Road Ahead for Risk Management in the Greater China Market

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Opening

I would like to thank the organiser Kornerstone for inviting me here to speak today.

This year is full of challenges. The global market turmoil, the collapse of Lehman Brothers, the sharp market sell-offs and the evaporation of liquidity all point to the importance of prudent financial risk management by market practitioners. On top of this, several operational risk incidents have made headlines, the most prominent being the unauthorised trading at Société Générale. I will take this opportunity to share with you a few observations I have on risk management in the Hong Kong finance industry.

Challenges in financial risk management

By now, you will have heard many explanations of the causes of the recent financial crisis and the possible solutions. As governments worldwide keep a close eye on the market reaction to the numerous bail-out proposals and stimulus packages, policymakers including ourselves continue to review the framework governing the international financial architecture and consider how market resilience can be strengthened.

The financial crisis has shown that the private sector has not been exercising sufficient self-restraint on excessive risk-taking. The continued supply of abundant liquidity, lax risk management standards and skewed incentive structure all contributed to the single-minded pursuit of returns without sufficient regard for risks. Risk management has fallen behind financial innovation. Product complexity masked the dynamic interaction of risk factors. Marking-to-model offered false comfort about true asset value. Mathematical sophistication gave risk measurement priority over proper risk identification and management.

Market participants are the primary beneficiaries of a stable financial system and the reduction in systemic risks. It is in the collective interest of the public and private sectors to take an active approach towards achieving this objective.

In this regard, the private sector should be proactive and take steps to ensure the implementation of proper risk systems, methodologies and controls in their organisations. Senior management have an active role to play in driving the risk culture and risk governance of the organisation, and in striking the balance between risk appetite and risk controls. The linkages between credit, market and liquidity risks call for better integration of risk management functions, as well as organisation structures which encourage cross-disciplinary communication. Equally important is the exercise of market discipline by industry participants in their allocation of investment capital and credit lines.

On the public sector side, the recent crisis has shown that the financial tsunami has global reach, and demands global solutions. One of the inevitable results of globalisation is that there are no effective firewalls between markets. The crisis has demanded a co-ordinated and consistent response by authorities around the world in order to restore market confidence and stability. The experience points to the need to review the regulatory framework and structure in a global context in order for regulation to be more effective in today's financial landscape and global marketplace.

The post-mortem of a crisis usually leads to a call for more regulation. At the same time, it is important that we do not over-react. There is a need for increased dialogue between the regulators and the market if we want to maintain a sound, robust market. Our duty as regulators first and foremost is investor protection and market integrity. We recognise, of course, that regulation should not come at the expense of market development. We adopt a consultative approach in the introduction of new rules and regulations. We therefore welcome your views and suggestions as to how our market infrastructure and the stability of our financial markets can be further strengthened.

Operational risk management for trading activities

In January this year, a single trader at SocGen managed to take open futures positions of about EUR 50 billion notional on three European stock market indices, and the bank lost EUR 4.9 billion in closing out those exposures. This incident brings operational risk under the spotlight, and is a timely reminder of the need for proper internal controls.

We would like to remind senior management of financial institutions to maintain adequate oversight in the following three key areas.

Senior Management Responsibility

Effective control requires management buy-in. Senior management should take primary responsibility to maintain effective control procedures to prevent errors, omissions, fraud and other unauthorised activities. Firms with business lines undergoing rapid growth should assess whether or not adequate resources have been allocated to the support, monitor and control functions to ensure that they are commensurate with such business growth. From time to time, we notice that the operational infrastructure and support functions in some firms are in the continuous "catch-up" mode. Firms need to review regularly the balance between business demand and operational capability.

Senior management should enhance their staff's awareness of the potential risks inherent in the firm's operations in the context of the functions performed by such staff, so that staff members have the ability to relate their day-to-day activities to the risks they may encounter and are alive to these risks. Support, monitor and control should be performed by qualified and experienced individuals who have sufficient understanding of their role and responsibility in surveillance over any suspicious activities, transactions or product valuations and violation of internal and external requirements.

In several incidents where unauthorised trading was discovered, it transpired that the supervisor of the rogue trader did not have a proper understanding of the activities of the trader and the corresponding exposure his positions would bring. Management should ensure that supervisory staff have sufficient skill and authority to perform their functions.

Trading Controls

Appropriate trading limits and position limits should be established and monitored at appropriate intervals. Firms should consider imposing limits on the size of individual trades and on cumulative gross nominal exposure, in addition to limits on net exposure. Trader confirmations should be sent out and reconciled promptly by back-office staff independent of front office.

For firms that carry out proprietary trading or market making, it is a good practice to put in place for each trader a trading mandate that defines the products, markets and authorised strategies. Likewise, firms should reconcile margin or collateral requirements to trader or book level. There should also be a regular review of the records of individual traders and trading units and the profit and loss attribution of the trading operations to ensure unusual items are properly analysed and understood in the context of the trader's strategy and positions.

Red Flag Transactions Reporting

Firms should consider implementing a systematic process for handling "red flag" transactions reported by staff. Red flag transactions would include unusually large trading volumes, an unusual amount of profit and loss attributable to a trader vis-à-vis his trading strategy, transactions with no legitimate purpose or a recurring pattern of late allocations, errors or cancellations and questionable product valuations.

To enable the above process to function properly, a clear reporting channel for red flag transactions should be put in place to ensure that staff can report any suspicious transactions swiftly to the appropriate management level within the firm where decisions on corrective action can be taken.

Road Ahead

Looking ahead to the enhanced role of risk management in our financial markets, I will go beyond our own borders. Over the past 15 years, we have seen a gradual integration between the Hong Kong and Mainland markets. Since the listing of the first Mainland company in the Hong Kong stock market in 1993, Hong Kong has become the capital-raising centre for Mainland enterprises. We also see Mainland financial intermediaries such as banks, insurance companies and securities brokers establish or expand operations here, competing alongside their international and local Hong Kong peers. This year also marks the first time that we grant a licence to a Mainland asset manager to operate in Hong Kong.

As more Mainland financial intermediaries are setting up operations here, they will gain first-hand exposure in a global financial market setting, operate under strict market discipline, and learn international financial skills. Operating in Hong Kong means that these entities are forced to compete in the global market, which demands best practice in governance, conduct and risk management.

Presently, the Mainland and the Hong Kong markets have built smooth linkages in capital raising, fund flows and intermediary operations. We hope to see a further integration of systems, platforms, regulations, standards and products that would make the China market, with Hong Kong being a key component, a strong competitor on a global level.

We have a close partnership with our Mainland counterpart CSRC, as well as co-operation agreements with other Mainland financial regulators CBRC and CIRC. Through information sharing and staff exchange, we could develop regulatory policies that would foster a synergistic relationship between Hong Kong and the Mainland. In a similar vein, we also look upon the risk professionals in Hong Kong to share their experience and insights with their Mainland counterparts so that together we develop deeper, broader and stronger markets as we weather uncertainties that lie ahead.

Conclusion

Hong Kong has been working hard to build its platform as a financial centre with standards on par with international norm. The resilience of our financial system and the robustness of our financial institutions are built on the foundation of prudent risk management practice and tight risk discipline. It is a collaborative effort which requires contribution from the public sector and the private sector, from us and from you.

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