Chapter 4

Financial and Monetary Affairs

Hong Kong ranks highly as an international financial centre, reinforced by its well established and regulated banking, securities and insurance business. The stock exchange is the third largest in Asia and seventh largest in the world in terms of market capitalisation. With a workforce of 204 000, or 5.8 per cent of the total workforce, the financial sector contributes some 19.5 per cent of GDP.

Hong Kong is one of the most vibrant international financial centres in the world with a sophisticated financial infrastructure, world-class financial professionals, a sound regulatory regime on a par with international standards, and high liquidity and efficiency. The Government's policy is to further reinforce Hong Kong's position by making continuous improvements to the regulatory system, promoting corporate governance, strengthening investor protection, fostering market development and enhancing links and co-operation with the Mainland.

Hong Kong made a number of major achievements in 2008 including:

- continuing to be the world's 15th largest banking centre in terms of external assets and sixth largest centre for foreign exchange trading;
- its stock market being ranked seventh worldwide and third in Asia in terms of market capitalisation; fourth worldwide and second in Asia in terms of equity funds raised through initial public offerings; and fifth worldwide and second in Asia in terms of total equity funds raised;
- 716 companies are licensed or registered to conduct asset management business, 16 per cent up on 2007;
- total outstanding Hong Kong dollar debt securities (including the Exchange Fund Bills and Notes) exceeding $716 billion at year-end, compared with $764 billion a year earlier;
- total assets of Mandatory Provident Fund (MPF) schemes were $209 billion by year-end. About 99.8 per cent of employers, 98 per cent of relevant employees and 73.7 per cent of self-employed people have enrolled in MPF schemes;

- continuing to be one of the most open insurance markets in the world, achieving an annual growth in premium of 17.3 per cent for the last five years; and
- the market capitalisation of Real Estate Investment Trusts (REITs) was $46 billion by year-end.

Hong Kong as an International Financial Centre

Hong Kong as a leading international financial centre in the region and the premier capital formation centre for the Mainland is helped by a favourable geographical position, bridging the time gap between New York and London; strong links with the Mainland and other economies in Southeast Asia and excellent communications with the rest of the world; the rule of law; a level playing field for carrying out business and a sound regulatory regime. The absence of restrictions on capital flows into and out of Hong Kong is another important strength.

Hong Kong's financial markets are characterised by a high degree of liquidity. They operate under effective and transparent regulations, which are in line with international standards. A highly educated workforce and ease of entry for professionals from outside Hong Kong also contribute to the development of its financial markets.

International financial institutions maintain a strong presence in the city. Of the world's top 100 banks, 69 have operations in Hong Kong. At the end of 2008, 135 of the 145 licensed banks in Hong Kong were foreign-owned.

The interbank money market is well established. Wholesale deposits are traded actively among local authorised institutions, and between local and overseas institutions, with an average daily turnover of $362.9 billion in 2008.

Hong Kong also has a mature and active foreign exchange market, which is an integral part of the global market. The link with overseas centres enables foreign exchange dealings with the rest of the world 24 hours a day. The last triennial survey co-ordinated by the Bank for International Settlements in 2007 shows the daily average foreign exchange turnover in Hong Kong as US$174.6 billion. Hong Kong continues to be the world's sixth largest foreign exchange market.

With a total market capitalisation of about $10,299 billion at year-end, the Hong Kong stock market ranked seventh in the world and third in Asia. The daily turnover averaged $72.1 billion in 2008. At year-end, 1 261 public companies were listed on the Stock Exchange of Hong Kong (SEHK). The 31 newly listed companies on the Main Board raised $66.0 billion from initial public offerings (IPOs).

Hong Kong ranked fifth worldwide in terms of IPO funds raised. Besides new share issues, $337.7 billion were raised on the secondary market. The Real Estate Investment Trusts market continued to develop and the aggregate market capitalisation was $46 billion at year-end.

The Hong Kong stock market is an important fund-raising platform for Mainland enterprises. At year-end, there were 465 Mainland enterprises listed on the SEHK. In

2008, equity funds raised by Mainland enterprises[1] amounted to $287.0 billion, which was 71 per cent of the total equity funds raised through the SEHK during the year. About $47.7 billion were raised in new listings of Mainland enterprises in Hong Kong, accounting for 72 per cent of the total equity funds raised in IPOs on the SEHK. The market capitalisation of Mainland enterprises accounted for 60 per cent of the SEHK's total market capitalisation at year-end. In 2008, the total annual trading turnover of Mainland enterprises accounted for 71 per cent of the total annual equity turnover of the Hong Kong stock market. It is expected that Mainland issuers will continue to be major growth drivers of the stock market in the future.

Overseas intermediaries were increasingly interested in setting up business operations in Hong Kong. The number of Stock Exchange Participants[2] (SEPs) increased from 439 at the end of 2007 to 449 at the end of 2008. The futures market also saw an increase in the number of Futures Exchange Participants (FEPs), from 140 at the end of 2007 to 148 at the end of 2008. Among the SEPs and FEPs, 156 and 74 respectively were owned by non-Hong Kong interests. In 2008, 18 new SEPs were admitted, including 11 from various regions around the world; 14 new FEPs were admitted, of which 11 were from areas outside Hong Kong.

The Hong Kong asset management industry is characterised by its strong international flavour, in terms of the presence of both global fund managers and the different domiciles of authorised funds. At year-end, 716 companies were licensed or registered to carry out asset management business, representing an increase of 16 per cent from a year earlier. In addition to SFC-licensed corporations, banks and insurance companies also participate in asset management business.

Hong Kong operates one of the most active physical gold markets in the world. Spot gold can be traded through two closely related yet independent markets in the city — the Chinese Gold and Silver Exchange Society and the Loco-London gold market. The Society, established in 1910, provides trading of both tael bars and kilo bars[3]. Prices closely follow those in the other major gold markets in London, Zurich and New York.

Hong Kong continues to be one of the most open insurance centres in the world. Among the 175 authorised insurers at year-end, 85 were from 21 overseas countries or the Mainland. 15 of the world's top 20 insurers are authorised to conduct insurance business in Hong Kong either directly or through a group company. There are 21 professional reinsurers in Hong Kong, including most of the top reinsurers in the world. Gross premium income in 2007 was $197.3 billion.

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1 Mainland enterprises include H share companies, red-chip companies and non-H share Mainland private enterprises.

2 Corporations with the right to trade on or through the Stock Exchange and licensed under the Securities and Futures Ordinance to engage in such activity. Non-trading Stock Exchange Participants are not included.

3 Tael bars are of 99 per cent fineness and weighted in taels (one tael equals approximately 1.20337 troy ounces). Kilo bars are of 999.9 parts per thousand fineness and weighted in kilograms.

The Hong Kong Monetary Authority (HKMA) worked with relevant government bureaux to foster a better understanding of Hong Kong's economic and financial strengths among international credit rating agencies. Standard & Poor's and Rating and Investment Information Incorporation raised Hong Kong's sovereign credit rating from 'AA' to 'AA+' in 2008, which is the highest rating ever assigned to Hong Kong. The upgrade reflected international recognition of Hong Kong's strong economic fundamentals, as well as improved public finances and growth prospects.

Banking Sector

Main Features

Hong Kong maintains a three-tier system of deposit-taking institutions — licensed banks, restricted licence banks and deposit-taking companies. They are collectively known as authorised institutions (AIs) under the Banking Ordinance. The HKMA is the licensing authority for all three types of AIs.

Only licensed banks may conduct full banking services, including in particular the provision of current and savings accounts and acceptance of deposits of any size and maturity. Restricted licence banks may take deposits of any maturity of $500,000 or above. Deposit-taking companies may take deposits of $100,000 or above with an original maturity of at least three months. Many deposit-taking companies are owned by, or otherwise associated with, licensed banks.

Hong Kong has one of the highest concentrations of banking institutions in the world. At the end of 2008, there were 145 licensed banks, 27 restricted licence banks and 28 deposit-taking companies. These 200 AIs maintained an extensive network of more than 1 300 local branches. In addition, there were 71 representative offices of overseas banks in Hong Kong.

The total deposit liabilities of all AIs to customers and the total loans and advances extended by these institutions at the end of 2008 were $6 060 billion and $3 284 billion respectively. The total assets of all AIs amounted to $10 726 billion.

Hong Kong has a robust interbank payment system, which operates through the Real Time Gross Settlement (RTGS) system. All banks in Hong Kong maintain settlement accounts with the HKMA through the Hong Kong dollar RTGS system. All RTGS payment transactions are settled in real time across the books of the HKMA. Intraday liquidity can be obtained by the banks through the use of their Exchange Fund Bills and Notes (EFBNs) for intraday repurchase agreements with the HKMA.

