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Panel on Financial Affairs

Minutes of special meeting
held on Thursday, 19 November 2009 at 2:30 pm
in Conference Room A of the Legislative Council Building

Members present :
Hon CHAN Kam-lam, SBS, JP (Chairman)
Hon Ronny TONG Ka-wah, SC (Deputy Chairman)
Hon Albert HO Chun-yan
Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP
Dr Hon David LI Kwok-po, GBM, GBS, JP
Hon James TO Kun-sun
Hon Emily LAU Wai-hing, JP
Hon Abraham SHEK Lai-him, SBS, JP
Hon Vincent FANG kang, SBS, JP
Hon Jeffrey LAM Kin-fung, SBS, JP
Hon Andrew LEUNG Kwan-yuen, SBS, JP
Hon WONG Ting-kwong, BBS, JP
Hon CHIM Pui-chung
Hon KAM Nai-wai, MH
Hon Starry LEE Wai-king
Hon Paul CHAN Mo-po, MH, JP
Hon CHAN Kin-por, JP
Hon CHAN Tanya
Hon Mrs Regina IP LAU Suk-yee, GBS, JP

Member attending : Hon LEE Wing-tat

Member absent : Dr Hon Philip WONG Yu-hong, GBS

Public officers attending :	Agenda Item I Mr Norman CHAN, SBS, JP Chief Executive Hong Kong Monetary Authority Mr Peter PANG, JP Deputy Chief Executive (Development) Hong Kong Monetary Authority Mr CHOI Yiu-kwan, JP Deputy Chief Executive (Banking) Hong Kong Monetary Authority Mr Eddie YUE, JP Deputy Chief Executive (Monetary) Hong Kong Monetary Authority
Clerk in attendance:	Ms Rosalind MA Chief Council Secretary (1)5
Staff in attendance :	Miss Constance MAN Senior Council Secretary (1)8 Ms Haley CHEUNG Legislative Assistant (1)8

Action

I Briefing on the work of Hong Kong Monetary Authority

(LC Paper No. CB(1)371/09-10(01)	—	Hong Kong Monetary Authority (HKMA)'s paper on its work
LC Paper No. CB(1)445/09-10(01)	—	Speaking note of the Chief Executive of HKMA (Chinese version tabled at the meeting and issued to members on 23 November 2009, English version issued to members on 30 November 2009))

Briefing by the Hong Kong Monetary Authority

At the invitation of the Chairman, Chief Executive, HKMA (CE/HKMA) gave a point-point presentation on the economic environment, the risks facing Hong Kong and the work of HKMA. He highlighted the following points in his briefing:

(a) On labour market conditions, the labour market was more resilient under the current global financial crisis and job losses had been less severe than during the Asian Financial Crisis. Apart from solid corporate balance sheets, the Government had introduced prompt measures to stabilize the financial system, support enterprises and preserve employment. For example, the Government had enhanced the Small and Medium-sized Enterprise (SME) Loan Guarantee Scheme and introduced a special loan guarantee scheme, which had provided financial assistance to more than 14 600 companies up to the end of October 2009 and indirectly secured more than 250 000 jobs.

(b) On cross-border capital inflows, balance-of-payments statistics indicated that there had been strong capital inflows since the fourth quarter of 2008. Driven by the strong Hong Kong dollar inflows, the Aggregate Balance and the market value of the outstanding Exchange Fund (EF) Bills and Notes increased by HK$567.5 billion between 1 October 2008 and 13 November 2009. Unlike other Asian economies, Hong Kong could not adjust its interest rate policy to cope with the inflationary pressure resulting from the strong capital inflows. Hong Kong dollar interest rates remained low and the overnight Hong Kong Interbank Offered Rate had stayed close to zero since the beginning of 2009.

(c) On the surge in asset prices, the Hang Seng Index rebounded by almost 100% after bottoming at 11 345 on 9 March 2009. The recent stock market rally did not have a great impact on the quality of bank loans and the ratio of stock-market-related loans to total domestic loans had been below 2% for most of the time. As to the property market, although measures of household purchasing power had changed little in the past 18 months, this might have been distorted by the prevailing exceptionally low interest rates. To guard against the risk of imprudent lending in the banking sector, HKMA introduced a new measure on 23 October 2009, lowering the loan-to-value (LTV) ratio of luxury properties valued at HK$20 million or above to 60%. HKMA also reminded banks to be more prudent in valuing properties and calculating the debt-servicing-ratios of the prospective borrowers.

