Legislative Council Panel on Financial Affairs

Follow-up to the meeting on 6 February 2006 on the progress report on proposed measures to address risks arising from securities margin financing

Purpose

This note sets out the results of the study conducted by the Securities and Futures Commission (SFC) on the impact of complete segregation of collateral of borrowing and non-borrowing margin clients.

Background

2. On 6 February 2006, the SFC briefed Members on its proposal to implement a re-pledging limit on securities margin finance ("SMF") providers. At the meeting, Members requested the SFC to provide the following information:

(a) the number of SMF providers that are likely to be affected by a re-pledging limit of 180%; and

(b) the impact of complete segregation of collateral of borrowing and non-borrowing margin clients.

3. The required information on item (a) and the interim reply for item (b) were issued to Members vide LC Paper No. CB(1)1023/05-06 (01) on 3 March 2006. Since then, the SFC had gathered information from the industry and conducted a study on the impact of complete segregation of collateral of borrowing and non-borrowing margin clients. The major findings of the study are set out in the ensuing paragraphs.

Cost Study on Complete Segregation

4. We have obtained from eight SMF brokers of different sizes their estimates of the costs for segregating securities belonging to non-borrowing margin clients (i.e. "complete segregation"). The charging scales of the handling fees for stock deposits and withdrawals of five banks to which these brokers repledge their client securities have also been analysed. Details of the

cost estimates and the analyses on the bank charging scales are summarised at **<u>Annexes A and B</u>** respectively.

5. Based on the study results and our discussions with these brokers, it is found that the costs of complete segregation may be affected by a number of factors, which include:

(a) the number of margin clients of the brokers;

(b) the trading pattern of the clients;

(c) the clients' needs for margin financing;

(d) the brokers' own borrowing needs; and

(e) the banks' charging scales.

6. Factors (a) to (d) above vary among the brokers, depending on the specific conditions of their own and/or of their clients. They may also change over time even for the same broker. In addition, we noted that the banks' charging scales vary among different banks and for different brokers. As indicated in Annex B, there were significant differences among the handling fees charged by different banks. Some banks may even apply different charging scales on the brokers. There were also significant differences in the handling fees charged on different stocks by the same bank. In view of the above, the cost estimates obtained in this study may not necessarily reflect the real costs that might be incurred by the brokers in practice.

7. Regarding the cost implications to the borrowing and non-borrowing margin clients, only two of the eight selected brokers advised that they would not transfer the costs of complete segregation to their clients. The rest indicated that they would consider the actual market conditions before deciding whether to transfer the costs of complete segregation to their clients.

8. The transaction costs of complete segregation can be significant to the clients and/or brokers. As indicated in Annex B, at the time of the study the average handling fee for $1 million worth of HSBC shares was $211, whereas the average handling fee for $1 million worth of CITIC Bank shares was $982. These amounts represent about 0.02% and 0.1% of the value of the shares respectively.

9. Compared with other transaction costs, such as brokerage commission (typically 0.25%) and stamp duty (0.1%), the handling fees could be significant to the clients should the brokers decide to transfer the costs to them. The fees could also be significant to the brokers should they bear the costs by themselves.

Cost Incurred in Operating the 140% Repledging Limit

10. With effect from 1 October 2007, the repledging limit has been set at 140%. We have made enquiries with some brokers regarding the costs incurred in complying with the repledging limit. In general, their response was that there were no significant costs in complying with the limit.

Conclusion and Way Forward

11. The study reveals that the costs of complete segregation could vary greatly among brokers and could be a significant transaction costs to be borne by the clients. In addition, based on our discussions with these eight selected brokers, the possibility of the brokers to transfer the relevant costs to their clients could not be ruled out.

12. Brokers seemed to have coped well with the repledging limit and the costs of compliance appear not to be significant. The recent monthly returns revealed that among some 230 SMF brokers, over 70% of them did not repledge the securities of their clients. In addition, since October 2006, SMF brokers are required to disclose to their clients that they repledge client securities, both upon account opening and on the monthly client statements. Investors are thus allowed to make an informed decision when they choose their brokers.

13. We remain of the view that Hong Kong should move to a complete segregation model in the longer term. Meanwhile, we will continue to observe how the 140% repledging limit restrictions which have taken effect since October last year are working with a view to better assessing the costs in the industry.

