Structure of the Brokerage Industry

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The securities and futures industry worldwide is going through a period of consolidation and adjustment since the peak of the technology bubble in 2000. Turnover in major markets have broadly declined by 25% since last year, partly due to the price effect as indices fell. Hong Kong is no exception to this global trend.

The brokerage industry in Hong Kong has a two-tier structure, with world-class international brokers serving essentially an institutional network, working with a large number of small and medium-sized local brokers serving the retail market.

Consolidation of the Brokerage Industry – A Worldwide Phenomenon

Various market research data show that the profits for the brokerage industry in major European markets dropped 54% in 2001 after the peak in 2000 (Chart 1). The decline in profits for retail brokers was 58%. Wholesale brokerage profits (brokers mainly for institutional investors) fell 51%. Consolidation of the brokerage industry is clearly taking place, and the industry has to adjust quickly to the new environment.


[2] The views expressed are those of the author and are not necessarily those of the Commission.
Consolidation has been happening also in the United States (Chart 2). The number of NYSE members decreased from 649 in 1930 to 365 last year. The same trend is true in Hong Kong. In 1986, there were 839 stock exchange members, when the four exchanges merged to form the SEHK. Since then, the number of active exchange participants fell to about 500 as of the end of September 2002.

Chart 2 - Number of Exchange Participants of the NYSE and SEHK

Hong Kong has the highest number of brokers amongst the major markets, even though our market was 9th largest in terms of market capitalization at the end of September 2002 and 20th largest in terms of market turnover for the 12 months ending September 2002 (Table 1). Our market turnover is roughly the size of the Australian market, but we have about 5 times more broker firms.

Table 1 - Number of Exchange Participants in Major Markets (End 2001, US$bn)

<table>
<thead>
<tr>
<th>No. of exchange participants</th>
<th>Market turnover</th>
<th>Avg market turnover per exchange participant</th>
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<tbody>
<tr>
<td>HKEx</td>
<td>495</td>
<td>241</td>
</tr>
<tr>
<td>NYSE</td>
<td>365</td>
<td>10,489</td>
</tr>
<tr>
<td>LSE</td>
<td>258</td>
<td>4,551</td>
</tr>
<tr>
<td>TSE</td>
<td>114</td>
<td>1,661</td>
</tr>
<tr>
<td>ASX</td>
<td>93</td>
<td>244</td>
</tr>
<tr>
<td>SGX</td>
<td>34</td>
<td>72</td>
</tr>
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Remark: The number of exchange participants in Hong Kong here only includes those who report the FRR, and does not include those who have ceased (or indicated to cease) business or those who have not commenced business.

Sources: Websites of various exchanges and broker associations
The market share is also quite concentrated. Taking Categories A and B brokers together, the 13% of the brokers by number contributed some 83% to the total market turnover (Table 2). In contrast, Category C brokers (i.e. about 87% of the brokers by number) competed for the remaining 17% of the market. In general, our small brokers handle a smaller amount of turnover and have a smaller client base, but they are well capitalized (as reflected by the relatively high shareholders’ funds / total assets ratio).

The shareholders’ funds to total assets ratio has remained stable at roughly 40+% for the industry as a whole. The ratio dropped in mid-year to 39% at the end of June 2002, due to accounting adjustments, but rebounded due to increases in capital to 43% at the end of August 2002. This trend is applicable across the board to all categories of brokers.

**Turnover Trends in the Hong Kong Stock Market**

Turnover of equities has tended to be quite cyclical. However, other than during the peak periods of 1997 and 2000, the average daily turnover has been quite steady, averaging roughly HK$6-8 bn daily. Average daily turnover was well above HK$10 billion in 1997 and 2000.

The recent shrinkage in turnover was largely attributable to price effect, a drop in the turnover of non-HSI constituent stocks and a drop in trading activity of retail investors. The turnover of HSI constituent stocks in volume terms remained relatively stable throughout the peak and the post peak periods (Chart 3). In contrast, the turnover of Mainland enterprise stocks dropped from the peak in 2001 Q2 following the opening up of the Mainland B markets to domestic investors in March last year. The turnover of other stocks has also declined since the peak period of early 2000, mainly attributable to the decline in the turnover of tech stocks.

