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HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

21 May 2012

1. **Assessment of Risk to Hong Kong's Financial Stability**
2. Banking Supervision
3. Hong Kong as an Offshore RMB Centre
4. Performance of the Exchange Fund
5. Financial Infrastructure
6. Hong Kong Mortgage Corporation

ASSESSMENT OF EUROPE'S ECONOMY: RECENT DEVELOPMENTS

- The debt crisis is escalating:
  - ➢ Financial and political risks in Greece have surged
  - ➢ Spain failed to meet its fiscal deficit target, banks' bad debts went up and the government bailed out Bankia
  - ➢ The victory of Mr Francois Hollande in the French presidential election spelled uncertainty for the commitment to the new fiscal compact
  - ➢ General elections are due to take place in the Netherlands
  - ➢ In Ireland, a referendum is scheduled for May

- The debt crisis is escalating:
  - ➢ In Greece financial and political risks surged as the re-election is due to be held. Yields of new 10-year government bonds rose to nearly 30% following an earlier haircut. Money is also being pulled out of Greek banks at an alarming rate. Markets fear about Greece's possible exit of the eurozone, which could send Greek government bonds sharply lower and trigger bank runs and failures, setting off a domino effect on their counterparts in other "PIIGS" countries.
  - ➢ Spain's failure to meet its 2011 fiscal deficit targets sparked market concern for a deepening recession and rise in bad debts of banks. Yields of 10-year government bonds soared to 6.3% as the country's fourth-largest bank, Bankia, became the subject of a government bailout.
  - ➢ The victory of Mr Francois Hollande in the French presidential election may spell setbacks for the government's fiscal austerity and commitment to the new fiscal compact.
  - ➢ In the Netherlands, general elections are due to take place in September.
  - ➢ In Ireland a referendum will be held on the new fiscal compact.

- Despite an expansion in the "firewall" by both eurozone finance ministers and the IMF (with the former's cap of rescue lending increased from 500 billion euros to 700 billion euros and IMF receiving over USD430 billion in funding pledges), success in achieving its desired effect is still hinged on numerous political risks.

ASSESSMENT OF EUROPE'S ECONOMY:

- The gist of the escalating European debt crisis:
  - ➢ The Longer-Term Refinancing Operations can only meet banks' liquidity shortages
  - ➢ Fiscal and structural reforms are possible only with a huge determination and long-term efforts
  - ➢ Europe is facing a vicious cycle of a debt crisis and economic recession

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- The gist of the escalating European debt crisis:
  - ➢ The Longer-Term Refinancing Operations can only meet banks' liquidity shortages
  - ➢ Fiscal and structural reforms are possible only with a huge determination and protracted effort from the governments and the public alike
  - ➢ Europe is facing a vicious cycle of a debt crisis and economic recession：
    - – Economic woes make it difficult to meet debt cut targets and cause banks' bad debts to grow
    - – Markets fear yields of government bonds will go up again, which increase fiscal burden and worsen the economy
    - – Should market confidence dive again, the European debt crisis will resurge

ASSESSMENT OF THE US ECONOMY: RECOVERY HAS SLOWED RECENTLY

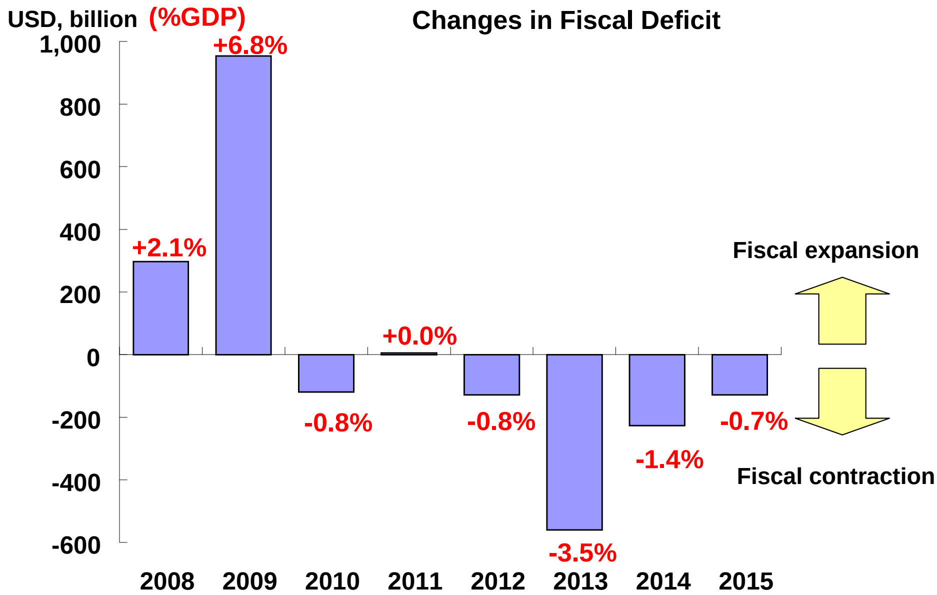
- GDP growth in Q1 2012 fell to 2.2%
- Market forecasts for growth in 2012: 2.3%
  The US Fed forecasts: 2.7%
- Recovery in the US economy still under way but showed signs of slowing
  - ➢ Job growth fell markedly
  - ➢ Home prices seem to stabilise but transactions fell again
- The Fed expects moderate growth and a gradual fall in unemployment, with the current extremely low interest rates staying until at least late 2014

