



HONG KONG MONETARY AUTHORITY

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

15 December 2011



DISCUSSION TOPICS

Updates on

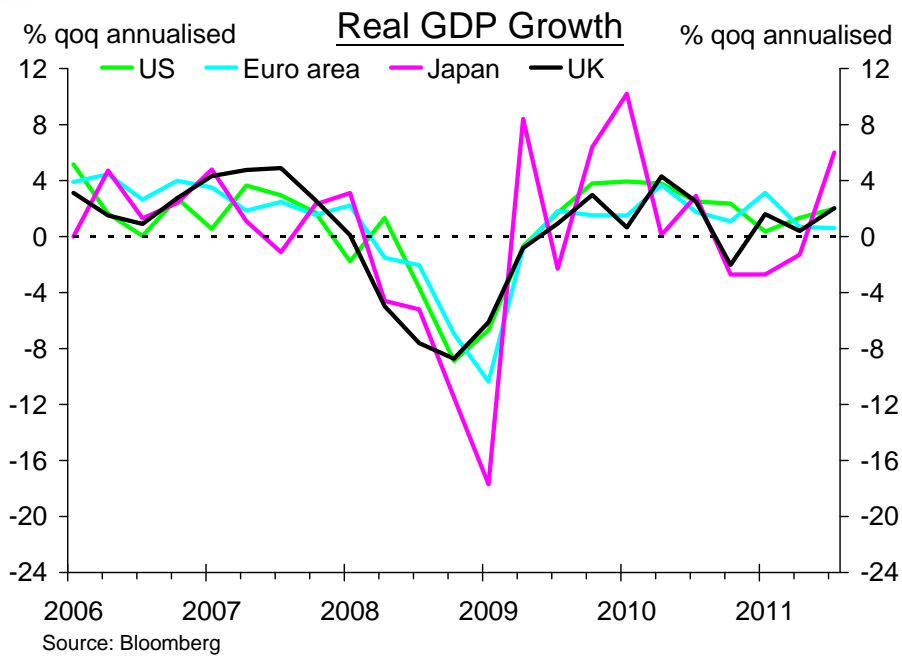
- Financial and Economic Conditions
- Currency Stability
- Banking Stability
- Financial Infrastructure
- Hong Kong as an International Financial Centre
- The Exchange Fund
- Hong Kong Mortgage Corporation



FINANCIAL AND ECONOMIC CONDITIONS

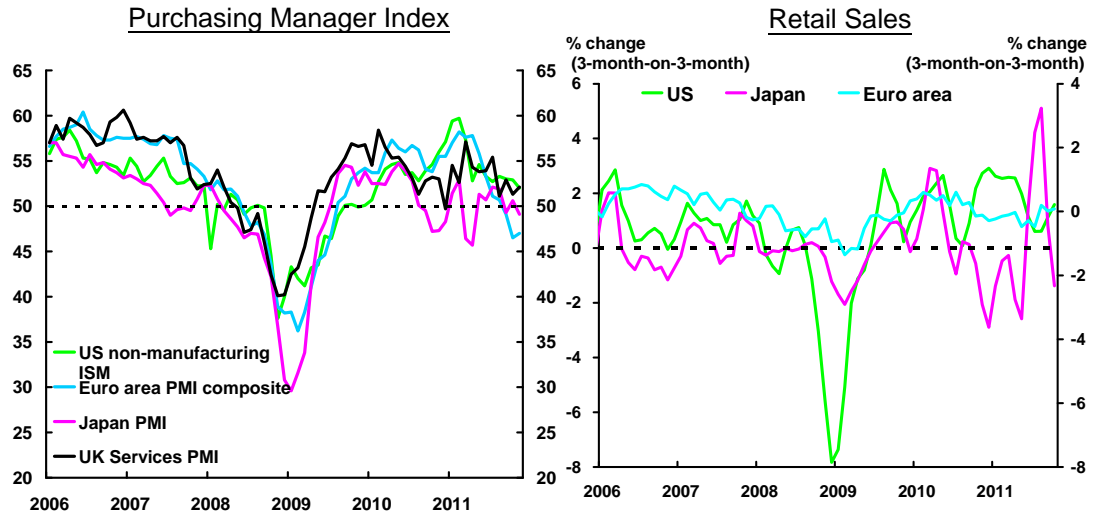


ECONOMIC SITUATION IN MAJOR COUNTRIES





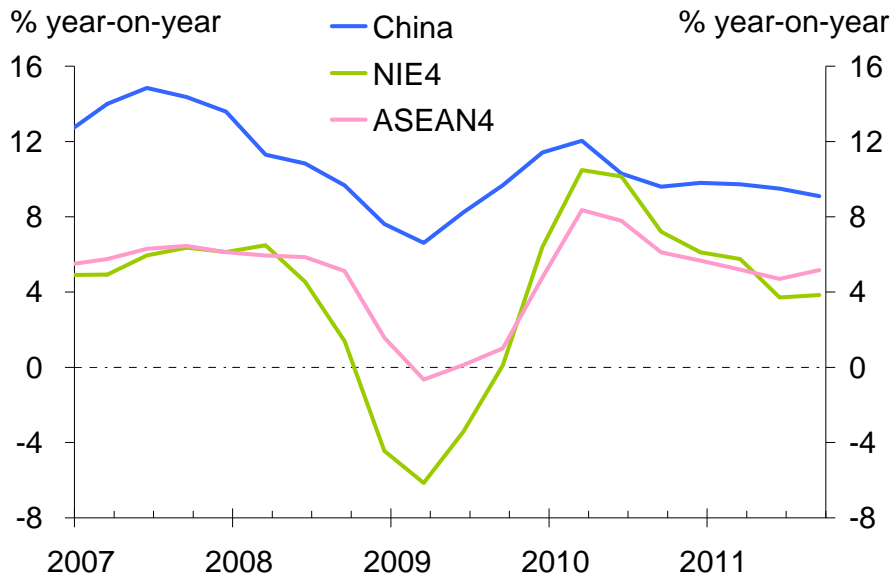
ECONOMIC SITUATION IN MAJOR COUNTRIES



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.
Sources: CEIC, IMF and staff estimates



Economic growth under baseline scenario

Real GDP growth

(%, annual rate)

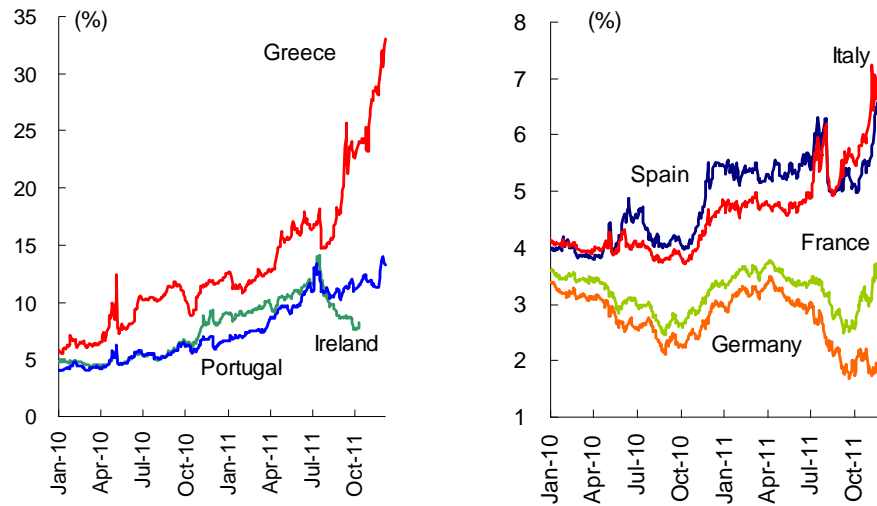
	2011 Consensus Forecasts		2012 Consensus Forecasts	
	May FAP Briefing	Dec FAP Briefing	May FAP Briefing	Dec FAP Briefing
US	2.7	1.8	3.2	2.1
Euro area	1.7	1.6	1.7	0.4
Japan	0.0	-0.4	2.8	2.1
Asia (ex. Japan)	7.7	7.3	7.5	6.9

Source: Consensus Forecasts



European sovereign debt crisis

10-year sovereign bond yield

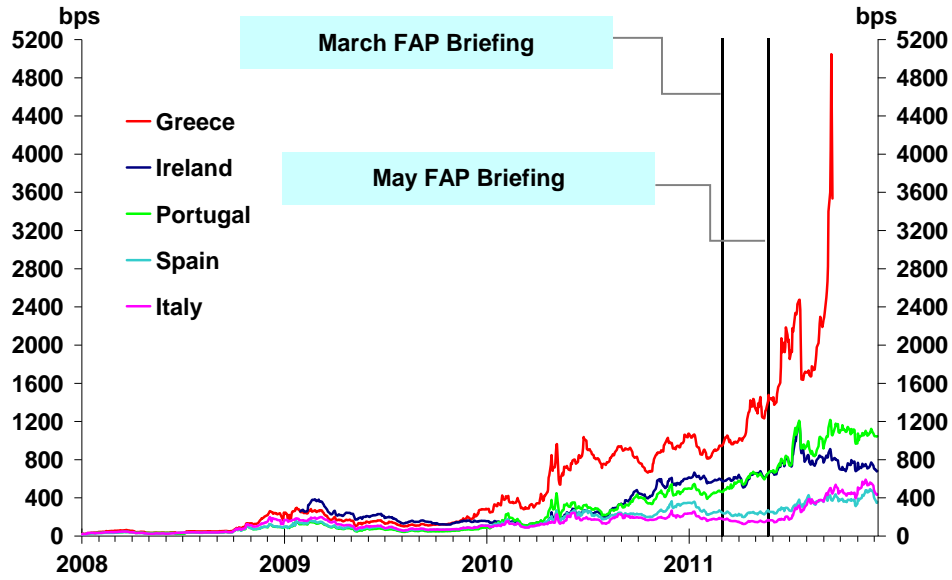


Source: Bloomberg Note: Bloomberg has stopped updating Ireland's 10-year bond yield since 11 Oct



EUROPEAN SOVEREIGN DEBT PROBLEM: CDS SPREADS

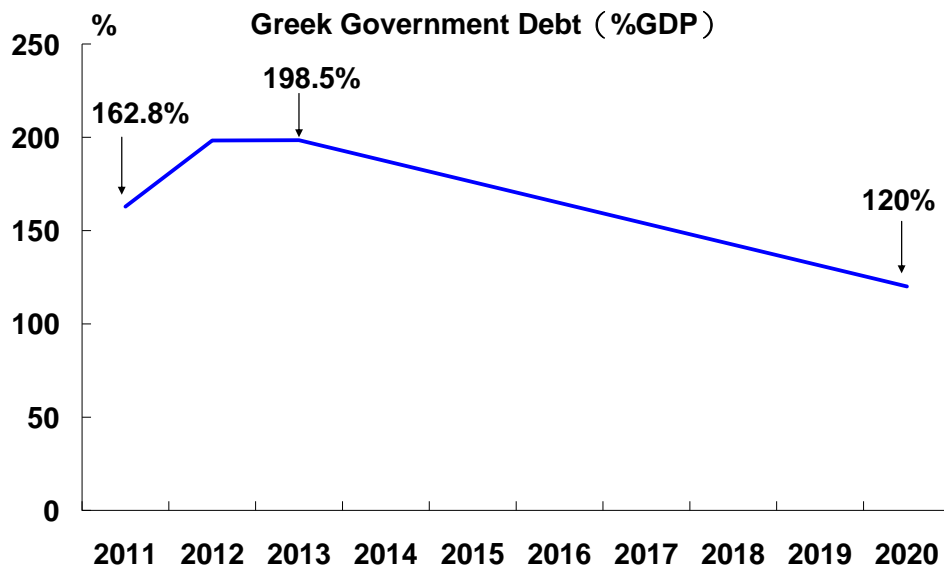
Prices of 5-year sovereign CDS



Source: Bloomberg Note: Bloomberg's data on Greece CDS spread was not updated since 16 Sep.



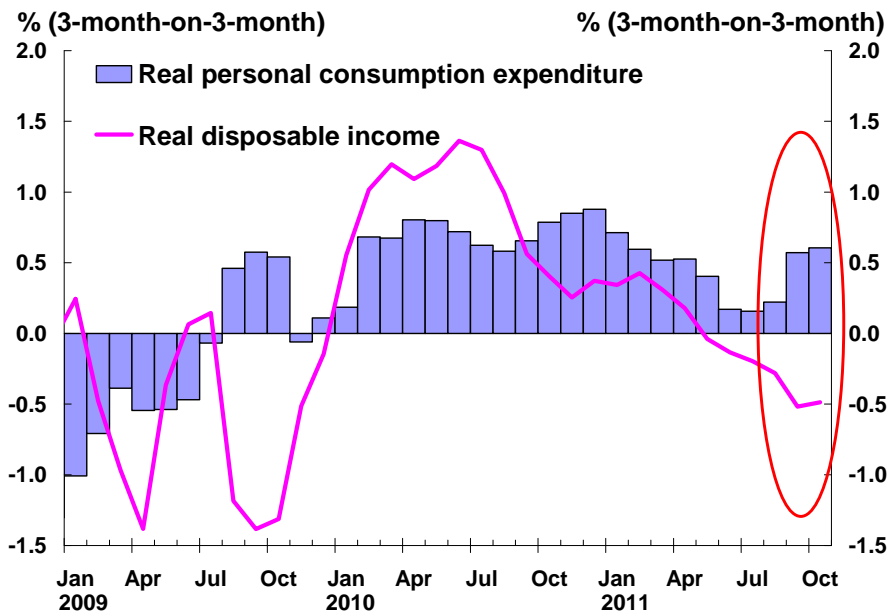
European rescue plan: Restructuring of Greek debt



