Hong Kong Credit Risk Challenges and Innovations 2023

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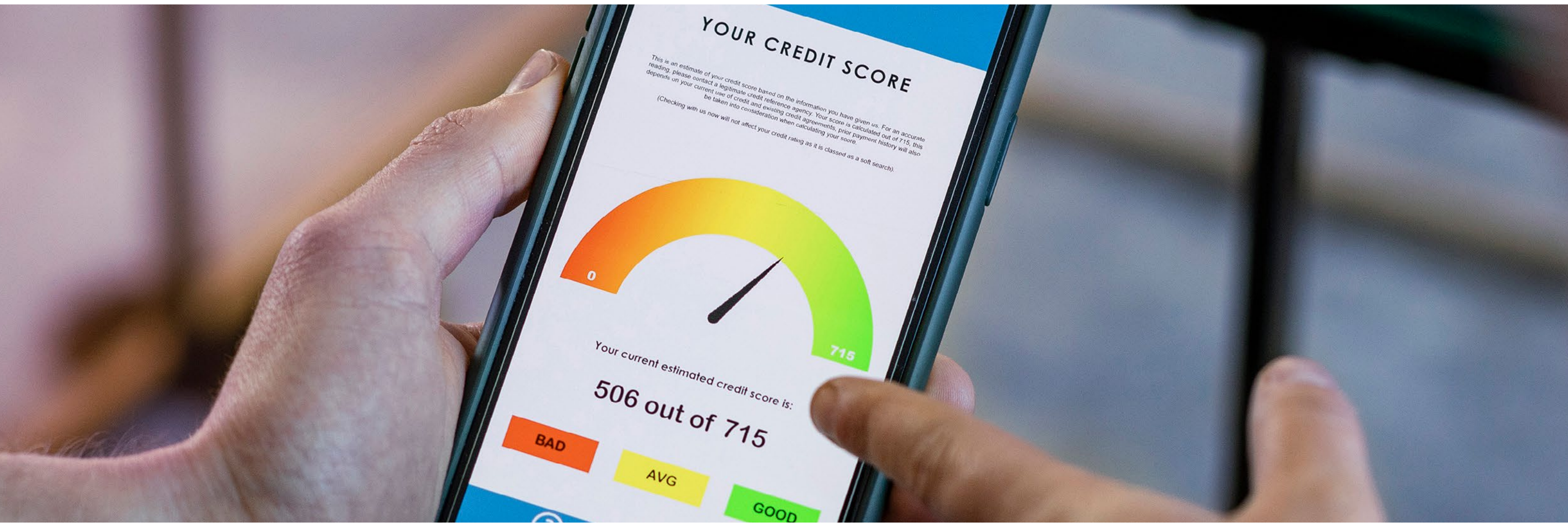
Introduction

As the Year of the Rabbit got under way in Hong Kong the city welcomed the return of normal business operations. However, the new year also brings a number of new credit risk challenges and opportunities for banks[1] to digest, in addition to the existing challenges. The HKMA recently released its Work Priorities for 2023, which covers key areas related to credit risk management[2] including Basel III, property developer reviews, asset quality and climate risk.

Over the next few pages, we highlight a few of the key credit risk management trends that are likely to be top of mind for management and board members at banks this year.

