Supervisory Policy Manual		
CR-G-9	**Connected Lending**	V.1 – 29.06.01

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 the Manual. If reading on-line, click on blue underlined headings to activate hyperlinks to the relevant module.

Purpose

To specify systems and controls that AIs should have to identify, measure, monitor and control their financial exposure to connected parties

Classification

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

Previous guidelines superseded

Circular "Connected lending" dated 12.11.99

Application

To all locally incorporated AIs

Structure

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1. Introduction

1.1 This module should be read in conjunction with the Banking Ordinance as it covers only selected parts of the Banking Ordinance relating to connected lending.

1.2 As a general rule, all credits should be granted by an AI on an arm's length basis to protect its best interests.

1.3 §83 of the Banking Ordinance limits unsecured advances of locally incorporated AIs to connected parties. This is to reduce the risk of improper and excessive lending to connected parties which may jeopardise an AI's interests or be detrimental to its financial position. A breach of §83 is a serious offence which may result in fines and/or imprisonment.

1.4 Therefore, AIs should monitor carefully their credits to connected parties, whether individuals or companies, and take appropriate steps to control or reduce the risks of connected lending.

1.5 To prevent breaches of §83 and imprudent connected lending, AIs should have a robust system of checks and balances to monitor compliance with the statutory limits, uphold impartiality and prevent credit activities of any kind (including on- and off-balance sheet transactions) which override established credit approval policies and procedures when granting credit facilities to connected parties. AIs should ensure that the terms and conditions of such lending should not be more favourable than those granted to non-connected parties with similar background and creditworthiness.

1.6 The principle of impartiality and other standards laid down in this module should also apply to other business transactions (e.g. acquisition/sale of assets or management service contracts) between AIs and their connected parties.

2. Statutory limitations on connected lending

2.1 Connected parties specified under §83(4)

2.1.1 The following provides a list of connected parties which are specified under §83(4) of the Banking Ordinance for the purposes of determining an AI's aggregate amount of connected lending against the statutory limits prescribed under §§83(1) and 83(2):

	Relationship of connected party with AI	Exclusion
(i)	Director and his relatives	N/A
(ii)	Employee who is responsible, either as a member of a committee (e.g. Credit Committee) or individually, for approving loan applications and his relatives	N/A
(iii)	Controller[1] or minority shareholder controller and his relatives in the case of individuals	Excluded if the connected party is an AI, or an overseas incorporated bank which is not an AI but is approved by the MA for the purposes of §83(4)

[1] Controller, for the purposes of connected lending, means any person who is an indirect controller or a majority shareholder controller as defined in the Banking Ordinance.

	Relationship of connected party with AI	Exclusion
(iv)	Firm, partnership or non-listed company[2] in which the AI or any of its controllers, minority shareholder controllers or directors (including their relatives in the case of individuals) is interested as director, partner, manager or agent	Excluded if the firm, partnership or non-listed company is an AI, or an overseas incorporated bank which is not an AI but is approved by the MA for the purposes of §83(4)
(v)	Individual, firm, partnership or non-listed company of which any controller, minority shareholder controller, or director of the AI (including their relatives in the case of individuals) is a guarantor	N/A

2.1.2 For connected parties who are individuals, "relative" is defined under §79(1) of the Banking Ordinance as:

- any immediate ascendant, any spouse, or former spouse of any such ascendant, and any brother or sister of any such spouse or former spouse;
- any immediate descendant, and any spouse or former spouse of any such descendant;
- any brother or sister, aunt or uncle and any nephew or niece and any first cousin; or
- any spouse or former spouse, any immediate ascendant of any such spouse or former spouse, and any brother or sister of any such spouse or former spouse.

For the purposes of this definition, any step-child shall be deemed to be the child of both its natural parent and of its step-parent and any adopted child to be the child of the adopting parent, and a spouse shall include anyone living as such.

2.1.3 §83(6) of the Banking Ordinance further provides that a facility granted to or on behalf of any firm, partnership or non-listed company which a person specified in (i), (ii) or

[2] Under §79 of the Banking Ordinance, a non-listed company is defined as a company not listed on the Unified Exchange.

(iii) of para. 2.1.1 above is able to control shall be deemed to be granted to that person or on his behalf.

