



HONG KONG MONETARY AUTHORITY

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

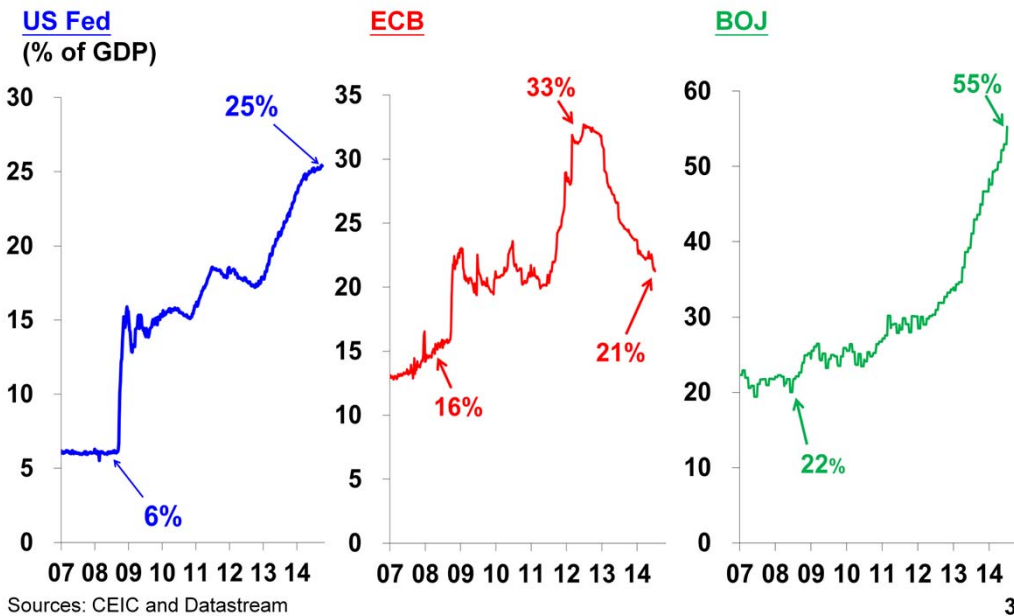
3 November 2014



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



BALANCE SHEETS OF MAJOR CENTRAL BANKS HAVE EXPANDED SHARPLY IN RECENT YEARS



- The Fed's balance sheet expanded substantially from 6% of GDP in mid-2008 to 25% of GDP in Q3 2014 (an increase of about US\$3.6 trillion). The asset purchase programme ended in end-October.
- The European Central Bank also expanded its balance sheet with the launch of Long-Term Refinancing Operations (LTRO) in end-2011. To address deflationary risk, it announced a series of monetary easing measures in June and September this year. They included the introduction of Targeted Longer-Term Refinancing Operations (TLTRO) and the asset-backed securities and covered bonds purchase programmes. The ECB predicted that its balance sheet would return to the peak of €3.1 trillion in mid-2012.
- The use of monetary easing was pioneered by the Bank of Japan, though with lacklustre stimulus to the economy. Attributing this mainly to an insufficient scale of easing, the BoJ introduced a new round of larger-scale quantitative and qualitative easing (QQE) last year, followed by further expansion in late October. This lifted the growth target of the monetary base from 60-70 trillion yen each year to 80 trillion yen. The BoJ's balance sheet expanded from 22% of GDP in mid-2008 to 55% of GDP in mid-2014. It has already bought about 23% of Japanese government bonds issued.

