

CB(1)1905/09-10(01)

HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

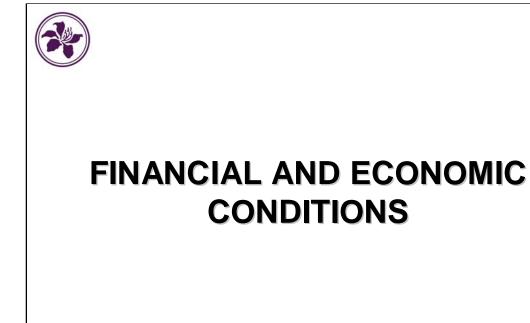
20 May 2010

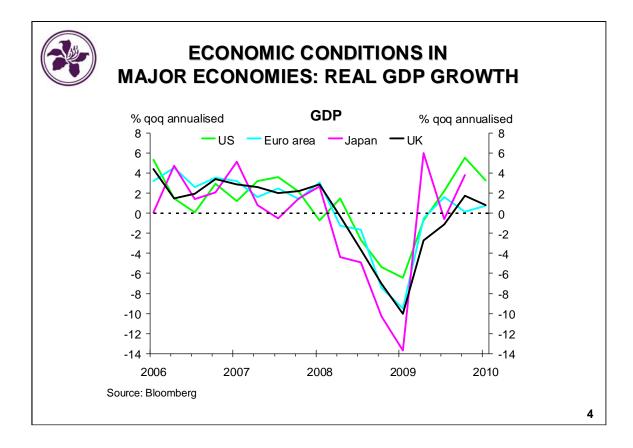


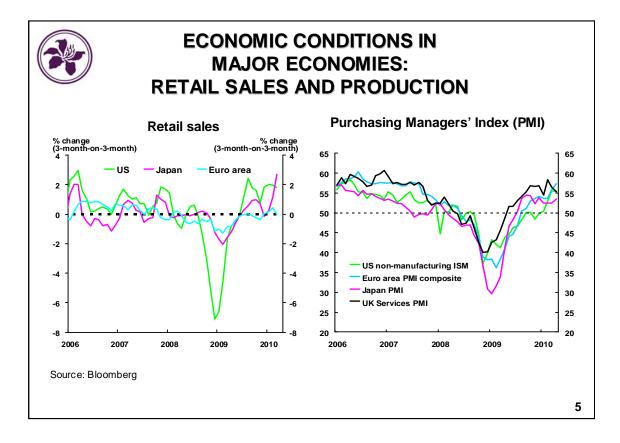
DISCUSSION TOPICS

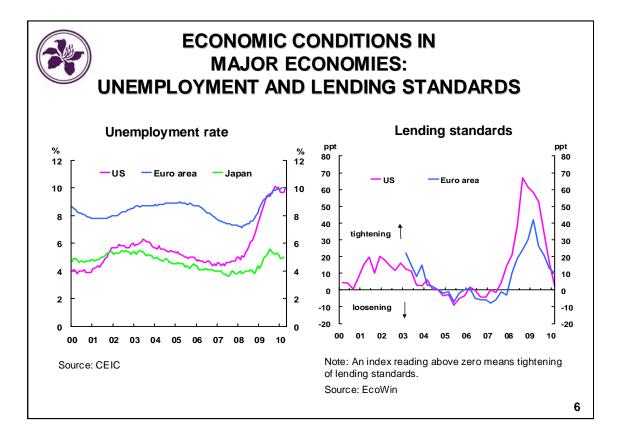
Updates on

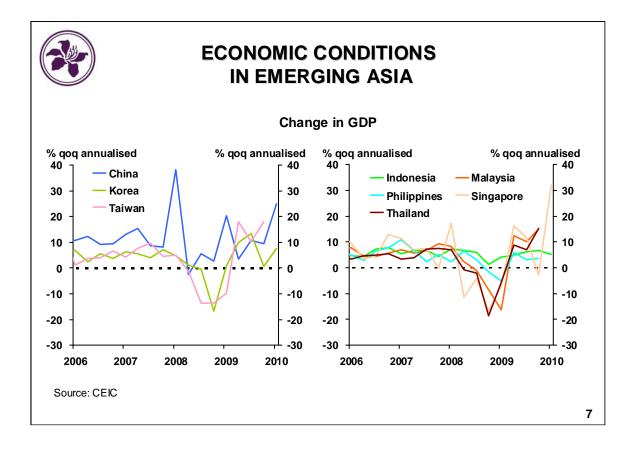
- Financial and Economic Conditions
- Currency Stability
- Banking Stability
- Financial Infrastructure
- Hong Kong as an International Financial Centre
- The Exchange Fund

