Assessing Hong Kong as an International Financial Centre
Assessing Hong Kong as an International Financial Centre

First Report
of the

Hong Kong Research Grants Council Theme-based Research Scheme Project: Enhancing Hong Kong’s Future as a Leading International Financial Centre

Authors (in alphabetical order):

Douglas W. Arner (Project Coordinator)
David C. Donald
Say Goo
Richard W.X. Hu
Chen Lin
Bryane Michael
Frank M. Song
Wilson H.S. Tong
Chenggang Xu
Dariusz Wojcik
Simon X.B. Zhao (Deputy Project Coordinator)

April 2014

with special thanks to the

Policy Research Committee
of the
Hong Kong Financial Services Development Council

This report reflects the views solely of the authors and should not be attributed to any institution or organisation with which they may be affiliated nor any supporting and/or cooperating organisations providing support through funding and/or review of this report.
## Contents

Preface, Acknowledgements and Disclaimer ........................................................................................................ 4  

Chapter 1: Introduction and Summary .................................................................................................................. 7  
  Structure of the report and objectives .................................................................................................................. 7  
  Overview of the recommendations ...................................................................................................................... 9  
  Enhancing public engagement in financial policy-making ................................................................................ 12  
  Deepening participation in Hong Kong’s financial and corporate affairs ......................................................... 12  
  Broadening co-operation with Mainland China ................................................................................................. 13  
  Diversifying financial sector opportunities ...................................................................................................... 14  
  Hong Kong’s financial regulators ....................................................................................................................... 14  
  Conclusion ......................................................................................................................................................... 16  

Key Recommendations ......................................................................................................................................... 17  

Chapter 2: What Do the Data tell us about Hong Kong as an IFC? ........................................................................ 19  
  Hong Kong’s entrepot equity finance ................................................................................................................ 23  
  Increased compliance likely to decrease competitiveness .............................................................................. 27  
  Debt capital markets ......................................................................................................................................... 32  
  Double crisis vulnerability .................................................................................................................................. 39  
  Conclusions ....................................................................................................................................................... 45  

Chapter 3: Employment Policies and Practices – Looking for Wider Opportunities ............................................. 46  
  Hong Kong’s financial sector employment in perspective ............................................................................... 47  
  The China effect .................................................................................................................................................. 53  
  Interim measures: Increasing financial advisors to service a wider catchment ............................................. 57  
  An ASEAN investment passport ......................................................................................................................... 63  
  Conclusions ....................................................................................................................................................... 67  

Chapter 4: Mainland Internationalisation and its Impact on Hong Kong ............................................................... 69  
  Hong Kong’s co-opetition with Shanghai and Shenzhen .................................................................................. 70  
  Improving policymaking .................................................................................................................................. 79  
  Passporting Hong Kong’s mutual funds ............................................................................................................ 81  
  Offshore yuan markets ........................................................................................................................................ 89  
  Building on-shore and off-yuan markets in Hong Kong .................................................................................. 93  
  Conclusions ....................................................................................................................................................... 102  

Appendix: Appraisal of today’s offshore RMB debt market ................................................................................. 103  

Chapter 5: Corporate Governance in Hong Kong as an IFC ............................................................................... 105  
  Where does Hong Kong stand? ......................................................................................................................... 106  
  Encourage Hong Kong pensions to engage in governance-related activism ............................................. 111  
  Reducing self-dealing by connected parties through whistleblowing ......................................................... 113  
  Broadening awareness of concentrated shareholding .................................................................................... 117  
  Professionalising corporate board directors .................................................................................................... 122  
  Private action ..................................................................................................................................................... 127  
  Conclusions ....................................................................................................................................................... 128  

Chapter 6: Dealing with a Double Crisis ............................................................................................................. 130  
  Chinese high leverage poses systemic risks which may spread to Hong Kong ......................................... 131  
  Risk of economic slow-down and its effects on Hong Kong ........................................................................ 141  
  Knock-on effects on Hong Kong’s real estate sector ....................................................................................... 144  
  Regulatory changes for insulating Hong Kong against a Chinese-source financial crisis .................................. 147
Conclusions ........................................................................................................................................ 152
Chapter 7: Financial Regulation – Adopting International Regulations while Addressing Unique
Financial Stability Concerns ........................................................................................................ 153
  Why financial law reform for Hong Kong? .................................................................................. 153
  Safeguarding Hong Kong from the usual suspects .................................................................. 157
  Reviewing Hong Kong’s regulatory structure .......................................................................... 159
  Increasing effectiveness of financial sector consultations ....................................................... 163
  Dealing with a potentially over-sized compliance sector ......................................................... 164
  What to do with the Financial Services Development Council? ............................................ 167
  Conclusion .................................................................................................................................. 170
Chapter 8: Looking Forward ............................................................................................................ 171
  Broad global macroeconomic trends affecting the sequencing of reform .......................... 171
  Reforming Hong Kong’s regulators ......................................................................................... 173
  Diversifying opportunities beyond the Mainland ................................................................. 174
  Deepening client relations in the Mainland .......................................................................... 175
  Improving the governance of Hong Kong’s financial and non-financial corporations .... 176
  Conclusion .................................................................................................................................. 177
Appendix I: Bibliography .................................................................................................................. 178
Appendix II: List of Recommendations Generated from 2013 Research Round ......................... 198
Appendix IV: Author Biographies ................................................................................................. 203
Appendix V: Project Advisory Board (in alphabetical order) ...................................................... 207
The Government of the Hong Kong Special Administrative Region shall provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre.

Article 109, Basic Law of the Hong Kong SAR

By the end of the 20th century, Hong Kong had emerged as one of the world's major international financial centres. As one high profile indicator, by 2011, this East Asian financial centre’s new equity listings comfortably outstripped the more established markets of London and New York in aggregate transaction volumes. Today, while finance remains central to Hong Kong’s future, it is facing unprecedented challenges, in China, in the region and globally. In the context of China, the continuing process of economic reform and financial development raises many opportunities but at the same time brings into question Hong Kong's traditional role as the primary intermediary between China and the global financial system. At the same time, the global and European financial crises have raised fundamental questions about finance, exchange rate systems, the global position of China, and the future role of the renminbi, including Hong Kong's role therein.

Reflecting the centrality of finance to Hong Kong, Article 109 of the Hong Kong Basic Law, ascribes the Hong Kong Government an obligation “to provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre.” However, Hong Kong has yet to take a comprehensive approach to this obligation or to consider its strategic and practical implications. While the creation of the Hong Kong Financial Services Development Council (FSDC) is a very important step, more remains to be done.

There is no question that Hong Kong has developed impressively and is performing very well as an international financial centre. This is clear and well established\(^1\) and is thus not the central theme of this report. Rather, this report seeks to consider areas where Hong Kong could do better. Thus, the central theme of this report focuses on the need for a more strategic approach to Hong Kong’s future as a financial centre, based on an analysis of academic and policy research and current expectations of best regulatory and commercial practice.

The present report is the first of a major research project on “Enhancing Hong Kong’s Future as a Leading International Financial Centre”, funded by the Hong Kong Research Grants Council Theme-based Research Scheme.\(^2\) This project, built around a team of

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\(^1\) See for example IMF (2014, 2003), Z/Yen (2014), FSDC (2013b), Arner et al. (2010), and Hsu et al. (2006).

\(^2\) Project number T31-717/12-R (2012-2017). The Theme-based Research Scheme (TRS) was established by the Hong Kong Government in 2009 through an endowment of HK$18 billion, with the investment
internationally recognized experts from economics and finance, geography, law, and international relations, is dedicated to analysing the elements required not only to maintain, but also enhance, Hong Kong's future as an international financial centre, focusing on its role in China's ongoing financial liberalisation and economic development. In addition to the authors (from the University of Hong Kong, the Chinese University of Hong Kong, the Hong Kong Polytechnic University and Oxford University), the project brings together over 40 leading financial and regulatory policy experts from China, Hong Kong, the United States, Europe and Australia, constituted as the project Advisory Board.

The project focuses on four central questions addressing regulation, corporate governance, Mainland liberalisation and international competitiveness and their relevance to Hong Kong’s future as a leading international financial centre:

(1) Regulation: in the wake of the global financial crisis, Eurozone financial crisis and Lehman Brothers Minibonds crisis, it is imperative to review Hong Kong’s regulatory framework and infrastructure.

(2) Corporate governance: As one of the world’s leading centres for capital raising, corporate governance of Hong Kong, Mainland and foreign companies raising money in Hong Kong is central to both local and international investors as well as economic performance and the competitiveness of Hong Kong as a fund raising centre, not least due to its precepts in relation to shareholder control and representation.

(3) Mainland financial liberalisation: The Mainland's ongoing financial liberalization (including RMB internationalization and the establishment of RMB offshore centres) presents major opportunities, risks and challenges for both Hong Kong and Mainland China and their financial systems.

(4) International and regional cooperation and competitiveness: Hong Kong’s component markets compete in some respects with those elsewhere in Asia and other regions. What does the future hold, what lessons can be learned from recent events and the increasing connectivity among global financial hubs, and where are the appropriate areas for cooperation and competition?

The present report is the first of a series of three major reports (with the second and third to follow in 2015 and 2017 respectively) on Hong Kong’s international financial centre role, competitiveness and prospects for development, focusing on pragmatic policy recommendations.

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income (around HK$ 200 million per year) to finance academic research focused on issues of long-term strategic importance to the development of Hong Kong: www.ugc.edu.hk.

Details of the Project Principal Investigators and Report Co-Authors can be found in Appendix IV.

See Appendix V for a full list.
We extend special thanks to the FSDC, and in particular members of the FSDC’s Policy Research Committee, who provided feedback and valuable advice. Importantly, the present report reflects the views of the authors only and does not constitute the views of the FSDC Policy Research Committee, the FSDC, the Project Advisory Board, or any institutions or organisations with which they are associated.

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5 The present report benefited in particular from the discussions underlying FSDC (2013b).
Chapter 1: Introduction and Summary

At one time, Pingyao Country served as the hub of the piaohao – some of China’s first banks. Genoa and Amsterdam were, at other times, the world’s leading international financial centres. Likewise, Philadelphia initially developed as a larger centre of finance than New York. These centres – as with others before and since – failed to keep up with shifting trade patterns, geopolitical forces and legal and institutional change. Financial centres – like the trust and confidence that underpins them – rise slowly and can fall quickly.

This report – the first of three under the project – examines the forces that will determine Hong Kong’s ability to enhance its inherent human capital resources, attract and retain those individuals and commercial organisations that use its banks, trade securities on its exchanges, and execute contracts to give effect to both simple and complex financial instruments.¹ We will propose ways to make Hong Kong more resilient to economic shocks (particularly any arising from the Mainland). We will also provide step-by-step recommendations about putting these proposals into practice.

To avoid repeating previous analysis, rather than focusing on areas where Hong excels, the report focuses on areas where more could be done.² This focus should not be taken as criticism of Hong Kong’s often excellent financial sector structure or performance but rather as an attempt to identify areas where Hong Kong could perform at an even higher level.

Structure of the report and objectives

This first report centres on Hong Kong’s reliance on China for its current standing as an international financial centre. A range of factors could jeopardise Hong Kong’s role in the years ahead. We show in chapter 2 that Hong Kong is more susceptible to such shocks than may generally seem feasible given the scale of the financial sector activity it hosts. In the subsequent three chapters, we present three structural issues which may affect how a slowing of China’s economic expansion will affect local activity. The reader should understand the issues in each of these sectors (financial sector labour markets, trade in financial services with the Mainland, and corporate governance in Hong Kong) in order to understand the landscape which we describe in this report.

The three chapters on structural issues focus on changes which should make Hong Kong a more resilient international financial centre. In chapter 3, we show that Hong Kong’s financial sector employment may peak once growth plateaus at a lower level on the Mainland. Slowing growth on the Mainland and increased compliance costs will likely reduce Hong Kong financial sector employees’ marginal productivity. Recruiting

¹ We refer to the Hong Kong Special Administrative Region throughout the report as Hong Kong for ease of reference.
financial professionals with language skills and client relationships in the region is one possible way to expand the use of Hong Kong’s banking, securities, and asset management markets. Another is greater access to other regions, such as through APEC and/or ASEAN, in addition to Mainland China.

In chapter 4, we compare and contrast Hong Kong’s competitive advantages in several financial sub-sectors vis-à-vis centres of finance on the Mainland – particularly Shanghai, Shenzhen and to a lesser extent Beijing. We discuss ways of bolstering Hong Kong’s competitive advantages through the establishment of a fund management passporting scheme with the Mainland and ways of increasing liquidity in the offshore yuan deposit and securities markets in Hong Kong. In chapter 5, we describe a range of corporate governance reforms which would likely improve the ability of Hong Kong companies to attract portfolio investment. We describe how poor corporate governance practices (particularly self-serving activities by families and company insiders) deter external investment. We describe how to set up a database to help investors assess the extent of concentration in corporate ownership. We also describe measures aimed at strengthening Hong Kong companies’ boards of directors – including training and mentoring schemes for younger members.

The final chapters address directly how best to prepare for possible crises. In chapter 6, we describe how an economic and financial slow-down could occur on the Mainland (focusing on high local government leverage and poor disclosure of impaired bank lending). We also look at how decreases in trade and investment could affect Hong Kong asset values and the resilience of the banking sector. In chapter 7, we look at the regulatory changes needed to prepare Hong Kong for economic shocks coming from the Mainland, whether or not originating on the Mainland. Most significantly, we argue for the need for a thorough review of Hong Kong’s current financial regulatory structure and financial legislative foundation. In the last chapter, we look at the sequencing and timing of the reforms we propose with an eye on global macroeconomic events which make particular policies (such as reform of Hong Kong’s financial regulators) more urgent in the short term.

While we cover many topics in this report, given that this is the first of three reports, there are also many that are not addressed at this time. First, we do not address insurance intermediation, an important and growing feature of Asia’s financial system and key to Hong Kong’s future in regional fund management and long-term finance. With a new independent Insurance Authority probable in the near future, this is an area which will attract closer attention in our second report. Second, we did not address the many technical and specific recommendations generated from this year’s assessment exercise. Some of these include strengthening offshore yuan securities trading and interest rate determination. Third, we did not address in detail the recently launched mutual

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3 Local vocation, academic and language training in Hong Kong will also help Hong Kong develop as an international financial. We do not discuss these issues in this year’s report but will return to these in future reports.

4 We do not address ownership and control by the Mainland government in this report. We leave this for next year’s report.
connectivity of the Chinese securities markets. Such connectivity is a proposal we have made on a conceptual basis in separate work after the outset of this project. It raises a number of issues that will have to be addressed by Mainland and Hong Kong regulators. The intention is instead to focus on the larger and strategic issues, leaving further analysis for future reports. Some of these strategic issues – such as an analysis of Hong Kong’s initial public offering (IPO) markets – are the subject of ongoing discussions and more suitable to detailed treatment in subsequent reports. Fourth, we could not look at every issue or previous recommendation under consideration. A “grocery-list report” (one simply listing recommendations and commenting on them) would lose its message and lose the analysis of factors that determine Hong Kong’s place among international financial centres.

Our work differs from official, industry and other advisory bodies. As academics, we have the liberty to focus on the data and propose ideas, and take the liberty to do so herein. Moreover, each of the principal investigators of this project is pursuing both individual and collaborative research, and such research does not always fully overlap or concur with the recommendations made in this report.

Throughout this report (and in the two others which will follow in 2015 and 2017) our analysis seeks to answer one specific question: What policies and legislative/regulatory changes will maximise the long-run, risk-adjusted value of financial activities to Hong Kong, given that other international financial centre policymakers react strategically to such policies? Using data and analysis, we derive recommendations aimed at that sole objective.

Overview of the recommendations

Strategically placed throughout the report, our recommendations cover 5 general areas of policy change. Figure 1.1 shows the recommendations we make in this report. The first grouping addresses methods to help improve the way the public contributes to financial sector policymaking. The second group proposes ways that the directing minds of Hong Kong’s financial and commercial organisations can participate more actively in ensuring Hong Kong’s regulators adopt policies which actually improve Hong Kong’s competitiveness among international financial centres (rather than just copy international “best practice”). The third grouping looks at ways to broaden cooperation with China. The fourth grouping looks at ways to diversify Hong Kong’s financial sector to access opportunities beyond those presented by the Mainland. The final grouping of recommendations discusses ways of improving the way Hong Kong’s regulators work to help maximise the risk-adjusted returns to the financial sector as a whole.

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5 See Pauly (2011) for some of these recommendations and considerations.
Figure 1.1: Recommendations Organised Thematically

Enhancing public engagement in financial policy-making

Unless a political objective requires otherwise, require all reports financed with public money contain data-supported, SMART recommendations (Recommendation 4).

Put existing Memoranda of Understanding with Mainland authorities and other regulatory instruments which affect Hong Kong financial institutions operating on the Mainland online. Engage in public consultation about revised MoU (Recommendation 5).

Government and/or regulators should require (except when ambiguity is useful for strategic or political reasons) the use plain-English, justification of proposals using concrete data and links to internal or other studies, and where appropriate provide a cost-benefit analysis, in financial sector public consultations (Figure 19).

Deepening participation in Hong Kong’s financial and corporate affairs

Produce a brochure for dissemination in organisations like the Hong Kong Retirement Schemes Association to educate schemes’ investment committee members and trustees about risks of firms controlled by dominant shareholders who also engage in management and rights of shareholders under the HKEx Code of Corporate Governance (Recommendation 9).

Introduce provisions into the Hong Kong Code of Corporate Governance (new provision section G) requiring listed companies to: a) waive their right to sue for libel against good faith whistleblowers, b) adopt internal policies which prevent retaliation and c) reward good-faith whistleblowers (Recommendation 10).

Development of a working paper modelled after the UK’s “Transparency and Trust” working paper with the view to collecting and disseminating information about beneficial ownership in Hong Kong’s companies through a database like the CCASS Concentration database kept on the Webb-Site.com (Recommendation 11).

Encourage Directors in the Code of Corporate Governance (particularly non-executive directors) to learn the skills contained in programmes like the UK Institute of Director’s Board Evaluation Toolkit (Recommendation 12).

Create an HKEx committee with the terms of reference to create an apprentice system for junior directors and a market for directors so they can acquire experience (Recommendation 13).

Introduce a scheme into the Code of Corporate Governance (and consistent with Exchange Rule 8.11) allowing for independent directors such that shareholders not among the top 10% shareholders can nominate one or more independent directors (Recommendation 14).
**Broadening co-operation with China**

Government and/or regulators to develop a complete Draft Mutual Recognition Platform Agreement (Recommendation 6)

The HKMA should work with the PBOC and CBRC and one or more large collateral management providers to deepen amounts available to Hong Kong banks for Mainland inter-bank lending, and increase the number of banks able to give-receive collateral services (Recommendation 7).

Hong Kong should develop proposals for an appropriately regulated euro-yuan market in Hong Kong which does not conflict with Hong Kong’s international obligations (Recommendation 8).

**Diversifying financial services away from dependence on the Mainland**

The government and/or SFC should focus on legal and regulatory changes needed to support funds passporting across multiple markets from Hong Kong. Such changes would allow for asset managers (wealth managers) to legally solicit for business in each others’ markets (Recommendation 1).

The SFC should negotiate at least one Memorandum of Understanding setting up a Foreign Qualified Regulated Persons Scheme as we describe in this report (Recommendation 2).

The government should conduct a study of legal issues involved in Hong Kong’s observer status in the ASEAN Capital Market Forum and leadership of a “Hong Kong ASEAN Passporting Scheme” (Recommendation 3).

Create the statutory basis for open-ended investment companies (Recommendation 16).

Once amendments from the previous recommendation appear in the Companies Ordinance, the SFC adopt a Code on Open-Ended Investment Companies (Recommendation 17).

**Reforming Hong Kong’s Regulators**

Provide the Hong Kong Monetary Authority with an explicit mandate to address financial stability across the entire financial system (Recommendation 15).

Empanel a Financial Regulatory Structure Working Group to conduct a thorough review of Hong Kong’s existing financial regulatory system with recommendations for strategic enhancement (Recommendation 18).

The government and/or regulators should conduct a regulatory guillotine of Hong Kong’s financial sector regulations in parallel with the work of the Financial Regulatory Reform Working Group (Recommendation 20).

Establish the Financial Services Development Council as a public body with clear mandate and resources necessary to fulfil it (Recommendation 21)
Enhancing public engagement in financial policy-making

Although, given the size of the Region, Hong Kong’s regulators are considerably more accessible than those in larger jurisdictions like the United States and the United Kingdom, Hong Kong regulatory consultations tend to focus on implementation rather than overall strategy and cost-benefit analysis, with limited empirical basis. Such a gap can lead to regulatory failures.

To address this gap, we provide three (3) recommendations in this report which should help close this gap. First, regulators should publish existing Memoranda of Understanding with Mainland authorities and all regulatory instruments which affect Hong Kong financial institutions operating on the Mainland available online (recommendation 5). Second, we recommend that regulators use plain-English and publish their underlying analysis including cost-benefit appraisals with any consultation documents (recommendation 19). Third, unless ambiguity serves as administrative or political purpose, justification for banking and securities policymaking changes should include data and cost-benefit analyses (recommendation 19).

Deepening participation in Hong Kong’s financial and corporate affairs

The trend in most upper-income economies has tended toward more investment in these countries’ publicly listed corporations. Many locally listed corporations remain stubbornly closely held – discouraging foreign investment. How can Hong Kong’s regulators encourage foreign financial and operational participation in local financial and other corporations? We provide six (6) recommendations aimed at encouraging the outsider participation in Hong Kong’s corporations needed to attract long-run and stable investment.

Our first sub-set of recommendations encourages such participation through the development of more active mutual fund markets. First, we recommend that the development of a brochure for dissemination in organisations such as the Hong Kong Retirement Schemes Association to educate schemes’ investment committee members and trustees about risks of firms with dominate shareholders also serving in management and rights of shareholders under the HKEx Code of Corporate Governance (recommendation 9). Second, we recommend the creation of a “concentration database” (recommendation 11). This would resemble those maintained by commercial and other governance monitors, including for example the one concentrating on locally-listed

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6 We acknowledge the difficulties inherent in cost-benefit analysis, and the potential distortion such analysis might have on policymaker’s objectives. We do not necessarily argue that policymakers’ decisions be ruled only by such analysis. Hong Kong’s policymakers will certainly use other criteria as well in reaching decisions.
7 Hong Kong has many widely held companies, like HSBC and Bank of East Asia. We discuss the extent to which shareholding patterns correlate with company performance in a later chapter.
8 We do not argue against all family or concentrated shareholding. Concentrated shareholding may reduce some kinds of agency problems. We refer to empirical studies we cite later that concentrated holdings tend to lower performance specifically in the Hong Kong context.
companies managed by David Webb. However, the database would show beneficial interests in Hong Kong listed companies and allow investors and regulators to better understand the risks (and returns) posed by concentrations of ownership.

In a series of four (4) recommendations, we encourage Hong Kong’s corporations to enhance the rights of minority shareholders and outside interests. Ceding such control will only encourage larger amounts of investment. First, we recommend introducing provisions into the Hong Kong Code of Corporate Governance (new provision section G) basically setting up a corporate whistleblowers scheme (recommendation 10). Second, we recommend using the Code of Corporate Governance to encourage directors (particularly non-executive directors) to learn the skills contained in programmes such as the UK Institute of Director’s Board Evaluation Toolkit (recommendation 12). Third, we recommend creating an HKEx committee with the terms of reference to create an apprentice system for junior directors and a market for directors so they can acquire experience (recommendation 13). Fourth, we recommend introducing a scheme for independent directors into the Code of Corporate Governance such that shareholders not among the top 10% shareholders can appoint one or more independent directors (recommendation 14).

**Broadening co-operation with Mainland China**

The Mainland represents Hong Kong’s most important and semi-captive opportunity in further developing asset and wealth management services, corporate advisory, trade finance and securities issuance services. Yet, the rapid expansion of financial services in Beijing, Shanghai and Shenzhen threaten to make Hong Kong far less attractive to Mainland and other clients. Mainland China’s ever-growing network of ties with other centres such as Frankfurt, London and Singapore also threaten to side-line Hong Kong. What can Hong Kong policymakers do in order to protect the share of Mainland financial business transacted through Hong Kong?

We provide three recommendations aimed at making Hong Kong more indispensable to Mainland corporate and financial interests. First, we recommend that the development of a Mutual Recognition Platform Agreement (recommendation 6). Second, we recommend that the HKMA (working with the People’s Bank of China and the Chinese Banking Regulatory Commission) should work with market actors (collateral management providers) to deepen the liquidity available to banks for onshore inter-bank lending, and increase the number of banks able to provide collateral services (recommendation 7). Third, proposals should be developed conducive to regulation of the offshore yuan

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9 We plan to expand this suggestion in future work by suggesting the use of Central Clearing and Settlement System (CCASS) and non-CCASS sources (like disclosure of interest data found in companies’ financial statements), combined with an easy-to-use interface for easy data retrieval.

10 A number of existing initiatives already exist for training directors. The Hong Kong Institute of Directors and Hong Kong Institute of Chartered Secretaries represent example of training service providers.

11 Such a recommendation could negatively impact on managerial efficiency and provide a conduit for the use of insider information. Taking apprentices from the company’s own management represents an ideal way of running such an apprentice system.
market in Hong Kong which do not conflict with Hong Kong’s international obligations
(recommendation 8).

**Diversifying financial sector opportunities**

We argue throughout this report that China may at some point in the not-to-distant future experience some form of banking and/or financial crisis.\(^{12}\) Any such shock will have significant effects on Hong Kong’s securities, real estate and banking sectors. What can Hong Kong do to ensure that if a financial crisis in China does occur, the value of deposits in Hong Kong’s banks, funds deposited with its brokers and revenue from new issues and other transactions do not collapse? Our main approach focuses on diversifying the Hong Kong financial sector to enable access to a wider range of opportunities and from over-reliance on the Mainland. We argue that developing client relationships within the ASEAN states and other regions can complement those directed to the Mainland.

Our five recommendations aim to further develop vibrant financial services markets in the ASEAN and other regions, with Hong Kong as an innovative and instrumental player. First, the government and/or SFC should focus on legal and regulatory changes needed to support funds passporting across multiple markets from Hong Kong. Such changes would allow for asset (and wealth) managers to legally solicit clients across borders subject to acceptable regulatory recognition (recommendation 1). Second, the SFC should make provision for a foreign country equivalence examination and continuing professional education on securities law and practices in foreign jurisdictions in fulfilment of offshore licensing requirements (recommendation 2).\(^{13}\) Third, the government should work with ASEAN members to implement a passporting scheme – using the ASEAN investment liberalisation initiative (recommendation 3). Fourth, a statutory basis for open-ended investment vehicles needs to be put in place (recommendation 16). Fifth, once amendments from the previous recommendation appear in the Companies Ordinance, the SFC should adopt a code on such open-ended investment companies, structures and other structures (recommendation 17).

**Hong Kong’s financial regulators**

Hong Kong’s current regulatory structure was created primarily in reaction to events in the 1970s and 1980s, albeit also with reference to experiences during the 1990s. Since then, broker-dealers and banks have converged in product offerings. In this report, we highlight three major reasons why the institutional structure governing Hong Kong’s financial services regulators should be changed. First, the web of Memoranda of

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\(^{12}\) For an alternate view, see Anderlini for a discussion about one of the many voices arguing for the remoteness of such a possibility.

\(^{13}\) Such a recommendation may controversially imply the future recognition of foreign continuing professional development points. The passporting we recommend may also work also at the level of the “responsible persons” licensed to perform “regulated activities” under the Securities and Futures Ordinance. The details of these proposals is the subject of ongoing work.
Understanding and the over-lapping competencies of the Hong Kong Monetary Authority (HKMA), Securities and Futures Commission (SFC) and others can no longer ensure Hong Kong’s regulators engage in prudential regulation and exercise adequate discipline over Hong Kong’s banking and securities markets. Second, a growing body of research indicates that dividing regulators by policymaking (prudential regulation) and enforcement (market discipline) can tackle risks emerging in the post-2000s internationalised financial services sector better than having a system of sector-specific regulators, particularly one with significant overlaps and complexities. Third, many of the major threats to Hong Kong’s banking sector will come from securities markets. Many of the threats to its securities markets will come from its banking (and insurance) sectors.

Having regulators focused mainly on specific types of institutions or markets fails to address these risks. We understand that a 1990s trend favouring unitary regulators (followed by the UK, Germany and France, among others) has now been discredited in the UK and replaced with another trend toward a “twin-peaks” model used in Australia, while the institutionally oriented models of the US and China have not been fundamentally altered for decades. We also understand that if Hong Kong and China were to use complementary models, this could facilitate both liaison and eventual integration.

To tackle these issues, we outline three measures discussed by Hong Kong’s financial sector advisors for years. First, we propose the HKMA hold responsibility for financial stability of Hong Kong’s entire financial system. Second, we propose creating a financial regulatory structure working group (recommendation 18). The working group would analyse Hong Kong existing structure in light of local, regional and international experiences and recommend changes. Under one possible model, usually referred to as “twin peaks”, a Prudential Regulation Authority would oversee rulemaking across banking, securities, insurance and other financial institutions. A Financial Conduct Authority would help ensure the detection and punishment of market misconduct – in whatever financial sub-sector it occurs. At the same time, we propose a “regulatory guillotine” of the ever expanding financial legal system (recommendation 20) to help simplify the work of the regulators (and the regulated). Such a regulatory rewrite would allow the new regulators to focus on “outcome based” regulation – rather than enforcing a growing body box-ticking rules criticised by our financial industry.

We also discuss the way the new Financial Services Development Council (FSDC) can play a pro-active role in enhancing Hong Kong’s development as a leading international financial centre. This is a role that the government is required to undertake under Article 109 of the Basic Law. At this point, the FSDC is potentially one way forward but would require an explicit mandate in order to be most effective in this context. Absent this, the government should devise a structured mechanism to address its Article 109 obligations and support the future development of Hong Kong as an international financial centre. The FSDC should be a public body (recommendation 21).
Conclusion

How can Hong Kong’s policymakers help increase the long-run (equilibrium) risk-adjusted value of assets under management in Hong Kong, knowing that other jurisdictions will react strategically to policies adopted here? In other words, how can policymakers help improve Hong Kong’s performance among international financial centres? In this report, we argue that Hong Kong’s policymakers should take a range of immediate and longer-range steps in order to ensure Hong Kong’s financial institutions do not lose large amounts of assets when a financial crisis comes to Hong Kong (probably through China). Any international financial centre can perform well during periods of stable growth. If Hong Kong wants to maintain and enhance its performance as one of the world’s leading international financial centres, its policies must help ensure the preservation of capital during crisis conditions. We provide 21 recommendations which should help Hong Kong’s policymakers best strengthen the Region against potential instability, while increasing its efficiency and competitiveness.
Key Recommendations
(in the order they appear in the text)

**Recommendation 1:** The government and/or SFC should focus on legal and regulatory changes needed to support funds passporting across multiple markets from Hong Kong. Such changes would allow for asset managers (wealth managers) to legally solicit for business in each others’ markets.

**Recommendation 2:** The SFC should negotiate at least one Memorandum of Understanding setting up a *Foreign Qualified Regulated Persons Scheme* as we describe in this report.

**Recommendation 3:** The government should conduct a study of legal issues involved in Hong Kong’s observer status in the ASEAN Capital Market Forum and leadership of a “Hong Kong ASEAN Passporting Scheme”.

**Recommendation 4:** Unless a political objective requires otherwise, require all reports financed with public money contain data-supported, SMART recommendations.

**Recommendation 5:** Put existing Memoranda of Understanding with Mainland authorities and other regulatory instruments which affect Hong Kong financial institutions operating on the Mainland online. Engage in public consultation about revised MoU.

**Recommendation 6:** Government and/or regulators to develop a complete Draft Mutual Recognition Platform Agreement.

**Recommendation 7:** The HKMA should work with the PBOC and CBRC and one or more large collateral management providers to deepen amounts available to Hong Kong banks for Mainland inter-bank lending, and increase the number of banks able to give-receive collateral services.

**Recommendation 8:** Hong Kong should develop proposals for an appropriately regulated euro-yuan market in Hong Kong which does not conflict with Hong Kong’s international obligations.

**Recommendation 9:** Produce a brochure for dissemination in organisations like the Hong Kong Retirement Schemes Association to educate schemes’ investment committee members and trustees about risks of firms controlled by dominant shareholders who also engage in management and rights of shareholders under the HKEx Code of Corporate Governance.

**Recommendation 10:** Introduce provisions into the Hong Kong Code of Corporate Governance (new provision section G) requiring listed companies to: a) waive their right
to sue for libel against good faith whistleblowers, b) adopt internal policies which prevent retaliation and c) reward good-faith whistleblowers.

**Recommendation 11:** Development of a working paper modelled after the UK’s “Transparency and Trust” working paper with the view to collecting and disseminating information about beneficial ownership in Hong Kong’s companies through a database like the CCASS Concentration database kept on the Webb-Site.com.

**Recommendation 12:** Encourage Directors in the Code of Corporate Governance (particularly non-executive directors) to learn the skills contained in programmes like the UK Institute of Director’s Board Evaluation Toolkit.

**Recommendation 13:** Create an HKEx committee with the terms of reference to create an apprentice system for junior directors and a market for directors so they can acquire experience.

**Recommendation 14:** Introduce a scheme into the Code of Corporate Governance (and consistent with Exchange Rule 8.11) allowing for independent directors such that shareholders not among the top 10% shareholders can nominate one or more independent directors.

**Recommendation 15:** Provide the Hong Kong Monetary Authority with an explicit mandate to address financial stability across the entire financial system.

**Recommendation 16:** Create the statutory basis for open-ended investment companies.

**Recommendation 17:** Once amendments from the previous recommendation appear in the Companies Ordinance, the SFC adopt a Code on Open-Ended Investment Companies.

**Recommendation 18:** Empanel a Financial Regulatory Structure Working Group to conduct a thorough review of Hong Kong’s existing financial regulatory system with recommendations for strategic enhancement.

**Recommendation 19:** Government and/or regulators should require (except when ambiguity is useful for strategic or political reasons) the use plain-English, justification of proposals using concrete data and links to internal or other studies, and where appropriate provide a cost-benefit analysis, in financial sector public consultations.

**Recommendation 20:** The government and/or regulators should conduct a regulatory guillotine of Hong Kong’s financial sector regulations in parallel with the work of the Financial Regulatory Reform Working Group.

**Recommendation 21:** Establish the Financial Services Development Council as a public body with clear mandate and resources necessary to fulfil it.
Chapter 2: What Do the Data tell us about Hong Kong as an IFC?

In this chapter, we present some of the background data needed to understand Hong Kong’s place among international financial centres. Hong Kong typically ranks in third or fourth place in commercial or academic surveys of international financial centres. Figure 2.1 shows the most recent rankings of overall competitiveness of each financial centre according to consultants Y/Zen, placing Hong Kong third in overall competitiveness. Its investment management, banking, insurance and professional services sub-sectors all rank in the top 5. Hong Kong’s official and commercial marketing materials frequently refer to these rankings. And the results have become popular – with frequent citations in published and broadcast media. Other surveys, such as the Xinhua-Dow Jones International Financial Centre Development Index for 2013, also place Hong Kong third, behind New York and London.

Figure 2.1: Hong Kong Ranks Third in a Z/Yen ‘Survey of Surveys’

<table>
<thead>
<tr>
<th>Rank</th>
<th>Overall</th>
<th>Investment Management</th>
<th>Banking</th>
<th>Government and Regulation</th>
<th>Insurance</th>
<th>Professional Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>New York</td>
<td>London</td>
<td>Hong Kong</td>
<td>New York</td>
<td>Hong Kong</td>
<td>New York</td>
</tr>
<tr>
<td>3</td>
<td>Hong Kong</td>
<td>Singapore</td>
<td>London</td>
<td>Hong Kong</td>
<td>New York</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>4</td>
<td>Singapore</td>
<td>Hong Kong</td>
<td>Singapore</td>
<td>Zurich</td>
<td>Singapore</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>5</td>
<td>Zurich</td>
<td>Tokyo</td>
<td>Seoul</td>
<td>Geneva</td>
<td>Zurich</td>
<td>Geneva</td>
</tr>
<tr>
<td>6</td>
<td>Boston</td>
<td>Zurich</td>
<td>Boston</td>
<td>Tokyo</td>
<td>Monaco</td>
<td>Boston</td>
</tr>
<tr>
<td>7</td>
<td>Geneva</td>
<td>Toronto</td>
<td>Zurich</td>
<td>Frankfurt</td>
<td>Geneva</td>
<td>Sydney</td>
</tr>
<tr>
<td>8</td>
<td>Frankfurt</td>
<td>Sydney</td>
<td>Geneva</td>
<td>Paris</td>
<td>Luxem’g</td>
<td>Tokyo</td>
</tr>
<tr>
<td>9</td>
<td>Seoul</td>
<td>Geneva</td>
<td>San Fran’</td>
<td>San Fran’</td>
<td>Oslo</td>
<td>Toronto</td>
</tr>
<tr>
<td>10</td>
<td>Geneva</td>
<td>San Fran’</td>
<td>San Fran’</td>
<td>Oslo</td>
<td>Toronto</td>
<td></td>
</tr>
</tbody>
</table>

We refer to the Y/Zen approach as a survey of surveys because it relies on an index of over 80 surveys and indicators from other sources. Only about 15 of them actually measure the volume and value of financial transactions in the markets indicated. Source: Y/Zen (2013)

Source data suggests that Hong Kong may not rank in third place according to a fully objective standard. Figure 2.2a shows one substantive metric, the volume of portfolio investment in US dollar terms. In terms of portfolio assets, Hong Kong ranks in sixth place. Yet, Hong Kong’s total portfolio assets value at less than 1/15th of those in the US.

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1 We do not have the space to define rigorously such international financial centres or discuss their typical features. See Lejot (2014) and Zorome (2007) for fuller discussions.
2 InvestHK (2012) provides a number of these examples.
3 Rather than citing each source individually, we provide a link to the search page. Interested readers may repeat our search to see just how far Hong Kong’s third place ranking has entered into the popular discourse.
4 The IMF does not fall into the trap of relying on a survey of surveys. In their overview of Hong Kong as a global financial centre, they use only objective measures (Leung and Unteroberdoerster, 2008). The HKMA staff do not take this approach either. In their survey of Hong Kong as an international financial centre, they place Hong Kong sixth according to their “world concentration of traditional financial activities” measure (Cheung and Yeung, 2007).
Several other measures of the depth of various financial markets indicate Hong Kong ranks well below third place. In foreign exchange turnover, Hong Kong ranks in 6th place. Yet, in value terms, Hong Kong transacts less than 1/10th of top-ranking UK’s total. Rank-based measures of Hong Kong’s place among international financial centres – and particularly Y/Zen’s Global Financial Centres Index – arguably inflate the absolute standing and contribution of Hong Kong’s financial sector.

So what does the Global Financial Centres Index actually measure? The index represents an index of indices: a survey of surveys. Figure 2.3 shows the International Financial Centre rankings of the top 4 jurisdictions over time. We also show some of the components of these rankings. Of the 80 indicators Y/Zen uses, only about 20 of them relate to the size of finance in that jurisdiction. Other indicators serve as proxies for each jurisdiction’s political or electoral system, the liberalness of its economic and trade policies, the amount of pollution and a range of other factors. The other set of data used

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5 We leave the reader to the many studies we cite in this chapter and in subsequent chapters. We do not review volumes traded in various markets as several other authors have already done this.

6 See Appendix IV of the Y/Zen publication for the entire list.
to construct the index consists of online surveys. The online survey itself requires the user to have accurate, in-depth and correct assessments of 32 cities – leaving no room for an “I don’t know” response. These surveys measure perceptions about an international financial centre rather than the attractiveness of any centre itself. Like other such questionnaire-based indices, previous Y/Zen rankings probably strongly influence the people who fill in these online surveys. Survey respondents, having a pre-conceived view of a financial centre’s ranking, may give it a particular rank because of its previous ranking rather than because of the centre’s inherent attractiveness.

Resilience represents another, usually over-looked and just as important, measure of an international financial centre. The extent to which an international financial centre copes with economic shocks determines its longer-run viability. In figures 2.4,

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7 The use of principal components analysis represents another area ripe for critique. However, as this report seeks to find ways to improve portfolio flows to Hong Kong (and not to critique the Z/Yen study), we provide no further analysis of the survey.
8 As Wojcik notes, rating methodologies intentionally focus on financial centres’ competitiveness (however defined) rather than their size, and use measures of market sentiment. Such measures rely on surveys among market participants, as an important input into ratings. Such surveys allow for large changes in rankings over time. Such volatility may, depending on one’s point of view, reflect either appropriate responsiveness to changes in actual financial centre competitiveness or simply a method to generate variability which attracts media organisations’ interest. See Wojcik (2013) for a discussion on the virtues and vices of financial centre development indices.
9 See Thompson and Shah (2005) for an example of the use of these indices of indices which have an online survey component.
10 See Kreston and Wojcik (2013a and 2013b) for examples of research on the resilience of financial centres to crises.
11 Macroeconomic shocks can significantly affect Hong Kong financial institutions’ holdings of foreign securities and deposits. See Buch, Carstensen and Schertler (2010) for recent cross-country data.
we show the robustness of Hong Kong’s banks to economic shocks. The figure specifically shows the size of the shock needed to drive Hong Kong banks into bankruptcy. In the first panel (figure 2.4a), we show the time-to-bankruptcy scores for Hong Kong, compared with other international financial centres. Only Switzerland, Korea and the UK require smaller shocks in order to drive their banks into bankruptcy. 12 More worryingly, Hong Kong’s fragility seems to have increased over time. Figure 2.4b shows the way Hong Kong banks’ z-scores have changed over time. 13 Hong Kong’s banks specifically have become more fragile over the decade, with the uncertainty of bank returns and bank equity getting smaller over time as risk has increased.

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**Figure 2.4a: The "Tidal Wave" Needed to Knock Over Hong Kong's Banks is Much Smaller than in Most Rival IFCs**

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Size of Shock Needed to Bankrupt</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>30</td>
</tr>
<tr>
<td>Singapore</td>
<td>25</td>
</tr>
<tr>
<td>Japan</td>
<td>20</td>
</tr>
<tr>
<td>Germany</td>
<td>15</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>5</td>
</tr>
<tr>
<td>Switzerland</td>
<td>10</td>
</tr>
<tr>
<td>Korea</td>
<td>5</td>
</tr>
<tr>
<td>UK</td>
<td>5</td>
</tr>
</tbody>
</table>

The figure shows the bank z-scores for each jurisdiction in 2011. The z-score represents the average return on assets plus the ratio of equity-to-assets divided by the standard deviation of the return on assets. The z-score measures the number of standard deviations a financial institution's rate of return on assets can fall in a year becoming insolvent. Higher scores are “better” (lower probability of bank insolvency).


**Figure 2.4b: Size of Shock Needed to Bankrupt Hong Kong's Banks has Been Getting Smaller while Size of Shocks Menacing It Grow Larger**

The data in the figure show the size of the shock needed to bankrupt Hong Kong's banks (z-scores). Overtime, the ability of Hong Kong's banks to withstand sizeable shocks has fallen.


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12 By the time of publication, these data will almost certainly have changed. The UK has taken aggressive policy measures to capitalise its banks (Prudential Regulation Authority, 2013).
13 Cihak et al. (2013) provide the best definition of such z-scores. As many regulators and academics do not (yet) use z-scores, we repeat their explanation in full. Namely, “the z-score is defined as \( z = \frac{(k+\mu)}{\sigma} \), where \( k \) is equity capital as percent of assets, \( \mu \) is return as percent of assets, and \( \sigma \) is standard deviation of return on assets as a proxy for return volatility. The popularity of the z-score stems from the fact that it has a clear (negative) relationship to the probability of a financial institution’s insolvency, that is, the probability that the value of its assets becomes lower than the value of its debt...A higher z-score therefore implies a lower probability of insolvency.”
When taken together, objective market data are less encouraging. Hong Kong’s financial activity levels (by most objective measures and by the HKMA’s own studies) lag behind those of London and New York, and in many cases fall below third place. Hong Kong, while not extremely vulnerable to economic shocks, still falls further behind other jurisdictions.\textsuperscript{14} Hong Kong’s banking sector also has a far less diversified client base than other jurisdictions such as Singapore.\textsuperscript{15} In other words, Hong Kong represents a riskier banking environment than London or New York.

