HONG KONG MONETARY AUTHORITY
香港金融管理局

Our Ref: B1/15C
G16/1C

9 August 2013

The Chief Executive
All Registered Institutions

Dear Sir / Madam,

Product Risk Rating of High-Yield Bonds[1] and Related Products[2]

The circulars entitled "Selling of Fixed Income Products" issued by the Hong Kong Monetary Authority ("HKMA") and the Securities and Futures Commission ("SFC") separately on 19 November 2012 highlighted the key risks associated with high-yield bonds. Intermediaries were reminded of their obligations to conduct due diligence on fixed income products that they recommend to customers, to ensure that they are able to provide proper explanation of the key features and risks of such products and to ensure suitability of their recommendation or solicitation for a customer. In particular, intermediaries were reminded not to treat all bonds as risk-free products that are suitable for all investors. In this connection, I am writing to provide further guidance in relation to the assigning of product risk ratings to high-yield bonds and related products[3].

The HKMA expects Registered Institutions ("RIs") to adopt robust methodologies for assessing product risk and assigning product risk ratings to high-yield bonds and related products. In setting such methodologies, RIs should observe, among other things, the principles set out below:

- It will not be appropriate to simply assign a lower risk rating to all fixed income products (e.g. all bonds and bond funds as compared to other asset classes such as equities and equity funds);

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[1] High-yield bonds refer to bonds which are generally below investment grade or are unrated.

[2] In the context of this circular, high-yield bond "related products" refer to investment products primarily investing in or linked to the performance of high-yield bonds.

[3] Exemptions in relation to product risk ratings that may be applicable to corporate banking customers and private banking customers in specified circumstances are set out in the circulars "Applicability of Enhanced Measures to Sale of Investment Products to Corporate Customers" of 20 December 2012 and "Applicability of Enhanced Measures to Sales of Investment Products to Private Banking Customers" of 20 January 2012 respectively.

- Examples of relevant factors to be taken into account include the asset class, features (e.g. whether a bond has special features) and structure of an investment product, and the creditworthiness of the issuer, etc.; and

- As factors affecting product risk may change over time, such as a product's or issuer's credit rating (if any), RIs should perform review of product risk ratings at appropriate intervals.

High-Yield Bonds

High-yield bonds are generally of higher risk than investment-graded bonds and hence their product risk ratings should reflect this.

Funds Investing Primarily in High-Yield Bonds ("High-Yield Bond Funds")

It follows that product risk ratings of high-yield bond funds should generally be higher than those of funds investing primarily in investment-graded bonds, so that investors can differentiate between the risk ratings of these two types of bond funds. Therefore, RIs should have due regard for such differences in risks in their risk disclosure and assessment of product suitability for customers. For high-yield bond funds, while bond issuer risks may be mitigated to some extent through diversification of investment by the funds, this may be impeded during economic downturn or other stressed market conditions, due to factors such as market-wide risk aversion and higher correlation among high-yield investment products, especially if a high-yield bond fund is concentrated in a small number of bond issuers. Accordingly, product risk ratings of high-yield bond funds that are lower than those of high-yield bonds should be properly justified. For instance, high-yield bond funds with proper risk mitigation strategies such as having sufficient diversification through proper geographical, sector and company selection may be assigned with a slightly lower (but not substantially lower) product risk rating as compared to that of a high-yield bond.

Other Related Investment Products

Similarly, RIs should adopt a prudent approach in assigning product risk rating to other investment products related to high-yield bonds, taking into account, inter alia, the structure, features and risks of these products.

RIs should take prompt action to implement adequate procedures and controls, and review the product risk ratings assigned to high-yield bonds and related products to ensure compliance with this circular. The HKMA expects RIs' compliance with this circular as soon as possible, but no later than six months from the date of this circular if major system or operational changes are needed.

If you have any questions on this circular, please contact Ms Florence To at 2878-1582, or Ms Ada Au at 2878-8814.

Yours faithfully,

Meena Datwani
Executive Director (Banking Conduct)

c.c. Securities and Futures Commission (Attn: Mr James Shipton, Executive Director of Intermediaries Supervision and Licensing)