Update to the HKMA's Supervisory Policy in relation to share margin financing

October 2021

On 22 October 2021, the Hong Kong Monetary Authority ("HKMA") wrote to the Chief Executives of all Authorized Institutions informing them of an update to the HKMA's supervisory policy in relation to share margin financing. The update relates to the HKMA's supervisory requirements contained in module CR-S-4 of the supervisory policy manual which Authorized Institutions in Hong Kong must follow when granting loans to customers which are secured by share collateral ("share margin financing").

Given that share margin financing is a key component of the 'Lombard Lending' collateralized loan product offered by private banks and wealth managers to their clients in Hong Kong, all private banks and wealth managers should pay particular attention to this policy change. On the one hand, it provides banks with an opportunity to achieve greater alignment between their Hong Kong Lombard Lending product and the same product offered in other jurisdictions. On the other hand, the HKMA has indicated that it has clear expectations on the robustness of credit risk management and mitigation controls which banks must have in place to ensure that their share margin financing exposures remain appropriate collateralized, especially in periods of market volatility. The HKMA has stressed that this change in supervisory policy does not reflect an intention to relax the existing supervisory standards on AIs' share margin financing business. The HKMA also stated that going forward, they will proactively assess whether AIs are prudent in setting maximum loan-to-value ("LTV") ratios by stepping up surveillance and collection of data.

Overview of the revised supervisory policy for share margin financing

Previous supervisory policy (CR-S-4)	Revised supervisory policy (22 October 2021 update)
Maximum LTV ratio for each category of Stocks • Lending AIs may adopt different ratios depending on their level of expertise and proficiency in share margin financing. • However, they should exercise prudence in setting the ratios and have regard to the underlying financial strength, liquidity and price volatility of individual stocks. • If the maximum loan-to-value ratios adopted by a lending AI exceed the prevailing market norms , the AI should discuss the situation with the HKMA. • As a reference, the current market norms are: (i) around 50-60% for blue chips (with higher ratios of, say, 70% adopted by lending AIs which are specialised in share margin financing and have the expertise and sophisticated risk management systems to control the risks involved); and (ii) around 30-40% or below for selected second and third liners. • Lending AIs should note that such market norms may change from time to time according to market situations.	Maximum LTV ratio for each category of Stocks • Considering the global nature of Hong Kong's wealth management and private banking business, and benchmarking against the latest supervisory practices in other major financial centres, the HKMA is of the view that continued enforcement of the requirement to observe market norms in the setting of maximum LTV ratios is no longer appropriate. Starting from 22 October 2021, AIs are no longer expected to fulfil this requirement. • AIs should continue to undertake share margin financing business in a prudent manner. In setting maximum LTV ratios for share collateral, AIs should give due regard to key factors such as their credit risk appetite, risk characteristics of individual stocks, and their expertise and proficiency in margin call management. • Other requirements in the SPM module will continue to apply. • Going forward, the HKMA will proactively assess whether AIs are prudent in setting maximum LTV ratios by stepping up surveillance and collection of data.

LTVs for Hong Kong Share Margin Financing are capped at 70% to comply with the HKMA requirement on market norms

Requirement to observe market norms in the setting of maximum LTV ratios no longer applies but maximum LTV ratios should be set with due regard to relevant factors including credit risk appetite, risk characteristics of individual stocks and expertise/proficiency in margin call management

The updated requirements impact a number of key steps in the Share Margin Financing Process

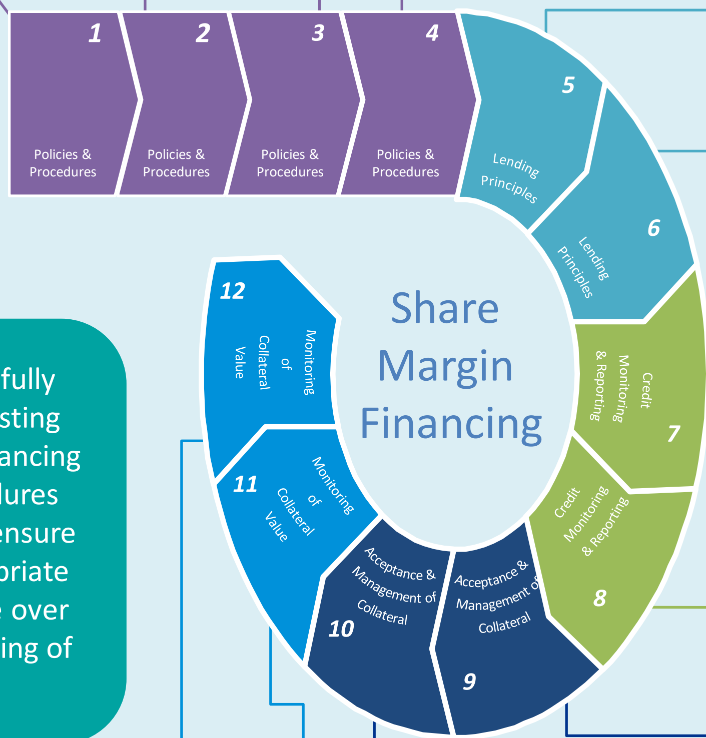
Board/Senior Management Approvals
- Board/Senior Management review and approve key share margin financing policies & procedures including credit assessment criteria
- Risk appetite set and translated into overall exposure limit for share margin financing

