



HONG KONG MONETARY AUTHORITY

**Briefing to the Legislative Council
Panel on Financial Affairs**

15 May 2018

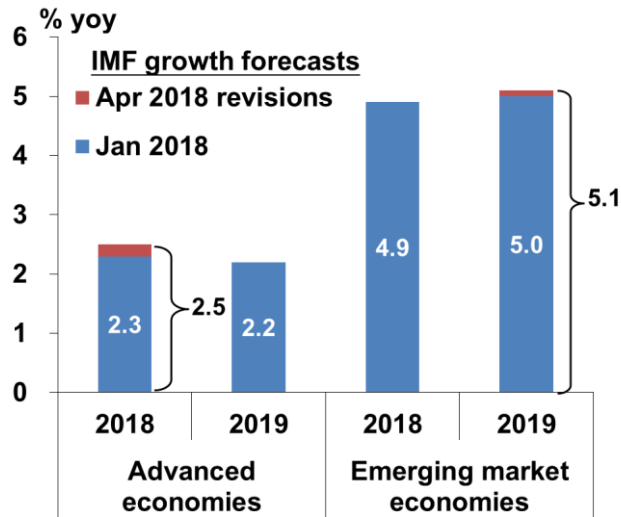
[Translation]



- 1. Assessment of Risk to Hong Kong's Financial Stability**
2. Banking Supervision
3. Financial Infrastructure
4. Development of Financial Market
5. Investment Performance of the Exchange Fund
6. HKMC Life Annuity Scheme



ECONOMIC GROWTH CONTINUES

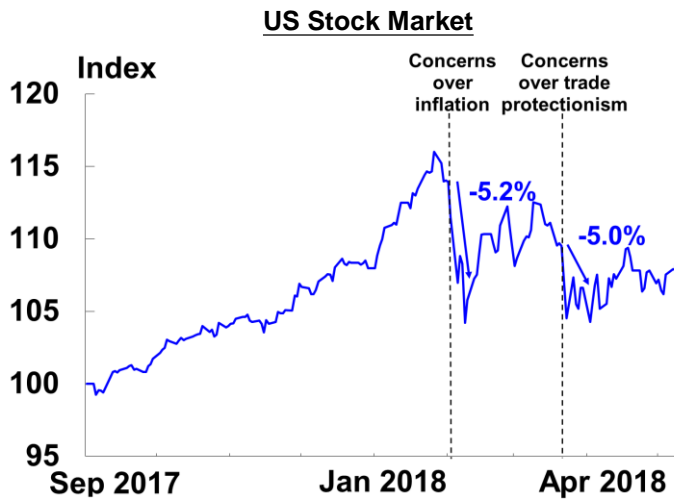


Source: International Monetary Fund

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POSITIVE MARKET SENTIMENT BEGAN TO CHANGE...



Note: The S&P 500 is re-based to be 100 on 1 September 2017.

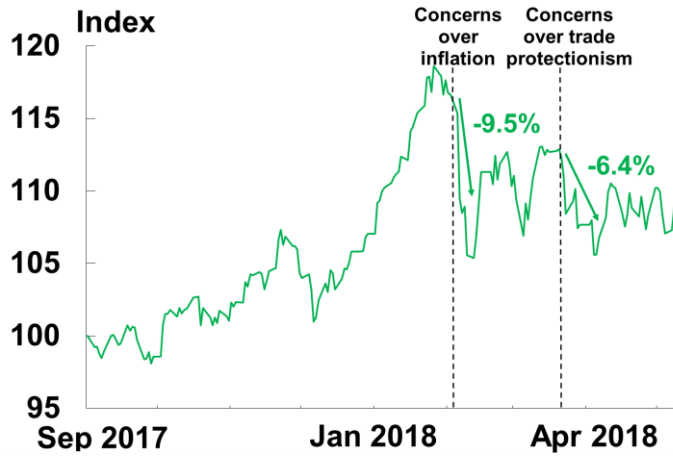
Source: Bloomberg

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POSITIVE MARKET SENTIMENT BEGAN TO CHANGE...

Hong Kong Stock Market



Note: The Hang Seng Index is rebased to be 100 on 1 September 2017.

