



## Financial Services

Hong Kong is a major international financial centre, comprising an integrated network of institutions and markets which provide a wide range of products and services to local and international customers and investors. Hong Kong's financial markets are characterised by a high degree of liquidity and operate under effective and transparent regulations, which meet international standards.

The Government of the Hong Kong Special Administrative Region (HKSAR) abides by the principle of keeping intervention into the way in which the market operates to a minimum and has endeavoured to provide a favourable environment in which business operates. Its policy of low and simple taxation allows maximum room for business initiatives and innovation. There is a strong emphasis on the rule of law and fair market. There are no barriers of access to the market by foreign businesses and no restrictions on capital flows into and out of Hong Kong. There are also no exchange controls.

**The Financial Markets:** In the banking sector, at the end of September 2007, there were 142 licensed banks, 29 restricted licence banks and 30 deposit-taking companies in Hong Kong, together with 82 local representative offices of overseas banking institutions. These institutions come from 38 countries and include 68 out of the world's largest 100 banks. Together they operated a comprehensive network of about 1 330 local branches, excluding their principal place of business in Hong Kong. Banks in Hong Kong engage in a wide range of retail and wholesale banking business such as deposit-taking, trade financing, corporate finance, treasury activities, precious metal trading and securities broking.

Hong Kong has been ranked first in terms of economic freedom for 13 years (1995 – 2007), according to the Heritage Foundation. The external net assets held by banks and deposit-taking institutions reached HK\$2,299 billion (end of August 2007), making Hong Kong one of the largest banking centres in the world.

Hong Kong has a mature and active foreign exchange market, the development of which has been stimulated by the absence of exchange controls in Hong Kong and its favourable time zone location. Links with overseas centres enable foreign exchange dealing to continue 24 hours a day around the world. According to a triennial global survey conducted by the Bank for International Settlements in 2007, Hong Kong was the world's sixth largest foreign exchange market in terms of turnover.

The Hong Kong money market consists primarily of the interbank market. The money market is mostly utilised by institutions at the wholesale level. The Hong Kong Interbank Offer Rate (HIBOR) is determined by the supply of and demand for funds between market players, and therefore is one of the most important indicators of the price of short-term funds in Hong Kong. The daily turnover

in the Hong Kong interbank market averaged HK\$396 billion in July 2007.

Hong Kong's stock market was the seventh largest in the world and the third largest in Asia in terms of market capitalisation as at the end of September 2007<sup>1</sup>. In terms of total equity funds raised in 2006, Hong Kong ranked fourth in the world and first in Asia. A wide variety of products are traded in the stock market, ranging from ordinary shares to options, warrants, Callable Bull Bear Contracts (CBBCs), Real Estate Investment Trusts (REITs), units trusts and debt securities. As at the end of September 2007, 1 210 companies were listed in the Stock Exchange of Hong Kong (SEHK), with a market capitalisation of HK\$20,055 billion. Among them, 388 were Mainland enterprises which have together raised more than HK\$1,687 billion. Trading on the SEHK is executed through the Automatic Order Matching and Execution System. The third generation of the system, namely AMS/3, is in full implementation. The system provides a trading infrastructure that connects investors, brokers and the exchange, enhancing market efficiency and facilitating online trading in the stock market.

For the derivatives market, as at the end of September 2007, four types of futures product and two types of options product were traded on the Hong Kong Futures Exchange (HKFE) and the Stock Exchange of Hong Kong (SEHK), including index futures, stock futures, interest rate futures, bond futures, index options and stock options. With the growing presence of Mainland enterprises in Hong Kong stock market, H-shares index futures and options were launched in December 2003 and June 2004 respectively. In addition, futures and options on the FTSE/Xinhua China 25 Index and futures on H-financials Index were launched in May 2005, and April 2007 respectively. The derivatives market has become fully electronic with the migration of the trading of Hang Seng Index Futures and Options to the Hong Kong Futures Automated Trading System in June 2000.

The transactions on the two exchanges are cleared and settled through their three associated clearing houses, namely, the Hong Kong Securities Clearing Company (HKSCC), the Stock Exchange of Hong Kong Options Clearing House Company (SECH) and the Hong Kong Futures Exchange Clearing Corporation (HKCC). Clearing and settlement in the stock market are carried out by the HKSCC through the Central Clearing and Settlement System (CCASS). The Hong Kong Exchanges and Clearing Limited (HKEx), the holding company of the two exchanges and the three clearing houses, completed the introduction of CCASS/3, a new generation of CCASS in mid 2003. The open architecture of CCASS/3 enables connectivity with

<sup>1</sup> Ranking is based on the market capitalisation of each member stock exchange of World Federation of Exchanges.

market participants. For the derivative markets, HKEx launched the new Derivative Clearing and Settlement System (DCASS) in early 2004 to replace the two legacy clearing systems used by SEOC and HKCC. DCASS allows Futures Exchange and Stock Options Exchange Participants to clear and settle their transactions in the futures and options markets through one single front-end.

