



HONG KONG MONETARY AUTHORITY
香港金融管理局

Our Ref: B1/15C
B9/25C

12 May 2017

The Chief Executive
All authorized institutions

Dear Sir / Madam,

Risk management for lending to property developers

The Hong Kong Monetary Authority (HKMA) observes that it is now common for property developers to offer mortgage financing with high loan-to-value (LTV) ratios to buyers to promote sales of their property projects. The LTV ratios of these mortgage financing plans often exceed the prudential requirements on property mortgage lending applied by the HKMA on authorized institutions (AIs). Moreover, the lending practices adopted by some of the property developers are inconsistent with prudent lending practices followed by AIs. In some cases, we understand that borrowers are not required to go through an assessment of their repayment ability.

While the aggregate amount of mortgage loans extended by property developers remains small relative to the outstanding amount of mortgage loans provided by AIs based on the information collected by the HKMA from different sources, it is growing at an increasingly rapid pace. Given the continued accumulation of these mortgages, there is a need for AIs to review the credit risks posed by property developers to which they have exposures.

The HKMA further notes from recent examinations of AIs that some property developers involved in recent land acquisition and development projects used high gearing to finance these projects. In a few cases, the amount of the land acquisition cost is financed entirely through borrowing from different AIs. The extension of construction financing to these property developers may expose AIs to a substantially higher level of credit and moral hazard risks.

In view of these developments, the HKMA considers it necessary to strengthen the credit risk management of AIs with respect to lending to property developers. For construction financing, AIs generally apply financing caps of up to 50% of the value of the property site (or the transaction price if it is lower) and 100% of the construction cost, with an overall cap of up to 60% of the expected value of

the completed properties. From 1 June 2017, AIs should lower the caps respectively to 40% of the site value and 80% of the construction cost, with an overall cap lowered to 50% of the expected value of the completed properties. For property developers with weaker financial positions (e.g. higher gearing ratios), AIs should consider further lowering the financing ratios where appropriate. In determining the site value and the expected value of the completed properties, AIs should obtain valuations from at least two independent professional valuers, and use the lower valuation as the basis for calculating the financing ratios.

In addition, locally incorporated AIs should set aside an adequate amount of capital for exposures to property developers offering high LTV mortgages. To ensure that this is the case, the risk weights for credit exposures to property developers will be subject to floors under the Internal Ratings-Based Approach and adjusted upward under the Standardised Approach under certain conditions. The revised risk weights are set with reference to the level of mortgage exposures of property developers. AIs should make their best effort to obtain information from property developers to whom they have extended credit to determine the applicable risk weights. Please refer to the Annex for more details about the adjusted risk weight framework.

The above capital requirement will be implemented in two phases. During phase 1 (i.e. starting from 1 August 2017), the revised risk weights will be applicable to any new exposures to relevant property developers incurred starting from today. During phase 2 (i.e. starting from 1 August 2018), the revised risk weights will be applicable to all existing exposures to relevant property developers.

The HKMA will conduct a round of thematic examinations of AIs to ensure that they continue to follow prudent underwriting standards in extending credit to property developers. It will also monitor market development, and refine and enhance its supervisory requirements regarding AIs' lending to property developers as appropriate.

Should you have any questions about this circular, please send them to the following e-mail account of the HKMA (rml_hkma@hkma.gov.hk).

Yours faithfully,

Arthur Yuen
Deputy Chief Executive

Encl.

Annex

Capital adequacy requirements for credit exposures to property developers offering mortgages with high loan-to-value (LTV) ratios

Capital adequacy requirements

1. For **authorized institutions (AIs) using Internal Ratings-Based Approach in calculating capital charges for credit risk (IRB banks)**, they can continue to determine the capital risk weights for their credit exposures to a property developer based on their approved IRB models. However, they should apply the following risk weight floors for their credit exposures (including both on- and off-balance sheet exposures) to a property developer offering mortgages with high LTV ratios for the purpose of calculating their capital adequacy ratios (CARs):
 - (a) a risk weight floor of 50%, if the property developer's mortgages-to-equity (MTE) ratio (see paragraphs 3 – 4 below for details) exceeds 5% but does not exceed 10%; and
 - (b) a risk weight floor of 100%, if (i) the property developer's MTE ratio exceeds 10%; or (ii) AIs cannot obtain information from the property developer for calculating the MTE ratio.
2. For **AIs using Standardised Approach in calculating capital charges for credit risk (STC banks)**, they should calculate the difference between their CAR computed by means of the existing capital risk weighting treatments for credit exposures (including both on- and off-balance sheet exposures) to a property developer offering mortgages with high LTV ratios and the CAR computed by means of the following adjusted capital risk weighting treatments:
 - (a) 1.5 times of the existing applicable risk weight (subject to a cap of 150%), if the property developer's MTE ratio exceeds 5% but does not exceed 10%; and
 - (b) 2 times of the existing applicable risk weight (subject to a cap of 150%), if (i) the property developer's MTE ratio exceeds 10%; or (ii) AIs cannot obtain information from the property developer for calculating the MTE ratio.

