own [due diligence \(including comprehensive and independent assessment of the borrower’s creditworthiness\)](#) or to make up for insufficient information.

1.3.2 Als that rely on CRM as a secondary source of repayment face two major risks:

- (a) they may be unable to [enforce their security interest in collateral or their rights under a guarantee](#); and

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<sup>2</sup> Als should refer to the BCR, instead of this module, for the types of collateral and guarantee that can be recognised for the purposes of capital ratio calculations. This module focuses on credit risk management in general and therefore may include collateral and guarantees that are not acceptable for the purposes of the BCR.

<sup>3</sup> Except certain asset-based lending under which the primary source of repayment is the conversion of the collateral (e.g. IPO loans) into cash, and certain structured (limited recourse) lending (e.g. project finance), Islamic products and mortgage loans for purchasing investment properties, where the primary source of repayment is the income or cash flows (e.g. rental) generated from the collateral.



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- (b) the amount recovered from the CRM may eventually be less than originally estimated.

1.3.3 It is therefore essential for AIs to set up appropriate systems and controls for the management of CRM.

## 2. CRM management policies, procedures and limits

### 2.1 Policies and procedures

2.1.1 AIs should have in place written policies and procedures, approved by their Board of Directors, the Credit Committee or their designees, for the management of CRM. The policies and procedures of an AI should cover inter alia:

- (a) clear delegation of authorities and responsibilities to relevant individuals and departments for approving the acceptance, monitoring and enforcement/release of CRM;
- (b) clear definitions of acceptable forms of CRM and acceptable types of asset and credit protection provider, taking into account any statutory restriction imposed by the laws or regulations applicable to the AI (e.g. the Banking (Exposure Limits) Rules (Cap. 155S) (BELR));
- (c) types of risk (i.e. residual risks, including legal, operational, liquidity and market risks) arising from the use of CRM, and the associated policies and procedures for managing those risks; and
- (d) collection of data and compilation of management information on CRM for different purposes.

2.1.2 The policies and procedures mentioned in paragraph 2.1.1(c) typically include—

- (a) eligibility criteria for evaluating whether a CRM is acceptable (see section 3);
- (b) loan-to-value ratio, margin level or haircut for each type of acceptable collateral and for each type of credit exposure (see subsection 2.2);



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- (c) for each type of acceptable collateral, the procedures and practices for verification, valuation (and revaluation) and inspection (in the case of physical collateral) of the collateral (see section 5); and
- (d) systems and controls for—
  - (i) ensuring validity and enforceability of CRM (see section 4);
  - (ii) ensuring compliance with relevant laws, regulations and supervisory requirements (see subsection 4.3);
  - (iii) safe custody of, and access to, collateral and CRM-related legal documents (see subsection 6.2);
  - (iv) ensuring collateral (basically physical collateral) is adequately insured against the risk of damage (see subsection 6.3);
  - (v) identifying, measuring, monitoring and controlling credit risk concentration and, if applicable, roll-off risk, arising from the use of CRM (see subsection 2.3);
  - (vi) managing the interaction between any credit risk concentration arising from the use of CRM and the overall credit risk profile of the AI concerned;
  - (vii) regular review and monitoring of the adequacy and quality of CRM (see subsection 6.4);
  - (viii) managing top-up of collateral (see subsection 6.5); and
  - (ix) timely release, and realisation, of CRM (see section 7).

## 2.2 Loan-to-value ratio, margin level and haircut

### 2.2.1 AIs should specify—



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- (a) the loan-to-value (LTV) ratios, [margin levels and haircuts, however described](#), for [different types of acceptable collateral and credit exposures](#); and
  - (b) the manner in which the actual LTV ratio, margin level or haircut for a credit exposure should be calculated (in principle, all credit exposures, including the undrawn portion of any credit facility, collateralised against the same asset must be included in the calculation).
- 2.2.2 The LTV ratios, [margin levels and haircuts](#) should be commensurate with the risks of the collateral [and the credit exposures concerned](#) and should be able to provide an adequate buffer against—
- (a) volatility of the market value of the collateral [during normal times and in stressed situations](#);
  - (b) any currency mismatch between the collateral and the credit exposure; and
  - (c) the liquidity risk of the collateral.
- 2.2.3 In calculating the LTV ratio of a new mortgage loan for financing the purchase of an immovable property, Als should use a property value (i.e. the denominator) that is the lower of the valuation of the property or the effective<sup>4</sup> purchase price of the property.
- 2.2.4 For certain types of collateral such as trade receivables or real estate, other factors should also be reflected in the LTV ratios, margin levels or haircuts, where appropriate, such as—
- (a) [estimated costs of collection or repossession](#);
  - (b) [estimated carrying costs of maintaining the repossessed collateral before it is disposed of](#); and
  - (c) [estimated costs that would be incurred for disposing of the collateral \(e.g. auction fees\)](#).

