Report on Hong Kong

Hong Kong is ranked at fourth position on the 2011 Financial Secrecy Index. This ranking is based on a combination of its secrecy score and a scale weighting based on its share of the global market for offshore financial services.

Hong Kong has been assessed with 73 secrecy points out of a potential 100, which places it towards the top end of the secrecy scale (see chart 1 below).

Hong Kong accounts for slightly over 4 per cent of the global market for offshore financial services, making it a large player compared with other secrecy jurisdictions (see chart 2 below), though not on the same scale as huge players such as Luxembourg, UK and the USA.

Chart 1 - How Secretive?

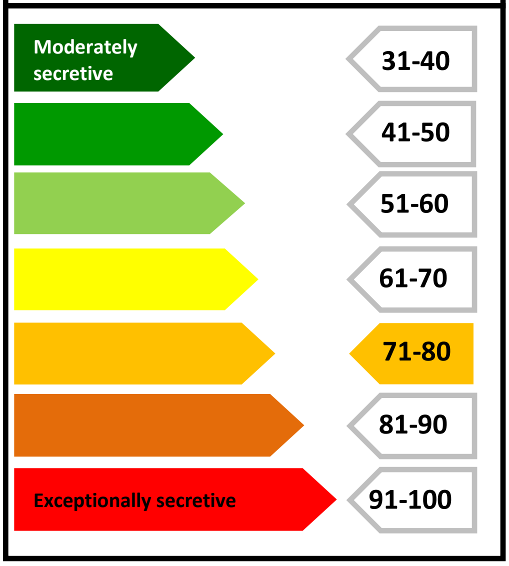
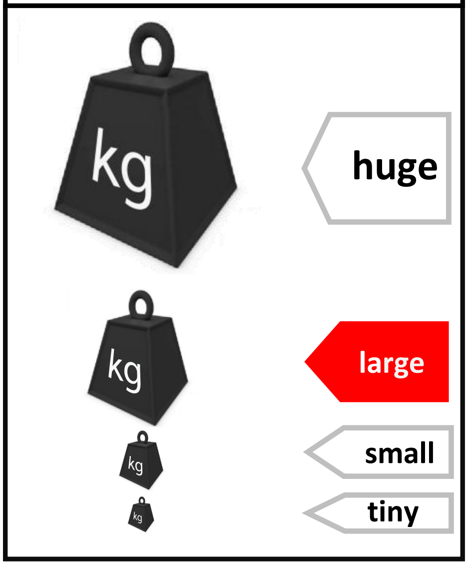


Chart 2 - How Big?



Part 1: Telling the story

The Hong Kong Financial Centre: History and Background

Hong Kong's official designation as a "Special Administrative Region" of China, and its Basic Law stating that it enjoys 'a high degree of autonomy' from China in all matters except foreign relations and defence – points clearly to its 'offshore' status. In this respect the Hong Kong-China link resembles Britain's links with its three Crown Dependencies and 14 Overseas Territories – most of which are secrecy jurisdictions, partly independent from the UK yet also partly linked to and supported by it. This partly-in, partly-out relationship is a crucial ingredient in Hong Kong's growth as a financial centre.

Hong Kong ranks as one of the more secretive jurisdictions on our index, with an opacity score of 73, on a par with Mauritius. It offers a wide range of offshore services, including tax exemptions, strong financial secrecy and the widespread use of opaque companies and trusts that can assist tax evasion and other crimes. There is no formal bank secrecy but in practice secrecy is strict, embedded in common law. Hong Kong also offers a wide array of tax exemptions, as well as an escape from Chinese exchange and capital controls. Hong Kong does not tax capital gains, dividends or deposit interest, and it has no inheritance taxes. For corporations, Hong Kong taxes only income arising in Hong Kong, and profits from overseas trading operations accruing to Hong Kong wealth managers are also generally not taxed. Hong Kong is also widely used as a base for transfer mispricing, where corporations shift profits offshore to escape tax.

Since long before 1997 Hong Kong became well known for a spirit of extreme *laissez-faire* and anti-tax, anti-government attitudes. Some call it 'the freest economy in the world." However, its financial success stems most importantly from its role as a gateway and conduit to China: Hong Kong now accounts for about three fifths of foreign investment into China.

Since a (rather timid) crackdown on tax havens began in the West in 2009, major wealth management business heavily reliant on secrecy has been displaced from financial centres in and around the Atlantic Ocean and towards Asia, notably to Hong Kong and Singapore. Hong Kong has about 150 licenced banks, with Swiss banks and others increasing their presence significantly in the last three years or so. China has supported Hong Kong secrecy facilities in the face of international pressure. When the OECD sought to prepare a 'blacklist' of tax havens in April 2009 at a G20 summit meeting in April 2009, Chinese Premier Hu Jintao worked hard behind the scenes – successfully – to keep Hong Kong and Macau, a much smaller Chinese-linked haven, off the OECD blacklist.

