



HONG KONG MONETARY AUTHORITY
香港金融管理局

(Translation)

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**Report on the Work of the Hong Kong Monetary
Authority**

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Introduction

1. Happy New Year to all Members of the Panel on Financial Affairs! May the financial sector of Hong Kong enjoy prosperity and success in the Year of the Ox and demonstrate the strength and ability to face the challenges arising from the current financial crisis.
2. As in the past, I have provided the Panel with a set of slides with detailed notes in advance. With a host of financial sector-related issues to be dealt with, there are 67 slides in total. But in the interest of time, I will focus only on the more important topics in my presentation. Nevertheless, my colleagues and I are happy to answer any other questions that Members may have.

Second Wave

3. Markets participants have used the term “second wave” to describe the latest developments in global finance. Indeed structural problems in the financial systems, especially the banking sector, in the US and Europe, have come into focus again. The gravity of the financial tsunami, in particular its far-reaching impact on financial institutions, has become better understood as companies’ fourth-quarter 2008 results gradually come out. The last round of what markets regarded as unprecedentedly large rescue plans has proved to be insufficient to bring stability to the financial system, not to mention effective financial intermediation by financial institutions to support the economy.
4. The fact that the financial sector is not functioning normally, with financial institutions not performing the role of financial intermediation properly, has exacerbated the impact on the slumping economy. Immense gloom reigns at all levels, from production to consumption, corporations to households. Comments have been made recently comparing the current situation to that of 1929-30, which marked the advent of the Great Depression. But I personally think this view is overly pessimistic. I believe governments in the US and Europe have the determination and ability to devise and deploy effective measures to turn things around. This is unquestionably a daunting task. The political climate may also be uncongenial to the use of effective but unconventional tools. But current circumstances seem to have shifted to such an extent that consensus can now be reached more easily on the

use of untraditional methods. In the US, the “visible hand” or even the socialist structure characterised by public ownership is no longer as unacceptable as in the past.

5. The key to solving the current problems lies in restoring financial stability, so that financial institutions and the markets can quickly return to normal to support the economy. This will prevent spiral effects of credit tightness and economic slowdown from forming or becoming more severe. On the monetary policy front, credit costs need to be kept low and credit supply eased as much as possible. Nevertheless, banks as intermediaries of credit supply should continue to exercise caution in managing credit risks, which will make it harder for the monetary easing by the central bank at the macro level to be passed on to borrowers. Should this happen, the governments, central banks or commercial banks the majority of whose shares are held by their governments should think out of the box by assuming some of the credit risks by providing credit guarantees or credit. On the fiscal front, an expansionary approach is obviously necessary to stimulate the economy and the job market.

6. The US and European governments are indeed making progress in these directions. Actions to address or pre-empt the impact of the second wave are also expected. These actions will require mobilising a massive amount of resources from a limited supply. Attempts to address the problems through money creation (i.e. printing notes) will have a large impact on sovereign credit and monetary confidence, which may create another source of instability for the monetary and financial sectors. In an era of globalisation, the financial markets are very sensitive to these developments. The volatility seen in the major currencies recently is a clear example of this.

7. Emerging markets should pay particular attention to the contagion effect of the second wave, which I believe may be more potent than that of the first wave. The financial crisis has caused a severe economic downturn in these markets, which may render them more vulnerable; and those with financial sectors that are less robust may be more susceptible to shocks. Regrettably the global financial markets have recently seen a shift in sentiment such that financial institutions and systems that had not required liquidity injection or assistance from their governments have suddenly been put under the spotlight. With the arrays of analyses seen in the market and the announcement of company results, it would not be surprising to see speculative activities. Everyone should be vigilant, seek to understand

more background information, and manage risks prudently taking into account his or her own circumstances.

Exchange rate

8. The fixed exchange rate of the Hong Kong dollar has always been a focus of attention in global financial markets. In an extremely open economy with deep and liquid financial markets, the currency of a fixed exchange rate regime is always of particular interest to market participants. Fortunately the exchange value of the Hong Kong dollar has consistently remained stable. In more than 10 years since the Asian financial crisis, our currency has not been a target of market speculation. In fact, however, factors that may affect market sentiment on the Hong Kong dollar exchange rate have appeared from time to time – the reform of the renminbi exchange rate regime in 2005 was an example. The current once-in-a-century financial tsunami is another unusually sensitive time for the Hong Kong dollar exchange rate, particularly when major currencies have been extremely volatile, causing considerable ripples to other currencies in the region.

