

Responses to Follow-up Issues Arising from the Hearing on 15 May 2009

1. The teams/divisions established by the Hong Kong Monetary Authority (HKMA) after April 2003 tasked to supervise the regulated activities conducted by Registered Institutions (RIs), the number of staff of such teams/divisions, and the relevant qualifications and experience possessed by such staff.

1.1 The teams engaged in regulating RIs' regulated activities within the HKMA include the securities supervision team, the securities enforcement team and individual general banking supervision staff who are also involved in supervising regulated activities, in addition to the banking businesses, of authorized institutions (AIs). In April 2003, the number of HKMA staff involved in the regulation of RIs' regulated activities was 75, comprising 7 staff in the securities supervision team, 7 staff in the securities enforcement team and 61 general banking supervision staff. This increased to 119 in mid-September 2008, comprising 11 staff in the securities supervision team, 9 staff in the securities enforcement team and 99 general banking supervision staff.

1.2 The qualifications and experience required for the HKMA staff involved in the regulation of RIs' regulated activities are set out in Table 1 below:

Table 1

	General qualifications and experience
Securities supervision team	<ul style="list-style-type: none"> • University degree in banking, accountancy, finance or related field. • Qualifications from relevant professional bodies in banking, accountancy, finance or related field an advantage. • Relevant experience in banking, securities operations or auditing field. • Priority is given to individuals who have qualifications and working experience relevant to the securities industry.

General qualifications and experience	
Securities enforcement team	<ul style="list-style-type: none"> • University degree, preferably in finance, accounting or law. Relevant advanced degree or professional qualification a definite advantage • Relevant experience in: (a) investigation of misconducts, corruption offences or commercial crimes related to the financial industry, or dealing with matters relating to those misconducts, offences or crimes; and (b) disciplinary or regulatory proceedings, preferably in the financial industry.
General banking supervision staff	<ul style="list-style-type: none"> • University degree in banking, accountancy, finance or related field. • Qualifications from relevant professional bodies in banking, accountancy, finance or related field an advantage. • Relevant experience in banking, securities operations or auditing field.

2. *The number of HKMA staff engaged in the regulation of banks' business for each year before April 2003, and the number of staff engaged in the regulation of RIs' regulated activities for each year since April 2003.*

2.1 The numbers of HKMA staff, who were responsible for supervising banks' securities business from 2001 to 2002, are set out in Table 2 below.

Table 2

Year	Number of HKMA staff engaged in the regulation of banks' securities business
2001	71
2002	71

2.2 The numbers of HKMA staff engaged in the regulation of RIs' regulated activities since April 2003 are set out in Table 3 below.

Table 3

Year	Number of HKMA staff engaged in the regulation of RIs' regulated activities
2003	75
2004	123
2005	122
2006	114
2007	118
2008 (mid September)	119

3. *The cost breakdown of the staff (203 or more) hired by HKMA to investigate the complaints about RIs' sale of LB-related Minibonds and structured financial products.*

3.1 A breakdown of the cost per month of the temporary staff who are currently hired by the HKMA to investigate the complaints against RIs' sale of LB-related Minibonds and structured financial products is as follows:

Table 4

	Monthly cost
Specially recruited contract investigators and support staff	\$3.5 million
Temporary personnel seconded from audit firms	\$3.3 million
Total	\$6.8 million

The other staff working on the project (not included in the table above) are HKMA permanent staff who are redeployed either on a part-time or full-time basis to assist with the investigation.

4. *The work undertaken by HKMA, either on its own or in collaboration with the Securities and Futures Commission (SFC), on investor education since April 2003.*

4.1 The SFC is the regulator of the securities and futures industry, which has express functions under the Securities and Futures Ordinance (SFO) for investor education, including “to promote understanding by the public of the securities and futures industry and of the benefits, risks and liabilities associated with investing in financial products” (section 5(1)(i) of the SFO) and “to promote understanding by the public of the importance of making informed decisions regarding transactions or activities related to financial products and of taking responsibility therefor” (section 5(1)(k) of the SFO).