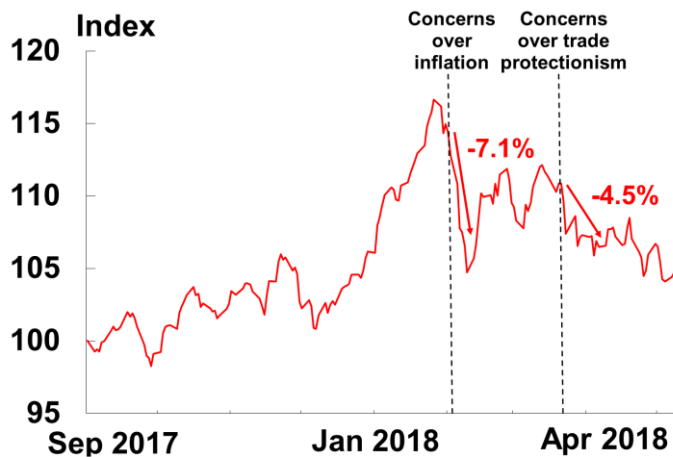
Source: Bloomberg

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POSITIVE MARKET SENTIMENT BEGAN TO CHANGE...

Stock Markets in Emerging Market Economies



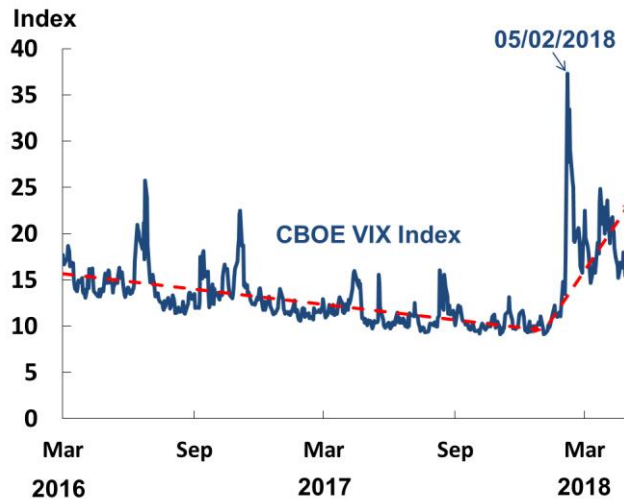
Note: The MSCI Emerging Markets Index is rebased to be 100 on 1 September 2017.

Source: Bloomberg

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...BRINGING AN END TO THE PERIOD OF HISTORICALLY LOW VOLATILITY



Source: Bloomberg

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MAJOR RISKS TO GLOBAL FINANCIAL ENVIRONMENT

- Tightening monetary conditions
 - US Fed's balance sheet normalisation, with the monthly maximum pace of reduction increasing from current US\$30 billion to US\$50 billion starting from October 2018
 - Pace of Fed rate hikes may be faster than expected
 - Widening US fiscal deficit may push up US interest rates
- Heightened trade protectionism and US-China trade frictions
- Geopolitical tensions remained elevated amid the US withdrawing from the Iran nuclear deal
- US dollar may regain strength, putting pressure on emerging market economies

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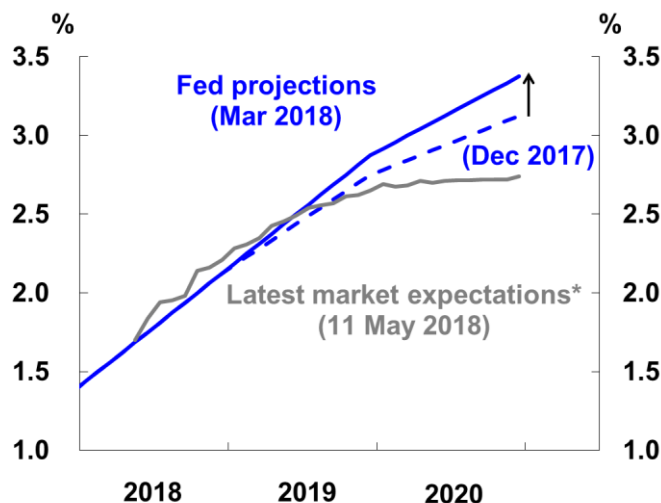
US RATE HIKES MAY BE FASTER THAN EXPECTED

- The median projection among FOMC members in the March meeting suggested a total of 3 rate hikes this year. However, 7 out of the 15 members expected 4 or more hikes
- US tax reforms would lead to a widening of fiscal deficit (by US\$1,500 billion in ten years), which could drive up Treasury yields
- US inflation may pick up
 - Low unemployment rate (3.9%) coupled with faster economic growth may lead to faster increases in wages
 - Trade conflicts may lead to higher import prices and hence inflationary pressure
 - 10-year US Treasury yield rose above 3% on 25 April

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MARKETS STILL UNDERESTIMATE THE PACE OF RATE HIKES BY THE US FED



Note: * Market expectations are derived from the latest prices of the Fed funds futures contracts.