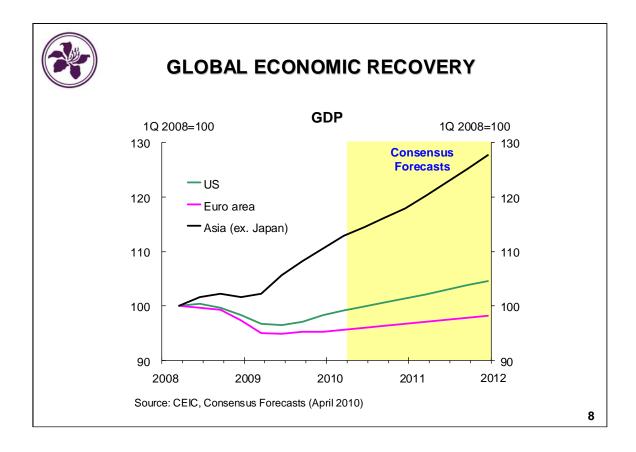


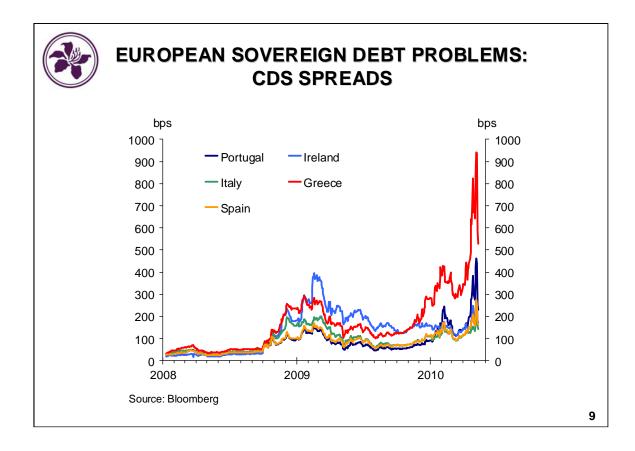


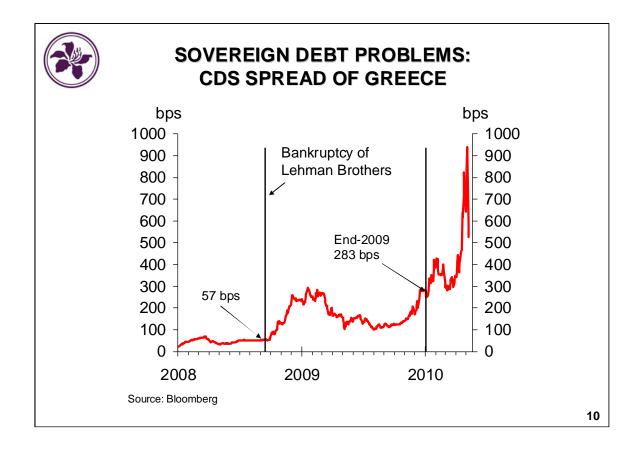


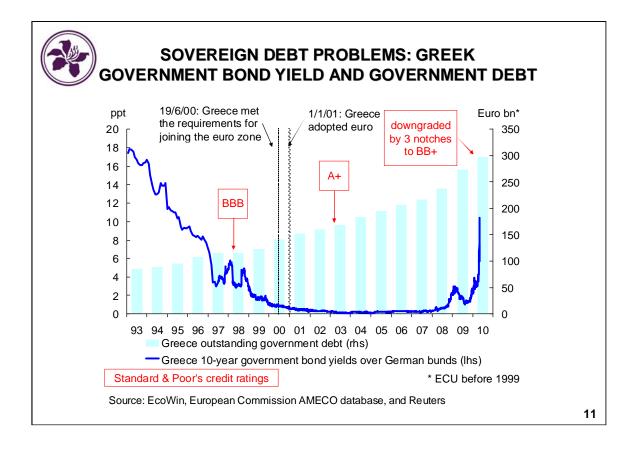


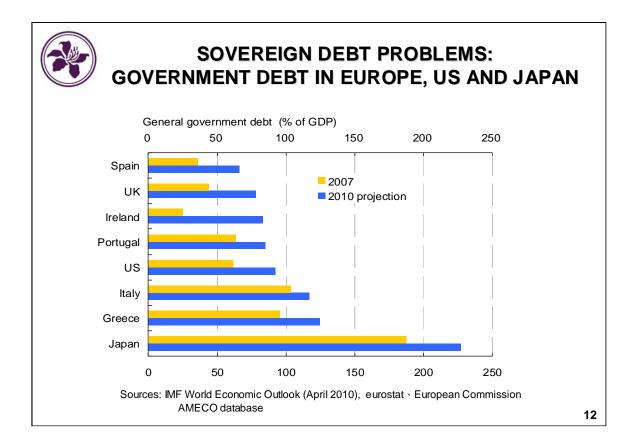








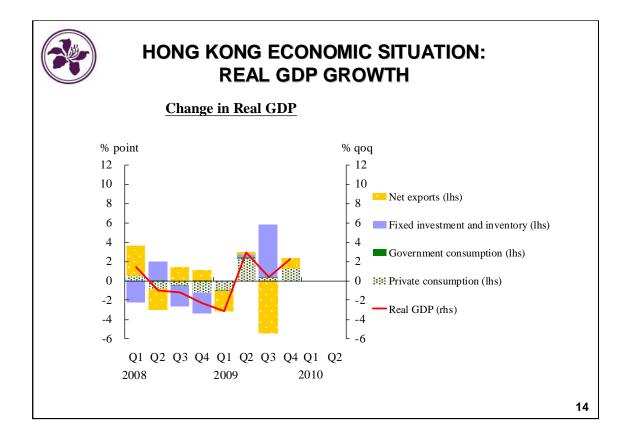


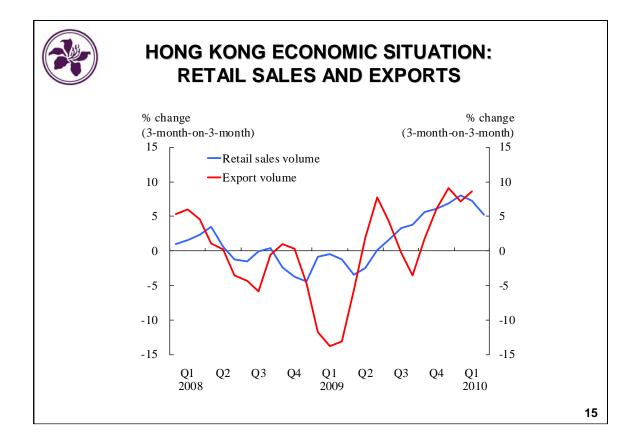


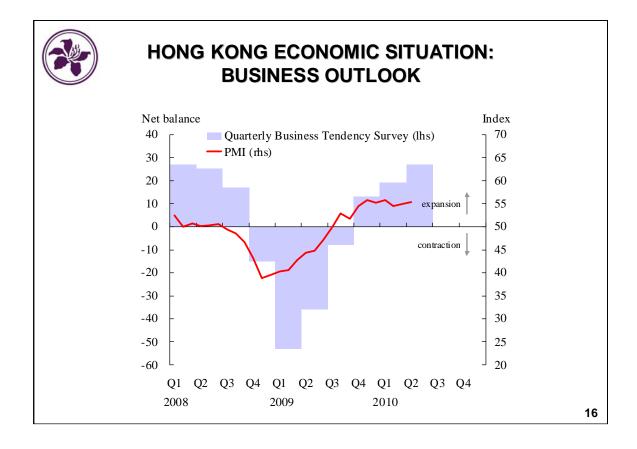


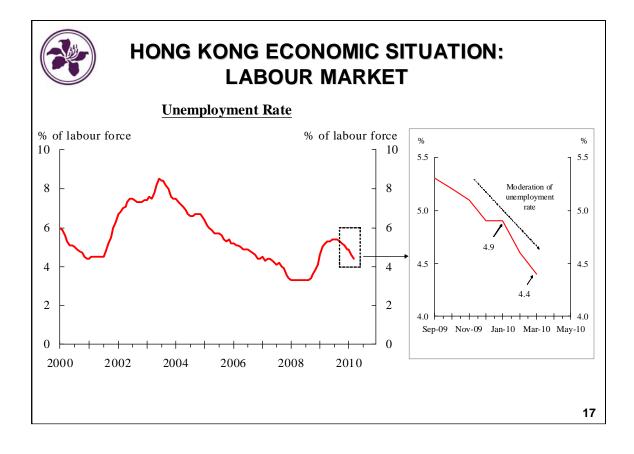
EU/IMF MEASURES TO AVERT A SOVEREIGN DEBT CRISIS IN EUROPE

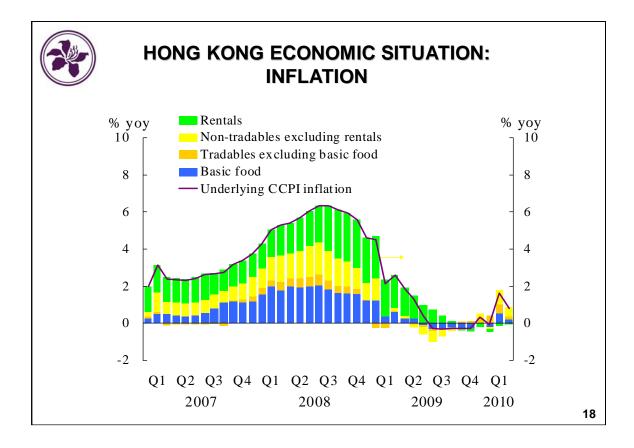
- Loans and guarantees up to €750 billion are provided to the EU members by the EU and the IMF (earlier EU and IMF has agreed to provide Greece with a financing package of €110 billion)
- European Central Bank to buy government and private bonds in the secondary market and provide up to 6-month liquidity to the European banking sector
- Re-open the US dollar liquidity swap facilities between the Federal Reserve and other major central banks

