For Focus Group Discussion - Financial Services

Paper Ref.: 2006ES/5

Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong"

Consolidating Hong Kong's Position as an International Financial Centre

(Translation)

Purpose

Expediting financial reform on the Mainland and maintaining the status of Hong Kong as an international financial centre are two stated policy directions in the 11th Five-Year Plan. This paper discusses the financial development strategy for Hong Kong in response to the 11th Five-Year Plan, considering the associated challenges and opportunities. It analyses the issues from the government and regulators' perspective, with a view to initiating discussions while a practical "action agenda" will be formulated in the next few months.

(I) Stock Market

Background

2. Hong Kong is recognised as an important international financial centre with an active securities industry. With a total market capitalisation of HK$10,114.1 billion in end July 2006, Hong Kong's securities market ranked eighth in the world and second in Asia. In terms of equity funds raised, it ranked fifth in the world and first in Asia. Hong Kong's stock market has all along been the premier capital formation centre for the Mainland. Following the first listing of a H share company in 1993, there are 350 Mainland enterprises listed on our stock exchange, raising a total of

HK$1,245.8 billion.

<u>Opportunities and Challenges</u>

3. Many quality Mainland enterprises and banks are now listed in Hong Kong. Looking ahead, apart from continuing our efforts to encourage quality Mainland enterprises to list in Hong Kong, we may consider broadening the source of corporations seeking to use Hong Kong as a platform for listing, with a view to attracting listings of quality overseas companies. The existing Listing Rules of the Stock Exchange of Hong Kong Ltd (SEHK) expressly set out the listing requirements for companies incorporated in Hong Kong, the Mainland, Bermuda and the Cayman Islands. But the Listing Rules do not specify the listing requirements applicable to companies incorporated outside the four specified jurisdictions, and hence such listing applications can only be processed on a case-by-case basis. Due to the regulatory uncertainties, some overseas companies might not be keen to apply to the SEHK for listing. In this context, we have invited the Securities and Futures Commission and the Hong Kong Exchanges and Clearing Limited to work together in exploring ways to facilitate the listing of overseas companies in Hong Kong, with a view to strengthening Hong Kong's position as an international financial centre. Panel members are invited to provide comments on the above recommendation and other suggestions that are worth pursuing.

(II) Asset Management Industry

<u>Background</u>

4. Hong Kong is one of the most important international asset management centres. Both the depth and breadth of the investment funds managed in Hong Kong have increased notably in recent years. In 2005, the combined fund management business in Hong Kong amounted to $4,526 billion, which was 33% ahead of Singapore, and has also represented a growth of 25% compared with 2004. As of end-July 2006, 82 fund management companies were approved to manage more than 1,950 authorized unit trusts and mutual funds. To further enhance the competitiveness of our fund management industry, the Government has abolished estate duty and exempted offshore funds from profits tax in the past year. These can help attract foreign funds and encourage existing funds to stay in Hong Kong.

5. There is currently a broad range of funds in Hong Kong, including bond funds, money market funds and exchange traded funds, etc. Hong Kong is also one of the very first jurisdictions in the world to allow the offering of hedge funds to the retail public. As at end-June 2006, there are more than 160 hedge funds in Hong Kong, operating total assets under management of more than HK$140 billion. Separately, we saw the takeoff of the Hong Kong Real Estate Investment Trust (REIT) market last year, which was followed by the launching of the first REIT with 100% of its portfolio in Mainland properties. These have allowed the Hong Kong REIT market to offer investors a wide choice of properties.

Opportunities and Challenges

6. The Central authorities announced in April this year measures to allow investment in overseas financial markets through qualified institutional investors. Under the new measures, the huge savings in the Mainland will become a growth driver for Hong Kong's asset management industry. To capitalise on the new opportunities, we may consider introducing new financial products to cater for the needs of Mainland investors. The products may include Mainland equity-based derivatives as well as international products such as financial products like ETFs and REITs. This will help attract Mainland funds to invest in Hong Kong markets. We propose conducting a study on ways to further develop Hong Kong into a regional asset management centre, including measures to encourage product development. Panel members are invited to provide comments on the above recommendation and other suggestions that are worth pursuing.

(III) Commodity Futures Market

Background

7. There is no commodity futures market in Hong Kong. In terms of the total trading volume in 2005, the New York Mercantile Exchange (300 million contracts) was World's largest commodity futures market in the world. The Dalian Commodity Exchange (99 million contracts) ranked second. In the Mainland, the Dalian Commodity Exchange ranked first followed by the Shanghai Futures Exchange (33 million contracts) and the Zhengzhou Commodity Exchange (28 million contracts).

8. Between 1977 and 1980, the then Hong Kong Commodities Exchange Ltd. (restructured as Hong Kong Futures Exchange Ltd. in 1985) offered four commodity futures contracts involving cotton, sugar, soyabean and gold. However, due to lack of demand from local and international participants, all the contracts were subsequently suspended from trading one after another from 1981 to 1999.

