

CR-G-9 “Exposures to Connected Parties”

A Guideline issued by Monetary Authority under Section 7(3) of the Banking Ordinance

Purpose

To specify systems and controls that AIs should have in order to identify, measure, monitor and control their exposures to connected parties (including those covered under §83 of the Banking Ordinance)

Classification

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

Previous guidelines superseded

Circular “Connected lending” dated 12.11.99; and CR-G-9 “Connected Lending” (V.1) dated 29.06.01

Application

To all locally incorporated AIs

Structure

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1. Introduction

1.1 Background and scope

- 1.1.1 This module provides guidance on the manner in which the MA proposes to exercise functions in relation to the statutory limitations on exposures to connected parties under §83 of the Banking Ordinance, and sets out prudent controls and risk management measures applicable to exposures to connected parties. AIs should read this module in conjunction with the relevant provisions of the Ordinance.
- 1.1.2 As a general rule, all credits should be granted by an AI on an arm's length basis to protect its best interests.
- 1.1.3 §83 of the Banking Ordinance limits the unsecured advances which locally incorporated AIs may make to connected parties. This is to reduce the risk of improper and excessive lending to connected parties which may jeopardise an AI's interests or be detrimental to its financial position. A contravention of §83 by an AI is a serious matter which may result in any director, chief executive or manager of the AI committing an offence and being liable to fines and/or imprisonment on conviction (§83(7)).
- 1.1.4 Therefore, AIs should monitor carefully their credits to connected parties, whether individuals or companies, and take appropriate steps to control or reduce the risks of connected lending.

- 1.1.5 To prevent contravention of §83 and imprudent connected lending, AIs should have a robust system of checks and balances to monitor compliance with the statutory limits, uphold impartiality and prevent credit activities of any kind (including on- and off-balance sheet transactions) which override established credit approval policies and procedures when granting credit facilities to connected parties. AIs should also ensure that the credit assessment undertaken for such lending should not be less stringent than that performed on non-connected parties, and the terms and conditions of such lending (e.g. tenor, interest rates, fees, amortisation schedules and collateral requirements) should not be more favourable than those granted to non-connected parties with similar background and creditworthiness.
- 1.1.6 The principle of impartiality and other standards laid down in this module should also apply to other business transactions and dealings (e.g. acquisition/sale of assets, service contracts, lease agreements, construction contracts, and derivative transactions) between AIs and their connected parties.

2. Statutory limitations on exposures to connected parties

2.1 Connected parties specified under §83(4)

- 2.1.1 The following provides a list of connected parties which are specified under §83(4) of the Banking Ordinance for the purposes of determining an AI's aggregate amount of exposures to connected parties against the statutory limits prescribed under §§83(1) and 83(2):

<u>Relationship of connected party with AI</u>	<u>Exclusion</u>
(i) Director and his relatives	N/A
(ii) Employee who is responsible, either as a member of a committee (e.g. Credit Committee) or individually, for approving loan applications and his relatives	N/A

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|-------|---|--|
| (iii) | Controller ¹ or minority shareholder controller and his relatives in the case of individuals | Excluded if the connected party is an AI, or an overseas incorporated bank which is not an AI but is approved by the MA for the purposes of §83(4) |
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<u>Relationship of connected party with AI</u>	<u>Exclusion</u>
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|------|---|--|
| (iv) | Firm, partnership or non-listed company ² in which the AI or any of its controllers, minority shareholder controllers or directors (including their relatives in the case of individuals) is interested as director, partner, manager or agent | Excluded if the firm, partnership or non-listed company is an AI, or an overseas incorporated bank which is not an AI but is approved by the MA for the purposes of §83(4) |
| (v) | Individual, firm, partnership or non-listed company of which any controller, minority shareholder controller, or director of the AI (including their relatives in the case of individuals) is a guarantor | N/A |

2.1.2 For connected parties who are individuals, the term “relative” is defined under §79(1) of the Banking Ordinance as:

- any immediate ascendant, any spouse, or former spouse of any such ascendant, and any brother or sister of any such spouse or former spouse;
- any immediate descendant, and any spouse or former spouse of any such descendant;
- any brother or sister, aunt or uncle and any nephew or niece and any first cousin; or
- any spouse or former spouse, any immediate ascendant of any such spouse or former spouse, and any brother or sister of any such spouse or former spouse.

