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HONG KONG MONETARY AUTHORITY

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

1 March 2011



- 1. International Macro Financial Conditions**
- 2. Assessment of Risk on Hong Kong's Financial Stability**
- 3. Latest Developments of Hong Kong as an International Financial Centre**
- 4. Latest Developments in the Banking Sector**
- 5. Investment Income of the Exchange Fund in 2010**



1. **International Macro Financial Conditions**
2. **Assessment of Risk on Hong Kong's Financial Stability**
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4. **Latest Developments in the Banking Sector**
5. **Investment Income of the Exchange Fund in 2010**

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GLOBAL ECONOMIC GROWTH FORECASTS

(% year-on-year)

Real GDP Growth

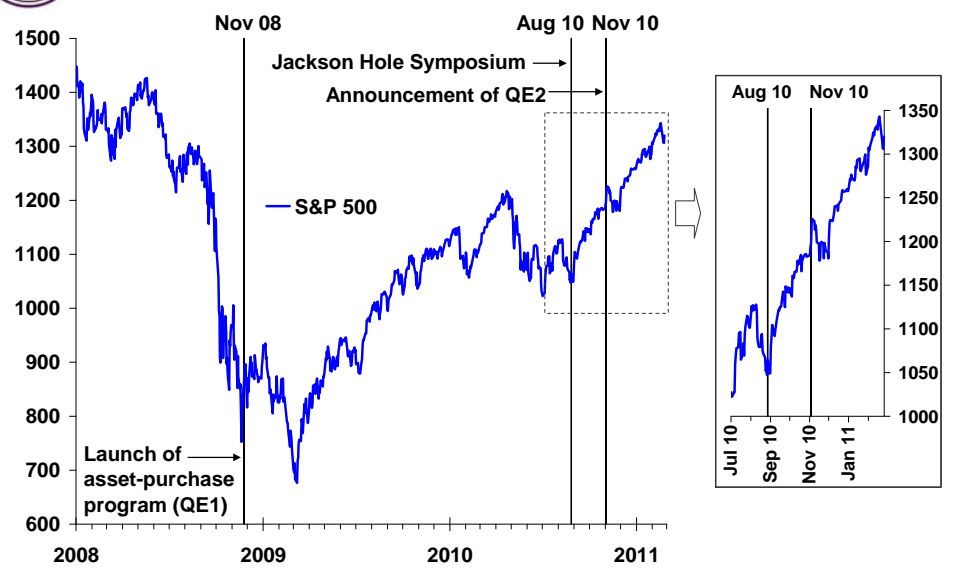
| | 2010 | 2011 Forecasts | | |
|------------------|------|--------------------------|--------------------------|-----------------|
| | | May 2010 FAP briefing | Nov 2010 FAP briefing | Feb 2011 |
| US | 2.8 | 3.1 | 2.4 | 3.2 |
| Euro area | 1.7 | 1.5 | 1.4 | 1.6 |
| Japan | 3.9 | 1.7 | 1.2 | 1.5 |

Source: Consensus Forecasts

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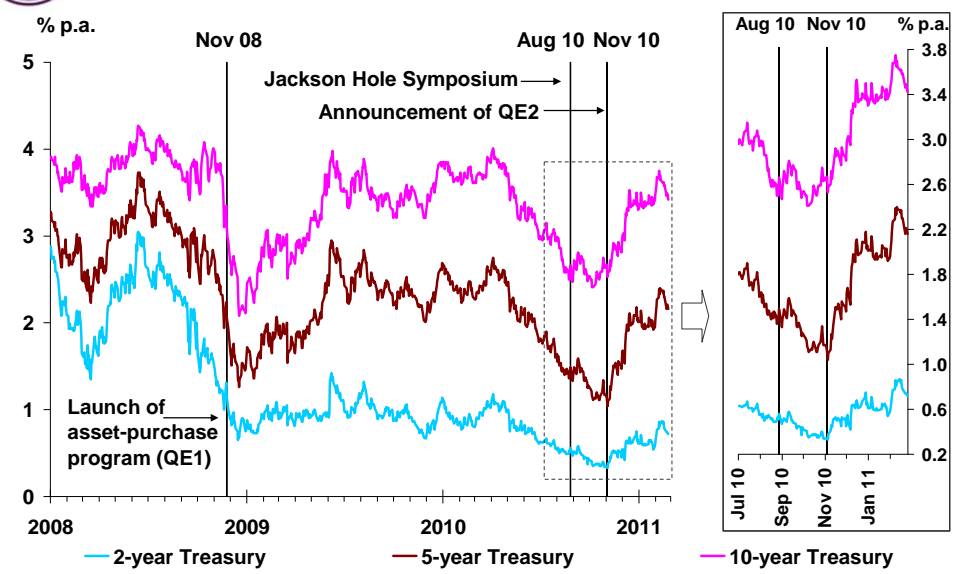
US EQUITY INDEX



