



HONG KONG 2020 - THE BIG PICTURE :

FINANCIAL SERVICES



**Business and Professionals
Federation of Hong Kong**
香港工商專業聯會

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ACKNOWLEDGEMENTS

The Business & Professionals Federation of Hong Kong (BPF) and its Task Force on Financial Services for the Hong Kong 2020 Project would like to thank the following individuals (listed in chronological order of their interviews with us) as well as those interviewees who chose to remain anonymous for sparing their valuable time to share their insights with us. The views they expressed are their own and do not represent the organisations they belong to. Their insights combined with those of the Task Force have culminated in this Report.

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Ms Ginnie S W Choi of the Hong Kong Institute of Economic and Business Strategy, University of Hong Kong provided the research support needed for this Report and this is gratefully acknowledged.

ABBREVIATIONS USED IN THIS REPORT

AO	Administrative Officer (of the Hong Kong Government)
BPF	Business & Professionals Federation of Hong Kong
CEPA	Closer Economic Partnership Arrangement
CCACS	Central Clearing and Settlement System
CMU	Central Moneymarkets Unit
CO	Company Ordinance
DCASS	Derivatives Clearing and Settlement System
DTCC	The Depository Trust & Clearing Corporation (in the US)
FDI	Foreign Direct Investment
FSTB	Financial Services and Treasury Bureau
GDP	Gross Domestic Product
HDR	Hong Kong Depository Receipts
HKEx	Hong Kong Exchange and Clearings Ltd
HKMA	Hong Kong Monetary Authority
HKSAR	Hong Kong Special Administrative Region
HKTDC	Hong Kong Trade Development Council
IMF	International Monetary Fund
IPO	Initial Public Offering
IRO	Inland Revenue Ordinance
MPF	Mandatory Provident Fund
MPFA	Mandatory Provident Fund Authority
NDRC	National Development and Reform Commission (of China)
OECD	Organisation for Economic Co-operation and Development
OTC	Over-the-counter
PRD	Pearl River Delta
QDII	Qualified Domestic Institutional Investor
RMB	Renminbi
RTGS	Real Time Gross Settlement
SFC	Securities and Futures Commission
SOE	State-owned Enterprises
UCITS	Undertakings of Collective Investment in Transferable Securities
WTD	Withholding Tax on Dividends

EXECUTIVE SUMMARY

1. Mainland China's development into a medium-income economy in the coming decade, and the gradual liberalisation of its capital account and the Renminbi (RMB), will result in an enormous demand for efficient financial services based on international market standards. This is offering Hong Kong a unique opportunity to develop into China's international financial centre with global market reach and significance.
2. Shanghai's rise does not mean Hong Kong's downfall. However, Hong Kong must continue a proactive dialogue with the key decision makers in the Central Government to stress the Hong Kong Special Administrative Region's (HKSAR's) valuable competitive strengths in meeting the rapidly rising financial services and risk management demands as China further liberalises its financial markets, as well as the strategic importance of developing Hong Kong into China's international financial centre with global significance. Hong Kong's profound experience in international finance is also an asset to China as it participates in shaping rules for global finance.
3. Given the significant changes in the global financial landscape in the aftermath of the global financial crisis and the unprecedented changes in China's international role, Hong Kong must act decisively to realise the potentials of the opportunities that will arise. The Government must demonstrate commitment at the top, strengthening its strategic and professional leadership capabilities while increasing its market development efforts so as to steer Hong Kong through the unique challenges of developing into a first-class global financial centre of China. More professional and market expertise are needed in the Government and in the various regulatory agencies to strategically take a long-term approach to financial market development, and to adopt a more balanced approach when looking to enhance Hong Kong's financial market regulations.
4. Long-term plans to grow significantly the pool of expertise on financial services in the government are needed. The traditional system of having generalist administrative officers (AOs) rotating through different jobs every two to three years needs to be supplemented by a system of "streaming" AOs and by attracting more professionals with financial market expertise to work in the public sector. While the regulators should continue to maintain their prudential regulatory role, they should also step up their market development efforts. An Ambassador should be appointed whose job is to promote Hong Kong's financial services overseas and to advise the Financial Secretary on actionable steps to further develop Hong Kong as an international financial centre. Some of the senior and vital positions in the Securities and Futures Commission (SFC) should be employed on a long-term basis to promote long-term strategic thinking, commitment and accountability.
5. A holistic review should be made on how Hong Kong could develop further its financial infrastructure. The current arrangements in the settlement and shareholder registration of listed shares could be improved. Closer links and coordination amongst the various settlement systems in Hong Kong should be fostered so as to enhance risk management by facilitating

cross-collateralisation. Opportunities for broadening the range of products covered by the settlement systems should be looked into.

6. Hong Kong's success in raising huge amounts of international capital for Mainland companies through IPOs is a significant achievement. More efforts in this direction are needed. But at the same time, we need to relax the overly stringent listing requirements for companies from other jurisdictions to list in Hong Kong. The listing requirements and processes in general should also be fine-tuned to improve effectiveness and efficiency.
7. Hong Kong should aim at developing into a Centre of Asset Management in Asia. Regulations governing offshore funds with global distribution should be upgraded to align with international development, while new regulations should be drawn up to facilitate the setting up of domestic open-ended funds.
8. Hong Kong has much potential to develop into the global base for China's insurance industry as it seeks to internationalise in the future. Meanwhile, the government should press ahead with its strategy to foster a proper environment that empowers Hong Kong to become an attractive centre for captive insurance.
9. Hong Kong's strength as the preferred location as regional and global headquarters must be further developed. Given that more and more Mainland Chinese companies and institutions are "going out", it is important that Hong Kong establishes more double tax agreements with other jurisdictions to increase Hong Kong's attraction as a first base for these Mainland companies.

