HONG KONG MONETARY AUTHORITY

# Briefing to the Legislative Council Panel on Financial Affairs

28 April 2008

## DISCUSSION TOPICS

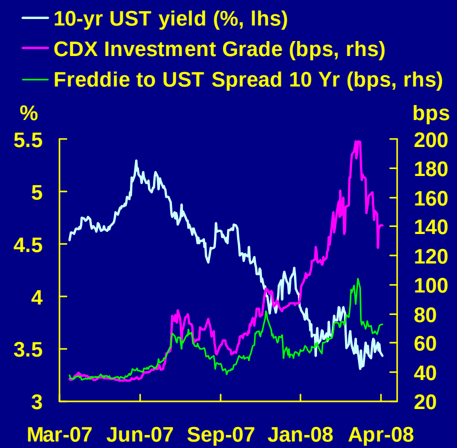
Updates on

- Credit Market Turmoil
- Currency Stability
- Banking
- Financial Infrastructure
- Hong Kong as an International Financial Centre
- Exchange Fund

## THE US FINANCIAL TURMOIL CONTINUES TO UNFOLD

- **De-leveraging spiral triggered a credit crunch**

**Flight to quality**




Source: Bloomberg

**IMF's latest estimates (GFSR April 2008)**

- **Aggregate potential loss: US$945 billion**
- **Losses shouldered by banks: US$440-510 billion**
- **Impact on banks' CARs:**
  - **US: 250 basis points**
  - **Europe: 150 basis points**
- **Total reported losses among banks: US$193 billion**
- **Total capital injection into banks: US$105 billion**



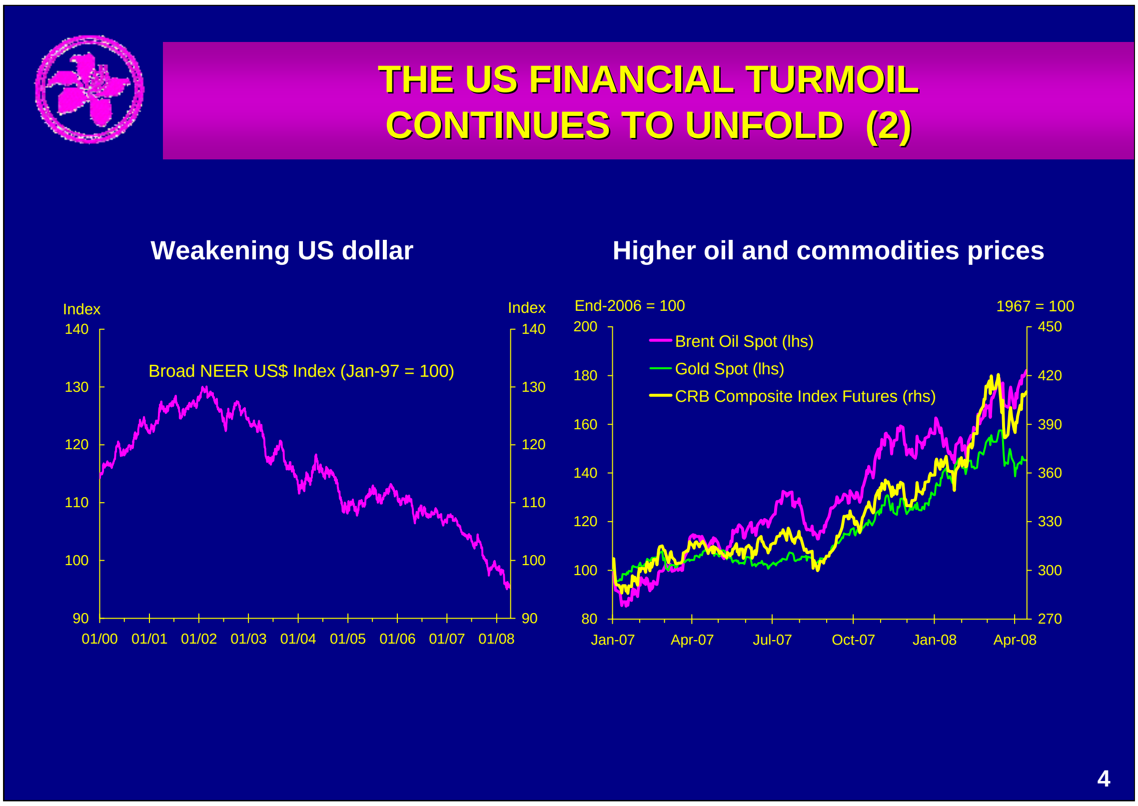
- The financial crisis in the US and Europe has escalated with a credit crunch triggered by a de-leveraging spiral. Banks, under pressure to shrink balance sheets and worried about a deteriorating US housing market, made margin calls to leveraged investors in mortgage-backed securities (MBS). These investors sold more-liquid triple-A papers (including agency papers) to meet the collateral requirements. The forced sale led to the de-leveraging cycle.

- The resulting credit crunch led to a flight to quality, with investors rushing to US Treasuries. As leveraged investors such as hedge funds and private equity funds sold liquid high-grade papers in order to meet margin calls from their lenders, the spreads of these high-grade papers over the US Treasuries widened.

- The IMF has recently estimated the aggregate potential writedowns and losses related to the current financial crisis at US$945 billion. Global banks are likely to shoulder roughly half of these losses, while insurance companies, pension funds, money-market funds, hedge funds and other institutional investors will account for the rest.

- The potential credit losses would lower capital adequacy ratios (CARs) at large US banks by about 250 basis points, and at large European banks by about 150 basis points.

- Reported losses among global banks are about US$193 billion to date. To restore their balance sheets, banks have received about US$105 billion in capital injections, of which US$41 billion came from sovereign wealth funds.




- With expected further easing in monetary policy in response to fears of a US recession and further financial-sector losses, the US dollar weakened. The US dollar effective exchange rate index has depreciated by almost 8% since September 2007.

- Despite deteriorating economic prospects, higher oil and food prices have kept inflationary pressure elevated.

# US SLOWDOWN
# MORE PROTRACTED THAN EXPECTED

- **Growth forecast has been revised downward sharply**
- **Equity markets remain volatile**

**IMF's growth forecast**

(Annual % Change)

| | 2007 Actual | 2008 Forecast | 2009 Forecast |
|---|---|---|---|
| *World* | 4.9 | 3.7 | 3.8 |
| United States | 2.2 | 0.5 | 0.6 |
| Japan | 2.1 | 1.4 | 1.5 |
| European Union | 3.1 | 1.8 | 1.7 |
| Hong Kong | 6.2 | 4.3 | 4.8 |
| China | 11.4 | 9.3 | 9.5 |

**Major equity indices**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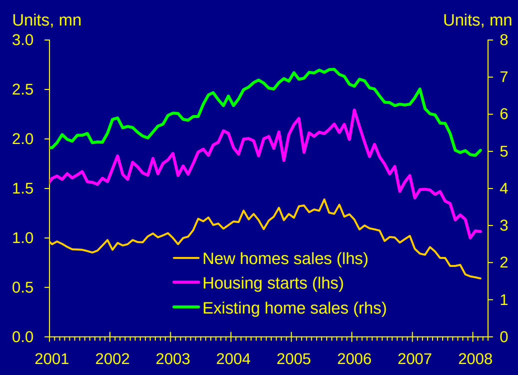
- The process of adjustment to the financial turmoil is proving more protracted than expected. The deteriorating global economic and financial conditions have substantially increased global uncertainties.
- The IMF has revised its growth forecast for the US economy downward to 0.5% for 2008 and 0.6% for 2009. Growth forecasts for the other economies have also been revised downward.
- The global equity markets have remained volatile amidst increased uncertainties.

## US SLOWDOWN
## MORE PROTRACTED THAN EXPECTED (2)

**Housing contraction continues**




**Payrolls decline**




- There are increasing signs that the US is entering a recession. US real GDP slowed sharply to grow by 0.6% quarter on quarter (annualised) in Q4 2007 after rising by 4.9% in Q3, dragged down by the continuing contraction in home construction, weaker household consumption, and a cut-back in business inventory accumulation, although net exports provided some support to growth.

- Monthly indicators suggested a broad-based decline in economic activity in the US:

  – Consumer spending slowed amid more restrictive access to credit, softening labour market conditions, and on-going financial-market turmoil.

  – Jobs data pointed to softening labour demand, with non-farm payrolls declining by 85,000 in January and February and rising weekly initial jobless claims.

  – Residential investment continued to contract. Housing starts and sales of new homes were less than half of their peaks, while house prices in 20 US metropolitan areas fell by 9.1% year on year in December. The inventory of unsold homes remained unusually high, as record foreclosures increased supply and stricter lending reduced demand.

- Concerns are now focused not on whether the US is in a recession, but on whether the recession is going to be shallow and short-lived or deep and protracted. The recession may be more protracted than that of 2001:

  – There is a risk of a global contraction of credit supply as financial institutions make adjustments to losses, impairing their ability and willingness to lend.

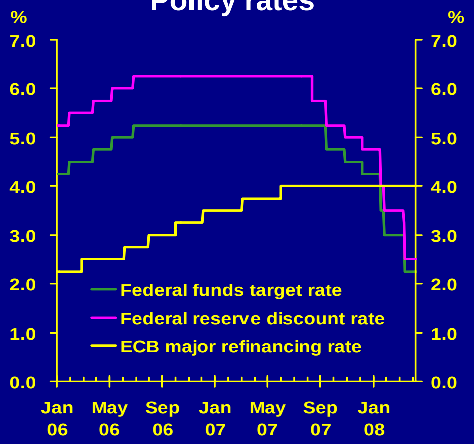
  – The debt work-out process due to impaired household balance sheets may lengthen the time taken for households to spend again.

  – Further declines in house prices could lead to a vicious cycle in the housing market and pose a major risk to economic growth.

## CENTRAL BANKS' POLICY RESPONSES

- **The Fed cut policy rates and injected liquidity**
- **ECB stayed put amidst inflation concerns**

**Policy rates**




Source: Bloomberg

**Fed's other measures**

- **Term Auction Facility (TAF)**
- **Term Securities Lending Facility (TSLF)**
- **US$30 billion non-recourse facility for JPMorgan Chase to acquire Bear Stearns**
- **Opened up the discount window to primary dealers**
- **Continued FX swap with other central banks**



- Spurred by the higher uncertainty surrounding the outlook for economy, the Fed has taken steps to safeguard the economy, through monetary and regulatory policies.