Source: CEIC



US LONGER-TERM INTEREST RATES



Source: CEIC



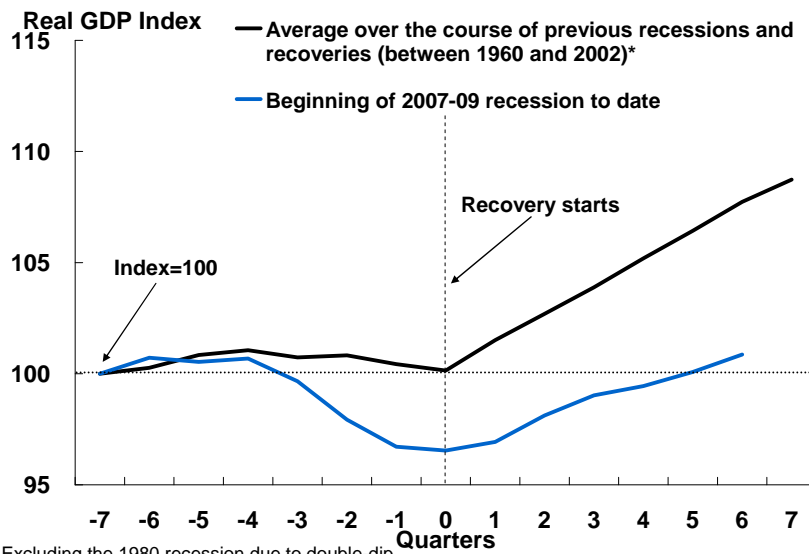
US: NEW FISCAL STIMULUS PACKAGE

- The new US\$858 billion fiscal stimulus package passed by the Congress in December 2010:
 - Temporary extension of tax relief, including all Bush-era tax cuts (\$668 billion)
 - A 2%, one-year cut in Social Security payroll tax from 6.2% to 4.2% (\$112 billion)
 - Temporary extension of emergency unemployment benefits (\$57 billion)
 - Temporary extension of investment incentives (\$22 billion)

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US: COMPARISON OF CURRENT ECONOMIC RECOVERY WITH PAST CYCLES



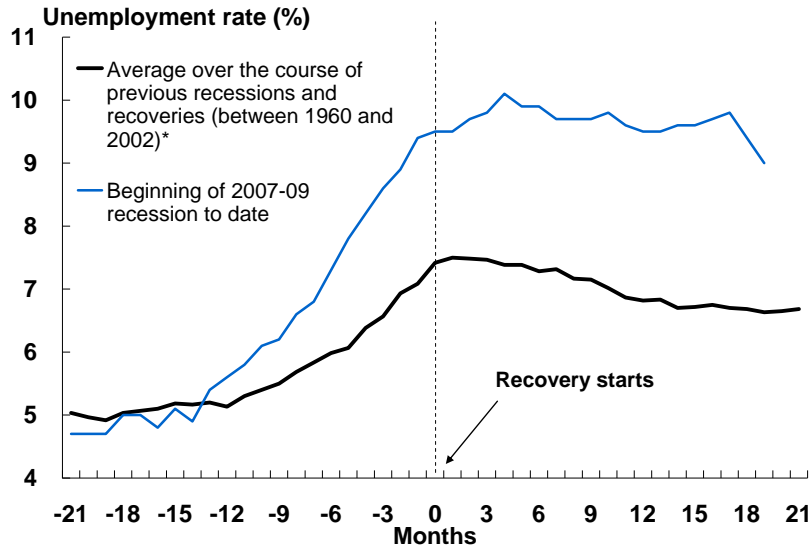
* Excluding the 1980 recession due to double-dip

Source: CEIC

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US: COMPARISON OF UNEMPLOYMENT RATES WITH PAST CYCLES



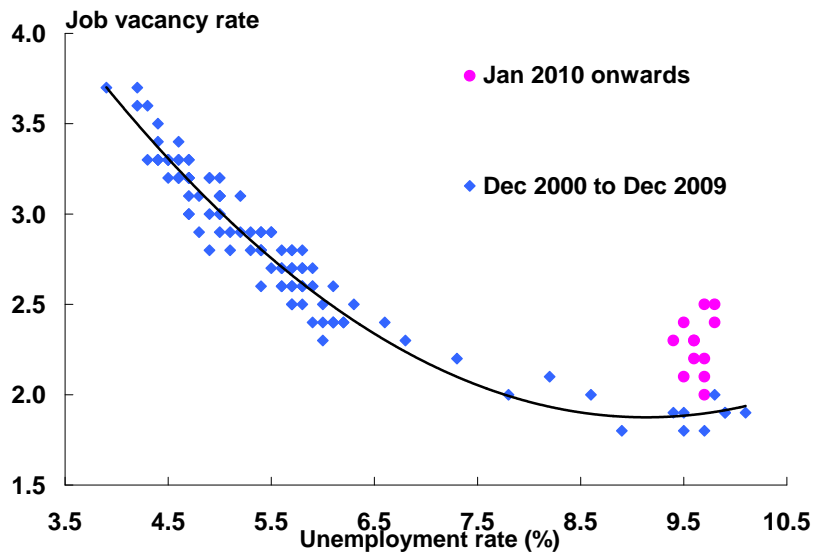
* Excluding the 1980 recession due to double-dip

