



HONG KONG MONETARY AUTHORITY
香港金融管理局

Practice Note

Credit risk management for loans to the corporate sector

1. In light of the increasing diversity and sophistication of loan products to the corporate sector, AIs should step up their risk awareness and risk controls correspondingly to ensure that all risk factors arising from the products are properly identified, monitored, and managed. Such loan products can be developed and marketed by AI themselves or through collaboration with off-shore financial institutions; and the associated loan exposures can be incurred from direct lending to the borrowing entities or indirectly through risk participation arrangements.
2. This note outlines the key steps that the HKMA expect AIs to adopt in order to prudently manage credit risks in extending loans to the corporate sector.

Applicability

3. This note takes effect from 1 April 2015. All AIs should implement the requirements set out in this note into their policies and procedures.
4. This practice note is complementary to other supervisory requirements of the HKMA. As such, it should be adopted in conjunction with the existing and applicable supervisory requirements of the HKMA. The HKMA expects every AI to give full consideration to the adoption of the recommended practices set out in this note.
5. If an AI's practices are deviated from the practices stipulated in this note, the AI must stand ready to demonstrate to the satisfaction of the HKMA that their practices are offering the same degree of effectiveness and prudence in managing the risks. The AI will be considered by the HKMA to be non-compliant if it cannot provide sound justifications and alternatives when being requested by the HKMA.

Loan product approval

6. AIs should put in place prudent and effective internal systems for developing and approving new loan products. The supervisory requirements in this area are set out in section 3.3 under module IC-1 General Risk Management Controls of the Supervisory Policy Manual of the HKMA. In this regard, AIs should not exclude non-bank customer loan business conducted in collaboration with financial institutions outside Hong Kong, whether or not they are affiliated with or within the same group of the relevant AIs, from compliance with these requirements.
7. AIs should perform comprehensive risk assessment before engaging in any new loan businesses. The assessment should cover all aspects of risks such as credit risks, legal risks, operational risks, money laundering risks, and compliance risks. Moreover, the connectivity and interplay of different risk factors should be adequately and critically evaluated.

Risk management

8. Before engaging in new lending business, AIs should identify and properly manage the associated credit risks as required in section 3.4 of module CR-G-1 General Principles of Credit Risk Management of the Supervisory Policy Manual of the HKMA. AIs that involve in participations and assignments in loans should also conduct a comprehensive, thorough and independent risk assessment before committing themselves in the business. They should apply the same standards of prudence, credit assessment and approval criteria, and risk control limits as if they were originating the loans.
9. AIs should conduct borrower-specific credit risk assessment and manage the identified risks in accordance with the principles stipulated in the Supervisory Policy Manual and other requirements of the HKMA. AIs should always be mindful of the reputational risk associated with poorly underwritten loans. As such, a multi-dimensional risk assessment that has addressed different types of risk such as credit risk, compliance risk, legal risk and operational risk should be employed in the loan underwriting process. Moreover, the evaluation of connectivity and interplay of credit and other risks should not stop at the product level. The evaluation should also be conducted for each borrower and loan levels.
10. The primary consideration for credit decisions should always be the borrower's debt-servicing capability. The presence of collateral or guarantees should not replace the need for prudent assessment on the repayment ability of borrowers during the loan underwriting process nor

any comprehensive and continuous customer due diligence and know-your-customer efforts.

11. AIs should be mindful that the amount of loans and advances supported by bank guarantees issued by their wholly-owned subsidiary banks without backing by tangible collateral such as deposits pledged to the subsidiary banks should be treated as an unsecured amount.
12. For collaborative loans or purchased participations, timely credit information or credit risk mitigation tools such as guarantees obtained from the collaboration institutions are helpful for credit risk mitigation but AIs should not use such information to replace their own credit assessment.
13. The relationship between borrowers and other parties involved in any loan arrangement should also be thoroughly established, verified and assessed. Examples of these parties include non-shareholding controllers, applicants of bank guarantees supporting the borrowers' credit and major trade counterparties such as suppliers and customers. A good understanding on the background of such parties is particularly important for loan businesses involving cross-border parties, such as in the case of cross-border collaborative loan businesses.
14. Credit underwriting standards, which reflect the risk appetite of an AI for a specific portfolio or transaction of loans, should be clear and prudent. In general, AIs should not approve loans that based on conditions which are to be met after the loan approval if they do not have good control on the fulfilment of the conditions by the borrowers. Moreover, AIs should follow up with the borrowers to ascertain the fulfillment of post-approval conditions closely.
15. AIs engaging in loans in collaboration with off-shore financial institutions should ensure that such activities are in full compliance with the applicable supervisory and regulatory requirement of the relevant jurisdictions. In this regards, AIs should seek clarification from the relevant authorities of the jurisdictions concerned in case they have doubt on the interpretation of regulatory requirements of other jurisdictions.
16. With the exception of plain vanilla trade finance products such as direct export bills discounting as they are more relevant to the exposures to the accepting banks than to the corporate customers, AIs should obtain written confirmations from external legal professionals confirming that the business and the related collaboration arrangements are in compliance with the applicable laws and regulations of the jurisdictions concerned. The confirmation is required at the product level or the jurisdiction level where appropriate. In other words, AIs are not required to obtain such

confirmation for each and every transaction of the same loan product. For loan products or arrangements that have already existed prior to the effective date of this note, AIs should obtain the required confirmation within a reasonable period of time if they have not done so before. Before the required confirmation is properly obtained, AIs should refrain from taking new customers under the concerned arrangements or products.

17. The HKMA considers that the risks arising from customer loan business in collaboration with financial institutions in places outside Hong Kong are comparable; and hence the risk management practices on these loans should be harmonised.
18. If the written confirmation cannot be obtained after exhausted efforts of the AIs, compensating controls that are equally effective in serving the same purposes are acceptable if alternative controls are supported by sound justifications. In this case, AIs should maintain proper records of the relevant processes of discussion and decision making.

Checks and balances

19. The aforesaid multi-dimensional risk assessment should primarily be performed by the credit risk management function, and where necessary views and advice from other risk management functions, such as anti-money laundering function, should also be obtained.
20. AIs' deliberation during the processes of risk assessment and credit approval should be properly recorded. The records of discussions that lead to a credit decision should at minimum include details on the dates of discussion, names and positions of the staff who have participated in the discussion, their comments and views expressed during the discussion. Views given on anonymous basis in the records are not acceptable.

Resources and expertise

21. AIs should deploy adequate risk management resources and expertise to manage the risks associated with their lending businesses. This is particularly important for loan products that involve counterparties in other jurisdictions, such as cross-border collaborative loan business and credit to those borrowers whose main sources of repayment are mainly derived outside Hong Kong. As a minimum requirement, AIs should have a designated officer or a designated unit that possesses up-to-date knowledge and expertise in the regulatory development and credit market environment of the jurisdictions involved in their loan business. AIs' risk appetite should be consistent with their knowledge and expertise on the

markets that they expose to. Moreover, AIs should have in place channels for effective communication of such information to the staff handling the loan business.

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