- Since mid-December 2007, the Fed has been auctioning funds to banks via the Term Auction Facility (TAF). The Fed also announced on 11 March 2008 a Term Securities Lending Facility (TSLF) which offers Treasury securities for loan over a one-month term to primary dealers against agency and mortgage-backed debt.

- On 16 March 2008, the Fed took a series of measures to ease financial institutions' access to liquidity and to contain systemic risks. It provided JPMorgan Chase a US$30 billion non-recourse facility to acquire Bear Stearns, opened up the discount window to primary dealers, and lowered the discount rate to just 25 basis points above the Fed funds rate.

- The Fed continues to conduct FX swaps through the temporary arrangement with other central banks to ensure adequate liquidity in other markets.

- The ECB remains wary of inflation and has kept the policy rate unchanged.

## LATEST DEVELOPMENTS

There are signs of improvement, but the situation has not yet returned to normal

- US Fed continues to inject large amounts of liquidity into the market
- Securitisation market still stagnant
- Interbank market still tight
- Equity market still being affected
- Credit crunch spill-over to the general economy, increasing the risk of recession
- US property market trending down, creating pressure on financial institutions

# MEASURES TO
# REFORM THE FINANCIAL MARKETS

**Recommendations of the Financial Stability Forum**

– Strengthened prudential oversight of capital, liquidity and risk management

– Enhancing transparency and valuation

– Changes in the role and uses of credit ratings

– Strengthening the authorities' responsiveness to risks

– Robust arrangements for dealing with stress in the financial system

## REGIONAL CO-OPERATION IS IMPORTANT

- **Participation in an enhanced monitoring mechanism of Asia-Pacific central banks to monitor risks to regional financial stability**
- **Sharing information with other authorities in the region, cataloguing cross-border issues and addressing the identified challenges**
- **Establishing a small group with other authorities in the region to address specific cross-border crisis management planning issues**
- **Contributing to regional financial co-operation initiatives and crisis management**



- While the region has shown resilience to the financial turmoil, continuous vigilance is crucial. The HKMA has been actively participating in an enhanced mechanism of Asia-Pacific central banks to monitor risks to monetary and financial stability in the region including Hong Kong.

- The HKMA will accelerate information sharing with other regional authorities for dealing with problem banks, cataloguing cross-border issues and addressing the identified challenges.

- The Financial Stability Forum suggests that for the largest cross-border financial institutions, the most directly involved regulators and central banks should establish a small group to address specific cross-border crisis management planning issues.

- The HKMA will continue to contribute to regional financial co-operation initiatives and crisis management to promote greater financial stability. The active participation of the HKMA also helps strengthen Hong Kong's status as the leading international financial centre in the region.

## RESPONSES OF THE HKMA

- The HKMA as a member of the Financial Stability Forum supports the recommendations, and is studying the reform measures
- Hong Kong's banking system does not have sub-prime-related systemic problems, banks continue to adopt prudent lending standards
- Actively participate in international forums and committees to secure adoption of financial market stabilisation measures suitable for Hong Kong
- Maintain communication with other regulatory bodies through the Financial Stability Committee of the HKSAR Government to implement the recommendations

## RESPONSES OF THE HKMA (2)

**Authorized Institutions in Hong Kong should:**

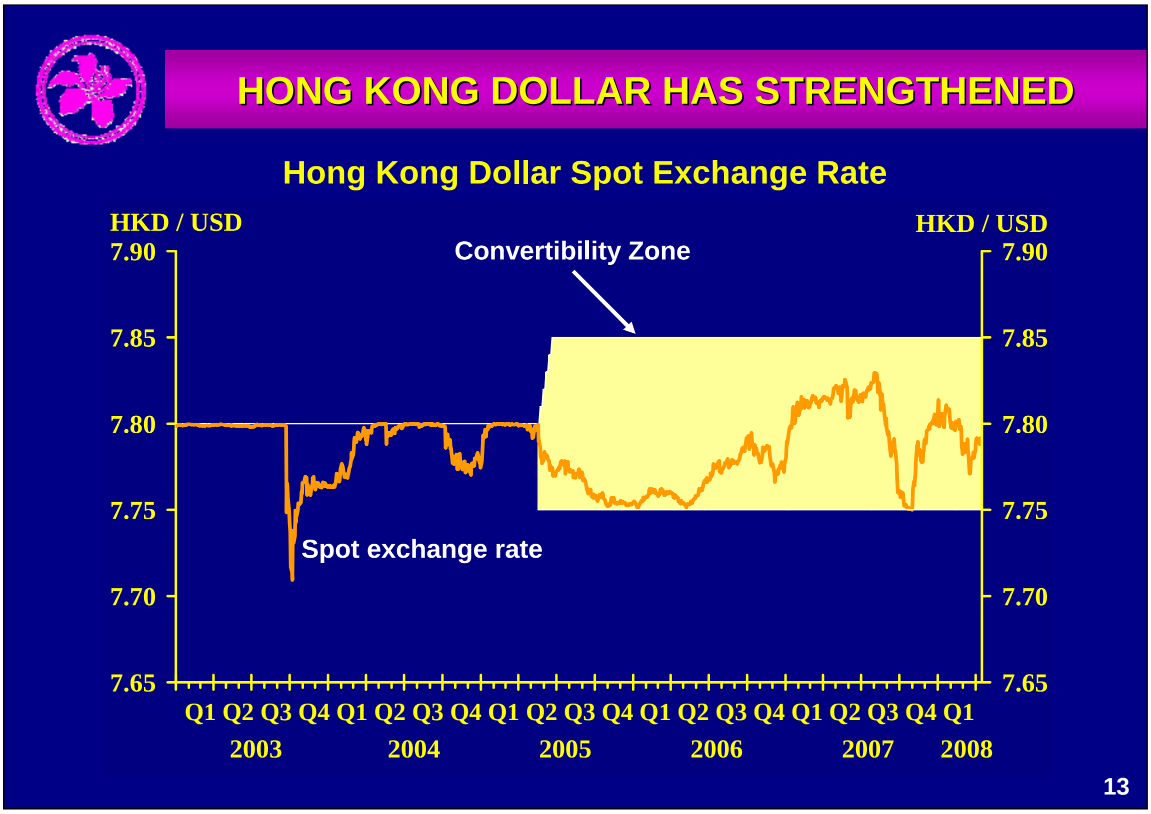
- **Pay close attention to prudent underwriting criteria e.g. LTV, DSR, loan use and avoid imprudent terms such as principal repayment holidays**
- **Review liquidity management back-up in case of market disruption**
- **Ensure they fully understand the risks of any complex/structured products they engage in**
- **Ensure adequate disclosure of exposures to sub-prime and sub-prime-related instruments**
- **Continue to keep a close watch on valuation to ensure prudent provisioning**



In the context of the Hong Kong banking sector, we are monitoring and requiring AIs:

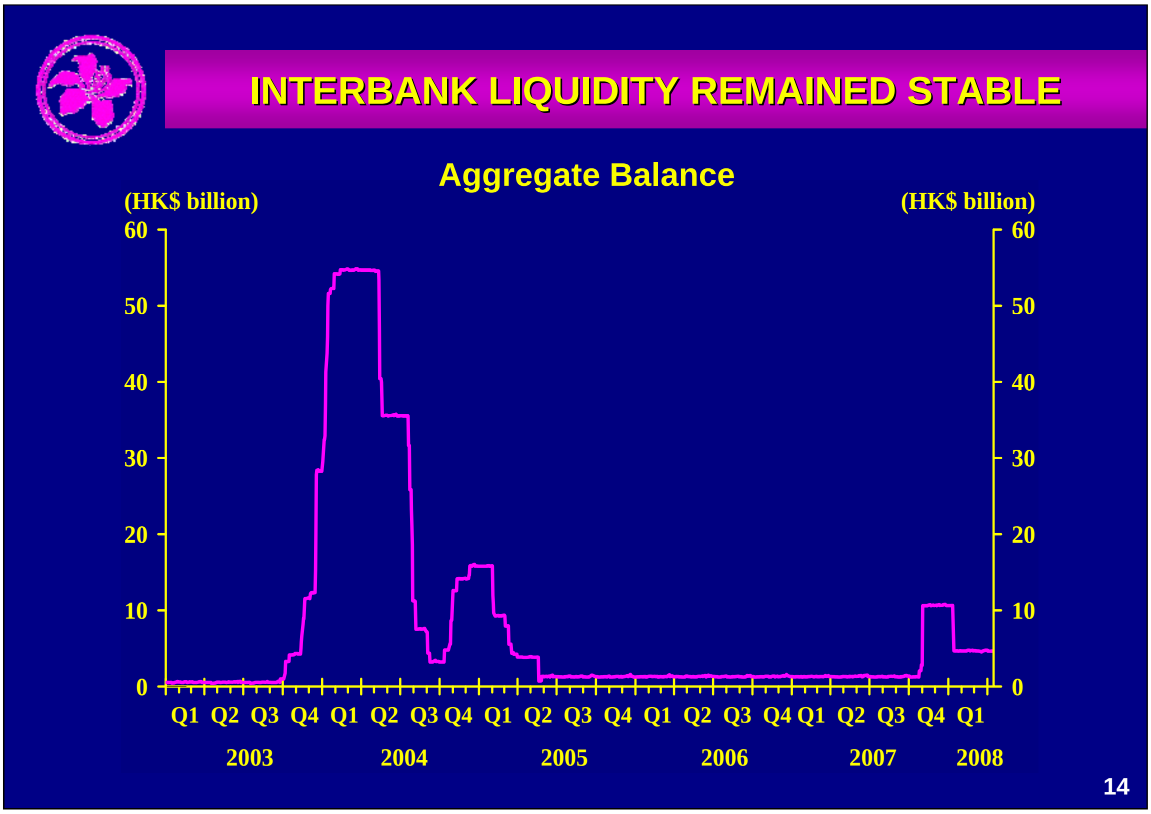
- to continue to adhere to prudent underwriting criteria such as the 70% Loan-to-Value Ratio guideline, a 50%-60% debt servicing ratio and to ensure they are aware of the purpose of loans (to avoid use for speculation). Banks should also avoid offering imprudent terms such as principal repayment holidays for residential mortgage loans. The HKMA has noticed that there is a growing trend among AIs to offer aggressive terms for loans in some properties. Of particular concern are loans with deferred repayment features such as principal repayment holidays. These loans may expose lenders to considerably higher risks in the event of default. Given this concern, AIs have been asked not to offer RML products with such feature to customers.

