Proposed reforms for the TMA USD/HKD and USD/CNY(HK) 11am Spot Rates

Consultation Conclusion

1. BACKGROUND

1.1 International standard bodies including International Organization of Securities Commissions and Financial Stability Board announced certain recommendations to reform the determination of financial benchmarks, including foreign exchange (FX) spot benchmarks that are primarily used in the global financial markets. These recommendations aim at improving the robustness and transparency of the financial benchmarks. The gist is that if market conditions permit, financial benchmarks should be anchored by observable *bona fide* arm's length transactions, i.e. a more transaction-based determination mechanism.

1.2 The Treasury Markets Association (TMA), as the administrator of the FX spot benchmarks in Hong Kong, i.e. the TMA USD/HKD and USD/CNY(HK) 11am Spot Rates (each as "Spot Rate"), studied the situation in Hong Kong, and considered that there would be conditions to reform both Spot Rates along the latest international recommendations under a set of reform proposals.

1.3 On 20 May 2015, the TMA launched a six-week public consultation, asking specific questions to seek views from the market on such reform proposals. The consultation closed on 30 June 2015, and TMA received 25 responses by that day. The names of respondents are at the **Annex**.

1.4 Backed by the responses, the TMA will proceed to transit both Spot Rates to transaction-based with effect from **1 August 2016**, based on the parameters summarised in **Box 1**. This document summarises the responses received in relation to the consultation questions, as well as TMA's responses to them.

<u>Box 1: Summary of the reform proposals</u>

- From calculated using banks' contributions based on expert judgement, to using **<u>FX spot transactions</u> with effect from <u>1 August 2016</u>**.

- Transactions that meet the following criteria will be used –
  - **executed through an Approved Money Broker** that has dedicated FX spot business in the relevant currency pairs;
  - having a transacted amount of **at least US$1 million**; and
  - transacted between **10:45 am and 11:15 am** Hong Kong time.

- TMA has appointed **Thomson Reuters** as the **Calculating Agent**. The Spot Rates will be calculated as the **<u>volume-weighted median</u>** of eligible transactions.

- **There will not be a published rate if there are no eligible transactions within the 30-minute window.** Users of the benchmarks should include contingency arrangements they consider appropriate in their transaction documents, such as those promulgated by the International Swaps and Derivatives Association (ISDA).

- The transition will take place on **<u>1 August 2016</u>** as an overnight change to the above calculation methodology. The Spot Rates will continue to be published on the existing pages of TMA website and newswires.

2. SUMMARY OF CONSULTATION RESPONSES

Sufficiency of market conditions

2.1 To study the feasibility of reform, TMA collected data on FX spot transactions that were executed through certain Hong Kong's AMBs between July 2013 and June 2014. Such transactions were considered to best meet the international recommendations of observable, *bona fide*, and arm's length. The consultation paper presented turnover data in different times of the day, and asked whether respondents agreed there would be sufficient conditions to calculate both Spot Rates using actual transactions every day.

2.2 All respondents agreed there would be sufficient market conditions.

TMA’s responses

2.3 TMA notes market’s views that there would be sufficient market conditions for reform. The TMA will **proceed with transiting both Spot Rates to transaction-based**, using the parameters discussed in the ensuing sections.

Use of wholesale trades executed through AMBs

2.4 The consultation paper proposed calculating both Spot Rates using wholesale FX spot transactions executed through Hong Kong’s AMBs, from both voice and electronic channels.

2.5 Majority of respondents agreed that trades executed through AMBs could be best demonstrated as being observable, *bona fide* and arm’s length. Some respondents pointed out that not all AMBs operate a dedicated FX spot business in the two currency pairs.

2.6 A few respondents suggested using transactions executed through electronic brokers or platforms only. Reasons cited were either such transactions constituted a representative sample of the market, or transactions executed through voice brokers might not have accurate time stamps.

2.7 One respondent suggested that apart from using transactions executed through brokers, bilateral interbank transactions should also be used.

TMA’s responses

2.8 The TMA notes that some respondents suggested calculating the Spot Rates using only transactions executed through electronic brokers or platforms. However, the TMA is of the view that including also transactions executed through voice brokers will yield a more comprehensive dataset.

