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HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

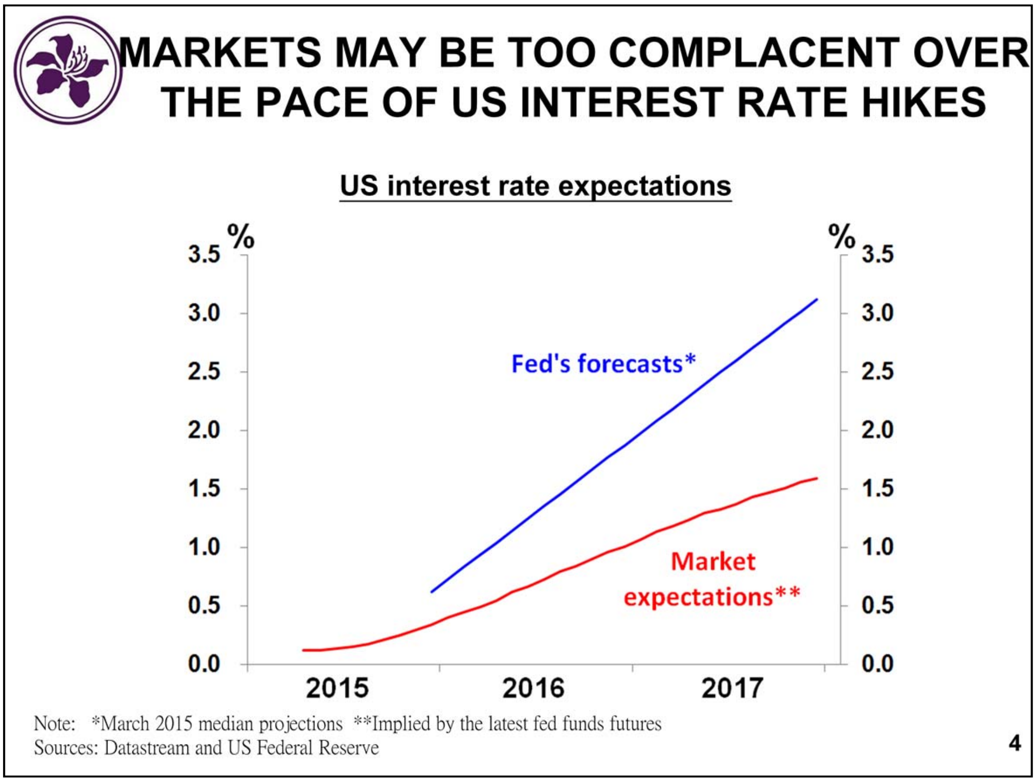
4 May 2015

[Translation]

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

TIMING OF THE FIRST US RATE HIKE IS GETTING CLOSER

- At the March FOMC meeting, the majority of members believed it would be appropriate to hike rate this year but said it would unlikely do so in April
- First quarter growth was weak but that hasn't changed the Fed's assessment of US economic outlook
- No predetermined course of tightening, the pace would depend on economic conditions
- Recent US economic growth and inflation have been slowed by transitory factors, momentum could pick up soon:
  - Continued improvement in the labour market and faster rise in real income would drive consumption and wage growth
  - Once the fall in oil prices and the strengthening of the US dollar stabilise, downward pressures on inflation would ease



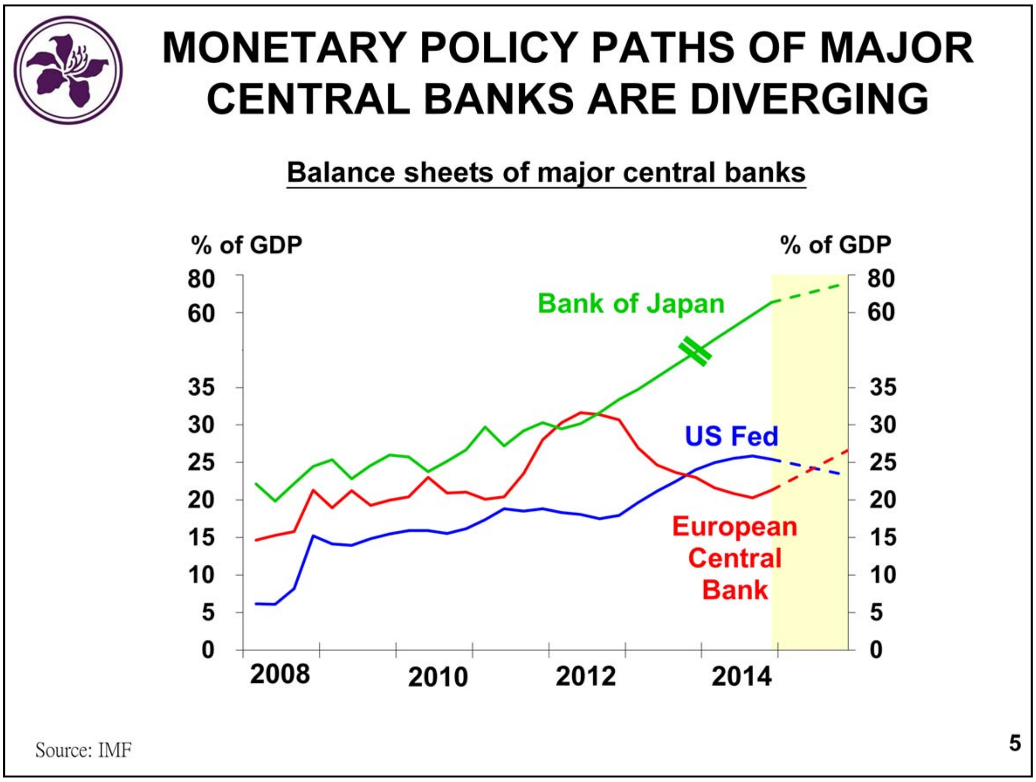
- With accelerating economic growth and anticipation of rising inflation in the US, the Fed should normally quicken the pace of monetary normalisation. However, markets still expect the US Fed Funds Rates to rise slowly.

- The red line in the chart indicates that markets expect the US Fed Funds Rates to rise slowly to 0.3% at the end of 2015, which is slightly lower than the Fed's median projection of 0.6% (blue line).

