

The Legislative Council Panel on Financial Affairs

SFC progress report on the public consultation on proposed measures to address risks arising from securities margin financing

PURPOSE

The purpose of this Paper is to brief Members on the responses received on the recent public consultation on proposed measures to address risks arising from securities margin financing (“SMF”) and its two principal proposed measures, namely:

- (i) imposing a limit on the re-pledging of margin clients’ collateral (“re-pledging limit”); and
- (ii) adjusting the haircut percentages applied to margin clients’ collateral under the Securities and Futures (Financial Resources) Rules (“FRR”).

2. The SFC shall continue to engage in close dialogue with the market and industry participants and other relevant parties to ensure that the final measures provide adequate investor protection but in such a way that the cost burden on the industry is kept to a minimum.

SUMMARY OF RESPONSES

3. The SFC has received 24 written submissions, 17 of which were from industry respondents. These consist of organisations representing the brokerage industry/staff (collectively “Trade Associations”), individual brokerage firms, and the Chamber of Hong Kong Listed Companies. The remaining 7 submissions came from non-industry respondents. These included the Consumer Council, independent persons and professional bodies (such as the two legal professional bodies).

4. All respondents generally accepted that the rationale behind the proposed reforms is to enhance investor protection.

5. Of the industry respondents, some (including two of the Trade Associations) expressed their support for the proposed reforms, recognizing that the proposals would provide better investor protection which would, in turn,

benefit the brokerage industry. The majority of industry respondents, however, either had concerns that the proposed measures would affect their business, or did not support the proposals. They also argued that the C.A. Pacific collapse could not happen again today and questioned the legitimacy of citing this case as an example.

6. All non-industry respondents supported the proposed measures, echoing the concern that Hong Kong investors deserve to be better protected. Some even criticized that the measures do not go far enough to provide more complete protection for investors.

BACKGROUND

7. The SFC's Working Group on the Review of the Financial Regulatory Framework for Licensed Corporations ("Working Group") was formed in 2002 in response to the call made by the previous Legislative Council Panel on Financial Affairs (the "previous Panel") for more effective measures to manage risks in the securities industry, in particular arising from pooling and re-pledging of margin clients' collateral. The Working Group consisted of senior financial and industry people, members from academia and the Consumer Council.

8. Recommendations were made by the Working Group after 22 months of deliberation and 14 meetings.

9. In March 2004, the SFC reported to the previous Panel on the recommendations made by the Working Group and had its support to consult the public on the recommended measures.

Introduction of the Re-pledging Limit

10. The primary objective underlying the consultation and the SFC's recommendations is to close the loophole and minimize the risk of another broker collapse similar to the C.A. Pacific incident in 1998. The C.A. Pacific incident caused huge losses to clients, especially those margin clients whose securities had been pooled and re-pledged by C.A. Pacific¹. Some of these margin clients had not even borrowed from C.A. Pacific at the time. Any broker collapse, let alone a large one like C.A. Pacific, damages Hong Kong's reputation as the premier financial centre in the region.

¹ Allowed compensation claims by clients of C.A. Pacific amounted to \$983 million and the Unified Exchange Compensation Fund made payments totalling \$300 million.

11. This problem of pooling and re-pledging of client collateral still exists in the industry today. When the Securities (Margin Securities) (Amendment) Ordinance was enacted in 2000, it brought previously unregulated SMF providers within the SFC's regulatory ambit. However, the Ordinance continued to allow SMF providers to pool and re-pledge client collateral provided that there is valid client authorization, irrespective of whether the collateral belongs to clients who have not borrowed from the SMF providers at the relevant time. In this respect, Hong Kong is lagging behind other major financial markets which do not allow the re-pledging of collateral of those margin clients who have not borrowed.

12. While only a very small number of SMF providers currently take advantage of the loophole and excessively re-pledge client collateral (including, in particular, collateral of those margin clients who have not borrowed), if this loophole remains unplugged, investors, the brokerage industry and the Hong Kong market continues to be exposed to the risks arising from excessive re-pledging of margin clients' collateral.

13. On the basis of recommendations made by the Working Group, the SFC proposed the introduction of a per-firm re-pledging limit which caps the amount of client collateral that an SMF provider can re-pledge to banks as security for borrowings by the firm. The cap is to be set at a percentage of the aggregate margin loans lent out by the firm. This will ensure that at least a portion of client collateral will be retained by the SMF provider and will be available for distribution to margin clients in the event of it becoming insolvent. In addition, this measure will also help reduce the SMF provider's gearing risk.

14. The design of the per-firm re-pledging limit has taken into consideration the unique characteristics of the Hong Kong market and avoided introducing drastic change to the existing practices of SMF providers. Although the per-firm re-pledging limit is not strictly in line with the measures taken by other major financial markets in respect of securities belonging to margin clients who have not borrowed, it can nevertheless effectively reduce the level of risks that investors and the industry would face if the existing loophole continues unaddressed.

Adjusting the Haircut Percentages

15. There are also a few SMF providers that currently engage in imprudent lending practices. They lend against collateral whose value in the event of an abrupt liquidation may not be easily realizable or sufficient to cover

the loan outstanding². We are concerned that failure of one major SMF provider may create a contagion effect causing more failures, leading to serious losses to investors and significant damage to the reputation of Hong Kong's financial market.

16. The current practice to encourage prudent lending is by applying commensurate haircut percentages to margin clients' collateral under the FRR where

- (a) the FRR are the rules designed by the Commission to ensure that firms have sufficient liquid assets that can be readily realizable into cash to pay all liabilities of the firms; and
- (b) the haircut percentages are effectively a risk management tool that discounts the market value of margin clients' collateral to cover the potential drop in price.