Source: CEIC

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US: STRUCTURAL MISMATCH IN THE LABOUR MARKET



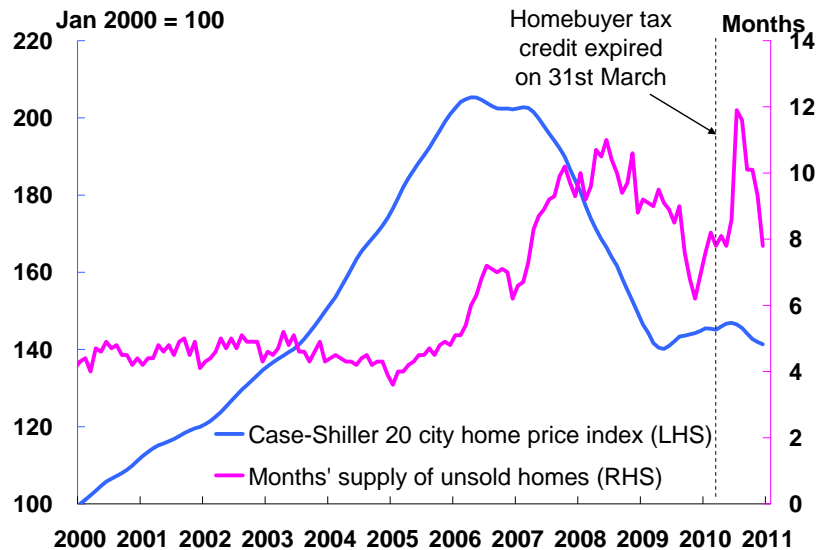
Note: The Beveridge curve (the black fitted line) is derived from monthly data between December 2000 and December 2009.

Source: CEIC

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US: HOUSE PRICES AND SUPPLY OF UNSOLD HOMES

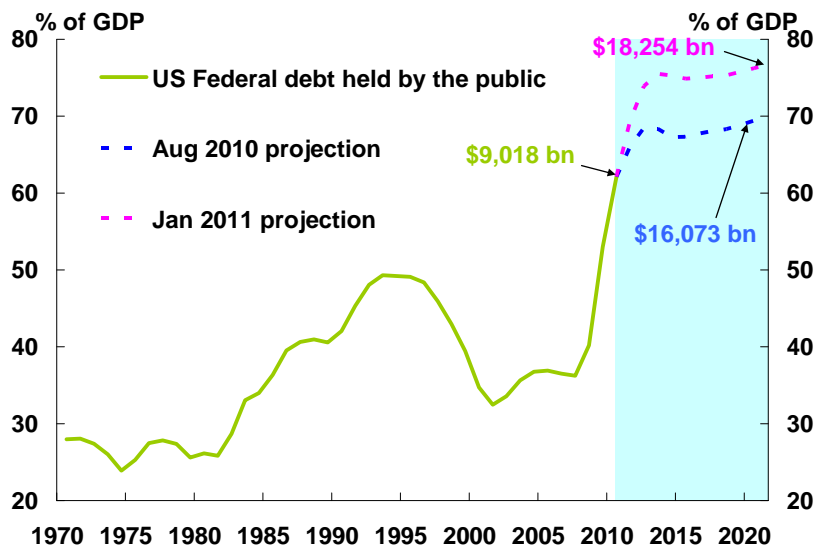


Source: CEIC

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US: FISCAL SITUATION



Source: Congressional Budget Office

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ASSESSMENT OF THE US ECONOMY

- Favourable factors supporting growth in the short term:
 - Fiscal stimulus measures
 - Accommodating monetary conditions
 - Improved corporate earnings
 - Positive wealth effect arising from a buoyant equity market
- A number of risks to economic growth in the medium-to-longer term:
 - Increases in long-term interest rates
 - Reduced scope for fiscal policies
 - Household deleveraging yet to be completed
 - Continued weakness in the housing market
 - Negative wealth effect to drag on growth
 - Reduced geographical mobility of unemployed workers

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Assessment of the economies of Europe and Japan

