Hong Kong Monetary Authority

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Briefing to the Legislative Council Panel on Financial Affairs

15 December 2011

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

2. Hong Kong as an Offshore RMB Centre

3. Banking Supervision

4. Investment Return of the Exchange Fund in Q3 2011

EUROPE'S DEBT CRISIS MAY CLOUD OUTLOOK FOR GLOBAL ECONOMY

Baseline scenario:
Europe's debt crisis is largely contained, averting global recession

Adverse scenario:
Europe's debt crisis cannot be contained, leading to global financial shocks and economic recession

- Looking ahead, global economic growth and financial stability remain uncertain. Europe's debt crisis may cloud the outlook for the world economy.
- In the baseline scenario, Europe's debt crisis is largely contained, averting global recession.
- In the adverse scenario, Europe's debt crisis cannot be contained, degenerating into global financial shocks and extensive economic recession.

ECONOMIC GROWTH FORECASTS CONTINUE TO BE REVISED DOWNWARDS UNDER BASELINE SCENARIO

Real GDP growth

(%, annual rate)

	2011 Consensus Forecasts		2012 Consensus Forecasts	
	May FAP Briefing	**Dec FAP Briefing**	May FAP Briefing	**Dec FAP Briefing**
US	2.7	**1.8**	3.2	**2.1**
Euro area	1.7	**1.6**	1.7	**0.4**
Japan	0.0	**-0.4**	2.8	**2.1**
Asia (ex. Japan)	7.7	**7.3**	7.5	**6.9**

Source: Consensus Forecasts

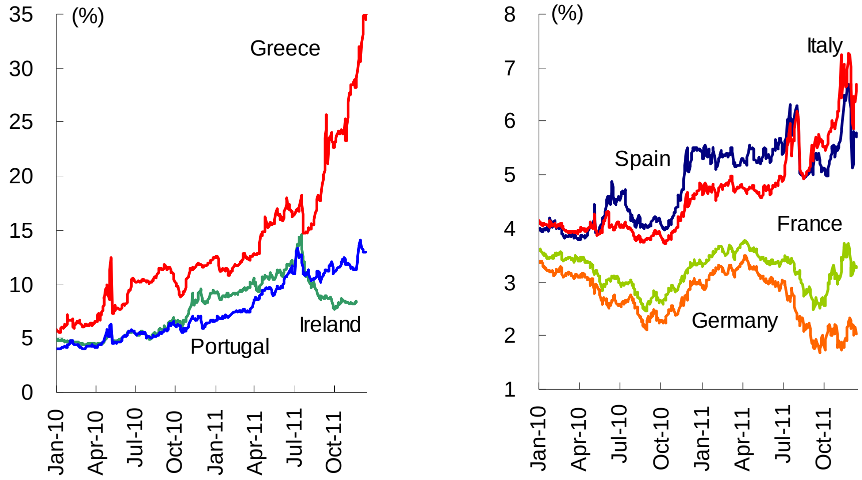
- Market forecasts for the US economy in both 2011 and 2012 have been substantially revised downwards since the last FAP briefing.
- As Europe became clouded by the debt crisis, forecasts for the region's growth were also significantly revised downwards.
- In Japan where the economy was shaken by earthquakes in March, market forecasts generally pointed to a slight reduction in output, followed by a rebound in 2012.
- As the outlook for advanced economies continue to deteriorate, momentum for growth in Asian countries was also expected to slow.

EUROPEAN SOVEREIGN DEBT CRISIS HAS SPREAD TO CORE COUNTRIES

Increased default risks of Greek sovereign debt

Yields on Italian and Spanish government bonds rose sharply

10-year government bond yields



Source: Bloomberg and EcoWin Note: EcoWin has stopped updating Ireland's 10-year bond yields since 22 Nov

- Since the outbreak of the European sovereign debt crisis in May 2010, Greece, Ireland and Portugal have successively received aid from the EU and the IMF.

- The crisis has now spread from small peripheral economies to core ones like Italy and Spain. Yields on 10-year Italian government bonds temporarily went beyond 7% (first on 9 November, then between 24 and 30 November), a level regarded by the market as being unsustainable.

- Contagion from the crisis has now reached France and Germany, with indication by some credit rating agencies that France's sovereign ratings may be downgraded if local banks have to be bailed out by the French government.

EUROPE ANNOUNCED RESCUE PLAN ON 26 OCTOBER

- European leaders announced at the EU summit on 26 October a three-pronged rescue plan

  (i) to restructure Greece’s sovereign debt

  (ii) to recapitalise the European banking system, and

  (iii) to leverage up the European Financial Stability Facility

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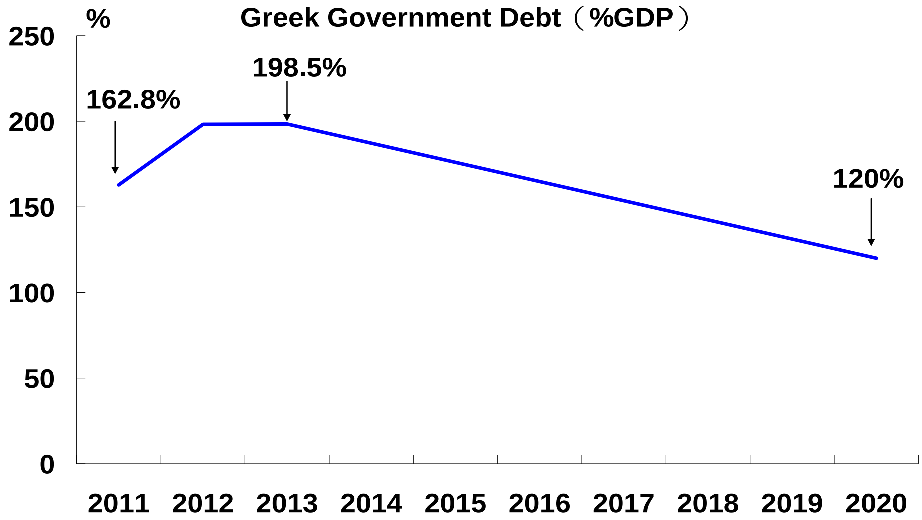
  (ii) to recapitalise the European banking system, and

  (iii) to leverage up the European Financial Stability Facility.

