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SFC Consults on Guidelines for Securities Margin Financing

I. Introduction

The Securities and Futures Commission (the **SFC**) published a consultation paper[1] on 17 August 2018, proposing additional guidelines on risk management practices for securities margin financing (**SMF**) activities (the **Consultation Paper**). The cut-off date for responding to the consultation is 18 October.

The proposals come in response to the findings of a 2017 review of brokers' margin lending activities by the SFC (**SMF review**) which showed that total margin loans granted by brokers have grown nine times from $21 billion in 2006 to $206 billion in 2017. The SFC also expressed concerns relating to a deterioration in margin loan quality, excessive concentration of exposure to margin clients and individual collateral stocks, particularly non-index stocks[2] and illiquid stocks. The SMF review also identified delays in collecting outstanding margins and inadequate stress testing.

The proposed guidelines consist of qualitative guidance for margin lending policies and risk controls for SMF activities, supplemented by quantitative benchmarks. Non-compliance with any of the quantitative benchmarks will need to be reported immediately to the SFC. Any deviation from the guidelines must be properly justified by equivalent or compensating controls which are no less prudent than those set out in the guidelines.

1 Consultation Paper on the Proposed Guidelines for Securities Margin Financing Activities. August 2018. https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=18CP7

2 A stock which was not a constituent stock of the Hang Seng Index or Hang Seng China Enterprises Index.

The key proposals include:

- a "total margin loans-to-capital multiple" which would restrict an SMF broker's aggregate margin loans to a multiple of either two, three, four or five times its capital;
- a limit on aggregate margin loans advanced to any individual margin client or group of related margin clients to a prescribed percentage of 20%, 30% or 40% of the broker's shareholders' funds;
- strict enforcement of client credit limits and a requirement for waivers to be justified by risk assessments which are approved by management and properly documented;
- the setting of prudent securities collateral concentration limits to avoid excessive exposure to individual securities held as collateral or groups of highly correlated securities held as collateral;
- no granting of waivers for margin calls to margin clients with poor settlement histories or whose outstanding margin loans exceed the market value of the underlying collateral;
- stress tests on excess liquid capital and liquidity to be conducted at least monthly and whenever any material adverse event happens (such as a sharp drop in the price of securities held as collateral.

Hong Kong brokers are reportedly wary of the proposed curbs on margin lending. Christopher Cheung Wah-fung, Legco member representing the financial services sector, has been reported as saying that if there has to be a limit, it should be at the lower end of the proposed restrictions, five times a broker's capital. He also warned that the restriction would limit the money available to invest in the stock market and negatively impact market sentiment.[3]

In determining whether an SMF broker is fit and proper, the SFC will be guided by the proposed guidelines and will adopt a holistic approach and take into account all the circumstances including the seriousness of the deviations, the level of risks, the potential impact on investors, the duration and frequency of the deviations and any remedial measures taken. In general, the SFC will allow a reasonable period of time for the broker to implement rectification and compensating measures. However, in urgent cases, the SFC may take immediate action, such as imposing licensing conditions.

Current Requirements

The current SMF regulatory framework is set out in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**), and the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (**Internal Control Guidelines**). Schedule 5 to the Code of Conduct (**Schedule 5**) provides guidelines on brokers' margin lending policy and related internal risk controls while the Internal Control Guidelines provide general guidelines for risk management, such as setting credit limits and stress testing. Since these conduct requirements are high level or principles-based, brokers apply their own interpretations of the requirements and may fail to consider regulatory standards in designing their risk controls.

II. Proposed Guidelines for Securities Margin Financing Activities

The proposed guidelines are set out in Appendix 1 to the Consultation Paper. They include qualitative requirements for seven key risk control areas, supplemented by quantitative benchmarks. The proposed guidelines will apply to all licensed corporations carrying on SMF activities (**SMF brokers**).

1. Total margin loans controls

Paragraph 2 of Schedule 5 requires an SMF broker to have a prudent margin lending policy, while paragraph 10(a) of Schedule 5 specifies that the margin lending policy should provide a basis for protecting the capital of the SMF broker. The SMF review noted that SMF brokers were increasingly reliant on external funding such as bank borrowings for financing, leading to a high leverage risk.

