



HONG KONG MONETARY AUTHORITY

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

19 November 2012



- 1. Assessment of Risk to Hong Kong's Financial Stability**
2. Banking Supervision
3. Financial Infrastructure
4. Hong Kong Mortgage Corporation
5. Hong Kong as an Offshore RMB Centre
6. Investment Performance of the Exchange Fund



ASSESSMENT OF EUROPE'S ECONOMY: RECENT DEVELOPMENTS

- Market concerns over the European debt crisis slightly eased:
 - €100 bn bailout plan announced by eurozone for Spanish banks
 - A single regulatory body for the eurozone to be set up
 - Outright Monetary Transactions programme (a government bond purchase plan) announced by European Central Bank
 - European Stability Mechanism ratified by German constitutional court ruling

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ASSESSMENT OF EUROPE'S ECONOMY

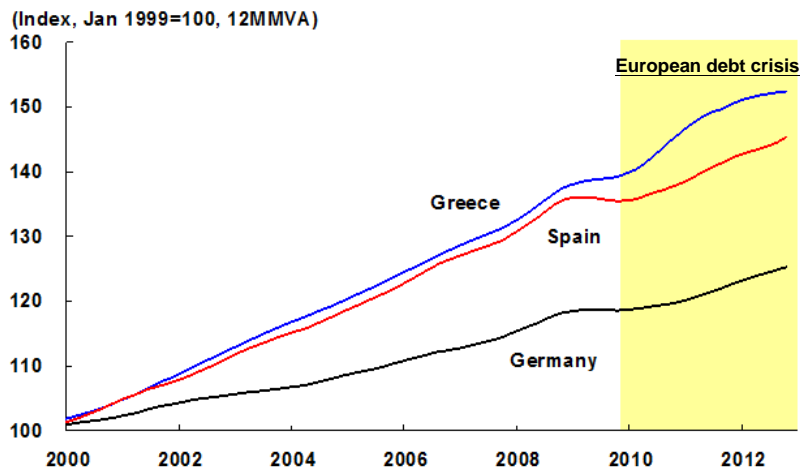
- Relevant measures can help reduce adverse feedback loop between sovereign debt and banking recapitalization problems
- Time gained for countries concerned to put in place fiscal tightening and structural reforms
- However, strong determination and persistent efforts required for pushing through reforms
- Fiscal tightening and banking deleveraging in eurozone increase risk of economic contraction
 - Deficit reduction targets not met
 - Public sentiment against tightening measures still running high

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ASSESSMENT OF THE EUROPEAN ECONOMY: A LONG-DRAWN-OUT PROCESS OF ECONOMIC ADJUSTMENT

Spain and Greece's price indices rose faster than that of Germany



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ASSESSMENT OF THE US ECONOMY: RECENT RECOVERY STILL SLOW

- US recovery continued but still at a slow pace
- Market forecasts for full-year growth at 2.2%; Fed forecasts at 1.7 - 2.0%
- Some positive economic data lately:
 - Housing price and sales volume showed signs of stabilising
 - Unemployment fell from 8.3% in July to 7.9% in October
- US Federal Reserve announced 3rd round of quantitative easing in September, buying an additional USD40 bn of mortgage-backed securities each month until outlook for the labour market improves substantially. Ultra low interest rates will also be kept at least through mid-2015
- Fixed rates for 30-year mortgage loans fell 21 basis points to a historically low level of 3.34% following the announcement

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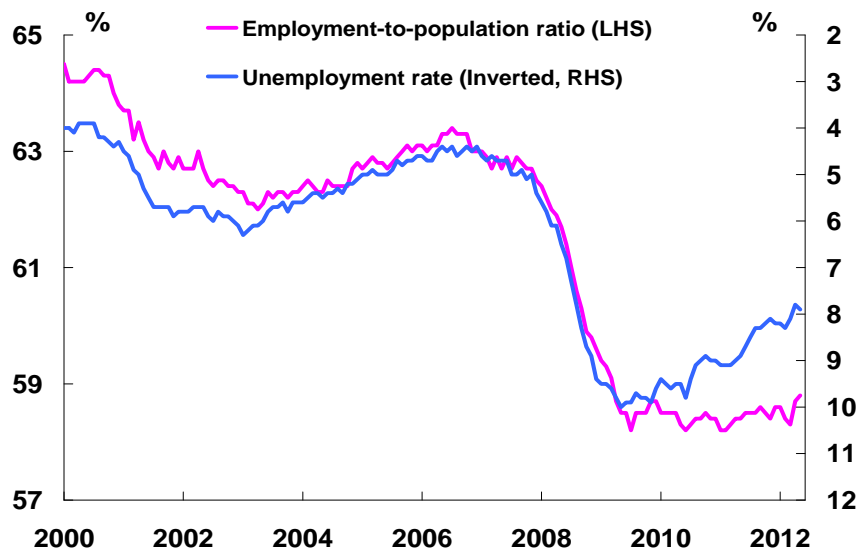
ASSESSMENT OF THE US ECONOMY: MAJOR DOWNSIDE RISKS

