



HONG KONG MONETARY AUTHORITY

• CB(1)484/12-13(03)

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

4 February 2013



DISCUSSION TOPICS

Updates on

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



FINANCIAL AND ECONOMIC ENVIRONMENT



GLOBAL ECONOMIC GROWTH FORECASTS

Real GDP Growth

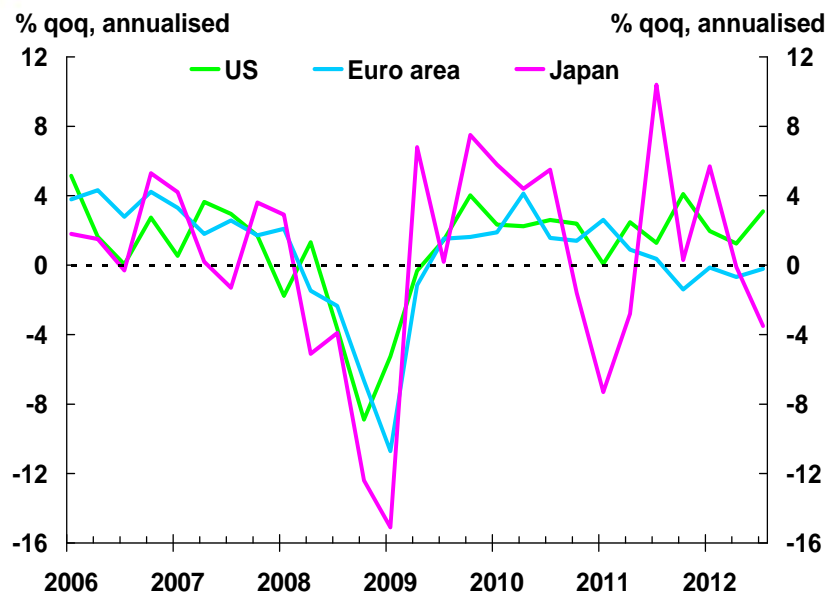
(% year-on-year)

	2012 Forecasts/ Estimates		2013 Forecasts
	Nov 2012 FAP briefing	Feb 2013 FAP briefing	
US	2.1	2.3	2.0
Euro area	-0.5	-0.4	-0.1
Japan	2.3	2.0	0.7
Asia (ex-Japan)	6.1	6.0	6.6
Mainland China	7.7	7.8	8.1
Hong Kong	1.6	1.4	3.4

Sources: Consensus Forecasts and CEIC



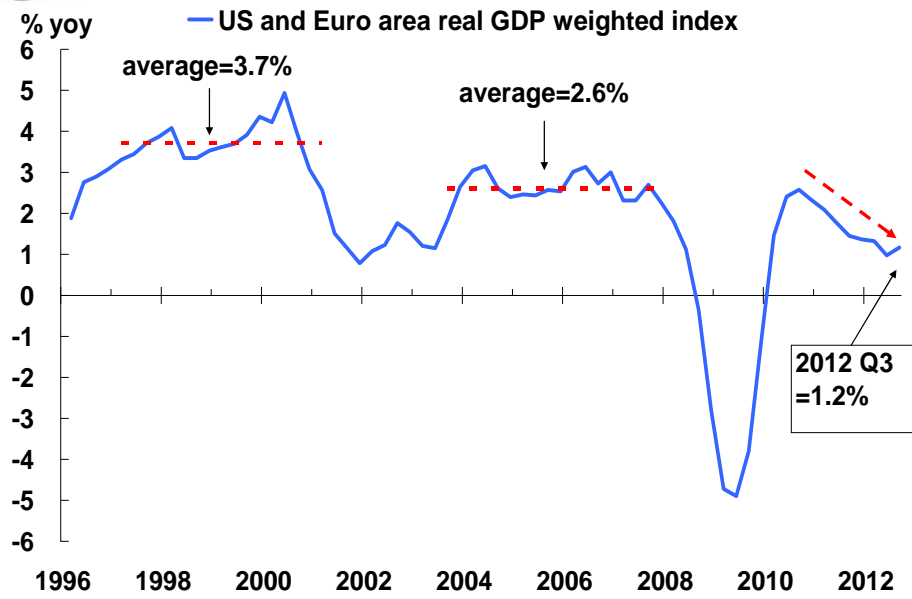
REAL GDP GROWTH IN MAJOR COUNTRIES



Source: Bloomberg



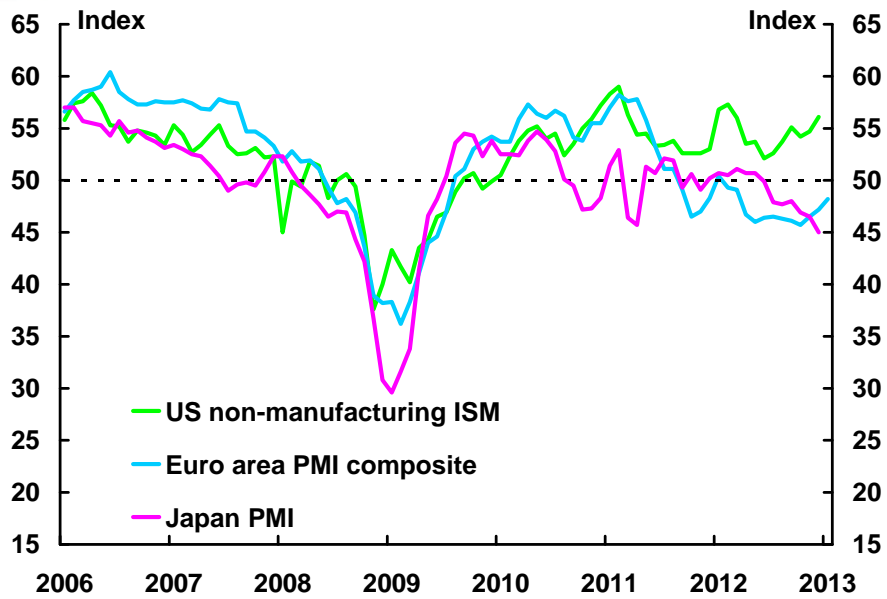
US AND EURO AREA REAL GDP GROWTH



Sources: CEIC and HKMA staff calculations



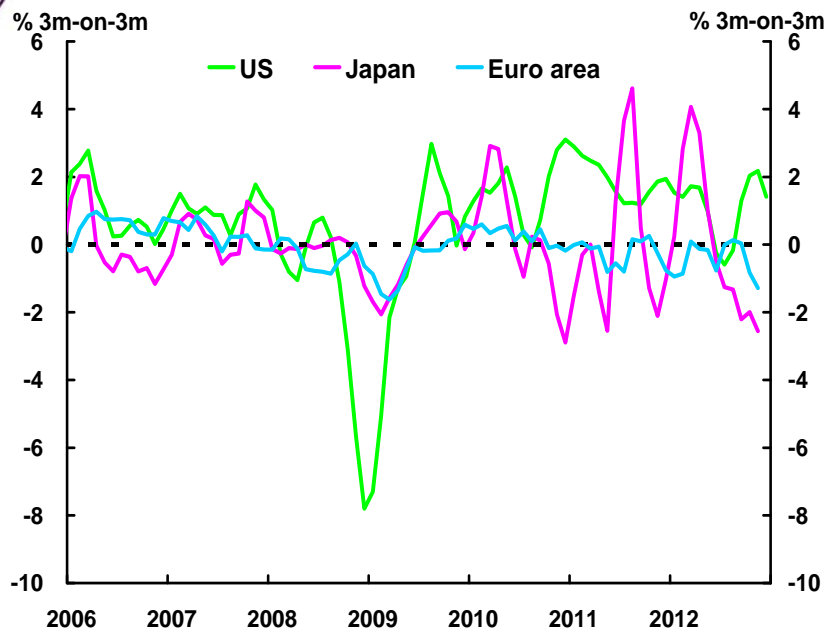
PURCHASING MANAGERS' INDEX IN MAJOR ECONOMIES



Source: Bloomberg



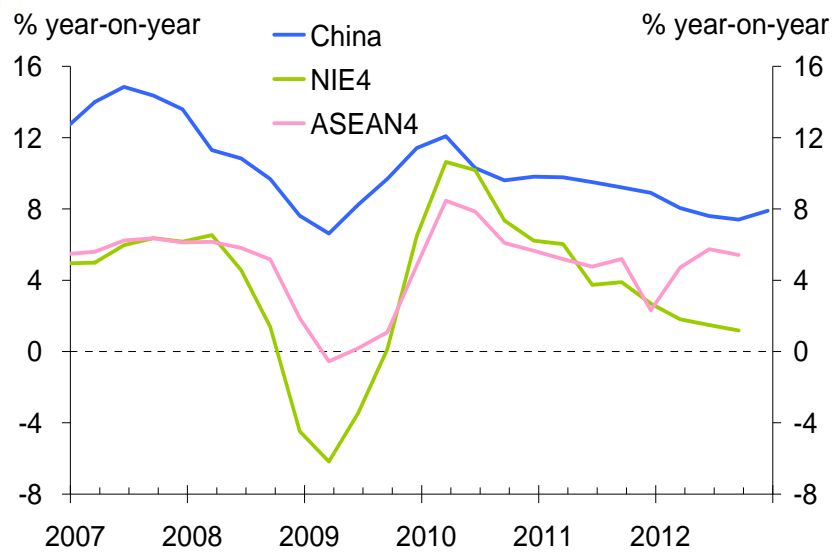
RETAIL SALES IN MAJOR ECONOMIES



Source: CEIC



ASIA: REAL GDP GROWTH



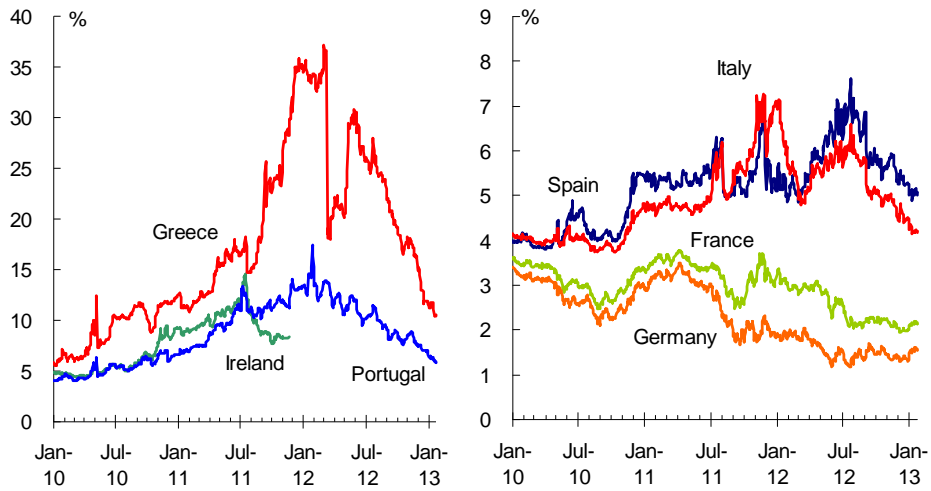
Note: NIE4 includes Hong Kong, Singapore, South Korea and Taiwan; ASEAN4 includes Indonesia, Malaysia, the Philippines and Thailand

Sources: CEIC, IMF and HKMA staff estimates



EUROPE: SOVEREIGN BOND YIELDS

10-year sovereign bond yield

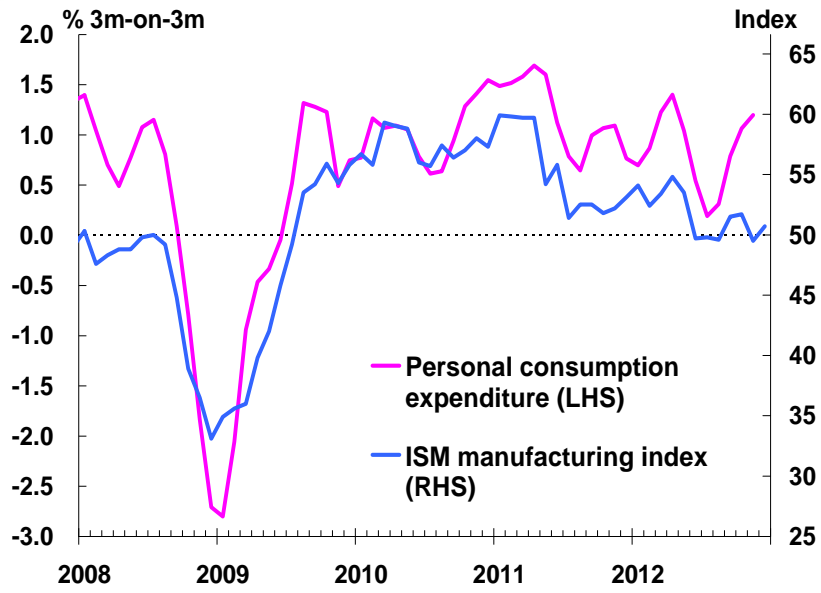


Sources: Bloomberg and EcoWin

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



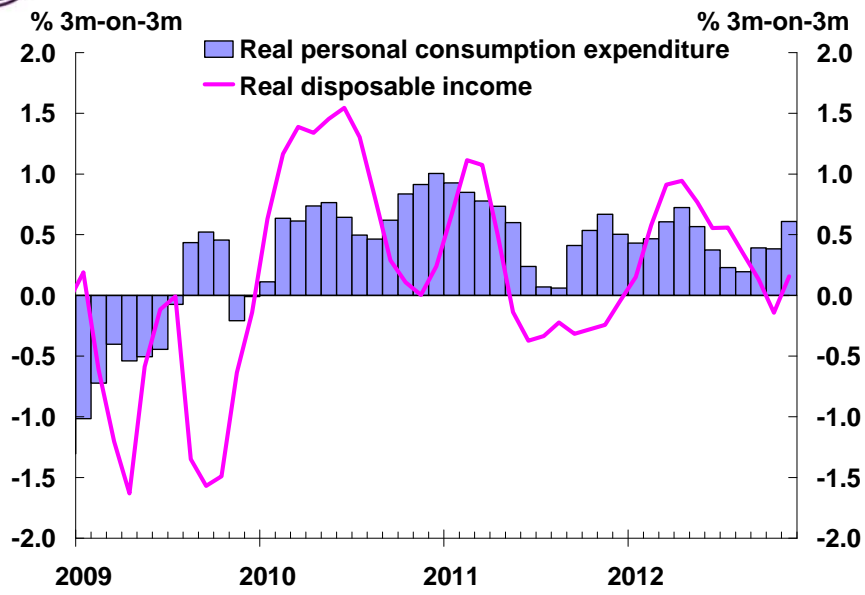
US: CONSUMPTION GROWTH & BUSINESS ACTIVITY