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<sup>4</sup> Any significant incentives or benefits offered by the property developer or seller that may inflate the price of the immovable property should be deducted.





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- 2.2.5 In general, AIs should set a conservative haircut for collateral whose value is highly volatile or where a longer time is needed to liquidate the collateral. The quantum of that haircut will also depend on the term of the credit exposure being secured and, if there is a mismatch between the currencies in which the credit exposure and the collateral are denominated, [the volatility of the exchange rate concerned](#).
- 2.2.6 In determining the security coverage of problem exposures secured by collateral, AIs should, where appropriate, apply a discount to the valuation of the collateral to take into account possible marketing constraints under a forced sale [or fire sale](#) situation, or under unfavourable [or stressed](#) market conditions.
- 2.2.7 AIs should also ensure that the LTV ratios, [margin levels and haircuts](#)—
- (a) comply with the regulatory requirements issued from time to time by the HKMA and, if applicable, the home supervisors of the AIs; and
  - (b) [are reviewed regularly to evaluate their reasonableness and to reflect changing market conditions and loss experience](#).

### 2.3 Concentration limits

- 2.3.1 AIs should consider concentration risk associated with CRM [\(e.g. in the case of mortgage insurance, concentrated exposure to a small number of insurers\)](#) from various dimensions, including concentration in—
- (a) the same type of asset;
  - (b) [the same type or form of guarantee \(e.g. indemnity, third-party guarantee, counter-guarantee, export credit insurance, mortgage insurance, standby letter of credit, etc.\)](#);
  - (c) [\(in the case of immovable property\) the same geographical location](#);
  - (d) financial instruments issued by, or guarantees provided by, the same entity [\(or entities in the same group\)](#), entities



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in the same industry, entities in closely related industries or entities with similar economic characteristics.

- 2.3.2 AIs should formulate a policy with respect to the amount of concentration risk they are prepared to run, **taking into account their own risk appetite and the relevant legal and regulatory requirements applicable to them.** For example, limits on concentration risk could be **set based on the dimensions discussed in paragraph 2.3.1.**

### 2.4 Regular review

- 2.4.1 AIs should have detailed procedures **and measures** to enforce the above policies, **procedures and limits**, and to ensure that they are subject to regular reviews in light of changes in the AIs' risk appetite, risk management strategies, business models, and market and regulatory environments.
- 2.4.2 The internal audit **and compliance functions of AIs** should carry out periodic reviews to ensure that the above policies, procedures **and limits are adequate and effective**, in **compliance with applicable legal and regulatory requirements and** adhered to by all relevant staff members.

## 3. Eligibility of CRM

### 3.1 General

- 3.1.1 Collateral whose value, or a guarantee whose credit protection provider's credit quality, has a material positive correlation with the credit quality of the borrower<sup>5</sup> is unlikely to provide any meaningful credit protection to AIs. Hence, AIs should not rely on such collateral or guarantee for mitigating credit risk.
- 3.1.2 **Collateral that are financial instruments issued by the parent, subsidiary or affiliate company of the borrower, or guarantees provided by any of these parties, are acceptable provided that the requirement set out in paragraph 3.1.1 is met.** The

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<sup>5</sup> For example, **shares, debt securities or guarantee issued by an entity where the borrower is the entity's key or only customer**, or the borrower's own shares or debt securities.



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assessment of correlation should take into account the credit risk of the whole group.