- However, the disparity between market expectations and the Fed's forecasts of interest rate hikes widens from this point onwards. Markets expect that the Fed Funds Rates will continue to rise slowly:

  - reaching 1% at the end of 2016, which is far lower than Fed's median projection of 1.9%.
  - reaching 1.6% at the end of 2017, which is far lower than Fed's median projection of 3.1%.

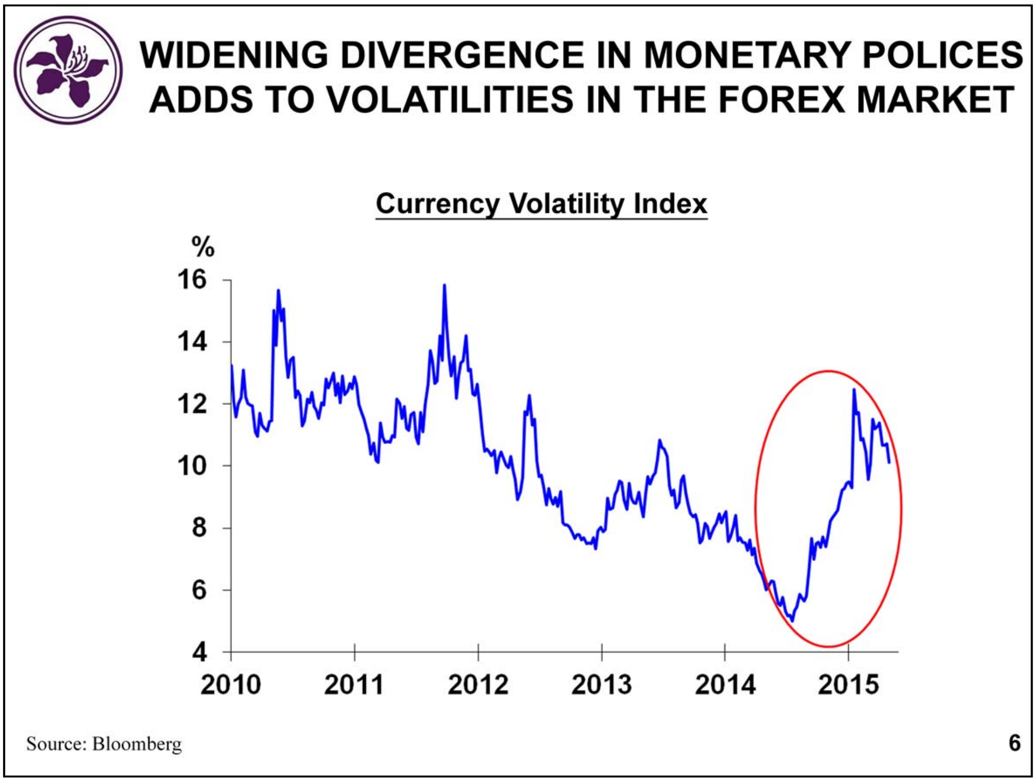
- The marked difference between market expectations and the Fed's projections indicates that market sentiment may be over optimistic.



- Major central banks have expanded their balance sheets substantially in recent years.

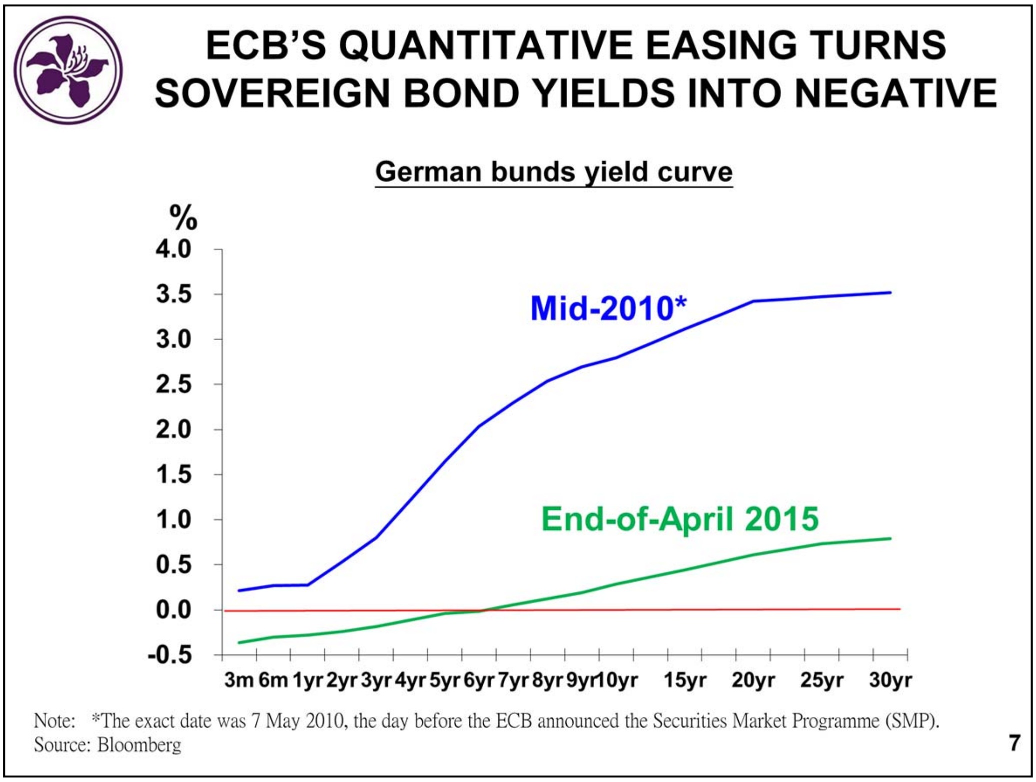
- With the Bank of Japan (BoJ) expanding its Quantitative and Qualitative Easing (QQE) programme and the Central Bank of Europe (ECB) introducing Quantitative Easing, the International Monetary Fund expects the size of their balance sheets to grow to 76% (green dotted line) and 27% (red dotted line) of their GDP respectively by the end of this year. Meanwhile, the US Fed has begun monetary normalisation and its balance sheet is expected to gradually shrink to 23% of GDP (blue dotted line).

- The substantial expansion of the balance sheets of the ECB and the BoJ and the gradual contraction of the Fed's balance sheet shows that the monetary policy paths of major central banks are diverging.



- Widening divergence in monetary policies of major central banks adds to volatilities in the forex market.

- The chart shows that the currency volatility index has rebounded significantly from its record low since the middle of last year, reversing its downward trend during the period after the financial crisis in 2008.