For the purposes of this definition, any step-child shall be deemed to be the child of both its natural parent and of its step-parent and any adopted child to be the child

¹ The term “controller” means any person who is an indirect controller or a majority shareholder controller as defined in the Banking Ordinance.

² Under §79 of the Banking Ordinance, a “non-listed company” means a company not listed on a recognized stock market. However, any public statutory corporation designated for the purposes of this definition by the Financial Secretary by notice in the Gazette shall be deemed not to be a non-listed company.

of the adopting parent, and a spouse shall include anyone living as such.

2.1.3 §83(6) of the Banking Ordinance further provides that a facility granted to or on behalf of any firm, partnership or non-listed company which a person specified in (i), (ii) or (iii) of para. 2.1.1 above is able to control shall be deemed to be granted to that person or on his behalf.

2.1.4 In determining the extent of “control” of a person in a company, the HKMA will consider whether that person is a “controller” as defined in §2 of the Banking Ordinance. In particular, the HKMA will have regard to the following:

- the percentage of voting power at any general meeting of the company or its holding company that the person, either alone or with any associates, is entitled to exercise; and
- whether the directors of the company or its holding company are accustomed to act in accordance with the directions or instructions of the person (excluding an Advisor or a Manager appointed under §52 of the Banking Ordinance or any person giving advice in a professional capacity).

2.2 Limits under §§83(1) and 83(2)

2.2.1 §83 of the Banking Ordinance imposes various limits on the unsecured advances of locally incorporated AIs to their connected parties who might be able to exert undue influence on the AIs’ activities.

2.2.2 Under §83(1), the maximum aggregate unsecured facilities granted to all connected parties of a locally incorporated AI shall not exceed 10% of its capital base.

2.2.3 Under §83(2), the unsecured facilities granted to connected parties of a locally incorporated AI who are individuals specified in (i), (ii) and (iii) of para. 2.1.1 above shall not exceed HK\$1 million per person or 5% of the AI’s capital base in aggregate.

2.2.4 For AIs’ reference, a chart illustrating the scope of coverage of the statutory limits under §83 is set out in **Annex A**.

2.3 Definition of facilities under §83(3)

2.3.1 For the purposes of §§83(1) and 83(2) of the Banking Ordinance, facilities are defined under §83(3) as:

- the granting, or permitting to be outstanding, of unsecured advances, unsecured loans or unsecured credit facilities including unsecured letters of credit;
 - the giving of unsecured financial guarantees; and
 - the incurring of any other unsecured liability.
- 2.3.2 According to §83(3A), any facility to the extent to which it has been written off, or to which specific provision has been made for it, shall be excluded for the purposes of §83(3).

2.4 Exemption under §83(4A)

- 2.4.1 The MA may exempt under §83(4A) of the Banking Ordinance, subject to such conditions as the MA may think proper to attach thereto, any facility granted by an AI to its connected parties from complying with the statutory limitations set out in §§83(1) and (2).
- 2.4.2 AIs should note that such exemption will only be granted on a very exceptional basis after considering all the circumstances of the application. Whilst each case will be considered on its own merits, the following criteria should, as a minimum, be satisfied, though this will not in itself be sufficient for exemption to be granted:
- the facility granted is on arm's length terms and commercially justified;
 - in the case of common directors, the relevant director(s) of the AI should play no part in the approval process;
 - in the case of common directors, the relevant director(s) of the AI should have no executive responsibility, except in situations where an executive director of the AI is appointed as a director of the borrower only to help protect the existing interests of the AI as a lender; and
 - in the case of an intra-group exposure, the connected party is under effective consolidated supervision.

2.5 Secured exposures to connected parties

- 2.5.1 Although §83 of the Banking Ordinance only applies to unsecured exposures, care should also be taken by AIs when granting secured credit facilities to connected parties.

2.5.2 Under §79(3), “security” means such security as would, in the opinion of the MA, be acceptable to a prudent banker for the purposes of §83. Generally, AIs 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. in the case of gold, other precious metal or taxi medallion) or have the means of locating its whereabouts (e.g. in the case of vehicle, machinery or equipment); and
- the AI has the expertise and systems to manage the asset concerned.

2.5.3 AIs should consult with the HKMA or seek legal advice in case of doubt about whether a particular type of collateral is acceptable for §83 purposes.

2.5.4 Where the collateral is not considered acceptable by the MA, the facilities will be treated as unsecured and subject to the restrictions under §83 mentioned above. AIs should be careful not to inadvertently contravene the §83 limits as a result of taking collateral which is not acceptable to the MA.