- GDP growth in Q1 2012 fell to 2.2% (Q4 2011: 3%)
  - (Growth in personal consumption rose in Q1, fuelled by higher household savings, rather than increased personal incomes, making growth trend hard to continue)
- Market forecasts economic growth in 2012 at 2.3%, compared with the Fed’s forecast of 2.7%
- Recovery in the US economy continued but showed signs of a slowing pace
  - ➢ Job growth has fallen markedly
  - ➢ Home prices have shown signs of stabilising but the number of home sales fell again
- The Fed expects moderate growth and a decline in unemployment, with the current extremely low interest rates staying until at least late 2014.

ASSESSMENT OF THE US ECONOMY: GROWTH STILL SUBJECT TO UNFAVOURABLE FACTORS

- US congressional and presidential elections in late 2012 add to the uncertainties for economic outlook
- US economy still faces numerous downside risks:
  - Possible major fiscal spending cuts in 2013
  - Persistently high oil prices could dampen growth and increase inflationary pressures
- Obstacles remain in the medium-to-longer term
  - Chronic long-term unemployment
  - Household deleveraging still not completed
  - A large overhang of foreclosed homes yet to be disposed of

US: PUBLIC FINANCE MAY TIGHTEN DRASTICALLY IN 2013



- In a worst-case scenario where the two major US political parties failed to reach consensus, public finance in the US may head onto a fiscal cliff and tighten drastically. The extent of tightening may be as much as 5% of GDP in the 2013 calendar year and 3.5% in the 2013 fiscal year, causing a serious drag on the US economy.

- Factors contributing to the fiscal cliff:

  (1) Fiscal stimulus measures due to expire at the end of 2012:

  1. All Bush-era tax cuts (US$340 billion)
  2. Social protection wage tax reliefs (US$115 billion)
  3. Emergency unemployment benefits (US$50 billion)
  4. Incentives for investment (US$40 billion)
  5. Subsidies for doctors (Medicare scheme for the elderly) (US$20 billion)

  (2) New medical tax on high-income earners to be launched in early 2013 (US$25 billion)

  (3) A new round of fiscal spending cuts to be introduced in early 2013:

  ➢ Budget Control Act 2011 provides for across-the-board spending cuts of US$1.2 trillion beginning in January 2013 (automatic budget cap on discretionary spending) [???] (deficit cuts of US$95 billion in 2013 fiscal year)

ASSESSMENT OF MAINLAND CHINA'S ECONOMY:

- The Central Government has revised downward economic growth target for 2012 to 7.5%
- Economic growth for Q1 2012: 8.1%; consensus forecast for the year: 8.3%
- Inflation in April: 3.4%; consensus forecast for the year: 3.4%
- Slower economic growth in the short term, but risk of hard landing seen to be low. A cooling property market helps sustain growth
- Monetary policy will remain prudent but become even more focussed, flexible and forward-looking

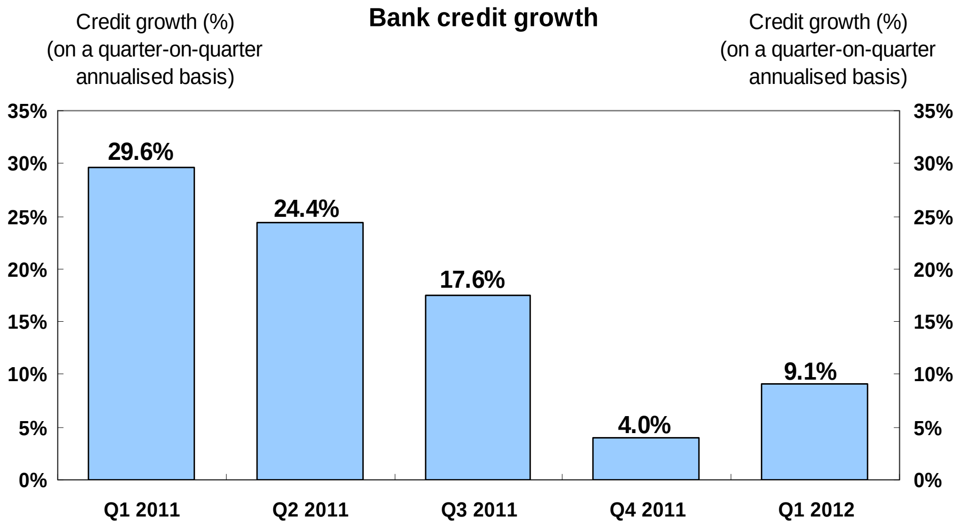
- The Central Government has revised downward the economic growth target to 7.5% this year (maintained at 8% from 2005 to 2011).
- Economic growth for Q1 2012: 8.1%; consensus forecast for the year: 8.3%
- Inflation in April: 3.4%; consensus forecast for the year: 3.4%; peak in July 2011: 6.5% (inflation fell due mainly to slower growth in food prices)
- Slower economic growth in the short term, but risks of hard landing seen to be low as a cooling property market helps sustain growth
- Monetary policy will remain prudent but become even more focussed, flexible and forward-looking
  - Greater support for key social and economic aspects and weak sectors

