Development of Hong Kong's Offshore RMB Market as a Leading Centre
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Distinguished guests, ladies and gentlemen

I would like to thank the organiser for inviting me here today. I am delighted to have the opportunity to speak about Hong Kong's role as an offshore RMB market.

As the world's largest offshore RMB centre, as well as the global hub for both RMB trade settlement and offshore RMB financing and wealth management, Hong Kong continues to play an important role in facilitating the transformation of the RMB into an internationally accepted and widely used currency.

We have heard many interesting viewpoints this morning on the increasing use of RMB in business and for trade purposes. What I would like to do is to take you back to the point of origin of the RMB internationalisation story in Mainland China and how Hong Kong played its part in those early days. History, as we know, can be a good teacher. After that, I will touch on the lessons that can be gleaned from Hong Kong's experience in this process as we move closer towards full RMB internationalisation.

Hong Kong's position as the largest offshore RMB centre

Hong Kong is first and foremost an international financial centre that prides itself on its commitment to an open market and fair competition, our strong regulatory institutions that uphold the rule of law, and an open economy with free capital and information flows, which provides certainty, stability and a level playing field. Taken together, these advantages form the foundations of our success as an international financial centre and in turn, Hong Kong's role as a testing ground for the internationalisation of the RMB.

Hong Kong enjoys a unique position of strength in developing its offshore RMB business, thanks to a number of key factors including an important geographical one. The relationship between Mainland China and Hong Kong is summed up by "One Country, Two Systems". Under "One Country", Hong Kong is part of China and close to its fast-changing financial landscape and capital market reforms. Indeed, Hong Kong is both an international market and an offshore market of China, where the Chinese Central government can experiment with policies and reform initiatives, with full confidence that those policies and reform initiatives will be tested with rigor under Hong Kong's transparent system, and be subject to intense external scrutiny.

We are also China's natural global financial centre for very good reasons, not least because Hong Kong has been deeply involved in the Mainland's financial liberalisation since the late 70's. We have a unique geographic position and a long history of close cooperation with Mainland China due to our proximity, and we have been the gateway to Mainland China for decades.

The foundations of this historic and strategic relationship are firmly rooted in the mutual trust and confidence shared by regulators on both sides of the border, buttressed by years of bold experimentation, meticulous risk management and hard-won solutions to achieve the level of integration between the Hong Kong and Mainland markets that we now enjoy.

How the RMB began to cross borders

To understand how this all began, we need to go way back to the point where the RMB first began to venture outside China's borders. In 1978, after an insular China started to usher in modernisation and reforms, trade and personnel exchange between China and her neighbours began to blossom. Traders in the region started to accept payment in RMB. Although the currency was not freely convertible, and there was no avenue to use or bank the RMB in their own countries, these traders were happy to accept the currency which they could use to settle future trades with their Chinese customers.

Now let's press the fast forward button. After 30 years of rapid growth, China is now the world's second largest economy. But a persistent and enormous trade surplus and foreign capital inflows have led to a rapid swelling of China's reserves, causing a "monetary indigestion" due to a substantial international payment imbalance.

To ease this pressure, in 2009 China officially allowed cross border trade settlement in RMB in a pilot scheme covering five Chinese cities. While the policy was clear, the market responded very slowly. The higher cost of funding, and the lack of banking and financial products to hedge and manage the currency gave foreign traders little incentive to settle their trades in RMB.

This situation started to change in 2010, when RMB became easily transferrable within Hong Kong. By 2013, close to 12% of all China's foreign trades were settled in RMB. Today, the RMB has become the second most-used currency in global trade finance, after the USD, and the 7th most-traded currency in the world. So how did we get to this position?

Hong Kong's role in the Internationalisation of the RMB

China started creating inroads into its otherwise closed capital account as early as 2004. Hong Kong was encouraged to develop an infrastructure that allowed individuals to open RMB accounts with banks in Hong Kong. While such RMB funds were not freely transferrable among different account holders, and daily conversions into RMB by each individual was capped at RMB20,000, these transactions do not have to be current account related, and are directly cleared with the People's Bank of China (PBoC).

