HONG KONG MONETARY AUTHORITY

CB(1)217/10-11(03)

Briefing to the Legislative Council Panel on Financial Affairs

1 November 2010

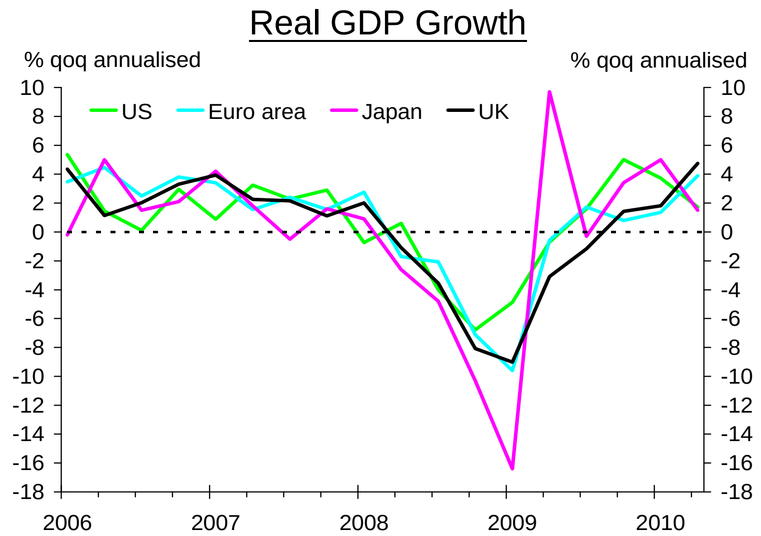
DISCUSSION TOPICS

Updates on

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

FINANCIAL AND ECONOMIC CONDITIONS

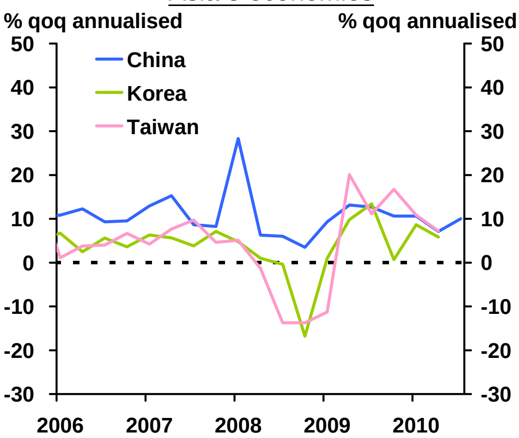
GLOBAL ECONOMIC CONDITIONS



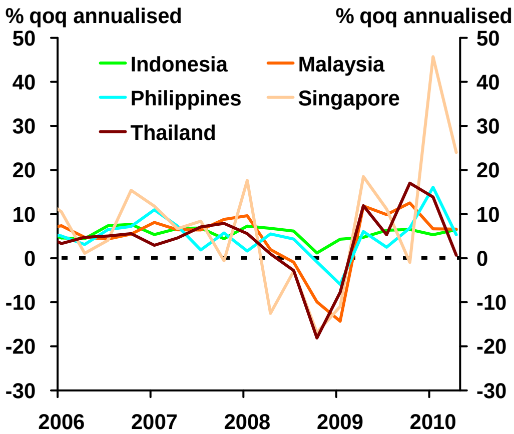
Source: Bloomberg

ECONOMIC CONDITIONS IN EMERGING ASIA

Real GDP Growth: Northeast Asia 3 economies

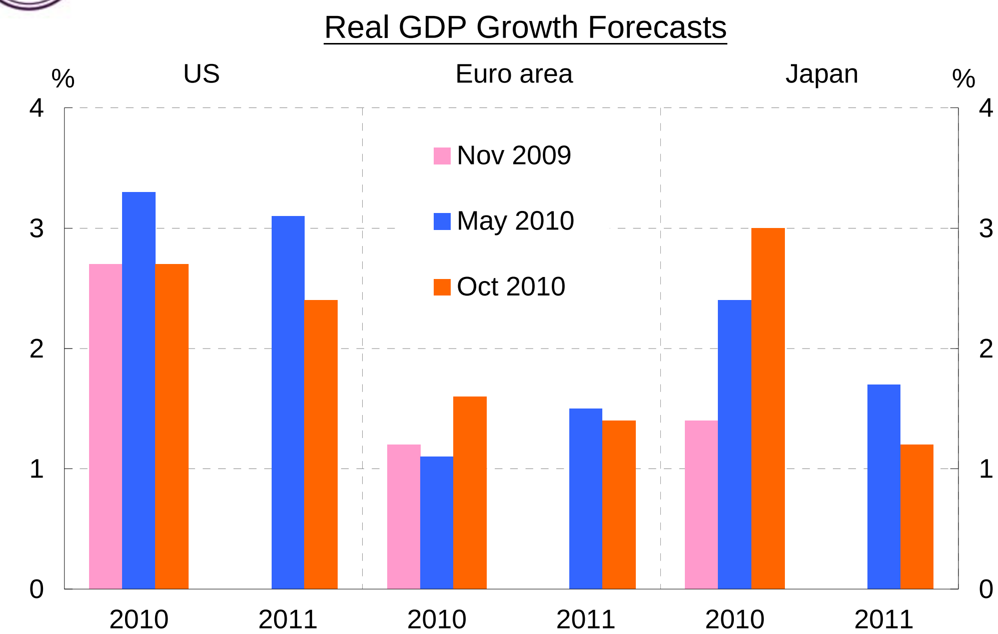


Real GDP Growth: ASEAN-5



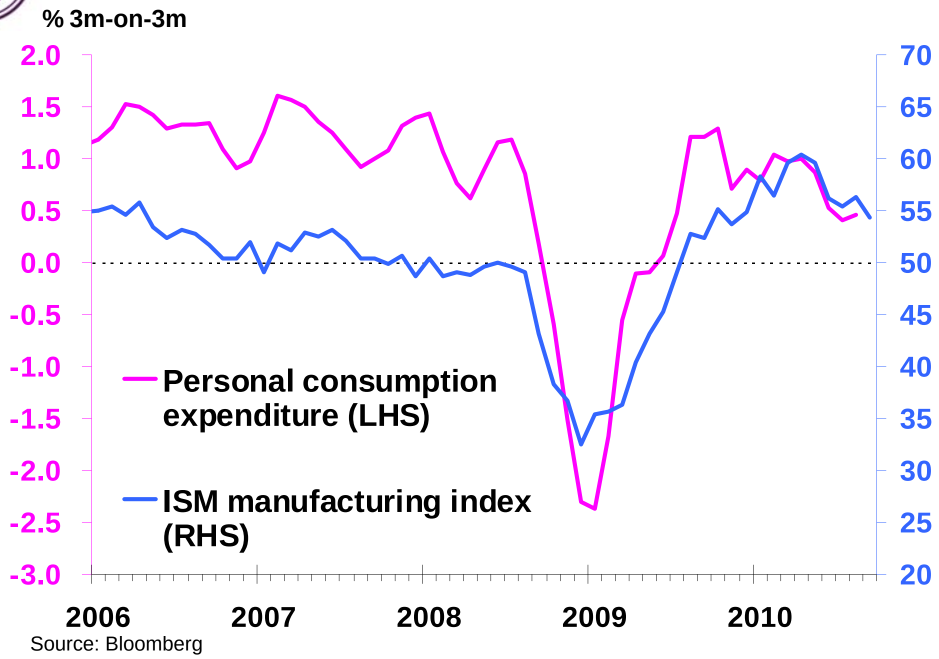
Source: CEIC

GLOBAL ECONOMIC GROWTH FORECASTS



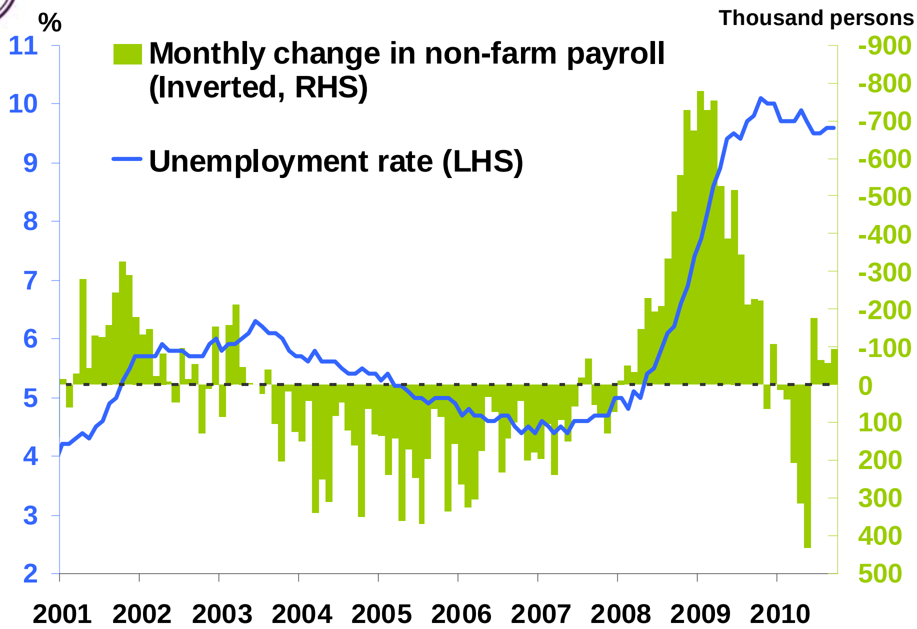
Source: Consensus Forecasts (Nov 2009 and May and Oct 2010)

GROWTH MOMENTUM IS WEAKENING IN THE US



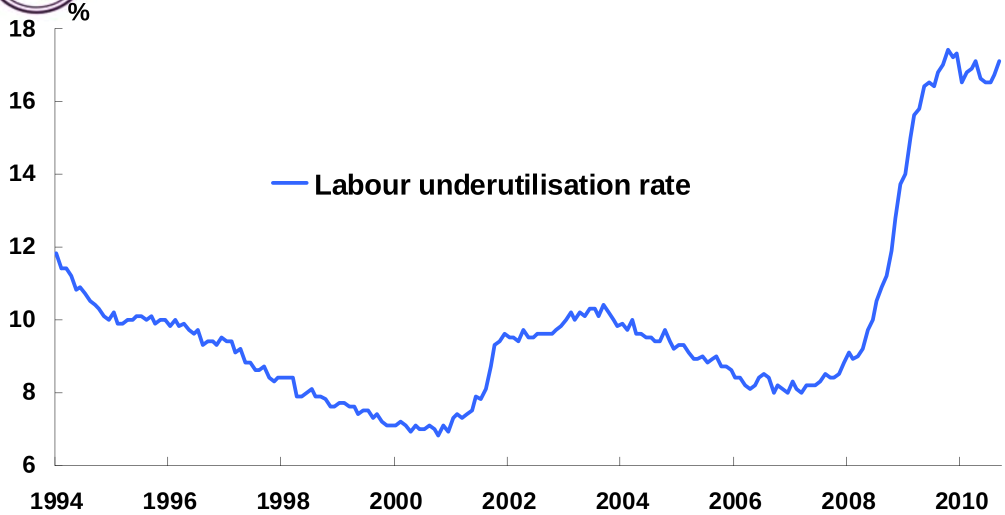
Source: Bloomberg

US LABOUR MARKET



Source: CEIC

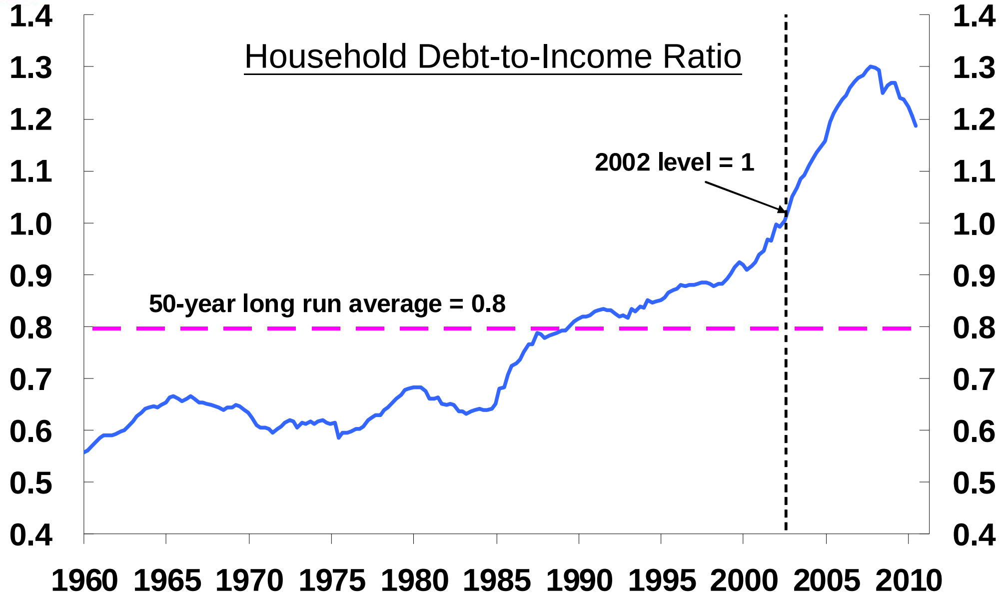
US HIDDEN UNEMPLOYMENT: LABOUR UNDERUTILISATION RATE



Labour underutilisation rate: Include total number of unemployed, plus persons who have not been looking for work for the 4 weeks preceding the survey, but currently want a job and are available for work, plus part time workers who want but unavailable to secure full time employment; as percentage of total labour force that includes the aforementioned categories of persons.

