



HONG KONG MONETARY AUTHORITY

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**Briefing to the Legislative Council
Panel on Financial Affairs**

21 May 2009



DISCUSSION TOPICS

Updates on

- **Global Financial and Economic Environment**
- **Currency Stability**
- **Banking Industry**
- **Financial Infrastructure**
- **Hong Kong as an International Financial Centre**
- **The Investment Environment and Performance of the Exchange Fund**



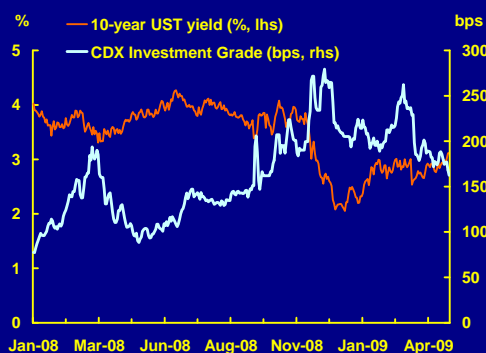
GLOBAL FINANCIAL AND ECONOMIC ENVIRONMENT



FINANCIAL MARKET CONDITIONS STABILISED SOMEWHAT

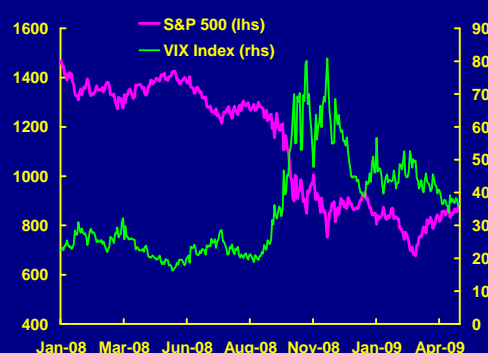
- Some signs of stabilisation have emerged although sentiment remains fragile.

US Treasury yield and CDX index



Source: Bloomberg

S&P 500 and VIX



Source: Bloomberg

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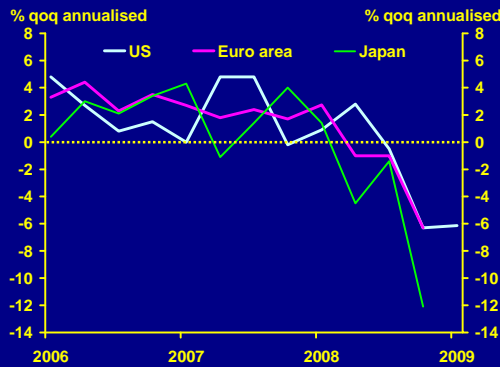
- There are some signs of stabilisation in financial conditions, as CDX indices declined from their previous high levels, suggesting a lower risk of default. (The CDX is one such credit default swap index. A credit default swap index is a benchmark for hedging credit risk or to take a position on a basket of credit entities.)
- Globally, equity markets rebounded from their lows in mid-March, as investor sentiment improved following the G20 meeting and some better-than-expected economic news and financial institutions' earnings results.
- At the same time, market volatility fell from previous high levels.



TENTATIVE SIGNS OF CONTRACTION IS SLOWING BUT RECOVERY REMAINS UNCERTAIN

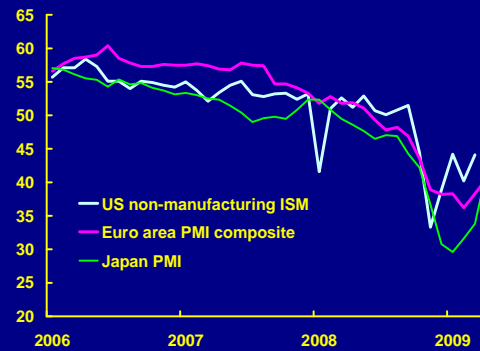
- **Advanced economies are in a deep recession but the rate of contraction slowed.**

GDP: US, Euro area, Japan



Source: Bloomberg

PMI: US, Euro area, Japan



Source: Bloomberg

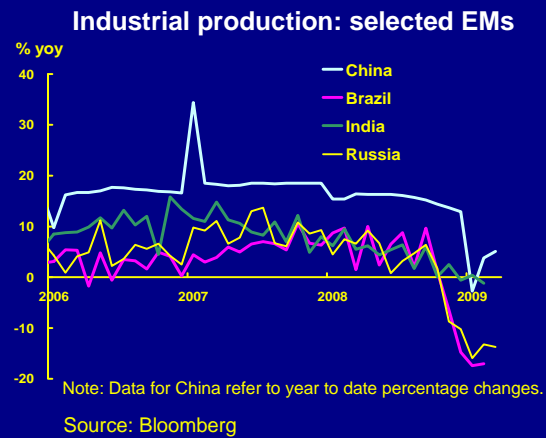
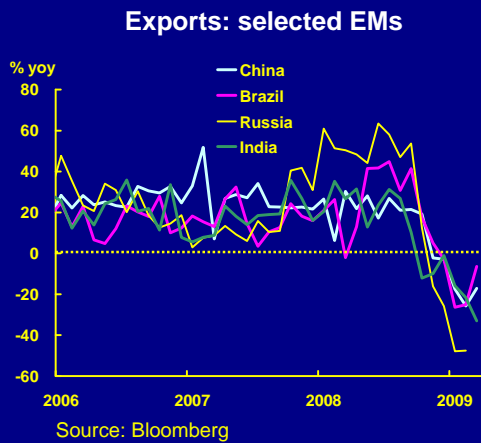
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- The economies of the US, euro area, and Japan have all experienced deep recessions. Private sector spending slowed dramatically, consumer and business confidence was severely undermined, and industrial production and exports also slowed markedly in the face of the global downturn.
- There seem to be some green shoots in the economic outlook – US housing-related indicators for instance show some stabilisation in housing demand. More generally, it appears that the rate of contraction of the US economy has slowed from the sharp rates of Q4 2008. However, recovery remains uncertain.



EMERGING MARKETS IN DOWNTURN

- The downturn in emerging markets continued, although sentiment improved somewhat recently.



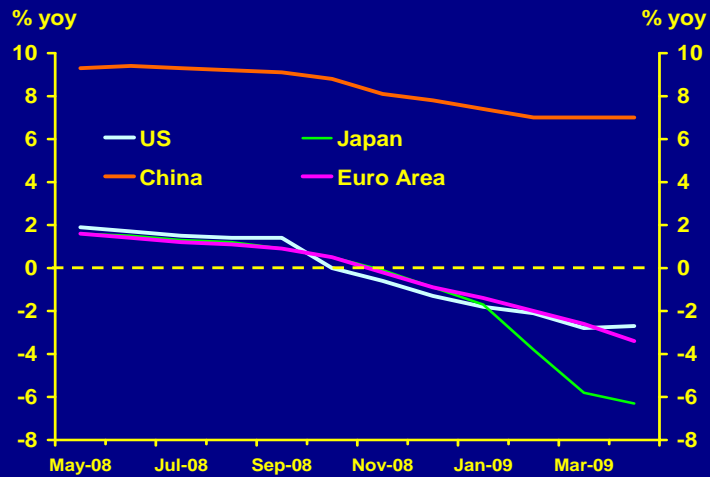
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- The slowdown in emerging markets continued, reflecting slowing exports and industrial production. However, recently, there are some signs that investor sentiment towards emerging markets has improved on a combination of IMF backstop finance and the substantial reduction in exposure to emerging markets that had earlier taken place.



CONTINUED DOWNGRADING OF ECONOMIC FORECASTS

Consensus Forecasts for 2009 growth: US, Euro area, Japan, China



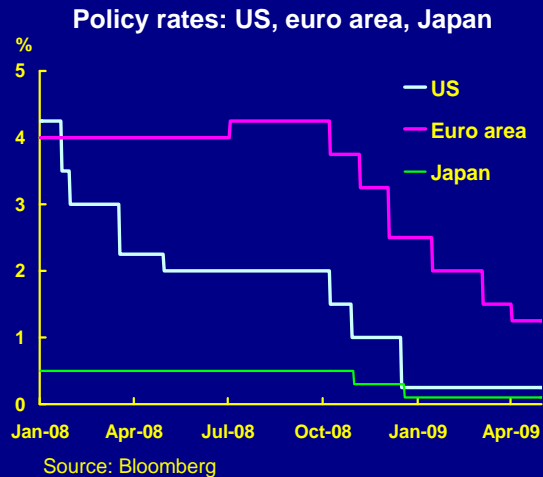
Source: Consensus Forecasts

- The outlook for 2009 remained a gloomy one, as the market revised downward growth forecasts for major economies such as the US, euro area, Japan, and China until most recently.



MONETARY EASING REACHES FLOOR IN SOME ECONOMIES

- Many economies eased monetary policy aggressively to counter growth risks, some to levels where it cannot be lowered any further.



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- The US Fed, for instance, lowered its target for the fed funds rate to a range of 0 – 0.25%; the European Central Bank lowered its refinancing rate to 1.25%, while the Bank of Japan reduced its uncollateralised overnight call rate to 0.1%.



UNCONVENTIONAL MEASURES TO MAINTAIN FINANCIAL STABILITY

- The US Fed, the Bank of England, and the Bank of Japan expanded direct injections of money into credit and corporate bond markets, and bought government bonds.