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



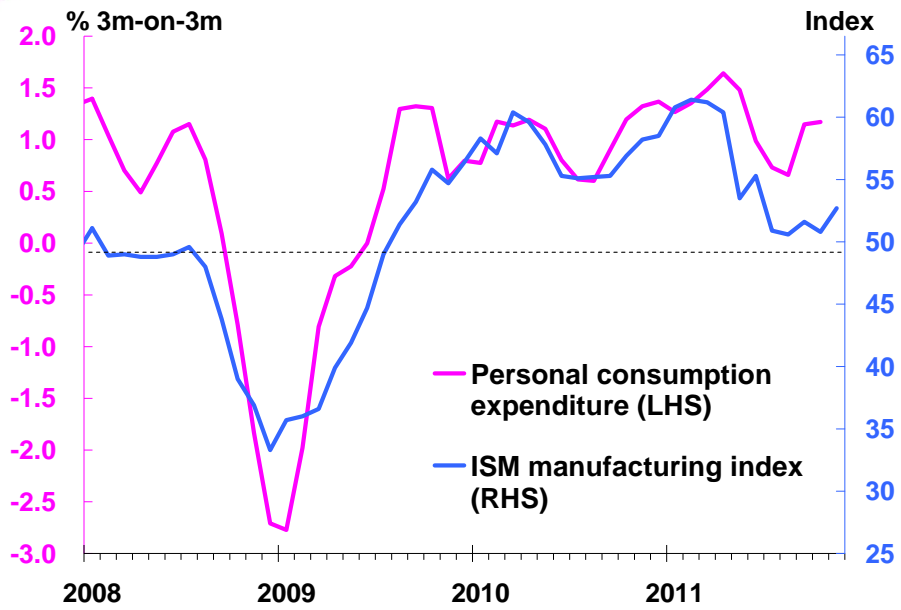
US: Third quarter consumption and income growth



Source: CEIC



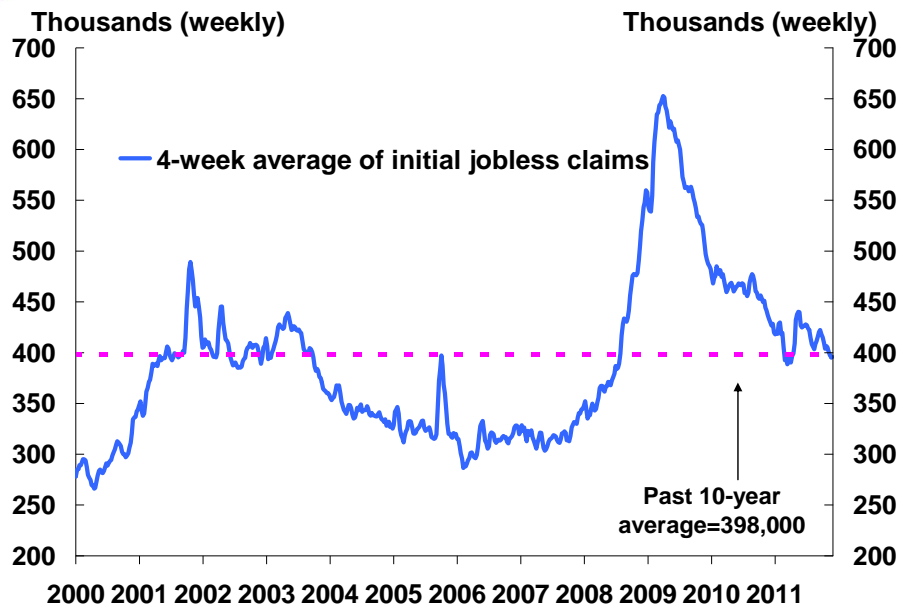
US: CONSUMPTION GROWTH & BUSINESS ACTIVITY



Source: CEIC



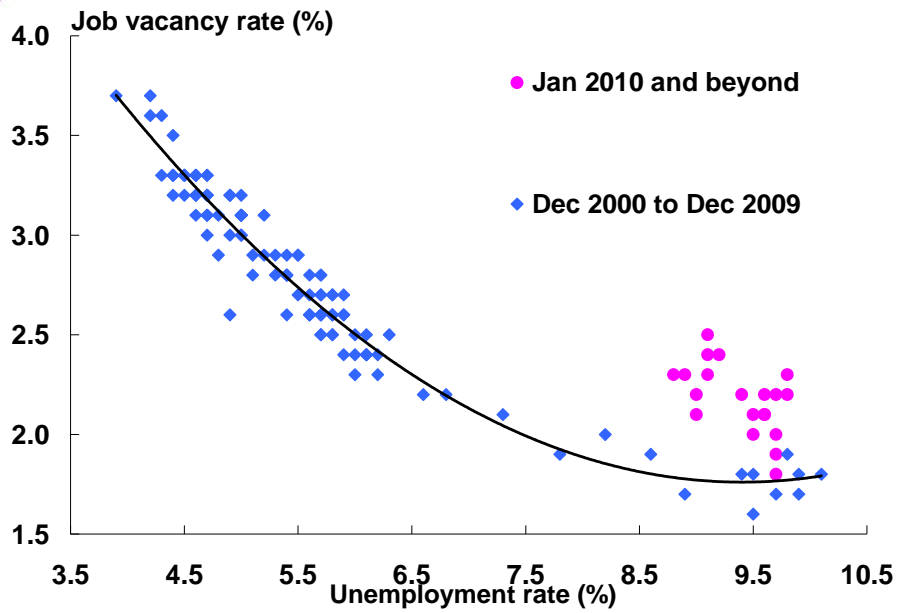
US: WEEKLY INITIAL JOBLESS CLAIMS



Source: CEIC



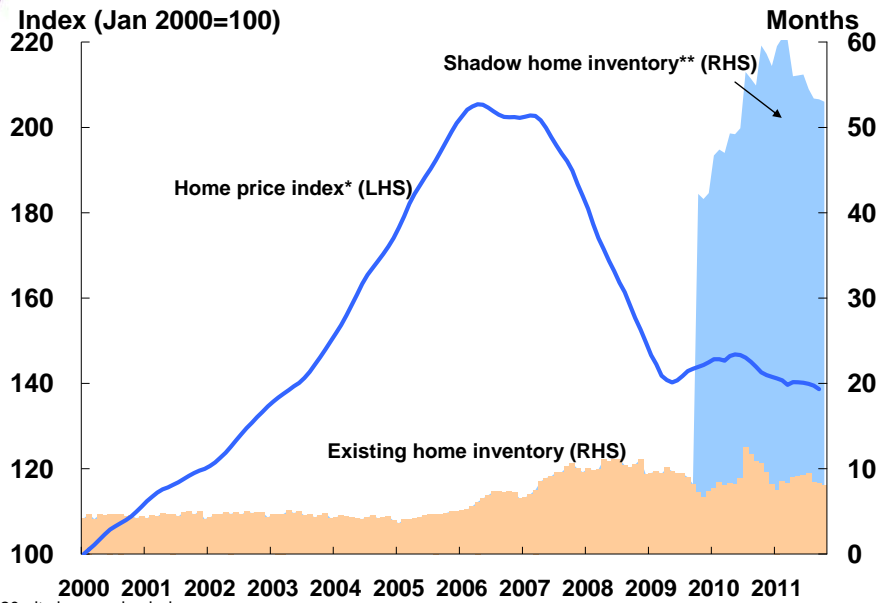
US: STRUCTURAL MISMATCH IN THE LABOUR MARKET



