



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.2 – 11.04.2025

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 provide guidelines to AIs on credit risk mitigation in the form of collateral or guarantee

Classification

A non-statutory guideline issued by the MA as a guidance note

Previous guidelines superseded

CR-G-7 “Collateral and Guarantee” (v.1) dated 29.06.01

Application

To all AIs

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1. Introduction

1.1 Terminology

For the purposes of this module—

1.1.1 **collateral** means any financial collateral or physical collateral;

1.1.2 **credit protection provider** means the guarantor of a guarantee (see [paragraph 1.1.5](#)), including the insurer of any insurance policy that falls within the meaning of “guarantee” given by [paragraph 1.1.5](#);

1.1.3 **credit risk mitigant** (CRM), in relation to a credit exposure (whether existing or proposed)—

(a) means any collateral or guarantee obtained or intended to be obtained by an AI to mitigate the credit risk of the credit exposure; and

(b) excludes any collateral or guarantee that falls within either or both of the following descriptions—

(i) the collateral or guarantee does not have or is not expected to have any meaningful credit risk mitigation effect for the credit exposure;

(ii) the collateral or guarantee has been or is intended to be obtained simply as additional comfort;

1.1.4 **financial collateral** means any financial instrument or financial asset that may be used as collateral, such as cash, bank deposits, debt securities, investment funds, equities, paper gold, life insurance policies, residential mortgage loans, trade receivables, etc.;

1.1.5 **guarantee**, in relation to an AI—

(a) means a legal agreement, other than a credit derivative contract, that allows one party (beneficiary) to transfer the credit risk of one or more specific credit exposures to another party; and



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- (b) includes any legal agreement falling within [paragraph \(a\)](#) that is in the form of indemnity, letter of credit, risk participation, mortgage insurance, export credit insurance or other credit risk insurance;

1.1.6 **physical collateral** means any tangible asset (other than financial collateral) that may be used as collateral, such as real estate, machinery, inventories, equipment, automobile, aircraft, gold bullion, taxi licence, etc.

1.2 Scope of application

1.2.1 The guidance set out in this module is applicable to CRM used for mitigating credit risk arising from credit exposures including margin lending¹, lending commitments and contingent liabilities (such as those arising from shipping guarantees or performance bonds issued by AIs).

1.2.2 Regarding CRM used for mitigating counterparty credit risk (CCR)² and credit risk arising from share margin financing (within the meaning given by [CR-S-4](#)), apart from the general principles set out in this module (e.g. sections 2, 3 and 4), AIs should also refer to the following SPM modules for more specific guidance—

- (a) [CR-G-13](#) “Counterparty Credit Risk Management” for guidance on the use of collateral, central clearing and netting in mitigating CCR arising from derivative contracts and securities financing transactions;

¹ Margin lending includes—

- margin lending transactions as defined in section 2(1) of the Banking (Capital) Rules;
- share margin financing as defined in CR-S-4 “New Share Subscription and Share Margin Financing”; and
- margin lending that is neither of the above two types of transactions.

² Please refer to CR-G-13 “Counterparty Credit Risk Management” for the definition of “counterparty credit risk”. This risk arises mainly from derivative contracts and securities financing transactions (e.g. repo transactions) where the AI is exposed to the risk of default of the other party to the contract or transaction and that other party is also exposed to the risk of default of the AI. This is different from a loan granted by the AI to a borrower because the loan does not expose the borrower to the risk of default of the AI.



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- (b) [CR-G-14](#) “Non-centrally cleared OTC derivatives transactions – Margin and other risk mitigation standards” for requirements on the use of margins for mitigating CCR arising from non-centrally cleared OTC derivative contracts; and
- (c) [CR-S-4](#) “New Share Subscription and Share Margin Financing” for specific guidance on the acceptance and management of share collateral.

1.2.3 Als should refer to—

- (a) [CR-S-2](#) “Syndicated Lending” for further guidance when certain functions discussed in this module are performed by agents (however described) appointed by the syndicate on behalf of the lending banks; and
- (b) [CR-G-12](#) “Credit Risk Transfer Activities” for guidance on the use of credit risk transfer techniques in the form of credit derivative contracts and securitization.

1.2.4 The guidance in this module applies to Als on a proportionate basis, taking into consideration the nature, scale, complexity and credit risk profile of the Als’ credit activities and CRM.

1.3 Interaction with other statutory requirements or supervisory guidance

1.3.1 To avoid doubt, the purpose of this module is to provide general guidance on the use of collateral and guarantees for credit risk management purposes. It does not seek to introduce any new requirements into, or replace or modify any existing requirements specified in, the rules made by the MA under the Banking Ordinance (e.g. the eligibility criteria for recognised credit risk mitigation set out in the Banking (Capital) Rules (BCR)³) or other documents issued by the MA (e.g. SPM CR-G-8 on Large Exposures and Risk Concentrations,

³ Als should refer to the BCR, instead of this module, for the types of collateral and guarantee that can be recognised for the purposes of capital ratio calculations. This module focuses on credit risk management in general and therefore may include collateral and guarantees that are not acceptable for the purposes of the BCR.



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circulars on prudential measures for residential mortgage loans, etc.). Hence, in the event of any conflict between this module and the specific guidance/requirement provided elsewhere (whether in the form of an SPM module or not), the specific guidance/requirement should prevail unless otherwise specified in it or this module.