2.9 As regards including bilateral interbank transactions, the TMA is of the view that these transactions may not be easily demonstrated as being observable, *bona fide*, and arm’s length. In particular, we note that these transactions could be relationship-based at times.

2.10 Drawing reference from other transaction-based FX spot rates and having discussed with Thomson Reuters (i.e. the Calculating Agent), the TMA will calculate both Spot Rates using **wholesale transactions (i.e. at least US$1 million) executed through Hong Kong's AMBs that have a dedicated FX spot business in USD/HKD and/or USD/CNY(HK)**. To strengthen the quality and integrity of the data contributed by the AMBs, the TMA will publish a "Code of Conduct". All AMBs who are contributing their transactions for calculating the two Spot Rates are required to follow the requirements of the "Code of Conduct".

2.11 The TMA has been assisting relevant AMBs to connect with Thomson Reuters, so that these AMBs can contribute their transactions for benchmark calculation purposes.

The benchmark determination window

2.12 The consultation paper noted that the benchmark determination window (i.e. the period in which transactions made will be used to calculate the Spot Rates) should be set with a view to (i) capturing a reasonably large number of transactions under different market conditions; and (ii) enabling dealers to hedge their positions when they need to deliver at the fix. The paper proposed the window to be 10:45 am to 11:15 am, i.e. a 30-minute window with mid-point at the 11 am benchmark determination time.

2.13 Large majority agreed with this recommendation, although one respondent proposed narrowing it to +/- 7.5 minutes around 11 am, considering 15 minutes to be a sufficiently wide window. One other respondent agreed with a 30-minute window, but suggested setting it as 10:30 am to 11:00 am, because he considered that period to have the critical mass of transactions.

TMA's responses

2.14 TMA notes the suggestion on narrowing the benchmark determination window to +/- 7.5 minutes around 11 am. The TMA considers that doing so might not enable the capturing of a reasonably large number of transactions under different market conditions, which would be undesirable.

2.15 As regards setting the window as 10:30 am to 11:00 am, TMA revisited the back-testing results and found that market liquidity was broadly similar around the two different timeframes. Also, this timeframe only captures transactions *before* 11 am, i.e. fewer pricing information than the proposed 10:45 am to 11:15 am (before *and* after 11 am). It is further noted that WM/Reuters 4 pm London fix, the most widely used FX spot benchmark in the global financial market, also has its determination window surrounding the 4 pm benchmark determination time.

2.16 In view of the above, the TMA will proceed with **setting the benchmark determination window as 10:45 am to 11:15 am**.

Averaging methodology

2.17 The consultation paper explored different averaging options to calculate the Spot Rates. With deliberation, the **volume-weighted median** approach was proposed.

2.18 Majority of respondents supported this. A few respondents preferred volume-weighted mean, suggesting that this would yield a better reflection of market price, or would be consistent with other Asian FX spot benchmarks.

2.19 One respondent suggested using time-weighted mean, where the Spot Rates would be calculated as the mean of those executed transaction prices snapshotted at regular, pre-announced intervals, which would make it easier for market players to hedge.

TMA's responses

2.20 The TMA notes the suggestions in calculating the Spot Rates as the volume-weighted mean of eligible transactions. Based on the back-testing results set out in the consultation paper, the TMA generally considers that, vis-à-vis the existing Spot Rates calculated using banks' contributions based on expert judgement, the outcomes calculated using "volume-weighted mean" tended to be (i) more affected by outliers; and (ii) more volatile than the outcomes calculated using "volume-weighted median".

2.21 As regards time-weighted mean, the TMA considers that this may lead to execution of transactions gravitating towards/outside the specific "snapshot" times so as to intentionally include/exclude such transactions from benchmark calculation. This may affect the liquidity in the underlying market and increase volatility.

2.22 Considering the above, the TMA will proceed with the **volume-weighted median** approach. If there were only one eligible trade within the benchmark determination window, the transacted price will be the rate of that day, i.e. the minimum number of transaction required to calculate a rate is one.