	Fed	BoE	BoJ
Asset swaps	Term Securities Lending Facility	Special Liquidity Scheme	-
Liquidity programmes	Term Auction Facility Term Asset Backed Securities Loan Facility Primary Dealer Credit Facility Asset-Backed CP Money Market Mutual Fund Facility	Discount Window Facility Additional longer-term repos	Corporate debt financing facility
Private asset purchases	Money Market Investor Funding Commercial Paper Funding Facility GSE purchase	Asset Purchase Facility	Corporate bond purchase Outright purchases of CP
Treasury purchases	Announced purchases of up to \$300 billion in Treasuries	Asset Purchase Facility	Increased purchases of Japanese Government bonds

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- The US Fed, the Bank of England, and the Bank of Japan all expanded their direct injections of money in credit and corporate bond markets, and bought government bonds to increase liquidity supply.
- The Fed has announced that it will purchase up to US\$300 billion in Treasuries, the Bank of England would make £75bn of Gilt purchases, while the Bank of Japan increased purchases of JGBs from banks from ¥1.4 trillion to ¥1.8 trillion a month.
- These measures were introduced to complement monetary-policy easing in efforts to stabilise financial market conditions and improve credit conditions.



FISCAL STIMULUS TO SUPPORT GROWTH

- The introduction of a second round of fiscal stimulus measures in some economies underscored the gravity of the economic situation.

Fiscal stimulus packages recently announced

	US\$ billion	% of GDP	Announced
Japan	\$150	3.0	Apr 2009
US	\$787	5.5	Feb 2009
Italy	\$2.5	0.1	Feb 2009
Australia	\$27	3.9	Feb 2009



IMF RESOURCES BOOSTED

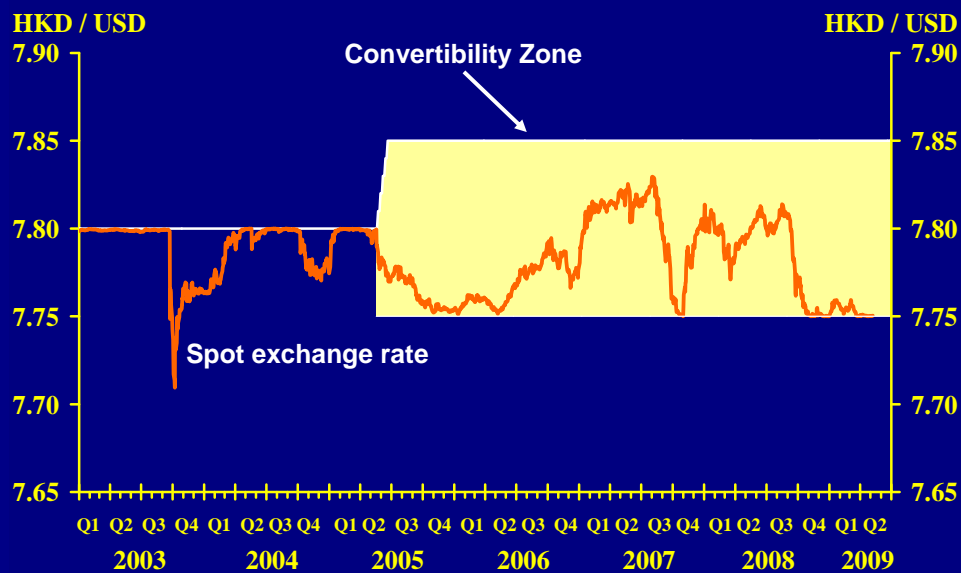
- **G20 agreed to triple IMF resources to US\$750 billion, allowing the IMF to increase its lending capacity and relax its borrowing conditions.**
- **The new IMF Flexible Credit Line offers countries with strong fundamentals access to large sources of funding.**
- **This measure may help reduce liquidity premiums and contagion risks in emerging market economies.**



CURRENCY STABILITY



HK DOLLAR EXCHANGE RATE CLOSE TO STRONG-SIDE CU LEVEL OF 7.75

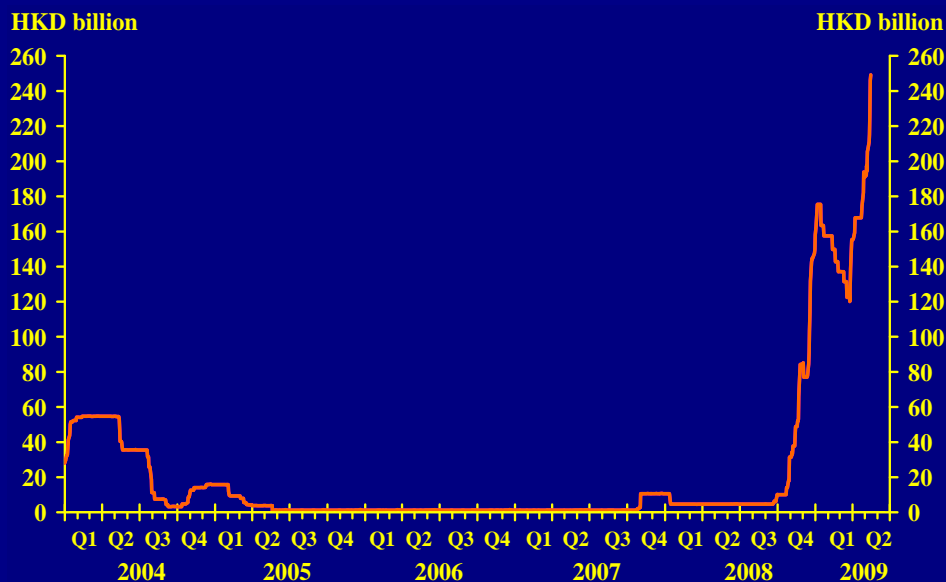


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- The Hong Kong dollar has stayed close to the strong-side Convertibility Undertaking (CU) level since the end of last year.
- Recently, the Hong Kong dollar firmed to near 7.75 again, with the strong-side CU being triggered a number of times since late-March.



AGGREGATE BALANCE REMAINED HIGH

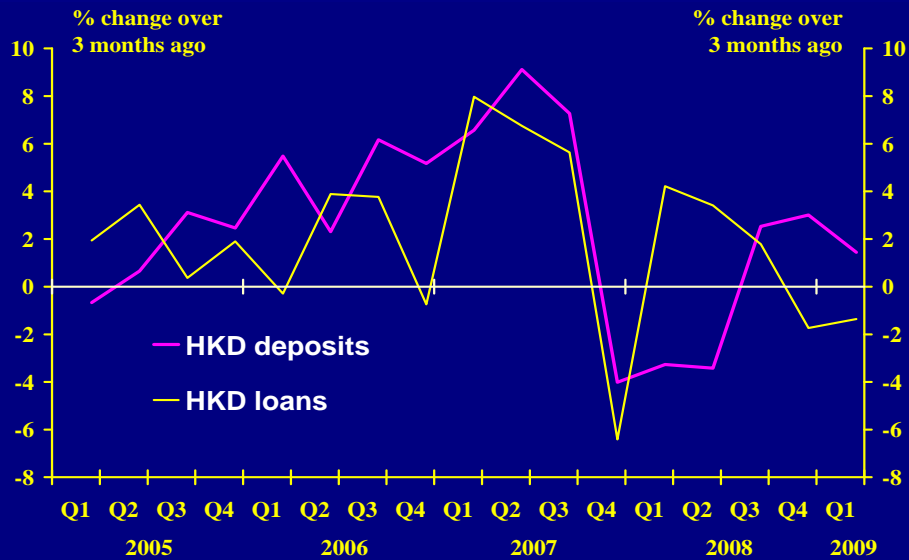


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- Additional issuance of Exchange Fund Bills led to a decrease in the Aggregate Balance (AB) at the beginning of the year. But with the triggering of the strong-side CU since March, the HKMA injected a total of HK\$150 billion into the banking system up until 13 May. The AB stood at HK\$249.2 billion on 15 May 2009.
- The inflows into the Hong Kong dollar were possibly driven by:
 - Repatriation by corporations ahead of the quarter-end and financial year-end in March; and
 - Foreign investors' demand for HK dollars.
- A large AB reflects abundant liquidity in the banking system. Since banks' money in their settlement accounts with the HKMA is interest free, the large AB has helped lower the interest rates and hence the funding costs of banks. The HKMA will monitor closely whether this situation might lead to any behavioral change of banks on the lending and deposit sides.
- While ample liquidity and a loose monetary environment should be conducive to economic recovery, investors should be aware of the risk of transmission to potential inflationary pressure in the asset markets and of any fund flows reversal in the future, especially when the outlook of global economy remains uncertain.



GROWTH IN HK DOLLAR DEPOSITS



Note: Quarter-end figures.

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- HK dollar deposits continued to grow despite contraction in loans, reflecting net inflows into the HK dollar. Indicators compiled by the major equity custodian banks also suggest increased inflows into HK equities.



FORWARD DISCOUNT REMAINED STABLE

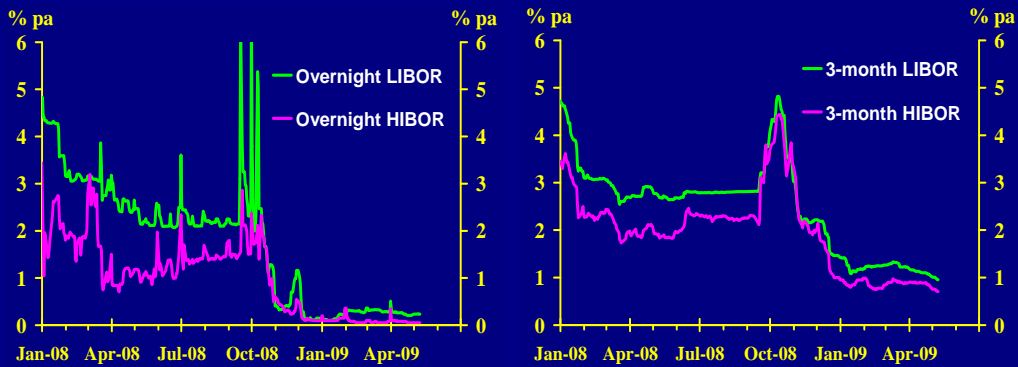


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- The HK dollar forward discount remained stable, which suggests that the recent inflow into the Hong Kong dollar does not relate to exchange-rate speculation.



