Press release

LCQ2: Speculative and high-risk financial products

Wednesday, May 11, 2011

Following is a question by the Hon Mrs Regina Ip and a reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (May 11):

Question:

An eminent political economist has pointed out that since the financial tsunami in 2008, advanced economies especially Europe and the United States are increasingly stringent in their regulation of financial business (such as hedge funds, private equity funds and other alternative investment vehicles, etc) which is of a high-risk and relatively strong speculative nature coupled with the fact that the markets in those places are already saturated, these funds will continue to flood the emerging markets, including China, so as to seek much higher investment returns. The political economist has further pointed out that Hong Kong will continue to be an important base for investing in China, given Hong Kong's low tax regime, mature legal system and geopolitical factors. In this connection, will the Government inform this Council:

(a) whether it knows the total assets, turnovers and total profits in the past three years of the hedge funds, private equity funds and other alternative investment vehicles in Hong Kong at present, as well as the respective percentages of these amounts in the relevant total amounts of the local financial system (please provide annual figures and percentages of increase); how these percentages compare with the relevant figures of other international financial centres, including New York, London, Tokyo and Singapore;

(b) whether the financial institutions which issue the aforesaid investment products are regulated by the Securities and Futures Commission under the Securities and Futures Ordinance at present; of the details of the policy objective and legislative framework for regulating these institutions; and

(c) given the gradual internationalisation of Renminbi (RMB) and the development of Hong Kong as a RMB offshore centre, whether the Government has assessed if the investments in the mainland market or RMB made through Hong Kong by those financial institutions which issue such high-risk and strongly speculative investment products which are of a high-risk and strong speculative nature will have impact on the national financial security?

Reply:

President,

Since the onset of the financial crisis, national authorities and international bodies, including the Group of Twenty (G20) and the Financial Stability Board (FSB), have taken action to review and reform the financial regulatory arrangements including alternative investment vehicles to reduce systemic risks and enhance financial stability. Hong Kong participates in the G20 as part of the China delegation and supports the implementation of the G20's initiatives on financial regulatory reforms. Besides, Hong Kong is an active member of the FSB, which plays a pivotal role in coordinating and monitoring progress in the reforms of the international financial system commissioned by the G20.

Of particular relevance to the question raised is the G20 commitment to subject all systemically important financial institutions, markets and instruments to an appropriate degree of regulation and oversight; and to ensure that national regulators possess the powers for gathering relevant information on material financial institutions, markets and instruments. While the international discussions are still ongoing, the Government in collaboration with our financial regulators have been taking part in relevant information collection exercises and/or taking action to implement some of the key G20 financial regulatory reforms, such as those relating to the regulations of credit rating agencies (CRAs), over-the-counter (OTC) derivatives and hedge funds.

Hong Kong was among the first jurisdictions to have in place a licensing regime for hedge fund managers, in line with the recommendations of G20. Hedge funds, if offered to the public, are authorised and regulated. Besides, hedge fund managers, as with other market participants, trading in our markets are subject to the relevant regulation of that market, such as the Securities and Futures (Contracts Limits and Reportable Positions) Rules and the Securities and Futures (Short Selling Exemption and Stock Lending) Rules. Hedge funds or private equity funds making investments on the Mainland are subject to relevant regulations, such as those on approving remittances of funds into the Mainland and the use of those funds on the Mainland.

My replies to the sub-questions are as follows:

(a) According to the Report of the Survey on Hedge Fund Activities of SFC-licensed Managers/Advisers published by the Securities and Futures Commission (SFC) in March 2011, the number of hedge funds and the total Asset Under Management (AUM) in Hong Kong in the past three years are as follows:

As at	Number of hedge funds	Total AUM (USD billion)
September 30, 2010	538	63.2
March 31, 2009	542	55.3
March 31, 2008	488	90.1

Of the USD 63.2 billion of total hedge fund AUM in Hong Kong as at September 30, 2010, only USD 9.3 billion was invested in Hong Kong and USD 7.6 billion in China. The remaining 73% total hedge fund AUM in Hong Kong was invested overseas. Hedge funds were invested in various asset classes and instruments, the main ones being equities, corporate/sovereign bonds, convertible bonds and credit derivatives, etc. Due to the dynamic nature of hedge fund investments across markets and geographies, a direct comparison between the total hedge fund AUM and any specific sector of the local financial market may not be appropriate.

