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 2007-08 Policy Agenda issued on 10 October 2007.

Financial Services

Overview

2. Hong Kong's development as an international financial centre during the past year has been most encouraging. As at end-September 2007, our stock market had a market capitalization of over HK$20 trillion with a daily market turnover averaging HK$65.5 billion in the last 12 months. Hong Kong is also the premier capital formation centre for Mainland enterprises. 388 Mainland enterprises are listed on our stock exchange, raising a total of some HK$1,686 billion.

3. Hong Kong's sophisticated market infrastructure and efficient financial system have also enabled us to seize the opportunities brought by the booming economic development and increasing investment demand in the region to further develop our asset management

industry. In 2006, our combined fund management business amounted to HK$6,154 billion, a substantial growth of 36% over that of 2005. On the banking side, we remain to be one of the most vibrant banking centres in the world with total assets exceeding HK$7,200 billion as at end 2006. With 181 authorised insurers representing the highest concentration of insurers in Asia, our insurance industry has continued to develop steadily in tandem with economic development with total gross premiums reaching HK$156 billion in 2006, a 13.7% year-on-year increase. Having been in operation for seven years, the Mandatory Provident Fund ("MPF") schemes have continued to expand in size with a total net asset value of HK$240 billion as at end-August 2007.

4. While pursuing market development, we have not lost sight of the need to enhance market quality and strengthen investor protection. The Financial Reporting Council ("FRC") has become fully operational starting from 16 July 2007, assuming responsibility for investigating irregularities committed by auditors or reporting accountants of listed entities. The FRC plays a key role in enhancing the quality of financial reporting in Hong Kong, and will be working closely with other regulators and market players in upkeeping Hong Kong's corporate governance regime. As for the banking sector, Hong Kong started to implement a new capital adequacy regime in line with the international capital adequacy standards known as Basel II on 1 January 2007. The increased attention to risk and incentives for enhanced risk management under the new regime is expected to contribute to greater robustness and stability of the banking system.

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

5. All the above achievements in financial developments would not have been possible if not for the concerted efforts of the Government, the financial regulators and the industry practitioners to foster a favorable environment for the sustained development of the financial services industry and to enhance Hong Kong's role as the financial intermediation platform for the region, Mainland China in particular.

6. Following the publication of the Action Agenda by the Focus Group on Financial Services under the Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong" ("Action Agenda"), we have been actively following up the recommendations in the Action Agenda in collaboration with the financial regulators and the industry. In less than a year, we have pursued and achieved significant progress in over one-third of the 80 recommendations contained in the Action Agenda. A number of the new measures thus promulgated / implemented have substantial and long-term positive impact on strengthening Hong Kong's status as an international financial centre, and developing a mutually-assisting, complementary and interactive relationship with the financial system of the Mainland. Those measures include recent expansion of the investment scope of the Qualified Domestic Institutional Investors ("QDII") Scheme; the issuance of Renminbi ("RMB") bonds in Hong Kong in June 2007; the announcement by the Mainland Authorities in August 2007 of a pilot scheme for Mainland individuals to invest directly in Hong Kong securities; and the relaxation measures under Supplement IV to CEPA that will help Hong Kong banks to expand their operation on the

Mainland and allow Hong Kong insurance agency companies to set up wholly-owned enterprises on the Mainland.

7. Looking ahead, we will continue to work closely with the industry and relevant organizations to implement the other recommendations in the Action Agenda. The policy initiatives explained in the ensuing paragraphs align with the directions of the Action Agenda with a view to consolidating Hong Kong's position as an international financial centre and positioning Hong Kong as the international financial centre of China.

2007-08 Policy Agenda

8. 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) Advancing financial cooperation with the Mainland

9. Under the blueprint of the Action Agenda, we are committed to advancing the financial services cooperation with the Mainland with a view to developing a mutually-assisting, complementary and interactive relationship between the financial systems of the two places. This is to be achieved by pursuing a five-pronged strategy which includes seeking for Hong Kong financial institutions to expand their presence on the Mainland; encouraging Mainland funds, investors and financial

institutions to go overseas through Hong Kong; strengthening the links of the financial markets in Hong Kong and the Mainland; continuing to expand the RMB business in Hong Kong; and strengthening the financial infrastructural links between Hong Kong and the Mainland.

