The Chief Executive
All Authorised Institutions

14 February 2000

Dear Sir/Madam,

<u>Principles Underlying Prudent Credit Control by Authorised Institutions</u>

Over the last two years much of the focus of authorised institutions ("institutions") in Hong Kong has been on improving their balance sheets and on dealing with problem loans. With demand for new loans remaining weak, domestic lending has fallen significantly during the period. There are, however, now signs that this process of adjustment is coming to an end. Institutions have plentiful liquidity and are willing to lend, and loan demand is likely to pick up this year as the economy continues to expand.

In view of this, it is an appropriate time for institutions to review their lending policies, procedures and controls, if they have not already done so, to ensure that they are fully equipped to meet the expected upturn in lending.

To assist in this process, I enclose a set of principles that should underlie prudent credit control. To a large extent, these principles should be familiar to lending institutions. However, past experience indicates that they are not always fully observed by individual institutions.

I recommend that you review these principles in relation to your own institution in order to determine whether any improvements in your institution's credit controls are required. The HKMA will continue to review such matters, and to offer more detailed guidance, in the course of regular on-site examinations.

Yours sincerely,

D T R Carse
Deputy Chief Executive

Encl.

Principles Underlying Prudent Credit Control by Authorised Institutions

1. Authorised institutions ("institutions") should be very clear about their lending strategy, including how much risk, and what types of risk, they are prepared to undertake. Before they enter into new types of lending, they should ensure that they fully understand the risks and have established appropriate lending policies, procedures and controls. The Board of Directors should approve the lending strategy and lending policies.

2. Institutions' lending policies should set down, among other things, the maximum maturity and the maximum debt servicing ratio for different types of loan. In calculating the debt service ratio, institutions should, to the extent possible, verify the borrower's indebtedness to other lending institutions and take into account the service payments due on such indebtedness.

3. All locally-incorporated institutions should have a formal policy statement, endorsed by the Board of Directors, on connected lending (further guidance on this is given in the HKMA's letter of 12 November 1999 to locally-incorporated institutions).

4. Institutions should ensure that their pricing of lending reflects the underlying risk and is sufficient to provide a reasonable return which will cover the cost of funds, operating expenses and anticipated bad debts, and will provide a reasonable level of profit.

5. Institutions should not relax their lending policies for the sake of competition. Any change to the lending policies should be approved by the Board of Directors and should not expose the institution to excessive risk.

6. Institutions should be wary of too rapid expansion of particular types of lending since this may be indicative of a relaxation of credit standards and increased focus on more marginal borrowers.

7. Institutions should be careful about risk concentrations of various kinds, including exposure to individual borrowers (in particular those over 10% of capital), groups of borrowers with similar characteristics, economic and geographical sectors, and types of lending with similar characteristics (eg those based on assets with similar price behaviour).

8. Institutions should know their customers, their business, their funding needs, and, to the extent possible, their other financial commitments.

9. Institutions should be wary of name lending and relationship lending which is not based on a firm understanding of the borrower.

10. Institutions should establish what their lending is actually being used for and the sources of repayment. Sometimes borrowers have channeled funds away from core businesses into ill-advised diversification or into speculative ventures in the stock and property markets. Similarly, short-term trade finance has often become in effect part of the general working capital of the company.

11. In granting credit, institutions should undertake proper financial review of their customers based on reliable information. Institutions should ensure that sufficient information is available on an ongoing basis to enable the account to be monitored effectively.

12. Particular attention needs to be paid to cash flow and the ability to service debt in stress conditions as well as normal conditions.

13. Institutions should be wary of over-reliance on collateral. Collateral has an important part to play in providing secondary protection to the lender if the borrower defaults. But the primary consideration should be the debt servicing capacity of the borrower.

14. Where collateral is taken, institutions should adopt loan to value ratios which are appropriate to the nature of the collateral. For provisioning purposes, in calculating the net realisable value of property held as security, it will usually be sensible for institutions to apply a discount to the estimated market value of the property to arrive at a more realistic indication of the amount that would actually be realised should the property be sold.

15. Institutions should keep the functions of loan generation (by account officers), loan approval and loan review as separate as possible. Where lending limits are delegated to account officers, the limits should be subject to regular review to ensure that they remain appropriate to current market conditions.

16. Institutions should maintain an effective early warning system for problem loans and should make sure that the loan portfolio is properly classified. On this latter point, given that institutions' internal ratings are becoming an increasingly important management and supervisory tool, banks should be looking to improve the sophistication of their loan classification system beyond the simple five grade system currently employed for regulatory reporting. In particular, banks are advised to adopt multiple grades for loans that are still "performing" and to develop the ability to track the migration of individual loans through the various loan grades.

17. Institutions should have policies on provisioning which ensure that loans are prudently provided against on a timely basis (further guidance on this is given in Supervisor's Memo in the HKMA Quarterly Bulletin, November 1999).

18. Institutions should establish a dedicated unit to handle the recovery of problem loans and should have well-established policies for the referral of loans to this unit.

Hong Kong Monetary Authority
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