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SFC Compliance Bulletin: Intermediaries

Risk management in a time of uncertainty

This edition of the *SFC Compliance Bulletin: Intermediaries* discusses risk management and governance during times of market stress, volatility and deteriorating credit outlook. Using illiquid investments as an example, it highlights some specific risks facing Hong Kong intermediaries in the current market and suggests precautionary responses.

Elevated credit risks. Market uncertainty. Hard-to-sell assets. Massive redemptions. These are common characteristics of recent problems involving big names in the global fund industry.

These incidents were warnings to the financial industry that funds which are overweight in less liquid investments face heightened risks in volatile markets. Managing liquidity risk is not only key for fund managers, but also for financial intermediaries with leveraged exposure to illiquid bonds.

The International Monetary Fund's Global Financial Stability Report issued in October 2019 noted rising corporate debt burdens as well as increasing holdings of riskier and more illiquid assets by institutional investors in several large economies.

Global fund managers face liquidity problems

UK's Woodford Investment Management suspended trading of a flagship fund exposed to illiquid and unquoted investments

Lime Asset Management in South Korea suspended withdrawals when it could not liquidate convertible bonds

London-based H2O Asset Management saw huge withdrawals following concerns about its corporate bond holdings

Risk governance

In this environment, it is crucial for intermediaries to put in place a sound risk governance structure. This structure should be commensurate with the nature, size and complexity of the intermediary's operations. The roles and responsibilities of senior management should be clearly defined within the risk management and oversight functions of the firm. In particular, licensed corporations should have appointed Managers-In-Charge (MICs) who are suitably qualified and experienced to be responsible for risk management functions.

Risk governance implemented through organisational structures, measures and procedures ought to be supplemented by the deployment of appropriate resources.

Step 1

Risk identification
Understand the firm's business operations and identify the associated risks having regard to its strategy, size, operations and risk profile, as well as prevailing market conditions

Step 2

Risk evaluation
Assess and analyse potential risks and the corresponding impact on the firm's business operations

Step 3

Risk mitigation
Establish risk management and internal control systems to mitigate the impact of risks, and conduct ongoing monitoring and evaluation of risk controls

Step 4

Risk reporting
Report risk management results to senior management to form the basis for decision making and accountability

Liquidity risk

Liquidity risk arises when there is a mismatch between a fund's assets and its liabilities. The risk may be greater if the fund is concentrated in illiquid investments. Funds with an open-ended structure, especially those with daily dealing arrangements, run an even higher risk of liquidity problems when investors rush to redeem on any hint of trouble or poor performance. This was the case with Woodford Investment Management in the UK.

In Hong Kong, a private fund with highly concentrated assets was unable to meet redemption requests. The fund, which was distributed on the Mainland, was incorporated in the Cayman Islands and managed by a company which was not licensed by the SFC. The fund's major assets were senior notes issued by a Hong Kong listed company with which it was affiliated. The listed company could not meet payment deadlines under the notes and extended the maturity dates. Unable to redeem the notes, the Cayman fund deferred redemption.

Investors should be wary of investing in funds concentrated in hard-to-sell assets, particularly illiquid bonds issued by the same group, and funds with long or extendable redemption dates. Intermediaries should also heed the guidance issued by the SFC on managing the liquidity risk of open-ended funds[1].

Good practices for managing liquidity risk

Establish effective liquidity risk management policies and procedures, with action plans to meet redemption requests under normal and stressed market conditions

Target investment diversification and regularly assess the liquidity profile of the fund's assets and liabilities, considering its investor profile and historical and expected redemption patterns

Ensure that the fund's dealing (subscription and redemption) arrangements are appropriate for its investment strategy and underlying assets throughout the entire product life cycle

Perform liquidity stress tests on an ongoing basis to assess the impact of severe adverse changes in market conditions as well as the fund manager's action plans and liquidity risk management tools

1 Circular to licensed corporations, Managing the liquidity risk of funds, 23 August 2019 and Circular to management companies of SFC-authorised funds on liquidity risk management, 4 July 2016.

Credit risk

In a prolonged low interest rate environment, investors look for higher yields and better returns. In Hong Kong, sales of non-investment grade corporate bonds grew 65% between 2016 and 2018 and transactions in high-yield bond funds increased from $2 billion to $18 billion[2]. Many of these bonds yield double digit returns, reflecting a high risk of default. Investors should be cautious when investing in high-risk investment products.

Intermediaries distributing or advising on these high-risk products should be mindful of the requirements governing selling practices, including the suitability obligations under the Code of Conduct[3]. Intermediaries also need to provide investors with sufficient and accurate information about these products, including their features and risks. They must present balanced views and not focus solely on the products' advantages.

There have been more cases where financial groups affiliated with securities brokers have had their capital substantially tied up in investments in defaulted corporate bonds or notes, overdue loans or mature but unsettled private funds. Some of these bonds, notes or loans were secured by illiquid shares or shares suspended from trading on the stock exchange. Similarly, some private funds also had holdings in defaulted corporate bonds or notes and illiquid or suspended shares. It is important for brokers to adopt a prudent approach when extending credit.