1.4 Nature of risks associated with CRM

1.4.1 An AI's primary consideration when approving credits should always be the financial strength and debt-servicing capacity of the parties⁴ to which the AI has or may have credit exposures (referred to as "obligor" in this module). AIs should not rely solely on the proceeds from the enforcement of CRM as the primary source of repayment⁵, as a substitute for their own due diligence (including a comprehensive and independent assessment of the obligor's creditworthiness) or to make up for insufficient information.

1.4.2 AIs that rely on CRM as a secondary source of repayment face two major risks:

- (a) they may be unable to enforce their security interest in collateral or their rights under a guarantee;
- (b) the amount recovered from the CRM may eventually be less than originally estimated.

1.4.3 It is therefore essential for an AI to set up systems and controls for CRM management that are commensurate with the nature, scale, complexity and credit risk profile of the AI's credit activities and CRM.

⁴ These parties are not necessarily the other party to a contract or transaction entered into with the AI. They could be, for example, the borrower of the underlying exposures on which credit protection is provided by the AI.

⁵ Except for certain asset-based lending that is specifically designed so that the primary source of repayment is the conversion of the collateral into cash (e.g. IPO loans) and certain structured (limited recourse) lending (e.g. project finance), Islamic products and mortgage loans for purchasing investment properties, where the primary source of repayment is the income or cash flows (e.g. rental income) generated from the collateral.



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2. CRM management policies and procedures

2.1 Policies and procedures

2.1.1 AIs should have in place written policies and procedures, approved by their Board of Directors, the Credit Committee or their designees, for CRM management. The policies and procedures of an AI should cover inter alia:

- (a) clear delegation of authorities and responsibilities to relevant individuals and departments for the approval of the acceptance of CRM and for the monitoring and enforcement/release of CRM;
- (b) clear definitions of acceptable forms of CRM and acceptable types of asset and credit protection provider, taking into account any statutory restriction imposed by the laws or regulations applicable to the AI (e.g. the Banking (Exposure Limits) Rules (Cap. 155S) (BELR));
- (c) types of risk (i.e. residual risks, including legal, operational, liquidity and market risks) arising from the use of CRM, and the associated policies and procedures for managing those risks; and
- (d) collection of data and compilation of management information on CRM for different purposes.

2.1.2 The policies and procedures mentioned in [paragraph 2.1.1\(c\)](#) typically include the following—

- (a) eligibility criteria for evaluating whether a CRM is acceptable (see [section 3](#));
- (b) loan-to-value ratio, margin level or haircut for each type of acceptable collateral and for each type of credit exposure (see [subsection 2.2](#));
- (c) for each type of acceptable collateral, the procedures and practices for verification, valuation (and revaluation) and inspection/examination (in the case of physical collateral) of the collateral (see [section 5](#)); and
- (d) systems and controls for—



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- (i) ensuring the validity and enforceability of CRM (see [section 4](#));
- (ii) ensuring compliance with relevant laws, regulations and supervisory requirements (see [subsection 4.3](#));
- (iii) safe custody of, and access to, collateral and CRM-related legal documents (see [subsection 6.2](#));
- (iv) ensuring that collateral (basically physical collateral) is adequately insured against the risk of damage (see [subsection 6.3](#));
- (v) identifying, measuring, monitoring and controlling risk concentrations and, if applicable, roll-off risk, arising from the use of CRM (see [subsection 2.3](#));
- (vi) managing the interaction between any credit risk concentration arising from the use of CRM and the overall credit risk profile of the AI concerned;
- (vii) regular review and monitoring of the adequacy and quality of CRM (see [subsection 6.4](#));
- (viii) managing the top-up of collateral (see [subsection 6.5](#)); and
- (ix) timely release, and realisation, of CRM (see [section 7](#)).

2.2 Loan-to-value ratio, margin level and haircut

2.2.1 AIs should specify—

- (a) the maximum loan-to-value (LTV) ratios, minimum margin levels and minimum haircuts, however described, for different types of acceptable collateral and credit exposures; and
- (b) the manner in which the actual LTV ratio, margin level or haircut for a credit exposure should be calculated (in principle, all credit exposures, including the undrawn portion of any credit facility, collateralised against the same asset must be included in the calculation).



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Nevertheless, AIs should determine the calculation basis(es) that should suitably be used for different purposes and stages of their credit risk management processes).

2.2.2 The maximum LTV ratios, minimum margin levels and minimum haircuts should be commensurate with the risks of the collateral and the credit exposures concerned and should be able to provide an adequate buffer against—

- (a) volatility of the market value of the collateral;
- (b) any currency mismatch between the collateral and the credit exposure; and
- (c) the liquidity risk of the collateral.

2.2.3 In calculating the LTV ratio of a new mortgage loan for financing the purchase of an immovable property, AIs should use a property value (i.e. the denominator) that is the lower of the valuation of the property or the effective⁶ purchase price of the property.

2.2.4 For certain types of collateral, such as trade receivables or real estate, other factors should also be reflected in the maximum LTV ratios, minimum margin levels or minimum haircuts, where appropriate, such as—

- (a) estimated costs of collection or repossession;
- (b) estimated carrying costs of maintaining the repossessed collateral prior to its disposal; and
- (c) estimated costs that would be incurred for disposing of the collateral (e.g. auction fees).

2.2.5 In general, AIs should set a conservative haircut for collateral the value of which is highly volatile or susceptible to changes in stressed situations, or that requires a longer time to liquidate.

⁶ Any significant incentives or benefits offered by the property developer or seller that may inflate the price of the immovable property should be deducted.



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The quantum of that haircut will also depend on the term of the credit exposure being secured and, in cases where there is a currency mismatch between the credit exposure and the collateral, the volatility of the exchange rate concerned.