Europe

- Weak European economies are still troubled by the sovereign debt problem
- Major economies such as Germany and France are expected to see slow but steady growth

Japan

- High growth rate in 2010 not likely to repeat
- Japan's economy will see slow but steady growth in the short term
- Fiscal problems and an aging population will continue to pose risks to the medium-to-longer term outlook

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ASIAN ECONOMIC GROWTH FORECASTS

(% year-on-year)

Real GDP Growth

| | 2010 | 2011 Forecasts |
|-----------|-------------|-----------------------|
| Hong Kong | 6.8 | 4.8 |
| China | 10.3 | 9.3 |
| Korea | 6.1 | 4.5 |
| Singapore | 14.5 | 5.1 |
| Taiwan | 10.5 | 4.5 |
| Indonesia | 6.1 | 6.2 |
| Thailand | 7.8 | 4.5 |

Source: CEIC and Consensus Forecasts (Feb 2011)

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CURRENCY APPRECIATION AND RESERVES ACCUMULATION IN ASIAN ECONOMIES

| | Change in foreign reserves in 2010 | | Currency appreciation against USD in 2010 |
|----------------|------------------------------------|------------------|---|
| | (USD bn) | (%) | (%) |
| Hong Kong | 12.9 ¹ | 5.0 ¹ | - |
| Mainland China | 448.2 | 18.7 | 3.4 |
| Indonesia | 30.1 | 45.5 | 4.6 |
| Korea | 21.6 | 8.0 | 3.2 |
| Singapore | 37.9 | 20.2 | 9.3 |
| Taiwan | 33.8 | 9.7 | 9.7 |
| Thailand | 33.7 | 24.4 | 11.0 |

1. The increase in foreign reserves in Hong Kong was partly contributed by the investment income

Source: Bloomberg and CEIC

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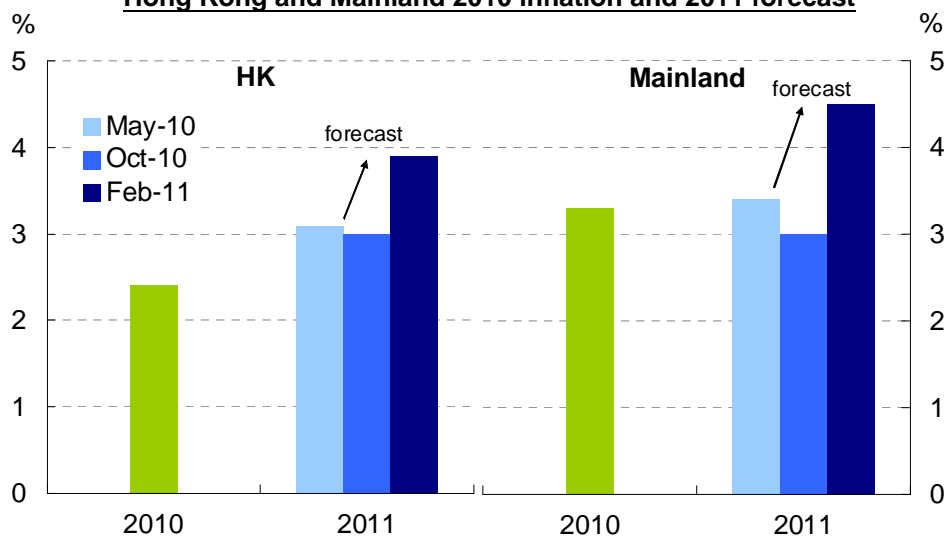
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ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: INFLATION

Hong Kong and Mainland 2010 inflation and 2011 forecast



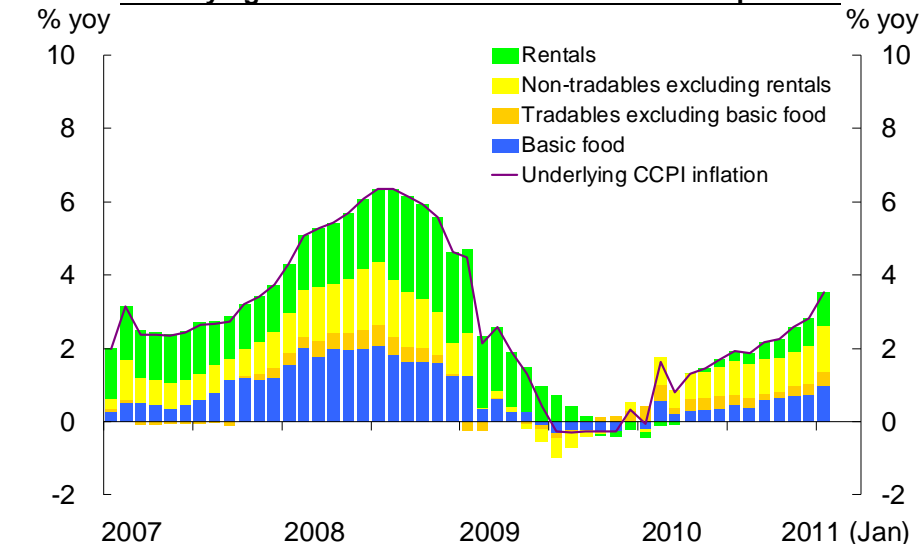
Source : Consensus Forecast (May and Oct 2010 and Feb 2011)

