Securities Broker/Dealer - China

Stock repo and margin financing: do we need to worry about them?

Industry Overview

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Stock repo and margin financing, any concerns?

The answer is "Yes but not like what you think". In short, any business related to stock prices, from stock repo to margin financing - both using stocks as collaterals, to Snowball and other derivatives - linking to indices, is under pressure when market slumps consistently. The vicious cycle, or self-fulfilling process, can definitely lead to worse scenario. However, in practice, it is not as disastrous as it may look, in our view.

While media headlines can draw attentions of investors with "total size of stock repo at RMB2tn" and "margin financing coverage ratio dropped to the crisis level in 2015", which are also the data we follow for sure, we suggest investors to focus on what measures can be taken to avoid the worst case.

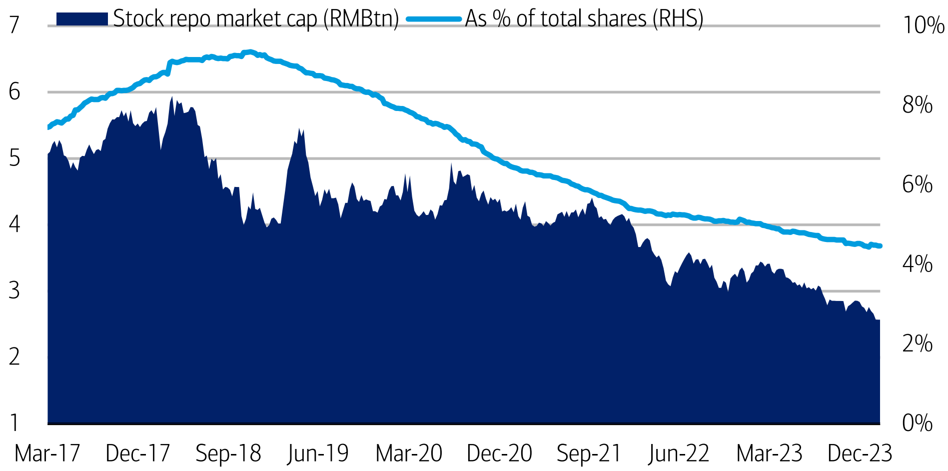
Stock repo: brokers as buffer in the middle

Stock repo business is not complicated. Shareholders give brokers their stocks as collaterals to get collateral loans at 30-40% of the face value of the stocks and brokers will monitor the market value of the stocks. For example, RMB100mn worth ICBC stocks as collaterals could get RMB30-40mn from brokers, but when the value drops from RMB100mn to RMB50-60mn, i.e., stock prices drop by 40-50%, brokers, in order to control their own risks, will choose to sell the collaterals in the market unless shareholders add more collaterals or margin deposits. The last crisis of stock repo was in 2018 when ChiNext Index dropped by 34% (as most stock repo collaterals are small and mid-cap stocks, ChiNext and other small cap indices are the major way to gauge the impact). During the drop, stock repo size decreased from ~RMB6tn to ~RMB4tn. The reasons that the vicious cycle was not formed, or was not as bad as expected, were mainly: 1) instead of selling collaterals, brokers tended to require shareholders to add more collaterals as to selling collaterals could lead to following chaos, such as major shareholder changes in related companies; 2) regulators asked brokers to avoid force liquidation; 3) some local governments set up funds to help local companies to repurchase shares from brokers.

We are in a worse market environment than that in 2018. ChiNext Index dropped by 37% YoY and local government/shareholders' financial status are worse than 2018. However, the measures in 2018 can still work to avoid a blow-up scenario, in our view. We suggest investors with investment in small- and mid-cap companies to check the collateral level and potential large shareholders' risks, but we believe the impact on the overall market is, technically, limited.

- See next page about margin financing

Exhibit 1: Stock repo market cap (RMB tn)
Stock repo market cap currently at RMB2.4tn, compared with RMB2.8tn at end 2023



