Proposal on the Mainland-Hong Kong Bond Market Connect
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EXECUTIVE SUMMARY

1. This paper studies the possibility of connecting the Mainland and Hong Kong’s bond markets for retail investors. Since China’s capital account is not fully open yet, it is essential that any investment associated with cross-border capital movement is properly tracked and repatriated back to the Mainland origin upon sale or divestment. Tracing cross-border capital investment in the Mainland and Hong Kong’s bond markets becomes a key challenge. In addition, requirements for retail investors investing respectively in the Mainland and Hong Kong’s bond markets differ. These need to be matched and reconciled.

2. The paper recommends allowing mutual market access for both Mainland and Hong Kong retail investors to each other’s exchange-traded bond market under the prototype of the Shanghai-Hong Kong Stock Connect (Stock Connect) scheme. However, most of the trading of bonds in both Mainland and Hong Kong markets is conducted over-the-counter (OTC). To widen the mutual access, it is thus also recommended to allow both Mainland and Hong Kong retail investors access to each other’s OTC-traded bond market by opening and maintaining a special trading account with designated banks in the Mainland and Hong Kong. This would especially beneficial at a time when the Mainland’s demand for foreign fixed-income products is growing rapidly amid depreciation of RMB.

3. While the paper recommends both the southbound investment by Mainland investors and the northbound investment by Hong Kong investors to commence at the same time, if due to technical reasons, a separate implementation for investment in either direction is also welcome.
BACKGROUND

Mainland Bond Market

Market size and structure

4. The Mainland’s bond market is the third-largest in the world after the US and Japan, with total depository balance of USD8.7 trillion1 as of the end of July 2016. It can mainly be subdivided into: (i) the interbank bond market and (ii) the exchange-traded bond market.

5. China’s interbank bond market (CIBM) is an OTC wholesale market, which accounts for over 90% of outstanding value and 80% of trading settlement of the Mainland’s overall bond market. Participants include mainly financial institutions, including commercial banks, securities companies, insurance companies, and also various investment vehicles, i.e. pension funds, mutual funds and private equity funds. Non-financial companies can trade on the interbank bond market through settlement agent banks.

6. Major products traded on the interbank bond market are policy bank bonds, central bank papers, medium term notes (MTNs), treasury bonds, corporate bonds, financial bonds, local government bonds, collective notes, international development institutions bonds, subordinated bonds, hybrid capital bonds, asset-backed securities, and super short-term commercial papers.

7. By contrast, the exchange-traded bond market is retail-oriented, and accounts for less than 10% of the Mainland’s overall bond market. There are treasury bonds, corporate bonds, convertible bonds and bonds with warrants trading on both the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZE). Exchange-traded corporate bonds can further be classified into “Large Public Offering Bonds” (大公募債券) and “Small Public Offering Bonds” (小公募債券). While qualified investors2 can invest in all types of corporate bonds, retail investors can only invest in large public offering bonds, which are subject to more stringent

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2 Qualified investors of corporate bonds include financial institutions, financial products issued by financial institutions, corporate investors with net assets of not less than RMB10 million, QFIIs and RQFIIs, pension funds and charity funds, individual investors with financial assets of not less than RMB3 million and other qualified investors recognised by the China Securities Regulatory Commission.
listing requirements. These include absence of debt default or delayed payments over the past three years, an AAA credit rating, and a minimum annual average disposable profit of no less than 1.5 times the annual bond interest payments in the latest three financial years. Companies can issue small public offering bonds if they cannot meet these requirements or if they choose to offer the bonds to qualified investors only.

Trading, Clearing and Settlement, and Centralised Custody

8. Interbank bond market trading takes place via the China Foreign Exchange Trade System and National Interbank Funding Center (CFETS), which is the unified trading platform for the interbank bond market. Trades are mostly done through “bilateral negotiation and click-and-deal” mode. The trade data are entered to the CFETS for price transparency. The CFETS also provides an automatic trade matching function.

9. Exchange-traded bonds are traded mainly on the SSE and the SZE.

10. There are three central securities depositories for the Mainland’s bond market: the China Central Depository and Clearing Corporation (CCDC); the Shanghai Clearing House (SHCH); and the China Securities Depository and Clearing Corporation (ChinaClear). The first two, CCDC and SHCH, are responsible for custody of the interbank bond market. Both are also responsible for settlement, and the SHCH for clearing of the interbank bond trading. The ChinaClear is the custodian, settlement and clearing house for the exchange-traded bond market.

