

Consultation Document
The Proposed Amendments to the Current Financial Resources Rules

Introduction

1. The Securities and Futures Commission (SFC) releases for public consultation certain draft amendments proposed to be made to the current Financial Resources Rules (FRR) under section 28 of the Securities and Futures Commission Ordinance (Cap. 24) (SFCO). These will be a separate consultation of the Financial Resources Rules made under the Securities and Futures Bill at a later stage.
2. Rules made by the SFC are subject to negative vetting by the Legislative Council. The SFC must also consult the Financial Secretary before promulgating the Financial Resources Rules or any changes. In addition, the SFC now releases the draft amendments to the Financial Resources Rules for public consultation.
3. The SFC has sent copies of this consultation document to all registered securities dealers and securities margin financiers via the FinNet communication network. The public may also obtain copies free of charge at the SFC office and on the SFC Internet website at <http://www.hksfc.org.hk>.
4. The public is invited to submit comments before close of business on 26 March 2002. Those comments may be sent to:

By mail: SFC FRR
 12/F, Edinburgh Tower
 The Landmark
 15 Queen's Road Central
 Hong Kong

By fax: 2523-4598

By way of on-line: <http://www.hksfc.org.hk>

By e-mail: FRR@hksfc.org.hk

Please note that the names of the commentators and the contents of their submissions may be published on the SFC website and in other documents. In this connection, please read the Personal Information Collection Statement attached to this consultation document (see Attachment 2).

You may wish not to have your name and/or submission to be published by the SFC. If this is the case, please state that you wish your name and/or submission to be withheld from publication when you make your submission.

II. Background

5. Hong Kong currently has 8 securities margin financiers and 255 securities dealers that conduct securities margin financing. The total outstanding margin loans were HK\$13 billion as at month-end January 2002, down from HK\$15 billion for December 2000. In the competition for business, the SFC has observed a tendency for more aggressive lending practices, even though the size of the margin loan has declined.
6. Margin finance business involves the firm providing securities margin financing in essentially credit business, which subjects it to credit risks. As the SFC has time and again communicated to the market and to public investors, securities margin financing involves additional risks – to the investors as well as the margin financiers or the securities dealers – arising from leverage, pooling arrangements, and need for ongoing liquidity.
7. The SFC has reviewed the practices among securities margin financiers and securities dealers conducting securities margin financing (collectively referred to as “firms conducting securities margin financing”), and has identified two practices that are particular risky and imprudent:
 - (a) accepting as collateral for margin loans a high quantity of stocks that are low quality, illiquid, or thinly traded; and
 - (b) re-pledging the more liquid and higher quality stocks from “inactive” margin clients (who borrow very little or not at all) in order to obtain bank loans to fund the firms’ own working capital.
8. The current FRR already apply differential haircuts to stocks that are on the Hang Seng Index and stocks that are not. The rules also discount the value of securities pledged in margin accounts where there is concentration in particular securities. However, the rules currently do not adequately cover risks in respect of illiquid securities held as collateral.
9. Furthermore, the rules currently permit firms to pool and re-pledge the securities of their margin clients (subject to annual written authorization from the clients). Firms are, therefore, able to re-pledge securities from clients, regardless of whether the particular clients have borrowed, to obtain funding for the firms’ own working capital. In practice, the re-pledged securities are generally of higher quality because banks tend not to accept (or would assign extremely low lending ratios to) lower quality or illiquid securities as collateral.
10. In the event of default on a margin loan by a particular client, a highly-g geared firm might be unable to liquidate its holding of largely illiquid securities to cover the default. Such a firm would also be unable, due to cash-flow shortages, to redeem the more liquid securities re-pledged to banks. That these securities are often from “inactive” margin clients gives rise to an additional issue. In short, one large default of a margin client could potentially cause such a firm to default on its bank loan(s) with very damaging consequences to its clients and market confidence. Given current market conditions, the risk to some of these firms has increased considerably.