- In short term: fiscal cliff; in medium to longer term: major fiscal consolidation still required
- Stimulus from 3rd round of quantitative easing on growth and employment, though effective for a while, is likely limited. Creates difficulty when considering a timely exit
- Household deleveraging may continue depending on whether the property market can see an early bottoming out
- Structural problems in job market difficult to tackle

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ASSESSMENT OF THE US ECONOMY: NO SIGNIFICANT IMPROVEMENT IN THE EMPLOYMENT-TO-POPULATION RATIO



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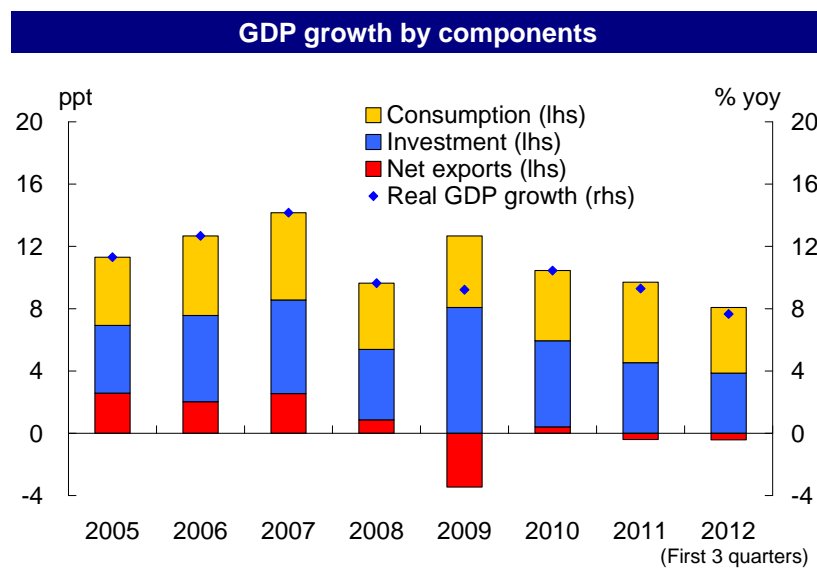
ASSESSMENT OF MAINLAND CHINA'S ECONOMY

- Economic growth weakened; consensus forecast for the year: 7.7%
- Inflation fell; consensus forecast for the year: 2.7%
- People's Bank of China cut benchmark interest rates in both June and July and will continue to pursue its robust monetary policies, put stabilising growth in a more important position
- With policy focus turned to support growth, impetus for growth is expected to increase in coming quarters:
 - Increase in infrastructural investments will keep up a brisk pace
 - Real estate market will show signs of stabilising
 - Measures will be introduced to promote external trade

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MAINLAND CHINA ECONOMIC ASSESSMENT: CONTRIBUTION OF TRADE TO GROWTH FELL NOTICEABLY

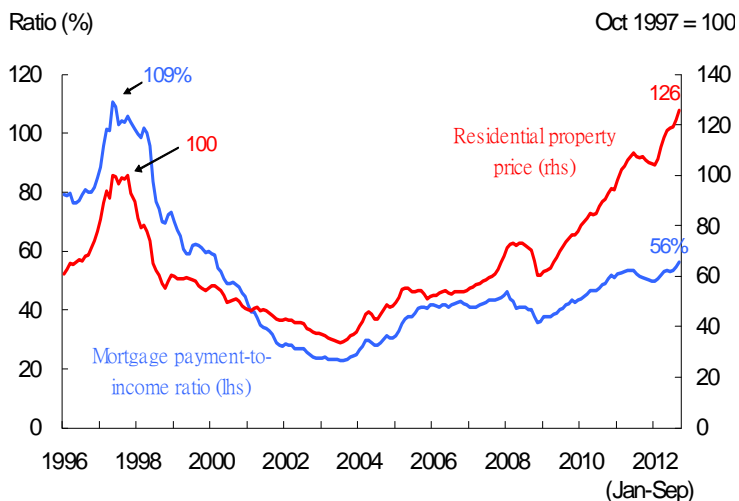


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ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