LOW DOMESTIC INTEREST RATES

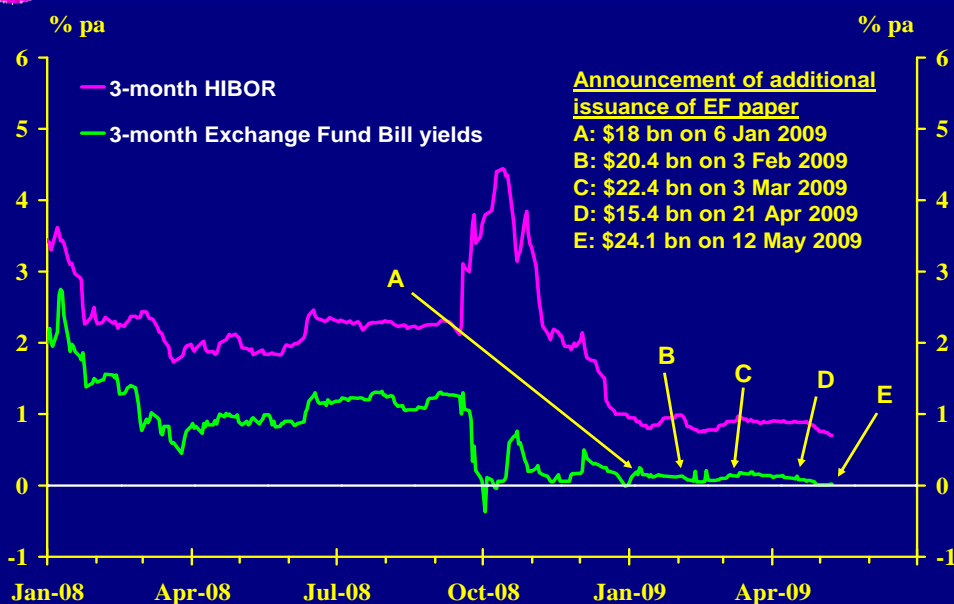


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- Hong Kong dollar interest rates remained fairly stable at low levels and were slightly below their US dollar counterparts, owing in part to the large Aggregate Balance and an improvement in market sentiment. Since the start of the year, overnight HIBOR has remained at near zero levels while the three-month rate has stayed at below 1%.
- Low interbank interest rates and the large Aggregate Balance provided an accommodative monetary environment to support real economic activity.



INCREASED ISSUANCE OF EF PAPER



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- Banks' demand for Exchange Fund paper for liquidity management purposes continued to be strong, as seen in the very low yields of short-dated Exchange Fund paper.
- To meet the strong demand, an additional HK\$82.3 billion worth of Exchange Fund Bills was offered to the market since February, bringing the total additional issuance since October 2008 to HK\$112.3 billion. (Note: these figures include the additional HK\$17.4 billion worth of EFB to be issued on 26 May and 2 June 2009.)
- This increased issuance of the paper was well-received by the market. Owing to the large Aggregate Balance, the additional issuance of the paper did not have significant impact on the exchange rate and interest rates.



REVIEW OF LIQUIDITY ASSISTANCE TO BANKS

Exit arrangements of the five temporary measures:

Expansion of eligible securities for Discount Window (DW) borrowing	Expired 31 Mar 09
Tenor of repo through DW extended to 3 months	
Waive the penalty rate for using over 50% EF paper in accessing the DW	
Conduct FX swaps with banks if needed	Incorporated into ongoing market operations
Offer term lending against collateral if needed	

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- At the end of September 2008, the HKMA introduced five temporary measures to provide liquidity assistance to individual banks to help stabilise the local interbank market. These measures were effective in relieving stress in the interbank market. Only the fourth and fifth measures (i.e. FX swap and term repo with the HKMA) were actually used. With the stabilisation of the local money market in recent months, banks no longer used these temporary measures to borrow liquidity. Nevertheless, since international financial markets have not yet completely returned to normal, it is important that continued assurance should be given to banks that the HKMA will provide them with liquidity in case of need.
- Against this background, the HKMA has decided to incorporate the foreign exchange swap and term repo (against securities of acceptable quality to the HKMA) into its ongoing market operations to offer HK dollar liquidity assistance to banks if needed, on a case-by-case basis. The previous arrangements for the Discount Window (i.e. banks using only Exchange Fund paper for overnight repo) have been resumed to safeguard exchange rate stability under the currency board system.
- The exit from the five temporary measures was well received by the market.



THE “LENDER OF LAST RESORT FRAMEWORK” STRENGTHENED

- **Expand the types of asset and facilities eligible for obtaining HK dollar liquidity by**
 - **Including foreign exchange swaps as one of the basic instruments**
 - **Including securities in foreign currencies with acceptable ratings as eligible securities for repo transactions**

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- The HKMA has also reviewed and strengthened the “Lender of Last Resort (LOLR) framework” for individual banks under liquidity stress by expanding the types of assets and facilities eligible for obtaining HK dollar liquidity more flexibly through the framework.
- Foreign exchange swaps have been included among the basic instruments to be used by HKMA to provide LOLR support, and the definition of eligible securities for repos has also been expanded to include securities in foreign currencies with acceptable ratings.



RISKS TO CURRENCY STABILITY

- **Further downturn in the Hong Kong economy due to deeper-than-expected recessions in developed economies**
- **Volatility in international financial markets will continue due to risks to financial stabilisation in developed markets**
- **Strength and sustainability of the Mainland economic growth falling short of expectations**

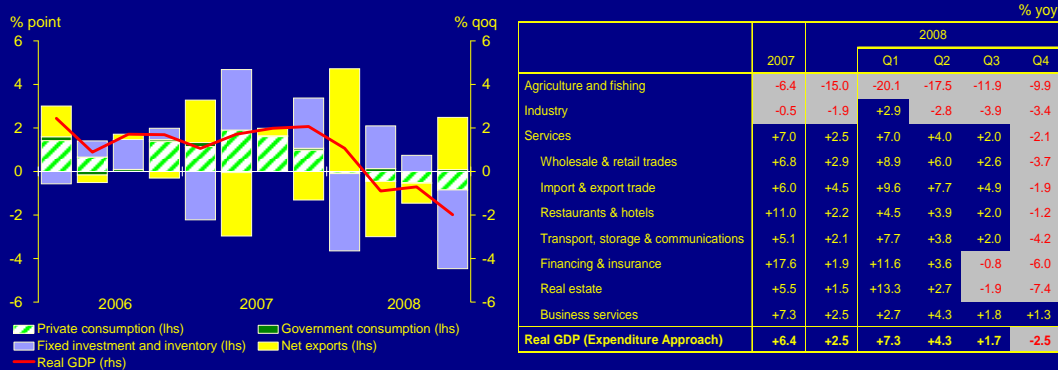
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- There is the risk that fiscal and monetary policies adopted in developed economies may not be sufficient to drag the global economy out of recession. Should this happen, it may translate into further downturn of the HK economy, which in turn will heighten the risk of capital outflow from HK.
- There are still uncertainties over the progress of developed economies in removing toxic assets from and strengthening capital of their banks. The global financial markets will become more volatile if there are renewed concerns about the health of these banking systems.
- There are some signs of pick-up in economic activity in Mainland China, which provides support to Mainland-related stocks listed in Hong Kong. However, if the strength and sustainability of the Mainland's recovery fall short of market expectations, the risk of a sell-off in the Hong Kong stock market may be triggered.



SIGNIFICANT ECONOMIC DOWNTURN IN HONG KONG

- Real GDP has contracted for three consecutive quarters since Q2 2008 amid global downturn and weak local demand
- Economic activity weakened in most sectors, led by finance, insurance and real estate; transport; wholesale and retail



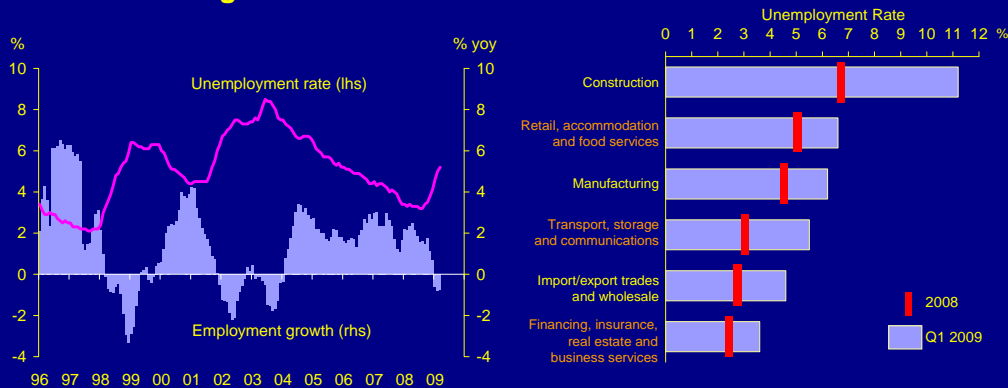
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- Real GDP posted its first year-on-year decline in more than five years, down 2.5% year on year in Q4 after successive quarters of growth moderation. On a seasonally-adjusted quarter-on-quarter comparison, real GDP fell by 2.0% in Q4 2008 after contracting by 0.7% in Q3 and 0.9% in Q2, signifying that the recession was deepening.
- As the global financial crisis intensified and local labour-market conditions deteriorated, private consumption expenditure fell by 3.2% year on year in Q4 2008, after staying flat in Q3. Held back by credit stringency and an uncertain business outlook, overall investment spending declined conspicuously by 17.3% year on year in Q4.
- In value terms, merchandise exports slid by 21.9% year on year in Q1 2009, clearly accelerating from a decline of 2.1% in Q4 2008.
- Economic activity weakened in most sectors. Net output of the services sector fell by 2.1% from a year ago in Q4, mainly led by sectors such as finance and insurance (-6.0%) and real estate (-7.4%).



