



Supervisory Policy Manual

CR-L-2

**Exemption of Financial Exposures:
§81(6)(b)(i)**

V.1 - 31.08.01

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 set out the criteria against which the MA will exercise the discretion whether to accept specific types of collateral and guarantees for exempting financial exposures under §81(6)(b)(i) of the Banking Ordinance

Classification

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

Previous guidelines superseded

Guideline 5.2.2 "Exemption of Financial Exposures which are secured by Cash Deposits, Government Securities, Guarantees, or Other Undertakings similar to Guarantees under Section 81" dated 27.07.92

Application

To all locally incorporated Als

Structure

1. Introduction
2. Acceptance criteria
 - 2.1 General
 - 2.2 Cash deposits



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- 2.3 Securities issued or guaranteed by the central bank or central government of a Tier 1 country
- 2.4 Guarantees, indemnities and risk participation agreements
- 2.5 Standby letters of credit
- 2.6 Other undertakings
3. Limitation on amount guaranteed

1. Introduction

- 1.1 §81 of the Banking Ordinance regulates concentration of risk by limiting a locally incorporated AI's aggregate financial exposure to a single party or group of related parties to within 25% of its capital base. This is to prevent an AI from running an undue concentration of risk from a customer or group of customers.
- 1.2 §81(6)(b)(i) empowers the MA to grant exemption to a financial exposure to the extent to which it is secured by:
 - a cash deposit;
 - a guarantee;
 - an undertaking which, in the opinion of the MA, is similar to a guarantee; or
 - securities issued or guaranteed by the central bank or central government of a Tier 1 country, as defined in the Third Schedule to the Ordinance,subject to such conditions as the MA may think proper to attach thereto. Exemption is not automatic upon compliance with the criteria in this module but should be sought from the MA under §81(6)(b)(i). If granted, consent will be in the form of a written notice.
- 1.3 The portion of an exposure which is not covered by the collateral or guarantee accepted by the MA remains subject to the 25% limit.



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Some types of collateral, however, may not count 100% for exemption, i.e. a haircut may be applied (see paras. 2.2.1 and 2.3.1).

- 1.4 The following section sets out the criteria that the MA will apply in deciding whether such collateral or guarantee is acceptable for the purpose of obtaining exemption.

2. Acceptance criteria

2.1 General

- 2.1.1 The MA needs to be satisfied that the collateral and guarantees which are eligible for exemption under §81(6)(b)(i) will effectively reduce an AI's exposure to the customer concerned or transfer the risk to another party whose financial strength will enable it to fulfil its obligation to the AI.
- 2.1.2 The criteria that the MA will apply to specific types of collateral and guarantees are described in subsections 2.2 to 2.6 below but the MA reserves the discretion to apply additional criteria if this is warranted.
- 2.1.3 AIs are expected to ensure that there are proper systems and controls for the management of collateral and guarantees taken (see [CR-G-7](#) "Collateral and Guarantees" for more guidance).

2.2 Cash deposits

2.2.1 The following criteria should be met:

- the deposit should be placed with the AI in Hong Kong or its overseas branches, if any. Where the exposure and the deposit are in two different jurisdictions, there should be no legal or other regulatory barriers to perfecting the collateral in the jurisdiction where the deposit is held;
- the deposit should be charged in favour of the AI. This should be evidenced by a duly executed charge



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document. There should be no other encumbrances of prior or equal ranking;

- subject to the next criterion, the deposit cannot at any time be less than the exposure which it secures; and
- where the exposure and the deposit are denominated in different currencies, a 10% haircut will be applied. In other words, the relevant exposure is only exempted to the extent of 90% of the mark to market value of the deposit in order to cover exchange rate fluctuations. This haircut does not apply where the deposit is in Hong Kong dollars and the exposure is in US dollars or vice versa.

2.3 Securities issued or guaranteed by the central bank or central government of a Tier 1 country

2.3.1 The following criteria should be met:

- the securities should be held by the AI in Hong Kong or its overseas branches, if any. Where the exposure and the securities holding are in two different jurisdictions, there should be no legal or other regulatory barriers to perfecting the collateral in the jurisdiction where the securities are held;
- the securities should be charged in favour of the AI. This should be evidenced by a duly executed charge document. There should be no other encumbrances of prior or equal ranking;
- subject to the next two criteria, the value of the securities may not at any time be less than the exposure which they secure;
- a 10% haircut will be applied. In other words, the relevant exposure is only exempted to the extent of 90% of the mark-to-market value of the securities in order to cover market price fluctuations; and
- where the exposure and the securities are denominated in different currencies, a further haircut



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of 10% will be applied in order to cover exchange rate fluctuations. This haircut does not apply where the exposure is in Hong Kong dollars and the securities are denominated in US dollars or vice versa.

