HONG KONG MONETARY AUTHORITY

# Briefing to the Legislative Council Panel on Financial Affairs

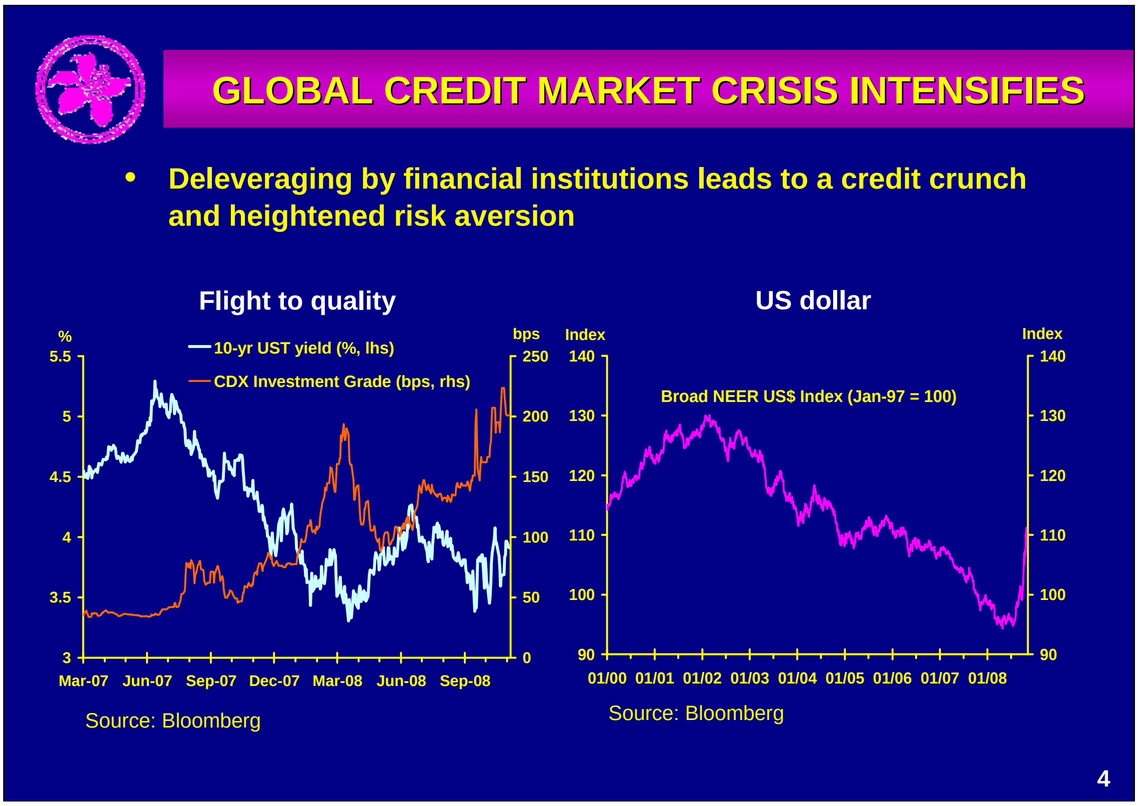
21 November 2008

# DISCUSSION TOPICS

Updates on

- Financial Market Crisis
- Currency Stability
- Banking Industry
- Financial Infrastructure
- Hong Kong as an International Financial Centre
- Exchange Fund

