Update on LIBOR Reform:
- HKMA Circular
- FMSB Publication

July 2020

On 10 July 2020, the Hong Kong Monetary Authority (HKMA) issued a Circular to update authorised institutions (AIs) on the latest survey result on Reform of Interest Rate Benchmarks and the key milestones that AIs should endeavour to achieve in the transition to alternative risk-free rates (ARRs). This client update explores the preparatory work the HKMA recommended and suggests actions to be taken by AIs in Hong Kong.

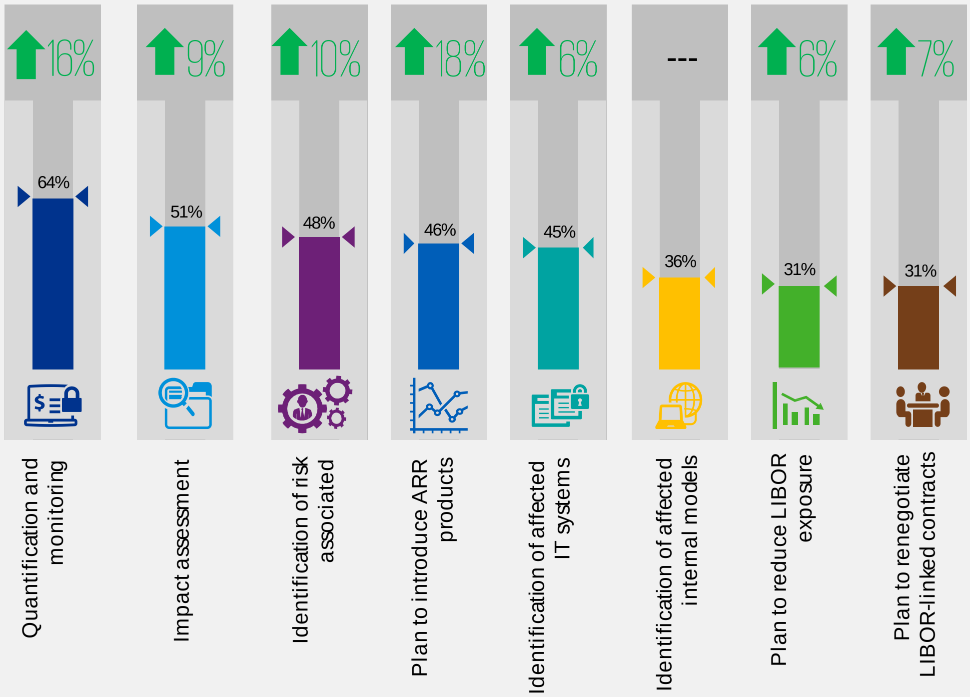
Results of the HKMA Survey on Benchmarks Reform

Key element	Results of the HKMA Survey
Increase in LIBOR-linked Exposures	• As of end-March 2020, there is an increasing amount of total LIBOR Exposure, in which over 35% of the LIBOR-linked Assets, Liabilities and Derivatives will mature after end-2021 without adequate fall-back. • The LIBOR-linked Assets, Liabilities and Derivatives with maturity date after end-2021 and without adequate fall-back have increased for 4%, 11%, and 50% respectively from end-September 2019 to end-March 2020.

As at end-March 2020	Assets	Liabilities	Derivatives
Total Amount of LIBOR Exposure	HK$4.8 trillion	HK$1.6 trillion	HK$34.7 trillion
Amount of LIBOR Exposure with Maturity Date after end-2021 and Without Adequate Fall-back	HK$1.7 trillion	HK$0.6 trillion	HK$17.4 trillion
% of LIBOR Exposure with Maturity Date After end-2021 and Without Adequate Fall-back	35%	39%	50%

Results of the HKMA Survey on Benchmarks Reform

Key element	Results of the HKMA Survey
Increase in Readiness of Transition Plan	The survey finds that the majority of banks have established a steering committee or appointed a senior executive for overseeing the preparation. Furthermore, banks are also making progress in the development of a bank-wide transition plan, with the following areas with most progress made. The following diagrams show the proportion of AIs having the component in place:



Release of the HKMA's Expected Timeline

The HKMA has developed several LIBOR transition milestones in which AIs are expected to achieve. The transition milestones include offering products that are referencing the ARRs, incorporating adequate fallback provision for all newly issued LIBOR-linked contracts, and casing issuance of new LIBOR-linked products with maturity after 2021. The following are the expected timeline proposed by different regulatory bodies and working groups:

	HK	US	UK
Offer products referencing the ARRs	Q1 2021	Not specified	Q3 2020
Adequate fall-back provisions for newly issued LIBOR contracts	Q1 2021	30 June - 30 September 2020 across different products	Q3 2020
Cessation of new LIBOR-linked products	Q3 2021	30 September 2020 - 30 September 2021 across different products	Q1 2021
Readiness of technologies and operations	Q1 2021*	30 June - 31 December 2020 across different products	Q3 2020

