SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

Risk 101: Back to Basics
Keynote Speech at 2019 Risk Hong Kong Conference

Ms Julia Leung
Deputy Chief Executive Officer and Executive Director, Intermediaries

21 June 2019

Good morning. It's an honour to be invited to give the keynote for the 2019 Risk Hong Kong conference.

The agenda for today covers some of the hottest issues facing the financial services industry, from investing in China and quant strategies to the use of artificial intelligence (AI) and machine learning. You may find yourselves operating in an uncertain political and economic environment, facing rising costs, fee compression and mounting competition from disruptors deploying novel technologies and business models. In response, firms seek to reinvigorate their businesses by entering new markets, trying out different strategies or experimenting with distributed ledger technology or using AI to make investment or trading decisions.

Compared to these exciting developments, risk and risk management may seem like a dull distraction which stifles the innovation needed to succeed in today's global markets. But the real-life examples I'm about to share illustrate the dangers firms face as they chase the next big thing. They may lose sight of a key tenet for running a sound and sustainable business. That is, the need to get the basics right and have prudent risk management controls in place.

Trends come and go, but sound risk management is an immutable regulatory principle. It applies no matter whether you are an old-school securities broker or a pioneer in virtual assets or robo-advising. So today, I want to get back to the basics of risk management and talk about what the SFC has been doing to address some of the issues in the markets.

Credit risks

Let's start with credit risks – specifically, securities margin financing (SMF). Some of you may know that the SFC's new guidelines for SMF activities[1] will take effect in October this year. This guidance arose out of our concerns from the sharp increase in margin loans[2] accompanied by a deterioration in loan quality and concentrated exposures to individual margin clients and collateral stocks. What's more, margin loans were often granted based on single stock collateral which were illiquid or already heavily pledged.

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

[1] Guidelines for Securities Margin Financing Activities. See the press release issued on 4 April 2019.
[2] Between 2006 and 2017, margin loans increased nine-fold to $206 billion.

With such concentration risks, brokers may struggle to recover their margin loans in times of market stress and may be left with significant losses. This may have a knock-on effect on their clients and their bankers, undermining the integrity of the wider financial system.

And there is a lot of stock lending in our market. In many cases it involves newly-wealthy entrepreneurs whose money is tied up in their own companies' stocks. The bankers who advise on the companies' listings and acquisitions also manage the entrepreneurs' personal wealth, and think that gives them a clear line of sight into their finances. So when they pledge large parts of their controlling stakes for loans to finance their fast-growing businesses, the bankers are all too willing to oblige, spurred by the fear of missing out and the lure of easy money.

There is a lesson here for all of us, not just those involved in margin financing. It is that good credit risk management is not just the domain of securities brokers, it is essential for *any* financial institution in the lending business.[3]

Obscured risks

Even worse are those forms of credit risk which are obscure. We recently issued a joint circular with the Hong Kong Monetary Authority[4] where we expressed serious concerns about complex, opaque financing arrangements being used by some banking groups. These arrangements may conceal financial risks and make it hard for regulators and the group itself to conduct appropriate risk assessments.

This circular prompted a lot of speculation about whether or not the use of private funds, leveraged structured financing and multiple layers of investment vehicles or legal entities are acceptable to regulators. This is misguided. We recognise that SPVs[5], private funds, equity swaps, credit derivatives and other forms of structured finance bring tax efficiencies, capital savings and other benefits. Our focus in the circular was not on the layers in the financing structure but rather on the use of complex arrangements to obfuscate risks, conceal beneficial ownership or avoid regulatory scrutiny.

During our inspections of licensed firms, we have seen margin financing disguised as fund investments; one bank's lending to another masquerading as discretionary account investments in bonds; and structured products and derivatives used to channel money into private funds with a single underlying investment. We questioned these arrangements' underlying economic purpose and rationale, which appear to have been designed to circumvent regulations, bypass internal lending guidance, avoid credit analysis, evade audits or mask conflicts of interest in connected party transactions.

We have called on financial institutions to review any similar financial arrangements and take steps to address the risks. We would not hesitate to take regulatory action against firms aiding or abetting criminal activity.

[3] For example, a global bank syndicate extended EUR 1.6 billion in loans to Steinhoff, a South African retailer, in 2016. The loan was secured by the controlling shareholder's shares which were valued at twice the loan amount. After accounting irregularities came to light in December 2017, Steinhoff's shares dropped by nearly 90% and the syndicate faced substantial losses.
[4] See the circular dated 24 April 2019.
[5] Special purpose vehicles.

