CB(1)2155/11-12(03)

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來函檔號 YOUR REF.:

12 June 2012

Ms Anita Sit
Clerk to Subcommittee on Securities and Futures (Futures Contracts) Notice 2012
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong

Dear Ms Sit,

Subcommittee on
Securities and Futures (Futures Contracts) Notice 2012
Follow-up to meeting on 4 June 2012

We refer to the letters of 6 June 2012 from you and the Assistant Legal Adviser of the Legislative Council on the follow-up actions to the captioned meeting. The response is prepared as attached.

Yours sincerely,

(Jerry Cheung)
for Secretary for Financial Services
and the Treasury

c.c. SFC (Attn: Mr Keith Lui)
HKMA (Attn: Mr Daryl Ho)
HKEx (Attn: Mr Gerald D Greiner)

Subcommittee on Securities and Futures (Futures Contracts) Notice 2012

Further information provided by the Administration in response to issues raised at the meeting on 4 June 2012

1. To consider the request that the HKSAR Government make a public statement that the Government will not in any circumstances use public money to bail out any central counterparty ("CCP") established in Hong Kong for clearing of over-the-counter ("OTC") derivatives transactions as a recognized clearing house ("RCH") under the Securities and Futures Ordinance (Cap. 571)

(1) In the highly unlikely event that the OTC CCP has to wind down its operation through a limited recourse process, as shown in our reply in Item 2 below, the shortfall due to defaults by individual clearing members will be mutualised among all other clearing members and the amount owed by the OTC CCP to each clearing member would be the reduced amount calculated by the OTC CCP only. The limited recourse wind down procedures will be conducted without the need to initiate insolvency proceedings against the OTC CCP. The Government is not a party to the contract between the clearing members and the OTC CCP and does not have any legal obligation to provide any financial assistance to the OTC CCP or its clearing members. We do not see the need to stipulate in the law that Government shall not have any liability to the OTC CCP or its clearing members under all circumstances.

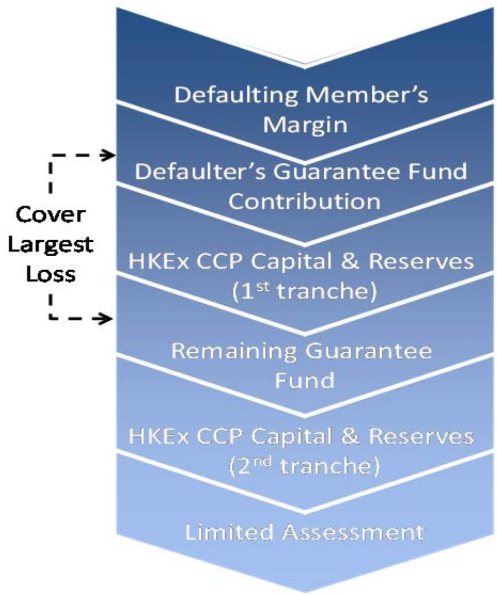
(2) On the request that the Government make a public statement that the Government will not in any circumstances use public money to bail out any recognized OTC CCP established in Hong Kong, we do not consider it appropriate to make such a statement as the Government has the responsibility to ensure the stability and integrity of our financial system, and any such statement will compromise the Government's position in the discharge of its function in maintaining the stability and integrity of our financial system. This, however, will not commit the Government to use public money to bail out any recognized OTC CCP established in Hong Kong or otherwise.

(3) With the robust risk management measures of the OTC CCP in place as detailed in paper LC Paper CB(1)2079/11-12(02), we consider it highly unlikely that the OTC CCP has to initiate the limited recourse procedures. Even in such a very remote scenario, we believe that the winding down of a CCP through the default management process

in an orderly manner would minimise the impacts on the financial market.

2. Given the various risk management measures that will be put in place by the established OTC CCP, as detailed in paper LC Paper CB(1)2079/11-12(02), under what circumstances will the following scenario occur: the financial resources of a local OTC CCP are not enough to absorb losses incurred by the CCP due to one or more clearing members' default and the CCP has to wind down all positions with a final mark to market settlement cycle; and if such an event occurs, which party will be responsible for taking forward the insolvency procedures in respect of the CCP

<u>The OTC CCP's Guarantee Resources</u>



(1) The OTC CCP will have six layers of financial protection to absorb losses from one or more clearing members' default. The OTC CCP will utilise a defaulting clearing member's margin and Guarantee Fund contribution as the first two layers. The third layer will be contributions made by the OTC CCP and will initially be sized at $150 million. The fourth layer will comprise Guarantee Fund contributions from non-defaulting clearing members. The fifth layer will be the OTC CCP's second tranche of contribution, while the sixth layer will comprise potential assessments against all non-defaulting clearing members.