EUROPEAN RESCUE PLAN: (1)
RESTRUCTURING GREECE'S SOVEREIGN DEBT

- Greece will remain heavily indebted even if debt restructuring through a 50% haircut is achieved



Source: European Commission "European Economic Forecast - Autumn 2011"

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- Under the latest sovereign debt restructuring plan for Greece, private creditors would have to cut the value of their Greek bond holdings in half so that the country's debt-to-GDP ratio will decrease to 120% by 2020.

- However Greece will remain heavily indebted even if debt restructuring through the above 50% haircut is completed.

EUROPEAN RESCUE PLAN: (2)
RECAPITALISATION OF BANKING SYSTEM

- European Banking Authority estimated in December that European banks must raise €114.7 billion to meet the target of 9% core Tier 1 capital adequacy ratio.

- It remains uncertain how the funds can be raised:

  - **Banks** may refrain from raising new capital from the market due to poor lending conditions. They may constrain lending instead to bolster their capital adequacy ratio, resulting in a credit crunch

  - Injection by **European governments** may endanger their sovereign ratings

  - **EFSF** must succeed in leveraging up itself before it has the necessary means

- On recapitalisation of the banking system, the European Banking Authority estimated in December that European banks must raise €114.7 billion before they can meet the 9% core Tier 1 capital adequacy ratio target. It remains uncertain how the funds can be raised.

- If the European banks are left alone on this, they may refrain from raising new capital from the market due to poor lending conditions. Instead they may constrain lending to bolster their capital adequacy ratio, resulting in a credit crunch. Reports suggested that not only have the banks stayed away from the capital market, they are also trying every possible means to adjust their balance sheets so as to boost up their capital adequacy levels. This will create tightness in credit.

- If the European governments are to inject the required capital, their sovereign ratings may be affected. One of the credit rating agencies has already warned that if France were to bear the recapitalisation costs for its local banks, its existing AAA rating may be downgraded.

- If the funds are to be paid from European Financial Stability Facility (EFSF), the facility must succeed in leveraging up itself before it has the necessary means.

EUROPEAN RESCUE PLAN: (3)
LEVERAGING UP EFSF

- The EU Economic and Financial Affairs Council passed two moves on 29 November to leverage up the EFSF:

  1. EFSF will provide guarantee against the default losses on the first 20-30% of the euro zone's sovereign debt

  2. A special purpose vehicle will be set up for debt financing to boost the financial strengthen required for rescue plans

- Market response was lukewarm as not enough details on the moves were announced

- EFSF's auction of €3 billion bonds on 10 November was poorly received, raising doubts about its ability to raise funds in future

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- With insufficient details on the leveraging plan, market response was lukewarm.

- The recent auction of €3 billion bonds by the EFSF on 10 November was poorly received (with yields rising to 3.59%, compared with 3.49% in the last auction; and subscription was just enough compared with an over-subscription rate of 9 times in the last auction), raising doubts about the EFSF's ability to raise funds in future.

RESCUE MEASURES BY EUROPEAN CENTRAL BANK AND OTHER MAJOR CENTRAL BANKS

- Recent rescue measures by the European Central Bank include:
  - announcement on 3 November of an interest rate cut by 25 basis points to 1.25%
  - announcement on 8 December of an interest rate cut by 25 basis point to 1%
  - introducing a series of extraordinary measures, including unlimited provision of liquidity to banks for a term of three years (announced on 8 December)
- The US Federal Reserve and five major central banks jointly announced on 30 November to lower the US dollar liquidity swap rate by 0.5 per cent so that the new level will be overnight index swap rate plus 50 basis points

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- As measures announced on 26 October failed to instill much confidence from the market, the ECB launched a series of rescue measures, including:
  - an interest rate cut by 25 basis points to 1.25% announced on 3 November
  - an interest rate cut by 25 basis point to 1% announced on 8 December
  - a series of extraordinary measures (including unlimited provision of liquidity to banks for a term of three years) announced on 8 December.

EU SUMMIT ON 9 DECEMBER
INTRODUCED FURTHER RESCUE MEASURES

- The EU agreed at its summit on 9 December that:
  - EU's 26 member countries (excluding the UK) will sign an inter-governmental fiscal compact
  - European Stability Mechanism (with total lending capacity of €500 billion) will be launched one year earlier in July 2012
  - EU will consider lending up to €200 billion to IMF so that it has sufficient resource to support crisis-stricken countries
  - "Voluntary" involvement by the private sector (haircut) as in the Greek debt problem will no longer be expanded

- European leaders introduced further rescue measures at the EU summit on 9 December.

- The EU's 26 member countries (excluding the UK) agreed on an inter-governmental fiscal compact. The agreement, which will be written into the constitution of each member country, provides for an automatic correction and sanction mechanism:

  - Constitutions will specify that where the annual structural deficit exceeds by 0.5% of GDP, the automatic correction mechanism will be triggered.

  - Implementation of the existing Excessive Deficit Procedure will be strengthened: if the deficit limit of 3% of GDP is breached, automatic sanctions may be imposed; and if debt-to-GDP ratio exceeds 60%, debt cuts must be made each year based on specified parameters.

- The launch of the European Stability Mechanism (with total lending capacity of €500 billion) will be brought up by one year to July 2012.

- The EU agreed to consider providing up to €200 billion in loans to the IMF so that it will have sufficient resource to deal with the European debt crisis.