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

- The property market has continued to cool for seven months since last July. Transactions fell sharply but prices rose slightly by 4%
- Activity became robust again in February and March this year, with transaction volume reaching 11,000 in March
- Turnover fell slightly in April but more than 8,200 transactions were still recorded
- Overall property prices began to climb again in February, up by 6% in March compared with January and above the peak of June last year by 1%
- The HKMA will continue to monitor the market developments closely and stand ready to introduce measures as appropriate to safeguard banking stability

- The property market has continued to cool for seven months since last July. Transactions fell sharply but prices rose slightly by 4%.
- Activity became robust again in February and March this year, with transaction volume reaching 11,000 in March.
- Turnover fell slightly in April but more than 8,200 transactions were still recorded.
- Overall property prices began to climb again in February, up by 6% in March compared with January and above the peak of June last year by 1%.
- The outlook of the property market is highly uncertain. On one hand, a further worsening of the European debt crisis will drive the property market down. On the other hand, as the monetary environment is still loose, the property market may risk heating up again. We should guard against these two risks.
- The HKMA will continue to monitor market developments closely and stand ready to introduce measures as appropriate to safeguard banking stability.

ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: MODEST BANK CREDIT GROWTH



ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: CONCLUSION

- European debt crisis may worsen again
- Growth in the US will likely remain modest in the short term but momentum for faster pace is doubted
- Growth in Mainland China may fall as other emerging markets grow markedly slower
- Therefore the global economic and financial environment is subject to considerable uncertainties
- We should be stay vigilant of potential shocks from a resurgence of the European debt crisis and risk of the local property market heating up again