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ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: INFLATION

Underlying inflation and contributions of its components



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INFLATIONARY PRESSURES IN ASIAN ECONOMIES

Annual inflation rate

(% year-on-year)

| | Hong Kong | Mainland China | Indonesia | Korea | Singapore | Taiwan | Thailand |
|-----------------|-----------|----------------|-----------|-------|-----------|--------|----------|
| 2008 | 4.3 | 5.9 | 9.8 | 4.7 | 6.6 | 3.5 | 5.5 |
| 2009 | 0.5 | -0.7 | 4.8 | 2.8 | 0.6 | -0.9 | -0.8 |
| 2010 | 2.4 | 3.3 | 5.1 | 2.9 | 2.8 | 1.0 | 3.3 |
| 2011 (Forecast) | 3.9 | 4.5 | 6.8 | 3.7 | 3.2 | 1.9 | 3.4 |

Sources: Census and Statistics Department, CEIC and Consensus Forecasts (Feb 2011)

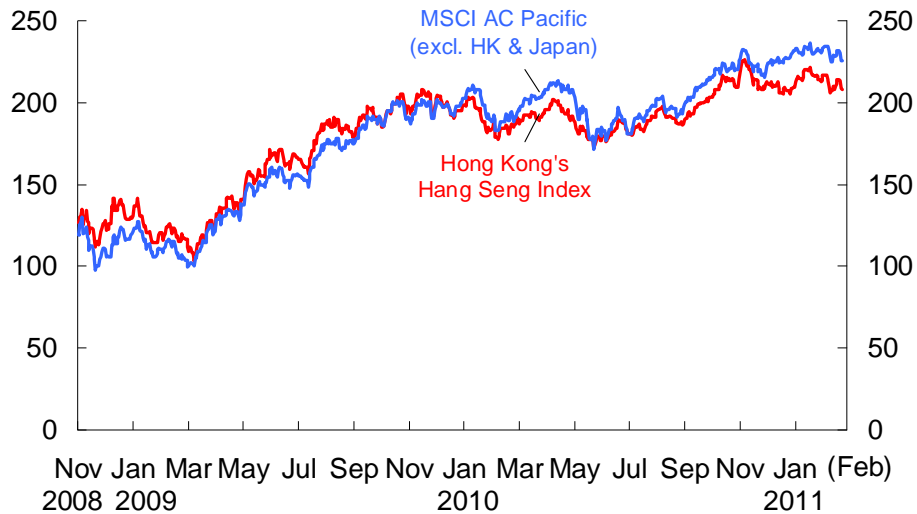
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ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: EQUITY MARKET

Hong Kong and Asia Pacific equity market performance

Rebased to Oct 27, 2008 = 100



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PRUDENTIAL MEASURES ON PROPERTY MORTGAGES

- Introduced more stringent requirements for mortgage lending to strengthen banks' risk management on 19 November 2010
 - LTV ratio reduced to 50% for properties at or above HK\$12 million, and 60% for value at or above HK\$8 million
 - 50% LTV for non-owner-occupied residential properties, properties held by companies, industrial and commercial properties, and mortgages granted on borrowers' net worth
 - Standardised DSR at 50% and stressed DSR at 60%
- The HKMA is conducting thematic on-site examinations on 21 banks starting from early 2011 to monitor compliance

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ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

| | 2010 | | | | 2011 | |
|--|--------|--------|--------|--------|--------|--------|
| | Aug | Sep | Oct | Nov | Dec | Jan |
| Number of transactions (Land Registry) | 14,699 | 10,424 | 9,552 | 13,189 | 9,328 | 8,002 |
| Weekly average transactions in 35 popular estates (Midland) | 239 | 156 | 357 | 215 | 187 | 329 |
| Housing prices (R&VD) (Oct 1997 = 100) | 89.6 | 90.3 | 92.6 | 94.4 | 93.6 | / |
| Housing prices (Centaline) (Oct 1997 = 100) | 83.2 | 84.5 | 85.5 | 87.9 | 88.4 | 90.1 |
| Number of new mortgage loans approved | 17,114 | 13,893 | 13,257 | 16,230 | 12,879 | 12,351 |
| Number of new applications for mortgage loans | 23,663 | 17,459 | 20,363 | 23,060 | 14,416 | 19,474 |
| Number of applications for MIP | 3,764 | 2,127 | 2,219 | 2,663 | 1,909 | 2,722 |

