

Anticipated Media Questions and HKEx's Answers on the Proposed HKEx Clearing House Risk Management Reform Measures 8 July 2011

OVERVIEW OF PROPOSALS

1. Why are clearing house reforms needed?

The reforms are needed because:

- The 2008 global financial crisis prompted governments, regulators, and financial institutions to, among other things, increase capital adequacy standards and enhance risk management requirements. The Securities and Futures Commission (SFC) requires that HKEx meets or exceeds the evolving international standards for clearing houses, which in some areas are more demanding than HKEx's current practices.
- The clearing houses of HKEx are of systemic importance and the robustness of their risk management is crucial to the long term stability and competitiveness of Hong Kong as an international financial centre.
- As one of the world's leading financial exchange and central counterparty (CCP) operators, HKEx strives to be on par with or exceed international standards and its counterparts in its risk management. The same standard is required by HKEx's regulator.
- The existing risk management framework in the Hong Kong securities market is heavily reliant on ad-hoc measures and static financial resources which are not scalable to the increasing levels of counterparty risk exposure and volatile nature of the local market.

More specifically:

- Hong Kong Securities Clearing Company (HKSCC) currently does not have a comprehensive and permanent margin arrangement and scalable Guarantee Fund (GF) regime, leaving HKSCC to significant exposure.
- HKFE Clearing Corporation (HKCC) stress testing is currently below the standards of the International Organisation of Securities Commission (IOSCO), resulting in under-funding of its risk management capital.

2. What is the rationale for implementing the proposals now?

HKEx needs to address the gaps identified in its risk management framework and apply additional measures which are consistent with international standards. For example, HKSCC's losses in connection with the defaults of Lehman Brothers entities in 2008 made it clear that HKSCC needed to strengthen its existing collateral policy and its fixed GF arrangement.

It is difficult to predict the timing of any future financial crisis and its magnitude. The long term interests of Hong Kong and its financial markets would be best served by moving forward with these risk management proposals rather than delaying. Hong Kong's securities and derivatives markets cannot afford the collapse of their central counterparties.

Other major clearing houses have implemented or proposed changes to their GF/Reserve Fund (RF) funding structures to better measure and address the default risk faced by them. With systemically important clearing houses operating in a major international financial centre, HKEx should not lag behind other major CCPs in terms of its risk management.

3. What will be the main changes?

Under the proposals, the main changes are to:

- introduce standardised daily margining and a Dynamic Guarantee Fund (Dynamic GF) into the securities market; and
- revise the stress testing assumptions for the securities and derivatives markets.

4. What is the market impact of the proposals?

As these proposals are intended to strengthen the risk management of the clearing houses, it is recognised that increased financial resources will be required from the market. The extent of impact on individual Clearing Participants (CPs) will depend on their respective business activities with the clearing houses.

To reduce the impact of the new requirements, HKEx will provide CPs with credits and a contingent advance (see further information in Q5 below) and increase its Risk Management Capital (HKEx RM Capital). Overall, had the proposed measures been applied throughout the reference period from September 2007 through December 2010 the impact on the markets would have been:

- HKSCC

On average, 80 per cent of the HKSCC CPs would not have been required to pay margin or into the Dynamic GF on a given day. Throughout the reference period, around 50 per cent of the HKSCC CPs would not have been affected by the new measures at all.

The average daily increase in margin collectible from the market due to the proposed margining would have been around \$1.4 billion (from \$2.4 billion* to \$3.8 billion).

The average daily increase in Dynamic GF collectible from the market would have been around \$1.1 billion (from Nil to \$1.1 billion).

* Although HKSCC currently does not have a standard margining mechanism, it collects additional collateral from certain CPs with major positions to protect the Guarantee Fund from material loss in the event of sizable default.

- HKCC

On average, around 90 per cent of the HKCC CPs would pay less than \$5 million additional for the Dynamic RF.

The average daily increase in Dynamic RF payments from HKCC's CPs is estimated at around \$280 million (increase from \$409 million to \$689 million).

SEOCH

On average, around 90 per cent of the SEOCH CPs would have benefited from paying less into the Dynamic RF.

SEOCH CPs would benefit from an estimated average daily reduction of around \$200 million in Dynamic RF collectible (reduction from \$560 million to \$358 million).

5. How will the new funding support help to alleviate the incremental financial burden of CPs under the proposal?

The new funding support backed by the HKEx RM Capital will mainly be provided in the form of (1) HKSCC Margin Credit (2) HKSCC Dynamic GF Credit and (3) HKCC Contingent Advance Capital (HKCC Contingent Advance).

HKSCC Margin Credit

HKSCC will grant a Margin Credit up to \$5 million to every HKSCC CP. CPs will only be required to provide margin for the amounts in excess of this Margin Credit. If a default event results in any losses, HKSCC will be responsible for the amount of losses up to the Margin Credit granted to the defaulting CP.