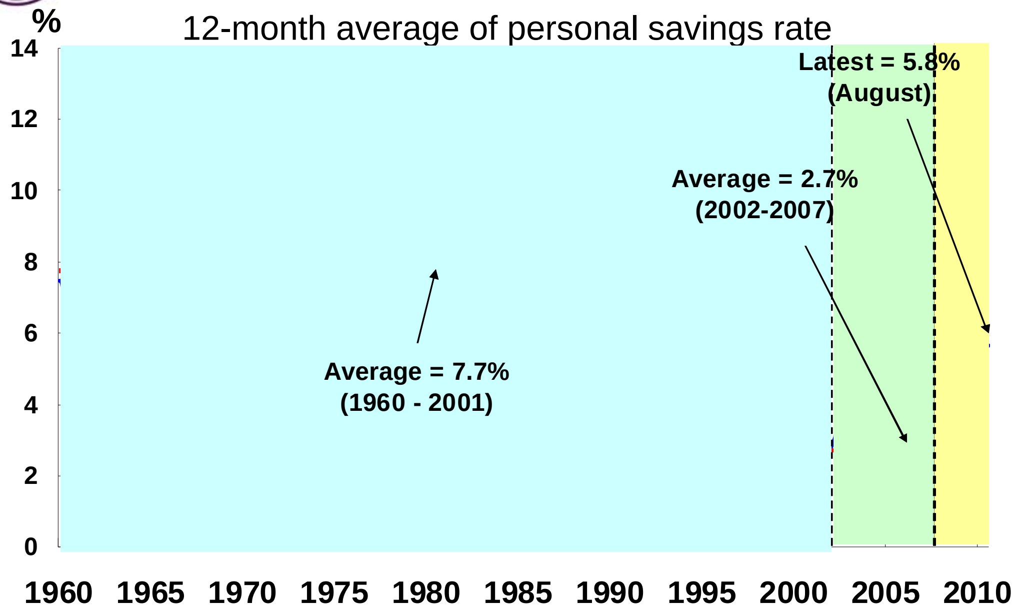
Source: CEIC

US HOUSEHOLD DEBT



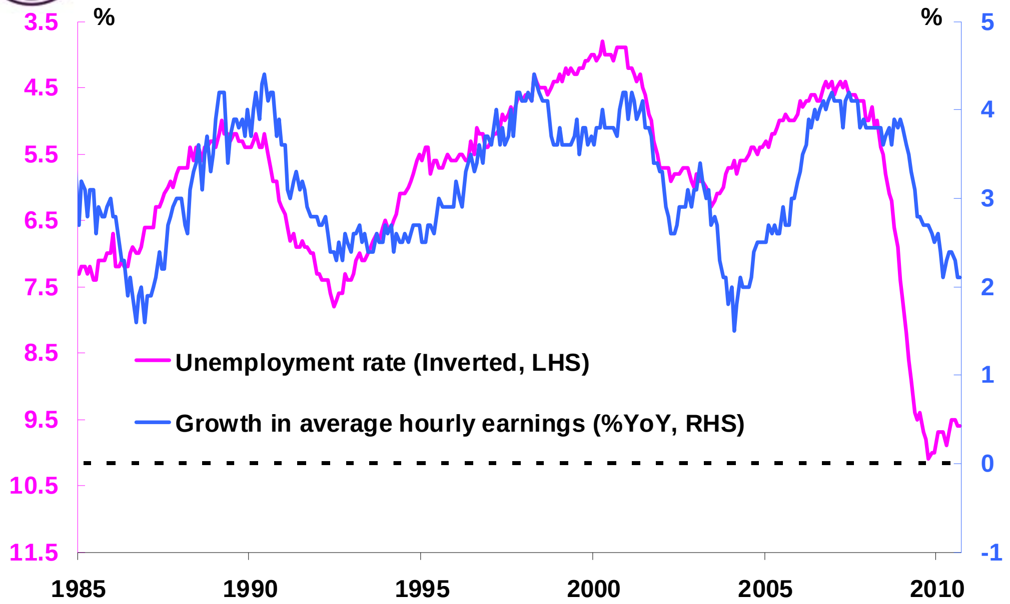
Source: CEIC

US PERSONAL SAVINGS RATE

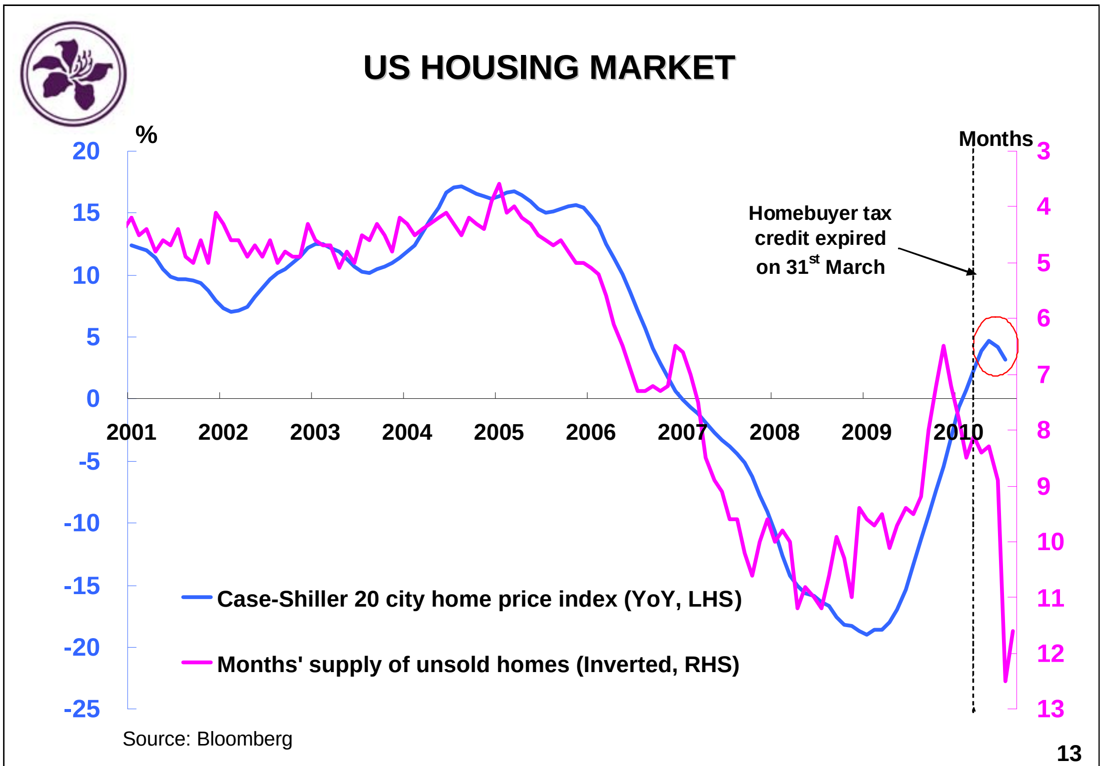


Source: CEIC, NBER

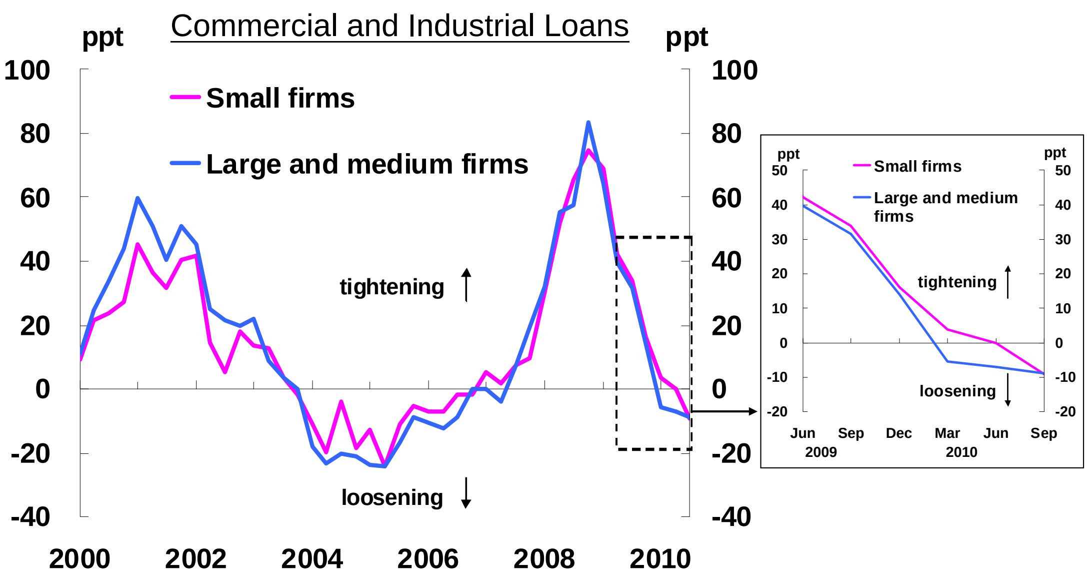
US INCOME GROWTH AND UNEMPLOYMENT RATE



Source: Bloomberg

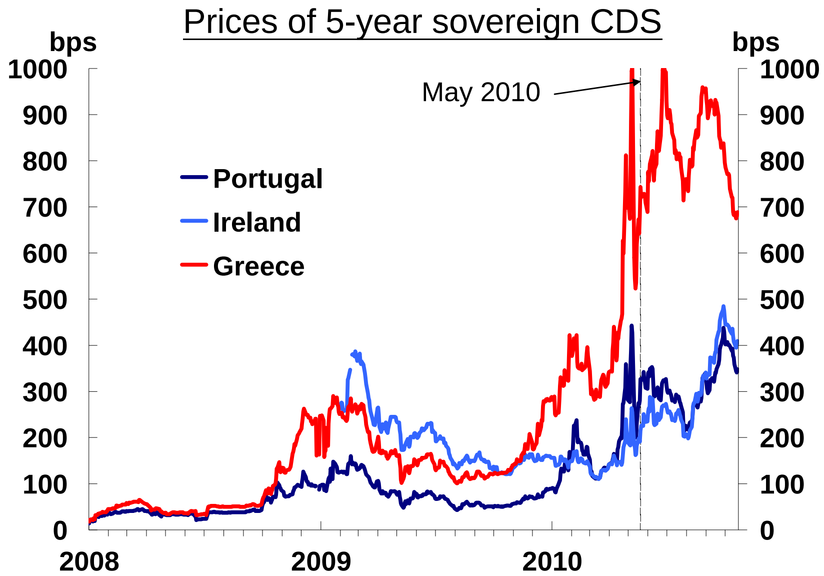

US HOUSING MARKET
%
Months
Homebuyer tax credit expired on 31st March
Case-Shiller 20 city home price index (YoY, LHS)
Months' supply of unsold homes (Inverted, RHS)
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
Source: Bloomberg

US CREDIT CONDITION



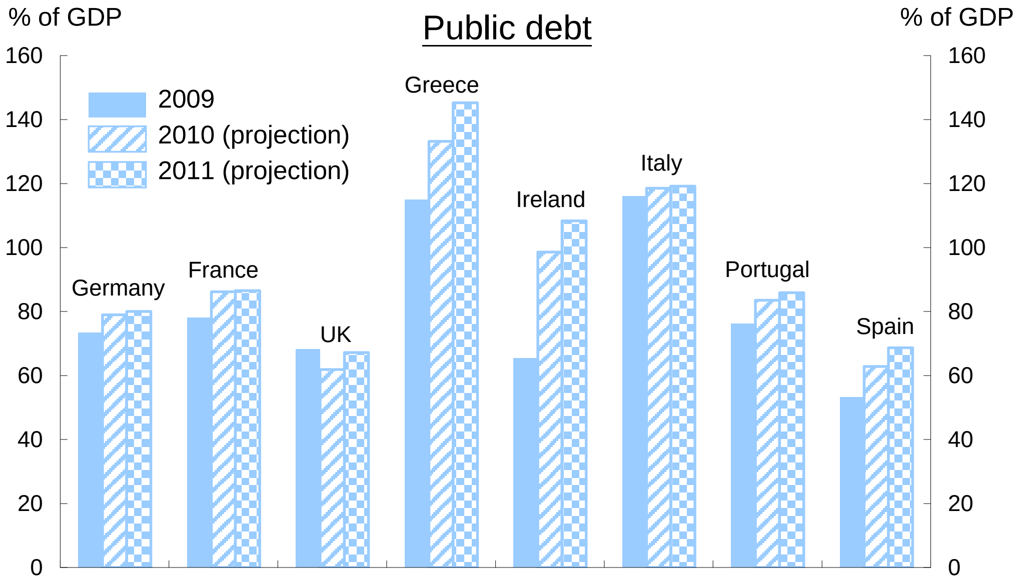
Source: Federal Reserve, Senior Loan Officer Survey

EUROPEAN SOVEREIGN DEBT PROBLEMS: CDS SPREADS



Source: Bloomberg

EUROPEAN SOVEREIGN DEBT PROBLEMS: PUBLIC DEBT CONTINUES TO INCREASE



Source: National sources, Eurostats, IMF, major press and staff estimations.