The SFC proposes to require SMF brokers to set a limit on total margin loans taking into consideration all relevant factors including, amongst others, their liquidity profile and capital, the risk profiles of margin clients and prevailing market conditions. The total margin loans limit should be reviewed and updated at least annually or when there is a significant change in the underlying consideration. SMF brokers are also required to clearly document the basis and methodology for setting its limit.

The SFC also proposes to set a quantitative benchmark called "total margin loans-to-capital multiple" which would restrict an SMF broker's aggregate margin loans to a multiple of either two, three, four or five times its capital. The Consultation notes existing restrictions on brokers' SMF business of three and four times regulatory capital in the Mainland and Singapore, respectively. SMF brokers would be allowed to treat outstanding approved subordinated loans as "capital" for the purpose of calculating the multiple. SMF brokers, in their calculation, may refer to either (i) their latest amounts of shareholders' funds and outstanding approved subordinated loans; or (ii) the amounts of shareholders' funds and outstanding approved subordinated loans reported in their latest monthly financial returns submitted to the SFC. In the event of non-compliance with the benchmark, the SFC would take into consideration each broker's own circumstances, including the quality of its margin loans and its compensating measures, in assessing whether such non-compliance would pose undue risk to the broker. This is to strike a balance between ensuring the adequacy of brokers' capital for covering their business risks and maintaining brokers' competitiveness.

2. Margin client credit limit controls

Paragraph 3 of Schedule 5 requires an SMF broker to be satisfied that a margin client has the financial capacity to meet its obligations. Paragraph 12(a) of Schedule 5 also requires an SMF broker to use objective proof of net income or net worth as a reference for setting credit limits. In addition, paragraph 23 of the Suggested Control Techniques and Procedures

3 SCMP. *"Brokers warn proposed cap on margin lending could reduce trading turnover and even threaten industry's survival."* 6 September 2018. https://www.scmp.com/business/banking-finance/article/2162884/brokers-warn-proposed-cap-margin-lending-could-reduce

in the Internal Control Guidelines sets out the factors to be considered in setting appropriate credit limits. However, despite these existing requirements, most of the brokers covered in the SMF review either failed to strictly enforce the credit limits granted to clients, or determined their margin clients' credit limits based solely on the value of the securities collateral deposited by them.

The SFC's proposes requiring SMF brokers:

- to be prudent in setting the credit limits for individual margin clients or groups of related margin clients to ensure that margin clients have the financial capability to meet their obligations arising from the financing provided. The credit risks of related margin clients should be aggregated for the purposes of setting credit limits and monitoring their interconnectedness and aggregate risks. While "group of related margin clients" is defined in section 42(3) of the Securities and Futures (Financial Resources) Rules (**FRR**), the SFC is consulting on whether its coverage should be extended, e.g. to include margin accounts which are held by the same beneficial owner; and

- to strictly enforce client credit limits and ensure that any waivers are justified by risk assessments which have been approved by management and properly documented.

3. Securities collateral concentration controls

Paragraph 11(c) of Schedule 5 requires an SMF broker to have a margin lending policy to avoid building up excessive exposure to individual securities deposited as collateral. However, different SMF brokers may have a different understanding of what amounts to "excessive exposure". Although the FRR already require a deep haircut (80%) for illiquid collateral to discourage brokers from accepting illiquid stocks as collateral or over-relying on a single stock as collateral, the SMF review reportedly found that securities collateral concentration risks have worsened, particularly in relation to heavily pledged stocks (**HPS**).

The proposed guidelines require SMF brokers to set prudent securities collateral concentration limits to avoid building up excessive exposure to individual securities held as collateral or groups of highly correlated securities held as collateral. The SFC suggests that exposures to different securities held as collateral which are highly correlated should be aggregated for the purposes of monitoring concentration risk. For this purpose, "highly correlated securities" refer to:

a) two or more securities (including bonds, shares or other securities) issued by the same issuer or by different companies within the same group of companies; or

b) two or more securities which exhibit a high correlation in historical price movements, and their issuers either have group affiliations, material cross-shareholdings, significant business affiliations or are engaged in the same industry.

The proposed guidelines provide a non-exhaustive list of factors which SMF brokers should take into consideration when setting securities collateral concentration limits. SMF brokers should clearly document the basis and methodology for determining the limits and monitor and strictly enforce the limits. In addition, the limits should be subject to review at least annually or whenever there is a significant change to any of the underlying factors.

