



HONG KONG MONETARY AUTHORITY
香港金融管理局

Banking Policy Department

Our Ref: B1/15C
CB/POL/4/5

23 July 2020

The Chief Executive
All Authorized Institutions

Dear Sir/Madam,

The Basel Framework: FAQs on benchmark rate reforms

Among recent developments on benchmark rate reforms¹, the Basel Committee on Banking Supervision (“BCBS”) published on 5 June 2020 the answers to a number of frequently asked questions (“FAQs”)² about the prudential issues relating to the reforms. The following provides guidance for AIs with regard to these issues which include the definition of capital, market risk, counterparty credit risk, liquidity and operational risk.

1) Definition of capital

Regarding the question on whether amendments to the contractual terms of capital instruments would potentially trigger a reassessment of their eligibility as regulatory capital, the HKMA adopts an approach that is in line with the BCBS clarification. Where a capital instrument is amended solely for the purpose of implementing benchmark rate reforms, this will not result in the instrument being assessed anew on whether it meets the minimum maturity and call date requirements under Schedules 4B and 4C of the Banking (Capital) Rules (“BCR”). Nor will this affect the instrument’s eligibility as an extant capital instrument for the purposes of the transitional arrangements specified in section 5 of Schedule 4H to the BCR.

¹ Please refer to Annex 2 (<https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2020/20200710e1a2.pdf>) of a previous HKMA circular on the reform of interest rate benchmarks issued to all AIs on 10 July 2020 (<https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2020/20200710e1.pdf>) for further information on recent key developments.

² <https://www.bis.org/bcbs/publ/d503.pdf>

2) Market risk (revised framework)

a) Count of real price observations for the risk factor eligibility test (“RFET”)

Under the revised market risk internal models approach (“IMA”), only risk factors with sufficient market liquidity are eligible for modelling. New benchmark rates may initially not meet this requirement due to a lack of historical price observations.

To address this, the HKMA allows AIs, in conducting the real price observation test for a new benchmark rate, to count both: (i) real price observations of the old benchmark rate from before its discontinuation³; and (ii) those of the new benchmark rate, until one year after the discontinuation of the old benchmark rate.

b) Calculation of expected shortfall (“ES”)

In calculating the capital requirements under the revised IMA, AIs can use the historical data for a subset of the risk factors (the “reduced set”) in their model to calculate market risk during a historical stressed period. The ES measure using the reduced set of risk factors calibrated to a period of stress is then scaled up by the ratio of the internal model ES result for the full set of risk factors to that for the reduced set of risk factors based on current market conditions. The reduced set of risk factors must cover at least 75% of the risks of the trading portfolio, therefore, it may need to include benchmark rates.

Consistent with the clarification provided by the BCBS, if the new benchmark rate is eligible for modelling but was not available during the stressed period, the HKMA allows AIs to use:

- (i) for the current period, the new benchmark rate in the full set of risk factors ($ES_{F,C}$) and in the reduced set of risk factors ($ES_{R,C}$); and
- (ii) for the stressed period, the old benchmark rate in the reduced set of risk factors ($ES_{R,S}$).

This interpretation, however, does not annul the specification in MAR33.5(2) of the BCBS’s consolidated framework that the reduced set is subject to supervisory approval and the data quality requirements.

³ In this context, discontinuation includes cessation of the old benchmark rate or an event whereby the old benchmark rate is deemed by its regulator to no longer be representative of the underlying market.

3) Counterparty credit risk

For the purposes of sections 226BZE(4), (5) and (6) under the SA-CCR approach of the future version⁴ of the BCR and sections 226M(3), (6) and (7) under the IMM(CCR) approach of the current and future versions of the BCR, AIs may, during the one-year period starting from the date of discontinuation of an old benchmark rate, disregard any transitional illiquidity of collateral and OTC derivative transactions that reference the relevant new benchmark rate when determining whether the collateral is illiquid collateral and whether the OTC derivative transactions cannot be easily replaced.

4) Liquidity

When a type of instrument that references an old benchmark rate and has historically qualified as high quality liquid assets (“HQLA”) under the Liquidity Coverage Ratio is being replaced with an equivalent type of instrument that references a new benchmark rate, AIs could take into account anticipated increases in the market liquidity of the replacement instrument when determining whether it qualifies as HQLA.⁵

5) Operational risk (revised framework)

On the implementation of the revised operational risk framework under the 2017 BCBS final Basel III reform package, the FAQs provide a few clarifications related to the reform of benchmark reference rates and other technical issues which the HKMA intends to adopt when implementing the framework locally. In relation to the reform of benchmark reference rates, it is clarified that operational losses resulting from such reform do not fulfil the criteria for exclusion from the operational risk charge based on OPE25.30 of the BCBS’s consolidated framework, while certain associated legal or IT costs may not represent operational risk losses. To minimise the risk of operational risk losses, AIs should consider the effects of the benchmark rate reform on their businesses in a timely manner and make the necessary preparations for the transition to the alternative rates.

⁴ This refers to the version of the BCR as amended by the Banking (Capital) (Amendment) Rules 2020.

⁵ In particular, when assessing the replacement instrument against the relevant HQLA’s qualifying criteria and characteristic requirements set out in Schedules 2 and 3 to the Banking (Liquidity) Rules (e.g. whether the instrument is traded in large, deep and active market, having low pricing spreads, etc.), category 1 institutions could also take into account the market data of an equivalent type of instrument referencing to the old benchmark rate for assessment of the anticipated increases in the market liquidity of the replacement instrument.

If you have any queries about this letter, please approach your usual supervisory contact.

Yours faithfully,

Daryl Ho
Executive Director (Banking Policy)

cc: The Chairperson, The Hong Kong Association of Banks
The Chairperson, The DTC Association
FSTB (Attn: Ms Eureka Cheung)