



HONG KONG MONETARY AUTHORITY

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

6 November 2017

[Translation]

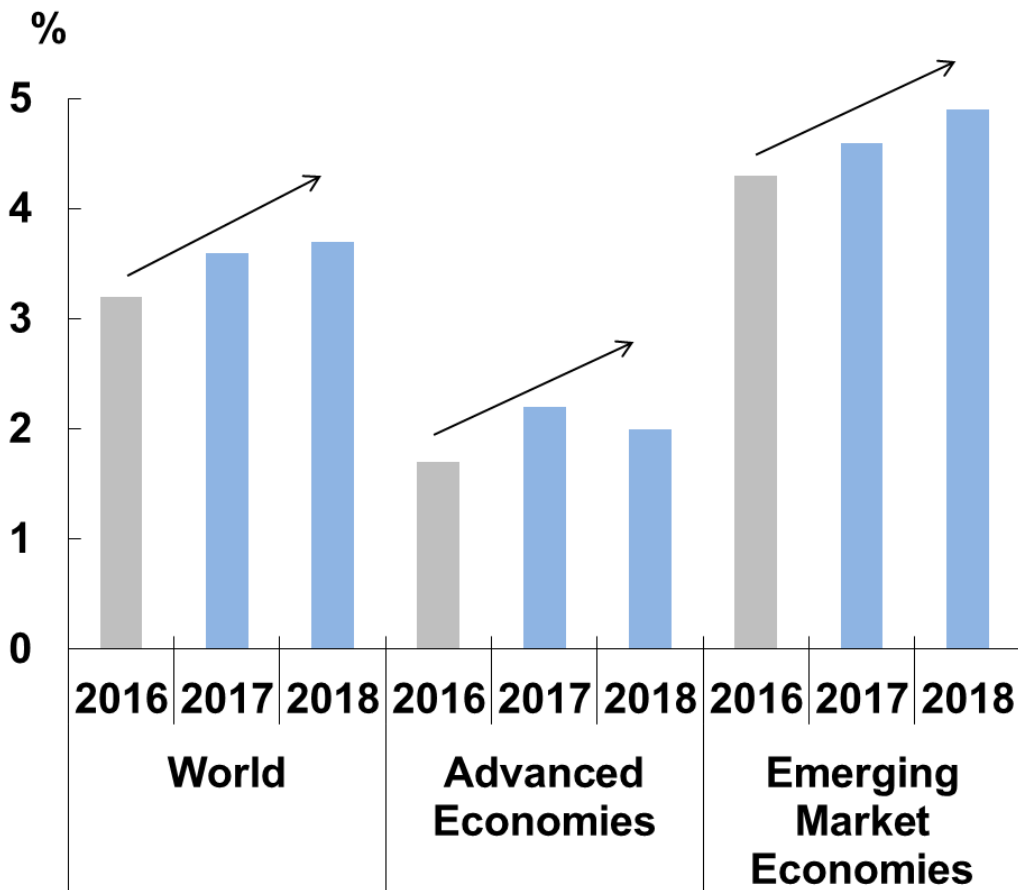


1. **Assessment of Risk to Hong Kong's Financial Stability**
2. Smart Banking
3. Banking Supervision
4. Financial Infrastructure
5. Development of Financial Market
6. Investment Performance of the Exchange Fund



SUSTAINED RECOVERY IN GLOBAL ECONOMY

Growth projections by International Monetary Fund

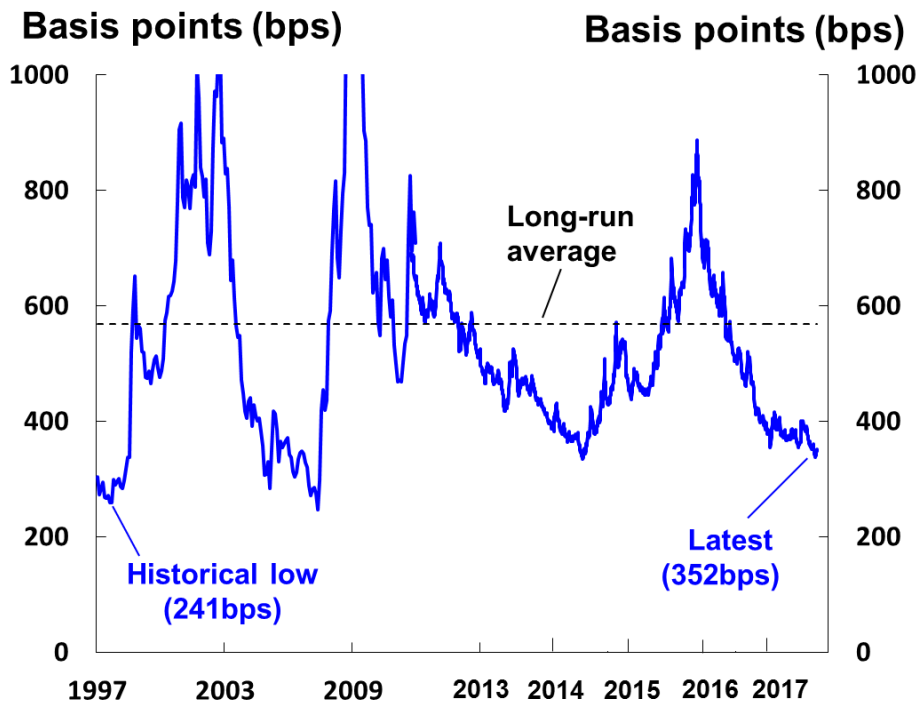


Source: International Monetary Fund.

