HONG KONG MONETARY AUTHORITY
香港金融管理局

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7 March 2014

The Chief Executive
All Authorized Institutions

Dear Sir / Madam,

Foreign Exchange Accumulators[1] ("FX accumulators") and Non-leveraged Renminbi ("RMB")-Linked Deposits

I am writing to provide guidance and clarification on the regulatory requirements governing the sale of FX accumulators and non-leveraged RMB-linked deposits by Authorized Institutions ("AIs"), in particular the:

- framework for assessing customers' expected exposure to FX accumulators;
- treatment of FX accumulators for hedging purpose;
- sale of FX accumulators to corporate customers;
- classification of FX accumulators; and
- risk disclosure for roll-over and repeated placement of non-leveraged RMB-linked deposits.

(I) Framework for assessing customers' expected exposure to FX accumulators

The Hong Kong Monetary Authority ("HKMA") in its circular of 22 December 2010 entitled "Selling of Accumulators" (the "circular") set out the regulatory standard for the calculation of asset concentration in accumulators. This required taking into account a customer's total maximum exposure, i.e. using the full notional amount (regardless of the currencies involved) for assessment of the customer's exposure to FX accumulators.

In view of the link between the Hong Kong dollar ("HKD") and the US dollar ("USD") as well as relatively low volatility of HKD and USD against eight other major currencies[2], after consultation with the Hong Kong Association of Banks ("HKAB") and the DTC Association ("DTCA"), the HKMA has decided to allow AIs to use a flexible approach in the calculation

1 Accumulators in the circular also include decumulators, and products of a similar nature by whatever name they may be called.

2 Eight other major currencies refer to Euro, UK Pound Sterling, Australian dollar, New Zealand dollar, Canadian dollar, Swiss Franc, Japanese Yen, and Renminbi (both CNY and CNH).

of asset concentration for FX accumulators involving major currency pairs. A new framework, set out in **Annex 1**, for measuring the expected exposure to FX accumulators in major currency pairs has been developed for this purpose. In coming up with this framework, applicable to all customers, the HKMA has considered the price volatility data of the major currency pairs over a ten-year period. AIs which are not yet ready to use the flexible approach should continue to use the existing full notional approach in their suitability assessment.

(II) Treatment of FX accumulators for hedging purpose

The overarching principle is that only the properly hedged amount of a customer's exposure in a FX accumulator contract is exempted from inclusion in the calculation of concentration risk.

(II)(A) Treatment of FX accumulators for hedging existing FX exposure

If a customer already holds a long position in FX product(s) or anticipates some FX cash flows and intends to enter into a FX accumulator contract to hedge against such existing FX exposure, it is permissible not to include the relevant amount of such FX accumulator contract in the calculation of concentration risk. However, as stated in the circular, AIs should put in place proper procedures to establish whether an accumulator is indeed a suitable hedging instrument and if so, whether the maximum exposure in such FX accumulator contract is appropriate. For example, if the maximum exposure associated with the FX accumulator contract is materially higher than the original long position or anticipated cash-flows in a particular foreign currency, there will be over-exposure which should be included in the calculation of concentration risk. Further, whenever an AI becomes aware of changes in a customer's circumstances such that a transaction in FX accumulator contract no longer serves as a hedge (e.g. the risk exposure to be hedged no longer exists) and becomes an investment, the AI should, as soon as practicable, review the customer's position, draw to the customer's attention the fact that customer has an exposure to the FX accumulator, and take or recommend appropriate actions to address the situation.

(II)(B) Treatment of FX accumulators other than for hedging existing FX exposure

If a FX accumulator contract is entered into other than for hedging a customer's existing FX exposure, AIs should observe all relevant regulatory requirements, including the requirements for assessing the customer's concentration risk and the minimum expected exposure percentage for FX accumulators. For the avoidance of doubt, a FX accumulator contract will not be regarded as being entered into for hedging purposes if the customer enters into the FX accumulator contract first and subsequently takes up other FX product(s).

In the circular it is stipulated that AIs should refrain from soliciting or recommending accumulator contracts to customers who already have a high concentration in such contracts or in the specific underlying asset. Accordingly, AIs should set specific threshold(s) for FX accumulators as an investment product in determining concentration risk. Since FX accumulators are of high risk, the exposure in FX accumulators should not be netted out by other FX products when considering asset concentration on a product level. In this connection, the HKMA notes that perfect hedge for FX accumulators is uncommon given the costs involved especially as each product has its particular terms, tenor, strike price, etc.

Nevertheless, the HKMA does not rule out the possibility that in exceptional circumstances, some customers may have genuine need to use other FX products to hedge certain existing FX accumulator contracts (e.g. if the cost of unwinding the existing FX accumulator contracts is higher than the cost of hedging). AIs should have strong justifications and proper documentation to support such claim, including but not limited to: thorough analysis of all relevant terms and structure of the existing FX accumulators and the other FX product for hedging and critical review of the proposed arrangement of hedging against existing FX accumulator contracts, to demonstrate genuine hedging. In which case, the properly hedged amount of the FX accumulator contracts may be excluded from the calculation of concentration risk.

(III) Sale of FX accumulators to corporate banking customers

Having regard to the difference in the risks of FX products as compared with equities and the nature of corporate banking customers, it is considered reasonable to allow more flexibility in respect of the sale of FX accumulators to corporate banking[3] customers.