Opportunities and Challenges

9. The 11th Five-Year Plan (Section 2 in Chapter 33) mentioned the gradual development of the commodities futures market. Hong Kong may examine whether and how the commodity futures market would be developed with a view to serving the country by performing the risk transfer function of a commodities future market, and enhancing the function performed by, and product development in, the Hong Kong financial markets.

10. At present, there are three commodity futures exchanges in the Mainland, namely the Shanghai Futures Exchange, Dalian Commodity Exchange and Zhengzhou Commodity Exchange. The Mainland government has also announced its plan to launch a new financial futures market in Shanghai. Because of capital account control and other regulatory and market constraints, the Mainland commodity futures exchanges are segregated from the international markets. As such the current market structure is not the ideal way to enable the commodity futures markets to perform their price discovery and risk transfer functions for the economy.

11. To develop a commodity futures market, the availability of a competitive and efficient commodities futures market being able to connect various international liquidity pools in the Asian time zones would be critical. Compared with other well established commodity futures exchanges in Chicago (Chicago Mercantile Exchange, Chicago Board of Trade), New York (New York Mercantile Exchange) and London (London Metals Exchange), Hong Kong does face a number of market structural and business challenges if we wish to develop a world-class commodity futures exchange –

- the demand for commodities;
- the availability of talents and experts who have good knowledge

about the global commodity market and are familiar with the operation of a commodity futures exchange;

- competition from other commodity futures exchanges;
- willingness of market operators to devote resources to the development of the commodity futures market; and
- the prospect of the global commodity market.

12. We suggest that the Securities and Futures Commission be invited to study the issues mentioned above. The Government might also examine measures that are necessary for the development of the market. Panel members are invited to provide comments on the above proposals and other suggestions that are worth pursuing.

(IV) Foreign Exchange Futures Contracts

Background

13. Currently, there is no exchange-traded foreign exchange futures in Hong Kong. In terms of the total trading volume of financial futures and options contracts (including stocks, stock index, interest rate, foreign exchange futures and options), Hong Kong ranks 24th in the world with a trading volume of 25.5 million contracts. The Korea Exchange ranked first and the number of contracts traded is 2.6 billion. At present, foreign exchange futures or other financial futures or options are not traded in the Mainland, though it is expected that a financial futures exchange will soon commence operation in Shanghai which will first launch stock index futures contracts.

14. From 1995 to 2002, the Hong Kong Futures Exchange (HKFE) offered the trading of exchange traded foreign currency futures contracts to the market. A number of commercial banks were appointed by HKFE to act as market markers to provide bid/ask quotations for the Rolling Forex contracts. However, trading interests in Rolling Forex contracts diminished. In the end, HKFE delisted all the Rolling Forex contracts in May 2002.

15. With the support of the Central Government, starting from January 2004, banks in Hong Kong have been allowed to launch Renminbi banking business, including deposit taking, currency exchange, remittance, debit and credit cards. To cater for the expanded Renminbi business, the Hong Kong Monetary Authority (HKMA) launched a new Renminbi

Settlement System on 6 March 2006. The system lays a foundation for the future development of a fully-fledged Renminbi payment system that would put Hong Kong in a competitive position in relation to other financial centres.

16. Besides the spot RMB market described above, there are also offshore non-deliverable Renminbi forward market in Hong Kong, Singapore and Japan. Non-deliverable Forwards (NDF) are foreign exchange derivative products traded over the counter. According to market estimation, in September 2005, Singapore accounted for 80% of the RMB NDF turnover with 15% in Tokyo and 5% in Hong Kong. In July 2006, 17 banks in Hong Kong are offering retail RMB NDF contracts to their customers.

Opportunities and Challenges

17. The 11th Five-Year Plan (Section 3 in Chapter 33) mentioned the goal of gradually achieving full convertibility of the capital account. Hong Kong may examine whether and how to develop exchange-traded foreign currency futures contracts. In the long run, this will not only facilitate the Mainland in managing risks associated with the exchange rate, but also broaden the products and functions of the Hong Kong financial markets.

18. The continued strong growth of the Mainland economy, the move towards a more market-based exchange rate regime, the further opening up of the capital account and the increasing integration between the Mainland financial market and the external world have provided Hong Kong with favourable market environment and condition. Notwithstanding the delisting of the Rolling Forex contracts by HKFE in May 2002, HKFE has gained valuable experience in launching currency futures contracts. It had gone through the process to establish the relevant rules, procedures and systems which are essential for the operation of a currency futures market. We suggest conducting a study in this subject. Panel members are invited to provide comments on the above recommendation and other suggestions that are worth pursuing.