- Amid moderating inflation and continued expansion of major central banks' balance sheets, bond yields have fallen to very low levels.

- The German bunds yield curve has shifted downward significantly in the last five years, meaning that German bund yields of various tenors have fallen sharply.

- It is worth noting that in the secondary market, yields on German bunds with maturities of four years or below are now in the negative territory.

- Borrowers benefit from the low interest rate environment but prudent savers and pensioners are penalised as a result.

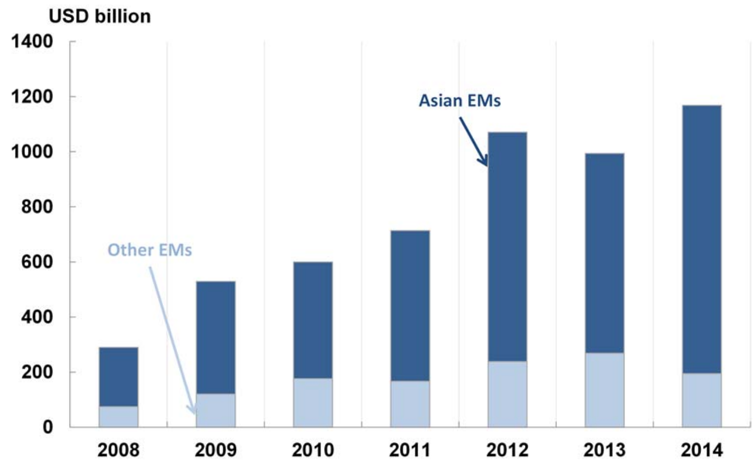
- Government bond yields turning negative is an abnormal situation, indicating distortions in the bond market.

- This situation may cause funds to flow into the US dollar assets from euro assets, and capital to flow into the equity market and high yield assets from the bond market in the eurozone, fuelling high risk investment activities.

- This will ultimately lead to resource misallocation: the continuing ultra low interest rate environment will distort investment decisions, resulting in capital flowing into high risk assets from productive real investments.

EMERGING MARKET CORPORATE BOND ISSUANCE ON THE RISE AMID LOOSE GLOBAL MONETARY CONDITIONS

Emerging market corporate bond issuance



Source: Dealogic

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- Emerging market corporate bond issuance has been on the rise in recent years amid accommodative monetary policies pursued by central banks around the world.

- According to market statistics, bond issuance by corporations in emerging markets amounted to US$1.1681 trillion in 2014, approximately four times of that in 2008.

- The increase in corporate bond issuance in Asian merging markets has been particularly significant. Bond issuance by corporations in Asian emerging markets amounted to US$973 billion (83% of total issuance in emerging markets) in 2014, about 3.5 times the amount of US$215.1 billion in 2008.

- The rapid increase in emerging markets bond issuance amid a distorted bond market indicates rising risks in the bond market.

POTENTIAL RISKS TO BOND MARKETS UNDER QUANTITATIVE EASING

- Global banks reducing their bond holdings and market-making activities
- Increasing foreign participation in bond market of emerging market economies
- Increasing size of bond ETFs – led by retail investors
- Concentrated holdings of corporate bonds issued by some large corporates in emerging market economies
- Corporations engaging in energy business are still under pressure

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- The bond market is faced with a number of potential risks amid accommodative global monetary conditions. The followings should be noted:

- First, global banks are reducing their bond holdings and market-making activities which will result in low liquidity in the bond market.

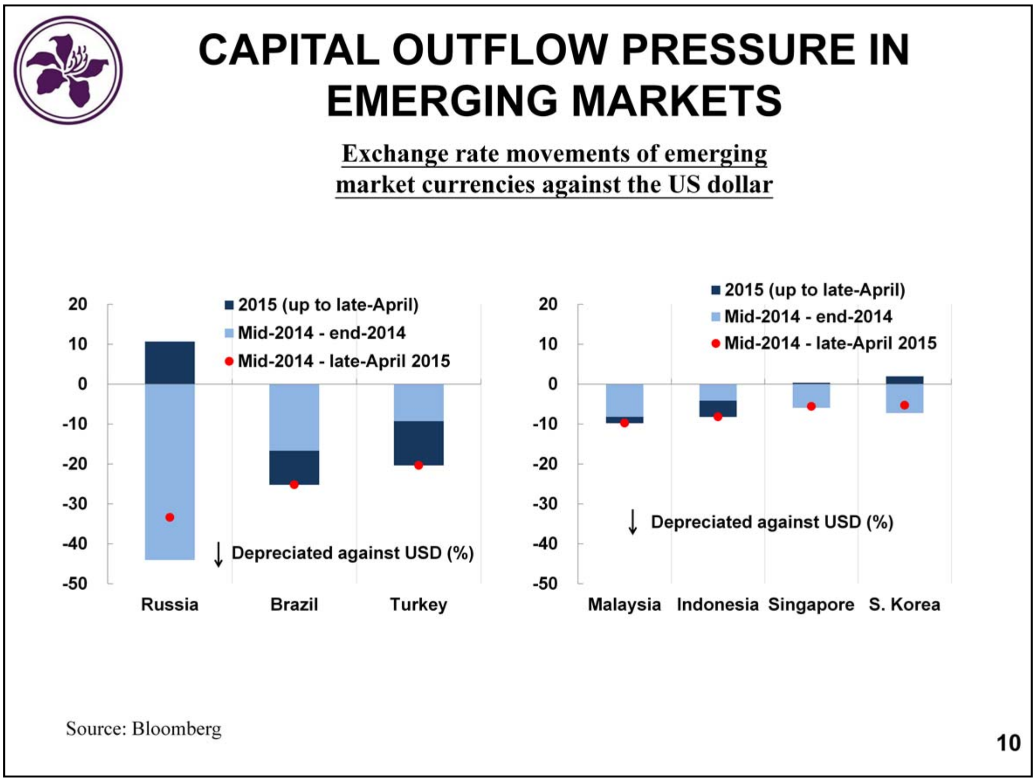
- Second, proportion of foreign holding of emerging market bonds has been increasing in recent years. In the event of a shock in the emerging market economies, foreign investors may sell off their emerging market bonds, adding to market volatilities.

