Guideline No. 5.1.2

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15 April 1993

To: The Chief Executive
All Authorised Institutions

Dear Sir

Financing of the subscription of new share issues

As you would be aware, Mr Joseph Yam, the Chief Executive of the Hong Kong Monetary Authority, established on 11 February a Working Party, chaired by himself and comprising senior government officials involved in banking and monetary affairs, to assess the monetary and banking implications of large new share issues.

The Working Group was asked to review the existing arrangements for large new share issues and assess their impact on

(a) marco-monetary management, particularly the stability of the interbank market; and

(b) credit exposures and risk management by banks involved in the financing of such share subscription.

The working Group has completed its Report. It has been decided that the Report will not be published in full in view of the fact that information on the operations of individual institutions has been provided in confidence and is protected by the secrecy provisions of the Banking Ordinance. However, it has been the intention that the findings and recommendation of the Working Group, suitably edited, would be made public.

In a recent speech to the Australian Chamber of Commerce in Hong Kong on 8 April, entitled "Financial Stability in Hong Kong and Oversubscription of New Share Issues", Mr Yam spelt on the findings and recommendations of the Working Group.

The Working Group came to the following conclusion:

. Under the present monetary management arrangements, the banking and monetary system has oversubscription of new share issues. However the effects on interbank liquidity and money supply would need to be carefully monitored, and, if necessary, specific monetary operation would need to be taken to ensure monetary stability.

. In the broad, the payment system is capable of handling the heavy paymentstraffic arising from the large oversubscription of new share issue. However, there is room for further strengthening of payment arrangements.

. However, it is not entirely clear that individual institutions have adequately understood and fully managed the risks from the financing of the subscription to new share issues. The Working Group has therefore put forward recommendations for consideration and adoption by institutions authorised under the Banking Ordinance.

Attached for your information is a copy of the synopsis of the Working Group's Report which was circulated as an annex to the printed version of Mr Yam's speech. I draw your particular attention to the Working Group's recommendations and hope that you will be able to apply them in your share financing business.

If you have any comments on the recommendation, we would most certainly like to receive them. As regards next steps, we may wish to consider adopting the Working Group's recommendations as formal guidelines issued under section 7 (3) of the Banking Ordinance.

Yours faithfully

Albert Cheok
Executive Director (Banking Supervision)

A Synopsis of Findings and Recommendations
in the Report of the
Working Party on the
Monetary and Banking Implications of
Over Subscription of New Share Issues

Monetary effects

1. The Working Group found minimal impact on interest rates. Little officals intervention was needed to ensure the smooth flow of credit. This could be asxribted to the stablishing effects of the monetary operations through the Accounting Arrangements and the Liquidity Adjustment Facility (LAF) . As can be seen from the table attached, the intra-day Overnight HIBOR on the Closing Day was 88 b.p. (Denway and China Overseas) to 288 b.p. (Guangzhou Investment) higher than the level 7 days earlier. The smaller increase for Denway and China Overseas almost certainly reflected the injection of liquidity by the Exchange Fund on or near the Closing Day. However, the amount of official intervention had been relatively small; in Denway's case, it was $650 million compared with the $240 billion in total subscription. LAF was used by banks on the Closing Day for China Overseas, China Travel and Guangzhou Investment but not for Denway.

2. Interbank rates would normally start to ease after the Closing Day. However, in relation to some recent new issues the large amounts of refund cheques issued by the Receiving Banks have made it difficult for recipient banks concerned to manage their liquidity positions with the usual accuracy on the Refund Day. As a result, there has been some impact on interbank interest rates on the Refund Day, but the effects have been less than on the Closing Day. As with the Closing Day, banks are also able to use LAF on the Refund Day. This has been the case in all recent issues; the resort to LAF ranged from $29 million (Guangzhou Investment) to $2.8 billion (Denway).