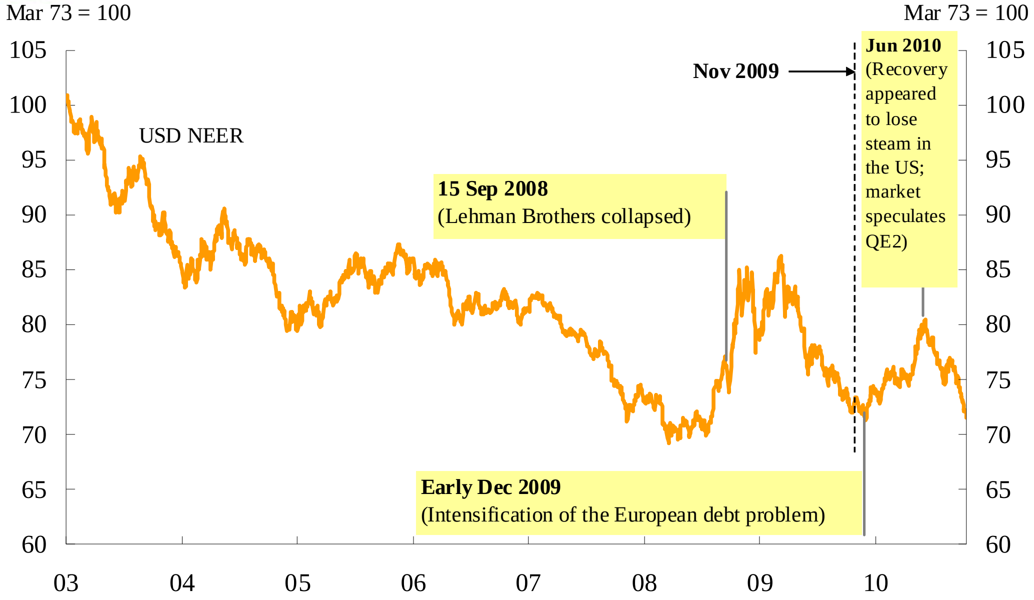
MAJOR CENTRAL BANKS CONTINUE TO IMPLEMENT QUANTITATIVE EASING MEASURES

Change in the Size of Balance Sheets

	Before QE[1]	Latest[2]	Change (%)	Latest monetary policy statement
US Fed (USD billion)	909 (6.3%)	2,302 (15.7%)	153.2	prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate (22/9)
Bank of England (GBP billion)	93 (6.4%)	245 (16.7%)	162.8	will continue to offer to purchase high-quality private sector assets on behalf of the Treasury, financed by the issue of Treasury bills (7/10)
Bank of Japan (JPY1,000 billion)	110 (21.8%)	121 (25.4%)	10.0	will examine establishing a program to purchase government securities and other financial assets, the size of the program will be about 5 trillion yen (5/10)

1. As of around end-August 2008. 2. As of around end-September 2010. 3. Figures in brackets are ratio to GDP.
Source: Websites of various central banks.

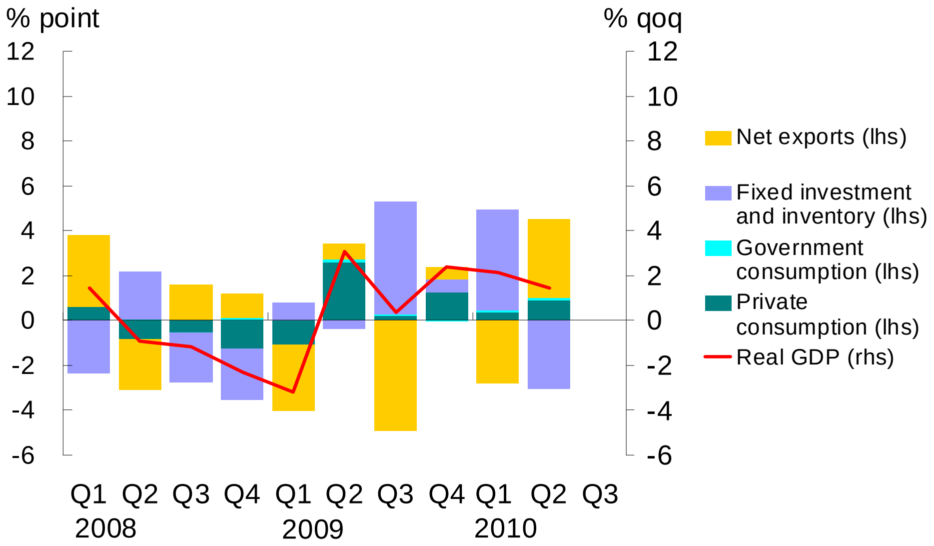
USD NEER



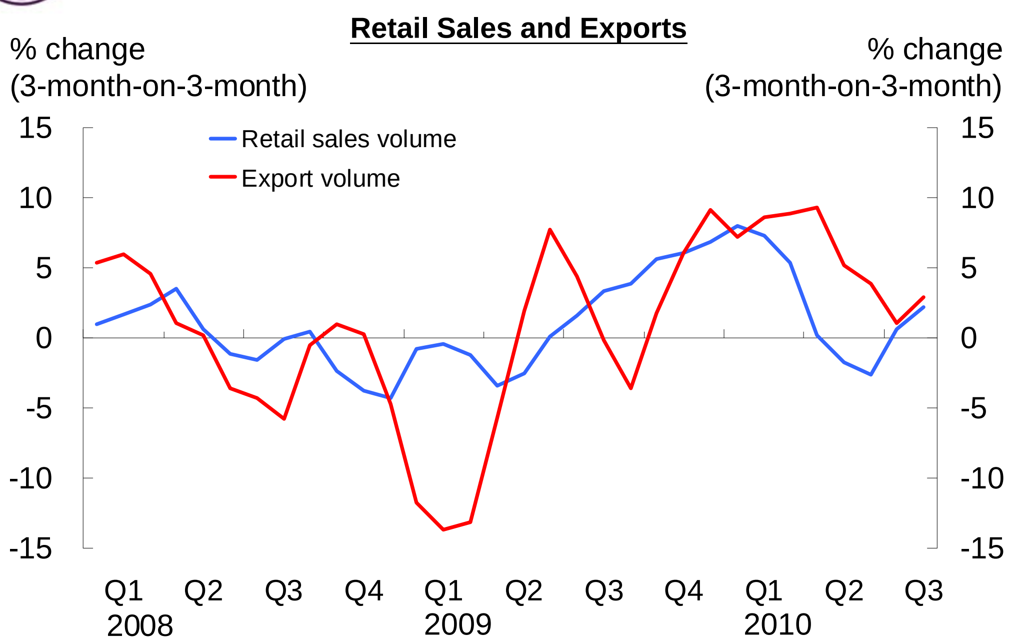
Source: EcoWin

HONG KONG ECONOMIC SITUATION

Change in Real GDP

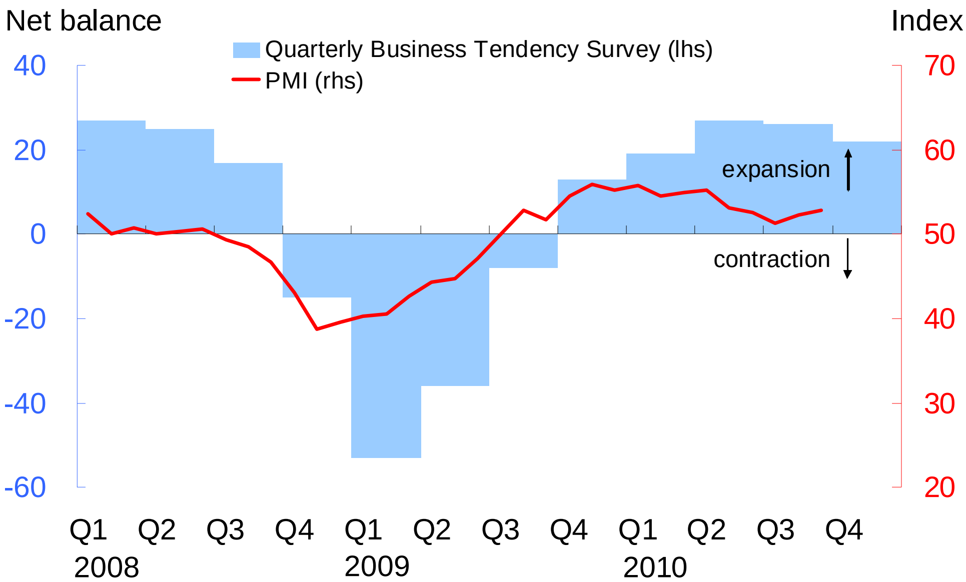


HONG KONG ECONOMIC SITUATION



HONG KONG ECONOMIC SITUATION

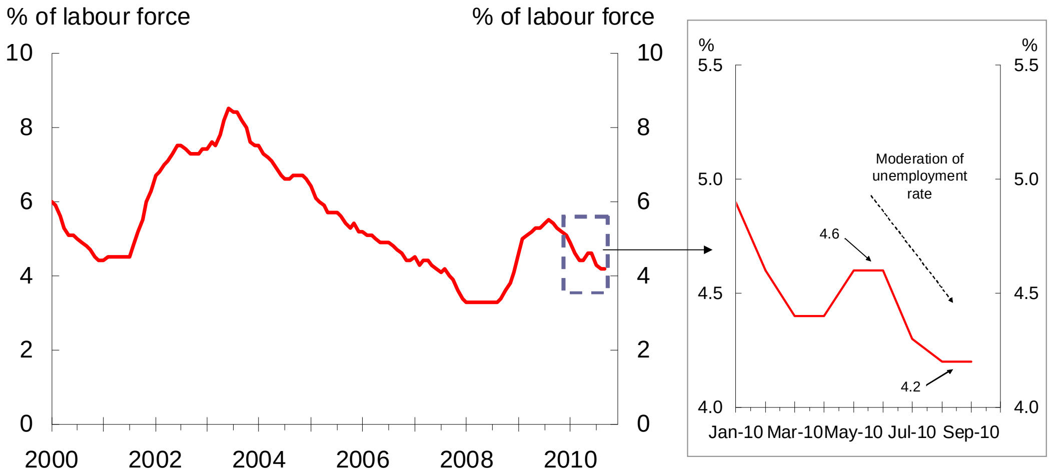
Business Outlook



HONG KONG ECONOMIC SITUATION

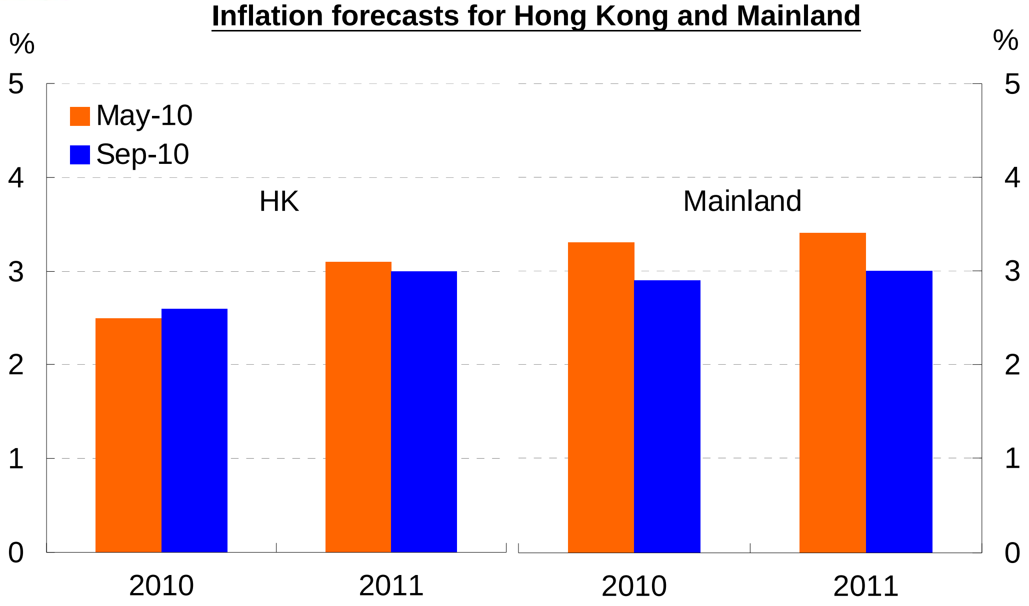
Labour Market

Unemployment rate



ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: INFLATION

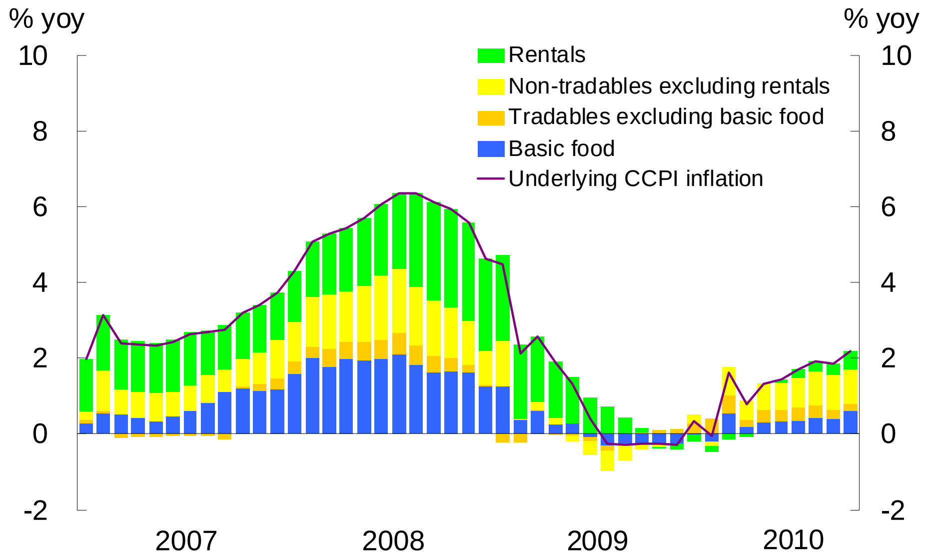
Inflation forecasts for Hong Kong and Mainland



Source：Consensus Forecast (May and Sep 2010)

ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: INFLATION

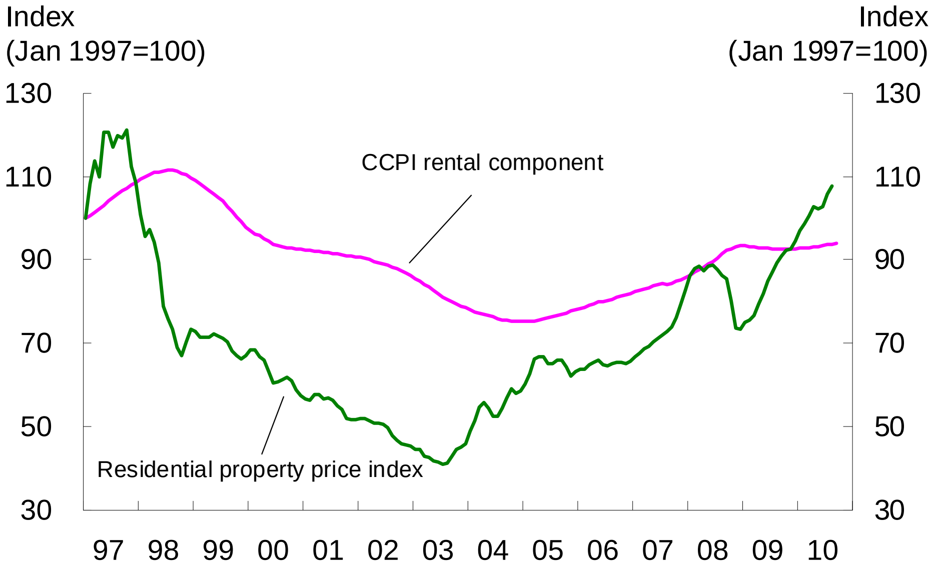
Underlying inflation and contributions of its components



Underlying inflation: Netting out the effects of all Government's one-off relief measures from headline inflation.