(d) The risk of fund flow reversal needed to be monitored closely. A reversal might possibly be triggered if there was a tightening of monetary policy in the United States (US), or a reassessment of current market expectations of a continued depreciation of the US dollar. While many market participants expected the US dollar to remain weak, this should not be taken for granted from the history of US dollar's trend in exchange rate changes and the experience of Japan's yen where there was no distinct relationship between the increases in public debt and the strength of a currency. Investors should therefore be alert to the possibility of reversals of capital flows triggered by the reverting of the US dollar to an upward trend and the risks that this would create for asset prices.

(e) On the performance of EF, investment income for the first three quarters of 2009 was HK$96.9 billion. Gains on equities made the largest contribution to the investment income, which amounted to HK$76.8 billion. According to the fixed rate fee payment arrangement, payment to the Treasury was HK$25.6 billion. The accumulated surplus of EF had increased by HK$72.5 billion in the first three quarters of 2009. HKMA would continue to be vigilant in the ever-changing investment environment and manage EF prudently.

(f) On the work relating to the Lehman Brothers incident, HKMA received nearly 14 000 minibonds-related complaints, of which 13 100 complainants had accepted the repurchase offer or voluntary settlements. Out of the 7 700 complaints related to non-minibonds products, 2 526 cases had been closed due to insufficient evident, 766 cases were under disciplinary consideration and 4 406 cases were being investigated. HKMA aimed to complete substantially the investigation of all outstanding complaints by the end of March 2010.

(g) On the development of renminbi (RMB) business, since the commencement of the RMB trade settlement pilot scheme in July 2009, 32 authorized institutions had entered into clearing agreements with the clearing bank in Hong Kong or Mainland correspondent banks. HKMA had been working closely with the Mainland authorities and local industry to explore ways to further develop the scheme. There had been good progress in the development of RMB bond market since the first issuance of RMB bonds in Hong Kong in mid-2007. The total amount of RMB bonds issued in 2009 reached a record of RMB 16 billion. The Ministry of Finance issued a total of RMB 6 billion in sovereign bonds in Hong Kong at the end of October 2009.

Discussion

Economic recovery and asset markets

2. Referring to CE/HKMA's briefing on the effect of the loan guarantee schemes for SMEs in preserving employment, Mr Andrew LEUNG asked whether CE/HKMA would support similar relief measures by the Government to cope with financial crises in the future. Mr Jeffrey LAM shared Mr LEUNG's concern. In reply, CE/HKMA pointed out that the Government accorded priority to preserving employment in devising measures to cope with challenges of the financial crisis, and the loan guarantee schemes for SMEs had been enhanced to help business enterprises to tide over the credit problem in the immediate term. Banks had to assess the credit risks of loan applications based on the credit profiles of the applicants concerned.

3. Ir Dr Raymond HO highlighted the perception of market participants that the worst time of the financial crisis was over and the economy was reviving with the relief measures implemented by governments around the world. In this connection, he sought the view of CE/HKMA on the sustainability of the economic recovery in Hong Kong. He was concerned that the public would be misled by the seemingly rosy economic environment as revealed by the stabilizing unemployment rate, consumer spending and Gross Domestic Product (GDP).

4. CE/HKMA responded that although economists and central bankers shared the view that the global economy had bottomed out, the pace and strength of recovery was expected to be mild. Despite market forecast of a 3%-4% GDP growth in 2010, CE/HKMA opined that economic growth of Hong Kong would be subject to the performance of export services, which accounted for about 25% of GDP. Given the externally-oriented economy of Hong Kong and the impact of uncertainties in the US and European economies, the pace of economic recovery in Hong Kong would be difficult to forecast. CE/HKMA said that the investing public should stay vigilant of the potential risks in the asset markets, such as those resulting from an interest rate hike.

