



## Supervisory Policy Manual

CR-L-3

Letters of Comfort: BELR  
Rule 57(1)(d)

V.2 – 27.12.19

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.

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### Interpretation

In this module:

- **BELR** means the Banking (Exposure Limits) Rules (Cap. 155S);
- unless otherwise specified, a reference to a Rule means a Rule in the BELR and a reference to a section (§) means a section in the Banking Ordinance (Cap. 155)

### Purpose

To specify the criteria that the MA applied in assessing the acceptability of letters of comfort for large exposure purposes and the factors taken into account in setting and renewing limits for such letters

### Classification

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

### Previous guidelines superseded

Guideline 5.2.3 "Letters of Comfort: Section 81" dated 13.07.93; CR-L-3 "Letters of Comfort: §81(6)(b)(ii)" (V.1) dated 31.08.01

### Application

To all locally incorporated AIs

### Structure

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## 1. Introduction

- 1.1 Risk diversification is essential for bank management. Before the implementation of the BELR, §81 regulated concentration risk by limiting a locally incorporated AI's aggregate financial exposure to a single party or a group of related parties to 25% of its capital base. This has been replaced, from 1 July 2019, by Part 7 of the BELR, which limits a locally incorporated AI's aggregate exposure to a single counterparty or a group of linked counterparties ("LC group") to generally 25% of its Tier 1 capital.
- 1.2 As an international financial centre, Hong Kong accommodates a number of foreign banks that maintain their presence here in the form of locally incorporated subsidiaries. A number of local banks also conduct part of their business through local AI subsidiaries for commercial reasons.
- 1.3 For historical reasons, such subsidiaries have been allowed to incur financial exposure to a single party or a group of related parties in excess of 25% of their capital base under §81(6)(b)(ii) in force before 1 July 2019 to the extent that the exposure is covered by a letter of comfort acceptable to and approved by the MA. This provision confers on these subsidiaries some of the flexibility that a branch operation would give.
- 1.4 By issuing a letter of comfort the issuer signifies its willingness and commitment to provide such support as the beneficiary AI may need, if problems arise as a result of default in any exposures covered by the letter, in order to ensure that it continues to maintain adequate capital and liquidity levels to meet its obligations.



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- 1.5 The use of letters of comfort for §81 purposes is a historical feature of the Hong Kong banking system which has helped to promote the development of Hong Kong as an international financial centre. It has to be recognised, however, that letters of comfort are in principle less effective than guarantees in protecting AIs against credit risk. This is because they are not formal guarantees and are not intended to be enforceable in a legal sense.
- 1.6 For the foregoing reasons, it has been the MA's general policy not to accept new letters of comfort<sup>1</sup> for large exposure purposes since 31 August 2001, the date of version one of this module.
- 1.7 It is now also the MA's policy to cease the acceptance of AIs' existing letters of comfort gradually. When the provisions in Part XV of the Ordinance were replaced by the BELR on 1 July 2019, for the sake of a smooth transition, the provisions of §81(6)(b)(ii) have been carried over to Rule 57(1)(d)(i). Transitional arrangements are provided for in Rule 116(1) that, if a letter of comfort was accepted by the MA under §81(6)(b)(ii) and the acceptance was in effect immediately before 1 July 2019, the acceptance is deemed to be an approval of the letter of comfort given under Rule 57(1)(d)(i) on 1 July 2019. Nonetheless, this deemed approval ceases to have effect at the end of 30 June 2020 pursuant to Rule 116(2).
- 1.8 An AI currently relying on its letter of comfort for compliance with the limits under Part 7 of the BELR is expected to make necessary arrangements to achieve compliance without such aid by 30 June 2020. To this end, an AI may consider making arrangements to cover an exposure by recognized credit risk mitigation under Subdivision 2, Division 3 of Part 7, the BELR, in addition to diversification of exposures. It should also be noted that certain offsetting is permitted under Subdivision 4, Division 3 of Part 7 of the BELR, which helps relieve pressure from exceeding the statutory limits under Part 7 of the BELR.
- 1.9 A letter of comfort may still be accepted in exceptional cases, for example, a letter of comfort from the Government has been accepted to support an AI's exposure arising from the 80% Loan Guarantee Product under the SME Financing Guarantee Scheme set up by the Hong Kong Mortgage Corporation Limited or its subsidiaries. In future, to be consistent with the standards set out in

<sup>1</sup> To avoid doubt, the renewal/reissuance of an existing letter of comfort for valid reasons, e.g. group restructuring of an AI, is acceptable.



