



HONG KONG MONETARY AUTHORITY

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

**7 February 2014
[Translation]**



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



**US recovery continues and the Fed has started to taper
Is it going to be smooth sailing for the global economy?**

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ECONOMIC CONDITIONS IN THE US

- US monetary policy normalisation process has begun
- Signs of US growth momentum
 - Continued fall in the unemployment rate
 - Solid recovery in the housing market
 - Solid growth in consumer spending
 - The Fed forecasts economic growth to pick up and unemployment rate to fall (2014: growth 3%; unemployment rate 6.5%)
- Fiscal deal struck between Republicans and Democrats in December, resulting in a slight public spending cut for the next two years

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CONCERNS FOR THE US ECONOMY

- Business investment remains weak
- Fall in unemployment rate mainly driven by the falling labour force participation rate (to a 35-year low of 62.8%)
- Surge in US equities largely supported by low interest rates, abundant liquidity and share buybacks
- Fiscal consolidation yet to be resolved
- Market interest rates may react greater and faster than the normalisation of monetary policy

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ASSESSMENT OF THE EURO AREA ECONOMY

Latest developments:

- Economy has stopped contracting and begun to recover slowly
- Ireland and Portugal successfully returned to capital markets with favourable response to their sovereign debt auctions
- Sovereign bond yields in most peripheral countries have fallen to pre-crisis levels

Concerns:

- Unemployment rates remain high with few signs of improvement
- Despite fiscal consolidation across member countries, public debt levels continue to climb in many countries
- Bank credit remains tight as the private and banking sectors remain heavily in debt

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ASSESSMENT OF JAPAN'S ECONOMY

Latest developments:

- Growth accelerated (3% year-on-year in the first 3 quarters of 2013; 1.4% in 2012)
- Inflation rate and inflation expectations have risen substantially as deflation gradually ended (core inflation rate in December 2013: 1.3%; 2012: -0.08%)
- Investor sentiment has improved (Nikkei has risen 33% since the start of 2013)

Concerns:

- Consumption tax hike in April may impact negatively on consumption and investment
- Given the enormous government debt (256% of GDP) with interest payments mounting to 19% of government revenue, rises in interest rates could pose a significant risk to fiscal sustainability
- Wage growth remains slow (real wages are still falling)
- Despite substantial yen depreciation, trade deficit continues to widen
- Abe's "third arrow" of structural reform yet to be implemented

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ASSESSMENT OF MAINLAND CHINA'S ECONOMY

Latest developments:

- The economy continued to expand at a steady pace (2013: 7.7%; 2014: consensus forecast 7.5%)
- The Third Plenum has pledged to deepen reforms and opening-up in a comprehensive way, and let markets play a decisive role in resource allocation, with a view to enhancing the efficiency and sustainability of economic developments
- Policy focus will centre on containing and addressing risks associated with local government debts, as well as strengthening the regulation and supervision of shadow banking activities. Meanwhile, the authorities will continue to guard against key risks such as real estate-related credit risks, industry overcapacity problems, and liquidity risks

Concerns:

- Near-term growth and employment would be held back by the policy objective to resolve the overcapacity problem
- Measures to prevent excessive credit growth and strengthen regulation of shadow banking activities may result in tightening in credit and liquidity conditions
- With the progressive exit from quantitative easing and interest rate normalisation in the US, large-scale capital outflows from emerging market economies could re-emerge and thereby pose negative impacts

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ASSESSMENT OF RISKS TO GLOBAL FINANCIAL STABILITY: CONCLUSION

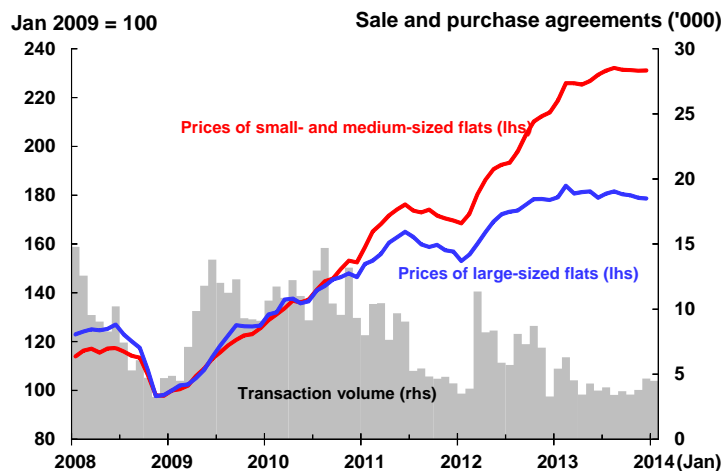
- The Fed has started its policy exit and scaled back its asset purchases. Markets initially reacted calmly or even positively before witnessing heightened volatility on worries about capital outflows from emerging market economies
- There are still considerable uncertainties on global monetary and financial conditions
 - Although economic conditions in advanced countries have improved, there are still uncertainties over the strength and sustainability of their recoveries
 - The Fed's policy exit may increase capital outflow pressures from emerging market economies. This may lead to faster than expected rise in market interest rates in these economies, exacerbating asset price corrections