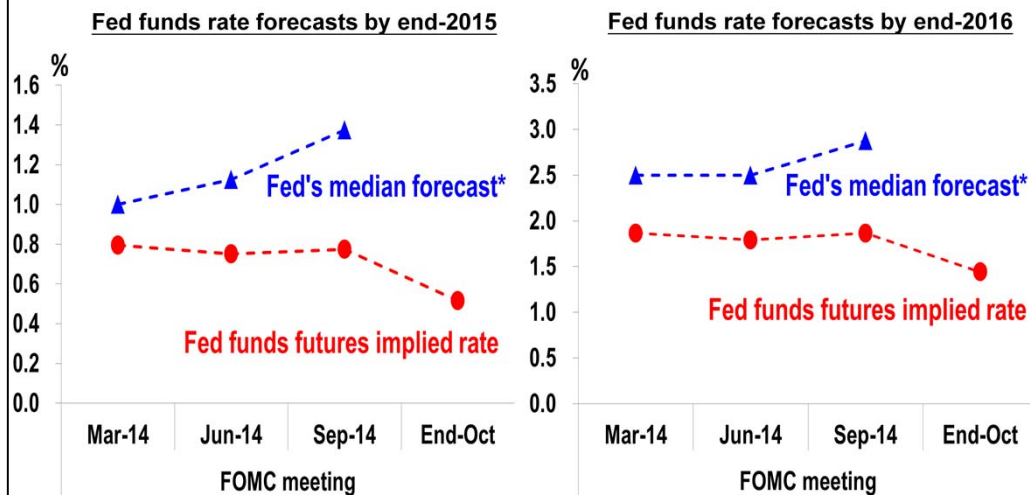


THE FED'S POLICY EXIT WILL COMPLICATE THE GLOBAL MONETARY ENVIRONMENT

- Impact of the Fed's monetary normalisation on global monetary conditions may be partially offset by accommodative monetary policies by the ECB and the BoJ
- Fed's monetary normalisation is not a one-off process and future monetary tightening cycle will involve multiple rate hikes or measures to tighten liquidity
- Divergence in growth and monetary policy paths of the US vis-a-vis Europe and Japan will lead to strengthening of the US dollar, inducing inflows to US dollar assets from emerging markets and, resulting in liquidity tightening in those markets



MARKETS EXPECT SLOWER INTEREST RATE RISE THAN THE FED'S FORECASTS



Note: *The Fed will publish its latest fed funds rate forecasts in the December FOMC meeting.

Sources: US Federal Reserve and Datastream

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- In view of faster than expected rise in inflation and decline in unemployment rate, the Fed has at its FOMC meetings repeatedly revised upwards its federal funds rate forecasts for the end of 2015 and 2016. However market expectations for the pace of interest rate rises have not adjusted accordingly. There are signs that the Fed's forward guidance suppressed interest rate expectations of the market.



MARKET COMPLACENCY HAS ABATED, RESULTING IN HIGHER MARKET VOLATILITY

- S&P500 recorded its largest intraday fall in 3 years (-3%) followed by its largest single-day gain in 1 year (+2%), within one week in mid-October
- Commodity index at one point fell by 14% since June and crude oil prices once fell by as much as 27%
- US high-yield corporate bond spread once widened by 173 basis points in the past 4 months
- 10-year US treasury yield once fell from 2.2% to 1.9%, before rebounding to close at 2.1%, in one single day in mid-October

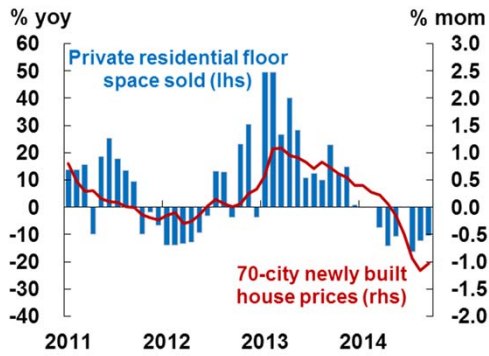
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- In contrast to its earlier complacency, the market turned volatile recently amid concern over slower growth in global economy.
- The S&P 500 recorded its largest intraday fall in 3 years (-3%) followed by its largest single-day gain in 1 year (+2%), within one week in mid-October.
- The commodity index at one point fell by 14% since June and Brent Crude once fell by as much as 27%.
- The US high-yield corporate bond spread once widened by 173 basis points in the past 4 months.
- The 10-year US treasury yield once fell from 2.2% to 1.9%, before rebounding 27 basis points to close at 2.1%, in one single day in mid-October.

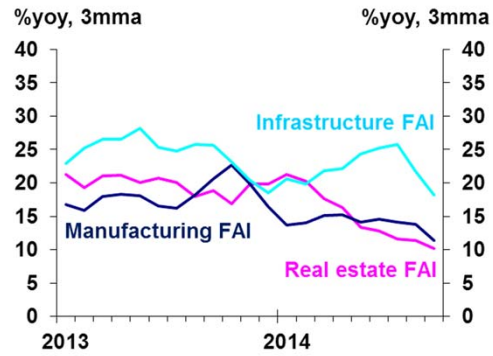


GROWTH MOMENTUM SLOWED IN THE MAINLAND ECONOMY...