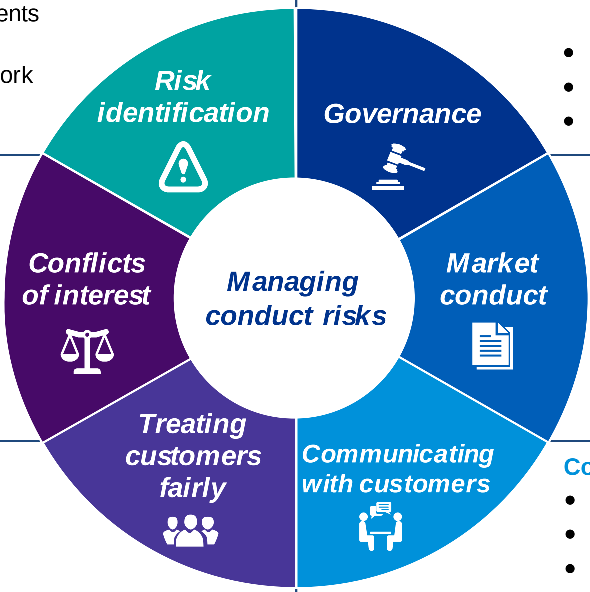
** The HKMA expects AIs should be in a position to offer products referencing the ARRs to LIBOR, and we expect banks to have technologies and operations ready by this time*

Managing Conduct Risk Throughout the Transition

In June 2020, the FICC Markets Standard Board (FMSB) issued a Spotlight review on LIBOR transition focusing on discussions around conduct risks. Six focus areas are identified in managing risks to the fairness and effectiveness of markets during the transition.

Risk identification
- Identifying and managing risks
- Conducting impact assessments
- Considering sufficiency of existing conduct risk framework

Governance
- Board level understanding of risks
- Robustness of governance arrangements
- Record keeping
- System changes
- Product governance



Conflicts of interest
- Identify conflicts of interest
- Mitigate conflicts of interest
- Benchmark performance

Market conduct
- Acknowledging a range of potential risks
- Contributing to benchmarks

Treating customers fairly
- Fallbacks
- Replacement rates
- LIBOR-RFR spread
- Firms investing on behalf of customers
- Customer needs

Communicating with customers
- Ensuring timely disclosures
- Comprehensive disclosures
- Discussing product options
- Internal and external communication strategies
- Objective overview of alternative products

What should be included in communications with clients?

To promote effective communication with customers, FMSB also provides good practice observations on what banks should include in their client communications throughout the LIBOR transition process.

Background information on LIBOR transition

Understanding of client needs and situation

Product options and an objective overview on related pros and cons of different product options

Suggesting the client to consider advice from independent professional advisers

Explaining adjustment on lending margin

Potential Conduct Risk Scenarios

The FMSB Spotlight review also includes case studies, focusing on areas of uncertainty that are of particular concern to market participants. The following summaries the different scenarios highlighted by the FMSB as areas where there is potential conduct risk.

Highlights on Case Studies Scenarios

Corporate Customer A

A customer is seeking five-year financing, and the Bank offers products with different possible terms, including referencing ARR, LIBOR (with appropriate fallback provisions) and fixed rate.

Corporate Customer B

A customer wants to seek finance and simultaneously enter into an interest rate swap to lock in the interest payments, and the Bank offers ARR-based interest rate swap.

Corporate Customer C

Following scenario B, the customer seeks to hedge the cross-currency exposure on her loan investments in foreign currency. The Bank offers cross-currency swap options with reference on ARR in the receive leg, and LIBOR in the pay leg of the swap.

Fund Manager

A fund manager is seeking to change the LIBOR benchmark to ARR-based rate on a number of fixed income funds and alternative strategies with different characteristic that use LIBOR-linked benchmarks or performance targets.

Key considerations for conduct risks

The above case study scenarios suggested by the FMSB give concrete examples arising from LIBOR transition for banks and fund managers, and the following tables summarize the key areas where the FMSB has highlighted potential conduct risks:

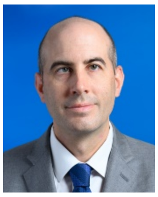
Banks

Consideration	Applicable scenario
Customer may not be aware that forward-looking term ARR rate would become available. The customer may be better off in terms of cashflow forecasting and liquidity management.	Cust A, Cust B, Cust C
Customer may not be aware of the spread of LIBOR over ARR and the fact that it could narrow going forward. The customer may have the impression that he/she would have been better served if the Bank extends the LIBOR until the end of 2020.	Cust A, Cust B, Cust C
Customer may accuse the Bank of not fully explaining and/or managing the basis risk arising from the disconnect between the lookback period and the interest period.	Cust A, Cust B, Cust C
Although the transaction cost is likely to be mitigated by the standard ISDA protocol, the customer may not be aware of the need for a change in the LIBOR leg once liquidity has developed further, resulting in additional operational burden for the customer.	Cust C

Fund Managers

- Investors may be concerned if the spread of LIBOR over ARR narrows, impacting resultant analysis of fund performance and having implications on underlying portfolio investments.
- Investors may not be aware of the impacts to performance fee charged to them and accuse the fund manager of negligence.
- Investors may perceive that the timing of the transition of the performance benchmark unfairly advantaged the fund manager

Contact us



Tom Jenkins
Partner, Head of Financial Risk Management
KPMG China
T: +852 2143 8570
E: tom.jenkins@kpmg.com

Michael Monteforte
Partner, Financial Risk Management
KPMG China
T: +852 2847 5012
E: michael.monteforte@kpmg.com

Gemini Yang
Director, Financial Risk Management
KPMG China
T: +852 3927 5731
E: gemini.yang@kpmg.com

Connie Kang
Associate Director,
Financial Risk Management
KPMG China
T: +852 3927 4619
E: cs.kang@kpmg.com

Desmond Yu
Associate Director,
Financial Risk Management
KPMG China
T: +852 2913 2591
E: desmond.yu@kpmg.com

kpmg.com/cn