HKSCC Dynamic GF Credit

HKSCC will grant a Dynamic GF Credit up to \$1 million to every HKSCC CP. CPs will only be required to provide Dynamic GF for the amounts in excess of this Dynamic GF Credit.

HKCC Contingent Advance

HKCC will share 50 per cent of the daily Dynamic RF collectible with HKCC CPs through the HKCC Contingent Advance. By sharing half of the total Dynamic RF, the HKCC Contingent Advance in effect shoulders more than half of the *incremental* Dynamic RF which CPs would otherwise be required to contribute daily. Non-defaulting CPs will be responsible for the HKCC Contingent Advance amount in cases of default. Any default loss sustained would first be paid through HKCC Contingent Advance and subsequently recovered from non-defaulting CPs.

HKEx believes the proposed support maximises the number of CPs that would benefit from the proposed changes, taking into account of the different situations in the respective markets.

6. What is the HKEx RM Capital?

The HKEx RM Capital is funded by HKEx to strengthen the risk management of its clearing houses and to support their roles as CCPs. The HKEx RM Capital is available to all three clearing houses as the third line of support for potential default losses.

HKEx has currently set aside \$3.1 billion of shareholders' funds for the HKEx RM Capital and will set aside an additional \$900 million to support the extra financial resources requirements under these proposals.

Notwithstanding the HKEx RM Capital, HKEx stands by its CCP obligations and needs to provide the liquidity to fund any default at any given time.

7. How would an additional \$900 million set aside from the shareholders' funds impact HKEx's income and dividends?

This increased financial support arrangement is not expected to affect HKEx's profit of the year or HKEx's dividend payout. HKEx would make appropriate disclosure on this in its published financial statements.

8. What was the basis in determining the additional \$900 million? Would HKEx increase it further in the future?

HKEx determined the \$900 million with reference to the proposed changes and back-testing results based on the level of activities during the reference period.

HKEx will review the adequacy of the HKEx RM Capital from time to time, taking into account of the changing market dynamics and evolving regulatory standards.

9. When would the proposals be implemented if adopted?

HKEx targets to release the consultation conclusions in early 2012. HKEx expects to introduce the new measures in mid-2012 if it decides to adopt the proposals after this consultation. HKEx will give due consideration to market responses and opinions before deciding on the next step.

10. Will HKEx combine the GF/RFs of the securities and derivatives markets?

HKEx is not proposing the combination of the GF and RFs of its three clearing houses. However, like the current arrangement, funding provided by HKEx (the HKEx RM Capital) supports the risk management of the three clearing houses under the proposal.

11. Don't these proposals favour large brokers and discriminate against small brokers?

No. The proposals were formulated based on the "user pays" principle.

Risk management contributions should commensurate with the levels of risk created by individual CPs. This means that the larger the risk exposure, the higher the margin and Dynamic GF/RF requirements.

12. Won't any new HKSCC margin arrangements increase HKEx's revenue/profit?

The objective of these proposals is to enhance risk management of the clearing houses, not to increase HKEx's profit.

HKEx's investment guidelines require it to invest margin funds mainly in liquid assets and investments that can be easily liquidated to enable the clearing houses to meet their obligations. Therefore, profit making is not the primary goal and any profits would be incidental.

Irrespective of HKEx's investment return on the margin funds, interest would be paid to CPs on their cash margin at the prevailing savings rate.

13. Will these proposals have any implication on the development of OTC Clearing or its risk management measures?

No, these proposals are independent from the OTC Clearing initiative and cover only trades cleared through HKSCC, HKCC and SEOCH. HKEx is working with the SFC to formulate the risk management model for its planned OTC clearing business.

OTHER CONSIDERATIONS

14. What is the Risk Management Fund (RMF) and why is it needed?

The concept of the RMF is to set up a fund dedicated for risk management purposes. It is based on the principle that all key stakeholders, including market participants, the clearing houses and the SFC, should play a role in supporting the overall stability and long term viability of Hong Kong's securities and derivatives markets.

HKEx anticipates that future tightening of IOSCO standards, growth in market turnover or other changes in market dynamics may require increased funding from HKEx and its CPs.

To ensure long term sustainability and scalability of funding to support appropriate risk management measures and to mitigate any higher funding contributions from its CPs, HKEx is keen to work with the Hong Kong Government and the SFC in establishing an RMF which is funded by the SFC, HKEx and the market in equal proportion.

HKEx's discussions of the RMF with its regulator are still at a preliminary stage and details of the RMF do not form part of HKEx's risk management proposal at this time.

15. What is the target size of the RMF?

While there is no pre-determined size for the RMF, HKEx believes that the fund should be large enough to provide adequate coverage for the risk exposure in connection with the activity levels of its three clearing houses.