# Panel on Financial Affairs
# Meeting on 7 July 2003

## Speaking Notes of Alexa Lam, SFC

1. Thank FAP for the opportunity to report on work of WG. In May last year, the Panel urged us to review the regulation of financial resources of brokers and the problem relating to pooling and re-pledging of margin clients collateral and to report back.

2. We formed the WG, which comprises 11 broker representatives and 4 other members from different sectors, to examine the issues. The WG identified that the current market structure and business model pose risks to investors when brokers default. 2 main reasons for default:

   2.1 integrity risk (misappropriation of client assets)

   2.2 risky margin lending practices and pooling and re-pledging client collateral

3. Integrity Risk

   3.1 Last 15 months, 9 cases of misappropriation of client assets. Total loss amounts to $186.6M. 3 cases involved fraud by proprietor.

4. Margin Financing and Pooling Risks

   4.1 Brokers take on excessive risks when they engage in aggressive and imprudent lending. Under the current law, there are no restrictions on brokers pooling and re-pledging client collateral. If a broker fails, the loss to investors could be huge.

   4.2 The failure of CA Pacific is a good example. In January 1998, CA Pacific and its finance arm collapsed. Total investor loss was $983M. The Compensation Fund paid out $300M. That means, over $600M remains uncompensated. Total liquidation costs are about $120M. At the time of its collapse, the finance arm of CA Pacific had a capital of only $16M. But it had borrowed $548M against client collateral (total value over $2.5 billion).

   4.3 Current rules on financial resources of brokers are the old rules. The current liquid capital level of $3M was set in 1993 when the FRR was first introduced. The current required paid-up capital level of $5M (agency brokers) was in place before the SFC came into existence. Market conditions and risk levels have substantially changed since then but the required capital levels remain the same.

4.4 Under the SFO, we had the opportunity to bring in changes to the FRR. However, as the WG was examining the overall regulatory structure and capital, we agreed to wait for the WG's recommendations.

4.5 When we took over the function of regulating all brokers from the SEHK in March 2000, we immediately worked to get brokers who had margin shortfalls to manage down the exposures by injecting capital, reducing margin loans, taking better quality collateral and segregating non-borrowing client assets.

4.6 To ensure there would be a safety net for clients of risky brokers, we came before LegCo in June 2001 to ask for a market levy of 0.002% to be paid to the Compensation Fund, to build the Fund to the size of $1 billion.

4.7 Fortunately, the Compensation Fund now has about $1 billion which could go towards compensating clients if one of these risky brokers were to fail. However, not every investor would receive full compensation. Moreover, there would be a net loss in the market.

4.8 While we have succeeded to manage down the risks of some brokers because they were willing to change, we do not have any specific legal power designed to force firms to take the necessary actions, such as injecting additional capital and not re-pledging non-borrowing client collateral.

4.9 Accordingly the FRR review is timely and urgent change is necessary to protect investors and the integrity of the market.

## 5. **Way Forward**

5.1 The WG reached agreement as early as January 2003 that the capital level of brokers should be commensurate with their risks. After studying the models adopted in the Mainland [HK$47M-HK$470M][1], Singapore [HK$22M][2] and Taiwan [HK$45M to $90M][3], the WG concluded that it was international practice to require brokers to be well capitalised. Hong Kong's capital requirements ($5M and $10M) are the lowest in the region. WG also notes that in the Mainland and Taiwan, where IP accounts are mandatory, there are no integrity risks. These risks are also significantly less in Singapore, where most of the 30 odd brokers are bank-owned.

[1] In the Mainland, the initial capital requirement for a brokerage securities company (who engages only in brokerage business) is HK$47M while that for a comprehensive securities company (who, besides brokerage, engages also in proprietary trading, underwriting and custodian services etc.) is HK$470M.
[2] In Singapore, the base capital for a securities dealer who clears trades for customers is HK$22M.
[3] In Taiwan, the initial capital requirement for a securities underwriter (who facilitates distribution of issuers' securities) or securities dealer who buys or sells for its own account is HK$90M, while that for a securities broker who trades as agent for its customer accounts is HK$45M.

5.2 In international and regional markets, the regulatory policy is to require intermediaries to put in sufficient capital to buffer against risks. The higher the risks, the higher the capital. The higher the risks to investors, the lower the confidence in the market and the incentive to invest.

5.3 The current capital adequacy ratio of the broker industry as a whole is still higher than that mandated under the Basel Accord. However, brokerage businesses have inherently higher risk than banks because of volatility in the capital market.

5.4 The WG recommended that capital should be lower for brokers who do not hold client assets (no integrity risk) and higher for those who do. While some members believe the present capital level should be increased for these brokers, others believe it is adequate. The WG will continue to examine this.

5.5 The WG also recognised that, if capital were increased for brokers holding client assets, there should be a solution for existing brokers who could not meet the new capital requirements. Some members believed that the new IP Account model that HKEx was developing could provide such an option. As this model is being developed by HKEx, WG considered that it was necessary to continue to examine the issues and await details from HKEx on its IP Account model. We are urging HKEx to expedite a viable solution for IP Accounts.

5.6 Small brokers' market share has gone down. Competition from banks is one of the prime reasons. It is important that an affordable and user-friendly IP account model is introduced as soon as possible, one that would allow small brokers to continue to distinguish their service and give value to clients.

5.7 On pooling and re-pledging client collateral, the WG agreed that it was international best practice to segregate non-borrowing margin client collateral. However, WG members could not reach consensus on a workable model for segregation.

5.8 The WG recognised, however, that margin brokers that pool and re-pledge client securities are inherently riskier than cash brokers' business. The WG believed that capital requirement for these brokers should be very substantial. In addition, to quickly manage down the risk of very risky practices in margin financing, we should put in place swift and effective measures.

5.9 The WG has formed no definitive view on the capital level for share margin financing providers. However, there was broad consensus among WG members that the present capital requirements for share margin financing providers who re-pledge should be strengthened and WG should continue to examine the following interim measures quickly:

- giving the SFC the power to require individual firms to reduce their risks (e.g. by retaining higher levels of shareholders equity in the firm itself);
- tightening the FRR to curb risky margin lending practices (e.g. imposing capital charge on the portion of a margin loan exceeding a prudent level).

5.10 We also presented the WG's general proposals and thinking to our Advisory Committee. Committee members strongly supported the proposal to tier capital to risks and to put appropriate restrictions on re-pledging practices.

5.11 The WG also agreed that margin clients should be better informed regarding the re-pledging of the securities collateral. Brokers should be required to explain the risks of pooling to margin clients, when they make or renew their authorisation for the share margin financing provider to re-pledge their collateral.

5.12 In addition, the WG recommended that the SFC step up investor education on the risks of pooling and re-pledging.

5.13 We have provided a briefing to the Bureau on the views of the WG. The Bureau encouraged us to continue to work with the WG on further details.

5.14 In the interim, we will remain proactive in monitoring the risk levels of share margin financing providers and will not hesitate to use the powers at our disposal (including use of restriction notices) where we think it appropriate to do so to protect the interests of investors or in the public interest.

5.15 We fully understand that the securities industry is undergoing a period of difficulty and stress as market conditions continue to change. We will of course do our part to help the industry. It is understandable that some brokers do not wish to increase capital. However, the SFO puts the interest of investors as priority. It is also the industry's own long term interest to protect investors. As such, we will work together with the WG, the industry, LegCo and the Administration to find a suitable solution as soon as possible.