立法會
Legislative Council

LC Paper No. CB(1) 993/99-00
(These minutes have been seen by the Administration)

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Bills Committee on
Securities (Margin Financing) (Amendment) Bill 1999

Minutes of meeting held on
Monday, 21 June 1999, at 8:30 am
in Conference Room A of the Legislative Council Building

Members present	**:**	Hon Ronald ARCULLI, JP (Chairman) Hon Albert HO Chun-yan Hon Bernard CHAN Hon SIN Chung-kai Hon Jasper TSANG Yok-sing, JP Hon FUNG Chi-kin
Public officers attending	**:**	Mr Bryan CHAN Principal Assistant Secretary for Financial Services Miss Hinny LAM Assistant Secretary for Financial Services Mr William MADDAFORD Senior Assistant Law Draftsman Department of Justice Ms Vicki LEE Government Counsel Department of Justice

Attendance by Invitation	:	Securities and Futures Commission Mr Andrew PROCTER Executive Director of Intermediaries and Investment Products Mr Richard YIN Director of Intermediaries Supervision Mrs Yvonne MOK Associate Director of Intermediaries Supervision Mr Leo LEE Director of Licensing Ms Judith YUEN Senior Manager of Licensing
Clerk in attendance	:	Ms Estella CHAN Chief Assistant Secretary (1)4
Staff in attendance	:	Mr KAU Kin-wah Assistant Legal Adviser 6 Ms Connie SZETO Senior Assistant Secretary (1)1

I Discussion with the Administration

Follow-up on outstanding issues arising from previous meetings
(LC Paper NO. CB(1)1533/98-99(02))

Members noted the Administration's responses in respect of rules on "pooling" in Singapore, the United States (US), the United Kingdom, and Taiwan. Under the US System, members noted that credit balances of margin clients could be used to finance other customers' margin loans. Unused credit balances were to be deposited in an omnibus "special reserve bank account for the exclusive benefit of customers". However, there was no information as to whether interest would be payable to clients for the unused credit balance. In the Singapore model of "pooling", members noted that no further details had been received from the relevant authority on the arrangement of allowing a dealer to

pledge a client's securities for a sum not exceeding the amount owed by the client. However, to the understanding of SFC, some of these arrangements might have not been written down in the form of rules in order to allow flexibility of implementation.

2. Members also noted the list of Hang Seng Index (HSI) constituent stocks identified as "related securities" as defined in the Financial Resources Rules (FRR). Noting from the list the substantial cross-ownership among HSI constituent shares, Mr FUNG Chi-kin reiterated the industry's concern that grouping "related securities" within HSI constituent stocks for calculation of liquid capital for FRR purposes would have the effect of encouraging securities margin financiers (SMFs) to diversify their loan portfolios by accepting second and third line stocks as collateral which were of higher risk. Members shared the view that given the high liquidity of HSI constituent stocks, these stocks should be exempted from the rule on "related securities" so as to encourage SMFs to hold good quality stocks as collateral.

3. In response, the Principal Assistant Secretary for Financial Services (PAS/FS) said that the Administration had taken into account the industry's view and had already relaxed the proposed concentration risk adjustments to include a higher threshold of 20% for HSI constituent stocks vis-à-vis 10% as proposed in the consultation paper of 1998. The Executive Director of Intermediaries and Investment Products, Securities and Futures Commission (ED/IIP(SFC)) supplemented that SFC recognised the merits in relaxing the rule on "related securities" for HSI constituent stocks and agreed to amend the FRR in this respect.

Admin/ SFC

4. Mr FUNG Chi-Kin remained concerned about the sole business requirement to be imposed on SMFs restricting their scope of business to providing loans to margin clients for acquisition of securities, which was considered a hindrance to business development upon the merging of the Exchanges since existing registered securities and futures dealers running an exclusive business might find it beneficial to expand to other businesses.

5. ED/IIP(SFC) clarified that the sole business requirement would only be imposed on financiers who applied for registration as "SMFs" under the legislation. The requirement would not apply to existing registered securities dealers or registered persons to be permitted to trade on the merged Exchange in the future. Securities dealers were free to engage in other non-dealing business under the current regulatory regime insofar as they did not breach the licensing and financial resources requirements.

