



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

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

Purpose

To provide guidelines to Als on the management of collateral and guarantees for credit risk mitigation

Classification

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

Previous guidelines superseded

Guideline 5.5 “Section 80 of the Banking Ordinance: Advance against Security of Own Shares, etc.” dated 10.10.90

Application

To all Als

Structure

1. Introduction
2. Policies and procedures
3. Acceptance criteria
 - 3.1 Collateral
 - 3.2 Guarantees
 - 3.3 Concentration limits
4. Validity of collateral and guarantees
 - 4.1 Enforceability
 - 4.2 Title and ownership
5. Loan-to-value ratio



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.1 – 29.06.01

6. Valuation
 - 6.1 Basis of valuation
 - 6.2 Valuers' competence
 - 6.3 Frequency of revaluation
 - 6.4 Independence of valuation
 - 6.5 Stress-testing
 7. Safe custody and access controls
 8. Top-up of collateral
 9. Insurance
 10. Disposals
 11. Management information
-

1. Introduction

- 1.1 Als' primary consideration when approving credits should always be the borrower's financial strength and debt-servicing capacity. It is important that they do not rely solely on collateral or guarantees as the primary source of repayment or as a substitute for evaluating the borrower's creditworthiness.
- 1.2 Nevertheless, collateral¹ and guarantees, if properly taken and managed, do serve a number of important functions in credit risk management. These include:
 - to mitigate credit risk by providing Als with a secondary source of repayment in the event that the borrower defaults on a credit facility;
 - to gain control of the collateral which is the primary source of repayment of a facility in default. For example, a loan to a property developer secured on the property being developed would be repaid by the sale proceeds of that developed property;

¹ "Collateral" has the same meaning as, but is used in preference to, "security" to avoid confusion with stocks, shares, etc.



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.1 – 29.06.01

- to provide early warning of a borrower's deteriorating repayment ability (particularly for credit facilities such as margin financing where top-up of collateral may be required from time to time); and
- to enable locally incorporated AIs to apply a lower capital risk weight to credits which are secured by collateral or guarantees as specified in the Third Schedule to the Banking Ordinance².

1.3 AIs that rely on collateral to provide secondary protection in the event of a borrower's default in repayment however face two major risks:

- they may be unable to establish a title to the collateral for disposal; and
- the cash proceeds eventually realised by the disposal of the collateral may be less than its estimated value.

1.4 It is therefore essential for AIs to set up appropriate systems and controls for the management of collateral and guarantees.

1.5 For the purpose of this module, guarantees refer to those accepted by an AI to support the granting of credit facilities and reduce the underlying credit risk. It does not cover those guarantees accepted simply as additional comfort for the facilities granted.

2. Policies and procedures

2.1 AIs should have in place written policies, approved by their Board of Directors, the Credit Committee or senior management

² Such collateral or guarantees mainly include:

- cash deposits;
- residential mortgages within the meaning of the Third Schedule to the Banking Ordinance;
- securities or guarantees issued by the Exchange Fund, the central government, the central bank or public sector entities of a Tier 1 country or multilateral development banks; and
- guarantees from AIs or banks incorporated in a Tier 1 country.

Please see the Third Schedule to the Banking Ordinance for details.



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.1 – 29.06.01

with delegated authority, for the management of collateral and guarantees. They should cover inter alia:

- criteria for the acceptance of collateral and guarantees;
- validity of collateral and guarantees;
- loan-to-value ratios;
- valuation;
- safe custody and access controls;
- top-up of collateral;
- insurance;
- disposals; and
- management information on collateral held.