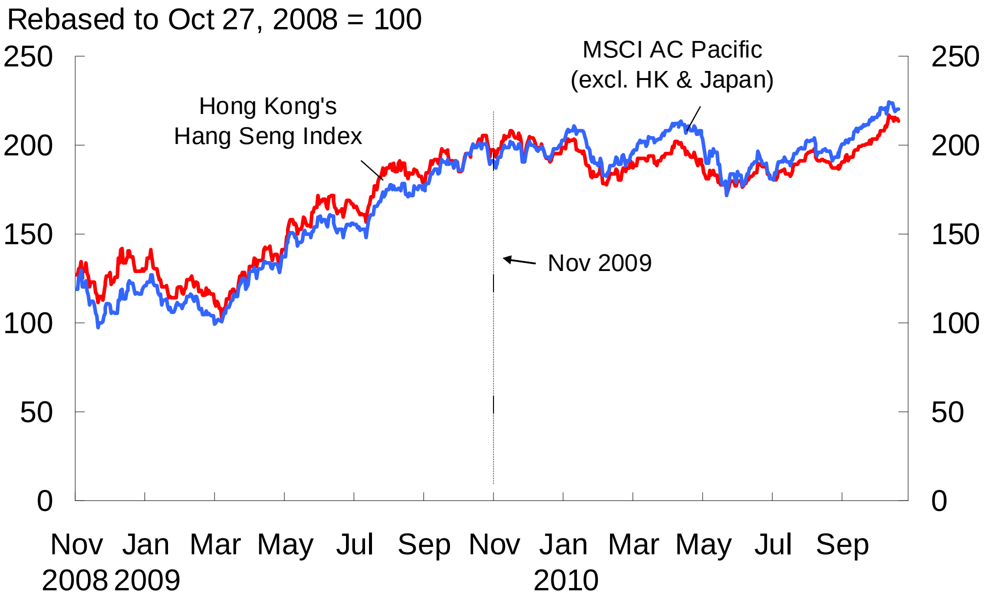
ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: INFLATION

CCPI rental component and residential property price index

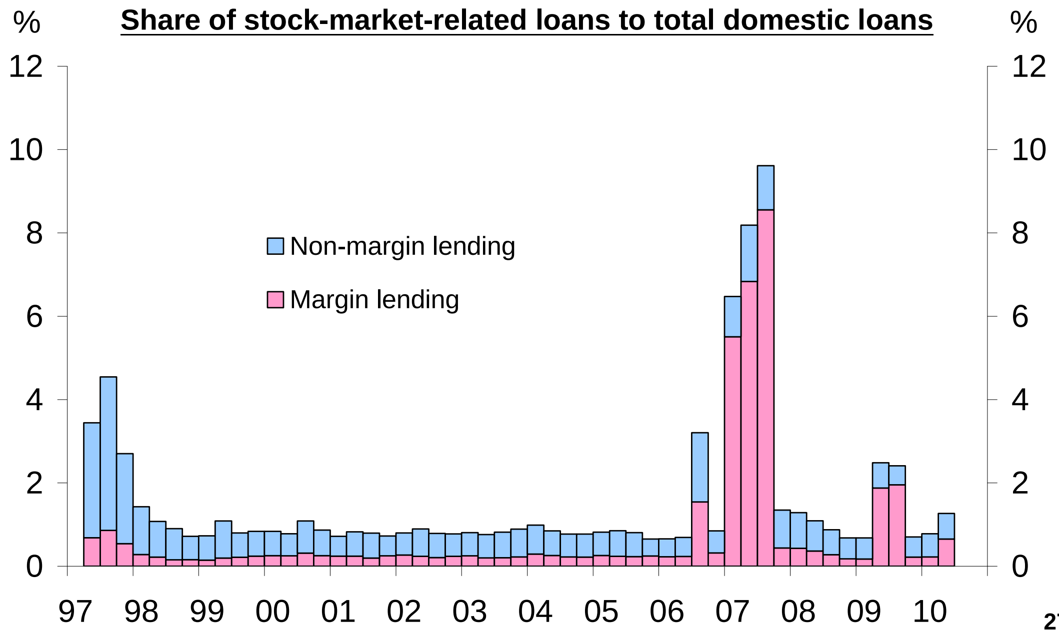


ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: EQUITY MARKET

Hong Kong and Asia Pacific equity market performance

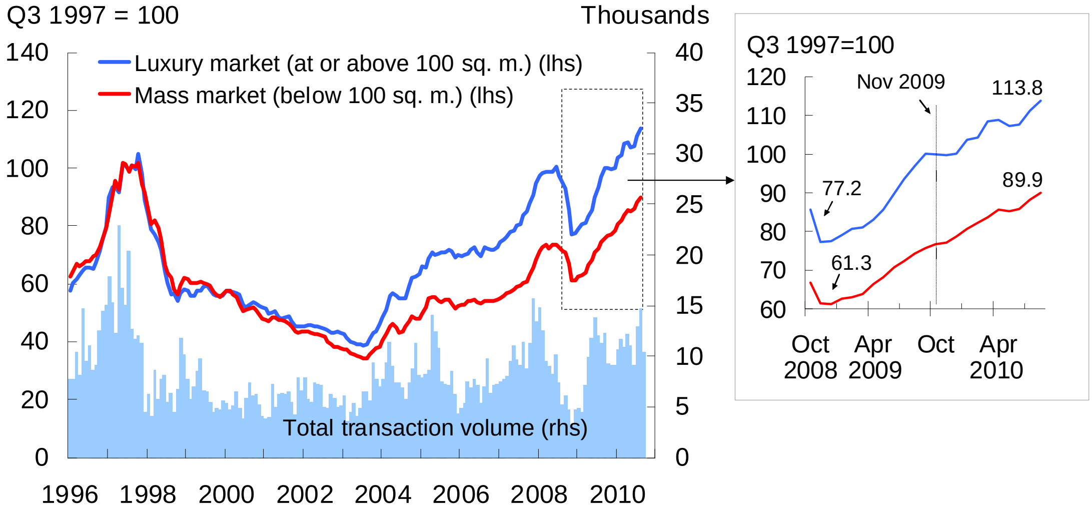


ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: EQUITY MARKET

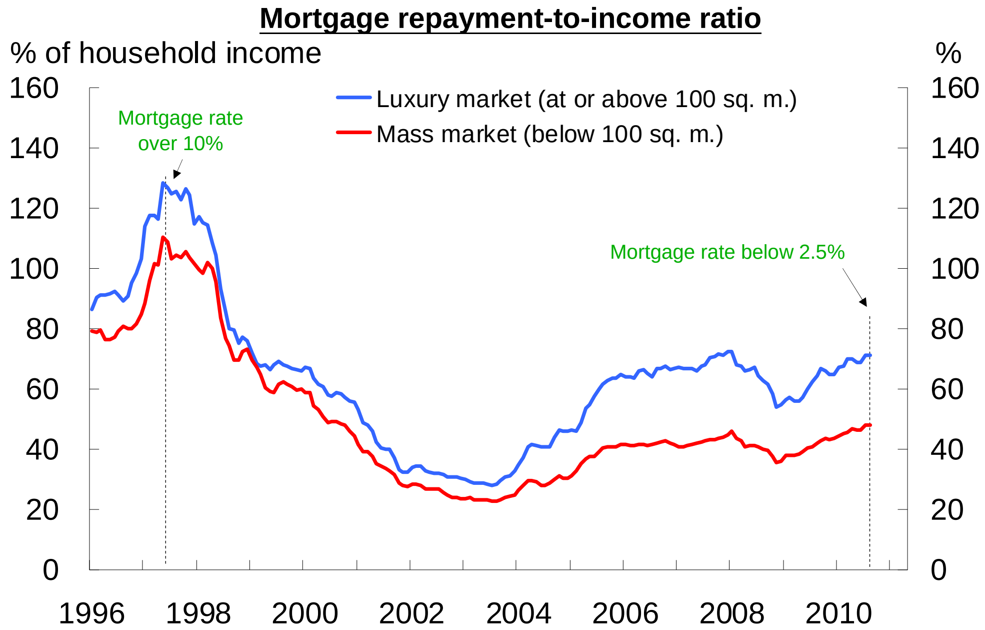


ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

Residential property prices and transaction volume

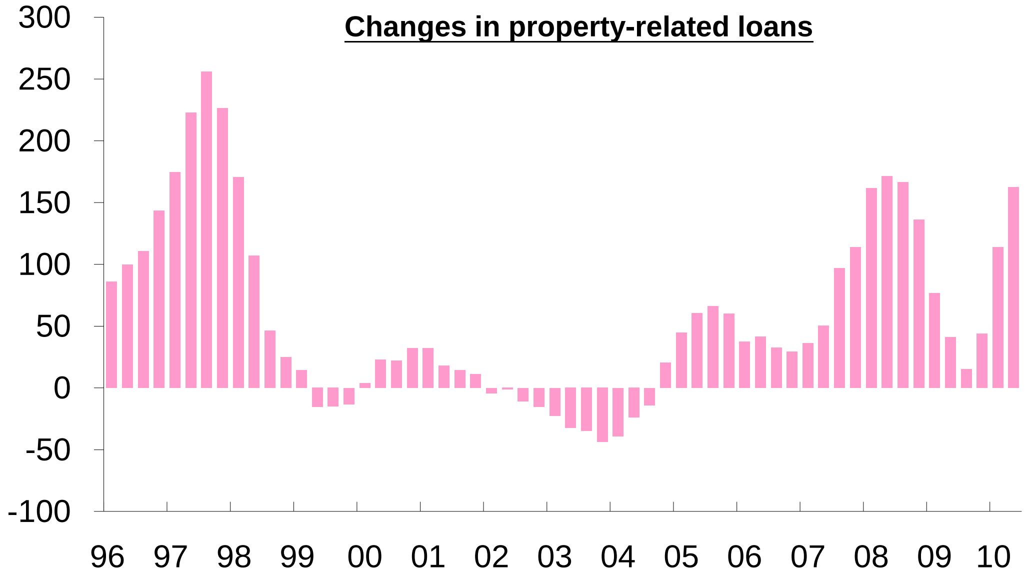


ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET



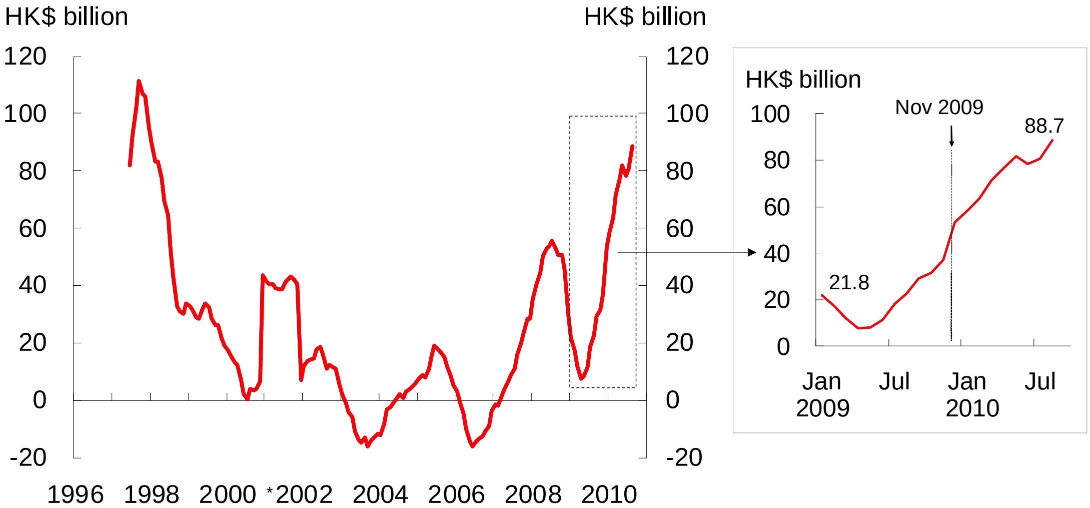
ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

Changes over a year (HK$ bn)



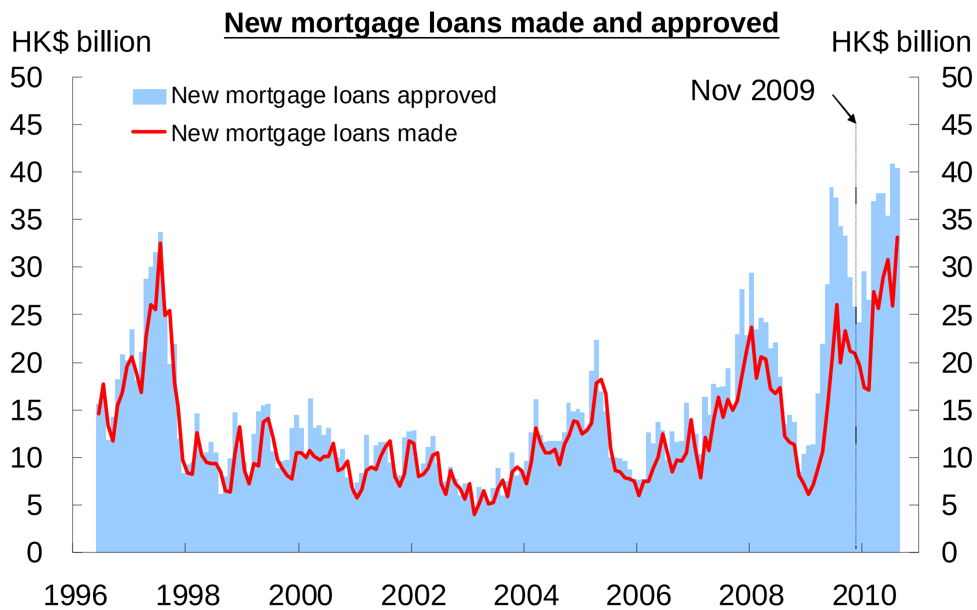
ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

Year-on-year change in outstanding mortgage loans



*There is a break in data series at December 2000 due to an increase in the number of surveyed institutions.

