

Responses to Follow-up Issues Arising from the Hearing on 26 May 2009

1. Apart from Minibonds and other Lehman Brothers (LB)-related structured financial products, whether the Hong Kong Monetary Authority (HKMA) was aware of any other complex and widely sold structured financial products offered by Registered Institutions (RIs) between April 2003 and September 2008; if yes, please provide the details of such products, including their nature, associated risks and sales value.

1.1 The information relating to structured financial products¹ sold by registered institutions (RIs) to retail customers in 2007 and 2008 (the HKMA does not have similar information prior to 2007) is set out in Table 1 below. It is noted that equity-linked products were the most widely sold structured financial products offered by RIs, accounting for almost 80% (both in terms of total notional value and total number of transactions) of all sales concluded during the period from 2007 to 2008.

¹ “Structured financial products” generally refer to products which, in addition to an exposure to the credit or default risk of the issuer (or guarantor where applicable), contain an exposure to an underlying asset, opportunity or risk that is usually unrelated to the issuer or the guarantor (adopting the definition of “structured products” in Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance published by the Securities and Futures Commission in September 2006). The information in Table 1 excludes transactions in structured financial products between RIs and other financial institutions and also excludes insurance products.

Table 1

Type of structured financial products	Transactions in the period 2007 to 2008			
	Total notional value		Total number of transactions	
	HK\$ billion	as % of total	Number	as % of total
Equity-linked products other than stock accumulators / decumulators	384.2	77.9%	734,886	79.4%
Stock accumulators / decumulators (excluding gearing)	53.3	10.8%	5,896	0.6%
Credit-linked products	5.9	1.2%	18,696	2.0%
Interest rate-linked notes	5.9	1.2%	7,576	0.8%
Fund-linked notes	1.7	0.3%	35,884	3.9%
Commodity-linked notes	1.0	0.2%	565	0.1%
Others	41.4	8.4%	121,971	13.2%
Total	493.4	100.0%	925,474	100.0%

1.2 In addition, Table 1 does not include foreign currency-linked products as they do not fall under the Securities and Futures Ordinance (SFO) regime. During the period between 2007 and 2008, foreign currency-linked products transactions of retail banks with retail customers had a total notional value of HK\$1,430.1 billion and the total number of transactions was 1,843,115 (i.e. about 3 times in notional value and 2 times in number of transactions of all structured financial products listed in Table 1 above). Although foreign currency-linked products do not fall under the SFO regime, our thematic examinations on retail wealth management also covered these products given their popularity among retail customers.

1.3 On the question of product complexity, it should be noted that there is no

common standard for complexity and different investors may have different views on the complexity of a particular investment product depending on their background such as investment experience. The regulatory focus of the HKMA is on the compliance of RIs and their relevant individuals (ReIs) with the applicable regulatory requirements in the selling of investment products, in particular in ensuring the suitability of the products for clients, adequate disclosure of the nature and risks of the products to clients, and proper explanations to clients to help them make informed decisions regardless of the complexity of the product.

- 1.4 Instead of focusing on complexity of the investment products, the criteria adopted by the HKMA for sample selection of investment products for review during on-site examinations include the popularity of the investment product (i.e. high sales volume), the number of customer complaints about possible mis-selling of the product, and other factors such as transactions with vulnerable customers and the sales commission attached to the product. The intention is to ensure that products that are widely circulated (in particular those to vulnerable customers) would be captured by our on-site examinations, because any problems associated with the selling of such products could affect a larger segment of investors.

2. Please provide further information on HKMA's Derivatives Team including its functions, composition and work, if any, relating to credit-linked or equity-linked notes (e.g. Minibonds or other LB-related structured financial products) before mid-September 2008.

2.1 In the light of the increased risks faced by authorized institutions (AIs) in their treasury and derivatives operations, the HKMA established a team under the Banking Supervision Department specialising in the oversight of treasury and derivatives operations. As of mid-September 2008, the specialist team had 6 staff members who possessed good understanding of various treasury and derivatives products, generally obtained a university degree in finance or accountancy, and had more than 3 years' experience in risk management or treasury and derivatives business operations.