Property market in 1997 and the current episode



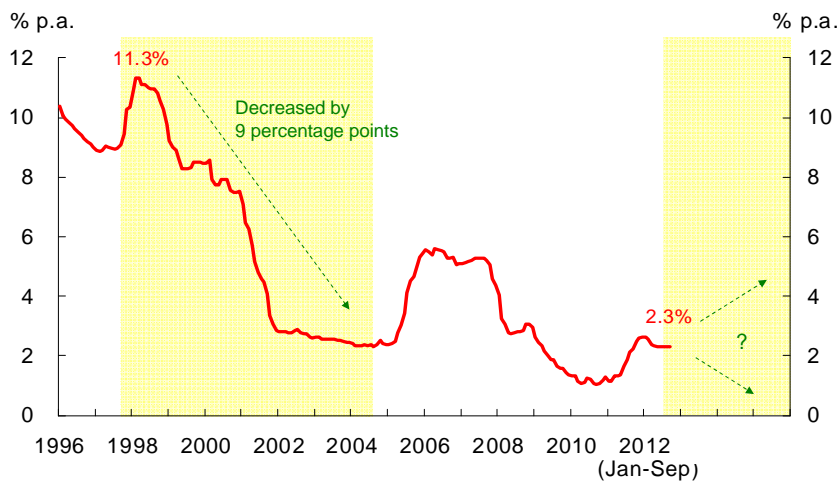
Note: The mortgage repayment-to-income ratio compares the amount of mortgage payment for a typical flat of 50 sq. m. (under a 20-year mortgage with a 70% loan-to-value ratio) to the median income of households living in private housing

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ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: MORTGAGE INTEREST RATE

Interest rates have a lot of room to go up from the current ultra-low level

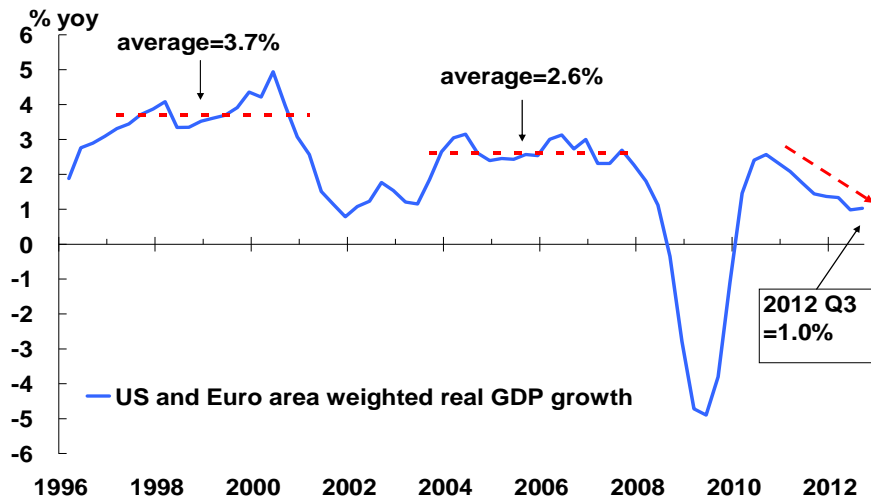


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ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: COMPARING CURRENT US AND EURO AREA ECONOMY WITH THAT BACK IN 1997

Difficult to count on exports again as a driver for economic growth



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ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: PRUDENTIAL MEASURES FOR MORTGAGE LENDING

- Risks to Hong Kong's financial stability now are no smaller than those in 1997
- Therefore the HKMA introduced its 5th round of prudential measures for mortgage lending on 14 September 2012 to strengthen risk management of banks
- For borrowers with multiple property mortgages:
 - Debt servicing ratio further reduced
 - Loan to valuation ratio lowered (for mortgage loans assessed based on the net worth of borrowers or for borrowers whose principal income is derived from outside Hong Kong)
- Maximum loan tenor of mortgage loans is 30 years