2.2 Als should have detailed procedures for enforcing the above policies.

2.3 Internal Audit should carry out periodic checks to ensure that the above policies and procedures are adhered to.

3. Acceptance criteria

3.1 Collateral

3.1.1 Als 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



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.1 – 29.06.01

- the AI has the expertise and systems to manage the asset concerned.
- 3.1.2 Collateral which does not satisfy the above criteria may still be accepted as additional comfort, but the facilities concerned should be regarded as unsecured.
- 3.1.3 AIs should align the term of validity of the collateral with that of the obligation it secures. For example, if a property development loan is collateralised on the property being constructed, the collateral right over the property should not be released before the loan is fully repaid.
- 3.1.4 Collateral whose value has a material positive correlation with the credit quality of the borrower (e.g. securities issued by the borrower or any related group entity) is likely to provide little credit protection to AIs. They should not therefore rely too much on such collateral for reducing credit risk.
- 3.1.5 For internal control purposes, AIs should draw up the types of asset acceptable as collateral and the maximum loan-to-value ratio for each of these assets (see section 5 below). They should take into account the criteria set out above and the following statutory restrictions under §80 of the Banking Ordinance:
- §80(1) prohibits AIs from granting any credit facilities against the security of their own shares³, and
 - under §80(2), prior written approval should be obtained from the MA if an AI wishes to grant any credit facilities against the security of the shares of its holding company or a subsidiary of itself or its holding company.

3.2 Guarantees

³ A loan by an AI secured by an instrument creating a charge or other security over that AI's own shares is illegal, void and consequently, unenforceable. This could happen notwithstanding that the charge or security was over a portfolio of shares and the AI's shares constituted only a portion of the shares. In such circumstances, it is unlikely that the illegal portion of the contract could be severed from the remainder. The whole security would be void.



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.1 – 29.06.01

3.2.1 For the purpose of credit risk mitigation, Als should ensure that guarantees accepted fulfil the following criteria:

- the guarantee should represent a direct claim on the guarantor;
- the guarantee should be unconditional and irrevocable⁴;
- the guarantee should be properly documented and legally enforceable;
- the guarantee should remain continuously effective until the facility covered by the guarantee is fully repaid or settled; and
- the financial strength of the guarantor should be thoroughly assessed and considered as adequate for discharging the obligation under the guarantee.

3.2.2 The creditworthiness of a guarantor should ideally not be linked to or affected by the financial position of the borrower.

3.2.3 Where an AI has accepted a guarantee, the financial strength of the guarantor should be reviewed where appropriate (e.g. during the annual credit review) to ensure that the guarantee remains valid for credit risk mitigation.

3.2.4 Guarantees should not be regarded as collateral and the facilities covered by them should be regarded as unsecured, unless the guarantees are issued by the central government or the central bank of a country without repayment difficulties, an AI or an overseas incorporated bank which is under adequate supervision.

3.3 Concentration limits

3.3.1 Taking the same type of asset as collateral or accepting collateral or guarantees from the same issuer or provider

⁴ In the case of a continuing guarantee (i.e. one securing both a specific sum and any further advances that may be made to the borrower in future), a guarantor may, by giving notice to the AI, revoke his guarantee in respect of any new advances to be made to that borrower. Normally, Als will allow the guarantor to revoke his guarantee after a period of notice. Such revocation will therefore only discharge the guarantor's obligation in respect of new advances made after the expiry of that period but not those outstanding prior to that.



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.1 – 29.06.01

creates a concentration risk. Als should consider formulating a policy with respect to the amount of concentration risk they are prepared to run.

3.3.2 For example, the limits on concentration risk could be in the form of a cap on the amount of:

- lending secured by the same type of collateral;
- financial collateral taken from a particular issuer or market; and
- credit protection obtained from a particular guarantor.

4. Validity of collateral and guarantees

4.1 Enforceability

4.1.1 Als should ensure that credit documentation, including guarantees and pledge agreements, is legally enforceable in all relevant jurisdictions. Where appropriate, Als should obtain positive legal opinions to this effect.

4.1.2 The credit documentation should empower the AI to apply the collateral freely to discharge the borrower's obligations in so far as they are not discharged by the borrower in accordance with the loan agreement (e.g. due to breach of repayment terms, liquidation or bankruptcy of the borrower).