Hong Kong has also, since 2009, begun to serve as a hub to increase the global role of China's Renminbi currency, under long-term Chinese objectives to see it attain global reserve status to rival the U.S. dollar.

History

After China ceded Hong Kong to Britain under the Treaty of Nanking in 1842, the colony of Hong Kong became a unique entrepôt and British commercial gateway to China. Along with shipping and general trading, finance was a central ingredient of Hong Kong's success from the outset. The historians P.J. Cain and A.G. Hopkins (p424) argue that for much of the 19th Century, British policy towards China was anchored in a collaboration principally between the Foreign Office and the Hong Kong-based Hongkong and Shanghai Bank, the forerunner of today's HSBC. A loan to China's Ch'ing dynasty in 1874, the first ever foreign loan issued to China, helped cement the bank and Hong Kong as the key links between China and the City of London.

In the 19th Century and for much of 20th Century, the "difficult" Chinese market never turned out to be the fabled source of riches that many British entrepreneurs had hoped, and

Chinese infrastructure funded by City of London capital even became a cause for Chinese nationalists. "China's present situation," said one Chinese revolutionary leader in around 1910 (p441), "is that if it is not conquered by partition it will be lost by invisible financial control by foreign powers." Still, the City of London increasingly drove British policy in Hong Kong, and by the time of the Chinese revolution in 1911 British policy was no longer dominated by trade and manufacturing, but by finance.

From 1911 China turned inwards, and trade and finance were small, though the turmoil did divert significant trade from Shanghai and elsewhere to the relative stability of British Hong Kong. The Chinese civil war of 1945-49 saw a new influx of Chinese refugees and capital, setting the stage for a period of rapid industrialisation in Hong Kong.

From the early years, British administrators espoused an almost extremist approach to *laissez-faire* capitalism. In the early 20th Century the Scottish banker Sir Charles Addis, a fervent British imperialist and arguably Hong Kong's most influential player then, espoused the predominant world view: "a world in which, ideally, capital new no national frontiers; he had no time for protectionist sentiments or for the special pleading of industrial interests." This *laissez-faire* influence, which is commonplace in the world of secrecy jurisdictions today, set the tone for future economic development. Sir John Cowperthwaite, Hong Kong's Financial Secretary from 1961-1971, had such stridently anti-government views that he refused to collect official statistics for fear they would give government officials too much power. The former Singaporean premier Lee Kuan Yew who visited Hong Kong regularly (p605) described "The few trade unions they had did not fight market forces. . . There was no social contract between the colonial govermnent and [Hong Kong's people.] Unlike Singaporeans they could not and did not defend themselves or their collective insterests. They were not a nation – indeed, were not allowed to become a nation. China would not have permitted it, and the British never tried it." What is often forgotten, however, is that Hong Kong was never, in practice, such a free-marketeer's paradise, and its success was rooted not so much in its economic policies as in its unique position as the key conduit between China and the outside world.

China's Open Door policy announced by Deng Xiaoping in 1978 marked Hong Kong's real emergence as a financial centre and secrecy jurisdiction. Visible trade grew by an astonishing 28 percent per year from 1978-1997, according to the historian Catherine Schenk, and by the time of the British handover in 1997 an estimated 80 percent of foreign investment in China's rapidly industrialising Guangdong province was from Hong Kong. Manufacturing, which began to plateau in about 1990, was eclipsed by a massive growth in finance: from 1981-2000 employment in services sectors such as finance, insurance and business services rose from half to four fifths of the labour market, while manufacturing's share fell from 40 percent to just ten percent.

Years before the handover in 1997, Britain began to consult and negotiate with China on policy changes, in what was known locally as a "through train" to ensure continuity. Britain hoped this would help City of London financial interests maintain the historical foothold they had always maintained in this gateway to China; and today about half of all foreign financial claims on Hong Kong are from British banks.

Hong Kong has also for years served as a major 'round tripping' turntable for China (and for other countries). Essentially, Chinese investors come to Hong Kong, dress up in offshore secrecy, then return to China masquerading (illegally) as foreign investors, to obtain special privileges afforded to foreigners: the State Administration of Foreign Enterprises (SAFE) recently admitted that mainlanders, not foreigners, were significantly behind the flow of speculative 'hot money' into China. Not only that, but Hong Kong has also served, very often, as the location for Chinese bribery and other corrupt activities: business can be conducted in familiar, neaby and Chinese-speaking environment, but significantly protected from scrutiny by the mainland authorities. Large quantities of illicit capital flows are also being attracted to Hong Kong out of other developing countries, particularly those with increasing commercial ties to China. Especially since the 1997 handover, as Chinese seeking to hide funds have worried about China's increased ability to investigate financial affairs in Hong Kong, they have sought to transfer ownership of Hong Kong companies to other secrecy jurisdictions, notably the British Virgin Islands (BVI). Officially, the BVI is the second-largest source of foreign investment into China after Hong Kong. These additional offshore links create deeper secrecy.

