

Hong Kong Management Association
“Promoting a Competitive and Vibrant Economy”
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Enhancing Hong Kong as an International Financial Centre

by

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Professor Edward Chen,
Distinguished Guests,
Ladies and Gentlemen,

1. I am honoured to be invited to this seminar to discuss a subject of such crucial importance to Hong Kong. Hong Kong's future is closely tied to its future as a service economy, with 84% of its GDP being generated by the service sector. One of the highest value added sectors within the service sector is the financial sector. Enhancing Hong Kong's capability as an international financial centre will therefore enhance Hong Kong's future growth and prosperity.
2. Why should a market regulator talk about the competitiveness of the financial system? The Securities and Futures Commission Ordinance sets out the development of financial markets as one of the objectives of the SFC. However, let me make clear right at the outset that the development of markets is the job of the front-line institutions, such as the Stock Exchange of Hong Kong and the Hong Kong Futures Exchange. I see the role of the SFC as a market regulator to ensure that the regulatory framework *facilitates* the development of the market.
3. However, it is quite clear in my mind that in the global markets of today, markets will drift to those financial centres with the fairest regulatory framework, lowest transaction costs, high transparency and robust financial infrastructure. Financial regulators have some influence on the question of the regulatory framework, the degree of market transparency and the systemic risks of markets. In this world where there is also increasing regulatory arbitrage, we need to be concerned about the deadweight costs of regulation and market intermediation.

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4. In recent years, a number of useful studies have been made on the impact of the regulatory framework on the development of the financial system. Australia, for example, launched the Wallis Inquiry to examine this specific question. The Inquiry concluded that the financial landscape to the year 2010² comprises four key elements:-
- *Greater competition and use of technology* – changing consumer behaviour and technology driven innovation will erode old franchises, create new products and change the structure, costs and operations of the present financial structure.
 - *Greater globalization of markets* – deregulation, market reforms and improved communications will create global markets, intensify competition and complicate regulation.
 - *Conglomeration and market widening* – product and institutional boundaries will be blurred as more complex conglomerates straddling different products and markets invade the turf of banks, insurance companies and securities houses.
 - *Shift from intermediaries to markets* – derivative markets are evolving to meet the diverse financial services of a wider range of users. Markets are helping users to manage risks more efficiently.
5. Based upon this prognosis,, the Wallis Report recommended that Australia should seek to:-
- create a *flexible regulatory structure* which will be more responsive to the forces for change operating on the financial system;
 - clarify regulatory goals;
 - *increase the accountability* of the agencies charged with meeting those goals;
 - ensure that the regulation of similar financial products is more *consistent* and *promote competition* by improving comparability;
 - introduce *greater competitive neutrality* across the financial system;
 - establish more *contestable, efficient and fair financial markets* resulting in reduced costs to consumers;
 - provide more effective regulation for financial conglomerates which will also *facilitate competition and efficiency*; and
 - facilitate the *international competitiveness* of the Australian financial system.
6. These are some of the questions that we should ask when we seek to enhance Hong Kong's position as an international financial centre.

² The Australian Financial System Inquiry, 1997 (Wallis Report) – Chapter 4, PP 139-140

Hong Kong as an International Financial Centre

7. Technology and globalization means that higher efficiency and faster telecommunications enable markets to cut out the intermediary by connecting the consumer directly with the producer. Technology makes the past obsolete, destroying old franchises and creating new value. What Hong Kong can do today, someone with access to Internet can do tomorrow with the higher speed and at lower costs. Thus, despite her past and present success, the future of Hong Kong's role as a leading international financial centre is by no means assured. In short, we cannot be complacent.
8. Of course, Hong Kong's achievements as an international financial centre are impressive (**see Annex**). Hong Kong is home to Asia's third largest stock market and an active rapidly growing debt market.
9. Hong Kong's forex and derivatives market is the eighth largest in the world. With more than 75% of trading between foreign currencies other than the Hong Kong dollar, and about 70% of turnover done with forex dealers abroad, our forex market is clearly outward-looking.
10. As an international banking centre, Hong Kong is the sixth largest in terms of external assets of banks. The strength of this market has also created a critical mass of the world's top financial services firms. About 500 banking institutions from over 40 countries, including about 80 of the world's 100 largest, are located here. The external liabilities and claims accounted for an average of 48% and 53% respectively of the total liabilities and assets of all authorized institutions.
11. The advantages of Hong Kong as an international financial centre, centering on its strategic geographical position as a major hub and gateway to China are many, as listed by Professor Y. C. Jao (1997):-