Sources: Datastream and US Federal Reserve

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RISKS FROM US-CHINA TRADE CONFLICTS

- US trade protectionism
 - Import tariffs on washing machines and solar panels starting 22 January, with a 20% and 30% tariff respectively during the first year
 - A 10% tariff on aluminum and 25% tariff on steel starting 23 March
 - Based on the results of the Section 301 Investigations, the US announced on 3 April the introduction of a 25% tariff on US\$50 billion worth of some 1,300 Chinese high-tech products, and restrictions on Chinese investments in the US
- China announced on 4 April a 25% tariff on 106 types of US products worth US\$50 billion, including soybeans and automobiles
- The US announced on 5 April additional tariffs on US\$100 billion worth of Chinese goods
- First round of US-China trade talks was held on 3-4 May, but without any significant breakthroughs

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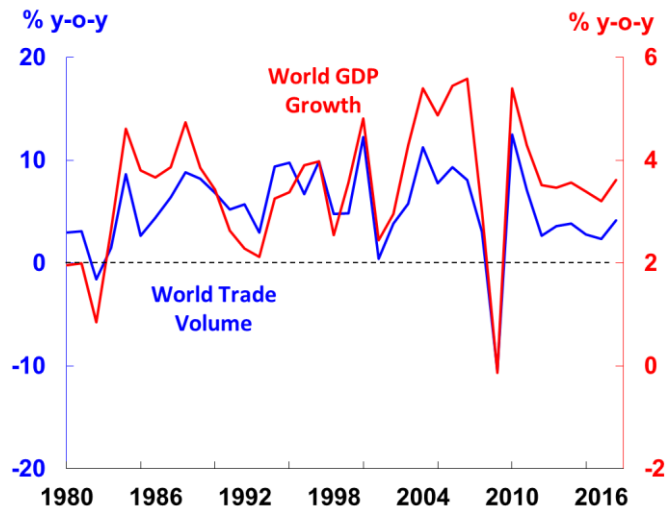
US-CHINA TRADE CONFLICTS THREATEN GLOBAL SUPPLY CHAIN

- US figures show that China's trade surpluses in goods with the US reached US\$375.2 billion in 2017
 - China exported US\$505.6 billion of goods to the US, with high-tech goods accounting for US\$171.1 billion, and imported US\$130.4 billion of goods from the US
- Yet, China is at the end of the global supply chain. For example, export value of high-tech products from China includes value-added from imported parts from Japan, Korea and Taiwan
 - Partly reflected in China's persistent trade deficits with these three economies (a combined US\$214.1 billion in 2017)
- US-China trade conflicts will affect global supply chain and other economies

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TRADE WAR WILL THREATEN GLOBAL ECONOMY AND BENEFIT NOBODY



Source: International Monetary Fund

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PRIORITIES OF ECONOMIC DEVELOPMENT OF MAINLAND CHINA

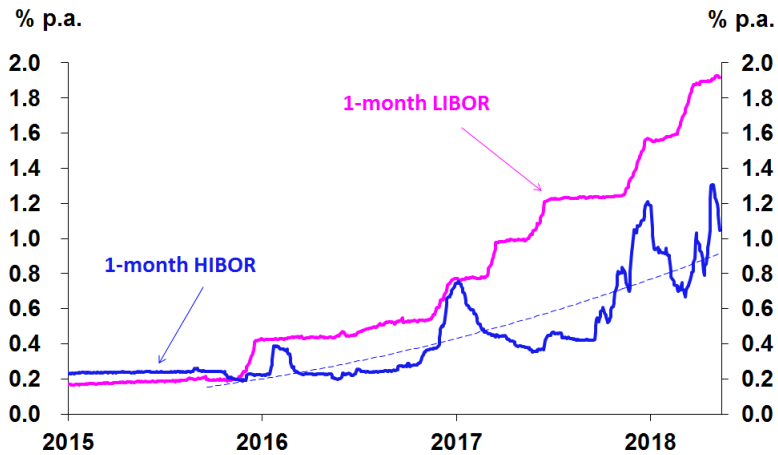
- Economy remained robust in Q1 2018
 - The economy grew by 6.8% year-on-year in the first quarter and the market expects a 6.6% growth for the whole year
 - The growth of industrial production and fixed asset investment rebounded after slowing down in the second half of last year
- Government Work Report highlighted this year's priorities
 - Enhance the quality of economic development and cut outdated steel and coal capacity
 - Push ahead with reform of state-owned enterprises as well as market and financial reforms
 - Guard against major financial risks (local government debts, financial system)