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



US : HOUSING PRICES AND INVENTORY



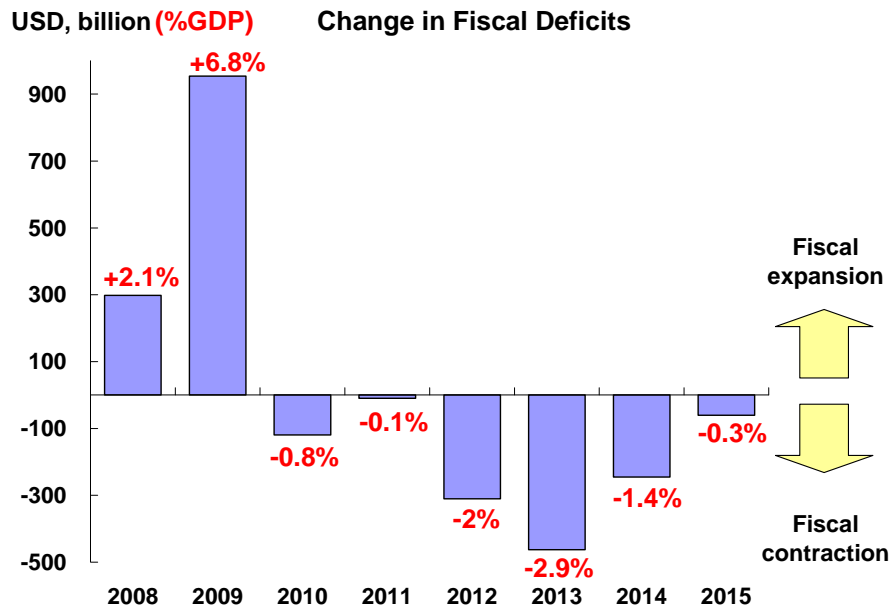
* Case-Shiller 20-city home price index

** 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



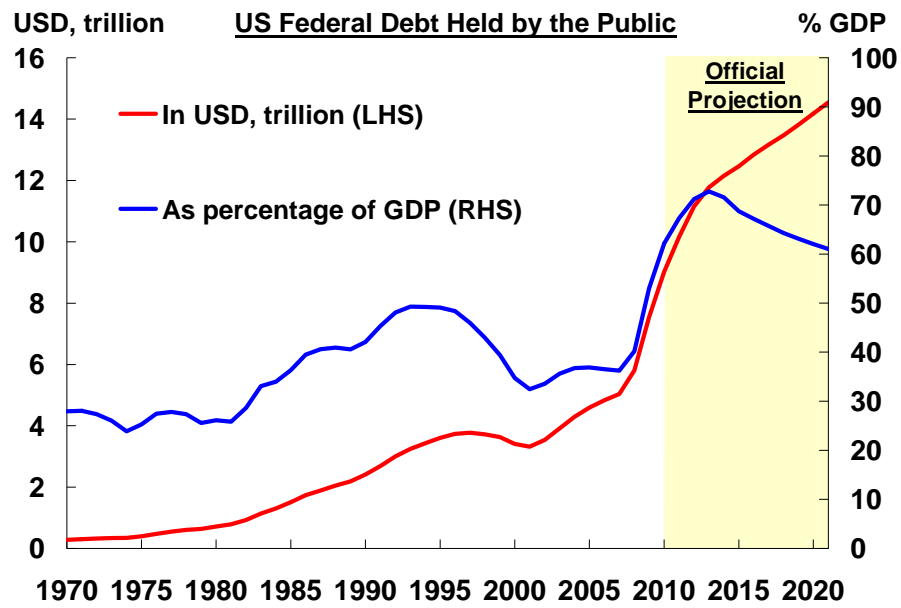
US: Fiscal consolidation



Sources: Congressional Budget Office and CEIC



US: Federal government debt



Source: Congressional Budget Office



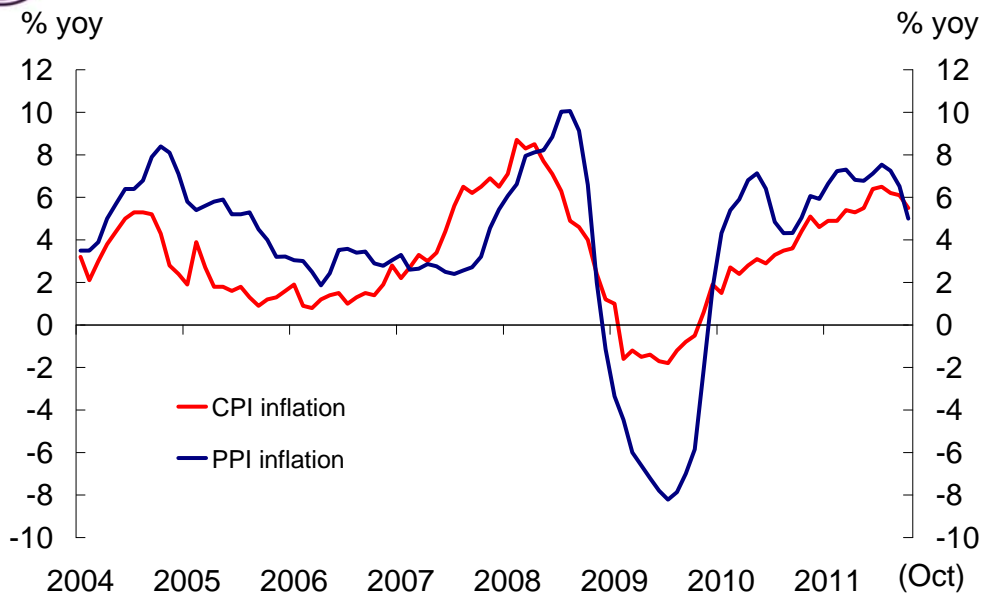
FORECASTS OF MAJOR INDICATORS IN MAINLAND CHINA

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

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



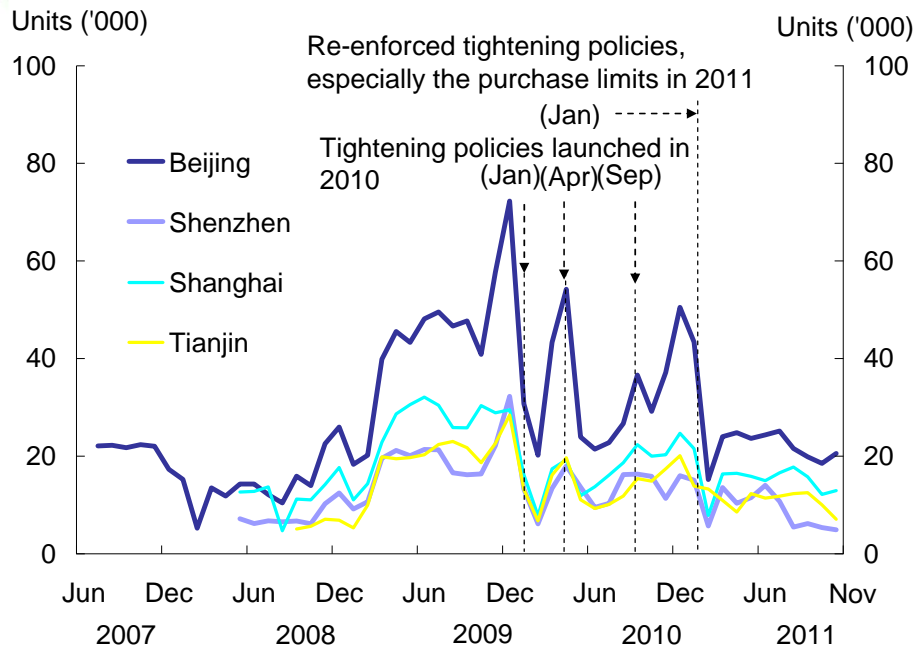
MAINLAND INFLATION RATES



Source: CEIC



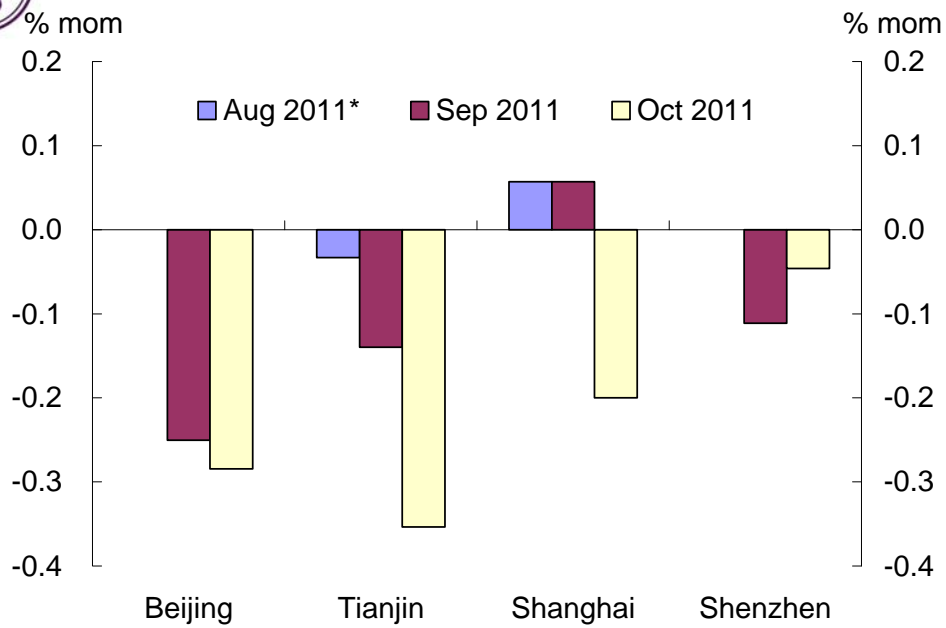
TRANSACTION VOLUME IN MAINLAND MAJOR CITIES



Source: WIND



HOUSING PRICE CHANGES IN MAINLAND MAJOR CITIES



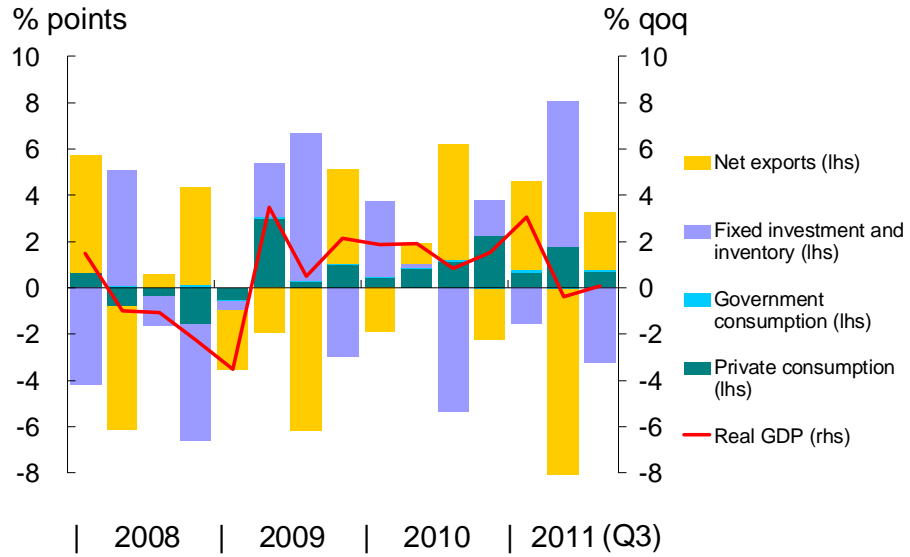
* Beijing and Shenzhen registered 0% mom in Aug 2011.

Sources: CEIC, WIND and staff estimates



HONG KONG ECONOMIC SITUATION

Changes in Real GDP

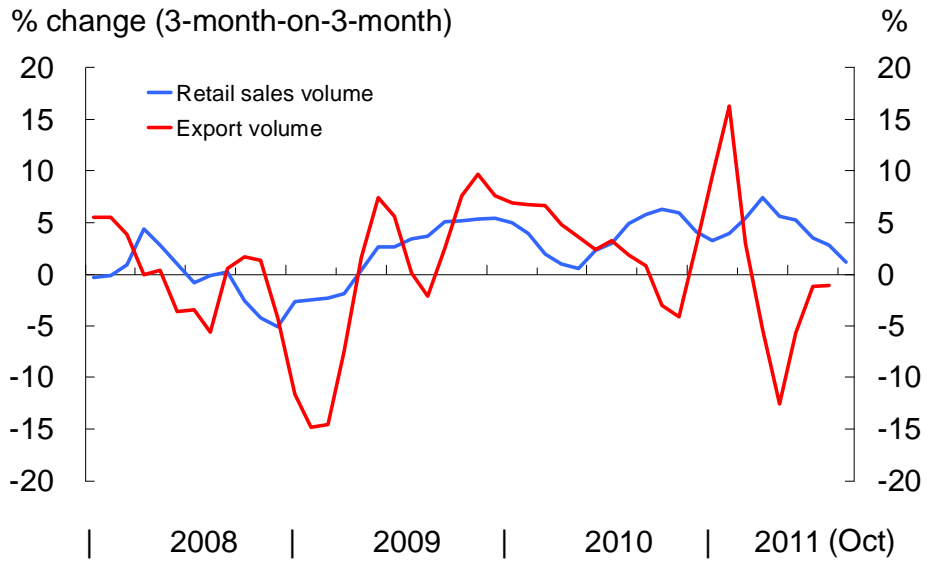


Sources: C&SD and staff estimates.



HONG KONG ECONOMIC SITUATION

Retail Sales and Exports

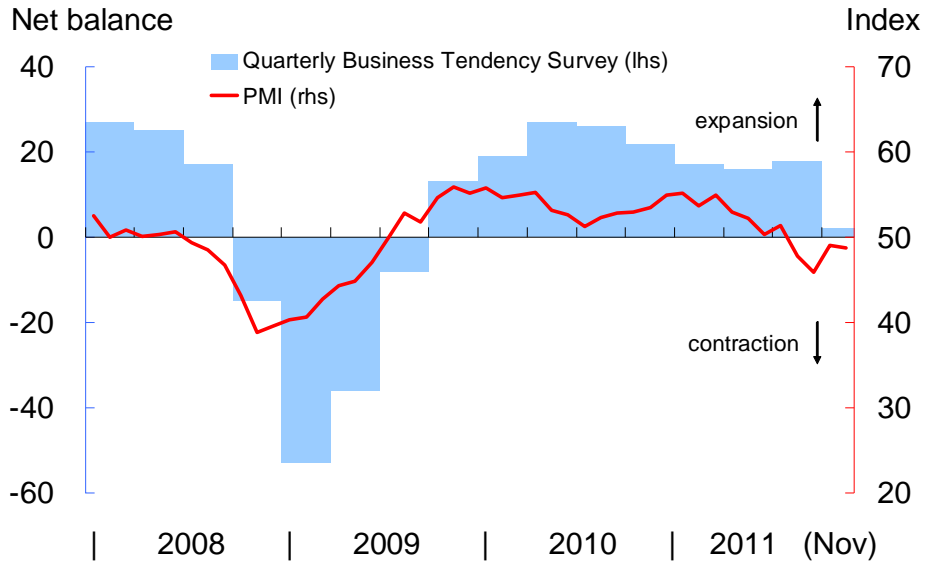


Source: C&SD.



HONG KONG ECONOMIC SITUATION

Business Outlook

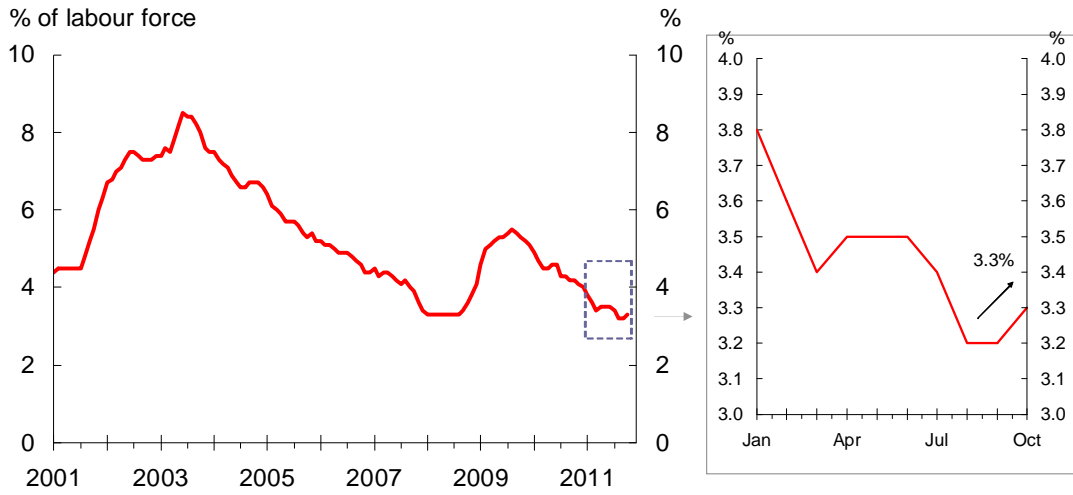


Sources: C&SD and Markit Economics.



HONG KONG ECONOMIC SITUATION

Unemployment rate

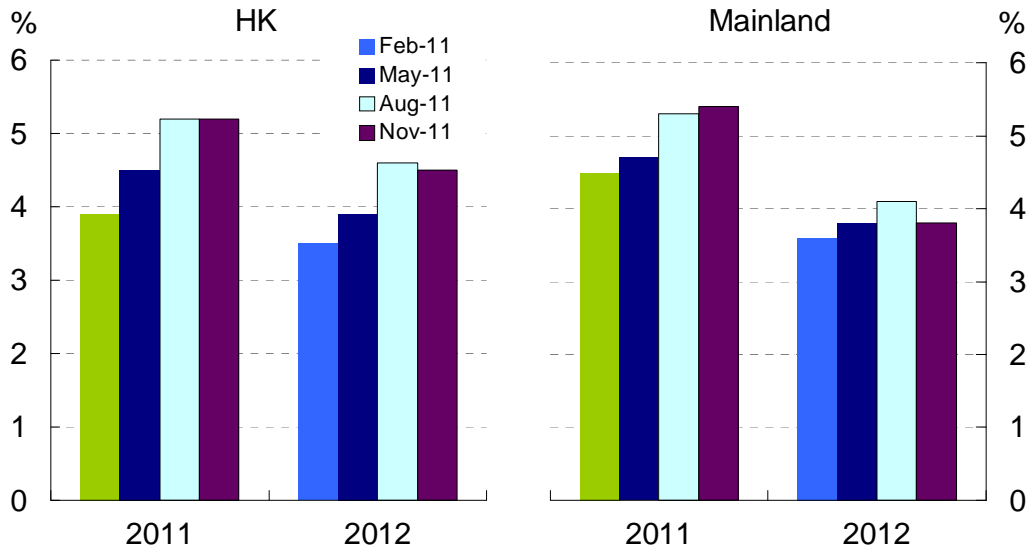


Source: C&SD.



HONG KONG ECONOMIC SITUATION

2011 and 2012 inflation forecasts for HK and Mainland

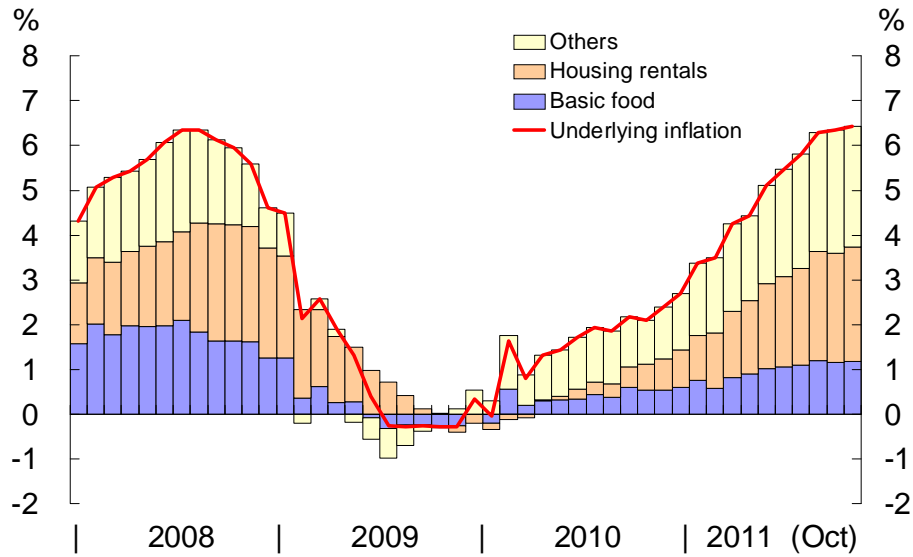


Source: Consensus Forecast (Feb, May, Aug and Nov 2011).



