



HONG KONG MONETARY AUTHORITY

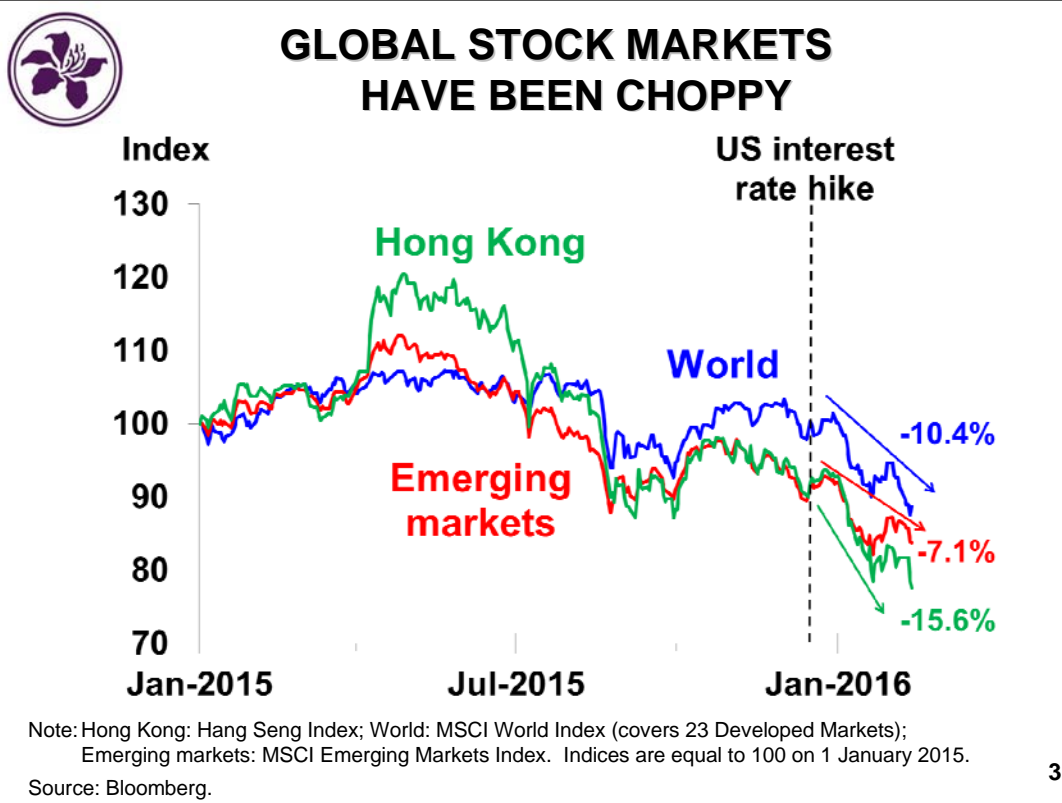
**Briefing to the Legislative Council
Panel on Financial Affairs**

15 February 2016

[Translation]



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

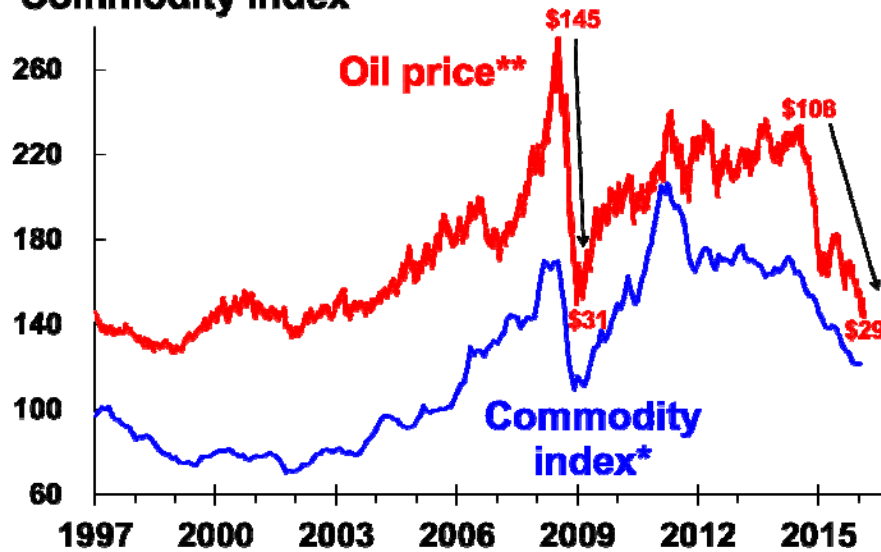


- Following a gain of 11.2% in the first half of 2015, the Hang Seng Index fell 16.5% in the second half, plunging 20.6% (5,404 points) in the third quarter, its worst quarterly point fall. In the second half of 2015, the CSI 300 Index in Mainland China recorded a fall of 16.6% after surging 26.6% in the first half.
- As shown in the chart, significant corrections in major indices have continued since the Fed's interest rate lift-off in December last year (black dotted line) . The MSCI World Index (blue line) fell 10.4%, while the MSCI Emerging Markets Index (red line) and Hang Seng Index (green line) were down 7.1% and 15.6% respectively.