The US dollar, Euro and Renminbi RTGS systems provide real-time settlement services for transactions in these currencies, thereby reducing or eliminating settlement risk. RTGS systems in Hong Kong are linked to provide settlement services for foreign exchange transactions on a payment-versus-payment (PvP) basis.

The HKMA operates the Central MoneyMarkets Unit (CMU) to provide clearing and custodian services for EFBNs and other Hong Kong dollar or foreign currency private debt securities. It is linked with a number of international and regional central securities depositories to enable overseas investors to trade CMU securities.

Through its integration with the RTGS systems in Hong Kong, the CMU enables securities to be settled on a delivery-versus-payment (DvP) basis, thereby enhancing settlement efficiency and eliminating settlement risk. The interface also enables automatic intraday repurchase agreements to provide intraday liquidity to participants in the RTGS systems.

The Clearing and Settlement Systems Ordinance empowers the Monetary Authority to designate and oversee 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. The CMU, the Hong Kong dollar Clearing House Automated Transfer System (CHATS), the US dollar CHATS, the Euro CHATS, the Renminbi CHATS and the Continuous Linked Settlement System have been designated under the Ordinance. Each system was issued a certificate of finality, which provides statutory backing to the finality of settlement for transactions made through the system. The HKMA found all designated systems to be continuously in compliance with the Ordinance.

Hong Kong Monetary Authority

The HKMA was established on April 1, 1993 after the Legislative Council passed amendments to the Exchange Fund Ordinance in 1992 empowering the Financial Secretary to appoint a Monetary Authority.

Its policy objectives are to maintain currency stability within the framework of the Linked Exchange Rate system through sound management of the Exchange Fund, monetary policy operations and other means deemed necessary; promote safety and stability of the banking system through the regulation of banking business, the business of taking deposits and the supervision of AIs and promote efficiency, integrity and development of the financial system, particularly payment and settlement arrangements.

The HKMA is an integral part of the Government, but can employ staff on terms that differ from those of the civil service to attract personnel of the appropriate experience and expertise. Its staff and operating costs are charged directly to the Exchange Fund instead of the general revenue. The HKMA is accountable to the Financial Secretary, who is advised by the Exchange Fund Advisory Committee (EFAC) on matters relating to the control of the Exchange Fund.

The authority seeks advice on policy matters routinely from the Banking Advisory Committee and the Deposit-taking Companies Advisory Committee. Both committees are established under the Banking Ordinance. They are chaired by the Financial Secretary and comprise members from the banking industry and other relevant professions.

The Banking Ordinance provides the legal framework for banking supervision in Hong Kong. Under the ordinance, the HKMA is the licensing authority responsible for granting and revoking the authorisation of all AIs, and the approval and revocation of money broker licences. The HKMA seeks to maintain a regulatory framework that is fully in line with international standards. The aim is to devise a prudential supervisory system to help preserve the general stability and effective operation of the banking system, while at the same time providing sufficient flexibility for AIs to make commercial decisions.

Hong Kong's framework of banking supervision is in line with the Core Principles for Effective Banking Supervision promulgated by the Basel Committee on Banking Supervision. The HKMA also participates in a number of international and regional initiatives and forums for banking supervisors.

Recent Developments

The HKMA has reinforced its supervisory efforts in monitoring the impact of the global financial turmoil on banks' asset quality, liquidity and profitability, particularly as the crisis intensified following the collapse of Lehman Brothers in mid-September 2008.

The HKMA deployed a significant amount of resources to handle investor complaints arising from the collapse of Lehman Brothers. As at the end of 2008, it had received nearly 20 000 complaints. It had opened investigations in more than 4 500 cases, including the referral of 238 cases to the Securities and Futures Commission (SFC) for the latter to decide whether to take further action.

During the year, the HKMA continued to assist the operations of the Hong Kong Deposit Protection Board, which launched the Deposit Protection Scheme in September 2006.

The Report of the Review of the HKMA's Work on Banking Stability was published by the HKMA on July 17, 2008, following which a three-month public consultation on the report was conducted. Policy response to the recommendations in the report will be published in 2009.

Details of the operation of the Banking Ordinance and the activities of the office of the HKMA during the year can be found in the chapter on Banking Stability in the HKMA's Annual Report.

Securities and Futures Sector

Main Features

The securities market in Hong Kong is operated by the SEHK and futures market, the Hong Kong Futures Exchange Limited (HKFE), both being wholly owned subsidiaries of the Hong Kong Exchanges and Clearing Limited (HKEx). At year-end, there were 449 exchange participants on the SEHK and 148 exchange participants on the HKFE.

By the end of 2008, there were 1 261 companies listed on the Main Board and the Growth Enterprises Market (GEM) of the SEHK with a total market capitalisation of about $10,299 billion, raising an aggregate of $403.7 billion within the year. The total turnover of the securities market amounted to $17,653 billion.

New products continued to be launched during the year. In July 2008, the SFC authorised the first exchange traded fund (ETF) which tracks the price of gold for listing on the SEHK. This new product offers investors a means of participating in the gold bullion market without having to take physical delivery of gold. During the year, seven new ETFs were authorised, increasing the total number of ETFs traded on the SEHK to 24, offering a wide range of investment exposures to world, regional and Mainland indices and commodities for investors.

The number of newly listed Callable Bull/Bear Contracts (CBBCs) leaped to 4 231 from 391 a year ago. As at the end of 2008, there were 1 314 CBBCs in the market, compared with 131 a year ago. Turnover of CBBCs surged from $71.4 billion in 2007 to $1,039.6 billion in 2008. A total of 3 011 derivative warrants were listed on the securities market at the end of 2008. Turnover of derivative warrants was $3,434 billion, which represented nearly 20 per cent of the total market turnover. Stock options turnover increased from 45 982 968 contracts in 2007 to 54 692 865 contracts in 2008.

In the futures market, a number of new records were set as a result of strong growth in trading volume and open interest. Over 105 million futures and options contracts were traded, representing a year-on-year increase of 19 per cent. The Hang Seng Index Futures and the H-shares Index Futures recorded a turnover of 21 716 508 contracts and 14 440 965 contracts respectively, rising 27 per cent and 33 per cent from 2007.

The Gold Futures was re-launched in October 2008 and recorded a total turnover of 3 075 contracts. It is expected that more new products, including carbon emission products, will be introduced in the coming year to further enrich the product base of the Hong Kong market.

The SEHK operates the Third Generation Automatic Order Matching and Execution System (AMS/3) for securities trading. AMS/3 provides an electronic platform for trading equities, derivative warrants, CBBCs, debt securities, unit trusts/ mutual funds and equity linked instruments. It also provides facilities and investor access channels that make securities trading more accessible.

The Hong Kong Securities Clearing Company Limited (HKSCC), a wholly owned subsidiary of HKEx, operates the latest generation of Central Clearing and Settlement System (CCASS/3) for clearing and settlement of securities transactions concluded at the SEHK. The CCASS/3 is a computerised book-entry system that operates on an open, secure and flexible modularised architecture. In addition to brokers and custodians, certain CCASS services are also available to retail investors. For example, investors may open Investor Participant Accounts with the clearing company to keep their securities in CCASS.

The HKFE operates the Hong Kong Futures Automated Trading System for the trading of futures and options contracts and the Derivatives Clearing and Settlement System (DCASS) for the clearing and settlement of such contracts. DCASS shares the same common database and system infrastructure as the trading system.

The HKEx upgraded the capacity and functionality of the above mentioned trading, clearing and settlement systems in 2008.

At year-end, there were 13 automated trading services providers, comprising mainly foreign exchanges and regulated entities, authorised by the SFC under section 95 of the Securities and Futures Ordinance (SFO) to provide automated trading services in Hong Kong. Automated trading services are services provided by means of electronic facilities, not being facilities provided by a recognised exchange company or a recognised clearing house, to transact or settle transactions in securities or futures contracts.

Securities and Futures Commission

The SFC was established in May 1989 following the enactment of the Securities and Futures Commission Ordinance, which was replaced by the SFO that came into effect on April 1, 2003. The regulatory objectives of the SFC, as set out in the SFO, are:

- to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
- to promote public understanding of the operation and functioning of the securities and futures industry;
- to provide protection for members of the public investing in or holding financial products;
- to minimise crime and misconduct in the securities and futures industry;
- to reduce systemic risks in the securities and futures industry; and
- to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

Established as an autonomous statutory body, the SFC is responsible for regulating the securities and futures markets in Hong Kong. At year-end, the SFC had a governing body of 14 directors (the Chairman, six executive directors and seven non-executive directors) appointed by the Chief Executive. The Government is not involved in the day-to-day regulation of the securities and futures industry.