\textit{Hong Kong’s entrepot equity finance}

Hong Kong excels at attracting investment. Figure 2.5 shows the value of equities listed on Hong Kong’s stock market, compared with those of other international financial centres. The market capitalisation of Hong Kong’s stock markets (as a percent of GDP) eclipses other economies, at roughly 600\% of GDP.\textsuperscript{16} In other words, if all investors divested their holdings in Hong Kong listed companies, the value would equal six times the value of overall annual output.\textsuperscript{17} In other economies – like the UK, Singapore, Japan and Germany – their market capitalisations more closely equate to the value of the economies they locate in. At first glance, the data seem indisputable. Hong Kong’s economy is marked by the characteristic of being an international financial centre without large domestic base. Hong Kong market capitalisation far exceeds the productive value of the Hong Kong economy.\textsuperscript{18}

\textsuperscript{14} We do not want to present an overly pessimistic view of Hong Kong’s fragility. When confronted with normal shocks, Hong Kong’s banking institutions will hold up well. For recent data and analysis, see HKMA (2013).
\textsuperscript{15} Garcia-Herrero (2011) provides data to support this assertion.
\textsuperscript{16} As Hong Kong markets serve the Mainland as well as Hong Kong, dividing data in this chapter by combined Mainland and Hong Kong GDP might make more sense. We do not use Mainland GDP in following with standard practice. If we used combined Mainland and Hong Kong GDP as a measure, the ratio would fall to about 10\% of GDP according to one measure.
\textsuperscript{17} We use this simple and intuitive explanation to show that stock market capitalisations probably reflect the supply and demand for shares (of course) rather than the value of the underlying assets those companies produce. Naturally, selling shares will depress their price and decrease the actual market capitalisation of these companies. Many Hong Kong listed companies come from abroad – making this simple thought-exercise somewhat misleading.
\textsuperscript{18} A detailed analysis of the reasons why market capitalisation is so high falls outside the scope of this report. Part of the reason lies in the foreign ownership and operation of many of these companies (many of these companies represent Mainland companies whose value would naturally far exceed the real value of the economy these companies nominally list in). High property prices also provide part of the explanation. In fact, scholars have not yet studied and explained in any in-depth Hong Kong’s market capitalisation levels. Garcia and Liu (1999) and Tse (2001) provide a general discussion. This is clearly an area meriting further research.
Hong Kong’s economy has also remained buffered from the global financial crisis. The figure also shows changes in stock market capitalisation from 2009 to 2012 (the period of greatest adjustment to the 2007-8 global financial crisis). As shown, Hong Kong’s market capitalisation fell over the 2009-2012 period by only about 4%. In contrast, the US lost about 15% of its market capitalisation and Singapore lost almost 10% of its market capitalisation. Economies such as South Korea and Germany showed greater stability than Hong Kong during the crisis. However, the fact remains that Hong Kong’s equities markets demonstrated significant resistance to external shocks. As we explain later in this report, such insulation from the global financial crisis came about from Hong Kong’s close trade and investment ties with a large economic power which grew steadily even during the financial crisis.

In addition, Hong Kong’s market capitalisation combines a large number of small companies with a smaller number of larger companies, mainly Mainland companies, Hong Kong conglomerates and property developers, and HSBC. Figure 2.6 shows the way the market capitalisation we showed above divides over (into) the companies listed in each international financial centre. In other words, we divided the market capitalisations shown in the previous figure by the number of companies listed in that jurisdiction. On a per-company basis, Hong Kong slides from the top of the list toward the bottom. Many small companies list in Hong Kong, a characteristic attractive to most exchanges in developed economies, especially those with special listing rules or separate markets for smaller entrants, but these data are equally indicative of a body of ‘main board’ Hong Kong listed companies that are either dormant, failing to expand, or expanding activity through non-listed affiliates. One way for HKEx to encourage expansion would be to provide incentives for follow-on or secondary listings, as well as trying to maximise the number of new IPOs.

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19 We only want to show the size and nature of this fragility rather than attempt to explain its causes. For an example of the way the US sub-prime crisis spilt over to China and Hong Kong, see Sun and Zhang (2009). Wojcik (2011) provides a discussion on the market capitalisation to GDP ratios around the world.

20 These data suggest that Hong Kong regulators should not seek to maximise the number of IPOs. We purposely avoid discussing the IPO market – leaving it for our second report in 2015.
Hong Kong appears easily able to attract cross-border direct investment, despite its indigenous private equity and venture capital resources having expanded only recently. A significant and persistent explanation is the relatively free access to new and expanding Mainland ventures given to foreign direct investment (FDI), which has resulted since the 1980s in Hong Kong becoming an entrepôt for FDI sourced from Greater China and elsewhere. Not all of these flows are spurious, but a portion will be intended to avoid Mainland controls on foreign portfolio investment and lending, or circumvent rules concerning the repatriation of foreign currency earnings.

Figure 2.7 shows Hong Kong’s gross annual inward FDI since 2005, results that in cyclical terms appear similar to those for the US in the same period. To the extent that FDI is deployed in Hong Kong, it may help improve capital productivity and risk-adjusted returns. To the extent that inward FDI is used elsewhere, its value to the local financial sector is limited either to compensation for simple transaction execution by banks or corporate advisors, or dividends reinvested locally by the sources of FDI.

Figure 2.8 shows the distribution of Hong Kong’s outward and inward foreign investment. Investment in real estate represents the lion’s share of such investment (more than half in
both cases). These flows clearly reflect large construction projects by Hong Kong’s real estate companies at home and on the Mainland. Other economists have suggested that up to half of Hong Kong’s FDI into China represents the result of capital round-tripping. These arrangements may not survive unaltered if China’s liberalisation of financial markets and capital controls progresses, except to the extent that Mainland ‘flight capital’ finds precautionary reasons for directing capital to Hong Kong.

Other data suggest that Hong Kong’s role as an international financial centre fails to fully bolster its real economy. One measure of the usefulness of Hong Kong’s role as an international financial centre revolves around the extent to which it helps create sustainable business clusters. To date, no rigorous study has shown whether Hong Kong’s financial sector represents a sustainable and competitive business cluster. However, we do have proxies for real data. Figure 2.9 shows the extent to which foreign executives think Hong Kong has developed sustainable and competitive business clusters.

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21 A later chapter shows how employment in the Hong Kong real estate sector exceeds (as a proportion of professional services employment) the share in leading international financial centres other than Singapore, partly reflecting the centrality to the local economy of property development based on the accretion of government land.

22 In this version of Hong Kong-Mainland investment, Mainland parties inflated the invoice value of exports to Hong Kong. They use the proceeds to reinvest in the Mainland in the guise of foreign investment (Han, 2011). Wójcik and Camilleri (2013) discuss the role of offshore financial centres in Hong Kong FDI.

23 Similar considerations have traditionally attracted FDI to Singapore from neighbouring Southeast Asian states. The finance literature customarily assumes that multinational firms use FDI to enter new markets, exploit proprietary technology or brand capital, or take advantage of low cost foreign factor inputs. Chen (2011) explains Hong Kong’s investment flows to China without addressing any distinct reasons for Hong Kong’s inward FDI.

24 Many studies purport to look at the extent to which Hong Kong’s financial centre represents a sustainable business cluster (and give advice about what to do to improve the competitiveness of Hong Kong’s financial sector cluster). At this point, no comprehensive study exists for financial services. For a good example of a cluster analysis for financial services which the reader can see and manipulate online, see US Cluster Mapping, available online. Ketels and Solvell (2011) provide an example from the EU showing financial sector competitiveness.
Compared to the jurisdictions hosting other international financial centres, Hong Kong ranks poorly for cluster development and competitive advantage. These data suggest that the large volumes of portfolio investment coming to Hong Kong do not actually make its real economy more competitive and productive. Hong Kong’s success in generating investment banking transactions is a signal of socio-commercial effectiveness in networking typically associated with sectoral clustering, but the extent to which this feeds the non-financial sector in positive ways is less clear.

![Figure 2.9: Business System Indicators Place Hong Kong Toward the Bottom](image)

The data in the figure show indicators from the Global Competitiveness Forum’s annual survey about the state of cluster development compared with the nature of each country’s competitive advantage. Source: Global Competitiveness Forum (2012).

So what does all this mean? Hong Kong attracts a significant amount of portfolio and direct investment. However, such investment seems to fuel Hong Kong’s volatile real estate sector rather than more productive sectors. Such investment does not seem to correlate (to the extent one might expect) with the development of competitive clusters (though we do not include neighbouring centres of production in Guangdong province in our analysis).

*Increased compliance likely to decrease competitiveness*

Banking analysts tend to associate sectoral competitiveness with management’s capacity to control variable costs while maximising non-recurring revenues from transaction generation and non-credit based activities. Focusing on the cost part of the equation, Hong Kong banks’ overhead costs rate among the largest among its international financial centre peer group. Figure 2.10 shows overhead costs in Hong Kong compared with other jurisdictions – roughly twice as high as in other jurisdictions (except the US). Naturally, different banks exhibit differing overhead costs – suggesting that regulation (at

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25 Most analysts increasingly view Hong Kong as part of a semi-integrated Pearl River Delta. To the extent Hong Kong’s financial sector serves the broader region, Hong Kong policymakers should worry less about these data. We provide a brief discussion about this in the chapters to follow.

26 High sectoral overheads may stem from a lack of competition. Chu et al. (2013) provide evidence of oligopoly power in Hong Kong banking sector.
least in part) impacts on different banks in very different ways. However, when banks – on average – have higher overhead costs in one jurisdiction than in others, such differences signal a regulation-induced distortion.

Figure 2.10: Hong Kong’s Financial Institutions Have the Largest Overheads

The data in the figure show the ratio of overhead assets to total assets for financial institutions in a range of jurisdictions for 2011. As the ranking of these overheads between countries does not change over time, we did not take an average.


What do cost and net revenue variations tell us about bank regulation in Hong Kong? In theory, we would not expect to see large variation in costs and profits. Results within the sector can be expected to be similar, subject to cyclical changes in loan impairments and general economic conditions (with variations due to differences in strategy, deployment of regulatory capital, quality of management, or unexpected credit impairments). Hong Kong’s higher cost banks might have incentives to shift their target customer segments or “prune” less profitable customers, were it not for the domestic banking market being saturated. Figure 2.11 shows the relationship between overall revenue and costs as a proportion of revenue. Using 2012 as an illustrative year, we see significant variation in cost-to-income ratios as well as revenue, taking net interest margins as a proxy, such variations appearing among banks of similar origin (local, foreign or Mainland).

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27 Differences in business strategy, local markets, customers and a range of other factors may explain difference in overhead costs. However, many of these effects should cancel out (in our analysis) when we look at a wide range of banks which operate in the same market pointing to “asymmetric regulatory impacts” (differing impacts on different banks).

28 Given that bank lenders adopt similar practices and structures in order to collect deposits and create credit, differences in overall expenses tend to be attributable to variable endogenous and regulatory costs.

29 All countries’ banking sectors exhibit variation in bank revenues and costs between banks. Variation reflects normal market processes. However, high and asymmetric variation may suggest that regulations have an inefficient impact on banking sector (by giving competitive advantages to some over others).
The data in the figure show the relationship between net interest margins and cost-to-income ratios in 2012 for a range of banks operating in Hong Kong. We have drawn the line of best fit for each relationship between cost-to-income ratios and net interest margins for each group of banks. For example, the downward sloping black line shows that net interest margins fell in 2012 for local banks as their costs rose—meaning they didn’t seem to spend money on things that would raise their profits. In contrast, the Chinese banks did. The colored bars on the right hand side of the graph and at the bottom show the range of net interest margins and cost-to-income ratios for each group of banks. Cost-to-income ratios differed most across banks for international bank operating in Hong Kong. Net interest margins varied most for international banks operating in Hong Kong.

Source: KPMG (2012).

Hong Kong revenue and cost data highlight three potential trends interest for supervisors and bank management. First, in contrast to other sub-groups, Chinese banks operating in Hong Kong in 2012 were able to absorb higher costs and still produce higher revenues. What did the Chinese banks do right that the others did not? Second, international banks displayed higher variations in costs (as a percent of income) than the other groups. They also earned lower net income margins, which may not be surprising given that few enjoy either advantageous funding costs. What does (did) Hong Kong banking regulation do to the internationals that it did not do to the other categories of banks? Third, local banks earned higher profits (net interest margins) on average, even though the other groups had lower costs (expressed as a percent of income). How did other types of banks achieve these lower costs and why did it not help them profit?

Has regulation encouraged banks in Hong Kong to turn from seeking net interest income as a primary revenue source towards other forms of activity? If banking regulations impose materially compliance higher costs than comparable securities regulations, then the banking sector may be incentivised to shift resources into securities activities (and vice versa). Figure 2.12 shows the way that the size of a Hong Kong bank relates to its

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30 Not surprisingly because variations in bank practices can be associated with decreased profitability (Heckl et al., 2010). It should be noted that the data under discussion exclude revenues from non-recurring sources.

31 Table 2.1 illustrates the importance of a prominent example in the origination of syndicated credit facilities.

32 We cannot cover the many ways that intensified capital demands, business conduct requirements and other forms of enhanced post-crisis regulation have affected the composition of any bank’s commercial activity ability, but Haubrich and Wachtel (1993) discuss such a result in a US context.
proportion of non-lending revenue. In 2012, most banks with larger loan books earned a smaller share of their money from securities and other non-interest income. The variation between banks points to potential regulatory-induced distortions in the market for loans in Hong Kong. First, why do local banks seem to book more securities-related income as their loan portfolios increase, while other types of banks do not? Are they better at cross-selling, or do banking regulations discourage international banks from competing in these market segments? Second, why do international banks – on average – earn a higher percent of their revenue from non-lending sources, and does this reflect a greater focus on capital efficiency? Third, what seems to push banks from all groups toward an “equilibrium” revenue split of about 40%-60% non-interest to interest revenue and portfolio sizes of about HK$200 billion? Will regulation favouring sectoral consolidation (meaning fewer banks with larger loan books) impact on securities transaction volumes? Regulatory incentives may provide answers to some of these questions.

Do bank profit maximisation decisions deter individuals and companies from depositing funds with Hong Kong’s banks? If so, what can Hong Kong’s banking regulation do to encourage growth in deposits. Bank profits partly represent funds periodically withheld from depositors. The demand for savings accounts decreases when net returns to depositors falls. Demand for loans also decreases when interest rates rise. Bank profits lower demand for lending and borrowing – potentially decreasing the amount of money savers and borrowers put into Hong Kong’s banks. Figure 2.13 shows that Hong Kong’s banks recorded both the highest return on assets and the highest return on equity

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33 Naturally, competitive strategy (which market segments a bank services, how well its employees work and so forth) affects the size and revenue mix of Hong Kong’s banks as much or more than regulation. However, regulation represents a likely culprit when systemically relevant or unusual patterns emerge when no whole-market-changing event can explain the data.

34 Bank profits may serve many beneficial roles besides creating an efficiency-reducing wedge between savers and borrowers. Some of these include increasing stock market capitalisation (and returns), increasing the size of the banking sector, and increasing incomes. We avoid this complexity to focus on our main point.
among their peers in other international financial centres. Such high profits may introduce a wedge between savers and borrowers in Hong Kong – as profits shave off returns that Hong Kong’s depositors earn and increase the rates that borrowers must pay. High profits may also signal a higher price of banking – resulting in lower quantity and quality of service provision. Previous studies have shown that Hong Kong bank profitability coincides with market concentration – as larger banks dominate smaller ones. Do these patterns reflect banks’ competitive reaction to costly regulation – which forces them “up the demand curve”?

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**Figure 2.13: Do Hong Kong banks operate too far up the demand curve?**

The data in the figure show the 3 year average of return on equity and assets from 2009 to 2011. High bank profits mean these institutions give more surplus to their shareholders and less to their customers. In theory, if Hong Kong banks offered higher yields, these would induce demand for Hong Kong banks’ services – increasing the amount of money Hong Kong financial institutions attract at home and from abroad.


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**Recent banking regulations clearly appear to focus on areas which raise bank costs without helping them become better, more competitive attractors of assets.** Figure 2.14 shows that the major banking regulations coming into force in recent years in Hong Kong. New regulations centre around implementing new anti-money laundering statutory provisions and Basel III requirements. Of the regulations focused on “productive” aspects of banking – such as Hong Kong’s burgeoning RMB banking infrastructure – regulation tends to focus on hindering bank activity rather than supporting it. While it is clearly important to balance growth and financial stability, it is also important to carefully consider the merits of any new regulation.

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35 Wong et al. (2007).
36 Gensberg and Hui (2008) provide an overview of the local bank sector’s operating performance.
37 A considerable literature finds that bank margins need to rise (and quantity of service falls) with costly regulation, for example Guiso et al. (2006).
38 As we argue in this report, financial regulation needs to provide both sticks (prohibitions and requirements) as well as carrots (rights, authorisations and services which encourage compliance). In the wake of the global financial crisis, regulation has arguably shifted to an over-focus on sticks.
Figure 2.14: Notable Recent Banking Regulatory Developments
(Deloitte’s Reporting on HKMA Developments)

<table>
<thead>
<tr>
<th>Broad Area</th>
<th>Regulatory Activity</th>
<th>HKMA Link</th>
</tr>
</thead>
<tbody>
<tr>
<td>AML</td>
<td>United Nations Sanctions Ordinance and List of Names for Suspicious Account Reporting</td>
<td>*</td>
</tr>
<tr>
<td>Corp Gov.</td>
<td>Skills and Knowledge Development for Directors of Locally Incorporated Authorized Institutions (AIs)</td>
<td>*</td>
</tr>
<tr>
<td>FATCA</td>
<td>Foreign Account Tax Compliance Act in the U.S.</td>
<td>*</td>
</tr>
<tr>
<td>Basel III</td>
<td>Basel III Implementation – Standard Templates for Disclosures in Relation to Regulatory Capital</td>
<td>*</td>
</tr>
<tr>
<td>RMB</td>
<td>Supervisory Policy Manual (SPM) Annex B to CG-7: “Code of Conduct for Reference Banks for TMA’s CNH Hong Kong Interbank Offered Rate</td>
<td>*</td>
</tr>
<tr>
<td>Derivatives</td>
<td>Interim Reporting Requirements for OTC derivative transactions – Enrolment status of HKTR membership</td>
<td>*</td>
</tr>
<tr>
<td>Basel III</td>
<td>Implementation of Basel III</td>
<td>*</td>
</tr>
<tr>
<td>Basel III</td>
<td>Basel Committee on Banking Supervision (“BCBS”) guidance on Monitoring Tools for Intraday Liquidity Management</td>
<td>*</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>Consultation on the proposed regulatory regime for stored value facilities and retail payment systems began</td>
<td>*</td>
</tr>
<tr>
<td>AML</td>
<td>Statements issued by Financial Action Task Force on Money Laundering</td>
<td>*</td>
</tr>
<tr>
<td>AML</td>
<td>Advance activation of overseas ATM cash withdrawal capability</td>
<td>*</td>
</tr>
<tr>
<td>AML</td>
<td>Mystery Shopping Programme (MSP) in respect of sale of investment and insurance products</td>
<td>*</td>
</tr>
<tr>
<td>Basel III</td>
<td>Implementation of Basel III: Revision of Capital Adequacy Ratio Return</td>
<td>*</td>
</tr>
<tr>
<td>RMB</td>
<td>Renminbi (RMB) Net Open Position (NOP) and liquidity ratio</td>
<td>*</td>
</tr>
<tr>
<td>Basel III</td>
<td>Basel III: Revisions to Liquidity Coverage Ratio (LCR)</td>
<td>*</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>HKMA’s announcement on measures to strengthen the HIBOR fixing mechanism</td>
<td>*</td>
</tr>
<tr>
<td>RMB (FX)</td>
<td>BCBS revised supervisory guidelines for managing risks associated with the settlement of foreign exchange transactions</td>
<td>*</td>
</tr>
</tbody>
</table>

We list only developments for HKMA (even though we dedicate most of this report to showing the futility of trying to separate banking and securities regulation).

Source: Deloitte (various issues), available online.

**Debt capital markets**

Origination, distribution and trading of debt instruments is by modern traditional a more commercially-centred segment of finance than credit creation by banks or issuance and share trading on organised exchanges. No sector of finance is free of regulation but today’s global and local markets for bonds, money market instruments and structured notes have been profoundly affected by custom and practice developed since the 1980s in the Euromarkets. These became established as a trans-national forum for new issues and
securities trading that was institutionally permissive, largely making its own sophisticated operating rules and avoiding much of the well-established but idiosyncratic features of national debt markets used historically by national governments and municipal authorities.

The results are twofold, first, innovation in debt capital markets is largely contractually intrinsic and driven by commercial preferences, compared with the more procedural characteristics of the banking or equities sectors; second, practices from the international bond markets have gradually infected many aspects of the sale and trading of government debt in national markets and across borders. Major financial centres with strong resource clusters of debt issuance and trading accordingly tend to be those that have accommodated established international practices, including providing efficient systems for settlement and custody. The result is that international bond market origination and trading concentrates in London, New York, Hong Kong and Singapore.

This is helped by the international debt markets focusing on dealings with professional counterparties rather than individual or small-scale retail investors, banks and asset managers being thought in less need of strict rules for investor protection. Bond market practice involving major investors in the US can be little more demanding than elsewhere despite the very elaborate investor protection demands of federal securities law.

Clustering can result from four main factors, first, the proximity of issuer clients; second, the proximity of investor own funds or assets under management; third, a supervisory regime amenable to rapid transaction formation and sale; fourth, the resource needs of deal arrangers, for example, to assist pricing, hedging, syndicate formation and distribution, and to be witnessed as being part of a successful cluster. These are largely commercial choices, albeit influenced by internal path dependent factors that may cause one bank to manage its Asian bond business in Hong Kong and another in Singapore, even if they share single target lists of regional issuer and investor clients.

Figure 2.15 illustrates recent transaction volumes for Asian borrowers of several domiciles in the debt capital markets, and for comparative purposes in Asia’s syndicated loan markets. The totals are for all disclosed completed transactions in all currencies for the 24 months to 5 April 2014, and exclude issues of fixed or floating rate CDs and MTN issues by banks since a large number are transacted outside the region, for example for branches or subsidiaries of Asian banks in Australia, Europe or North America. They also exclude retail-oriented sales of structured or option-driven notes, which are at times voluminous in certain Asian centres.

The table gives an approximation to the universe of new debt transactions conceived and arranged globally for all other borrowers of the six domiciles and two regional groups. Northeast Asia deals were for issuers domiciled in China, Hong Kong, Korea, Macau,

40 The discussion in this section largely excludes Japan. Tokyo is a hub solely for domestic bond issues denominated mainly in yen, and Japan’s substantial debt markets are far more akin to those of the US than any other Asian local currency or international sectors, chiefly due to highly parochial investor preferences.
41 See Lejot (2013); Sassen (2001).
Mongolia and Taiwan, and Southeast Asia deals were for supranational issuers such as the ADB, and those domiciled in Brunei, Indonesia, Malaysia, Laos, Philippines, Singapore, Thailand and Vietnam. We estimate that of the bond issues shown for Northeast Asian issuers, banks in Hong Kong arranged 40-50 per cent by number; of those arranged for Southeast Asian issuers, banks in Hong Kong arranged 35-45 per cent by number. Almost all of the issues completed for local borrowers were arranged in Hong Kong, and large shares of those for China and Korean issuers. Loan arrangement is more difficult to apportion by location, partly because the identity of the mandated arranger may not been known, or that the transaction formation extends to more than one financial centre.

**Figure 2.15: Completed Bond and Loan Issues**
(1 April 2012 to 5 April 2014)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>266</td>
<td>93,972</td>
<td>584</td>
<td>241,052</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>250</td>
<td>74,459</td>
<td>366</td>
<td>181,242</td>
</tr>
<tr>
<td>Japan</td>
<td>178</td>
<td>96,009</td>
<td>1,994</td>
<td>699,134</td>
</tr>
<tr>
<td>Korea</td>
<td>311</td>
<td>63,322</td>
<td>215</td>
<td>74,357</td>
</tr>
<tr>
<td>Singapore</td>
<td>59</td>
<td>19,700</td>
<td>231</td>
<td>100,343</td>
</tr>
<tr>
<td>Taiwan</td>
<td>13</td>
<td>3,170</td>
<td>458</td>
<td>96,958</td>
</tr>
<tr>
<td>North Asia</td>
<td>907</td>
<td>253,609</td>
<td>1,637</td>
<td>608,997</td>
</tr>
<tr>
<td>Southeast Asia</td>
<td>232</td>
<td>95,217</td>
<td>654</td>
<td>312,441</td>
</tr>
</tbody>
</table>

Source: International Financing Review, Thomson Reuters

Asia’s debt capital markets have two facets, issuance and trading of international bonds denominated in major and niche minor currencies, and national issuance and increasingly widespread trading of local currency instruments. Hong Kong’s regulatory environment, systemic architecture and resource skills favour both segments but it excels at the first more than dealings in HK dollar bonds, which are proficient but inconsiderable, the result of the territory’s approach to monetary policy, a relative scarcity of professional investors with natural demand for long-term HK dollar assets, and the preference among local borrowers of all kinds to raise funds from the banking or equity markets. Singapore’s domestic market is more restricted in scope but shares

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42 The major currencies are the US dollar, euro and yen; minor currencies used for bonds with simple terms include from time-to-time Australian, Canadian and New Zealand dollars and Sterling. Almost all currencies are used in more complex issues with embedded derivative features.

43 Domestic bonds are made in the local currency of the issue domicile and generally sell predominantly to home investors, although many are open to all. International issues are less easily defined but are taken to be bonds denominated in a foreign currency for any issuer, or sold as global issues without distinguishing between investors at home or abroad, see Liu, Lejot & Arner (2013), 311.

44 Or counterparties willing to enter long-term hedging transactions in HK dollars which tends to restrict the demand for new issues by non-Hong Kong borrowers.

45 Efficient debt capital markets provide price indicators for all commercial activities. It is unclear that capital allocation by Hong Kong companies and in local projects is made difficult as a result of its relatively small local currency debt markets, partly given the existence of the peg to the US dollar and because Hong Kong government issues of bills and notes provide most local currency market liquidity.
these features. Both centres have well-developed electronic central dealing platforms and efficient infrastructure for custody and settlement; retail investor activity is a small but permanent component of the total in both cases.

Issuance of international bonds for Asian credit risks in non-local currencies issuance has soared since 2008, as shown in Figures 2.16 and 2.17.

The growth in activity since 2008 is largely the result of Mainland credit expansion, and favourable demand conditions associated with low nominal interest rates, the second factor also affecting sales of local currency claims.

Local currency bond markets function in national silos, even if liquidity and demand is supported by foreign users. This means that except for structured or synthetic transactions involving currency derivatives or non-deliverable currency settlement, peso bonds for Philippine issuers are arranged in Manila, won bonds for Korean issuers in Seoul, and baht bonds for local users in Bangkok, even though foreign banks with appropriate resources may appear in some local currency bond syndicates. All governments have participated in efforts to developed larger and more robust local bond markets since 2000.

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46 This is seldom the case in China, Indonesia or South Korea.
However, ADB surveys of user attitudes to all Asian local currency bond markets show results that change little over a period of deliberate reform by national policymakers, with a lack of liquidity being the factor that most deters usage by both investors and issuers.

Such trends are puzzling – particularly given the relatively well developed domestic market for bonds. Compared to the size of its economy, Hong Kong has the largest bond markets in Asia. Figure 2.18 shows the size of bond markets in various Asian economies – compared with the size of their GDP. Such comparisons can seriously mislead, particularly when looking at a market aiming to serve as an international financial centre (and which attracts investment several times the value of its small domestic market). In relative terms, Hong Kong’s bond markets are the biggest in the region. Yet, in absolute value terms, China’s 30% of GDP bond markets eclipse Hong Kong’s roughly 70% of GDP.

The relatively small size of Hong Kong’s debt capital markets may not be worrying in itself. Many academics have noted that bond markets may not “fit” with particular types of capitalism. In one variant of this literature, Hong Kong’s capital markets focus on equities rather than debt because its labour markets, product markets and investors all have short time horizons. In another variant of this literature, investors may not want debt denominated in a currency pegged to the US dollar (as such debt gives no more benefit than investing in US debt directly in terms of yield or risk). In a third variant of the literature, Hong Kong’s bond markets provide little to help “crowd in” other investments (in FDI or equities for example) – as these markets already have developed. However, a range of other factors likely explain such under-development. Both the Hong Kong and Singapore corporate sectors are far less reliant on public debt issuance than

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47 See Mizen and Tsoukas (2013) for background on bond issuance behaviour in the region.
48 As such, equity and bank finance serve Hong Kong’s own “variety of capitalism” (Witt and Redding, 2013).
49 Latter (2008) provides a non-rigorous assessment of some of the portfolio demand related issues.
50 Not everyone would agree. We do not have the space to defend this assertion in this policy brief. Jiang et al. (2001) and Herring and Chatusripitak (2000) provide the reader with countering arguments.
equity and bank finance, a pattern that has persisted throughout a period of capital market development, and in spite of the resource skills of banks in both centres.

Yet, the little amount of debt which finds its way onto debt markets indicates that regulatory issues may lie at the heart of Hong Kong’s immature debt markets. Large differences in the size of Hong Kong companies’ liabilities and the value of the bonds they issue clearly indicate a problem in the way regulations incentivise the use of bond markets (as opposed to borrowing from banks). The first panel in Figure 2.19 shows the value of liabilities held by Hong Kong companies in 2012. If non-government entities issued about HK$250 billion in 2012 – and if our figures about the total liabilities of Hong Kong listed companies are correct – then less than 10% of Hong Kong companies’ debt finds its way onto bond markets. The other panel (figure 2.19b) represents the more interesting part of the figure. In that panel, we show the way that debt-to-asset ratios correlate with the absolute value of companies’ liabilities. Debt-to-asset ratios grow as Hong Kong companies grow – albeit at a decreasing rate. Clearly, something discourages these larger companies from taking on more debt. And something almost certainly discourages companies from passing such debt onto bondholders.

Figure 2.19a: A Lot of Hong Kong Companies Have Significant Debt - Why Can’t Investors Share in the Interest Payments?

The data in the figure show the size of total liabilities in 2012 for a range of companies listed and/or registered in Hong Kong. If these data are correct, Hong Kong companies’ total debt burden equals about HK$31 trillion. Source: WRDS (2013).

51 A range of other factors also influence the size of Hong Kong’s debt markets – including a relatively young government bond market (World Bank/IMF, 2001). A discussion of factors, like the way that underdeveloped government debt markets have contributed to under-developed debt markets, would take us far beyond the scope of the current report.

52 As we will see in a later chapter, Hong Kong companies borrow from banks who then issue bonds purchased by bondholders. Financial regulation clearly (somehow) discourages bondholders from holding companies’ bonds directly. Namely, bond investors prefer to hold bonds in the banks which hold these companies loans – rather than lend directly on bond markets.

53 We divided the outstanding value of Hong Kong dollar debt instruments issued by local corporates and non-multilateral development body overseas corporates (as reported by the HKMA) by the total value of company liabilities (as reported by WRDS) for 2012. We do not include the value of bank debt as banks simply “pass-through” (or intermediate) loans between lenders (the monied bond investors) and borrowers (companies listing in Hong Kong).
The data suggest that Hong Kong companies borrow instead from suppliers and non-bank financial institutions. Figure 2.20 shows the size of Hong Kong’s factor credit (relative to GDP) compared with jurisdictions housing other international financial centres. As shown, Hong Kong ranks second – supplying slightly more than 8% of GDP in discounted accounts receivable finance.\(^{54}\) UK credit finance institutions provide far more factor-based credit – reflecting deeper (albeit more fragile) credit markets.\(^{55}\)

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\(^{54}\) Factoring refers to the process by which companies sell invoices for payment (accounts receivable) to trade finance companies. To take the simplest example, a company may sell an invoice to a trade finance company worth $100 for an immediately payment of $97. Such finance gives the company $97 immediately usable for business operations and may replace short-term bank loans which provide money to the company while it waits to collect payment for its invoice.

\(^{55}\) Many academics have researched the ways that trade credit substitutes for (and complements) conventional bank loans and short-term commercial borrowing (through notes and other short-term instruments). Mateut and Mizen (2003) provide a discussion from the UK experience.
Hong Kong represents the largest shadow banking area (as measured as a percent of GDP) in the world. Figure 2.21 shows the size of non-bank financial assets as a proportion of GDP and as a proportion of all credit in the economy. At almost 500% of GDP, the FSB’s proxy for Hong Kong’s “shadow banking” represents the highest figure among the economies they track.  

The UK represents the next largest shadow banking hub – with non-bank financial institutions lending out 400% of the UK’s much larger GDP.

Reflecting the global macroeconomic environment, investors will likely shy away from bonds – including Hong Kong’s bonds – in the medium-term. As interest rates rise in various countries (including Hong Kong), bond prices will fall. Seeing declining bond prices in advance, demand for fixed-income investments in (from) Hong Kong will likely remain sluggish. Thus, Hong Kong’s growth as an international financial centre almost certainly will not come from its local currency bond markets.

**Double crisis vulnerability**

Close ties to the Mainland represent a positive and negative development for Hong Kong’s financial services sector. Figure 2.22 shows the Hong Kong financial sector’s exposure to the Mainland. Since the start of the global financial crisis, Hong Kong institutions have increased their holding of Mainland liabilities four-fold. Most of these liabilities represent bank liabilities – the kind that make Hong Kong’s banking sector vulnerable to Mainland macroeconomic shocks. Figure 2.23 shows the sharp rise in claims on the Mainland in recent years (since 2011). While claims on the UK and the US

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56 In all fairness, Hong Kong’s formal banking assets weigh in at a bit over 700% of GDP – making these eye-popping shadow banking proportions seem more reasonable in comparison with the formal banking sector. Moreover, the HKMA’s Banking Stability Report for 2012 presents a chart (Chart B5.2) showing that non-banking lending represents only about 1%-2% of GDP. What accounts for the other 499% of GDP in the FSB’s assessment of Hong Kong’s shadow banking sector? Further study of this issue is necessary.

57 Even in the short-term, fixed income investors have sought higher yields from Hong Kong junk bonds (Law, 2013). Large investments in junk quality bonds can only reduce the overall quality of the bond market in the short-term.
have remained flat, ties to the Mainland have exponentially increased. Yet, as Figure 2.24 shows, the probability of default on the Mainland well exceeds that in the UK and US. Hong Kong’s financial ties have steadily increased with a far riskier investment partner than the US or UK. As we will argue throughout this report, this presents major challenges to financial stability in Hong Kong.

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58 The most recent IMF (2014) consultation with the Hong Kong government notes the continuation of this trend.
59 Recent announcements of the “through train” allowing investors in Shanghai to invest directly in Hong Kong shares and visa versa will likely only increase Hong Kong’s exposure to the Mainland.
In this report, we describe the causes and effects of a possible double crisis. We show that a financial crisis on the Mainland would affect Hong Kong equity markets (the first leg) and real estate prices (the second leg). As we will show in a subsequent chapter, Hong Kong equity markets and real estate markets correlate closely with each other because of Hong Kong’s reliance on stocks and other securities based on real estate. As a thought exercise, let us imagine that such a financial crisis were to cause a decrease in Hong Kong deposit-to-GDP ratios. How much would that affect bank capitalisation? Figure 2.24 shows the effects – assuming that the present level of deposits-to-GDP exceeds the equilibrium-level based on market fundamentals. If a financial crisis rebalances the economy, so that the Hong Kong financial sector looks more like that of Japan, it would lose about 100% of GDP in deposits. If an economic crisis forced the deposit-to-GDP ratios to match that of Singapore, Hong Kong would lose 250% of GDP in deposits. 

**Large deposit losses which would put Hong Kong deposit-to-GDP levels in line with other financial centres would decimate bank capitalisation ratios.**

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60 Throughout this report, we show that deposits and portfolio investments in Hong Kong come from Hong Kong’s role as an entrepot financial centre. The Hong Kong financial sector eclipses the value of the real economy. We thus explore in the figure what an equilibrium level of deposits-to-GDP might be if an economic crisis rebalances the Hong Kong economy to look more like other international financial centres in its peer group.

61 We provide more detailed (and realistic) scenarios exploring the extent of Hong Kong banking sector distress in a later chapter. For now, we only want to the reader to understand that our deposit-to-GDP ratios are much higher than other international financial centres. If a crisis brought these ratios toward these other countries’ ratios, Hong Kong banks would lose very significant amounts of Tier I capital.
The government and regulators must be well-prepared for any such crisis. We show in this report that an economic crisis on the Mainland could have serious and negative effects on Hong Kong’s banks’ liquidity and equity prices – and thus Hong Kong’s ability to attract portfolio investment. Outside of the mass media, relatively few serious analysts consider such an outcome likely. Yet, throughout this report, we present reasons why the Hong Kong should prepare for such a seemingly unlikely crisis. Figure 2.25 summarises some of the reasons we give throughout this report showing the necessity of appropriate advance planning. At the same time, appropriate planning to deal with a serious financial crisis on the Mainland cannot only protect Hong Kong’s financial institutions. As one of the destinations of investment preference for Mainland investors, Hong Kong financial institutions can significantly increase their assets under management due to capital flight.
1. **Government as “insurer of last resort”** – the government has the duty to plan for catastrophic and highly unlikely events (like war and economic collapse).

2. **Increase in black swan planning after the crisis** – Hong Kong has yet to catch up to the planning for “extreme events” currently underway in other upper-income jurisdictions. A Chinese banking or economic collapse would certainly qualify as a black swan (extreme event) for Hong Kong’s financial markets.

3. **If banks are asked to prepare for the worst, the regulators should also** – the HKMA has conducted considerable analysis about the magnitude of risks banks should stress-test against. This applies equally to government. The upcoming IMF/World Bank Financial Sector Assessment of Hong Kong should go some way in this respect.

4. **Regulators and governments did not predict the 2007 crisis either** – even during later part of 2007, government officials in the US and UK considered a crisis highly improbable. Even if the Hong Kong public or regulators do not think a China-origin crisis is likely, they should still plan for it.

5. **Hong Kong will amass large amounts of portfolio assets if it proves itself capable of serving as a safe haven during a Mainland economic crisis** – if past wealth flows serve as any guide, a large-scale financial crisis on the Mainland will likely lead to financial flows to Hong Kong increasing by a factor or 10 to 20 – solidifying Hong Kong’s place among the top international financial centres.

How would such a Mainland financial crisis occur – and how might we see its effects in Hong Kong? Figure 2.26 tries to put the various graphs and statistical analyses we have presented in this report into a simple narrative timeline. The figure represents a hypothetical scenario, a “mockumentary” – a method of reporting on hypothetical events as if they were real. The timing and sequence of events in the figure represent only a fictional account of events which might occur if the studies we report on this in report turn out to be correct.

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62 In other jurisdictions, scholars and central banks such as Guarda et al. (2011) and Allen et al. (2011) have increasingly modeled the effects of extreme events – an activity not occurring (or publicly reported about) in Hong Kong.

63 The HKMA provides extremely simple monitoring of indicators of systemic risk in their biannual Banking Stability Report. However, they do not define what level of risk would cause a crisis or stress test the banking system as a whole against 5-sigma or other crises.

64 For an example, see the US Financial Crisis Inquiry Commission report.

65 See for examples, China Merchants Bank and Bain & Company (2012) and WealthInsight (2013).

66 Mock-umentaries represent an illustrative way of illustrating complex social science models and statistics in an easy to understand way. One of the most important mockumentary studies comes from the UK transportation sector – The Day Britain Stopped, showing the effects on the UK economy of a plane crash at Heathrow.

67 While the timeline and events are fictional, we have based the timing and nature of events on predictions made in this study and events as they usual occur during similar banking and financial crises. See Kindleberger and Aliber (2011) for one study (among many) which motivated this figure.
March 2015 – Local government lending crisis in Chongqing
Several local governments in China announce (after months of private discussions with officials and their banking lenders) that they cannot fully repay loans. Several banks make first announcements that non-performing loans may exceed official estimates.

April 2015 – Stoppage of several construction and infrastructure projects
Several unrelated projects at Hong Kong developers working on the Mainland suspended because of lack of funding across the Mainland. Reports on Chinese media sites report workers on large infrastructure projects have not received wage payments for previous work.

June 2015 – Decreases in inter-bank lending on the Mainland attendant with sharp rise in inter-bank rate
Another jump in inter-bank lending rates causes another intervention by the central bank. Instability in short-term lending rates in inter-bank sector (and shadow banking sector) cause rumours of lack of liquidity. Mainland banks in Hong Kong announce losses for reasons not altogether clear.

July 2015 – Increased demand for Hong Kong gold attracts attention of international media in Hong Kong
As Mainland Chinese try to smuggle assets out of the country, demand at jewellery shops in Hong Kong and overseas increases dramatically.

August 2015 – Raft of companies announce significant earnings “misses”
Mainland banks, property developers in Hong Kong and even Hong Kong high-end luxury retails all announce significant “misses” (earnings before analysts’ expectations). Misses cause a 10% fall in Hang Seng Index

February 2016 – China announces first significant slow-down, with independent analysts noting a likely quarterly contraction in GDP
Significant decreases in domestic demand, combined with a still weak global demand for Chinese exports, leads to first quarter contraction. Chinese official statistics show growth at a healthy 4%-5% which market actors discount.

March 2016 – Significant slump in demand for RMB and RMB-denominated securities in Hong Kong
Significant decrease in RMB deposits and for RMB-denominated assets. Hong Kong media report that several banks have met with regulators as part of “routine” stress test assessments.

April 2016 – Declining Hang Seng and Centaline indices make IPO, bond offerings and RMB and HK dollar denominated assets less attractive
Hong Kong starts losing foreign exchange reserves as demand for Hong Kong dollar assets declines. No announcement of increasing Hong Kong dollar stockpiles made. Members using RMB liquidity facility note significant under-use of RMB swap lines. By this time, Hang Seng has lost 30% of its value and real estate prices are back to their 2009 levels.
May 2016 – SFC announces investigation for Hang Seng-component Mainland company for insider trading and accounting fraud

The SFC investigation reflects only the first of several scandals which come to light (as asset prices decline) of accounting irregularities by several of Hong Kong’s blue chip corporations. Note: the dates and event represent a hypothetical crisis. We do not suggest necessarily that these events will occur, nor occur in the months we have put in the figure. We use specific months only to follow the mockumentary format used in this type of “what if” scenario planning.

The scenario shown in the figure would reflect significant stresses on Hong Kong banks’ balance sheets. Tier I capital in Hong Kong’s banks (as predicted by the various studies we cite in this report) would fall in three ways. First, the value of collateral held on loans would fall by about 30%. Housing prices should fall by about 30% in order to return to roughly their 2007 levels. Debit and equity securities would fall by roughly 30% (reflecting lower Mainland company valuations for equities and higher interest rates for bonds). Second, monthly payments should rise by about 30% as interest rates increase by approximately 2%. The net effect of these increases will be to increase delinquencies (and defaults) as well as reduce disposable funds available for investments and other banking services. Third, loan quality would worsen as Hong Kong’s companies come looking for loans on riskier projects. As a result, lending rates would rise – further increasing stress on Hong Kong’s real sector.

Conclusions

On objective measures, Hong Kong lags the world’s two leading international financial centres. Hong Kong’s financial service sector manages far fewer assets than rivals in London and New York. Moreover, unlike the relationships between London and the UK economy (or New York and the US economy), Hong Kong’s significant investment and trading relationships with the Mainland make its financial institutions particularly vulnerable to any crisis emanating from the other regions of China. If the government does not coordinate an effort to seize the “calm before the storm”, losses to Hong Kong’s financial institutions could be large. At the same time, with proper planning for such a crisis, in the event of such a crisis, Hong Kong could cement its standing among international financial centres as Beijing, Shanghai and Shenzhen financial institutions’ assets decline.

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68 HKMA (2013), chart 4.35.
69 Ibid., chart 4.39.
Chapter 3: Employment Policies and Practices – Looking for Wider Opportunities

The strength of Hong Kong’s financial sector depends on the size of its labour force and competencies of its employees. With about 250,000 people employed, Hong Kong’s financial services industry is a fraction of the US financial industry in absolute terms.\(^1\) Moreover, on a per-worker basis, Hong Kong’s bankers and brokers handle only about 40% as many assets as their American colleagues – at about US$4 million per worker.\(^2\) Even for New York City alone, the assets under management of its financial institutions far eclipse their Hong Kong rivals / colleagues.\(^3\) What policies can Hong Kong put in place to encourage the growth of assets under management (in both absolute terms and on a per money manager basis)? What effect would that have on employment?

