



HONG KONG MONETARY AUTHORITY

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

19 November 2009



DISCUSSION TOPICS

Updates on

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



FINANCIAL AND ECONOMIC ENVIRONMENT



GLOBAL FINANCIAL MARKETS

- Credit market conditions improved and equity prices rebounded

3-Month Libor spread over OIS



Source: Bloomberg

MSCI World and Asia indices



Source: Bloomberg

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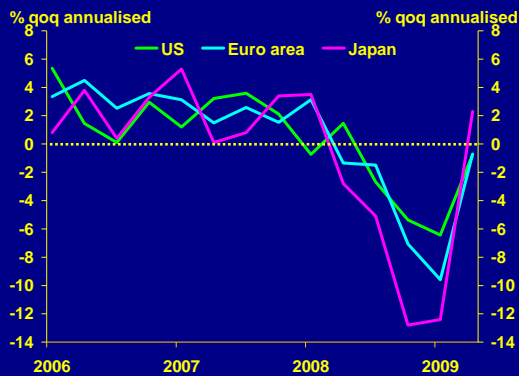
- There are increasing signs of stabilisation in financial markets. On the credit market front, the 3-month Libor spread over OIS has declined further in recent months, reflecting a continued reduction in counter-party risks.
- Global stock markets have rebounded. Until mid-October, equity prices had risen by more than 40% from the trough in mature markets and emerging Asian markets.



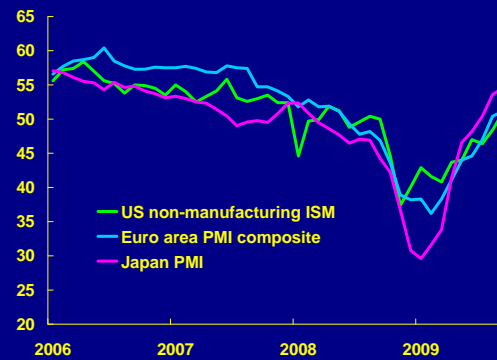
ECONOMIC CONDITIONS IN ADVANCED ECONOMIES

- **Contraction in advanced economies slowed in Q2, with business sentiment improving to the pre-crisis level**

GDP growth: US, euro area and Japan



PMI: US, euro area and Japan



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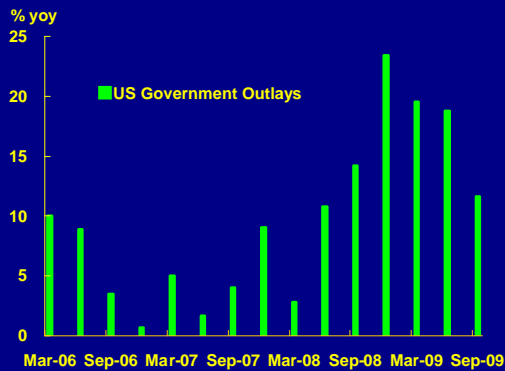
- As financial markets stabilised, contraction in advanced economies slowed in Q2 as shown in the quarter-on-quarter GDP growth. Business sentiment has also improved, with the purchasing manager index increasing above 50, reflecting expectations of a rise in business activities in the near term.



SUSTAINABILITY OF RECOVERY

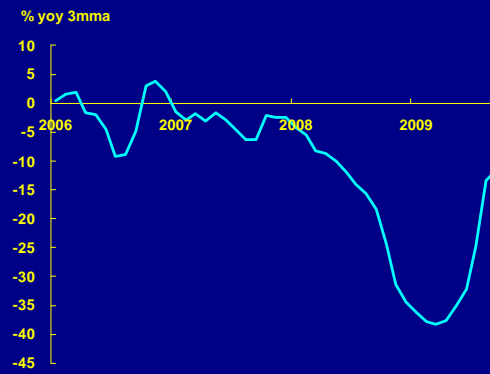
- To the extent that economic activity has been boosted by fiscal stimulus packages, the underlying strength of the economy is questionable

US government outlays



Source: Bloomberg

US new motor vehicle registration



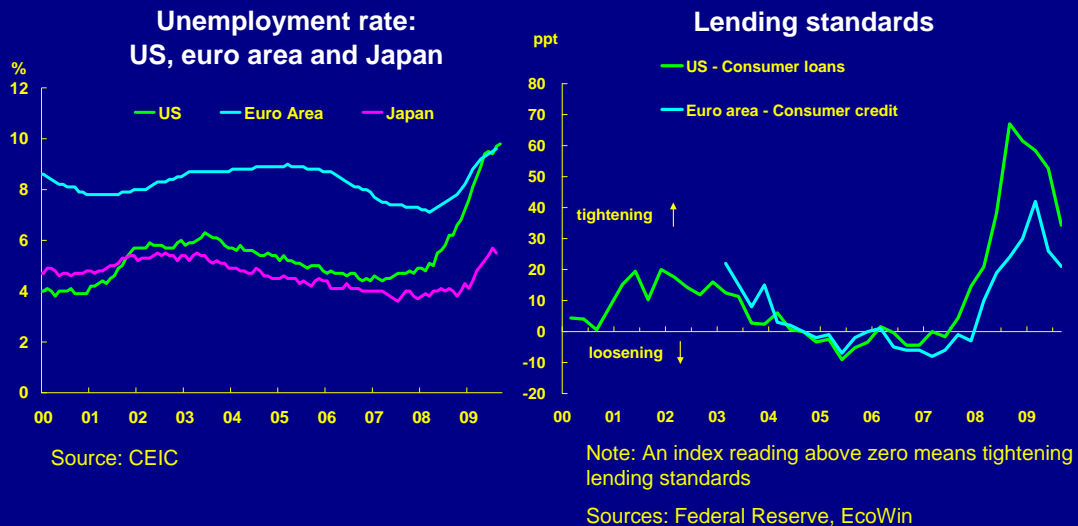
Source: CEIC

- However, the recent recovery has to a large extent been aided by large fiscal stimulus packages, the effects of which may wane.
- The underlying strength of the economy may be questionable. For instance, new motor vehicle registrations, which were boosted by various government programmes, have recently shown signs of weakening.



ADVERSE FEEDBACK BETWEEN REAL ECONOMY AND FINANCIAL SECTOR

- Rising unemployment rates suggest continuing loan losses for banks, which in turn restrict lending and weigh on growth



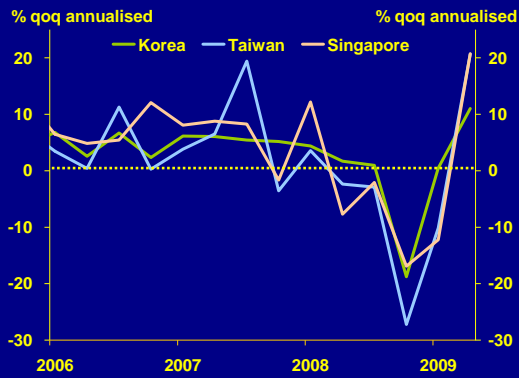
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- Hence, risks to medium-to-long term economic growth remain.
- Labour market conditions in the US, euro area and Japan have continued to worsen in recent months, with the unemployment rate climbing to nearly 10% in the US and euro area and a historical high in Japan in July. High unemployment has led to a deterioration in credit conditions. This, coupled with continued weakness in the commercial property market, will constrain the financing of economic activities by the banking sector, which may in turn undermine the nascent recovery.
- Credit surveys show that while credit conditions have become less restricted, more bank loan officers continued to report that they would tighten lending standards than would relax them in the period ahead.



ECONOMIC CONDITIONS IN EMERGING ASIA

GDP growth: NIE-3



Source: CEIC

GDP growth: ASEAN-4



Source: CEIC

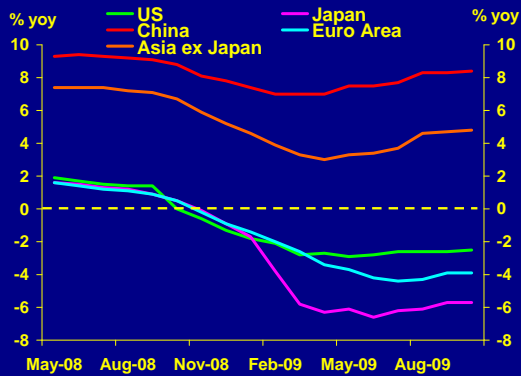
- As growth is likely to remain subdued and unemployment high in advanced economies, external demand will be weak. This is despite the fact that real activity rebounded strongly in Q2 in emerging Asia.



ACCOMMODATIVE MONETARY POLICY

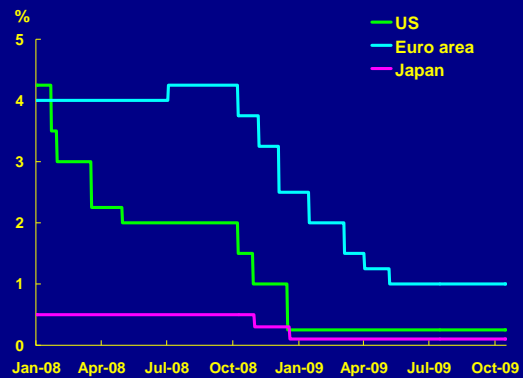
- Monetary accommodation is likely to remain for some time

Consensus forecasts for 2009 growth:
US, euro area, Japan, China and Asia



Source: Consensus Forecasts

Policy rates: US, euro area, Japan



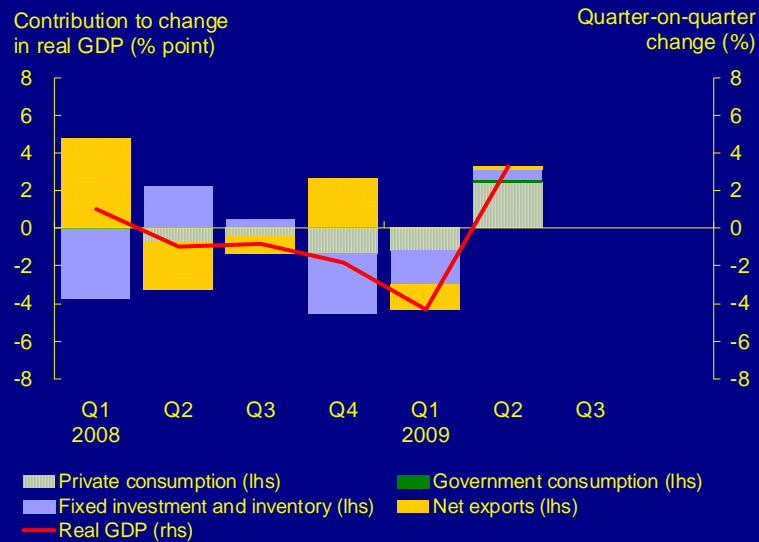
Source: Bloomberg

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- In all, while the global economic outlook has stabilised, as reflected in the gradually climbing consensus growth forecasts, major central banks are likely to maintain their accommodative policy stance to support the economy.



