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REPORT
Hong Kong's Role in Chinese Capital Formation

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Hong Kong's role in China's capital market formation

Hong Kong's role as a global financial hub and capital market for China has come under scrutiny in recent months with the recent passage of the National Security Law and deteriorating US-China relations. On October 2nd, Alison Schonberg, a business advisory services manager at the US-China Business Council, hosted a panel on Hong Kong's role in China's capital formation under recent political and macroeconomic trends.

China's successful rebound from COVID-19 and recent activity in the Hong Kong Exchange show that demand for capital from Mainland Chinese companies remains strong, and Hong Kong remains the preferred place for these companies to raise capital.

The following is a detailed synopsis on Hong Kong's future role in Chinese capital markets, featuring:

John Malloy – Portfolio Manager of Emerging Market Strategy at RWC Partners

Andy Rothman – Investment Strategist, Matthews Asia

Becky Liu – Head of China Macro Strategy for Standard Chartered

This conversation involves an in-depth discussion on the importance and stability generated by the Hong Kong Dollar Peg, Hong Kong being a beneficiary of any potential US efforts to force the delisting of Chinese firms who fail to comply with US audit standards, and the appeal of Chinese technology firms to utilize Hong Kong for either a primary or secondary listing.

Many are rightfully very concerned about the future of Hong Kong because it is not the Hong Kong I knew when I first set foot there in 1994. The city and its capital markets are evolving and are more reflective of China's agenda and less the values of the former colonial powers. Western observers are alarmed, but we can hardly be surprised by the transition.

However, despite hollow protests from foreign investors, Hong Kong will still attract great companies to list there as it remains the ultimate conduit between East and West. The Hong Kong Exchange will benefit tremendously in the years to come.

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Background: Hong Kong's importance to China

Becky Liu: Hong Kong's uniqueness as a financial capital for China remains irreplaceable.

- Hong Kong remains China's most important foreign currency fundraising center despite the emergence of Shanghai and Shenzhen as financial hubs; 60% of China's FDI in 2019 came through Hong Kong.
- As the only place in China where a common law system exists, Hong Kong enjoys similar advantages to other global financial centers such as London, New York, and Singapore.
- The Hong Kong dollar's international status and strong reserve positions allow it to serve as a significant cushion for Chinese companies facing scrutiny from the US government.

Hong Kong as a beneficiary from potential US delisting

Will Hong Kong benefit if the US government takes action to force the delisting of Chinese companies from US stock exchanges? Will these companies list in Hong Kong and other locations?

Andy Rothman: The US' delisting efforts will be a boon to Hong Kong and a detriment to the US capital markets.

Some context:

- The Sarbanes-Oxley Act of 2002 created the Public Company Accounting Oversight Board to audit the workbooks of accounting firms that audit companies listed on US stock exchanges.
- The Chinese government has been reluctant to allow the PCAOB to audit Chinese companies listed in the US.

The number of listings by Chinese firms in US markets this year is still strong, but we can also see that the trend is moving in the other direction. Some very well-known names have already decided on Hong Kong as their secondary or even primary listing. Some friends from the private equity world in China have told me that companies that a year ago would've been trying to list in New York are now looking only at Hong Kong.

Becky Liu: The Hong Kong Dollar has strengthened, despite the national security law, due to an influx of IPOs from Mainland Chinese companies.

Since the imposition of the new law, Hong Kong's aggregate balance indicating the level of excess liquidity in the banking system, has risen by nearly 140%, one of the fastest periods of capital inflows into Hong Kong. This is very different from what people initially expected when the law was proposed.

How would US sanctions on Chinese banks affect Hong Kong?

How likely are US sanctions on Chinese banks under the Hong Kong Autonomy Act? How would it affect Hong Kong as a global financial hub and for financial entities currently operating in Hong Kong?

Becky Liu: The easiest way to attack either Hong Kong's financial system or the Chinese banks' interest in Hong Kong would be targeting the Hong Kong Dollar's peg to the US dollar. Yet doing so means restricting one of the world's largest reserve managers from holding US dollar assets, which undermines the US dollar's reserve currency status. Targeting Hong Kong's financial system will hurt the US dollar more than Hong Kong itself and benefit the Chinese yuan.

It's more likely that the US government could target selected smaller branches of Chinese banks, for example, by restricting their access to the SWIFT system. To prepare for this, China has been actively promoting its digital currency by using new technology for cross border payments, including its own CIPS (China International Payment System), in case of a hard decoupling with the US dollar.

Andy Rothman: The Trump Administration often makes statements that turn out to be challenging to implement and come under sizable pushback from American industry. American companies opposed the WeChat ban, for example, of how it might affect their use of the app in China. There was also pushback on whether the executive order's broad language might impact American investors who own shares and receive dividend payments from Tencent. With the ban now blocked by the courts, the effects have been much less dramatic.