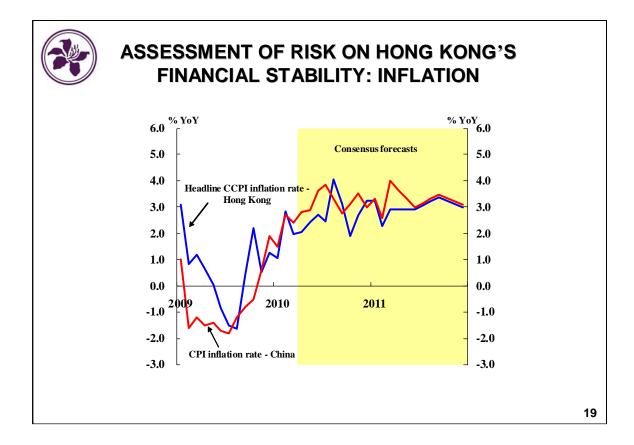


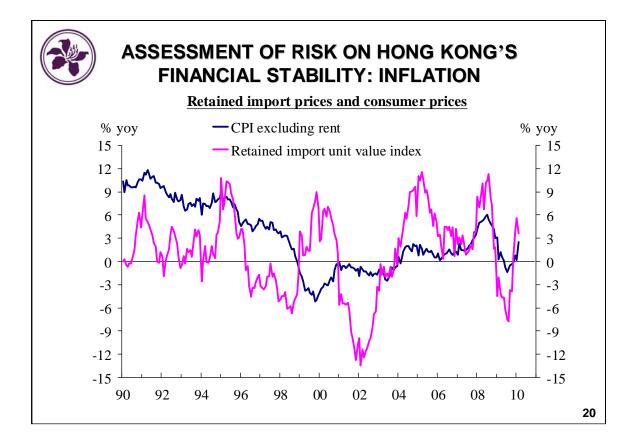


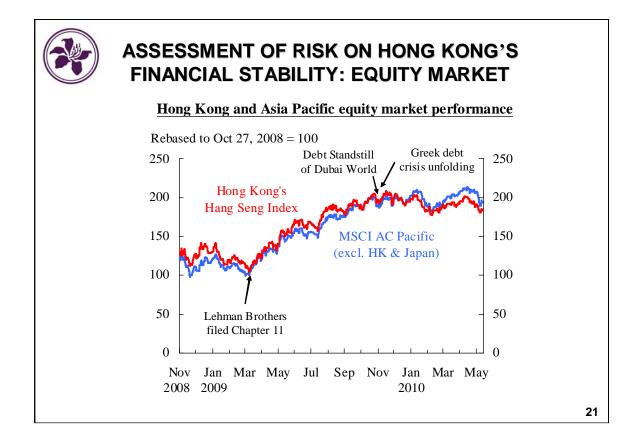


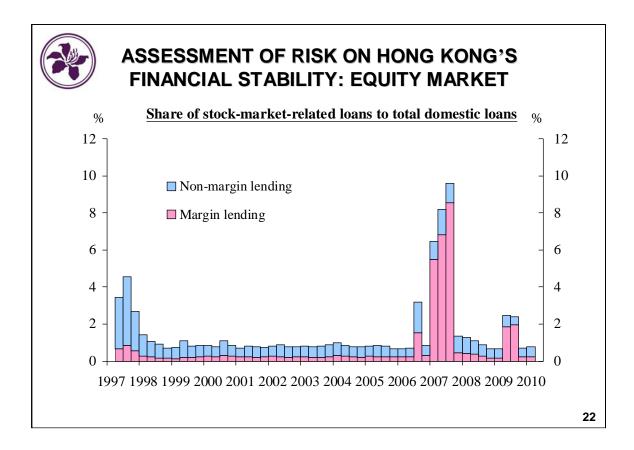


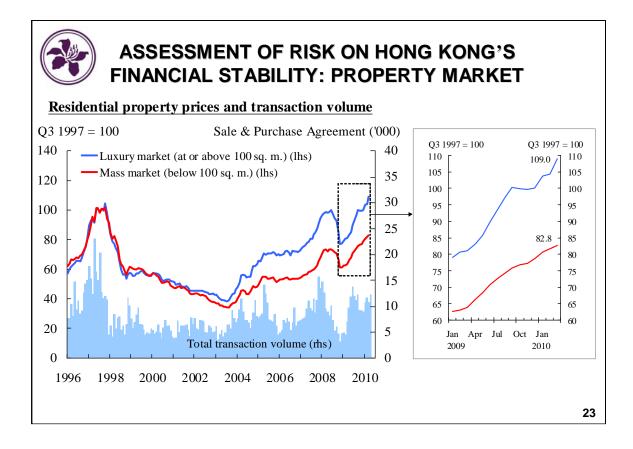


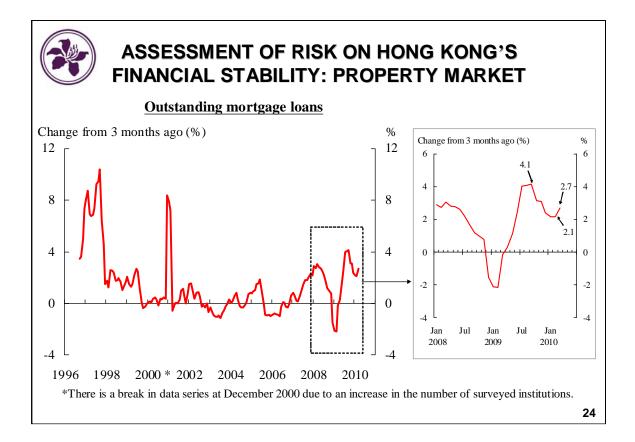


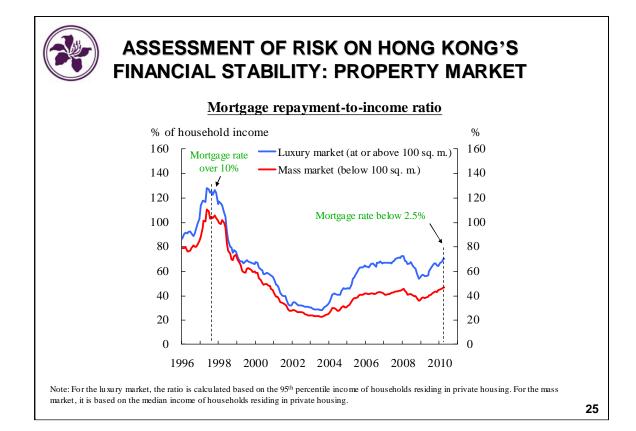








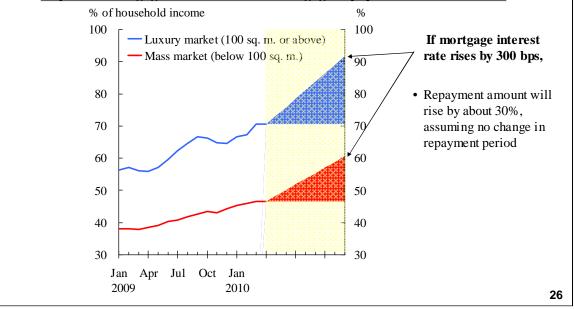


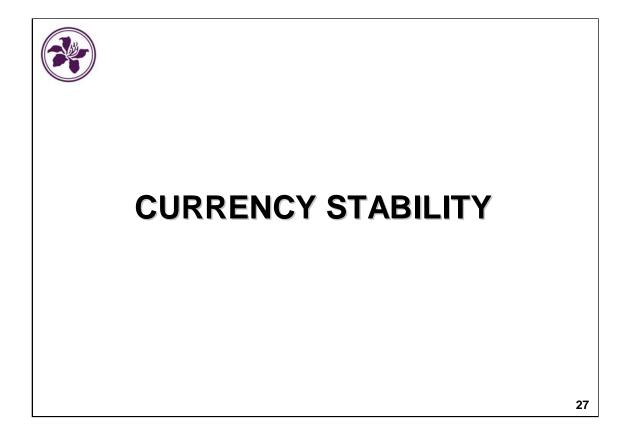


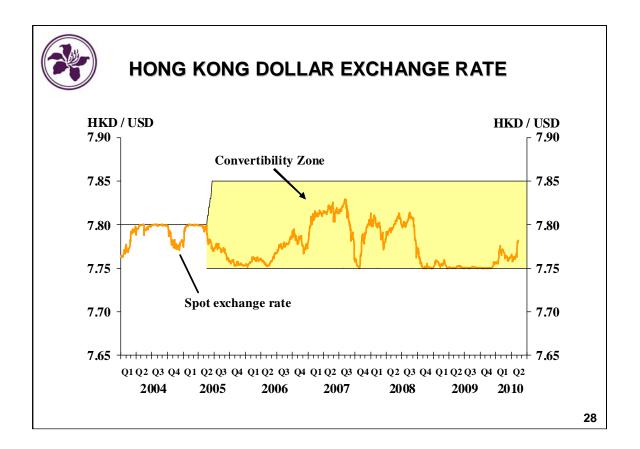


ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

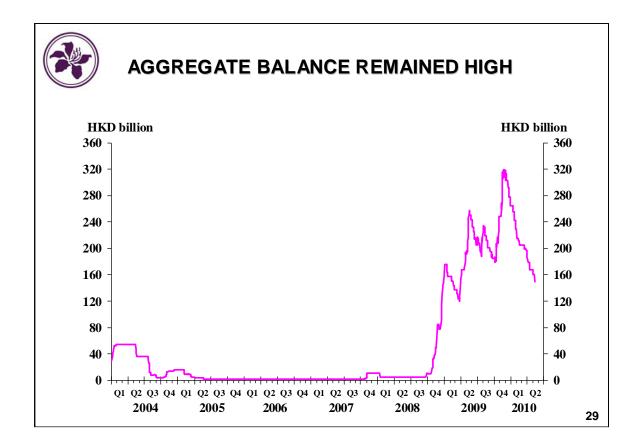
Impact of mortgage rate increase on mortgage repayment-to-income ratio



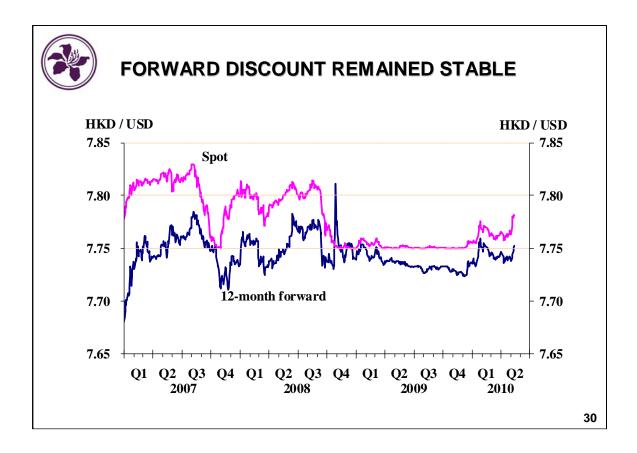