The higher the haircut, the lower the amount of liquid assets that can be maintained by the SMF provider. This would encourage the SMF provider to lend more prudently because if the SMF provider wishes to lend more, it will need to finance the additional amount with its own capital³.

17. The FRR currently prescribe a set of haircut percentages for different securities which are, on average, significantly lower than those assigned by banks and the more prudent SMF providers when making loans to their own clients. This proposal will also bring the existing haircut percentages up-to-date to better reflect the liquidity, volatility and realizable value of the different types of securities.

Benefits to the industry

18. We believe that these principal measures will, in fact, benefit the brokerage industry. An independent person who responded to the consultation pointed out that one key reason why many investors prefer to trade in securities through banks is that the C.A. Pacific incident and other broker failures in recent years have eroded investors' confidence in brokers. By re-establishing

² This risk is commonly found in cases where the quantity of a stock held as collateral is large compared to its market turnover, thus there is not enough demand in the market for that stock. Alternatively, liquidating a small portion of the stock alone may depress the share price significantly.

³ Under the FRR, the majority of shares currently attract a 30% haircut percentage which means that if a margin client provides share collateral with a market value of \$1,000,000, this will be discounted to \$700,000. If the SMF provider wants to lend more than \$700,000, it will need to fund the amount in excess of \$700,000 with its own capital.

their credibility and image, brokers can look forward to attracting more business as they have competitive advantage in that they provide good quality service.

BRIEF ANALYSIS OF PUBLIC RESPONSES

Re-pledging Limit

Non-industry respondents

19. All non-industry respondents fully supported the proposal as a way forward for better investor protection, market confidence and the larger interest of Hong Kong. The Consumer Council and a legal professional body, nevertheless, questioned whether the proposed measures were sufficient to protect the interests of investors. Both organizations took the view that Hong Kong should implement a complete segregation of non-borrowing client collateral as soon as possible.

Industry respondents

20. Most respondents from the brokerage industry accepted the option of setting a re-pledging limit as a means of establishing an effective measure to contain pooling risk, but held different views as to what would be an acceptable re-pledging limit level.

21. A few industry respondents expressed support for the proposed level recommended by the Working Group (130% to 150%). These included two of the five Trade Associations, and several individual broker firms. These include firms that currently have an active margin financing portfolio.

22. Several industry respondents, including two of the remaining Trade Associations, have reservations on the proposed re-pledging limit level. They pointed out that pooling and re-pledging of client collateral had been a standard practice in margin lending in Hong Kong and considered the level proposed by the Working Group to be too stringent. The key views of these two Trade Associations are summarised below:

- one expressed concern that the proposed level would have a drastic impact on market prices and liquidity, and SMF providers might also be reluctant to lend to clients on stocks which banks do not accept as collateral or stocks which are only marginally acceptable to banks. It requested a wider re-pledging limit (such as 180% to 220%) and implementation in phases;

- the other Trade Association argued that the SMF providers who re-pledge client collateral (89 firms out of a total of 243 firms that engaged in margin financing) were the active providers of margin financing in the market. The business operations of these firms would be affected if the proposed re-pledging limit were adopted. This would have a negative impact on the market. This association therefore advocated a very wide re-pledging limit (200% to 300%).

23. The last remaining Trade Association rejected the proposal, arguing that the reform was not necessary because the industry's profile had changed, the proposals would have adverse impact on the interests of different parties involved in the margin financing business, and that the Securities and Futures Ordinance had criminalised many other offences in trading activities.

24. Several individual broker firms also did not support the proposals. One of these broker firms considered complete segregation as being a more effective measure. This firm also has an active margin financing portfolio. The key concern of the others was the impact of the re-pledging limit on their business of providing margin financing on second and third liner stocks, and that the proposed re-pledging limit percentages would significantly impact the business of such SMF providers.

Investor Account model

25. In our discussions with market participants, some raised the question of whether the problem of pooling and lending risks could be remedied if the relevant authorities had implemented the investor participant account system at CCASS after the C.A. Pacific incident.

26. We explained that IP accounts cannot address the problems and risk associated with the re-pledging of clients collateral. In margin finance business, an SMF provider will take collateral from its clients into its possession or control. These shares will not be held in the clients' own names and thus, cannot be kept in their investor participant accounts. Therefore, the investor participant account model cannot resolve pooling risks inherent in margin finance business, although the model does provide the best protection for cash clients.

Responses on the FRR haircut percentages

27. Respondents were more divided as to the appropriate level of the haircut percentages applied to the value of margin clients' collateral under the

FRR. Some respondents supported the proposed haircut percentages and one of them went further to recommend increasing the haircut percentage for illiquid collateral. The Consumer Council noted that the proposed FRR haircut percentages were still more lenient than the average haircut rates adopted by banks and SMF providers. The Consumer Council suggested that the new FRR haircut percentage rates should be in line with the average haircut rates adopted by banks and SMF providers

28. Other industry respondents wanted no change at all or only a modest increase.

THE WAY FORWARD

29. As a number of respondents have reminded us, the SFC's primary statutory objective is to protect investors' interests. We will continue discussions with the brokerage industry to identify the most suitable model and transitional period to reduce the risks and give the industry a reasonable transitional period to accommodate any major changes to the existing practice. Our overall objective is to find a set of regulatory measures (once both the re-pledging limit and the haircut percentages are set) that would provide better investor protection, while keeping the cost burden to the industry to a minimum.

30. Once a decision has been made, the proposed rule amendments will be revised accordingly and submitted to the Department of Justice for comments.

31. We plan to finalise the proposals and issue rule amendments in 2005.

ACTION REQUIRED

32. This paper is merely a status report that does not require any action to be taken by Members at this stage.