In this chapter, we provide some initial analysis of financial sector employment issues in Hong Kong. This is an issue to which we will return in greater detail in our second report in 2015 and in our final report in 2017. In this first report, we describe how Hong Kong can help put in place policies which will help one important segment of the financial industry – money managers (and other related employees) – to increase assets under management and therefore employment. We describe a “passporting” scheme – similar to that of the EU – which should deepen asset managers business on the Mainland and potentially throughout the region included in the passporting scheme. In the first part of this chapter, we provide an overview of the non-insurance portions of Hong Kong’s financial sector employment – showing how employment in Hong Kong’s financial institutions focuses on less productivity-sensitive types of work than in other international financial centres. Compliance, in particular, represents a mushrooming area of employment and one which is not necessarily positive for financial firm profitability. The second section argues that Hong Kong cannot rely on Mainland growth to keep adding jobs or assets to its financial sector. Hong Kong must look beyond Mainland China for opportunities. The third section shows how hiring more Asian and international financial advisors may help financial institutions seize opportunities in Asia and around the world. The fourth section shows how Hong Kong could develop a passporting scheme – by becoming more involved in APEC and ASEAN processes – to bring in assets from a much wider catchment.

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2 These figures come from dividing total portfolio investment as reported by the IMF’s Co-ordinated Portfolio Investment Survey for 2012 by employment in each jurisdiction’s financial sector. We take employment for Hong Kong from the Census and Statistics Bureau and data on US employment from the Financial Services Employment Report.
3 A scan of the balance sheets of the top New York and Hong Kong banks will show the striking difference. We do not give an exact number because of the way New York’s financial institutions book their revenue and assets. The question of booking is one which we will investigate in detail in our second report in 2015.
Hong Kong's financial sector employment in perspective

Hong Kong employs roughly the same number of finance-related workers as other international finance centres. Figure 3.1 shows comparative employment in the top 5 international financial centres (as ranked by Y/Zen). As shown in Figure 3.1, and according to the imprecise estimates obtained from each financial centre’s urban government bodies, Hong Kong ranks in second place in terms of finance sector employment (in absolute terms). If real estate prices had not drawn so many workers into Hong Kong’s real estate sector, employment in Hong Kong’s financial sector might be lower than current levels. In Hong Kong, London and New York, the financial sector occupies about half of all professional employment. However, whereas real estate employment in London and New York represent about 20% of professional employment, it represents about 30% in Hong Kong. In contrast, Hong Kong’s legal and accounting sector weighs in at about 10% lower levels of employment than its London and New York peers. If Hong Kong’s real estate sector comes to reflect its peers (because of a housing price collapse), the real estate sector could lose 10,000 jobs. At the same time, there appear to be growth opportunities in legal and accounting employment.

Figure 3.1: Hong Kong Employes Almost the Same Number in its Financial Sector, with Far Less Pull over Assets

The data in the figure show employment in 2012 (or the latest year available) in the financial sector of each urban centre. Sources: HK Census and Statistics, UK Office for National Statistics, Singaporean Ministry of Manpower, New York City Independent Budget Office and the Bureau of Industrial and Labor Affairs of the Tokyo Metropolitan Government.

4 Using measurements of each urban centre’s financial sector employment presents obvious problems. Data at the urban level (city and/or sub-city level) from a sector notorious for its turn-over and changing job requirements can only hint at true employment levels. Moreover, the eponymous street in Manhattan giving its name to New York’s financial sector has come to represent the finance profession of the entire US. We thus use these figures only to hint at the number of physical bodies in an urban geographical area.

5 We do not know if employment in Hong Kong’s real estate sector complements or substitutes for employment in the financial sector. Both sectors expanded, causing an increase in labour in each sector. Such increases had almost a perfect correlation with each other since 2008 (as measured by a correlation coefficient of 0.98 between employment levels in these two sectors). Detrended correlation coefficients for financial sector and real estate employment still come in at about 0.51. However, we do not know (without an input-output matrix for the Hong Kong economy), the extent to which the real estate sector causes demand for financial services labour to rise. We also do not know the extent to which Hong Kong’s lower, mid and senior level professionals move from real estate into financial services based on changes in wages.

6 Wojcik and Zhao, forthcoming.

7 The estimate simply subtracts the current level of real estate employment from the level if real estate employment reflected the same proportion of professional sector employment as in New York or London.
Hong Kong’s securities sector in particular has shown signs of unremitting (albeit moderate) expansion even during the global economic crisis. The securities industry, as a sub-sector of the broader finance industry, constitutes the “elite” of finance, usually earning the highest salaries and generating the highest value-added per employee. Figure 3.2 shows the Hong Kong broker-dealer employment levels compared with the Hang Seng Index. Both series show an upward trend – suggesting that growth in finance sector labour markets broadly reflects growth in the Hang Seng Index (and thus the overall economy). Yet, employment increases do not appear, in any way, aimed at growing the sector into a more vibrant international competitor among international financial centres. Hong Kong’s financial institutions – like their peers world-wide – do not seem to use recession as a time to expand in order to take advantage of opportunities in the post-crisis marketplace.

Figures 3.3 show the extent and nature of employment change among broker-dealers in Hong Kong. In the first panel, we show the major employment gains and losses (as proxied by listing on the SFC’s registered individuals roster) from 2009 to the end of 2013. Unsurprisingly, Merrill Lynch posted large staff losses. Morgan Stanley and UBS appear to have positioned themselves to benefit from the crisis by taking on staff.

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8 Wojcik (2012) discuss the role of securities industry in financial employment generally.
9 In the early 2000s, scholars asked if entire financial sectors exhibit scale economies. Bossone and Lee (2004) popularised the notion of “systemic scale economies” (namely increasing returns to large financial sector sizes) with their IMF working paper. Recent evidence by Hughes and Mester (2011) points to potential gains from size at the firm-level, as large financial institutions benefit from scales of economy and scope when taking on particular risks.
10 Unsurprisingly, the major consultants to the large banks argue that banks can use the crisis as an opportunity to expand their market share and enter new markets – if they develop their capabilities. Booz & Co. provide an example.
11 The data refer specifically to the numbers of individuals holding licenses from the Hong Kong Securities and Futures Commission (SFC). For an overview on the 10 types of licenses the SFC confers on individuals.
12 Both organisations booked large losses during the global financial crisis, with concomitant staffing retrenchment in the US and EU. We thus interpret increases in employment (or at least numbers of individuals registered with the SFC) as a pro-active move to seize future opportunities in Hong Kong and Asia.
The second panel shows the numbers of companies experiencing relatively minor staffing changes. Only about 250 companies out the entire list of over 1,000 reported the same number of registered broker-dealers in 2009 as at the end of 2013. About 125 companies reported gains of one employee and losses of one employee in the interim. When comparing only the companies who appear in both the 2009 and 2013 lists, these broker-dealers employed 1,935 more registered persons overall. Finally, looking at the third panel, we deduce (and nothing more than a vague deduction given these data) that Hong Kong’s broker-dealers added slightly more registered financial advisors than they lost over the period.

Figures 3.3: Employment Dynamics Among Hong Kong’s Licensed Broker-Dealers

**Figure 3.3a: Top Five Gainers and Losers in Hong Kong’s Financial Sector**

The data in the figure show the largest changes (in headcount terms) in employment in Hong Kong financial institutions with staff licensed by the SFC. We omit companies who disappeared or appeared in the interval between 2009 and 2013. Our data also do not reflect continued employment in corporate holding companies which simply renamed registered companies.

**Figure 3.3b: More Employees Added for Companies Existing Throughout 2009 to 2013**

The data in the figure show the number of companies (on the y-axis) which gained or lost the number of registered staff shown on the x-axis. For example, about 55 companies gained 3 registered employees and about 20 lost 5.
Is hiring by Hong Kong’s broker-dealers “good” – meaning that the size and composition of hiring likely contributes to long-term growth in assets under management by the entire financial sector? Of course, we can only take a stab-in-the-dark at answering this question using the data available at the time of writing. Figure 3.4 represents one such stab – showing the extent to which Hong Kong companies advertised for certain kinds of finance-related jobs compared with London-based companies. London companies used eFinancialCareers to find asset managers, derivatives traders and investment bankers. In contrast, Hong Kong companies (compared with their London-based peers and rivals) sought commercial bankers and PR specialists. On the day viewed (chosen at random), the largest numbers of vacancies centred around IT experts (151), accounting and finance specialists (141) and compliance and legal (101). These represent supporting rather than profit-generating functions. To the extent job creation reflects supporting rather than profit-generating roles, Hong Kong’s financial sector employment will not contribute to a sector which can outpace New York and London.

13 We accept that drawing conclusions based only on one website and only using a one day sample hardly represents a rigorous basis upon which to draw inferences, albeit one that is potentially illustrative and also indicative of the need for further analysis.
Supporting and advisory roles can help increase asset values managed by Hong Kong’s financial institutions (and other companies). However, nothing guarantees that having higher levels of legal and accounting professional employment automatically correlates with increasing financial sector sizes. Using data which amounts to little more than anecdotal evidence, Figure 3.5 shows the returns earned by companies underwritten by the law firms shown in the figure. For example, for the period covered, the clients of some firms (on an aggregate basis) experienced negative compound annual returns, while the clients of other firms, indicating that legal advice may impact companies’ financial performance.

A number of factors – besides the quality of legal advice – may explain a firm’s financial performance. We hope this graph will inspire more rigorous research about the way Hong Kong’s legal sector contributes to its financial firms’ profitability. Also, we would need to compare firms which use legal services against a control group of those who do not in order to say anything definitive about the way the legal sector contributes to corporate valuations in Hong Kong.

14 Lawyers and accountants can either add or subtract value – depending on the extent to which their services contribute to individual firm and sector-wide profitability. Interestingly, economists like Klasa and others (2013) have only recently used econometric tools to assess whether particular lawyers and law firms add value.

15 A number of factors – besides the quality of legal advice – may explain a firm’s financial performance. We hope this graph will inspire more rigorous research about the way Hong Kong’s legal sector contributes to its financial firms’ profitability. Also, we would need to compare firms which use legal services against a control group of those who do not in order to say anything definitive about the way the legal sector contributes to corporate valuations in Hong Kong.
The expansion of internal and external advisory roles could reduce Hong Kong’s financial sector competitiveness over time if such roles seek to comply with value-subtracting legal requirements. Hong Kong’s banks and financial institutions have complained about increasing regulatory burdens imposed by new regulations – such as those imposed under the new Money Laundering Ordinance and the US Foreign Account Tax Compliance Act (FATCA). They have also complained about potential loss to Hong Kong’s financial firms of the extra-territorial application of the UK Bribery Act and the US Foreign Corrupt Practices Act.\(^\text{16}\) If the cost of these rules exceeds their benefit, they would likely both distort employment (toward non-value adding jobs) and reduce employment by taking up real resources.

If studies from other jurisdictions serve as any guide, the impact of these regulations on Hong Kong’s bank profitability easily cost them more than HK$1 billion in 2012. Figure 5.6 shows the overall reduction in bank profits due to Hong Kong banks’ compliance with money laundering, US foreign tax account and anti-bribery laws.\(^\text{17}\) Only taking licensed banks into account, the compliance cost of the three compliance rules we have previously cited easily cost these banks HK$1 billion in 2012.\(^\text{18}\) No particular effect dominates the others as a principal cost of compliance. Despite the Hong Kong compliance community’s focus on direct staff costs, such costs probably represent one of the smaller contributors to the profit impact of these rules.\(^\text{19}\) Customer compliance costs reflect the decrease in customer cross-selling and decreased demand for bank services. Bank compliance costs represent costs like training, extra office space, IT, and other expenses. The tax distortion represents the very slight increase in taxes that accompanies

\(^{16}\) Cowan and Vagen (2013).
\(^{17}\) An extensive footnote on the literally hundreds of studies we consulted in building this spreadsheet could fill an entire working paper. To give some pointers to the main sources, HMRC (2013) provides an impact assessment of the FATCA on UK business. As early as 2005, Z/Yen (2005) published on behalf of the City of London an impact assessment of anti-money laundering rules on financial firms. Veris (2013) provides a higher-level, global view.
\(^{18}\) Profit data come from WRDS with estimates about the impact of each effect from a range of econometric studies.
\(^{19}\) Shamdasani (2013) represents one such voice from the compliance community.
such rules. Avoidance costs represent the time and effort both banks and customers spend in avoiding AML, FATCA and other rules (for example by reporting less than the forms require). Jurisdiction hopping costs represent the profits Hong Kong’s banks lost because customers put their money in another jurisdiction (like the Mainland). Secondary impacts range from the cost of sandwiches at AML trainings for staff to the increase in salaries to compensate executives for learning and using these new rules. **Hong Kong’s compliance rules clearly affect financial sector employment levels.**

![Figure 3.6: The Regulatory Impact of the Three Major Compliance Burdens for Hong Kong Probably Cost Its Licensed Banks over HK$1 billion in 2012](image)

The data in the figure show the various costs associated with compliance with Hong Kong’s anti-money laundering ordinance and rulemaking related to the FATCA and FCPA/UKBA. We took the overall impact on Hong Kong’s licensed banks from the literature (about 1% of after-tax profits). The weight of each effect we show in the figure comes from the literature we cite in the body of the paper. We do not show effects on restricted license banks and foreign banks, due to their small profits relative to licensed banks.

Source: WRDS (for bank profitability) and range of literature for impacts (see text).

We will return to related issues and recommendations in later chapters.

**The China effect**

Most agree that China-related financial services business should naturally form part of Hong Kong financial institutions’ strategy for increasing assets under management. However, even a big push in/on the Mainland probably will not necessarily grow Hong Kong’s financial sector employment significantly. Figures 3.7 show, using an extremely simplistic yet illustrative method, how even large expansion in Chinese growth and investment probably will not translate into large increases in Hong Kong’s financial sector employment. In the first figure, we extrapolate the past few years’ relationship between Chinese GDP growth and financial sector employment in Hong Kong into a future when China has grown significantly larger than its current levels. Even if China

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20 In 2007, the HKMA said it would spend an extra HK$572 million in staff and other costs getting ready for AML (Yiu, 2007). These funds must, at the end of the day, come from taxes (or decreased amenities to taxpayers in case the funds come from profits from the Exchange Fund for example).

21 Simplistic “linear-like” regression fails to account for a wide range of factors. We call it linear-like because we show an exponential line of best fit to the data to account for geometric growth (which depends on the size of the Chinese economy and Hong Kong’s financial sector employment). Such a regression provides a useful way of predicting future financial sector employment patterns because our financial
manages to maintain its current growth rates (of both GDP and investment), jobs would not grow exponentially. **Under the most optimistic projections, Hong Kong would add only about another 100,000 jobs in its financial sector.**

![Figure 3.7a: Chinese Economic Growth Probably Won't Add alot More Financial Sector Jobs...](image1)

The data in the figure show the relationship between net portfolio investment in China and employment in Hong Kong’s financial sector. Even assuming foreign investment floods back into China, such a flood would only add another 100,000 jobs or so. The equation is: \( y = 145.8e5E-05x \)


![Figure 3.7b: ...and Relationships with Chinese Investment Tell the Same Story](image2)

The data in the figure show the relationship between net portfolio investment in China and employment in Hong Kong’s financial sector. Even assuming foreign investment floods back into China, such a flood would only add another 100,000 jobs or so. The equation is: \( y = 242.79e0.0088x \)


While continued growth on the Mainland probably will not affect financial sector employment, a sharp contraction will. The recent economic crisis shows that a large-scale domestic crisis can result in very significant drops in financial sector employment. Hong Kong weathered the global financial crisis reasonably well because the crisis did not originate in its domestic economy. What would happen if such a crisis did originate in Hong Kong’s “domestic” economy (putting “domestic” in quotes because the Mainland economy comprises a vital part of the Hong Kong economy). The US experience in particular serves as a useful example. Figure 3.8a shows the way that financial services sector’s employment will not structurally change (statisticians call it a “structural break”) after China’s economy surpasses a certain size.

22 In all fairness, such an increase would represent a 40% increase above current levels and contribute to employment in other sectors.

23 We cannot review the entire literature in this area. For the overview, see Sendanyoye (2009).

24 We choose the US rather than UK economy because the source of the crisis originated in the US economy. We want to see how a domestic-origin crisis likely affects equity prices and especially financial...
employment changed over time as the crisis unfolded in the US. On the figure, we highlight three well-known effects which would likely affect Hong Kong if it underwent a similar crisis. In all likelihood, financial services employment levels would fall dramatically, over-shoot their long-run equilibrium level, and stay at a lower level due to hysteresis effects.\textsuperscript{25} A number of studies of Hong Kong’s labour market (in general) show Hong Kong’s susceptibility (given the lack of downward wage flexibility) to general macroeconomic shocks.\textsuperscript{26}

An economic crisis – particularly one involving rapidly declining property price values – would likely significantly decrease financial services employment in Hong Kong. Figure 3.8b shows the way that employment in various parts of the US financial services sector changed leading up to, during and following the crisis. If Hong Kong’s financial services sector follows the US in any way, we can expect a 5% or more drop in financial services employment. Looking at particular sub-sectors, credit intermediation (banking) saw the largest decreases in employment. We show changes in real estate employment – to compare how changes in real estate employment correlated with changes in financial sector employment. If a future Hong Kong crisis resembled the recent US crisis (with rapid declines in real estate prices), real estate employment would decline significantly.

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\textsuperscript{25} Naturally, in theory, a partial or full (general) equilibrium would ostensibly seem the best way to model these effects for Hong Kong. However, as we saw in the US, the financial crisis showed a clear structural break with the past (in some ways even changing the structural relationship in the financial sector itself). We could not use a model which relied on Hong Kong’s current economy structure to predict events that would occur after a similar “structural break”. As such, a comparison with the US provides the best (albeit certainly less than ideal) method of analysis.

\textsuperscript{26} We used studies such as Pauwels and Zhang (2008) and Lubik (2011) to assess Hong Kong’s general labour flexibility and its response to macroeconomic shocks.
Yet, a more detailed examination of Hong Kong’s particulars shows that financial services employment will likely decline much more. Figure 3.9 shows the way the financial services employment would decrease for changes in the Hang Seng Index. In the lower part of the graph, we show the way that financial services employment has changed as one of the key stock indices (the Dow Jones Industrial Average) has changed. Economists refer to these types of changes as an elasticity – and we look specifically at the elasticity of financial services employment with respect to changes in equity prices.\textsuperscript{27} As shown, financial sector employment has become less sensitive to stock market prices over time.\textsuperscript{28} During the “high elasticity” crisis of 1970, financial services employment in New York decreased by 3% for every 1% decrease in the Dow Jones index. During the “medium elasticity” crises of the 1970s and 1980s, a 1% decline in the Dow Jones index corresponded to a 1% decline in financial services employment. In the most recent crisis, a 1% decline in the Dow Jones only led to a half-percent decline in financial services employment.\textsuperscript{29}

\textsuperscript{27} To calculate the elasticity, we looked at changes in financial sector employment in New York and changes in the Dow Jones Industrial Average during the dates of five major recessions (using the official definition of a recession). We divided the percent change in such employment by the percent change in the DJIA in each period. Such an elasticity tells us how much financial services employment changed as equity prices changed. We used New York State Department of Labor (2008) for employment data.

\textsuperscript{28} We do not have a reliable method for assessing Hong Kong’s own elasticity. Decreases in the Hang Seng Index due to SARS, the Asian financial crisis and the global financial crisis represent externally-driven events. Moreover, employment remained steady despite large changes in the Hang Seng Index (reflecting the open economy). As such, we use the US experience to provide scenarios for such a financial services retrenchment.

\textsuperscript{29} The size of the financial services sector does not explain these changing elasticities as a type of low-base-effect. Financial services employment in 2000 equalled a bit more than 200,000 people. In 2007, that number hovered at around 192,000. Thus, a larger employment base does not explain why elasticities shrank over the period.
The data in the figure show the new financial sector employment levels in Hong Kong if our economy reacts to changes in our equity levels the same way the US has in the past. We show three scenarios for the elasticity of financial sector employment with respect to changes in the Hang Seng Index (using historical elasticities from different recession events in the USA). During “high elasticity” recessions in the 1970s, Wall Street employment fell 3% for every 1% decrease in the Dow Jones Industrial Average. During “medium elasticity” events, such employment changes corresponded in percentage terms with declines in the market index. In low elasticity scenario, employment moves half as much (in percentage terms) as the equity market index.

Sources: data on Wall Street Employment from New York State Department of Labour. All other data from WRDS.

The top part of the figure shows the way that financial services employment would change in Hong Kong if a financial crisis resembled the US crisis. For the first set of bars, we show estimated employment levels assuming that the Hang Seng Index falls similar to the 2001 decline. If Hong Kong financial service employment is as sensitive to equity prices as the US market was in the early 1970s, we could see declines of up to 10,000 financial sector workers. If the market declines at rates seen in 2007 (and if Hong Kong financial services are as sensitive to changes in the market index as Wall Street was in the early 1970s), we would witness employment declines of up to 25,000 persons. In all likelihood, one of the “low elasticity” or “medium elasticity” bars better explains the likely decline in Hong Kong’s financial services employment under macroeconomic stress. However, Hong Kong’s policymakers have an obligation to be ready for the worst-case scenario.

Interim measures: Increasing financial advisors to service a wider catchment

One way to help avert such dire consequences would consist of diversifying financial employment away from the Mainland. Indeed, why does Hong Kong focus so heavily on Chinese assets when its other neighbours offer potentially attractive alternatives? Figure 3.10 shows the number and potential assets of wealthy individuals who might look for Hong Kong asset managers to manage their money. Roughly US$20 trillion in wealth lies
in the region for Hong Kong asset manager “rainmakers” who know how to find it. The number of potential clients for Hong Kong asset and wealth managers – ignoring the regulatory and other barriers for soliciting clients across borders for the moment – comes to about 12 million (more than the entire population of Hong Kong). Hong Kong-based financial advisors have traditionally focused on increasing their exposure to the Mainland. Yet, they can diversify their client bases (and risks) as well as increase assets under management by targeting other markets in the region.

Figure 3.10: Southeast Asia and Russia Also Offers Rich Pickings for Hong Kong’s Asset Management Sector

Not only can Hong Kong asset managers potentially access large amounts of portfolio assets in the wider Asian region, they also face less competition than on the Mainland. Figure 3.11 shows a proxy for the competition that Hong Kong’s wealth and other asset managers face in various jurisdictions in the region. Hong Kong represents the worst market for Hong Kong asset managers to compete in – in terms of the intensity of rivalry. The Mainland – with its banks and other financial institutions – offers only a slightly less competitive market. Yet, for Hong Kong firms interested in competing in Thailand, India and Indonesia, lack of serious rivalry may lead to far greater amounts of portfolio assets collected.

30 Jules Baer (2013) provides a more detailed analysis of wealth in these markets.

31 Our proxy actually mixes a measure of the depth of financial markets and the competition in those markets (as the number of financial institutions, their market penetration and other information). As more detailed data are not available, and as these data back up other qualitative assessments of the degree of market rivalry in these jurisdictions’ financial sectors, we used these data.

32 We ignore the effects of corruption and other institutional factors in this description. Even if we decided to include corruption in our analysis, the “best” market to compete in still remains roughly as we outline in the figure. The Mainland’s corruption levels remain some of the highest in the world (Transparency International, 2013).
Hong Kong asset managers (and wealth managers) can increase their assets under management by hiring individuals from these foreign markets and having them solicit business. (We discuss solutions to the legal impediments to this strategy below). Hong Kong’s financial institutions hire very few Malaysians, Indonesians, Taiwanese and other nationalities. Many international banks and broker-dealers have offices in these countries – hiring local professionals. However, such a division of labour does not benefit Hong Kong directly as an international financial centre. Hong Kong financial institutions must find ways to increase assets under management from these countries in order to grow and diversify their revenue base.

Financial advisors in Hong Kong’s financial institutions will need legal authorisation to solicit and work with clients in these jurisdictions in order to compete in these markets. At present, Hong Kong’s financial advisors may not solicit for new business without the appropriate licenses and registrations in each of these markets.  

For example, in Malaysia, the Capital Markets and Services Act of 2007 requires that “no person shall whether as a principal or agent, [engage in securities-related solicitation or intermediation] or hold himself [herself] out as carrying on such business unless he [she] is the holder of a Capital Markets Services Licence or is a registered person”. Like Hong Kong and most other jurisdictions, Malaysian law provides for a number of exemptions covering “specified persons”. Needless to say, Hong Kong SFC license holders do not qualify under Malaysian law as a “specified person”. The Malaysian Capital Markets and Services Act also provides for – like most other securities laws – certain types of securities issuances which do not require the Malaysian Securities Commission’s approval, authorization or recognition. Of course, Hong Kong issuances do not fall into this list. In theory, nothing prevents such authorisation.

33 Each country’s capital markets law or relevant securities legislation provides for a licensing requirement. We discuss in this paragraph the Malaysian case only as one example from the list of countries we have discussed. We could have chosen any example.
34 Malaysian Capital Markets and Services Act, 2007, art. 58(1).
35 Ibid., Schedule 3.
36 Ibid., Schedule 5, Schedule 6 and Schedule 7.
Malaysian financial institutions would require access to Hong Kong’s markets in the same way that Hong Kong’s desire access to Malaysia’s. The Securities and Futures Ordinance (Part V) naturally provides the same kinds of restrictions on soliciting and carrying on securities-related business as the Malaysian legislation. If direct changes at the legislative or regulatory level could not occur (for political or other reasons), the SFC could enter into agreements directly with the Malaysian regulator. The SFC has already entered into an agreement with its Australian counterparts which might provide a model for such agreements in the future. The Declaration on Mutual Recognition of Cross-border Offering of Collective Investment Schemes provides this framework of cooperation with Australia. Why not broaden these types of arrangements in the Asian region?

In theory, rulemaking allowing such market access may not require Legislative Council approval. In theory, the SFC has the authority to exempt certain types of persons and transactions. Similarly, in theory the Malaysian Securities Commission “may impose [or not impose] such terms and conditions as may be deemed appropriate on specified persons [or class of persons]” (additions ours). Naturally, adopting regulatory measures which increases competitive forces in each regulator’s domestic market would require public consultation and likely political approval.

Before the SFC can approach the Malaysian Securities Commission with any proposal for legislative or regulatory changes allowing for mutual market access, the SFC should have a concrete proposal in hand. We thus recommend that the SFC study the possibility of bilateral passporting arrangements, which could be applied both in the region and potentially globally .

**Recommendation 1:** The government and/or SFC should focus on legal and regulatory changes needed to support funds passporting across multiple markets from Hong Kong. Such changes would allow for asset managers (wealth managers) to legally solicit for business in each others’ markets.

How would such a scheme allow Hong Kong-based financial advisors (asset managers) to demonstrate competency in the securities legislation of the jurisdictions in which they work? While Hong Kong and Malaysian securities laws have many similarities, they also have many differences. Mudarabah and other Islamic banking institution represent an obvious area where Hong Kong based financial advisors soliciting securities clients in Malaysia would need knowledge of provisions dissimilar to Hong Kong’s. We do not have a good, comprehensive and authoritative cross-country comparison of securities regulations to illustrate our point – clearly an area for future research. However, the

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37 SFC, 2008.
38 SFO, sec. 309.
40 The analysis of the political interests which “attach” to securities market reform has fallen out of use in recent years. Kroszner (1998) provides a rather dated discussion and example.
41 The World Bank only provides a database – its Organization of Financial Sector Supervision Database – showing the way that regulatory agencies world-wide assume responsibility for various aspects of financial sector regulation.
World Bank does provide such a comparison of banking regulations. Figure 3.12 shows the number of areas where Hong Kong’s banking regulations match Malaysia’s – for various areas of banking activity. For example, in accounting, the two jurisdictions’ provisions match in about 80% of the questions asked by the World Bank assessment team(s). In the case of bank ownership rules, they match only about half the time. If differences in securities laws exist to the same extent as differences in banking law, such differences mean that Hong Kong domiciled financial advisors selling securities in Malaysia would require special knowledge of Malaysia’s laws.

We propose that the SFC would work with foreign regulators to define the content of already existing securities examinations in other Asian jurisdictions which Hong Kong-based financial advisors could sit and pass. Successful completion of the exam would allow the Hong Kong domiciled financial advisor to sell in the other relevant jurisdictions. Examinees could take these tests in testing centres similar to other types of exams given across borders. The regulators would define in a Memorandum of Understanding (or direct additions to domestic regulation– like a special SFC Code or Guideline) the content of the exam and what successful passing would allow the examinee to sell (do). Figure 3.13 shows the way that the SFC could add these examinations and licenses to the existing list. In addition to the types of examinations in existence, the regulations could outline examination rules for a set of licenses allowing broker-dealers to solicit in foreign jurisdictions. In the illustration we provide, examinees could sit for a “type A” license which would allow the candidate to solicit business on the Mainland.

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42 See the World Bank’s Bank Regulation and Supervision Survey.
43 These testing centres allow examination candidates to sit a range of exams world-wide. One of the authors of this report sat for exams for the US Certification in Internal Audit in Hong Kong.
44 The legal profession has already implemented similar schemes to encourage cross-border competition (cooperation). The UK’s Qualified Lawyers Transfer Scheme basically puts into practice the same scheme we recommend for financial advisors. In the US, the Foreign Legal Consultants scheme allows foreign licensed lawyers to practice (on a limited basis) in the US.
**Figure 3.13: Suggested Modification to SFC Licensing Regime to Allow for Cross-Border Securities Solicitation and Activity**

<table>
<thead>
<tr>
<th>Existing License types</th>
<th>Proposed license types</th>
</tr>
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<tbody>
<tr>
<td>Type 1 Dealing in securities</td>
<td>Type A China</td>
</tr>
<tr>
<td>Type 2 Dealing in futures contracts</td>
<td>Type B Malaysia</td>
</tr>
<tr>
<td>Type 3 Leveraged foreign exchange trading</td>
<td>Type C Indonesia</td>
</tr>
<tr>
<td>Type 4 Advising on securities</td>
<td>Type D Thailand</td>
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<tr>
<td>Type 5 Advising on futures contracts</td>
<td>Type E India</td>
</tr>
<tr>
<td>Type 6 Advising on corporate finance</td>
<td>Type F Taiwan</td>
</tr>
<tr>
<td>Type 7 Providing automated trading services</td>
<td>Type G Russia</td>
</tr>
<tr>
<td>Type 8 Securities margin financing</td>
<td></td>
</tr>
<tr>
<td>Type 9 Asset management</td>
<td></td>
</tr>
<tr>
<td>Type 10 Providing credit rating services</td>
<td></td>
</tr>
</tbody>
</table>

Source: SFC (for existing license types) and authors (for new types). We assume dealing in futures, foreign exchange and banking would be unavailable under this scheme.

How would such an equivalence occur in practice? In all likelihood, the SFC would need to sign a Memorandum of Understanding (MOU) with the relevant securities agencies involved and issue a guideline for each country’s license. Figure 3.14 shows some of the topics which the two securities regulators would need to negotiate in order to set up the foreign qualified regulated persons scheme. In terms of enforcing the agreement on the domestic securities industry, we propose to add a sixth topic to the existing licensing guidelines called “guidelines for obtaining type A-G foreign qualified regulated persons licences.” The guidelines would thus contain 7 sections, covering the provisions negotiated for each country. The guidelines would explain in simple language the contents of the relevant MOU and the content of the relevant exam. The MOU would also need to cover areas related to the licensing scheme – like punishing foreign qualified related persons for infractions of the foreign jurisdictions regulations and so forth.

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45 See the SFC’s [Guidelines by topic: Licensing](#).
Figure 3.14: Contents for MOU and Accompanying Guideline(s) for Foreign Qualified Regulated Persons Scheme

Chapter 1: Types of persons who may obtain a foreign qualification
Chapter 2: Sections form domestic licensing exam required for foreign qualification
Chapter 3: Language requirements
Chapter 4: Areas of activity allowed to foreign qualified individuals
Chapter 5: Areas of activity expressly forbidden even with a domestic qualification
Chapter 6: Reporting requirements
Chapter 7: Surveillance and oversight functions of domestic securities regulator
Chapter 8: Application of warnings and punishments
Chapter 9: Methods for ensuring the criminalisation of particular offense with effects in the foreign jurisdiction (when treaty on mutual co-operation in criminal matters is lacking)
Chapter 10: Special measures applicable to domestic broker-dealers with foreign qualified licensed regulated persons
Chapter 11: Fees and use of proceeds
Chapter 12: Continuing Professional Education Requirements
Chapter 13: Modification by Signatories to this MOU
Chapter 14: Dispute Resolution
Chapter 15: Transitory provisions and execution

Because securities law evolves more quickly in emerging markets, the A-G licenses would require continuing professional education credits to maintain. We do not want to discuss such a requirement in too much detail, as this will probably differ between countries (and thus Memoranda of Understanding). While individuals may work across borders, no framework exists for investments to also “work across borders”. How can Hong Kong set up a structure which will allow Hong Kong financial advisors to sell Hong Kong created financial products in Malaysia and other countries in the region?

Recommendation 2: The SFC should negotiate at least one Memorandum of Understanding setting up a Foreign Qualified Regulated Persons Scheme as we describe in this report.

An ASEAN investment passport

The risks and rewards for further opening to the Mainland are discussed throughout this report. What about to the ASEAN region and other markets in the region and around the world? Access to the wider ASEAN region would have a number of benefits.\footnote{46} First, as

\footnote{46} We do not discuss cooperation with Russia or Taiwan (as discussed in the previous section) for reasons of space. Also, in terms of prioritising, work with ASEAN may provide a more efficient way to gain access to multiple markets rather than pursuing a bilateral approach with all the markets we described in the previous section. We also do not discuss cooperation with jurisdictions in the region who do not belong to the ASEAN, for reasons of space.
we showed in the previous section, access to ASEAN markets would provide Hong Kong’s wealth managers access to markets worth over US$15 trillion. Second, access to markets such as Indonesia and Malaysia would help diversify Hong Kong financial institutions’ portfolios and clients away from China. As we explain in this report, a potential China-origin crisis could increase the risk of a focusing on Mainland clients. Third, increased access to risks and returns unique to ASEAN markets could help raise overall risk-adjusted returns to Hong Kong financial institutions’ portfolios.

What exactly should be the objective? The government should secure membership – at least at observer status – to ASEAN sufficient to allow the SFC to work with the ASEAN Capital Markets Forum on capital market integration in order to help develop a passporting arrangement with Hong Kong. Such a passporting arrangement clearly falls in line with ASEAN goals. Figure 3.16 shows several of ASEAN’s stated goals for passporting investments in the wider Asian region. As shown, ASEAN – as a community – has clearly and strongly stated goals to engage in such investment passporting.

Figure 3.16: ASEAN Goals in Alignment with a Passporting Arrangement with Hong Kong

<table>
<thead>
<tr>
<th>Document</th>
<th>Provision</th>
<th>Number</th>
<th>Link</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asian Economic Community</td>
<td>Facilitate mutual recognition arrangement or agreement for the cross recognition of qualification and education and experience of market professionals</td>
<td>A4.31.ii</td>
<td>*</td>
</tr>
<tr>
<td>Blueprint</td>
<td>Remove restrictions for the Insurance, Banking and Capital Market sub-sectors by 2015</td>
<td>A2</td>
<td></td>
</tr>
<tr>
<td>Implementation Plan for Regional Integration of Capital Markets in ASEAN</td>
<td>Develop a single passport/licensing regime for market intermediaries (e.g. broker/dealers) with home country approval for facilitating cross-border provision of products and services</td>
<td>6</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Develop a mutual recognition framework and guidelines for cross-border recognition initiatives</td>
<td>1.1</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Facilitate cross-border distribution of primary offerings of equity and debt securities and listed products, within ASEAN</td>
<td>1.3</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Develop mutual recognition of market professionals involved in cross-border offerings such as sponsors, financial advisors, credit rating agencies</td>
<td>3.3</td>
<td></td>
</tr>
</tbody>
</table>

Source: various ASEAN documents.

47 Such a figure might appear high for a relatively low income area of the world. Such a perception comes from confusing output with wealth. According to the World Bank, global output (the flow of goods measured by GDP) comes to about US$70 trillion. According to Credit Suisse, global wealth (a stock measure of all the output saved over time) comes to about US$225 trillion.

48 Hong Kong has – under the Basic Law – the authority to engage in technocratic discussions with the ASEAN Capital Markets Forum in order to work on an investment passport agreement between Hong Kong SAR and the regulator-members of the Forum.
The ASEAN Secretariat and its Member States, for their part, would (or at least should) welcome Hong Kong’s involvement in a regional investment passporting scheme under the aegis of ASEAN+3 framework. First, current analytical abilities in the Secretariat would benefit significantly from the inclusion of Hong Kong. Second, Hong Kong has been involved in very significant ways in regional capital development market initiatives through ASEAN+3, IOSCO and APEC.\(^{49}\) Third, despite numerous agreements and protocols signed between ASEAN member states, little actual increase in investment seems to have so far resulted.\(^{50}\) Many observers – after presenting data showing very limited opportunities for financial integration in the ASEAN region – go on to argue for extremely ambitious integration objectives, like the creation of joint capital market supervisors.\(^{51}\) A concrete and specific initiative from Hong Kong might at least get some of these programmes moving.

Does the government have the authority to work on an ASEAN passporting scheme? Hong Kong can participate in the ASEAN+3 activities through the Chinese representation in the mechanism. In all likelihood, the government would need to work closely with the Liaison Office of the Central People's Government in the Hong Kong and the Commissioner's Office of China's Foreign Ministry in the Hong Kong (as such work with the ASEAN probably would involve “foreign affairs” as defined in the Basic Law). Hong Kong has already engaged in various forms of dialogue with the ASEAN Secretariat. Since the passporting scheme is a business of “external affairs” the Hong Kong SAR Government can conduct on its own, little doubt remains that – if managed diplomatically – Hong Kong has the authority to engage in work with the ASEAN on such a passporting scheme.

At first glance, the ASEAN+3 looks like a credible interlocutor for Hong Kong. Under the ASEAN+3 framework, China, Japan, South Korea, and ASEAN have signed multilateral trade agreements. They have also signed the Chiang Mai Initiative Multilateralization Agreement as an extension to the Chiang Mai Initiative. In 2012, the finance ministers taking part in the Agreement increased the size the fund associated with the Agreement for managing regional short-term liquidity (from US$120 billion to US$240 billion). The Agreement benefits from a permanent institutional presence (namely an ASEAN+3 Macroeconomic Research Office based in Singapore). A Monetary and Financial Stability Committee (MFSC) works under the framework of the Executives’ Meeting of East Asia-Pacific Central Banks (EMEAP). The China-ASEAN Inter-bank Association (CAIBA) provides the relationships needed to build out inter-bank lending in the region.\(^{52}\) As we have written about in this report, the Asian Bond Markets

\(^{49}\) Socorro and Remolona (2012) provide a deeper description about bond market integration in the region.  
\(^{50}\) See Yu et al. (2010) for one of many studies showing the lack of increased portfolio investment as a result of many of these initiatives. Grant (2013) of the FT sums it up (albeit talking specifically about ASEAN Exchanges) when they say “On the face of it, the idea of a pan-ASEAN exchange looks like a pipe dream.”  
\(^{51}\) See Lee and Takagi (2013) for an example.  
\(^{52}\) As a signal of the Association’s gravitas, some salient names of initial members include the Brunei Islamic Bank, Canada Bank, Bank Mandiri, Lao Development Bank, CIMB Bank, Myanmar Foreign Trade Bank, BDO Bank, DBS Bank, Kasikorn Bank, the Bank for Investment and Development of Vietnam, and the China Development Bank.
Initiatives (ABMI) New Roadmap+ also serves to promote debt market integration in the region. ASEAN+3 also hosts a range of expos and investment summits, which could provide networking opportunities to Hong Kong’s wealth managers.

Figure 3.17 shows the likely steps involved in implementing such a passporting scheme in the wider ASEAN region under Hong Kong leadership. Legal, cost-benefit and regulatory impact studies can help Government and financial services firms understand the likely rules and their impact. Political analyses also will help regulators at home and abroad understand which groups would support and prevent such a scheme. By explicitly looking at political interests, the draft rules governing the passporting scheme can help avoid issues which might delay or prevent the adoption of such a scheme.53

**Figure 3.17: Steps in Working with the ASEAN Capital Markets Forum**

1. Commission a series of legal, cost-benefit, regulatory impact and political analyses studies related to the Passporting Initiative to build public understanding and support for the passporting framework at home and in the counterpart countries,

2. Conduct meetings with the Ministry of Foreign Affairs Liaison in Hong Kong and arrange for Executive Council discussion of an approach to the ASEAN Capital Markets Forum

3. Approach the ASEAN Capital Markets Forum as an ASEAN+3 Member seeking observer status in the Forum (or FSDC as unofficial, working-level counterpart)

4. Present text for Passporting Initiative following the outline provided in this report and using the Framework for the Cross-Border Offering of ASEAN CIS as needed,

5. Obtain ratification of the framework document as Memorandum of Understanding between regulators of the various Working Group member states,

6. Include in SFC and counterpart rules limited piloting on certain types of investments during the initial years as implementation tapers in.

The final rulemaking governing such a passporting scheme will likely involve a fair amount of regulation.54 However, the ground-work text for Hong Kong-Led ASEAN Capital Market Forum Initiative on the ASEAN+3 Investment Passport could appear on the Forum’s website relatively quickly. Figure 5.18 shows some of the likely chapters in such a model agreement. The Forum members would decide the exact way the passporting initiative would be negotiated and implemented. Namely, the Forum would

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53 The analysis of the political interests attached to financial sector rulemaking as only recently come into vogue. In the 1980s and 1990s, policymakers and administrators suppressed such political analyses – passing off highly politicised administrative decisions as “depoliticised” bureaucratic decisions. Many financial regulators have criticised the suppression of political analyses as an illegitimate form of politics in itself. Gray and Hamilton (2006) provide a clear exposition of the harms of such “depoliticising” analysis.

54 In the EU, such rulemaking still remains a work in progress.
decide if the text appearing in simple form in Figure 3.18 would represent a model template, the final text signed by various regulators and so forth. A similar rule – the Markets in Financial Instruments Directive (MiFID) – contains over almost 70 pages of text for the directive alone and over 57 pages of implementing directives.55

**Figure 3.18: Outline of the Hong Kong-Led ASEAN Capital Market Forum Initiative on the ASEAN+3 Investment Passport**

Chapter 1: Definitions and Scope
Chapter 2: Conditions and Procedures for Investment Firm Authorisation
Chapter 3: Operating Conditions for Investment Firms
Chapter 4: Investment Firm Rights
Chapter 5: Provisions for Regulated Markets
Chapter 6: Powers and Redress Procedures
Chapter 7: Co-operation Between Signatories
Chapter 8: Co-operation with Third-Party States
Chapter 9: Final Provisions
Annex I: List of Services, Activities and Financial Instruments
Annex II: Professional Client Definition

**Recommendation 3:** The government should conduct a study of legal issues involved in Hong Kong’s observer status in the ASEAN Capital Market Forum and leadership of a “Hong Kong ASEAN Passporting Scheme”.

Importantly, APEC – despite making limited progress in many areas – does appear to be making progress in the context of potential funds passporting arrangements similar to those described above. Hong Kong – as an APEC member – should be very actively involved in seeking to advance these discussions. With passporting to APEC, ASEAN, Mainland China (discussed below) and the EU, Hong Kong would be well placed to diversify its markets and enhance its role as an international financial centre.

**Conclusions**

Hong Kong’s financial sector represents one of its most important employment generators. Employment has risen with an expanding equities market (in terms of the Hang Seng Index values). Hong Kong’s financial industry has also weathered the 2008 economic crisis, actually adding staff in the post-crisis period. Yet, room for further expansion remains limited, especially when relying so heavily on economic prospects on the Mainland. In this chapter, we argued that Hong Kong’s financial institutions should diversify away from the Mainland in order to expand the quantity and quality of financial

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sector jobs. We argued that hiring more Malaysian, Indonesian and other financial advisors may help our financial institutions seize opportunities in the wider Asian area. We also showed how a passporting scheme may help promote such hiring.
Chapter 4: Mainland Internationalisation and its Impact on Hong Kong

Hong Kong’s GDP relies heavily on trade and investment links with the Mainland.\footnote{In 2012, China represented Hong Kong’s largest trading partner (with 48% of its total trade coming from and going to the Mainland). Outward direct investment to China amounted to about HK$8 trillion (about 3 times higher than the next largest investment partner), while inward direct investment represented about HK$3 trillion.} Hong Kong continues to serve as an entrepot, with its traders and bankers earning a percentage from the flow of goods and money between China and the rest of the world. Many fear that Mainland capital account restrictions in particular will reduce the rents Hong Kong financial institutions earn as they help bring yuan out of the country and bring foreign currency in.\footnote{Economists argue that loosening Mainland capital controls could either benefit or hurt revenues earned by Hong Kong’s financial sector. In an interesting (yet rather dated) paper, Liu et al. (2002) derive a model showing that fuller RMB convertibility will promote investment in and through Hong Kong.} In this chapter, we assess the extent to which Mainland financial internationalisation will affect Hong Kong’s position as an international financial centre. We focus on the competition for funds with the emerging centres of Beijing, Shanghai and Shenzhen. We also discuss the growing offshore yuan trade – and Hong Kong’s current and potential role in these offshore markets. We also discuss how such internationalisation can harm (as well as help) Hong Kong’s financial markets. To keep the report brief, we avoid discussing areas where Hong excels, and focus our discussion in this chapter on areas of possible improvement. Our focus on areas of possible reform should not be taken as a criticism of Hong Kong’s often excellent financial sector structure or performance.

