

IN-DEPTH

Lending And Secured Finance

HONG KONG



LEXOLOGY

Lending and Secured Finance

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In-Depth: Lending and Secured Finance (formerly The Lending and Secured Finance Review) is a global survey of the most consequential developments in the corporate lending and secured finance markets in each jurisdiction, including key challenges and opportunities facing market participants. Among other things, it addresses prevailing market conditions and regulatory changes; tax considerations; credit support and subordination; loan trading; and an outlook for future developments.

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Hong Kong

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Summary

INTRODUCTION

YEAR IN REVIEW

TAX CONSIDERATIONS

CREDIT SUPPORT AND SUBORDINATION

LEGAL RESERVATIONS AND OPINIONS PRACTICE

LOAN TRADING

SPECIAL CONSIDERATIONS

OUTLOOK AND CONCLUSIONS

ENDNOTES

Introduction

Hong Kong has an active bilateral and syndicated loan market.

Syndicated lending is generally documented using the facility agreement forms prepared by the Asia Pacific Loan Market Association (APLMA).

The main providers of finance are Hong Kong-regulated financial institutions that have been authorised under the Banking Ordinance (BO)^[1] as authorised institutions to hold banking licences. Funds and private equity houses are more visible in bilateral bridge or other short-term bespoke financing arrangements.

Year in review

The year 2023 saw an increase in syndicated and club loan volumes in the Asia-Pacific (excluding Japan) by 3.2 per cent year-on-year to US\$582.6 billion, which is partly attributed to China's performance surpassing expectations, and the robust activity in south and South East Asia. Nonetheless, loan volume in the region decreased more than 23.4 per cent in the second half of 2023 compared to the first half of 2023 in light of poor performance due to inflation, recession concerns and rising interest rates.

Event-driven financings in the region plunged by 57 per cent year-on-year to a decade low of around US\$26 billion. This is mostly attributable to the significant decline in the number of deals, from 95 transactions in 2022 to 54 transactions in 2023. There has been a reduction in merger and acquisition activity in light of geopolitical tension, high interest rates and differences in valuation expectations between buyers and sellers. In 2023, the largest merger and acquisition financing was the US\$3.2 billion bridge facility for Chow Tai Fook Enterprises' buyout of NWS Holdings in Hong Kong.

In 2023, Hong Kong's loan market totalled US\$100.5 billion in volume, which represents a decrease of 20.7 per cent year-on-year from the total of US\$126.8 billion in 2022. Other than low levels of deal activity, many borrowers sought cheaper funding in the onshore market in China instead.

Sustainability-linked loans have become increasingly popular. In 2023, the volume of sustainability-linked loans in the Asia-Pacific loan market increased nearly fivefold to around US\$111 billion compared to 2020. The most popular key performance indicators (KPIs) are greenhouse gas emissions, gender equality, water consumption, renewable energy and energy efficiency.

Tax considerations

The Hong Kong tax regime includes three separate types of income tax: property tax, salaries tax and profits tax. Of these, profits tax is most relevant to lenders.

Hong Kong does not have a separate capital gains tax regime.

Profits tax

Hong Kong adopts a territorial source principle of taxation.

Under the Inland Revenue Ordinance (IRO),^[2] profits tax is charged on a person carrying on a trade, profession or business in Hong Kong; and in respect of income profits (excluding capital gains profits) arising in or derived from Hong Kong from that trade, profession or business.

The rate of profits tax for corporations is 8.25 per cent on profits up to HK\$2 million and 16.5 per cent on the remainder for any year of assessment commencing 1 April 2018.

Carrying on a trade, profession or business in Hong Kong

A low threshold is required to fall within the scope of carrying on a trade, profession or business in Hong Kong. The activity of depositing may, for example, be sufficient to constitute a business.

Income arising in or derived from Hong Kong

If the above test – of carrying on a trade, profession or business in Hong Kong – is satisfied, profits tax will (subject to exemptions) be chargeable if the income arises in or is derived from Hong Kong.

This is a factual issue, which is determined by looking at what the taxpayer has done to earn the relevant profit. A test often applied in difficult cases is where the operations take place from which the profits in substance arise. The place where a taxpayer's profits arise is not necessarily the place where he or she carries on business.

Inland Revenue Department guidelines and case law assist in determining the locality where income arises, or where it is derived from.

Because of the difficulties in assessing the locality of interest and related fee income received by financial institutions, the Inland Revenue Department issued Departmental Interpretation and Practice Notes No. 21: Locality of Profits (revised July 2012), setting out the Inland Revenue Department's current practice.

A modified extract from the practice note on the tax treatment of interest from loans is set out below.

