

Update on LIBOR Reform: HKMA Circular

March 2019

On 5 March 2019, the Hong Kong Monetary Authority (HKMA) issued a [Circular](#) to banks in Hong Kong to request authorised institutions (AIs) to make preparations for the LIBOR transition. This client update explores the preparatory work the HKMA recommended and suggests actions to be taken by AIs in Hong Kong.

In 2017, the UK Financial Conduct Authority (FCA) announced that banks will no longer be compelled to submit LIBOR data after 2021. Banks are required to transit away from LIBOR to alternative risk-free rates (ARRs) in response to the interest rate benchmark reform initiated by the Financial Stability Board (FSB).

The HKMA stated its concerns about the impact the reform will have on AIs and encouraged AIs to make preparations for the transition to ARRs. The HKMA suggests that these preparations cover the following elements:

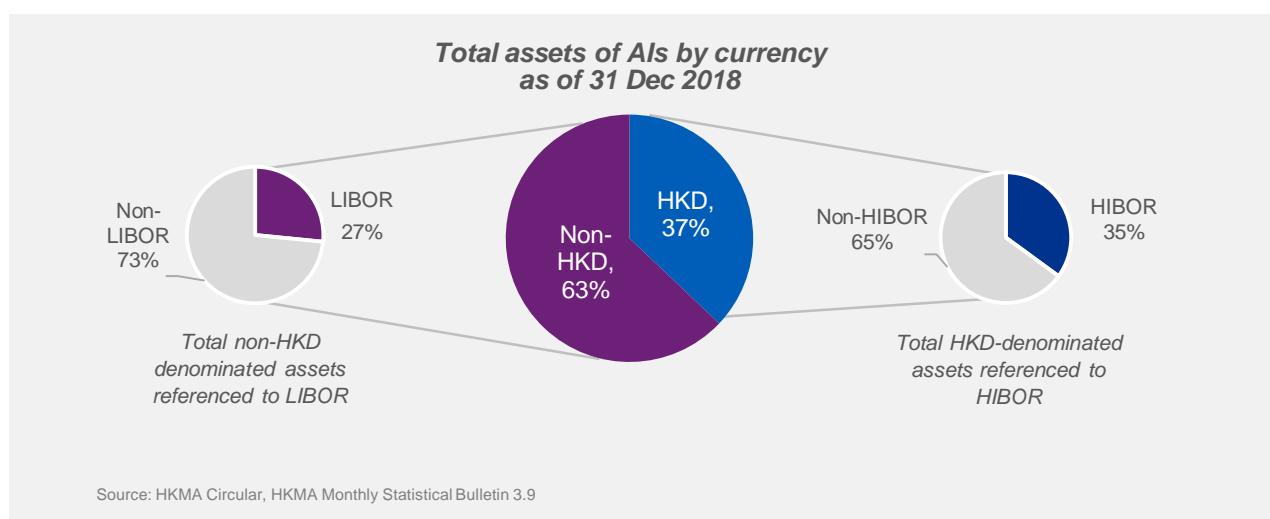
- Regular quantification and monitoring of affected exposures
- Identification and evaluation of key risks arising from the reform under different scenarios (including, but not limited to, a LIBOR discontinuation scenario)
- Formulation of an action plan to prudently manage the identified risks
- Close monitoring of benchmark reform developments both in Hong Kong and internationally and updating scenarios and action plans as appropriate



How about HIBOR transition?

- The HKMA said that it has no plan to discontinue HIBOR.
- The Treasury Markets Association (TMA) has proposed adopting the Hong Kong Dollar Overnight Index Average (HONIA) as the ARR.
- TMA plans to consult industry stakeholders in early 2019.
- Nevertheless, banks should take advantage of LIBOR transition to identify contracts that make references to HIBOR and their fall back clauses to better prepare for any future possible change in HIBOR.

The HKMA also released estimates of AI USD assets referenced to LIBOR at HKD 3.8 trillion and HKD assets referenced to HIBOR at HKD 3.4 trillion. The following chart shows the estimates of portions of HIBOR and LIBOR exposures compared to total assets of AIs in Hong Kong:



How should banks prepare for the change?

