

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

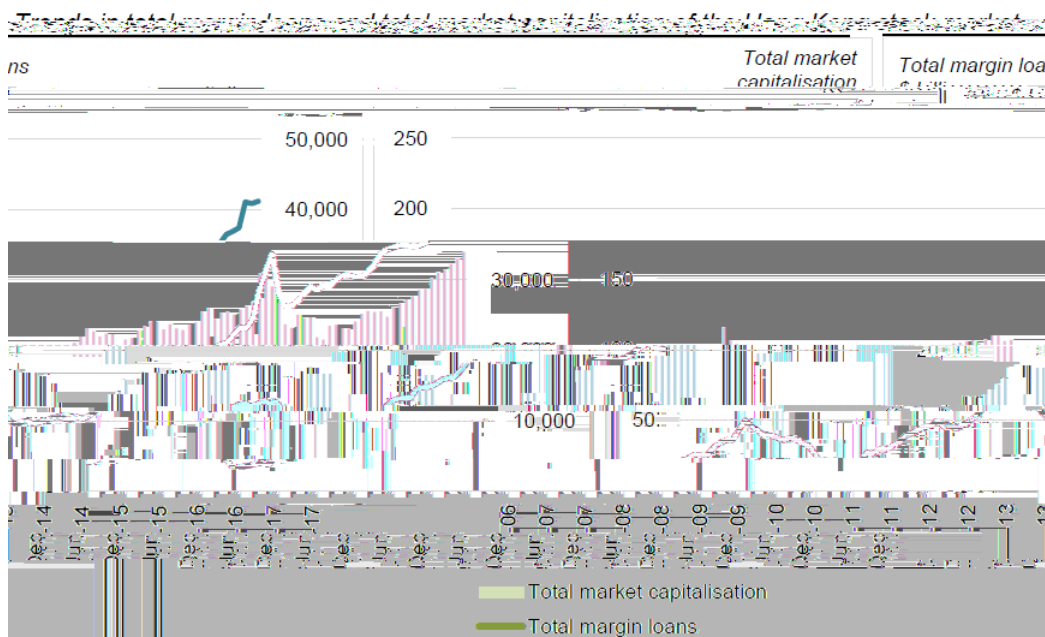
Covered the 20 largest SMF brokers

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)



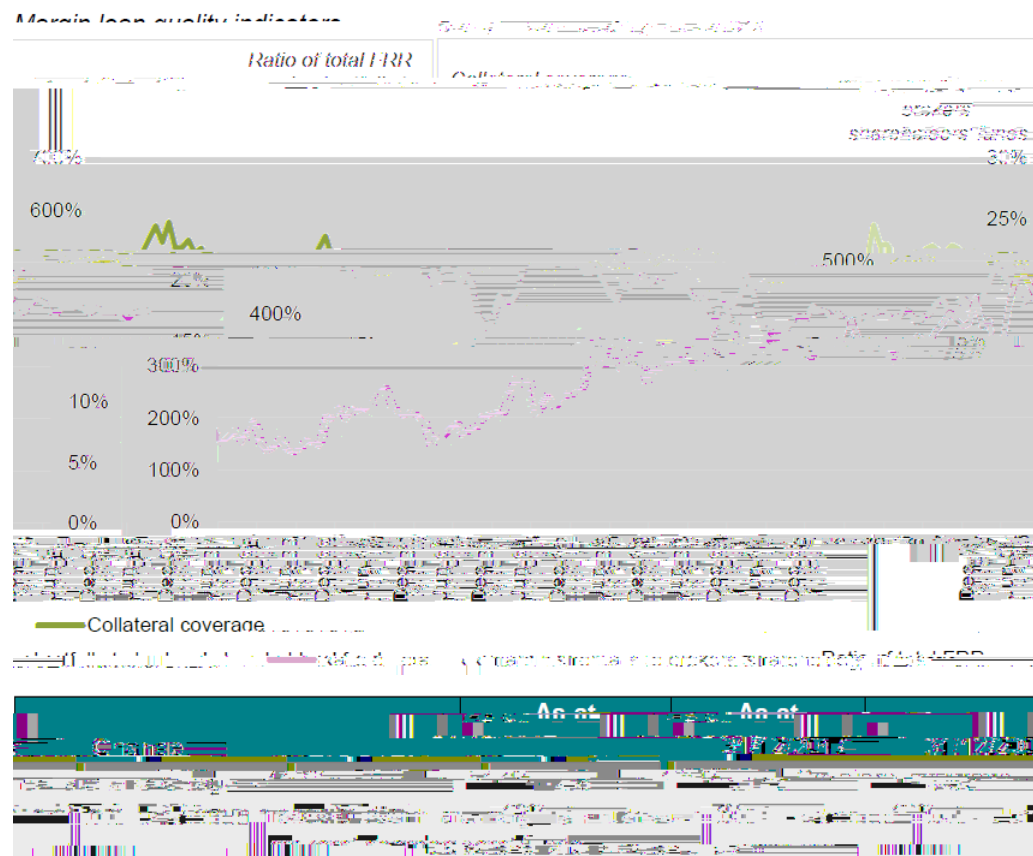
	As at 31/12/2017	As at 31/12/2006	Change
Total market capitalisation	\$41,100 billion	\$27,000 billion	52%
Total margin loans	\$206 billion	\$23 billion	800%
Number of SME brokers	315	224	41%
Margin clients	337,608	80,348	320%
Number of active margin clients	206,000	64,000	320%

