



HONG KONG MONETARY AUTHORITY

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

23 May 2011



DISCUSSION TOPICS

Updates on

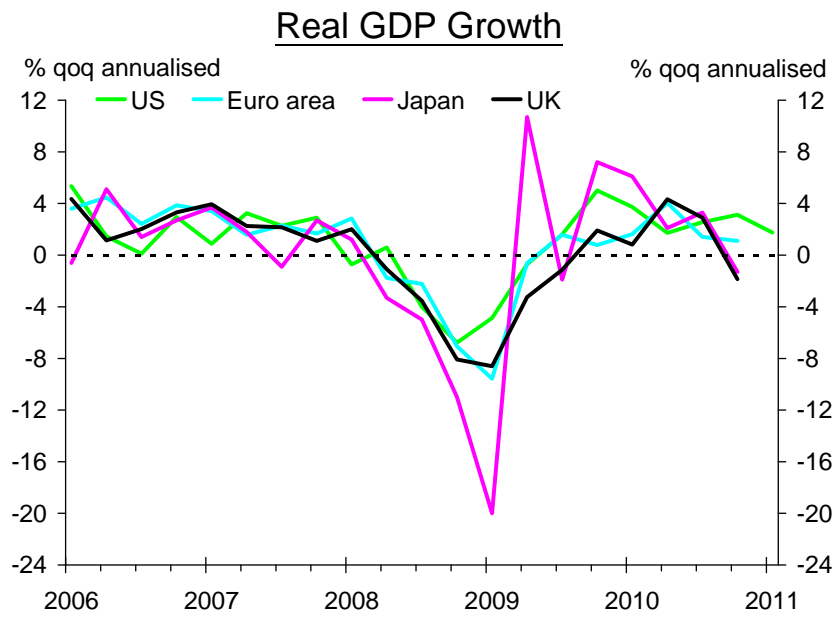
- Financial and Economic Conditions
- Currency Stability
- Banking Stability
- Financial Infrastructure
- Hong Kong as an International Financial Centre
- The Exchange Fund



FINANCIAL AND ECONOMIC CONDITIONS



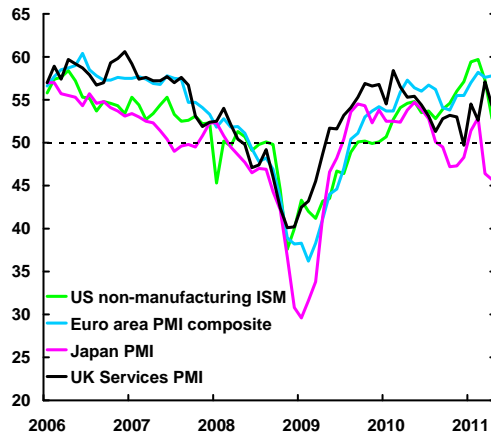
ECONOMIC SITUATION IN MAJOR COUNTRIES



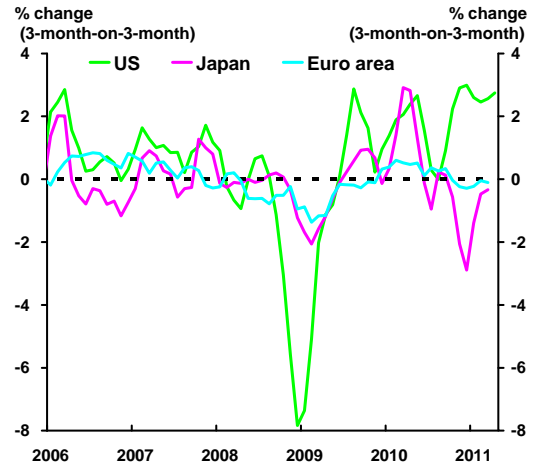


ECONOMIC SITUATION IN MAJOR COUNTRIES

Purchasing Manager Index



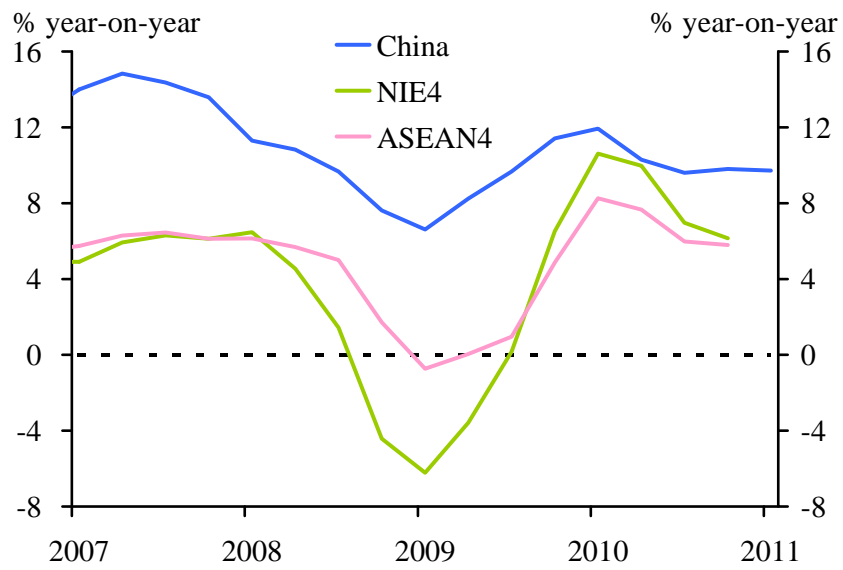
Retail Sales



Sources: Bloomberg and CEIC



ECONOMIC GROWTH IN ASIA



Note: NIE4 includes Hong Kong, Singapore, South Korea and Taiwan; ASEAN4 includes Indonesia, Malaysia, the Philippines and Thailand.

Source: CEIC



GLOBAL ECONOMIC GROWTH FORECASTS

Real GDP Growth

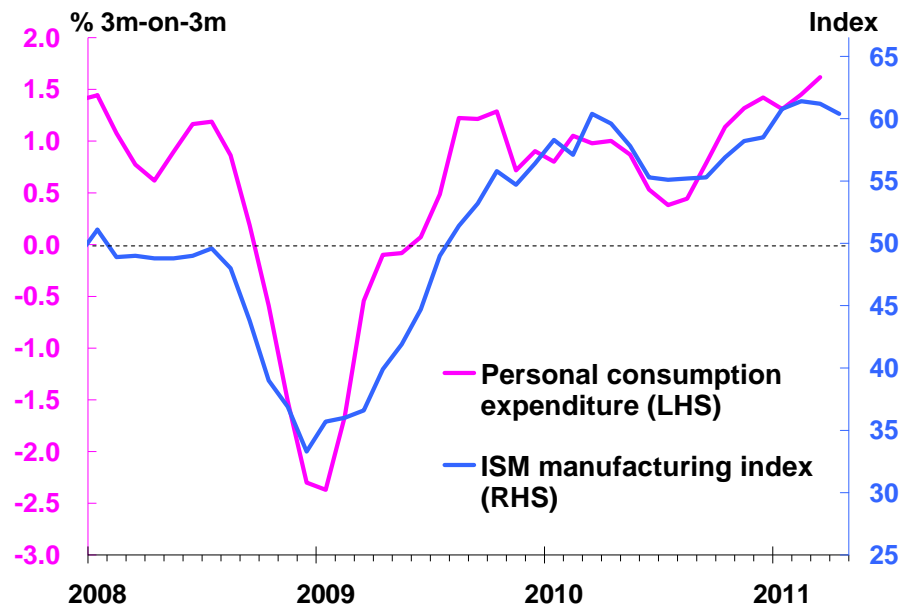
(% year-on-year)

	2009	2010	2011 Forecasts		
			Nov 2010 FAP briefing	Mar 2011 FAP briefing	May 2011
US	-2.6	2.9	2.4	3.2	2.7
Euro area	-4.1	1.7	1.4	1.6	1.7
Japan	-6.3	3.9	1.2	1.5	0.0
Asia (ex-Japan)	5.9	8.9	7.4	7.6	7.7

Sources: Consensus Forecasts and CEIC



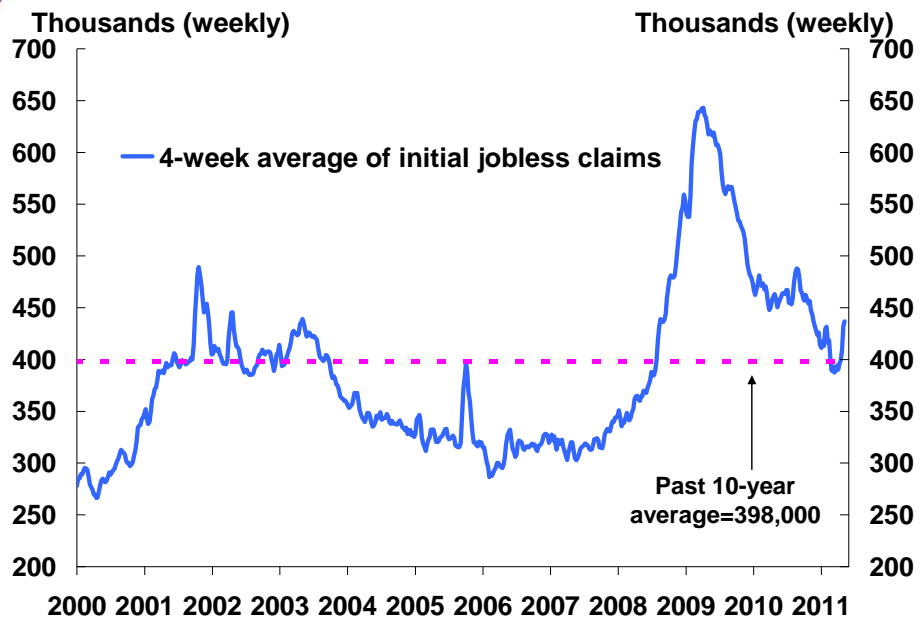
US: CONSUMPTION GROWTH & BUSINESS ACTIVITY



Source: CEIC



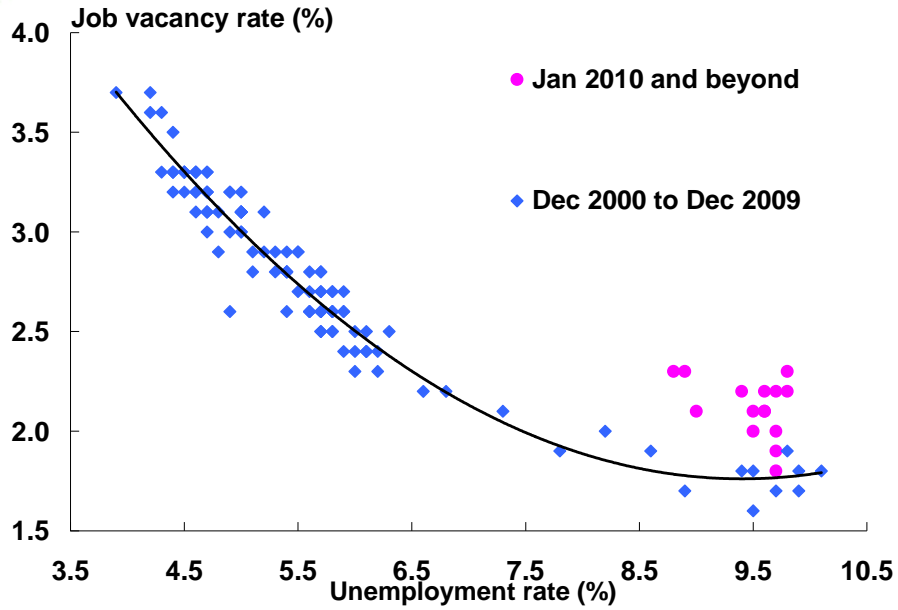
US: WEEKLY INITIAL JOBLESS CLAIMS



Source: CEIC



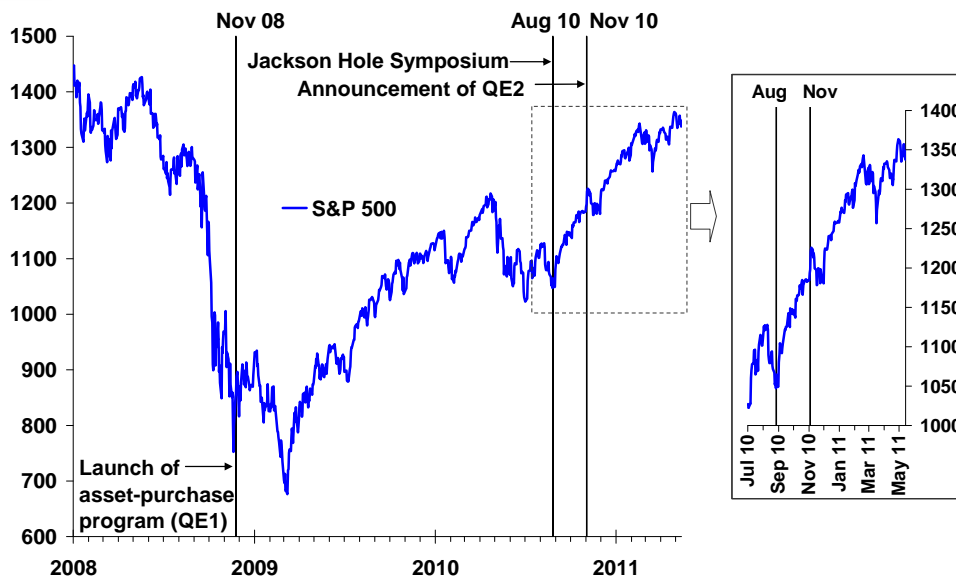
US: STRUCTURAL MISMATCH IN THE LABOUR MARKET



Note: The Beveridge curve (the black fitted line) is derived from monthly data between December 2000 and December 2009.
Source: CEIC