(2) The OTC CCP's Guarantee Fund will mutualise losses under extreme, but plausible, scenario. Examples of these scenarios include the following: i) 1987 Stock Crash; ii) 1998 Asian Financial Crisis; iii) 2003 SARS; and iv) 2008 Global Financial Crisis. The OTC CCP will gauge the adequacy of the Guarantee Fund daily and will resize the Guarantee Fund, as well as the required contributions from each clearing member, on a regular basis. Each clearing member's proportionate share of the Guarantee Fund will be based on the stress testing losses of its portfolio. This will ensure that each clearing member contributes to the Guarantee Fund based on the risk exposure it brings to the OTC CCP.

(3) After the application of a defaulting clearing member's margin and Guarantee Fund contribution, the OTC CCP's 1st tranche of contribution, the respective Guarantee Fund contributions of non-defaulting clearing members, and the OTC CCP's 2nd tranche of contribution, the OTC CCP will make assessment against all non-defaulting clearing members of up to 200% of their Guarantee Fund requirement whereby the remaining losses are shared among those clearing members.

Limited Recourse Winding Down

(4) If a default loss exceeds all the funds in the six layers of financial protection available to the OTC CCP, it will be able to wind down all the cleared positions through a limited recourse process. The OTC CCP will determine for each clearing member a total 'payable' obligation to, or 'receivable' expectation from, the OTC CCP. Non-defaulting clearing members will be subject to haircuts (or discount) on their 'net receivable' (i.e. gains) from the OTC CCP. The following table illustrates how this process works.

Clearing Member	**Member Receivable / (Member Payable)**	**Member Receivable with Limited Recourse**	**Member Payable with Limited Recourse**
A	2,000	2,000 x (1-6%) = 1,880	-
B	1,000	1,000 x (1-6%) = 940	-
C (Default)	(300)*	-	-
D	(2,500)	-	(2,500)
E	(2,200)	-	(2,200)
F	2,000	2,000 x (1-6%) = 1,880	-
Total		4,700	(4,700)

*Assuming no Collateral Remaining to Cover Deficit

Clearing Member Net Receivable:	5,000	(Member A + B + F)
Clearing Member Net Payable:	(4,700)	(Member D + E)
Shortfall Amount:	300	
Shortfall % (Shortfall Amount/Member Net Receivable)	6%	

<u>With Limited Recourse</u>

Clearing Member Net Receivable:	4,700
Clearing Member Net Payable:	(4,700)

(5) Under the clearing rules, all clearing members will contractually agree not to take steps to wind up the OTC CCP, and that the amount owed by the OTC CCP to each clearing member would, in the event of a shortfall in the financial resources of the OTC CCP, be the reduced amount calculated by the CCP pursuant to the limited recourse wind down provisions only. Thus, the limited recourse wind down procedures will be conducted without the need to initiate insolvency proceedings against the OTC CCP.

(6) The fact that all accounts of non-defaulting clearing members with a net receivable expectation will mutualise the shortfall allows for a wider loss sharing, which in turn minimises systemic risk and contagion since there is a broader set of accounts to share the final loss. It provides non-defaulting clearing members total clarity beforehand as to the nature of their potential liabilities and also a speedier resolution process, and in doing so, it will minimise the impact on the market. As a result, the limited recourse model minimises any unnecessary market disruption and destruction of value that would be involved through an OTC CCP insolvency.

3. Whether section 39 of Securities and Futures Ordinance (SFO) has the effect of ensuring the immunity of the HKSAR Government and HKEx as a recognized clearing house (RCH) from any liability to the losses sustained by parties due to default of one or more clearing members of the OTC CCP established by HKEx

(1) Section 39 of the SFO confers immunity on an RCH and any person acting on its behalf, from civil liability, in respect of anything done or omitted to be done in good faith in the discharge of the RCH's

duties under sections 38 and 47 of the SFO, or in the performance of its functions under the RCH rules, including its default rules made under section 40(2) of the SFO.

(2) Section 39 does not apply to recognized exchange controllers. Similar protection is provided to recognized exchange controllers under section 64 of the SFO.

(3) The liability of the OTC CCP and its shareholder, i.e. HKEx, in respect of any losses sustained by the OTC CCP or its clearing members is limited. Firstly, the OTC CCP will contractually agree with its clearing members to only pay out of funds available to it under the limited recourse wind down provisions. Secondly, the liability of OTC CCP, a limited company, to any claims is restricted to its assets. The liability of HKEx as the shareholder of the OTC CCP is restricted to the value of shares to which it subscribes.

(4) The obligations under the clearing rules are a matter of contract between the OTC CCP and its clearing members. The Government is not a party to the clearing rules, and the clearing rules do not impose any express or implied contractual duty or liability on the Government.

(5) Since the Government is not involved in the OTC CCP's clearing service and has no servant, agency or employment relationship with the OTC CCP, it is unlikely that the Government will be liable in tort for any losses sustained by the OTC CCP or its clearing members.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
Securities and Futures Commission
June 2012