OIL AND COMMODITY PRICES HAVE CONTINUED TO DECLINE

Commodity index



* Excluding energy.

** Oil prices are in US dollar per barrel.

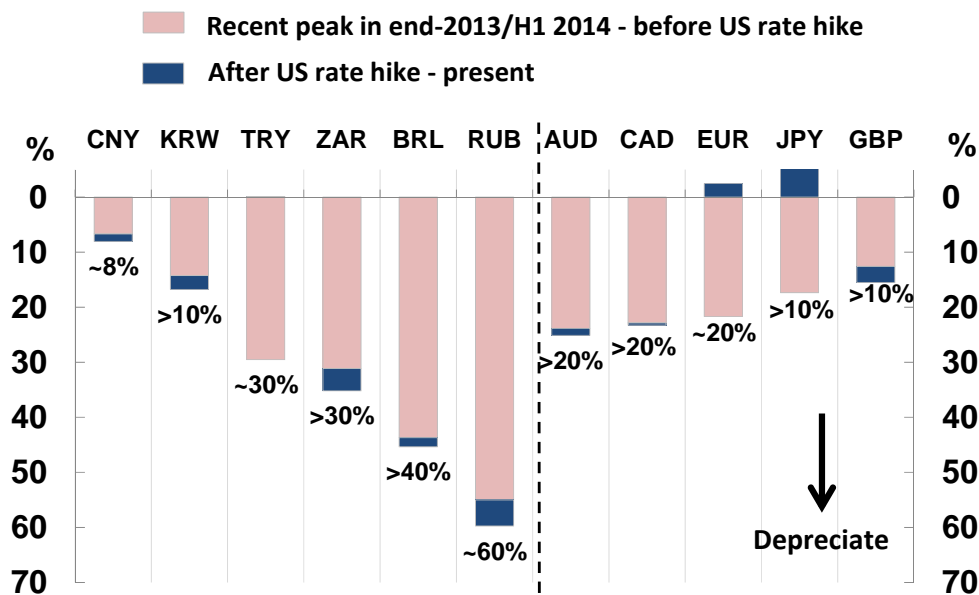
Sources: Bloomberg and the International Monetary Fund.

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- As shown in the chart, oil price (red line) recently plunged to their 12.5-year lows, down about 75% from their peaks in mid-2014. Commodity prices (excluding energy, blue line) also fell by 41% from their historic highs at April 2011, reaching 6.5-year lows.



NON-USD CURRENCIES ARE UNDER STRESS



Sources: Bloomberg and Reuters.

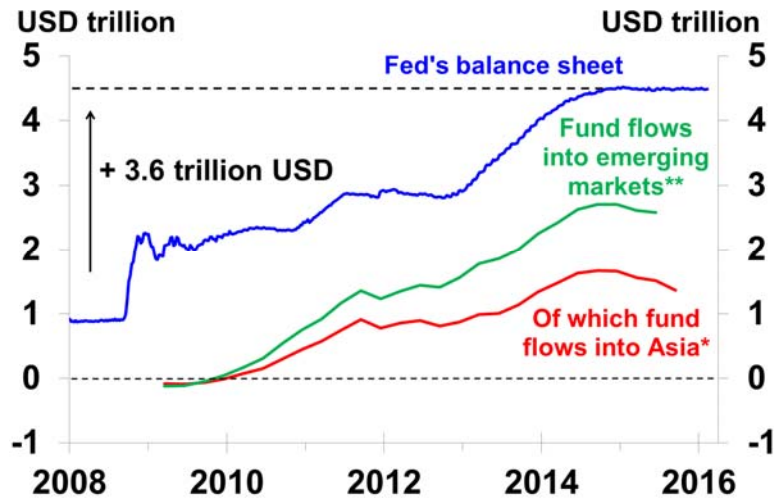
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- On currency, various currencies have come under significant downward pressure amid expectations for US rate hikes.
- Currencies of some emerging market economies such as Russia, Brazil, South Africa and Turkey fell markedly from their highs in the recent two years. Hit hard by plummeting oil prices, the Russian currency rouble depreciated by almost 60%.
- In Asia, despite relatively milder currency depreciation, the South Korean won depreciated considerably while the renminbi fell about 8% against the US dollar.
- Development market currencies were no exceptions, with the Australian dollar, Canadian dollar and euro each falling about 20%.