2.1.4 In determining the extent of "control" of a person in a company, the HKMA will consider whether that person is a "controller" as defined in §2 of the Banking Ordinance. In particular, the HKMA will have regard to the following:

- the percentage of voting power at any general meeting of the company or its holding company that the person, either alone or with any associates, is entitled to exercise; and
- whether the directors of the company or its holding company are accustomed to act in accordance with the directions or instructions of the person (excluding an Advisor or a Manager appointed under §52 of the Banking Ordinance or any person giving advice in a professional capacity).

2.2 Limits under §§83(1) and 83(2)

2.2.1 §83 of the Banking Ordinance imposes various limits on the unsecured advances of locally incorporated AIs to their connected parties who might be able to exert undue influence on the AIs' activities.

2.2.2 Under §83(1), the maximum aggregate unsecured facilities granted to all connected parties of a locally incorporated AI should not exceed 10% of its capital base.

2.2.3 Under §83(2), the maximum aggregate unsecured facilities granted to connected parties of a locally incorporated AI who are individuals specified in (i), (ii) and (iii) of para. 2.1.1 above should not exceed HK$1 million per person or 5% of the AI's capital base.

2.3 Definition of facilities under §83(3)

2.3.1 For the purposes of §§83(1) and 83(2) of the Banking Ordinance, facilities are defined under §83(3) as:

- the granting, or permitting to be outstanding, of unsecured advances, unsecured loans or unsecured credit facilities including unsecured letters of credit;

- the giving of unsecured financial guarantees; and
- the incurring of any other unsecured liability.

2.3.2 According to §83(3A), any facility to the extent to which it has been written off, or to which specific provision has been made for it, shall be excluded for the purpose of §83(3).

2.4 Exemption under §83(4A)

2.4.1 The MA may exempt under §83(4A) of the Banking Ordinance, subject to such conditions as the MA may think proper to attach thereto, any facility granted by an AI to its connected parties from complying with the statutory limitations set out in §§83(1) and (2).

2.4.2 AIs should note that such exemption will only be granted on a very exceptional basis after considering all the circumstances of the application. While each case will be considered on its merits, the following criteria should, as a minimum, be satisfied, though this will not in itself be sufficient for exemption to be granted:

- the facility granted is on arm's length terms and commercially justified;
- in the case of common directors, the relevant director(s) of the AI should play no part in the approval process;
- the common director is a non-executive director of the AI, except where he is appointed as a director of the borrower only to help protect the existing interests of the AI as a lender; and
- in the case of an intra-group exposure, the connected party is under effective consolidated supervision.

2.5 Secured lending to connected parties

2.5.1 Although §83 of the Banking Ordinance only applies to unsecured lending, care should be taken by AIs when granting secured credit facilities to connected parties.

2.5.2 Under §79(3), "security" means such security as would, in the opinion of the MA, be acceptable to a prudent banker for the purposes of §83. Generally, AIs should ensure that assets accepted as collateral satisfy the following criteria:

- the market value of the asset is readily determinable or can be reasonably established and verified;
- the asset is marketable and there exists a readily available secondary market for disposing of the asset;
- the AI's right to repossess the asset is legally enforceable and without impediment;
- the AI is able to secure control over the asset if necessary. In the case of a movable asset, the AI should either have physical custody of the asset (e.g. gold, precious metal or taxi medallion) or have the means of locating its whereabouts (e.g. vehicle, machinery or equipment); and
- the AI has the expertise and systems to manage the asset concerned.

2.5.3 AIs should consult with the HKMA or seek legal advice in case of doubt about whether a particular type of collateral is acceptable for §83 purposes.

2.5.4 Where the collateral is not considered acceptable by the MA, the facilities will be treated as unsecured and subject to the restrictions under §83 mentioned above. AIs should be careful not to inadvertently breach the §83 limits as a result of taking collateral which is not acceptable to the MA.

2.5.5 AIs should closely monitor their secured connected lending to ensure that fluctuations in the value of the collateral will not lead to a breach of §83.

3. Controls over connected lending

3.1 Oversight by Board of Directors

3.1.1 The Board of Directors should ensure that the AI fully understands its legal obligations under the Banking Ordinance in relation to connected lending.

3.1.2 The Board of Directors should ensure that the AI establishes a policy on such lending. The policy, and any changes thereto, should be reviewed and approved by the Board.

3.1.3 Connected lending should be reviewed and approved by the Board of Directors, the Credit Committee or any other committee with authority delegated from the Board. The Board should also receive regular reports on the amount of outstanding connected loans, including the amount of connected lending which falls within the scope of §83 of the Banking Ordinance.