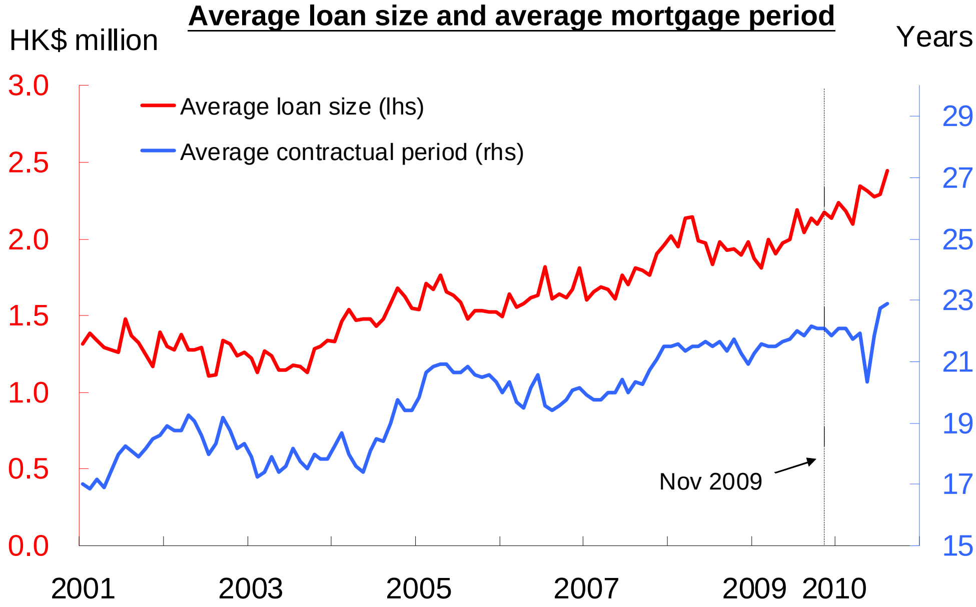
ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET



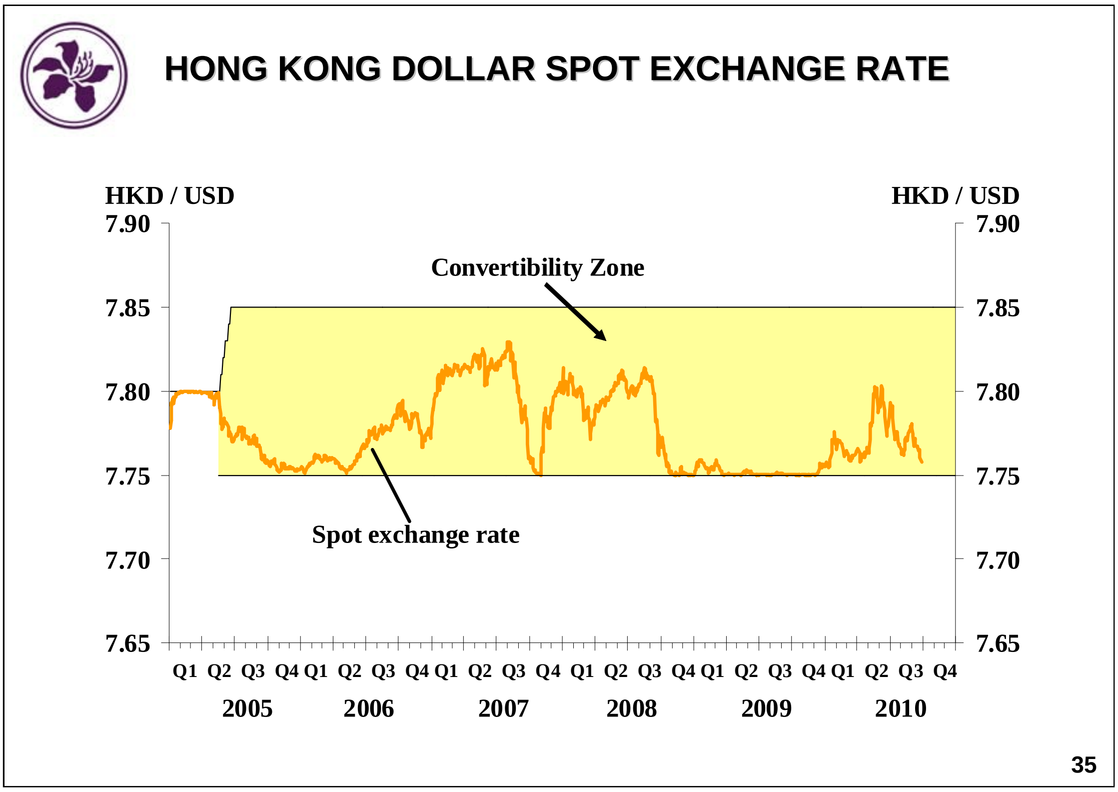
*There is a break in data series at December 2000 due to an increase in the number of surveyed institutions.

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

Average loan size and average mortgage period

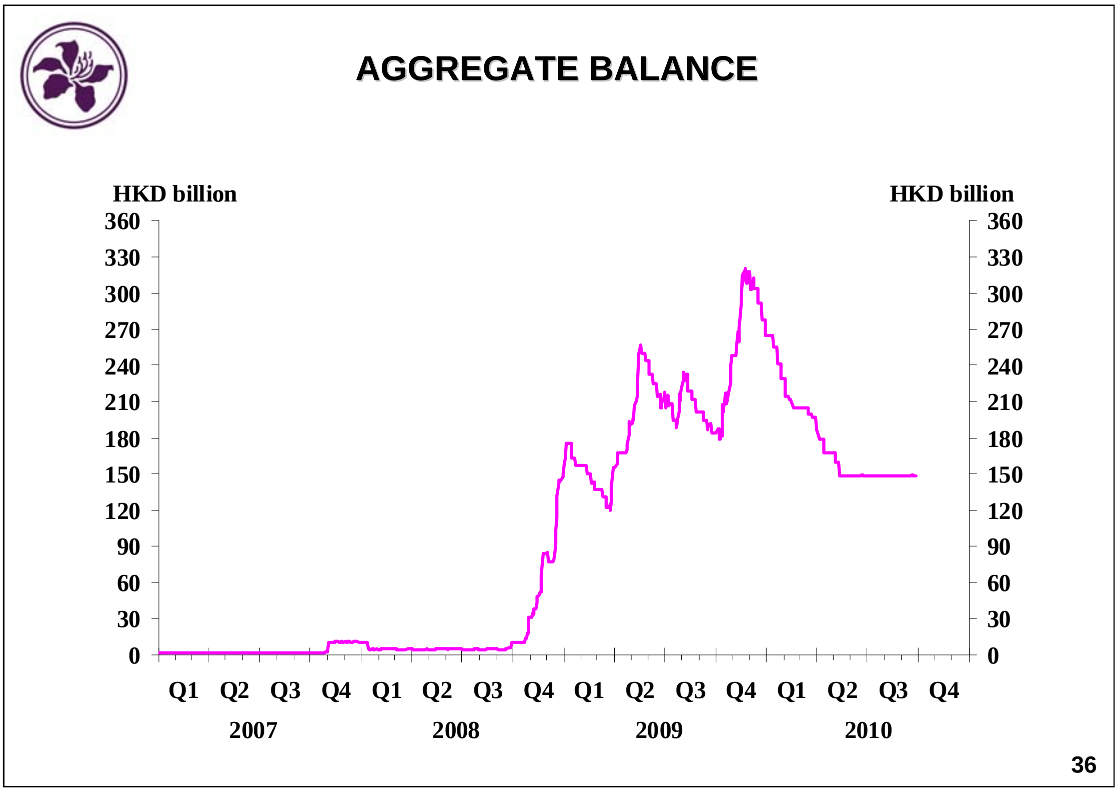


CURRENCY STABILITY



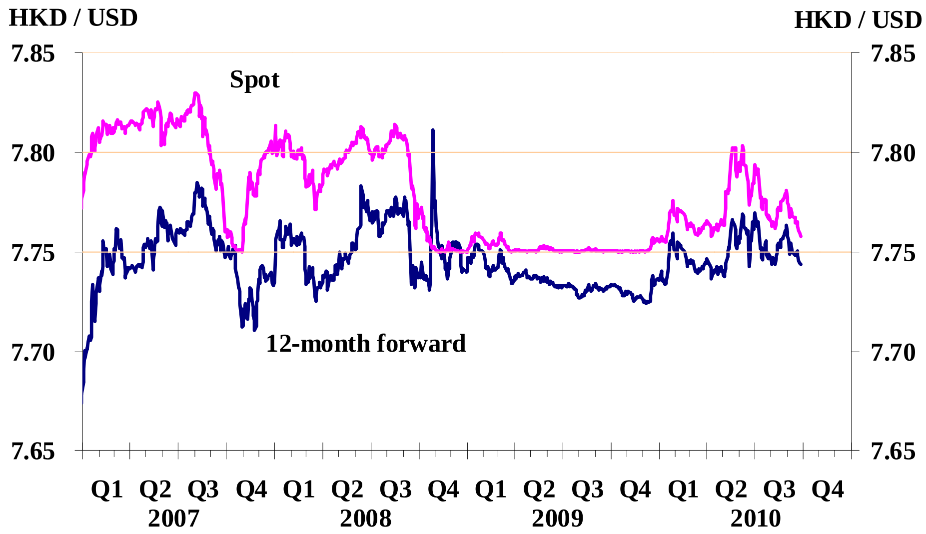
- Having been in a generally soft tone for the first half of 2010, the Hong Kong dollar resumed strength against the US dollar since mid-June alongside rebounds in stock market and increased equity fund-raising activity.

- The strong-side Convertibility Undertaking has not been triggered in 2010 so far.



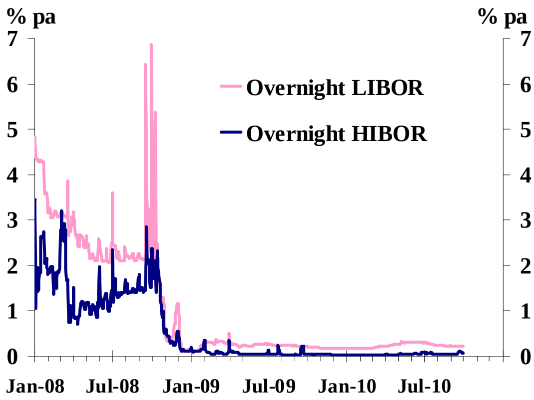
- Liquidity remained abundant in the interbank market. The Aggregate Balance stayed steady at around HK$150 billion since mid-May.

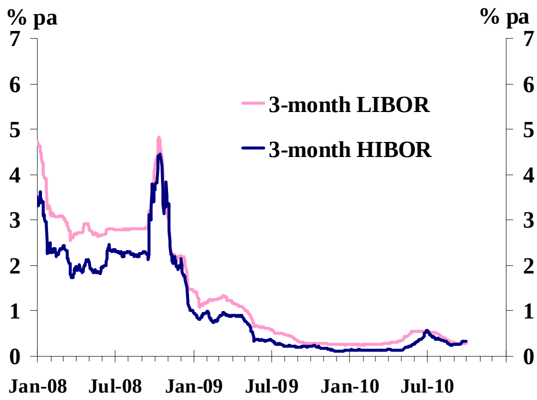
HKD FORWARD EXCHANGE RATE



- The Hong Kong dollar forward spreads were broadly stable in the past few months, in line with the interest rate differentials between the Hong Kong and US dollars.

DOMESTIC INTEREST RATES

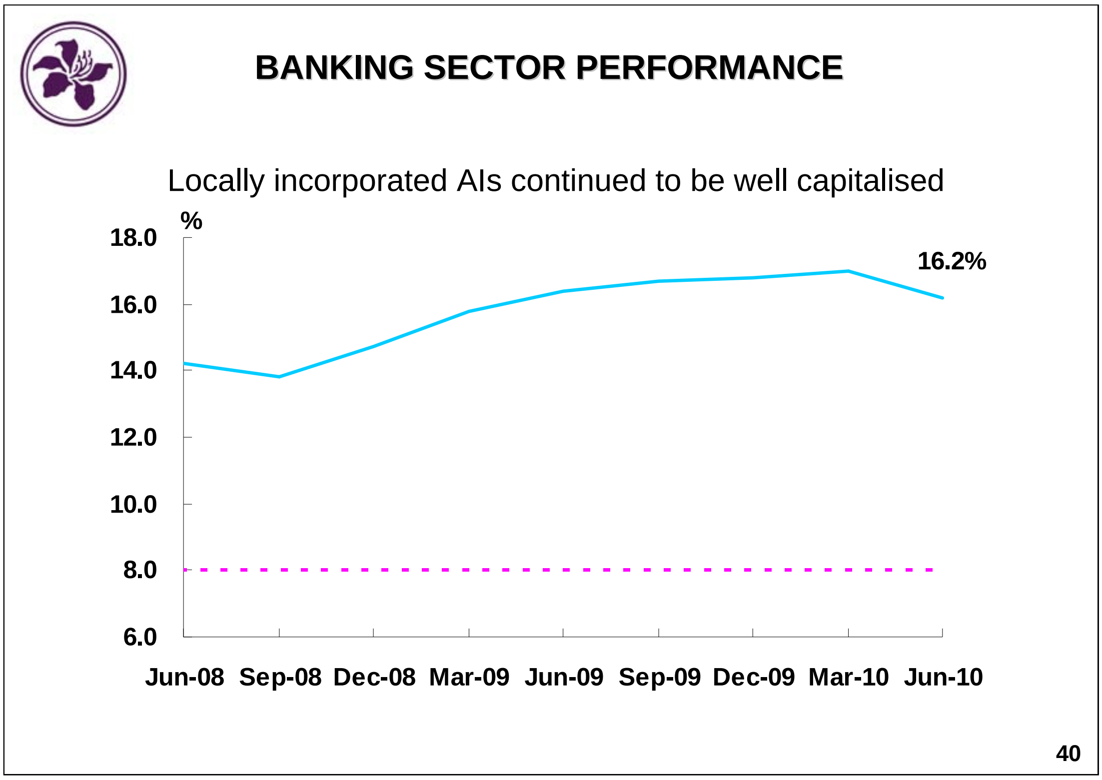




- With liquidity remained abundant, Hong Kong dollar interest rates were broadly stable at low levels below their US dollar counterparts.