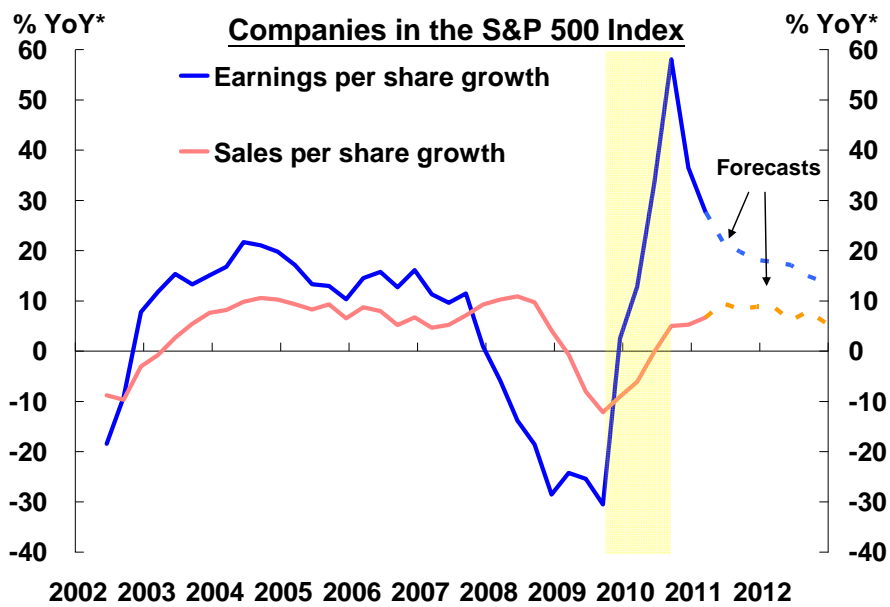
US: EQUITY INDEX



Source: CEIC



US : CORPORATE PROFITS

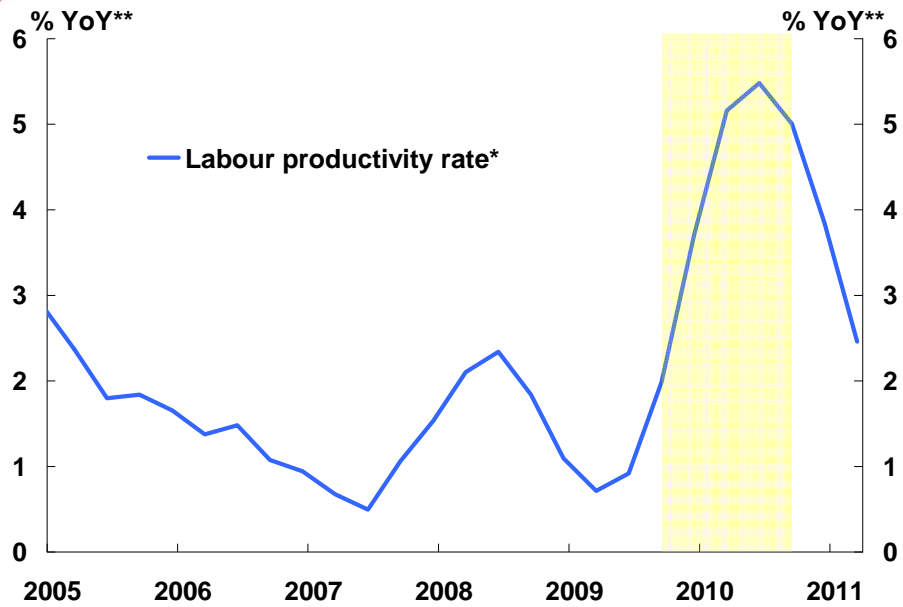


* Year-on-year growth is calculated based on the 4-quarter rolling average.

Source: Bloomberg



US : LABOUR PRODUCTIVITY



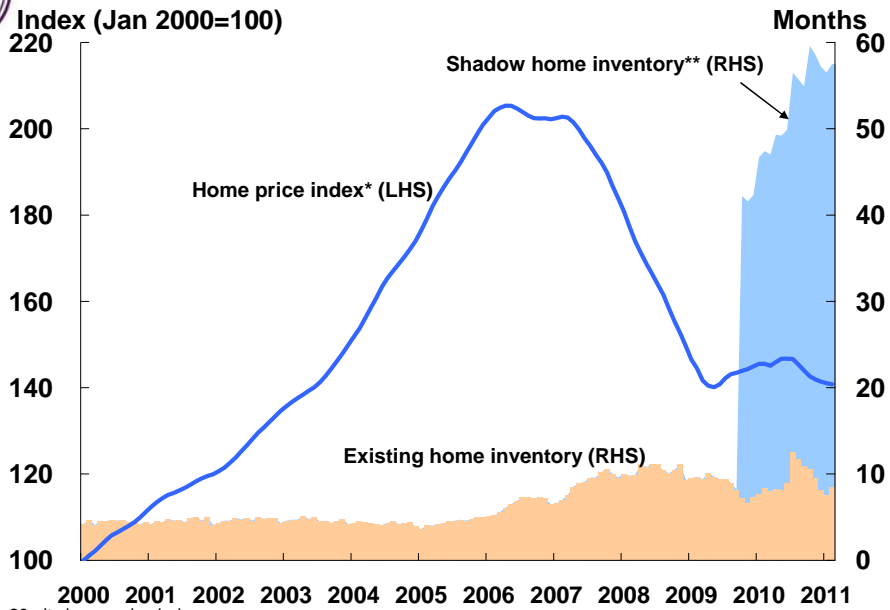
* Labour productivity rate is calculated by dividing the total output by the total number of labour hours.

** Year-on-year growth is calculated based on the 4-quarter rolling average.

Source: CEIC



US : HOUSING PRICES AND INVENTORY



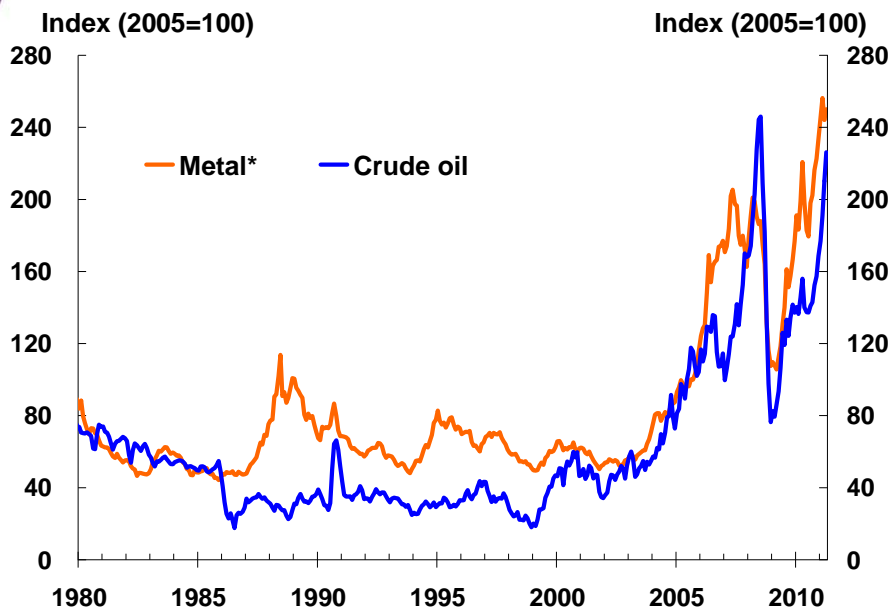
* Case-Shiller 20-city home price index

** Standard and Poor's estimates include the total number of homes with mortgage loans more than 90 days delinquent, currently or recently in foreclosure and those that are real estate owned (REO).

Sources: Standard & Poor's and CEIC



GLOBAL COMMODITY PRICES

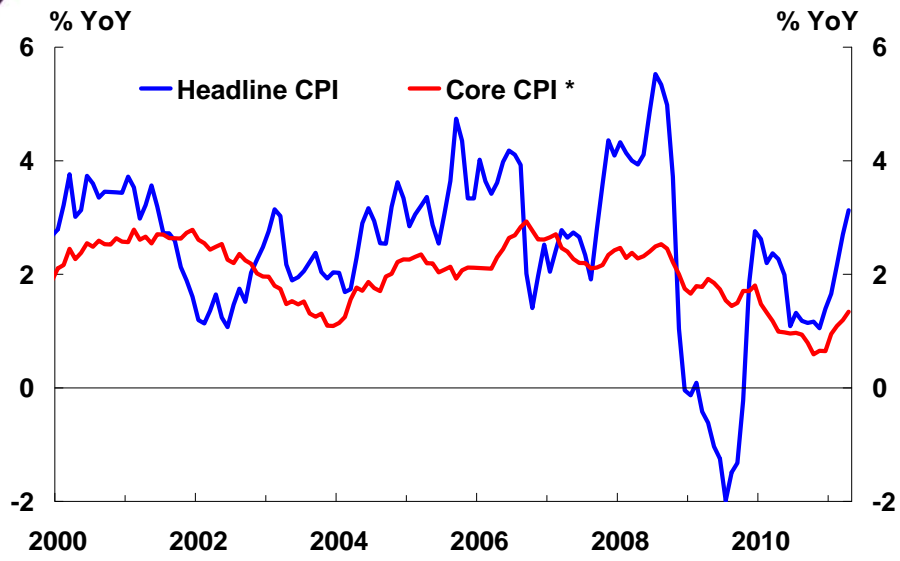


* Include copper, aluminium, iron ore, tin, nickel, zinc, lead, and uranium.

Source: IMF



US : INFLATION



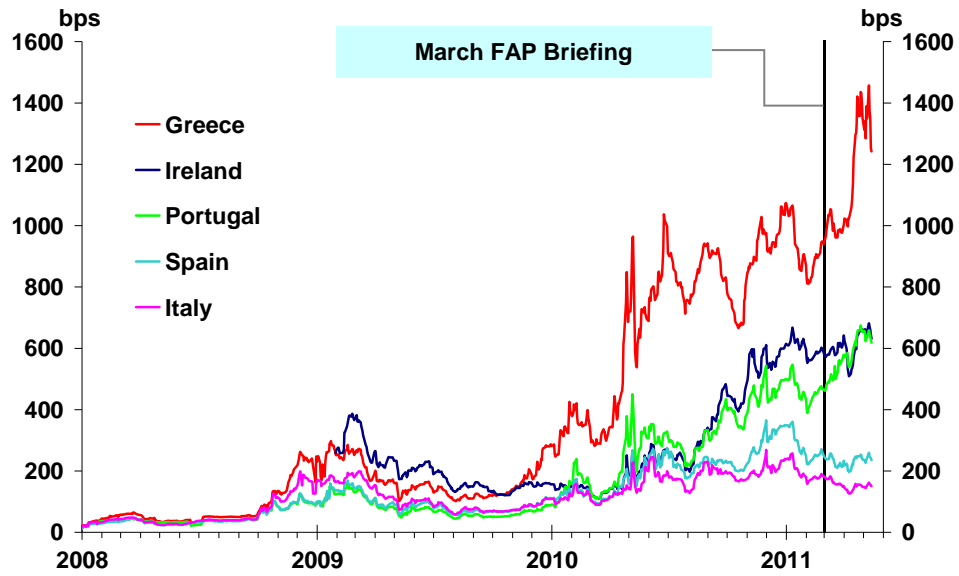
* Exclude food and energy components

Source: CEIC



EUROPEAN SOVEREIGN DEBT PROBLEM: CDS SPREADS

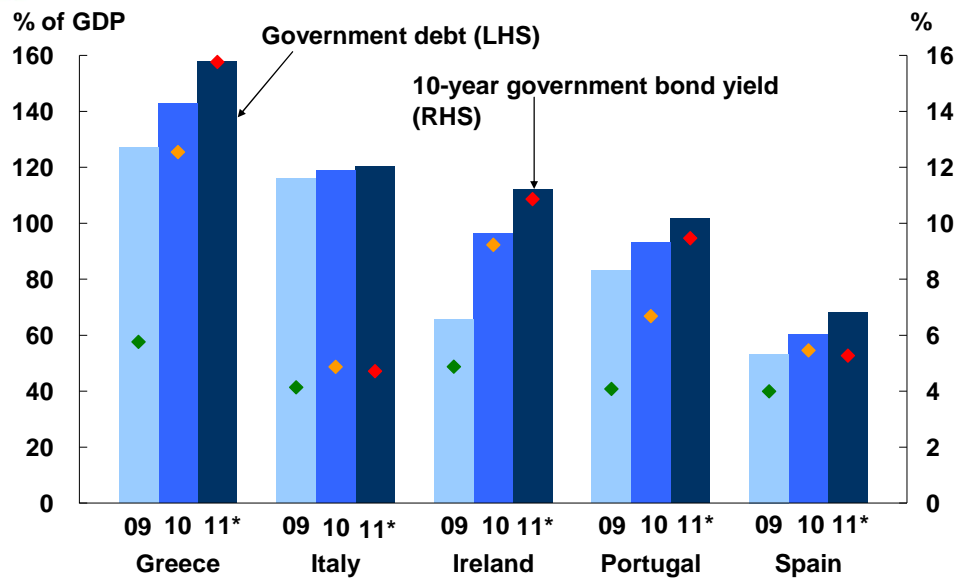
Prices of 5-year sovereign CDS



Source: Bloomberg



EUROPEAN SOVEREIGN DEBT PROBLEM: PUBLIC DEBT & BORROWING COST



* Government debts in 2011 are forecasts; bond yields are the latest available.

Sources: European Commission (AMECO database) and EcoWin



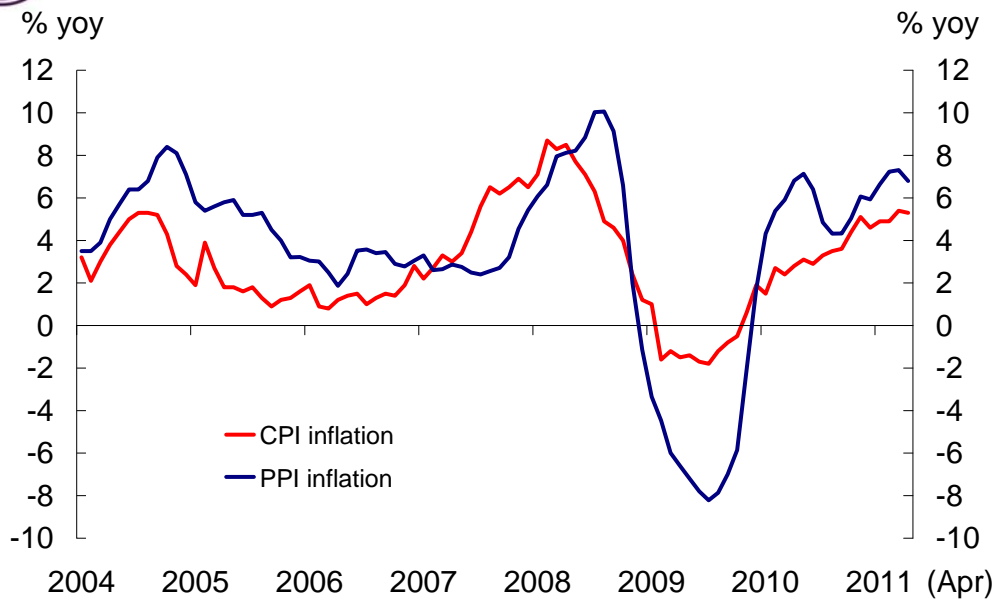
FORECASTS OF MAJOR INDICATORS IN MAINLAND CHINA

	2009	2010	2011 forecasts	
			IMF	Consensus
Real GDP growth (%)	9.2	10.3	9.6	9.3
CPI inflation (%)	-0.7	3.3	5.0	4.6

