

Guidelines for Securities Margin Financing Activities

April 2019

On 4 April 2019, the Securities and Futures Commission (SFC) released a paper on the conclusions of its consultations on the *Proposed Guidelines for Securities Margin Financing Activities* (the Guidelines). This circular provides an overview of requirements under the Guidelines and explores key implications for securities margin financing (SMF) brokers, i.e. licensed corporations (LCs) and licensed persons in Hong Kong carrying on SMF activities.

What is the latest development?

The current conduct and risk control requirements for SMF activities are mainly 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).

Following the review conducted by the SFC, SMF activities in Hong Kong have grown significantly. The total margin loans granted by brokers grew nine times from 2006 to 2017. The SFC also observed in its review that SMF brokers have been taking more financial risks. The SFC further noted that certain SMF brokers may have adopted aggressive margin lending practices and may not have robust risk controls in place. These two developments pose a threat to the financial stability and integrity of Hong Kong's brokerage markets.

In light of these findings, the SFC issued a consultation paper in August 2018 setting out the Guidelines, which are intended to provide SMF brokers with details of the general regulatory expectations related to SMF activities and provide guidance on how to fulfill the requirements prescribed in the Code of Conduct and Internal Control Guidelines.

The consultation was concluded and the finalized Guidelines were issued on 4 April 2019.

Who will be affected?

The Guidelines apply to all LCs carrying on SMF activities, i.e. **SMF brokers** who are:

- Licensed for **Type 1** regulated activity who provide **financial accommodations** to their clients in order to **facilitate the acquisition or holding of listed securities** by them for their clients; and
- Licensed for **Type 8** regulated activity

The Guidelines **do not apply to initial public offering (IPO) loans**, in other words, IPO loans will not be treated as margin loans for the purposes of the Guidelines.



When will it be effective?

The SFC provides **6 months transition period**. The Guidelines were gazetted on 4 April 2019 and will be effective on **4 October 2019**.



What are the requirements?

The Guidelines set out minimum standards for margin lending policies and risk controls expected of for SMF brokers. Qualitative guidance and supplementary quantitative benchmarks are provided in the Guidelines to guide SMF brokers in designing their margin lending policies and risk controls for SMF activities. The Guidelines cover different requirements set out by the SFC regarding SMF business. The chart on the next page provides an overview of the requirements set out in the Guidelines.

What are the requirements? (cont.)

Total Margin Loans Controls

- There should be **prudent total margin loans limits** commensurate with risk profiles and other prescribed factors to control the total amount of margin loans.
- SMF brokers should ensure their **total margin loans-to-capital¹ multiple does not exceed five²**.
- The total margin loan limits should be **reviewed regularly, at least annually**.

Margin Client Credit Limit Controls

- SMF brokers are required to implement **prudent credit limits for individual or groups of connected margin clients³**. The limits should be commensurate with the financial capabilities, profiles and other prescribed factors of the margin clients. SMF brokers should measure their own exposure to the **aggregate exposure** of each group of clients and **determine credit limits at the individual client level and group level**.
- The margin client credit limits should be **reviewed regularly, at least annually**.

Securities Collateral Concentration Controls

- Implementations of **prudent concentration limits for exposure to individual securities collateral or groups of connected major securities collateral⁴** are required. The concentration limits should be commensurate with the quality of the securities, risk profiles of loans and other prescribed factors.
- Regular (at least monthly) assessment should be made to determine if any **two or more of major securities collateral of SMF brokers are connected**. The concentration risks of connected securities collateral should be properly managed once SMF brokers become aware of the connection.
- Concept of **“connected”** is introduced in the Guidelines. Securities collateral are considered as connected if:
 - They are issued by the same issuer or **members of the same group**; or
 - Adverse events affecting one issuer is **likely to materially impact** the financial soundness of other issuers or impact the market prices of other securities. SMF brokers should consider all factors in making this assessment, including common control, significant business affiliations, cross investments and significant financial relationships among the issuers.
- SMF brokers should assess the effectiveness of the limits and concentration risks of individual securities collateral by performing **excess liquid capital (ELC) analysis** regularly, at least on a monthly basis. In the ELC analysis, they are required to measure the impacts on its ELC by **stressing the value of securities collateral to zero**. The estimated impacts on ELC of SMF brokers should be compared to quantitative benchmarks prescribed in the Guidelines. The SMF brokers should tighten the related concentration limits for any securities with ELC impacts exceeding the benchmark.
- The securities collateral concentration limits should be **reviewed regularly, at least annually**.