1. Assessment of Risk to Hong Kong's Financial Stability

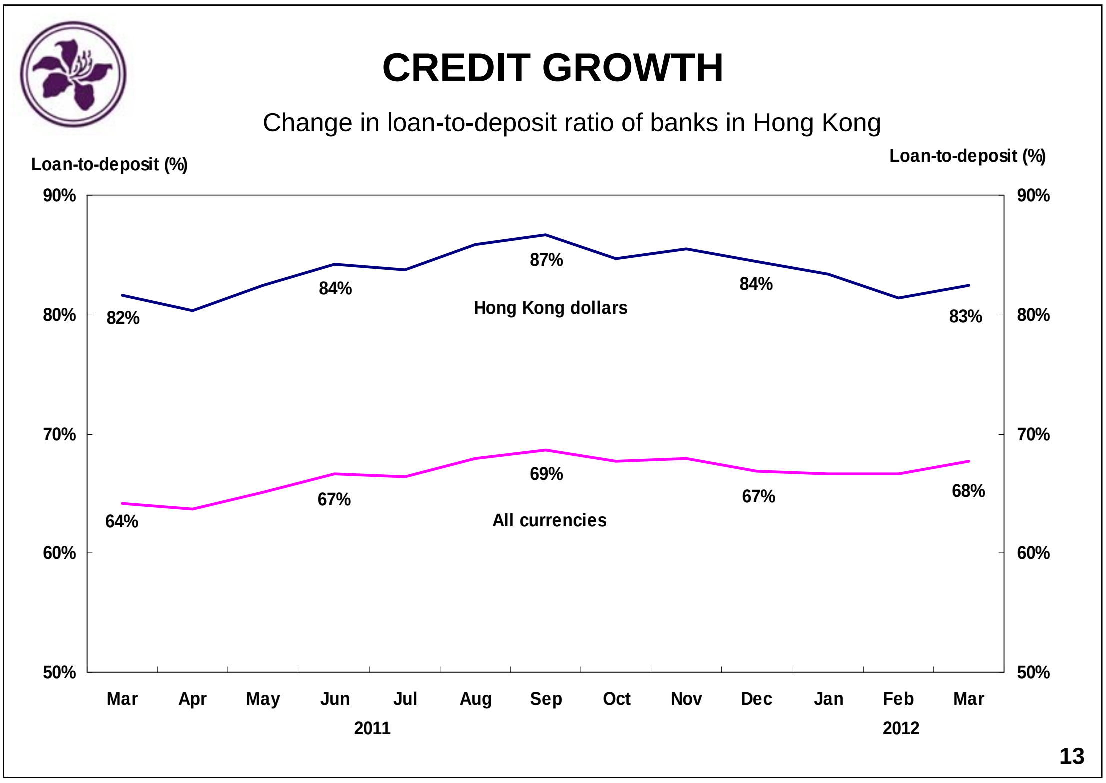
2. **Banking Supervision**

3. Hong Kong as an Offshore RMB Centre

4. Performance of the Exchange Fund

5. Financial Infrastructure

6. Hong Kong Mortgage Corporation



- Hong Kong dollar loan-to-deposit ratio decreased to 83% at end-March 2012 from 84% at end-December 2011. The HKMA will continue to monitor the movement of the loan-to-deposit ratio.

BASEL III IMPLEMENTATION PROGRESS

- Consultation on first phase of policy proposals completed. Industry comments being considered
- Other tasks in 2012:
  - Consultation on second phase of policy proposals (including details of disclosure requirements and liquidity standards)
  - Statutory consultation on the draft rules before tabling at LegCo

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Consultation on first phase of policy proposals

- Issued in January 2012 for industry consultation, covering proposals in relation to
  - the revised definition of capital (including the constituent elements of the capital base and the required regulatory deductions that must be made in the calculation);
  - the strengthened counterparty credit risk requirements (including the capital treatment of banks' exposures to central counterparties);
  - the integration of Pillar 2 requirements into the Basel III framework; and
  - certain aspects of the Basel III liquidity standards (including scope of application and relationship with the existing liquidity ratio in the Banking Ordinance).
- The consultation closed on 20 March. The HKMA has recently issued its response to the industry's comments.

Other tasks in the coming year

- A second round of consultation papers are expected to be issued in May. These will cover the disclosure requirements relating to the capital base and further details on the liquidity standards (such as the criteria for determining which AIs will be subject to the Basel III liquidity standards, the treatment of intragroup transactions under the new standards, and the enhanced framework for the existing 25% minimum liquidity ratio).
- The consultation results will form the basis for amending the Banking (Capital) Rules and the Banking (Disclosure) Rules for the first phase of implementation of the Basel III capital standards in Hong Kong (i.e. those that go into effect from 1 January 2013). The HKMA intends to issue the text of the draft rules for statutory consultation in Q3 prior to submitting the rules to LegCo in Q4.

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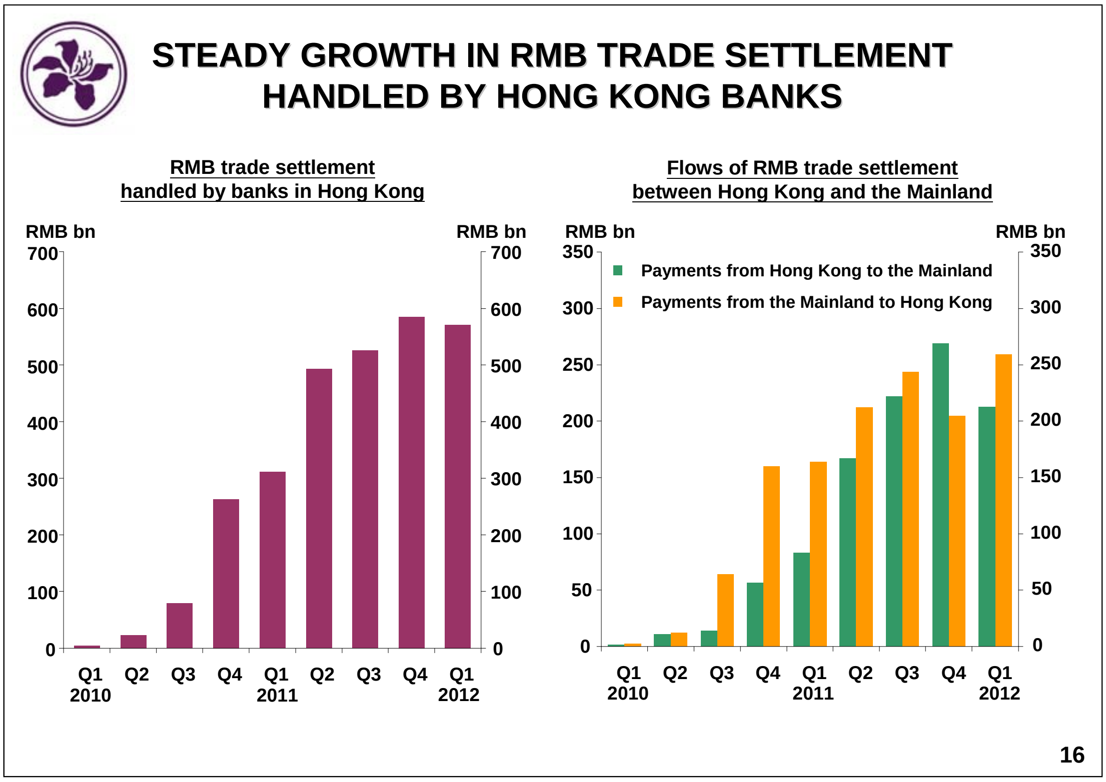
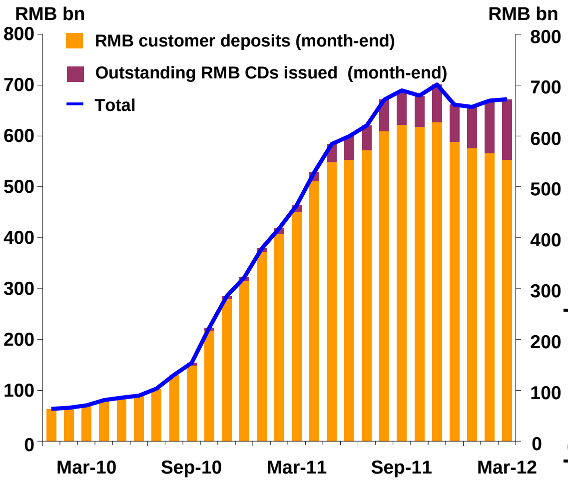