Source: CEIC

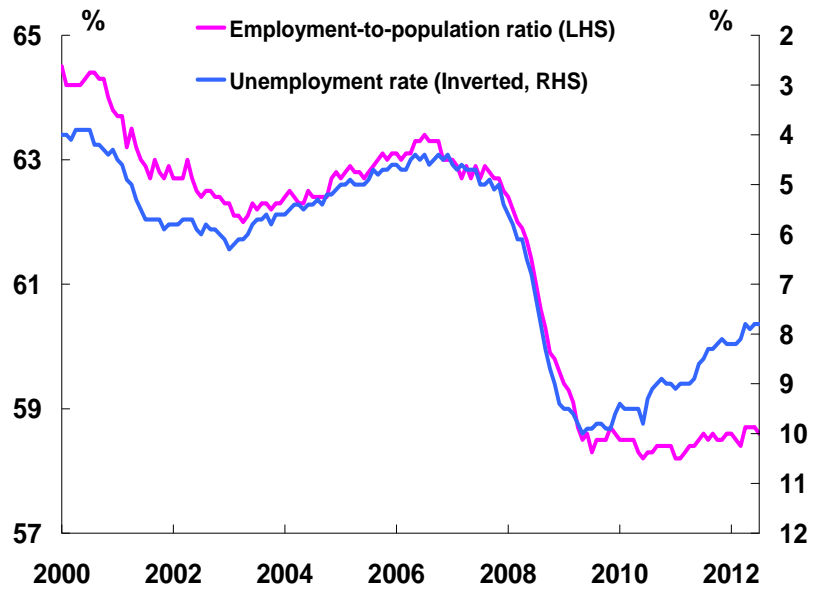


US: CONSUMPTION AND INCOME GROWTH





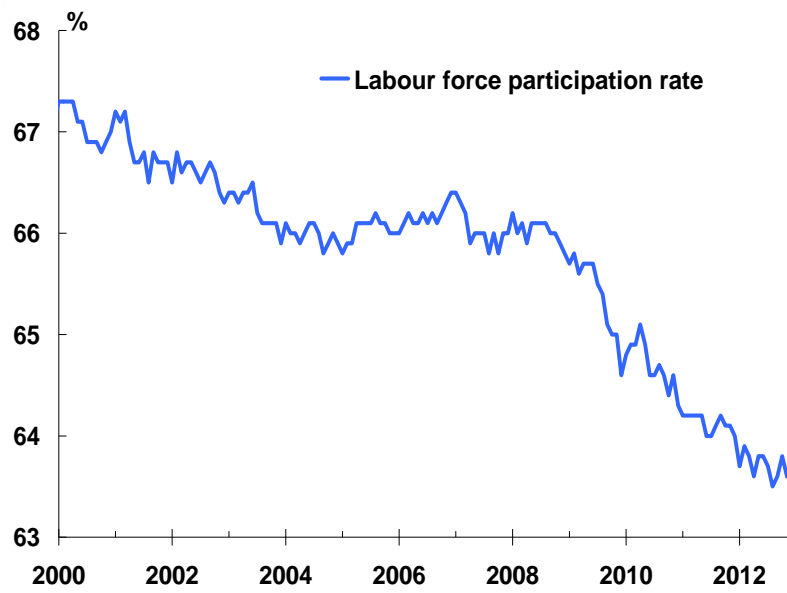
US: LABOUR MARKET SITUATION



Source: CEIC



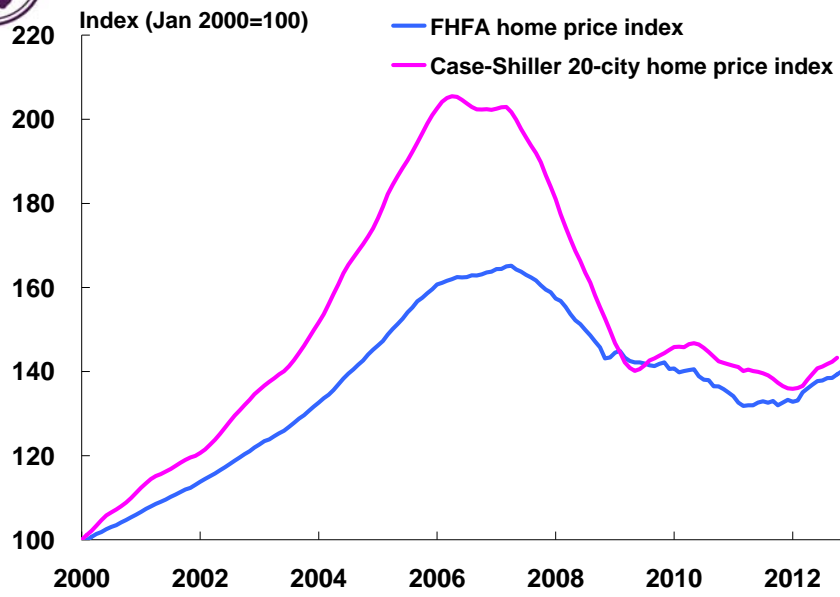
US: LABOUR FORCE PARTICIPATION



Source: CEIC



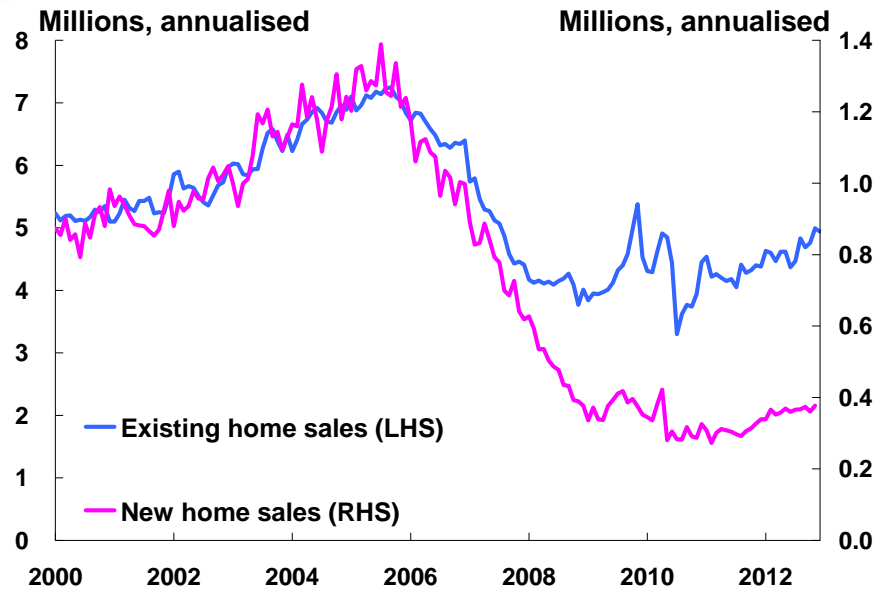
US: HOUSE PRICES



Sources: Standard & Poor's and CEIC



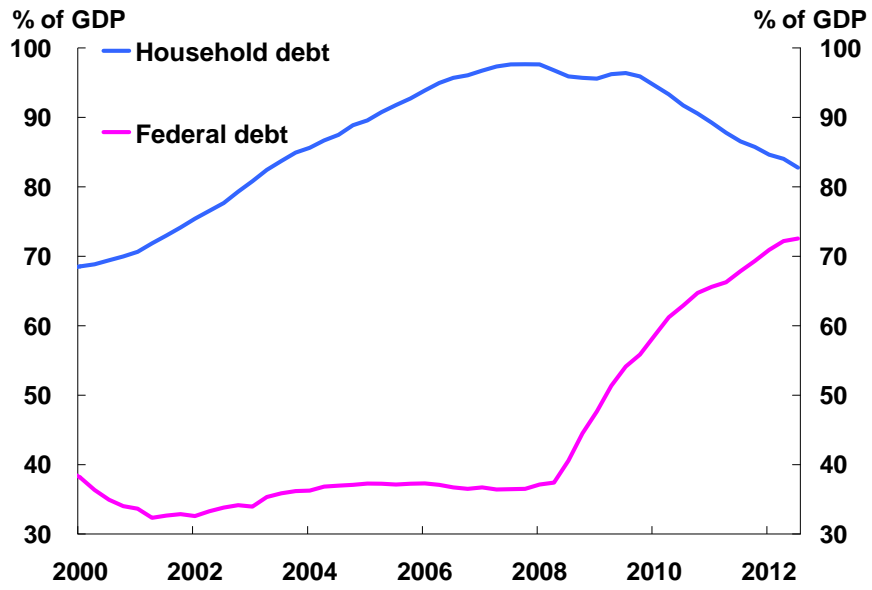
US: HOME SALES



Source: CEIC



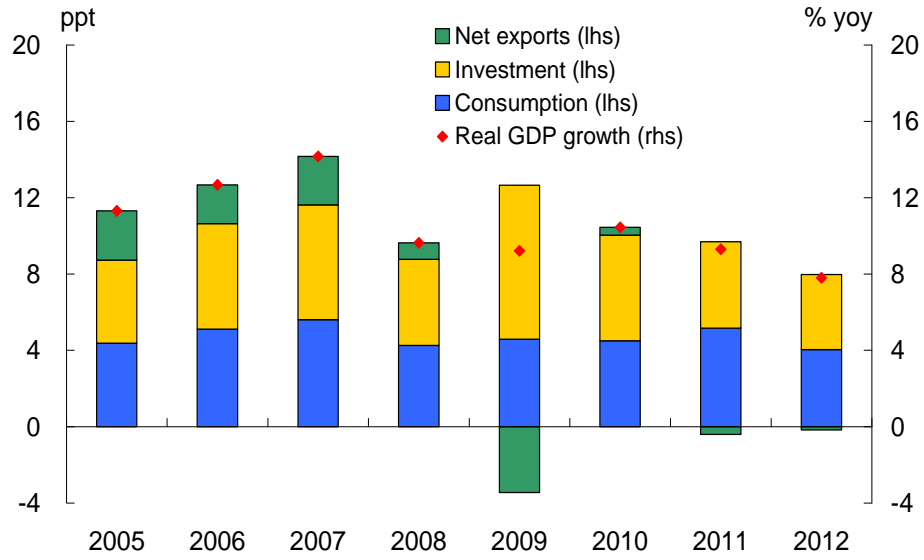
US: HOUSEHOLD AND FEDERAL GOVERNMENT DEBT