- "Voluntary" involvement by the private sector (haircut) as in the Greek debt problem will no longer be expanded.

EUROPEAN SOVEREIGN DEBT CRISIS AND ECONOMIC ASSESSMENT: CONCLUSION

- As danger of the European debt crisis spreading to the euro zone core countries grows, credit rating agencies become pessimistic about the outlook for the region and confidence of financial markets weakens
- EU summit introduced further measures on 9 December to prevent confidence crisis from spreading to core countries and their banks. However the market remains closely watchful of:
  - ➢ Whether crisis-hit countries will fully implement stringent fiscal austerity measures and structural reforms
  - ➢ Progress in recapitalisation of banks
  - ➢ Progress in raising rescue funds to ensure they can be readily deployed to stabilise financial markets if credit crunch aggravates
- **Even if the European debt crisis does not deteriorate, Europe is expected to experience a sharp slowdown or even recession**

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- Even if the European debt crisis does not deteriorate, we expect a sharp slowdown or even recession in Europe's economy. ECB chairman also admitted the euro zone may head into "a mild recession" at the end of this year.

ASSESSMENT OF THE US ECONOMY: SHORT TERM

- Driven by increased consumer spending, growth in the US economy accelerated to 2.0% in the third quarter, following a rise of 0.4% and 1.3% in the first two quarters
- Unemployment improved slightly, decreasing from 9.2% in June to 8.6% in November
- US Fed perceives that downside risks of the US economy have increased
- Monetary easing is expected to continue:
  - US Fed will likely keep the extremely low interest rates until at least mid-2013; announced Operation Twist in September
  - Likelihood for introducing third round of quantitative easing heightened

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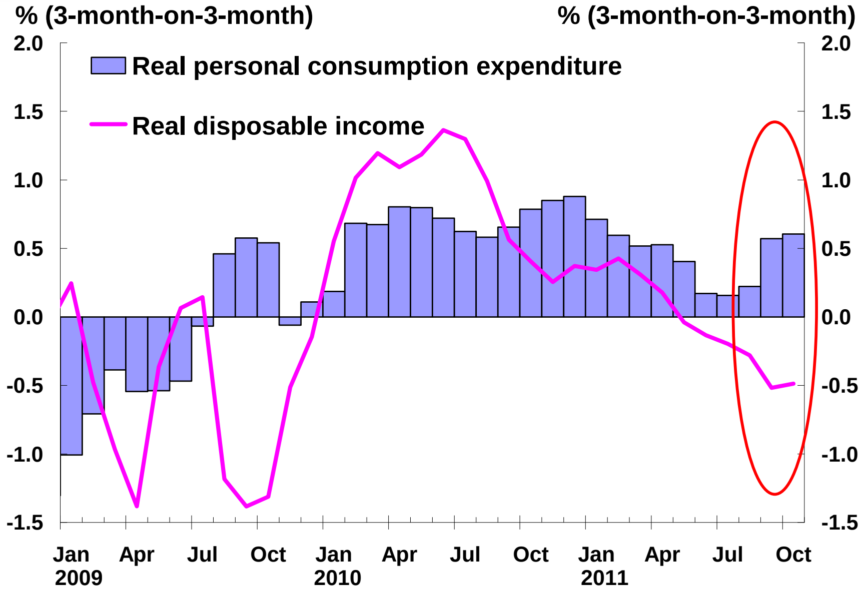
- The US Fed perceives that downside risks of the US economy have increased.
- In view of the downside risks, the US Fed has declared that the extremely low interest rates will likely be kept until at least mid-2013. It also announced a US$400 billion Operation Twist in September.
- With ongoing economic weakness, persistently high unemployment and limited room for fiscal manoeuvring, the chances for introducing third round of quantitative easing have heightened.
- I would like to elaborate on two points: (1) sustainability of growth in US personal consumer spending; and (2) implications of fiscal deficits for growth in the US economy.

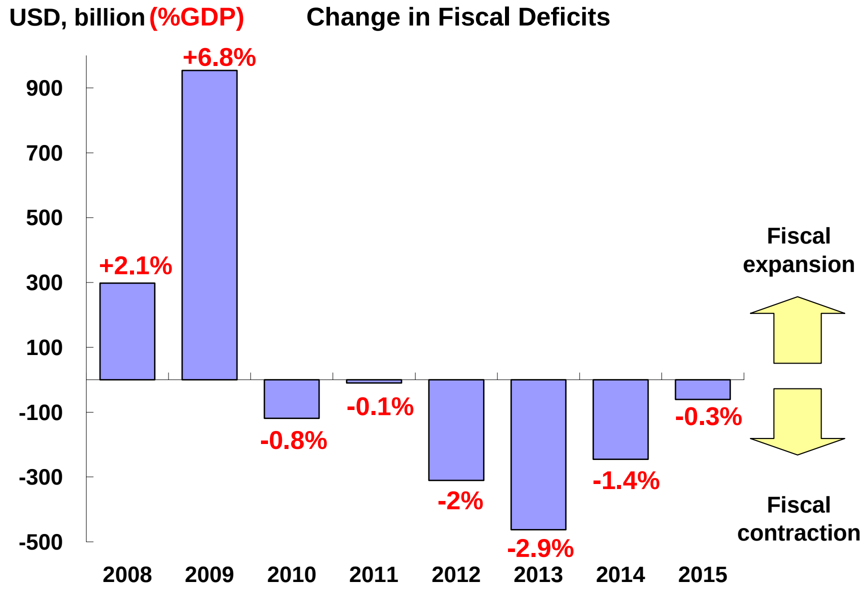
US: FASTER RISE IN CONSUMPER SPENDING NOT DRIVEN BY INCOME GROWTH



Source: CEIC

- Faster increase in personal consumption expenditure in the US helped propelled economic growth in the third quarter
- However whether the pace of growth in consumer spending will be continued remains uncertain
- The chart shows the recent 3-month-on-3-month rise in personal consumption expenditure accelerates significantly while the 3-month-on-3-month rise in real disposable income continued to fall.
- This reflects recent increase in personal spending was driven not by income growth, but rather dis-saving, a trend which is unlikely to continue in the long term.
- In the absence of support from strong income growth, personal consumption expenditure will ultimately slow, dragging on the pace of economic growth.