Margin Client Concentration Controls

- There should be **prudent concentration limits for exposure to individual margin clients or groups of connected margin clients**. The concentration limits should be commensurate with the quality of the collateral, risk profiles of clients and other prescribed factors.
- SMF brokers should limit their **exposure to a margin client or a group of connected margin clients to 40%² of their shareholders' funds**.

¹ It means total amount of margin loans granted divided by the capital of the SMF brokers. Capital refers to the sum of shareholders' funds and any outstanding subordinated loans approved by the SFC. The amount of subordinated loans is limited to shareholders' funds for the purpose of calculating this multiple.

² These quantitative benchmarks are only applicable to SMF brokers who comply with all other applicable provisions and have a high quality margin loan portfolio. Other SMF brokers should adopt lower benchmarks.

³ Group of connected margin clients includes group of related margin clients as defined under section 42(3) of Securities and Futures (Financial Resources) Rules (FRR), margin accounts held by the same beneficial owner and margin clients financially connected by guarantee.

⁴ Major securities collateral means any of the **ten largest securities collateral** (by aggregate market value) provided by borrowing margin clients. Any securities issued by a listed company whose share is a constituent of the Hang Seng index and any securities for which the FRR prescribe a haircut percentage of 100% are **excluded** from major securities collateral.

What are the requirements? (cont.)

Margin Client Concentration Controls (cont.)	<ul style="list-style-type: none"> • The impact of default and stress situations on ELC should be assessed before granting significant margin loans. Significant margin loans are margin loans exceeding 10% of shareholders' funds of the SMF brokers. • The margin client concentration limits should be reviewed regularly, at least annually.
Haircuts for Securities Collateral	<ul style="list-style-type: none"> • A list of acceptable securities as collateral for margin lending purposes should be maintained. • SMF brokers should implement prudent haircut percentages to individual securities collateral by considering the financial situation of the issuers, historical price volatility, market liquidity and other prescribed factors. • For re-pledging brokers, SMF brokers that re-pledge collateral received from clients, the haircut percentage implemented for securities collateral should not be lower than the average of the haircut percentages assigned to the same security by their top three lending banks minus 20%⁵. The haircut percentage must not be lower than the applicable haircut percentage prescribed under the FRR or 80% in the case of illiquid collateral. • The haircut percentage should be reviewed regularly, at least annually and quarterly for re-pledging brokers.
Margin Calls, stopping further advances and further purchases of securities, and forced liquidation	<ul style="list-style-type: none"> • There should be prudent triggers for margin calls, for stopping further advances and further purchase of securities, and forced liquidation. • SMF brokers should make margin calls immediately, subject to minimum transfer amounts, when the outstanding margin loan balance exceeds the lowest of the margin value of collateral, credit limits of margin clients and other pre-determined amounts in the policies of the brokers. • The total balance of outstanding margin calls⁶ should not be higher than shareholders' funds of SMF brokers and the total balance of long-outstanding margin call, which has an age of more than 90 days, should not exceed 25% of shareholders' funds of SMF brokers. • Waivers on margin calls must cease to be provided to margin clients who have poor settling histories or whose outstanding margin loan balance exceeds the market value of the collateral. Further advances and further purchases using margin facilities of SMF brokers cannot be granted to these clients with outstanding margin calls. • Credit limits to any margin clients (and their connected parties) should be reviewed immediately if these clients are found to have poor settling histories. • The policies over these processes should be reviewed regularly, at least annually.
Stress testing	<ul style="list-style-type: none"> • Stress tests on ELC and liquidity should be performed by SMF brokers regularly, at least monthly. The stress testing⁷ should be performed for: <ul style="list-style-type: none"> ▪ Prescribed scenarios for securities collateral provided by all borrowing margin clients, ▪ Scenarios stressing value of a significant group of connected securities collateral⁸ to zero, ▪ Prescribed scenarios for re-pledging brokers, subject to certain exemptions. • Details and results of stress tests performed are required to be documented. Escalation procedures for reporting the results of stress tests and any follow-up actions should also be documented. • Prompt and effective pre-emptive measures, such as contingency plans to prevent insolvency, liquidity squeeze and non-compliance of FRR, should be in place in accordance with the results from stress testing.

⁵ It applies to any share listed on The Stock Exchange of Hong Kong Limited, excluding any share which has been listed for less than six months consecutively. The re-pledging brokers should deem the average bank haircut percentage to be 100% if none of top three lending banks accept the particular security as collateral.