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ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY

HIBORs trended up but at a slower pace than their US counterparts



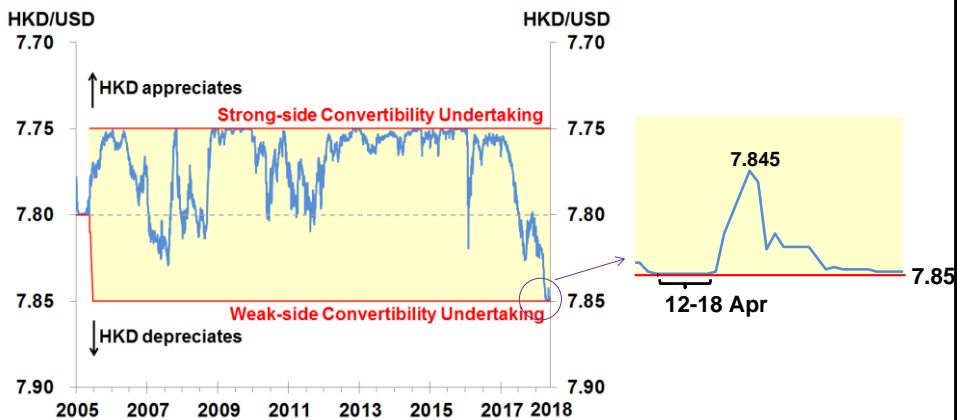
Source: Hong Kong Monetary Authority

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ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY

HKD touched the 7.85 level



Remark: The RHS chart shows the daily low of HKD exchange rate against USD

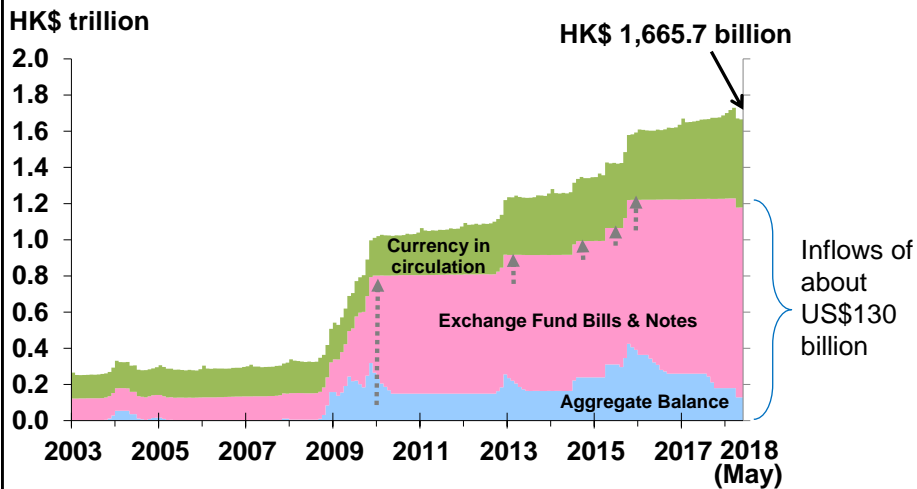
Source: Hong Kong Monetary Authority

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ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY

Sizeable Monetary Base serves as cushion for capital outflows



Source: Hong Kong Monetary Authority

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ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY

- Triggering of the weak-side Convertibility Undertaking is in accordance with the design and normal operation of the Linked Exchange Rate System
- The HKMA will buy HKD and sell USD at 7.85 level to ensure that the HKD will not fall below 7.8500
- It is possible that the weak-side Convertibility Undertaking will be triggered again in the future
- The HKMA is fully capable of maintaining HKD stability amid sizeable fund flows. There is no need to be worried