The SFC is funded by the market. No government funding has been sought since 1993. The 2008-09 operating expenditure (including depreciation) is estimated to be $716.82 million.

The SFC seeks advice on policy matters from its advisory committee, which comprises the Chairman, Chief Executive Officer and two executive directors of the SFC and 12 independent members. The independent members are appointed by the Financial Secretary under the authority delegated by the Chief Executive and are broadly-based and representative of market users.

The exercise of powers by the SFC is subject to a range of checks and balances. For instance, a wide range of SFC decisions are subject to appeal. Appeals are made to the independent Securities and Futures Appeals Tribunal chaired by a Judge of the Court of First Instance of the High Court. The Process Review Panel for the SFC

(PRP) was established by the Chief Executive in November 2000 to review and advise the SFC on the adequacy of the internal procedures and operational guidelines governing the actions and operational decisions it takes in the performance of its regulatory functions.

PRP members are appointed by the Chief Executive. In September 2008, the Government published the PRP's seventh annual report, which concluded that the SFC had generally followed its internal procedures in handling cases under review.

Broadly speaking, the SFC's work involves licensing, supervision and monitoring of intermediaries; regulation of the public marketing of unit trusts, mutual funds and other collective investment products; regulation of takeovers, mergers and other corporate activities; listing regulation under the dual filing system for IPO applicants and issuers; supervision of markets including the exchanges and clearing houses; enforcement of securities laws and rules; and investor education.

As at year-end, there were 37 243 licensed persons, including securities brokerage firms, futures dealers and securities margin financiers, as well as their representatives, and 102 registered institutions, such as banks, engaging in regulated activities like dealing and advising on securities and futures.

Insider Dealing Tribunal and Market Misconduct Tribunal

The Insider Dealing Tribunal is an important feature of the regulatory framework for the securities market in Hong Kong. Established under the repealed Securities (Insider Dealing) Ordinance, the tribunal looked into cases involving suspected insider dealing referred to it by the Financial Secretary. By year-end, it had concluded a total of 25 cases since it commenced operation in 1994.

When the SFO came into force on April 1, 2003, the Insider Dealing Tribunal was replaced by the Market Misconduct Tribunal (MMT), which covers five other types of market misconduct (false trading; price rigging; disclosure of information about prohibited transactions; disclosure of false or misleading information inducing transactions; and stock market manipulation) in addition to insider dealing.

The MMT decides cases on the civil standard of proof and can impose a range of civil sanctions, such as ordering the disgorgement of profits, banning a person from trading in SFC-regulated financial products and disqualifying a person from directorship or management of a company.

The MMT inquires into market misconduct that occurred on or after April 1, 2003. The Insider Dealing Tribunal continues to exist to inquire into cases of insider dealing that occurred before April 1, 2003.

The MMT concluded its first case in August 2008 and is handling three cases.

As an alternative to civil proceedings, market misconduct is subject to criminal prosecution, which, if successful, may result in more severe penalties on conviction, including up to 10 years' imprisonment or a fine of up to $10 million.

Recent Developments

In May 2008, a Closing Auction Session (CAS) was introduced to the stock market after market and public consultation. The CAS aimed at facilitating trading at market close and determining securities closing prices using the same auction algorithm applied in the Pre-Opening Session. As part of the HKEx's plan to consult market participants on possible enhancements to the existing closing auction mechanism based on experience with the CAS, the HKEx conducted another public consultation in November inviting comments on the introduction of a price control mechanism during CAS.

In June, the SFC issued a paper on consultation conclusions in relation to a number of proposed amendments to the Codes on Takeovers and Mergers and Share Repurchases (Takeovers Codes) relating to privatisations and withdrawal of listing from the stock exchange, securities borrowing and lending activity by persons connected to an offer and dealings by connected discretionary fund managers and principal traders. The amendments became effective on August 1.

In July, the SFC signed a Declaration on Mutual Recognition of Cross-border Offering of Collective Investment Schemes with the Australian Securities and Investments Commission (ASIC). The Declaration provides the framework for the mutual recognition by the SFC and ASIC of schemes offered to retail investors and is a significant milestone towards strengthening regulatory ties and co-operation between Australia and Hong Kong.

Upon conclusion of a month-long public consultation, the SFC amended a set of guidelines to exempt open-ended collective investment schemes offered to the public and listed locally as corporations from disclosure of interests requirements under Part XV of the SFO. The exemption came into effect on October 31. Currently, most of the ETFs listed in Hong Kong are in trust form, which are not subject to the disclosure requirements. Like these trust-form ETFs, corporate-form ETFs are open-ended in nature. Both now enjoy the same disclosure treatment after the amendment.

Following the launch of a pilot scheme requiring a new listing applicant to post prior to its issue of a listing document a web proof information pack[4] (WPIP) on the HKEx or GEM website, the SFC and the HKEx reviewed the operation of the pilot scheme and identified no major defect. The SFC and HKEx would consider formally codifying the requirement in the Listing Rules.

In light of the volatile market condition in 2008, the SFC enhanced monitoring of the financial integrity of licensed corporations by carrying out intensive and focused risk assessments and required rectification actions where deficiencies in risk management were identified. Circulars were issued to the industry reminding them

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4 A WPIP is a near-final draft listing document with the omission of pricing and offer size information intended to address the apparent inequality of information dissemination between institutional and retail investors in an initial public offering.

to tighten their risk management amidst market volatility. The SFC also conducted a review of brokers' securities margin financing policies and practices jointly with an accounting firm in anticipation of a volatile market situation.

This thematic exercise complemented the SFC's regular inspection and on-going supervision over risk management practices of securities firms. In addition, the SFC launched an enhanced IT platform to enable secured submission of financial returns by licensed corporations through the Internet and the legislative amendments mandating such electronic submission went into effect on October 1.

On the other hand, the SFC continued to focus its enforcement resources on combating market misconduct and intermediaries who are dishonest or put clients at risk. By year-end, there were 16 outstanding investigations of listed companies. In relation to listed company investigations, the SFC obtained the second disqualification order against a former listed company director disallowing him to become a director or be involved in the management of any company for five years. The SFC also commenced similar proceedings against 10 current and former company directors in 2008. For the first time, the SFC would ask the court to make orders that the responsible directors pay compensation to the company for the losses caused by their breaches of duty.

The SFC prosecuted successfully an insider, which marked the first criminal conviction since insider dealing was made a criminal offence under the SFO. By year-end, the SFC had instituted criminal insider dealing proceedings in five cases. The SFC continued to make applications seeking urgent interim freezing orders over money and other property. These orders prevented assets and property held by or on behalf of persons suspected of being involved in insider dealing from being dissipated during the SFC's investigations.

During 2008, the SFC prosecuted successfully seven entities for market manipulation and providing false or misleading information in a company announcement, and summonses were issued to an additional eight entities but those cases were not concluded by year-end. Twenty-two cases were referred to the Police in 2008.

Investor education continues to be a priority of the SFC's work. The investor education theme in 2008 was 'Know Your Risk', which aimed at encouraging investors to understand different aspects of 'risk' in their investments, including market volatility, increasing complexity of products, scams and malpractices.

To get the educational message across to the community, the SFC made extensive use of various media, such as television and radio programmes, audio-visual programmes on buses and free newspapers. Its essay competition also received wide press coverage. A total of 10 winners were recognised for sharing their lessons, mostly learned the hard way.

The SFC also put fresh focus on using cyberspace to reach out to the public. In October, the InvestEd website was relaunched featuring easier navigation, more interactive elements, more useful links, e-learning programmes and animated video clips on the internet.

Outreach activities targeting different audiences continued. The SFC organised investor education seminars jointly with the Hong Kong Society of Financial Analysts and The Open University of Hong Kong respectively. These public seminars were taped for broadcast on television, and their summaries published in newspapers.

The SFC also collaborated with the Institute of Financial Planners of Hong Kong and the Education Bureau to offer courses for secondary school teachers, assisting them in teaching business, accounting and financial studies under the New Senior Secondary curriculum starting in the 2009-10 school year.

Moreover, talks for university and secondary school students were held. The response to these outreach activities was positive – almost 8 560 persons attended the 59 sessions held.

To better understand the behaviour of investors and address their needs, the SFC conducted a 'Retail Investor Survey' for the first time. One key finding showed that although retail investors were aware that investments involved risks, two-thirds of the respondents bought investment products despite knowing little about them.

A calendar card featuring five fundamental questions was distributed to the public in November as a prelude to an education theme to be launched in 2009 that advises people to ask questions before investing

Insurance Sector

Main Features

At year-end, there were 175 authorised insurers, 90 of which were incorporated in Hong Kong while the remaining 85 were incorporated on the Mainland and in 21 overseas countries, with the United States taking the lead.