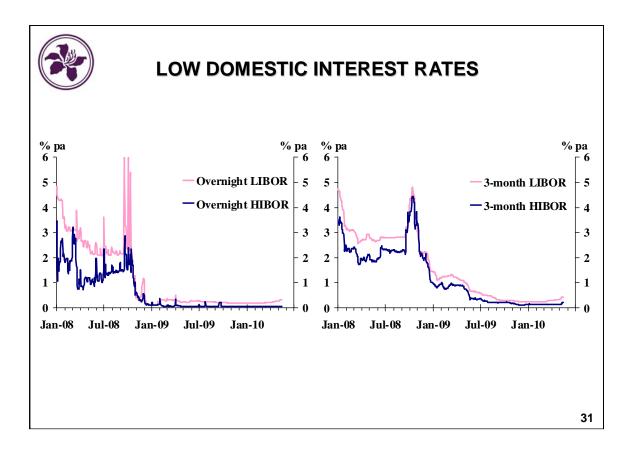


• The Hong Kong dollar eased slightly against the US dollar during the latter part of December 2009 through early February 2010, in the absence of net inflows alongside a consolidation in stock market. The strong-side Convertibility Undertaking has not been triggered during the period.

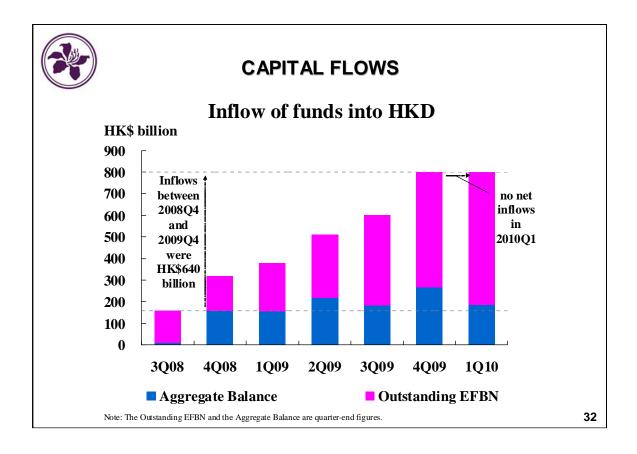


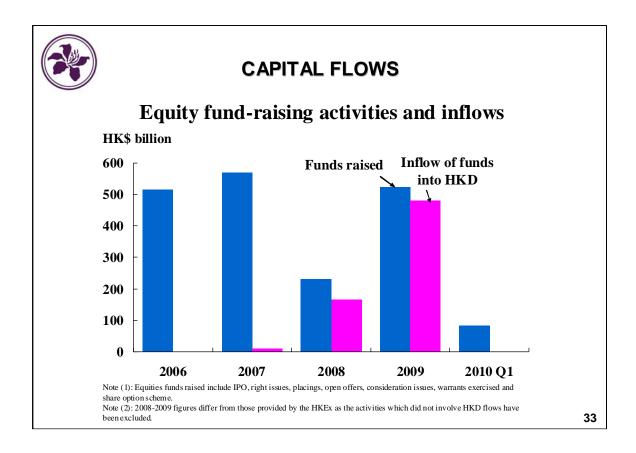
• The Aggregate Balance declined to HK\$148.6 billion by mid-May as more Exchange Fund Bills were issued to meet the continuing strong demand for the short-dated papers as manifested in the very low yields of such papers. Liquidity remained abundant in the interbank market.