10. Significant progress has been made in the above areas, as highlighted by the financial initiatives mentioned in paragraph 6 above. With respect to strengthening the financial infrastructural links, the Hong Kong Monetary Authority ("HKMA") has enhanced the RMB Real Time Gross Settlement ("RTGS") System in June 2007 to support the expanded RMB business. It is also in discussion with the People's Bank of China for linking Hong Kong's RTGS system with Mainland's foreign currency settlement system to be launched in 2008 to facilitate foreign currency payments between the two financial markets. In the coming year, we will continue to build on the success in fostering a closer financial services relationship with the Mainland by enhancing interaction and cooperation in the development of the capital markets of the two places.

(b) <u>Continuous expansion of RMB business in Hong Kong</u>

11. RMB business in Hong Kong has developed steadily since early 2004, with its scope further expanded in 2005 and 2007. In June 2007, the first RMB bond in Hong Kong was successfully launched, and so far three issues have been completed, raising a total of 10 billion yuan. Hong Kong is now the first and the only place outside the Mainland that possesses a RMB bond market. We will continue to develop RMB business in collaboration with the relevant Mainland authorities in tandem with the pace of financial reform and liberalisation on the Mainland. A further expansion proposal under discussion is to allow

Hong Kong importers to settle import trade from the Mainland in RMB.

(c) Developing Hong Kong's commodities futures market

12. The robust performance of the Mainland economy in recent years has led to increasing demand for risk management in respect of commodity prices, which presents potential for Hong Kong to develop commodity futures. The Hong Kong Exchanges and Clearing Limited ("HKEx") has appointed consultants to study the feasibility of trading commodities derivatives and emissions-related products in Hong Kong and to analyse the potential for successful trading of these products in our market. The Securities and Futures Commission ("SFC") will work with HKEx in studying the feasibility and way forward for the development of Hong Kong's commodities futures market.

(d) Promoting asset management business

13. With the rapid economic growth in the Asia Pacific region, the continual accumulation of savings in the Mainland and further liberalization measures of QDII, the prospects of Hong Kong's asset management industry are promising. The Government and our financial regulators will continue to promote Hong Kong's asset management industry and enhance our position as a major asset management centre in Asia.

(e) Broadening the source of listed companies

14. As part of our efforts to broaden the source of corporations using Hong Kong as a platform for listing, the SFC and HKEx published

a joint policy statement in March this year to facilitate overseas companies seeking a primary listing in Hong Kong. The HKEx has also been stepping up efforts in promoting Hong Kong as a preferred listing venue by organising marketing visits to the Mainland and other jurisdictions including Vietnam, Thailand, Malaysia, Kazakhstan, Russia and South Korea. In the coming year, the HKEx will continue with these promotional efforts to attract the listings of more quality overseas companies in Hong Kong.

(f) <u>Developing the Islamic bond market</u>

15. Islamic financial services and instruments are those that comply with the restrictions and prohibitions imposed by Islamic law, the Shariah. The Islamic financial services industry has grown into a global business in recent years, and is offering increasing opportunities with huge potential for development. To further enhance Hong Kong's position as an international financial centre, it is important for us to tap such new opportunities by establishing and developing a local platform for Islamic finance. Our priority will be on the development of an Islamic bond market.

16. As Islamic financial products are structured in a manner different from conventional bonds, we have engaged the industry and also the financial regulators, such as the HKMA, to consider whether and how the development of an Islamic bond market can be accommodated in our existing taxation, legal and regulatory frameworks. In this regard, the HKMA has set up a working group with the Treasury Markets Association to study relevant issues, with a view to providing recommendations to the Government for launching an Islamic bond

market as soon as possible.

(g) Promoting bond market development

17. 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. Following the refinements to the market-making arrangements and the publication of the league table related to the Exchange Fund Bills and Notes (EFBN) Programme, trading in EFBN has become more active. The benchmark yield curve has been extended to 15 years after the inaugural issue of 15-year EFN in August 2007. In addition, the HKMA is developing an electronic trading platform for EFBNs which is expected to be launched towards the end of this year. In parallel, the SFC has been working to develop a framework proposal for legislative amendments with a view to modernizing the regime for public equity and debt offerings.

(h) Promoting Hong Kong's position as an international financial centre

18. As the global competition among the major financial centres has become more keen, we are mindful of the need to actively promote the strengths and competitiveness of Hong Kong as the international capital formation and investment platform. The Asian Financial Forum which aims to showcase and enhance Hong Kong's prestige as an international financial centre was successfully held on 21 September 2007. The event has attracted over 800 participants from the global financial community in Asia, the US and Europe, and has provided a high-level platform for insightful exchanges on the opportunities,

challenges and strategies of financial development across the region.

