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From : Clerk to Bills Committee

To : 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

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

Follow-up to meeting held on 21 June 1999

I forward the Chinese translation of the Administration's response to Hon FUNG Chi-kin's proposals on the proposed Financial Resources Rules for members' perusal and retention.

2. The English version of the paper was issued vide LC Paper No. CB(1)1543/98-99 dated 19 June 1999.

(Ms Connie SZETO)
for Clerk to Bills Committee

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

Administration's Response to
The Hon. Fung Chi-kin's Proposals on Financial Resources Rules

INTRODUCTION

We are grateful to the Hon. Fung Chi-kin for his detailed comments in writing and the specific proposals to further improve the proposed regulatory framework for securities margin financing activities. This paper summarises the Administration's responses to the suggestions made therein on the Financial Resources Rules (FRR).

DETAILS

Objectives of the FRR

2. We concur with the comments that the key features of the FRR are intended to ensure that adequate liquid capital is held against the risk arising from the business of a firm by applying different thresholds to confine the risk exposure of the margin portfolio. The FRR, in conjunction with the Securities (Margin Financing) Bill and the applicable Code of Conduct will ensure greater transparency, better disclosure to investors and better management of risk for securities margin financing operations.

Concerns About Complexity

3. We note the Hon. Fung Chi-kin's concerns over the user- friendliness of the FRR. However, we do not share the notion that the FRR are too complicated to follow. Indeed, since the introduction of the FRR in 1993, the Rules have proved to be pragmatic for the practitioners and reasonably comprehensive in the treatment of the many issues that can arise in judging how to measure risk and how to guard against it. It may also be worth noting that the FRR, or aspects of them,

have been the subject of two recent public consultations[1]. The Securities and Futures Commission (SFC) has not received any comments from the practitioners nor the Stock Exchange of Hong Kong (SEHK) complaining that the FRR are too complex. Rather, Members may recall that at the Bills Committee meeting on 1 June 1999, one of the representatives of the Stockbrokers Association expressly said that the proposed new risk concentration rules would not be difficult to apply in practice.

4. It has also been suggested that practitioners may have difficulty in obtaining the appropriate computer software for implementation of the new Rules. We understand that finance companies have been using computers to assist in their routine monitoring of securities margin financing business and the software available is generally cheap and simple to operate. That said, we acknowledge that the existing computer software may need to be modified for the purpose of computing the concentration risk adjustments. We however do not believe that it would cause major practical difficulties for the dealers/financiers. As we have advised the Bills Committee at a previous meeting, the SEHK has inquired into the matter and is satisfied that the necessary modifications are available.

5. All in all, in developing the Rules to address risks arising from the businesses of securities margin financiers and other registered entities, we have had regard to the approach to risk taken by other securities regulators as well as the developments in the banking sector. We believe that the present approach is both effective and efficient for achieving our objectives and should be retained.

Shareholders' Capital

6. There are also suggestions of limiting client and stock exposures by reference to the "shareholders' capital"[2]. It should be noted that under the existing FRR, the share capital requirement is

[1] The first consultation was conducted in March 1997 by the SFC on the proposed overhaul of the existing FRR to bring the Rules in line with latest market development. The second one, which was mainly focused on the proposed regulation of securities margin financing activities, was conducted in May 1998.

[2] The Hon. Mr. Fung proposes that "shareholder's capital" should be defined as the aggregate of the paid-up capital, advances from shareholders (liquid capital), reserves and accumulated profits/loss.

merely a minimum entry requirement for financiers and there is no Rule on how the paid up capital is to be held, although some aspects of company law, including the prohibition on payment of dividends other than out of profit and the rules governing capital reductions will be relevant.

7. Under the FRR, financiers are required to maintain liquid capital to support an expanding business or to satisfy the concentration risk adjustments and they must find additional sources of funding to hold against risk. As we understand it, the Hon. Mr. Fung is proposing that those additional sources of funding should be confined to "shareholders' capital". However we note that the following assets have been excluded from the Hon. Mr. Fung's proposal, as compared with the existing FRR:

(a) the value of receivables;
(b) the value of security held against receivables;
(c) debt raised by the firm;
(d) current assets held on the proprietary trading book.

In short, it appears to us that the Hon. Mr. Fung's proposal may require a firm to hold significantly more capital against risk. It is also unclear to us as to what "shareholders' advances" （股東墊款）refers to. In any event, we believe such advances should have been reflected on the balance sheet as a liability of the company and therefore should not be included as a liquid asset unless repayment is in some way subordinated (an aspect which the existing FRR have addressed).