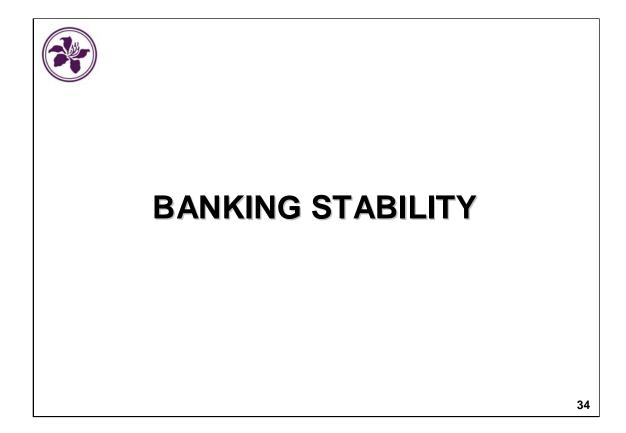


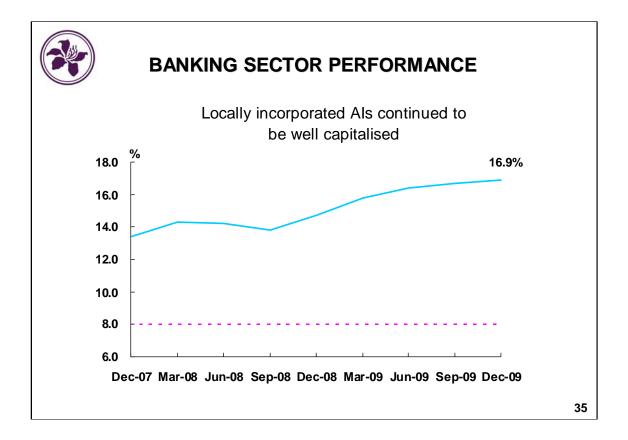


• As liquidity remained abundant, Hong Kong dollar interest rates were steady at near zero levels below their US dollar counterparts.

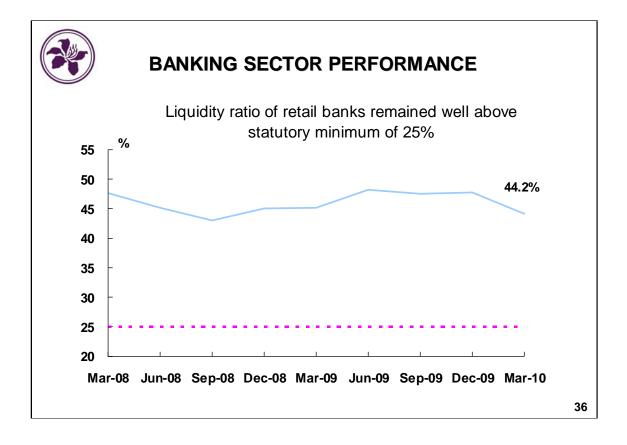


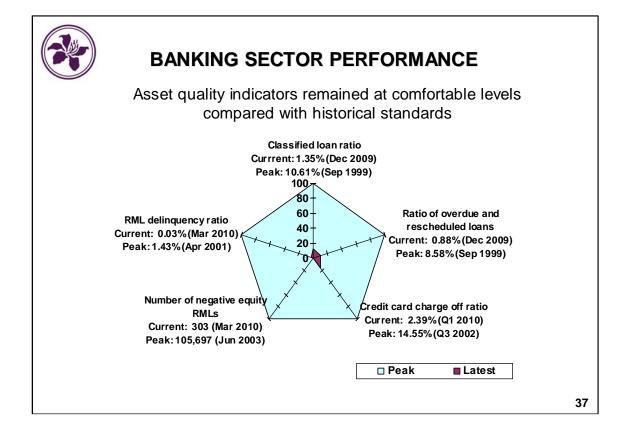




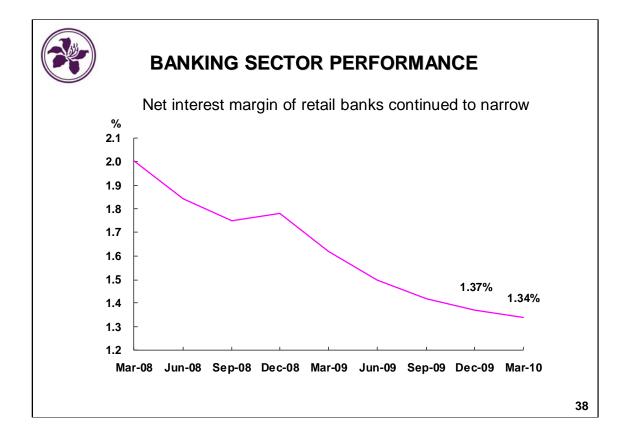


• The consolidated capital adequacy ratio of locally incorporated AIs rose to 16.9% at the end of December 2009, compared with 16.7% at the end of September 2009 and 14.7% at the end of December 2008. The ratio is not only well above the international standard of 8%, but is also notably higher than pre-crisis levels, reflecting banks' continuing focus on capital preservation.

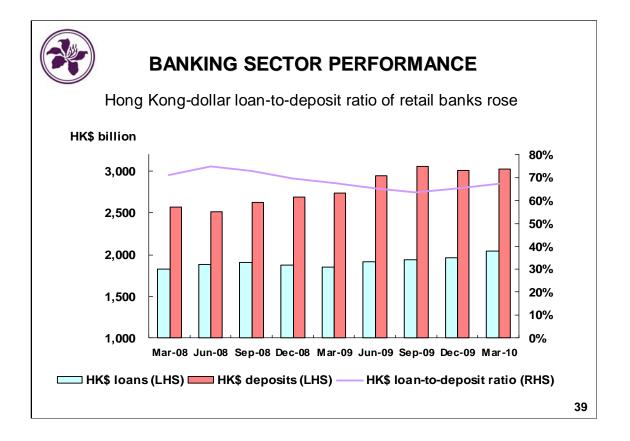




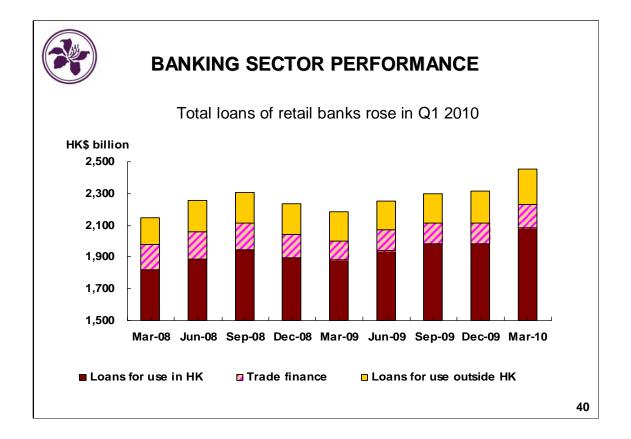
- Asset quality remains sound. Indeed the RML delinquency ratio and number of RMLs in negative equity in March were at record lows.
- Nevertheless, the HKMA will continue to monitor the quality of retail banks' loan portfolios closely because of the economic uncertainties following the global financial crisis.