- Third, an increasing number of asset management companies are packaging the emerging market corporate bond portfolios into exchange-traded funds (ETFs) targeting at retail investors, resulting in the increasing size of bond ETFs in recent years. As retail investors are susceptible to short-term market sentiment and herd mentality, they are more likely to sell off these readily tradable ETFs in the event of market shocks. The asset management companies concerned may be forced to sell the underlying emerging market bonds at a time when market liquidity is low, increasing market volatilities.

- Fourth, the International Monetary Fund pointed out in two of its reports published last year and this April that a large number of emerging market corporate bonds are concentrated on the hands of a few large asset management companies. Should these asset management companies encounter liquidity shortage and have to sell off their corporate bond holdings in exchange for cash, corporate bond yields may rise, increasing market volatilities.

- Fifth, a number of corporate bond issuers are engaged in energy-related business. Bond issuance by these corporations amounted to over 20% of total corporate bond issuance in some countries. In the second half of 2014, the spread of oil-related US high yield corporate bonds has surged amid falling oil prices, indirectly driving up the spread of other non-oil related US high yield corporate bonds. Although oil price has stabilised in recent months, it remains at a low level. Therefore, corporations engaging in energy-related business are still under pressure.

- All of the above factors may increase volatilities when the bond market adjusts.



- With a strengthening US dollar and falling oil prices, emerging market currencies were faced with tremendous depreciation pressure in the second half of 2014. Even though exchange rates stabilised at the beginning of 2015, many emerging market currencies are still under pressure.

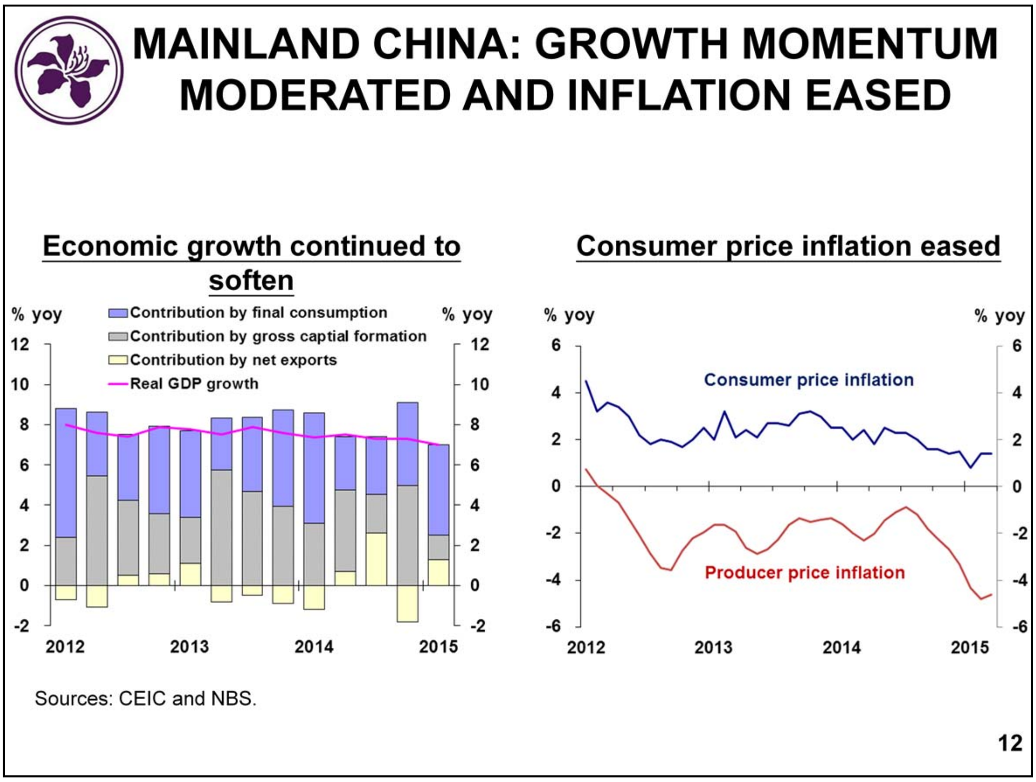
- The light blue bars in the charts show the magnitude of depreciation against the US dollar in the second half of 2014 while the dark blue bars show the changes from the beginning of the year to April. Overall changes during the whole period from the middle of last year to April this year are represented by the red dots.

- The left chart shows that during the period from the middle of last year up to the present, some emerging market economies have been under tremendous capital outflow pressure and their currencies have experienced substantial depreciation.

- The right chart shows that a number of Asian currencies have also depreciated against the US dollar.

ASSESSEMNT OF RISKS TO GLOBAL FINANCIAL STABILITY

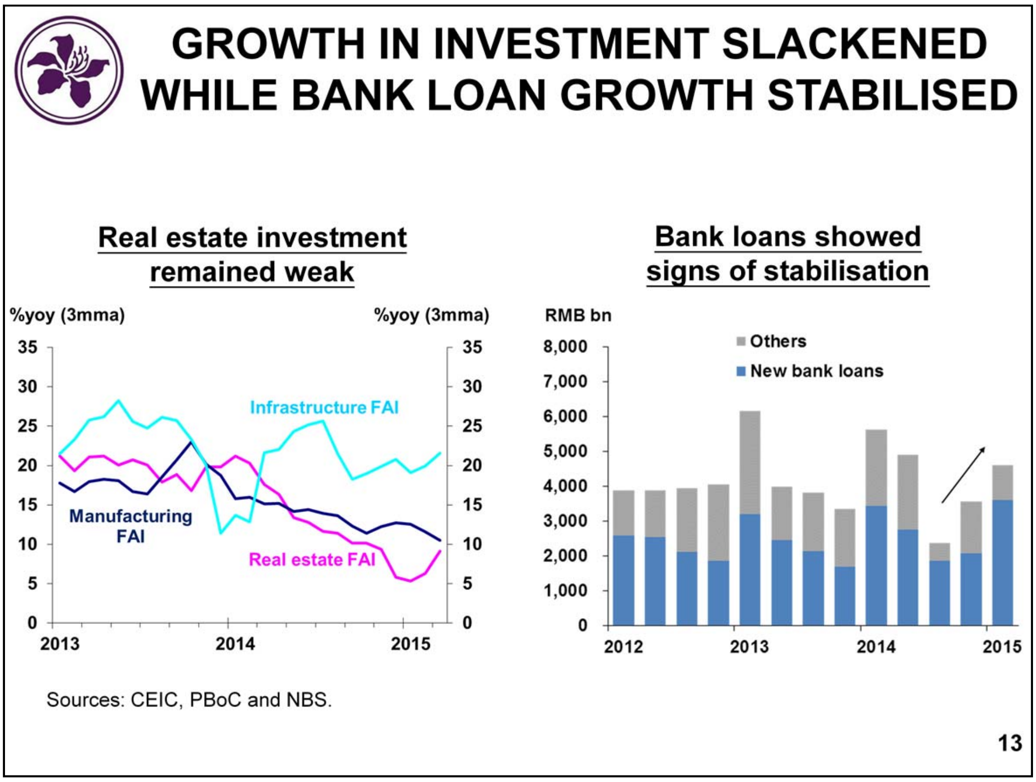
- High volatility in forex markets due to divergence in monetary policies in the US, Europe and Japan
- Quantitative easing by the ECB has resulted in negative yields of some sovereign bonds, leading to market distortions and dragging down other bond yields
- Structural change in the bond market will increase volatility and potential risks
- Downside risks in emerging markets are increasing, in particular in those countries with weaker fundamentals and relying on export of energy
- The pace and timing of interest rate normalisation in the US will affect fund flows, interest rates, exchange rates and asset prices