2.5.5 AIs should closely monitor their secured exposures to connected parties to ensure that fluctuations in the value of the collateral will not lead to a contravention of §83. (§79(3) of the Banking Ordinance defines “unsecured” to include “in respect of any advance, loan or credit facility granted or financial guarantee or other liability incurred with security, any part thereof which at any time exceeds the market value of assets constituting that security”.)

3. Controls over exposures to connected parties

3.1 Oversight by Board of Directors

- 3.1.1 The Board should fully understand the AI's legal obligations under the Banking Ordinance in relation to exposures to connected parties and ensure that the AI complies with such obligations.
- 3.1.2 The Board should ensure that the AI establishes a policy on exposures to connected parties that is appropriate to its business and risk profile. The policy, and any changes thereto, should be reviewed and approved by the Board.
- 3.1.3 Exposures to connected parties should be reviewed and approved by the Board (or the Credit Committee or any other committee with authority delegated from the Board). The Board should also receive regular reports on the amount of outstanding exposures to connected parties, including the amount of such exposures which falls within the scope of §83 of the Banking Ordinance.
- 3.1.4 Any write-off of exposures to connected parties exceeding a specified amount or otherwise posing special risks to the AI should be approved by the Board (or the Credit Committee or any other committee with authority delegated from the Board). The write-off policy for such exposures (including the threshold for approval by the Board or other committee) should be appropriate to the AI's business and risk profile.
- 3.1.5 Any member of the Board with conflicting interests should not be involved in the approval and management of exposures to connected parties.
- 3.1.6 Where necessary the Board should obtain legal advice in relation to exposures to connected parties.

3.2 Policy on exposures to connected parties

- 3.2.1 The policy on exposures to connected parties should cover, at a minimum, the following:
 - the types of exposures that the AI considers to be "connected" in nature - these should comprise the categories specified in §83(3) of the Banking

Ordinance but an AI may wish for its own purposes to include other types of lending or transactions³;

- the categories of connected parties – these should at least comprise the categories specified in §83(4) of the Banking Ordinance and the following parties:
 - the AI's senior management and key staff (collectively comprising chief executive and managers⁴) and the relatives⁵ of such persons;
 - the AI's subsidiaries⁶, affiliates⁷ and other entities (including their subsidiaries, affiliates and special purpose entities) over which the AI is able to exert control⁸; and
 - the controllers, minority shareholder controllers, directors, senior management and key staff⁹ (and the relatives of such persons) of the AI's subsidiaries, affiliates and other entities referred to in the second sub-bullet;
- the calculation of exposures to connected parties – this should take into account the requirements under §§83(5) and 83(6), the principles underlying which should, for risk management purposes, be similarly extended to cover the persons and entities referred to in the preceding three sub-bullets¹⁰;

³ Connected exposures do not include, for instance, an exposure to a connected party (being a broker of financial transactions) totally incidental to the AI's financial transactions undertaken on behalf of clients with that connected party.

⁴ The terms "chief executive" and "manager" are as defined in §2 of the Banking Ordinance.

⁵ The term "relative" is as defined in §79 of the Banking Ordinance (see para. 2.1.2 above for more details).

⁶ AIs should make reference to §2 of the Banking Ordinance for the meaning of "holding company and subsidiary".

⁷ For the purposes of this module, affiliates of an institution should include any entity in which a controller of the institution

- (i) has a beneficial interest in, or controls, 50% or more of the total number of ordinary shares; or
- (ii) is entitled to exercise, or control the exercise of, 50% or more of the voting power.

The meaning of the term "controller" in this definition is as specified in footnote 1.

⁸ The term "control" in this paragraph should be subject to the same interpretation as set out in para. 2.1.4 above.

⁹ For an AI's subsidiary, affiliate or other entity which is not an AI itself, "senior management and key staff" means the chief executive officer (or equivalent) and those persons having a principal responsibility for a line of business within the subsidiary, affiliate or entity concerned.

¹⁰ AIs will have a grace period of nine months from the date of issuance of this revised module to put in place the appropriate internal limits and risk management policies in respect of the persons referred to in the preceding three sub-bullets. Exposures arising from facilities lawfully provided to the persons referred to in the preceding three sub-bullets that are effective on the date of the issuance of this revised module can be excluded by an AI from its relevant internal limits with respect to connected exposures.