- to review their liquidity risk management, in particular ensuring that they have appropriate liquidity planning to cope with potential market liquidity distress.



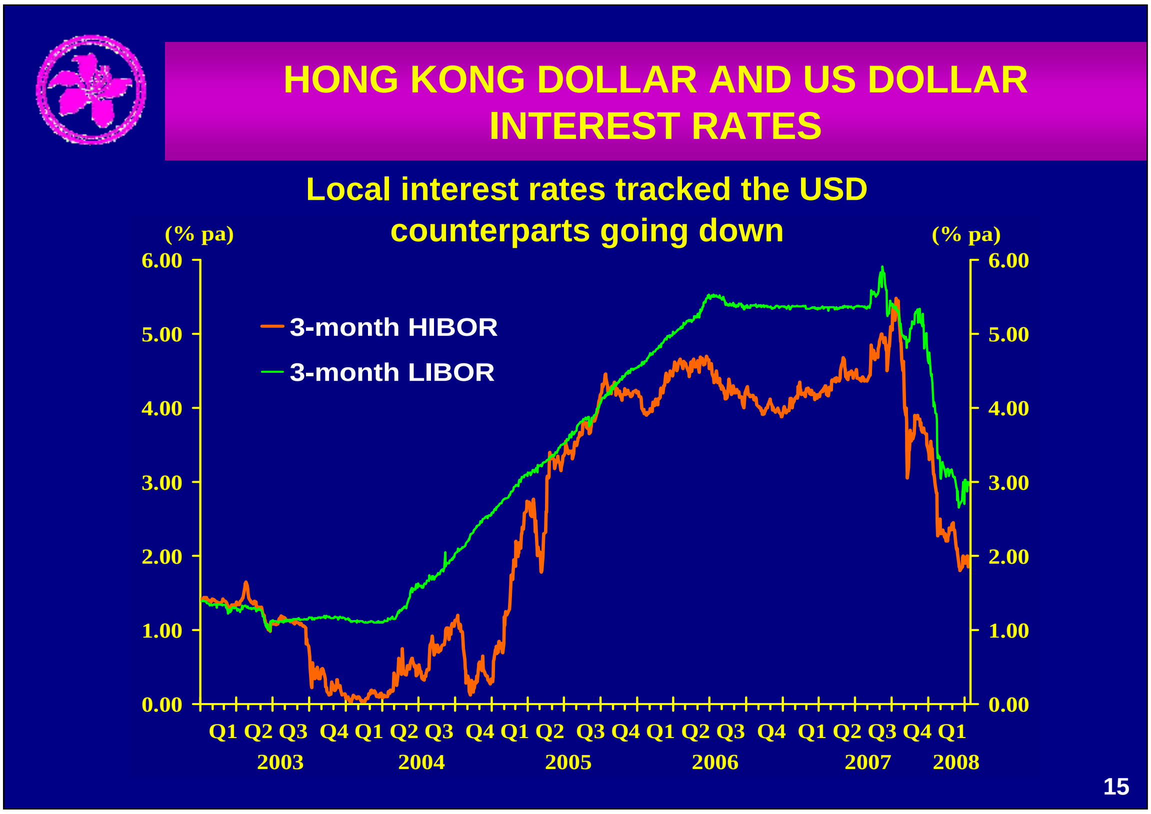

- Strong-side pressure on Hong Kong dollar emerged in mid-March with the rapid depreciation of the US dollar, the continued appreciation of the renminbi, the expected narrowing of the interest rate gap between the Hong Kong dollar and the US dollar, and concerns about domestic inflationary pressure.

- The spot exchange rate depreciated in late March and in April, partly reflecting carry trades amid wider negative interest-rate spreads.




- The interbank money market has continued to function smoothly despite the credit market turmoil in the US, and Discount Window borrowing activity remained normal. The HK$6 billion tap issue of Exchange Fund Bills in January 2008 went smoothly and had no major impact on interest rates and the exchange rate.

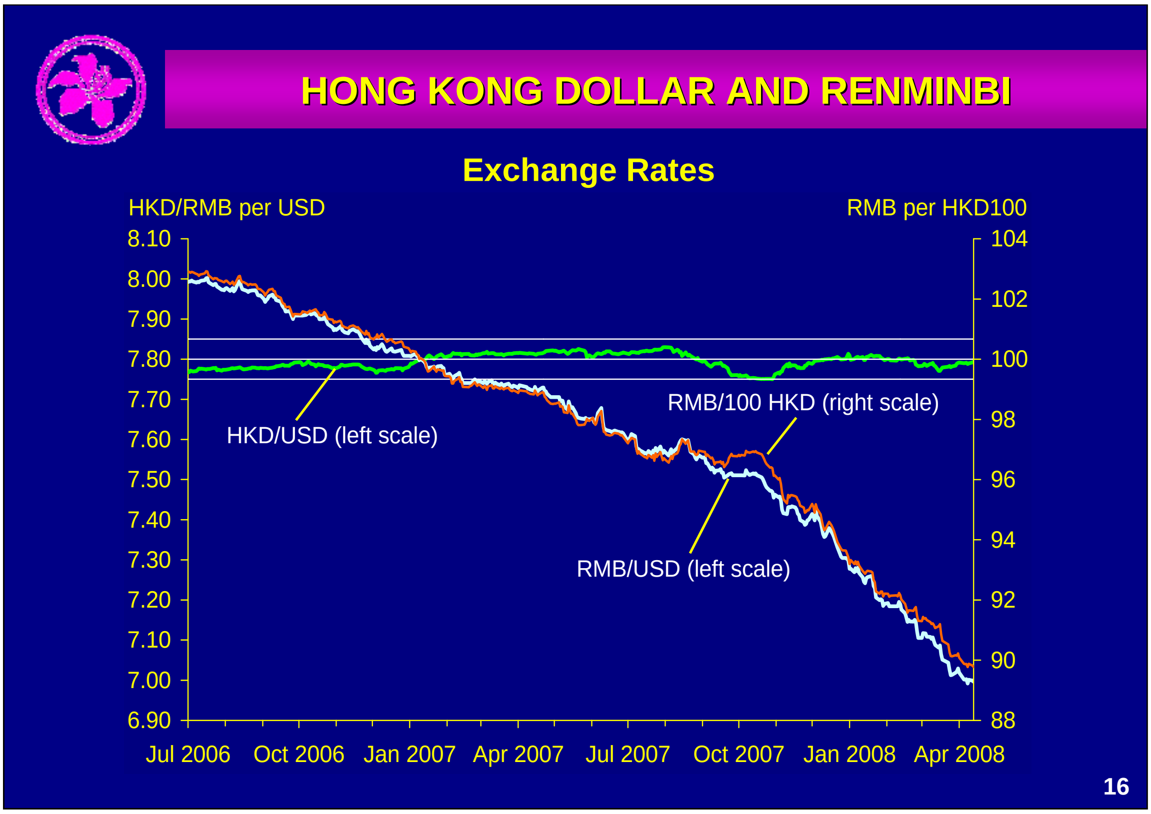
- The HKMA did not carry out any market operations during the first three months of 2008. The Aggregate Balance remained stable at slightly below $5 billion after the tap issue.



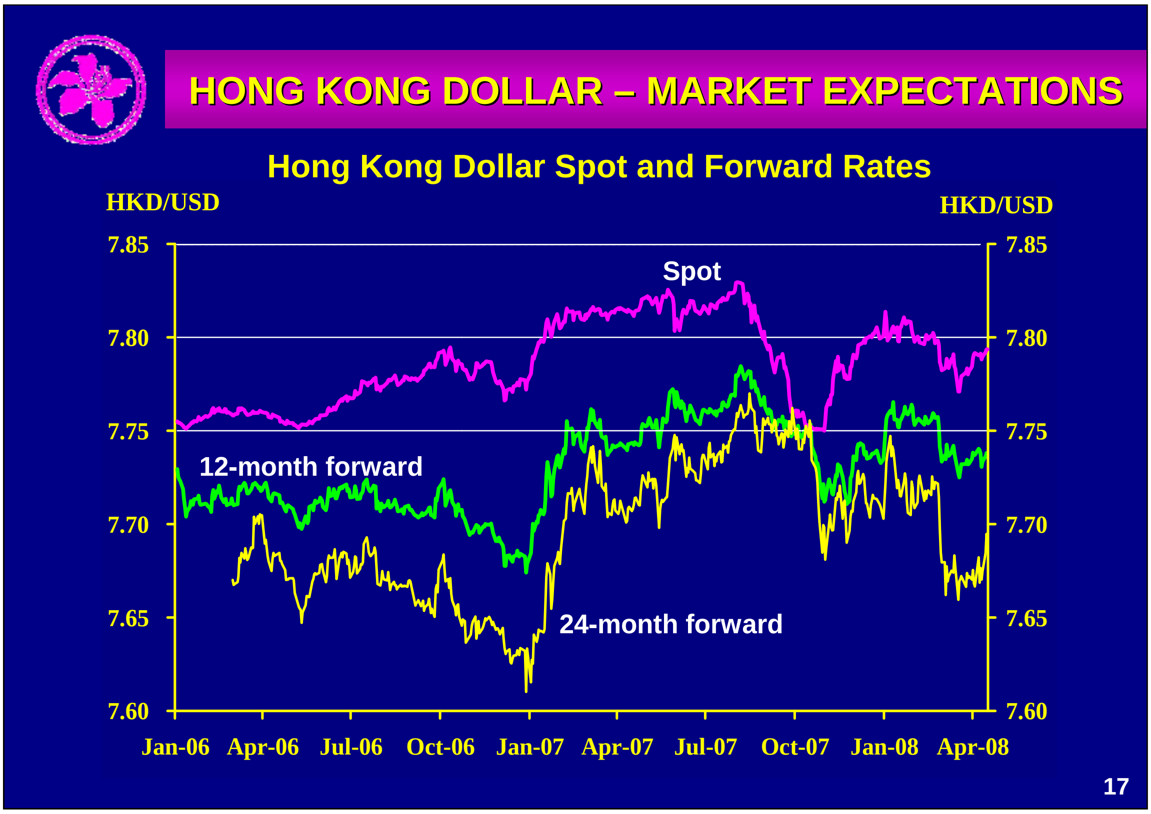

- The US Fed reduced the Federal Funds Target Rate by a total of 125 basis points in January 2008 and another 75 basis points in March. Short-term LIBORs fell significantly during this period.