Weakening of the property market



Slowdown in growth of fixed asset investment



Sources: CEIC and staff estimates

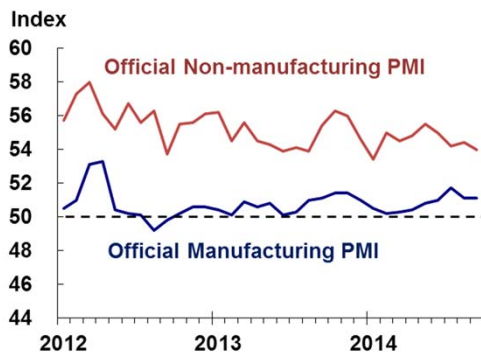
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- Growth momentum moderated in Mainland China. Reduced investment sentiment mainly reflects a weak property market, with house prices declined further. Newly built house prices in 70 cities fell month-on-month by 1.0%, with 69 cities recording a decline. Year-on-year growth in fixed asset investment fell to its lowest in almost three years (11.5%), with a more significant decline in real estate and infrastructure-related investments growth.

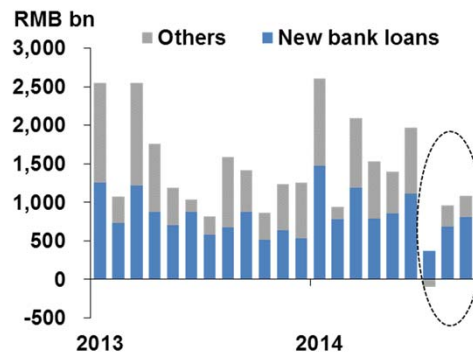


...BUT RISK OF A HARD LANDING IS NOT HIGH

Purchasing Manager Index remained solid



Aggregate financing rebounded



Sources: CEIC and staff estimates

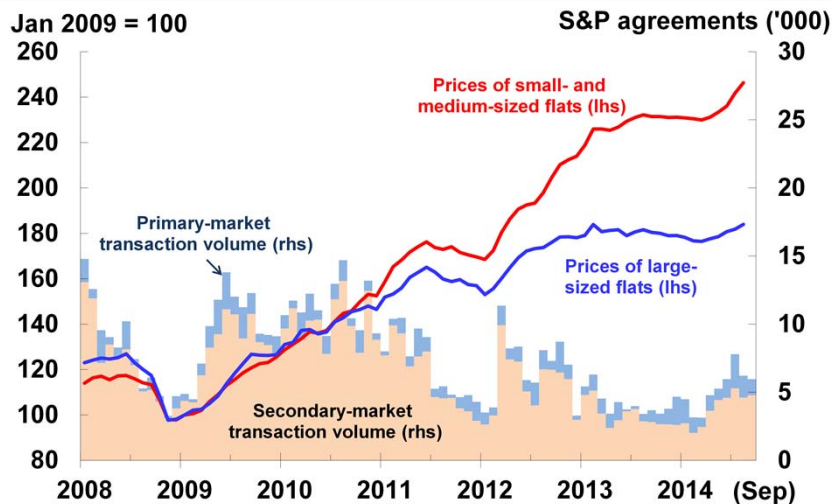
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- In October, the official manufacturing PMI was 50.8 and the official non-manufacturing PMI was 53.8.
- Aggregate financing showed signs of stabilising. In July, new bank loans recorded a three-year low, declining month-on-month by 67%. However they rebounded month-on-month by 85% and 18% in August and September respectively.
- The risk of an economic hard landing remains low.



HONG KONG FINANCIAL STABILITY RISK ASSESSMENT: PROPERTY MARKET

Property market has turned more active,
with housing prices rising



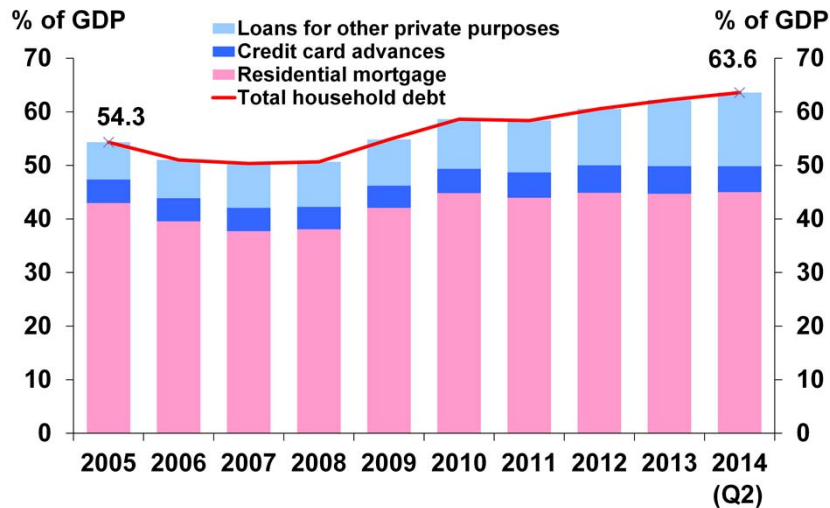
Sources: Rating and Valuation Department and Land Registry