Swiss and British banks, displacing activity out of Europe and North America where there have been somewhat stronger official efforts to stamp out tax evasion and criminal money since around 2005, have become increasingly active in Hong Kong and its close rival Singapore. (For instance, court papers involving the Swiss bank UBS, caught helping American taxpayers evade taxes, have shown significant Hong Kong and Singapore connections.) However, Singapore significantly eclipses Hong Kong in terms of private banking: according to the Boston Consulting Group, Hong Kong has US$200bn in private banking assets, to Singapore's $500 bn.

In 2009 China launched a pilot scheme in Hong Kong for the settlement of trade in Renminbi, rather than the U.S. dollar, in what appear to be China's first steps towards an eventual goal of seeing the Renminbi as a global reserve currency. This is potentially of profound geo-strategic importance: having a global reserve currency grants a country enormous fiscal room for manoeuvre. This new development in Hong Kong partly mirrors the period of the 1960s and 1970s, when the United States tolerated the existence of the fast-growing offshore "Eurodollar" market, partly because of its role in internationalising the U.S. dollar and cementing its status as a global reserve currency, allowing the United States to (among other things) fight the Vietnam war without having to worry about paying for it immediately. The offshore Renminbi market is growing rapidly: according to the Hong Kong Monetary Authority, the percentage of Chinese trade settled in Renminbi rose from 0.7% in the first half of 2010 to 7% in the first half of 2011. In September 2011 China and the UK agreed to start developing the City of London, via its age-old Hong Kong links, as another offshore Renminbi trading centre.

Read more:

Catherine Schenk, Economic History of Hong Kong, May 2010

The growth of the private wealth management industry in Singapore and Hong Kong, Capital Markets Law Journal, August 2010

Naomi Rovnick, South China Morning Post: Caribbean tax haven adds heat to China's hot money, May 19, 2011

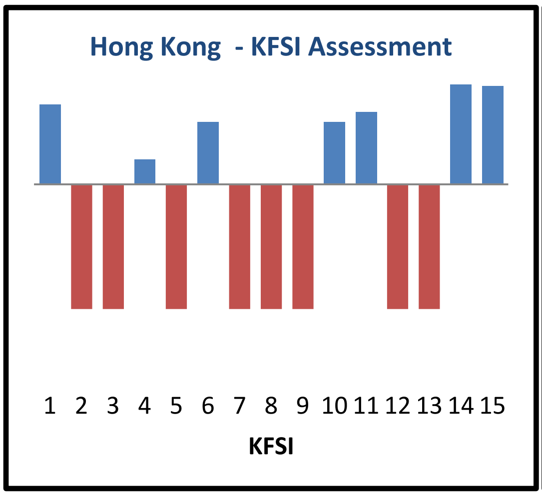
Sun, Sand and lots of hot money, May 19, 2011

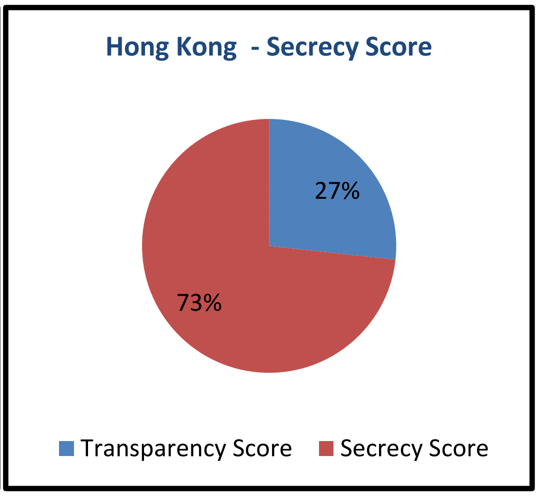
Next steps for Hong Kong

Hong Kong's 73 per cent secrecy score shows that it must still make major progress in offering satisfactory financial transparency[1]. If it wishes to play a full part in the modern financial community and to impede and deter illicit financial flows, including flows originating from tax evasion, aggressive tax avoidance practices, corrupt practices and criminal activities, it should take action on the points noted where it falls short of acceptable international standards. See part 2 below for details of Hong Kong's shortcomings on transparency. See this link http://www.secrecyjurisdictions.com/kfsi for an overview of how each of these shortcomings can be fixed.

