



OTC Derivatives Reform in Hong Kong – Development Update

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August
2025

01 OTCD Reform Latest Development and Overview

Latest SFC Consultation on Financial Resources Rules (FRR) Proposed Amendments*

Subsequent to the 2017 consultation, the Securities and Futures Commission (SFC) launched a **public consultation on 14 July 2025 on proposed amendments** to the Financial Resources Rules (FRR) and related guidelines. These amendments are designed to further develop the changes initially proposed in 2017.

Consultation Timeline

The new FRR is still under final consultation, and stakeholders are invited to submit their feedback by **October 2025**

Expected Development

Following the finalization of the proposed amendments, review by the **Legislative Council (LegCo)** is expected to be **completed in 2026**, after which the FRR will come into effect

The **Client-Facing Affiliate (CFA)** conduct requirements is expected to **align with the FRR effective date**:

All OTC derivatives transactions must be conducted through a **Licensed Corporation (LC)** holding the relevant types of SFC regulated activity (RA) licenses

Overall Inclination Toward the Revised Basel II Standard under Banking (Capital) Rules and Beyond

2017 Consultation

The 2017 consultation introduced FRR amendments on the following **3 key areas**:

1. Standardized Approach (SA) for Market Risk (MR) [SMRA]
2. Standardized Approach Counterparty Credit Risk (CCR) [SOCCRA]
3. Internal Model Approach [IMA]

2025 Consultation

2025 proposed amendments further incline towards Basel standards:

Key Amendments

- Overall alignment with the **revised Basel II standards** – covering **risk-weights** under SA, current exposure method under SOCCRA and IMA requirements
- Additional requirements to keep up **with Basel III standards** – **scaling factor under simplified SA** and adopting **CVA risk approach** under CCR
- Alternative Adoption of the Latest Basel Standards
- The SFC has indicated the possible adoption of the **latest Basel capital standards** (e.g. Basel III models), subject to regulatory approval

Overall Implications to Capital and Business Models

In light of recent global regulatory changes, amendments to the requirements are introduced to align with the latest developments. These amendments have **two primary implications**:

Capital Calculation Approach

The new FRR transitioned from **the product-based approach** to **risk-based approach**:

- Capital charges are determined by applying **risk-weights to position exposures**, where **position netting benefits** are considered

LCs are advised to enhance their risk frameworks to **improve risk exposure management by legal entity** and potentially benefit from **lower capital requirements**

Impact to Business Models

Principal-based Model

- Relatively beneficial for the **principal-based model adopted** by wealth management and securities firms engaged in **back-to-back business**
- Given the **nature of their business model and trading strategies**, **position netting** may result in **lower capital requirements**

Agency-based Model

A **reduction in minimum capital requirements** has been introduced for OTCD dealers acting as **inter-dealer brokers***, reflecting the lower risk associated with their activities

LCs that adopt **principal-based or agency-based models** (such as those involving inter-dealer brokers) could benefit from the **new capital requirements**

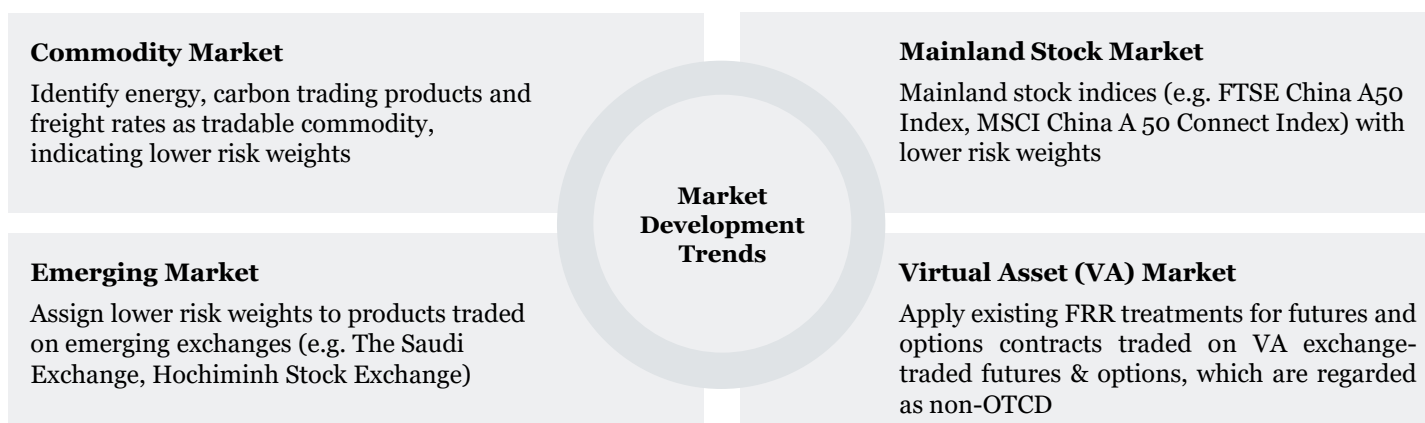
*This paper serves as a regulatory update and should be read in conjunction with the publication OTC Derivatives Reform in Hong Kong – Overview (2022).