- the application of the policy to exposures booked in the AI's subsidiaries;
- the maximum limits that apply to exposures to connected parties (individually or in aggregate), on a secured and on an unsecured basis, taking into account the limits specified in §83 of the Banking Ordinance¹¹;
- the interest rates and other terms and conditions (such as tenor, fees, amortisation schedules and collateral requirements) that apply to various types of exposures to connected parties. In general, these should not be more favourable than the terms and conditions applicable to exposures to non-connected parties under similar circumstances¹²;
- the authority and procedures for approving exposures to connected parties, including the extent to which such exposures should be subject to approval or review by the Board (or the Credit Committee or other committee with authority delegated from the Board). Directors and credit officers who are connected with the borrowing party should be restricted from taking part in the credit approval process;
- the policy and procedures for approving the write-off of exposures to connected parties (including circumstances under which such write-off should be approved by the Board (or a committee of the Board) (see also para. 3.1.4 above);
- the arrangements for reporting exposures to connected parties to the HKMA and for ensuring the accuracy of such reports;
- the policy and procedures for the taking of collateral in respect of exposures to connected parties, including the types of collateral which are considered acceptable and the arrangements for valuation of such collateral. In this connection, all marketable securities should be marked to market on a daily basis, and external valuations should be obtained, and regularly updated, for properties (see

¹¹ §83 applies only to unsecured exposures to connected parties. However, the HKMA considers that it is also a good practice for AIs to establish their own internal limits on secured exposures to connected parties. This is consistent with prudent credit management practices.

¹² An exception may be appropriate for beneficial terms that are part of a remuneration package whether under a specific employment contract or offered pursuant to, and in a manner consistent with, an AI's pre-existing documented staff policy (e.g. staff receiving credit at favourable rates).

section 6 of CR-G-7 "Collateral and Guarantees" for further guidance); and

- the arrangements for ensuring compliance with the AI's policy on exposures to connected parties, including the specific officers responsible for this.

3.2.2 The policies, and any changes thereto, should be submitted to the HKMA.

3.3 Monitoring of exposures to connected parties

3.3.1 AIs should assign a designated independent unit or officer, e.g. compliance officer, to monitor exposures to connected parties and to ensure their compliance with both statutory and internal limits.

3.3.2 AIs should have adequate information systems to measure their exposures to connected parties and identify exceptions promptly. The list of connected parties should be updated regularly. Any exceptions should be reported promptly to the appropriate level of management. If the exception is serious or the amount involved is significant, it should be reported directly to the Board or Audit Committee.

3.3.3 AIs should also be vigilant to situations in which a non-connected party (to which an exposure exists) subsequently becomes a connected party. Hence, in addition to monitoring exposures to, or transactions with, existing connected parties, an AI should have robust systems and procedures to promptly identify new connected parties (to which there are existing exposures) and ensure that the statutory or internal limits on exposures to connected parties (whether individually or in aggregate) will continue to be observed. For example, an AI's policy and procedures in relation to any merger and acquisition should include checking the extent of the AI's exposures to the target entity being considered under the merger/ acquisition (and its senior management and key staff), and assessing the implications in respect of the AI's compliance with statutory and internal limits relating to exposures to connected parties.

3.3.4 Internal Audit should conduct regular reviews to check whether an AI's established policies, limits and procedures in relation to exposures to connected parties are strictly adhered to.

3.3.5 As an additional safeguard, it is advisable for AIs to centralise all aspects of the granting, and subsequent

management, of exposures to connected parties at their head office in Hong Kong so that such exposures can be more effectively monitored and controlled.

4. Disclosure and regulatory reporting

4.1 Financial disclosure

- 4.1.1 Als, in consultation with their external auditors, should ensure that they have properly disclosed details of their connected party transactions as required by:
- §43 of the Banking (Disclosure) Rules on related parties transactions;
 - the Companies Ordinance (e.g. loans to directors under §383);
 - Hong Kong Accounting Standard 24 “Related Party Disclosures” issued by the Hong Kong Institute of Certified Public Accountants; and
 - other relevant disclosure rules (e.g. “Rules Governing the Listing of Securities” published by Hong Kong Exchanges and Clearing Limited).

