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28 Hong Kong Futures Exchange - Playing a Leading Role in Hong Kong's Financial Infrastructure

Rotary Club of Kowloon Luncheon
4 February 1999

There is so much to talk about when it comes to futures that I have often been accused of being long-winded. Although I did not grow up as a futures practitioner, I have been on the Board of the Hong Kong Futures Exchange for over eight years - most of the time as Vice-Chairman and recently as Chairman. So futures is really a topic close to my heart.

The attack on the Hong Kong dollar last August and the subsequent events which followed it brought the Hong Kong Futures Exchange more than its usual share of the spotlight. With it too came more than its usual share of misunderstanding. So I am pleased to be able to speak to you directly, and hope that I can shed some light onto the situation as it really exists today.

To do this I will inform you how the Exchange has grown to become a principal player on Hong Kong's financial stage. Then I will talk about the major market participants, and the main types of risk. Finally I will brief you on what we are doing to bring the Exchange into the next Millennium.

So, if you will excuse the ambiguity, back to the Futures.

Setting the Stage

The Hong Kong Futures Exchange (HKFE) was born in December 1976 out of the Hong Kong Commodity Exchange which changed its name in 1985 to what we are known today.

The Exchange started successfully trading financial futures, Hang Seng Index Futures, in 1986 but it met its first crisis a year later when, no doubt, many of you may still remember, trading was suspended for four days following the Black Monday Market Crash of October 1987.

Regrettably, this resulted in some of our Members then being unable to meet their margin calls. Those were dark days for the Exchange.

But time moved on, and we learned, and Hong Kong learned. In 1993, the Exchange diversified into options - the Hang Seng Index Options - complementing our Hang Seng Index Futures. Two years later, we launched our Automated Trading System (we call it the ATS), to complement our open outcry method of trading, with an aim to eventually replacing it. I shall say more about this later.

Our open outcry system operates from a modest size trading floor with over 300 traders in their different coloured jackets crying out their bargains in the pit using the most traditional channels of voice and hand signals. A lot of major futures exchanges are still hanging on to this system, but the global trend is to go electronic.

We currently trade eight product groups with a 1998 annual turnover of 8.5 million contracts. Among these, our flagship product - Hang Seng Index Futures - remains one of the top few stock index futures globally.

On the international stage we play our part too. The HKFE was one of the ten exchanges, and the only one based in Asia, to set up the global task force that produced the 60 recommendations following the Barings Incident in 1995. In addition, our former Chief Executive, Ivers Riley, who remains a special consultant to the HKFE, is currently President of the International Options Markets Association.

The Exchange itself is governed by a Board of 13 directors. Some of them represent Member firms, while others come from a variety of business, academic and non-market practitioner backgrounds. It is structured under a non-executive Chairman, currently myself, and a Chief Executive, Mr Randy Gilmore. Until 1995, Randy was Deputy Chairman of the Securities and Futures Commission (or the SFC).

There are over 130 Members, the majority of which are registered as "Futures Commission Merchants", a name which has had thrust upon it in recent months the pejorative overtones associated with "speculators" and about which I shall also say more later.

Clearing and settlement of contracts are executed by HKFE Clearing Corporation, which is a wholly-owned subsidiary of the Exchange. Its function is to act as counterparty to each side of every trade, thus removing the risk of default and guaranteeing that all contracts are honoured.

And we are regulated by the SFC in the same way as the Stock Exchange, and governed by five different Ordinances.

Hedgers, Speculators, Arbitrageurs

On the global financial stage, there are different people playing different roles in the futures market. Most of them fall into three categories - hedgers, speculators and arbitrageurs.

First, hedgers. The more conservative use of hedging is where a market user wishes to enter into a position as an investor or to protect an open position (one in which he has commodities, currency or securities bought but not sold) that is likely to fluctuate in price over the period that the position remains open. For instance, an investor with a long equity position might hedge against a future fall in equity prices.

In other words, futures provide a formalised method of transferring risk from those wanting to reduce their market exposure, to those willing to accept the risk - of course, for a reward.

So much for hedgers. What of "speculators"?

Sometimes referred to as "directional traders", speculators may be the highest flying gamblers on the financial stage, but they should not be universally denigrated. After all, they are prepared to accept the risk which more conservative investors wish to offset. As such, they are vital to the success of Hong Kong's futures market, and indeed the financial market as a whole, as it is their interaction with other market users that provides liquidity in the market, facilitating investors, fund managers, banks and companies to trade in the market effectively.

So, there is indeed a positive side to speculative activities. What then of arbitrageurs?