11. Mainland retail investors can invest in the Mainland’s bond market through three different ways: (i) invest in the interbank bond market through commercial banks (known as commercial banks’ OTC market), subject to some eligibility criteria; (ii) invest in exchange-traded bonds; and (iii) indirect access to the interbank bond market through investing in commercial banks’ wealth management products.

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3 Corporate investors with net assets of not less than RMB10 million; individual investors with annual income of RMB500,000 or above, financial assets of RMB3 million or more, and more than 2 years of securities investment experience; and any other corporate and individual investors who meet other requirements of the People’s Bank of China and are recognised by participants of the commercial banks’ OTC market, can invest in treasury bonds, local government debts, bonds issued by development and policy banks that have been issued, and also those newly issued debts that are available to investors of the commercial banks’ OTC market. Investors not meeting the above criteria can only invest in bonds with at least AAA credit rating and repos.
Hong Kong’s Bond Market

Market size and structure

12. Hong Kong’s bond market has a size of over USD400 billion⁴. It is an open market for both domestic and foreign issuers and investors, with a wide range of products, including government and corporate bonds, floating-rate notes, corridor notes, index-linked bonds, loan stocks and exchange-fund notes (EFN). Corporate bonds can be:

- Issued in Hong Kong dollars or foreign currency (US Dollar, Euro and RMB being the most common);
- Listed on the Hong Kong Stock Exchange (HKSE) or unlisted (mostly listed);
- Offered to retail and professional investors: Whether listed or unlisted, issuers can select to market bonds to both retail and professional investors, or solely to professional investors. A more comprehensive and detailed prospectus is generally required for public offers (i.e. for both retail and professional investors), whereas a relatively simple form of offer document or term sheet suffices for private placements;
- Traded on OTC market or the HKSE: Most trading of bonds in Hong Kong takes place on OTC market, including listed bonds. Bonds are listed on the exchange mainly due to the “separate requirements” by some mutual funds or unit trusts, which can only buy listed bonds.

Settlement, Clearing and Depositories

13. Central Moneymarkets Units (CMU): Most debt securities, including listed ones, are settled and cleared through the CMU. These debt securities include Exchange-Fund Bills and Notes (EFBNs), government bonds and debt securities issued by both public and private-sector entities. The system also provides depository service for CMU members (i.e. brokers or banks).

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⁴ Include debt securities issued in Hong Kong (in HKD and foreign currencies) and those issued by Hong Kong issuers in Eurobond market.
14. Central Clearing and Settlement System (CCASS): Some listed-debt securities are settled and cleared through the CCASS. CCASS also provides depository service for CCASS participants.

Cross-border investment in the Mainland and Hong Kong’s bond markets

Investing in Mainland bond market by foreigners

15. For foreign institutional investors, Qualified Foreign Institutional Investors (QFIIs) and RMB Qualified Foreign Institutional Investors (RQFIIs) were one of the first to be allowed to invest in both the exchange-traded and the interbank bond markets in the Mainland. However, with the liberalisation of the interbank bond market in 2015, most foreign financial institutions and institutional investors\(^5\) can now invest in the market without pre-approval requirements and individual quotas for medium-to-long term investments.

16. Foreign retail investors can only invest in the Mainland’s bond market (both the exchange-traded and the interbank markets) indirectly through investment in QFII or RQFII funds focusing on the Mainland’s bond market. The Mainland-Hong Kong Mutual Recognition of Funds (MRF) scheme, launched in mid-2015, is another new channel for overseas investors to invest in the Mainland’s bond market. It is a pilot scheme for cross-border investment in some “recognised” funds run by and registered in the Mainland and Hong Kong. Initially, a net quota of RMB300 billion (USD48 billion) was imposed on each way of investment. Funds have to meet some eligibility criteria, such as minimum fund size, location of fund registration and management, and geographical asset allocation, in order to participate in the scheme. As of the end of June 2016, the Securities and Futures Commission of Hong Kong (SFC) has approved 37 Mainland funds\(^6\) with 12 funds (including mixed and bond-only funds)\(^7\) investing in the Mainland’s bond market.

