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27 July 1992

The Chief Executive
All Authorised Institutions

Dear Sir,

**Exemption of financial exposures
which are secured by cash deposits,
government securities, guarantees
or other undertakings similar to guarantees
under section 81**

I am writing to inform you that the captioned guideline has been published in the Gazette on 24 July 1992 under section 7(3) of the Banking Ordinance (a copy is attached for your reference). The guideline will take effect from 1 August 1992 in conjunction with a related amendment to section 81 made by the Banking (Amendment) Ordinance 1992. The amendment grants exemption to a financial exposure to the extent to which it is secured by securities issued or guaranteed by the central bank or central government of a Tier 1 country.

You should also note that this guideline will supersede and hence replace the previous guideline on the subject (No. 5.2.2 in the Index for Guidelines and Circulars issued by the Commissioner of Banking).

Yours faithfully,

(D T R. Carse)
Commissioner of Banking

c.c. Chairman, HKAB
Chairman, DTCA

Encl.

BANKING ORDINANCE (Cap. 155)

Exemption of financial exposures
which are secured by cash deposits,
government securities, guarantees
or other undertakings similar to guarantees
under section 81

A Guideline issued by the Commissioner of Banking
under Section 7(3) to take effect on 1 August 1992

Introduction

This Guideline incorporates and supersedes the Guideline on the same subject published in the Government Gazette on 18 October 1991 under section 7(3) of the Banking Ordinance (the Ordinance).

2. The object of section 81 of the Ordinance is to prevent an authorized institution from exposing itself to undue concentration of risks to a customer or a particular group of customers.

3. Section 81(6)(b)(i) empowers the Commissioner of Banking (the Commissioner) to grant exemption to a financial exposure to the extent to which it is secured by a cash deposit, a guarantee, an undertaking which, in the opinion of the Commissioner, is similar to a guarantee, or securities issued by or guaranteed by the central bank or central government of a Tier 1 country as defined in the Third Schedule to the Ordinance, subject to such conditions as he may think proper to attach thereto.

4. This Guideline sets out the general criteria upon which the Commissioner will exercise his discretion whether to accept cash deposits, government securities, guarantees or other undertakings for exemption under section 81.

Cash deposit

5. The Commissioner needs to be satisfied that the cash collateral will effectively reduce an institution's exposure to the customer concerned. In particular, the following criteria should be met -

- a) the deposit is placed with the authorized institution, including its overseas branches. Where the borrowing and the deposit of the cash straddle different jurisdictions, there must be no legal or other regulatory barriers to perfecting the security in the jurisdiction where the deposit is held;

- (b) the deposit must be charged in favour of the institution, which must be evidenced by a duly executed charge document, and there must be no other encumbrances of prior or equal ranking;
- (c) subject to criterion (d), the deposit at any time cannot be less than the exposure which it secures; and
- (d) where the deposit and exposure are denominated in different currencies, only 90% of the mark-to-market value of the deposit is available for exemption purposes, in order to cover fluctuations in exchange rates. This does not apply in cases where the deposit is in Hong Kong dollars and the exposure is in U.S. dollars, and vice versa.

Securities issued by or guaranteed by the central bank or central government of a Tier 1 country

6. Like cash collateral, the Commissioner needs to be satisfied that such security will effectively reduce an institution's exposure to a counterparty. In particular, the following criteria should be met -

- a) the securities are held by the authorised institution, including its overseas branches. Where the exposure and the holding of securities straddle different jurisdictions, there must be no legal or other regulatory barriers to perfecting the security in the jurisdiction where the securities are held;
- b) the securities must be charged in favour of the institution, which must be evidenced by a duly executed charge document, and there must be no other encumbrances of prior or equal ranking;
- c) subject to criterion (d), the security at any time cannot be less than the exposure which it secures; and
- d) only 90% of the mark-to-market value of the securities is available for exemption purposes (i.e. a 10% safety margin is needed). If the securities and exposure are

denominated in different currencies (other than in U.S. dollars and Hong Kong dollars), a further 10% safety margin should be allowed to cover fluctuations in exchange rates.

