



# Revamping FRR for OTC derivatives in Hong Kong: 2025 key updates



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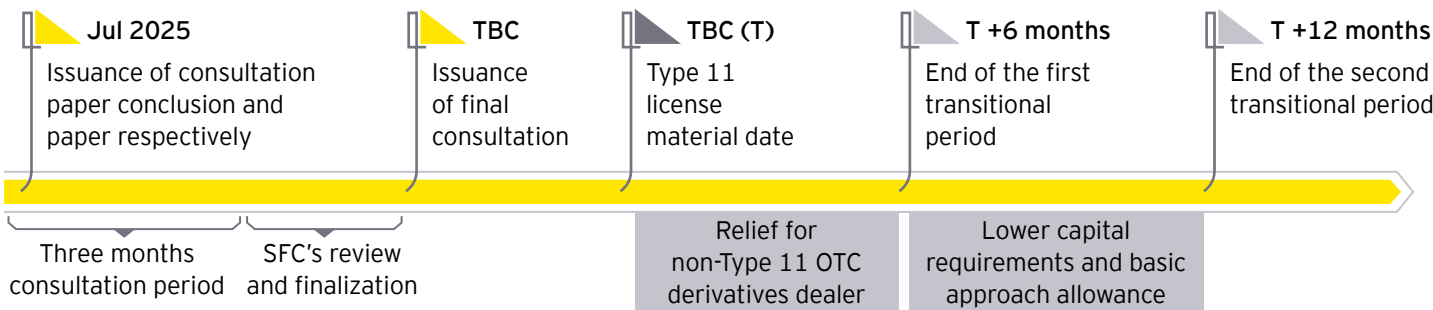


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# Introduction

On 14 July 2025, the Securities and Futures Commission (SFC) released a consultation conclusions for the Financial Resources Rules (FRR) and a consultation on draft amendments to the FRR accompanied by guidelines for the Internal Models Approach (IMA) for market risk charge calculations and general principles for model risk management (2025 consultation paper). This paper provides a summary of the key changes introduced by the SFC including the upcoming transition timeline for the institutions eyeing the Type 11 license application or to engage in the over-the-counter (OTC) derivatives business:



The following summarizes six key areas of change compared to the previous SFC paper that we would like to highlight:

## 1 Capital requirements

The SFC has clarified the minimum paid-up share capital and liquid capital requirements for several scenarios with key points below:

- The SFC has introduced the capital requirements for central OTC inter-dealer brokers and asset management groups to reflect lower systemic risks, summarized below:

OTC derivatives dealer type	Minimum paid-up share capital	Minimum liquid capital
OTC derivatives inter-dealer brokers	HK\$60 million	HK\$30 million
Asset management group central OTC derivatives dealer	HK\$30 million	HK\$15 million

License corporations' (LCs) activities limited to introducing or inducing clients to engage in OTC derivatives transactions (without executing deals) are excluded from the definition of OTC derivatives activities; this consideration may help inter-dealer LCs when applying for reduced capital requirements

- LCs seeking SFC approval to use the latest Basel capital standards such as the Fundamental Review of Trading Book (FRTB) (including its standardized and internal models approach) must meet the same minimum capital requirements as those using the standardized approach, specifically a minimum of HK\$1 billion tangible capital and HK\$156 million liquid capital for OTC derivatives activities above the specified threshold, with potential additional capital buffers for high-exposure portfolios
- LCs approved to use the IMA for capital calculation, regardless of whether they are OTC derivatives dealers, must maintain a minimum of HK\$2 billion tangible capital and HK\$156 million liquid capital

### What it means to you?

Entities should consider their current and future business plans to determine which type of OTC derivatives dealer type is most suitable and assess the ability to meet the capital requirements accordingly. The business plan, booking model and overall direction of the Type 11 LCs will be essential for the first step to prepare for the license application. For example, as a Type 1 LC with OTC derivatives business, it is essential to consider should the LC be a non-RA11 OTC derivative dealer or obtain a separate Type 11 license.