Types of interest incomes from loans	Tax treatment
Offshore loans initiated, negotiated, approved and documented by an associated party outside Hong Kong and funded outside Hong Kong (i.e., funds raised and loaned direct to the borrower by a non - resident; for example, head office, branch or subsidiary) albeit through or in the name of the Hong Kong institution	100 per cent non - taxable

Offshore loans initiated, etc., by the Hong Kong institution and funded by it in or from Hong Kong	100 per cent taxable
Offshore loans initiated, etc., by an associated party outside Hong Kong but funded by the Hong Kong institution	50 per cent taxable
Offshore loans initiated, etc., by a Hong Kong institution but funded by offshore associates. It is considered that this category only applies to start - up positions where the Hong Kong institution has yet to establish a market presence	50 per cent taxable

Note on 'funding'

For claims concerning loans funded by offshore associates, two essential requirements will have to be satisfied, namely:

1. that the Hong Kong institution does not have the authority to seek its own source of funds in respect of the loans; and
2. there must be documentary evidence to show that funds have been directly provided by an offshore associate even though such funds may have been routed through another vehicle in Hong Kong. In other words, arbitrary funding by another group vehicle in Hong Kong will not satisfy this requirement.

Note on 'initiation'

'Initiation' refers to the efforts exerted in obtaining the particular business including solicitation, negotiation and structuring of the loans. The financial institution must be able to substantiate that the mandate or invitation to participate was secured as a direct result of the activities of an associated party outside Hong Kong for an offshore claim to succeed.

Participation, commitment and other fees will follow the tax treatment accorded to the related loan under the above.

Deductibility of interest paid by borrowers

Payments of interest by a Hong Kong corporate that are incurred in the production of its chargeable profits are generally deductible, subject to certain anti-avoidance provisions that limit the available deduction where money is not borrowed from a financial institution or from a person who is taxable in Hong Kong on the interest received. The anti-avoidance provisions seek to deal with the lack of symmetry in tax treatment on interest received and interest paid.

Double taxation agreements

As at 4 March 2024, Hong Kong has comprehensive double taxation agreements with Austria, Belarus, Belgium, Brunei, Cambodia, Canada, the Czech Republic, Estonia, Finland, France, Georgia, Guernsey, Hungary, India, Indonesia, Ireland, Italy, Japan, Jersey, South Korea, Kuwait, Latvia, Liechtenstein, Luxembourg, Macau, mainland China, Malaysia, Malta, Mauritius, Mexico, the Netherlands, New Zealand, Pakistan, Portugal, Qatar, Romania, Russia, Saudi Arabia, Serbia, South Africa, Spain, Switzerland, Thailand, the United Arab Emirates, the United Kingdom and Vietnam. Hong Kong is in the process of concluding comprehensive double taxation agreements with Bahrain, Bangladesh and Croatia.

The terms set out in double taxation agreements take precedence over the other provisions of the IRO.

Stamp duty

Hong Kong stamp duty is chargeable on certain transactions (including the issue of certain bearer instruments) but is not chargeable on the entering into or transfer of loan facility agreements (on the basis that a transfer under a loan facility typically will not require registration in a register located in Hong Kong).

Lenders may, therefore, transfer their commitments and loans by way of either assignment or novation.

Credit support and subordination

Security

Common methods of taking security in Hong Kong include the following:

1. mortgages, which involve the mortgagor transferring the property to the mortgagee, with the mortgagor having an equitable right to have the property returned upon paying off the debts to which the mortgage relates. Although it may be used for a variety of types of properties, a mortgage is more commonly used for real property. The Conveyancing and Property Ordinance^[3] sets up a statutory overlay in respect of Hong Kong real property, so that any mortgage of a legal estate in Hong Kong real property may only be effected at law by a deed expressed to be a legal charge (which is a creature of statute);
2. charges or assignments by way of security:
 - Hong Kong recognises both fixed and floating charges, with fixed charges taking priority over floating charges where the chargee has had no notice of negative pledge prohibitions. Charges may be granted over future property; and
 -

security over choses in action are usually drafted as an assignment by way of security, although the courts make little distinction between charges and assignments by way of security;

3. pledges (by way of transfer of possession of tangible property); and
4. liens (by way of the lienholder retaining possession of tangible property).

The typical ways of taking security over real estate, tangible movable property, shares and financial instruments, contractual rights and receivables, and intellectual property (IP) rights are described below.

Real estate

Security over Hong Kong real estate is typically given by way of a fixed legal charge (whereas security over choses in action related to the property is given by way of an assignment). Although lenders are not required to adopt any specific mortgage form, The Hong Kong Mortgage Corporation Limited has introduced a set of standard form model mortgage documents in respect of residential properties.

Security granted over a registrable interest in land must be registered with the Land Registry.

Tangible movable property

Security over tangible movable property is often given by way of a fixed or floating charge.

A fixed charge is created over a particular identified property (which may include future property). The chargee's consent is required for the chargor to dispose of the property free from the charge. If the chargor defaults, the chargee may enforce the charge by selling the property. Typically, the chargee will appoint a third-party receiver to enforce the charge to protect the chargee from potential liability arising from enforcement.

A floating charge is similar to a fixed charge but created over a moving class of assets (such as stock), which may change on occasion. Unlike a fixed charge, the chargor may dispose of the charged assets and carry on its business as usual until an event (such as acceleration under an event of default) occurs that crystallises the floating charge into a fixed charge. Floating charges rank behind fixed charges granted (before floating charge crystallisation) over the same property and behind certain preferential creditors prescribed by statute.

