

Press release

LCQ14: Concentration risk in the sale of equity linked structured notes issued by Lehman Brothers

Wednesday, May 4, 2011

Following is a question by the Hon Lau Kong-wah and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (May 4):

Question:

In relation to the equity linked structured notes issued and guaranteed by Lehman Brothers (LB ELNs), the Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority (HKMA) reached an agreement with Standard Chartered Bank (Hong Kong) Limited (Standard Chartered) in March this year, under which Standard Chartered agreed to repurchase the products from eligible customers holding an outstanding LB ELN distributed by Standard Chartered. The authorities indicated in the relevant announcement that, following an investigation by SFC and HKMA, both regulators were concerned that Standard Chartered might have exposed LB ELN customers to higher levels of risk than were suitable for them by not adequately considering the risk that a customer's available assets for investment were overly-exposed to the same set of risks (concentration risk) when assessing the suitability of LB ELNs for customers. In this connection, will the Government inform this Council:

(a) given that SFC and HKMA also reached similar agreements with Dah Sing Bank Ltd and Mevas Bank Ltd in December 2009 and DBS Bank (Hong Kong) Limited in July 2010 respectively, whether it knows if SFC and HKMA have identified any issue relating to concentration risk in their investigations; if such issues have been identified, whether the cases were similar to those involving Standard Chartered, and whether such factor has been taken into account in determining the repurchase rate; if not, the reasons for that;

(b) whether it knows if SFC and HKMA have hitherto identified any issue relating to concentration risk in cases involving banks which have not yet reached any collective repurchase agreement (such as Citibank (Hong Kong) Limited); given that under the collective repurchase agreement in relation to the Lehman Brothers Minibonds announced on July 22, 2009, the banks concerned are required to implement special enhanced complaints handling procedures to handle the remaining complaint cases involving customers not eligible for taking part in the repurchase scheme, whether the authorities have identified any issue relating to concentration risk in such cases;

(c) whether it knows if SFC and HKMA have examined whether Standard Chartered had overlooked the concentration risk in its sale and distribution of LB ELNs because there were inadequacies in the risk assessment procedures in the bank's sale and distribution process, resulting in the failure of the bank or its frontline staff to carefully consider the level of concentration risk of their customers' investments; whether there were other major inadequacies, and whether they have identified any systemic issue within the bank with regard to the sale and distribution of financial products; and

(d) given that SFC and HKMA have reached the relevant agreements with individual banks without the banks' admission of liability in order to facilitate repurchase of LB products by the banks, whether it knows if SFC and HKMA will adopt similar arrangements to handle systemic errors of banks in the sale and distribution of their products; if such arrangements will not be adopted, how the authorities will handle such problems?

Reply:

President,

The Administration has consulted the Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority (HKMA) on the above questions. The reply is as follows:

(a) SFC and HKMA have entered into agreements under section 201 of the Securities and Futures Ordinance (SFO) with 18 banks (i.e. 16 Minibond distributing banks, DBS Bank (Hong Kong) Limited and Standard Chartered Bank (Hong Kong) Limited (Standard Chartered Bank)). SFC has also entered into such agreements with several brokerage firms.

Other than the section 201 agreement with the 16 Minibond distributing banks (Minibond Agreement), each case was dealing with different situations and was responding to different regulatory concerns based on the evidence collected. While there are common elements in each agreement, the foundation for each agreement is different.

The issue of concentration risk was the principal concern that arose in the investigation into the sale of Lehman Brothers-related products by the Standard Chartered Bank. Concentration risk is an aspect of suitability. In short, the Code of Conduct for Persons Licensed by or Registered with SFC requires intermediaries to ensure that any advice or recommendation concerning a securities product is suitable for a customer given the customer's circumstances. If concentration risk is relevant to the acquisition of the product, then concentration risk will be a necessary element to be considered when suitability is being addressed. A large number of other elements are also relevant to the way in which suitability needs to be addressed. They include the extent to which the intermediary has understood the customer's relevant circumstances, such as the person's risk tolerance, present and future plans, income needs and investment experience.

The Standard Chartered Bank case is the only one in which concentration risk was the key issue raising regulatory concerns. For this reason, the section 201 agreement in this case was designed to provide financial redress for the concerns that concentration risk was not properly addressed by the Standard Chartered Bank. This meant the resolution in this case is different from the ones that were applied in the other section 201 cases.

The resolution in the Standard Chartered Bank case was designed to cap each eligible customer's loss to no more than 5% or 10% of their available assets held at or with the Standard Chartered Bank. The formula uses a very customer friendly assessment of concentration risk which would normally be calculated on the basis of all assets and investments held by the customer, not just those held at or with the Standard Chartered Bank. Moreover, the relevant concentration risk percentage (which implies that a person who spent more than 5% of their available assets in a Lehman Brothers equity linked structured note (ELN) would be over-exposing their available assets to the risks presented by Lehman Brothers ELNs) is a reasonable arrangement.

As regards the scheme of Dah Sing Bank and Mevas Bank, it arose from the Enhanced Complaint Handling Procedures (ECHP) under the Minibond Agreement. Under the scheme, whether a customer is eligible for the repurchase offer is formulated on the basis of the date of purchase of the notes. The factor of concentration risk was not mentioned in the press release of December 23, 2009 in respect of the resolution reached between the SFC, the HKMA, Dah Sing Bank and Mevas Bank concerning the sale of certain Equity Index-linked Fixed Coupon Principal Protected Notes issued by Lehman Brothers.

(b) Neither SFC nor HKMA can comment on the details of their on-going investigations under the constraint of the secrecy provisions in the SFO and Banking Ordinance respectively.

In respect of Minibond customers who did not receive a repurchase offer under the section 201 agreement with the 16 Minibond distributing banks, they have been entitled to submit their complaints to their respective banks under the ECHP designed to require each bank to undertake a merit based inquiry into each complaint and to resolve them accordingly. Over \$161 million (out of a total of over \$600 million paid out under the ECHP to date) has been paid to these customers. Moreover, the announcement made on March 27, 2011 by the 16 Minibond distributing banks the receivers of the Minibond collateral about the repatriation of the Minibond collateral proceeds will benefit all Minibond customers including those who did not receive a repurchase offer (subject to the completion of the conditions). The repatriation of the collateral proceeds is another consequence of the section 201 agreement with the 16 Minibond distributing banks.

(c) The issue of "concentration risk" mentioned in the joint press release of SFC and HKMA dated March 1, 2011 was the principal concern identified in the regulators' investigation of the Standard Chartered Bank. Neither SFC nor HKMA has further comments.

(d) Given the uniqueness of each individual case, direct comparison is not appropriate and for the same reason, there is no simple answer to the question of whether systemic failure of banks in relation to the sale of investment products should be handled by broad-based settlement schemes.

In relation to enforcement actions and resolutions, SFC and HKMA will continue to work closely with each other to combat any systemic deficiencies in the banks' selling process.

Ends