Apart from the stock market and the futures market, there is also an active over-the-counter market which is mainly operated and used by professional institutions and trades swaps, forwards and options in relation to equities, interest rates and currencies.

Hong Kong's debt market has developed into one of the most liquid markets in the region. The Central MoneyMarkets Unit (CMU) Service, established in 1990, is operated by the HKMA to provide a clearing and custodian system for Exchange Fund Bills and Notes (EFBNs) and other private debt securities. The EFBNs had an outstanding amount of about HK\$135.6 billion at the end of September 2007, when daily turnover in these papers averaged HK\$48.4 billion. For Hong Kong dollar debt securities other than the EFBNs, a total of HK\$137 billion debt issues were launched in the first half of 2007.

The Chinese Gold and Silver Exchange Society has provided a platform for gold trading in Hong Kong since the early 20<sup>th</sup> Century. Turnover of 99 tael gold on the society totalled 3.2 million taels in 2006.

Hong Kong is one of the most open insurance centres in the world. In September 2007, there were 181 authorised insurers, 90 of which were incorporated in Hong Kong and the remaining 91 were incorporated in 23 countries, with the US and UK taking the lead. In recent years, Hong Kong's insurance market has shown considerable growth. The gross premium for 2006 was about HK\$156 billion.

Hong Kong has established its position as one of the largest asset management centres in Asia. Hong Kong's combined fund management business amounted to some HK\$6,154 billion as at the end of 2006, representing a growth of 36% over 2005 and an accumulated growth of 70.1% over 2004. Hong Kong is also the regional centre for portfolio management activity, including Hong Kong authorised unit trusts and mutual funds and, on a larger scale, institutional fund management. At the end of September 2007, there were 2,014 authorised unit trusts and mutual funds in Hong Kong. The net asset value of these authorised unit trusts and mutual funds as at the end of 2006 totalled around HK\$7,100 billion.

The introduction of the Mandatory Provident Fund (MPF) System in December 2000 has generated significant amounts of retirement assets, adding impetus to the further development of the financial markets. MPF is a long-term investment. Hence, apart from creating new and additional demands for investment products, MPF also contributes to greater stability in the financial markets. By August 2007, accrued assets of MPF schemes reached HK\$240.23 billion (US\$31 billion).

**Regulation of Financial Markets:** In line with the international trend, Hong Kong's financial services regulatory system has evolved and developed over the years. The principal regulators are the Hong Kong Monetary Authority (HKMA), the Securities and Futures Commission (SFC), the Office of the Commissioner of Insurance (OCI) and the Mandatory Provident Fund Schemes Authority (MPFA). They are responsible respectively for regulation of the banking; securities and futures; insurance and retirement scheme industries.

The HKMA was established in 1993, by merging the Office of the Exchange Fund with the Office of the Commissioner of Banking. This was done primarily to ensure that the central banking functions of maintaining monetary and banking stability can be performed with a high degree of professionalism and continuity, in a manner

that commands the confidence of the people of Hong Kong and the international financial community. Besides banking supervision, other functions and objectives of the HKMA include the maintenance of currency stability and promotion of the efficiency, integrity and development of the financial system. These functions and objectives are generally consistent with those of central banks around the world.

The Government is not involved in the day-to-day regulation of the securities and futures industry. The SFC, established in 1989, is an autonomous statutory body responsible for administering the laws governing the securities and futures markets in Hong Kong and facilitating and encouraging the development of these markets. It seeks to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry and to provide protection for investors. Within the regulatory framework, the SFC has regulatory oversight of the HKEx and its subsidiaries, namely the SEHK, the HKFE and three recognised clearing houses. The Government may act as a facilitator and co-ordinator of market reforms pursued by the SFC and the HKEx where necessary.

The Securities and Futures (Amendment) Ordinance 2006, which provides for the separation of the role of the Chairman from that of the executive arm of the SFC and to create a Chief Executive Officer (CEO) post, has commenced operation on June 23, 2006. Under the new structure, the Chairman leads the SFC Board in setting the overall direction, policies and strategies of the Commission and monitoring the performance of the executive arm in fulfilling the objectives, policies and strategies set by the board; while the CEO has the executive responsibility for the day-to-day running of SFC. This model is in line with best governance practices both locally and internationally.