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ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

- Short-term trading activities have reduced following the announcement of the government measures in mid-November.
- It is expected that buyers in the property market will comprise mainly of owner-occupiers and medium-to-long-term investors. Factors determining future market developments will include homebuyers' affordability, supply of land and housing, mortgage borrowing costs, as well as investors' expectations on future property price trend and all of the above-mentioned factors.
- Higher inflation may strengthen incentives for home-purchase and add upward pressure to property prices.
- On the other hand, the Government is committed to increasing land supply.
- Interest rates may make a turn earlier than expected:
 - The European Central Bank may tighten monetary policy amid rising inflation
 - The medium-to-long-term interest rates in the US have already risen. If the economy continues to recover at the current pace, the Federal Reserve could adjust the current accommodating monetary policy earlier than expected
 - Regulations and monetary tightening on the Mainland will, to a certain extent, affect demand for credit in Hong Kong and interest rates
- The HKMA will continue to closely monitor market developments and introduce further measures to maintain banking stability if necessary.

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DEVELOPMENT OF OFFSHORE RMB BUSINESS IN HONG KONG

- A year of rapid development

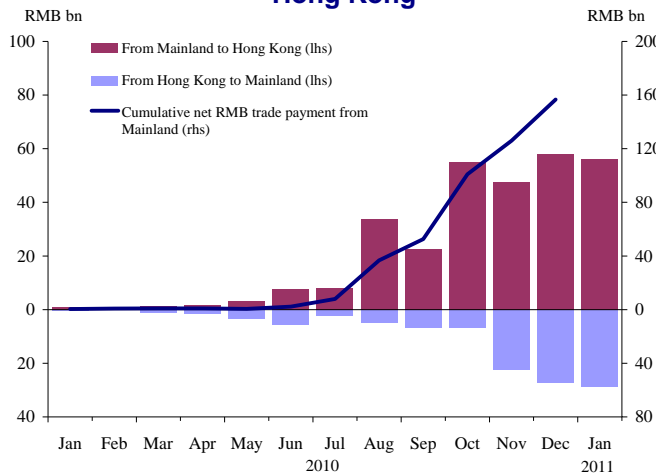
| | |
|---------------|---|
| February 2010 | HKMA provided elucidation on supervisory principles to streamline operational arrangements of offshore renminbi business in Hong Kong |
| June 2010 | Coverage of renminbi trade settlement pilot scheme expanded |
| July 2010 | Clearing Agreement on Renminbi Business amended, with restrictions on account opening of corporate and interbank fund transfers removed |
| August 2010 | Arrangement allowing Hong Kong banks to invest in the Mainland's interbank bond market launched |
| November 2010 | Renminbi sovereign bonds issued through HKMA's Central Moneymarkets Unit (CMU) |
| December 2010 | Number of Mainland enterprises eligible for settling merchandise exports in renminbi increased significantly |
| December 2010 | Refinement measures regarding Hong Kong's offshore renminbi business introduced |
| January 2011 | Pilot scheme for settlement of Mainland's overseas direct investment in renminbi launched |

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RMB TRADE SETTLEMENT ON RAPID GROWTH

RMB trade settlement conducted through Hong Kong



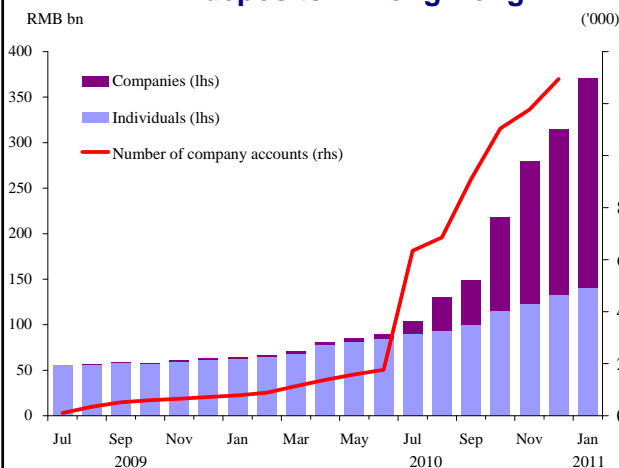
- After the expansion of RMB trade settlement scheme in June 2010, the amount of RMB trade settlement conducted through HK increased rapidly, from about RMB 4 bn per month in H1, to about RMB 57 bn per month in H2
- In 2010, total RMB trade settlement conducted through HK amounted to RMB 369.2 bn. Most of them were payments from Mainland importers to Hong Kong, with a net payment of RMB 156.7 bn to Hong Kong for trade settlement