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ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY

Hong Kong's resilience significantly enhanced

Monetary statistics (HK\$ bn)	end-1998	As of 20 April 2018 (changes)
Aggregate Balance	2.5	128.5 (+50.4 times)
Exchange Fund Bills and Notes	97.5	1,049.1 (+9.8 times)
Monetary Base	192.5	1,661.0 (+7.6 times)
Foreign currency reserve assets (US\$ bn)	89.6	432.7 (+3.8 times)
		end-March
Hong Kong stock market capitalisation	2,661.7	34,387.2 (+11.9 times)

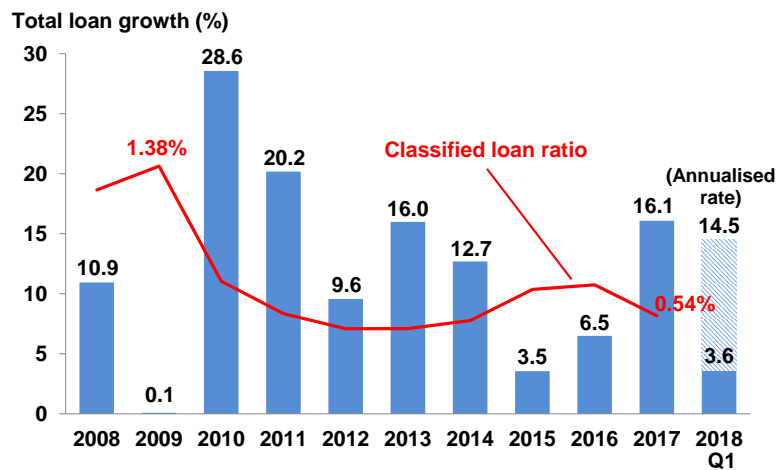
Banking statistics	end-1997	end-2017
Capital adequacy ratio	17.5%	19.1%
Loan-to-deposit ratio	152.1% (HKD: 112.3%)	73.0% (HKD: 82.7%)
Liquid assets held by banks (including Exchange Fund Bills and Notes)	~ HK\$600 bn	~ HK\$4,000 bn

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ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: BANK CREDIT

A steady credit growth with asset quality staying at a healthy level



Source: Hong Kong Monetary Authority

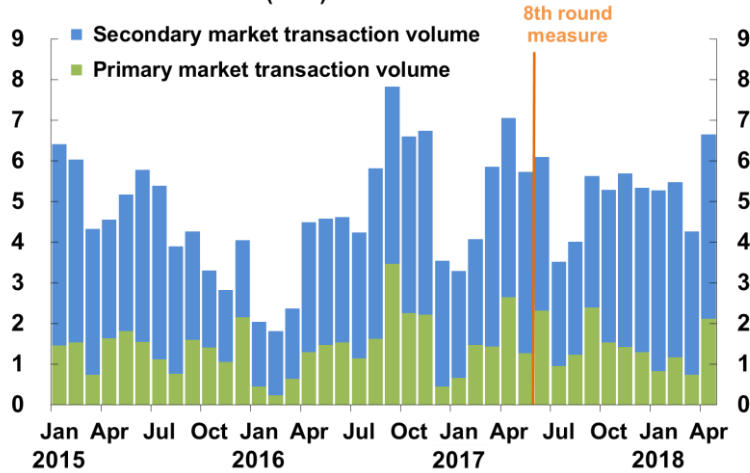
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ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

Property transactions remained buoyant

Number of transactions ('000)



Source: Land Registry

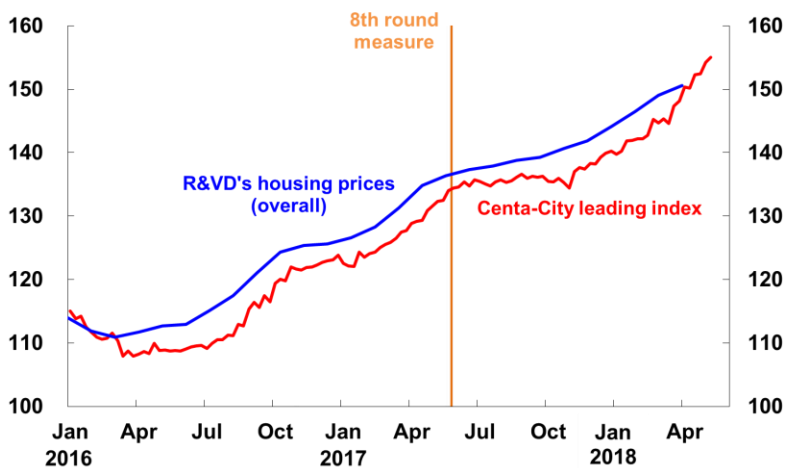
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ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