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ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: OUTLOOK FOR PROPERTY MARKET REMAINS UNCERTAIN

Property turnover stayed low, while prices decreased slightly

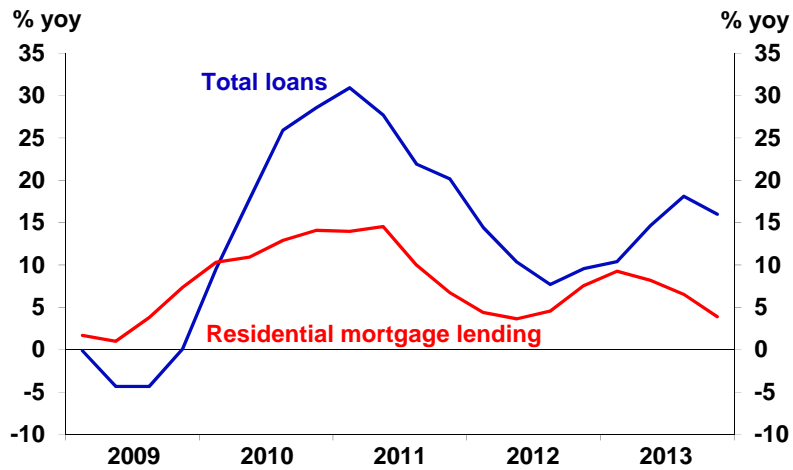


Sources: R&VD and Land Registry

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ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: BANKS' CREDIT GROWTH REMAINS TOO FAST

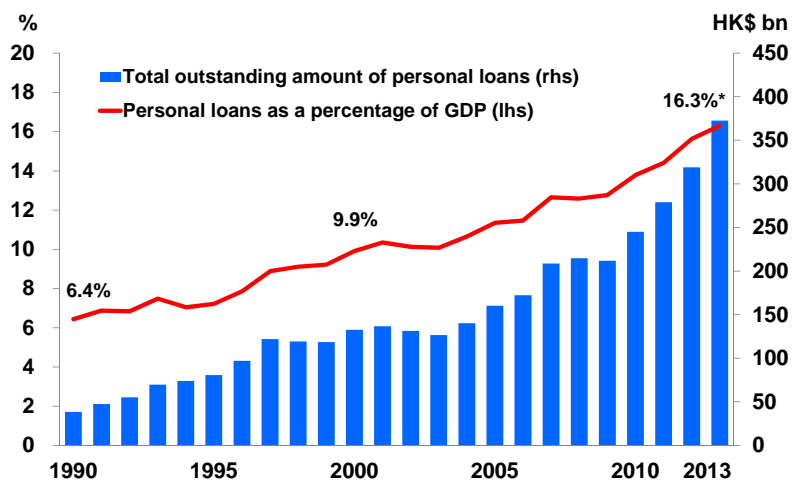


Source: HKMA

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ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: GROWTH IN PERSONAL LENDING REMAINS TOO FAST



Note: * the level of personal loans as a percentage of GDP is based on the position as at end-September 2013

Sources: HKMA and C&SD

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Counterfeit HK\$1,000 notes

- First surfacing of 2003 series Bank of China (Hong Kong) and HSBC HK\$1,000 counterfeit notes on 23 December 2013, with a total seizure of 258 pieces as at 4 February 2014.
- Though with a fair degree of resemblance to the genuine notes, the counterfeits can be quite easily identified by the public and retailers with care. In particular, they should pay attention to:
 - fluorescent barcode
 - metallic thread

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Identifying HK\$1,000 counterfeits