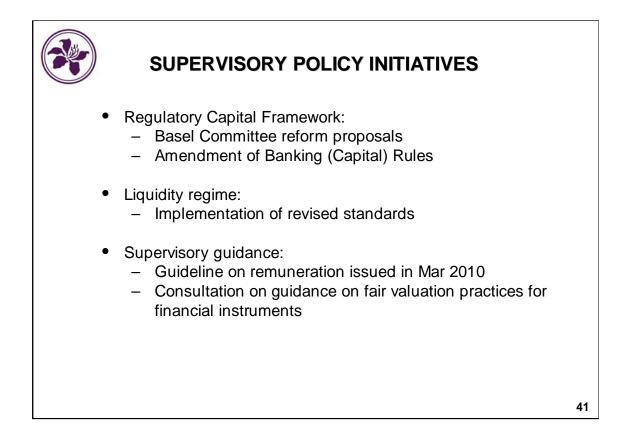
- The quarterly annualised net interest margin of retail banks continued to narrow to 1.34% in Q1 2010 from 1.37% in Q4 2009 as interest rates remain at unprecedentedly low levels and banks refrain from taking significant credit risks. Intense pricing competition, especially in the residential mortgage market, has also squeezed banks' interest margins.
- Nevertheless, the aggregate pre-tax operating profit of retail banks' Hong Kong offices rose by 13.6% in Q1 2010 compared with the same period in 2009, contributed mainly by improvements in investment and fees income and lower provisioning levels.



• The Hong Kong-dollar loan-to-deposit ratio of retail banks rose to 67.3% at the end of March 2010 from 65.2% at the end of December 2009. The increase was mainly due to growth in loans while deposits were relatively stable during the quarter.



• Retail banks' loan portfolios grew by 5.8% in the first quarter of 2010 due to the rising demand for credit. Loan growth was reported across major economic sectors, with property lending being a major driver.



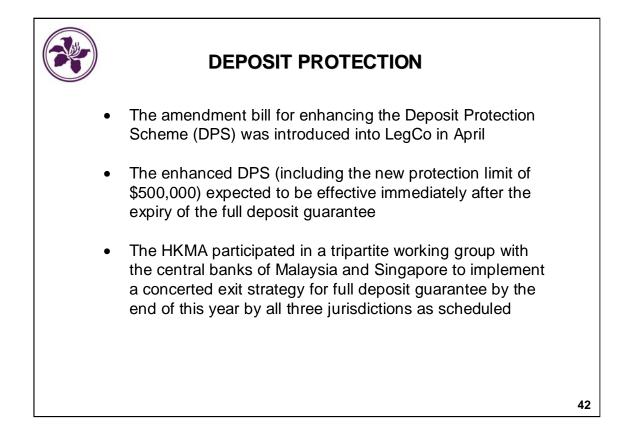
• <u>Regulatory Capital Framework</u>: Basel Committee's consultation on proposals to increase the level, quality and transparency of banks' capital and to produce global liquidity standards closed on 16 April 2010. The HKMA, as a member of the Committee, relayed local issues and concerns raised in discussions with various stakeholders back to the Committee. The Committee's aim is to develop a fully calibrated set of standards by the end of the year, to be phased into implementation by the end of 2012, as financial conditions improve and the economic recovery is assured.

To assist in this process, a quantitative impact study was launched in February 2010 and is currently still in progress. A number of Hong Kong banks are participating. The HKMA is also conducting a local impact study with a broader sample of banks to better assess the impact of the proposals on the local banking sector.

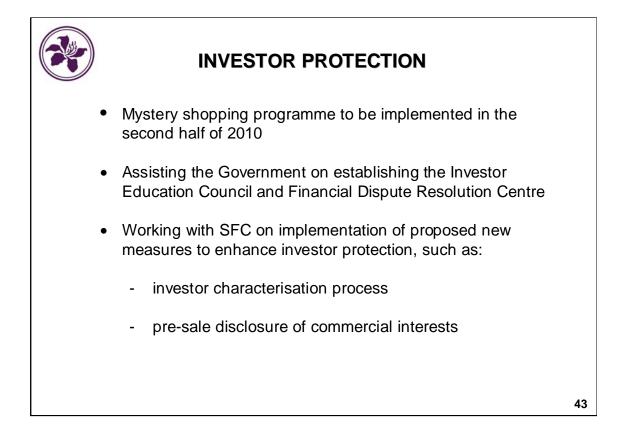
In due course, the HKMA will be updating the Banking (Capital) Rules in line with the new international capital standards, once agreed, taking into account local circumstances.

Meanwhile, the process of amending the Rules to reflect the enhancements already made by the Basel Committee, last July, in respect of the securitization and trading book frameworks continues, with the revised rules currently being drafted for implementation at the beginning of next year. This is in line with the Committee's proposed timeframe.

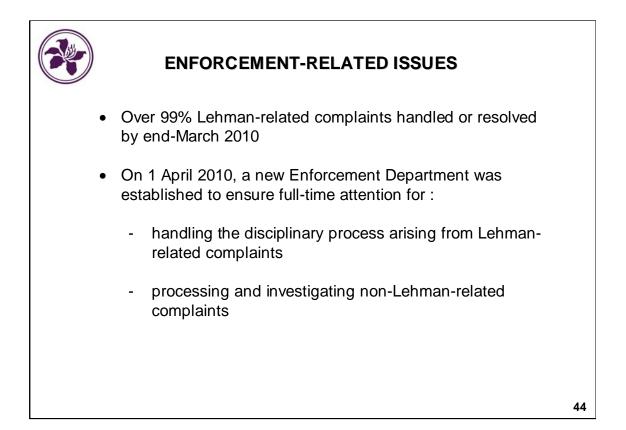
- <u>Revised liquidity standards</u>: The HKMA has revised its guidance on liquidity risk management standards, to implement the Basel Committee's *Principles for Sound Liquidity Risk Management and Supervision*. Following soft consultation with a number of banks, the draft guidance will be released shortly for formal industry consultation. The Basel Committee's Working Group on Liquidity is conducting a review to gauge the extent to which jurisdictions have implemented the *Sound Principles* in respect of liquidity risk supervision. The HKMA is participating in this review.
- <u>Remuneration guideline</u>: Following consultation with the industry associations, the HKMA issued the "Guideline on a Sound Remuneration System" in March 2010 to provide AIs with guidance for the development and operation of their remuneration systems in a manner consistent with effective risk management.
- <u>Fair value practices guidance</u>: The HKMA is updating its supervisory guidance on fair valuation practices for financial instruments, in recognition of the importance of fair value measurements for financial reporting, assessment of capital adequacy and internal risk management. The HKMA aims to issue the revised guidance shortly, after taking into account comments received from the industry consultation which closed at the end of April.



- The Deposit Protection Scheme (Amendment) Bill 2010 for effecting the enhancements to the DPS concluded in the DPS review last year was introduced into the LegCo on 21 April. The HKMA and the Deposit Protection Board (DPB) will render full support to the LegCo in scrutinising the Bill to facilitate an early passage of it.
- Subject to the progress on the legislative process, the enhanced DPS is targeted to take effect at the beginning of 2011, immediately after the expiry of the full deposit guarantee by the end of this year. Preparations are being made by the HKMA and the DPB to get the public and the industry ready for the transition.



- The HKMA and the SFC will engage a service provider to undertake a mystery shopping exercise covering the sales process of regulated entities in selling unlisted investment products. Preparatory work is underway and the fieldwork is expected to commence around July. A circular will be issued to inform the regulated entities of the launch of the programme.
- The Government's consultation on proposed establishment of an Investor Education Council and a Financial Dispute Resolution Centre ended on 8 May 2010. The HKMA supports the initiatives and will assist the Government with the implementation of the initiatives where appropriate.
- The HKMA has liaised with the SFC on formulating consultation conclusions of the SFC's proposed measures to enhance protection for the investing public, including the adoption of investor characterisation process and pre-sale disclosure of commercial interests. The two regulators will work together on the implementation of the new measures.