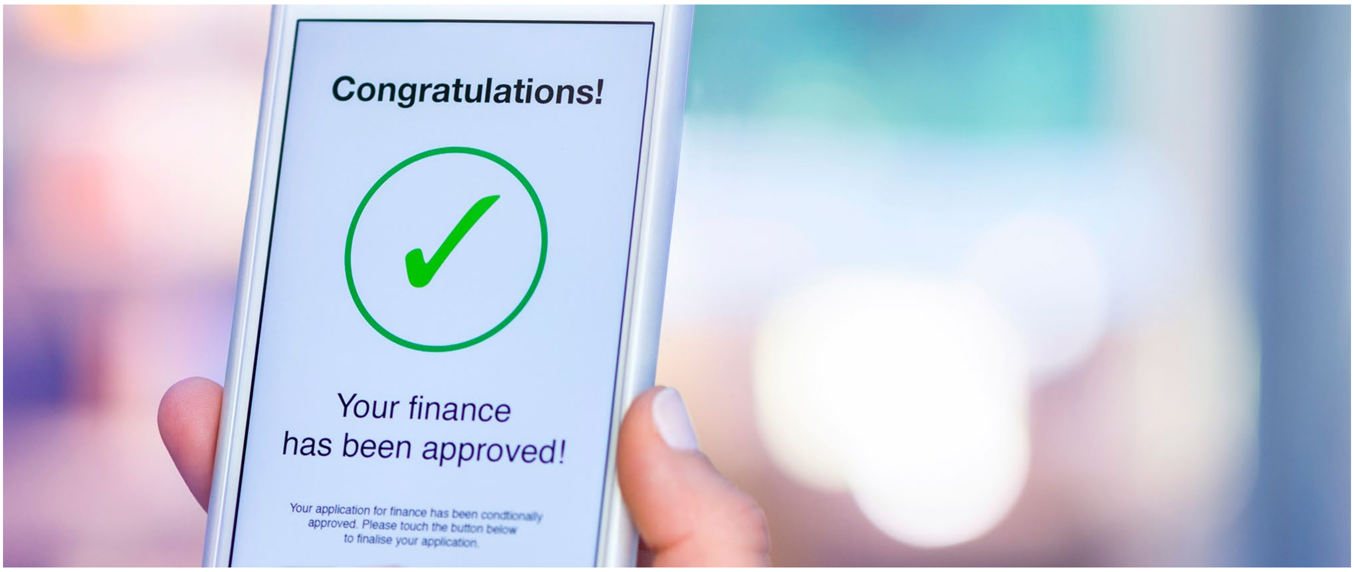


[1] KPMG uses the word Banks and Authorized Institutions (AI) interchangeably throughout this paper
[2] Hong Kong Banking Sector: 2022 Year-end Review and Priorities for 2023 (hkma.gov.hk)

2023 Credit and Lending Trends

The past year has seen increasing credit stress across retail, middle market and corporate wholesale lending. Whether in the commercial real estate sector, residential property mortgages or SME lending, it is apparent that credit risk is increasing, and in-house credit risk departments should be busy analysing individual names and conducting detailed portfolio reviews. Although some pockets of credit lending are benefiting from higher interest rates with expanding net interest margins (NIMs) lifting revenues, this could lead to stressed borrowers struggling to pay higher interest payments, which in turn triggers defaults.

The SME sector has recently reported that credit has been slightly more challenging to obtain[3]. This could be due to banks reducing credit lines, higher interest rates, longer approval times or the overall economic environment. Regardless of the macro challenges, banks have been exploring ways to increase lending efficiency and improve the overall credit experience for their customers. This includes initiatives like speeding up time to approvals, more advanced SME credit approval models, usage of new data sources, automation, new products and usage of the latest credit technology.



[3] Survey on Small and Medium-Sized Enterprises (SMEs)' Credit Conditions for Fourth Quarter 2022 (hkma.gov.hk)

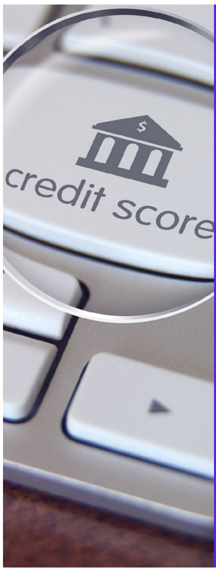
Lending products in the market have tended to be very static, with little change and limited forward-looking anticipation of clients' borrowing needs. Given recent developments around tech and data, banks should be able to anticipate a client's borrowing needs and create new more lending products to drive growth and demand. There is an opportunity to grab market share with dynamic product offerings to meet real-time client needs, but there are challenges when it comes to creating forward-looking lending solutions.

Existing credit and lending platforms systems inhibit innovation due to a lack of flexibility and legacy data issues. Out-of-date processes are burdened by a high degree of manual touchpoints, and a lack of credit tech is pushing some banks to replace or redesign their platforms to prepare for the future of credit and lending in Hong Kong. The credit tech and credit decision models and engines currently in place need to be redesigned to be able to incorporate new sources of data and new techniques to measure credit risk.

We have seen some banks use innovative machine learning and artificial intelligence (ML/AI) methods in a classical credit risk framework to boost the already good performances of the traditional credit model. For example, combining the logistic regression model with a random forest or gradient boost technique. These methods can provide more predictive results when using alternative sources of data that are frequently updated. Some banks are beginning to test straight-through auto-approval engines for SME credit.