\(^5\) They are foreign central banks, global financial organisations, sovereign wealth funds, commercial lenders, insurance companies, securities firms and asset managers (including, pension funds and charities funds but not hedge funds).

\(^6\) Quarterly Report, April-June 2016, SFC.

\(^7\) List of Southbound China funds under the MRF, ET Net website.
17. Further liberalisation of the interbank bond market to QFIIs and RQFIIs: Since February 2016, along with the opening up of the interbank bond market to foreign financial institutions and institutional investors, QFIIs and RQFIIs are no longer required to get pre-approval to invest in the interbank bond market. For the overall quota, QFIIs are no longer required to get approval from but record-filings to China’s State Administration of Foreign Exchange (SAFE) for application of investment quota that is within the “basic quota”. The “basic quota” is calculated based on the size of QFII’s assets or asset under management, and is subject to a cap of USD5 billion. However, any extra quota on top of the basic one still needs separate approval.

18. Taxation issues: QFIIs and RQFIIs registered in Hong Kong, and investors of recognised Mainland funds under the Mainland-Hong Kong MRF scheme are subject to a withholding income tax of 7% on interest income derived from debt instruments in the Mainland under the avoidance of double taxation arrangement between the Mainland and Hong Kong. Where Mainland bond issuers fail to withhold such withholding income tax on interest at source for foreign investors, the foreign investors need to self-report and pay the relevant Mainland withholding income tax. Currently QFIIs and RQFIIs are not subject to withholding tax on capital gains from trading debt securities.

Current market developments

19. Neither QFII nor RQFII investors are keen on investing in the Mainland’s bond market. As of the end of 2014, only 10% of QFIIs’ total portfolios were invested in the Mainland’s bond market. As of the end of March 2016, there are 65 unlisted RQFII funds and 25 RQFII ETFs approved by the SFC. Only four of 25 RQFII ETFs invest solely in the Mainland’s bond market.

20. Similarly, only one-third of 37 approved Mainland funds under the MRF scheme have invested in the Mainland’s bond market, and only four of them are sole bond funds, as of the end of June 2016.

21. According to recent data, the average trading volume of the four RQFII ETFs investing in the Mainland’s bond market was only 1% of the overall average trading volume of all ETFs listed on the HKSE (Table 1).

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Table 1: Trading volume of RQFII China bond ETFs on the HKSE (May 2016)

<table>
<thead>
<tr>
<th>Name of ETF</th>
<th>Stock code</th>
<th>T/O ('000)</th>
<th>YTD Average Daily T/O ('000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>E Fund Citi Chinese Government Bond 5-10Y Index ETF</td>
<td>82808</td>
<td>2,235</td>
<td>24</td>
</tr>
<tr>
<td>CSOP China Ultra Short-Term Bond ETF</td>
<td>83122</td>
<td>45</td>
<td>200</td>
</tr>
<tr>
<td>iShares RMB Bond Index ETF</td>
<td>83139</td>
<td>-</td>
<td>20</td>
</tr>
<tr>
<td>CSOP China 5Y Treasury Bond ETF</td>
<td>83199</td>
<td>20,199</td>
<td>979</td>
</tr>
<tr>
<td>Average trading vol of all ETFs</td>
<td></td>
<td>509,287</td>
<td>28,705</td>
</tr>
</tbody>
</table>

Source: HKSE

22. Several reasons have contributed to the low demand for Mainland debt investment by foreign investors in the past:

- The CIBM remained relatively closed prior to 2015. QFIIs were only allowed to invest in the market from 2013\(^9\) upon approval by the People’s Bank of China (PBoC). Before 2013, QFIIs could only invest in exchange-traded bonds. In the past, QFIIs were still subject to quota when investing in the interbank bond market. The approval process for participating in the market was lengthy and complex. For instance, Macquarie Bank, which was the first QFII approved by the PBoC to participate in the CIBM, only obtained the green light in September 2013, almost 6 months after the PBoC’s notice to allow QFIIs’ participation in the interbank bond market;

- The large spread in prices between A- and H-shares trading in the Mainland and Hong Kong’s stock markets attracted most foreign investor attention. This effectively reduced the attractiveness of bond investments;

- Low demand for QFII and RQFII products is reflected in the low utilisation rate of the allocated quota for QFIIs and RQFIIs. The total investment quota of QFIIs allotted as of the end of August 2016 was just USD81.5 billion, little more than half the USD150 billion\(^10\) in July 2013. The decline was due to a clean-up of the unused

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\(^9\) While the China Securities Regulatory Commission allowed QFIIs to invest in interbank bond markets since 2012, the PBoC only allowed them to participate in the interbank market in 2013.

