



**SECURITIES AND
FUTURES COMMISSION**
證券及期貨事務監察委員會

Guidelines for Securities Margin Financing Activities

17 June 2019

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SMF review findings

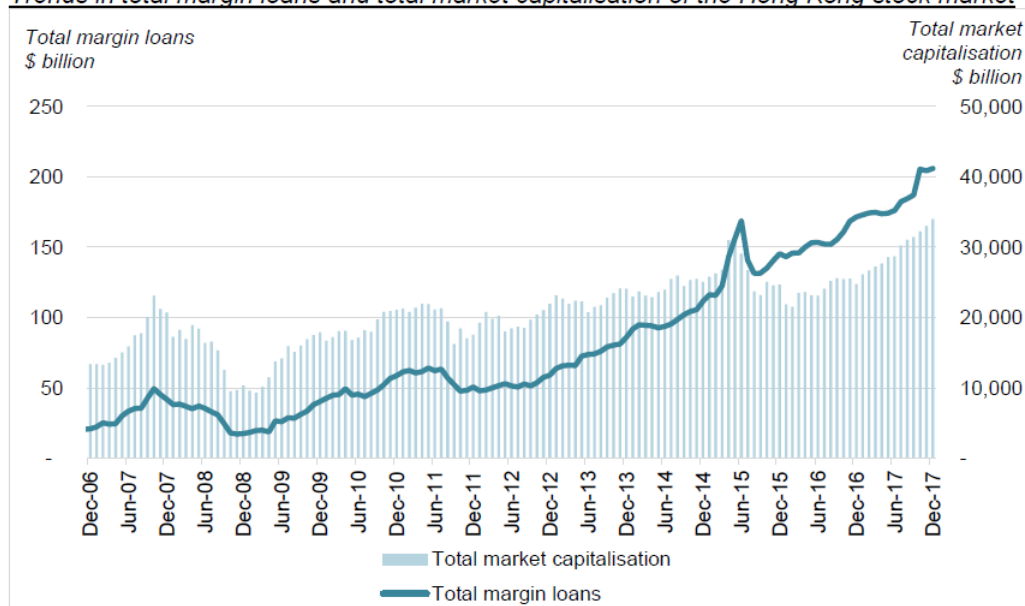
- Consisted of two parts:
 - i. Macro analysis
 - Analysed trends in SMF activities based on the monthly financial returns submitted by SMF brokers from 2006 to 2017
 - ii. In-depth study
 - Covered the 20 largest SMF brokers
 - Reviewed risk profiles and margin lending practices of selected SMF brokers

SMF review findings

■ Increase in total margin loans

- Total margin loans rose about 9 times to \$206 billion as at end-2017 from end-2006 (vs only 1.5 times growth of total market capitalisation during the same period)

Trends in total margin loans and total market capitalisation of the Hong Kong stock market



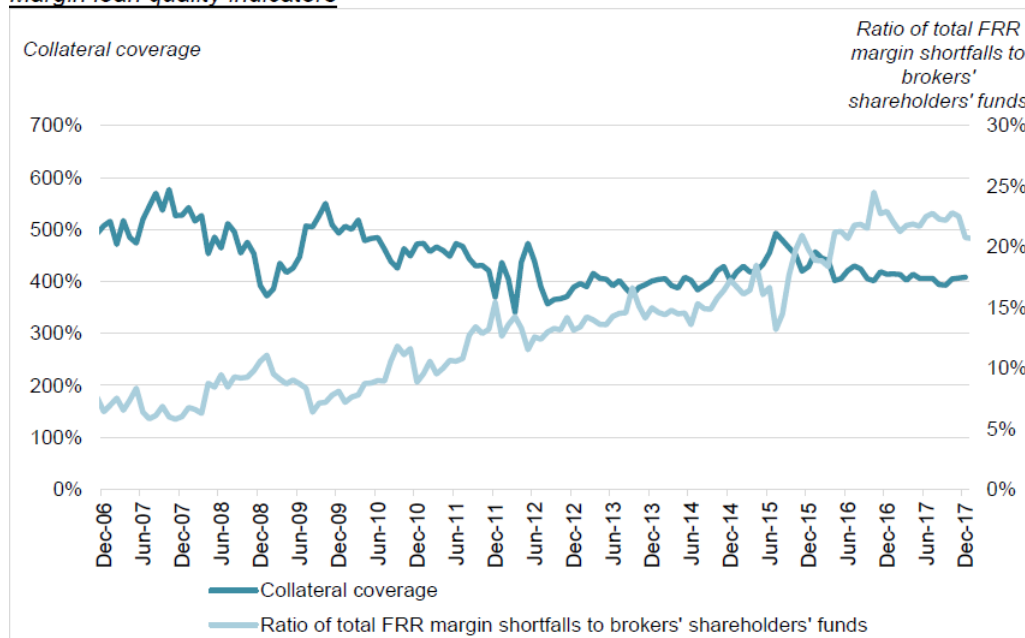
	As at 31/12/2017 \$ billion	As at 31/12/2006 \$ billion	Change
Total margin loans	206	21	881%
Total market capitalisation of the Hong Kong stock market	33,999	13,338	155%