- [Left chart] Mainland China's economic growth moderated from 7.3% year-on-year in the fourth quarter of 2014 to 7.0% in the first quarter of this year. This is mainly attributable to the marked slowdown in capital expenditure. Nevertheless, consumption remains robust.

- The World Bank's 2015 growth forecast for Mainland China is 7.1% (2016 forecast: 7.0%). In its World Economic Outlook published recently, the International Monetary Fund has maintained its growth forecast of 6.8% for this year (2016 forecast: 6.3%) for Mainland China.

- [Right chart] Inflation is moderating. Consumer price inflation has decreased to 1.2% in the first quarter of this year from the recent high of 2.9% in the fourth quarter of 2013. In addition, producer prices continue to fall and year-on-year decline accelerated to 4.6% in the first quarter of this year.

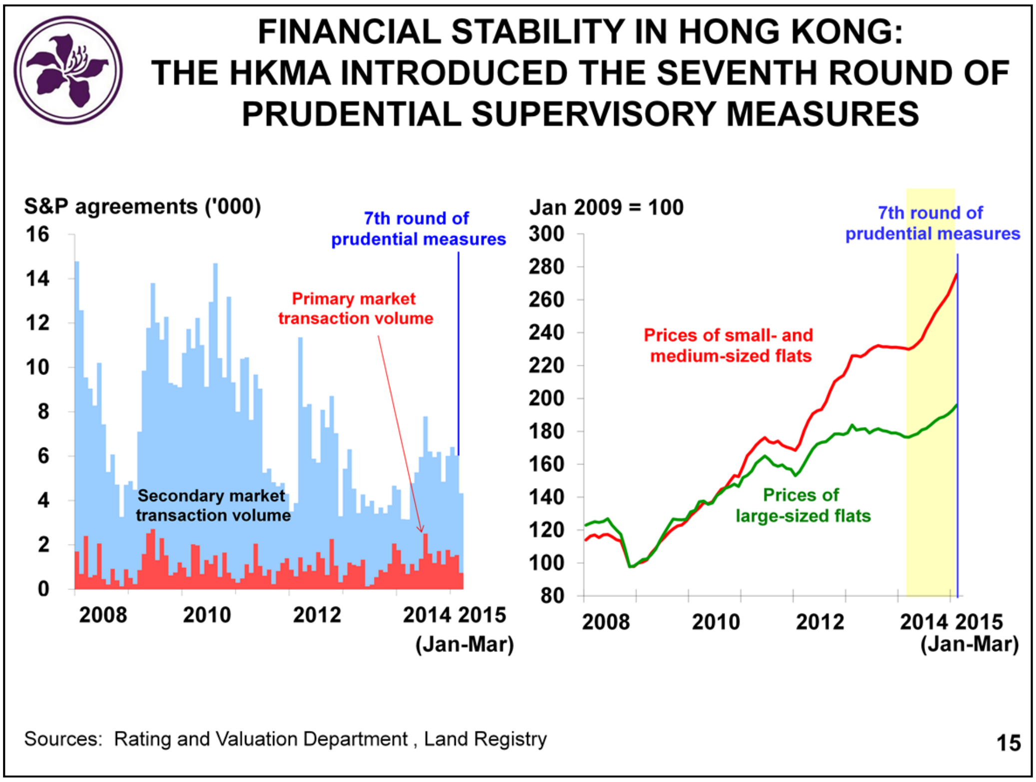


- [Left chart] Growth in fixed asset investment fell from 14.7% year-on-year in the fourth quarter of last year to 13.5% in the first quarter of this year. Investment in the real estate and manufacturing sectors remain weak. However, with policy support, infrastructure investment remains solid and maintained a year-on-year growth rate of over 20% in the first quarter of this year.

- [Right chart] On the back of rising new loans, aggregate financing rebounded to a monthly average of RMB1.5 trillion in the first quarter of this year from a monthly average of RMB1.2 trillion in the last quarter of 2014.

MAINLAND AUTHORITIES ROLLED OUT POLICY MEASURES TO ACHIEVE GROWTH TARGET

- Mainland economy entering a state of "new normal", with the growth target of this year lowered to around 7%
- There remains sufficient policy space to promote economic growth, and the risk of a hard-landing is not high:
  - Fine-tuning through monetary policy: cut benchmark interest rates and reserve requirement ratio twice
  - Stimulating through fiscal policy: expanded infrastructure investment in targeted areas, including railway and water conservancy projects totalling RMB 1.6 trillion
  - Pushing ahead financial reforms including interest rate liberalisation and introduction of deposit protection scheme, and promoting financial innovation