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



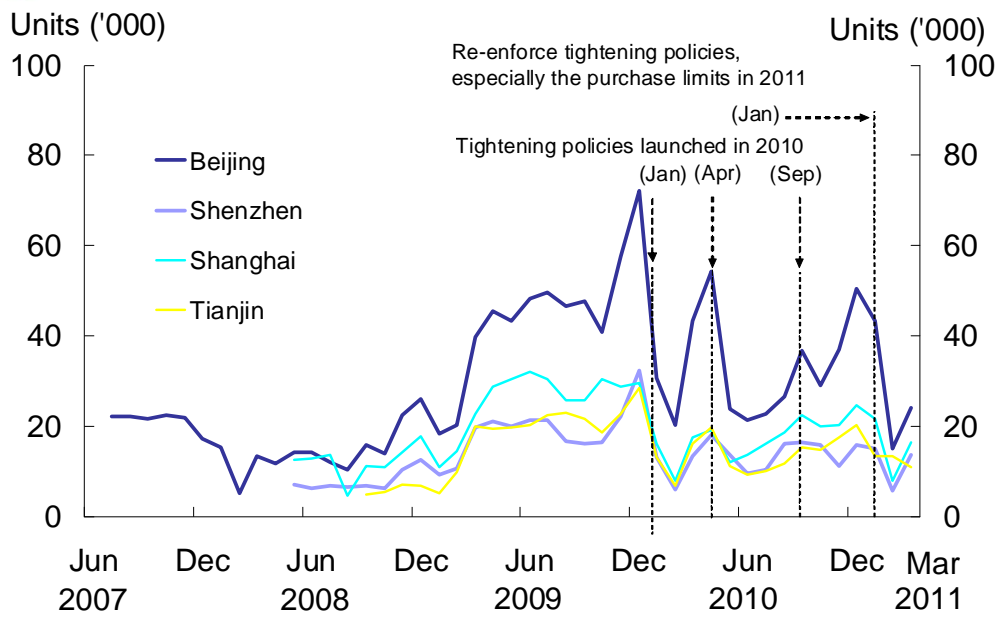
MAINLAND INFLATION RATES



Source: CEIC (Apr 2011)



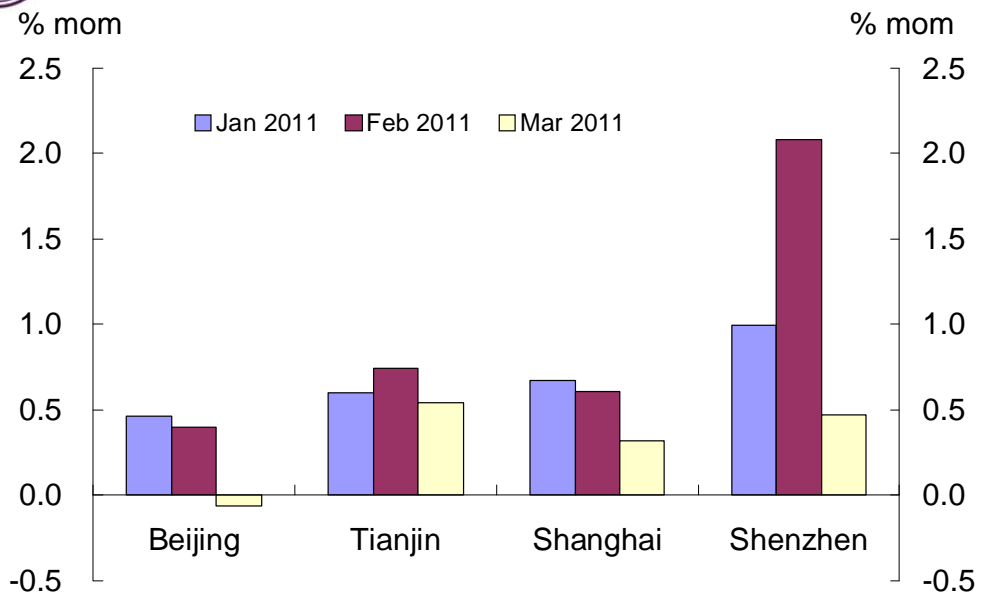
TRANSACTION VOLUME IN MAINLAND MAJOR CITIES



Source: WIND (Mar 2011)



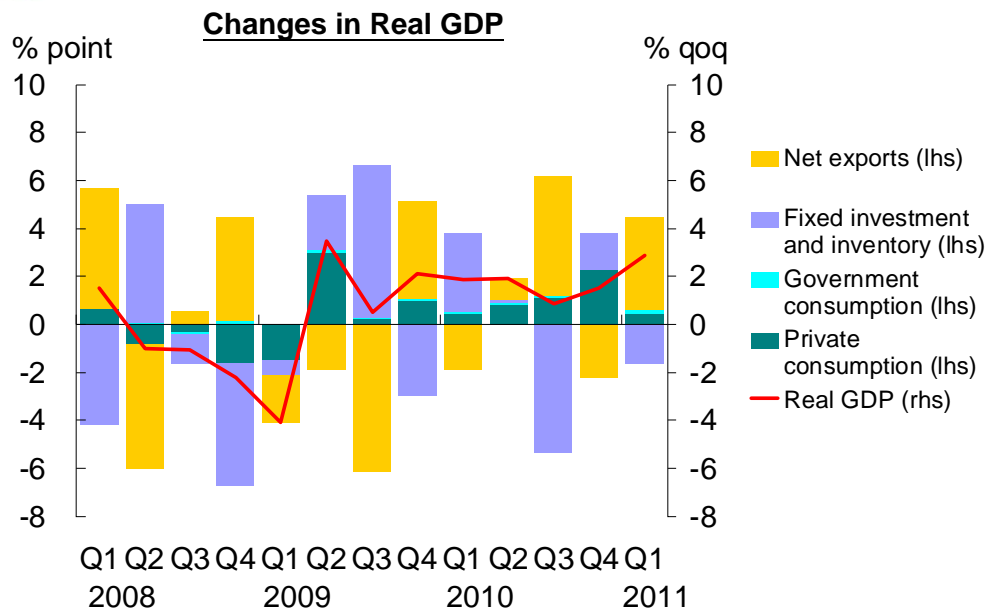
HOUSING PRICE CHANGES IN MAINLAND MAJOR CITIES



Sources: CEIC, WIND and staff estimates (Mar 2011)



HONG KONG ECONOMIC SITUATION

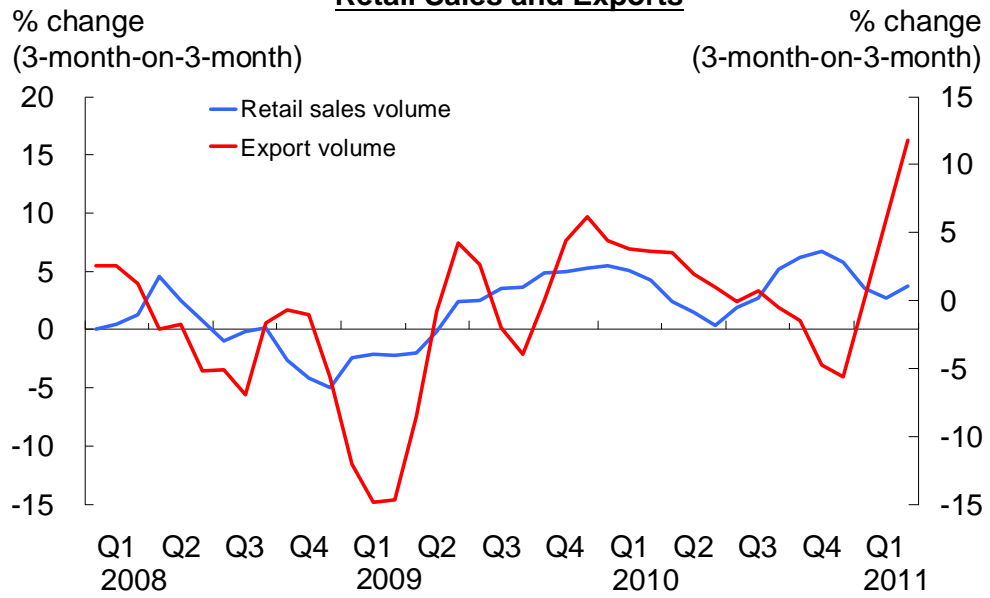


Sources : C&SD and staff estimates.



HONG KONG ECONOMIC SITUATION

Retail Sales and Exports

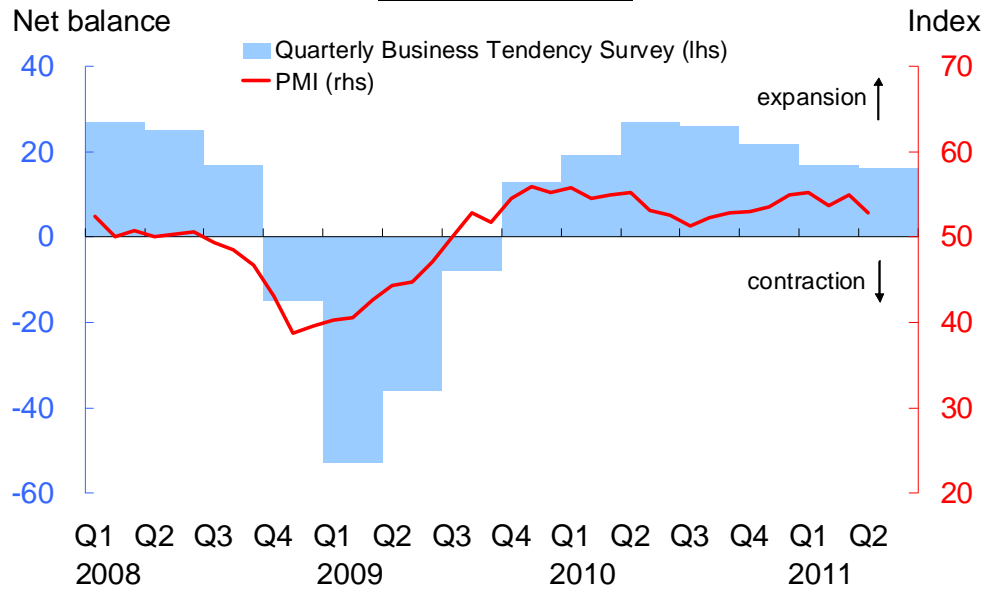


Source : C&SD.



HONG KONG ECONOMIC SITUATION

Business Outlook



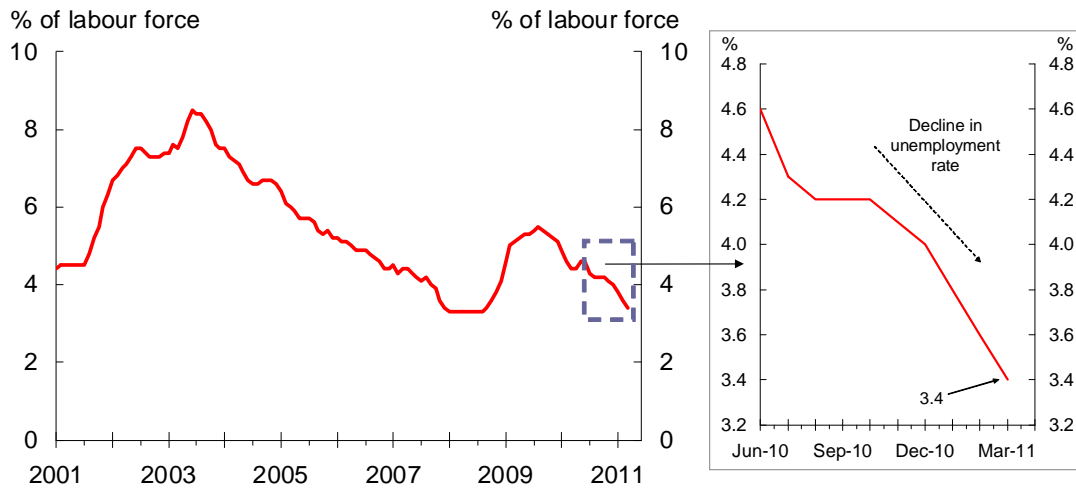
Sources : C&SD and Markit Economics.



HONG KONG ECONOMIC SITUATION

Labour Market

Unemployment rate

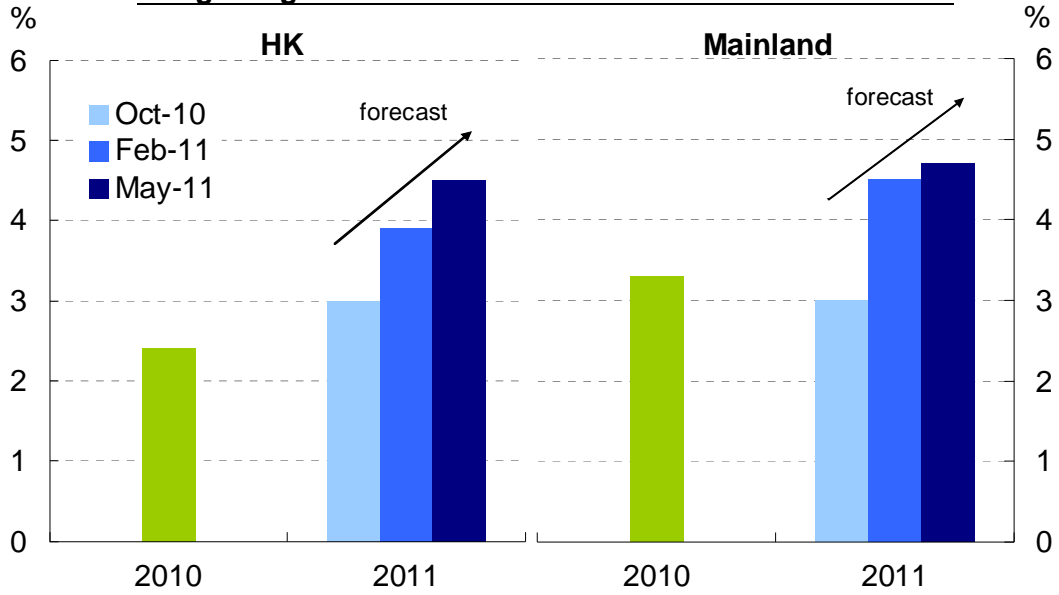


Source : C&SD.



ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: INFLATION

Hong Kong and Mainland 2010 inflation and 2011 forecast

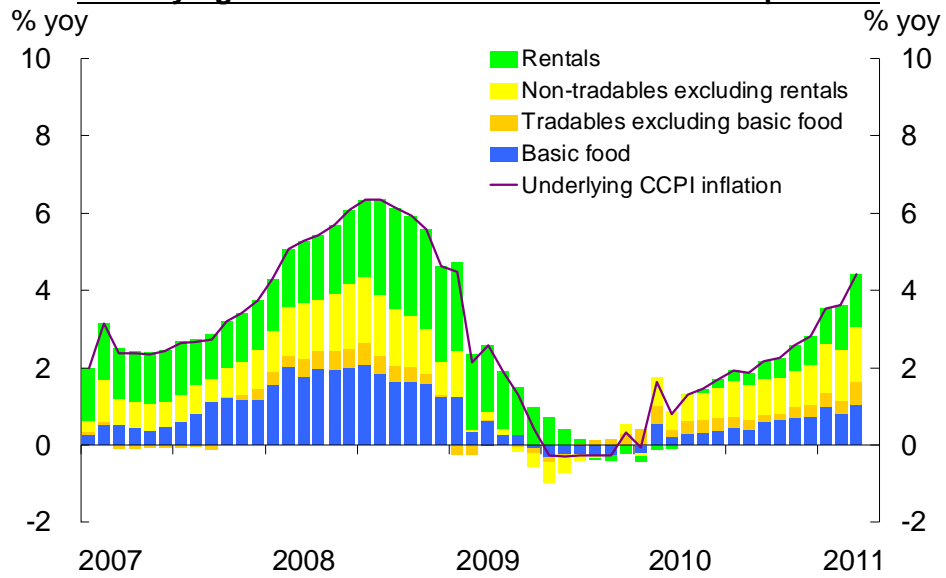


Source : Consensus Forecast (Oct 2010, Feb and May 2011).



ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: INFLATION

Underlying inflation and contributions of its components

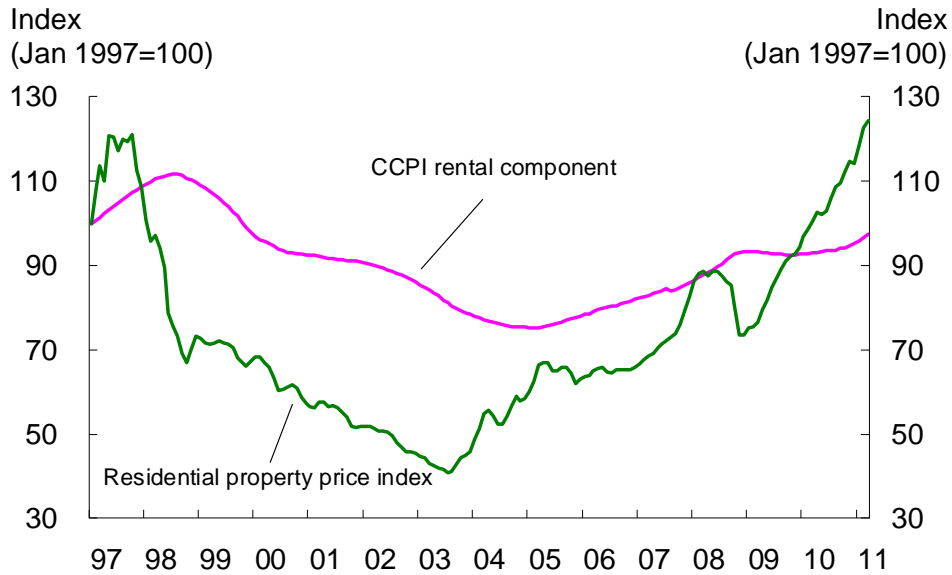


Underlying inflation: Netting out the effects of all Government's one-off relief measures from headline inflation.
Sources: C&SD and staff estimates.



ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: INFLATION

CCPI rental component and residential property price index

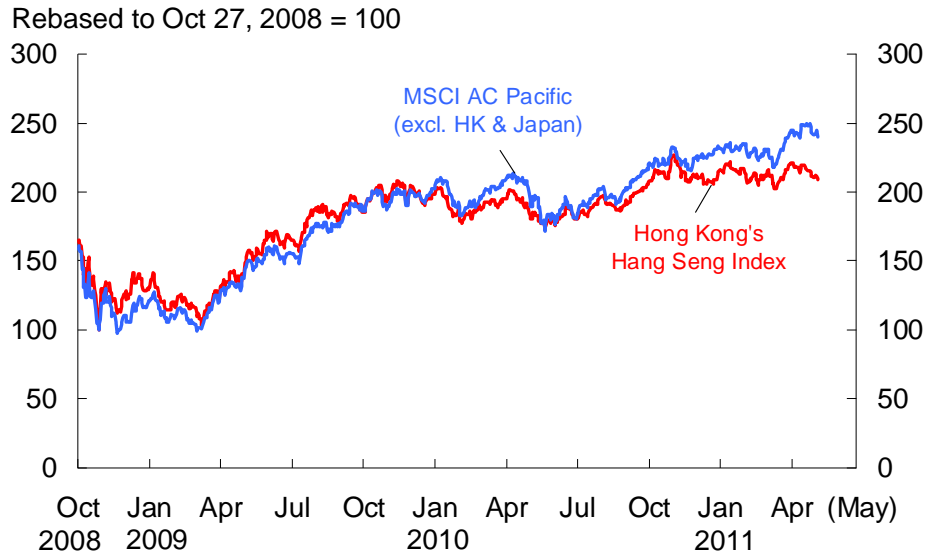


Sources : Rating and Valuation Department (R&VD), C&SD and staff estimates.



ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: EQUITY MARKET

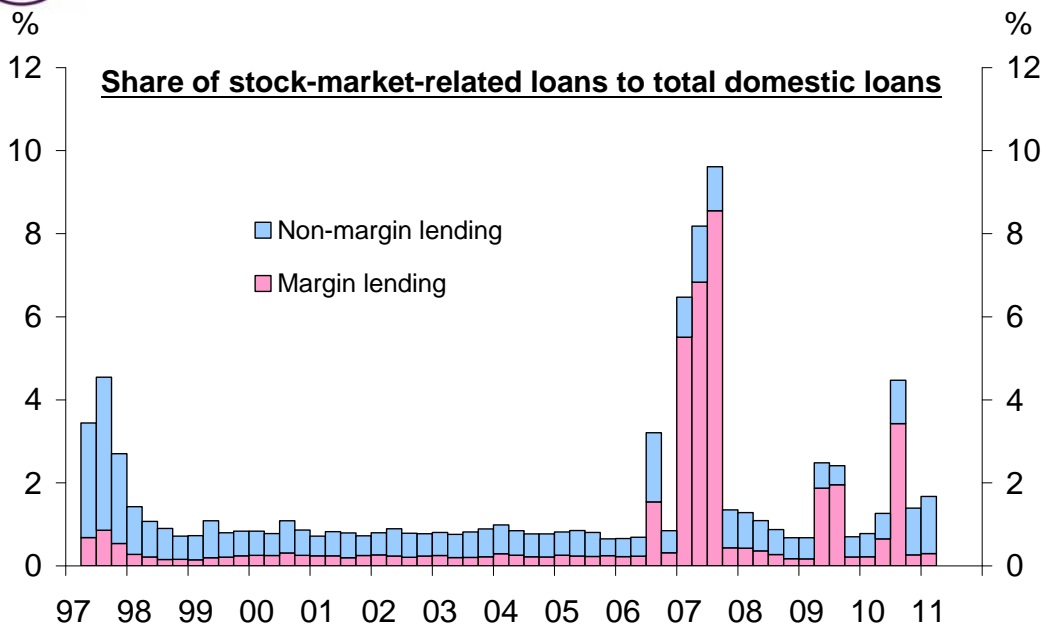
Hong Kong and Asia Pacific equity market performance



Source: Bloomberg



ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: EQUITY MARKET

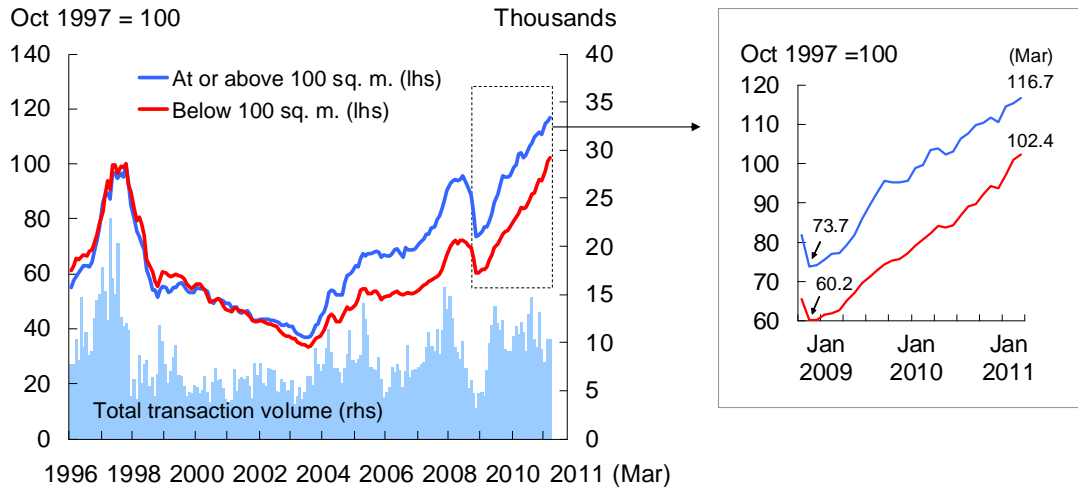


Source: HKMA



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

Residential property prices and transaction volume

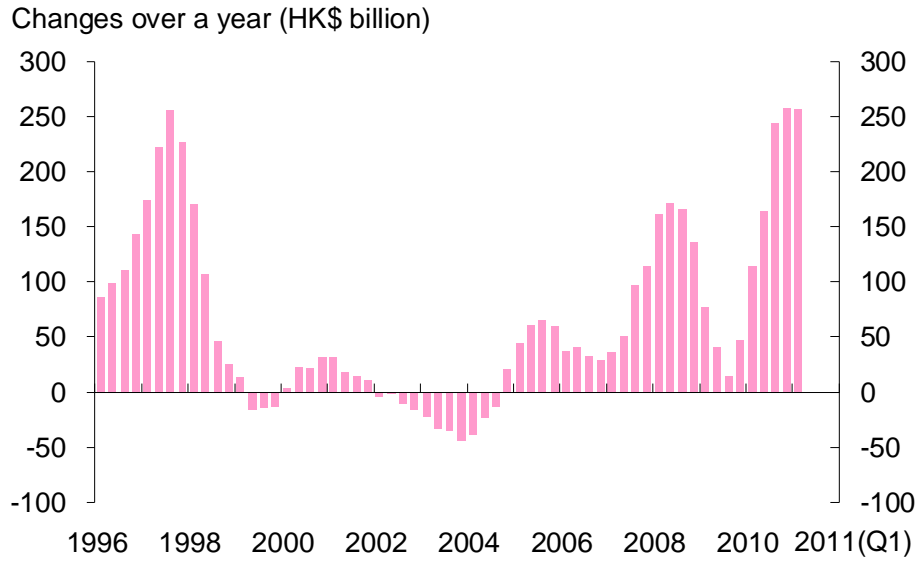


Source: Rating and Valuation Department



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

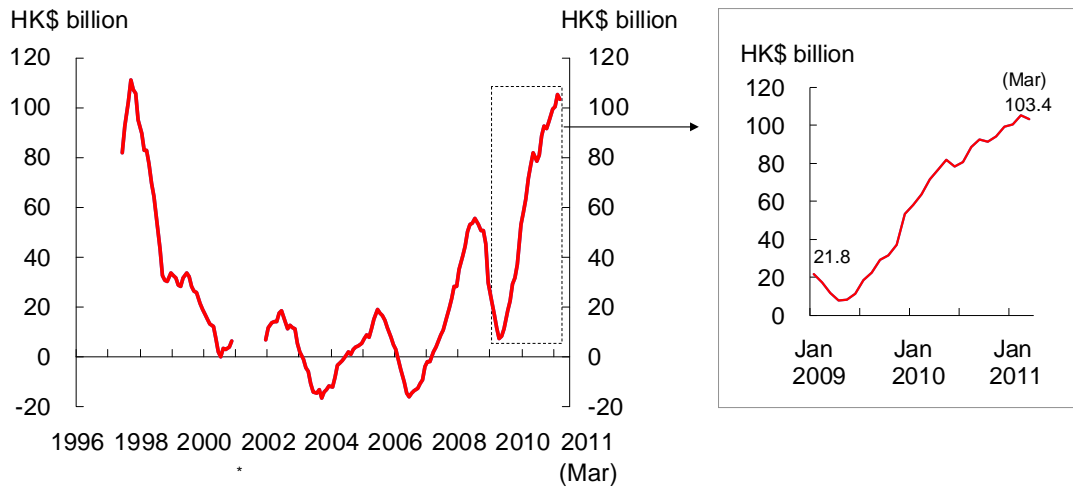
Changes in property-related loans





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

Year-on-year changes in outstanding mortgage loans

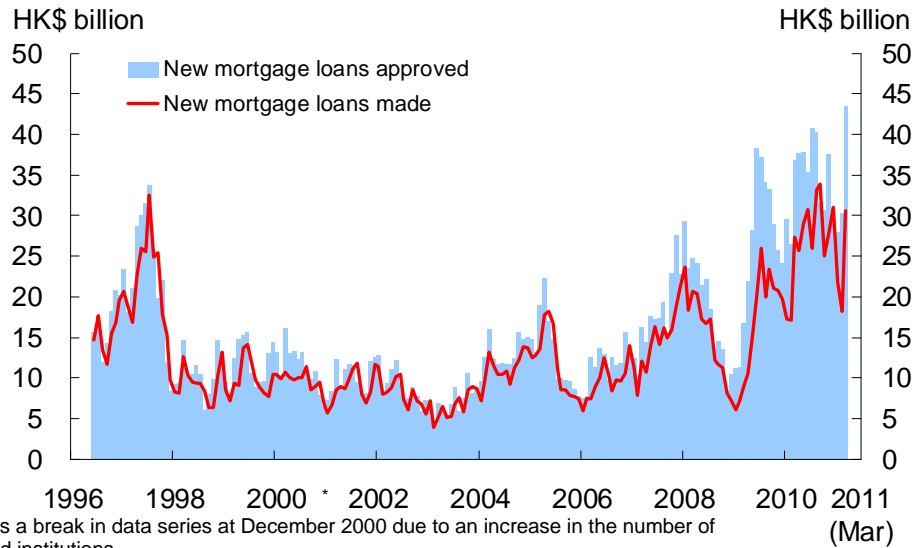


*There is a break in data series at December 2000 due to an increase in the number of surveyed institutions.
Source: HKMA



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

New mortgage loans made and approved

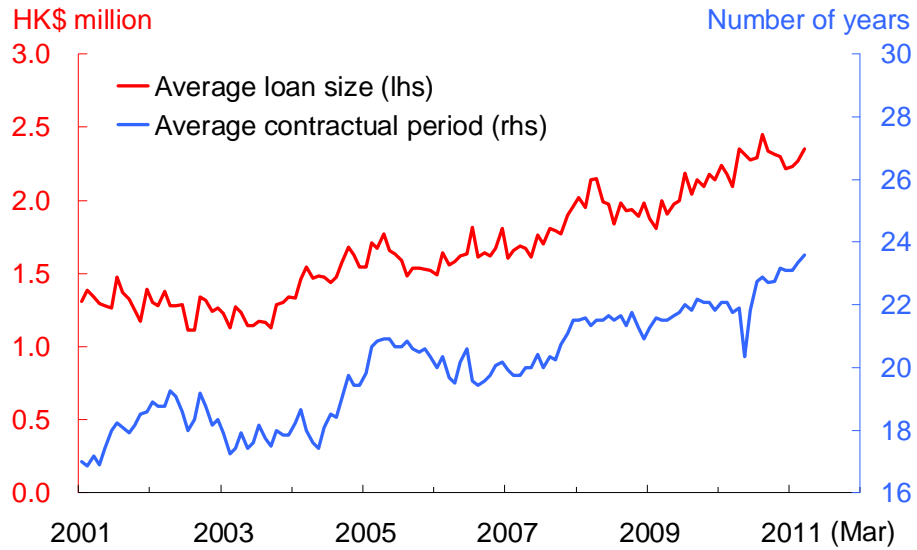


*There is a break in data series at December 2000 due to an increase in the number of surveyed institutions.
Source: HKMA