- 2.2.6 In determining the security coverage of problem exposures secured by collateral, AIs should, where appropriate, apply a discount to the valuation of the collateral to take into account possible marketing constraints under a forced sale or fire sale situation, or under unfavourable or stressed market conditions.
- 2.2.7 AIs should also ensure that the maximum LTV ratios, minimum margin levels and minimum haircuts set out in their policies and procedures—
- (a) comply with the regulatory requirements issued from time to time by the HKMA and, if applicable, the home supervisors of the AIs; and
 - (b) are reviewed regularly to evaluate their reasonableness and to reflect changing market conditions and loss experience.
- 2.2.8 To avoid doubt, for the purposes of this subsection, an AI may adopt quantitative approaches to assess factors (e.g. liquidity and price volatility of a collateral) that have a bearing on the size of the buffer needed against any loss in value of the collateral if there are sufficient data available to support such approaches. If quantitative approaches are infeasible for the collateral, the AI may rely on informed expert judgement.

2.3 Concentration risk policy

- 2.3.1 AIs should consider concentration risk⁷ associated with CRM (e.g. in the case of mortgage insurance, concentrated

⁷ Concentration risk, as discussed in [Subsection 2.3](#), refers to concentrated risk exposure(s) that may arise within or across different risk categories throughout an AI and should be viewed in the context of a single or a set of closely related risk drivers that may have varying impacts on the AI. Credit risk concentration is a narrower and more specific concept that refers to concentrated risk exposure(s) within a specific risk category.



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exposure to a small number of insurers) from various dimensions, including concentration in—

- (a) the same type of asset;
- (b) a particular type or form of guarantee⁸;
- (c) (in the case of immovable property) the same geographical location;
- (d) financial instruments issued by, or guarantees provided by, the same entity (or entities in the same group), entities in the same industry or similar industry, entities in closely related industries or entities with similar economic characteristics.

2.3.2 Als should formulate a policy with respect to the amount of concentration risk they are willing to accept, taking into account their own risk appetite and the relevant legal and regulatory requirements that apply to them. To implement this policy, limits on concentration risk or other equivalent control measures should be put in place, referencing relevant dimensions (e.g. those mentioned in [paragraph 2.3.1](#)).

2.4 Regular review

2.4.1 Als should have detailed procedures and measures to enforce the aforementioned policies and procedures, and to ensure that they are subject to regular reviews in light of changes in the Als' risk appetite, risk management strategies, business models, and market and regulatory environments.

2.4.2 The internal audit, compliance, or other similar function or functional unit of Als should conduct periodic reviews to verify that the aforementioned policies and procedures are adequate, effective, compliant with applicable legal and regulatory requirements, and adhered to by all relevant staff members.

⁸ Guarantee programmes sponsored by the Government, third-party guarantees, counter-guarantees, export credit insurance, mortgage insurance and standby letters of credit are non-exhaustive examples of the various types or forms that a guarantee may take. Als are expected to consider whether there is any type or form of guarantee concentration in which may pose risks (e.g. legal and/or operational risk) to the Als that warrant implementation of appropriate concentration risk control measures.



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The function or functional unit responsible for conducting these periodic reviews must be independent from the business and functional units that develop, update or implement the policies and procedures.

3. Eligibility of CRM

3.1 General

3.1.1 Collateral whose value, or a guarantee whose credit protection provider's credit quality, has a material positive correlation with the credit quality of the obligor⁹ is unlikely to provide any meaningful credit protection to AIs. Therefore, AIs should not rely on such collateral or guarantee to mitigate credit risk.

3.1.2 Collateral that are financial instruments issued by the parent, subsidiary or affiliate company of the obligor, or guarantees provided by any of those parties, are acceptable provided that the requirement set out in [paragraph 3.1.1](#) is met¹⁰. The assessment of correlation of credit quality should take into account the credit risk of the entire group.

3.1.3 In cases—

(a) where—

- (i) the obligor has little or no independent capacity to repay the credit exposure concerned (e.g. a special purpose vehicle (SPV))¹¹; or
- (ii) the terms and conditions of the credit exposure concerned provide that the lending AI has no or

⁹ For example, the obligor's own shares or debt securities, or the shares, debt securities or guarantee issued by an entity where the obligor is the entity's key or only customer.

¹⁰ To avoid doubt, there is no presumption that material positive correlation in credit quality must be present between the obligor and those related parties. AIs are expected to prudently assess whether material positive correlation exists, e.g. if a guarantee is provided by the obligor's parent, whether the obligor is the major source of income of its parent.

¹¹ Examples of a lack of independent capacity include cases where the assets pledged to the lending AI as collateral are the only assets held by the SPV or the SPV's income is derived entirely from the guarantor within the same group as the SPV and/or from other group companies.



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limited recourse to the obligor (whether it is an SPV or not) for repayment; and

- (b) the lending AI looks primarily to the income of the guarantor guaranteeing, or the revenues generated by the assets securing, the credit exposure as the primary source of repayment of the exposure,

[paragraphs 3.1.1](#) and [3.1.2](#) may not be applicable. Examples of this type of financing arrangement include project finance (including real estate development projects), mortgage loans granted to shell companies for the purchase of investment properties, and syndicated loans whose obligors are special purpose funding vehicles of corporate groups or conglomerates.

