

Dated 22 April 2010

**RESPONSE TO LEGCO SUBCOMMITTEE LETTER
DATED 16 APRIL 2010**

To the Subcommittee to Study Issues Arising from
Lehman Brothers-related Minibonds
and Structured Financial Products of the Legislative Council

Unless otherwise stated, capitalised terms in this response have the meanings ascribed in the Written Submissions of Ms Amy Yip, Chief Executive Officer of DBS Bank (Hong Kong) Ltd. dated 26 March 2010 (the "Submissions").

1 It is noted that DBSHK distributed Lehman Brothers-related (LB-related) CLN Notes during the period February 2006 to September 2007 (the period). Please provide:

(a) the name and the latest contact information of the persons who held the following positions during the period:

(i) Chief Executive Officer;

	Name	Contact	Duration
1.1	Mr Sullivan Randolph Gordon	[personal data]	12 Feb 1987 to 1 Oct 2006
	Ms Yip Yok Tak Amy	[REDACTED]	1 Oct 2006 to present

(ii) Head of Consumer Banking; and

	Name	Contact	Duration
1.2	Mr Cheung Yiu Tong Sunny	[personal data]	15 Nov 1999 to 1 Sept 2008

(iii) Senior Vice President, Consumer Investment & Insurance Products¹;

	Name	Contact	Duration
1.3	Mr Wong Kwong Lam Richard	[personal data]	1 Apr 2005 to 1 Mar 2010

(b) the name of the department in DBSHK responsible for the sale of CLN Notes, and the name and the latest contact information of the head(s) of this department during the period;

1.4 At the material time, IPG and S&D were responsible for the sale of CLN Notes. The details of the heads of these departments at the relevant time are as follows:

Position	Name	Contact	Duration
Managing Director, Head of S&D	Mr Sion Huang	[personal data]	1 Mar 2006 to 1 Apr 2009
Managing Director, Head of IPG	Mr Wong Kwong Lam Richard	[personal data]	1 Apr 2005 to 1 Mar 2010

¹ At the material time, the head of IPG was the Managing Director. Please also note that the group name was changed from IPG to Consumer Investment & Insurance Products in January 2009.

(c) the name of the department in DBSHK responsible for the training of frontline staff engaged in the sale of CLN Notes, and the name and the latest contact information of the head(s) of this department during the period; and

1.5 IPG and S&D were responsible for the training of frontline staff engaged in the sale of CLN Notes. IPG was responsible for ensuring that sufficient product knowledge was included in the training for sales staff. S&D was responsible for ensuring that sales staff received the relevant training before conducting sales to customers. See paragraph 1.4 above for details of the heads of these departments.

(d) the branches of DBSHK that recorded the highest and lowest retail sales amount during the period, and the name of the respective branch managers and their latest contact information.

1.6 Tsim Sha Tsui Branch and Yaumatei Branch of DBSHK respectively recorded the highest and lowest retail sales amount of LB-related CLN Notes during the period. The details of the branch managers at the relevant time are as follows:

Branch	Name	Contact	Duration
Tsim Sha Tsui	Mr Ho Chun Hung	Tel: 3668 [REDACTED]	1 Jan 2006 – 31 Dec 2007
Yaumatei	Mr So Ting Chong	Tel: 3668 [REDACTED]	1 Jan 2006 – 21 Dec 2006
Yaumatei	Mr Lee Tam Pick Yiu	[personal data]	18 Dec 2006 – 31 Dec 2007

2 The board resolution of DBSHK in respect of the decision to distribute CLN Notes was passed on 29 July 2004 (Item 1 and paragraph 4.3 of W26(C)), which was almost 10 months after the launch of the first series in September 2003. Please explain:

(a) the reasons that the resolution of the Board was made after the distribution agreement was entered into;

2.1 The Board had appropriately delegated the power to make the decision to distribute investment products to the management of DBSHK, including the CEO and Head of CB. The decision to distribute the CLN Notes was appropriately made by management, including the Head of CB. The Board resolution was simply to ratify agreements relevant to the distribution of the CLN Notes.

(b) the authorizing role, if any, of the Board relating to the distribution of CLN Notes.

2.2 The Board appropriately delegated to the Exco Subcommittee, comprising the Bank's CEO and Alternate/Deputy CEO, the power to approve, ratify and confirm agreements relevant to the distribution of the CLN Notes that had been executed by management.

3 It is noted that one of the considerations by DBSHK in assessing the risk of the CLN Notes is the credit ratings of the reference entities. Please provide information on the default of reference entities in CLN Notes prior to the collapse of Lehman Brothers in September 2008.