## 2 Market risk requirements

In the 2015 consultation paper, the SFC introduced a risk-based capital requirement framework for OTC derivatives transactions encompassing the Standardized Market Risk Approach (SMRA) and the Basic Market Risk Approach (BMRA). Following the 2025 consultation paper, the BMRA retains the existing FRR treatments for non-OTC derivatives proprietary positions with minimal changes. Notably, switching between the BMRA and SMRA now requires SFC approval. However, the SMRA is met with a series of enhancements and updates to further refine market risk requirements, as follows:

Risk classes	Key updates on SMRA
<b>Equity risk</b>	<ul style="list-style-type: none"> <li>■ Reduces haircut percentages for FTSE China A50 Index, MSCI China A50 Connect Index and CSI 300 Index</li> <li>■ Adds CSI 300 Index to specified equity indices</li> </ul>
<b>Specific interest rate risk (SIRR)</b>	<p>Introduces the following:</p> <ul style="list-style-type: none"> <li>■ 1.3 scaling factor for specific charge factors</li> <li>■ New specific charge factors for securitization and re-securitization positions</li> <li>■ Market risk charge calculation for debt security baskets based on weighted average of constituent risk charges</li> </ul>
<b>General interest rate risk (GIRR)</b>	<ul style="list-style-type: none"> <li>■ Introduces the 1.3 scaling factor</li> <li>■ Enhances treatment framework for derivatives on debt security baskets</li> <li>■ Updates on the guidance on treatment on credit default swaps</li> </ul>
<b>Commodity risk</b>	<ul style="list-style-type: none"> <li>■ Introduces the 1.9 scaling factor</li> <li>■ Expands scope of tradeable commodities to include energy products, carbon credits and freight rate products</li> <li>■ Introduces gross charge exemption when 100% net charge factor applies to net long commodity basket positions</li> </ul>
<b>Foreign currency risk and gold risk</b>	<p>Introduces the following:</p> <ul style="list-style-type: none"> <li>■ 1.2 scaling factor</li> <li>■ Broader acceptance of types of gold for the purpose of netting</li> <li>■ Broader Controlled Assets concept</li> </ul>
<b>Uncommon derivatives risk</b>	<ul style="list-style-type: none"> <li>■ Requires SFC approval for using alternative calculation approaches</li> <li>■ Introduces additional 8% risk charge if the underlying exposure is denominated in a foreign currency</li> </ul>
<b>Gamma and vega risk</b>	<ul style="list-style-type: none"> <li>■ Aligns the scaling factors with the underlying asset types</li> <li>■ No offsetting of gamma impacts and vega impacts of option contracts on illiquid investments</li> </ul>

### What it means to you?

- Entities should begin considering data readiness for implementing the market risk requirements and initiate the planning process for implementation of the market risk capital calculation methodology.
- Entities considering the IMA should also ensure that the SMRA is ready to support the OTC derivatives activities while the IMA is undergoing the approval process.



### 3 Counterparty credit risk requirements

Similar to the BMRA and SMRA, the SFC has introduced the Basic OTC Derivatives Counterparty Credit Risk Approach (BOCCRA) and the Standardized OTC Derivatives Counterparty Credit Risk Approach (SOCCRA) for LCs engaging in OTC derivatives activities to measure their counterparty credit risk (CCR) exposure. These approaches are designed to address potential losses arising from CCR, depending on the size of their OTC derivatives exposures and the nature of entities' business. The 2025 consultation paper presents a series of important enhancements and updates aimed at further refining CCR requirements, which include the following:

Capital charges	Key updates on SOCCRA
<b>CCR charge</b>	<ul style="list-style-type: none"> <li>■ A modified Current Exposure Method approach is introduced by the SFC for CCR charge</li> <li>■ LCs can apply to the SFC to use the latest CCR calculation in the Basel Framework (i.e., Standardized Approach to Counterparty Credit Risk)</li> </ul>
<b>Credit valuation adjustment (CVA) risk charge</b>	<ul style="list-style-type: none"> <li>■ Most significant change in the calculation logic from 2015 consultation paper is that the CVA risk charge is now equal to the LC's counterparty credit risk capital requirement on the same OTC derivatives transactions</li> <li>■ LCs can apply to the SFC to use the latest CVA charge calculation in the Basel Framework (e.g., reduced-or full-basic approach)</li> </ul>
<b>Counterparty concentration charge</b>	<ul style="list-style-type: none"> <li>■ New components added in the calculation of adjusted uncollateralized current exposure amount</li> </ul>
<b>Liquidity adjustment charge</b>	<ul style="list-style-type: none"> <li>■ No change in 2025's consultation paper compared to 2015's consultation paper</li> <li>■ LCs need to pay attention to the specific liquidity risk management measures</li> </ul>
<b>Margin shortfall charge</b>	<ul style="list-style-type: none"> <li>■ No change in 2025's consultation paper compared to 2015's consultation paper regarding clearing client margin shortfall charge</li> </ul>
<b>Repurchase transaction (Repo)-style transactions charge</b>	<ul style="list-style-type: none"> <li>■ Confirms to be included in the upcoming SOCCRA</li> <li>■ Similar to Basel II's comprehensive approach for collateral</li> </ul>

#### What it means to you?

- Similar to market risk, entities should follow the default approach for calculating the CCR, as there are fundamental differences between the BOCCRA and SOCCRA, and switching between them will require SFC approval.
- Entities should begin considering data readiness for implementing the counterparty credit risk requirements and initiate the planning process for implementation of the counterparty credit risk capital calculation methodology.





## 4 IMA requirements

The IMA offers the most sophisticated measure to a Type 11 LC to compute its market risk capital charge. The level of sophistication warrants additional tangible and required liquid capital from the Type 11 LC to protect entities from the higher inherent risk. However, depending on entities' portfolio, the capital saving may be substantial and outweighs the additional capital requirement. In 2025 consultation paper, SFC retained almost all requirements from the previous IMA Guideline and IMA Questionnaire and SFC offered additional clarification to the potential applicants on SFC's expectations, which:

- Introduces the regular (monthly, quarterly and ad hoc) reporting
- Tightens the overall model monitoring measures such as more frequent stress testing which increased from a regular basis to monthly to ensure the IMA models are functioning as intended
- Enhances the clarity on illiquidity risk management by requiring formalized processes to identify, measure and manage these risks, supported by a comprehensive, independently reviewed illiquid position inventory
- Strengthens the Risks-not-in-IMA model (RNIM) framework through requiring a rigorous process to identify, quantify and maintain excess liquid capital against unmodelled risks, including specific components including the Risks-not-in-VaR (RNIV), Risks-not-in-SVaR (RNISV) and residual RNIM
- Establishes a standalone section for the new product approval process
- Specifies the requirements for product inventory

### What it means to you?

- If entities are considering applying for a Type 11 license, evaluation should be made to decide among SMRA, IMA and FRTB. Beyond the potential for significant capital savings, it is important to think about the initial investment and ongoing maintenance cost for both the system and overall setup.
- It is also vital to consider how to achieve harmony between the SMRA and IMA to ensure the combination of both is sufficient to cover all products.
- Given Management-In-Charge (MIC) and SFC's approvals are required for IMA, entities should allocate ample time to cover both implementation and approval stage.

## 5 Model risk management requirements

The latest 2025 consultation paper introduces General Principles for Model Risk Management (MRM), which marks the first published guideline for MRM in Hong Kong, establishing the development and enhancement of firm-wide MRM as a mandatory requirement. The General Principles for MRM set out detailed governance and control requirements on MRM, which have been benchmarked to similar guidelines issued by the other regulators. These principles articulate the supervisory expectation for managing models used in trading-related activities, capital charge calculation, valuation and risk management. LCs engaged in OTC derivatives dealing or clearing must comply with the general principles for model risk management. This requirement also applies to LCs approved by the SFC to adopt the IMA or the latest Basel capital standards for calculating FRR risk charges. The General Principles for MRM cover the following:

Dimensions	Requirements highlight
<b>Model identification and inventory</b>	<ul style="list-style-type: none"> <li>■ <b>Establishes clear definition of model:</b> Quantitative approach with information input, processing and reporting components</li> <li>■ Maintains <b>firm-wide model inventory</b>, especially for all covered models</li> <li>■ Extends controls to <b>other models and non-models</b></li> </ul>
<b>Model development and use</b>	<ul style="list-style-type: none"> <li>■ <b>Model development:</b> Ensures conceptual soundness through <b>data quality assessment, sensitivity analysis and comprehensive testing</b></li> <li>■ <b>Model implementation:</b> Designs and implement for intended use</li> <li>■ <b>Model monitoring:</b> Assesses the effectiveness and performance over time, evaluate whether adjustment, redevelopment or replacement of models are necessary</li> </ul>
<b>Model validation, revalidation and periodic review</b>	<ul style="list-style-type: none"> <li>■ <b>Model validation:</b> Conducts model validation before models go live or upon any material changes</li> <li>■ <b>Revalidation:</b> Conducts ongoing model revalidation, track existing limitations and identify new ones.</li> <li>■ <b>Periodic review:</b> Performs desktop review <b>at least annually</b> for use-case and review if any needs to call for additional validation/revalidation activities</li> </ul>
<b>Governance, policies and controls</b>	<p>Establishes an <b>effective governance framework</b> with clearly defined policies, procedures and controls for MRM which includes the following:</p> <ul style="list-style-type: none"> <li>■ <b>Board:</b> Ultimately responsible for MRM, approve and review firm-wide policy</li> <li>■ <b>Policy:</b> Includes model definition, standards for steps in model life cycles and roles &amp; responsibilities of all relevant parties etc.</li> </ul>
<b>Use of vendor models</b>	<ul style="list-style-type: none"> <li>■ <b>Vendor selection &amp; due diligence:</b> Adopts a development-grade process to ensure suitability</li> <li>■ <b>Model inventory:</b> Obtains adequate documentation of chosen vendor models</li> <li>■ <b>Model validation and model testing:</b> Obtains and evaluates model testing results and conduct ongoing performance monitoring based on model use case</li> </ul>

### What it means to you?

- If entities are engaged in OTC derivatives dealing or considering applying for the IMA or the Basel approach, establishing a firm-wide MRM framework is essential. Begin by carrying out a gap assessment against the General Principles for MRM and preparing remediation plans to address any identified shortcoming. MRM plays a pivotal role for those applying for the Standard Initial Margin Model (SIMM) for calculating the initial margin amount.
- Entities should establish firm-wide MRM policies that clearly outline model definitions, materiality assessment criteria, documentation standards, roles and responsibilities, and requirements for model development, validation, implementation, revalidation, periodic review and decommission.
- For other LCs not yet required to comply with these principles, the SFC still encourages voluntary adoption of the guidelines when managing major financial models used in operations.



## 6 Other notable change highlights

Other updates that merit attention are summarized below:

- Control guidelines set to be proposed in future consultation papers will replace annual risk control self-assessment return on OTC derivatives activities, with the inclusion of a set of liquidity risk management measures
- A set of notification requirements will replace the capital requirements on the risk arising from trading loss sharing arrangement
- General FRR changes are proposed for promoting greater connection with the mainland markets, facilitating business diversification into emerging markets, commodity trading, virtual assets derivatives trading and central clearing of repo while improving the control over elections made under the FRR
- The consultation is set to end on 13 October 2025 whereby interested parties may submit their responses to the SFC for consideration





## Authored by

**Stephanie SY Cheng**  
Senior Manager

**Willy Tin**  
Senior Manager

**Sue Chen**  
Senior Manager

**Adam Bookless**  
Senior Manager

**Daniel So**  
Manager

**Ivan Yeung**  
Senior Consultant

**Wing Wong**  
Senior Consultant

**Desmond Chen**  
Consultant

## Contact points



### Sky So

Partner

Financial Services, Risk Consulting,  
Ernst & Young Advisory Services Limited

Tel: +852 2849 9217  
Email: sky.so@hk.ey.com



### Stephanie Cheng

Senior Manager

Financial Services, Risk Consulting,  
Ernst & Young Advisory Services Limited

Tel: +852 3471 2714  
Email: stephanie.sy.cheng@hk.ey.com



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APAC no. 03023609  
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