Key element	Transition Preparation
 Quantification and Monitoring	<ul style="list-style-type: none"> Institutions should conduct a comprehensive review of all documentation of financial instruments where LIBOR is directly and indirectly referenced (e.g., for valuation purposes). A wide range of financial instruments are impacted, including over the counter (OTC) derivatives, exchange-traded derivatives, repo and financing transactions, securitized products, loans, deposits, bonds and mortgages. Identification and quantification of LIBOR-based contracts should include key parameters for follow up and monitoring, including the number of contracts, amount of exposures, remaining maturity, counterparty risk, etc. Once the exposures impacted by the decommission of LIBOR are quantified, institutions should closely monitor the status of the transition to incorporate ARRIs into their contracts.
 Risk Identification and Evaluation	<p>The most significant risk arising from the LIBOR transition resides with legacy positions that will not expire before 2021. The key risks identified are:</p> <ul style="list-style-type: none"> Operations and Technology <ul style="list-style-type: none"> A wide range of systems may be significantly impacted, such as trade repositories, middleware solutions, market data providers and pricing platforms. Change is required for multiple valuation and risk systems with LIBOR references. Contracting <ul style="list-style-type: none"> Existing fallback language generally covers only temporary LIBOR outages but not a permanent discontinuation. Locating, gathering and identifying all related documentation and direct/indirect references to LIBOR, fallback clauses, etc. is onerous. Finance and Tax <ul style="list-style-type: none"> Change is needed on Day 1 balance sheet, fair value measurement and levelling. Accounting standards and hedge effectiveness tests will need to be changed. Potential impact from tax acceleration. Client Outreach <ul style="list-style-type: none"> Mobilizing impact assessment and raising client awareness. Risk that some of the clients might not want to consent to changes in existing contracts. Communication should not be limited just to clients but other market participants such as exchanges, clearing houses, regulators, product vendors, market data providers and others. Risk Management <ul style="list-style-type: none"> Change is needed for multiple valuation and risk systems and models, such as credit adjustments and term structure updates owing to the adoption of new ARRIs, that will need to be integrated into models and systems. There may be a need to make provision for parallel pricing using LIBOR and ARRIs, with adjustments.

How should banks prepare for the change? (continued)

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 Action Plan	<p>Transitioning away from LIBOR will have far reaching impacts for each impacted organisation. Therefore, firms should ensure that all impacted areas are involved in key work streams and activities guided and supported by a firm-wide Steering Committee.</p> <p>Firm-wide LIBOR Steering Committee</p> <table border="1" data-bbox="377 460 1362 595"> <tr> <td>Legal</td> <td>Tax</td> <td>Compliance</td> <td>Finance</td> <td>Technology</td> <td>Operations</td> </tr> <tr> <td>LOB Sales & Trading</td> <td>Product Control</td> <td>ORM / ERM</td> <td>Risk management</td> <td>Treasury</td> <td>Collateral / Margin</td> </tr> </table> <p>Key Workstreams</p> <table border="1" data-bbox="377 662 1362 1134"> <tr> <td>Program and Change Management</td> <td>Organise the firm by providing leadership and commitment to the transition project and oversee the work throughout the life of project.</td> </tr> <tr> <td>Products / Contracts</td> <td>Collect and analyse products and contracts that are directly or indirectly related to LIBOR and identify an approach for the use of ARR for each product type.</td> </tr> <tr> <td>Client Outreach and Education</td> <td>Assess the impact to existing clients and related business units, such as Legal or Treasury.</td> </tr> <tr> <td>Alternative Rate Adoption</td> <td>Assess the implications of the new rates across different business units, such as Risk Management, Finance, Treasury and others.</td> </tr> <tr> <td>Post Transition Activities</td> <td>Update books and records to reflect the impact of the new rates and perform post transition valuations across the organization.</td> </tr> </table>						Legal	Tax	Compliance	Finance	Technology	Operations	LOB Sales & Trading	Product Control	ORM / ERM	Risk management	Treasury	Collateral / Margin	Program and Change Management	Organise the firm by providing leadership and commitment to the transition project and oversee the work throughout the life of project.	Products / Contracts	Collect and analyse products and contracts that are directly or indirectly related to LIBOR and identify an approach for the use of ARR for each product type.	Client Outreach and Education	Assess the impact to existing clients and related business units, such as Legal or Treasury.	Alternative Rate Adoption	Assess the implications of the new rates across different business units, such as Risk Management, Finance, Treasury and others.	Post Transition Activities	Update books and records to reflect the impact of the new rates and perform post transition valuations across the organization.
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 Monitoring of Benchmark Reform Development	<p>Several regulators have set up working groups that are developing ARR or reforming national IBORs. The chart below provides an overview of the key jurisdictions where institutions should establish processes to monitor developments:</p> <div style="display: flex; justify-content: space-around; align-items: center;"> US UK HK Singapore </div> <table border="1" data-bbox="341 1538 1405 2122"> <thead> <tr> <th>ARRs</th> <th>SOFR</th> <th>SONIA</th> <th>TBD</th> <th>TBD</th> </tr> </thead> <tbody> <tr> <td>Working Group</td> <td>Alternative Reference Rate Committee (RFRC)</td> <td>Working Group on Sterling Risk-Free Rates (WGSRFR)</td> <td>Treasury Markets Association (TMA)</td> <td>ABS Benchmarks Administration (ABS) and Singapore Foreign Exchange Market Committee (SFEMC)</td> </tr> <tr> <td>Current Status</td> <td>RFRC consultation on fall back language for bilateral business loans issued in Dec'18.</td> <td>WGSRFR agreed to set up priority task forces for SONIA in Feb'19.</td> <td>TMA proposed adopting HONIA as RFR and will issue a consultation paper in 2019.</td> <td>Enhanced methodology for SIBOR proposed to be implemented in 2H 2019. ABS and SFEMC will continue to explore the ARR.</td> </tr> </tbody> </table>						ARRs	SOFR	SONIA	TBD	TBD	Working Group	Alternative Reference Rate Committee (RFRC)	Working Group on Sterling Risk-Free Rates (WGSRFR)	Treasury Markets Association (TMA)	ABS Benchmarks Administration (ABS) and Singapore Foreign Exchange Market Committee (SFEMC)	Current Status	RFRC consultation on fall back language for bilateral business loans issued in Dec'18.	WGSRFR agreed to set up priority task forces for SONIA in Feb'19.	TMA proposed adopting HONIA as RFR and will issue a consultation paper in 2019.	Enhanced methodology for SIBOR proposed to be implemented in 2H 2019. ABS and SFEMC will continue to explore the ARR.							
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What are the key challenges for banks?