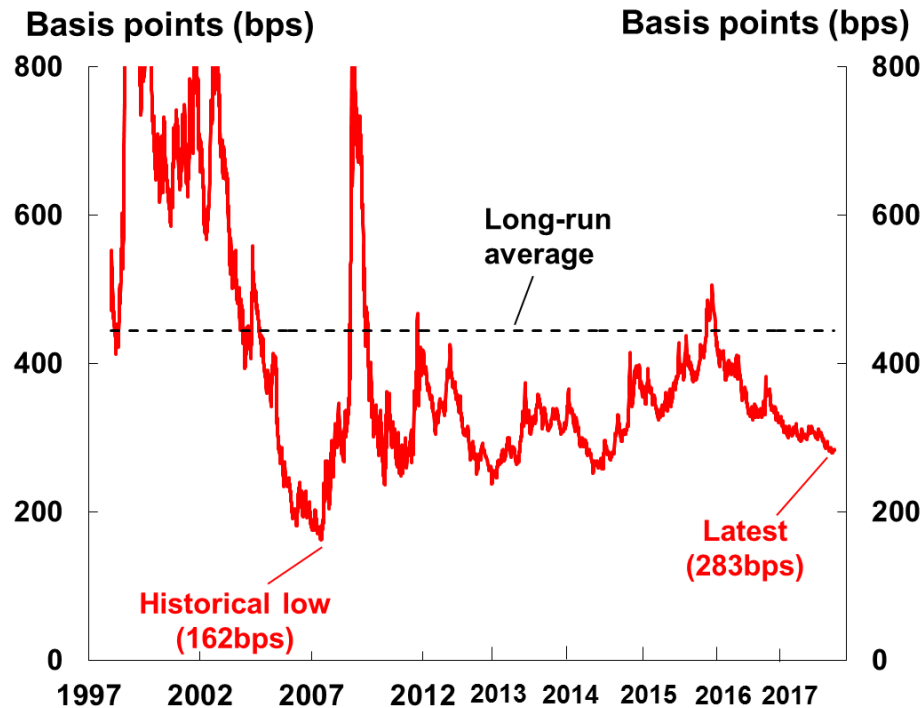


MORE BUOYANT BOND MARKET SENTIMENT

Credit spread of US high-yield corporate bonds declined



Credit spread of emerging market sovereign bonds also narrowed



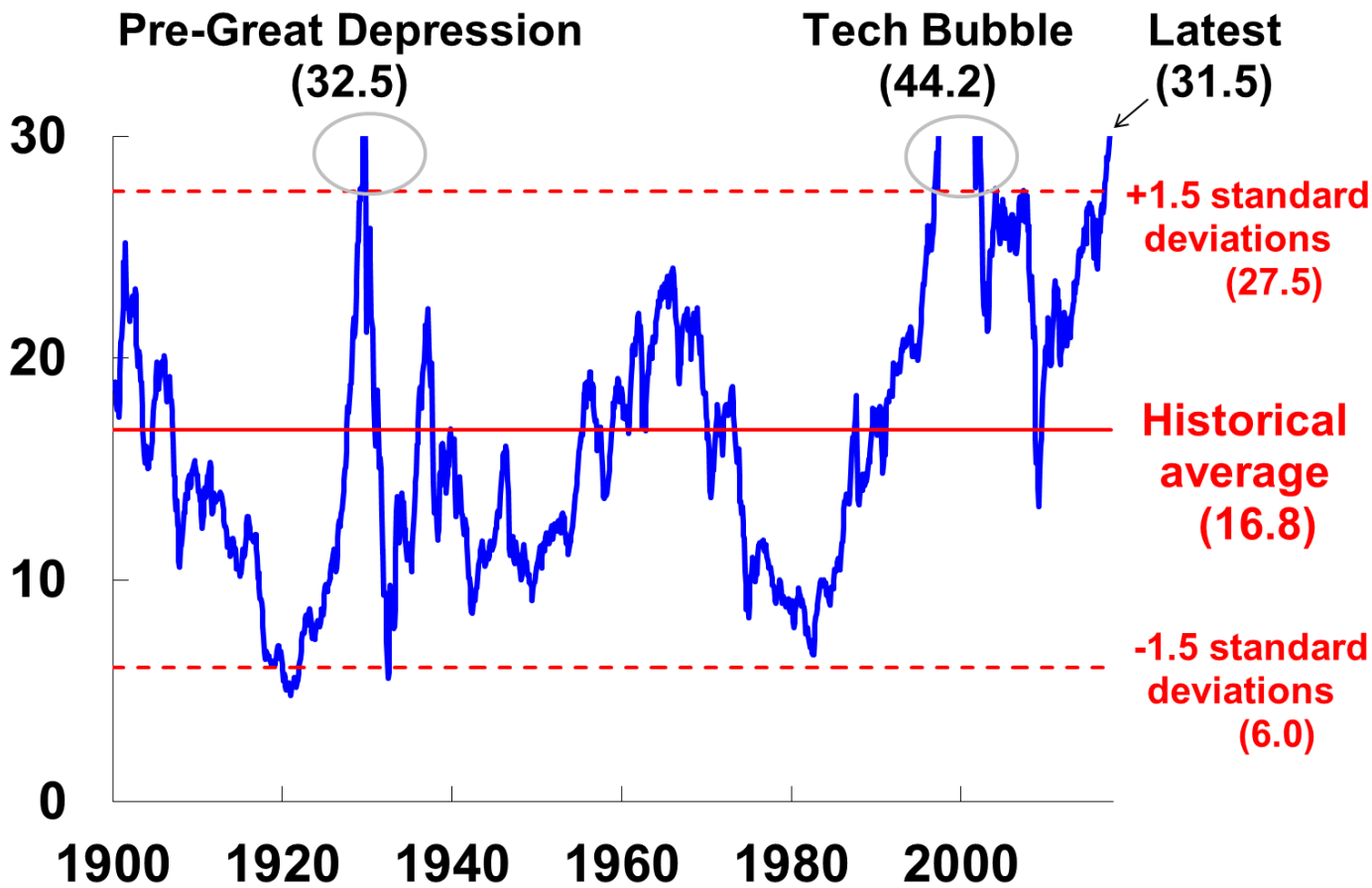
Note: Data shown in the charts are up to 2 November 2017. Credit spreads of US high-yield corporate bonds are derived from the Bank of America Merrill Lynch US High Yield Index. Credit spreads of emerging market sovereign bonds are derived from the JPMorgan EMBI Global Diversified Index.

Source: Bloomberg.