19. To promote greater financial services cooperation in the Pan-Pearl River Delta Region ("Pan-PRD") and facilitate our industry in tapping the opportunities, the Financial Services and the Treasury Bureau ("FSTB") led a Hong Kong financial services delegation to attend the Pan-RRD Regional Financial Cooperation Forum in Changsha, Hunan in June 2007. The HKEx also took part at the event to promote Hong Kong as an international platform for raising capital. Looking ahead, FSTB plans to lead financial services delegations to selected cities in the Mainland and in Asia to showcase Hong Kong's position as an international financial centre in general and to promote Hong Kong as a preferred listing venue.

II. Improving Market Quality

(a) Regulatory reform

20. A sound and effective regulatory regime is of paramount importance in maintaining investor confidence and our standing as a pre-eminent financial centre. Over the years, the Government has been making continuous enhancements to our regulatory regime in the light of operational experience, market development and evolving international standards. Our major policy initiatives in this regard are highlighted in the paragraphs below.

i. Legislative exercises

21. We introduced the MPF Schemes (Amendment) Bill 2007

into the Legislative Council in June 2007 to give effect to a number of proposals to enhance the administration and operation of MPF schemes. The Bill is currently being scrutinised by the Bills Committee. We are now working to prepare another bill for introduction in the 2007-08 legislative session which mainly seeks to strengthen enforcement of the MPF system for better protection of scheme members' interests. A major legislative proposal is to increase the penalty against default contributions and non-enrolment of employees in MPF schemes.

22. Moreover, we have reviewed the preparation of the Securities and Futures (Amendment) Bill to give statutory backing to important listing requirements. In view of the market's concern about the content of the statutory listing requirements, we intend to further consult the market on the provisions concerned before introducing an amendment bill into the Legislative Council.

ii. Setting up of an independent Insurance Authority ("IA")

23. We will soon commission a consultancy study to look into the relevant aspects of setting up an independent IA, including its governance structure, organisational framework, funding mechanism and budgetary system. Taking into account the consultant's recommendations, we will prepare proposals on the establishment of an independent IA for consultation with stakeholders.

iii. Rewrite of the Companies Ordinance

24. The Companies Ordinance ("CO") rewrite exercise is generally on track since its commencement in mid-2006. During Phase

I of the exercise, we will review the core company provisions that affect the operation of more than 630,000 live companies in Hong Kong. The Standing Committee on Company Law Reform and four Advisory Groups comprising representatives from relevant professional bodies, major chambers of commerce, and company law academics are expected to complete their study of various policy issues by early 2008. Meanwhile, we are studying the public responses to the public consultation on reforming the accounting and auditing provisions which ended in late June 2007. Another topical public consultation on complex subjects, including the share capital regime, registration of charges, directors' duties, company name registration and court-free merger procedure are planned to be launched in around April 2008. A White Bill will be produced for further public consultation in mid-2009 before the Companies Bill is introduced into Legislative Council by the third quarter of 2010.

iv. Review of the Trustee Ordinance

25. The present Trustee Ordinance ("TO") has not been substantially reviewed since its enactment in 1934. Some of the provisions such as those concerning trustees' powers and duties are considered to be outdated. Other comparable jurisdictions such as the United Kingdom and Singapore have reviewed and amended their equivalent Trustee Acts in recent years. We will review the TO with a view to modernising the provisions and hence strengthening the competitiveness of our trust services industry and enhancing Hong Kong's status as a major international financial centre.

(b) Investor Protection

26. Another key focus of our on-going efforts to improve market quality is enhancing investor protection, which is essential to the stability of our financial markets. The major measures in respect of this area are set out in the ensuing paragraphs.

i. SFC's efforts in investor protection and education

27. The SFC has a dedicated investor education website and issues monthly Dr Wise articles to increase the public's knowledge of topical investment issues. It also regularly organizes seminars and produces TV programmes on investor education. In the past year, the SFC joined efforts with HKEx to step up the promotion of the Investor Participant accounts and Stock Segregated Accounts for better investor protection.