HONG KONG ECONOMIC SITUATION

Underlying inflation and contributions of its components

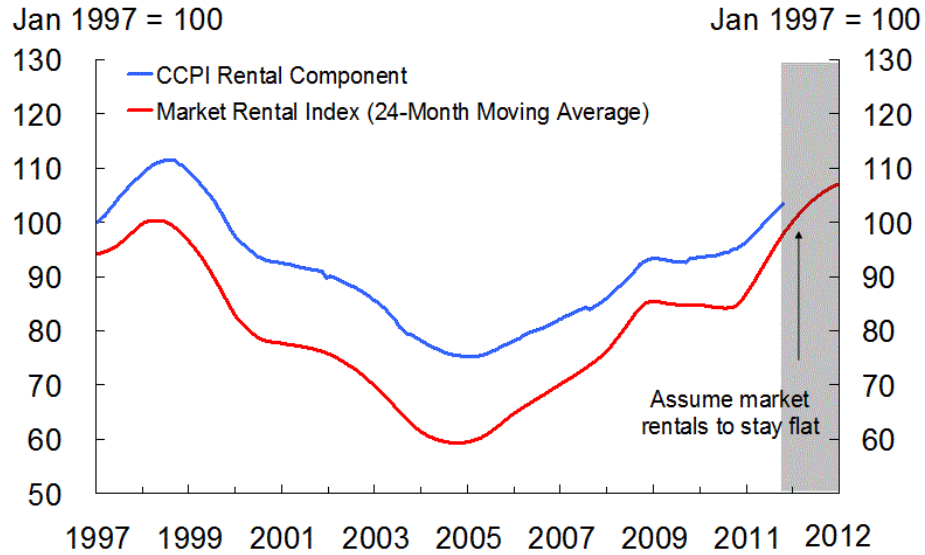


Underlying inflation: Netting out the effects of all Government's one-off relief measures from headline inflation.
Sources: C&SD and staff estimates.



HONG KONG ECONOMIC SITUATION

CCPI rental component and residential property rental index

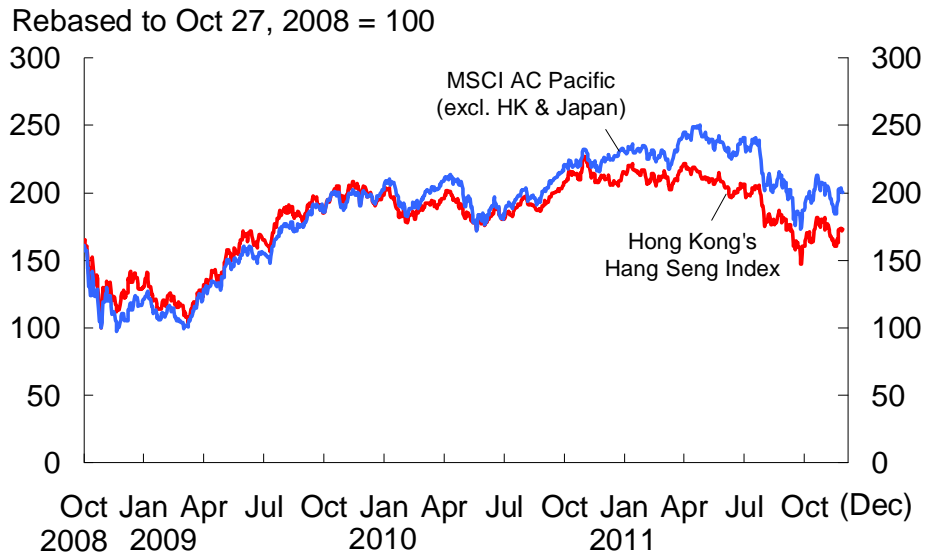


Sources: Rating and Valuation Department (R&VD), C&SD and staff estimates.



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

Hong Kong and Asia Pacific equity market performance

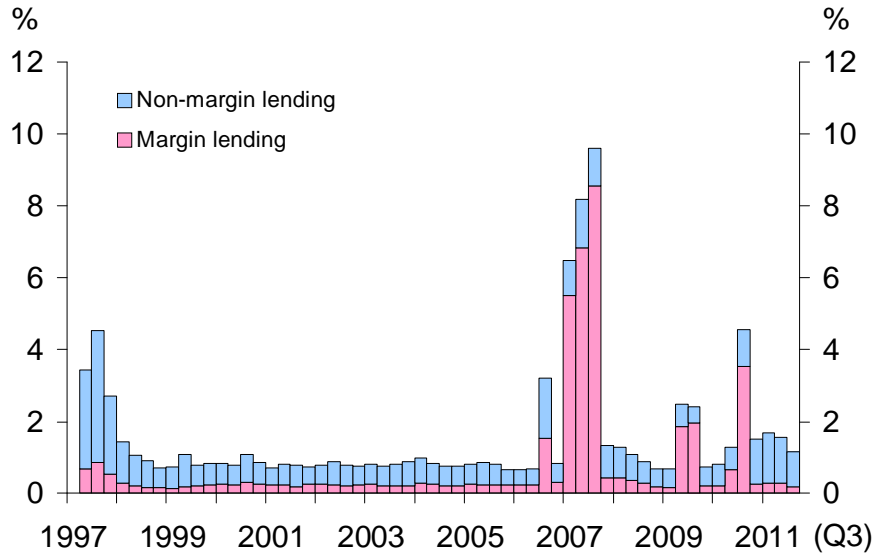


Source: Bloomberg.



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

Share of stock-market-related loans to total domestic loans

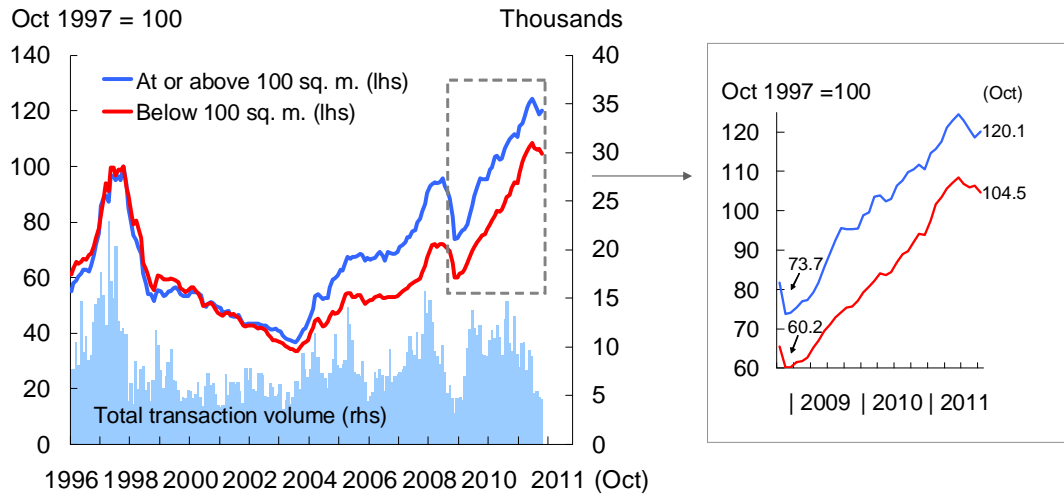


Source: HKMA.



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

Residential property prices and transaction volume

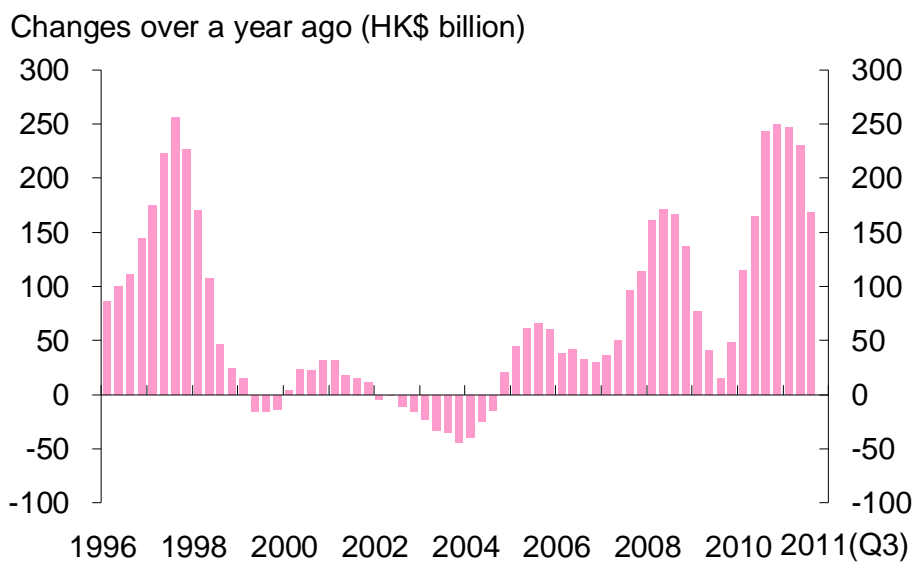


Source: Rating and Valuation Department.



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

Changes in property-related loans



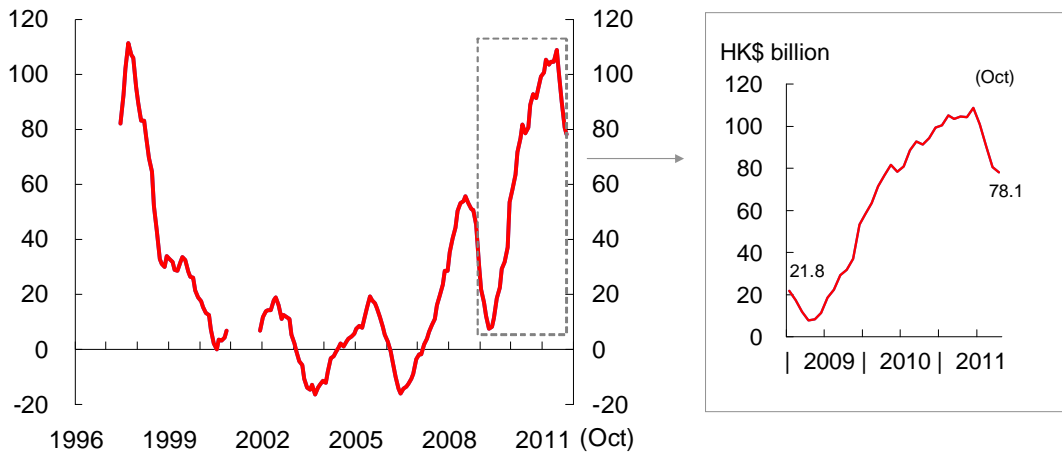
Source: HKMA.



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

Changes in outstanding mortgage loans

Changes over a year ago (HK\$ billion)

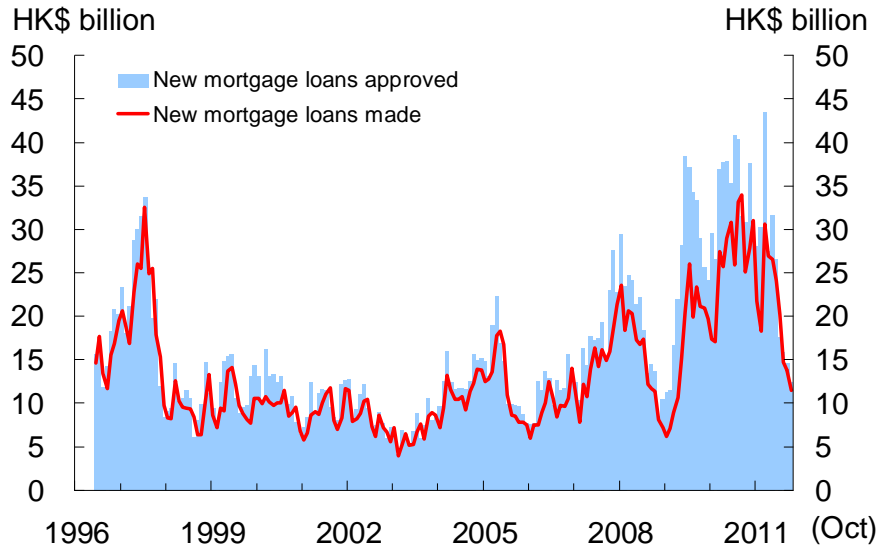


*There is a break in data series at December 2000 due to an increase in the number of surveyed institutions.
Source: HKMA.



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

New mortgage loans made and approved



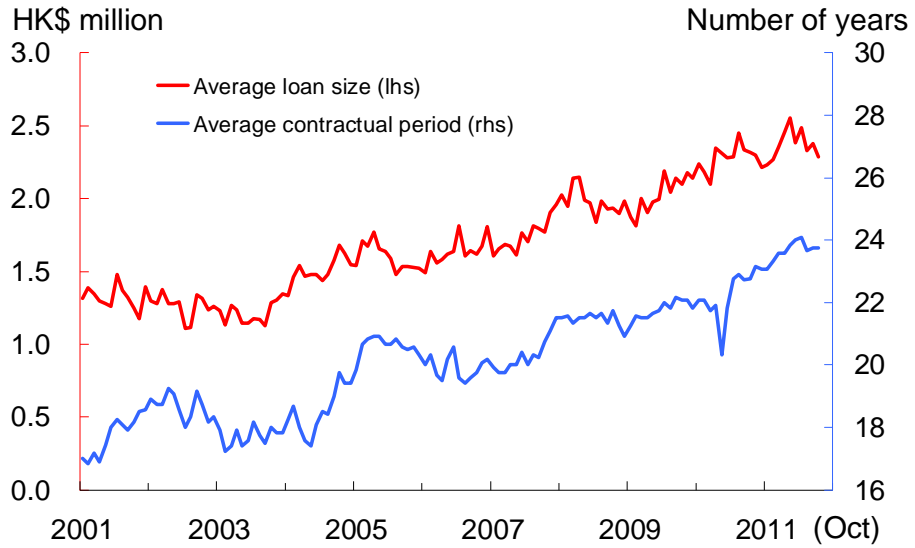
* There is a break in data series at December 2000 due to an increase in the number of surveyed institutions.

Source: HKMA.