- Although the Hong Kong dollar interbank interest rates generally tracked the easing trend in the USD rates, short-term HIBORs fell less than their US-dollar counterparts, resulting in narrowed interest rate gaps.

- However, the negative interest-rate gaps have widened since late March 2008, with short-term HIBORs remaining generally stable.




- The renminbi has continued to appreciate against the US dollar. The pace of appreciation has speeded up slightly since late 2007.




- With the risk of US recession and expectation of further rate cuts in the US, the US dollar reached new lows against major currencies. The renminbi has reached new highs against the US dollar and the pace of appreciation seems to have picked up.

- Against this background, some investment banks and their hedge-fund clients have reportedly been buying Hong Kong dollars against US dollars in both the spot and forward markets. The 1-year forward discounts have widened from 400 pips in late January to the current level of 570 pips, and the 2-year forward discounts from 805 pips to 1,074 pips.

- Nevertheless, in the second half of March, as the US dollar stabilised and the relatively wide interest-rate carry against the US dollar remained, the Hong Kong dollar softened.

## RISKS TO CURRENCY STABILITY

- **US recession amid lingering financial-market turmoil**
- **Increasing inflationary pressures**
- **Risks associated with the Mainland economy**



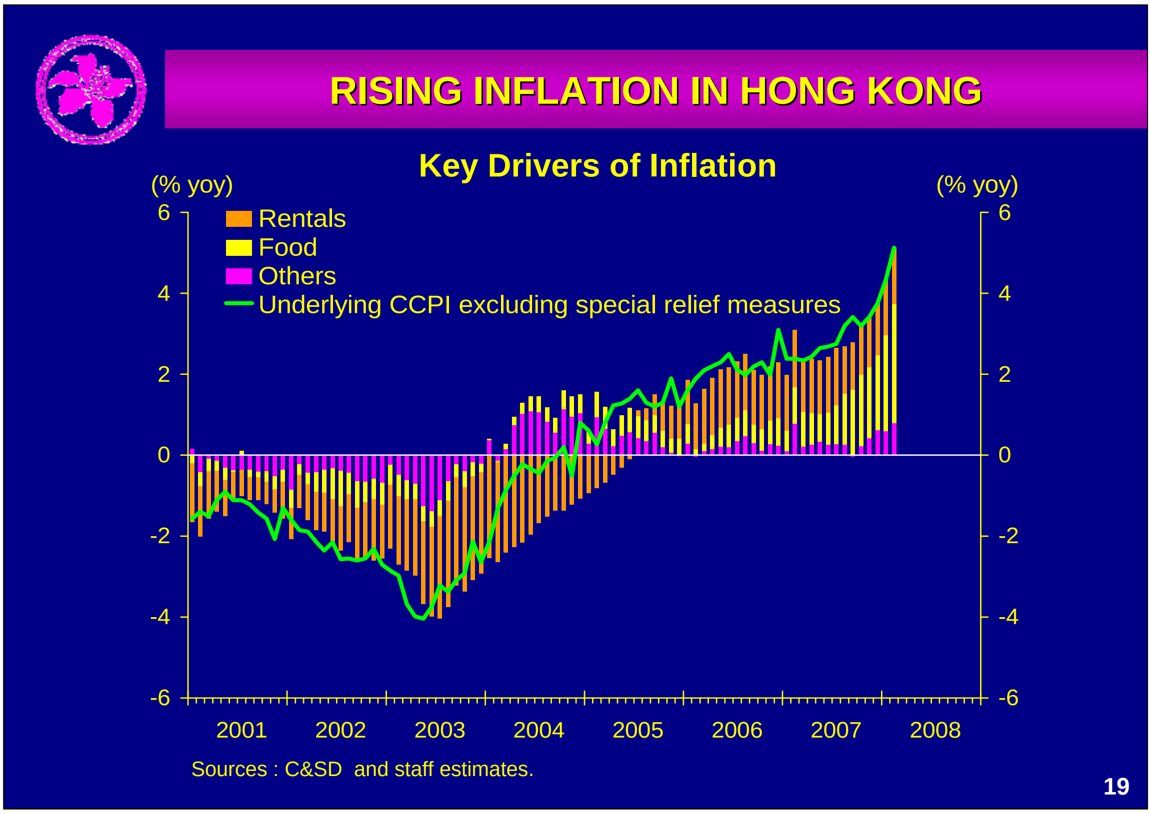
- Although solid economic fundamentals continue to underpin Hong Kong's currency and monetary stability, there are a number of risks. They include lingering financial-market turmoil, the possibility of a recession in the US, increasing inflationary pressures, and vulnerability of the Mainland economy.

- Over the past months, we have seen a further escalation of financial-market turbulence, with further widening of credit spreads and more losses in the equity markets. Heightened risk aversion among investors may trigger reversals of capital flows.

- The US economy slowed sharply in Q4 2007. The US may fall into a recession and experience a prolonged period of stagnant growth. Economic growth in Hong Kong will inevitably be affected. In addition, how vulnerable the Mainland economy is to a US recession may carry important implications.

- Inflationary pressure is likely to increase. Food prices have increased markedly recently, affected mostly by reduced supplies of some food products. Moreover, further tightening of labour-market conditions and continued increase in housing rentals have also fuelled domestic inflation.

- The Mainland authorities are facing a difficult task of balancing growth and price stability. This presents risks of slower growth and further policy tightening to curb inflation, and hence risks of acute sentiment changes among investors bringing more stock market volatility in Hong Kong.

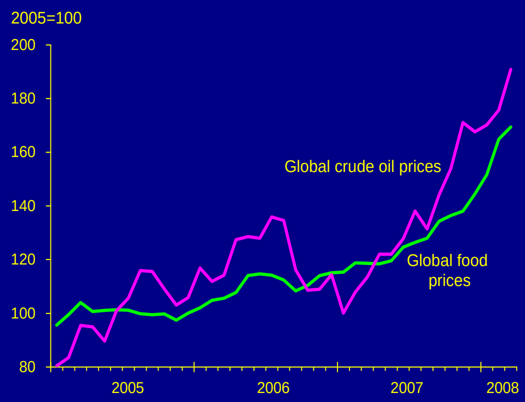



- The year-on-year headline inflation rate in Hong Kong increased to 6.3% in February 2008. Excluding the effects of the Government's one-off relief measures, the year-on-year underlying inflation rate was 5.1%.

- Recent increases in private housing rents and prices of imported food dominated the trend of underlying inflation.

## RISING OIL AND GLOBAL FOOD PRICES

### Higher oil and global food prices




### CPI inflation in the regional economies

| | CPI Inflation (% yoy) | |
|---|---|---|
| | Feb-2008[1] | 2007 |
| Hong Kong | 5.1% | 2.8% |
| India | 5.5% | 6.4% |
| Indonesia | 8.2% | 6.4% |
| Philippines | 6.4% | 2.8% |
| Singapore | 6.5% | 2.1% |
| Thailand | 5.3% | 2.2% |

[1] Inflation for Indonesia, Philippines and Thailand are Mar-08 figures.



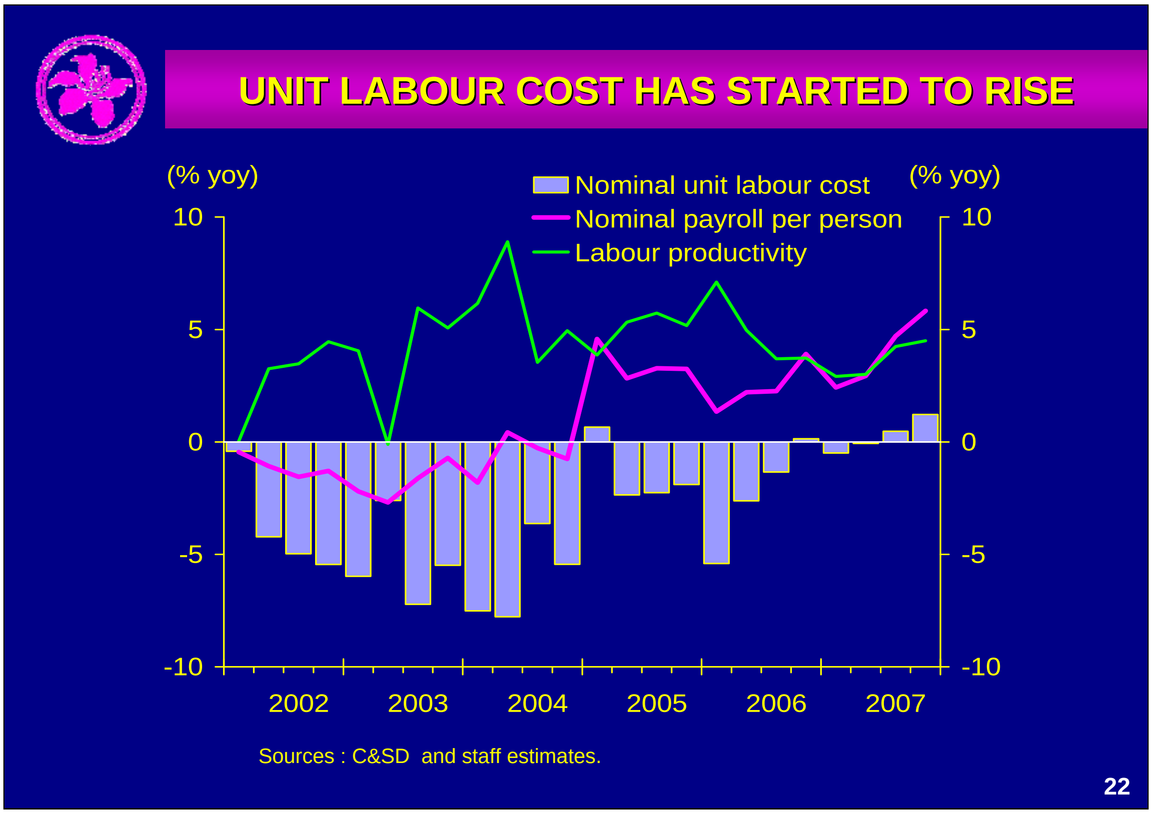
- Rising inflation is a global phenomenon, in part due to higher crude oil and food prices. Crude oil and food prices increased by 47% and 26% respectively in 2007. During the first quarter of this year, oil prices rose by 14% and food prices increased by 17%.