RECOVERY IN HONG KONG

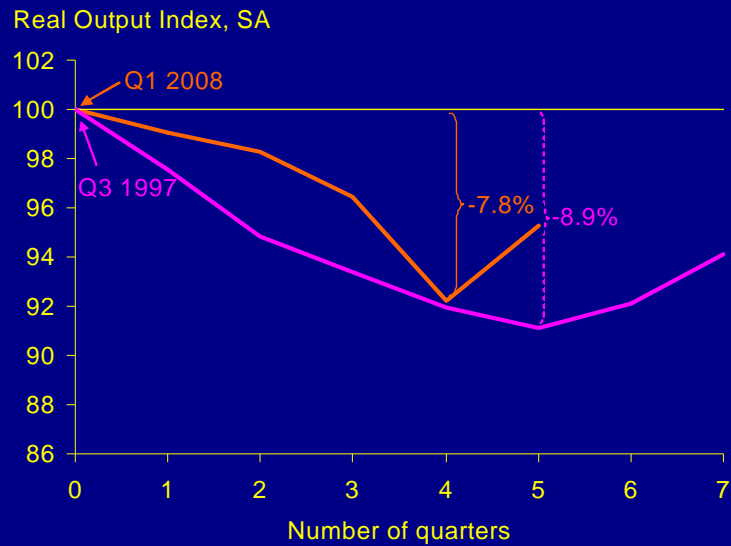


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- In Q2, real GDP grew by 3.3% quarter on quarter, after falling for four consecutive quarters (by a cumulative 7.8%).
- The rebound was fuelled by domestic demand and restocking.
- On a year-on-year basis, real GDP remained on a decline but the rate of decrease narrowed to -3.8% in Q2 from -7.8% in Q1.
- The sequential pace of recovery was sustained in recent months, albeit moderately, according to recent releases of high-frequency indicators such as PMI, retail sales and merchandise exports.



OUTPUT LOSS IN COMPARISON WITH THE ASIAN FINANCIAL CRISIS

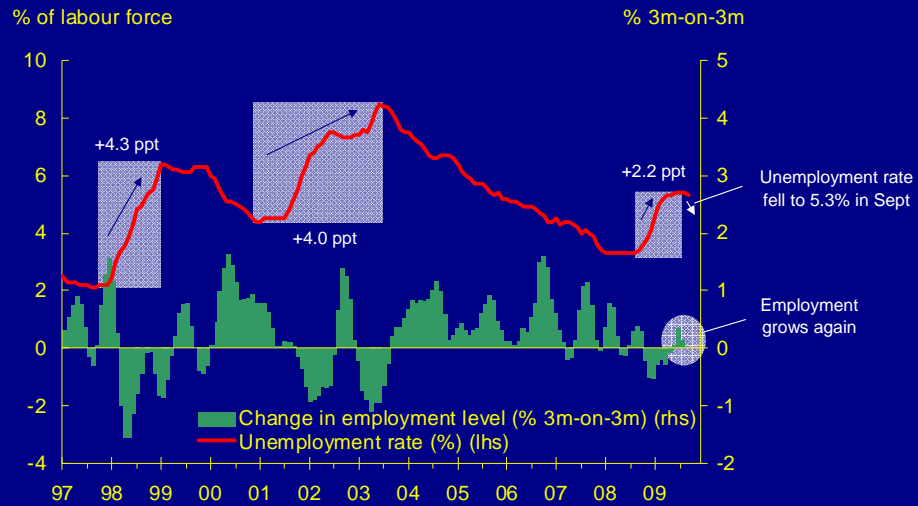


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- The current global financial crisis has posed a big output shock to Hong Kong. GDP fell by 7.8% (Q1/2009) in the fourth quarter after the outbreak of the crisis. GDP fell by a similar degree (-8.9%) during the 1997-98 Asian financial crisis.



LABOUR MARKET CONDITIONS



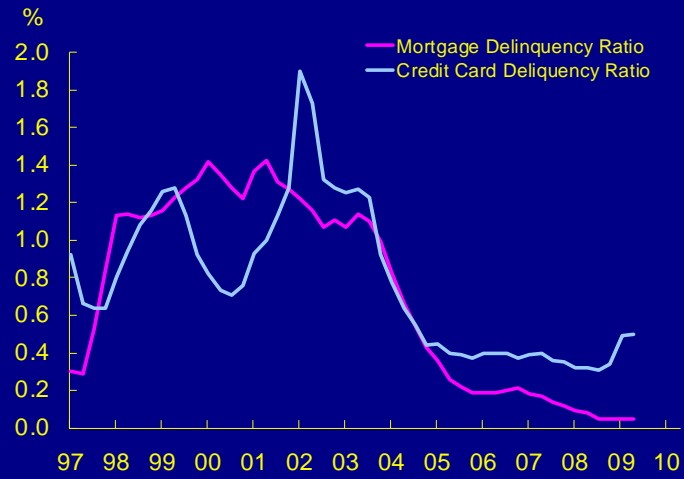
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- The unemployment rate rose by 2.2 percentage points during this crisis, compared with about 4 percentage points in previous recessions.



HOUSEHOLD BALANCE SHEET CONDITIONS

Delinquency Ratios

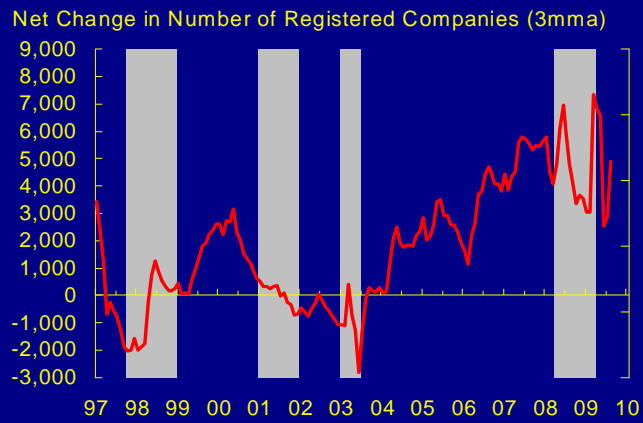


- Household balance sheets remain broadly solid.



CORPORATE BALANCE SHEET CONDITIONS

Change in the Number of Registered Companies

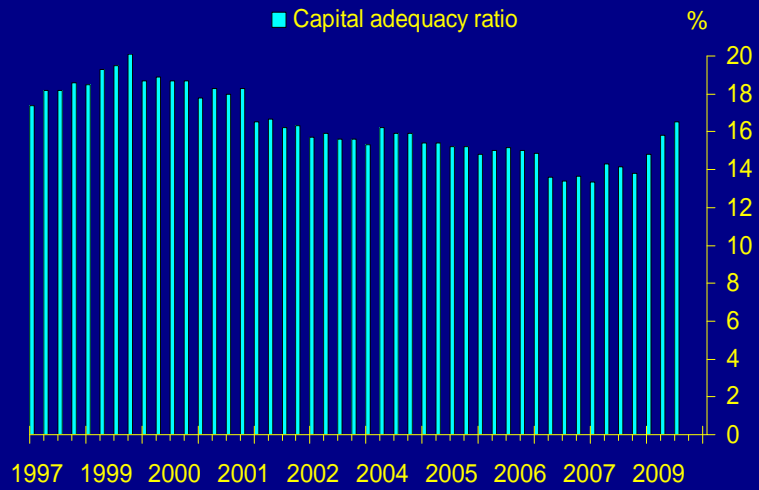


Note: Shaded areas indicate periods when real GDP declined for two or more consecutive quarters

- So are corporate balance sheets.



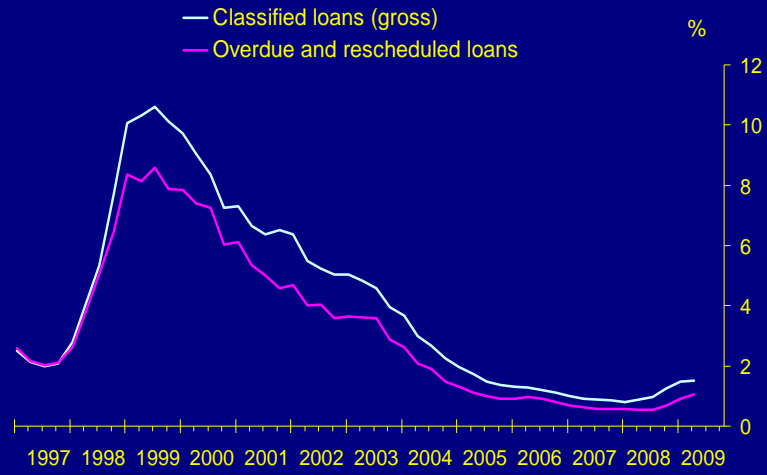
BANKING SECTOR CONDITIONS (I)





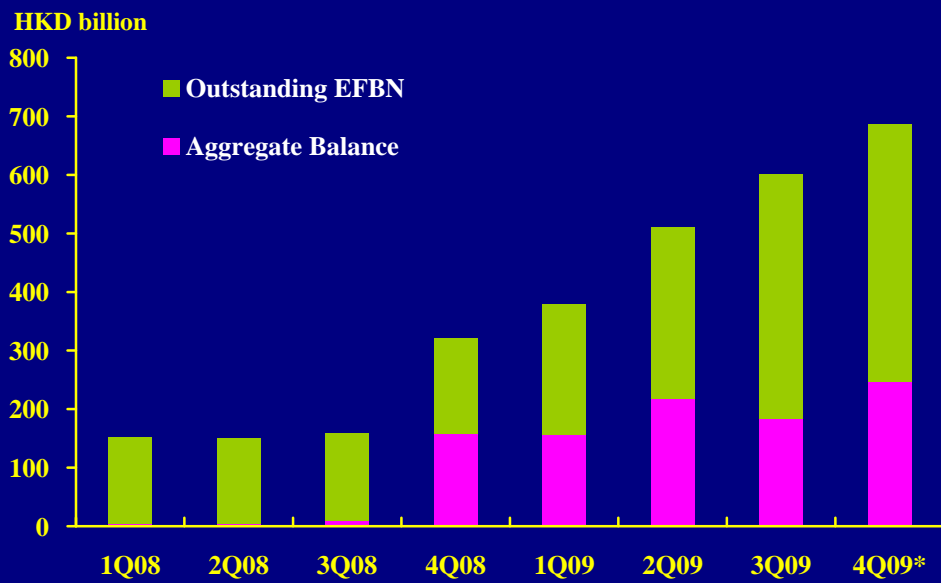
BANKING SECTOR CONDITIONS (II)

Asset quality





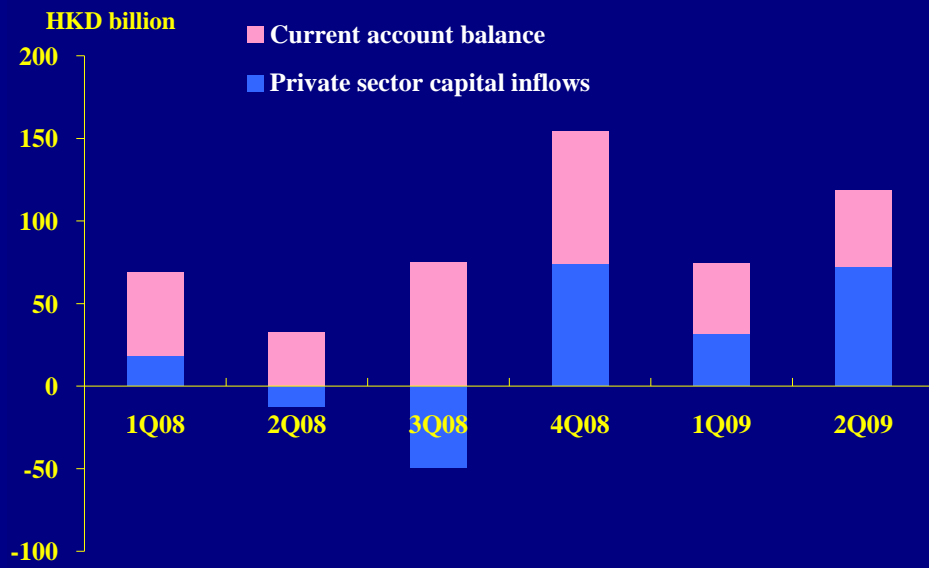
INFLOWS INTO THE HONG KONG DOLLAR



* Figure as of 29 Oct 2009.



