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 specify the criteria that the MA will apply in assessing the acceptability of letters of comfort for the purpose of §81 of the Banking Ordinance and the factors that will be taken into account in setting and renewing limits for such letters.

Classification

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

Previous guidelines superseded

Guideline 5.2.3 "Letters of Comfort: Section 81" dated 13.07.93

Application

To all locally incorporated AIs

Structure

1. Introduction
2. Supervisory approach
   2.1 Application
   2.2 Acceptance criteria
   2.3 Form and contents
   2.4 Maximum lending limit
2.5 Aggregate lending limit
2.6 Factors for consideration
2.7 Conditions
2.8 Review by the MA
2.9 Cancellation or variation of limits and conditions

1. Introduction

1.1 Risk diversification is essential for bank management. §81 of the Banking Ordinance regulates concentration of risk by limiting a locally incorporated AI’s aggregate financial exposure to a single party or a group of related parties to 25% of its capital base.

1.2 As an international financial centre, Hong Kong accommodates a number of foreign banks that maintain their presence here in the form of locally incorporated subsidiaries. A number of local banks also conduct part of their business through local AI subsidiaries for commercial reasons.

1.3 Under §81(6)(b)(ii), such subsidiaries may incur financial exposure to a single party in excess of 25% of their capital base to the extent that the exposure is covered by a letter of comfort acceptable to and approved by the MA. This provision confers on these subsidiaries some of the flexibility that a branch operation would give.

1.4 By issuing a letter of comfort the issuer signifies its willingness and commitment to provide such support as the beneficiary AI may need, if problems arise as a result of default in any exposures covered by the letter, in order to ensure that it continues to maintain adequate capital and liquidity levels to meet its obligations.

1.5 The use of letters of comfort for §81 purposes is a historical feature of the Hong Kong banking system which has helped to promote the development of Hong Kong as an international financial centre. It has to be recognised, however, that letters of comfort are in
principle less effective than guarantees in protecting AIs against credit risk. This is because they are not formal guarantees and are not intended to be enforceable in a legal sense.

1.6 For the foregoing reasons, while the MA is prepared to allow AIs currently relying on such letters for compliance with the §81 limit to continue to do so subject to the safeguards mentioned in this module, it is not the MA’s general policy to allow other AIs to enter into similar arrangements.

2. Supervisory approach

2.1 Application

2.1.1 This section covers the use of letters of comfort by AIs that are already approved by the MA to use them for §81 purposes. The MA will generally not approve any new applications for the use of letters of comfort by AIs that are not already using them.

2.2 Acceptance criteria

2.2.1 In order for a letter of comfort to be acceptable, the MA must be satisfied that the issuer has, and will continue to have, a strong commitment to support the beneficiary AI and is financially sound enough to fulfil its commitment under the letter.

2.2.2 As the letter is not a guarantee, it is particularly important to ensure that the following criteria are met on a continuing basis:

- the issuer is either a bank licensed in Hong Kong or an institution recognised as a bank in the place where it is incorporated and under adequate supervision by its home supervisor;

- the issuer is a controller of the beneficiary AI, normally a majority shareholder controller but possibly a minority shareholder controller or, in exceptional cases, an indirect controller of the AI;
the letter is issued under a resolution of the Board of Directors of the issuer;

the home supervisor of the issuer is aware of the letter of comfort and does not object to its issue by the issuer;

the issuer has, and will continue to have, the financial strength to support its obligations under the letter of comfort;

the issuer exercises effective oversight over the beneficiary AI’s large exposures; and

the home supervisor supervises the capital adequacy and large exposures of the issuer on a consolidated basis and the position of the beneficiary AI is taken into account in such supervision.

2.3 Form and contents

2.3.1 There is no specific format for letters of comfort but there are essential elements that should feature in their contents:

- the letter of comfort should acknowledge that the purpose of the letter is to enable the beneficiary AI to incur financial exposures which are in excess of 25% of its capital base;

- it should express clearly the nature and extent of the issuer’s commitment to support the beneficiary AI in the case of default affecting such exposures;

- it should set out the shareholding relationship between the issuer and the beneficiary AI;

- the issuer should undertake to inform the MA immediately of any change in the relationship and to

---

The MA will only accept letters of comfort issued by the controller(s) of the beneficiary AI that can satisfy this criterion. In most cases it will be the majority shareholder controller that can exercise effective oversight over the AI’s large exposures. But there may, for example, be cases where this oversight is exercised by a number of minority shareholder controllers which together have effective joint control over the beneficiary AI.
consult the MA in advance of any proposed decrease in the percentage of shares held;

- it should confirm that the issuer exercises effective oversight over the beneficiary AI’s large exposures and will ensure that it is informed of all exposures covered by the letter on a timely basis; and
- it should state that the letter has been authorized by a resolution of the Board of Directors of the issuer.

2.3.2 A specimen letter of comfort in a form acceptable to the MA is given below for reference. Items in square brackets should be completed appropriately.

2.3.3 Where existing letters of comfort differ in substance from this specimen the MA may seek to have these replaced over time.

SAMPLE LETTER OF COMFORT FOR SECTION 81
[The letter should be on the parent bank’s letterhead.]