- Hong Kong's offshore RMB business continued to grow steadily in the first quarter of 2012.

- In Q1 2012, Mainland's RMB trade settlement amounted to RMB 580.4 billion yuan. During the same period, RMB trade settlement handled by banks in Hong Kong amounted to RMB 571.2 billion yuan. In addition, there were two-way flows of RMB trade settlement activities. The ratio of payments from Hong Kong to the Mainland vs those from the Mainland to Hong Kong was 1:1.2 in Q1 2012.

VIBRANT RMB FINANCING ACTIVITIES

RMB customer deposits and certificates of deposit (CDs)



RMB financing activities

RMB dim-sum bond market

	Jan - Apr 2012	Jan - Apr 2011
Amount of issuance (RMB billion)	36.7	19.0
No. of issuers	30	23

RMB bank lending

	End-Mar 2012	End 2011
Outstanding RMB loans (RMB billion)	42.0	30.8

- Banks have been increasingly issuing certificates of deposit (CDs) as a means to tap RMB liquidity. The decrease in RMB customer deposits of RMB 34.2 billion yuan in Q1 2012 was more than offset by the RMB 45.1 billion yuan increase in the outstanding amount of CDs issued by banks. At end-March, the outstanding amount of RMB customer deposits and CDs issued amounted to RMB 554.3 billion yuan and RMB 118.1 billion yuan respectively, totalling RMB 672.4 billion yuan, up from RMB 661.6 billion yuan at end-2011.

- RMB financing activities in Hong Kong continued to be vibrant. In the first four months of 2012, RMB bond issuance in Hong Kong amounted to some RMB 37 billion yuan, almost doubling the issuance size in the same period last year. Meanwhile, the range of issuers continued to diversify. In particular, there was the first RMB bond by an issuer from the Middle East in March 2012.

- RMB lending business by banks in Hong Kong continued to grow, with the outstanding amount of RMB loans increasing to RMB 42 billion yuan at end-March 2012, from some RMB 30 billion yuan at end-2011.

FURTHER DEVELOPMENT OF HONG KONG'S ROLE AS GLOBAL HUB FOR OFFSHORE RMB BUSINESS

		Q1 2012	2011	Growth
1	No. of participating banks of Hong Kong's RMB clearing platform	194	187	+4%
	Of which: Branches and subsidiaries of overseas banks and overseas presence of Mainland banks	170	165	+3%
2	No. of RMB correspondent accounts set up by overseas banks at Hong Kong banks	1,104	968	+14%
3	Amount due to overseas banks (RMB billion at period-end)	128.5	116.4	+10%
4	Amount due from overseas banks (RMB billion at period-end)	146.1	121.7	+20%

- In order to better serve financial institutions and corporates from different parts of the world, the operating hours of the RMB Real Time Gross Settlement system in Hong Kong will be extended to 11:30 pm by the end of June. This will give financial institutions in London and other financial centres in the European time zone an extended window to settle offshore RMB payments through Hong Kong.

