Report of the Focus Group on Financial Services

January 2007

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Chapter 1 Executive Summary

1.01 The Economic Summit on "China's 11th Five-Year Plan (FYP) and the Development of Hong Kong" was convened by the Chief Executive of the Hong Kong Special Administrative Region (HKSAR) on 11 September 2006. Four Focus Groups, comprising experts from the private sector, were established to discuss the development strategy for Hong Kong's four major economic sectors. The Focus Group on Financial Services chaired by Dr the Hon. David Li (with the membership listed at the end of this Executive Summary – Appendix 1-1) has held several meetings and prepared a report for submission to the Chief Executive on how the financial services industry in Hong Kong should respond to the challenges and opportunities arising from the 11th FYP.

1.02 China is unique in having two financial systems in the country, under the framework of "one country, two systems". The Focus Group considers that from an institutional perspective, the two financial systems should establish a complementary, cooperative and interactive relationship. From a practical perspective, the Mainland can make better use of the financial system of the HKSAR in helping to enhance financial intermediation efficiency and to implement financial reform. The Focus Group also considers that, from a strategic perspective, developing Hong Kong to be an international financial centre of global significance will help enhance China's status and competitiveness in the world.

1.03 The development of Hong Kong as an international financial centre and that of the other financial centres on the Mainland are indeed complementary. A country as large as China requires not just one financial centre, and different financial centres can play their own role based on their respective comparative advantages. The Focus Group is of the view that, as the international financial centre of the country, the HKSAR has the responsibility to assist in ensuring the country's economic and financial stability and in strengthening the country's resilience to risks.

1.04 The Focus Group has adopted two complementary approaches in its deliberations: one a macro, strategic perspective and the other a micro, market-specific perspective, and provides specific proposals on how HKSAR can contribute to the economic development and financial reform of the country in a more significant manner.

Macro, strategic approach

1.05 In the 11th FYP, the important document that outlines the policies to be pursued by the country over the five-year period from 2006 to 2010, there are the clear statements of "supporting the development of financial services in Hong Kong" and "maintaining the status of Hong Kong as an international financial centre". The Focus Group is very encouraged by these clear statements and is of the view that the role of Hong Kong in the country's economic and financial development should be considered in three important perspectives.

1.06 **From the institutional perspective:** Under the framework of "one country, two systems", there should be **a complementary, cooperative and interactive** working relationship between the two financial systems. This is clearly in the national interest, and that efforts should be made by all concerned to develop such a working relationship. In this connection, it is important for the Hong Kong Special Administrative Region Government (HKSARG) to devote greater efforts in engaging the Central People's Government (CPG) on what Hong Kong as an international financial centre of the country can offer to assist financial development on the Mainland and on the benefits the Mainland could derive from making better use of the financial system of Hong Kong. The Focus Group considers that such a working relationship will not have undesirable implications on the autonomy of the HKSARG under the "one country, two systems" framework.

1.07 **From the practical perspective:** HKSAR can contribute to meeting Mainland's financial reform and development challenges in three aspects. First, Hong Kong's established financial platform, by offering diversified financial services to the Mainland, can help to raise the efficiency of financial intermediation and support the reform and development of the financial system on the Mainland. Secondly, HKSAR as an international financial centre can facilitate the two-way cross-boundary fund flows of the Mainland, which helps to address the increasing concern of external imbalances in the economy. Hong Kong can offer Mainland investors financial products and instruments with different levels of return and risk attributes. Thirdly, Hong Kong can serve as a testing ground for renminbi (RMB) to become fully convertible and to be used in international trade and financial transactions. During the liberalisation process, the robust financial system of HKSAR and the close cooperation between the regulators from the Mainland and HKSAR will help control and manage the risks, providing a buffer zone for the Mainland's opening up to the international markets.

1.08 Specifically, the Focus Group recommends that the Mainland can make appropriate use of the financial system of Hong Kong both in satisfying its financial intermediation needs and in experimenting with financial reforms, based on the five-pronged strategy developed by the Hong Kong Monetary Authority (HKMA). The five prongs are:

- **Expand the presence of HKSAR financial intermediaries (both bank and non-bank institutions) on the Mainland,** for example, in the form of increased **ownership** and **management** of financial institutions on the Mainland by Hong Kong entities, and a greater **scope of businesses** that can be conducted by Hong Kong financial institutions. This would facilitate constructive competition and transfer of know-how in product development, risk management, corporate governance and financial innovation.

- **Increase the outward mobility of Mainland investors, fund raisers and financial intermediaries, using Hong Kong as a platform for pilot schemes.** This would increase Hong Kong's role in domestic financial intermediation on the Mainland to the extent that Mainland investors buy financial instruments issued by Mainland entities. Better return and risk diversification for Mainland investors would stimulate consumption and facilitate more balanced economic growth, and the increased outflows should help to reduce the large balance of payments surpluses.

- **Allow financial instruments issued in the HKSAR, particularly those issued by Mainland fund raisers, to be marketed on the Mainland.** This would help satisfy investor demand on the Mainland, and insofar as financial instruments issued by Mainland entities are concerned, also complete the process of domestic financial intermediation. The financial instruments can be traded on the Mainland through stock exchanges, the interbank market or over the counter in appropriate forms.

- **Enhance the capability of the financial system of the HKSAR in handling financial transactions denominated in RMB.** This would help the HKSAR financial system to contribute to domestic financial intermediation on the Mainland and to be a testing ground for the international use of the RMB. RMB business, which started in 2004, provides a good foundation, and its scope can be expanded over time.

- **Strengthen financial infrastructural linkages between the Mainland and the HKSAR.** The enhancement of the linkages of payment and settlement systems will better ensure that Mainland's international fund flows and financial activities are conducted in a safe and efficient manner. There is also a need to intensify cooperation between stock exchanges in the HKSAR and the Mainland to promote integration of the two markets, which helps to guard against the growing competition from overseas markets.

1.09 **From the strategic perspective,** with an economy that is one of the largest in the world and rapidly growing, it is important that China should have **an international financial centre of global significance**, one that is comparable to New York and London in terms of scale and scope of financial services and instruments offered. First, it can provide an efficient financial intermediation platform that is required to support sustainable growth of a large economy, as the concentration of the vast amount of international financial activities increases the depth and breadth of the financial markets. Secondly, it can help avoid the payment and settlement risks associated with conducting international financial activities in a different time zone, and the high level of differences in risk attributes and appetites of participants should facilitate risk transfer and management. Thirdly, such a financial centre should play a significant role in the global pricing of financial instruments, and increase China's contribution to the formulation of global financial standards and policies.

1.10 As the Mainland's economy grows and capital account opening and RMB convertibility proceed, the scale and scope of Mainland's international financial activities will rapidly increase. This offers an opportunity for China to develop an international financial centre of global significance, but such opportunity does not last forever. All international finance centres are keen to capture the Mainland's international financial transactions and are able to do so given the increasing globalization of financial markets. If an international financial centre of global significance cannot be developed in a timely manner within the country, a habitual inertia will be built up to the advantage of the existing global financial centres.

1.11 Given that the HKSAR has already developed into a significant international financial centre in Asia while financial centres on the Mainland can become "international" only after Mainland's financial system is fully liberalised, Hong Kong is a natural choice for developing China's international financial centre of global significance. The Focus Group considers that there is a need for central government authorities to adopt **a proactive policy** to facilitate the use of Hong Kong's financial system for Mainland's international financial activities. The key points of the specific recommendations are:

- **For those international financial activities that HKSAR already has markets with the capacity of a global scale**, for example, equity fund-raising, bank lending, bond issuance, asset management, foreign exchange and treasury markets, Mainland authorities can provide policy encouragement, particularly to official and state-owned entities for making maximum use of Hong Kong's platform. In doing so, the commercial interests of Mainland entities should be respected. By increasing the market depth in Hong Kong, such proactive policy should reduce the transaction costs and ultimately benefit all participants.

- **For those international financial activities in which China is potentially a global player but HKSAR does not have developed markets**, new financial instruments and services can be introduced. In particular, consideration should be given to new financial derivatives and commodities futures that are not traded in Hong Kong but there is an active cash market on the Mainland. The demand and supply of the underlying commodities or financial instruments on the Mainland can be combined with HKSAR's advanced financial platform, sophisticated risk management techniques, and openness to international markets. For those derivatives where there is already a reasonably developed market on the Mainland, HKSAR can help to enhance the market depth by drawing the participation of international players through appropriate arrangements such as cross-trading.

Micro, market-specific approach

1.12 The Focus Group also adopts a micro, market-specific approach in its deliberations. Three Sub-groups of the Focus Group were established on the day of the Summit to explore initiatives that could be taken in the securities market, the foreign exchange and commodities futures markets, the insurance and reinsurance market and asset management industry, in order to enhance Hong Kong's status as an international financial centre, benchmarking Hong Kong with the major international financial centres of New York and London. As an international financial centre serving not only the Mainland of China but also other jurisdictions, where appropriate, the deliberations of the three Sub-groups extended to market development issues beyond those relevant to the 11th FYP. The three Sub-groups were chaired respectively by three members of the Focus Group, the Hon Ronald Arculli, Mr Gary He and Dr Edmund Tse, who tapped market expertise from within and outside the Focus Group.

1.13 **The market is formed by four essential components**: supply, demand, price discovery mechanism and market infrastructure. Demand and supply interacts to discover the market price for whatever is being traded. Transactions are concluded with the support of market infrastructure and markets involving financial instruments have a greater need for sound infrastructure to meet the payment, clearing, settlement and custodian needs. Thus each of the Sub-groups considered their respective areas with these four factors (supply, demand, pricing and market infrastructure) in mind. The Focus Group has accepted the findings of the three Sub-groups and their recommendations.

1.14 Hong Kong has established itself as one of the leading securities market in the world with unique advantages. Hong Kong is also the leading venue for the listing and trading of the securities of Mainland enterprises outside of the Mainland, and has succeeded in playing host to the world's largest initial public offering (IPO) of the Industrial and Commercial Bank of China. The ten largest IPOs in Hong Kong since 1993 were all by Mainland enterprises, some of which were among the largest IPOs globally. Chapter 33 of the 11th FYP has stated, among other things, that financial reform is targeted at speeding up the development of direct financing through greater use of the capital markets, including the equity market. The Focus Group considers that one of the foci of the further development of the securities market is to maintain close liaison with the Mainland in order to facilitate efficient capital formation for Mainland enterprises. As an international financial centre, our securities market should also extend its reach to potential quality issuers outside Hong Kong and the Mainland. Efforts should be made to establish a more flexible regulatory and operation infrastructure for local, Mainland and overseas financial intermediaries and investors to ensure the smooth and efficient operation of the markets.

1.15 The 11th FYP mentioned the development of futures market. The Mainland is one of the world's largest consumers and suppliers of commodities, precious metals and other raw materials. It would be in the strategic interest of the Mainland to have an increasing influence on the price discovery process of the commodities and their derivatives markets. The Focus Group considers the development of a commodities futures market in Hong Kong a worth pursuing initiative. As a first step, an independent consultancy study would need to be commissioned to look into the detailed conditions and requirements for such endeavour and make concrete proposals, with the Mainland intended as a major participant. The initiatives should include efforts to encourage the Mainland as well as international financial intermediaries to participate in Hong Kong's commodities futures market. The development of a highly effective and liquid market which links the liquidity pool in Asia with the American and European time zones is key to enhancing our price discovery function and influence on global commodities prices. Robust regulatory and market infrastructures are also essential to the development of commodities options and futures.

1.16 In view of the Mainland's goal to achieve RMB convertibility for capital account transactions in a gradual manner, as mentioned in the 11th FYP, the Focus Group considers that the development of RMB futures and options market can solidify Hong Kong's lead in offshore RMB trading and expand the range of non-deliverable RMB products, thereby boosting Hong Kong's foreign exchange (FX) market and enhancing Hong Kong as the leading hedging and derivatives centre, in particular for RMB.

1.17 An effective insurance market is of paramount importance to the sustainable development of the Mainland economy. Insurance companies provide risk protection and transfer services to the society, as well as foster the development of consumption, innovation and financial intermediation services. In particular, the asset management activities conducted by insurance companies can help to promote the expansion of institutional investors and enhance the efficiency of financial intermediation of the capital market. HKSAR possesses a highly competitive and well managed insurance market. Leveraging on the proven success of development, Hong Kong's insurance industry can assist the development of the Mainland insurance market. This can be achieved by increasing the proportion of shareholding that Hong Kong insurance institutions are permitted to hold in the Mainland insurance institutions, and expanding the scope of business and geographical operation of the Hong Kong insurance institutions. Besides, much more thoughts can be given by the Government to promoting the development of **international captive insurance market in Hong Kong.**

Action Agenda

1.18 Under the framework of "one country, two systems", a complementary, cooperative and interactive relationship should be established between the two financial systems in Hong Kong and the Mainland. There should also be structured channels for the CPG to consider the utility of the financial system of Hong Kong in a more significant manner for improving financial intermediation efficiency on the Mainland.

1.19 A five-pronged strategy should be pursued for Hong Kong to make contribution to Mainland's financial intermediation:

(1) Expand the presence of Hong Kong financial intermediaries (including Hong Kong banks, securities companies, investment banks, fund management companies and insurance companies) on the Mainland to provide financial services on location;

(2) Increase the outward mobility of Mainland investors, fund raisers and financial intermediaries;

(3) Allow financial instruments issued in Hong Kong, particularly those issued by Mainland fund raisers, to be marketed on the Mainland;

(4) Enhance the capability of the financial system of Hong Kong in handling financial transactions denominated in RMB; and

(5) Strengthen financial infrastructural linkages between the Mainland and Hong Kong.

1.20 The HKSAR should be positioned to develop into an international financial centre of global significance:

(1) Encourage Mainland entities to make better use of Hong Kong's markets and financial intermediaries for conducting their international asset management, treasury, fund raising (equity and debt) and other activities;

(2) Mainland stock and futures exchanges to take Hong Kong Exchanges and Clearing Limited (HKEx) as preferred partner for cooperation over exchanges elsewhere to pave way for integration of the two markets; and

(3) HKSAR institutions to work with Mainland entities in partnership to develop commodity and financial futures markets in Hong Kong and the Mainland, through means including strategic linkages.

1.21 Securities Market

(1) Strengthen liaison and cooperation

- With the sustained development of the Mainland economy during the 11th FYP period, it is expected that listings of Mainland enterprises will remain an important source of growth for the Hong Kong securities market. Besides, more enterprises may adopt the model for the simultaneous dual listing of A-share and H-share. In the light of the above, we hope to strengthen liaison and cooperation with the Mainland on areas including regulation, information dissemination, cross-boundary trading and clearing arrangements, etc. This can facilitate Hong Kong to play a more prominent role in supporting the continuous reform and economic development on the Mainland.

- To achieve the above objective, we recommend strengthening high-level Government liaison between the Mainland and Hong Kong, and enhancing communication among the HKEx, the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE) to deliberate on matters relating to the exchanges' operation.

(2) Strengthen Hong Kong's role as the investment platform for the Mainland

- As convertibility for capital account items on the Mainland is gradually implemented, it is expected that capital outflows would increase. To facilitate Hong Kong to perform fully its function as the global investment platform for Mainland capital, we recommend expanding the permissible investment universe for the Qualified Domestic Institutional Investors (QDII) scheme to include Hong Kong equities and collective investment schemes authorised by the Securities and Futures Commission (SFC). This may start with H-shares and H-share investment funds.

- To facilitate Mainland investors, we recommend introducing a "free-walk" scheme for capital, which allows Mainland individuals and institutions to remit "self-owned" foreign exchange out of the Mainland and make investments overseas on their own through Hong Kong without having to go through QDII. The scheme can, as a trial, start with high net worth Mainland individuals owning a certain amount of financial assets (e.g. over RMB 1 million).

1.22 Development of RMB and Commodities Futures Market

- The rapid economic growth in Mainland in recent years has created an increasing demand for risk management in respect of commodities prices. Hong Kong may consider utilizing our strengths to perform the risk transfer function of an RMB and commodities futures market. This can also broaden the functions performed by, and product development in, the Hong Kong financial markets.

- For the development of the RMB futures and options market, we can begin with non-deliverable RMB products and move towards deliverable RMB products when conditions warrant.

- As regards the development of the commodities futures market, it is recommended that an independent consultancy study be commissioned to look into the detailed conditions and requirements for such endeavour and make concrete proposals, with the Mainland intended as a major participant.

- Hong Kong should leverage on the Closer Economic Partnership Arrangement (CEPA) and QDII platforms to add the proposed RMB and commodities futures and options to the eligible investment vehicles list. Currently, 31 Mainland enterprises are permitted to trade commodities futures in overseas exchanges. Six Mainland futures brokerage firms are also allowed to set up branches in Hong Kong. We hope to attract those Mainland enterprises permitted to trade commodities futures overseas, and the customer base of Mainland futures brokerage firms operating in Hong Kong.

- Hong Kong's open and internationalized market can help bring Mainland and international players together and set the best benchmark for RMB exchange rate expectations and enhance China's pricing power in the commodities market.

- To develop our RMB and commodities futures market, it would be necessary to upgrade the current trading and clearing systems to handle the relevant futures and options trading. Rules and procedures for trading RMB and commodities products as well as regulatory issues would also need to be resolved. We would engage the support of the Mainland Government in the development of RMB and commodities futures markets in Hong Kong, and address the cross-boundary clearing and settlement issues.

1.23 Insurance, Reinsurance and Asset Management Sectors

- Promote Hong Kong to become an offshore RMB center by encouraging RMB trade-related settlements and as an offshore RMB bond market.

- Attract Mainland licensed insurance companies to set up asset management companies / affiliates in Hong Kong.

- Facilitate HK$ / US$ -denominated investments as admitted assets for insurance investments in the Mainland.

- Facilitate Mainland enterprises and investors to participate in Hong Kong authorised funds through the QDII initiatives.

- Hong Kong insurers to assist in the development of micro insurance in rural area of the Mainland.

- Foreign life insurers to participate in foreign currency denominated life insurance business in the Mainland.

- Hong Kong insurers to introduce specialised commercial liability insurance products to the Mainland market.

- Hong Kong insurers to set up specialised health insurance companies in the Mainland (including commissioning of hospitals/managed care and health maintenance organisations by Hong Kong companies), while Hong Kong pension providers may also participate in the offering of corporate annuity business in the Mainland.

- Set up examination centers for the Mainland agency qualification examinations in Hong Kong and provide a wider range of training courses as well as job attachments for Mainland professionals.

1.24 We recommend that the HKSARG engage in discussion with the concerned ministries and commissions of the Mainland as soon as possible on how the above-mentioned recommendations relating to policy and market issues may be taken forward, in order to complement the implementation of the 11th FYP, enhance the efficiency of the country’s financial system, safeguard the country’s financial security and consolidate Hong Kong's status as an international financial centre.

Focus Group on Financial Services - Membership

Panelists:

1. Dr The Hon LI Kwok-po, David, L.L.D., G.B.S., J.P. (Convenor)
2. The Hon ARCULLI, Ronald, G.B.S., J.P.
3. Professor CHAN Ka-keung, J.P.
4. Mr HE Guangbei, Gary
5. Dr HU Zu-liu, Frederick
6. The Hon LEE Yeh-kwong, Charles, G.B.M., G.B.S., J.P.
7. Mr LEUNG Pak-to, Francis
8. Dr TSE Sze-wing, Edmund, G.B.S.

Official Representatives:

1. Mr Frederick MA Si-hang, J.P., Secretary for Financial Services and the Treasury
2. Mr Joseph YAM, G.B.S., J.P., Chief Executive, Hong Kong Monetary Authority
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Chapter 2 The Working Relationship Between the Two Financial Systems under "One Country, Two Systems"

Introduction

2.01 China is unique in having two financial systems within the same country under "one country, two systems", allowing a unique strategy in financial sector development. However, how the two financial systems should work together for their mutual benefit and in the interest of the country as a whole is an important issue that, in the opinion of the Focus Group, can be further discussed and explored. It is necessary for the HKSARG to engage the Mainland authorities in developing the optimal working relationship between the two systems, having regard to the mutual benefits to the two systems and to the interests of the country in rapid economic transition as a whole.

Beyond politics and governance

2.02 In the years immediately before and after the resumption of sovereignty over Hong Kong, whenever "one country, two systems" is mentioned, the focus of attention was mostly on the governance arrangements for the HKSAR, in particular on the separateness of the two systems and the high degree of autonomy with which Hong Kong is to be governed. There has not been a lot of discussion on the relationship between the two systems within the country; where there is, again the focus has been mostly on the political relationship, with considerable emphasis on safeguarding the autonomy of the HKSAR.

2.03 This emphasis is understandable over the sensitive period of political transition. The concept of "one country, two systems" is new to everyone. There have therefore been great efforts from all concerned to make it work and ensure that it works well for the HKSAR. These efforts have been very successful, as is quite clearly demonstrated by the successful record of governance of the HKSAR since 1 July 1997.

2.04 But the relationship between the two systems within the country is a multi-dimensional one. While the governance relationship at the political level is of crucial importance, the relationships on other dimensions also require close attention. One important question that needs to be answered is whether, on any one of these other dimensions, the two systems have a working relationship that maximises the mutual benefits of the two jurisdictions and therefore is in the best interests of the country. There are two systems in our country in many respects, by virtue of the unique arrangement of "one country, two systems". It is time to articulate and develop the optimal relationships between the two systems on the non-political dimensions.

Hong Kong's financial system

2.05 Although the population of Hong Kong is equivalent to only 0.5% of that of the Mainland, its Gross Domestic Product (GDP) is about 8%. The total assets of the banking system of Hong Kong are equivalent to 21% of those of the Mainland. The quality of assets is better and the efficiency in financial intermediation through the banking channel is also higher. The capital markets of Hong Kong are more developed than those of the Mainland. Capitalisation of the equity market of Hong Kong is 2.6 times that of the Mainland. The amount of funds raised in the past ten years in the stock market in Hong Kong is nine times that on the Mainland. The size of Hong Kong's debt market is equivalent to 24% of that of the Mainland, and liquidity is a lot higher.

