

## SECTION 2: QUESTIONS FOR RESPONSE

Please indicate your views by providing comments as appropriate. Where there is insufficient space, please use additional sheets of paper as necessary.

### HKEx's Proposal 1: Revise HKEx Stress Testing Assumptions

#### Questions

1. Do you support the proposed revision of the Price Movement assumptions in stress testing?

☒ Yes

☐ No

Please provide reasons for your response and include any other suggestions or comments you may have on this question:

We support it in principle as we appreciate the fact that price movement is one of the major factors attributable to CP default.

Having said, we would like to comment that in the cash market, the effect of price movement to settlement default for long position is very different from that for short position ("the Asymmetric Price Risk"). Under the Securities and Futures Ordinance, a person who sells securities must possess the securities. When the market is up, the aggregated net worth of the market increases and the sellers will just deliver the securities they possess for settlement with HKSCC. It is very unlikely that there will be a massive amount of securities settlement default for short position just because of the price going up. The securities settlement risk of CPs to the HKSCC for the short position should be immaterial as the probability of settlement default due to price movement is small. The Asymmetric Price Risk can be verified with HKSCC historical data. We don't think that the price-up assumption of 20% for the cash market is necessary.

2. Do you support the proposed revision of the Counterparty Default assumption in stress testing?

☒ Yes

☐ No

Please provide reasons for your response and include any other suggestions or comments you may have on this question:

We don't disagree in principle on using the largest and the fifth largest counterparty as the assumption in stress testing.

However, when HKSCC evaluates the exposure of the largest and the fifth largest counterparty, it should consider the probability of settlement default, the Asymmetric Price Risk characteristic of securities settlement and the impact of all the risk mitigation measures HKSCC is in place which should be able to reduce the amount of the net settlement exposure of CPs to HKSCC.

## HKEx's Proposal 2: Introduce Margining and Dynamic Guarantee Fund in HKSCC

### Questions

3. Do you agree with the proposed margining arrangements at HKSCC?

☒ Yes

☐ No

Please provide reasons for your response and include any other suggestions or comments you may have on this question:

We are supportive of the proposed margining arrangement at HKSCC.

However, we have reservation on the magnitude of the margin rate proposed. We believe that the amount of the margin required should reflect the amount of settlement default risk of the products, not just the price movement risk of the products. The settlement risk should be the function of the chance of settlement default and the potential liquidation loss of the default positions. The securities settlement risk should be much smaller than the clearing risk of the futures products for 2 reasons. 1) the securities settlement has the Asymmetric Price Risk characteristic. 2) the futures products are highly leveraged (normally more than 10 times leverage) The leverage nature of the futures products will give rise to a fact that the investors in the futures market may take on excessive exposures beyond their financial capability, and therefore increase the chance of default. Due to the fact that cash market securities cannot be leveraged up to the size comparable to the leverage of the futures products. Therefore, on aggregated basis, the CP's default risk on the cash market should be significantly smaller than that on the futures market

Our rough estimation is that the margin rate for cash market settlement should not be greater than 1/4 of the margin rate for the corresponding futures products. The proposed minimum 5% margin rate and its methodology for cash market settlement looks excessive as compared to the normal futures margin rate which is normally set at around 6% to 8%.

4. Do you agree with the proposed Dynamic GF model at HKSCC?

☒ Yes

☐ No

Please provide reasons for your response and include any other suggestions or comments you may have on this question:

We agree that the proposed model is to improve the transparency of the system and alleviate the systemic risk of the market. It is much better than the current discretionary measures that HKEx has been implementing since the Lehman collapse.