Securities and Futures Commission
July 2008

Annex A

Estimated costs of complete segregation provided by selected brokers

Broker	**No. of Margin Clients**	**Basis of Estimation**	**Estimated Monthly Bank Charges ($) (a)**	**Estimated Monthly Administrative Costs ($) (b)**	**Total Estimated Monthly Costs ($) (c) = (a) + (b)**
Broker 1	12,550	Simulation	1,985,000	46,000	2,031,000
Broker 2	8,270	Simulation	800,000	No information	800,000
Broker 3	2,124	Rough estimation	450,000	50,000	500,000
Broker 4	921	Actual experience	40,000 to 65,000	No information	40,000 to 65,000
Broker 5	713	Actual experience	15,700	4,000	19,700
Broker 6	270	Rough estimation	20,000	10,000	30,000
Broker 7	135	Rough estimation	30,000	No information	30,000
Broker 8	107	Rough estimation	10,000	4,000	14,000

Annex B

Charging scales of the handling fees of the banks used by the selected brokers

				Scenario 1			Scenario 2		
Bank	**Broker**	**Basis of charge per stock deposit transaction**	**Basis of charge per stock withdrawal transaction**	**Handling fee for depositing 17 board lots of HSBC shares (worth approx. $1M)**	**Handling fee for withdrawing 17 board lots of HSBC shares (worth approx. $1M)**	**Total handling fee**	**Handling fee for depositing 164 board lots of CITIC Bank shares (worth approx. $1M)**	**Handling fee for withdrawing 164 board lots of CITIC Bank shares (worth approx. $1M)**	**Total handling fee**
Bank A	Broker 5 and Broker 6	$10 per lot for the first 100 lots, $2 per lot thereafter (capped at $1,000 per stock)	No charge	$170	$0	$170	$1,000	$0	$1,000
Bank A	Broker 7	0.002% of the market value + $1 per SI	0.002% of the market value + $1 per SI	$21	$21	$42	$21	$21	$42
Bank A	Broker 8	$10 per lot, capped at $1,000 per day	$10 per lot, capped at $1,000 per day	$170	$170	$340	$1,000	$1,000	$2,000
Bank B	Broker 3	0.002% of the market value (Min $2 / Max $100) + $11 per SI	0.002% of the market value (Min $2 / Max $100) + $31 per SI	$31	$51	$82	$31	$51	$82

				Scenario 1			Scenario 2		
Bank	**Broker**	**Basis of charge per stock deposit transaction**	**Basis of charge per stock withdrawal transaction**	**Handling fee for depositing 17 board lots of HSBC shares (worth approx. $1M)**	**Handling fee for withdrawing 17 board lots of HSBC shares (worth approx. $1M)**	**Total handling fee**	**Handling fee for depositing 164 board lots of CITIC Bank shares (worth approx. $1M)**	**Handling fee for withdrawing 164 board lots of CITIC Bank shares (worth approx. $1M)**	**Total handling fee**
Bank B	Broker 6	0.002% of the market value	No charge	$20	$0	$20	$20	$0	$20
Bank B	Broker 7	0.002% of the market value + $11 per SI	0.002% of the market value + $1 per SI	$31	$21	$52	$31	$21	$52
Bank B	Broker 8	0.002% of the market value + $11 per transaction	0.002% of the market value + $11 per transaction	$31	$31	$62	$31	$31	$62
Bank C	Broker 2	$6 per lot	No charge	$102	$0	$102	$984	$0	$984
Bank C	Broker 3	$5 per lot (Min $30) + 0.002% of market value (Min $2 / Max $100) + $1 per SI	$5 per lot (Min $30) + 0.002% of market value (Min $2 / Max $100) + $1 per SI	$106	$106	$212	$841	$841	$1,682

				Scenario 1			Scenario 2		
Bank	**Broker**	**Basis of charge per stock deposit transaction**	**Basis of charge per stock withdrawal transaction**	**Handling fee for depositing 17 board lots of HSBC shares (worth approx. $1M)**	**Handling fee for withdrawing 17 board lots of HSBC shares (worth approx. $1M)**	**Total handling fee**	**Handling fee for depositing 164 board lots of CITIC Bank shares (worth approx. $1M)**	**Handling fee for withdrawing 164 board lots of CITIC Bank shares (worth approx. $1M)**	**Total handling fee**
Bank D	Broker 1	$10 per lot (Min $30 / Max $2,500 per stock)	$600 per stock	$170	$600	$770	$1,640	$600	$2,240
Bank D	Broker 4	$10 per lot + 0.002% of the market value	$10 per lot + 0.002% of the market value	$190	$190	$380	$1,660	$1,660	$3,320
Bank E	Broker 4	$150 per stock	$150 per stock	$150	$150	$300	$150	$150	$300
Average handling fee						**$211**			**$982**