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

Average loan size and average mortgage period

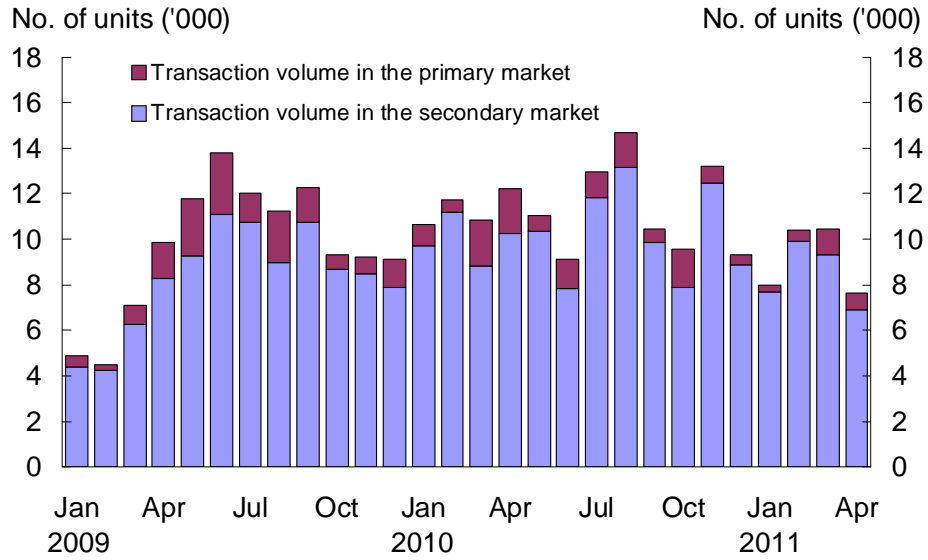


Source: HKMA



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

Transaction volumes in residential property market

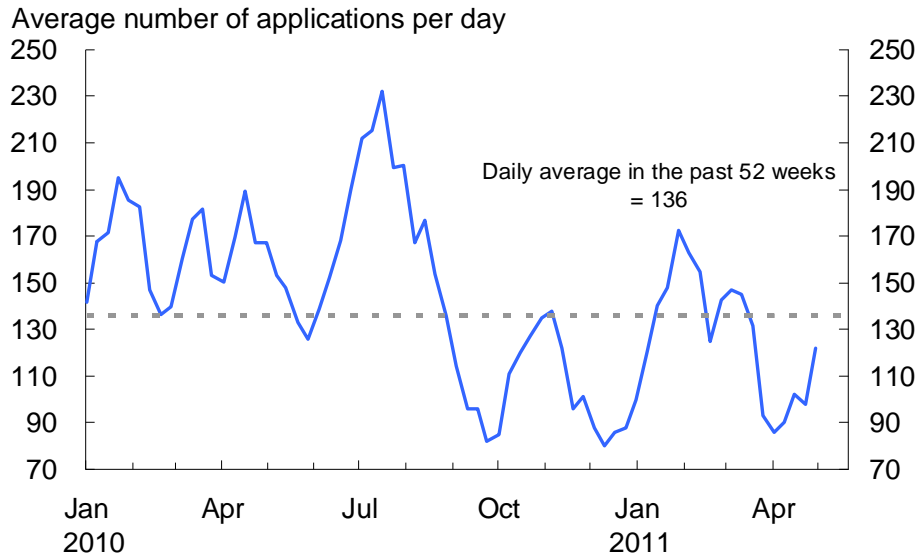


Source: Land Registry



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

Applications under Mortgage Insurance Programme



Source: Hong Kong Mortgage Corporation



ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: CREDIT GROWTH

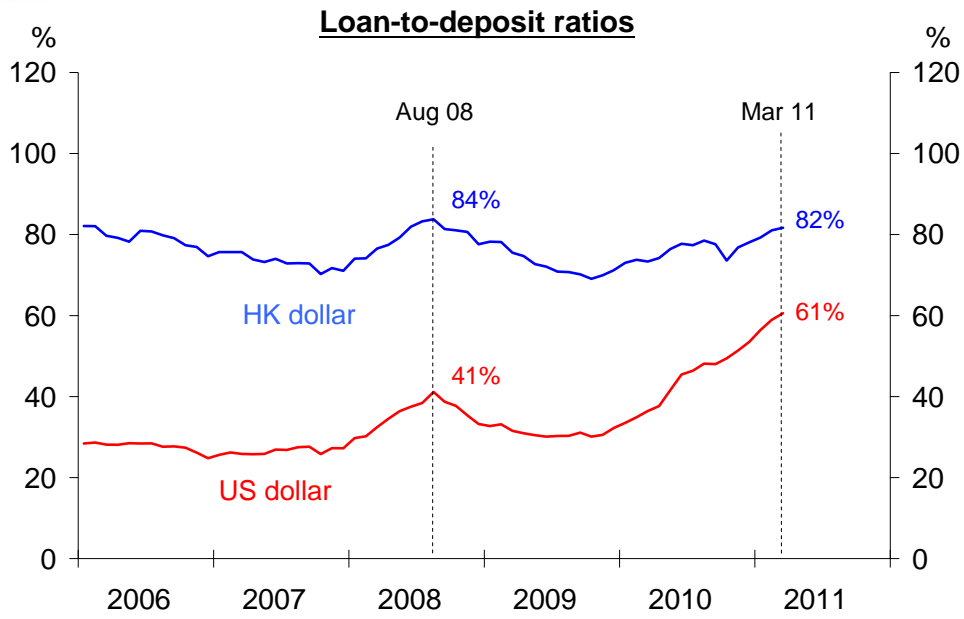
Analysis of loan growth

HK\$ billion	2010				2011
	Q1	Q2	Q3	Q4	Q1
Total loans	3469 (22%)	3773 (29%)	4126 (34%)	4228 (29%)	4539 (29%)
HKD loans	2479 (13%)	2620 (18%)	2856 (25%)	2824 (18%)	2945 (17%)
Foreign-currency loans (mostly in USD)	990 (46%)	1152 (60%)	1270 (58%)	1403 (58%)	1594 (54%)
Property lending	1382 (18%)	1442 (18%)	1529 (21%)	1579 (19%)	1637 (15%)
Non-property lending	2087 (25%)	2330 (37%)	2597 (43%)	2648 (35%)	2902 (38%)

Note: Annualised growth rates are given in parentheses. Source: HKMA.



ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: CREDIT GROWTH



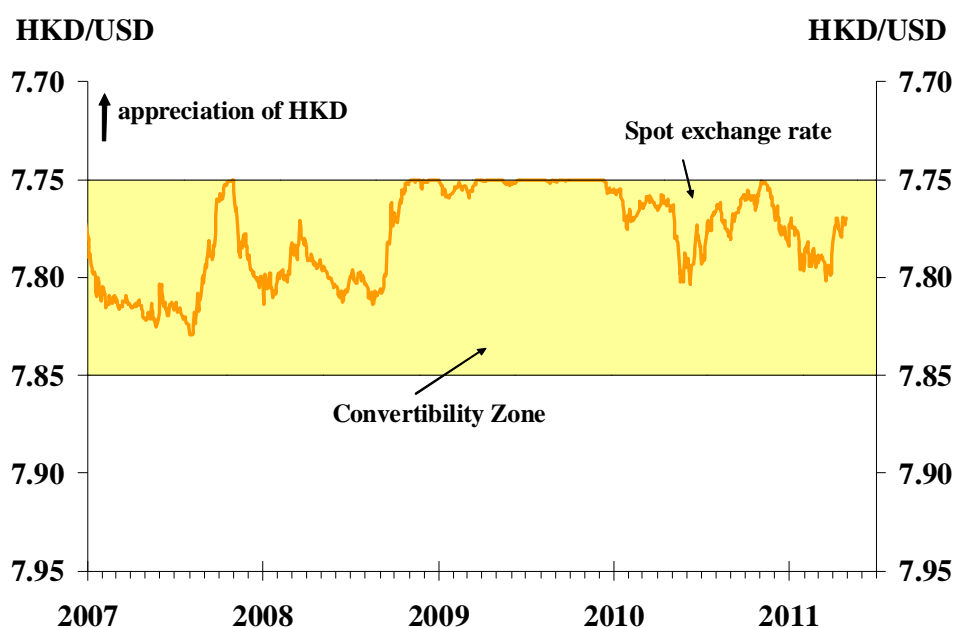
Source: HKMA



CURRENCY STABILITY



HONG KONG DOLLAR SPOT EXCHANGE RATE

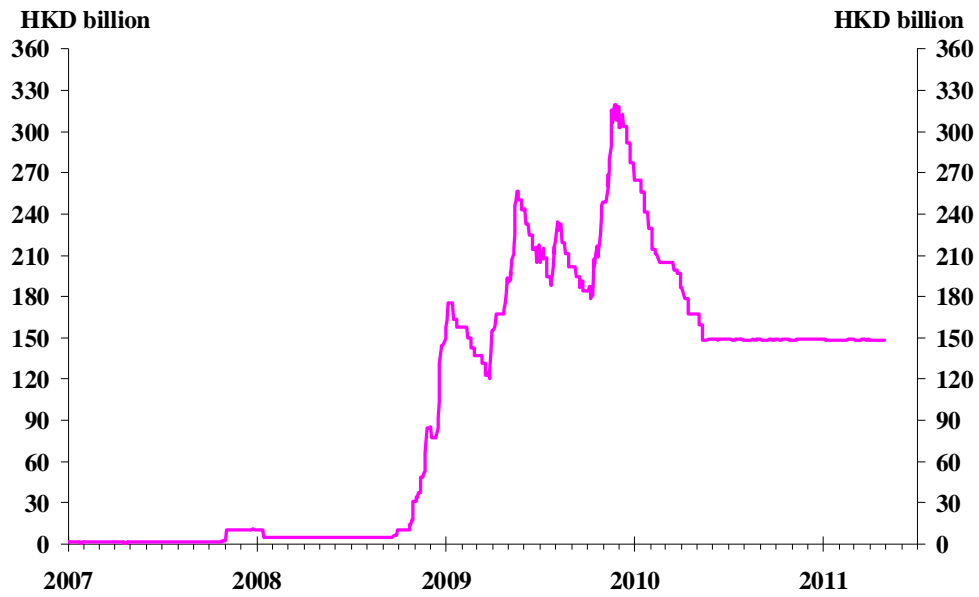


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- The Hong Kong dollar remained in a soft tone in the first quarter of 2011 amid the lingering concerns of European sovereign debt problems, the political unrest in the Middle East and North Africa, and the disaster events in Japan. The HKD eased to a nine-month low of 7.8016 HKD/USD on March 17, along with the broadly lower regional currencies and stock markets on risk aversion.
- Since then, the global risk appetite gradually improved after the G7 coordinated currency intervention and on signs of progress in containing the nuclear crisis in Japan. The HKD regained strength along with a broadly weak USD.
- Neither the strong-side nor the weak-side Convertibility Undertaking has been triggered so far this year.



AGGREGATE BALANCE

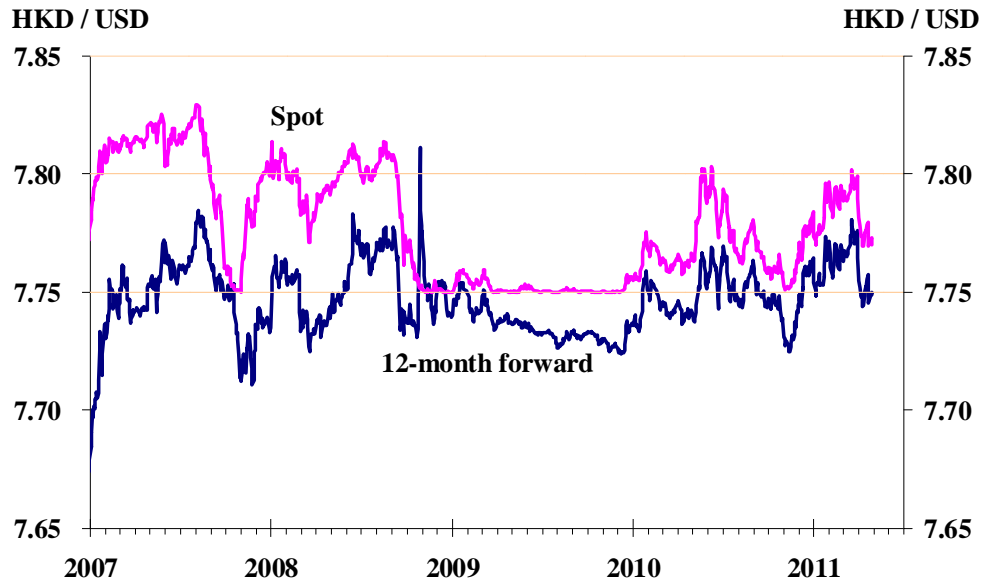


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- Liquidity remained abundant in the interbank market. The Aggregate Balance has stayed steady at around HK\$150 billion since mid-May 2010.



HONG KONG DOLLAR FORWARD EXCHANGE RATE

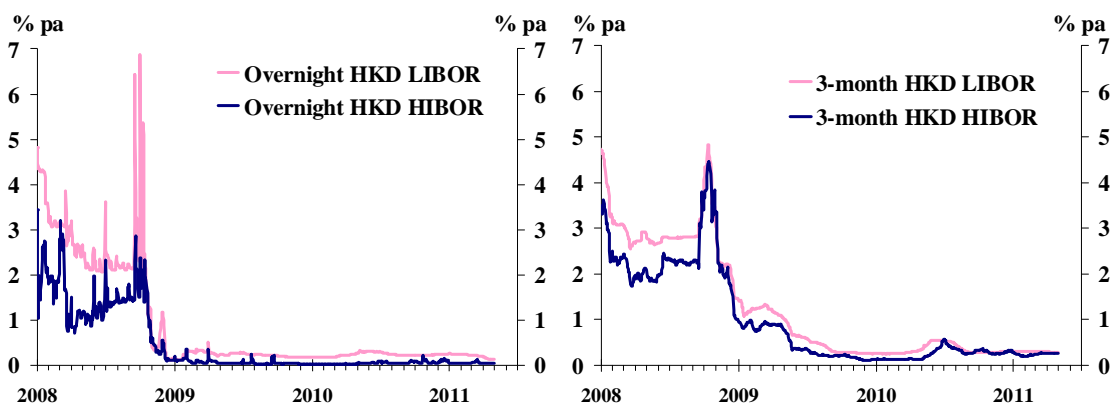


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- The Hong Kong dollar forward spreads were broadly stable in the past few months, in line with the interest rate differentials between the Hong Kong and US dollars.



