

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:

22% stressed daily price movement for HSI & HSCEI was derived base on worst 1-day price drop during life of index, which occurred in 89 for HSI (-22%) and 98 for HSCEI (-16%). However, equities market had evolved significantly since, such as conversion to electronic trading, improve liquidity & etc. These factors had reduced the crash magnitude, as evident by lower maximum daily drop since 2000 were 13% & 14% for HSI & HSCEI respectively. Currently, initial margin for HSI & HSCEI futures are 11% & 14% respectively, which is significantly lower than proposed 22%.

With these, we feel current price movement assumption of 20% is prudent and conservative enough.

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:

The approach of Hong Kong Exchange to cover the single largest and fifth largest clearing member may not be sufficient. Although not a standard yet, many CCPs are looking to cover the two largest with funded resources and more on an unfunded "assessment power" basis. Having said that, determining the amount and make-up of financial resources needed by a CCP to withstand one or more clearing member defaults depends on the specific market for which it clears. As a result, we would not recommend calling for specific parameters to be applied to all CCPs as they provide different services and support different product types. Indeed, just within the Hong Kong Exchange

Group, which has three clearinghouses, appropriate determinations need to be made to cover the default of one or more clearing members simultaneously. The basis of the determination should be transparent and clear to the members.

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 agree with the concern that the GF has been maintained at HKD 120 Million even though volumes have increase 30 times since 1992, and note that since 2008, the GF has been maintained at HKD 245 Million. The order of application of the GF is not currently specified although there has been a market practice they have applied to resolve defaults. The order should be clearly defined so that all market participants know what will happen in a default scenario. As to margining at HKSCC, Paragraph 81 states that the Margin Credit given by HKSCC would greatly reduce the number of margin paying CPs to only 19% of the total number of CPs. We believe that all CPs should have "skin in the game", and contribute to the additional working capital requirements of HKSCC with respect to margining. It is our view that if CPs have problems from a working capital perspective meeting margin requirements, they should not be CPs.

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:

The move to a dynamic default fund is appropriate and common practice globally. Fundamentally, a move to introduce margining at HKSCC is a good thing. We do want to be sure that the introduction of the Dynamic GF does not result in open-ended liability of CPs, or as noted in CPSS IOSCO Standards- "non-defaulting participants should not be exposed to losses that they cannot anticipate or control". That means that the GF can be dynamic and change and increase but at the beginning of any day, we would know what our GF amount is and maximum liability as a CP.

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:

No particular comments on HKCC collateral assumptions, however agree with HKEx that removing the assumed IDM credits from stress testing is recommended.

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:

The proposed changes will result in a substantial increase in the Dynamic RF Fund which is positive from a risk management perspective. The analysis done by HKEx clearly indicates that the current level of Dynamic RF is insufficient. We do have concerns about the HKCC Contingent Advance which we understand to be a way to reduce the market impact of the increase required for the RF. Under the arrangement proposed, HKCC shares 50% of the increased (incremental) RF requirement of each CP. However, in a default, non-defaulting CPs would be obligated to pay/re-pay HKCC for the amounts "advanced" by HKCC. This means non-defaulting CPs have a contingent risk against all the other CPs which would only be realized in a stress scenario where defaults or multiple defaults could be occurring. It is our view that the Contingent Advance concept can provide time for CPs to adjust to a higher level of contribution to the RF, but over a relatively short period, all CPs should fund their required contribution to the RF. We understand the benefit of easing the transition to a new risk regime, but it should be structured so the "pay-in" required of CPs takes place in a phased way in a relatively short period of time, and not on the back of CPs taking risk on other CPs who may lack resources. In summary, through the HKCC Contingent Advance, non-defaulting CPs are taking risk on all the other CPs for the risk they bring to the clearinghouse. It is our view that it would be

Questions

better to size the fund as is appropriate under the stress testing assumptions HKCC establishes, and collect from each CP. If a CP cannot cover or fund their share of the RF, they should not be a CP, or alternatively, they should be restricted/limited in their activity to a level of risk they can support in their contribution to the Dynamic RF. We note and agree the positive development that the Replenishment Arrangements (Para 96) caps the liability of the CP, which has not been the case under the current structure

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?

■■■■ is in support of counting RF contribution as liquid capital. It will reduce our liquid capital funding burden.

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:

It appears that the current SEOCH reserve fund structure is overly conservative and would agree that the Dynamic RF for SEOCH can be reduced.