

The Hong Kong Monetary Authority (HKMA)

Measures to strengthen the HIBOR fixing mechanism

Background

1 In light of international developments relating to benchmark fixing activities, the Hong Kong Association of Banks (HKAB) in July 2012 commissioned the Treasury Markets Association (TMA) to conduct a review of the fixing mechanism of HKAB's HKD Interest Settlement Rate (more commonly known as the Hong Kong Interbank Offered Rate, or HIBOR).

2 The TMA submitted the "Report on the Review of Hong Kong Interbank Offered Rate" to the HKAB and the HKMA on 26 November 2012, which proposed a five-pronged approach to improve the robustness of the HIBOR fixing mechanism by:

- (a) providing clear guidance for reference banks on rate submission;
- (b) developing a Code of Conduct covering both rate submission guidance and sound practices on systems of control for the fixing process for observance by reference banks;
- (c) enhancing the independence and governance of the HIBOR compilation process at the administrator level;
- (d) confining the scope of HIBOR fixing to tenors that have strong market demand; and
- (e) reviewing and enhancing provisions in contracts that reference HIBOR.

3 The HKAB, having separately appointed an independent consultancy firm to conduct industry consultation, submitted industry comments and additional suggestions to the HKMA in January 2013.

4 Internationally, the International Organization of Securities Commissions (IOSCO) issued a consultation paper on "Financial Benchmarks" while the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) jointly issued a consultation paper on "Principles for Benchmarks-Setting Processes in the EU". While the IOSCO notes that a one-size-fits-all approach may not be appropriate in the oversight of benchmark activities, it also notes that one of the "significant considerations" in deciding on the form and intensity of regulatory oversight is the economic impact of the benchmark in question.

5 After considering TMA's report and industry comments, the HKMA decided to take additional measures to strengthen the regulation of the HIBOR fixing mechanism on top of the recommendations made by the TMA and the HKAB.

Strengthening the regulatory oversight of HIBOR submission activities

6 Having considered international discussions on financial market benchmarks, in particular the analysis in the IOSCO consultation paper, the HKMA sees the need to add more weight to the Rate Submission Guidance and Code of Conduct to be developed by the TMA. To bring the stringency of regulatory oversight to a level commensurate with the importance of HIBOR, the HKMA would, in addition to endorsing the Rate Submission Guidance and Code of Conduct, issue a corresponding Guideline under Section 7 of the Banking Ordinance. Non-compliance with the Guideline could have serious consequence on the reference bank as well as its senior management. Specifically, breaches of the Guideline would call into question (i) the authorized institution's continued satisfaction of the minimum authorization criteria; and (ii) fitness and propriety of directors, shareholder controllers, and senior management of the authorized institution.

7 To avoid doubt and to ensure clear delineation of responsibilities among senior staff involved in the rate submission process, the HKMA will explicitly specify that Managers as defined under the Fourteenth Schedule of the Banking Ordinance who are responsible for treasury business, risk management, and compliance are accountable to the robustness of HIBOR submissions made by their bank. This supervisory approach would also address HKAB's suggestion to ensure strong management oversight of banks' rate submission activities.

Ensuring proper representation and continued participation in HIBOR fixing panels

8 The HKMA agrees with HKAB's proposal that the composition of the panel of reference banks should be reviewed every year instead of every two years. Once the current appointment term for reference banks ends in August 2014, the frequency of panel review will change from biennial to annual. In order to ensure appropriate representation on the reference bank panel, the HKMA will establish objective and fair criteria for identifying major players of the HKD interest rate markets. Major players so identified would be regarded as having a strong moral obligation to provide voluntary contributions for the common good of the industry. Amongst the factors to be considered in developing these criteria, the HKMA may make reference to banks' HKD assets, level of activities in relevant markets, as well as other relevant factors.

9 A concern raised in HKAB's submission is that banks may have less incentive to participate in the fixing as a result of the strengthened regulatory

oversight. The HKAB suggested that the HKMA should consider a mechanism to ensure sufficient representation of reference banks. The HKMA will continue to encourage banks' voluntary participation in the rate fixing process. However, the HKMA would also like to make clear that it is prepared to exercise appropriate powers under the Banking Ordinance to mandate submissions if there is a serious risk of withdrawal by contributing banks that may undermine the representativeness of HIBOR as a market benchmark, which could, in turn, prejudice the effective working of the banking system.

Enhancing independence of HIBOR administration process

10 The HKAB agrees that the administration of the fixing should be transferred to a more independent party such as the TMA. The HKMA accepts this proposal but requests that the following controls be installed to ensure the independence and diligence of the HIBOR administration process:

- (a) The HKMA supports the TMA proposal of establishing a Surveillance and Governance Committee (SGC). To ensure sufficient independence, SGC members should comprise a balanced representation of HIBOR stakeholders, including non-bank corporations and professional firms. SGC membership should be endorsed by the HKMA and subject to review regularly. The HKMA will unlikely endorse membership composition with reference banks representing the majority.
- (b) The HKAB emphasizes the importance of its ability, as the owner of HIBOR, "to conduct or require an independent review of the operations of the administrator". The HKMA supports this view and would take this further by requesting that the HKAB should obtain external assurance on the adequacy of administrator's systems of control in managing the fixings.

Forming a HIBOR Enhancement Implementation Joint Working Group

11 While the HKMA will forthwith implement the enhanced regulatory measures as set out in paragraphs 6-9, it would request the HKAB and the TMA to form a HIBOR Enhancement Implementation Joint Working Group to take forward the following enhancement measures as soon as possible:

- (a) transfer of the administrator function from the HKAB to the TMA;
- (b) establishment of the SGC for the fixing and development of the surveillance and monitoring framework;
- (c) development of the Rate Submission Guidance and Code of Conduct by the administrator;
- (d) finalising the transitional arrangement for phasing out those HIBOR fixings with little demand (i.e. 4-month, 5-month, 7-month, 8-month, 9-month, 10-month and 11-month). In this connection, the

HKMA accepts HKAB's suggestion to retain the 2-week HIBOR fixing, which is still being used by the market as pricing reference; and

- (e) development of an industry-wide action plan to review and revise provisions in existing contracts referencing HIBOR, with top priority given to HKD Forward Rate Agreement.

Longer term issues

12 In its submission, the HKAB made an observation regarding the need for ongoing review of the suitability of HIBOR and potential alternatives in light of relevant market developments. The HKMA is open-minded on this issue, noting that availability of alternatives to HIBOR is essentially market driven. The HKMA will ensure that any potential alternatives should be subject to similar governance and systems of control.

Way forward

13 The enhancement measures to the HIBOR fixing process introduced by the HKMA are a package of immediately actionable steps to strengthen the HIBOR fixing mechanism. The HKMA expects implementation of these measures in six months' time.