<table>
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<th>Table 2 - Major Statistics of SEHK Participants by Category</th>
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<tbody>
<tr>
<td><strong>Cat A</strong></td>
</tr>
<tr>
<td>Market Share in Turnover (Aug 2002, %)</td>
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<tr>
<td>Average Turnover (12 months ending Aug 2002, HK$ bn)</td>
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<tr>
<td>Average Number of Clients</td>
</tr>
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<td>Shareholders’ funds / total assets (%)</td>
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</tbody>
</table>

Remark: The number of exchange participants here only includes those who report the FRR, and does not include whose who have ceased (or indicated to cease) business or those who have not commenced business.
Source: SFC, FRR Returns and HKEx
Business Performance of SEHK Participants

As the recent shrinkage in turnover was due to the drop in trading activity of retail investors, Category C brokers were affected most. Commission income earned by the Category C brokers dropped 31% for the 12 months ending August 2002 from a year earlier. The corresponding figures for Category A and Category B brokers were 8% and 16%.

On the cost side, the trend is also on the downtrend. Recurring costs, which consist of mainly staff costs and rental expenses, for instance, fell over time, but so far, the decline in costs appear to be somewhat slower than the drop in commission income.

Changing Market Shares

As indicated earlier, the turnover volume of Hang Seng Index stocks has been relatively stable, because of the institutional investor client base. On the other hand, the retail investor is more likely to invest in non-Hang Seng Index stocks, which exhibited greater price and volume volatility. Consequently, the share of Category C brokers that dominate the retail investor business has witnessed a falling market share since 1999 to 17% by August 2002 (Chart 4).
The Cash Market Transaction Survey conducted by HKEx also showed that the share of local individual trading declined to 36% for the 12 months ending September 2001 from 49% a year ago. All other groups (such as local institutional trading and overseas institutional trading) gained in market share. Hong Kong has one of the highest institutional market share (57%) in Asia. Of this, 38% was overseas institutional trading.

Risks in the Brokerage Industry

Investing in shares carries risks. These include market risks, counter party risks, systemic risks and operational risks. Because clients trade through brokers, they are also subject to the risks of broker failure. The brokerage industry carries financial risks arising from margin financing. Margin risks stem from two key major aspects - pooling & re-pledging of clients' securities and accepting less liquid stocks as collateral. At the end of August 2002, 255 brokers (including securities dealers and margin financiers) engaged in margin financing with total margin loans amounting to $13.1 billion and collateral accepted totaling $44.6 billion. Of these, $10.9 billion worth of margin clients' collateral was re-pledged to obtain bank loans of $1.8 billion.

Because clients' securities are pooled with broker assets and may have been re-pledged to banks for loans to the broker, margin clients may not be able to recover their securities immediately in the event of broker failure. All margin clients are exposed to these “pooling” risks, but non-borrowing and low-borrowing margin clients have higher exposure because they have more assets pledged to the broker. Brokers are also exposed to liquidity and market risks arising from the fact that they accept less liquid stocks as collateral for margin loans.

SFC Regulatory Strategy

Since it took over the regulation of brokers in March 2000, the Commission has adopted a risk-based regulatory approach. Like the HKMA in regulating the banks, the Commission focuses its attention on the areas and institutions that carry higher risks.

Last month, certain changes regarding the Financial Resources Requirements (FRR) became effective. These changes aim at addressing the illiquid stock problem and avoiding excessive borrowing by brokers who may re-pledge margin clients' stock collateral.

Where necessary, we will also consider imposing licensing conditions on brokers that exhibit specific risks so as to target problem areas and avoid burdening the whole industry with additional restrictions which may be limited to a very small number indeed.

In the area of improvements in the financial infrastructure, we are currently working with HKEx, brokers, depository agents and other intermediaries on third party clearing. The existing clearing system, which requires every single broker to do his own clearing is clearly not as efficient on capital, compared to the global trend of large brokers and better capitalized institutions who provide third party clearing for the smaller brokers.

We want to ensure an open market with a level playing field for all financial intermediaries, namely banks, brokers and online brokers. We see a need to have concerted efforts and coordinated actions among regulators (i.e. the HKMA and the SFC), banks and brokers.
Concluding Remarks

To conclude, the global trend of convergence of the securities, asset management and banking industry is a matter of time. During this convergence period, smaller brokers are concerned about the level playing field between banks and the brokerage sector. The SFC and HKMA are working closely to ensure that regulatory approach is even-handed for all parties concerned.

My personal view is that there are great opportunities for banks and brokers to work together to improve the overall quality of service to the investor community. Indeed, there is a symbiotic relationship between banks and brokers. In almost all developed markets, retail brokers have worked closely with banks in improving retail service - many have moved to become boutique financial planners, working with financial supermarkets that provide the custody and payment services.