

**BANKING ORDINANCE**

**Letters of Comfort : Section 81**

**A Guideline issued by the Monetary Authority  
under Section 7(3)**

**Introduction**

The purpose of this guideline is to set out the criteria that the Hong Kong Monetary Authority ("HKMA") will apply in assessing the acceptability of a comfort letter for the purpose of section 81 and the factors that will be taken into account in setting the limit for a comfort letter. This guideline supersedes the previous guideline on the same subject issued on 18 October 1991.

2. Risk diversification is a key precept in banking. Section 81 of the Banking Ordinance (the Ordinance) regulates concentration of credit risk by limiting a locally incorporated authorized institution's exposure to a single party to 25% of its capital base.

3. In view of Hong Kong's role as an international financial centre, and the flexibility which a locally-incorporated authorized institution can give to a banking group, such subsidiaries have been allowed to exceed the 25% limit, up to other limits set by the Monetary Authority ("Authority"), provided that their liabilities are assured by a letter of comfort accepted by the Authority. The letter of comfort provision in effect confers some of the flexibility of having a branch operation in Hong Kong.

**Acceptability criteria**

4. A letter of comfort accepted by the Authority enables an institution to exceed the 25% limit for large exposures. In accepting a letter of comfort, the Authority needs to be satisfied that the risks are effectively transferred to the issuer. The issuer's strength and status must therefore be undoubted. As the instrument is not a guarantee and may not be legally enforceable, it is important to ensure that the issuer has a strong commitment to support the beneficiary by virtue of shareholding links. In particular, the following criteria must be met:

- (a) the issuer must be either a bank licensed in Hong Kong or an institution recognized as a bank in the place where it is incorporated and which is under adequate supervision by the home supervisor;
- (b) the issuing bank is a shareholder or the ultimate shareholder of the beneficiary, or is controlled by the same shareholder or ultimate shareholder as the beneficiary;
- (c) the letter is issued as a result of a resolution of the board of directors of the issuing bank;
- (d) the home supervisor of the issuing bank is aware of the letter of comfort and does not object to its issue by the issuing bank;
- (e) the issuing bank has the financial strength to support the obligations under the letter of comfort;
- (f) the issuing bank exercises effective oversight of the beneficiary's large exposures; and
- (g) the home supervisor supervises the capital adequacy and large exposures of the issuing bank on a consolidated basis and the position of the beneficiary is taken into account in such supervision.

#### **Form and obligations**

5. There is no specific form for the letter of comfort. But as a minimum, the letter should express clearly the nature and extent of the commitment to support. It should state that the letter has been authorized by a resolution of the board of directors of the issuer. In addition, it should set out the shareholding relationship between the issuer and the beneficiary institution. The issuer should undertake to inform the HKMA immediately of any change in the relationship, and to consult the Authority in advance of any proposed decrease in the percentage shareholding. A specimen letter of comfort in a form acceptable to the Authority is enclosed at the Annex for reference.

### Limit

6. In accepting a letter of comfort, the Authority will specify a limit on the aggregate amount of any financial exposures that the beneficiary institution may grant or make to any one customer or a group of related customers with regard to the letter of comfort. In setting the limit, the Authority will take into account the following factors:

- (a) the financial strength, background and credit rating of the issuer; the financial strength of the issuer will be assessed having regard to, inter alia, its capital base or capital and reserves as the case may be;
- (b) the extent to which the issuer's capital adequacy and credit risk (including those of the beneficiary) are subject to consolidated supervision by its home supervisor and the degree of oversight exercised by the issuer over the beneficiary's large exposures;
- (c) the financial strength of the beneficiary;
- (d) the sources of funding of the beneficiary and its reliance on public deposits to fund its operations; and
- (e) the justification for the limit.