The income and profit structure of hedge fund managers (HFM) differs amongst the firms, depending on such factors as allocation of fee and cost absorption basis between global offices, role of HFM in Hong Kong (ie advisory or asset management), and fee basis, etc. Certain HFMs act as both advisors and managers, or concurrently manage both hedge funds and non-hedge funds. Therefore, the income and profit figures could relate to a number of activities. The total income (TI) and net profit after tax (NPAT) reported by HFM in the past three years are as follows:

As at	TI (HKD billion)	NPAT (HKD billion)
December 2010	6.3	1.6
December 2009	4.7	1.1
December 2008	6.4	0.7

The hedge fund AUM information pertaining to markets outside Hong Kong is obtained from various public sources. The global hedge fund AUM was estimated at USD 1.7 trillion as at December 2010. Around USD 1.29 trillion in hedge fund AUM is managed in the US, USD 0.27 trillion in the UK, USD 15.6 billion in Tokyo and USD 42 billion in Singapore.

We do not have data on the transaction turnover of hedge funds or their share of the local financial market.

(b) Under the Securities and Futures Ordinance (SFO), fund managers including traditional fund managers, hedge fund managers and private equity managers are licensed and regulated. In respect of funds, they are authorised and regulated where the funds are distributed to the public.

On the international front, the G20 Leaders agreed that for hedge funds or their managers, they will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators necessary for assessment of the systemic risk that they pose individually or collectively.

At present, SFC periodically conducts surveys on hedge fund managers. According to SFC's assessment, at this point the Commission has more information on the funds managed by SFC-licensed hedge fund managers than most other overseas regulators do in respect of the hedge funds managed in their jurisdictions.

In consultation with financial regulators including the SFC, we would consider whether there would be a need to empower the regulator to gather information on alternative investment funds including hedge funds; whether there would be a need to develop criteria to identify systemically important intermediaries; and whether further regulatory requirements would be necessary, having regard to the discussions at the international arenas and the local market conditions.

(c) Mainland authorities have expanded the cross-border use of Renminbi (RMB) for trade settlement and investments. The development of Hong Kong's RMB offshore business follows the principles of steady growth and that risks are manageable. For the past year or so, RMB business in Hong Kong has developed rapidly, with total RMB deposits increasing to RMB 451.4 billion as at end-March 2011. The deposit base is expected to continue to grow steadily. National financial security has always been our key consideration. We believe that RMB business development in Hong Kong will not pose risks to financial stability on the Mainland, based on the following reasons –

(i) total RMB deposits in Hong Kong was RMB 451.4 billion, which was equivalent only to 0.5% and 4.2% of total assets of Mainland's banking system (RMB 100 trillion) and Hong Kong's banking system (RMB 11 trillion equivalent) respectively;

(ii) total RMB deposits for corporate customers was RMB 297.6 billion as of end-March 2011 (average balance per account was RMB 2.1 million). The deposits were mainly sourced from the net trade receipts from Mainland. These cross-border trade activities are genuine transactions which support real economic activities, and are conducted in accordance with the regulations of Mainland authorities and policies. We are not aware of any financial institutions making use of the conversion window of RMB trade settlement to conduct speculative activities;

(iii) many hedge funds have established offices in Hong Kong to cater for increasing customer bases in Hong Kong and Asian regions owing to the promising business outlook in Asia. Many private equity funds have this kind of direct investments in corporations with potential growth. These are activities that are supportive of real economic activities; and

(iv) at present, our country's capital account has yet to be fully liberalised. Overseas financial institutions including hedge funds are required to apply and obtain permission for the remittances of funds into the Mainland and for accessing investments on the Mainland. Meanwhile, as Mainland's financial market is segregated from that of Hong Kong, the activities of these financial institutions here in the RMB market are insulated from the Mainland. Hong Kong in effect is providing a firewall between onshore and offshore RMB market.

Ends