We argue that – in order to maintain and expand its role as a financial centre – Hong Kong must adopt strategies to complement (rather than compete with) emerging financial centres on the Mainland. Hong Kong’s policymakers must adopt measures which help its financial advisors gather assets across the region. Hong Kong’s policymakers and regulators must lead measures which help Hong Kong’s financial institutions participate in Hong Kong’s real economy. In the first part of the chapter, we describe to erosion of Hong Kong’s position as an IFC compared with Shanghai and Shenzhen. We also describe likely areas of future competitive advantage, particularly in equities and derivatives. In the second section, we show how recommendations have not really helped Hong Kong’s policymakers adapt strategically to these new international financial sectors. In the third section, we focus on one area where advice has fallen particularly short – yuan internationalization. We describe the way that London appears to position itself in the global yuan-trade value-chain. In the next sections, we describe how Hong Kong can beat London at its own game – creating a passporting scheme to help Hong Kong financial services firms participate in the Mainland’s real economy and supporting offshore yuan markets in the same way London created and dominated euro-dollar markets in the 1960s.
Hong Kong’s co-opetition with Shanghai and Shenzhen

Hong Kong represents one of four prominent financial centres in China (the others being Beijing, Shanghai and Shenzhen). Shanghai represents perhaps the biggest challenger to Hong Kong as an international financial centre. Mainland government authorities, both at the central level and in Shanghai, have announced plans to turn Shanghai into a preeminent financial centre. China’s National Development and Reform Commission (NDRC) has outlined its plans for Shanghai’s explicitly international role in the recent *Blueprint for the Construction of Shanghai International Financial Center* during the 12th Five-Year Plan Period. For its part, the State Council announced its *Overall Plan for China (Shanghai) Pilot Free Zone*. Already, the municipal government has started rulemaking in order to comply with the mandates imposed by the central government. Shenzhens’s legal base for the development of its financial centre focuses more on regional cooperation agreements rather than mandates from the central government. Two instruments serve as a basis for deepening Shenzhen’s role as a (international) financial centre. The *Outline of the Plan for the Reform and Development of the Pearl River Delta* and the *Overall Development Plan on Hong Kong/Shenzhen Cooperation on Modern Service Industries in Qianhai Area* represent agreements treating Hong Kong and Shenzhen as the integrated economic entity they are already quickly becoming. The basis for Beijing’s financial centre comes mostly from the forces of banking agglomeration and urban planning ordinances – rather than from strategic or other policies promulgated by the central government. According to anecdotal evidence, the banks residing on the Beijing Financial Street hold roughly 60% of the country’s financial assets. The Lize Financial District plans to become the *Qianhai* of the nation’s capital.

A cursory look at Beijing-based banks clearly shows the important domestic role Beijing already plays as a financial centre. Figure 4.1 show the value of loans (in RMB) held by Beijing-based banks – compared with Shanghai-headquartered banks. Beijing headquartered banks eclipse their Shanghai peers. If these data really reflect reality, the Industrial and Commercial Bank of China alone holds a loan portfolio greater than the

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3 A full review of the *Blueprint* is beyond the scope of this report. Sekine (2012) and Fulbright (2013) provide the major provisions and brief discussion of their impacts.
4 See *Overall Plan for China (Shanghai) Pilot Free Zone*. Linklaters (2013) provide an overview of the Plan.
5 Yang (2013) provides a discussion of the *Blueprint* with a particular focus on recent ordinance-making by Shanghai authorities.
6 Shenzhen’s strategy (as judging only by the adoption of the regulatory instruments we have cited) seems to focus on internationalisation through closer integration with Hong Kong. Because Hong Kong already serves as an important international financial centre, closer integration with Hong Kong will make the domestically-focused Shenzhen equity and debt markets more international by association with Hong Kong.
7 Sekine (2013) provides an overview of these two instruments. KPMG (2012) provides more specifically on the Qianhai.
8 Qianhai refers to the large-scale financial district under development in Shenzhen. Silk (2013) describes Lize.
We cannot know the extent to which these loans represent borrowing for foreign-held assets (namely, money Chinese companies borrow in order to purchase assets in foreign countries). However, as the Chinese economy internationalises, financial services offered by these Beijing banks will increasingly target foreign borrowers and/or foreign assets. Beijing represents an integral part of China’s international financial centre story – even if almost no research currently exists to help the analyst understand its position and role.

How does Shanghai stack up against Hong Kong? The data show that Shanghai has gained competitive advantage – or has already surpassed Hong Kong – in certain financial sector market segments. Figures 4.2 compare the value and volume of particular financial transactions related to companies listed on the Shanghai Exchange with those of their Hong Kong-listed rivals (peers). In all the panels, we divide data from Hong Kong by similar data in Shanghai. For example, in the first panel, we show total number of traded shares in Hong Kong relative to Shanghai (as the solid black line). In that particular case, the ratio fell from about 7 to slightly less than 1 in 2009. Such a fall means that the number of traded shares rose significantly in Shanghai, slightly surpassing the number traded in Hong Kong in 2009. We use these ratios as a measure of Hong Kong’s “revealed comparative advantage” (or at least its competitive advantage). We

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9 A wide range of commentators encourage the users of data from public and private sector organisations on the Mainland to exercise extreme caution. We discuss some of these problems later in the report.

10 Journalist accounts of these banks’ lending provides some clue about the nature of such lending. Sanderson and Forsythe (2013) describe in detail the way that banks such have loaned large amounts of money to local government corporate vehicles in order to build infrastructure. Using local land as collateral, these vehicles use their infrastructure investments to push up the value of the land and the value of the debt/equity of the vehicles themselves rises in local and international financial markets.

11 Few academic authors have conducted analysis about the size and function of Beijing-based equity and debt markets – particularly the China Beijing Equity Exchange. Derudder et al. (2011) represent a refreshing exception to the lack of scholarship about Beijing’s place as an international financial centre – telling the under-told story of jurisdictions like Beijing.

12 Comparative advantage comes from economic theory and refers to the extent to which firms in a particular sector or country have lower relative (comparative) costs. Competitive advantage comes from the business literature and refers to the extent these firms can maintain longer-term, above-market average
interpret more market activity in a particular jurisdiction as reflective of its competitiveness.\textsuperscript{13}

According to several measures of \textbf{equity market competitiveness}, Shanghai’s companies and financial institutions are overtaking their Hong Kong peers. In the first panel (figure 4.2a), we show the number of traded shares, the value of new shares, these shares’ market capitalisation and the number of listed companies on both the Shanghai and Hong Kong exchanges. The dramatic drops in the lines representing the ratio of the total number and value of traded shares demonstrate Shanghai’s rapidly deepening equity markets.\textsuperscript{14} Shanghai started 2005 with larger market capitalisations of new shares than Hong Kong – and kept its decisive advantage throughout the decade. Hong Kong, in contrast, kept its marginally larger number of listed companies throughout the decade. The second panel (figure 4.2b) shows that Hong Kong’s exchange traded fund (ETF) competitiveness has fallen markedly – with Shanghai holding on to advantages in the value of listed ETFs and trading volumes. As a sign of good news (for Hong Kong), the value of investment fund trading has risen significantly relative to trading on the Shanghai exchange. As shown in the third panel (figure 4.2c), the number of investment funds and number of trades in Hong Kong remains lower than those on the Shanghai exchange. However, such rapid increases in the value of investment fund trades in Hong Kong suggests (and no more than implies) increasing competitiveness in this sector.

\textsuperscript{13} A rigorous approach would consist of looking at the costs and profit margins associated with various financial transactions by financial and non-financial institutions in both jurisdictions. Moreover, for rapidly expanding markets, the ratios we use may give a misleading impression that one jurisdiction gains market share at the expense of another. Indeed, in the longer-run, increased financial activity in Shanghai may encourage – rather than replace – financial activity in Hong Kong. We address the extent to which deepening financial activity may complement, rather than compete with, Hong Kong financial activity later in this chapter.

\textsuperscript{14} We provide only a few illustrative examples. Luo (2006) provides a fuller analysis of Shanghai’s financial sector size and other attributes.
Figure 4.2a: Shanghai’s Equity Markets Quickly Catching Up to Hong Kong

The data in the figure show the ratio of the value/volume of the indicators shown for Hong Kong divided by Shanghai. Figures greater than one indicate more activity in Hong Kong, while figures less than one indicate greater values/volumes in Shanghai. Data do not include non-exchange traded securities.


Figure 4.2b: Hong Kong Losing Its Competitive Advantage in ETF trading

The data in the figure show the ratio of the value/volume of the indicators shown for Hong Kong divided by Shanghai. Figures greater than one indicate more activity in Hong Kong, while figures less than one indicate greater values/volumes in Shanghai. Data do not include non-exchange traded securities.


Figure 4.2c: Hong Kong Fighting Hard to Keep Dominance in Investment Fund Markets

The data in the figure show the ratio of the value/volume of the indicators shown for Hong Kong divided by Shanghai. Figures greater than one indicate more activity in Hong Kong, while figures less than one indicate greater values/volumes in Shanghai. Data do not include non-exchange traded securities.

Initial public offering (IPO) and bond markets should represent the two areas of biggest areas of concern for Hong Kong. Shanghai has gained significant ground in the number of IPO offerings relative to Hong Kong (as shown by the downward sloping lines in figure 4.2d). Total IPO investment flows have nudged up in recent years (meaning that the value of Hong Kong’s total IPO investment flows have increased slightly relative to Shanghai in recent years). However, with a faster growing pipeline of the number of new IPOs on the Shanghai exchange, these trends in the total value of IPO investment flows should turn to Shanghai’s favour in time.

Hong Kong has lost any claim as a domestic bond-offering or trading centre. Figure 4.2e shows the relative number and value of listed bonds on the Hong Kong and Shanghai exchanges. By the end of 2007, Shanghai’s number and value of listed bonds exceeded those in Hong Kong. Judging by the sharp angle of decent in the figure – combined with data about the shallowness of Hong Kong’s bond markets we presented in a previous chapter – the prospects for a Hong Kong dollar-based fixed income market look rather dismal. Some analysts point to RMB internationalization as a chance for Hong Kong to increase the number and value of bond issuances (in RMB denominations). Yet, why would issuers (for the primary market) and traders (in secondary markets) use Hong Kong when Shanghai bond markets appear much more liquid and popular, at least in the absence of capital controls limiting foreign participation? We return to this important issue below.

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16 Latter (2008) has argued that Hong Kong firms may seize the opportunity presented by the dim sum (RMB-denominated debt) market to build a Hong Kong-based debt market. Fung and Yau (2012) provide an account of dim sum bonds issued in Hong Kong as a core element of China’s plan to internationalise the use of renminbi.
17 Bottelier (2008) provides the necessary background on China’s emerging debt and bond markets.
**Figure 4.2e: Shanghai Will Be Greater China’s Bond Hub**

The data in the figure show the ratio of the value/volume of the indicators shown for Hong Kong divided by Shanghai. Figures greater than one indicate more activity in Hong Kong, while figures less than one indicate greater values/volumes in Shanghai. Data do not include non-exchange traded securities.


**Shenzhen** in particular represents an area of increasing interest for Hong Kong’s financial institutions and government officials. Hong Kong officials have encouraged closer integration with Shenzhen – resulting in the growth of Shenzhen’s capital markets possibly at the expense of Hong Kong’s. Companies in the Guangzhou area do seem to prefer to use Shenzhen rather than Hong Kong as the jurisdiction-of-choice in going public and in investment fund offerings. Figure 4.3 describes the ways that Shenzhen is quickly developing.

**Figure 4.3: Some Surprising Facts about Shenzhen’s Financial Development**

1. The two jurisdictions are basically neck-to-neck in IPO work. Shenzhen fell behind by only $30 million in new issues in 2011 and by about the same amount in total IPOs in 2012.

2. Which jurisdiction pushes through more company IPOs each year? Shenzhen. In 2011, they floated 162 more companies than Hong Kong (at 81). In 2012, their lead narrowed to 69 companies.

3. Who has more listed companies? Hong Kong. But just barely – at 1547 (compared with Shenzhen’s 1540). With their growth rate, they will double in 5 years (compared with our 18 years).

4. Who wins in the ETF space? Hong Kong – kind of. With neck-and-neck growth rates in ETF trades, Shenzhen wins at 3,066 (compared with Hong Kong’s 2,131). Hong Kong ETF trades by value still eclipse Shenzhen’s by 2.6 times.

5. What about in investment fund markets? Shenzhen wins hands-down. Shenzhen has about 11 investment funds for every 1 in Hong Kong. Shenzhen’s funds handled about 6 times more in value in 2012.


Will benefits from the market-expanding-effects of integration between Hong Kong, Shanghai and Shenzhen exceed the costs to Hong Kong’s financial actors of business

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18 Shen and Luo provide a useful background on such integration.
diversion (as listing and trading business goes to the Mainland)? For projects like the Qianhai district, we cannot know (as the district is still being built).\textsuperscript{19} No public studies of the effects of the Closer Economic Partnership Agreement (CEPA) serve as a guide to estimate the likely effect of the closer integration of Hong Kong’s and Shenzhen’s financial markets.\textsuperscript{20} Yet, we can observe the effects of the signature of a joint venture agreement between Hong Kong’s, Shanghai’s and Shenzhen’s exchanges culminating in the creation of China Exchanges Services’ (CES) indices, and declarations of a project of mutual trading access between the Hong Kong and Shanghai stock exchanges.\textsuperscript{21}

If the China Exchanges Service’s performance provides any guide, integration in Chinese equity markets will create no more value than the sum of each city’s parts. The indices provided by the CES just package and replicate portfolios of stocks listed on each of the three exchanges. No extra value from the CES’s products seems apparent (in terms of attracting investors to the exchanges or adding depth or better information about securities traded on the member exchanges).\textsuperscript{22} Previous financial integration has already brought significant co-variance in price movements and returns in each market – proving that integration has already occurred.\textsuperscript{23} If increased trading in Shenzhen or Shanghai does not expand markets for Hong Kong’s financial firms, then the development of these two markets will either have no effect on Hong Kong (in the best case) or divert business (in the worst case).\textsuperscript{24}

Yet, asking if Shenzhen, Shanghai and Beijing will crowd-in or draw away debt and/or equity investment to Hong Kong misses the point. Beijing, Shanghai, Shenzhen and Hong Kong – according to the available research – will develop complementary niches.\textsuperscript{25} To see how investment complements rather than competes between regions (particularly in the real economy) a look at the major components of the Hong Kong and Shenzhen market indices suffices. Looking specifically at bank finance, Lai finds that “differentiated markets lead[] to the distinctive development of Shanghai as a commercial centre, Beijing as a political centre and Hong Kong as an offshore financial centre, with all three financial centres performing distinctive and complementary roles within the regional banking strategies of foreign banks”.\textsuperscript{26} Even looking at the competitive “division

\textsuperscript{19} Leung and Pomfret provide a useful (media) version of events.

\textsuperscript{20} The Agreement provides for liberalization of barriers between financial sector service offerings in Hong Kong and Shenzhen (and the Mainland). A description of the Agreement itself would require a full chapter to cover. We refer interested readers to Cheung (2012) for a very adequate overview. Tuan and Ng provide the closest thing to an economic analysis of CEPA’s effects.

\textsuperscript{21} See Donald (2012), chapter 6.5.

\textsuperscript{22} In all fairness, the CES represents a relatively new venture. Time will tell if our conclusions remain valid in the medium-term.

\textsuperscript{23} Zhu and Dou (2012) and Chen et al. (2011) provide two empirical studies showing high correlation between Shenzhen and Hong Kong markets.

\textsuperscript{24} Several studies argue for the integration of Chinese exchanges (and financial markets) – without considering the strategic aspects of competition between exchanges in the Greater China region. For example, despite the word “shifting” in the title of their study, Subacchi et al. (2006) do not consider at all the way that growth in one exchange may come at the expense of another.

\textsuperscript{25} Jarvis (2009) provides a worthy overview of Hong Kong and Shanghai in comparative perspective (with Singapore as a comparator).

\textsuperscript{26} Lai, 2012.
of labour” between the Hong Kong and Shanghai stock exchanges, Shanghai focuses largely on ease (of listing for example) while Hong Kong focuses on access to deep foreign markets.\textsuperscript{27}

A glance at the regional distribution of company listing across China provides a quick-and-easy illustration of the complementarity, rather than competition, of and between various financial markets in China. While we provide an example related to company listings, we could have, just as easily, provided an example centered on banking, equity trading, or M&A – rather than on IPOs. Figure 4.4 shows the extent to which companies in each Chinese province choose to list on the Shanghai, Shenzhen or Hong Kong exchange. In almost every case, some companies prefer Shanghai or Shenzhen rather than Hong Kong. Hong Kong will always have some market for IPOs for companies coming from the various Chinese provinces. Hong Kong already has benefited from listing by large state-owned companies (to the neglect of inland regions). This province-level view shows that the best combination of listing fora comprises a mix of Shanghai, Shenzhen and Hong Kong listings.

![Figure 4.4: The Regional Distribution of Company Listings in 2006](image)

Different exchanges exist to match certain kinds of share buyers with certain kinds of companies. Investors in different regions and markets will want different kinds of shares that provide a desired level of risk, a certain time profile of returns, and a longed-for co-variance with other assets in their own portfolios.\textsuperscript{28} They will also want to hold certain kinds of shares of companies from certain cities or countries (depending on how much information investors can obtain, if they speak the language of that place and believe in the institutions of that place).\textsuperscript{29} Clearly, investors in Hong Kong (or using the Hong Kong

\textsuperscript{27} Lai, 2012, table 4.
\textsuperscript{28} Coeurdacier and Guibaud (2011) provide the economics and empirics behind the plain English description of modern portfolio theory we just provided.
\textsuperscript{29} Okawa and Wincoop (2012) and Bekaert et al. (2011) provide more technical explanations of the plain English explanation we have just provided.
exchange) will want different portfolio assets than an investor using Shanghai’s exchange. Figure 4.5 shows how investors using all three exchanges can access a wider range of portfolio assets than those tapping only one exchange. Because each exchange appears to specialise in listing companies from different industries, the optimal investor portfolio likely requires an investor to deal with each of the three exchanges (Hong Kong, Shenzhen and Shanghai).

![Figure 4.5: Co-opetition by Sector in the Race for Assets Under Management](image)

The data in the figure show the extent to which fund raising and investment in particular sectors corresponds with each of the three major exchanges. We do not have space to describe the multi-dimensional scaling techniques the authors use (which looks at the extent of similarities based on variances). See source for details. Source: Karreman and van der Knaap

Most scholars writing about competition between financial centres see a “division of labour” emerging between markets. Zhao et al. (2004) see the development of multiple financial centres in China as reflective of more than differences in the competitiveness of financial institutions in a particular jurisdiction. Differences in financial centres’ competitiveness come from transactions costs (particularly communications and travel costs) as companies and investors want to do business in a market to which they have easy access. They also want markets which provide access to government and particular lifestyles. All this theory does not help the practitioner however. What division of labour will Hong Kong likely attain in a region with four financial centres (Beijing, Shanghai, Shenzhen and Hong Kong)?

As of late 2013, Hong Kong’s competitive advantage appears in equities and derivatives (except currency derivatives). Figure 4.6 summarises our discussion, focusing on the areas where each financial centre seems to exhibit competitive advantages. Shanghai clearly has advantages in the bond markets. Beijing emerges as the centre of banking in China. Hong Kong still leads in equity trading. Because of its industrial and manufacturing base, Shenzhen has gained the upper hand in IPOs. Hong Kong’s policymakers, if they want to change Hong Kong’s emerging competitive advantages, will need to take decisive action to develop markets where other cities have decisive advantages.

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Zhao et al. (2004).
Figure 4.6: Emerging Competitive Advantages of China’s FOUR International Financial Centres

<table>
<thead>
<tr>
<th>City (IFC)</th>
<th>Equities*</th>
<th>IPOs</th>
<th>Banking</th>
<th>M&amp;A</th>
<th>Bonds</th>
<th>ETFs</th>
<th>Derivatives</th>
<th>Wealth Man</th>
<th>RMB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shenzhen</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hong Kong</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beijing</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: the competitive advantages shown in the figure represent areas where that jurisdiction has the largest or a rapidly growing share of the market segment shown. In some cases, we rely on interviews with market participants to supplement (or supplant!) market data. For some areas like M&A and ETFs, our review did not obtain enough information to make judgments. The emerging competitive advantages we show in the figure reflect our own judgment.

Improving policymaking

Current proposals aimed at improving the international competitiveness of Hong Kong banks and broker-dealers are largely abstract. Of course, data alone cannot provide the sole basis for policymaking. However, data should be used where available. Legal analysis based on principles must remain an important method of policymaking. However, data should supplement such analysis.

We recommend a SMART initiative aimed at advisors providing advice about Hong Kong as an international financial centre and/or as a part of China’s internationalisation strategy. Such Specific, Measurable, Actionable, Realistic and Time-Bound (SMART) recommendations would provide a more use base for public discussion and government action. Such a SMART initiative would encourage advisors and policy analysts to produce recommendations which other analysts could assess and which the government could actually adopt. Such a provision can be added into contracts or tender awards.

**Recommendation 4:** Unless a political objective requires otherwise, require all reports financed with public money contain data-supported, SMART recommendations.

Another issue deals with public review of cooperative arrangements reached with the Mainland. Recently, the SFC and HKMA have announced a series of agreements with Mainland regulatory authorities. Both the HKMA and SFC put domestic rulemaking online and carry on extensive public consultation. However, for agreements with the

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31 In a previous chapter, we described the abstract nature of recommendations aimed at improving domestic financial regulation. In this section, we focus on the abstract nature of recommendations aimed at improving cooperation and integration with other jurisdictions (particularly the Mainland).

32 Thousands of primers show how to create such SMART recommendations. Independent reviews continue to find that high-performing jurisdictions tend to produce SMART recommendations and assessments. Wooldridge (2004) provides one example of a description of the SMART methodology and an assessment of the extent to which advisors use SMART goals.

33 Two main regulatory instruments consist of the SFC Rulebook and HKMA Supervisory Policy Manual.
Mainland, the public have little chance to view or participate in these agreements. Instead, the public usually learn about these agreements in press releases and on the relevant authority’s website.\textsuperscript{34} Without access to the original agreements, commentators and those impacted have no way to assess the likely effectiveness of such agreements.

Even without access to existing agreements, we can clearly see that closer integration between Mainland and Hong Kong capital markets will require closer integration between its regulators.\textsuperscript{35} Hong Kong regulators’ memoranda of understanding with the Mainland probably reflect similar MoUs signed with foreign jurisdictions which put these MoUs online – like Australia.\textsuperscript{36} If so, such an MoU confines cooperation mostly to exchanging information. Yet, the degree of interaction between Hong Kong authorities and Mainland authorities will likely make the SFC-HKMA MoU a more applicable model for cooperation than the Australian MoU with the Mainland.\textsuperscript{37} Such an MoU must answer three questions. First, what competencies and obligations does the Hong Kong regulator have in dealing with their Mainland counterparts?\textsuperscript{38} Second, what organisational structure should a structure dealing with banking and securities regulation take – particularly if Hong Kong moves toward a more integrated regulatory structure (as we discuss in a subsequent chapter)?\textsuperscript{39} Third, how can regulators deal with the prudential regulation and market discipline of these increasing integrated markets? Fourth and finally, how can agencies with very different organisational cultures and even languages work together?

We propose thinking at this early stage about the design of the working group set-up to tackle these issues. Figure 4.9 provides the headline titles of a regulation governing the activity of a joint regulator working group will the Mainland. Initial public discussion at this early stage will help ensure the process occurs in public view (rather than in secret as present). The formation and function of such a working group would probably best resolve the questions we pose in the previous paragraph.\textsuperscript{40}

\textsuperscript{34} See the HKMA’s \textit{Co-operative Arrangements with Supervisory Authorities Outside Hong Kong}. In the case of the SFC, Lam’s \textit{speech} on \textit{A New Frontier for RMB Investment Products and Asset Management Business} provides a useful overview.

\textsuperscript{35} Most academics e.g. Wu (2008) agree that, regardless of the method of financial sector integration, cross-border regulatory structures must be built up.

\textsuperscript{36} The relevant document consists of the Memorandum of Understanding between the China Banking Regulatory Commission and the Australian Prudential Regulation Authority.

\textsuperscript{37} The relevant document consists of the SFC and HKMA’s \textit{Memorandum of Understanding between the Securities and Futures Commission and the Hong Kong Monetary Authority}.

\textsuperscript{38} The MoU would naturally define the obligations and authorisation devolved from their respective regulators to individual working with their foreign counterparts in a Working Group structure like the one we propose in this report. Korma (2009) provides a discussion on the optimal placement of legal competencies in regulatory agencies in a federal setting (a model which the Mainland and Hong Kong are quickly evolving toward).

\textsuperscript{39} The literature – as represented by examples like Kara (2010) and Brunner (2011) – comes out pretty strongly for a single coordinating body rather than the approach Hong Kong currently uses, with the SFC dealing bilaterally with its counterpart while the HKMA doing likewise).

\textsuperscript{40} We cover a large amount of proposed rulemaking in this report. Thus, we do not have space to analyse in depth how and why such a structure probably represents Hong Kong’s optimal response to regulatory cooperation with the Mainland.
We therefore recommend that Hong Kong regulators (after obtaining agreement with their counterparts) put existing memoranda of understanding with Chinese authorities on the internet. We also recommend discussing the future structure of these working groups – on the understanding that closer capital market integration between the Mainland and Hong Kong will require more integrated regulatory structures than the ones currently in operation.

**Recommendation 5:** Put existing Memoranda of Understanding with Mainland authorities and other regulatory instruments which affect Hong Kong financial institutions operating on the Mainland online. Engage in public consultation about revised MoU.

*Passporting Hong Kong’s mutual funds*

In recent years, Hong Kong and Chinese authorities have worked on the integration of Mainland and Hong Kong mutual fund markets. The **Mutual Recognition Platform** represents a first step in an on-going path toward capital market integration between the Mainland and Hong Kong.\(^{41}\) Growth will likely proceed slowly over the upcoming months and years.\(^{42}\) On the one hand, mutual access to each other’s mutual fund markets will increase the depth of markets in both jurisdictions. According to Brown, Brothers Harriman,\(^ {43}\) assets flowing into the Hong Kong mutual fund sector as a result of the

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\(^{41}\) The Government does not put online any of the preparatory materials related to the Platform – making scholarly analysis extremely difficult. See E&Y (2013) for an overview of the Platform and its likely impacts and shortcomings.

\(^{42}\) Integration between Hong Kong and the Mainland certainly will not be a “game changer” for Hong Kong as Citi’s (2013) hyperbolically titled report suggests.

\(^{43}\) (2013).
Platform could range – under their medium growth scenario – from US$146 billion to US$598 billion by 2018.

The Platform probably will not greatly increase mutual fund assets under management – at least in the short-run. First, Chinese mutual funds have not earned an exceptionally high rate of return (mostly because of negative returns toward the end of the 2010s). Lack of returns, combined with relatively high returns from developed world mutual funds as share prices recover has stunted the growth in Chinese mutual fund demand. Second, the Chinese mutual fund market (through Managed Fund Companies or MFCs) has developed quickly – though in spurts. Figures 4.8a and 4.8b show the growth, and the cycles which underlie this growth, of these funds. As shown in Figure 4.8a, the Chinese mutual fund industry has levelled off – in terms of assets under management (despite ongoing increases in the number of funds offered). Figure 4.8b shows that such investment tends to occur in spurts – with new entrants into various asset classes obtaining far more assets than latter mutual fund arrivals. Such data suggest that later Hong Kong-based entrants would not obtain the rich-pickings many predict.

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**Figure 4.8a: China Has More Funds without Much More Mutual Fund Money**

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Funds</th>
<th>Assets Under Management (billions RMB)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>290</td>
<td>290</td>
</tr>
<tr>
<td>2007</td>
<td>360</td>
<td>360</td>
</tr>
<tr>
<td>2008</td>
<td>430</td>
<td>430</td>
</tr>
<tr>
<td>2009</td>
<td>560</td>
<td>560</td>
</tr>
<tr>
<td>2010</td>
<td>700</td>
<td>700</td>
</tr>
<tr>
<td>2011</td>
<td>950</td>
<td>950</td>
</tr>
</tbody>
</table>

The data in the figure show the assets under management in China's fund industry for the years shown. We also show the number of funds for each year. As assets under management stagnate, the number of funds continued to grow.

Source: Z-Ben (reported in Citi-Z-Ben, 2012).

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44 A number of authors – particularly Chen and co-authors (2013) as well as Z-Ben Advisors (2013 on the chart on p. 6) – comment on Chinese mutual funds’ poor returns. Our own cursory analysis of mutual fund returns show relatively good returns over 1 year and 5 year horizons – with losses in many funds over a 3-year period.
As such, the success of the Platform (and the broader integration agenda) will involve deepening demand for Chinese securities which underpins mutual fund demand. Despite what all the press intimates, no torrent demand for Chinese assets exists. Figure 4.9 shows new quota allotments for Chinese assets under the Qualified Foreign Institutional Investor scheme. As shown, demand for Chinese investments has remained unsteady – and less than allotted amounts. Without increasing the value of the investments that Chinese mutual funds invest in, the Mutual Recognition Platform will unlikely stoke demand for such investment.

The success of the Platform will also depend on making Chinese investors (particularly fund investors) more sophisticated. Hong Kong investment on the Mainland can help develop such sophistication. Figure 4.10 shows several papers which draw the link between mutual fund investment in China and Chinese firm performance. Summarising the literature, mutual fund investment from Hong Kong might help improve investment capacities on the Mainland in three ways. First, Chinese fund managers have

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Io&C (2013) provide a further background on such a lack of market demand.
not developed the same skills as their foreign counterparts – either in terms of fund management and/or investment skill. Hong Kong investment can help transfer these skills as well as just money. Second, Hong Kong investment can help strengthen corporate governance on the Mainland. Significant evidence suggests that opening up to foreign investors has decreased investment in Chinese equities – because of “abnormal trading activities”. Foreign investment (either directly or through mutual funds) can help reduce the effects of collusion among traders and between traders and the companies they invest in. Third, joint ventures with foreign fund managers can help increase savvy – both inside China and outside.

**Figure 4.10: How Does Mutual Fund Investment Affect Returns on the Mainland?**

<table>
<thead>
<tr>
<th>Authors</th>
<th>Summary</th>
<th>Link</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yuan, Xiao, and Zou (2008)</td>
<td>Finds that equity ownership by mutual funds has a positive effect on firm performance.</td>
<td></td>
</tr>
<tr>
<td>Sharpe, Tian and Zhang (2012)</td>
<td>Mutual funds have specific (more and better) information which they help share with the market through their trading decisions</td>
<td></td>
</tr>
<tr>
<td>Yang, Chi and Young (2011)</td>
<td>Mutual fund ownership helps discourage company management from engaging in earnings manipulation</td>
<td></td>
</tr>
<tr>
<td>Tang, Wang, and Xu (2011)</td>
<td>They find that fund size positively correlates with performance up to a limit, then exhibits a negative correlation (an inverted U-shape relationship). Economies of scale and liquidity explain such a pattern in the data.</td>
<td></td>
</tr>
<tr>
<td>Chi (2013)</td>
<td>Mutual managers have inside information, but large proportional institutional investment tends to reduce this effect.</td>
<td></td>
</tr>
<tr>
<td>Gao, Wong, Xia &amp; Yu (2013)</td>
<td>Local fund managers have close relationships with company management, making their returns higher and giving extra-advantage.</td>
<td></td>
</tr>
</tbody>
</table>

Source: cited authors

Investor protection will represent an important issue for the development of the Platform – both for Hong Kong and Mainland China. Significant evidence continues to point to insufficient investor protection in investment fund disclosures in Hong Kong. Insiders clearly also have an advantage in the Chinese mutual fund market. Indeed, any Platform agreement which encourages the CSRC to adopt binding hard law measures against insider trading and market manipulation in investment fund markets can only improve investment in China’s mutual and other funds.

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46 For some salient analyses, see Yao and Wang (2013) and Zhao (2013).
47 Chen et al. (2013). Indeed, one of the objectives of the QFII has revolved around importing foreign know-how through longer-term investment. Such knowledge transfer has not been overly successful (Tam et al., 2010).
49 Young et al. (2010).
50 Gao et al. (2012); Chi (2013).
51 Howson (2012) provides a discussion of the current lack of provisions to detect and punish investment fund manipulation and insider trading.
While a “technical study” group is currently working out the substance of the Mutual Recognition Platform, we would make a number of suggestions at this time. Our proposals cover mutual fund companies (“makers”) and not distributors. We propose a regulatory regime based on **clear-line rules** – rather than discretionary approvals or lists of qualified institutional investors created by the SFC and/or CSRC. Such administrative vetting would introduce a degree of arbitrary action and take up significant regulator time. Such a vetting regime would also create non-uniform treatment of mutual funds – as the CSRC has very different capacities and obligations than the SFC. Second, we propose **automatic authorization** for mutual funds that meet the joint SFC-CSRC Platform rules. Similar rules govern listing in the EU and US. Third, we propose that automatic authorization clear-line rules be based on the asset quantity and quality of the mutual fund companies and the companies they own. As the Platform will create a common market for Hong Kong and Mainland mutual funds, the SFC and CSRC certainly should not set separate requirements on mutual fund registration (as this will create regulatory arbitrage). Such clear-line requirements also help promote competition, particularly in China where limited mutual fund company registration has restricted competition.

We propose that only mutual funds with US$10 million in assets or more obtain Platform Agreement automatic authorisation. Figure 4.11 shows the existing capitalisation, age and returns for a random sample of mutual funds based in China. As shown, many of these funds already meet the requirements. We also propose, based on similar rules in the EU and US, that mutual funds can hold no more than 5% of any particular stock (or 10% of that firm’s stock). In the same vein, we recommend that only funds with a track-record of 5 years or longer be eligible to receive automatic authorisation. By these measures, only 2 out of the 10 funds we show in the figure would receive authorisation.

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52 See Lam (2013) for more on the study group.
53 At present, at least on the Chinese side, authorisation seems to be on an *ad-hoc* basis, despite rules set down in the Chinese regulatory act *Measures for the Administration of the Sale of Securities Investment Funds* (Lim and Shao, 2013). See CSRC (2013) for the original.
54 As Lim (2013) notes, even for clearance by the SFC, wait times can last almost a year and domicile in Hong Kong provides no guarantee of ability to tap fund distribution channels on the Mainland.
55 As Boskovic et al. (2010) note, EU and US investment fund regulation is still undergoing rapid change – making any discussion of their respective regulatory approach a moving target.
56 A wide literature exists on the effects of mutual recognition of investment companies (particularly between US states and between EU Member States) to help us assess the likely impact here in the Greater China region. See Cumming et al. (2012) for a latest incarnation showing the market expanding effects of a single set of regulations.
57 The current thresholds on the Chinese side provide little guide for what the optimal threshold should be. The current $50 million threshold will likely be too large to attract many competitive firms. See E&Y (2013) for an overview of the QFII-2012 limits.
58 These mutual funds differ from foreign funds that invest in Chinese securities (such as a China fund).
Figure 4.11: Total Mutual Fund Sizes of Random Sample of Funds

<table>
<thead>
<tr>
<th>Fund Name</th>
<th>Assets (millions)</th>
<th>Age (years)</th>
<th>Return (1 year)</th>
<th>Return (3-year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dacheng Industrial Wheel Equity Fund</td>
<td>305</td>
<td>4</td>
<td>19%</td>
<td>-13%</td>
</tr>
<tr>
<td>Minsheng Selective Equity Fund</td>
<td>615</td>
<td>3</td>
<td>12%</td>
<td>-12%</td>
</tr>
<tr>
<td>CCB Principal Strategic Growth Fund</td>
<td>2,400</td>
<td>7</td>
<td>25%</td>
<td>-6%</td>
</tr>
<tr>
<td>ICBC Credit Suisse S&amp;P Global Natural Resources Index Fund</td>
<td>9.6</td>
<td>1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>GTJA Allianz CSI Equity and Bond Dynamic Strategy Index Fund</td>
<td>190</td>
<td>1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>CITIC-Prudential Selective Equity Fund</td>
<td>855</td>
<td>4</td>
<td>45%</td>
<td>-4%</td>
</tr>
<tr>
<td>Tianyuan Fund</td>
<td>2,870</td>
<td>14</td>
<td>24%</td>
<td>0%</td>
</tr>
<tr>
<td>SWS MU Quantitative Small-Cap Fund</td>
<td>212</td>
<td>3</td>
<td>35%</td>
<td>-</td>
</tr>
<tr>
<td>E Fund Consumption Industry Equity Fund</td>
<td>2,420</td>
<td>3</td>
<td>22%</td>
<td>-3%</td>
</tr>
<tr>
<td>Huaan SZSE 300 Price Index Fund</td>
<td>212</td>
<td>2</td>
<td>13%</td>
<td>-</td>
</tr>
</tbody>
</table>

The data in the figure show a random sample of China equity-based mutual funds reported by Bloomberg. We used a random number generator to provide a page number (1-10) and a fund (from 1-40 listed on each page). To meet the $10 million minimum, the fund would need to have $61 million in assets. All figures rounded to significant digits.

Source: Bloomberg, available online.

We further propose that constituent companies in mutual fund portfolios have a market capitalisation of US$100 million or more. This would eliminate many small and medium enterprises from serving as components of mutual funds in the first round of Mutual Recognition Platform trading. Yet, such a restriction would hardly seriously restrict the ability of mutual funds to offer diversified portfolios of Mainland companies. Figure 4.12 shows though the wide universe of securities still eligible for trading. Trillions of RMB in the assets and liabilities of the 2,365 companies we found can serve as the basis of securities which mutual funds traded under the Platform’s rules.

Figure 4.12: Mutual Funds Offering Securities under Our Platform Restrictions Would Still Have Thousands of Securities to Choose From

The figure shows the log value of RMB-valued assets and liabilities of 2365 Mainland companies as of 31 December 2011. If stocks securitise the value of these assets and bonds securitise the value of this debt, then mutual fund "packagers" will have no dearth of securities to choose from.

Source: WRDS (2013).
The Platform would not allow certain kinds of securities (at least in the short-run). First, any fund investing in derivatives would be automatically ineligible. Such derivatives receive different treatment in China and Hong Kong and their lack of transparency make them difficult to regulate. Second, funds of funds should not be allowed (due to lack of transparency and lack of direct provision of funding to companies). Third, foreign mutual funds listed on these markets would not be eligible for automatic authorization to market across the border. Hong Kong and Chinese regulators have already identified many of these restrictions.

Mutual fund companies would need registration and offices in both China and Hong Kong. Such a set-up would achieve three things. First, a physical office in each jurisdiction would expose to fund management to administrative, civil and criminal sanctions in both jurisdictions. Hong Kong and China have few provisions for co-operation in administrative, civil or criminal matters. Second, a physical presence helps ensure enhanced monitoring of mutual fund holdings (which enhances the public policy objectives of the Platform in improving corporate governance abroad and at home). Third, a physical office in each jurisdiction would allow regulators to monitor systemic and other risks emerging as a result of the Platform.

A Mutual Recognition Platform Agreement would probably include many of provisions we have already mentioned, even if we fail to influence policy. Most of the fundamentals already exist in both markets, as “the CSRC and SFC have already completed a six-month study on the regulatory framework of the two markets, concluding that both frameworks provide for the same level of investor protection”. Figure 4.13 shows the outline of the agreement between the SFC and CSRC which would likely clear up the outstanding issues in putting the Platform into practice. We do not have space here to describe each chapter in detail. We do not also exclude the possibility that the initial rules would change over time (by allowing for discretionary authorisations once the Platform is up-and-running). However, three issues broached in the figure bear further discussion.

59 This section repeats many of the observations Z-Ben Advisors (2013) already identified.
60 Zhang and Smart (2007).
61 The Platform would also certainly conform with the Mainland’s broader aims and objectives, as enshrined in foreign investor rulemaking. See Yi (2009) for an overview – with particular emphasis on the QFII’s rationale, policy objectives and provisions.
Figure 4.13: Outline of Mutual Recognition Platform Agreement between the SFC and the CSRC

Chapter 1: Conditions for Automatic Clearance (agency rating, types of securities, no derivatives).
Chapter 2: Common prospectus
Chapter 3: Chinese recognition of Hong Kong trusts
Chapter 4: Requirement for Office in Both Jurisdictions
Chapter 5: Requirement for licensing
Chapter 5: Phase out for QDII and QFII related specific to mutual funds
Chapter 6: Payment in RMB
Chapter 7: Mainland Affairs Department (Getting Ready for Prudential Regulation and Market Discipline)

Source: Based on market participant interviews, Citi (2013), and reviews of law firm reviews. We assume the SFC – rather than a successor – would serve as the main counterpart for this Agreement. For the timing of the implementation of such an Agreement, see Chapter 8.

The Platform Agreement would likely need to address the way that mutual fund companies would remit RMB. Under current provisions governing the State Administration of Foreign Exchange, mutual fund companies in Hong Kong would have limited access to RMB (both the give to Chinese companies and to return to investors). Mutual fund companies operating on the Mainland could not distribute RMB proceeds abroad as desired. As we previously showed, the foreign exchange quotas likely would not bind on these companies (meaning they could fill current demand for RMB with current quota allocations). However, if demand for remitted RMB exceeds supply in the future, Chapter 6 of the regulation we propose could set up a “queuing system” for RMB disbursements. Under the scheme, mutual fund companies would record an RMB credit to their clients’ accounts without the ability to pay immediately. The mutual fund company would enter a “RMB queue” or ask the client to take payment in a foreign currency.

The Platform Agreement would also need to deal with the way Hong Kong and Mainland regulators cooperate in areas of investigating mutual fund company fraudulent behaviour and other issues. The current ad-hoc working group structure (with SFC officials meeting their Mainland counterparts as needed) can no longer suffice. Too much prudential regulation and too many market disciplinary actions will likely ensure as a result of the

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63 China’s foreign exchange regulations undergo constant change, making observations about them outdated by the time the reader sees this brief. Grobowski and Liu (2013) provide a brief about the most recent changes. For the main statute, see Regulations on the Foreign Exchange System of the People’s Republic of China, available online.

64 Countries with capital controls have used such queuing systems under a quota-based allocation system for decades. The IMF’s Annual Report on Exchange Arrangements and Exchange Restrictions 2012 provides an overview of similar queuing arrangements world-wide (classified as “payment arrears”).
Platform – particularly as market actors attempt to engage in regulatory arbitrage. To deal with these issues, the SFC (or its successor) should create a unit to work with the CSRC on prudential regulation of the slowly merging mutual fund industry. The unit would also coordinate work on cross-border cases.

**Recommendation 6:** Government and/or regulators to develop a complete Draft Mutual Recognition Platform Agreement.

### Offshore yuan markets

Hong Kong’s role in yuan offshore markets depends basically on an embargo of China’s controlled currency – an embargo which will disappear over time. Figure 4.14 shows – in very simple form – the way offshore yuan markets work. China controls its currency, preventing foreigners and locals from buying and selling the currency (shown in the figure as the “wall” around China). As part of China’s yuan internationalisation strategy, the government rations out yuan through arrangements with foreign central banks, the HKMA and other financial intermediaries. Various swap agreements and authorisations to domestic and foreign financial institutions determine the supply for yuan in circulation outside China. The demand for the currency depends on portfolio and trade relations.