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

Average loan size and average mortgage period

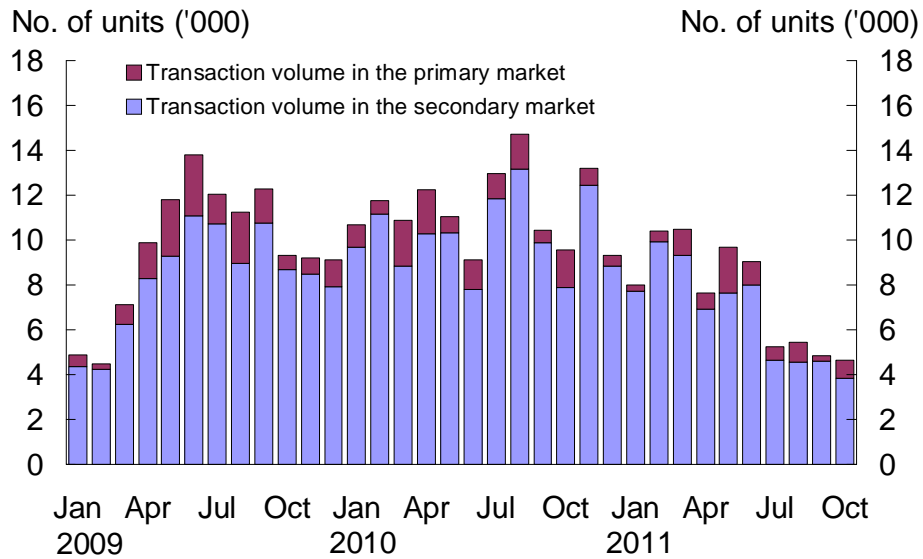


Source: HKMA.



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

Transaction volumes in residential property market

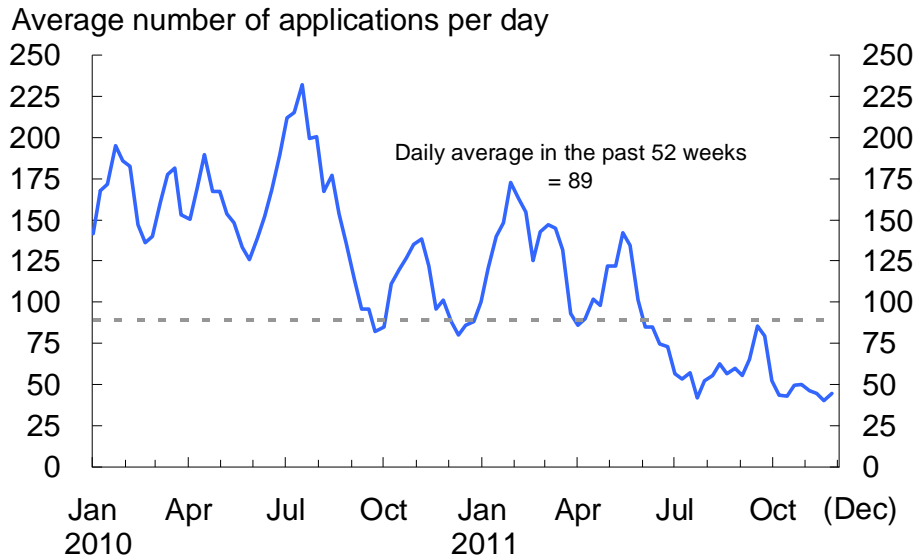


Source: Land Registry.



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

Applications under Mortgage Insurance Programme



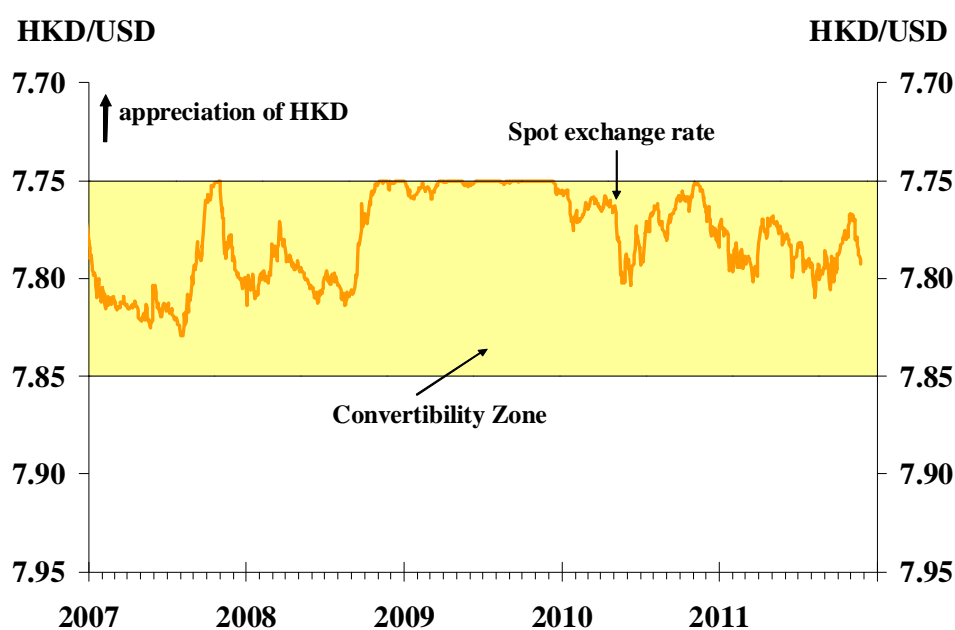
Source: Hong Kong Mortgage Corporation.



CURRENCY STABILITY



HONG KONG DOLLAR SPOT EXCHANGE RATE

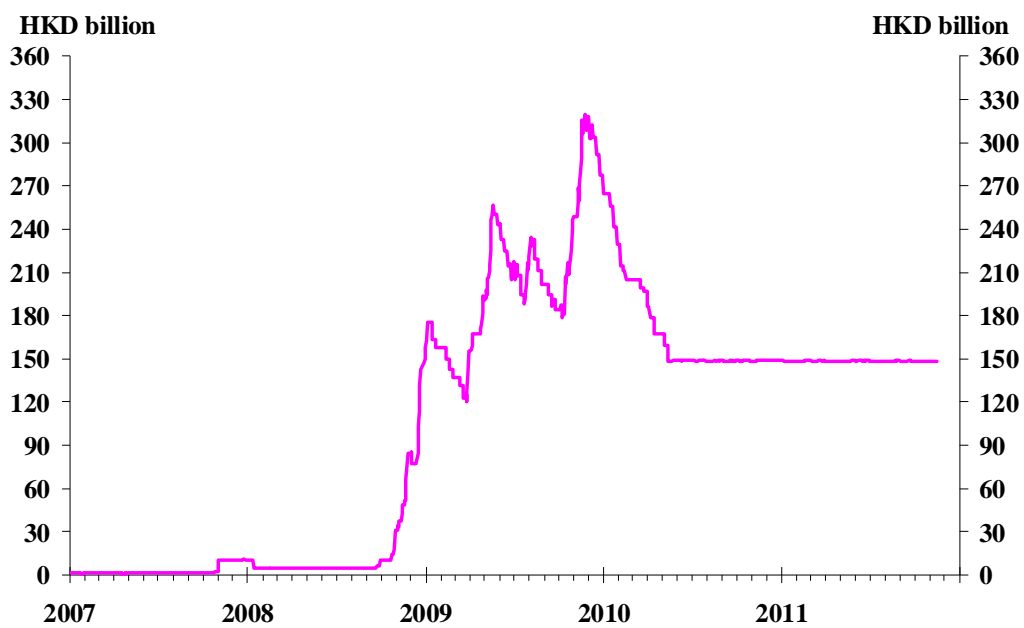


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- The Hong Kong dollar remained relatively stable despite increased concerns about the global economic outlook and European sovereign debt problems..



AGGREGATE BALANCE

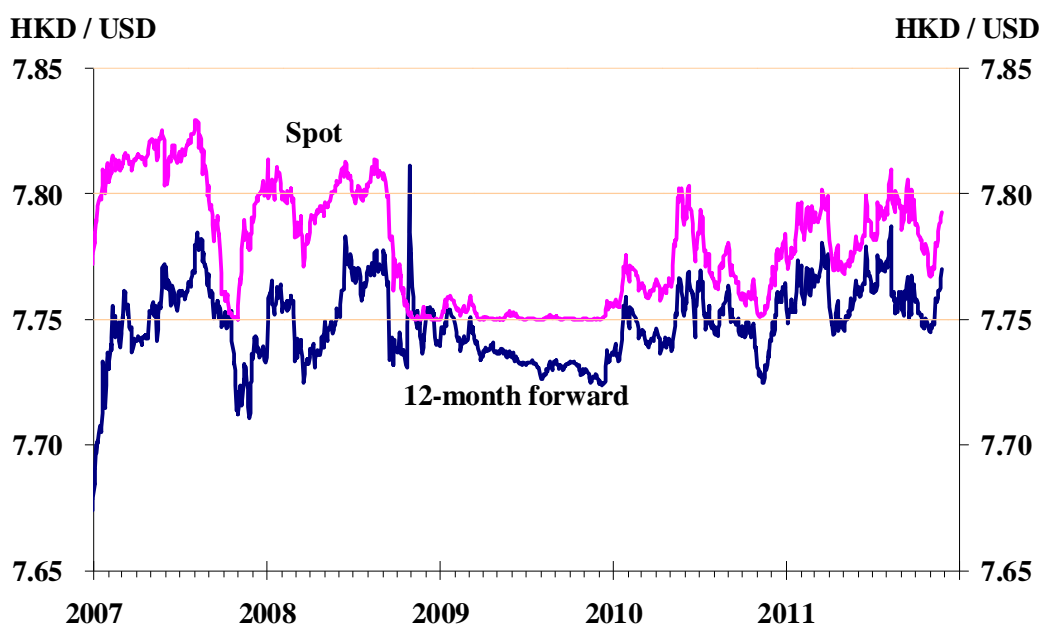


40

- 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

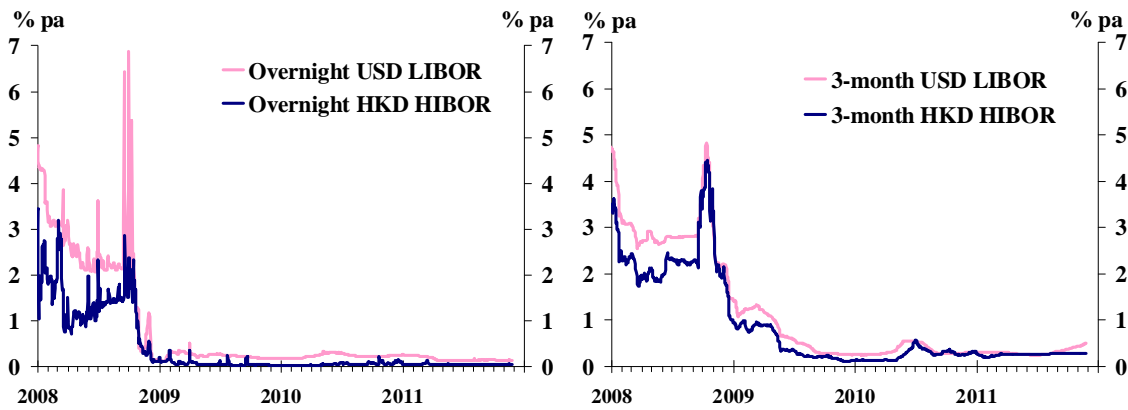


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- Interest rate differentials between the Hong Kong dollar and US dollar and the Hong Kong dollar forward discounts were broadly steady, although risk aversion arising from the European sovereign debt crisis led to tighter USD funding conditions in the global market.



DOMESTIC INTEREST RATES

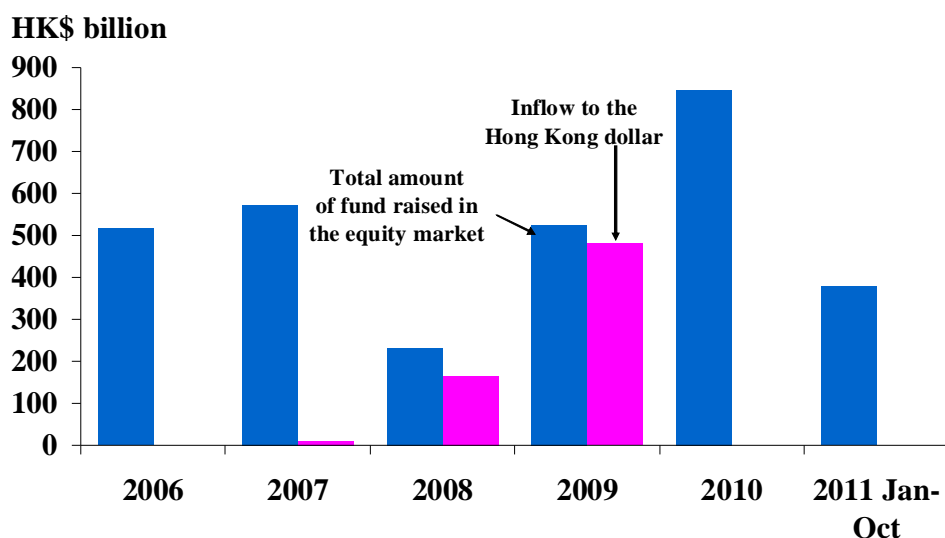


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- With abundant liquidity, Hong Kong dollar interest rates were broadly stable and remained below their US dollar counterparts.



EQUITY FUND-RAISING AND NET INFLOWS



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 has slowed in the recent months. A total of HK\$378.6 billion of funds was raised in the Hong Kong stock market so far this year, down from HK\$549.6 billion those raised in the same period last year.