\(^10\) China Securities Regulatory Commission news, 12\(^{th}\) July 2013.
quota by SAFE in 2016. In addition, Hong Kong has had a total of RMB270 billion RQFII quota since 2014, but the utilisation rate was low, and only recently topping 90%.

- Although the Mainland has recently stepped up its efforts to open further its domestic bond market, the effect is unfortunately dampened by the recent depreciation of RMB. A long period of appreciation following the liberalisation of RMB in 2005 abruptly ended in early 2014, and the downtrend actually gained speed from mid-2015. Investors have since then expected RMB to remain weak in the near-to-medium term, thereby reducing their appetite for RMB-denominated investment products.

**Investing in Hong Kong’s bond market by Mainland investors**

23. Currently, Mainland investors can invest in Hong Kong’s bond market through QDII and RQDII funds. They can also invest in Hong Kong bond funds that are sold in the Mainland under the Mainland-Hong Kong MRF scheme (see description in paragraph 16).

24. Taxation issues: Individual investors are waived from the Mainland’s income tax on gains from transfer of units in recognised Hong Kong funds sold in the Mainland during the three-year period from 18 December 2015 to 17 December 2018; they are subject to the Mainland’s income tax of 20% on distributions by the funds. However, corporate investors are subject to corporate income taxes on both gains from transfer of the units of funds and distributions received from recognised Hong Kong funds.

**Current market developments**

25. The share of bond-only funds under the QDII programme is small, at less than 3% of total USD90 billion QDII quota, as at the end of 2Q-2016. The majority of QDII funds invest mainly in the equity market due to the attractiveness of stock returns at the time when the QDII
programme was launched. In addition, there has been no new QDII quota issued since April 2015, but the utilisation rate has only reached over 90%\textsuperscript{11} this year.

26. There remain limited channels for investing in debt markets outside the Mainland for Mainland investors. One year after the Mainland-Hong Kong MRF scheme was launched, only six Hong Kong funds, compared to 37 recognised Mainland funds approved by the SFC, have been approved by the China Securities Regulatory Commission during the first two batches of approval. Only two of them have fixed-income products.

27. The shortage in supply of foreign bond funds has intensified recently due to the sudden strong demand from Mainland investors amid the depreciation of RMB and the sluggish A-share market. Illustrating this, the Mainland’s second-biggest fund company, China Asset Management, recently completed fundraising for its newly-launched overseas bond fund in just one day.\textsuperscript{12}

\textsuperscript{11} Sina news, 25\textsuperscript{th} August 2016.
\textsuperscript{12} Bloomberg News, 26\textsuperscript{th} July 2016.
THE PROPOSAL

Issues

28. Since China’s capital account is not fully open yet, it is essential that any cross-border capital investment is properly tracked, and repatriated back to the Mainland origin upon sale or divestment. Tracing cross-border capital movement for investment in the Mainland and Hong Kong’s bond markets is a key challenge. Unlike equity investment under the Stock Connect scheme, in which stocks are traded at the stock exchanges and individual’s accounts, and trading activities can be traced easily and be contained within the system of the Stock Connect scheme. Once a holding is sold, funds are repatriated to the origin-account held by the investor. This fulfils the capital restriction requirement that funds cannot be diverted for other purposes outside the country upon divestment.

29. In addition, requirements for retail investors investing in the CIBM and Hong Kong’s bond market differ. Domestic retail investors in the Mainland can buy various government-related bonds\(^\text{13}\) through the commercial banks’ OTC market, if they meet the minimum financial and investment experience requirements (i.e. annual income of RMB 500,000, financial assets of RMB 3 million and more than 2 years of securities-investment experience for individual investors; and minimum net assets of RMB10 million for corporate investors). However, there is no such requirement in Hong Kong for investors to trade in the local or overseas bond markets, as long as the bonds are offered also to retail investors.