6. As to the concern about securities dealers being exposed to non-securities risks when they undertook other non-dealing business, ED/IIP(SFC) advised that apart from complying with the relevant legislation, those registered securities

dealers who were corporate members of the Stock Exchange of Hong Kong (SEHK) were also subject to the sole business requirement under existing Exchange Rules restricting them from carrying on non-dealing activities except those which were normally ancillary to securities dealing. He also advised that about 90%, or some 98 finance companies currently providing securities margin financing service were associated with registered securities dealing companies which were corporate members of SEHK. In view of the sole business requirement on SMFs and enhanced capital requirement under the new FRR, SFC envisaged that the majority of these firms would likely find it commercially more viable to incorporate their SMF business back into the securities dealing entities rather than operating the business under a stand-alone company. As regards registered futures dealers, existing Futures Exchange Rules prohibited Futures Exchange members from providing financing to clients to meet the margin requirements.

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7. On the concern about the restricted scope of business of SMFs, ED/IIP(SFC) said that the Administration and the SFC had agreed to relax the rule to allow SMFs to engage in other businesses which were incidental to its normal course of business. However, to avoid undue exposure of the registrant to non-securities risks, it would be inappropriate to allow the scope of business of SMFs to include other lending activities, such as lending to clients for acquisition of futures and leveraged forex contracts.

Mr FUNG Chi-kin's proposal on Financial Resources Rules

(LC Paper No. CB(1)1468/98-99 - Mr FUNG Chi-kin's proposal (Chinese version) and 1518/98-99 (English version), LC Paper No. CB(1)1543/98-99 - the Administration's response.)

8. At the Chairman's invitation, Mr FUNG Chi-kin presented his proposal on FRR. He explained that his proposal, in essence, was to link the scale of margin financing business with the capital size of the firm so that a SMF would be required to increase the firm's capital (i.e. shareholders' capital) when it ran a larger scale of business. The additional capital was required to meet the higher risks involved in a larger business. The ratio of the scale of business to the total shareholders' capital should decrease with increase in scale so that a larger scale financier would need to maintain a proportionally larger capital base. Moreover, position risk adjustment measures should also be set with reference to the firm's capital. Margin loans provided to individual/related clients or in relation to specific/related stock collateral should not exceed a certain percentage level of the firm's capital. The proposed levels in respect of accepted exposure to specific/related stock collateral had taken into account the liquidity of stocks in that a higher percentage was applied to more liquid stocks. He stressed that the operation of his model would be similar to that of the capital adequacy requirements for banking institutions which would be simple and easy for SMFs

to follow. The percentage levels prescribed in the model could be reviewed in the light of its actual implementation.

9. While the Administration believed that the objectives of the measures proposed by Mr FUNG were in line with those sought to achieve by FRR, ED/IIP(SFC) explained the inadequacy of Mr FUNG's proposal in controlling risks of SMFs. As share capital requirement under FRR was merely a minimum entry requirement for financiers and such capital was not required to be held in specific forms, the capital was usually dissipated by firms in pursue of business of the enterprises and therefore might not be readily realisable to cover risks arising from the business. Hence, the concept of liquid capital was introduced, the level of which would be adjusted to take into account price fluctuations in stock collateral and over-exposure to any individual clients or stock collateral, and which securities dealers and SMFs were required to maintain at all times for meeting business risks. As such, securities dealers and SMFs would have to find additional sources of funding to hold against risks arising from an expanding business or to satisfy the concentration risk adjustments as suggested in Mr FUNG's proposal. However, Mr FUNG's proposal had confined those additional sources of funding to "shareholders' capital" and seemed to have excluded assets of the firm which were accounted as liquid capital under FRR, such as the value of receivables, the value of securities held against receivables, debt raised by the firm and current assets held on the proprietary trading book. As a result, Mr FUNG's proposal might in fact require a firm to hold significantly more capital against risk, leading to inefficiency in utilization of the firm's capital without ensuring sufficient readily realisable capital to guard against risks.

10. On Mr FUNG's proposal of setting limits on loans provided to individual/related margin clients and exposures to specific/related stocks by reference to the "shareholders' capital", ED/IIP(SFC) said that as illustrated in paragraphs 12 to 15 of the Administration's response paper, such approach was not sufficiently sensitive to how the securities margin financing business was run and would amount to an unnecessary restriction without reflecting the actual risk.