Source: Federal Reserve



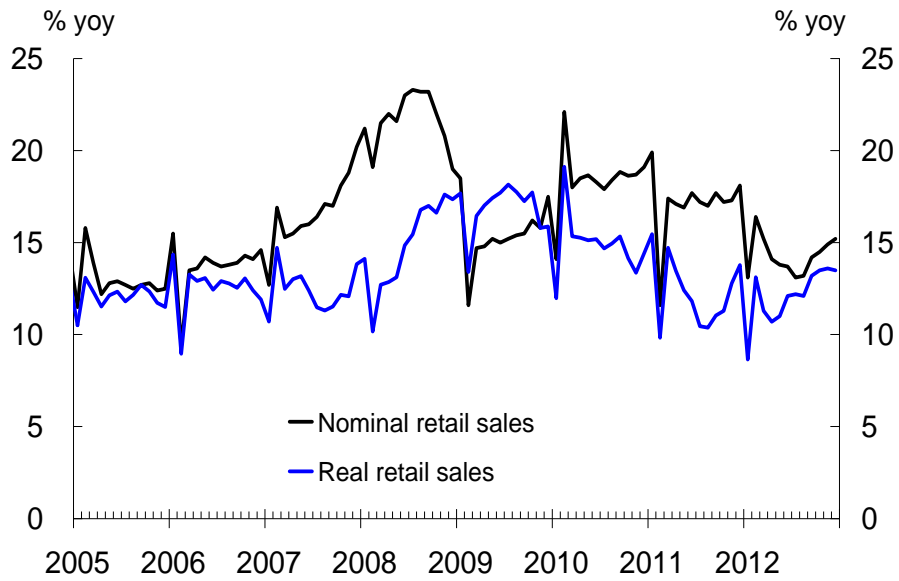
MAINLAND CHINA: REAL GDP GROWTH



Source: CEIC



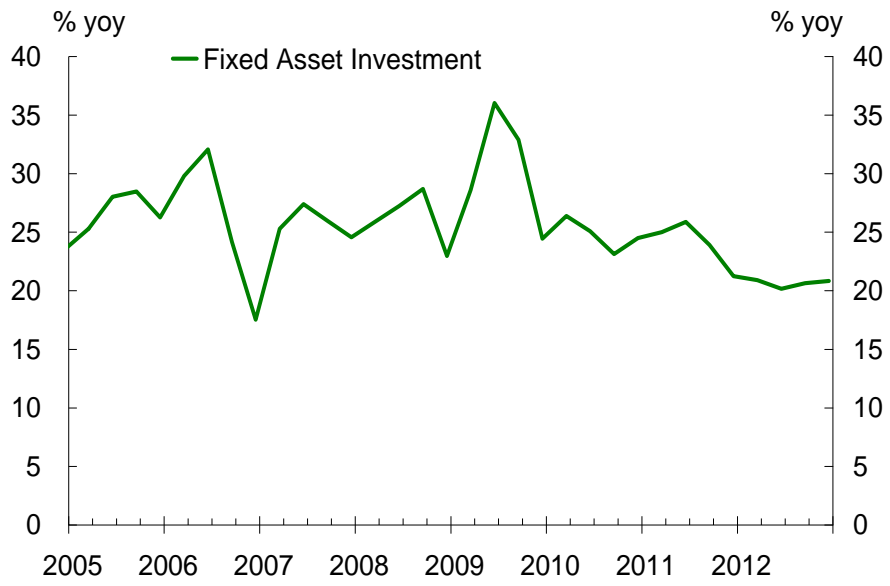
MAINLAND CHINA: RETAIL SALES



Sources: CEIC, WIND and HKMA staff estimates



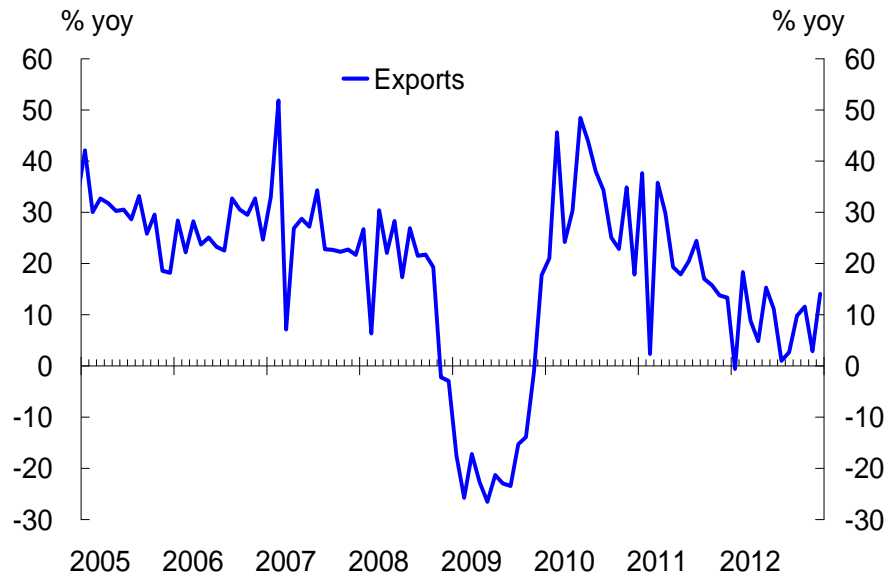
MAINLAND CHINA: FIXED ASSET INVESTMENT



Sources: CEIC and HKMA staff estimates



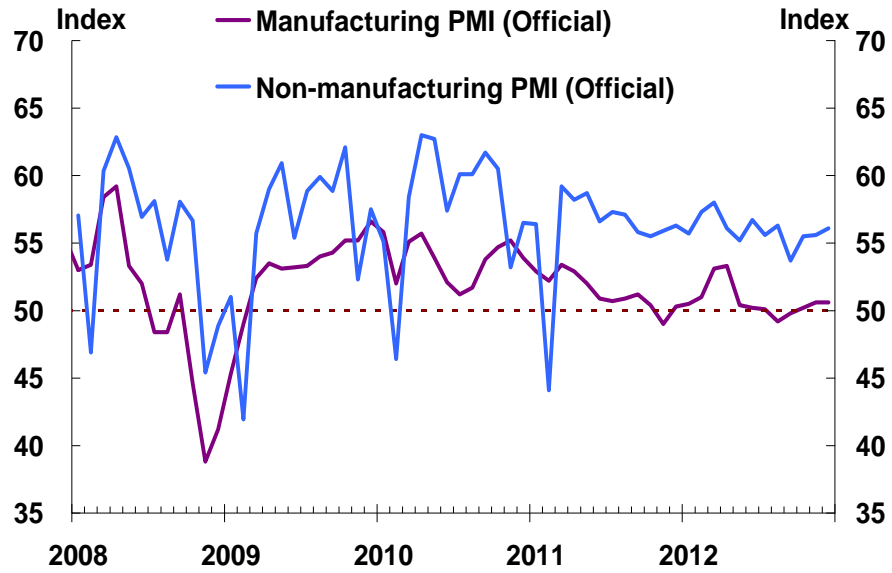
MAINLAND CHINA: EXPORT GROWTH



Sources: CEIC and HKMA staff estimates



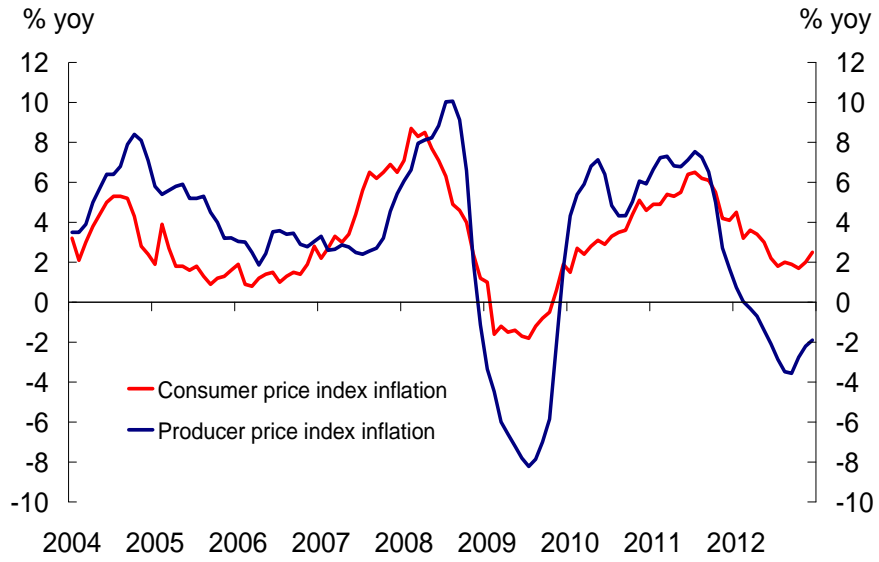
MAINLAND CHINA: PURCHASING MANAGERS' INDEX



Source: CEIC



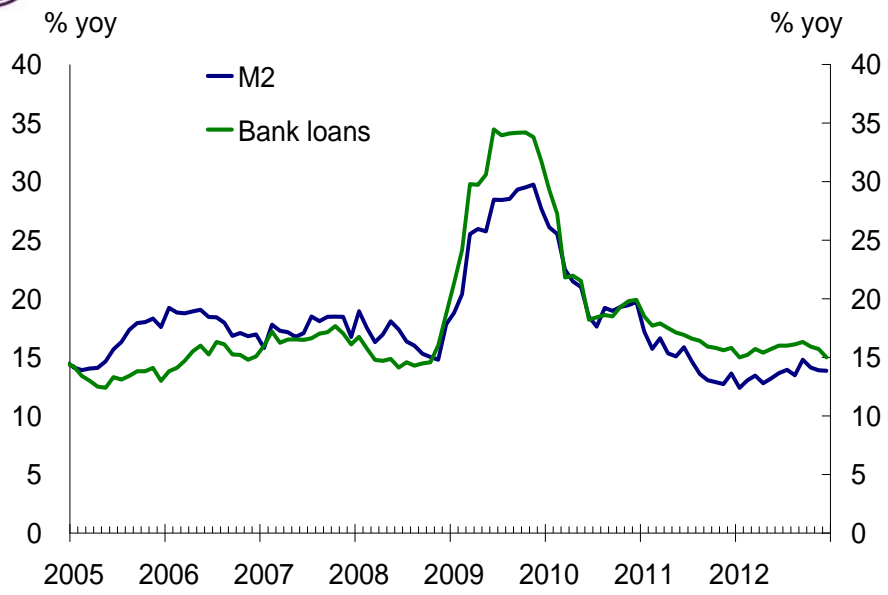
MAINLAND CHINA: INFLATION



Source: CEIC



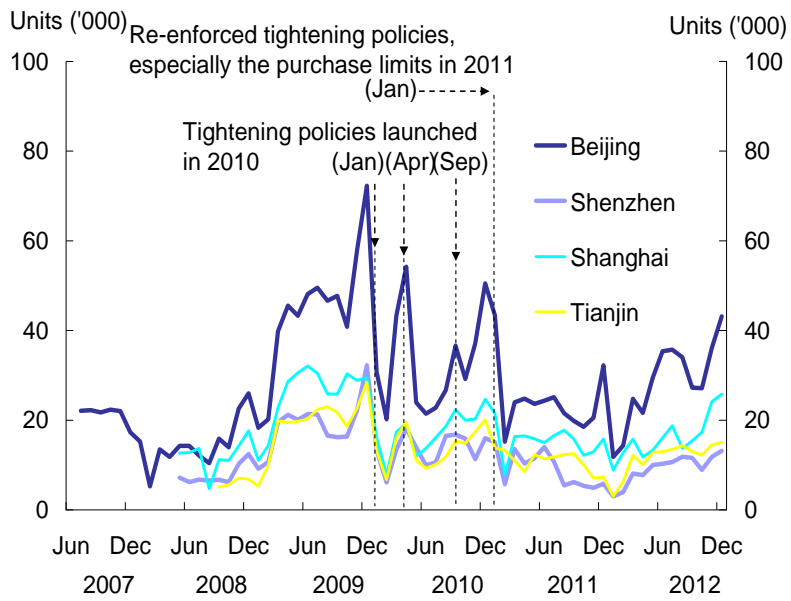
MAINLAND CHINA: MONEY AND LOAN GROWTH



Sources: CEIC and HKMA staff estimates



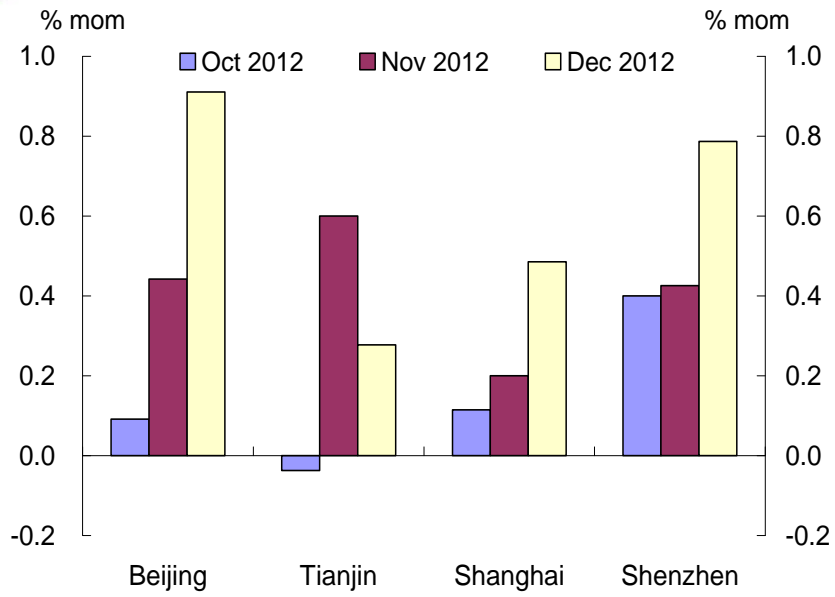
MAINLAND CHINA: PROPERTY TRANSACTION VOLUME IN MAJOR CITIES



Source: WIND



MAINLAND CHINA: HOUSING PRICE CHANGES IN MAJOR CITIES

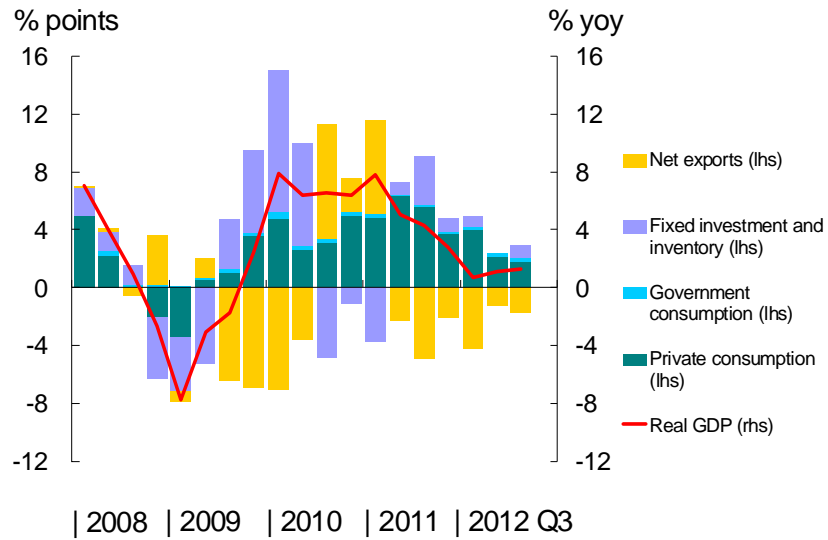


Sources: CEIC, WIND and HKMA staff estimates



HONG KONG: REAL GDP GROWTH

Changes in Real GDP and contributions by major components

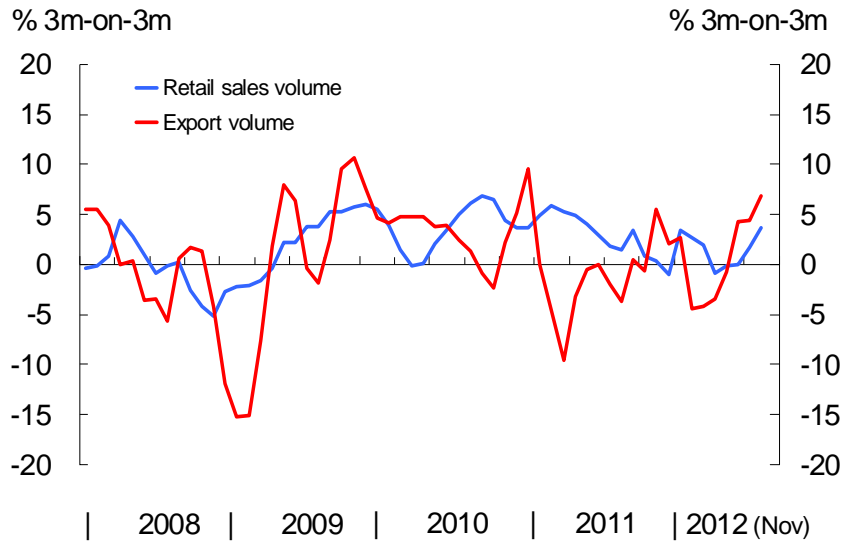


Source: C&SD



HONG KONG: ECONOMIC ACTIVITY

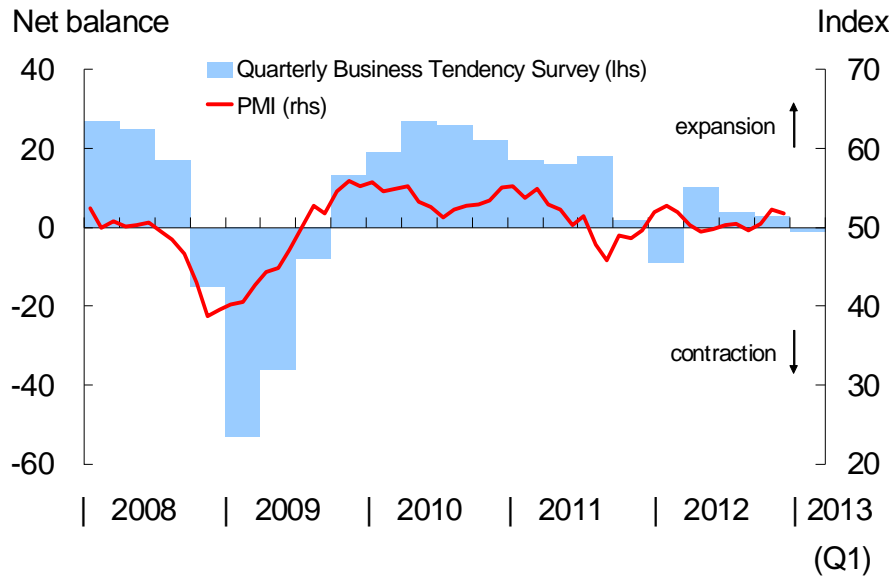
Retail Sales and Exports



Source: C&SD