SFC
證監會

Counterparty risk and margining of non-centrally cleared OTC derivatives

I also want to mention counterparty risk and the margin rules for non-centrally cleared over-the-counter derivatives (OTCD). Currently, counterparties whose derivatives notional exceeds the USD 1.5 trillion threshold need to exchange initial margin, or IM. This threshold will be lowered to USD 8 billion in September 2020. The industry has voiced concerns about this and requested changes to the margin framework.

Regulators have heard the concerns that many small firms would be brought into scope. In March this year, BCBS-IOSCO[6] released a statement which in essence said a firm need not make any preparations to exchange IM so long as its calculated margin amount is below the USD 50 million IM exchange threshold[7]. In addition, regulators around the world are committed to the same implementation timetable to avoid market fragmentation. We will take these developments into account and issue consultation conclusions on our margin regime in due course.

It is easy to forget that the whole point of collecting IM is to protect yourself against your trade counterparty's default, which is a very basic point. Therefore, even if a firm is outside the margin rules, if it has significant exposure to its counterparties, then it will need to demonstrate that it is properly managing the risks, be it through collecting discretionary IM (which some firms are already doing), or via other means. This is just common sense risk management and should not be a controversial concept.

Regulatory capital regime for OTCD

Since we are on the subject of OTCD, I want to make a few quick points about the proposed regulatory capital regime for the new regulated activity (RA) known as RA 11[8]. The proposed framework announced by the SFC in July 2017[9] includes minimum capital requirements for RA 11 dealers and advisers. It also introduces an internal models approach for calculating the capital requirements to address the market and counterparty credit risks of licensed corporations engaged in OTCD activities.

Firms will need to obtain the SFC's approval to adopt the internal models approach, and we will benchmark the approval criteria against the latest Basel capital standards. The approval process will entail a comprehensive review of the applicant's business and risk management processes, in addition to the technical details of the OTCD risks and the internal model itself. We are now working on the details and will consult the public on the draft rules when they are ready. Firms are encouraged to approach the SFC early if they are contemplating internal models and should ensure that the associated policies, procedures and documentation are in order before applying for approval.

[6] The Basel Committee on Banking Supervision and the International Organization of Securities Commissions.
[7] See the BCBS-IOSCO statement on the final implementation phases of the margin requirements for non-centrally cleared derivatives released on 5 March 2019.
[8] Dealing in or advising on OTCD products.
[9] See the Consultation Conclusions and Further Consultation on Proposed Changes to the Securities and Futures (Financial Resources) Rules.

SFC
證監會

Conduct risks associated with OTCD transactions

The last topic I want to cover on OTCD is conduct risk. Many of you are familiar with the business model where a Hong Kong-based licensed firm acts as an introducing broker for a client who contracts with a client-facing affiliate in another jurisdiction, say in London. The affiliate may conduct back-to-back trades to offload the risks to a risk-booking affiliate. There may also be transfer pricing arrangements between the affiliate and the Hong Kong firm to share the profits and losses. Such booking models enable the aggregation of risks into a centralised hub which facilitates netting and hedging, resulting in more efficient use of capital.

As a regulator, our baseline is that the client's interests must be adequately protected when a licensed firm induces the client to contract with an affiliate. This is particularly important if the affiliate is not licensed by the SFC, or subject to comparable regulatory oversight, and commits misconduct or fails to honour its contractual obligations due to its poor financial condition or improper risk management. In this connection, we have updated the list of jurisdictions that we regard as comparable on the SFC's website and included Ireland[10]. We have also begun a thematic review of licensed corporations' risk governance and oversight frameworks as well as their risk management practices[11], with a particular focus on the underlying risks of remote booking models and the use of transfer pricing arrangements.

Conduct risks and the sell side

Inevitably, no discussion of conduct risk is complete without mentioning the sell side. Conflicts of interest have been a recurring regulatory concern and we have identified a number of conduct issues in our inspections over the years[12]. Common deficiencies associated with client facilitation include traders who misrepresented a house or client facilitation trade as an agency trade, were silent or not transparent about whether facilitation would be involved in a trade or failed to obtain explicit pre-trade consent from clients[13].

We take these findings very seriously. I want to reiterate that firms and their traders should obtain explicit client consent prior to each client facilitation trade. Client consent should never be unidirectional, blanket, implied by the making of disclosure or obtained after the trade. More importantly, when dealing with clients, licensed individuals should always act honestly and fairly. Firms are expected to correctly identify and disclose their trading capacity to mitigate conflicts of interest. If a client asks to be crossed by a natural order, provide agency trading. If you want to conduct a principal trade, obtain the client's explicit consent first.

At the end of the day, it boils down to whether you do the right thing. This is not rocket science and should come naturally to licensed persons who are fit and proper. It is about acting in an ethical manner, in accordance with your fiduciary duty to clients and in compliance with the rules and regulations. The SFC will not hesitate to investigate suspicious conduct and non-compliance, and will take action against the individuals responsible, including the Managers-In-Charge (MICs) as well as the firms.