2.06 The potential for the utility of Hong Kong's financial system to the country is great. For instance, what the country needs now, and urgently, is an effective mechanism for financial intermediation, in other words, in the mobilisation of the huge amount of savings (now equivalent to about 45% of GDP) into the hands of those who need funding to finance consumption, investment and other economic activities – a process essential for sustaining economic growth and development. Currently, domestic savings are mostly trapped in the banking system. Even though they are earning fairly low rates of interest, the savings rate is still extremely high. There is a lack of diversity in investment opportunities. The ability of the banking system in allocating funds in accordance with the credit-worthiness of the borrower, while improving, is still not entirely efficient in view of the relatively low degree of market orientation in credit allocation. Thus, the overall effectiveness of the financial system on the Mainland in performing the important task of financial intermediation is not what it should be for a country of such economic strength.

There are, of course, concrete plans for improvement, but meanwhile the need for financial intermediation is there and has to be satisfied. This is where Hong Kong's financial system can come in.

2.07 As reform and liberalisation of the financial system on the Mainland continue, allowing the greater play of market forces, there would be a need to conduct experiments in specific areas of activity in finance. The free markets of the HKSAR provide the ideal environment for such experiments.

2.08 The Mainland is also becoming an increasingly important player in international financial markets, to the extent possibly of being in a position, in time, to cause (or indeed dictate) a migration of activity and liquidity into the Asian time zone, if the financial infrastructure in support of the market is available here. It would be in the interests of the Mainland to see such migration, if only for the purpose of prudently managing the market, payment, settlement and other risks arising from operating in markets not in the same time zone. Thus the increasing involvement of the Mainland in international financial markets and the sophisticated financial infrastructure already in existence in Hong Kong should have considerable scope for co-operation and interaction between the two systems.

Relationship building

2.09 Developing the non-political, working relationship between the two financial (and indeed other) systems of the country is clearly of benefit to the country as a whole and to the two respective financial systems. There seems considerable scope for a complementary, cooperative and interactive working relationship:

- **Complementary** means that the respective strengths of the two financial systems are exploited and weaknesses of one system are addressed by the other system. For instance, with Hong Kong's financial system already open to the rest of the world while Mainland's not yet fully liberalised, accessing international financial markets through Hong Kong can help reduce direct exposure of Mainland's financial systems to external financial risks in the course of its reform. Furthermore, the more developed and diversified financial system in Hong Kong can also complement Mainland's financial system that relies largely on the banking channel for financial intermediation;

- **Cooperative** means that the two financial systems can benefit from closer collaboration in areas such as financial supervision, financial infrastructures, risk management, through technical transfers, information exchange, qualification recognition and harmonisation of standards; and

- **Interactive** means that the two financial systems should interact with a view to enhancing the role of China as a country in the setting of international financial standards and policies. Furthermore, interaction in terms of constructive competition can help promote financial intermediation efficiency and the development of financial markets within the country.

2.10 The question is, of course, how such a working relationship should best be developed. It is quite natural to think that the development of such a relationship between the two financial systems could be left to the market. While this is theoretically possible, it requires that market forces be allowed to work freely across the two financial systems, which is not the case. By contrast, for example, in terms of visible trade, market forces do, by and large, work freely, and the two economic systems were thus able to specialise in areas in which they each have a comparative advantage in producing. But in terms of the provision of different services, there are restrictions limiting the working of market forces, for example, restrictions on access of service providers from the other system and restrictions on the mobility of the user of services across the two systems. On top of these, there are the restrictions in the mobility of factors of production, notably labour and capital. These restrictions are there for good reasons, but they do mean that the development of a working relationship that is beneficial to both systems and to the country as a whole cannot be left just to market forces. There is a clear case for the involvement of the authorities responsible for the respective policy areas.

2.11 Notable cooperative efforts have already developed between the authorities in the two financial systems, particularly since China's resumption of the exercise of sovereignty over Hong Kong. These arose simply out of need and also out of the initiatives of the authorities concerned, for example in financial supervision. But it is fair to say that the process has in general required considerable effort of all those concerned. Neither has the outcome always been as productive as it could be, having regard to the purely economic considerations. This partly reflects the asymmetry of the restrictions mentioned earlier, with the restrictions being much more prevalent on the Mainland than in the HKSAR. Thus the development of the working relationship of mutual benefit will normally require policy decisions on the Mainland to a much greater extent than in the HKSAR.

2.12 The Focus Group notes that, to take advantage of the utility of the financial system of the HKSAR, there is a need on the part of the Mainland to embark on new areas of financial liberalisation. This may present risks to monetary and financial stability on the Mainland, and the risks need to be closely monitored and prudently managed. The high degree of financial freedom in the HKSAR, buttressed by the requirement in Article 112 of the Basic Law that no foreign exchange control policies shall be applied in the HKSAR, calls for a special approach in the HKSAR for satisfying the need on the part of the Mainland concerning risk monitoring and management.

2.13 The Focus Group notes further that the special approach in the HKSAR in the enforcement of prudential safeguards and the provision of regulatory information essentially through contractual arrangements involving only the service providers has worked well. A notable example is the contractual access by licensed banks conducting RMB banking business to the RMB inter-bank clearing system on the Mainland through a RMB clearing bank in the HKSAR. Confidence of the Mainland authorities in the robustness of such a special approach to risk monitoring and management is essential to providing encouragement to financial liberalisation. Market practitioners therefore have an important role to play voluntarily in safeguarding the integrity of these contractual arrangements. There is also considerable scope for them to contribute to the design of the relevant "management methods".

Way forward

2.14 Clearly, under the unique arrangement of "one country, two systems", a complementary, cooperative and interactive working relationship should be developed between the two financial systems of China. This is for the mutual benefits of the two systems and in the best interest of the whole country. Such a relationship does not and should not cause any concern on the governance of the HKSAR at a political level, although there is a need for initiatives at the political level to bring it about. The implementation of the 11th FYP on the Mainland and the articulation of an appropriate response from the HKSARG provide an ideal opportunity for pursuing such initiatives. Further, as the broad directions in the 11th FYP are being translated on the Mainland into policy proposals and concrete action, there is a need for the HKSAR to get involved in the process, at least in matters in which the HKSAR has an interest. Concurrently, in Hong Kong, a proactive stance should be adopted to explore how our financial system could contribute in a more systematic way than hitherto to enhancing the effectiveness of financial intermediation on the Mainland and be used as a testing ground for financial reform and liberalisation of the Mainland.

2.15 Specifically, the Focus Group recommends that:

- **At the political level, the HKSARG should intensify efforts to impress upon CPG the utility of the financial system of the HKSAR to China, in satisfying the fundamental needs on the Mainland for effective financial intermediation, in organising international financial activity of the Mainland and in providing the ideal laboratory for experimenting with financial reform and liberalisation, and the benefits to the country for CPG to maximise and take advantage of such utility.** ***(Recommendation F1-1)***

- **At the policy-making level, the relevant financial authorities of the HKSARG should proactively engage in discussions with their counterparts on the Mainland on policy formulation and the design of strategies, including sequencing of financial development, particularly in areas where the utility of the financial system of the HKSAR points to distinct benefits to the country as a whole. To facilitate this, it is advisable for the HKSARG to seek CPG's agreement to establish structured channels whereby the HKSARG could participate and the CPG could consider the**

views of HKSARG regularly in national financial policy formulation. ***(Recommendation F1-2)***

- **At the working level, the relevant financial authorities of the HKSARG and the market practitioners in the HKSAR should, under close collaboration with counterparts on the Mainland, develop operational details (management methods) of specific policy initiatives, particularly those for application in the HKSAR under a contractual or voluntary framework.** ***(Recommendation F1-3)***

Chapter 3 A Strategy for the HKSAR to Make Greater Contribution to Financial Intermediation on the Mainland

Introduction

3.01 Deng Xiaoping said "finance is very important; it is the nucleus of a modern economy". The essence of finance is about financial intermediation – the mobilisation of savings to finance economic activities and investments in an effective manner. Financial intermediation is conducted through three channels - banking, and the equity and bond markets - whereby the investment needs of savers, with varying risk appetites, and the financing needs of fund-raisers, with varying degrees of credit-worthiness, can be effectively matched, with or without financial intermediaries, both on a domestic and on an international dimension. Supporting the three channels of banking and the equity and bond markets are insurance market and derivatives markets, which are essential to the functioning of the financial system by providing risk transfer and protection. A stable, diversified and efficient financial system with a high degree of integrity is crucial to sustaining economic growth and development.

3.02 There is clear recognition on the Mainland of the importance of finance, in particular the need for improving the structure and efficiency of the financial system. The 11^{th} FYP has set out, in its Chapter 33, the policies for expediting financial reform in a number of areas. In particular, reform is targeted at improving direct finance through the greater use of the equity and bond markets. The FYP has also emphasised the need to deepen the reform of financial enterprises and improve corporate governance of financial institutions as well as their supervision. At the same time, the FYP confirms the policy desire to make the RMB convertible also in the capital account in a gradual manner.

3.03 As pointed out in the previous chapter, China is unique in having two financial systems at its disposal for satisfying the needs of effective financial intermediation for the country. The Focus Group is of the view that, given the many differences of the two financial systems, there is considerable scope for exploiting relative strengths, addressing relative weaknesses and maximising synergies in the best interests of the country as a whole and that a complementary, cooperative and interactive working relationship between the two systems should be fostered. Building on this argument, this chapter discusses, from a macro, strategic point of view, the relevant financial challenges confronting the Mainland and how the Mainland could make greater use of the financial system of the HKSAR in meeting these challenges, and develops a strategy and specific recommendations for doing so. The rest of this chapter is organised as follows: Part 1 discusses certain financial challenges confronting the Mainland, which sets the scene for a discussion, in Part 2, on what the financial system of the HKSAR can offer to help meet those challenges. Part 3 then develops a five-pronged strategy to enable the financial system of the HKSAR to play the roles identified and, within that strategy, presents a total of 27 specific recommendations.

Part 1 – Financial challenges on the Mainland

3.04 The Focus Group recognises that there are many financial challenges on the Mainland, some of which are specific to the Mainland, operating a Chinese style, socialist market economy with a continuing emphasis on ownership by the public sector. These challenges may require special solutions that reflect the special circumstances on the Mainland. But the basic function of the financial system in financial intermediation is a universal one and, with globalisation, there is considerable scope for interaction and therefore the adoption of common practices between the financial systems of different jurisdictions. In view of what is outlined in the 11th FYP and the desire to enhance the utility of the financial system of the HKSAR to the Mainland, the Focus Group considers that three specific financial challenges confronting the Mainland as most relevant to its deliberations. For the purpose of scene-setting, these are discussed below.

Effectiveness of financial intermediation

3.05 Currently, financial intermediation of the Mainland on the international dimension – predominantly the channelling of foreign savings into the hands of fund raisers on the Mainland and significantly less so the channelling of Mainland savings to overseas investments – is mainly conducted effectively, to the extent the related activities have received approval from the Mainland authorities, through the HKSAR and other international financial centres. Domestic financial intermediation of the Mainland – the mobilisation of domestic savings into the hands of fund raisers on the Mainland – is performed on location by the domestic financial system, as is traditionally the case in any jurisdiction.

3.06 This important process of domestic financial intermediation on the Mainland has for a long time been characterised by a high degree of dependence on the banking channel. In the past five years, for example, bank credit accounted for around 80% of the external finance of the corporate sector. The degree of diversity in the channels for the mobilisation of domestic savings, in other words the diversity of investment opportunities open to investors, is relatively low. Furthermore, the ability of the banking system in allocating funds in accordance with the credit-worthiness of the borrower, while improving, is still not entirely efficient in view of the relatively low degree of market orientation in credit allocation. Mis-pricing of risks also remains a problem. Thus, the overall effectiveness of the financial system on the Mainland in undertaking the important task of domestic financial intermediation is not as high as it should be.

3.07 Significant progress has been made on the Mainland in reforming and developing the equity and bond markets in recent years. However, the equity market as a fund-raising platform has yet to attain a degree of sophistication and command an adequate degree of investor confidence to becoming a meaningful alternative channel for domestic financial intermediation. At the same time, the bond market is accessible only by large enterprises, and the issuance of medium to long term corporate bonds is still subject to approval and regulations on quantity. Coupled with the need for banks to improve their capacity in allocating credit on a commercial basis, funding from the financial system has been disproportionately oriented towards large corporations, which have better collateral for borrowing and in many cases government support, making it particularly difficult for small to medium-sized enterprises to obtain financing. On the other hand, although having grown rapidly in the recent years, the insurance industry on the Mainland is still in a relatively early stage of development and its dual roles of savings mobilisation and risks pooling and transfer are far from being fully utilised.

3.08 Diversity in financial intermediation is important to financial stability, in terms of the availability of alternative sources of finance when, for whatever reasons, the predominant channel of financial intermediation is under stress. This also means that economic growth and development are more vulnerable than otherwise is the case to financial shocks, either requiring the maintenance of unusually high levels of corporate savings as cushions or the frequent involvement of the official sector in underwriting the financial system and possibly large state-owned enterprises, and assuming the moral hazard that this involvement entails.

3.09 Furthermore, with domestic savings largely trapped in the banking system, earning fairly low rates of interest, the savings rate, at about 45% of GDP, is being sustained at an unusually high level. Consequently, the rate of gross domestic fixed capital formation is also sustained at a high level, and the imbalance in the structure of economic growth persists, presenting unusually high risks for the occurrence of sharp and destabilising economic cycles.

3.10 It is not the task of the Focus Group to prescribe appropriate responses to these financial challenges confronting the Mainland. But it seems clear to the Focus Group that, the responses may need to have as one objective the provision, sooner rather than later, of a spectrum of investment opportunities, involving varying combinations of risk, return and liquidity, to Mainland investors, so that they can make investment decisions with confidence, earn a higher rate of return for their savings and subsequently feel more comfortable in increasing consumption and saving less. The responses should also have, as another important objective and with some urgency, the creation of effective and diversified avenues for domestic financial intermediation, including the possibility of facilitating this offshore, in particular where efficiency is high, investor protection measures adequate and where there is deep appreciation on the needs and concerns of the Mainland: this points quite naturally to the financial system of the HKSAR.

External imbalance, the exchange rate and monetary management

3.11 The Mainland is running a large balance of payments surplus. This is attracting intensive international attention, largely manifested in accusations that China is to a great extent responsible for the global imbalance, unhelpful political pressure on the exchange rate of the RMB and a resurgence of protectionist sentiment in the international trade in goods and services. The Focus Group is, however, aware of a number of academic studies and public statements made by authoritative sources that, while greater flexibility in the RMB exchange rate is helpful, it is unlikely that even a large appreciation in the exchange rate of the RMB would make a meaningful difference to the global imbalance, let alone eliminate it. The Focus Group agrees with this view, along with the associated concern also expressed in the studies and statements that sharp and large exchange rate volatility may present risks for the financial system on the Mainland.

3.12 The Focus Group also notes the large current account surplus of the Mainland, coupled with some expectation of further appreciation in the exchange rate of the RMB and continuing net inflow of foreign direct investment, have led to a rapid accumulation of foreign reserves, which is fast approaching US$1 trillion. This is in turn posing difficulties to monetary management on the Mainland. Sterilisation of base money injected along with reserve accumulation on the Mainland requires the issue of increasing amounts of central bank papers and the involuntary holding of such papers mainly by the banks. As the yield of the papers is fairly low, this has adverse effects on the profitability of the banks, which could only be countered by the maintenance of a net interest margin for traditional banking activities that is larger than would otherwise be the case, further inhibiting the efficiency of the banks as a channel of financial intermediation.

3.13 Again, the Focus Group is not in a position, and is not attempting, to prescribe appropriate responses to this set of challenges. But it does seem that one possible response, having regard also to the need to provide a greater variety of investment opportunities to those who save, may be to implement bold but careful steps in capital account liberalisation, giving priority to, for example, outward portfolio investments by residents. This would lessen, stem or even reverse the capital inflow that is now proving to be difficult to handle and possibly storing up financial problems for the future.

3.14 Expectation of further appreciation in the exchange rate of the RMB may, however, dampen the enthusiasm of Mainland investors concerning overseas investments. But further relaxation of outward investment by residents (and other capital account liberalisation measures) should help alleviate the pressure on RMB and hence dampen expectation of appreciation in the exchange rate. In any case, the extent of any residual expectation on exchange rate appreciation is likely to be exceeded by the risk adjusted investment return of foreign assets. And there are “foreign” financial assets, for example H-shares in Hong Kong, which have already an imbedded hedge against exchange rate risks.

3.15 There are many options for capital account liberalisation, and, very much in the spirit in which the QDII schemes have been organised. The Focus Group is confident that, if further liberalisation is conducted through Hong Kong markets where there is close regulatory cooperation with the Mainland, these can be structured in a manner satisfying the three important criteria of reform and liberalisation measures laid down by Premier Wen that they should be “proactive, controllable and gradual”.

Internationalisation of the RMB

3.16 As the RMB gradually becomes a convertible currency also in the capital account, meaning that it gradually achieves the status as a freely convertible currency, and being the currency of the fourth largest economy of the world and third largest trading nation, the RMB will become an international currency, and will be used as a medium of exchange, store of value and unit of accounting outside of the domestic economy. In the longer term, the RMB may become a reserve currency in which foreign reserves are held and an anchor currency against which exchange rates of other currencies are fixed. Although there is as yet no declared policy on the Mainland that the Focus Group is aware of concerning the internationalisation of RMB, this in the opinion of the Focus Group seems to be an inevitable process.

3.17 There are, of course, strategic advantages for the RMB to become an international currency. These include: seigniorage revenue for the central bank as a result of the circulation of RMB offshore; domestic institutions and individuals can avoid exchange rate risk by using RMB for external trade and investments; and furthermore, Mainland institutions can issue RMB-denominated bonds overseas, facilitating the finance of any deficits in balance of payments. But, on the other hand, changes in the offshore demand for RMB could pose risks to financial stability and the operation of monetary policy on the Mainland.

3.18 The pace of that process will obviously be dependent upon the pace of liberalisation of the capital account, interacting with the dynamism of the free market. The experience of currencies of other jurisdictions suggest that there is nothing much that the authorities can do to internationalise a currency if the market does not accept it or to prevent the internationalisation of a currency if the market so desires. The sheer size and the rapid growth of the Mainland economy clearly put the RMB in the latter category and it is therefore advisable to be prepared for its internationalisation, along with capital account liberalisation. Preparation should, on the one hand, focus on putting in place a mechanism for the prudent management of the risks arising from that inevitable process and from that international status after it has been achieved, and, on the other hand, in providing a robust and efficient financial infrastructure to facilitate the use of the currency in international financial transactions.

3.19 In the opinion of the Focus Group, there is a clear need now on the part of the Mainland to experiment with the convertibility of the RMB in different, hitherto restricted areas, and for a "laboratory" to conduct these experiments. The ideal laboratory is a place where the forces of the free market are allowed to play to their fullest extent. It should be a place in which there are considerable economic and financial linkages with the Mainland, in other words, where there is considerable demand for a convenient medium (currency) for the conduct of transactions arising from that close relationship. It should also be a place in which the financial infrastructure is capable of handling financial transactions denominated in the RMB safely and efficiently, enables the risks associated with the use of a foreign currency "offshore" to be prudently managed, and is structured, insofar as RMB payments are concerned, as an extension of the RMB payment system on the Mainland. That ideal laboratory is already in existence.

Part 2 – Meeting challenges: what the HKSAR can offer

3.20 These are formidable challenges and it would be in the interest of the country as a whole to mobilise resources available to it to ensure that these challenges are met, the opportunities taken advantage of and the risks prudently managed. The Focus Group is strongly of the view that the financial system of the HKSAR has a great deal to offer in assisting the Mainland to meet these challenges. Furthermore, to be able to do so is a necessary condition for the maintenance of the status of Hong Kong as an international financial centre, as mandated in Article 109 of the Basic Law and reiterated in the 11th FYP.

3.21 The Focus Group examines and endorses a view developed earlier by the HKMA that there are, in general terms, three roles for the financial system of the HKSAR in assisting the Mainland in meeting the financial challenges identified in Part 1 of this Chapter. These are discussed below.

Role in financial intermediation between the Mainland and the rest of the world

3.22 The financial system of the HKSAR has been a significant conduit for the channelling of foreign savings to Mainland fund raisers. Indeed, in recent years, insofar as the raising of funds through the equity market is concerned, the HKSAR has become the largest funding source for Mainland enterprises, surpassing London and New York. H-shares have become so popular to international investors that they are now quite willing to come to the stock market of the HKSAR to participate in the offer, rather than the Mainland enterprises having to list shares in for example New York in order to attract the investor interest in the United States. This is encouraging and every effort should be made to sustain this role of the stock market of the HKSAR as the premier fund raising centre for Mainland enterprises. This subject is discussed in greater detail in Chapter 5.

3.23 By comparison, the popularity of the HKSAR as a centre for Mainland enterprises to raise funds through the issue of debt is less well developed. Foreign debt is invariably raised in foreign currencies and the liquidity of the debt market in those currencies is obviously a lot higher in the jurisdictions of the currencies in question.

And there does not seem to be a significant need for Mainland enterprises to raise Hong Kong dollar debt. But it is possible for debt issues in the major foreign currencies (the US dollar and the euro in particular) to be organised in the HKSAR – the demand for foreign currency debt in the region is substantial, given the abundance of foreign reserves, the price discovery mechanism should therefore be efficient, and the financial infrastructure of the HKSAR, which includes real time payment systems for the US dollar and the euro, should be able to cope with debt issues in those currencies without difficulty. More extensive marketing efforts from the HKSAR may help. The Focus Group, however, considers that, given the extensiveness of State ownership of many of the Mainland issuers of foreign debt, a conscious policy shift may be required to boost development on this front. This is a subject matter discussed in greater detail in Chapter 4 of this Report.