Hong Kong 2020 – the Big Picture: Financial Services

Introduction

10. Hong Kong's importance as an international financial centre has grown rapidly in recent years. A major development is the role Hong Kong has played in helping to raise significant amounts of international capital for many Mainland Chinese financial institutions and enterprises. The rapid growth in wealth management and private banking in recent years has also increased considerably the breadth and depth of the markets for many products and services. Reflecting these developments, there has been a rise in Hong Kong's status in various international rankings and studies on global financial centre developments and potential (such as The Global Financial Centres Index published by the City of London which ranks Hong Kong the world's third or fourth global financial centre). According to IMF data, Hong Kong has a very high ratio of total external assets and liabilities (including direct investments, portfolio investments, financial derivatives, loans, trade credits, financial leases, etc.) to Gross Domestic Product (GDP), and this ratio has been soaring in recent years, reflecting the growing importance of Hong Kong in intermediating cross-border investments.

Table 1: External assets and liabilities of Hong Kong vs selected economies

		Total External Assets (US\$ bn)	Ratio to GDP (%)	Total External Liabilities (US\$ bn)	Ratio to GDP (%)	Net IIP (US\$ bn)	Ratio to GDP (%)
Hong Kong	2001	1,071	643	806	484	265	159
	2007	2,717	1,312	2,233	1,078	484	234
Mainland China	2004	930	48	637	33	293	15
	2007	2,288	71	1,266	39	1,022	32
USA	2001	6,309	62	8,178	81	-1,869	-18
	2007	17,640	128	20,082	145	-2,442	-18
UK	2001	4,573	311	4,658	317	-85	-6
	2007	12,995	469	13,697	494	-702	-25
Germany	2001	2,748	146	2,586	137	162	9
	2007	7,230	217	6,278	189	952	29
Japan	2001	2,882	70	1,521	37	1,360	33
	2007	5,355	122	3,160	72	2,195	50
Singapore	2001	370	432	309	360	61	71
	2007	880	546	725	450	155	96
Switzerland	2001	1,323	519	1,003	394	320	126
	2007	3,165	742	2,536	594	629	147

Source: International Monetary Fund (IMF)

11. From 2002-2007, the economic value added of the financial services sector grew by an average of 15.9% per annum, much faster than the average of 6.4% in real GDP. The share of financial services to Hong Kong's GDP thus rose from 12.2% in 2002 to 18.7% in 2007. The financial services industry is interlinked with other economic sectors in Hong Kong, particularly the professional and business services, and real estate. Therefore, the drastic expansion of

financial services has also contributed directly to Hong Kong's strong economic growth in recent years before the onset of the current global financial crisis.

Table 2: Growth of the financial services sector vs GDP in Hong Kong

Year	Value added of finance and insurance in chained (2007) dollars (HK\$ bn)	year-on-year growth rate%	as % share of real GDP	Real GDP in chained (2007) dollars (HK\$bn)	year-on-year growth rate%
2000	140	8.0%	12.0%	1,159	8.0%
2001	139	-0.3%	11.9%	1,165	0.5%
2002	145	4.0%	12.2%	1,186	1.8%
2003	159	9.6%	13.0%	1,222	3.0%
2004	192	21.0%	14.5%	1,325	8.5%
2005	215	11.9%	15.1%	1,419	7.1%
2006	257	19.7%	16.9%	1,519	7.0%
2007	302	17.6%	18.7%	1,615	6.4%
2008	306	1.4%	18.5%	1,654	2.4%
Average Annual Growth Rate%					
2002-2007		15.9%			6.4%
2002-2008		13.3%			5.7%

Source: Census & Statistics Department, HKSAR

12. Hong Kong's financial services industry is also noted for its professional quality, the broad array of services it offers, its global reach and high quality market infrastructure, underpinned by a first-class business environment. There is a wide range of global financial institutions operating in Hong Kong, with Hong Kong being their centre of excellence in Asia or the world. Hong Kong is also the preferred headquarters location for many regional/global functions for many financial institutions.
13. However, the onset of the global financial crisis in 2008 has been changing the landscape of the global financial market in important ways. The business opportunities for the global financial services sector will be subdued for a period of time, particularly in activities and services where the financial services institutions need to rebuild investor confidence. This sector will also have to contend with many regulatory and political challenges in the months and years to come.
14. China's economy has been quite resilient in the midst of the ongoing global "Great Recession", particularly given the sizeable fiscal and monetary stimuli the government has introduced. However, from a medium-term perspective, China faces many new economic challenges, as outlined in the Eleventh Five Year Plan and exacerbated by developments after the recent global economic crisis. Such challenges include stimulating domestic demand, reducing the relative weight of exports and investments in driving economic development, shifting the mode of economic development from quantitative to qualitative growth, improving economic efficiency and enhancing innovative capabilities. To effect such changes, China must improve the

efficiency of its resource allocation mechanisms. Financial market reform and development are key elements in this reform process. Given the strength and efficiency Hong Kong has developed in the financial services sector, the SAR is in a unique position to work with the Mainland in this direction in the next decade and beyond.

15. The decision by Beijing to develop Shanghai into an international financial centre that is commensurate with China's economic development and the RMB's status will not change the macro picture, but it does mean that Hong Kong will face more competition and challenges in its quest to be China's key international financial centre. While Hong Kong must continue to maintain a constructive dialogue with decision makers in Beijing, there is also a need to critically examine where we can improve and strengthen our competitive advantages, particularly in the ever-changing global financial markets.

The global financial crisis - short-term and medium-term challenges for Hong Kong

16. The global financial services industry is going through challenges and uncertainties that are unprecedented in recent decades, as the global financial chaos triggered by the problems of sub-prime mortgage loans in the US evolved into a global economic crisis. While the macro-economic statistics in recent months show that the drastic fall in economic activity and confidence has bottomed, it is very likely that the recovery in many developed economies would be tempered as investment is likely to remain weak, unemployment would continue to rise, consumer demand would not recover to the level before the crisis for some time, banking problems would linger on, and large scale fiscal stimulation could not be sustained for a prolonged period of time. Furthermore, as many institutions and individuals would gradually reduce their debt, it is probable that the deflationary forces of such a balance sheet deleveraging process would pose a drag on global financial and economic developments, resulting in a prolonged period of sluggish economic growth.
17. Many major global financial institutions have suffered heavy losses and are relying on massive government rescue efforts for their survival. While global financial markets have rebounded strongly in recent months, the credit problems associated with weak property prices, rising unemployment and sluggish economic prospects will lead to further write-offs for many financial institutions. Meanwhile, the political and social pressures on the financial services industry, coupled with the need for regulatory reform to plug the loopholes and the excesses as shown by developments in recent years, will mean that the industry will come under much greater scrutiny going forward. The risk of regulatory overkill is real and may adversely affect financial market innovation.
18. Against this backdrop, the Hong Kong financial services industry will have to endure a rather difficult period for some time. The local economy experienced a serious contraction and will continue to be adversely affected by a sluggish global economy for some time to come. On the other hand, customers have become much more conservative in their dealings with financial institutions. On the supply side, many global financial institutions in the local market will be less active as their parents continue an ongoing restructuring process and re-evaluate their core

business models. Meanwhile, problems associated with the Lehman minibond saga have consumed an enormous amount of energy of some banks, the government and the regulatory authorities.

