



HONG KONG MONETARY AUTHORITY

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

**15 November 2013
[Translation]**



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



WHAT HAS ULTRA-LOOSE MONETARY POLICY ACHIEVED?

**Major central banks' balance sheets have
grown substantially**

| | Before 2008 global financial crisis (Q3 2008) | Latest* (Early Nov 2013) | Change |
|------------------|--|-------------------------------------|---------------|
| US | \$1.2 trillion | \$3.9 trillion | +217% |
| Euro area | €1.5 trillion | €2.3 trillion | +52% |
| Japan | ¥113 trillion | ¥216 trillion | +92% |
| UK | £138 billion | £404 billion | +194% |

*The latest figures for Japan are from October

Sources : CEIC, US Federal Reserve, European Central Bank and Bank of Japan



WHAT HAS ULTRA-LOOSE MONETARY POLICY ACHIEVED?

US

- Labour and housing markets still recovering but growth momentum remains subpar (markets expect 1.6% growth for 2013)
- Unemployment rate has fallen significantly, but the 8.7 million jobs lost during the financial crisis are yet to be recovered
- The future path of fiscal consolidation remains uncertain

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- Unemployment rate has fallen significantly but the 8.7 million jobs lost during the financial crisis have yet to be recovered (only 7.2 million jobs recovered while the labour force participation rate fell to a 35-year low of 62.8%).
- The future path of fiscal consolidation remains uncertain.



WHAT HAS ULTRA-LOOSE MONETARY POLICY ACHIEVED?

Euro area

- After significant shocks and painful economic contraction, market confidence for the euro system diminished greatly before recent stabilisation
- Euro-area economy has resumed modest growth since Q2 this year; contraction has continued to ease in the peripheral countries
- Yet high unemployment and deleveraging in both public and private sectors will continue to drag on growth
- European Central Bank cut interest rates by 25 basis points to 0.25% last week, but boost to the economy will likely be limited



WHAT HAS ULTRA-LOOSE MONETARY POLICY ACHIEVED?

Japan

- First to implement quantitative easing, but effect had been mediocre
- Since taking office, the Abe government has stepped up monetary easing efforts and introduced fiscal measures and structural reforms to stimulate growth
- Market sentiment has improved; inflation expectations on the rise; positive economic momentum has continued



DEBT BURDEN OF ADVANCED ECONOMIES KEEPS ON RISING

**Sovereign and private sector liabilities as
percentage to GDP***

| | Before 2008 global financial crisis (Q3 2008) | Latest (Q2 2013) | Change (Percentage points) |
|------------------|--|-----------------------------|---|
| US | 231% | 249% | +17 |
| Euro area | 289% | 325% | +36 |
| Japan | 413% | 476% | +63 |
| UK | 268% | 310% | +42 |

*Excluding the financial sector

Sources: CEIC, US Federal Reserve, European Central Bank and Bank of Japan



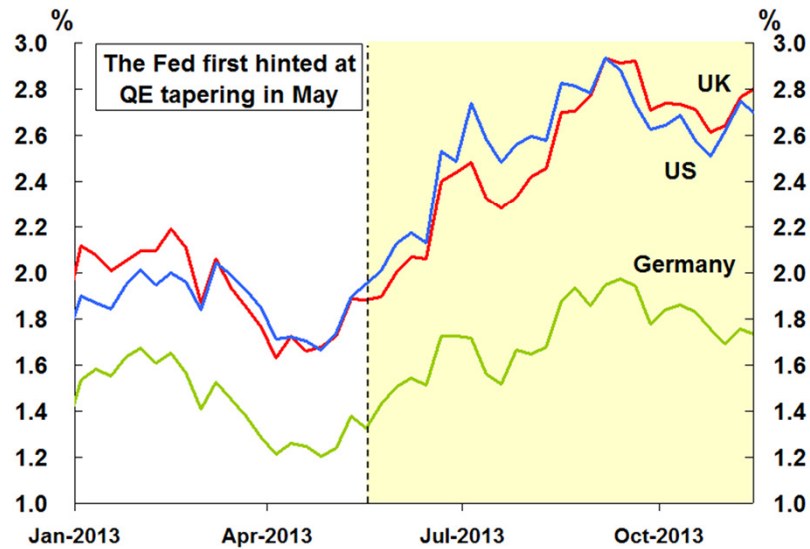
THE FED'S EVENTUAL POLICY EXIT WILL PROVE A CRITICAL MOMENT

- The US Fed first hinted at reducing asset purchases (QE tapering) in May and provided a “tapering roadmap” in June, sending shockwaves to global financial markets
 - Global bond yields surged rapidly
 - Global stock markets plummeted
 - Emerging markets saw sizeable capital outflows and currency depreciation
- The Fed surprised markets by not tapering QE in the September Federal Open Market Committee (FOMC) meeting; global markets broadly stabilised
- The Fed kept its ultra-loose monetary policies unchanged in the October FOMC meeting
- But uncertainties over the timing and scale of the Fed’s policy exit have increased; when the exit eventually begins, whether market reaction would be as strong as those observed back in May and June remains to be seen



