



**Progress Report on Consultation on  
Proposed Measures  
to Address Risks Arising From  
Securities Margin Financing**

**Alexa Lam  
Executive Director  
Intermediaries and Investment Products  
17 December 2004**



## Objectives of the two principal measures

- ◆ Improve fairness and protection to investors
- ◆ Protect Hong Kong's reputation as premier financial centre
- ◆ Enhance investor confidence in brokers
- ◆ Keep cost burden to industry to a minimum



## Risks of no reform

### What is the existing loophole?

- ◆ Margin clients who have not borrowed or have borrowed very little, could have all their shares re-pledged by their broker
- ◆ If the broker fails, these clients stand to lose the most

### How do other markets deal with this problem?

- ◆ No other major financial market allows re-pledging of non-borrowing margin clients' collateral
- ◆ Mainland China completely disallows re-pledging of client stocks



## Balancing different interests

- ◆ SFC's primary objective is investor protection.
- ◆ Industry requests for measures that suit local conditions
- ◆ SME brokers draw particular attention to their resources limitations



## Pragmatic approach

- ◆ Proposals firmly based on SFC Working Group recommendations
- ◆ Working Group consisted of brokerage industry participants of all different sizes, Consumer Council and academia
- ◆ The proposals, while striving to enhance investor protection, also have to take care of the need to give smaller firms leeway to continue business
- ◆ Depending on the level of protection afforded by the new measures, certain existing financial resources requirements can be relaxed accordingly.



## Two Principal Measures

- (i) **Re-pledging limit** - to curb excessive re-pledging of margin clients' collateral, it is proposed to impose a cap on the amount of margin clients' collateral that a firm may re-pledge. The proposed re-pledging limit will be based on the aggregate amount of margin loans lent by the firm. The Working Group recommended that the limit should be set at 130% to 150% of the total amount of margin loans lent out by a firm.
- (ii) **Revised FRR haircut percentages** applied to margin clients' collateral to more accurately reflect market and volatility risk



## Effect of different levels of re-pledging limit

- ◆ Total margin loans : \$100
- ◆ Total collateral received from clients: \$200
- ◆ **More collateral remained** in the hand of the broker **under 130% re-pledging limit**

	130% re-pledging limit	200% re-pledging limit
Value of client collateral Re-pledged to bank	\$130	\$200
Collateral remained in broker's hand ( $\$200$ minus Value of client collateral re-pledged to bank)	<b>\$70</b>	<b>NIL</b>



## General support for proposed measures

Summary of public responses- Total 24 written submissions, 17 from industry respondents:

- ◆ **All respondents** generally accepted rationale that proposed reforms enhance investor protection
- ◆ Those who supported the measures recognised the necessity for **better investor protection** and resulting **benefit for whole industry**
- ◆ **Public opinion**, based on commentaries in the media, is supportive of need for reform, which would provide better protection for the investing public and enable fairer treatment of them.



## Support for re-pledging limit

- ◆ **Non-industry respondents:** All supportive
- ◆ Consumer Council and Bar Association stated that the proposed measures should go further to protect investors
- ◆ **Industry respondents:** Two brokerage associations and some brokers supported the proposed re-pledging limit (130%-150%), others either had reservation about or disagreed with the proposals



## Support for complete segregation

- ◆ Consumer Council and Bar Association advocated **complete segregation of non-borrowing clients' collateral**
- ◆ A broker preferred **complete segregation** to the re-pledging limit (this firm is one of the existing 89 securities margin financing firms that re-pledge client collateral, and it has a sizeable margin financing business)



## Against re-pledging limit

- ◆ Industry respondents: Some argued that existing broker firms would be impacted and suggested a wider re-pledging limit (180% to 300%)
- ◆ A few industry respondents did not agree with the mechanism at all
- ◆ Those who disagreed argued that pooling is a long-established common practice, the proposals would increase their costs, and affect their business in relation to 2<sup>nd</sup> and 3<sup>rd</sup> liner stocks /profitability



## Response to FRR haircut

- ◆ Fewer comments
- ◆ Some supported the proposed FRR haircut percentage rates, and others suggested modest increase or wanted no change at all
- ◆ Consumer Council suggested bringing FRR haircut percentage rates in line with average rates adopted by banks and industry (i.e. **higher** rates than those proposed)



## Impact analysis of proposed measures

- ◆ 7 firms might be impacted more significantly by 130% re-pledging limit and proposed FRR haircuts
- ◆ Re-pledged **\$3.5 billion** client collateral in aggregate
- ◆ Serve **42,000 clients**, **high impact** if these firms were to collapse
- ◆ SFC has started dialogue with these firms. With strong turnover and profitability, these firms are generally positive about compliance with new requirements
- ◆ SFC will continue discussions with them to ensure that they take appropriate steps to ensure compliance.



## Large number of investors protected ; Small market impact

These 7 firms:

- ◆ Contributed less than 2% of total market turnover
- ◆ Employed 350 licensed representatives and 200 back office staff
- ◆ Business prospect looks promising  
(6 firms made **good profits (total: \$152 million)**, the remaining one is in the process of selling its business)



## Right time for reform

- ◆ 2004 Turnover expected to **break the all-time high in 1997** (\$20 billion average daily turnover in 11/2004)
- ◆ Total margin loans **increased by 20%**, total re-pledged collateral value **increased by 27%** (from 6/2003 to 9/2004)
- ◆ **Concept stock bubbles** re-surfaced (share price easily rose several times, but could also plummet intraday or overnight - one stock plunged by 92% within just one afternoon)
- ◆ Plug the loophole before any possible **market overheating**



## Way forward

- ◆ Continuing dialogue with the industry to identify most suitable measures and transitional period
- ◆ Once measures decided upon, rules will be revised and submitted to Department of Justice for vetting
- ◆ Plan to finalise proposals and issue rule amendments in 2005