

## TOPIC 2 - OVERVIEW

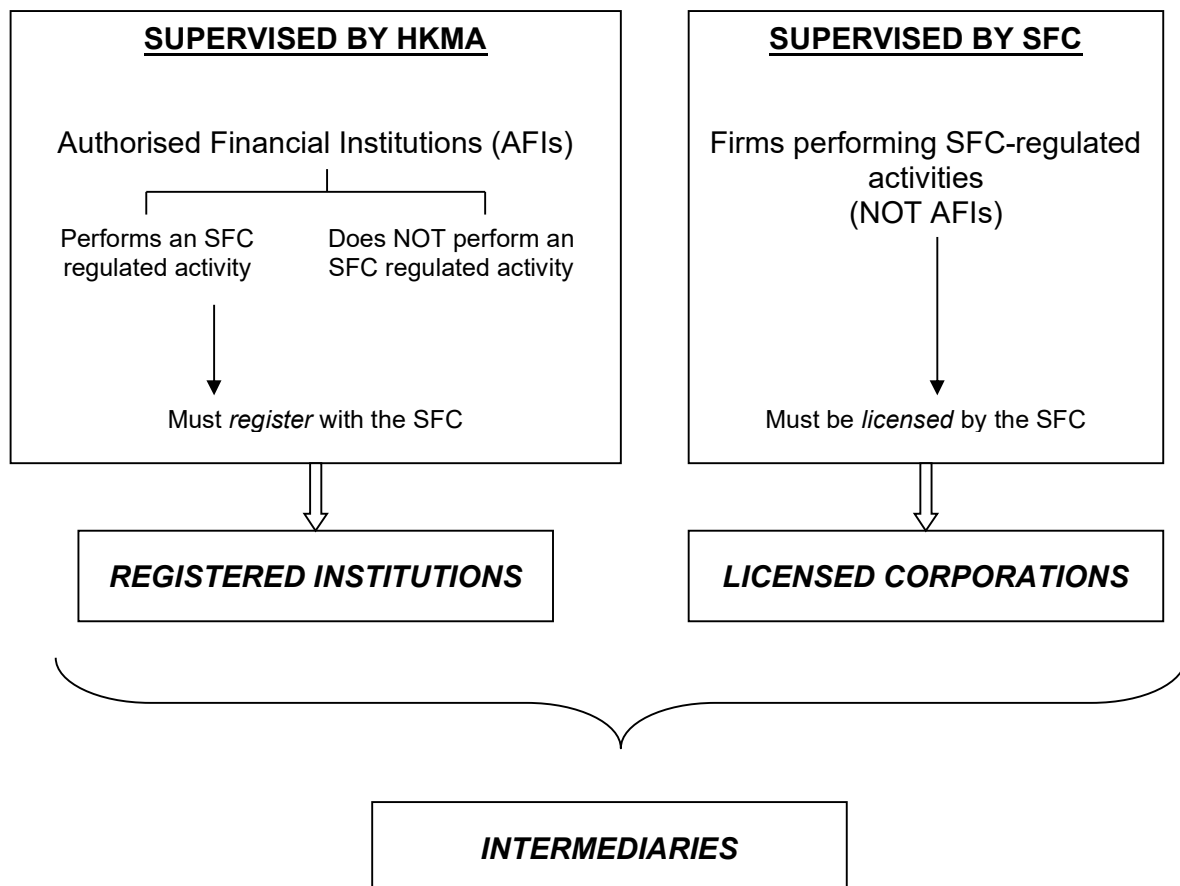
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# 1. ROLES OF THE GOVERNMENT AND REGULATORS

## 1.1 Hong Kong Monetary Authority

- The HKMA acts as Hong Kong's central bank and is directly accountable to the Financial Secretary
- The HKMA is required to:
  - Maintain currency stability
  - Ensure the safety and stability of the banking system
  - Promote the efficiency, integrity and development of the financial system
  - Manage the Exchange Fund
  - Manage Hong Kong's monetary policy
  - Supervise the banking system

### Supervision of Intermediaries – HKMA or SFC?



- Further details of the HKMA's activities follow:

### Currency Board System and the Exchange Fund

- The Financial Secretary sets monetary policy objectives, while the HKMA is responsible for achieving those objectives
- Currently, **Hong Kong's monetary policy objective is currency stability**, defined as:

*A stable external exchange value of the currency against the US dollar, at around HKD7.8 to USD1, through monetary structure characterized by Currency Board arrangements, requiring the Hong Kong dollar Monetary Base to be at least 100 per cent backed, and changes in it to be 100 per cent matched, by corresponding changes in the US dollar reserves held in the Exchange Fund at the fixed exchange rate of HKD7.8 to USD1*

- Exchange rate stability is maintained via a **market-induced interest rate adjustment mechanism**
- The linked exchange rate means that **Hong Kong interest rates need to follow US interest rates** to maintain the peg, thereby giving the HKMA little scope to influence interest rates

### Central Bank and Liquidity Management

- The HKMA acts as the **lender of last resort** and, therefore, can be considered an intermediary in the financial system
- The HKMA provides liquidity to banks (*referred to as AIs in the Banking Ordinance and AFIs in the Securities and Futures Ordinance*)
- There are **three tiers of AIs** in Hong Kong:
  - *Licensed banks*: min paid-up capital of HK\$300 million; can take all types of deposits without restriction
  - *Restricted license banks*: min paid-up capital of HK\$100 million; can only take time deposits of HKD500,000 or more without restriction on term to maturity
  - *Deposit taking companies*: min paid-up capital of HK\$25 million; can only take time deposits of HKD100,000 or more with original term to maturity not less than three months
- HKMA operates a **discount window** whereby fully licensed banks and restricted licensed banks can obtain **overnight liquidity** to cover shortfalls by entering into **repurchase agreements (repos)**
- Under repo arrangements, banks can sell high quality assets, such as **Exchange Fund Notes (EFNs)**, to the HKMA, promising to buy them back at an agreed price at a future date
- The HKMA's provision of short-term liquidity is **vital to the stability and credibility of the financial system**

### Payment Systems

- HKMA oversees the banking sector payment systems
- The **Real Time Gross Settlement System** (RTGS) settles all gross positions of banks in the financial system. Both licensed and restricted license banks are included in the RTGS
- AIs maintain settlement accounts with the HKMA and payment obligations are cleared on a continuous, deal by deal basis
- HKMA operates the **Central Moneymarkets Unit** (CMU) which is the electronic clearing and settlement system for Exchange Fund Bills and Notes and other debt securities
- An **interface between the RTGS and the CMU** allows repurchase agreements to be electronically transacted

### Exchange Fund

- Established by the Currency Ordinance of 1935 to hold assets backing the note issue in Hong Kong
- Managed by the HKMA to preserve capital, provide liquidity for financial and currency stability and generate an adequate long-term return
- The fund is key to the HKMA maintaining the HKD/USD exchange rate under the linked exchange rate system
- The government's fiscal reserves are included in the Exchange Fund
- Fiscal reserves are maintained to cover seasonal and cyclical deficits

### Banking Supervision

- The HKMA has implemented a risk-based supervisory approach under the Banking Ordinance
- Banking supervisory standards put forward by the Basel Committee on Banking Supervision are followed by the HKMA to ensure Hong Kong maintains its reputation as a world-class financial centre

## 1.2 Securities and Futures Commission (SFC)

- The SFC was established in 1989, with the role to administer the laws governing the securities and futures markets in Hong Kong, and to facilitate and encourage the development of these markets
- The SFC's objectives, as stated in the Securities and Future Ordinance, are to:
  - Maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the industry;
  - Promote understanding by the public of financial services, including the operation and functioning of the industry;
  - Provide protection to the investing public;
  - Minimize crime and misconduct in the industry;
  - Reduce systemic risks in the industry; and
  - Assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the industry

- To achieve the above objectives, the SFC operates through the following functional units:
  - Corporate Finance
  - Investment Products
  - Enforcement
  - Supervision of Markets
  - Legal Services
  - Intermediaries
  - Corporate Affairs