HONG KONG: BUSINESS OUTLOOK

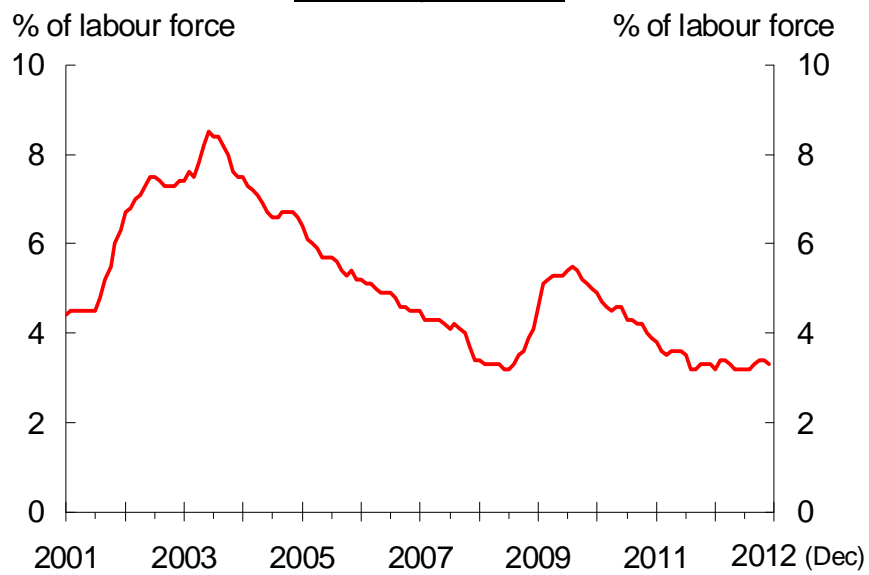


Sources: C&SD and Markit Economics



HONG KONG: LABOUR MARKET

Unemployment rate

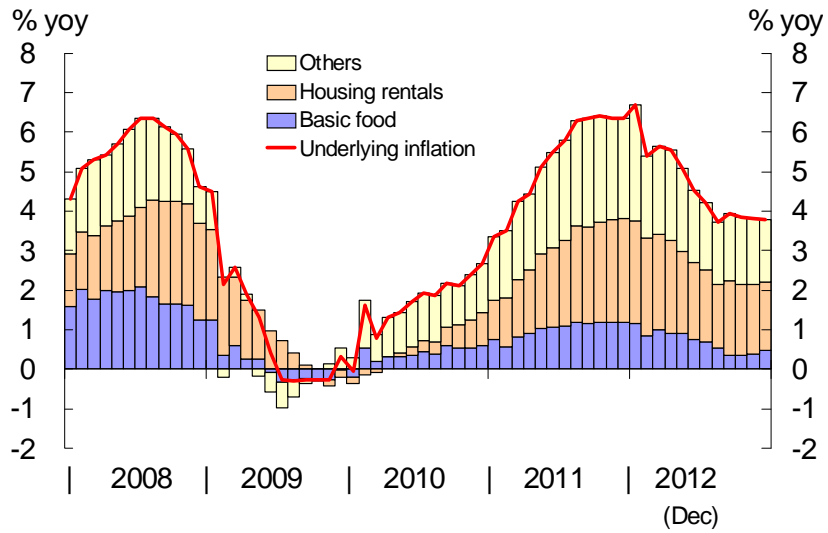


Source: C&SD



HONG KONG: INFLATION

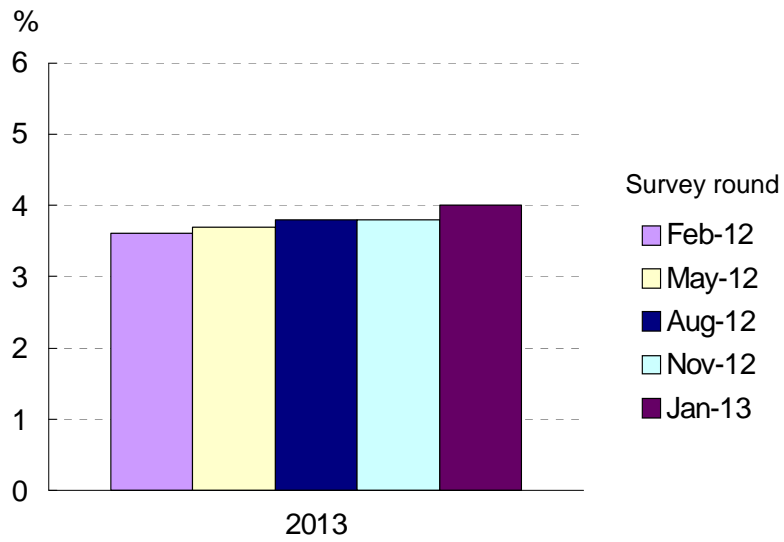
Underlying inflation and contributions of its components



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



HONG KONG: INFLATION FORECASTS

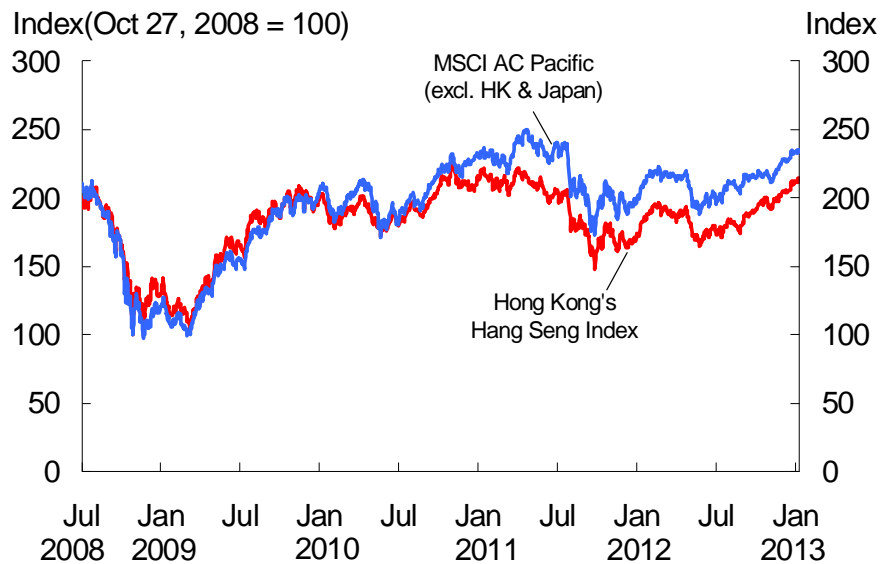


Source: Consensus Forecasts (Feb, May, Aug, Nov 2012 and Jan 2013)



HONG KONG: EQUITY MARKET

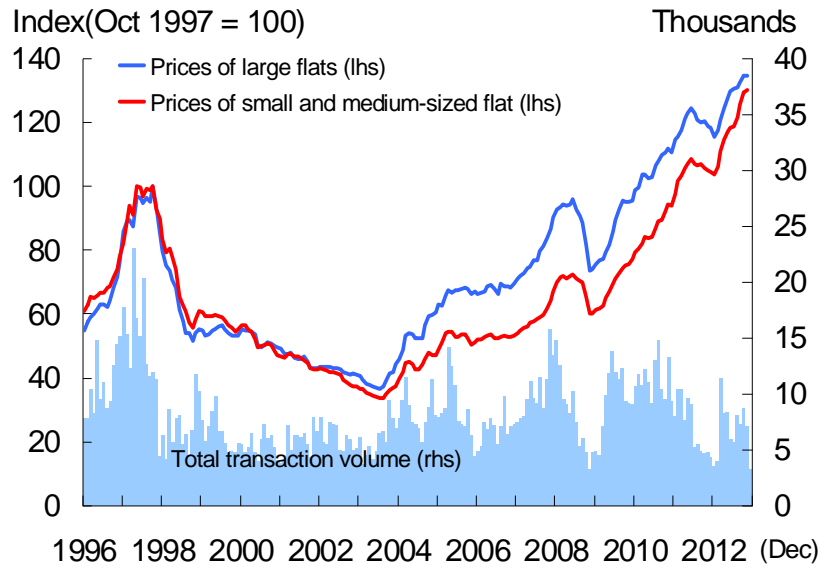
Hong Kong and Asia Pacific equity market performance



Source: Bloomberg



HONG KONG: RESIDENTIAL PROPERTY PRICES AND TRANSACTION VOLUME

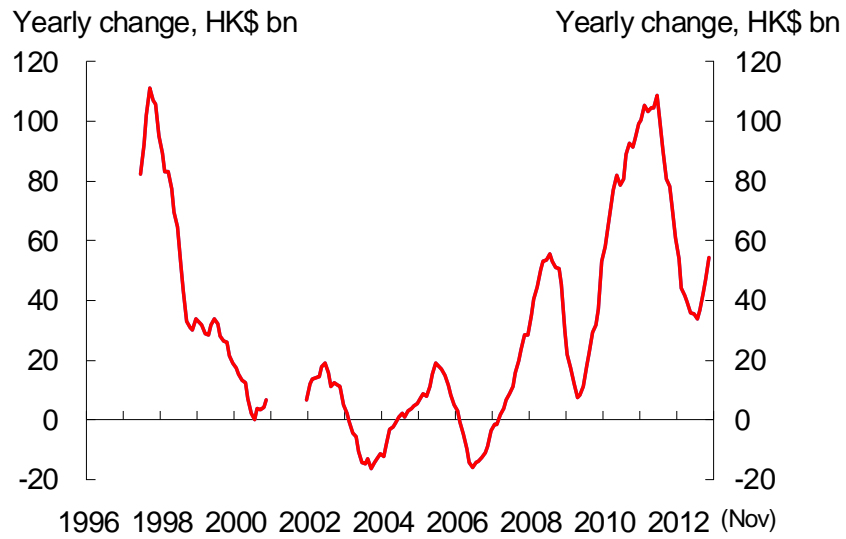


Source: Rating and Valuation Department



HONG KONG: OUTSTANDING MORTGAGE LOANS

Changes in outstanding mortgage loans

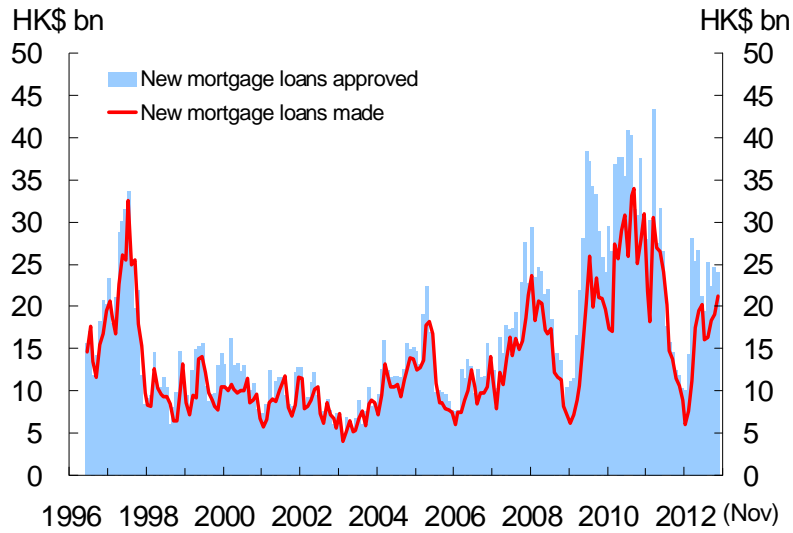


* There is a break in data series at December 2000 due to an increase in the number of surveyed institutions
Source: HKMA



HONG KONG: NEW MORTGAGE LOANS

New mortgage loans made and approved

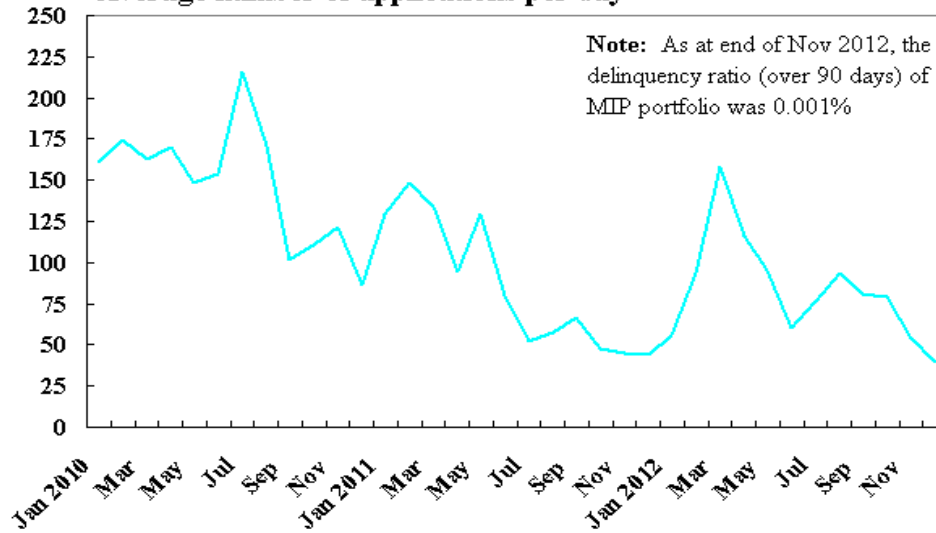


* There is a break in data series at December 2000 due to an increase in the number of surveyed institutions
Source: HKMA



