

**Information Note for
LegCo Panel on Financial Affairs**

**Policy Initiatives of
The Financial Services and the Treasury Bureau**

Introduction

This information note elaborates on the new and on-going policy initiatives relating to the Financial Services and the Treasury Bureau under the 2006-07 Policy Agenda issued on 11 October 2006.

Financial Services

Hong Kong's Position as an International Financial Centre (IFC) and the Premier Capital Formation Centre for the Mainland

2. In the past year, Hong Kong's financial markets continued to flourish. With a market capitalisation of over HK\$10 trillion in August 2006, Hong Kong's stock market was the 2nd largest in Asia and 8th globally; and in terms of equity funds, we came first in Asia and 5th in the world. The total assets of Hong Kong's banking sector exceeded HK\$6.2 trillion at end 2005, being 4th largest in Asia and 17th worldwide. Asset management activities have been expanding rapidly in Hong Kong,

with combined fund management business exceeding HK\$4,500 billion in 2005. Moreover, with 180 authorised insurers and total gross premiums of HK\$141 billion, we have the highest concentration of insurers in Asia. In less than six years, the total net asset value of Mandatory Provident Fund (“MPF”) schemes has already reached HK\$179 billion as at end August 2006.

3. Notably, the growth of the Mainland economy and implementation of various financial reforms on the Mainland continue to provide impetus to the development of Hong Kong’s financial markets. Hong Kong has developed as a channel for international capital to invest in Mainland enterprises, positioning prominently as the premier capital formation centre for these enterprises. As at September 2006, there are 352 Mainland enterprises listed on our stock exchange, raising a total of about HK\$1,281 billion. We are also expecting new opportunities to Hong Kong’s asset management industry brought about by the Mainland’s liberalisation measures, announced in April 2006, to allow investments in financial markets outside the Mainland through qualified institutional investors.

2006-07 Policy Agenda

4. Looking into 2006-07, we will continue to implement policy initiatives and supportive measures to enhance Hong Kong’s position as a major international financial centre and the premier capital formation and investment platform for the Mainland. In particular, we are formulating financial development strategies to capitalise on the opportunities associated with “China’s 11th Five-year Plan”. The Focus Group on

Financial Services under the Economic Summit on “China's 11th Five-Year Plan and the Development of Hong Kong” convened by the Chief Executive on 11 September 2006 has formed three working groups to advise on strategies and action plans with particular respect to (i) facilitating further development of our equity market, (ii) development of Hong Kong’s foreign exchange, futures and commodities trading, and (iii) the insurance and reinsurance as well as asset management industries in Hong Kong.

5. We set out below the progress and upcoming plans in connection with our major policy initiatives which are aimed at two main areas, namely, promoting market development and improving market quality.

I. Promoting Market Development

(a) Broadening the source of listed companies

6. Apart from continuing our efforts to encourage quality Mainland enterprises to list in Hong Kong, we will identify ways to broaden the source of corporations seeking to use Hong Kong as a platform for listing, with a view to facilitating listings of quality overseas companies. This is one of the major issues currently being examined by one of the working groups mentioned in paragraph 4 above.

(b) Furthering the development of foreign exchange, futures and commodities trading

7. The robust performance of the Mainland economy in recent years has led to increasing demand for risk management in respect of both commodity prices and exchange rates. The Mainland's development presents potential for Hong Kong to consider ways in developing commodity futures contracts and foreign exchange futures contracts trading. This is the subject being studied by one of the working groups mentioned in paragraph 4 above.

(c) Reinforcing the development of insurance and reinsurance industry

8. As one of the most open insurance markets in the world and with a strong presence of leading insurers, Hong Kong is well-positioned to take advantage of immense market potentials offered by the Mainland. One of the working groups mentioned in paragraph 4 above is exploring ways to develop the insurance and reinsurance industries in Hong Kong, leveraging on rapid economic growth in the Mainland and its gradual integration with the global financial market.

(d) Promoting asset management business

9. We have abolished estate duty and exempted offshore funds from profits tax to promote the development of the asset management industry. It is expected that the rapid growth of the Mainland's economy and increasing number of high-net-worth individuals in the Mainland will give further impetus to the development of the asset

management industry in Hong Kong. In the coming year, we will also study how to capitalise on these opportunities, with a view to further strengthening the city as an international asset management centre.

