



HONG KONG MONETARY AUTHORITY

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

1 March 2012



DISCUSSION TOPICS

Updates on

- Financial and Economic Environment
- Currency Stability
- Banking Stability
- Financial Infrastructure
- Hong Kong as an International Financial Centre
- The Exchange Fund
- Hong Kong Mortgage Corporation



FINANCIAL AND ECONOMIC ENVIRONMENT



GLOBAL ECONOMIC GROWTH FORECASTS

Real GDP Growth

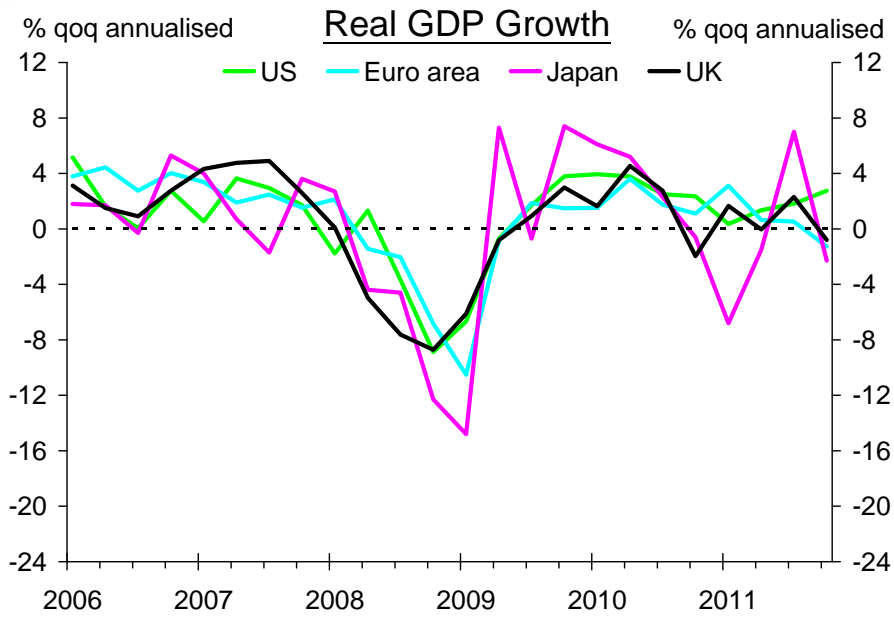
(% year-on-year)

	2011	2012 Forecasts		
		May 2011 FAP briefing	Dec 2011 FAP briefing	Mar 2012
US	1.7	3.2	2.1	2.2
Euro area	1.5	1.7	0.4	-0.3
Japan	-0.9	2.8	2.1	1.8
Asia (ex-Japan)	7.2	7.5	6.9	6.7

Sources: Consensus Forecasts



ECONOMIC SITUATION IN MAJOR COUNTRIES

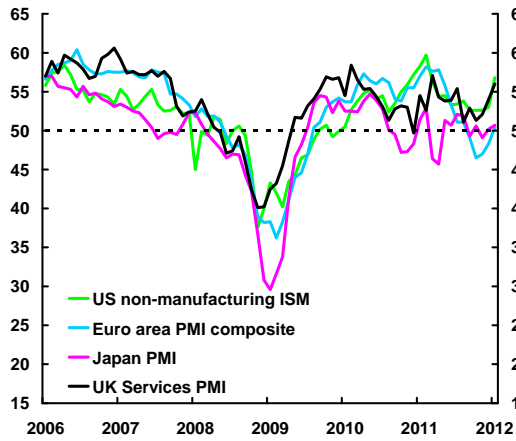


Source: Bloomberg

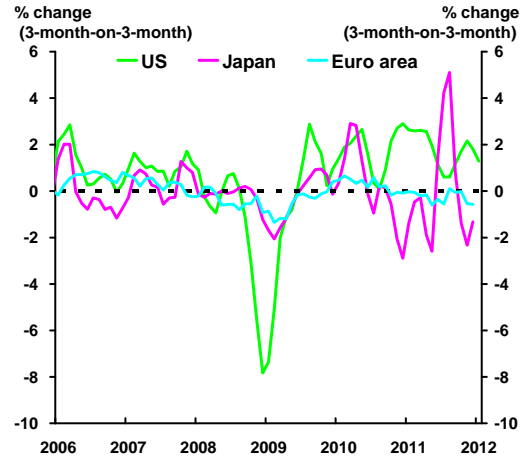


ECONOMIC SITUATION IN MAJOR COUNTRIES

Purchasing Manager Index



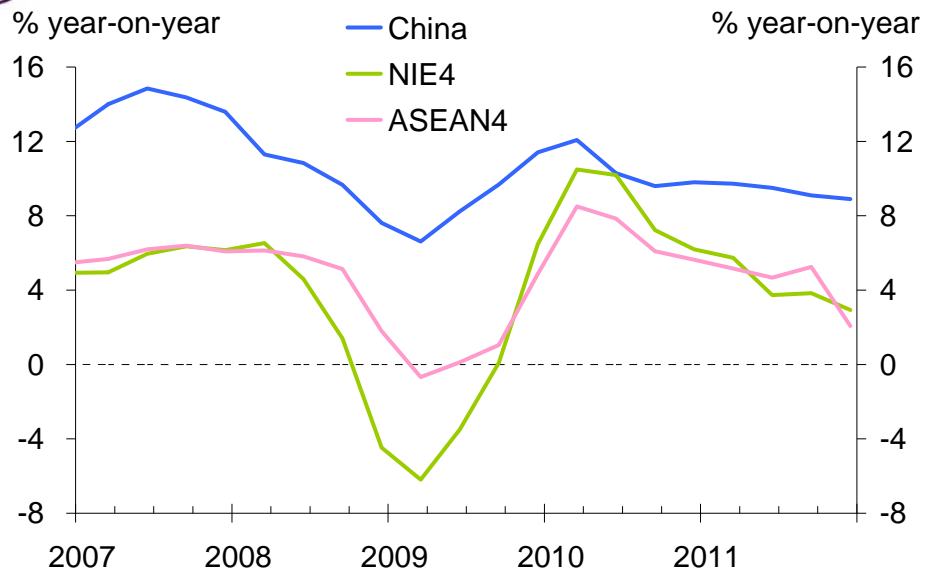
Retail Sales



Sources: Bloomberg and CEIC



ECONOMIC GROWTH IN ASIA



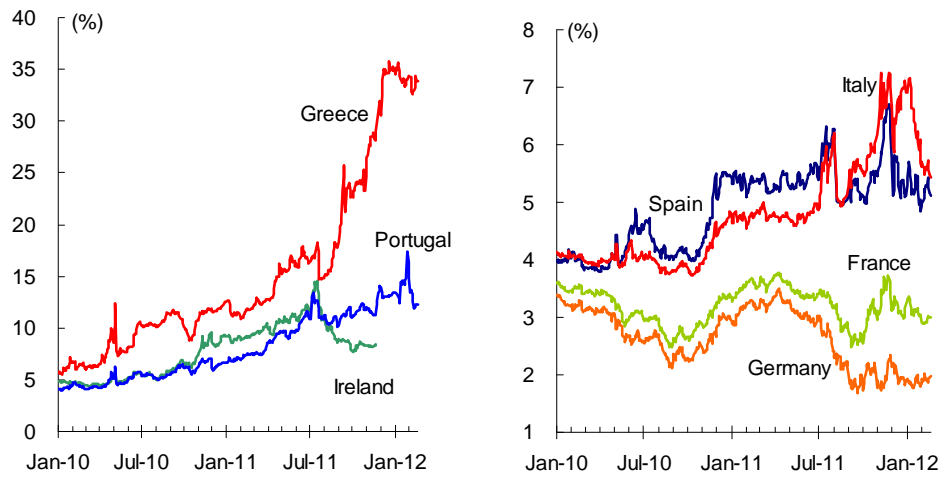
Note: NIE4 includes Hong Kong, Singapore, South Korea and Taiwan; ASEAN4 includes Indonesia, Malaysia, the Philippines and Thailand.

Sources: CEIC, IMF and staff estimates



EUROPEAN: SOVEREIGN DEBT CRISIS

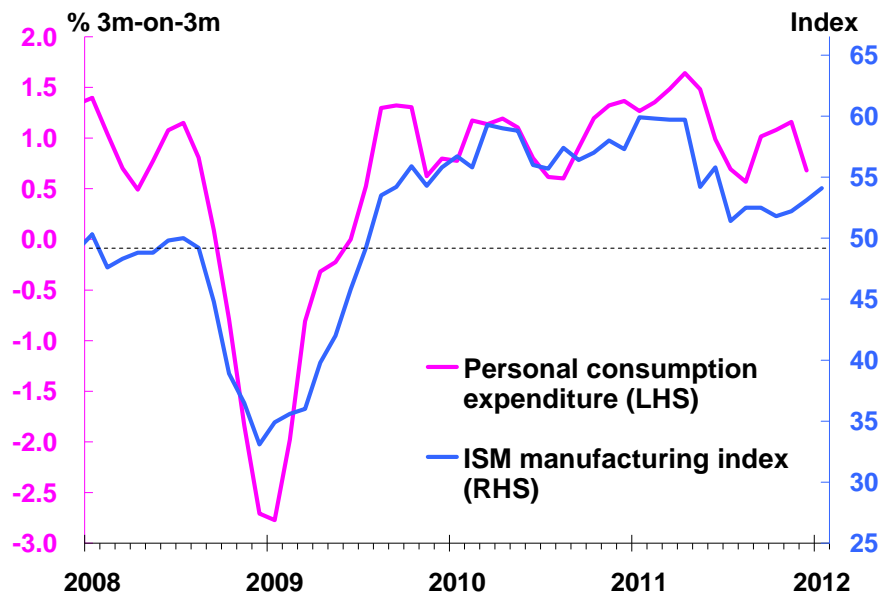
10-year sovereign bond yield



Source: Bloomberg Note: Ecwin has stopped publishing Ireland's 10-year bond yield since 22 Nov, 2011



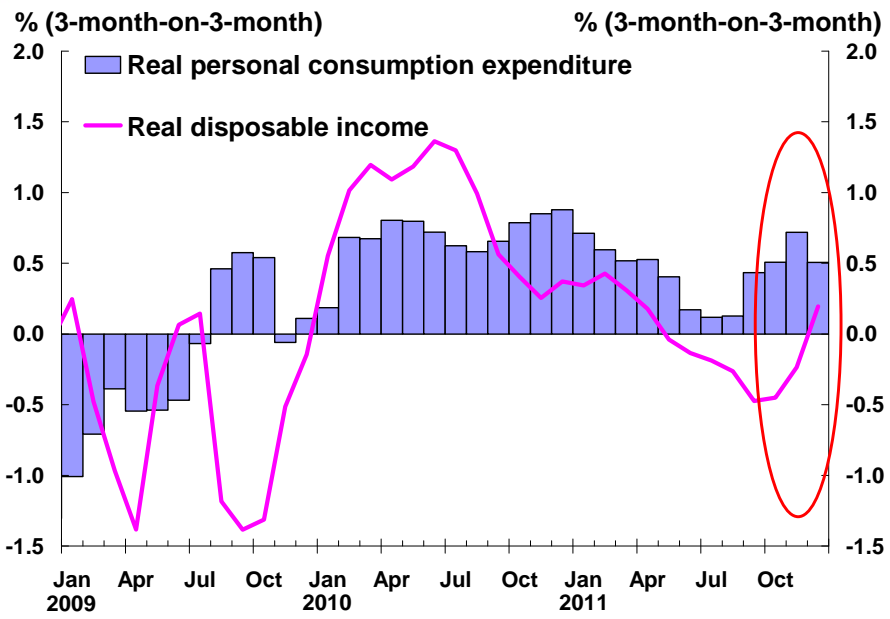
US: CONSUMPTION GROWTH & BUSINESS ACTIVITY



