

Keynote address at AIMA APAC Annual Forum 2021

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The last time this forum was held was in March 2019, and obviously we are now living in a very different world. A broad range of issues have emerged since the pandemic struck, but I want to focus my remarks on two important items on the regulatory agenda.

The first is sustainable finance, and specifically disclosures of climate-related risks by funds and corporates. The second concerns issues flowing from the Archegos saga, in particular how that episode relates to prime brokers and derivatives.

Sustainable finance

Over the past 18 months or so we have been dealing with the pandemic. But we are also in the midst of another major global crisis, which has been an increasing focus of concern over several decades: climate change. It is now obvious to most that climate change is a source of extreme risk—if not an existential threat.

Looking beyond the possibility of irreversible damage to ecosystems, societies and economies, climate change also poses significant financial risks for businesses. At the same time, it presents tremendous opportunities to finance the massive energy-related investments needed to fund the complex transition to a more sustainable economy.

Policymakers around the world have been rightly focused on how to manage this transition. More jurisdictions and businesses have now committed to net-zero targets and global regulators are pushing ahead with concrete initiatives under the umbrella heading of sustainable finance. These efforts are increasingly well-coordinated at the international level. More progress has been made over the past few months than in previous years combined.

My firm belief is that Hong Kong's status as an international financial centre and its unique access to Mainland markets create an opportunity for us to make a significant contribution to these efforts. We therefore intend to play a leadership role not only in Asia but also globally. As a result, the sustainable finance agenda is accelerating very quickly in Hong Kong, moving well beyond green bond programmes.

Note: This is the text of the speech as drafted, which may differ from the delivered version.

Last year, we set up a cross-agency steering group¹ to coordinate the initiatives of Hong Kong's financial regulators—as well as the Government—to more firmly orientate the financial system around a broader sustainability agenda.

One of our first decisions was to require that climate-related disclosures be aligned with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) no later than 2025. However, this goal may be superseded at a corporate level by the adoption of new global climate reporting standards even earlier.

Climate disclosures by fund managers

To move this agenda forward, the SFC has conducted a public consultation on mandatory climate disclosures by asset managers. Proposed amendments to our Fund Manager Code of Conduct would provide high-level principles for these disclosures. A circular to the industry would set out baseline requirements and enhanced standards for compliance.

By issuing guidance, we can help make the disclosure of climate-related risks clearer, more comparable and higher-quality. This will go a long way towards helping investors understand the extent to which their portfolios are financing emissions, as well as portfolio exposures to climate risks, both with the ultimate aim of helping them make more informed decisions. Not only that, but better, more consistent disclosure should also reduce opportunities for greenwashing.

At the initial stage, our proposed climate disclosure requirements would apply to all fund managers, irrespective of whether they delegate their investment management functions to other firms. We do not intend to limit them to ESG-focused managers or funds, not least because international standards are going much further and to do so would not move the dial very much.

These requirements would not apply to the management of discretionary accounts, other than in obvious cases such as where a client's climate-related investment preference has been incorporated into the mandate.

We took great care to ensure a proportional approach when formulating these proposals. All fund managers would be required to comply with baseline requirements, but larger fund managers—those with a significant market share—would have to make more detailed disclosures.

During our consultation we have been asked about the thresholds which would trigger the stricter requirements, and we are still looking carefully at where to draw the line.

We also understand that the industry has some concerns about the availability of data—that is, of the underlying data needed to make quantitative assessments of the impact of climate-related risks on a fund or investment strategy, or the data necessary to disclose a portfolio's weighted average carbon intensity or alternatively its carbon footprint.

¹ The Green and Sustainable Finance Cross-Agency Steering Group is co-chaired by the Hong Kong Monetary Authority and the SFC and also includes the Environment Bureau, Financial Services and the Treasury Bureau, Hong Kong Exchanges and Clearing Limited, Insurance Authority and Mandatory Provident Fund Schemes Authority.

When we put our proposal together, we acknowledged that common standards and data are lacking in many areas. We were also mindful that this is an evolving field and we should avoid being overly prescriptive. For these reasons, we made it clear that fund managers would initially have the flexibility to adopt the tools and metrics they consider appropriate, within reason.

Over the longer term, we expect that trends towards global convergence of metrics and standards will accelerate, and I should say that a great deal of progress is already being made in this direction.

Global sustainability reporting standards

This brings me to another major global regulatory initiative which aims to address the less-than-ideal situation where a multiplicity of different sustainability disclosure standards are vying for the private sector's attention.

The IFRS Foundation has proposed to establish a new, global sustainability standard-setting board alongside its existing International Accounting Standards Board. This would be a way to institutionalise the TCFD recommendations at the corporate level, together with other leading sustainability standards, to create a comprehensive, harmonised reporting framework. An alliance of existing standard setters have proposed a climate-related financial reporting prototype which can help kick-start this process.

The advantage of this approach is that it would build on the IFRS Foundation's proven standard-setting process for financial accounting, which rests on a rigorous governance structure to ensure public accountability and widespread acceptance. The International Organization of Securities Commissions (IOSCO), which I chair, has an important governance role in this project, and would look to assess and, if appropriate, endorse sustainability reporting standards for use across jurisdictions.