Fluorescent barcode as viewed under ultraviolet light

Genuine note

The yellowish fluorescent barcode is bright and clear



Counterfeit note

Barcode image looks dull and unclear



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Identifying HK\$1,000 counterfeits

Metallic thread

Genuine note

Visibly uneven paper fibre edges in the holographic windowed thread



Counterfeit note

Relatively even edges in the holographic windowed thread



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Counterfeit HK\$1,000 notes

- Counterfeit rate in Hong Kong is much lower than that of many countries; the public should feel assured in using banknotes dispensed over bank counters or via ATMs as they are all duly verified as genuine
- HKMA and banks will speed up withdrawal of 2003 series HK\$1,000 notes from circulation; which will be replaced by new 2010 series incorporated with even more robust security features
- HKMA has organised 33 seminars since the first surfacing of the counterfeits; instrumental in enhancing knowledge and skills of over 7,000 frontline employees from banks, retail businesses and public services in identifying counterfeits
- The public may refer to the counterfeit identification tips and a recording of the seminar on HKMA website. They may also contact HKMA, banks or the Police for further assistance

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DEVELOPMENT OF ISLAMIC FINANCE

- Supporting the Government in amending the Loans Ordinance to enable the issuance of Islamic bonds (sukuk) under the Government Bond Programme to promote further development of sukuk market in Hong Kong
- The first meeting of the Joint Forum on Islamic Finance between Hong Kong and Malaysia was held in Hong Kong on 3 December 2013. Participants from the private sector supported the following initiatives:
 - Identifying and encouraging potential fund raisers to issue sukuk and actively studying the launch of Islamic funds
 - A seminar on Islamic finance to be jointly organised in Hong Kong by the HKMA and the Malaysia central bank in the first half of 2014 to promote awareness of Islamic finance in the local market

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RETAIL PAYMENT INITIATIVES

Electronic Bill Presentment and Payment (EBPP) service

- The EBPP service platform was launched on 11 December 2013
- The scope of services includes Business-to-Customer (B-2-C) and Business-to-Business (B-2-B) e-billing and e-payments, cross-border e-billing and e-payments, and e-donation and presentment of e-receipt

NFC mobile payment service

- The HKMA worked closely with an industry working group under the Hong Kong Association of Banks (HKAB) on a set of common standards and guidelines to enable multiple payment services on a single NFC-enabled mobile phone, service continuity despite switching mobile network operators and changing phones, and a high-level of security. The guideline was issued by HKAB on 25 November 2013 for banks to follow

Legislative framework for stored value facilities and retail payment systems

- Policy adjustments for incorporation in the draft Bill are being considered where appropriate, taking into account comments received from the public consultation
- Preparatory work for the drafting of the Bill is at an advanced stage. Targeting to introduce the Bill into LegCo in second half of 2014

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CROSS-SECTOR RESOLUTION REGIME FOR HONG KONG

- Legislative reform to meet international standards: Financial Stability Board (FSB)'s "Key Attributes of Effective Resolution Regimes"
- Fill gaps in HK regulators' existing toolkits to support resolution of failing financial institutions
- Three-month public consultation started on 7 January 2014
- Second consultation exercise later in 2014, with a view to implementation by FSB's end-2015 deadline

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BASEL III IMPLEMENTATION PROGRESS

Capital standards

- 2nd phase
 - Capital buffers
 - Higher loss absorbency for global systemically important banks / domestic systemically important banks

Liquidity standards

- Liquidity Coverage Ratio

Legislative changes (in 2014) to:

- Banking (Capital) Rules
- Banking (Disclosure) Rules
- Banking (Liquidity) Rules

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INCIDENTS OF ERRONEOUS DEDUCTION OF TRANSPORT FARE FROM OCTOPUS CARDS

- Recently there were three incidents of erroneous deduction of transport fare from Octopus Cards; one was caused by the upgrading of a bus company's card reader software by Octopus Cards Ltd (OCL). OCL has subsequently rectified all the reader software involved and is reviewing the related procedures
- The HKMA is very concerned about the above incident and has reminded OCL to make its best endeavors to minimise the occurrence of operational incidents and their impact on customers
- The other two incidents were caused by a public transport operator and did not involve any malfunctioning of the Octopus Cards system