8. We also have reservations regarding the introduction of reserves into the basket of assets available to be counted against risk. This would give rise to difficult issues of valuation and accounting treatment in cases of revaluation. We are also concerned about the fact that "shareholders' capital" may not be available to meet risk. As noted above, shareholders' capital is not required to be held in any specific form. The shareholders' capital may have been pledged or used to support other businesses conducted by a financier and may no longer be available for paying off liabilities that arise from securities margin financing. By way of contrast, the concept of "liquid capital" as defined in the FRR ensures that there are adequate liquid assets (i.e. assets

which are realizable into cash within a reasonably short period of time) to meet liabilities as they fall due.

Specific Proposals

9. The Hon. Mr. Fung has suggested that the share capital requirement imposed on a securities margin financier should increase where the financier runs a larger securities margin financing operation. Prima facie, this proposal may seem to give a significant commercial advantage to large well capitalised firms, even though, as we have explained, that capital would not, under The Hon. Mr. Fung's proposal, have to be held against the risk of the operation. The proposal may also appear to disadvantage brokers in competing with banks to provide margin loans because the securities firm may require a significant increase in capital in order to remain in business.

10. In our view, we see no strong grounds of requiring larger businesses to maintain a proportionally larger capital base compared to smaller counterparts. In fact, the SFC has suggested, in the 1997 consultation, that larger businesses should maintain a proportionally smaller capital based on the ground that their clients would tend to be more creditworthy. That proposal was eventually withheld on grounds of maintaining a level playing field regardless of the portfolio of the companies. Turning back to the present proposal raised by the Hon. Mr. Fung, it may be worth noting that to our knowledge, there is no similar requirement presently practised in other overseas jurisdictions. We would also add that the 5% liabilities test has provided adequate protection for the market even during the most volatile period in the recent financial turmoil.

11. It should also be noted that the FRR do not set limits on the size of the securities margin financing operation, the amount of individual/related securities collateral or the value of loans to clients. As the financier sees fit, it may operate provided that it has sufficient liquid capital to hold against risk. The FRR do not take away the right of the financier to make a commercial decision but ensure any such decision should not result in undue risk for the business or the other clients. We therefore do not support the suggestion of setting a limit on the size of the individual/related margin clients by reference to the

"shareholders' capital". In our view, such approach is not sufficiently sensitive to how the securities margin financing business is run and would amount to an unnecessary restriction which does not reflect actual risk.

12. To illustrate our concern, take an example where a financier has $10 million share capital, borrows $190 million from the bank and lends $200 million to margin clients. According to The Hon. Mr. Fung's suggestion, each individual margin client or each group of related margin clients must not have outstanding loans in excess of $10 million (being 100% of shareholders' stakes). This, in effect, lowers the proposed triggering threshold (under the FRR) from 10% of aggregate margin loan to 5% which, in our view, is not warranted. In contrast, if the financier only lends a total of $20 million to its margin clients, The Hon. Mr. Fung's proposed cap will be $10 million whereas the FRR cap will be $2 million. This means that the financier can concentrate its securities margin financing business on 2 margin clients, which is again against our objective to encourage diversification of risks.

13. As regards the concentration on stock collateral, we again have strong reservation of setting a limit on the size of the individual/related securities collateral based on "shareholders' capital" as this would amount to an unnecessary restriction which does not reflect actual risk.

14. To illustrate, take the same example given above and assume that the clients have pledged $350 million worth of securities as collateral. Under the Hon. Mr. Fung's suggestion, in the case of a constituent stock of the Hang Seng Index, the triggering threshold will be set at $10 million (i.e. 100% of shareholders' stakes). This appears to be considerably more onerous as under our proposed FRR, the triggering threshold will be substantially higher at $70 million, being 20% of aggregate collateral worth of $350 million.

15. However, if the financier only lends $20 million against $35 million collateral, then whilst The Hon. Mr. Fung's threshold remains the same at $10 million, the threshold under FRR will have fallen to $7 million. In other words, in the former scenario a financier will be allowed to hold 4 individual/related securities collateral whereas in the

latter case, he must at least hold 6 different collateral positions to avoid the concentration risk adjustments.

16. It was also suggested that the concentration in stock collateral should be confined to a certain ratio by reference to the size of issued shares of that company. While we are always concerned about the potential systemic risk that may arise from the excessive pledging of a particular issue, we do not believe that a limit on the basis of number of issued shares is appropriate as such limit does not pay regard to the particular loan portfolio or the type of stock concerned. We believe the most prudent way to manage the risk exposure on a particular stock is to base on the liquidity and volatility of that stock, as presently adopted in the FRR.

CONCLUSION

17. In conclusion, we believe the objectives of the measures proposed by the Hon. Mr. Fung are not different from those sought to achieve by the FRR and the regulatory framework for securities margin financing in general. On the basis of the above assessment, we are of the view that the present approach of a risk-based FRR is still desirable and should be effective and efficient in ensuring the financial resources adequacy of the securities dealers and other registered entities.

Financial Services Bureau
19 June 1999