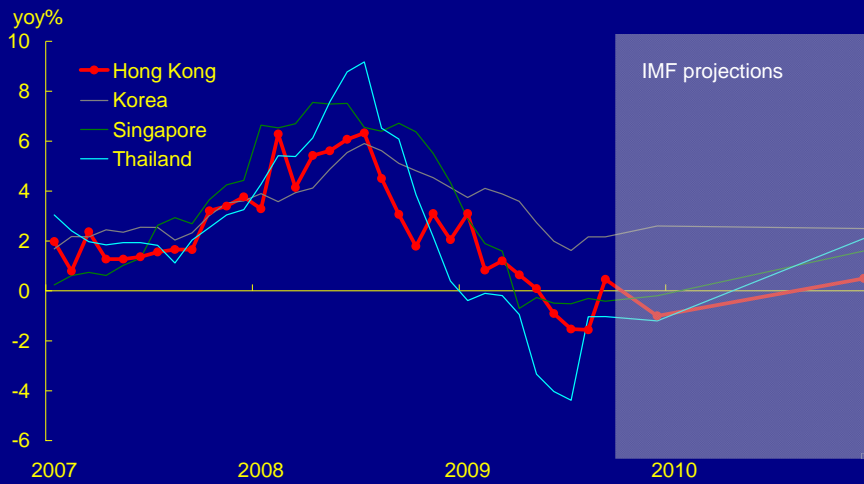
CROSS-BORDER CAPITAL INFLOWS





RISKS TO FINANCIAL STABILITY IN HONG KONG (I): INFLATION

Inflation rate in HK vs. other Asian economies



Sources: CEIC, IMF World Economic Outlook and HKMA estimates



RISKS TO FINANCIAL STABILITY IN HONG KONG (II): ASSET BUBBLE: STOCK MARKET



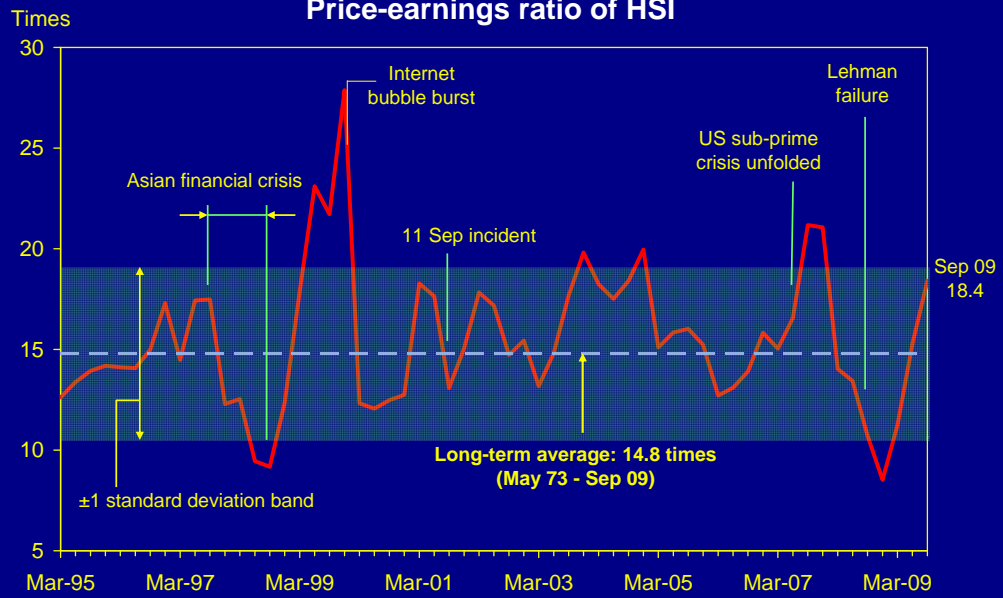
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- Domestic equity prices rallied in the past eight months along with regional markets.



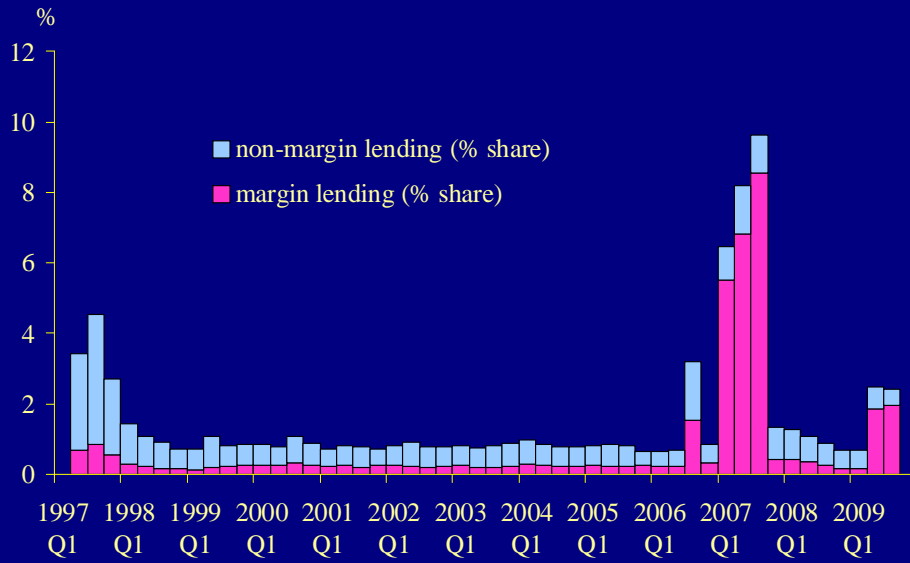
EQUITY MARKET VALUATION

Price-earnings ratio of HSI



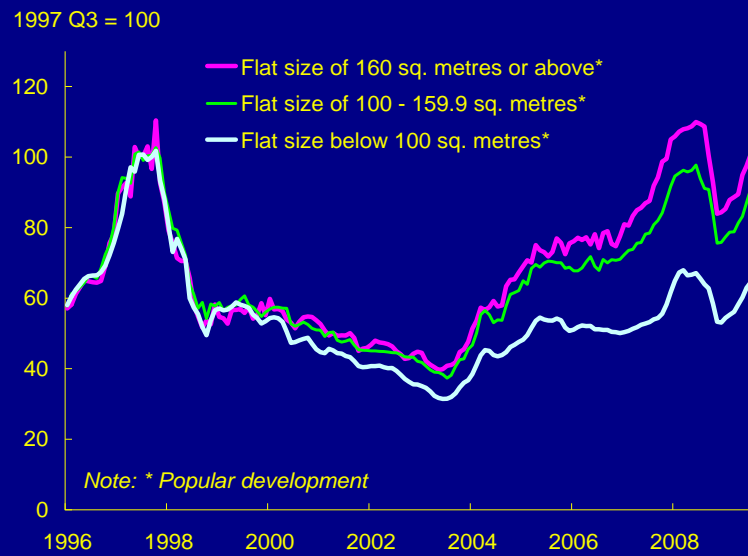


BANKING EXPOSURE TO THE STOCK MARKET





RISKS TO FINANCIAL STABILITY IN HONG KONG (III): ASSET BUBBLE : RESIDENTIAL PROPERTIES

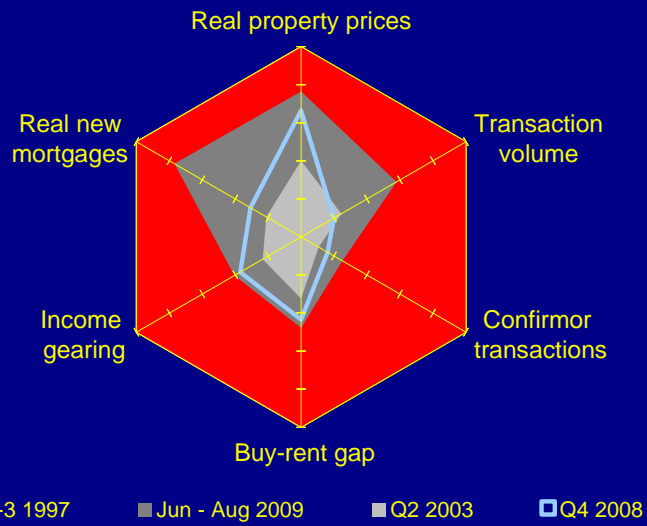


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- The property market turned active with residential property prices and transactions returning to pre-crisis levels.