They are one group of market users, sometimes wrongly branded "short sellers". These are, technically, completely non-speculative. Here, positions from one market are transferred to another to take advantage of price differences between the two markets. It is not speculative as the trader will only switch from one market to another knowing exactly what the rates or prices are in both markets and will only switch if the profit outweighs the cost of the trade. These "arbitrageurs" too play a vital role in the global marketplace as their activities help smooth out market and price inefficiencies in related markets and products.

Hedgers, speculators, arbitrageurs. They form the tripod of any successful futures market because between them they create liquidity.

Risk

Having talked about the three major roles on the "futures" stage, it is time to discuss the theme of the drama itself. If I were to sum it up in just one word, I would choose the word "risk". Indeed, risk (or the transfer of risk) is what the futures business is all about, and the principal role of the HKFE is to provide the forum, a marketplace where hedging and risk sharing can take place for the investment community.

What then is risk? Risk falls into four main areas - Counterparty risk; Market risk; Legal risk and Systemic risk.

Counterparty Risk is associated with the guarantor role played by our Clearing House, which we own. In effect it is a form of credit risk because should a Member default on a transaction, the Clearing House is responsible for ensuring payment to non-defaulting Members. This concept also extends to any external organisation for which the Exchange deals on a regular basis, for example settlement banks and custodians.

The next is **Market Risk** - when volatility in the market increases, risk increases, and thus, in times of acute volatility, the Clearing House will impose intra-day margin calls to ensure that every position is adequately covered. These intra-day margin calls have to be settled within 60 minutes and only in some extremely rare cases have the calls not been met, in which case the Member may be barred from entering into new positions and may be forced to liquidate others. This excellent record over many years testifies to the prudence of our risk management system.

The third kind of risk, **Legal Risk**, occurs if a dispute were to arise between the Clearing House and its settlement bank over the finality of transfers between deposit accounts of the clearing Member and the Clearing House.

Finally, **Systemic Risk** - as it is the Exchange's duty to collect margins from Members holding open positions on the Exchange, it is imperative that the banks into which these monies are placed by the Clearing House are thoroughly scrutinised for integrity and creditworthiness. And there is the Money Settlement system itself. Any failure in the system will affect the risk exposure of the Clearing House.

Some of these risks I have mentioned may seem extremely remote, but considering the colossal size of transactions undertaken by the global fund managers, they are absolutely necessary. It is the HKFE's view that if Hong Kong is to hold its head high and grow in stature as an international financial centre, we must maintain the lead where risk management is concerned.

What are some of the other measures we take to manage risk?

Time does not allow me to run through them in detail, but they are both comprehensive and effective. Indeed, they are tougher than most, if not all, other exchanges in the world. Trigger points on margin calls are constantly reassessed in light of the degree of volatility, position limits are controlled tightly and are strictly adhered to, and the Reserve Fund is maintained at a level covering considerable market risk. Indeed we at the HKFE believe that one of the Exchange's major achievements has been its "success in managing risk in extreme volatility". One such period was the third quarter of 1998 - a period to which we look back with pride.

1999 - The Year of the Future

But what of the future?

I believe 1999 will be truly "The Year of the Future" for the HKFE, for one major reason, above all others. Electronic trading.

While we first launched ATS in November 1995 and at present most of our products are already being traded electronically, our two flagship products - Hang Seng Index Futures and Hang Seng Index Options - which account for about 90% of our trading volume, are still traded on the open outcry system, although such days are numbered. This year, we are pressing ahead full speed with the phasing in of the HK$100 million computerised system, which will allow these two products to be migrated to the ATS, thus making the HKFE a fully electronic marketplace.

We will, however, not announce the date of full migration until the new electronic trading system has been thoroughly tested by both ourselves and our Members, and that we are all confident in a totally successful 'premiere'. But I do hope we can make such an announcement before very long.

Why did we decide to go electronic? We believe to compete with the world's best in what is increasingly a 24-hour global market, we simply have to be as good as the best, and better if we can possibly achieve it.

I will close by quoting from the recently appointed new Chairman of the SFC, Mr Andrew Sheng, who summed it up very clearly when he said, "To put it simply, markets are drifting to those centres that are most transparent, liquid, efficient, competitive, fair and robust in terms of financial infrastructure and regulation." Well, that just about says it all!

Using the theatrical simile, I believe that the role of the HKFE is to provide the stage, to attract the international players, to set the rules, and to fill the house with a growing body of enthusiastic supporters. I believe we are achieving all of these, and more international players want to appear on our stage, thus enticing even more supporters.

The 'premiere' of the full migration to electronic trading this year will again place us squarely in the spotlight. The world will be watching, and we have every confidence that Hong Kong will have one more success story to tell.