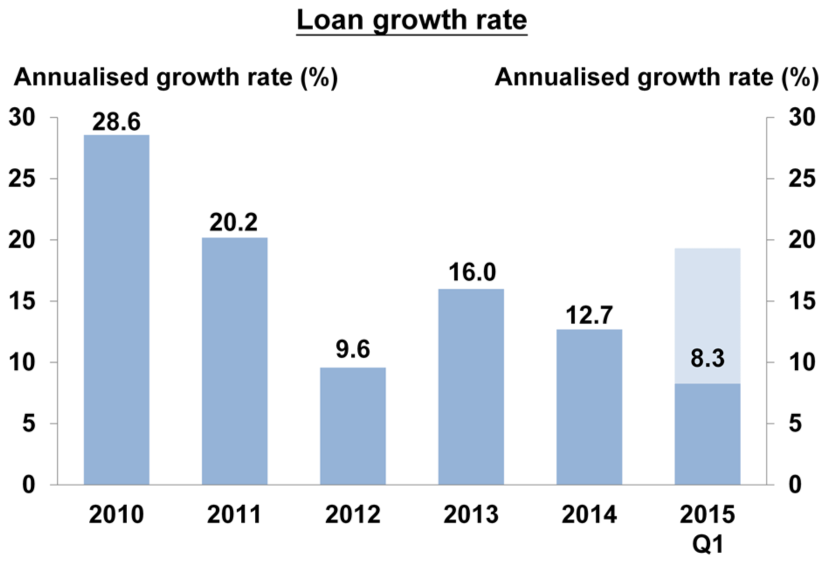


- The property market became buoyant again in the second half of 2014, with notable increases in prices and transaction volume, particularly the small- and medium-sized residential units.

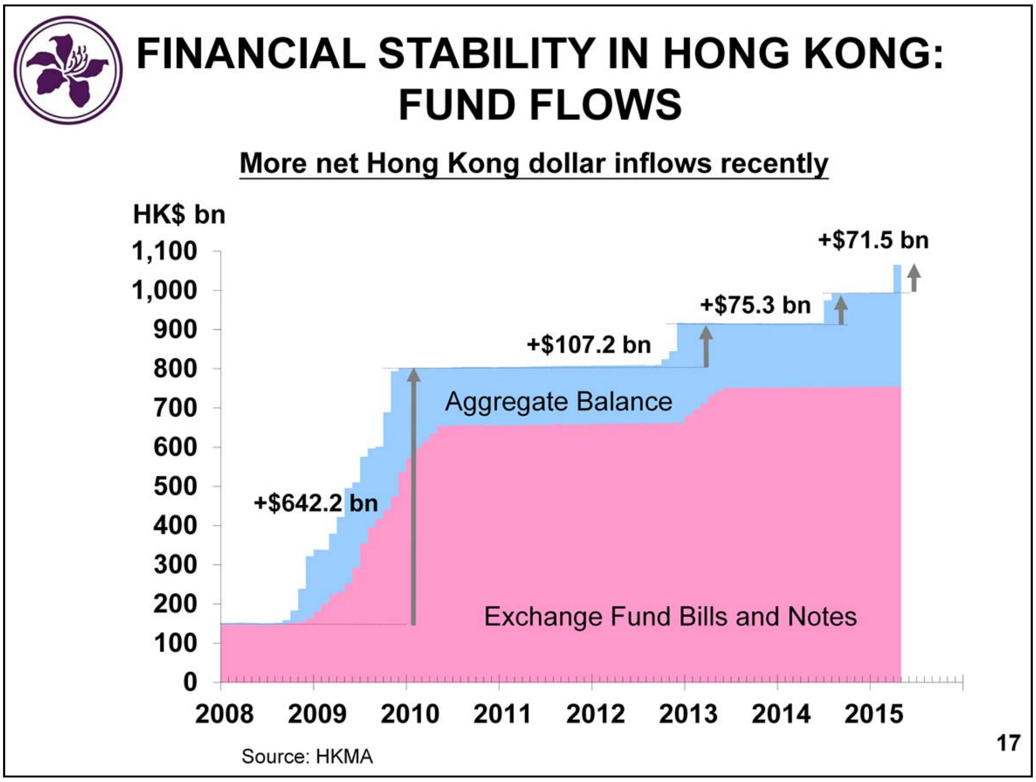
- As the risk of overheating in the property market has risen, the HKMA introduced the seventh round of countercyclical measures to safeguard the stability of the banking and financial systems in late February this year.

- The new measures have been in place for just over two months and we will need more time to observe their effect on the property market.

FINANCIAL STABILITY IN HONG KONG: BANK CREDIT CONTINUED TO GROW MODERATELY



Source: HKMA



- There have been more net inflows into the Hong Kong dollar recently. The Hong Kong dollar exchange rate strengthened to 7.75 in early April and the strong-side Convertibility Undertaking was triggered a few times during the period from April 9 to 24. Aggregate balance in the banking system increased as a result. Net inflows during this period amounted to around HK$71.5 billion (equivalent to US$9.23 billion). A substantial part of these inflows were reportedly related to equity-related investment activities and some were also related to ordinary commercial activities, including dividend distribution, merger and acquisition, business transactions and loan repayment.

- With the expectation of interest rate hikes in the US, the pressure of funds flowing back to the US from overseas is going to increase. Past experience also indicates that with a strengthening US dollar, capital outflow pressure in emerging markets will increase. Hong Kong as a emerging market economy may also face capital outflow pressure.

- The Linked Exchange Rate System has a robust automatic adjustment mechanism which helps offset the pressure on the exchange rate resulting from fund outflows, thereby maintaining currency stability.

FINANCIAL STABILITY IN HONG KONG: EQUITY MARKET

- The Shanghai-Hong Kong Stock Connect enables the interconnection of equity markets between Hong Kong and Shanghai.
- Such interconnection will naturally lead to interactions between the two markets.
- Changes and new dynamics in Hong Kong's equity market will emerge and we need to understand and adapt to such new market characteristics.
- Fund flows into and out of Hong Kong and Mainland China, as well as between the two places, will increase significantly. The equity market in Hong Kong may become more volatile, and investors should remain vigilant and manage the associated risks properly.