WORSENING LABOUR MARKET

- **Labour market deteriorated rapidly:**
 - unemployment rate rose to 5.2%, a 3-year high, in March
 - 187,200 persons were unemployed, an increase of 68,200 from a year ago
- **Sectors such as construction, transport, wholesale and retail trades were among the hardest hit.**



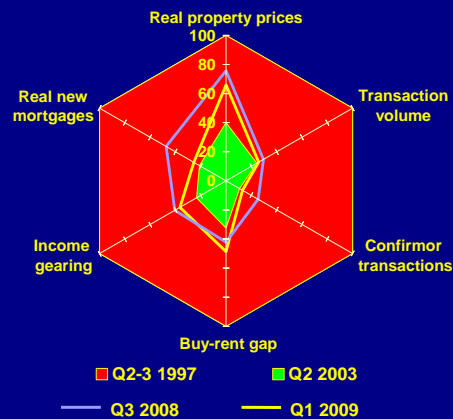
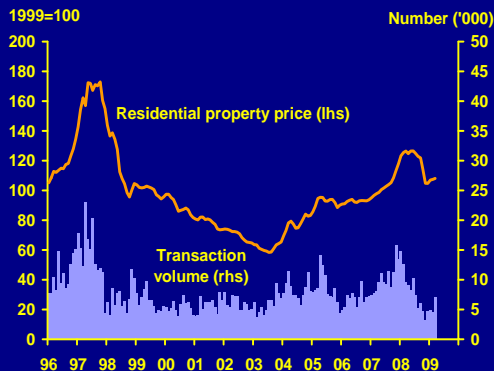
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- The seasonally adjusted three-month moving average unemployment rate climbed to a 3-year high of 5.2% in March 2009 from 5.0% in February and as low as 3.2% in July 2008.
- Total employment fell by 0.6% year on year in January 2009 and 0.8% in both February and March. This marked the first decline in five years.
- Some 187,200 persons were unemployed in March 2009, an increase of 68,200 from a year ago of which 45,900 were added just in Q1. The duration of unemployment lengthened, with 55% being unemployed for over two months in Q4 2008 (as against 50% in Q3).
- The unemployment rate was very high in the construction sector (11.2% in March), followed by retail, restaurants and hotels (6.6%), manufacturing (6.2%), transport (5.5%), and import / export and wholesale (4.6%).
- Given a deepening recession and more company closures and layoffs in the pipeline, the near-term labour market outlook remains grim.



TENTATIVE SIGNS OF STABILISATION IN HOUSING MARKET

- The housing market was buffeted by tight credit conditions and weak economic prospects in late 2008 and early 2009
- Incoming data seem to suggest that home prices have started to rebound and transaction volume has gained some strength



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- In March 2009, residential property prices decreased by 14.5% and transaction volume by 25.6% from the same month a year ago.
- After reaching a recent low in December 2008, home prices stabilised in the past few months. In March, home prices rose for the third consecutive month, by 0.7% month on month. On a quarter-to-quarter comparison, home prices fell by 0.5% in Q1 but the decline was due to the high base in October. This compared favourably with the 12.4% decline in Q4.
- The number of residential mortgage loans in negative equity increased to 10,949 cases (or 2.3% of total mortgage borrowers) at the end of December from 2,568 cases (0.5%) at the end of September. The combined mortgage-delinquency and rescheduled-loan ratio fell to 0.18% in Q1, compared with 0.26% a year ago.
- When compared with previous cycles, there are no major signs of imbalances in the residential property market, with the six indicators staying within their comfort zones relative to the peak in mid-1997 and the trough in mid-2003.

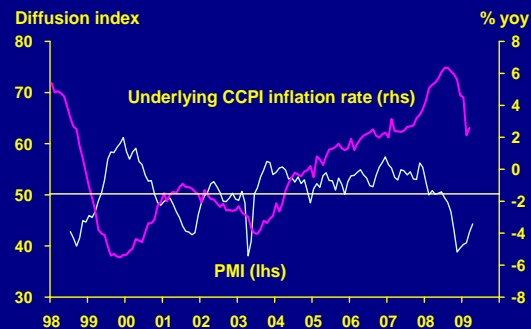


NEAR-TERM ECONOMIC OUTLOOK

- Against the background of an adverse external environment, various forecasts project that Hong Kong economy will contract in 2009
- Inflationary pressure is expected to moderate further with weaker domestic demand
- The Purchasing Managers' Index (PMI) improved to 44.3 in April but still remains inside the contraction zone

Economic forecasts

	2009
GDP Growth (% yoy)	
HKSAR Government (Feb 09)	-2 to -3
IMF (Apr 09)	-4.5
ADB (Mar 09)	-2
Consensus Forecast (Apr 09)	-3.5



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- The outlook for the world economy in 2009 remains bleak. The latest IMF forecast suggests that global output will shrink by 1.3% in 2009, while the World Bank expects a contraction in the volume of world trade in goods and service of 6.1%. Being a regional entrepot and one of the most open economies in the world, Hong Kong is bound to be negatively affected. Various forecasts project that Hong Kong economy will contract in 2009, the first full-year decline since the Asian Financial Crisis.
- Consumer prices have not increased for several months now amid the current economic downturn and the declines in food prices and rental costs. The underlying CCPI price index fell by 0.2% quarter-on-quarter (-0.9% annualised) in Q1, the first decrease since Q3 2004. Although the underlying CCPI inflation rate picked up slightly to 0.2% month-on-month in March from -0.3% in February, this mainly reflected the impact of a 50% tax hike on cigarettes. The underlying inflation is expected to moderate further given the slacks in the global economy and sluggish domestic demand.
- On a year-on-year basis, the underlying consumer price inflation eased to 2.6% in March from 3.3% in January and February combined and 5.6% in 2008.
- The PMI improved to 44.3 in April, increasing for the fifth consecutive month from a recent low of 38.8 in November 2008. Nevertheless, the reading has been below 50, the cut-off line between growth and contraction, since July 2008.



RISKS TO ECONOMIC OUTLOOK

- **The global economic downturn may be deeper and more protracted than expectations, as the IMF and market consensus have repeatedly cut world growth forecasts**
- **Heightened risk of protectionism in different countries**
- **But signs of recovery in China, which if sustained, will provide some support to the Hong Kong economy**
- **There are tentative signs that extraordinary monetary and fiscal actions taken across the globe may be starting to have positive effects**

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- The global economic downturn may be more severe and protracted than market expectation. The IMF and market consensus have repeatedly revised downward the forecasts for world economic growth.
- Political risk of trade and financial protectionism is mounting in different countries, which if realised could jeopardise global economic growth.
- Nevertheless, signs of recovery emerged in China, which if sustained, will provide some support to the Hong Kong economy through the close economic and financial ties.
- There are also initial signs that the extraordinary monetary and fiscal policy measures taken across the globe may be starting to have positive effect on global financial conditions and economic activities. The recent rebound in housing activities in the US and rallies in global equity markets are cases in point.



MAINLAND ECONOMY SHOWED SIGNS OF BOTTOMING OUT

- The Mainland economy showed signs of bottoming out. While the year-on-year growth slowed to a low of 6.1% in Q1 2009, the quarterly comparison indicates a re-acceleration in growth momentum.
- Prices remained soft amid weak aggregate demand. Headline inflation was negative at -0.6% in 2009 Q1, the first time since 2002 Q4, but the decline in consumer prices narrowed in March.
- Investor sentiment is improving as reflected by a 36% gain in stock prices in the first four months of this year. The property market remained weak, but began to show signs of stabilisation.
- Mainland authorities have continued to support the economy
 - Credit expansion has been brisk so far this year, and the PBoC re-affirmed the accommodative monetary stance
 - An expansionary budget was announced in March, and projects under the RMB 4 trillion fiscal stimulus package are being rapidly implemented
- The Central government pro-growth measures are bearing fruit, and the Mainland economy will probably take a lead in the world in the economic recovery. This should help improve Hong Kong's economic prospects.

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- While real GDP growth eased further to 6.1% year on year in Q1, from 6.8% in 2008 Q4, the sequential momentum picked up in the period, indicating a turnaround in economic activities. The latest monthly indicators also showed that the growth momentum gathered pace in the past two months, reflecting the effects of Central government's policy measures. Notably, growth in fixed asset investment accelerated further to 30.3% in March.
- Headline CPI inflation was -0.6% in Q1, down further from 2.5% in 2008 Q4. PPI inflation — an index representing production cost — fell to -4.6% in Q1 from an increase of 2.5% in 2008 Q4, amid the tumbling international commodity prices.
- The Mainland stock market outperformed the global stock markets in the first four months of this year, with Shanghai A-share index rising by 36%, compared to a 3% decline in the MSCI Global Index. Housing prices increased modestly by 0.2% in March from the previous month, reversing the downtrend recorded in the past seven months.
- The Mainland authorities have taken proactive, well-coordinated, and timely actions to support economic growth. Since September 2008, the benchmark lending and deposit rates have been cut by totals of 216 bps and 189 bps respectively, and the RRR has also been reduced significantly. Money and loan growth accelerated to 25.5% and 29.8% respectively in March amidst monetary easing. On the fiscal front, subsequent to the announcement of the RMB 4 trillion package, the government pledged to significantly increase government investment and planned a deficit of RMB 950 billion (around 3% of GDP) for 2009 during the National People's Congress.
- The Mainland economy will probably be among the first in the world to recover, given its strong fundamentals and the Central government's determination to achieve stable growth. This should help improve Hong Kong's economic prospects, in view of the close economic and financial linkages between these economies.