	As at 31/12/2017	As at 31/12/2006	Change
Number of SMF brokers	315	224	41%
Number of active margin clients	337,608	80,348	320%

SMF review findings

- **Significant deterioration in margin loan quality**
 - FRR margin shortfall (Note) as a % of brokers' shareholders' funds rose to 19% in 2017 (7% in 2006)
 - Collateral coverage dropped to 4 times in 2017 (5 times in 2006)

Margin loan quality indicators



	As at 31/12/2017	As at 31/12/2006	Change
Collateral coverage	412%	517%	-105%
Ratio of total FRR margin shortfalls to brokers' shareholders' funds	19%	7%	12%

Note: FRR margin shortfall would arise if the market value of the securities collateral securing the margin loan after deducting the applicable FRR haircut amount is less than the outstanding margin loan

SMF review findings

- Increase in securities collateral concentration risk
 - Proportion of top 20 margin loans secured by single collateral increased to 30% in 2017 (12% in 2006)

FORM 4 MARGIN CLIENT ANALYSIS

Table 1 By unadjusted loan balance as of the end of reporting month [1004] (Note 1)

Top 20 margin clients with the largest unadjusted loan balances as of reporting date

Row	Name of client	Ranking	Unadjusted loan balance (HK\$'000)	Collateral market value (HK\$'000)	Adjusted loan balance (Note 1) (HK\$'000)	Top 3 collateral (Note 2)									Row
						Collateral 1			Collateral 2			Collateral 3			
						Name	Stock code / sedol no.	Market value (HK\$'000)	Name	Stock code / sedol no.	Market value (HK\$'000)	Name	Stock code / sedol no.	Market value (HK\$'000)	
[1]	Client 1	1	300,000	1,200,000	240,000	A Co.	09980	1,200,000			0			0	[1]
[2]	Client 2	2	290,000	580,000	116,000	B Co.	09981	580,000			0			0	[2]
[3]	Client 3	3	280,000	0	0	C Co.	09982	0			0			0	[3]
[4]	Client 4	4	270,000	1,350,000	270,000	D Co.	09983	1,350,000			0			0	[4]
[5]	Client 5	5	260,000	500,000	250,000	E Co.	09984	250,000	A Co.	09980	120,000	B Co.	09981	80,000	[5]
[6]	Client 6	6	250,000	355,000	143,500	F Co.	09985	350,000	E Co.	09984	5,000			0	[6]
[7]	Client 7	7	240,000	650,000	240,000	G Co.	09986	200,000	E Co.	09984	200,000	F Co.	09985	200,000	[7]
[8]	Client 8	8	230,000	460,000	230,000	H Co.	09987	460,000			0			0	[8]
[9]	Client 9	9	220,000	440,000	220,000	I Co.	09988	440,000			0			0	[9]
[10]	Client 10	10	210,000	150,000	60,000	J Co.	09989	150,000			0			0	[10]
[11]	Client 11	11	200,000	400,000	80,000	K Co.	09990	400,000			0			0	[11]
[12]	Client 12	12	190,000	0	0	L Co.	09991	0			0			0	[12]
[13]	Client 13	13	180,000	250,000	50,000	M Co.	09992	250,000			0			0	[13]
[14]	Client 14	14	170,000	250,000	50,000	M Co.	09992	250,000			0			0	[14]
[15]	Client 15	15	160,000	260,000	58,500	M Co.	09992	250,000	N Co.	09993	10,000			0	[15]
[16]	Client 16	16	150,000	260,000	58,500	M Co.	09992	250,000	N Co.	09993	10,000			0	[16]
[17]	Client 17	17	140,000	300,000	140,000	O Co.	09994	100,000	H Co.	09987	60,000	I Co.	09988	40,000	[17]
[18]	Client 18	18	130,000	200,000	80,000	P Co.	09995	200,000			0			0	[18]
[19]	Client 19	19	120,000	400,000	120,000	Q Co.	09996	400,000			0			0	[19]
[20]	Client 20	20	110,000	250,000	100,000	R Co.	09997	250,000			0			0	[20]
	Sub-total	[4000]	4,100,000	8,255,000	2,506,500	[4002]									[4002]
	Other borrowing clients	[4003]	2,000,000	4,000,000	1,800,000	[4005]									[4005]
	Less: General provision for bad or doubtful debts for all margin clients, if any (Note 3)	[4006]	0		0	[4007]									[4007]
	Total loan balance after general provision for bad or doubtful debts, if any (Note 3)	[4008]	6,100,000	12,255,000	4,306,500	[4010]									[4010]