### **1.3 Mandatory Provident Fund Schemes Authority (MPFA)**

- MPFA supervises all Mandatory Provident Fund (MPF) schemes
- Introduced by the Hong Kong government to provide retirement protection for the working population, the MPF system was launched in December 2000
- As of December 2011, MPF schemes accounted for approximately 71% of all Hong Kong retirement plans
- Main functions of MPFA include:
  - Registering MPF schemes and approving trustees
  - Regulating activities of approved trustees to ensure prudent scheme administration
  - Making rules/guidelines for mandatory contributions and related administration
  - Proposing relevant law reforms

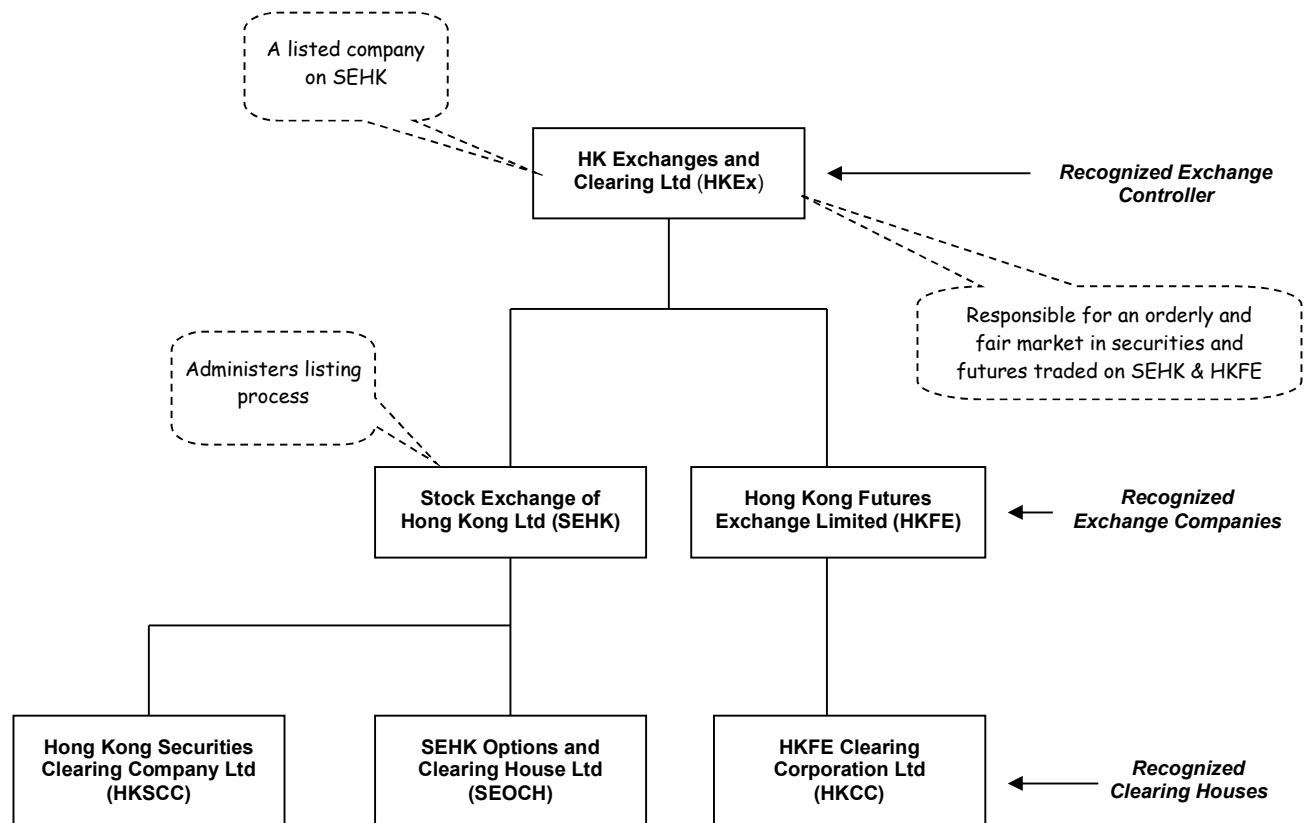
### **1.4 The Hong Kong Mortgage Corporation Limited (HKMC)**

