Ref. CB/POL/6/67 27 March 1996

The Chief Executive
All Authorized Institutions

Dear Sir/Madam,

Guideline on Risk Management of Derivatives and Other Traded Instruments

The Monetary Authority ("MA") issued in December 1994 a guideline on "Risk Management of Financial Derivatives Activities" to set out the basic principles of a prudent system to control the risks in derivatives activities. That guideline focused on high level controls. As indicated earlier, the MA is now issuing a further guideline which provides more detailed guidance on specific, in particular the operational, aspects of the process for managing the risks of authorized institutions' derivatives activities. Given that the derivatives market and risk management in this area are still rapidly evolving, the guideline is not yet being issued under section 7(3) of the Ordinance.

The MA has finalized the operational guideline following consultation with the Hong Kong Association of Banks, the Deposit-taking Companies Association, the Hong Kong Society of Accountants and the International Swap and Derivatives Association. The guideline has also been endorsed by the Banking Advisory Committee and the Deposit-taking Companies Advisory Committee. A copy of the guideline, entitled "Guideline on Risk Management of Derivatives and Other Traded Instruments" is enclosed.

While the guideline is relevant to the trading of financial instruments in general, it concentrates particularly on the trading of derivatives. This reflects the rapid growth in these instruments, the opportunities for increased leverage which they offer and the complexity of some derivatives products which may complicate the task of risk management. The guideline is not intended to break new ground in the risk management of trading activities. It is mainly based on observations from, and weaknesses identified in, the surveys and treasury visits conducted by the MA since December 1994; the findings of the review of internal controls systems in respect of trading activities carried out by authorized institutions in March 1995 in response to the MA's request following Barings collapse; the recommendations of the Group of Thirty and the lessons learned from the cases of Barings and Daiwa having regard to the official reports on the Barings collapse issued in the UK and Singapore. The guideline covers the following specific areas:

- Risk management and corporate governance
- Board and senior management oversight
- Identification and measurement of risks
- Limiting risks
- Operational controls.

All authorized institutions and the subsidiaries of all locally incorporated authorized institutions which engage in the trading of financial instruments are expected to follow the risk management practices set out in the guideline. The guideline acknowledges that the actual risk management processes that should be put in place should be commensurate with the nature, size and complexity of individual institutions' trading activities. In general, institutions which are active dealers or active position-takers will require a more elaborate system of risk management. The MA will during the course of its supervision of institutions' trading activities, classify institutions into four categories : active dealers, dealers, active position-takers and limited end-users. We will communicate the classification to the institutions concerned in due course and assess the adequacy of institutions' risk management system against this classification.

Should you have any questions on the guideline, please feel free to contact Ms. Rose Luk (2878 8218) or Mr. Frederic Lau (2878 1620).

Yours faithfully,

(D T R Carse)
for Monetary Authority

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Auditors of authorized institutions