2.2 The general responsibilities of the specialist team include:

- monitoring of market developments with potentially significant market risk implications to AIs;
- conducting on-site examinations of selected AIs' treasury and derivatives operations; and
- provision of technical and training support to other banking supervision staff in relation to treasury operations and derivatives products.

3. *The number of and other information on the following types of complaints received by HKMA since mid-September 2008 in relation to Minibonds or other LB-related structured financial products:*

(a) failure of RIs to ensure suitability of investment solicitations or recommendations for vulnerable customers who were aged 65 and those who were illiterate or had only received basic primary education; and

(b) RIs' inadequate disclosure of the risks associated with such products to customers.

3.1 Since the majority of LB-related complaint cases are still under investigation, it is premature to draw any conclusion at this stage on whether individual RIs have failed to ensure suitability of investment solicitations or recommendations for vulnerable customers or provided inadequate risk disclosure of investment products to customers during the selling process. Nevertheless, to assist the Subcommittee in its inquiry, we have summarised some information below based on the allegations made by the complainants and recorded in the HKMA's complaint database up to 29 May 2009.

Item (a)

3.2 According to the HKMA's records, there are 3,774 complaint cases involving customers who were aged 65 or above. Among these 3,774 cases, there are 1,215 cases involving customers who were either illiterate or had only received basic primary education.

Item (b)

3.3 Our records of LB-related complaints do not contain a category of alleged inadequate disclosure of the risks associated with LB-related products. However, our system has captured similar allegations such as insufficient explanation and misrepresentation of product features/risk during the selling process. The number of such complaints is 17,778.

4. The number of complaints from investors of Minibonds or other LB-related structured financial products the sales process of which had not been audio-recorded.

4.1 Our computer records of LB-related complaints do not contain information on whether the sale process was audio-recorded. Such information is recorded manually in individual case files when the investigation teams obtain further information from the relevant RIs during the detailed assessment and/or investigation process. Based on the information obtained from complaints and the relevant RIs so far, a majority of the related transactions were conducted at RIs' branches without audio-recording.

5. *The number of and other information on complaints received by HKMA since mid-September 2008 in relation to (a) the use of cold-calling by RIs to promote the sale of Minibonds or other LB-related structured financial products; and (b) the marketing of such products as products comparable to term deposits.*

Item (a) and item (b)

- 5.1 As explained in paragraph 3.1 above, the HKMA is still investigating most of the LB-related complaint cases and it is pre-mature to draw any conclusion at this stage on whether RIs used cold-calling to sell LB-related Minibonds and structured products, and whether RIs had marketed such products as term deposits.
- 5.2 Nevertheless, according to our records on LB-related complaints, as at 29 May 2009, the number of complaints received which contain allegations about possible cold-calling and product risk misrepresentation were 6,697 and 12,917 respectively. It should be noted that 4,707 of these complaint cases involved allegations of both cold-calling and product risk misrepresentation.

6. *The attached written questions raised by Mr LEUNG Kwok-hung at the hearing on 26 May 2009.*

1. 你認為 CDS 作為一個「信貸衍生工具」，槓桿比率高不高？
2. CDS 對出售者來說是不是風險高的金融產品？
3. 你認為銀行自己坐盤買賣 CDS 的風險是不是需要特別審慎管理？
4. 金管局那一年開始通知銀行要注意包括 CDS 及 CLN 在內的「信貸衍生工具」的風險管理的？
5. 香港的零售銀行有沒有出售自己發行的 CDS 合約？總數量大不大？
6. 你指「信貸掛勾票據」(CLN) 佔零售銀行的「零售結構產品」很小比重，約 1%，請給我這兩者的客戶數字每年分別的總數，以 04，05，06，07，08，按年計算？
7. 另請給我這 5 年，從零售銀行購買，含有 CDS 或 CLN 售金融產品的客戶的每年總人數。另請給相關「零售結構產品」的客戶每年總人數。

Item 1

6.1 Please refer to paragraphs 9.1.1 to 9.2.6 of the Monetary Authority's response dated 20 May 2009 to item (1) to item (3) of question 9 of the Subcommittee's information requests regarding follow-up to the hearing on 15 May 2009 (SC Ref. No. M21).