19. Nevertheless, the financial market crisis has also created new opportunities. Hong Kong-based financial institutions have suffered much smaller losses during this global financial crisis as compared with their American and European counterparts. Some Hong Kong banks have actually benefited from the flight to quality as customers shifted their assets away from some US and European financial institutions.
20. Financial institutions from the Mainland are also relatively unscathed owing to their low involvement in the global credit and derivative markets, and thanks to the relatively high resiliency of China's economy. Therefore, the current downturn has offered the Mainland Chinese financial institutions an opportunity to re-position their businesses, increase market share and catch up with the capabilities of the more sophisticated financial institutions. From a macro and longer-term perspective, the financial crisis has also heightened China's concerns about the dominance of the US dollar in the global financial system, and the need for China to participate in international forums that set global financial regulations, and to accelerate the process of RMB internationalisation.
21. Significant changes will gradually unfold in the years ahead in the global financial system, in China's international status, and in China financial services industry. Hong Kong is uniquely placed to become an important player in this new paradigm if we do things right. But Hong Kong could also be gradually sidelined if we do not rise to the challenges. As the saying goes, a crisis is too important an opportunity to miss. While Hong Kong is endowed with a vast array of fundamental strengths and competitive advantages, such as a good business environment, the rule of law, transparency, level playing field and world-class financial market infrastructure, and being located in a huge and rapidly growing region, there are still many areas where Hong Kong could do better, perhaps much better. Financial services will remain one of the highest value-added economic sectors globally and a pillar economic sector for Hong Kong. The Government should take the global financial crisis as a wake-up call to put more focus on its financial sector development strategy, and to strengthen its leadership capacity in this important economic sector.

Shanghai's plans to develop into an international financial centre - a challenge or an opportunity?

22. The decision by the Central Government to develop Shanghai into an international financial centre commensurate with the global status and importance of China's economy and the RMB has aroused a lot of discussions in Hong Kong in recent months. This is good news as it directs Hong Kong's attention to reassess the competitive landscape it is facing and drum up the political will to reform and change the areas where there is a need. It is also good news in the sense that Shanghai's more proactive steps to develop itself into an international financial

centre will inevitably quicken the pace of financial market reform and liberalisation by China as a whole, which in turn will create more business opportunities for Hong Kong.

23. As Premier Wen Jiabao has indicated, an international financial centre status is not to be conferred upon by the Central Government. It has to be earned through market competition. If Hong Kong seizes the opportunity well, it will be in a good position to serve China's immense domestic financial services needs and spearhead China's financial link with the rest of the world. Market competition will also drive Hong Kong to excel in its strengths while Shanghai (and other cities in China too) will stand out in other areas. Given the large size of China's economy, China will most likely develop more than one international financial centre. Shanghai's rise does not mean Hong Kong's downfall. Indeed, similar to the relationship between Hong Kong and Singapore in the past few decades as East Asia grew in leaps and bounds, there will be more business opportunities for both Hong Kong and Shanghai as China evolves. One should also bear in mind that in Asia, there is a history of dispersed financial centre development because of political, cultural and geographical diversity. There are a number of sizeable financial centres and it is unlikely that there would be only one dominant financial centre in the East Asian time zone within the next decade or so.
24. However, unlike the competition between Hong Kong and Singapore, the relationship between Hong Kong and other cities in the Mainland happens within a one-country framework where national policy decisions on financial market development could favour one city over another. It is important therefore that Hong Kong maintains a close dialogue with the authorities in Beijing and to lobby for the introduction of national policies that promote constructive competition and complementary developments amongst various cities across the country.
25. Financial sector reform has lagged behind many other sectors in China's development and modernisation in the past three decades. This has to be rectified as China strives to effect a change from quantitative growth to better quality growth. Improving economic efficiency is the key to this process. China is already implementing reforms to rationalise the prices of natural resources and land in order to encourage a more efficient utilisation of these scarce resources. Reform to promote an efficient use of financial resources is another important leg in China's further reform in the coming years that will go hand in hand with other reforms. This will help reduce inefficient investments by enterprises, provide more investment opportunities and investor protection for individual and institutional investors, promote the development of small and medium-sized enterprises and the non-state sector, raise the share of consumer spending in the GDP, and maintain monetary and banking system stability while avoiding excessive economic cycles. Given Hong Kong's experience and strength in financial services, there will be much room for Hong Kong to contribute to the Mainland's development in these areas.
26. For a long time, a major constraint on Hong Kong's growth as an international financial centre is the relatively small size of its domestic economy, even though the city has been able to attract an abundance of global and regional businesses. As China rises to become a major economy and as financial sector integration between Hong Kong and the Mainland intensifies, this constraint has been diminishing. The large amount of capital raised through the Hong Kong

financial market for many Mainland enterprises is a good example. Furthermore, as China has built up sizeable foreign currency reserves and has been running large current account surpluses in recent years, regulations have gradually been relaxed to allow individuals to purchase more foreign currencies and remit them out of China. For instance, since early 2007, the amount of foreign currencies that individuals in the Mainland could purchase annually without having to show any documentary justification has been raised from US\$20,000 to US\$50,000. With effect from 1 August 2009, regulations governing remittance of foreign exchange have been further relaxed to facilitate enterprises to “go out” and make investments overseas. In view of the strength, credibility and history of Hong Kong’s financial system, the freedom of capital movement, the rule of law and the protection of property rights, there is every reason to believe that as China develops further and as its capital flows are further relaxed, there will be more and more demand from Mainland customers for Hong Kong’s international financial services.