- 3.1.3 In cases where the borrower is only a special purpose vehicle (SPV) where the lending AI looks primarily to the income of the guarantor guaranteeing, or the revenues generated by the assets securing, the credit exposure concerned as the primary source of repayment of the exposure because the SPV has little or no independent capacity<sup>6</sup> to repay the exposure, paragraphs 3.1.1 and 3.1.2 may not be applicable. Examples of this type of financing arrangement include project finance (including real estate development projects), mortgage loans granted to shell companies for purchasing investment properties, and syndicated loans whose borrowers are special purpose funding vehicles of corporate groups or conglomerates.
- 3.1.4 For certain types of CRM (e.g. trade receivables and mortgage insurance), AIs will also need to evaluate the underwriting practices, risk management systems and internal controls of the borrower or the credit protection provider concerned when assessing the extent and effectiveness of the credit protection provided by the CRM. Moreover, in the case of credit risk insurance, AIs should have a clear understanding of the policy coverage.
- 3.1.5 AIs may accept an asset or a guarantee as CRM only if they are capable of creating security interests in the asset (including any right to repossess the asset without impediment), or imposing legal obligations on the credit protection provider of the guarantee, that are binding on all relevant parties and legally enforceable in all relevant jurisdictions (see subsection 4.1).
- 3.1.6 In general, the CRM arrangement should remain effective throughout the term of the credit exposure concerned. In other words, collateral should not be released, or obligations of the credit protection provider under a guarantee should not be discharged, before the obligations of the borrower concerned

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<sup>6</sup> Examples of lack of independent capacity include cases where the assets pledged to the lending AI as collateral are the only assets held by the SPV or the SPV's incomes are all from the guarantor within the same group as the SPV and/or from other group companies.



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are fully discharged. In the case of life insurance policies, this means that the policy must remain current for the life of the credit exposure (e.g. a life insurance policy that has the premium fully paid up).

- 3.1.7 Collateral or guarantees that do not satisfy the eligibility criteria set out in this section (e.g. paragraph 3.1.1) may still be accepted as additional comfort, but the credit risk of the credit exposure concerned should be assessed and managed without taking into account the collateral or guarantee.

### 3.2 Collateral

- 3.2.1 In addition to the general criteria set out in subsection 3.1, AIs should ensure that only assets that satisfy the following eligibility criteria are accepted as collateral:

- (a) the asset should be of satisfactory quality, e.g. in terms of the credit risk of the issuers in the case of debt securities (or the debtors in the case of trade receivables), or of the insurers in the case of life insurance policies;
- (b) the market value of the asset is readily determinable or can be reasonably established and verified (see section 5);
- (c) the asset can be realised in a reasonable period of time. If the asset has to be realised by sale, there exists a readily available market for disposing of the asset;
- (d) the AI is able to secure control over the asset if necessary. In the case of movable physical collateral, the AI should either have physical custody of the asset (e.g. gold bullion) or have the means of locating its whereabouts (e.g. vehicle or machinery). For life insurance policies, any amount payable under the life insurance policy should only be made to the AI or to other parties with the AI's prior consent; and
- (e) the AI has the expertise and systems to—
  - (i) assess the risks of the asset; and



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- (ii) manage the collection or repossession of the asset, or, where the asset is held by or under the custody of the AI, manage the asset.

### 3.3 Guarantee

3.3.1 In addition to the general criteria set out in subsection 3.1, AIs should ensure that only guarantees that fulfil the following eligibility criteria are accepted as CRM for their credit exposures:

- (a) the guarantee should be evidenced in writing and represent a direct claim of the AI on the credit protection provider;
- (b) the guarantee should be unconditional and irrevocable<sup>7</sup>;
- (c) the financial strength of the credit protection provider has been thoroughly assessed, under the same rigorous credit risk assessment process as applied to a borrower, as adequate for discharging the obligations under the guarantee. If the credit protection provider is a financial institution (including banks, securities firms and insurance companies), that institution should be subject to prudential and regulatory oversight by a competent authority, unless the financial activities carried on by the institution are not required by law to be subject to regulation and prudential supervision;
- (d) the undertaking of the credit protection provider to make payment in specified circumstances (e.g. bankruptcy of the borrower) relating to the credit exposure is clearly documented in the guarantee so that the extent of the credit protection provided by the guarantee is clearly defined;