Internal Factors - Political and Social Stability
Economic Freedom
Sound Legal System and the Rule of Law
Good and Responsive Government
Unrivalled Record of National Treatment
Favourable Tax Regime
Low Regulatory Costs
Efficient and Modern Infrastructure
Freedom of Information
A Skilled Population
Use of English

External Factors - Location and Time Zone Advantages
The China Factor
Robust Economic Growth in the Asia-Pacific Region
Globalization of Banking and Finance

12. These factors are necessary but not sufficient conditions of success, as we learnt from the Asian financial turmoil. It is easy to be an international financial centre when the going is good. To maintain this status in the face of increasing competition and high costs is another matter, a problem we cannot under-estimate.

The Competitive Landscape

13. Whilst most commentators would agree that Hong Kong has many competitive strengths, almost all would agree that high costs are a major factor of operating in Hong Kong. Today, the major competitive financial centres in the Asia Pacific region from Sydney to Tokyo have rents and staff costs that are lower than that in Hong Kong. Singapore has recently begun to throw down the gauntlet in offering a MSCI Hong Kong futures index that directly competes with our Hang Seng Index futures. Bangkok, Kuala Lumpur and Shanghai can offer significantly cheaper labour with strong English skills. A growing volume of Hong Kong equities is now being traded in London and New York.
14. How should we respond? The answer is that we have a lot of work ahead of us.
15. I think we should recognize that in the service economy, it is not a question of whether we will be cheap, but whether we offer value for money. As long as Hong Kong is able to offer high quality service with good value, it will be able to maintain its competitive standing.

Competitive Enhancement

16. A major role of an international financial centre is to enable investors to manage their risks and efficiently allocate their resources. Sophisticated investors today seek to manage their assets and liabilities in those markets that offer the highest returns with lowest risks/volatilities. To do this effectively, they will need superior information, and they will be looking at the standards of prudential regulation and the degree of integrity and transparency in the financial markets.
17. *Improving transparency standards* – There is no question in my mind that Hong Kong has the highest standards of transparency in Asia. We have a vibrant free press, a high concentration of regional and international press, television and news distribution centres here and high standards of accounting disclosure. For example, the Government will establish an on-line Government Electronic Delivery Service scheme to allow 24-hour access to government services and information. As in the case of transparency standards internationally, it is not so much whether or not disclosure standards are high or low, but whether the existing standards are more closely implemented and enforced. We will be working with the professional bodies and the corporate sector to see how we can improve transparency across the board.

18. *High prudential standards* - Hong Kong already has a financial supervisory framework that ranks well with the best internationally. By and large, it is market-friendly without sacrificing the need for supervisory authorities to monitor developments and be in a position to deal with shocks to the system. The banking system has an average capital adequacy ratio of more than 17%. We seek to regulate the securities markets with a light, firm and fair touch. Both in the banking and securities fields, we have engaged studies on future regulatory trends and how we can improve our own regulatory standards. For example, we are looking comprehensively at the Composite Securities and Futures Bill to examine how we can modernize the legislation in the light of major changes and innovation abroad. I would like to correct the impression made by the press that we are looking at a super-regulatory structure. On the contrary, I want to stress that the issue whether a single super-regulatory structure fits Hong Kong is not in our study terms of reference.
19. *Legal Framework* - Hong Kong's common law framework, backed by the highest concentration of international lawyers in the region, offers the surety of fair recourse action.
20. *Enhancing competition* – Given the most level playing field in Asia, we are working on how to enhance competition in a number of fields. For example, deregulation in the telecommunications and media field is on-going. The potential for privatization of public services in Hong Kong is still considerable.
21. *Financial Infrastructure* - As the boundaries for banking, securities and futures markets become blurred internationally, supervisory authorities must also look closely at systemic and cross-border payment and settlement risks. The development of global financial markets depends heavily on the availability of efficient telecommunications and a robust technological platform. Hong Kong has the potential of being the first to exploit the true benefits of seamless global financial trading, where global financial products can be traded, cleared and settled at the lowest transaction costs and the lowest trading and settlement risks.
22. The HKSAR government aims to build a world-class financial infrastructure in Hong Kong. Last year, I chaired an Informal Working Group (IWG) comprising experts from the private sector, the HKMA and the government to develop a vision of Hong Kong as a Financial Technology Supercity for the 21st century. As a first step in that direction, the HKMA implemented the most modern Real-Time Gross Settlement (RTGS) inter-bank payment system in Asia in December 1996, well ahead of competition. We are examining the feasibility of a secure FinNet to enable fully electronic straight through processing (STP) to be executed in Hong Kong between the banks, the securities houses, the exchanges and clearing system. The objective is to enable Delivery versus Payment (DvP) to be implemented to eliminate settlement risks. Once RTGS systems in the region come on-stream, we will be able to facilitate DvP for regional and global transactions to be conducted in real-time with minimal payment and settlement risk.