- 3.1.4 For certain types of CRM (e.g. trade receivables and mortgage insurance), AIs will also need to evaluate the underwriting practices, risk management systems and internal controls of the obligor who provides the collateral (e.g. the originator of the trade receivables) or the credit protection provider concerned (e.g. the insurer) when assessing the extent and effectiveness of the credit protection provided by the CRM. Moreover, in the case of credit risk insurance, AIs should have a clear understanding of the policy coverage.
- 3.1.5 AIs may accept an asset or a guarantee as CRM only if they are capable of creating security interests in the asset (including any right to repossess the asset without impediment), or imposing legal obligations on the credit protection provider of the guarantee, that are binding on all relevant parties and legally enforceable in all relevant jurisdictions (see [subsection 4.1](#)).
- 3.1.6 In general, the CRM arrangement should remain effective throughout the term of the credit exposure concerned. In other words, collateral should not be released, or obligations of the credit protection provider under a guarantee should not be discharged, before the obligations of the obligor concerned are fully discharged. If the CRM concerned are life insurance policies, this means that the policy must remain current for the life of the credit exposure (e.g. a life insurance policy with the premium fully paid up).



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3.1.7 Collateral or guarantees that do not satisfy the eligibility criteria set out in this section (e.g. [paragraph 3.1.1](#)) may still be accepted as additional comfort, but the credit risk of the credit exposure concerned should be assessed and managed without taking into account the collateral or guarantee.

3.2 Collateral

3.2.1 In addition to the general criteria set out in [subsection 3.1](#), Als should ensure that only assets that satisfy the following eligibility criteria are accepted as collateral for their credit exposures:

- (a) the asset should be of satisfactory quality, e.g. in terms of the credit risk of the issuers in the case of debt securities (or the debtors in the case of trade receivables), or of the insurers in the case of life insurance policies;
- (b) the market value of the asset is readily determinable or can be reasonably established and verified (see [section 5](#));
- (c) the asset can be realised in a reasonable period of time. If the asset has to be realised by sale, there exists a readily available market for disposing of the asset;
- (d) the AI is able to secure control over the asset if necessary. In the case of movable physical collateral, the AI should either have physical custody of the asset (e.g. gold bullion) or have the means of locating its whereabouts (e.g. vehicle or machinery). For life insurance policies, any amount payable under the life insurance policy should only be made to the AI or to other parties with the AI's prior consent; and
- (e) the AI possesses the necessary expertise and systems to—
 - (i) assess the risks associated with the asset; and
 - (ii) manage the collection or repossession of the asset, or, where the asset is held by or under the custody of the AI, manage the asset.



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3.3 Guarantee

3.3.1 In addition to the general criteria set out in [subsection 3.1](#), AIs should ensure that only guarantees that satisfy the following eligibility criteria are accepted as CRM for their credit exposures:

- (a) the guarantee should be evidenced in writing and represent a direct claim of the AI on the credit protection provider;
- (b) the financial strength of the credit protection provider has been thoroughly assessed, under the same rigorous credit risk assessment process as for direct extension of credit to an obligor, as adequate for discharging the obligations under the guarantee. If the credit protection provider is a financial institution (including banks, securities firms and insurance companies), that institution should be subject to prudential and regulatory oversight by a competent authority, unless the financial activities carried on by the institution are not required by law to be subject to regulation and prudential supervision;
- (c) the undertaking of the credit protection provider to make payment relating to the credit exposure in specified circumstances (e.g. bankruptcy of the obligor) should be clearly documented in the guarantee so that the extent of the credit protection provided by the guarantee is clearly defined;
- (d) the guarantee should not contain any clause, the fulfilment of which is outside the direct control of the AI, that would—



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- (i) allow the credit protection provider to reduce or cancel the credit protection unilaterally¹²¹³¹⁴; or
- (ii) prevent the credit protection provider from being obliged to make prompt payment to the AI¹⁵; and
- (e) collection of funds under the guarantee should not be subject to unduly complex procedures or processes.

4. Validity of CRM

4.1 Enforceability

4.1.1 The CRM arrangements should be properly documented. AIs should conduct sufficient legal review to verify that a CRM arrangement and the associated credit documentation, including any guarantee form or legal documents (e.g. mortgage deed), are binding on all parties relevant to the creation and enforcement of the CRM arrangement and legally enforceable in all relevant jurisdictions. Where appropriate, AIs should obtain positive legal opinions¹⁶ to this effect. The

¹² In the case of an all monies or continuing guarantee, if the credit protection provider may, by giving advance notice to the AI, revoke its obligations under the guarantee in respect of any new credit exposures to the obligor concerned, the guarantee will not be considered as failing to meet the criteria set out in [paragraphs 3.3.1\(c\) and 3.3.1\(d\)](#) as long as the revocation will only discharge the credit protection provider's obligations in respect of new credit exposures incurred by the AI after the revocation, but not those incurred prior to the revocation. However, the AI must take into account this right of revocation when measuring the effectiveness of such a guarantee as a CRM.

¹³ A sanctions clause in a letter of credit will not automatically be classified as a clause caught by [paragraph 3.3.1\(d\)](#). As generally stated in the *Consolidated ICC Guidance on the Use of Sanctions Clauses in Trade Finance-related Instruments subject to ICC Rules* issued by the International Chamber of Commerce, it is recommended that banks refrain from issuing or accepting trade finance instruments that include sanctions clauses that purport to impose restrictions beyond those applicable to the performance of the obligation under the trade finance instruments as a matter of law. Consequently, any sanctions clause that permits the issuing bank to exercise discretion beyond, or conflicts with, the requirements of applicable sanctions law or regulations would generally be considered as a clause caught by [paragraph 3.3.1\(d\)](#). As mentioned in [paragraph 3.1.7](#), a letter of credit with such a clause may still be accepted by an AI as a guarantee, but the AI should refrain from relying on the guarantee for supporting credit decisions.