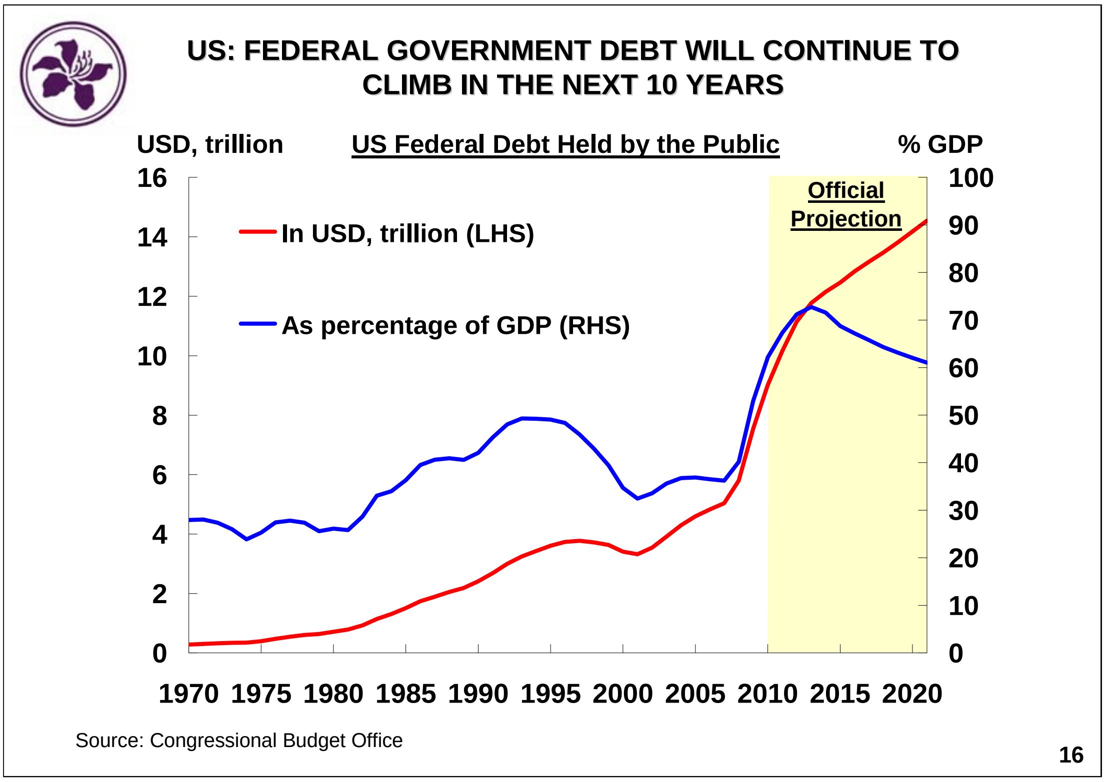
US: FISCAL CONSOLIDATION DRAGGING ON ECONOMIC GROWTH



Sources: Congressional Budget Office and CEIC

- On the fiscal policy front, the US government will need to reduce its fiscal deficit by US$2.1 trillion in the coming 10 years.

- As the US congressional ‘Super Committee’ failed to reach an agreement on deficit reduction, automatic across-the-board spending cuts of at least US$1.2 trillion will be made. Fiscal consolidation by this indiscriminate approach will put a drag on the US economic growth in the medium term.



- The US Congressional Budget Office (CBO) predicted earlier that in the absence of fiscal consolidation, the US federal government debt will increase substantially by US$8 trillion between 2011 and 2021, weakening the country's sovereign credit rating.

- This prediction is based on the CBO's estimated average GDP growth rate of 2.9%. In view of the current bleak economic outlook, this growth projection may be too optimistic, underestimating the actual government debt to GDP ratio.

ASSESSMENT OF THE US ECONOMY: STRUCTURAL PROBLEMS

The economy is still faced with a number of unresolved issues:

Structural problems

- Household deleveraging still in progress
  - Yet household savings rate reversed its prior upward trend and dropped to 3.5%
- Unemployment rate fell to 8.6%
  - Yet 43% of the total unemployed workers has been jobless for six months or even longer
- A sluggish property market
  - Negative wealth effect will slow down recovery
  - Reduce geographical mobility of unemployed workers
  - Falling house prices might result in a vicious circle with more houses being foreclosed

Serious differences of views between the Democrats and the Republicans have lessened the chance of taking timely and decisive measures to resolve problems

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- On household debt, the process of deleveraging is not yet completed. Recently, household savings rate has reversed its upward trend and dropped to 3.5% in October from 5% in June. This means that the household deleveraging process might take longer to complete and household consumption will be affected as a result. [(for reference: the ratio of household debt to disposable income dropped to 1.156 in Q2 2011 from its historic high of 1.298 in Q4 1997)]

- On the labour market, although unemployed has dropped to 8.6%, but it is still at an elevated level. Among the total unemployed workers, 43% has been jobless for six months or even longer. An extended period of joblessness will lead to the loss of important skills of unemployed workers, thereby resulting in a deepening of the structural unemployment problem.

- On the property market of the US, residential sales remain sluggish. House price index has dropped by 32.5% from its peak in April 2006. The continued fall in house prices might result in a vicious circle with more houses being foreclosed.