27. From a strategic perspective, it is in China’s interest to have a financial centre that is comparable in significance with London and New York today. China’s financial services needs have grown to a scale that China could gravitate financial intermediation activities towards financial centres in China, instead of having to channel such activities into financial centres overseas. As Hong Kong is the only city in China that has well-established capabilities in international finance, a unique opportunity is opening up for China to strengthen Hong Kong’s role as the nation’s international financial centre with global significance and footprint. In addition, as is evident in the aftermath of the current global financial crisis, China will have to increase its participation in international forums on banking and finance, and to build up its capabilities to participate in setting rules for global finance. Hong Kong’s profound experience in international finance will be a valuable asset to the authorities in Beijing in this aspect.
28. Meanwhile, RMB businesses in Hong Kong are expanding gradually in line with the growing importance of the RMB as a regional currency. For example, since RMB deposits started in Hong Kong in early 2004, total RMB deposits in the local banking system rose to a high of around RMB78bn in mid-2008 before coming down to around RMB53bn in recent months as some of these deposits were used to purchase RMB-denominated bonds. By the end of July 2009, a total of RMB28bn of RMB-denominated bonds have been issued in Hong Kong. The recent introduction of trade settlement in RMB services is another milestone in this development. It has not only enabled trade with China to be settled in RMB, but also resulted in the introduction of corporate RMB accounts, corporate RMB financing, and an interbank market in RMB in Hong Kong. Moreover, as Mainland exporters could choose to have their RMB receipts kept in bank accounts in Hong Kong, while trading companies from elsewhere could choose to settle their trade with China in RMB through accounts in Hong Kong, the source of RMB deposits for Hong Kong’s banking system has also been extended to corporate customers outside Hong Kong. In the longer term, as Hong Kong’s trading, clearing and settlement capabilities in RMB grows, the importance of Hong Kong as an offshore RMB centre would increase, eventually helping to promote the regionalisation of the RMB.

29. There are therefore ample opportunities for financial sector cooperation between Hong Kong and the Mainland in the coming years. In order to capture the opportunities and to contribute further to China's development in the next stage of its modernisation process, Hong Kong needs to further develop the integrity, the depth and the breadth of its financial markets, and to upgrade its thought leadership capabilities in international financial issues. It is also important that Hong Kong and the Central Government authorities work effectively together to liberalise financial market related restrictions that segregates Hong Kong from the Mainland in a progressive and prudent manner so as to deepen financial sector integration.

Supervision and regulation

30. Hong Kong is chosen by many major international financial institutions as the preferred Asian regional headquarters. Amongst other reasons, these institutions were attracted by Hong Kong's solid regulatory framework which is friendly to business development, as well as our excellent international reputation in keeping up and advocating financial best practices. The fact that Hong Kong's financial system has suffered much less than many other economies in the ongoing global financial crisis is due in no small part to the successes of Hong Kong's financial market supervision.

31. However, global rules for financial markets and institutions are changing significantly in the wake of the global financial crisis. New legislations, regulatory reviews and reform proposals put forward so far by the leading financial market regulators in Europe and the US, and by the Bank for International Settlement have already suggested some common themes that are likely to become part of the future global standards in regulatory regimes. In so far as Hong Kong is concerned, the themes that are relevant include:

- i) A better dialogue and stronger coordination amongst the various regulators is necessary. Better monitoring and management of systemic risks is required, and this will make it necessary to set up the proper institutional structures, and to formalise the necessary risk monitoring and management processes.
- ii) Stronger protection of consumer and investor interest is needed. A separate regulatory institution may have to be set up for this purpose. Better and faster ways may need to be introduced to deal with widespread complaints against financial service providers.
- iii) Provisions in the Basle II framework, including the level and the quality of capital for financial institutions, and how such levels should be determined, should be reviewed in the light of the experiences of the recent global financial crisis. The pro-cyclical nature of some of these provisions needs to be critically examined. There is also a need to focus on regulating liquidity, and the ease with which bank assets can be turned into cash, particularly under conditions of market stress.
- iv) More transparency is required for new financial products/services. Derivatives should, as far as possible, be encouraged to be standardised, be liquid, have price transparency, and be cleared through central counterparties.

- v) Supervisors need to have a better understanding of financial innovation. The risk models of financial institutions need to be subject to more stringent stress tests. This will call for investments by the authorities in specialist skills.
 - vi) The regulatory regime and the proper powers for the authorities to deal with investment banks, non-financial institutions that have significant systemic impact on the financial system, and of holding companies of financial institutions, need to be reviewed.
 - vii) To mitigate the problems arising from “too big to fail” financial institutions, contingency plans have to be put in place to deal with situations when any of these institutions do get into trouble. This may also mean that when new financial products/services are introduced in the future, the way that they would be dealt with when financial institutions get into trouble would have to be considered.
 - viii) Corporate governance of banks needs to be reformed. Risk management needs to be strengthened at the board level, and this could include changes to the balance of skills, experience and independence, and a better approach to audit, risk and remuneration.
32. While some of these issues will have to be discussed and agreed at the international level, there are others that could be and need to be reviewed by Hong Kong on its own, including in particular the relationship amongst the regulators and how their work could be better coordinated. Regulatory reforms in the US and the main European countries will affect Hong Kong’s financial sector development and its competitiveness in many ways. Because of the Lehman minibond problems, the attention and energies of our financial sector leadership and the regulatory authorities have been overly consumed and sidetracked. It is important that Hong Kong gets over these problems as soon as possible and gets on with the broader regulatory issues.
33. A careful balance needs to be struck between regulation and innovation. Over-regulation is something Hong Kong could not afford. In particular, there is considerable political and social pressure on the Government to do more in consumer and investor protection, and in the supervision of business conduct by market practitioners, on top of their more traditional emphasis on maintaining systemic stability and the prudential supervision of financial institutions. This has already led to a significant increase in bureaucracy and the introduction of unreasonable regulatory practices that are stifling business. We hope our community, politicians and the authorities understand these risks. We also hope that the regulatory authorities would develop future regulatory practices in full consultation and collaboration with various private sector practitioners.