5. Noting the substantial capital inflow and the surge in asset prices in the recent months, Ir Dr Raymond HO expressed concern about the formation of asset-price bubbles and the impact on the financial stability resulting from bursting of the bubbles. He sought the advice of CE/HKMA for the investing public to prepare for the risks of a bubble burst and measures HKMA would implement to cope with such impact. Ms Starry LEE also expressed concern about the recent surge in property prices, notably prices of luxury properties.

6. CE/HKMA appreciated that excessive liquidity as a result of substantial capital inflow could feed asset price bubbles, particularly in a low interest rate environment. However, under the Currency Board arrangements, there was little room for Hong Kong to use monetary tools to contain inflation in asset prices since monetary conditions in Hong Kong were determined by interest rates in the US and by capital inflows. Given the low exposure of the banking sector to the stock market,

risks to the banking system in the recent stock market rally were limited. HKMA would be vigilant to exposure in bank lending to investment in stocks as well as investment in properties, and remind the banking sector to maintain prudent risk management standards in the lending business. As to concerns about the formation of property price bubbles, CE/HKMA advised that the overall residential property prices in September 2009 were about 75% of the peak in 1997. However, the prevailing interest rate was much lower than the level back in 1997. While the risk of property price bubbles was not high, market development had to be closely monitored as any bubble burst could bring about significant shocks to the market and the economy. CE/HKMA said that the capping of LTV ratio for residential properties valued at $20 million or more could help to contain the risks of mortgage lending in the recent market surge and help maintain banking stability. Home-buyers should be careful not to over-stretch themselves in obtaining mortgage loans in the current low interest rate environment.

7. Ms Emily LAU enquired whether HKMA considered the recent surge in property prices alarming. Noting that many buyers of luxury properties did not require mortgage, Ms LAU was concerned whether the lowering of the LTV ratio from 70% to 60% for luxury properties valued at $20 million or more could effectively help to reduce the risks of asset bubbles and maintain banking stability.

8. CE/HKMA responded that it would be hard to draw a line and compile statistics on mortgages for luxury properties among the some 10 000 transactions in October 2009, as a number of these transactions had yet to be completed. Given the variety of payment plans offered by developers, it would be difficult to provide information on the number of buyers who would not require mortgages at the present stage. In any case, where the property buyers did not require mortgages, the transactions would not increase the exposure of the banking sector to mortgage lending and hence would not give rise to concern about banking stability. In the circular issued to banks on the lowering of the LTV ratio to 60%, HKMA had also reminded banks that they should be prudent in valuing properties and calculating borrowers' debt-servicing-ratios.

9. Mr Andrew LEUNG was concerned that exit from quantitative easing by central banks might result in reversal of fund flow and credit tightening. Mr LEUNG enquired about possible measures to cope with such capital outflow, in particular measures to maintain banking stability. Mr CHAN Kin-por and Mr Paul CHAN also expressed concern about the exit strategies and enquired about HKMA's plans to cope with the impact of the exit.

10. CE/HKMA said that with the abundance in liquidity resulting from the accommodative monetary policy of central banks, there had been substantial capital inflow into Hong Kong, driving the Aggregate Balance up from the normal level of HK$10 billion to about HK$300 billion. He pointed out that the timing of exit from quantitative easing was crucial, as incorrect timing could bring about risks to the financial market. CE/HKMA was of the view that from the emerging-market perspective, the risks of a delayed exit could be worrying. While a premature exit

could have impact on the pace of economic recovery, a delayed exit could also give rise to serious risks, in particular the formation of asset price bubbles fuelled by excessive liquidity. It would be a challenging task for the central banks to determine the best timing for exit, given the possible political and public pressure to opt for a delayed exit so as to enjoy the improvements in the asset markets. CE/HKMA reiterated that HKMA would stay vigilant and ensure prudent risk management in the banking sector in the lending business.

11. As to the exit strategies for Hong Kong, CE/HKMA advised that these would involve mainly the uplifting of the full deposit guarantee and the duration of the loan guarantee schemes for SMEs. As the uplifting of the full deposit guarantee had been targeted in end 2010 during the announcement of this special measure, Hong Kong was working in collaboration with the relevant authorities of Singapore and Malaysia for the detailed arrangements such as publicity in order to facilitate a smooth uplifting and minimize the impact on the banking system and the community. The Government would have to gauge the views of stakeholders and the public on the duration of the loan guarantee schemes for SMEs.