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ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: EFFECTIVENESS OF PRUDENTIAL MEASURES

	Before introduction of measures	Recent status
Average mortgage rates	64% (Sep 2009)	55% (Sep 2012)
Debt servicing ratio	41% (Aug 2010)	36% (Sep 2012)

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ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: CAPITAL FLOWS

- Following the US Fed's introduction of 3rd round of quantitative easing, Hong Kong dollar exchange rate strengthened, triggering the strong-side Convertibility Undertaking (CU) repeatedly since October 19 and causing Aggregate Balance of the banking sector to expand by HK\$32.2 bn to HK\$180.9 bn
- Recent capital inflows mainly a result of increased local equity holdings by overseas investors and conversion by local corporates of proceeds from foreign currency bond issuance into Hong Kong dollars
- Net inflows into the Hong Kong dollar are expected to continue for some time
- The strong-side CU operates in accordance with the standing procedures of the currency board system. Under this system, when the strong-side CU is triggered by capital inflows, the HKMA can create Hong Kong dollars limitlessly by expanding the monetary base

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ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: CONCLUSION

- Sentiment in the financial markets improves slightly but major uncertainties still abound in the global economic and financial environment
 - European debt crisis remains the biggest threat to global financial stability
 - Outlook of the US economy hinges on fiscal policies
 - Growth in Mainland China and other emerging economies slackens
- Meanwhile, global conditions of low interest rates and abundant liquidity will persist for a longer period, which may bring inflationary and asset price pressures to emerging economies
- Domestic growth decelerates but property market continues to heat up, aggravating misalignment between house prices and real economy
- In such an unusual global financial environment, we must brace ourselves for potential renewed volatilities caused by capital flows and risks of an overheating property sector to financial and economic stability

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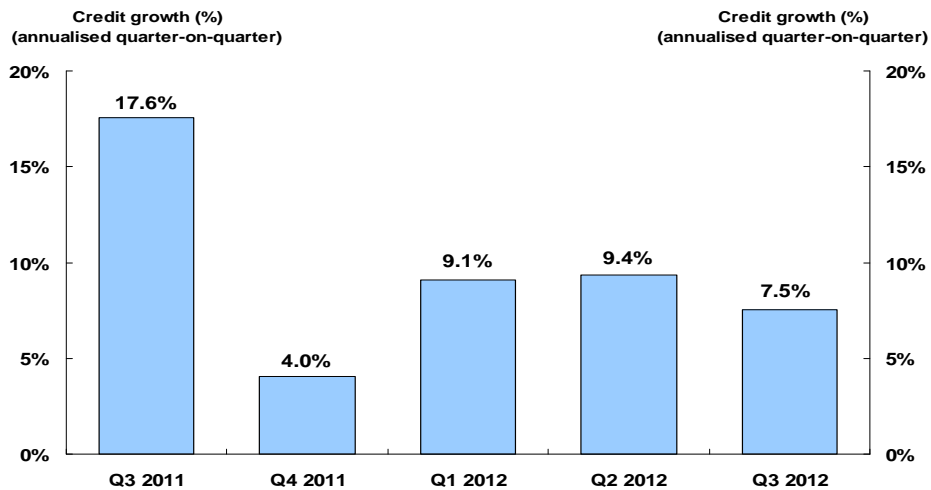
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CREDIT GROWTH

Credit growth remained at a moderate level in the first three quarters of 2012



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BASEL III IMPLEMENTATION PROGRESS

First phase of implementation:

- Capital standards
 - Rules tabled at LegCo for negative vetting
 - Consultation conducted on revisions to the Pillar 2 “Supervisory Review Process”
- Disclosure standards
 - Industry consultation on draft rules

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BANKING DEVELOPMENT: PRIVATE WEALTH MANAGEMENT

- Provides supervisory guidelines for private wealth management sector
- Establishes a professional qualification framework to enhance professional competence of private wealth management practitioners
- A trade organisation to be formed to promote development private wealth management business in Hong Kong