Established as an office within the Government structure, the OCI administers the legislation governing the operation of insurance companies and insurance intermediaries in Hong Kong. The Commissioner of Insurance, who is appointed the Insurance Authority (IA), exercises prudential supervision of the insurance industry with a view to protecting the interests of policy holders. Self-regulatory measures to strengthen professional discipline in the insurance market are also formulated by the insurance industry, in consultation with the IA. Under the Insurance Intermediaries Quality Assurance Scheme initiated by the IA, insurance intermediaries are now required to pass a qualifying examination before they can practise. Commencing 2002, insurance intermediaries are further required to attend continuing professional development programmes as a condition for renewal of their registration or authorisation.

The MPFA was established in September 1998 as an autonomous, statutory body to regulate, supervise and monitor the operation of the MPF System.

**Banking:** Hong Kong maintains a three-tier system of deposit-taking institutions, namely, licensed banks, restricted licence banks and deposit-taking companies. They are collectively known as authorised institutions (AIs) under the Banking Ordinance. AIs may operate in Hong Kong as either locally incorporated companies or branches of foreign banks.

Only licensed banks may operate current accounts, and accept deposits of any size and maturity. Restricted licence banks are principally engaged in merchant banking and capital market activities. They may take deposits of any maturity of HK\$500,000 and above. Deposit-taking companies are mostly owned by or, otherwise associated with, licensed banks and engage in a range of activities, in particular consumer finance. These companies are restricted to taking deposits of HK\$100,000 or above with an original term to maturity of at least three months. Depositors in Hong Kong are protected by the Deposit Protection Scheme. Under the scheme, each depositor is

entitled to compensation up to a maximum of HK\$100,000 in the event of a bank failure.

The three-tier structure enables soundly based institutions which do not qualify for a full banking licence to apply for a restricted banking licence or a deposit-taking company registration so as to enter the local deposit-taking market or to conduct wholesale and investment banking business. The authorisation criteria for licensed banks, restricted licence banks and deposit-taking companies seek to ensure that only fit and proper institutions are entrusted with public deposits. The licensing criteria are subject to periodic reviews to ensure that they reflect the changing needs of the regulatory environment and are consistent with evolving international standards.

Als have to comply with the provisions of the Banking Ordinance which, *inter alia*, require them to maintain adequate liquidity and capital adequacy ratios; to submit periodic statistical returns to the HKMA; to adhere to limitations on loans to any one customer or to directors and employees; and to seek the HKMA's approval for the appointment of directors, chief executives (including their alternatives) and for changes in control. Overseas banks which operate in branch form are not required to hold capital in Hong Kong. They are also not subject to capital ratio requirements or to capital-based limits in large exposures under the Banking Ordinance.

The legal framework for banking supervision in Hong Kong is in line with international standards including the Basel Committee's *Core Principles for Effective Banking Supervision* published in September 1997. The supervisory process follows a risk-based approach which puts emphasis on the evaluation of the quality of Als internal risk management systems in respect of current and emerging risks they face. The objective is to devise a prudential supervisory system to help preserve the general stability and effective operation of the banking system, but which at the same time provides sufficient flexibility for Als to take commercial decisions.

**Securities and Futures:** The HKSAR Government's policy towards the securities industry is to provide a favourable environment in the industry and a level playing field for market participants, with adequate regulation to ensure as far as possible, sound business standards and confidence in the institutional framework, but without unnecessary impediments of a bureaucratic or fiscal nature.

The advances in technology and globalisation of the financial markets have also intensified the competition between the markets. To strengthen the competitiveness of Hong Kong as an international financial centre, the Financial Secretary announced in his Budget Speech in March 1999 a three-pronged reform for the securities and futures market. The reform includes enhancing the infrastructure for the market; modernising the market structure through the demutualisation and merger of the two exchanges and their three associated clearing houses, and modernising and rationalising the legal framework for the regulatory regime.

For the market structure reform, the merger of the two exchanges and three clearing houses was completed on March 6, 2000 following the enactment of the enabling legislation, viz the Exchanges and Clearing Houses (Merger) Ordinance, on February 24, 2000. The HKEx as the merged entity became a listed company on its own stock market on June 27, 2000. The merger seeks to create a new market structure to achieve higher efficiency, cost reduction, better risk management and to facilitate development of new products and services, thereby improving the competitiveness of the market. While the HKEx is a commercial entity, it is vested with the important public functions of maintaining a fair and orderly market and managing its risks prudently. Checks and balances are in place under the law to ensure that it would balance its public and commercial objectives in developing its business.