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- Since the Government's introduction of a new round of demand management measures and the HKMA's introduction of the sixth round of macro-prudential supervisory measures in February 2013, the property market experienced some respite until February 2014, with a fall in turnover and a slight drop in prices.
- Between March and September this year, property trading turned active and prices rose again.
 - Average monthly turnover grew from 3,596 transactions in Q1 to 5,337 and 6,654 transactions in Q2 and Q3 respectively.
 - Property prices went up by a cumulative 7.0% between April and August.
- Is an upward cycle in the property market already being formed? The property market outlook remains uncertain and warrants further observation before its future direction is clearer.
- We will continue to closely monitor the property and mortgage lending markets. Should the upward cycle in property market continues to develop, we will keep continue to tighten the counter-cyclical measures; if a downward property cycle has been confirmed, we will relax the tightening measures implemented earlier as appropriate.



HONG KONG FINANCIAL STABILITY RISK ASSESSMENT: RISING HOUSEHOLD DEBT



Sources: HKMA and Census and Statistics Department

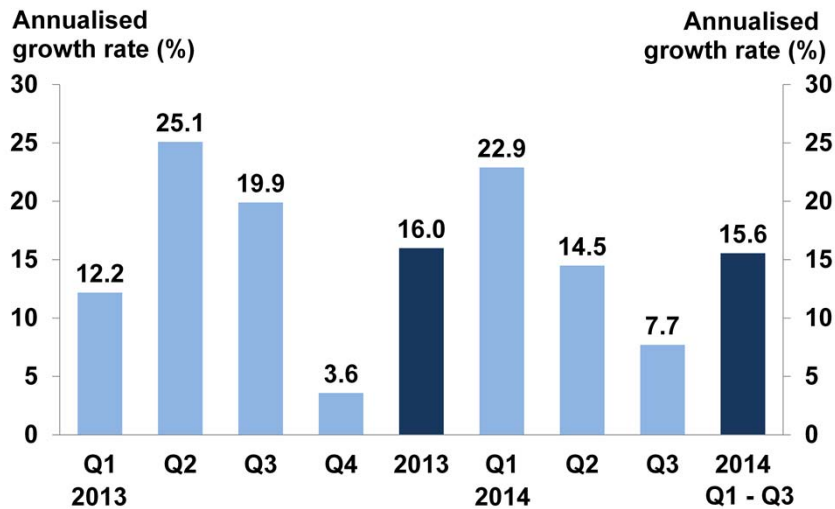
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- Household debt (the sum of residential mortgages and loans for other private purposes) as a percentage of GDP climbed to a record high of 63.6% in Q2 2014.
- Household debt in Q1-Q3 rose by 9.3% on an annualised basis (same as that in Q1-Q2). This has been driven mainly by a rapid growth in other personal loans, which rose by an annualised 21.6%. On an annualised basis, growth in residential mortgages expanded slightly by 7.3% while credit card advances fell by 2.0%.
- In view of increasingly intense competition in the personal loan market, the HKMA has requested banks in a circular in January 2014 to review their underwriting policy for personal loans and strengthen risk management.