Single securities collateral

Validate This Sheet

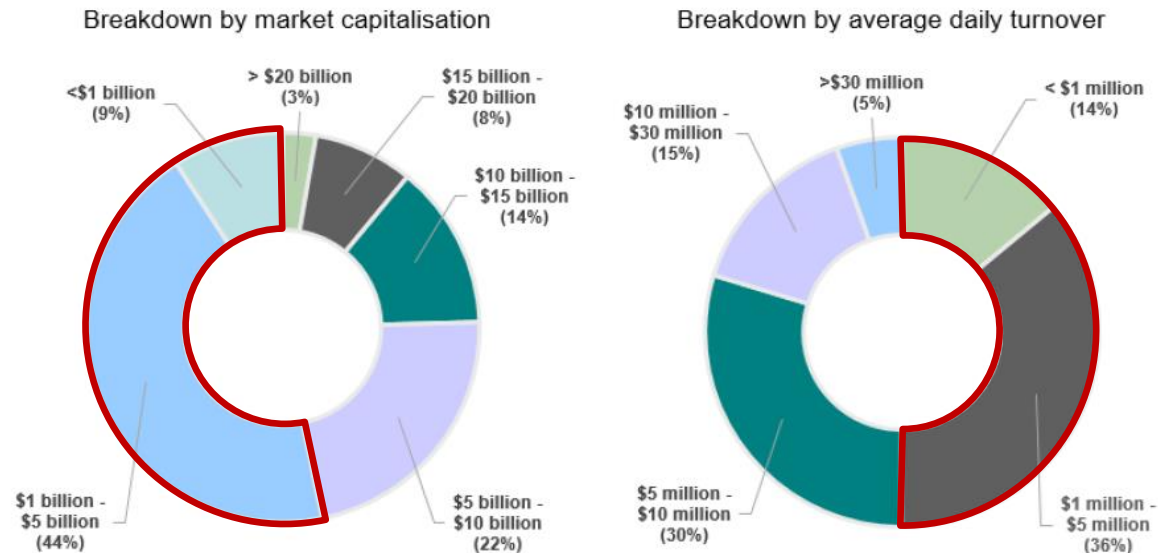
SMF review findings

- **Increase in securities collateral concentration risk (cont'd)**
 - Nearly 80% of the SMF brokers were found to have margin loan(s) among their top 20 margin loans secured by single securities collateral at the end of 2017
 - Risk further amplified if the relevant securities collaterals are:
 - Illiquid collateral stocks
 - Around 600 stocks were reported as illiquid collateral among the top 3 collaterals of top 20 margin clients at the end of 2017, nearly twice the level at the end of 2006
 - One-third of brokers held at least three stocks which were illiquid collateral at the end of 2017
 - Heavily pledged stocks (see next page)

SMF review findings

- **Heavily pledged stocks (HPS)** (Note)
 - HPS accounted for 50% in terms of market value of the top 3 collaterals securing the top 20 margin loans of SMF brokers at the end of 2017, more than twice the level at the end of 2006
 - 67 SMF brokers each held at least one securities collateral which shareholding accounted for 10% or more of the total issued shares of that securities