Foreign financial firms and the National Security Law

Will the National Security Law have any impact on Hong Kong's appeal to some foreign, particularly Western financial firms? Will any impact be offset by the entrance of firms and general interest from Mainland China?

Becky Liu: Despite COVID-19 and China-US conflicts, foreign financial institutions continue to enter the Chinese market. There is even less reason to fear doing business in Hong Kong when it promises so many opportunities to capture either Mainland activities or future money to invest in the rest of the world.

Several examples include:

- China's expansion of its Bond Connect programs through Hong Kong's banking system would allow Chinese money to be invested in the rest of the world.

- A Wealth Connect program in the Greater Bay Area would allow Mainland Chinese to purchase mutual funds from US and European asset managers directly.

However, the long-term impact of the Security Law on the financial industry remains to be seen, especially if the common law system is undermined in any way.

Future of the Hong Kong Dollar

Do you see any potential risk to the Hong Kong dollar in the future, either due to US actions or other external factors?

Becky Liu: It is unlikely for the Hong Kong dollar peg to break. Once it touches the strong side of the band, the Hong Kong Monetary Authority would be injecting Hong Kong dollars until the Hong Kong dollar rate drops below the US dollar rate, and the exchange moves toward the weaker side of the band.

Historically, this has all been working very well. The most significant risk is if the Hong Kong Exchange Fund will no longer be able to hold US dollar-denominated assets. That risk is relatively low at this stage. If the Hong Kong dollar touches the lower side of the peg, the HKMA will accumulate US dollars as part of the reserves, unless Hong Kong banks are excluded from a US dollar payment system such as SWIFT, or the Exchange Fund being unable to hold Hong Kong dollar assets.

Homecoming for China's listed companies

Discuss if overseas-listed Chinese companies will continue returning home to the Hong Kong Exchange and even the STAR market. Will these listings remain secondary, or might companies prefer to delist elsewhere for various reasons, including a deteriorating US-China outlook?

John Malloy: While companies such as Ant Financial seeing Hong Kong as a secondary listing opportunity, A-share companies will continue coming to the H-share market. Mainland companies who want to grow will want a subsidiary that can transact overseas instead of being solely onshore. That's another driver that will increase listings within the Hong Kong market.

A dual listing with ADRs is attractive because those shares are fully fungible. We're seeing institutions coming back and holding more of Hong Kong. While probably 80% of the trading with an ADR to H-share will be in the US, 20% in Hong Kong right now, a possible shift over time is another positive for Hong Kong.

Do low taxes help Hong Kong's case?

Does Hong Kong's corporate territorial tax regime — such as offshore profits tax exemption — play any role in Hong Kong's importance as a financial center?

Becky Liu: Hong Kong's low tax environment is helpful, but it's not the biggest reason for Hong Kong to remain an international financial center. None of these financial institutions are based in Hong Kong due to the low tax environment, yet it does help retain financial expertise here to facilitate the system's continued success.

Hong Kong's success is largely hinged on its exclusivity as the only open capital market in the country.

Hong Kong: a haven for Chinese tech companies?

Will Hong Kong be even more critical for secondary or primary listings of Chinese tech companies as the US-China tech competition becomes more heated, and Mainland China places a greater emphasis on developing self-reliance in key and core technologies?

Andy Rothman: It's already happening. Just as the US considers sanctions on China's financial system, the same is happening for Chinese tech companies.

Innovative, privately-run, publicly-listed Chinese companies are increasingly listing either in Shanghai or in Hong Kong, taking advantage of the Mainland's nervousness in doing more business and being more dependent on the US.

John Malloy: Unlike China, the US is not focused on rolling out 5G, autonomous vehicles, AI, and everything else. Frankly, China is catching up very fast. Adopting technology will drive innovation, and the capital markets that feed into it will not just be the NASDAQ, but also Hong Kong and Mainland exchanges.

Hong Kong’s role in the Greater Bay Area

What role will Hong Kong play in the Greater Bay Area initiative?

Despite concerns that Hong Kong's role in China’s financial system was weakening, China emphasized Hong Kong's role as the most important financial center for the Greater Bay Area and the leading offshore R&D center as well.

We’re seeing more pilot programs being planned. The advantage here is that the Greater Bay Area is very close to Hong Kong, and their banks can work out solutions to open up China's capital market step by step. If it’s successful, it could be rolled out nationwide and internationally, too, from Hong Kong to the rest of the world.

Conclusion

Hong Kong’s role in Chinese capital formation could be about to enter a hyper-growth phase, despite the National Security Law. While the direct challenges to the foundations of Hong Kong’s democracy will rightly scare many, this issue is dwarfed by the practicalities of the insatiable capital needs of Mainland technology companies who are looking to be part of Beijing’s efforts for technology self-sufficiency. Coupled with Washington pressure to force Chinese firms benefitting from US listings to comply with US accounting standards, and Hong Kong has the opportunity to play an unprecedented role in the capital raisings of the next generation of Chinese corporate leadership.

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