Currency stability

12. Mrs Regina IP questioned whether the Japanese yen was a relevant illustration of the relationship between the increases in public debt and the strength of a currency, as the appreciation of yen was resulted from political pressure from the US. Pointing out that RMB was also under similar political pressure to appreciate, Mrs IP sought CE/HKMA's view on the impact of a strong RMB and a weak US dollar on the currency stability of Hong Kong under the Linked Exchange Rate (LER) system where Hong Kong dollar was pegged to the US dollar.

13. CE/HKMA clarified that his earlier reference to the Japanese experience merely aimed to illustrate that increases in public debt did not necessarily result in weakening of a currency. While appreciating Mrs IP's view that political factor was involved in the appreciation of yen, CE/HKMA opined that as the exchange rate of a currency was a complicated issue, it was difficult to ascertain the weighting of this factor among the various factors affecting the strength of the currency. It was therefore hard to forecast the short-term fluctuations in the exchange rate of a currency. Given that the status of the US dollar as the world's major reserve currency would unlikely be replaced in the near future, the trend of a weakening US dollar was not expected to continued in the long run. On the other hand, market expectations for RMB to appreciate following the visit of the US President to China had not been realized. CE/HKMA was therefore of the view that the weighting of the political factor on the strength of RMB was difficult to ascertain.

14. In view of the weakening US dollar and the anticipated appreciation of RMB, Mr Abraham SHEK asked whether the peg to the US dollar under the LER system should be maintained. Mr Paul CHAN asked whether consideration would be given to pegging HK dollar to a basket of currencies in view of the increasing economic integration between Hong Kong and the Mainland.

15. CE/HKMA advised that the LER system had been functioning effectively in maintaining the monetary and financial stability of Hong Kong since its implementation in 1983, even during periods of extreme market volatilities. While acknowledging the increasing integration and cooperation between the economies of the Mainland and Hong Kong, CE/HKMA pointed out that Hong Kong as an entrepot relied heavily on its major trading partners such as the US and European economies for export of services. CE/HKMA stressed that there was no plan to change the arrangements under the LER system.

16. Noting the proposal of a regional currency in the Chief Executive's 2009-2010 Policy Address, Ms Starry LEE and the Chairman expressed concern about the timing for pursuing the proposal and preparation for the implementation. The Chairman opined that a regional currency could achieve a decoupling effect from the US economy and facilitate regional cooperation. He enquired about the circumstances/preconditions required for the establishment of a regional currency and the difficulties anticipated.

17. Referring the long process of establishment of Euro and the European Union, CE/HKMA pointed out that the establishment of a regional currency would take time. The idea of a regional currency was not new and had in fact been raised a decade ago by the incumbent Chief Executive when he was in the post of the Financial Secretary. While the idea did not attract much attention among economies in the region at that time, more active examination had been given to the idea recently amid the global financial crisis leading to market concern about the drastic depreciation of the US dollar. CE/HKMA advised that given the considerable economic, cultural and political differences among countries in the Asian region, quite a number of issues would have to be sorted out before discussion of a regional currency could start.

Complaints relating to the Lehman Brothers incident

18. Noting the decline of 9.7% in the aggregate pre-tax operating profit of retail banks' Hong Kong offices in the first three quarters of 2009, Mr CHAN Kin-por enquired whether the decline had reflected the funding requirement for the minibond repurchase scheme.

19. Deputy Chief Executive (Banking), HKMA (DCE(B)/HKMA) confirmed that the total amount of more than HK$6 billion required for the repurchase scheme had been recorded in the accounts of the distributing banks. However, the exact amount of loss would be subject to the amount of collaterals to be recovered and the corresponding amount to be returned to the complainants under the repurchase scheme. In response to Mr CHAN Kin-por's further enquiry, DCE(B)/HKMA advised that the impact of the repurchase scheme on individual banks would vary depending on the amount of minibonds sold.