Stronger leadership at the top, more professional and market expertise in the Financial Services Bureau and in our regulators, and more market development efforts by the Government as a whole

34. Given the increasing complexity and the rapid rate of change in financial markets, it is important that we have strong and dedicated leadership at the top of the Government, supported by

professional and responsive officials in the bureau and regulators level. To steer Hong Kong through the coming decade as the SAR evolves into a unique global financial centre of China, Hong Kong will need a group of financial leaders who have the depth of experience, as well as insights and foresights to lead Hong Kong through the complex issues related to China's financial market liberalisation as well as the constant financial innovation in an ever-changing global financial market landscape, in a timely, appropriate and comprehensive manner.

35. Experiences in recent years show that there is no shortage of ideas from industry experts on the Government's role in promoting Hong Kong's financial centre development. In order to take up these issues effectively and overcome the obstacles, dedicated officials who have market expertise, administrative capabilities and political wisdom are required. These officials also need to be supported by strong and committed leadership at the top. One common complaint in the industry is that generalist administrative officers in the Financial Services and Treasury Bureau (FSTB) do not usually have adequate specialist knowledge and experience required to strategically coordinate and steer developments in Hong Kong's financial system, particularly when there is any disagreement amongst different stakeholders in the market.
36. Government officials and regulators responsible for the financial sector need to have an in-depth and sophisticated understanding of global financial markets, as well as the peculiarities of China's financial market development. To lead our financial services development, on top of the traditional practice of having generalist administrative officers rotating through different jobs once every two to three years, there is a need to implement a "streaming" system so that some administrative officers could build up their professional expertise and could take a longer-term view in developing Hong Kong's financial services industry. The "streaming" concept was actually raised many years ago but unfortunately has not been implemented properly. In addition, more efforts should be put into attracting professionals and practitioners with market expertise into FSTB and the regulatory bodies.
37. While the primary responsibility of regulators is to enforce regulations effectively, there is always a need to have a leadership and regulatory structure in place that constantly balances the interests and evaluates the effects between regulation and market development. Our interviews with market practitioners suggest that, with some exceptions, the regulatory system and the regulators in Hong Kong, particularly the SFC, had their focus tilted too much to the side of regulation and at the expense of market development. While there were improvements in recent years, the Lehman minibond saga has arrested and even reversed this positive trend. Many market practitioners opined that Hong Kong has missed many market opportunities over the years as a result of a rather bureaucratic SFC that is often out of touch with the market. The need for investor protection should not stifle innovation and market development. Hong Kong's success in financial centre development in the past was due in no small part to favourable developments in our external environment. However, in the face of increasing competition, we need to improve the formulation and the implementation of financial market development strategies in the coming years.

38. Recruiting industry professionals is an excellent way to nurture more market expertise and business acumen into the regulatory and government decision-making process. More of this should happen in Hong Kong. In this connection, it is unfortunate that the public sector is becoming less and less attractive as an employer for talented and experienced people from the private sector with the passion to serve Hong Kong, particularly given the unsatisfactory relationship between the executive and the legislature, and the increasing level of suspicion on developing a more constructive relationship between the private and the public sectors.
39. The human resources pool in the Government that has in-depth knowledge about global financial markets is too small. A long-term plan to grow this pool is needed given the importance of the financial services sector to the Hong Kong economy. Senior officials in the SFC are mostly employed on contract terms, with no guarantee that their contracts would be renewed. This system does not help to develop long-term strategic thinking and commitment amongst these senior level leaders in the SFC. Consideration should be given to turn some of these senior level officials into long-term employees.
40. It will take time to strengthen the leadership and to improve the balance between regulation and market development. To expedite changes, we propose the appointment of an Ambassador whose job is to promote Hong Kong's international financial centre development efforts overseas (including the Mainland) and to provide advice to the Financial Secretary on strategic issues and actionable ideas that would promote Hong Kong's attractiveness. Historically, Hong Kong has dedicated marketing and promotional agencies for trade and for tourism. It should be natural for Hong Kong to also have a dedicated Ambassador for promoting financial services. Past experiences show that financial services are too specialised for agencies such as the Hong Kong Trade Development Council (HKTDC) or InvestHK to do the promotional work.

Financial cooperation with Pearl River Delta (PRD)

41. The PRD has a highly externally-oriented economy and has very close connections with Hong Kong and Macao. Per capita GDP in Guangdong has reached US\$5,400 (2008) and the amount of wealth built up over the years is very substantial. Therefore, there is a very strong underlying demand for international financial services. The rapidly increasing cross-boundary people and business flows between Hong Kong and PRD are also generating growing demands for cross-boundary integration of financial services.
42. The Mainland has also strategic plans for the PRD to develop its regional financial capabilities that could radiate and promote development in southern China. The PRD Strategic Development Plan document released by the National Development and Reform Commission (NDRC) in late 2008 has created opportunities for the possibility that financial sector liberalization could happen in Guangdong first before the rest of the country.
43. Against this backdrop, Hong Kong should pursue actively with the Mainland authorities ways to promote financial integration with PRD. Hong Kong's expertise in financial services can be transferred to and adapted for the Mainland market. For example, Hong Kong's well-established

insurance sector can help Guangdong establish a vibrant insurance market with the various stakeholders in mind. The Hong Kong insurance industry can help to establish best practices in the marketing and distribution of various insurance products, improve new product development adapted for the local market and to build risk management systems to ensure individuals' interests are well protected. The smaller local Hong Kong banks have a special niche in helping the development of banking in Guangdong, particularly in the second-tier cities, given the close economic and people connections between Hong Kong and the PRD. With a combined GDP (Guangdong and Hong Kong) accounting for 16.4% and bank deposits 21.5% of the national total, closer integration of financial services between Guangdong and Hong Kong will create numerous opportunities and develop southern China into a significant region in financial services.