The total gross premiums of the insurance industry reached $197.3 billion in 2007, representing 26.4 per cent growth over that in 2006. Gross premiums of the general insurance sector increased by 5.7 per cent to $24.3 billion in 2007. The increase was mainly driven by the strong momentum registered in accident and health insurance business.

Overall underwriting profit of general insurance business improved from a profit of $2.1 billion to $2.4 billion in 2007, attributable to better claims experience as well as release in claims reserves.

The long-term insurance business continued to attain double-digit annual growth from 1991 to 2007, with office premiums increased by 30 per cent to $173.0 billion in 2007. The individual life business remained dominant with the office premiums in force of $153.1 billion, accounting for 88.5 per cent of the total office premiums. The number of individual life policies in force grew by 8.5 per cent to 7.7 million in 2007.

At year-end, there were 33 697 insurance intermediaries, including 33 159 agents of whom 2 304 were agency firms and 538 brokers.

Insurance Authority

The Commissioner of Insurance, appointed by the Chief Executive as the Insurance Authority (IA), has the principal function under the Insurance Companies Ordinance (ICO) to regulate and supervise the insurance industry to promote its general stability and protect policy holders.

The ICO, which prescribes a regulatory framework for all classes of insurance business, has two main objectives of ensuring the financial stability of all insurers authorised in Hong Kong and the fitness and propriety of their management. These objectives are achieved through the prescription of, among other things, minimum share capital and solvency margin requirements, as well as the requirement for directors and controllers of insurers to be fit and proper persons.

A general business insurer is also required to maintain assets locally to meet the claims of Hong Kong policyholders. For life insurance business, an appointed actuary system is in place to ensure that the insurer is able to meet its obligations.

Supervision of insurers is carried out mainly through examination of the financial statements, actuarial reports and other returns submitted by insurers and regular on-site visits. The IA may take appropriate action under the ICO against an insurer to safeguard the interests of policyholders.

These measures include limitation of premium income, placing of assets in the IA's custody, assumption of control by a manager appointed by the IA or petitioning for winding-up of the insurer. There are also measures in place to strengthen market discipline for the insurance industry, such as the adoption of a Code of Conduct for Insurers governing the writing of insurance contracts and insurance benefit illustration standards for life insurance policies, which was formulated by the insurance industry in consultation with the IA.

Insurance intermediaries have been subject to regulation under the ICO since 1995. An insurance agent must be properly appointed by an insurer, who is required to comply with the Code of Practice for the Administration of Insurance Agents in appointing and controlling its agents. Moreover, an insurance broker must meet certain minimum requirements to become eligible for authorisation.

As a member of the International Association of Insurance Supervisors, Hong Kong makes its best efforts to ensure that its supervisory regime is in line with prevailing principles and standards. It has also established an Insurance Advisory Committee, as provided for in the ICO, comprising representatives drawn from the industry.

Recent Developments

In view of the financial crisis, the IA with the support of a robust regulatory framework — has stepped up its monitoring of market movements and their impact on the financial and solvency position of authorised insurers in Hong Kong.

There are plans to improve the insurance supervisory framework. A Government-commissioned study is being carried out on establishing an independent Insurance Authority. The study is expected to be completed in 2009 and the stakeholders will be consulted afterwards.

One of the aims of the study is to give the IA more flexibility in carrying out its work and in hiring staff for the regulatory body to better prepare Hong Kong for the 'risk-based capital regulatory regime' to be adopted by the international community. The Government believes an independent Insurance Authority will benefit the insurance industry in the long term.

To protect policy holders in the event of insurer insolvency, the IA is exploring with the Hong Kong Federation of Insurers options for establishing a Policyholders' Protection Funds (PPFs). Careful consideration will be given to the need to strike a reasonable balance between the scope of coverage, moral hazard problems and additional costs to the industry and the consumers.

To facilitate mutual assistance and exchange of information, the IA concluded a Memorandum of Understanding (MoU) with the Federal Financial Supervisory Authority (BaFin) of Germany in October 2008.

Mandatory Provident Fund Schemes and Occupational Retirement Schemes

Main Features

On December 1, 2000, the MPF System was implemented to help encourage the workforce to save and invest for their retirement. It is a privately managed, employment-related mandatory system of provident fund schemes. Unless exempted, employees and self-employed people aged between 18 and 65 are required to join MPF schemes.

The employer and employee are each required to contribute 5 per cent of the employee's relevant income to a registered MPF scheme, subject to the maximum and minimum levels of income for contribution purposes. The accrued benefits are fully vested in the scheme members and can be transferred from scheme to scheme when employees change employment or cease to be employed. A self-employed person has to contribute 5 per cent of his or her relevant income. In normal circumstances, benefits must be preserved until the scheme member attains the retirement age of 65.

By year-end, 99.8 per cent of employers (about 237 500), 98 per cent of relevant employees (2 174 700) and 73.7 per cent of self-employed persons (266 700) had enrolled in MPF schemes. Total MPF assets amounted to about $209 billion, with monthly MPF contributions amounting to around $3 billion.

Unlike the compulsory MPF schemes, occupational retirement schemes registered under the Occupational Retirement Schemes Ordinance (ORSO) are voluntary schemes established by employers. To tie in with the implementation of the MPF system in 2000, schemes registered under the Ordinance that fulfilled certain conditions were exempted from MPF requirements. Members of such schemes may choose to remain in the existing scheme or join an MPF scheme. At year-end, there were 4 625 MPF-exempted occupational retirement schemes covering over 410 000 employees.

Mandatory Provident Fund Schemes Authority

Established in September 1998 under the Mandatory Provident Fund Schemes Ordinance, the Mandatory Provident Fund Schemes Authority (MPFA) is responsible for regulating and supervising the MPF System and ensuring compliance with the ordinance. It is also the Registrar of Occupational Retirement Schemes. To ensure that the interests of MPF scheme members are protected, the MPFA closely monitors the operation of MPF trustees and other service providers, investigates cases of non-compliance identified through reports, complaints or proactive inspections, and takes enforcement actions accordingly. The MPFA also conducts MPF investment education to strengthen the public's awareness of the need to take care of their MPF investment and disseminates in-depth messages that will assist scheme members in choosing the appropriate funds.

Recent Developments

On February 27, the Financial Secretary announced in his 2008-09 Budget the Government's proposal to make a one-off injection of $6,000 into the account of each eligible MPF/ORSO scheme member who earned not more than $10,000 a month to enhance their retirement protection. The Government and the MPFA have worked closely on this proposal. On July 10, the Mandatory Provident Schemes (Amendment) (No. 3) Ordinance 2008 was enacted to provide a legal framework for the MPFA. The MPFA has since begun collecting data on over seven million accounts from MPF/ORSO trustees and ORSO employers to assess the eligibility of scheme members according to the eligibility criteria. The Government started injecting funds into MPF accounts in the 2008-09 financial year.

As part of its on-going effort to improve the efficiency of the MPF system, the MPFA will seek Legislative Council's approval of a plan in the 2008-09 legislative year to increase employees' control over their MPF investments by allowing them to transfer the accrued benefits from their MPF contributions to an MPF scheme of their choice at least once a year. This would encourage more active management of MPF investments by employees and prompt stronger market competition.

Companies Registry

The Companies Registry (the Registry) administers and enforces the major part of the Companies Ordinance (CO). The Registry registers local and non-Hong Kong companies and documents required to be filed under the CO and related ordinances, deregisters defunct solvent private companies and provides the public with services and facilities for inspecting and obtaining company information kept by the Registry. It also administers and enforces several other ordinances including the Trustee Ordinance (insofar as it relates to trust companies), the Registered Trustees Incorporation Ordinance and the Limited Partnerships Ordinance. The Registry is also responsible for a wide range of legal, policy and regulatory matters related to the relevant ordinances.

The Registry has been operating as a trading fund department since 1993. Consequently, it can deploy its resources as necessary and more flexibly to meet business turnover and customers' demands and expectations. The department achieved a surplus of $130.1 million in the 2007-08. The surplus generated over the past years has enabled the Registry to build up a healthy reserve to finance the department's development projects and avoided the need to raise fees since December 1997.

The Registry has continued to implement the Integrated Companies Registry Information System in phases to fully computerise its operations and enable electronic delivery of services in filing, processing, storing and obtaining information. The electronic search services developed under Phase I are well received by customers and over 98 per cent of company searches are conducted online nowadays. Phase II, which includes the provision of electronic filing services for incorporation and document registration, is expected to be implemented in 2010-11.

In 2008, a total of 98 645 local companies were incorporated. By the end of 2008, 710 766 local companies were on the register, compared with 655 038 in 2007.