Historically, alternative sources of credit scoring data have been limited. Now with the launch of the HKMA's Commercial Data Interchange (CDI),[4] new sources of data can be used to develop auto-approval models. Rich data sources, such as e-payment transactions, logistics and online purchase orders, will be available in 2023. Many banks still rely on a highly manual process for credit and lending. Some are starting to move toward minimal or no manual processes to speed up the time to cash decisions, freeing up relationship managers to focus on client needs. Another key objective is automating all paper-based processes across the entire lending chain.

The recently established virtual banks in Hong Kong are beginning to build up their balance sheets and some will focus on SME and retail lending. Virtual banks are establishing data and lending ecosystems with other technology and e-commerce companies in the market. This trend should accelerate in 2023 and drive further innovation in the market.



There are several key things banks should be looking to accomplish this year:

1. Strategic review of credit and lending infrastructure platforms
2. Take steps to automate internal manual processes along the entire credit and lending cycle
3. Analyse new alternative sources of credit data that are now available
4. Develop automated approval and decisioning engines for SME clients
5. Design more innovative and forward-looking lending products to match borrowing trends and needs
6. Upskill the credit risk and credit modelling teams

[4] Hong Kong Monetary Authority - Commercial Data Interchange (CDI) (hkma.gov.hk)

2023 Credit Risk Regulatory Radar

Basel III Reform

Due to the breadth and complexity of the changes to credit risk under the final Basel III reform package (the revised *Standardised Approach for Credit Risk and Internal Ratings-Based Approach*), authorised institutions in Hong Kong are facing several multi-faceted challenges implementing these reforms as they prepare for go-live on 1 January 2024. KPMG has been working closely with banks across the Hong Kong market to support them on their Basel III implementation initiatives and overcome some key challenges.

Challenges banks face when implementing the new Basel III final reform

Data

- New methodology for exposure classifications will undoubtedly increase the data management burden
- RWA increases if certain data fields are not available

People

- Increasing need for staff with good understanding of the Basel III HKMA RWA calculations
- Upskilling and training for staff on understanding regulatory impacts based on new data inputs in source system

Governance

- Unclear roles and responsibilities for overseeing end-to-end RWA calculations
- Lack of integration between regulatory reporting and data governance

Controls and Process

- Outdated or lack of end-to-end controls on accuracy and completeness of the data at all stages of the RWA calculation process
- No clearly defined data ownership of Basel III related data fields

Credit RWA Impacts

- Difficult to estimate accurate RWA by product, entity and BU level under Basel III requirements
- Lack of strategy planning on RWA and Capital optimisation

Technology

- Low automation levels on RWA calculation requiring heavy duty manual inputs
- RWA calculation system not fully updated to incorporate latest regulatory requirements

Other business-related challenges relate to the interpretation of the HKMA regulatory requirements, and are especially challenging for the **business units** and **overseas branches**. For example, where there are new data field requirements – including specialized lending types, income currency mismatches (e.g., where a client has two income sources for the completion of a single data field by the inputter in the source system), interpretation of property classification as residential or commercial – all of which can lead to incorrect implementation outcomes if not handled properly. For some real estate transactions, new requirements may need to be implemented with regard to loan-to-value calculations as well.

Another example is the new methodology required for exposure classification and risk-weight calculations (i.e. SCRA grade for bank exposures and the 1.5 multiplier for currency mismatch for unhedged retail exposures), which could increase the workload for business units to supplement additional required data for risk-weighted assets (RWA) calculations. Failure to supplement required data elements **could cause an increase in RWA of 30% to 50%** for certain asset classes. Furthermore, business units may need to assess whether external ratings are appropriately assigned as compared to internal ratings to fulfil the customer due diligence requirements under the new regime.