(III)(A) FX accumulators used as a hedging tool for corporate customers are exempted from the following requirements[4]:

(a) only selling to customers with experience in investing in structured investment products or writing options;

(b) only selling to professional investors as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance ("SFO");

(c) providing customers with reasonable alternative investment products with lower risks and / or less complex structure for addressing their investment needs;

(d) providing strong justification and conducting review by a senior officer and / or an independent internal control unit other than a credit control unit for any mismatch transactions;

(e) refraining from making any solicitation or recommendation of accumulator contracts to customers who already have high concentration in accumulator contracts (taking into account the customers' total maximum exposure as well as their ability to withstand loss and fulfil potential margin obligations under adverse market conditions) or in the specific underlying asset;

(f) making available and encouraging customers who are interested in investing in accumulators to read the inSight article entitled "Buy at a discount?" issued by the HKMA on 28 September 2011;

(g) recording the rationale for investing in accumulators rather than suitable alternative investment products with lower risk and / or less complex structure

[3] Corporate banks are AIs which operate as corporate banks or have dedicated corporate banking units.

[4] Requirements (a) to (e) are stated in the HKMA's circular "Selling of Accumulators" of 22 December 2010. Requirements (f) and (g) are stated in the HKMA's circular "Rationale for Selling of Accumulators" of 31 October 2011.

(if any) given the risk return profile of accumulators and the customer's circumstances; and obtaining the customer's acknowledgement (audio or written) of the investment rationale and maintaining a proper audit trail; and

(h) the last section of the HKMA's circular "Selling of Investment Products to Private Banking Customers" of 12 June 2012 concerning "Selling of Accumulators".

However, where there is over hedging (e.g. investment amount is materially in excess of the risk exposure, or investment tenor is longer than the tenor of the risk to be hedged), such transactions in FX accumulator contract are not exempted. Further, whenever a corporate bank becomes aware of changes in a customer's circumstances such that a transaction no longer serves a hedging purpose (e.g. the risk exposure no longer exists) and becomes an investment, the corporate bank should, as soon as practicable, review the customer's position, draw to the customer's attention the fact that customer has an exposure to the FX accumulator, and take or recommend appropriate actions to address the situation.

The above exemptions only apply to accumulators linked to FX but not other underlying assets.

(III)(B) For non-hedging transactions of FX accumulators by "large / sophisticated" corporate customers[5], corporate banks are exempted from adopting the enhanced measures specified in (III)(A) above, except item (e) which is exempted only for hedging transactions for corporate customers. For non-hedging transactions involving other corporate customers, corporate banks should continue to observe the HKMA's additional measures concerning the sale of accumulators.

(III)(C) No exemption is granted in respect of product risk rating and the Securities and Futures Commission's standards. Consequently, the HKMA continues to expect AIs in general to assign the highest risk rating to accumulators and to follow similar standards as those applicable to SFO-regulated investment products, in selling FX accumulators.

The exemptions and expectations set out in section (III) above have been disseminated to AIs through the assistance of HKAB and DTCA in January 2013.

(IV) Classification of FX accumulators

In determining whether a product is classified as an accumulator, AIs should make reference to the product features mentioned in the HKMA's circulars on accumulators and the inSight

[5] As set out in the circular "Applicability of Enhanced Measures to Sale of Investment Products to Corporate Customers" of 20 December 2012, a corporate customer may be classified as "large / sophisticated" corporate customer if it is a:
(i) company listed on any stock exchange;
(ii) corporate entity, public body, tertiary institution, registered charitable organization or other legal entity having a dedicated / specialised investment function;
(iii) trust;
(iv) person falling under any of the paragraphs (a) to (i) of the definition of "professional investor" in Part 1 of Schedule 1 to the Securities and Futures Ordinance;
(v) professional partnership in a designated field (law, accounting, taxation, actuary or finance); or
(vi) group entity (including holding company, subsidiary and associated company) of any of (i) to (v) above.

article “Buy at a discount?” issued on 28 September 2011. While the product structures and features keep evolving, and there may not be a single definition that can fit all types of FX accumulators, the following paragraph provides general guidance but AIs should exercise professional judgment to reasonably classify accumulators for the purpose of complying with the relevant circulars.

> *“FX accumulators/ decumulators, in general, are FX structured products which consist of a series of options/ forwards within a single contract where customers, when writing the options or entering into the forwards, are obliged to purchase/ sell a fixed sum of foreign currency/ currencies at a predetermined strike price periodically, within a specified period. The upside is “capped” (e.g. gain amount is capped, number of settlements with positive returns is limited when compared with those for losses, with knock-out features etc). FX accumulators/ decumulators, for the purpose of determining the applicability of the relevant regulatory requirements as stipulated in the HKMA circulars of 22 December 2010, 31 October 2011, 12 June 2012 and this circular, may or may not have knock-out features or a multiplier.”*

For illustration purposes, an example of a FX structured product that should be classified as an accumulator according to the above guidance is provided in **Annex 2**.

(V) Risk disclosure for roll-over and repeated placement of non-leveraged RMB-linked deposits

According to the HKMA’s circular entitled “Selling of Investment Products” of 13 July 2009, operational flexibility is allowed in complying with the risk disclosure requirements for roll-over and repeated placement of non-leveraged FX-linked deposits in major currencies[6]. After considering recent market developments, the HKMA has decided to extend such flexibility in terms of risk disclosure to non-leveraged RMB-linked deposits. However, such flexibility does not discharge AIs from the obligation to ensure the suitability of the product for the customer in each transaction.

AIs should put in place adequate controls to ensure compliance with applicable regulatory requirements.

If you have any questions on this circular, please contact Mr Andy Lam on 2878-8790 or Ms Anita Chan on 2878-1538.

Yours faithfully,

Meena Datwani
Executive Director (Banking Conduct)

[6] For the purpose of the circular of “Selling of Investment Products” of 13 July 2009, major currencies refer to US dollar, Euro, UK Pound Sterling, Australian dollar, New Zealand dollar, Canadian dollar, Swiss Franc, and Japanese Yen.

Encl.

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