- Overnight HIBOR stayed very closed to zero level while the three-month HIBOR climbed up moderately towards end-June on higher US dollar interest rates, and a relatively strong local funding demand associated with half-year end and IPO activity.

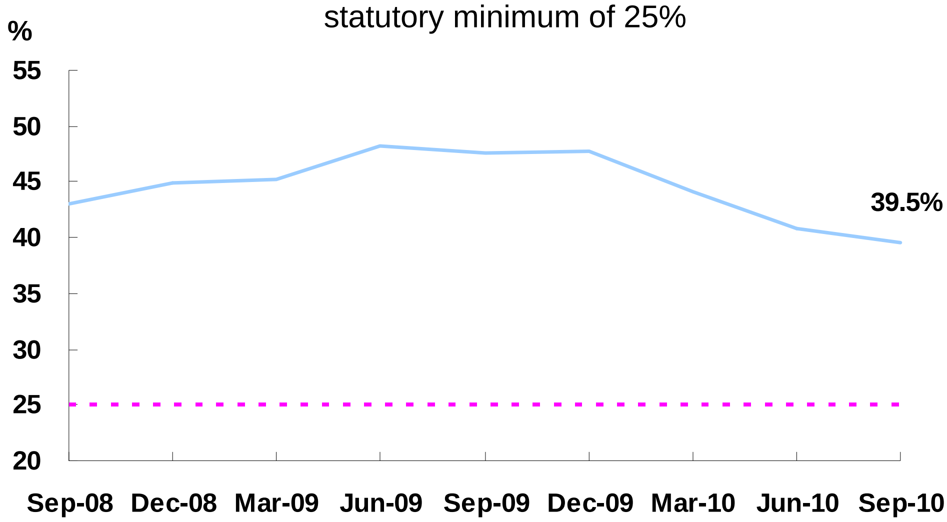
BANKING STABILITY



- The consolidated capital adequacy ratio of locally incorporated AIs declined slightly to 16.2% at the end of June 2010, compared with 17.0% at the end of March 2010 and 16.8% at the end of December 2009. The decline was due to asset growth and a modest increase of corporate exposures which in general carry a higher risk weight than government securities. The ratio remained well above the international standard of 8% and the pre-crisis levels.

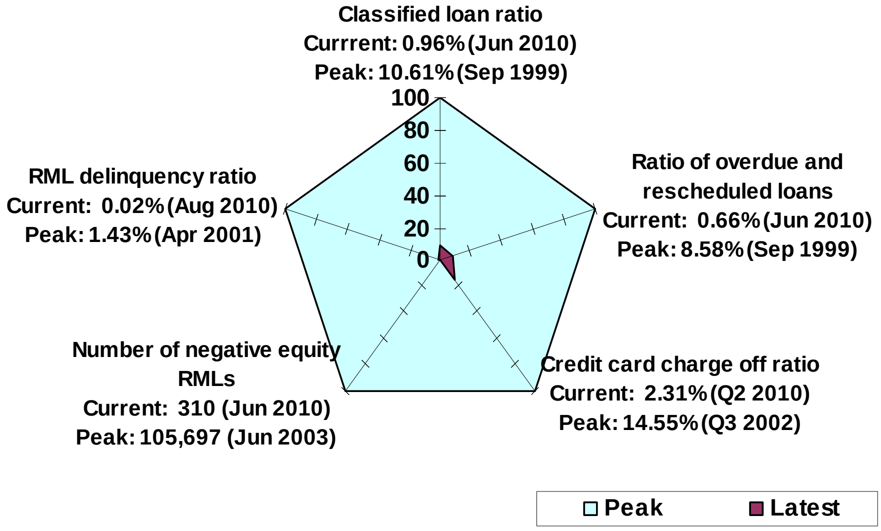
BANKING SECTOR PERFORMANCE

Liquidity ratio of retail banks remained well above statutory minimum of 25%



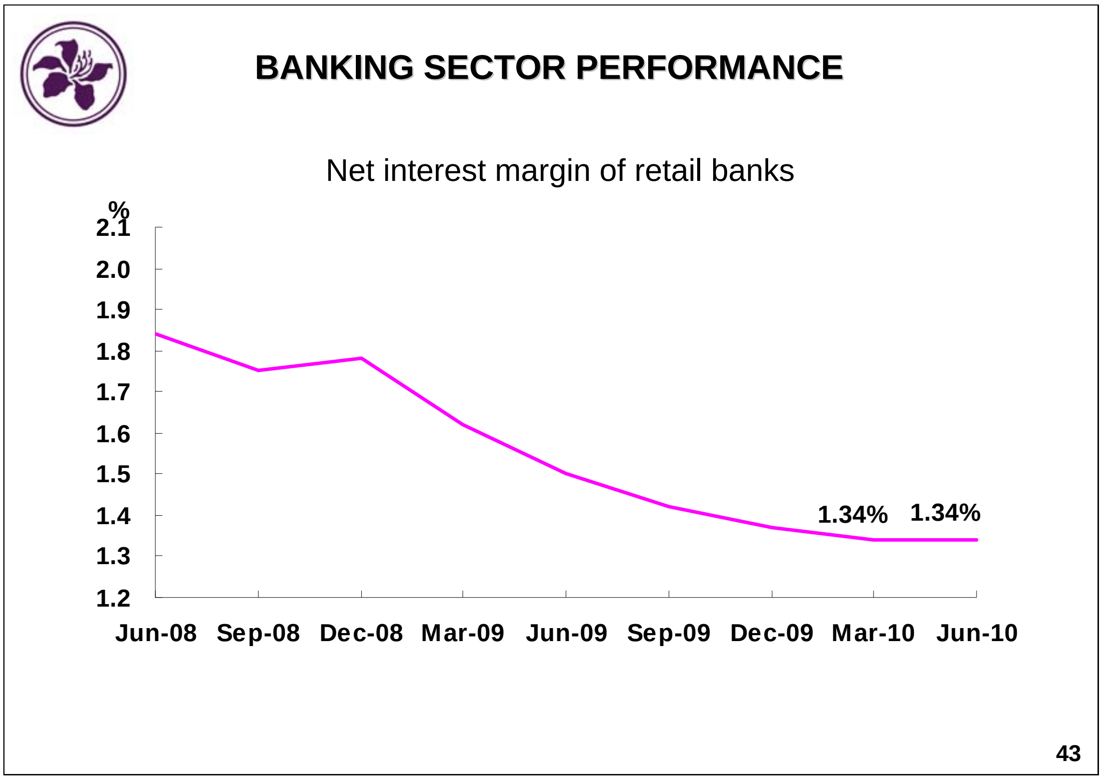
BANKING SECTOR PERFORMANCE

Asset quality further improved and at comfortable levels compared with historical standards



- Asset quality further improved in tandem with domestic economic growth.

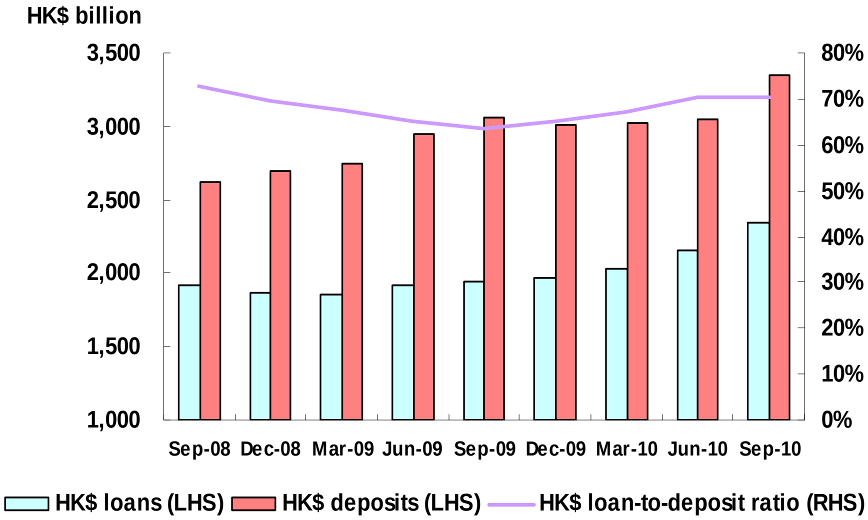
- The HKMA continues to monitor closely the asset quality of retail banks’ loan portfolios.



- The quarterly annualised net interest margin of retail banks remained stable at 1.34% in Q2 2010.
- The aggregate pre-tax operating profit of retail banks' Hong Kong offices in H1 2010 was up 8.1% year on year, as lower credit provisions coupled with improvement in non-interest income lifted banks' profitability.

BANKING SECTOR PERFORMANCE

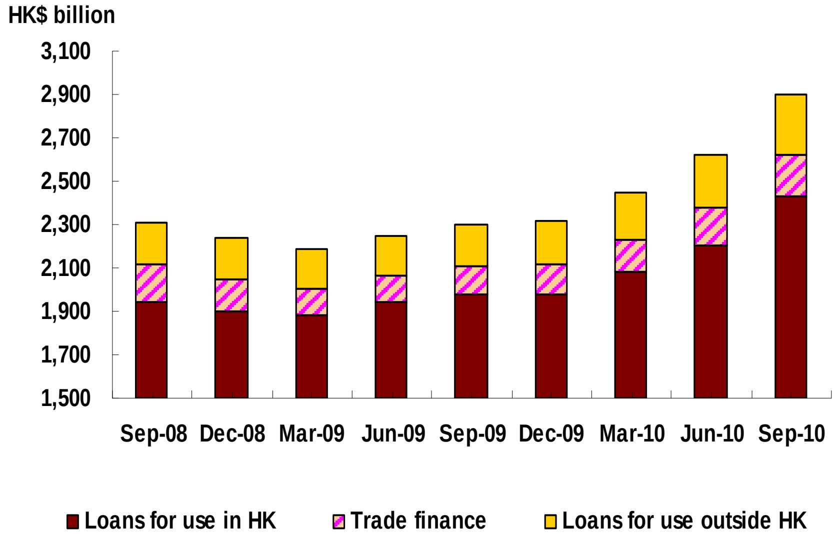
Hong Kong-dollar loan-to-deposit ratio of retail banks rose slightly



- The Hong Kong-dollar loan-to-deposit ratio of retail banks slightly reduced to 70.2% in September from 70.4% at the end of June 2010.

BANKING SECTOR PERFORMANCE

Total loans of retail banks continue to rise



- Retail banks' loan portfolios grew by 10.7% in the third quarter compared with the second quarter as a result of increased demand for domestic loans.

STRENGTHENED RISK MANAGEMENT ON RESIDENTIAL MORTGAGE LENDING

- To strengthen banks' risk management on residential mortgage lending, the HKMA issued guidelines on 13 August to implement the following prudential measures:

  – Loan-to-value Ratio: lowering the maximum loan-to-value ratio to 60% for non-owner-occupied properties and for properties valued at $12 million and above

  – Debt Servicing Ratio (DSR): standardising borrowers' DSR to 50% and requiring banks to conduct stress tests in order to avoid borrowers running into financial difficulties when mortgage rates increase in the future

- The HKMA will conduct thematic on-site examinations to monitor banks' compliance with above measures

ENFORCEMENT-RELATED ISSUES

- In July 2010, the SFC and the HKMA reached a resolution with DBS Bank (Hong Kong) Limited over its distribution of the Lehman related Constellation Notes under s. 201 of the Securities and Futures Ordinance:
  - about 2,160 eligible accounts
  - eligible to a receive the full amount invested plus interest less coupon payments made
- The Enforcement Department is currently deploying resources to accelerate:
  - the handling of the disciplinary process arising from Lehman-related complaints
  - the investigatory process of non-Lehman-related complaints

- Up to 21 October, out of the 21,722 Lehman-related complaints received:
  - 16,847 cases had been resolved under the Minibond Repurchase Scheme or through banks' enhanced complaint handling procedures
  - 1,555 cases were under disciplinary process
  - 2,664 cases had been closed because of insufficient evidence and grounds for disciplinary process
  - 492 cases were pending decision after investigatory process
  - 162 cases were still under investigation.

DEPOSIT PROTECTION

- The protection limit of the Deposit Protection Scheme will increase to $500,000 starting from 1 January 2011

- Banks will have to make sufficient representation on the protection status of their products. The related changes to subsidiary legislation have been submitted to LegCo in October

- A large-scale multi-media publicity campaign has commenced in August to inform the public that the full deposit guarantee will expire by the end of this year and the enhancements to the DPS will take effect from January 2011

- The Deposit Protection Scheme (Amendment) Ordinance 2010 has been enacted by the LegCo on 30 June to enhance the existing DPS, including:

  – The protection limit of the DPS will increase to HK$500,000;
  – Secured deposits will become protected by the DPS;
  – Cost mitigating measures will be implemented to avoid the cost of providing better protection being transferred to depositors

- Subject to the passage of the LegCo on the changes to subsidiary legislation for enhancing the representation on protection status of financial products by banks, the representation enhancements will also take effect in January 2011.