(V) Insurance Industry

Background

19. Hong Kong is one of the most open insurance markets in the world. As at end June 2006, there were 175 authorised insurers, 88 of which were incorporated in Hong Kong while the remaining were incorporated on the Mainland and in 20 overseas jurisdictions. There are a total of about 50,000 insurance agents and brokers in Hong Kong. In the past decade, our insurance business has achieved double-digit annual growth. In 2005, the total gross premiums of the insurance industry reached HK$141 billon ($24 billion for general insurance and $117 billion for life insurance), an increase of about 16% from 2004. As one of the founding members of the International Association of Insurance Supervisors (IAIS), Hong Kong is committed to abiding by the regulatory principles and standards promulgated by the Association. This will help ensure that our regulatory standards are on a par with international standards. In Hong Kong, our regulation relating to corporate governance, market transparency, margin of solvency, etc., is on a par with international standards. In supervising the insurance industry, the Insurance Authority also adheres to the free market principle, and endeavour to promote an open, stable and transparent insurance market.

Opportunities and Challenges

20. Panel members are invited to provide comments on the following recommendations and other suggestions that are worth pursuing.

Access to the Mainland Market

21. Under the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA), Hong Kong insurance companies can gain access to the Mainland insurance market through the formation of groups or strategic mergers. Some insurance companies which intend to enter the Mainland market through this channel have already obtained the Certificate of Hong Kong Service Supplier. Besides, the maximum allowed equity participation by Hong Kong insurers has been raised to 24.9%. These arrangements help our insurance companies enter the Mainland market and enhance the growth potential of the insurance industry.

Exchange of Talent

22. For exchanges in the insurance sector, exchange visits between Hong Kong and the Mainland are held from time to time to discuss the latest development. We will continue to foster mutual exchanges between the insurance practitioners of the two places. Also, we will explore the possibility of accelerating the opening of the insurance intermediary services to Hong Kong under the framework of CEPA, for it will encourage insurance institutions (for example professional insurance agents) and professionals familiar with the operation of the international insurance market to start their business in the Mainland.

23. On industry regulation, in addition to day-to-day contact at the working level, the regulatory bodies in Hong Kong regularly participate in joint meetings of the insurance regulators of Guangzhou, Hong Kong, Macao and Shenzhen to discuss issues of common interest. The coming Sixth Joint Meeting of the Insurance Regulators will be held in November in Hong Kong. Enhancing Mainland-Hong Kong exchanges on regulatory issues is conducive to strengthening insurance regulation, preventing insurance risks and increasing the efficiency of the insurance markets in both places.

Reinsurance Centre

24. As the development of reinsurance will help enhance the status of Hong Kong as a regional insurance centre, the Hong Kong Government has devoted much effort to encouraging international professional reinsurance companies to set up operations here. At present, a number of international reinsurance companies are operating in Hong Kong. Of the world’s top 20 reinsurance companies, most of them have branch offices in Hong Kong. These offices stand ready to provide reinsurance services and offer professional advice on risk management and related matters.

25. The rapid development of the Mainland insurance industry has generated much demand for reinsurance. As an international insurance and reinsurance market, Hong Kong is well positioned to meet such demand for reinsurance services, and to facilitate the development of the Mainland financial markets and their integration with the international markets.

26. Human resources is important for the development of regional reinsurance centres. Currently, the seven universities in Hong Kong offer various courses to develop expertise in such areas as insurance, actuarial science, risk management and financial planning. To further enhance the quality of insurance practitioners, the HKSAR Government supports the efforts by the Insurance Institute of Hong Kong in collaboration with various professional insurance bodies in developing local insurance qualifications that are internationally recognised. The HKSAR Government also encourages insurance companies to organise training courses and on-the-job training for professionals in the areas of insurance, risk management and actuarial science. Such courses may also be open to Mainland insurance practitioners, for this will not only help develop Hong Kong into a training centre in insurance business, but also enhance the exchange of insurance expertise between the two places.

Investment Funds

27. On 13 April this year, the People's Bank of China announced measures whereby the business of overseas securities investments by insurance institutions shall be broadened. Qualified insurance institutions shall be allowed to purchase foreign exchange for investing in overseas products with fixed proceeds and money market instruments. Although the details of the measures are yet to be released, we expect that our global and diversified financial markets will be able to attract the inflow of capital. Part of the funds may also make use of Hong Kong as the platform for global investment.

Issues for Discussion

28. Members are invited to comment on the following issues –

(i) Has the paper provided a thorough analysis on the competitiveness of Hong Kong as an international financial centre? Is there any other consideration?

(ii) Has the paper provided a thorough analysis on the challenges and opportunities for Hong Kong's financial services industry arising from the country's 11th Five-Year Plan? Is there any other consideration?

(iii) Are the recommendations proposed by the Government and the regulators relevant for consolidating and developing Hong

Kong's financial services industry? Are there any adjustments needed for any of the recommendations?

(iv) Are the recommendations proposed for consolidating and developing Hong Kong's financial services industry appropriate for further studies and consideration?

Financial Services and the Treasury Bureau
September 2006