



HONG KONG MONETARY AUTHORITY

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

**3 May 2013
[Translation]**



1. **Risk Assessment on Hong Kong's Financial Stability**
2. Banking Supervision
3. Financial Infrastructure
4. Hong Kong as the Offshore Renminbi Centre
5. Investment Performance of the Exchange Fund



GLOBAL FINANCIAL MARKET CONDITIONS

- Global market sentiment has continued to improve since the start of this year :
 - Major stock market indices have risen
 - European sovereign bond yields have stabilised
 - Spreads of sovereign credit default swaps have narrowed

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- Global market sentiment has continued to improve since the start of this year with the lessening of systemic risk in the euro zone and the partial resolution of the fiscal cliff stalemate in the US.



ECONOMIC CONDITIONS IN EUROPE

- Financial crisis broke out in Cyprus in March
- Although a “grand coalition” government has been formed in Italy, uncertainties still exist over the implementation of reforms
- Economic fundamentals in the euro zone have generally worsened. The IMF forecasts the euro zone economy to contract by 0.3% in 2013 and grow by 1.1% in 2014
- Prolonged economic downturn causes many European countries to ease off austerity, meaning a more distant prospect for restoring fiscal balance
- As markets believe the risk of a euro dissolution has subsided, market sentiment remains sanguine despite negative economic factors in Europe



ASSESSMENT OF THE US ECONOMY

- Economic activity indicators in the US generally improved
- Short-term economic outlook:
 - Growth momentum in the private sector supported by the following factors:
 - Continued recovery in the housing market
 - Progress made in household deleveraging
 - Falling unemployment rate
 - but tax hikes and budget “sequester” will drag on recovery
- Diverging views within the Fed on adjusting the size of quantitative easing, making the timing of exit highly uncertain

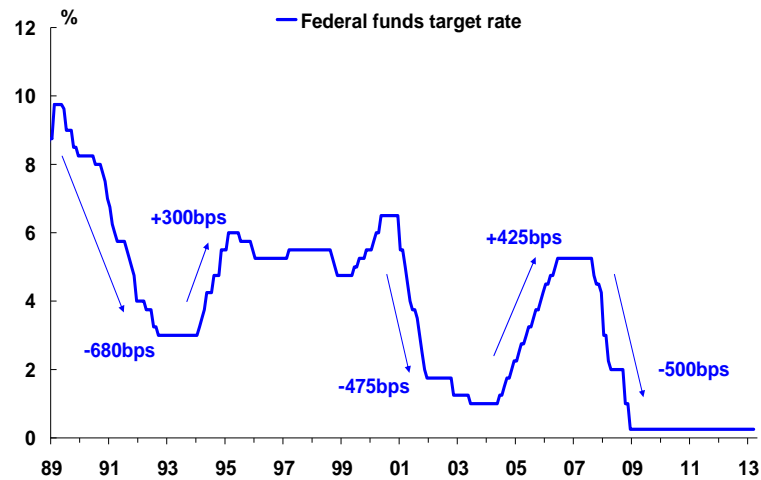
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- Growth momentum in the private sector supported by the following factors:
 - Continued recovery in the housing market: housing prices rebounded by 8 – 9% from their lows (mainly benefited from the ultra-low mortgage rates and the lower-than-historical average home inventory and housing completions).
- However, tax hikes and budget “sequester” will drag on recovery
 - The Congressional Budget Office (CBO) estimated that tax hikes and budget “sequester” will reduce economic growth in 2013 by 1.5 percentage point
- Several members of the Federal Open Market Committee (FOMC) expressed concerns over potential risks associated with the overly accommodative monetary policy. Minutes of the March meeting indicated diverse views on adjusting the size of quantitative easing, making the timing of exit highly uncertain.