3.24 As identified earlier in Part 1 of this Chapter, meeting the financial challenges confronting the Mainland now requires attention on how domestic savings on the Mainland should better be mobilised, including enhancing its outward mobility, in order to achieve a higher rate of return for Mainland investors, thereby increasing consumption, lowering the savings rate and achieving more balanced economic growth. Indeed, as convertibility for capital account items is gradually implemented and the placing of foreign currency assets overseas is allowed, capital flows will become increasingly two-way. The HKSAR should try and position itself as the first port of call, if not the final destination, for the much anticipated capital outflow that will come. A strategy for doing so, together with specific recommendations, is discussed in Part 3 of this Chapter. While it is for the HKSARG to open doors and to create channels to facilitate the outward mobility of capital from the Mainland, the Focus Group is confident that the free market can be relied upon to come up in the HKSAR with an impressive range of investment and risk management products for offshore investments by Mainland institutions and individuals.

Hong Kong's role in assisting domestic financial intermediation on the Mainland

3.25 Financial intermediation on an international dimension, while important, is probably only a small part of the financial activity needed to support the economy of the Mainland and sustain economic growth there. This is evidenced in the sheer size of the economy of the Mainland, the still relatively low degree of external orientation of the economy and the very high savings rate. The domestic financial intermediation needs on the Mainland are enormous and, as pointed out earlier in this Chapter, enhancing the effectiveness of domestic financial intermediation on the Mainland is a quite a formidable challenge. As a sophisticated financial system, the HKSAR should be in a position to play a significant role in meeting this challenge.

3.26 Building on the function as a platform for Mainland's international financial intermediation, the HKSAR can increase its participation in Mainland's domestic financial intermediation in two ways to help improve financial intermediation efficiency on the Mainland. First, the financial institutions of the HKSAR can broaden their presence on the Mainland, thereby introducing competition, financial innovation and risk management practices. Secondly, as Mainland's capital account is liberalised, the outward mobility of fund-raisers and investors is enhanced. The HKSAR can provide a convenient, low-risk and efficient platform for Mainland investors and fund-raisers to meet, thereby channelling Mainland savings to the hands of fund-raisers on the Mainland. For instance, with restrictions on offshore investments being relaxed, Mainland investors can invest in the shares of Mainland enterprises listed in the HKSAR.

Hong Kong's role as laboratory for capital account RMB convertibility and increasing international use of the currency

3.27 Hong Kong is the first place outside of the Mainland to have banks providing deposit-taking, exchange, remittance and card services in RMB. With the experience of conducting RMB business since 2004 and the close cooperation between the financial regulators in the HKSAR and on the Mainland, the HKSAR can provide a reliable testing ground for the move towards RMB convertibility and its increased use in international trade and financial transactions and for the associated risks to be prudently managed. The State Council is studying the scope for further expansion of RMB business in the HKSAR, which includes allowing HKSAR importers to settle direct import trade from the Mainland in RMB, and financial institutions on the Mainland to issue RMB financial bonds in the HKSAR on a pilot basis. In tandem with the process of RMB internationalisation, the HKSAR should strive to be the first mover and develop into a commercial and financial centre for trade and financial transactions settled in RMB outside the Mainland.

Part 3 – Strategy and recommendations

3.28 The Focus Group is convinced that the successful performance of these roles by the HKSAR will be of substantial benefit to the Mainland in meeting the financial challenges identified. But the HKSAR cannot pursue these roles in isolation. This requires conscious decisions on the part of the Mainland in a wide range of areas concerning currency convertibility; the cross border mobility of money (domestic or foreign currency), financial instruments, investors, fund raisers and financial intermediaries; and external financial infrastructure linkages. These are important decisions in financial liberalization, requiring careful consideration about sequencing, risk management and monetary and financial stability, and balancing them against the potential benefits of achieving higher financial efficiency and greater sustainability of economic growth and development.

3.29 As the Mainland adopts a comprehensive and strategic approach to financial liberalisation, there is a need for HKSAR to position itself to play the roles that it should. For this purpose, the Focus Group examines and endorses a five-pronged strategy developed earlier by the HKMA. The Focus Group also explores specific proposals in each of the five strategic areas, building on the efforts of the HKSAR in recent years. These are presented below under individual headings representing the five elements in that strategy. There are, in total, 27 specific recommendations that the HKSARG should usefully take up with the Mainland authorities. Obviously, having regard to present circumstances on the Mainland, some of the recommendations are more plausible than others, in terms of gaining acceptance on the Mainland. It is up to the HKSARG, along with developing a complementary, cooperative and interactive working relationship between the two financial systems, to work with the Mainland authorities on the appropriate sequence for the implementation of the relevant recommendations.

Expand the presence of HKSAR financial intermediaries (including banks, securities companies, investment banks, fund management companies and insurance companies) on the Mainland to provide financial services on location

3.30 With a savings rate of about 45% and rapid economic growth, the demand for financial services on the Mainland is enormous. Many of these services, in particular the more basic ones of, for example, retail deposit-taking and lending, need to be provided on location. The efficiency of the financial intermediaries of the HKSAR is high and, more importantly, they understand the financial needs on the Mainland, in terms of the services required by investors and in terms of the credit-worthiness of fund raisers, a lot more than those from other jurisdictions. As such, they are less likely than others to be "fair-weather friends" and likely to function in a manner more consistent with the long term economic well being of the Mainland. Their financial strength, in terms of for example capital adequacy (rather than size of capital) is also superior.

3.31 Entry restrictions on the Mainland are being relaxed gradually, through for example CEPA efforts, but significant obstacles remain, in terms of foreign ownership, management and the scope of financial business that can be undertaken. The risks of greater competition presented to domestic financial institutions obviously need to be managed, which explains the gradual pace of relaxation hitherto adopted by the Mainland authorities. The benefits arising from the transfer of know-how in areas such as product development, risk management, corporate governance, financial innovation are also obvious, not to mention the overall increase in efficiency in the delivery of financial services that comes with competition. The Focus Group thinks that the pace of relaxation could be considerably quickened without threatening the position of the domestic financial institutions and financial stability, particularly in areas concerning the **ownership** and **management** of financial institutions on the Mainland by Hong Kong entities, and the **scope of businesses** that can be conducted by foreign financial institutions. The Focus Group has the following specific recommendations:

- **Increase the allowable maximum level of shareholding by Hong Kong financial intermediaries in Mainland financial**

intermediaries beyond the current arrangements. *(Recommendation F2-4)*

- **Increase, through appropriate arrangements (such as management contracts), the involvement of Hong Kong shareholding representatives in the management of the Mainland financial intermediaries. *(Recommendation F2-5)***

- **Allow Hong Kong banks to conduct the full range of business and on same conditions as Mainland domestic banks, including:**

  - **to offer RMB services on the Mainland without the requirement of prior operation on the Mainland;**

  - **to offer intermediary services including distribution of RMB bonds and investment funds on the Mainland;**

  - **to sell as agents both onshore and offshore investment products, with the necessary investor protection arrangements in place;**

  - **to provide custodian services on the Mainland beyond Qualified Foreign Institutional Investors (QFII) and QDII schemes; and**

  - **lower the level of operational funds required for the Mainland branches of Hong Kong banks. *(Recommendation F2-6)***

- **Allow Hong Kong securities companies (including investment banks), fund management companies and insurance companies to set up wholly-owned subsidiaries or branches on the Mainland. *(Recommendation F2-7)***

- **Allow Hong Kong securities companies and fund management companies (wholly-owned subsidiaries, branches, or joint-ventures with Mainland counterparts) to conduct the full range of business and on same conditions as their Mainland domestic counterparts, including**

participating in corporate bond issues, IPOs and other financing activities on the Mainland. ***(Recommendation F2-8)***

- **Allow Hong Kong insurers and pension providers (wholly-owned subsidiaries, branches, or joint-ventures with Mainland counterparts) to have a wider scope of business and penetration in geographical markets in the areas of reinsurance, life, general and medical insurance and pension etc. (See details in Chapter 7)** ***(Recommendation F2-9)***

Increase the outward mobility of Mainland investors, fund raisers and financial intermediaries

3.32 Greater outward mobility for Mainland investors will expose them to a much greater diversity of investment opportunities, including importantly financial instruments issued by fund raisers from the Mainland, thus completing the process of "domestic" financial intermediation by using the platform offered by the financial system of Hong Kong. Investors will also be able to achieve a significantly higher rate of risk adjusted return for their savings, which will eventually stimulate consumption, lower the savings rate, thus achieving more balanced and therefore sustainable growth for the economy.

3.33 Greater mobility for fund raisers will enhance the source of funding for them, particularly for those that are credit-worthy but have experienced difficulty in obtaining funding on the Mainland, for example, the small and medium sized private sector enterprises. At the same time, they will be subject to the scrutiny of the free market in Hong Kong and the international standards that apply, in terms of corporate governance and information disclosure, which will work to enhance the economic efficiency of the borrowers. Meanwhile, to ensure that the HKSAR platform is an efficient one for use by Mainland fund raisers, there is a need for the HKSAR to continue to improve the price discovery mechanism and market infrastructure of the stock market, in terms of liquidity and market making arrangements, hedging and risk management, transaction costs etc. Specific proposals in this regard are set out in Chapter 5.

3.34 The greater mobility of financial intermediaries to the HKSAR will bring more intimate knowledge of the Mainland to the HKSAR and enable the financial system of the HKSAR to satisfy better the needs of Mainland investors and fund raisers. It would also serve to expose financial intermediaries on the Mainland to the free market and to international practices, which will serve as a springboard for the further development of the international businesses of these financial intermediaries. The good cooperation among regulators in the HKSAR and the Mainland can ensure effective supervision over activities of such Mainland financial intermediaries outside the Mainland.

3.35 The Focus Group has the following specific recommendations:

- **Expand the permissible investment universe for offshore wealth management services by banks on the Mainland, such as to include Hong Kong equities and collective investment schemes (including investment-linked insurance schemes) authorised by the Hong Kong Securities and Futures Commission. This can start with H-shares and H-shares investment funds, and extend to other shares in Hong Kong and other types of investment funds later on. *(Recommendation F2-10)***

- **Allow Mainland individuals and institutions to remit "self-owned" foreign currency funds out of the Mainland and make investments overseas on their own through Hong Kong without having to go through QDII or bank wealth management scheme. Such "free walk" scheme for foreign exchange can start with high net worth Mainland individuals having financial assets of over, say RMB1 million, as trial for the purpose of investor protection. *(Recommendation F2-11)***

- **Further relax gradually the existing restrictions on Mainland enterprises raising funds through listings in Hong Kong, including for instance, by allowing issuance of RMB shares in Hong Kong. *(Recommendation F2-12)***

- **Further relax gradually the existing restrictions on Mainland enterprises raising funds through bank borrowing or bond issuance in Hong Kong, including for instance, by allowing**

bank borrowing or bond issuance in RMB. ***(Recommendation F2-13)***

- **Introduce a mechanism for Mainland's small and medium-sized enterprises to obtain venture capital and financing in Hong Kong, and facilitate their bond issuance using innovative financial arrangements organised in Hong Kong (such as high-yield bonds and collateralized debt obligations).** ***(Recommendation F2-14)***

- **Allow Mainland entities to establish captive insurance companies in Hong Kong, tapping into the expertise of the insurance industry in Hong Kong.** ***(Recommendation F2-15)***

- **Allow Mainland financial institutions to have bigger presence here, using Hong Kong as a springboard to develop their international business in relation to banking, securities, asset management, insurance and other activities. It is particularly important for the national social security funds and asset management companies to establish operation in Hong Kong, to diversify their asset holdings for better risk and return management.** ***(Recommendation F2-16)***

Allow financial instruments issued in the HKSAR, particularly those issued by Mainland fund raisers, to be marketed on the Mainland

3.36 This would help satisfy investor demand on the Mainland and, insofar as financial instruments issued by Mainland fund raisers are concerned, also complete the process of domestic financial intermediation. It would also alleviate the concern expressed by some in relation to the IPOs of certain H-shares in the HKSAR that the good assets of the country are sold overseas and not available to Mainland investors. The financial instruments can be traded on the Mainland through stock exchanges, the interbank market or over the counter, perhaps conveniently in the form of depository certificate evidencing the holding in trust of the underlying securities in the HKSAR, depending on Mainland preferences, but should be fungible with the corresponding financial instruments originally issued in the HKSAR. There should be a mechanism for arbitrage to facilitate price equalization between the two markets, operated either through a dedicated, non-profit making institution or through free entry to the arbitrage mechanism. Given that foreign exchange transactions are involved in the arbitrage process and given exchange controls, it may be that the former is more practicable initially.

3.37 The Focus Group is aware that movement in this strategic direction involves breaking new ground and the possible resistance from interested parties, both on the Mainland and in the HKSAR. The Focus Group, however, takes a long-term view on the matter, which necessarily points to the need to eliminate market fragmentation. Concerns about migration of market liquidity are short-term issues – there is simply a much bigger pie, in terms of secondary market activity, that in the fullness of time benefits everybody. It is the satisfaction of investor demand on the Mainland that will sustain primary and therefore secondary market activity in the HKSAR. In any case, a large proportion of investors still prefer to be serviced on location and have (perhaps physical) access to what they have bought, even though it is merely a statement that the underlying instruments are held in trust for their benefit somewhere else. It is also unrealistic, having regard to the circumstances confronting the HKSAR, to try and capture the lion's share of all secondary market activity originating from the Mainland in the HKSAR, on top of having the bulk of the primary market activity here.

3.38 The Focus Group has the following specific recommendations:

- **Introduce "depository certificates" of financial instruments issued in the HKSAR for trading on stock exchanges, inter-bank market or over the counter on the Mainland. This requires also the introduction of an arbitrage mechanism, with approvals for conducting the necessary foreign exchange transactions, to facilitate price equalisation between the depository certificates and their underlying financial instruments. As a trial, the scheme can start with depository certificates for newly issued H-shares, and then gradually be extended to existing H-shares, constituents of the Hang Seng Index, blue chips and other shares, and depository certificates of debt issues in Hong Kong, such as Exchange Fund Bills and Notes (EFBN).** ***(Recommendation F2-17)***

- **Allow trading of investment funds authorized by the Hong Kong Securities and Futures Commission, such as the Hong Kong Tracker Fund, on the stock exchanges, inter-bank market and over the counter on the Mainland. *(Recommendation F2-18)***

Enhance the capability of the financial system of the HKSAR in handling financial transactions denominated in RMB

3.39 The great majority of activities arising from domestic financial intermediation are invariably denominated in the domestic currency. For the financial system of the HKSAR to play a significant role in domestic financial intermediation of the Mainland, albeit conducted "offshore", it must be capable of efficiently handling financial transactions denominated in RMB. Furthermore, having regard to the prospect of RMB becoming an international currency used for international financial transactions, that capability is essential for the HKSAR as an international financial centre.

3.40 The Focus Group endorses the efforts of the HKSARG in the development of RMB banking business in the HKSAR in recent years. This business, which started in 2004, provides a good foundation for further development in this respect. It has also shown that, with a set of properly designed arrangements, allowing RMB convertibility and its use outside the Mainland in a controlled manner would be of benefit to both the Mainland and the HKSAR, without any negative implications on financial stability of both places. The pilot can be extended to areas using RMB to denominate trade transactions and financial instruments.

3.41 The Focus Group has the following specific recommendations:

- **Direct import trade from the Mainland to be settled in RMB first, and for indirect imports from the Mainland and exports from Hong Kong to be settled in RMB later on. *(Recommendation F2-19)***

- **Mainland financial institutions to issue RMB financial bonds in Hong Kong, with the scope of eligible issuers extended**

later on to Mainland corporates and Hong Kong entities. *(Recommendation F2-20)*

- **"Free walk" of RMB back onto the Mainland, i.e. to allow Hong Kong companies and residents to make RMB remittances freely to any accounts on the Mainland, starting with their own settlement account. *(Recommendation F2-21)***

- **Hong Kong banks to lend RMB funds to their group entities (subsidiaries or branches) on the Mainland. *(Recommendation F2-22)***

- **Establishment of a RMB Repurchase Agreement ("repo") and inter-bank market in Hong Kong. *(Recommendation F2-23)***

- **Non-residents to open RMB deposit accounts in Hong Kong. *(Recommendation F2-24)***

- **Hong Kong banks to provide and collect RMB notes to and from their overseas branches. *(Recommendation F2-25)***

Strengthen financial infrastructural linkages between the Mainland and the HKSAR

3.42 The utility of the financial system of the HKSAR for the country can only be maximised if there is unrestricted mobility of capital and financial instruments between the Mainland and the HKSAR, which will eventually come when the capital account of the Mainland is fully liberalized. But there is a need to ensure that such mobility is supported by a robust and reliable financial infrastructure that is safe and efficient. This requires the financial infrastructures of Mainland and the HKSAR to be linked up. The Focus Group notes that the HKMA has already established close contacts with the People's Bank of China on this important matter and that there is an effective Working Group between the two organisations looking at financial infrastructure linkage issues. The Focus Group endorses this worthwhile effort and encourages continued close cooperation.

3.43 Specifically concerning the financial infrastructure needed to support the international financial activities of the Mainland, whether or not these are conducted in the HKSAR, the Focus Group is of the opinion that the HKSAR has an important role to play. The HKSAR already has a multi-currency financial infrastructure platform that can cater for most of the Mainland's international payment and settlement needs. Given that there are already several cross-boundary linkages of payment and settlement systems established between the Mainland and the HKSAR, it will be cost effective for the Mainland to make fuller use of the foreign currency payment systems in the HKSAR, in terms of settling foreign currency transaction there or accessing other international payment systems through the HKSAR. The enhancement of the linkages of payment and settlement systems between Mainland and the HKSAR will also better ensure that Mainland's international fund flows and financial activities are conducted in a safe, reliable and efficient manner, and that the risks involved are properly monitored.

3.44 More broadly, there is a need to enhance financial infrastructural integration between the Mainland and the HKSAR. In particular, cooperation between stock exchanges in the HKSAR and the Mainland should intensify to help integration of the two markets, to enhance mobility of investors and investment products between the two markets, and to help guard against the growing competition from overseas markets.

3.45 The Focus Group has the following specific recommendations:

- **Link up of the RMB and foreign currency clearing and settlement systems in Hong Kong and the Mainland. *(Recommendation F2-26)***

- **Link up of Hong Kong's Central Moneymarkets Unit (CMU, a centralised clearing and custodian system for debt instruments) with the debt instrument settlement system provided by China Government Securities Depository Trust & Clearing Co., Ltd.. *(Recommendation F2-27)***

- **Link up of Hong Kong's Central Clearing and Settlement System (CCASS) with Mainland's equity settlement systems. *(Recommendation F2-28)***

- **Establish a platform for cross-trading of securities listed on the stock exchanges of Hong Kong and the Mainland. *(Recommendation F2-29)***

- **Strategic linkages between the stock exchanges of Hong Kong and the Mainland to facilitate mobility of investment products and investors. *(Recommendation F2-30)***

Chapter 4 A Strategy for Mainland to Promote Hong Kong as an International Financial Centre of Global Significance for the Country

Introduction

4.01 Underpinning the "one country, two systems" governance arrangements is the Mainland's policy to maintain the long-term stability and prosperity of HKSAR. Maintaining and further developing HKSAR as an international financial centre is critical to achieving this policy objective, given the importance of the financial sector to HKSAR. This is fully recognised in the 11^{th} FYP which "supports development of financial services industry in Hong Kong" and "maintenance of the status of Hong Kong as an international financial centre". Another important consideration is that as the Mainland has become an economy of global significance, it would need an international financial centre of global significance to provide an efficient platform to meet its financial intermediation needs and to manage the risks of its increasingly sophisticated economic activities. Hence, the Focus Group, considers that developing Hong Kong into an international financial centre of global significance would be in the Mainland's national interest. This can be achieved by the central government authorities adopting a proactive policy to facilitate the use of Hong Kong's financial system for Mainland's international financial activities. The key considerations and specific proposals for implementing such a proactive policy are presented in this Chapter.

Importance of the international financial centre status to the prosperity of Hong Kong

4.02 The financial sector is one of the most important sectors of the Hong Kong economy. In 2005, the share of value added in financial and related professional services accounted for 12.7% of the GDP, the second largest industry following trading and logistics which had a share of 28.2%. The financial sector accounted for about 5% of total employment, and over 20% of the total corporate tax revenue in recent years. Nevertheless, the significance of the financial sector is often understated by headline statistics, which do not capture the indirect contribution of the financial sector, as efficient financial services are crucial to the growth of many other economic activities. Being a high value-added service industry, financial services have been a critical part of the core competence of the Hong Kong economy and earnings and wealth generated in this sector have significant multiplier effects on local consumption and investment. Thus, maintaining Hong Kong's position as an international financial centre is critical to the long-term growth potential of the economy.

Importance of having an international financial centre of global significance for China

4.03 The Mainland economy has grown rapidly in the past two and a half decades, and has now become one of the largest in the world. It was the fourth largest in terms of GDP and the third largest in terms of external trade in 2005. By other measures, for example the amount of foreign reserves and the size of population, it already ranks first. With the economy currently growing at around 10% a year in real terms, which is much faster than developed economies, and with the RMB expected to appreciate against most other currencies, the **global significance** of the Mainland's economy would increase further in the coming years.

4.04 Along with the rise of the Mainland as an economic power, economic activities have become increasingly globalised. **Globalisation** means increasing interaction with and dependence on the rest of the world. At present, China is already well integrated with the rest of the world in terms of the trading and production of physical goods, but integration in terms of financial transactions remains limited owing to existing foreign exchange controls. With the RMB becoming convertible and restrictions on cross-boundary capital flows relaxed gradually, China will be increasingly integrated with the rest of the world financially as well. By then, China's international financial activities should also grow to a scale that is of global significance. In particular, as the Mainland authorities gradually reduce capital controls, the demand of non-public entities for investing their huge amount of savings offshore will increase. According to a study by the HKMA, it is projected that total outward portfolio investments from the Mainland could reach 23% to 54% of its GDP (or US$904 billion to US$4,468 billion) by the time the Mainland reaches a stage of capital account openness similar to that of developed economies, compared with 5% or US$117 billion at present.

4.05 With an economy and its international financial activities both attaining a scale of global significance, it is of strategic importance that China should have **an international financial centre of global significance** within the country, one that is comparable to New York and London in terms of scale and scope of financial services and instruments offered.

