

Acceptable “security” under section 79(3) of the Banking Ordinance

by the Banking Supervision Department

Sections 83 and 85 of the Banking Ordinance limit locally incorporated authorized institutions' (AIs) unsecured exposures to their connected parties and staff members. For the purposes of these sections, an unsecured facility refers to a facility granted without security or any part thereof which at any time exceeds the market value of assets constituting that security. Under section 79(3) of the Ordinance, security means such security as would, in the opinion of the Monetary Authority (MA), be acceptable to a prudent banker. In the Supervisory Policy Manual (SPM) module on “Connected Lending” (CR-G-9), the MA has set out the criteria that security should generally meet before it is considered by the MA as acceptable under section 79(3) (that is, the Acceptable Criteria). Moreover, the SPM module on “Collateral and Guarantees” (CR-G-7) sets out the principles the MA may also consider in deciding whether a security is acceptable under section 79(3).

This memo addresses some questions recently raised by individual AIs in relation to acceptable security under section 79(3), particularly regarding the acceptability of unlisted shares and debenture creating a floating charge of assets for the purposes of sections 83 and 85. AIs are required to be careful not to inadvertently breach sections 83 and 85 as a result of taking security that is not regarded as acceptable security under section 79(3). In case of doubt, AIs should consult with the MA or seek legal advice about whether a particular type of security is acceptable under section 79(3).

Q1. Are unlisted shares regarded as acceptable security under section 79(3)?

A1. Among the Acceptable Criteria, an asset to be considered by the MA as acceptable security under section 79(3) should generally satisfy that (i) the market value of the asset is readily determinable or can be reasonably established and verified; and (ii) the asset is marketable and there exists a readily-available secondary market for disposing of the asset. As unlisted shares do not meet these criteria, they would not generally be regarded as acceptable security under section 79(3).

Q2. Would the assets of an unlisted company be considered as acceptable security under section 79(3) if its shares have been charged to an AI?

A2. One of the Acceptable Criteria is that the AI should be able to secure control over the assets where the situation warrants. As the unlisted company may create fixed legal charges over its assets in favour of a third party, notwithstanding the fact that its shares have been pledged with the AI, the assets of an unlisted company would not generally be considered by the MA as acceptable security under section 79(3) unless a fixed legal charge has been obtained by the AI.

Q3. Is a debenture with floating charge over assets, either of the borrower or third party, considered as acceptable security under section 79(3)?

- A3. For a floating charge over assets created under a debenture in favour of an AI, the AI is normally unable to secure control over the charged assets until the floating charge becomes "fixed" or "crystallised" when an event of default occurs. For example, the borrower defaults in payment or the company executing the debenture goes into liquidation. Hence, a debenture with floating charge over assets would not generally be regarded as acceptable security under section 79(3), and no collateral value should be attributed to the debenture before the floating charge is crystallised.

Q4. Do the criteria for determining whether a security is acceptable under section 79(3) apply to security that is located both in Hong Kong and outside Hong Kong?

- A4. Yes, the Acceptable Criteria are applicable to assets whether they are located in Hong Kong or outside Hong Kong. In line with the principles set out in CR-G-7, an AI should consider whether its right to repossess the assets is legally enforceable and without impediment. As different jurisdictions have different legal requirements, an AI should ensure that its legal title to the assets has been perfected according to the legal requirements of the relevant jurisdiction. To this end, it should consult counsels with sufficient expertise in the jurisdictions in this regard. Enforceability of the security is regarded by the MA as a necessary condition before the security would be considered as acceptable security under section 79(3).

Q5. In determining the extent to which a facility is secured by listed shares under the meaning of section 79(3), could the current market price of the listed shares be used as the market value?

- A5. Generally speaking, the application of the full market price of listed shares as the value of security is not considered as a prudent practice. AIs are expected to apply a prudent discount for this purpose. AIs are also expected to set a limit on the maximum quantity of shares in a listed company acceptable as collateral, for example, not more than 10% of the issued share capital of the company. This is to cater for a situation where the market price of the shares drops significantly if a large quantity of the shares are realised by the AI at the same time in the event of a loan default.