7. During the first year of operation, an authorized institution will only be permitted a modest increase over the 25% limit. Thereafter higher limits may be considered, provided the institution is meeting the prudential requirements of the Authority. The aggregate credit exposures to an individual customer or a group of related customers to be allowed - expressed as a fixed sum - will not normally exceed 10% of the capital base or the capital and reserves, as the case may be, of the issuer of the letter of comfort (depending on the capital rules applicable in the issuer's jurisdiction). The amount will need to be justified, in the light of the institution's business, and increases up to the 10% limit will be considered on a progressive basis.

### **Annual review of comfort letter limits**

8. To monitor whether or not the issuer of a letter of comfort continues to be financially sound to honour its obligations under the letter, all the comfort letter limits will be subject to annual review by the HKMA. In deciding whether an existing limit is appropriate or not, and, in particular, whether an existing limit should be reduced, the HKMA will take into account any changes in the factors mentioned in paragraph 6 above. In considering whether the existing limit is justified, it will also have regard to the actual and prospective utilisation of the limit.

### **Variation of limit and other conditions**

9. The HKMA may, after consulting the issuer and the beneficiary institution, vary the limit approved for a comfort letter. This would be either on being requested to do so by the beneficiary, or in the event of significant deterioration in the financial strength of the issuer or the beneficiary. Such variation, however, will not affect an existing exposure which has exceeded the revised limit. The beneficiary will be allowed to run down the exposure in accordance with the terms of its agreement with the customer. Subsequent to a change in the limit for a comfort letter, the relevant overseas supervisor will be notified.

DRAFT LETTER OF COMFORT FOR SECTION 81 (FROM BANK PARENT)

To : The Monetary Authority

Heading : [Name of Authorized Institution] ("the Company")  
The Banking Ordinance, Cap. 155 ("the Ordinance")

In support of an application by the Company for exemption, under the provisions of section 81(6)(b)(ii) of the Ordinance, from the financial exposure restrictions contained in section 81(1) of the Ordinance, we state and confirm the following:

1. We are the legal and beneficial owners of .....% of the paid up share capital of the Company. It is our present intention to maintain that percentage holding in the Company. We undertake to inform you forthwith of any change in that intention and to consult you in advance of any likely decrease in that percentage holding;
2. It is in our interest that the Company continues to conduct its business as an Authorized Institution under, and in conformity with, the provisions of the Ordinance;
3. It is in our interest that the Company and its subsidiaries should meet their financial obligations at all times. It is our policy to provide the Company with such support and assistance as may be required to ensure that it maintains capital and liquidity levels to enable it at all times to meet its obligations in conformity with standards of prudence generally accepted for its field of business; and
4. This letter of comfort was duly authorized by a resolution of our board of directors dated ....., a copy of which is enclosed.

Yours, etc.

Comfort Letter Review Questionnaire

Capital adequacy

1. Does your country subscribe to the Basle capital adequacy framework? If no, please provide information on your framework to supervise capital adequacy of your banks.

Concentration of credit risks

2. Are there any limitations on your banks' maximum exposures to a single party or a single group of related parties? If yes, please provide information on the limitations and the scope of exposure covered, e.g. is investment in the shares and securities included?
3. Are there any financial exposures exempted from the limitations? If yes, please elaborate.
4. How do you define "a group of related parties"?

Consolidated supervision

5. In supervising the capital adequacy and large exposures of your banks, do you consolidate the positions of their subsidiaries and associates? And to what extent are they consolidated?
6. Have you established the necessary capabilities to meet the minimum standards for supervision of international banks and their cross-border establishment as recommended by the Basle Committee? If no, do you have plans to implement the recommendation?

Re: Banks listed in Annex A

7. Are all the issuing banks shown in Annex A required to meet your prudential requirements concerning capital adequacy and concentration of credit risks?

8. Are all the beneficiaries shown in Annex A captured in your consolidated supervision of the capital adequacy and concentration of credit risks of the issuers?
  
9. Are you content with the commitments under the comfort letters and the approved limits as shown in Annex A? Do you have any doubt on the ability of the issuing banks to honour the obligations under the comfort letter and provide the beneficiaries with the necessary financial support?

**NOTE :** Exclude from the questionnaire those questions which we already have the information.