4.06 There are a number of reasons to aspire for an international financial centre of global significance within the country. First, it can provide an **efficient financial intermediation platform** that is required to support sustainable growth of a large economy. The experience of New York and London indicates that the vast amount of international financial activities conducted in such centres creates a critical mass, generating economies of scale and scope and hence a higher level of efficiency for both international and domestic financial intermediation. The economy of scale derived from providing an efficient market to match the demand and supply, both domestically and internationally, for a particular type of financial product or service, will enhance market liquidity, facilitate efficient price discovery and reduce the cost of the intermediation service. The economy of scope arises from the concentration of a wide range of financial services and instruments, which helps to meet the different types of demand and supply in an efficient way.

4.07 Secondly, it is of strategic importance to have an international financial centre of global significance within the country from a **risk management** perspective. Given the large scale of China's international financial activities, the payment and settlement risks could be rather significant if such were to be conducted in an international financial centre located within a different time zone. Having such a centre within the country can help avoid the need to conduct such activities elsewhere and the risks so involved while still benefiting from the transaction efficiency offered by a large, global market.

4.08 There is another dimension of risk management that should be considered. Market participants from the same country tend to have similar attributes and hence the needs for intertemporal and intratemporal diversification of risks. For instance, the intertemporal choices (i.e. present vs. future consumption) of a country with a young population as a whole are likely to be different from one with an aging population. While on the same time dimension, owing to the different stages of development and economic circumstances, countries also tend to have different risk appetites. With an international financial centre of global significance located within the country means that, there will be a substantial amount of players from other countries participating in the local market alongside with domestic participants. The high level of differences in risk attributes and appetites of participants should help risk transfer and management.

4.09 In relation to risk management, there is a particular consideration on derivatives of commodities. With the growing importance of the Mainland in global production and trade and its wealth of natural resources, China is one of the world's largest consumers and suppliers of commodities, precious metals and other raw materials. It makes sense for the trading transactions generated by Mainland's demand and supply to help foster an international trading market for these products and their derivatives within China, rather than financial centres overseas.

4.10 Thirdly, an international financial centre of global significance should be able to attract a substantial share of international financial activities and play a significant role in the determination of the global price for financial instruments. This would expand the role of Mainland commercial entities from purely a price taker to increasingly also a price setter in the global market. At the same time, it would allow Chinese market participants to have better access to first-hand and more timely information of the markets concerned. Moreover, with gravitation of international financial activities to a centre within China, China will better contribute to the formulation of **global financial standards** and policies, thereby playing its part in global finance that is commensurate with its global significance. All economies of global economic significance in history and modern times have a global financial centre and a global currency. Among other things, it will help promote the international role of RMB in particular, which will bring economic benefits and underpin the global importance of China's financial system, as discussed in Chapter 2.

Hong Kong as China's international financial centre of global significance

4.11 For many countries, enhancing the status of its international financial centre forms an important part of its financial development strategy. Both London and New York are striving to maintain their existing global significance as international financial centres, while the competition for becoming international financial centres of regional significance is also intensifying. In this regard, Ireland and Dubai are pursuing proactive measures in recent years. Within Asia, Japan, Singapore, Australia and Korea are also actively developing their international financial centres.

4.12 For China, the Mainland has emerged as one of the largest global players in an increasing range of financial products. Increasingly, it will be in a position to influence, or even dictate, a migration of global activities to its market. This presents an opportunity for China to develop an international financial centre of global significance within the country.

4.13 One may consider that financial centres on the Mainland would have the potential of developing into an international financial centre of global significance. However, financial centres on the Mainland can truly become "international" only after Mainland's financial system is fully liberalised and integrated with the international market. The activities of financial centres on the Mainland are still subjected to foreign exchange and other controls. Given the risks involved, it will be prudent that liberalisation of Mainland's financial system and opening to international markets should be gradual and properly sequenced, which means this takes time.

4.14 But the opportunity for China to develop an international financial centre of global significance within the country does not last forever. As its economy grows and capital account opening and RMB convertibility proceed, the scale and scope of Mainland's international financial activities will rapidly increase. All international finance centres are keen to capture these activities and are able to do so given the increasing globalization of financial markets. If an international financial centre of global significance cannot be developed in a timely manner within China, such activities will have no choice but to go to the markets in New York or London.

And over time, a **habitual inertia** will be built up and such activities will remain in other places. By then the chance of developing an international financial centre of global significance within China will be lost.

4.15 A case in point is that, while many might have thought that with the introduction of the euro a large part of continental Europe's financial activities could migrate back to continental Europe from London, it did not turn out to be so. One important reason is that, although the introduction of euro helped to enhance the scope and scale of Frankfurt as an international financial centre, this had not been strong enough to prevail over the critical mass of financial activities established in London through a long period of time. Particularly, due to habitual inertia, market participants have already accustomed to using London's financial system for their financial activities, supported by many well-established financial intermediaries and related professional services providers there. Indeed, riding on the forces of globalisation, by linking up with the clearing and payment systems in the euro-area, London has become an important international financial centre for euro-denominated financial activities. This reflected lost opportunity on the part of the European authorities to build up their own international financial centre when they had a chance to do so.

4.16 As mentioned previously, China is unique in having two financial systems within the country. The HKSAR has a robust financial platform, internationally recognised regulatory and market standards and several decades of openness to the international players. For an international financial centre, and even more so for one of global significance, a pre-requisite is that it should be operating under a legal, regulatory and institutional framework that commands the confidence and respect of international financial market participants.

4.17 Indeed, the HKSAR has already developed into a significant international financial centre in Asia, although there is still a marked gap when compared with the global financial centres such as London and New York, reflecting the small size of its domestic economy. With a market capitalisation of US$1,055 billion, Hong Kong's stock market was the 2nd largest in Asia and 8th in the world; and in terms of the amount of capital raised during 2005, Hong Kong came first in Asia and 5th globally as an equity fund-raising centre. At end-2005, the total assets of Hong Kong's banking sector exceeded US$800 billion, being the 4th largest in Asia and 17th in the world. The size of Hong Kong's bond market was relatively small, with the amount of outstanding bonds at around US$100 billion, being the 8th in Asia and 35th in the world.

4.18 Therefore, to seize the opportunity provided by the process of capital account liberalisation and RMB gradually attaining full convertibility to nurture an international financial centre of global significance within the country, there are merits for China to consider gravitating its international financial activities towards HKSAR. By combining the large size of financial activities generated by the Mainland economy and HKSAR's efficient financial platform, China will be able to gain a competitive edge over other international financial centres, particularly in Asia. Missing the opportunity associated with the financial integration between the Mainland and the rest of the world would be a great loss for the country.

4.19 In the process, the development of Hong Kong as an international financial centre and that of the financial centres on the Mainland are not mutually exclusive. Rather, the relationship between the two should also be a complementary, cooperative and interactive one. First, given the large size of China's economy, the country will need more than one financial centre, with each pursuing development strategy based on its respective comparative advantages. Hong Kong's comparative advantage is its openness to the rest of the world, and therefore is a natural choice for developing into the country's international financial centre. Moreover, the experience from the past two decades of Mainland's liberalisation and reform has shown that cooperation and constructive competition between Hong Kong and Mainland financial systems are of mutual benefit to both, as evidenced by the development and interaction of the H-share and A-share markets. In the long term, when RMB becomes fully convertible, the distinction between international and domestic financial centres will become less significant, and market forces will determine the relative roles of the financial centres within China. But at present, given the urgency for seizing the opportunity presented by Mainland's increasing international financial activities, Hong Kong can be positioned to compete, on behalf of the country, with other international financial centres overseas.

Strategy and recommendations

4.20 In order to develop HKSARG into an international finance centre of global significance, there is a need for central government authorities to adopt **a proactive policy** to facilitate the use of Hong Kong's financial system for Mainland's international financial activities. This is consistent with the well-established observation that market participants in general prefer to conduct financial activities at "home" rather than elsewhere. For instance, US market participants normally prefer to conduct financial activities (even with foreigners) within the US. It is also common for the financial authorities to take into account the implications for competitiveness of the domestic industry at home when formulating market development and regulatory policies. In our case, the **"home" is China, of which HKSAR is a part.**

4.21 Such proactive policy actually would help to reduce the prevailing external bias in financial intermediation in the Mainland. The G3 (USA, the EU and Japan) financial systems are often seen to have played an important role in financial intermediation in Asia, including the Mainland. The Mainland is one of the largest recipient economy of foreign direct investment (FDI), and returns on these foreign savings have benefited from strong economic growth in the country. But owing to the foreign exchange controls, excess domestic savings on the Mainland have been channelled mainly through official entities to holdings of US treasury paper and other developed countries' sovereign debt, which earn a relatively low return. Developing a financial centre of global significance within China would help to enhance domestic financial intermediation in channelling domestic savings to domestic investment, thereby raising the overall efficiency of resource allocation and reducing the risks associated with excessive cross border fund flows.

4.22 The Focus Group considers the specific recommendations for the proactive policy in accordance with two categories of international financial activities:

(1) those that HKSAR already has markets with the capacity of a global scale; and

(2) those in which China is or potentially is a global player but the

HKSAR currently does not have such markets with the capacity of a global scale.

(1) <u>International financial activities that HKSAR already has markets with the capacity of a global scale</u>

4.23 Markets in which the HKSAR has global capacity include equity fund-raising, bank lending, bond issuance, asset management, foreign exchange and treasury markets etc. Mainland authorities can provide policy encouragement to official and state-owned entities for making maximum use of Hong Kong to conduct international financial activities. Policies can also be considered to provide incentives for the private sector to use Hong Kong markets. In addition, the proactive policy should be adopted in the consideration of linkages between Mainland's equities, commodities and futures exchanges with the rest of the world, giving preference to the HKEx. The close cooperation between the regulatory authorities on the Mainland and Hong Kong provides a strong reason why Hong Kong Exchange should be the preferred partner. Such cooperation will in turn provide favourable demand and supply factors for the development of the stock markets in Hong Kong and that on the Mainland, thereby countering the effects of intensified competition as a result of an increasingly globalised market place for exchange businesses. Specific recommendations are:

- **Encourage Mainland entities to make better use of Hong Kong's markets and financial intermediaries for conducting their international asset management activities. This includes official reserves management and asset management by the National Social Security Fund, financial institutions, insurance companies and fund management companies. *(Recommendation F3-31)***

- **Encourage the channelling of the portfolio flows from the Mainland to HKSAR as a trial for further liberalisation of portfolio outflows. Possible measures would include enlarging the permissible investment universe for offshore wealth management services to cover instruments traded in the Hong Kong stock market and collective investment schemes authorised by the Hong Kong Securities and Futures**

Commission (SFC), and allowing Mainland entities and individuals to remit funds out of the Mainland and invest in Hong Kong markets on their own, i.e. "free walk" of foreign exchange. ***(Recommendation F3-32)***

- **Encourage Mainland financial institutions to establish treasury centres in Hong Kong and increase the use of Hong Kong's markets and financial intermediaries for conducting their international treasury activities.** ***(Recommendation F3-33)***

- **Concentrate overseas listings of Mainland entities in Hong Kong to ensure a continuous supply of shares issued by Mainland entities. Hong Kong should be taken as the first choice location for overseas listings of Mainland entities as a matter of policy, and be used in pilot schemes for further liberalising the existing restrictions on overseas listings including, for instance, by allowing issuance of RMB denominated shares.** ***(Recommendation F3-34)***

- **Mainland stock and futures exchanges to take HKEx as preferred partner for cooperation over exchanges elsewhere to pave way for integration of the two markets in substance. Supportive policies would include establishment of a platform for cross-trading of securities and futures listed on the stock exchanges of Hong Kong and the Mainland.** ***(Recommendation F3-35)***

- **Encourage Mainland entities to use Hong Kong as the prime location for global bond issuances and the subsequent depository and listing of such bonds. State-owned entities as a matter of policy should use Hong Kong as the prime location for bond issuances, and the use of CMU and the HKEx for depository and listings.** ***(Recommendation F3-36)***

- **Encourage Mainland entities to use Hong Kong as the prime location for international banking services, such as the arrangements of international syndicated loans. Mainland entities should also be encouraged to make use of the United States Dollar (USD) and Euro Real Time Gross Settlement**

Systems in Hong Kong to remove the settlement risk of their foreign exchange transactions. ***(Recommendation F3-37)***

(2) International financial activities in which China is or potentially is a global player but the HKSAR currently does not have such markets with the capacity of a global scale

4.24 An international financial centre of global significance includes trading of instruments such as commodity futures and financial futures in which Hong Kong does not already have an active market for. Mainland can help develop the relevant markets in HKSAR by encouraging official and state-owned entities to make maximum use of Hong Kong for the activities concerned, together with policy incentives for the private sector to do the same.

4.25 In considering market development in the HKSAR, four key factors, namely **supply, demand, price discovery mechanism and market infrastructure**, should be considered. A necessary condition for a market to come into being is the existence of supply and demand for whatever product that is to be traded in that market. The use of Hong Kong by Mainland entities in conducting international financial activities will not only bring their own demand and supply, but also provide a clustering effect by helping to deepen and broaden financial markets in Hong Kong, thereby attracting demand and supply from other parts of the region.

4.26 An efficient mechanism for price discovery is essential for attracting market participants to come forward, whether from the supply side or the demand side. This is important, particularly to avoid potential costs or efficiency loss to Mainland entities in pursuing the developmental efforts. Here, there is a host of important issues, such as the liquidity and market making arrangements, including short-selling; hedging and risk management; transaction costs; market concentration; disclosure of information, particularly those that is price sensitive; the role of the intermediaries; etc.

4.27 Also of importance is the market infrastructure, which includes the trading platform (exchange-traded or over-the-counter (OTC)); the payment, clearing, settlement and custodian arrangements; and, importantly, the framework (whether or not involving a formal regulatory regime) that safeguards market integrity and therefore sustains confidence of market participants in continuing to use that market. In many aspects, Hong Kong already has one of the most advanced financial infrastructures in the world. But there is a need to build up closer linkages to the Mainland markets, to facilitate the provision of financial services to the Mainland entities and development of the markets in the whole country to meet competition from other financial centres.

4.28 With these factors in mind, the Focus Group recommends consideration be given to introducing new financial derivatives and commodities futures that are currently not being traded on the HKEx but where there is an active underlying cash market in the Mainland and HKSAR. Considering that Hong Kong itself is not a major source either of demand or supply for the underlying commodities or financial instruments, it is necessary for Hong Kong to work with the Mainland in partnership to develop the relevant derivatives markets, particularly those that would take physical delivery. Hong Kong would bring to the partnership its advanced financial platform, sophisticated risk management techniques, and openness to international markets that are key to participation of international players.

4.29 For those derivatives that there is already a reasonably developed market on the Mainland, by interfacing with the Mainland market, the Hong Kong market can act as a link between the domestic market participants on the Mainland and the international players. Consideration can be given to setting up arrangements to allow international market participants to access the Mainland market, for instance, through cross-trading arrangements between Hong Kong and Mainland. Such partnership will help develop the relevant markets on the Mainland. Some agricultural commodities futures and RMB derivatives are some examples of such potential products.

4.30 Whereas for those products that there is an active cash market but not yet a developed derivatives market on the Mainland, there is a case for combining the sophisticated financial infrastructure in Hong Kong and openness to international participants, with Mainland's hedging demand as generated by an active cash market. The participation of Mainland entities will help develop the relevant market in Hong Kong, while at the same time allowing the Mainland demand and supply factors to play a greater role in global price setting. Possible choices in this category would be gold futures, energy futures and possibly credit derivatives with China exposure. As the Mainland is becoming an increasingly important player in the commodities markets, there is a need to hedge against the risks involved. For credit derivatives, which is getting increasingly popular in the US and Europe, it is advisable to keep a close watch and introduce the relevant products when there is demand in the market. HKSAR should have a location advantage for developing an international markets for credit derivatives with China exposure, given our proximity with and hence information advantage about China. (See details in Chapter 6).

4.31 Specific recommendations by the Focus Group are:

- **HKSAR institutions to work with Mainland entities in partnership to develop commodity and financial futures markets in Hong Kong and the Mainland, through means including strategic linkages.** ***(Recommendation F3-38)***

- **Encourage or provide policy incentives for Mainland entities and individuals to trade financial derivatives in Hong Kong.** ***(Recommendation F3-39)***

- **Encourage or provide policy incentives for Mainland entities and individuals to trade commodities futures in Hong Kong for commodities that Mainland is a global player.** ***(Recommendation F3-40)***

4.32 Finally, it is noteworthy that the Mainland's international financial activities identified above in fact mirror some of the proposals set out in Chapter 3. This shows that, in most if not all of the cases, proposals for Mainland to make greater and better use of Hong Kong's financial system are of benefit to the whole country.

Chapter 5 Further Development of the Securities Market

Introduction

5.01 Pursuant to the direction of the Focus Group at the Economic Summit, the Securities Market Sub-group convened by the Honourable Ronald Arculli was established to study rules and regulations, products and services, and market infrastructure for the betterment of the Hong Kong cash and derivatives markets, and to further contribute to the Mainland's financial reform and development.

5.02 Members of the Sub-group comprise leading market practitioners as well as representatives from the SFC, the HKMA and HKEx. In addition, the Sub-group has established a separate high-level Working Group between the SFC and HKEx (SFC/HKEx Working Group), chaired also by the Honourable Ronald Arculli, to discuss specific market and product development matters that are of direct interest to the two regulators. Members of the Sub-group and the SFC/HKEx Working Group are listed in Appendix 5-1.

5.03 In order to solicit views from the broader public, the Honourable Ronald Arculli, on behalf of the Sub-group, issued a letter to 160 professionals and market practitioners on 22 September 2006. A total of 21 replies, representing industry organisations, the brokerage community, banks and market professionals, have been received.

China's 11th Five-Year Plan

5.04 Chapter 33 of the 11th FYP has stated the objective to speed up the development of direct financing through greater use of the capital markets, including the equity market. The Focus Group considers that one of the foci of the further development of the Hong Kong securities market is to maintain close liaison with the Mainland in order to facilitate continuous capital formation for Mainland enterprises. As an international financial centre, our securities market should also extend its reach to potential quality issuers outside Hong Kong. Efforts should be made to establish a more flexible regulatory and operation infrastructure for local, Mainland and overseas financial intermediaries and investors to ensure the smooth and efficient operation of the markets, as well as to bring about incremental efficiency and quality enhancements.

Overview of the Securities Market

Leading International Securities Market

5.05 Hong Kong's crown jewels are its free economy, well-established rule of law, adoption of international standards and practices, high degree of transparency, and pool of experienced talent. For the securities market, these attributes translate into a level-playing field for market practitioners to operate, innovate and compete in, and the smooth functioning of the marketplace. In addition, strong links with the Mainland and other economies in Asia and excellent communications with the rest of the world have helped Hong Kong develop into a leading international financial centre.

5.06 As at October 2006, with HK$11.4 trillion in market capitalisation[1], Hong Kong was ranked 8th among the world’s exchanges and 2nd among Asian exchanges behind only Japan. Hong Kong was also ranked 3rd among world exchanges by total equity funds raised in 2006 as of October 2006. For IPOs only, Hong Kong was ranked 2nd by the end of October 2006 after completion of the largest ever IPO in the world (i.e. the listing of the Industrial and Commercial Bank of China on the SEHK). Average daily turnover has surged to HK$31.1 billion for the first ten months of this year from HK$18.3 billion during the same period last year.

5.07 One characteristic of the Hong Kong market is its balanced mix of retail and institutional participation. According to HKEx’s 2004/2005 Cash Market Transaction Survey[2], there were 1.6 million active retail investors in Hong Kong, accounting for 30 per cent of market turnover, while institutional investors contributed 69 per cent[3]. Servicing these investors were both local and international brokers which represented 27 per cent and 73 per cent of total trading respectively.

[1] Source: World Federation of Exchanges
[2] A copy of the survey is available at http://www.hkex.com.hk/news/hkexnews/060619news.htm.
[3] The rest (ie ~1%) being overseas retail investors.

5.08 Hong Kong's exchange-traded derivative products, in particular index futures and stock options, have also enjoyed substantial growth albeit not as fast as some overseas exchanges and the OTC market. With the stock option market revamp initiative in 2005 coupled with the relief of position limits in February 2006, turnover of the stock option market has increased by 90 per cent year-on-year. In the first ten months of this year, the derivatives market commanded a total trading volume of over 33 million contracts, already surpassing the annual figure of 2005. In terms of notional value traded, Hong Kong was ranked 8th in the world for both stock index futures and stock options[4].

5.09 Hong Kong's derivative warrants market is the second largest in the world by trading value. There were 1,644 listed derivative warrants as at October 2006, and turnover totalled HK$1.4 trillion in the first ten months, representing over 22 per cent of total market turnover. Callable Bull/Bear Contracts (CBBC) were introduced in June 2006 and trading volume has steadily increased over time.

Premier Capital Formation Centre for China

5.10 Hong Kong is by far the leading venue for the listing and trading of the securities of Mainland enterprises outside the Mainland. The ten largest IPOs in Hong Kong since 1993 were all by Mainland enterprises, some of which were among the largest IPOs globally. In the first ten months of this year, there were 46 newly listed companies, of which 26 were from the Mainland, raising HK$237.4 billion, or 92 per cent of total IPO funds raised. As at October 2006, there were 355 Mainland enterprises listed in Hong Kong[5], representing 31 per cent of all listed companies, with a combined market capitalisation of HK$5,265.4 billion or 46 per cent the market total. At the same time, there are around 250 additional Mainland China Operating Enterprises listed in Hong Kong – these are companies controlled by non-Mainland China entities and have substantial operations in the Mainland. With respect to trading activities, Mainland enterprises accounted for 58 per cent of the average daily equity turnover for the first ten months of 2006.

4 Source: World Federation of Exchanges

5 These included Red Chips, H shares and non-H-share Mainland Private Enterprises but excluded, as mentioned in the latter part of the same paragraph, Mainland China Operating Enterprises owned by non-Mainland entities.