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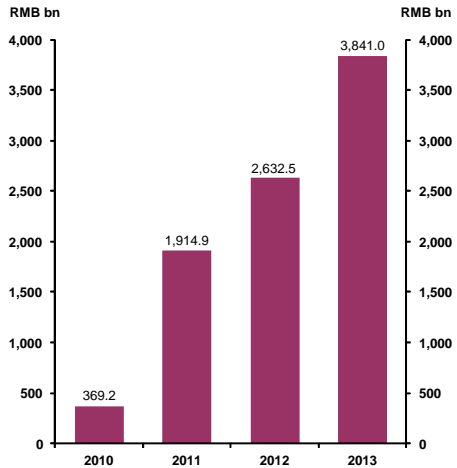
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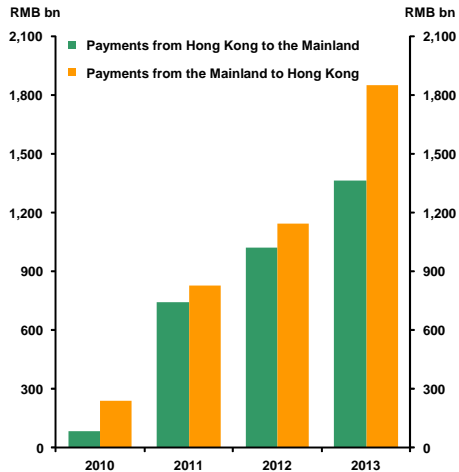


CONTINUED EXPANSION IN RMB TRADE SETTLEMENT

RMB trade settlement handled by banks in Hong Kong



Flows of RMB trade settlement between Hong Kong and the Mainland

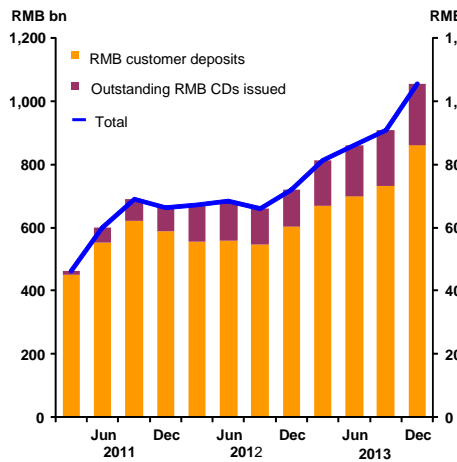


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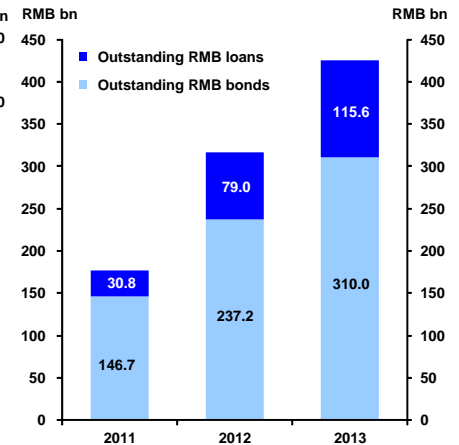


STEADY DEVELOPMENT OF RMB FINANCING MARKET

RMB customer deposits and certificates of deposit (CDs)



RMB financing activities



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STRENGTHENING OF HONG KONG'S RMB BUSINESS LINKS WITH OTHER PARTS OF THE WORLD

	2013	2012	2011
1 No. of participating banks of Hong Kong's RMB clearing platform	216	204	187
Of which:			
Branches and subsidiaries of overseas banks and overseas presence of Mainland banks	191	181	165
2 Amount due to overseas banks (RMB billion)	166.0	99.1	116.4
3 Amount due from overseas banks (RMB billion)	164.5	117.1	121.7
4 Turnover in Hong Kong's RMB RTGS system (Daily average during the period; RMB billion)	395.4	213.7	121.4

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INVESTMENT INCOME

(HK\$ billion)	2013					2012	2011	2010	2009
	Full year *	Q4 *	Q3 *	Q2 *	Q1 *	Full year	Full year	Full year	Full year
Hong Kong equities[^]@	10.1	3.9	13.7	(6.1)	(1.4)	30.7	(24.2)	11.6	48.9
Other equities[^]	71.6	22.6	17.9	6.2	24.9	42.8	(12.2)	27.1	48.8
Bonds[#]	(19.1)	(4.1)	1.8	(19.6)	2.8	33.1	71.9	42.1	(0.6)
Other investments^{&}	11.7	1.3	5.7	2.1	2.6	6.4	0.7	1.7	0.8
Foreign exchange	<u>1.6</u>	<u>1.7</u>	<u>15.6</u>	<u>(5.9)</u>	<u>(9.8)</u>	<u>(1.4)</u>	<u>(9.1)</u>	<u>(3.1)</u>	<u>9.8</u>
Investment income/(loss)^{@&}	75.9	25.4	54.7	(23.3)	19.1	111.6	27.1	79.4	107.7