Specific Basel III reform credit related technical challenges

RWA Aggregation Logic for Credit Risk

- Risk weight assignment on on-balance sheet exposure Credit conversion factors (CCFs) considerations for off-balance sheet exposure
- Credit risk mitigation (CRM) allocation and measurement RWA calculation logic

SA Credit Risk RWA under HKMA Rules

- Interpretation of regulatory requirements (e.g. transactor)
- Data mapping and transformation logic from source system to RWA calculation engine
- Credit due diligence requirements

IRB Credit Risk RWA under HKMA Rules

- Interpretation of regulatory requirements
- Restriction of uses of IRB for certain asset classes
- Incorporation of the updates on PD / LGD floor
- Removal of scaling factor

Exposure segmentation, risk mitigation and Exposure-at-Default

- Risk exposure classification process
- Eligibility of credit risk mitigation
- Commitment identification and classification process
- Logic setting of exposure segmentation, risk mitigation and Exposure-at-Default calculation

Specialised Lending, Guarantee, Equity Investments in Funds and Securitisation Exposures

- Definition of specialized lending and their criteria
- Calculation methodology for RWA of equity investments in funds (look through approach/mandatory approach / fallback approach)
- Calculation methodology for RWA of securitisation exposure

Other HKMA Credit RWA asset classes

- Classification of equity exposure, capital investments, LAC investment and subordinated debts (more granular level required in the latest MA(BS)3 banking return template)
- Defaulted exposure definition

These are just a few examples of the many challenges banks will need to handle as they race towards the deadlines at the end of this year.

There are several actions banks should be taking now:

1. Enhance source systems with new data fields based on HKMA regulatory requirements
2. Upgrade the RWA calculation engine to ensure that it has incorporated the latest regulatory requirements and requires a limited level of manual inputs
3. Upskill staff and teams on Basel III regulatory requirements and RWA calculation approaches
4. Enhance policies and procedures to ensure accuracy and completeness of RWA data
5. Strategic product review looking at RWA impacts based on latest rules
6. Analyse and communicate the business and product level RWA impacts to the front lines

CDI and Use of Alternative Data in Credit Decisions

Due to the breadth and complexity of the changes to credit risk under the final Basel III reform package (the revised *Standardised Approach for Credit Risk and Internal Ratings-Based Approach*), authorised institutions in Hong Kong are facing several multi-faceted challenges implementing these reforms as they prepare for go-live on 1 January 2024. KPMG has been working closely with banks across the Hong Kong market to support them on their Basel III implementation initiatives and overcome some key challenges.

The Commercial Data Interchange (CDI), one of the key initiatives under the Fintech 2025 strategy, was officially launched by the HKMA in October 2022. Arthur Yuen, Deputy Chief Executive of the HKMA, sent a letter on 15 February 2023 to all banks in Hong Kong encouraging the use of the CDI.[5]

The CDI aims to create a common data platform for credit data providers and financial institutions to share real-time commercial data in Hong Kong. The next-generation data infrastructure paves the way for seamless data exchanges within a secure ecosystem. Banks participating in the CDI program will be able to access the commercial data of their borrowers and connect with new data providers securely and with minimal effort. Before the CDI was established, each time a bank wanted to connect to a new data provider, the bank would need to invest money and resources creating a new connection to handle the business and IT requirements. These bespoke connections are costly to build and often act as a major roadblock preventing banks from acquiring new data sources.

The CDI aims to resolve these pain points, and banks and data providers only need to set up a single connection to the CDI platform. The standardised Application Programming Interface (API) and data models defined by the CDI allow new data providers to be on-boarded to the platform and banks can easily and quickly make use of the new data.

For banks, the CDI represents an opportunity to improve their operational efficiency and customer experience. By having **real-time access** to traditional firmographic data as well as alternative data sources, banks can enhance their credit risk management, reduce operational costs, and improve the speed and accuracy of credit assessment processes. The commercial data available from the CDI contains credit reference agency, e-trade declaration, e-commerce, supply

5 Leveraging Commercial Data Interchange for digitalisation of banking processes (hkma.gov.hk)

chain and payment data, with additional data to be connected to the CDI such as company register data and other information from both government agencies and private sector data providers.

The CDI will bring the greatest benefit to borrowers from the small and medium-sized enterprises (SMEs) segment. This segment of the market historically posed several challenges for banks to assess due to data scarcity. When SME customers in need of financing approach a bank for a loan, the know-your-customer (KYC) process often yields only basic firmographic information, while credit reference agencies have limited information or no record. It doesn't help that SME customers often have never prepared a detailed financial statement, which traditional credit scoring and decisions rely heavily upon.

Combined with the fact that most banks' credit assessment and review processes are entirely manual, the end-to-end approval process can take up to six months before the SME customer finally receives the much-needed funds. To improve customer experience, with the help of the CDI, banks in Hong Kong should invest in both innovative credit decision engines and improving the credit application process.