5.11 In addition to stocks, the Hang Seng China Enterprise Index options and futures, the FTSE/Xinhua China 25 options and futures, and the iShares FTSE/Xinhua A50 China Tracker have been successfully launched over the past few years. Most of these products, together with stock options on Mainland related enterprises, have also been traded actively.

Further Development of the Securities Market

5.12 The Focus Group recognises that Hong Kong has already established itself as one of the leading securities markets in the world with unique advantages. The strategy going forward focuses on solidifying Hong Kong's marketplace by further enhancing openness, security, fairness, orderliness, efficiency and transparency for investors, issuers and intermediaries alike while expanding into innovative ventures that meet market demand.

5.13 In formulating recommendations on the way forward, consideration has been given to four integral factors pivotal to the development of the market, namely supply, demand, price discovery and market infrastructure. The relevant considerations and recommendations pertaining to these four facets are presented in the ensuing paragraphs.

Recommendations: Supply Side

<u>Strengthening Cross-boundary Liaison</u>

5.14 Hong Kong's success as an international capital-raising centre for Mainland enterprises lies in its abilities to position itself as the home market for these enterprises. Furthermore, the Hong Kong market provides Mainland issuers with the cachet of an international listing. By listing in Hong Kong, Mainland enterprises achieve compliance with international standards in accounting, corporate governance, disclosure and management discipline, acquire high-quality investors, and enhance their international recognition.

5.15 With the continuous transformation of the Mainland economy, Mainland listings will remain an important source of growth for the Hong Kong securities market in the foreseeable future. The increasing cooperation of the Mainland and Hong Kong capital markets would mean that there is more imminent need to make progress in structural market issues such as bilateral regulatory co-operation, information dissemination, cross-boundary trading and clearing arrangements, facilitation of QDII and QFII, share structure reform, and alignment of corporate governance and accounting standards.

5.16 First and foremost, high-level liaison between the Mainland and Hong Kong should be strengthened. At the political level, it is recommended that the HKSARG intensifies its efforts to impress upon the CPG the utility of the financial system of Hong Kong to China in organising international financial activities of the Mainland, thereby allowing and encouraging more Mainland enterprises to raise funds in Hong Kong. HKSARG should take a leadership role in maintaining high-level communication with Mainland government officials and authorities, and engaging policy makers, regulators and business leaders in Hong Kong as appropriate. Effective and regular communication is a prerequisite for fostering closer cross-boundary collaboration and facilitating Hong Kong to play an even more prominent role in supporting the continuous policy and economic development on the Mainland under the one-country-two-system framework.

5.17 Furthermore, with simultaneous A- and H-share listings becoming the norm and the expected launch of a Mainland financial derivatives exchange[6], closer liaison with the Mainland exchanges is called for. It is recommended that HKEx, the SHSE and the SZSE should enhance communication to deliberate on matters in relation to exchange operations. This complements the existing half-yearly meetings among the Chian Securities Regulatory Commission (CSRC), SHSE, SZSE, the SFC and HKEx, focusing primarily on

[6] The new Mainland financial derivatives exchange is expected to be launched in late 2006 or 2007 jointly by Shanghai Stock Exchange (SHSE), Shenzhen Stock Exchange (SZSE), Shanghai Futures Exchange (SHFE), Dalian Commodity Exchange (DCE) and Zhengzhou Commodity Exchange. The new exchange will first focus on stock index futures, to be followed by individual stock options and futures.

regulatory issues pursuant to the Memorandum of Regulatory Co-operation established after the first H-share listing in 1993.

5.18 The aim of strengthened liaison would be to persuade the Mainland to further relax the existing restrictions on Mainland enterprises raising funds through listings in Hong Kong. It is, however, important to note that the supply of Mainland IPOs would be crucially dependent upon the strength of the demand, and measures to raise demand by allowing Mainland investors to access the primary IPO market and participate in the secondary market should be considered. More on this will be covered under paragraphs 5.25 to 5.27.

Expanding Pre-approved Jurisdictions for Listing

5.19 At present, the only non-Hong Kong jurisdictions of incorporation pre-approved for Hong Kong listing are Bermuda, the Cayman Islands, the People’s Republic of China, Australia and Canada’s British Columbia. The respective chapters of the Listing Rules include supplementary provisions that such companies are to adopt, e.g. by incorporation in their constitutional documents, where necessary, to bring their shareholder protection in line with that of a Hong Kong incorporated company. Suitability of other overseas jurisdictions is assessed on a case-by-case basis with the burden of proof primarily resting with the listing applicants to demonstrate the adequacy of shareholder protection of the jurisdiction in question. In practice, this makes it relatively onerous for companies incorporated outside the pre-approved jurisdictions to list in Hong Kong.

5.20 Concurring with the policy address by the Chief Executive of HKSAR in October 2006, the Focus Group is of the view that the list of pre-approved overseas jurisdictions for the purpose of listing should be expanded for two reasons: to facilitate listing of overseas companies which have substantial operations on the Mainland, and to develop Hong Kong into an international listing platform for quality companies from around the world.

5.21 The approach taken to liberalise the pre-approved list of jurisdictions should be practical yet should not compromise shareholder protection. It is recommended that the following approach be adopted to balance commercial flexibility and regulatory arbitrage:

(1) companies incorporated outside Hong Kong will be able to seek admission of their shares to list in Hong Kong where they are incorporated in a jurisdiction of which the statutory securities regulator either is a full signatory to the International Organisation of Securities Commissions Multilateral Memorandum of Understanding Concerning Consultation and Co-operation and the Exchange of Information or has entered into bilateral co-operation arrangements with the SFC which the SFC considers appropriate for this context; and

(2) an overseas company incorporated in a jurisdiction that satisfies the criteria under (1) seeking a primary listing in Hong Kong shall comply with a requirement for a number of shareholder protection provisions which will be set out in the main body of the Listing Rules, in the case of core provisions, or in Codes and Guidelines promulgated with the Listing Rules. Overseas companies will be able to demonstrate their compliance with such requirement by a number of means including, but not limited to, making reference to corporation laws in their jurisdiction of incorporation or by reference to the provisions of the company's constitutional documents such as its Articles of Association or By-laws. Where compliance with the provisions of the Listing Rules is contrary to the law in the jurisdiction of a company's incorporation, a waiver or modification of the Listing Rules can be sought from the Listing Committee of the SEHK.

5.22 It is proposed that listing applicants incorporated in jurisdictions that do not satisfy the above criteria will be considered on a case-by-case basis. Those jurisdictions already approved by the SEHK will continue to be acceptable.

5.23 It is recommended that the SFC and HKEx consider the above framework and work on an implementation plan, subject to due process, and the requisite rule amendments with a view to rolling out the new measures in early 2007. Upon agreement on the framework, HKEx should co-ordinate with HKSARG, market practitioners, and industry and trade associations to conduct business development activities to solicit interest from potential issuers.

5.24 The Focus Group has the following specific recommendations:

- **Strengthen high-level liaison at the Government level and enhance communication among Mainland and Hong Kong stock exchanges to facilitate further development of the securities market in Hong Kong.** ***(Recommendation F4-41(a))***

- **Amend listing rules to facilitate expanding pre-approved jurisdictions for listing in Hong Kong.** ***(Recommendation F4-42)***

Recommendations: Demand Side

<u>Facilitating Mainland Investors</u>

5.25 Demand is crucial in pulling Mainland IPOs to Hong Kong. The key investor pool to tap for the Hong Kong markets would be the huge investing demand from the Mainland. Indeed as convertibility for capital account items on the Mainland is gradually implemented and the placing of foreign currency assets overseas allowed, capital flows would become increasingly two-way. Hong Kong should position itself to be the destination for the much anticipated capital outflow that would come eventually.

5.26 In line with recommendation F2-10 set out in Chapter 3, and recommendation F3-32 in Chapter 4, it is proposed to further expand the permissible investment universe for the QDII scheme to include Hong Kong equities and collective investment schemes authorised by the SFC. This may start with H-shares and H-share investment funds.

5.27 Furthermore, in the same spirit as the “free-walk” scheme for travelling, it is recommended that HKSARG suggest to the Mainland authorities introducing a “free-walk” scheme for capital, which allows Mainland individuals and institutions to remit "self-owned" foreign exchange out of the Mainland and make investments overseas on their own through Hong Kong without having to go through QDII. Such a "free walk" scheme for foreign exchange can start with high net worth Mainland individuals with financial assets of over, say RMB 1 million yuan, as trial for the purpose of investor protection. This is in line with recommendation F2-11 in Chapter 3, and recommendation F3-32 in Chapter 4.

Encouraging Financial Intermediation

5.28 Brokers mediate between buyers and sellers, act as distributors, liquidity providers and risk managers, and provide financial expertise and advice. Hong Kong has one of the most diverse mixes of brokers, with over 122 international brokers as well as more than 345 local brokers serving different niches and clienteles.

5.29 With the Third Phase of CEPA already in place, Mainland securities and futures companies are now permitted to establish a presence in Hong Kong subject to approval by the CSRC. At the same time, foreign brokers have shown increasing interest in participating directly in the Hong Kong securities market in order to gain a foothold in the Mainland. To capture these opportunities, Hong Kong needs to progressively improve accessibility to its market within a framework of world-class risk management practices. In particular, the Focus Group supports the direction of facilitating Mainland financial institutions to have a bigger presence in Hong Kong, using Hong Kong as a springboard to develop their international financial activities.

5.30 HKEx is in the process of opening up its trading right regime by introducing a transparent and market-driven tendering approach. Under the current proposal which has already been approved by the HKEx Board, a trading right application will be opened for tender by all existing trading right holders, and the lowest auctioned price will be chosen. If no tender is received, HKEx will issue trading rights at a price of HK$500,000 each.

5.31 On the clearing side, the Focus Group supports a recent HKEx initiative to introduce third party clearing to the market. Third party clearing gives brokers a choice to automatically give up their executed trades to a designated third party for clearing and settlement in the clearing house. This is an important risk mitigation arrangement widely adopted in a number of overseas markets such as the United States, the United Kingdom and Australia. The SFC and HKEx should develop a regulatory model for third party clearing which could provide existing brokers with a means to outsource their clearing operations and obligations and, along the same lines, allow overseas brokers trade on HKEx's trading platform without the need of establishing an elaborate clearing operation and infrastructure. Third party clearing can also help the clearing house manage risk more efficiently, for example, by having a smaller number of well-capitalised[7] clearing participants support a larger group of non-clearing participants and with higher netting efficiency to lower and decentralise overall settlement risk.

5.32 In conjunction with the implementation of third party clearing, it is recommended that the SFC and HKEx look into the feasibility of allowing overseas brokers that do not have a physical establishment in Hong Kong to trade on HKEx's trading platform.

5.33 The Focus Group has the following specific recommendations:

- **Facilitate Mainland enterprises and investors to participate in our securities market through the Qualified Domestic Institutional Investors (QDII) scheme.** ***(Recommendation F4-43)***

- **Facilitate Mainland individuals and institutions to remit self-owned foreign exchange to make investments outside the Mainland through a proposed "free-walk" scheme.** ***(Recommendation F4-44)***

- **Implement new trading right regime.** ***(Recommendation F4-45)***

[7] There would be a need to consider aligning the third party clearer's capital requirements to that of Authorized Institutions licensed by the HKMA.

- **Implement third party clearing, and explore options to allow foreign brokers to trade on HKEx. *(Recommendation F4-46)***

Recommendations: Price Discovery

Lowering Transaction Costs

5.34 Overall, the existence of stamp duty on the Hong Kong market tends to constrict liquidity and is one of the most often mentioned barriers by market practitioners.

5.35 Statistically, Hong Kong does have a relatively low turnover ratio compared with major overseas markets. Although ranked 8th in the world by market capitalisation and 13th by absolute turnover value for the ten months to October 2006, Hong Kong was ranked only 22nd by annualised turnover ratio, at 63 per cent[8]. Sixteen markets have turnover ratios greater than 100 per cent.

5.36 There are other possible factors contributing to Hong Kong's relatively low turnover ratio but it is likely that stamp duty, at 0.2 per cent per round trip (amounting to about 10 times[9] the trading fee and transaction levy imposed by HKEx and the SFC respectively), is the main factor. The presence of stamp duty encourages certain institutional trades, which are the most mobile, to be done off-shore or through OTC synthetic structured products, and it discourages arbitrage and market-neutral activities, which are important for liquidity and price formation.

5.37 To maintain our position as an international financial centre, keeping our stock market competitive rates as a high priority. At present, no stamp duty is levied on transactions in many stock markets around the world, including the US, Japan, Germany, Singapore and New Zealand. Indeed, the worldwide trend is to reduce or entirely abolish stamp duty on stock transactions.

5.38 The stamp duty was last reduced from 0.225 per cent to 0.2 per cent per round transaction in 2001-02. Whilst noting that the HKSARG

[8] Source: World Federation of Exchanges

[9] With effect from 1 December 2006, the transaction levy imposed by SFC per side of a transaction was reduced from 0.005% to 0.004%.

takes a cautious and step-by-step approach, with due regard to the fiscal conditions, in considering suggestions for further reduction in the stamp duty on stock transactions, the Focus Group recommends the HKSARG to consider reducing stamp duty further with a view to lowering market transaction costs.

5.39 In keeping with the spirit to promote liquidity and minimise market frictions, it is also recommended that the SFC and HKEx rationalise their fees from time to time to ensure that they are and remain reasonable and competitive.

Reforming Position Limit Regime

5.40 Currently, derivative contracts launched by HKEx are subject to statutory limit on the open positions that a person[10] may hold and a (lower) reporting limit. These limits help minimise the impact of potentially destabilising market situations arising from over-concentrated positions accumulated by market participants, and are thus crucial in maintaining an orderly market, facilitating market surveillance and enhancing market stability. It is worth noting that the position limits for Hang Seng Index futures and options contracts were introduced as part of the HKSARG's "Thirty Measures" following the 1998 Asian financial crisis. Since then, position limits have been introduced on nearly all new futures and options contracts traded on the exchange. There are, however, areas worth reviewing:

(1) Breach of the limits is a criminal offence, but there are mixed views as to whether this should remain the case. On one hand, criminalisation has a chilling effect on the derivatives market. Brokers may as a result stop well short of the limits in order to be sure not to breach them, particularly if their monitoring systems and procedures are less sophisticated and advanced, or may simply do business offshore or OTC which cannot be effectively monitored by the regulators and thus increasing risk to financial stability. On the other hand, some form of criminalisation may be necessary to give regulatory teeth to the limits and create a sufficient deterrent. Moreover, the SFC has issued a guidance note to clarify the SFC's policy position on

[10] That is, beneficiary owners such as investors or market participants taking on a proprietary position.

position limits and various issues raised by the industry regarding compliance with these limits.[11]

(2) Subsidiary legislation takes time to be introduced and amended, hence changes to position limits of existing products may be slowed down.

(3) The limits are relatively low with respect to the futures contracts open interest and the daily trading volume of the cash market.

(4) In some cases, the limits do not take sufficient account of offsetting positions or market-neutral activities (that is, gross limit versus delta-based limit[12]).

(5) Limits have to be observed on a real-time basis, hence requiring extensive monitoring by brokers.

5.41 It is noted that the SFC is processing proposals to adjust the position limits for futures and options contracts over the Hang Seng China Enterprises Index and the Hang Seng Index. The proposal aims to bring the position limits in line with changing market demand and needs.

5.42 In order to address the issues on criminalisation and to bring more flexibility to the current position limit regime, it is recommended that the SFC and HKSARG explore the feasibility of carving out the current prescribed limits from the statute while retaining some form of criminalisation for breaches of the limits. One suggestion is for the prescribed limits to be included in the rules of the exchanges for which any change is subject to approval by the SFC.

[11] The Guidance Note, which was issued in March 2003 and was amended in April 2004, is available at http://www.sfc.hk/sfc/doc/EN/speeches/public/consult/e_conclusion_large_open_position.pdf. To date there has been no criminal prosecution for breach of position limits.

[12] In contrast to the gross limit, delta-based limit takes into account the net exposure by which a portfolio of options or futures contracts of the same underlying will change for a corresponding change in price of the underlying.

Relieving Uptick Rule for Short Selling

5.43 Under the current regime, naked short selling, that is, short selling without possession of the ability to deliver the stock, is a criminal offence. Furthermore, short selling is allowed only on an uptick and in designated stocks.

5.44 It is noted that the uptick rule serves as a deterrent to abusive short selling and that this is particularly vital during extreme market conditions or a financial crisis situation. Nevertheless, it does affect the price-formation process in normal business situations. Given that there are in place statutory provisions, such as criminalisation of naked short selling, it is recommended that the SFC and HKEx consider putting in place a mechanism that allows for the suspension of the uptick rule in normal business situations and its reinstatement in extreme market conditions or during a financial crisis situation.

Regulatory Review

5.45 Given that the Securities and Futures Ordinance (SFO) has been enacted for over three years and valuable experience has been gained and in view of the fast changing market environment facing Hong Kong, it is recommended that the SFC work with the HKSARG and HKEx to constantly review the market impact of the SFO and other relevant legislation with a view to ensuring that the regulatory framework is appropriate for the growth, competitiveness and development of the Hong Kong markets.

5.46 The Focus Group has the following specific recommendations:

- **Consider stamp duty reduction. *(Recommendation 4-47)***
- **Regularly review SFC and HKEx fees to ensure they are and remain reasonable and competitive. *(Recommendation 4-48)***
- **Implement adjustments to position limits for futures and options on -**

  (a) Hang Seng China Enterprises Index; and

(b) Hang Seng Index ***(Recommendation F4-49)***

- **Review the legislation and rules regarding the position limit regime.** ***(Recommendation F4-50)***
- **Amend trading rules to relieve uptick rule in non-crisis situation.** ***(Recommendation F4-51)***
- **Undertake regular review of market impact of the Securities and Futures Ordinance (SFO) and other relevant legislation.** ***(Recommendation F4-52)***

Recommendations: Market Infrastructure

<u>Implementing Statutory Backing of Major Listing Requirements and Review of Dual Filing Regime</u>

5.47 The market has deliberated on the issue of statutory backing of major listing requirements extensively over the past four years with a number of consultations and consultation conclusions being released. It is noted that the HKSARG plans to introduce the legislative amendments into the Legislative Council in the 2006-07 legislative session. Given the profound impact of this initiative on market practitioners, it is recommended that an implementation timetable should be established as soon as possible by the SFC and Financial Services and the Treasury Bureau (FSTB) in order to manage market expectations. The SFC and HKEx should also prepare for any changes to the existing operational arrangement and consider the impact on the dual filing regime after enshrining the major listing requirements in statute.

5.48 Given that the dual filing regime has been in place for over three years and that some market practitioners believe there are overlaps and duplications between the SFC and HKEx, it is recommended that the SFC and HKEx review the current *modus operandi* so as to minimise unnecessary duplication of efforts, if any, between the SFC and HKEx.

Encouraging Financial Innovation

5.49 Hong Kong is blessed with a diverse investor base ranging from retail to institutional investors, and from local to multi-national market participants. The Focus Group considers that, in order for the Hong Kong securities market to cater for the hedging and speculative needs of different investors, financial innovation should be encouraged. This requires a mindset to manage risks, not avoid risks, and a market and product infrastructure that focuses on objective principles, not prescriptive measures. Against this background, it is recommended that the SFC and HKEx consider the following three areas –

(1) Hong Kong should accelerate the development of its derivatives market, focusing particularly on the feasibility of launching Mainland- and RMB-related derivative products and strengthening its derivative risk management capability. It is noted that the Chicago Mercantile Exchange (CME) has recently launched a number of RMB Non-Deliverable Futures which are settled in US dollar, Euro or Yen, and the Mainland is in the process of establishing a financial derivatives exchange.

(2) To further develop the CBBC market, which was launched in June 2006, attention should be given to conducting more investor education, soliciting issuer participation and expanding the number of eligible underlyings from the current five[13]. It is noted that the CBBC market has grown rapidly overseas, and some markets including Singapore and Germany have already launched contracts on Hong Kong-listed stocks which are traded actively.

(3) The SFC and HKEx should consider the merits of establishing within the cash market a trading platform and regulatory structure for Exchange Traded Commodities (ETCs). It is noted that the London Stock Exchange recently announced a distinct

[13] The SFC and HKEx have in principle agreed to increase the number of eligible stocks to up to 30, subject to review on a quarterly basis.

trading platform for ETCs. The platform allows investors to gain exposure to commodities using the same systems and brokers they use to trade shares. ETCs are open-ended and can be created and redeemed on demand and can be single-commodity or index tracking. (As stated in para. 6.38 of this report, the Focus Group considers that the development of a commodities futures market in Hong Kong is a worth pursuing initiative. As a first step, an independent consultancy study would need to be commissioned to look into the detailed conditions and requirements for such endeavour and make concrete proposals, with the Mainland intended as a major participant.)

5.50 With regards to the overall product launch structure, it is recommended that the SFC and HKEx conduct a review of the general regulatory framework to facilitate the launch of new products.

Enhancing Debt Securities Market

5.51 The HKMA initiated a review in early 2006 to study issues related to the development of the debt market in Hong Kong and has made policy recommendations to promote further market development. The review focuses on withdrawing the three-year rule imposed on Multilateral Development Banks since 1998[14] and on issues related to the EFBN programme such as enhancing market making system, extending the benchmark yield curve, streamlining the issuance programme and establishing an electronic trading platform. The Focus Group supports that these initiatives should continue to be pursued as planned.

5.52 On debt listing, there has been a general decline over the past few years in Hong Kong in terms of the number of new listings and turnover volume while regional markets such as Singapore have seen

[14] The three-year rule refers to the request made in 1998 by the HKMA to nine Multilateral Development Banks to confine their issuance to tenors of three years or longer. The nine Multilateral Development Banks are Asian Development Bank, Council of Europe Social Development Fund, Eurofima, European Bank for Reconstruction and Development, European Investment Bank, Inter-American Development Bank, International Bank for Reconstruction and Development, International Finance Corporation and Nordic Investment Bank.

significant growth. It appears that the market in general perceives the listing process in Singapore as faster, cheaper and less onerous. While the competitiveness of debt listing services in Hong Kong vis-à-vis other countries is not considered a major constraint on bond market development, enhancing such service would provide "one-stop-shop" financial services to issuers, particularly for those companies which already have their stocks listed in Hong Kong. Hence, it is recommended that HKEx consider aligning its fees and charges with those imposed by overseas exchanges as well as streamlining the overall application process as appropriate.