Property prices continued to go up

Index (Jan 2014 = 100)



Sources: Rating & Valuation Department and Centaline Property Agency Limited

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

- Despite the sound fundamentals of the global economy, financial and asset markets will become more volatile in light of various risks
- Triggering of the Convertibility Undertaking provides the necessary condition for the normalisation of local interest rates which is conducive to the sustainable and healthy development of Hong Kong's economy and financial markets
- It is unrealistic to expect that ultra-low HKD interest rates will continue
- The HKMA reminds the public to assess the various factors carefully when taking out loans and manage the risks associated with interest rate and market volatilities prudently

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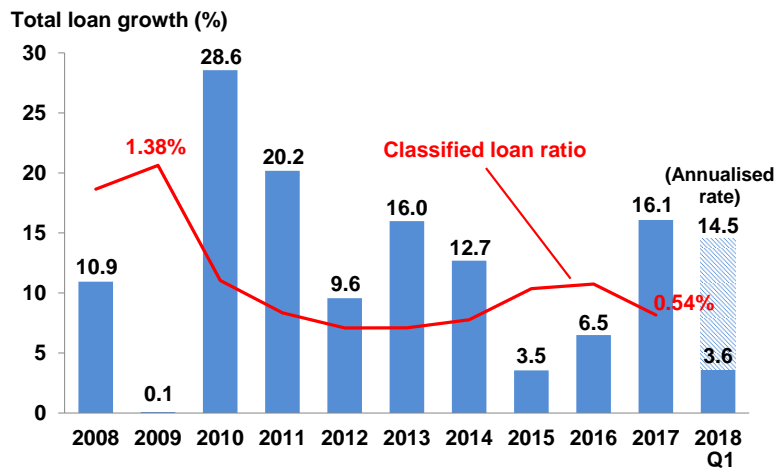
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BANKING SECTOR PERFORMANCE

A steady credit growth with asset quality staying at a healthy level



Source: Hong Kong Monetary Authority

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INTERNATIONAL STANDARDS IMPLEMENTATION

- Banking (Exposure Limit) Rules 2018
- Banking (Disclosure) (Amendment) Rules 2018
- Banking (Capital) (Amendment) Rules 2018
- Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2018

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HONG KONG RESOLUTION REGIME

- Financial Stability Board confirmed that with the coming into force of the Financial Institutions (Resolution) Ordinance (FIRO) last year, Hong Kong has a fully cross-sectoral resolution regime
- Rules will be developed pursuant to the FIRO to prescribe loss-absorbing capacity (LAC) requirements for authorized institutions. Public consultation was closed in March 2018. It is expected that the LAC rules and consequential Inland Revenue Ordinance amendment bill will be introduced into LegCo in the second half of 2018

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SMART BANKING

Fintech Supervisory Sandbox 2.0

- Launched in November 2017 and operating smoothly

Introduction of Virtual Banking

- Public consultation was completed on 15 March
- Comments received from the consultation are being studied
- A number of local and overseas firms expressed interest to submit application

Banking Made Easy

- Engaging the banking industry and tech community
- Issued supervisory guidelines to provide greater flexibility for banks to adopt financial technology in personal lending business

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LATEST FINTECH INITIATIVES

Faster Payment System to be launched in September 2018

- System development work completed and system testing underway
- A single common QR code standard to be implemented for accepting different payment schemes

Open Application Programming Interface

- Industry consultation completed, and feedback being reviewed with an aim to finalising the framework by mid-2018

Trade Finance Platform based on Distributed Ledger Technology

- Development of Hong Kong Trade Finance Platform in progress
- Tendering of Global Trade Connectivity Network between Hong Kong and Singapore underway

Upgraded version of Fintech Career Accelerator Scheme (FCAS 2.0)

- To provide various training opportunities for 250 students

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STORED VALUE FACILITIES (SVFs)