DOMESTIC INTEREST RATES



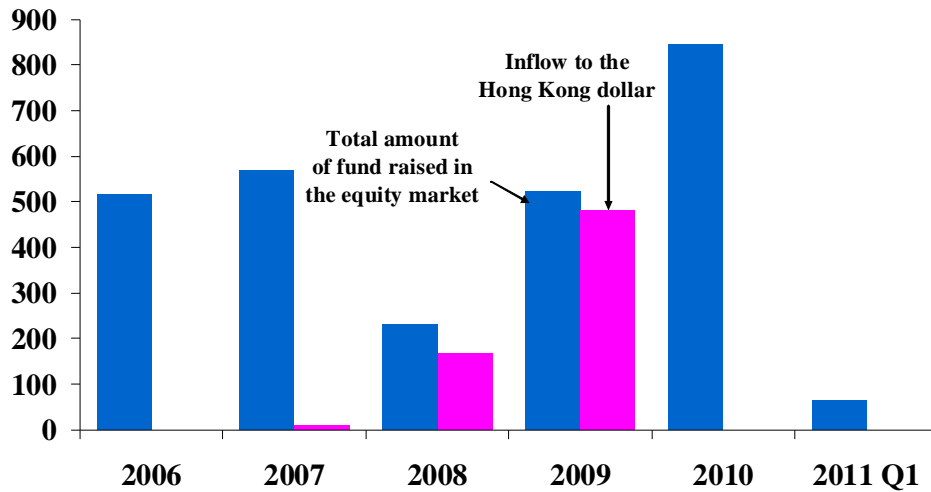
45

- With abundant liquidity, Hong Kong dollar interest rates were broadly stable and remained below their US dollar counterparts.



EQUITY FUND-RAISING AND NET INFLOWS

HK\$ billion



Note (1): Total amount of fund raised in the equity market include those from IPOs, right issues, placings, open offers, consideration issues, exercise of warrants and share option scheme.

Note (2): The 2008-09 figures are slightly different from data of Hong Kong Exchanges and Clearing Limited, since fund raising activities not involving Hong Kong dollar flows have been excluded.

- Fund-raising activities slowed in 2011 Q1. During the period, a total of HK\$63.2 billion of funds was raised in the Hong Kong stock market, HK\$21.6 billion less than those raised in 2010 Q1.

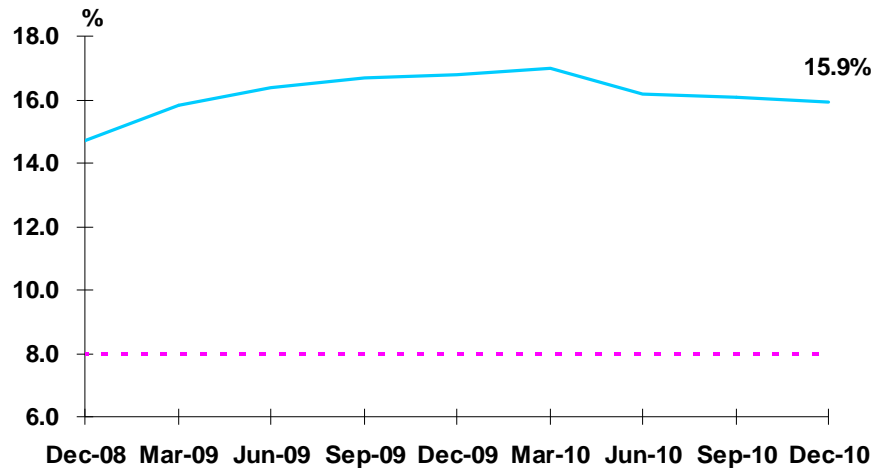


BANKING STABILITY



BANKING SECTOR PERFORMANCE

Locally incorporated AIs continued to be well capitalised



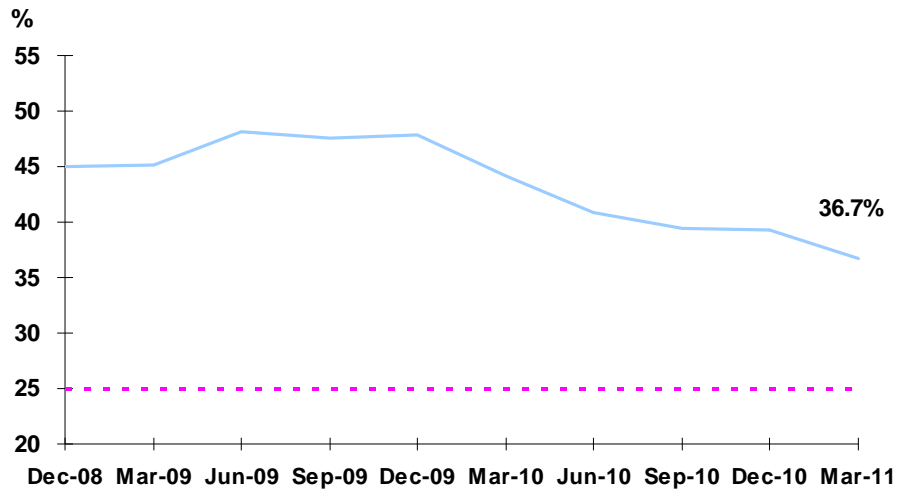
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- The consolidated capital adequacy ratio of locally incorporated AIs was 15.9% at the end of December 2010, compared with 16.1% at the end of September 2010. The ratio remained well above the international standard of 8% and the pre-crisis levels.



BANKING SECTOR PERFORMANCE

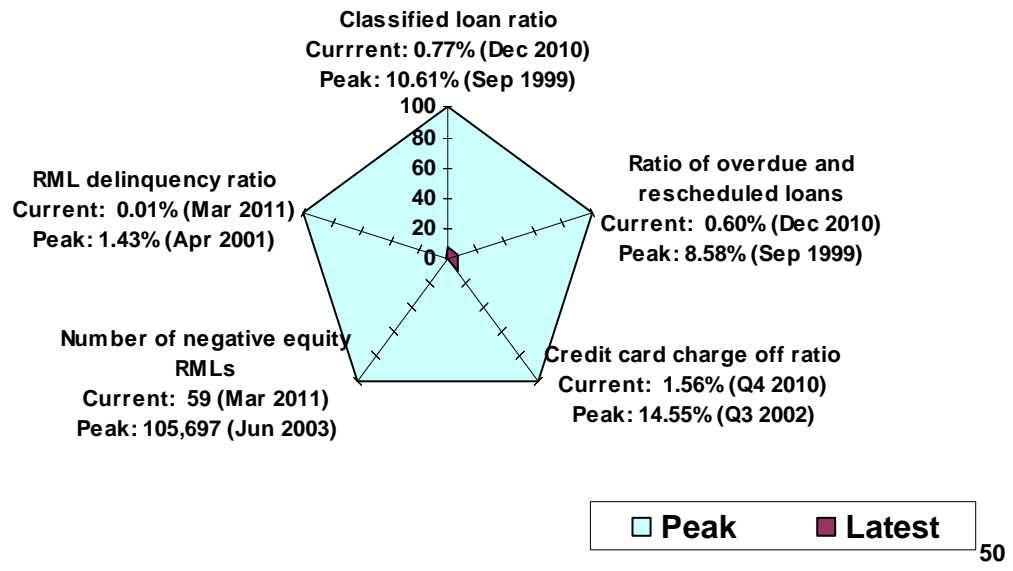
Liquidity ratio of retail banks remained well above statutory minimum of 25%





BANKING SECTOR PERFORMANCE

Asset quality indicators remained good compared with historical standards

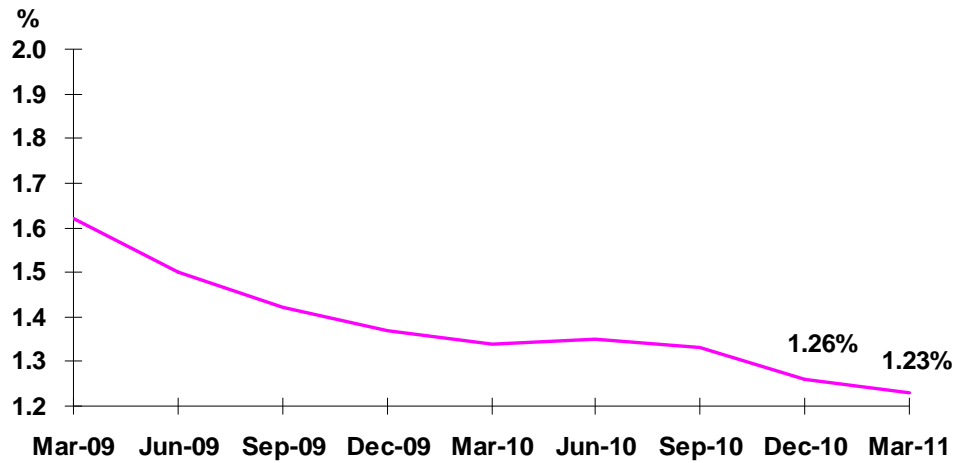


- The HKMA continues to monitor closely the asset quality of retail banks' loan portfolios.



BANKING SECTOR PERFORMANCE

Net interest margin of retail banks



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- The quarterly annualised net interest margin of retail banks declined to 1.23% in Q1 2011.
- The aggregate pre-tax operating profit of retail banks' Hong Kong offices in Q1 2011 increased by 26.6% compared with same period last year, as an improvement in the non-interest income lifted banks' profitability.



RISK MANAGEMENT IN RESIDENTIAL MORTGAGE LOANS

- The HKMA commenced a round of thematic on-site examinations of 21 banks in February 2011, focusing on banks' compliance with supervisory requirements on assessment of borrowers' repayment ability, stress-testing, loan pricing, and mortgage applicants' declaration of debt obligations.
- The HKMA will closely monitor market developments and, if necessary, introduce further measures to strengthen banks' risk management in mortgage lending.



CREDIT GROWTH

- Total loans extended by the banking sector in Hong Kong grew by 29% or HK\$940 billion in 2010. This is the largest increase in more than ten years. Total loans continued to grow rapidly in the first quarter of 2011.
- This trend may cause pressure on funding and liquidity, and induce higher concentration risk. The HKMA is highly concerned about the development and has written to banks requiring them to assess their business plans and funding strategies and to submit relevant information to HKMA. The HKMA is reviewing the relevant information and, if necessary, will take appropriate follow up actions.
- The HKMA is currently conducting on-site examinations on banks' credit underwriting practices. So far, there is no indication that banks have lowered their underwriting standards.
- As loans are growing faster than that of deposits, there will be upward pressure for interest rates. Borrowers should therefore manage interest rate risk properly and avoid over-borrowing.



SHARING OF MORTGAGE DATA FOR CREDIT ASSESSMENT

- On 21 March 2011, the Office of the Privacy Commissioner for Personal Data (“PCO”) released its report on the public consultation on the sharing of mortgage data for credit assessment, concluding that the banking industry’s proposal for positive mortgage data sharing (“PMDS”) would lead to responsible borrowing and lending
- The Code of Practice on Consumer Credit Data was revised on 1 April 2011 to allow for the implementation of PMDS
- The industry has been taking steps to implement PMDS in respect of pre-existing mortgage data and new mortgage loans

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- The Office of the Privacy Commissioner for Personal Data (PCO)’s Consultation Report on the Sharing of Mortgage Data for Credit Assessment concluded that it is appropriate to revise the Code of Practice on Consumer Credit Data (the Code) to allow for the sharing of positive mortgage data.
- The sharing of positive mortgage data through a credit database can help banks verify the information provided by applicants in respect of mortgage loans they already have, thus deterring mortgage applicants from providing false information to authorized institutions (AIs) during the mortgage loan application process. This will strengthen AIs’ credit risk assessment, which is crucial to banking and financial stability in Hong Kong.
- The industry has been taking steps to implement PMDS
 - *Pre-existing mortgage data:* AIs have been sending letters to their existing mortgage customers (i.e. borrowers, mortgagors or guarantors) to seek their prescribed consent for the uploading of their pre-existing mortgage data to the credit reference agency (CRA).
 - *New mortgage loan applications:* Applicants for new mortgage loans will be requested to sign a consent form for sharing data of their pre-existing mortgages as well as for uploading of data on their applied mortgage after completion of the loan drawdown. Where a mortgage applicant chooses not to give his/her consent, the AI will still continue to process the mortgage loan application by obtaining additional relevant information from the applicant to assess the applicant’s repayment ability. The AI will then decide whether it has sufficient information to conduct the credit assessment of the customer and whether additional measures are required to mitigate the potential credit risk involved.



INVESTOR PROTECTION

- Results of mystery shopping exercise to be published in May
- Introduced new investor protection measures
 - Issued circular in March to further enhance regulatory requirements for the sales of investment-linked assurance scheme products by AIs
 - Issued circular in April to require AIs to provide important facts statements for currency-linked instruments and interest rate-linked instruments to retail customers
- The HKMA has been providing assistance to the Financial Services and the Treasury Bureau to enable the establishment of Investor Education Council and Financial Dispute Resolution Centre

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- The HKMA completed a mystery shopping exercise in 2010 to check banks' sales practices in respect of unlisted investment products and structured deposits. With a view to enhancing the industry's sales practice, the HKMA plans to publish the relevant findings in May.
- The HKMA has introduced new measures to further enhance investor protection:
 - (a) To offer better protection to customers in respect of investment-linked assurance scheme (ILAS) products, the HKMA issued a circular in March to further enhance the related regulatory requirements. Key enhanced measures include:
 - restricting the use of gifts for promoting ILAS products;
 - requiring AIs to conduct their own product due diligence;
 - requiring proper disclosure of both the insurance and investment elements of ILAS; and
 - requiring AIs to test the sales process of ILAS products in their mystery shopping programmes.
 - (b) In view of the popularity of currency-linked instruments and interest-rate linked instruments issued by AIs and the exemption of such instruments from the authorization requirements under the Securities and Futures Ordinance, the HKMA developed templates for Important Facts Statement to enhance disclosure of key features and risks of such products for distribution to retail customers. A circular was issued to AIs in April to implement this requirement.
- The Financial Services and the Treasury Bureau (FSTB) announced on 13 December 2010 that the Government has decided to establish Investor Education Council (IEC) and Financial Dispute Resolution Centre (FDRC). The HKMA has been assisting FSTB with these initiatives and will continue to work closely with FSTB, the Securities and Futures Commission and the industry to prepare for the establishment of IEC and FDRC. The HKMA will consult AIs as required by the Banking Ordinance on amendments to the licensing conditions of AIs to mandate their participation in the FDRC scheme and to require them to abide by the FDRC procedures.



