



HONG KONG MONETARY AUTHORITY
香港金融管理局

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14 January 2014

The Chief Executive
All Authorized Institutions

Dear Sir/Madam,

Risk Management of Personal Lending Business

The Hong Kong Monetary Authority (HKMA) noticed a persistent trend of rising household indebtedness since the global financial crisis. The level of household indebtedness as a percentage of GDP has reached a level that may prove unsustainable should global monetary conditions normalise and interest rates increase. Data further suggest that personal loans represent one of the key drivers behind this trend. In view of this, the HKMA has recently conducted a review of the risk management practices that Authorized Institutions (AIs) adopt in underwriting personal loans. This circular sets out (i) the observations of the HKMA in respect of the macro-prudential environment of Hong Kong, (ii) the growth and competition of personal lending business, and (iii) the supervisory requirements of the HKMA on risk management of personal lending business by AIs.

Trend of rising Household Indebtedness

In large part due to a prolonged period of low interest rate environment, the ratio of household indebtedness to GDP had increased from 50.4% in December 2007 before the global financial crisis to 61.2% in September 2013, surpassing the levels recorded during the 1997/98 Asian financial crisis. Experience suggests this ratio would likely surge further during an economic downturn as the GDP of an economy grows much slower or even shrinks. During the Asian financial crisis, the ratio had increased from 48.3% in December 1997 to 59.6% in December 2002, in part a result of declines in GDP. If history offers any guide, it is prudent to assume that the ratio of household indebtedness to GDP could surge from the current level of 61.2% to a significantly higher and potentially unsustainable level in case of an economic downturn.

Growth and competition of personal lending business

While the growth of property mortgage finance has moderated after six rounds of countercyclical measures, the size of loans and advances granted for other private purposes had grown from HKD209 billion in December 2007 to HKD343 billion in September 2013. Once global monetary conditions normalise, interest rates may potentially increase substantially and create a significant impact on households' debt-servicing ability¹ and consequently the loan quality of AIs. Within this category, we further noticed intensified competition in personal loans products, in particular in terms of loan tenor, loan size, and revolving features. The situation has raised concerns about the ability of AIs to maintain prudent credit risk management standards.

Supervisory requirements

The HKMA considers it important for AIs to maintain prudent underwriting standards for personal loans despite competitive pressures. AIs should continue to adopt the prudent principles set out in the HKMA's Supervisory Policy Manual Module CR-G-1 "General Principles of Credit Risk" for their personal loan business. In particular, AIs should adhere closely to the "Know Your Customer" principle in considering a loan application, and lending decision should be supported by a thorough assessment of the borrower's repayment ability based on reliable information including, the borrower's total debt liability.

The recent review by the HKMA indicated that AIs' underwriting practices vary. Some AIs are more prudent in the use of debt-servicing ratio limit, maximum loan tenor, portfolio-based limit structure and internal stress testing. Details of such prudent measures are summarised in the Annex of this letter. Given the rising trend of household indebtedness, the HKMA considers it prudent for these measures to be adopted by all AIs in underwriting personal loans.

AIs should review and assess their existing policies and risk management systems and take immediate measures to bring them in line with these requirements by the end of March 2014. AIs are then required to advise the HKMA by 14 April 2014 the extent to which they have implemented these measures. Nil return is required if your institution does not have personal loan

¹ There are views suggesting that the interest rates for certain types of credit, e.g. personal loans products, are fixed and therefore borrowers would not be impacted by an increase in interest rates. However, at a macro level, a significant portion of borrowers (e.g. tax loans borrowers) may have refinancing needs and their ability to seek refinancing would be negatively impacted when interest rates increase.

business. The HKMA will monitor AIs' implementation of these measures through its routine on-site examinations and off-site reviews.

The HKMA recognises that in certain circumstances AIs may need to exercise flexibility to cater for the needs of individual customers and allow exceptions to their standard underwriting policies or practices. The HKMA considers this acceptable provided that such flexibility is managed prudently within the personal loan portfolio and governed by clear policies and guidelines. Among other things, the number of exceptions must be subject to stringent limits and all exceptions must be properly approved with clear audit trails evidencing the justifications for the approval.

We would like to take this opportunity to remind AIs that it remains their responsibility to manage the risks of personal loans prudently. The HKMA will continue to monitor the situation and if further developments suggest that risks associated with personal lending business might have built up to a systemic level, the HKMA might consider the need for introducing prudential limits on debt-servicing ratio and maximum loan tenor at the industry level.

If you have question on this circular, please feel free to contact your usual supervisory contacts at the HKMA.

Yours faithfully,

Henry Cheng
Executive Director (Banking Supervision)

Encl.

Requirements on Underwriting Personal Loans by AIs**Applicability**

The following requirements are applicable to all “personal loans”, which are general purpose loans granted to individuals (i.e. retail banking customers) and are typically lent on unsecured basis. Common product types include:

- Personal instalment loans
- Personal revolving loans
- Tax loans
- Overdrafts

Personal loans with specific purpose such as auto-financing loans, property mortgage loans (whether for use of property acquisition or not), etc are excluded.

Requirements

1 Debt servicing ratio (DSR)	
1.1	DSR limits should be binding for personal loan lending. Given the generally short-term nature of personal loans, the HKMA is prepared to allow some flexibility and not impose a rigid DSR cap at this stage.
1.2	DSR limits should be granular, such that longer tenor loans are subject to lower corresponding DSR limits.
1.3	The calculation of DSR should include repayment of all kinds of loans, including both secured (e.g. residential mortgage loans) and unsecured debts.
2 Loan tenor	
2.1	Tenors of personal loans should be consistent with the purposes of the respective loans.
2.2	Given that credit risk increases with loan tenor and personal loans are short-term loans in nature, AIs should generally refrain from offering personal loans with long tenors. Exceptional approvals, if any, should be supported by well documented justifications and be subject to stringent portfolio limits (see 3.2 below).
3 Portfolio-based limit structure	
3.1	AIs should establish an overall internal portfolio limit for personal loans.
3.2	AIs should set internal portfolio sub-limits for higher risk exposures (e.g. long tenor loans, high DSR loans, and loans with revolving features etc) with proper justifications.
4 Internal stress testing	
4.1	AIs should conduct internal stress tests on their personal loan portfolios, assuming a 300 basis point increase in personal loans’ interest rate and taking appropriate actions if called for by the stress test results.