GLOBAL FINANCIAL MARKETS: RAPID RISE IN BOND YIELDS

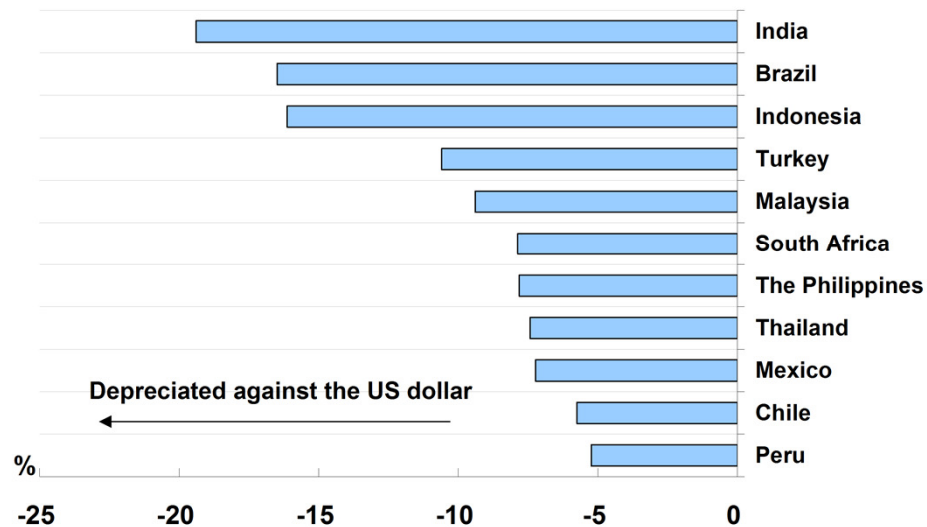
10-Year Sovereign Bond Yields



Source: Bloomberg



EMERGING MARKETS: CURRENCY DEPRECIATION



Note:

1. This chart shows the biggest depreciation of various currencies against the US dollar from 22 May to 18 September.

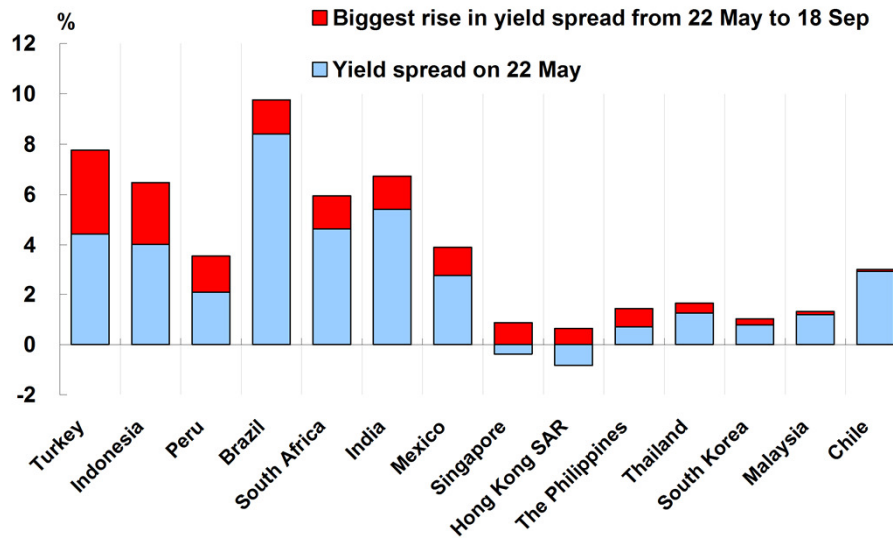
Source: Bloomberg

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- Many emerging markets have faced capital outflow and currency depreciation pressures.
- The chart shows the Indian rupee having depreciated briefly by almost 20%.



EMERGING MARKETS: YIELD SPREADS OF SOVEREIGN BONDS ROSE



Note:

1. This chart shows yield spreads between 10-year sovereign bonds (or, in the case of Hong Kong, 10-year Exchange Fund Notes) and the US Treasury.