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<sup>7</sup> In the case of an all monies or continuing guarantee, if the credit protection provider may, by giving advance notice to the AI, revoke its obligations under the guarantee in respect of any new credit exposures to the borrower concerned, the guarantee will not be considered as failing to meet the criteria set out in paragraphs 3.3.1(d) and 3.3.1(e) as long as the revocation will only discharge the credit protection provider's obligations in respect of new credit exposures incurred by the AI after the revocation but not those incurred prior to the revocation. However, the AI must take into account such right of revocation when measuring the effectiveness of such guarantee as a CRM.



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- (e) the guarantee should not contain any clause, the fulfilment of which is outside the direct control of the AI, that would reduce or cancel the credit protection<sup>8</sup>, or prevent the AI from obtaining prompt payment from the credit protection provider; and
- (f) collection of funds under the guarantee should not be subject to unduly complex procedures or processes.

### 4. Validity of CRM

#### 4.1 Enforceability

4.1.1 The CRM arrangements should be properly documented. Als should **conduct sufficient legal review to verify that a CRM arrangement and the associated credit documentation, including any guarantee form or legal documents (e.g. mortgage deed), are binding on all parties concerned and legally enforceable in all relevant jurisdictions.** Where appropriate, Als should obtain positive legal opinions to this effect. **The legal review should be re-conducted, as necessary, to ensure continuing legal enforceability.** There should also be measures to avoid, among other things—

- (a) contracts (or any clauses in such contracts) being rendered **void, voidable or unenforceable** by virtue of the Unconscionable Contracts Ordinance (Cap. 458) **or for other reasons such as lack of capacity, misrepresentation or undue influence;**
- (b) taking assets as collateral that may violate any law or regulatory requirement applicable to the AI concerned **(see subsection 4.3 for more information);** and
- (c) **omitting any steps that should be taken (whether by the AI or by other relevant parties such as the borrower or the credit protection provider) to fulfil requirements under the law applicable to, or any contractual terms associated with, the CRM concerned that are necessary to perfect the security interest or credit protection, such as prompt registration of legal charges or guarantees with the**

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<sup>8</sup> See footnote 7.



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relevant authorities (e.g. the Companies Registry in Hong Kong or the State Administration of Foreign Exchange in Mainland China), or prompt notification to insurers in respect of security or assignment agreements executed for insurance policies taken as collateral.

4.1.2 The CRM arrangement and the associated credit documentation should empower the AI to enforce or realise the CRM without any impediment and in a timely manner on the occurrence of any event of default (e.g. bankruptcy of the borrower) or any similar event as defined in the credit documentation. For example, the AI should have the right to cancel the life insurance policy assigned to it as collateral and receive the surrender value in the event of the default of the borrower.

4.1.3 Apart from enforceability in the legal context, AIs should also consider practical or operational issues in enforcing cross-border CRM arrangements where the collateral or credit protection provider is located outside Hong Kong. For example, procedural risks of legal proceedings in overseas jurisdictions, practical difficulties in repossession of collateral, withholding tax on the proceeds of enforcement of CRM, exchange controls, etc..

### 4.2 Title and ownership of assets taken as collateral

4.2.1 AIs should verify the existence and ownership of the asset intended to be taken as collateral before acceptance. Moreover, there should not be any claim of a higher or equal ranking by another party on the asset, or any other encumbrances (e.g. court order or unregistrable third party interest) that may jeopardise the AIs' security interest in the asset.

4.2.2 AIs should ensure that all legal documents are properly executed and, where applicable, AIs' control over the collateral is secured prior to the drawdown of credit facilities. For example, an AI should have obtained its customer's authorisation to allow it to transfer the legal title to the shares taken as collateral to the AI or have received its lawyer's confirmation of having taken possession of the original title deeds of the mortgaged immovable property.



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4.2.3 Where there is a need for the collateral (e.g. shares or debt securities) to be held by a third party (e.g. a custodian), Als should take reasonable steps to verify that the third party does not have any claim over the collateral (e.g. by obtaining a written confirmation from the third party) and the collateral is segregated from the third party's own assets and held in a bankruptcy remote manner.