9. The long-term stability of the Hong Kong dollar has been a clear goal of the HKMA's continuous efforts over the years to strengthen the Linked Exchange Rate system even in the best of times. A credible fixed-exchange-rate regime can also provide support to the economy in a critical time. During this once-in-a-century crisis, the Hong Kong dollar has, to a certain extent, become a safe haven for capital. Our robust banking sector, 100% deposit protection, and having the Mainland as our economic hinterland are also reasons for the considerable capital inflow seen in the last quarter of 2008. This helped create benign conditions allowing the HKMA to ease the monetary environment to support the economy.

10. While the Hong Kong dollar has been strengthening following the capital inflows since the outbreak of the crisis in mid-September last year, the HKMA has bought a total of US\$23 billion both actively within the Convertibility Zone and passively at the strong-side Convertibility Undertaking, injecting HK\$179 billion into the local money market. In the midst of the global credit crunch, and alongside monetary actions taken by the Federal Reserve, the injection by the HKMA has caused short-term HIBORs to move to near zero. The longer-term rates have also fallen substantially. During this time, not only did the Hong Kong dollar spot rates remain stable and forward discounts narrow, but the one-year forward

rate also returned to within the Convertibility Zone. This reflects the positive response by the market to our operations. There has been no speculative activity against the Hong Kong dollar.

11. However, the risk of a market u-turn remains. Hong Kong cannot be immune to the challenges faced by other emerging markets. Indeed while the Hong Kong dollar has remained strong since the start of 2009, no further net inflows of capital have been recorded. This may be attributable to withdrawals of funds from the sale of Hong Kong-listed Mainland banking shares by foreign investors, offsetting capital inflows. Recently released economic data and operating results of companies (including financial institutions) will undoubtedly create a new force affecting the market and its impact will be reflected in the exchange rate of the Hong Kong dollar. But I believe our monetary and financial sectors are robust enough to accommodate these new market forces. The HKMA will take action as necessary to maintain currency stability and an accommodative monetary environment.

Money market

12. The Hong Kong interbank market was gripped by extreme nervousness when the crisis broke out in mid-September 2008. The HKMA injected liquidity into the interbank market and implemented temporary measures to provide banks affected by the crisis with liquidity, helping the interbank market return to normal. In the past two months or so, despite the looming of the second wave, the interbank market has continued to operate normally. We are therefore inclined to remove these temporary measures at the end of March as planned. However, a final decision will only be made after our review in March. Meanwhile, banks are welcome to let us know their views or suggestions in regard to these arrangements.

13. As the money market is not yet fully developed on the Mainland, some standing arrangements are necessary to enable branches and subsidiaries of Hong Kong banks on the Mainland to obtain renminbi liquidity to meet contingency needs. As reported in my presentation to the Panel last November, the HKMA has signed a currency swap agreement with the People's Bank of China (PBoC), providing liquidity support up to RMB200 billion or HK\$227 billion. One purpose of the currency swap is to provide local-currency liquidity to banks in Hong Kong and Mainland China. Subject to the agreement of the PBoC and the

HKMA, the use of funds obtained from the swap arrangement is unlimited. For example, the funds can be used to help promote the use of renminbi to settle trade transactions between Hong Kong and the Mainland.

14. While tensions in the Hong Kong dollar interbank market have eased, the demand for local currency liquidity is still strong, as shown by activities in the Exchange Fund Bills market. Exchange Fund Bills are highly liquid Hong Kong dollar assets, which are eligible for use at the Discount Window. Although the yields of the paper are not particularly attractive, banks prefer holding them to keeping liquidity in the HKMA's clearing accounts earning no interest. This helps explain the strong demand for the paper. In view of this and the capital inflows since the outbreak of the crisis, the HKMA increased the supply of Exchange Fund Bills by HK\$30 billion. We may further increase the supply depending on market needs. The Aggregate Balance will contract accordingly following these additional issues, but it will not affect the operation of the interbank market. Barring any sudden and substantial outflows of capital, monetary easing will continue. As I mentioned just now, the risk of a market reversal is there but is considered to be low.

