* Building Momentum

*Firms have had their hands full dealing with the market and economic fallout from the coronavirus pandemic, but it's critical that market participants escalate their efforts to prepare for the shift away from LIBOR, says **Howard Lee**, deputy chief executive at the Hong Kong Monetary Authority*

IQ: What was the Hong Kong Monetary Authority's (HKMA) approach to maintaining financial stability in response to the coronavirus pandemic?

Howard Lee (HL): Despite the recent volatility in the stock market, the Hong Kong dollar exchange rate has remained stable and on the strong side of the convertibility zone. Interest rates have stayed low. Financial markets have also been operating in a smooth and orderly manner. There has not been a noticeable sign of fund outflow from either the Hong Kong dollar or the banking system. In fact, the strong-side convertibility undertaking has been repeatedly triggered since April, leading to a net inflow of funds amounting to about HK$130 billion.

If the economic situation continues to deteriorate, Hong Kong banks may see a pick-up in insolvencies. Nonetheless, Hong Kong's banking system should be able to withstand potential shocks. Banks have a strong capital position (the capital adequacy ratio is currently at 20%), abundant liquidity (the liquidity ratio is at 160%), good asset quality (the classified loan ratio is at 0.6%), and a solid track record in operational resilience. The HKMA also conducts regular supervisory stress tests, and the latest results show the banking sector would remain resilient under extreme shocks to the economy and financial markets.

Given distress in the corporate sector, the HKMA has offered policy accommodation to enhance the ability of banks to support the real economy and ease the cashflow pressures faced by corporates and individuals. We have cut the countercyclical capital buffer ratio of banks twice since October last year, by a total of 1.5 percentage points, and clarified supervisory expectations on the use of liquidity buffers. We have also introduced a number of measures to increase overall liquidity in the banking system. Finally, we are in close dialogue with banks to encourage them to continue to provide credit – for example, via the banking sector small- and medium-sized enterprises (SME) lending coordination mechanism established in October

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eight rounds of housing macroprudential measures since 2009, and steadily increased the countercyclical capital buffer rate to 2.5% after its introduction in 2016. In addition, fiscal prudence and substantial FX reserves contributed to investors' strong confidence in Hong Kong's financial system.

The March episode has also shown that liquidity is paramount and policy support measures need to be speedy and adequate. Central banks around the world have taken swift and bold action to stabilise markets by offering funding facilities, security purchases and central bank swap lines. In Hong Kong, the HKMA also introduced a series of liquidity support measures, such as reducing the issuance size of exchange fund bills and setting up a US dollar liquidity facility to ensure the continued smooth operation of Hong Kong dollar markets. Without such action, the initial shock could have potentially led to a negative feedback loop between asset prices and liquidity that would have had disastrous consequences for the financial system.

IQ: Market participants reported a sudden drop in liquidity in March, even in relatively vanilla products. Was this a concern for the HKMA?

HL: Market liquidity tends to drop suddenly in extremely stressful periods, when market makers become risk-adverse and reluctant to provide quotes for financial products given the uncertainties. Nonetheless, we have not seen any significant change in the liquidity of the Hong Kong dollar interbank money and FX markets so far this year. In general, our markets have been functioning in a fairly smooth and orderly manner.

2019. A number of relief measures for corporate and retail customers have been rolled out, such as principal payment holidays for SMEs and residential mortgages, and a special 100% loan guarantee was launched under the SME financing guarantee scheme of the Hong Kong Mortgage Corporation, a subsidiary of the HKMA.

IQ: What lessons can be learned from the crisis, both in terms of the regulatory and market response?

HL: While the sell-off in March led to significant stress in financial markets, the banking sector has so far been able to absorb the shocks, as banks have more capital and liquidity than at the onset of the global financial crisis. In Hong Kong, financial markets have operated smoothly and the banking system has remained sound and stable. This underscores the importance of having strong buffers in the banking system and building them up during the up-cycle. For example, the HKMA has introduced

IQ: What impact will the coronavirus outbreak have on the initiative to transition from LIBOR and other interbank offered rates (IBORs) to risk-free rates (RFRs)?

HL: Over the past few months, industry efforts have focused on maintaining critical operations and managing cashflows. Under such circumstances, it is understandable that some industry participants might have temporarily readjusted their business priorities. However, as jurisdictions gradually relax restrictions and economies start to reopen, we expect the industry will regain momentum and continue its hard work in preparing for the transition from LIBOR.

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→ **IQ:** What should firms be doing now to prepare for a possible cessation of LIBOR after the end of 2021?

HL: Time is of the essence, and market participants should get operationally ready for transitioning from LIBOR to alternative reference rates. We would strongly encourage firms to take concrete action, and implement a robust transition programme to facilitate the adoption of RFRs as early as possible.

Given the scale and complexity of the task, it is important that market participants understand what the transition will mean for their business operations and undertake detailed risk assessments. As a starting point, firms should take stock of their LIBOR exposures and identify all contracts that reference LIBOR. This is critical, as the transition will likely impact various functions of the firm.