S&P 500 PRICE-EARNINGS (PE) RATIO CONTINUES TO RISE

S&P 500 cyclically adjusted PE ratio*



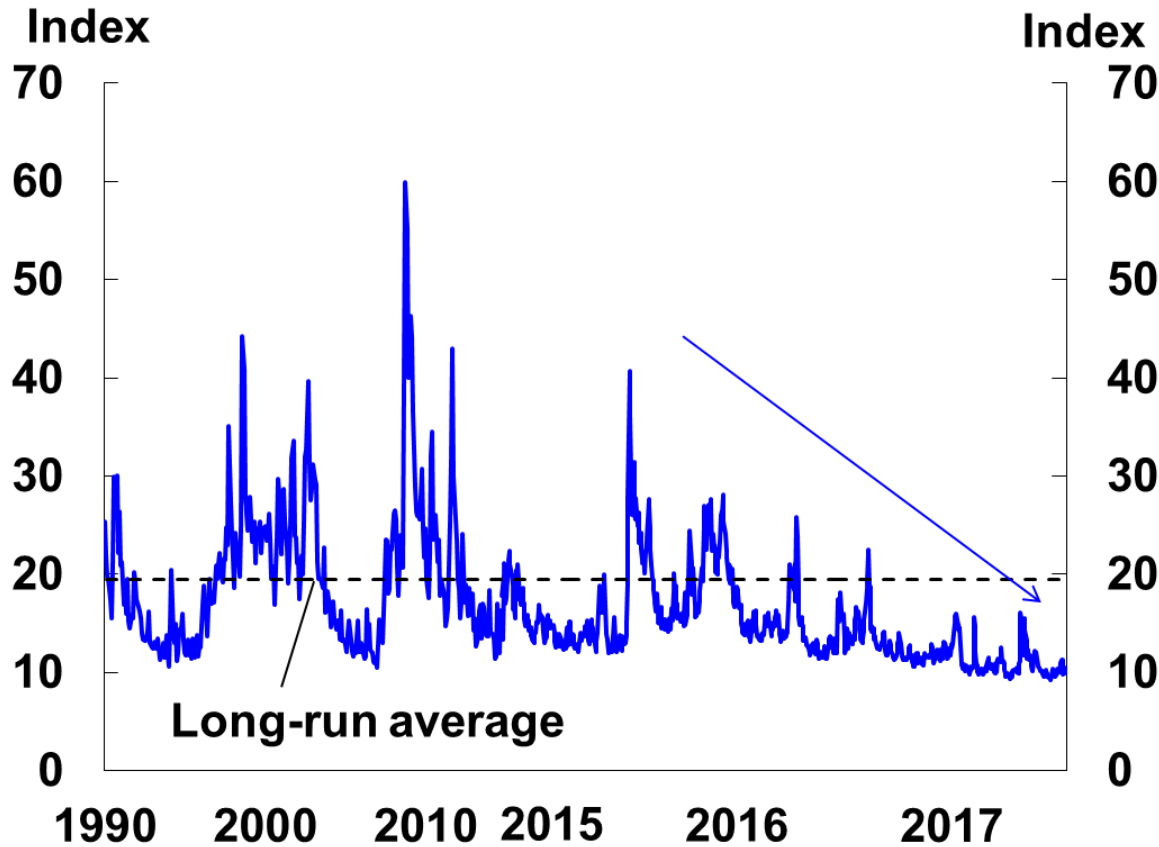
*The cyclically adjusted PE ratio is calculated by dividing the price of S&P 500 by the average earnings in the previous 10 years.

Source: Multpl.com



SUBDUED MARKET VOLATILITY MAY REFLECT UNDER-ESTIMATION OF DOWNSIDE RISKS BY INVESTORS

S&P 500 option-implied volatility (VIX)



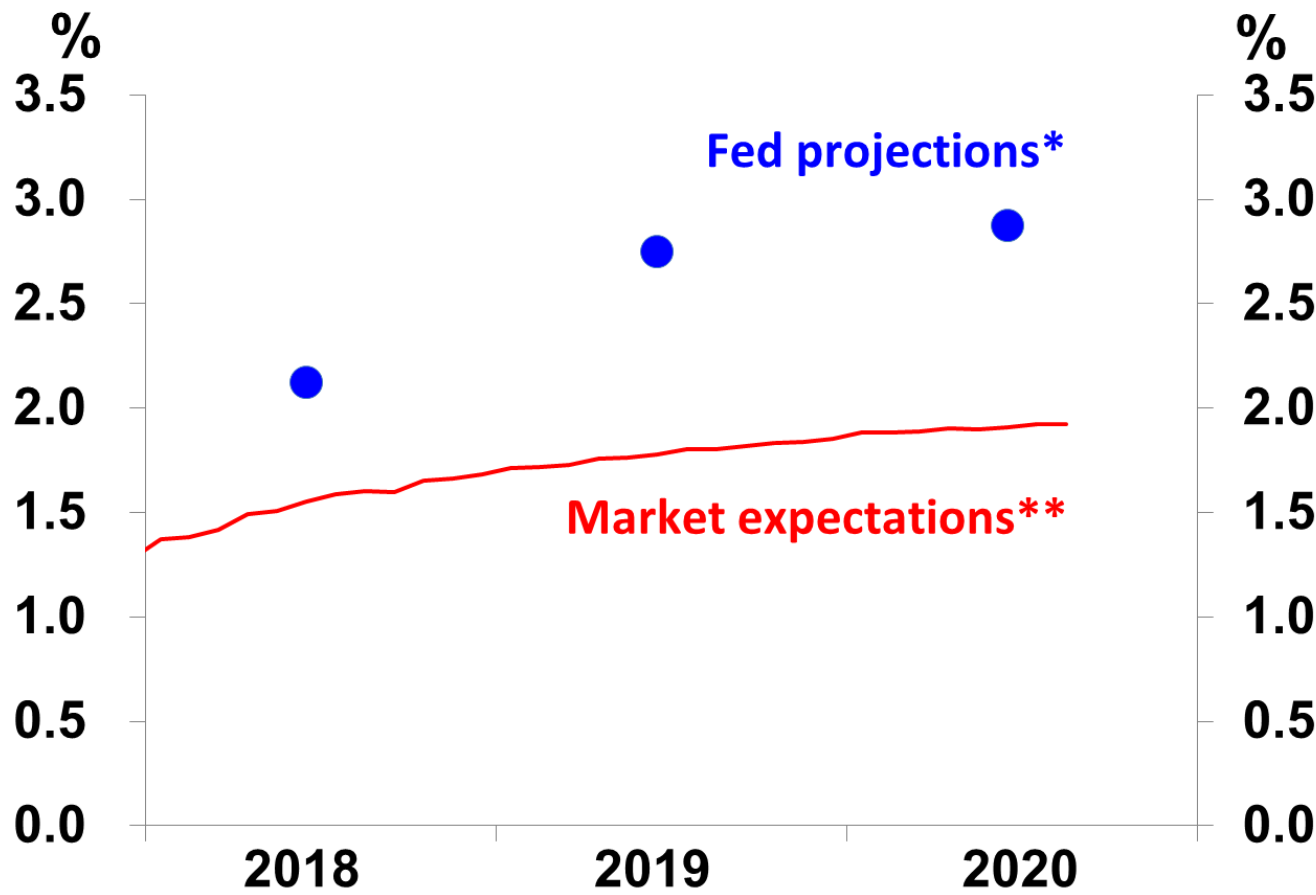
Note: VIX index reflects the S&P 500 option-implied volatility. Lower readings suggest market expectations of lower volatility of the S&P 500.

Source: Bloomberg.