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65 We do not have the space to provide a side-by-side comparison of Mainland and Hong Kong mutual fund law. For the Mainland provisions, the *Securities Investment Fund Law of the People’s Republic of China*, available [online](#). 66 The US and EU both have responded to the need for such an agency by creating stable agencies (at the Federal and Union level respectively). 67 Recent announcements by officials at the People’s Bank of China place such liberalisation at about 3-5 years (Nomura Research Institute, 2012). 68 We present the most simple depiction for readers who may not follow currency issues closely. Minikin and Lau (2005) provide a fuller description. 69 Subacchi and Huang (2012) provide a market sizing project for future demand for RMB. Several studies, such as Liao and McDowell (2005), attempt to assess whether swap agreements effectively match supply with demand for offshore RMB.
Despite Hong Kong’s favourable relations with the Mainland government and historic ties with the Mainland economy, Hong Kong’s place as the choice for holding and using the yuan has eroded overtime. In December 2011, Hong Kong held over 85% of offshore yuan. By Sept 2013, that proportion fell to just over 65% (FSDC, 2013). In 2011, both offshore yuan deposits and bond issuances surged – as a result of expected yuan appreciation against the dollar.\(^{70}\) Figure 4.15 shows the growth in yuan markets in Hong Kong – along with the arrested development of these markets around 2011. Many analysts think that the burst in deposits and bond issuances came from temporary misalignment in yields – and not from any fundamental or underlying demand.

Mainland investors also seem to have little incentive to invest in Hong Kong. Figure 4.16 shows returns to Qualified Domestic Institutional Investor (QDII) investments – as a percent of each fund’s investment in Hong Kong.\(^{71}\) As shown, a distinctive negative relationship exists between the extent to which a QDII fund invests in Hong Kong and its returns. In other words, Mainland investors lose money as they increase their investments (as a proportion of their total portfolio) in Hong Kong. The regulations underlying the QDII scheme treat Hong Kong as just another foreign jurisdiction – providing few incentives for Chinese investors to place their money in Hong Kong rather than somewhere else.\(^{72}\) A new version of the QDII (a QDII2) would facilitate investment from centres like Shanghai. However, many commentators doubt whether the new provisions would actually bring Mainland money to Hong Kong.\(^{73}\) Even if QDII2 creates a “through

\(^{70}\) We do not want to discuss in great detail the drivers of RMB offshore markets (namely the supply of CNH or offshore “free” yuan). Some salient works include Rossi and Jackson (2011), HKMA (2013), Deutsche Bank (2012), and Deloitte (2013).

\(^{71}\) The Qualified Domestic Institutional Investor programme allows Mainland investors to acquire foreign currency needed to invest abroad.

\(^{72}\) Article 44 of the CSRC (2013) Trial Measures specifically stipulates that the Measures apply to Hong Kong (and Macau) just like any other jurisdiction.

\(^{73}\) Yu (2013).
“through-train” for Mainland investment through Hong Kong, the likely profitability (and thus attractiveness) of such investment locomotion remains very much in doubt.\footnote{Mazzochi et al. (2012) provide a discussion of the most recent evolution of QDII and the through-train concept.}

Even if Hong Kong manages to profit from a “through-train” status, such gains would only likely be temporary. When China eliminates capital controls, the advantages Hong Kong has will be removed as well.\footnote{A number of papers – for example Hooley (2013) – describe the effects of capital account liberalisation. The Bank of England’s analysis provides an excellent overview of the types of issues economies like Hong Kong will face. We provide the thought-experiment in the rest of the paragraph as a way to simplify issues to their core elements for our discussion.} For our purposes, the reader only needs to consider the following. If foreigners could open yuan accounts or make investments through any institution, they could just as easily go to Shanghai or Shenzhen. What gives Hong Kong its current advantages? First, a large swap agreement with the People’s Bank of China gives access to more RMB than in other places. Second, preferential relations with Government (both Hong Kong and Mainland) give institutions access (like listed on a qualified foreign institutional investors list). Third, preferential relations with financial and non-financial institutions on the Mainland give Hong Kong’s financial institutions privileged access to particular deals.

However, other jurisdiction can compete, as the Mainland government has shown clemency in granting regulatory-given advantages to other jurisdictions. London in particular seems poised to compete with and/or overtake Hong Kong as an RMB centre. Figure 4.17 shows magnitude of various RMB products sold in London. As shown, over 26.5 trillion yuan came through London in 2012. For most of these products (like yuan futures, options and so forth), London intermediaries offer products that quickly rival or outstrip Hong Kong’s.\footnote{Public data on trading in RMB-related derivates in Hong Kong prove somewhat difficult to obtain. The HKEx does provide some data \url{here}.}
London has every intention of capturing the most attractive parts of the RMB value chain. Hong Kong currently dominates in terms of RMB access – supplying the “inputs” into the offshore yuan market. Yet, London-based financial institutions want to chop up those renminbi, writing derivatives and writing loans on them in corporate and trade finance. Hong Kong will likely serve as a wholesale provider of renminbi (with preferential access to particular RMB equities and bonds) in the short-run. However, once the Chinese government lifts capital controls, Hong Kong could have little role to play in a higher value-added parts of international financial intermediation.

Hong Kong can play a temporary role in managing offshore RMB funds. Figure 4.18 shows data about the largest holders of Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) quotas from the State Administration of Foreign Exchange. Only 13 out the 169 institutions listed as receiving QFII quotas had an obvious tie with Hong Kong. Yet, some unusual institutions – like Harvard, Yale, Princeton and the Bill & Melinda Gates Foundation – hold sizeable quotas. Such a quota allocations shows no obvious preference for Hong Kong institutions. In contrast, the largest RQFII holders show an obvious Hong Kong connection. All 24 of the institutions listed in the 2012 report show strong connections with Hong Kong. At first glance, Hong Kong seems poised to dominate RQFII investments.

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77 Subacchi and Huang (2012) provide more on the Mainland government’s strategy of cross-market division of labour.
78 SAFE (2012) at Table S13.
79 Such dominance comes from the Trial Measures for Domestic Securities Investment Made by RMB Qualified Foreign Institutional Investors promulgated on the 6 March 2013. The Measures require Hong Kong domicile. See Hui (2012) for a background on these Trial Measures. As we argue in this report, trial measures can take away these advantages as easily as they gave them.
Figure 4.18: Quota Allocations for QFII and RQFII Programmes in 2012

The data in the figure show the allocation of foreign exchange quotas allotted by SAFE during 2012 for the QFII and RQFII programmes. We show the dollar value of renminbi quotas allotted under the RQFII programme. Source: SAFE (2012).

Yet, recent Chinese RFQII quota allocations suggest that China will quickly remove the temporary advantages bestowed on Hong Kong based financial institutions. Singapore received a 50 billion RMB quota in late 2013.\textsuperscript{80} London received an 80 billion RMB quota around the same time.\textsuperscript{81} Many commentators say Taiwan will soon receive a quota, given its trade and investment links with the Mainland.\textsuperscript{82} In any case, offering products authorised by the programme represents no simple matter.\textsuperscript{83} Hong Kong financial institutions should not try to capture advantage from temporary programmes which serve China’s own strategic objectives. \textit{Hong Kong’s banks should tap into the core of China’s financial system rather than work around its edges through QFII and RQFII programmes.}

\textbf{Building on-shore and off-yuan markets in Hong Kong}

A relatively new feature of the capital markets in Hong Kong is the ‘Dim Sum’ (點心) offshore yuan bond market, that opened in Hong Kong in 2007 and has become a closely-watched micro-sector following the freeing of rules for issuance by the HKMA in February 2010.\textsuperscript{84} The market is currently constrained by expectations of liquidity and the availability of offshore Rmb deposits or appropriate hedging mechanisms to settle non-deliverable forward Rmb contracts, but has considerable scope to become a medium for regional funding and investment as China gradually allows its currency to be used more freely in overseas trade, and for liquidity to be retained overseas.

The market’s has been a competitive source of yuan funding at intervals since in 2010-11, although investor interest during this phase was based largely on expectations of a rising

\textsuperscript{80} Yu (2013).
\textsuperscript{81} Commentators – for example the China Economic Review (2013) – believe that such large amounts may not attract demand, given the undesirable nature of Chinese equity markets.
\textsuperscript{82} Fei (2013).
\textsuperscript{83} Shipman (2012) provides a practical discussion of the issues in-house counsel needs to consider when offering RMB denominated products.
\textsuperscript{84} This section draws on Liu, Lejot & Arner (2013), 330-1.
yuan exchange rate. Most issues made in 2010-12 were accordingly expensive in relation to onshore yuan yields and to comparable credit spreads in other markets.

Currency convertibility became freer in late 2003 when PBOC allowed a pool of yuan liquidity resulting from trade payments to remain in Hong Kong, in effect sanctioning a controlled offshore deposit market. Mainland state borrowers began issuing retail-targeted bonds in Hong Kong to capture that liquidity from 2007. Settlement of wholesale trade payments in yuan outside China was allowed in 2009, so that Hong Kong’s liquidity pool grew quickly from 2010.

There are now three parallel markets:

- **Onshore Renminbi**, identified by the currency symbol CNY. Used in mainland China and restricted for use in funding and investment. Cross-border capital movements are strictly controlled but open to abuse through over-invoicing or disguised FDI.
- **Offshore Renminbi (CNH)** in Hong Kong. Freely used for issuance and investment but restricted and requiring prior permission for use in China.
- **Offshore synthetic Renminbi** instruments created using non-deliverable forward (NDF) FX contracts by banks in Hong Kong and Singapore. Settled in US dollars.

The build up of offshore liquidity resembles the early Eurocurrency markets and the Dim Sum bond market a mirror of the Eurobond markets under the Bretton Woods system, when UK regulators allowed banks in London to arrange offshore debt capital market issues except denominated in Sterling. The HKMA assisted the market by giving access to new issues to its settlement architecture, so that offshore yuan bonds can be settled through the real-time securities settlement system. Issuing offshore yuan bonds in Hong Kong is thus no more onerous than issuing in local currency or US dollars. Using the proceeds in the Mainland currently entails a foreign issuer obtaining permissions from SAFE, PBOC and, for bank issuers, the Commerce Ministry. Mainland issuers similarly require permissions from CSRC, PBOC, and access to NDRC’s foreign borrowing quota. These approvals may take several months to obtain and are not always granted. Funds raised in Hong Kong or elsewhere can be deployed for onshore equity infusions or shareholder loans, providing PBOC agrees the commercial terms.

Hong Kong financial institutions can create sustainable market position if they can tap China’s inter-bank repurchase (repo) markets. Such inter-bank repurchase markets have increased proportionately in China in recent years. Figure 4.19 shows the rapid growth in Chinese inter-bank lending in recent years. Representing undoubtedly over a 10 trillion RMB business by now, providing inter-bank loans to Chinese banks would provide a lucrative revenue source for Hong Kong banks for three reasons. First, much of such lending has yet to move to exchanges. As such lending moves from personal and state-

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85 Repurchase agreements (or “repo” for short) refers to an agreement between banks where one bank lends to another bank securities or some other collateral for a short time period (often over-night). The loan usually serves as collateral for a short-term loan which provides liquidity (usable cash) to the borrowing bank.

mediated relations to market-based ones, Hong Kong banks can move in to provide such finance (if they come before competitors). Second, state commercial banks still provide the bulk of such finance. As Chinese banking moves from state-directed capital to a system of market-based capital allocation, Hong Kong banks can move in to provide capital (which represents excess funds in Hong Kong’s already developed market) into China’s capital markets. Third, the inter-bank market provides an entry point into China’s commercial debt market. Until 2007, China’s tight regulatory regime made banks the main purchasers of Chinese companies’ bonds and commercial paper.87

The interbank repo market represents more than just a chance to earn small amounts of money on a 10 trillion RMB market opportunity. Access to China’s inter-bank market would provide Hong Kong’s banks with access to China’s emerging bond market. Figure 4.20 shows the size, growth and volatility of commercial lending in China in recent years. Financial bonds – providing money to banks in need of cash – represent a growing area of this intra-bank lending market. However, corporate bonds and medium-term commercial paper have grown most quickly (at least before 2010). Access to China’s interbank lending markets gives access to its regulated and highly lucrative corporate debt markets (and China’s real economy).88 Access also provides Hong Kong banks with a fair amount of risk stemming from differences between managed interest rates and market rates.89

87 Commercial paper refers – like bonds – to loans given to companies. Unlike bonds (which can have longer maturities), commercial paper loans usually come due within 12 months.
88 We do not want to discuss China’s bond markets (a complex area we would save for a subsequent year’s report). For excellent overviews, see Liu et al. (2010) and/or Mu (2012).
89 We do not want to discuss the ways that Hong Kong banks would deal with a system which uses both administered rates and market-based ones. See Chen et al. (2011) for a discussion of these risks (and an attempt to quantify the way that monetary policy changes would affect interbank lending).
Hong Kong banks have a competitive advantage due to Hong Kong’s more reliable bank regulation. Recently, the People’s Bank of China (PBOC) has put increasing pressure on banks to account for interbank loans correctly. Recent news reports from Bloomberg indicate that demand from Hong Kong has already started. However, according to the regulations, banks which did not enter the bank quickly lost access. For banks which caught this opportunity too late, Hong Kong’s regulators have a role to play in helping to ensure Hong Kong’s banks hear about such opportunities and can participate in them. However, their participation requires far more access to renminbi than currently available.

How do Hong Kong banks obtain access to renminbi and collateralise lending to Mainland banks? The cross-border collateral management service provides an important mechanism for ensuring that Hong Kong banks can provide adequate liquidity to Chinese banks. Yet, the funds behind the collateral are denominated in dollars and euros. The amount of yuan Hong Kong banks can tap depend on off-shore renminbi they can buy and/or on-shore renminbi they can procure through local intermediaries. However, the channels that Hong Kong banks can tap onshore lending are limited.

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90 Silk (2013).
91 (2013).
92 Linklaters (2013).
93 We discuss the risks and ways of protecting against such risks in a later chapter. See Lee (2012) for more on the new collateral management service.
94 Such a collateral management service exists – thanks to JP Morgan and Euroclear. But the arrangement cannot guarantee access to renminbi. See Hong Kong Monetary Authority, Euroclear Bank and J.P.Morgan (2012) for more on the current arrangement.
We therefore recommend the HKMA work with the PBOC and CBRC to consider ways to develop on-shore RMB collateral services to bolster Hong Kong’s participation in onshore inter-bank lending. The HKMA can support the creation of a tri-party repo services provider on the Mainland (in the same way that The Bank of New York Mellon and JP Morgan Chase serve the US and Euroclear and Clearstream serve Europe). The financial crisis both showed the important role these tri-party repo collateral providers can serve – and ways of protecting them from systemic risk. JP Morgan and Euroclear would unlikely be able to compete in providing the kind of liquidity needed for inter-bank repo lending. Figure 4.22 shows a method by which the HKMA could lead the creation of a tri-party collateral management service focused on onshore-only repo transactions.

Figure 4.22 How Can the HKMA Encourage the Creation of a Tri-Party Repo Clearing Bank on the Mainland?

How can the HKMA – a Hong Kong institution -- encourage the development of a tri-party clearing bank on the Mainland? The HKMA has no jurisdiction on the Mainland and cannot directly control the creation of banking companies even in Hong Kong. It does exercise moral authority and research legitimacy. Directed practical research on how such a tri-party clearing bank could develop and operate would attract policymaker and banking industry attention.

Recommendation 7: The HKMA should work with the PBOC and CBRC and one or more large collateral management providers to deepen amounts available to Hong Kong banks for Mainland inter-bank lending, and increase the number of banks able to give-receive collateral services.

95 The PBOC has incentives to work with the HKMA because of Hong Kong’s well-developed legal and regulatory infrastructure. We provided links to articles previously showing how current regulations on Mainland interbank repos have not effectively stemmed access to funds.  
96 A discussion about the optimal design of a tri-party repo collateral services provider would take us beyond the scope of the current report. See Copeland et al. (2011) and Adrian et al. (2012) for more.
Yet, Hong Kong policymakers and financial institutions have not contented themselves with serving as an offshore RMB centre through swap arrangements and cross-border collateral management activities. Leading Hong Kong policymakers and their advisors have ambitions to play a leading role in RMB trade – including the development of spot exchange, forward, futures and other renminbi-denominated markets. The Financial Services Development Council has dedicated one of its recent reports to finding ways for Hong Kong to capture a greater share in world RMB trading markets.

Hong Kong’s policymakers and financial institutions have rightly chosen the emerging RMB trade as an area of high potential profits. Figure 4.23 shows the expected size of RMB foreign exchange markets – assuming no further growth in global currency markets. The figure assumes that the renminbi grows to become the second most used currency in the world. If various types of foreign exchange transactions mimic the growth in overall use and trade of the renminbi, spot market transactions and foreign exchange swaps will dominate the new RMB trade. If Hong Kong traders manage to trade a quarter of this US$2.2 trillion market and earn 0.1% returns, this will generate US$2 billion in profits.

Figure 4.23: RMB Foreign Exchange has at Least US$2.2 trillion in Growth Potential

The simple market-infrastructure-building measures aimed at increasing Hong Kong’s share in future renminbi trading will not cause Hong Kong to have a dominant role. London currently serves as home to the majority of global foreign exchange trade – its

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97 See Chan (2012) and Yue (2012) for several examples of senior Hong Kong policymakers making statements about Hong Kong’s future role in RMB foreign exchange markets.

98 FSDC (2013).

99 We choose to use the 2013 level of renminbi trading as the future size of the market because our job consists of figuring out the “market size” of RMB trading which Hong Kong financial institutions will attempt to manage (trade). We know, from other experts’ estimates, the estimated size of RMB markets in the future relative to the dollar and euro. But we do not know how quickly RMB use will grow in order to arrive at those levels. As such, we cannot apply any particular growth rate into the future. Knowing the future size of the market without knowing how long it will take to get there basically leaves us with no reliable estimate to use. So, we use the current level for illustrative purposes.

100 Prasad and Ye (2012) provide one of the many economic studies predicting that the renminbi will become the second largest currency in foreign exchange markets.
dealers accounting for around 35% of all trades in foreign exchange. Yet, the Electronic Broking Services (EBS) and Reuters 3000 Xtra platforms did not cause London to the hold pole position among trading centres. Conducive regulation – combined with close relationships and scale economies – encouraged dealers and traders to work in London rather than elsewhere.

What can Hong Kong learn from the UK (and to a lesser extent the US) and its dominance of foreign exchange and Eurodollar markets? London became the centre of the Eurodollar market because of tight monetary and policies which allowed banks to circumvent UK regulations as long as they dealt in dollars. The US had a similar development – allowing individuals to escape US banking regulation while residing in the US through International Banking Facilities (IBFs) Such conducive regulation provides a way for a jurisdiction to gain a competitive advantage in the international trade, albeit with potential costs to financial stability. Such a regime may also encourage a decline in market segmentation so that offshore issuance and trading of renminbi securities becomes aligned with Eurocurrency practice.

Hong Kong can develop the size it requires to dominate in international renminbi markets through a light regulatory touch in off-shore renminbi markets. The best way Hong Kong can compete with the US and UK in the international renminbi trade consists of learning from their practice of applying conducive regulation to offshore

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101 BIS (2013).
102 Economist (2014).
103 Schenk provides more on the Euromarkets London roots.
104 Goodfriend provides a useful review of the US’s off-shore market regulation of its on-shore currency.
105 He and McCauley describe the ways the loosely regulated Eurodollar market might help develop the offshore RMB market.
transactions. A number of studies document how New York, Delaware and the City of London have used what amounts to off-shore banking regulation to attract funds and develop their banking and securities sectors.\(^{106}\) Different “intensities” of regulation on various banking and securities clients may not only increase assets under management, they may also help improve regulatory performance.\(^{107}\) Having a dual track regulatory regime for renminbi transactions – one governing most retail and commercial transactions and one decidedly “offshore” – can help prevent Hong Kong from losing its place-of-privilege as a global renminbi trading centre. Many commentators argue that China already maintains an unregulated renminbi finance sector.\(^{108}\)

Yet, the development of off-shore RMB markets pose risks to Hong Kong as well as to China. Like their euro-dollar counterparts, a lightly regulated euro-yuan market in Hong Kong would increase yuan money multipliers, making the conduct of monetary policy less predictable on the Mainland.\(^{109}\) The threat of “leakage” from the offshore regime into the onshore one also can undermine the effectiveness of Hong Kong’s general banking regulation.\(^{110}\) Figure 4.27 shows several of the objections to a lighted-regulated renminbi denominated banking and securities market. The answers to these objections show that such a market does not need to undermine the stability of the formal banking sector. An optimal regulatory regime would create a complementary rather than competing lightly-regulated renminbi market.

\(^{106}\) Besides Shaxson’s account, a wide number of studies – for example Rose and Spiegel (2007) – document the role that an offshore banking regime played in the development of New York and London as international financial centres.

\(^{107}\) In theory as well as in practice, not all classes of bank clients and securities clients require the same regulatory protections. A regulatory regime tailored to (discriminating for) various groups’ risk preferences may clearly allow for the transfer of socially beneficial risks to groups more willing and able to bear those risks. Jackson (2013) provides an excellent discussion of these issues.

\(^{108}\) China’s shadow banking sector represents an unregulated renminbi market. International trade finance represents another regulated area of renminbi finance. See Das et al. (2013) for the arguments that Hong Kong maintains what amounts to an offshore renminbi centre onshore. Bi (2013) represents one of the many commentators noting that Shanghai will create the same kind of offshore regime that London and New York already run.

\(^{109}\) He and McCauley (2012b) talk about the effects of offshore use of a currency on money multipliers and the use of monetary policy.

\(^{110}\) Policy leakage between formal and informal regulation – particularly in Eurodollar markets – has been an issue since the 1970s. Saporta (2009) provides a discussion of the way Eurodollar markets helped circumvent formal banking regulation.
We thus propose fuller study of differentiation between normally regulated onshore RMB-denominated banking and securities transactions and lesser regulated “offshore” regime.\footnote{We put “offshore” in quotes because, like London and New York, these transactions would take place onshore – even if they are treated as occurring off-shore.} Such a regulatory regime would have 5 major characteristics. First, for RMB-denominated transactions affecting Hong Kong persons or institutions, normal regulations would apply. Second, for RMB transactions between foreign persons and institutions only effected in Hong Kong, we propose the relaxed regulatory regime. Third, traders operating under the relaxed regime would not have access to any clearing or settlement arrangements which provide RMB to Hong Kong’s financial institutions. In other words, traders and service providers using the relaxed regime could not go to the HKMA to ask for RMB coming from Hong Kong’s swap agreement with the Mainland.\footnote{Some of these include provisions related to agreements with the Clearing Bank for Renminbi Clearing and Settlement Services in Hong Kong (Bank of China (HK)). Wo (2011) provides an overview of the issues.} Fourth, dealers operating under the regime would still have HKMA and SFC oversight – and operate under the threat that these regulators could change the rules.
as needed or in the public interest. Fifth, funds managed by these dealers and intermediaries must not be mingled with other monies under the normal regulatory regime. In that way, no possible contagion can occur.

Some transactions covered may include renminbi-denominated lending, trade in various RMB options and futures, settlement in RMB, as well as bonds and stocks from various jurisdictions denominated in RMB (and not for sale in Hong Kong). The study would also need to ensure that the scheme does not conflict with agreements made vis-à-vis the other G-20 jurisdictions.

**Recommendation 8:** Hong Kong should develop proposals for an appropriately regulated euro-yuan market in Hong Kong which does not conflict with Hong Kong’s international obligations.

**Conclusions**

Hong Kong is at risk of losing competitiveness to the other main financial centres in China and around the world. On some measures, Beijing beats Hong Kong in banking; Shanghai and Shenzhen top Hong Kong in certain aspects of equities trading. Frankfurt, London and Singapore have established similar agreements with the Mainland authorities to protect of liquidity in offshore RMB deposits. Hong Kong seems to face increasing exposure to Mainland macroeconomic and financial sector risks – without reaping the returns in the form of towering international markets in the trade of Mainland equities, debt and currency. In this chapter, we have proposed that Hong Kong deepen its participation in China’s real economy. We have provided concrete proposals for the Mutual Recognition Platform Agreement. We have also provided concrete proposals for making other advisors’ recommendations more concrete. We have finally shown how Hong Kong can keep its international role in renminbi banking and investment through a dual-track regulatory scheme. Implementing these recommendations should help Hong Kong’s financial institutions bring in more assets and tie our financial institutions in a more sustainable way to the Mainland.
Appendix: Appraisal of today’s offshore RMB debt market

A new segment of the global capital markets opened in Hong Kong in 2007, and is an important resource for the territory despite being small in terms of completed transactions or proceeds raised for borrowers. The Dim Sum offshore yuan bond market began modestly with small-scale issues for non-Chinese companies and banks wishing to fund Mainland operations, and has become a closely-watched micro-sector following the freeing of rules for issuance by the HKMA in February 2010.

Issuance grew in the three succeeding calendar years, although the average transaction size fell by over 50 per cent, as Table 4.26 shows. That fall paradoxically suggests a maturing but illiquid market, as many completed transactions represented increases or “reopenings” to existing issues.

Figure 4.26: Completed Global Offshore RMB Bonds 2011-13

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of issues</th>
<th>Total proceeds (billion RMB)</th>
<th>Average deal size (millions USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>217</td>
<td>147.9</td>
<td>112.6</td>
</tr>
<tr>
<td>2012</td>
<td>331</td>
<td>148.5</td>
<td>74.1</td>
</tr>
<tr>
<td>2013</td>
<td>407</td>
<td>179.0</td>
<td>72.6</td>
</tr>
</tbody>
</table>

Source: International Financing Review, Thomson Reuters
Equity-linked issues are excluded

The average transaction size of dim sum issues in 2013 compares to over US$600m for all international bond issues in all currencies in the same period, and US$120m for international issues in Swedish krona, a niche market currently similar in overall scale. Offshore yuan issues became the eighth most voluminous currency sector, well behind traditional core markets but more prominent than several established minor sectors, including the Swedish krona, Norwegian krone, New Zealand dollar and both the Hong Kong and Singapore dollars.

The market is currently constrained by low expectations of liquidity and the availability of offshore RMB deposits or appropriate hedging mechanisms to settle non-deliverable forward RMB contracts. It has considerable scope to become a medium for regional funding and investment as China gradually allows its currency to be used more freely in overseas trade, and for liquidity to be retained overseas. It has been a competitive source of yuan funding at intervals since 2010-11, although investor interest during this phase was based largely on their expectations of a rising yuan exchange rate. Most issues made in 2010-12 were accordingly expensive in relation to onshore yuan yields and to comparable credit spreads in other markets.

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113 This section draws on Liu, Lejot & Arner (2013), 330-1.
114 Two reasons explain this outcome. Issues in US dollars and euros together accounted for about 89% of the 2013 total, and basis swap arbitrage in 2013 was typically not advantageous for issuers hoping to exchange minor currency fixed coupon liabilities for floating rate US dollar payments.
Currency convertibility became freer in late 2003 when PBOC allowed a pool of yuan liquidity resulting from trade payments to remain in Hong Kong, in effect sanctioning a controlled offshore deposit market. Mainland state borrowers began issuing retail-targeted bonds in Hong Kong to capture that liquidity soon after 2007. Settlement of wholesale trade payments in yuan outside China was allowed in 2009, resulting in Hong Kong’s overall liquidity pool growing from 2010. Renminbi funds held offshore (CNH) may be generally used for issuance and investment but restricted and requiring permission for use in China.

The buildup of offshore liquidity resembles the early Eurocurrency markets, making the Dim Sum bond market a mirror of the Eurobond markets under the Bretton Woods system, when UK regulators allowed banks in London to arrange offshore debt capital market issues except denominated in Sterling. The HKMA assisted the market by giving access to new issues to its settlement architecture, so that offshore yuan bonds can be settled through the real-time securities settlement system. Issuing offshore yuan bonds in Hong Kong is thus no more onerous than issuing in local currency or US dollars.

Using the proceeds in the Mainland requires foreign issuers to obtain permissions from SAFE, PBOC and, for bank issuers, the Commerce Ministry. Mainland issuers similarly require permissions from CSRC, PBOC, and access to NDRC’s foreign borrowing quota. These approvals may take several months to obtain and are known to have been withheld. Funds raised in Hong Kong or elsewhere can be deployed for onshore equity infusions or shareholder loans, providing PBOC agrees the commercial terms.

The importance of the market to Hong Kong is twofold, in signalling an international capital market of conventional sophistication that may achieve significant size and liquidity as yuan revenues are permitted to accumulate offshore, and in providing a natural home for issuance. Although dim sum bonds have been issued in London and Singapore, and the returns to Hong Kong banks from arranging new issues are unlikely to be lucrative until considerable scale is feasible but the growth of the sector is likely to assist Hong Kong’s capital markets and human resource base.
Chapter 5: Corporate Governance in Hong Kong as an IFC

The quality of corporate governance in Hong Kong will play an important role in its competitiveness with other international financial centres in the years ahead. Hong Kong’s corporate governance has undergone significant changes in the 2000s – thanks to revisions to the Companies Ordinance, a new Code on Corporate Governance Practices for Hong Kong’s listed companies, aggressive policing by the SFC, the Companies Registrar and the Office of the Official Receiver, and other legal changes. Yet, Hong Kong’s corporate governance nonetheless still has room for improvement. How can corporate governance arrangements improve in order to solidify Hong Kong’s position among international financial centres?

We argue that Hong Kong can improve its position among the world’s financial centres by encouraging minorities and outside shareholders to exercise more oversight over Hong Kong companies.1 If they have a stronger position in Hong Kong companies, domestic and foreign investors will have an incentive to increase their investment flows to Hong Kong listed companies. 2 In the first section, we look at the quality of corporate governance in Hong Kong and the way such governance affects firm valuation. In the remaining sections, we look at specific ways regulation can help promote the flow of funds to Hong Kong’s equity markets. The second section will argue for increased pension fund investment in Hong Kong companies (and increased activism to help improve their rates of return). The third section argues that regulatory protections for whistleblowers can help reduce self-dealing by Hong Kong company “insiders” (like entrenched family members and managers). In the fourth section, we propose the creation of a concentration database – looking at the extent to which various individuals and companies own shares in Hong Kong companies – that goes beyond the data currently available through the Central Clearing and Settlement System (CCASS). In the fifth section, we argue for a scheme aimed at encouraging aggrieved investors and other company stakeholders to use arbitration as another route seek compensation for harms they have experienced. Hong Kong has both a common law and a statutory derivative action (allowing shareholders to sue directors on behalf of the company for misconduct) and a statutory unfair prejudice action (allowing shareholders to sue controllers, whether shareholders or directors for abuse of power to the detriment of the minority) 3; however, an arbitration scheme could be a useful supplement. In the final section, we look at further professionalising corporate directors (namely, making board-level directorship a

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1 This chapter is derived in large part from a larger working paper by Michael and Goo (2013).
2 Such increases, of course, depend on risks, competing investments and returns to these investments. In our view, such increased flows (after adjusting for risks and other factors affecting demand for Hong Kong securities) reflect a partial solution to the famous “time inconsistency” problem and “hold up” problems. Shareholders with excessive rights over a company can expropriate minority shareholders. Seeing the potential for such expropriation, potential outside minority shareholders decide not to invest. See Leuz et al. (2013) for more on this.
3 See Donald (2014), Chapters 3 and 5.
profession like lawyers and accountants). We deal with the political issues of corporate governance reform – and timing issues – in the final chapter of this report.  

Where does Hong Kong stand?

Depending on the corporate governance measure considered, Hong Kong ranks excellently or poorly. Figure 5.1 contrasts two different measures of corporate governance – one looking at the business system in general and one at specific corporate governance practices. According to the World Competitiveness Forum data, Hong Kong ranks second (only behind Singapore). A recent assessment of Hong Kong corporate governance designed to measure it against its real, economic risks – rather than international best practices – found Hong Kong corporate generally governance good, yet still wanting in protection against dominant shareholders. Other experts find that Hong Kong companies have many reforms to undertake – both in comparison to other countries and in terms of achieving maximum scores on international evaluations according to standard best practices. In following pages, we discuss general ratings of Hong Kong corporate governance.

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4 This report is both political economic and doctrinal, drawing on empirical studies to support each leg. Without addressing what Gourevitch (2003) calls “the politics of corporate governance regulation” (and financial regulation in general) reform in Hong Kong shall not occur.

5 The World Competitiveness Report provides data showing Hong Kong’s corporate governance practices in relation to its comparator jurisdictions – using a survey of business executives. The Governance Metrics International data attempt to use expert evaluation of corporate governance practices. Together we hope these provide some insight into Hong Kong’s corporate governance practices in the aggregate. Yet, the wide disparities between these data show that social scientists have a long way to go before they will generate reliable and internationally accepted data about corporate governance. See World Competitive Report and Governance Metrics International.

6 See Donald (2014), chapter 3.
International surveys seem to find Hong Kong companies’ corporate governance practices best in the area of accounting and worst in terms of the overall corporate governance culture (a term whose meaning is open to debate). Figure 5.2 shows scores assigned to various aspects of corporate governance in Hong Kong by CLSA analysts – including compliance with internationally generally accepted accounting principles, policies and regulations, internal enforcement, rules and practices, and a corporate governance culture. Across all given criteria, Hong Kong companies (on average) rate higher than their Japanese counterparts. However, Singaporean companies rate higher on average in compliance with internationally generally accepted accounting principles, adopting “good” corporate governance policies and regulations as well as rules and practices. Particularly noteworthy, Hong Kong does not rate near perfect (with scores of 90 or above) in any of these areas of corporate governance, and in the rubric entitled ‘rules and practices’ it earns a score of 60.

Rankings of more specific aspects of Hong Kong’s corporate governance indicate that local companies have improved in some areas and declined in others. Figure 5.3 shows scores assigned by the Hong Kong Institute of Directors in five areas of Hong Kong companies’ corporate governance-related policies and practices. Shareholder rights score a respectable 88% (up from about 70% in 2005). For reasons which are not clear – given that Hong Kong company law demands transparency far beyond that required in any US or European jurisdiction for unlisted companies – disclosure and transparency ratings

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7 Not everyone – for example Bhagat et al. (2008) – agrees that corporate governance can be quantified in the way we present here. Moreover, a partial explanation may come from the Hong Kong Stock Exchange’s acceptance of Mainland Chinese accounting.

8 CSLA (2012).

9 While, for example, neither Delaware law nor the Second EU Company Law Directive require annual disclosure from companies formed under it, the Hong Kong Companies Ordinance requires annual financial statements that discuss directors’ emoluments in detail, a directors’ report summarizing major activities during the year, assessing future risks, and disclosing any related party transactions entered into, plus an auditor’s report on the quality of the financial statements. See CO, ss 380, 388, Schedule 5, and the Companies (Directors’ Report) Regulation.
have deteriorated since 2005 from slightly over 90% to about 83% (on a scale from 0% to 100%). Hong Kong companies still rate relatively low in the area of equitable treatment of shareholders, board responsibilities for corporate governance and assigning roles to other stakeholders in corporate governance.

Corporate governance policies and practices clearly differ between companies and industries. Figure 5.4 shows the range of scores for companies in each industry – and the average corporate governance score across industries. Hong Kong utility companies exhibit the widest variation in corporate governance scores – from roughly 60 to close to 90. Telecom companies exhibit the least variation – centring around 73. These scores appear to indicate that corporate governance in Hong Kong is very different within and between industries, but they in part reflect the differences in the structures of the industries themselves. Property companies tend to receive among the lowest scores also because the companies are large, family controlled groups with a dominant shareholder and family member shareholders dominating the board, while finance receives among the highest score because these companies are widely held, with no controlling family.\(^{10}\)

\(^{10}\) See Donald (2014), chapter 2, discussion of ownership and management structure in Hong Kong’s property sector and financial sector companies.
We care about quality corporate governance for several reasons. First, companies with better corporate governance tend to weather financial crises (like the double crisis we hypothesize in this report).  

Second, firms with good corporate governance do not contribute to financial crises like those with bad corporate governance. Poor corporate governance – particularly in banks and broker-dealers – can lead to increased losses and uncovered risks which exacerbate a general banking and/or macroeconomic crisis. 

Third, there is a good possibility that Hong Kong corporate governance standards may help improve corporate governance on the Mainland – decreasing both the probability and the impact of a potential Mainland-origin banking/financial crisis.

The data suggest that improvements in corporate governance lead to higher market valuations and investment in Hong Kong companies. We do not have direct data on corporate governance indicator scores and equity investment. But we do have data showing the relationship between equity returns, risk (as measured by the standard deviation of those returns) and corporate governance scores. In theory, higher return companies should attract more investment. Figure 5.5 shows the relationship between equity returns, risks and corporate governance scores for Hong Kong companies in 2005. 

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11 See Kirkpatrick (2009) for the latest discussion about the way better corporate governance helped companies weather the global financial crisis (from the policy brief literature). Kose et al. (2008) provide for a more rigorous analysis of the ways that corporate governance helps companies take “good” risks and avoid “bad” ones.

12 The Asian financial crisis provided a useful “natural experiment” for scholars to assess the effects that corporate governance had on resilience to the crisis (Johnson et al., 2002).

13 A number of authors note the important role key jurisdictions play in diffusing corporate governance norms to other countries. As a number of Mainland companies already list on the Hong Kong Exchange (and thus comply with the Code of Corporate Governance), Hong Kong clearly plays a role in diffusing corporate governance norms to our neighbour to the North. Gordon and Roe (2004) provide other examples.

14 Cheung et al. (2011) conduct regression analysis comparing corporate governance scores they assign to Hong Kong companies and returns – but only for 2005. Obtaining more recent corporate governance scores
governance score companies earned an average abnormal stock return of about 8%. Their low score colleague companies lost about 4% over the course of 2005. Moreover, investors in the low corporate governance companies took on slightly more risk (about 1% standard deviation in returns) for their poor returns.

The data in the chart show the average 12-month abnormal cumulative average stock returns for three groups of Hong Kong companies sorted by their corporate governance index scores. In comparison, we show the standard deviations of market-market residuals for each of these groups (which proxies the risk of investing in these companies).

Source: Cheung et. al. (2005) at Table 5.

The relationships evidenced in Figure 5.5 do not control for (account for) a range of market and other factors that can interfere with the relationship between corporate governance and market performance. For example, corporate governance in the Hong Kong financial sector has been rated most highly and 2005 was the peak of a financial boom that began to deflate 18 months later and lead to the GFC. If 2012 were the control year, the poorly governed property sector would be shown to highly profitable. Yet, more sophisticated analysis also supports the argument in favour of governance. Companies with better corporate governance earn higher returns on their investments than those with low corporate governance scores. Figure 5.6 shows the results of statistical analysis looking at the extent to which unfavourable changes in corporate governance lead to (or at least correlate with) lower company valuations. As shown, worsening corporate governance scores (as measured by an assessment methodology proposed by the OECD) correlates with an almost 30% reduction in company value for high-value companies. For low valued companies, worsening corporate governance made little difference to already low company value. Similarly, improving corporate governance scores made

from the Hong Kong Institute of Directors proves exceedingly difficult. Thus, we could neither repeat these statistical tests, nor report more recent data.

These returns reflects gains (or losses) made by shareholders overall. As we discuss later, insiders may earn higher returns from their investments in the company through expropriating other shareholders.

We do not have the space in this report to describe our sources in-depth. Readers interested in variable definitions, companies surveyed and so forth should see the source publication(s).

Company value refers to Tobin’s q – an indicator which compares (divides) the market value of a company's stock with its equity book value. The reader can think of Tobin’s q as the extra value priced into a stock above the simple cost of its assets. Such value can reflect growth opportunities, management skills and other parts of the company which make the company more valuable the sum of its parts. The OECD methodology refers to mostly binary (yes/no) answers to 86 questions covering the rights of shareholders, the equitable treatment of shareholders, the role of stakeholders, disclosure and transparency as well as board responsibilities.
little difference to corporate value for high-valued companies. Improving corporate governance scores, however, did correlate with a 10% improvement in valuations for low-valued companies. These data imply that high valued companies have the most to lose from deteriorating corporate governance practices, whereas low valued firms have the most to gain from improving practices.

![Figure 5.6: Bad Corporate Governance in Hong Kong has Reduced Firm Value by almost 30% and good Corporate Governance can increase value in low value companies by 10%](image)

Although Hong Kong sells itself to the world primarily based on its rather orthodox adherence to strict corporate governance, as was recently evidenced by the recent refusal to follow the US in accepting low and nonvoting shares on the SEHK, there is still room for improvement, particularly in the face of controlling shareholders. What can Hong Kong’s policymakers do in order to encourage better corporate governance practices?

**Encourage Hong Kong pensions to engage in governance-related activism**

The historical evidence shows that pension investments in the domestic stock markets lead to wider-spread holdings of companies and improved oversight over these companies. Sweden provides a recent and useful example for Hong Kong – both because of its size (economically and in population terms) and the rapid government-led development of a domestic pension industry. Henrekson and Jakobsson (2003) document two factors that contributed to the large-scale reduction of family ownership and control in Sweden’s traditionally family dominated corporations. Foreign acquisitions of Swedish firms and large investments made by the national and company pension funds helped to disperse share ownership and reduce the concentration of family ownership. Moreover, Mariassunta and Laeven (2007) provide strong (statistically significant) evidence that

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18 Cheung et al. also point to several other conclusions. First, the measure of corporate value does not affect the results. Corporate governance affects corporate value – whether measured as market-to-book value or as Tobin’s q. Second, corporate governance changes affect China-based companies as well as large companies listed in the MSCI index. Thus, the trend is not particular to Hong Kong centred companies.
pension fund ownership of Swedish shares led to increased value and better corporate governance (as measured by representation on nomination committees). They also find a decrease in the premiums commanded by the largest shareholder(s). In a concurrent study looking at the actual effect of Swedish pension fund participation on corporate boards, Engvall and Holmberg (2007) find that these pension funds particularly affect board turnover and nomination committee decisions in smaller firms where their ownership buys a larger proportion of the shares.

Increased investment by Hong Kong’s pension schemes into local companies could help reduce potentially harmful control by dominant shareholders that also dominate the board (as is present in family-owned and controlled firms, such as in areas like the property sector). However, their small share of investment in local equity restricts their ability to promote the good corporate governance practices which will ultimately increase their rates of return. Figure 5.7 shows the estimated equity investment in Hong Kong shares by regulated pension schemes in the mandatory pension fund. While investment by the mandatory pension schemes has increased over the years in local equities, such investment still represents a microscopic part of total equity investment. On their own, these schemes will have little bargaining power to militate for better corporate governance.

![Figure 5.7: Hong Kong's Pension Schemes Don't Even Generate Enough Funds to Buy 1% of Hang Seng's Market Cap](image)

**Figure 5.7: Hong Kong's Pension Schemes Don't Even Generate Enough Funds to Buy 1% of Hang Seng's Market Cap**

Estimated Net Asset Value of Equity Investments from Hong Kong Pension Funds in Hong Kong Companies.
Source: Mandatory Provident Fund Schemes Authority (2011) and SFC (2012).

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19 Family ownership and control may not always reduce firm value. We rely on econometric studies for several years ago to make the assertion that family control very potentially reduces firm value in Hong Kong. Further studies will need to draw out the effects more clearly.

20 While we know that pension investment often corresponds with higher rates of return in particular public companies, we do not know if such returns come from their shareholder activism. The evidence is decidedly mixed – with authors such as Del Guercio and Hawkins (2002) finding that pension fund activism helps improve returns in the companies they invest in. Woidtke finds that pension fund activism may not benefit other shareholders.

21 The main pension schemes in Hong Kong consist of the Mandatory Provident Fund (a mandatory scheme) and the Occupational Retirement Schemes Ordinance funds (a voluntary scheme). We show the value of investment by the mandatory fund only. The estimated investment in the much larger voluntary scheme would only about double the estimated equity stake these funds have in local companies (Mandatory Provident Fund Schemes Authority, 2011).
With their current holdings, Hong Kong pensions could not play a crucial role in improving corporate governance among Hong Kong’s listed (and unlisted) companies. With only HK$2 billion on average per Mandatory Provident Fund scheme, the amount of money each fund has at its disposal remains small.\textsuperscript{22} The economic ability of pension trustees and investment board members to use governance tools to improve corporate governance in the firms they invest in remains questionable. Their duty under Hong Kong’s trust law towards their beneficiaries may not extend to using investment criteria which would potentially lower returns and incur additional costs.\textsuperscript{23}

Within the confines of Hong Kong law and practice at present, we recommend giving pension scheme trustees a brochure describing the risks of investing in companies with high shareholder concentrations.\textsuperscript{24} The SFC already issues regular warnings about the risks of high equity ownership concentration.\textsuperscript{25} Hong Kong pension investment committee members and trustee do not need to engage in a campaign of activism. However, a clear understanding of their rights as shareholders and ways to exercise them serves their beneficiaries’ interests.\textsuperscript{26} In the longer term, a local information intermediary, formed along the lines of a body like Institutional Shareholder Services, could provide regular information facilitating the kind of action we will recommend in our brochure.

