

**Letterhead of Hong Kong Monetary Authority**

**Joseph C K Yam, JP**  
*Chief Executive*

任志剛 JP  
總裁

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The Hon. Ambrose Lau Hon-chuen, JP  
Chairman  
Legislative Council Panel on Financial Affairs  
Legislative Council Building  
8 Jackson Road  
Central  
Hong Kong

As you are aware, we in the HKMA have spent a lot of effort in producing for Hong Kong a safe, cost-effective and efficient financial infrastructure. There is a rationale behind this initiative. We believe that such a financial infrastructure is of crucial importance to the maintenance of Hong Kong as an international financial centre, a requirement laid down in the Basic Law.

Our approach to this task has been well documented in our various publications, including our annual reports and our quarterly bulletins. But in view of the importance of the subject, I have written a series of three Viewpoint Articles on it, in order to prompt wider public interest and attract constructive comments. I attach for your attention a copy of these Articles.

Should you or any other member of the Panel have any views on this subject, for example the extent of our involvement in it, I would be very happy to receive them.

With kind regards,

Yours sincerely,

Encl.

## **Hong Kong's Financial Infrastructure (I)**

*In this first in a series of three articles on financial infrastructure, Joseph Yam explores how developing a cost-effective and efficient financial infrastructure helps to promote Hong Kong's role as an international financial centre.*

Readers may be aware of my frequent references, in this column and elsewhere, to the financial infrastructure. I realise that this is not exactly a subject of general interest, even within the financial community. But it is of such great importance to Hong Kong that I feel I should draw special attention to it in the hope of attracting constructive comment on it. I hope therefore that readers, particularly those with an interest in monitoring what we do in the HKMA, will not be put off by this series of three Viewpoint Articles, beginning this week, on this somewhat technical subject.

We all know that Hong Kong aspires to develop its position as an international financial centre. Indeed, there is a requirement, spelt out in Article 109 of the Basic Law, that "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". The Government of the Hong Kong SAR, of course, takes this responsibility seriously. So does the HKMA, as the government agency most closely involved in this field. Indeed, one of our main policy objectives is "to enhance the efficiency, integrity and development of the financial system, particularly payment and settlement arrangements."

In attempting to figure out how we can best discharge our responsibility, we first have to be clear about what constitutes an "international financial centre". I must confess I did have difficulty with this. The term "international financial centre" is not defined in the Basic Law. Nor are there internationally accepted criteria that can be relied on for guidance. We often refer to quantitative measures of, for example, the number of international banks present, or the size of the stock market in terms of market capitalisation, or the turnover in the foreign exchange market. While these measures are still being used, they are becoming less

meaningful. Globalisation and the advance of information technology have been changing, and will continue to change, the way financial transactions are conducted. Increasingly, there is less of a need for physical presence to access a particular market, as the platforms for financial transactions take wing and migrate into cyberspace. So in addressing this matter we had to go back to basics. We took the view that, to facilitate growth and development in any economy, there is always the crucial need for savings to be channelled efficiently into investments, in other words, for money to be mobilised productively for the economy. This process is commonly described in the financial sector as "financial intermediation" where the needs of those who have money to save and those who require money to invest are matched through an intermediary channel. And there are three internationally recognised channels for financial intermediation, namely, banking, debt and equity. On this basis, we took the view that an international financial centre is where financial intermediation of an international dimension takes place. For Hong Kong to qualify for the label of international financial centre, these three channels of financial intermediation in Hong Kong should be a popular place both for foreign savings and for fund raising by foreign entities.

The more important question then is how to achieve, if we have not already done so, and how to maintain this popularity. Specifically, given what is spelt out in Article 109 of the Basic Law, there is the question of what the Government of the Hong Kong SAR should do to "provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre". Thankfully, we do not have to start from scratch in this task. Given that, by whatever measure, Hong Kong has for some time been recognised as an international financial centre, the existing economic and legal environment must have been more or less right. Our task appears to be just one of maintaining it.