Source: CEIC



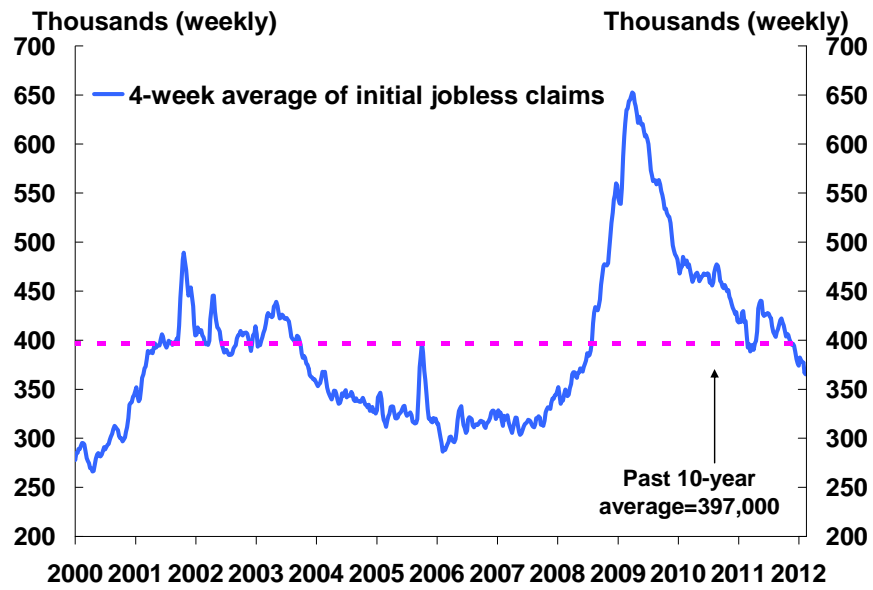
US: CONSUMPTION AND INCOME GROWTH



Sources: CEIC



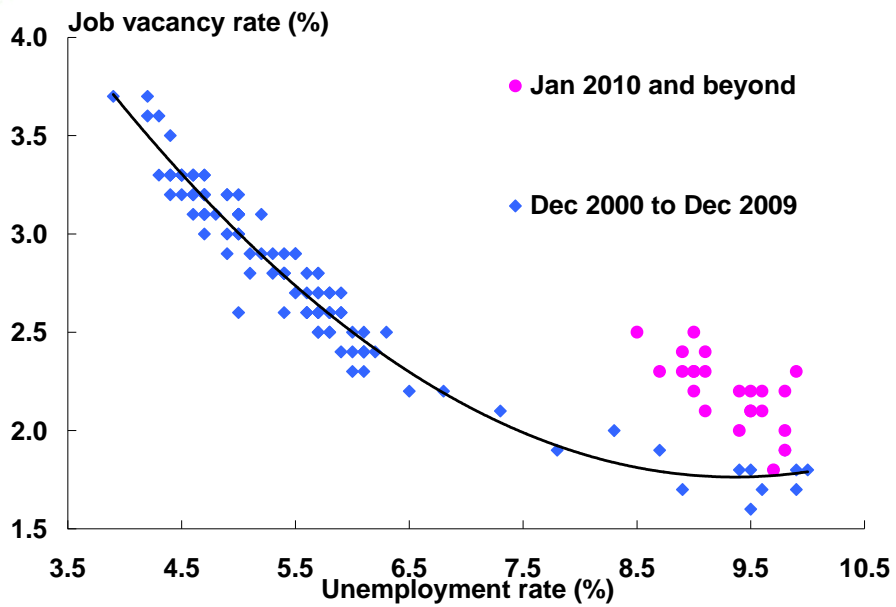
US: WEEKLY INITIAL JOBLESS CLAIMS



Source: CEIC



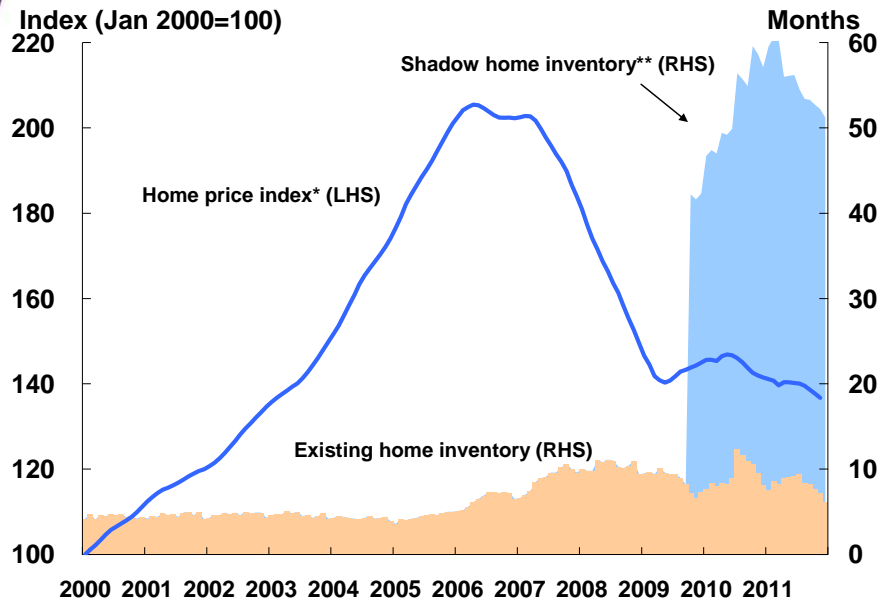
US: STRUCTURAL MISMATCH IN THE LABOUR MARKET



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



US : HOUSE PRICES AND HOME INVENTORY



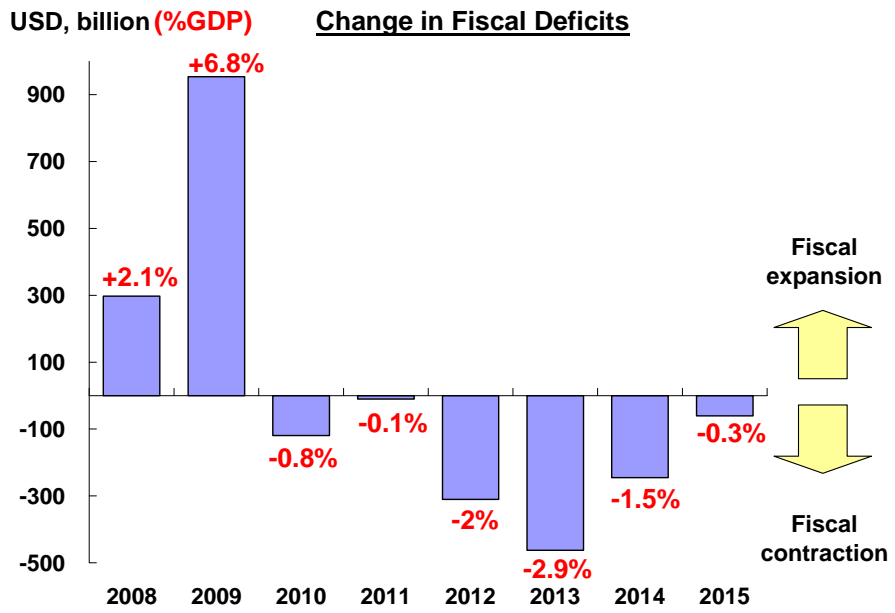
* Case-Shiller 20-city home price index

** Standard and Poor's estimates include the total number of homes with mortgage loans more than 90 days delinquent, currently or recently in foreclosure and those that are real estate owned (REO).

Sources: Standard & Poor's and CEIC



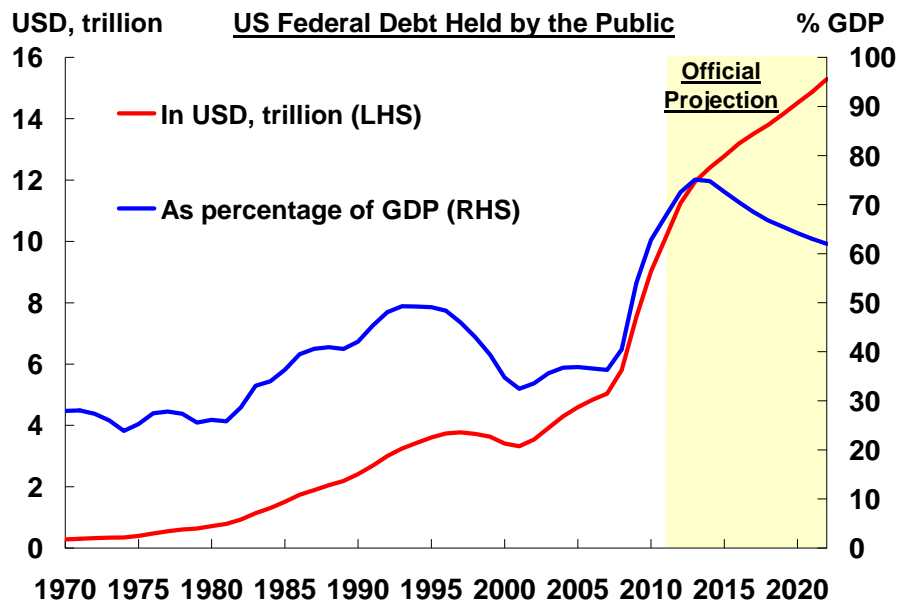
US: FISCAL CONSOLIDATION



Source: US Congressional Budget Office (CBO) and CEIC



US: FEDERAL GOVERNMENT DEBT



Sources : CBO



ECONOMIC ASSESSMENT OF MAINLAND CHINA

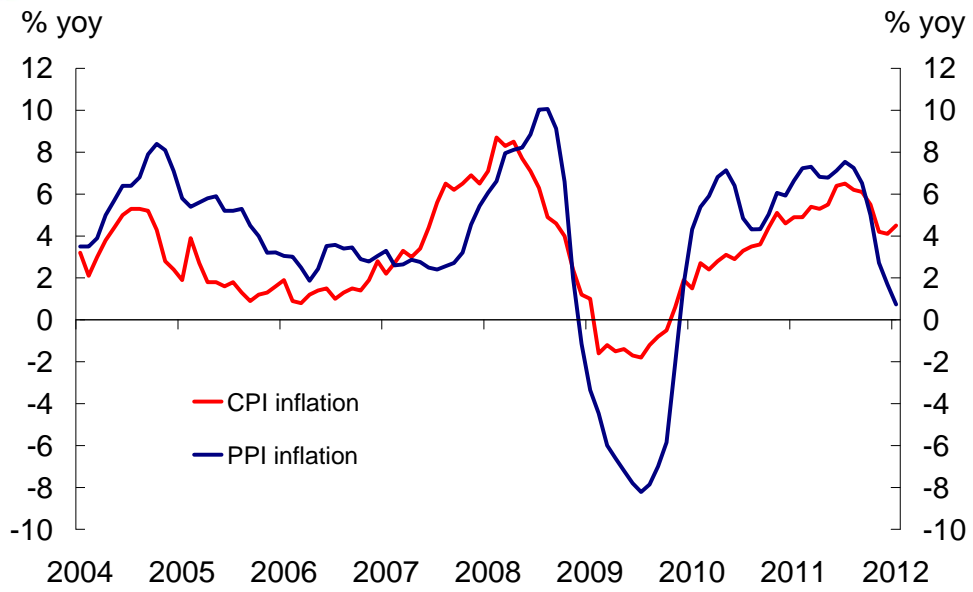
Forecasts of Major Indicators for 2012

	2010	2011	2012 Consensus Forecasts	
			Nov 2011	Feb 2012
Real GDP growth (%)	10.4	9.2	8.5	8.4
CPI inflation (%)	3.3	5.4	3.8	3.3

Sources: CEIC and Consensus Forecasts (November 2011, February 2012)