- Up to 6 May, out of the 21,603 Lehman-related complaints received:
 - 15,287 cases had been resolved under the Minibond Repurchase Scheme or through banks' enhanced complaint handling procedures
 - 2,783 cases were under disciplinary process
 - 2,561 cases had been closed because of insufficient evidence and grounds for disciplinary process
 - 775 cases were pending decision after investigatory process
 - 196 cases were still under investigation.

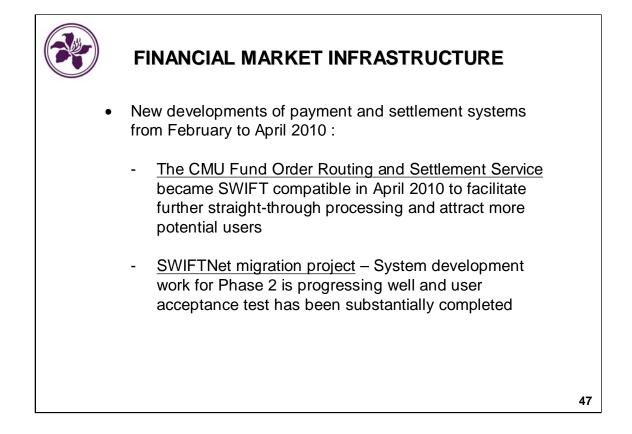




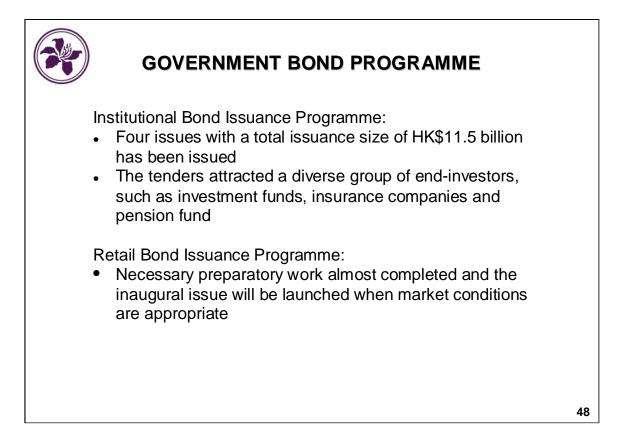
FINANCIAL MARKET INFRASTRUCTURE

Development strategy:

- Robust and efficient payment and settlement system is essential to monetary and financial stability important to ensure fault-proof day-to-day operation
- Business development Hong Kong as a settlement service utility centre to attract transaction banking business in the region



• The SWIFTNet migration project, which replaces the proprietary platform of Hong Kong's RTGS systems and CMU with an open platform, is being implemented in two phases. Phase 1, allowing banks to use SWIFT messages for payment instructions on the SWIFTNet platform, was launched in May 2009 as scheduled. Phase 2 is scheduled to launch on 12 July 2010. The banking industry welcomes the migration as it enhances the interoperability between Hong Kong's RTGS systems and the global platform, improving participating banks' operational efficiency and helping attract more overseas institutions to use Hong Kong's RTGS systems.



- 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 banking and equity markets.
- The GBP is a long-term programme comprising an Institutional Bond Issuance Programme and a Retail Bond Issuance Programme.
- The Institutional Bond Issuance Programme was launched in September 2009. HK\$11.5 billion worth of bonds have been issued:
 - HK\$3.5 billion of a 2-year bond in September 2009;
 - HK\$2.0 billion of a 5-year bond in November 2009;
 - HK\$2.5 billion of a 10-year bond in January 2010; and
 - HK\$3.5 billion of a 2-year bond in March 2010.
- The enlarged investor base 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.



DEVELOPMENT OF ISLAMIC FINANCE

Develop market infrastructure:

 Supporting the Government in drawing up legislative proposals for modifying Hong Kong's tax laws to level the playing field between Islamic and conventional financial products

Build international links and enhance international profile:

- Working closely with Bank Negara Malaysia to explore collaborative initiatives under the scope of the MoU
- Seeking to forge closer ties with international Islamic organisations

Promote market awareness:

Continue to participate in regional seminars and conferences and provide training to the industry

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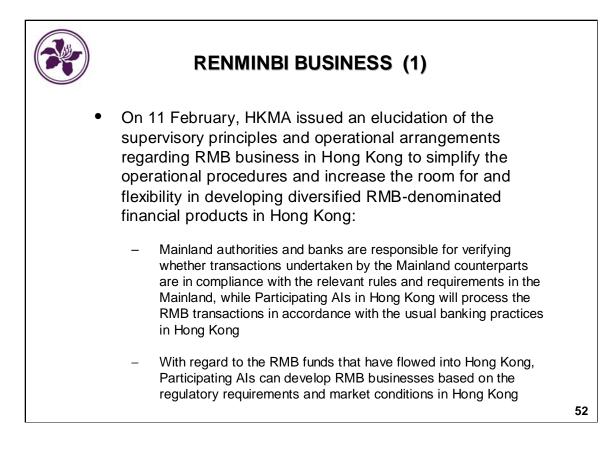
• The HKMA together with the Financial Secretary had a high-level Islamic finance roundtable discussion in Malaysia in March with the regulators and major market players in Malaysia to explore and discuss areas of co-operation, including the development of financial infrastructure, strengthening of financial ties, cross-border business opportunities and human capital development in Islamic finance.



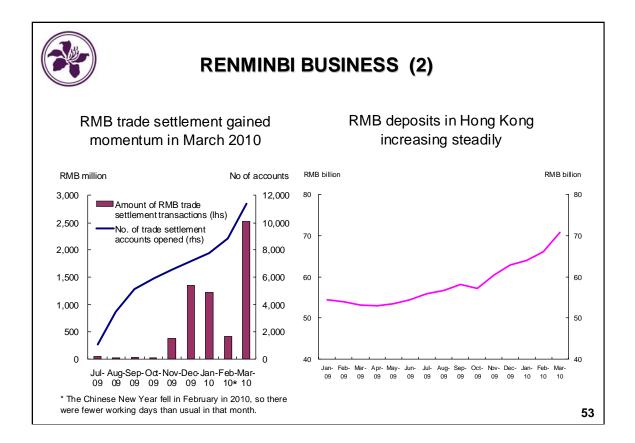
HONG KONG AS AN INTERNATIONAL FNANCIAL CENTRE



- Work continues to be underway at the FSB to implement the G20 recommendations for strengthening financial stability. These include the completion of the FSB thematic review on the implementation of the FSB *Principles for Sound Compensation Practices* and *Implementation Standards* in March.
- With a total amount of US\$120 billion, the CMIM aims to supplement existing international financial arrangements and guard against financial contagion in the region.
- The multi-region macroeconomic model developed for EMEAP by the HKMA has been used to conduct scenario analyses for EMEAP Monetary and Financial Stability Committee.



• The circular also clarifies the operational arrangements in respect of account opening, remittance and financing for corporate customers. The range of eligible issuers, issue arrangements, and target investors in relation to RMB bonds in Hong Kong are to be determined in accordance with the usual applicable regulations and market conditions in Hong Kong.