I believe that this initiative offers a very promising pathway to convergence on a single set of global standards, with the ultimate aim of laying a foundation for independent assurance of climate reporting modelled on traditional financial audits. The current plan is for the new board to be set up later this year and discussions are now focusing on the more technical aspects of the proposal.

Initially, the emphasis would be on climate reporting standards—centred on the “enterprise value” of businesses. Reporting will cover physical and transition climate risks, as well as assessments of the degree to which a business's own emissions footprint affects its enterprise value. The basic idea is to report on data and metrics which are of concern to investors, categorised to address the specific circumstances of different industry sectors.

This “climate first” approach can be expected to expand to other sustainability areas. We can also expect the new standards to evolve in much the same way that the international accounting standards have.

Archegos

Now I want to turn to the recent Archegos incident.

The type of derivatives at the heart of this saga—total return swaps (TRS)—were used by Archegos to obtain synthetic exposure to a small range of stocks through its prime brokers.

These transactions were highly leveraged via TRS margining, and gross exposures were in the tens of billions of US dollars.

So when Archegos failed to meet margin calls, this triggered a multi-billion dollar sell-off and extremely large losses at prime brokers. This episode raised a large number of issues, but today I want to mention just two areas of regulatory interest.

Now to be clear, we do not have a direct regulatory handle on Archegos itself, which is a single family office. But we—and our international counterparts—do regulate the prime brokers which had Archegos as a client. So an obvious place for us to begin is with the role of prime services and equity derivatives.

The starting point is that in Hong Kong we had already made clear our expectation that our licensed firms to properly manage their risks². The firms involved were all global and have global frameworks in place to monitor margin financing activities.

A key aspect of internal risk management is to ensure that appropriate margin is obtained at the outset, and clients' financial positions and margin profiles are monitored throughout the life of a TRS.

Proper attention must also be given to the need to collect additional margin based on changes to the counterparty's credit quality and underlying exposures. We have also communicated our expectation that firms have established procedures for stress testing and conduct tests regularly.

Concentration risk also seems to have been a major factor. Archegos built up huge positions in some single stocks, and some prime brokers may not have known the full extent of its overall exposure.

All of these are areas for further examination and we have been working with firms and other regulators on lessons learned. The focus for now is on how potential red flags can be identified before problems occur.

We will consider additional guidance for prime brokers if we identify shortcomings. Although we are looking at this through the lens of regulated prime brokers, any outcomes will inevitably flow through to and affect clients, whether they are regulated hedge funds or unregulated family offices.

A second area of interest has to do with the scope and effectiveness of some post-crisis reforms to the derivatives market. Archegos used multiple prime brokers, so it seems each only had limited visibility over the positions it had taken. This seems to have resulted in an increase in the concentration risk as well as the counterparty risk.

The international margin requirements jointly imposed by the Basel Committee on Banking Supervision and IOSCO for non-centrally cleared derivatives require in-scope firms to collect and post margin, with a view to reducing the systemic impact of a counterparty default. These requirements are being rolled out in stages, with final implementation now scheduled for September 2022.

² The SFC issued a [circular](#) and a [report](#) in June 2019 setting out its expected standards of conduct and internal controls for prime brokers.

TRS are equity derivatives which would be subject to margin requirements. So the question arises: if these requirements had been in place earlier, would they have made a difference? There are a number of factors at play here.

Obviously, there is no way of knowing for sure what may have happened. This is largely a counterfactual exercise.

There are questions about whether specific counterparties to the trades would be subject to the margin regime and whether bilateral positions reached the level where initial margin requirements would kick in. We also have to consider the impact of splitting concentrated positions across multiple prime broker counterparties.

Separately, we have been looking in detail at whether information held in the over-the-counter derivatives trade repositories could provide regulators with a line of sight into the build up of the sorts of exposures and concentration risks resulting from TRS positions which were central to the Archegos incident.

Trade repositories were a key part of financial market reforms in response to the role of derivatives in the global financial crisis, and in my view the information reported to and stored in them may not have been used as effectively as it could have been to identify emerging risks.

The Archegos incident did not lead to serious systemic implications. But it has provided a window into potentially unsatisfactory risk management of leverage, margin and hedging. It also provides an opportunity to re-examine some aspects of the reforms introduced in response to the global financial crisis.

Conclusion

I said at the beginning that we are living in a very different world compared to the last time this event was held. More and more, the challenges we face are global challenges—whether they be financial disruptions caused by COVID, climate or something else.

Firms worked closely with us during the crisis to ensure they could still serve their clients and address the inevitable regulatory and operational risks arising from dispersed working environments. We kept in close contact with our overseas and Mainland counterparts to ensure our responses to the crisis were properly coordinated and consistent across borders.

We have faced unprecedented challenges, but despite all of the uncertainty brought about by the pandemic, our markets have operated normally throughout. This is to the credit of Hong Kong's financial services industry, which has demonstrated commendable adaptability in the face of severe disruptions.

Thank you.