ASSESSMENT OF THE US ECONOMY: OVERLY-ACCOMMODATIVE MONETARY POLICY MIGHT BE FOLLOWED BY SHARP INTEREST RATE HIKES IN FUTURE

Movements in the federal funds target rate



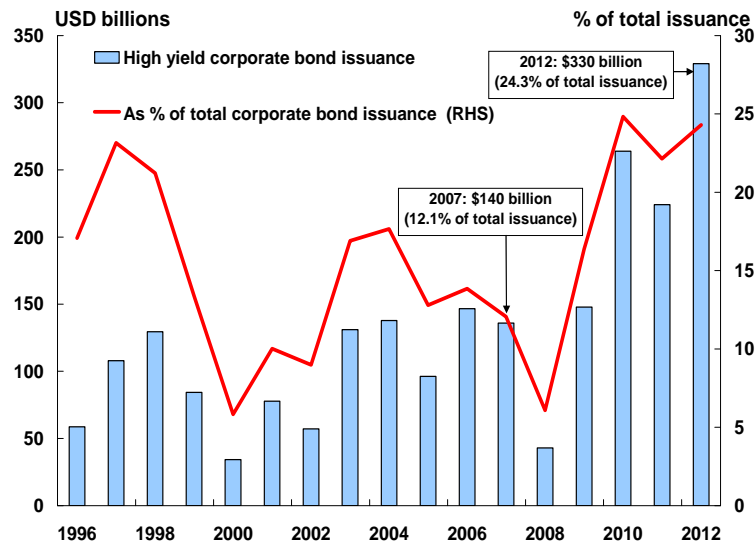
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- As indicated by its past movements, interest rate may rise sharply during its upward cycle.
- Prior to its upward cycle in 1994, the fed funds target rate experienced sharp fall and remained at the low level of 3% for a prolonged period. However, it recorded a sharp rise of 300 bps in the following 13 months.
- During 1995 to 2000, interest rates hovered at relatively high levels and then fell sharply in 2001.
- During the upward cycle that began in 2004, the magnitude and duration of the rise of the fed funds target rate were even greater and longer than before. It rose by 425 bps from a low of 1% in 25 months.



ASSESSMENT OF THE US ECONOMY: ULTRA-LOW INTEREST RATES ENCOURAGE HIGH-RISK INVESTMENTS

Share of US high yield corporate bond issuance
has risen to historical high



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- There are signs indicating that ultra-low interest rates is spurring high-risk investments.
- US high yield corporate bond issuance has risen significantly. As can be seen from the chart, high yield corporate bond issuance (blue line) rose to US\$330 billion in 2012, more than double the US\$140 billion recorded prior to the outbreak of the global financial crisis in 2007. The percentage of high yield corporate bond issuance to total corporate bond issuance (red line) also rose to 24.3% in 2012 from 12.1% in 2007.



JAPAN'S MONETARY POLICY RISKS

- The Bank of Japan introduced large scale quantitative and qualitative monetary easing (QQE)
 - To double the monetary base in two years
 - To double the Japanese government bond (JGBs) holdings in two years and purchase JGBs with longer maturities
 - To achieve 2% inflation target in two years
- Market participants made large scale purchases of Japanese equities and conducted short yen trades. Nikkei 225 index has risen almost 60% since November last year while yen has depreciated by close to 20% against the US dollar
- These measures will drive stock market exuberance in Japan and a surge in yen carry trades, possibly causing greater volatility in international fund flows and exchange rates of major currencies