Financial market infrastructure

44. Hong Kong has a very efficient financial market infrastructure. In particular, the real time gross settlement (RTGS) systems for HKD, USD and Euro transactions developed since the 1990s have uniquely positioned Hong Kong as the regional leader in payments settlement denominated in these currencies. Since RMB business was introduced in Hong Kong, the RTGS has been extended to settlements in RMB. This highly efficient payments system is linked to the Central Moneymarkets Unit (CMU) which not only provides for the settlement of Exchange Fund bills and notes, and other debt instruments, but also offers these financial assets as collateral to secure the credit needed to facilitate efficient settlement. Stocks traded on the stock exchange are settled through the Central Clearing and Settlement System (CCASS) while derivatives traded in the stock market are settled through the Derivatives Clearing and Settlement System (DCASS). Both CCASS and DCASS are of a very high standard in both the efficiency and security of settlement.
45. One area that Hong Kong should improve expeditiously is "scripless trading", an issue that has been highlighted by the media from time to time. This is strictly speaking not a "scripless" issue, but more an issue related to better investor protection, greater transparency for shareholders and improved shareholder service. The problem arises as current arrangements in the CCASS system make it inconvenient and not cost-efficient for individual shareholders to register themselves as Individual Investor Participants in CCASS. Therefore, most individual shareholders use the electronic settlement process through stockbrokers or other nominee agents (mostly banks), while others continue to hold physical shares and experience numerous manual procedures to handle the share scripts when they trade and settle. On the other hand, the stockbrokers, nominee agents and CCASS currently hold their clients' and Participants' shares in nominee accounts, with the result that individual shareholders will not have their names registered in CCASS nor in the Registrars of the listed companies concerned. This leads to investor protection problems should a stockbroker declare bankruptcy, as the shares held under the stockbroker's nominee account would be frozen and be pooled together with other assets to meet its many obligations. Another problem with the current system is that since the individual shareholders do not have their names registered in the Registrars, they do not get the shareholder service that other registered shareholders enjoy (such as news announcements,

proxy voting, shareholder communication, timely dividend distribution and share subscription). These problems have long been recognised, but still have yet to be addressed.

46. Furthermore, the institutional separation between the Hong Kong Monetary Authority (HKMA) and the SFC/Hong Kong Exchange and Clearings Limited (HKEx) has meant that the cash and securities clearing and settlement systems are run and governed by two different institutional structures. Even within the Hong Kong Securities Clearing Company, the CCASS that offers settlement in shares and the DCASS that settles listed derivatives are not entirely linked with each other. At the working level, there are links across these systems. But at the top level, stronger leadership and more dedicated efforts are required to take a more holistic view of the overall development strategy for Hong Kong's clearing and settlement infrastructure as a whole, to promote stronger linkages across these systems, and to expand the product coverage of these systems over time. For example, better risk management could be achieved by enabling participants to have cross-collateralisation across the different systems. Greater dedicated efforts to increase the product scope of Hong Kong's settlement system would encourage new business opportunities to evolve.
47. London and the US offer examples for us to learn from. In London, the LCH.Clearnet Group has developed into a leading independent central counterparty group in Europe offering clearing and settlement services for a broad range of assets including securities, exchange traded derivatives, energy and electricity, freight, interest rate swaps, and bonds and repos. In the US, the Depository Trust & Clearing Corporation (DTCC) provides clearing, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and over-the-counter (OTC) derivatives. In addition, the DTCC is a leading processor of mutual funds and insurance transactions, linking funds and carriers with their distribution networks. The strong capabilities of London, the US and other European centres to settle derivatives in various instruments have now positioned these markets very well as the world is reforming its financial regulatory practices by routing more and more OTC derivatives through central counterparty clearing.

Stock market and initial public offerings (IPOs)

48. The enormous amount of capital raised by Mainland Chinese companies through IPOs in Hong Kong is a landmark development and a significant achievement for Hong Kong in the past two decades. This has not only helped raise Hong Kong's profile as an international financial centre, but it has also provided many Mainland companies the chance to reform and grow while attracting sizeable amounts of foreign capital. As of end July 2009, 478 listed companies in the local stock exchanges are Mainland based companies. Their combined market capitalisation accounts for about 59% of the total market, while trading of these companies averaged 73% of total market turnover during the first seven months of 2009.
49. This success is the result of many years of hard work by Hong Kong's financial services industry and the experiences it has gained over the years in bridging the gap between Mainland companies and the global investment community. The listing of Mainland companies in Hong

Kong has gone through different stages of development - initially selling shell companies to Mainland companies, next to the listing of “red chips” and then to the listing of H shares and, in more recent years, the listing of smaller state-owned enterprises (SOEs), large SOEs and non-state enterprises. By helping these Mainland companies to gain access to the international financial markets and investors, and by improving their corporate governance, Hong Kong has also made a significant contribution to the economic reform and development in the Mainland.

50. Hong Kong’s success in getting many Mainland companies listed should be viewed in the proper perspective given the stock markets in the Mainland were still in their formative years and were only re-established in the early 1990s. As with stock markets in other developing countries, China’s stock markets in Shanghai and Shenzhen have to overcome many challenges in their early stages of development before maturing. Once the stock markets in the Mainland mature and the RMB becomes fully convertible, the special role Hong Kong has played will likely change.
51. While Hong Kong should continue to capitalise on its competitive advantages in attracting companies from the Mainland to get listed, proactive steps should be taken to enlarge the catchment area with a view to attracting more companies from other jurisdictions to get listed in Hong Kong. The current listing rules only recognise companies from four jurisdictions while companies from other jurisdictions often have to comply with a more costly and lengthy process before obtaining approval for a listing. Several sizeable companies from other jurisdictions have expressed their intention to get listed in Hong Kong, yet they were turned away by the large amount of work and regulatory hurdles needed to get through the listing process. This market impediment is highly unsatisfactory and highlights the need for the regulatory bodies to focus more on market development. We hope the relevant authorities will double their efforts to rectify this problem as soon as possible. Regulations on Hong Kong Depository Receipts (HDR) were issued in 2008, but the requirements are quite unattractive as they are similar to the requirements for a primary listing. Regulations should be examined with a view to facilitating companies seeking a secondary listing in Hong Kong.
52. Hong Kong should also study whether the listing requirements and standards need to be fine-tuned in order to attract more companies to list in Hong Kong. For example, there are over 100 Mainland Chinese companies now listed in the Singapore Stock exchange. Most of them were attracted to Singapore because they found it difficult to meet the high listing standards in Hong Kong. Some local companies that could not meet local listing standards or found local listing requirements too onerous were also driven elsewhere. While Hong Kong should not simply attract companies to list by lowering listing standards, there is room for more flexibility in implementing standards to cater for different circumstances, and in making the listing and vetting process more effective and efficient.