As an aggregate data platform, the CDI also helps to streamline the data ingestion process for banks across three key areas:

1) **Risk and costs:** Banks take on additional risk when onboarding each data vendor individually. After investing time and resources to integrate individual data sources into the bank's lending process, each data vendor might make changes to the data format over time. The CDI's API helps to standardize data feeds, reducing maintenance costs.

2) **Reliability:** Data quality and accuracy of each standalone data source are easier to verify.

3) **Coverage:** External data sources often offer niche coverage and require banks to negotiate one at a time. CDI maximises coverage by combining multiple data sources.

Bank should plan to leverage the benefits of the CDI by:

- **Developing advanced credit decisioning engines** - Alternative data from new non-traditional sources of information provide insights into borrowers' financial profiles, business and cash-flow needs, which in conjunction with traditional credit agency references and financial statement analysis will support banks to make more informed credit assessments. Examples of alternative data sources include digital footprints such as e-commerce transactions, telecommunication data, supply chain and payment data.

- **Building fraud and behaviour analytics** - This new type of data has many use cases during the credit application lifecycle including: customer due diligence, fraud analytics and KYC, credit decisions, credit approval and risk management processes by the banks. The CDI can be used to help banks assess the creditworthiness of new SME customers who may not have a traditional credit history. Risk management can also benefit from using alternative data as it provides valuable insights into a customer's behaviour and financial profile, enabling banks to manage risk and identify opportunities where customers require further funding. By enhancing or automating some of the credit decision processes, banks can greatly speed up time-to-decision, reduce human error and enhance efficiency.

- **Looking to reduce errors** - Banks can use CDI for more secure and automated data retrieval, reducing human error.

- **Reference check analysis** - Banks are encouraged by the HKMA to use CDI for Commercial Credit Reference Agency reference checks. Banks should develop systems compatible with CDI API and align with the standardised data format.

- **Faster approval times** - Banks can improve customer experience by shortening the time to approval and time to release funds, better understanding their customers' needs and preferences, thus enabling banks to offer personalised products and services.

- **Supporting business growth** - Banks can build comprehensive business profiles of borrowers to uncover potential lending opportunities, helping them to locate potential clients that match the bank's lending requirements and that can demonstrate repayment capabilities.

- **Finalise your HKMA CDI plan** - The HKMA is asking that all banks with a significant SME business build out their technical connections and submit a plan to the HKMA no later than 30 April 2023.[6]

  The CDI is a significant step towards bridging the gap between data providers and financial institutions in Hong Kong, as well as levelling the playing field among banks of various sizes and resources. The CDI has the potential to open new opportunities and streamline the credit decision process, benefiting both banks and SMEs in need of financing.

[6] https://www.hkma.gov.hk/eng/news-and-media/speeches/2021/05/20210528-1/

Collateralized Lending and Non-Bank Financial Institutions (NBFI)

In a speech in May 2021, the HKMA's Yuen highlighted that the accommodative monetary policies adopted by central banks had led to an increase in property prices globally. In Hong Kong accommodative monetary policy has also posed risks from property mortgage lending to the asset quality of banks and the long-term stability of the banking sector. Regulators also have concerns on collateralized lending and exposure to non-bank financial instutions (NBFI) as this poses interconnectivity risks.

The HKMA conducted the first wave of a thematic review of banks' compliance with the prudential requirement in 2015, with the second wave of reviews starting recently. In these reviews, the HKMA has uncovered instances where some banks have circumvented the HKMA's macroprudential policies, and is keen to limit such practices.

It will be of paramount importance for banks to conduct a back-book review of all corporate loans secured by Hong Kong properties to identify any exceptions and identify the root causes of such for remediation. KPMG has been helping banks conduct these internal reviews and providing recommendations and advice on the corrective measures needed to ensure compliance with regulatory standards.

Another area currently in focus is reviews of collateralised lending. The economic disruption caused by Covid-19 has increased fraud risk and market volatility. Institutions with exposure to securities collateral that is highly concentrated, correlated (e.g. stocks with significant cross shareholdings), volatile or illiquid (i.e. holding a large portion of a stock in terms of its turnover or market capitalisation, making it difficult to liquidate) can be exposed to greater risk of losses from share margin financing and Lombard lending activities.