HONG KONG FINANCIAL STABILITY RISK ASSESSMENT: CREDIT EXPANSION

Loan growth moderated somewhat but remained at a fast pace



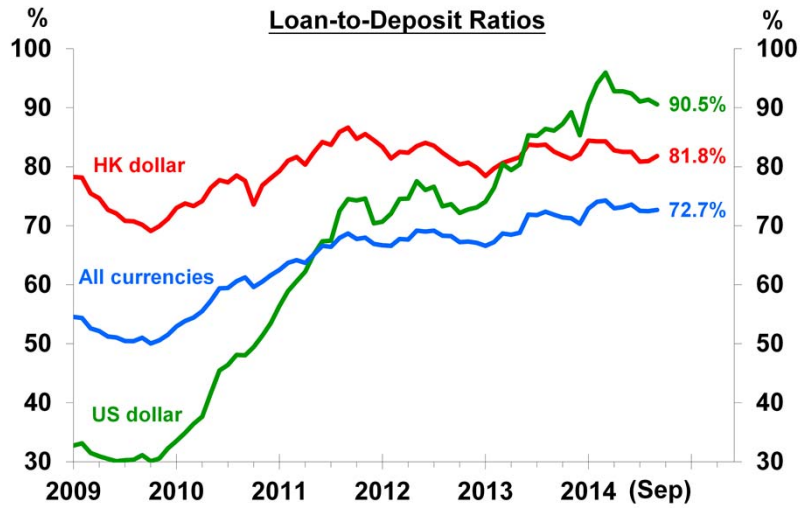
Source: HKMA

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- Bank loan growth moderated but remained at a fast pace.
- Overall loan growth slowed from an annualised double-digit rate in Q1 and Q2 to 7.7%.
- Factors leading to a reduction in loan growth:
 - Demand-side: the normalisation of the US monetary policy and showing growth in major economies have created uncertainties in macroeconomic outlook, causing some large corporations to become more conservative with borrowing.
 - Supply-side: despite the lack of any signs of asset quality deterioration, isolated loan default incidents have reduced banks' credit risk appetite.
- The HKMA has been monitoring the operation of the Stable Funding Requirement (SFR) since its launch in October 2013, taking into account comments of the industry. Having regard to industry views and implementation experience, the HKMA has completed a review of the SFR. We will seek to streamline the operation and reduce the reporting burden on banks. Details will be announced to industry associations shortly.



HONG KONG FINANCIAL STABILITY RISK ASSESSMENT: SLIGHT DECREASE IN THE HK DOLLAR AND US DOLLAR LOAN-TO-DEPOSIT RATIOS



Source: HKMA

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- As loan growth moderated, HK dollar and US dollar loan-to-deposit ratios declined to 81.8% and 90.5% respectively in September .



IMPACT OF THE “OCCUPY” MOVEMENT ON HONG KONG’S FINANCIAL SYSTEM

HK dollar exchange rate	Remained steady at around 7.75 - 7.77
HIBOR (overnight)	Remained steady at 0.03% on average
Payment and Settlement Systems	Normal operation
Temporary closure of bank branches/offices	29 September: 44 31 October: 1
HK equity market	Hang Seng Index closed at 23,998 at end-October, up 1.3% from 26 September. Equity market turnover and short-selling proportion were stable.

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- Financial markets have operated smoothly so far. The banking system and currency board also functioned normally. The HK dollar exchange rate remained steady. There was ample liquidity in the interbank market, with interbank rates remained steady. Stock market also functioned normally.



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IMPLEMENTATION PROGRESS OF BASEL III

Submitted to LegCo

- Banking (Amendment) Ordinance 2012 (Commencement) Notice 2014
- Banking (Capital) (Amendment) Rules 2014
- Banking (Liquidity) Rules

Consultations

- Disclosure requirements associated with 2nd phase of Basel III implementation
- Supervisory guidelines on “Countercyclical Capital Buffer” and “Systemically Important Banks”

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Legislation

- 3 pieces of subsidiary legislation for 2nd phase of Basel III implementation introduced into LegCo on 29 October for negative vetting.
- **Banking (Capital) (Amendment) Rules (BCAR)** and **Banking (Liquidity) Rules (BLR)** – to respectively implement capital buffers and Liquidity Coverage Ratio (LCR) pertaining to 2nd phase of Basel III implementation. Both sets of rules have taken account of comments received during statutory consultation, which were mostly to seek clarifications on specific areas at a technical level.

Consultations

- To consult the industry on draft Banking (Disclosure) (Amendment) Rules and proposed disclosure requirements associated with LCR, capital buffers and Leverage Ratio, with a view to developing a set of amendments to the Banking (Disclosure) Rules for introduction into LegCo within 2014.
- Draft Supervisory Policy Manual (SPM) module on Countercyclical Capital Buffer (CCyB) under Basel III, which explains the Monetary Authority’s approach in implementing CCyB, issued for industry consultation on 14 August. Industry comments received are being processed.
- Draft SPM module on SIBs issued for consultation on 8 October.