HIGH MARKET VOLATILITY IS THE AFTER-EFFECT OF QUANTITATIVE EASING

QE resulted in sizeable fund inflows into emerging markets



* Emerging Asia include Mainland China, HK, Indonesia, South Korea, the Philippines, Singapore, Thailand.

** Emerging markets include Mainland China, HK, Indonesia, South Korea, the Philippines, Singapore, Thailand, Brazil, Russia, India, South Africa, Turkey.

Source: CEIC.

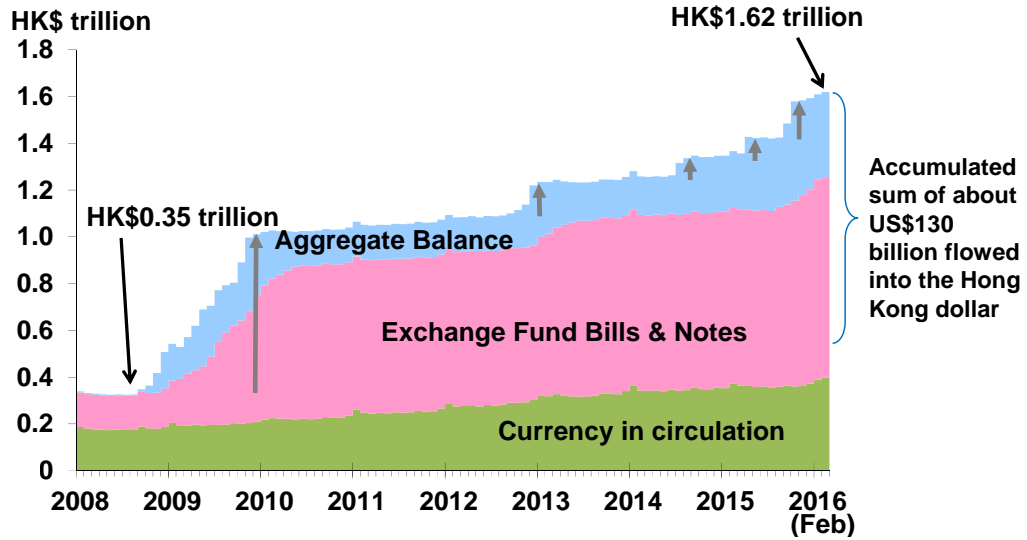
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- As shown in the chart, the Fed's balance sheet (blue line) stood at US\$4.5 trillion, having expanded by US\$3.6 trillion from some US\$900 billion in mid-2008. Abundant global liquidity has resulted in massive inflows into emerging markets in search of yields. At peak levels (third quarter of 2014), cumulative inflows into emerging markets amounted to US\$2.7 trillion (green line), of which a cumulative US\$1.7 trillion flew into Asian emerging markets (red line) at peak.



ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: FUND FLOWS

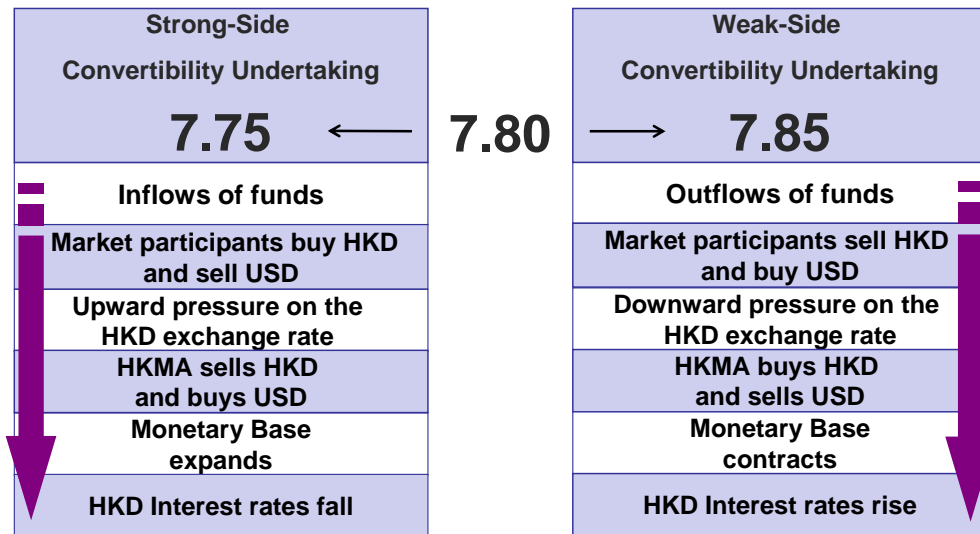
Monetary Base



Source: HKMA.