Companies incorporated outside Hong Kong must register with the Registry within one month of establishing a place of business in Hong Kong. During the year, 872 non-Hong Kong companies were registered and, by year-end, there were 8 487 registered non-Hong Kong companies from 83 countries.

Money Lenders

Under the Money Lenders Ordinance, anyone wishing to carry on business as a money lender must apply to a licensing court for a licence. The Ordinance does not apply to AIs within the meaning of the Banking Ordinance.

Licence applications are submitted to the Registrar of Companies as Registrar of Money Lenders. During the year, 779 applications were received. A total of 748 licences were granted or renewed. At the end of 2008, there were 760 licensed money lenders.

Bankruptcies, Individual Voluntary Arrangement and Compulsory Winding-up

The Official Receiver's Office ensures that service in personal and corporate insolvencies is of a high quality on a par with international standards, and that the legislation is commensurate with the objective of keeping Hong Kong at the forefront as a major international financial centre.

When acting as the trustee or liquidator, the Official Receiver or a private sector insolvency practitioner investigates the affairs of the bankrupt or the wound-up company, realises assets and distributes dividends to creditors. The Official Receiver also prosecutes certain offences set out in the Bankruptcy Ordinance and the

Companies Ordinances, applies for disqualification orders against unfit company directors of wound-up companies, monitors the conduct of outside liquidators and trustees, and monitors the funds held by liquidators in both compulsory and voluntary liquidations.

During the year, the court made 10 779 bankruptcy orders, 1 721 interim orders in individual voluntary arrangements and 468 winding-up orders, compared with last year's respective figures of 11 063, 1 883 and 455. The assets realised by the Official Receiver during 2008 amounted to $153.6 million, while $135.6 million in dividends was paid to creditors in 2 012 insolvency cases.

Professional Accountancy

Hong Kong had 27 885 certified public accountants at year-end. Of these, 3 680 were certified public accountants (practising), who are in public practice and may perform statutory audits. There were 1 179 firms of certified public accountants (practising) and 254 corporate practices registered at year-end.

The Hong Kong Institute of Certified Public Accountants (HKICPA) operates a largely self-regulatory framework under the Professional Accountants Ordinance. The institute is vested under the ordinance with a wide range of responsibilities, such as registering certified public accountants; maintaining financial reporting, auditing and ethical standards for the profession; and conducting training programmes and qualifying examinations.

Since the Financial Reporting Council became fully operational in July 2007, it took over from the HKICPA the investigation of cases concerning audit irregularities and accounting non-compliances relating to listed companies.

Financial Links between Hong Kong and the Mainland

As an international financial centre located at the heart of Asia with strong global linkages, Hong Kong provides a premium platform for Mainland enterprises to access international capital through its banking, equity and debt markets. Being a city in China and Asia's world city, Hong Kong is at the best strategic location for being a gateway for global enterprises and investors to explore the potential of the Mainland. Hong Kong's banks have also maintained a strong presence in the Mainland, while more Mainland enterprises got listed in Hong Kong. Over time, demand for a wide range of financial support services would increase with trade and investment flows between the Mainland and the rest of the world.

The smooth and orderly development of Renminbi business facilitates cross-boundary tourist spending in Hong Kong and helps promote economic integration between Hong Kong and the Mainland. Further development of Renminbi business is expected to enhance the capability of Hong Kong's financial system to handle Renminbi transactions, which is an important step in strengthening the status of Hong Kong as an international financial centre.

There has been a steady flow of cross-boundary funds among financial institutions in both places. Over the years, the Mainland has accumulated a substantial amount of funds in Hong Kong dollars from trading activities and inward investment. These funds are placed with financial institutions in the Mainland and are subsequently channelled back to Hong Kong through the inter-bank market.

By the end of 2008, AIs' external liabilities to banks on the Mainland amounted to $390.6 billion, while their claims on banks in the Mainland totalled $333.2 billion. The amounts represented 14.8 per cent and 6.9 per cent respectively of AIs' total liabilities to and claims on banks outside Hong Kong.

The use of cross-boundary links with Guangdong Province and Shenzhen reflected increasing economic integration between the Mainland and Hong Kong. In 2008, the RTGS system links with Shenzhen and Guangdong handled more than 26 000 transactions, with a total value equivalent to $360 billion.

In light of the potential of the fund management industry in the Mainland, Hong Kong-based fund managers, who are recognised for their knowledge and experience in asset management, have successfully established joint ventures with Mainland fund managers. Hong Kong managers have also embarked on ways to enable investors to capture investment opportunities in the Mainland. At year-end, there were 26 SFC-authorised funds with significant exposure to the A-share market in the Mainland. These included the first equity fund that directly invests in A-shares via the fund manager's own Qualified Foreign Institutional Investment (QFII[5]) quota and an ETF that tracks the A-share market, funds that invest indirectly in A-shares via equity-linked investments issued by qualified foreign institutional investors, and guaranteed funds with their upside potential returns linked to the A-share market performance.

Renminbi Business in Hong Kong

Renminbi business in Hong Kong has developed in a steady and orderly manner. At the end of 2008, the outstanding Renminbi deposits in Hong Kong exceeded RMB 56 billion. Four Renminbi bond issues were made in 2008, following the three successful ones in 2007, bringing the total amount of outstanding Renminbi bonds in Hong Kong to RMB 22 billion.

Capital Formation Centre and Global Investment Platform for the Mainland

Hong Kong's fundamental strengths, including its high market liquidity, a robust regulatory system, efficient information flow, a rich pool of financial professionals and proximity to the Mainland market, mean it is well placed to provide excellent services to Mainland enterprises seeking listing in an international financial centre.

The rapidly expanding Mainland market provides abundant opportunities. The presence of Mainland issuers has increased the breadth and depth of Hong Kong's securities as well as its futures markets. Hong Kong's equity market has evolved from

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5 Foreign institutions approved by the China Securities Regulatory Commission as Qualified Foreign Institutional Investors (QFIIs) may invest in China A shares and other Renminbi-denominated securities in the Mainland subject to the grant of investment quotas by State Administration of Foreign Exchange.

one with a high concentration of property and finance businesses to a market with a great diversity of constituent stocks and a wide range of products.

Hong Kong has become the premier international fund-raising centre for Mainland enterprises. At year-end, 465 Mainland enterprises were listed in Hong Kong, together raising a total of $2,146 billion since 1993. The 10 largest IPOs listed on the SEHK were all from the Mainland.

Mainland enterprises also raise capital in Hong Kong through the issuance of bonds, project financing and loan syndication. Mainland enterprises have easy access in Hong Kong to investment banking services for mergers and acquisitions, and consultancy on restructuring.

In April 2006, the Mainland authorities announced measures to allow Mainland companies and individuals to invest overseas through qualified institutional investors covering commercial banks, securities firms and insurance institutions. The measures, commonly referred to as the Qualified Domestic Institutional Investors (QDII) Scheme, are a further boost to the development of Hong Kong's asset management industry. Since 2007, nine QDII funds have been launched, all of which have their portfolio mandates to invest in the Hong Kong stock market.

In March 2008, the SFC signed a Regulatory Co-operation Agreement of Understanding with the China Insurance Regulatory Commission (CIRC). This is the first regulatory co-operation agreement on the use of Mainland insurance funds outside the Mainland.

The Government and the regulatory authorities will continue to promote the links and co-operation between Hong Kong and the Mainland on financial services.

Mainland and Hong Kong Closer Economic Partnership Arrangement

Under the Closer Economic Partnership Arrangement (CEPA), Hong Kong's financial services suppliers and professionals enjoy greater market access and flexibility for their operations on the Mainland. CEPA's implementation has enhanced Hong Kong's attractiveness to market users, as well as strengthened its competitiveness as an international financial centre and the premier capital formation centre for Mainland enterprises.

On May 4, the China Securities Regulatory Commission (CSRC) announced measures allowing qualified Mainland fund management companies to set up operations in Hong Kong under CEPA IV. By year-end, the subsidiaries of two Mainland fund management companies had been licensed to conduct asset management business in Hong Kong.

Hong Kong-incorporated banks have gained greater access to the Mainland market since the implementation of CEPA in January 2004. A further section, Supplement V, was added to CEPA this year, giving Hong Kong additional privileges. One of Supplement V's provisions allows the data centres of Hong Kong's Mainland-incorporated banking institutions to locate in Hong Kong, provided they meet the criteria set out in the agreement in Supplement V and the relevant Mainland regulations.

Hong Kong's insurance industry also made capital of CEPA during 2008. Under CEPA's Supplement IV, a centre was established in Hong Kong for local residents to take Mainland examinations to qualify as insurance intermediaries in the Mainland. The supplement also enabled local insurance agencies, with Certificates of Hong Kong Service Supplier, to establish wholly-owned companies in the Mainland to provide insurance agency services to Mainland insurance companies.