CROSS-SECTOR RESOLUTION REGIME FOR FINANCIAL INSTITUTIONS IN HONG KONG

- Legislative reform to meet international standards: Financial Stability Board (FSB)'s "Key Attributes of Effective Resolution Regimes"
- Fill gaps in Hong Kong regulators' existing toolkits to support resolution of failing financial institutions
- First three-month public consultation closed in April 2014
- Second consultation exercise expected to be launched in late 2014 with a view to introducing a bill into LegCo by Q4 2015

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- As highlighted to the Financial Affairs Panel at its meetings in February and May 2014, as part of the policy measures designed to reduce the risks posed by systemically important financial institutions (SIFIs), the FSB set new standards for resolution (in its "Key Attributes of Effective Resolution Regimes for Financial Institutions") in late 2011;
- The FSTB, together with the HKMA, the Securities and Futures Commission and the Office of the Commissioner of Insurance, issued a first-stage three-month public consultation paper in January 2014 setting out the authorities' initial thinking and proposals. A total of 33 submissions were received from a wide range of stakeholders;
- Following proactive engagement with stakeholders during the consultation period, the FSTB and the regulators have carefully reviewed respondents' submissions to the first-stage consultation while developing further proposals through a cross-authority working group. A second public consultation exercise providing more details on the proposals and tackling some of the more complex issues is expected to take place in late 2014 with a view to introducing a Bill into LegCo in Q4 2015.



ENHANCEMENTS TO DEPOSIT PROTECTION SCHEME

- 3-month public consultation launched in September 2014
- Aim: swifter payouts, change to gross payout basis
- Benefit to:
 - Depositors - Faster access to compensation
 - Banks - Simpler systems
 - Deposit Protection Scheme
 - More effective financial safety net
 - In line with peers

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- The FSTB and the HKMA jointly launched a three-month public consultation on the proposed enhancements to the Deposit Protection Scheme (DPS) on 12 September 2014. The key proposal is to adopt gross payout basis for deposit compensation calculation so as to achieve a faster payout in case there is a bank failure.
- Under the proposed gross payout approach, set-off between the protected deposits held by a depositor against his liability owed to the failed bank will be dis-applied up to the DPS protection limit (i.e. HK\$500,000 at present) in determining the amount of compensation payment.



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DEVELOPMENT OF ISLAMIC FINANCE

- Assisted the Government in successfully issuing its inaugural US\$1 billion 5-year sukuk under the Government Bond Programme in September
 - the world's first US dollar-denominated sukuk originated by an AAA-rated government
 - achieved the tightest spread ever for a benchmark US dollar issuance from an Asian (ex-Japan) government (2.005% or 23 basis points over 5-year US Treasuries)
 - strong demand from global investors, attracting orders exceeding US\$4.7 billion.
- Will continue to maintain close dialogue with market players, encouraging other public and private sector entities to issue sukuk through Hong Kong's platform



COIN COLLECTION PROGRAMME

- Began operation in October 2014, serving 18 districts



- Users may choose to receive banknotes in exchange for coins, or top up Octopus cards; they can also donate to the Community Chest
- The two Coin Carts visited 7 districts during October. By 31 October, 19,000 people used the service. We collected 19 million pieces of coins with total face value of \$15 million. This helps save minting costs
- Two Coin Carts collected 740,000 pieces of coins each day on average



LEGISLATIVE FRAMEWORK FOR STORED VALUE FACILITIES AND RETAIL PAYMENT SYSTEMS

- Drafting of the Clearing and Settlement Systems (Amendment) Bill is in final stage
- The new regulatory framework seeks to ensure adequate protection of users' float maintained with stored-value facilities (SVF) issuers and the security and soundness of the operations of SVF and retail payment systems (RPS) in Hong Kong
- The draft Bill includes provisions to:
 - (i) introduce a licensing regime for SVF
 - (ii) introduce a designation regime for RPS
 - (iii) confer relevant supervisory and enforcement powers on the Monetary Authority
- Consultation conclusion was jointly issued by FSTB and HKMA on 31 October 2014. The Bill is scheduled for introduction into LegCo in February 2015

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Legislative framework for stored value facilities and retail payment systems

- Drafting of the Clearing and Settlement Systems (Amendment) is in final stage.
- The purpose of the Bill is to ensure adequate protection of users' float maintained by the issuers of SVF and the security and soundness of SVF and RPS products and systems.
- The FSTB and HKMA jointly conducted a 3-month public consultation on the proposed regulation between 22 May 2013 and 22 August 2013. Comments received indicated that general support of the regulatory proposals. We have incorporated these comments in the draft Bill where appropriate.
- A consultation conclusion has been issued to the public on 31 October 2014. The Bill is scheduled for introduction into the LegCo in February 2015.