Source: Wind, CSDC, BofA Global Research

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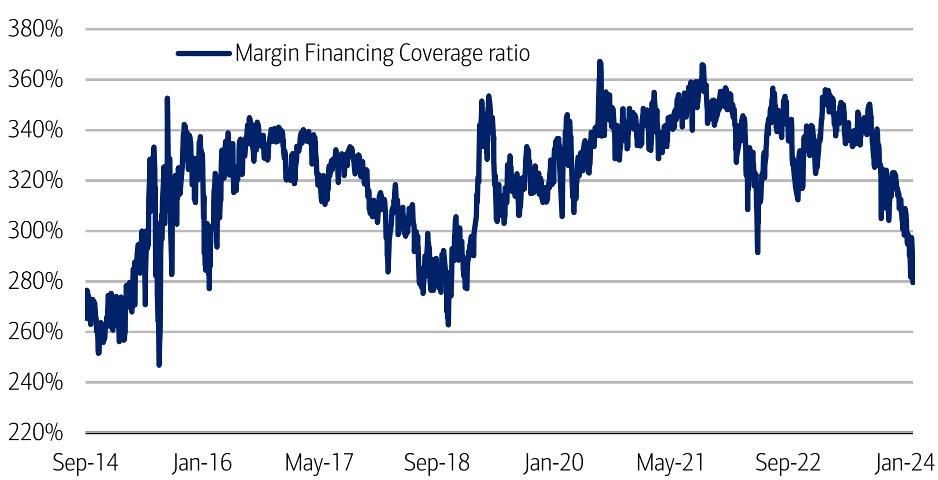
Margin financing: stampede matters, not the size

The total outstanding balance of margin financing amounted to RMB1.5tn by end Jan, remaining stable at RMB1.5-1.6tn level in the past 5 months. The key risk indicator to watch, and used by brokers, is the coverage ratio, i.e., current margin financing portfolio value/margin financing loans. The alert level is 150% and the force liquidation level is 130%. As the market dropped in the past few months, the overall coverage ratio of margin financing business dropped from 345% in Aug 2023 to 280% now, based on our calculation. The level remains higher than 247% in 2015 when market crashed, but already lower than the last trough in 2022 at 291%.

Exhibit 2: A-share margin financing coverage ratio
A-share margin financing coverage ratio has dropped to 280% now, but still higher than trough in 2015



Source: CSFC, Shanghai Stock Exchange, Shenzhen Stock Exchange, BofA Global Research

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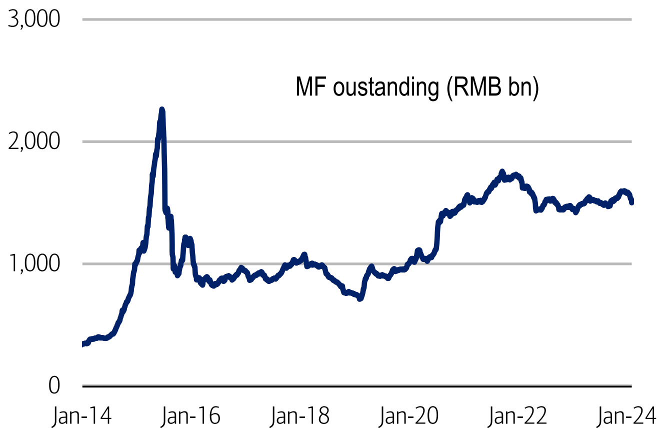
To us, the worst scenario of margin financing includes two parts: rapid surge and fall of margin financing and less visible OTC leverage. In 2015, the size of margin financing rose from RMB1.0tn in the beginning of the year to RMB2.0tn in 1H15 and dropped back to RMB1.0tn in the next two months, and OTC leverage was reportedly even larger than the margin financing size.

Stampede when de-leveraging takes place is the major risk that margin financing could bring in a bear market. However, when the overall pace of margin financing increase is slow, stampede, or panic de-leveraging is not the case we expect now.

Similar to stock repo business, force liquidation is not the preferred solution for brokers and regulators and we expect to see the buffer to mitigate the pain.

Exhibit 3: Outstanding margin financing balance (RMB bn)
Margin financing now at RMB1.5tn, down from RMB1.6tn at end 2023



Source: Wind, BofA Global Research

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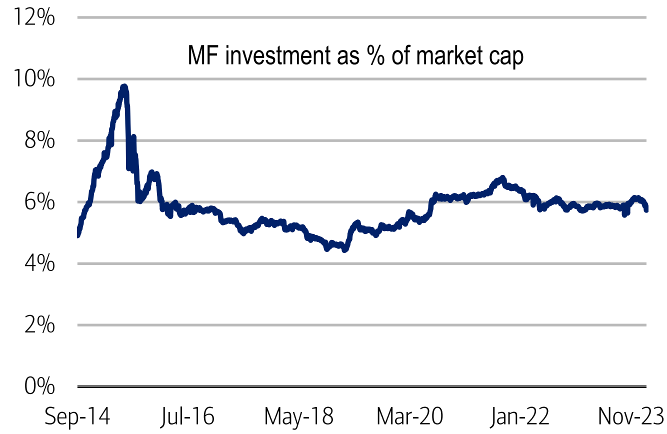
Exhibit 4: Margin financing as % of A-share market cap
Margin financing balance at 5.7% of A-share market cap



Source: Wind, Shanghai Stock Exchange, Shenzhen Stock Exchange, BofA Global Research

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