4.2 Under the Banking Ordinance and the SFO, the HKMA does not have any statutory function for investor education. Nevertheless, the HKMA supports the SFC’s investor education initiatives and efforts. In this connection, the HKMA has set out in paragraph 4.1.3 of the Supervisory Policy Manual module SB-1 “Supervision of Regulated Activities of SFC-Registered Authorized Institutions” that for the sake of investor education, RIs are encouraged to distribute the SFC’s investor education leaflets to customers and refer their customers to the SFC-operated investor education portal for further information where appropriate. In addition, in collaboration with the SFC, the HKMA issued a circular “New Publications of the Securities and Futures Commission (SFC) and the HKMA” on 21 August 2003 (enclosed as Annex 11 of SC Ref. W6(C)). In this circular, the HKMA introduced the SFC’s publications on investor education, invited RIs to distribute the relevant SFC publications to their securities clients where appropriate (particularly at the retail level) and strongly recommended relevant individuals to read the SFC’s publications.

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- 4.3 Apart from providing support to the SFC, the HKMA also alerts investors of the risks and nature of investment products in some of its publications and its senior staff's public speeches from time to time. Please refer to Annex 9 of SC Ref. W6(C) for some of the relevant publications and speeches in recent years.

5. *The number of RIs' clients involved in the regulated activities for each year since April 2003, and where practicable, a breakdown of the number of clients under each type of regulated activities.*

5.1 According to the "Return of Securities Related Activities" submitted by RIs to the HKMA semi-annually, the number of accounts for securities dealing, dealing in futures contracts and asset management services maintained by RIs in each year since 2003 is set out in Table 5 below.

Table 5

Year	Number of accounts					
	2003	2004	2005	2006	2007	2008
Type 1: Dealing in securities	1.29 million	1.51 million	1.62 million	2.24 million	3.16 million	3.09 million
Type 2 : Dealing in futures contracts	6	0	0	0	1,032	1,506
Type 9: Asset management						
Number of accounts for asset management services:						
- for "non-discretionary" services for private banking clients	13,711	15,329	19,241	23,497	13,920	14,854
- for "discretionary" services for private banking clients	1,288	1,768	2,389	3,695	4,567	3,257
- for collective investment schemes	206	193	317	437	624	424
- for other asset management services	2	3	1	9	7	6

6. Details of “the proposal” mentioned in the extract of the notes of meeting of the Event Review Committee on 7 November 2003 (Annex 6 of M17), and the relevant records and documents, if any, about the said proposal and HKMA’s internal deliberation on “mystery shoppers”.

6.1 As mentioned in the MA’s response to item (i) of the Subcommittee’s information requests (follow-up to the hearing on 17 April 2009) (M17), during one of the meetings of the HKMA’s Event Review Committee (ERC) in November 2003, members considered whether it would be appropriate to send a supervisory staff member as a “mystery shopper” to ascertain the selling approach of a RI. This arose from a recommendation made in a report submitted to the ERC on the related case. The report set out the preliminary assessment and recommendations in relation to a possible case of misconduct by a bank. The relevant extract of the report is given as below:

“It is therefore recommended that the case should be referred to the case team for following up with the Bank to ensure that the selling practice of the Bank does not lead to contravention of any relevant legal and regulatory requirement. As an additional step to make sure that the alleged selling approach is not being used in the branch concerned, it is recommended that a member of the securities on-site team be sent to check that out in the branch concerned as a “mystery shopper” and report to the ERC for further consideration if such practice does exist.”

7. The statutory basis, if any, of the four key elements of the disclosure-based system as understood by MA in paragraph 5 of his written statement formally produced to the Subcommittee at the hearing on 14 April 2009 (W6(C)).