The banking system

15. With the once-in-a-century financial crisis affecting the whole world, banks in Europe and the US have been badly hit. Some of them have had to be bailed out by their governments. But the banking system in Hong Kong remains robust and resilient. Hong Kong banks have fared much better than their US and European counterparts. Of course, the falling prices of financial assets, the economic downturn and other unfavourable factors will inevitably affect banks' asset quality and drive up the ratio of non-performing loans. But preliminary figures show that the banks' non-performing loan ratio has only risen from below 1% before the global financial crisis to just above 1% at the end of 2008. Nevertheless, the upward trend is clear and the economy is clearly moving downward. The situation is likely to deteriorate further but we believe that Hong Kong's banking system will remain stable.

16. The capital adequacy ratio of local banks remains high. This enables them to cope with the possibility of rising non-performing loan ratios and incurring losses in the financial markets. The HKMA has also introduced the Contingent Bank Capital Facility and will

adopt a flexible approach to adjusting the “premium” over the statutory capital adequacy ratio on individual local banks to help them maintain adequate capital. Banks are welcome to use these contingent arrangements. We also encourage them to create flexibility in their capital structures to enable them to use these arrangements when necessary. Good capital planning is crucial, particularly during volatile times. In the current economic environment, it is prudent for banks to reassess their capital planning.

17. We understand the worry of some banks that Basel II, which has been implemented in Hong Kong, might create extra burdens for them to meet the minimum capital adequacy ratio requirement in this difficult time. Their concern is understandable. In fact, the risk-based international banking supervisory standards do have a negative effect of enhancing pro-cyclicality in the financial system. The international financial community has become aware of this issue. The Basel Committee and other supervisory forums are currently working on ways to address the problem. The HKMA is actively participating in these discussions. Our flexible approach to the “premium” over the statutory capital adequacy ratio is unprecedented, but the prerequisite is that the “premium” can be adjusted upward during good times. This approach is feasible in Hong Kong but may not be workable in other jurisdictions where capital inadequacy is a long-term phenomenon. Prudent supervision should aim at ensuring that banks conduct their business prudently. It should also aim at making the operation of the banking system counter-cyclical rather than pro-cyclical.

Credit supply

18. With the current economic situation and the low level of activity in new listings and bond issuances in Hong Kong, bank lending is the main channel for financial intermediation to support the economy. The smooth operation of this channel should be the centre of attention, particularly at the policy level. Timely and appropriate actions will need to be taken if necessary to ensure its effective operation.

19. First, at the macro-economic level, the HKMA will seek to maintain a more accommodative monetary environment, reduce the cost of credit and increase credit supply. However, as I have mentioned earlier, an accommodative monetary environment might not necessarily lead to more lending. The prudent regulatory requirement that banks should

manage their credit risk and price the risk reasonably cannot be compromised. Moreover, on a level playing field, a reasonable price should be determined by market forces and intervention is therefore unnecessary. What we should be aware of is whether there is adequate supply of credit when the financial system is under pressure, particularly when financial institutions have to reduce their leverage for various reasons, so as to avoid the emergence of a vicious cycle arising from the interaction between the financial system and the economy. It is difficult to draw a conclusion on this. We also have to take into account the uncertainties in the external environment. But it is still important to find an objective answer and the appropriate policy response.

20. According to the observations of the HKMA, credit provided by banks shrank slightly after the outbreak of the global financial crisis. Lending by retail banks declined by an average of about 3% in the last quarter of 2008. Loans relating to trade finance decreased more significantly by nearly 15%, mainly reflecting the reduction in external trades rather than tightening of credit by banks. The Hong Kong-dollar loan-to-deposit ratio of retail banks also declined to 69.4% at the end of December from 72.9% at the end of September, partly reflecting the quicker increase of Hong Kong dollar deposits due to repatriation of funds and capital inflow.

21. There are signs that, as a result of the tightness in credit supply, some corporations are repatriating funds from overseas to finance their domestic activities. Hong Kong's ratio of overseas assets to GDP is much higher than that of other jurisdictions. Of course, not all borrowers who need financing can repatriate funds from overseas. Bank lending is therefore still crucial to the operations of these borrowers, such as the SMEs, and to the economy as a whole. It is therefore necessary to maintain ample credit supply during the current global financial crisis. The credit guarantee programme introduced by the Government earlier is timely and appropriate.

