HONG KONG MONETARY AUTHORITY
香港金融管理局
Banking Supervision Department *銀行監理部*

Our Ref.: B1/15C
B9/25C

19 January 2015

The Chief Executive
All Authorized Institutions

Dear Sir/Madam,

Compliance with existing prudential measures on property mortgage lending

The Hong Kong Monetary Authority (HKMA) has recently completed a round of on-site examinations of selected authorized institutions (AIs) to review the effectiveness of their policies and controls in ensuring compliance with the prudential measures on property mortgage lending as set down by the HKMA. The examinations revealed, among other issues, the following two main observations:

Interpretation of operating companies

The HKMA recognises that AIs would provide operating companies with credit facilities secured by properties to support the genuine business or funding need of the normal business operations of the companies. The HKMA has all along allowed AIs to exercise flexibility for not adopting the countercyclical measures on property mortgage lending in respect of such credit facilities on the understanding that AIs will assess the creditworthiness of these companies in totality. The companies should, in most cases, be subject to more comprehensive credit underwriting standards and assessment, closer credit monitoring and more frequent credit review that are applicable to corporate borrowers.

However, we note from our sample review during the on-site examinations that some AIs have taken a "liberal" interpretation of operating companies in the extension of credit facilities for acquisition or refinancing of properties. In particular, there are some sampled property mortgage loans to corporate borrowers that do not have any clearly identifiable business operations other than the companies being used as vehicles for property holding, investment or leasing

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purpose. The setup of these companies is effectively no different from those shell companies established by individuals for such purpose. In respect of such cases, AIs should have followed the countercyclical measures, including the applicable maximum loan-to-value ratio and debt-servicing ratio (DSR) when providing property mortgage loans to those corporate borrowers.

In connection with the above observation, AIs are reminded that they should adopt a robust approach to distinguish whether a corporate borrower is a genuine operating company. There should be effective control and review systems in place to ensure that all exemptions from the countercyclical measures are granted on the ground that the borrower is a genuine operating company.

Although credit facilities to genuine operating companies may not be subject to the countercyclical measures on property mortgage lending as mentioned above, AIs should maintain prudent underwriting standards as well as adequate credit monitoring and review of such facilities in order to ensure that the credit risks involved are properly managed.

Discount rates in recognising rental income of investment properties

The HKMA issued a circular on 30 October 2009 to stipulate, among other things, that in the computation of DSR, a discount rate of at least 20% should be applied to the gross rental income to account for the associated expenses (e.g. maintenance cost, government rent and rates, management fees, cost of vacancy and property or profits tax). Having reviewed the market trends and the results of our on-site examinations, we believe that it is not sufficient to cover the associated expenses within the 20% discount level. AIs should instead adopt a higher discount rate of at least 30% for cases with rental income proof or at least 40% for cases without rental income proof.

For the avoidance of doubt, the minimum discount rates apply to mortgage loans for residential and non-residential properties as well as standalone car park space to individual and corporate borrowers. Where appropriate, AIs should consider applying discount rates higher than the above-mentioned thresholds.

The above supervisory requirements on property mortgage lending to operating companies and of applying higher discount rates on recognising rental income should be adopted by AIs with effect from Tuesday 20 January 2015. AIs are required to review and assess their lending practices, and where necessary, take immediate measures to bring them into line with the requirements described in this letter. These requirements are good underwriting practices and do not constitute a new round of countercyclical measures on property mortgage lending.

In case you have any questions concerning this letter, please do not hesitate to contact Mr Eric Kan at 2878-1096 or Ms Rachel Wan at 2878-8297.

Yours faithfully,

Henry Cheng
Executive Director (Banking Supervision)