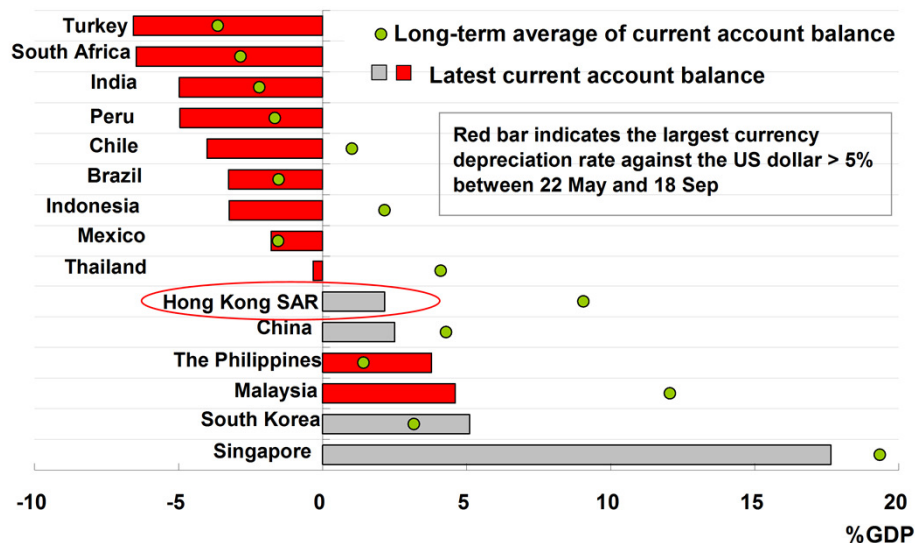
Sources: Bloomberg and HKMA

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- The chart shows fund outflows led to a rise in yield spreads in emerging market sovereign bonds during the period from May 22 to September 18. In particular, yield spreads in Turkey once surged more than 3 percentage points.



GENERALLY LARGER CURRENCY DEPRECIATION IN EMERGING MARKETS WITH A WEAKER CURRENT ACCOUNT



Note:

1. Latest current account figure refers to the sum of the latest four quarters (2012 Q3 to 2013 Q2)
2. Long-term average current account figure refers to the average of the figures from 1998 to 2012.

Sources: Bloomberg and CEIC



OUTLOOK FOR US MONETARY POLICY HAS BECOME EVEN MORE UNCERTAIN

- Markets generally expect the Fed to begin reducing asset purchases in March 2014
- However, the Fed has adjusted the thresholds for policy exit

At June's FOMC meeting:

- Fed Chairman indicated it could start tapering gradually before the end of 2013, bringing the asset purchases programme to a halt by mid-2014, when the unemployment rate is expected to fall to about 7%
- Exceptionally-low fed funds rate at least for as long as the unemployment rate remains above 6.5%

But at September's FOMC meeting:

- The Fed no longer used unemployment rate falling to 7% as a threshold for ending asset purchases
- Fed Chairman also suggested federal funds rate may not rise until the unemployment rate drops "considerably" below 6.5%
- The Fed maintained the size of quantitative easing on the grounds of recent tightening in financial conditions and fiscal uncertainties

Recent October's FOMC meeting:

- The Fed removed the reference of tightening financial conditions potentially slowing the pace of improvement in the economy and labour market



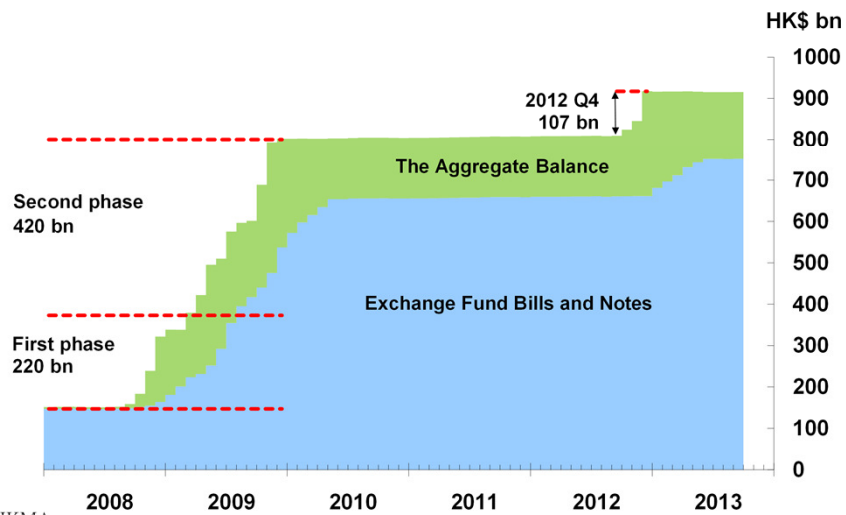
ASSESSMENT OF MAINLAND CHINA'S ECONOMY

- Growth accelerated in Q3 (7.7% in first three quarters, faster than Central Government's target of 7.5%)
- Government will focus on economic transformation and upgrading, and adjustment and improvement of industrial structure, will not launch short-term stimulus to boost growth, and will actively address the problem of overcapacity
- Monetary policy: neither tightening nor loosening is expected, and the focus would be invigorating existing funds and making good use of new funds
- The authorities would continue to contain and manage risks associated with local government financing platforms and shadow banking, and further improve allocation of financial resources
- Third plenary session pledged to deepen reforms and opening up in an all-round way



ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY (I): FUND FLOWS

**The HK dollar remained stable
with no visible fund flow pressures**



Source: HKMA

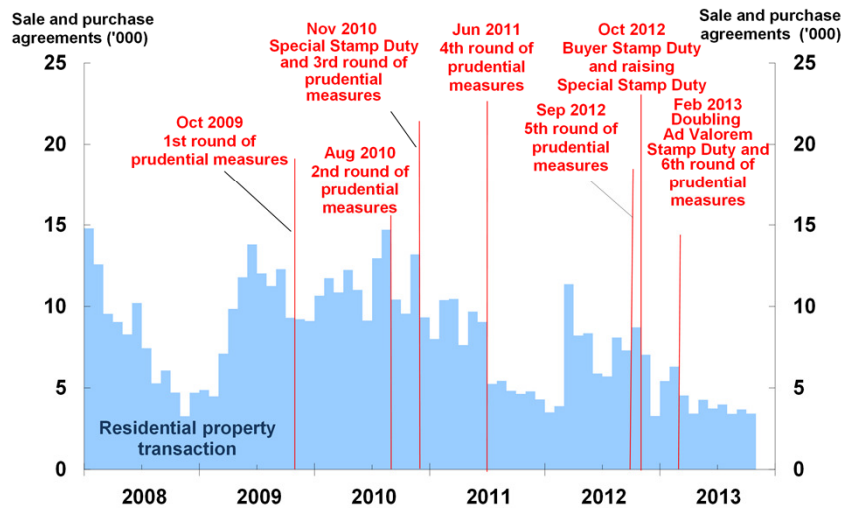
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- The fourth quarter of 2012 saw fund inflows of about \$100 billion into the Monetary Base of Hong Kong. No such inflows were recorded so far this year.



ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY (II): PROPERTY MARKET

Property market activities see some signs of cooling



Source: Land Registry

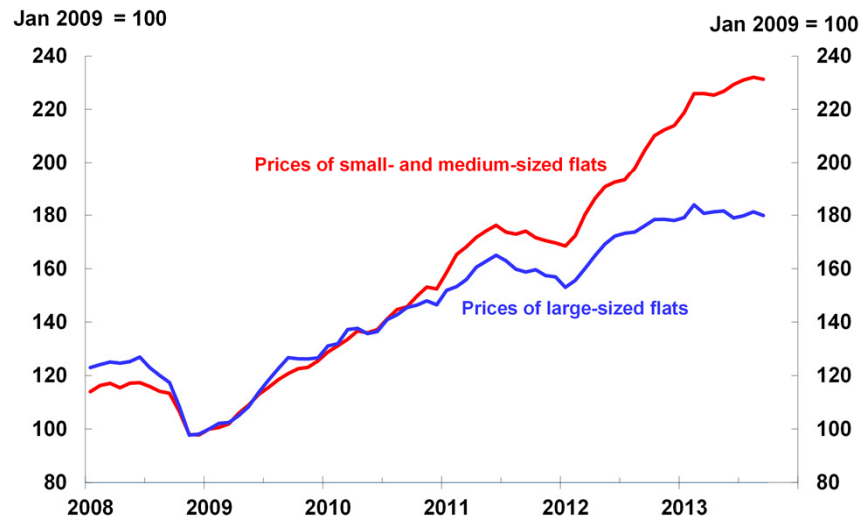
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- Residential property transactions fell after each round of property market stabilisation measures.
- Recently property market turnover has dropped significantly to an average of about 3,800 cases each month.



ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY (III): PROPERTY MARKET

Trend in the property market remains uncertain



Source: R&VD

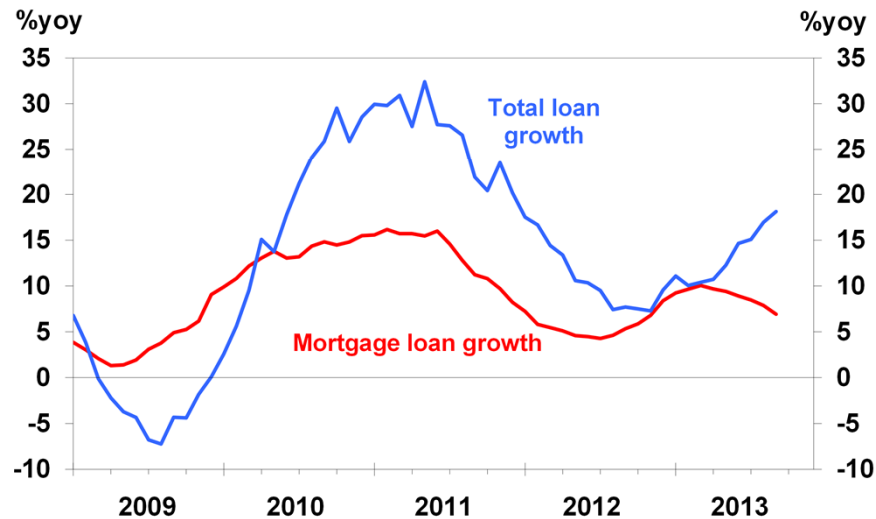
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- However the residential property price trend remains uncertain.
- Prices for large apartments fell by 2.2% during February to September 2013, while those for small- and medium-sized ones still rose by 2.4% from the level in February.
- Given the uncertainty about the price trends, one cannot conclude that a down cycle is already formed in the property market.



ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY (IV): BANK LENDING GROWTH

**Growth in mortgage loans slowed
while growth in other lending continued to accelerate**



Source: HKMA

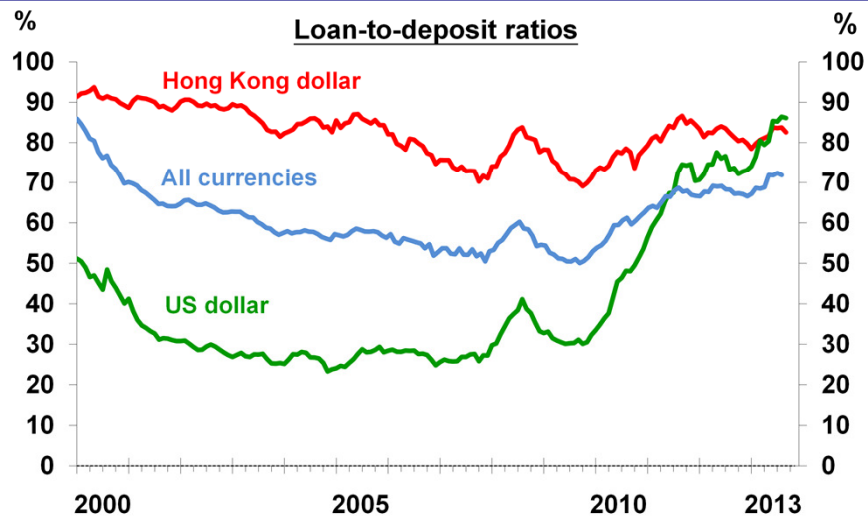
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- Following six rounds of prudential supervisory measures, property transactions dropped and mortgage lending growth slowed.
- Growth in total loans accelerated markedly since the beginning of 2013, reaching a year-on-year rate of 18% in September.



ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY (V): BANK LENDING GROWTH

The HKMA has required banks to strengthen the sources for stable funding



Source: HKMA

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- The Hong Kong dollar loan-to-deposit ratio remained stable at around 82% in recent years, while that for the US dollar increased significantly, shooting from a low of 30% at the end of 2009 to 86% recently.
- In view of an overly quick growth in some loans for use in Hong Kong, local branches of foreign banks have introduced tenor matching since the second half of 2011.



ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: CONCLUSION

- US Fed's policy exit would affect the global economy and financial markets, but the timing and scale of exit remain highly uncertain
- Once the policy exit starts, emerging markets could face risks of capital outflows, asset price correction and currency depreciation
- Should the Fed's policy exit cause interest rates to rise and lead to large volatility in global asset markets, Hong Kong would inevitably be affected, especially with the still overheated property market, high household indebtedness, and deteriorating current account balance (which turned into a deficit in the first six months of 2013)
- Hong Kong needs to stand ready for the possibility of a shock emanating from a sudden reversal in global interest rates and capital flows



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RETAIL PAYMENT INITIATIVES

Legislative Framework for Stored Value Facilities and Retail Payment

- 3-month public consultation ended; 41 submissions received; generally supportive
- Preparatory work on drafting of Bill began; to be introduced to LegCo in second half of 2014

Electronic Bill Presentment and Payment (EBPP) service

- Starting from December 2013, the public can subscribe to and benefit from a one-stop EBPP service gradually launched by 23 participating banks
- Scope of service: Business-to-Person (B-2-P) and Business to Business (B-2-B) e-billing and e-payments; cross-border e-billing and e-payments; e-donation and presentment of e-receipt; handling e-bills in HKD, RMB and USD