¹⁴ For a letter of credit with a sanctions clause that is not caught by [paragraph 3.3.1\(d\)](#), AIs are still expected to take into account any genuine risk of sanctions in relation to the letter of credit and the enforcement of the sanctions clause when evaluating the effectiveness of such a letter of credit as a CRM.

¹⁵ See [footnotes 13 and 14](#).

¹⁶ In general, it would be appropriate to obtain external legal opinions for CRM arrangements that involve jurisdictions other than Hong Kong or in cases where an AI's in-house counsel lacks sufficient knowledge,



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legal review should be re-conducted, as necessary¹⁷, to ensure continuing legal enforceability. There should also be measures to avoid, among other things—

- (a) contracts (or any clauses in such contracts) being rendered void, voidable or unenforceable by virtue of the Unconscionable Contracts Ordinance (Cap. 458) or for other reasons such as lack of capacity, misrepresentation or undue influence;
- (b) taking assets as collateral that may violate any law or regulatory requirement applicable to the AI concerned (see [subsection 4.3](#) for more information); and
- (c) omitting any steps that should be taken (whether by the AI or by other relevant parties such as the obligor or the credit protection provider) to fulfil requirements under the law applicable to, or any contractual terms associated with, the CRM concerned that are necessary to perfect the security interest or credit protection, such as prompt registration of legal charges or guarantees with the relevant authorities (e.g. the Companies Registry in Hong Kong or the State Administration of Foreign Exchange in Mainland China), or prompt notification to insurers in respect of security or assignment agreements executed for insurance policies taken as collateral.

4.1.2 The CRM arrangement and the associated credit documentation should empower the AI to enforce or realise the CRM without any impediment and in a timely manner on the occurrence of any event of default (e.g. bankruptcy of the obligor) or any similar event as defined in the credit documentation. For example, if the intention of a security arrangement with an obligor is for the lending AI to receive the surrender value in a life insurance policy in the event of the default of the obligor, the lending AI should ensure that it has

skills or experience in the law or legal issue concerned (including those cases that involve Hong Kong law only).

¹⁷ For example, when there are events, such as changes in laws, new court cases, etc., that may have implications for legal enforceability.



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the rights to terminate the life insurance policy and receive the surrender value.

- 4.1.3 Apart from enforceability in the legal context, AIs should also consider practical or operational issues in enforcing cross-border CRM arrangements where the collateral or credit protection provider is located outside Hong Kong. For example, procedural risks of legal proceedings in jurisdictions outside Hong Kong, practical difficulties in repossession of collateral, withholding tax on the proceeds of enforcement of CRM, exchange controls, etc.

4.2 Title and ownership of assets taken as collateral

- 4.2.1 AIs should verify the existence and ownership of the asset intended to be taken as collateral before acceptance. Moreover, there should be no claim of a higher or equal ranking by another party on the asset, nor any other encumbrances (e.g. court order or unregistrable third-party interest) that may jeopardise the AIs' security interest in the asset.
- 4.2.2 AIs should ensure that all legal documents are properly executed and, where applicable, AIs' control over the collateral is secured prior to the drawdown of credit facilities. For example, an AI should have obtained its customer's authorisation to allow it to transfer the legal title to the shares taken as collateral to the AI or have received its lawyer's confirmation of having taken possession of the original title deeds of the mortgaged immovable property.
- 4.2.3 Where it is necessary for the collateral (e.g. shares or debt securities) to be held by a third party (e.g. a custodian), AIs should take reasonable steps to ascertain that the third party does not have any claim on the collateral¹⁸ (e.g. by obtaining a written confirmation from the third party) and that the

¹⁸ The guidance on third party's claim on collateral is not intended to cover—

- (a) collateral held by central securities depositories, such as Clearstream; or
- (b) a custodian's right of retention/pledge/set-off or other similar right, as long as such a right is required by law or is for securing the obligations that the AI has or may have towards the custodian in consequence of the services rendered to it by the custodian.



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collateral is segregated from the third party's own assets and held in a bankruptcy remote manner.

4.3 Compliance with relevant laws and regulations

- 4.3.1 Als should not accept assets as collateral that would violate any statutory restrictions, whether imposed by the laws of Hong Kong or other jurisdictions, applicable to the AI, such as the concentration risk limits imposed by the BELR.
- 4.3.2 In handling collateral (including disposal), Als should ensure compliance with all relevant laws and regulations, e.g. Als that are registered institutions should adhere to the relevant requirements set out in the Securities and Futures Ordinance (Cap. 571) or the rules made under that Ordinance, as well as the relevant guidance issued by the Securities and Futures Commission, in respect of collateral received from clients. Where appropriate, legal advice should be sought.
- 4.3.3 Als should also comply with the Code of Banking Practice in respect of secured lending, guarantees and third party securities for transactions that fall within the scope of the Code.

5. Valuation of collateral

5.1 Type of valuation

- 5.1.1 This subsection applies to all types of asset taken as collateral, and should be applied by Als having regard to the type of asset accepted or intended to be accepted as collateral.
- 5.1.2 Als should define collateral valuation approaches per asset type that are adequate and appropriate for the asset class in question¹⁹. Where applicable and appropriate, there should be clear requirements on the acceptable types of valuation for different purposes (e.g. new credit origination, annual credit review, credit monitoring, etc.), such as full and formal valuation reports that include on-site inspections or desktop valuation reports.