- Financial intermediary established to encourage development of secondary mortgage market
- Illiquid individual mortgages are combined to create more liquid securities, known as mortgage-backed securities (covered in Topic 4)
- HKMC operates a Mortgage Insurance Programme for mortgage providers (banks) to help promote Hong Kong home ownership

### **1.5 Insurance Authority (IA)**

- IA regulates and supervises the insurance industry
- Ensures that the interests of Hong Kong policy holders are protected
- Promotes general stability of the insurance industry

## 1.6 Exchanges and Self-Regulatory Bodies



- The SFC supervises and monitors the activities of all HKEx companies
- All exchange companies and clearing houses are 100% owned subsidiaries of HKEx

### The Chinese Gold & Silver Exchange Society

- Runs a market now focused on bullion trading in tael gold and kilo gold
- The Society is NOT directly regulated
- Promotes paper gold schemes, which are classified as Collective Investment Schemes, which are, in turn, regulated by the SFC

### Industry Associations and Professional Bodies

- The following industry associations and professional bodies encourage their members to maintain professional standards of conduct:
  - HK Securities and Investment Institute
  - HK Investment Funds Association
  - HK Association of Banks
  - Alternative Investment Management Association
  - Institute of Financial Planners of HK
  - HK Society of Financial Analysts
  - HK Capital Markets Association

## 2. PARTICIPANTS IN THE HONG KONG FINANCIAL SYSTEM

### 2.1 Hong Kong Monetary Authority

- Covered in the previous section

### 2.2 Authorized Institutions

- As at August 2019, the three tiers of AIs consisted of:
  - 160 licensed banks
  - 18 restricted license banks
  - 15 deposit taking companies
  - 135 of the above were foreign owned

#### Licensed Banks

- Need to have paid-up capital of HKD300 million. Banking services provided include:
  - Current and savings accounts
  - Time deposits
  - Loans and overdrafts
  - Syndicated lending
  - Leasing
  - Mortgages
  - Trade finance
  - Securities and commodities dealing
  - Securities margin financing
  - Leveraged foreign exchange trading
  - Money market operations
  - Investment products for private banking clients (eg equity-linked notes)

#### Restricted Licensed Banks

- Need to have paid-up capital of HKD100 million, generally branches or subsidiaries of foreign banks and authorized to accept minimum deposits of HKD500,000. Activities, which are mainly investment banking, include:
  - Securities and futures dealing
  - Securities margin financing
  - Leveraged foreign exchange trading
  - Syndicated lending/corporate financing
  - Money and debt market trading

### **Deposit-Taking Companies**

- Need to have paid-up capital of HKD25 million and usually wholly owned by licensed banks. Can take minimum deposits of HKD100,000. Specialized services provided include:
  - Mortgage and commercial loans
  - Trade finance
  - Credit cards
  - Insurance
  - Trustee services
  - Investment and treasury operations

## **2.3 Fund Houses**

- Fund houses consist of fund managers who invest funds on behalf of investors
- Majority of Hong Kong fund houses are foreign financial institutions
- Products offered in Hong Kong include:
  - Unit trusts and mutual funds
  - Pension funds
  - Insurance policies
  - MPF schemes
  - Hedge funds (not for retail investors)

## **2.4 Brokerage Houses**

- Consists of dealers and traders buying and selling securities and futures
- Also includes securities margin financiers and investment advisers
- Products traded include equities, bonds, derivatives, and foreign exchange

## **2.5 Investment Banks**

- Middlemen acting between companies issuing securities to raise funds and investors who wish to invest in the companies
- Income derived from fee-based activities and not from the spread between lending and borrowing
- They underwrite and distribute securities, devising innovative finance packages
- Skills rely on market knowledge and expertise



### 3. FACTORS AFFECTING THE HONG KONG MARKET

#### 3.1 Government Objective and Policies

- The government's economic policies are designed to maintain Hong Kong's position as a leading global financial centre
- **Government policies** include:
  - *Monetary policy*: maintaining stability of HKD and ensuring an efficient, fair and transparent finance and banking system
  - *Fiscal policy*: managing government finances, ensuring Hong Kong's economic prosperity and encouraging foreign investment
  - *Industrial and structural policy*: stimulating economic activity while keeping government intervention to a minimum