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LEGISLATIVE PROPOSALS TO ENHANCE FINANCIAL MARKET INFRASTRUCTURE

Development of Islamic finance

- Aims to provide a tax regime for Islamic bonds comparable to that for their conventional counterparts
- Consultation conclusions published in October; briefing to Panel on Financial Affairs in early November; legislative proposal scheduled for early 2013

Over-the-counter (OTC) derivatives market reforms

- Seeks to be in line with commitment of G20, which includes establishing a regulatory regime for reporting and central clearing of OTC derivatives transactions
- Consultation conclusions published in July; results of subsequent consultation under review; legislative proposal scheduled for early 2013

Enhancing legal framework to be in line with retail payment developments

- Aims to ensure retail payment systems and instruments operate safely and efficiently, with provision of consumer protection and robust management of systemic risks, and keep Hong Kong's related legislation in line with international standards
- Specific development strategy announced in September; consultation scheduled for the first half of 2013 followed by legislative proposal

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HONG KONG MORTGAGE CORPORATION

Reverse Mortgage Programme

- Introduction of three enhancements in November 2012
 - Minimum age of borrowers lowered from 60 to 55
 - Maximum specified property value for payout calculation increased from HK\$8 mn to HK\$15 mn
 - Maximum lump-sum payout amount increased

SME Financing Guarantee Scheme

- Positive market response with 4,319 applications approved for a total loan amount of HK\$19 bn as at 12 November 2012, benefitting some 2,800 enterprises with 82,000 employees

Microfinance Scheme

- As at October 2012, over 1,500 phone enquiries and 56 loan applications were received. Of the latter, 25 were approved, with a total loan amount of HK\$6.5 mn. 16 cases are pending vetting panel interviews

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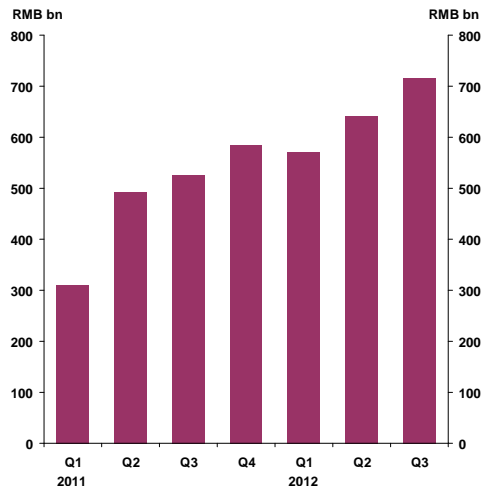
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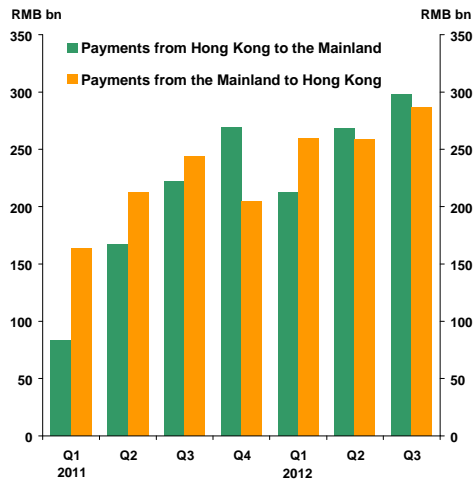


FURTHER EXPANSION OF RMB TRADE SETTLEMENT

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



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

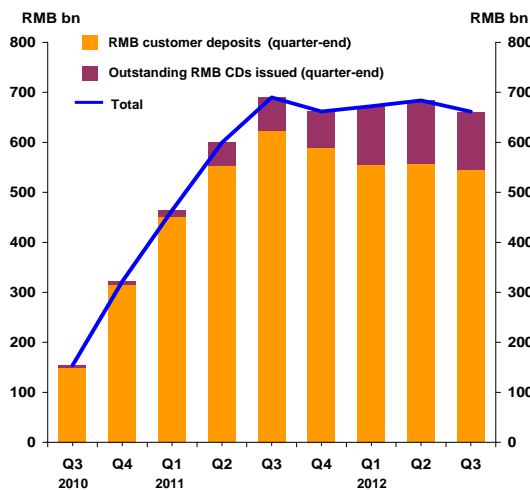


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STEADY DEVELOPMENT OF RMB FINANCING ACTIVITIES

**RMB customer deposits and
certificates of deposit (CDs)**



RMB financing activities

RMB dim-sum bond market

	Jan - Sep 2012	Jan - Sep 2011
Amount of issuance (RMB billion)	93.8	85.8
No. of issuers	59	65