BANKING STABILITY



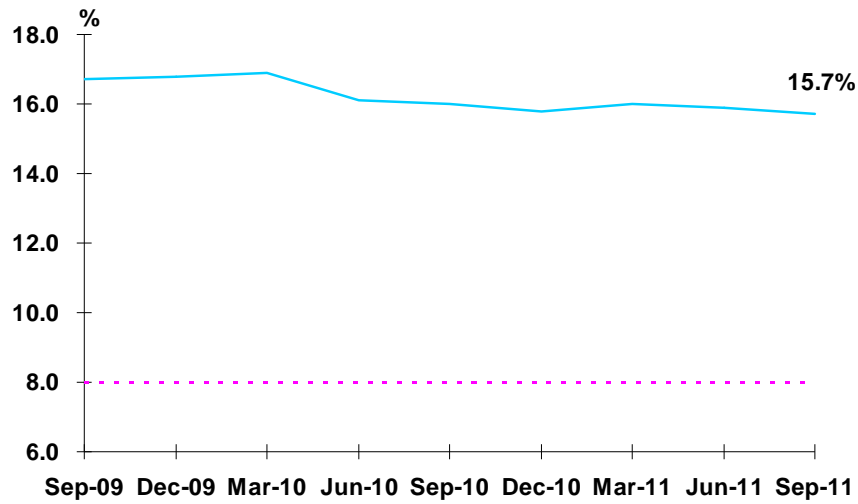
BASEL II Enhancements & BASEL III Implementation Progress

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



BANKING SECTOR PERFORMANCE

Locally incorporated AIs continued to be well capitalised



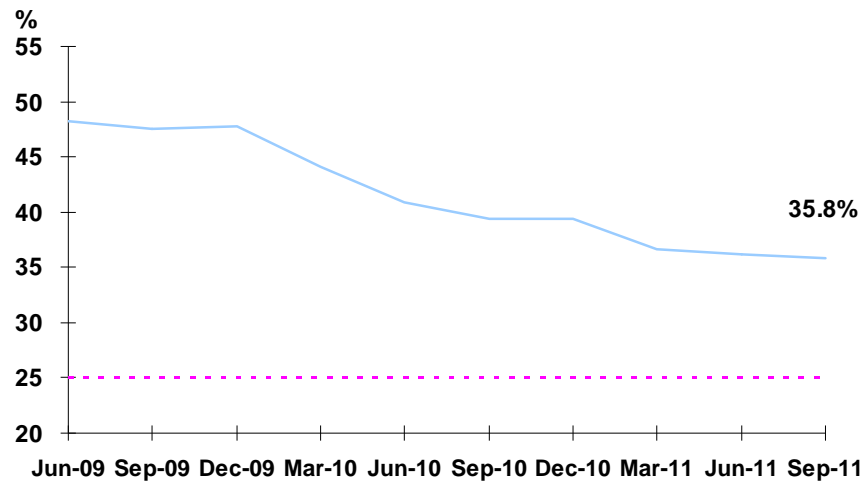
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- The consolidated capital adequacy ratio of locally incorporated AIs was 15.7% at the end of September 2011, compared with 15.9% at the end of June 2011. The ratio remained well above the international standard of 8%.



BANKING SECTOR PERFORMANCE

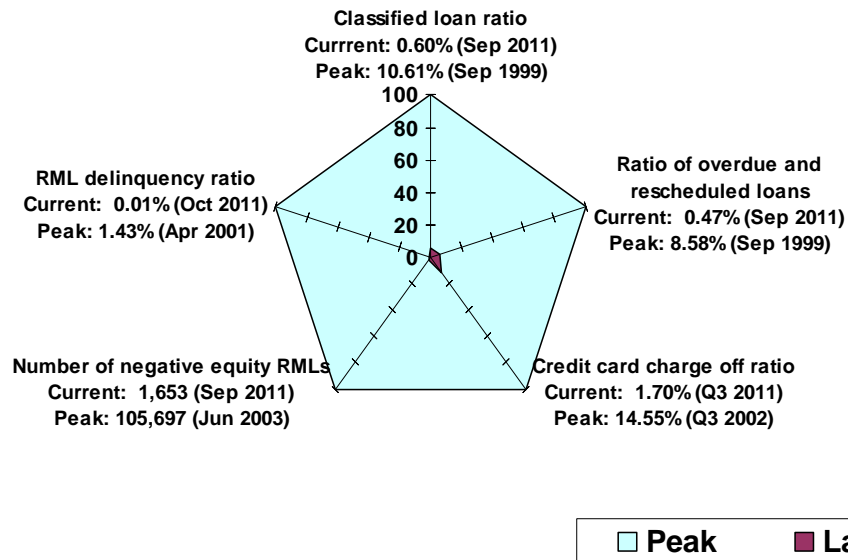
Liquidity ratio of retail banks remained well above statutory minimum of 25%





BANKING SECTOR PERFORMANCE

Asset quality indicators remained good compared with historical standards

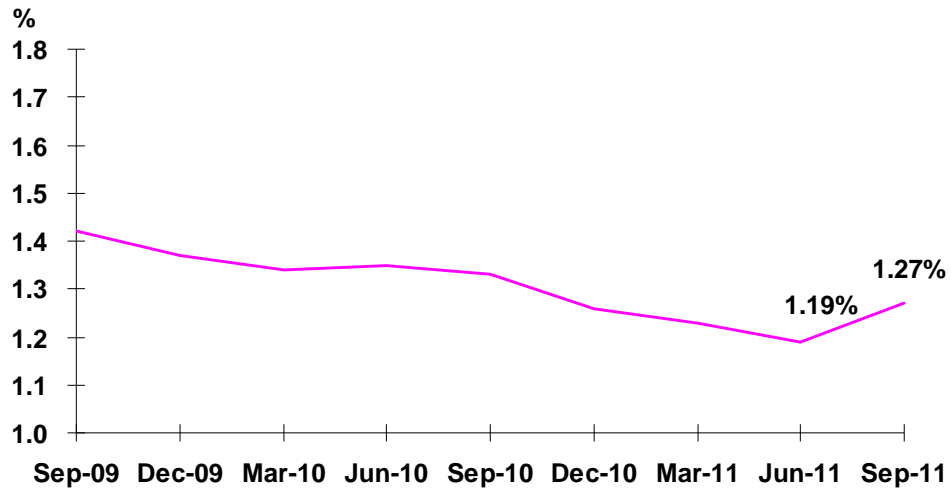


- The HKMA continues to monitor closely the asset quality of retail banks' loan portfolios.



BANKING SECTOR PERFORMANCE

Net interest margin of retail banks



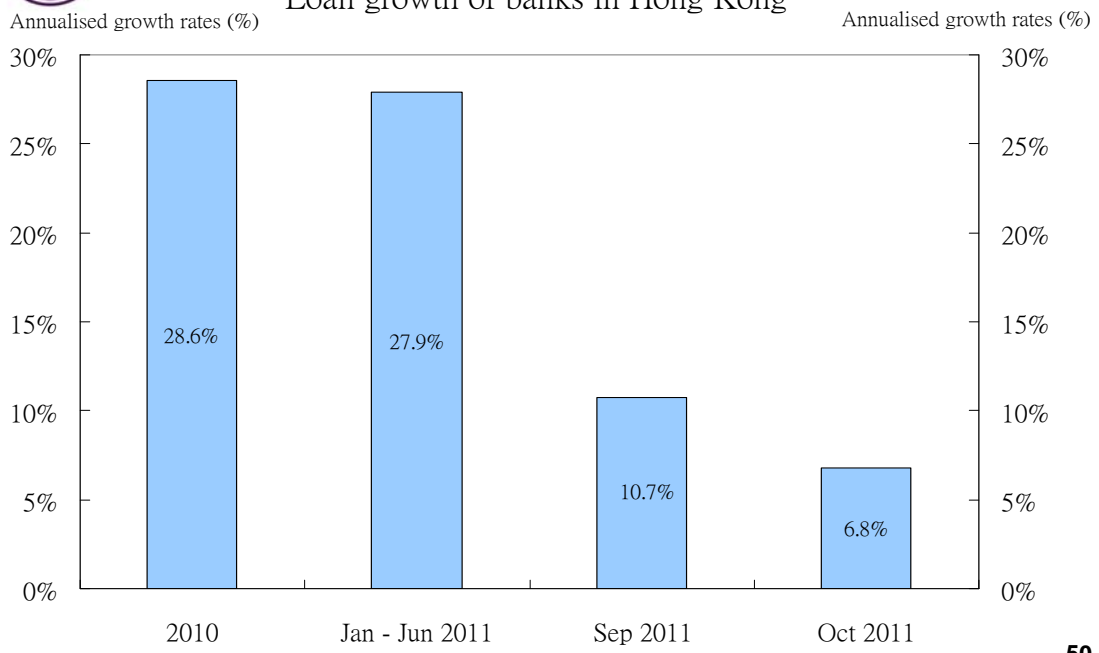
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- The quarterly annualised net interest margin of retail banks rebounded to 1.27% in Q3 2011 as net interest income increased during the quarter despite an increase in funding costs.
- The aggregate pre-tax operating profit of retail banks' Hong Kong offices in the first three quarters of 2011 increased by 22.2% compared with same period last year, as an improvement in both interest income and non-interest income lifted banks' profitability.



CREDIT GROWTH OF BANKS IN HONG KONG

Loan growth of banks in Hong Kong





RISK MANAGEMENT IN RESIDENTIAL MORTGAGE LOANS (“RMLs”)

- In May and June 2011, there were signs of renewed exuberance following high transaction prices recorded in government land sale auctions. The HKMA introduced on 10 June the fourth round of countercyclical macroprudential measures to strengthen the risk management of banks in Hong Kong.
- Recently, we observed signs of slowing down in the property market amid deepening of the European sovereign debt crisis, uncertainties over the global economic outlook and increases in mortgage rates.
- Property transaction in Q3/2011 fell noticeably. In October, the number of new RML applications dropped to 6,613, which was 71% lower than the recent peak recorded in March 2011. The value of new RMLs approved fell 71% over the same period to HK\$12 billion.

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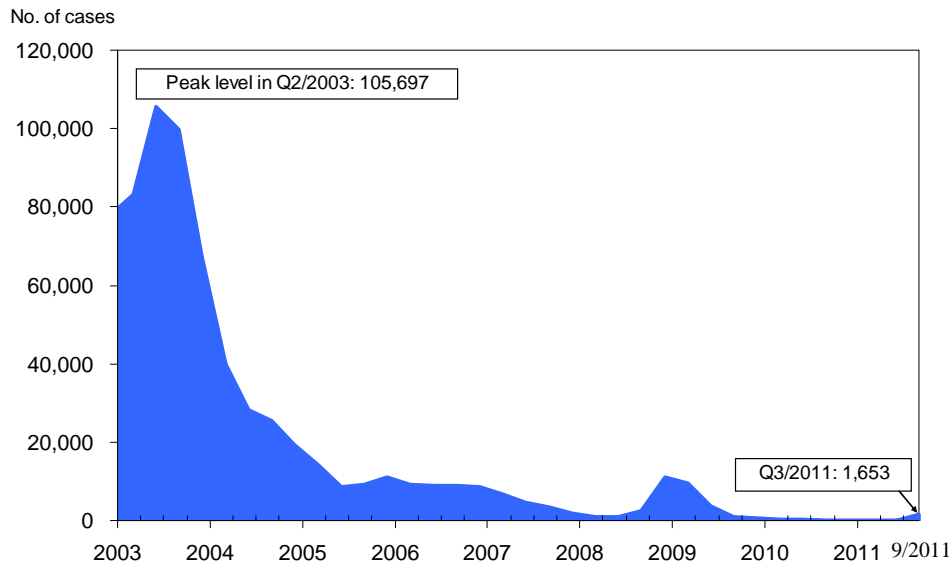
The HKMA issued on 10 June 2011 guidelines to the banks requiring them to implement the following measures to strengthen risk management in RML business:

- (i) the maximum loan-to-value (“LTV”) ratio for residential properties with a value between HK\$10 million and HK\$12 million is lowered to 50%. In other words, the 50% maximum LTV ratio introduced in November last year is applicable to all residential properties with a value of HK\$10 million or above.
- (ii) the maximum LTV ratio for residential properties with a value between HK\$7 million and HK\$10 million is lowered to 60%, with the maximum loan amount capped at HK\$5 million.
- (iii) the maximum LTV ratio for residential properties with a value below HK\$7 million is 70%, with the maximum loan amount capped at HK\$4.2 million.
- (iv) if the principal income of the mortgage loan applicant is not derived from Hong Kong, the applicable maximum LTV ratio is lowered by at least 10 percentage points regardless of property types or values.
- (v) the maximum LTV ratio for properties under the net worth-based mortgage is lowered from 50% to 40%.



RESIDENTIAL MORTGAGE LOANS (“RMLs”) IN NEGATIVE EQUITY

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



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Statistics on RMLs in negative equity

	12/2010	3/2011	6/2011	9/2011
Total outstanding number of RMLs in negative equity	118 (0.02%)	59 (0.01%)	48 (0.01%)	1,653 (0.3%)
Total outstanding value of RMLs in negative equity (HK\$Mn)	147 (0.02%)	72 (0.01%)	58 (0.01%)	4,148 (0.5%)
Value of unsecured portion (HK\$Mn)	46 *	22 *	18 *	165 (0.02%)
Proportion of RMLs in negative equity with delinquencies of more than three months	0.7%	0%	0%	0%

() as percentage of total outstanding RMLs

* Less than 0.01% as percentage of total outstanding RMLs



RESIDENTIAL MORTGAGE LOANS (“RMLs”) IN NEGATIVE EQUITY

- The vast majority of the negative equity cases were related to mortgage loans with loan-to-value ratio at 90% or above, including staff housing loans and RMLs under mortgage insurance programme.
- The increase in the number of negative equity does not affect the overall quality of the RML portfolio of the banking sector. As of end-September 2011, there has not been any RMLs in negative equity with repayment overdue for more than three months.
- The HKMA will continue to monitor the market situation closely and introduce appropriate measures in the light of the latest development in the property market to safeguard the banking stability in Hong Kong.