BANKING INDUSTRY



REVIEW OF BANKING SECTOR IN Q1 2009

- **Retail banks' profitability continued to be under stress in Q1 2009**
- **Loan quality remained at comfortable levels despite continued signs of deterioration**
- **Banking sector remains highly liquid**
- **Banks generally remain well capitalised. The HKMA will continue to monitor banks' capital position closely**

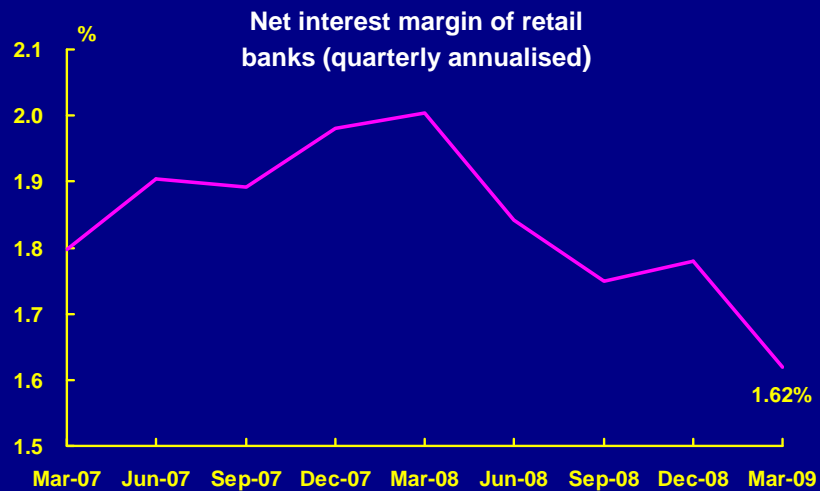
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- Profitability of retail banks continued to be affected by the global crisis. Net interest margin narrowed significantly in Q1 2009.
- Nevertheless, the banking sector remains highly liquid. Local banks in general are well capitalised. With loan quality likely to deteriorate further given the current economic situation, the HKMA will continue to monitor banks' capital position closely.



BANKING SECTOR PERFORMANCE

Net interest margin of retail banks narrowed



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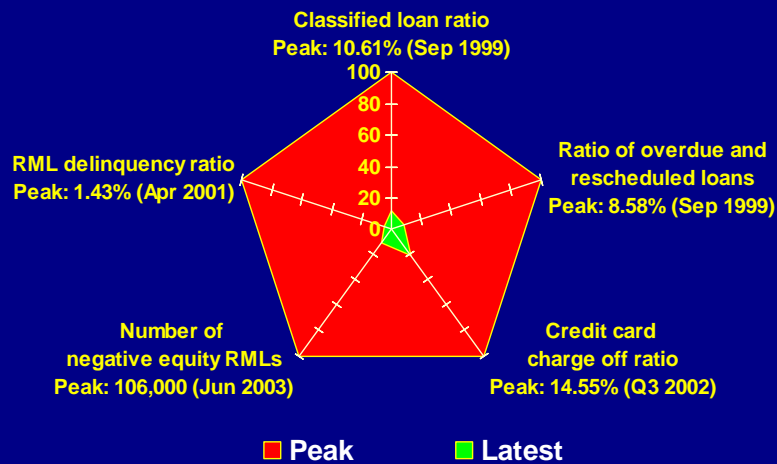
- The aggregate pre-tax operating profit of retail banks' Hong Kong offices declined by 28% in Q1 2009 compared with the same period last year.
- Net interest margin was 1.62% in the first quarter of 2009 compared with 1.78% in the final quarter of 2008.



BANKING SECTOR PERFORMANCE

Loan quality remained at comfortable levels but signs of deterioration were observed

Overview of loan quality



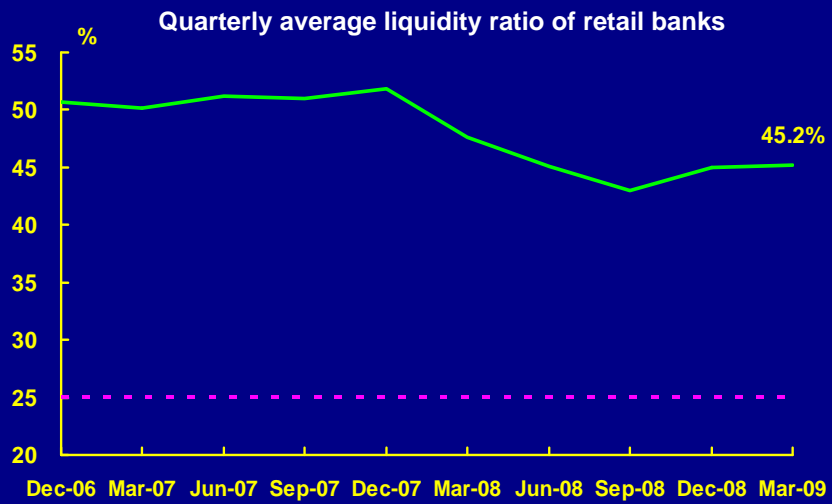
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- Banks' various asset quality indicators remained at comfortable levels, although signs of deterioration continued to be observed. Classified loan ratio increased to 1.24% in Q4 2008 from 0.96% in Q3 2008. The ratio of overdue and rescheduled loans also rose to 0.68% in Q4 2008 from 0.55% in Q3 2008.
- The quality of retail banks' residential mortgage lending was good. At the end of March 2009, the delinquency ratio and the rescheduled loans ratio were 0.05% and 0.13% respectively.
- The credit card delinquency ratio and quarterly annualized charge-off ratio were 0.34% and 3.09% respectively in the final quarter of 2008, compared with 0.31% and 2.74% in the third quarter of 2008.
- The HKMA will monitor the quality of retail banks' loan portfolios closely.



BANKING SECTOR PERFORMANCE

Liquidity level remained high



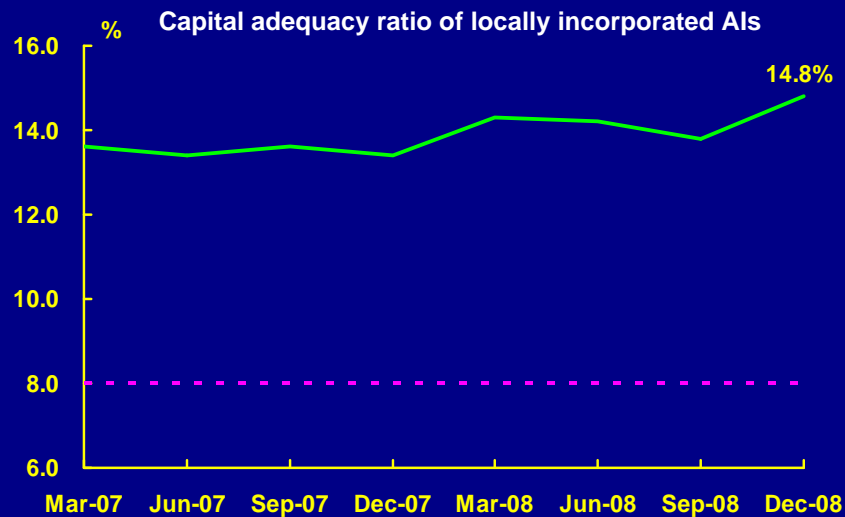
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- The quarterly average liquidity ratio of retail banks was 45.2% in Q1 2009 compared with 45.0% in Q4 2008. The ratio was well above the statutory minimum of 25%.



BANKING SECTOR PERFORMANCE

Local AIs remained well capitalised



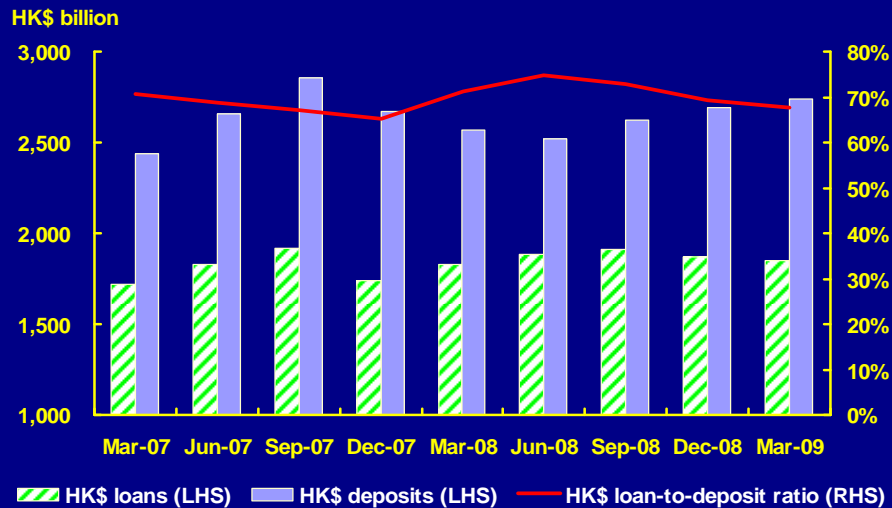
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- Notwithstanding the difficult environment in 2009, local banks in general remained well capitalised. The consolidated capital adequacy ratio of locally incorporated AIs rose to 14.8% at the end of 2008, compared with 13.8% at the end of September. The ratio is well above the international standard.