The accounting sector also benefited from CEPA's liberalisation measures. Two supplementary agreements were signed on July 29, 2008 between China's Ministry of Finance and Hong Kong's Financial Services and the Treasury Bureau exempting Hong Kong's practising accountants from sitting for a third paper in the Mainland's accountancy examination and to extend this exemption to all members of the Hong Kong Institute of Certified Public Accountants (HKICPA). Other liberalisation measures include the proposed setting up of an examination centre in Hong Kong for the Mainland's Accounting Professional Technician Qualification Examination and dedicated examination centres in the Guangdong Province for Mainland's accounting qualification examination. Furthermore, the validity period of temporary audit permits issued to Hong Kong accounting firms has been extended from two years to five years.

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

A 'Focus Group on Financial Services' was formed in January 2007, arising from the economic summit on 'China's 11th Five-Year Plan and the Development of Hong Kong' held in September 2006 in Hong Kong. Following the summit, the group drew up an 'Action Agenda' containing 80 recommendations and an overall direction for developing Hong Kong as China's international financial centre and establishing a co-operative, complementary and interactive relationship with the Mainland's financial systems. Progress was made in over one-third of the 80 recommendations by the end of 2008. This included the launching of gold futures by the HKEx on October 20, and continuous efforts to facilitate financial co-operation with the Mainland. The Government and Hong Kong's financial regulators will continue to foster links between Mainland and Hong Kong markets to widen the scope of their operations and to strengthen their effectiveness. Hong Kong will also try to expand the business of its financial institutions in the Mainland, and help Mainland capital, investors and financial institutions make better use of the city to go global. To keep up the momentum, the HKEx will continue to lead intermediaries in promoting Hong Kong as the premier capital raising centre for Mainland enterprises.

Guangdong-Hong Kong Financial Co-operation

Guangdong is the Mainland province closest to Hong Kong not only in terms of geographical location, but also culture and economic links. Guangdong and Hong Kong have been exploring ways to strengthen financial co-operation with each other. The first 'Guangdong-Hong Kong Financial Co-operation Forum' was held in Guangzhou in October. More than 300 delegates from Guangdong and Hong Kong attended. The event established an important milestone in financial co-operation between the two places.

In December, Premier Wen Jiabao announced measures to support Hong Kong's economic growth as well as the Central People's Government's support of Guangdong-Hong Kong financial co-operation. A new task force on financial co-operation will be set up under the Guangdong-Hong Kong Co-operation Joint Conference in 2009 to draw up proposals.

Enhancing Hong Kong's Competitiveness as an International Financial Centre

The Government is committed to strengthening Hong Kong's competitiveness as an international financial centre and the premier capital formation centre for the Mainland through enhancing its regulatory regime, promoting corporate governance, upgrading financial infrastructure and fostering development of the bond market.

Work on Hong Kong's regulatory framework continued in 2008 based on international experience and standards to ensure sound business standards and confidence in the market. Major initiatives were pursued to improve Hong Kong's competitiveness as an international financial centre.

Optimising the Supervisory Framework

As pledged by the Chief Executive in the 2008-09 Policy Address, the Government will review and strengthen the supervisory framework for authorised institutions in Hong Kong to further strengthen the resilience of Hong Kong's banking system and to reinforce Hong Kong's role as an international centre, following recommendations from the Financial Stability Forum, the Basel Committee on Banking Supervision and other international organisations charged with analysing the causes and effects of the subprime and credit market crises. The Government will also conduct a review on the Deposit Protection Scheme to provide depositors with better protection.

An effective regulatory regime is a pre-requisite to maintaining investor confidence and Hong Kong's standing as an international financial centre. The collapse of Lehman Brothers in September triggered complaints about sales of structured investment products by financial intermediaries to retail investors. The HKMA and the SFC each prepared a report on its observations, lessons learnt and issues identified during the process of investigating these complaints. The government and the regulators will implement in phases the various recommendations made in the reports to further improve the regulatory framework and enhance investor protection, particularly when securities business is conducted by banks.

Developing Islamic Finance

The Government is also pressing ahead creating a platform for developing Islamic finance. In 2008, the Chief Executive and the Secretary for Financial Services and the Treasury visited the Middle East to promote Hong Kong's strengths to develop Islamic finance. The Government is also reviewing its tax regime to provide a level playing field for Islamic bonds (sukuk) vis-à-vis conventional bonds. Market response to the Government initiative is positive as reflected in the launching of Islamic bonds, funds, indices and banking windows.

Upgrading of the Quality of Financial Reporting

The Hong Kong Financial Reporting Standards (HKFRS), issued by the HKICPA, have been fully convergent with the International Financial Reporting Standards (IFRS). This convergence is beneficial to Hong Kong because international investors and financial analysts are well acquainted with the IFRS.

The Government is acutely aware of the need to maintain an effective, transparent and accountable regulatory regime for the accountancy profession.

The Financial Reporting Council (FRC) which became fully operational in 2007, is a new statutory body that investigates the audit irregularities and accounting non-compliances of listed companies in Hong Kong. The FRC received 29 complaints in 2008, of which investigations into 19 were completed by year-end.

Expanding the Sources of Listed Enterprises on the Exchange

Hong Kong is the premier capital formation centre for the Mainland whose enterprises raised $2,146 billion during the past few years. At year-end, 465 Mainland enterprises were listed on the Hong Kong stock exchange, accounting for 37 per cent of listed companies in Hong Kong; their market capitalisation accounted for 60 per cent of the total market capitalisation; and their turnover accounted for 71 per cent of the stock market's daily equity turnover.

The HKEx has been stepping up its promotion of Hong Kong as a preferred listing venue and establishing closer co-operation with other stock markets. These initiatives included the signing of MoUs with the Abu Dhabi Securities Market and the Moscow Interbank Currency Exchange to establish co-operation in areas such as information exchange. The HKEx also has MoUs with the Ho Chi Minh and Mongolian stock exchanges.

HKEx members also pay visits regularly to the Mainland, Vietnam, Thailand, Malaysia, Kazakhstan, Russia, Taiwan and other places to promote Hong Kong as a premier capital formation centre.

Promoting Asset Management Business

Asia's saving rates are high compared to other regions. Located at the heart of Asia, Hong Kong is well positioned to further develop as an international asset management centre. According to the Fund Management Activities Survey 2007 released by the SFC in 2008, the combined fund management business of banks, major insurance companies and other corporations grew by 57 per cent from $6,154 billion in 2006 to $9,631 billion in 2007. The number of retail funds in Hong Kong was 2 040 in 2007, valued at $8,400 billion.

The Government continues to lead financial services delegations to the Mainland and different countries to promote Hong Kong's financial services and its advantages as a major asset management centre in Asia. At the same time, the SFC routinely reviews codes and guidelines to facilitate the launching of new investment products and international funds in the local market.

Improvement of the Mandatory Provident Fund Schemes Ordinance

Since the enactment of the Mandatory Provident Fund Schemes Ordinance in August 1995, the MPFA has been reviewing and making proposals to improve the MPF legislation in the light of operational experience. Amendments to the legislation since the implementation of the MPF System have sought to simplify MPF scheme administration, strengthen protection for scheme members and improve the regulation of MPF schemes and investments.

The Legislative Council passed the Mandatory Provident Fund Schemes (Amendment) Bill 2007 on January 9, 2008 to improve the administration and regulation of MPF schemes, to enhance the enforcement of the MPF System and to better protect the interests of scheme members. The major amendments include removal of the 30-day settlement period to facilitate early recovery of default contributions and removal of the exclusion of housing allowance from the definition of relevant income.

The Mandatory Provident Fund Schemes (Amendment) (No. 2) Bill 2007, covering proposals to enhance enforcement actions and penalties against non-compliant employers so as to better protect the interests of employees, was passed by the Legislative Council on June 18, 2008. Major amendments include the imposition of criminal and civil liability on employers who failed to make MPF contributions when they also failed to enroll their employees in the MPF system, and increasing the maximum penalty against employers for non-enrolment cases and default contributions.

The Mandatory Provident Fund Schemes (Amendment) Bill 2008 was passed by the Legislative Council on July 10 to provide a legal framework for the Mandatory Provident Fund Schemes Authority to implement the Government's proposal to make a one-off injection of $6,000 into the accounts of eligible members of MPF schemes and ORSO schemes to enhance their retirement protection.

Modernising the Companies Ordinance and other Legislative Amendments

The Standing Committee on Company Law Reform (SCCLR) advises the Government on major reviews of Hong Kong's company law to modernise the law and upgrade Hong Kong's corporate governance. Many of the reviews' recommended amendments have been adopted over the years.