As regards regulatory reform, the Securities and Futures Ordinance commenced operation on April 1, 2003. The Ordinance consolidated and modernised 10 existing ordinances into a composite piece of legislation governing the securities and futures markets to keep the regulatory regime on a par with international standards and practices. The opportunity was also taken to add new regulatory elements which include introduction of a single licence for market intermediaries to streamline regulatory arrangements and reduce compliance burden; introduction of new licensing requirements to enhance the quality of intermediary services; establishment of a civil Market Misconduct Tribunal and expansion of the existing criminal route to combat market misconduct; modernising the regime for disclosure of securities interests to enhance market transparency; and instituting a flexible framework for the regulation of automated trading services to facilitate market innovation. The Ordinance provides a more transparent and coherent regulatory regime and strikes a reasonable balance between protecting investors and promoting market development. It has enhanced Hong Kong's position as a major international financial centre and the premier capital formation centre for the Mainland of China.

**Insurance:** The Insurance Companies Ordinance provides for the authorisation and prudential supervision, by the IA, of all insurers carrying on insurance business in, or from, Hong Kong. It is the Government's policy to admit new insurers who are well established, financially sound and well managed. All insurers seeking authorisation from the IA are subject to the same authorisation criteria and all authorised insurers are subject to the same prudential supervision, regardless of their place of incorporation.

**MPF System:** In August 1995, Hong Kong took a major step in enacting the Mandatory Provident Fund Schemes Ordinance, which provides the framework for the establishment of a privately managed, mandatory provident fund system. The ordinance was amended in March 1998 and supplemented by subsidiary regulations enacted in April 1998 and May 1999 respectively, setting out the detailed rules governing the operation of the MPF System and exemption of members covered by certain occupational retirement schemes.

As contributions are mandatory, the Government has built into the MPF System a multiplicity of measures to ensure that MPF assets are safe and secure. The measures include stringent criteria for the approval of MPF trustees; prudential supervision to ensure compliance with standards and regulations; smooth and transparent operation of schemes; as well as a compensation fund mechanism to make good losses caused by illegal conduct. The MPF System has been implemented since December 2000. As at the end of September 2007, about 99.4 per cent of employers, 98.3 per cent of the relevant employees and 76 per cent of the self-employed persons have participated in MPF schemes. The MPF legislation has been under continual review to enhance the effectiveness and efficiency of the MPF System. A number of amendments to the legislation related to operational and technical issues have been enacted in 2002. Another batch of amendments related to investment regulation was enacted in 2006. A further batch of amendments covering scheme administration and enforcement issues is being considered by the Legislative Council. Further proposed amendments on enforcement issues are being prepared for submission to the Legislature.

In June 2004, the MPFA issued a Code on Disclosure for MPF Investment Funds to improve the disclosure of information on fees and charges and performance of MPF funds. The objective is to enhance transparency and to enable scheme members to make informed and effective investment decisions. The transparency of MPF products was further enhanced with the introduction of an MPF Fee Comparative Platform to facilitate comparison of fees and charges of MPF funds. The first phase of the Platform was

launched in July 2007. The MPFA also published a set of Compliance Standards in July 2005 to assist approved MPF trustees in establishing a rigorous framework for monitoring their compliance with statutory duties and responsibilities.

**Money Market:** Hong Kong has a sizeable and active interbank market where wholesale Hong Kong dollar funds are transacted among banking institutions. The Hong Kong interbank bid and offer rates are important indicators of the liquidity situation in the financial system and are central to the pricing of Hong Kong dollar credits.

Interbank funds have always been a major source of Hong Kong dollar funding for the banking system, particularly for those banks (mostly foreign incorporated institutions) not operating extensive retail networks. The interbank market is also the venue for those banks with a large customer deposit base to invest in short term loans

**Monetary Policy:** The monetary policy objective of Hong Kong is to maintain currency stability, defined as a stable external exchange value of the currency of Hong Kong, in terms of its exchange rate in the foreign exchange market against the US dollar, at around HK\$7.80 to US\$1. This is adopted having regard to Hong Kong being a highly externally-oriented economy. Stability of the external value of the currency has special significance to Hong Kong, both in terms of the nature of the businesses carried out in the territory and in terms of general confidence.