3. While the heavily oversubscribed new share issues did cause a slight and temporary rise in Overnight HIBOR rates, there appears to have been little impact on the exchange rate. The Hong Kong dollar actually weakened slightly on the Closing Days of two new issues. Despite the movements of the large amounts of funds, the banking system appears to have coped quite well

4. Monetary operations have been valuable and effective in reducing volatility in interbank interest rates. In doing so, this has deflected pressure on the exchange rate. When Cathay Pacific floated its shares in 1986, the overnight HIBOR rose by 12.75 percentage points on the Closing Day. Similarly when the Oriental Press Group went public in 1987, the overnight HIBOR jumped by 6 percentage points on the Closing Day. These sharp fluctuations have largely disappeared since

the introduction of the Accounting Arrangements in July 1988. The introduction of LAF in June 1992 has resulted in further stability of interest rates.

5. While the recent large share issues did not appear to have any significant impact on the exchange rate, it would still be unhelpful to have a sudden rise of short-term interest rates when the Hong Kong dollar is on the strong side of the link. Even small rises in interest rates could exacebate the pressure on the link if the oversuvscription of new shares coincided with speculation about possible revaluation of the Hong Kong dollar. From the monetary management standpoint, sharpe fluctuations in interest rates caused by large share issues, even for a short period of time, should be avoided as much as possible.

Impact on the payments system

6. It is essential for the efficient functioning of the payments system that payments be processed quickly and securely. A breakdown somewhere in the clearing or settlement process, eg a failure of a counterparty bank to give finality of settlement or a blowout of essential computer software or hardware, could produce costly disruption and inconvenience to the banking system.

7. In view of the huge sums of moneys involved, the Working Group was concerned to see if there had been any "traffic problems" in the clearing and settlement system from large new share issues. The wider concern is that while the clearing and settlement systems might well be able to handle the normal payments traffic, the systems could come under stress when there is a heavy build up of traffic.

8. The only incident of concern occurred on the Refund Day of one of the new share issues when there was a hiccup in the computer system involving the truncation of an entry which exceeded the computer's programmed capacity. It was not until the late morning of the next day that the problem was resolved by the Clearing House and the correct position report for members of the Clearing House produced. There was some disruption that morning to the interbank market, as well as to the retail operations of banks, as the banks concerned were unsure of the opening positions in their clearing accounts when they opened for business that morning.

9. The Working Group is, nevertheless, broadly satisfied that the payments system is capable of handling the heavy payments traffic arising from the large over subscription of new share issues. The Management Bank of the Clearing House, the Settlement Banks and the Receiving Banks have been efficient in maintaining a smooth flow of funds, including the recycling of funds that come with the subscription of new share issues.

10. The Working Group has doubts, however, on whether the payments system is as robust as it can and should be, in terms of enabling the possible adverse effects on shock to the system to be isolated in time and dealt with in a way that is least disruptive. But this is not a matter specific to the over subscription of new share issues. It will therefore be addressed separately.

Risks to individual banks

11. Even if it were demonstrated that the banking system has been efficient at handling large new share issues, with little implications for system liquidity and interest rates, there is still the question as to whether individual banks could have been taking on unduly large credit exposures in their financing of applications for the new share issues. The Working Group found a widerspread belief among banks that the credit risk from lending for new share applications is minimal if the issue is heavily oversubscribed.

12. This belief appears to have some basis. When an issues is heavily oversubscribed, the borrower is likely to be alloted only a small fraction of the total number of share applied for. This means that the substantial part of the application moneys would be available to reduce the outstanding loan. The actual loan to the borrower would be reduced to the credit needed to finance the alloted shares. As the alloted shares themselves would form the underlying security for the loan, the bank's credit risk to the borrower is effectively the risk that the market value of the new shares might fall below the subscription price. In principle, this market risk could be covered by a margin requirement.

13. For this belief to be correct, ie for the actual loans to be reduced to the financing of the alloted shares, some legal and physical means must be found which would enable lending banks to hold on to the refund moneys on the unsuccessful and partially unsuccessful applications and to protect their interest in the refund moneys from the winding up or bankruptcy of the borrowers.