(e) Enhancing bond market development

10. We are committed to enhancing the breadth and depth of our bond market and encouraging more local and international issuers to use our bond issuance platform. To this end, following a review on the local debt market earlier this year, the Hong Kong Monetary Authority (“HKMA”) will seek to improve the arrangements, including the market-making system, the issuance programme and the trading platform, that relate to the Exchange Fund Bills and Notes Programme. In addition, following the publication of consultation conclusions in September 2006, the Securities and Futures Commission (“SFC”) will develop a framework proposal for legislative amendments with a view to modernizing the regime for public equity and debt offerings.

(f) Fostering Pan-PRD co-operation

11. To leverage on the opportunities in the Pan-Pearl River Delta Region (“Pan-PRD”) and the preferential access given to the financial services sector under the Mainland and Hong Kong Closer Economic Partnership Arrangement (“CEPA”), we would continue to promote co-operation with other provinces and region in the Pan-PRD Region to facilitate our financial services providers in tapping the opportunities in the Pan-PRD Region. In March 2006, we successfully organised the “Pan-Pearl River Delta Region Financial Services Forum” in Hong Kong

to enable leaders and entrepreneurs from the Pan-PRD Region to gain a better understanding of Hong Kong's financing and investment services, and encourage them to use Hong Kong as the capital formation and investment platform. Moreover, in September 2006, the Secretary for Financial Services and the Treasury (“SFST”) led a financial services delegation to Hunan to showcase Hong Kong’s strengths and promote our role as the Mainland’s international capital formation and investment platform. Looking ahead, we will continue these efforts to enhance co-operation with the Pan-PRD Region on financial services.

(g) Operation of renminbi business in Hong Kong

12. Renminbi business in Hong Kong has developed steadily since early 2004, with its scope further expanded in 2005. Under the expanded scope of business, and amongst other things, Hong Kong residents are able to use renminbi cheques for consumer spending in the Guangdong Province. Moreover, in March 2006, a new Renminbi Settlement System was launched to cater for the expanded renminbi business and to provide a safe and efficient clearing and settlement platform to support the further expansion of renminbi business in Hong Kong. We have been liaising closely with the relevant authorities in Mainland on further expansion of the business. This includes proposals to allow Hong Kong importers to settle direct import trade from the Mainland in renminbi and to allow financial institutions on the Mainland to issue renminbi bonds in Hong Kong on a pilot basis. The early implementation of these measures will further strengthen Hong Kong’s status as an IFC.

(h) Promoting Hong Kong's position as IFC internationally

13. We are also mindful of the growing competition from other major financial centres and spare no efforts in promoting Hong Kong's competitive edge globally. In this regard, SFST visited Kuala Lumpur, Dubai and Vancouver this year to update our international investors on the latest developments in Hong Kong's financial markets and tap co-operation opportunities. We are preparing to stage an Asian Financial Forum in end March 2007 to highlight Hong Kong's position as an IFC.

II. Improving Market Quality

(a) Regulatory reform

14. We are committed to continuing to enhance the regulatory regime in the financial markets in light of the operational experience, market development, and benchmarking on international standards. The progress of some major initiatives is set out below –

i. Financial Reporting Council

15. Preparatory work for the establishment of the Financial Reporting Council (“FRC”) is now in full swing following the enactment of the Financial Reporting Council Ordinance (“FRCO”) by the Legislative Council on 13 July 2006. An open recruitment exercise for the position of the Chief Executive Officer of the FRC began in September 2006. We expect the FRC to begin operation formally in

early 2007. This would help to enhance the quality of financial reporting of corporations and collective investment schemes listed in Hong Kong.

ii. Legislative exercises

16. We plan to introduce into the Legislative Council two amendment bills in the coming 2006-07 legislative session. They include (i) the Securities and Futures (Amendment) Bill to give statutory backing to major listing requirements; and (ii) MPF Schemes (Amendment) Bill to give effect to a number of proposals to enhance the administration and operation of MPF schemes.