ASSESSMENT OF THE JAPANESE ECONOMY

- The Japanese economy continues to recover after the earthquake, albeit at a slow pace
  - Industrial production and exports have returned to pre-earthquake levels
  - GDP growth picked up to 1.4% quarter-on-quarter in Q3, after contracting for two consecutive quarters
  - However, inflationary pressure remains.
- Monetary policy: Bank of Japan maintains the zero-interest rate policy and continues to expand its asset purchase programme.
- Public finance: Japan's public debt is rapidly rising even though it has not yet led to a confidence crisis
  - The Japanese government has approved three supplementary budgets in the financial year of 2011, totaling 19 trillion yen (accounting for 4% of GDP), to help fund reconstruction costs
  - Public debt will increase to more than 200% of GDP.
- Forecast: Amid a strong yen, an ageing population, and a gloomy outlook for the US and European economies, the momentum of Japan's economic recovery from the earthquake will be adversely affected.

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FORECASTS OF MAJOR INDICATORS IN MAINLAND CHINA

	2009	2010	2011 forecasts		2012 forecasts	
			IMF	Consensus	IMF	Consensus
Real GDP growth (%)	9.2	10.4	9.5	9.1	9.0	8.5
CPI inflation (%)	-0.7	3.3	5.5	5.4	3.3	3.8

Sources: CEIC, IMF World Economic Outlook (September 2011) and Consensus Forecasts (November 2011).

- Growth momentum will moderate as external environment continues to deteriorate.
- Inflationary pressure is somewhat relieved but inflation rate remains elevated.
- The current prudent monetary policy is expected to continue without any significant ease in inflationary pressure.

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- As external environment deteriorates, growth momentum of the Mainland economy will inevitably moderate. Both the IMF and market consensus forecast that the growth of the Mainland economy will slow to 9% or less next year.
- With inflation decelerating, the People's Bank of China (PBoC) has decided to lower the reserve requirement ratio for financial institutions by 0.5 percentage point with effect from 5 December.

SOLUTIONS TO THE ECONOMIC ISSUES FACED BY THE MAINLAND ECONOMY

- Factors affecting Mainland's financial and economic condition:
  - Property market: After several rounds of measures to stabilize property market, there have been signs of slowing down
  - Inflation: Recent significant drop in inflation rate indicates that inflation might have reached its peak
  - Local government financing platform: In the process of stepping up controls.

- Overall risk remains at a manageable level. Moreover, with various financial and monetary policy tools at their disposal, the Mainland authorities will be able to implement macro adjustment against shocks and to minimize the risk of a hard-landing in the economy.

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EXTERNAL FACTORS AFFECTING HONG KONG'S FINANCIAL ENVIRONMENT

- In the event that the European debt crisis continues to deteriorate, the world might again be sent into recession and the risk of a global financial crisis will increase as a result.
- Even if Europe manages to muddle through the debt crisis, sluggish growth in the US and the euro zone is expected in the coming years.
- Hong Kong is faced with a highly uncertain macro-economic and financial environment
  - ➢ Downside risks to the Hong Kong economy has increased and external shocks will affect Hong Kong through international trade linkages and financial channels
  - ➢ The global financial market will continue to waver between risk-on and risk-off sentiments, resulting in a highly volatile market.

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- Even if Europe manages to muddle through the debt crisis, the US and the euro zone will enter an era of slow growth in the coming years.
- As a result, Hong Kong is faced with a highly uncertain macro-economic and financial environment.
- First, with Hong Kong being a highly external-oriented economy, downside risks will affect Hong Kong's economy through international trade linkages and financial channels.
- Moreover, the global financial market will continue to waver between risk-on and risk-off sentiments, resulting in a highly volatile market.

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

- There are signs of cooling down in the property market after the HKMA introduced the fourth round of prudential measures for property mortgage loans in June.
- Property transaction volume averaged 5,000 per month since July, representing a sharp fall of nearly 50% compared with the first half of this year. Property prices in October also fell by 3.6% compared with June.
- Results of the residential mortgage survey for October 2011 showed that the number of newly approved mortgages fell by 50% compared with the first half of this year.
- The HKMA will continue to closely monitor market development and review the situation from time to time based on cyclical developments.

- With the introduction of the fourth round of prudential measures for property mortgage loans in June by the HKMA, the uncertain global economic outlook and rising mortgage rates, property transactions are affected and there are signs showing that the property market is slowing down.
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ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: CREDIT GROWTH

- Bank lending continued to grow in the first half of 2011 following an increase of 29% in 2010. The HKMA has repeatedly reminded banks to manage their credit and liquidity risks properly.
- Loan growth began to slow down in July. Bank loans recorded a 11% month-on-month growth (annualised) in September and 7% in October.
- Although loan growth rate has somewhat moderated, credit condition remains tightened on the Mainland and in the US and the euro zone. Moreover, with the elevated loan to deposit ratio of local banks, interest rates are under upward pressure.

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

- When faced with an unstable financial and monetary environment similar to that in 2008/09, Hong Kong should prepare itself and enhance the resilience of the banking system
  - Introduced four rounds of counter-cyclical prudential measures for mortgage loans
  - Required banks to strengthen their credit and liquidity risk management
  - Increased the level of banks' regulatory reserve from an average of 0.85% in 2010 to 1.4%
  - Required local branches of foreign banks to ensure adequate funding sources to support their lending activities.

- Actively participating in discussions to enhance global stability and financial supervision and implementing relevant new international standards and reforms (put forward by international organizations such as the Financial Stability Board, the Basel Committee and the International Monetary Fund).

