De-Coupling Financial Economic Risk and Limited Holding of Future Indexes

For

Securities and Futures Commission, Hong Kong

By

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Do you support the proposed increase of position limits for the Hang Seng Indexes Derivatives as set out in this paper?

Yes.

There are two reasons I would like to present.

<u>A. Increasing Volatility of Financial Markets</u>

As the contemporary financial markets are increasingly volatile, participants in the Hong Kong financial market would seek risk-free options to invest within the market. As the Index Futures provide some kind of a mechanism (discussed below), customers would indeed like to invest into more such assets, to reduce the impact of global financial instability. As major markets such as in UK, EU and US are in contracting stages, the hedges of market risk in Asia is loaded further by seeking an outlet for some such inherent global risks. A global portfolio of shares that previously consisted or risk assessed investments in UK, EU and US now has to be reassessed with increasing weightages on risk-free elements for the total portfolio.

To allow market participants to hold an increasing number of Index Futures, would send a clear message to the financial markets that such risk-free derivatives are available in Hong Kong for investors. Whilst not stated to be 100% risk-free, but that there is a regulatory oversight on such holdings would bring a certain risk-free assessment (at least about 30%) for the customer market portfolio.

To appropriately adjust this 30% risk free assessment, in terms of the Hong Kong financial market capitalization, is the critical factor for such announcements. However, to increase the limit seems reasonable and a certain way forward.

B. Economic De-Coupling from Financial Market

Hong Kong has been a financial market intensive economy for most of this century. Historically, as Hong Kong became increasingly the hot-spot for Asian Finance, the economic architecture of Hong Kong, to be completely dependent and driven by the financial market has been the growing phenomenon, with its stated advantages and dis-advantages.

However, in the next century of Asian development, to have an economy that is completely driven by financial market, is a high-risk economy, even in terms of global financial status, and eventually, the demise of a financial market, should not mean the unfortunate demise of a once versatile and throbbing economic hot-spot in Asia.

To meet such economic conditioning, a step forward for an economic de-coupling of Hong Kong from its financial market is a requirement for the growing Asian economies, large and small. The high-risk factor of financial economy, especially when left in the open of the funds flowing from external investors, would mean that when the sun shines in Timbuctoo, the rice falls in Hong Kong, which is not really the economic agenda of any free and prosperous nation. However, that is the nature of financial markets, and to depend too much on it would be an unknown economic risk. All financial economies from US, UK and EU would regulate their financial markets to their own will, and no economy in Asia should not not have this choice, simply on assumptions of Asia being a stated poorer economic zone.

To provide a free-er holding of Index Futures would mean that the market participants would have no limit on the fixtured presumably government assured financial assets. However, such assurances are also correspondingly lowered as the financial markets are de-coupled from the success of Hong Kong's economic future. Economic future is seldom dependent on financial success, as are the suggestions of the current financial climate, and to have a stronger economy, by reducing the inherent risk of the financial markets, would certainly make Hong Kong a better stabilized and progressive economy, with larger offerings in the FinTech Sector. Importantly, FinTech, is not only about financial markets, but needs a dual coupling of Finance with successful Technology, and this should really be the focus of a gradual economic re-shuffling of financial markets. Stated simply, the world economy, and indeed the Asian Economy, does not need the opportunity of a low-probability future such as 6G telecommunication in our lives, and the associated financial impacts that it may have, but that the world needs real FinTech, where we can touch our lives realistically with proven and successful technology, which would indeed irradicate some of the poverty and economic challenges in Asia. Today, the Index of global finance, is loaded with disputed financial assets, in terms of AI, Data Privacy and Cybersecurity, and to have this as any economic entity's risk-free assessment would be a certain basis for financial crises, and should indeed be lowered to an acceptable level.

Accordingly, the need to re-assess Hong Kong financial market, as per the conduct of global financial market is needed, and a gradual de-coupling would be a step forward, implemented through some means of increased limit on holdings of such assets.

Discussions

6. The position limit regime, which comprises statutory position limits and reportable position reporting requirements, was put in place in 1999 after the Asian Financial Crisis. Its purpose is to strengthen the transparency of the Hong Kong securities and futures markets, and prevent and discourage the buildup of large positions which may affect the orderly functioning and stability of the Hong Kong financial market.

Whilst the intention to stabilize the Hong Kong financial markets is the key objective, a regulative limit on the number of Index Futures a customer can hold is assumed as the key manipulator of the any de-stabilizing effect that is caused from holding too many Index Futures.

Index Futures are observed to be a critical factor in a customer portfolio that determines the ultimate stability of the Hong Kong Financial market.

8. At present, the Rules stipulate the position limits for HKFE's Hang Seng Indexes Derivatives. The prescribed limits of these derivatives contracts are the same as those stipulated in the rules of HKFE. Therefore, any person holding a position above the prescribed limit does not only breach the exchange rules but may also commit a criminal offence under the Rules. The creation of the offence under the Rules gives regulatory teeth to the position limit regime and enhances deterrence against disruptive behaviour that may affect the stability of the Hong Kong financial market.

The key driver for the stated regulatory teeth is the imposed limit on the number of derivative contracts a customer can hold. It is understood that when a customer holds too many of such contracts, it would destabilize the market because the customer is not diversifying away from the key indices, rather depending too much on the established index components to have any virtual risk assessment of the market in the total held market portfolio. It is also inferred, that there maybe a regulatory limit, as the Government of Hong Kong, or its named associates, may depend on such an index as a public infrastructure, which may have associated insurances, payouts and monetary effects. To a market participant, the important reason of government oversight is realistically derived from a government financial infrastructure. It may even seem, that to hold too many of such contracts, resembles the perfect government portfolio for public finances, as maybe deemed to be risk-free in some instances. As the objective of the financial market is to derive a risk-premium, to depend purely on the stated indexes, would then seem inappropriate in Hong Kong, as the true benefits of market participation is overshadowed by this perceived risk-free participation, that would hinder the free flow of capital to the most suitable investments.

9. Over the years, the SFC has reviewed the position limit regime regularly to ensure it keeps pace with market development. To date, the regime has helped fulfil the SFC's regulatory objectives of maintaining and promoting orderly securities and futures markets.

This statement means that SFC uses regularly the stated Indexes, in order to associate and develop fiscal and monetary effects of the economy of Hong Kong, as is contained in its financial markets. It is not a usual phenomenon for any financial regulator worldwide, that any such limits are explicitly placed on the holding such indexes, and is as such beyond the reasonable scope of global financial regulation on security holdings. Hence, there seems to be an insistence by the SFC that coming to close to 100% holding of Future Indexes in a limited portfolio, would be too much financial pressure on the financial market, in terms of risk assessments and chance of failure, and such market participants should not hold too many of such indices in the portfolio.

Conversely, the SFC may deem market participants as an equal partner for diversifying the total market risk amongst participants and becoming a market participant itself.

$$T_f = \sum (P_f - M_f)$$

T_f : Total Market Risk (Hedged)

P_f : Hong Kong Public Financing Risk

M_f : Market Participants Risk

However, it is an expectation as per global and Asian Finance that a better evaluation of the fundamental economy is undertaken in any financial analysis. An increase in limits would thereby increase M_f, and whilst keeping T_f constant, would provide an economic opportunity in P_f.