As Hong Kong began to build a pool of RMB deposits, the first offshore RMB investment products were developed and launched in the form of RMB bonds and treasuries of 2 - 3 year duration issued by Chinese financial institutions and the Chinese Ministry of Finance. While there were restrictions aplenty, these bonds, and the RMB bank accounts underpinning them, served an important function of developing and testing the infrastructure for the circulation of the RMB outside Mainland China, thus creating the very first historic linkage between the offshore and the onshore capital markets.

The year 2010 saw what was arguably the first “Big Bang” event for RMB internationalisation. This happened when Hong Kong signed a clearing amendment agreement with Mainland China under which all corporates and institutions from anywhere in the world could open RMB bank accounts in Hong Kong, and funds in RMB bank accounts became freely transferrable. Hong Kong quickly experienced a flourishing of first-in-the-world offshore RMB investment products – RMB mutual funds, and listed RMB equities and funds. The following year, Hong Kong worked closely with Mainland China to create a new innovation – the RMB Qualified Foreign Institutional Investors programme (RQFII).

The concept of the RQFII is quite simple. It is, at its core, a QFII quota, which China has been giving foreign banks and investors since 2002, allowing them to directly invest in China’s securities market. Unlike the QFII, the RQFII quota is denominated in RMB. The key innovation behind the RQFII is that it uses the Hong Kong asset management platform to successfully connect offshore RMB liquidity with the onshore securities market. Riding on the back of the RQFII, Hong Kong rapidly developed a wide range of RMB investment products.

Meanwhile, other deliberate policy measures were introduced to encourage an orderly flow of the currency under the capital account - foreign direct investments (inbound, FDI) and overseas direct investments (outbound, ODI) could be made directly in RMB. The Chinese Ministry of Finance also commenced a regular programme of issuing government treasuries of different tenors in the Hong Kong market. By the end of Q3 2014, there was a total outstanding value of over RMB11 billion government bonds, some for durations as long as 30 years, with coupon rates ranging from 1.8% to 4.5%.

At the same time, RMB business was also exported to other financial centres. Since 2009, China has entered into swap agreements with a total of 29 central banks[1] , with an aggregate agreed value of RMB3,000 billion. These arrangements give foreign central banks guaranteed access to RMB, which helps them satisfy cross border demands for the currency within their markets.

By 2013, recognising that the financial experiments carried out in Hong Kong had proven successful, China was ready to replicate the experience in other markets. RMB clearing services were gradually expanded and the RQFII scheme was made available to other markets including Taiwan, Singapore, United Kingdom, France, Germany, Korea, Qatar and Canada. Each of these jurisdictions now has a China-designated RMB clearing bank and a modest RQFII quota. I’m sure other markets are waiting in anticipation to join the programme. It appears that the provision of an RQFII quota and a RMB clearing bank arrangement have replaced the giant panda as the most coveted gift for countries who desire new business opportunities with China.

Challenges for Hong Kong

Although the liberalisation of the Mainland economy, in particular, the internationalisation of the RMB through relaxing exchange and capital controls, has generated numerous growth

[1] Those 23 monetary authorities are Korea, Hong Kong, Malaysia, Belarus, Indonesia, Argentina, Iceland, Singapore, New Zealand, Uzbekistan, Mongolia, Kazakhstan, Thailand, Pakistan, United Arab Emirates, Turkey, Australia, Ukraine, Brazil, the United Kingdom, Hungary, Albania and the European Central Bank.

opportunities for Hong Kong, it has also created challenges and uncertainties. With improved market infrastructure and governance in the Mainland market, the gap between Hong Kong and Mainland financial centres is narrowing. In particular, Shanghai has been earmarked to become an international financial centre by 2020 and the recently established Free Trade Zone indicates that some of the market liberalisation measures may first be tested there.

In addition, many of you will no doubt have noticed that China has begun exporting RMB business to other financial centres, all with aspirations to have a bigger role in the unfolding of the global RMB story. We welcome the emergence of this trend.