### 4.3 Compliance with relevant laws and regulations

4.3.1 Als should not take assets as collateral that will violate any statutory restrictions, whether imposed by the laws of Hong Kong or other jurisdictions, applicable to the AI, such as the concentration risk limits imposed by the BELR.

4.3.2 In handling collateral (including disposal), Als should ensure compliance with relevant laws and regulations, e.g. Als that are registered institutions should observe relevant requirements set out in the Securities and Futures Ordinance (Cap. 571) or the rules made under that Ordinance, and the relevant guidance issued by the Securities and Futures Commission, in respect of collateral received from clients. Where appropriate, legal advice should be sought.

4.3.3 Als should also comply with the Code of Banking Practice in respect of secured lending, guarantees and third party securities for transactions that fall within the scope of the Code.

## 5. Valuation of collateral

### 5.1 Type of valuation

5.1.1 Als should establish clear requirements on the acceptable types of valuation for different asset types and purposes (e.g. new credit origination, annual credit review, credit monitoring, etc.), such as full and formal valuation reports that include on-site inspections or desktop valuation reports.

5.1.2 Notwithstanding the type of valuation used, Als should maintain adequate valuation documentation for collateral, which should include the methodologies and assumptions used in a valuation.





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5.1.3 The scope and extent of the valuation report should be commensurate with the value of the collateral and its inherent risks.

### 5.2 Basis of valuation

5.2.1 For assets that do not have readily available and observable market values (e.g. immovable properties), valuation should be conducted in accordance with the relevant international or local valuation standards issued by global standard setters or professional bodies. Under this high level principle, the valuation, whether internal or external, of an asset taken or to be taken by an AI as collateral—

- (a) should reflect the asset's current price level;
- (b) should be conservative and based on reasonable, prudent and substantiated methodologies and assumptions, and should have taken into account all factors (e.g. climate risks (such as potential damage related to weather hazard), liquidity, obsolescence and deterioration) that are relevant to the value of the asset. Onsite or physical inspection of the asset by the appraiser may be warranted in order to produce a valuation report that is professionally adequate for its purpose. The AI should ensure that it, and its agents, have the right to inspect the asset where necessary;
- (c) should not take into consideration expected future price appreciation and temporary aberrations; and
- (d) should not be biased in order to enable the AI to inflate the credit quality of a borrower so that the AI could, for example, grant a higher credit limit to the borrower, improve the borrower's internal credit rating, reduce the capital requirement of a credit exposure, reduce the amount of credit loss allowance required or continue interest accrual for a problem credit.

5.2.2 In the case of assets that have readily available and observable market value (e.g. equities and investment funds), the valuation should not be higher than such market value. AIs should have reliable sources of timely price data in order to



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measure the collateral coverage of their credit exposures accurately.

5.2.3 Where applicable, AIs should adjust the valuation to take into account—

- (a) potential realisation costs (e.g. carrying costs of the repossessed collateral, legal fees or other charges associated with disposing of the collateral); and
- (b) the potential for the current valuation to be significantly above the value that would be sustainable over the life of the credit exposure concerned.

### 5.3 Appraisers' competence

5.3.1 AIs should establish criteria for determining when to use external appraisers. Examples of situations where external valuation may be warranted include collateral that does not have a readily available and observable market value (e.g. unlisted investments), lack of price information of an identical or similar asset for comparison with the collateral (e.g. a large commercial complex), and collateral that an AI does not have the expertise to assess its value (such as fine arts and antiques).

5.3.2 AIs should maintain a list of approved external appraisers that have been selected based on pre-specified assessment criteria in terms of factors including professional qualification, reputation, experience and competence. The performance of the external appraisers should be regularly monitored and evaluated. Appraiser selection and evaluation should be conducted by an AI's risk management function, rather than the staff involved in credit/business origination.

5.3.3 AIs that have their own internal valuation unit should put in place systems and controls to ensure that—

- (a) the responsible staff possess sufficient knowledge and expertise to perform their duties;
- (b) sufficient resources are deployed to provide appropriate training to the staff for maintaining their competence level



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and to provide access to information that is necessary for conducting high quality valuation; and

- (c) where applicable, the valuation methodologies and models used by internal appraisers are reviewed and validated on a regular basis. For example, internal valuations can be back-tested against the actual sale proceeds received on subsequent disposal of the assets concerned or cross-checked from time to time with external valuations on a sampling basis.