- The Hong Kong – London Forum to Promote Cooperation on Development of Offshore Renminbi Business, which was established at the beginning of this year with the facilitation of the HKMA and the UK Treasury, will hold its first meeting from 22 to 23 May. The meeting will cover cooperation between Hong Kong and London in areas such as payment and settlement systems, market liquidity and the development of RMB denominated financial products.

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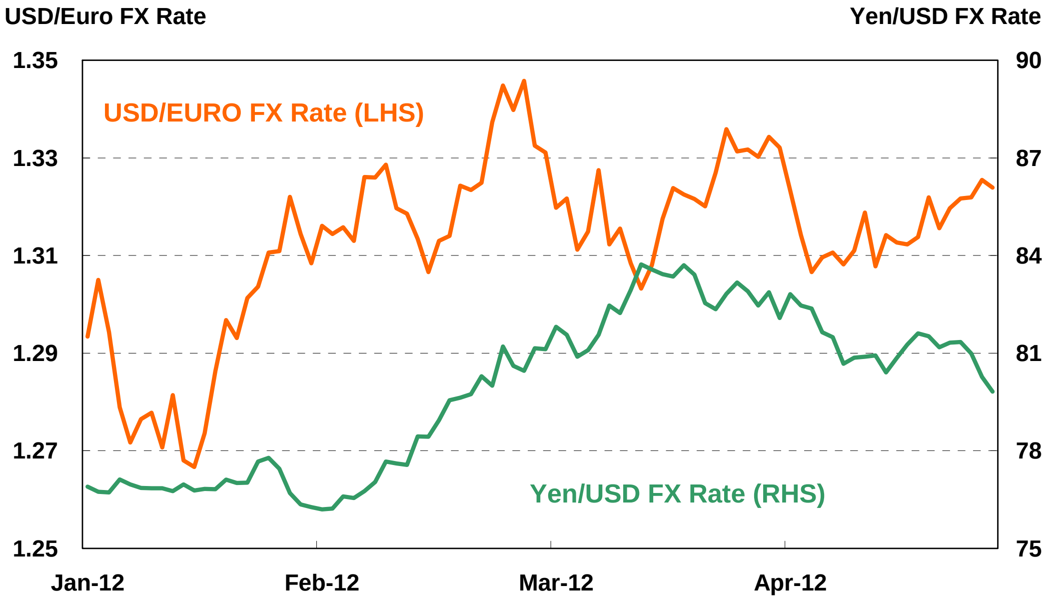
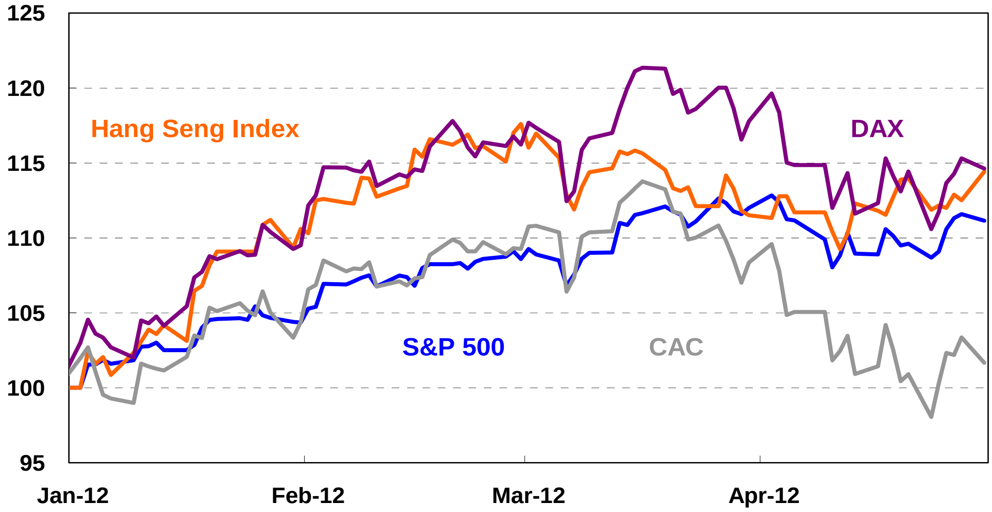
CURRENCY MARKETS