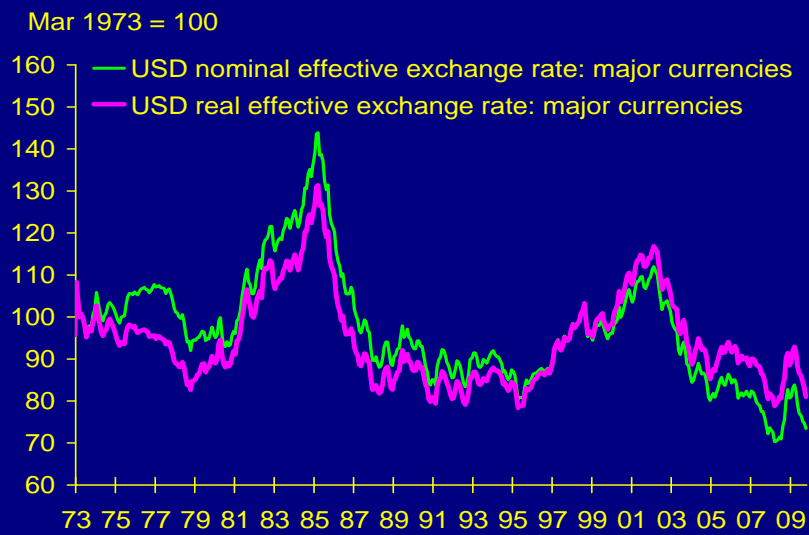
GRAPHICAL FRAMEWORK OF PROPERTY MARKET





RISK OF FUND FLOW REVERSAL

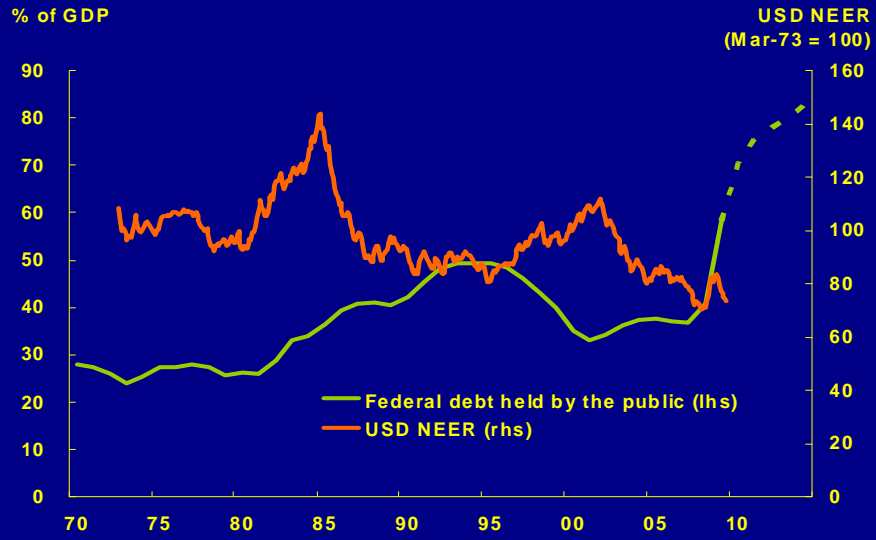
US dollar exchange rates could revert to their longer-term trends





RELATIONSHIP BETWEEN PUBLIC DEBT AND EXCHANGE RATE: US SITUATION

US government debt and value of USD

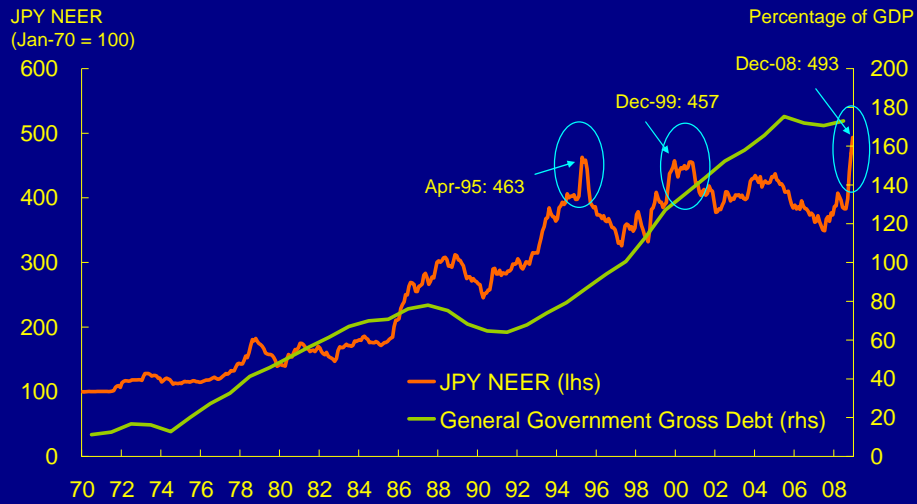


Source: IMF, CEIC



RELATIONSHIP BETWEEN PUBLIC DEBT AND EXCHANGE RATE: JAPAN'S EXPERIENCE

Japan's general government debt and value of yen



Sources: CEIC and Haver Select



NEAR-TERM ECONOMIC OUTLOOK

- A recovery should be in place
- Inflationary pressure is likely to remain subdued
- Unemployment rate may stay high

	Projection for 2009			Projection for 2010		
	%YoY		%	%YoY		%
	GDP	CPI	Unemployment rate	GDP	CPI	Unemployment Rate
HK Government (Aug 09)	-3.5 to -4.5	0.5	-	-	-	-
IMF (Nov 09)	-2.0	-1.0	5.1	5.0	0.5	4.8
ADB (Sep 09)	-4.0	1.3	-	3.0	2.0	-
Consensus (Oct 09)	-3.1	0.4	5.4	3.7	1.7	5.2



RISKS TO ECONOMIC OUTLOOK

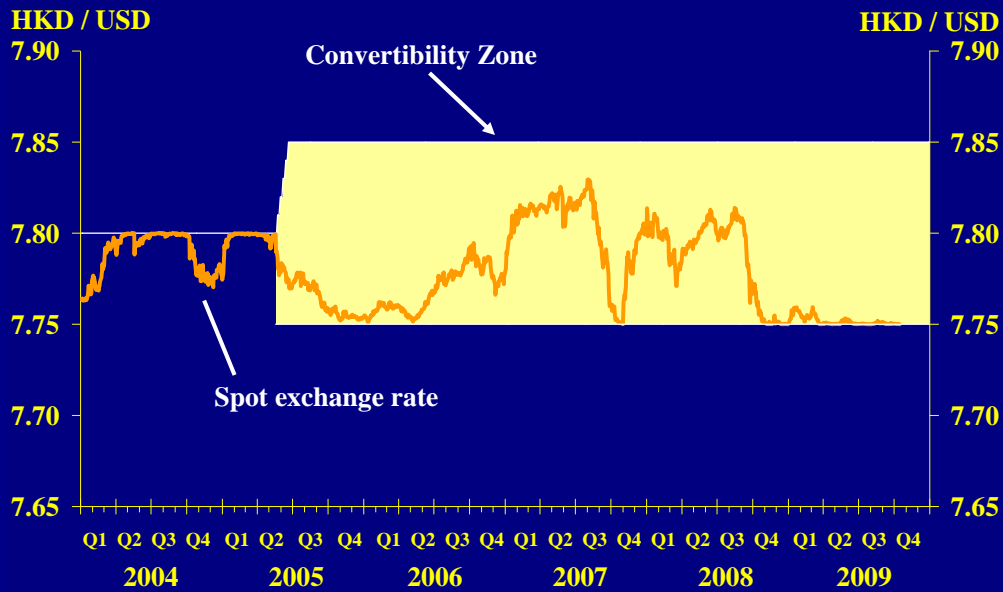
- **Reduced strength of global recovery**
- **Re-intensification of the adverse feedback between the real and financial sectors**
- **Incorrect timing of exit strategies**



CURRENCY STABILITY



HONG KONG DOLLAR STAYED CLOSE TO 7.75

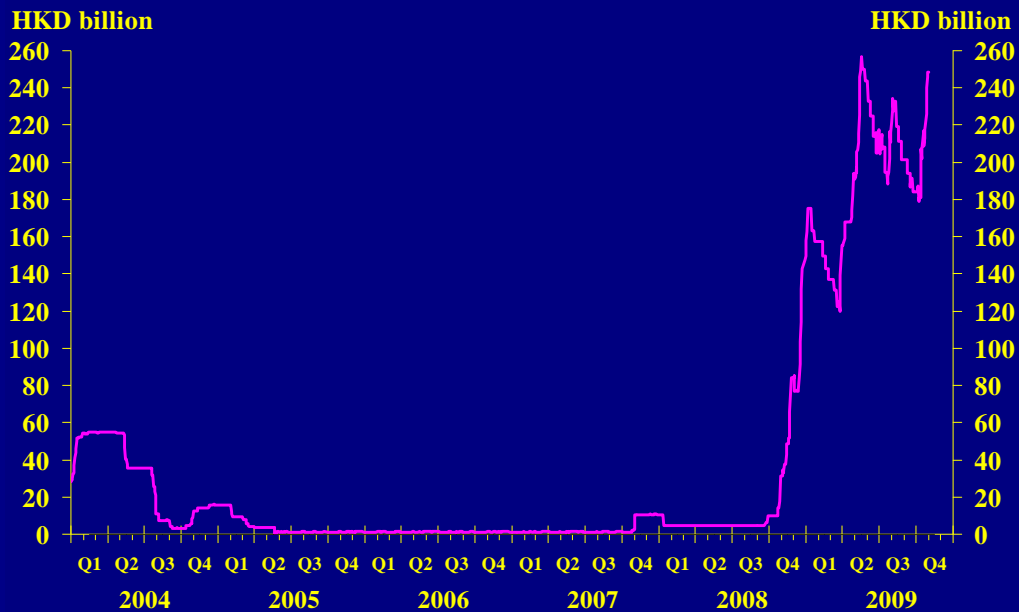


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- The Hong Kong dollar has remained close to the strong-side Convertibility Undertaking (CU) level since the end of last year.
- Having softened slightly against the US dollar at the beginning of 2009, the Hong Kong dollar moved to near 7.75 again, with the strong-side CU being triggered a number of times from late-March through October.



AGGREGATE BALANCE REMAINED HIGH

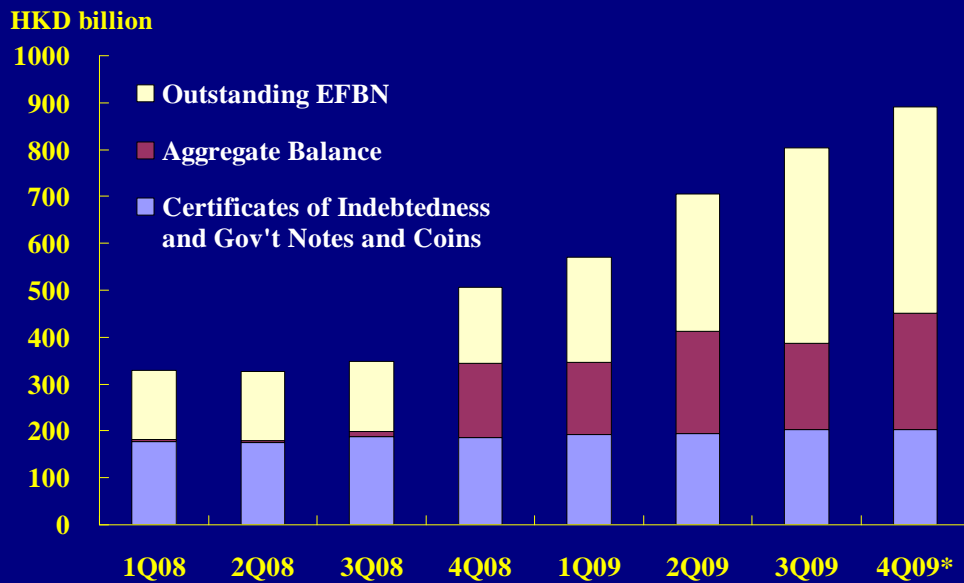


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- Issuance of additional Exchange Fund Bills led to a decrease in the Aggregate Balance at the beginning of the year. But with the triggering of the strong-side CU, the HKMA injected a total of HK\$350 billion into the banking system (up to October 2009), which was offset by an additional issue of Exchange Fund Bills (HK\$277 billion from January to October 2009). The Aggregate Balance stood at HK\$249 billion on 2 November 2009.
- According to market intelligence, the bulk of the capital inflows into Hong Kong since the second quarter was related to investment in HKD assets, supported by improving economic data in Hong Kong and the Mainland. With upbeat economic growth in China (8.9% GDP growth in Q3 2009) and renewed appreciation pressure on RMB, investment demand for HKD assets is likely to remain strong.
- Increasing risk appetite and expectations of recovery in emerging markets also led to increased investment in the region.