To reduce the risk of tangible charged property being sold to a bona fide purchaser of the legal estate without notice of the charge, where possible, plaques should be attached to the charged property to give notice to third parties of the existence of the charge.

Shares and financial instruments

Security over shares and financial instruments is often given by way of a fixed or floating charge.

The charging language used will depend upon whether the shares are held directly in certificated form or indirectly via a nominee or custodian.

In the case of a charge over Hong Kong shares held directly in certificated form, the chargor will transfer the share certificate to the chargee and execute a blank form of instrument of transfer and a blank sale contract note, which the chargee may complete upon enforcement and use to transfer the shares to a third party. The chargee may also ask the chargor to arrange for the signature – by the directors of the underlying company whose shares are charged – of certain undated board resolutions and undated resignation letters of directors, with authority for the chargee to complete these documents upon enforcement.

Unless the share charge extends to a charge over dividends, notice is typically not sent to the company whose shares are charged as this will not affect priorities (Section 634 of the Companies Ordinance (CO)^[4] states that no notice of trust may be entered in a Hong Kong company's register of members). This means that, under a share charge, a chargee is exposed to the risk of a chargor transferring legal title to the charged shares to a bona fide purchaser without notice. Such a bona fide purchaser without notice would likely take the shares free of the charge. Although the chargee holds the share certificate, the chargor may apply to the company for a new share certificate on the basis that the previous share certificate has been lost or destroyed. Although there is a court process under which a 'stop notice' may be served by the chargee on the underlying company whose shares are charged, requiring the underlying company to give notice to the chargee if the chargor attempts to transfer the shares, this process is rarely used.

When taking security over shares and financial instruments, the terms governing the underlying shares or instrument must be checked to ensure there are no provisions prohibiting transfer (and, if there are, those provisions should be amended).

In the case of a charge over shares held indirectly via a nominee or custodian, the charging language is more similar to that used for contractual rights and receivables (described below). Notice of the share charge should be sent to the nominee or custodian to preserve priority.

For other financial instruments, notice of a charge should usually be given to preserve priority (with the notice given to the person who either owns the instrument on behalf of the chargor, or to the payor under the instrument, as applicable).

Contractual rights and receivables

Security over contractual rights and receivables is usually drafted in the form of an assignment by way of security. Courts make little distinction between a fixed charge and an assignment by way of security.

As for shares and other instruments, the terms of the contractual rights and receivables should be reviewed to ensure there are no provisions prohibiting transfer (and, if there are, those provisions should be amended).

Notice of charge should be given to the debtor or payor to which the contractual rights and receivables relate to preserve priority.

IP rights

Hong Kong has specific registries for patents, trademarks and designs, although there is no registry for copyright.

Security is usually taken in the form of a mortgage, charge or assignment, by way of security.

Security over registered IP should be registered at the Hong Kong Patents Registry, the Trade Marks Registry or the Designs Registry. If the security is not registered, it is ineffective against certain acquirers who acquire the IP without notice of the security. There is no legal requirement to make registrations within a specified time, although late registration may impact upon damages claims as well as priority and perfection against third parties.

Formalities

Hong Kong real estate – Land Registry

Security over Hong Kong real estate (if registrable) must be registered with the Land Registry to protect its priority. If the document is registered within one month of execution, it takes priority from the date of execution. Late registrations will take priority from the date of registration.

Companies Registry

Where the grantor is a Hong Kong-incorporated company or a non-Hong Kong company that is registered at the Companies Registry (usually required by reason of having a place of business in Hong Kong) that is granting security over Hong Kong property, specified types of assets must be registered with the Companies Registry within one month of execution. Otherwise, the security will be void against any creditor or liquidator, and the chargor company (and certain of its officers) will commit an offence.

The following are the more common types of secured assets that must be registered:

1. any property where the security granted is a floating charge;
2. chattels;
3. land;
4. book debts (but excluding bank accounts);
5. ships;
6. aircraft; and
7. goodwill, patents, trademarks and copyright.

The full list of assets that must be registered is set out in Section 334 of the CO.

Although security over a bank account is not registrable as a book debt, it will be registrable if the security is a floating charge. The question of characterisation of security is a matter of both form and substance. A factor to take into account will be the nature of the dealings and interactions between the chargor and chargee.

Registration requirements also apply where an asset is acquired that is subject to security.

IP registers

Security over patents, registered designs and trademarks are subject to specific registrations:

1. security over patents and registered designs must be recorded at the Hong Kong Patents Registry by filing Form P19 or at the Designs Registry by filing Form D5; and
2. security over a registered trademark must be registered at the Trade Marks Registry by filing Form T10.

An unregistered security interest over a registered patent, design or trademark is ineffective against certain acquirers who did not have notice of the security interest at the time of the acquisition.

Aircraft

Although there is no statutory requirement, market practice is to notify the Civil Aviation Department in Hong Kong of the security interest, and to include chargee details on the nameplate of the aircraft to give notice of the security interest to third parties.