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INCREASING RMB DEPOSIT BASE IN HONG KONG

RMB deposits in Hong Kong



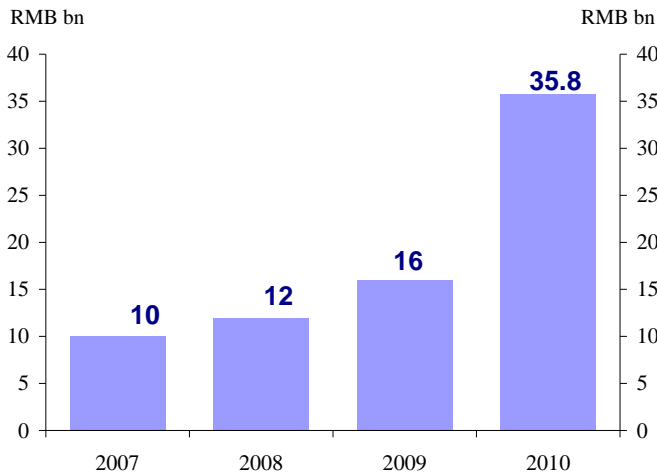
- RMB deposits increased by four times to RMB 314.9 bn at end-Dec; and further increased to RMB 370.6 bn at end-Jan 2011
- Mainly attributed to an increase in RMB receipts by corporate customers through trade settlement transactions
- At end-Jan, RMB deposits by corporate customers amounted to RMB 230.3 bn, accounting for 62% (2009: 1%) of total RMB deposits
- The number of corporate accounts also increased to nearly 130,000 (2009: 7,200)

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FURTHER DEVELOPMENT OF RMB BOND MARKET

RMB bond issuance in Hong Kong



- **Expansion of issuers in 2010:** from Mainland financial institutions to HK corporations, multinationals and international financial institutions
- **Tenors:** from 2 or 3 years to 10 years (e.g. bonds issued by the Ministry of Finance of China and the Asian Development Bank)

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RMB BUSINESS IN HONG KONG – FURTHER DEVELOPMENT

- Actively promote the use of Hong Kong's RMB platform for settlement of the Mainland's overseas direct investment (ODI) and foreign direct investment (FDI) into the Mainland in RMB
- Facilitate the development of various RMB financial products in Hong Kong
- Enhance the circulation of RMB funds and interaction between the offshore and onshore markets
- Capitalise the "first mover" advantage by actively promoting the development of Hong Kong as the offshore RMB centre

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ADVANCEMENT OF HONG KONG'S SOVEREIGN CREDIT RATINGS

- Attained upgrades in Hong Kong's sovereign credit ratings by all three major international credit rating agencies:
 - Moody's upgraded Hong Kong's ratings to Aa1, only one notch below the highest rating category, and assigned a "Positive" outlook to Hong Kong's ratings (Nov 2010)
 - Fitch upgraded Hong Kong's ratings to AA+, only one notch below the highest rating category (Nov 2010)
 - S&P upgraded Hong Kong's ratings to triple-A, the highest rating category (Dec 2010)
- Hong Kong was the only economy around the world being upgraded to AAA in 2010

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REFORMING OTC DERIVATIVES MARKET

- The Financial Stability Board (FSB) has recently approved a report containing recommendations to promote consistent implementation of the G20's commitments concerning –
 - Increasing the proportion of the market that is standardised
 - Moving standardised OTC derivatives to exchanges or electronic trading platforms
 - Moving to central clearing of standardised OTC derivatives by end 2012
 - Ensuring that OTC derivatives transactions are reported to trade repositories by end 2012
- As a member of the FSB and to fulfil the role of an international financial centre, we have the responsibility to comply with international standards
- Under the current regulatory framework, the HKMA, the SFC and the Government will work together in building the regulatory regime for OTC derivatives market and consult the market on the detailed regulatory requirements by Q3 2011

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SUPERVISION ON CREDIT GROWTH

- 29% growth in loans in 2010, with substantial growth in:
 - property related lending (+19%)
 - trade finance (+57%)
 - wholesale and retail sector (+53%)
- The HKMA
 - has gathered information about the reasons for the credit growth
 - will ensure the banks will not lower loan approval requirements
 - is conducting on-site examinations to assess banks' credit underwriting standards

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SHARING OF MORTGAGE DATA FOR CREDIT ASSESSMENT

- The financial services industry, represented by the Consumer Credit Forum, proposes the sharing of positive mortgage data for credit assessment
- The HKMA fully supports the proposal
- The Office of the Privacy Commissioner for Personal Data (“PCO”) published a consultation paper on the sharing of mortgage data for credit assessment on 5 January (Consultation period finished on 8 February)
- The public focus is more on whether
 - non-residential mortgage data should be shared
 - banks should be allowed to have access to the shared mortgage data when processing applications for non-mortgage lending (e.g. credit cards or personal loans)
 - Pre-existing mortgage data should be shared
- The HKMA will work closely with the PCO and the banking sector in taking this proposal forward