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the “Supervisory framework for measuring and controlling large exposures” (April 2014) issued by the Basel Committee on Banking Supervision, the MA will not approve a letter of comfort under Rule 57(1)(d) with respect to the exposures of a Category A institution. The only exception is Government-issued letter of comfort, which supports exposures to the Hong Kong Mortgage Corporation Limited or its subsidiaries. In that case, the Government takes on the credit risk fully and ultimately.

## 2. Supervisory approach

### 2.1 Application

2.1.1 This section covers the use of letters of comfort by AIs that are already approved by the MA to use them for large exposure purposes. The MA will generally not approve any new applications for the use of letters of comfort under Rule 57(1)(d)(i) by AIs that are not already using them.

### 2.2 Acceptance criteria

2.2.1 In order for a letter of comfort to be acceptable, the MA must be satisfied that the issuer has, and will continue to have, a strong commitment to support the beneficiary AI and is financially sound enough to fulfil its commitment under the letter.

2.2.2 As the letter is not a guarantee, it is particularly important to ensure that the following criteria are met on a continuing basis:

- the issuer is either a bank licensed in Hong Kong or an institution recognised as a bank in the place where it is incorporated and under adequate supervision by its home supervisor;
- the issuer is a controller of the beneficiary AI, normally a majority shareholder controller but possibly a minority shareholder controller or, in exceptional cases, an indirect controller of the AI;
- the letter is issued under a resolution of the Board of Directors of the issuer;
- the home supervisor of the issuer is aware of the letter of comfort and does not object to its issue by the



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issuer;

- the issuer has, and will continue to have, the financial strength to support its obligations under the letter of comfort;
- the issuer exercises effective oversight over the beneficiary AI's large exposures<sup>2</sup>; and
- the home supervisor supervises the capital adequacy and large exposures of the issuer on a consolidated basis and the position of the beneficiary AI is taken into account in such supervision.

### 2.3 Form and contents

2.3.1 There is no specific format for letters of comfort but there are essential elements that should feature in their contents:

- the letter of comfort should acknowledge that the purpose of the letter is to enable the beneficiary AI to incur financial exposures which are in excess of 25% of its Tier 1 capital;
- it should express clearly the nature and extent of the issuer's commitment to support the beneficiary AI in the case of default affecting such exposures;
- it should set out the shareholding relationship between the issuer and the beneficiary AI;
- the issuer should undertake to inform the MA immediately of any change in the relationship and to consult the MA in advance of any proposed decrease in the percentage of shares held;
- it should confirm that the issuer exercises effective oversight over the beneficiary AI's large exposures and will ensure that it is informed of all exposures covered by the letter on a timely basis; and

<sup>2</sup> The MA will only accept letters of comfort issued by the controller(s) of the beneficiary AI that can satisfy this criterion. In most cases it will be the majority shareholder controller that can exercise effective oversight over the AI's large exposures. But there may, for example, be cases where this oversight is exercised by a number of minority shareholder controllers which together have effective joint control over the beneficiary AI.



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- it should state that the letter has been authorized by a resolution of the Board of Directors of the issuer.

2.3.2 As mentioned in para. 1.7, a letter of comfort accepted by the MA under the former §81(6)(b)(ii) is deemed to be approved by the MA under Rule 57(1)(d)(i). It is therefore not necessary to resubmit a letter of comfort incidental to the replacement of the relevant provisions in the Banking Ordinance by the BELR.

## 2.4 Maximum lending limit

2.4.1 In accepting a letter of comfort, the MA will set a maximum lending limit for any financial exposure that the beneficiary AI may take on to any single counterparty or group of linked counterparties with regard to the letter of comfort.

2.4.2 This limit is determined in relation to the AI's capital base. It sets a limit on the total amount of an individual exposure that may be supported by the letter of comfort, including the portion of the exposure up to the 25% statutory limit and that in excess of the 25% limit. From the implementation of the BELR on 1 July 2019, the general 25% statutory limit is calculated with reference to the Tier 1 capital instead of capital base of an AI. Any exposure that exceeds the maximum lending limit would be in breach of rule 44(1)<sup>3</sup> of Part 7 of the BELR, provided that it is not exempt under any other relevant provision of that Part.