But I seriously doubt if this is enough. Nothing is permanent. Given the keen competition from other financial centres in the region and the profound changes that we have been seeing in international finance, clearly we should always strive to do better. This is where the financial infrastructure comes in. In this technological age, time is of the essence, financial transactions are priced in terms of the finest of margins, and there is a much greater emphasis on risk management. I believe that those engaging in international financial intermediation activities will increasingly favour a financial infrastructure that is

safe, cost-effective and efficient. This is where the competitive advantage of an international financial centre lies. Correspondingly, such a financial infrastructure has become a crucial part of that "appropriate economic and legal environment" mentioned in the Basic Law. The Government of the Hong Kong SAR has a responsibility to provide it. In the next two Viewpoint Articles I shall discuss how we should do this with reference to two important elements of the financial infrastructure: the platform for international financial intermediation and the settlement system.

Joseph Yam  
24 May 2001

## **Hong Kong's Financial Infrastructure (II)**

*Effective financial infrastructure, even in a free market economy, needs a degree of government involvement.*

Last week I emphasised the importance of a safe, efficient and cost-effective financial infrastructure to Hong Kong's development as an international financial centre and argued that the Government of the Hong Kong Special Administrative Region has a responsibility, under the Basic Law, to provide it. For this week and next, I would like to describe how we in the HKMA, as part of the Government of the Hong Kong SAR, view this task. I shall this week focus on the platform for international financial intermediation. Next week I shall deal with the settlement system.

To preface this, I have to make clear, in case I am accused of being interventionist, that I believe that the free market can largely be relied upon to come up with a safe, efficient and cost-effective financial infrastructure. It is indeed in the long-term interest of the financial community that this is so. But, like the construction and operation of various forms of the physical infrastructure, there is invariably also a role, necessitating differing degrees of involvement, for the authorities. We need a safe and efficient platform (a robust banking system for example) for the conduct of financial transactions, just as we need a convention and exhibition centre - a physical platform for people to interact and conduct activities that keep the economy going. We need a settlement system to effect payments and transfers of ownership of financial products safely, cost-effectively and efficiently, just as we need a transport system, for people and goods, with the same characteristics. Some of these facilities will simply not be built if left entirely to the private sector operating in a free market environment. There is a need for this to be understood and accepted.

The busiest and most extensive platform for financial intermediation is the banking channel: the banks are all privately run, and they are free to decide who to lend money to and who to take deposits from. And, with the removal of the remaining Interest Rate Rules for Hong Kong dollar current account and savings

deposits in July this year, they will be entirely free to determine the pricing of all such activities. Their business has, with hardly any involvement by the authorities, achieved a highly international profile in terms of both deposits and loans, off-balance sheet activities, and currency denomination. But for the purposes of affording depositors a degree of protection and promoting the general stability and effective working of the banking system, there is a need for the banks to be supervised. This is done in accordance with the provisions in the Banking Ordinance and the requirement of Article 110 of the Basic Law. In doing so, we have, in effect, also assumed the responsibility, in the context of the banking channel for financial intermediation, of ensuring that there are no cracks in that channel and that those who maintain it are not abusing their franchise.

The stock exchange is privately run and provides in essence a monopolised channel (in Hong Kong) for financial intermediation through equity. Because this monopolistic arrangement enables market liquidity to be maximised and therefore enhances the efficiency in the flow of money through that important channel, this departure from the free market principle is accepted and is furthermore sanctioned by law. For this and other reasons, there is a need for a regulatory system, in the body of the Securities and Futures Commission, to oversee the operation of that monopoly, among other things. The stock exchange is, of course, responsible for developing its business and has been successful in attaining an increasingly international product profile - a trend that is likely to continue with financial liberalisation on the Mainland. The regulatory authorities, both here and on the Mainland, are merely facilitating the identification and opening up of opportunities, particularly when policy changes are involved.

By comparison, the debt channel is not as well defined as the other two. Nor is the involvement of the regulatory authorities. The primary market is for professionals and is largely free. At the wholesale, secondary market level, it is very much an over-the-counter market and the participants are mostly banks: there is no specific involvement of the authorities in that market, either in the regulation or in the licensing of participants. The exceptions are the Exchange Fund paper market and the Hong Kong Mortgage Corporation. But our involvement there is in the capacity as suppliers of debt, satisfying demand in and helping to develop the debt market. At the retail secondary market level, again the banks are mainly the service providers in an unregulated environment, although some of the debt instruments are listed on the stock exchange. Overall, there is greater market freedom and less involvement of the regulatory authorities

in developing the debt channel, but ironically, and perhaps only coincidentally, it is also less developed. This explains our continuing emphasis on the further development of the debt market.