RMB bank lending

	End-Sep 2012	End 2011
Outstanding RMB loans (RMB billion)	67.9	30.8

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ENTRENCHING ROLE OF HONG KONG AS GLOBAL HUB FOR RMB SETTLEMENT AND CORRESPONDENT BANKING

	<u>Sep 2012</u>	<u>2011</u>	<u>Change</u>
No. of participating banks of Hong Kong's RMB clearing platform	199	187	+6%
Of which:	176	165	+7%
Branches and subsidiaries of overseas banks and overseas presence of Mainland banks			
No. of RMB correspondent accounts set up by overseas banks at Hong Kong banks	1,315	968	+36%

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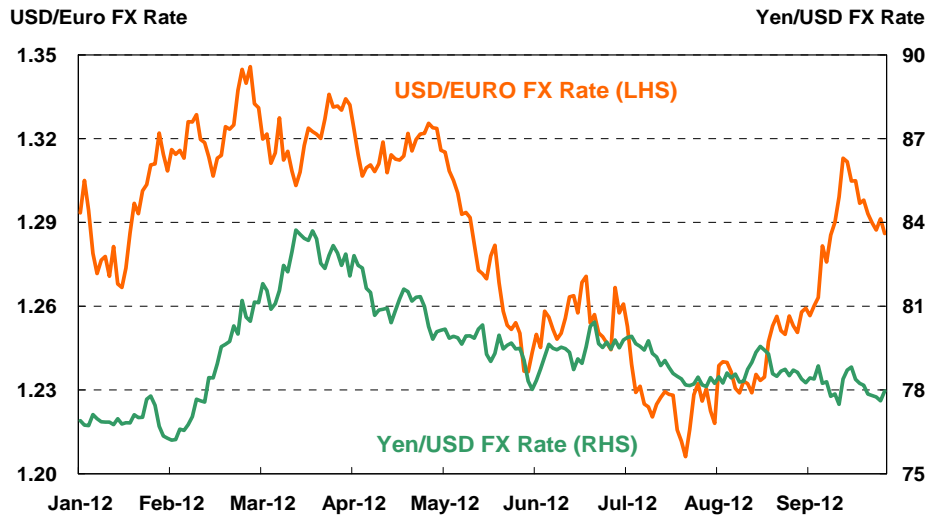