SMF review findings

Significant deterioration in margin loan quality

FRR margin shortfall (Note) as
(7% in 2006)

Collateral coverage dropped to 4 times in 2017 (5 times in 2006)



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)



Single securities collateral

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

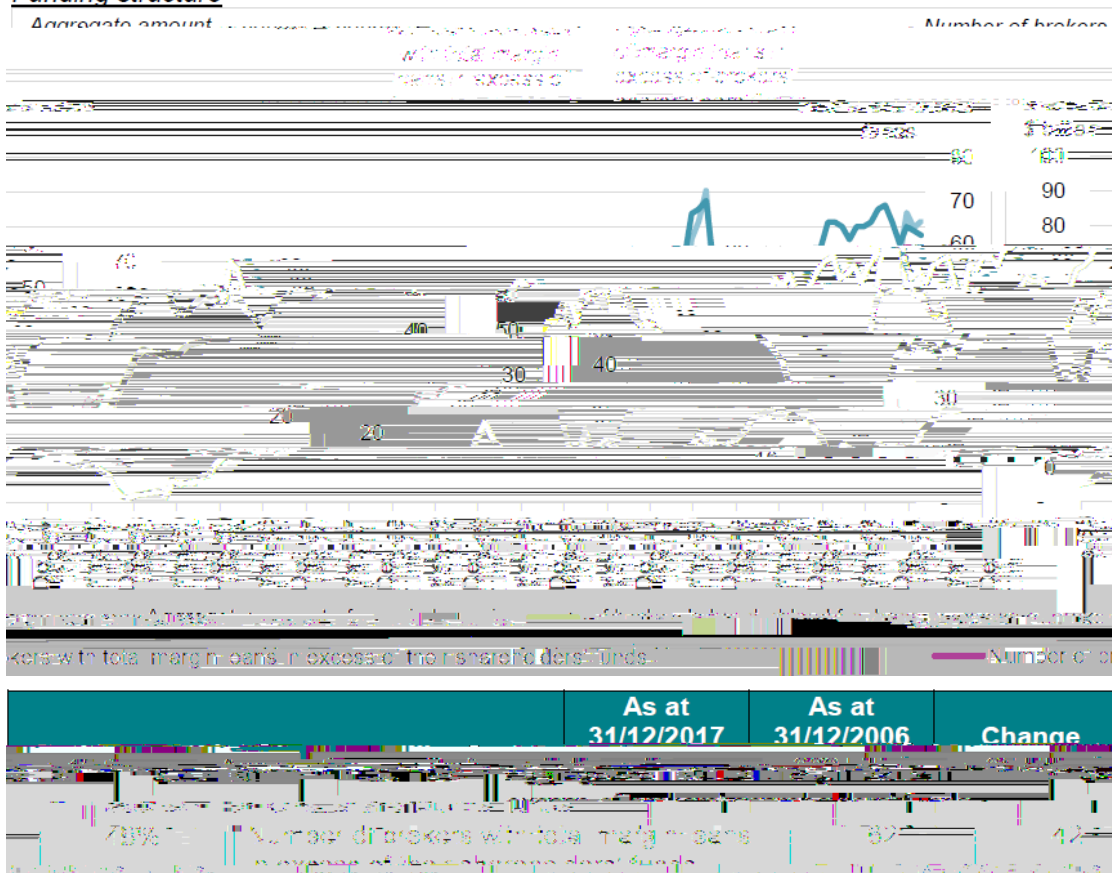
Note : A stock reported by an SMF broker in its monthly financial return as among the top 3