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Key Highlight of Latest Proposed FRR Amendments

Current Market Trend: Development of FRR under Proposed Amendments

The July 2025 consultation paper highlights the inclusion of a broader range of products and markets, aiming to **align with evolving market trends** while providing capital benefits and lowering of regulatory requirements:



Overview of Capital Requirements for OTCD Activities

A. Market Risk (MR) and Counterparty Credit Risk (CCR) Capital Requirements

CHANGES Risks types with changes in 2025 consultation

Risk Charge Type	Risk Calculation Approach		
	Basic Approach (BA)	Standardized Approach (SA)	Internal Model Approach (IMA)
Market Risk	Basic Market Risk Approach (BMRA)	Standardized Market Risk Approach (SMRA)	Internal Model Approach (IMA)
		Equity risk	
		Interest rate risk	
		Commodity risk	
CCR	Basic OTCD CCR Approach (BOCCRA)	Foreign and notional currency risk	Internal Models Approach to CCR (IMM)
		Uncommon derivatives risk	
		Continuous options contracts risk	
		Concentration risk	
CCR	Basic OTCD CCR Approach (BOCCRA)	Standardized OTCD CCR Approach (SOCCRA)	Internal Models Approach to CCR (IMM)
		Counterparty credit risk (CCR)	
		Client Margin shortfall	
		Credit valuation adjustment (CVA)	
CCR	Basic OTCD CCR Approach (BOCCRA)	Counterparty concentration & liquidity adjustment	Internal Models Approach to CCR (IMM)
		Repo-style transactions	

Market Risk and CCR Capital Requirements	Involve simple calculations ; Design for LCs engage in OTCD activities not as a regulated activity and as a regulated activity but subject to certain restrictions	Mainly benchmarked to Basel II's standardized market risk approach , current exposure method for CCR, and the CVA risk approach applied at the early stage of the Basel III reform package ; and Design for LCs engage in OTCD activities as a regulated activity (except where the activities are subject to certain restrictions)	Design for LCs engage in complex OTCD trading activities
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B. Other Requirements

Other Requirements	Model Risk Management (MRM)	Liquidity risk management controls
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Key Highlight of Latest Proposed FRR Amendments

Internal Model Approach (IMA) Requirements

As an alternative to SMRA, LCs are permitted to use internal models for calculation of market risks subject to application SFC approval, while additional standards are required, including qualitative and quantitative standards, as well as model risk management (MRM) requirements.

Qualitative Standards		Quantitative Standards	
Governance - Responsibilities of the Board - Approval on risk appetite and market risk limits	Data and System Infrastructure - Risk data architecture and IT infrastructure - Manual process controls	Value-at-risk (VaR) Measurement of potential loss in value of portfolio over specific time	Stressed VaR (SVaR) Measurement of potential loss in value of portfolio under stress period
Risk Management - Risk identification, measurement, monitoring process - Independent risk control function	Product Control - Intraday exposure monitoring - P&L attribution - Independent pricing verification	Incremental Risk Charge (IRC) Measures default risk and credit migration risk	Risk-not-in-Model Capture of market risk not captured or poorly captured in the model
Policies and Procedures - Annual review - Documentation of BAU process and controls	Internal Audit - Internal audit review on risk management at least annually - Address of deficiencies	Back-testing Controls to ensure accuracy and reliability of IMA model	Stress-testing Evaluate and assess capital adequacy under stress

Model Risk Management (MRM) General Principles and Requirements

MRM general principles and requirements are applicable specifically to:

- LCs using **internal models (e.g. IMA)** to calculate FRR risk charges
- LC **engaging in OTCD dealing or clearing** (as they may make extensive use of financial models in their business)
- LCs **approved by the SFC to use the latest Basel capital standards** to calculate FRR risk charges

Model Lifecycle	Model Identification Define a model, how models are categorized, and how materiality levels are set	Model Development Design model methodology, conduct performance testing and establish model monitoring plan	Model Validation Perform model validation function as second line of defence
	Model Inventory Implement and maintain a firm-wide model inventory	Governance Framework Establish of MRM governance control framework and approval process	External Model Conduct testing, assessment, and ongoing maintenance of external vendor models

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How We Can Help

As LCs will be subject to new FRR requirements, PwC can provide support through the following approach:

Areas	Key Activities
1 Impact Analysis and Process Enhancement for New FRR Reporting Requirements	Impact analysis Identify key differences between current and new FRR in terms of reporting elements – including market risk and CCR calculations (refer to Section 2 for details) FRR reporting process enhancement - Enhance the FRR reporting process by establishing clearly defined roles and responsibilities aligned with the new FRR reporting requirements Update or develop FRR policies and operational procedures to ensure compliance and support effective implementation
2 Automated Solution for FRR Reporting	Data and system infrastructure assessment on FRR - Identify relevant systems and data sources for new FRR reporting - Conduct data mapping and define data transformation logic Automated solution development Design and implement automated solutions based on the identified data infrastructure and mapping logic, utilizing automation applications to streamline ongoing BAU FRR reporting
3 FRR Capital Planning and Management Framework Development	Capital planning framework development Establish FRR and internal capital planning framework and methodology, including risk-based capital assessment, capital adequacy analysis, on-going capital monitoring and capital stress testing

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