3.1 The table below shows the rate of default for investment grade entities². All reference entities in the LB-related CLN Notes were investment grade, and these statistics formed part of the information considered in relation to the reference entities when assessing the risk of these CLN Notes.

Rating	Investment grade default history					
	Within 1 year	Within 2 years	Within 3 years	Within 4 years	Within 5 years	Within 6 years
AAA	0.00%	0.00%	0.03%	0.06%	0.10%	0.17%
AA	0.01%	0.04%	0.09%	0.19%	0.30%	0.41%
A	0.04%	0.13%	0.24%	0.40%	0.61%	0.84%
BBB	0.29%	0.81%	1.40%	2.19%	2.99%	3.73%

4 Please provide information on the following:

(a) the total amount (HK\$) of LB-related structured financial products sold by DBSHK through its Consumer Banking Division (CB);

4.1 Approximately HK\$1.3 billion (depending on the exchange rate used).

(b) the number of customers involved in the sale of the products in (a); and

4.2 3,396 customer accounts.

(c) the number of complaints in respect of the products in (a).

4.3 2,775 customer accounts.

5 Paragraph 6.1 of W26(C) stated "it was anticipated that CLN Notes would be sold to other appropriate customers". Please provide the document(s) that recorded the considerations and discussion leading to this view.

5.1 In the absence of an express prohibition on the sale or distribution of a product, and in circumstances where a decision has been made to sell or distribute the product, the practice of CB is that the relevant product should ostensibly be considered appropriate for distribution to such customers who are assessed as suitable by the DBSHK suitability process (see paragraphs 30.1 to 30.4 of the Submissions). Consequently, there is no document that records a specific discussion resulting in this view being taken.

5.2 Sales staff were reminded to conduct IPQ and conduct suitability assessment when selling CLN Notes to new customers. See p.3 of sales script of Series 34 (Item 27 of the list in Appendix 1 to the Submissions).

6 It is noted that DBSHK ceased to distribute the CLN Notes in September 2007 and revised the risk ratings for all the CLN Notes to Level 5 in March 2008 (paragraph 14.10 of W26(C)). Please provide the notes of meetings that documented:

(a) the considerations leading to the decision to cease distribution of CLN Notes; and

² The information is extracted from the Issue Prospectus of Series 34-37 dated 22 February 2006. The table is the result of the Ratings Performance Study conducted by S&P in 2004, which shows the cumulative default history for the 4 investment grade rating categories. The study is global and covers the period from 1981 to 2004.

- 6.1 The decision to cease distribution of CLN Notes was made after considering the market conditions and the potential return of the product relative to the risks borne by investors. The participants in the relevant discussions were the core team responsible for conducting product due diligence on CLN Notes (see paragraph 11.2 of the Submissions) at a weekly meeting. No minutes were produced in respect of these weekly meetings. Hence, the relevant decision was not documented.
- (b) **the considerations leading to the decision to revise the risk ratings for all the CLN Notes.**
- 6.2 In light of market volatility and the significant fluctuation in prices in the CLN Notes in late 2007, DBSHK conducted an annual review of the PRM (including CLN Notes) in January 2008, two months before the scheduled date. The Bank proposed to raise the CLN risk level to Level 3 to 5 (depending on the credit rating of the reference entities and the tenor) and consulted the HKMA in February 2008 on the same. The HKMA first requested that DBSHK raise the risk rating of all series of CLN Notes to a level higher than the proposed levels (i.e. to Level 4 to 5). As a result of subsequent discussions with the HKMA, it was agreed that all risk ratings of outstanding series of CLN Notes would be raised to Level 5. Relevant discussions were conducted by emails and telephone calls. The emails are provided in Appendix 1.
- 7 **In the months following DBSHK's decision to cease distributing CLN Notes in September 2007 and up to around March 2008 when DBSHK revised the risk ratings for all the CLN Notes to Level 5 in response to HKMA's request in February 2008 (paragraph 14.10 of W26(C)), please advise:**
- (a) **during the aforesaid period, the information, if any, provided by DBSHK to its customers who had bought CLN Notes to apprise them of the volatilities to which their investments were exposed;**
- 7.1 The following actions were taken to ensure that customers were well-informed:
- (i) Monthly statements with indicative bid prices were sent to customers. The indicative bid prices were updated bi-weekly on the intranet to equip sales staff to provide such information to customers. As stated in paragraph 16.1 of the Submissions, IPG monitored the prices on a weekly basis as the credit market became more volatile.
- (ii) As explained in paragraphs 11.3 and 11.4 of the Submissions, the performance of the Bank's investment products was discussed at monthly meetings. Participants in such meetings, including the Head of ISMs and District Managers, would then convey relevant market information to sales staff and customers. For example, in March 2008, when Bear Stearns was in financial difficulties, DBSHK provided a market update on Bear Stearns, together with updates on other entities like Merrill Lynch, Morgan Stanley and Lehman Brothers to sales staff and customers by posting information on the Bank's website.
- (iii) Fannie Mae was a reference entity of Series 12 and 13 of CLN Notes. A credit event was declared by the issuer in respect of Fannie Mae on 10 July 2008. DBSHK informed affected customers of the price decline of Fannie Mae in July 2008 by way of telephone calls and SMS messages. Relevant information was posted on the Bank's website. FAQs were also produced to assist sales staff in handling relevant enquiries.