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CURRENCY MARKETS

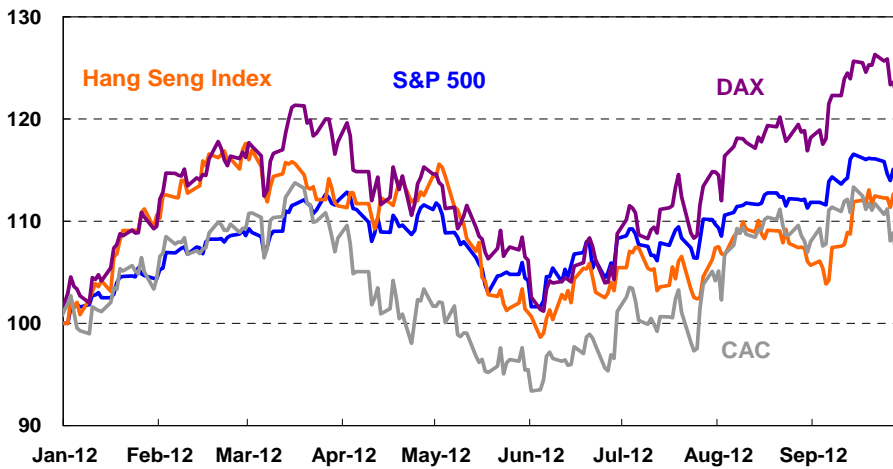


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EQUITY MARKETS

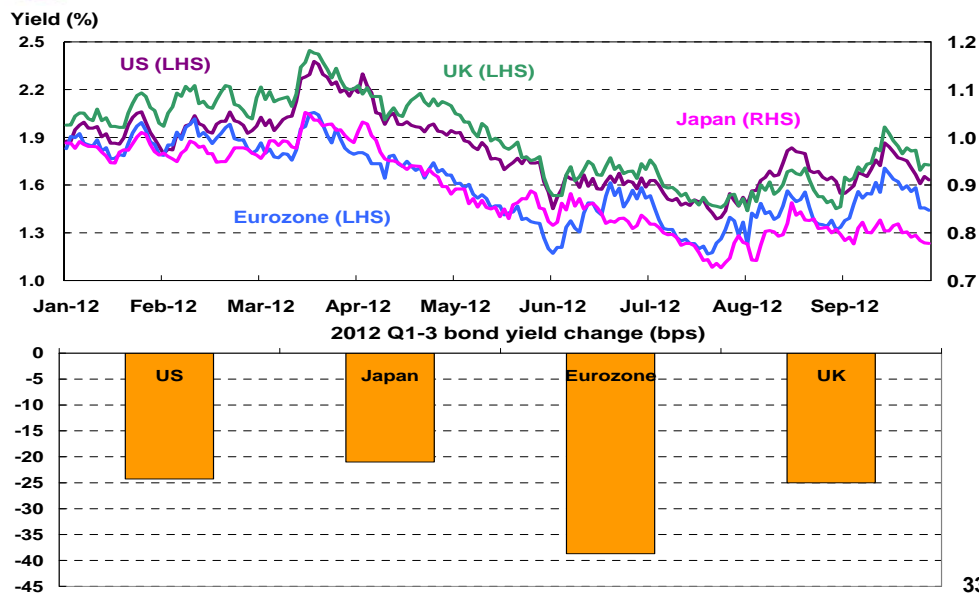
Normalized Index Level (2011 year-end = 100)



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CHANGES IN 10-YEAR GOVERNMENT BOND YIELDS



INVESTMENT INCOME

(HK\$ billion)	← 2012 →		2011	2010	2009
	Jan - Sep*	Q3	Full Year	Full Year	Full Year
Bonds#	30.6	10.8	71.9	42.1	(0.6)
Hong Kong equities^@	18.9	9.3	(24.2)	11.6	48.9
Other equities^	32.3	14.4	(12.2)	27.1	48.8
Foreign exchange	(3.8)	6.6	(9.1)	(3.1)	9.8
Other investments&	<u>2.1</u>	<u>0.1</u>	<u>0.7</u>	<u>1.7</u>	<u>0.8</u>
Investment income@&	80.1	41.2	27.1	79.4	107.7

* Unaudited figures

^ Including dividends

Including interest

@ Excluding valuation changes in Strategic Portfolio

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



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

(HK\$ billion)	2012				2011
	Jan – Sep*	Q3	Q2	Q1	Full year
Investment income/(loss)	80.1	41.2	(5.6)	44.5	27.1
Other income	0.2	0.1	0.1	-	0.2
Interest and other expenses	<u>(3.4)</u>	<u>(1.1)</u>	<u>(1.4)</u>	<u>(0.9)</u>	<u>(4.7)</u>
Net investment income/(loss)	76.9	40.2	(6.9)	43.6	22.6
Payment to Fiscal Reserves#	(28.5)	(9.2)	(9.6)	(9.7)	(37.0)
Payment to HKSAR government funds and statutory bodies#	(5.8)	(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>(2.3)</u>	<u>0.5</u>	<u>(1.7)</u>	<u>(1.1)</u>	<u>(3.6)</u>
Increase/(Decrease) in EF Accumulated Surplus	40.3	29.4	(20.1)	31.0	(23.6)

* Unaudited figures

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

^ Including dividends

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DIVERSIFICATION OF INVESTMENT

- To enhance 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. These include emerging market bonds and equities, private equity funds, real estate properties, and Mainland renminbi bonds and equities
- At end-September 2012, the Fund's total investment value in new asset classes amounted to HK\$131 bn (end-2011: HK\$83.6 bn). Outstanding investment commitments were HK\$69.5 bn (end-2011: HK\$56 bn)
- As the size of diversified investment must not exceed one-third of the accumulated surplus of the Fund, the ceiling for such investment is HK\$202.7 bn based on the figures of September 2012
- The HKMA is reviewing the strategy for diversifying the Fund's investment. Proposals will be submitted to the Exchange Fund Advisory Committee by the end of 2012

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