Risk 101: Back to Basics
Keynote Speech at 2019 Risk Hong Kong Conference

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21 June 2019

Good morning an honour to be invited to give the keynote for the 2019 Risk Hong Kong conference.

The agenda for today covers some of the hottest issues facing the financial services industry, from investing in China and quant strategies to the use of artificial intelligence (AI) and machine learning. You may find yourselves operating in an uncertain political and economic environment, facing rising costs, fee compression and mounting competition from disruptors deploying novel technologies and business models. In response, firms seek to reinvigorate their businesses by entering new markets, trying out different strategies or experimenting with distributed ledger technology or using AI to make investment or trading decisions.

Compared to these exciting developments, risk and risk management may seem like a dull distraction which stifles the innovation needed to succeed But the real-life examples illustrate the dangers firms face as they chase the next big thing. They may lose sight of a key tenet for running a sound and sustainable business. That is, the need to get the basics right and have prudent risk management controls in place.

Trends come and go, but sound risk management is an immutable regulatory principle. It applies no matter whether you are an old-school securities broker or a pioneer in virtual assets or robo-advising. So today, I want to get back to the basics of risk management and talk about what the SFC has been doing to address some of the issues in the markets.

Credit risks

L s specifically, securities margin financing (SMF). Some of you may know that the SFC new guidelines for SMF activities[1] will take effect in October this year. This guidance arose out of our concerns from the sharp increase in margin loans[2] accompanied by a deterioration in loan quality and concentrated exposures to individual margin clients and collateral stocks. , margin loans were often granted based on single stock collateral which were illiquid or already heavily pledged.

Note: This is the text of the speech as drafted, which may differ from the delivered version.

[1] Guidelines for Securities Margin Financing Activities. See the press release issued on 4 April 2019.
[2] Between 2006 and 2017, margin loans increased nine-fold to $206 billion.

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With such concentration risks, brokers may struggle to recover their margin loans in times of market stress and may be left with significant losses. This may have a knock-on effect on their clients and their bankers, undermining the integrity of the wider financial system.

And there is a lot of stock lending in our market. In many cases it involves newly-wealthy
ks. The bankers who
advise on the companies
wealth, and think that gives them a clear line of sight into their finances. So when they pledge large parts

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Counterparty risk and margining of non-centrally cleared OTC derivatives

I also want to mention counterparty risk and the margin rules for non-centrally cleared over-the-counter derivatives (OTCD). Currently, counterparties whose derivatives notional exceeds the USD 1.5 trillion threshold need to exchange initial margin, or IM. This threshold will be lowered to USD 8 billion in September 2020. The industry has voiced concerns about this and requested changes to the margin framework.

Regulators have heard the concerns that many small firms would be brought into scope. In March this year, BCBS-IOSCO[6]

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Conduct risks associated with OTCD transactions

The last topic I want to cover on OTCD is conduct risk. Many of you are familiar with the business model where a Hong Kong-based licensed firm acts as an introducing broker for a client who contracts with a client-facing affiliate in another jurisdiction, say in London. The affiliate may conduct back-to-back trades to offload the risks to a risk-booking affiliate. There may also be transfer pricing arrangements between the affiliate and the Hong Kong firm to share the profits and losses. S

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Risk governance

Poor risk governance is another issue we are laser focussed on. One recent case involved a hedge fund trading emerging market currencies. Even though it seemingly made the right bets, its derivative positions were so huge it could not exit them in a thin and volatile market. In a matter of months net asset value

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