Asset management

53. Hong Kong has done very well in international asset management. According to a regular survey by the SFC, total assets under management by Hong Kong’s asset management

industry grew from US\$209.6 billion in 2002 to over US\$1.2 trillion in 2007. But because of the global financial crisis, total assets under management fell by almost 40% in 2008. Many global investment companies have set up their Asian regional headquarters in Hong Kong either for managing and developing their regional business, or for better positioning themselves for entry into the China market. Anecdotal evidence suggests that private banking has grown rapidly in recent years to serve the rapidly increasing business coming out from Northeast Asia.

Table 3: Funds managed in Hong Kong

Year	Combined Fund Management Business (US\$bn)	year-on-year growth rate%	Of which :		As % share of total funds	
			Sourced from HK (US\$bn)	Sourced from non-HK investors (US\$bn)	Sourced from HK	Sourced from non-HK investors
2001	208.4		62.1	146.3	30%	70%
2002	209.6	0.6%	77.1	132.5	37%	63%
2003	378.5	80.5%	139.7	238.8	37%	63%
2004	464.6	22.7%	173.3	291.3	37%	63%
2005	582.0	25.3%	215.3	366.6	37%	63%
2006	792.2	36.1%	300.3	492.0	38%	62%
2007	1,234.5	55.8%	390.1	844.4	32%	68%
2008	745	-39.6%	266.5	478.9	32%	68%

Source: SFC

54. With over 2,000 authorised offshore funds, Hong Kong is second only to the European Union in terms of global distribution of offshore mutual funds. Most of these funds are not meant for the local market and many of them are merely using the Hong Kong authorisation as good branding for distribution elsewhere, particularly to Qualified Domestic Institutional Investor (QDII) funds from the Mainland and the potential of future demands from China. Currently, Hong Kong is predominantly penetrated by foreign global asset managers. They bring to Hong Kong their global fund complexes (the majority of which are established in Luxembourg or Ireland) for authorisation in Hong Kong. A side result of this is that Hong Kong has not been able to nurture its own product development and innovation capabilities. A comprehensive regulatory regime governing and promoting collective investment schemes incorporated locally has also been lacking.
55. There has been a rapid growth of wealth in Asia, and the rapid ascent of China's asset management industry is going through a period of explosive growth. In the longer term, while the ageing population situation in East Asia as a whole is not as bad as that of Japan or Europe, the problem will worsen very quickly. This is not a risk but a demographic certainty. There is an enormous opportunity for Hong Kong to position itself as the centre for asset management, facilitating asset managers, particularly those from the Mainland, to expand their regional and global businesses here.
56. To achieve this, one of the critical issues is that Hong Kong should secure mutual recognitions with more jurisdictions, initially in Asia, thus enabling Hong Kong funds be distributed in these markets, as exemplified by the agreement with Australia concluded in 2006. With a greater

number of funds set up and run from Hong Kong, the SAR will not only retain higher value-added jobs across a wide spectrum of skills, but also enhance the product development and innovation capabilities of the local financial services industry.

57. A regulatory regime governing open-ended collective investment schemes needs to be developed. One area that has caused a considerable amount of concern amongst some fund managers in recent years is the tax treatment of funds domiciled in Hong Kong and of offshore funds that are managed in Hong Kong. Currently, profit tax exemption is granted to funds authorised by the SFC. However, many new offshore funds, such as private equity funds and hedge funds managed in Hong Kong, are not targeted for local retail distribution and, therefore, do not need to obtain SFC authorisation. Whilst the Inland Revenue Ordinance (IRO) has been amended to offer tax exemption for unauthorised offshore funds, there are certain conditions that must be satisfied in order to qualify for the exemption, e.g. the offshore fund must be “non-resident”, bona fide widely held. Furthermore, the Companies Ordinance (CO) does not facilitate the setting up of open-ended funds with the concept of variable capital through selling and redeeming units in a speedy and low-cost manner as this is deemed to be an issue of increasing or reducing the share capital under the CO. This has the undesirable effect of driving some fund managers to go elsewhere and has hurt Hong Kong’s objective to develop into an asset management centre. Applying SFC authorisation as a criterion for a fund to be exempted from profits tax is obviously inappropriate as the purpose of authorisation is retail investor protection. One way to resolve this problem is to have a separate regulatory regime for open-ended collective investment funds covering all types of fund structures so there would be less impediments in the development of Hong Kong’s fund management industry. This would enhance Hong Kong’s attractiveness as a base for the emerging Mainland fund management industry to head for international expansion.
58. Another effort needed to promote Hong Kong as a stronger asset management centre is to update the Code on Unit Trusts and Mutual Funds (the Code) that governs unit trusts and mutual fund managers, including product registration, as well as promotional and marketing activities. This Code is based on a framework developed in the 1980s. Over the years, the SFC has developed a set of internal policies and issued a number of circulars on the interpretation and practical application of the provisions of the Code. However, to strengthen Hong Kong’s position as an asset management centre, the Code should be updated to make it more principle-based (currently the Code is too rule-based) and in line with international standards such as the Undertakings of Collective Investment in Transferable Securities (UCITS). The new Code should incorporate all the circulars and all subsequent amendments to produce a consistent and transparent set of regulations. A comprehensive regulation is vital to Hong Kong’s positioning as a premier centre for asset management in Asia.
59. There is also room for improvement in further refining the division of roles and responsibilities in supervision by the various regulators, given the developments in the market for wealth management over time, particularly the increasing overlap amongst securities, bonds, funds and insurance. The problems revealed in the recent Lehman minibond saga have highlighted the grey areas in supervisory functions between the HKMA and the SFC over consumer banks

in their marketing and promotion of investment products. Similarly, the supervision over insurance-linked investment products needs a proper review, striking a balance between investor protection and product innovation. The Mandatory Provident Fund Authority (MPFA) and the SFC have also different demands on market participants in the supervision of retirement products, with the result that international asset managers need to establish additional Hong Kong-specific internal guidelines and control procedures, thereby increasing their operational costs. Good practices in Hong Kong's MPF could become models for China's retirement protection system to take into account.