HONG KONG: MIP LOAN APPLICATIONS

Average number of applications per day



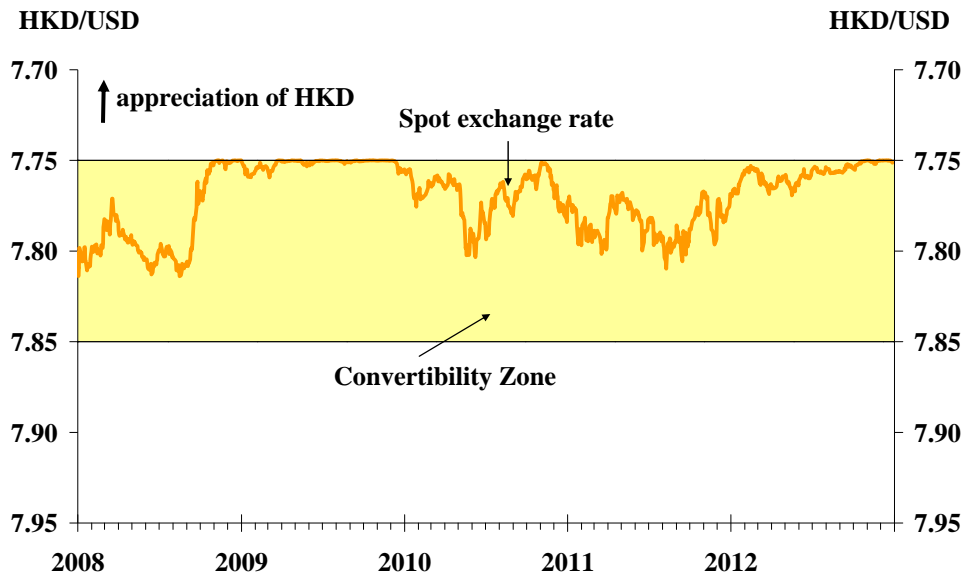
Source: Hong Kong Mortgage Corporation



CURRENCY STABILITY



HONG KONG DOLLAR SPOT EXCHANGE RATE

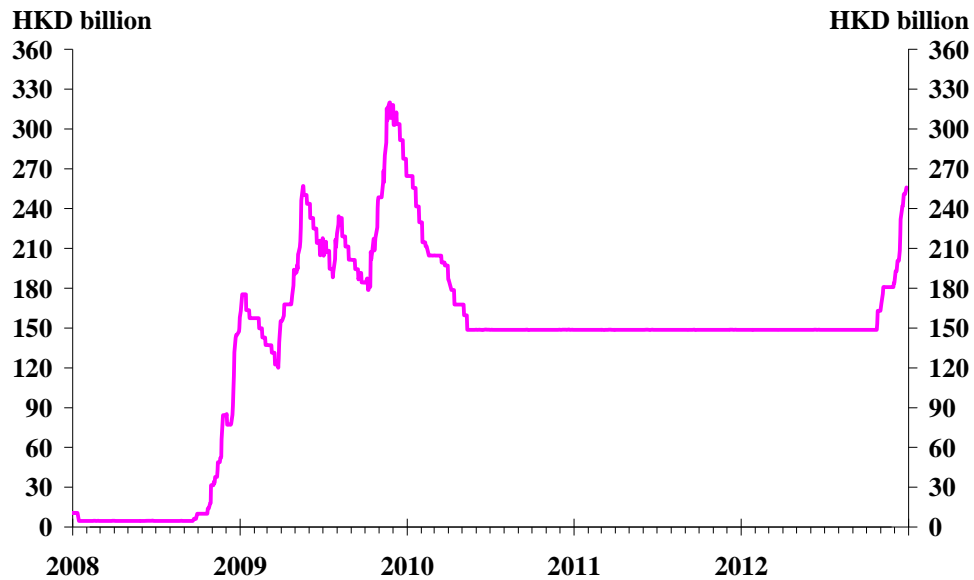


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- The Hong Kong dollar spot exchange rate stayed close to the strong-side Convertibility Undertaking (CU) level since mid-November 2012.
- The strong-side CU was triggered intermittently in the period. The net inflows of funds were partly driven by increased allocations to Hong Kong equities by overseas investors and partly by conversion of proceeds from foreign-currency bond issuance by Hong Kong firms into Hong Kong dollars.



AGGREGATE BALANCE

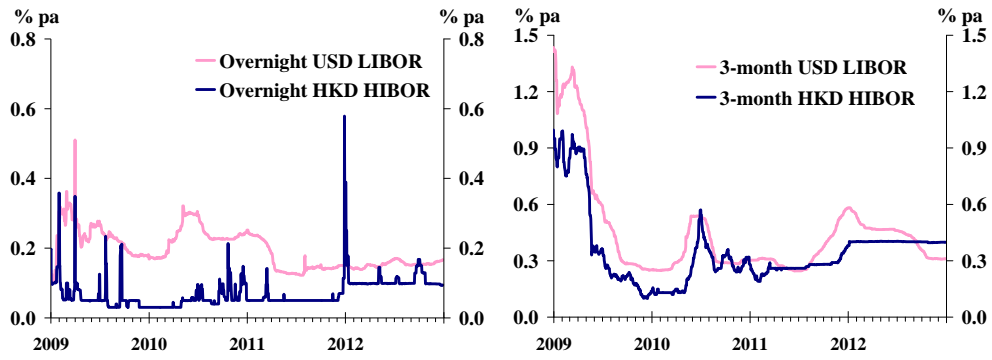


40

- As of 2 January 2013, due to the triggerings of the strong-side CU since 19 October 2012, the HKMA injected a total of HK\$107.2 billion into the banking system. The Aggregate Balance hence rose to HK\$255.8 billion on 2 January 2013.
- Liquidity remained abundant in the interbank market.



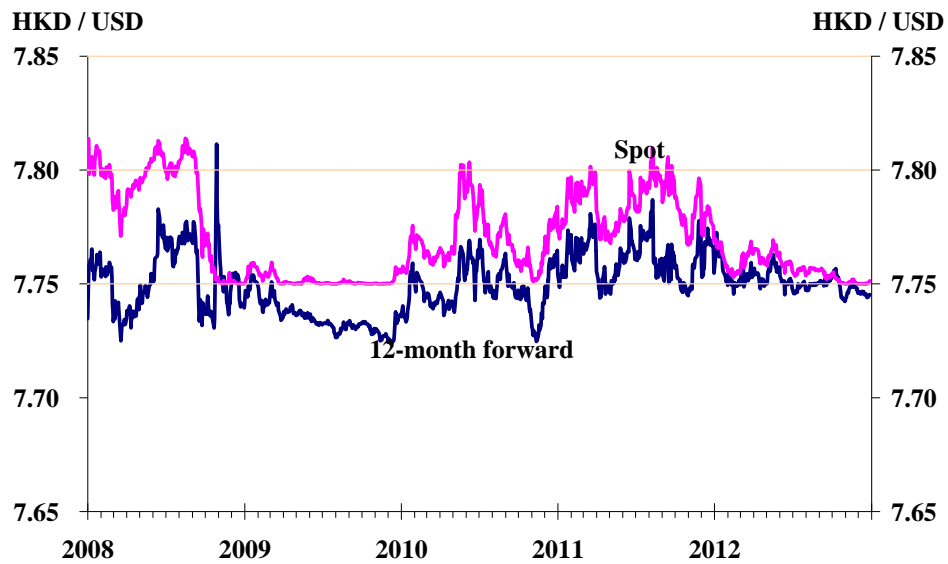
DOMESTIC INTEREST RATES



- Short-term Hong Kong dollar interbank interest rates have remained largely stable.



HONG KONG DOLLAR FORWARD EXCHANGE RATE



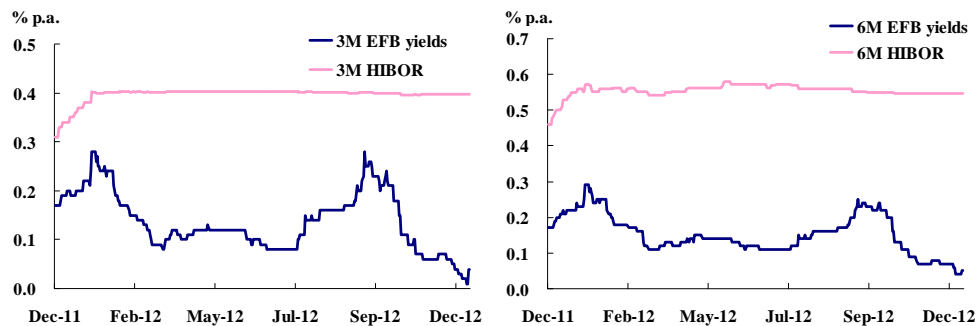
42

- Alongside a rise in the Aggregate Balance, the 12-month Hong Kong dollar forward discounts have widened slightly since mid-November.



YIELDS OF EXCHANGE FUND BILLS

- Banks' demand for EFB has increased along with the Aggregate Balance expansion, pushing yields lower. To meet the strong demand, the HKMA announced on 7 January 2013 the issuance of a total of HK\$21 billion of additional EFB in the month.



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- Along with the expansion of the Aggregate Balance, banks' demand for Exchange Fund paper for liquidity purpose has increased, leading to a decline in EFB yields. With the interbank interest rates staying stable, the spreads between HIBORs and EFB yields have gradually widened.
- To meet the banks' strong demand for EFB, the HKMA announced on 7 January 2013 the issuance of a total of HK\$21 billion of additional EFB in the month.

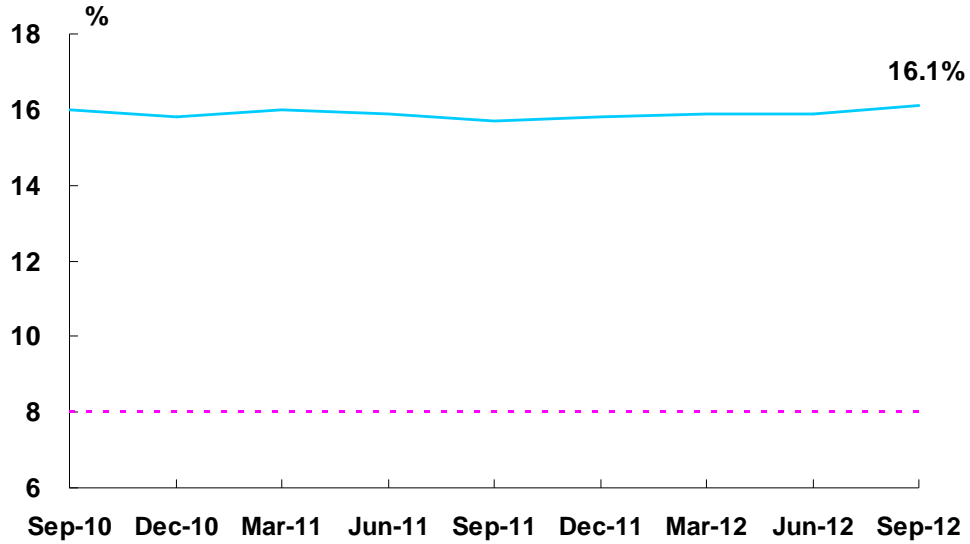


BANKING STABILITY



BANKING SECTOR PERFORMANCE

Locally incorporated AIs continued to be well capitalised



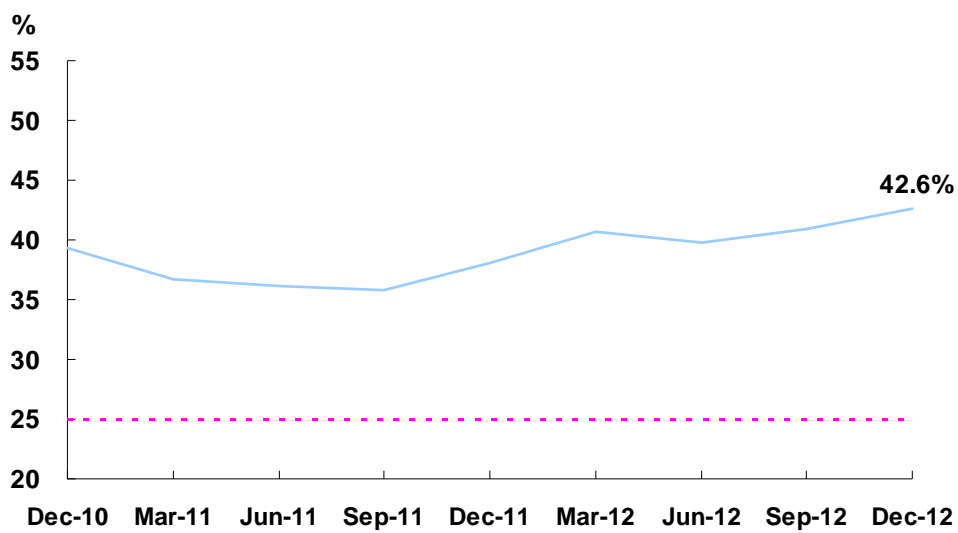
45

- The consolidated capital adequacy ratio of locally incorporated AIs stood at 16.1% at end-September 2012, and remained well above the international standard of 8%.



BANKING SECTOR PERFORMANCE

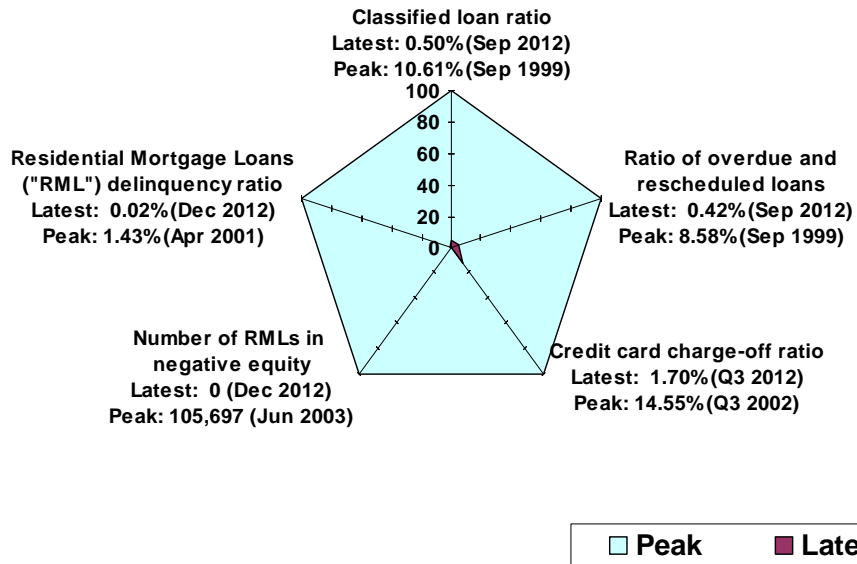
Liquidity ratio of retail banks remained well above statutory minimum of 25%





BANKING SECTOR PERFORMANCE

Asset quality remained good compared with historical standards

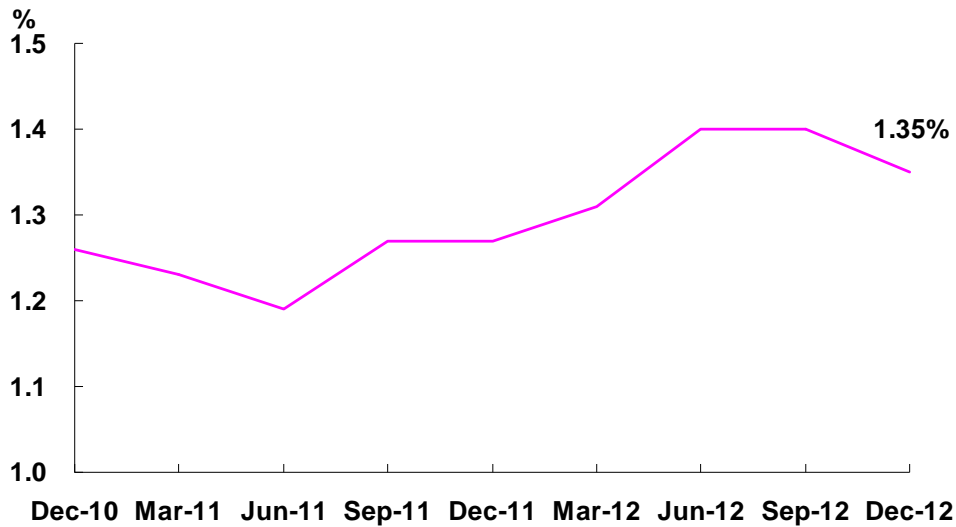


- The HKMA will continue to monitor closely the asset quality of retail banks' loan portfolios.



