Hedgeweek Interview: Calvin C K Tai, Head Trading Division, Hong Kong Exchanges and Clearing Ltd

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Calvin CK Tai outlines the latest developments in trading at the HKEx, including the launch of new volatility and futures indices

HW: How busy have the derivatives markets been in Hong Kong this year

CT: Post-2008, in the U.S. and European exchanges there was quite a big setback in terms of volatility and trading firms' activities in the market but in Hong Kong we kept it quite stable, particularly our futures market. I would say that 2010 has been particularly good in index options. We have two underlying indexes that we trade futures and options on: the Hang Seng Index and the H Share Index (Hang Seng China Enterprises Index). Index options year-to-date have increased over 50 per cent.

We have a lot of expectations in terms of options-related business so we're doing a few things. We have quite an actively utilised block-trade function that helps transactions executed outside our open option market report straight back to us, so there's quite a bit of booking from OTC to our market. Also, we have a solid infrastructure to grow our options market further. We plan to build a Volatility Index in conjunction with Hang Seng Indexes Company Ltd, which will also be useful for structured products traded in our cash market (e.g. derivative warrants).

HW: And this Volatility Index will launch as a new product in 2011?

CT: I think Hang Seng Indexes will be in a better position to announce it but I would say in a few months' time we're going to see this brought to market.

HW: With options up over 50 per cent y-o-y are you seeing a lot of activity in this area amongst hedge fund managers?

CT: We don't see too many things that we can point out or differentiate. Generally speaking, during our interactions with hedge fund managers and proprietary traders, we see them getting more enthusiastic about Hong Kong. Some are becoming liquidity providers in our market. Over the last few months we've noticed that the open interest in our futures market has gone up. Using the Hang Seng Index as an example, our open interest was 85,000 to 90,000 contracts. Now, it's around 110,000 to 120,000 contracts. That percentage increase is probably related to hedging activities in the market.

HW: Regionally, hedge fund start-up numbers are over 100 year-to-date. With Dodd-Frank causing prop desks to close, do you expect deal flows to increase next year as another wave of newly launched funds enters the market?

CT: If you look at potential, most people see Asia as a growing and important market. If you look at futures and options turnover, Asia has already overtaken the U.S. market (according to FIA figures) in terms of numbers of contracts traded.

HW: And you expect this trend to continue on into 2011?

CT: What I'm trying to say actually is there is a pushing and pulling factor. For European and North American funds, while they have to find places in high growth areas to move and develop their business what they'll do is move their talent and their funds into those areas. I would expect to see more firms establishing their presence here in Hong Kong. For money and talent I think we can be bullish on this market.

HW: Yes, Hong Kong is certainly well positioned to take advantage…

CT: Not just Hong Kong though. I think this will benefit the overall Asia market. Hong Kong is particularly lucky though. If the mainland wants to establish an offshore RMB centre, Hong Kong is in the best position to serve that purpose. It will give the city's financial markets a boost and we believe the equity and derivatives markets would benefit from it.

HW: In dollar terms how much money has been flowing through HKEx this year?

CT: I think we trade 90,000 contracts a day in the Hang Seng Index Futures. That's HKD100 billion (USD13 billion), or roughly 1.3 to 1.5 times our daily cash market turnover, so we're talking about USD10 billion a day just for the Hang Seng Index Futures.

HW: Is 2007 still the exchange's high-water mark?

CT: Yes and no. It was for the cash market, but not derivatives. The highest turnover in our derivatives market was the following year. We haven't done better since then. But if you look at Index futures and options we're quite close now. We traded more than 100 million contracts in 2008. This year we're going to break 100 million contracts again.

HW: Aside from the Volatility Index, what other new products are HKEx preparing to roll out?

CT: Actually, a series of things. Firstly, we've decided to build our own data centre. It's been difficult finding a place big enough to accommodate us – when I say 'big' I don't mean space I mean power supply. This year, the board made a decision to buy a piece of land in Tseung Kwan O. That will allow us to build a 31,000 square metre data centre.

HW: When is it due to open?

CT: We're looking at mid-2012 to finish the building, moving in probably 2H2012.

HW: And how about technology-related products?

CT: Short-term we have two: one completed, the other still underway. For the derivatives market we've upgraded our capacity and moved to an Itanium platform, which will increase our processing power by 150 per cent. We just rolled it out (Monday Oct 18th). It has helped shorten our latency by roughly 50 per cent. The other product is for the cash market. We can handle 3,000 orders per second so we're going to upgrade to 10 times (current) capacity and bring down latency to less than one tenth. This will take a year to complete.

HW: So the Volatility Index is the next big investor-focused product rollout?

CT: No, before that we're going to rollout the Dividend Index Futures at the start of November. We've completed the work with Hang Seng Indexes. We came up with this idea because our participants have been active in the OTC market in dividend swaps. They've become an important asset class with people wanting to make investments focusing on the change in dividend yield for some of the major benchmark indices. If you have a derivative portfolio replicating a cash portfolio there'll be a difference between the two because indices don't reflect dividends and for institutional players this discrepancy will become a big risk. That is why we see the need for the Dividend Index.

HW: Which hedge fund instruments would best benefit from using this index?

CT: For those using derivatives the index will help them eliminate risk. If hedge fund managers want to focus their trading tied to dividend payout rate this will be something very convenient for them to go to. A specific group using a unique strategy on dividend returns will certainly benefit. The other, more general group using index-based derivatives, if they decide to hedge it they can come to our market.

HW: What about RMB. Are you seeing a lot interest?

CT: We're seeing a lot of interest in holding RMB but returns may not be that attractive. Therefore there could be demand for RMB investment products. Fixed income is one area – in the interbank market there have been a number of bond issues in RMB (including BOCI, McDonald's and Asian Development Bank - ADB listed RMB bonds on HKEx on Oct 22nd).

HW: Do you anticipate demand rising?

CT: Definitely. Obtaining a listed status so fund managers can make their investments in these bonds will become a trend. Fixed income trading on exchange is always challenging because a lot takes place in the interbank market but Hong Kong has a unique opportunity.

HW: Could that be where Asian hedge fund evolution lies – fixed income and RV arbitrage strategies in RMB?

CT: I think the most important thing is that mainland policy makers have made up their mind about RMB internationalisation as the preferred solution to resolve their foreign reserve problem. In that case, with Hong Kong as an offshore centre, people would take on a lot more RMB and also for international trade settlement RMB usage would be much higher.

HW: Finally, is it important for HKEx to continue evolving its product suite for hedge fund managers in Hong Kong?

CT: Well, new products take time to build so I would say increasing the depth of our market is very important for us. For hedge funds, they would be very interested in liquid instruments. When we introduce products we're not just purely introducing something new. What we're introducing surrounds our anchor products. Our products become more interesting collectively if you focus on different risks or exposures within our equities market. RMB could make our market very different although it will take time to trade RMB-margined products.

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