Ships

Security over ships is usually by way of mortgage. A mortgage over a Hong Kong-registered ship must be in a prescribed form and registered with the Hong Kong Shipping Registry of the Marine Department in Hong Kong. Priority is accorded from the time of registration.

Guarantees and other forms of credit support

Guarantees are commonly used in Hong Kong as a form of credit enhancement. Market documentation prepared by the APLMA includes loan facility agreements with integrated guarantee provisions.

Other credit support techniques that may be used include sale and leasebacks, transfer of collateral with an obligation to return the same (or equivalent) collateral, disposal of receivables with recourse remaining against the transferor, retention of title arrangements and contractual set-off arrangements.

Negative pledge undertakings are usually included in loan facility agreements. Breach by a borrower of a negative pledge entitles the lender to bring a damages claim as an unsecured creditor, but a breach is unlikely to disturb the security granted in favour of a bona fide third party created in breach of the negative pledge.

Priorities and subordination

Subordination of debts

A lender may commonly seek subordination of debt owed by the borrower to creditor shareholders, so that the lender's loan ranks in priority to the creditor shareholders' loans. Such subordination is effected by way of contract, often by way of a deed of subordination between the borrower, the lender and the creditor shareholders.

Structural subordination is also permissible.

Priority of competing security interests

Priority is a complex matter that depends upon the particular facts and the relevant registrations (if any).

A common priority concern arises where a company grants security by way of two fixed charges over the same debt chose in action to two creditors. The starting point under common law is that the creditor who gives notice first to the debtor takes priority over the other creditor. If that fixed charge is registrable at the Companies Registry, to preserve priority the fixed charge must be registered within the required period of one month after execution. The CO requires that a certified copy of the instrument of charge be submitted for registration. The text of the instrument of charge is therefore available to the public for a small fee.

Although it is unclear how registration under the CO legislation affects the doctrine of notice, it is expected that registration of an instrument of charge will likely give rise to constructive notice of all the terms in the charge instrument – including negative pledge clauses – on the part of those who may reasonably be expected to search the Companies Registry, including banks, financiers and relevant professionals. It would appear that, for example, where a company grants a charge over a debt chose in action to a first financial institution and then subsequently grants a charge over the same debt chose in action to a second financial institution, the first financial institution may take priority if the second financial institution would have been aware of the first financial institution's interest had it searched the Companies Registry (regardless of whether the first financial institution has given notice to the debtor). In a similar way, negative pledges in floating charges may now bind later financial institutions that have a fixed charge interest in the same asset.

Legal reservations and opinions practice

Legal limitations on the validity or enforceability of lending and secured arrangements are described below.

If lenders (including via their agents) are put on notice that a borrower may not have properly convened and held the board meeting that authorised the relevant loan and security documents, the court may find that the documents do not bind the company. Care needs to be taken by lenders' counsel that there are no irregularities that would so put lenders on notice. The

- a charge over shares in a company where company directors have discretion not to register a transfer of shares; and

- security over a contract where that contract does not permit parties to dispose of their interests.

Legal opinions usually set out the relevant registry filings that must be made upon the creation of security, and then assume those filings will be made within the prescribed time limits.

Loan trading

Loan trading is usually carried out by way of novation and assignment, and both methods are catered for in APLMA primary documentation. Sub-participations and synthetic methods are available but less commonly used.

Special considerations

If a lender is not an authorised institution licensed by the HKMA, it may fall under the Money Lenders Ordinance (MLO)^[7] if it is carrying on a business in Hong Kong (whether by itself or through agents) of making loans, or if it advertises or announces itself as carrying on that business. This legislation seeks to protect consumers against unfair credit transactions – for example, by requiring money lenders to be licensed – and for money lenders to use prescribed forms and not to charge compound interest. Breach of the MLO may result in the committal of offences, and underlying transactions being unenforceable. A number of loans are exempted from the above requirements (including the requirement to be licensed to lend money). A commonly used exemption is for loans made to a company that has a paid-up share capital of not less than HK\$1 million (or its equivalent in another currency).

Legal and regulatory developments

CO

Lenders have expressed concern with respect to the clarification under the CO that charges over bank accounts are not charges over book debts (and so are not registrable under that head of registration). Lenders receiving security over bank accounts wish to protect their position by ensuring the bank account charge is registered at the Companies Registry. In light of bank account charges not being registrable per se, the usual technique to register a bank account charge is to notify the Companies Registry that the bank account charge may be construed as a floating charge (as all floating charges are registrable under a separate head of registration).

With underlying instruments of charge now publicly available, the Companies Registry has stated it is now more important than ever for lenders to make enquiries and search the Companies Register for charges. The availability of the underlying instrument of charge will likely impact upon the issue of priorities between competing charge instruments.

Foreign Account Tax Compliance Act

Hong Kong has implemented the Foreign Account Tax Compliance Act (FATCA) Model 2 intergovernmental agreement. Although there remains variance in terms, as far as borrower risk is concerned, the market has moved towards a balanced position (namely that FATCA withholding is lender risk).