Furthermore, as part of their transition plan, firms should develop the necessary operational and system capability to support a smooth and timely transition. We would also encourage firms to proactively engage with their counterparties, and make sure that appropriate fallback provisions are in place in their LIBOR contracts.

IQ: How would you describe the level of readiness in Hong Kong? Are certain sectors more advanced in terms of LIBOR transition than others?

HL: It is encouraging to see that momentum in Hong Kong is growing. But like many other jurisdictions, there is still a gap in the level of readiness between banks and their clients (eg, corporates). Client education is therefore vital. Banks should step up outreach efforts and educate their clients about LIBOR transition early. This could help to minimise misunderstanding and costly litigation in the future.

IQ: What is the HKMA planning to do to encourage LIBOR transition? A recent survey by the HKMA identified taxation, accounting, regulatory and conduct risk issues as among the key challenges in preparing for transition. Does the HKMA plan to work with other regulators/agencies to address these issues?

HL: The HKMA has been working closely with the Treasury Markets Association's (TMA) Working Group on Alternative Reference Rates in raising market awareness of the accounting, tax and regulatory issues that may arise from the transition. To identify such issues, the working group has included representatives from the accounting and legal professions. So far, we have made progress in addressing some of the issues.

For example, the HKMA issued a circular to banks in March 2019, clarifying that genuine amendments to existing derivatives contracts that are made as a result of interest rate benchmark reform will not be considered new contracts from the perspective of the HKMA's margin requirements. This could help remove uncertainty in transitioning derivatives contracts from IBORs to RFRs.

The HKMA will continue to work with foreign regulators and relevant standard-setting bodies such as the Basel Committee on Banking Supervision to address the regulatory issues. Through the Financial Stability Board's (FSB) Official Sector Steering Group (OSSG), we will also provide input to the International Accounting Standards Board on necessary amendments to accounting standards. Finally, OSSG members including the HKMA are reaching out to tax authorities to alert them to the potential tax impact of the transition. We hope all these efforts will pave the way for a smooth transition.

IQ: Hong Kong has opted for a multi-rate approach, with HIBOR continuing to exist alongside HONIA. Why was this approach taken?

HL: In Hong Kong, HIBOR has been in place for many years and is still widely recognised by market participants as a credible and reliable benchmark. While HONIA serves as an alternative to HIBOR, there is no plan to discontinue HIBOR. With HONIA and HIBOR co-existing in the market, market participants are free to choose between them.

This multi-rate approach has also been adopted by many other jurisdictions and is consistent with the FSB's discussion.

IQ: The recent HKMA survey highlighted uncertainty over the status of HIBOR versus HONIA as the local interest rate benchmark over the longer term. What might threaten the long-term viability of HIBOR?

HL: The results of the recent HKMA survey reported some of the uncertainties and challenges identified by respondents in preparing for the transition. However, as I have already mentioned, there is no plan to discontinue HIBOR, which will exist alongside HONIA. So, whether market participants choose to use HIBOR or HONIA will depend on industry preference.

While it will take time for a HONIA market to develop, it is possible that when market participants gradually switch to the new RFRs (eg, SOFR), they may choose to reference equivalent overnight RFRs in both legs of a cross-currency swap transaction. This may, in turn, create more demand for HONIA in the financial market.

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IQ: How should firms determine which rate – HONIA or HIBOR – is the most appropriate?

HL: There is no straightforward answer to this question. Considerations often vary for different market participants when negotiating contractual terms with their counterparties. A variety of factors, such as market liquidity and familiarity with the rate, may influence the decision-making process. Firms should take into account their own circumstances when determining which rate could best suit their needs.

IQ: How important is it to have robust fallbacks in place, even in a multi-rate environment?

HL: Having robust fallbacks in place is crucial. This could ensure contracts continue to function and any potential market disruption is avoided in the event a benchmark is no longer available. We would strongly encourage firms to put fallbacks in place in financial contracts. This would not only help minimise potential disputes between counterparties, but could also mitigate litigation risk in the future.

IQ: What steps can the official sector take to encourage firms to adopt fallbacks?

HL: Given the inherently globalised nature of the financial market, international cooperation is important. Through the FSB OSSG, financial regulators including the HKMA have been encouraging regulated institutions to adopt fallbacks in contracts. We are happy to see that financial institutions are relaying this message to their clients. Of course, we need the assistance of industry associations to develop robust contractual language for fallbacks. In this regard, we will continue to work with industry bodies such as ISDA and the Asia Pacific Loan Market Association to strengthen contractual robustness.

IQ: Some market participants, particularly in cash markets, would like to see the development of forward-looking term risk-free rates to support transition. How important is this? Have the HKMA and TMA taken any steps to encourage the development of forward-looking term rates based on HONIA, and what are the challenges to developing new term rates?

HL: We understand some market participants are keen to have forward-looking term rates, which provide advance knowledge and certainty over interest payments. The best way to translate overnight RFRs into term rates is through overnight index swap (OIS) trading. Higher turnover in the HONIA OIS market will help a HONIA swap curve to develop that can be used for term rates. But this will depend on market conditions. Like many other jurisdictions, the challenge is that it will take time for liquidity in the OIS market to develop. IQ