- Rising fuel costs and food prices have driven up CPI inflation in the regional economies in recent months. Compared with economies adopting more flexible exchange rate regimes, the current inflation rate in Hong Kong is not particularly high. This suggests that the exchange rate is not a key factor driving domestic inflation.

## EXCHANGE-RATE PASSTHROUGH TO INFLATION

An HKMA study shows that:

- For every 10% depreciation of the US dollar nominal effective exchange rate, Hong Kong's CCPI inflation increases by 0.8% in the short run and by 1.6% in the medium run
- A 10% appreciation of the renminbi against the US dollar would, on average, increase Hong Kong's CCPI inflation by 0.4 percentage points, as only 9-17% of Hong Kong's retained imports are from Mainland China
- Productivity plays a more important role in driving domestic inflation




- Strong labour productivity growth kept Hong Kong's inflation in check in the past. Growth in labour productivity has been increasing at a year-on-year rate of 4.9% on average since the third quarter of 2003. As a result, the change in unit labour cost was modest, suggesting limited inflationary pressure from wage increases.

- However, the strong and sustained economic recovery, which has led to a persistent fall in the unemployment rate to near 10-year lows, has started to reverse the downward trend in unit labour cost.

## RISKS ASSOCIATED WITH THE MAINLAND ECONOMY

- **The Mainland’s growth was strong in 2007 Q4, but may weaken in 2008 because of the rapidly deteriorating external environment**
- **CPI inflation hit an 11-year high in 2008 Q1, and near-term inflation pressures remain high**
- **Balancing the goals of robust economic growth and price stability has become increasingly challenging**
- **Stock market volatility increased substantially recently as a result of the continuing global financial-market turmoil and uncertainties over an increasing supply of stocks**



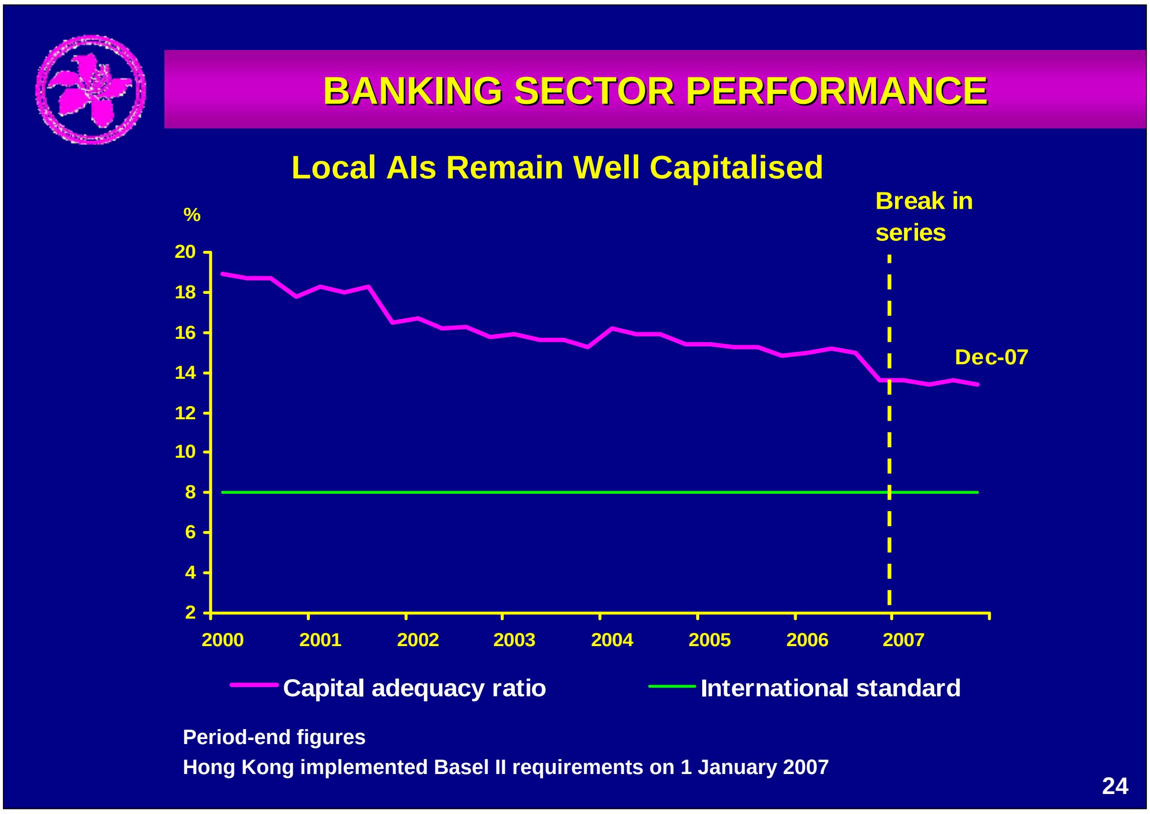
- Following a fifth consecutive year of double-digit growth at 11.9% in 2007, the latest data suggest economic activity on the Mainland China might slow in 2008 Q1. The slowdown reflects weakening external demand and the disruptions from the heavy snowstorms in early 2008.

- Inflation continued to trend up in 2008 Q1, with CPI inflation hitting an 11-year high of 8%, reflecting in part the supply interruptions from the bad weather. Sustained world commodity and food price inflation as well as rising domestic labour costs and inflationary expectations are likely to keep CPI inflation high. Reflecting this, the government reiterated at the annual National People’s Congress meeting that containing inflation is its top priority for 2008, and the PBoC raised the reserve requirement ratio for the third time this year by 50 basis points to 16% in April (it was raised by the same amount in January and March).

- Amid a deteriorating external environment and persistent domestic inflationary pressures, the Mainland Authorities are facing a difficult task of balancing growth and price stability.

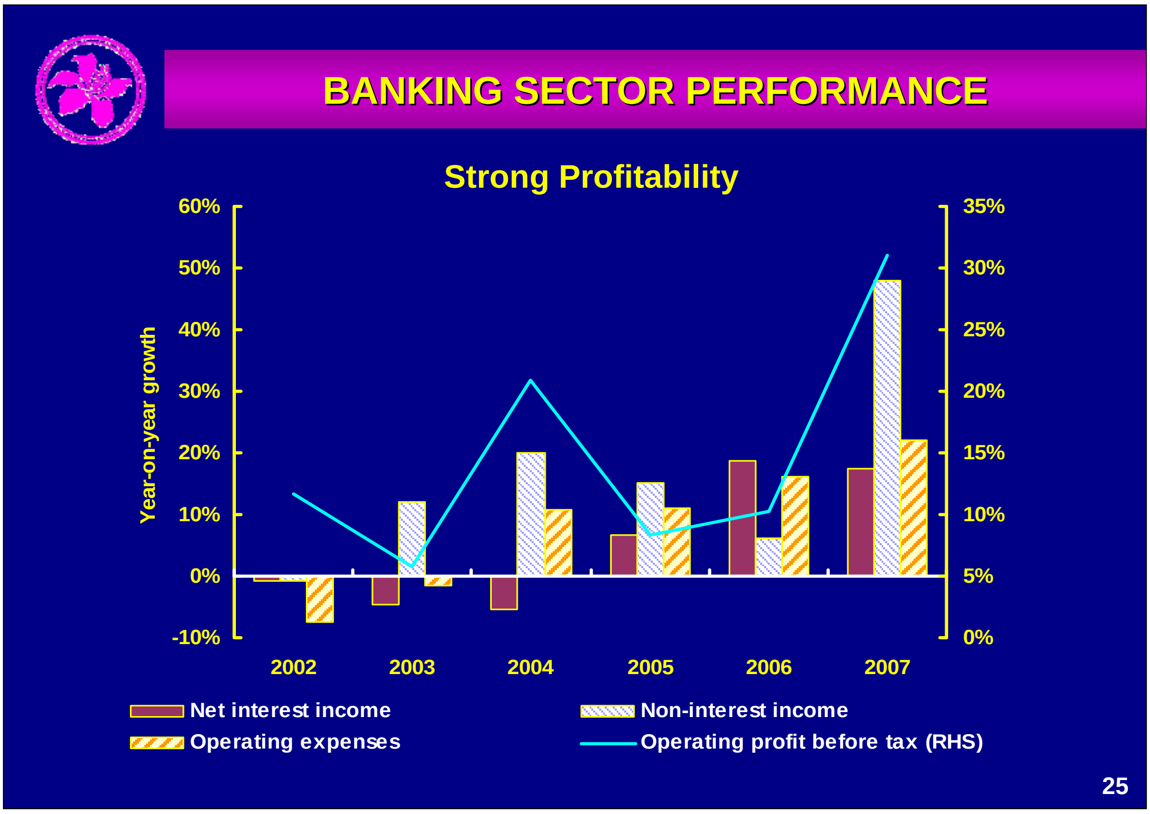
- The A-share market declined by 36% in 2008 Q1, and the market volatility increased substantially. Market sentiment has been fragile due to the continuing global financial-market turmoil and uncertainties over an increasing supply of stocks.

- The risk of slower growth and further tightening to curb inflation on the Mainland could expose Hong Kong to greater financial market volatility.




- From January 2007, all Hong Kong-incorporated authorized institutions (AIs) are required to report their capital adequacy positions under the revised capital adequacy framework based on the Basel II requirements. There was therefore a break in the series at this date.

- Under the new system, which is more risk-sensitive than the previous framework, the capital position of the banking industry remains strong and well above the international minimum standard of 8%. The average consolidated capital-adequacy ratio of Hong Kong AIs at the end of 2007 was 13.4%.