Areas banks should pay attention to include:

1. Concentrated exposure to stocks and NBFIs which have high correlation risk
2. Exposure to individual securities relative to their market liquidity or market capitalisation
3. Updates to the list of acceptable securities collateral and haircuts/LTVs for each collateral due to changed liquidity and volatility (CR-G-7 6.1.5)[7]
4. Concentration of lending to related margin clients (CR-G-7 3.3.2)
5. Preventing clients with outstanding margin calls from trading on margin
6. Promptly collecting margin calls
7. Intraday collateral valuation in volatile markets

[7] https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CR-G-7.pdf

Integrating Climate Risk Management and ESG

In 2022, climate risk management was thrust into the spotlight when the HKMA issued the Supervisory Policy Manual GS-1 "Climate Risk Management". Banks are expected to understand the impact of climate risk on customers' repayment abilities and further integrate climate risk considerations into credit and lending.

Under the Risk Management pillar of GS-1, banks in Hong Kong have made considerable efforts to build comprehensive risk management frameworks that include risk identification, quantification, scenario analysis, stress testing, monitoring, reporting, control and mitigation. The expectation is that the first line of defence within banks will be to perform climate risk assessment during the credit application and credit review process.

KPMG has observed an industry trend of integrating factors relating to climate and environment, social and governance (ESG) into the credit and lending process. Many banks have developed climate and ESG-related questionnaires to be answered during the client credit assessment process. Larger banks have either completed or are in the process of building a climate and ESG profile database for their key portfolios, such as property exposures for physical risk and greenhouse gas (GHG)-intensive sector exposures for transition risk. Leading banks from the Chinese Mainland and Hong Kong have developed climate-related and ESG scores in parallel to existing credit scores. These banks are able to perform forward-looking creditworthiness assessments to assess the long-term sustainability of their borrowers.

However, some obstacles prevent the widespread adoption of climate risk and ESG factors from being integrated into credit risk frameworks, including:

- Climate-related data challenges: lack of standardisation and consistency among climate and ESG data sources, especially when comparing data sources from different countries, and the varying data quality and granularity poses major issues.
- Market standards and methodologies are still under development and subject to constant revisions.
- Governance and climate risk appetite: industry risk appetite settings are currently mostly qualitative based, and climate-related quantitative risk metrics to facilitate tracking and reporting are expected.
- Slow adoption by clients and counterparties of banks means that, despite leading banks having incorporated climate and ESG-related factors into the credit assessment process, borrowers are unable to provide meaningful information, hence rendering the process ineffective.
- Integration of climate risk into internal credit rating framework: the nature of climate risk is long-term whereas credit assessments are short-term focused. The existing credit risk assessment framework focuses on creditworthiness over the next 12 months, so climate and ESG rating should operate on a different scale to traditional credit risk ratings.
- Independent climate risk/ESG rating: leading banks are exploring building a separate rating scale on climate/ESG risk and experimenting with adjusting lending strategy and customer approval processes based on these ratings. As a result of banks shifting towards limiting their exposure to GHG-intensive sectors, borrowers with poor climate/ESG ratings will be quoted non-favorable loan prices.

Driven by regulatory pressure and internal needs, individual banks have been making considerable efforts in enhancing risk management capabilities to make more informed and responsible credit and lending decisions to better position themselves for success in a rapidly changing market.

Next steps for banks to continue building climate risk resilience into credit and lending:

1. **Building capability for climate risk assessments:** Banks need to invest in developing the skills and knowledge necessary to understand climate risk, ESG assessment, sustainability and data analytics.
2. **Collect climate risk and ESG data:** Banks need to collect relevant data, including data regarding physical and transition risk assessment, customers' GHG emissions, energy efficiency, and customers' progress towards net zero.
3. **Integrate climate risk into credit risk assessments:** Banks will need to enhance customer due diligence and KYC processes to embed ESG-related factors while developing climate risk assessment ratings and framework.
4. **Implement green lending policies:** Based on the internal credit assessment framework, banks should prioritise financing for projects with positive environmental impacts, and fund projects to support the transition to a low-carbon economy.
5. **Ongoing monitoring and review:** Banks will need to continuously monitor and review their climate risk management practices to ensure effectiveness.