* Unaudited figures

[^] Including dividends

[@] Excluding valuation changes in Strategic Portfolio

[#] Including interest

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

(Investments held by EF's investment holding subsidiaries include private equity and real estate investments. The figure for the latest quarter is preliminary and is subject to change in case there are changes in the valuations of these investments.)

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

(HK\$ billion)	2013					2012
	Full year *	Q4 *	Q3 *	Q2 *	Q1 *	Full year
Investment income/(loss)	75.9	25.4	54.7	(23.3)	19.1	111.6
Other income	0.2	0.0	0.1	0.1	0.0	0.2
Interest and other expenses	<u>(4.9)</u>	<u>(1.2)</u>	<u>(1.3)</u>	<u>(1.5)</u>	<u>(0.9)</u>	<u>(4.4)</u>
Net income/(loss)	71.2	24.2	53.5	(24.7)	18.2	107.4
Payment to Fiscal Reserves[#]	(36.8)	(9.0)	(9.0)	(9.5)	(9.3)	(37.8)
Payment to HKSAR government funds and statutory bodies [#]	(9.3)	(2.6)	(2.5)	(2.1)	(2.1)	(8.0)
Valuation change of Strategic Portfolio less valuation change of investments held by EF's investment holding subsidiaries [^]	<u>(11.7)</u>	<u>(1.0)</u>	<u>(5.1)</u>	<u>(3.0)</u>	<u>(2.6)</u>	<u>(5.6)</u>
Increase/(Decrease) in EF Accumulated Surplus	13.4	11.6	36.9	(39.3)	4.2	56.0

* Unaudited figures

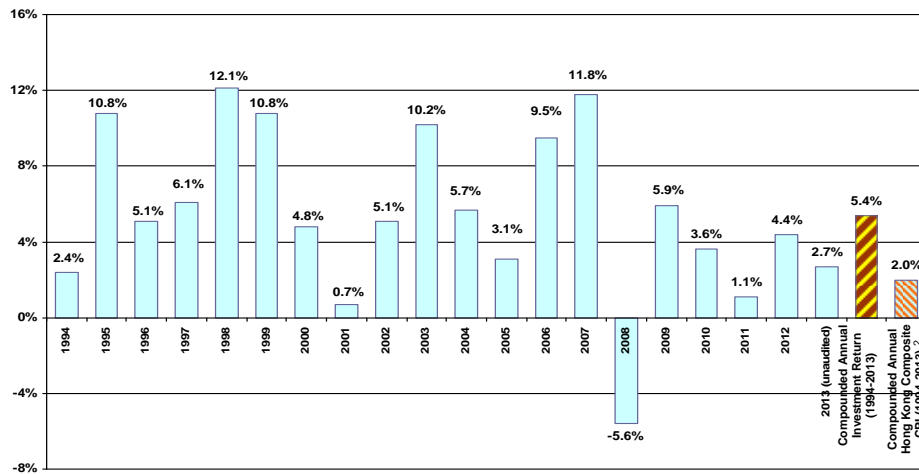
[#] The fixed rate of fee payment is 5.0% for 2013 and 5.6% for 2012.

[^] Including dividends

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INVESTMENT RETURN OF THE EXCHANGE FUND (1994-2013) ¹



- ¹ Investment return calculation excludes the holdings in the Strategic Portfolio
² Composite CPI is calculated based on the 2009/2010 base series

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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. Emerging market bonds and equities and renminbi assets were transferred to the Investment Portfolio of the Exchange Fund in March 2013.
- Private Equity and Real Estate remain under the Long-Term Growth Portfolio (LTGP). Positions at end-2013 and performance since inception are as follows:

As of end 2013

New Asset Classes	Market Value HK\$ billion	Annualized return since inception till end 2013
Private Equity	64.2	15.9% (IRR)
Real Estate	24.4	
Total	88.6	

Note: Outstanding investment commitments at the end of 2013 amounted to HK\$81.3 billion

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