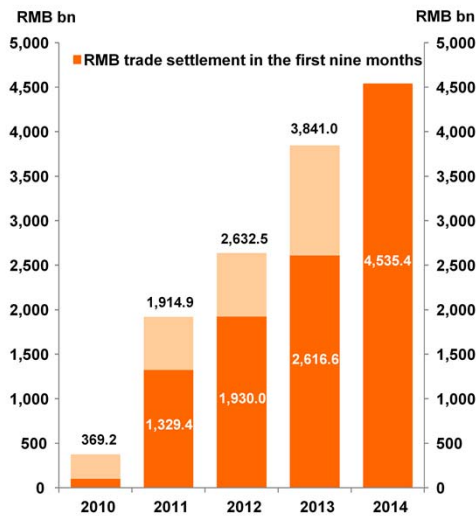


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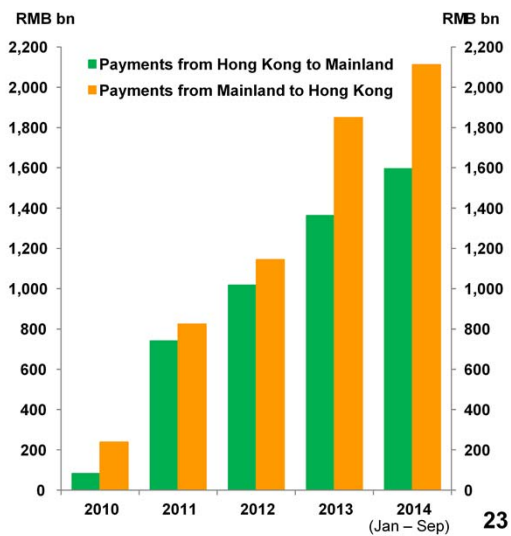


FURTHER EXPANSION IN RMB TRADE SETTLEMENT

RMB trade settlement handled by banks in Hong Kong



Flows of RMB trade settlement between Hong Kong and the Mainland

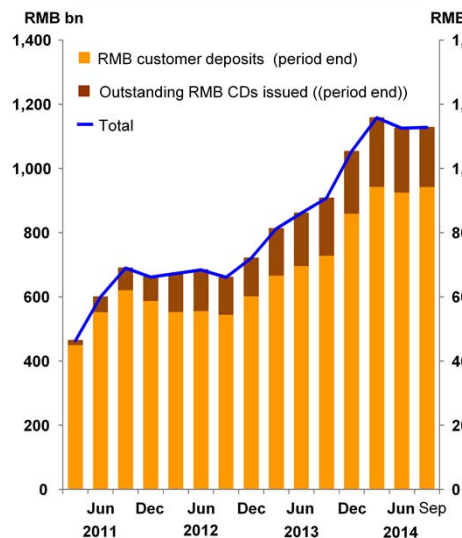


- In the first nine months of 2014, RMB trade settlement handled by banks in Hong Kong amounted to RMB4.5354 trillion, up 73% as compared with the same period in 2013.

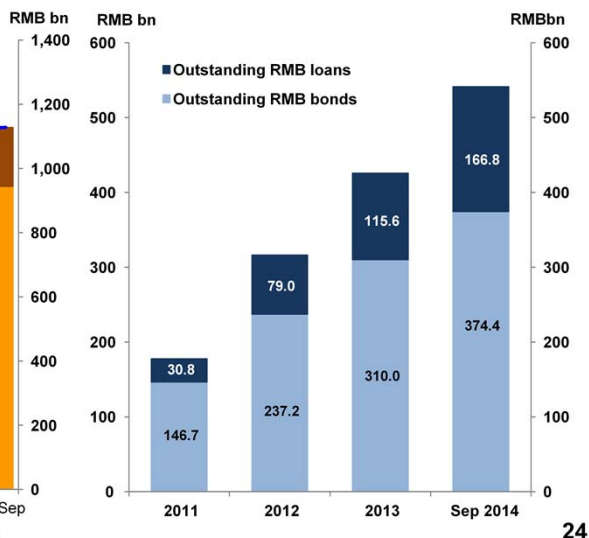


VIBRANT RMB FINANCING ACTIVITIES

RMB customer deposits and certificates of deposit (CDs)