**Recommendation 9:** Produce a brochure for dissemination in organisations like the Hong Kong Retirement Schemes Association to educate schemes’ investment committee members and trustees about risks of firms controlled by dominant shareholders who also engage in management and rights of shareholders under the HKEx Code of Corporate Governance.

**Reducing self-dealing by connected parties through whistleblowing**

Connected party transactions clearly reduce shareholder value in Hong Kong. Figure 5.8 shows the reduction in market premia (the difference between a listed company’s market capitalisation and its book value). Cheung et al. (2004) investigated the extent to which Hong Kong directors engaged in tunnelling, propping and expropriation. To measure the extent of expropriation by “insiders”, they measure the extent to which a range of connected party transactions affect firm value in Hong Kong. The figure shows the

\textsuperscript{22} We have divided funds under management by the number of funds to arrive at your highly biased average.

\textsuperscript{23} Trustees have a duty to ensure their beneficiaries receive the most return for their investment. By requiring the companies they invest in to follow policies which may lower these returns, such requirements may actually breach the investment trustee’s duty to his or her investor.

\textsuperscript{24} For reasons of space, we cannot discuss the way that Hong Kong’s disclosure of interests regime affects funds’ choice to invest beyond a certain percentage and whether a fund will actively engage in influencing corporate governance once they invest. We cannot talk about the way that executive regulations affect such decisions. We plan to consider disclosure of interests in our second report.

\textsuperscript{25} See the SFC’s [High shareholding concentration announcements](http://www.sfc.hk) online.

\textsuperscript{26} Eventually, some of these funds may accumulate enough shares to ask for Board seats. When such a time comes, the next generation of corporate governance advisors can advise these pension fund institutional investors on ways of encouraging the good corporate governance practices which will help their funds as well as the Hong Kong family-owned businesses they invest in.
summary results of their findings. When connected parties engage in takeover (M&A) activity, firm value decreases by about 30%. Asset sales between connected parties tend to reduce firm value (as measured by the market premium over book value) by about 20%. Such transactions suggest tunnelling – as most transactions should aim to increase (rather than decrease) firm value. Such data suggest that corporate governance arrangements did not protect those who contributed the capital that insiders employed at the turn of the century.

![Figure 5.8: Connected Party Takeovers and Asset Sales Destroy About 25% of the Value of Hong Kong Companies at Turn of the Century](image)

The data in the figure show the reduction in market premia (measured by market values divided by the book value of the firm's assets) in 328 regulatory filings. The authors correlate type of transaction with associated change in market premia one year on.

Source: Cheung et al. (2004) at Table 4A.

Now the Hong Kong Stock Exchange Listing Rules contain some of the most comprehensive connected party transactions rules in the world, and the Hong Kong Companies Ordinance requires disclosure of connected party transactions involving the directors of non-listed companies. These rules are important. Indeed, in the past, lack of information about connected party transactions has also resulted in the destruction of firm value in Hong Kong, and insufficient transparency in the future can be expected to have like effect. Figure 5.9 shows the reduction in firm value (expressed in positive numbers as a harm) due to several informational constraints related to connected party transactions. When the company provided no public information about a connected party transaction, cumulative annual returns on average fell by about 10%. When the financial advisor involved in the transaction provided no report, firm value fell in the authors’ sample by about 30%. These data clearly show a value to corporate governance relationships which promote the publicising of corporate transactions – particularly when connected parties are involved. Publicising corporate transactions adds value. Arrangements which encourage the release of other kinds of information can also help improve corporate governance.

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27 We show decreases in firm value in the figure as positive numbers to provide the reader with intuitions about the harms to the company involved in these activities.
28 Book value represents the value of all assets at their cost.
29 See SEHK Listing Rules, Chapter 14A.
30 See Companies (Directors’ Report) Regulation, s 10.
Whistleblowing represents another kind of activity which releases information to the public. Whistleblowing works. It works to prevent both harmful connected party transactions and other finds of corporate fraud. Echoing a rich literature about the detection of corporate fraud, Dyck et al. (2010) use statistical analysis in the US to show that whistleblowing detects far more fraud than regulatory agencies like the SEC. Whistleblowing programmes increase firm value by reducing self-dealing, providing companies with strong incentives to detect and prevent self-dealing among corporate executives, owners and directors.  

Experience from the US shows that providing employees and others with internal recourse (complaint mechanisms) before they use external channels (like regulatory agencies and the media) clearly allows companies to tackle self-dealing.

Hong Kong does not have whistleblowing legislation. The lack of black letter law encouraging companies in Hong Kong to protect whistleblowers has resulted in a lack of such programmes. Figure 5.10 shows data from Hong Kong’s companies about their whistleblower protection practices.

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31 Brown et al. (2010).
33 Fordham (2013).
In order to promote wider-spread adoption of these practices, we recommend in the first instance to require listed companies to adopt whistleblower protection provisions. Such an approach – incorporating these protections in the Code of Corporate Governance – serves three purposes. First, adoption as a regulatory (a self-regulatory measure) increases speed of adoption – allowing Hong Kong’s companies to reap the increased investment concomitant with such protections. Second, adoption under Code of Corporate Governance allows companies who already have such programmes to “comply or explain.” Such comply or explain (and particularly the explanations) will help prepare the empirical basis for eventual lawmaking. Third, introducing these provisions as a listing requirement (either directly or first in the “voluntary” Code of Corporate Governance) will prepare companies for the inevitable whistleblower legislation that will come. Indeed, many of the companies operating in Hong Kong already must comply with whistleblower protections laws at home in the form of Sarbanes-Oxley and/or the Public Interest Disclosure Act.34

34 Beller (2011) provides an overview of the issues.
Broadening awareness of concentrated shareholding

Both unlisted and listed corporations in Hong Kong are in almost all cases in the control of a dominant shareholder. A few shareholders almost certainly hold a large proportion of the shares in Hong Kong’s corporations. Yet, proving such concentration – and developing policies which investment in such a concentrated shareholding environment – remains elusive. Figure 5.11 shows the custodianship of the top 5 share custodians (or shareholders) in Hong Kong’s corporations and the value of such holding/custodianship. In 2013, the top 5 custodians or shareholders held between 95% and 100% of the shares in 48 corporations with a market capitalisation of about HK$500 billion. These top 5 custodians or shareholders held (or held in custody) at least 75% of the shares (a super-majority) in 614 companies for a combined market value of $HK14.5 trillion. Figure 5.13 furthermore shows the correlation between such custodianship (or shareholding) and market value (size). Larger companies (by market cap) tend to have more (rather than less) concentrated custodianship/ownership. If we could look past share custodians to discover the real owners of these shares, such data would imply that a small group of shareholders control large amounts of resources. Yet, without data on the beneficial owners of these shares, we lack the information necessary to inform appropriate policy development.

35 In the working paper version of this chapter, we spend about 40 pages showing historical and current data pointing to concentrated shareholding in Hong Kong. We do not repeat this analysis here so we can focus on policy implications and recommendations. We can not provide further details about these shareholders due to lack of data and space in this report.

36 The original data – as David Webb on his website very rightly points out – relates to custodianship rather than shareholding. Data on custodianship come indirectly from Hong Kong’s Central Clearing and Settlement System. When an individual or organisation buys shares, they may have their broker hold the shares for them. As such, the broker’s name would appear as the holder of the shares rather the final “beneficial” owner.

37 In the working paper version of this chapter, we assumed that concentration in custodianship correlated with concentration in the underlying shareholding. In this chapter, we remove this assumption to tackle the gap between custodianship and beneficial ownership.
If we could look past share custodianship, we could more directly prove the harms that many scholars have already shown for concentrated shareholding in Hong Kong. Figure 5.13 shows a number of studies which look at the extent to which these concentrated owners enrich themselves through self-serving dividend and salary payment practices. While we know the concentrated shareholding decreases shareholder value and deters investment in Hong Kong’s companies, we cannot make policies which remedy concentration-related market distortions in Hong Kong’s equities markets. Investors in Hong Kong’s companies’ shares also cannot know the extent of beneficial ownership concentration in the shares they buy (with some exceptions which we address below). With knowledge about the underlying concentration of beneficial ownership in the shares that institutions and individuals purchase, they can engage in activism or hedge the risks that such concentration might bring.

38 Most market participants and the SFC accept the principle that providing information to investors – rather than regulating them – provides one of the most effective methods of protecting investors. In the words of Edgar Cheng (1995), the general regulatory philosophy reflects “the principle of caveat emptor (Let the Buyer Beware) - the belief that investors are grown up people and should look after their own interests without Nanny (in the form of Government or the Stock Exchange) needing to intervene to bail them out.”

39 Market participants can even develop markets for products which help investors understand and mitigate the risks from concentrated concentration in the beneficial ownership of a company (or companies’) equities. Smith (2011) provides one example.
Figure 5.13: Do Hong Kong’s Majority Owners Benefit Excessively?

<table>
<thead>
<tr>
<th>Issue</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self-serving salary payments</td>
<td>Cheung et al. (2003) find that even 5% stake or more in a large Hong Kong company means executives get paid more.</td>
</tr>
<tr>
<td>Self-serving dividend payments</td>
<td>Chen et al. (2005) find evidence for increased dividend payments as concentrated ownership increases. They view this as expropriation of other investors.</td>
</tr>
<tr>
<td>Self-serving short-termism</td>
<td>Carney and Gedajlovic (2002) find evidence for lower capital expenditure and earnings manipulation among companies with high ownership concentrations.</td>
</tr>
<tr>
<td>Earnings manipulation</td>
<td>Leung and Horowitz (2003) find that highly concentrated ownership correlates with less disclosure related to each of the firms’ operating business segments.</td>
</tr>
<tr>
<td>Other self-dealing</td>
<td>Zhang (2008) finds that dividend payments correlate with higher equity valuations – suggesting that investors pay a premium to be able to get their money back. Cheung et al. (2003) find concentrated ownership leads to reductions in firm value.</td>
</tr>
</tbody>
</table>

Insiders may also take the company public when a public valuation will likely bring large premiums over the book value of assets and then go private again when the market under-values shares. We do not discuss such self-serving profit-taking as no rigorous academic research exists on this trend.

Source: cited authors.

The current approach to informing investors about concentrated shareholding does not provide enough information for either policymakers or investors to make informed decisions. Figure 5.14 compares the official approach to informing investors about concentrated shareholdings with the “ideal” approach. At present, the SFC provides High Shareholder Concentration announcements. However, at a frequency of 1-2 per month and at only 1-2 pages each, these announcements do not contain sufficient information in order for investors to analyse the risks that concentration might pose (particularly as part of a portfolio of these concentrated holdings). We recommend that a database be created to provide such information, possibly under the supervision of the SFC and/or HKEx. What if a database – like the Webb-Site’s reporting on concentration in the CCASS database – provided information on the concentration of beneficial interests (ownership) in Hong Kong’s companies? By providing more detailed data about shareholdings and concentrations, investors can decide for themselves (using statistical analysis) how concentration in any one company (or group of companies) affects their overall financial interest.

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40 SFC, High Shareholder Concentration Announcements, available online.
41 Without going into too much high theory of corporate finance, when investors combine securities with concentrated holdings into a same portfolio, the risks inherent in each of them may interact (in terms of overall risk and return) completely separately from the risks each one poses individually.
42 The move toward a scriptless securities system and a direct registration system should solve the problem caused by the current indirect holding system. Such a system would remove the difference between registered and beneficial owners.
In order to compile a database which “looks through” custodians, we would need to collect information about the beneficial ownership of Hong Kong’s companies. Such data collection would follow a trend becoming increasingly popular in other upper-income (OECD) jurisdictions to identify and publicise beneficial ownership in public companies. In 2013, the UK Prime Minister announced his intention to compile and release to the public a database presenting underlying beneficial ownership of shares in UK companies. Figure 5.15 shows the main elements of a terms-of-reference for a study which might look at the design of such a beneficial ownership database and its impacts on investment in Hong Kong’s companies.

43 Vermeulen (2013) provides a review of such work across the OECD.  
44 Wintour (2013).  
45 The sections for the terms of reference basically replicate the UK working paper on the subject (UK Department for Business Innovation and Skills, 2013)
The database will replace or complement the SFC’s current warnings about concentrated shareholdings. The database will also probably look something like the CCASS concentration database currently on the Webb-Site. In theory, nothing keeps a private sector (civil society) representative from keeping or re-disseminating information from such a beneficial ownership database. We recommend further study to put in place a beneficial interests database.
**Recommendation 11:** Development of a working paper modelled after the UK’s “Transparency and Trust” working paper with the view to collecting and disseminating information about beneficial ownership in Hong Kong’s companies through a database like the CCASS Concentration database kept on the Webb-Site.com.

**Professionalising corporate board directors**

Education of senior company officials appears correlated with investment returns but not managerial quality. If these trends hold at the board-level, then the Code of Corporate Governance’s training requirements will “work” for non-executive (but not executive) directors. On the one hand, education clearly has no apparent influence on executives’ managerial and governance performance (and thus executive directors’ performance). These studies tend to find three things. First, CEOs and executives from higher ranked undergraduate and MBA programmes perform no better than those from lower ranked programmes. Second, firms whose executives and chief executives have MBAs and law degrees perform no better than firms with those which have senior managers without such specialist training. Indeed, CEOs without graduate degrees in their sample did slightly better. Third, experience matters far more for executives’ and directors’ performance than training or education.

On the other hand, Gottesman and Morey (2006) represent the relatively wide body of research showing a link between education (specifically in business administration) and investment performance. They find three trends in their study of investment managers and investment performance which might bear out for their investor-director counterparts on boards. First, holding an MBA and having high GMAT scores statistically significantly positively correlates with investment fund performance. Second, “quality” the MBA program positively and significantly correlates with fund performance. Managers who hold MBAs from schools ranked a top 30 ranked MBA programme (on Business Week rankings) earn higher returns than investment strategists and managers without MBA degrees and those holding MBAs from unranked programs. Third, other qualifications – like a CFA, a masters degree (except for MBA) or doctorate – did not seem to help these investment managers.

What do studies of investment managers have to do with board-level directors? Which senior manager to hire? Which business lines should the company pursue next year? How

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46 Provision A.6.5 of the Code of Corporate Governance stipulates that “all directors should participate in continuous professional development to develop and refresh their knowledge and skills.”

47 We chose Gottesman and Morey (2010) as a reference because they encapsulate succinctly the findings from this branch of the literature. In general, the studies fail to find any link between education, training and executive (and thus executive director) performance.

48 Ng and Feldman (2010) provide a recent incarnation of these studies.

49 Non-independent board directors are by definition major investors in the firm. They hold a large enough interest in the corporation to make them non-independent. For its part, the firm invests in portfolios of activities, people and assets. Economists have long been comfortable with the equivalence between investing directly in equities or investing in a company that invests in equities. We hope the reader will see this as clearly and easily as we see it.
much funding should accounting and compliance get in order to minimise regulatory risk? All these represent investment decisions. Non-managerial directors clearly represent investors (whether as major shareholders in the company themselves or as key decision makers). We thus recommend that the “investor” directors train in the MBA-related topics (like strategy, finance and marketing). We do not want to endorse any particular skills or product. We choose the topics assessed by the UK Institute of Directors (2012) Evaluation Toolkit because their description is relatively comprehensive and the topics broad enough to cover specific topics of relevance to individual companies.

**Recommendation 12: Encourage Directors in the Code of Corporate Governance (particularly non-executive directors) to learn the skills contained in programmes like the UK Institute of Director’s Board Evaluation Toolkit.**

Experience – not training or education – serves as a key predictor of a director’s performance.\(^{50}\) As such, instead of mandating training, the HKEx (or the Companies Registry) should work with organisations such as the Hong Kong Institute of Directors (HKIoD) to promote apprentice schemes and a flexible job market for corporate directors.\(^{51}\) The data suggest that a directorship in Hong Kong still relies on experience and contacts built up over a long career. Figure 5.16 shows the age in 2013 of directors in Hong Kong’s listed companies. The average age sits at around 55 years old (the age when many used to contemplate retirement). While the average age for other elite professions (like professors, CEOs and top-ranked lawyers and economists) has fallen significantly, the market for directors appears to defy this trend. Hong Kong – and specifically the Chartered Institute of Corporate Secretaries – has made significant strides in professionalising the occupation of (and thus lowering the age of) the corporate secretary.

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\(^{50}\) A number of studies show that experience serves as a rich predictor of directors’ performance – both in general and on specific sub-committees. To cite one example, Dezoort et al. (2001) show that an audit committee member’s experience determined their ability to interact with external auditors.

\(^{51}\) At present, the HKIoD does provide a directors’ matching service. However, the extremely long list of people looking – combined with old average ages of directors suggests the market is not clearly adequately at the younger age segments.
The best way to encourage the professionalisation of today’s cohort of company directors (which the Code of Corporate Governance clearly seeks to do) consists of making corporate directorship into a self-regulating profession. As the HKEx has already sought to regulate the experience and performance standards of directors through the Code of Corporate Governance, the HKEx should create an ad hoc committee with the terms of reference for creating such a profession. A first step could be creating an apprentice system for young investor-managers keen on serving as a director on a larger company. The standing committee would decide on methods of training, evaluation, job “matching” and so forth.

**Recommendation 13: Create an HKEx committee with the terms of reference to create an apprentice system for junior directors and a market for directors so they can acquire experience.**

The best directors balance multiple board appointments with the strains of over-commitment. For Hong Kong, the data suggest that 6 directorships serves as the maximum for Hong Kong’s very effective directors. Figure 5.17 shows the rates of return on the companies that various Hong Kong directors governed in 2013. Companies should seek to attract the most (or most influential) directors – who in turn take on several directorships. However, beyond 6 directorships, the data suggest these directors become too busy and their returns start to fall. Numerous proposals to limit the number of boards directors sit on focus on the “busyness” part of a director’s ability to handle such appointments – without looking at the “skill” part. Figure 5.18 shows – specifically for independent directors – the number of directorships each one has. For example, 60% of independent directors made up the group of 5 directors who held 11 seats. Roughly 3,000 independent directors held one board seat – compared with the 9,000 directors that held

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52 Lei and Jie (2011), looking at data from 2001 to 2009, argue that independent director quality pushes up the number of board they sit on – whereas their busyness decreases it. The optimal number of directorships for any director then depends on his governing skills and time management.

53 Yiu (2012) provides an overview of the last attempt to limit directorships in Hong Kong.
such seats. Independent directors – when they hold directorships – seem to hold many. Assuming independent directors quality distributed the same way as other directors, then they should hold 33% of the seats across the board. For example, the independent directors who were just as good as the other directors who hold 11 seats should hold only 33% of these seats. They do not. They hold 60% of these seats. This suggests either independent directors who hold more seats are very much superior to their non-independent colleagues – or more likely serious under-supply and over-demand for excellent independent directors. Proposals aimed at limiting directorships would cause serious under-supply in the market for directors.54

The data in the figure show the returns of the companies various Hong Kong directors serve on (presumably over their tenure). For example, directors with 6 board seats led their companies to a roughly 5% compound annual average rate of return. Authors like Lei and Jie (2011) argue these data reflect the desire boards to get the best talent but such talent becomes overwhelmed if taking up too many board positions.

Source: webb-site.com

54 Our proposal to introduce a mentoring system would address the supply constraint faced by firms for directors. The market environment sets the demand for directors – so policy cannot directly influence this (except for types of directors like those sitting on audit, nomination, and remuneration committees).
Another – extremely valid – question concerns whether independent directors actually work. The Hong Kong media points to independent directors who resigned rather than face the difficult problems faced by their companies. On the one hand, a host of academic evidence (which we have previously reviewed) supports the fact that independent directors “work” better than the alternative. On the other hand, Webb (2011) makes an excellent point when he notes that independent directors who require the votes of concentrated majority shareholders cannot act independently or objectively. Current board room incentives perversely suppress the expression of dissenting opinions which can promote board performance.

What system of independent directorship would attract the most investment into Hong Kong’s financial institutions and companies? Would a “party-list” like approach advocated by Webb (whereby minority shareholders vote in one or two independent directors) encourage or repel foreign and local investors? The data show that independent directors increase firm value – but we do not know if such statistical findings would translate into portfolio managers’ dollars. Figure 5.19 – if representative at all of true local preferences – suggest that reserving some independent director spots for minority shareholder election might be popular among investors. Popularity in the UK suggests these proposals may also find favour in Hong Kong.

Such an approach would improve corporate governance – and thus investment prospects of Hong Kong as an international financial centre for three reasons. First, the extent data shows that truly independent independent-directors do improve a company’s investment
prospects. When companies really need outside capital, they tend to desire truly independent directors. Second, “dissenting opinions” by independent directors during board meetings and AGMs help serve as the empirical fodder for changing long-term codes of corporate governance. Webb wants independent directors to have their own section in annual reports and to have the right to submit reports to the SFC. Even if they do none of these things, their deliberations will publicly identify weak parts of Hong Kong companies’ corporate governance. With such information, policymakers will have evidence for future corporate governance reform proposals. Third, such a proposal would improve the system without affecting the economic interests of majority shareholders. Even 33% directors would have relatively little say during board meetings – and no voting power at AGMs. As such, their deliberations would likely generate a fair amount of public discussion, without actually impairing the interests of Hong Kong’s concentrated shareholders in the short-term.

**Recommendation 14:** Introduce a scheme into the Code of Corporate Governance (and consistent with Exchange Rule 8.11) allowing for independent directors such that shareholders not among the top 10% shareholders can nominate one or more independent directors.

**Private action**

Private actions in Hong Kong have been limited to derivative suits and unfair prejudice suits. As only 33 statutory derivative actions have been filed since the provisions were introduced into the Companies Ordinance in 2004, and they have had a success rate (i.e., leave has been granted to proceed) of about 45%, it is difficult to say anything meaningful about the treatment of these actions except that the published decisions appear reasonable and that the judges have expressed a desire to hear challenges to allegedly bad governance if a plausible argument is made. One observation that can be made about Hong Kong derivative actions is that in almost all (12/14) actions in which leave has been granted to go forward, the defendant director was also a substantial shareholder. The actions were not based on shareholder action against a professional manager. Controlling shareholders present a real problem in Hong Kong. As mentioned above, the Hong Kong courts have recently applied unfair prejudice relief to listed companies for the first time, and this could be very meaningful for the markets. The case was *Luck Continent Ltd v Cheng Chee Tock Theodore* [2012] HKEC 567, affirmed on appeal at [2013] 4 HKLRD 181. *Luck Continent* had unusual facts. It was filed by a majority, not a minority, shareholder, Luck Continent Ltd, which had acquired the listed company CY Foundation Group Ltd through a reverse merger. The unfairness occurred

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58 As a clever proxy for independence, Miletkov and colleagues (2011) look at independent directorships of high-flying foreigners. These foreigners – with different cultures then their company boards – represent a natural experiment giving us a glimpse at how directors appointed with very different corporate cultures would perform.
59 Dahya (2009).
60 Donald (2014), chapter 5.
61 *Luck Continent*, para 5.
because a shareholder with something more than 25% of the shares blocked a special resolution to amend the company’s articles, which were in breach of the Exchange’s listing rules, thereby forcing the company to stay in suspension from the exchange, with concomitant damage to its share price. The CFI found that there was a tacit agreement – in the form of an “agreement with the Exchange made for the benefit of both the company and its shareholders” between the company and the shareholders that the company should comply with the SEHK listing requirements, and thus equity demanded such agreement be enforced. As such the company’s continuing failure to meet the listing rules (as caused by the blocking shareholder) unfairly prejudiced the plaintiff’s legitimate interests, and the court ordered that the company’s articles of association be amended to allow for removal of directors by majority vote. In affirming the decision, Lam JA for the Court of Appeals observed:

I see no difficulty in holding in the present case that the blocking of the amendment of the Bye-law to facilitate the resumption of trading of the shares of CYF was in breach of a fundamental understanding between the shareholders in associating together and this gave rise to ground for equitable intervention by the court. The Judge was correct in finding that there was unfair prejudice in the present case.

A short term proposal for Hong Kong regulation is that courts should accept and extend the Luck Continent decision to guarantee adequate policing of the markets against controlling shareholders. Hong Kong is challenged by an agency problem between controlling and minority shareholders, and not primarily by one between professional managers and dispersed shareholders. Derivative actions are the solution of choice for the latter problem in the US, and much attention has been focused on such actions because they are widely held to be important by Western standards. However, the former problem is addressed by the unfair prejudice action, which has finally been brought to the level of the listed company and must be kept there for future application.

Conclusions

In the long-run, the value of Hong Kong’s portfolio investment will depend on the value of the companies in those portfolios. Corporate governance (in part) determines that value. How can Hong Kong’s companies use the time before a potential economic slowdown in China puts their governance under pressure in order to improve their corporate governance – and thus their value and resistance to a possible impending crisis?

In this chapter, we argue that Hong Kong’s regulators should adopt a series of measures aimed at giving “outsiders” (like minority shareholders) increased rights of Hong Kong’s corporations. We have shown that extending these rights will likely increase financial flows to Hong Kong’s companies rather than discourage them. We argued for rules which encourage Hong Kong’s pensions to invest more in our companies (and engage in the activism needed to raise their returns). We also argued for whistleblowing measures (so

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62Luck Continent, para. 98.
people who see directors or corporate agents destroying firm value can complain). We argued for the creation of database showing the levels of concentration of shareholding by various shareholders. We also argued for schemes to professionalise corporate directorship in Hong Kong. If a China-origin economic crisis does hit Hong Kong, these measures should help ensure our directors and investors can protect their firms’ value.
Chapter 6: Dealing with a Double Crisis

China’s resilience has kept Hong Kong’s financial institutions from experiencing the brunt of the global financial crisis. What will happen when the Mainland undergoes a crisis of its own? Such an event is by no means far-fetched or even necessarily distant. Economists and policymakers predict fewer than 5% of all economic crises. A banking/financial crisis may not seem likely to Hong Kong’s policymakers and economists. Neither did the 2007 global economic crisis and the hundreds of crises which occurred under the IMF’s watch during the last 20-30 years.

In this chapter, we argue that Hong Kong will need special rules to protect the Hong Kong financial system against large-scale decreases in asset prices and potential banking stresses. We specifically look at the possibility of what we call a double crisis. The first leg comes from a Mainland macroeconomic slowdown and its effects on Hong Kong’s real estate prices. The second leg comes from a Mainland slowdown’s effect on Hong Kong’s banks’ balance sheets. In the first section of this chapter, we look at the ways that higher leverage ratios (large debt loads) in the Mainland’s public and private sectors pose risks to the Mainland’s banking sector which may spread to Hong Kong. The second section looks at what would happen to the Hong Kong economy if the Mainland economy slowed down significantly. The third section looks at the ways a Mainland slowdown would affect Hong Kong’s real estate sector (particularly prices and quantities demanded). The final section looks at the regulatory changes which can help protect Hong Kong from such a double crisis.

By way of overview, the dependence between Hong Kong’s real estate and banking sectors (both of which depend heavily on Mainland demand) make Hong Kong particularly vulnerable to a slowdown on the Mainland. Figure 6.1 shows the ways Mainland banking shocks and a general decline in economic activity would affect Hong Kong’s banks, real estate companies and the general equities markets. The Mainland economy influences almost every aspect of economic life in Hong Kong. Mainland consumers buy real estate, export goods through Hong Kong, deposit funds in banks, and provide the renminbi used to buy and sell RMB-denominated bonds and investment products. Mainland companies list on the Hong Kong stock exchange and its banks provide loans to businesses. Yet, as we will see in the next section, much of these assets result from debt contracted back on the Mainland.

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1 Even when we use historical data, economists models have relatively high rates of failing to predict even past crises. Naturally, when comparing banking crises with public statements by economists before the crisis occurred, the “success” rate is even lower (Borio and Drehmann, 2009).

2 We do not have room in this report to describe the extent to which government authorities and the IMF predicted banking and financial crises. To see how tough it is to try and predict a crisis (even with the benefit of hindsight), interested readers can try to build their own models using IMF data provided by Laeven and Valencia (2008).
Chinese high leverage poses systemic risks which may spread to Hong Kong

Financial leverage on the Mainland poses a threat, not only to the Mainland’s financial and non-financial institutions, but to Hong Kong’s as well. Figure 6.2 shows Hong Kong claims on Mainland banks and Hong Kong liabilities to them. The combination of loans and deposits in Mainland banks well exceed Hong Kong GDP. Such a combination poses two major risks. First, Hong Kong-based clients of these Chinese lenders (and borrowers) may pay off domestic creditors first and collect from Hong Kong borrowers first. Such a situation would place the burden of Chinese “real sector” adjustment disproportionately on Hong Kong’s shoulders. Second, Hong Kong lenders (particularly bond holders) may not have the legal authority (or practical means) of collecting collateral. As roughly US$30 billion out of the US$40 billion invested in Mainland CNH bonds was unrated, the risks are there.
The rapid expansion of credit on the Mainland represents one good reason to worry about Hong Kong’s exposure to the Mainland and its financial assets. According to a wide range of scholars and financial sector practitioners, credit has grown dangerously quickly in China.\(^3\) Figure 6.3 represents one example from this litany of analyses of recent credit growth on the Mainland, with the red showing – in enlarged form – the difference between what total credit to GDP is (the black line) and what it should be (the red line). Never before since the early 1990s has Mainland credit grown so disproportionately to real GDP growth. A wide number of scholars have shown that such credit growth rates – such as those exhibited on the Mainland in recent years – often correlate with financial crises in cross-country data.\(^4\)

Local governments represent one of the largest sources of debt build-up in/on the Mainland economy. Figure 6.4 shows sub-national debt levels across China. As debt builds up, the probability of higher taxes and/or default rises. Both events would stunt Chinese growth – and have effects on the Hong Kong economy. According to the China National Audit Office (2012), sub-national governments owe more than US$1 trillion in debts (or about 13% of GDP). The majority of such debt has financed a construction boom across the country (which we will discuss in greater detail below). The Eastern region has experienced the greatest build-up of such debt. As the East represents China’s major urban areas for production and consumption, any debt default in that region would have significant economic effects.

\(^3\) We cannot hope to cite even a fraction of the large number of recent scholarly and practitioner articles warning about excess credit growth on the Mainland. Borst (2013) provides a representative article (and the source of the data from the figure in the text).

\(^4\) Borst provides evidence for this assertion (p. 14) as do Mendoza and Terrones (2012) – just to name a couple of works in this branch of literature.
What effects would a default on (or re-negotiation of) local government debt have on the Chinese banking sector – and thus indirectly on Hong Kong? Figure 6.5 shows the likely effect of a renegotiation of local-government-financing-vehicle debt on several large Chinese banks – most of which operate and take deposits in Hong Kong.\(^5\) Nomura economists predict that, in the worst case, the major Chinese banks holding local government financing vehicle debt would need to write down 20% of such debt immediately when the crisis starts.\(^6\) These banks would increase their loss provisions for the low-quality debt by 50%. In agreement with the 2012 Chinese Banking Stability Report (which finds that Chinese banks can withstand a severe economic shock without most banks’ risk-based capital falling below 8%), no bank would become insolvent in the Nomura analysis. As Viohl notes, “an estimate of consolidated national/local government-controlled assets suggests that the Chinese public sector is ultimately solvent even after the run-up in debts”.\(^7\) However, even considering whether China would be solvent in case of a local-government-financial-vehicle disaster signals something is wrong.

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\(^5\) We provided an overview of these Chinese banks’ participation in Hong Kong’s banking sector in a previous chapter. We analyse the effect of large write-downs of these bank’s loan portfolios later in this chapter.

\(^6\) Viohl (2012).

\(^7\) Ibid, figure 7, p. 13.
Figure 6.5: Chinese Banks’ Earnings Would Fall Significantly if Local Governments Default on Loans

<table>
<thead>
<tr>
<th>Bank</th>
<th>Earnings DECLINE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minsheng</td>
<td>30%</td>
</tr>
<tr>
<td>BOC</td>
<td>50%</td>
</tr>
<tr>
<td>BCOM</td>
<td>40%</td>
</tr>
<tr>
<td>COB</td>
<td>50%</td>
</tr>
<tr>
<td>ABC</td>
<td>40%</td>
</tr>
<tr>
<td>CITIC</td>
<td>0%</td>
</tr>
<tr>
<td>CRCB</td>
<td>0%</td>
</tr>
<tr>
<td>CMB</td>
<td>10%</td>
</tr>
<tr>
<td>ICBC</td>
<td>20%</td>
</tr>
</tbody>
</table>

Percent exposure to local government debt

The data in the figure show the likely effects on Chinese banks’ earnings in the “worst case” scenario involving local government default on loans. We also show each bank’s holdings of local government debt (the black proportions below each bank) and the percent of these holdings involving low-grade debt (the gray boxes above each bar).

Source: Nomura Equity Research (as cited by Viohl, 2012).

Declines in Chinese banks’ earnings (and a worsening of the quality of their loan portfolios) would have three effects back in Hong Kong. First, the affected banks would need to increase their loss provisions, lowering the capacity to extend new loans. Second, they might reduce staffing or other expenses – leading to less spending on consumer and other goods and services in Hong Kong. Third, international and local competitor banks might capture some of these banks’ business. These specific effects – when considered alone – would probably not have serious consequences on Hong Kong’s financial markets. However, when considering secondary effects – such as effects on land prices on the Mainland, investment in equities and other factors – these would add up to larger effects on Hong Kong’s economy.

The link between local government borrowing and real estate development on the Mainland illustrates the double effect of any shock to land prices or bank lending on the Mainland side of the border. Land sales represented roughly 30% of local government revenues in 2010 – or 2.9 trillion RMB. Local governments do not report these revenues on their balance sheets and budgets. Land-related expenditure (construction) also represents about 27% of local government outlays – again not reported on their balance sheets. As land sales represent a large part of local government revenue (and construction makes such land more valuable), the construction boom looks unlikely to diminish in the near future.

The majority of such local government debt has fuelled a construction boom in infrastructure and housing. Yet, authors like Wu et al. (2012) show that the value of the housing stock will likely decrease. Specifically, even modest declines in expected

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8 Many of the banks listed in the previous figure operate and/or list in Hong Kong. Thus, any balance sheet impacts on their business on the Mainland would certainly have effects on their Hong Kong-based operations as well.

9 They will also likely have significantly negative effects on China’s GDP growth rates. Garcia and Santabarbara (2013) provide one of the many reviews showing how the excess local government borrowing for land development imperils Chinese economic growth.

10 Garcia and Santabarbara (2013), figure 4.
appreciation would lead to large price declines of over 40% in markets such as Beijing, absent offsetting rent increases or other countervailing factors. Price-to-income ratios also are at their highest levels ever in Beijing and select other markets. The upcoming property price correction will like result in lower incomes and asset values.

For some analysts, the property development correction has already started. After a spike in 2010 and 2011, revenues from land lease sales have fallen significantly. Yet, investment continues. Figures 6.6 show the link between ever increasing investment, continuing loan growth and collapsing prices. The first panel shows the steady march of real estate investment on the Mainland – rising to about one-eighth of GDP. The second panel shows the lending that underpins much of this investment. Real estate lending has grown at about 15% per year. Such growth rates still hover around 15% - meaning that the volume of these loans will double in 4.5 years. The final panel shows the decline in real estate prices in recent quarters – reflecting the likely excess supply of real estate and building. Across China as a whole, real estate prices have declined to about 15% below their price based on market fundamentals. Such price decreases clearly signal over-expansion – and the inevitable correction. Such trends clearly increase the fragility of the Mainland banking sector. If real estate prices fall, borrowers have lower rent income to repay mortgages. Mainland banks have lower value of collateral, which means they need to keep extra cash in order to meet statutory capital adequacy ratios. Lower valued collateral also decreases the value of the stocks and bonds sold at home and abroad to investors in local government financial vehicle paper. Such a nexus clearly ties the value of Mainland securities to real estate values across the country.

What effect will declines in real estate investment have on China’s economy? Figure 6.7 shows the effects of a real estate shock on the Chinese economy. The Shanghai Stock

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12 Such a doubling time comes from the famous Rule of 70.
Exchange (a growing exchange with linkages to Hong Kong’s) suffers significantly. Exports fall (as do manufactured exports) and imports fall even more. Part of this effect on trade stems from the number and importance of the construction sector’s backward linkages. The Mainland’s construction sector reaches into all the categories shown in the figure. Roughly 30% of the construction sector’s backward linkages reach back to itself. Roughly 14% of the value of these backward linkages reaches into the construction materials sector and another 11% to the metal product manufacturing sector. Roughly 7% of these backward linkages reach into the mining sector and another 7% into the machinery equipment sector. A shock to the construction sector thus touches these sectors significantly – and thus China’s imports, exports and so forth.

![Figure 6.7: Effect of Real Estate Shock on Chinese Economic Outcomes](image)

The figure shows the decline (in percentage terms) on each of the factors listed for a 1 standard deviation shock in the construction sector. As shown, the Shanghai Stock Exchange takes the biggest hit – with certain implications for Hong Kong’s financial sector.

Source: Ahuja and Myrvoda (2012)

What effect will a decline in real estate prices ultimately have on Mainland investment (and thus Hong Kong prospects of lending and gathering assets from the Mainland)? Foreign investment in China likely exhibits the same “bull-whip effect” that real estate investment exhibits. Namely small changes in Mainland property sales magnify into large changes in inward portfolio investment. Figure 6.8 shows one of the many analyses pertaining to China’s currently falling property market – and the effect it has on investment in that sector. As shown, falling property sales lead to declines in housing starts. Lower starts mean declines in land sales, floor space completions, and thus decreases in investment. Notice that even relatively small changes in property sales have led in the past to large decreases in foreign investment. Mainland investment clearly shows extensive sensitivity to Mainland real estate prices.

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13 The jury is still very much out as to the extent to which Mainland equity valuations cause changes on the in Hong Kong stock market. Zhu et al. (2004) find that changes in the Hong Kong stock market probably “cause” (in the statistical sense of the word) changes in the Shanghai exchange – but not visa verse.


15 The bull-whip effect refers to the large changes that occur in one variable when another variable moves just a little bit. We can not hope to review this extensive literature in a footnote. Altomonte et al. (2011) provides one example of studies looking at the way small changes in “real” economic variables lead to large relative changes in portfolio or other investment.

16 A number of studies – for example Le et al. (2013) -- find similar results. Naturally, not everyone agrees. The IMF (2011) banking stability studies have come back relatively clean.
Loans to local government investment vehicles and real-estate lending – combined with risks of diminishing foreign portfolio investment – present a high risk of decreasing Chinese banking sector’s balance sheet quality. Figure 6.9 shows the various media analyses this year about the impending banking crisis in China. The consensus view remains the same. Rapid and large-scale credit expansion has led to bank over-lending – much of such lending on poor quality projects (themselves the result of over-capacity in many sectors). Following the typical debt spiral, companies and banks have taken on more debt to help serve existing debt loads. At some point, the spiral will need to unwind – with large-scale effects on the Hong Kong economy.

**Figure 6.9: Media Mentions of Upcoming Chinese Banking Crisis**

<table>
<thead>
<tr>
<th>Media</th>
<th>Description</th>
<th>Link</th>
</tr>
</thead>
<tbody>
<tr>
<td>WSJ</td>
<td>“Standard &amp; Poor’s Ratings Services warned Thursday of a threat to the region’s financial stability from a credit and debt bubble in China.”</td>
<td>*</td>
</tr>
<tr>
<td>Forbes</td>
<td>“Hard landing guys are looking like geniuses right now.”</td>
<td>*</td>
</tr>
<tr>
<td>RT</td>
<td>“The world’s biggest foreign lender is now seeking to avoid a wave of domestic defaults.”</td>
<td>*</td>
</tr>
<tr>
<td>Bloomberg</td>
<td>“A $6.6 trillion credit binge during the past five years, encouraged by Beijing policy makers as stimulus to combat a global economic slowdown, now threatens to stoke a debt crisis.”</td>
<td>*</td>
</tr>
<tr>
<td>Telegraph</td>
<td>“BIS sees risk of 1998-style Asian crisis as Chinese dollar debt soars”</td>
<td>*</td>
</tr>
<tr>
<td>Financial</td>
<td>“In other words, there is a significant risk that Chinese growth could collapse at any time in the years ahead, due to a credit crisis.”</td>
<td>*</td>
</tr>
<tr>
<td>Time</td>
<td>“Even without a full-blown financial crisis, if China starts to slow down, we’ll all feel the headwind.”</td>
<td>*</td>
</tr>
<tr>
<td>SCMP</td>
<td>“Even IMF staffers are warning of an economic crisis in China”</td>
<td>*</td>
</tr>
</tbody>
</table>

Sources: see media cited in the figure.

The data bear out the popular media story that investment flows to particular regions and projects faster than those projects can turn a profit. Figure 6.10 shows the regions which have attracted high, medium and low amounts of investment. We compare such investment with the marginal productivity of capital in those regions.  

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17 Nabar and N’Diaye (2013).
(in theory) equal their how much extra output that capital generates (in other words, its marginal product). Declining marginal productivity should correlate with declining investment. Instead, we observe increasing investment in areas which pay off (in output terms) much less than they did before. Liaoning, Chongqing and Fujian in particular represent areas which continue to attract investment, despite rapidly declining returns to capital in those places. Over-investment – likely financed in part by bank loans – help create a bubble ready to deflate. Large investment from Hong Kong in areas of diminishing marginal returns – like Chongqing and Fujian – may thus experience significant losses in the years ahead (with negative impacts on the Hong Kong economy).

**Figure 6.10: Areas with fastest decreasing marginal productivity of capital getting the most investment**

- **Heilongjiang** -13%
- **Liaoning** -12%
- **Chongqing** -11%
- **Fujian** -8%
- **Hebei** -6%
- **Zhejiang** -4%
- **Shandong** -3%
- **Jiangsu** -3%
- **Tianjin** -3%
- **Inner Mongolia** -13%
- **Jiangsu** -13%
- **Shandong** -13%
- **Zhejiang** -13%
- **Heilongjiang** -13%
- **Liaoning** -13%
- **Chongqing** -13%
- **Fujian** -13%
- **Hebei** -13%

The figure shows (in the centre) the regions attracting the most investment. The boxes on the side show the change in the marginal productivity of capital from 2002 to 2011.

Source: Sauvant et al. (2012) for investment data and IMF (2013) for marginal productivity of capital

Official statistics almost certainly under-estimate the losses that banks and other investors experience in Chinese markets. Figure 6.11 shows the sharp – almost unbelievable – decline in non-performing loans in recent years. The overall amount of “bad” lending has not decreased over time. Instead, we see a change in the relative proportion of special mention to non-performing loans. A number of scholars have argued that, when taking into account various forms legal reclassification and down-right accounting fraud, true non-performing loans probably weigh in at their previous levels around 5% to 10%. Recent write-downs of US$3.6 billion by China’s largest banks also suggest that the

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18 When reporting on these trends, IMF reports tend to include some caveat like “assuming these data are reliable” or similar.

19 Any citation of this literature runs the risk of making speculation seem like fact. Because methods of concealing true non-performing assets remain concealed from researchers’ eyes, we cannot know for sure. Bihong (2012) and Gao et al. (2013) provide some examples of studies concerning problems with NPL data. Other authors, for example Lu (2005), suggest that official non-performing loan data reflect biased lending patterns, as banks lend to state-owned enterprises and starve private sector firms of capital in order to improve their NPL ratios.
extent of non-performing loans extends more deeply than official statistics suggest. The effect of these NPLs on Hong Kong’s financial sector will depend on the extent to which Mainland authorities can put in debt resolution mechanisms faster than harms accrue to the Mainland economy.

Other official data seem suspect as well. The results of recent stress tests and official data also suspiciously show China’s financial sector as particularly well-prepared for any financial crisis. Figure 7.12 shows the results of stress tests on Chinese banks. Even under severe shock conditions (panel on the left-hand side), China’s banks maintain significant capital and experience relatively marginal increases in non-performing loans. The panel on the right-hand side shows quickly rising capital adequacy standards in recent years. Yet (as we will show in subsequent paragraphs), a number of studies show that banks no longer play the leading role in providing credit to the Chinese economy. Combined with excess credit growth, the obvious implication is that under-performing loans – and under-capitalised financial institutions – dwell in China’s immense shadow banking system.

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20 Bloomberg (2013). Many banks have non-performing loans which require shareholder or other authorisations to classify and ultimately write off (McMahon, 2013).

