Opening Statement by Mrs Alexa Lam, Executive Director of Intermediaries and Investment Products, Securities and Futures Commission
at Legislative Council Panel on Financial Affairs (FA Panel) Meeting
1 March 2004

Honourable Chairman Henry Wu, Honourable Members of the FA Panel,

I would like to thank the FA Panel for this opportunity today to discuss the Report of the SFC on the Recommendations of the Working Group on Review of the Financial Regulatory Framework for Licensed Corporations. I look forward to receiving comments from Members on the issues set out in the report.

The Working Group is concerned with the risks involved with margin lending practices of pooling and re-pledging of margin clients' collateral by brokers as security for their own bank borrowings, aggressive lending practices and excessive re-pledging of client collateral for banking facilities to meet brokers' own funding needs. If the risks are not addressed properly, clients may suffer losses when the broker firms concerned encounter any problem, thereby undermining investors' confidence in the market and also impacting on the operations of other broker firms and the healthy development of the market as a whole due to the contagion effect. The collapse of C.A. Pacific some years ago is a classic example of the serious consequences stemming from such practices. At the time of the collapse, C.A. Pacific had borrowed over $500 million from the bank by re-pledging client collateral of $2.5 billion in market value at that time. As a result, clients were unable to recoup their shares. The total amount of claims arising from the collapse exceeded $900 million, while compensation payments came up to over $300 million. Nevertheless, pooling and re-pledging of client collateral still remains an issue to be dealt with.

Of the 13 members of the Working Group, 10 are market practitioners who are well-versed in the business operations and needs of broker firms. The consensus among Working Group members is that in devising workable proposals, it is necessary to take into account two main principles: first, we need to make sure the proposals would give the 1,000,000 investors of Hong Kong better protection; second, any measures should not affect those firms currently operating in a prudent and proper manner and should provide the industry with space and flexibility to operate. We believe a vast majority of the broker firms operate prudently and would honour their commitment to clients.

The proposals of the Working Group mainly comprise two core measures as follows:

1. Limit the amount of margin client collateral that can be re-pledged by a broker to secure its bank borrowings

At present, brokers may re-pledge all client collateral, including that belonging to margin clients who have no current borrowing from the firms, with the bank to secure bank lines which may be used for various purposes.

In contrast, other major international financial centres do not permit the re-pledging of collateral belonging to clients who have not borrowed. Such collateral is segregated

and safely kept in segregated trust accounts by broker firms. Clients would be able to get back the collateral that belongs to them in the event of any broker problems.

U.S. goes further in protecting the client by imposing restrictions on re-pledging in respect of each client who has borrowed at a 140% limit. In other words, if a client has borrowed $100 from the firm by offering securities collateral with a market value of $200 to the firm, the broker concerned may only re-pledge up to $140 of such collateral with the bank, the rest of which has to remain with the firm. In the event of problems, the client would at least have something to hold onto. This 140% limit is set on a per-client basis.

The Working Group considers that at present Hong Kong lacks a suitable infrastructure for the segregation of non-borrowing clients' collateral by broker firms on a cost-effective basis. If we have to take this route right away, it would have considerable impact on small-scale broker firms currently adopting the practice of securing loans by pooling and re-pledging client collateral.

The Working Group believes it is necessary to impose reasonable restrictions on excessive re-pledging by broker firms. It has put forth recommendations modelling on the U.S. re-pledging limit. However, to allow the industry space and flexibility in its operation, such limit is proposed to be set on the basis of the aggregate value of the margin loans extended by a firm instead of on a per-client basis. It is because a per-firm limit based on the aggregate margin loans would allow broker firms to withdraw excess re-pledged client collateral from banks less frequently. As proposed by the Working Group, a limit within the range of 130% to 150% of the total margin loans extended by a firm may be considered.

The Working Group fully understands that the above measures cannot completely stop a broker from re-pledging collateral belonging to non-borrowing margin clients to obtain bank loans. In addition, imposing a limit may induce a broker to re-pledge blue-chips of relatively better quality and higher marginable values. Therefore, the protection so afforded to clients would not be as sound as it can be. However, the Working Group believes that in the absence of any existing infrastructure to allow segregation of client securities in a cost-effective manner, imposing a re-pledging limit is a viable measure, as it could ensure at least a portion of client securities remains with the broker.