INVESTOR PROTECTION

- Mystery shopping exercise commenced in July
- Implementation of measures to enhance investor protection:
  – Banks need to implement Pre-Investment Cooling-off Period by 1 January 2011
  – Circulars issued in September on selling practices of Renminbi products and synthetic exchange-traded funds
- Pilot scheme of streamlined selling arrangements for Renminbi bonds launched in September with remarkable results
- Continue to assist the Financial Services and the Treasury Bureau on establishing Investor Education Council and Financial Dispute Resolution Centre

- The HKMA and the SFC commenced a mystery shopping exercise in July 2010 covering the sales process of regulated entities in selling unlisted investment products. Any industry-wide themes that emerge from the mystery shopping exercise may be shared with the industry.

- The HKMA continues to implement measures to enhance investor protection.
  (a) In view of the increasing popularity of derivative products marketed by banks over the years, the HKMA issued a circular in May 2010, requesting banks to implement Pre-Investment Cooling-off Period (PICOP) by 1 January 2011 in order to offer additional protection to retail customers who may not fully understand derivative products. Under the PICOP arrangements, a bank not only needs to ensure product suitability and adequate disclosure of material information in relation to the product, it should also allow the elderly and inexperienced customers at least two days to consider their contemplated investment and consult third parties.
  (b) In the light of the increasing popularity of Renminbi products and synthetic exchange-traded funds, the HKMA issued circulars in September 2010, reminding and urging banks that their product due diligence, suitability assessment and disclosure to customers in respect of these products should take into account the specific product nature and risks properly.

- The pilot scheme of streamlined selling arrangements for Renminbi bonds was launched in September 2010. Key streamlined arrangements include:
  (a) no need for audio recording of the selling process (for transactions with no risk mismatch) conducted at bank branches;
  (b) use of a standardised risk disclosure statement to facilitate the risk disclosure process; and
  (c) temporary designation of selected counters in the general banking area of branches for handling transactions.

  Given the simple structure of the products and Hong Kong investors' experience in these products, the HKMA believes that such arrangements would help streamline the selling process of these bonds yet ensure adequate investor protection. The HKMA will continue to discuss with the banking industry on possible ways to streamline the selling process of investment products with simple product structures, taking into account, inter alia, the results of the pilot scheme.

- 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 is assisting the Financial Services and the Treasury Bureau with the implementation of the initiatives where appropriate.

Handling of Customer Personal Data by Banks

- HKMA reminds banks from time to time that they should ensure that their handling of customers' personal data is in compliance with the Personal Data (Privacy) Ordinance and relevant codes and regulations
- Issued circulars in August and September 2010 to require banks to review their current practices in handling customers' personal data in light of the Privacy Commissioner's interim report on the Octopus case and a recent decision of the Administrative Appeals Board
- HKMA will issue a further circular in October drawing AIs' attention to the "Guidance on the Collection and Use of Personal Data in Direct Marketing" issued by the Privacy Commissioner on 18 October
- The HKMA published the interim findings in the auditors' report in relation to the Octopus incident on 18 October and is monitoring Octopus' implementation of the recommendations made in the report

- In 1996, when the Personal Data (Privacy) Ordinance (PDPO) came into effect, the HKMA issued a circular to remind banks that their policies and practices must comply with the PDPO.

- The Code of Banking Practice took effect in 1997. It was also stated in the Code that banks should at all times comply with the PDPO in the collection, use and holding of customer data, and with any relevant codes of practice issued or approved by the Privacy Commissioner giving practical guidance on compliance with the PDPO.

- Following public concerns over data privacy issues raised by the Octopus case and a recent Administrative Appeals Board (AAB) decision involving a bank, HKMA issued two circulars on 12 August and 3 September 2010 to require banks to review their practices in light of the observations of the Privacy Commissioner's interim report on Octopus case and a recent decision of the AAB. The HKMA has been communicating with the banks on an ongoing basis, and has further clarified that they can finalise their reviews after PCO's final report on ORL and guidance notes are issued. Banks were also asked to suspend transferring customers' personal data to unrelated third parties for marketing use until the Privacy Commissioner issued the final report on the Octopus case, when the applicable standards may be further clarified.

- Taking into account the Privacy Commissioner's final report on the Octopus case and Guidance on the collection and use of personal data in direct marketing issued on 18 October, the HKMA will issue a further circular to banks in October and will work closely with the industry to ensure their compliance with the new guidance.

Global Financial Regulation Reforms – “Basel III”

- To enhance the resilience of the global banking system, the Basel Committee on Banking Supervision reached board agreement on 12 September 2010 regarding “Basel III”
- “Basel III” tightens the definition of regulatory capital; increases the minimum requirement of Tier 1 Capital; establishes conservation / countercyclical capital buffers; introduces a non-risk based leverage ratio; a new liquidity coverage ratio and a net stable funding ratio
- The new requirements will be phased-in between 1 January 2013 and 1 January 2019
- Local banking sector should generally be able to comply with the new requirements

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- The oversight body of the Basel Committee (the Group of Governors and Heads of Supervision (GHOS)) announced on 12 September 2010 the broad agreement on the reform proposals of Basel III. The reform measures will enhance the resilience of the global banking system which would in turn help minimise the risk of banking crisis in the future.

- The Basel III covers a tighter definition of regulatory capital and higher capital standards：
  - The minimum common equity requirement will be increased from 2% to 4.5% and minimum Tier 1 capital from 4% to 6%.
  - Banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirements to 7%.
  - A countercyclical buffer within a range of 0% to 2.5% of common equity will be implemented according to national circumstances.
  - Ｔhese capital requirements are supplemented by a non-risk based Tier 1 leverage ratio of 3%.

- It also introduces a new global liquidity standard：
  - A Liquidity Coverage Ratio (LCR) ensures that a bank has a sufficient stock of high quality liquid assets to cover its liquidity needs under a 30-day liquidity stress.
  - A Net Stable Funding Ratio (NSFR) promotes the use of more stable and longer term funding sources to support their assets and activities.

- To ensure that the banking sector can meet the higher capital standards while still supporting lending to the economy, the various new capital and liquidity requirements will be phased in from 1 January 2013 to 1 January 2019.

- Given that banks in Hong Kong are well-capitalised and place more reliance on common equity to meet regulatory capital requirements, the local banks are generally able to meet the tighter capital requirements.

- While some banks may need to adjust their liquid assets composition to satisfy the new liquidity standards, the HKMA expects that banks would not have major problems to comply with the new standards.

FINANCIAL INFRASTRUCTURE

International Development –
Reforming OTC Derivatives Market

- Objective: To enhance financial market stability and minimise systemic risk; and improve market transparency and enhance market surveillance mechanism

- G20 reached an agreement in September 2009 on improvement in the operation of OTC derivatives market, with the focus on:
  – Standardisation of OTC derivatives
  – Central clearing, exchange or electronic platform trading of OTC derivatives
  – Trade reporting of OTC derivatives

- As a follow-up on the objectives agreed by G20, FSB has prepared a report with recommendations to address issues which authorities may encounter when implementing these measures by end-2012

- The HKMA will take into account local situation and work with other regulators to explore the appropriate measures that should be taken, and consult the market when necessary

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- The G20 leaders reached an agreement at the Pittsburgh meeting in September 2009.

- "All standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivatives contracts should be reported to trade repositories."

- This forms the basis for reform of the OTC derivatives market.

- An FSB working group on OTC derivatives has been established to prepare a report on Implementing OTC Derivatives Market Reforms as a follow-up on the objectives agreed by the G20 in Pittsburgh.

- The use of central clearing helps mitigate counterparty credit risk, and reduce interconnectedness between market participants. The development of a trade repository helps improve market transparency and enhances market surveillance role of regulators.

PROMOTING ASSET MANAGEMENT BUSINESS

- Working closely with other Government agencies and the private sector to explore ways to strengthen the competitiveness of Hong Kong's asset management industry and reinforce Hong Kong's position as a leading asset management centre

- Stepping up marketing efforts to proactively reach out to overseas fund managers and investors to promote Hong Kong's financial platform with a view to attracting more fund managers to Hong Kong

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- With the promising growth prospects of the Asian region, there has been increasing interest for overseas fund managers to expand into Asia. To capitalise on this trend and attract more fund managers into Hong Kong, the HKMA is working in conjunction with other Government agencies and market players to promote Hong Kong's asset management business, thereby reinforcing Hong Kong's role as a premier international financial centre.

DEVELOPMENT OF ISLAMIC FINANCE

Develop market infrastructure:

- Supporting the Government in drawing up legislative proposals to modify 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 signed
- 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 has been working closely with other industry associations and Islamic organisations to provide appropriate training programmes for the industry with a view to nurturing a larger Islamic finance talent pool in Hong Kong. At the end of September, the HKMA hosted a two-day workshop for Hong Kong regulators and market players on the Islamic Financial Services Board (IFSB) standards for Islamic financial institutions and Islamic capital markets, with focus on topics such as Islamic bonds (sukuk), Islamic collective investment schemes and Shariah governance standards.

GOVERNMENT BOND PROGRAMME

Institutional Bond Issuance Programme:

- Five issues with a total issuance size of HK$21.5 billion have been issued
- The tenders attracted a diverse group of end-investors, such as investment funds, insurance companies and pension funds

Retail Bond Issuance Programme:

- Necessary preparatory work almost completed and the inaugural issue will be launched when market conditions are appropriate

- 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. As of 11 October, 2010, a total of five issues have been issued under eight tenders, and they are:

  – HK$3.5 billion of a 2-year bond maturing in September 2011;
  – HK$3.5 billion of a 2-year bond maturing in March 2012;
  – HK$3.5 billion of a 2-year bond maturing in September 2012;
  – HK$3.5 billion of a 5-year bond maturing in November 2014; and
  – HK$7.5 billion of a 10-year bond maturing in January 2020.

- By enlarging the investor base over time, the GBP 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.

HONG KONG AS AN INTERNATIONAL FNANCIAL CENTRE

NOTABLE DEVELOPMENTS IN RENMINBI BUSINESS

11 Feb	HKMA issued an important elucidation on supervisory principles and operational arrangements
22 Jun	Mainland authorities announced a major expansion of the RMB trade settlement scheme with the rest of the world
19 Jul	Clearing Agreement on RMB business amended
17 Aug	Mainland authorities launched a pilot scheme for eligible institutions outside the Mainland to invest in the Mainland's interbank bond market

- Further to HKMA's elucidation of the supervisory principles of RMB business in Hong Kong in February, which has helped increase flexibility for banks in operating the relevant business, there have been some significant developments.

- On 22 June, the Mainland authorities announced an expansion of the RMB trade settlement scheme:

  - Cover 20 Mainland provinces and cities. Their trade transactions with any part of the world can be settled in RMB;
  - Any enterprises in those provinces and cities can settle their merchandise imports, service trades and other current account transactions in RMB;
  - An expanded list of eligible enterprises will be able to settle their merchandise exports in RMB.

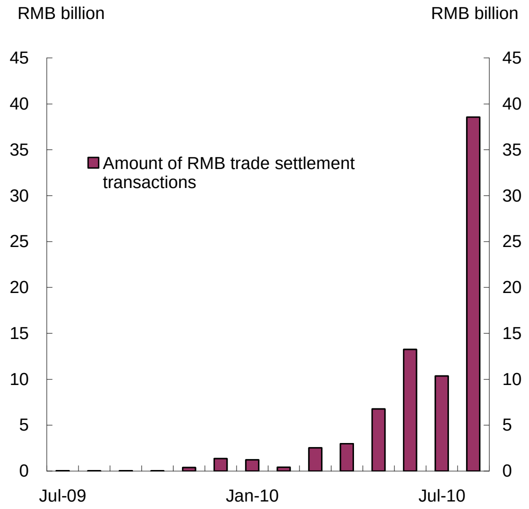
- On 19 July, the Clearing Agreement for RMB business was revised, providing policy headroom for the development of RMB financial products in Hong Kong, and three key changes were made, including:

  - all companies and organisations can open RMB accounts at banks;
  - restrictions on inter-bank transfers of RMB funds between personal and corporate customers were removed;
  - banks can provide RMB conversion services to corporate customers for purposes other than for trade settlement, provided that they do not square the corresponding open position with the Clearing Bank.

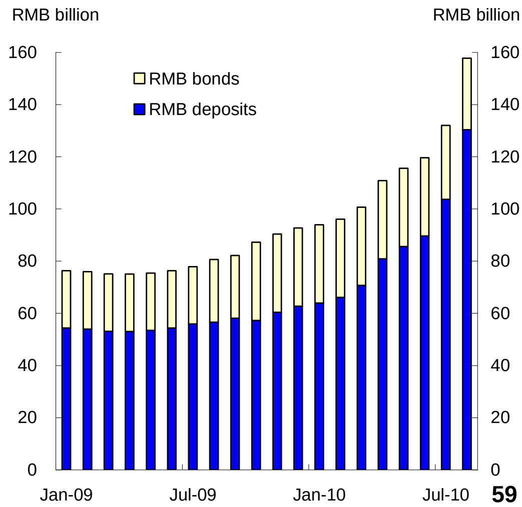
- The PBOC promulgated, on 17 August, a notice on a pilot scheme for eligible institutions outside the Mainland, including the Clearing Bank and Participating Banks of RMB business in Hong Kong, to invest in the Mainland's interbank bond market. This has opened up a channel for RMB funds in Hong Kong to invest in the Mainland, which will further promote the development of RMB trade settlement in Hong Kong, and enhance the attractiveness of RMB offshore business in Hong Kong.