5.3.4 In cases where there is any doubt about the valuation conducted by an internal or external appraiser, the HKMA may, for the purposes of assessing the adequacy of capital requirements, credit loss provisions or credit risk management, or ascertaining compliance with other regulatory/supervisory requirements, request an AI to obtain an independent second valuation from another appraiser.

### 5.4 Frequency of revaluation

5.4.1 Collateral should be revalued on a regular basis and whenever there are concerns over the performance of the collateral or the borrower or there are reasons to believe that a significant decrease in the market value of the collateral has occurred. Where feasible, clear triggers should be set for increased frequency of revaluation.

5.4.2 The frequency<sup>9</sup> of regular revaluation may vary with the type of collateral involved (e.g. collateral with higher price volatility should be subject to more frequent revaluation) and the nature and the internal credit rating of the credit exposure concerned. For example, AIs should mark to market securities posted by their margin lending customers at least on a daily basis. At times when market volatility is high, this should be performed intra-day at short notice (and margin calls should be made, if appropriate).

5.4.3 For large or problem exposures that are secured by immovable properties, there should preferably be quarterly revaluations.

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<sup>9</sup> If an AI intends to recognise the collateral under the BCR for capital adequacy purposes, the frequency of revaluation must comply with the requirements set out in the BCR.



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The frequency may need to be increased further to monthly if the property market is declining rapidly. Problem exposures secured by other types of collateral also deserve revaluation on a more frequent basis.

5.4.4 AIs should specify the minimum frequencies of revaluation for different types of asset and credit exposure.

### 5.5 Independence of valuation

5.5.1 External appraisers, providers of valuation systems, and the staff of an AI responsible for performing valuations or carrying out related activities (e.g. conducting site visits or deciding on the use of external appraisers) should be independent of the AI's functions responsible for credit/business origination, credit assessment and credit approval. They should also be independent of the borrower (and the mortgagor/chargor or credit protection provider, if any) and should not have an interest in the result of the valuation.

5.5.2 The AI should ensure that the compensation arrangements with appraisers and the AI's staff involved in valuation will not create inappropriate influence on, or wrong incentives for, them.

## 6. Risks of failed or reduced credit protection

### 6.1 General

6.1.1 AIs should have robust procedures and processes to control risks of failed or reduced credit protection.

6.1.2 Credit protection could become ineffective or less effective in cases such as—

- (a) a significant decline in the value of the collateral (e.g. shares, debt securities or commodities) attributable to market-wide risk sources such as market turmoil or economic downturn;
- (b) a decline in the value of the mortgaged immovable property due to climate risks (e.g. the location of the property has become vulnerable to damages caused by severe weather events or repeated flooding);



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- (c) [deterioration or obsolescence of the collateral due to introduction of new substitutes or technologies \(e.g. machinery or equipment\), or the fashion- or date-sensitive nature of the collateral \(e.g. inventories\); and](#)
- (d) [deterioration in the financial strength of the credit protection provider of a guarantee or in the credit quality of a financial collateral \(such as worsening creditworthiness of the issuer of a debt instrument taken as collateral\).](#)

### 6.2 Safe custody and access controls

6.2.1 Authorities and responsibilities should be clearly delegated to relevant individuals and departments for safe custody of [CRM-related legal documents \(e.g. deed of guarantee and title deed of a mortgaged immovable property\)](#) and collateral physically held by AIs.

6.2.2 Collateral [and CRM-related legal documents](#) should be kept in a fire-proof safe or vault under dual control, with the locations properly recorded and controlled so as to facilitate easy retrieval in future.