Basel III

Capital adequacy ratio

The Hong Kong Monetary Authority (HKMA) has issued the Banking (Capital) Rules^[8] under the BO, which prescribe in detail how the capital adequacy of Hong Kong-incorporated authorised institutions should be calculated. These rules incorporate Basel III technical guidance.

A Hong Kong-incorporated authorised institution is required under the Banking (Capital) Rules to maintain a Common Equity Tier 1 (CET1) capital ratio of at least 4.5 per cent, a Tier 1 capital ratio of at least 6 per cent and a total capital ratio of 8 per cent. Branches of foreign banks are not subject to this requirement but the HKMA will generally require any foreign bank that wishes to establish a branch in Hong Kong to maintain capital levels consistent with the latest applicable capital standards issued by the Basel Committee on Banking Supervision.

Leverage ratio

Hong Kong-incorporated authorised institutions must also comply with the minimum leverage ratio set out in the Banking (Capital) Rules. The leverage ratio is a non-risk based measure of an authorised institution's capital adequacy, introduced as a back-stop to restrict the build-up of excessive leverage in the banking sector and to provide an additional safeguard against model risk and measurement error in the risk-based capital adequacy ratios. The minimum leverage ratio is 3 per cent.

Capital buffers

In accordance with the Basel III recommendations, the HKMA requires a Hong Kong-incorporated authorised institution to have further capital buffers to cater for risks and uncertainties that are not already captured by the three minimum risk-weighted capital ratios that comprise the capital adequacy ratio. The HKMA has implemented the following capital buffers: the capital conservation buffer, the countercyclical capital buffer and (for domestic systemically important banks (D-SIBs) and global systemically important banks (G-SIBs)) the higher loss absorbency (HLA) requirement.

The capital conservation buffer is an additional band of CET1 capital at 2.5 per cent.

The level of the countercyclical capital buffer is an additional band of CET1 capital that ranges from zero to 2.5 per cent. The level is determined by the HKMA's analysis of whether there is excess aggregate credit growth associated with a build-up of system-wide risk in Hong Kong. It is an extension of the capital conservation buffer. On 20 February 2024, the

HKMA announced that the countercyclical capital buffer would remain unchanged at 1 per cent.

The HLA requirement applies to Hong Kong-incorporated authorised institutions that are designated as D-SIBs and G-SIBs. It is also an additional base of CET1 capital that acts as an extension of the capital conservation buffer. The HLA range (where applicable) is normally between 1 and 2.5 per cent, although there is a top range of 3.5 per cent. On 29 December 2023, the HKMA announced that the total number of D-SIBs remains unchanged at five compared to the number of D-SIBs published on 30 December 2022. There is currently no Hong Kong-incorporated authorised institution that has been designated a G-SIB.

If a Hong Kong-incorporated authorised institution's capital level erodes to a level falling within the capital conservation buffer zone, the countercyclical capital buffer zone or the HLA buffer zone, restraints will be imposed on that institution's distributions. A Hong Kong-incorporated authorised institution is expected to submit a capital plan with proposals to manage and improve its capital position to the HKMA for its approval if it anticipates that any of its capital levels will fall close to the buffer zones.

Loss-absorbing capacity rules

The Financial Institutions (Resolution) Ordinance (FIRO)^[9] covers resolution, including bank resolution. The Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules (FIR LAC Rules)^[10] enable the HKMA to prescribe loss-absorbing capacity (LAC) requirements for 'within-scope' financial institutions that are Hong Kong-incorporated authorised institutions, and for their Hong Kong-incorporated holding companies or Hong Kong-incorporated affiliated operational entities. Not all Hong Kong-incorporated authorised institutions will be classified as within-scope – meaning that not all of them will be subject to LAC requirements. The LAC consolidation group may differ from the regulatory capital consolidation group. The FIR LAC Rules set out how to calculate LAC leverage ratios (both external and internal LAC, and under a solo, solo-consolidated and consolidated basis), capital component ratios and resolution component ratios (which will often be the same as the related capital component ratio). The FIR LAC Rules also cover disclosure requirements in relation to LAC and deductions for holding non-capital LAC liabilities.

Capital that counts towards meeting the regulatory capital requirement (i.e., hard requirements, ignoring the 'softer' capital buffers) will generally count towards meeting a LAC requirement. This means that the new additional burden for a within-scope Hong Kong-incorporated authorised institution will likely be the resolution component ratio.

Implementation of Basel III final reform package

The following rules (the Rules) will come into operation to implement the Basel III final reform package and related updates:

1. the Banking (Capital) (Amendment) Rules 2023 (BCAR) set out the revised capital standards contained in the Basel III final reform package. The revised capital methodologies are used to determine the capital requirements of banks in relation to their exposures to credit risk, operational risk, market risk and credit value

adjustment (CVA) risk, and the output floor. The BCAR also introduces the option of a positive neutral countercyclical capital buffer;

2. the Banking (Disclosure) (Amendment) Rules 2023 (BDAR) contain updated disclosure requirements replicating those found in the documents published by the Basel Committee on Banking Supervision in connection with disclosure requirements relating to Pillar 3, leverage ratio and market risk;
3. the Banking (Exposure Limits) (Amendment) Rules 2023 (BELAR) mainly incorporate consequential amendments arising from the BCAR for implementing the revised capital standards contained in the Basel III final reform package; and
4. the Banking (Liquidity) (Amendment) Rules 2023 (BLAR) introduce consequential amendments arising from the BCAR.