NFC mobile payment service

- A task force established by the HKMA and HKAB to issue a set of standards and guidelines by end-November 2013 for banks to follow
- A shared infrastructure to support banks will be ready by the end of 2013



COIN COLLECTION MOBILE KIOSKS PILOT SCHEME

- Aims at providing the public with a convenient and free channel of exchanging coins to enhance circulation and reduce minting expenditure
- Users may choose to receive banknotes in exchange of coins, or add value to Octopus cards
- Two mobile kiosks will collect coins at various locations throughout Hong Kong on a rotational basis
- Target launch date: mid-2014
- The HKMA will announce coin collection locations and schedule in advance



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BASEL III IMPLEMENTATION PROGRESS

Capital standards

- 1st phase (minimum capital ratios)
 - Associated disclosure
 - Supplementary guidance
 - On-going monitoring
- 2nd phase
 - Capital buffers
 - Higher loss absorbency for global systemically important banks / domestic systemically important banks

Liquidity standards

- Liquidity Coverage Ratio

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Capital standards

- 1st phase implementation:
 - Further to the Basel III minimum capital requirements taking effect on 1 January, Banking (Disclosure) Rules to implement the associated disclosure standards took effect from 30 June. All 1st phase standards have therefore been successfully implemented in Hong Kong.
 - Supplementary guidance has been issued to facilitate implementation. This includes common disclosure templates to ensure consistent disclosures and interpretative guidance in the form of FAQs on certain technical areas relating to the calculation of the minimum ratios.
 - Capital position of local AIs remains relatively strong under Basel III, their Common Equity Tier 1 ratios averaging above 13% and total CAR around 16% as of end-June.
- 2nd phase implementation:
 - Consultative proposals are being developed for industry consultation within Q4. These will cover (i) the mechanism to operationalise the two Basel III capital buffer requirements and (ii) the framework for the identification of and application of the “higher loss absorbency requirements” to systemically important banks. HK is not the home regulator of any of the global systemically important banks (GSIBs) but we do have DSIBs (domestic systemically important banks).
 - The 2nd phase Basel III standards are scheduled to take effect from Jan 2016 but legal framework is required to be in place one year before (i.e. from Jan 2015). We will soon be preparing draft rules next year and will brief members on our proposals in this regard in due course.

Liquidity standards

- HKMA launched a third round of consultation in July on proposals to implement the Basel III Liquidity Coverage Ratio (LCR) in Hong Kong, taking into account industry comments received in the first two rounds of consultation.
- The consultation results will be incorporated into the rule-making process in 2014 to ensure timely implementation of the LCR standard in 2015. We will brief members on the contents of the draft rules next year.



CROSS-SECTOR RESOLUTION REGIME FOR HONG KONG

- G20 mandate to tackle “Too Big to Fail” problem
- Legislative reform to meet international standards: Financial Stability Board (FSB)’s “Key Attributes of Effective Resolution Regimes”
- Fill gaps in HK regulators’ existing toolkits to support resolution of failing financial institutions
- FSB deadline for reform: end-2015
- With many stakeholders; public consultation to be held
- FSTB will launch the consultation



INVESTOR AND CONSUMER PROTECTION

- At a launch hosted by HKMA in October, banks gave their pledge by signing up to the Treat Customers Fairly Charter
- Banks decided to stop charging dormant account fees
- Vulnerable group customers are exempted from low-balance charges
- HKMA will launch a financial consumer education programme in late November, aiming to help the public become “smart and responsible” consumers



ANTI-MONEY LAUNDERING

- As a member of the Financial Action Task Force, Hong Kong has a responsibility to implement international standards on anti-money laundering
- According to Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance, which came into effect in April 2012, financial institutions must comply with the anti-money laundering requirements which are consistent with the international standards.
- Banks must observe stringent customer due diligence requirements, and detect and report any suspicious transactions. They must also take additional measures or enhanced due diligence in regard to higher-risk customers (for example money changers and other sectors with involvement of cash-intensive businesses)