The Linked Exchange Rate System in Hong Kong was established in October 1983. It is characterised by Currency Board arrangements, requiring the Hong Kong dollar monetary base to be at least 100 per cent backed by, and changes in it to be 100 per cent matched by corresponding changes in, US dollar reserves held in the Exchange Fund at the fixed exchange rate of HK\$7.80 to US\$1. The monetary base includes banknotes and coins issued, the sum of the clearing accounts of licensed banks maintained with the HKMA – the Aggregate Balance – and the outstanding Exchange Fund paper. The Hong Kong dollar banknotes and coins are fully backed by, and their changes fully matched with corresponding changes in US dollars held by the Exchange Fund. Since September 1998, the HKMA has provided a clear undertaking to licensed banks to convert Hong Kong dollars in their clearing accounts into US dollars. On May 18, 2005 the HKMA introduced a strong-side Convertibility Undertaking to buy US dollars from licensed banks at 7.75, and announced the shifting of the existing weak-side Convertibility Undertaking from 7.80 to 7.85, so as to achieve symmetry around the Linked Rate of 7.80. Within the Convertibility Zone defined by the levels of the Convertibility Undertakings, the HKMA may choose to conduct market operations consistent with Currency Board principles with the aim of promoting the smooth functioning of the money and foreign exchange markets.

**Development of the Debt Market:** Over the past decade, a number of measures have been taken to promote the development of the local debt market, including the issuance of EFBN, and the establishment of the Central Moneymarkets Unit (CMU). The Exchange Fund paper programme has encouraged the growth of the debt market by supplying high quality Hong Kong dollar debt paper and providing a benchmark yield curve for Hong Kong dollar debt. The establishment of the CMU provides an efficient clearing and settlement system for Hong Kong dollar as well as non-Hong Kong dollar denominated bonds, while the linkages with other overseas clearing systems facilitate cross border investment in debt instruments. Other initiatives include allowing the use of Exchange Fund paper as margin collateral for trading futures, index options and stock options. The listing of Exchange Fund Notes on

the SEHK since August 1999, broadens the investor base to include retail investors. This paves the way for the listing of debt securities issued by other corporations such as the Hong Kong Mortgage Corporation (HKMC), which has listed its Notes on the SEHK since October 1999.

In addition to the Hong Kong dollar real-time-gross-settlement (RTGS) System, the HKMA launched the US Dollar and Euro RTGS Systems in 2000 and 2003 respectively, which facilitates the efficient settlement of US dollar and euro denominated debt securities on a real-time basis within the Asian time zone. In 2007 the HKMA launched the Renminbi RTGS System to cater for clearing and settlement of the renminbi in Hong Kong.

The HKEx introduced the three-year Exchange Fund Notes futures contract in November 2001 so as to provide a risk management instrument for the debt market. To encourage bond listings, the HKEx reduced the listing fees for debt securities from July 1, 2002. Besides, the government put forward a number of measures to streamline the regulations and procedures in issuing and listing debt securities.

Continued efforts have been made to enhance the retail bond market, including lowering the minimum denomination requirement for eligible debt securities for tax concession purposes in 1999 from HK\$500,000 to HK\$50,000; educating the public about bond investment; reviewing the regulations relating to the public offering of debt securities; the issuance of bonds targeting at retail investors through the bank network by the HKMC since 2001; and the launch of retail Exchange Fund Notes. The implementation of the MPF System in December 2000 added impetus to the further growth of the debt market as well as fund management business.

The successful launch of two Government bond programmes in May and July 2004 has raised the awareness level and interest of the public in bonds and increased their investment choices. The overwhelming response from both retail and institutional investors have not only proved that Hong Kong possesses the expertise and infrastructure for large scale bond issuance, but also showed that there is a large potential demand for high quality bonds.

Efforts to improve the regime governing the public offering of debt and equity are ongoing. Following the publication in August 2005 by the SFC of a consultation paper on possible reforms to the prospectus regime in the Companies Ordinance, the SFC published the consultation conclusions in September 2006. Draft bill consultation paper(s) will be published to set out, and invite public comments on, the proposed draft amendments to the relevant provisions of the Companies Ordinance and the Securities and Futures Ordinance.

**Oversight of Clearing and Settlement Systems:** The Clearing and Settlement Systems Ordinance (CSSO) helps promote the general safety and efficiency of clearing and settlement systems that are material to the monetary or financial stability of Hong Kong or to the functioning of Hong Kong as an international financial centre. Under the CSSO, the Monetary Authority (MA) is empowered to designate and oversee such clearing and settlement systems. The Ordinance also provides statutory backing to the finality of settlement for transactions made through systems designated under the Ordinance by protecting the settlement finality from insolvency laws or any other laws. The Monetary Authority issues certificates of finality to designated systems meeting certain criteria specified in the Ordinance. The Central Moneymarkets Unit (CMU) and Hong Kong dollar Clearing House Automated Transfer System (CHATS), Continuous Linked Settlement (CLS) System, US dollar CHATS and Euro CHATS, have been designated and each was issued a certificate of finality.