RISK 1: MARKET EXPECTATIONS OF THE PACE OF US RATE HIKES ARE SLOWER THAN THE PROJECTIONS OF THE FEDERAL RESERVE (FED)

Expectations of future Fed funds rate



Note: * The median projections published after the September FOMC meeting.

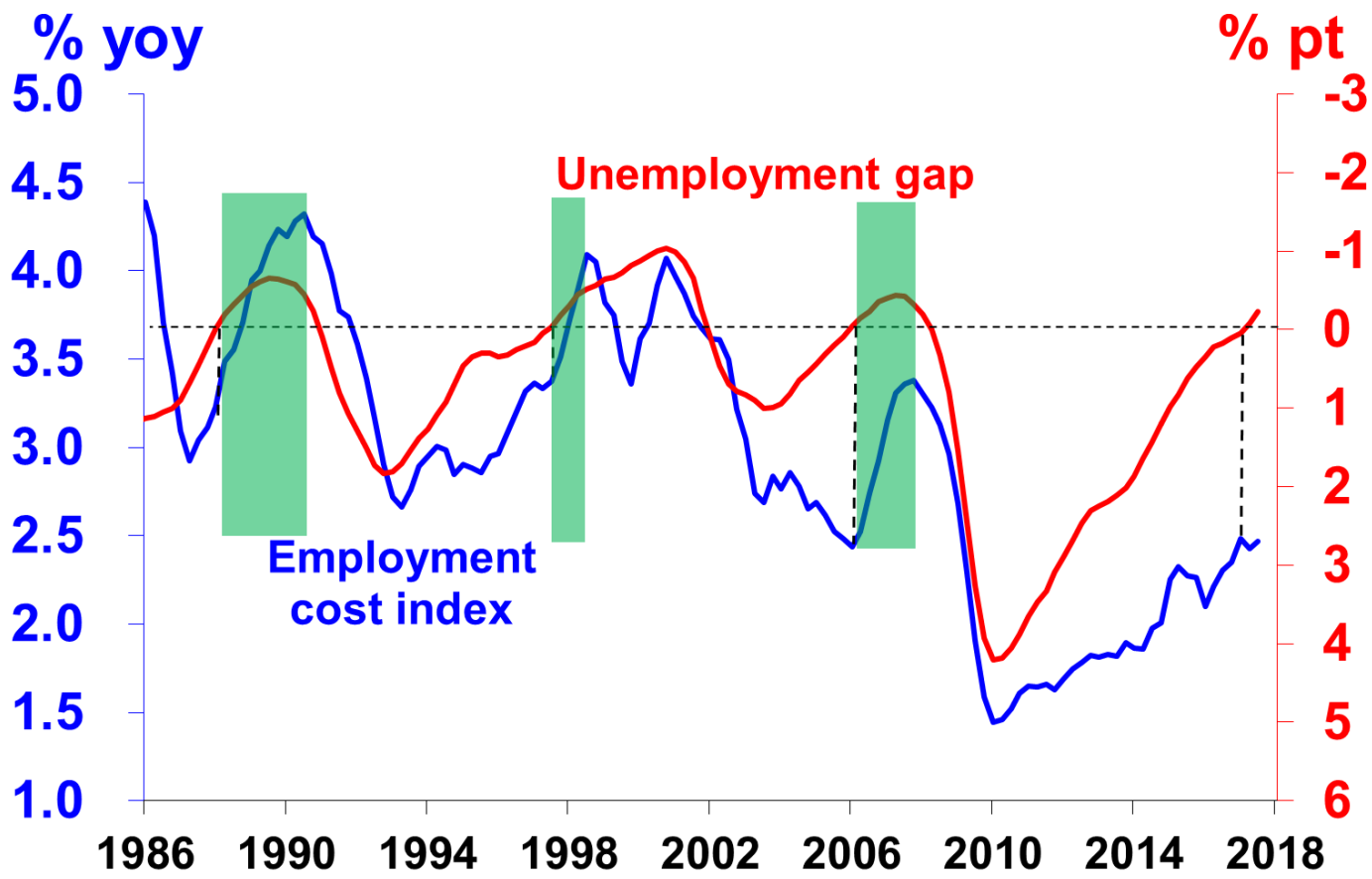
** Market expectations are implied by the latest (as at 2 November) Fed funds futures contracts.

Sources: Datastream and the Fed.



FULL EMPLOYMENT IN THE US MAY RESULT IN FASTER WAGE GROWTH

Relationship between unemployment gap and labour cost



Note: Unemployment gap is defined as the difference between the actual unemployment rate and the natural rate as estimated by the Congressional Budget Office (CBO). A negative gap indicates a tight labour market relative to equilibrium. Data shown in the chart are 4-quarter moving averages.

Sources: Datastream and CBO.



RISK 2: GEOPOLITICAL RISKS CONTINUE TO HEIGHTEN

- Asia: Korean Peninsula
- Europe: Spain, refugee crisis, terrorist attacks
- Middle East: Iran, Kurdish independence referendum, Syria, ISIS



MAINLAND CHINA: ECONOMY HAS STABILISED, WITH FOCUS ON PREVENTING ECONOMIC AND FINANCIAL RISKS

- Mainland economy has continued to stabilise since the second half of 2016
- Renminbi depreciation expectations and capital outflow pressures have eased
- Step up macroeconomic and financial management
 - Continue to urge enterprises and financial institutions to carry out deleveraging
 - Strengthen the management of local government debt issuance
 - Set up the Financial Stability and Development Committee under the State Council
 - Strengthen property market regulation
 - Regulate mergers and acquisitions in overseas markets