4.1.3 Where the cost of liquidating collateral is to be borne by the borrower, this should be clearly stated in the relevant loan agreement to give the borrower notice and to avoid such a clause being unenforceable against a person dealing as a customer by virtue of the Unconscionable Contracts Ordinance.

4.1.4 Als should comply with section 20 of the "Code of Banking Practice" in respect of guarantees and third party security provided by individuals.

4.2 Title and ownership

4.2.1 Als should verify the existence and ownership of the assets being pledged before acceptance.



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.1 – 29.06.01

- 4.2.2 Als should ensure that there is no prior claim, or claim of equal ranking, by another party on the collateral.
- 4.2.3 Als should secure their control of the collateral prior to the drawdown of credit facilities. For example, they should obtain customers' authorization to transfer the legal title to the pledged shares to them or receive their lawyers' confirmation of having taken possession of the original title deeds for mortgaged properties.
- 4.2.4 Where there is a need for the collateral to be held by a third party, the AI should obtain that party's written confirmation that it has no claim over the collateral.
- 4.2.5 Charges on collateral should be registered promptly with the relevant authorities (e.g. the Companies Registry), where appropriate.

5. Loan-to-value ratio

- 5.1 Als should specify the maximum loan-to-value ratio for major types of asset to be accepted as collateral. Such ratios should be commensurate with the relative risk of the assets and be able to provide an adequate buffer against potential losses in realising the collateral arising from the following:
- potential fluctuations in the market value of the collateral (or the exchange value for foreign currency assets);
 - the carrying costs of maintaining the repossessed collateral before it is disposed of; and
 - the costs incurred for disposing of the collateral (e.g. auction fees of properties).
- 5.2 The HKMA has from time to time issued guidance on the maximum loan-to-value ratios that should be observed by Als in respect of some common types of secured financing (e.g. residential mortgages, share margin financing, taxi loans, etc.). Als are expected to adhere closely to such guidance and will be required to justify any departure from the maximum loan-to-value ratios prescribed.



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.1 – 29.06.01

6. Valuation

6.1 Basis of valuation

- 6.1.1 Valuation should be based on the current market value of the collateral and should not be biased in order to enable the AI to grant a higher credit limit to the borrower or improve its internal credit rating, make a smaller amount of provision or continue interest accrual for a problem credit.
- 6.1.2 AIs should ensure that the valuation method used, whether internal or external, is based on assumptions that are both reasonable and prudent and all assumptions should be clearly documented.
- 6.1.3 Collateral should be valued, wherever possible, at net realisable value, being the current market value less any potential realisation costs (e.g. carrying costs of the repossessed collateral, legal fees or other charges associated with disposing of the collateral).
- 6.1.4 Market value should be the price at which an asset might be sold at the valuation date assuming:
- a willing buyer and seller;
 - the transaction is at arm's length;
 - a reasonable period has been allowed for the sale; and
 - the asset is freely exposed to the market.
- 6.1.5 To cater for collateral whose market value is highly volatile, AIs should apply a conservative haircut when valuing it for the purpose of determining the extent to which an exposure is secured. The quantum of that haircut will depend on the price volatility of the collateral, the term of the exposure and whether the collateral is denominated in a different currency to the underlying debt.
- 6.1.6 A more conservative approach should be adopted for valuing the collateral of problem credits. This is because, in practice, the forced-sale value, rather than the open market value, is likely to be closer to what eventually may be realised from an asset sale when the market conditions are unfavourable. Therefore, a discount to the



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.1 – 29.06.01

estimated market value should be applied where appropriate.

- 6.1.7 In assessing the value of an asset, temporary aberrations should be disregarded (e.g. a sudden rebound in the market price).