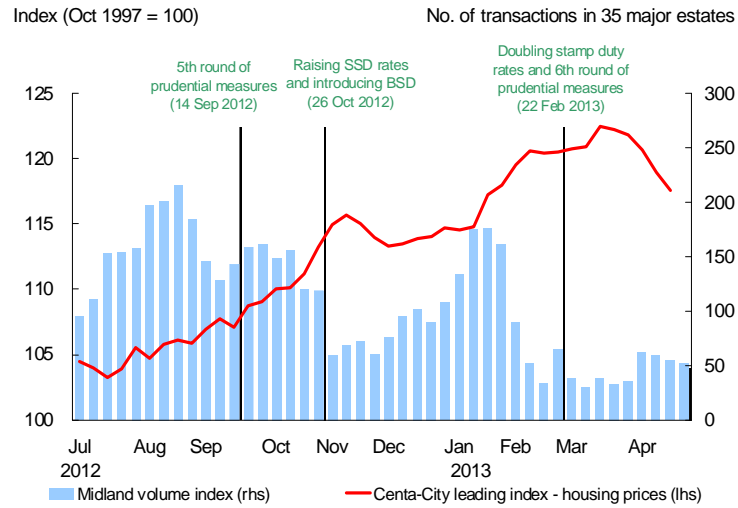
ASSESSMENT OF MAINLAND CHINA'S ECONOMY

- Economic growth is expected to improve:
 - The Central Government's growth target of 7.5% and inflation target of 3.5% for the year should be achievable
- Proactive fiscal policy and prudent monetary policy to continue
- Major risks:
 - Overheating in the property market: a new round of measures has been introduced to prevent a resurgence of overheating risks in the property market. For example, home purchase restrictions would be implemented more strictly in some cities
 - Risks from the shadow banking system: the CBRC released a circular at the end of March to strengthen the regulations on banks' wealth management products to prevent and control risks, and to promote healthy development of related business activities



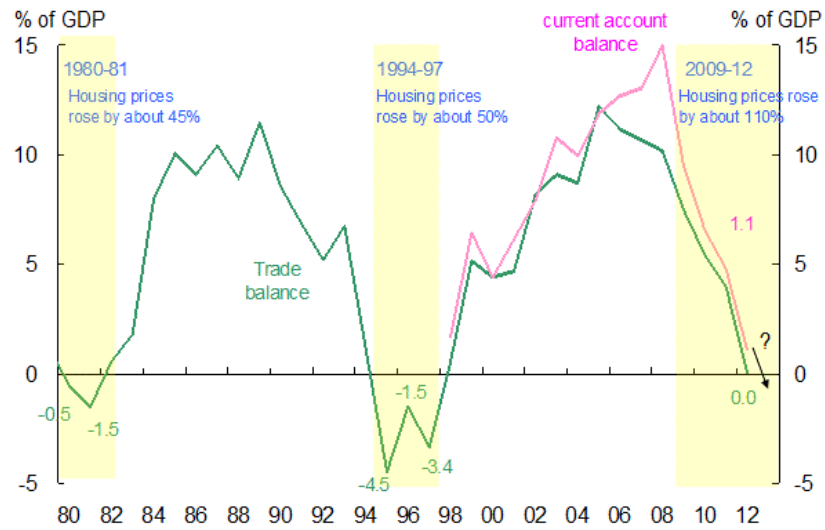
RISK ASSESSMENT ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

Transaction volume dropped and prices showed signs of softening after introduction of property measures in February





PERSISTENT DECLINE IN CURRENT ACCOUNT BALANCE: POSSIBLY A WARNING SIGN OF AN OVERHEATING ECONOMY

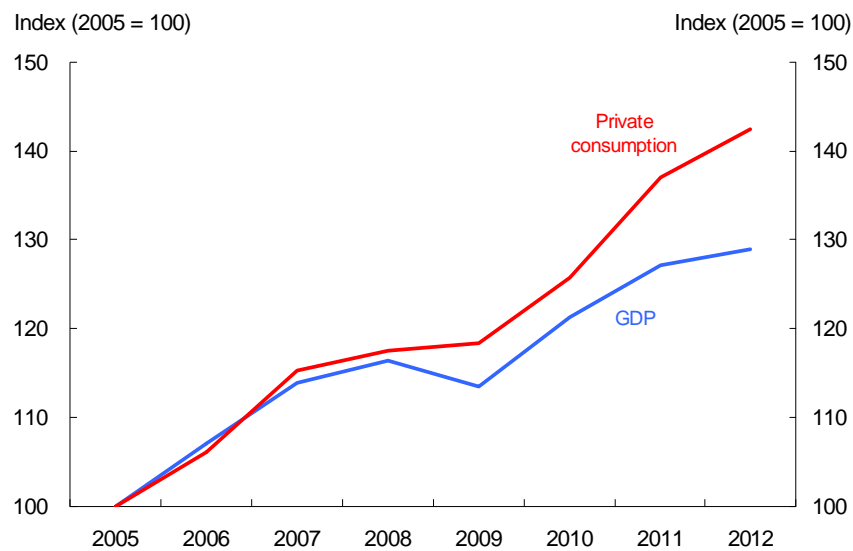


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- The persistent decline in current account balance may possibly be a warning sign of an overheating economy.



