HKMA and SFC adopt a coordinated approach to supervise banks and licensed corporations

24 Apr 2019

The Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) recently conducted coordinated inspections of a bank within a Mainland-based banking group and a licensed corporation (LC) owned by a subsidiary (Group). The HKMA and the SFC found that the Group, one of many Mainland-based groups operating banks, licensed corporations and other affiliates in Hong Kong, had entered into a series of complex transactions via a private fund and other entities which give rise to a number of serious concerns.

The findings from the coordinated inspections are illustrative of complex structures which appear to have been adopted by other Mainland financial institutions in Hong Kong together with complex, opaque financing arrangements which may conceal embedded financial risks and make it difficult to conduct rigorous risk assessment. The HKMA and the SFC are therefore issuing this Circular in order to encourage all institutions which may have adopted similar financing arrangements involving subsidiaries or affiliates of licensed entities to review them urgently and take all necessary steps to address all untoward risks.

Complex arrangements to finance risky investments

The regulators found that the subsidiary within the Group obtained a credit facility from the bank for general business and working capital purposes. The subsidiary then made a large investment in a private fund set up by a licensed asset manager. The sole purpose of the fund was to provide a loan (Loan A) to a special purpose vehicle (SPV) owned by a substantial shareholder of a listed company against a pool of collateral which was mainly composed of the listed company’s shares.

Loan A was used to repay part of a loan of another SPV owned by the substantial shareholder which had financed projects in an emerging market. It was subject to a margin call arrangement whereby additional cash or securities collateral would be required when the loan-to-collateral ratio exceeded an agreed level.

In a circular dated 3 August 2018, the SFC expressed concerns about arrangements which effectively provide margin financing in the guise of investments; it is of the view that the arrangement put in place by the Group, which was accounted for as an investment in a private fund by its subsidiary, was in substance a margin loan leveraging on the funding support from the bank.

Deficient lending practices

The HKMA’s inspection identified deficiencies in the bank’s lending practices. Banks should ensure that credit facilities granted to their subsidiaries and affiliated companies or those of their holding company are granted on an arm’s length basis and subject to a prudent credit assessment which should be at least as stringent as that performed on unrelated companies. The assessment should include an evaluation of the borrowing company's ability to repay and how the facility is intended to be used.

Banks should also ensure that there is an effective post-lending monitoring framework to identify and follow-up on any major adverse developments of a borrower in a timely manner. If the borrower is engaging in high-risk activities (in this case a margin loan to finance high risk investments) or activities that deviate from its normal scope of business, the bank should critically assess the risk implications, including whether and how such activities may affect the repayment ability of the borrower as well as the reputation of the bank. The bank should take appropriate risk mitigation measures to reduce the risks identified. The HKMA will review the effectiveness of controls of banks as part of its ongoing supervisory work.

Coordinated supervision

The SFC also found that the Group’s subsidiary, via a separate subsidiary holding a money lender licence, also had provided lending to other listed companies secured by collateral provided by major shareholders. Some borrowers had pledged a significant proportion of the listed companies’ total issued shares (up to 70%). These were illiquid stocks of doubtful quality.

The SFC wishes to remind all holding companies or controllers of LCs to prudently manage the overall group financial risks to ensure it has the ability to provide financial support to the LCs and to contain contagion risks to the LCs that may affect their financial integrity.

The HKMA and the SFC will continue to enhance regulatory cooperation and are also closely coordinating with Mainland regulators to share information and observations derived from their supervisory work.

Should you have any queries regarding the contents of this circular, please contact Mr Sing Hsu at the Banking Supervision Department of the HKMA on 2878 1447 or Ms Kammy Kwok at the Intermediaries Supervision Department of the SFC on 2231 1455 or your case officer.

Banking Supervision Department	Intermediaries Supervision Department, Intermediaries Division
Hong Kong Monetary Authority	Securities and Futures Commission

End

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Circular

HONG KONG MONETARY AUTHORITY
香港金融管理局

SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

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