SMF review findings

Increased reliance on bank borrowings

SMF brokers

Funding structure



SMF review findings

Increased

SMF review findings

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 capability

SMF guidelines

Overview

Effective date

4 October 2019

Scope of application

Apply to:

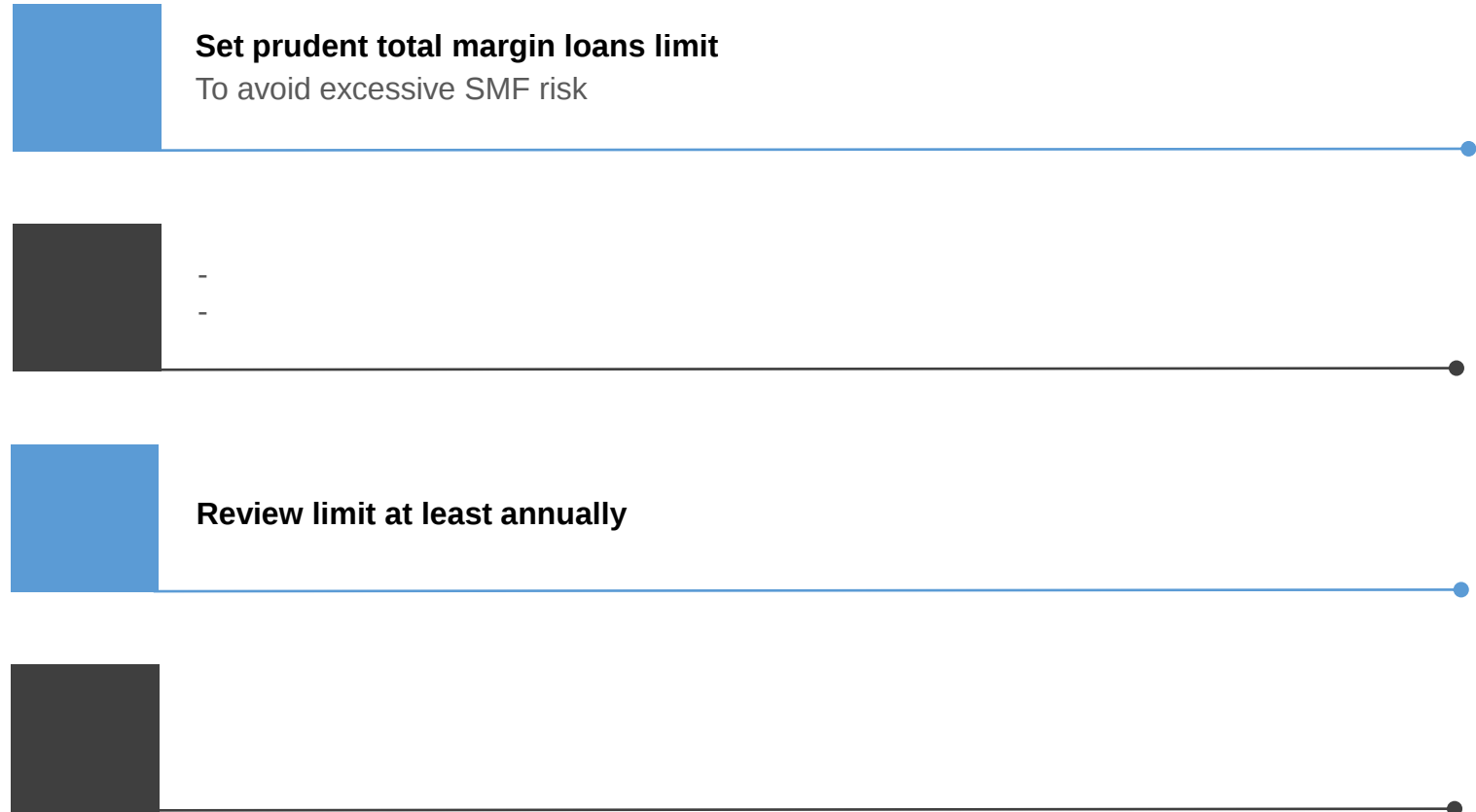
persons licensed for Type 1 regulated activity (dealing in securities) who provide financial accommodation to any of their clients in order to facilitate acquisitions or holdings of listed securities