RECENT DECLINE IN CURRENT ACCOUNT BALANCE: FASTER GROWTH IN PRIVATE CONSUMPTION THAN THE OVERALL ECONOMY

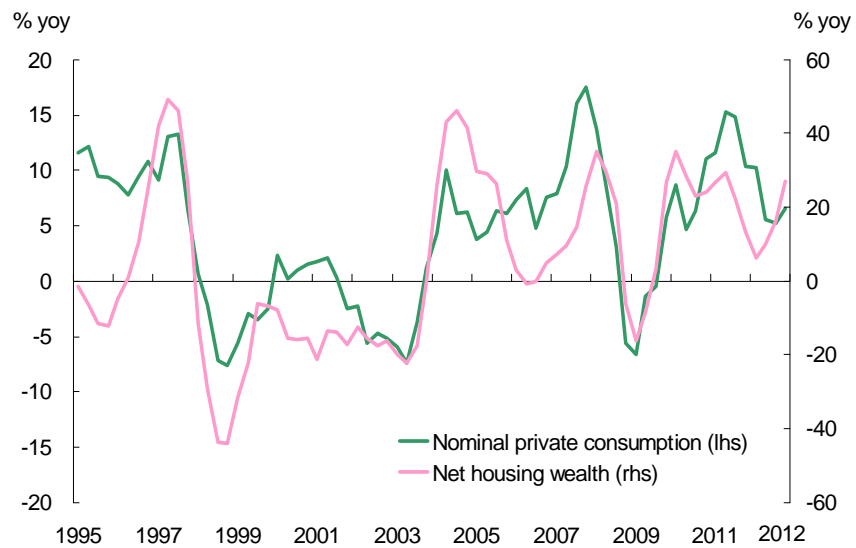


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- Current account balance refers to the difference between the income and expenditures of an economy. Expenditures comprise of consumption and investment. Our analysis showed that while there were some increases in investment in the last few years, substantial growth was recorded in private consumption which surpassed the growth rate of the overall economy (i.e. increase in revenues). This was the main reason behind the persistent decline in current account balance.



HOUSING WEALTH EFFECT HAS ENCOURAGED PRIVATE CONSUMPTION

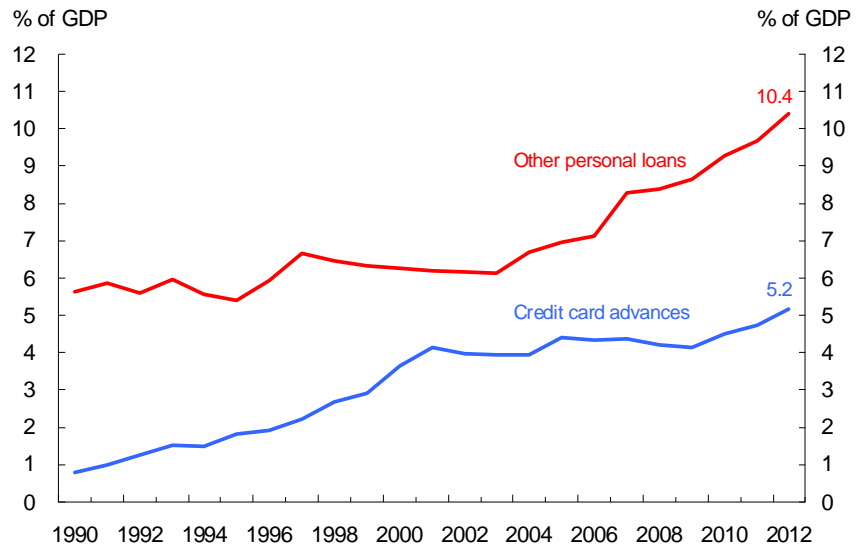


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- Our quantitative analysis showed that the sharp increase in consumption may be caused by the wealth effect associated with the rising residential property prices. The chart shows that growth in private consumption and changes in net housing wealth are closely related.