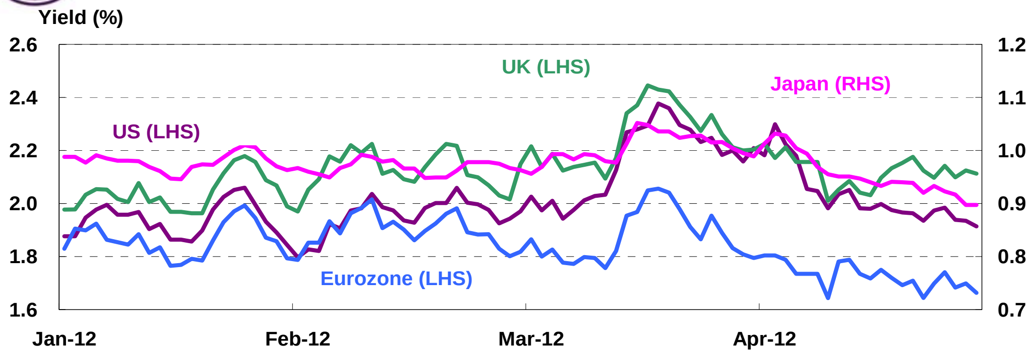


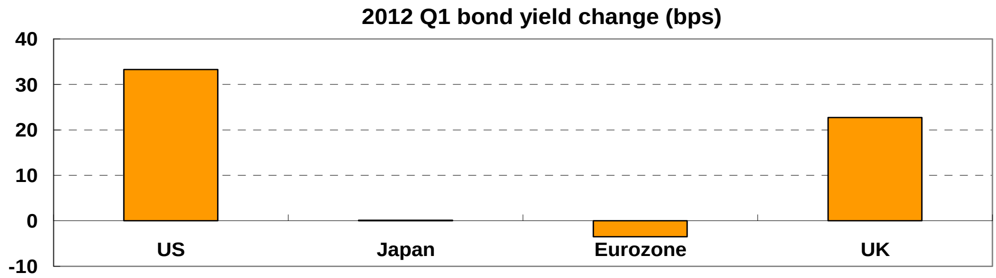
EQUITY MARKETS

Normalized Index Level (2011 year-end = 100)



CHANGES IN 10-YEAR GOVERNMENT BOND YIELDS





INVESTMENT INCOME

(HK$ billion)	2012 Q1*	2011 Full Year	2010 Full Year	2009 Full Year
Bonds#	**(2.9)**	**71.9**	**42.1**	**(0.6)**
Hong Kong equities^@	**13.6**	**(24.2)**	**11.6**	**48.9**
Other equities^	**28.2**	**(12.2)**	**27.1**	**48.8**
Foreign exchange	**4.1**	**(9.1)**	**(3.1)**	**9.8**
Other investments&	**0.8**	**0.7**	**1.7**	**0.8**
Investment income@&	**43.8**	**27.1**	**79.4**	**107.7**

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

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

(HK$ billion)	2012 Q1*	2011 Full year	2011 Q4	2011 Q3	2011 Q2	2011 Q1
Investment income/(loss)	**43.8**	**27.1**	**22.1**	**(41.4)**	**21.6**	**24.8**
Other income	-	0.2	-	0.1	0.1	-
Interest and other expenses	(0.9)	(4.7)	(0.9)	(1.0)	(1.6)	(1.2)
Net investment income/(loss)	42.9	22.6	21.2	(42.3)	20.1	23.6
Payment to Fiscal Reserves#	**(9.7)**	**(37.0)**	**(9.5)**	**(9.2)**	**(9.1)**	**(9.2)**
Payment to HKSAR government funds and statutory bodies#	(1.8)	(5.6)	(1.7)	(1.5)	(1.3)	(1.1)
Valuation change of Strategic Portfolio less valuation change of investment held by EF's investment holding subsidiaries^	(0.4)	(3.6)	(0.1)	(1.7)	(0.5)	(1.3)
Increase/(Decrease) in EF Accumulated Surplus	**31.0**	**(23.6)**	**9.9**	**(54.7)**	**9.2**	**12.0**

* *Unaudited figures*

\# *The fixed rate of fee payment is 5.6% for 2012 and 6.0% for 2011*

^ Including dividends

PROGRESS ON INVESTMENT DIVERSIFICATION

New Asset Classes	Market value as at end-2011 (HK$ billion)	Investment return from inception to end-2011#
Emerging market bonds and equities	28.1	7%
RMB bonds and equities	21.3	
Private equity	29.8	9% (combined internal rate of return)^
Real estate	4.4	
Total	83.6*	

* *In addition, outstanding investment commitments amounted to HK$56 billion.*

\# *annualised rate*

^ *Internal rate of return is commonly used by the investment industry to measure long-term performance of project-based investments. It takes into account the time value factors of all cash flows (including the amount of investment and gains) during the investment period.*

2007	• The HKMA conducted studies of and recommended the ways of increasing the medium- and long-term investment return of the Exchange Fund • On the advice of the Exchange Fund Advisory Committee, the Financial Secretary approved diversification of investment to be undertaken by the HKMA • Preparation work began: vastly experienced professionals were engaged to assist in establishing rigorous investment policies, rules and procedures
2008	• Diversification of investment formally launched with investments in emerging- market bonds
2009 to 2010	• Investments were expanded to private equity, emerging-market equities and the real estate sector
2011	• Investments in mainland China renminbi-denominated bonds and equities