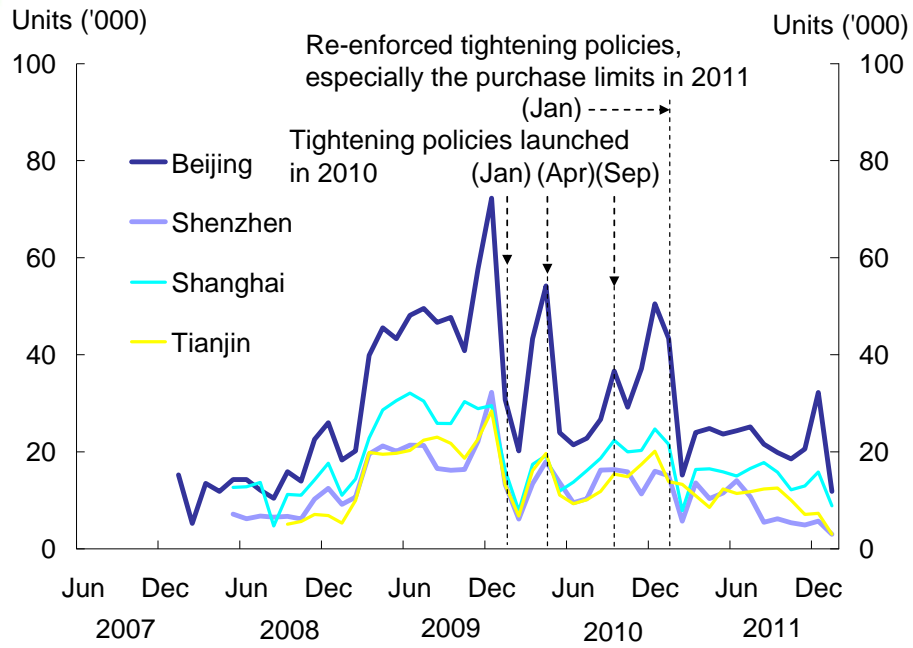
MAINLAND INFLATION RATES



Source: CEIC



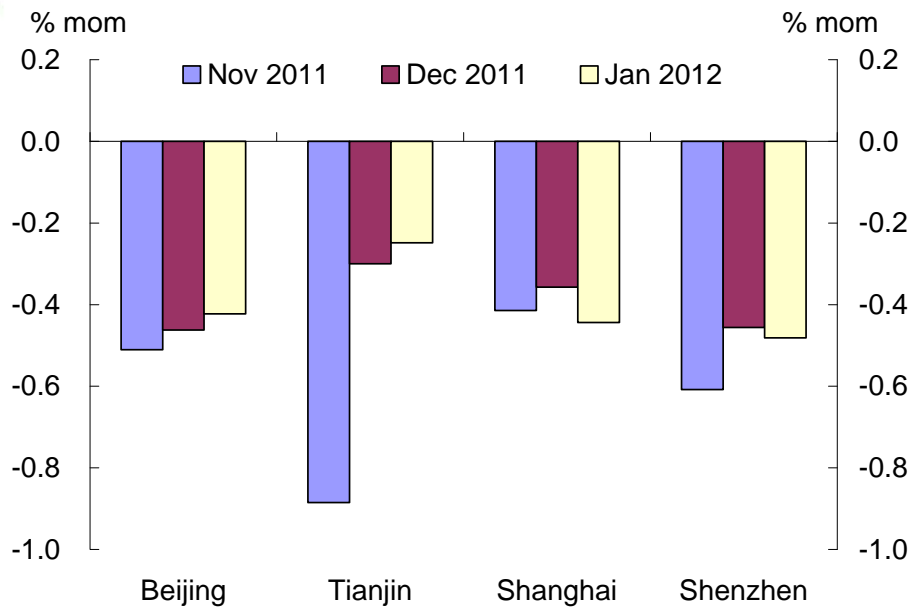
PROPERTY TRANSACTION VOLUME IN MAINLAND MAJOR CITIES



Source: WIND



HOUSING PRICE CHANGES IN MAINLAND MAJOR CITIES

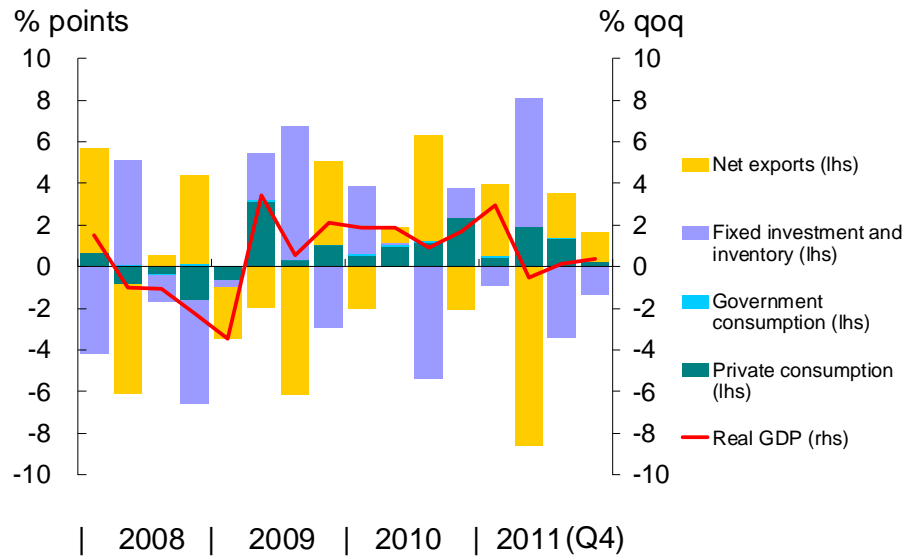


Sources: CEIC, WIND and staff estimates



HONG KONG ECONOMIC SITUATION

Changes in Real GDP and contributions by major components

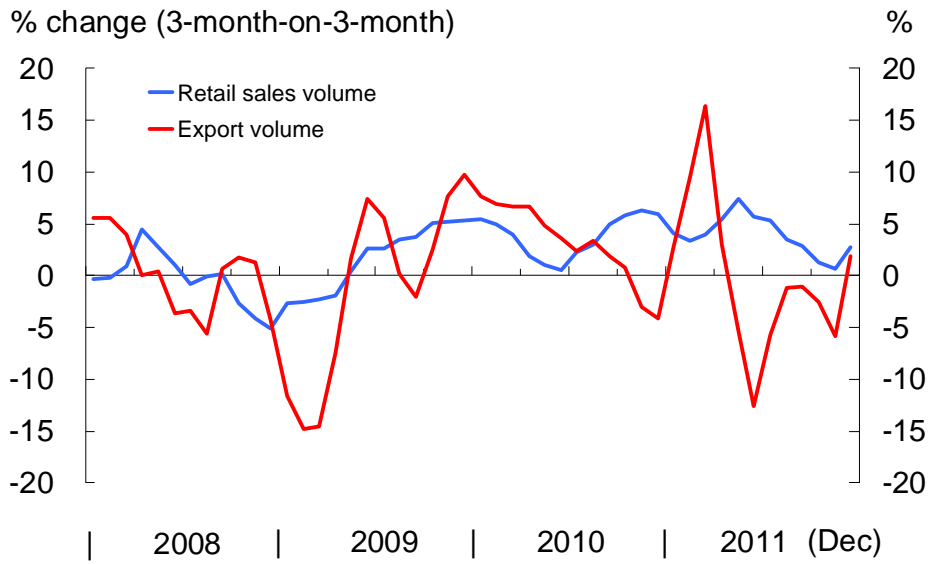


Sources: C&SD and staff estimates.



HONG KONG ECONOMIC SITUATION

Retail Sales and Exports

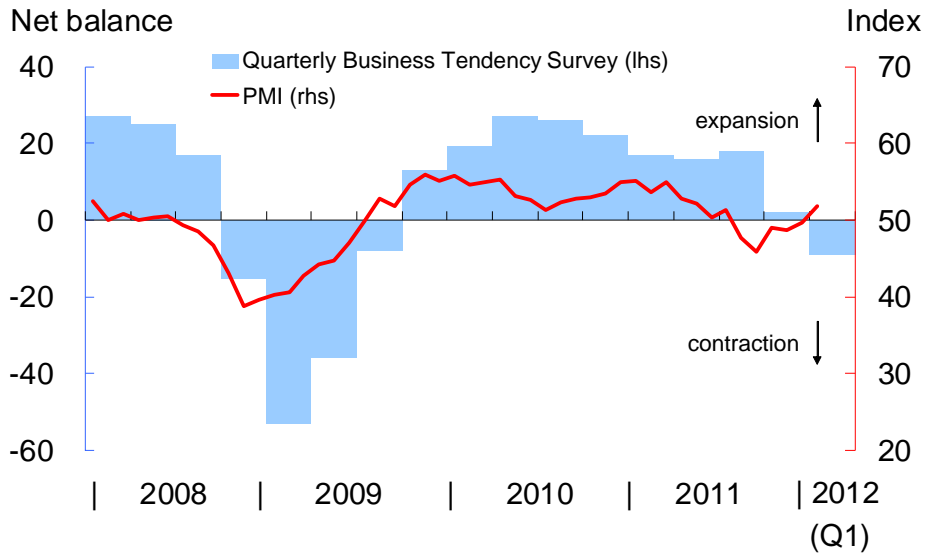


Source: C&SD.



HONG KONG ECONOMIC SITUATION

Business Outlook

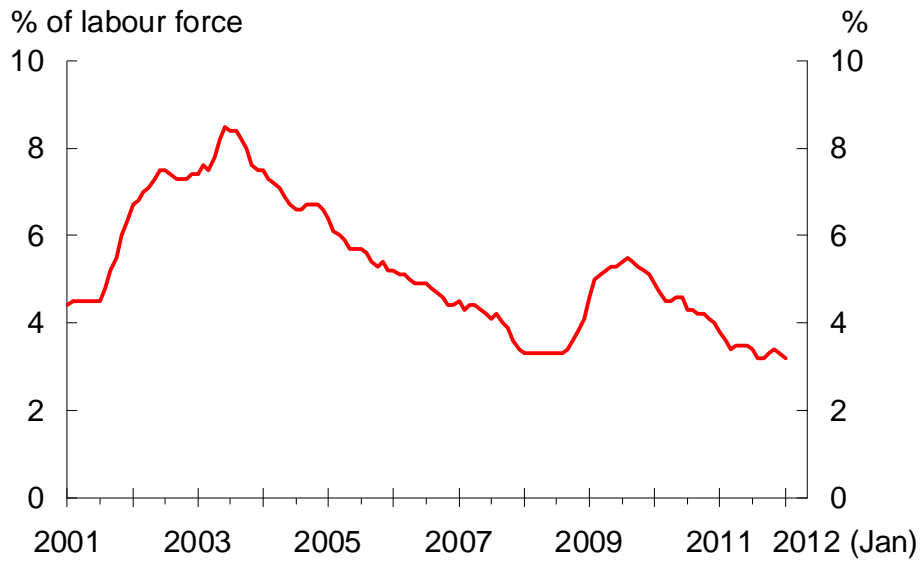


Sources: C&SD and Markit Economics.



HONG KONG ECONOMIC SITUATION

Unemployment rate

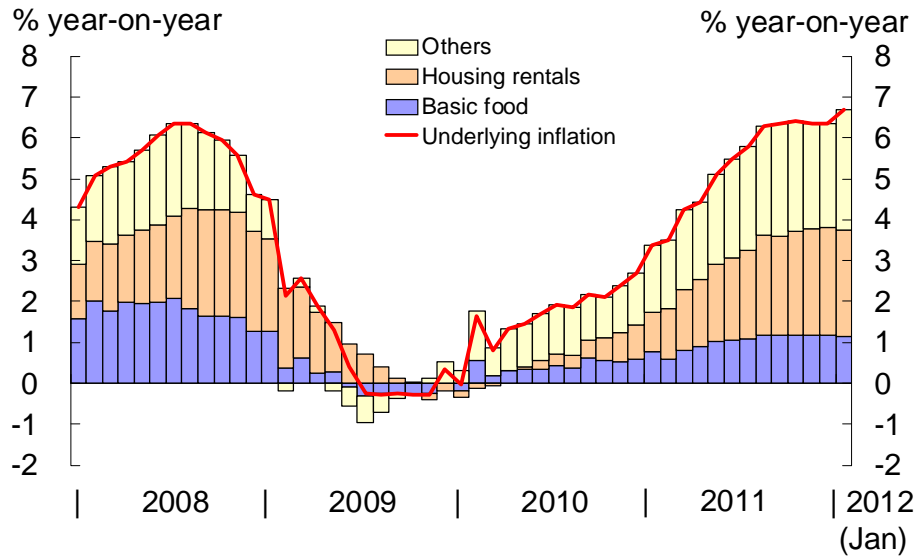


Source: C&SD.



HONG KONG ECONOMIC SITUATION

Underlying inflation and contributions of its components

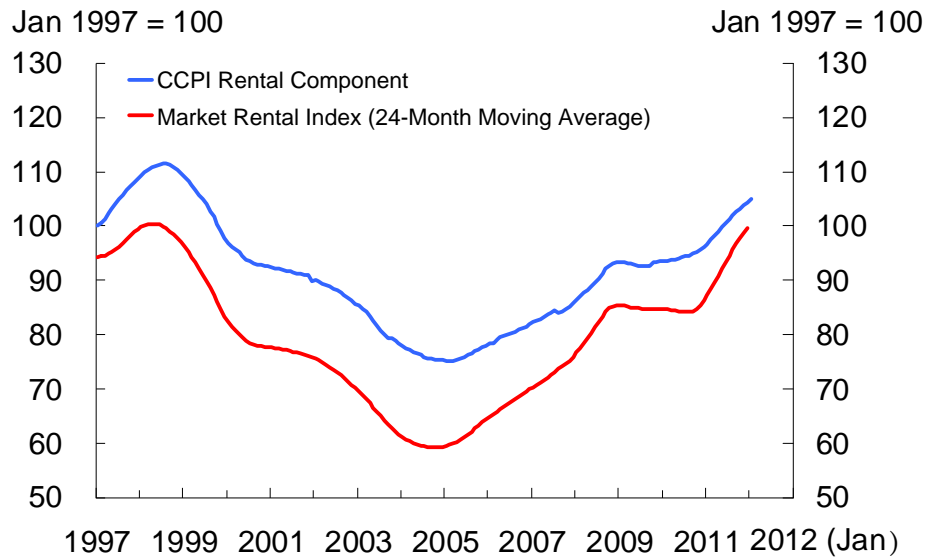


Underlying inflation: Netting out the effects of all Government's one-off relief measures from headline inflation.
Sources: C&SD and staff estimates.



HONG KONG ECONOMIC SITUATION

CCPI rental component and residential property rental index

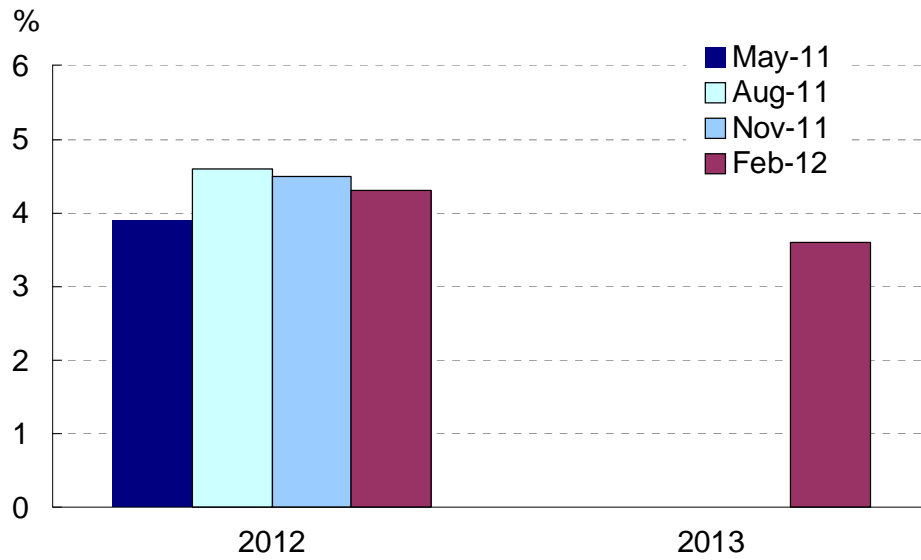


Sources: Rating and Valuation Department (R&VD), C&SD and staff estimates.



HONG KONG ECONOMIC SITUATION

2012 and 2013 inflation forecasts

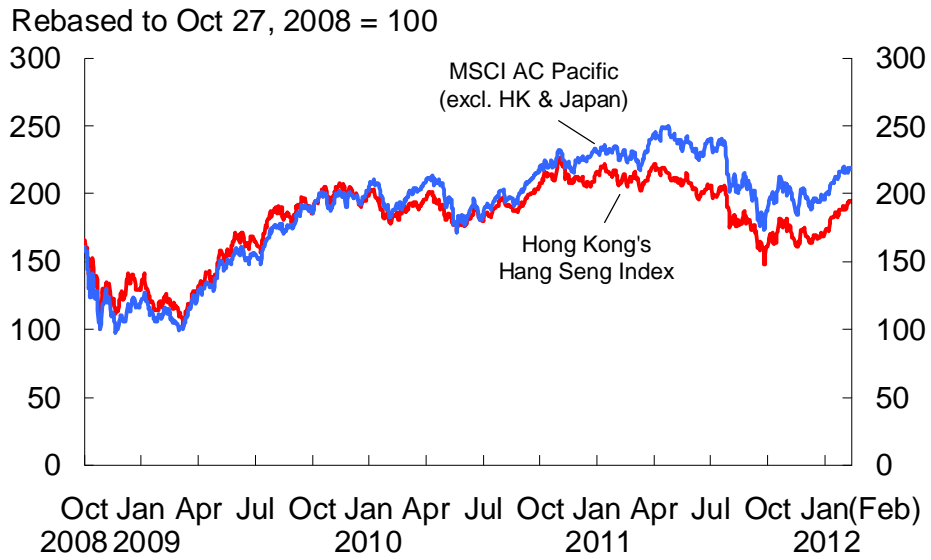


Source: Consensus Forecast (May, Aug, Nov 2011 and Feb 2012).



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

Hong Kong and Asia Pacific equity market performance

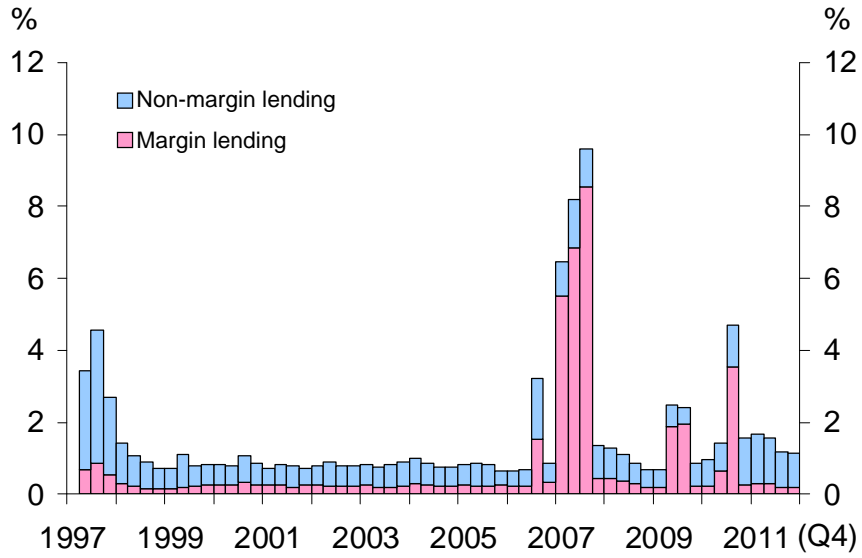


Source: Bloomberg.