Insurance

60. Hong Kong has a well-established insurance industry comprising both local and major international firms demonstrating market expertise in life insurance, general insurance, reinsurance, international insurance broking, actuarial science, risk management and product innovation. The industry has uniquely operated under a supervised self-regulated regime that has worked well to its benefit. The insurance sector has continued to thrive by offering innovative products and an array of choices for consumers and companies. Nevertheless, given the increasing overlap amongst insurance, banking and securities, there is a need to consider insurance as an important part of Hong Kong's overall financial system.
61. While the industry has been successful in maintaining its role as a regional headquarters location for international insurers and brokers, particularly in the investment side of their businesses, its ability to grow into a significant international insurance centre has been severely constrained by the small size of the domestic market. The ability to further develop the industry is therefore heavily dependent upon the extent to which China sees the benefit of using Hong Kong as a base for the internationalisation of its own insurance business, and most particularly in the more immediate future, its reinsurance business. For the past 30 years, the sole emphasis of China's insurance and reinsurance industry has been to serve its domestic market. Reinsurance by its nature, however, is an international business and it seems inevitable that in time, Mainland reinsurers will follow the Mainland banking industry in going global. Hong Kong has a very strong claim to be the international city where China bases its centre for such operations and taps international skills.
62. Whilst becoming an international reinsurance centre should be a longer-term goal, we urge the Government to press ahead with establishing the proper environment to make Hong Kong a captive insurance centre. This was highlighted in the Government's 2007 Action Agenda on opportunities arising from the Economic Summit on the National 11th Five Year Plan and has been examined by a BPF task force working closely with the Commissioner for Insurance and Insurers.
63. Hong Kong's development as the captive domicile of choice to Mainland companies pursuing international opportunities will benefit both the Mainland and Hong Kong, and is a natural first step in establishing Hong Kong as the preferred platform for Mainland China's international insurance expansion. However, there are currently many impediments and disincentives for the

establishment of captive insurance subsidiaries. For example, the current tax provisions need to be amended to permit exemption from tax for captives or substantially simplify the tax provision to clarify when captive business will be taxable in Hong Kong.

64. Success in capturing this anticipated business demand will depend on whether Hong Kong is properly positioned to compete for business. If Hong Kong continues to be reactive to developing market needs without establishing a clear regulatory and tax environment, other Asian domiciles will gain a foothold and Hong Kong will have lost a golden opportunity.
65. We also highlight three additional areas in which the Government can help strengthen our insurance industry. The first by helping to extend the footprint of the industry through CEPA negotiations to obtain more favourable terms for Hong Kong insurers to operate on the Mainland both through reducing the capital and other establishment criteria, which are extremely high for international insurers, and by permitting Hong Kong insurers to insure the PRD-based operations of Hong Kong clients.
66. The second is to nurture the growth of a mature health insurance industry by working jointly with the industry to work towards a community-wide, risk-pooled solution to health care financing. This can be both a model and a future platform serving the Mainland's health care industry.
67. The third area is that of strengthening Hong Kong's capacity in marine hull and cargo insurance as a corollary to wider initiatives which we have recommended separately for the strengthening of Hong Kong's important maritime industry.

Double-tax agreements and the further development of Hong Kong as a headquarters hub

68. The low tax environment in Hong Kong and the absence of withholding tax on dividends (WTD) paid from Hong Kong subsidiaries to overseas parent companies are part of the reasons why Hong Kong is an attractive location for multinationals to set up holding companies and regional headquarters. Starting from 1 January 2008, Hong Kong's attraction as a base for companies to locate their regional headquarters for Mainland China is further enhanced by the new tax laws in China which impose a 5% WTD remitted by companies in Mainland China to Hong Kong, while the WTD rate would be 10% for most other jurisdictions.
69. However, the new tax laws in China effective since 1 January 2008 have also introduced other new WTD provisions, such that Mainland Chinese companies using Hong Kong as the base for overseas operations may have to face higher WTD remitted from their overseas subsidiaries, as compared to the case if they had chosen some other jurisdictions, such as Singapore. To remedy this problem, Hong Kong needs to have more double-tax agreements with other economies. Today, Singapore has signed about 60 such agreements and Hong Kong has signed only six.
70. The subject of double-tax agreements should have been pursued more aggressively in the past when other economies were more receptive in signing agreements with Hong Kong. Recognising the importance of this subject, the HKSAR Government has taken this subject up

more actively in recent years. But unfortunately, some countries have now become less enthusiastic in signing agreements with Hong Kong. Furthermore, the Government's efforts in this direction in recent years have been hampered by some local businesses opposing to the requirements on exchange of information between tax authorities, a condition that has become a standard clause in most new double-tax agreements. Hong Kong's refusal to accept this exchange of information requirement with overseas jurisdictions is also part of the reason why the Organisation for Economic Co-operation and Development (OECD) once put Hong Kong on its grey list of tax haven jurisdictions and why Hong Kong came under global attention in the G-20 discussions about tax havens in April 2009. While the OECD has since the G-20 meeting dropped Hong Kong from its grey list, a draft bill in the US targeting tax havens is still a threat hanging over Hong Kong.

71. Double-tax agreements are important to Hong Kong as a business centre for regional headquarters, particularly in view of the increasing number of Mainland Chinese companies and institutions "going out". It is important that Hong Kong gets this subject right so that the city could become the best platform for these Mainland companies. A lot of the financial services and other high value-added business and professional services in Hong Kong are targeted at the corporate headquarters of companies, particularly those with cross-boundary businesses. Maintaining and further developing Hong Kong as the most preferred location for regional or global headquarters operations for companies in the region is of utmost importance to the sustained economic development of Hong Kong.

China : Inward FDI flows and outward FDI, 1997-2008



Source: China Statistical Yearbook 2008, China Statistics Report 2008 and UN FDI Statistics

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