MONETARY BASE EXPANDED



* Figure as of 2 Nov 2009.

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- The Monetary Base has also risen significantly to about HK\$890 billion from about HK\$500 billion at the end of 2008, driven mainly by the expansion of the Aggregate Balance and the issuance of additional Exchange Fund Bills.
- The issuance of additional Exchange Fund Bills only represents a transfer among the components of the Monetary Base. It will not fundamentally change the monetary conditions, since Exchange Fund Bills are very liquid and highly substitutable with the clearing balances.



FORWARD DISCOUNT REMAINED STABLE

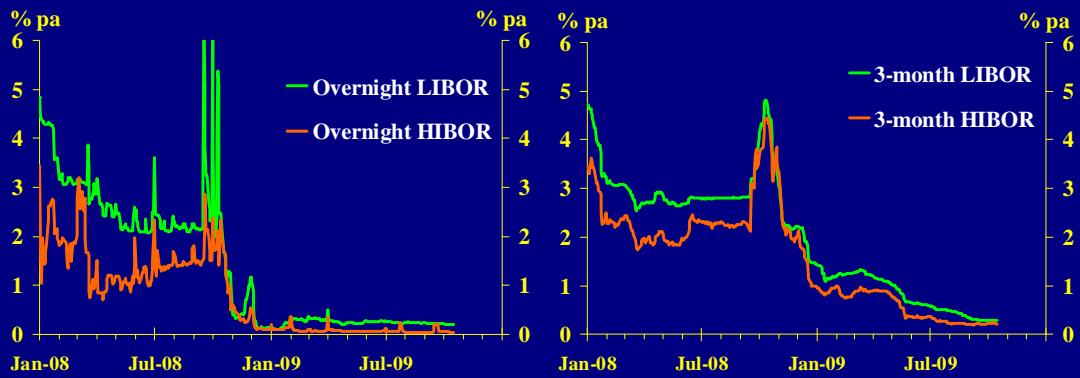


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- In the forward market, the HK dollar forward discount remained stable, with a discount of around 200 pips on one-year forwards. This suggests little speculation on the Hong Kong dollar exchange rate.



LOW DOMESTIC INTEREST RATES

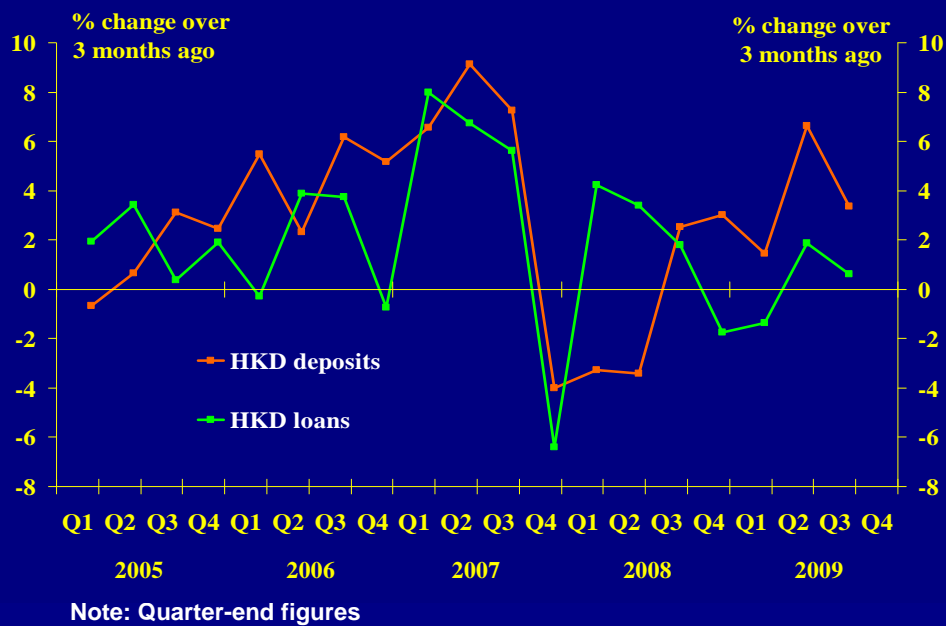


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- With ample liquidity in the banking system, Hong Kong dollar interest rates remained fairly stable at low levels and were slightly below their US dollar counterparts. Since the beginning of the year, overnight HIBOR has remained at near zero levels while the 3-month HIBOR has edged lower.



GROWTH IN HK DOLLAR LOANS AND DEPOSITS PICKED UP



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- The growth in Hong Kong dollar deposits could be a result of higher savings and demand deposits arising from IPO activities.
- Hong Kong dollar loans resumed growth in Q2 2009, probably due to the more active equity and property markets. While the inflow has not yet led to significant credit creation, we will need to monitor developments closely and guard against the risk of any excessive credit expansion by banks.



STRATEGY TO COPE WITH INFLOWS

- **Under the Currency Board system, the strong-side CU will be triggered to buy USD and sell HKD at 7.75**
- **Issuance of additional Exchange Fund Bills, subject to market demand**
- **Little room for the use of monetary tools to contain inflows-induced price pressure**
- **Need to strengthen prudential and supervisory measures**

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- If the Aggregate Balance continues to expand, there will be room to issue more Exchange Fund Bills. The timing and amount of further issuance will be determined in response to market demand, and is unlikely to have a significant impact on monetary conditions.
- Continued strong inflows into the Hong Kong dollar may give rise to inflation in asset prices and consumer prices which could pose threats to macroeconomic stability. Under the Currency Board arrangements, there is little room to use monetary tools to contain inflationary pressures since monetary conditions in Hong Kong are determined by interest rates in the US and by capital flows.
- However, prudential and supervisory measures may be deployed to increase the resilience of the economy and banking sector against asset price booms and busts. Residential home buyers have been reminded that interest rates will not remain low forever. The HKMA has issued a circular to banks to provide guidance on loan-to-value (LTV) ratios for residential mortgages on properties valued at \$20 million or more. The circular also reminds banks that they should be prudent in valuing properties and in calculating borrowers' debt servicing ratios. The aim of the measures is to ensure that banks are taking a prudent approach to risk management in their residential mortgage lending, particularly in the luxury sector.



STRATEGY TO DEAL WITH REVERSAL OF FUND FLOWS

- **Market operations under the Currency Board System**
 - Foreign reserves built up during the inflow and the large pool of EF paper held by banks will help cushion the downward pressure on HKD if weak-side CU is triggered
 - Where appropriate, within-zone operations can be conducted to ensure orderly adjustment in monetary conditions
- **Raise the alertness of banks and borrowers to risk of reversal of fund flows**
 - Remind all market players the exceptionally low interest rates will not last forever
 - Strengthening of risk management is the best means of protection from market volatilities in the future

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- Foreign reserves built up during the inflows and the automatic interest-rate adjustment resulting from any reversal will act as a cushion against downward pressure on the exchange rate. In case of reversal, it is inevitable that interest rates will rise.
- It is difficult to predict the timing and size of any outflows, but it would be desirable for the adjustment in monetary conditions to be orderly. Where appropriate, operations within the Convertibility Zone may be conducted to avoid destabilising movements in the exchange rate and interest rates.
- At the same time, there is a need to alert banks and borrowers to the risk of higher interest rate volatility upon reversal of fund flows. In particular, banks should be mindful of the possible impact of higher interest rates on asset prices and the debt-servicing ability of borrowers.
- In this connection, the HKMA issued a circular to banks in September 2009, reminding them of the importance of risk management in pricing residential mortgages.

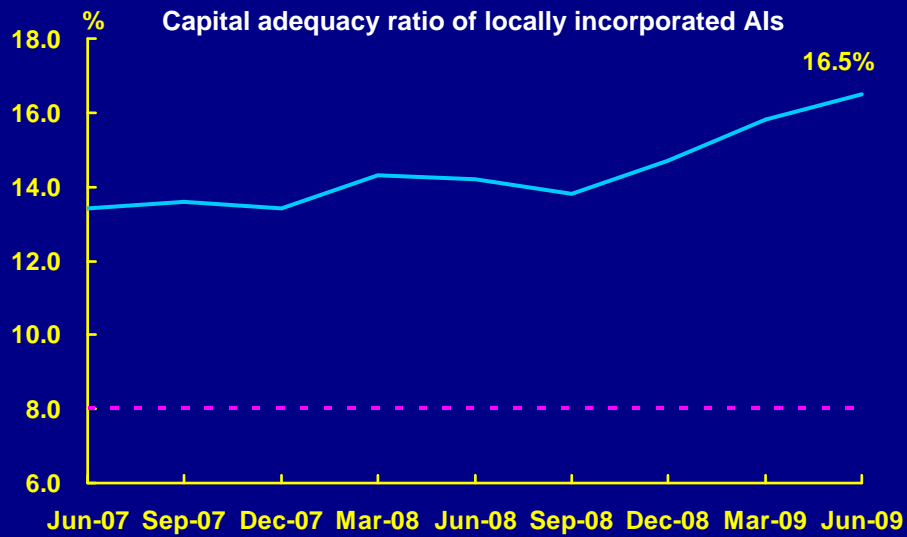


BANKING STABILITY



BANKING SECTOR PERFORMANCE

Capital adequacy ratio improved



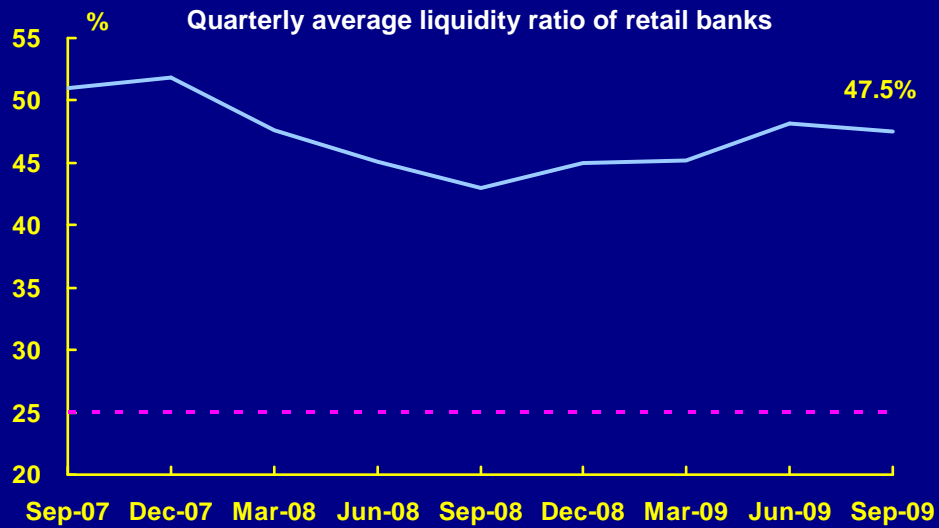
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- The consolidated capital adequacy ratio of locally incorporated AIs rose to 16.5% at the end of June 2009, compared with 15.8% at the end of March 2009 and 14.7% at the end of December 2008. The ratio is well above the international standard of 8%.