We do not consider that Hong Kong has the sole, imperative right to develop offshore RMB business. That runs counter to our open and competitive culture and markets. Nor do we consider offshore RMB business as a zero sum game. With an increasing percentage of trade settled in RMB, the global pool of offshore RMB will continue to grow and generate business for financial centres around the world. Different financial centres can contribute to the growth of this pie, from which everyone can benefit.

In fact, I strongly believe that there can and should be increased interaction among different financial centres - to identify strategic areas for collaboration and to explore, together, ways to support the overall growth and development of the wider offshore RMB market.

As mentioned, the RQFII scheme has already been expanded to other overseas markets. I would encourage financial institutions to think creatively, and make use of Hong Kong's deep pool of RMB liquidity and expertise built up over the years to work together to fully utilise the RQFII quota available in different jurisdictions.

New initiatives

Before I conclude, I should mention two developments that have caused quite a bit of excitement in financial circles. The first development is a special initiative called the Shanghai-Hong Kong Stock Connect programme, which I'm sure some of you may have heard of. As the name implies, under the Stock Connect, investors from Hong Kong and around the world will be able to trade directly on the Hong Kong Stock Exchange the 568 Shanghai-listed shares, whereas Mainland China investors will be able to trade directly on the Shanghai Stock Exchange the 266 Hong Kong-listed shares. This also means that upon the implementation of Stock Connect, international investors can invest in the Shanghai A-share market through Hong Kong. As you can imagine, this is a seminal event for the Mainland's financial markets. Through the Stock Connect, Shanghai will effectively become a market open to international capital flows, and in so doing it will be subject to rhythms, rules and discipline of the international market.

Trading through the Shanghai-Hong Kong Stock Connect will commence on Monday, 17 November. I will say that regulators on both ends have worked tirelessly in the background to complete all the work necessary to enable the Stock Connect to simply connect and to ensure that the integrity of the markets and investor protection will be preserved. Underlying this arrangement was the need to connect two markets with two significantly different legal systems, market infrastructures, investment cultures and behaviour. In many respects, the mechanism established to achieve this is ground-breaking. In my view, it creates a blueprint for future cross-border co-operation.

For instance, the system and operational arrangements at the Exchange had to be ready. This included the necessary trading and clearing rules and other relevant rules, the daily and aggregate quota mechanisms and other regulatory and operational arrangements which have now been finalised. The regulatory arrangements for the Stock Connect include a new benchmark for cross-border regulatory operation including the timely provision of client and order data to facilitate real time surveillance of market activity by the SFC and the CSRC.

Just as importantly was the enforcement MoU between the SFC and CSRC that established an enhanced platform for information sharing, alerts, investigative assistance and joint investigations for both regulators. New regulatory arrangements have also been agreed upon on key areas such as investor complaints and addressing extreme market situations.

These arrangements mark a significantly enhanced level of cross-border collaboration between regulators that mirrors the level of connectivity between our markets in terms of systems, regulation of market players and cross border monitoring.

The second development is the proposed arrangement for the mutual recognition of funds between Mainland China and Hong Kong. This initiative will follow after the Stock Connect. Once implemented, the arrangement will allow cross-border offering of funds in Hong Kong and Mainland China and provide more investment options for offshore RMB. For a fund to qualify under this initiative, it must be a SFC-authorized Hong Kong domiciled fund managed by a SFC-licensed fund manager in Hong Kong. The aim is to ensure that there is an effective regulatory handle over the qualified funds and their managers. Also, only simple and regular type of fund products would be covered at the initial stage.

Closing remarks

By sharing Hong Kong's experience, I hope I have given you all an idea of what it takes to be a successful offshore RMB centre.

To compete in the offshore RMB business sector, the necessary ingredients are liquidity, talents and infrastructure. In particular, as China goes through the most difficult phase of its capital market reform which includes opening its capital account and introducing market-based mechanisms for setting its interest rates and exchange rates, it will need new tools, processes, products and solutions to manage price discovery, cross-border capital flows and financial stability. In this, markets around the world have a crucial role to play.

We should therefore pool our liquidity, talent and expertise to work together towards a common goal of taking offshore RMB business to the next level.

Thank you and I wish you all a fruitful second half of the conference.