14. The banks appear to have fooound a legal sardguard in what is called "specific purpose" trust arrangements. There is a well-established legal principle that the lending bank continues to have an equitable interest in the proceeds of a loan made for a specified purpose until the loan is utilised for the intended purpose. If this principle is applied to loans for new share applications, the legal implications is that the portion of the loan which is not utilised for the purchase of the new shares will not form part of the borrower's assets available for distribution on his bankruptcy.

15. In other words, the trust arrangement arises because the loans are advanced for the sole and specified purpose of applying for the new share issue. If the application is unsuccessful of partially unsuccessful,

the refund moneys will be held in trust for the lending bank, which could use the amounts to discharge the customer's outstanding loan. The trust arrangement effectively deems the lending bank to be the ultimate beneficial owner of the refund moneys.

16. As a supplement to the legal protedtion afforded by the trust arrangement, the lending bank would wish to be able to physically track and control the movement of the loan moneys and refund moneys. In this regard, it is a common practice for the lending bank to require the borrower to apply for the new shares in the name of a nominee company owned by the bank ("Lender Nominee Company"). This arrangement enables the lending bank to route the subscription and refund moneys through the Lender Nominee Company.

17. All the lending banks interviewed appear to recognise that their real credit risk is to the Receiving Banks because they depend on the safe refund of the application moneys to redeem the outstanding loans of customers. However, with only one exception, all the institutions interviewed had not seen a need to establish a cap on their exposures to the Receiving Banks.

18. Reasons given by the institutions interviewed for the more generous treatment of the Receiving Banks included (i) the status and standing of the Receiving Banks in Hong Kong, (ii) as the Receiving Banks are also note-issuing banks, the belief that a bank must have financial substance to be given note issuing status, and (iii) new share financing loans are very short term exposures.

19. Prudence would require that lending banks should keep their exposures to the Receiving Bank(s) within appropriate limits. However, in relation to one issue, the credit exposures of some individual lending banks to the Receiving Banks were quite substantial relative to their capital bases. There were cases in which those exposures were substantially larger than the lending bank's capital base.

20. In respect of individual banks' lending to individual brokers and customers, the Working Group recognises that the "specific purpose" trust arrangements, if properly formulated, may justify limits to be higher than would be acceptable in the normal course of business. No legal arrangements can be totally watertight, however, and it would seem sensible that there should be <u>some</u> limit in place on individual large exposures (and on the overall exposure in respect of each issue).

21. In any case, notwithstanding the "specific purpose" trust arrangements, the lending bank is still exposed to the customer in relation to the financing of allocated shares. This is the risk of a shortfall in the value of the securtiy constituted by the shares, which will be increased if the issue turns out to be less fully subscribed than expected and, in particular, if it is undersubscribed. Institutions can mitigate this risk by

imposing a margin requirement on customers and brokers. However, some institutions choose not to take margin.

Risk to applicants

22. The Working Group has sought to determine if there were adequate arrangements in place to ensure that application moneys are well protected until the allotment of shares to successful applicants or the despatch of refund moneys to unsuccessful and partially unsuccessful applicants.

23. It found that the "specific purpose" trust arrangements seem to provide a legal underpinning for the protection of these moneys. The application moneys are held in a New Issue Account on trust for the applicants by the Receiving Bank's Nominee Company. This should mean that the moneys in the New Issue Account belong benefically to the applicants and the Issuer is entitled to receive only the amount which represents payment for the issued shares. The balance of the application moneys after allotment of shares is transferred by the Receiving Bank to a Refund Account which ensures that the moneys continue to be held in trust until their refund to the unsuccessful and partially unsuccessful applicants.