There is no specific formula for setting securities collateral concentration limits and brokers will be free to set their own limits in light of their own circumstances. That said, a set of quantitative benchmarks is proposed for evaluating whether an SMF broker's exposure to individual securities held as collateral is excessive.

The proposed guidelines also require SMF brokers to perform an excess liquid capital (**ELC**) impact analysis for securities held as collateral, by estimating the impact on ELC of a hypothetical stress scenario where the securities being tested are no longer acceptable by the FRR for liquid capital calculation purposes (such as when a listed stock has been suspended from trading for three days or more). By comparing the ELC impact of this scenario with the benchmarks, the broker can test the effectiveness of its concentration limits, which should be tightened if the ELC impact exceeds the proposed quantitative benchmarks.

More lenient benchmarks are proposed for higher-quality securities considering their lower event risk and this proposal aims to encourage brokers to take higher-quality securities as collateral. The proposed quantitative benchmarks are:

a) for securities held as collateral which are constituents of the Hang Seng Index or Hang Seng China Enterprises Index (index stocks), the impact on the broker's ELC under the hypothetical stress scenario shall not be greater than a certain level between 30% and 50% of the ELC;

b) for other securities held as collateral, the impact on the broker's ELC under the hypothetical stress scenario shall not be greater than a certain level between 20% and 25% of the ELC.

The SFC is also consulting on whether constituent stocks of any other stock indices should also be treated as index stocks for the purposes of the ELC impact analysis.

To alleviate the compliance burden and difficulty in performing the ELC impact analysis, the SFC proposes to require brokers to perform the ELC impact analysis on a monthly basis. However, it should be performed on a more frequent basis if the concentration risk increases greatly during the month. SMF brokers may refer to either (i) their latest ELC; or (ii) the ELC amount reported in their latest monthly financial returns submitted to the SFC in performing the ELC impact analysis. Moreover, it is proposed that the ELC to be applied in the ELC impact analysis can be stripped of the effects on the required liquid capital arising from short-term events, such as IPO subscriptions and placement transactions.

4. Margin client concentration controls

Paragraph 11(b) of Schedule 5 requires an SMF broker to have a margin lending policy to avoid building up excessive exposures to individual margin clients or groups of related margin clients, but does not specify what amounts to "excessive exposure". For significant margin loans, an SMF broker is subject under the FRR to a capital charge for the concentration risk when adjusted significant margin loans exceed 10% of the aggregate amount of adjusted margin loans receivable from all clients. However, an SMF broker can lend more than 10% of its total margin loans to a single client provided that it puts in more capital to cover the additional capital charge. Still, the SFC noted that a number of SMF brokers had granted significant margin loans to individual margin clients, each of which exceeded 10% of the broker's total margin loans, with some exceeding half of the broker's shareholders' funds.

The proposed guidelines would require:

a) SMF brokers to set prudent client concentration limits with reference to a number of factors such as their liquidity profiles and capital and their clients' financial situations;

b) a quantitative benchmark which would limit aggregate margin loans advanced to any individual margin client or a group of related margin clients to a prescribed percentage of 20%, 30% or 40% of the broker's shareholders' funds; and

c) SMF brokers to estimate the ELC impact before granting a significant margin loan. A margin loan would be classified as significant if it is greater than 10% of the broker's shareholders' funds.

5. Haircuts for securities collateral

Paragraph 12(b) of Schedule 5 provides general guidelines on the factors to be considered in setting haircut percentages for securities held as collateral. However, no specific haircut percentages are suggested in the Code of Conduct and SMF brokers can decide which securities are acceptable as margin loan collateral and the related haircut table. The SMF review apparently found that some brokers have applied very lenient haircuts to low quality or illiquid collateral, or indiscriminately applied a uniform haircut to all types of securities collateral paying no regard to the differences in their liquidity, quality and volatility.

The SFC proposes to require SMF brokers to:

a) maintain a list of securities accepted for margin financing;

b) document the basis and factors to be considered in setting haircut percentages for the margin lending policy;

c) review the haircut percentages at least annually;

d) strictly apply the haircut percentages; and

e) document the risk assessment and risk mitigation measures to be adopted when a haircut percentage lower than the normal rate is assigned to collateral deposited by a margin client.