However, we think that the size of Dynamic GF is too excessive for the following reasons:

1. On page 39, the calculation of reference positions for stress testing doesn't allow cross-stock netting among different stocks. In reality, at the time of defaults, HKSCC has the right to exercise cross-stock netting.
2. The securities settlement risk to HKSCC for short position is very different from that for long position. (the Asymmetric Price Risk).
3. In order to address the too big to fail risk, we recommend that if necessary, HKSCC should consider capping the settlement risk exposure to those concentrated players or applying a weighted proportion for GF fund contribution requirement by respective CPs.
4. All CPs are securities dealers subject to the prudential supervision of SFC and are required by the SFC to maintain adequate financial resources at all time. All CPs have set aside liquid capital for minimizing their respective default risks and providing a protection to the CP's counterparties. As a major counterparty of CPs, and for the sake of reducing the systemic risk of the market, HKSCC should ask the SFC's support to allow HKSCC to have preferential or direct access into some, if not all, the financial resources of the defaulting CPs at the time of default, for example, replenishment right arrangement, recourse to the defaulting CP's owned securities positions in the HKSCC and/or the futures positions in the other two clearing houses or allowing inter-group offset across among all the licensed corporations within the same group. HKSCC should be allowed to make use of the financial resources of the defaulting CPs to reduce the risk exposure arising from price movement risk of the CP's net settlement positions.. It doesn't make sense that despite all CPs have set aside financial resources, HKSCC as the major counterparty of CPs cannot access the financial resources of the defaulting CPs at the time of default and let the tedious liquidation process consume the residual value of the financial resources.
5. The Dynamic Fund model doesn't take account for the probability of settlement default and occurrence of the stress scenario. Capitalizing the RF in full up to the amount of the projected loss according to the model is not the best use of the capital funding resources of CPs and the HKEx. Please bear in mind that all CPs have been well capitalized according to the Financial Resources Rules. We recommend HKEx should consider alternatives for funding the RF, for example, buying insurances or allowing the replenishment rights as the contributions. Furthermore, according to the Dynamic Fund model, the price movement risk of the market is deemed as the major factor attributed to the default, HKEx can also consider buying rolling forward 20% out of the money options on HS Indices to cover the extreme price movement risk.
6. Last but not the least, we appreciate and support HKEx's asking the SFC to allow margin and GF contributions to be counted as liquid assets

in the FRR. In the FRR, securities trade receivables prior to the settlement day are counted as liquid assets. Since the margin and the contribution to the GF are related to securities trade settlement, they should be treated as same as securities trade receivables in the FRR. Otherwise, CPs are subject to double capital requirements whereas the non-HKEx dealer can avoid.

### HKEx's Proposal 3: Revise HKCC Reserve Fund Calculation

#### Questions

5. Do you support the proposed revisions to the HKCC Collateral assumption?

☐ Yes

☐ No

Please provide reasons for your response and include any other suggestions or comments you may have on this question:

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6. Do you support the use of HKCC Contingent Advance in relieving burden of CPs?

☐ Yes

☐ No

Please provide reasons for your response and include any other suggestions or comments you may have on this question:

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7. What is your view on allowing RF contribution to be counted as liquid capital? Will this help your company in terms of reducing liquid capital funding burden?

We agree that if not all, at least part of the RF contribution should be counted as liquid capital. The reasons are 1) the probability of stress scenario occurrence is small and therefore the chance for the RF contribution to be used is small. 2) The FRR and the SFO Ordinance should already have adequate provisions to minimize CP's default risk, which should have a positive effect to mitigate CP's default risk to HKCC. Not mentioning that the positive impacts are not considered in the RF contribution requirement, CPs are subject to further capital requirements on the RF Fund contribution. A clearing member of HKCC has much bigger capital requirements than a

### Questions

non-clearing futures dealer of same size of open interests. It discourages futures brokers becoming the clearing members of HKCC and thus increases the concentration risk of HKCC.

#### **HKEx's Proposal 4: Revise SEOCH Reserve Fund Calculation**

##### **Questions**

8. Do you support the proposed revisions to the SEOCH Collateral assumption?

☐ Yes

☐ No

Please provide reasons for your response and include any other suggestions or comments you may have on this question:

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