24. Put simply, the "specific purpose" trust arrangements serve to protect the application moneys from the winding up or bankruptcy of the Issuer or the Receiving Bank. Additionally, the nominee accounts ["New Issue Account" and the "Refund Account"] serve as an administrative device to keep control of the flow of moneys. The Receiving Banker's Agreement contains clauses which severely limit the use of the moneys in the New Issue Account unless the essential conditions relating to the allotment of shares have been fulfilled. If the Issuer fails prior to the allotment of shares, the shares issue would be cancelled. Under the usual terms of the Receiving Bank's Agreement, the application moneys in the New Issue Account would be transferred into the Refund Account for return to the applicants. If the Issuer fails after allotment of shares, only the successful applicants, as shareholders of the Issuer company, would be at risk. If the lead underwriter fails, the issue could still proceed, with any undersubscription taken up by the secondary underwriters or the Issuer itself.

25. In effect, if the applicants are to be at risk to any one, it would be to the Receiving Bank which is holding the application moneys pending their refund to unsuccessful and partially unsuccessful applicants. However, remote it might be, there is of course the risk that the Receiving Bank could fail. If that happens, the "specific purpose" trust arrangements should deem that the application moneys are not deposits but moneys being held in trust for the applicants.

26. However, the facts that the application moneys are held on trust by the Receiving Bank may not entirely remove the credit risk faced by the applicants and the banks funding them. The applicants' right to get the application moneys back could be fraught with practical delays and difficulties. In particular, there is no segregation of the application moneys on the assets side of the balance sheet. Applicants are therefore exposed to the risk that the Receiving Bank may not have the funds to repay applicants (eg because of default by the Receiving Bank's counterparts).

Interbank risks

27. What the "specific purpose" trust and nominee arrangements appear to have achieved is to keep the banking system from being at risk to the borrowers and to the issuer of the new shares. In doing so, the application and refund moneys are kept in a closed circuit within the banking system. This means that the flow of credit fot the financing of a new share issue is essentially between the Receiving Bank(s) and the lending banks.

28. The Working Group is concerned that even within this closed circuit, the lending banks are still at risk to the Receiving Bank which in turn, because of its recycling role, is at risk to the banks which it has in turn financed. While the "specific purpose" trust arrangements may have reduced the risk characteristics of new share financing loans, it may also have encouraged both the Receiving Banks and lending banks to relax their normal credit limits to one another for the financing of application for new share issues, in some cases by a substantial margin.

29. The working Group notes that the effectiveness of the "specific trust" arrangements depends importantly on the unhindered circular flow of funds between the Receiving Bank and the lending banks. The danger of course is that no legal or operational arrangements can be completely watertight. Unforessen impediments could cause disruption to the circular flow of funds with serious consequences for the banking system because of the huge sums of moneys involved.

30. For example, if the Receiving Bank should get into difficulty, and despite the fact that the application moneys are held in trust by the Receiving Bank, it could take time for the respective rights and obligations to be resolved through the Courts. A "grid lock" stand off could result. The Receiving Bank in difficulty could find it difficult to collect amounts from the lending banks it had funded, as these banks would try to set these off against the amounts that are due back to them as refund moneys. This problem would bear particularly on those banks which have funded themselves from sources other than the Receiving Bank (ie they would have nothing to set off),.

31. This reflects the fact noted above that although the application moneys are held on trust by the Receiving Banks, the assets in which the moneys are held form an indistinguishable part of the assets of the Receiving Bank. This means that the Receiving Bank itself could be put into difficulty by the default of major counterparties to whom it had lent the application moneys. Given the substantial amounts involved it is possible that the Receiving Bank might not have adequate cash resources of its own to refund the application moneys.

32. The Working Group is concerned that the exposures taken on by the Receiving Banks and the lending banks to one another for the financing of new share issues may in some cases be well in excess of their normal credit limits. Essentially, the financing of new share issues is unsecured seven day lending. The Working Group finds no prudential reason why lending banks should be prepared during a new share issue to take on a much larger exposure than they would be prepared to accept for an unsecured seven day lending to the same Receiving Bank in the normal courses of business. Conversely, it can see no prudential reason why the Receiving Bank's exposures to individual lending banks to which it recycles application moneys should be significantly higher than its normal credit limit for the individual banks concerned.