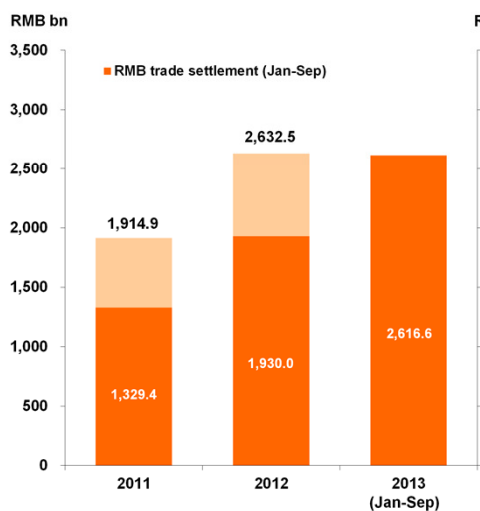


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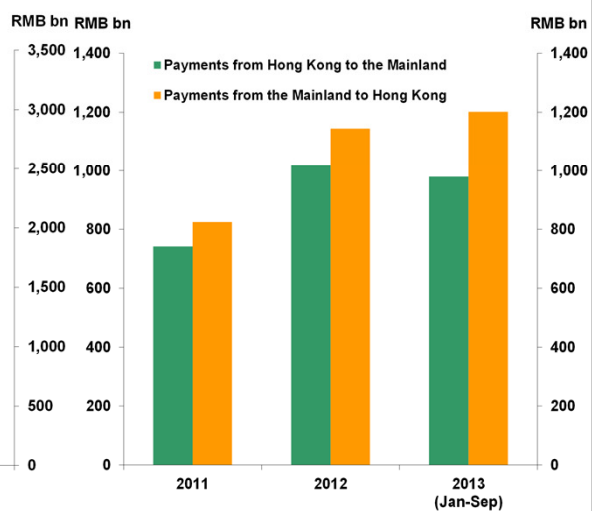


CONTINUED GROWTH IN RMB TRADE SETTLEMENT

RMB trade settlement
handled by banks in Hong Kong



Flows of RMB trade settlement
between Hong Kong and the Mainland



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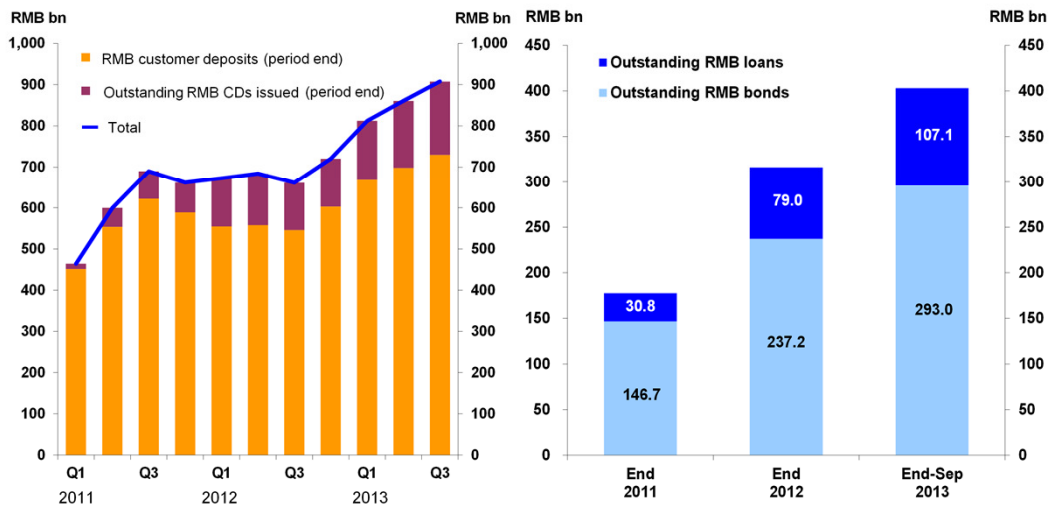
- In the first nine months of 2013, RMB trade settlement handled by banks in Hong Kong amounted to RMB2,616.6 billion, a 36% growth compared with the same period of last year.



RMB FINANCING ACTIVITIES REMAINING VIBRANT

RMB customer deposits and
certificates of deposit (CDs)

RMB financing activities



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- At end September 2013, RMB customer deposits and outstanding RMB certificates of deposits amounted to RMB730.0 billion and RMB177.6 billion respectively, totaling RMB907.6 billion, a 26% growth from RMB720.2 billion at the end of 2012.
- The RMB dim sum bond market continued to develop. Notwithstanding a slowdown in July and August due to global market adjustments, dim sum bond issuance started to regain momentum in mid-September. In the first nine months of 2013, dim sum bond issuance amounted to RMB75.4 billion. Outstanding dim sum bonds at end September amounted to RMB293 billion. RMB lending grew further, with outstanding amount of RMB loans increasing to RMB107.1 billion at end September 2013, a 36% growth from the end of last year.