Item 2

6.2 How credit default swap (CDS) will affect the level of risk for the protection seller will depend on how this product is incorporated into a

structured product. For instance, credit-linked note (CLN) is a fully pre-funded investment embedded with CDS and its maximum principal loss is the original investment. In addition to the issuer's default risk, an investor of CLN is also exposed to the default risk of credit reference entities. Therefore the level of risk will be determined mainly by the probability of suffering a loss if the issuer or a reference entity is in default. In the case of LB-related minibonds, they are fully pre-funded investment products embedded with CDS and the maximum loss is the original investment. Therefore, these products are not leveraged in a strict sense, and the risk of suffering loss is when the issuer, a reference entity or the credit swap guarantor is in default.

Item 3

6.3 AIs are required to ensure prudent management of risks across different lines of business. Within the general risk management infrastructure that the HKMA expects AIs to have in place, the HKMA requires, among other things, that AIs should consider carefully all related risks and rewards before entering the credit derivatives market and should establish sound risk management policies and procedures, integrated into their overall risk management processes, and effective internal controls for such transactions².

Item 4

6.4 Under section 10 of the Seventh Schedule to the Banking Ordinance, AIs have a statutory obligation to satisfy the Monetary Authority that they continue to have adequate systems of controls. Therefore, AIs are required under this provision to ensure proper management of risks when

² Refer to the HKMA's Supervisory Policy Manual module CR-G-12 "Credit Derivatives".

conducting all banking businesses, including derivatives business operations.

6.5 The HKMA issued in December 1994 a guideline on "Risk Management of Financial Derivative Activities" to set out the basic principles of a prudent system to control the risks in derivatives activities. Further guideline on "Risk Management of Derivatives and Other Traded Instruments" was issued in 1996 to provide more detailed guidance on specific aspects of the process for managing the risks of authorized institutions' derivatives activities. The aforesaid two guidelines contain fundamental risk management principles that are applicable to all types of derivatives. In view of the rapid evolution of credit derivatives globally, a circular "Supervisory Approach to Credit Derivatives" was issued in 1999 to highlight, among other things, specific risk management issues in credit derivatives. In 2001, the circular was further enhanced and transformed to a Supervisory Policy Manual module entitled CR-G-12 "Credit Derivatives". M24

Item 5

6.6 According to the HKMA's information (apart from CLN which is a fully pre-funded investment embedded with CDS), retail banks in Hong Kong did not sell any CDS issued by them to retail customers.

Item 6

6.7 The HKMA does not have the requested information on hand. However, to assist the Subcommittee in its inquiry, the transactions in relation to CLNs and structured financial products in the period 2007 to 2008 are set out in Table 2 below.

Table 2

	Transactions in the period 2007 to 2008	
	Notional Amount	Number of Transactions
CLNs	HK\$5.9 billion	18,696
Structured Financial Products	HK\$493.4 billion	925,474

Item 7

6.8 The HKMA does not have information on the number of customers who have purchased CDS or CLN from retail banks. The HKMA also does not have information on the number of customers who have bought retail structured financial products. However, to assist the Subcommittee in its inquiry, the number of accounts involved in the securities dealing activities for each year since 2003 are set out in Table 3 below.

Table 3

Year	Number of accounts					
	2003	2004	2005	2006	2007	2008
Dealing in securities	1.29 million	1.51 million	1.62 million	2.24 million	3.16 million	3.09 million