The Rules will come into operation on the following dates:

1. 1 April 2024 regarding:
 - the provisions unrelated to the Basel III final reform package in the BCAR (including the introduction of the option of a positive neutral countercyclical capital buffer); and
 - the provisions in the BELAR that are considered significant to ensuring the effective operation of the Rules; and
2. a date to be appointed by the HKMA (which is currently expected to be 1 January 2025) regarding:
 - the other provisions in the BCAR and the BELAR; and
 - the BDAR and BLAR.

The HKMA requires Hong Kong-incorporated authorised institutions to comply with the reporting requirements for the new standards on market risk and CVA risk from 1 July 2024.

Anti-money laundering and counter-terrorist financing

Authorised institutions must comply with the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO),^[11] which in particular sets out specific customer due diligence (CDD) and record-keeping requirements that must be followed.

The AMLO was amended on 1 June 2023. The key changes were to:

1. amend the definition of 'politically exposed person' to align with the international standards set by the Financial Action Task Force;
2. enable a risk-based approach to be adopted to determine the degree of customer due diligence (CDD) that persons formerly designated to have been 'politically exposed persons' are subject to;
- 3.

clarify that recognised digital identification systems can be used for CDD and identification purposes; and

4. specify that the beneficial owner of a trust includes the trustee of the trust, a beneficiary and a class of beneficiaries of the trust entitled to a vested interest in the trust.

Hong Kong-incorporated authorised institutions are required to check and report against the list of names issued under US President Executive Order 13224 and the list of names published under Hong Kong's United Nations (Anti-Terrorism Measures) Ordinance^[12] (which is updated to reflect changes to the list of specified terrorists and terrorist associations designated by the United Nations Security Council).

Hong Kong has a separate enforcement agency, the Independent Commission Against Corruption (ICAC), to counter corruption. Its main focus is on preventing bribery (in both the public and private sectors). The ICAC published the 'Corruption Prevention Guide for Banks' in March 2023, which provides guidance on anti-bribery legislation, corporate governance practices, anti-corruption controls and corruption risks and safeguards for banks.

Benchmarks

Hong Kong Interbank Offered Rate

The Hong Kong Interbank Offered Rate (HIBOR) is available for borrowings in Hong Kong dollars and offshore yuan (although the majority of offshore yuan-denominated loans do not use the HIBOR in respect of interest calculations).

The continuous US interest rate increases have contributed to a rise in overall funding costs and a higher HIBOR. The one-month HIBOR fixing averaged 5.19 per cent for the quarter that ended in December 2023, up from 3.67 per cent in the equivalent quarter in 2022. The three-month HIBOR fixing averaged 5.34 per cent for the quarter that ended in December 2023, up from 4.75 per cent in the equivalent quarter in 2022.

HIBOR remains in use and there are no plans to discontinue, although the Hong Kong Dollar Overnight Index Average has been recognised as an alternative to HIBOR.

London Interbank Offered Rate transition

The London Interbank Offered Rate (LIBOR) for one-week and two-month US dollar settings as well as pounds sterling, euro, Swiss franc and Japanese yen LIBOR settings ceased to be published after 31 December 2021. The remaining US dollar LIBOR settings were discontinued after 30 June 2023.

There has been a smooth transition away from LIBOR in the Hong Kong banking sector. Initial trends indicate that Term SOFR is popular replacement benchmark for US dollar loans. Term SOFR is forward-looking and easier to implement, as it utilises data that is available at the beginning of an interest period. A survey conducted by the APLMA in March 2023^[13] revealed that, although there is mixed practice, majority of borrowers preferred

Term SOFR to compounding daily rates in arrears. The survey results also showed that credit adjustment spreads were often incorporated in legacy deals but not new deals.

Banking resolution

EU Bank Recovery and Resolution Directive

With the implementation of Article 55 of the EU Bank Recovery and Resolution Directive 2014/59/EU (Directive), EU-based lenders typically require loan facilities that are governed by Hong Kong law to include contractual recognition of bail-in, whereby non-EU entities acknowledge that EU lenders may be subject to bail-in powers under that Directive. The relevant language is usually based on the bail-in template language prepared by the Loan Market Association (LMA).