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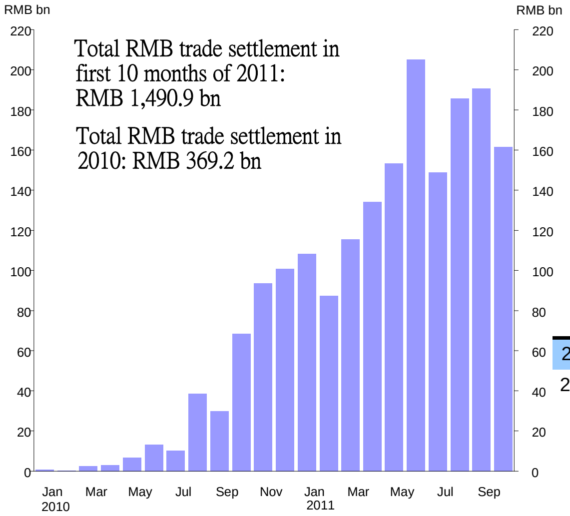
CONTINUOUS PROGRESS IN RMB TRADE SETTLEMENT

RMB trade settlement conducted through banks in Hong Kong

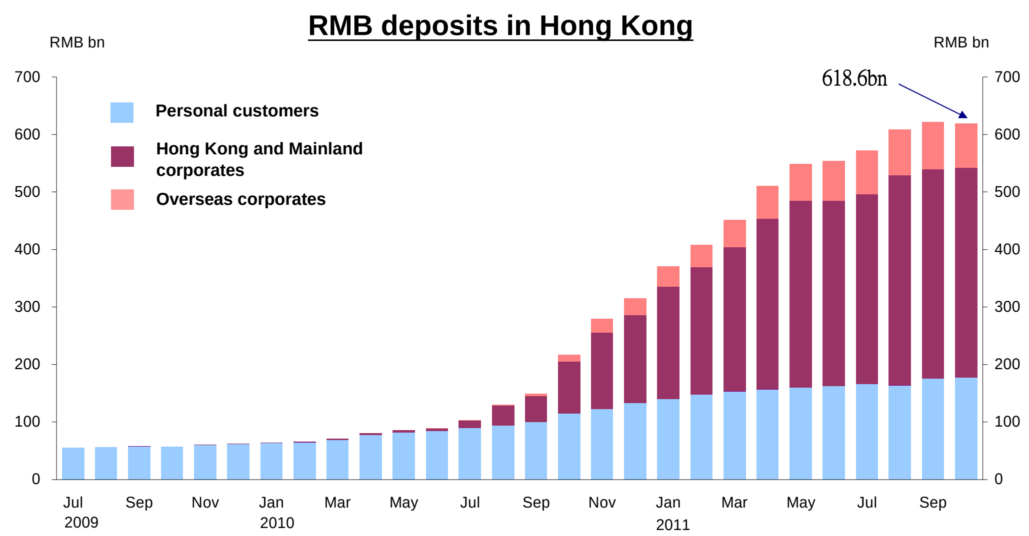


		Mainland's trade settled in RMB (RMB billion)	As percentage of Mainland's total trade (%)
2010	H1	67.0	0.7
	H2	439.3	4.0
	Annual	506.3	2.5
2011	H1	957.6	8.6
	Q3	583.4	9.3

		RMB trade settlement conducted through banks in Hong Kong (RMB billion)	As percentage of Mainland's trade settled in RMB (%)
2010	Annual	369.2	72.9
2011	Q1	311.3	86.4
	Q2	492.7	82.5
	Q3	525.4	90.1

- RMB trade settlement conducted through banks in Hong Kong increased from a monthly average of RMB57 billion yuan in the second half of last year to RMB134 billion yuan in the first half of this year, and further to RMB175.1 billion yuan in the third quarter. Currently, the amount of RMB trade settlement conducted through banks in Hong Kong is equivalent to more than 80% of the Mainland's trade settled in RMB. This shows that Hong Kong is an important platform for offshore RMB trade settlement business.

STEADY GROWTH OF RMB DEPOSITS IN HONG KONG



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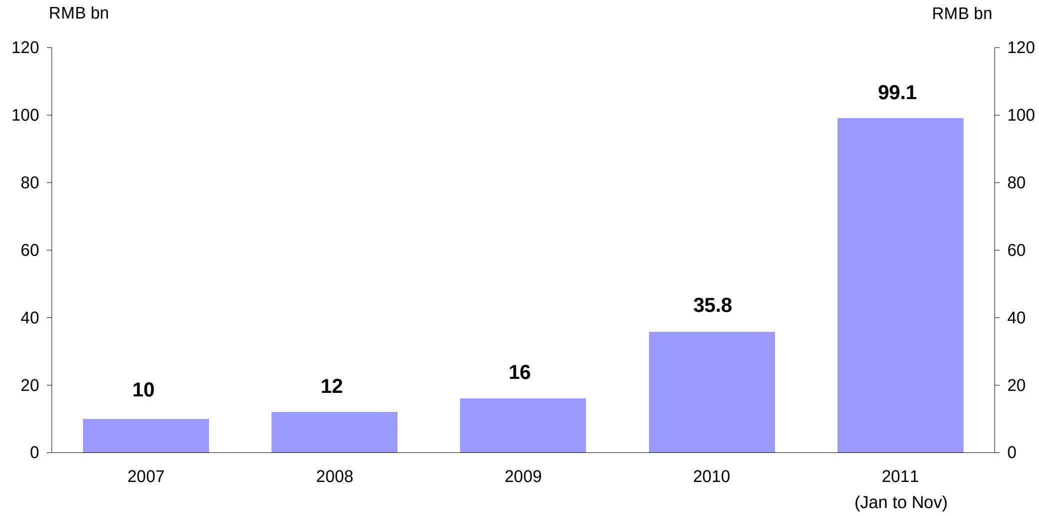
- RMB deposits in Hong Kong almost doubled from RMB314.9 billion yuan in the beginning of this year to RMB618.6 billion yuan at end-October. RMB deposits of corporates increased by RMB259 billion yuan to over RMB440 billion yuan at end-October, representing 71% of the total RMB deposits. 18% of the corporate deposits were deposits of corporates incorporated overseas.