PERSONAL LOANS HAVE BEEN GROWING FASTER THAN THE OVERALL ECONOMY





RISK ASSESSMENT ON HONG KONG'S FINANCIAL STABILITY: CONCLUSION

- Signs of cooling off in the property market following the introduction of policy measures. Whether there would be a reversal of the property market cycle remains to be seen.
- But growth in consumption and personal loans in Hong Kong continues to be higher than overall economic growth amid the ultra-low interest rate environment and an overheating property market, thereby posing risks to macroeconomic stability
- External financial conditions remain highly uncertain:
 - The very aggressive policies taken by the Bank of Japan have increased the risk of higher volatility in global fund flows and exchange rates
 - The timing and pace of the Fed's policy exit remain highly uncertain
 - The longer and larger the Fed maintains its quantitative easing programmes, the higher the difficulty and risk of policy exit
 - Heightened geopolitical risks
- Hong Kong will therefore need to prepare for the risk of large volatility in fund flows and the risks of a reversal of the property market and interest rate cycles

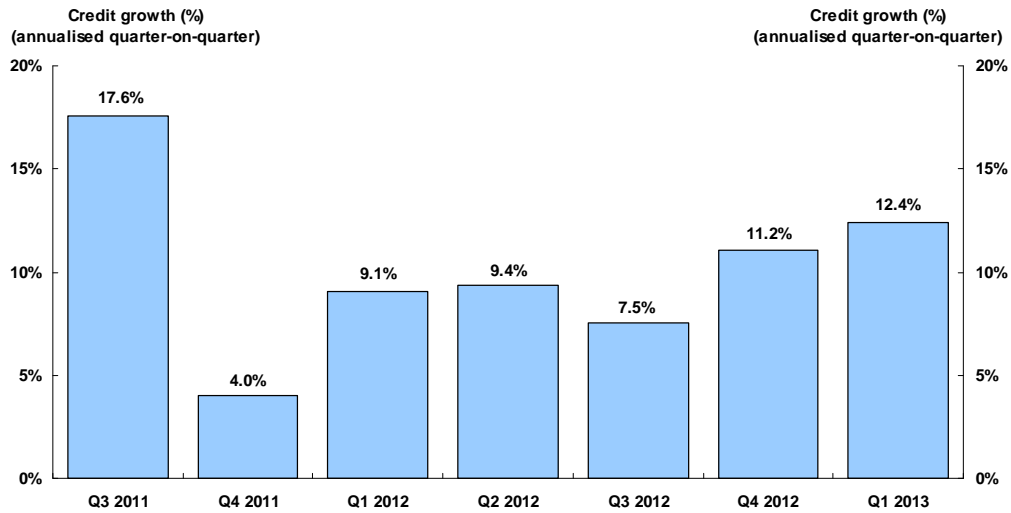


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CREDIT GROWTH

Credit growth remained at a moderate level in the first quarter of 2013



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- In 2012, credit growth was 9.6%. It is much slower than the 20.2% growth recorded in 2011.
- In the first quarter of 2013, credit growth was 3.1% or 12.4% on an annualised basis. The accelerated credit growth was mainly contributed by trade finance and loans for use outside Hong Kong.
- The HKMA will continue to monitor the credit growth of the banking sector.