BANKING SECTOR PERFORMANCE

Net interest margin of retail banks slightly reduced



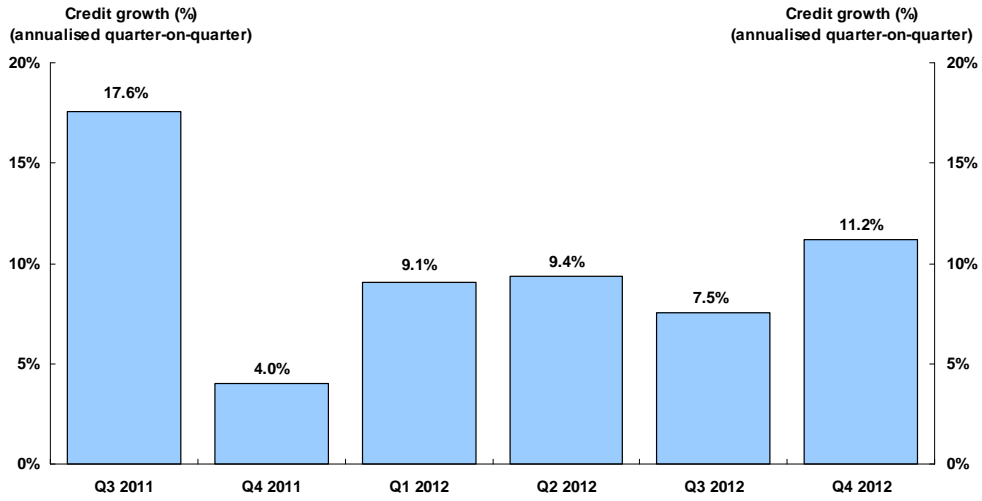
48

- The quarterly annualised net interest margin of retail banks slightly reduced to 1.35% in Q4/2012 from 1.40% in Q3/2012.
- The aggregate pre-tax operating profit of retail banks' Hong Kong offices in 2012 increased by 12.7% compared with the same period last year. Benign increases in net interest income (+15%) contributed to most of the profit growth.



CREDIT GROWTH

Credit growth remained at a moderate level in 2012

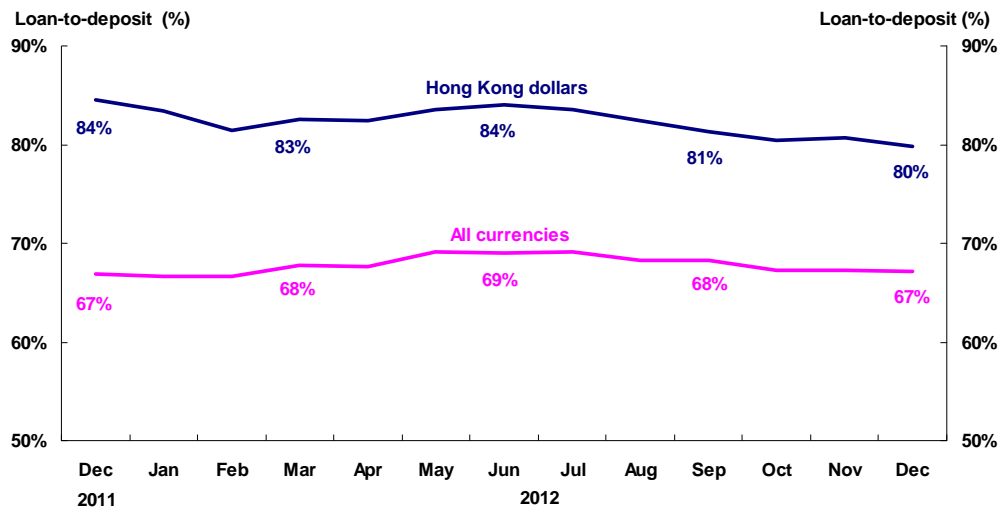


- In 2012, credit growth was 9.6%. It is much slower than the 20.2% growth recorded in 2011.



CREDIT GROWTH

Loan-to-deposit ratios of banks in Hong Kong remained stable



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- Hong Kong dollar loan-to-deposit ratio was 80% at end-December 2012, lower than 84% as at end-December 2011.
- The HKMA will continue to monitor the movement of the loan-to-deposit ratio.



Risk Management of Property Mortgage Loans

Macroprudential measures introduced by the HKMA

- The HKMA introduced the fifth round of macroprudential measures for property mortgage lending in September 2012 to tighten the underwriting criteria for mortgages where borrowers already have one or more properties under mortgage and to limit the maximum loan tenor for all new property mortgages to 30 years
- These measures are applicable to both residential and non-residential properties, including mortgages for commercial properties and retail premises
- The HKMA also reminded banks in September 2012 to strengthen their risk management of car park mortgage loans

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Macroprudential measures for mortgage lending currently in force:

(A) Measures applicable to applicants who have no outstanding property under mortgage at the time of a mortgage loan application

(1) Maximum loan-to-value (LTV) ratio

- | | |
|--|---|
| (i) Owner-occupied properties | : 50% - 70% (depending on the property value) |
| (ii) Non-owner-occupied properties | : 50% |
| (iii) Net worth based lending | : 40% |
| (iv) Borrowers whose principal income is derived from outside HK | : Lower the applicable LTV limits by 10 percentage points |

(2) Maximum debt servicing ratio (DSR)

- | | |
|---|-------|
| (i) Base cap | : 50% |
| (ii) Maximum stressed DSR with a 2 percentage point rise in interest rate | : 60% |

(3) Maximum loan tenor : 30 years

(B) Measures applicable to applicants who have one or more outstanding property mortgage loans at the time of a mortgage loan application

(1) DSR based lending

- | | |
|---|-------|
| (i) Maximum DSR | : 40% |
| (ii) Maximum stressed DSR with a 2 percentage point rise in interest rate | : 50% |

(2) Net worth based lending : Maximum LTV ratio is 30%

(3) Borrowers whose principal income is derived from outside HK : Lower the applicable LTV limits by 20 percentage points

(C) Measures applicable to car park mortgage loans

- | | |
|--|------------|
| (1) Maximum LTV ratio | : 50% |
| (2) Maximum DSR | : 50% |
| (3) Maximum stressed DSR with a 2 percentage point rise in interest rate | : 60% |
| (4) Maximum loan tenor | : 15 years |



Risk Management of Property Mortgage Loans

- The macroprudential measures introduced by the HKMA have contained the risks of the mortgage loan portfolios of the banking system in Hong Kong:
 - The average loan-to-value ratio for new mortgage loans declined from 64% in September 2009 to 52% in December 2012
 - The average debt servicing ratio for new mortgage loans dropped from 41% in August 2010 to 36% in December 2012
- The HKMA will continue to closely monitor developments in the mortgage market and introduce appropriate measures in response to changes in the property market cycle to safeguard banking stability

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Latest developments in the residential mortgage market

- Property transaction volume fell recently and the number of mortgage applications also decreased

	11/2012	12/2012
Number of residential property transactions	7,035	3,286 (-53%)
Number of new residential mortgage applications	10,627	7,449 (-30%)



Basel III Implementation Progress

- Capital standards
 - Banking (Capital) Rules – further amendment/refinement
 - Revised guideline on Pillar 2 "Supervisory Review Process"
 - Consultation conducted on revised banking return
- Disclosure standards
 - Statutory consultation – Rules to be tabled before LegCo in March
- Liquidity standards
 - To proceed with policy consultation shortly (taking into account Basel revisions to the Liquidity Coverage Ratio)

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Capital standards

- First phase of standards (re definition of capital, minimum requirements and counterparty credit risk capture) was implemented in Hong Kong with the Banking (Capital) (Amendment) Rules 2012 coming into operation, and the revised guideline on Pillar 2 taking effect, on 1 Jan 2013.
- Following industry consultation, the revised capital adequacy ratio banking return is being finalised for the first reporting of Als' capital position based on Basel III as of end-March 2013.
- Second phase of standards (covering the two capital buffer requirements) is scheduled for implementation from 2016. Policy proposals are being developed for industry consultation later in the year.
- On-going refinements will be introduced to the Banking (Capital) Rules as and when the Basel Committee issues further clarifications/interpretive guidance in light of implementation experience.

Disclosure standards

- Statutory consultation has been conducted on a set of Banking (Disclosure) (Amendment) Rules 2013 which set out disclosure requirements associated with the first phase of the Basel III capital standards. The industry's comments mainly sought clarification on a few points. The Rules will be finalised for tabling before LegCo in March 2013.

Liquidity standards

- In early January, the Basel Committee published a package of revisions to the Liquidity Coverage Ratio (LCR), which is one of the two new global liquidity standards included in the Basel III reform package. The HKMA is developing policy proposals for local implementation of the LCR taking into account the latest revisions and local circumstances. We intend to conduct a new round of industry consultation on the liquidity proposals within the first quarter of this year.



INVESTOR AND CONSUMER PROTECTION

- Required AIs to enhance controls over sale of bonds with certain features and high-yield bond funds
- Developing an enhanced competency framework for private wealth management practitioners
- Hosted jointly with the OECD and the SFC an Asian Seminar and Roundtable on financial consumer protection and education

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- On 19 November, the HKMA issued a circular to AIs requiring them to take prompt action to enhance controls to ensure proper selling practices as required by the Securities and Futures Commission (“SFC”) and audio-recording of sale process involving retail customers in respect of certain debentures with special features and risks (e.g. extendable, convertible) and high-yield bond funds. AIs should also apply pre-investment cooling-off period arrangement to the sale to less sophisticated retail customers of these debentures.
- With a view to raising the competency and ethical standards of industry practitioners and to developing and maintaining a pool of professional talents for the private wealth management (PWM) industry in Hong Kong, the HKMA and the SFC are working with the industry and professional bodies to develop an enhanced competency framework covering the requisite level of competency and on-going professional development of PWM practitioners.
- The HKMA together with the OECD and the SFC jointly hosted an Asian Seminar on financial consumer protection and education and an Asia Financial Consumer Protection Roundtable on 13 and 14 December 2012. It was the first time that a high-level international conference on financial consumer protection was held in Hong Kong. The Seminar attracted over 120 local and overseas participants, including representatives from regulatory and supervisory authorities, financial industry practitioners, industry associations, consumer and investor education bodies and academics. The Roundtable was attended by some 30 senior officials of local and overseas regulatory authorities and public bodies responsible for financial consumer protection. Participants discussed the key lessons learnt from the global financial crisis and the recent development to support financial consumer protection, and exchanged views on major challenges in developing and implementing financial consumer protection policies in their respective jurisdictions.



DEPOSIT PROTECTION

- Completed a self-assessment of the Deposit Protection Scheme (DPS) against the Core Principles for Effective Deposit Insurance Systems and identified areas for further enhancing the DPS
- Formulated a payout reform plan for improving payout efficiency
- Second round of advertising campaign launched in Q4 2012 to sustain public awareness

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- A thorough self-assessment of the DPS in Hong Kong against the Core Principles for Effective Deposit Insurance Systems (Core Principles) jointly issued by the Basel Committee on Banking Supervision and the International Association of Deposit Insurers was completed. It is concluded that the design features of the current DPS is compliant with the Core Principles and areas for further improvement in some key aspects of the Scheme, mainly on how to enhance payout efficiency, are identified.
- A full-scope rehearsal to test the capability of the Hong Kong Deposit Protection Board and its payout agents was completed in October 2012. Taking into account the results of the Core Principles review and the experience of the rehearsal exercise, an implementation plan is formulated to improve payout efficiency and enhance the readiness to deal with the challenges faced in promptly compensating depositors should the DPS be triggered. Areas being considered include tightening the requirements on submission of depositor information by banks, alternative payment methods such as by electronic means, closer coordination with the HKMA and relevant government departments to ensure a better work arrangement in a payout, and fine tuning on payout system and procedures.
- Riding on the high awareness level generated by the recent publicity campaign embarked in mid-2012, the second round of advertising campaign was launched in Q4 2012 to sustain the level of public awareness and understanding of the protection and coverage of the DPS.



FINANCIAL INFRASTRUCTURE



REFORMING OTC DERIVATIVES MARKET

G20 Commitments

- All standardised OTC derivative contracts should be traded on exchanges/electronic trading platforms and cleared through central counterparties
- OTC derivative contracts should be reported to trade repositories

Implementation

- **Regulation:**

- Aim to introduce the Securities and Futures (Amendment) Bill into the Legislative Council to implement the clearing and reporting requirements

- **Central Counterparty:**

- HKEx is building a local central counterparty for OTC derivatives, which is expected to commence operation in Q2 2013

- **Trade Repository:**

- The HKMA is building a trade repository (TR) under its Central Moneymarkets Unit. The matching and confirmation functions of the TR to support clearing at HKEx's central counterparty was launched in December 2012. The reporting function of the TR is targeted to be launched by mid-2013

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- Following the public consultation on the proposed regulatory regime for the OTC derivatives market in October 2011, the HKMA and SFC published the consultation conclusions to respond to the comments received from the consultation and issued a supplemental consultation paper on the proposed scope of new/expanded regulated activities and the oversight of systemically important players in July 2012. The supplemental consultation was closed on 31 August 2012. The HKMA and SFC are studying the feedbacks received from the supplemental consultation.
- The detailed requirements of the new regulatory regime will be set out in the subsidiary legislation in the form of rules. The HKMA and SFC aim to conduct a public consultation on the draft subsidiary legislation in summer 2013.
- The local TR will be launched in two stages – the first stage was launched in December 2012 to support central clearing; the second stage is targeted to be launched by mid-2013 to support mandatory reporting.