SIGNIFICANT EXPANSION OF RMB BOND ISSUANCE IN HONG KONG

RMB bond issuance in Hong Kong



- Hong Kong is the global hub for RMB bond issuance. In the first eleven months of 2011, 76 entities issued RMB bonds in Hong Kong totalling RMB99.1 billion yuan (including the RMB20 billion yuan sovereign bonds issued by the Ministry of Finance), 2.8 times of the RMB35.8 billion yuan issued in the entire year of 2010. The range of issuers has diversified, with a number of multinational enterprises (such as Volkswagen, British Petroleum, etc.) having issued RMB bonds in Hong Kong.

HONG KONG AS KEY PLATFORM SUPPORTING RMB BUSINESS OVERSEAS

- **A global RMB payment and settlement network**
  - At end-Oct 2011, there were 184 participating banks in Hong Kong's RMB clearing platform, of which 161 were branches and subsidiaries of foreign banks and overseas branches of Mainland banks
  - Banks in Hong Kong are also actively providing RMB correspondent banking services to banks overseas
- **HKMA's proactive promotion work**
  - **2011:** Conducted roadshows in Australia, Russia, UK and Spain
  - **2012:** Plans to visit South America and other places with close trade and investment links with China

PROMISING OUTLOOK FOR HONG KONG AS OFFSHORE RMB CENTRE

- Supportive measures of the Central Government: Arrangement for use of RMB for foreign direct investments will generate significant demand for RMB financing in Hong Kong
- More two-way movements in cross-border RMB trade flows and offshore RMB pricing show that the Hong Kong offshore RMB market is maturing
- Expansion of currency swap agreement between PBoC and HKMA allows provision of liquidity to maintain stability of offshore RMB market in Hong Kong when necessary, supporting steady business development

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- The support for Hong Kong to develop as offshore RMB business centre has been set out in the national 12th Five-Year Plan. A series of supportive measures was also announced in August. In particular, implementation of the administrative arrangements for the use of RMB for foreign direct investments will greatly expand the use of RMB funds in Hong Kong and promote the development of the RMB bond market and financing activities in Hong Kong.

- The PBoC and the HKMA renewed the currency swap agreement with an expanded size from RMB200 billion yuan to RMB400 billion yuan. This will allow the HKMA to provide liquidity to maintain the stability of the offshore RMB market in Hong Kong when necessary, thereby facilitating the steady development of the business.

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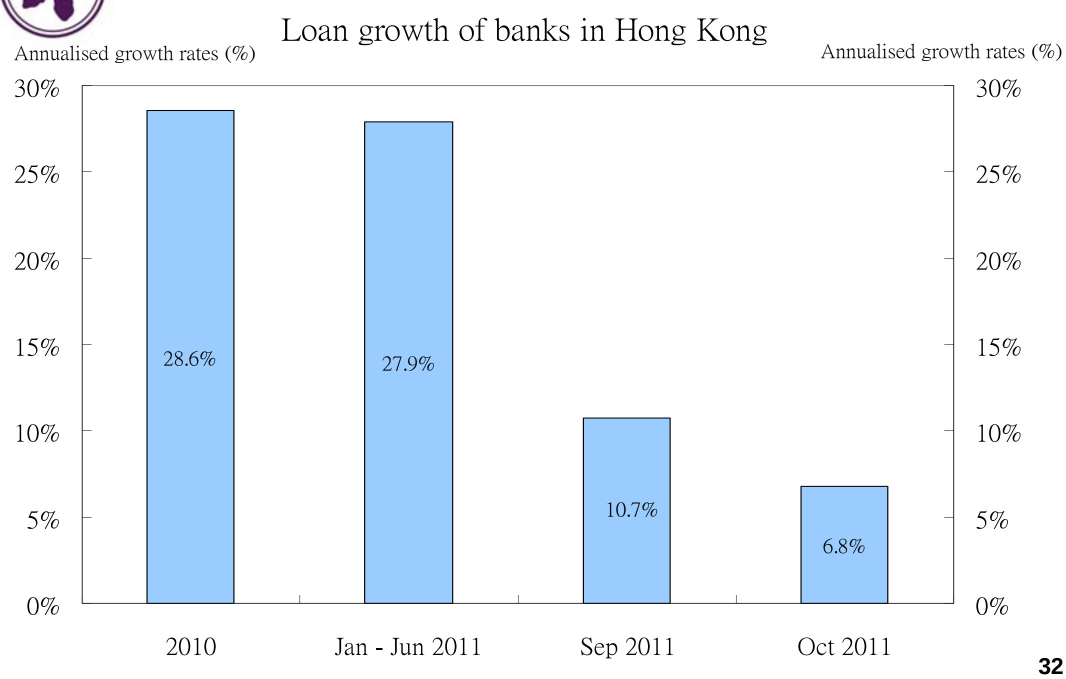
CREDIT GROWTH OF BANKS IN HONG KONG



RISK MANAGEMENT IN RESIDENTIAL MORTGAGE LOANS (“RMLs”)

- In May and June 2011, there were signs of renewed exuberance following high transaction prices recorded in government land sale auctions. The HKMA introduced on 10 June the fourth round of countercyclical macroprudential measures to strengthen the risk management of banks in Hong Kong.

- Recently, we observed signs of slowing down in the property market amid deepening of the European sovereign debt crisis, uncertainties over the global economic outlook and increases in mortgage rates.

- Property transaction in Q3/2011 fell noticeably. In October, the number of new RML applications dropped to 6,613, which was 71% lower than the recent peak recorded in March 2011. The value of new RMLs approved fell 71% over the same period to HK$12.5 billion.