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

Share of stock-market-related loans to total domestic loans

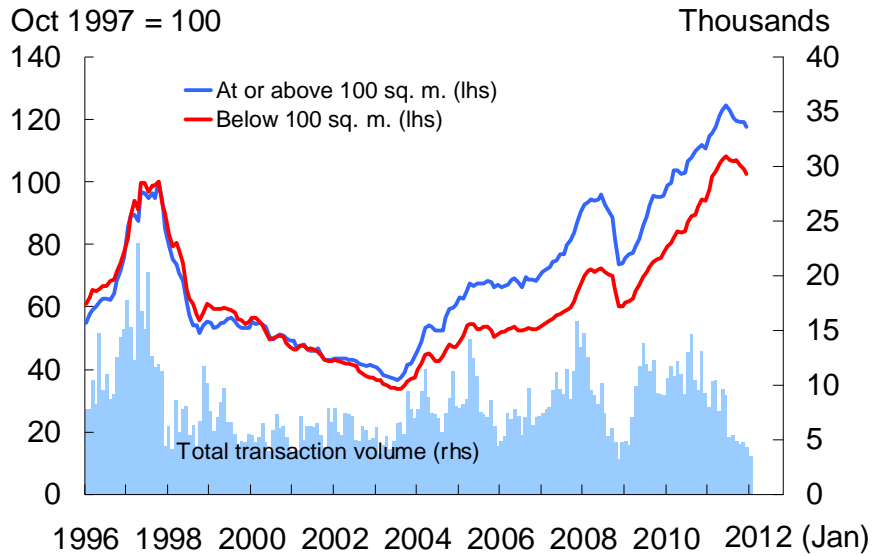


Source: HKMA.



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

Residential property prices and transaction volume

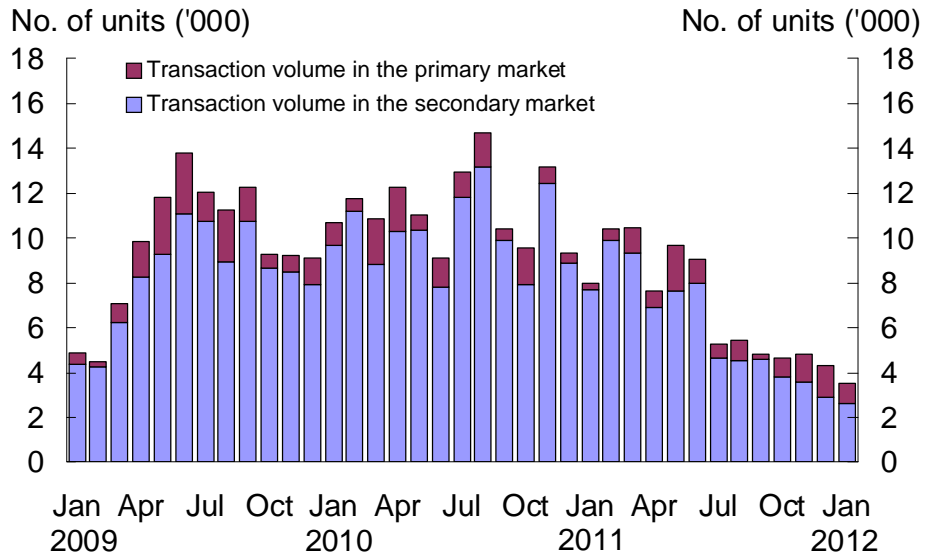


Source: Rating and Valuation Department.



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

Transaction volumes in residential property market

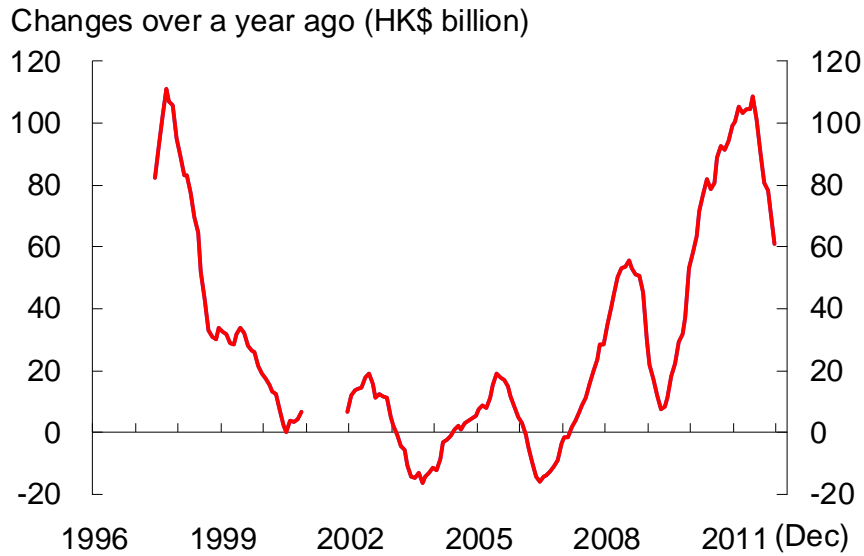


Source: Land Registry.



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

Changes in outstanding mortgage loans

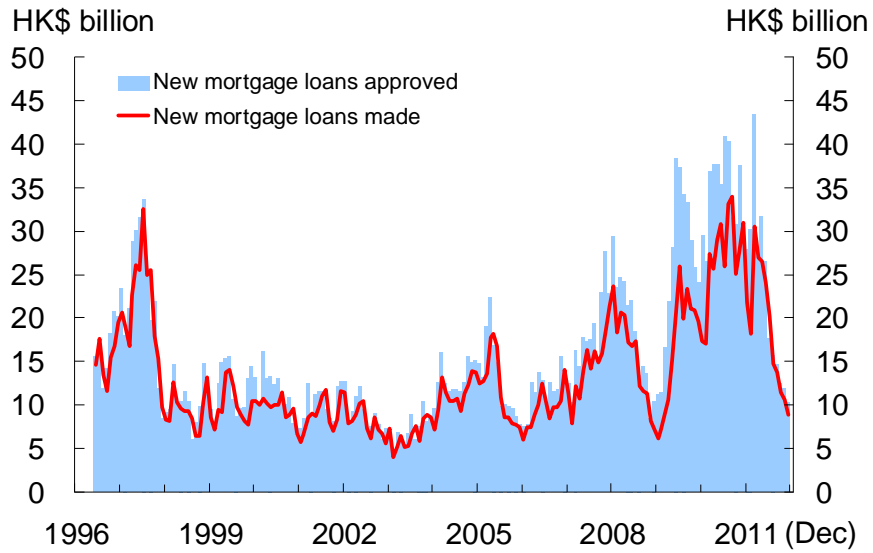


*There is a break in data series at December 2000 due to an increase in the number of surveyed institutions.
Source: HKMA.



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

New mortgage loans made and approved



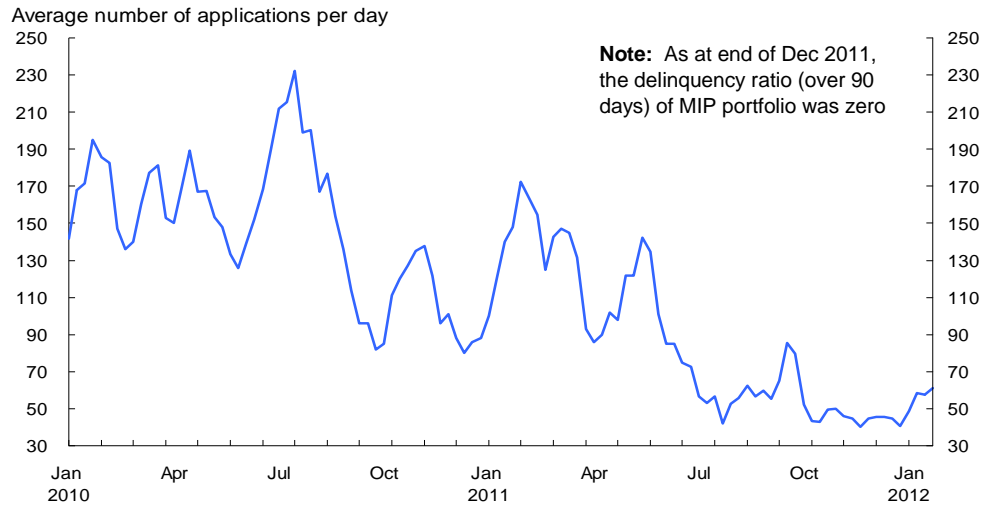
* There is a break in data series at December 2000 due to an increase in the number of surveyed institutions.

Source: HKMA.



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

Slow down in MIP loan applications



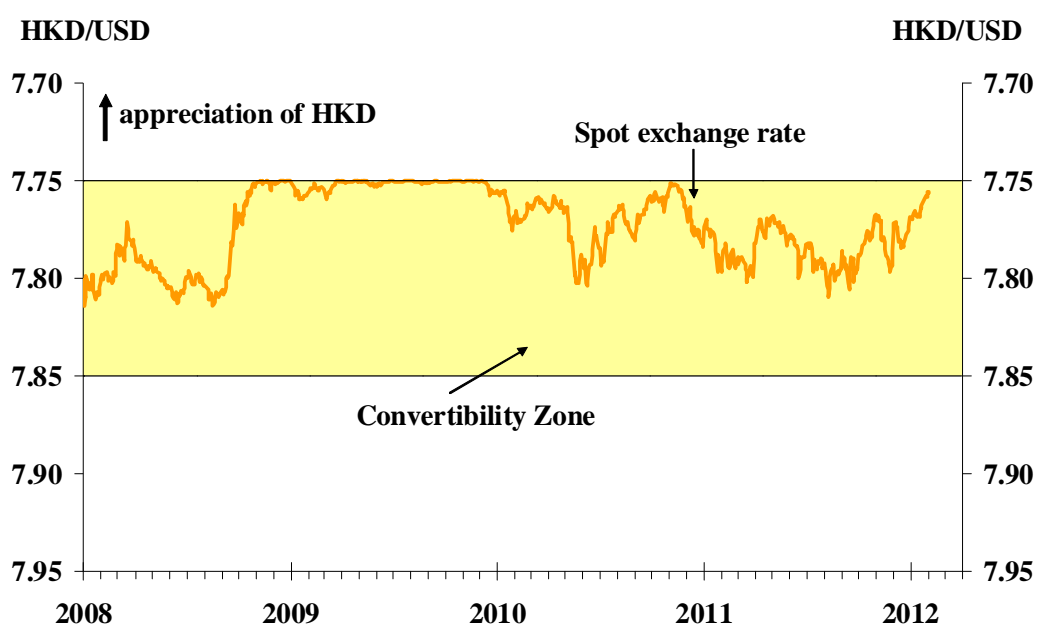
Source: Hong Kong Mortgage Corporation



CURRENCY STABILITY



HONG KONG DOLLAR SPOT EXCHANGE RATE

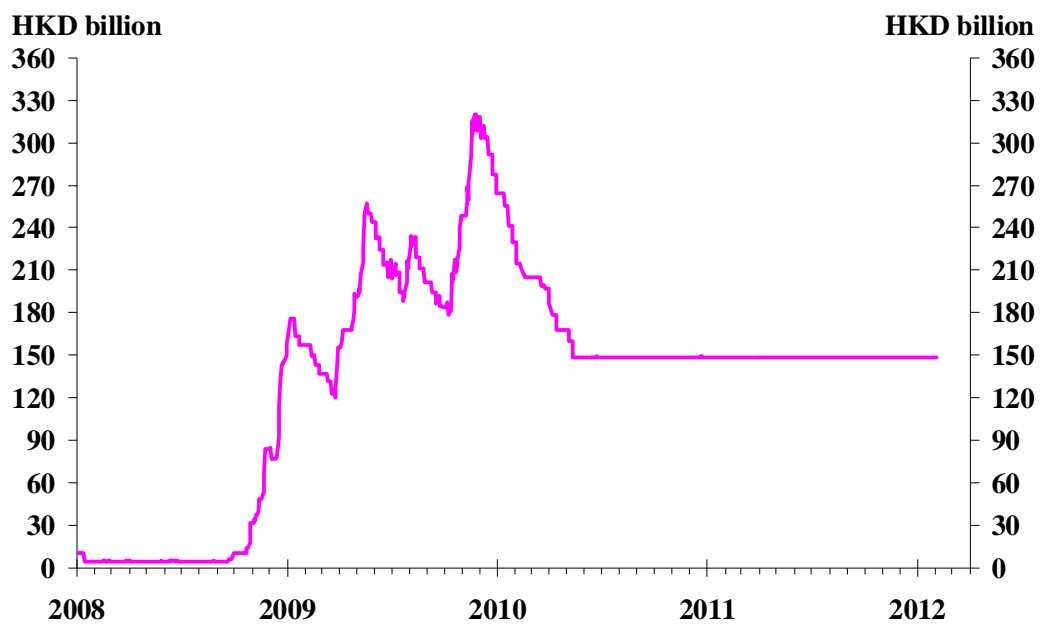


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- The Hong Kong dollar has traded in a firmer tone against the US dollar since late 2011, alongside the broadly higher regional stocks and currencies, as risk sentiment improved on signs of progress in solving the Eurozone sovereign debt crisis and the US Fed's forecast of exceptionally low interest rates at least until late 2014.
- The Hong Kong dollar's strength was also supported by the strong Hong Kong dollar funding demand around the year-end and ahead of the Chinese New Year holidays.