Expected Credit Losses in a Post-Covid Landscape

Without a doubt the last few years have been a rollercoaster ride for those who oversee and manage IFRS 9 Expected Credit Loss (ECL) models. Hong Kong experienced several waves of Covid outbreaks, while loan portfolios originated in Hong Kong have also been impacted by the Chinese Mainland's Covid policies including the recent opening up, as well as global geopolitical and macroeconomic factors. For those charged with developing forward-looking economic forecasts, the past few years have likely been filled with in-depth discussions on management overlays and economic scenarios.

Now that the world is moving beyond the pandemic, auditors and IFRS 9 ECL modellers need to revisit the wide use of management overlays on provisions. Covid overlays tended to be implemented due to either lack of data, unexpected economic results, or late breaking information that the ECL models could not capture.

Forecasting the economic environment and how these forecasts should be transmitted to relevant variables including probability of default (PD), loss given default (LGD) and exposure at default (EAD) and other relevant variables has been incredibly challenging. Using historic data to model these relationships also leads to problems as these variables have not been this volatile in at least 25 years – for example Hong Kong's GDP growth fell to -6.5% in 2020. Historical economic variable relationships and their relationship to credit loss distributions all but broke down during the pandemic. Some banks started to look at V-shaped, L-shaped or other shaped recoveries only to be torpedoed again by another wave of infections. In addition, major challenges came to light with assigning probabilities to each scenario such as baseline, optimistic or pessimistic. So, there is now a question of what banks should be doing from an ECL perspective as we move to a more normal economic environment.

KPMG recommended actions:

1. **Refreshing economic models** – Models that were developed over the past three years to forecast and transmit economic outcomes to credit losses should be refreshed. This includes either developing new regressions or back-testing the current models to ensure they are still fit for purpose.

2. **Reviewing or removing management overlays** – Management overlays were used substantially over the past few years as a response to some of the issues mentioned above. Often these adjustments were not supported by sufficient analysis and justification and required further analysis. Going forward, auditors and regulators may become more skeptical of overlays, so banks will need to place more governance on the overlay process. The reasons for employing overlays should not be based on consistently underperforming ECL models.

3. **Lack of validation and monitoring** – While some banks performed independent validation exercises, others have not done so over the past two or three years. The entire suite of ECL models including PD, LGD, EAD, behavioural life, SICR (staging models) should all be validated. Areas that are underperforming should be addressed or generation 2.0 models should be developed using more recent data.

4. **Data review** – Assumptions that have been in place since 2018 to address data gaps should be reviewed. A more permanent solution should be put in place to ensure that credit risk data is up to date and the latest available information is used for ECL calculations.

5. **Automation** – There are still banks relying on many manual processes to collate and aggregate data for IFRS 9 ECL calculations. These processes should be automated to reduce model risk and data errors that can lead to last-minute adjustments.

Integration of Non-traditional Fraud and Credit Data

Expected challenges in the year ahead include persistent inflationary costs and slowing orders from major economies, which will erode the operating leverage and margins of banks' corporate clients. Interest rates at highs not seen in more than a decade make debt service and refinancing expensive. Credit stress will undoubtedly rise.

Stressed borrowers who struggle to meet debt commitments, if not confident of their creditors' support, may resort to transactional fraud and financial statement misrepresentation (borrower fraud[8]). Banks will need to be vigilant in traditional credit financial analysis and also actively look out for red flags of borrower fraud as part of their corporate credit risk management.

Warning signs of borrower fraud can be visible across multiple points of a customer's profile, activities and transaction flows. Investing in tools and practices for early recognition of borrower fraud, including harnessing technology, allows more effective mitigation of exposure to risk. Banks with such capabilities have a significant competitive advantage over their peers that don't.

New technology solutions that can help banks analyse financial statement ratios can identify "yet-to-emerge" frauds by using algorithms to screen financial ratios over time and against peer groups. Transaction and other system analytics can also be used to identify undisclosed counterparty connections, which could indicate borrower fraud, by monitoring transactions and checking counterparty details against internal and external data. Optical character recognition and AI can help identify flaws in trade documents that may have been fabricated to support trade finance transactions.

Potential actions banks can take to improve credit and borrower fraud risk management are:

1. Establish clear structures and accountabilities to detect borrower fraud, including a suitable governance overlay, backed by the right management information to monitor the effectiveness of the risk control. First-line responsibility within relationship management and operations is essential.