- The number of Hong Kong authorized institutions engaging in RMB trade settlement business increased to 64 at the end of March 2010 from 52 at the end of December 2009.
- The number of overseas banks which had signed the clearing agreement with the Hong Kong Clearing Bank increased from 15 at the end of December 2009 to 30 at the end of March 2010.
- The amount of trade transactions settled in RMB increased markedly to RMB2.5 billion yuan in March 2010, compared with a total amount of RMB1.6 billion yuan for January and February together.
- At the end of March 2010, RMB deposits amounted to RMB 70.8 billion yuan.

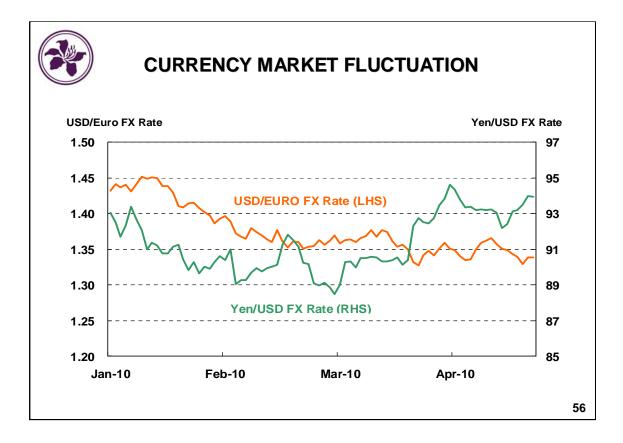


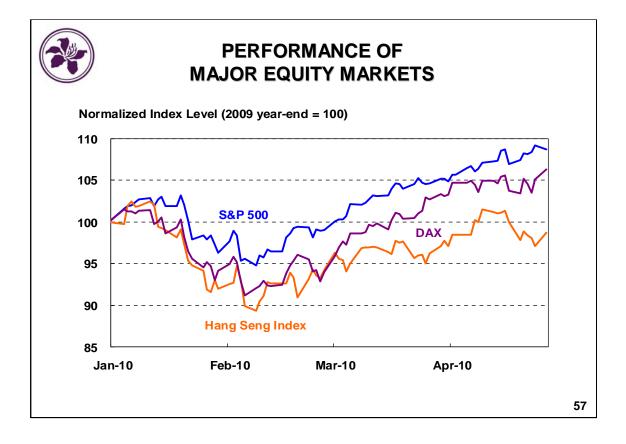
INVESTMENT ENVIRONMENT AND PERFORMANCE OF THE EXCHANGE FUND

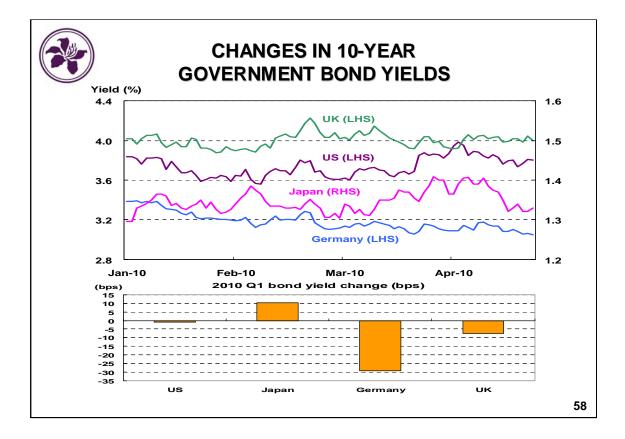


INVESTMENT ENVIRONMENT IN Q1 2010

- Exchange rates: US dollar strengthened against major currencies due to faster economic recovery in the US than other major developed countries and the debt crisis in Greece.
- Equity markets: Major equity markets dropped during January as investors remained cautious in the beginning of the year due to Greece's debt crisis and uncertainties on the eventual exit strategies of major central banks. Investors turned positive as the Federal Reserve indicated the maintenance of accommodative monetary policy. Equity markets rebounded since February.
- Interest rates: With extended period of accommodative monetary policy, US government bond yields stayed in a narrow range. Government bond yields in core European countries declined.







INVESTMENT INCOME								
	2010	2009	2008	2007				
(HK\$ billion)	Q1 *	Full Year	Full Year	Full Year				
Gain/(Loss) on Hong Kong equities^® Gain/(Loss) on other equities^		48.9 48.8	(77.9) (73.1)	55.8 6.7				
Exchange gain/(loss)		9.8	(12.4)	18.7				
Return from bonds#		<u>(0.6)</u>	<u>88.4</u>	<u>61.0</u>				
Investment income/(loss)@		106.9	(75.0)	142.2				
 * Unaudited figures ^ Including dividends # Including interest 								
[®] Excluding valuation changes in Strategic Portfolio				59				



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

	2010	◀		_ 2009_		→ I
(HK\$ billion)	Q1*	Full year	Q4	Q3	Q2	Q1
Investment income/(loss)		106.9	10.0	71.9	58.5	(33.5)
Other income		0.2	0.0	0.0	0.2	0.0
Interest and other expenses		<u>(3.8)</u>	<u>(1.0)</u>	<u>(0.9)</u>	<u>(1.2)</u>	<u>(0.7)</u>
Net investment income/(loss)		103.3	9.0	71.0	57.5	(34.2)
Payment to Fiscal Reserves #		(33.5)	(7.9)	(8.0)	(8.5)	(9.1)
Payment to HKSAR government funds and statutory bodies #		(1.2)	(0.6)	(0.3)	(0.3)	0.0
Valuation change of Strategic Portfolio^		4.4	0.0	<u>1.3</u>	3.2	<u>(0.1)</u>
Increase/(Decrease) in EF Accumulated Surplus		73.0	0.5	64.0	51.9	(43.4)
* Unaudited figures						
# The fixed rate of fee payment is 6.3% for 2010 and 6.8% for 2009						
 Including dividends 						60

	н	ISTORICA	_ INVES	TMENT II	NCOME		
)	(HK\$ billio	on)					
	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*	106.9	10.0	71.9	58.5	(33.5)	
	2010*#	N/A	N/A	N/A	N/A		
		ng valuation char æd figures	nges in the S	trategic Portfo	lio		
		~					61

EXCHANGE FUND ABRIDGED BALANCE SHEET							
(HK\$ billion)	At 31 Mar 2010*	At 31 Dec 2009	At 31 Dec 2008				
ASSETS							
Deposits		126.3	172.8				
Debt securities		1,637.6	1,151.3				
Hong Kong equities		142.9	92.9				
Other equities		214.9	103.3				
Other assets		27.7	40.0				
Total assets		2,149.4	1,560.3 ======				
LIABILITIES AND FUND EQUITY							
Certificates of Indebtedness		199.0	176.1				
Government-issued currency notes & coins in circulation		8.4	8.3				
Balance of the banking system		264.6	158.0				
Exchange Fund Bills and Notes		536.4	162.5				
Placements by banks and other financial institutions		28.3	13.6				
Placements by Fiscal Reserves		504.1	531.4				
Placements by HKSAR government funds and statutory bodies	S	41.8	0.1				
Other liabilities		13.3	29.8				
Total liabilities		1,595.9	1,079.8				
Accumulated Surplus		553.5	480.5				
Total liabilities and fund equity		2,149.4	1,560.3				
* Unaudited figures				62			