3.1.4 Where necessary the Board should obtain legal advice in relation to connected lending.

3.2 Connected lending policy

3.2.1 The policy on connected lending should cover, at a minimum, the following:

- the types of lending that the AI considers to be "connected" in nature - these should comprise the categories specified in §83(3) of the Banking Ordinance but an AI may wish for its own purposes to include other types of lending or transactions;
- the categories of connected parties – these should comprise the categories specified in §83(4) but an AI may wish, where appropriate, to include other parties that may be able to exert considerable influence over it (such as its senior management, significant subsidiaries and affiliates);
- the calculation of exposure to connected parties – it should take into account the requirements under §§83(5) and 83(6);
- the application of the policy to loans booked in subsidiaries of the AI;
- the maximum limits that apply to individual connected loans and connected loans in aggregate, on a secured and on an unsecured

basis, taking into account the limits specified in §83 of the Banking Ordinance[3];

- the interest rates and other terms and conditions that apply to the various types of connected lending. In general, these should not be more favourable than loans granted to non-connected borrowers under similar circumstances;
- the authority and procedures for approving connected loans, including the extent to which such loans should be subject to approval by the Board and to review by the Board or other committee. Directors and credit officers who are connected with the borrowing party should be restricted from taking part in the credit approval process;
- the arrangements for reporting connected lending to the HKMA and for ensuring the accuracy of such reports;
- the policy and procedures for the taking of collateral in respect of connected lending, including the types of collateral which are considered acceptable and the arrangements for valuing such collateral. In this connection, all marketable securities should be marked to market on a daily basis, and external valuations should be obtained, and regularly updated, for properties (see section 6 of CR-G-7 "Collateral and Guarantees" for further guidance); and
- the arrangements for ensuring compliance with the AI's policy on connected lending, including the specific officers responsible for this.

3.2.2 The policies, and any changes thereto, should be submitted to the HKMA.

3.3 Monitoring of connected lending

[3] §83 applies only to unsecured lending. However, the HKMA considers that it is also a good practice for AIs to establish their own internal limits on secured lending to connected parties. This is consistent with prudent credit management practices.

3.3.1 AIs should assign a designated independent unit or officer, e.g. compliance officer, to monitor connected lending and to ensure their compliance with both statutory and internal limits.

3.3.2 AIs should have adequate information systems to measure their connected exposures and identify exceptions. The list of connected parties should be updated regularly. Any exceptions should be reported promptly to the appropriate level of management. If the exception is serious or the amount involved is significant, it should be reported directly to the Board of Directors or Audit Committee.

3.3.3 Internal Audit should conduct regular reviews on this particular area to check whether established policies, limits and procedures in relation to connected lending are strictly adhered to.

3.3.4 As an additional safeguard, it may be advisable for AIs to centralise connected lending at their head office in Hong Kong so that it can be more effectively monitored and controlled.

4. Disclosure and regulatory reporting

4.1 Financial disclosure

4.1.1 AIs, in consultation with their external auditors, should ensure that they have properly disclosed details of their connected party transactions in their annual reports as required by:

- the Companies Ordinance (e.g. loans to directors under §161B);
- Statements of Standard Accounting Practice issued by the Hong Kong Society of Accountants (e.g. Statement 2.120 “Related Party Disclosures”); and
- other relevant disclosure rules (e.g. “Rules Governing the Listing of Securities” published by The Stock Exchange of Hong Kong Limited).

4.2 Regulatory reporting

4.2.1 AIs should establish systems and procedures to ensure the accuracy of reporting in respect of connected lending in the HKMA's "Return of Large Exposures – MA(BS)1D" and "Certificate of Compliance – MA(BS)1F(a)".

4.2.2 Any cases in breach of §83 should be reported to the HKMA immediately. In case of doubt, AIs should consult with the HKMA or seek relevant legal advice.

4.3 Capital adequacy treatment

4.3.1 Exposure to connected parties specified in Clause 3(B) of the Third Schedule to the Banking Ordinance should be deducted from an AI's capital base if, in the opinion of the MA, it was incurred other than in the ordinary course of business.

4.3.2 The MA will normally consider a loan or an exposure to have been made or incurred outside the ordinary course of business of an AI if it has any of the following characteristics:

- interest free or granted at an unreasonably low interest rate;
- no final maturity;
- granted on non-commercial terms; or
- capital in nature (e.g. it is being used by the recipient to fund investment in subsidiaries).

4.3.3 AIs should review their portfolios to identify any exposure of this nature to ensure that it is reported to the HKMA and that it is deducted from their capital base.