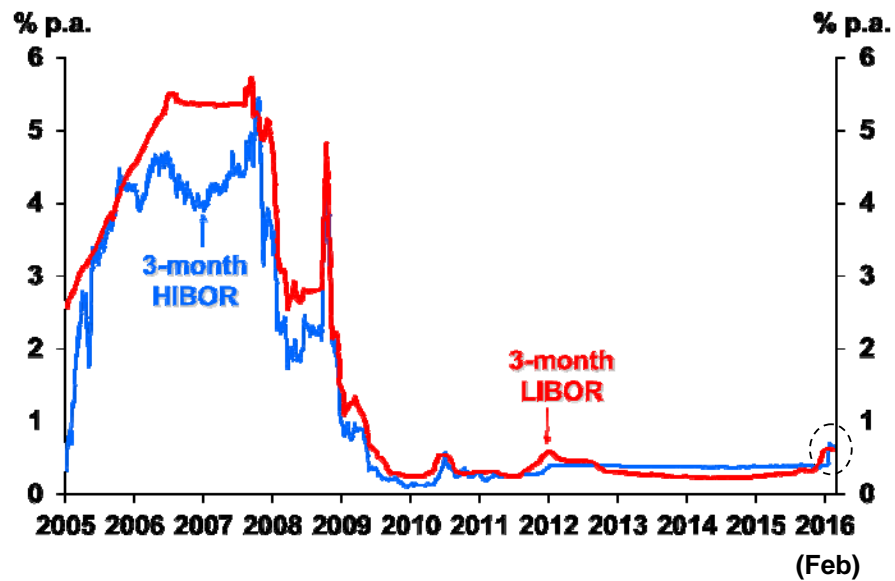


CURRENCY BOARD AUTOMATIC ADJUSTMENT MECHANISM





HONG KONG DOLLAR INTEREST RATES REPORTEDLY HAVE SURGED “MARKEDLY” BUT ACTUALLY REMAINED AT EXTREMELY LOW LEVELS



Source: HKMA.

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- Recently, there were reports that Hong Kong dollar interbank rates increased to their 7-year highs, or have surged markedly.
- In fact, local interest rates only rose from close to zero levels, and still remained at extremely low levels.



ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: INTERBANK RATE MOVEMENTS

- HKD fund flows are affected by a number of factors including HKD-USD interest rate spreads, Hong Kong economic outlook, as well as financial market developments and sentiments
- As funds flow out of HKD to a certain extent, HIBORs will go up, narrowing HKD-USD interest rate spreads
- Pace of US rate hikes should be gradual. Coupled with a sizable HKD monetary base, adjustments in HIBORs should not be too rapid
- Contraction in monetary base as a result of the triggering of the weak-side Convertibility Undertaking at 7.85 is a necessary step in the process of normalisation of the HKD interest rates. We should not overreact
- In the face of volatile market conditions, the HKMA will stay vigilant and get well-prepared



ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: 1997 PEAK vs 2016

Financial data	July 97	12/02/2016
Aggregate Balance (HK\$bn)	1.5	363.4 (+244.4 times)
Exchange Fund Bills and Notes (HK\$bn)	98.7	857.4 (+7.7 times)
Monetary Base (HK\$bn)	189.6	1,621.4 (+7.5 times)
Exchange Fund's foreign currency assets* (US\$bn)	67.6	422.3 (+5.2 times)
Hong Kong Stock Market#	July 97	12/02/2016
Market capitalisation (HK\$bn)	4,607.2	20,377.0 (+3.4 times)
P/E ratio	19.2	7.5 (-61.2%)
P/B ratio	2.3	1.0 (-58.6%)

() denotes the magnitude of change. Some of the changes may not be reconciled due to rounding.