Enhancing Stock Segregated Account (SSA) Service and Investor Participant Service

5.53 To meet the demand of the broker community and to improve protection of investor assets, the Focus Group notes that HKEx is in the process of enhancing the SSA service in the coming months. The enhancements will be implemented in two phases:

(1) Phase One, which will be implemented by early 2007, covers electronic access (via Internet or through Interactive Voice Response system of CCASS Phone system to SSA) in addition to the receipt of physical statements, email and Short-Message-Service alerts of account movements in SSA, and Chinese statements.

(2) Phase Two, which will be implemented by the second quarter of 2007, covers electronic voting and removal of the restriction on 1,000 SSA available for each broker/custodian.

5.54 The Focus Group recognises the importance of investor protection, especially given the occurrence of the recent broker default cases, and encourages HKEx to continue to actively promote and expand its SSA and Invetor Participant Account services.

Encouraging Electronic Filing and Dissemination

5.55 With the anticipated implementation of the No-paid-ad initiative by HKEx in the second quarter of 2007 which will end the requirement for issuers to place their announcements in newspapers, automation in the Hong Kong market will take a step forward. However, many filings in the Hong Kong securities market remain manual and paper-based. Although in many cases electronic channels are available, only a minority of filings are made through such channels.

5.56 The Focus Group considers that encouraging electronic filing and dissemination will improve not only environmental friendliness, but also efficiency and security of the market as a whole. This requires a change in culture and mindset. It is recommended the SFC and HKEx, to mandate, to the extent possible, electronic filings and dissemination in the following areas:

(1) Disclosure of interests filings
(2) Issuance of prospectus, IPO application forms and IPO allotment results
(3) Remittance of IPO commissions to brokers
(4) Financial Resources Rules filings
(5) Various application documents
(6) Invoices to and payments by brokers

The SFC is fully supportive of this initiative and will actively pursue electronic submission of filings of documents in relation to Financial Resources Rules and licensing related matters.

5.57 The Focus Group also supports a current initiative by the SFC with regard to promoting the use of eXtensible Business Reporting Language (XBRL) in Hong Kong. XBRL, which has gained popularity in major financial markets such as the United States, the United Kingdom and the Mainland, is an Extensible Markup Language (XML)-based standard to define and exchange business and financial performance information in electronic and standardised format so as to enhance processing efficiency and improve data reusability. The SFC established an XBRL Preparatory Working Group in April 2005 and has since been actively monitoring the global development of XBRL. It is recommended that the SFC and HKEx should continue to monitor the development of the application of XBRL in other major markets, and to assess the feasibility of adopting XBRL in Hong Kong.

Improving Shareholding Transparency

5.58 While trading, clearing and settlement activities in Hong Kong are already conducted in a highly immobilised and electronic manner, one shortcoming of the current setup is that all securities traded through the exchange must be cleared and settled through the Hong Kong Securities Clearing Company, and securities must be registered under the Company's Nominees for electronic clearing and settlement purpose. Hence the beneficial ownership does not appear on the Register of Members. This limits shareholding transparency and thus shareholder communication.

5.59 It is recommended that the SFC and HKEx work with the industry to consider devising a workable model to improve shareholding transparency, whilst retaining the option for investors to opt to hold shares through nominees. One possibility is to consider enacting legislation to deem all direct beneficial owners of shares held under the central depository, ie the CCASS, as registered shareholders, hence achieving the objectives of higher shareholding transparency, enhanced certainty of shareholding ownership, especially for shares held under SSA and Investor Participant Accounts, and more efficient corporate communication and corporate actions via e-voting facilities.

5.60 The Focus Group has the following specific recommendations:

- **Implement statutory backing of major listing requirements including establishing a time-table for the implementation. *(Recommendation F4-53)***
- **Review dual filing regime. *(Recommendation F4-54)***

- **Consider expanding product range:** ***(Recommendation F4-55)***

  (a) Encourage launch of appropriate derivative products, eg Mainland- or RMB-related products.

  (b) Promote Callable Bull/Bear Contracts (CBBC) and progressively expand their eligible stocks.

  (c) Consider launch of Exchange Traded Commodities (ETCs).
  Review the general regulatory framework for new products. ***(Recommendation F4-56)***

- **Enhance Exchange Fund Bills and Notes (EFBN) programme.** ***(Recommendation F4-57)***

- **Enhance debt listing regime.** ***(Recommendation F4-58)***

- **Implement Phase 1 and Phase 2 enhancements to Stock Segregated Accounts.** ***(Recommendation F4-59)***

- **Encourage or mandate use of electronic submissions and disseminations, and continue monitoring global developments of eXtensible Business Reporting Language (XBRL) and assessing Hong Kong's position.** ***(Recommendation F4-60)***

- **Consider formulation of a workable model to improve shareholding transparency.** ***(Recommendation F4-61)***

Appendix 5-1

	Members of the Securities Market Sub-group	
1	The Honourable Ronald Arculli	Chairman, HKEx (Convenor)
2	Professor K C Chan	Dean of Business and Management, Hong Kong University of Science and Technology
3	Dr. Frederick Hu	Managing Director, Goldman Sachs
4	The Honourable Charles Lee	Consultant, Woo, Kwan, Lee & Lo
5	Mr. Francis Leung	Independent Market Practitioner
6	Mr. Martin Wheatley	Chief Executive Officer, SFC
7	Mr. Peter Wong	Managing Director and Chief Executive, Tai Fook Securities Group
8	Mr. Joseph Yam	Chief Executive, HKMA

	Members of the SFC/HKEx Working Group	
1	The Honourable Ronald Arculli	Chairman, HKEx (Convenor)
2	Mr. Paul Chow	Chief Executive, HKEx
3	Mr. Brian Ho	Executive Director, SFC
4	Mr. Keith Lui	Executive Director, SFC
5	Mr. Martin Wheatley	Chief Executive Officer, SFC
6	Mr. Richard Williams	Head of Listing, HKEx

Chapter 6 Further Development of the Foreign Exchange and Commodities Futures Market

Introduction

6.01 Pursuant to the direction of the Focus Group, a Sub-group convened by Mr. Gary He was established to further study the development of Hong Kong's foreign exchange and commodities futures trading. The Sub-group has looked into the necessity, feasibility and proposed way forward for developing these markets.

6.02 Members and observers of the Sub-group comprise leading market practitioners, academia as well as representatives from FSTB, HKMA, SFC, HKEx and the Central Policy Unit. The membership list of the Sub-group is at Appendix 6-1.

China's 11th Five-Year Plan

6.03 Chapter 33 of the 11th FYP mentioned the gradual development of the commodities futures market and the goal of gradually achieving full convertibility of the capital account. In the light of this, the Focus Group considers that Hong Kong should examine whether and how to develop exchange traded foreign currency futures and commodities futures. This initiative will not only facilitate the Mainland in managing risks associated with the exchange rate and commodity prices, but also broaden the products and functions of the Hong Kong financial markets.

Overview of the Foreign Exchange and Commodities Futures Market

6.04 Currently, there are no exchange-traded FX futures or commodities futures in Hong Kong. The choices of futures products in Hong Kong are limited to equity index, stock, interest rate and fixed-income only. Almost all transactions are generated by equity index and stock futures. Although the spot, forward and swap FX trading is very active among banks and in the OTC market, there are no exchange traded standardized FX or commodities futures and options. The short product list in Hong Kong is not conducive to enhancing our competitiveness and reputation as an international financial centre, or fostering the clustering effects and strengthening the development potential of our financial markets.

6.05 As part of the strategy to develop Hong Kong into China's international financial centre of global significance (see Chapter 4), consideration should be given to new financial derivatives and commodities futures that are not traded in Hong Kong but there is an active cash market on the Mainland. The demand and supply of the underlying commodities or financial instruments on the Mainland can be combined with HKSAR's advanced financial platform, sophisticated risk management techniques, and openness to international markets.

(A) <u>Foreign Exchange Futures and Options Market</u>

6.06 The Hong Kong Futures Exchange (HKFE) traded FX futures from 1995 to 2002 on four currency pairs. However, trading was subsequently suspended due to low market demand.

6.07 According to the triennial central bank survey conducted by the Bank for International Settlements, Hong Kong is the sixth largest FX centre in the world and third in Asia. The average daily FX turnover in Hong Kong was US$102 billion in April 2004, compared with US$199 billion and US$125 billions for Japan and Singapore respectively. If OTC FX derivatives products are counted, the average daily turnover in Hong Kong was about US$82 billion, seventh in the world and third in Asia, which was also lower than US$185 billion and US$100 billion for Japan and Singapore respectively.

6.08 In August 2006, Chicago Mercantile Exchange (CME) launched RMB/USD, RMB/Euro and RMB/Japanese Yen (JPY) futures and options. CME appointed two notes-issuing banks in Hong

Kong, The Hongkong and Shanghai Banking Corporation Limited and Standard Chartered Bank, to become the market maker for their RMB products. The average daily volume of the RMB/USD futures was 78 contracts (with 4 trading days in August only). No transaction was recorded for RMB/Euro and RMB/JPY futures, and all three options.

Further Development of the Foreign Exchange Futures and Options Market

6.09 The Mainland has moved to a more flexible exchange rate regime in July 2005, with flexibility expected to increase over time. At the same time, with the gradual opening up of capital account of the Mainland and increased convertibility of the RMB, the potential demand for hedging the volatility of the RMB would be huge both domestically in the Mainland and overseas. In developing RMB business in Hong Kong, we already enjoy the first mover advantage of a RMB cash market in Hong Kong, though it is limited to banking initially. Early pursuit of an RMB futures and options market will solidify Hong Kong's lead in offshore RMB trading and the range in non-deliverable RMB products, boosting Hong Kong's FX market, enhancing Hong Kong as the leading hedging and derivatives centre particularly for RMB, closing the gap between us and our major competitors, and checking outside competition.

6.10 The Focus Group considers that by developing our RMB futures and options market, Hong Kong can better serve the Mainland's opening and its drive toward RMB convertibility, provide important tools for the Mainland to hedge FX risks, facilitate price discovery process and help set international RMB exchange rate expectations in the Asia time zone.

6.11 In formulating recommendations on the way forward, consideration has been given to four integral factors pivotal to the development of the market, namely supply, demand, price discovery and market infrastructure. The relevant considerations and recommendations pertaining to these four facets are presented in the ensuing paragraphs.

Recommendations : Supply Side

Developing RMB Futures and Options Market

6.12 Currently, Hong Kong has OTC RMB Non-deliverable forward (NDF) market for institutional investors. This OTC market is linked with the global FX market. In addition, many local banks also provide retail RMB NDF products, but there is no exchange traded standardized RMB futures and options. It is recommended that Hong Kong should pursue an RMB futures and options market with a sense of urgency given intensifying external competition. Since RMB is not yet fully convertible, the contracts have to be settled in cash for the time being. As such, these are essentially extensions of current RMB NDF products and not incompatible with the Mainland's FX control. In the long run, with RMB moving towards full convertibility and Hong Kong's RMB deposits increasing substantially, the contracts can have the deliverable feature.

Products for Consideration

6.13 **RMB/USD futures and options.** Amongst all the existing CME RMB products, this is the only one actually traded, which is also at the centre of the global FX market. This is the most basic product for Hong Kong's RMB futures and options market to start with.

6.14 **RMB/HKD futures and options.** This pair can complement the proposal of using RMB to settle trade between Hong Kong and the Mainland. Hong Kong's re-exports are mainly denominated in USD. However, Hong Kong also has domestic exports to the Mainland and retains a large proportion of goods imported from the Mainland for local use. Such imports and exports could be denominated in RMB and the RMB/HKD futures and options could be used to hedge the exchange rate risk involved. As HKD is pegged to USD, and it moves against the USD within an upper and a lower band, the trading of RMB/USD futures and options side-by-side with RMB/HKD futures and options will provide a USD/HKD futures and options trading opportunity.

6.15 **RMB/Euro and RMB/JPY futures and options.** The Mainland's domestic FX market and CME both offer these RMB cross rate products given their key roles in international trade. Such trading is relatively thin. So these pairs are to be further explored once a solid foothold is established.

6.16 **RMB/NZD, RMB/AUD and RMB/other Asian currencies futures and options.** Further down the development path, these pairs are viable given the Mainland's continuous push for RMB convertibility. As the world factory, the Mainland requires raw materials and semi-finished product imports from Asia and Oceania countries. China records trade deficits against some of these countries while running trade surplus against the US and Europe. A convertible RMB is expected to generate substantial demand for such cross rate futures and options. Hong Kong should prepare itself for such demand in order to differentiate from other major competitors.

6.17 The Focus Group has the following specific recommendation :

- **Develop an RMB futures and options market, beginning with non-deliverable and moving towards deliverable when conditions warrant. Pairs to consider include: RMB/USD, RMB/HKD, RMB/EURO, RMB/JPY, RMB/NZD, RMB/AUD, etc.** ***(Recommendation F5-62)***

Recommendations : Demand Side

<u>Demand generated from RMB Reform</u>

6.18 The RMB's appreciation pressure is intensifying amid record foreign reserves and trade surplus. If the flexibility of the RMB exchange rate will increase, the demand for RMB futures and options both domestically in Hong Kong and in the Mainland, and internationally will increase as well.

6.19 The CPG has repeatedly ruled out more one-off appreciation of the RMB. Instead, the RMB reform is aimed at increasing the flexibility of the exchange rate regime. As the RMB exchange rate regime becomes more and more flexible, the demand for highly leveraged RMB futures and options (the CME products have a leverage ratio of more than 300 times) from users and the investing community will increase.

Drawing Mainland Demand for Managing RMB Exchange Risk

6.20 Given the Mainland's tremendous international trade volume and accumulation of foreign reserves, demand for tools to manage the RMB exchange risk is believed to be substantial. Currently, only limited spot forward RMB products are available from major commercial banks. Hong Kong with the right positioning and expertise should be able to fill the void.

6.21 Hong Kong should make necessary efforts to facilitate the Mainland enterprises and investors to participate in our RMB futures and options market once it is established because they will bring tremendous demand as well as supply. The HKSARG should impress on the CPG the utility of the financial system of Hong Kong to China in providing important tools for hedging RMB exchange risks and facilitating the process toward RMB convertibility, and encourage Mainland entities to make better use of the RMB futures and options market in Hong Kong in conducting their international treasury and asset management activities.

Seeking the Active Participation of Mainland Users and Investors

6.22 The success of Hong Kong's RMB futures and options market hinges on whether we can bring Mainland players to actively conduct their RMB derivatives trading here. Hong Kong stands a good chance of success. The buoyant stock market showcases our ability to link Mainland's financial needs with the international capital market. Hong Kong should leverage on the CEPA and QDII platforms to promote the proposed RMB derivatives. We should seek to expand the CEPA opportunity from direct investment to portfolio and securities investment including derivatives. As QDII allows Mainland investors to invest in overseas securities, we should seek to add the proposed RMB futures and options to the eligible investment vehicles list.

6.23 According to the CSRC, currently 31 Mainland enterprises are permitted to trade commodities futures in overseas exchanges. Six Mainland futures brokerage firms are already allowed to set up branches in Hong Kong under CEPA. It is proposed to pursue extending their eligible product list and customer base to facilitate the development of RMB futures and options in Hong Kong.

6.24 The Focus Group has the following specific recommendation:

- **Make necessary efforts to facilitate and attract Mainland enterprises and investors to participate in our RMB derivatives and commodities futures market once it is established.** ***(Recommendation F5-63)***

- **Leverage on the CEPA and QDII platforms to promote the proposed RMB derivatives and commodities futures and options, and to seek to add these to the eligible investment vehicles list.** ***(Recommendation F5-64)***

Recommendations : Price Discovery

<u>Setting the Benchmark RMB Exchange Rate Expectations</u>

6.25 The Mainland's RMB derivatives market is still in its early development stage and closed to foreign players. Hong Kong is best positioned to capture the market and attract Mainland players, given Hong Kong's international market and platforms such as CEPA and QDII. Bringing international and Mainland players together will help set the best benchmark for RMB exchange rate expectations.

6.26 The Focus Group has the following specific recommendation :

- **A market in Hong Kong participated by both Mainland and international players will help set the best benchmark for RMB exchange rate expectations. The key is to bring in Mainland players.** ***(Recommendation F5-65)***

Recommendations : Market Infrastructure

Setting Up Regulatory and Infrastructure Framework

6.27 Hong Kong traded FX futures from 1995 to 2002. The current trading and clearing systems of HKEx are capable of handling FX products with some upgrading. The technical challenges are considered relatively easy to meet. Apart from system requirements, the rules and procedures for trading FX products as well as regulatory issues also need to be resolved.

Securing Approval from Mainland Authorities

6.28 Coordinated efforts should be made to secure approval from the Mainland authorities. The HKSARG and HKMA should spearhead such efforts, with necessary input and assistance rendered by the SFC and HKEx.

6.29 The Focus Group has the following specific recommendations :

- **Upgrade the current trading and clearing systems of HKEx to handle FX futures and options trading. Rules and procedures for trading FX products as well as**

regulatory issues would also need to be resolved. ***(Recommendation F5-66)***

- **Engage the support of the Mainland Government in the development of RMB futures and options market in Hong Kong.** ***(Recommendation F4-41(b))***

(B) <u>Commodities Futures Market</u>

6.30 Hong Kong used to have commodities futures. Between 1977 and the late 1990s, cotton, sugar, soybean and gold futures were offered in the Hong Kong Commodities Exchange Ltd (restructured as HKFE in 1985), but all of them eventually ceased trading because of lack of demand from local and international participants. Over the past decade, HKEx tried to form alliance with other exchanges in commodities futures. In 1997, HKFE cooperated with the New York Mercantile Exchange (NYMEX) to allow its members to trade crude oil products offered by NYMEX, but this trading arrangement was suspended due to low market demand. In 2003, HKEx signed a memorandum of understanding with SHFE on crude oil product development, but its implementation met difficulties due to different regulatory systems.

6.31 Internationally, there are well developed commodities futures markets covering a wide range of products from agricultural, energy, non-precious metals to precious metals. In terms of the number of contracts traded, NYMEX (mainly energy and metal products) was the largest commodities futures exchange in 2005, followed by the Dalian Commodity Exchange (DCE) (agriculture products) and the Chicago Board of Trade (CBOT) (agriculture and precious metal products). The London Metal Exchange was fourth. It should be noted that in 2005, the two most liquid agricultural futures contracts in the world were soybean and soy meal futures contracts offered by DCE. The just announced takeover bid by CME to acquire CBOT suggests a consolidation trend in global exchanges for stocks as well as futures.

6.32 The other two commodities futures exchanges in the Mainland, namely, SHFE and the Zhengzhou Commodity Exchange have recorded strong growth in recent years. In terms of the number of contracts traded, DCE and SHFE are also ranked within the top ten of world commodities exchanges with active trading in soybean and copper.

Further Development of the Commodities Futures Market in Hong Kong

6.33 The Mainland is one of the world's largest consumers and suppliers of commodities, precious metals and other raw materials. It would be in the strategic interests of the Mainland to have an increasing influence on the price discovery process of the commodities markets and their derivatives markets, and for the trading transactions generated by the Mainland's demand and supply to help foster an international trading market for these products and their derivatives within the Mainland, rather than financial centres overseas.

6.34 Hong Kong, given its open and robust financial system, internationally-recognised regulatory and market standards, is well positioned to capitalise on these opportunities. We should therefore re-examine the key factors for market development, i.e. supply, demand, price discovery and market infrastructure, in light of latest developments in the Mainland, with a view to identifying the appropriate market positioning and our own niche market, and, to map out a way to serve the Mainland's tremendous demand and supply in commodities.

6.35 It would be mutually beneficial for Hong Kong to work with the Mainland in partnership to develop the relevant derivatives markets, particularly those that would take physical delivery. Hong Kong would bring to the partnership the factors key to participation of international players, while the Mainland, with its three fast-growing commodities futures exchanges, will bring demand for commodities futures and perhaps, physical delivery capability.

6.36 The commodities futures market in the Mainland is currently not open to foreign investors. Due to capital control and other regulatory and market constraints, the Mainland commodity futures exchanges are segregated from the international markets. As a consequence, the Mainland commodities futures market does not have a strong influence on global commodities prices, as compared with other overseas markets. The current market structure is not the most ideal way to enable commodities futures markets to perform their price discovery and risk transfer functions for the economy given the global nature of commodity trading. If a commodities futures market is established in Hong Kong, it can bring both the international and Mainland liquidity pools together. This will greatly strengthen the price discovery function of the commodities futures exchange where, like other leading commodities futures exchanges, global liquidity meets. This, in turn, will provide a powerful market pricing signal for the formation of spot cash prices of underlying commodities. The existence of an efficient and well-functioning commodities futures exchange will also enhance Hong Kong's role as a key risk management centre for the Mainland and the region.

6.37 At present, the majority of the global trading in major commodities futures products (e.g. energy and metals) occurs in New York and London. Outside the American and European time zones, in Asia, we do not have a truly international commodities futures exchange with significant participation by global investors and users. With the increasingly important role played by the Mainland economy and other Asian countries in the global economy, there is a strong case to be made to establish the third leg of the global liquidity pool in the Asian time zone. The opportunity exists for Hong Kong to play such a role in the new global market environment. The relevant considerations and recommendations pertaining to the four integral factors pivotal to market development (i.e. supply, demand, price discovery and market infrastructure) are presented in the ensuing paragraphs.

Recommendations: Supply Side

Developing Exchange Traded Commodities Futures and Options

6.38 Currently, Hong Kong does not have any exchange traded commodities futures and options. The technical difficulties involved in developing commodities futures and options are challenging. Nevertheless, given the substantial demand and supply from the Mainland economy, the Focus Group considers that the development of a commodities futures market in Hong Kong is a worth pursuing initiative. As a first step, an independent consultancy study would need to be commissioned to look into the detailed conditions and requirements for such endeavour and make concrete proposals, with the Mainland intended as a major participant.