FIRO

FIRO establishes a cross-sectorial resolution regime designed to meet international standards set by the Financial Stability Board. The purpose of the Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights – Banking Sector) Rules (the Stay Rules)^[14] is to mitigate the risk of early termination in the resolution of financial contracts and assist authorised institutions to proceed to orderly resolution. The Stay Rules require Hong Kong-incorporated authorised institutions (and certain group companies or Hong Kong-incorporated holding companies) to include terms in certain non-Hong Kong law governed contracts to ensure those non-Hong Kong law contracts will be subject to the HKMA's power to require stays on termination rights. The Stay Rules also contain requirements on systems of control and on the keeping of records. Industry associations are preparing or have prepared template language to assist authorised institutions in satisfying their obligations under the Stay Rules to include the new required terms. For example, on 24 September 2021 the International Swaps and Derivatives Association (ISDA) published a Hong Kong Jurisdictional Module to the ISDA Resolution Stay Jurisdictional Modular Protocol. Generally, non-Hong Kong-law governed loan agreements fall outside the scope of the definition of financial contracts and are not subject to the Stay Rules.

Insolvency regime

Hong Kong's insolvency regime remains creditor-friendly with no specific debtor resolution regime in place.

On 22 October 2020, the government issued a paper to the Legislative Council stating that it intended to introduce a corporate rescue regime in 2021 (although, as at March 2024, no draft legislation has been tabled in the Legislative Council). The proposals include:

1. the introduction of an insolvent trading prohibition, under which a director responsible for insolvent trading of a company will be liable to make a contribution to the company's assets as the court considers appropriate. The director's liability is civil in nature. The regime will introduce a lower threshold for liability compared to the existing fraudulent trading regime; and

2. the introduction of a corporate rescue procedure with a statutory moratorium.

The statutory moratorium is expected to prohibit enforcement, including self-help enforcement of security. Lenders may change their approach to security documents as the statutory moratorium cannot be put in place if a holder of a charge over all or substantially all of the company's assets objects to the statutory moratorium. Secured lenders may therefore consider amending their policies on taking security in order for the secured lenders to have the right to prevent the imposition of a statutory moratorium.

Sustainable finance

The APLMA, the LMA and the Loan Syndications and Trading Association (LSTA) published updated versions of the Green, Social and Sustainability-Linked Loan Principles and related guidance in February 2023 covering the following:

1. Green Loan Principles – use of proceeds, process for project evaluation and selection, management of proceeds and reporting;
2. Social Loan Principles – use of proceeds, process for project evaluation and selection, management of proceeds and reporting; and
3. Sustainability-Linked Loan Principles – selection of KPIs, calibration of sustainability performance targets (SPTs), loan characteristics, reporting and verification.

The revised Green Loan Principles and Social Loan Principles and related guidance are intended to align with the International Capital Market Association's (ICMA) Green Bond Principles and Social Bond Principles where appropriate. The updated principles are designed to focus on the eligibility of projects rather than the nature of the borrower, although borrowers will need to present their overall strategy to lenders. There is increased emphasis on disclosure and transparency; for example, borrowers should be able to attest to the management of proceeds by conducting a formal internal process and informing lenders of temporary placement for the balance of unallocated proceeds.

The revised Sustainability-Linked Loan Principles and related guidance examine materiality in KPI selection. The best practice is for borrowers to conduct a materiality assessment of itself and its industry when selecting KPIs. The purpose of SPTs is to show progress beyond business as usual and SPTs should not be lower than applicable regulatory requirements or publicly announced targets. SPTs should therefore be set annually and remain ambitious throughout the life of the loan. Furthermore, the updated principles show an increased focus on transparent reporting and public accountability as protection against greenwashing. In particular, there should be annual reporting against SPTs.

To improve efficiency and to promote the consistency of sustainability-linked loan terms, the LMA published draft provisions for sustainability-linked loans in May 2023 (the SLL Draft Provisions). The intention of the SLL Draft Provisions is to provide a common starting point and options for market participants to consider. The key components of the SLL Draft Provisions include:

1. environmental, social and governance metrics;

2. sustainability margin adjustments;
3. repeating representations;
4. annual reporting;
5. external reviews of KPI performance;
6. sustainability amendments;
7. declassification; and
8. sustainability breach, sustainability coordinator and agency provisions.

In particular, the draft provisions provide a framework for documenting the agreed KPIs, SPTs, and associated calculation and benchmarking methodologies and standards. There are numerous options, blanks and footnotes to provide flexibility as there is no consistent market view.

To address the uncertainty over the different types of external review (including related terminology) relating to green, social and sustainability-linked loans, the APLMA, LMA and LSTA issued the second edition of Guidance for Green, Social, and Sustainability-Linked Loans External Reviews in January 2024. The guidance (which is voluntary in nature) provides clarity on:

1. the types of external review (i.e., second-party opinion, verification, scoring or rating);
2. the professional and ethical standards for external reviewers;
3. the organisation of external reviewers; and
4. the expected content and disclosure of external reviews.

The guidance closely follows the ICMA's 2022 Guidelines for Green, Social, Sustainability and Sustainability-Linked Bonds External Reviews to ensure consistency across the bond and loan markets.