⁶ It means unsettled margin shortfalls for all margin calls that have been made or should have been made by the SMF brokers.

⁷ Other not less prudent stress testing methodologies or scenarios may be used. Documentation and justifications should be made by SMF brokers.

⁸ Significant group of connected securities collateral means any group of collaterals, which the SMF brokers are aware that they are connected, with aggregate market value equal to 10% or more of the total market value of the securities collateral provided by all borrowing margin clients.

What are the requirements? (cont.)

Margin Lending Policy

The following areas should be included in the **margin lending policy** of SMF brokers:

- Methodology and factors for determination of all applicable limits, haircuts for securities collateral and triggers of margin calls and other controls,
- Details of stress testing,
- Pre-emptive measures to be adopted,
- Requirements that SMF brokers should strictly enforce and monitor the compliance of all provisions, and immediate rectification and escalation should be made on any material breach,
- Requirements that any waivers or deviations of the policies should be assessed, mitigated, justified, documented and approved by senior management of SMF brokers.

Notification Requirement

- SMF brokers are required to **report with full details to the SFC immediately** once they are aware of any breaches in benchmarks set out in the Guidelines or any failure in passing stress tests on ELC or liquidity prescribed in the Guidelines.

What actions should be taken by SMF brokers?

- **Determine quantitative benchmarks** as required in the Guidelines.
- **Design and revise their margin lending policies and risk controls on SMF activities** in accordance with the requirements set out in the Guidelines.
- **Prepare for the implementation of the limits, controls, analysis and testing** prescribed. **Any deviations** from the Guidelines **must be properly justified** by equivalent or compensating controls which are at least as prudent and effective as those set out in the Guidelines.



What are the key challenges for SMF brokers?

Operations

- SMF brokers may lack knowledge and resources to apply the new requirements, perform the required quantitative analysis and stress tests, or identify and monitor "connected" clients and securities under the new requirements.
- Brokers may not have sufficient experience to use required factors to assess and document exposure limits.
- Existing systems may not have the capability to capture, store and/or process required data.



Internal controls and processes

- SMF brokers need to design and implement robust and adequate control processes and deploy systems to fulfill the requirements and monitor the quantitative benchmarks.
- Margin management and control processes may be required to be strengthened and uplifted.
- The design and implementations of controls and procedures governing the review and monitoring of quantitative limits and other requirements may require fundamental changes to systems and processes.



Policies and client agreements

- A large volume of SMF policies and procedures across functions need to be reviewed and revised.
- The repapering of existing client agreements for revising limits, collateral requirements, haircut and margin call processes may be costly and time-consuming.



Funding

- The size of capital, shareholders' funds and ELC of SMF brokers may constrain current and future SMF business given the new total margin loans-to-capital multiple.
- Market fluctuations and uncontrollable factors may require sudden and significant additional funding.



How can KPMG help?





KPMG can provide SMF brokers with assistance in relation to the gap analysis and implementation of the Guidelines. KPMG is well-placed to provide support in areas including but not limited to:

Impact analysis

- Conducting awareness and knowledge training across business lines and functional groups.
- Performing impact analysis of the Guidelines, the impact analysis can cover:
 - Operations, systems and infrastructure,
 - Internal controls and processes,
 - Policies and procedures,
 - Capital and funding.
- Identifying any systems, operations, controls, policies and funding gaps in order to fulfill the requirements of the Guidelines.



Implementation

 Operations	 Internal controls and processes	 Policies and Client agreements	 Funding
<ul style="list-style-type: none"> • Developing new tools and models for SMF brokers to fulfill the requirements • Designing procedures and metrics of relevant factors for the required assessment, monitoring and documentation • Advising on data architecture and system design necessary to the implement the Guidelines • Where necessary, facilitating the process and recommending vendor selection for systems enhancements 	<ul style="list-style-type: none"> • Assisting in designing and implementing controls and processes to monitor the quantitative benchmarks and fulfill other requirements • Providing guidance in designing robust and adequate margin management and control processes • Advising on the governance framework for controls and processes under the requirements 	<ul style="list-style-type: none"> • Assisting in reviewing and enhancing the existing policies of SMF business • Assisting in designing and implementing additional required SMF policies to fulfill the requirements • Assisting in reviewing existing client agreements and providing suggestions on amendments • Assisting in repapering the updated client agreements with clients 	<ul style="list-style-type: none"> • Reviewing financial data and loans portfolio to advise on optimistic capital structures for current and future SMF business plans • Advising on operational models to achieve higher regulatory capital efficiency



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