Brokers should also be aware that listed bonds (such as those listed under Chapter 37 of the Listing Rules) on the balance sheet of a licensed corporation can no longer qualify, based on their listed status only, as liquid assets in the liquid capital computation under the revised financial resources rules[4] which came into effect on 1 April 2019.

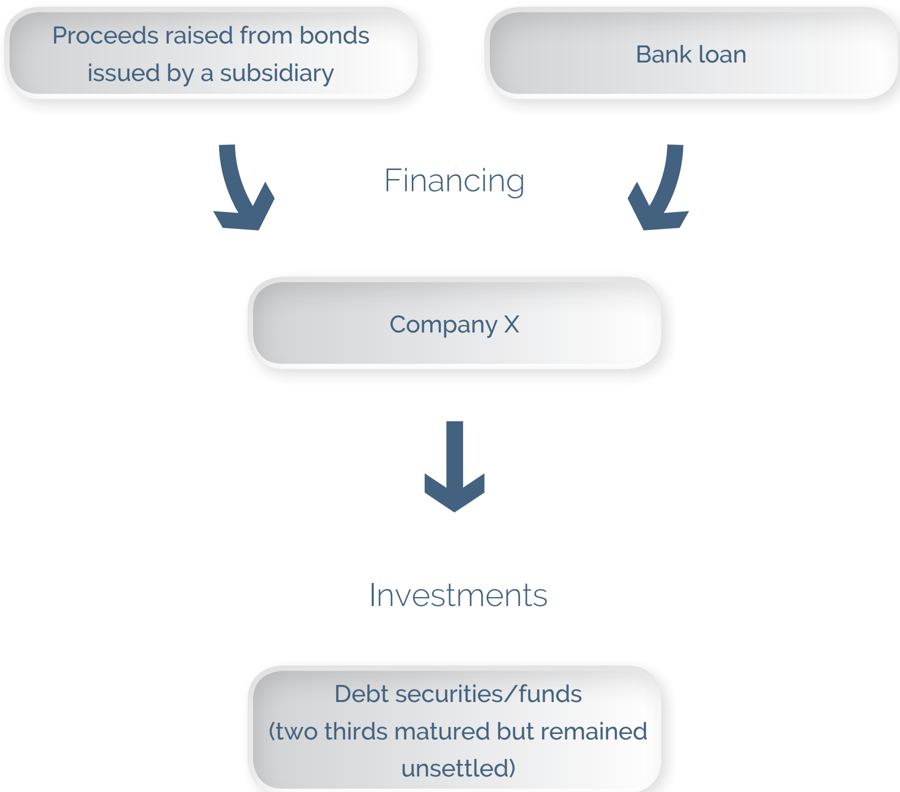
The Hong Kong Monetary Authority (HKMA) and the SFC issued a joint circular in April 2019 on complex financing arrangements noted during their coordinated inspections[5]. In addition, recent cases noted by the SFC involved similar financing arrangements with loans from affiliates secured by listed shares. These complex arrangements made it difficult to properly manage overall financial risks.

2 Survey on the Sale of Non-exchange Traded Investment Products, December 2018.
3 Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.
4 Securities and Futures (Financial Resources) Rules.
5 HKMA and SFC adopt a coordinated approach to supervise banks and licensed corporations, circular issued on 24 April 2019.

Case studies – Credit risk of investments or lending by affiliated entities

- Company X is the Hong Kong holding company and approved substantial shareholder of several licensed corporations. It invested extensively in (i) unsecured notes issued by listed and private companies, (ii) notes issued by substantial shareholders of listed companies and secured by the shares of these listed companies, and (iii) funds that invested in a single stock, notes which subsequently defaulted or stocks with low market liquidity. Two-thirds of the company's investments had passed their maturity dates and either remained unsettled or had their maturity dates extended. Most of the remaining investments were subject to long lock-up periods. Financing was provided by a bank loan and proceeds from bonds issued by a subsidiary. As the majority of the investments had technically defaulted or would not mature before the bank loan and the bonds came due, Company X may face a funding gap.

Company X's financing arrangements



- Company Y is the Hong Kong holding company and approved substantial shareholder of several licensed corporations. It nearly defaulted on its outstanding syndicated bank loan because most of its funds and those of its subsidiaries were locked up in doubtful share pledge loans advanced by a money lending subsidiary. In the end, the company resorted to a capital injection from its parent company to save it from a liquidity crunch.

We have repeatedly warned against opaque and complex financing arrangements whereby margin lending risk or credit risk is disguised as investment risk. When credit risk materialises in one part of a group, the reputation and financial integrity of the licensed corporations within the group may also be adversely affected. Holding companies and controllers of intermediaries should prudently manage overall group financial risks to ensure they can provide financial support to the intermediaries and contain contagion risks which may affect their financial integrity. The SFC cooperates closely with fellow regulators, both locally and outside Hong Kong, to require licensed corporations to take prompt corrective action where necessary.

Conclusion

It is paramount for intermediaries to exercise due care, skill and diligence and deploy necessary resources to manage and contain the risks facing their business activities. This is particularly important in times of market uncertainty and slower economic growth. Intermediaries should put in place a sound risk governance structure and be aware that risk management is not solely the responsibility of the risk management team or designated individuals. Senior management, including the board, responsible officers and MICs, should bear the primary responsibility and will be held accountable for the overall risk management control of their firms.

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