RMB financing activities



- At end September 2014, RMB customer deposits and outstanding RMB certificates of deposit amounted to RMB1.1276 trillion in total, a 7% growth from RMB1.0530 trillion at the end of 2013.
- The RMB dim sum bond market was active in the first three quarters of 2014, with issuance totalled RMB163.6 billion, 40% more than the total amount of RMB116.6 billion in 2013.
- RMB bank lending continued to grow, with outstanding amount of RMB loans increased to RMB166.8 billion at end September 2014, a growth of 44% from the end of 2013.



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

	Sep 2014	2013	2012	2011
1 No. of participating banks of Hong Kong's RMB clearing platform	223	216	204	187
Of which:	198	191	181	165
Branches and subsidiaries of overseas banks and overseas presence of Mainland banks				
2 Amount due to overseas banks (RMB billion)	146.4	166.0	99.1	116.4
3 Amount due from overseas banks (RMB billion)	208.9	164.5	117.1	121.7
4 Turnover in Hong Kong's RMB RTGS system (Daily average during the period; RMB billion)	781.9	395.4	213.7	121.4

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- Hong Kong's RMB business links with other parts of the world continue to grow. Collaboration on RMB business between Hong Kong and other markets has also been further broadened. The first Hong Kong-Thailand RMB Business Forum, facilitated by the HKMA and the Bank of Thailand, was held on 13-14 October. The HKMA also organised a seminar on RMB business as part of the Hong Kong Trade Development Council's "Think Asia, Think Hong Kong" campaign in Paris on 28 October.
- The HKMA will continue its RMB business promotion efforts, including supporting private sector dialogues between Hong Kong and other places such as London and Malaysia.



MEASURES TO ENHANCE OFFSHORE RMB LIQUIDITY

Intraday CNH liquidity

- To enhance the provision of intraday CNH liquidity in offshore market, in anticipation of a rise in demand for RMB upon the launch of Shanghai-Hong Kong Stock Connect
- A maximum of RMB 10 billion will be offered in a single day via repos (in addition to the intraday liquidity provided by the Clearing Bank)

Primary Liquidity Providers (PLPs)

- Banks designated as PLPs would
 - expand their market-making activities in CNH instruments in Hong Kong
 - make use of their Hong Kong platforms in promoting global offshore RMB business
- Each PLP is provided with a dedicated repo line



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INVESTMENT INCOME

← 2014 → 2013 2012 2011

(HK\$ billion)	Jan - Sep*	Q3*	Full Year	Full Year	Full Year
Hong Kong equities[@]	1.7	(0.2)	10.1	30.7	(24.2)
Other equities	22.4	2.8	71.8	42.8	(12.2)
Bonds	33.7	7.1	(19.1)	33.1	71.9
Other investments^{&}	7.9	-	16.8	6.4	0.7
Foreign exchange	<u>(28.0)</u>	<u>(28.4)</u>	<u>1.6</u>	<u>(1.4)</u>	<u>(9.1)</u>
Investment income/(loss)	37.7	(18.7)	81.2	111.6	27.1

* Unaudited figures

[@] Excluding valuation change of the Strategic Portfolio

[&] Including valuation changes of private equity and real estate investments held by Exchange Fund's investment holding subsidiaries

(The above figures represent valuation changes up to the end of June 2014. Valuations of these investments from July to September are not yet available.)



INCOME AND EXPENDITURE

(HK\$ billion)	← 2014 →				2013
	Jan – Sep*	Q3*	Q2*	Q1*	Full year
Investment income/(loss)	37.7	(18.7)	43.3	13.1	81.2
Other income	0.2	0.1	0.1	0.0	0.2
Interest and other expenses	<u>(4.1)</u>	<u>(1.3)</u>	<u>(1.7)</u>	<u>(1.1)</u>	<u>(4.9)</u>
Net income/(loss)	33.8	(19.9)	41.7	12.0	76.5
Payment to Fiscal Reserves#	(20.6)	(6.7)	(6.8)	(7.1)	(36.8)
Payment to HKSAR government funds and statutory bodies#	(6.4)	(2.3)	(2.2)	(1.9)	(9.3)

* Unaudited figures

The fixed rate of fee payment is 3.6% for 2014 and 5.0% for 2013.