The Securities Lending Programme aims specifically to enhance the liquidity of Central Moneymarkets Unit (CMU) private sector debt securities in the secondary market by providing a mechanism to utilise securities held by long-term investors for short-term use by the more active market participants. The Programme will also help to achieve two other important objectives. First, it will improve the settlement efficiency of CMU instruments as securities made available by borrowing through the Programme will help to reduce the chance of settlement failure. Secondly, it will increase the attractiveness of private sector securities to investors by enhancing the yields for the lenders. The operational framework for the Programme has been finalised after consultation with the Hong Kong Capital Markets Association and institutional investors. The Programme will commence operation on 1 December 1997.

Introduction

As a further enhancement to Hong Kong's debt market infrastructure, the Hong Kong Monetary Authority (HKMA) is going to introduce a securities lending programme for private sector debt instruments lodged with its Central Moneymarkets Unit (CMU). This article sets out the objectives and the operational framework of the programme.

Objectives

The objectives of the proposed securities lending programme are:

(a) to improve the settlement efficiency of CMU instruments as securities made available by borrowing through the programme will help to reduce the chance of settlement failure;

(b) to further enhance the liquidity of CMU debt securities by providing a mechanism to utilise securities held by long-term investors for short-term use by the more active market participants;

(c) related to (b), to enhance the liquidity of the secondary market in general through facilitating the market making process. Market makers tend to be more willing to quote two way prices if they can borrow securities to cover short positions arising from their market making activities; and

(d) to increase the attractiveness of the CMU instruments by enhancing the yields for the lenders.

Eligible Securities

The above objectives support the view that the scheme should cover a wide range of CMU instruments. However, practical considerations suggest that the eligible securities should be of reasonable issue size to ensure an adequate supply of lendable securities to make the scheme a meaningful one for potential borrowers. In line with this, it is proposed that the initial pool of eligible securities should include all private sector securities cleared through the CMU which have an issue size of over HK$500 million. Currently, 102 issues or 19% of the total number of private sector issues lodged with the CMU meet this size criterion. The total value of these issues amounts to HK$130 billion, accounting for 71% of the total.

The proposed risk management procedures for the scheme require daily marking to market of the loaned securities and the related collateral (see the part on "Daily marking to market" below). Therefore, in addition to the size criterion, it is proposed that only securities which have at least one CMU member who has agreed to act as market maker to quote two way prices for the issue during business hours would qualify as eligible securities.

Participants

All CMU members may participate in the securities lending programme as "Lender" but only CMU members who are prepared to perform the role of market maker for the eligible securities (see below) can participate as "Borrower". CMU members who wish to take part in the programme as lenders and the market makers who intend to borrow securities under the programme will be required to sign an Acceptance of Terms and Conditions for Securities Lending and Borrowing Programme. These terms and conditions will govern CMU members' participation in the programme.

Lender: After signing the Acceptance of Terms and Conditions, CMU will open a Securities Lending Account ("lending account") for the lender. The lender can use its Central Moneymarkets Terminal (CMT) to transfer the eligible securities from its main account or custody account to its lending account on a real time basis. The lender is required to obtain an explicit consent of its client before transferring the lendable securities into this lending account.

A lender in the programme will be an "automatic lender". The Acceptance of Terms and Conditions will specify that once the lender has transferred approved securities into the lending account, CMU will not need to obtain further consent from the lender before lending out the securities in the lending account. A lender can withdraw from the securities lending programme by issuing a notice to the CMU (see the part on "Withdrawal from the programme" below).

Borrower: CMU members who intend to borrow securities under the programme will need to apply to the HKMA to become market makers for the eligible securities. They are required to quote two-way prices at reasonable spread for at least 5 issues or 50% of the issues in the lendable pool whichever is the lower during business hours. This is important because the proposed risk management procedures for the scheme requires daily marking to market of the loaned securities and the related collateral. The eligible borrowers may borrow securities in the lendable pool for which they act as market makers. HKMA will monitor the performance of the market makers in quoting two-way prices. Their right to borrow under the programme may be suspended or terminated if their performance is considered unsatisfactory.

After signing the Acceptance of Terms and Conditions, the market makers can make use of the programme to borrow securities. Requests to borrow securities from the borrowers will be processed by CMU on a case by case basis in accordance with the procedures set out in the "Operation Framework" section below.

Risk Management

The risk management measures for the scheme will focus on protecting the lenders by ensuring that in case a borrower defaults, the lender(s) will be compensated with:

(a) an equivalent amount of the same issue acquired from the market; and

(b) failing (a), the market value of the loaned securities at the time when the securities are due to return to the lender.

The measures to achieve the above risk management objectives are set out below.

