

Proposal by TFEC Member Mr K C Leong  
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H Shares Tracker in RMB

1. The H Shares Tracker is a collective investment fund with an objective to provide investment results that closely correspond to the performance of the Hang Seng China Enterprise Index (HSCEI).
2. It is proposed to introduce an H Share Tracker to be traded in RMB.
3. Technically,ETF and index tracking products are very standard in the market. This will not be further discussed.
4. In the following, I shall put down the rationale why this is the time to introduce H Share Tracker in RMB.
5. In this global financial tsunami, it is clear that the economic order is going to change. China is coming out in a relatively better position than many of the matured western economies. Market consensus is that while the US and the European economies, including Britain, will take a long “L” to recover, Asian economies excluding Japan, led by China, may have a good chance to have a “U” recovery.
6. Hong Kong, being part of China, must ride this megatrend. And that is to co-develop the China-Hong Kong-International financial market with China.
7. There are several issues in the Chinese financial market.
  - a. There is a huge amount of savings which needs to be channeled into investment. But there are not enough investment products in the domestic market.
  - b. The Chinese capital market is still in an early stage of development. The efficiency of capital formation has room to improve.
  - c. The balance of payment with huge surplus of foreign exchange reserve is putting pressure on the macro economic system domestically and globally.

8. What is the role for Hong Kong given the above?
  - a. Ideally, Hong Kong financial institutions including banks can extend their business operations in China.
  - b. Hong Kong can help to design and provide products for the Chinese market.
  - c. Hong Kong can provide a platform for Chinese financial institutions including banks to go international.
  - d. Hong Kong can provide a testing ground for RMB towards convertibility.
  - e. Hong Kong can co-operate to develop a China-Hong Kong-International infrastructure, with sound risk management as a priority.
9. 7. and 8. demonstrate the tremendous potential and opportunities for a China-Hong Kong-International regime.
10. To develop this China-Hong Kong-International financial regime would take time. There are many issues to tackle. There are different concepts and expectations between policy makers, regulators and market stakeholders to iron out.
11. An easier approach would be to develop less ambitious products to test out the market, the regulators and policy makers. The merit is to build up confidence of all stakeholders step by step.
12. ETF of HSCEI traded in RMB in Hong Kong is one idea.
13. We can design a completely closed investment tunnel for Mainland Chinese investors. For example, only the front offices of the Chinese authorized banks and financial institutions in China can handle this product. All the RMB will be channeled through Bank of China (BOC), which is already the clearing bank for RMB in Hong Kong. When the Chinese investors sell out the units, the fund must go through BOC to channel back to the accounts of the corresponding banks or financial institutions inside China.

- There will be no ‘leaking’ in RMB in this process, but investors have to bear the exchange risk of RMB-HKD.
14. There will be a ‘tap’ mechanism of the ETF so that new units can be created or cancelled.
  15. The ‘tap’ mechanism actually provides an opportunity to equalize the price difference between the H share market and the A share market. More important, this mechanism can be a channel for easing the pressure of non-tradable shares in China. New units can be created in baskets for these non-tradable shares. And this would not create more pressure in the market because new units are created only when there is a demand.
  16. Under this scheme, Mainland investors can only trade this ETF. They are not able to trade individual shares that they are unfamiliar with. Speculators or insiders cannot take advantage to move the price of individual shares in the market thereby reducing the risk of the investors. Investors are buying and selling a basket of shares of which many of them have State-owned Assets Supervision and Administration Commission of the State Council being a shareholder.
  17. By introducing a small product like this would give a very good opportunity for policy makers, and regulators to work on a China-Hong Kong-International platform of which RMB-HKD is the medium of exchange. This co-operation will provide an opportunity for all parties concerned to look into the infrastructure of the China-Hong Kong-International platform and the risk management issues associated at a practical and operational level.
  18. This product will give a new perspective for Chinese investors to participate in an international market. At the same time, this will give a product for the authorized banks and financial institutions in China to sell. QDII products, most of which failed, have a tarnished image and are giving bad memory to investors; this will serve as an alternative

and a new starting point to restore confidence in investing in Hong Kong.

19. For Hong Kong and international investors, the introduction of this product also shows that Mainland Chinese funds are going into the market, which will provide definitely a feel good and confidence booster.
20. If this is to go ahead, the simplicity of the product means that there are sufficient Hong Kong and Mainland Chinese talents to handle and manage the product. This will not only create employment at this moment but to give a good opportunity to build up a reliable team as the concept of China-Hong Kong-International platform expands.
21. If successful, other types of ETF trading in RMB can be introduced in Hong Kong. This will offer a wide spectrum of products to Mainland investors. This will also enhance Hong Kong as the ETF centre in Asia; further consolidate the image that Hong Kong is the international financial centre of China.
22. This is a concept only. There are many technical issues to be covered. The products itself is plain vanilla. The more concerned issues are in clearing and settlement, risk management and short selling etc. If this concept is worth exploring, a small group should be put together to implement it.