Howard Lee: Benchmark regulation and migration

Closing keynote by Mr Howard Lee, Deputy Chief Executive of the Hong Kong Monetary Authority, at the Bloomberg-ISDA Benchmark Conference "Benchmark Regulation and Migration", Hong Kong, 30 May 2019.

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Taran [Khera], ladies and gentlemen,

1. First of all, I would like to thank Bloomberg and ISDA for organising this Benchmark Conference and for gathering so many speakers and participants to exchange views on the important subject of benchmark reform. The subject of benchmark reform is always very close to my heart, as I have been involved in the review of interest rate benchmarks both in Hong Kong and in the context of the Financial Stability Board's Official Sector Steering Group (FSB OSSG) deliberations for many years.

LIBOR discontinuation: A turning point

2. If we look back to 2013 when the OSSG started to operate, there was a general agreement that given the changes in the interbank market, the interbank offer rates, or IBORs in short must be reformed. But given the long history of IBORs and the huge value of financial contracts referencing them, moving to new IBORs with fundamentally different determination methodologies, or switching to alternative reference rates is a very complex task, as we heard from many speakers just now. Understandably market participants generally took a 'wait-and-see' approach when dealing with benchmark transition issues. But now – with a growing recognition that LIBOR may discontinue after end-2021 – the situation is changing. This is an important wake-up call for the financial market, and market participants are spending a lot more efforts on the transition issues, with the support of ISDA and other industry bodies.
3. But, with this growing momentum, are we all geared up? I would reply with a simple 'no'. Clearly, much more remains to be done.

Transition: A challenging process even for the deep USD market

4. Among all the IBORs, USD LIBOR is the most widely used benchmark in the global market. And the US authorities have been proactively engaging with the industry in promoting the use of Secured Overnight Financing Rate (SOFR) as an alternative.
5. Since the launch of SOFR in April 2018, the trading volume of interest rate derivatives (IRD) referencing SOFR has been growing, but it remains relatively small. According to ISDA's Interest Rate Benchmarks Review, the total traded notional volumes of IRD referencing SOFR was US$22.6 billion in Q1 2019. This was less than 0.1% of those referencing USD LIBOR, which totalled US$34.8 trillion.
6. So, even for the USD market, which is the deepest and most liquid market in the world, the build-up of transactions based on an alternative risk-free rate could take some time. For other IBORs, this could be an even longer and more challenging process.

Transition: A multi-dimension challenge

Wide-ranging impact arising from the transition

7. As many speakers have pointed out, transitioning to alternative reference rates is a complex multi-dimension task. It will have potential profit and loss, tax and accounting implications on market participants. Migration of legacy contracts and adoption of new documentation involving hundreds of thousands of clients would be another complex exercise. All these

issues will cut across different segments of the financial market, from derivatives, to bonds, to loans and many others. The implications may also vary greatly across different jurisdictions given the different market structure and legal environment. Therefore, industry associations such as ISDA have an important role to play, in helping to address these wide-ranging issues with a global and industry-wide perspective.

Global banks should take the lead

8. Likewise, international banks, which have operations across many jurisdictions, will be better placed to help shape the path for transition for the banking sector. As we all know, IBORs are used in nearly every aspect of their business – from trading, to risk management, to pricing and valuation. Preparing for the transition means they need to develop the necessary operational and system capability for their global operations, probably dealing with multiple alternative reference rates at the same time. I can see this is a very onerous and resource-intensive process. But then, given the quantity and diversity of financial contracts on their book, and their presence and market knowledge in various jurisdictions, these global banks should be best equipped to take the lead in devising a comprehensive transition plan. After all, it is in their best interest to act early and get themselves ready for the transition given the scale of their business.

Smaller banks should not wait and see

9. The flip side of this argument is that smaller banks or non-banks would likely look to the global banks to act first. But I would caution against waiting until the last minute. Although there may still be uncertainties for the transition, all banks and corporations should keep updated of the latest development and understand what aspects of their business would be affected – this is a fundamental first step. Undertaking detailed risk assessment and formulating an action plan would be next. For now, some banks may hesitate to trade in products using the new alternative reference rates, as they want to see better market liquidity before they start. But this is a 'chicken and egg' scenario – if everyone plays a waiting game, the market will never be developed. More importantly, going into the market in a manageable scale would enable your people to learn the rope early before these trades become more main stream.