Basel III Implementation Progress

- Capital standards
 - Banking (Disclosure) (Amendment) Rules / Banking (Capital) (Amendment) Rules
 - Phase 2 implementation
- Liquidity standards
 - Liquidity Coverage Ratio

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Capital standards

- Banking (Disclosure) (Amendment) Rules 2013 (“BDAR”) and Banking (Capital) (Amendment) Rules 2013 (“BCAR”) tabled at LegCo for negative vetting on 17 April. These Rules are respectively to:
 - BDAR – prescribe new Basel disclosure requirements associated with first phase of capital standards already in effect in Hong Kong from 1 January. (The Rules are intended to take effect from 30 June 2013 in accordance with the BCBS timetable, which recognises the fact that jurisdictions and banks need time to implement new disclosure standards BCBS released in June 2012, a year after the BCBS issued the finalized and revised Basel III capital standards.)
 - BCAR – incorporate miscellaneous refinements principally to align rules with latest Basel guidance (for counterparty credit risk weighting). Going forward refinements / updates of similar nature may be needed on regular basis.
- Second phase of capital standards – covering two capital buffer requirements – which is scheduled for implementation from 2016 – policy proposals being developed for industry consultation re (i) mechanism to operationalise the two buffer requirements and (ii) framework for application of “higher loss absorbency” capital requirements for domestic systemically important banks.

Liquidity standards

- In early January, the Basel Committee published a package of revisions to the Liquidity Coverage Ratio (LCR). The HKMA is developing policy proposals for local implementation of the LCR taking into account these latest revisions and local circumstances. We intend to conduct a new round of industry consultation on the liquidity proposals within the second quarter of this year.



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FINANCIAL INFRASTRUCTURE

Government Bond Programme

- 14 issues totalling HK\$64.5 billion and two iBonds totalling HK\$20 billion were outstanding. The HKMA is co-ordinating the issuance of the third iBond
- To expand the size of the Programme from HK\$100 billion to HK\$200 billion to provide room for issuance for another 5 years

Development of Islamic Finance

- The amendment bill was introduced into LegCo on 9 January 2013
- Organised a series of seminars in collaboration with Bank Negara Malaysia for market players

Retail Payment Initiatives

- NFC mobile payment: through common standards and market-driven approach for shared infrastructure to achieve the following objectives
 - Ability to download multiple payment services onto a single NFC-enabled phone
 - Payment service continuity despite switching from one mobile network operator to another
 - Payment service continuity despite changing one's NFC-enabled phone
 - High level of security
- Legal framework for stored value electronic facilities and retail payment systems

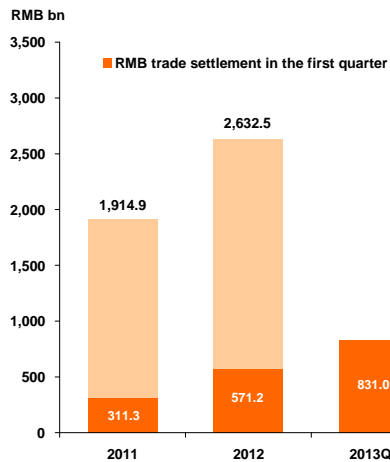


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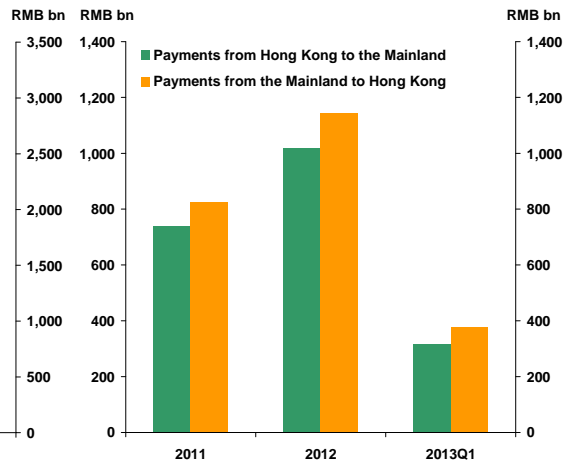