BANKING SECTOR PERFORMANCE

Hong-Kong-dollar loan-to-deposit ratio fell



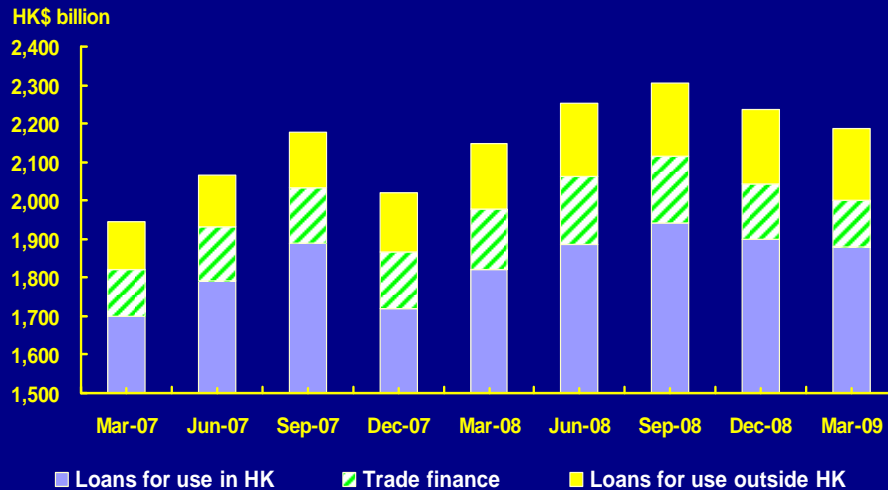
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- The Hong-Kong-dollar loan-to-deposit ratio of retail banks fell to 67.6% at the end of March 2009 from 69.4% at the end of December 2008. Hong-Kong-dollar loans declined while Hong-Kong-dollar deposits increased during the period.
- Since the introduction of full deposit guarantee in October 2008, total deposits of AIs increased by 3%. The HKMA will continue to monitor deposit movement of AIs to guard against any imprudent business practices.



BANKING SECTOR PERFORMANCE

Total loans of retail banks declined



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- Total loans of retail banks declined by 2.2% in Q1 2009. Trade finance related lending fell more notably by 17.1%, as the global economic slowdown had a direct impact on export and import business. Loans for use in Hong Kong declined by 1% while loans for use outside Hong Kong fell by 2.7% in the same period.
- The banking industry has continued to support the SME sector. Over 35 AIs have joined the Government's enhanced SME Loan Guarantee Scheme and Special Loan Guarantee Scheme as participating lending institutions (PLIs). As at 1 May 2009, they had forwarded over 8,800 loan applications to the Trade and Industry Department for processing. Around 8,000 of these have been approved, involving a total loan amount of over HK\$16 billion.



LEHMAN-RELATED ISSUES - INVESTIGATIONS (1)

- Up to 14 May, 20,960 complaints had been received, the vast majority of which have already gone through preliminary assessment
- A total of 5,956 complaints were under investigation while further information was being sought in 13,727 complaints
- In 449 cases, involving 16 banks, adequate justifications were found for referral to the SFC to determine whether there has been a failure at the bank level (i.e. top down investigation)
- The HKMA will continue its investigations into individual cases to establish whether there has been any misconduct committed by the relevant individuals
- There were 108 complaints under disciplinary consideration
- 1,012 complaints have been closed as there are no sufficient grounds and evidence for the HKMA to continue its investigation in respect of the relevant individuals

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- The HKMA has continued to handle the Lehman-related complaints following the expedited process agreed with the SFC. Up to 14 May, a total of 449 cases involving 16 banks have been referred to the SFC to facilitate its investigations into the banks concerned.
- In addition, there were 108 cases under disciplinary consideration. These are cases which were already at a very advanced stage of the enforcement process. Before making a final determination in these cases, the HKMA has to go through due process to ensure fairness, including giving the subjects of investigation an opportunity to be heard and a right to make appeal to the Securities and Futures Appeal Tribunal.
- A majority of cases closed are those where investigations are unable to proceed further because the complainants have declined to provide further information to the HKMA.



LEHMAN-RELATED ISSUES - INVESTIGATIONS (2)

- **The HKMA is stepping up its investigation force by recruiting more contract staff as well as seconding professional staff from auditing firms, with the aim of bringing the total number of staff in the enforcement units to more than 300 persons within the coming months**
- **Subject to the availability of investigators and the minimum outcome of the SFC's top-down investigations, the target is to complete investigation of more than 70% of complaints by end-March 2010**



LEHMAN-RELATED ISSUES - VOLUNTARY SETTLEMENT

- **According to the banks' figures, up to 13 May, a total of 6,736 Lehman-related complaints have resulted, or will likely result, in voluntary settlement**
- **Of these voluntary settlements, 4,970 cases have already been concluded**
- **Discussions about settlements are in progress in the remaining 1,766 cases**

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- The HKMA encourages banks to settle with complainants.
- While the HKMA welcomes voluntary settlements between banks and complainants, its investigations into allegations of mis-selling will not be closed simply because of settlements. The HKMA will continue its investigation into cases to establish whether there has been any misconduct.



REPORT ON COMPLAINTS ABOUT SALE OF LEHMAN-RELATED INVESTMENT PRODUCTS

- **Circular issued to AIs on 25 March 2009 on implementation of a number of the HKMA's recommendations by end March 2009**
- **Audio recording: implementation expected by 30 June 2009. Physical segregation: by 30 September 2009**
- **The HKMA and the SFC to consult the market and/or the public on other recommendations in the second half of this year**
- **The HKMA will assist Government in reviewing present regulatory framework for protection of retail investors**

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- Some recommendations such as the “health warning” statement on structured products; enhanced procedures for assessing customers’ risk profiles; improved selling processes in the case of risk mismatch; and “mystery shopper” programmes have been implemented by AIs since the end of March 2009.
- For recommendations involving system changes, i.e. audio recording and physical segregation of retail securities business and traditional deposit-taking activities, AIs are expected to complete implementation by 30 June and 30 September 2009 respectively.
- For the other recommendations (e.g. the introduction of a cooling-off period and restrictions on the use of gifts as a marketing tool), the HKMA is working with the SFC and will consult the market and/or the public in the second half of this year.



SUPERVISORY POLICY INITIATIVES

- **Policy work to strengthen capital adequacy, liquidity and risk management include:**
 - **Implementation of the Basel Committee's proposed enhancements to the Basel II framework**
 - **Implementation of the Basel Committee's liquidity sound principles**
- **International initiatives to strengthen regulatory standards promoted by FSF, G20, etc.**

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- The HKMA has continued to monitor closely international initiatives in response to the financial crisis and has already started the process for implementing some of the recommended policy measures in areas such as:
 - **Capital:** the Basel Committee on Banking Supervision (BCBS) has already issued one package of proposals to strengthen banks' capital requirements principally in respect of the trading book and securitisation exposures, and is currently working on another package to enhance the risk coverage of the Basel II framework and mitigate its procyclicality.
 - **Liquidity:** the BCBS issued revised liquidity sound principles in September 2008. The HKMA requests AIs to conduct self-assessments to identify gaps in liquidity risk management practices and is reviewing its existing supervisory framework to align it with the new BCBS principles.

The HKMA will consult the banking industry once concrete proposals are drawn up.

- The HKMA has also been monitoring closely the progress in respect of the Financial Stability Forum's Report on "Enhancing Market and Institutional Resilience" and the G20 Action Plan to enhance sound regulation. The HKMA will work with Government and other regulators on implementation of these international initiatives.



DEPOSIT PROTECTION SCHEME

- With the assistance of the HKMA, the Deposit Protection Board completed the review of the coverage of the Deposit Protection Scheme (DPS) in Q1 2009 as scheduled
- The Board published a consultation paper on 27 April on the recommendations of the review. The consultation period will end on 26 June. The key recommendations include:
 - raising the DPS protection limit from HK\$100,000 to HK\$500,000
 - expanding the coverage of the DPS to protect secured deposits referable to the provision of banking and financial services
 - halving premium rates and allowing banks to report protected deposits on net basis for contribution assessment purpose to offset the cost impacts of raising protection limit and expanding coverage

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- The HKMA assisted the Hong Kong Deposit Protection Board (the Board) in its review of the coverage of the Deposit Protection Scheme (DPS). The review has been completed in Q1 2009 as scheduled and consultation on the review proposals has started.
- The Board expects to submit legislative proposal to LegCo in Q1 2010. Hopefully, the enhanced DPS will take effect as soon as possible so that depositors will be able to enjoy the benefits of an enhanced scheme when the full deposit guarantee expires in end 2010.



FINANCIAL INFRASTRUCTURE



DEBT MARKET DEVELOPMENT

- **Government Bond Programme**
- **Review of debt market development**
- **Islamic Finance**



GOVERNMENT BOND PROGRAMME

- **The HKMA is assisting the Government in the execution of the programme**
- **The objective is to promote bond market development and financial stability**
- **This programme is expected to provide a steady and consistent supply of Government bonds**
- **The Government is seeking approval for relevant resolutions from the LegCo**

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- The Government has announced the proposed introduction of a Government Bond Programme (GBP), and the HKMA will assist the Government in the execution of the GBP.
- The primary objective of the GBP is for promoting the further and sustainable development of Hong Kong's bond market. It can also help promote financial stability by developing an alternative channel for financial intermediation.
- For the proposed programme to achieve these objectives, the GBP is designed to issue government bonds in a systematic and consistent manner, unlike the previous ad-hoc bond issues.
- The resolutions, which seek to authorize the Government to borrow and to set up a fund for the purpose of managing sums raised under the Programme, have been introduced to the LegCo for approval.