BANKING SECTOR PERFORMANCE

Liquidity level remained high



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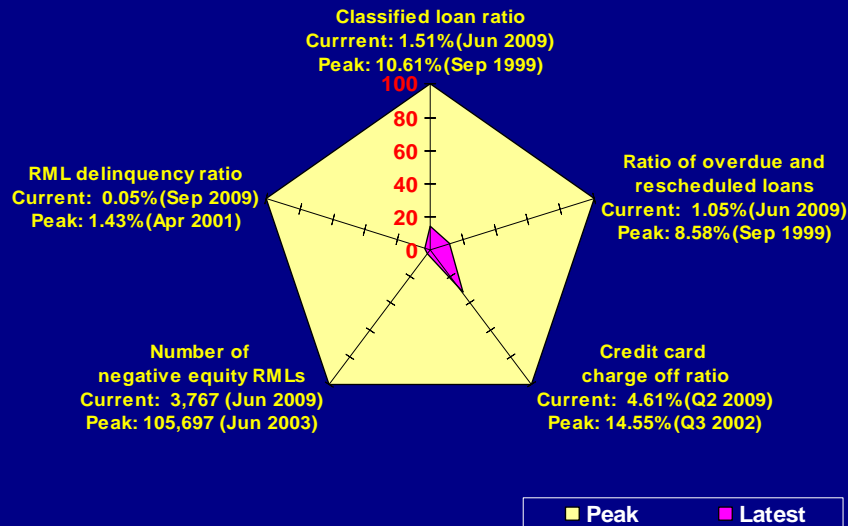
- The quarterly average liquidity ratio of retail banks was 47.5% in Q3 2009, well above the statutory minimum of 25%.



BANKING SECTOR PERFORMANCE

Loan quality showed signs of stabilisation

Overview of loan quality



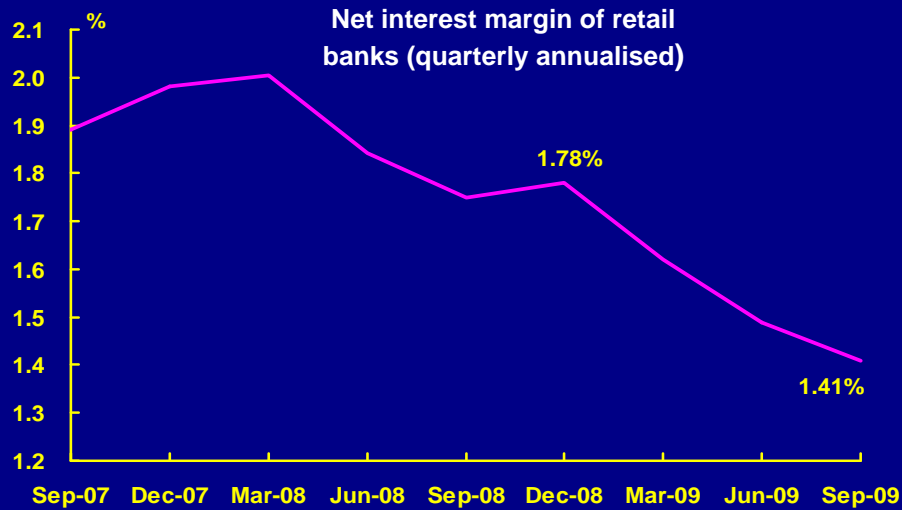
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- Asset quality indicators for banks' loan portfolios are showing signs of stabilisation and have remained at comfortable levels compared to their historical peaks. The HKMA will continue to monitor the quality of retail banks' loan portfolios closely.



BANKING SECTOR PERFORMANCE

Net interest margin of retail banks further narrowed



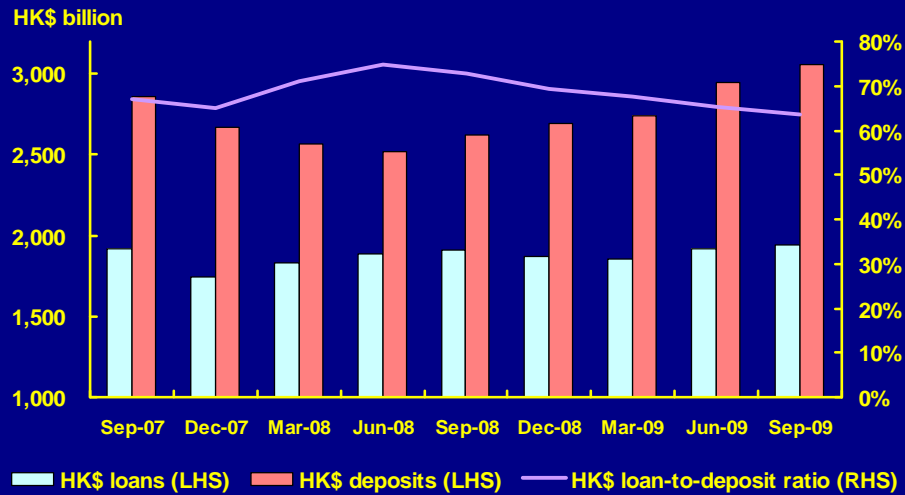
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- Retail banks' profitability continued to be under pressure. The net interest margin of retail banks narrowed to 1.41% in Q3 2009 from 1.78% in Q4 2008. The narrowing appears to be mainly the result of : (1) the low interest rate environment; (2) increased competition in mortgage lending; and (3) redeployment of surplus funding to safer and more liquid assets such as government papers, which generally offer lower interest yields.
- The aggregate pre-tax operating profit of retail banks' Hong Kong offices declined by 9.7% in the first three quarters of 2009, compared with the same period last year.



BANKING SECTOR PERFORMANCE

Hong-Kong-dollar loan-to-deposit ratio declined



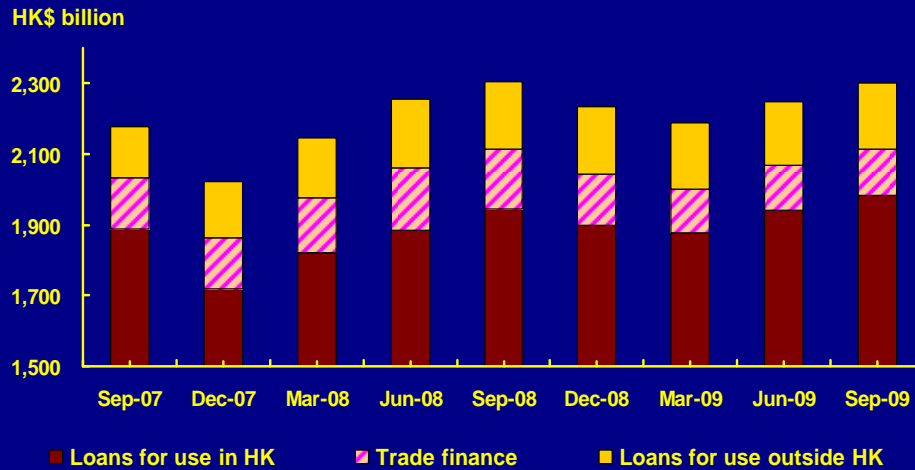
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- The Hong-Kong-dollar loan-to-deposit ratio of retail banks declined to 63.7% at the end of September 2009 from 65.2% in June, as deposits grew faster than loans during the quarter. The increase in Hong-Kong-dollar deposits was largely attributable to capital inflows. The HKMA will continue to monitor deposit movements in Als.



BANKING SECTOR PERFORMANCE

Total loans of retail banks almost returned to pre-crisis level



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- Total loans of retail banks have almost returned to the pre-crisis level. They increased by 2.4% in Q3 2009, following an increase of 2.8% in Q2.
- The banking industry continued to support the SME sector. Over 35 AIs have joined the Government's enhanced SME Loan Guarantee Scheme and Special Loan Guarantee Scheme as participating lending institutions. Up to 6 November 2009, they had forwarded over 26,500 loan applications to the Trade and Industry Department for processing. Around 24,000 have been approved, involving a total loan amount of over HK\$60 billion.



RESIDENTIAL MORTGAGE LENDING

- Reminded AIs to be prudent in setting mortgage interest rates
- Lowered the LTV ratio for luxury properties
- Stressed the need for prudence in property valuation and in assessing borrowers' repayment ability and provided additional guidance to AIs

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- The HKMA reminded AIs to be prudent in setting mortgage interest rates in September. AIs have been asked to ensure that their pricing strategies are sustainable and have given due regard to the risk of the prime-HIBOR spreads returning to more normal levels.
- Prices of luxury properties increased rapidly in Q3 2009. To ensure that banks properly manage the risks of mortgage lending, and to safeguard the stability of the banking system, the HKMA issued a circular to all AIs on 23 October, requiring them to lower the LTV ratio for properties with a value of \$20 million or more from 70% to 60%.
- The circular also emphasised the need for AIs to remain prudent in valuing properties and in assessing borrowers' repayment ability. In particular, AIs are asked to take into account the potential impact on borrowers' repayment ability if the current unusually low interest rates were to return to more normal levels. Additional guidance on property valuation and computation of debt servicing ratios was provided to AIs on 30 October.



SUPERVISORY POLICY INITIATIVES

- **Consultative papers issued**
 - **Enhancements to the Basel II capital framework**
 - **Guideline on a Sound Remuneration System**
- **Proposals to strengthen the liquidity regime will be issued for consultation in early 2010**

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- Industry consultation is underway on enhancements to the Banking (Capital) Rules and Banking (Disclosure) Rules, in line with the recommendations issued by the Basel Committee on Banking Supervision (BCBS) in July 2009, which effectively raise regulatory capital requirements in respect of banks' trading books and certain securitisation activities. The BCBS is also working on policy proposals to strengthen the quality, consistency and transparency of regulatory capital and to introduce a countercyclical capital buffer and a leverage ratio to supplement the Basel II framework. As a member of the BCBS and various of its subgroups, the HKMA is actively participating in these initiatives.
- The HKMA is also consulting the industry on a guideline on sound remuneration systems (based on the FSB Principles for Sound Compensation Practices). We aim to issue this guidance by the end of 2009. This guideline aims to ensure that AIs have sound remuneration systems which are consistent with, and promote, effective risk management and which align remuneration practices with long-term value creation and financial stability.
- Proposals to refine and strengthen our liquidity regime, in line with the latest BCBS Liquidity Sound Principles, will be issued for industry consultation in early 2010. The Principles raise the bar for the management of liquidity risk in a number of areas including stress-testing, contingency funding plans, and identification of contingent liquidity risks. We will also be considering the introduction of further quantitative liquidity standards, taking into account the anticipated BCBS proposals for a global liquidity standard to strengthen banks' resilience to liquidity shocks.