Guarantees/Indemnities/Risk Participation Agreements

7. In considering granting exemption to exposures secured by guarantees or other undertakings akin to guarantees, the Commissioner needs to be satisfied that the risks are effectively transferred to another party whose strength and status are undoubted. In particular, the following criteria should be met -

- (a) the guarantor/indemnifier/participant must be a central government or a central bank of a country which, in the past five years, has neither declared a moratorium on repayment of external debt nor made any debt rescheduling, or an authorized institution, or an institution recognized as a bank in the place where it is incorporated and which is under adequate supervision;
- (b) the borrower must be explicitly and correctly named in the agreement and the undertaking of the guarantor/indemnifier/participant must be clearly stated;
- (c) the country where the guarantor/indemnifier/participant is located or incorporated must either have no exchange control or, where there are exchange controls, approval has been obtained for the funds to be remitted freely in the event of a call on the obligation;
- (d) the obligation must be unconditional and irrevocable and it must be expressed to be on-demand i.e. the obligation must be documented in such a way as to provide the authorized institution the legal right to require the guarantor/indemnifier/participant to pay to it the secured amount immediately on demand in the event that there is default or non-performance by the borrower;
- (e) the maturity of the instrument must allow sufficient time for the institution concerned to claim reimbursement in case of default. Under no circumstances can the maturity of the instrument be less than that of the loan. In case the instrument has no maturity, it should be explicitly stated that it is a continuing security; and

- (f) the instrument must be enforceable either in Hong Kong or in the country of incorporation or residence of the guarantor/indemnifier/participant.

Standby letter of credit

8. Standby letters of credit are acceptable as collateral for offsetting financial exposures under section 81 provided they satisfy the following criteria -

- (a) the issuer must be an authorized institution, or an institution recognized as a bank in the place where it is incorporated and which is under adequate supervision;
- (b) the borrower must be explicitly and correctly named in the agreement and the undertaking of the issuer must be clearly stated;
- (c) the country where the issuer of the credit is located or incorporated must either have no exchange control or, where there are exchange controls, approval has been obtained for the funds to be remitted freely in the event of a call on the obligation;
- (d) the obligation under the credit must be unconditional and irrevocable and it must be expressed to be on-demand i.e. it must be documented in such a way to provide the authorized institution the legal right to require the issuer to pay to it the secured amount immediately on demand in the event that there is default or non-performance by the borrower;
- (e) the maturity of the credit must allow sufficient time for the institution concerned to claim reimbursement in case of default. Under no circumstances can the maturity of the credit be less than that of the loan. In case the credit has no maturity, it should be explicitly stated that it is a continuing obligation; and
- (f) the credit must be enforceable either in Hong Kong or in the country of incorporation or residence of the issuer.

Other undertakings not specified in this guideline

9. Other undertakings which are similar to a guarantee and not specified in this guideline e.g. back to back letters of credit have to be examined on their own merits, case-by-case. Acceptance of these will be conditional upon the underlying terms

and conditions of the undertakings and the criteria specified in paragraph 8(a) to (f) inclusive will be applied.

Limitation on the amount guaranteed

10. Where a guarantee (an indemnity, a risk participation agreement or a standby letter of credit) is issued by an authorized institution or a bank under adequate supervision, the amount guaranteed etc. by the institution or the bank for any one customer or group of related customers, should not exceed 25% of the capital base or capital and reserves, as the case may be, of the issuer (depending on the capital rules applicable in the issuer's jurisdiction). The institution which is the beneficiary of the guarantee etc. should obtain from the guarantor etc., and submit with the application to the Commissioner, a warranty certifying that the amount guaranteed etc. does not exceed the 25% limit. For significantly large transactions, the Commissioner will check with the relevant supervisory authorities that they are comfortable with the exposure incurred by the guarantor etc. The 25% limit needs to take account of the other exposures of the guarantor etc. to the same customer or group of related customers.

11. In cases where an institution and its subsidiary(ies) both give a guarantee etc to the same counterparty the total amount guaranteed etc will be aggregated for the purpose of section 81 in calculating the consolidated exposure of the institution. In this case, the consolidated capital base will be used as the basis for assessing compliance. There is, however, no limitation on the total amount of all guarantees etc. from the same issuer covering the exposures of different obligors.