SMF guidelines

Risk control areas

2

1. Total margin loans controls



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

-
- 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 marketng (en-US)>> BD2(/F2 12 Tf1 0 0 1 ..000010729 0 720 540go 18/Lang (en-US)>> BD q

3. Securities collateral concentration controls (cont'd)

Assessment and identification of connected major securities collateral

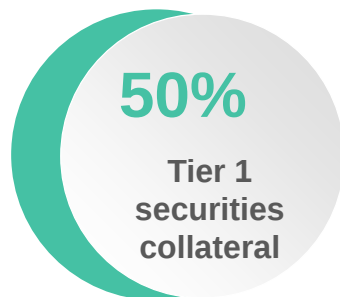
Only major securities collateral is subject to regular (at least monthly) assessment

3. Securities collateral concentration controls (cont'd)

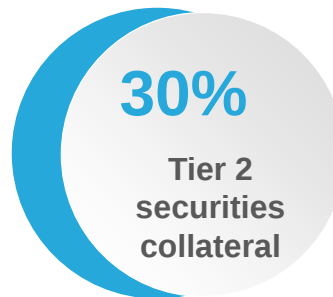
Excess Liquid Capital (ELC) impact analysis

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)

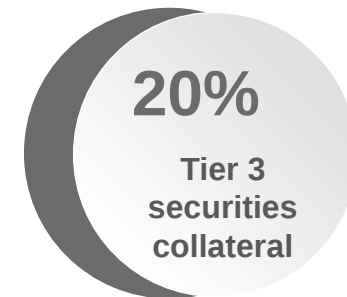
Quantitative benchmarks of the ELC impact



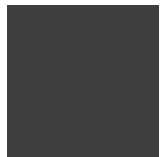
1. **Securities collateral being a constituent stock of:**
 - a) Hang Seng Index;
 - b) Hang Seng China Enterprises Index;
 - c) FTSE 100 Index;
 - d) Nikkei Stock Average;
 - e) S&P 500 Index; or
 - f) Euro Stoxx 50 Index
2. **Qualifying debt securities, special debt securities or specified securities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



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%**



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



5. Haircuts for securities collateral (cont'd)

5. Haircuts for securities collateral (cont'd)

Additional benchmarking requirement for re-

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:



funds



Total amount of long-outstanding margin call (i.e. outstanding for more than 90 days) > 25%