Client education is also important

10. While banks are gearing up their own preparation, the wide-spectrum of IBOR users is adding further complexity to the transition process. Switching to alternative reference rates is not something that can be done unilaterally. Banks need to work closely with their counterparties to develop the necessary fall-back arrangements.
11. It may be relatively easy to discuss the transition plans with counterparties that are also financial institutions, as everyone is more or less on the same page. But IBORs are also used by banks' different clients, both corporations and individuals. There is a big gap among these IBOR users on the awareness of the benchmark reform, so the situation becomes less straightforward.
12. Therefore, client education is another vital task. Banks should begin outreach to their clients, and educate them about the benchmark transition early. This could help to minimise misunderstanding and costly litigation in the future.

Raising market awareness in Hong Kong

13. Closer to home in Hong Kong, the Treasury Markets Association (TMA) has been working with bank representatives on benchmark reform for many years. More recently it has intensified its reach-out to other sectors. It has set up a Working Group to engage a wider spectrum of stakeholders including accountants, lawyers, bank customers and industry

associations like ISDA. It is important that different market participants understand what the transition will mean for their business operations and how they should prepare for these changes. The Working Group is now looking at issues like the implications on accounting and the transition of cash products. It will further engage stakeholders to explore means of encouraging the adoption of alternative reference rates in their day-to-day transactions and business activities.

14. At the same time, the HKMA supervisors has also been actively engaging banks. In March, we issued two circulars to all banks in Hong Kong. The first one reminded them to undertake risk assessment and make preparation for the necessary transition. The second one served to clarify that genuine amendments to existing derivatives contracts which are made to give effect to interest rate benchmark reform will not be considered new contracts from the perspective of the HKMA's margin requirements. This removes one of the uncertainties about the transition. For the time being, we have not specified a timeline for the banks to get ready their transition plan but we will approach them at a later stage to understand their progress and readiness for the transition.

HIBOR and HONIA

15. As financial institutions in Hong Kong are gathering pace in their preparation for the LIBOR transition, we are also making progress in identifying an alternative reference rate for HIBOR. We understand market participants are keen to have forward-looking term rates to mirror the structure of HIBOR. Therefore, the HKMA conducted a feasibility study of compiling HKD term rates based on actual wholesale funding transactions by major banks. But the results showed that while transaction-based wholesale term funding rates generally followed term HIBORs, they exhibited a high level of daily volatility, which made them an impractical substitute for term HIBORs.
16. More recently, TMA proposed adopting the Hong Kong Dollar Overnight Index Average (HONIA) as the alternative reference rate for HIBOR. Similar to many alternate reference rates chosen in other currency areas, HONIA is an overnight interbank funding rate. While lacking a term structure on its own, this reference rate is robust and based purely on transaction data.
17. In early May, TMA completed a consultation with the industry on several technical refinements to HONIA. This is part of its ongoing initiative to further enhance the robustness of its benchmarks. It is now reviewing the feedbacks received, and will consider how best to put in place the relevant enhancements.
18. When these enhancements are done, TMA will work with the industry to promote development and trading of HONIA-based financial products. Later on, it will also try to promote trading in the OIS market, and hopefully develop an OIS curve from HONIA. But this would have to depend on market conditions.
19. While HONIA serves as an alternative to HIBOR, there is currently no plan to discontinue HIBOR. HIBOR has been in place for many years and is still widely recognised by market participants as a credible and reliable benchmark. Similar to a few other jurisdictions in the region, Hong Kong will adopt a multiple-rate approach. In other words, HONIA and HIBOR will co-exist in the market and market participants are free to choose between them. Meanwhile, TMA will continue to strengthen HIBOR to ensure that it remains in compliance with international standards.
20. Of course, we are facing the irony that if HIBOR remains, market players may see little incentive to develop and trade HONIA-based products. However, I encourage all market participants to start exploring how to incorporate HONIA into their business. It may be true that HIBOR will last for some more time. But the transition to SOFR in the USD space could gradually lead to changes in market practices and conventions that may eventually shift market preference for interest rate benchmarks. Therefore, if more HONIA-based products can be introduced in the market going forward, it would help reduce any market impact in

case HIBOR has to discontinue one day owing to changes in market circumstances.

Closing

21. Ladies and gentlemen, as we have learned from speakers earlier this morning, interest rate benchmark reform is complex, but it is something too important for any market participant to ignore. When LIBOR ceases to exist, there will certainly be an impact on global financial markets. Some people may say end-2021 seems a long way off. But it's not, given the tremendous amount of preparatory work required to ensure a smooth transition. No one in the market can afford to play a waiting game. Let's all devote resources now, and work closely together on this important task.
22. Thank you.