11. Pooling and re-pledging securities of margin clients has been the market practice for a long period of time. Immediate prohibition against pooling of securities may be inappropriate as it would require systems for tracking collateral movement that could be operationally cumbersome.
12. The SFC is considering whether firms conducting securities margin financing should be required to provide their own funding for the conduct of this business, instead of re-pledging securities out of the pool (regardless of whether the clients owning the securities have borrowed money and how much) as collateral for bank financing. In the long term, an increase in the minimum capital requirement for firms conducting securities margin financing is a desirable measure that may help mitigate the potential losses clients could suffer.
13. Considering the current market conditions, it has become particularly important for firms to manage their lending and liquidity risks. This is key to the firms' own financial health and to investor protection.
14. In light of the above, the SFC has reviewed the FRR and considers that a speedy solution is needed to more appropriately measure and manage the relevant risks. Accordingly, the SFC proposes to introduce two interim measures: (a) an "illiquid collateral haircut" and (b) a "firm borrowing to margin loan ratio trigger".

III. Proposed amendments

15. A copy of the draft amendments to the FRR is attached for reference (please see **Attachment 1**). The proposals are to:
 - (a) apply a 90% "illiquid collateral" haircut on stocks and warrants pledged as margin collateral where:
 - (i) considering the trading in that pledged stock or warrant during the previous 6 months, it will likely require more than one month to liquidate the collateral; or
 - (ii) the pledged stocks or warrants constitute 5% or more of the market capitalization of the shares or the issue size of the warrants.

To limit the application of this proposal to situations where default of a margin loan would have particularly damaging consequences to the firm, the two tests in (i) and (ii) will only be applied to the shares and warrants identified as the three largest collateral holdings (based on the securities' respective market value) of each firm's top 20 margin clients (those with the largest outstanding margin loan balances). But once any shares and warrants have been identified as "illiquid collateral", the 90% haircut will apply to all such shares and warrants held by the firm as collateral.

The haircut will not apply to constituent stocks of certain specified major indices, such as the Hang Seng Index, the Hang Seng Hong Kong LargeCap Index and the Hang Seng Hong Kong MidCap Index; and

- (b) include in a firm's ranking liabilities the amount of its total borrowings secured by re-pledging margin clients' securities that is in excess of 50% of the total amount of loans extended to margin clients.

Illiquid collateral haircut

16. A one-month yardstick is chosen in paragraph 15(a)(i) in light of the fact that a number of higher-risk firms accept securities collateral that would take more than one month to liquidate. In the case of paragraph 15(a)(ii), 5% is chosen as the alternative shareholding trigger on the basis that, assuming a minimum 25% public float, any holding of more than 5% would be difficult to liquidate in a timely manner. Similar consideration applies to warrants.
17. With a 90% haircut, firms will have to make nearly full provision for margin loans secured by illiquid stocks. This will provide the firm with a better capital buffer in the event of margin loan defaults or sudden changes in market conditions.
18. The FRR are not applicable to authorised institutions providing securities margin financing. Besides being subject to stringent capital adequacy and liquidity ratios as prescribed under the Banking Ordinance, authorised institutions are generally expected by the Hong Kong Monetary Authority to apply a steep haircut (for example, 80%) to illiquid stocks accepted as collateral.

Firm Borrowing to Margin Loan Ratio Trigger

19. The second amendment links the amount of borrowings by a firm (through repledging client securities) to the amount of margin loans it actually provides. Those firms that rely heavily on borrowings secured by their clients' securities collateral would be required to finance at least 50% of their margin loans with their own capital. In providing credit to clients, and obtaining credit from banks or other parties, it is only fair that the firm has adequate capital to cushion itself and its clients against credit, liquidity and other risks. The second amendment represents a fair and reasonable requirement in the interests of both maintaining confidence in the Hong Kong markets and improving investor protection.

Transitional arrangements

20. The SFC realizes that some firms may have genuine problems in complying with the proposed amendments to the FRR. In view of this, we propose a three-month transitional period for existing firms from the date of the amended FRR coming into effect. Moreover, the SFC will also work together with any firm that may have difficulty in meeting the new requirements with a view to ensuring as smooth a transition as possible.

Conclusion

21. The SFC is particularly interested in receiving comments on the definition of "illiquid collateral", the "illiquid collateral haircut" percentage and the firm borrowing to margin loan ratio trigger level.
22. The proposed amendments are intended to improve the lending and liquidity risk management by firms conducting securities margin financing which will result in better investor protection.