

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 agree with the proposed stress scenarios for the HKCC. These are based on volatilities linked to their main underlying markets – the HSI and the HSCEI. We therefore consider the proposed daily price movement assumptions of 25% for HSI and 20% for HSCEI as adequate.

However, we believe the assumptions for HKSCC (for cash market) and SEOCH (for stocks options) are understated. We are on the opinion that using the HSI to assess volatility on single stocks is inappropriate for several reasons, including:

- i. The HSI tracks the performance of a selected group of stocks, which happen to be: a) stocks of companies with large market capitalizations, b) the most active and liquid stocks listed in HKEX, and c) stocks that have the capacity to react more resiliently during periods high volatility given its relatively ample liquidity.*
- ii. The HKEX lists other large cap stocks that are notably more volatile than the HSI. A good example are some of the large H-Shares on where its observed volatility is significantly higher than that of the index (e.g.: 1288.HK)*
- iii. The HSI is heavily skewed towards one particular stock – HSBC Ltd (5.HK). HSBC weights in for approximately 15% of the index. The volatility of the index, consequently, is somewhat correlated to the performance of HSBC. HSBC is arguably Hong Kong's most liquid stock, with average daily trading volumes of approximately USD 200mn. Average volumes on Mid-to-small cap stocks (e.g. 330.HK, 410.HK or 2899.HK to name a few) are usually a fraction of that of HSBC and therefore are less resilient to absorb intensified volatility.*

We therefore propose a layered structure for daily price movement for stock and stock options. The structure should be a factor of liquidity and

volatility - e.g.: Tier 1 for large caps, Tier 2 for Mid-caps and Tier 3 for small caps. The 'shock' scenarios under each tier should be based on historical records from stocks representative of each tier.

This late approach is consistent with market risk practices within our organization.

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 selection of the first and the fifth largest clearing participant should be adequate as long as their respective pools of clearing and guarantee/reserve funds adequately absorb related unsecured potential exposures measured under both normal and stress conditions.

Bear in mind that dynamic guarantee/reserve funds are built proportionally to clearing participants' shares in each fund. Thus, an eventual default of the 1st and 5th largest contributors may, consequently, reduce the fund's capacity to absorb further losses. Guarantee/reserve funds should be engineered to absorb 'tail risk' – i.e.: residual risk as result of extremely abnormal market moves.

We are on the opinion that an adequate calculation of margin requirements and stress-test scenarios to derive guarantee/reserve fund requirements should be primordial. Hence, kindly note our observations about stress-tests on Question No1

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 principle of implementing a margining for securities trading, as it will mitigate losses arising from slippage in an event of a failed trades or force liquidations due to a clearing member's default.

However, as indicated in answer for Question No 1, any margining or further requirements for securities should be based on a factor of liquidity of the underlying stock rather than on volatility of the HSI.

As indicated earlier, we are on the opinion that the performance of the HSI is not a good proxy to assess risk from medium and small cap stocks, recently listed stocks or some H-Shares. Please refer to answer for Question No 1 and 2 for more details.

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 do agree with the idea of making the fund dynamic; however, as indicated earlier, we are on the opinion that the performance of the HSI is not a good proxy to assess risk from medium and small cap stocks, recently listed stocks or some H-Shares. Please refer to answer for Question No 1 and 2 for more details

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:

The idea of removing intra-day margin calls from collateral assumptions during periods of stress is sound from an exchange point of view; however we wonder if adopting such measure may eventually result in higher reserve fund requirements.

Could you kindly explain if the exclusion of intra-day margins may result in additional reserve fund top-ups? We are on the impression that this new measure may result in actual double margining – on where clearing members may be subject to reserve fund top-ups in addition to regular intra-day margin calls.

We understand that removing intra-day margin calls from collateral assumptions is simply an exercise to re-calibrate the effectiveness of the reserve fund. It will not necessarily stop the intraday margin practice per se.

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:

We are, indeed, in favour of such suggestion. The proposal certainly eases liquidity burdens on clearing brokers.

However, we understand from the paper that non-defaulting clearing brokers are in the obligation to pay back to the exchange any eventual loss absorbed by the Contingent Advance fund. This may lead to a situation where non-defaulting clearing brokers may end having relatively large, sizable commitments (or liabilities) to the exchange due to indirect, unrelated default events.

We pointed out in Question No 2 that eventual defaults by large

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clearing participants may notably reduce the size of guarantee/reserve funds. Thus, we stress the importance of adequate margin and guarantee fund requirement calculations that are ample and proportional to the risk of each individual clearing participant.

Kindly refer to Questions No1 and 2 for further details.

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?

It will certainly help, as it will ease the costly need to inject additional capital to top up liquidity requirements. The new guarantee/reserve funds may end being a very expensive exercise to clearing brokers. A broker may be on a need to further inject liquid capital on top of guarantee fund requirements to maintain regulatory liquidity levels.

However, we do acknowledge the regulatory rationale on not letting guarantee/reserve funds to qualify as liquid capital. These funds appear to be highly restricted and consequently subordinated to any other for margin requirement.

We are on the opinion that financial stability should prevail over individual interest; thus, we will be inclined towards any regulatory decision on the matter.

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:

Yes, those are resources that are liquid and already under the custody of the clearing house. Giving credit for these funds under the daily reserve fund calculation may also eliminate any potential double requirement through Reserve Fund contributions.

Placements in guarantee/reserve funds are expensive; thus, we are on the opinion that clearing brokers will welcome any initiative that will ease any subordinated capital requirements