2.4.3 Large exposures covered by a letter of comfort accepted by the MA are not subject to the clustering limit referred to in [CR-G-8](#) "Large Exposures and Risk Concentrations".

## 2.5 Aggregate lending limit

2.5.1 On top of the maximum lending limit for individual exposures, the MA will require an AI to adhere to an

<sup>3</sup> The limits under rule 44(2) of the BELR are irrelevant because they are applicable to local G-SIBs, which are unlikely to rely on letters of comforts for large exposure purposes.



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aggregate limit on the exposures to all customers supported by a letter of comfort.

## 2.6 Factors for consideration

2.6.1 In setting the above limits, the MA will take into account the following factors:

- the financial strength, background and credit rating of the issuer. The financial strength of the issuer will be assessed in the light of, inter alia, its capital base or capital and reserves, as the case may be, depending on whether the issuer's jurisdiction follows the Basel Committee's capital adequacy framework;
- the extent to which the issuer's capital adequacy and credit risk (including those of the beneficiary AI) are subject to consolidated supervision by its home supervisor and the degree of oversight and control exercised by the issuer over the beneficiary AI's large exposures;
- the financial strength of the beneficiary AI;
- the sources of funding of the beneficiary AI and the degree of its reliance on deposits from the public to fund its operations; and
- the justification for the limits (e.g. in relation to the nature of the beneficiary AI's business).

## 2.7 Conditions

2.7.1 Apart from setting the above limits, the MA may, if appropriate, attach conditions to the letter of comfort, either generally or in any particular case. For example, the MA may restrict the application of the letter of comfort to a specific type of the beneficiary AI's business, e.g. trade finance or underwriting.

2.7.2 A condition attached to the acceptance of a letter of comfort under §81(6)(b)(ii) is deemed, if it was in effect immediately before 1 July 2019, to be a condition attached to the deemed rule 57(1)(d)(i) approval by virtue of rule 116(1). Failure to comply with such condition is a notifiable event which the AI should immediately notify the MA under rule



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7(1).

#### 2.8 Review by the MA

- 2.8.1 To monitor whether the issuer of a letter of comfort continues to be financially sound and able to honour its obligations under the letter, the MA will conduct a review of the letters of comfort accepted for §81 purposes at least annually.
- 2.8.2 In deciding whether the existing limits are still appropriate and, in particular, whether they should be reduced or cancelled, the MA will take into account any changes in the factors mentioned in para. 2.6.1 above.
- 2.8.3 In considering whether the existing limits are justified, the MA will also have regard to the actual and prospective utilisation of the limits. If a beneficiary AI has continuously shown a low utilisation of the limits for a period of time (e.g. 12 months), the MA may require the AI to justify why the existing limits ought not to be reduced. If there are insufficient grounds to support the limits, the MA may consider cancelling or reducing the limits as set out in subsection 2.9 below.
- 2.8.4 To facilitate the review, the MA will require the issuer to submit information including the following:
- its latest audited financial statements;
  - its capital base (or where applicable, capital and reserves) and capital adequacy ratio based on the latest audited accounts and on the latest unaudited information;
  - its internal control policies relating to the control of large exposures of the beneficiary AI; and
  - its current long-term and short-term credit ratings, if available, as appraised by an internationally recognised credit rating agency.

#### 2.9 Bilateral cancellation or variation of limits and conditions

- 2.9.1 The MA may, after consulting the issuer and the beneficiary AI, cancel or vary the limits or the conditions attaching to a letter of comfort. Such cases would generally either be at



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the request of the beneficiary AI or in the event of low utilisation of the limits or other concerns about the issuer or the beneficiary AI (e.g. significant deterioration in their financial strength).

- 2.9.2 Where a letter of comfort is cancelled or a limit is reduced, existing exposures will remain covered by the letter of comfort up to the amount of the previous limit. The beneficiary AI should, however, agree with the MA a time period within which the exposure will be run down in a manner which is consistent with the terms of its agreement with the customer concerned.
- 2.9.3 Subsequent to any change in the limits for a letter of comfort, the MA will notify the relevant overseas supervisor.

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