CB(1) 1468/98-99

(English translation prepared by the
Legislative Council Secretariat for Members' reference only)

4 June 1999

To : The Bills Committee on Securities (Margin Financing)(Amendment) Bill

From : Hon FUNG Chi-kin (a member of the Bills Committee)

Re : Other suggestions regarding the Financial Resources Rules (FRR)

When the Bills Committee had a meeting with the deputations of the industry in the morning of 1 June 1999, I also made some suggestions regarding FRR. At the request of the Chairman of the Bills Committee, I now put my views into writing as follows.

I understand that the key features of bringing margin financiers into regulation (referring to finance companies which currently conduct margin financing business) or tightening FRR so as to enhance supervision (referring to securities companies which currently conduct margin financing business by themselves) are (1) to increase capital; (2) to apply the sole business requirement; (3) to apply different thresholds to the portfolio of financing loans, and (4) to enhance transparency, to ensure that the financiers will operate soundly, so as to lower the chances of default and reduce market systemic risks resulting from failure on the part of individual financiers.

According to the proposals made by SFC, the minimum paid-up capital required is $10 million. A financier (e.g. a securities company) has to spend $5 million to purchase a broker seat of SEHK, $2 million for renovation work and the installation of equipment required for margin financing business, the remaining $3 million is the cash flow (i.e. the liquid capital) for margin financing operations. If a financier is required to maintain a minimum liquid capital of $3 million or an amount not less than 5% of the portfolio of financing loans, the margin financing business of that financier could be as much as $60 million (day one). If various requirements and thresholds could not be met or there is a change in the value of stocks as collateral against financing loans, the financier has to increase the liquid capital so as to meet the minimum requirement, otherwise he commits an offence.

Both the regulators and financiers are aware that the factor of being well-capitalised is of paramount importance. However, instead of implementing a set of complicated FRR currently proposed which requires the development of a new computer software programme, it is desirable for the Government to regulate such kind of business in a simple, direct and efficient way. Under the current proposal, it is difficult for the financiers to manage their business. They may even be forced to violate the law (e.g. the suspension of trading of stocks of HSBC group or Cheung Kong group for more than five days) for some technical reasons (e.g. they are unable to dispose the stock collateral after the close of trading).

<u>The consideration of risks</u> Regarding the scale of margin financing as a whole, in order to address the problem of over-exposure to individual/related clients or specific/related stock collateral, different thresholds should be applied to different categories of stocks as collateral against financing loans extended to clients. Moreover, it should be linked up with the shareholders' equities and the liquid capital requirement can be retained. All these requirements seek to minimize the concentrated risks of the financiers as well as the market risks.

As far as the scale of business is concerned, taking the minimum liquid capital requirement (5%) into consideration, if financiers have a liquid capital of $3 million, they can provide margin financing amounting to $60 million. The business can be as much as $100 million for a liquid capital of $5 million and $1 billion for a liquid capital of $50 million. However, the minimum paid-up capital required is only $10 million. The above-mentioned examples show that the scale of their margin financing business is, in fact, 20 times of the liquid capital (paid-up capital plus other sources of the shareholders' equities). Obviously, when the financiers engage in margin finance business of $100 million, of which $95 million should be obtained through financing arrangements. If the operation is $1 billion, the amount which should be obtained through financing arrangements will be as high as $950 million! Since the stock market is quite volatile, if there is any failure on the part of 10% of their individual/related clients or specific/related stock collateral, the required paid-up capital of $10 million may not relieve them from liquidity pressure. The risk involved is quite high. Hence, it may not be appropriate to apply such a level of liquid capital requirement across the board. If the scale of business is small, it can be 20 times. If the scale of business is large, consideration should be given to lowering it to, say, 10 times. Moreover, instead of rigidly fixing a minimum paid-up capital of $10 million, it is certainly more desirable to vary the level of the capital requirement according to the scale of the business of the financiers.

My suggestion is therefore as follows.

[shareholders' equities = paid-up capital +advance from shareholders (liquid capital) +reserves + accrued profits/loss]

(1) The scale of the margin financing business should be 20 times to 10 times of the shareholders' equities (from $200 million to $1 billion or above; the larger the scale, the smaller the ratio);

(2) The financing loans provided to individual/related clients (all the stocks) must not exceed the total amount of the shareholders' equities;

(3) The financing loans in relation to specific/related stocks (all the clients) (adjusted according to different haircut ratios) must not exceed the following percentages of the shareholders' equities:

a. 100% for blue chips (the 33 constituent stocks of HSI)

b. 75% for constituent stocks of HSI 100

c. 50% for second and third liners

d. 25% for stocks of low liquidity or stocks of high volatility as well as derivative warrants

(4) The amount of financing loans in respect of specific stock (all the clients) shall not exceed 10% of the issued shares of that company.

Items (1) to (3) seek to minimize the client exposure and the concentrated stock exposure by the operators. Item (4) is to prevent market systemic risks (to avoid possible knock-on effect on other financiers resulting from a financier cutting margin when any of its single stock is used as collateral against financing loans provided by different financiers and the aggregate value of the stocks used as collateral forms a high percentage of the issued shares of that company).

Apart from the above requirements, in order to ensure that the financiers maintain a certain level of working capital, the requirement for liquid capital may be retained which is proposed to be $3 million at the minimum or 3% of the margin financing portfolio.

Since this document is prepared in haste, some suggestions regarding different thresholds are subject to further tests. Members may therefore consider from the conceptual point of view to see if it is easy for them to understand and whether it is a simple, direct, and efficient way to regulate securities margin financing business (it is not easy for members and even the industry to understand the current amendments to FRR).

Thank you for your attention.

Yours faithfully,

(Signed)