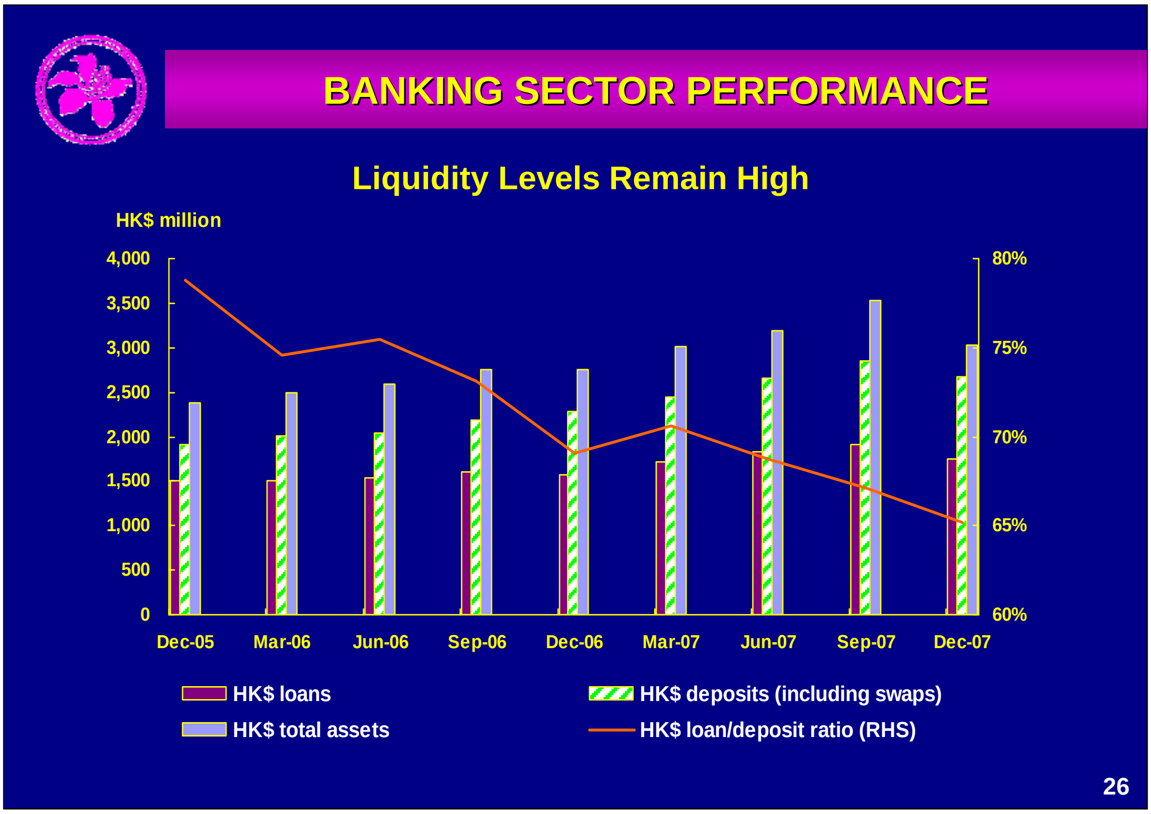



- Retail banks recorded strong profit growth in 2007, as both net interest income and non-interest income rose despite rising operating expenses. The aggregate pre-tax operating profits of retail banks' Hong Kong offices increased by 31.1% in 2007 following a 10.2% increase in 2006.

- The significant increase in net interest income (17%) reflected both expanding asset base and improving net interest margin, which widened to 1.87% in 2007 from 1.80% in 2006. The strong growth in non-interest income (48%) was underpinned by increases in fees and commission income arising from a very active stock market and income from foreign-exchange operations.

- However, operating costs of retail banks also grew at a faster rate of 22% in 2007, compared with 16% in 2006. This mainly reflected the favourable economic conditions and the resulting business expansion and increased demand for staff.

- In light of the current market conditions, banks are facing a challenging operating environment this year. The HKMA is monitoring closely the impact of the sub-prime fallout and macroeconomic adjustment in Mainland China.




- The Hong Kong banking sector remains highly liquid. The Hong Kong dollar loan-to-deposit ratio decreased to 65.1% at the end of 2007 from 69.1% a year ago, as customer deposits grew faster than loans. Deposits increased sharply in 2007 mainly as a result of the buoyant stock market and heavy IPO-related activities in the year.

- One of the lessons of the US Sub-prime crisis is that market liquidity could dry up quickly. The HKMA has asked local banks to review and enhance, where appropriate, their liquidity risk management.

## BANKING SECTOR PERFORMANCE

### Higher Domestic Loan Demand

Quarterly increases (in HK$ bn)

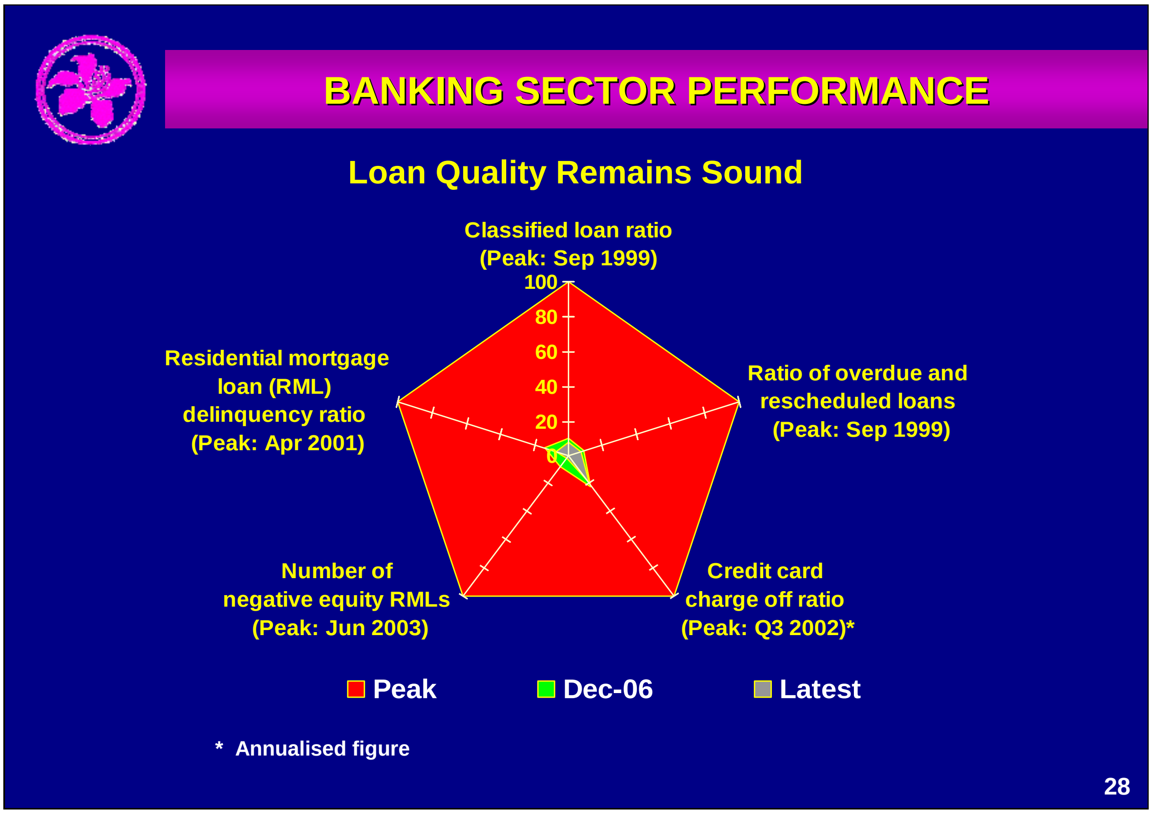
| | Trade financing | Share financing | Property lending | Others | Total domestic loans |
|---|---|---|---|---|---|
| Mar-07 | 0 | 127 | 10 | 9 | 146 |
| Jun-07 | 18 | 47 | 25 | 21 | 111 |
| Sep-07 | 3 | 43 | 28 | 26 | 100 |
| Dec-07 | 3 | -210 | 30 | 10 | -167 |
| Total 2007 | 24 | 7 | 93 | 66 | 190 |



- With steady economic growth, retail banks' domestic lending rose by 11.4% in 2007, compared with 2.7% in 2006. The growth was across a broad range of economic sectors.

- Property-related lending increased by 10.4% in 2007 as sentiment improved and property prices increased throughout the year. Lower best lending rates in the fourth quarter of 2007 also underpinned the demand for residential mortgage loans.

- Growth in share financing was strong for most of 2007, bolstered by the buoyant domestic stock market and the large number of initial public offerings during the year. As IPO activities subsided near the end of 2007, share margin financing fell sharply in the final quarter.




- Stable macroeconomic conditions in 2007 have kept credit losses low. At the end of 2007, classified loan, and overdue and rescheduled-loan ratios were at new lows of 0.86% and 0.57% respectively.

- In light of the macroeconomic adjustments in Mainland China and continuing uncertainty in global economic growth, the HKMA will continue to monitor the banks' asset quality and review the adequacy of their risk management systems.

- The HKMA observed a trend of AIs providing residential mortgage loans with a principal repayment holiday of 2-3 years. In a bid to prevent risks from spreading, the HKMA issued a circular in March 2008 asking AIs to cease the practice.

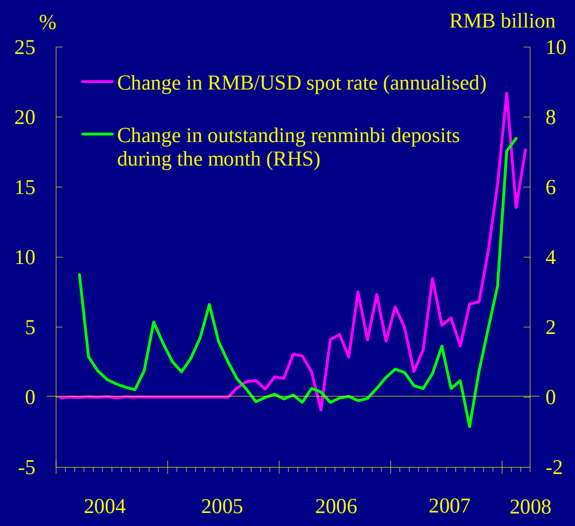
## REVIEW OF THE HKMA'S WORK ON BANKING STABILITY

- **The Consultant is working on his report. His overall assessment is that Hong Kong's banking sector is robust**
- **The Consultant's report will be finalised in the second quarter of 2008, taking into account the latest Financial Stability Forum's Report and recent official reports on Northern Rock and reform of the US regulatory structure**



- The HKMA will consider a policy response to the Consultant's recommendations when they are available.