GOVERNMENT BOND PROGRAMME

Institutional Bond Issuance Programme:

- Nine issues totalling HK\$47 billion outstanding as at end-2012
- Tenors from 2 years 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:

- Two issues totalling HK\$20 billion issued as at end 2012
- Have helped to enhance the interest and awareness of retail investors in bond investments

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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 equity markets and the banking sector.
- 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 two issuances of inflation-linked bonds (i.e. iBonds) have helped to achieve such objective.



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 promote Hong Kong's financial platform to overseas and Mainland asset managers and investors. Promotional campaigns have so far covered Abu Dhabi, Beijing, Boston, Dubai, Dublin, Edinburgh, Frankfurt, Geneva, Guangzhou, Korea, London, Lugano, Luxembourg, Montreal, New York, Paris, San Francisco, Singapore, Shanghai, Shenzhen, Toronto and Zurich
- 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 FSTB and the SFC, in holding a series of promotional roadshows in leading global financial centres. Since November 2010, the campaign has visited London, New York, Zurich, Geneva, Lugano and Luxembourg, during which the HKMA also took the opportunities to meet with key asset managers based in their financial centres to promote the financial platform in Hong Kong and listen to their business plans in Asia and their views on potential hurdles for their operations in Hong Kong.
- At the same time, the HKMA has also been reaching out to market players in Abu Dhabi, Beijing, Boston, Dubai, Dublin, Edinburgh, Frankfurt, Guangzhou, Korea, Montreal, Paris, San Francisco, Singapore, Shanghai, Shenzhen and Toronto to explain the opportunities and advantages presented by Hong Kong as an asset management centre and to highlight Hong Kong's latest positive developments to overseas business decision makers.



DEVELOPMENT OF ISLAMIC FINANCE

- Supporting the Financial Services and the Treasury Bureau in its work on a legislative proposal to amend Hong Kong's tax laws to provide a comparable tax regime for some common types of Islamic bonds vis-à-vis conventional bonds
- The amendment bill was published in the Gazette on 28 December 2012 and introduced into LegCo for First Reading on 9 January 2013



FINANCIAL INFRASTRUCTURE

- Continue to maintain safety and efficiency of financial infrastructure
- 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.

Trade Repository

- The development of the trade repository (TR) has been progressing as scheduled. To prepare for the commencement of central clearing of OTC derivatives transactions, the matching and confirmation function of the TR was launched in December 2012. The reporting function of the TR is targeted to be launched by mid-2013.



RETAIL PAYMENT INITIATIVES

- **Electronic bill presentment and payment (e-bill) system:**
 - over 20 banks confirmed participation, including all major retail banks
 - major billers such as Government, utilities companies and telecommunication companies indicated interest in the platform
 - plan to launch the system in the second half of 2013
- **e-cheque:**
 - completed industry consultation and aim to commence system development in the first quarter of 2013
 - aim to deliver the service near the end 2014
- **Near Field Communication (NFC) mobile payment services:**
 - consultancy study completed in end January 2013
 - continue to work with the industry to implement the recommendations of the consultancy report
- **Legislative framework for stored value facilities and retail payment systems:**
 - industry soft-consultation completed in December 2012
 - formal industry consultation commenced near the end of December 2012
 - commenced preparatory work for the drafting of the Bill

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Retail Payment Initiatives

- A press conference was held on 4 September 2012 to announce the HKMA's three-pronged strategy of enhancing the retail payment infrastructure and instruments in Hong Kong. The strategy include: (i) moving from paper-based and semi-electronic payment instruments to a fully electronic platform; (ii) exploring the possibility of developing a common interface for Near Field Communication (NFC) mobile payment; and (iii) enhancing the legislative framework to cover innovative payment instruments.

e-bill system

- The e-bill system is a multi-currency multi-functional centralised platform which will facilitate the public to view, manage and pay regular and non-regular bills. It supports bill payments denominated in HKD, RMB and USD. The scope of services include: (i) business-to-customer billing and payment; (ii) business-to-business billing and payment; (iii) cross-border billing and payment; and (iv) online charity donations and presentment of online donation receipts. System development is under way and marketing campaign continues to arouse the public's awareness and interest. The e-bill system is scheduled for launch in the second half of 2013.

e-cheque

- The HKMA has completed soft consultation with the major banks on the operating model of e-cheque. Once seeking endorsement of the Retail Payment Working Group, system development will commence in early 2013 with the tentative launch date in the end of 2014.

NFC mobile payment

- The HKMA has appointed a consultancy firm to conduct a feasibility study and advise the strategy and approach of establishing an interoperable NFC mobile payment infrastructure in Hong Kong. Indeed, Hong Kong is in the initial stage of NFC mobile payment development and a few NFC mobile payment services will be rolled out in the next few months. It is timely for us to conduct the study in response to the market needs for interoperability and portability. Stakeholder interviews have been completed and the study will be completed in January 2013. An industry working group will then be formed to discuss and implement the recommendations of the consultancy report.

Legislative framework for stored value facilities (SVF) and retail payment systems (RPS)

- The proposed legislation seeks to empower the HKMA to exercise the supervisory and enforcement functions on SVF and the oversight function on designated RPS, with a view to ensuring adequate consumer protection and the safety and soundness of such facilities and systems in Hong Kong. The HKMA completed the draft drafting instructions to amend the Clearing and Settlement Systems Ordinance and the Banking Ordinance and submitted them to the FSTB and the DoJ for consideration in November 2012. The HKMA also conducted soft consultations with over 20 stakeholders to gauge their initial views on the proposed regulatory framework. Taking into account the initial comments received from the soft consultation, the HKMA prepared a formal industry consultative paper and circulated it to around 30 industry participants on 21 December 2012 to seek their further feedback on the proposed regulatory framework. Following the formal industry consultation, the HKMA plans to do a public consultation in the first half of 2013 before introducing an amendment bill to LegCo in mid-2013.

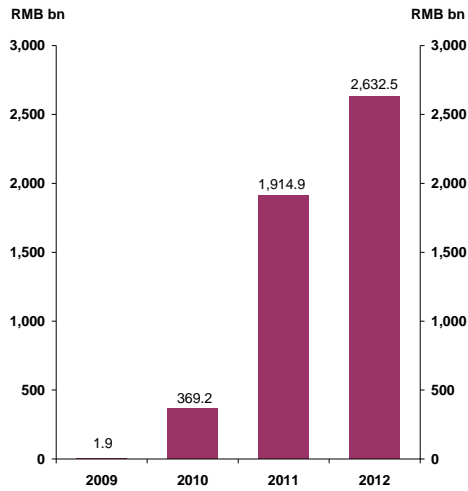


HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

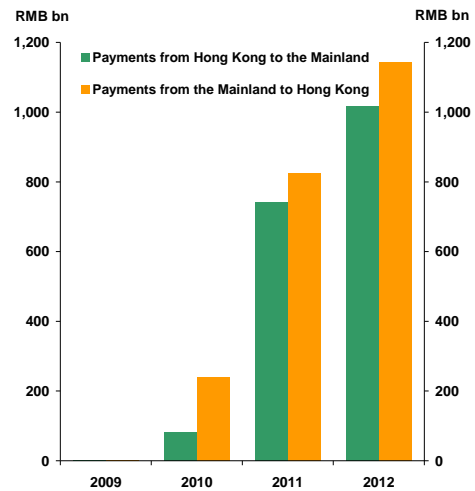


Steady growth in RMB trade settlement

**RMB trade settlement
handled by banks in Hong Kong**



**Flows of RMB trade settlement
between Hong Kong and the Mainland**



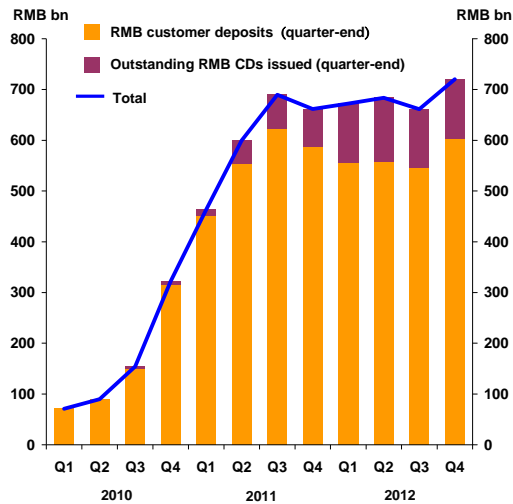
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- In 2012, RMB trade settlement handled by banks in Hong Kong amounted to RMB2,630 billion yuan, a 37% growth compared with 2011. Meanwhile, the payment flows to and from the Mainland were largely balanced.



Increasing maturity of RMB financing markets

RMB customer deposits and certificates of deposit (CDs)



RMB financing activities

RMB dim-sum bond market

	2012	2011
Amount of issuance (RMB billion)	112.2	107.9
Outstanding amount (RMB billion)	237.2	146.7

RMB bank lending

	End 2012	End 2011
Outstanding RMB loans (RMB billion)	79.0	30.8

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- At end-2012, the outstanding amount of RMB customer deposits and CDs issued amounted to RMB603.0 billion yuan and RMB117.3 billion yuan respectively, totalling RMB720.2 billion yuan, up 9% compared with RMB661.6 billion yuan at end-2011.
- At end-2012, over 29,000 accounts were opened by non-resident personal customers, with deposits exceeding RMB4 billion yuan.
- RMB bank lending expanded significantly over the past year, with outstanding RMB loans amounting to RMB79.0 billion yuan at end-2012, a 157% growth from end-2011.



Continued development of Hong Kong's role in supporting offshore RMB business overseas

	2012	2011	2010
1 No. of participating banks of Hong Kong's RMB clearing platform	204	187	153
Of which:			
Branches and subsidiaries of overseas banks and overseas presence of Mainland banks	181	165	133
2 No. of RMB correspondent accounts set up by overseas banks at Hong Kong banks	1,402	968	187
3 Amount due to overseas banks (RMB billion at period-end)	99.1	116.4	19.6
4 Amount due from overseas banks (RMB billion at period-end)	117.1	121.7	10.9

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- The growth in corporates and financial institutions around the world conducting RMB business is conducive to Hong Kong's development as the offshore RMB business centre.
- The Hong Kong – London RMB Forum, established in January 2012, convened two meetings and significant progress has been achieved. For instance, banks in London and Hong Kong have sought to raise awareness of corporates regarding the use of RMB, both individually and collectively, resulting in a substantial increase in RMB corporate accounts and foreign exchange trading in both the London and Hong Kong markets, while the average daily turnover in Hong Kong's RMB Real Time Gross Settlement system, which serves the global RMB market, has exceeded RMB250 billion. In addition, banks in London and Hong Kong have been taking advantage of the lengthened operating hours of the RMB RTGS system in Hong Kong, by extending their internal cut-off times for handling RMB transactions with customers and other banks. Looking ahead, the Forum will continue to expand marketing initiatives and efforts in various areas to facilitate the further development of the offshore RMB market.
- The RMB Trade and Investment Dialogue between Hong Kong and Australia is scheduled to have the first meeting in the first half of 2013.



Qianhai cross-border lending arrangement

- Provisional administrative rules for RMB cross-border bank lending in respect of Qianhai released in December 2012
- Corporates incorporated in Qianhai can borrow RMB loans from banks in Hong Kong for uses relating to the development of Qianhai
- This will further enhance the circulation of RMB funds between Hong Kong and the Mainland. Banks in Hong Kong will have more business opportunities in developing their RMB lending business
- The HKMA will continue to work closely with People's Bank of China Shenzhen Central Sub-branch on implementation



INCREASING REGIONAL AND INTERNATIONAL FINANCIAL CO-OPERATION

Financial Stability Board (FSB)

- HKMA continues to participate actively in FSB meetings and activities. Key areas of work include implementing over-the-counter derivatives market reforms, strengthening regulation of the shadow banking system and reviewing the FSB governance structure. The HKMA also attended the FSB Regional Consultative Group for Asia meeting in Seoul in November 2012 to discuss risks and vulnerabilities in the region and status of financial regulatory reforms

Executives' Meeting of East Asia-Pacific Central Banks (EMEAP)

- HKMA chaired the EMEAP Monetary and Financial Stability Committee (MFSC) Meeting held on 16 November 2012. Based on the MFSC's half-yearly Macro-Monitoring Report prepared by the HKMA, the Committee reviewed recent economic and financial developments in the region and their policy implications. The Committee also discussed issues of common interest to EMEAP members, in particular implications of the global financial regulatory reforms for the region, and agreed on the need to raise a collective regional voice to contribute to the international discussions



INVESTMENT ENVIRONMENT AND PERFORMANCE OF THE EXCHANGE FUND

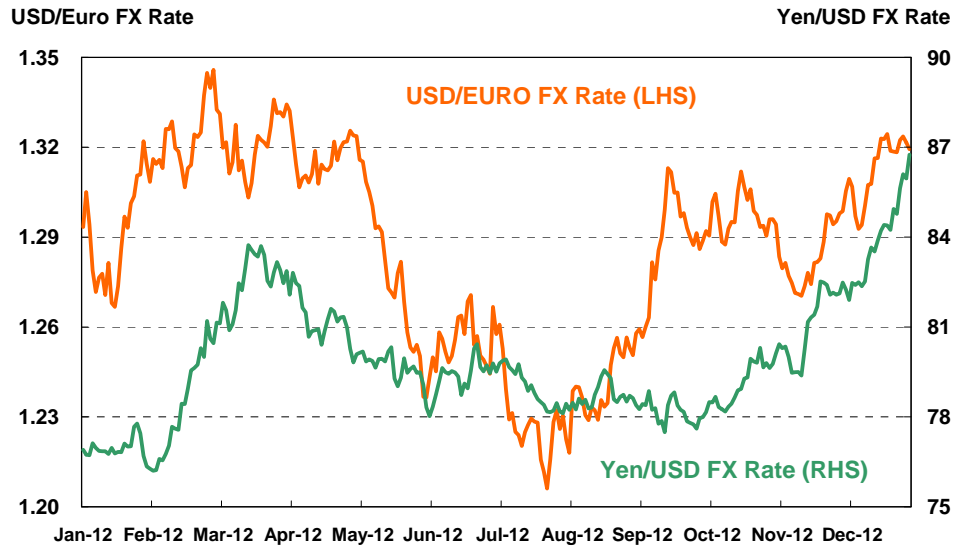


INVESTMENT ENVIRONMENT IN 2012

- **Exchange rates:** The Euro weakened in Q2 as market sentiment deteriorated over the debt crisis in the European peripheral countries, but subsequently rose as the European Central Bank's plan to purchase sovereign bonds allayed investors' concerns. The yen weakened against the dollar substantially in Q4 as investors expected the Bank of Japan would undertake more aggressive easing
- **Equity markets:** Amid heightened concerns about economic environment in Euro-zone, major equity markets in developed economies suffered a correction in Q2 that erased most of the gains in Q1. Markets rallied in the second half of the year on investor expectation of more accommodative monetary policies of major central banks and some compromise among US politicians to avoid the "fiscal cliff"
- **Interest rates:** Extension of low rate guidance and additional asset purchases by the Fed supported US Treasuries and pushed the yields lower. Other major government bond yields moved largely in tandem with the Treasury yields