Recommendations

Allow mutual market access for both Mainland and Hong Kong retail investors to invest in each other’s exchange-traded bond market under the prototype of the Stock Connect scheme

\(^{13}\) Include treasury bonds, local government debts, bonds issued by development and policy banks that have been issued, and also those newly issued debts that are available to investors of the commercial banks’ OTC market. Investors not meeting the above criteria can only invest in bonds with at least AAA credit rating and repos.
30. This can be done through the same trading mechanism of the Stock Connect scheme, but will be limited to bonds that are available to retail investors in both exchanges and CCASS-settled bonds traded on the HKSE.¹⁴

31. Under the Stock Connect scheme, the HKSE’s Shanghai subsidiary, which is the non-member trading participant of the SSE, acts as the general broker for HKSE participants who are eligible to trade through the Stock Connect scheme, and places the northbound orders to the SSE. The Hong Kong Securities Clearing Company Limited (HKSCC), which is a participant of ChinaClear, acts as “clearing agency” for its CCASS participants to settle trades directly with ChinaClear in respect of northbound trades. Investors hold SSE securities through their brokers/custodians’ own record (no depository slip is available as SSE securities are issued in scripless form), but HKSCC is the shareholder on record of SSE listed companies. Therefore, HKSCC also provides nominee and other related services for the northbound trades. Similar trading and settlement mechanisms can also be applied to the southbound trades.

Allow mutual market access for both Mainland and Hong Kong retail investors to invest in each other’s OTC bond market by opening and maintaining a special trading account with designated banks (designated “Bond Connect” account)

32. Please refer to Appendix “Proposed Operating Model and Implementation Issues” for details on establishment and operations of the designated “Bond Connect” account.

33. For the restrictions as mentioned in paragraph 29 for Mainland investors who can invest in the CIBM through the commercial banks’ OTC market, it is recommended that the Mainland may waive overseas investors from the application of local investor criteria, if they wish to invest in the interbank bond market through designated commercial banks which have operations in both Hong Kong and the Mainland (including Mainland banks and foreign banks) and are members of the CIBM.

34. For Mainland investors who wish to invest in Hong Kong’s OTC bond market, similar local investor criteria can also be applied, i.e. investors who meet all the criteria for investing in

¹⁴ There are CCASS-settled and non-CCASS-settled bonds traded on the HKSE. The buyer and seller of non-CCASS settled bonds will separately work with their brokers and agree on the settlement arrangements and settlement amount.
the CIBM through the commercial banks’ OTC market, can invest in all of the OTC-traded bonds which are available to retail investors in Hong Kong. Those not meeting the criteria can only invest in bonds with at least AAA credit rating. This will involve the use of designated banks in Hong Kong, which also have operations in the Mainland as well as are the CMU members, being the agent banks for Mainland investors.

35. In both northbound and southbound trades, the designated banks will be responsible for placing orders, trading, as well as clearing and settlement on behalf of their customers. They should also provide depository/custodian services for those bonds being traded. The designated banks will be responsible for all cross-border fund flows, including investment, interest payment and principal repayments, in relation to their customers. As such, all fund flows in relation to investors of the two territories can be traced.

36. In Hong Kong, investors can transfer their bond investment, represented by global certificates, from one custody to another without limitation. They do so normally due to price differences offered by different banks or brokers. However, the process will increase the difficulties for authorities to trace the bond holders, which may also involve cumbersome documentation. We therefore suggest restricting investors from changing the custody under the pilot stage of the Mainland-Hong Kong Bond Connect scheme.
Appendix: Proposed Operating Model and Implementation Issues of the Bond Connect scheme (Southbound investment by Mainland investors)

1. Proposed Operating Model

Chart 1: Account opening and maintenance flow:

1.1 Account Opening

1.1.1 Mainland investors can open only ONE designated account with ONE authorised bank in the Mainland; subject to a set of criteria for participation as set out by Mainland regulators.

1.1.2 The designated bank in the Mainland will be responsible for conducting an “eligibility check” and the Know Your Customer (KYC) process, which is tailored to comply with account-opening requirements and pre-requisites in both the Mainland and Hong Kong.