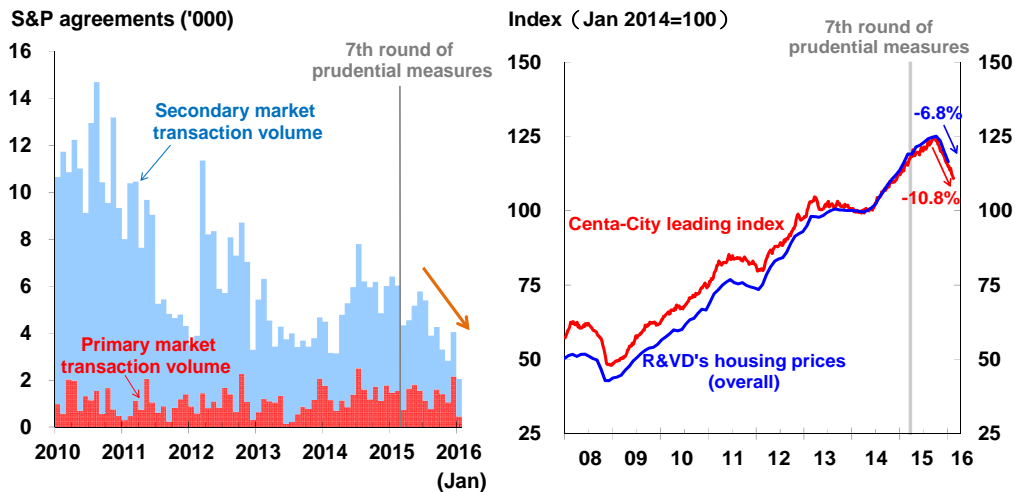
* refers to the figures in Jun 1997 and Dec 2015.

P/E and P/B ratios correspond to those of the Hang Seng Index.



ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

Housing transaction volume stayed low, while housing prices fell



Sources: Land Registry, Rating & Valuation Department and Centaline Property Agency Ltd.

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- Property prices in the secondary market have fallen since October 2015. According to statistics from the Rating and Valuation Department, in December 2015, property prices have fallen 6.8% from their highs at September 2015. The Centa-City Leading Index also shows prices in secondary property market were down 10.8% in early February 2016 from their highs at mid-September 2015.



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

- Challenges facing Hong Kong's economic and financial environment:
 - Slowdown in economic growth
 - Moderation in credit growth, with signs of deterioration in asset quality
 - Uncertainties in the property market outlook
 - Financial market volatilities
- The counter-cyclical macroprudential measures and other supervisory measures introduced over the past few years have significantly enhanced the resilience of Hong Kong's banking system
- HKMA's determination and ability to maintain the Linked Exchange Rate System is beyond doubt

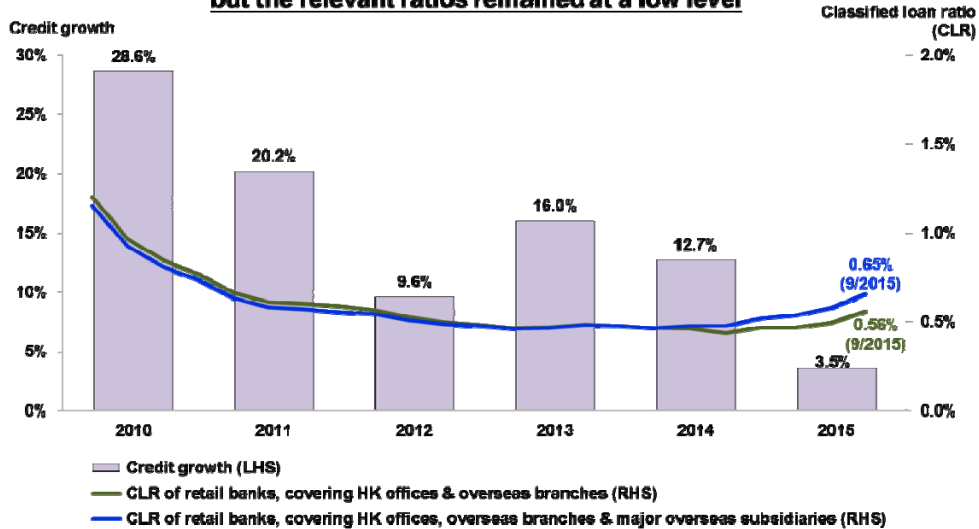


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CREDIT GROWTH AND ASSET QUALITY

Credit growth moderated; Asset quality deteriorated slightly, but the relevant ratios remained at a low level



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- In 2015, credit growth moderated to 3.5% from 12.7% in 2014.
- The banking industry's overall asset quality has deteriorated slightly since mid-2014, but remained at healthy levels.
- The HKMA will continue to monitor market development closely, and take necessary measures to safeguard the stability of the banking system.