PROGRESS ON INVESTMENT DIVERSIFICATION

Investment Team

Investment managers from HKMA's Reserves Management Department

- **Emerging market bonds**
- **RMB bonds**

External investment managers

- **Emerging market equities**
- **Private equity**
- **Real estate**

When handling transactions

engage financial, tax and legal consultants

Risk Management

- the size of diversified investment shall not exceed one-third of the accumulated surplus of the Exchange Fund
- Stringent investment policy and rules
- Due diligence vetting
- Each investment project to be approved by internal committee
- Regular reporting to EFAC and its Investment Sub-Committee

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Investment Team

- Investments in emerging market bonds are mainly managed by staff of the Reserves Management Department of the HKMA. Investments in emerging market equities, which adopt both index-based passive management and active management strategies, are managed by external managers.
- Highly specialised analysis and personnel with top class professional knowledge are required for making private equity fund investments, which are managed by external private equity fund managers.
- For real estate, we have engaged major international real estate investment managers to help identify prime-quality commercial properties in major overseas cities. Investment in real estate was also done through subscription of funds specialising in this field.
- Investments in RMB bonds are managed by investment managers of the Reserves Management Department of the HKMA, while investments in RMB equities are managed by external managers.
- We have commissioned relevant financial, tax and legal experts and consultants when handling transactions, and proceeded with these investments in a gradual and orderly manner.

Risk Management

- Before embarking on diversification of investment for the Exchange Fund, the HKMA has made reference to the operating models of major institutional investors and wealth funds and consulted specialists with relevant experience. The HKMA has also developed a set of stringent investment policies, rules and procedures, as well as risk management practices.
- Apart from rigorous due diligence vetting, approval by an internal committee chaired by the Chief Executive of the HKMA is required before individual investment for the Exchange Fund is made.
- The HKMA reports to EFAC and its Investment Sub-Committee on the work of the diversification of investment on a regular basis.

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REFORMING OTC DERIVATIVES MARKET

G20 Commitments

- All standardised OTC derivative contracts should be traded on exchanges/electronic trading platforms and cleared through central counterparties
- OTC derivative contracts should be reported to trade repositories

Implementation

- **Regulation:**
  - Aim to introduce the Securities and Futures (Amendment) Bill into the Legislative Council in Q4 2012 to implement the clearing and reporting requirements. The target is to implement the new regulations in mid-2013
- **Central Counterparty:**
  - HKEx is building a local central counterparty for OTC derivatives, which is expected to commence operation by end 2012
- **Trade Repository:**
  - HKMA is expanding the functions of the Central Moneymarkets Unit to develop a local trade repository, which is expected to commence operation in Q2 2013

- HKMA and SFC conducted public consultation on the proposed regulatory regime for the OTC derivatives market in October 2011. The target is to publish the consultation conclusions in Q2 2012 to respond to the comments received from the consultation.

- The detailed requirements of the new regulatory regime will be set out in the subsidiary legislation in the form of rules. HKMA and SFC aim to conduct a public consultation on the draft subsidiary legislation in Q4 2012.

- The local trade repository will be ready to provide the necessary matching service to facilitate clearing by the local central counterparty by end 2012 and to receive information from users upon satisfactory testing of the system in Q2 2013.

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SME FINANCING GUARANTEE SCHEME ("SFGS")

- Since the launch on 1 January 2011, as at 10 May 2012:
  - 265 applications approved *(Note)*
  - total loan amount about HK$913 million
  - average loan interest rate is 5.3% p.a.
  - average guarantee fee is 1.6% p.a.

- In response to a request from the Government, the HKMC launches in May 2012 a special product under the SFGS to assist SMEs in obtaining bank financing under challenging market conditions:
  - the new product provides 80% loan guarantee
  - guarantee fee is substantially reduced – only about 30% of the guarantee fee payable for 70% guarantee protection
  - application period is open for nine months
  - total loan commitment for the 80% product is HK$100 billion
  - the Government bears all losses and claims arising from the new product while the HKMC provides the operating platform

Note : Excluding applications already expired or withdrawn

MICROFINANCE PILOT SCHEME

- A three-year microfinance pilot scheme with a tentative aggregate loan amount of HK$100 million to be launched in mid-2012
- Three types of loans – business start-up, self-employment and self-enhancement (with loan ceilings at HK$300,000, HK$200,000 and HK$100,000 respectively)
- Several banks will join the scheme, with many opting for 50/50 share of funding alongside the HKMC
- Several voluntary agencies will also join to provide supporting network in training and mentorship