Breakdown of the individual broker-level HPS

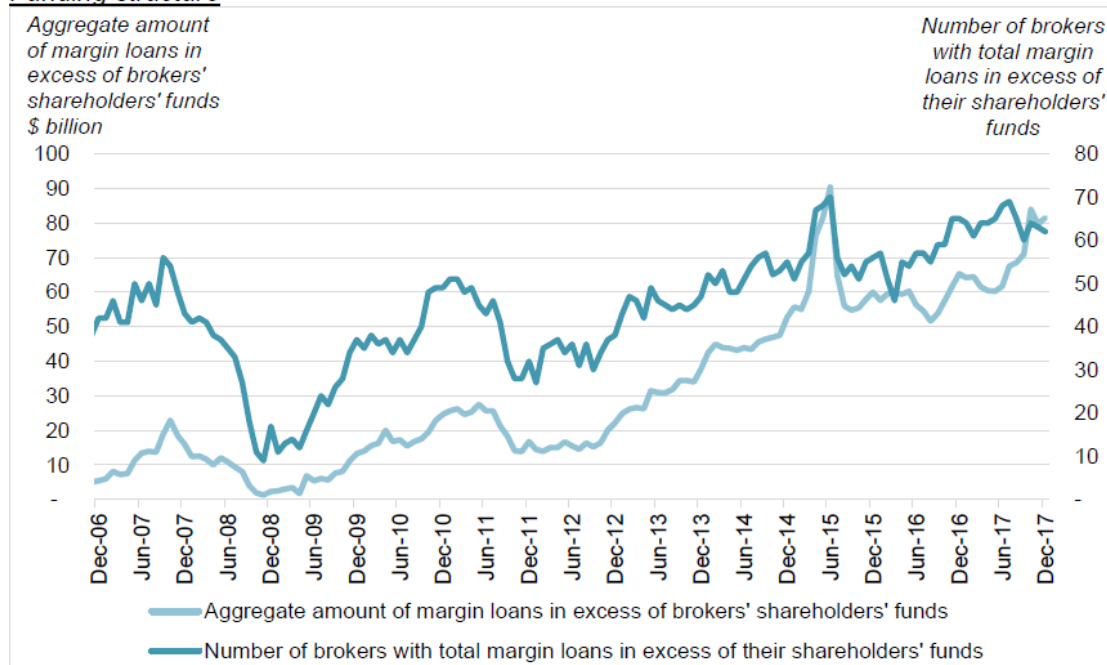


Note : A stock reported by an SMF broker in its monthly financial return as among the top 3 collaterals securing the top 20 margin loans, where the aggregate market value of the stock held by all SMF brokers was equal to or greater than 10% of the market capitalisation of the stock.

SMF review findings

- **Increased reliance on bank borrowings**
 - Increase in total margin loans far exceeded the increase in shareholders' funds of the SMF brokers

Funding structure



	As at 31/12/2017	As at 31/12/2006	Change
Aggregate amount of margin loans in excess of brokers' shareholders' funds	\$82 billion	\$5 billion	+ 15 times
Number of brokers with total margin loans in excess of their shareholders' funds	62	42	48%

SMF review findings

- **Increased bank loans secured by client securities collaterals**
 - Total bank loans secured by client securities collaterals and the market value of client securities collateral re-pledged rose substantially by 18 times and 6 times

Brokers' re-pledging status

	As at 31/12/2017	As at 31/12/2006	Change
Number of re-pledging brokers	58	58	0
Bank loans secured by margin client securities collateral	\$26.9 billion	\$1.4 billion	+ 18 times
Market value of margin client securities collateral re-pledged	\$85.6 billion	\$11.7 billion	+ 6 times

- **Common control deficiencies identified from the in-depth study**
 - Absence of, or inadequate adherence to, an internal total margin loans limit, stock concentration limit and client concentration limit
 - Margin loans being granted to clients solely or mainly based on the value of collateral with little regard to the client's financial capability
 - More lenient haircut percentages for collateral than those of lending banks', with even lower haircut percentages being applied to collateral deposited by "special" clients
 - Slack control over the collection and waiver of margin calls and forced liquidation, with additional margin loans being granted to clients who have failed to meet margin calls
 - Stress testing not performed (or not regularly performed) to assess the financial impact on the broker of market stress or a plunge or suspension of collateral

SMF guidelines

- **Overview**

- **Effective date**

- 4 October 2019

- **Scope of application**

- Apply to:

- persons licensed for Type 1 regulated activity (dealing in securities) who provide financial accommodation to any of their clients in order to facilitate acquisitions or holdings of listed securities by the persons for their clients; and
 - persons licensed for Type 8 regulated activity (securities margin financing)

SMF guidelines

- Risk control areas

1

Total margin loans controls

2

Margin client credit limit controls

3

Securities collateral concentration controls

4

Margin client concentration controls

5

Haircuts for securities collateral

6

Margin calls, stopping further advances and further purchases of securities, and forced liquidation

7

Stress testing

1. Total margin loans controls

Set prudent total margin loans limit

To avoid excessive SMF risk

Factors to consider in setting the limit

- Broker's liquidity profile and capital
- Risk profile of margin loan portfolio
- Prevailing market conditions

Review limit at least annually

Adopt a total margin loans-to-capital multiple benchmark ^(Note) up to 5 provided that the broker:

- complies with all other applicable provisions in the guidelines; and
- has high quality margin loan portfolio

Note: Capital refers to the aggregate of the broker's shareholders' funds and outstanding approved subordinated loan

2. Margin client credit limit controls

Set prudent credit limit

- Ensure margin client's obligation is commensurate with the client's financial capability
- Aggregate exposures to all clients within a group of connected margin client

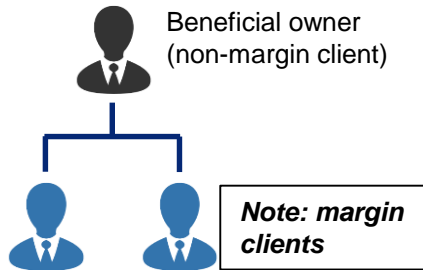
Factors to consider in setting the credit limit