Green Classification Framework for Hong Kong

The HKMA is planning on introducing a local green taxonomy and published a discussion paper on the 'Prototype of a Green Classification Framework for Hong Kong' in May 2023. A green taxonomy provides a standardised framework for categorising financial products and investments based on their sustainability. The introduction of a local taxonomy will help investors to identify appropriate financial products and investments based on their sustainability goals, help issuers to gain credibility and legitimacy, and help regulators to better navigate and measure sustainability performance. In particular, the discussion paper stipulates that a taxonomy will attract international climate-oriented capital, support and standardise data disclosure, measure climate-related risks and support climate goals. The HKMA hopes that this scheme will help Hong Kong to achieve its goal of carbon neutrality before 2050.

Amendments to statutory interest rate cap

The MLO was amended on 30 December 2022 to introduce new statutory interest rate caps.

It is illegal for any person (whether a licensed money lender under the MLO or not) to lend, or to offer to lend, money at any effective rate of interest that exceeds 48 per cent per annum. This represents a 12 per cent per annum reduction from the previous threshold of 60 per cent per annum. Any agreement to repay any loan, pay any interest or grant any security in respect of such an agreement or loan shall be unenforceable if the effective rate of interest exceeds such a rate.

The MLO gives Hong Kong courts a statutory basis to, having regard to all circumstances, reopen transactions that are considered extortionate. The threshold of an extortionate interest rate was reduced from 48 per cent to 36 per cent per annum.

Property mortgage loans

In light of the decline in property prices in Hong Kong and the uncertainties in the economic outlook abroad and domestically, the HKMA announced the following countercyclical macroprudential measures to adjust the loan-to-value (LTV) ratios for property mortgage loans in Hong Kong with effect from 28 February 2024.

Type of property	Maximum LTV ratio before adjustment	Maximum LTV ratio after adjustment
Residential properties for self - occupation	70 per cent for properties valued at HK\$15 million or below 60 per cent for properties valued above HK\$15 million and up to HK\$30 million 50 per cent for properties valued above HK\$30 million	70 per cent for properties valued at HK\$30 million or below 60 per cent to 70 per cent (adjusted downward gradually) for properties valued above HK\$30 million and below HK\$35 million 60 per cent for properties valued at HK\$35 million or above
Residential properties not for self - occupation	50 per cent irrespective of property price	60 per cent irrespective of property price
Non - residential properties (including offices, retail shops and industrial buildings)	60 per cent irrespective of property price	70 per cent irrespective of property price

The HKMA also adjusted the maximum LTV ratio for mortgage loans based on the net worth of mortgage applicants (with respect to residential and non-residential properties) from 50 per cent to 60 per cent. In light of the property market situation, the HKMA also raised the financing caps back to pre-2017 levels as follows:

1. the financing cap for the expected value of completed properties was increased from 50 per cent to 60 per cent;
2. the financing cap for the value of the property site was increased from 40 per cent to 50 per cent; and
3. the financing cap for the construction cost of the property was increased from 80 per cent to 100 per cent.

Outlook and conclusions

Interest rates remain high amid uncertainties regarding inflation. Hong Kong borrowers are turning to borrowing in offshore renminbi rather than Hong Kong dollars or US dollars to reduce the cost of borrowing. The sentiment for market recovery remains cautious but hopeful, as lenders are optimistic that M&A financing will pick up in 2024 if interest rates stabilise and valuation gaps in potential acquisitions narrow.

Borrowers and lenders alike will need to pay increased attention to geopolitical tensions. Geopolitical developments (such as the Russia–Ukraine war, the Israel– Hamas war and the relationship between China and the United States) have a fundamental impact on economic outlook, risk appetite and investment policies.

There is significant appetite for investment in sustainability, and there is continued focus on the promotion of green and sustainable banking. With the introduction of standardised draft provisions for sustainability-linked loan provisions and the publication of updated principles and guidance, market participants have more tools than ever to develop and build their sustainability-linked loan strategies and documentation.

Endnotes

- 1 Chapter 155 of the Laws of Hong Kong. [^ Back to section](#)
- 2 Chapter 112 of the Laws of Hong Kong. [^ Back to section](#)
- 3 Chapter 219 of the Laws of Hong Kong. [^ Back to section](#)
- 4 Chapter 622 of the Laws of Hong Kong. [^ Back to section](#)
- 5 Moulin Global Eyecare Holdings [2010] 1 HKC 90. [^ Back to section](#)

- 6 R (on the application of Mercury Tax Group and another) v. Revenue and Customs Commissioners and others [2008] EWHC 2721 (Admin). [^ Back to section](#)
- 7 Chapter 163 of the Laws of Hong Kong. [^ Back to section](#)
- 8 Chapter 155L of the Laws of Hong Kong. [^ Back to section](#)
- 9 Chapter 628 of the Laws of Hong Kong. [^ Back to section](#)
- 10 Chapter 628B of the Laws of Hong Kong. [^ Back to section](#)
- 11 Chapter 615 of the Laws of Hong Kong. [^ Back to section](#)
- 12 Chapter 575 of the Laws of Hong Kong. [^ Back to section](#)
- 13 'APLMA Survey on LIBOR Transition', published in April 2023. [^ Back to section](#)
- 14 Chapter 628C of the Laws of Hong Kong. [^ Back to section](#)

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