Significant scale to the transition

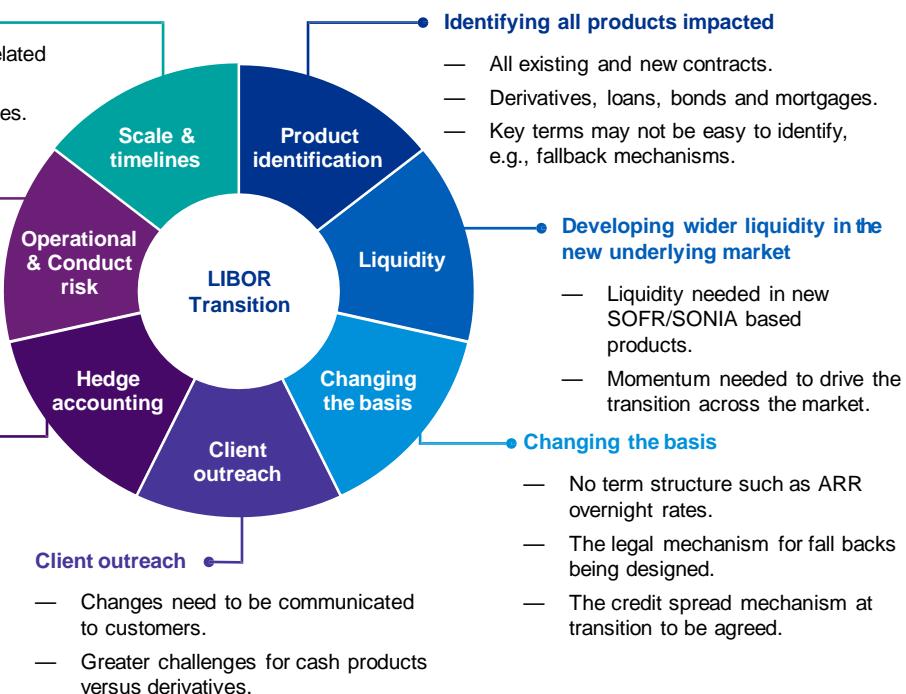
- Impacts all clients participating in LIBOR related contracts.
- US/UK/Euro likely to have different timelines.
- Detailed transition timeline needed.

Operational and conduct risk

- Introduces conduct risks with the application of changes in benchmark and spreads.
- Large scale changes in legal documentation, models and curves introduces significant operational risk.

Hedge accounting impact

- Expected to impact forecast transactions.
- Hedge effectiveness tests need to be changed in accounting standards.



How can KPMG support you?

In order to assess the potential impact of the phase-out of LIBOR and mobilise a transition program, KPMG can assist institutions across the spectrum of preparatory activities.



Establish Program Governance

- Provide program management templates and functional ARR activities and budget forecast templates developed by KPMG to enable banks to closely monitor the status of projects.
- Develop an Initiation Phase plan to outline key activities, high level timeline and responsible functional areas.



Perform Financial Contract Assessment

- Define an approach to scope the population of agreements impacted based on products and business lines.
- Provide an AI-enabled solution (**KPMG Ignite Financial Contract Assessment Solution**) that allows institutions to adopt automated processing engines to read and assess LIBOR-related contracts and agreements; trace rate reset and determination mechanisms across related documents; and test and validate contract changes at scale.
- Develop dashboards to track financial contracts based on product, tenor, and notional or risk exposure.



Perform System Impact Assessment

- Identify the systems impacted by the LIBOR transition.
- Provide risk prioritization templates and prioritise all impacted systems on a risk-based approach.



Define Exposure Analysis Approach

- Define an approach to scope the population of LIBOR exposures for each division based on the institution's infrastructure and products.
- Conduct workshops for key stakeholders to support decision-making.

Contact us



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