List of acceptable stocks and corresponding LTVs approved
- **List of stocks which may be accepted as collateral is approved and subject to regular review and updating.**
- **Minimum market cap applied to prohibit lending against thinly traded stocks.**
- **Maximum LTV ratio set for each category of stocks.**

Other key limits set/reviewed
- Minimum margin requirement.
- Margin call/liquidation triggers
- Maximum loan amount to single borrower or group of connected borrowers.
- Maximum % of shares in single company that can be accepted.
- Other concentration limits.

Credit authorities
- Credit approval criteria set
- Limits set for specific clients/industries/geographies
- Clear criteria and guidance set for any exceptions or deviations from standard policies and limits including LTVs, margin call triggers and liquidation triggers.

Credit Decision
- Credit decisions must be supported by adequate evaluation of the borrower's repayment ability based on reliable information
- Related borrowers are identified in order to ensure that total exposures to groups of connected borrowers can be monitored (and large exposure limits complied with)



AIs should carefully review their existing Share Margin Financing Policies, Procedures and Systems to ensure there are appropriate controls in place over the prudent setting of LTV ratios

Regular review of lending criteria
- **List of acceptable stock collateral is subject to regular review as market conditions change**
- **Regular monitoring of LTV ratios in light of economic/market conditions**
- **Factors considered include volatility in the price and trading of such stocks, the financial strength and prospects of individual companies.**

Daily credit monitoring
- **Daily monitoring of share margin loans (including LTV)**
- Daily management reporting of key metrics
- Follow-up actions triggered immediately limits are breached

Other credit monitoring & reporting
- **Regular stress testing to assess resilience of portfolio to a significant decline in stock prices**
- Regular internal audit reviews
- Board and senior management reporting on credit quality

Prompt action when clients fail to meet margin calls
- Block is put on any further drawdowns by clients who fail to meet margin calls.
- Follow-up actions for clients who fail to meet margin calls are documented and escalated.
- Forced liquidation process.

Daily collateral monitoring
- Systems revalue the portfolio intraday at short notice or on a continuous basis whenever there is a need to do so
- Margin call triggers set at appropriate level.
- Accounts with insufficient margin are required to be topped up immediately.

Loans & collateral documentation and record keeping
- Verification of loan and collateral documents
- Regular reconciliations with custodian records
- Breaks promptly investigated

Controls over custody of pledged shares
- Verification of existence and ownership of pledged shares
- Controls to ensure control of collateral is obtained prior to loan drawdown
- Pledged shares held in name of AI's nominee company

Key considerations for setting prudent share margin financing LTVs

Risk Appetite - LTV methodology should be clearly documented and linked to the AIs overall risk appetite for credit risk including country risk	**Risk Characteristics of Individual Stocks** – Market and liquidity risk of individual stocks needs to be taken into account, including risks arising from small cap or thinly traded shares	**Margin Call Management** – Speed and effectiveness of margin call management process needs to be taken into account to ensure LTV ratio incorporates an appropriate margin period of risk

HKMA will proactively assess appropriateness of LTVs

Effective use of RegTech will be key to ensure compliance

- The HKMA has stated they will **proactively assess** whether AIs are prudent in setting maximum LTV ratios by stepping up **surveillance** and **collection of data**.
- AIs which continue to rely on static LTVs referencing 'market norms' (such as the 70% cap for blue chips) will likely find that they will be challenged by the HKMA which will use data obtained from market sources as well from the AI itself via regulatory reporting to **proactively identify cases where LTVs set by the institution are no longer appropriate given changes in the risk profile of individual stocks**.
- AIs should effectively harness regulatory technology ("RegTech") to implement a **dynamic methodology** which updates LTVs to take into account the changes in market risk and liquidity risk profiles of individual stocks.
- **Timely monitoring** of share margin exposures against the updated LTVs and **prompt issuance and tracking of margin calls** is also necessary to ensure compliance with the HKMA's expectations for prudent risk management of share margin financing.

How can KPMG support you?

- Advise on the impact of the updated requirements on your Lombard Lending product, related processes and internal controls.
- Benchmark processes and internal controls to market practices and regulatory expectations.

- Advise on the design and parameters for models used to set LTVs.
- Perform independent validation of models used to calculate LTVs for individual stocks.
- Benchmark and compare models used to market practices and regulatory expectations.

- Advise on 'RegTech' solutions which can automate key aspects of the Lombard Lending process including LTV setting, collateral monitoring, margin call process and portfolio liquidations.
- Advise on 'RegTech' solutions which can automate key aspects of the credit decisioning and review process, satisfying the regulatory expectation that all accounts are reviewed at least annually.

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