However, the piecemeal approach to amending the CO has limitations, particularly with regard to the enhancement of the overall structure, the drafting style and clarity of the CO provisions. To bring the law up-to-date, the CO had to be rewritten extensively and a Companies Bill Team, comprising officers from the Financial Services and the Treasury Bureau and the Companies Registry was formed in 2006 to do the rewriting.

A number of advisory groups were also set up to scrutinise the revisions and to advise on different aspects of the rewritten ordinance. The task was completed in

2008 and a draft Companies Bill will be presented for public consultation in the fourth quarter of 2009.

Meanwhile, the Government continues to work closely with stakeholders, including the SFC and the HKEx, to ensure that the legislative proposal to give statutory backing to major listing requirements can improve market quality and increase investor protection without hampering market development.

Review of the Trustee Ordinance

A Government review of the Trustee Ordinance is continuing. The aim is to provide a better framework for the operation of trusts in Hong Kong, strengthen the competitiveness of Hong Kong's trust services industry and to enhance Hong Kong's position as an international financial centre.

Enhancement of the Financial Infrastructure

The HKMA is committed to building a safe and efficient financial infrastructure in Hong Kong, based on a multi-currency, multi-dimensional platform. It is also developing Hong Kong as a payment and settlement centre in the region.

Major projects completed in 2008 include:

- improvements to the CMU to facilitate Discount Window borrowing by banks under five temporary measures to provide liquidity assistance to banks;
- new RTGS facilities to facilitate liquidity management by banks;
- System improvements to facilitate Islamic-related transactions; and
- one-way joint-clearing service for US dollar cheques between Hong Kong and Macao.

During the year, the HKMA stepped up its drive to explore opportunities to link the various RTGS systems and the CMU with similar systems in the region, and to promote the adoption of Hong Kong's clearing and settlement systems.

Development of the Bond Market

The Government has boosted development of the bond market in recent years by providing it with the necessary financial infrastructure, simplifying the issuance process, removing regulatory impediments, offering tax incentives and encouraging public corporations to issue bonds. The education for bond investors was also strengthened.

The HKMA has increased the issuance of 5-year and 10-year Exchange Fund Notes and launched the 15-year Exchange Fund Notes to improve the maturity balance of the Exchange Fund Bills and Notes (EFBNs). The electronic trading platform for EFBNs, launched in December 2007, entered in its first full year of operation in 2008. The daily turnover of transactions done through the electronic trading platform rose to 40 per cent of the market's total transactions by year-end.

Outstanding Hong Kong dollar debts exceeded $716 billion at the end of 2008. Issuers included the Exchange Fund, statutory bodies or government-owned corporations, AIs, multilateral development banks (MDBs), non-MDB overseas borrowers and local corporations. New EFBN issues amounted to $286 billion and accounted for around 67 per cent of the total new Hong Kong dollar debt issuance in 2008.

Excluding the Exchange Fund papers, new issuance of Hong Kong dollar debt totalled $138 billion in 2008. Non-MDB overseas borrowers continued to be the most active, taking up nearly 37 per cent of all new issues. Issuance by statutory bodies and government-owned corporations, local corporations and authorised institutions remained stable in 2008.

Excluding EFBNs[6], fixed rate debt constituted about 82 per cent of total new issues in 2008.

Following its study to assess the potential of developing an Islamic bond market in 2007, the HKMA introduced in 2008 enhancements in the clearing and settlement systems to facilitate Islamic-related transactions.

Hong Kong's free and open financial markets, with free flow of capital, help create a large international investor base and will continue to fuel the growth of Hong Kong's bond market. Hong Kong's vast amount of Hong Kong dollar time deposits, its growing retirement funds and capital from the Mainland are other factors contributing to the higher demand for bond investment.

Debt Issuance

Through its debt-issuing activities, the Hong Kong Mortgage Corporation (HKMC) plays a part in promoting the development of the Hong Kong dollar debt market. By the end of 2008, it had $42.8 billion of debt securities outstanding with a tenor of up to 15 years.

The HKMC has pioneered the development of Hong Kong's retail bond market since 2001. In 2008, it launched a new retail bond issue with four series of notes totalling HK$540 million. The amount of retail bonds outstanding at the end of the year was $3.1 billion.

In 2008, the HKMC issued debut foreign currency (including the US dollar, the Japanese yen and the Singapore dollar) corporate debts to diversify its investor base and funding sources in the international bond market, raising a total of HK$4.7 billion equivalent under its US$3 billion Medium Term Note Programme.

HKMC's local and foreign currency issues continued to be rated as triple-A by Moody's, enhancing its ability to promote the development of the local and regional debt and securitisation markets.

6 All EFBNs were fixed rate debt instruments.

Development of a Secondary Mortgage Market

A well-developed secondary mortgage market is useful in channelling long-term funds, such as insurance and pension funds, to meet demand for long-term home financing. The HKMC was set up in March 2007 to carry out the following tasks:

- Promote the development of a secondary mortgage market in Hong Kong;
- Improve banking and monetary stability;
- Facilitate the development of the local debt market; and
- Promote wider home ownership.

In 2008, the Government authorised a threefold increase to $30 billion in the size of the Revolving Credit Facility offered by the Exchange Fund, underlining the important role the HKMC is playing. The enhancement of the Facility aims to provide the HKMC with the necessary funding to perform its role to purchase banking assets and contribute to financial stability in Hong Kong.

Asset Purchase Programme

Under the Asset Purchase Programme, the HKMC purchases assets from banks to facilitate their risk and balance sheet management. The HKMC is a key player in the secondary mortgage market. Its asset portfolio's outstanding principal balance at the end of 2008 amounted to $51.2 billion.

Mortgage Insurance Programme

The Mortgage Insurance Programme (MIP) was launched in 1999 to provide mortgage insurance cover to banks so that they can extend residential mortgage loans to homebuyers above the loan-to-value ceiling set by the HKMA. In 2008, the HKMC improved the programme by lowering the threshold above which insurance would be made available from the previous 70 per cent loan-to-value ratio (LTV) to 60 per cent up to a total LTV ratio of 90 per cent; and refined the eligibility criteria for 95 per cent LTV mortgages under the MIP.

The MIP has gained wide acceptance and promoted home ownership through product diversification and improvements to servicing standards. At the end of 2008, over 117 800 applications had been received involving an aggregate mortgage loan of $238 billion.

Mortgage-backed Securities Market

The HKMC runs a back-to-back mortgage-backed securities (MBS) programme that provides a platform for banks to effectively repackage their mortgage portfolios into more liquid MBS. The HKMC also guarantees the timely payment of interest and repayment of principal for securitised mortgage loans.

The HKMC also runs a multi-currency Bauhinia MBS Programme that enables MBS to be used as collaterals for mortgage loans. A total of $3.1 billion of MBS were outstanding under this programme at year-end.

Anti-money Laundering and Counter Financing of Terrorism

Hong Kong keeps in view its anti-money laundering and counter financing of terrorism programme to maintain a safe business and investment environment. A high-level Central Co-ordinating Committee on Anti-Money Laundering and Counter Financing of Terrorism, chaired by the Financial Secretary, is in place to give steer on this policy area.

Monetary Policy

The monetary policy objective of Hong Kong is 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 clear policy aim is achieved through the linked exchange rate system introduced in 1983.

The linked exchange rate system 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 $7.80 to US$1. In Hong Kong, the monetary base includes the amount of currency notes and coins issued, the Aggregate Balance (the sum of the clearing balances of banks held with the HKMA for the purpose of effecting the clearing and settlement of transactions between banks themselves and also between the HKMA and banks), and the outstanding amount of EFBNs.

Note-issuing banks are required to hold Certificates of Indebtedness (CIs) issued by the Exchange Fund to provide backing for bank note issuance. The issuance and redemption of CIs are made against US dollars at the convertibility rate of HK$7.80 to US$1 for the account of the Exchange Fund. Similarly, the issue and withdrawal of government-issued currency notes and coins in circulation are conducted against US dollars at the fixed exchange rate of HK$7.80.

A Discount Window was introduced in 1998 under which banks have unrestricted access to day-end liquidity through repurchase agreements using EFBNs as collateral. The Base Rate is the reference on which the interest rates charged by the HKMA for different types of borrowings by licensed banks through the Discount Window are calculated. Before October 9, it was set at either 150 basis points above the prevailing US Federal Funds Target Rate or the average of the five-day moving averages of the overnight and one-month Hong Kong Interbank Offered Rates, whichever is higher.

Since October 9 the spread of 150 basis points above the prevailing US Federal Funds Target Rate has been reduced to 50 basis points. In addition, the other leg relating to the moving averages of the relevant interbank interest rates has been removed from the formula until the end of March 2009.