6.2 Valuers' competence

- 6.2.1 Als should establish criteria for determining when to use external valuers. For assets without a readily available market value (such as unlisted investments or a large commercial complex) and assets which an AI does not have the expertise to assess (such as fine arts and antiques), external valuation is called for.
- 6.2.2 Als should maintain a list of approved external valuers and surveyors. They should be professionally qualified, reputable, experienced and competent. Their performance should be regularly monitored and evaluated.
- 6.2.3 Als which have their own internal valuation unit should ensure that the responsible staff possess sufficient knowledge and expertise to perform their duties.
- 6.2.4 Procedures should be established to ensure that internal valuations are not out of line with prevailing market values. For example, internal valuations can be cross-checked from time to time with professional valuations on a sampling basis.
- 6.2.5 Accuracy and effectiveness of methodology for conducting internal valuations should also be back-tested by comparing the valuation with actual sale proceeds received on subsequent disposal of the assets.
- 6.2.6 In cases where there is any doubt about the valuation made by internal or external valuers, the HKMA reserves the right, for the purpose of assessing the adequacy of provisions, to request an AI to obtain an independent second valuation from another valuer.

6.3 Frequency of revaluation

- 6.3.1 Collateral should be revalued on a regular basis, though the frequency may vary with the type of collateral involved and the nature and the internal credit rating of



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.1 – 29.06.01

the underlying credit. For example, Als should mark to market their portfolio of shares pledged by margin financing customers at least on a daily basis. At times when the stock market is highly volatile, this should be performed intra-day at short notice (and margin payment should be demanded, if appropriate). For large or problem exposures which are secured by properties, there should preferably be quarterly revaluations. The frequency may need to be increased further to monthly if the property market is declining rapidly.

6.4 Independence of valuation

6.4.1 The back office⁵ is normally assigned with the responsibility to perform periodic valuations of collateral. Staff conducting internal valuations, carrying out site visits to collateralised properties or deciding on the use of external valuers should be independent of the marketing or credit initiation function.

6.5 Stress-testing

6.5.1 Als should monitor general trends in markets (e.g. property price and stock indices) for the major types of collateral taken.

6.5.2 Als are recommended to conduct stress-tests and scenario analysis on their portfolio of collateral in order to assess the impact under unusual market conditions (e.g. a significant decline in property or stock prices).

7. Safe custody and access controls

7.1 Authority and responsibility should be clearly delegated to relevant individuals and departments for approving the acceptance, monitoring or safe custody of collateral⁶ and guarantees.

7.2 Collateral and guarantees received by Als should be kept in a fire-proof safe or vault.

⁵ Please see Diagram 1 of [CR-G-1](#) “General Principles of Credit Risk Management” for an illustration of functions typically performed by the back office.

⁶ In this context, the term “collateral” refers to both physical collateral (e.g. marketable shares) and any forms of document representing the legal title to the collateral (e.g. title deeds).



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.1 – 29.06.01

- 7.3 The location of collateral and guarantees placed in the custody of AIs should be properly recorded and controlled to facilitate easy retrieval in future.
- 7.4 There should be dual control over the access to collateral and guarantees, in particular, where the collateral is in bearer form or can easily be sold in the market.
- 7.5 Movements of collateral and guarantees should be duly authorized, acknowledged by the persons taking possession of them and properly recorded.
- 7.6 Collateral and guarantees withdrawn for processing should be promptly returned to the officer in charge of their safe custody. The officer should chase up collateral and guarantees withdrawn for an unusually long period.
- 7.7 Prior to the release of collateral or guarantees, the officer in charge of their safe custody should ensure that:
- all conditions for release stipulated in the relevant loan agreements have been fully complied with; and
 - the release has been properly authorized.
- 7.8 Once the conditions for release are satisfied, collateral and guarantees should be returned to the borrower promptly, except in cases where it is stipulated in the relevant documentation that the guarantee remains the property of the AI after the principal indebtedness has been repaid.
- 7.9 Confirmation of receipt should be obtained from the borrower upon the release of collateral and guarantees.
- 7.10 In relation to the handling of collateral, AIs should ensure compliance with relevant laws and regulations, e.g. AIs which are exempt dealers should observe §81A of the Securities Ordinance for securities accepted as collateral.