Fall-back arrangement

2.23 The consultation paper deliberated two possible arrangements to handle a situation of no eligible transactions within the benchmark determination window (albeit noted as highly unlikely), namely, "no fix" and "use the last fix". The consultation also asked respondents to suggest alternative arrangements (with justifications) if they considered both arrangements unsuitable.

2.24 Majority of respondents supported "no fix". They suggested that given market movements (especially for USD/CNY(HK)), "last fix" (at least released 24 hours ago) would unlikely be the prevailing market price. Using that as today's fix would create confusion in the market and affect the credibility of the benchmarks.

2.25 A few respondents supported "last fix", saying that not all existing contracts referencing the Spot Rates have contingency arrangements for a "no fix" situation.

2.26 As regards alternative arrangements, some suggested using –

(i) market rate in the previous 30 minutes (one respondent);

(ii) TMA to publish an expert-judgement rate (one respondent);

(iii) use last fix for a relatively short pre-defined period (e.g. up to three days or up to 14 days), and if there were still no eligible transactions, then no fix (two respondents);

(iv) A "waterfall", where the "fall-back" will first be based on brokers' executable prices, and if there were none, the last fix (up to three days). If still using the "last fix" after three days, revert to a rate based on expert judgement (one respondent).

TMA's responses

2.27 TMA considered the proposed alternative arrangements recapitulated in paragraph 2.26, seeking inputs from market participants as required –

(i) given the nature of the FX spot market, if there were no eligible transactions within the benchmark determination window, there would be a possibility of a "market rate" not available in the previous 30 minutes either;

(ii) it would be impractical to ask banks to contribute within a very short notice, or to ask them to contribute daily purely for maintaining a "fall-back" expert judgement-based rate;

(iii) there is not a specific rationale why the "last fix" should apply for up to three or 14 days; and

(iv) "waterfall" would have similar issues as discussed above.

2.28 TMA notes that majority of respondents preferred "no fix" over "last fix". With further industry consultation, the TMA notes that most interbank transactions are using arrangements promulgated by the ISDA to handle "no fix" situations. In view of the above, the TMA can confirm that **it will not publish a rate if there were no eligible transactions within the benchmark determination window. It also endorses the ISDA arrangements, and encourages market participants who have no existing contingency arrangements in their transaction documents to consider adopting the ISDA arrangements wherever possible**.

Transition notice

2.29 The consultation paper proposed a three-month notice period for an overnight change in the calculation methodology, and no public parallel run for the existing Spot Rates and the transaction-based Spot Rates.

2.30 Majority of respondents supported the above. Two respondents asked for a public parallel run so as to see the differences.

TMA's responses

2.31 As explained in the consultation paper, a public parallel run might confuse the market and result in "cherry-picking" by the benchmark users. Thus, TMA considers that public parallel run is not conducive to transition, and **will not do so**.

2.32 **The benchmarks will be determined based on the new determination mechanism with effect from <u>1 August 2016</u>**, i.e. a three-month notice period is hereby given**.**

3. WAY FORWARD

3.1 Backed by majority support from the consultation exercise, TMA has started necessary work to transit both Spot Rates to transaction-based. TMA has appointed Thomson Reuters as the Calculating Agent for both Spot Rates after going through a selection process.

3.2 TMA will transit both Spot Rates to transaction-based using the arrangements set out above **with effect from <u>1 August 2016</u>**. The Spot Rates will continue to be published on existing pages of the TMA website and newswires.

Treasury Markets Association
3 May 2016

Annex

List of respondents*

1. Agricultural Bank of China, Hong Kong
2. BOC International Holdings Limited
3. Cheungkong Hutchison Holdings Limited
4. Hong Kong & China Gas Company Limited, The
5. Hong Kong Association of Banks, The
6. Hong Kong Exchanges and Clearing Limited
7. Hong Kong Inter-Dealer Brokers Association
8. Mizuho Bank Limited
9. Nittan Capital Asia Limited
10. Standard Chartered (Hong Kong) Limited
11. Sumitomo Mitsui Banking Corporation
12. Thomson Reuters
13. Zuellig Group, The

*A total of 25 responses were received. This list includes only names of those who did not request their identities be kept confidential.