HKSFA 25th Anniversary
香港財經分析師學會
THE HONG KONG SOCIETY OF FINANCIAL ANALYSTS

20th August 2018

Sent by Email and by Post

Securities and Futures Commission
35/F Cheung Kong Center
2 Queen's Road Central
Hong Kong

Dear Sirs/Madams,

Re: Consultation Paper on the OTC derivatives regime for Hong Kong – Proposed margin requirements for non-centrally cleared OTC derivative transactions

HKSFA is of the view that margin requirement is important to mitigate systematic risk in non-centrally cleared OTC derivative. This could help reduce contagion effects and counterparty credit risks.

It is recognised that significant non-financial counterparties may engage in OTC derivatives for hedging purpose. However, because the transaction amounts are significant and may give rise to systemic risk, it may be prudent to apply margin requirements on significant non-financial counterparties along with financial counterparties even if it is to a smaller degree.

The specific response to the questions from our society members is set out in the appendix. We welcome further discussions in case you have further questions on this topic.

Yours sincerely,
For and on behalf of
The Hong Kong Society of Financial Analysts

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Appendix: HKSFA Specific Response to the Questions

Q1 .
Do you have any comments on the proposed scope of licensed corporations subject to the requirements and the types of counterparties constituting the covered entities? Is it appropriate to exclude transactions with a significant non-financial counterparty which engages in OTC derivatives predominantly for hedging? Would such an exclusion pose systemic risk concerns?

Answer to Q1:
It could be difficult to define whether a non-financial counterparty is genuinely engaged in OTC derivatives for hedging purpose. As a matter of prudent measure, it is suggested that margin requirement should not be exempted for this type of transaction.

Q2.
Do you have any comments on the instruments excluded from the proposed margin requirements, or the application of the requirements to single-stock options, equity basket options and equity index options starting only from 1 March 2020?

Answer to Q2:
Whether to exempt IM and VM requirements for physically settled FX forward and FX swaps and the FX transaction embedded in cross currency swaps associated with the exchange of principal should depend on the price volatility of these instruments.

For transactions that are within T+7 day cap, since the duration and hence the systematic risk implications are not significant, it is reasonable to exempt margin requirement for this kind of transaction so as to reduce the operational burdens.

Q3.
Do you have any comments or concerns on the proposed IM requirements, including the IM modelling standards, the IM threshold and the treatment of IM collected?

Answer to Q3:
It is a good practice to exchange IM on a gross basis so as to mitigate large gross derivative exposures. The standardized approach and the quantitative portfolio model approach are both reasonable methodologies to adopt, provided that the licensed corporation is using the same model consistently over time for the same type of asset classes.

Q4.
Do you have any comments or concerns about the proposed VM requirements?

Answer to Q4:
It is a good practice to collateralize VM amount with the current exposure of transaction. Whether the threshold should be set at HK$15 billion or smaller could be subject to further analysis so as to strike a balance between operational burden and systemic risk reduction.

Q5.
Do you have any comments on the proposed requirements for minimum transfer amounts, timing of the exchange of margin, assets eligible as margin or haircuts? Should any other assets be excluded from collateral eligibility? Since an external credit rating of a debt instrument is not a measure of the instrument's price volatility or liquidity during market stress, are the proposed haircuts for debt securities determined by reference to credit quality grades appropriately calibrated?

Answer to Q5:
It would be a better approach to recalculate the IM amount for a given counterparty on a weekly basis instead of the proposed 10 business days since the current financial market is evolving quickly.

The issue size of the debt securities and average weekly transaction volumes of the subject bonds can be taken into account to calibrate the haircut levels.

Q6.
In relation to the proposed requirements for the FX haircut, should onshore renminbi (CNY) and offshore renminbi (CNH) be considered as different currencies for the purpose of determining a currency mismatch between the contract currency and the collateral currency? If so, how should the FX haircut be calibrated? Is there any reason for not treating this as a currency mismatch for the purpose of the FX haircut?

Answer to Q6:
CNH volatility historically tend to be higher and liquidity thinner than onshore CNY, as such this should be taken into account and a higher haircut level should be applied.

Q7.
Do you have any comments on the proposed exemptions for non-netting jurisdictions or intragroup transactions?

Answer to Q7:
The proposed netting exemption looks reasonable.

Q8.
Should substituted compliance be available? Do you have any comments on the proposed substituted compliance regime?

Answer to Q8:
Substituted compliance makes business sense provided that the substitutions are from internationally recognised financial market regimes. Other emerging market regimes may need a second look to see if they are of the same standard levels.

Q9.
Do you have any comments on the proposed IM phase-in schedule or the effective date of the VM requirements?

Answer to Q9:
The schedule looks reasonable.