##### Monetary Policy

- Involves government actions to influence the supply and cost of money
- **Tight** monetary policy usually involves higher interest rates reducing the supply of money, whereas **loose** monetary policy is the reverse
- Usually carried out by a separate institution – in Hong Kong it is the HKMA
- Hong Kong's monetary policy is limited due to the linked exchange rate system
- Two approaches to **implementing monetary policy**:
  - *Direct approach*: controlling interest rates; limiting lending; and establishing reserve deposit requirements – used in developing economies
  - *Market-based approach*: use of open market operations (eg quantitative easing) – used in well-developed, free-enterprise economies

##### Fiscal Policy

- Deals with taxation and government expenditure
- **Expansionary** fiscal policy is designed to energize a sluggish economy through reduced taxation and/or increased government spending thereby increasing household and business spending
- **Contractionary** fiscal policy is designed to dampen an overheating economy through increased taxation and/or reduced government spending thereby reducing household and business spending

##### Government Budget

- The main vehicle for implementing fiscal policy is the government budget
- In Hong Kong:
  - The Financial Secretary presents a budget every March
  - Government policy states that expenditure growth should not exceed the growth of the economy

- Article 107 of the Basic Law states:  
*The Hong Kong Special Administrative Region shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product*
- During 2000 to 2004, Hong Kong experienced four consecutive years of budget deficit due to 1997 Asian financial crisis and SARS in 2003
- During 2005 to 2019, Hong Kong maintained a budget surplus each year

### 3.2 Mainland China as a Major Trading and Investment Partner

- The PRC is a major investment partner with Hong Kong
- PRC companies raise both debt and equity capital in Hong Kong
- Hong Kong outsources manufacturing to PRC while providing services such as finance, insurance and accounting
- PRC's entry to the World Trade Organization in 2001 was a positive event for Hong Kong, significantly increasing its global trade and investment opportunities
- Trade and investment cooperation between PRC and Hong Kong took a positive step with the signing of the Closer Economic Partnership Agreement (CEPA) in 2003
- In December 2018, under the CEPA framework, a new agreement on the trade of goods was signed between Mainland China and Hong Kong

### 3.3 The US Economy

- As a major trading and investment partner, the US economy has a significant impact on the Hong Kong economy
- US direct investment to Hong Kong is predominantly concentrated in the finance and insurance industries
- As previously noted, the HK dollar is directly linked to the US dollar, with any changes in US interest rates being directly reflected in changes to Hong Kong interest rates

### 3.4 Other Global and Regional Influences

- Hong Kong financial markets are also influenced by the stability of regional economies and currencies, as well as free trade versus trade barriers
- As happened during the Asian financial crisis of 1997-98, when international fund managers decide to reduce their exposure to Asian securities, Hong Kong securities are often sold in large numbers

### 3.5 Regulatory, Political and Social Trends

- The Hong Kong government ensures that regulatory practices and procedures are kept in line with **world best practices**, taking its lead from supranational supervisory organizations such as the International Monetary Fund (**IMF**) and the Bank for International Settlements (**BIS**)

- Domestic policy, such as the introduction of MPF schemes, has a direct effect on local financial markets
- A more financially and technologically literate Hong Kong investor base has developed as people live longer and become more active in retirement

### **3.6 The Impact of Technology**

- Most Hong Kong AIs offer their services online, including transaction review, fund transfer and bill payment
- Share subscriptions for initial public offering are performed electronically
- Securities and futures trading and settlement on HKEx are fully automated
- Technology helps develop efficient, fair and transparent markets, however this has led to risks of globalization. Such risks are considered in Topic 6
- Technology has had a major impact on Hong Kong's financial markets and will continue to do so in the future
- In the late 2010s, both the SFC and HKMA adopted their sandbox approach to support Fintech (financial technology) development of financial institutions and certain Fintech start-ups
- In 2016 and 2019 respectively, the HKMA began issuing stored value facility licenses for digital payment services providers and virtual bank licenses