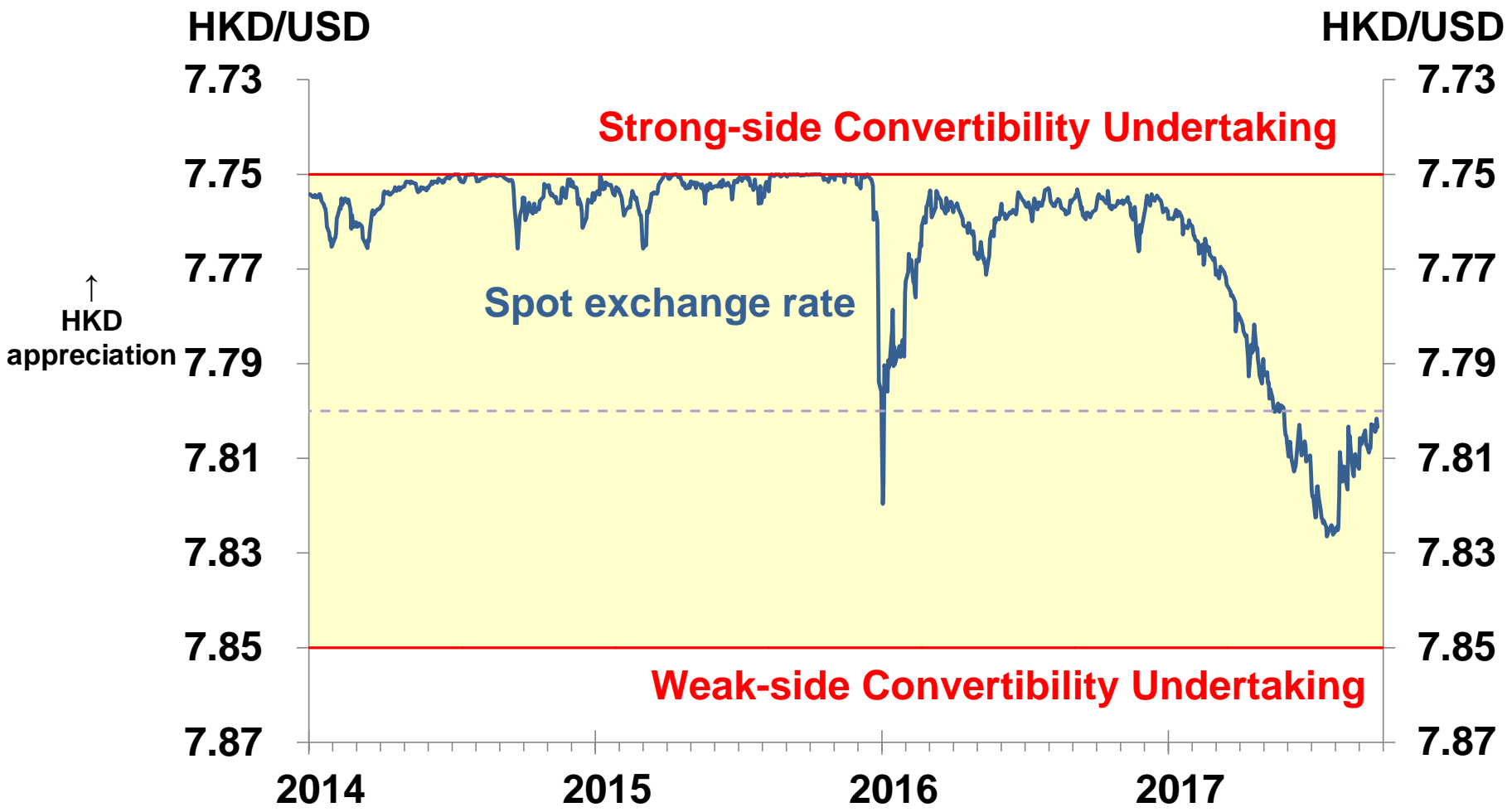
ASSESSMENT OF RISKS TO GLOBAL FINANCIAL STABILITY

- Global economy continues to improve and financial market sentiment turns more positive
- Amid ample liquidity, stock market valuation has exceeded the peak recorded right before the global financial crisis
- Market may have under-estimated two major risks:
 - The pace of inflation pick-up and interest rate hikes in the US may be faster than expected
 - Heightened geopolitical tension



ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: HONG KONG DOLLAR SPOT RATE

Easing of HKD as a result of interest rate arbitrage reflects the normal operation of the Linked Exchange Rate system

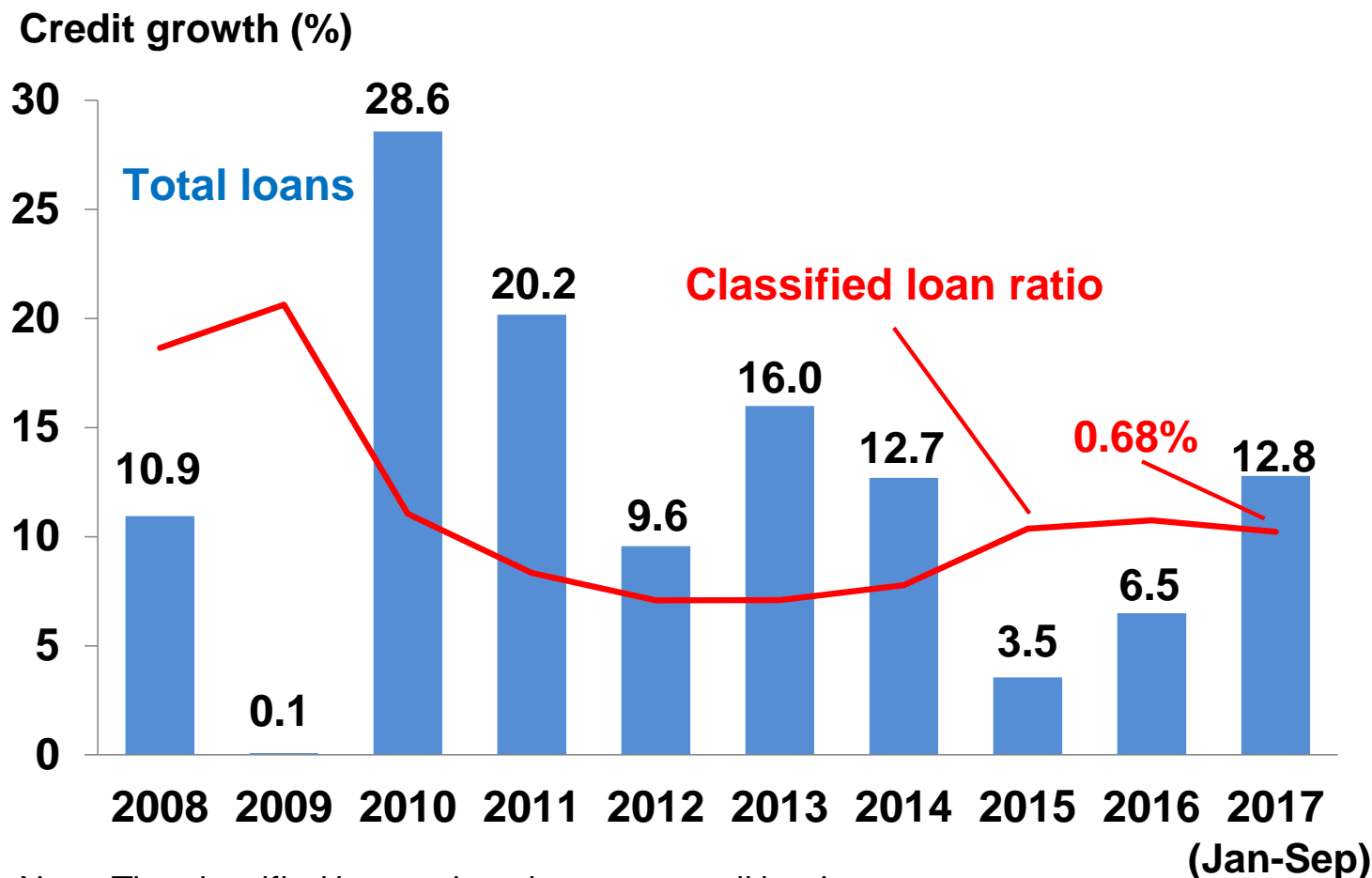


Source: HKMA.



ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: BANK CREDIT

Credit growth showed signs of moderation in the third quarter with asset quality staying at a healthy level



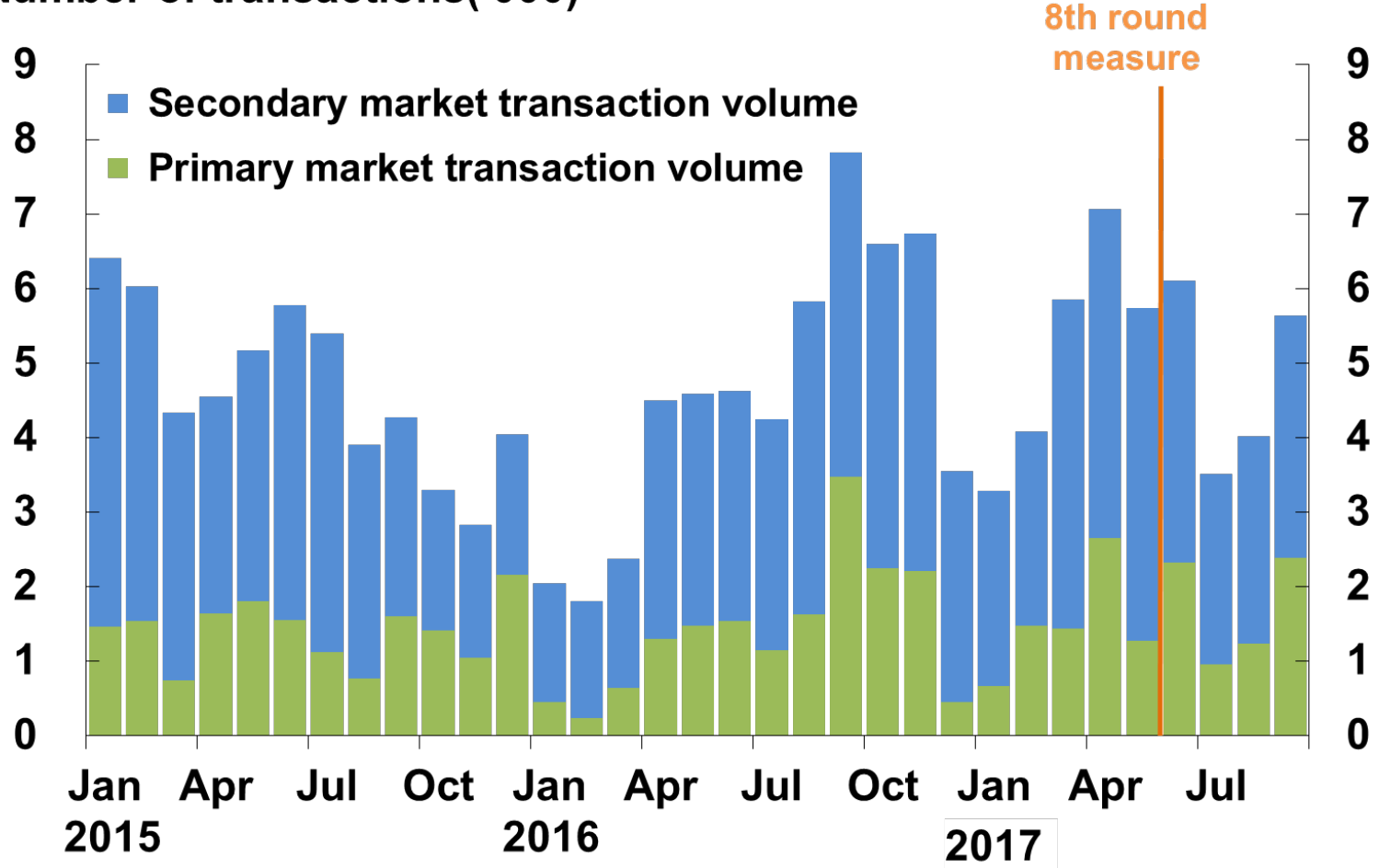
Note: The classified loan ratio only covers retail banks.



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

Transaction volume picked up again in September after falling in July and August

Number of transactions('000)