- The number of RMLs in negative equity increased to 1,653 in Q3/2011. The number of RMLs in negative equity accounted for a very small portion of total outstanding mortgage.

- The HKMA will continue to monitor the market situation closely and introduce appropriate measures in the light of the latest development in the property market to safeguard banking stability in Hong Kong.

BASEL II ENHANCEMENTS &
BASEL III IMPLEMENTATION PROGRESS

- Basel II enhancements
  - Negative vetting of the Amendment Rules completed by LegCo on 23 November 2011
  - Amendment Rules will take effect from 1 January 2012 in line with the Basel Committee's timetable.
- Basel III
  - Industry consultation on proposed amendments to Banking Ordinance conducted in October 2011.
  - Banking (Amendment) Bill 2011 is intended to be introduced into LegCo in December 2011.
  - Basel III capital reforms will raise quality and level of banks' capital and promote the build-up of capital buffers.
  - Basel III liquidity ratios will strengthen banks' capability to withstand short-term liquidity shocks and ensure availability of more stable and longer-term funding.
  - Regulatory framework for "Global Systemically Important Banks" issued in November 2011.

Basel III

Implementation progress

- The FSTB intends to introduce the Bill into LegCo this month.

- Work will now need to begin on the development of the rules to specify the required ratios and detailed calculation methodologies in order to allow sufficient time for consultation and necessary system-changes before the first phase of Basel 3 capital requirements go into effect on 1 January 2013.

Basel G-SIBs (globally systemically important banks) framework

- The framework sets out a "bucketing approach" of tiered capital surcharges for systemically important banks and categorises banks as systemic by reference to an assessment of their size, interconnectedness, substitutability, complexity and cross-border activities. 29 banks have been identified as GSIBs thus far in a preliminary list issued after the G20 Cannes Summit.

- Anticipated that now the GSIBs have been dealt with – there may be more focus on DSIBs (i.e. domestically systemically important banks) and what measures may be appropriate for them.

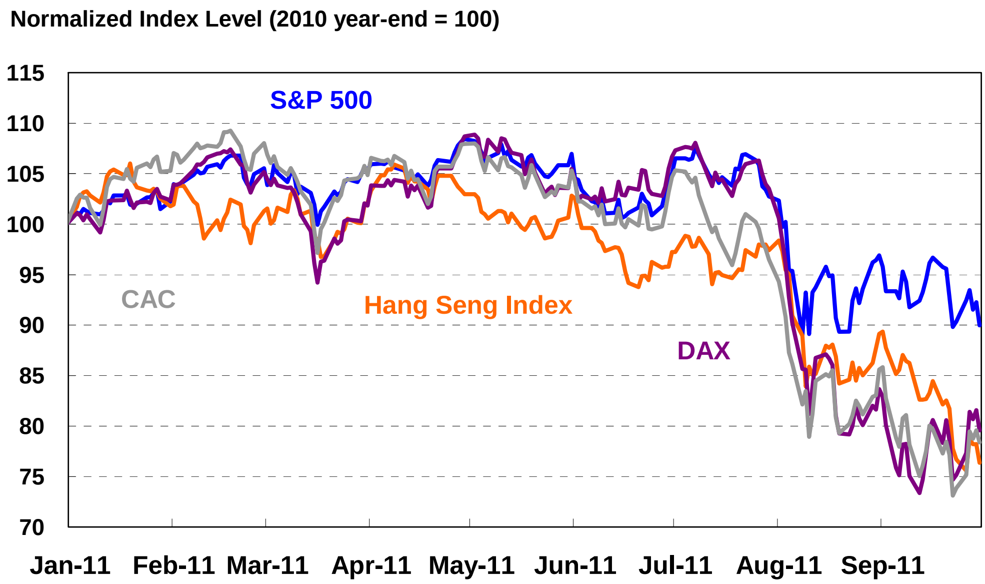
1. Assessment of Risk to Hong Kong’s Financial Stability

2. Hong Kong as an Offshore RMB Centre

3. Banking Supervision

4. **Investment Return of the Exchange Fund in Q3 2011**

EQUITY MARKETS



INVESTMENT INCOME

(HK$ billion)	2011 Jan-Sep*	2011 Q3	2011 Q2	2011 Q1	2010 Full Year
Hong Kong equities^@	(29.7)	(28.7)	(4.5)	3.5	11.6
Other equities^	(28.0)	(37.5)	0.6	8.9	27.1
Foreign exchange	2.1	(20.1)	7.7	14.5	(3.1)
Other investments&	0.5	(0.7)	0.4	0.8	1.7
Bonds#	60.7	46.2	17.4	(2.9)	42.1
Other income/loss@ &	5.6	(40.8)	21.6	24.8	79.4

* 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)	2011 Jan - Sep*	2011 Q3	2011 Q2	2011 Q1	2010 Full year
Investment income/(loss)	5.6	(40.8)	21.6	24.8	79.4
Other income	0.2	0.1	0.1	-	0.2
Interest and other expenses	(3.8)	(1.0)	(1.6)	(1.2)	(4.8)
Net investment income/(loss)	2.0	(41.7)	20.1	23.6	74.8
Payment to Fiscal Reserves #	(27.5)	(9.2)	(9.1)	(9.2)	(33.8)
Payment to HKSAR government funds and statutory bodies #	(3.9)	(1.5)	(1.3)	(1.1)	(3.9)
Valuation change of Strategic Portfolio less valuation change of investment held by EF's investment holding subsidiaries^	(4.1)	(2.3)	(0.5)	(1.3)	0.9
Increase/(Decrease) in EF Accumulated Surplus	(33.5)	(54.7)	9.2	12.0	38.0

* *Unaudited figures*

The fixed rate of fee payment is 6.0% for 2011 and 6.3% for 2010

^ Including dividends