DEPOSIT PROTECTION

- **Completed a review of the Deposit Protection Scheme (DPS) in light of lessons learnt from the financial crisis**
- **Aim at submitting legislative proposals to LegCo in Q1 2010 to raise coverage amount to \$500,000 and introduce other changes**
- **Formed a tripartite working group with Malaysia and Singapore to coordinate exit from full deposit guarantee at the end of 2010**

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- With the assistance of the HKMA, the Hong Kong Deposit Protection Board (the Board) has completed a review of the DPS taking into account lessons learnt from the global financial crisis.
- The Board is finalising its proposals in consultation with the industry. It aims to submit the legislative proposals to LegCo in Q1 2010 to raise the coverage amount to \$500,000 and introduce other relevant changes, and complete the legislation process to allow the enhanced scheme to come into effect before the full deposit guarantee expires by the end of 2010.
- The HKMA, Bank Negara Malaysia and the Monetary Authority of Singapore formed a tripartite working group in July 2009 with a view to mapping out a coordinated strategy for exiting their respective full deposit guarantee. The working group held the first of a series of conference calls in October 2009 to develop a work plan.



LEHMAN-RELATED ISSUES - MINIBOND REPURCHASE SCHEME

- **About 97% of eligible customers (exceeding 24,000) accepted the repurchase offer of banks**
- **About 4,800 previously settled customers eligible for voluntary top-up offer**
- **Investigation will continue in respect of about 800 cases involving ineligible customers or customers who have rejected the offer**

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- Under s.201 of the SFO, the SFC, the HKMA and 16 banks reached an agreement in relation to the repurchase of minibonds in July 2009.



LEHMAN-RELATED ISSUES - INVESTIGATION PROGRESS

- Received nearly 22,000 Lehman-related complaints, of which around 7,700 relate to non-minibond products
- Of the non-minibond complaints:
 - 766 cases under disciplinary consideration
 - 2,473 cases closed due to insufficient evidence
 - 4,457 cases in progress
- Aims to substantially complete the investigation of all outstanding complaints by end-March 2010

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- Lehman-related non-minibond products mainly include Constellation Notes, Octave Notes and ELNs.



REPORT ON COMPLAINTS ABOUT SALE OF LEHMAN-RELATED INVESTMENT PRODUCTS

- **Recommendations which can be introduced by RIs quickly have been implemented**
 - **Audio recording: by 30 June 2009**
 - **Physical segregation: by 30 September 2009**
- **Proposals to enhance investor protection issued for public consultation in September**
- **Assisting Government on proposals to improve investor education and establish a financial services ombudsman**

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- The HKMA submitted a report to the FS in December 2008. The report contains a series of recommendations aimed at enhancing the current regulatory framework for the securities business of banks. These recommendations were developed having regard to the HKMA's observations from the handling of the complaints about the sale of Lehman-related investment products.
- Those recommendations which can be introduced by RIs quickly (e.g. "health warning" statement for structured products; enhanced customer risk profiling procedures; improved selling process in the case of risk mismatch; audio recording; and physical segregation) have been implemented.
- The SFC, in collaboration with the HKMA, issued a public consultation paper on proposals to enhance protection for the investing public on 25 September 2009. The proposed recommendations include a products code handbook (including product key facts statements, eligibility requirements imposed on issuers and guarantors, and criteria established for eligibility of collateral), and additional requirements concerning conduct of intermediaries (including a cooling-off period for purchase of investment products, and pre-sale disclosure of monetary and non-monetary benefits received by RIs). The consultation period will last until the end of December 2009.
- The HKMA supports the initiatives to enhance investor education and establish a financial services ombudsman. Investor education is important to enable the public to make informed investment decisions. The establishment of a financial services ombudsman will provide an efficient means to adjudicate and settle disputes between investors and financial institutions. Government intends to issue consultation papers on these proposals before the end of the year. The HKMA will provide assistance.



FINANCIAL INFRASTRUCTURE



FINANCIAL MARKET INFRASTRUCTURE

Development strategy:

- **Robust and efficient payment and settlement system is essential to monetary and financial stability – important to ensure fault-proof day-to-day operation**
- **Business development – Hong Kong as a settlement service utility centre to attract transaction banking business in the region**



FINANCIAL MARKET INFRASTRUCTURE

- **New functions and capabilities of payment and settlement systems introduced in 2009:**
 - **March 2009:** Payment arrangements with Mainland China's foreign currency payment systems to facilitate cross border correspondent banking activities
 - **July 2009:** Upgrading the RMB RTGS system in Hong Kong to clear and settle the use of RMB for Mainland's external trade with Hong Kong and ASEAN economies
 - **August 2009:** CMU Fund Order Routing and Settlement Service to provide a standard processing platform for investment funds in Hong Kong and in the region
- **To be introduced in 2010**
 - Payment-versus-payment link between Hong Kong's US dollar RTGS system and the Indonesian Rupiah RTGS system to reduce settlement risk in USD/Rupiah forex transactions and to attract Indonesian banks to use Hong Kong for their USD payment activities



GOVERNMENT BOND PROGRAMME

- **Objective: to promote bond market development and financial stability**
- **HKMA is assisting the Government in implementing the Programme**
- **The first two bond issues under the Institutional Bond Issuance Programme were well-received by the market, with the bid-to-cover ratios of 6.45 and 4.56**
- **The Retail Bond Issuance Programme will be launched when market conditions are appropriate**

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- The establishment of the Government Bond Programme (GBP) was proposed by the Financial Secretary in his Budget Speech in February 2009, and was approved by the Legislative Council in July 2009.
- The primary objective of the GBP is to promote the further and sustainable development of Hong Kong's bond market through systematic issuance of Government bonds. It can also help promote financial stability by making our debt market an effective channel of financial intermediation, complementing the banking and equity markets.
- The GBP is a long-term programme comprising an Institutional Bond Issuance Programme and a Retail Bond Issuance Programme.
- The Institutional Bond Issuance Programme was launched in September, with a successful inaugural issue of HK\$3,500 million 2-year Government bond, followed by a further issue of HK\$2,000 million 5-year Government bond in November. Both issues were well received by the market, with the bid-to-cover ratios, i.e. the ratio of bonds applied for to bonds issued, being 6.45 and 4.56, respectively. The Government bonds have attracted a more diversified group of institutional investors, particularly end-investors like insurance companies and pension funds. The enlarged investor base is expected to improve liquidity in the bond market and attract more issuers to raise funds via the bond market.
- The HKMA is now waiting for an appropriate time to launch the Retail Bond Issuance Programme, taking into consideration the prevailing market conditions and the advice of Co-arrangers.



DEVELOPMENT OF ISLAMIC FINANCE

HKMA's Four-Part Strategy

Promote market infrastructure

- Continue to support the Government in drawing up legislative proposals for modifying Hong Kong's tax laws

Encourage product development

- Maintaining close contact with the industry

Build regional and international profile

- Hosted the Technical Committee Meeting for the Islamic Financial Services Board
- Signed MoU with Bank Negara Malaysia
- Conducted an educational talk for representatives of Bank of Ningxia

Promote market awareness

- Continue to provide training to the industry and help resolve tax and regulatory issues

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- **Promote market infrastructure:** The HKMA provided input to the Government in drawing up legislative proposals for modifying the tax laws in Hong Kong, with a view to creating a level playing field for Islamic financial products vis-à-vis conventional ones. The HKMA will continue to assist the Government to consult the market on its legislative proposals.
- **Encourage product development:** The HKMA is maintaining close contact with the major market players, especially those who are active in executing Islamic finance transactions in the region, to keep track of market development in Islamic finance.
- **Build regional and international profile:**
 - (a) Hosted the Technical Committee meeting for the IFSB in October 2009.
 - (b) MoU signed in September 2009 to establish a long-term strategic partnership to co-operate in the development of Islamic finance, particularly in the areas of human capital, financial market infrastructure and cross-border financial activity.
 - (c) Talk given in September 2009 in Hong Kong to the Bank of Ningxia which has been approved as a pilot operator of Islamic banking in Mainland China.
- **Promote market awareness:** A high-level seminar was organised in October, with Professor Rifaat, Secretary-General of IFSB, sharing his insights on the latest developments in Islamic finance with officials from the HKMA, FSTB, SFC and IRD, and representatives from major market players. The HKMA will continue to work with the Treasury Markets Association to deliver training programmes and maintain dialogue with market participants.



HONG KONG AS AN INTERNATIONAL FNANCIAL CENTRE



INCREASING REGIONAL AND INTERNATIONAL FINANCIAL CO-OPERATION

- **Financial Stability Board (FSB): Hong Kong participates in the Plenary and all three Standing Committees of the FSB, which has become a focal point of efforts to reform the international financial system**
- **Chiang Mai Initiative Multilateralisation (CMIM): Hong Kong will participate in this regional joint-defence mechanism that provides participating economies with contingent credit facilities**
- **14th EMEAP Governors' Meeting, 21-23 July, Hong Kong: HKMA coordinated the macro-monitoring work of EMEAP**
- **Tripartite working group of HKMA, Bank Negara Malaysia and Monetary Authority of Singapore: To map out a coordinated strategy for the scheduled exit from the full deposit guarantee by the end of 2010**

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- With the political impetus by G20, the Financial Stability Board (FSB) has become a focal forum of global financial cooperation. Three Standing Committees were established to carry out the recommendations made by the G20. Hong Kong participates in all three:
 - The Standing Committee on Assessment of Vulnerabilities is responsible for assessing and monitoring vulnerabilities in the financial system and proposing to the FSB actions needed to address them. Its findings form the basis of the FSB's vulnerabilities deliberations, and will provide input for the FSB-IMF Early Warning Exercise.
 - The Standing Committee on Supervisory and Regulatory Cooperation is responsible for addressing coordination issues among supervisors and regulators, and the oversight of supervisory colleges. It has been tasked to monitor and advise on best practice in meeting regulatory standards to ensure consistency, cooperation and a level playing field across jurisdictions. Regulatory issues discussed by the Committee include strengthening the global capital framework, enhancing accounting standards, and improving compensation practices. The Standing Committee is also involved in issues pertaining to cross-border crisis management.
 - The Standing Committee on Standards Implementation has been tasked to prepare the FSB's planned peer reviews of its members and will report on members' progress in implementing international financial standards and other initiatives.
- The CMIM is a regional joint-defence mechanism to provide short-term US dollar funding to members facing liquidity shortages. Hong Kong undertakes to commit, on a callable basis, up to US\$4.2bn. The separate participation of HK is a testimony of the recognition of Hong Kong as an international financial centre and has substantial practical and symbolic importance to Hong Kong's financial stability.
- The HKMA hosted the 14th EMEAP Governors' Meeting in Hong Kong on 21-23 July. All 11 Central Bank Governors of EMEAP attended the meeting. The HKMA's effort to coordinate the macro-monitoring work of the EMEAP Monetary and Financial Stability Committee (MFSC) was endorsed by the EMEAP Governors, who continued to task the HKMA to play the coordinating role in the MFSC and to prepare MFSC's Macro Monitoring Reports.