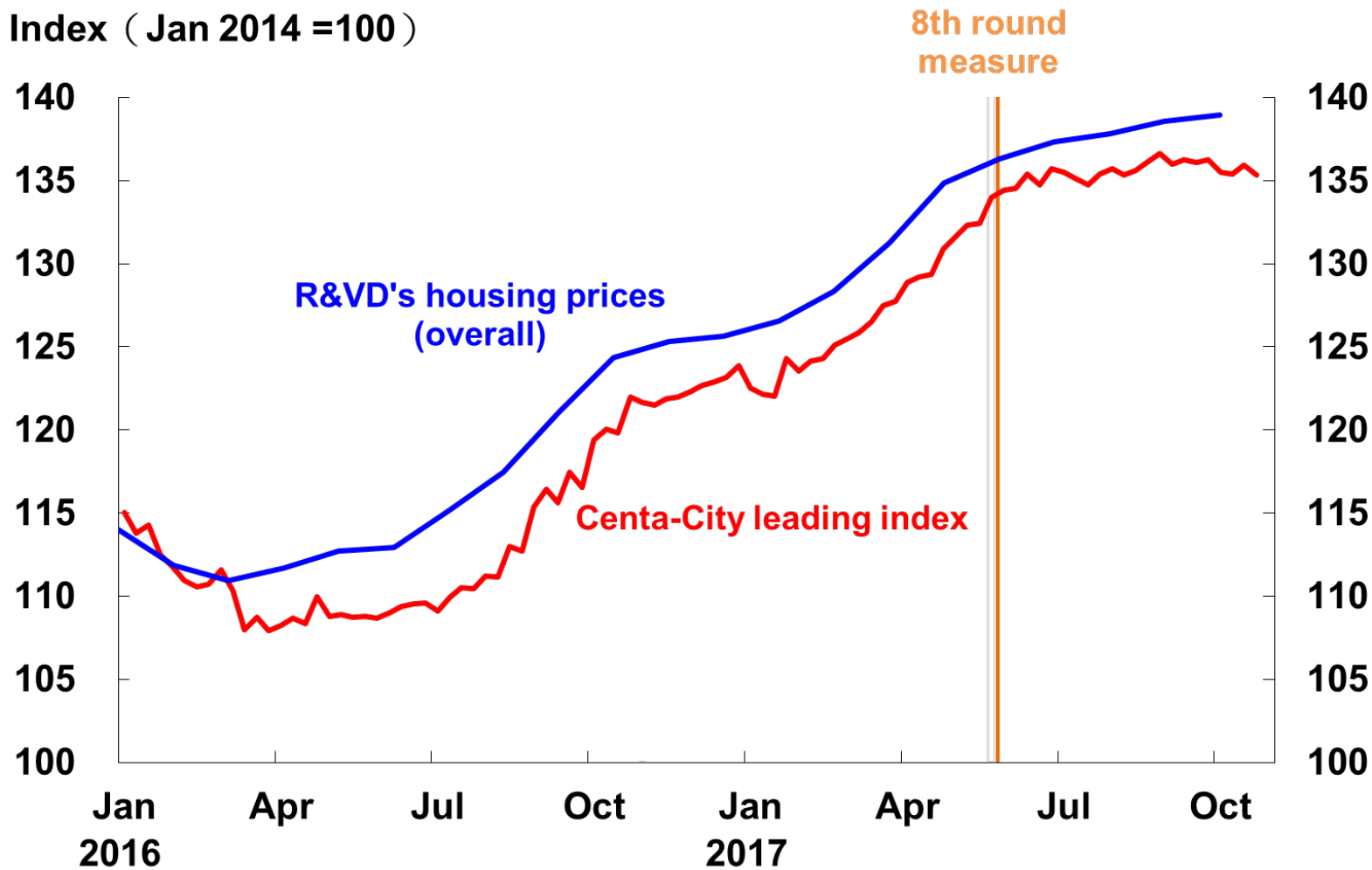


Source: Land Registry.



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

Property prices continued to grow from July to September





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

- Normalisation of US monetary policy is expected to affect global financial conditions and capital flows. Hong Kong is no exception
- Interest rate arbitrage activities have led to softer Hong Kong dollar exchange rate and some outflows. This reflects the normal functioning of the Linked Exchange Rate System in accordance with its design
- Trends in the property market remain uncertain since the introduction of prudential measures in May. More time is needed to observe market developments
- Global asset markets continue to rise, reflecting that markets may have under-estimated the pace of increase in US inflation and interest rates as well as the potential risks associated with the worsening geopolitical conditions



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A NEW ERA OF SMART BANKING

Seven initiatives launched by the HKMA:

1. Full connectivity of digital retail payments through the Faster Payment System
2. Upgrading of our existing Fintech Supervisory Sandbox to Version 2.0
3. Facilitating the introduction of virtual banking
4. A new Banking Made Easy initiative to reduce regulatory frictions and improve customer experience
5. Development of an Open Application Programming Interface framework
6. Stepping up cross-border cooperation in fintech
7. Enhancing research and talent development

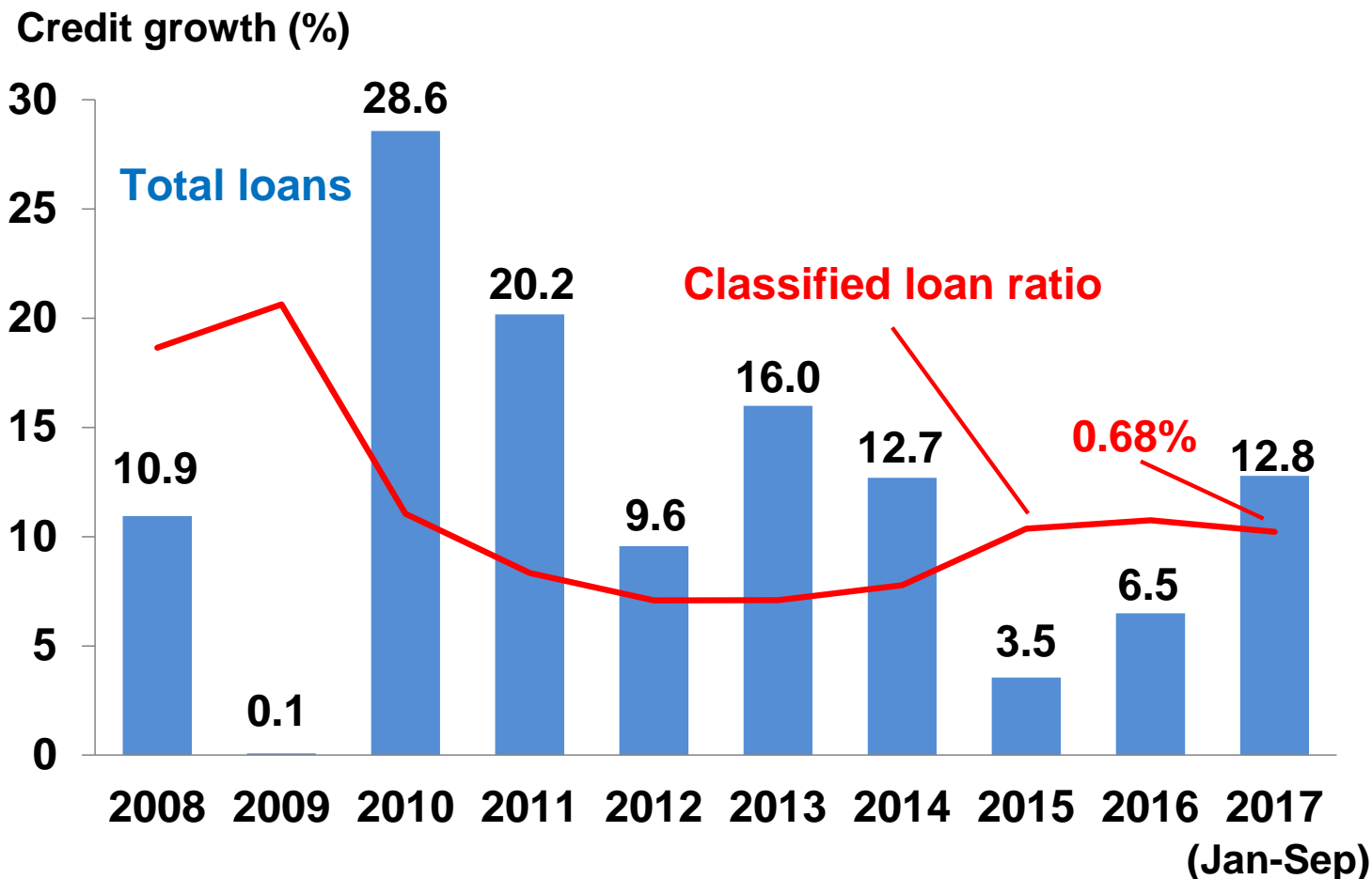


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BANKING SECTOR PERFORMANCE

Credit growth showed signs of moderation in the third quarter
with asset quality staying at a healthy level



Note: The classified loan ratio only covers retail banks.