REVIEW OF DEBT MARKET DEVELOPMENT

- **The HKMA completed second phase of the review on debt market development in 2008**
- **The HKMA continues to follow up the implementation of the recommendations relating to regulatory process, investment benchmarks and guidelines, and tax treatments**
- **The HKMA has been assisting the Government to review the existing tax concessions for Qualifying Debt Instruments**

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- In early 2008, the Council of Financial Regulators endorsed the recommendations arising from the second phase of the review on debt market development conducted by the HKMA. The recommendations cover various issues related to regulatory process, investment benchmarks and guidelines and tax treatments with the aim of attracting issuers and broadening the investor base.
- The HKMA, in collaboration with other relevant authorities, continues to follow up the implementation of these recommendations.
- In this regard, the HKMA has been assisting the Government to review the existing tax concessions for Qualifying Debt Instruments, which is designed to encourage bond issuance through relevant tax treatments. We will draw on the market expertise available through the Treasury Market Association in this study.



DEVELOPMENT OF ISLAMIC FINANCE

HKMA's Four-Part Strategy

Promote market infrastructure

- **Provided inputs to the Government in drawing up legislative proposals for modifying the tax laws in Hong Kong**

Encourage product development

- **Maintaining close dialogue with the industry**

Build international profile

- **Hosted the inaugural Asia Sukuk Summit in Hong Kong**

Promote market awareness

- **Organised two Islamic finance education workshops**
- **Published a feature article in HKMA Quarterly Bulletin**

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- HKMA has a four-part strategy to develop Islamic Finance in Hong Kong, including,
 - **Promote market infrastructure:** Provided inputs to the Government in drawing up legislative proposals for modifying the tax laws in Hong Kong, with a view to creating a level playing field for Islamic financial products vis-à-vis conventional ones
 - **Encourage product development:** Maintaining close dialogue with the industry to keep track of market development in Islamic finance
 - **Build international profile:** Hosted the inaugural Asia Sukuk Summit in Hong Kong on 18-19 February 2009
 - **Promote market awareness:**
 - (i) Organised two Islamic finance education workshops to TMA members in late February 2009;
 - (ii) Published a feature article in HKMA Quarterly Bulletin in March 2009 explaining HKMA's four-part strategy in promoting Islamic finance in Hong Kong



FINANCIAL MARKET INFRASTRUCTURE

- **To develop Hong Kong into a regional payment and settlement hub, enhancing its role and status as an international financial centre**
- **Strategy for developing market infrastructure**
 - **Maintain smooth and efficient operation of payment systems**
 - **Improve the functions and capabilities of payment and securities settlement systems**
 - **Maximum system readiness for RMB trade settlement**
 - **New settlement run in US dollar RTGS system for credit card payments**
 - **System migration to SWIFTNet**



FINANCIAL MARKET INFRASTRUCTURE

- **Promote links with overseas systems and use of Hong Kong's financial infrastructure**
 - **Payment-versus-payment link between Hong Kong's US dollar RTGS system and the Indonesian Rupiah RTGS system**
 - **Payment arrangements with Mainland China's foreign currency settlement systems**
 - **Promotion of Hong Kong's payment services and role as a payment and settlement hub**



MARKET INFRASTRUCTURE

Oversight of the clearing and settlement systems

- **All local designated systems remain in compliance with the safety and efficiency requirements of the Clearing and Settlement Systems Ordinance.**
- **The Process Review Committee submitted its fourth annual report to the Financial Secretary in January 2009, which was subsequently published on the HKMA's website. The report concluded that the HKMA had duly followed the established procedures and was procedurally fair in carrying out its oversight activities across different designated systems.**

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- The HKMA oversees five local designated systems, including the Hong Kong-dollar Clearing House Automated Transfer System (CHATS), US dollar CHATS, Euro CHATS, RMB CHATS and the Central Moneymarkets Unit through on-site examination, off-site reviews and continuous monitoring.
- The Process Review Committee is an independent committee to review the process and procedures adopted by the HKMA in overseeing designated systems. The fourth annual report on the work of the Committee concluded that the HKMA had followed duly the procedures and was procedurally fair in carrying out its oversight activities.



HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE



RENMINBI BUSINESS (1)

Latest developments in promoting renminbi trade settlement:

- **On 8 April, the State Council decided to introduce a pilot scheme for using renminbi for cross-border trade settlements**
- **Hong Kong has completed the necessary technical preparations for becoming the first place outside the Mainland to conduct renminbi trade settlements**
- **The business will commence once the Mainland authorities have promulgated the operational arrangements**

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- On 8 April, the State Council decided to introduce a pilot scheme for using renminbi for cross-border trade settlements (“pilot scheme”) in Shanghai and four cities in Guangdong Province, namely, Guangzhou, Shenzhen, Zhuhai and Dongguan.
- The implementation of the pilot scheme will facilitate Hong Kong as a regional renminbi clearing centre and underscore its position as an international financial centre. The pilot scheme is significant in three aspects:
 - It enables import and export enterprises to manage flexibly and thus reduce the risks arising from fluctuations in exchange rate.
 - It will bring about new business for the banking sector in Hong Kong. Banks can expand their renminbi services from individual clients to enterprises.
 - It will enhance the diversification of renminbi assets in the Hong Kong banking system, increase the liquidity of renminbi funds in Hong Kong, and bolster the renminbi settlement platform in Hong Kong. These developments are conducive to the further development of renminbi business in Hong Kong.
- The outstanding amount of renminbi deposits was RMB 53.1 billion at end-March 2009.



RENMINBI BUSINESS (2)

Renminbi bond issuance in Hong Kong

- **The Central Government supports Hong Kong's status as an international financial centre by expanding issuance of renminbi bonds in Hong Kong:**
 - **Allowing Hong Kong banks operating on the Mainland to issue renminbi bonds in Hong Kong**
 - **Consideration will be given to issuance of renminbi bonds in Hong Kong by the Ministry of Finance**

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- Allowing Hong Kong banks operating on the Mainland to issue renminbi bonds in Hong Kong will help expand their sources of renminbi funding and enhance their ability to provide services on the Mainland. This will have a positive effect on their business.
- Issuance of renminbi bonds in Hong Kong by the Ministry of Finance, while still being considered, represents the Central Government's confidence in and support for Hong Kong's status as an international financial centre. It will be a further experiment of the use of renminbi in bond issuance outside the Mainland, and also underscore the role of Hong Kong as the testing ground for the Mainland's financial reforms.
- Since the launch of renminbi bonds in Hong Kong in June 2007, there have been seven renminbi bond issues and all of them received favourable market responses. These new measures will increase the diversity of issuers in Hong Kong's renminbi bond market, thereby providing investors with more choices, and will be conducive to the development of Hong Kong's bond market.
- The HKMA will maintain close communication and cooperation with the People's Bank of China and other relevant Mainland authorities, to ensure that such renminbi bonds could be issued in Hong Kong as soon as practicable.



FACILITATING HONG KONG COMPANIES OPERATING ON THE MAINLAND TO OBTAIN FINANCING

- **Hong Kong companies operating on the Mainland can use their assets in Hong Kong as collateral for securing borrowings from the Mainland subsidiaries of Hong Kong banks**
- **The measure will be implemented on a trial basis in Shanghai and Guangdong**
- **Hong Kong banks will be able to better utilise resources from their cross-border operations and those of the customers in providing financing services with increased flexibility**



INCREASING REGIONAL CO-OPERATION

- **Monitoring of regional monetary and financial stability: Further substantiating the regional surveillance framework of EMEAP Monetary and Financial Stability Committee**
- **Banking stability: Chairing EMEAP Working Group on Banking Supervision which has been tasked with monitoring the implementation of G-20's proposed actions that are relevant to banking supervision in EMEAP jurisdictions**
- **Financial co-operation initiatives:**
 - **HKMA participated in the March 2009 plenary meeting of the Financial Stability Forum, which has been re-established as the Financial Stability Board with expanded membership and a broadened mandate.**
 - **ASEAN+3 Finance Ministers announced on 3 May 2009 that they welcomed Hong Kong's participation in the Chiang Mai Initiative Multilateralisation which is a regional self-help emergency liquidity facility.**

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- Since the establishment of the EMEAP Monetary and Financial Stability Committee (MFSC) in 2007, the HKMA has coordinated surveillance inputs and prepared macro-monitoring reports for the biannual MFSC meetings. The HKMA has also further substantiated the surveillance work of the MFSC by developing a multi-region macroeconomic model to strengthen the surveillance framework of the Committee. The HKMA will continue to improve the macroeconomic model by involving other EMEAP members and enhance policy analyses by making use of the model.
- As the Chair of EMEAP Working Group on Banking Supervision, the HKMA has coordinated the working group's efforts in monitoring the implementation of G20's proposed actions that are relevant to the area of banking supervision in the EMEAP region and assessing how the regulatory systems and standards in EMEAP jurisdictions can be further improved.
- The Financial Stability Forum (FSF) continued to receive considerable attention amid the global financial crisis. In March, HKMA participated in the FSF plenary meeting held in London. It was decided at the meeting that the FSF would broaden its membership and invite as new members the G20 countries that were not in the FSF, as well as Spain and the European Commission. The FSF was also re-established as the Financial Stability Board with a broadened mandate.
- At the ASEAN+3 Finance Ministers' Meeting on 3 May 2009, Finance Ministers welcomed Hong Kong's participation in the Chiang Mai Initiative Multilateralisation (CMIM), which is a regional self-help emergency liquidity facility. The arrangement will help enhance financial stability in the region and in Hong Kong. The HKMA will continue to work closely with the ASEAN+3 members on the detailed modality of Hong Kong's participation.