DEPOSIT PROTECTION

- Enhanced Deposit Protection Scheme (DPS) providing a higher protection limit of HK\$500,000 commenced operation, smoothly on 1 January 2011.
- On-going monitoring of the compliance of banks with the improved representation requirements on protection status of deposits. Results satisfactory with no major non-compliance issues noted.
- Banks are conducting a self-assessment review to ascertain the level of their compliance with the representation requirements. On-site examinations will also commence later this year.
- Extensive publicity activities are continuing to increase public awareness of the increased deposit protection provided by the DPS. Resources will also be deployed to deepen the public's understanding of the key features of the enhanced DPS.



BASEL III

- Basel III will be phased in from 1 January 2013
 - More stringent capital requirements and higher minimum requirement for common equity (1.1.2013)
 - New liquidity standards: Liquidity Coverage ratio and Net Stable Funding Ratio (1.1.2015 / 1.1.2018)
 - Capital conservation / countercyclical capital buffer (1.1.2016)
 - Capital to assets leverage ratio (1.1.2018)
- Banks are expected to be able to meet the new requirements
- Legislative amendments will begin in this year: a briefing to the LegCo Financial Affairs Panel is scheduled for 9 June
- HKMA plans to table the Banking (Amendment) Bill 2011 before LegCo in December 2011

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- Basel III, which will require banks to hold better quality and higher levels of capital and liquidity so as to strengthen the banking sector's resilience to financial and economic stress, will be phased in from 1 January 2013 to 1 January 2019. The HKMA has already written to AIs indicating its intention to adopt Basel III in full following the BCBS's timetable, including the transition arrangements.
- Banks in Hong Kong are generally well-placed to meet the new capital standards, given that they are well-capitalised and place more reliance on common equity to meet regulatory capital requirements.
- While some banks may need to adjust their liquidity profiles to satisfy the relevant requirements in the new liquidity standards, we do not expect any major problems for banks in Hong Kong to comply with the standards.
- To enable the implementation of Basel III in Hong Kong, the HKMA proposes to amend the Banking Ordinance (BO) so that the MA is empowered to
 - make Rules, to give effect to banking supervisory standards relating to capital and liquidity issued by the Basel Committee from time to time (to replace the existing capital and liquidity ratios set out in the BO); and
 - issue codes of practice to provide guidance in respect any of the provisions of the rules.
- The new standards are, inevitably, technical in nature and are likely to require refinement over time as business practices and markets evolve. The use of Rules (which will be subsidiary legislation and subject to negative vetting by the Legislative Council) supplemented by codes of practice should provide a practical means to handle, within the legislative framework, the complex calculation methodologies and the need for flexibility to effect changes relatively quickly in response to changing circumstances. Consultation and appeal mechanisms will be built in to provide further checks and balances.
- The HKMA expects to submit a Banking (Amendment) Bill, for the purposes of implementing Basel III, in December 2011, after industry consultation. This timeline should allow sufficient time for development of, and consultation on, the Rules before the first phase of the new requirements (i.e. the new minimum capital requirements) comes into effect on 1 January 2013.



INTERNATIONAL DISCUSSIONS ON REGULATORY REFORM

- Systematically Important Financial Institutions (SIFIs)
 - relevant measures expected in October 2011
- Resolution Regime
- Financial Stability Board (FSB)
 - The HKMA attended the Plenary Meeting of the FSB on 5 April. The meeting discussed risks and vulnerabilities affecting global financial stability, and reviewed the progress of major regulatory reform initiatives.
 - The FSB recently commenced two peer reviews. The HKMA chairs the peer review of deposit insurance systems and participates in another review team on compensation practices.

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SIFIs

- The size, interconnectedness and/or lack of substitutability of SIFIs makes their failure a potential threat to the stability of financial system. The FSB is considering measures to reduce the risks associated with SIFIs including more intensive and effective supervision (with better coordination among home and host supervisors), capital surcharges and recovery and resolution plans.

Resolution Regimes

- Interconnectedness with SIFIs – there is a need to devise effective resolution regimes to contain the damage potentially caused by a SIFI's failure and provide the authorities with tools to resolve the firm in a manner that ensures the continued performance of essential financial functions and uninterrupted access of depositors to their funds, without exposing taxpayers to the risk of loss.

Financial Stability Board

- The HKMA continued to participate actively in meetings and activities of the FSB Plenary and Standing Committees. At the April Plenary meeting, members reviewed macroeconomic and financial market developments of consequence to global financial stability. Members also discussed various proposals to continue to reform the financial system. One of the major areas is to tackle the “too-big-to-fail” problem posed by systemically important financial institutions (SIFIs). The FSB is currently developing a framework that will, among other things, set higher loss-absorbency requirements for global SIFIs, enhance supervisory intensity, and enable the orderly resolution of these institutions. A number of global SIFIs have operations in Hong Kong and the development of an effective SIFI regulatory framework is of vital importance to Hong Kong's financial stability. The HKMA has been participating actively in the relevant international discussions to ensure that our views are heard. Another key area of work under the FSB is the reform of the OTC derivatives market.
- As part of its efforts to encourage consistent implementation of international standards across its membership, the FSB conducts peer reviews regularly. The HKMA chairs the recently set up peer review of deposit insurance systems and participates in another review team on compensation practices.



FINANCIAL INFRASTRUCTURE



REFORMING OTC DERIVATIVES MARKET

- The HKMA, the SFC and the Government are working together in building the regulatory regime for over-the-counter (OTC) derivatives market in Hong Kong, and will consult the market on the detailed regulatory requirements around Q3 2011
- The proposed regulation would cover the reporting of OTC derivatives transactions, particularly those which are relevant to the Hong Kong market, to the trade repository (TR) and the clearing of standardised OTC derivatives transactions through an authorised central counterparty (CCP). At the initial stage, the clearing and reporting requirement will be applied to interest rate swaps and non-deliverable forwards
- The HKMA will ride on its existing Central Moneymarkets Unit (CMU) infrastructure to develop the TR, scheduled for launch in 2012. Hong Kong Exchanges and Clearing Ltd has also decided to establish a local CCP for OTC derivatives in Hong Kong
- We will closely follow international regulatory development and take necessary steps to ensure alignment with international standards



GOVERNMENT BOND PROGRAMME

- Institutional Bond Issuance Programme:
 - Seven issues with a total issuance size of HK\$30 billion have been issued
 - Tenors from 2 years up to 10 years have been offered in order to build a benchmark yield curve
 - The tenders attracted a diverse group of end-investors, such as investment funds, insurance companies and pension funds
- Retail Bond Issuance Programme:
 - The issuance of an inflation-linked bond (iBond) was announced by the Financial Secretary in his Budget Speech
 - Up to HK\$10 billion will be offered to HK residents
 - Preparatory work is in progress and the launch is expected in early third quarter

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- 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 2009. As at mid-May, a total of seven issues have been issued under eleven tenders, and they are:
 - HK\$3.5 billion of a 2-year bond maturing in September 2011;
 - HK\$3.5 billion of a 2-year bond maturing in March 2012;
 - HK\$3.5 billion of a 2-year bond maturing in September 2012;
 - HK\$3.5 billion of a 2-year bond maturing in March 2013;
 - HK\$3.5 billion of a 5-year bond maturing in November 2014;
 - HK\$5 billion of a 5-year bond maturing in December 2015; and
 - HK\$7.5 billion of a 10-year bond maturing in January 2020.
- By enlarging the investor base over time, the GBP is expected to improve liquidity and attract more issuers to raise funds via the bond market. This will help increase the breadth and depth of our bond market, thereby consolidating our role as an international financial centre.
- The objective of the Retail Programme is to enhance the interest and awareness of local individual investors in bond investments. The Financial Secretary announced the issuance of an inflation-linked bond (the "iBond") under the Retail Programme in his 2011-12 Budget Speech. The HKMA is assisting the Government in implementing the offering.
- The HKMA is working closely with the external service providers, such as the Co-arrangers (Bank of China (Hong Kong) Limited and The Hongkong and Shanghai Banking Corporation Limited) to prepare for the offering of iBond in the early third quarter. Offering details will be announced in due course.



PROMOTING ASSET MANAGEMENT BUSINESS

- Working closely with other Government agencies and the private sector to explore ways to strengthen the competitiveness of Hong Kong's asset management industry and reinforce Hong Kong's position as a leading asset management centre
- Stepping up marketing efforts to proactively reach out to overseas and Mainland fund managers and investors to promote Hong Kong's financial platform with a view to attracting more fund managers, capital and financial products to Hong Kong

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- With the promising growth prospects of the Asian region, there has been increasing interest from overseas fund managers to expand into Asia. To capitalise on this trend and attract more fund managers into Hong Kong, the HKMA is working in conjunction with other Government agencies and market players to promote Hong Kong's asset management business, thereby reinforcing Hong Kong's role as a premier international financial centre.
- To this end, the HKMA is taking part in a joint Government campaign, along with the Financial Services and the Treasury Bureau and the Securities and Futures Commission, in holding a series of promotional roadshows in leading global financial centres. The campaign started with a roadshow to London in November 2010, during which the HKMA also took the opportunity to meet with key European fund managers to explain to them the opportunities in Hong Kong and listen to their views. A second promotional roadshow was held in New York in March 2011 for North American fund managers.



DEVELOPMENT OF ISLAMIC FINANCE

- Develop market infrastructure :
 - Supporting the Government in drawing up legislative proposals to modify Hong Kong's tax laws to level the playing field between Islamic and conventional financial products
- Build international links and enhance international profile :
 - Working closely with Bank Negara Malaysia to explore collaborative initiatives under the scope of the MoU signed
 - Seeking to forge closer ties with international Islamic organisations
- Promote market awareness :
 - Continue to participate in regional seminars and conferences and provide training to the industry

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- The HKMA has been working closely with other industry associations and Islamic organisations to provide appropriate training programmes for the industry with a view to nurturing a larger Islamic finance talent pool in Hong Kong. For example, at the end of last year, the HKMA co-ordinated the invitation and selection of Hong Kong candidates for the nomination of two scholarships offered by the International Centre for Education in Islamic Finance (INCEIF) to study its Masters-degree programme on Islamic finance in Malaysia. The two nominated candidates have passed INCEIF's further screening and have commenced their studies in January 2011.



FINANCIAL INFRASTRUCTURE

- Continued to maintain safety and efficiency of financial infrastructure
- Continued to enhance financial infrastructure, especially for coping with potential business opportunities arising from the further liberalisation of RMB business in Hong Kong
- Developing a trade repository for over-the-counter derivatives trades to enhance market surveillance and transparency, and bring Hong Kong in line with international standards

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Operation of financial infrastructure

- The HKD, USD, EUR and RMB Real Time Gross Settlement (RTGS) systems and the Central Moneymarkets Unit (CMU) have been operating smoothly.

Financial infrastructure to support RMB business

- New features added to the RMB RTGS system include RMB autopay, same-day EIPO refund capability and intraday repo facility. Will gradually bring the RMB RTGS system in line with the HKD RTGS system in terms of functionality.
- The RMB RTGS system successfully supported the first RMB IPO in April 2011.

Trade Repository

- Commenced system development work. The trade repository is targeted for launch in 2012, in line with the G-20 deadline of end-2012.

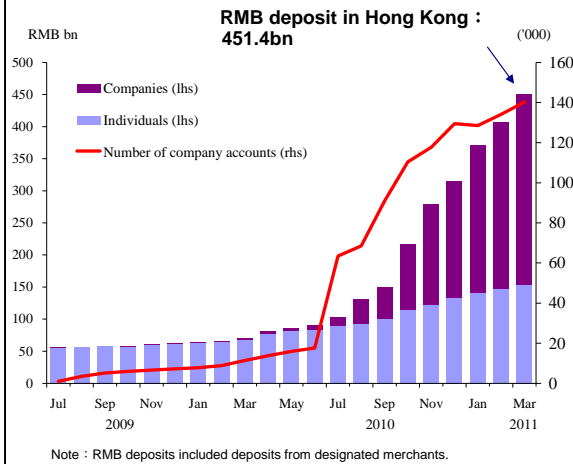


HONG KONG AS AN INTERNATIONAL FNANCIAL CENTRE

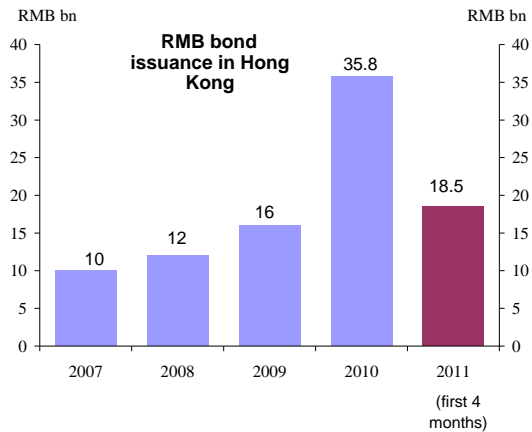


ENCOURAGING DEVELOPMENTS OF HONG KONG'S RMB BUSINESS

Largest RMB liquidity pool outside the Mainland



Largest offshore RMB bond market

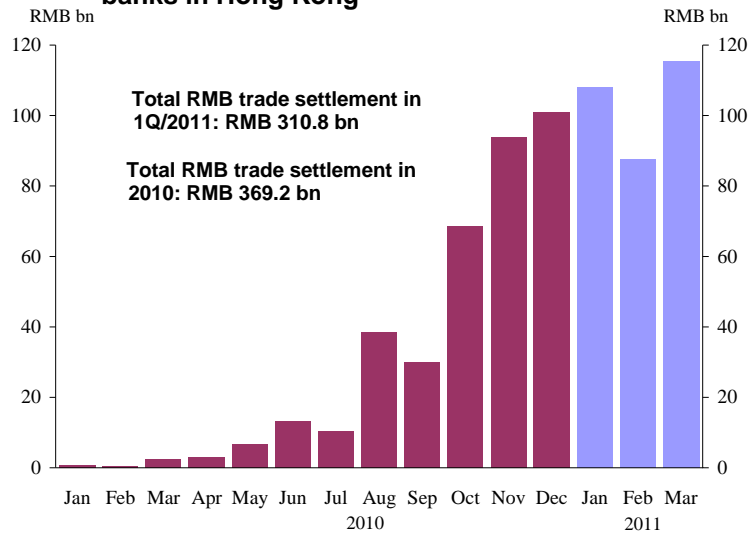


- Hong Kong has the largest RMB liquidity pool outside the Mainland: RMB deposits in Hong Kong increased by RMB136.6 billion during the first quarter of 2011, or RMB45.5 billion per month on average.
- Hong Kong has the largest offshore RMB bond market: In the first four months of 2011, there were 20 enterprises and institutions issuing RMB bonds in Hong Kong, involving a total of RMB18.5 billion. It is expected that the RMB bond market in Hong Kong will continue to expand steadily.
- Comprehensive RMB financial infrastructure: The first RMB REIT was completed in mid-Apr. Hong Kong's RMB platform can support the listing and trading of RMB financial products, paving the way for the launch of more products in the future to meet market demand.