The SFC also proposes to establish quantitative benchmarks for re-pledging brokers to set in-house haircut percentages. It is proposed that the haircut percentage set by a re-pledging broker for collateral deposited by margin clients should not be lower than the average of the haircut percentages assigned by its top three lending banks[4] to the same collateral minus a prescribed percentage point and in any event, not lower than the corresponding haircut percentage prescribed in the FRR.

The purpose of the built-in prescribed percentage point is to strike a balance between prudent risk management and re-pledging brokers' business competitiveness. It would act as a buffer in the above formula allowing the brokers' haircut percentages to be lower than their lending banks' by certain percentage points, so that the brokers can lend more to clients than they can borrow from the banks with the same collateral using their own capital. The prescribed percentage point should not be excessive, otherwise it will defeat the purpose of the benchmark. The SFC is proposing to set it at a level between 15% and 20%.

6. Margin calls, stopping further advances and forced liquidation

Paragraph 12(f) of Schedule 5 requires an SMF broker to establish a trigger for margin calls. Nevertheless, the SMF review found that the selected SMF brokers' triggers for margin calls varied. The SFC therefore proposes that an SMF broker should document the basis and factors to be considered in setting margin call triggers in its margin lending policy, and in general, an SMF broker should initiate a margin call when a margin loan exceeds the margin value (i.e. market value minus haircut) of the underlying collateral or the client's credit limit.

Paragraph 12(l) of Schedule 5 requires an SMF broker to put in place appropriate controls to deal with any deviations from its margin lending policy. If these deviations have an adverse effect on an SMF broker's liquid capital position, it should take steps to ensure that it will not, as a result, be in breach of the FRR. Therefore, the SFC further proposes that an SMF broker should stop granting waivers of margin calls to margin clients with poor settlement histories (e.g. failure to meet margin calls on more than 15 occasions in the preceding 30 days) or whose outstanding margin loans exceeded the market value of the underlying collateral.

In addition, the SFC proposes to specify thresholds for outstanding margin call amounts to encourage brokers to take steps to promptly collect margins. Specifically, the SFC proposes that SMF brokers should take reasonable steps to avoid:

i) total unsettled margin calls exceeding the firm's shareholders' funds; and

ii) total long-outstanding margin calls exceeding a prescribed percentage of the firm's shareholders' funds. The SFC has proposed setting the prescribed percentage at a level between 20% and 25% and is consulting on the period (between a minimum of 30 days and maximum of 90 days) for which margin call would need to remain outstanding in order to be treated as a long-outstanding margin call.

In designing this proposal, the SFC has taken into account that it may take time to collect margin from clients and margin calls may arise due to unexpected market movements. Thus, an SMF broker would not be treated as failing to meet these thresholds if it can prove that reasonable steps have been taken to follow-up on outstanding margin calls to protect its interests. Moreover, as these thresholds do not specify how SMF brokers should design their margin call and follow-up procedures, they should tailor-make their policies and procedures according to their business needs, subject to the overarching principle of prudence.

Paragraph 12(i) of Schedule 5 requires an SMF broker to set a trigger for stopping further advances to clients, for example, where there are outstanding margin calls yet to be met. However, the SMF review found that a number of SMF brokers allowed clients with unsettled margin calls to make further purchases using their margin facilities. To address this issue, the proposed guidelines specify the circumstances under which an SMF broker should stop providing further advances or allowing its clients to make further purchases, such as when the margin loan balance has exceeded the market value of the underlying collateral. It is also proposed that SMF brokers should strictly follow their policies on margin calls, stopping further advances and forced liquidation. Where deviation is granted, the broker should conduct and document its risk assessment in detail.

4 If the re-pledging broker has less than three lending banks, it refers to the haircut assigned by its lending bank or the average haircut assigned by its lending banks. The banks' rankings are determined by the amounts of the loans the re-pledging broker has drawn from each bank's credit facilities secured by client collateral.

7. Stress testing

Paragraph 30(c) of the Suggested Control Techniques and Procedures in the Internal Control Guidelines requires licensed corporations to establish and maintain effective risk management measures to quantify the impact of changing market conditions on the firm.