Continued growth in RMB trade settlement

RMB trade settlement handled by banks in Hong Kong



Flows of RMB trade settlement between Hong Kong and the Mainland

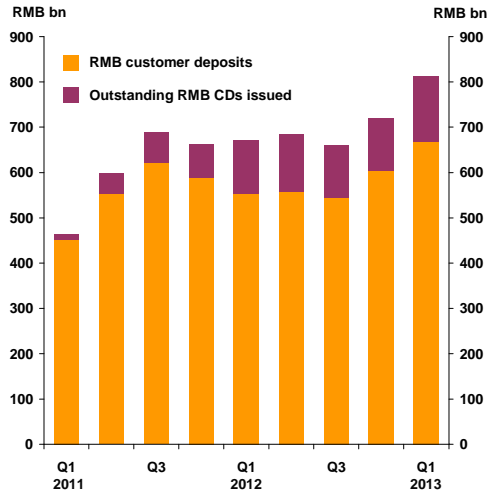


- In the first quarter of 2013, RMB trade settlement handled by banks in Hong Kong amounted to RMB831.0 billion, a 45% growth compared with the same period of last year. Meanwhile, the payment flows to and from the Mainland were largely balanced.

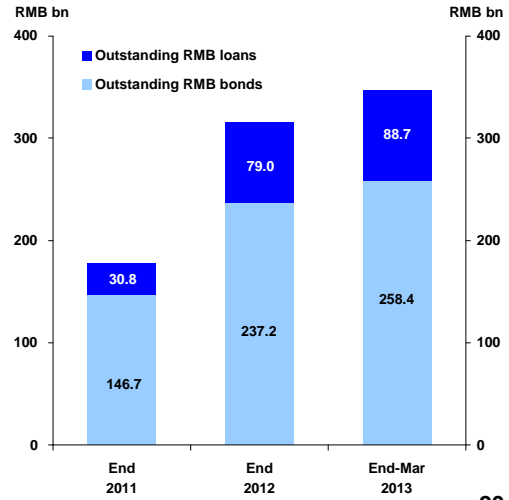


RMB financing activities remaining vibrant

RMB customer deposits and certificates of deposit (CDs)



RMB financing activities





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INVESTMENT INCOME

	2013	2012	2011	2010
(HK\$ billion)	Q1*	Full Year	Full Year	Full Year
Hong Kong equities[^]@	(1.4)	30.7	(24.2)	11.6
Other equities[^]	24.9	42.8	(12.2)	27.1
Bonds[#]	2.8	33.1	71.9	42.1
Other investments^{&}	0.6	6.4	0.7	1.7
Foreign exchange	<u>(9.8)</u>	<u>(1.4)</u>	<u>(9.1)</u>	<u>(3.1)</u>
Investment income^{@&}	17.1	111.6	27.1	79.4

* Unaudited figures

[^] Including dividends

[@] Excluding valuation changes in Strategic Portfolio

[#] Including interest

[&] 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)	2013	2012				
	Q1*	Full year	Q4	Q3	Q2	Q1
Investment income/(loss)	17.1	111.6	30.3	42.4	(5.6)	44.5
Other income	-	0.2	-	0.1	0.1	-
Interest and other expenses	<u>(0.9)</u>	<u>(4.4)</u>	<u>(1.0)</u>	<u>(1.1)</u>	<u>(1.4)</u>	<u>(0.9)</u>
Net investment income/(loss)	16.2	107.4	29.3	41.4	(6.9)	43.6
Payment to Fiscal Reserves#	(9.3)	(37.8)	(9.3)	(9.2)	(9.6)	(9.7)
Payment to HKSAR government funds and statutory bodies#	(2.1)	(8.0)	(2.2)	(2.1)	(1.9)	(1.8)
Valuation change of Strategic Portfolio less valuation change of investment held by EF's investment holding subsidiaries^	<u>(0.6)</u>	<u>(5.6)</u>	<u>(2.1)</u>	<u>(0.7)</u>	<u>(1.7)</u>	<u>(1.1)</u>
Increase/(Decrease) in EF Accumulated Surplus	4.2	56.0	15.7	29.4	(20.1)	31.0

* Unaudited figures

The fixed rate of fee payment is 5.0% for 2013 and 5.6% for 2012

^ Including dividends