7.1 The four elements of the disclosure-based system can be construed from the relevant provisions of the SFO, Companies Ordinance and Banking Ordinance. For instance, section 5(1) of the SFO provides that the functions of the SFC, among other things, are, so far as reasonably practicable –

- (i) to encourage the provision of sound, balanced and informed advice regarding transactions or activities related to financial products (section 5(1)(e) of the SFO);
- (ii) to promote understanding by the public of the securities and futures industry and of the benefits, risks and liabilities associated with investing in financial products (section 5(1)(i) of the SFO);
- (iii) to encourage the public to appreciate the relative benefits of investing in financial products through persons carrying on activities regulated by the SFC under any of the relevant provisions (section 5(1)(j) of the SFO); and
- (iv) to promote understanding by the public of the importance of making informed decisions regarding transactions or activities related to financial products and of taking responsibility therefor (section 5(1)(k) of the SFO).

Disclosure in offering documentation

7.2 When investment products are offered to the Hong Kong public, the offering documentation must be authorized by the SFC unless an exemption applies.

In the authorization process, the SFC will seek to ensure that based on the information provided by the product issuer sufficient information is disclosed in the product documentation to enable a reasonable person to make an informed decision. Under the existing legislation, the requirements for authorization of product documentation are set out in the Companies Ordinance and the SFO, and which of these applies depends on the nature and legal form of the investment product.

Suitability

7.3 The Code of Conduct for Persons Licensed by or Registered with the SFC (“Code of Conduct”) requires intermediaries to ensure that the product is suitable for the particular client taking into account the client’s profile and investment needs. The Code of Conduct was made under section 169 of the SFO. Relevant provisions in the Code of Conduct include: S1-Appendix 11

- in conducting its business activities, a licensed or registered person should act with due skill, care and diligence, in the best interests of its clients and the integrity of the market (General Principle 2);
- when providing advice to a client a licensed or registered person should act diligently and carefully in providing the advice and ensure that its advice and recommendations are based on thorough analysis and take into account available alternatives (paragraph 3.4);
- having regard to information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence, the licensed or registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances (paragraph 5.2); and

- a licensed or registered person providing services to a client in derivative products, including futures contracts or options, or any leveraged transaction should assure itself that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products (paragraph 5.3).

7.4 The SFC's Questions and Answers on Suitability Obligations also requires that investment advisers should help each client make informed decisions by giving the client proper explanations of why recommended investment products are suitable for the client and the nature and extent of risks the investment products bear. M4

7.5 Although suitability assessment is the responsibility of the intermediaries under the Code of Conduct, the SFC and the HKMA have the function to supervise regulated activities conducted by intermediaries under their respective supervision. Section 5(3) of the SFO specifically enables the SFC to rely, in whole or in part, on the supervision of authorized financial institution or person by the MA. S1-Appendix 11

7.6 A breach of the Code of Conduct is a misconduct if in the opinion of the regulators it is or likely to be prejudicial to the interest of the investing public or the public interest (see sections 58A(6)(b) and 71C(12)(c) of the BO and section 193(1)(d) of the SFO). Also, it will call into question the intermediary's fitness and properness as such.

Role of the Investor

7.7 The regulatory scheme is designed to ultimately (after the nature and the risks of the investment products have been properly disclosed by the issuer and the

intermediary and a suitability assessment properly conducted) enable the investing public to make informed decisions regarding transactions or activities related to financial products and to take responsibility therefor (see section 5(1)(k) of the SFO above).

8. Whether HKMA's thematic examination of RIs' sale of credit-linked investment products from February to August 2008 (Annex 1(F) of M20) covered Lehman Brothers-related Minibonds and structured financial products.

8.1 The focus of the HKMA's thematic examinations mentioned in Annex 1(F) of M20 was to review the investment advisory and dealing activities of RIs in relation to retail credit-linked notes (CLNs) instead of focusing on any issuer-specific products such as Lehman Brothers (LB) related Minibonds and structured financial products. Nevertheless, our sample checks during the thematic examinations did cover some of the LB-related financial products.