The proposed guidelines require SMF brokers to regularly conduct stress tests on their ELC and liquidity (at least monthly) and whenever any material adverse event happens (such as a sharp drop in the price of the securities held as collateral) so as to quantify the impact of stress situations. Various hypothetical stress scenarios are provided in the proposed guidelines, which are designed for collateral pools composed of different weightings of higher-quality stocks. A broker is required to choose the appropriate scenario according to the composition of its collateral pool. For simplicity, each hypothetical scenario assumes a uniform percentage price drop for all the stocks in the pool of collateral provided by all borrowing margin clients. The suggested hypothetical scenarios are as follows:

i) [X%] price drop, if 75% or more of the collateral pool in terms of market value are index stocks;

ii) [Y%] price drop, if less than 75% but more than 25% of the collateral pool in terms of market value are index stocks; and

iii) [Z%] price drop, if 25% or less of the collateral pool in terms of market value are index stocks;

where X < Y < Z.

It is suggested a hypothetical price drop of 15% to 30% should be applied where the collateral pool mainly comprises index stocks, whereas for a collateral pool comprised of few index stocks, the hypothetical price drop should be between 30% and 50%. The SFC is consulting on whether the suggested thresholds (i.e. 75% and 25%) as the dividing line for distinguishing a high-quality collateral pool from a low-quality collateral pool are appropriate. It is also consulting on whether constituent stocks of any other stock indices should be treated as index stocks for the purposes of stress testing.

The proposed guidelines further require an SMF broker to conduct stress tests on its ELC for the hypothetical scenario of a significant group of highly correlated securities held as collateral losing its value. Any group of highly correlated securities with an aggregate market value equals 10% or more of the total market value of the collateral pool provided by all borrowing margin clients would be considered as significant.

In addition, given the large amount of margin client securities collateral being re-pledged (a total market value of $85.6 billion as at 31 December 2017) and the fact that most brokers re-pledge margin client securities collateral on a pooled basis, the proposed guidelines require re-pledging brokers to perform stress tests on their liquidity to ensure that it is maintained at a sufficient level. It is proposed that stress tests be performed using the assumption that the values of all re-pledged margin client securities collateral plunge in a stress scenario, similarly to the hypothetical stress scenarios provided for the margin client securities collateral re-pledged, with the collateral pool substituted by the pool of margin client securities collateral re-pledged.

Moreover, a re-pledging broker would be required to assess the impact on its liquidity of stock concentration in the re-pledged portfolio by performing stress tests for the scenario of a significant re-pledged securities collateral or a significant group of highly correlated re-pledged securities collateral losing all its value. A significant re-pledged collateral is defined as having a market value amounting to 10% or more of the total market value of the re-pledged portfolio, and a significant group of highly correlated re-pledged collateral as having an aggregate market value amounting to 10% or more of the total market value of the re-pledged portfolio.

SMF brokers will be allowed to apply their own stress testing models and stress scenarios provided that they are no less prudent than those suggested in the proposed guidelines. Brokers should clearly document the methodology for stress testing models including the data sources, the assumptions applied and the justification for deploying them in lieu of those suggested in the proposed guidelines. The stress test results are indicators of the SMF broker's resilience under stress situations. Although it does not mean that a broker will immediately run into financial difficulties if it cannot pass a stress test, the broker must follow-up on the stress test results in a timely manner, examine its risk exposures, report the stress test results and any risk issues to senior management and, where appropriate, take pre-emptive action and plan for market contingencies. The SFC will take into account brokers' stress test results and follow-up actions in assessing their resilience under stress situations as well as the adequacy and effectiveness of their risk management.

III. Notification Requirement

Apart from the existing obligation under the Code of Conduct to notify the SFC of material breaches, it is proposed that an SMF broker will be required to report to the SFC immediately if it fails to comply with the quantitative benchmarks specified in the proposed guidelines or pass the stress test on its ELC or liquidity performed in accordance with the proposed guidelines to enable the SFC to follow-up with it on any risk issue underlying the non-compliance. The report to the SFC must include full details of the matter and the reasons for the non-compliance or stress test failure; and any measures it has taken, or is taking or proposing to take to deal with the non-compliance. Where an SMF broker cannot pass a stress test, it will have to provide the SFC with a detailed contingency plan.

IV. Implementation Timeline

The SFC proposes to provide a six-month transition period for the industry to ensure compliance after the gazettal of the guidelines.

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