6.39 If found feasible, Hong Kong should strive to develop one to two key products that we possess competitive edge at the first stage. The width and depth of the market could be built on the participation of users, investors as well as intermediaries both from the Mainland and overseas. Further expansion will be considered after the successful first step.

6.40 There are two possible approaches of servicing the Mainland's commodities needs. The first is to partner with the futures exchanges in the Mainland or overseas. The cooperation can be comprehensive or focusing on technical aspects such as product development, risk management and training, etc. Among all the options, comprehensive cooperation in trading, clearing and settlement is preferred. The second approach is for Hong Kong to develop the products on our own and then attract both international and Mainland players to trade here. No matter which approach to use, institutional barriers that may present difficulties for the participation of Mainland players need to be addressed and removed.

6.41 As commodities trading normally involves physical settlement, there are also two options for consideration. The first is to partner with the futures exchanges or logistics and facilities providers in the Mainland to provide physical settlement there. As the users are mainly located in the Mainland, this approach will solve the transportation, storage and quality control issues. The second is to provide cash settlement contracts only which are solely for hedging and investment purposes. Hong Kong can develop these products on its own.

Products for Consideration

6.42 In terms of product offerings, Hong Kong should complement the development of the Mainland futures exchanges. The products that have better chance of success are those which Mainland either has large demand for or is a major producer/supplier of, and which the futures exchanges in the Mainland are not currently offering. Hong Kong should position itself at either providing complementary services to the Mainland or enhancing Mainland's pricing power in the international market in product design. If our products are to compete and overlap with overseas exchanges, they have to be better designed or at least on a par with existing ones. This issue should be further examined in the consultancy study as recommended above.

6.43 **Gold futures and options.** Gold futures and options are believed to stand a better chance of success due to Hong Kong's already active spot and forward gold trading, and the large demand from investment and jewellery business. Hong Kong also has the talent, expertise and infrastructure to provide gold futures trading. With the decision of the Hong Kong Airport Authority to build a gold depository in the Hong Kong International Airport in 2007, and with participation from the trade, including the Chinese Gold and Silver Exchange Society, banks, local and international gold dealers and producers, etc., and the Government's proposal to exempt the import and export of gold bars from trade declaration charges, more gold traders and investors will be attracted to use Hong Kong as their trading platform to meet their trading, settlement, storage and transportation needs, thereby increasing the competitiveness of Hong Kong as a gold trading centre and the possibility of developing a gold futures and options market.

6.44 **Energy futures and options.** It is noted that the Mainland has high energy demand for crude oil, gasoline and natural gas. All these have well established futures markets internationally. Currently, SHFE already has fuel oil trading. Hong Kong may need to consider developing trading alliances with leading commodities exchanges and the Mainland exchanges in pursuit of energy futures trading during the Asian trading hours in order to accommodate the growing needs of the Mainland. In addition, the consultancy study can also look into the possibilities of developing futures contracts for the crude oil, gasoline and natural gas produced in the Mainland, the production, delivery, clearing and settlement of which can all be based on existing arrangements. The futures contracts in Hong Kong can be used for hedging and investment purposes only, and be settled in cash.

6.45 **Alternative commodities linked products.** We should also look into the development potentials of ETCs, ETFs, commodity-based derivative warrants, and other forms of commodities linked products.

6.46 The Focus Group has the following specific recommendation :

- **Commission an independent consultancy study to look into the detailed conditions and requirements and make concrete proposals. The study should explore the following aspects :**

(a) Products to get the development off the ground, e.g. gold and energy products;

(b) alternative commodities linked products such as Exchange Traded Commodities (ETCs), Exchange Traded Funds (ETFs), commodity-based derivative warrants, and other forms of commodities linked products; and

(c) deliverable contracts.

(Recommendation F5-67)

Recommendations : Demand Side

<u>Substantial Demand Generated From Mainland's Opening</u>

6.47 Hong Kong is neither a commodity producer nor a significant consumer. It lacks the warehouse and other facilities. It also lacks the industries that utilize commodities. Therefore, efforts in developing a commodities futures market will have to be based on the Mainland as well as international demand. According to CSRC, currently 31 Chinese enterprises are permitted to trade commodities futures in overseas exchanges. If Hong Kong can offer the right products, we can attract them to trade here. Six Mainland futures brokerage firms are already allowed to set up branches in Hong Kong under CEPA. Their Mainland customer bases as well as those Chinese commodities producers listed in Hong Kong are all potential sources of demand.

6.48 The HKSARG should take the lead together with the financial regulators making use of the CEPA and QDII platforms to promote the benefits of a commodity futures exchange in Hong Kong to the Mainland markets and economy. With the gradual opening up of the Mainland market, the Mainland futures brokerage firms allowed to set up branches in Hong Kong could provide an important function in facilitating cross-boundary commodity-related transactions. Under QDII, we could seek to add commodities futures and options to the eligible investment vehicles list, especially for those Mainland organisations or companies that have a genuine need to use the commodities futures market to manage their business risk.

Drawing the Mainland Demand for Commodities Trading

6.49 Currently, the Mainland's futures market mainly serves the users' needs. In order to safeguard against financial risks, speculation is discouraged. Besides, the futures market is closed to foreign investors. Therefore, other than those enterprises already permitted to go abroad, there is huge untapped demand for commodities trading from the Mainland. There is a case for HKSARG to impress upon the Mainland authorities the utility of Hong Kong's financial markets to China in providing an efficient platform for risk management and price discovery for commodities trading. It will be beneficial to both the Mainland and Hong Kong for Mainland enterprises and investors to participate in our commodities futures and options market once it is established because they will bring tremendous demand as well as supply.

Securing the Participation of Mainland Users and Investors

6.50 The success of Hong Kong's commodities futures and options market hinges on whether we can bring Mainland players to trade here. Hong Kong stands a good chance of success. The buoyant stock market showcases our ability to link Mainland's financial needs and the international capital market. Hong Kong should leverage on the CEPA and QDII platforms to promote the proposed commodities products. We should seek to expand the opportunity from direct investment to portfolio and securities investment including derivatives and to add the proposed commodities futures and options to the eligible investment vehicles list. We can begin with those 31 Mainland enterprises permitted to trade commodities futures in overseas exchanges and six Mainland futures brokerage firms allowed to set up branches in Hong Kong.

6.51 The Focus Group has the following specific recommendations (also set out in paragraph 6.24 above):

- **Make necessary efforts to facilitate and attract Mainland enterprises and investors to participate in our RMB derivatives and commodities futures market once it is established.** ***(Recommendation F5-63)***

- **Leverage on the CEPA and QDII platforms to promote the proposed RMB derivatives and commodities futures and options, and to seek to add these to the eligible investment vehicles list.** ***(Recommendation F5-64)***

Recommendations: Price Discovery

<u>Enhancing China's Pricing Power in International Commodities Market</u>

6.52 The Mainland's commodities futures exchanges are expanding fast in terms of product range and turnover. Yet they are not directly accessible by international players. In their pricing process, while they already make reference to the global market place and have increasing contacts and cooperation with their overseas peers, it cannot be said that their prices are converging with international prices as a result of the lack of foreign participation. In this regard, Hong Kong can offer the Mainland players an open and internationalized market with a regulatory framework on par with international standards. By linking Mainland and the global market, it will help set benchmark prices and enhance Mainland's pricing power in the process.

6.53 In view of the market view that deliverable contracts would help substantially in the price discovery process and avoid manipulation and excess volatility, it is proposed to carefully weigh the pros and cons of the deliverable feature in the consultancy study, even though it is easier to establish and operate cash-settled contracts.

6.54 The Focus Group has the following specific recommendation :

- **Hong Kong's open and internationalized market can help bring Mainland and international players together and set benchmark prices and enhance China's pricing power in the process.** ***(Recommendation F5-68)***

Recommendations : Market Infrastructure

Setting Up Regulatory and Infrastructure Framework

6.55 The core infrastructure/system should be established in order to accommodate the new commodities futures market in Hong Kong. The extent of such development depends on the business model, e.g. whether Hong Kong will build the new commodities futures market by itself or partner with the Mainland or overseas exchanges. Rules and procedures for trading commodities products as well as regulatory issues also need to be put in place and resolved, which could be extended to cover ETCs and ETFs, etc.

6.56 As for success factors such as expertise, talent, experience, network, liquidity, infrastructures for physical settlement, transportation, tracking, quality control and warehouse management, etc., they need to be built up gradually.

Securing Approval from Mainland Authorities

6.57 Once a decision is made to establish a commodities futures market, HKSARG, together with the financial regulators, should proactively approach the relevant Mainland authorities with a view to seeking their support to facilitate the development of such a market in Hong Kong.

6.58 The Focus Group has the following specific recommendations :

- **Upgrade the current trading and clearing systems to handle commodities futures and options trading. Rules and procedures for trading commodities products as well as regulatory issues would also need to be resolved. *(Recommendation F5-69)***

- **Gradually build up the necessary expertise, talent, experience, network, liquidity, infrastructures for physical settlement, transportation, tracking, quality control and warehouse management, etc. *(Recommendation F5-70)***

- **Engage the support of the Mainland Government in the development of commodities futures market in Hong Kong, and address the cross-boundary clearing and settlement issues. *(Recommendation F4-41(c))***

Appendix 6-1

	Members of the Foreign Exchange and Commodities Futures Sub-group	
1	Mr. Gary He Guangbei	Vice Chairman and CEO, BOCHK (Convenor)
2	Professor Chan Ka Keung	Dean, School of Business and Management, Hong Kong University of Science and Technology
3	Dr. Frederick Hu	Managing Director, Goldman Sachs
4	The Honourable Charles Y.K. Lee	GBM, GBS, JP
5	Miss Alice Cheung	Principal Assistant Secretary, FSTB
6	Mr Keith Lui	Executive Director, SFC
7	Mr. Peter Pang	Deputy Chief Executive, HKMA
8	Ms. Julia Leung	Executive Director, HKMA

	Observers of the Foreign Exchange and Commodities Futures Sub-group	
1	Mr. Calvin Tai	Senior Vice President of Derivatives Market, HKEx
2	Mr. Eric Yip	Personal Assistant to Chief Executive, HKEx
3	Mr. Lee Tak-keung	Government Town Planner, CPU

Chapter 7 Further Development of the Insurance, Reinsurance and Asset Management Sectors

Introduction

7.01 The Insurance, Reinsurance and Asset Management Sub-group ("Sub-group"), convened by Dr Edmund Tse, was established to study the further development of the insurance and reinsurance industries in Hong Kong and the Mainland as well as ways to further enhance Hong Kong as an international asset management centre.

7.02 Members of the Sub-group comprise prominent market practitioners of the insurance and asset management industries as well as representatives from the Office of the Commissioner of Insurance (OCI), the SFC and the HKMA. A list of its members is at Appendix 7-1.

7.03 The Sub-group convened two meetings on 29 September and 11 October 2006 to work out proposals for further promoting the insurance and reinsurance industries of Hong Kong. Apart from this, the views of the Hong Kong Investment Funds Association were also obtained.

Overview of the Insurance/Reinsurance/Asset Management Market

7.04 Based on the statistics recently released by the OCI, the Hong Kong insurance industry performed well in 2005. In tandem with the robust economic growth in 2005, total gross premiums of Hong Kong insurance business (combining general insurance business and long term insurance business), compared with 2004, recorded a significant increase of 13.2% to $137.3 billion. The total amount of gross premiums written by pure reinsurers (i.e. insurers that are only authorised to carry on reinsurance business in or from Hong Kong) in 2005 were $2,030 million.

7.05 As regards the conditions of the insurance/reinsurance/asset management market on the Mainland, detailed information is provided below when stating the Sub-group's proposals in various aspects. A well-functioning insurance and asset management industry is important for sustainable economic growth in Mainland China. Insurance companies provide risk protection and transfer — which promote consumption and innovation — as well as financial intermediation services. Asset management fosters development of institutional investors which helps the efficiency of financial intermediation. Increasing presence of Hong Kong insurers and asset managers on the Mainland is part of the five-pronged strategy for the HKSAR to make greater contribution to financial intermediation on the Mainland, as outlined in Chapter 3.

Further development of the Insurance/Reinsurance/Asset Management Market

7.06 In working out the proposals, the Sub-group has taken into account China's 11th FYP, the Plan promulgated by the China Insurance Regulatory Commission (CIRC), the insurance and asset management needs of the Mainland people and enterprises, as well as the strengths of the insurance and asset management industries in Hong Kong.

I. Summary of the 11th Five Year Plan Objectives

7.07 The 11th FYP, which is in the first year of implementation on the Mainland, correctly identifies "harmonious growth" as the next essential target for China's successful reform and development efforts. The general aims of the 11th FYP can be summarized as follows:

(1) Attain sustainable and "quality" economic growth, instead of just high growth rates;

(2) Shift from investment/export-driven to consumption-driven growth;

(3) Promote service/tertiary industries to upgrade the economic structure;

(4) Deepen economic reform, including financial and capital market reforms;

(5) Build a harmonious society by narrowing income disparities and by developing a social safety net; and

(6) Bridge developmental gaps between the eastern and western provinces.

7.08 The development of financial services in general and insurance in particular is critical to the successful implementation of the 11th FYP. This is most notable in the 11th FYP's emphasis on developing the service sector, promoting a harmonious society through the development of a social safety net, and deepening the development of capital markets.

7.09 The CIRC has issued its own Five-Year Plan ("CIRC's Plan") that highlights the relevance of the insurance industry to the general aims of the 11th FYP. The CIRC's Plan has ten key points:

(1) ***Develop the market and enhance competitiveness.*** Measures are aimed at encouraging qualified companies to restructure and make acquisitions to become internationally competitive; expanding the reinsurance sector; developing insurance intermediaries; and improving the regulatory environment for entry and exit.

(2) ***Deepen reforms and change the mode of growth.*** This is an effort to improve corporate governance in general and accelerate reform in the state-owned sector in particular.

(3) ***Expand products and broaden service areas.*** A top priority is the development of more diversified insurance products such as property, health, and liability insurance. A second aim in this regard is to expand insurance penetration in more industrial sectors, particularly high-tech, project finance, consumer credit, and freight transportation.

(4) ***Improve the use of capital and asset management.*** Expand the use of investment options and develop innovative approaches to hedge risks via derivative products. Allow insurance capital to be invested in a wider range of securities and asset classes to include property and venture capital.

(5) ***Promote coordinated regional development.*** Expand insurers' presence and penetration in central, northeastern, and western parts of the Mainland.

(6) ***Continue informatisation.*** The CIRC's Plan specifically addresses the issue of improved use of e-government means to

improve regulatory capabilities as well as public sources of information on the industry.

(7) ***Open the industry to more competition.*** Bring more foreign firms into the health, liability, and other types of coverage as well as into central, northeastern, and western parts of the country.

(8) ***Strengthen industry supervision and risk management.*** This includes regulatory supervision as well as internal controls within insurance companies.

(9) ***Enhance human resources.*** Improve the management and certification of insurance personnel and increase protection of trade secrets.

(10) ***Strengthen the legal system.*** The CIRC aims to complete a second revision of the Insurance Law during the Five-Year Plan period and finalise regulations on health and liability insurance.

7.10 These ten points complement the specific aim of the 11th FYP in terms of deepening capital markets reforms. In addition to providing additional asset classes to foster the insurance industry's development, the deepening of capital markets will provide more financing channels for Mainland enterprises, and more investment options for Mainland households.

II. Importance of Insurance in Economic Development

7.11 The goals of the 11th FYP as they relate to the insurance industry are entirely consistent with the proven importance of insurance in economic development studies. Banks, non-bank financial institutions and capital markets play one of the most critical roles in an economy: they transfer funds between savers (i.e. economic agents with excess funds) and borrowers (i.e. economic agents with financing needs) at the lowest cost and with the least amount of distortion.

7.12 Insurance companies are key players in the financial intermediation process in terms of both risk protection and capital formation. Investors save and invest excess funds for a variety of reasons. They choose instruments and use intermediaries (such as banks, mutual funds, or stock brokers) that most closely match their requirements in terms of risk-adjusted investment return, maturity, and liquidity. Typically, individuals and corporations also purchase insurance policies, both life insurance and P&C (property & casualty) coverage. While many of them are conventional risk transfer vehicles, others are hybrids like investment-linked life insurance.

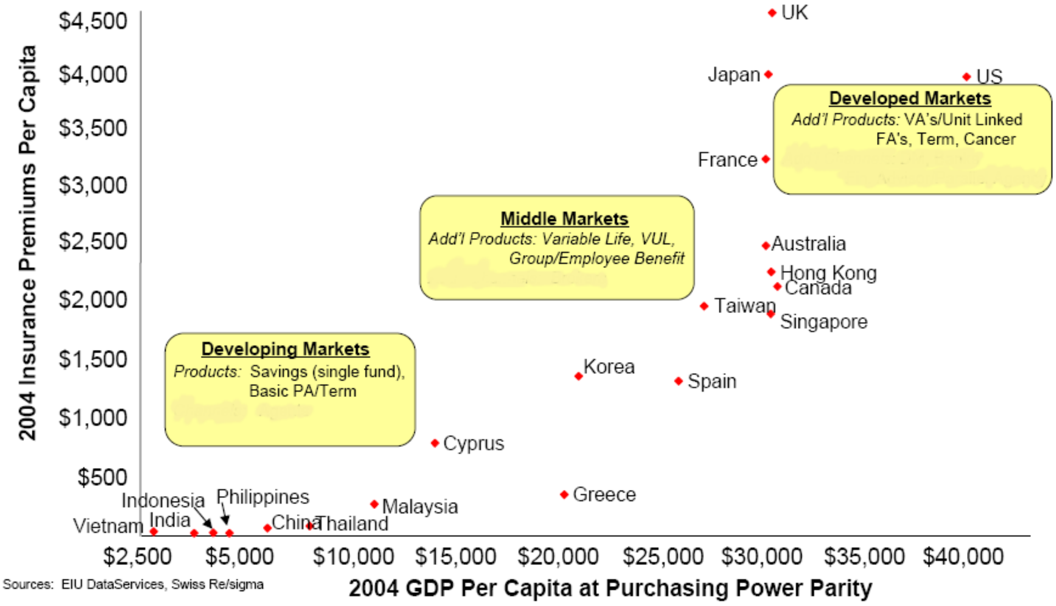
7.13 Insurance companies then invest the premium income in capital markets, thus converting an insurance policy – a risk management and/or wealth preservation tool – into an investment. Insurance companies thus act as capital market intermediaries between a particular type of investor – namely policyholders – and borrowers.

7.14 Not surprisingly, insurance companies, along with pension funds, are among the key intermediaries for medium- and long-term investments in financial markets at virtually every level of development.

7.15 Given the critical role of insurance in capital markets and the economy as a whole, it is not surprising to see a high correlation between insurance penetration and income levels. Developed economies, as noted in the graph below, also have very developed insurance markets with high rates of penetration, sophisticated products, and a variety of distribution channels.[15]

[15] These data and argument are derived from Rudolf Enz, *The S-Curve Relation Between Per Capita Income and Insurance Penetration*, Geneva Papers on Risk and Insurance, No. 3, Vol. 25, July 2000, p. 396-406.

Insurance Expands as Income Increases



7.16 As noted in the chart above, China's unique "one country, two systems" economic structure incorporates the developed experience of the Hong Kong insurance market with the developing market needs of the Mainland market. It is in this regard that Hong Kong can make its most valuable contribution to the 11th FYP. Hong Kong insurers operate in a developed, sophisticated market and can bring this expertise to the Mainland to assist in achieving the goals outlined in the CIRC's Plan. More to the point, Hong Kong insurers have participated in the transformation of the HKSAR's own insurance market from a relatively under-developed level to one of the most sophisticated markets in the world. This experience has given Hong Kong insurers a level of expertise that is highly relevant to the development goals of the Mainland under the new Five-Year Plan.

7.17 As the CIRC's Plan recognises, the development of deep and efficient insurance markets is desirable for two key reasons:

(1) More developed insurance markets broaden the scope of financial products for savings, risk management, and wealth preservation purposes and thus improve consumer choice; and

(2) The development of insurance suppliers as financial intermediaries is a critical ingredient of deep, liquid, and efficient financial markets, most notably for long-term investments.

Insurance: Risk Protection

7.18 As noted, insurance products serve the dual purpose of providing risk management tools and vehicles for wealth preservation. As a risk management tool, insurance protects policyholders against the financial impact of a loss, be it the loss of the insured's property (property loss), a claim for monetary damages because of injury to another party or damage to someone else's property (liability loss), or the losses to individuals and families due to death, sickness, injury or unemployment (personal loss).[16]

7.19 To the extent that individuals invest in (real or personal) property to supplement their retirement savings – or derive their income from the ownership use of such property – insurance protection is a critical wealth preservation tool, as it ensures future cash flows. Rent from residential or commercial property is one such source of income; income derived from offering transportation services (e.g. taxi and minibus services, trucking, etc.) is another common example. Insurance ensures the continuity of these income and cash flows, even in the event of partial or total damage to the property (e.g. car, bus, truck, or real estate).[17]

7.20 These benefits are highly relevant to the 11th FYP. Private consumption is encouraged, as the advent of insurance protection gives consumers greater confidence that their present and future well-being is appropriately protected against the occurrence of loss events. A wider range of asset classes in which insurers can invest will similarly deepen capital markets, as outlined by the 11th FYP. Both of these developments will enhance the service sector of the economy and promote more balanced economic growth.

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[16] In the same way, businesses frequently protect themselves against the consequences of a death, disability, retirement, or resignation of their key employees.

[17] By simple virtue of its existence, every (real or personal) property is subject to a loss **exposure**, i.e. the possibility that a loss will occur.