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

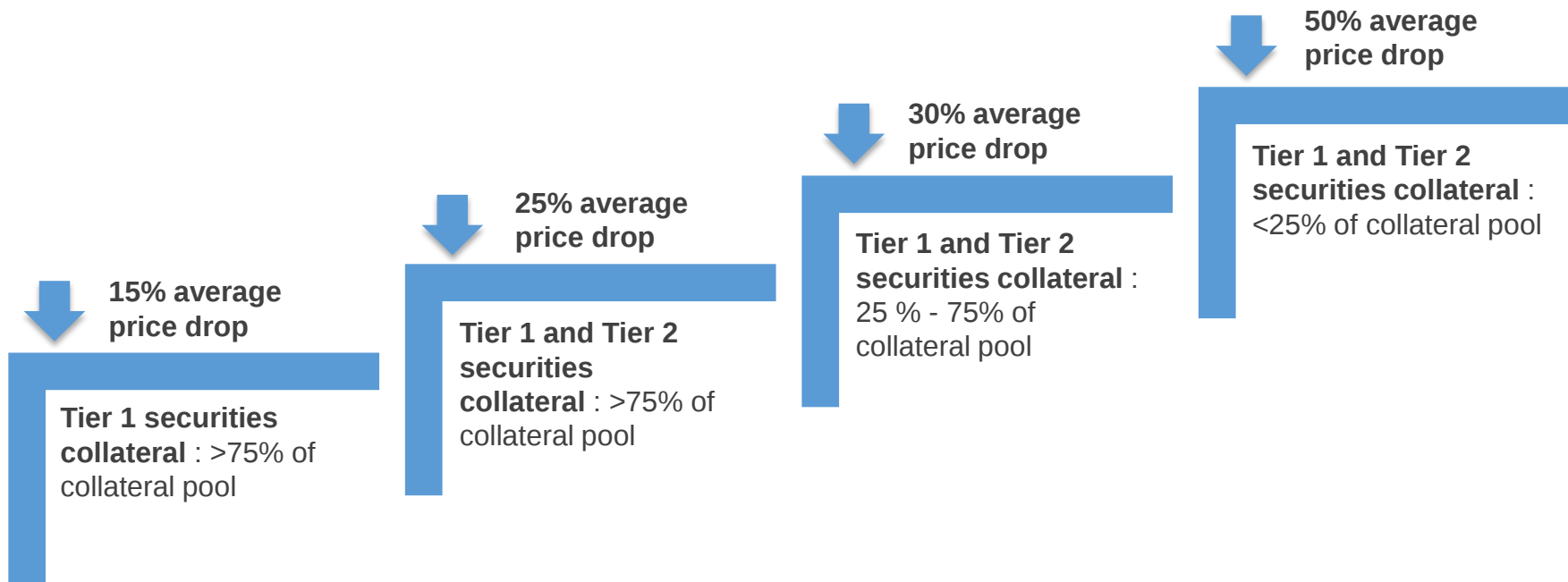
regularly (at least monthly); and

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

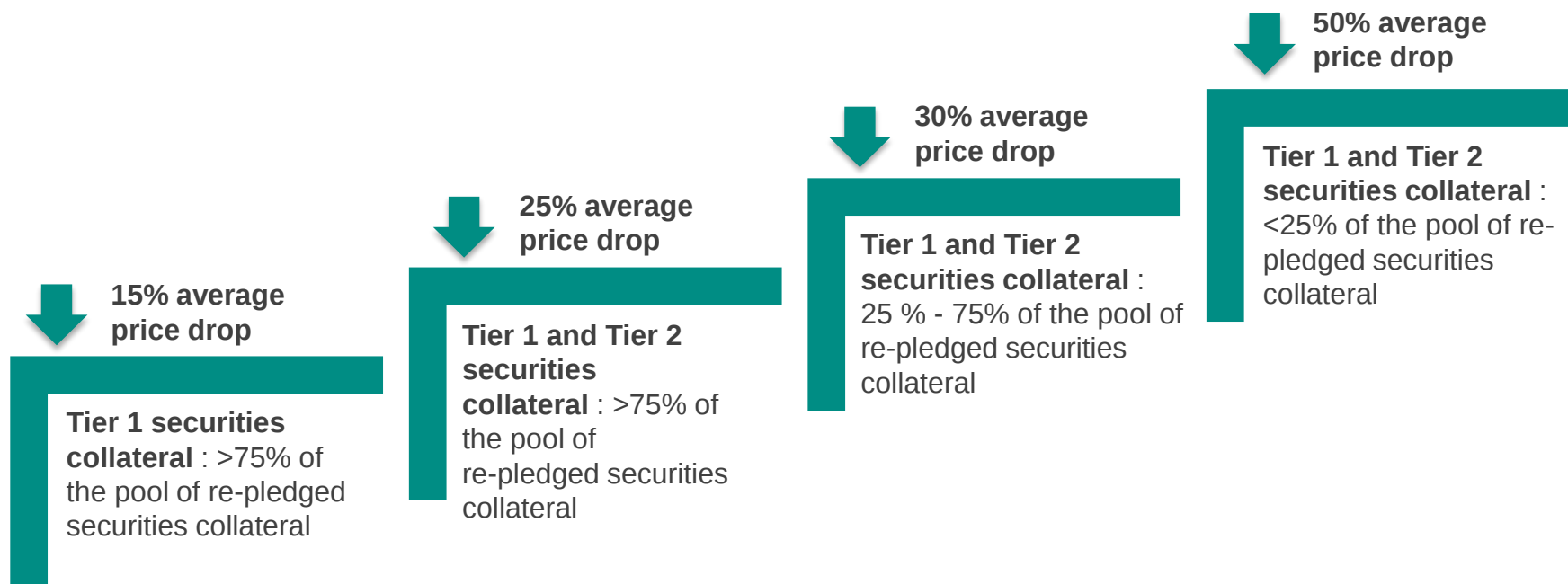
To quantify the impact on broker's ELC under the applicable hypothetical scenario, which assumes an uniform price drop of securities collateral provided by all borrowing margin clients



7. Stress testing (cont'd)

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

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 bird graphic, possibly a phoenix, is positioned on the left side of the slide. The bird is depicted in profile, facing right, with its wings spread wide. The design is composed of several overlapping, curved shapes that create a sense of movement and form. The color is a muted teal or seafoam green. The background is a solid, very light cream or off-white color.

Thank you.

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