It is recognised that broker firms may have to consider certain additional issues in actual operation. However, the SFC would further study those issues together with the industry during the consultation period in order to find detailed solutions. We are happy to discuss with various firms concerned to work out feasible implementation details in light of their practices.

2. Increase the haircut percentages under the Financial Resources Rules ("FRR")

I would like to clarify that by haircut percentage, we are not referring to the haircut rate as agreed between a broker and its clients in respect of margin loans. Irrespective of the haircut percentages under the FRR, a broker and a client can freely negotiate the amount of the margin loan that can be extended to the client against securities pledged with the broker. However, under the FRR, a prescribed haircut percentage

must be applied to the value of securities collateral obtained by a broker from its margin clients before it can be included in the broker's liquid capital. This is a common and prudent tool for managing market and liquidity risks.

The Working Group considers the current haircut percentages under the FRR too low and not commercially realistic. For example, the haircut applicable to the 33 Hang Seng Index constituent stocks under the FRR is 15% while that adopted by banks and brokers on average is around 40%. For non-constituent stocks, the FRR haircut is 30% while banks and brokers on average apply a haircut of 96%. Moreover, in the case of warrants, as opposed to a haircut of 40% under the FRR, banks and brokers generally do not lend against warrants, the haircut of which is essentially 100%.

The Working Group believes the haircut needs to be raised to bring it closer to actual market practices. However, in order to allow more room for brokers to operate, the haircut percentages should not be as stringent as those adopted by banks. For example, the haircut percentages for the 33 Hang Seng Index constituent stocks and non-constituent stocks should be raised from the existing level of 15% to 20% and from 30% to 80% respectively, which are still lower than the corresponding levels of 40% and 96% adopted by banks. For warrants, they would be assigned with zero marginable value.

The Working Group also recognises that only a handful of firms would be impacted by the new haircut percentages. They would be required to obtain additional collateral from all or some of their clients or put in more capital of their own. The Working Group believes that firms that intend to lend against securities with high haircut percentages should put in their own capital as the first line of defence to guard against risks rather than re-pledging client securities.

Other complementary measures include enhancing the disclosure requirements under the Code of Conduct and stepping up investor education.

During the Working Group's discussion, we conducted a series of impact analysis in respect of the two proposed measures. According to the brokers' financial resources returns obtained by the SFC last September, if these two measures were to be implemented simultaneously, only a handful of broker firms would need to change their existing lending and pooling patterns. They may reduce their pooling ratio or collect additional or better quality securities collateral from clients, or choose to put in more capital, thereby using their own funds instead of clients' securities, as the first line of defence of the risk buffer. In fact, the rising market in the last six to nine months has led to a continued increase in turnover and improved profit levels for broker firms, making it possible for them to comply with the new requirements. We are also willing to facilitate them in complying with the requirements. In fact, we have already started our talks with these firms.

We believe that the recommendations of the Working Group have struck a proper balance and are feasible. Although they are not yet on par with international best practices, they are nevertheless measures which can bring about extensive benefits with minimum impact. Of course, as our long-term goal, we should put in place a system whereby the securities of non-borrowing clients are segregated and where capital requirements are tiered in proportion to risks.

We plan to consult the market on the Working Group's recommendations, whether they are appropriate, the transitional period and other details in the second quarter of 2004. On these issues, the SFC maintains an open mind. Our objective is to reach a consensus through collaboration with all parties concerned so as to come up with practical measures to protect the investors in Hong Kong, and to promote market confidence and the robust development of the industry.

The proposal on whether an independent person similar to a manager should be appointed to manage a firm which is in financial distress is just a preliminary idea. The SFC has yet to study its feasibility internally. Besides, a host of issues are also involved, such as how and by whom the mechanism is to be triggered, how should the trigger point for the exercise of such powers be set, the relevant thresholds to be met, and the various checks and balances which have to be put in place etc. We would set up an internal working group to study the matters and report the findings to the FA Panel.

Thank you.