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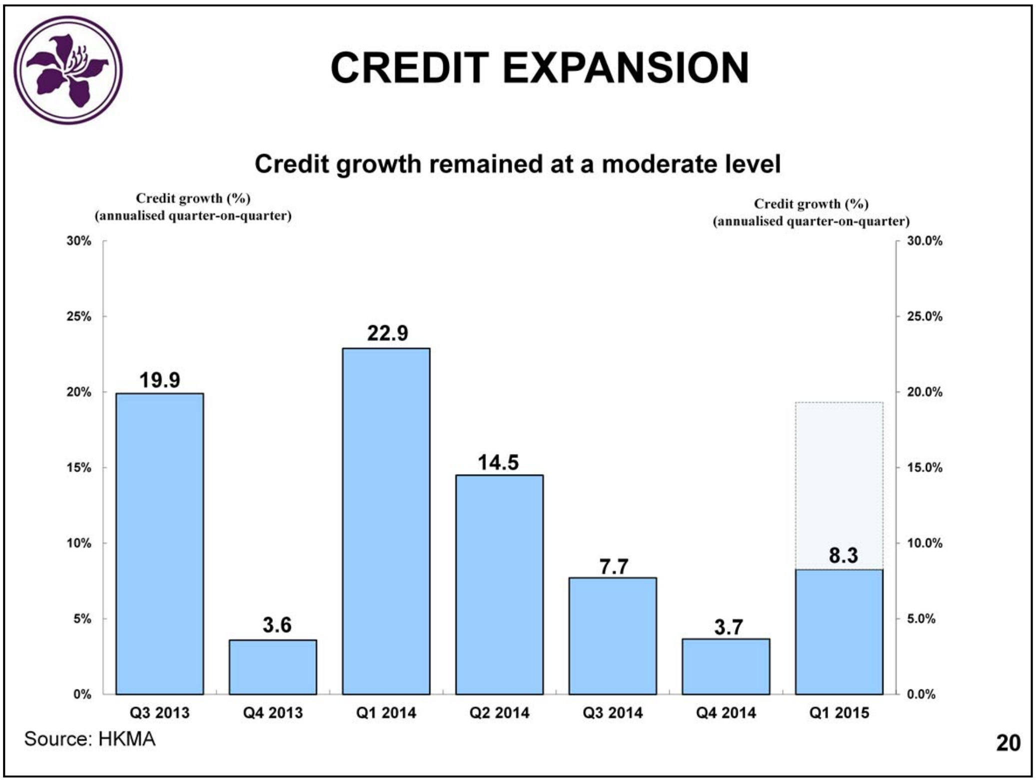

- The robust credit growth in Q1 2015 was mainly driven by IPO loans (around HK$201 billion) straddling end-March 2015. Excluding the IPO loans, the credit growth in Q1 2015 was moderate with an annualised rate of 8.3%.

- The moderate loan growth was mainly attributed to subdued demand for loans for use in Hong Kong. The growth in trade finance was relatively stronger.

- According to the banks, they have not adjusted their risk appetite or loan pricing strategy. The moderation in loan growth was driven by conservative loan demand by corporations.

BASEL III IMPLEMENTATION PROGRESS

Second phase implementation

- Legislative amendments effective from 1 January (capital and liquidity) and 31 March (disclosure)
- Announcement of Countercyclical Capital Buffer (CCyB)
- Designation of Domestic Systemically Important Banks (D-SIBs)

Future Work

- Amendments to capital rules to address Basel Committee's Regulatory Consistency Assessment Programme (RCAP) findings
- Implementing revised standards on:
  - capital treatment of counterparty credit risk exposures and equity investments in funds
  - revised Pillar 3 disclosure requirements

CROSS-SECTOR RESOLUTION REGIME FOR FINANCIAL INSTITUTIONS IN HONG KONG

- To meet international standards: Financial Stability Board (FSB)'s "Key Attributes of Effective Resolution Regimes for Financial Institutions"
- Second consultation exercise on legislative reform closed on 20 April 2015
- A third, shorter consultation paper expected around mid-year
- Aim to introduce a Bill into LegCo by Q4 2015

- The second consultation on resolution (issued on 21 January) ended on 20 April 2015. We received 27 submissions. The responses are, as in the first consultation, broadly supportive of the proposals.

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The Clearing and Settlement Systems (Amendment) Bill

- The Bill seeks to put in place a legal framework for regulating stored value facilities (SVF) and retail payment systems (RPS) to ensure adequate protection of users' float maintained with SVF issuers and the security and soundness of the operations of SVF and RPS in Hong Kong.

- The Bill was introduced into the LegCo on 4 February 2015. So far, four Bills Committee meetings have been held.

GOVERNMENT'S SECOND SUKUK

- Successfully issued US$1 billion inaugural sukuk (Islamic bond) in September 2014. It was well received, attracting orders exceeding US$4.7 billion. To continue enhancing market development, the HKMA is preparing for issuance of the second sukuk on behalf of the Government.

- The preliminary plan is to adopt a new structure, reducing the proportion of the sukuk's underpinning tangible assets from 100% to 34%. This demonstrates that sukuk of different structures can be issued using the Hong Kong platform and sets a precedence for issuers that have fewer assets to underpin the sukuk; tenor will be 5 years and issuance size US$1 billion.

DEVELOPING HONG KONG AS A CTC HUB

- To attract multinational and Mainland enterprises to establish corporate treasury centres (CTCs) in Hong Kong, the Government will amend the Inland Revenue Ordinance to allow, under specified conditions, interest deductions under profits tax for CTCs, and reduce profits tax for specified treasury activities by 50%

- Legislative proposal: The Government will consult the industry later this year with a view to introducing the relevant amendment bill in the 2015-16 legislative session

- Promotion work: HKMA will continue to engage the industry and step up marketing effort to promote Hong Kong as a preferred regional location for CTCs