21 Chinese authorities do not sit passively by as the probability-weighted expected value of bank losses rises. We therefore must include strategic and dynamic elements into our analysis. Li (2012) provides a discussion of Mainland options for resolving bad debt.

22 IMF (2011); People’s Bank of China (2013).
Most commentators note that the size of China’s shadow banking sector represents the largest risk – both to the Mainland and its trading/investments partners such as Hong Kong. Estimates of China’s shadow banking sector range from about 25% of GDP to over 55%. These estimates span the gambit from about US$2.3 trillion to about US$5 trillion. According to the most recent Chinese Banking Stability Report, off-balance sheet “entrusted” loans and investments rose to about 35% of the value of on-balance sheet assets at banking institutions. With growth rates of China’s shadow banking system hovering around 20% per year, China’s US$6.6 trillion non-conventional banking sector will double in little over 3 years. The People’s Bank of China also highlighted the need to enhance discipline on the roughly 4,280 micro-credit companies, 5,240 pawn houses and 8,400 credit guarantee companies which receive far less regulatory oversight than conventional banks.

The risks of shadow banking to China’s (and thus Hong’s Kong’s) economy are so well known that they barely merit repeating. Figure 6.13 shows the types of instruments used in China’s shadow banking sector. Wealth management unsurprisingly represents the largest part of China’s shadow banking industry. Short-term loans – which can dry up at a moment’s notice – represent the bulk of China’s shadow banking transactions outside of wealth management.

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23 Federal Reserve Bank of San Francisco (2013).
25 The estimate given by the PBC equals 40 trillion yuan which we converted at recent exchange rates. Such an estimate places the shadow banking sector at about 75% of GDP – showing the wide range of estimates for China’s shadow banking sector. On the other hand, according to the Financial Stability Board’s 2012 Shadow Banking Monitoring Report, non-bank financial institutions represent only about 5% of GDP. The wide range of estimates for China’s shadow banking sector mean it’s anyone’s guess how big China’s shadow banks truly are.
26 Li and Hsu (2013).
27 Li et al. (2013).
Shadow banking in China makes the economy much more fragile to economic shocks. Figure 6.14 shows an index of economic fragility compared with several proxies for the size of shadow banking markets in China. Economic fragility – as an agglomeration of variables like economic growth, output volatility and so forth – increases as shadow banking services increase. Such economic fragility correlates with economic crisis – as economies which experience high credit growth with lower output growth tend to experience far more crisis than countries without these features. The main conclusion remains: China’s high and growing shadow banking markets correlate with (if not indirectly cause) an increased probability of an economic and/or financial crisis in China.

What would happen if China experiences a financial crisis (or at least a rapid deceleration in GDP growth)? China represents Hong Kong’s largest trading partner – with roughly half of its investment and trade going to China. Figure 6.15 shows the impact of Hong Kong’s financial sector and trade sector on overall GDP growth. Depending on the year,
trade and finance together contribute between half to three-quarters to GDP growth in Hong Kong. If a slowdown in China reduces investment and trade from/to Hong Kong, the impacts through the trade and investment channels alone would very significantly disrupt GDP growth in Hong Kong.\footnote{He et al. (2005) provide a discussion specifically about the GDP effects.} Such a crisis would even disrupt “domestic” demand from Mainlanders coming to Hong Kong to shop.\footnote{Many economists focus on trade in goods and the effect crisis in China would have on exports and imports. However, a larger trade in goods has emerged from tourists coming to shop in Hong Kong (Wong, 2013).} We saw previously how slow-down or crisis in China would affect the quality of bank loan portfolios.

If a crisis causes distress in even one or two of Hong Kong’s largest banks, chances are that Hong Kong will experience a banking and/or financial crisis of its own. Such distress can occur because of non-performing loans held by banks on the Mainland, changes in interest rates which adversely affect their asset holdings, reduce depositor’s interest in placing funds with them and so forth.\footnote{Macroeconomic conditions affect demand for banking services (and desire to deposit money in banks). We do not have space to describe the way that deposits respond to macroeconomic changes in Hong Kong. See Gerlach et al. (2005) for more.} Figure 6.16 shows the probability of Hong Kong financial sector distress if one or two large banks experience distress. As late as 2010, if HSBC and Standard Chartered experienced distress, then the entire Hong Kong economy had more than a 50% chance of experiencing distress. These data from the past probably do not reflect the current reality. However, the moral of the story remains the same. The Hong Kong economy probably remains susceptible to large shocks which would cause financial distress in one or several of its larger financial institutions.\footnote{On the one hand, the HKMA has issued a number of rules since the IMF study aiming to increase capitalisation and liquidity ratios at Hong Kong’s banks. On the other hand, if a systemic crisis (one which affects more than the two institutions described in the figure) occurs, the probability of distress could well be higher than the figure shows.}
What effects would a bank crisis or corporate distress on the Mainland have in Hong Kong? Figure 6.17 shows the likely effects on GDP and the Hang Seng index of a banking crisis and corporate distress on the Mainland. Such a crisis would trim only roughly 1%-2% off GDP growth (costing Hong Kong about US$2-4 billion). **However, a Mainland banking crisis could cost US$140 billion loss in Hong Kong’s market capitalisation.** Severe Mainland corporate distress could result in roughly a US$420 billion loss. Greater diversification in Hong Kong’s investment and trade partners could help reduce the harms to Hong Kong (as an international financial centre) in case of a crisis on the Mainland, an issue we discussed in an earlier chapter.

![Figure 6.17: Effects on Hong Kong's Economy During a Chinese Crisis](image)

The data in the figure show the probability of systemic distress in Hong Kong for bank-specific shocks. Source: N'Diaye and Ahuja (2012).

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32 We use the 2012 ending Hang Seng market capitalisation to derive this finding.
**Knock-on effects on Hong Kong’s real estate sector**

Economists cannot agree on whether real estate prices in Hong Kong reflect an asset bubble. The IMF – and authors affiliated with the Fund – have found that housing and real estate prices have not diverged from values predicted by market fundamentals. For our purposes, we do not need to determine if current prices are too high. Instead, we merely need to assess what the effects of a Mainland financial/economic shock would be on Hong Kong’s equity and banking markets – whether in equilibrium or not. The relevant linkages between the Mainland and Hong Kong include real estate linkages and banking linkages (as we have already shown in Figure 6.1). As for real estate, Mainlanders purchase Hong Kong real estate and Hong Kong real estate companies have projects on the Mainland. As for banking linkages, Hong Kong’s banks lend for real estate purchases and receive savings for deposit and investment (based on the wealth of Hong Kong and Mainlander clients). Let us first consider Mainland demand for real estate before we consider the effects on banks’ balance sheets.

Credit growth on the Mainland has encouraged Mainland purchases of real estate – which has driven up real estate volumes and prices. Figures 6.18 provide three charts side-by-side which illustrate our argument. The story line between the three graphs goes as follows. Credit on the Mainland expanded by about three times since 2007-2008 (as shown in the first panel). Such credit growth provides (in part) the funds for Mainland purchases of Hong Kong real estate. Mainland purchases of primary real estate exceeded one-quarter of all purchases in 2011, though this has now decreased substantially as a result of local cooling measures. As a share of general residential purchases, Mainland purchases approached 10% in recent years. Even anecdotal evidence suggests that Mainland purchases have taken advantage of easy credit on the Mainland to purchase real estate in Hong Kong. Mainland real estate demand has probably

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33 Ahuja and Porter (2010); IMF (2013), Box 1; Shaffer (2013).
34 LegCo Secretariat (2012).
contributed to increasing prices and quantities sold (as shown in the bottom panel). Higher real estate valuations have come from both rising quantities and rising prices. If/when credit growth on the Mainland slows, Mainland impact on Hong Kong’s real estate prices and quantities demanded will also slow (or correct from excessively high levels).

How will a Mainland economic slow-down effect Hong Kong’s equity markets? Figure 6.19 shows the way that residential real estate sale and purchase agreement changes correlate with changes in the Hang Seng Index. These data correlate far too closely to reflect a common effect (such as both reflecting changes in GDP or trade). If Mainland demand for either real estate or equities decreases, a decline in “the other” market will likely follow. If Mainland demand decreases in both Hong Kong equities and real estate markets fall, the effects will likely magnify each other. As shown in the bottom part of the figure, if the property and H-share components of the Hang Seng index alone lose 10% of their market capitalisation, that would already cost the Hong Kong economy roughly HK$1 trillion in lost wealth.

Figure 6.19: Changes in Real Estate Transactions Volumes and the Hang Seng Index Closely Related

The top part of the figure shows the year-on-year change in number of sale and purchase agreements and the level of the Hang Seng index (at year's end). The bottom part shows the loss in market capitalisation for each of the Hang Seng Index' constituents for a 10% decrease (as of 31 December 2013).

Source: Rating and Valuation Department (2012) for SPAs and Yahoo finance (for Hang Seng levels).

35 A number of studies have shown that changes in property prices and equity valuation feedback into each other through household income and wealth effects. Funke et al. (2009) provide one recent example.
36 Holland (2013) provides a similar argument.
What effect would a rapid deceleration on the Mainland have (through the real estate channel) on Hong Kong’s banks? Naturally, banks more exposed to the real estate sector (through mortgage lending) would suffer more. Figure 6.20 shows the proportion of residential mortgage loans to total lending portfolios in 2012 for a range of large financial institutions operating in Hong Kong. For all banks, the residential mortgage survey shows new lending in 2012 at roughly HK$200 billion and a stock of lending roughly HK$900 billion. Clearly, mortgage lending represents an area of potential fragility for Hong Kong’s financial institutions (some more than others).

Figure 6.20: Banks with 20% of Lending Portfolio in Residential Mortgage Lending

The data in the figure show the proportion of the value of residential mortgage lending to the value of total lending. We also show the value of those loans (in absolute terms) in the black boxes above each bar. For example, Bank of China's residential loan portfolio might represent a smaller proportion of its lending. Yet, the absolute value of such lending in 2012 outstrips HKMC's by 10-to-1.

Source: WRDS (2013).

A number of authors point to the effects a Mainland credit crunch would have on Hong Kong’s economy (by reducing demand for local real estate). Figure 7.21 shows the results of several studies which draw the link between credit contraction on the Mainland and increasing banking distress in Hong Kong. The HKMA shows that as real estate values fall, loan-to-value ratios rise. Such increases in such ratios will increase mortgage delinquencies by as much as 2%. Decreased real estate demand would decrease the stock market values of real estate companies. Tse shows that decreased real estate valuations tend to correlate almost 1-to-1 with changes in the value of overall equity market. Falling demand for real estate will cause real estate valuations to fall. Decreases in these values, Hoffman shows, leads to overall credit contraction in Hong Kong (as the value of collateral used to borrow on falls). Lower real estate demand also lowers bank profits (because demand for high-interest rate mortgages decreases). Lower bank profits in Hong Kong, as Peng and Fan show, lead to higher probability of bank distress. Decreases in real estate valuations lead to less disposable income to invest. Less disposable investment income (as Davis and Zhu show) leads to decreases in Hong Kong bank capital ratios and profit margins. Declining property prices will likely require the government to change its prudential policies – especially the level of property stamp duties. Craig and Hua show that such counter-cyclical policy will decrease Government’s budget surplus. Ahuja and Nabar also describe the way that decreasing real estate values would lead to

37 Residential Mortgage Survey shows new lending in 2012 as roughly HK$200 billion and a stock of roughly HK$900 billion. Difference due to WRDS reporting overall mortgages where HKMA only in Hong Kong. See RVD (2013).
contractionary fiscal policies in Hong Kong. Gan notes that decreased wealth (including property based wealth) will discourage domestic consumption – again leading to macroeconomic decline.

**Figure 6.21: Effect on Hong Kong of Mainland Credit Crunch Passing through the Real Estate Channel**

<table>
<thead>
<tr>
<th>Effect of falling property prices</th>
<th>Result</th>
<th>Author</th>
<th>Link</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increases Loan to Value Ratios</td>
<td>Raises mortgage delinquency ratios by as high as 2%</td>
<td>HKMA</td>
<td>*</td>
</tr>
<tr>
<td>Decreases real estate company equity prices</td>
<td>Overall equity markets fall roughly to same degree as real estate</td>
<td>Tse</td>
<td>*</td>
</tr>
<tr>
<td>Decreases collateral values available to borrow</td>
<td>Falling real estate prices will result in credit contraction in Hong Kong</td>
<td>Hofmann</td>
<td>*</td>
</tr>
<tr>
<td>Decreases bank profits</td>
<td>Lower bank profits increases likelihood of distress</td>
<td>Peng and Fan</td>
<td>*</td>
</tr>
<tr>
<td>Decreases deposits and investments in HK banks</td>
<td>Decreases in capital ratios and bank margins</td>
<td>Davis and Zhu</td>
<td>*</td>
</tr>
<tr>
<td>Requires Government to ease Stamp Duty or provide tax rebates</td>
<td>Easy fiscal policy leading to decreases budget surpluses</td>
<td>Craig and Hua</td>
<td>*</td>
</tr>
<tr>
<td>Decreases real estate values</td>
<td>Increases loan-to-value ratios, resulting in contractionary prudential policies</td>
<td>Ahuja and Nabar</td>
<td>*</td>
</tr>
<tr>
<td>Hong Kongers feel poorer</td>
<td>Consume less and so reduces domestic-led growth</td>
<td>Gan</td>
<td>*</td>
</tr>
</tbody>
</table>

The credit boom on the Mainland will eventually cause banking, equities market and other disruption in Hong Kong. In order to prevent contagion of a Mainland banking and financial crisis in Hong Kong, policymakers should ensure that regulators have in place appropriate powers and tools to think about and propose solutions. The government should also put in place policies to diversify the economy though the creation of open-ended investment vehicles.

*Regulatory changes for insulating Hong Kong against a Chinese-source financial crisis*

An excellent starting point for ensuring that developments on the Mainland do not affect the Hong Kong banking system consists of ensuring that the HKMA can serve as a dispassionate monitor of developments – both on the Mainland and in Hong Kong. Figure 6.22 represents one kind of measure the HKMA uses (or at least reports on) in their monitoring of Hong Kong’s banking sector’s stability. Their measure – based on two
academic papers the report cites – uses backward looking measures. The measure in the figure supposedly “goes up” (namely the value of the index increases) as an impending crisis approaches. Indeed, looking at the figure itself, the indicator is does not provide much in the way of advance warning.

At present, the HKMA has no explicit mandate to address macroprudential issues concerning the entire financial system, i.e. it lacks a specific financial stability mandate. Based on experiences of the global financial crisis, this is a significant omission and one that should be addressed.

**Recommendation 15: Provide the Hong Kong Monetary Authority with an explicit mandate to address financial stability across the entire financial system.**

Another important step will consist of diversifying the Hong Kong economy away from China and its growing debt. The creation of open-ended investment companies represents one of those best ways. The Financial Services Development Council (2013) has seized on the fact that, of the 1845 funds authorised in Hong Kong, only 318 are domiciled here as unit trusts. In other words, less than 20% of the mutual funds sold in Hong Kong have their domicile here. However, the current situation results in a harm which few comment on. At present, Hong Kong’s collective investment schemes fail to draw capital to Hong Kong and diversify risk in the hands of wider numbers of people and institutions. Figure 6.23 shows the investment focus of the mutual funds listed in Hong Kong. **Only 8% of the funds listed in Hong Kong actually invest in Hong Kong securities.** Of the 85 funds focusing on Hong Kong securities, about 25% of them focus on bond (fixed income). Hong Kong mutual fund markets aim to provide local investors with foreign diversification rather than diversify Hong Kong asset-based risks abroad.

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38 The two papers they cite – Wong et al. (2010) and Demirguc-Kunt and Detragiache (2000) – use indicators, which are themselves, constructions based on preliminary data. We do not have the space to critique the actual measures from the two papers the HKMA report cites. However, reliance on these methodologies – as evidenced by the “misses” exhibited in the figure – clearly shows the measures the HKMA has adopted are too conservative.

39 We have shown in previous sections that Hong Kong equity markets rely heavily on China and that credit expansion on the Mainland influences our real estate markets.
The structure of Hong Kong’s mutual fund markets implies three things about Hong Kong’s ability to weather a Mainland-origin crisis. First, Hong Kong investors tend to be over-exposed to Hong Kong investments. Hong Kong listed funds focusing on Hong Kong securities (equity and debt) are sold to Hong Kong individuals and institutions. All the 30 foreign-listed mutual funds which invest in Hong Kong are exchange-traded funds – providing no particular diversification of risks for unlisted companies. Second, roughly 40% of the funds listed in Hong Kong offer exposure to China or the greater Asian region (including global or sector-based funds with significant investments in Asian companies). These are exactly the companies investors will not want when/if a China-origin crisis appears. Third, inability to create open-ended investment companies also prevents the collective undertaking for collective investment in transferable securities in a range of risky sectors. Hong Kong real estate qualifies as a high-risk risk (at least in our view).

Similar to the FSDC, we recommend the establishment of open-ended investment corporations in Hong Kong. The UK method of legalising open-ended investment companies provides a useful model for Hong Kong legislators. The Financial Services and Markets Act 2000 provides the statutory basis for further rulemaking in the area of investment companies. The Act specifically defines them as a class or type of a “body corporate” which in essence manages the investment funds (property) of others. To boil the argument down (perhaps too much), when a UK “body corporate” (as established in

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40 We refer to the 30 foreign-listed mutual funds investing in Hong Kong from Bloomberg’s mutual fund database.

41 So many analysts have commented on the under-development of the REIT market that we do not repeat this analysis here.


43 Ibid., sec. 236.2.
the UK Companies Act) engages in open-ended investment activity, that company becomes an OEIC. The Financial Services and Markets Act then authorises the Treasury to make any necessary rules related to the government of these OEICs.\footnote{Ibid., sec. 236(5). The provision we cite authorises the Treasury to “amend the definition of ‘an open-ended investment company’ for the purposes of this Part [of the Act].” Under art. 262, the Act provides that “the Treasury may by regulations make provision for” a long list of various regulatory functions.}

If the Financial Services and Markets Act provides the “statutory anchor” (speaking informally) for the establishment of OEICs and the Treasury’s regulatory role, the Open-Ended Investment Companies Regulations of 2001 provide the specific regulatory provisions.\footnote{The Open-Ended Investment Companies Regulations 2001, No. 1228.} These include the Treasury’s regulation over the formation, supervision and control of OEICs (in part II), corporate organisation and administration (part III), OEIC registration (part IV), and matters contained in various schedules – such as the form of the instrument of incorporation, register of shareholders and so forth. As the Regulations make plain in their introduction “whereas a draft of these Regulations has been approved...pursuant to section 429(2) of the Financial Services and Markets Act 2000...now therefore, the Treasury, in exercise of the powers conferred on them by...that Act...hereby make[s] the following Regulations”.\footnote{Ibid., introduction.} In a nutshell, once the relevant regulator (in this case the Treasury) had the brief statutory authorisation, it could regulate OEICs as needed.

**Recommendation 16: Create the statutory basis for open-ended investment companies.**

Once the SFC has the authority to regulate open-ended investment companies, what kinds of regulations should appear in their rulebooks? We propose that the SFC create a Code on Open-Ended Investment Companies.\footnote{The Code would join the 13 codes (including one Handbook) on various aspects of securities law in Hong Kong. The Handbook has a brief section on mutual funds and unit trusts. Given the amount of rulemaking likely required, we recommend a separate Code rather than just an addition to the Handbook.} Figure 6.25 shows the likely chapter topics for the Code.\footnote{We do not have space to describe the way we have “filtered” OIEC regulations from various jurisdictions to identify the provisions best suited for Hong Kong. We also do not have space to describe how we matched these provisions with the Companies Ordinance, SFO and assumed subsidiary rulemaking by the SFC. We presume the SFC will repeat this exercise and report on their deliberations during the public consultation.} The Code basically repeats many of the provisions found in the US and EU – omitting provisions already existing under Hong Kong law. In general, the SFC’s work regulating and supervising OEICs would not differ substantially from its current work regulating and supervising off-shore mutual funds operating in Hong Kong and Hong Kong domiciled unit trusts.
The SFC should not wait until the relevant amendments appear in the Companies Ordinance to begin drafting the Code for Open-Ended Investment Companies for three reasons. First, public consultation on the Code will help build public support and understanding for the statutory changes required to authorise the establishment and function of Hong Kong OEICs. Second, work on the Code now can help ensure that foreign regulators see and provide feedback on the any problems in the mutual recognition of Hong Kong’s OEIC regulations. Such mutual recognition will be particularly important for the proposed mutual recognition scheme between the Mainland
Third, current proposals for establishing OEICs usually also include establishing limited liability partnerships and modifying the existing unit trust framework governing Hong Kong’s mutual funds. By publishing a Draft Code on Open-Ended Investment Companies before the legislative basis for the Code appears in the Companies Ordinance, the SFC can help encourage public dialogue on legal changes needed (or not) for limited liability partnerships and unit trusts.50

**Recommendation 17:** Once amendments from the previous recommendation appear in the Companies Ordinance, the SFC adopt a Code on Open-Ended Investment Companies.

**Conclusions**

Rapid credit expansion on the Mainland, increasingly leveraged local-government-financial-vehicles, and a burgeoning shadow banking sector will likely contribute to a Mainland banking and/or financial crisis. The effects of such a crisis will translate into significantly lower equity and real estate prices. Such a Mainland crisis will also translate into weaker Hong Kong bank balance sheets (as the value of real estate and securities collateral falls and stressed-out clients withdraw funds). Because the HKMA has no explicit mandate to address system-wide macroprudential issues, overall analysis is weakened.

In this chapter, we have looked at three ways to help protect Hong Kong from a double whammy crisis (decreasing securities prices and concomitantly falling real estate prices). We argue for an explicit system-wide financial stability mandate for the HKMA. We also argued for the creation of provisions allowing for the registration and operation of Hong Kong open-ended investment companies. In the next chapter, we describe the sequence in which Hong Kong’s policymakers should adopt each of these reforms (and the other reforms we have recommended in this report).

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49 We have described the mutual recognition scheme in a previous chapter. See Bond et al. (2013) for a description specific to the proposed changes in the OEIC framework in Hong Kong and its effect on the cross-border mutual fund trade with the Mainland.

50 At the time we wrote this chapter, new rules on Trusts had just been announced.
Chapter 7: Financial Regulation – Adopting International Regulations while Addressing Unique Financial Stability Concerns

Hong Kong escaped relatively unscathed from the 2008 the global financial crisis. Nevertheless, Hong Kong policymakers can learn lessons from the crisis. Some of the lessons involve adopting regulations similar to those adopted in other upper-income jurisdictions participating in the Group of Twenty (G20) and Financial Stability Board (FSB). Other lessons from the crisis will need to result in home-grown regulations aimed at risks specific to Hong Kong. In this chapter, we will review Hong Kong’s policymakers’ response to various regulatory reforms promulgated by the G20 through the FSB. We will also review the major changes needed if Hong Kong policymakers are to respond to Hong Kong’s unique financial sector challenges – specifically the risk of concomitant real estate price decreases and economic slow-down (or crisis) on the Mainland. We provide several proposals aimed at making Hong Kong’s financial system more resilient to its unique potential systemic risks.

Why financial law reform for Hong Kong?

At first glance, Hong Kong has little need for financial regulatory reform – as other economies transmitted to Hong Kong most of the losses in its equities and other markets. Figure 7.1 shows the way that GDP growth rates changed in the recent years. Hong Kong’s GDP reflected to some extent macroeconomic developments in other upper-income economies (and we use the US growth rate to illustrate the trends in these other economies). However, due to Hong Kong’s important investment and trading links with the Mainland, its GDP growth rates did not reflect the recession experienced in the rest of the world. The Mainland served as a stabilizer – helping to buffer Hong Kong’s financial sector (and other sectors) from the results of the 2008 crisis.

<table>
<thead>
<tr>
<th>Year</th>
<th>Hong Kong</th>
<th>USA</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>5%</td>
<td>-3%</td>
<td>8%</td>
</tr>
<tr>
<td>2006</td>
<td>6%</td>
<td>-2%</td>
<td>7%</td>
</tr>
<tr>
<td>2007</td>
<td>8%</td>
<td>-1%</td>
<td>6%</td>
</tr>
<tr>
<td>2008</td>
<td>9%</td>
<td>-%</td>
<td>5%</td>
</tr>
<tr>
<td>2009</td>
<td>7%</td>
<td>-%</td>
<td>4%</td>
</tr>
<tr>
<td>2010</td>
<td>6%</td>
<td>-%</td>
<td>3%</td>
</tr>
<tr>
<td>2011</td>
<td>5%</td>
<td>-%</td>
<td>2%</td>
</tr>
<tr>
<td>2012</td>
<td>4%</td>
<td>-%</td>
<td>1%</td>
</tr>
</tbody>
</table>

The data show the growth rate of real GDP in each jurisdiction shown. Hong Kong’s GDP growth rate reflects some combination of Chinese, US and other investment/trading partners’ growth.

If Hong Kong’s real economy seems to reflect a mix of Chinese and OECD macroeconomic performance, its financial sector appears to be dominated by China effects. Figure 7.2 shows increase of foreign currency liabilities and claims of Hong Kong’s financial institutions. Even during one of the most severe crises since the 1920s, Hong Kong’s banks continued to amass deposits and other assets as well as increase lending. Even during the mini-bond scandal, banking assets and liabilities continued to grow. Such trends (beguilingly) suggest that the current system of financial regulation insulates Hong Kong from domestic and foreign shocks alike.

Figure 7.2: The China Effect or How Hong Kong’s Financial Assets Continue to Grow Despite Foreign and Domestic Financial Crises and Scandals

The data in the figure show the external liabilities and claims of Hong Kong bank and non-bank entities. As previously mentioned, Hong Kong’s financial sector and real sector developments depend on a weighted combination of China’s and the OECD’s financial and real sector outcomes. If the real sector has reflected a blend of the two jurisdictions’ output growth, the financial sector so far reflects mostly Chinese developments. Source: HKMA (2013) at Table 3.11 and events from Arner et al. (2010).

Hong Kong’s large dependence on Mainland China has made its financial sector relatively immune to foreign shocks (so far). However, Mainland developments do not pass directly and completely through to the Hong Kong economy. Figure 7.3 shows the extent to which the changes in the Hang Seng index correlate with property prices changes and changes in Mainland equity valuations. The Hong Kong and Chinese markets correlate strongly with each other (about 0.56 out of 1.00). The Hang Seng Index and Hong Kong property prices weakly correlate with each other (owing to the continuous rise of property prices across Hong Kong in recent years). Hong Kong property prices and Chinese equity prices (specifically A-share prices) negatively correlate with each other (possibly showing that Hong Kong property serves as a substitute investment). Dependence on the Mainland economy has helped insulate

1 The numbers 0.56 and 1.00 refer to correlation coefficients. These numbers range between -1 and 1. A correlation of -1 means perfect negative correlation. Zero means no correlation and 1 means perfect positive correlation.
2 The correlation coefficient equals 0.12 – implying a weak correlation between these two variables.
3 A correlation coefficient of -0.62 implies a relatively strong negative correlation. Economists would report another statistic which measures the likelihood that such a correlation actually does not equal zero. Like all statistics, we can not be certain that our estimate of -0.62 actually does not just measure random variation. We do not report on these statistics in detail here.
the Hong Kong economy from foreign shocks – but has made Hong Kong vulnerable to shocks from the Mainland.4

![Figure 7.3: Under Normal Circumstances, Hong Kong’s Stock and Property Markets Don't Seem to Depend on Mainland Markets](image)

The data in the figure show the way private residential real estate prices have (not) correlated with Hong Kong stock market levels and valuations of Mainland companies. The private real estate index shows data from Table 5 of the Hong Kong Property Review Monthly Supplement – overall private domestic price indices for selected popular developments. The China A-share index shows the Market Vectors China ETF (PEK).

Source: Yahoo finance (2013) and Hong Kong Rating and Valuation Department (2013) for Real Estate Prices.

Is Hong Kong’s reliance on Chinese economic growth leading to a financial crisis waiting to happen? Figure 7.4 shows the extent to which various types of shocks from the Mainland, Singapore and the UK spill-over into changes in Hong Kong’s bank capital. Hong Kong’s bank capital levels – according to an IMF study’s authors – are extremely sensitive to inter-bank lending, cross-border equity contagion and non-bank/sovereign debt shocks from the Mainland, Singapore and the UK.5 If Hong Kong had been less sensitive to shocks from the Mainland before the Lehman collapse, its banks’ capital levels reflect changes far more the effects of such shocks now.

**Figure 7.4: Impact on Hong Kong of Credit and Funding Shocks from its Main Investment/Trading Partners**

<table>
<thead>
<tr>
<th></th>
<th>interbank only</th>
<th>cross-border contagion</th>
<th>non-bank sovereign</th>
<th>and</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mainland</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-Lehman</td>
<td>40%</td>
<td>55%</td>
<td>80%</td>
<td></td>
</tr>
<tr>
<td>Now</td>
<td>80%</td>
<td>80%</td>
<td>80%</td>
<td></td>
</tr>
<tr>
<td><strong>Singapore</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-Lehman</td>
<td>80%</td>
<td>80%</td>
<td>80%</td>
<td></td>
</tr>
<tr>
<td>Now</td>
<td>80%</td>
<td>80%</td>
<td>80%</td>
<td></td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-Lehman</td>
<td>80%</td>
<td>80%</td>
<td>80%</td>
<td></td>
</tr>
<tr>
<td>Now</td>
<td>50%</td>
<td>80%</td>
<td>80%</td>
<td></td>
</tr>
</tbody>
</table>

The data in the figure show the extent of spill-over of various kinds of shocks into Hong Kong’s banks’ capital. For example, an inter-bank shock on the Mainland would pass through by 40% of less in the pre-

4 The simple analysis in Figure 8.3 suggests little correlation between Hong Kong’s real estate prices, equity prices and Mainland equity prices. Later in this report, we show why the simple analysis in the figure fails to explain the way these variables interact.

5 In fairness, both the HKMA and the IMF argue that even significant shocks like a slow-down on the Mainland and/or a real estate property bubble burst in Hong Kong would not have severe consequences for Hong Kong bank capitalisation and/or the stability of her financial system.
Lehman collapse era. Now, changes in Hong Kong’s banks’ capitalisation would experience 80% of more of such a shock. All kinds of shocks from Singapore (inter-bank lending shocks, cross-border contagion and non-bank and sovereign debt shocks) translate almost completely.


Macroeconomic shocks would probably have far larger effects than generally thought. Figure 7.5 shows the estimated credit losses to Hong Kong’s banks for a GDP shock, property price shock, interest rate shock and slow-down on the Mainland. Yet, even a moment’s reflect suggests that if China’s banks experience a period of significant stress, the effects would reverberate onto various Hong Kong markets. The People’s Bank of China might need to raise interest rates to keep deposits in the country’s banks, trade would significantly decrease and Mainlanders would have less disposable income to purchase Hong Kong residential properties, financial assets and goods. In other words, these shocks would likely occur together. In the figure, we show – even using basic assumptions about the way these shocks “work together” – the credit losses from such a black swan event. Hong Kong’s policymakers would be remiss to dismiss the harms to Hong Kong’s financial sector from these Mainland-origin shocks.

Hong Kong’s policymakers and regulators should adopt measures aimed at reducing the risks to Hong Kong’s financial sector – particularly from shocks coming from the Mainland. The global crisis affected so many countries and markets because regulators failed to put in place regulations which would protect their money and capital markets from foreign shocks. Hong Kong policymakers and particularly its regulators should not make the same mistakes.

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6 In a previous chapter, we describe these linkages in detail.

7 In the pop vernacular of post-Lehman finance, a black swan event refers to a highly improbable event occurring extremely rarely.

8 We cannot provide an overview of this extensive literature. Claessens et al. (2010) and Cetorelli and Goldberg (2010) provide a recent discussion of regulators’ failure to put such measures in place.
Safeguarding Hong Kong from the usual suspects

At first glance, Hong Kong’s legislators and regulators have done a rather good job adopting the same kinds of reforms as other top-tier international financial centres. Figure 8.1 shows some of these recent changes. Hong Kong’s regulators have adopted (or are in the process of adopting) internationally agreed standards of the FSB. In almost all the areas the FSB addresses, Hong Kong has adopted measures and/or conducted studies.

**Figure 7.6: Recent Developments in Hong Kong’s Adoption of FSB Recommendations**

<table>
<thead>
<tr>
<th>Rulemaking Area</th>
<th>Progress</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital, leverage, liquidity and pro-cyclicality</strong></td>
<td></td>
</tr>
<tr>
<td>Adoption of Basel 2.5</td>
<td>Adopted Basel 2.5 in January 2012 through amendments to the Banking (Capital) Rules and Banking (Disclosure) Rules.</td>
</tr>
<tr>
<td>Adoption of Basel 3</td>
<td>Basel III began implementation on 1 January 2013 and is scheduled for full implementation by 1 January 2019 through various Banking Ordinance revisions</td>
</tr>
<tr>
<td><strong>OTC derivatives</strong></td>
<td></td>
</tr>
<tr>
<td>Legislative mandate for rulemaking</td>
<td>Securities and Futures (Amendment) Bill 2013 gazetted on 28 June 2013</td>
</tr>
<tr>
<td>Reporting of OTC derivative transactions to trade repositories</td>
<td>Hong Kong Trade Repository (HKTR) for the collection of data relating to OTC derivative transactions established under the HKMA’s Central Money Markets Unit (with a link being developed with the HKEx’s clearing facilities – the CCP).</td>
</tr>
<tr>
<td>Capital requirements for OTC transactions</td>
<td>Capital requirements in line with the IOSCO and BCBS recommendations with margin requirements still in the proposal stage</td>
</tr>
<tr>
<td>Other subsidiary rulemaking</td>
<td>Subsidiary legislation (such as detailed rules for mandatory clearing and reporting/trading requirements) being jointly developed by the HKMA and SFC. Current speed of adoption behind other G20 jurisdictions.</td>
</tr>
<tr>
<td><strong>Resolving crises involving systemically important financial institutions</strong></td>
<td></td>
</tr>
<tr>
<td>Cross-border co-operation agreements</td>
<td>SFC has already entered into cooperative arrangements and cross-border MoUs to exchange information and participate in investigatory assistance</td>
</tr>
<tr>
<td>Recovery and resolution involving SIFIs</td>
<td>In the Banking Ordinance, authorised institutions that are going concerns (and gone concerns) are subject to corporate winding-up procedures. Proposals on comprehensive systems currently open for public consultation</td>
</tr>
<tr>
<td>Hong Kong’s own SIFIs</td>
<td>SFC intends to participate with IOSCO to develop methodologies to identify firms that carry out potentially systemically important activities</td>
</tr>
<tr>
<td>Stress testing</td>
<td>HKMA and SFC conduct regular stress testing on financial institutions</td>
</tr>
</tbody>
</table>

Note: the following represents a partial review of Hong Kong’s regulators’ adoption of provisions contained in various FSB guidance documents. Much of this information will likely be out of date by the time the reader reviews it. Please consult the primary sources – namely the SFC and HKMA websites as well as Thompson Reuters Compliance Complete -- of more information.

Source: Arner and Gibson (forthcoming) and Thompson Reuters Compliance Complete.

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9 We do not have the space to provide a discussion of these reforms. Huang and Schoenmaker (2014) provide a good review of the issues.
Figure 7.6 (continued): Recent Developments in Hong Kong’s Adoption of FSB Recommendations

<table>
<thead>
<tr>
<th>Compensation (remuneration) policies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Guidance to financial institutions</strong></td>
</tr>
<tr>
<td><strong>Regulator oversight</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Credit rating agencies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Regulatory oversight of credit agencies</strong></td>
</tr>
<tr>
<td><strong>Use of credit agency ratings</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Hedge funds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Licensing</strong></td>
</tr>
<tr>
<td><strong>Reporting</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other issues</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Securitisation and Retained ownership of risks underlying asset</strong></td>
</tr>
<tr>
<td><strong>Accounting Standards</strong></td>
</tr>
</tbody>
</table>

Note: the following represents a partial review of Hong Kong’s regulators’ adoption of provisions contained in various FSB guidance documents. Much of this information will likely be out of date by the time the reader reviews it. Please consult the primary sources – namely the SFC and the HKMA websites -- of more information.
Yet, Hong Kong has done far less than other international financial centres in considering strategic reform of its financial sector. The United Kingdom (host and home to the international financial centre of London) has completely redesigned its regulatory institutions and modified much its financial regulation.\textsuperscript{10} As early as 2008, the US Treasury (2008) had developed wide-reaching proposals for protecting the US financial sector from self-inflicted and foreign-inflicted shocks.\textsuperscript{11} While Hong Kong regulators have not even broached the subject of systemic reform, US authorities are already assessing the extent of reforms already undertaken.\textsuperscript{12} Both the HKMA and SFC have engaged in piece-meal reform of the Securities and Futures Ordinance and Banking Ordinance in response to various regulatory reform proposals coming from the Financial Stability Board.\textsuperscript{13} However, unlike in other upper-income jurisdictions, the government has not led a comprehensive blueprint for financial sector reform. The lack of such a blueprint has led financial institutions to feel as though ad hoc reform will continue into the indefinite future.\textsuperscript{14} \textbf{As long as Hong Kong keeps its fragmented structure of regulatory institutions, it will not have a coherent regulatory blueprint, resulting in gaps, overlaps and excess costs to the economy and risks to financial stability.}\textbf{Reviewing Hong Kong’s regulatory structure}\n
In the 1990s and 2000s, Hong Kong’s banks and financial institutions have diversified their product and service offerings into each others’ markets. Figure 7.7 shows – using the simple example of HSBC – how modern financial institutions encompass banking, securities, insurance, and other activities. In 2012, HSBC’s revenue came relatively equally from all these branches of financial service provision. HBSC typifies many of Hong Kong’s financial institutions – a bundle of banking, securities, insurance and other risks and returns.

\textsuperscript{10} See HM Treasury (2010) and Green et al. (2011) for more.
\textsuperscript{11} See Hansen et al. (2010) for a critique of recent US legislative and regulatory provisions.
\textsuperscript{13} Figure 3.6 describes some of these piece-meal reforms. Hong Kong’s financial press has consistently reported on (and commented on) the ad hoc nature of these reforms. See Linklaters (2013) for one example.
\textsuperscript{14} The closest thing to a systemic-wide rethink of Hong Kong’s financial regulation comes in the form of several submissions to the Legislative Council. The submissions consist of statements without any form of substantiation or data. See Carst (2009) for an example.
While Hong Kong’s financial institutions have evolved to merge the offering of a wide range of financial services, their regulators have not merged to keep up with these merged offerings. Instead of reflecting the organisations they regulate (by merging), Hong Kong’s regulators have patched together a regulatory regime based on committees and memoranda of understanding between regulators. Figure 7.8 shows the way Hong Kong’s financial sector regulation has attempted to adjust overlapping competencies of Hong Kong’s regulators. An array of inter-institutional committees and memoranda of understandings act as surrogates for what counts as internal regulations in other jurisdictions. The HKMA takes an institutional (cross-sectoral) approach while the SFC takes a sectoral approach – excluding the activities of banks (authorised institutions or AIs in the local vernacular). The SFC regulates credit rating agencies – which work cross-sectorally. The SFC will regulate hedge funds and large unregulated players in the over-the-counter derivative market, despite the fact that the systemic problems they pose make their regulation a larger concern for the HKMA.

These arrangements has attracted considerable criticism from Hong Kong’s financial industry.¹⁶

¹⁵ See the Group of Thirty (2008) for a cross-country description of these regulatory structures.

¹⁶ The practitioner literature is too large and fragmented to provide an account of every time someone in the industry complains about overlapping and confusing competencies between the SFC and HKMA. See Ng (2012) for an academic discussion.
A number of jurisdictions recently have adopted a twin-peaks regulatory structure (or other similar structure). In the UK, a review of regulators’ response to the financial crisis has led the Government to adopt a Twin Peaks structure.\(^\text{17}\) According to recent surveys, “79% of firms believe the changes to the regulatory system will result in improved effectiveness, which can be expected to contribute to promoting the UK as a global hub for the financial sector.”\(^\text{18}\) Regarding Australia’s twin peaks system, Brown (2010) echoes the many voices in the literature that have argued that Australia’s twin peaks regulatory model helped it during the crisis: “The evidence from this examination suggests that Australia was able to avoid many of the problems that arose in the United States and the United Kingdom and that this was at least partly due to its twin peaks regulatory structure.”\(^\text{19}\) Given its promise, the EU is considering adopting a twin-peaks approach in its Union-wide surveillance and monitoring actions.\(^\text{20}\) Such action is not surprising, as the IMF has found evidence that consolidated regulation can improve regulatory outcomes.\(^\text{21}\)

While such a proposal has its detractors, **Hong Kong should closely consider adopting a Twin Peaks regulatory structure.**\(^\text{22}\) We see five advantages in such an approach. First,
such an approach would cover the gaps in Hong Kong’s existing regulation. Recent
controversies involving the regulation of activities like over-the-counter derivatives show
how such a regulatory structure presents obstacles for Hong Kong’s regulators. Second,
the approach offers a complementary approach to China’s sectoral approach. China – like
the US – regulates based on financial activity. As the Mainland uses Hong Kong to
internationalise, Mainland authorities can be sure that Hong Kong regulators will catch
risks which its own regulatory approach might miss. Third, the new structure can better
deal with a large domestic and foreign-origin crises. Assume (for the sake of argument) a
Lehman-like crisis occurred in China – with the ripple effects on the Hong Kong
economy. Under the current system, the SFC and HKMA would need to both step in –
attempting to co-ordinate a large resolution package to Hong Kong’s various broker-
dealers and banks. Under the revised structure, only the Prudential Regulation
Authority would have jurisdiction. A single voice would coordinate both inside Hong
Kong and with China. Fourth, even the process of preparing the HKMA and SFC for
such a reform will bring up issues and weaknesses that current reviews do not address.
Fifth, and possible most importantly, a Twin Peaks structure ensure Hong Kong’s
regulators provide a strategic and well-defined blueprint for current and future
regulatory reform.

If Hong Kong’s policymakers decide to adopt a Twin Peaks regulatory approach, under
the current system, they could propose two new bills aimed at putting the institutional
arrangements in place. As shown in Figure 7.9 (and following the experience of the UK
and Australia), these new bills might consist of a Hong Kong Prudential Regulation
Authority Bill and a Hong Kong Financial Conduct Authority Bill. The organisations
these pieces of legislation would create would follow the example of their counterparts in
the UK and Australia. Because the competencies of these authorities are so clearly
defined in other countries, and because their competencies would need to be “lifted” from
the Banking Ordinance and Securities and Futures Ordinance, we do not describe the
provisions of these Bills in detail in this report.

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23 Insurance companies would also likely feel the effects of such a crisis. We avoid any discussion of
insurance markets and institutions in this paper, leaving them for next year’s report.
24 The SFC in particular undergoes various types of performance reviews. However, these reviews most
focus on compliance and ignore the larger issues around the SFC’s fulfilment of its broader mandate and
role in Hong Kong’s financial sector. For an example of a “compliance audit” type review, see SFC Process
Review Panel for the SFC (2013).
25 We do not include the creation of such a blueprint as a recommendation in this report because the
creation of a Prudential Regulation Authority would necessarily need to create such a blueprint.
26 A twin peaks approach actually consists of three pillars, the two we previously mentioned and a third
pillar focused on the robustness of central payment systems and the overall function of the financial system.
As these areas so clearly fall into the HKMA’s competence, we do not spend time to describe this. See Lin
(2009) for a fuller description of the twin peaks approach in a Hong Kong context.
How to enhance Hong Kong’s current regulatory structure? We propose establishing a Regulatory Structure Reform Working Group. The Working Group would have terms of reference tailored to reviewing the suitability and mechanisms for strategically improving Hong Kong’s existing regulatory structure. The Working Group should contain significant non-government participation. As we describe in the last chapter in this report, we recommend such reform to begin as soon as possible.

**Recommendation 18:** Empanel a Financial Regulatory Structure Working Group to conduct a thorough review of Hong Kong’s existing financial regulatory system with recommendations for strategic enhancement.

### Increasing effectiveness of financial sector consultations

The quality of Hong Kong’s financial regulation can only reflect the quality of the inputs Hong Kong’s regulators receive. Hong Kong’s civil society (including the objects of financial regulation like banks and broker-dealers) can only provide advice based on the materials available.