- (iv) FAQs were produced for sales staff in June 2007 in response to the financial difficulties faced by Bear Stearns. In light of recent news regarding Bear Stearns' subprime mortgage loan issues, relevant information was posted on the Bank's website on 25 March 2008.
- (v) There was a Fitch rating adjustment in respect of the collateral of Series 71-74, 78-81 and 82-85 on 25 June 2008. DBSHK circulated a notification of the rating adjustment to customers by a letter dated 3 July 2008. The letter also enclosed copies of the notice and FAQ prepared by the Arranger. Internally, the Bank prepared a separate set of FAQs, customer communication guidelines, suggested scripts, a macro economic market update and a product information summary of the affected CLN Notes to equip sales staff to respond to customer enquiries.

(b) the number of redemptions during this period; and

7.2 37 transactions were redeemed in respect of 33 customer accounts.

(c) the exit prices of the CLN Notes and the losses, if any, sustained by the investors as a result of the early redemption of the CLN Notes.

7.3 The total losses sustained were HK\$1,421,180 representing 16 per cent. of the notional amount invested by the relevant customers. The table below sets out the exit price of the relevant series when the relevant redemptions were made:

Transaction date	Series No.	Risk Rating at Inception	Exit Price ³
07/09/2007	4	2	94.34
	50	2	86.02
21/09/2007	4	2	92.72
	18	2	86.99
05/10/2007	1	2	95.32
	9	2	90.80
	47	2	84.42
	50	2	89.07
22/10/2007	4	2	93.00
	66	2	85.06
02/11/2007	1	2	96.15
	19	2	88.79
	23	2	89.22
	56	2	76.55
16/11/2007	1	2	95.35
	2	2	94.58

³ Expressed as a percentage of the principal amount

Transaction date	Series No.	Risk Rating at Inception	Exit Price ³
	3	2	93.08
	4	2	93.43
	6	2	96.60
	7	2	95.91
	8	2	97.04
30/11/2007	2	2	94.51
	4	2	93.92
14/12/2007	2	2	94.08
11/02/2008	3	2	91.89
22/02/2008	4	2	92.92
	19	2	64.41
	37	2	84.96
07/03/2008	2	2	93.92
25/03/2008	12	3	55.43

8 Please provide the following information:

(a) the number of complaints received by DBSHK before collapse of Lehman Brothers concerning LB-related CLN Notes and as a percentage of the number of sale transactions through CB;

8.1 Before the collapse of Lehman Brothers, DBSHK received four complaints concerning LB-related CLN Notes. These four complaints constitute 0.09 per cent. of the LB-related CLN Note transactions conducted through CB.

(b) the nature of the complaints mentioned in (a);

8.2 The nature of the complaints was as follows:

- (i) one complaint about a drop in price of the CLN Notes;
- (ii) one complaint that inadequate information had been provided about the collateral risk of the CLN Notes;
- (iii) one complaint that the risk of the product had been mis-classified; and
- (iv) one complaint that an unsatisfactory response had been received to questions regarding the residual value of the CLN Notes.

(c) the number of complaints received by DBSHK after collapse of Lehman Brothers concerning LB-related CLN Notes and as a percentage of the sale transactions through CB; and

8.3 As of 16 April 2010, DBSHK has received 2,775 complaints concerning LB-related CLN Notes. These complaints constitute 62 per cent. of the LB-related CLN Note transactions conducted through CB, and 0.3 per cent. of the investment transactions made through CB.

(d) **out of the complaints received after the collapse of Lehman Brothers (i.e. complaints from 2,775 customer accounts as mentioned in paragraph 44.2 of W26(C)), please provide a breakdown on:**

(i) **the percentage of complaints from primary target customers in paragraph 6.1 of W26(C);**

8.4 84 per cent.

(ii) **the percentage of complaints from "other appropriate customers" in paragraph 6.1 of W26(C); and**

8.5 16 per cent.