2. Provide those responsible with specific training to understand the issue and be confident to flag any potential borrower fraud warning signs arising from their customers.

3. Require relationship managers and credit officers to explicitly explain in credit applications for new clients, and at facility renewals, why they are confident a customer does not present a borrower fraud risk.

4. Adopt technology systems to detect borrower fraud, rather than relying on manual processes or expert judgements.

8 Borrower Fraud is where a borrower manipulates or falsify transactions, including supporting documentation, and in doing so misrepresents financial accounting statements, to obtain or retain access to bank financing.

Non-Performing Credit Risk Management

There are two key observations from the recent and ongoing credit environment.

Firstly, recent defaults by Chinese Mainland property developers have reminded banks of the real risk of exposure to facilities that are structurally subordinated: in particular, offshore lenders often have little or no legally enforceable, direct access to the borrower's primary onshore operating assets and cash flow.

Hong Kong corporate profiles are often complex, with integrated relationships with the Mainland via parental control or onshore operating subsidiaries. Competition between banks and prolonged benign credit conditions have encouraged banks to provide credit facilities that, under current weaker credit conditions, have exposed the weakness of being structurally subordinated. This cycle of ambitious credit appetite and subsequent losses has been seen before, most notably:

I. during the Asian Financial Crisis with Chinese "window companies",

II. post-Global Financial Crisis with commodity corporates' offshore trading subsidiaries, and

III. now, with Mainland property developers' offshore financing vehicles and listed companies defaulting on offshore debt.

Lenders' past credit decisions created structurally subordinated claims that now most need to be dealt with any restructuring or repayment agreement. Repayment priorities will tend to be given to senior direct onshore lenders and haircuts or deferments to subordinated offshore claimants. The value of such distributions will also be dependent on the quality of the financial information and cashflow models that can give some reasonable certainty, albeit not absolute, that restructuring terms will be met. Although successful restructurings are grounded on the legal priority of claims, and confidence of asset existence and cashflow availability, some pragmatism around these principles is often required to achieve a restructuring deal that is acceptable to all material stakeholders.

Using advisors that have the trust of most parties involved, even when engaged by the debtor group, or by a segment of creditors, is also essential to a successful restructuring.

Secondly, competition between banks is primarily focused on growing client relationship revenue, including providing credit facilities. But competition between banks also includes the use of judicious credit mitigation, including an ability to manage down exposure where perceived credit risks are rising. In the current environment credit risk management will be a significant competitive differentiator, in areas including.:

i. Quality of credit analysis, facility structuring and approval process.

ii. Effectiveness of identification of and acting upon credit and borrower fraud warning signs.

iii. Early engagement with a client where warning signs are identified to understand the true debt service capacity.

Notwithstanding a bank's prerogative to adjust credit facilities, banks should be aware that their actions can cause a direct adverse impact on the borrower. Banks in such circumstances should consider the implications of their actions with reference to the "Hong Kong Approach to Corporate Difficulties" – the Guidelines issued by the HKMA and the Hong Kong Association of Banks in 1999. The Guidelines explain the expectations of the HKMA and the banking industry when companies face credit difficulties, and this guidance has been reiterated and reflected in more recent publications such as the HKMA's IC-7 "The Sharing and Use of Commercial Credit Data through a Commercial Credit Reference Agency"[9] Similar guidance is set out in INSOL International Statement of Principles for a Global Approach to Multi-Creditor Workouts (as updated in 2017).

Banks have a difficult judgement call when reducing credit lines as to whether their actions comply with the Guidelines. Each situation will be unique so there are no simple rules on the correct decisions. However, if a bank knowingly reduces its exposure, creating a reasonably foreseeable risk that its action will trigger a wider payment default within the bank group, that proposed action probably sits outside the HKMA's expectations.

If banks decide to withdraw or reduce lines, banks should take the following action:

1. Consider the impact of their action on the company's sufficiency of working capital finance to continue operations.

2. If there is doubt as to such sufficiency, ask the customer, with reasonable notice, to call an all-bank meeting to discuss a bank group standstill and restructuring as per the Guidelines. If the customer refuses to call such an all-bank meeting, then the bank would be more justified to protect its position and unilaterally reduce its credit exposure.

[9] The Sharing and Use of Commercial Credit Data through a Commercial Credit Reference Agency (hkma.gov.hk)

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