Public consultations should include substantive analysis (with reasons for each organisation’s proposals supported by data and authoritative analysis). Following the trend in other upper-income jurisdictions, public consultation documents should income a cost-benefit analysis of the proposed rulemaking. Naturally, administrations must use ambiguity when the politics or sensitivity of the issue require. However, such ambiguity should represent the exception to the norm rather than the norm.

**Recommendation 19:** Government and/or regulators should require (except when ambiguity is useful for strategic or political reasons) the use plain-English, justification of proposals using concrete data and links to internal or other studies, and where appropriate provide a cost-benefit analysis, in financial sector public consultations.

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27 We describe the administrative politics around this reform in a previous chapter.
Dealing with a potentially over-sized compliance sector

Hong Kong’s complex financial regulation probably needlessly increases the cost of business.\textsuperscript{28} It is often suggested that Hong Kong represents one of the easiest places in the world to do business.\textsuperscript{29} Yet, the specific data and view from the compliance sector says something else. Figure 7.13 shows the results of an Asian wide survey which industry interviews support for Hong Kong. Over the recent years, over 80% of risk, governance and compliance officers report higher or significantly higher costs of compliance in Asia (with Hong Kong being no exception). Recent articles in the popular media also report that asset managers in Hong Kong face significant difficulties in complying with new rules.\textsuperscript{30} Despite these increasing costs, as previously indicated, regulators do not provide sufficient cost-benefit analysis of regulations.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{figure7.13.png}
\caption{Cost of Compliance Certainly Up – Do Private Costs Equal Risk-Adjusted Benefits?}
\end{figure}

\textbf{Figure 7.13: Cost of Compliance Certainly Up – Do Private Costs Equal Risk-Adjusted Benefits?}

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>65%</td>
<td>Report local regulations not overseas represent key concern</td>
</tr>
<tr>
<td>80%</td>
<td>Executives report cost of compliance significantly or moderately higher</td>
</tr>
<tr>
<td>50%</td>
<td>Report their sector is over-regulated or significantly over-regulated</td>
</tr>
</tbody>
</table>

Three priorities
- Cross-border regulation: 20%
- AML regulations: 40%
- FATCA: 40%

Source: Cowan and Vägen (2013)

If Hong Kong reflects the Asia-Pacific, then the costs of compliance with regulations (particularly hedge fund regulations) exceed those in other jurisdictions.\textsuperscript{31} Figure 7.14 shows the costs to hedge funds (the only data available to us) and for the Asia-Pacific region. If these data reflect Hong Kong’s hedge fund industry, then Hong Kong costs of compliance well exceed those in other jurisdictions. Roughly 30% of firms would leave Hong Kong because of its onerous financial regulations. Assuming that average costs of compliance represent 0.8% of assets under management for Hong Kong’s asset managers (from the largest to the smallest), the cost would equal US$8 billion.\textsuperscript{32}

\begin{footnotesize}
\textsuperscript{28} Hong Kong reflects a broader global trend in increasing compliance regulations, and thus costs. Our focus on Hong Kong in this report does not mean to suggest that Hong Kong’s regulators alone impose these costs.
\textsuperscript{29} Heritage Foundation (2013).
\textsuperscript{30} Hubbis (2013).
\textsuperscript{31} KPMG (2013).
\textsuperscript{32} Our estimate of assets under management come from chapters 2 and 4 from this report. The Census and Statistics Department (2010) have a small overview of the asset management industry in Hong Kong. The overview unhelpfully does not tell the value of assets under management.
\end{footnotesize}
Even a back-of-the-envelope analysis shows how even small changes in Hong Kong’s rules can lead to large costs. Figure 7.15 shows the likely effect that the additional burden imposed on Hong Kong’s financial institutions by recent anti-money laundering and other regulations. Even under conservative estimates about the extra amount of resources (valued as extra working hours) that Hong Kong’s financial services firms must spend on new regulatory requirements, these new requirements impose an extra US$12 million in compliance costs.

How can Hong Kong’s regulators compensate financial firms for the additional regulatory burden they impose? An obvious solution comes from “pruning” the expanding body of regulations which has yet to undergo the type of review conducted in other jurisdictions.³³ We do not in any way want to argue for deregulation. Instead, we

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³³ The recent debate on regulation versus deregulation of the financial sector has missed the main point that all sides agree on. Financial regulations require regular review to ensure they address the risks and returns
argue for right-regulating. Even a cursory glance at existing regulatory instruments suggests that the time has come to give them a complete review. Figure 7.16a shows each regulatory instrument and the number of provisions, pages and other information. We do not spend the time needed to assess all the obvious overlaps and repeated provisions we have found – a separate and important exercise in itself. Figure 7.16b shows the number of pages in each part of the HKMA’s Supervisory Policy Manual. The anti-money laundering section alone contains over 100 pages of rules. We do not want to argue that more regulations (as measured by page numbers and provision counts) mean Hong Kong’s financial sector is over-regulated. However, the accretion of rules – not counting circulars and administrative decisions – means that compliance officers cannot possibly keep track of them all. The board members and senior executive officers that compliance officers and in-counsel report to have even less chance of understanding these rules.

**Figure 7.16a: SFC Codes alone contain over 4,000 provisions**

<table>
<thead>
<tr>
<th>Instrument</th>
<th>pages</th>
<th>provisions</th>
<th>Link</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SFC Codes</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission</td>
<td>155</td>
<td>318</td>
<td>*</td>
</tr>
<tr>
<td>Code of Conduct for Persons Providing Credit Rating Services</td>
<td>15</td>
<td>68</td>
<td>*</td>
</tr>
<tr>
<td>The Code of Conduct for Share Registrars</td>
<td>18</td>
<td>93</td>
<td>*</td>
</tr>
<tr>
<td>Code on Immigration-Linked Investment Schemes</td>
<td>25</td>
<td>142</td>
<td>*</td>
</tr>
<tr>
<td>Code on Investment-Linked Assurance Schemes</td>
<td>30</td>
<td>107</td>
<td>*</td>
</tr>
<tr>
<td>Code on Pooled Retirement Funds</td>
<td>40</td>
<td>131</td>
<td>*</td>
</tr>
<tr>
<td>Code on Real Estate Investment Trusts</td>
<td>84</td>
<td>364</td>
<td>*</td>
</tr>
<tr>
<td>The Codes on Takeovers and Mergers and Share Repurchases</td>
<td>368</td>
<td>924</td>
<td>*</td>
</tr>
<tr>
<td>Code on Unit Trusts and Mutual Funds</td>
<td>108</td>
<td>532</td>
<td>*</td>
</tr>
<tr>
<td>Corporate Finance Adviser Code of Conduct</td>
<td>14</td>
<td>56</td>
<td>*</td>
</tr>
<tr>
<td>Fund Manager Code of Conduct</td>
<td>19</td>
<td>87</td>
<td>*</td>
</tr>
<tr>
<td>SFC Code on MPF Products</td>
<td>36</td>
<td>136</td>
<td>*</td>
</tr>
<tr>
<td>SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products</td>
<td>217</td>
<td>1057</td>
<td>*</td>
</tr>
<tr>
<td><strong>Sub-totals</strong></td>
<td><strong>1,129</strong></td>
<td><strong>4,015</strong></td>
<td></td>
</tr>
</tbody>
</table>

Provisions relate to the number of independent articles or provisions (usually with numbers in front of them). Naturally, these numbers may not exactly reflect the true number as a fair of discretion is required to decide what counts as a separate provision. Provision count includes appendices and may be approximate. Source: authors (based on rulebooks and regulatory instruments provided on the websites of the HKMA and SFC).

they seek to regulate when the financial industry’s structure changes. Andenas and Chiu (2013) provide a review of recent trends and issues.
Figure 7.16b: The HKMA Policy Supervisory Manual Alone Has Over 1960 Pages

<table>
<thead>
<tr>
<th>Instrument</th>
<th>pages</th>
<th>Instrument</th>
<th>pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>HKMA Policy Supervisory Manual</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Supervisory Approach</td>
<td>40</td>
<td>Operational Risk Management</td>
<td>29</td>
</tr>
<tr>
<td>Corporate Governance</td>
<td>184</td>
<td>Reputation Risk Management</td>
<td>63</td>
</tr>
<tr>
<td>Internal Controls</td>
<td>188</td>
<td>Strategic Risk Management</td>
<td>43</td>
</tr>
<tr>
<td>Capital Adequacy</td>
<td>420</td>
<td>Trading Activities</td>
<td>31</td>
</tr>
<tr>
<td>Consolidated Supervision</td>
<td>27</td>
<td>Technology Risk Management</td>
<td>90</td>
</tr>
<tr>
<td>Credit Risk Management</td>
<td>328</td>
<td>Securities and Leveraged Foreign Exchange Business</td>
<td>57</td>
</tr>
<tr>
<td>Interest Rate Risk Management</td>
<td>38</td>
<td>Mandatory Provident Fund</td>
<td>4</td>
</tr>
<tr>
<td>Liquidity Risk Management</td>
<td>167</td>
<td>Money Laundering</td>
<td>112</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Disclosure</td>
<td>145</td>
</tr>
</tbody>
</table>

The page numbers excludes links to guidance and circulars.

In all fairness, these detailed provisions still weigh in far lighter than their US or other upper-income peers. Moreover, the level of detail may serve to reduce the likelihood of arbitrary and/or capricious interpretation of vague rules and punitive enforcement based on such interpretations.

Nevertheless, we recommend that the government and/or regulatory bodies would engage in a regulatory guillotine exercise. The guillotine would review – provision by provision – the contents of existing rules. Once the review team identifying overlapping provisions or other provisions which have not been used, they can submit to the relevant organisation for change. Such a review would fit in with the redesign of the overall regulatory system.

**Recommendation 20:** The government and/or regulators should conduct a regulatory guillotine of Hong Kong’s financial sector regulations in parallel with the work of the Financial Regulatory Reform Working Group

One could combine the regulatory structure review and the review of the financial legal and regulatory framework with an overall cost-benefit analysis to consider the future development of Hong Kong financial sector strategically. This is exactly the process being conducted by Australia in its currently ongoing Financial System Inquiry, with full details and public consultation. Given Article 109 of the Basic Law, a similar exercise in Hong Kong would be most justified.

**What to do with the Financial Services Development Council?**

Well-aware of the need for greater strategic thinking about improving Hong Kong’s position among international financial centres, the government created the Financial Services Development Council. The Council may only provide advice to the Government – and at present mainly the Chief Executive’s Office and the Financial

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34 We review the role of the FSDC in the next section.
In theory, the Council has close relations with the Chief Executive’s Office (the body that created the Council) and the various parts of the Government like the Secretary for Financial Services and the Treasury (who sits on the Council as an ex-officio member). However, without a clear and stronger mandate, the Council’s ability to carry out its even relatively vague terms of reference seems highly constrained.

The Financial Services Development Council clearly should serve as a counterbalance to the risk aversion of financial regulation in general. Financial 7.17 shows the focus of the main organisations overseeing Hong Kong’s financial sector. The regulators have the mandate to minimise risks to the financial system – giving them a constraining role, despite their market development mandates. At the same time, the various regulators are sectorally limited in reach. The government encourages the adoption of policies aimed at enhancing Hong Kong’s role as an international financial centre. However, Hong Kong’s industry groups and individual financial institutions play the key role in pushing for systemically beneficial policies. The FSDC – at present – represents these interests to government. However, without a formal role and well-defined competencies, the FSDC lacks the authority to engage in serious policy advice.

The current structure has a number of problems which serious compromise its ability to fulfil its mandate. In particular, the FSDC and its secretariat have very limited resources to support necessary research. In addition, the Council has no access to data or information which can help it provide advice to Government (as envisioned in its terms

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35 Specifically, according to the announcement of the Council, the FSDC aims to “provide a high-level and effective platform for stakeholders to explore ways to complement the internationalisation of the financial market of our country and to help facilitate the further development of Hong Kong’s financial services industry, including advising the Government on areas related to diversifying the financial services industry and enhancing Hong Kong’s position and functions as an international financial centre of our country and in the region” [bold ours].

36 Both of Hong Kong’s major global IFC competitor jurisdictions have bodies which represent the “return” part of financial sector policy to Government. The City of London Corporation has been most visible in actively promoting London’s financial institutions’ interests in Whitehall, Westminster and abroad.
of reference and the preparatory report on its creation). In many countries, any high-level think tank like this has a formal relationship with Government, providing it with access to information and Government officials.

We thus propose to structure the FSDC as a public body. The FSDC would have the authority and resources to engage in policymaking focused on enhancing returns to the entire financial sector. If the FSDC were to be structured as a private company, this would imperil its survival and greatly reduce the likelihood of its achieving its objectives. As a public body, the FSDC would have a mandate to propose regulation and militate for legislation which enhances Hong Kong’s role as an international financial centre. Public bodies have accountability and oversight the FSDC under its current structure does not have. The FSDC is not currently a private company but rather simply a committee set up by the Chief Executive. Setting it up as a “private company” literally means private – whereas the Council clearly has public-oriented objectives. The FSDC clearly has more in common with public bodies such as the Financial Reporting Council and the Urban Renewal Authority – and less in common with private companies as generally considered.

As a public body, the FSDC would have clear objectives, a clear organisational form and firm competencies, obligations, and accountability that a talk shop does not have. We thus propose setting up the FSDC as a public body. With independence guaranteed by its regulations and its membership, the FSDC would serve a vital role that no organisation currently fills.

**Recommendation 21:** Establish the Financial Services Development Council as a public body with clear mandate and resources necessary to fulfil it.

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37 In the original study looking to set-up the Council, the Council’s architects imagined a role much more similar to the one we propose. They specifically argue for an independent role of the Council as a limited company with its own funding (Cha et al., 2012).

38 The FSDC has specifically been created to solve a collective action problem and serve as a public good. For details on the FSDC’s establishment as a private company, see Cha et al. at 4.19 and 4.25.

39 The authors of the scoping report commit a fundamental error in their understanding of regulation – seeing only the risk-management side of regulation, as “FSDC will not assume any regulatory role. Prudential and conduct regulation is squarely the regulators’ job by mandate.” Regulation also enables market actors by providing public goods and providing co-ordination.

40 The Prevention of Bribery Ordinance (POBO) covers public bodies, ensuring the accountability of the Council in a way its function as a private company can not.

41 Its closest analogue the City of London Corporation is also an administrative body and not a corporation.

42 As a private company, the FSDC would not possess competencies (powers to do things) and could not face disciplinary action for poor performance. Under administrative law, the Council would have to account for its actions and have powers vested by Government (and in theory by the financial sector it serves).
Conclusion

Changes to Hong Kong’s financial regulation follow an ad hoc process – largely inspired by changes recommended by the Financial Stability Board. The government (under Article 109 of the Basic Law) needs to develop its own blueprint for the future of Hong Kong’s financial sector – and the regulation that will underpin that sector. The time has come for a redesign of Hong Kong’s regulators. Concurrently, a review of existing rulebooks will help engage that ever accreting set of regulations does not impose an excessive regulatory burden on Hong Kong’s financial institutions. A new and improved Financial Services Development Council can help lead the way. In this way, Hong Kong’s policymakers can best take advantage of the calm before the storm. With a redesigned regulatory structure, Hong Kong can maintain and improve its position as an international financial centre even if a large-scale crisis emerges at home or on the Mainland.
Chapter 8: Looking Forward

Many signs indicate that Hong Kong’s financial sector currently experiences a “calm before the storm”. Even if the macroeconomic factors we have pointed to do not create a crisis, public distrust of Hong Kong’s financial institutions might. Less than 65% of respondents to a recent survey trust government and business in Hong Kong.¹ Less than 50% of respondents trust banks’ lending to small business, providing home mortgage loans, offering reasonable rate credit cards, trading and investing in government debt, ensuring the privacy of customers’ information and overseeing IPOs.² The majority of respondents think that problems in Hong Kong’s financial sector stem from corporate mischief and a distorted culture.

In this final chapter, we describe the timing and sequencing of reform which “fits” into Hong Kong’s broader policy environment. We first describe the salient macroeconomic trends predicted by the IMF for the upcoming years – and describe what these trends mean for the overall timing and sequencing of the reform “packages” we propose in this report.³ We then describe a timing and sequencing of each recommendation – giving a justification for the timing and sequencing we describe. We dedicate one section to each grouping of reforms – or give five groups in total. To keep the report brief, we avoid discussing areas where Hong excels, and focus our discussion in this chapter on areas of possible improvement. Our focus on areas of possible reform should not be taken as a criticism of Hong Kong’s often excellent financial sector structure or performance.

Broad global macroeconomic trends affecting the sequencing of reform

During the next 4 years, the macroeconomic environment should improve considerably in the developed world (the US and EU). As growth improves in the US and EU – growth opportunities (and the asset management opportunities such growth creates) – should diminish in the Asian region. Figure 8.1a shows projected GDP growth in the advanced and emerging economies. Hong Kong sits between these two groups – bringing money from advanced economies into the Mainland (and other places) while bringing goods and money from the Mainland out.⁴ Figure 8.1b shows the other predictions made by the IMF – and the ways these predictions affect the timing and sequencing of the recommendations we make in this report. Stepping back, the reader can think about the way macroeconomic developments “tilt” in favour of the US/UK, China or the ASEAN.

¹ Edelman (2013).
² Ibid., slide 32.
³ In order to keep this chapter from becoming a treatise on the macroeconomics of Hong Kong, we focus only on the IMF Economic Outlook report. We want to provide an overview of the major macroeconomic issues, without a detailed discussion of the macroeconomics behind our analysis.
⁴ These data obviously suggest that Hong Kong should market high-yielding investments from emerging markets (China but also Indonesia, Malaysian and other jurisdictions) in advanced economies like the US and UK. As the HKMA organises regular road shows doing just this, we do not add this as a recommendation.
Figure 8.1b: Likely Macroeconomic Events and Impact on Financial Services Reform

<table>
<thead>
<tr>
<th>Macroeconomic event</th>
<th>Implication for financial services reform</th>
</tr>
</thead>
<tbody>
<tr>
<td>Slight slow-down in Mainland economic growth</td>
<td>Makes our recommendations just as valid, if only less urgent</td>
</tr>
<tr>
<td>Growth differential between advanced and emerging markets</td>
<td>Hong Kong financial institutions intermediate between yield-giving emerging markets and yield-hungry advanced markets.</td>
</tr>
<tr>
<td>Slowing growth in Hong Kong</td>
<td>Focus on developing regional economies</td>
</tr>
<tr>
<td>Slowing growth in China</td>
<td>Focus on other ASEAN economies</td>
</tr>
<tr>
<td>Slow economic growth in UK and USA</td>
<td>Improve corporate governance for yield-hungry investors looking to put funds in high-yield safe haven.</td>
</tr>
<tr>
<td>Increasing recovery in US/EU with slow down in Asia</td>
<td>The timing suggests Hong Kong policymakers should focus on seizing these opportunities before slow-down stymies impetus for capital market integration in the region.</td>
</tr>
<tr>
<td>Increasing US interest rates</td>
<td>Raises Hong Kong interest rates and makes paying investors a high-yield return more difficult</td>
</tr>
<tr>
<td>Appreciating Hong Kong dollar</td>
<td>Unlikely according to IMF. If so, should speed up domestic reforms to increase returns to investors in Hong Kong assets.</td>
</tr>
</tbody>
</table>

Source: macroeconomic events from IMF (2013) and implication from authors.

Figure 8.1c: Sequencing of Financial Services Reforms
What do the macroeconomic trends identified by the IMF mean for the timing and sequencing of the “baskets” of reforms we recommend in this report? In other words, what will the tilt between US/UK, China and the ASEAN region look like in the short, medium and longer-term? Figure 8.1c shows the best timing (in our opinion) for each of these baskets of reforms. First, we argue that review and reform of Hong Kong’s regulators should proceed first. Without the added capacity such a reform will bring, other reforms will prove more difficult. If the previous crises provide any indication, the current structure will not have the capacity to deal with a serious (double) crisis. Second, Hong Kong’s financial institutions should take advantage of the growth opportunities in the ASEAN while they last. As such, government and regulators should move expeditiously to adopt the policy measures we propose to help financial institutions collect assets in the wider Asian region next. Third, with risks of a double crisis relatively tamed, Hong Kong authorities can negotiate with Mainland authorities for increased market access and “infrastructure” (such as collateral arrangements for interbank lending and so forth). Fourth, the government and regulators should support the adoption of the corporate governance measures we propose. By that time, recovery in the US and EU should make higher yielding Hong Kong assets more appealing.

Reforming Hong Kong’s regulators

We recommend, as the very first activity, review and reform of Hong Kong’s regulators. A China-origin double crisis represents the largest threat to Hong Kong’s position as an international financial centre. The data suggest that the risks Hong Kong’s financial sector regulators need to tackle will only increase in the upcoming four years. Figure 8.2 shows two measures of the volatility of capital inflows into developed countries. The panel on the left-hand side shows the volatility of emerging market inflows, as a percent of GDP. The panel on the right hand side shows the volatility (as measured by standard deviation) of capital flows into resilient, not-resilient and developed economies. Developed economies exhibit relatively high volatility of capital flows. Even resilient economies can exhibit changes in capital flows measuring several percent points of GDP. The implication could not be clearer. Even if capital flows have remained relatively stable, the odds are that capital flows will become more volatile.

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5 See Arner et al. (2010) for the justification of this statement.
The politics of such reform also indicate, as we have previously suggested, that the time for reform is sooner rather than later. Yet, without the proper timing and sequencing of reform, key political actors in Hong Kong will likely block such reform.

If the UK and Australian experience serve as any guide, the brunt of regulatory reform should take about two years. As we discuss below, by 2016-2017, inflation and interest rate strains will likely become a focus of Hong Kong’s financial sector. Reform should thus end around the beginning of 2016.

**Diversifying opportunities beyond the Mainland**

Once Hong Kong’s regulators have undergone structural reform, they can work with foreign counterparts more effectively. Even if Asia (and the ASEAN region) slows down, very rapid growth in the region suggests that Hong Kong’s financial institutions should seek to diversify into these markets as their next priority. Figure 8.3 shows the IMF’s estimates for growth in emerging Asia all the way to 2017. As shown, even under their pessimistic scenario, Asian growth still remains high. Delaying entry into these markets only delays the large amounts of funds that Hong Kong financial institutions can reap from these economies.
Given the need to seize profitable asset collection opportunities in the ASEAN region, we recommend putting cooperation with ASEAN countries second in line, followed by APEC. The groundwork covering the needed legal analysis can proceed quickly. The actual negotiation with ASEAN and amending the draft rules used during discussions with the ASEAN Capital Markets Forum may take much longer.

**Deepening client relations in the Mainland**

Growth on the Mainland will decelerate – either as we have warned, or as the IMF as warned. Figure 8.4 shows the IMF’s predicted deceleration in Mainland growth – compared with other BRICS economies. While the Mainland’s growth rate will continue at a relatively high rate, the slow-down seems here to stay. Such a trend implies that integration with Mainland financial markets (which all commentators agree are overheating) should proceed with some caution, highlighting the urgent need for diversification noted above.

**Figure 8.4: Other BRICS downturn will be cyclical, the Mainland’s will be Structural**

The data in the figure shows the composition of growth changes in the BRICS economies from 2011 to 2013. If the future repeats the past, the majority of the Mainland's slow down will come from structural rather than cyclical factors.

At the same time, given commitments to further liberalise, it is necessary to proceed in parallel on continually improving Mainland related opportunities in order to avoid being overtaken by Mainland or other competitors.

**Improving the governance of Hong Kong’s financial and non-financial corporations**

As the US Federal Reserve Board starts raising interest rates, the Hong Kong economy will need to start paying higher returns to keep money in Hong Kong. Figures 8.5 show the likely effects of interest rates in Hong Kong in the medium-term. If the future repeats the past, US interest rate policy will pass through (to some degree) to Hong Kong. As shown in the upper panel, if Hong Kong’s future real interest rates return to their previous levels, interest rates will rise by 6%. As shown in the lower panel, for unexpected US interest rate increases, Hong Kong interest rates rise almost lock-step.\(^6\) Higher interest rates mean that Hong Kong’s bond and stock holders will require higher returns in order to keep up with returns abroad.

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\(^6\) We do not show the data, but during the last 3 US interest rate increase episodes, interest rates in countries with a dollar peg went up twice and down once. Real exchange rates in US dollar pegged economies showed similar patterns.
As we have shown in this report, improving corporate governance represents one of the most effective ways to squeeze more returns out of Hong Kong’s financial and non-financial corporations. As the IMF’s predictions about macroeconomic events shows, such reforms should occur roughly as investors demand higher yields (around 2016-2018). During that time, corporations looking to improve yields have stronger economic incentives to engage in corporate governance reforms than they do at present. The intervening period (at least for corporate governance) represents a time when Hong Kong’s corporations lack strong incentives to tackle corporate governance reform, meaning that such reforms may not have the urgency of others.

Conclusion

Macroeconomic conditions (and local political conditions) right now point to a particular timing and sequencing of reform. A slow global recovery, combined with mounting risks on the Mainland mean that reforming Hong Kong’s regulatory system has become a priority. International financial centres like London and New York – as well as domestic ones like Beijing, Shanghai and Shenzhen – will only benefit from the economic recovery. The government and regulators should take advantage of the “calm before the storm” in order to solidify Hong Kong’s position as an international financial centre. Any international financial centre can grow during periods of macroeconomic growth. However, the enduring ones hold their position during periods of crisis. How Hong Kong’s financial centre responds to upcoming crises depends only on its policymakers.
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Appendix II: List of Recommendations Generated from 2013 Research Round

The following represents a partial list of some of the recommendations we obtained during the course of this year’s report. Naturally, we could not include all recommendations. We omitted recommendations in areas outside of this year’s report (like insurance and taxation). We will include these in subsequent reports when we deal with these issues. In most cases, we modified the recommendation we received to make it more specific. ¹

1. Amend Companies Ordinance (and Limited Partnerships Ordinance as necessary) to specifically define, and allow the operation of, open-ended investment companies and limited liability partnerships.

2. Modify SFC rulebook pertaining to the definition of a “responsible officer” to allow for a wider (and more relevant) range of experiences definable as “relevant industry experience.”

3. Allow listing of a wider range of investment products on HKEx.

4. SFC passes a rulebook addition to define a clear and simple method of approving derivative products for sale/use.

5. Allow for the grant of Type 9 licenses for non-discretionary asset managers in private equity fund houses. (NB: This will allow them to engage in incidental “dealing” activities).

6. Amend relevant SFC rulebook to exclude deal execution as the regulated activity of “dealing in securities.”

7. Amend SFC guidance dealing with exemptions for “dealing in securities” to allow for Type 4 and Type 9 exemptions when executing deals within the same business group (organisation).

8. Modify the HKMA / SFC rulebook dealing with regulatory capital requirements to give placement agents the same exemption as introducing agents and traders.

9. Amend SFC rulebook to add specific rule providing a clear and simple process for authorising investment products.

10. Replace current KFS document with simplified version similar to the EU KIID.

¹ SMART refers to recommendations which are Specific, Measurable, Actionable, Realistic and Time-Bound. SMART recommendations answer the five questions – who, what, where, when and how. Using the SMART criteria, we had to eliminate about 85% of all the “recommendations” we received.
11. Introduce into SFC rulebook a “fast track” procedure for modifying prospectuses (investor information documents) when another regulator has already approved the change in the document.

12. Replace the list-based tests in the SFC rulebook with principles-based tests governing the sale of derivatives, investor disclosure, and suitability as a high-net-worth investor.

13. SFC to issue a guidance document for the private placement of non-corporate hedge funds, limited liability partnerships and non-corporate structured funds under the Structured Products Bill.

14. SFC to draft regulation creating a restricted scheme registration (similar to Singapore’s) for funds marketed to institutional investors.

15. Amend relevant SFC regulation preventing offshore transactions booking (such that client-facing advisors in Hong Kong send transactions to New York, London, Singapore, etc for booking).

16. SEC should issue informational circular or guidance, after discussions with the SEC, to explain what the SEC can investigate/prosecute extra-territorially as a result of the Dodd-Frank Act’s elimination of the “private advisor” exemption.

17. SFC should sign a memorandum of co-operation allowing Hong Kong dealers to have continued access to EU investors given the new Alternative Investment Fund Managers Directive.

18. The SFC modify the rule dealing with derivatives-trading position limits (setting them higher and base them on notional value rather than the number of contracts transacted).

19. Remove from the listing requirements the requirement that a foreign issuer come from a list of particular jurisdictions. REPLACE with a disclosure-based regime (as long as issuer supplies ample set of information, can list).

20. Adopt an Audit Supervision Authority Ordinance creating an independent and statutorily based regulator for external audit in Hong Kong.

21. Put to tender a HK$750,000 service-procurement to conduct cost-benefit analysis of current and planned signature of double taxation treaties. Analysis should include estimated decrease (or increase) in portfolio assets coming to Hong Kong and strategic aspects (estimated diversion of funds to/from other international financial centres).
Appendix III: Proposals for Regulatory Review for 2014 Report

We experienced difficulty this year because of the large gap between the abstract proposals for change and the very specific rule changes proposed by Hong Kong’s regulators. In order to bridge this gap in next year’s report, we are asking our readers to submit for our review the regulations they think which hinder Hong Kong’s development as an international financial centre. Or if the reader submits very specific working for a regulation, we can also assess the cost and benefits, conduct cross-country comparisons, legal analysis and so forth.

What exact do we want?

We can only consider proposals which:

1. reference an exact provision in relevant legislation (such as the Banking Ordinance, Securities and Futures Ordinance etc) or provisions (or group/list of provisions) in the regulatory rulebooks and guidance materials,

2. make a specific assertion or claim (e.g. the provision has decreased lending from my bank by 8%, the rule increases compliance staff costs by 5%, and so forth), and

3. make a specific proposal about what is to be done (e.g. remove a group of words, delete the provision, add an exception targeting a specific group of people, etc.).

What do we do with your proposal?

We will use an independent set of eyes to assess the provision’s social impact. We might collect data about things that regulation affects (or might affect), compare with other countries, build a larger model to understand the way changing that regulation affects other things, conduct a legal analysis of the surrounding law, compare with foreign laws, and so forth. We will select the highest impact problems for consideration in next year’s report.

What yardstick must we use to decide if a financial regulation is “good”?

We must limit our objectives, and the way we judge if a regulation is good if we want to be concrete and limited in our scope. For our purposes, we assess regulations by the extent to which they increase the risk-adjusted, long-term amount of portfolio investment in Hong Kong, knowing that other international financial centres may react strategically to the provision.
What if I want you to analyse a general policy?

We can only analyse a general policy if you provide a draft regulation (or legal change). It does not have to be perfect. Just something concrete we can redraft into a specific proposal which we can confront with data. We can help redraft your proposal, but we do not have the manpower to turn policies into black letter law from a blank sheet of paper.

Answer the five questions in your proposal

Think about who the regulation will apply to (in concrete terms and specific institutions), what it will do (if you told it as a command to a bank executive, would it be specific enough for him to act on?), where, when and how would it work?

I don’t want my bank chief or government department head to know I’m going to you with a proposal of my own

You can send anonymous proposals. Just in fill in the sheet and send from an anonymous email.
Regulatory Review Request Sheet
Please return to the project co-ordinator Bryane Michael at bmichael@hku.hk

1. Your name and/or institution (optional)

2. What regulation do you want us to evaluate (or do you find grievance with)?
   (please give exact Ordinance number or rulebook provision number)

   □ Banking Ordinance       □ Securities and Futures Ordinance
   □ Rulebook or guidance

   Link to relevant rule or legislative provision

3. Current text (how does the provision currently read)?

4. Why you do not like this provision?

   □ Costs exceed benefits                □ The way its executed is bad
   □ Will not do what it is supposed to do  □ other ______________________

5. How do you want it to read?
   (Please rewrite the current provision in the way you want it)

   It does not have to be perfect. Just enough for us to redraft. If it is a copy of a foreign provision, that is fine.

6. What is so great about your proposed modification?

   □ It lowers institutions’ costs without increasing systemic risks
   □ Decreases burden on regulators
   □ Helps push institutions to work more efficiently
   □ Other ____________________________
   □ It helps manage systemic risks
   □ Decreases burden on regulators
   □ Makes policymakers more accountable

Thank you!
Appendix IV: Author Biographies
(in alphabetical order)

Douglas W. Arner  Head of the Department of Law at the University of Hong Kong and a member of the Hong Kong Financial Services Development Council. In addition, he is Project Coordinator of the Hong Kong Research Grants Council Theme-based Research Scheme Project: Enhancing Hong Kong’s Future as a Leading International Financial Centre. Prior to his appointment as Head of Department, Douglas served as Director of the HKU’s Asian Institute of International Financial Law from 2006 to 2011. He also is author, co-author or editor of thirteen books, including From Crisis to Crisis: The Global Financial System and Regulatory Failure (Kluwer), Finance in Asia (Routledge), Financial Stability, Economic Growth and the Role of Law (Cambridge University Press), and Financial Markets in Hong Kong: Law and Practice (Oxford University Press) and more than 100 articles, chapters and reports on related subjects. Professor Arner has served as a consultant with, among others, the World Bank, Asian Development Bank, APEC, EBRD and Development Bank of Southern Africa. He is Co-Director of the Duke-HKU Asia America Institute in Transnational Law, a Senior Fellow of Melbourne Law School, University of Melbourne, and a member of the International Advisory Board of the Australian Centre for International Finance and Regulation.

David C. Donald  is a Professor at the Faculty of Law of The Chinese University of Hong Kong (CUHK) since 2008. Prof Donald practiced corporate and international commercial law for a decade in Frankfurt am Main (Germany), Milan and Rome (Italy) and Washington DC (USA) before the academic appointment at CUHK. Professor Donald is a member of Hong Kong’s Standing Committee for Company Law Reform and the Policy Research Committee of the Hong Kong Financial Services Development Council. Professor Donald’s areas of research interest range from company and capital markets laws to the historical evolution of legal and normative systems. His publications include A Financial Centre for Two Empires: Hong Kong’s Corporate, Securities and Tax Laws in its Transition from Britain to China (Cambridge University Press, 2014), The Hong Kong Stock and Futures Exchanges – Law and Microstructure (Thomson, Sweet & Maxwell 2012) and Comparative Company Law (Cambridge University Press 2010).

Say Goo  is a Professor at the Faculty of Law and Director of Asian Institute of International Financial Law (AIIFL) at the University of Hong Kong. Professor Goo specialises in land and real estate law, company law (particularly corporate governance and shareholder remedies), corporate insolvency, securities regulation, and aspects of financial law. He has published widely, with approximately 34 books (including scholarly books, edited books, new editions, Halsbury’s and Annotation books), 35 articles and book chapters and delivered more than 25 conference papers. He is often invited to deliver lectures in Beijing, Taipei, Tokyo, Zurich, Melbourne, Brisbane and Okinawa, and was invited to speak at an Expert Consultation in Toronto in Support of the
Corporate Law Tools Project of the UN Special Representative and nominated by the Hong Kong Government to speak at an APEC conference in Washington DC. In addition to research work, Professor Goo has been a member of the Hong Kong Government’s Standing Committee on Company Law Reform since January 2009.

**Richard W.X. Hu** is an Associate Professor of political science in the Department of Politics and Public Administration, University of Hong Kong. Dr Hu’s primary research interests lie in the field of international relations and comparative politics. His research and publications trespass several subfields in international relations, ranging from area studies on China, Taiwan, and East Asia, political economy issues such as regionalism and regional integration, and international security issues such as nuclear non-proliferation and major power relations in East Asia. Dr Hu has been invited to serve in seven editorial boards of academic journals and book series. He is currently sitting on the editorial board for Journal of Contemporary China and International Review.

**Chen Lin** joined the University of Hong Kong as a Chair Professor of Finance at the School of Economics and Finance in 2013. Before joining HKU, Professor Lin was awarded the Choh-Ming Li Professorship in Finance at the Chinese University of Hong Kong in 2012. His research interests include banking and financial institutions, corporate finance, financial contracting, financial regulation, and development economics. Professor Lin’s papers are widely published in the world’s top journals in finance, one of them was received the Jensen Prize (First Prize) for the Best Papers Published in the Journal of Financial Economics in the Areas of Corporate Finance and Organizations. Prof Lin currently also serves on the editorial boards of Journal of Comparative Economics and Journal of Financial Economic Policy. His research works and views have been presented in major finance conferences. He has provided consulting services for the Asian Development Bank, the Bank of International Settlement and the World Bank. Professor Lin currently serves as a panel member of the Research Grant Council of Hong Kong and the Research Assessment Exercise conducted by University Grants Committee of Hong Kong.

**Bryane Michael** is currently a Fellow of HKU’s Asian Institute of International Financial Law and has served as a Cabinet-level advisor to over 12 ministries of finance, 9 ministries of justice and 3 monarchs world-wide. During his 5 years at the World Bank and OECD in the 1990s, he worked on financial sector reform programmes in over 5 countries. During his time with the EU and UN in the 2000s, he helped Eastern European and Former Soviet countries adopt important changes approximating the *acquis communautaire* in tax, customs and financial sector reform. He has served as an advisor to over 100 large companies in Turkey, Russia, the UK, US, India and Eastern Europe. Dr. Michael has held teaching positions at Oxford University as well as recently at Columbia University and has taught over 900 executives in training programmes in over 15 countries. He has done his graduate work in economics at Harvard and Oxford and ranks among the top 3% of all law and economics scholars in the SSRN Network (by
Frank M. Song is a Professor of the School of Economics and Finance, Director of the Centre for China Financial Research since 2002, and Associate Director of Institute of China and Global Development since 2011, of the University of Hong Kong. Professor Song’s research interests are financial economics and macroeconomics with specialized fields in bank regulation and management, financial market, derivatives and macroeconomics. In addition to published two monographs on banking and financial market, Professor Song has published more than 40 articles in well-known finance and economics journals. Professor Song has successfully completed several large research projects funded by Hong Kong Research Grants Council, HKU foundation, and HKU Strategic Research Themes, and obtained several grants from the business sector, including from HKEx and the Shanghai Stock Exchange. In 2013, Professor Song was appointed as the Deputy Convenor of the HKU “China Business and Economics” Strategic Research Theme. In addition to being active in research, Professor Song is a frequent speaker in various universities and research institutes, and has also been consultant and adviser for several financial service companies and local governments in Mainland China. He currently serves as an independent non-executive director for several listed companies in Hong Kong and China.

Wilson Tong is Professor of Finance and Associate Head (Research) of the School of Accounting and Finance, and Programme Director of the Master of Corporate Finance and the Master of Finance at The Hong Kong Polytechnic University. His primary research interests include privatisation, China markets, Asian markets, and return anomalies. Professor Tong has published numerous research articles in top finance journals such as Journal of Financial Economics, Journal of Financial and Quantitative Analysis, Financial Management, etc. He serves on the editorial boards of Journal of Economics and Business and as ad hoc reviewer for prestigious journals like Journal of Financial and Quantitative Analysis and Review of Financial Studies. He is also a panel reviewer for the National Natural Science Foundation of China. Professor Tong is recipient of various research grants and awards including the Competitive Earmarked Research Grant of the Hong Kong Research Grants Council and the Outstanding Faculty Research Award of The Hong Kong Polytechnic University.

Dariusz Wojcik is an Associate Professor at the School of Geography and the Environment at Oxford University and a Fellow of St. Peter’s College Oxford. Dr Wójcik specialises in economic geography and social studies of finance. His research has been funded by the British Academy, the Leverhulme Trust, and the European Science Foundation. He has published two books, and has written over thirty papers in the leading journals in geography and related fields, including Journal of Economic Geography, Economic Geography, and chapters in edited books. Dr Wójcik is a member of the Editorial Board of the journal Economic Geography. He has given numerous invited
lectures for conferences and seminars in geography and finance, including Cambridge, Dublin, Strasbourg, Frankfurt, Amsterdam, Hong Kong, Seoul, Singapore, Toronto and New York. Dr Wójcik worked as a full-time consultant for KPMG and collaborated with the United States Agency for International Development, the Warsaw Stock Exchange, Towers Watson, and the City of Busan.

Chenggang Xu is the Quoin Professor in Economic Development at University of Hong Kong. He is also World-Class University Visiting Professor at Seoul National University, Special-Term Visiting Professor at Tsinghua University, and has taught/worked at the London School of Economics, Harvard, the IMF and the Chinese Academy of Social Sciences. He was the President of the Asian Law and Economics Association (2010-2012) and won the Sun Yefang Economics Prize in 2013. He is a co-editor of 3 major international and national journals in economics, finance and law-and-economics, and a member of editorial boards for more than a dozen major international and Chinese journals in economics, finance and law-and-economics. He has dozens of publications in major journals, chapters in more than a dozen books, and has published a book. He delivered invited speeches or keynotes at the Econometric Society’s World Congress, International Economic Association (IEA) World Congress, IEA Round Tables, AEA Meetings, EEA Meetings, China Economic Annual Conference, and Hong Kong Economic Association Biennial Conference etc. He has been invited to provide policy advises by the Chinese State Council, Peoples Bank of China, Chinese Academy of Social Sciences, UNDP, EBRD, and UK Treasury. He has served as consultant for the World Bank and the IMF. He has involved in Chinese reform debates since the 1980s.

Simon X.B. Zhao is Director of International Centre for China Development Studies and an Associate Professor in the Department of Geography and Director of Master of Arts in China Development Studies at the University of Hong Kong. He is an urban and regional specialist with research interests in broad areas of urban studies, regional economic development and transformation, geography of trade and finance, and development of international financial centres (IFCs). He is a highly productive researcher whose thoughts and ideas have had strong impacts on policy-making. He has published a total of about 100 academic papers, of which 70 were in international refereed journals and 41 in ISI (SSCI) Citation Journals. Many of these journals are among the top 10 journals worldwide. Currently he is an editorial member for two international and mainland top journals. Dr. Zhao is recognized as one of the renowned international experts on financial centres studies, particularly for China and Asia region. He is Deputy Project Convenor of the Hong Kong Research Grants Council Theme-based Research Scheme project “Enhancing Hong Kong’s Future as a Leading International Financial Centre”. In 2013, Dr. Zhao was appointed as the Deputy Convenor of the HKU “China Business and Economics” Strategic Research Themes. He is regularly invited by governments, including the PRC central and municipal governments and HKSAR as a consultant, adviser and a keynote speaker at top national and international projects, forums and conferences.
Appendix V: Project Advisory Board (in alphabetical order)

Shahla Ali  
University of Hong Kong

Emilios Avgouleas  
University of Edinburgh (UK)

Susong Ba  
Study Centre for Development of the State Council (PRC)

James R. Barth  
Milken Institute and Auburn University (USA)

Thorsten Beck  
Tilburg University (Germany)

Patrick Bolton  
Columbia University (USA)

Ross P. Buckley  
University of New South Wales (Australia)

Chun Chang  
Shanghai Jiaotong University (PRC)

Wilson Chow  
University of Hong Kong

Gordon Clark  
Oxford University (UK)

Richard Cullen  
University of Hong Kong

Julan Du  
Chinese University of Hong Kong

Eilis Ferran  
Cambridge University (UK)

Guido Ferrarini  
University of Genoa (Italy)
Kevin Fung  
Victor Capital

Hongmian Gong  
City University of New York (USA)

Michael H. Grote  
Frankfurt School of Finance and Management (Germany)

Di Guo  
University of Hong Kong

Ryoichi Hisasue  
National Graduate Institute for Policy Studies (Japan)

Joel F. Houston  
University of Florida (USA)

Berry F.C. Hsu  
University of Hong Kong

Robin Hui Huang  
Chinese University of Hong Kong

Yiping Huang  
Peking University (PRC)

Kun Jiang  
University of Hong Kong

Byung-Yeon Kim  
Seoul National University (South Korea)

Jing Leng  
East China University of Politics and Law (PRC)

Dan Li  
University of Hong Kong

Qiao Liu  
Peking University (PRC)

Paul McGuiness  
Chinese University of Hong Kong
Eric Pan
U.S. Securities and Exchange Commission (USA)

Katharina Pistor
Columbia University (USA)

Hyun Song Shin
Princeton University (USA)

Michael Taylor
Moody’s (Hong Kong)

Yung Hoi Tse
Bank of China International (Hong Kong)

Jin Wang
Hong Kong University of Science and Technology

Rolf H. Weber
University of Zurich (Switzerland)

Sarah Worthington
Cambridge University (UK)

Chao Xi
Chinese University of Hong Kong

Geng Xiao
Fung Global Institute (Hong Kong)

Li Zhang
Fudan University (PRC)

Shaojun Zhang
Hong Kong Polytechnic University

Yangsheng Zhang
National Development and Reform Commission (PRC)

Zhongfei Zhou
Shanghai University of Finance and Economics (PRC)