Insurance: Capital Formation

7.21 Life and non-life insurance companies are among the most critical intermediaries in the world's financial markets. Not surprisingly, the share of insurance assets relative to economic output tends to be higher in the industrialised world than in emerging markets and transition economies. Obviously, this is simply a by-product of a higher insurance penetration rate in jurisdictions with higher standards of living. In the United States, for instance, life and non-life assets accounted for almost 40% of GDP in 2000, in Japan the ratio is 69% (2001), and in the United Kingdom the ratio reached a staggering 107% (2001).

7.22 The Mainland's insurance assets have been expanding at double-digits rates for the past decade. However, investment restrictions remain a constraint on the ability of the insurance industry to contribute more fully to the country's economic development. Currently on the Mainland there are sufficient national capital supplies with lower financing costs but limited investment channels. National capital runs the risk of not being efficiently allocated and utilised which might lead to the risk of a price bubble for domestic assets, such as overheated investment in real estate or excessive growth of fixed asset investments. National capital highly concentrated in a single market is also against the principle of risk diversification. The CIRC's Plan recognises that this should change. In a similar vein, the inability to offer foreign currency insurance prevents domestic insurers from mobilizing capital in foreign currency for investment purposes. Hong Kong, given its experience in insurance and capital markets, stands ready to contribute to the successful fulfillment of these goals over the next five years.

III. Proposals for Hong Kong's Contribution to Success of the 11th FYP in Financial Services

7.23 As a result of the unique nature of the "one country, two systems" formula, China benefits from the existence of two different economic systems alongside each other. This has proven to be enormously beneficial to the development of manufacturing, for example, in coastal Mainland. Now that the Mainland has become more focused on the development of the services sector in general and financial services in particular, Hong Kong's unique position as a separate economic system within China can provide significant developmental benefits to the Mainland. Hong Kong should enhance cooperation with the Mainland to facilitate the further development of the insurance, reinsurance and asset management industries.

7.24 As noted above, the insurance sector plays a key role in the financial sector and the economy as a whole. There is a high correlation between insurance penetration and economic development. Hong Kong, which has a high level of income and correspondingly high insurance penetration ratio, is, thus, in a unique position to make a contribution to the successful implementation of the 11th FYP by sharing its experience with the Mainland.

7.25 The Focus Group has the following specific recommendation –

- **Enhance cooperation with the Mainland for the further development of the insurance, reinsurance and asset management industries.** ***(Recommendation F4-41(d))***

Specific proposals on the insurance (life, general, medical, captive/re-insurance, pensions) and asset management industries follow in the paragraphs below.

Supply Side Proposals

7.26 The proposals below aim at attracting Mainland enterprises to take advantage of our unique geographical/cultural linkage, professional expertise, market knowledge and management capability by setting up or expanding their operations in Hong Kong.

Reinsurance/Captive Insurance

1. Market Conditions on the Mainland

7.27 The reinsurance industry on the Mainland has evolved from a situation of state monopoly to a gradual lifting of mandatory cessions as spelled out in the protocol on China's accession to the World Trade Organisation. The reinsurance industry is recognised as an important player in the Mainland's domestic capital markets and as an important carrier of risks for the domestic insurance industry. While the reinsurance industry is playing an important role in supporting the primary insurers on the Mainland and participates in the domestic capital markets in a meaningful way, it is acknowledged that the reinsurance sector is still in an early stage of development. Similarly, captive insurance programmes are relatively underdeveloped in the Mainland.

2. China's 11th Five-Year Plan

7.28 The Plan as spelled out by the CIRC aims to:

(1) Develop the Mainland reinsurance industry.

(2) Promote reinsurers' activity in capital markets.

3. HKSAR's Market Experience

7.29 As in the life and general insurance industries, Hong Kong's reinsurance market is highly competitive, effectively overseen by the financial regulators, and fully integrated with global capital markets. With the continuous development of the Mainland market, Hong Kong could realize its full potential as an international reinsurance hub in the same way as other offshore centres, notably Bermuda and the Cayman Islands, where there is a much higher concentration of reinsurance companies. Some common features of these centres include tax concessions (ranging from 0% to 10%) and accommodating regulatory requirements for domestically registered reinsurance businesses.

7.30 Similarly, with only two registered captive companies, Hong Kong is lagging behind offshore insurance centres like Bermuda, the Cayman Islands and Singapore with 1,326, 737 and 57 companies respectively. Again, these centres offer a combination of tax and regulatory incentives to build up a critical mass. Hong Kong's tax rate on captives is similar to its general corporate tax rate, whereas Singapore has had a special 10% tax rate for captives and has seen the number of such companies grow from only two in 1984 to 57 today. Singapore announced recently a new 10-year tax exemption scheme for qualified captive insurance companies. Similar measures by the Hong Kong authorities could help develop the captive sector in the HKSAR and also service Mainland firms.

4. Proposals for HKSAR

7.31 The Focus Group has the following specific recommendation :

- **Carry out detailed analysis on possible measures to enhance the development of Hong Kong into a regional captive insurance centre, targeting at those Mainland enterprises listed on overseas stock markets at the initial stage.** ***(Recommendation F6-71)***

Asset Management

1. Market Conditions on the Mainland

7.32 The asset management industry in the Mainland remains relatively underdeveloped. Up until the beginning of this year, the domestic stock market was on a five-year decline and the corporate bond market has been hampered by a relative lack of offerings. The turnaround in the stock market this year has been attributed in part to the successful dual listing of domestic Chinese banks on the Hong Kong and Shanghai stock markets, an example of the success that can be achieved through enhanced financial cooperation between Hong Kong and the Mainland. Expansion of this type of cooperation would help foster the development of the Mainland asset management industry and also keep Hong Kong competitive when measured against regional rivals.

2. China's 11th Five-Year Plan

7.33 Reform of the financial services sector is not only critical to developing the services industry more broadly on the Mainland, but also lowering the savings ratio. Chinese households save a disproportionate share of their income partly because of relatively low returns on investment within the Mainland financial system. Other things being equal, households can afford to save less today in that higher investment returns help attain the same financial security and goals in the future as those would have been otherwise achieved by higher savings under a low investment returns environment.

3. HKSAR's Market Experience

7.34 The asset management industry is extremely competitive and completely integrated with global capital markets. At the same time, Hong Kong serves as the preferred listing venue for the Mainland enterprises. In equity markets, Mainland companies already account for the bulk of the Hong Kong stock market, either directly as "H" shares or through so-called "red chips." Encouraging this same sort of integration in the bond and forex markets would assist the Mainland enterprises in their corporate financing needs as well as enable Hong Kong to retain its role as a regional financial centre.

4. Proposals for HKSAR

7.35 The Focus Group has the following specific recommendations:

- **Promote Hong Kong to become an offshore RMB centre by encouraging RMB trade-related settlements and setting up offshore RMB bond market in Hong Kong. *(Recommendation F6-72)***
- **Facilitate foreign currency as well as RMB insurance assets to be invested overseas by attracting Mainland licensed insurance companies to set up asset management companies / affiliates in Hong Kong. This will provide additional investment conduits for foreign currency products currently under pilot testing, as well as corporate annuity business. *(Recommendation F6-73)***
- **Facilitate HK$ / US$ -denominated investments as admitted assets for insurance investments in the Mainland. *(Recommendation F6-74)***
- **Facilitate Mainland enterprises and investors to participate in Hong Kong authorised funds through the QDII initiatives. *(Recommendation F6-75)***

Demand Side Proposals

7.36 The proposals below aim at enabling Hong Kong to render its assistance to the Mainland in strengthening market discipline and achieving goals set out in the 11^{th} FYP.

Life Insurance

1. Market Conditions on the Mainland

7.37 The Mainland's life insurance market ranks among the fastest growing in the world. According to Sigma Insurance Research of Swiss Re, the Mainland life market expanded by 11.8% in 2005 versus 3.9% globally and 3.7% in Asia.

7.38 The Mainland's growth, however, is from a very low base. Life insurance premium per capita is at US$ 30.5 versus a global average of US$ 299.5 and an Asian average of US$ 149.6. Moreover, much of the expansion of the life insurance sector has been concentrated in the urban and coastal areas, leaving the inland provinces and rural sector behind. Life insurance companies also face the challenges of limited investment channels and lack of local talents.

7.39 Life insurance is, nevertheless, projected to continue to grow at a level equal to or higher than the growth of GDP. Following are some of the main reasons behind this projection:

(1) Dismantlement of the cradle-to-grave system of social welfare;

(2) Increasing affluence with heightened awareness of the importance of protection;

(3) High savings, nearly 45% of GDP, a long-term trend on the Mainland;

(4) Expansion of the financial services sector beyond the urban and coastal areas; and

(5) "Graying" of the population is associated with higher purchases of life insurance.

2. China's 11th Five-Year Plan

7.40 The 11th FYP aims to address growing income inequality; increase consumption as an engine of economic growth; develop the service sector; raise rural incomes; and generally promote more balanced economic growth.

7.41 The life insurance industry in China can help to achieve the goals of the 11th FYP in the following ways:

(1) As one of the most basic tools of capital formation, the life insurance industry underpins the long-term healthy

development of the financial services sector.

(2) Life insurance brings about enhanced financial security for the society, thus being conducive to increasing consumption per the 11th FYP as households can afford to save less in that life insurance helps safeguard their future well-being.

(3) Increased competition in the rural life insurance market will extend the proven benefits of a competitive life market to the countryside.

3. HKSAR's Market Experience

7.42 Hong Kong is recognised as a leading international financial centre and this is particularly true in life insurance. Hong Kong's life insurance premium per capita was US$ 2,213.20, second only to Japan in Asia and 9th in the world.

7.43 Commensurate with its higher level of insurance penetration and density, Hong Kong has a wider range of product offerings and sophisticated distribution channels in the life insurance industry.

7.44 Hong Kong has a highly competitive, well-regulated insurance market, with local and foreign companies vying for business and providing first-class protection and investment products and services to consumers and companies. Significantly, the life insurance industry is also a key source of capital in Hong Kong's sophisticated capital markets.

4. Proposals for HKSAR

7.45 Hong Kong's market experience allows Hong Kong to contribute to the Mainland's development. The Focus Group has the following specific recommendations:

- **Hong Kong insurers to assist in the development of micro insurance in rural area of the Mainland based on their international experience through pilot programmes in selected provinces and/or pilot programmes for selected products. *(Recommendation F6-76)***
- **Foreign life insurers to participate in foreign currency denominated life insurance business in the Mainland,**

starting with pilot programmes in selected cities/provinces such as Guangdong involving asset management companies/affiliates established in Hong Kong. ***(Recommendation F6-77)***

General Insurance

1. Market Conditions on the Mainland

7.46 Similar to the life insurance market, general insurance on the Mainland is growing at a fast pace, but from a low base. In 2005, the general market increased by 12.7%, compared to global growth of 0.6% and Asian growth of 2.9%. Per capita general insurance density was US$ 15.8 versus a global average of US$ 219.0 and Asian average of US$ 48.3.

7.47 While the general insurance market sector has been gradually opening up to more competition, the industry remains highly concentrated in terms of market players, product offerings, and distribution. As the Mainland's economy has grown more closely integrated with the world economy, demand for more varied general insurance product offerings has increased. As an example, Mainland enterprises listing their stocks overseas generally purchase directors' and officers' liability insurance and Mainland exporters are increasingly required to purchase product liability insurance in order to protect themselves from the litigious practices in foreign markets.

2. China's 11th Five-Year Plan

7.48 As noted, the 11th FYP aims to address growing income inequality; increase consumption as an engine of economic growth; develop the service sector; raise rural incomes; and generally promote more balanced economic growth.

7.49 The development of the general insurance sector can assist in achieving the goals of the 11th FYP in the following ways:

(1) Develop liability insurance for safer, "greener" growth (production safety & architectural engineering, environmental

pollution liability).

(2) Develop specialised liabilities insurance companies.

(3) Develop directors' and officers' liability insurance for companies seeking to conduct IPOs.

(4) Start pilot programmes for employer's liabilities insurance & uniform medical liability insurance to alleviate health care /disability concerns of the lower income groups.

(5) Promote product innovations that will encourage more private consumption in the economy (e.g. mortgage & auto insurance).

3. HKSAR's Market Experience

7.50 Hong Kong has a highly competitive and well-regulated general insurance market, with healthy competition among leading local companies and multinational financial service conglomerates. There is an abundant supply of innovative products and sophisticated risk management know-how in the Hong Kong general insurance market.

4. Proposals for HKSAR

7.51 Hong Kong can help bring some of the specialised commercial liability insurance products such as public construction, third party liability, product liability for exports, and professional liability insurance from Hong Kong to the Mainland market. This can be achieved through pilot programmes in selected provinces and/or pilot programmes for selected products.

7.52 The Focus Group has the following specific recommendation:

- **Hong Kong insurers to introduce specialised commercial liability insurance products to the Mainland market. *(Recommendation F6-78)***

Medical Insurance and Pensions

1. Market Conditions on the Mainland

7.53 The Mainland's health care market has been the subject of a series of intensive reforms over the past two decades. State-owned enterprises formerly met the bulk of workers' health care needs, but this burden has increasingly fallen on individual workers and families. Concern over health care is one of the main reasons for the high savings ratio among the Mainland consumers. Promoting reform of the health care system is essential to developing consumption as an engine of growth in the broader Chinese economy.

7.54 Similarly, pensions have been a focused area of reform in the Mainland for more than two decades. Unfunded pension liabilities are an important concern for the Mainland enterprises, provincial governments, and the central government. Significantly, concern over financing retirement is one of the main reasons for the Mainland's excessively high savings ratio and its resultant low rate of consumption.

2. China's 11th Five-Year Plan

7.55 The 11th FYP aims to address the health care needs through the following ways:

(1) Develop health insurance and support insurers to invest in hospitals;

(2) Develop specialised health insurance companies;

(3) Enhance a multi-layer health protection system; and

(4) Improve health care throughout the Mainland, especially rural areas.

7.56 In respect of pensions, the 11th FYP aims to:

(1) Promote pension reform to relieve the state's social security burden.

(2) Encourage greater consumption by alleviating popular concern over financing retirement.

(3) Develop specialised pension insurance companies.

3. HKSAR's Market Experience

7.57 Hong Kong's health care system includes both public and private funding (such as private insurance). The health care system has been effective in responding to systemic health crises as well as in providing care to individuals.

7.58 The introduction of the Mandatory Provident Fund (MPF) System in Hong Kong represents a significant step forward in the provision of retirement protection for the workforce of Hong Kong. The MPF System is a system of employment-related schemes to accrue financial benefits for members of the workforce when they retire. MPF schemes are privately managed under a free competition environment. Competition tends to increase investment returns and reduce costs, which will benefit scheme member ultimately. Hong Kong has a well-established and sound financial services sector. The significant amount of retirement assets generated by such a privately managed retirement system under prudential regulation and supervision adds impetus to the further development of the financial markets. There are increased demands for equities, quality bonds and other investment products. There are also increased demands for trust and custodial services, investment management and scheme administration. The MPF market players in Hong Kong excel in product and service offerings.

4. Proposals for HKSAR

7.59 Bring Hong Kong's experience to the Mainland through participating in pilot programmes, such as allowing Hong Kong insurers to setup specialised health insurance companies in the Mainland in selected cities/provinces such as Guangdong to be used as a model for further development.

7.60 Furthermore, the Mainland could capitalise on Hong Kong's proven success in retirement services by allowing the participation of Hong Kong pension providers, including but not limited to trustees, administrators, record-keepers and investment managers, in the offering of corporate annuity business to Foreign Invested Enterprises in selected provinces such as Guangdong.

7.61 The Focus Group has the following specific recommendation:

- **Hong Kong insurers to set up specialised health insurance companies in the Mainland (including commissioning of**

hospitals/managed care and health maintenance organisations by Hong Kong companies), while Hong Kong pension providers may also participate in the offering of corporate annuity business in the Mainland. *(Recommendation F6-79)*

Price Discovery Proposals

7.62 Formation of captive insurance companies in Hong Kong will assist Mainland enterprises in reaching out to the international market, thus developing their ability to determine pricing strategies in accordance with their insurance needs.

7.63 Since taxation and regulatory regimes remain a major consideration borne by captive insurers interested in entering Hong Kong, focus should be placed upon feasible ways to narrow the gap with our competitors, an effective mechanism to identify Mainland enterprises with potential to establish captives, as well as possible measures designed to attract and cater for these enterprises.

7.64 For re-insurers, there is a case to reappraise the existing incentives and evaluate their effectiveness in comparison with other jurisdictions, bearing in mind the emerging demand arising in step with market reforms and liberation in the Mainland.

Market Infrastructure Proposals

7.65 In order to realize the proposals, especially pilot programmes in selected provinces, modifications to the regulatory and infrastructure framework requiring approval from the CPG and relevant Mainland authorities are inevitable.

7.66 Hong Kong should also open up a wider range of training courses and job attachments for professionals from the Mainland in subjects such as insurance, risk management and actuarial science. The Swiss Insurance Training Centre established in May this year serves as a good example. Knowledge and awareness of insurance practitioners will help to promote insurance in a complementary way.

7.67 Market discipline and trade practices are best nurtured through peer pressure and consumer choice. To this end, centres providing Mainland agency qualification examinations should be set up in Hong Kong to encourage and facilitate our local insurance practitioners to seek a long-term career in the Mainland insurance market, thereby elevating professional standards and client expectations. Detailed arrangements can be worked out between the regulatory authorities and industry trade associations.

7.68 The Focus Group has the following specific recommendation:

- **Set up examination centres for the Mainland agency qualification examination in Hong Kong and provide a wider range of training courses as well as job attachments for Mainland professionals. *(Recommendation F6-80)***

Appendix 7-1

	Members of the Insurance, Reinsurance and Asset Management Sub-group	
1	Dr Edmund Tse	Chairman & CEO of American International Assurance Company Limited (Convenor)
2	Mr Victor Apps	Chairman of Manulife (International) Limited
3	The Hon Bernard Chan	President of Asia Financial Group
4	Mr Kin Por Chan	CEO of Munich Reinsurance Company Hong Kong Branch
5	Mr Chung Foo Choy	Chief Executive of HSBC Insurance (Asia-Pacific) Holdings Ltd.
6	Dr Frederick Hu	Managing Director of Goldman Sachs (Asia)
7	Mrs Sally Wong	Executive Director of Hong Kong Investment Funds Association
8	Mr Clement Cheung	Commissioner of Insurance of the Office of the Commissioner of Insurance
9	Mrs Alexa Lam	Executive Director of Securities and Futures Commission
10	Mr Peter Pang	Deputy Chief Executive of Hong Kong Monetary Authority
11	Ms Julia Leung	Executive Director of Hong Kong Monetary Authority

Chapter 8 Conclusion

8.01 The 11th FYP includes a series of financial reform and development initiatives that will help to sustain the rapid economic growth on the Mainland. China is in a unique situation in that there are two financial systems within the country, including a significant international financial centre in HKSAR. With the 11th FYP moving into implementation and the 10th anniversary of China's resumption of sovereignty over Hong Kong approaching, it is an opportune time to consider how HKSAR should fit into the next stage of economic and financial development of the country.

8.02 The Focus Group is of the view that the two financial systems in HKSAR and the Mainland should develop a complementary, cooperative and interactive working relationship, in which strengths are exploited and weaknesses addressed, and synergies maximised. To this end, Hong Kong's financial development strategy should look into how HKSAR can contribute to the financial reform and development on the Mainland, and how HKSAR should position itself as an international financial centre of the country.

8.03 The Focus Group notes the benefits of making use of the HKSAR financial system in satisfying financial intermediation needs on the Mainland, and in experimenting with financial reforms, such as capital account convertibility of RMB. In this regard, the Focus Group puts forward specific recommendations to be pursued under the five-pronged strategy developed by the HKMA, which includes: (i) enhance the presence of Hong Kong financial intermediaries on the Mainland to provide financial services on location; (ii) enhance the outward mobility of Mainland investors, fund raisers and financial intermediaries; (iii) allow financial instruments issued in Hong Kong, particularly those issued by Mainland fund raisers, to be marketed on the Mainland; (iv) enhance the capacity of the financial system of Hong Kong in handling financial transactions denominated in RMB; and (v) strengthen financial infrastructural linkages between the Mainland and Hong Kong.

8.04 The Focus Group also considers that it is in China's national interest to develop HKSAR into an international financial centre of global significance, one that is comparable to New York and London in terms of scale and scope of financial services and instruments offered.

The Focus Group sees an urgent need to seize the opportunity offered by the increasing scale of Mainland's international financial activities generated by the growing size of the economy, and the process of capital account liberalisation and RMB gradually attaining full convertibility. In view of the increasing competition among international financial centres, proactive policies are required to facilitate the use of Hong Kong for conducting Mainland's increasing international financial activities. The Focus Group also notes that the development of Hong Kong as an international financial centre and that of the financial centres on the Mainland are not mutually exclusive. Rather, the relationship between HKSAR and other financial centres on the Mainland should also be a complementary, cooperative and interactive one.

8.05 In pursuit of the objective to develop Hong Kong as an international financial centre of global significance and to better serve the Mainland's financial intermediation needs, the Focus Group attaches importance to the further development of the financial markets in Hong Kong, including the securities market, foreign exchange and commodities futures trading, insurance, reinsurance and asset management sectors. The Focus Group offers recommendations on strategies and initiatives to advance the development of these markets through enhancing the supply and demand, raising the scale and broadening the scope of financial services and instruments, facilitating price discovery and further improving the market infrastructure.

8.06 A near-term and medium-long term action plan has been proposed, based on the specific recommendations put forth in this report. In many cases, these measures involve policy initiatives and liberalisation of restrictions on the Mainland, particularly in relation to capital account control and RMB convertibility. The reform process will be prudently managed to limit risks and safeguard financial stability on the Mainland. Thus, the Focus Group suggests that the HKSAR regulatory entities should work closely with the relevant Mainland authorities in designing an implementation plan. A careful assessment of the benefits and risks for the Mainland and feasibility of these measures should be carried out, and priority should be given to those that help resolve pressing issues on the Mainland or that are easier to implement at this stage.

Proposed Action Agenda

8.07 The proposed action agenda of the Focus Group on Financial Services is at Appendix 8-1.