EXPANDING RMB TRADE SETTLEMENT BUSINESS

RMB trade settlement conducted through banks in Hong Kong





FURTHER DEVELOPMENT OF HONG KONG'S OFFSHORE RMB BUSINESS

- **China's 12th Five-Year Plan supports development of Hong Kong as an offshore RMB business centre**
- Develop and promote Hong Kong as the offshore RMB centre and further promote the use of RMB for cross-border trades and investments in an **orderly** and **controllable** manner
- **An established and expanding RMB clearing and settlement network with global coverage**
 - At end-Mar 2011, there were 154 branches and subsidiaries of foreign banks, as well as overseas branches of Mainland banks directly participating in Hong Kong's RMB clearing platform
- **Will continue to conduct overseas roadshows**

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- China's 12th Five-Year Plan supports development of Hong Kong as an offshore RMB business centre. As Hong Kong's offshore RMB centre has taken shape, we have to foster further growth in RMB business and promote the use of RMB for cross-border trades and investments in an orderly and controllable manner.
- At the end of March 2011, there were 170 banks participating directly in Hong Kong's RMB clearing platform. Among the participating banks, there were 154 branches and subsidiaries of foreign banks, as well as overseas branches of Mainland banks. Hong Kong's RMB platform has developed into a global network, and will continue to expand.
- HKMA has conducted overseas roadshows for the promotion of RMB business in Hong Kong since March 2011. HKMA also participates in seminars on RMB business organised by other central banks to promote Hong Kong's one-stop RMB financial services to overseas banks and companies (particularly those from Asia).



INCREASING REGIONAL AND INTERNATIONAL FINANCIAL CO-OPERATION

Financial Stability Board (FSB)

- The HKMA attended the Plenary Meeting of the FSB on 5 April. The meeting discussed risks and vulnerabilities affecting global financial stability, and reviewed the progress of major regulatory reform initiatives. Two key priorities of the FSB are to reduce the moral hazard risks posed by systemically important financial institutions and to reform the OTC derivatives markets.
- The FSB recently commenced two peer reviews. The HKMA chairs the peer review of deposit insurance systems and participates in another review team on compensation practices.

Monitoring of regional monetary and financial stability

- The HKMA conducted analyses for discussion at the EMEAP Monetary and Financial Stability Committee on 12 May to assess risks and vulnerabilities in the region, in particular those associated with global commodity prices and rising inflationary pressures.

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- The HKMA continued to participate actively in meetings and activities of the FSB Plenary and Standing Committees. At the April Plenary meeting, members reviewed macroeconomic and financial market developments of consequence to global financial stability. Members also discussed various proposals to continue to reform the financial system. One of the major areas is to tackle the “too-big-to-fail” problem posed by systemically important financial institutions (SIFIs). The FSB is currently developing a framework that will, among other things, set higher loss-absorbency requirements for global SIFIs, enhance supervisory intensity, and enable the orderly resolution of these institutions. A number of global SIFIs have operations in Hong Kong and the development of an effective SIFI regulatory framework is of vital importance to Hong Kong’s financial stability. The HKMA has been participating actively in the relevant international discussions to ensure that our views are heard. Another key area of work under the FSB is the reform of the OTC derivatives market.
- As part of its efforts to encourage consistent implementation of international standards across its membership, the FSB conducts peer reviews regularly. The HKMA chairs the recently set up peer review of deposit insurance systems and participates in another review team on compensation practices.
- The HKMA continued to play an important role in the surveillance work of the EMEAP Monetary and Financial Stability Committee (MFSC). The HKMA conducted analyses and prepared the MFSC’s bi-annual Macro-Monitoring Report to assess the risks and vulnerabilities in the region.



INVESTMENT ENVIRONMENT AND PERFORMANCE OF THE EXCHANGE FUND



INVESTMENT ENVIRONMENT IN Q1 2011

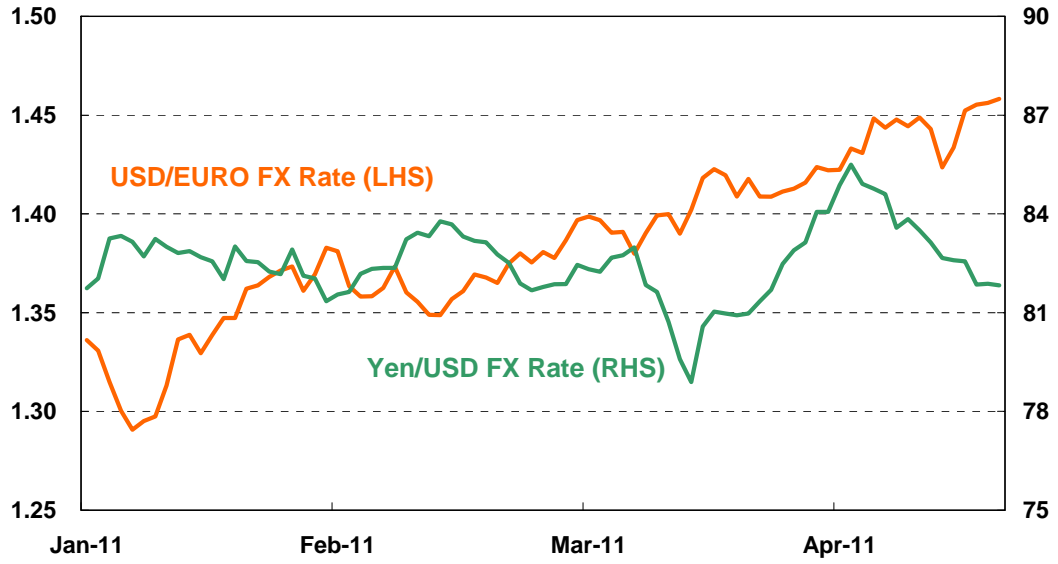
- **Exchange rates:** The Euro strengthened markedly against the Dollar, as optimism about the prospects for an expansion of the European Financial Stability Facility (EFSF) and higher rate-hike expectation overwhelmed concerns about Europe's sovereign debt crisis. The Yen weakened from its recent high upon G7's joint intervention following the earthquake.
- **Equity markets:** Major stock markets in developed economies ended the quarter higher. Concerns arising from higher oil prices as a result of geopolitical concerns and Japan's earthquake were offset by the support from strong investors' risk appetite, reversing capital flows from emerging markets, and the better-than-expected Q4 corporate earnings.
- **Interest rates:** US Treasury yields rose in early February on positive economic data, but had retraced since mid-February due to social unrest in Middle East and North Africa and Japan's earthquake. German government bond yields rose on the better prospect brought by EFSF and rate hike expectation.



CURRENCY MARKETS

USD/Euro FX Rate

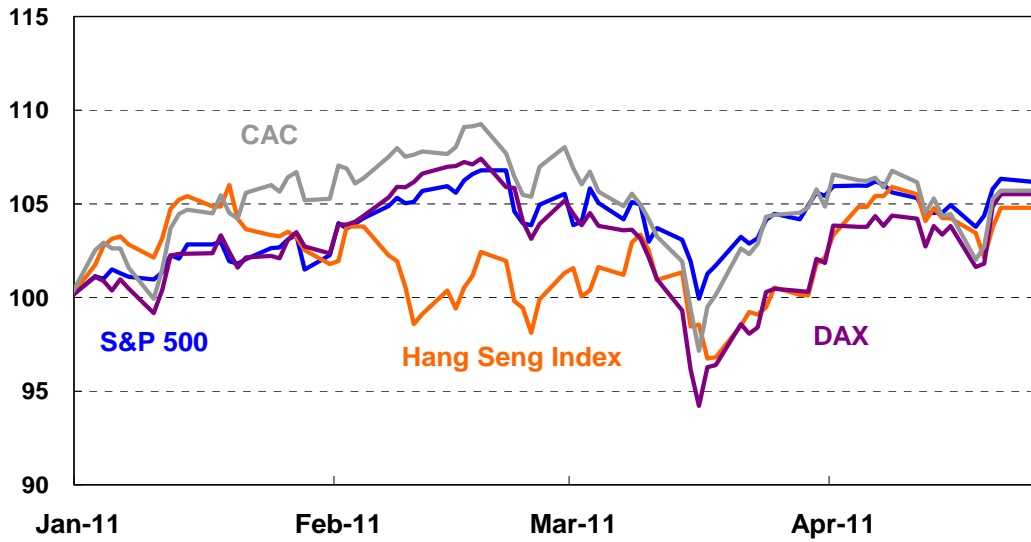
Yen/USD FX Rate





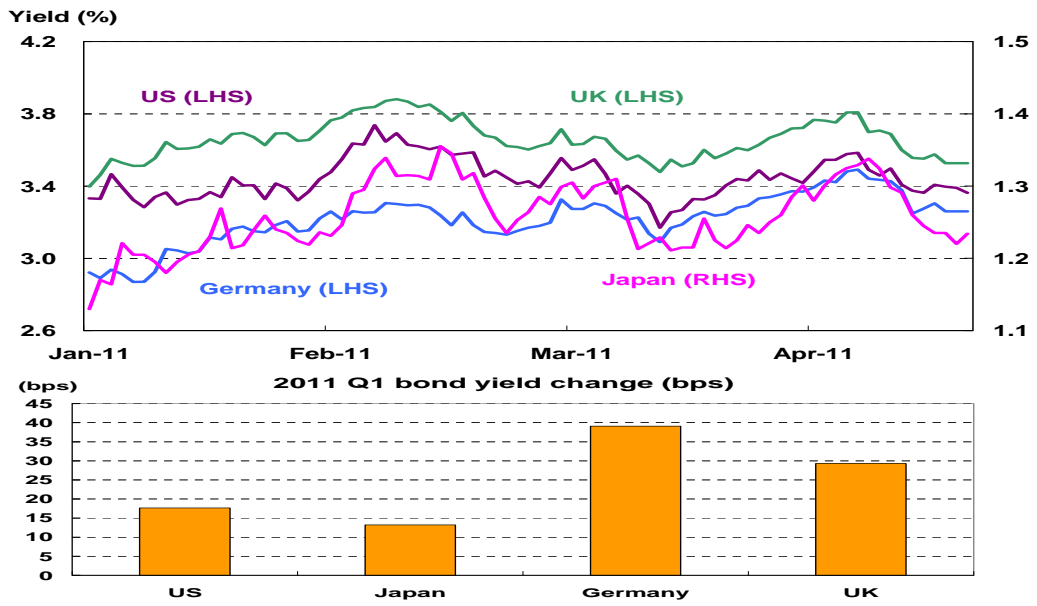
EQUITY MARKETS

Normalized Index Level (2010 year-end = 100)





CHANGES IN 10-YEAR GOVERNMENT BOND YIELDS





INVESTMENT INCOME

	2011	2010	2009	2008
(HK\$ billion)	Q1*	Full Year	Full Year	Full Year
Hong Kong equities [^] [@]	3.5	11.6	48.9	(77.9)
Other equities [^]	8.9	27.1	48.8	(73.1)
Foreign exchange	14.5	(3.1)	9.8	(12.4)
Other investments ^{&}	0.2	1.7	0.8	-
Bonds [#]	<u>(2.9)</u>	<u>42.1</u>	<u>(0.6)</u>	<u>88.4</u>
Investment income/(loss) ^{@&}	24.2	79.4	107.7	(75.0)

* Unaudited figures

[^] Including dividends

[#] Including interest

[@] Excluding valuation changes in Strategic Portfolio

[&] Including valuation changes of investment held by EF's investment holding subsidiaries



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

(HK\$ billion)	2011			2010		
	Q1*	Full year	Q4	Q3	Q2	Q1
Investment income/(loss)	24.2	79.4	5.9	74.5	(12.1)	11.1
Other income	-	0.2	-	0.1	0.1	-
Interest and other expenses	<u>(1.2)</u>	<u>(4.8)</u>	<u>(1.2)</u>	<u>(1.2)</u>	<u>(1.5)</u>	<u>(0.9)</u>
Net investment income/(loss)	23.0	74.8	4.7	73.4	(13.5)	10.2
Payment to Fiscal Reserves [#]	(9.2)	(33.8)	(8.6)	(8.3)	(8.4)	(8.5)
Payment to HKSAR government funds and statutory bodies[#]	(1.1)	(3.9)	(1.1)	(1.1)	(0.9)	(0.8)
Valuation change of Strategic Portfolio less investment held by EF's investment holding subsidiaries[^]	<u>(0.7)</u>	<u>0.9</u>	<u>1.0</u>	<u>1.2</u>	<u>(0.4)</u>	<u>(0.9)</u>
Increase/(Decrease) in EF Accumulated Surplus	12.0	38.0	(4.0)	65.2	(23.2)	-

* Unaudited figures

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

[^] Including 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*	(75.0)	8.3	(48.3)	(20.4)	(14.6)
2009*^{&}	107.7	10.6	71.9	58.7	(33.5)
2010*^{&}	79.4	5.9	74.5	(12.1)	11.1
2011*^{&}[#]	N/A	N/A	N/A	N/A	24.2

* Excluding valuation changes in the Strategic Portfolio

Unaudited figures

[&] Including valuation changes of investment held by EF's investment holding subsidiaries

N/A: Not Applicable



EXCHANGE FUND ABRIDGED BALANCE SHEET

(HK\$ billion)	At 31 Mar 2011*	At 31 Dec 2010	At 31 Dec 2009
ASSETS			
Deposits	213.5	198.4	126.3
Debt securities	1,729.4	1,706.7	1,637.6
Hong Kong equities	155.2	152.6	142.9
Other equities	257.7	245.3	214.9
Other assets[#]	<u>52.4</u>	<u>42.0</u>	<u>27.7</u>
Total assets	<u>2,408.2</u>	<u>2,345.0</u>	<u>2,149.4</u>
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness	233.3	225.9	199.0
Government-issued currency notes & coins in circulation	9.3	8.9	8.4
Balance of the banking system	148.7	148.7	264.6
Exchange Fund Bills and Notes	654.8	654.2	536.4
Placements by banks and other financial institutions	23.2	23.2	28.3
Placements by Fiscal Reserves	610.3	592.3	504.1
Placements by HKSAR government funds and statutory bodies	81.6	76.8	41.8
Other liabilities	<u>43.5</u>	<u>23.5</u>	<u>13.3</u>
Total liabilities	<u>1,804.7</u>	<u>1,753.5</u>	<u>1,595.9</u>
Accumulated Surplus	<u>603.5</u>	<u>591.5</u>	<u>553.5</u>
Total liabilities and fund equity	<u>2,408.2</u>	<u>2,345.0</u>	<u>2,149.4</u>

* Unaudited figures

Including investment in EF's investment holding subsidiaries amounted to HK\$16.6 billion at 31 Mar 2011 (HK\$14.7 billion at 31 Dec 2010)