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INVESTOR / CONSUMER PROTECTION

Investor protection

- Fieldwork of mystery shopper exercise completed in 2010
- The HKMA issued circular in December 2010 reminding AIs to adopt a cautious approach when selling accumulators
- The HKMA has been providing assistance to the Financial Services and the Treasury Bureau on the establishment of Investor Education Council and Financial Dispute Resolution Centre

Consumer protection

- Credit card reform measures

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DEPOSIT PROTECTION

- Full deposit guarantee expired at the end of 2010
- The protection limit of the Deposit Protection Scheme (DPS) increased to \$500,000 with effect from 1 January 2011
- Improved representation requirements on protection status of deposits have also taken effect
- Large-scale multi-media publicity activities are continuing to increase public awareness of the expiry of the full deposit guarantee and the increased deposit protection provided by the enhanced DPS

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IMPLEMENTATION OF BASEL III

- Final text of Basel III – reforms to strengthen banks' capital adequacy and liquidity – published in December 2010:
 - Tightening the definition of regulatory capital and increasing the minimum requirements of common equity and tier-1 capital
 - Establishing conservation / countercyclical capital buffers
 - Supplementing the capital adequacy ratio with a non-risk based leverage ratio
 - Introducing a new liquidity coverage ratio and a net stable funding ratio
- HKMA plans to phase-in the new requirements from 1 January 2013 in line with Basel Committee timetable
- Legislative process will begin soon

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INVESTMENT INCOME

| (HK\$ billion) | 2010 | | | | | 2009 | 2008 | 2007 | 2006 |
|----------------------------|-------------|------------|------------|------------|------------|------------|-----------|-----------|-----------|
| | Full year * | Q4 | Q3 | Q2 | Q1 | Full year | Full year | Full year | Full year |
| Bonds# | 42.1 | (18.6) | 19.9 | 29.4 | 11.4 | (0.6) | 88.4 | 61.0 | 31.9 |
| Hong Kong equities^® | 11.6 | 4.3 | 15.0 | (4.6) | (3.1) | 48.9 | (77.9) | 55.8 | 35.9 |
| Foreign equities^ | 27.0 | 19.1 | 18.1 | (21.4) | 11.2 | 48.8 | (73.1) | 6.7 | 18.7 |
| Foreign exchange | (3.1) | 0.5 | 20.7 | (15.6) | (8.7) | 9.8 | (12.4) | 18.7 | 17.3 |
| Other investments& | <u>1.4</u> | <u>0.2</u> | <u>0.8</u> | <u>0.1</u> | <u>0.3</u> | <u>0.8</u> | - | - | - |
| Investment income/(loss)®& | 79.0 | 5.5 | 74.5 | (12.1) | 11.1 | 107.7 | (75.0) | 142.2 | 103.8 |

* Unaudited figures

Including interest

^ Including dividends

® Excluding valuation changes in Strategic Portfolio (HK\$2.6 billion)

& Including valuation changes of investment held by EF's investment holding subsidiaries

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CHANGES IN INVESTMENT INCOME, PAYMENT TO FISCAL RESERVES AND ACCUMULATED SURPLUS

| (HK\$ billion) | 2010 | | | | | 2009 |
|--|--------------------------|--------------|--------------|---------------|--------------|--------------|
| | Full year (unaudited) | Q4 | Q3 | Q2 | Q1 | Full year |
| Investment income/(loss) | 79.0 | 5.5 | 74.5 | (12.1) | 11.1 | 107.7 |
| Other income | 0.2 | - | 0.1 | 0.1 | - | 0.2 |
| Interest and other expenses | (4.8) | (1.2) | (1.2) | (1.5) | (0.9) | (3.8) |
| Net investment income/(loss) | 74.4 | 4.3 | 73.4 | (13.5) | 10.2 | 104.1 |
| Payment to Fiscal Reserves # | (33.8) | (8.6) | (8.3) | (8.4) | (8.5) | (33.5) |
| Payment to HKSAR government funds and statutory bodies # | (3.9) | (1.1) | (1.1) | (0.9) | (0.8) | (1.2) |
| Valuation change of Strategic Portfolio less investment held by EF's investment holding subsidiaries^ | 1.2 | 1.3 | 1.2 | (0.4) | (0.9) | 3.6 |
| Increase/(Decrease) in EF Accumulated Surplus | 37.9 | (4.1) | 65.2 | (23.2) | - | 73.0 |

The fixed rate of fee payment is 6.3% for 2010 and 6.8% for 2009.

^ Including dividends