AGGREGATE BALANCE

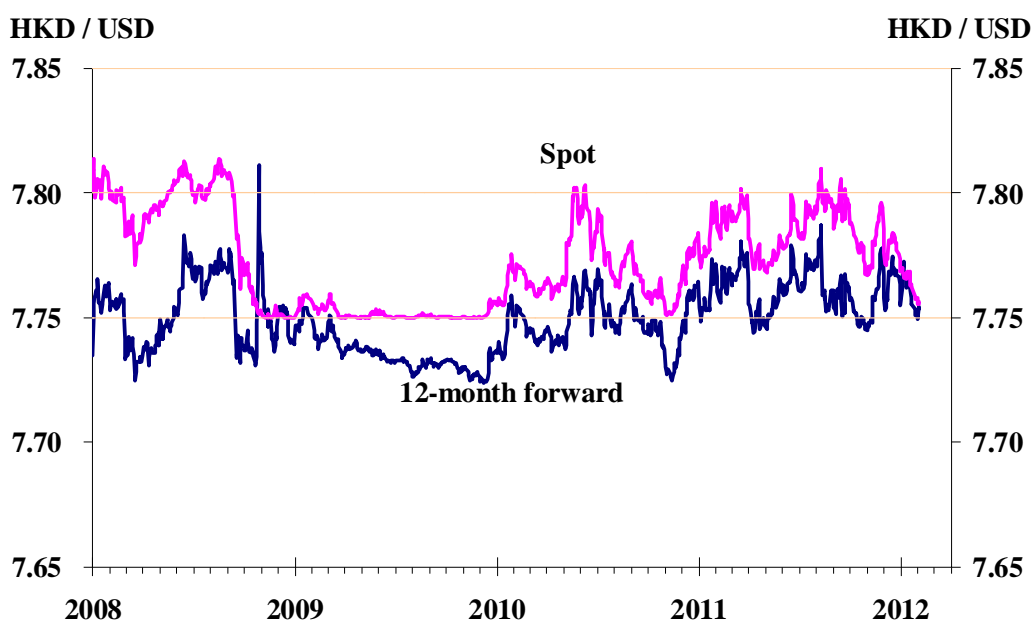


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- Liquidity remained abundant in the interbank market. The Aggregate Balance has stayed steady at around HK\$150 billion since mid-May 2010.



HONG KONG DOLLAR FORWARD EXCHANGE RATE

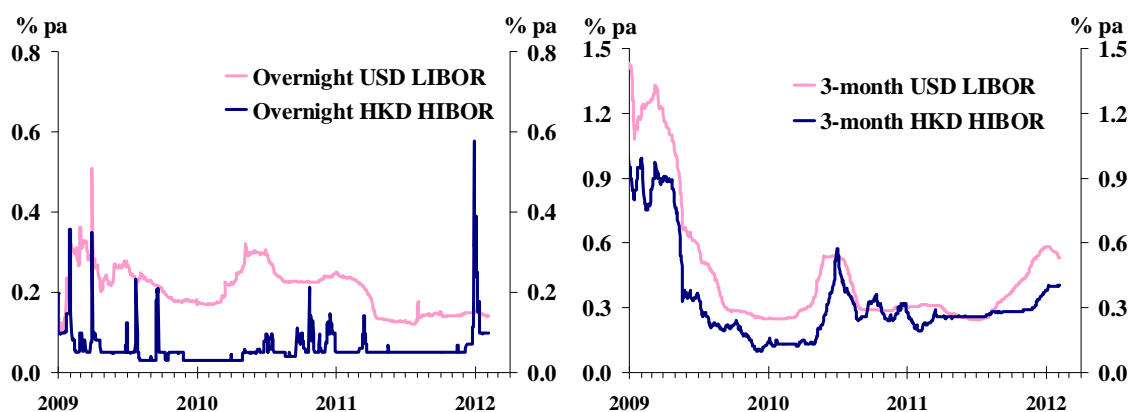


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- Reflecting the increased Hong Kong dollar funding demand, the Hong Kong dollar forwards have traded in a firmer tone alongside a stronger spot rate. The 12-month forward discounts shrank to the narrowest levels since late 2008 and turned into premia occasionally in early January.



DOMESTIC INTEREST RATES



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- Short-term Hong Kong dollar interest rates have risen modestly alongside higher US dollar interest rates since late 2011, but remained low and stayed below their US dollar counterparts.
- The temporary spikes in overnight HIBOR in late December and early January reflected the strong Hong Kong dollar demand around the year-end.

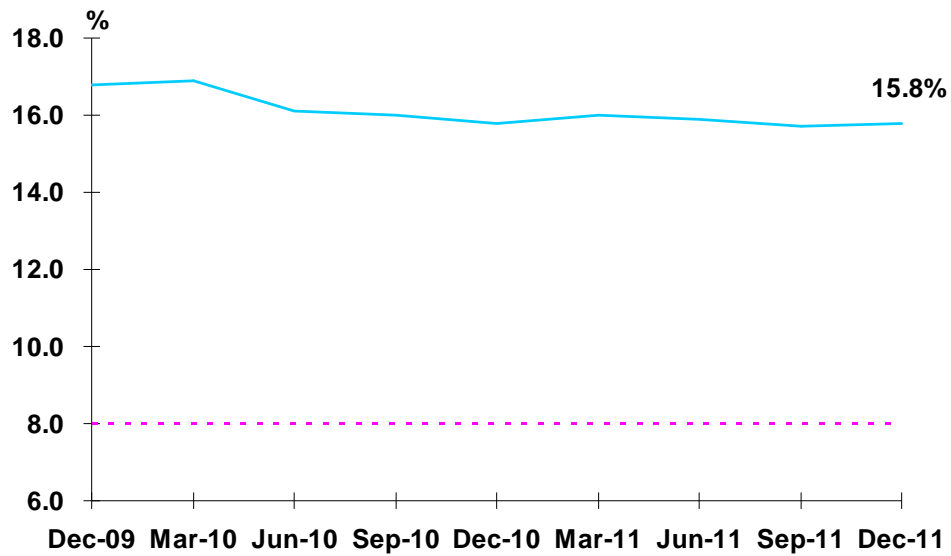


BANKING STABILITY



BANKING SECTOR PERFORMANCE

Locally incorporated AIs continued to be well capitalised



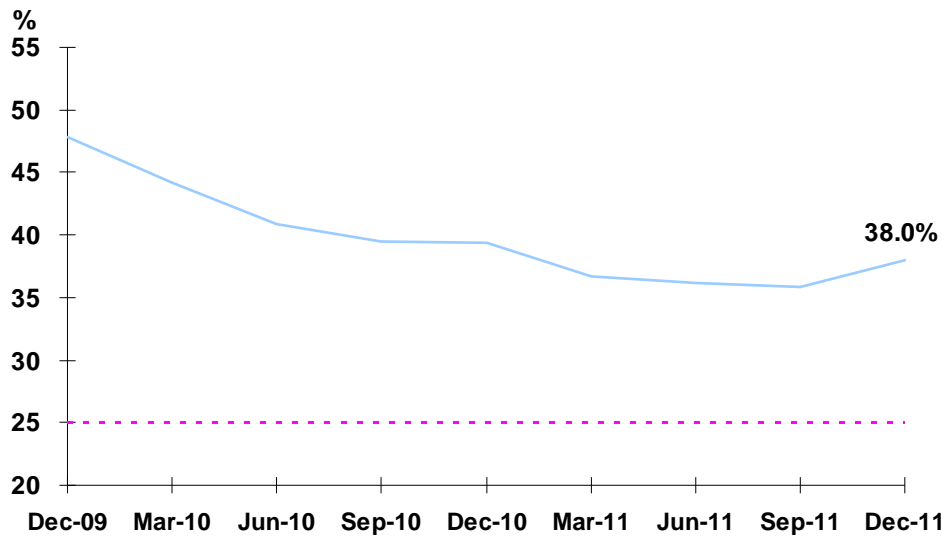
40

- The consolidated capital adequacy ratio of locally incorporated AIs was 15.8% at the end of December 2011, compared with 15.7% at the end of September 2011. The ratio remained well above the international standard of 8%.



BANKING SECTOR PERFORMANCE

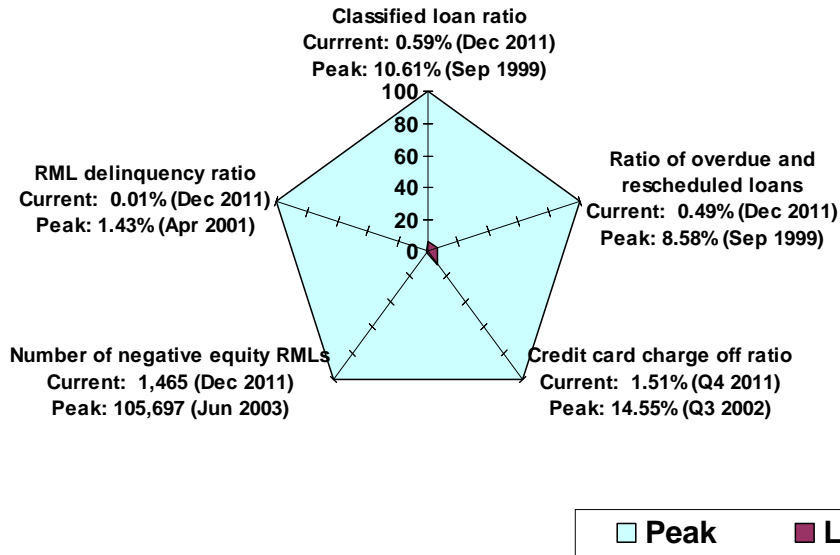
Liquidity ratio of retail banks remained well above statutory minimum of 25%





BANKING SECTOR PERFORMANCE

Asset quality indicators remained good compared with historical standards

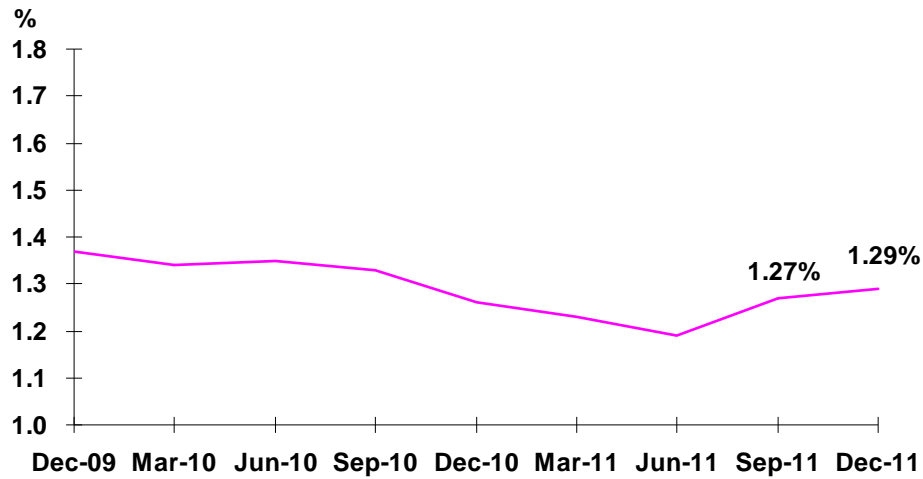


- The HKMA continues to monitor closely the asset quality of retail banks' loan portfolios.



BANKING SECTOR PERFORMANCE

Net interest margin of retail banks



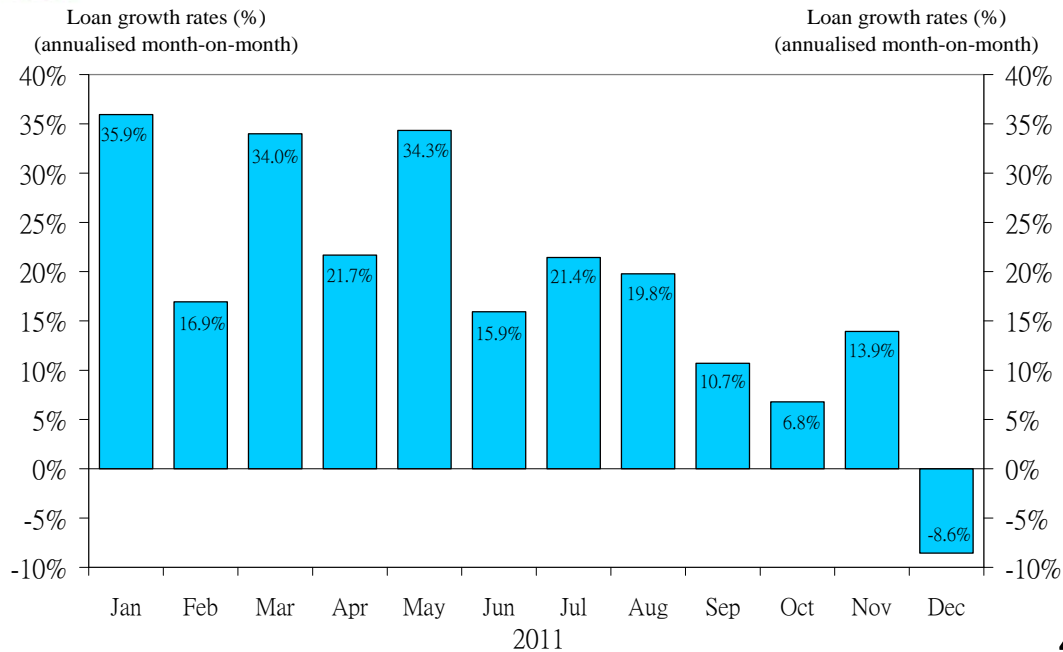
43

- The quarterly annualised net interest margin of retail banks increased for the second consecutive quarter to 1.29% in Q4 2011.
- The aggregate pre-tax operating profit of retail banks' Hong Kong offices in 2011 increased by 18.0% compared with a year ago. Benign increases in both net interest income (+11%) and non-interest income (+9%), together with a milder increase in operating expenses (+3%), contributed to the profit growth.