THE INVESTMENT ENVIRONMENT AND PERFORMANCE OF THE EXCHANGE FUND

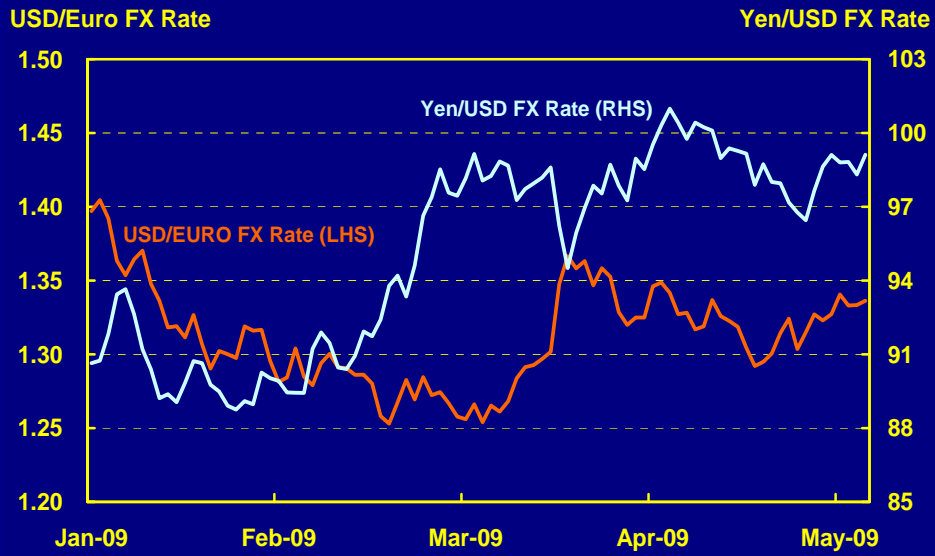


INVESTMENT ENVIRONMENT IN Q1 2009

- **Exchange rates: US dollar strengthened against the euro and the yen**
- **Equity markets: Major markets declined before rebounding in mid-March**
- **Interest rates: US government bond yields, especially long-term yields, rose sharply on concerns over large increases in supply, before declining in mid-March**
- **Market optimism since mid-March on the back of US government's announcement of quantitative easing and measures to address legacy loans and securities of financial institutions**
- **Market volatility prevails before full effects of government measures become clear**



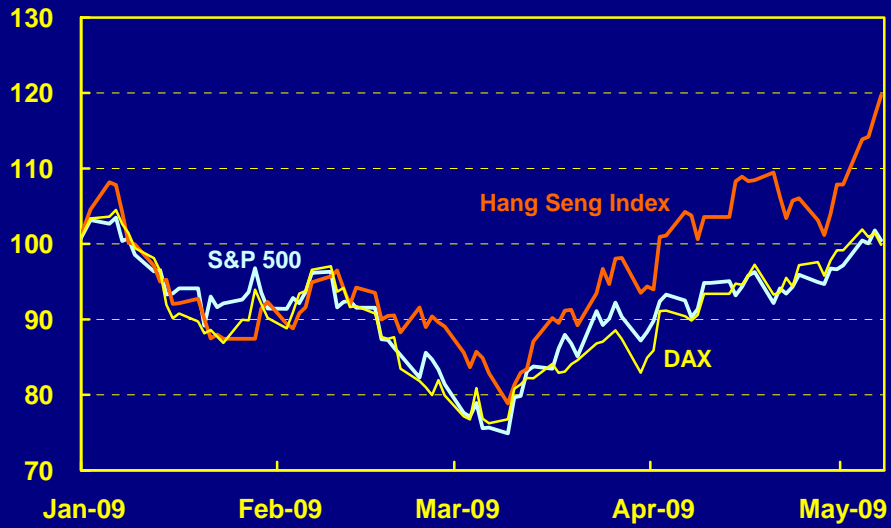
CURRENCY MARKET FLUCTUATION





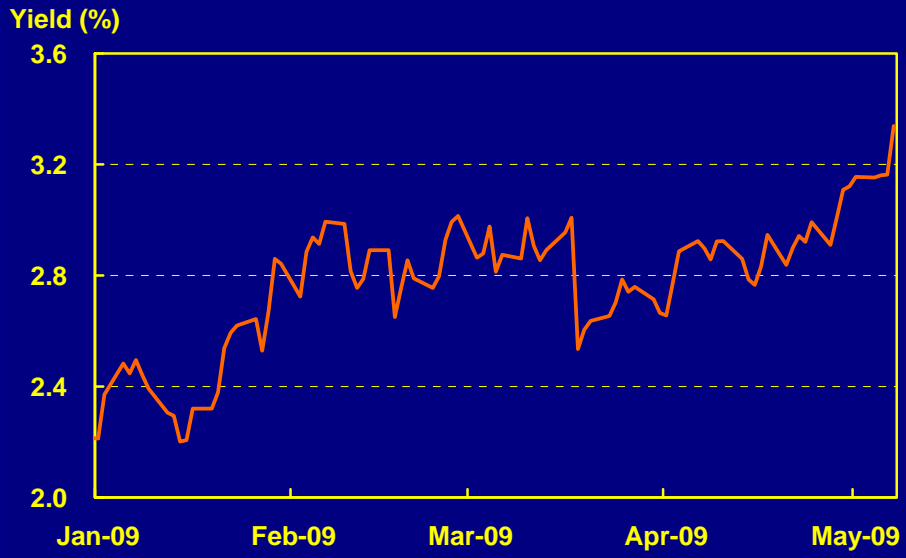
PERFORMANCE OF MAJOR EQUITY MARKETS

Normalised Index Level (2008 year-end = 100)





10-YEAR UST YIELD





INVESTMENT INCOME

	2009	2008	2007	2006
(HK\$ billion)	Q1 *	Full Year	Full Year	Full Year
Gain/(Loss) on Hong Kong equities [^] @	(4.2)	(77.9)	55.8	35.9
Gain/(Loss) on other equities [^]	(16.7)	(73.1)	6.7	18.7
Exchange gain/(loss)	(9.7)	(12.4)	18.7	17.3
Return from bonds [#]	<u>(2.9)</u>	<u>88.4</u>	<u>61.0</u>	<u>31.9</u>
Investment income/(loss) [@]	(33.5)	(75.0)	142.2	103.8

* Unaudited figures

[^] Including dividends

[#] Including interest

[@] Excluding valuation changes in Strategic Portfolio



CHANGE IN INVESTMENT INCOME, PAYMENT TO TREASURY AND ACCUMULATED SURPLUS

(HK\$ billion)	2009		← 2008 →			
	Q1*	Full year	Q4	Q3	Q2	Q1
Investment income/(loss)	(33.5)	(75.0)	8.3	(48.3)	(20.4)	(14.6)
Other income	0.0	0.3	0.1	0.1	0.0	0.1
Interest and other expenses	<u>(0.7)</u>	<u>(6.5)</u>	<u>(1.3)</u>	<u>(1.8)</u>	<u>(1.8)</u>	<u>(1.6)</u>
Net investment income/(loss)	(34.2)	(81.2)	7.1	(50.0)	(22.2)	(16.1)
Payment to Treasury #	(9.1)	(46.4)	(11.5)	(11.3)	(11.8)	(11.8)
Valuation change of Strategic Portfolio^	<u>(0.1)</u>	<u>(8.9)</u>	<u>(1.2)</u>	<u>(1.2)</u>	<u>(1.0)</u>	<u>(5.5)</u>
Decrease in EF accumulated surplus	(43.4)	(136.5)	(5.6)	(62.5)	(35.0)	(33.4)

* Unaudited

The fixed rate of fee payment to Treasury for 2009 and 2008 are 6.8% and 9.4% respectively.

^ Including dividends



HISTORICAL INVESTMENT INCOME

(HK\$ billion)

Year	Full Year	Q4	Q3	Q2	Q1
2001	7.4	13.6	10.4	(2.0)	(14.6)
2002	47.0	26.3	(2.1)	26.5	(3.7)
2003	89.7	33.5	8.4	41.1	6.7
2004	56.7	33.0	14.1	(7.2)	16.8
2005	37.8	7.3	19.0	13.6	(2.1)
2006	103.8	36.0	37.1	12.5	18.2
2007*	142.2	33.4	61.8	26.3	20.7
2008*	(75.0)	8.3	(48.3)	(20.4)	(14.6)
2009*#	N/A	N/A	N/A	N/A	(33.5)

* Excluding valuation changes in the Strategic Portfolio.

Unaudited figures



EXCHANGE FUND ABRIDGED BALANCE SHEET

(HK\$ billion)	At 31 Mar 2009*	At 31 Dec 2008	At 31 Dec 2007
ASSETS			
Deposits	173.1	172.8	132.9
Debt securities	1,205.7	1,151.3	922.9
Hong Kong equities	88.5	92.9	184.6
Other equities	96.8	103.3	146.0
Other assets	<u>39.8</u>	<u>40.0</u>	<u>28.0</u>
Total assets	<u>1,603.9</u>	<u>1,560.3</u>	<u>1,414.4</u>
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness	181.9	176.1	163.4
Government-issued currency notes & coins in circulation	8.4	8.3	7.5
Balance of the banking system	157.9	158.0	10.6
Exchange Fund Bills and Notes	226.8	162.5	141.8
Fiscal Reserves Account	506.1	531.4	464.6
Other liabilities	<u>85.7</u>	<u>43.5</u>	<u>9.5</u>
Total liabilities	<u>1,166.8</u>	<u>1,079.8</u>	<u>797.4</u>
Accumulated surplus	<u>437.1</u>	<u>480.5</u>	<u>617.0</u>
Total liabilities and fund equity	<u>1,603.9</u>	<u>1,560.3</u>	<u>1,414.4</u>

* Unaudited figures

- Accumulated Surplus of the Exchange Fund at 31 March 2009 amounted to HK\$437.1 billion.
- A reduction in the Accumulated Surplus by HK\$43.4 billion for the first quarter of 2009 was due mainly to investment loss (HK\$33.5 billion), fee payment to the Fiscal Reserves (HK\$9.1 billion) together with interest and other expenses (HK\$0.7 billion).
- Fiscal Reserves placed with the Exchange Fund at 31 March 2009 were HK\$506.1 billion.