(iii) **the percentage of complaints from those customers referred to in paragraph 7.1 of W26(C).**

8.6 The figure 2,775 represents the number of complaints from CB customers who invested in LB-related CLN Notes. This does not include the number of complaints made by customers invested in LB-related structured products other than CLN Notes. However, please note that there were 6 complaints from customers referred to in paragraph 7.1 of W26(C).

9 **Please give an account of the work done by the internal audit function and the compliance function of DBSHK in respect of the following areas during that period from 2003 to September 2008, and their findings:**

[Please note that, given the focus of the LegCo inquiry, the following answers refer to the CB department of DBSHK]

(a) **product due diligence;**

9.1 As stated in paragraph 4.2 of the Submissions, Compliance was one of the supporting units required to approve the issuance of the CLN Notes. In particular, Compliance highlighted the regulatory requirements relevant to: the establishment of the Programme; staff training; and conduct of sales (including the rules on unsolicited calls), to ensure that business and supporting units were aware of the regulatory requirements when arranging the issuance and distribution of the CLN Notes.

9.2 To ensure internal policy was in compliance with the regulatory requirements, Compliance helped to formalise the annual review of PRM, the tool used to ascribe a risk rating to investment products, by being involved in the promulgation of the PRM Review Guideline published in May 2007.

9.3 During a review on the distribution of CLN Notes conducted in July 2008, Compliance acknowledged that CLN Notes were rated in accordance with the PRM. It noted that the documentation on defining the risk level of the product could be enhanced.

9.4 In accordance with its responsibility to conduct post-implementation review⁴, Internal Audit reviewed the internal process as relevant to the issuance and distribution of the CLN

⁴ This is stipulated in the NPSP policy.

Notes. It confirmed that the contemplated control and support infrastructure was in place and was functioning effectively.

(b) complaints handling;

- 9.5 Compliance helped to ensure that communications to customers with regard to complaints were in compliance with the regulatory requirements.
- 9.6 In an internal audit conducted in May to June 2005, Internal Audit found that, overall, relevant risk management and control processes were adequate and effective and that, overall, management's control awareness was sound and the escalation processes were effective. However, Internal Audit noted that some customer complaints had not been reported to the Complaint Handling Officer within the stipulated timeframe. This finding was addressed.

(c) selling process of investment products.

- 9.7 To ensure that various business units and sales staff were in compliance with the applicable regulatory requirements in relation to the sale of investment products, Compliance highlighted the relevant requirements to CB when the CLN Notes were first issued in 2003 (see paragraph 9.1 above), cooperated with business units to develop and review internal policies on the selling process (see paragraph 9.2 above), updated various units in respect of the new requirements imposed by the SFC/HKMA, and reviewed ethical training materials regularly to ensure that sales staff were aware of, and were constantly reminded of, the requirements to which they were subject in the sales process.
- 9.8 In July 2008, Compliance conducted a sampling check on the sale of CLN Notes. Compliance concluded that there was no evidence of any major deviations from the standard sales process save for certain documentation lapses. Compliance considered that the utilisation of IPQ and GAA would assist sales staff in discharging their "know-your-customer" obligations and providing suitable product recommendations to match the customers' needs. In addition, Compliance affirmed the regular reviews of the IPQ forms conducted by external and internal experts and noted the improvements in the content of the form. Compliance recommended that business units act in accordance with market practice when conducting sales of long tenor investments to elderly customers over a certain age.
- 9.9 As noted above, in an internal audit conducted in May to June 2005, Internal Audit found that risk management and control processes were adequate and effective and that, overall, management's control awareness was sound and the escalation processes were effective. However, it was noted that the daily customer suitability review procedures conducted specifically by CBBO were not effective in highlighting exceptions. Management actions to address this observation were agreed upon and implemented. In an internal audit conducted in November 2005, Internal Audit noted that sales processes should be enhanced to protect vulnerable customers.
- 9.10 In an internal audit conducted in September 2006, Internal Audit found that, overall, risk management and control processes were adequate and effective and that, overall, management's control awareness was sound and the escalation processes were effective. Internal Audit noted that the IPQ had been completed in all sampled instances. However, in 3 out of 15 sampled instances, Internal Audit noted that the GAA had not been fully completed by sales staff. Immediate remedial action was taken to address this finding.

9.11 In an internal audit conducted in December 2007, Internal Audit found that, overall, risk management and control processes were adequate and effective and management's control awareness was sound and the escalation processes on major control issues were effective. However, Internal Audit's own mystery shopping checks (in 10 branches) found:

- (i) 2 sales staff who failed to complete customer suitability assessments in a timely manner;
- (ii) 2 sales staff who recommended products of a higher risk than the customer's risk appetite;
- (iii) one instance of an inadequate explanation of handling charges, fund switching and certain early redemption scenarios;
- (iv) one instance of a sales staff giving personal investment advice;
- (v) 2 sales staff who did not return completed IPQs in accordance with the required procedure.