## RENMINBI BUSINESS (1)




- **Outstanding renminbi deposits reached 47.8 billion yuan at end-February 2008**
- **Recent growth in renminbi deposits was attributed to a number of market factors:**
  - ➢ **Faster pace of renminbi appreciation**
  - ➢ **Volatility in global financial market**
  - ➢ **Lower Hong Kong dollar deposit rates along with decline in US interest rates**

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- Outstanding renminbi deposits in Hong Kong increased by 7.0 billion yuan and 7.4 billion yuan in January and February 2008 respectively, growing faster than previously.

- Because of a number of market factors, renminbi deposits offer more attractive returns than other investments: -

  – The renminbi has been appreciating against the US dollar at a faster annualised rate of about 20% during January to March 2008, which raises expectations of further appreciation of the renminbi.

  – Affected by the US sub-prime crisis, the stock market in Hong Kong, like markets elsewhere, experienced a marked adjustment. The Hang Seng Index closed at 22,849 at the end of March 2008, 28% below the peak in October last year.

  – The Fed Funds Target Rate has been reduced by 300 basis points period since September 2007, and banks in Hong Kong have adjusted Hong Kong dollar deposits rates accordingly. The Hong Kong dollar savings deposit rate is now 0.01%, compared with 2.25% in September last year.

## RENMINBI BUSINESS (2)

- **Recent growth in renminbi deposits has had limited impact on the Hong Kong dollar and the Mainland's money supply**
  - **Renminbi deposits only accounted for 0.8% of total deposits in Hong Kong**
  - **Renminbi deposits placed by Participating Banks through the Clearing Bank with the Shenzhen branch of the PBoC, not affecting Mainland's money supply**
  - **Remitted deposits amounted to only 0.13% of the increase in renminbi saving deposits on the Mainland**
- **Further development of renminbi business can provide a robust testing ground for a gradual move towards renminbi convertibility for capital account items**

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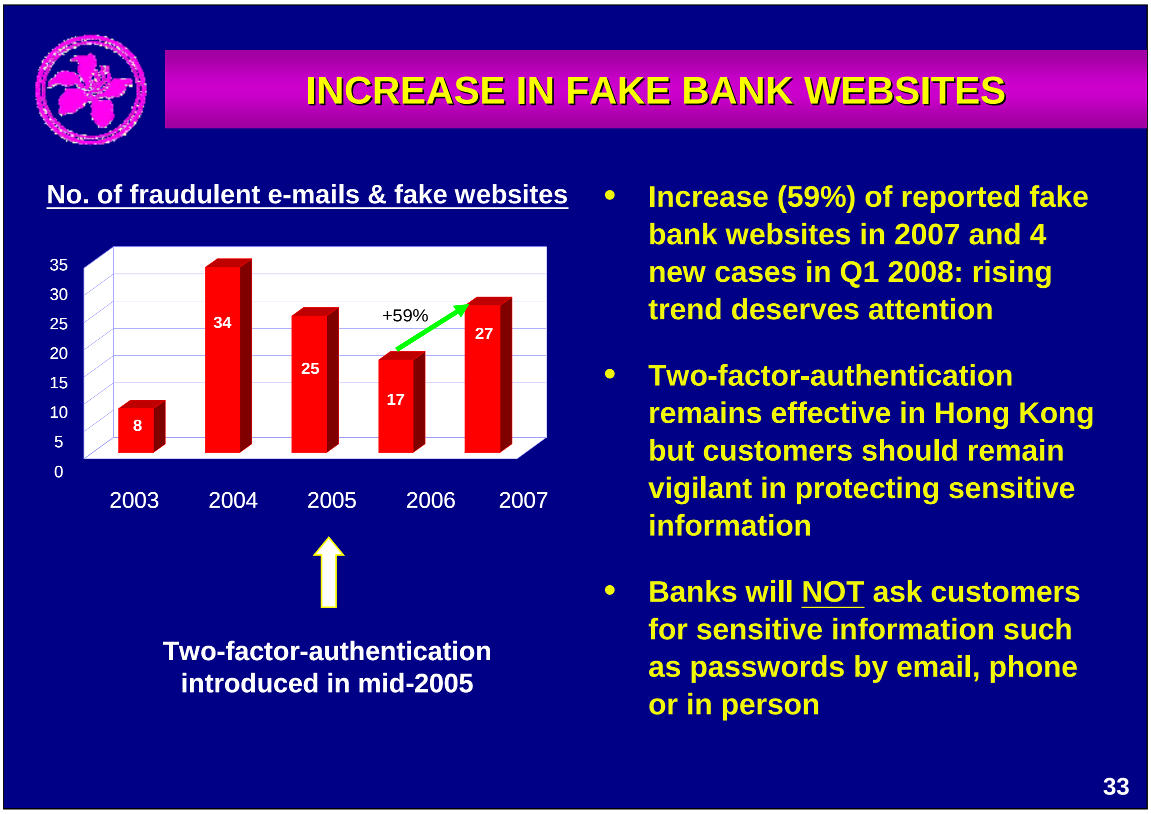
- Renminbi business in Hong Kong continued to operate smoothly. Given the related clearing arrangements and risk control measures, the recent growth in renminbi deposits had limited impact on Hong Kong dollar and Mainland's money supply:
  - At end-February 2008, renminbi deposits accounted for a mere 0.8% of total deposits in Hong Kong.
  - The bulk of the new renminbi deposits were placed by the Participating Banks through the Clearing Bank with the Shenzhen branch of People's Bank of China, and hence no direct impact on Mainland's money supply.
  - Renminbi remittances from Hong Kong to the Mainland was around 1.2 billion yuan in February 2008, being only 0.13% of the 958.3 billion yuan increase in renminbi saving deposits on the Mainland.
- As the Mainland is improving the pricing mechanism for renminbi exchange rate and gradually moving towards renminbi convertibility for capital account items, the demand for renminbi outside the Mainland will increase. Renminbi business provides a robust testing ground in this regard, whereby the related market responses under the scheme can serve as a useful reference for the Mainland authorities for future policy development.

## ANTI-MONEY LAUNDERING AND COUNTER-TERRORIST FINANCING

- **The HKMA continues to assist the Government in completing the FATF mutual evaluation of Hong Kong's anti-money-laundering and counter-terrorist-financing measures**
- **The Industry Working Group on Prevention of Money Laundering and Terrorist Financing led by the HKMA issued two further guidance papers to AIs in March:**
  - **Customer-due-diligence process for offshore companies**
  - **Address proof for personal customers**



- The Financial Action Task Force on Money Laundering – FATF – is conducting a mutual evaluation of Hong Kong's anti-money laundering and counter-terrorist financing measures. The HKMA will continue to assist the Government in completing the evaluation. It is expected that the evaluation results will be available in June 2008.




- In 2007, the HKMA noted an increase in the number of reported e-banking fraud cases related to fake bank websites. The rising trend of reported fake bank websites deserves attention. Similar issues were encountered overseas.

- The increase was probably attributable to the lower cost and technical skills required to host fake websites in some countries.

- The public should bear in mind that banks in Hong Kong will NOT ask for sensitive information (e.g. passwords) by email, by phone or in person. Bank customers should remain vigilant and not provide sensitive information to third parties. Major banks have already implemented additional precautionary measures such as notifying customers through SMS of every high-risk transaction. Bank customers are encouraged to utilise such services.

- In view of the increasing number of fake bank websites reported, the HKMA and Hong Kong Association of Banks plan to step up customer education programmes in 2008 to promote awareness of e-banking security.

## FINANCIAL MARKET INFRASTRUCTURE (1)

- To develop Hong Kong into a regional payment and settlement hub, enhancing its role and status as an international financial centre
- New projects
  - HK/Macau US-dollar joint cheque clearing
  - Migration to SWIFTNet



- Hong Kong has established RTGS payment links with Shenzhen and Guangdong Province, and payment-versus-payment and delivery-versus-payment links with Malaysia's Ringgit RTGS system and Malaysia's debt securities settlement system. The Regional Cross-border Payment service covers over 1,800 participants from over 40 economies.

- With the successful launch of the HK/Macau Hong Kong-dollar joint cheque clearing in August 2007, The HKMA and the Monetary Authority of Macao have agreed to implement HK/Macau US-dollar joint cheque clearing in June 2008. This new one-way facility will streamline the processing and shorten the settlement time from 4-5 working days to 2 working days (Hong Kong domestic cheque settlement standard).

- SWIFTNet: The existing proprietary platform for the RTGS systems and the Central Moneymarkets Unit will be replaced by an open platform to facilitate a greater use of the payment and settlement systems in Hong Kong by overseas financial institutions.

## FINANCIAL MARKET INFRASTRUCTURE (2)

- **Strategy for development of market infrastructure**
  - **Continue to maintain a smooth and efficient operation of the payment systems in Hong Kong**
  - **Adding new functions to the payment systems**
    - **CCASS Optimiser launched in Jan 2008**
  - **Promoting links with overseas systems and use of Hong Kong's financial infrastructure**
    - **Turnover of RTGS systems increased**
    - **Marketing and roadshows held in various Asian countries**
- **Continue to further strengthen Hong Kong's multi-currency, multi-dimensional payment and settlement platform**



- Increased turnover of RTGS systems:
  - Although there was a slowdown in IPO activities during the first quarter of 2008, the daily average RTGS turnover in Hong Kong dollars in the first 3 months of 2008 still grew by 5% ($925 billion) compared with 2007 as a whole (HK$879 billion).
  - As a result of the HKMA's marketing efforts, the usage of Hong Kong's US-dollar and RMB RTGS systems showed strong growth in the first 3 months of 2008:
    - US dollar: daily average of US$10,961 million, 27% increase over 2007(US$8,650 million).
    - RMB: daily average of RMB683 million, 224% increase over 2007 (RMB211 million).

# OVERSIGHT OF THE CLEARING AND SETTLEMENT SYSTEMS

- **All local designated systems remain in compliance with the safety and efficiency requirements of the Clearing and Settlement Systems Ordinance**
- **The Process Review Committee submitted its third annual report to the Financial Secretary in January 2008, and the report was published on the HKMA's website. The report concluded that the HKMA had duly followed the procedures and was procedurally fair in carrying out its oversight activities across different designated systems**



- The HKMA oversees four local designated systems through on-site examination, off-site reviews and continuous monitoring. The Hong Kong-dollar Clearing House Automated Transfer System (CHATS), US dollar CHATS, Euro CHATS and the Central Moneymarkets Unit are all in compliance with the safety and efficiency requirements under the Clearing and Settlement Systems Ordinance.