- Financial situation of the client
- Credit reference information (e.g. credit history) about the client
- Quality of underlying collaterals and any other credit support
- Investment objectives, risk appetite and trading patterns of the client
- Any known adverse events reflecting financial status or default risk of the client

Review credit limit at least annually

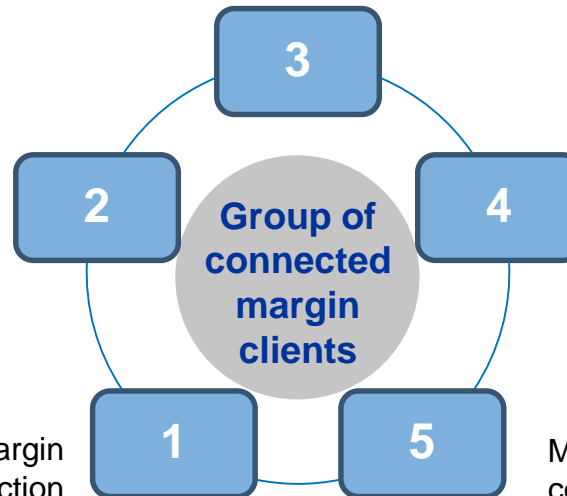
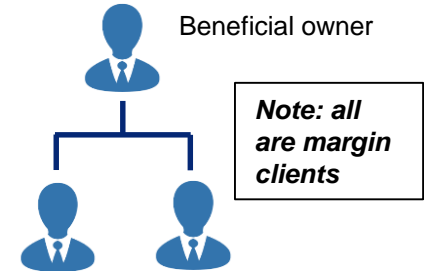
2. Margin client credit limit controls (cont'd)

Group of connected margin clients



Margin clients (natural persons other than spouses) act on behalf of the same non-margin client (i.e. beneficial owner or person stands to gain/bear the benefit/risk)

Margin clients (natural persons other than spouses) where one acts through the others and is the beneficial owner of the others' accounts, or stands to gain/bear the benefit/risk in the others' accounts



A group of related margin clients (defined under section 42(3) of the FRR)

Corporate margin clients of which a natural person, either alone or with his spouse, controls 35% or more of their voting rights

Margin clients financially connected by guarantee arrangements

3. Securities collateral concentration controls

Set prudent concentration limits

To avoid building up excessive exposure to individual securities collateral or groups of connected major securities collateral

Factors to consider in setting concentration limits

- Broker's liquidity profile and capital
- Risk profile of margin loans
- Quality of securities collaterals
- Holding as a percentage of the total issue size of the security and prospect of realisation
- Aggregated holdings in a group of connected major securities collateral
- Potential financial impact under stress scenarios
- Prevailing market conditions

3. Securities collateral concentration controls (cont'd)

Assessment and identification of connected major securities collateral

- Only major securities collateral is subject to regular (at least monthly) assessment

Major securities collateral :

- Top 10 securities collateral, in terms of market value of securities collateral provided by borrowing margin clients, excluding
 - any securities issued by a listed company whose share is a constituent of HSI
 - any securities with a FRR haircut percentage of 100%

- Securities collateral is considered as connected if:

1

Issued by the same issuer or by members of the same group of companies

2

Adverse event of the issuer of a security is likely to materially affect the financial soundness or the market prices of the others

Factors to be considered in making the assessment including:

- under common control?
- have significant business affiliations (e.g. major supplier or customer)?
- have significant investments in the others' securities?
- have significant lending to or other financial relationships with the others?

3. Securities collateral concentration controls (cont'd)

Excess Liquid Capital (ELC) impact analysis

- Assume the securities collateral to be valued at nil for liquid capital calculation in FRR, and calculate the estimated ELC impact (measured as the percentage reduction of the ELC)

Quantitative benchmarks of the ELC impact

50%

Tier 1
securities
collateral

1. **Securities collateral being a constituent stock of:**
 - a) Hang Seng Index;
 - b) Hang Seng China Enterprises Index;
 - c) FTSE 100 Index;
 - d) Nikkei Stock Average;
 - e) S&P 500 Index; or
 - f) Euro Stoxx 50 Index
2. **Qualifying debt securities, special debt securities or specified securities with FRR haircut % of 15% or below**

30%

Tier 2
securities
collateral

1. **Securities collateral not being a Tier 1 securities collateral but being a constituent stock of:**
 - a) Hang Seng Composite Index;
 - b) MSCI Hong Kong Index; or
 - c) MSCI China Index
2. **Qualifying debt securities, special debt securities or specified securities with FRR haircut % of higher than 15% but not above 30%**

20%

Tier 3
securities
collateral

Any securities collateral not being Tier 1 or Tier 2 securities collateral.