28. Investor education is a long-term undertaking and is crucial in maintaining a stable and healthy financial market. The SFC will continue to implement its proactive investor education initiatives to raise investors' awareness of their rights and the benefits and risks of investing. SFC is also exploring ways of utilizing part of its levy income to further enhance investor protection and education. The SFC will also keep in view the regulatory framework and supervision of intermediaries to maintain market integrity.

ii. Measures to promote transparency of and competition in MPF fees and charges

29. Following the publication of the Code on Disclosure for MPF Investment Funds ("the Code") in 2004, the Mandatory Provident Fund Schemes Authority ("MPFA") has been undertaking continuous efforts to promote transparency of fees and charges. Two comparison tools, namely the Fund Expense Ratio ("FER) and the On-going Cost Illustration ("OCI"), have been introduced to facilitate understanding and comparison of fees and charges by scheme members for more informed investment decision-making. A Fee Comparative Platform was launched on MPFA's website in July this year to provide information on the highest, average and lowest FER by fund types. MPFA will upgrade the Platform to include detailed information about fees and charges of individual funds and introduce new disclosure requirements in the annual benefit statements once the relevant legislative proposals contained in the MPF Schemes (Amendment) Bill 2007 have been approved by the Legislative Council.

30. In addition, the MPFA has been in discussion with the industry and relevant stakeholders on possible ways to lower fees and charges, including the development of a proposal to increase employees' control over their MPF investments by allowing them to transfer accrued benefits derived from employee mandatory contributions to an MPF scheme of their own choice. MPFA has just sent to Government the framework proposal for legislative amendments in this regard[Note]. We are consulting the Department of Justice on the proposed legislative

[Note] The proposal has yet to be approved by the MPFA Management Board.

amendments and will follow up with the MPFA on the details and rationale of the proposal as a matter of priority.

31. The MPFA also puts great emphasis on educating scheme members about the importance of fees and charges in investment decisions. It is now conducting Phase Two of the MPF Investment Education Campaign to enhance scheme members' understanding of the characteristics, risk and return profile of various types of MPF funds, with a view to facilitating informed investment choices and better management of MPF savings.

Fiscal Policy

Fiscal Targets

32. In the 2007 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 make proper use of fiscal surplus, if any, after taking account of Hong Kong's long-term interest. We will also review our tax base and continue to implement the asset sale and securitisation programme.

33. Against the backdrop of a solid economic growth, we forecast that the government accounts will continue to be in surplus in 2007-08 and over the medium term. We will continue to maintain fiscal balance, manage our public finances prudently and keep expenditure within the revenue limits. On the other hand, we will make proper use

of fiscal surplus to respond to the calls of the community for increasing public services and reducing taxes, and to meet the future challenges including an ageing population and rising medical cost.

Consultation on Reform of Tax System

34. The Administration issued a Consultation Document on Tax Reform in July 2006. During the consultation, the public have generally gained a better understanding of the problem of our narrow tax base and agreed that the problem should be addressed. While the community is generally against the introduction of a Goods and Services Tax, there have not been any clear inclinations or mainstream views on which alternative options should be adopted to broaden our tax base.

35. The Government will continue to study options for broadening the tax base and take into full account the views collected in this consultation exercise. We will consult the public further on those options which are more practical at a suitable time in the future.

Reducing the Standard Rate of Salaries Tax and Corporate Profits Tax Rate

36. Our economic situation has greatly improved in the past few years. The 2007-08 revenue figures available so far indicate that the receipt from some revenue sources would be higher than estimated. To address the strong calls from different sectors of the community to lessen their tax burden, the Government will reduce the standard rate of salaries tax to 15% and corporate profits tax rate by one percentage point to 16.5% in 2008-09. The Government will receive about $5 billion less

each year arising from these two measures. If our economy continues to grow and financial conditions allow, we will explore the possibility of proposing further cut in corporate profits tax rate in future financial years.

Rates Exemption

37. The Financial Secretary announced in February 2007 rates exemption for the first two quarters of the current financial year. The Chief Executive further announced in his Policy Address that rates exemption will be offered for the last quarter, subject to a ceiling of $5,000 per quarter for each rateable tenement. It is estimated that the exemption will cost the Government about $2.6 billion. Nearly 99% of domestic properties and 86% of non-domestic properties will be subject to no rates in the last quarter. Together with the rates exemption offered for the first two quarters, the Government will receive $7.8 billion less this financial year.

Financial Services and the Treasury Bureau
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