BASEL STANDARDS IMPLEMENTATION

- Amendments to Banking (Capital) Rules to introduce revised capital treatment for counterparty credit risk exposures and equity investment in funds
- Amendments to Banking (Disclosure) Rules to implement revised Pillar 3 disclosure package
- Amendments to Banking Ordinance to update rules on exposure limits



ESTABLISHING A CROSS-SECTORAL RESOLUTION REGIME FOR FINANCIAL INSTITUTIONS IN HONG KONG

- To meet international standards: Financial Stability Board’s “Key Attributes of Effective Resolution Regimes for Financial Institutions”
- Compliance with international standards should be achieved as soon as possible, lest overseas financial institutions might need to reduce the weighting of their Hong Kong business
- Financial Institutions (Resolution) Bill (FIRB) introduced into LegCo in December 2015
- Bills Committee scrutiny of the FIRB began in January 2016



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DEVELOPING HONG KONG AS A CTC HUB

- **Amendment Bill:** The Inland Revenue (Amendment) (No. 4) Bill 2015 introduced into LegCo in December 2015 to allow, under specified conditions, interest deductions under profits tax for Corporate Treasury Centres (CTCs) and reduce profits tax for specified treasury activities by 50%
- **Promotion Work:** Continue to engage the industry and step up marketing effort targetting overseas and Mainland multinational corporations to promote Hong Kong as a preferred location for CTCs



FINANCIAL INFRASTRUCTURE DEVELOPMENT

- Regulatory framework for Stored Value Facilities (SVF) and Retail Payment Systems (RPS)
 - The Payment Systems and Stored Value Facilities Ordinance was enacted on 4 November 2015 and commenced operation on 13 November 2015
 - A one-year period is allowed for existing and new SVF issuers to apply for SVF licences. The licensing process has commenced
 - The HKMA will gather information from RPS operators to determine whether any of them should be designated



E-CHEQUE

- The e-Cheque service was launched on 7 December 2015. The operations of the e-Cheque infrastructure have been smooth and robust, and the usage of e-Cheque has been steadily increasing
- The HKSAR Government also launched the “Pay e-Cheque” Portal on the same date to facilitate the public to pay tax bills and the General Demand Notes by e-Cheque
- The HKMA continues to conduct consumer education campaigns to enhance the public’s awareness of and familiarity with the e-Cheque

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- As of 31 January 2016, over 27,000 customers have registered to issue or deposit e-Cheques. Besides, between 7 December 2015 and 31 January 2016, more than 34,000 e-Cheques with an aggregate value of around HK\$760 million equivalent were issued by the bank customers and deposited with the banks.



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DEVELOPMENT OF HONG KONG OFFSHORE RMB BUSINESS

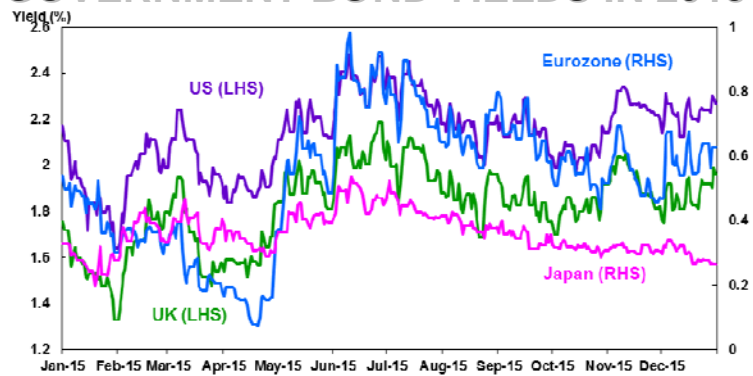
- Offshore RMB exchange rate and interest rates saw larger fluctuation in late 2015 and early 2016. The situation now becomes more stable
- RMB deposit pool in Hong Kong contracted by 12% in September and October 2015, stabilised in November and increased by 5% month-on-month in December
- Market expectation on RMB exchange rate changes, offshore RMB liquidity declines, but market operations remain orderly
- Steady growth in RMB trade settlement and RMB bank loans in Hong Kong, significant increase in turnover of RMB Real Time Gross Settlement system, with moderation in dim sum bond issuance over the past few months
- RMB market development may have short-term impact on the scale of offshore RMB deposit pool and related business in different parts of the world