8. Top-up of collateral

- 8.1 Where it is anticipated that a borrower may need to provide additional collateral, the conditions warranting this action should be clearly documented in the relevant agreement with the borrower.
- 8.2 Cases where additional collateral may be required include:
- the value of the original collateral has fallen significantly due to fluctuations in market price (e.g. of commodities);



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.1 – 29.06.01

- a decline in the value of collateral has caused the maximum loan-to-value ratio for that type of collateral to be exceeded (e.g. share margin financing);
- the original collateral has become obsolete due to the introduction of new substitutes or more superior models (e.g. hi-tech equipment); and
- deterioration in the debt-servicing ability of the borrower.

8.3 Procedures for requesting additional collateral should be clearly documented.

9. Insurance

- 9.1 Als should, wherever possible, take out insurance for collateral naming the AI as the beneficiary.
- 9.2 The cost of insurance, unless borne by the borrower, should be factored into the pricing of the credit.
- 9.3 The insurer should be under adequate supervision⁷, financially sound and independent of the borrower concerned. If the insurer is a related company of the AI, it should also be operationally independent of the AI (i.e. with a separate management team). In addition, the AI should consider taking appropriate measures (e.g. reinsurance) to ensure that the group as a whole is not exposed to undue risks.

10. Disposals

- 10.1 All properties, share capital and debt securities acquired by a locally incorporated AI in the course of the satisfaction of debts due to it should be disposed of at the earliest suitable opportunity and not later than 18 months after its acquisition or within such further period as may be approved by the MA. Otherwise, the AI will be required to include the assets acquired and held for more than 18 months or such further period approved by the MA in the computation of its exposure relating to the following statutory limits:

<u>Type of collateral</u>	<u>Statutory limit</u>
---------------------------	------------------------

Share capital and	§81(1) – Financial exposure to a person should not
-------------------	--

⁷ This condition is satisfied in relation to insurance companies in Hong Kong by virtue of their supervision by the Insurance Authority.



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.1 – 29.06.01

<u>Type of collateral</u>	<u>Statutory limit</u>
----------------------------------	-------------------------------

debt securities of an issuer	exceed 25% of an AI's capital base
------------------------------	------------------------------------

Share capital	§87(1) – Aggregate value of an AI's shareholding in other companies should not exceed 25% of the AI's capital base
---------------	--

Properties	§88(1) – Aggregate value of an AI's interest in land should not exceed 25% of the AI's capital base.
------------	--

10.2 Disposal of collateral should be at arm's length and through a transparent process (such as a public auction or independent estate agents for foreclosed properties) to avoid complaints by the original owner.

10.3 AIs should ensure that the disposal of collateral is in compliance with relevant laws and regulations. For example, AIs which are exempt dealers should observe §81A of the Securities Ordinance when disposing of securities pledged as collateral by their customers. Where appropriate, legal advice should be sought.

11. Management information

11.1 Management information on collateral should be produced periodically to facilitate management of credit risk. Information required will depend on the nature and value of collateral taken by an AI. AIs may wish to include, where appropriate, the following information:

<u>Management information</u>	<u>Proposed frequency</u>	<u>Purpose</u>
Breakdown of credit exposure by type of collateral	Monthly	For the identification of concentration risks in the pool of collateral accepted and stress-testing
Borrowings exceeding maximum loan-to-value ratio	Margin financing: daily Others: monthly	To highlight facilities requiring top-up of collateral



Supervisory Policy Manual

CR-G-7

Collateral and Guarantees

V.1 – 29.06.01

Management information

Total current market value of assets foreclosed in the course of satisfaction of debts

Proposed frequency

Monthly

Purpose

To facilitate formulation or modification of strategies for disposal of assets foreclosed (e.g. residential properties – wait for market to improve or sell immediately)

Comparison of latest assessed market value with actual proceeds of collateral sold

Monthly

To facilitate evaluation of the accuracy and validity of methodology for conducting collateral valuations

Current market value of collateral related to each classified credit

Quarterly

For determining the amount of provision required for classified credits

[Contents](#)

[Glossary](#)

[Home](#)

[Introduction](#)