23. *Investing in Human Capital* - Hong Kong's continuing success as an international financial centre depends on its ability to generate high quality knowledge-based workers with adaptive skills. As an open society, it also depends on the ability to import new skills, particularly in the rapidly changing financial and technology fields. The Chief Executive's Policy Address has already indicated how the government is determined to increase investment in human capital, by making greater investments in the education of information technology and worker retraining. In the securities field, we will be devoting more effort to raising securities skills through the Hong Kong Securities Institute. The SFC will be working closely with the local universities to update curricula and establish academic-industry exchange programs.
24. *Venture Board* – We are already looking very closely at proposals to develop a venture board for the trading of shares in smaller and emerging companies, particularly those in the technology field.
25. *Debt market* - Of the eight broad classes of products in Asia: banking, equity, debt, foreign exchange, derivatives, commodities, asset management and insurance, the domestic-currency debt markets for historical reasons have been the slowest to develop. The Asian crisis has highlighted the need for Asians to mobilize more efficiently their high level of domestic savings for better investment through long-term bond markets. This would avoid both the maturity and currency mismatches that have plagued Asian borrowers.
26. Under careful but step-by-step nurturing, particularly through the creation of a benchmark yield curve and an efficient infrastructure, we have developed the debt market in Hong Kong into one of the most liquid in Asia. With the institutionalization of savings in Hong Kong through the introduction of Mandatory Provident Fund schemes and the securitization of bank assets such as home mortgages through the creation of the Hong Kong Mortgage Corporation, the debt market is poised to take off.

Conclusion

27. My personal view is that what keeps Hong Kong competitive in the 21st century is not just all the factors we have listed above, but the resilience, creativity, entrepreneurship and competitive spirit of her people. The competition of the 21st century, which will be the competition of knowledge-based societies, still depends ultimately upon people. A service-based economy depends first and foremost on people's skills. How we enhance transparency and distribution of knowledge and skills and encourage competition and efficiency will determine Hong Kong's future as an international financial centre.
28. In the securities field, the SFC will work closely with the industry and the financial community, as well as the other parts of the government, to strengthen our ability to compete. The competition will be fierce and the

obstacles are many, but I am confident that it is always too easy to underestimate the strength and resilience of Hong Kong's free markets.

29. Thank you.

Securities and Futures Commission
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Table: Hong Kong's International Standing

| Category | World Ranking |
|---|----------------------|
| Economic Freedom Index | 1 st [2] |
| Container port traffic (throughput) | 1 st |
| Foreign exchange reserves | 3 rd [1] |
| GDP per capita (ppp estimates) | 4 th |
| Airport (no. of international passengers) | 5 th |
| Banking (volume of external banking transactions) | 6 th |
| Foreign exchange market (turnover) | 7 th |
| Foreign trade | 9 th |

- [1] As at end-September 1998, the foreign exchange reserves were at US\$88.4bn.
- [2] Heritage Foundation Index of Economic Freedom found Hong Kong for the fourth consecutive year to be the freest economy in the world.