CREDIT GROWTH

Credit growth began to moderate in H2/2011



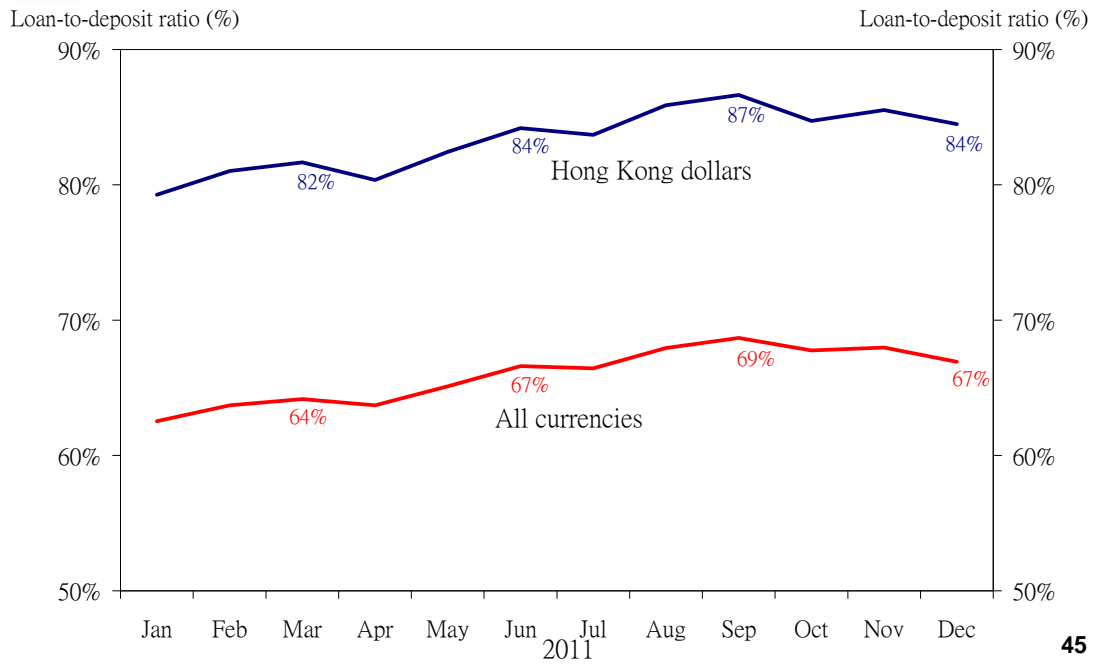
44

- Given the uncertainties over the global economic outlook as well as a series of supervisory actions taken by the HKMA in 2011 to address rapid credit expansion, the total loan growth of banks in Hong Kong moderated to 20.2% in 2011 from 28.6% in 2010.
- Loan growth began to slow down in H2/2011. Total loans and advances recorded a 8.6% (annualised) month-on-month decrease in December. This may be attributable to seasonal factors.



CREDIT GROWTH

Change in loan-to-deposit ratio of banks in Hong Kong

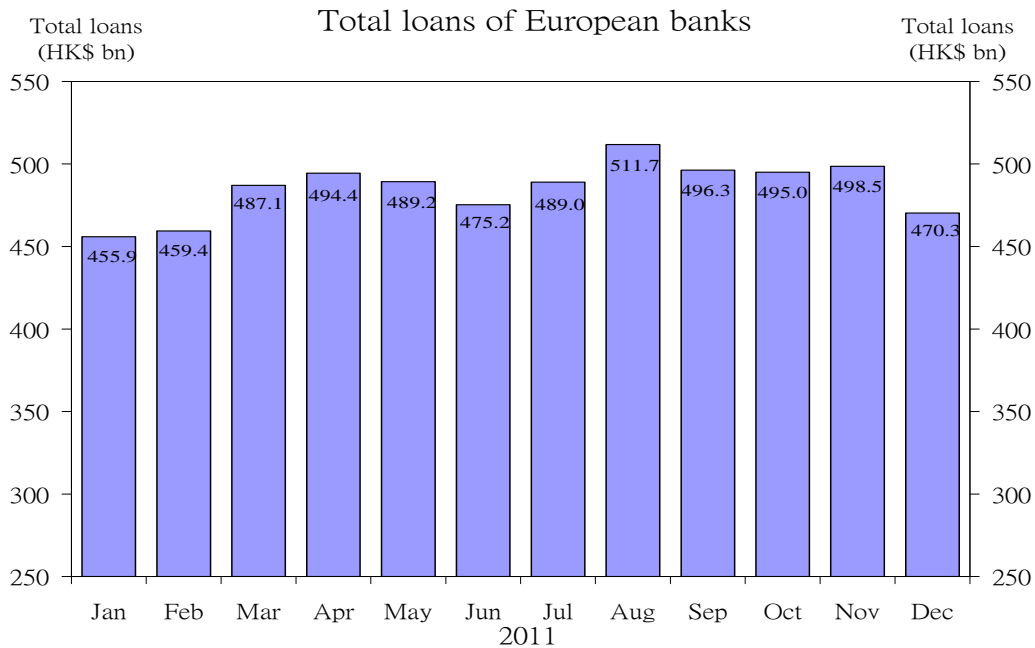


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- Loan-to-deposit ratio (HKD) dropped from 87% at end-September 2011 to 84% at end-December 2011. The HKMA will continue to monitor the movement of the loan-to-deposit ratio.



CREDIT GROWTH



- Total loans and advances of European banks in Hong Kong maintained at some HK\$400 billion in 2011. Month-on-month decline was noted in individual months. Among these, there was a 5.7% month-on-month drop in Dec 2011.
- Given the uncertainties of the external environment, the HKMA will continue to closely monitor the market development and the operations of European banks in Hong Kong.



RISK MANAGEMENT IN RESIDENTIAL MORTGAGE LOANS (“RMLs”)

- The HKMA introduced in June 2011 the fourth round of countercyclical macroprudential measures on RMLs. Banks have strengthened their risk management in RML business.
 - Average loan-to-value (“LTV”) ratio for new RMLs lowered from 64% in September 2009 to 53% in December 2011
 - Average debt servicing ratio for new RMLs lowered from 41% in August 2010 to 36% in December 2011
- Under the new measures, the maximum LTV ratio for owner-occupied residential properties with a value at or below HK\$6 million remains unchanged at 70%. Eligible buyers may also obtain from banks a mortgage loan of up to 90% LTV ratio through mortgage insurance programme.
- There were signs of easing of mortgage lending in H2/2011.

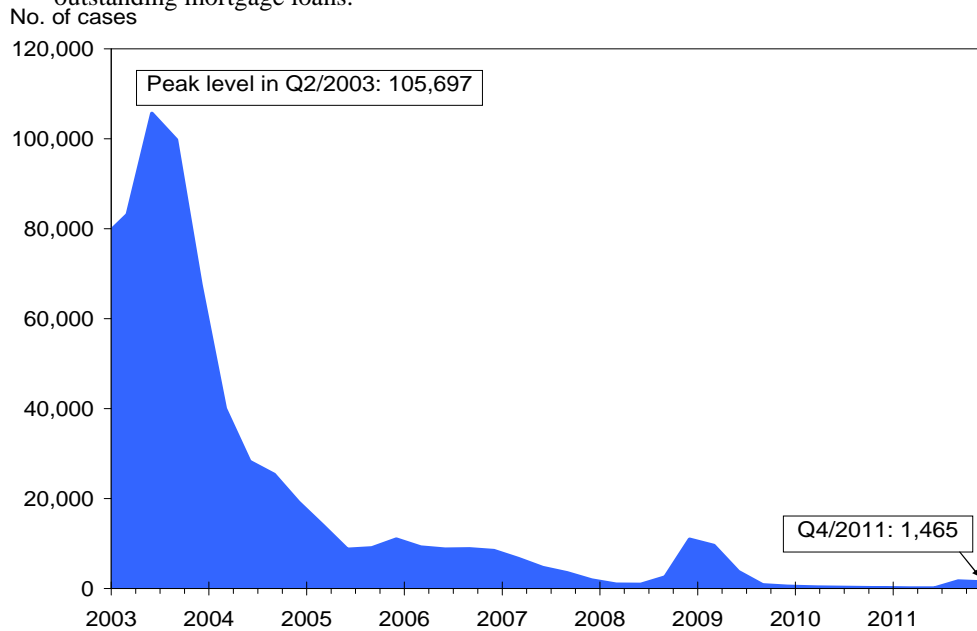
	6/2011	12/2011
New RML applications	11,913	6,039 (-49%)
New RML approvals (HK\$bn)	26.6	10.4 (-61%)

- The HKMA will continue to monitor the mortgage market closely and introduce appropriate measures in the light of the latest development to safeguard banking stability in Hong Kong.



RESIDENTIAL MORTGAGE LOANS (“RMLs”) IN NEGATIVE EQUITY

The number of RMLs in negative equity accounted for a very small portion of total outstanding mortgage loans.



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Statistics on RMLs in negative equity

	6/2003	12/2010	3/2011	6/2011	9/2011	12/2011
Total outstanding number of RMLs in negative equity	105,697 (22%)	118 (0.02%)	59 (0.01%)	48 (0.01%)	1,653 (0.3%)	1,465 (0.3%)
Total outstanding value of RMLs in negative equity (HK \$Mn)	164,577 (31%)	147 (0.02%)	72 (0.01%)	58 (0.01%)	4,148 (0.5%)	3,647 (0.5%)
Value of unsecured portion (HK \$Mn)	35,316 (6.75%)	46 *	22 *	18 *	165 (0.02%)	122 (0.02%)
Proportion of RMLs in negative equity with delinquencies of more than three months	2.3%	0.7%	0%	0%	0%	0%

() as percentage of total outstanding RMLs

* Less than 0.01% as percentage of total outstanding RMLs

- The vast majority of the negative equity cases reported in Q3 and Q4/2011 were related to mortgage loans with loan-to-value ratio at 90% or above, including staff housing loans and RMLs under mortgage insurance programme.
- The number of RMLs in negative equity decreased to 1,465 cases in Q4/2011 from 1,653 cases in Q3/2011. The drop was mainly due to repayment of mortgage loans where the outstanding amount only marginally exceeded the value of mortgaged properties in Q3/2011. Through repayment, the amount of outstanding loans for such cases was reduced to below the value of the mortgaged properties in Q4/2011.



INVESTOR AND CONSUMER PROTECTION

- Streamlined procedures for private banks to implement enhanced sales measures
- Issued circulars to remind banks of the HKMA's expected standards in the sales of investment products (investment products with special features and risks and RQFII funds)
- The HKMA has been providing assistance to the Financial Services and the Treasury Bureau to enable the establishment of Investor Education Council and Financial Dispute Resolution Centre.

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- To cater for the operational realities of the private banking industry while providing an appropriate degree of investor protection, the HKMA engaged in detailed discussions with the private banking industry and worked out a set of enhanced measures applicable to sales of investment products to private banking customers. The HKMA issued a circular to banks setting out the implementation details of the flexible version of the enhanced measures in January 2012
- With a view to enhancing the industry's sales practice, the HKMA issued two circulars in January 2012 to remind banks of the HKMA's expected standards in selling investment products with special features and risks that may warrant particular attention (e.g. subordinated debentures, perpetual debentures, contingent convertible or bail-in debentures and basket equity-linked product) and RQFII funds.
- The Financial Dispute Resolution Centre Limited was incorporated on 18 November 2011 and is expected to come into operation by mid 2012. The HKMA is working with FSTB and SFC on the training program for mediators and arbitrators. The training course will be conducted in February/March 2012.



DEPOSIT PROTECTION

- HKMA chaired a peer review of deposit insurance systems launched by the Financial Stability Board taking into account reform experience during the financial crisis; key features of DPS in Hong Kong compare favourably with other major DIS
- The design of the DPS will be thoroughly reviewed against the Core Principles for Effective Deposit Insurance Systems, taking into account the results of the peer review
- Collection of contribution amounting to HK\$329 mn from banks for the year 2012 in progress
- On-going monitoring of the compliance of banks with the enhanced representation requirements on protection status of deposits. On-site examinations in progress
- Publicity campaigns continued to maintain public awareness of the DPS at a high level

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- The Financial Stability Board (“FSB”) launched a peer review of deposit insurance systems (“DIS”). The review was to take stock of the DIS of 24 FSB member jurisdictions, using the Core Principles for Effective DIS issued jointly by the Basel Committee on Banking Supervision and the International Association of Deposit Insurers as a benchmark. The review also sought to draw lessons of experience on the effectiveness of reforms implemented in response to the recent financial crisis. The report concluding the review results has been published in February 2012.



BASEL II ENHANCEMENTS & BASEL III IMPLEMENTATION PROGRESS

- Basel II enhancements
 - Amendment Rules have taken effect from 1 January 2012 in line with the Basel Committee’ s timeline.

- Basel III
 - Intends to implement Basel III in accordance with the Basel Committee’ s transition arrangements.
 - Banking (Amendment) Bill 2011 introduced into LegCo in December 2011.
 - First consultation package on a series of policy proposals for implementation of Basel III capital and liquidity standards released in January 2012.

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Basel III

- Hong Kong intends to follow the Basel III transitional arrangements for phasing in the new capital standards. Amidst recurring economic uncertainties worldwide, a “steady as we go” approach would work best to ensure that AIs are able to meet new standards (through reasonable earnings retention, capital or fund raising and other balance sheet adjustments) while continuing to support economic activity through lending.

- Local AIs tend to be conservative in their capital management, with common equity as a major constituent of their capital base (*As at end September 2011, average Tier 1 ratio at 12.4% and about 88% of Tier 1 Capital made up of common equity*), and are therefore generally well-placed to implement the capital standards.

- The standards that will first come into effect from 1 January 2013 are those in relation to capital standards. To meet the implementation timeline, the Banking (Amendment) Bill 2011 was introduced into LegCo in December 2011, with a view to its passage within the first half of 2012. The HKMA also released on 20 January this year its first package of Basel III implementation proposals to the industry for a two months’ consultation, covering:
 - (a) ***Implementation of Basel III Capital Standards in Hong Kong***, which includes proposals on the revised definition of capital, the enhanced risk-weighting framework for counterparty credit risk exposures, the integration of Pillar 2 into the Basel III framework and the implementation timetable for these requirements; and

 - (b) ***Implementation of Basel III Liquidity Standards in Hong Kong***, which includes proposals on the scope of application of the liquidity standards, the relationship between the new ratios and the existing liquidity ratio, and the overall timing and approach to implementing these standards.

- The issuance of the papers is part of the policy development process which will eventually feed into the making of rules by the Monetary Authority under the Banking Ordinance. Other aspects of the Basel III reform package, including disclosure requirements, capital buffers, the leverage ratio and some of the more detailed aspects of the liquidity standards will be the subject of future consultations.