INVESTOR PROTECTION

- Results of mystery shopping exercise were published in May
- Issued a circular in October to further elaborate on the HKMA's expected standards of conduct for AIs engaged in selling accumulators
- Stepped up efforts in investor education, e.g. regarding the risks of exchange-traded funds and accumulators
- 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
- The HKMA will jointly host with the OECD and the SFC a Regional Seminar on Financial Consumer Protection and Education in Hong Kong in the second half of 2012

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- With a view to enhancing the industry's sales practice, the HKMA published on 24 May the findings of the mystery shopping exercise on the sales practices of retail banks in respect of unlisted investment products and structured deposits. AIs were required to give due regard to the issues identified and were encouraged to adopt the good practices set out in the report.
- In view of the recent market volatility and further to the HKMA's circular of 22 December 2010 on accumulators, the HKMA issued a circular to all AIs in October 2011 to further elaborate on the HKMA's expected standards of conduct of AIs engaged in selling accumulators. In particular, selling of accumulators should be justified with specific grounds acknowledged by the customer.
- The HKMA has stepped up efforts in investor education. The HKMA issued "*inSight*" articles to highlight key features and risks of exchange traded funds and accumulators in August and September respectively.
- The FSTB is finalising the Memorandum and Articles of Association and Terms of Reference of the FDRC. FSTB plans to register the FDRC Limited under the Companies Ordinance in November.
- The tentative duration of the Seminar would be around 1.5 days. 80-100 speakers and participants from Hong Kong, Mainland China, South East Asia/ASEAN Region, OECD International Network on Financial Education (INFE) and Task Force on Financial Consumer Protection would be invited to the Seminar.
- The HKMA is in discussion with the OECD and the SFC on the topics to be discussed in the seminar as well as the list of speakers and participants to be invited to the seminar.



SHARING OF MORTGAGE DATA FOR CREDIT ASSESSMENT

- AIs that have mortgage business have completed the IT development work required for full automation of uploading mortgage data to the Credit Reference Agency and mortgage count enquiry.
- The HKMA is working with the industry to set the threshold for non-mortgage related consumer credit facilities as required by the Office of the Privacy Commissioner for Personal Data (PCPD). Subject to the PCPD's endorsement of the threshold, for non-mortgage related consumer credit facilities of an amount not less than the threshold, AIs will be allowed to access the mortgage count of customers for the purpose of considering granting, renewing or reviewing such non-mortgage related consumer credit facilities.

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- HKAB plans to survey members' views on the appropriate level of the threshold for non-mortgage related consumer credit facilities for discussion with the Office of the Privacy Commissioner for Personal Data.



DEPOSIT PROTECTION

- The Deposit Protection Scheme (DPS) has been operating smoothly for 5 years. Under the enhanced protection limit of HK\$500,000, 90% of depositors are fully protected by the DPS.
- A peer review on deposit insurance system (DIS) was launched by the Financial Stability Board in June 2011. The HKMA, representing Hong Kong, is chairing the review team. Opportunity will also be taken to assess the robustness of the DPS in Hong Kong, taking into account reform experience of other major DIS.
- Closely monitoring the compliance of banks with the enhanced representation requirements on protection status of deposits. On-site examinations have commenced.
- Extensive publicity campaigns continued to maintain public awareness of the DPS at a high level.

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- Under the Deposit Protection Scheme Ordinance, the Deposit Protection Board is required to perform its functions through the HKMA.
- The Financial Stability Board (“FSB”) has launched a peer review of deposit insurance systems (“DIS”). The review is to take stock of the DIS of 24 FSB member jurisdictions, using the Core Principles for Effective DIS issued jointly by the Basel Committee on Banking Supervision and the International Association of Deposit Insurers as a benchmark. The review also seeks to draw lessons of experience on the effectiveness of reforms implemented in response to the recent financial crisis. The report concluding the review results will be published in early 2012.



FINANCIAL INFRASTRUCTURE



REFORMING OTC DERIVATIVES MARKET

- To comply with the G20's commitments in reforming the OTC derivatives market, Hong Kong is working towards putting in place a regulatory regime for its OTC derivatives market by end-2012. The HKMA and SFC are currently working with the Government on the legislative amendments necessary for implementing this new regulatory regime
- The HKMA and SFC jointly issued a consultation paper on the proposed regulatory regime for the OTC derivatives market on 17 October 2011. Market comments in response to this consultation will be critical to finalising some of the key aspects of the regime and the legislative amendments
- The proposed regulatory regime will cover mandatory reporting and clearing requirements. The reporting and clearing requirements will initially be applied to interest rate swaps and non-deliverable forwards, and will extend to other asset classes in subsequent phases
- The HKMA will ride on its existing Central Moneymarkets Unit (CMU) infrastructure to develop a trade repository. Hong Kong Exchanges and Clearing Ltd is also building a local central counterparty for OTC derivatives in Hong Kong. These infrastructures are scheduled for launch in 2012



GOVERNMENT BOND PROGRAMME

- Institutional Bond Issuance Programme:
 - Eight issues totalling HK\$35.5 billion outstanding as at mid-November
 - 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:
 - Successful issuance of HK\$10 billion inflation-linked bond, the iBond, to Hong Kong residents on 28 July
 - Attracted over 155,000 applications, with application monies exceeding HK\$13 billion
 - Help promote retail investors' awareness and interest in bond investment

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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.
- 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.
- As for the Retail Bond Issuance Programme, its objective 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 offering was completed with a successful issuance of HK\$10 billion iBond to HK residents on 28 July. A total of 155,835 valid applications were received for around HK\$13.16 billion in principal amount of bond.



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, and also provide them with insights on our regulatory developments, as they plan to establish or expand their presence in Hong Kong. Promotional campaigns so far covered New York, London, Switzerland and Luxembourg
- Building on the feedback from our regular dialogues with industry players, we continue to improve our platform and keep pace with the latest developments in the asset management industry

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- With the promising growth prospects of the Asian region, there has been increasing interest for 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.



FINANCIAL INFRASTRUCTURE

- Continued to maintain safety and efficiency of financial infrastructure
- Continued to enhance financial infrastructure, especially for supporting the continual growth 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 bulk settlement runs and optimisers. We have brought the RMB RTGS system largely in line with the HKD RTGS system in terms of functionality.

Trade Repository

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

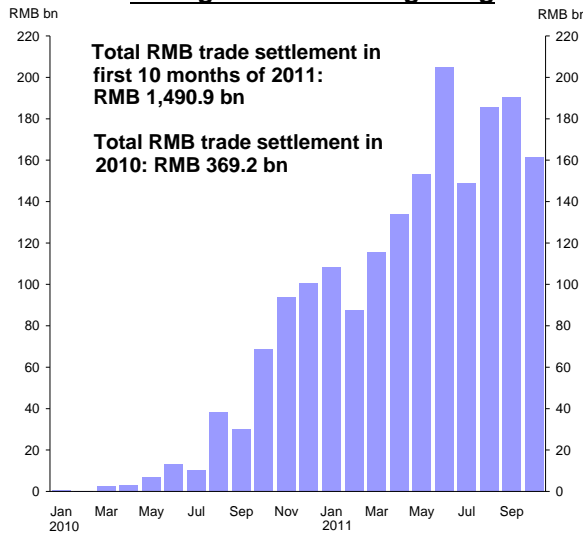


HONG KONG AS AN INTERNATIONAL FNANCIAL CENTRE



Continuous progress in RMB trade settlement

RMB trade settlement conducted through banks in Hong Kong



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

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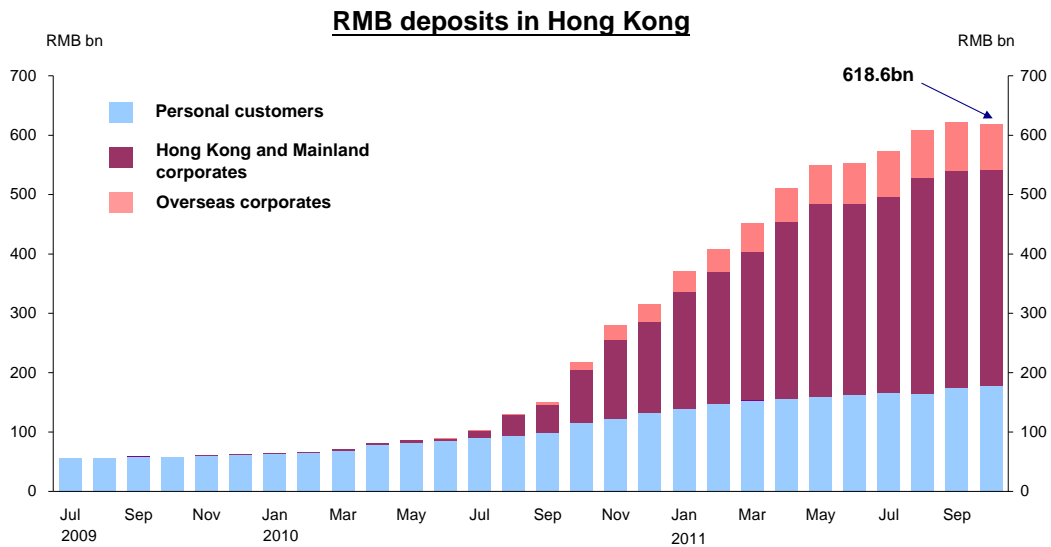
2010	Annual	369.2	72.9
2011	Q1	311.3	86.4
	Q2	492.7	82.5
	Q3	525.4	90.1

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



Steady growth of RMB deposits in Hong Kong

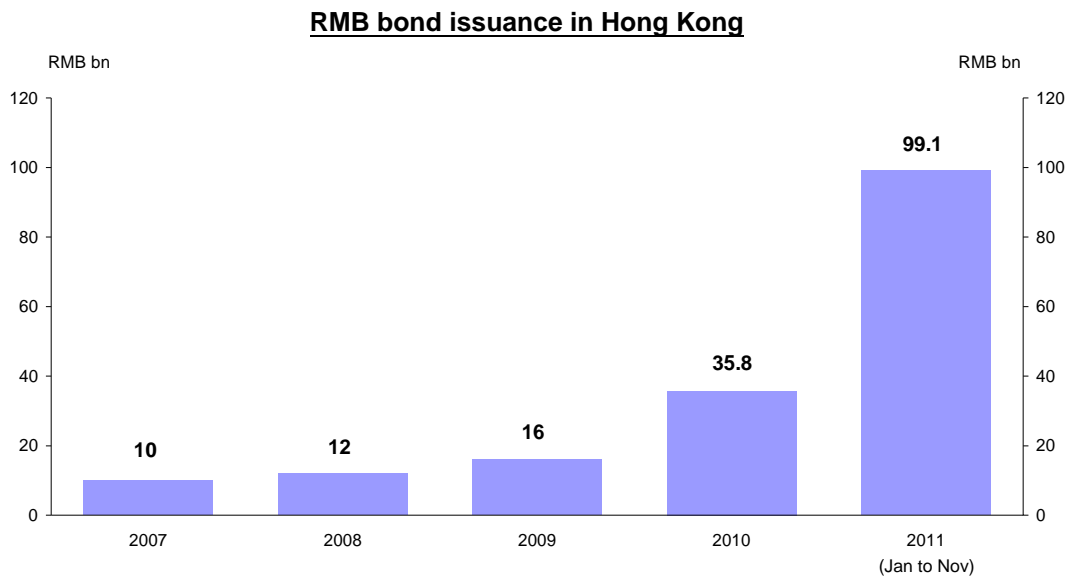


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- RMB deposits in Hong Kong almost doubled from RMB314.9 billion yuan in the beginning of this year to RMB618.6 billion yuan at end-October. RMB deposits of corporates increased by RMB259 billion yuan to over RMB440 billion yuan at end-October, representing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



Significant expansion of RMB bond issuance in Hong Kong



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



Hong Kong as key platform supporting RMB business overseas

- **A global RMB payment and settlement network**
 - At end-Oct 2011, there were 184 participating banks in Hong Kong's RMB clearing platform, of which 161 were branches and subsidiaries of foreign banks and overseas branches of Mainland banks
 - Banks in Hong Kong are also actively providing RMB correspondent banking services to banks overseas

- **HKMA's proactive promotion work**
 - **2011:** Conducted roadshows in Australia, Russia, UK and Spain
 - **2012:** Plans to visit South America and other places with close trade and investment links with China



Promising Outlook for Hong Kong as Offshore RMB Centre

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

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- The support for Hong Kong to develop as offshore RMB business centre has been set out in the national 12th Five-Year Plan. A series of supportive measures was also announced in August. In particular, implementation of the administrative arrangements for the use of RMB for foreign direct investments (FDI) will greatly expand the use of RMB funds in Hong Kong and promote the development of the RMB bond market and financing activities in Hong Kong.
- The PBoC and the HKMA renewed the currency swap agreement with an expanded size from RMB200 billion yuan to RMB400 billion yuan. This will allow the HKMA to provide liquidity to maintain the stability of the offshore RMB market in Hong Kong when necessary, thereby facilitating the steady development of the business.



INCREASING REGIONAL AND INTERNATIONAL FINANCIAL CO-OPERATION

Financial Stability Board (FSB)

- The HKMA attended Plenary Meetings of the FSB in July and October. The meetings discussed risks and vulnerabilities affecting global financial stability, and reviewed the progress of major regulatory reform initiatives. A package of measures to address the moral hazard risks posed by systemically important financial institutions was developed and endorsed by G20 Leaders. The reform of the OTC derivatives markets will be the main focus of FSB in 2012.
- The HKMA attended the inaugural meeting of the FSB Regional Consultative Group for Asia in November, which was set up to broaden outreach to non-FSB members in the region. The HKMA participated in the discussion on the importance of capital markets development for financial stability.

Executives' Meeting of East Asia and Pacific Central Banks (EMEAP)

- The HKMA conducted analyses for discussion at the EMEAP Deputies' and Monetary and Financial Stability Committee Meetings in November to assess risks and vulnerabilities in the region and policy implications. Members also discussed issues of common interests in the global financial regulatory reforms.



