

**HKMA's Input for Response to Item 1 of requests by Subcommittee
to Study Issues Arising from Lehman Brothers-related Minibonds
and Structured Financial Products
(as requested in letter of 22 December 2008)**

1. *"In his 2002-2003 Budget Speech, the Financial Secretary (FS) stated, among other things, that the Government would work with HKMA, SFC, the Hong Kong Exchanges and Clearing Limited and the financial services sector to attract more financial product issuers to Hong Kong. Please give an account of the initiatives taken and the new financial products offered to investors following such initiatives."*

The Hong Kong Monetary Authority (HKMA) conducted a comprehensive review of Hong Kong's financial infrastructure in the first half of 2005, with a view to establishing a coherent development strategy and implementation plan for building a safe and efficient financial infrastructure based on a multi-currency, multi-dimensional platform. The review and subsequent analysis identified the following initiatives, among others, which are conducive to the development of a more diversified range of financial products in Hong Kong.

- (a) To cater for the settlement needs of Renminbi (RMB) business in Hong Kong, the Renminbi Settlement System (RSS) was launched in March 2006. To support the issuance and trading of RMB bonds in Hong Kong, the RSS was further upgraded into a RMB real time gross settlement (RTGS) system in June 2007. The clearing and settlement facilities at the Central Moneymarkets Unit (CMU) were also expanded to cover RMB debt securities.

Retail investors can use RMB cheques or bank transfers to settle payments relating to the subscription and trading of RMB bonds. Since July 2007, seven Mainland banks have issued RMB bonds totaling RMB22 billion yuan in Hong Kong. The infrastructure helps expand the multi-currency financial infrastructure and intermediation platform in Hong Kong.

- (b) To facilitate the development of Islamic financial products in Hong Kong, the HKMA implemented several initiatives in 2008 to maximize the readiness of the financial infrastructure to process related transactions. These initiatives include (i) activation of a new payment code specifically for Islamic-related payments; (ii) provision of additional settlement accounts in the US dollar and euro

RTGS systems for segregation of Islamic-related funds from other funds; and (iii) CMU enhancements to cater for custodian, clearing and settlement services for Islamic bonds in Hong Kong.

- (c) To shorten the turn-around time of subscription monies during initial public offerings, a re-engineered electronic initial public offering (e-IPO) refund process was launched in December 2008 to allow e-IPO subscribers to receive their refunds on the refund day instead of the day after. The enhanced efficiency of the financial infrastructure further increased the attractiveness of Hong Kong as a fund-raising centre.
- (d) To improve access by retail investors to information on bond products available on the market and their indicative prices, the CMU Bond Price Bulletin was launched on 9 January 2006. Through enhancing product awareness and improving price transparency, the Bulletin helps promote retail investors' participation in the secondary market in Hong Kong. At the end of 2008, indicative prices of about 161 bonds quoted by 12 financial institutions were available on the Bulletin.
- (e) To help improve the price transparency among market players and streamline the trading process, an electronic trading platform for the trading of bonds in Hong Kong, primarily for Exchange Fund bills and notes, was launched in December 2007. The platform will be linked to the CMU to facilitate straight-through processing.

The HKMA is working closely with the Treasury Markets Association (TMA) on exploring the potential for developing Islamic finance in Hong Kong, in particular an Islamic bond market, as a natural extension of Hong Kong's role as an international financial centre. The TMA formed a Working Group on Development of Islamic Finance in August 2007, aiming at assessing the market potential, identifying existing hurdles to the development of an Islamic bond market in Hong Kong, and making recommendations on any changes that might be needed in the taxation, legal and regulatory framework. The working group considered that Hong Kong's existing legal and regulatory infrastructure can readily support the development of an Islamic bond market. However, suitable changes or clarifications are needed to the tax laws in Hong Kong to provide a level playing field for the issuance of Islamic bonds. These include the treatments of stamp duties and periodic payments arising from such bonds. The TMA working group report has been submitted to the Financial Services and Treasury Bureau for consideration. Considerable

progress was also made in forging partnership and business links with other financial centres in this respect. The HKMA signed a Memorandum of Understanding with the Dubai International Financial Centre Authority in May 2008 to explore co-operation in the development of Islamic finance products and financial infrastructure.

It is also worth noting that Hong Kong is engaged in regional bond market development initiatives. Working with other central banks in East Asia and Pacific, the HKMA led the successful launch of the Asian Bond Fund 2 (ABF2) Initiative, contributing to the development of bond markets in Hong Kong and the region by improving access to regional bond market and enhancing market infrastructure. Under the ABF2 Initiative, ABF Hong Kong Bond Index Fund (HKSE stock code 02819) and Pan Asia Bond Index Fund (PAIF) (HKSE stock code 02821) were listed on the Hong Kong Stock Exchange in June and July of 2005 respectively. The PAIF is a listed open-ended fund which targets regional and international investors who want to invest in the eight Asian bond markets through a single product. The ABF Hong Kong Bond Index Fund) was listed as exchange traded funds (ETFs), and it provides local retail investors a convenient way to invest in a portfolio of local bonds and, at the same time, to give regional and international investors the flexibility to invest in the bond market in Hong Kong.

Apart from providing a low-cost and convenient way to invest in Asian bonds, the ABF2 Initiative has acted as a catalyst for regulatory and tax reforms and improvements to market infrastructure. For example, the listing of ABF2 funds as ETFs has strengthened the linkage between bonds and equities clearing systems in Hong Kong and in other markets. Harmonisation of documentation has helped promote the adoption of best international practices across Asian markets, while allowing for regional diversity. A set of credible, representative and transparent bond indices was introduced under the ABF2 Initiative, which can be adopted and customised by private sector investors as benchmarks for other fixed income products.