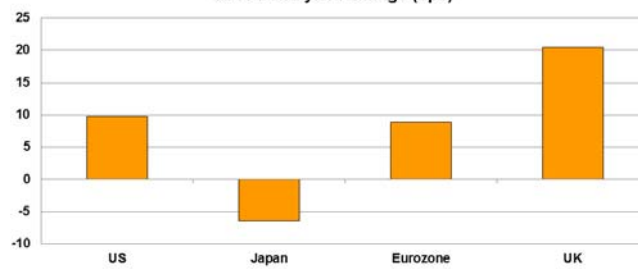
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CHANGES IN 10-YEAR GOVERNMENT BOND YIELDS IN 2015



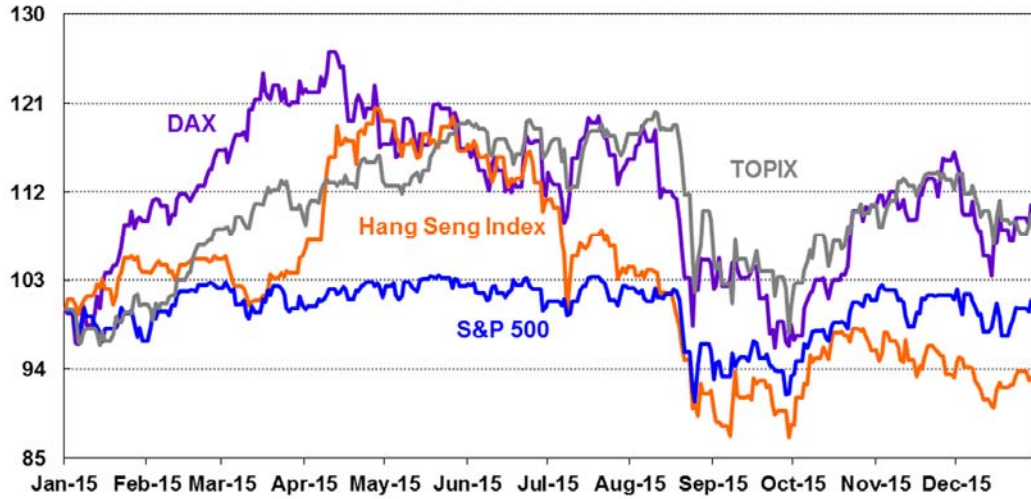
2015 bond yield change (bps)





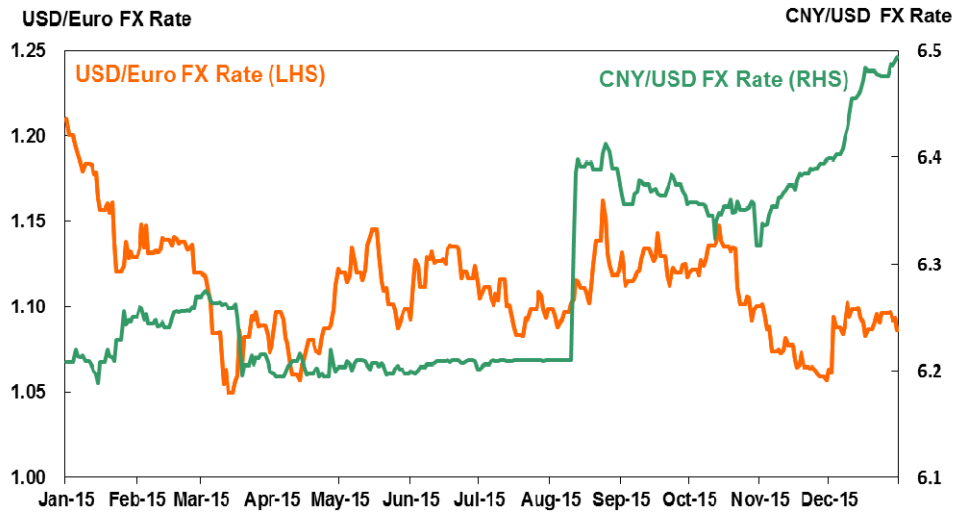
EQUITY MARKETS IN 2015

Normalized Index Level (2014 year-end = 100)