11. As regard the appropriateness of adopting a banking style capital regime for managing risks of securities margin financing business, ED/IIP(SFC) remarked that while Mr FUNG's proposal might be a risk management model similar to the capital adequacy model used in the banking sector, there had been on-going criticisms on the stringency of the capital requirement rules in the banking sector indicating the inadequacy of the model. Indeed it had been recognised in a recent consultation paper of the Basle Committee on Banking that the banking capital model should be dynamic and kept under constant review to better reflect the type of risks that were being undertaken by financial institutions. The paper covered difficult and complex issues, such as analysing risks undertaken by institutions and identifying suitable capitals for dealing with them, as well as exploring methods of calculating risks and capitals.

12. Regarding risk management models for regulating securities margin financing business adopted by regulators of other jurisdictions, ED/IIP(SFC) advised that, conceptually, the existing FRR was comparable to the model used in US although there were differences in the applicable haircut and risk adjustment levels. On the other hand, while SFC was not aware of any model currently in use which was similar to that proposed by Mr FUNG, it recognised that there were developments in European countries where the banking and securities sectors were moving towards adopting a uniform approach in respect of risk management. PAS/FS re-iterated that a clear definition on liquid capital and explicit methods for calculation of such were provided under FRR. The Administration considered the revised FRR both effective and efficient in ensuring capital adequacy of securities dealers and SMFs in meeting their business risks.

13. Some members opined that apart from the deficiency in the concept of "shareholders' capital" under Mr FUNG's proposal vis-à-vis "liquid capital" under FRR, the proposal which required larger scale financiers to maintain a proportionally larger capital base than their smaller counterparts was not conducive to maintaining a level playing field for different scales of business operators.

14. In response to the Administration's comments, Mr FUNG Chi-kin re-iterated that the amount of capital held by a firm should be sufficient in guarding the business risks and the FRR requirement of a minimum liquid capital of $3 million or 5% of total liabilities of a SMF, whichever was the higher, would be inadequate in dealing with the risks faced by a very large scale securities margin financing operation.

15. ED/IIP(SFC) remarked that there was no strong grounds for requiring a larger business to maintain a proportionally larger capital base than for the smaller counterparts. In fact, SFC had suggested in the 1997 consultation that larger businesses should maintain a proportionally smaller capital based on the grounds that large businesses would tend to be more soundly operated and that their clients were more creditworthy. However, the proposal was eventually withdrawn on grounds of the need to maintain a level playing field regardless of the portfolio of the companies. The 5% liabilities test had provided adequate protection for the market even during the most volatile period in the recent financial turmoil.

16. Regarding the concern about the user-friendliness of FRR, ED/IIP(SFC) did not share the notion that the rules were too complicated to follow. Notwithstanding that existing finance companies which had been operating under a less vigorous regime might need time to adapt to the rules, there should be no compliance difficulty for existing securities dealers as FRR had been

introduced since 1993. Moreover, appropriate computer software was available in the market to assist companies in monitoring their securities margin financing business for FRR compliance.

New submissions on the Bill
(LC Paper No. CB(1)1508/98-99 and 1533/98-99)

17. Members noted that a further submission from the Law Society of Hong Kong (LSHK), and separate submissions from Hong Kong Association of Banks (HKAB) and Mr Leo CHIU of Chiu & Partners Solicitors had been received since the last meeting. They also noted that the submission from LSHK was on "exemptions", which was made in response to the Chairman's request at the meeting on 1 June 1999. The Administration had been provided with copies of the submissions prior to the meeting and had undertaken to provide written responses in due course. Members agreed that the Bills Committee would consider the submissions when the Administration's responses were available.

II Any other business

Date of next meetings

18. Due to the disposition of some representatives of the Administration, members agreed to cancel the meeting scheduled for 22 June 1999. They also agreed to schedule three further meetings for 28 June at 2:30 pm, 29 June at 4:30 pm, and 7 July 1999 at 8:30 am.

19. There being no other business, the meeting ended at 10:05 am.

Legislative Council Secretariat
16 February 2000