Joseph Yam  
31 May 2001

### **Hong Kong's Financial Infrastructure (III)**

*In this final article in the series, Joseph Yam looks at Hong Kong's settlement system, which has seen considerable developments over the past decade.*

This is the third and last piece in this series of Viewpoint Articles on the financial infrastructure. I would like to deal here with the settlement system, which I define to encompass payment, clearing and custodian arrangements. Readers will have noticed our pro-active approach in the organisation of this element of our financial infrastructure, reflected in the significant involvement on our part in the design, construction and operation of facilities comprising that system. I am glad that there has been little criticism of this approach, notwithstanding our extensive involvement. Perhaps here the analogy between the financial infrastructure and the physical infrastructure is more readily understood.

It is important to be clear about the objective. We want a safe, cost-effective and efficient settlement system. In this technological age, this means a cost-effective settlement system capable of settling financial transactions of a wide range of financial products denominated in the domestic currency as well as the major international currencies in real time, with delivery versus payment (DvP) and payment versus payment (PvP). We are not there yet, but we are among the leaders.

Here is what we have done in the past and our plans for the future:

- We developed a computerised and paperless debt clearing and custodian system (the CMU, which stands for the Central Moneymarkets Unit in the HKMA) as an essential part of the Exchange Fund paper programme, which started in 1990 and which was designed, among other objectives, to develop the debt market. This service was extended also to private sector debt in response to demand in the market. It later became the debt clearing system of Hong Kong. We have a standing offer to other jurisdictions to link their debt clearing systems with ours, so as to facilitate a two-way flow of investment in debt instruments. We have only had limited success in forging linkages within this region, reflecting, in part, the lack of such a two-way flow. But there are good prospects that the linkage itself will in time generate that two-way flow, given the strong mutual desire to develop

the regional debt market. Our linkage with debt clearing systems in the European time zone has, nevertheless, produced significant traffic since its establishment in December 1994. We shall persevere with our initiative to build these international linkages with our debt clearing system.

- In 1996 we established the Real Time Gross Settlement (RTGS) payment system for Hong Kong dollar transactions among banks. This was developed at our initiative and in conjunction with the then Clearing Bank of the Hong Kong Association of Banks (HKAB). It has a seamless interface with the CMU to enable real time DvP for debt transactions in Hong Kong. This system has, since its establishment, been run independently by a company, Hong Kong Interbank Clearing Limited, which is 50-50 owned by the HKMA (for the account of the Exchange Fund) and HKAB. But in view of the systemic significance of this operation, in particular the risk to systemic stability of a failure, it is necessary for us in the HKMA to maintain an oversight. The RTGS form of payment, and the associated DvP capability, is very robust and eliminates settlement risk. Our view is that its usage should be encouraged and, if there is demand, the services should be extended to non-bank customers as well. Indeed, many banks have made this service available to their valued customers. There may be a business case for extending this service even more widely to the retail level, both for the purpose of better risk management and to enable money to be mobilised more efficiently. We shall give further thought to this and, without pre-judging the outcome, we may initiate a feasibility study on it.
- Last year, again at our own initiative, and with the help of The Hongkong and Shanghai Banking Corporation Limited (HSBC), we replicated our Hong Kong dollar RTGS payment system for the US dollar. This was to facilitate the efficient settlement of the increasingly large number of financial transactions conducted in this time zone involving the US dollar, a practice that in itself should be encouraged so as to minimise the destabilising impact of international financial activities on domestic currencies in the region. This is now run by HSBC under our supervision. This US dollar RTGS system is also linked up with the Hong Kong dollar RTGS system to facilitate Pvp for transactions involving the two currencies concurrently. We have the first and the only system in the world, so far, that enables Pvp, and therefore eliminates Herstatt risk, 27 year after its discovery.
- We are currently exploring the viability of creating similar RTGS payment systems for other foreign currencies in which there is a significant business

interest in our time zone so as to attract this business to Hong Kong.

- We are also working, in co-operation with the Securities and Futures Commission and the stock exchange management, towards enhancing the existing linkage between the securities clearing system and our RTGS payment systems and promoting its usage. This would enable settlement time for securities transactions to be shortened and therefore made more efficient, with a view in the end of achieving real time DvP.

We shall continue to work hard to enhance our competitive advantage to be an international financial centre through the development of a safe, cost-effective and efficient financial infrastructure.

Joseph Yam

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