Under the currency board system, Hong Kong dollar exchange rate stability is maintained through an interest rate adjustment mechanism. The monetary base increases when the foreign currency (in Hong Kong's case, US dollars) to which the domestic currency is linked, is sold to the currency board for the domestic currency (inflow into the Hong Kong dollar). It contracts when the foreign currency is bought from the currency board (outflow from the Hong Kong dollar).

The expansion or contraction in the monetary base leads interest rates for the domestic currency to fall or rise, respectively, creating the monetary conditions that automatically counteract the original capital movements, ensuring stability of the exchange rate.

A Currency Board Sub-Committee under the Exchange Fund Advisory Committee (EFAC) was established in August 1998 to oversee the operation of the currency board system in Hong Kong and recommend to the Financial Secretary through EFAC measures to enhance the robustness and effectiveness of Hong Kong's currency board arrangements.

The HKMA pursues a policy of transparency to ensure that the financial industry and the wider public are fully informed of the currency board operations. The Aggregate Balance and forecast changes to the Aggregate Balance attributable to the currency board's foreign exchange transactions are disclosed on a real-time basis. The size of the monetary base and its components are published every day, while the Currency Board Account is published each month. The records of the meetings of the Currency Board Sub-Committee are also published regularly.

The Government is fully committed to the maintenance of the linked exchange rate system, which is a cornerstone of Hong Kong's monetary and financial stability, and to the strict discipline of the currency board arrangement under that system.

Monetary Situation

The Currency Board continued to function smoothly in 2008 despite persistent capital inflows and the global financial turmoil. The money market was operating in an orderly way despite continued tension in the credit market. The HKMA introduced a number of measures to increase the supply of liquidity and reduce banks' borrowing costs. These measures helped alleviate the tension in Hong Kong's interbank market and mitigate the adverse impact of the credit strain on the wider economy.

The Hong Kong-dollar market exchange rate traded within a narrow range of 7.7710 and 7.8139 in the first eight months of 2008. The collapse of Lehman Brothers in mid-September sent shock waves through global financial systems, making the currency markets extremely volatile. The Hong Kong dollar generally strengthened alongside the US dollar during July to November, appreciating against the Australian dollar, the Korean won, the British pound and the Euro by over 20 per cent. The strong-side Convertibility Undertaking was repeatedly triggered in the last two months of the year, prompting the HKMA to passively sell Hong Kong dollars against US dollars at HK$7.75 to US$1.

Hong Kong-dollar interest rates generally declined in the first four months of 2008 along with their US dollar counterparts as the US Federal Funds Target Rate was lowered by a total of 225 basis points. The one-month and three-month Hong

Kong Interbank Offered Rates (HIBORs)[7] rose in late May and June. From May to August, the overnight HIBOR gradually climbed. After the collapse of Lehman Brothers, heightened concerns on credit risks and the desire to preserve liquidity resulted in banks refraining from lending to each other. Hong Kong-dollar interbank interest rates increased sharply in tandem with the soaring US-dollar interest rates. Interest rate volatility also rose, and the HIBOR-London Interbank Offered Rate differentials fluctuated sharply, with discounts occasionally turning into premiums suggesting the interbank market was not functioning normally.

A small-scale, rumour-driven run on a retail bank occurred on September 24, 2008 leading to further tightness in the domestic money market. At around the same time, strong demands of Exchange Fund paper by banks for liquidity management purposes drove the (implied) yields of short-dated Exchange Fund paper to very low levels, resulting in a divergence between interbank interest rates and yields of the corresponding Exchange Fund paper.

The HKMA introduced a series of measures to help contain liquidity and solvency risks in the banking system. It injected liquidity into the banking system by operating within the Convertibility Zone in September and October, purchasing US dollars against Hong Kong dollars. The Aggregate Balance increased to a record high of HK$158 billion on December 31, 2008. It introduced five temporary measures on September 30, 2008 (and two refinements on November 6, 2008) to provide individual banks in need with collateralised liquidity through or outside the Discount Window. On October 14, 2008, the Financial Secretary announced the introduction of 100 per cent deposit guarantee and a Contingent Bank Capital Facility to bolster public confidence in the banking system – both measures will remain in force until the end of 2010. The HKMA lowered the price of liquidity by adjusting the formula for determining the Discount Window Base Rate on October 9, 2008. As the US Federal Funds Target Rate was lowered from 2 per cent to 0-0.25 per cent in the last quarter of 2008, the Base Rate declined to 0.5 per cent at the end of the year.

Following the introduction of these measures since September, the interbank credit market generally stabilised and local interbank rates declined across the board. Efforts around the world to provide liquidity to the markets and an improvement in market sentiment also helped the recovery of the wholesale funding market. The injection of Hong Kong-dollar liquidity by the HKMA also creates an opportunity to provide an accommodative monetary environment to support general economic activity, helping borrowers to overcome the challenges caused by the global financial turmoil.

Exchange Fund

The Exchange Fund was established by the Currency Ordinance of 1935 (later renamed the Exchange Fund Ordinance). Since its establishment, the fund has been responsible for backing Hong Kong dollar note issues. The role of the fund was

[7] The rate of interest offered on Hong Kong dollar loans by banks in the interbank market for a specified period ranging from overnight to one year.

expanded in 1976 to include the backing for coins issues. The Coinage Security Fund was merged with the Exchange Fund on December 31, 1978.

The Government transferred the fiscal reserves of its General Revenue Account (apart from the working balances) to the fund to centralise the investment management of its financial assets. Through this transfer, the bulk of the Government's financial assets are placed with the fund.

When the Hong Kong Special Administrative Region (HKSAR) was established on July 1, 1997, the Chief Executive appointed the Financial Secretary as the public officer to receive, hold and manage the Land Fund, as part of the HKSAR Government reserves, which were merged into the Exchange Fund and has been managed as part of the Investment Portfolio of the Exchange Fund since November 1, 1998.

In May 2003, a resolution was passed by the Legislative Council under the Public Finance Ordinance to authorise the transfer of $120 billion from the Land Fund to the General Revenue Account to meet the Government's expenditure requirement. A further transfer of $40 billion was made under a similar resolution passed by the Legislative Council in June 2004.

The Exchange Fund's primary statutory role, as defined in the Exchange Fund Ordinance, is to affect the exchange value of the Hong Kong dollar. Its functions were extended to maintaining the stability and integrity of the monetary and financial systems, with a view to maintaining Hong Kong as an international financial centre, when the Exchange Fund (Amendment) Ordinance 1992 came into force.

The HKMA manages the Exchange Fund. Apart from ensuring that the fund meets its statutory responsibilities, the HKMA's principal activity is the day-to-day management of the fund's assets.

To meet the objectives of preserving capital, providing liquidity to maintain financial and currency stability and generating an adequate long-term return, the Exchange Fund is managed as distinct portfolios. The Backing Portfolio holds highly liquid US-dollar-denominated debt securities to fully back the monetary base. The Investment Portfolio aims to preserve the fund's long-term purchasing power. The asset allocation strategy of the Exchange Fund is guided by the investment benchmark, which defines the bonds and equities mix as well as the overall currency composition of the fund. The details of the management of the fund and the investment style adopted are set out and explained in the HKMA's annual report. A Strategic Portfolio was set up in 2007 to hold all the shares of Hong Kong Exchanges and Clearing Limited acquired for strategic purposes by the Financial Secretary using the Exchange Fund.

On December 31, 2008, the Exchange Fund's total assets stood at $1,557.7 billion, of which foreign currency assets amounted to $1,440.7 billion. The accumulated surplus of the Exchange Fund amounted to $480.7 billion. Foreign currency asset figures have been published monthly since January 1997 to demonstrate the Government's continued commitment to greater openness and transparency. In addition, an abridged balance sheet of the Exchange Fund and a set of Currency Board accounts are published monthly.

Another function related to the Exchange Fund is currency issuance. Bank notes in denominations of $20, $50, $100, $500 and $1,000 are issued by the three note-issuing banks: Standard Chartered Bank (Hong Kong) Limited, the Hongkong and Shanghai Banking Corporation Limited and Bank of China (Hong Kong) Limited. The note-issuing banks may issue currency notes only by surrendering non-interest-bearing US dollar backing at a fixed exchange rate of $7.80. Thus the fund enjoys the seigniorage from the notes.

Through the HKMA, the Government issues $10 currency notes and coins of $10, $5, $2, $1, 50 cents, 20 cents and 10 cents denominations. The Hong Kong $10 polymer note was put into circulation in July 2007. The HKMA, which has been examining alternative technologies for the production of currency notes, issued the note to assess the performance and acceptability of polymer notes in Hong Kong. The value of all notes and coins in circulation at year-end was $185.3 billion.

Websites

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