---

[10] See the circular dated 17 May 2019.
[11] The SFC announced the thematic review of remote booking, operational and data risk management practices on 16 November 2018.
[12] See for example the press release dated 16 December 2008 and the circular on client facilitation dated 14 February 2018.
[13] See the circular dated 14 May 2019. The inspection found that some firms' policies and procedures could not ensure compliance with the SFC's expected standards, even though the firms claimed that they had been reviewed and enhanced following the SFC's February 2018 circular.

SFC 證監會

Risk governance

Poor risk governance is another issue we are laser focussed on. One recent case involved a hedge fund trading emerging market currencies. Even though it seemingly made the right bets, its derivative positions were so huge it could not exit them in a thin and volatile market. In a matter of months, hedging losses wiped out the fund's entire net asset value, leaving some of its counterparties in the red.

Although private funds sold to professional investors do not require the SFC's authorisation, we expect licensed fund managers to comply with our Fund Manager Code of Conduct. Our requirements include maintaining a satisfactory risk governance structure as well as risk management procedures, which should be commensurate with the nature, size, complexity and risk profile of the firm and the funds' investment strategies.

In this and other cases, fund managers failed to adequately account for the liquidity and concentration risks of their investments and did not set appropriate limits on market risk and derivatives concentration. We have also seen instances where risk managers failed to exercise independent oversight by asking portfolio managers to define the risk limits or relying solely on data provided by them to monitor risk limits.

Suffice it to say, the SFC takes a dim view of such deficiencies. We expect asset managers to properly manage risks. Having a risk management function capable of independently overseeing and challenging the front office, setting and enforcing risk limits, is key. Such considerations apply irrespective of whether the asset manager is trading simple vanilla instruments or exotic derivatives, or moving into novel products such as virtual assets. This is just basic risk management 101.

People risk

An effective risk management function builds on the strength of a firm's governance framework and the calibre of its people. This brings me to my final topic, people risk. This is about having capable senior management, which include the board, responsible officers and MICs, to prudently oversee a firm, supported by competent staff.

As I'm sure you're all aware, the SFC's MIC regime emphasises the importance of senior management bearing primary responsibility for ensuring appropriate standards of conduct and compliance. A critical part of this is to understand the firm's business strategy and the risks it is exposed to. If these are too complex for senior management to understand, then one has to ask whether they are competent and whether the business activities and risks are suitable for the firm.

I want to add a quick word on the significance of the SFC's revamped licensing process[14]. This allows us to collect more relevant information from applicants upfront, make decisions faster and identify issues earlier. For example, the revised notification form require firms to explain the reasons for a licensed employee's departure and specifically asks whether the employee was subject to an internal investigation in the six-month period prior to leaving. This was designed to provide us with information to assess the ongoing fitness and properness of licensed individuals. It also helps keep track of "rolling bad apples" who could potentially repeat their misbehaviour at another firm.

---

[14] See the circular to announce new licensing forms and mandatory electronic submission of annual returns and notifications dated 1 February 2019.

The new licensing forms also ask corporate applicants to project their operating expenses for the first six months after they are licensed. This helps us assess their financial soundness and ensure they can comply with the regulatory capital requirements. If their excess liquid capital cannot cover the projected expenses, applicants would need to demonstrate that additional funding would be forthcoming if needed.

Conclusion

In this day and age, it is all too easy to lose sight of the basics, get sucked in by the latest trend or put profits before prudence. As a regulator, I cannot overstate the importance of having robust and effective risk management.

Donald Rumsfeld once famously said that there are known unknowns and unknown unknowns. The art of risk management then, is how to identify and deal with such unknowns effectively. Inherently, risk deals with uncertainties and probabilities. You can never be sure if there will be a black swan event. But there is one thing you can be sure of. If you forget the basics, if you fail to properly manage your risks, if you neglect your fiduciary duty to treat your clients fairly, if you put your firm's interests ahead of clients, then the SFC will come knocking on your door.

And when we do, you do not want to be the MIC of risk management who failed to notice the risk flags, or failed to exercise independent judgement and escalate your risk management concerns; you do not want to be the MIC of compliance who turned a blind eye to the warning signs of misconduct; and you most certainly do not want to be the MIC of Overall Management Oversight who fell asleep at the wheel and allowed unethical, egregious or reckless behaviour go undetected. The consequences can be dire.

So to conclude basic risk management 101, my final questions to you are: do you really understand the risks your firm is exposed to? Do you have the proper safeguards in place to effectively manage those risks? At the end of the day, have you done your homework and are you doing the right thing?

I hope you have an enjoyable conference. Thank you very much.