4.2 Regulatory reporting

- 4.2.1 Als should establish systems and procedures to ensure the accuracy of reporting in respect of exposures to connected parties in the HKMA’s “Return of Large Exposures – MA(BS)1D” and “Certificate of Compliance – MA(BS)1F(a)”.
- 4.2.2 Any cases of contravention of §83 should be reported to the HKMA immediately. In case of doubt, Als should consult with the HKMA or seek relevant legal advice.

4.3 Capital adequacy treatment

- 4.3.1 Under certain circumstances, an AI’s exposure to a connected company specified in §46 of the Banking (Capital) Rules¹³ should be deducted from the AI’s capital base if, in the opinion of the MA, it was incurred other than in the ordinary course of business. In this regard, Als should put in place sufficient controls (including, but not limited to, an independent review by the compliance or other appropriate function) to ensure that their relevant exposures to connected companies

¹³ The term “connected company” is defined in §35 of the Banking (Capital) Rules.

to which capital deduction is not applied have all been incurred in the ordinary course of business. The HKMA will sample review the effectiveness of such controls as part of its ongoing supervisory work. AIs should note that there are differences in the meanings of “connected company” (for capital adequacy purposes) and “connected party” (for the purposes of this module).

- 4.3.2 The MA will normally consider a loan or an exposure to have been made or incurred outside the ordinary course of business of an AI if it has any of the following characteristics:
- interest free or granted at an unreasonably low interest rate;
 - no final maturity;
 - granted on non-commercial terms; or
 - capital in nature (e.g. it is being used by the recipient to fund investment in subsidiaries).
- 4.3.3 AIs should review their exposures to connected companies to identify any exposures of this nature to ensure that they are, as appropriate, deducted from the capital base.

Legend

A: denotes any firm, partnership or non-listed company (other than a firm, partnership or non-listed company which is an AI, or a bank incorporated outside Hong Kong which is not an AI but is approved by the MA for the purposes of §83(4)(g)). To avoid doubt, “A” referred to in different boxes in the chart should not be construed as representing the same entity.

B: denotes any individual, firm, partnership or non-listed company. To avoid doubt, “B” referred to in different boxes in the chart should not be construed as representing the same entity.

C: denotes any firm, partnership or non-listed company. To avoid doubt, “C” referred to in different boxes in the chart should not be construed as representing the same entity.

#: denotes, in relation to any two boxes in the chart linked together by this symbol, that the person in the upper box is able to control the person in the lower box. The term “control” follows the interpretation set out in para. 2.1.4 of this module.

*****: denotes, in relation to any two boxes in the chart linked together by this symbol, that the person in the upper box is a director, partner, manager or agent of the person in the lower box.

^: denotes, in relation to any two boxes in the chart linked together by this symbol, that the person in the upper box is a guarantor of the person in the lower box.

Explanatory Notes

1. The chart should be read in conjunction with §83 of the Banking Ordinance and section 2 of this module.
2. Each yellow rectangle in the chart illustrates one of the six situations in which an AI's aggregate amount of unsecured facilities granted to a single connected party (who is an individual) in the upper box of the rectangle, as specified in §83(4)(a), (b), (c), (d), (e) or (f), is subject to the limit of HK\$1 million under §83(2)(b). By virtue of §83(6), the same limit also covers an AI's aggregate amount of unsecured facilities granted to an entity in the lower box of the rectangle if the connected party in the upper box of the rectangle is able to control that entity. For example, as depicted in the first yellow rectangle from the left, an AI's aggregate amount of unsecured facilities granted to any director of the AI and any firm, partnership or non-listed company that the director is able to control should not exceed HK\$1 million. The connected parties shown in the yellow rectangles correspond to those specified in (i), (ii) and (iii) of para. 2.1.1 and para. 2.1.3 of this module.
3. The green rectangle in the chart illustrates that an AI's aggregate amount of unsecured facilities granted to all connected parties of the AI shown in the six yellow rectangles (i.e. those individuals specified in

§83(4)(a), (b), (c), (d), (e) and (f) and those entities covered by virtue of §83(6)) should not exceed 5% of its capital base under §83(2)(a).

4. The blue rectangle in the chart illustrates that an AI's aggregate amount of unsecured facilities granted to all connected parties of the AI within the rectangle, whether they are individuals or otherwise, should not exceed 10% of its capital base under §83(1). The connected parties include those shown in the yellow rectangles and those specified in §83(4)(g) and (h) (i.e. corresponding to those specified in (iv) and (v) of para. 2.1.1 of this module).