9. *The attached written questions raised by Mr LEUNG Kwok-hung and handed to MA at the hearing on 15 May 2009.*

梁國雄議員五月十五日提問

你在四月十七日答葉劉淑儀議員話，賣 CDS 是等於賣一個保險，收取「保費」。你話：CDS 的溢價低，就「顯示它的風險是低的」。你又話「用 CDS 加高回報的安排，不會牽涉多很多的風險」。

我的問題是：

1. CDS 是不是一種衍生工具？
2. 它的槓桿比率高不高（即 leverage）？
3. 高槓桿比率約 50-100 倍的 CDS，是否比同佢掛勾的証券的風險高很多？
風險的定義是什麼？
4. 請任總簡述一下，CDS 作為一個保險工具或一個高槓桿比率的信貸衍生工具，主要的風險來源(source of risks)是什麼？
5. 一張保單的溢價低，只代表保單所保障的人或財產損毀的風險是低的，但並不表示該保單本身的風險是低的。因此 CDS 的溢價與 CDS 本身的風險並無直接關係。因此，你上次答葉劉淑儀〔議員〕時話，CDS 溢價低，則 CDS 的風險低，是錯的。對嗎？

梁國雄議員提供的答案：

” Answer to

- Q1. CDS 亦是信貸的衍生工具 credit derivative。
- Q2. 根據你哋 HKMA 的專家話，CDS 的槓桿比率非常高。一隻 CDS 每年收保費 US\$20 萬，去保障 US\$2000 萬的債券，槓桿比率是 100 倍。
- Q3. 高槓桿比率的信貸的衍生工具的波幅，是較該工具所承保的証券的波幅高很多。好似 CDS，一般槓桿比率可達 50-100 倍。風險的定義是，實現的收益或損失與預期的收益或損失的差距。

Q4. CDS 風險來源是多方面的，包括：

1. 保單數目不夠多，就有不符合 the Law of Large Number 的風險；
2. 保險公司一般不會獨自承擔保額高於該公司資產 5% 的單一保單。他們會做 Pooling(即 reinsurance)，以減低風險。但雷曼結構性產品，所賣出的 CDS 所承擔的保額，幾乎是發債公司的全部資產，又沒有做 Pooling，故此風險很高。
3. CDS 市場又不完善，交易的透明度不足，當市面上的 CDS 賣家太多時，會使保費偏低；
4. 雷曼迷債的發債公司與 CDS 的交易對手，同時是由同一母公司所操控，會產生不公平的作價；
5. 可能發生的系統性的大型風險或大型災難事故；
6. 新的風險的出現，在計算保費時，未有考慮這些新的風險”；

任總答葉劉淑儀議員時所講的「風險轉變是一個時間上會出現的轉變」，是想說，雷曼迷債的風險增加，並不能說是金管局對迷債風險的錯誤評估，而是風險後來才出現，這論點是錯的。因為這種改變亦是風險之一，應一并加入 CDS 的風險當中。

若任總這樣高人工的人才也搞不清 CDS 的風險，銷售員又怎能向客戶說明風險所在？

Item 1

9.1.1 Yes, credit default swap (CDS) is a derivative product.

Items 2 & 3

9.2.1 The HKMA issued a research paper of “Credit Risk Transfer Using Derivatives and Implications for Financial Market Functioning” in December 2003. The paper commented that CDS was highly leveraged, but it did not

mention CDS having 50-100 times of leverage or use the ratio of insured amount to insurance premium to represent the level of leverage.