22. Thanks to the efforts of all parties concerned, I think Hong Kong has successfully avoided the credit crunch that has seriously affected Europe and the US. On the whole, there is adequate credit supply to meet demand. However, things may change significantly in the coming months. There are some estimates that the terms of more than \$100 billion of syndicated loans will expire in 2009. These loans may or may not be extended or restructured particularly when the attitude of some foreign banks may change. Indeed, since

European and US banks may have to address problems at home, they may have to continue to reduce their leverage this year and their overseas operations will be affected as a result. The HKMA will monitor the situation closely and take appropriate actions if necessary.

Lehman incident

23. Chairman, the fact that Hong Kong's banking sector remain robust amid the once-in-a-century financial tsunami, preserving the confidence of millions of depositors and the safety of trillions of dollars of deposits, is something that its counterparts in the US and Europe have not been able to achieve. This is also the fruit of many years of co-operation between the banks and the supervisory authority to ensure that banks conduct their business in a prudent manner. The Lehman incident is something that nobody wishes to see. To put it more accurately, mis-selling of financial products is something that nobody wishes to see. While it is true that no single regulatory and enforcement regime can absolutely prevent mis-selling, the HKMA's stance has always been to process the allegations of mis-selling seriously according to the rules.

24. The HKMA has almost completed the initial assessment of the nearly 20,000 complaints, and has opened investigations in about 5,000 cases. The HKMA has so far reviewed 280 cases involving 15 banks, determining that there are sufficient grounds for referring them to the SFC for it to investigate whether these banks as Registered Institutions have mis-sold financial products and whether enforcement actions are warranted.

25. The HKMA submitted a report on the Lehman incident to the Financial Secretary at the end of 2008. Members may be aware of the 19 recommendations made in the report. The HKMA has already requested the banks to conduct feasibility studies on or implement those recommendations relating to improving sales practices. I shall not repeat the details of the report, on which Mr YK Choi has already briefed the Panel.

Work in the other areas of finance

26. Chairman, in the interest of time, I will skip the reporting of the work of the HKMA in other areas. May I suggest Members refer to the materials submitted to them earlier. Here I would like to highlight three points

27. First, the key to maintaining the role of Hong Kong as an international financial centre is to discharge its function of providing financial-intermediation services between Mainland China and other parts of the world. As the Mainland economy and the pace of liberalisation and reform progress, together with significant changes in global finance, intermediation and economic activities between Mainland China and other parts of the world will obviously move towards using renminbi as the transaction unit. Using Hong Kong's free-market environment and advanced financial infrastructure to provide renminbi-related financial services is the key to maintaining the status of Hong Kong as an international financial centre in accordance with Article 109 of the Basic Law. Renminbi business in Hong Kong has been built on a good foundation thanks to many years of hard work. We look forward to changes on the policy level in China and the creation of a suitable environment for Hong Kong to play its role. Focuses of the HKMA' work in this area include the renminbi-Hong Kong dollar currency-swap agreement, promotion of the use of renminbi to settle transactions and many other recommendations relating to integrating the financial systems of the Mainland and Hong Kong.

28. Secondly, we believe that emerging markets should be more active in expressing their views on issues such as reform of international financial structure, improvements in the rules of global finance and global financial co-operation. Put simply, the financial "tsunami" reflects the exporting of problematic financial operations and products from developed markets to other parts of the world. But the rules of the game of international finance have always been dominated by the developed markets. This bias needs to be balanced. Hong Kong's experience and views in global finance can be a reference in international finance forums. As a member of the Financial Stability Forum, the HKMA will continue to actively participate in its work. The Central Government has invited the HKSAR Government to participate in the G20 Summit and its various working groups as part of the China delegation. The HKMA will actively participate in reforming the rules of the game of international finance, bearing in mind the overall interest of Hong Kong. This is a challenging and time-consuming task, and we will do our best.

29. Thirdly, the once-in-a-century financial "tsunami" has proved that the HKMA has been right to adopt a conservative investment strategy for the Exchange Fund. In 2008 the Fund recorded an investment loss of 5.6%. I shall not repeat the numbers here since they

have already been announced earlier. But I must point out that the fee arrangement between the fiscal reserves and the Exchange Fund enables the use of the Accumulated Surplus of the Fund to stabilise the fiscal income of the HKSAR Government. I am sure this is a welcome development.

30. Chairman, my colleagues and I are happy to answer any questions Members might have about the work of the HKMA.

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