RENMINBI BUSINESS IN HONG KONG

RMB trade settlement gained momentum since March 2010



RMB deposits in Hong Kong increased steadily



- As at end August 2010, RMB deposits amounted to RMB 130.4 billion.

- Total RMB trade settlement conducted through Hong Kong reached RMB77.9 billion from July 2009 to August 2010.

- Over 100 banks have already signed the Clearing Agreement to participate in Hong Kong's RMB clearing platform, with more than 30 from overseas.

GROWTH OF RMB FINANCING ACTIVITIES IN HONG KONG

- **RMB bond issuance to reach record amount this year**
  - Total issuance in 2010 to be at least RMB 17.8 billion
  - Issuers broadening to Hong Kong corporations, multinationals and international financial institutions (including Asian Development Bank and International Finance Corporation)

- **A wide range of RMB services and products launched since the amendment of Clearing Agreement**
  e.g.:
  - Certificates of deposit
  - Structured deposits
  - Insurance products
  - Syndicated loans
  - Investment funds

- Since 2007, there have been 18 RMB bond issues with a total issuance size of over RMB 47 billion. Apart from the Ministry of Finance, the issuers that have issued or launched RMB bonds in Hong Kong include: the China Development Bank, China Export and Import Bank, Bank of China, Bank of Communications, China Construction Bank, HSBC (China), Bank of East Asia (China), Hopewell Highway Infrastructure Limited, McDonald's, Asian Development Bank and International Finance Corporation.

- Recent issues of RMB bonds launched include:
  - China Development Bank (floating-rate bonds of RMB 2 billion with a 3-year tenor, and fixed-rate bonds of RMB 3 billion with a 3-year tenor)
  - Asian Development Bank (fixed-rate bonds of RMB 1.2 billion with a 10-year tenor)
  - International Finance Corporation of the World Bank Group, with a bond programme to finance private sector projects in Mainland China.

INCREASING REGIONAL AND INTERNATIONAL FINANCIAL CO-OPERATION

- Financial Stability Board (FSB): The HKMA attended the Plenary Meeting of the FSB on 27 September 2010 and a number of other meetings of the FSB Standing Committees and working groups, which continued the discussion of the key proposals to reform the global financial system and macroeconomic developments of consequence to global financial stability

- Monitoring of regional monetary and financial stability: The HKMA conducted analyses for EMEAP Monetary and Financial Stability Committee to assess the region's risks and vulnerabilities, in particular those associated with the global growth outlook and sovereign debts in advanced economies

- The EMEAP Working Group on Banking Supervision chaired by the HKMA had conducted a study on the Basel Committee on Banking Supervision (BCBS)'s package of reforms and submitted comments to the BCBS to allow the region's collective point of view to be duly taken into account in the development of the international standards

- The HKMA continued to participate actively in meetings and activities of the FSB Plenary and Standing Committees. At the September Plenary meeting, FSB members reviewed macroeconomic developments of consequence to the global financial system, and emphasised the need for continued actions to strengthen the system. Members also continued the discussion on the key proposals to reform the global financial system, including measures to address the moral hazard risk of systemically important financial institutions, reduce reliance on credit rating agencies, and implement central clearing and trade reporting in over-the-counter derivatives markets.

- The HKMA has been playing an important role in the surveillance work of the EMEAP Monetary and Financial Stability Committee. The HKMA uses the macroeconomic models it developed for the EMEAP region to conduct analyses.

- As the chair of EMEAP Working Group on Banking Supervision, the HKMA led the Working Group's studies on the reform package of the Basel Committee on Banking Supervision (BCBS) and submitted the collective point of view of EMEAP members to the BCBS. The comments were well received by the BCBS.

INVESTMENT ENVIRONMENT AND PERFORMANCE OF THE EXCHANGE FUND

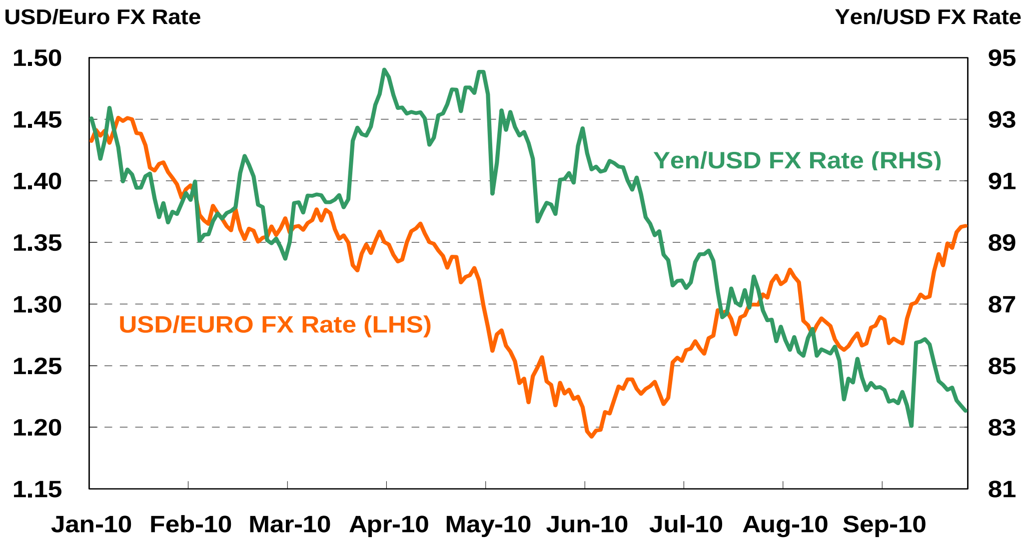
INVESTMENT ENVIRONMENT IN Q1 – Q3 2010

- **Exchange rates**: In 1H 2010, the US dollar strengthened against major currencies due to faster economic recovery in the US and the euro debt crisis. After the unprecedented EU/IMF rescue package, the US dollar drifted lower in Q3 on reversal of safe-haven flows. Despite intervention by the Bank of Japan to halt yen's strength, speculation of further US Quantitative Easing also weighed on the dollar.

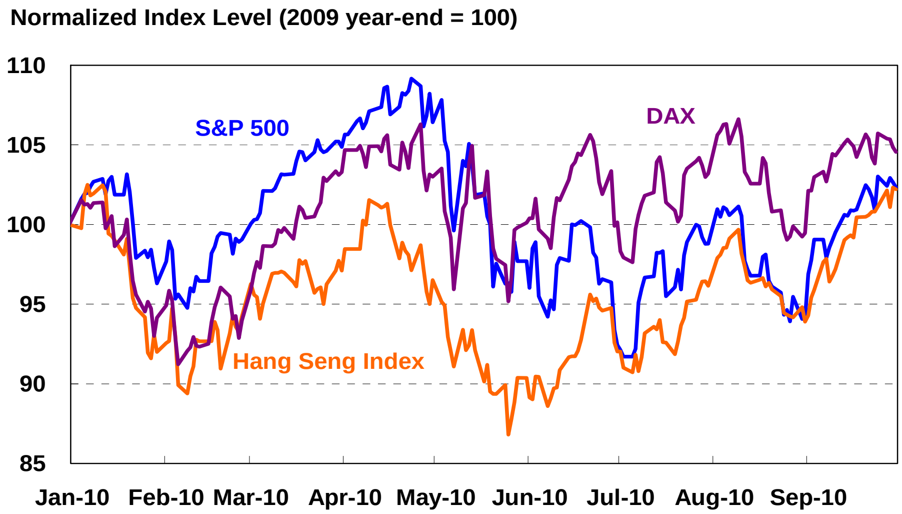
- **Equity markets**: After modest gains in Q1, fears of unsustainable US recovery and peripheral sovereign credit crisis sent equities lower in Q2. However, low interest rate environment, reasonable stock valuation, positive earnings reports and increasing merger and acquisition activities contributed to the rise in global stock markets in Q3.

- **Interest rates**: On the back of the Fed's commitment to maintain an accommodative monetary policy for an extended period, together with expectations of further monetary easing due to the fragile US economic recovery after stimulus measures expired, Treasury yields were driven lower. Meanwhile government bond yields in core European countries also declined in tandem.

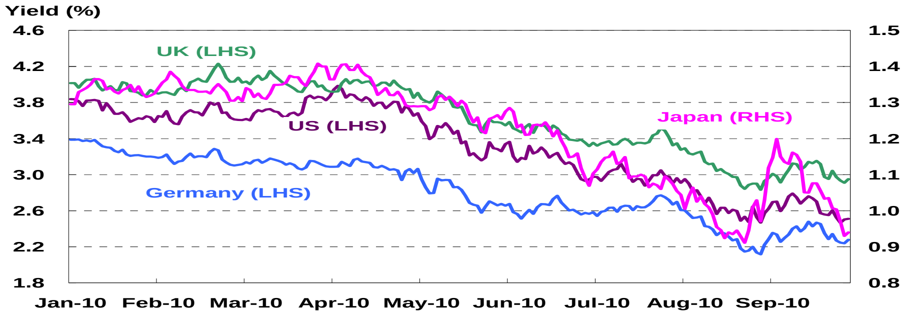
CURRENCY MARKET FLUCTUATION

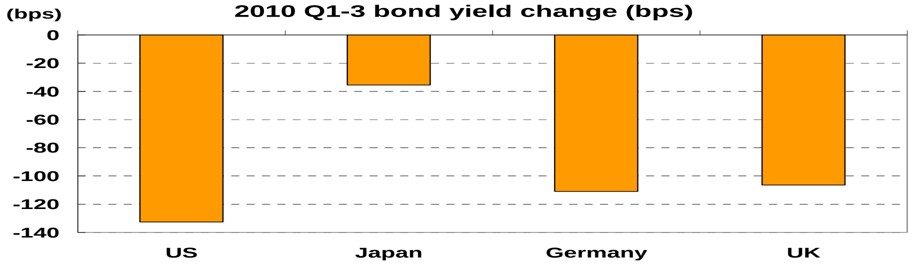


PERFORMANCE OF MAJOR EQUITY MARKETS



CHANGES OF 10-YEAR GOVERNMENT BOND YIELDS





INVESTMENT INCOME

(HK$ billion)	2010 Jan - Sep *	2009 Full Year	2008 Full Year	2007 Full Year
Hong Kong equities^@	7.3	48.9	(77.9)	55.8
Foreign equities^	7.9	48.8	(73.1)	6.7
Foreign exchange	(3.6)	9.8	(12.4)	18.7
Other investments&	0.8	0.8	-	-
Bonds#	60.7	(0.6)	88.4	61.0
Investment income/(loss)@&	73.1	107.7	(75.0)	142.2

* Unaudited figures
^ Including dividends
# Including interest
@ Excluding valuation changes in Strategic Portfolio
& Including valuation changes of investment held by EF's investment holding subsidiaries

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

(HK$ billion)	2010 Jan - Sep*	2010 Q3	2010 Q2	2010 Q1	2009 Full year
Investment income/(loss)	73.1	74.1	(12.1)	11.1	107.7
Other income	**0.2**	**0.1**	**0.1**	**-**	**0.2**
Interest and other expenses	**(3.6)**	**(1.2)**	**(1.5)**	**(0.9)**	**(3.8)**
Net investment income/(loss)	**69.7**	**73.0**	**(13.5)**	**10.2**	**104.1**
Payment to Fiscal Reserves #	(25.2)	(8.3)	(8.4)	(8.5)	(33.5)
Payment to HKSAR government funds and statutory bodies #	**(2.8)**	**(1.1)**	**(0.9)**	**(0.8)**	**(1.2)**
Valuation change of Strategic Portfolio less investment held by EF's investment holding subsidiaries^	**0.3**	**1.6**	**(0.4)**	**(0.9)**	**3.6**
Increase/(Decrease) in EF Accumulated Surplus	42.0	65.2	(23.2)	0.0	73.0

* *Unaudited figures*

\# *The fixed rate of fee payment is 6.3% for 2010 and 6.8% for 2009*

^ Including dividends

HISTORICAL INVESTMENT INCOME

(HK$ billion)

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*&	107.7	**10.6**	**71.9**	**58.7**	**(33.5)**
2010*#&	N/A	**N/A**	**74.1**	**(12.1)**	**11.1**

* Excluding valuation changes in the Strategic Portfolio
\# Unaudited figures
& Including valuation changes of investment held by EF's investment holding subsidiaries
N/A: Not Applicable

EXCHANGE FUND ABRIDGED BALANCE SHEET

(HK$ billion)	At 30 Sep 2010*	At 31 Dec 2009	At 31 Dec 2008
ASSETS			
Deposits	**133.6**	**126.3**	**172.8**
Debt securities	**1,722.4**	**1,637.6**	**1,151.3**
Hong Kong equities	**147.4**	**142.9**	**92.9**
Other equities	**228.2**	**214.9**	**103.3**
Other assets#	**34.2**	**27.7**	**40.0**
Total assets	2,265.8	2,149.4	1,560.3
	======	======	======
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness	**218.4**	**199.0**	**176.1**
Government-issued currency notes & coins in circulation	**8.8**	**8.4**	**8.3**
Balance of the banking system	**148.7**	**264.6**	**158.0**
Exchange Fund Bills and Notes	**654.6**	**536.4**	**162.5**
Placements by banks and other financial institutions	**-**	**28.3**	**13.6**
Placements by Fiscal Reserves	**517.2**	**504.1**	**531.4**
Placements by HKSAR government funds and statutory bodies	**68.3**	**41.8**	**0.1**
Other liabilities	**54.3**	**13.3**	**29.8**
Total liabilities	**1,670.3**	**1,595.9**	**1,079.8**
Accumulated Surplus	**595.5**	**553.5**	**480.5**
Total liabilities and fund equity	2,265.8	2,149.4	1,560.3
	======	======	======

* Unaudited figures

\# Including investment in EF's investment holding subsidiaries amounted to HK$8.2 billion at 30 Sep 2010 (HK$2.8 billion at 31 Dec 2009)