- 9.2.2 The use of the ratio of insured amount to insurance premium to represent the level of leverage is inappropriate and represents a common confusion between leverage and probability. An insurer is willing to accept a small premium for providing insurance mainly because the probability of the insured event happening is low (i.e. the risk is low).
- 9.2.3 Separately, there are two interpretations of leverage. A strict interpretation is to multiply yields by borrowing funds to invest, as a result of which the maximum potential loss can be larger than the original investment. A broader interpretation is to enhance yields by taking up additional exposures, with the maximum potential loss limited to the original investment.
- 9.2.4 Like most other derivative instruments, the unfunded nature of CDS potentially allows high leverage. However, it must be stressed that the actual leverage is decided by how a CDS is used. One should adopt a more objective assessment by comparing the notional value of a CDS to the face value of a bond, and compare the CDS premium to the credit risk premium as reflected in the yield of the bond. With this objective comparison, one would conclude that a single-named CDS carries about the same risk as the securities that it is linked to. And this is why investors often use CDS to hedge against their debt securities holdings.
- 9.2.5 Another example is Credit linked note (CLN), which is a fully pre-funded investment embedded with CDS. Its maximum principal loss is the original investment, thus is not leveraged in a strict sense. Nevertheless, CLN is leveraged in the broader sense because, in addition to the issuer's default risk, an investor of CLN is also exposed to the default risk of credit reference entities. However, the leverage of most CLN is moderate at most.

9.2.6 Simply put, risk refers to the possibility of suffering a loss. In assessing risk, one would usually consider factors like (i) what loss events could happen; (ii) the probability of happening of the loss events; and (iii) the financial impact if these loss events actually happen.

Item 4

9.4.1 The major risk of CDS is the default of the reference entity. In addition, I would like to take this opportunity to share my views of the answers provided by Hon. LEUNG Kwok-Hung below:

- i & ii. Concepts such as “law of large number” and “reinsurance” are relevant to firms running an insurance business, which adopts a highly leveraged business model. Insurance companies make profits by providing a very huge volume of insurance protection, relying on a relatively small amount of capital. This is different from investors who seek to obtain investment returns using their own funds.
- iii. An increase in number of CDS sellers will necessarily cause the CDS premium to fall. This is a general function of supply and demand.
- iv. Similar to the selling of any products, a margin would be charged when the issuer sold LB-related Minibonds. Nevertheless, whether the issuer and the CDS counterparty are under the same group is technically speaking irrelevant. The issuer of structured notes is usually a special entity established to hold specific assets/liabilities. By design and in market practice, such special entities are usually under the same group as the CDS (or other

derivatives) counterparty.

- v. At the macro level, CDS might have given rise to systemic risks because some systemically important financial institutions sold CDS contracts based on a very high level of leveraging. As they did not have adequate capital to support the risk, there were concerns about their safety and soundness, contributing ultimately to the prevailing financial crisis. Strictly speaking, it is those financial institutions that have played a part in leading to the crisis, not the financial product itself.

- vi. In general, the CDS premium is a reflection of credit risks and determined based on the available information and interpretation of such information at a particular point of time, including happening of any possible events. The materialization of a risk or happening of an event does not mean a new risk emerged.

Item 5

9.5.1 My earlier comment that a lower CDS premium implies a lower CDS risk is valid. It is a fundamental principle of free market that market price is decided by supply and demand. If the CDS premium lowers, it is normally either caused by a decreased demand or an increased supply for credit protection. Logically, this can only happen when the market as a whole perceives that the CDS risk is lower.

9.5.2 Of course, a CDS premium can only reflect the general market perception of that CDS risk “at the time” when it is traded. And inevitably the general market perception is based on information available at the time. When new information becomes available, market perception of the level of risk could change and so would the CDS premium. This however does not change the

nature of risk (i.e. default risk). For instance, a bond bears minimal perceived default risk when the issuer is AAA-rated and a CDS referencing that bond would have a lower CDS premium. However, once there are rumours that the issuer is facing financial trouble, the level of the perceived risk and the CDS premium will rise significantly, but the nature of risk remains one of default.

9.5.3 It is also important to distinguish between “risk” and “outcome”. No matter how low the risk or chance of an event happening is, it can just happen. It is inappropriate to purely rely on a single outcome (e.g. bankruptcy of LB) to infer that one should have known the risk of that event happening is high. At least in theory one needs to take into account many such outcomes with similar nature to infer whether such an event risk is high or not.