Collateral: The borrowers will be required to provide collateral of sufficient size (equivalent value of the loaned securities plus the haircut margin) to CMU. Once a borrowing request is accepted by the CMU, the borrower will be required to transfer the collateral to CMU's Collateral Account prior to CMU transferring the loaned securities from the lender's lending account to the borrower's main account. Upon the return of the loaned securities, the collateral will be transferred back to the borrower's account.

In order to fulfil the obligations to the lenders in the event of default by the borrower, securities eligible as collateral for this purpose must be of good credit rating and highly liquid in the secondary market. It is proposed that only securities eligible for repo under Liquidity Adjustment Facility (LAF) will be included as eligible collateral. This should be adequate as the outstanding issue size of LAF eligible paper is HK$195 billion which accounts for 69% of the total value of CMU securities or 1.5 times of the total value of the securities proposed to be eligible for lending under the scheme. The borrowers, however, will not be allowed to use LAF eligible securities issued by itself or by any company within the same group of companies as collateral for borrowing under the proposed programme.

The CMU reserves the right to refuse or reject collateral which it deems unacceptable for whatever reasons, including the right to demand a borrower to provide substitute collateral for collateral which has been previously accepted. Subject to CMU's prior approval, a borrower may also replace the collateral already placed with CMU's Collateral Account by other eligible securities.

Haircut: To protect the lender from market risk exposure, appropriate haircuts would be applied to the collateral having regard to the type and credit rating of the instruments. The levels of the haircut for the scheme should be more stringent than those under LAF to take account of the possible longer duration of the exposure and the need to provide comfort to the lenders in lieu of a guarantee by the HKMA. It is proposed that :

(a) a haircut of 2% per annum of the remaining period to maturity or a minimum of 10% be applied to Exchange Fund Bills and Notes, Specified Instruments and those LAF eligible CMU instruments with AAA rating; and

(b) the 2% rule would also apply to non-AAA rated LAF eligible CMU instruments but these instruments would be subject to a higher minimum haircut of 20%.

Daily marking to market: All loaned securities and supporting collateral will be marked to market on a daily basis and the borrower will be required to top up any shortfall to ensure continuous compliance with the haircut requirement. CMU will normally conduct the process once a day at 10:00 am. In order to avoid any disputes over the market quotations, all market makers are required to quote prices on a designated Reuters page at 10:00 am. Borrowers with shortfalls in collateral will be asked to top up by transferring additional eligible securities into CMU's Collateral Account before 2:00 pm the same day. If a borrower fails to do so, the CMU will require the borrower to return the loaned securities by 3:00 pm the same day, failing which the CMU will trigger the procedures for recalling the securities as set out in the paragraphs under "Recall of Loan" below. In times of high market volatility, CMU may conduct marking to market and require topping up of collateral at more frequent intervals.

Operation Framework

A borrower initiates a borrowing request by sending a request form (see Annex A) to the CMU. To ensure the liquidity of the eligible securities will not be unduly affected by the programme and to avoid a single borrower taking too big a trunk of a particular issue, it is proposed that a borrower cannot borrow more than 20% of a particular issue. For an eligible security with the minimum issue size of $500 million, the maximum value of the security that a market maker can borrow would be $100 million. This should be sufficient to meet the borrowing needs of most participants as the average deal size of CMU instruments is about $30 million. Setting a higher limit would increase substantially the risk of the borrower being short squeezed by other market players. On the other hand, to meet the objective of minimising settlement failures, it is not proposed to set any minimum limit on the borrowing request for each issue.

Borrowing requests received by the CMU will be processed on a first come first served basis. Requests received by the CMU before 12:00 noon, subject to the availability of lendable securities, will be processed for execution within the same day. Borrowing requests received by CMU after 12:00 noon will be processed for execution on the next business day.

The CMU will match a borrowing request with the securities available in the lending accounts. There are two basic scenarios:

(a) the requested amount is greater than the lendable amount; or

(b) the lendable amount is greater than or equal to the requested amount.

Under scenario (a), the CMU will ask the borrower to confirm whether it will accept the amount available in the lending pool. The CMU will execute the lending arrangement if the borrower confirms acceptance. Otherwise, the application will be cancelled.

Under scenario (b), where there are two or more lenders with the requested securities, the allocation of the securities among the lenders will normally be processed on a pro-rata basis by reference to each lender's share in the lendable pool of the securities concerned. In cases where there is a large number of lenders and the amount allocated to each would be very small using the pro-rata approach, the CMU will set the minimum allocation to each lender at HK$1 million or the amount of borrowing request and select the lenders on a random basis by the computer.