Source: HKMA.



LEGISLATIVE PROPOSALS (1)

- Amendments to capital and liquidity rules to implement Basel standards: (i) leverage ratio; (ii) revised securitisation framework; (iii) treatment of expected loss provisions; and (iv) net stable funding ratio. Addition of a new multilateral development bank
- Banking (Amendment) Bill 2017 to implement latest international standards on large exposure limits and recovery planning



LEGISLATIVE PROPOSALS (2)

- Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) (Amendment) Bill 2017 to (i) cover some non-financial sectors; and (ii) fine-tune some customer due diligence requirements for financial institutions
- Developing subsidiary legislation under Financial Institutions (Resolution) Ordinance as well as other relevant legislation, including:
 - Loss-absorbing capacity (LAC) rules for authorized institutions, and amendments to the Inland Revenue Ordinance to clarify tax treatment of LAC instruments
 - Rules made by the Chief Justice regulating Court practice and procedures on (i) remuneration clawback; and (ii) presentation of winding up petition for within scope entities



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REGULATORY REGIME FOR STORED VALUE FACILITIES (SVFs) AND RETAIL PAYMENT SYSTEMS (RPSs)

- Electronic payments are popular and diverse in Hong Kong
 - 2.6 credit cards per person; on average around 1.7 million transactions per day totalling \$1.7 billion
 - Multiple payment choices: Octopus card, mobile payment, online payment, etc.
- 16 SVF operators are working to expand reach and roll out new services
 - 43.5 million SVF accounts in use; around 15 million transactions per day
 - Enhance retailer and user adoption, and expand applications, including cross-border usage
- Four RPSs (Visa, Mastercard, UnionPay International and American Express) were designated in August 2017 under the Payment Systems and Stored Value Facilities Ordinance and are subject to HKMA's oversight



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BOND CONNECT AND OFFSHORE RENMINBI BUSINESS

Bond Connect

- Bond Connect has been operating smoothly since its launch on 3 July. Currently, over 180 institutional investors have joined Bond Connect
- HKMA continues to closely monitor Bond Connect operation, and maintains close communication with the Mainland authorities and relevant parties to further enhance operational arrangements

Offshore Renminbi Business

- Hong Kong's renminbi deposit pool stabilised at around RMB600 billion; transactions through our renminbi RTGS system also stayed at a high level, averaging RMB900 billion daily
- Hong Kong's RQFII quota was expanded to RMB500 billion in July



PROMOTION OF HONG KONG'S FINANCIAL PLATFORM

Corporate Treasury Centres (CTC)

- The HKMA has been actively engaging the industry to promote Hong Kong's CTC platform. After launching tax measures in June 2016, we have reached out to about 300 corporates, more than 30 of which are actively considering setting up or expanding their CTC operations in Hong Kong

Developing an Onshore Private Equity (PE) Fund Platform

- To maintain Hong Kong as Asia's PE hub, the HKMA is working with the Financial Services and the Treasury Bureau in reviewing the local PE fund platform. The review covers the limited partnership legal framework and tax treatments for PE funds, with a view to attracting more PE funds to set up in Hong Kong



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INVESTMENT INCOME

| | ← 2017 → (unaudited) | | | | 2016 | 2015 |
|---------------------------------|-------------------------|-------------------|--------------------|--------------------|----------------------|----------------------|
| (HK\$ billion) | Jan - Sep | Q3 | Q2 | Q1 | Full Year | Full Year |
| Hong Kong equities* | 42.2 | 14.4 | 13.5 | 14.3 | 5.3 | (5.0) |
| Other equities | 58.9 | 18.8 | 15.6 | 24.5 | 28.6 | 7.1 |
| Bonds | 27.2 | 10.7 | 10.1 | 6.4 | 33.1 | 15.9 |
| Other investments@ | 17.5 | - | 9.7 | 7.8 | 16.9 | 11.1 |
| Foreign exchange# | <u>44.0</u> | <u>9.7</u> | <u>22.4</u> | <u>11.9</u> | <u>(15.8)</u> | <u>(44.9)</u> |
| Investment income/(loss) | 189.8 | 53.6 | 71.3 | 64.9 | 68.1 | (15.8) |

* Excluding valuation changes of the Strategic Portfolio

@ Including valuation changes of private equity and real estate investments held under the Long-Term Growth Portfolio (LTGP). (The above figures represent valuation changes up to the end of June 2017. Valuations of these investments from July to September are not yet available.)

This is primarily the effect of translating foreign currency assets into Hong Kong dollar after deducting the portion for currency hedging.



INCOME AND EXPENDITURE

| (HK\$ billion) | ← 2017 → (unaudited) | | | | 2016 | 2015 |
|---|-------------------------|--------------|--------------|--------------|--------------|---------------|
| | Jan - Sep | Q3 | Q2 | Q1 | Full year | Full year |
| Investment income/(loss) | 189.8 | 53.6 | 71.3 | 64.9 | 68.1 | (15.8) |
| Other income | 0.1 | 0.0 | 0.1 | 0.0 | 0.2 | 0.2 |
| Interest and other expenses | <u>(7.2)</u> | <u>(2.2)</u> | <u>(2.8)</u> | <u>(2.2)</u> | <u>(6.4)</u> | <u>(4.8)</u> |
| Net income/(loss) | 182.7 | 51.4 | 68.6 | 62.7 | 61.9 | (20.4) |
| Fee payment to Fiscal Reserves** | (17.4) | (6.0) | (5.8) | (5.6) | (33.1) | (46.7) |
| Fee payment to HKSAR government funds and statutory bodies* | (6.5) | (2.2) | (2.2) | (2.1) | (9.6) | (14.7) |

* The rate of fee payment is 2.8% for 2017, 3.3% for 2016 and 5.5% for 2015.

This does not include the 2017 fee payment to the Future Fund because such amount will only be disclosed when the composite rate for 2017 is available (For 2016, the composite rate was 4.5% and fee payable to the Future Fund was HK\$10.1 billion).