STC banks should report the difference to the HKMA. The HKMA will take into account the difference in determining the Pillar 2 capital required for the STC bank and include it as part of the minimum CAR.

3. The MTE ratio of a property developer should be calculated as the total amount of outstanding mortgages already drawn down by property buyers and those committed to be provided by the property developer to, but not yet drawn down by, property buyers, divided by the equity value of the property developer.
4. AIs should obtain most recently available information from property developers to which they have exposures every six months for calculating the MTE ratios and reviewing the capital adequacy requirements to be applied. Proper documentation should be maintained for future inspection by the HKMA.
5. The above capital adequacy requirements should be applied on a group basis. This means that the above risk weights will be applicable to an AI's exposures to any group company of a property developer so long as the MTE ratio calculated in respect of the property developer on a group basis exceeds the thresholds stated above.
6. A table showing the capital risk weighting treatments for IRB banks and STC banks is at the Appendix.

Implementation arrangement

7. The above capital adequacy requirements should be implemented in two phases. During phase 1 (i.e. starting from 1 August 2017), the specified risk weights will be applicable to any new exposures to relevant property developers incurred starting from today. During phase 2 (i.e. starting from 1 August 2018), the specified risk weights will be applicable to all existing exposures to relevant property developers.
8. Should there be any questions about this note, please send them to HKMA's email account at <rml_hkma@hkma.gov.hk>.

Table on capital adequacy requirements for credit exposures to property developers offering mortgages with high loan-to-value ratios

Property developer’s mortgages-to-equity ratio	Risk weights for credit exposures											
	AIs using Internal Ratings-Based Approach	AIs using Standardised Approach										
≤ 5%	Based on AI’s own model calculation	No change, based on AI’s current risk weights.<table><tr><th>Credit rating</th><th>Risk weights</th></tr><tr><td>AAA to AA-/ Aaa to Aa3</td><td>20%</td></tr><tr><td>A+ to A-/ A1 to A3</td><td>50%</td></tr><tr><td>BBB+ to BB-/ Baa1 to Ba3, unrated</td><td>100%</td></tr><tr><td>B+ to D/ B1 to C</td><td>150%</td></tr></table>	Credit rating	Risk weights	AAA to AA-/ Aaa to Aa3	20%	A+ to A-/ A1 to A3	50%	BBB+ to BB-/ Baa1 to Ba3, unrated	100%	B+ to D/ B1 to C	150%
Credit rating	Risk weights											
AAA to AA-/ Aaa to Aa3	20%											
A+ to A-/ A1 to A3	50%											
BBB+ to BB-/ Baa1 to Ba3, unrated	100%											
B+ to D/ B1 to C	150%											
> 5% to 10%	Higher of 50% or AI’s own model calculation	Risk weights are adjusted upward by 50%, subject to a cap of 150%.<table><tr><th>Credit rating</th><th>Risk weights</th></tr><tr><td>AAA to AA-/ Aaa to Aa3</td><td>20% -> 30%</td></tr><tr><td>A+ to A-/ A1 to A3</td><td>50% -> 75%</td></tr><tr><td>BBB+ to BB-/ Baa1 to Ba3, unrated</td><td>100% -> 150%</td></tr><tr><td>B+ to D/ B1 to C</td><td>150%</td></tr></table>	Credit rating	Risk weights	AAA to AA-/ Aaa to Aa3	20% -> 30%	A+ to A-/ A1 to A3	50% -> 75%	BBB+ to BB-/ Baa1 to Ba3, unrated	100% -> 150%	B+ to D/ B1 to C	150%
Credit rating	Risk weights											
AAA to AA-/ Aaa to Aa3	20% -> 30%											
A+ to A-/ A1 to A3	50% -> 75%											
BBB+ to BB-/ Baa1 to Ba3, unrated	100% -> 150%											
B+ to D/ B1 to C	150%											
> 10% or AIs cannot obtain information from the developer	Higher of 100% or AI’s own model calculation	Risk weights are doubled, subject to a cap of 150%.<table><tr><th>Credit rating</th><th>Risk weights</th></tr><tr><td>AAA to AA-/ Aaa to Aa3</td><td>20% -> 40%</td></tr><tr><td>A+ to A-/ A1 to A3</td><td>50% -> 100%</td></tr><tr><td>BBB+ to BB-/ Baa1 to Ba3, unrated</td><td>100% -> 150%</td></tr><tr><td>B+ to D/ B1 to C</td><td>150%</td></tr></table>	Credit rating	Risk weights	AAA to AA-/ Aaa to Aa3	20% -> 40%	A+ to A-/ A1 to A3	50% -> 100%	BBB+ to BB-/ Baa1 to Ba3, unrated	100% -> 150%	B+ to D/ B1 to C	150%
Credit rating	Risk weights											
AAA to AA-/ Aaa to Aa3	20% -> 40%											
A+ to A-/ A1 to A3	50% -> 100%											
BBB+ to BB-/ Baa1 to Ba3, unrated	100% -> 150%											
B+ to D/ B1 to C	150%											