20. In response to Ms Emily LAU's call to expedite the investigation of all outstanding Lehman Brothers-related complaints to allay the concern of the complainants, CE/HKMA assured members that HKMA would endeavour to deploy necessary resources for completing the investigations of all the outstanding complaints.

Exchange Fund

21. Ms Emily LAU noted with concern the commitment of US$4.2 billion to the Chiang Mai Initiative Multilateralization via EF and the usage of EF for investment in overseas assets by Hong Kong Mortgage Corporation Limited. Ms LAU opined that the use of the public money in the accumulated surplus of EF should be subject to more prudent scrutiny, such as by seeking the approval of the Legislative Council (LegCo).

22. CE/HKMA explained that there was established and transparent governance arrangement for scrutinizing the spending and budget of EF. Pursuant to the Exchange Fund Ordinance (Cap. 66), the Financial Secretary (FS) exercised control of EF having regard to its statutory objectives and the advice of the Exchange Fund Advisory Committee (EFAC). HKMA was only managing EF on behalf of FS.

23. Noting that EF had recorded investment gain in the first three quarters of 2009, Mr Jeffrey LAM enquired whether the anticipated gain for the full year would exceed HK$100 billion and whether HKMA would adjust the investment portfolio of EF to maximize the gain. Noting the percentage of US dollar assets in the investment portfolio of EF, Mr Paul CHAN enquired whether the asset allocation would be adjusted to increase holdings of other assets such as gold so as to reduce the impact of a weakening US dollar on the investment income of EF.

24. In the light of market uncertainties such as changes in interest rate environment and timing for exit from quantitative easing, CE/HKMA advised that it would be difficult to forecast market changes and hence the investment performance of EF in the coming months. CE/HKMA stressed the importance of prudent investment of EF to achieve return to preserve the long-term purchasing power of the fund, having regard to the other statutory objectives of EF to preserve capital, to ensure full backing of the Monetary Base by highly liquid US dollar-denominated securities and to ensure sufficient liquidity available for the purposes of maintaining monetary and financial stability. As to the investment portfolio of EF, CE/HKMA pointed out that EF had made investments in bond and equity outside the US markets. Adjustments to the strategic asset allocation of EF could only be made with due regard to the prudent management of EF to achieve its statutory objectives. Given the status of the US dollar as the major reserve currency, it would be unlikely for another currency to replace US dollar and provide a market with adequate breadth and depth to meet the need of investment of EF. Deputy Chief Executive (Monetary), HKMA (DCE(M)/HKMA) added that tactical deviations would be allowed for HKMA to made tactical decisions on the actual asset allocation within the limits for such deviations determined by FS in consultation with EFAC.

Financial infrastructure and Hong Kong's role as an international financial centre

25. Referring to the fast development of other financial centres in the region, in particular Shanghai, Mr Jeffrey LAM was concerned about measures to enhance the strengths and competitiveness of Hong Kong in maintaining its status of an international financial centre (IFC). Mr LAM enquired about measures to facilitate financial development of Hong Kong, for example, through enhancing the economic cooperation with the Mainland.

26. CE/HKMA said that with the size of the Mainland market, there was great business potential for the financial services sector. In fact, the financial development on the Mainland was progressing at a fast pace. While facing challenges from competition of Mainland markets, Hong Kong had been doing well as an IFC in a number of financial services and infrastructures, for example the development of RMB business in Hong Kong. Hong Kong was well-prepared and possessed the competitive edge to play a role in the financial intermediation on the Mainland. CE/HKMA said that Hong Kong should further sharpen its competitive edge to meet the challenges of the fast economic growth on the Mainland and secure a greater share in the huge Mainland market.

27. Noting HKMA's strategy to develop Hong Kong as a settlement service utility centre to attract transaction banking business in the region, the Deputy Chairman sought information on the measures and initiatives in this regard.

28. DCE(M)/HKMA advised that HKMA had taken forward a number of measures to develop a robust and efficient payment and settlement system in Hong Kong. In this connection, system links had been established to facilitate payment and settlement in different currencies. For example, the link between the ringgit clearing system in Malaysia and the US dollar clearing system in Hong Kong which came into operation in 2006, enabling the payment-versus-payment (PvP) settlement of foreign exchange transactions in ringgit and US dollars during Malaysian and Hong Kong business hours, thereby eliminating settlement risk. Another cross-border PvP link with the rupiah clearing system in Indonesia was scheduled for completion in early 2010.