¹⁹ For example, "mark to market" approach for listed equities.



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5.1.3 Notwithstanding the approach or type of valuation used, AIs should maintain adequate documentation of collateral valuations, which should include the methodologies and assumptions used in a valuation.

5.1.4 The scope and extent of the valuation report should be commensurate with the value of the collateral and its inherent risks.

5.2 Basis of valuation

5.2.1 For assets that lack readily available and observable market values (e.g. immovable properties), valuation should be conducted in accordance with the relevant international or local valuation standards issued by global standard setters or professional bodies where such standards are available. Under this high level principle, the valuation, whether internal or external, of an asset taken or to be taken by an AI as collateral—

- (a) should reflect the asset's current price level;
- (b) should be conservative and based on reasonable, prudent and substantiated methodologies and assumptions, and should have taken into account all relevant factors affecting the asset's value (e.g. climate risks (such as potential damage related to weather hazards)²⁰, liquidity, obsolescence and deterioration). An onsite inspection or physical examination of the asset by the appraiser may be warranted in order to produce a valuation report that is professionally adequate for its intended purpose. The AI should ensure that it or its agents have the right to inspect or examine the asset if such inspection or examination is necessary;

²⁰ Given the challenges arising from, for example, methodological and data limitations that cannot be fully resolved currently, in considering whether climate risks have been given due consideration, the HKMA will adopt a pragmatic approach and apply the proportionality principle in line with the implementation approach of SPM GS-1 "Climate Risk Management".



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- (c) should not take into consideration expected future price appreciation or temporary aberrations; and
- (d) should not be biased in a manner that enables the AI to inflate the credit quality of an obligor so that the AI could, for example, grant a higher credit limit to the obligor, improve the obligor's internal credit rating, reduce the capital requirement for a credit exposure, or decrease the required amount of credit loss allowance or continue interest accrual for a problem credit.

5.2.2 In the case of assets with readily available and observable market value (e.g. equities and exchange-traded funds), the valuation should not exceed the market value. AIs should have access to reliable sources of timely price data to accurately measure the collateral coverage of their credit exposures.

5.2.3 Where applicable, AIs should adjust the valuation to account for—

- (a) potential realisation costs (e.g. carrying costs of the repossessed collateral, legal fees or other charges associated with disposing of the collateral); and
- (b) the potential for the current valuation to be significantly above the value that would be sustainable over the life of the credit exposure concerned.

5.3 Appraisers' competence

5.3.1 AIs should establish criteria for determining when to engage external appraisers. Examples of situations that may warrant external valuation include collateral that does not have a readily available and observable market value (e.g. unlisted investments), a lack of price information on an identical or similar asset for comparison with the collateral (e.g. a large commercial complex), and collateral that an AI does not have the expertise to assess its value (such as fine arts and antiques).

5.3.2 AIs should maintain a list of approved external appraisers that have been selected based on pre-specified assessment criteria in terms of factors including professional qualifications, reputation, experience and competence. The performance of



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the external appraisers should be regularly monitored and evaluated. Appraiser selection and evaluation should be conducted by a unit that is independent of the unit or staff involved in credit/business origination.

5.3.3 Als that have their own internal valuation unit should put in place systems and controls to ensure that—

- (a) the responsible staff possess sufficient knowledge and expertise to perform their duties;
- (b) sufficient resources are deployed to provide appropriate training to the staff for maintaining their competence level and to provide access to information that is necessary for conducting high quality valuation; and
- (c) where applicable, the valuation methodologies and models used by internal appraisers are reviewed and validated on a regular basis. For example, internal valuations can be back-tested against the actual sale proceeds received on subsequent disposal of the assets concerned or cross-checked from time to time with external valuations on a sampling basis.

5.3.4 In cases where there is any doubt about the valuation conducted by an internal or external appraiser, the HKMA may, for the purposes of assessing the adequacy of capital requirements, credit loss provisions or credit risk management, or ascertaining compliance with other regulatory/supervisory requirements, request an AI to obtain an independent second valuation from another appraiser.

5.4 Frequency of revaluation

5.4.1 Collateral should be revalued on a regular basis and whenever concerns arise regarding the performance of the collateral or the obligor, or when there is reason to believe that the market value of the collateral has significantly decreased. Where feasible, clear triggers should be set for increased frequency of revaluation.



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- 5.4.2 The frequency²¹ of regular revaluation may vary with the type of collateral involved (e.g. collateral with higher price volatility should be subject to more frequent revaluation) and the nature and the internal credit rating of the credit exposure concerned. For example, AIs should mark to market securities posted by their margin lending customers at least on a daily basis. During periods of high market volatility, this should be performed intraday at short notice (with margin calls made as appropriate).
- 5.4.3 For large or problem exposures that are secured by immovable properties, there should preferably be quarterly revaluations. The frequency may need to be increased to monthly if the property market is declining rapidly. Problem exposures secured by other types of collateral also deserve revaluation on a more frequent basis.
- 5.4.4 AIs should specify the minimum frequencies of revaluation, or the circumstances under which revaluation is required, for different types of asset and credit exposure.

5.5 Independence of valuation

- 5.5.1 External appraisers, providers of valuation systems, and the staff of an AI responsible for performing valuations or carrying out related activities (e.g. conducting site visits or deciding on the use of external appraisers) should be independent of the AI's functions responsible for credit/business origination, credit assessment and credit approval. They should also be independent of the obligor (and the mortgagor/chargor or credit protection provider, if any) and should not have an interest in the outcome of the valuation.
- 5.5.2 The AI should ensure that the compensation arrangements with appraisers and the AI's staff involved in valuation do not create inappropriate influence on, or wrong incentives for, them.