FINANCIAL INFRASTRUCTURE



REFORMING OTC DERIVATIVES MARKET

- To comply with the G20's commitments in reforming the OTC derivatives market, the HKMA and SFC are currently working with the Government on the legislative amendments necessary for implementing this new regulatory regime
- The HKMA and SFC jointly issued a consultation paper on the proposed regulatory regime for the OTC derivatives market on 17 October 2011. The consultation period ended on 30 November 2011. The HKMA and SFC are working together to consolidate and evaluate the responses, which will be critical to finalising some of the key aspects of the regime and the legislative amendments. The HKMA and SFC target to issue the consultation conclusions in early Q2 2012
- The proposed regulatory regime will cover mandatory reporting and clearing requirements. The reporting and clearing requirements will initially be applied to interest rate swaps and non-deliverable forwards, and will extend to other asset classes in subsequent phases
- The HKMA is riding on its existing Central Moneymarkets Unit (CMU) infrastructure to develop a trade repository. Hong Kong Exchanges and Clearing Ltd is also building a local central counterparty for OTC derivatives in Hong Kong.
- We will closely follow international regulatory development and take necessary steps to ensure alignment with international standards



GOVERNMENT BOND PROGRAMME

Institutional Bond Issuance Programme:

- Nine issues totalling HK\$39.5 billion outstanding as at end January
- Tenors from 2 years up to 10 years have been offered in order to build a benchmark yield curve
- The tenders attracted a diverse group of end-investors, such as investment funds, insurance companies and pension funds

Retail Bond Issuance Programme:

- Further issuance of inflation-linked bond (iBond) was announced by the Financial Secretary in his Budget Speech
- Up to HK\$10 billion will be offered to HK residents
- Preparatory work is in progress and the issuance is expected to complete within the second quarter

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- The primary objective of the GBP is to promote the further and sustainable development of Hong Kong's bond market through systematic issuance of government bonds. It can also help promote financial stability by making our debt market an effective channel of financial intermediation, complementing the banking and equity markets.
- The GBP is a long-term programme comprising an Institutional Bond Issuance Programme and a Retail Bond Issuance Programme.
- By enlarging the investor base over time, the GBP is expected to improve liquidity and attract more issuers to raise funds via the bond market. This will help increase the breadth and depth of our bond market, thereby consolidating our role as an international financial centre.
- The objective of the Retail Programme is to enhance the interest and awareness of local individual investors in bond investments. The Financial Secretary announced a second inflation-linked bond (the "iBond") issuance to further promote the sustainable development of retail bond market in his 2012-13 Budget Speech.
- The HKMA is tasked to co-ordinate the issuance, and is working closely with the external service providers, such as the Co-arrangers (Bank of China (Hong Kong) Limited and The Hongkong and Shanghai Banking Corporation Limited) to complete the issuance within the second quarter. Offering details will be announced in due course.



PROMOTING ASSET MANAGEMENT BUSINESS

- Working closely with other Government agencies and the private sector to explore ways to strengthen the competitiveness of Hong Kong's asset management industry and reinforce Hong Kong's position as a leading asset management centre
- Stepping up marketing efforts to proactively reach out to overseas and Mainland asset managers and investors to promote Hong Kong's financial platform. Promotional campaigns so far covered New York, London, Switzerland and Luxembourg
- Building on the feedback from our regular dialogues with industry players, we continue to improve our platform and keep pace with the latest developments in the asset management industry

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- With the promising growth prospects of the Asian region, there has been increasing interest for overseas asset managers to expand into Asia. To capitalise on this trend and attract more asset managers into Hong Kong, the HKMA is working in conjunction with other Government agencies and market players to promote Hong Kong's asset management business, thereby reinforcing Hong Kong's role as a premier international financial centre.
- To this end, the HKMA is taking part in a joint Government campaign, along with the Financial Services and the Treasury Bureau and the Securities and Futures Commission, in holding a series of promotional roadshows in leading global financial centres. Since November 2010, the campaign has visited London, New York, Switzerland and Luxembourg, during which the HKMA also took the opportunity to meet with key asset managers based in their financial centres to promote the financial platform in Hong Kong and listen to their business plan in Asia and their views on potential hurdles for their operations in Hong Kong.



FINANCIAL INFRASTRUCTURE

- Continued to maintain safety and efficiency of financial infrastructure
- Continued to enhance financial infrastructure, especially for supporting the continual growth of RMB business in Hong Kong. Preparations are being made to extend the daily operating hours of the RMB RTGS system in Hong Kong from currently 10 hours to 15 hours, from 8:30 to 23:30 (Hong Kong time), by end June 2012
- Developing a trade repository for over-the-counter derivatives trades to enhance market surveillance and transparency, and bring Hong Kong in line with international standards

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Operation of financial infrastructure

- The HKD, USD, EUR and RMB Real Time Gross Settlement (RTGS) systems and the Central Moneymarkets Unit (CMU) have been operating smoothly.

Financial infrastructure to support RMB business

- Enhancements for bringing the RMB RTGS system in line with the HKD RTGS system in terms of functionality have been completed in 2011.
- To better serve financial institutions in different regions for offshore RMB business through the Hong Kong infrastructure and enhance the competitiveness of the RMB clearing platform in Hong Kong, preparations are being made to extend the daily operating hours of the RMB RTGS system from currently 10 hours to 15 hours by end June 2012. The extended operating window will be able to cover both the Asian and European business hours and early US business hours.

Trade Repository

- Progressing on system development work as scheduled. The trade repository is targeted for launch in 2012, subject to the progress on the establishment of the relevant regulatory framework.



HONG KONG AS AN INTERNATIONAL FNANCIAL CENTRE



Hong Kong as offshore RMB business centre expanding rapidly

(RMB billion)	2010	2011	Growth
1 RMB trade settlement handled by banks in Hong Kong	369.2	1,914.9	+419%
2 RMB deposits in Hong Kong (at year-end)	314.9	588.5	+87%
3 Outstanding RMB certificates of deposits (CDs) issued in Hong Kong (at year-end)	5.7	72.0	+1,163%
4 RMB bond issuance in Hong Kong	35.8	107.9	+201%
5 Outstanding RMB loans (at year-end)	1.8	30.8	+1,611%

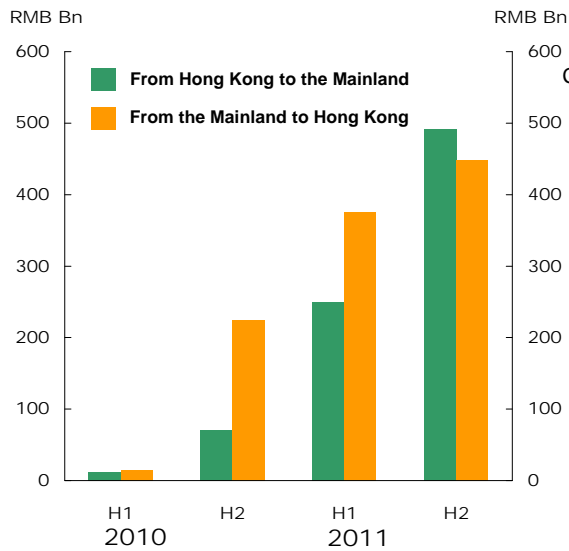
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- Hong Kong's offshore RMB business grew rapidly in 2011, with across-the-board expansion in various areas:
 - Hong Kong is the prime platform for offshore RMB trade settlement. RMB trade settlement conducted through banks in Hong Kong amounted to RMB1,914.9 billion yuan in 2011. During the year, Mainland's trade settled in RMB amounted to RMB2,081.3 billion yuan.
 - RMB deposits in Hong Kong grew from RMB314.9 billion yuan at the beginning of 2011 to RMB588.5 billion yuan at end-December 2011. RMB deposits of corporates increased by RMB232 billion yuan to over RMB414 billion yuan at end-December 2011, representing 70% of the total RMB deposits.
 - Also, apart from customer deposits, banks have been increasingly issuing Certificates of Deposits (CDs) as a means of tapping RMB funds. At end-2011, the outstanding amount of customer deposits and CDs issued were RMB588.5 billion yuan and RMB72 billion yuan respectively (adding to a total of RMB660.5 billion yuan).
 - In 2011, issuance of RMB bonds in Hong Kong totalled RMB107.9 billion yuan, three times of the RMB35.8 billion yuan issued in the entire year of 2010. Meanwhile, the range of issuers continued to diversify.
 - In addition, the outstanding amount of RMB loans extended by banks in Hong Kong increased from less than RMB2 billion yuan at the beginning of 2011 to some RMB30 billion yuan in end-December 2011.



Development of Hong Kong as RMB trade settlement and bond issuance centre deepens

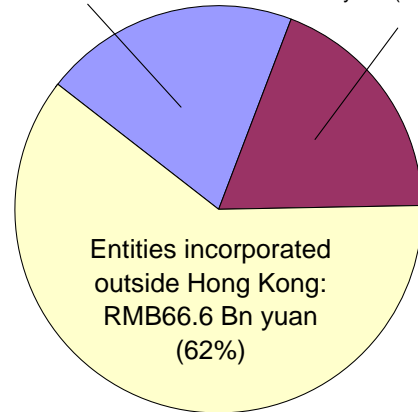
Flow of trade settlement payments becoming more balanced



More diversified range of RMB bond issuers

RMB bonds issued in Hong Kong in 2011 (By type of issuers)

Companies incorporated in Hong Kong:
RMB21.3 Bn yuan (20%)
Ministry of Finance:
RMB20 Bn yuan (18%)





Hong Kong's growing role in supporting RMB business worldwide

	<u>2010</u>	<u>2011</u>	<u>Change</u>
1 No. of participating banks of Hong Kong's RMB clearing platform	153	187	+22%
Of which:	132	165	+25%
Branches and subsidiaries of overseas banks and overseas presence of Mainland banks			
2 No. of RMB correspondent accounts set up by overseas banks at Hong Kong banks	187	968	+418%
3 Amount due to overseas banks (RMB billion at year-end)	19.6	116.4	+494%
4 Amount due from overseas banks (RMB billion at year-end)	10.9	121.7	+1,017%

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- Hong Kong is also playing an increasingly prominent role as the key platform supporting RMB business overseas. In addition to serving overseas corporates directly, Hong Kong's RMB financial platform also supports banks and financial institutions around the world in conducting RMB business worldwide:
 - At end-2011, deposits placed by overseas corporates accounted for 15% of the RMB corporate deposits in Hong Kong.
 - Currently, there are 187 banks participating in Hong Kong's RMB clearing platform, of which 165 are branches and subsidiaries of overseas banks and overseas presence of Mainland banks. This represents a RMB payment and settlement network covering more than 30 countries in 6 continents.
 - Meanwhile, RMB banking activities between Hong Kong and overseas banks have also been growing. The amount due to overseas banks by Hong Kong banks increased from 19.6 billion yuan at the beginning of 2011 to some RMB116 billion yuan at end-2011. While the amount due from overseas banks by Hong Kong banks increased from RMB10.9 billion yuan to RMB121.7 billion yuan at end-2011.



Actively promoting Hong Kong as offshore RMB business centre

- It is expected that offshore RMB business in Hong Kong, and particularly RMB financing activities and introduction of RMB financial and wealth management products, will grow substantially as channels for cross-border circulation of funds continue to broaden
- HKMA's proactive promotion work
 - **2011:** Conducted roadshows in Australia, Russia, UK and Spain
 - **2012:** Plans to visit South America and other places with close trade and investment links with China
- Hong Kong-London Forum
 - Joint private-sector forum, facilitated by HKMA and the UK Treasury
 - To foster cooperation between Hong Kong and London, focusing on clearing and settlement systems, market liquidity and the development of RMB financial products



INCREASING REGIONAL AND INTERNATIONAL FINANCIAL CO-OPERATION

Financial Stability Board (FSB)

- The HKMA attended the FSB Plenary Meeting in January. The meeting discussed the European debt crisis and set the priority of the FSB in 2012. Key areas of work in 2012 include, among others, monitoring implementation of agreed regulatory reforms, extending the framework for global systemically important financial institutions to domestic systemically important banks, implementing the OTC derivatives market reforms, strengthening regulation of the shadow banking system, and reviewing the FSB governance structure.

Bank for International Settlement (BIS)

- The HKMA together with the BIS co-hosted an informal meeting of central bank governors in Hong Kong on 4-5 February. The meeting is an annual event in Asia for central bank governors to review the global economic and financial situation, with specific emphasis on developments in the region. 22 central banks and monetary authorities from around the world participated in the meeting. There was also a session with CEOs of major financial institutions to promote the exchange of views between the public and private sectors.

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- The HKMA continued to participate actively in FSB meetings and activities. At the Plenary meeting in January, members discussed risks and vulnerabilities in the global financial system, focusing on the European debt crisis. Members also reviewed the progress of financial regulatory reforms, and the work plan for 2012. Key areas of work for the FSB in 2012 include monitoring implementation of the regulatory reforms agreed, such as Basel III and the framework to tackle the “too-big-to-fail” problem posed by global systemically important financial institutions (G-SIFIs). The FSB will also work on extending the SIFI framework to domestic systemically important banks. The HKMA has been participating actively in the relevant international discussions to ensure that our views are heard. Other key areas of work include implementing OTC derivatives market reforms and strengthening of regulation and oversight of the shadow banking system. Tasked by G20, the FSB will also consider options to strengthen its organisation structure and capacity to meet with its mandate.
- The HKMA co-hosted an informal meeting of central bank governors with the BIS in Hong Kong on 4-5 February. The meeting has been taking place annually in different locations in Asia and the Pacific over the last thirteen years. The meeting provides an opportunity for central bank governors to review the global economic and financial situation, with specific emphasis on developments in Asia and the Pacific. 22 central banks and monetary authorities from all over the world, including the European Central Bank, US Fed, Bank of Japan and People’s Bank of China, participated in the meeting. There was also an ad-hoc meeting of central bank governors and CEOs of major financial institutions to facilitate the exchange of views.