2.4 Guarantees, indemnities and risk participation agreements

2.4.1 The following criteria should be met:

- the guarantor, indemnifier or participant, as the case may be, should be:
 - a central government or a central bank of a country which, in the past five years, has neither declared a moratorium on repayment of external debt nor rescheduled any debt;
 - an AI; or
 - an institution recognised as a bank in the place where it is incorporated and which is under adequate supervision;
- the borrower should be explicitly and correctly named in the agreement and the undertaking of the guarantor, indemnifier or participant, as the case may be, should be clearly stated;
- the country where the guarantor, indemnifier or participant, as the case may be, is located or incorporated should either have no exchange controls or, where there are exchange controls, approval should have been obtained for the funds to be remitted freely in the event of a call on the obligation;
- the obligation should be unconditional, irrevocable and expressed to be on demand, i.e. documented in such a way as to provide the AI with the legal right to require the guarantor, indemnifier or participant, as the case may be, to pay the secured amount to it



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immediately on demand in the event that there is a default or non-performance by the borrower;

- the maturity of the instrument should allow sufficient time for the AI concerned to claim reimbursement in the case of default. Under no circumstances can the maturity of the instrument be less than that of the loan. If the instrument has no maturity, it should explicitly state that it is a continuing guarantee or undertaking; and
- the instrument should be legally enforceable either in Hong Kong or the country of incorporation or residence of the guarantor, indemnifier or participant, as the case may be.

2.5 Standby letters of credit

2.5.1 The following criteria should be met:

- the issuer should be an AI or an institution recognised as a bank in the place where it is incorporated and which is under adequate supervision;
- the borrower should be explicitly and correctly named in the agreement and the undertaking of the issuer should be clearly stated;
- the country where the issuer of the letter is located or incorporated should either have no exchange controls or, where there are exchange controls, approval should have been obtained for the funds to be remitted freely in the event of a call on the obligation;
- the obligation under the letter should be unconditional, irrevocable and expressed to be on demand, i.e. documented in such a way as to provide the AI with the legal right to require the issuer to pay the secured amount to it immediately on demand in



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the event that there is a default or non-performance by the borrower;

- the maturity of the letter should allow sufficient time for the AI concerned to claim reimbursement in the case of default. Under no circumstances can the maturity of the letter be less than that of the borrowing. If the letter has no maturity, it should explicitly state that it is a continuing obligation; and
- the letter should be legally enforceable either in Hong Kong or the country of incorporation or residence of the issuer.

2.6 Other undertakings

2.6.1 Other undertakings which are similar to a guarantee and not specified above, e.g. back-to-back letters of credit, will be examined on their own merits, case by case. Acceptance of these will be dependent upon the underlying terms and conditions of the undertakings and application of the criteria specified in para. 2.5.1.

3. Limitation on amount guaranteed

3.1 The MA expects that where a guarantee¹ is issued by an AI or a bank under adequate supervision, the amount guaranteed by the AI or the bank for any one customer or group of related customers should not exceed 25% of its capital base or capital and reserves, as the case may be, depending on the capital rules applicable in the issuer's jurisdiction.

3.2 An AI which is the beneficiary of a guarantee issued by another AI or a bank under adequate supervision should obtain from the guarantor, and submit with the application to the HKMA, a warranty certifying that the amount guaranteed does not exceed 25% of the

¹ Section 3 of this module also applies similarly to an indemnity, a risk participation agreement or a standby letter of credit.



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guarantor's capital base or capital and reserves, as the case may be. For significantly large transactions, the HKMA will check with the relevant supervisory authorities, where applicable, that they are comfortable with the exposure incurred by the guarantor.

- 3.3 The above 25% limit needs to take account of the other exposures of the guarantor or any of its subsidiaries ("group exposure") to the same customer or group of related customers. In case of a group exposure, the consolidated capital base or capital and reserves of the guarantor, as the case may be, will be used as the basis for assessing the limit.

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