

Our Ref: CB/POL/6/67

19 December 1994

The Chief Executive
All Authorised Institutions

Dear Sir / Madam,

Risk Management of Financial Derivatives Activities

The Basle Committee issued in July 1994 a paper which provides guidance on sound risk management of financial derivatives business. The industry Associations have been consulted on the paper and on the extent to which it should be adopted as a formal guideline for authorised institutions.

The industry Associations have indicated support for the general principles and procedures outlined in the Basle paper and have agreed that they should be adopted as an indication of best practice. In the light of the positive response, the Monetary Authority has decided to adopt in full the Basle paper, together with an introductory note by the Monetary Authority, as a guideline for authorised institutions (attached at Annex A). Pending further study of the appropriate supervisory regime for derivatives (see below), the guideline will not be issued under Section 7(3) of the Banking Ordinance for the time being. The introductory note by the Monetary Authority sets out the key risk management practices which the Monetary Authority regards as particularly important.

We agree with the industry Associations that the actual controls that should be put in place by authorised institutions in accordance with the general principles set out in the Basle paper should have regard to the nature, size and complexity of individual institutions' derivatives activities. The Monetary Authority will take into account these factors in assessing the adequacy of institutions' systems for managing the risks arising from their derivatives transactions.

The Basle paper focuses on high level controls. The Monetary Authority intends to study further the more operational aspects of the risk management of derivatives and will issue a further guideline on this subject in 1995. To facilitate the preparation of this guideline, we intend to conduct a series of visits to the treasury departments of institutions which are more active in derivatives activities.

Survey on Risk Management Practices

In order to establish the extent to which institutions are already complying with the guidelines set out in the Basle paper and to assist in future assessment of risk management practices, the Monetary Authority has prepared a questionnaire which is attached at Annex B. In order to reduce the reporting burden on institutions, this is designed to be completed by ticking boxes. We intend to publish the results of this survey in aggregate form in our Quarterly Bulletin.

Only those institutions with a material volume of derivatives business have been selected to participate in the survey. Your institution is not one of those which have been selected. You may nonetheless wish to study (and complete) the questionnaire for your own purposes as a self-assessment.

Client selection and appraisal

Recent events have demonstrated the credit, legal and reputational risks that can arise for banks or other financial institutions that engage in derivatives transactions with customers who do not fully understand the risks involved or for whom such transactions may be inappropriate. An added complication arises if the customer does not have the necessary legal or regulatory authority to engage in the transactions.

It is not the intention of the Monetary Authority to impose a "suitability" requirement on authorised institutions with respect to derivatives or other banking transactions in which they engage with their customers. Nonetheless, we consider that institutions should, for their own protection, have policies and procedures to reasonably ensure that their customers have the capability to understand the nature and risks of derivatives transactions into which they enter, particularly those which involve complex structured products; and that customers should be provided with sufficient information (such as sensitivity analyses) to help them to understand the risks. It is, of course, essential that the institution establishes that the customer has the power and authority to enter into the transaction in the first place.

Yours faithfully,

D T R Carse
Deputy Chief Executive (Banking)

c.c. SFS (Attn: Mrs Erika Hui)
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Auditors of authorised institutions