²¹ If an AI intends to recognise the collateral under the BCR for capital adequacy purposes, the frequency of revaluation must be in compliance with the requirements set out in the BCR.



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6. Risks of failed or reduced credit protection

6.1 General

6.1.1 AIs should have robust procedures and processes to control risks of failed or reduced credit protection.

6.1.2 Credit protection could become ineffective or less effective in cases such as—

- (a) a significant decline in the value of the collateral (e.g. shares, debt securities or commodities) attributable to market-wide risk sources such as market turmoil or economic downturn;
- (b) a decline in the value of the mortgaged immovable property due to climate risks (e.g. the location of the property has become vulnerable to damages caused by severe weather events or repeated flooding);
- (c) deterioration or obsolescence of the collateral due to the introduction of new substitutes or technologies (e.g. machinery or equipment), or the fashion- or date-sensitive nature of the collateral (e.g. inventories); and
- (d) deterioration in the financial strength of the credit protection provider of a guarantee or in the credit quality of a financial collateral (such as worsening creditworthiness of the issuer of a debt instrument taken as collateral).

6.2 Safe custody and access controls

6.2.1 Authorities and responsibilities should be clearly delegated to relevant individuals and departments for the safe custody of CRM-related legal documents (e.g. deed of guarantee and title deed of a mortgaged immovable property) and collateral held by AIs (whether physically or digitally).

6.2.2 Collateral and CRM-related legal documents that are physically held by an AI—

- (a) should be kept in a fire-proof safe or vault under dual control, with the locations properly recorded and



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controlled so as to facilitate easy retrieval in the future;
and

- (b) the movements of which should be duly authorised and tracked, with acknowledgements obtained from the persons withdrawing them from the safe or vault. There should be internal controls to ensure that collateral and CRM-related legal documents withdrawn are returned promptly and to chase up any collateral or CRM-related legal documents that have not been returned after an unusually long period. In addition, there should be regular physical checks²² of collateral and CRM-related legal documents.

6.2.3 For financial collateral held by custodians, AIs should conduct regular reconciliation of collateral balances.

6.2.4 Collateral and CRM-related legal documents that are held by an AI or a third party on behalf of the AI (e.g. a technology service provider) in digital form should also be subject to safekeeping and access controls having equivalent effects as those set out in [paragraphs 6.2.2 and 6.2.3](#), for example, internal controls and security measures that safeguard against unauthorised access to, or damage of, the relevant electronic records.

6.3 Insurance

6.3.1 Where applicable, physical collateral taken by AIs should be adequately insured against the risk of damage or loss. The AI should be the beneficiary of the policy (or otherwise entitled to receive the policy proceeds, e.g. the interest in the policy has been properly assigned to the AI).

6.3.2 The insurance policy should provide appropriate coverage, and remain valid until the collateral is released by the AI.

²² The physical checks could be conducted on a sampling basis if adequate systems and controls are already in place to track the movements of collateral and documents.



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6.3.3 The cost of insurance, unless borne by the obligor, should be factored into the pricing of the credit facility concerned.

6.3.4 The insurer should be subject to adequate supervision²³, financially sound and independent of the obligor concerned (and the mortgagor/chargor, if any). If the insurer is a related company of the AI, the insurer should also be operationally independent of the AI (i.e. with a separate management team). Furthermore, the AI should consider whether the insurer has taken appropriate measures (e.g. reinsurance) to ensure that the group as a whole is not exposed to undue risks.

6.4 Evaluation of quality of CRM after acceptance

6.4.1 The quality of the CRM obtained should be evaluated on a regular basis. The frequency will depend on the nature, size, and risk of the credit exposure concerned. The evaluation can be conducted in parallel with the credit review of the credit exposure, if applicable. However, adverse changes in the financial markets or property market, or deterioration in the credit quality of the obligor, may necessitate a prompt review of the likely performance of the CRM.

6.4.2 Where applicable and appropriate, the evaluation may also need to cover—

- (a) in the case of movable physical collateral such as machinery and equipment—periodic visits to the sites where the assets are located so as to verify the existence and condition of the assets; and
- (b) in the case of equitable mortgage loans involving off-plan properties—monitoring of the construction progress and the financial position of the property developer concerned.

6.4.3 AIs should regularly review the credit quality of financial collateral and guarantees (e.g. during the annual credit review), where appropriate, to ensure continued compliance

²³ This condition is satisfied if the insurer is an insurance company subject to the supervision of the Insurance Authority.



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with the eligibility criteria. This should encompass a review of the financial strength of the following parties—

- (a) for financial collateral—the obligors in respect of the financial instruments or financial assets in question (e.g. the issuers of debt securities or the insurers of life insurance policies); and
- (b) for guarantees—the credit protection providers (e.g. the insurer in the case of a mortgage insurance).

6.4.4 If the evaluation indicates that the credit protection has become ineffective or less effective, the AI should assess, having considered the specific circumstances, the credit quality and the prospect of repayment of the obligor as a whole, whether the risks involved exceed the level the AI is willing to assume and whether any appropriate protective measures should be taken, such as, requiring additional collateral or guarantee, replacing collateral, modifying credit terms or adjusting credit limits.

6.5 Collateral maintenance requirement

6.5.1 For credit facilities (e.g. margin lending) that require obligors to provide additional collateral under certain circumstances, the circumstances (including the collateral level that must be maintained by the obligors) and any right of the lending AI to make any subsequent changes should be clearly defined and documented in the relevant agreements with the obligors.