CONTINUED DEVELOPMENT OF HONG KONG'S ROLE IN SUPPORTING OFFSHORE RMB BUSINESS OVERSEAS

| | Sep 2013 | 2012 | 2011 |
|--|----------|-------|-------|
| 1 No. of participating banks of Hong Kong's RMB clearing platform | 211 | 204 | 187 |
| Of which: | | | |
| Branches and subsidiaries of overseas banks and overseas presence of Mainland banks | 186 | 181 | 165 |
| 2 Amount due to overseas banks (RMB billion) | 144.1 | 99.1 | 116.4 |
| 3 Amount due from overseas banks (RMB billion) | 151.1 | 117.1 | 121.7 |
| 4 Turnover in Hong Kong's RMB RTGS system (Daily average during the period; RMB billion) | 411.0 | 213.7 | 121.4 |

- The HKMA and UK Treasury jointly facilitated the third meeting of the Hong Kong – London RMB Forum in Hong Kong on 26 September. Representatives of banks participating in the Forum agreed to further enhance the breadth and depth of the offshore RMB market while actively seeking to provide services in response to the opening of more channels for cross-border flows with Mainland China. They also engaged in detailed discussions on future work to enhance RMB trade settlement and banking services, financing and investment, and interbank activities.



SHANGHAI PILOT FREE TRADE ZONE

- The State Council announced the “Framework Plan for China (Shanghai) Pilot Free Trade Zone” in late September.
- The Framework Plan sets out to: expedite changes in government functions, actively explore innovative administrative methodologies, facilitate trade and investment, expand opening up of the service sector, and promote financial liberalisation and innovation.
- Policy measures in respect of RMB capital account convertibility and foreign exchange management are still being considered.



DEVELOPMENT OF THE QIANHAI SHENZHEN-HONG KONG COOPERATION ZONE FOR MODERN SERVICE INDUSTRIES

- A set of policies supporting the development and opening-up of the Qianhai Shenzhen-Hong Kong Cooperation Zone for Modern Service Industries was approved by the State Council in June last year. The policies are being implemented progressively.
- Among which, administrative rules for cross-border RMB lending in Qianhai were promulgated at end of last year. Companies registered in Qianhai with substantive operations or investments there can borrow RMB funds from banks in Hong Kong.
- Cross-border RMB loans of RMB7 billion yuan registered at the end of August this year.



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INVESTMENT INCOME

← 2013 → | 2012 2011 2010

| (HK\$ billion) | Jan - Sep* | Q3* | Full Year | Full Year | Full Year |
|---|---------------------|--------------------|---------------------|---------------------|---------------------|
| Hong Kong equities^{^@} | 6.2 | 13.7 | 30.7 | (24.2) | 11.6 |
| Other equities[^] | 49.0 | 17.9 | 42.8 | (12.2) | 27.1 |
| Bonds[#] | (15.0) | 1.8 | 33.1 | 71.9 | 42.1 |
| Other investments^{&} | 4.8 | - | 6.4 | 0.7 | 1.7 |
| Foreign exchange | <u>(0.1)</u> | <u>15.6</u> | <u>(1.4)</u> | <u>(9.1)</u> | <u>(3.1)</u> |
| Investment income^{@&} | 44.9 | 49.0 | 111.6 | 27.1 | 79.4 |

* Unaudited figures

[^] Including dividends

[#] Including interest

[@] Excluding valuation changes in Strategic Portfolio

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

(Valuation of EF's investment holding subsidiaries is undertaken predominantly on a quarterly basis.)

The above figures reflect the latest available valuations.)



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

| (HK\$ billion) | 2013 | | | | 2012 |
|---|---------------|--------------|---------------|--------------|---------------|
| | Jan – Sep* | Q3* | Q2 | Q1 | Full year |
| Investment income/(loss) | 44.9 | 49.0 | (23.2) | 19.1 | 111.6 |
| Other income | 0.2 | 0.1 | 0.1 | - | 0.2 |
| Interest and other expenses | <u>(3.7)</u> | <u>(1.3)</u> | <u>(1.5)</u> | <u>(0.9)</u> | <u>(4.4)</u> |
| Net income/(loss) | 41.4 | 47.8 | (24.6) | 18.2 | 107.4 |
| Payment to Fiscal Reserves[#] | (27.8) | (9.0) | (9.5) | (9.3) | (37.8) |
| Payment to HKSAR government funds and statutory bodies [#] | (6.7) | (2.5) | (2.1) | (2.1) | (8.0) |
| Valuation change of Strategic Portfolio less valuation change of investment held by EF's investment holding subsidiaries [^] | <u>(5.1)</u> | <u>0.6</u> | <u>(3.1)</u> | <u>(2.6)</u> | <u>(5.6)</u> |
| Increase/(Decrease) in EF Accumulated Surplus | 1.8 | 36.9 | (39.3) | 4.2 | 56.0 |

* Unaudited figures

[#] The fixed rate of fee payment for 2013 and 2012 are 5.0% and 5.6% respectively

[^] Including dividends