證券及期貨　　監　委員會

In this environment, it is crucial for intermediaries to put in place a sound risk governance structure. This structure should be commensurate with the nature, size and complexity of the intermediary's operations. The roles and responsibilities of senior management should be clearly defined within the risk management and oversight functions of the firm. In particular, licensed corporations should have appointed Managers-In-Charge (MICs) who are suitably qualified and experienced to be responsible for risk management functions.

Risk governance implemented through organisational structures, measures and procedures ought to be supplemented by the deployment of appropriate resources.

Risk identification2

In a prolonged low interest rate environment, investors look for higher yields and better returns. In Hong Kong, sales of non-investment grade corporate bonds grew 65% between 2016 and 2018 and transactions in high-yield bond funds increased from $2 billion to $18 billion [2]. Many of these bonds yield double digit returns, reflecting a high risk of default. Investors should be cautious when investing in high-risk investment products.

Intermediaries distributing or advising on these high-risk products should be mindful of the requirements governing selling practices, including the suitability obligations under the Code of Conduct [3]. Intermediaries also need to provide investors with sufficient and accurate information about these products, including their features and risks. They must present balanced views and not focus solely on the products' advantages.

There have been more cases where financial groups affiliated with securities brokers have had their capital substantially tied up in investments in defaulted corporate bonds or notes, overdue loans or mature but unsettled private funds. Some of these bonds, notes or loans were secured by illiquid shares or shares suspended from trading on the stock exchange. Similarly, some private funds also had holdings in defaulted corporate bonds or notes and illiquid or suspended shares. It is important for brokers to adopt a prudent approach when extending credit.

Brokers should also be aware that listed bonds (such as those listed under Chapter 37 of the Listing Rules) on the balance sheet of a licensed corporation can no longer qualify, based on their listed status only, as liquid assets in the liquid capital computation under the revised financial resources rules [4] which came into effect on 1 April 2019.

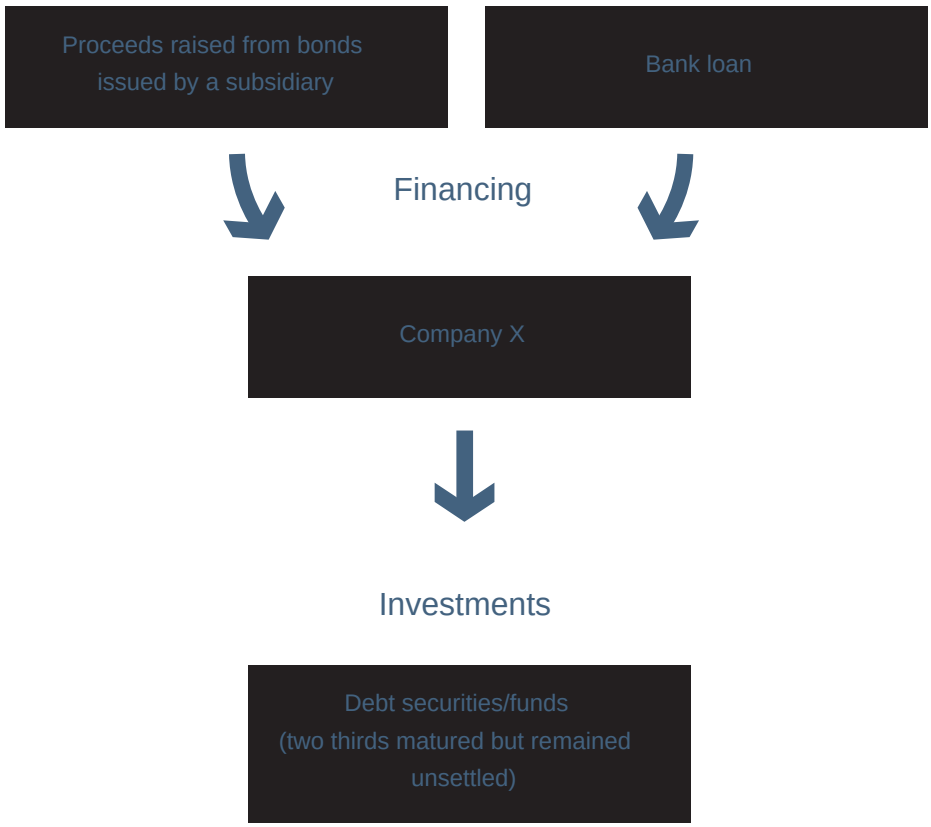
The Hong Kong Monetary Authority (HKMA) and the SFC issued a joint circular in April 2019 on complex financing arrangements noted during their coordinated inspections [5]. In addition, recent cases noted by the SFC involved similar financing arrangements with loans from affiliates secured by listed shares. These complex arrangements made it difficult to properly manage overall financial risks.

2 Survey on the Sale of Non-exchange Traded Investment Products, December 2018.
3 Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.
4 Securities and Futures (Financial Resources) Rules.
5 HKMA and SFC adopt a coordinated approach to supervise banks and licensed corporations, circular issued on 24 April 2019.

Case studies – Credit risk of investments or lending by affiliated entities

- Company X is the Hong Kong holding company and approved substantial shareholder of several licensed corporations. It invested extensively in (i) unsecured notes issued by listed and private companies, (ii) notes issued by substantial shareholders of listed companies and secured by the shares of these listed companies, and (iii) funds that invested in a single stock, notes which subsequently defaulted or stocks with low market liquidity. Two-thirds of the company's investments had passed their maturity dates and either remained unsettled or had their maturity dates extended. Most of the remaining investments were subject to long lock-up periods. Financing was provided by a bank loan and proceeds from bonds issued by a subsidiary. As the majority of the investments had technically defaulted or would not mature before the bank loan and the bonds came due, Company X may face a funding gap.

Company X's financing arrangements



- Company Y is the Hong Kong holding company and approved substantial shareholder of several licensed corporations. It nearly defaulted on its outstanding syndicated bank loan because most of its funds and those of its subsidiaries were locked up in doubtful share pledge loans advanced by a money lending subsidiary. In the end, the company resorted to a capital injection from its parent company to save it from a liquidity crunch.

We have repeatedly warned against opaque and complex financing arrangements whereby margin lending risk or credit risk is disguised as investment risk. When credit risk materialises in one part of a group, the reputation and financial integrity of the licensed corporations within the group may also be adversely affected. Holding companies and controllers of intermediaries should prudently manage overall group financial risks to ensure they can provide financial support to the intermediaries and contain contagion risks which may affect their financial integrity. The SFC cooperates closely with fellow regulators, both locally and outside Hong Kong, to require licensed corporations to take prompt corrective action where necessary.

It is paramount for intermediaries to exercise due care, skill and diligence and deploy necessary resources to manage and contain the risks facing their business activities. This is particularly important in times of market uncertainty and slower economic growth. Intermediaries should put in place a sound risk governance structure and be aware that risk management is not solely the responsibility of the risk management team or designated individuals. Senior management, including the board, responsible officers and MICs, should bear the primary responsibility and will be held accountable for the overall risk management control of their firms.

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