29. Noting the increasing ties among the member countries of the Association of Southeast Asian Nations (ASEAN), Ir Dr Raymond HO enquired about measures to ensure that Hong Kong could leverage on the opportunities and benefit from the closer cooperation with other economies in the region.

30. CE/HKMA recognized the increasing significance of the ASEAN economies and the enhanced cooperation among economies in the Southeast Asian region, such as through the signing of multilateral financial arrangements to provide short-term liquidity support. CE/HKMA was of the view that Hong Kong could benefit from a wide range of business opportunities in trade, tourism and financial services etc., through active participation in the ASEAN as part of the Chinese delegation. In this

connection, the RMB Real Time Gross Settlement (RTGS) system in Hong Kong had been upgraded to clear and settle the use of RMB for Mainland's external trade with Hong Kong and ASEAN economies. Publicity of clearing and settlement services provided through the RTGS system would be conducted through means such as roadshows to attract more enterprises of the ASEAN countries to use the services for cross border payment settlement.

31. In response to the Deputy Chairman’s concern about progress of the issuance of Government bonds, CE/HKMA advised that the bid-to-cover ratios in the first two bond issues under the Institutional Bond Issuance Programme (IBIP) represented the ratio of bonds applied for to bonds issued. A higher ratio meant greater popularity of the bonds among investors. DCE(M)/HKMA added that a bid-to-cover ratio of 6.45 for the inaugural issue of Government bond meant more than five-fold oversubscription of the bonds. The total of HK$5.5 billion bond issued was accounted for in EF Abridged Balance Sheet under the item "Placement by Hong Kong government/statutory bodies".

32. Referring to the small size of issuance under IBIP and the pending launch of the Retail Bond Issuance Programme, Mrs Regina IP was concerned whether the Government Bond Programme (GBP) could achieve its policy objective of promoting the development of debt market in Hong Kong.

33. CE/HKMA advised that the limit of HK$100 billion of Government bonds to be issued through GBP was not a small amount, though not comparable to the amount of US public debt. Deputy Chief Executive (Development), HKMA (DCE(D)/HKMA) supplemented that while the abundance of liquidity in the banking sector might have reduced market demand for debts and hence attributed to the slow development of the debt market, it was necessary for Hong Kong to promote further and sustainable development of the local bond market, so as to provide an alternative channel for financial intermediation.

34. The Deputy Chairman and Mrs Regina IP expressed concern about the prospect of developing Islamic finance in Hong Kong, given the slow progress in the past year and the fact that Hong Kong had lagged behind other financial centres such as Singapore and Kuala Lumpur in the development of Islamic finance. Mrs IP was also concerned about the difficulties for Hong Kong to develop the Islamic bond market due to geopolitical reasons.

35. In response, DCE(M)/HKMA explained that the existing tax laws in Hong Kong could not provide a level playing field for Islamic financial products vis-à-vis conventional ones. For example, Islamic bonds were usually backed by properties or lands that were purchased by using the proceeds received from issuing the bonds. Bond issuers would be discouraged from issuing Islamic bonds because they would need to pay stamp duty for purchasing these properties or lands in accordance with Hong Kong’s tax laws. DCE(M)/HKMA advised that HKMA provided input to the Government in drawing up legislative proposals for modifying the tax laws in this regard and would continue to assist the Government to consult the market on the

proposals, with a view to introducing the proposed amendments into LegCo in the 2009-2010 session.

36. CE/HKMA advised that there was good potential and prospects for the development of Islamic finance, given the demand of Islamic investors for greater diversity of investment products other than the existing ones offered by the traditional Islamic market. Hong Kong should get prepared to leverage the upcoming business opportunities by putting in place the necessary financial infrastructures and legislation for the development of Islamic finance.

II Any other business

37. There being no other business, the meeting ended at 4:24 pm.

Council Business Division 1
Legislative Council Secretariat
2 February 2010