6.2.3 Movements of collateral and [CRM-related legal documents](#) should be duly authorised [and tracked](#), acknowledged by the persons withdrawing them from the safe or vault. [There should be internal controls to ensure that collateral and CRM-related legal documents](#) withdrawn are returned promptly and to chase up collateral and [CRM-related legal documents](#) that have not been returned after an unusually long period. [In addition, there should be regular physical checks on collateral and CRM-related legal documents.](#)

6.2.4 For financial collateral held by custodians, AIs should conduct regular reconciliation of collateral balances.

### 6.3 Insurance

6.3.1 [Where applicable, physical collateral taken by AIs should be adequately insured against the risk of damage or loss.](#) The AI should be the beneficiary of the policy [\(or otherwise entitled to receive the policy proceeds, e.g. the interest in the policy has been properly assigned to the AI\).](#)



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- 6.3.2 The coverage of the insurance policy should be appropriate, and the policy should remain valid until the collateral is released by the AI.
- 6.3.3 The cost of insurance, unless borne by the borrower, should be factored into the pricing of the credit facility concerned.
- 6.3.4 The insurer should be under adequate supervision<sup>10</sup>, financially sound and independent of the borrower concerned (and the mortgagor/chargor, if any). If the insurer is a related company of the AI, the insurer should also be operationally independent of the AI (i.e. with a separate management team). In addition, the AI should consider whether appropriate measures (e.g. reinsurance) have been taken by the insurer to ensure that the group as a whole is not exposed to undue risks.

### 6.4 Evaluation of quality of CRM after acceptance

- 6.4.1 The quality of the CRM obtained should be evaluated regularly. The frequency will depend on the nature, size, and risk of the credit exposure concerned. The evaluation can be conducted in parallel with the credit review of the credit exposure, if applicable. However, adverse changes in the financial markets or property market, or deterioration in the credit quality of the borrower, may warrant a prompt review of the likely performance of the CRM.
- 6.4.2 Where applicable and appropriate, the evaluation may also need to cover—
- (a) in the case of movable physical collateral such as machinery and equipment—periodic visits of the sites in which the assets are located so as to verify the existence and the conditions of the assets; and
  - (b) in the case of equitable mortgage loans involving off-plan properties—monitoring of the construction progress and the financial position of the property developer concerned.

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<sup>10</sup> This condition is satisfied if the insurer is an insurance company subject to the supervision of the Insurance Authority.



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6.4.3 AIs should review [regularly the credit quality of financial collateral and](#) guarantees where appropriate (e.g. during the annual credit review) to ensure that they continue to meet the eligibility criteria. This should include a review of the financial strength of the following parties—

- (a) [for financial collateral—the obligors in respect of the financial instruments or financial assets concerned \(e.g. the issuers of debt securities or the insurers of life insurance policies\); and](#)
- (b) [for guarantees—the credit protection providers \(e.g. the insurer in the case of a mortgage insurance\).](#)

6.4.4 [If the evaluation indicates that the credit protection has become ineffective or less effective and the increased credit risk to the borrower exceeds the level the AI is willing to assume, the AI should take appropriate protective measures, such as, requiring additional collateral or guarantee, replacement of collateral, changes to credit terms or reducing credit limits.](#)

### 6.5 Collateral maintenance requirement

6.5.1 For credit facilities (e.g. margin lending) that require borrowers to provide additional collateral under certain circumstances, [the circumstances and the relevant quantitative triggers](#) should be clearly [defined and](#) documented in the relevant agreements with the borrowers.

6.5.2 [There should be clearly documented systems and controls to—](#)

- (a) [monitor the outstanding credit exposure of a borrower and the current market value of the collateral posted by the borrower to ensure that requests for additional collateral are made in a timely and accurate manner; and](#)
- (b) [follow up promptly any collateral requests that have not been met by borrowers.](#)

### 6.6 Stress-testing

6.6.1 AIs should monitor general trends in markets (e.g. property and stock markets), [financial systems and economies that are relevant to](#) the major types of CRM used.



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6.6.2 AIs should include CRM in their stress-tests and scenario analysis in order to assess the overall impact of any adverse changes in the values or effectiveness of the CRM under unusual or stressed market conditions (e.g. a significant decline in property or stock prices, or insolvency of a major financial institution) on the AIs' financial positions. Stress-testing would help highlight vulnerabilities in an AI's CRM portfolios to adverse external factors or market conditions. AIs should refer to [IC-5](#) "Stress-testing" for more details.