CURRENCY MARKETS IN 2015





INVESTMENT INCOME

	← 2015 → (unaudited)					2014	2013	2012	2011
	Full year	Q4	Q3	Q2	Q1				
(HK\$ billion)						Full year	Full year	Full year	Full year
Hong Kong equities*	(5.0)	6.9	(30.7)	9.7	9.1	6.5	10.1	30.7	(24.2)
Other equities	7.4	21.0	(34.1)	2.0	18.5	33.7	71.8	42.8	(12.2)
Bonds	15.9	(0.4)	11.8	(7.7)	12.2	47.3	(19.1)	33.1	71.9
Other investments[@]	8.3	-	0	6.6	1.7	9.9	16.8	6.4	0.7
Foreign exchange[#]	<u>(44.9)</u>	<u>(9.0)</u>	<u>(10.8)</u>	<u>8.1</u>	<u>(33.2)</u>	<u>(52.7)</u>	<u>1.6</u>	<u>(1.4)</u>	<u>(9.1)</u>
Investment income/(loss)	(18.3)	18.5	(63.8)	18.7	8.3	44.7	81.2	111.6	27.1

* Excluding valuation change of Strategic Portfolio

[@] Including valuation changes of private equity and real estate investments held by Exchange Fund's investment holding subsidiaries. (The above figures for 2015 represent valuation changes of these investments up to end-September. The valuation figures for the fourth quarter are not yet available.)

[#] This is primarily the effect of translating non-US dollar foreign currency assets into Hong Kong dollar after deducting the portion for currency hedging



INVESTMENT DIVERSIFICATION

As of end-2015

New Asset Classes	Market Value HK\$ billion	Annualised return since inception till end-2015
Private Equity	90.0	} 12% (IRR)
Real Estate	49.3	
Total	139.3	

Note: Outstanding investment commitments at the end of 2015 amounted to HK\$122.4 billion



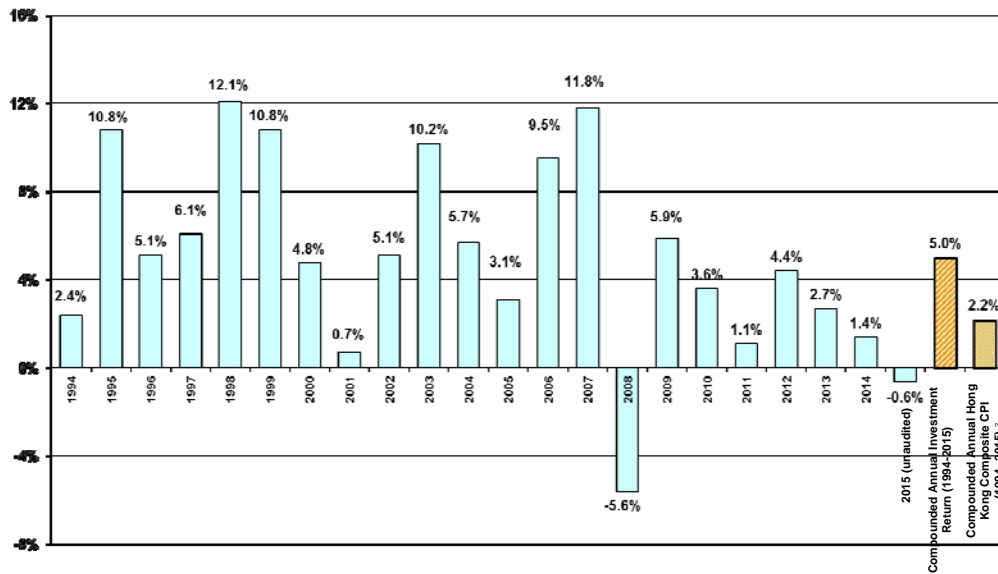
INCOME AND EXPENDITURE

(HK\$ billion)	← 2015 →					2014
	(unaudited)					
	Full year	Q4	Q3	Q2	Q1	Full year
Investment income/(loss)	(18.3)	18.5	(63.8)	18.7	8.3	44.7
Other income	0.2	0.1	0.0	0.1	0.0	0.2
Interest and other expenses	<u>(4.8)</u>	<u>(1.1)</u>	<u>(1.0)</u>	<u>(1.7)</u>	<u>(1.0)</u>	<u>(5.2)</u>
Net income/(loss)	(22.9)	17.5	(64.8)	17.1	7.3	39.7
Fee payment to Fiscal Reserves #	(46.7)	(11.6)	(11.5)	(11.8)	(11.8)	(27.5)
Fee payment to HKSAR government funds and statutory bodies #	(14.7)	(3.8)	(3.7)	(3.7)	(3.5)	(8.6)

The rate of fee payment is 5.5% for 2015 and 3.6% for 2014.



INVESTMENT RETURN OF THE EXCHANGE FUND (1994-2015) ¹



¹ Investment return calculation excludes the holdings in the Strategic Portfolio.

² Composite CPI is calculated based on the 2009/2010 base series.