4. Margin client concentration controls

Set prudent concentration limits

To avoid building up excessive exposure to individual margin clients or groups of connected margin clients

Factors to consider in setting concentration limits

- Broker's liquidity profile and capital
- Client's financial situation
- Composition and quality of securities collaterals
- Potential financial impact of client default and in stress situations
- Client's credit history
- Risk profiles of margin loan portfolio
- Prevailing market conditions

Assess ELC impact of client defaults and stress situations

Prior to granting a significant margin loan (i.e. > 10% of broker's shareholders' funds)

Adopt a margin client concentration benchmark up to 40% of the broker's shareholders' funds provided that the broker:

- complies with all other applicable provisions in the guidelines; and
- has high quality margin loan portfolio

5. Haircuts for securities collateral

For all SMF brokers

Set prudent haircut percentages for securities collateral

Factors to consider in setting the haircut percentages

- Financial situation of the issuer
- Historical price volatility, reasonableness and sustainability of the valuation and market liquidity
- Any adverse news

Review haircut percentage at least annually

Consistently apply haircut percentages to securities collateral of all margin clients

- Adopt higher haircut percentage – if prudent
- Adopt lower haircut percentage – only if broker has financial capability to take up additional risk, and has taken risk mitigation measures

5. Haircuts for securities collateral (cont'd)

Additional benchmarking requirement for re-pledging brokers

- Haircut percentage for securities collateral should not be lower than:

1

Average haircut percentage assigned by the broker's top 3 lending banks minus 20% (Note)

2

Applicable haircut percentage prescribed by the FRR (80% in case of illiquid collateral)

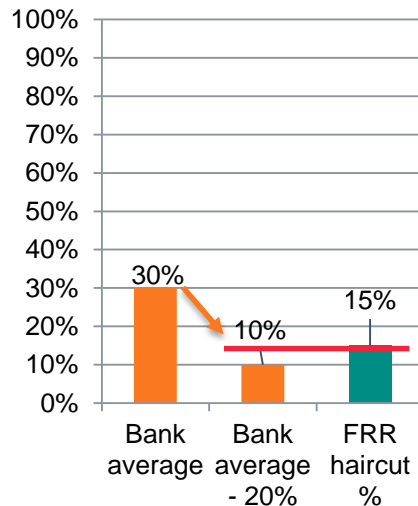
Note: Only applies to Hong Kong listed shares, except for any share listed for less than 6 months.

5. Haircuts for securities collateral (cont'd)

Additional benchmarking requirement for re-pledging brokers



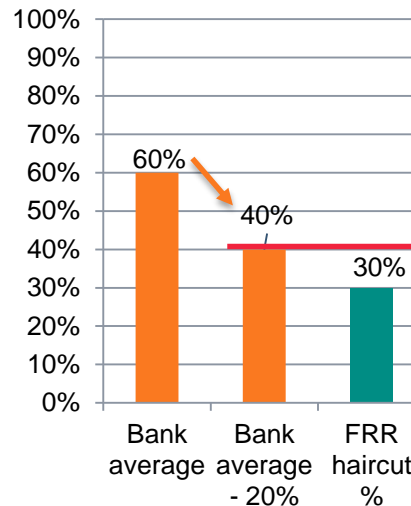
Example 1: Securities collateral A
(For a HSI stock)



Haircut for securities collateral A should be at least 15%.



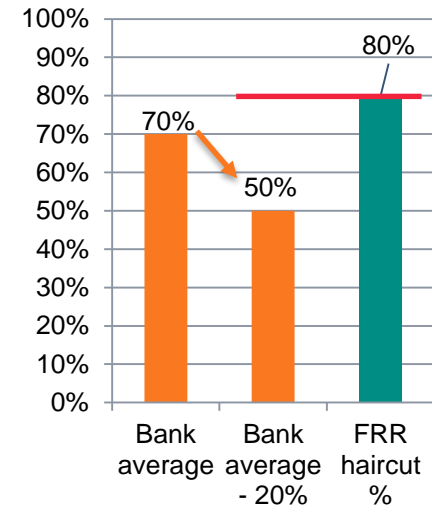
Example 2: Securities collateral B
(For a HSCI stock)



Haircut for securities collateral B should be at least 40%.



Example 3: Securities collateral C
(For an illiquid collateral)



Haircut for securities collateral C should be at least 80%.