## TREASURY MARKETS ASSOCIATION

- **Islamic Finance**
  - **Recommendations made on Islamic bond market development in Hong Kong**
  - **Organising the Hong Kong Financial Sector Roadshow in the Middle East to promote Hong Kong's development of an Islamic finance platform**
- **Treasury Markets Certificate Programme in Beijing**
  - **Jointly launched with Hong Kong Institute of Bankers, targeting Mainland professionals**



**Islamic finance**

- The TMA will continue to provide market input on Islamic finance to the authorities.

- The TMA will jointly organise with HKMA and HKTDC a "Hong Kong Financial Sector Showcase on Islamic Finance" in Dubai and Jordan in May to promote Hong Kong to serve the investment and financing needs of the Middle East financial industry.

**Treasury Markets Certificate Programme in Beijing**

- The TMA and the Hong Kong Institute of Bankers jointly launched the Programme in Beijing in January 2008. This is a professional training course designed for Mainland treasury market practitioners, covering the theoretical and practical aspects of treasury business. Attended by 39 representatives from 13 Mainland financial institutions, the programme aimed to further enhance the professionalism of the Mainland's treasury markets.

## INVESTMENT OBJECTIVES OF THE EXCHANGE FUND

Investment objectives of the Exchange Fund:

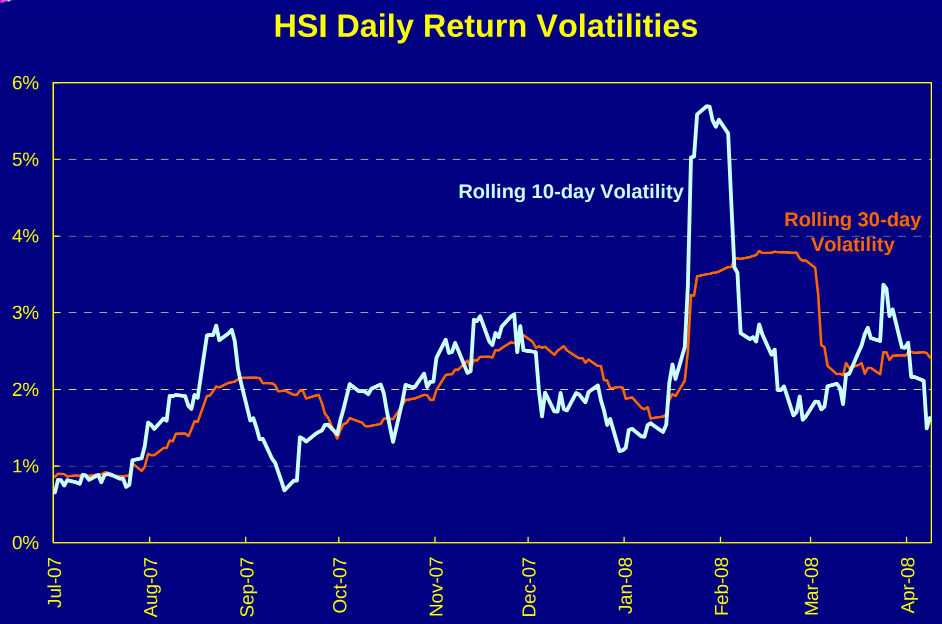
(1) to preserve capital;

(2) to ensure that the entire Monetary Base at all times will be fully backed by highly liquid US dollar denominated assets;

(3) to ensure sufficient liquidity for the purpose of maintaining monetary and financial stability; and

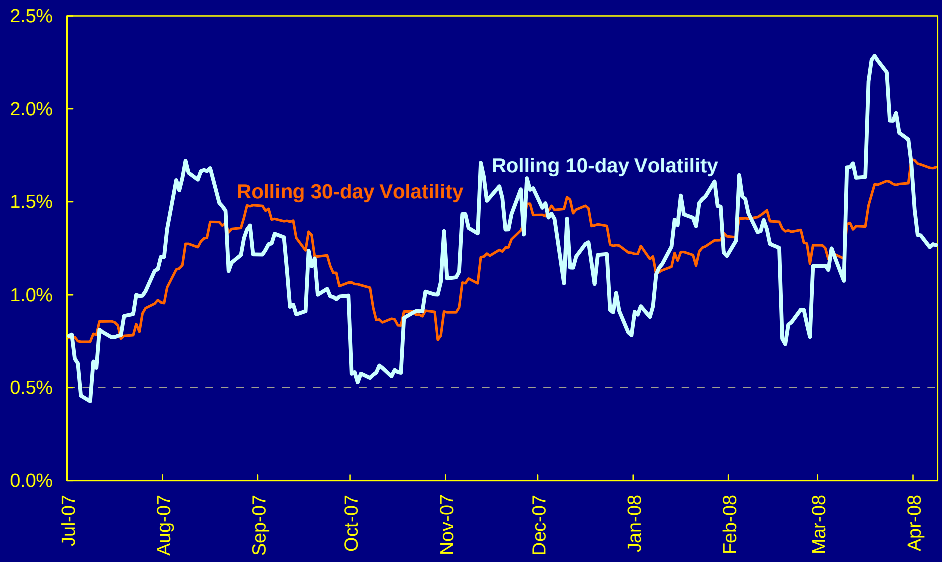
(4) subject to (1) – (3), to achieve an investment return that will preserve the long-term purchasing power of the Fund.

# INCREASED STOCK MARKET VOLATILITY (1)



# INCREASED STOCK MARKET VOLATILITY (2)

S&P500 Daily Return Volatilities



# INVESTMENT INCOME

| (HK$ billion) | 2008 Q1 * | 2007 Full Year | 2006 Full Year | 2005 Full Year |
|---|---|---|---|---|
| Gain/(Loss) on Hong Kong equities ^ | (30.0) | 55.8 | 35.9 | 7.0 |
| Gain/(Loss) on other equities ^ | (22.4) | 6.7 | 18.7 | 20.5 |
| Exchange gain/(loss) | 12.2 | 18.7 | 17.3 | (19.5) |
| Return from bonds # | 25.6 | 61.0 | 31.9 | 29.8 |
| Investment income / (loss) | (14.6) | 142.2 | 103.8 | 37.8 |

* Unaudited figures

^ Including dividends

# Including interest

# CHANGES IN INVESTMENT INCOME, TREASURY'S SHARE AND ACCUMULATED SURPLUS

| (HK$ billion) | 2008 Q1 * | 2007 Full year | 2007 Q4 | 2007 Q3 | 2007 Q2 | 2007 Q1 |
|---|---|---|---|---|---|---|
| **Investment income / (loss)** | **(14.6)** | **142.2** | **33.4** | **61.8** | **26.3** | **20.7** |
| Other income | 0.1 | 0.2 | 0.1 | 0.0 | 0.1 | 0.0 |
| Interest and other expenses | (1.6) | (10.2) | (2.2) | (2.8) | (2.9) | (2.3) |
| Net investment income / (loss) | (16.1) | 132.2 | 31.3 | 59.0 | 23.5 | 18.4 |
| **Payment to Treasury #** | **(11.8)** | **(27.6)** | **(7.4)** | **(6.9)** | **(6.9)** | **(6.4)** |
| Valuation change of Strategic Portfolio^ | (5.5) | 4.7 | (1.1) | 5.8 | N/A | N/A |
| **Increase / (Decrease) in EF accumulated surplus** | **(33.4)** | **109.3** | **22.8** | **57.9** | **16.6** | **12.0** |

* *Unaudited*

\# The fixed rate of fee payment to Treasury for 2007 (w.e.f. 1 April 2007) and 2008 are 7% and 9.4% respectively.

^ The Strategic Portfolio holds the shares of the HK Exchanges and Clearing Ltd purchased for strategic purpose. Valuation change Includes 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* | **N/A** | N/A | N/A | N/A | (14.6) |

* Excluding valuation changes in the Strategic Portfolio

## NEW FEE ARRANGEMENT WITH THE TREASURY

- Main purposes :
  - to enable the fiscal reserves placed with the Fund to achieve a more stable and predictable return
  - to increase the Government's investment income in the long run subject to the principle that the Fund's ability to defend our currency and stabilise our monetary and financial systems will not be undermined
- Fiscal reserves placed with the Exchange Fund will be paid an annual fee at a fixed rate being the higher of:
  - the average annual rate of return of the Exchange Fund’s Investment Portfolio in the past 6 years; and
  - the average annual yield of 3-year Exchange Fund Notes of the preceding year.

## ABRIDGED BALANCE SHEET OF THE EXCHANGE FUND

| (HK$ billion) | At 31 Mar 2008 (Unaudited) | At 31 Dec 2007 (Audited) | At 31 Dec 2006 (Audited) |
|---|---|---|---|
| **ASSETS** | | | |
| Deposits | 108.0 | 132.9 | 62.4 |
| Debt securities | 1,046.5 | 922.9 | 828.4 |
| Hong Kong equities | 147.6 | 184.6 | 122.4 |
| Other equities | 131.8 | 146.0 | 137.4 |
| Other assets | 25.7 | 28.0 | 25.8 |
| Total assets | 1,459.6 | 1,414.4 | 1,176.4 |
| **LIABILITIES AND FUND EQUITY** | | | |
| Certificates of Indebtedness | 168.1 | 163.4 | 156.9 |
| Government-issued currency notes & coins in circulation | 8.1 | 7.5 | 6.9 |
| Balance of the banking system | 4.7 | 10.6 | 2.0 |
| Exchange Fund Bills and Notes | 146.5 | 141.8 | 129.2 |
| Fiscal Reserves Account | 503.2 | 464.6 | 324.5 |
| Other liabilities | 45.4 | 9.5 | 49.2 |
| Total liabilities | 876.0 | 797.4 | 668.7 |
| Accumulated surplus | 583.6 | 617.0 | 507.7 |
| Total liabilities and fund equity | 1,459.6 | 1,414.4 | 1,176.4 |



- The Accumulated Surplus of the Exchange Fund amounted to HK$583.6 billion on 31 March 2008.

- The Fiscal Reserves placed with the Exchange Fund amounted to HK$503.2 billion on 31 March 2008.