Part 2: Secrecy Scores

The secrecy score of 73 per cent for Hong Kong has been computed by assessing the jurisdiction's performance on the 15 Key Financial Secrecy Indicators, listed below.





The numbers on the horizontal axis of the bar chart on the left refer to the Key Financial Secrecy Indicators (KFSI). The presence of a blue bar indicates a positive answer, as does blue text in the KFSI list below. The presence of a red bar indicates a negative answer as does red text in the KFSI list. Where the jurisdiction's performance partly, but not fully complies with a Key Financial Secrecy Indicator, the text is coloured violet in the list below (combination of red and blue).

This paper draws on key data collected on Hong Kong. Our data sources include regulatory reports, legislation, regulation and news available at 31.12.2010[2]. The full data set is available here[3]. Our assessment is based on the 15 Key Financial Secrecy Indicators (KFSIs, below), reflecting the legal and financial arrangements of Hong Kong. Details of these indicators are noted in the following table and all background data can be found on the Mapping Financial Secrecy web site[4]. This data is the basis on which the Financial Secrecy Index[5] is compiled.

The Key Financial Secrecy Indicators and the performance of Hong Kong are:

TRANSPARENCY OF BENEFICIAL OWNERSHIP – Hong Kong	
1.	Banking secrecy: Does the jurisdiction have banking secrecy? **Hong Kong does not adequately curtail banking secrecy**
2.	Trust and Foundations Register: Is there a public register of Trusts and Foundations? **Hong Kong does not put details of trusts on public record**
3.	Recorded Company Ownership: Does the relevant authority obtain and keep updated details of the beneficial ownership of companies? **Hong Kong does not maintain company ownership details in official records**
KEY ASPECTS OF CORPORATE TRANSPARENCY REGULATION – Hong Kong	
4.	Public Company Ownership: Does the relevant authority make details of ownership of companies available on public record online for less than US$10? **Hong Kong partly requires that ownership of companies is put on public record**
5.	Public Company Accounts: Does the relevant authority require that company accounts are made available for inspection by anyone for a fee of less than US$10? **Hong Kong does not require that company accounts be available on public record**
6.	Country-by-Country Reporting: Are companies listed on a national stock exchange required to comply with country-by-country financial reporting? **Hong Kong partly requires country-by-country financial reporting by companies**
EFFICIENCY OF TAX AND FINANCIAL REGULATION – Hong Kong	
7.	Fit for Information Exchange: Are resident paying agents required to report to the domestic tax administration information on payments to non-residents? **Hong Kong does not require resident paying agents to tell the domestic tax**

	authorities about payments to non-residents
8.	Efficiency of Tax Administration: Does the tax administration use taxpayer identifiers for analysing information effectively, and is there a large taxpayer unit? **Hong Kong does not use appropriate tools for effectively analysing tax related information**
9.	Avoids Promoting Tax Evasion: Does the jurisdiction grant unilateral tax credits for foreign tax payments? **Hong Kong does not avoid promoting tax evasion via a tax credit system**
10.	Harmful Legal Vehicles: Does the jurisdiction allow cell companies and trusts with flee clauses? **Hong Kong partly allows harmful legal vehicles**
INTERNATIONAL STANDARDS AND COOPERATION – Hong Kong	
11.	Anti-Money Laundering: Does the jurisdiction comply with the FATF recommendations? **Hong Kong partly complies with international anti-money laundering standards**
12.	Automatic Information Exchange: Does the jurisdiction participate fully in Automatic Information Exchange such as the European Savings Tax Directive? **Hong Kong does not participate fully in Automatic Information Exchange**
13.	Bilateral Treaties: Does the jurisdiction have at least 60 bilateral treaties providing for broad information exchange, covering all tax matters, or is it part of the European Council/OECD convention? **As of June 30, 2010, Hong Kong had no tax information sharing agreements complying with basic OECD requirements**
14.	International Transparency Commitments: Has the jurisdiction ratified the five most relevant international treaties relating to financial transparency? **Hong Kong has partly ratified relevant international treaties relating to financial transparency**
15.	International Judicial Cooperation: Does the jurisdiction cooperate with other states on money laundering and other criminal issues? **Hong Kong partly cooperates with other states on money laundering and other criminal**

[1] Our definition of financial transparency can be found here: http://www.secrecyjurisdictions.com/PDF/FinancialTransparency.pdf.
[2] With the exception of KFSI 13 for which the cut-off date is 30.6.2010. For more details, look at the endnote number 2 in the corresponding KFSI-paper here: http://www.secrecyjurisdictions.com/PDF/13-Bilateral-Treaties.pdf.
[3] That data is available here: http://www.secrecyjurisdictions.com/sj_database/menu.xml.
[4] http://www.secrecyjurisdictions.com.
[5] http://www.financialsecrecyindex.com/.