1.1.3 Once the designated “Bond Connect” account has been opened, the designated Mainland bank will pass on the necessary account-opening documents to instruct
the counterpart bank in Hong Kong to open the investment account (for custodian of Bonds) and cash account (for settlement) for the customer.

1.2 Ongoing Operating Flow

1.2.1 The quota for each eligible customer is to be monitored and actioned by the designated Mainland bank. The customer will give the relevant cash remittance instructions to the Mainland bank and to the Bond Connect account in Hong Kong.

1.2.2 The counterpart bank in Hong Kong will take direct instructions from the investor on (i) currency exchange, (ii) bonds subscription and redemption, and (iii) cash remittance back to the designated Bond Connect account in the Mainland.

1.2.3 The counterpart bank in Hong Kong will not provide the following in-and-out services on the Bond Connect account: (i) bonds transfer; (ii) cash remittance other than with the designated Bond Connect account in the Mainland.

2. Implementation Issues

2.1 Account Structure and Maintenance

2.1.1 Retail investors - It is suggested to confine the customer’s eligibility to opening just ONE single designated Bond Connect account at ONE authorised bank in the Mainland, paired with corresponding investment account, including a cash account for settlement and a bond account for custodian purpose in the authorised bank in Hong Kong.

2.1.2 Designated banks (the Mainland) – Customer communications on the designated Bond Connect account activities should be sent to customers in compliance with local regulations, including but not limited to account statements and advices, quota usage and monitoring, terms and conditions (T&Cs), etc.
2.1.3 Connected banks (Hong Kong) – Customer communications on investment account activities, transaction history and balance summary should be sent to customers in compliance with local regulations as the financial service provider, including but not limited to account statements and advices, contract notes etc.

2.2 **Customer Eligibility and KYC**

2.2.1. Retail investors – Customer level eligibility will depend on the requirements as determined by regulators for the Bond Connect scheme, on top of which further checks and KYC should be conducted by both banks at account opening to ensure full compliance with local regulations on investment services in the respective jurisdiction, including but not limited to the customer’s asset level, risk profile, product knowledge, investment experience, credit record, etc.

2.2.2. Designated banks (the Mainland) – Responsible for conducting both the eligibility check and the KYC process, which should be tailored to comply with requirements for both the Mainland and Hong Kong. Regulators may consider requiring banks to maintain a dedicated process and linkage between themselves for record reconciliation.

2.2.3. Connected banks (Hong Kong) – System enhancement or additional indicators to differentiate the designated Bond Connect accounts may be necessary.

2.3 **Product Eligibility**

2.3.1. To maximise options for selection to suit customers’ needs and appetites, it is preferred to make available for trading via the Bond Connect the full list of bonds currently on offer for Hong Kong retail market, subject to the same set of dealing restrictions applicable. This will also minimise compliance risk, and potential system and operations errors.

2.3.2. Eligible bonds should be reviewed on a regular basis for addition and removal.
2.4 *Sales and Distribution*

2.4.1. The current sales and distribution model of bonds in Hong Kong should prevail, with full compliance with the end-to-end sales process, including investment objectives, suitability checking, dealing restrictions, etc.

2.5 *Taxation Treatment*

2.5.1. Well-established tax policies for the Bond Connect scheme are required in both the Mainland and Hong Kong to clearly address how tax rules are applicable to investors under the scheme.

2.5.2. For example, a withholding system shall be established in the Mainland for listed and unlisted bond interest payable to foreign investors to create an efficient tax compliance and collection platform. Similarly, Hong Kong taxation rules and Inland Revenue Department's practice shall also be reviewed and amended as appropriate to facilitate the growth of listed and unlisted bonds markets in Hong Kong.

*A reversed, but similar, operating model can be applied on northbound investment by Hong Kong investors under the proposed Bond Connect scheme.*
About the Financial Services Development Council

The Hong Kong SAR Government announced in January 2013 the establishment of the Financial Services Development Council (FSDC) as a high-level and cross-sector platform to engage the industry and formulate proposals to promote the further development of Hong Kong’s financial services industry and map out the strategic direction for development. The FSDC advises the Government on areas related to diversifying the financial services industry, enhancing Hong Kong’s position and functions as an international financial centre of our country and in the region, and further consolidating our competitiveness through leveraging the Mainland to become more global.

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