Management actions to address these findings were agreed upon and implemented.

10 It is noted that some series of the CLN Notes were not distributed by DBSHK. Please advise:

(a) the series of the CLN Notes that had not been distributed by DBSHK;

10.1 Series 38, 54 and 75-77 of the CLN Notes were not distributed by DBSHK.

(b) the reasons for not distributing the series in (a); and

10.2 Series 38 and Series 75-77 of the CLN Notes were distributed by DBSSG. They were not recommended to DBSHK for distribution by the Arranger. Consequently, DBSHK was not afforded an opportunity to distribute these series.

10.3 Series 54 was withdrawn due to under-subscription. The number of orders received did not meet the minimum threshold DBSHK needed to achieve in order that the Arranger could fund the cost of structuring the underlying collateral.

(c) the series of CLN Notes, if any, that DBSHK decided not to distribute to retail investors because it/they failed to pass the product due diligence process.

10.4 A zero coupon note proposed to be issued under the Programme was rejected for distribution by CB after the product due diligence process. DBSHK was of the view that its customer base expected CLN Notes to pay a coupon and rejected the zero coupon note on that basis.

Appendix 1

From: [REDACTED]
Sent: Thursday, March 06, 2008 18:14
To: Eric Yiu Wing Wong
Cc: Christopher Hing Keung Tsang; [REDACTED]
Subject: Annual Review (2008) on Product Risk Matrix

Dear Eric,

Thank you for the assistance of you and your colleagues in providing the information on the captioned subject.

Based on your bank's product risk matrix, your bank proposed to re-classify the risk level of credit-linked notes ("CLN"). However, we note that the re-classification of the risk level of CLN is still not in line with the current practices of other banks offering CLN to retail customers, which would normally classify the CLN in the highest risk category. We consider that it is an appropriate benchmark reference given the complexity of the products and the current market condition.

In this connection, you are expected to re-classify the different risk levels of CLN by 1 notch higher than the proposed risk levels. We would appreciate it if your bank would advise us of any revision you have effected by **21 March 2008**.

Please let us know if you have any questions on the above.

Thanks and regards,
 Anthea

----- Forwarded by Anthea MY TAM/HKMA/HK on 04/03/2008 07:08 PM -----

----- Reply History -----

To: [REDACTED]
cc: "Christopher Hing Keung Tsang" [REDACTED]
bcc:

From: "Eric Yiu Wing Wong" [REDACTED]
Date: 29/02/2008 11:13 AM
Subject: Annual Review (2008) on Product Risk Matrix

Dear Anthea,

Please find below a summary of our review and the enhanced version of our Product Risk Matrix.

Background

To better assess and categorize products into appropriate product risk levels, Investment Product Group has a practice to review the Investment Product Risk Matrix annually. The last review was conducted in March 2007. In view of the recent market volatility, the review in 2008 was carried out earlier in January and it covers all products in the existing matrix.

Key Observations and Recommendations

Owing to the sub-prime crisis and global credit crunch, the secondary market price of some of the Credit-Linked Notes (CLN) recorded a drop to below 70% since late 2007. Moreover, market consensus is that the uncertainties in credit market will sustain in the first half of 2008. Against this backdrop, it is proposed to re-classify the CLN risk level to a more prudent level ranging from "3 to 5" and detailed criteria are as follows –

Ratings of Underlying Reference Entities in the CLN Basket Tenor	Risk Level
All with AA and above ³	5yrs and below 3
All with AA and above ³	Above 5 yrs 4

Between A and BBB⁴

5yrs and below 4

Between A and BBB

Above 5 yrs 5

Note:

1. The Charged Asset (if any) for CLN must be in AAA at inception.
2. The underlying reference entities of all CLNs must be in investment grade (i.e. Moody's: Baa3 or above / S&P: BBB- or above / Fitch: BBB- or above).
3. If credit rating of any one of the reference entities in the basket is not at least AA rated, the risk level will be up by one level.
4. If credit rating of any one of the reference entities in the basket is not at least BBB rated, the risk level will be up by one level.

Conclusion and Way Forward

We decided to adjust the risk level of CLN while that of the remaining products would remain unchanged. To play safe, DBSHK will review the risk levels again in 6 months time.

Should you need any clarification, please feel free to let us know.

Thanks and regards,

Eric Wong
Compliance, Greater China

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