iii. Basel II

17. We remain on course in our preparatory work for implementing the new capital adequacy standards (commonly known as “Basel II”) for locally incorporated banks from 1 January 2007. Following a public consultation conducted by the HKMA, the Banking (Capital) Rules and Banking (Disclosure) Rules will soon be made under the Banking Ordinance for the purpose of strengthening the risk management of banks.

iv. Setting up of an independent Insurance Authority

18. The Insurance Authority (“IA”) is presently a public officer who exercises his statutory regulatory functions on the insurance industry in Hong Kong through the Office of the Commissioner of Insurance as

part of the government structure. To bring our regulatory regime in line with international practice and allow enhanced flexibility to cope with new demands and challenges, we are formulating proposals on the setting up of an independent IA for consultation with stakeholders.

v. Rewrite of the Companies Ordinance

19. We have embarked on a major exercise to rewrite the Companies Ordinance to provide Hong Kong with a modernised legal infrastructure attuned to our needs in the 21st century as an international business and financial centre. The Companies Bill Team was established in mid-2006 to take forward Phase I of the rewrite exercise. It will follow up on the recommendations of the Standing Committee on Company Law Reform, and seek advice from relevant professional bodies, major chambers of commerce, market practitioners and company law academics. We will issue the first topical consultation document in early 2007 to consult the public on reforms for the accounting and auditing provisions of the Companies Ordinance.

(b) Investor Protection

20. Closely linked to market quality is investor and depositor protection, which is essential to the stability of our financial markets. The progress of the on-going initiatives in this regard is set out below –

i. Deposit Protection Scheme

21. The Deposit Protection Scheme was launched on

25 September 2006. The Hong Kong Deposit Protection Board will continue to monitor the operation of the scheme closely and review the scheme framework from time to time.

ii. SFC's regulation of securities firms

22. To enhance protection of brokers' clients, the SFC has devised a three-pronged action plan. The action plan will focus on (i) continuing the rigorous supervision of brokers; (ii) educating investors and encouraging the use of Investor Participant (IP) accounts; and (iii) enhancing greater collaboration with auditors to use circularization more effectively to uncover fraud. In addition, the SFC has recently amended the client securities rules to enhance investor protection by imposing a repledging limit on firms licensed for dealing in securities or securities margin financing. In the longer run, the SFC will conduct a review on the existing asset custody arrangements by brokers. The Government and the SFC will continue to keep in view the regulatory framework to enhance investor protection and maintain market integrity.

iii. Improvement of MPF investment regulations and better disclosure

23. Whilst the various implementation measures recommended by the Code on Disclosure for MPF Investment Funds issued in 2004 are being implemented, the Mandatory Provident Fund Schemes Authority ("MPFA") continues to consult the industry and the public on further proposals, including the possibility of setting up a comparative platform for MPF funds and measures to improve the member benefit statements. Meanwhile, the MPF Schemes (General) (Amendment) Regulation 2006

was passed by the LegCo in June 2006 to improve the existing investment regulations in respect of MPF scheme funds. As a long-term measure to protect the interest of scheme members, the MPFA continually educates the public on MPF with an emphasis on investor education.

FISCAL POLICY

Fiscal Targets

24. In the 2006 Policy Agenda, we pledge to continue the strive to achieve a fiscal balance, avoid deficits and keep the Budget commensurate with the growth rate of Gross Domestic Product. This is in line with the principle of keeping expenditure within the limits of revenue in our management of public finances. We will also review our tax system.

Consultation on Reform of Tax System

25. The existing tax base of Hong Kong is very narrow. We have been relying on a very limited range of taxes and non-tax income to support our expenditure. This is not healthy and has constrained the Government's ability to make long-term planning for the well-being of Hong Kong. To sustain our growth and prosperity, there is a need to have a robust, reliable and steadily growing tax base to put our public finances in stronger and healthier footing.

26. In this respect, we have launched a public consultation on tax reform with the introduction of a Goods and Services Tax (GST) as the proposed option to broaden our tax base. The consultation will last for some nine months and we would consider the views of the community carefully before making a recommendation to the Government of the next term.

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