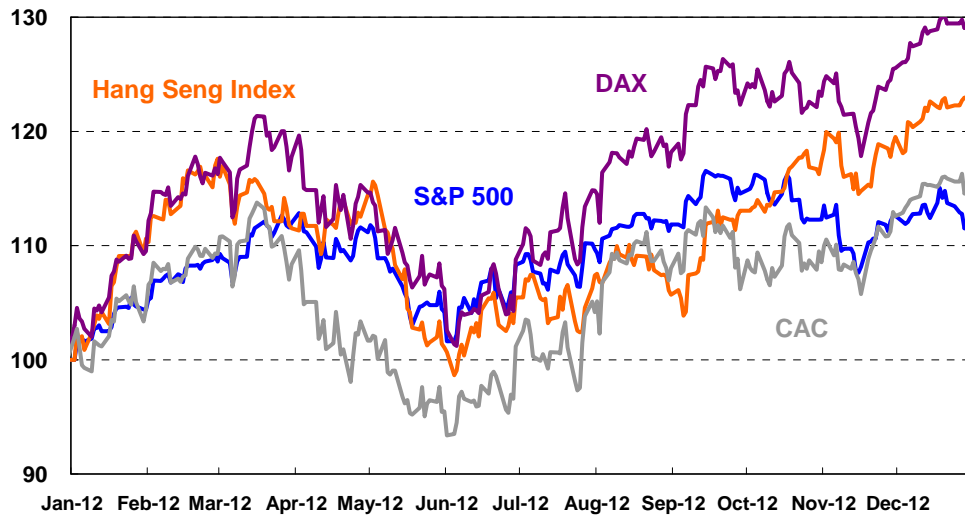
CURRENCY MARKETS IN 2012





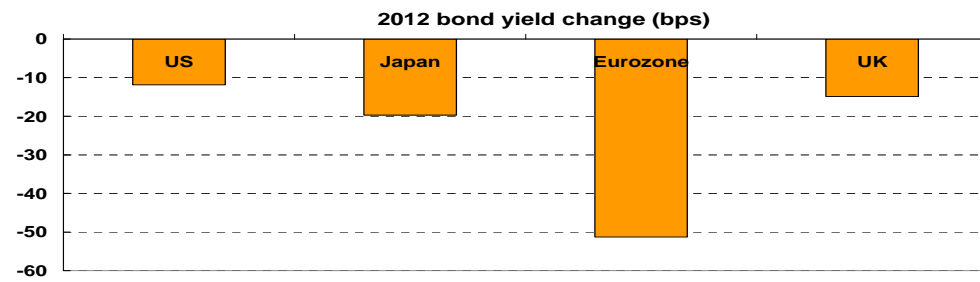
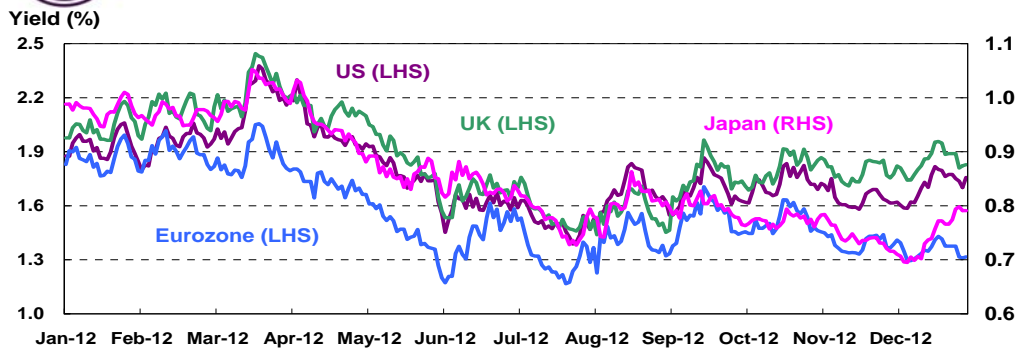
EQUITY MARKETS IN 2012

Normalized Index Level (2011 year-end = 100)





CHANGES IN 10-YEAR GOVERNMENT BOND YIELDS IN 2012





INVESTMENT INCOME

(HK\$ billion)	← 2012 →					2011	2010	2009	2008
	Full year *	Q4	Q3	Q2	Q1	Full year	Full year	Full year	Full year
Hong Kong equities[^][@]	30.7	11.8	9.3	(4.0)	13.6	(24.2)	11.6	48.9	(77.9)
Other equities[^]	42.6	10.3	14.4	(10.3)	28.2	(12.2)	27.1	48.8	(73.1)
Bonds[#]	33.1	2.5	10.8	22.7	(2.9)	71.9	42.1	(0.6)	88.4
Other investments^{&}	3.6	0.3	1.3	0.5	1.5	0.7	1.7	0.8	-
Foreign exchange	(1.4)	<u>2.4</u>	<u>6.6</u>	<u>(14.5)</u>	<u>4.1</u>	(9.1)	(3.1)	9.8	(12.4)
Investment income/(loss)^{@&}	108.6	27.3	42.4	(5.6)	44.5	27.1	79.4	107.7	(75.0)

* Unaudited figures

[^] Including dividends

[@] Excluding valuation changes in Strategic Portfolio (a gain of HK\$0.8 billion in 2012)

[#] Including interest

[&] 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)	2012					2011
	Full year (unaudited)	Q4	Q3	Q2	Q1	Full year
Investment income/(loss)	108.6	27.3	42.4	(5.6)	44.5	27.1
Other income	0.2	-	0.1	0.1	-	0.2
Interest and other expenses	<u>(4.4)</u>	<u>(1.0)</u>	<u>(1.1)</u>	<u>(1.4)</u>	<u>(0.9)</u>	<u>(4.7)</u>
Net investment income/(loss)	104.4	26.3	41.4	(6.9)	43.6	22.6
Payment to Fiscal Reserves #	(37.8)	(9.3)	(9.2)	(9.6)	(9.7)	(37.0)
Payment to HKSAR government funds and statutory bodies #	(8.0)	(2.2)	(2.1)	(1.9)	(1.8)	(5.6)
Valuation change of Strategic Portfolio less valuation change of investment held by EF's investment holding subsidiaries^	<u>(2.8)</u>	<u>0.7</u>	<u>(0.7)</u>	<u>(1.7)</u>	<u>(1.1)</u>	<u>(3.6)</u>
Increase/(Decrease) in EF Accumulated Surplus	55.8	15.5	29.4	(20.1)	31.0	(23.6)

The fixed rate of fee payment is 5.6% for 2012 and 6.0% for 2011

^ 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*&	27.1	22.1	(41.4)	21.6	24.8
2012*&#	108.6	27.3	42.4	(5.6)	44.5

* Excluding valuation changes in the Strategic Portfolio

Unaudited figures

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



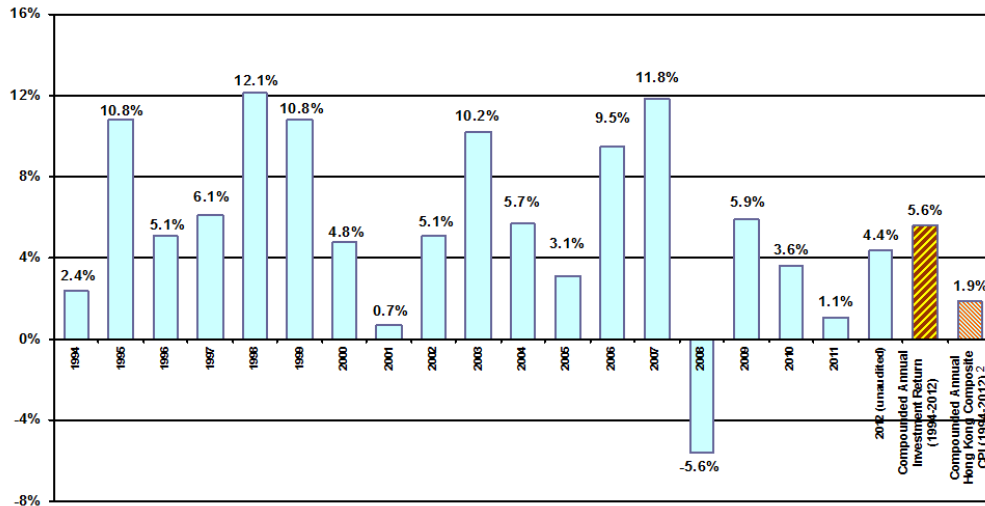
EXCHANGE FUND ABRIDGED BALANCE SHEET

(HK\$ billion)	At 31 Dec 2012 (unaudited)	At 31 Dec 2011	Change
ASSETS			
Deposits	189.2	221.7	(32.5)
Debt securities	2,047.5	1,844.4	203.1
Hong Kong equities	148.0	120.6	27.4
Other equities	284.9	238.2	46.7
Other assets [#]	<u>112.6</u>	<u>63.1</u>	<u>49.5</u>
Total assets	<u>2,782.2</u>	<u>2,488.0</u>	<u>294.2</u>
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness	289.8	258.7	31.1
Government-issued currency notes & coins in circulation	9.9	9.9	-
Balance of the banking system	255.9	148.7	107.2
Exchange Fund Bills and Notes	688.5	655.8	32.7
Placements by banks and other financial institutions	-	24.5	(24.5)
Placements by Fiscal Reserves	717.5	663.5	54.0
Placements by HKSAR government funds and statutory bodies	167.9	126.2	41.7
Other liabilities	<u>29.0</u>	<u>32.8</u>	<u>(3.8)</u>
Total liabilities	2,158.5	1,920.1	238.4
Accumulated Surplus	<u>623.7</u>	<u>567.9</u>	<u>55.8</u>
Total liabilities and fund equity	<u>2,782.2</u>	<u>2,488.0</u>	<u>294.2</u>

[#] Including investment in EF's investment holding subsidiaries amounted to HK\$53.6 billion at 31 Dec 2012 (HK\$31.1 billion at 31 Dec 2011)



INVESTMENT RETURN OF THE EXCHANGE FUND (1994 - 2012)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}
2012	4.4%
3-year average (2010 – 2012)	3.0%
5-year average (2008 – 2012)	1.8%
10-year average (2003 – 2012)	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



INVESTMENT DIVERSIFICATION

- To enhance the return of the Exchange Fund in the medium and long term, the HKMA has, since 2008, been diversifying part of the Fund's investment into more asset classes, including emerging market bonds and equities, private equity, real estate, and Mainland renminbi bonds and equities
- These assets are housed under the Long-Term Growth Portfolio (LTGP). Positions at end-2012 and performance since inception are as follows:

As of end 2012

New Asset Classes	Market Value HK\$ billion	Annualised return since inception till end 2012
Emerging market bonds and equities	41.4	8%
RMB assets (including bonds and equities)	46.9	
Private equity	47.1	10% (IRR)
Real Estate	13.5	
Total	148.9	

Note: Outstanding investment commitments at the end of 2012 amounted to HK\$63.8 billion



REVIEW OF THE LTGP

- In 2012, the HKMA conducted a review of the overall strategy of investment diversification. Results support that investment diversification should further be pursued.
- In November 2012, the Financial Secretary, on the advice of the Exchange Fund Advisory Committee (EFAC), endorsed the following recommendations:
 - To maintain the investment cap on LTGP size at one-third of the accumulated surplus of the Exchange Fund
 - To transfer Emerging Market Bonds and Equities and Renminbi Assets into the Investment Portfolio of the Exchange Fund
 - Private Equity and Real Estate will remain in the LTGP



HONG KONG MORTGAGE CORPORATION



Reverse Mortgage Programme

- By end-December 2012, 316 applications have been approved:
 - Average age of borrowers: 71 years old
 - Average monthly payout: HK\$13,400
 - Payment terms: 10-year (35%), 15-year (19%), 20-year (12%), life (34%)
 - Average property value: HK\$3.7 million
 - Average property age: 30 years
- 3 enhancements were launched in November 2012
 - Lowering the minimum age of borrowers from 60 to 55
 - Increasing the maximum specified property value for payout calculation from HK\$8 million to HK\$15 million
 - Increasing the maximum lump-sum payout amount

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Market response to the 3 enhancements

- Since the 3 enhancements came into effect, there were 6 applications involving applicants aged below 60 as of end-December 2012 (accounting for about 26% of the total applications during the period).
- Separately, there was 1 application which took out the maximum lump-sum payout (i.e. receiving no monthly payouts) for repaying the existing mortgage loan.
- Also, 4 out of the 7 relevant eligible existing cases have opted for higher monthly payouts by adjusting the specified property value upwards (average increase of 28% or about HK\$13,000; ranging from 16% - 56% or HK\$3,700 – nearly HK\$30,000).



SME Financing Guarantee Scheme (“SFGS”)

- In response to the request from the Government, the HKMC launched in May 2012 an 80% loan guarantee product under the SFGS until end-February 2013 to assist SMEs in obtaining bank financing amid challenging economic conditions
- The new product has been well received by the market. As of end-December 2012:
 - 5,068 applications were approved
 - total loan amount was about HK\$22.7 billion
 - average loan interest rate and guarantee fee rate were 4.6% p.a. and 0.5% p.a. respectively
- Over 3,700 SMEs involving approximately 106,000 employees have benefitted from the Scheme



Microfinance Scheme

- Launched in June 2012 for a trial period of 3 years with a tentative aggregate loan amount of HK\$100 million
- 6 banks and 5 non-governmental organisations have joined
- As of end-December 2012, the Scheme received over 1,800 hotline enquiries and 81 formal loan applications, out of which 47 have been approved with the total loan amount of HK\$12.75 million
- For the approved applications, the average loan size was HK\$270,000 and the average loan tenor was 4 years

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(1) MF applications (as of 31 Dec 2012)

Application Status	Total No. of Application	Micro Business Start-up (for new business set-up)	Micro Business Start-up (for established business)	Self-employment	Self-enhancement
Approved	47	17	26	4	0
Rejected	18	6	8	4	0
Pending vetting	12	5	7	0	0
Withdrawn	4	0	3	0	1
Total	81	28	44	8	1

Approval rate: 72% (= 47 / (47+18))

(2) Industry type for the approved cases

- Servicing 21 cases (45%)
- Retailing 14 cases (30%)
- Wholesales 6 cases (13%)
- IT related 3 cases (6%)
- Manufacturing 2 cases (4%)
- Others 1 case (2%)