INVESTMENT ENVIRONMENT AND PERFORMANCE OF THE EXCHANGE FUND



INVESTMENT ENVIRONMENT IN Q1-Q3 2011

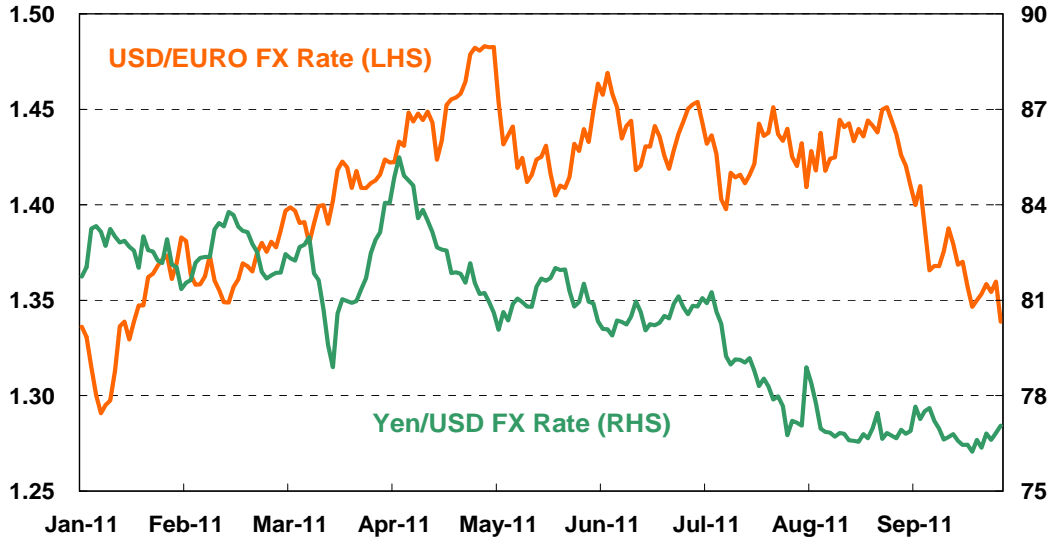
- **Exchange rates:** The US dollar weakened against major currencies in Q1 and came under further pressure through August, especially after one notch downgrade by S&P. However, safe haven flows amid concerns of deeper European debt crisis, liquidity problem of European banks and possible economic recession drove US dollar markedly higher in September.
- **Equity markets:** After posting modest gains in Q1, major stock markets in developed economies became volatile as risk appetite deteriorated. Selling pressure intensified after the credit rating downgrade of the US and amid the worsening European sovereign debt crisis. All stock indices fell sharply in Q3.
- **Interest rates:** US Treasury yields rose in the first quarter on investor expectation of economic improvement but fell significantly in the second quarter amid safe haven flows into bond market as the European sovereign debt crisis intensified. In view of the weaker economic outlook and in anticipation of the additional policy accommodation by the Fed, US Treasury yields declined significantly in Q3, hovering around the lowest levels in decades. Meanwhile, German government bond yields also fell in tandem.



CURRENCY MARKETS

USD/Euro FX Rate

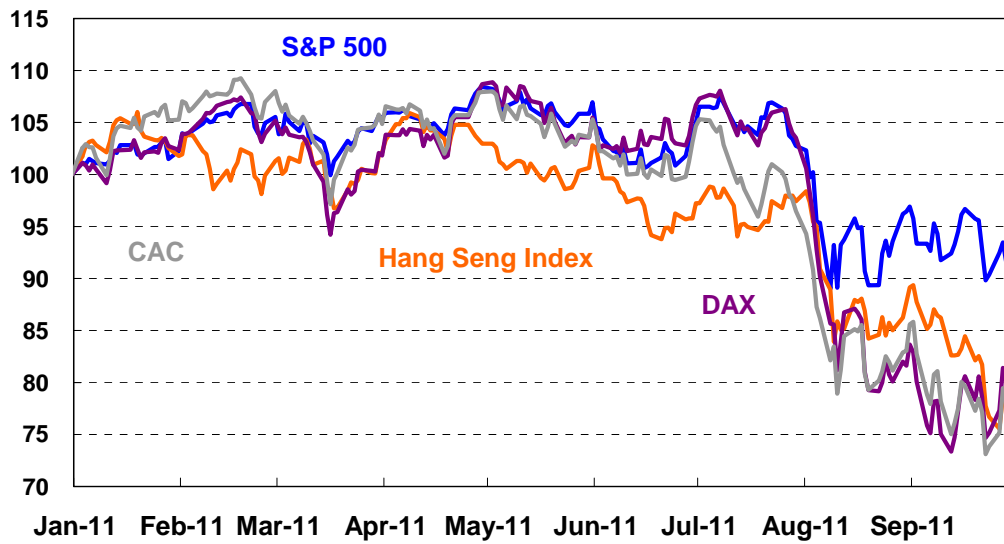
Yen/USD FX Rate





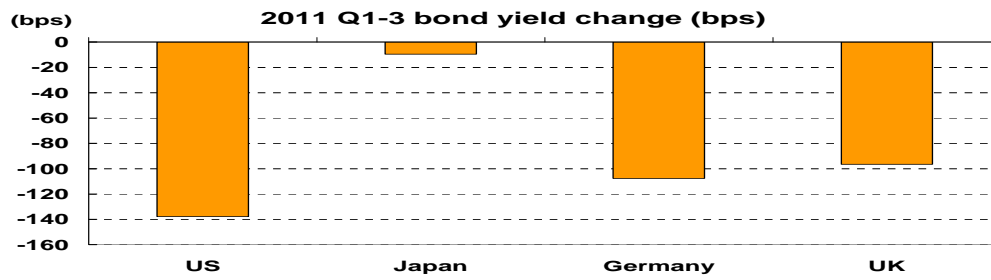
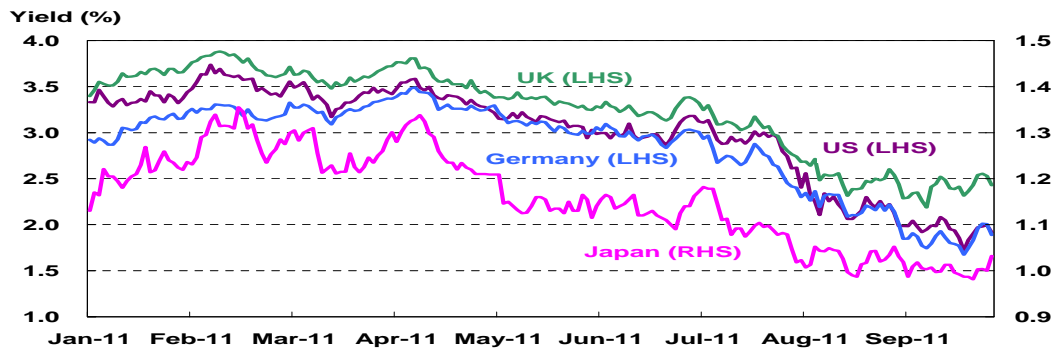
EQUITY MARKETS

Normalized Index Level (2010 year-end = 100)





CHANGES IN 10-YEAR GOVERNMENT BOND YIELDS





INVESTMENT INCOME

	2011	2010	2009	2008
(HK\$ billion)	Jan - Sep *	Full Year	Full Year	Full Year
Hong Kong equities [^] [@]	(29.7)	11.6	48.9	(77.9)
Other equities [^]	(28.0)	27.1	48.8	(73.1)
Foreign exchange	2.1	(3.1)	9.8	(12.4)
Other investments ^{&}	0.5	1.7	0.8	-
Bonds [#]	<u>60.7</u>	<u>42.1</u>	<u>(0.6)</u>	<u>88.4</u>
Investment income/(loss) ^{@&}	5.6	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



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

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

* *Unaudited figures*

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

^ *Including dividends*



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	(40.8)	21.6	24.8

* 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 30 Sep 2011*	At 31 Dec 2010	At 31 Dec 2009
ASSETS			
Deposits	204.1	198.4	126.3
Debt securities	1,805.7	1,706.7	1,637.6
Hong Kong equities	114.8	152.6	142.9
Other equities	226.4	245.3	214.9
Other assets#	<u>64.6</u>	<u>42.0</u>	<u>27.7</u>
Total assets	<u>2,415.6</u>	<u>2,345.0</u>	<u>2,149.4</u>
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness	245.6	225.9	199.0
Government-issued currency notes & coins in circulation	9.3	8.9	8.4
Balance of the banking system	148.6	148.7	264.6
Exchange Fund Bills and Notes	657.9	654.2	536.4
Placements by banks and other financial institutions	23.9	23.2	28.3
Placements by Fiscal Reserves	604.0	592.3	504.1
Placements by HKSAR government funds and statutory bodies	105.3	76.8	41.8
Other liabilities	<u>63.0</u>	<u>23.5</u>	<u>13.3</u>
Total liabilities	1,857.6	1,753.5	1,595.9
Accumulated Surplus	<u>558.0</u>	<u>591.5</u>	<u>553.5</u>
Total liabilities and fund equity	<u>2,415.6</u>	<u>2,345.0</u>	<u>2,149.4</u>

* Unaudited figures

Including investment in EF's investment holding subsidiaries amounted to HK\$23.5 billion at 30 Sep 2011 (HK\$14.7 billion at 31 Dec 2010)

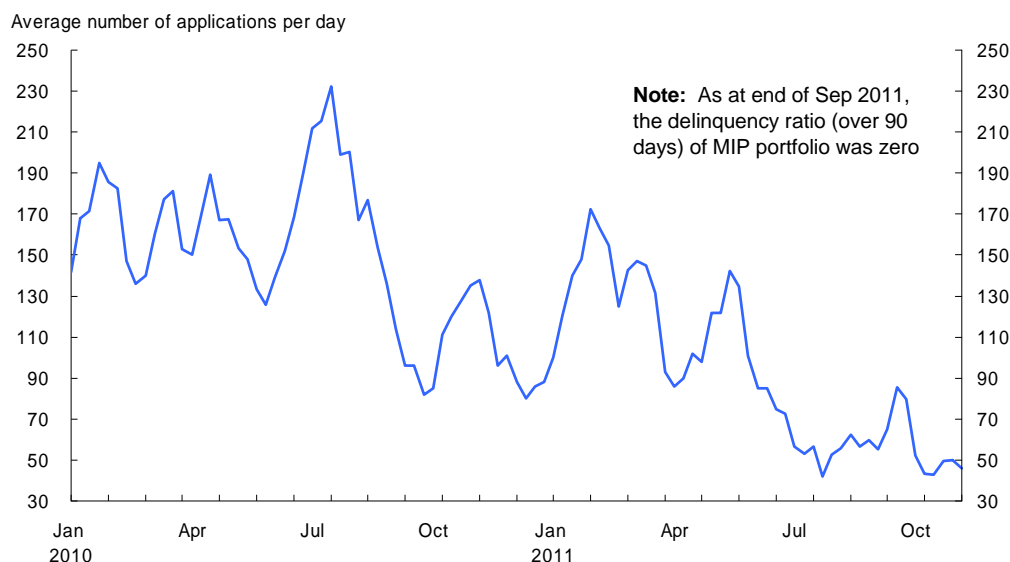


HONG KONG MORTGAGE CORPORATION



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

Slow down in MIP loan applications



Source: Hong Kong Mortgage Corporation

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- The HKMC has implemented 5 rounds of revisions to the MIP since Jan 09 (latest one was announced in June 11). Collectively, the HKMC has (i) reduced the max. loan amount to HK\$5.4 Mil, subject to a cap of property value of HK\$6 Mil, (ii) lowered the max. DTI ratio to 50% across-the-board, (iii) suspended 95% LTV product and non owner-occupied property product & (iv) excluded overseas income applicants.
- The overall performance of MIP portfolio outperformed the industry throughout the years. Delinquency ratio (over 90 days) of MIP portfolio has been kept at zero since Jan 2011 (industrial level: 0.01% as of Sept 2011).
- As at end of September 2011, no negative equity loan was found in MIP portfolio. The fall in property prices will generally increase the number of negative equity mortgage loans insured under the MIP, but the risk is somehow mitigated by the prudential underwriting standard of the HKMC since our past experience showed that the delinquency/loan performance hinged more on the repayment ability of the borrowers.



SME Financing Guarantee Scheme

- From the launch on 1 January 2011 up to mid-November 2011: 218 applications received for aggregate loan amount of around HK\$750 million; Average loan interest rate of 5.2% p.a. and guarantee fee of 1.5% p.a.
- In October 2011, a number of product enhancements were introduced:
 - i. Increase of the interest rate ceilings from 8% / 10% p.a. to 10% / 12% p.a.
 - ii. SFGS can guarantee loans refinanced from the Government's Special Loan Guarantee Scheme upon expiry of existing guarantee
 - iii. Drawdown on all types of revolving facilities can be in HK dollars or foreign currencies
 - iv. Allowing temporary excess of revolving facility limit on one-off basis to provide flexibility to SMEs
 - v. Clarification of the collateral sharing arrangement with banks

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- Application volume peaked between March and June 2011, with an average of 35 cases and aggregate loan amount of HK\$114 million per month.
- Application volume has slowed down since July and even more remarkably since September because:
 - a. the guarantee fee discount promotion which offered a waiver up to six months' guarantee fee ended in June;
 - b. banks have been more cautious toward SME lending in the light of deteriorating business turnover and pace of loan repayment by SMEs;
 - c. many AIs have already met their business quota in the first three quarters and so they can afford to wait and see;
 - d. many AIs need to conduct annual review of SME business / lending volume towards year-end; and
 - e. Q4 is usually the traditional quiet period with fewer business transactions.



Reverse Mortgage Programme

- The Reverse Mortgage Programme launched by the Hong Kong Mortgage Corporation on 11 July 2011 receives good response in the market
- By 11 November 2011, there have been 128 applications, with total property value totalling HK\$478 million
 - Average age of borrowers: 70 years old
 - Payment terms: 10-year (30%), 15-year (20%), 20-year (16%), life (34%)
 - Average property value: HK\$3.7 million
 - Average monthly payout: HK\$13,000
 - Average property age: 30 years

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- Of the seven participating banks, Wing Lung Bank, Bank of China (Hong Kong), Nanyang Commercial Bank, Bank of East Asia, and Bank of Communications Hong Kong Branch have been open to applications. Standard Chartered Bank (Hong Kong) and Wing Hang Bank will be open to applications very soon.
- The interest rate under the Programme is Hong Kong Prime Rate minus 2.5% per annum (i.e. 2.75% p.a.)
- Since November the HKMC has published the statistics on reverse mortgage on a monthly basis