INVESTMENT ENVIRONMENT AND PERFORMANCE OF THE EXCHANGE FUND

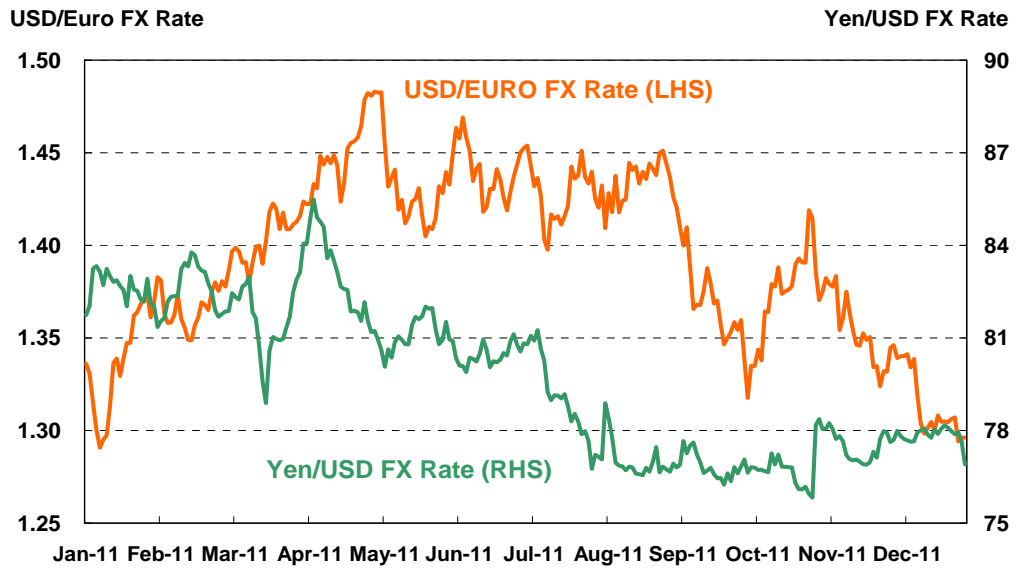


INVESTMENT ENVIRONMENT IN 2011

- **Exchange rates:** The US dollar weakened against major currencies in Q1 and came under further pressure through August, especially after one notch downgrade by S&P. However, safe haven flows amid concerns of deeper European debt crisis, liquidity problem of European banks and intensified fear of possible economic recession in the Euro-zone, as well as the two consecutive cuts in the policy rates by the European Central Bank, drove the US dollar markedly higher in Q4, ending the year slightly stronger.
- **Equity markets:** After posting modest gains in Q1, major stock markets in developed economies became volatile as risk appetite deteriorated. Selling pressure intensified in the second half of the year, after the credit rating downgrade of the US and amid the worsening European sovereign debt crisis. The volatilities extended into Q4. While the US S&P's 500 Index ended the year flat, major European markets finished the year significantly lower.
- **Interest rates:** US Treasury yields rose in Q1 on investor expectation of economic improvement but fell significantly in Q2 amid safe haven flows into bond market as the European sovereign debt crisis intensified. In view of the weaker economic outlook and in anticipation of the additional policy accommodation by the Fed, US Treasury yields declined significantly in Q3, and hovered around the lowest levels in decades for most of the time in Q4. German and UK government bond yields also ended the year much lower.



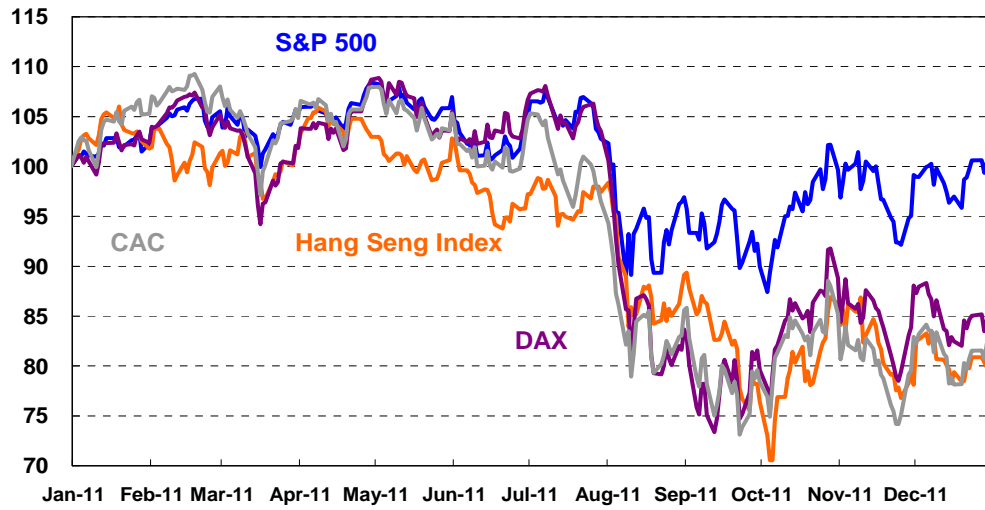
CURRENCY MARKETS





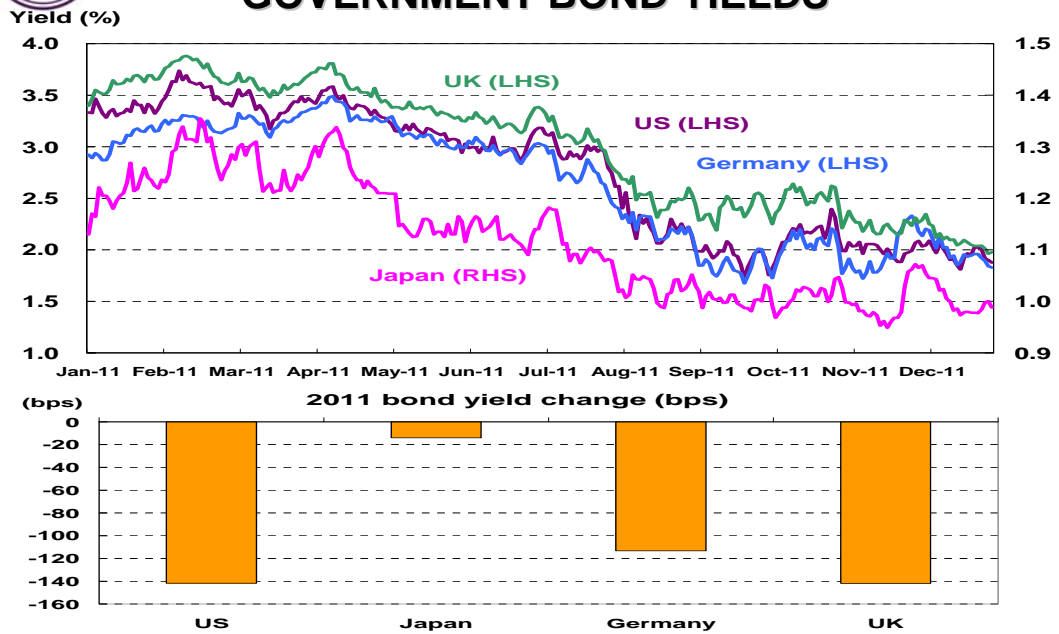
EQUITY MARKETS

Normalized Index Level (2010 year-end = 100)





CHANGES IN 10-YEAR GOVERNMENT BOND YIELDS





INVESTMENT INCOME

(HK\$ billion)	2011					2010	2009	2008	2007
	Full year *	Q4	Q3	Q2	Q1	Full year	Full year	Full year	Full year
Bonds#	71.9	11.2	46.2	17.4	(2.9)	42.1	(0.6)	88.4	61.0
Hong Kong equities[^]@	(24.2)	5.5	(28.7)	(4.5)	3.5	11.6	48.9	(77.9)	55.8
Other equities[^]	(12.2)	15.8	(37.5)	0.6	8.9	27.1	48.8	(73.1)	6.7
Foreign exchange	(9.1)	(11.2)	(20.1)	7.7	14.5	(3.1)	9.8	(12.4)	18.7
Other investments^{&}	0.3	0.4	(1.3)	0.4	0.8	1.7	0.8	-	-
Investment income/(loss)^{@&}	26.7	21.7	(41.4)	21.6	24.8	79.4	107.7	(75.0)	142.2

* Unaudited figures

[^] Including dividends

[#] Including interest

[@] Excluding valuation changes in Strategic Portfolio (a loss of HK\$3.0 billion in 2011)

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



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

(HK\$ billion)	← 2011 →					2010
	Full year (unaudited)	Q4	Q3	Q2	Q1	Full year
Investment income/(loss)	26.7	21.7	(41.4)	21.6	24.8	79.4
Other income	0.2	-	0.1	0.1	-	0.2
Interest and other expenses	<u>(4.6)</u>	<u>(0.8)</u>	<u>(1.0)</u>	<u>(1.6)</u>	<u>(1.2)</u>	<u>(4.8)</u>
Net investment income/(loss)	22.3	20.9	(42.3)	20.1	23.6	74.8
Payment to Fiscal Reserves #	(37.0)	(9.5)	(9.2)	(9.1)	(9.2)	(33.8)
Payment to HKSAR government funds and statutory bodies #	(5.6)	(1.7)	(1.5)	(1.3)	(1.1)	(3.9)
Valuation change of Strategic Portfolio less valuation change of investment held by EF's investment holding subsidiaries^	<u>(3.3)</u>	<u>0.2</u>	<u>(1.7)</u>	<u>(0.5)</u>	<u>(1.3)</u>	<u>0.9</u>
Increase/(Decrease) in EF Accumulated Surplus	(23.6)	9.9	(54.7)	9.2	12.0	38.0

The fixed rate of fee payment is 6.0% for 2011 and 6.3% for 2010.

^ 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* ^{&}	107.7	10.6	71.9	58.7	(33.5)
2010* ^{&}	79.4	5.9	74.5	(12.1)	11.1
2011** ^{&}	26.7	21.7	(41.4)	21.6	24.8

* Excluding valuation changes in the Strategic Portfolio

Unaudited figures

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



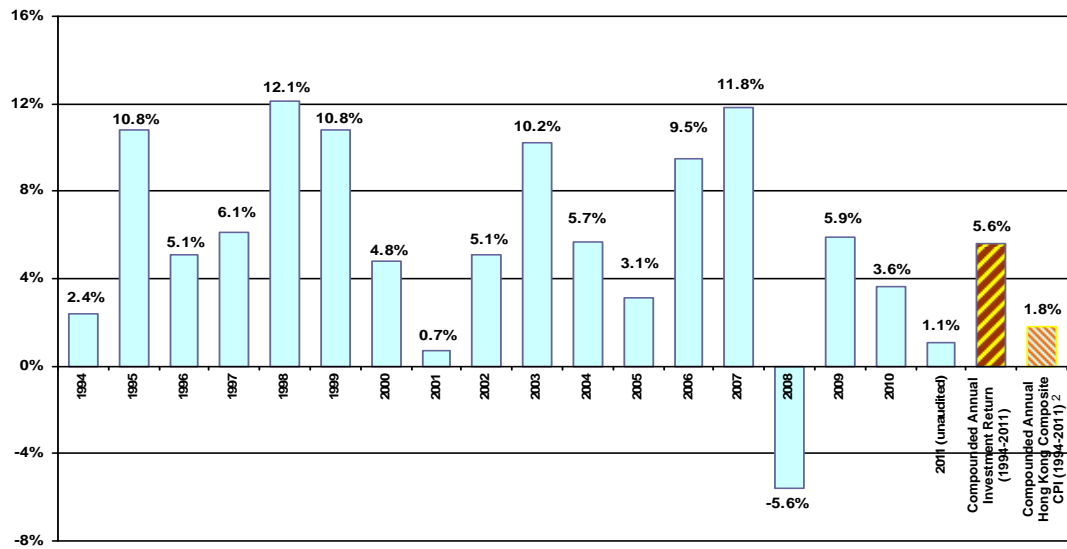
EXCHANGE FUND ABRIDGED BALANCE SHEET

(HK\$ billion)	At 31 Dec 2011 (unaudited)	At 31 Dec 2010	Change
ASSETS			
Deposits	222.8	198.4	24.4
Debt securities	1,843.9	1,706.7	137.2
Hong Kong equities	120.6	152.6	(32.0)
Other equities	240.9	245.3	(4.4)
Other assets [#]	<u>64.5</u>	<u>42.0</u>	<u>22.5</u>
Total assets	<u>2,492.7</u> =====	<u>2,345.0</u> =====	<u>147.7</u> =====
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness	258.7	225.9	32.8
Government-issued currency notes & coins in circulation	9.9	8.9	1.0
Balance of the banking system	148.7	148.7	-
Exchange Fund Bills and Notes	655.8	654.2	1.6
Placements by banks and other financial institutions	24.5	23.2	1.3
Placements by Fiscal Reserves	663.5	592.3	71.2
Placements by HKSAR government funds and statutory bodies	126.3	76.8	49.5
Other liabilities	<u>37.4</u>	<u>23.5</u>	<u>13.9</u>
Total liabilities	<u>1,924.8</u>	<u>1,753.5</u>	<u>171.3</u>
Accumulated Surplus	<u>567.9</u>	<u>591.5</u>	<u>(23.6)</u>
Total liabilities and fund equity	<u>2,492.7</u> =====	<u>2,345.0</u> =====	<u>147.7</u> =====

[#] Including investment in EF's investment holding subsidiaries amounted to HK\$31.1 billion at 31 Dec 2011 (HK\$14.7 billion at 31 Dec 2010) **71**



INVESTMENT RETURN OF THE EXCHANGE FUND (1994-2011) ¹



¹ Investment return calculation excludes the holdings in the Strategic Portfolio.

² Composite CPI is calculated based on the 2009/2010-based series.



INVESTMENT RETURN OF THE EXCHANGE FUND IN HONG KONG DOLLAR TERMS ¹

	Investment return ^{2,3}
2011	1.1%
3-year average (2009 – 2011)	3.5%
5-year average (2007 – 2011)	3.2%
10-year average (2002 – 2011)	4.9%
Average since 1994	5.6%

¹ The investment returns for 2001 to 2003 are in US dollar terms.

² Investment return calculation excludes the holdings in the Strategic Portfolio.

³ Averages over different time horizons are calculated on an annually compounded basis.



HONG KONG MORTGAGE CORPORATION



Reverse Mortgage Programme

- Good response in the market since the launch on 11 July 2011
- By 31 January 2012, there have been 191 applications, with total property value totalling HK\$710 million
 - Average age of borrowers: 71 years old
 - Payment terms: 10-year (32%), 15-year (21%), 20-year (13%), life (34%)
 - Average property value: HK\$3.7 million
 - Average monthly payout: HK\$13,500
 - Average property age: 31 years



SME Financing Guarantee Scheme (“SFGS”)

- Since the launch on 1 January 2011, as at end-January 2012:
 - there are 250 applications in total
 - total loan amount is about HK\$852 million
 - the average loan interest rate is 5.2%
 - the average guarantee fee is 1.5% p.a.
- A special concessionary measure would be launched in mid-2012 with a 9-month application period
 - guarantee ratio of 80% for which the Government will provide a total guarantee commitment of HK\$100 billion
 - guarantee fee substantially reduced, 70% lesser than the existing guarantee fee for loans with 70% guarantee ratio



Microfinance Pilot Scheme

- A three-year microfinance pilot scheme with a tentative aggregate amount of HK\$100 million would be launched in mid-2012
- The maximum loan tenor will be five years and there will be three categories of target borrowers:
 - business starters (maximum loan amount of HK\$300,000)
 - self-employed persons (maximum loan amount of HK\$200,000)
 - people who wish to receive training, enhance their skills or obtain professional qualifications for self-improvement (maximum loan amount of HK\$100,000)
- The HKMC is discussing with banks, voluntary agencies and other stakeholders to work out the details such as the interest rate level, application and approval procedures, and ancillary services, etc.