- SVF industry saw significant growth in 2017. As at the fourth quarter of 2017:
 - SVF accounts in use: 46.73 million (up 15.4% from the fourth quarter of 2016)
 - quarterly total transaction: 1.5 billion in volume (up 6% year-on-year); HK\$38.7 billion in value (up 27.7% year-on-year)
 - quarterly P2P funds transfer: up 916% in volume and 167% in value year-on-year
- SVF licensees continue to expand their business reach to different sectors, e.g. taxis, wet markets and small merchants

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COIN COLLECTION PROGRAMME

- Extend the Coin Collection Programme until September 2020
- From April 2018 onwards, the public may choose to upload the equivalent amount of counted coins to five different e-wallets

GOVERNMENT BOND PROGRAMME

- To issue the third batch of Silver Bond in the third quarter of 2018, targeting Hong Kong residents aged 65 or above

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OFFSHORE RMB BUSINESS

- Bond Connect is operating smoothly. Over 280 investors have joined Bond Connect, with an average daily turnover of almost RMB3 billion in the first quarter of 2018. The HKMA will continue to optimise operational arrangements and promote Bond Connect to overseas investors
- RMB deposit pool held steady, hovering at around RMB600 billion in recent months. Turnover recorded by RMB RTGS system stayed at a high level, averaging more than RMB900 billion per day
- Daily quotas under Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect have been expanded. The HKMA is also in discussion with the relevant authorities and the industry on liquidity arrangements to ensure a smooth process for inclusion of A-shares in MSCI

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DEVELOPING HONG KONG'S FINANCIAL PLATFORM

Promoting Green Finance

- Working with the Government to study the issuance of the first Government green bond
- A large-scale international conference on green bond and a joint seminar with the Research Bureau of the People's Bank of China will be held in June to explore green finance opportunities and promote Hong Kong's international profile on green finance

Developing Hong Kong's Bond Market

- Working on the implementation of the three-year Pilot Bond Grant Scheme which covers eligible enterprises issuing bonds in Hong Kong for the first time
- Working with the Government on the legislative changes to enhance the Qualifying Debt Instrument Scheme

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INVESTMENT INCOME

(HK\$ billion)	2018	2017	2016
	Q1	Full Year	Full Year
	(unaudited)		
Hong Kong equities*	1.7	58.3	5.3
Other equities	(7.4)	80.4	28.6
Bonds	5.5	34.4	33.1
Foreign exchange#	26.3	53.5	(15.8)
Other investments@	-	37.4	16.9
Investment income	26.1	264.0	68.1

* Excluding valuation changes of the Strategic Portfolio.

This is primarily the effect of translating foreign currency assets into Hong Kong dollar after deducting the portion for currency hedging.

@ Including valuation changes of private equity and real estate investments held under the Long-Term Growth Portfolio. Valuations of these investments for the first quarter of 2018 are not yet available.

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INCOME AND EXPENDITURE

(HK\$ billion)	2018	2017	2016
	Q1	Full Year	Full Year
	(unaudited)		
Investment income	26.1	264.0	68.1
Other income	-	0.2	0.2
Interest and other expenses	(3.1)	(9.9)	(6.4)
Net income	23.0	254.3	61.9
Fee payment to Fiscal Reserves*#	(11.1)	(46.2)	(33.1)
Fee payment to HKSAR government funds and statutory bodies*	(3.4)	(8.6)	(9.6)

* The rate of fee payment is 4.6% for 2018, 2.8% for 2017 and 3.3% for 2016.

This does not include the 2018 fee payment to the Future Fund because such amount can only be determined after the composite rate for 2018 is available.

(The composite rate was 9.6% for 2017 and 4.5% for 2016. Fee payable to the Future Fund was HK\$22.7 billion for 2017 and HK\$10.1 billion for 2016.)

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HKMC LIFE ANNUITY SCHEME (LAS)

- Preparatory work on LAS is making good progress. Details for subscription will be announced in July 2018 pending authorisation by the Insurance Authority
- Given the expected strong demand for LAS, all retail banks have been invited to be the agency banks to facilitate subscription by customers. Banks' reaction has been positive
- Public education campaign has been launched to enhance public awareness of the suitability and associated risks of LAS as a retirement planning tool through TV, radio, and social media
- The amount offered for subscription will be subject to a quota, tentatively up to HK\$10 billion for the first tranche, with the actual sale amount subject to subscription demand and prudent risk management considerations

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