## 7. Release and realisation of CRM

### 7.1 Release of CRM

7.1.1 Prior to the release of CRM, there should be internal controls to ensure that:

- (a) all conditions for release stipulated in the relevant legal agreements have been fully satisfied; and
- (b) the release has been properly authorised, executed and documented.

7.1.2 After verifying that the conditions for release are satisfied and the release has been properly authorised, the collateral and/or the relevant CRM-related legal documents should be returned to the appropriate party (e.g. the borrower, the credit protection provider or the owner of the collateral) promptly, unless otherwise specified in the relevant documentation (e.g. where it is stipulated that the deed of guarantee remains the property of the AI after the principal indebtedness has been repaid). Confirmation of receipt should be obtained from the party concerned upon the release.

7.1.3 If the CRM to be released will be substituted with another CRM, AIs should evaluate the substitute CRM and exercise due diligence in the same manner as if it were obtaining a new CRM for a new credit facility. Adjustments to the limit and other credit terms of the existing credit facility may be warranted. The substitute CRM must be received prior to the release of the existing CRM.





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### 7.2 Realisation of CRM

- 7.2.1 AIs should have clear and robust procedures to ensure that any legal conditions required for declaring the default of a borrower and the timely realisation of CRM are satisfied.
- 7.2.2 All **assets** acquired by **an AI** in the course of the satisfaction of debts due to it should be disposed of at the earliest suitable opportunity. Where relevant, **the AI should also observe the requirements applicable to it under the BELR on the maximum holding period of the assets so acquired.** Otherwise, the assets must be included in the computation of the AI's exposures **under applicable provisions of the BELR.**
- 7.2.3 Disposal of collateral should be at arm's length and **conducted in a prudent and commercially reasonable manner** through a transparent process (such as a public auction or independent estate agents for foreclosed immovable properties) to avoid **any disputes with the borrower, mortgagor or chargor concerned.** If the costs of the realisation of the collateral are to be borne by the borrower, this should be clearly stated in the relevant legal agreement.

## 8. Management information system

### 8.1 Data collection

- 8.1.1 AIs should have CRM management information systems (MISs) to collect CRM data and maintain records of CRM data to facilitate accounting and regulatory reporting and for risk management purposes, such as for timely and accurate margin calls, tracking of realisation dates of CRM and the net proceeds received, estimation of loss given default, and determination of allowance for expected credit losses.
- 8.1.2 AIs should establish and implement processes to ensure that the MISs are able to generate timely, accurate and comprehensive information to enable proactive and prompt credit risk monitoring and oversight by the Board of Director, relevant committees, senior management and other relevant functions.



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### 8.2 Management reports

8.2.1 Management information on CRM should be produced regularly to facilitate management of credit risk. Information required and the reporting frequency will depend on the purposes and the types of CRM involved. Als may wish to include, where appropriate, the following information:

<u>Management information</u>	<u>Proposed frequency</u>	<u>Purpose</u>
Breakdown of credit exposures by type of CRM and collateral types and by issuer and credit protection provider	Monthly	<ul style="list-style-type: none"> <li>◆ Identification of concentration risks</li> <li>◆ Stress-testing</li> </ul>
Analysis on collateral composition, concentration and LTV ratios	Monthly	Formulation of corresponding risk management strategies or follow-up actions
Latest collateral valuation and due dates for revaluation	Monthly	Follow-up of collateral valuation
Credit exposures exceeding maximum LTV ratio	Margin lending: daily Others: monthly	Highlighting facilities requiring top-up of collateral for follow-up actions
Total valuation of collateral foreclosed in the course of satisfaction of debts	Monthly	Formulation or modification of strategies for disposal of collateral foreclosed (e.g. residential properties – wait for market to improve or sell immediately)
Comparison of latest valuation with actual	Monthly	Evaluation of the accuracy and validity of



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<b><u>Management information</u></b>	<b><u>Proposed frequency</u></b>	<b><u>Purpose</u></b>
sale proceeds of collateral		valuation methodology (including any haircut or discount applied to the valuation)
<a href="#">Recovery rates</a>	Quarterly	<a href="#">Development of internal loss estimates</a>
Current valuation of collateral in respect of each classified credit exposure	Quarterly	Determination of provisions for credit losses

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