RENMINBI BUSINESS (1)

Renminbi trade settlement pilot scheme

- **Commenced operation on 6 July, covering trades between pilot cities in the Mainland *and* HK, Macau and ASEAN countries**
- **Banks in HK can offer a wide range of renminbi business to trade enterprises**
- **At end-Sep, 32 authorized institutions had entered into the clearing agreement with the Clearing Bank or Mainland Correspondent Banks**
- **Roadshows were conducted to promote HK's renminbi clearing platform to the ASEAN countries**

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- After the State Council decided in April to introduce a pilot scheme for using renminbi for cross-border trade settlements, the “Administrative Rules for the Pilot Scheme for Settlement of Cross-border Trade in Renminbi” were promulgated on 1 July by the relevant Mainland authorities. The scheme commenced operation on 6 July.
- Under the scheme, cross-border trade transactions (both imports and exports) between the approved areas of Mainland China and selected areas outside the Mainland are eligible for settlement in renminbi. At present, Shanghai, Guangzhou, Shenzhen, Dongguan and Zhuhai are the approved Mainland cities ; and Hong Kong, Macau and the ASEAN member countries have been specified as areas outside the Mainland that are covered by the Pilot Scheme.
- Banks in Hong Kong can now offer a range of RMB banking services to enterprises, including deposit-taking, currency exchange, remittance, trade finance, and interbank transfers/cheques. At the end of September, 32 authorized institutions had entered into the clearing agreement with the Clearing Bank in Hong Kong or Mainland Correspondent Banks.
- It is the first time outside Mainland China that renminbi is used for cross-border trade settlement through the banking system, with geographical coverage wider than previously envisaged. Hong Kong's renminbi clearing platform, which has been serving as an efficient and safe platform for the relevant RMB transactions since RMB business was launched in 2004, is well positioned to facilitate the settlement of cross-border trade between Mainland China and other countries. In light of this opportunity to develop Hong Kong into a regional renminbi clearing centre, the HKMA has conducted roadshows to promote Hong Kong's renminbi clearing platform to the ASEAN countries in the past few months. The preliminary responses from the commercial banks have been positive.
- The outstanding amount of renminbi deposits was RMB 58.2 billion at the end of September 2009.



RENMINBI BUSINESS (2)

Renminbi bond issuance in Hong Kong

- **PRC Ministry of Finance issued RMB 6 bn in sovereign bonds in September**
- **HSBC (China) and Bank of East Asia (China) issued RMB 7 bn worth of bonds in total**
- **China Development Bank issued renminbi bonds in Hong Kong raising RMB 3 bn**

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- In April 2009, after meeting with Premier Wen Jiabao, CE/HKSAR said the Central Government would support Hong Kong's status as an international financial centre by expanding issuance of renminbi bonds in Hong Kong:
 - (a) allowing Hong Kong banks operating on the Mainland to issue renminbi bonds in Hong Kong
 - (b) giving consideration to issuance of renminbi bonds in Hong Kong by the Ministry of Finance
- In July and September, HSBC (China) and Bank of East Asia (China) issued RMB bonds in Hong Kong, raising a total of RMB 7 bn. All of the issues were oversubscribed. Allowing Hong Kong banks operating on the Mainland to issue renminbi bonds in Hong Kong will help expand their sources of renminbi funding and enhance their ability to provide services on the Mainland. This will have a positive effect on their business.
- In September, the PRC Ministry of Finance issued RMB 6 bn in sovereign bonds in Hong Kong. The bonds were issued on 27 October receiving a very positive market response (RMB 18 bn in total subscription). The issuance of RMB sovereign bonds in Hong Kong demonstrates the Central Government's confidence in and support for Hong Kong's status as an international financial centre. It is a further experiment of the use of the renminbi for bond issuance outside the Mainland, and underscores Hong Kong's role as the testing ground for the Mainland's financial reforms.
- In August, China Development Bank tapped the RMB bond market in Hong Kong for the second time since the market was launched in 2007, raising RMB 3 bn.
- Since the launch of renminbi bonds in Hong Kong in June 2007, there have been 13 issues raising RMB 38 bn in total.



THE INVESTMENT ENVIRONMENT AND PERFORMANCE OF THE EXCHANGE FUND

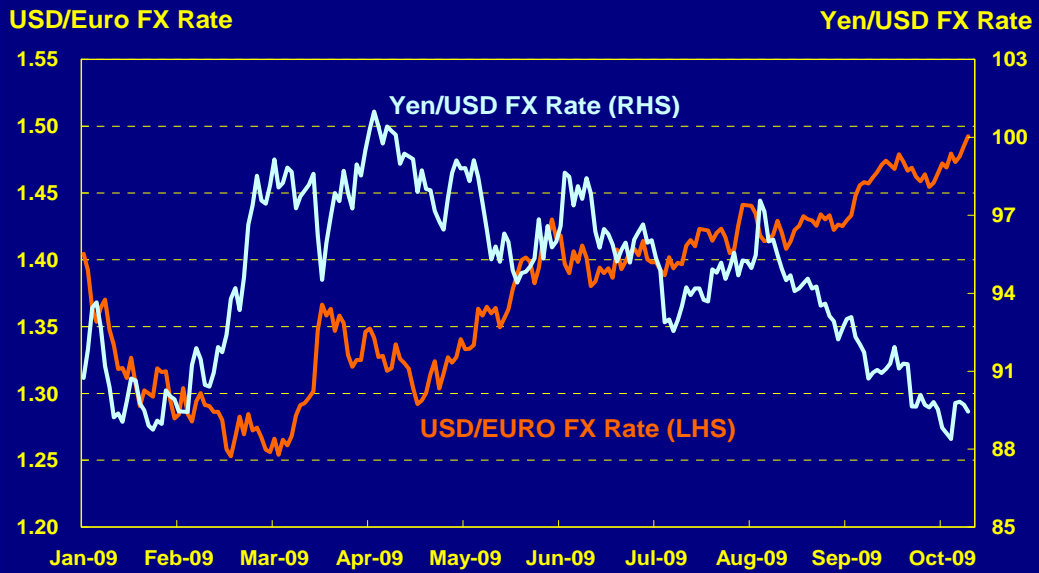


INVESTMENT ENVIRONMENT IN Q1-Q3 2009

- **Exchange rates:** US dollar strengthened against the euro and the yen in the first quarter before weakening in the subsequent two quarters
- **Equity markets:** Major markets declined in the early months of the year but rebounded strongly since mid-March as risk appetite increased on the hope of economic recovery
- **Interest rates:** US government bond yields, especially long-term yields, rose in the first half of 2009 on inflation expectation and concern over large increases in supply, before declining moderately in the third quarter
- **Market optimism** emerged since mid-March following the US government's introduction of quantitative easing. Appetite for risky assets increased amid further signs of stabilisation in the global economy



CURRENCY MARKET FLUCTUATION



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- Exchange rates movement: the US dollar strengthened against the euro and the yen in the first quarter before weakening in the subsequent two quarters.



PERFORMANCE OF MAJOR EQUITY MARKETS

Normalised Index Level (2008 year-end = 100)



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- Major equity markets declined in early months of the year but rebounded strongly since mid-March as risk appetite increased on the hope of economic recovery.



10-YEAR UST YIELD



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- US government bond yields, especially long-term yields, rose in the first half of 2009 on inflation expectation and concern over large increase in supply, before declining moderately in the third quarter.



INVESTMENT INCOME

	2009	2008	2007	2006
(HK\$ billion)	Jan - Sep *	Full Year	Full Year	Full Year
Gain/(Loss) on Hong Kong equities[^]@		(77.9)	55.8	35.9
Gain/(Loss) on other equities[^]		(73.1)	6.7	18.7
Exchange gain/(loss)		(12.4)	18.7	17.3
Return from bonds[#]		<u>88.4</u>	<u>61.0</u>	<u>31.9</u>
Investment income/(loss)[@]		(75.0)	142.2	103.8

* Unaudited figures

[^] Including dividends

[#] Including interest

[@] Excluding valuation changes in Strategic Portfolio

- Figures relating to the third quarter of 2009 will be provided later.



CHANGES IN INVESTMENT INCOME, PAYMENT TO TREASURY AND ACCUMULATED SURPLUS

(HK\$ billion)	← 2009 →			2008	
	Jan - Sep *	Q3	Q2	Q1	Full year
Investment income / (loss)			58.5	(33.5)	(75.0)
Other income			0.2	0.0	0.3
Interest and other expenses			<u>(1.2)</u>	<u>(0.7)</u>	<u>(6.5)</u>
Net investment income / (loss)			57.5	(34.2)	(81.2)
Payment to Treasury #			(8.5)	(9.1)	(46.4)
Payment to HK government / statutory bodies #			(0.3)	0.0	0.0
Valuation change of Strategic Portfolio ^			<u>3.2</u>	<u>(0.1)</u>	<u>(8.9)</u>
Increase / (Decrease) in EF accumulated surplus			51.9	(43.4)	(136.5)

* Unaudited figures

The fixed rate of fee payment is 6.8% for 2009 and 9.4% for 2008

^ Including dividends

- Figures relating to the third quarter of 2009 will be provided later.



HISTORICAL INVESTMENT INCOME

(HK\$ billion)

Year	Full Year	Q4	Q3	Q2	Q1
2001	7.4	13.6	10.4	(2.0)	(14.6)
2002	47.0	26.3	(2.1)	26.5	(3.7)
2003	89.7	33.5	8.4	41.1	6.7
2004	56.7	33.0	14.1	(7.2)	16.8
2005	37.8	7.3	19.0	13.6	(2.1)
2006	103.8	36.0	37.1	12.5	18.2
2007*	142.2	33.4	61.8	26.3	20.7
2008*	(75.0)	8.3	(48.3)	(20.4)	(14.6)
2009*#				58.5	(33.5)

* Excluding valuation changes in the Strategic Portfolio

Unaudited figures

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- Figures relating to the third quarter of 2009 will be provided later.



EXCHANGE FUND ABRIDGED BALANCE SHEET

(HK\$ billion)	At 30 Sep 2009*	At 31 Dec 2008	At 31 Dec 2007
ASSETS			
Deposits		172.8	132.9
Debt securities		1,151.3	922.9
Hong Kong equities		92.9	184.6
Other equities		103.3	146.0
Other assets		<u>40.0</u>	<u>28.0</u>
Total assets		<u>1,560.3</u>	<u>1,414.4</u>
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness		176.1	163.4
Government-issued currency notes & coins in circulation		8.3	7.5
Balance of the banking system		158.0	10.6
Exchange Fund Bills and Notes		162.5	141.8
Placements by banks and other financial institutions		13.6	0.0
Fiscal Reserves Account		531.4	464.6
Placements by Hong Kong government/statutory bodies		0.1	0.0
Other liabilities		<u>29.8</u>	<u>9.5</u>
Total liabilities		1,079.8	797.4
Accumulated surplus		<u>480.5</u>	<u>617.0</u>
Total liabilities and fund equity		<u>1,560.3</u>	<u>1,414.4</u>

* Unaudited figures

- Figures relating to the third quarter of 2009 will be provided later.