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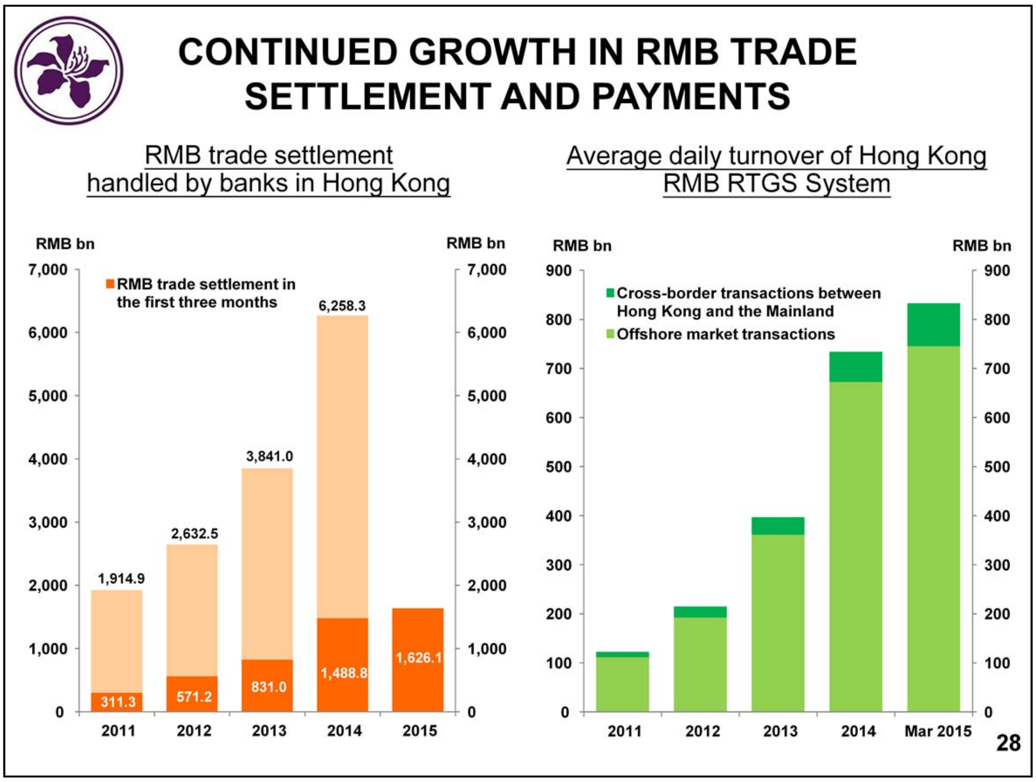
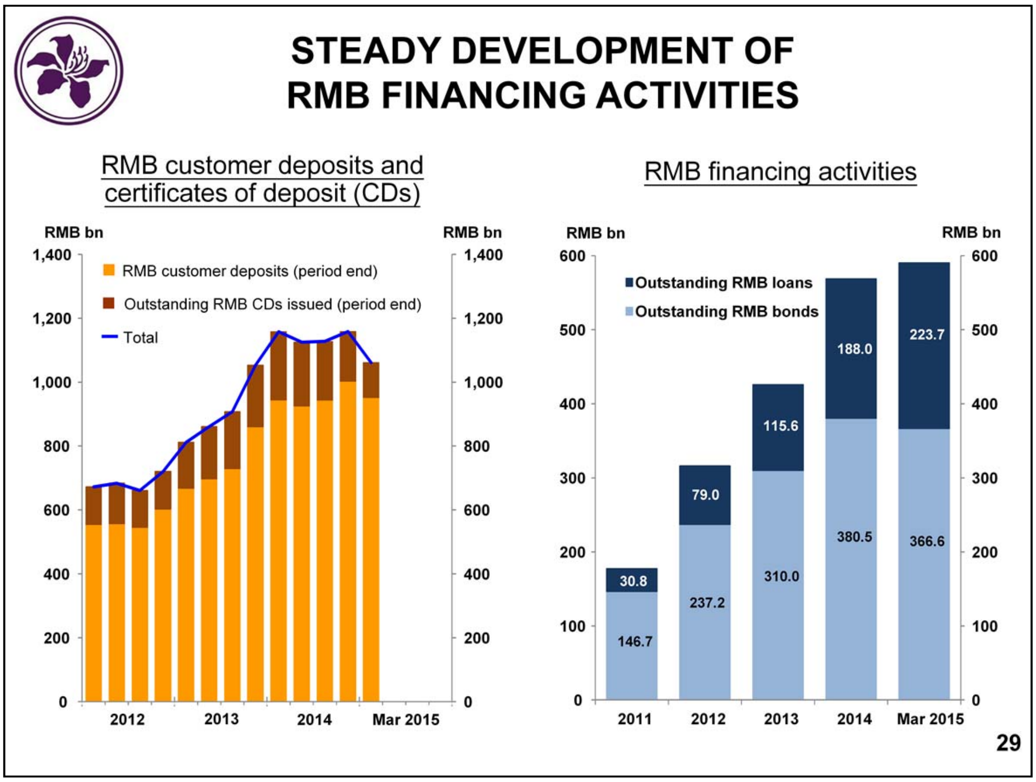


- In the first quarter of 2015, RMB trade settlement handled by banks in Hong Kong amounted to RMB1,626.1 billion, up 9% compared with the same period in 2014.

- Transactions handled by Hong Kong RMB Real Time Gross Settlement (RTGS) system increased further, with daily average turnover reaching RMB831.3 billion in March 2015.



- At end-March 2015, RMB customer deposits and outstanding RMB CDs amounted to RMB952.0 billion and RMB109.2 billion respectively, totaling RMB1,061.2 billion, a 8% decline from the end of 2014. The drop in customer deposits in early 2015 was mainly attributable to a net outflow of RMB from Hong Kong to the Mainland under trade settlement, and a net sale of RMB by corporations through banks. Deposits held by personal customers recorded an increase during the period.

- RMB dim sum bond issuance moderated, with issuance in the first quarter of 2015 totalling RMB6.6 billion. Outstanding dim sum bonds amounted to some RMB366.6 billion at end-March 2015. On the other hand, RMB bank lending continued to grow, with outstanding amount of RMB loans increased by 19% to RMB223.7 billion at end-March 2015 from the end of 2014.

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INVESTMENT INCOME

(HK$ billion)	2015 Q1*	2014 Full Year	2013 Full Year
Hong Kong equities@	**9.1**	**6.5**	**10.1**
Other equities	**18.5**	**33.7**	**71.8**
Bonds	**12.2**	**47.3**	**(19.1)**
Other investments&	**-**	**9.9**	**16.8**
Foreign exchange	**(33.2)**	**(52.7)**	**1.6**
Investment income	**6.6**	**44.7**	**81.2**

* Unaudited figures

@ Excluding valuation changes of the Strategic Portfolio

& Including valuation changes of private equity and real estate investments held by Exchange Fund's investment holding subsidiaries. The figure for the latest quarter is not yet available.

INCOME AND EXPENDITURE

(HK$ billion)	2015 Q1*	2014 Full Year	2013 Full Year
Investment income	**6.6**	**44.7**	**81.2**
Other income	-	0.2	0.2
Interest and other expenses	(1.0)	(5.2)	(4.9)
Net income	5.6	39.7	76.5
Fee paid/payable to Fiscal Reserves#	**11.4**	**27.5**	**36.8**
Fee paid/payable to HKSAR government funds and statutory bodies#	3.5	8.6	9.3

* Unaudited figures
\# The fixed rate of fee payment is 5.5% for 2015 and 3.6% for 2014.