

**Bills Committee on Securities and Futures and Companies Legislation
(Structured Products Amendment) Bill 2010**

**Regulation of currency-linked, interest rate-linked
and currency and interest rate-linked instruments**

Purpose

This paper briefs Members on the proposed arrangement with regard to the regulation of currency-linked, interest rate-linked and currency and interest rate-linked instruments (ILCL instruments) and provides information on relevant arrangements in other major markets.

Background

2. ILCL instruments will be caught by the wide definition of structured products under the Securities and Futures and Companies Legislation (Structured Products Amendment) Bill 2010 (the Bill). In order not to affect the existing arrangement and inadvertently catch ILCL instruments issued by Authorized Institutions (AIs), we propose that the Bill should exempt ILCL instruments issued by AIs from the Securities and Futures Commission (SFC)'s authorization requirement. At the meeting of the Bills Committee on 26 October 2010, Members requested the Administration to re-consider critically the above proposed arrangement and provide information on relevant arrangements in comparable jurisdictions.

Practices in other major markets

3. ILCL instruments are essentially banking products that typically do not fall under the securities and futures regulatory regime. They are not subject to the Securities and Futures Ordinance (SFO). Such arrangements are in line with practices in other major markets –

- (a) In the United Kingdom, currency-linked and interest rate-linked deposits are not subject to authorization of the Financial Services Authority.
- (b) In the United States, “structured certificates of deposit” are generally not “securities” and thus the offering documents are not subject to the rules of the Securities and Exchange Commission (e.g. prospectus filing requirements).
- (c) In Australia, the Australian Securities and Investment Commission does not authorize “financial products” and heavy reliance is put on disclosure based on a “post-vetting” philosophy and the intermediaries’ conduct, e.g. investment advice at point of sale.
- (d) In Singapore, the offering documents of structured deposits do not need authorisation or approval from the Monetary Authority of Singapore.

ILCL instruments vs structured products

4. ILCL instruments are products of the foreign exchange or treasury desks of banks. Issuers of these products are typically AIs (e.g. banks and restricted licence banks) which can participate in the inter-bank market and take deposit from the public. ILCL instruments are banking products and investors are exposed to interest rate risk, foreign currency exchange rate risk and credit risk of the issuing AI only (without other counterparty). They are similar to ordinary banking deposit products and different from other structured investment products such as equity-linked instruments.

5. During the first half of 2010, retail banks in Hong Kong sold around \$323 billion worth of currency-linked instruments and around \$2 billion worth of interest rate-linked instruments to their retail customers. As to currency and interest rate-linked instruments, they are not common for

retail customers in Hong Kong. Please see Annex for the nature of the common types of ILCL instruments.

6. The key requirements for structured products that fall under the regulatory remit of the SFO (e.g. eligibility of issuers / guarantors, criteria for reference assets, criteria for collateral) are irrelevant to ILCL instruments because: (i) the issuers are AIs (i.e. the direct counterparty to the ILCL instrument is an authorized institution with substantive assets), (ii) the “reference assets” are currencies or interest rates, which are very different from shares or bonds, and (iii) as the direct counterparty to the ILCL instrument is an AI with substantive assets, there is no collateral. In fact, the SFO regulatory framework is designed primarily for regulating the securities and futures market. It is not intended for the regulation of banking activities.

7. The current regulatory regime operated by the Hong Kong Monetary Authority (HKMA) is proper and effective taking into account the nature of ILCL instruments. In particular, AIs and banking business are subject to the HKMA’s prudential supervision which regulates the safety, soundness and risk management systems of AIs, and through these, an AI’s obligation to its customers. The HKMA also exercises supervision over AIs’ sale of ILCL instruments through its day-to-day supervision. The sale conduct requirements are similar to those for other investment products.

8. In view of the above and the practices in other major markets, we consider that the interest of investors in ILCL instruments is safeguarded properly under HKMA’s current regulatory regime. It is not necessary to impose authorization requirements on ILCL instruments issued by AIs and their offering documents. Subjecting ILCL instruments issued by AIs to authorization would create unnecessary compliance burden on AIs and affect adversely the competitiveness of Hong Kong as an international financial centre, since ILCL instruments are products of the foreign exchange or treasury desks of banks which are part and parcel of the global currency market.

9. As regards Members' concerns about inconsistency arising from the arrangement for HKMA to supervise the sale of ILCL instruments issued by an AI in Hong Kong, and SFC to regulate any such products issued by non-AIs, SFC has advised that it has not received any applications from non-AIs to offer ILCL instruments to the public. In fact, in light of the nature of ILCL instruments as explained above, it is hard to foresee that any non-AI would have the basis or business case as a bank to publicly offer such instruments. Subject to Members' views, we are prepared to consider prohibiting public offers of ILCL instruments by non-AIs altogether through this Amendment Bill. Both HKMA and SFC advise that to do so would not compromise choices to investors or undermine our market competitiveness.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
Securities and Futures Commission
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Nature of the Common Types of ILCL Instruments

Currency-linked instruments

- Currency-linked deposits (CLDs) are a common type of currency-linked instruments offered by retail banks to retail customers in Hong Kong. Both capital-protected CLDs and non-capital-protected CLDs are commonly offered to retail customers.
- For a typical capital-protected CLD, the customer chooses the Deposit Currency (i.e. the currency in which the initial deposit is denominated) and the Linked Currency (i.e. the reference currency). Upon maturity, the customer receives the full principal plus an interest in the Deposit Currency, while the amount of the interest depends on the exchange rate between the Deposit Currency and the Linked Currency at the fixing date.
- For a typical non-capital-protected CLD, the customer chooses the Deposit Currency and the Linked Currency. Upon maturity, the customer receives the full principal plus an interest in the depreciated currency. If the Linked Currency depreciates, the customer may suffer a loss of capital and the amount of loss depends on the extent of depreciation.
- The key risks for CLDs include possible adverse performance of the foreign exchange rate and the credit risk of the issuing bank. CLDs are not protected under the Deposit Protection Scheme of Hong Kong. Investors should be willing, and possess the financial capability, to have the principal amount locked up in the CLDs throughout the investment period.

Interest rate-linked instruments

- Interest rate-linked deposits (IRLDs) are a common type of interest rate-linked instruments offered by retail banks to retail customers in Hong Kong. A typical type of IRLDs for retail customers is capital-protected IRLDs. The customer chooses the reference interest index (e.g. USD 6-month LIBOR). Depending on the specific structure of the IRLD, during the investment period the customer may receive regular interest income, the amount of which depends on the performance of the reference interest index. Upon maturity, the customer receives the full principal plus an interest, while the amount of the interest depends on the performance of the reference interest index.
- The key risks for IRLDs include possible adverse performance of the reference interest index and the credit risk of the issuing bank. IRLDs are not protected under the Deposit Protection Scheme of Hong Kong. Investors should be willing, and possess the financial capability, to have the principal amount locked up in the IRLDs throughout the investment period.

Currency and interest rate-linked instruments

- Currency and interest rate-linked instruments are not common for retail customers in Hong Kong.