To: The Monetary Authority

Subject: [Name of AI] ("the Company")

The Banking Ordinance, Cap 155 ("the Ordinance")

In support of an application by the Company for exemption, under the provisions of section 81(6)(b)(ii) of the Ordinance, from the financial exposure restrictions contained in section 81(1) of the Ordinance, we state and confirm the following:

1. We are the legal and beneficial owners of [percentage]% of the paid-up share capital of the Company. It is our present intention to maintain that percentage holding in the Company. We undertake to inform you forthwith of any change in that intention and to consult you in advance of any likely decrease in that percentage holding;

2. We acknowledge that the purpose of this letter is to enable the Company to incur financial exposures in excess of 25% of its capital base and up to the maximum lending limit approved by the MA;

3. We exercise effective oversight over the Company’s large exposures and maintain an effective system to ensure that we are informed of all exposures of the Company covered by this letter in a timely manner;
4. It is in our interest that the Company continues to conduct its business as an Authorized Institution under, and in conformity with, the provisions of the Ordinance;

5. It is in our interest that the Company and its subsidiaries meet their financial obligations at all times. It is our policy to provide the Company with such support and assistance as may be required (including in the event of loss arising as a result of default in any exposures covered by this letter) to ensure that it maintains capital and liquidity levels to enable it at all times to meet its obligations in conformity with standards of prudence generally accepted for its field of business; and

6. This letter of comfort was duly authorized by a resolution of our Board of Directors dated [date], a copy of which is enclosed.

For and on behalf of the parent bank

[Authorized signature]
[Name and title of signatory]

### 2.4 Maximum lending limit

2.4.1 In accepting a letter of comfort, the MA will set a maximum lending limit for any financial exposure that the beneficiary AI may take on to any single customer or group of related customers with regard to the letter of comfort.

2.4.2 This limit is determined in relation to the AI’s capital base. It sets a limit on the total amount of an individual exposure that may be supported by the letter of comfort, including the portion of the exposure up to the 25% statutory limit and that in excess of the 25% limit. Any exposure that exceeds the maximum lending limit would be in breach of §81(1) of the Banking Ordinance, provided that it is not exempt under any other relevant provision of §81.

2.4.3 Large exposures covered by a letter of comfort accepted by the MA are not subject to the clustering limit referred to in CR-G-8 "Large Exposures and Risk Concentrations".

### 2.5 Aggregate lending limit
2.5.1 On top of the maximum lending limit for individual exposures, the MA will require an AI to adhere to an aggregate limit on the exposures to all customers supported by a letter of comfort.

2.6 Factors for consideration

2.6.1 In setting the above limits, the MA will take into account the following factors:

- the financial strength, background and credit rating of the issuer. The financial strength of the issuer will be assessed in the light of, inter alia, its capital base or capital and reserves, as the case may be, depending on whether the issuer's jurisdiction follows the Basel Committee's capital adequacy framework;

- the extent to which the issuer's capital adequacy and credit risk (including those of the beneficiary AI) are subject to consolidated supervision by its home supervisor and the degree of oversight and control exercised by the issuer over the beneficiary AI's large exposures;

- the financial strength of the beneficiary AI;

- the sources of funding of the beneficiary AI and the degree of its reliance on deposits from the public to fund its operations; and

- the justification for the limits (e.g. in relation to the nature of the beneficiary AI's business).

2.7 Conditions

2.7.1 Apart from setting the above limits, the MA may, if appropriate, attach conditions to the letter of comfort, either generally or in any particular case. For example, the MA may restrict the application of the letter of comfort to a specific type of the beneficiary AI’s business, e.g. trade finance or underwriting.

2.8 Review by the MA
2.8.1 To monitor whether the issuer of a letter of comfort continues to be financially sound and able to honour its obligations under the letter, the MA will conduct a review of the letters of comfort accepted for §81 purposes at least annually.

2.8.2 In deciding whether the existing limits are still appropriate and, in particular, whether they should be reduced or cancelled, the MA will take into account any changes in the factors mentioned in para. 2.6.1 above.

2.8.3 In considering whether the existing limits are justified, the MA will also have regard to the actual and prospective utilisation of the limits. If a beneficiary AI has continuously shown a low utilisation of the limits for a period of time (e.g. 12 months), the MA may require the AI to justify why the existing limits ought not to be reduced. If there are insufficient grounds to support the limits, the MA may consider cancelling or reducing the limits as set out in subsection 2.9 below.

2.8.4 To facilitate the review, the MA will require the issuer to submit information including the following:

- its latest audited financial statements;
- its capital base (or where applicable, capital and reserves) and capital adequacy ratio based on the latest audited accounts and on the latest unaudited information;
- its internal control policies relating to the control of large exposures of the beneficiary AI; and
- its current long-term and short-term credit ratings, if available, as appraised by an internationally recognised credit rating agency.

2.9 Cancellation or variation of limits and conditions

2.9.1 The MA may, after consulting the issuer and the beneficiary AI, cancel or vary the limits or the conditions attaching to a letter of comfort. Such cases would generally either be at the request of the beneficiary AI or in the event of low
utilisation of the limits or other concerns about the issuer or the beneficiary AI (e.g. significant deterioration in their financial strength).

2.9.2 Where a letter of comfort is cancelled or a limit is reduced, existing exposures will remain covered by the letter of comfort up to the amount of the previous limit. The beneficiary AI should, however, agree with the MA a time period within which the exposure will be run down in a manner which is consistent with the terms of its agreement with the customer concerned.

2.9.3 Subsequent to any change in the limits for a letter of comfort, the MA will notify the relevant overseas supervisor.