6. Margin calls, stopping further advances and further purchases of securities, and forced liquidation

- Margin calls should be made immediately when margin loan balance exceeds the lower of:
 - ➔ margin value (*i.e. market value – haircut amount*) of underlying collateral;
 - ➔ credit limit; or
 - ➔ other amount as may be determined by the SMF broker according to its margin call policy

Unless the margin shortfall < the minimum transfer amount

6. Margin calls, stopping further advances and further purchases of securities, and forced liquidation (cont'd)

- Brokers should take reasonable steps to avoid excessive exposure to outstanding margin calls:



Total amount of outstanding margin call > broker's shareholders' funds



Total amount of long-outstanding margin call (i.e. outstanding for more than 90 days) > 25% of the broker's shareholders' funds

6. Margin calls, stopping further advances and further purchases of securities, and forced liquidation (cont'd)



Stop waiving margin calls on any margin client:

- who has a poor history of settling margin calls (*e.g. failed to settle margin call on 15 days or more in last 30 calendar days, with an amount of long-outstanding margin call in last 12 calendar months*); or
- outstanding margin loan > market value of underlying collateral



Stop any further advance to, and any further purchase of securities using the margin facility by, any margin client:

- who has an amount of outstanding margin call and a poor history of settling margin calls; or
- outstanding margin loan > market value of underlying collateral

except where the further purchase can reduce the risk of the margin loan (*e.g. improving the overall quality of its underlying collateral or reducing the margin shortfall*)

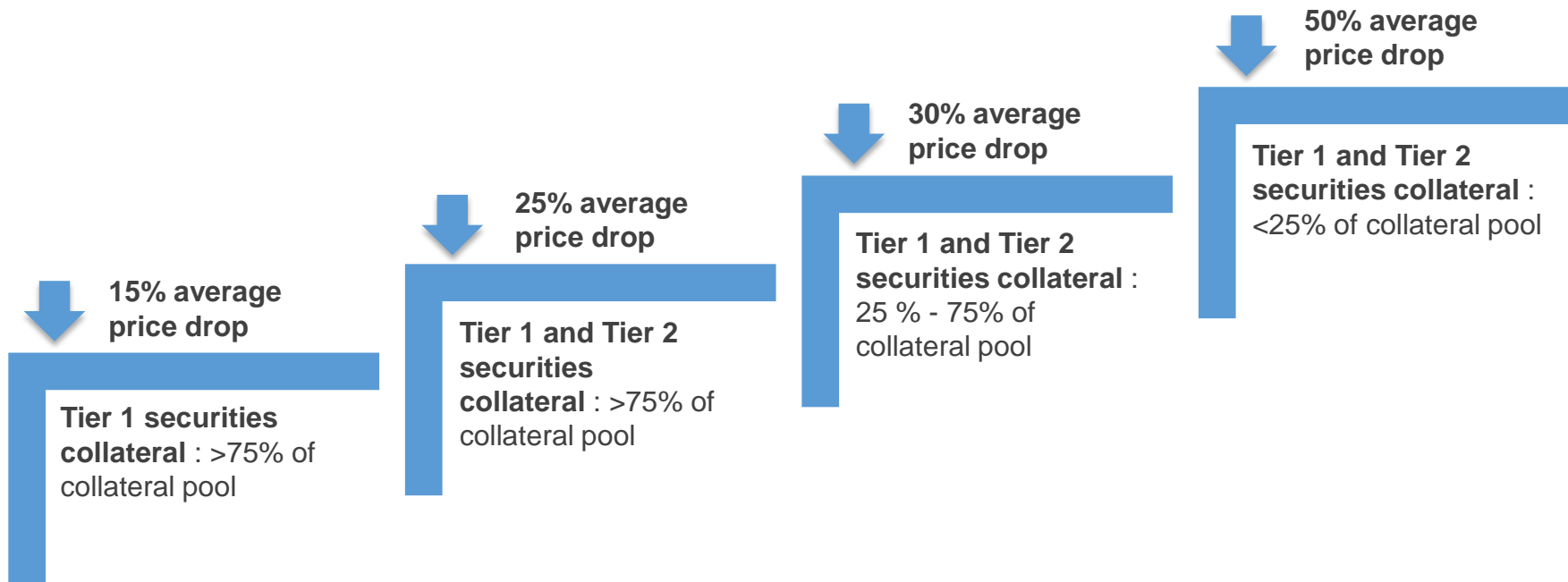
7. Stress testing

- Conduct stress tests on its ELC and liquidity
 - regularly (at least monthly); and
 - upon the occurrence of any material adverse market event or securities-specific event (*e.g. sudden plunge in the market price of a significant securities collateral*)

7. Stress testing (cont'd)

Suggested hypothetical scenario for ELC stress test

To quantify the impact on broker's ELC under the applicable hypothetical scenario, which assumes an uniform price drop of securities collateral provided by all borrowing margin clients



7. Stress testing (cont'd)

ELC stress test of a significant group of connected securities collateral

- Conduct ELC stress test regularly (at least monthly), assuming a significant group of connected securities collateral losing all its value

Group of connected securities collateral:

- A group of connected major securities collateral; or
- Any two or more other securities collateral the broker is aware that they are connected

A group of connected securities collateral would be considered as significant when:

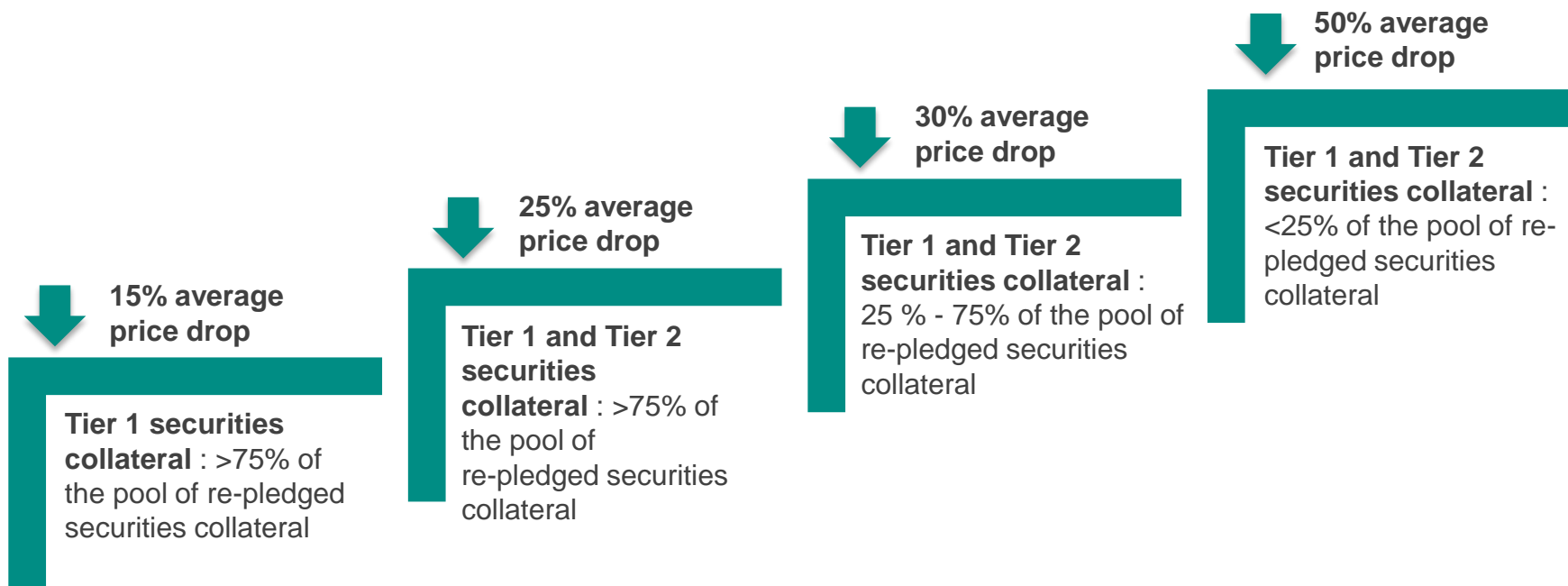
- Its aggregate market value equals 10% or more of the total market value of the collateral pool provided by all borrowing margin clients

SMF guidelines

7. Stress testing (cont'd)

Suggested hypothetical scenario for liquidity stress test (for re-pledging brokers only)

To assess re-pledging broker's ability to meet margin calls from lending banks under the applicable hypothetical scenario, which assumes an uniform price drop of securities collateral re-pledged to banks



7. Stress testing (cont'd)

Liquidity stress test of a significant individual re-pledged securities collateral or a significant group of connected re-pledged securities collateral (for re-pledging brokers only)

- Conduct liquidity stress test regularly (at least monthly), assuming significant individual re-pledged securities collateral or a significant group of connected re-pledged securities collateral losing all its value

Group of connected re-pledged securities collateral:

- Any two or more major re-pledged securities collateral assessed to be connected; or
- Any two or more other re-pledged securities collateral the broker is aware that they are connected

Major re-pledged securities collateral:

- Top 10 re-pledged securities collateral, in terms of market value of securities collateral re-pledged by the broker, excluding
 - any securities issued by a listed company whose share is a constituent of HSI
 - any securities with a haircut percentage of 100% assigned by the lending banks of the broker

An individual re-pledged securities collateral or a group of connected re-pledged securities collateral would be considered as significant when:

- The market value / aggregate market value equals 10% or more of the total market value of the pool of re-pledged securities collateral

- **Notification requirement**

- Broker should report to the SFC immediately when it:



- does not comply with or exceeds the quantitative benchmarks in the guidelines; or



- does not pass any stress test on ELC or liquidity conducted in accordance with the guidelines

A large, stylized teal graphic of a bird in flight, positioned on the left side of the page. The bird's wings are spread wide, and its tail feathers are visible. The graphic is semi-transparent, allowing the white background to show through.

Thank you.

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