6.5.2 For the aforementioned credit facilities, clearly documented systems and controls should be in place to—

- (a) monitor the outstanding credit exposure of an obligor and the current market value of the collateral posted by the obligor to ensure that requests for additional collateral are made in a timely and accurate manner; and
- (b) promptly follow up on any collateral requests that have not been met by obligors.



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6.6 Stress-testing

- 6.6.1 Als should monitor general trends in markets (e.g. property and stock markets), financial systems and economies that are relevant to the major types of CRM used.
- 6.6.2 Als should include CRM in their stress-tests and scenario analysis²⁴ in order to assess the overall impact of any adverse changes in the values or effectiveness of the CRM under unusual or stressed market conditions (e.g. a significant decline in property or stock prices, or the insolvency of a major financial institution) on the Als' financial positions. Stress-testing would help identify vulnerabilities in an AI's CRM portfolios to adverse external factors or market conditions. Als should refer to [IC-5](#) "Stress-testing" for more details.

7. Release and realisation of CRM

7.1 Release of CRM

- 7.1.1 Prior to the release of CRM, internal controls should be in place to ensure that:
- (a) all conditions for release stipulated in the relevant legal agreements have been fully satisfied; and
 - (b) the release has been properly authorised, executed and documented.
- 7.1.2 After verifying that the conditions for release are satisfied and the release has been properly authorised, the collateral and/or the relevant CRM-related legal documents should be returned to the appropriate party (e.g. the obligor, the credit protection provider or the owner of the collateral) promptly, unless otherwise specified in the relevant documentation (e.g. where it is stipulated that the deed of guarantee remains the property of the AI after the principal indebtedness has been repaid) or there are practical difficulties in doing so. Confirmation of

²⁴ In this context, stress-tests and scenario analysis refer to those that are designed and conducted under an AI's stress-testing programme developed in accordance with the guidance provided by SPM IC-5 "Stress-testing".



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receipt should be obtained from the party concerned upon the release.

- 7.1.3 If the CRM to be released will be substituted with another CRM, AIs should evaluate the substitute CRM and exercise due diligence in the same manner as if they were obtaining a new CRM for a new credit facility. Adjustments to the limit and other credit terms of the existing credit facility may be warranted. The substitute CRM must be received prior to, or at the same time as, the release of the existing CRM unless there are compensating measures to mitigate or contain any risk that may arise during the time gap between release and receipt of CRM.

7.2 Realisation of CRM

- 7.2.1 AIs should have clear and robust procedures to ensure that any legal and/or contractual conditions required for declaring the default of an obligor and the timely realisation of CRM are satisfied.
- 7.2.2 All assets acquired by an AI in the course of satisfying debts due to it should be disposed of at the earliest suitable opportunity. Where relevant, the AI should also comply with the requirements applicable to it under the BELR regarding the maximum holding period of the assets so acquired. Otherwise, the assets must be included in the computation of the AI's exposures under the applicable provisions of the BELR.
- 7.2.3 Disposal of collateral should be conducted at arm's length and in a prudent and commercially reasonable manner through a transparent process (such as a public auction or through independent estate agents for repossessed immovable properties) to avoid any disputes with the obligor, mortgagor or chargor concerned. If the costs of collateral realisation are to be borne by the obligor, this should be clearly stated in the relevant legal agreement.



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8. Management information system

8.1 Data collection

8.1.1 AIs should have CRM management information systems (MISs) to collect CRM data and maintain records of CRM data to facilitate accounting and regulatory reporting and for risk management purposes, such as for timely and accurate margin calls, tracking of realisation dates of CRM and the net proceeds received, estimation of loss given default, and determination of allowance for expected credit losses.

8.1.2 AIs should establish and implement processes to ensure that the MISs are able to generate timely, accurate and comprehensive information to enable proactive and prompt credit risk monitoring and oversight by the Board of Directors, relevant committees, senior management and other relevant functions.

8.2 Management reports

8.2.1 Management information on CRM should be produced regularly to facilitate management of credit risk. The specific information required and the frequency of reporting will depend on the purposes of the management information in question and the types of CRM involved. AIs may wish to include, where appropriate, the following information:

<u>Management information</u>	<u>Proposed frequency</u>	<u>Purpose</u>
Breakdown of credit exposures by type of CRM and collateral types and by issuer and credit protection provider	Monthly	<ul style="list-style-type: none"> ◆ Identification of concentration risks ◆ Stress-testing
Analysis of collateral composition, concentration and LTV ratios	Monthly	Formulation of corresponding risk management strategies or follow-up actions



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<u>Management information</u>	<u>Proposed frequency</u>	<u>Purpose</u>
Latest collateral valuation and due dates for revaluation	Monthly	Follow-up of collateral valuation
Credit exposures exceeding maximum LTV ratio	Margin lending: daily Others: monthly	Highlighting facilities requiring top-up of collateral for follow-up actions
Total valuation of collateral repossessed during the course of debt satisfaction	Monthly	Formulation or modification of strategies for the disposal of repossessed collateral (e.g. residential properties – wait for market improvement or sell immediately)
Comparison of latest valuation with actual sale proceeds of collateral	Monthly	Evaluation of the accuracy and validity of the valuation methodology (including any haircut or discount applied to the valuation)
Recovery rates	Quarterly	Development of internal loss estimates
Current valuation of collateral in respect of each classified credit exposure	Quarterly	Determination of provisions for credit losses



HONG KONG MONETARY AUTHORITY
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