After completing the above matching process, the CMU will confirm to the borrower whether the application is successful. The successful borrowers will also be asked to transfer the collateral into CMU's Collateral Account. After this is done, the CMU will debit the securities in the lender's lending account and transfer them to the borrower's main account via a CMU suspense account in order to protect the confidentiality of both the lender and the borrower.

In line with the practice adopted by most other systems, all the loans are intended to be open-ended and granted for an undetermined period of time. The loan will be terminated upon return of the loaned securities by the borrower or the lender recalling the loan. Furthermore, in case the lender has no inclination to recall the issue by the time of maturity, the loan will be terminated automatically when the redemption takes place. The borrower is obliged to return the redemption proceeds and interest income to the lender.

Return of securities: After use, the borrower will transfer the securities back to CMU's Collateral Account and issue a message to inform CMU of the transfer. After receipt of the returned securities, CMU will transfer the securities held as collateral in the Collateral Account for that particular loan back to the borrower's main account.

Recall of loan: The lenders can recall their loaned securities by issuing a notice to the CMU. The recall will take effect on the same day if the recall notice reached the CMU before 10:00 am and a replacement lender(s) can be found on the same day. If replacement lender(s) cannot be found, the CMU will serve a notice to the borrower to require the return of the loaned securities within the next three business days. Detailed procedures are set out below.

After receiving a recall notice from the lender, CMU will in the first instance try to identify a replacement lender by going through the process as set out above. If there are replacement lenders, the CMU will substitute the original loan with the replacement loan and the borrower will not be affected.

If replacement lender(s) cannot be found on the day of recall (RD), CMU will serve a mandatory recall notice to the borrower on the following business day (RD+1) to require return of the loaned securities, that is, no later than 3:00 pm on RD+4. A reminder will be issued to the borrower on RD+3. A timetable for the loan recall procedures is at Annex B.

If the borrower fails to return the loaned securities by 3:00 pm on RD+4, the CMU will liquidate the borrower's collateral kept in the Collateral Account on the following business day (RD+5). The CMU will appoint reputable agents with the necessary professional expertise and market knowledge to execute such liquidation orders. The lender will have the following options:

i) to ask the CMU to use the sale proceeds to purchase the same amount of the issue in the market; or

ii) to accept an equivalent value in cash as a substitute; or

iii) if the lender is a Recognised Dealer, to ask the CMU to use the equivalent value in cash to purchase Exchange Fund Bills and/or Notes (issues to be chosen by the lender).

The purchases of loaned securities or Exchange Fund Bills and Notes in the market will be done by the same agents appointed by the CMU. The lender will be asked to exercise the discretion after 3:00 pm on RD+4. The price of the loaned securities at 10:00 am on RD+5 will be used as the reference price to calculate the cash equivalent. Any surplus, having taken into account the loaned securities, interest charge and administrative fee to the CMU (in descending order of priority), will be returned to the borrower. The terms and conditions of the Securities Lending and Borrowing Programme will specify that the borrower will be liable for any costs, claims and loss caused by its default.

The lender will only be compensated up to the amount of the proceeds from the sale of the collateral put in by the borrower even if the amount falls short of the marked-to-market value of the securities at the cut-off time. The CMU will use its best endeavour (and will be responsible for the necessary legal costs) to recover from the borrower any shortfall if the proceeds are insufficient to discharge the borrower's obligations. Any proceeds recovered from this process by the CMU will be distributed in accordance with the arrangement set out above.

Withdrawal from the programme: A lender may withdraw from the securities lending programme by issuing a written notice to the CMU. The withdrawal will take effect seven business days after the date of receipt of the notice by CMU. All securities lent out by the lender will be recalled in accordance with the procedures set out above.

Fee

The fee for the service will be as follows:

		CMU
Charge on borrower	:	2.0% p.a.
Fee income for lender	:	1.5% p.a.

– Prepared by the Monetary Policy & Markets Department

Annex A

CENTRAL MONEYMARKETS UNIT SERVICE
SECURITIES LENDING / BORROWING PROGRAMME

BORROWING REQUEST FORM

To : Monetary Authority   Date : ____________________

From : ____________________ (Name of Member)   (____________________) (Member Code)

We hereby submit you this request form to execute the borrowing of below securities in accordance with the Securities Lending / Borrowing Programme :

Start Date: ________________ Intended return date: ____________________

Securities to be borrowed: ____________________
(CMU Instrument No.)

Nominal amount: ____________________

Please transfer the below collateral from our main account to the HKMA Collateral Account:

Instrument No.	Nominal amount

(The loaned securities shall be credited to our main account)

Person to contact in case of query: ________________ (Tel) ____________________

____
Authorized Signatures
Company Chop

____
Testkey
(Tested on the total nominal amount of loaned securities and collateral: __________Mn)

Recall of Loan