# FINANCIAL MARKET CRISIS

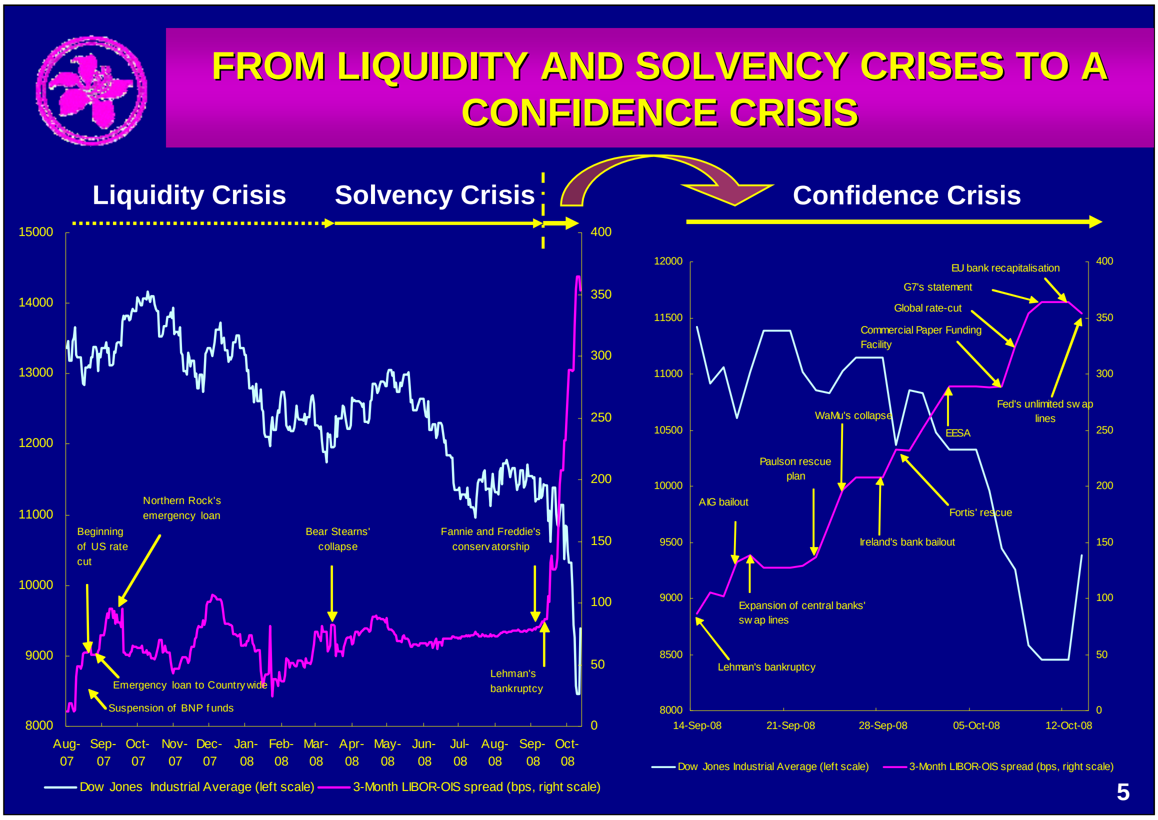



- In the US and in other advanced economies, the credit market crisis intensified from mid September.

- Credit markets became dysfunctional and risk aversion escalated along with deleveraging by financial institutions.

- Investors sought the safe haven of US Treasuries, driving yields to very low levels, as markets priced in rising risks of defaults among financial institutions, corporates and even sovereigns.

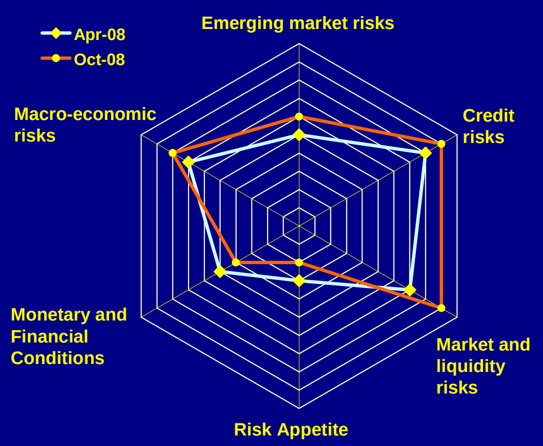
- The US dollar rebounded as investors fled risky assets and deleveraging brought about some repatriation into the dollar.




- The development of the financial turmoil can be broadly divided into 3 phases:
  - a liquidity crisis that began in August 2007 and deteriorated into a solvency crisis marked by the bailout of Bear Stearns in March and the failure of Lehman Brothers in mid-September, triggered a confidence crisis that threatened a meltdown in financial markets.

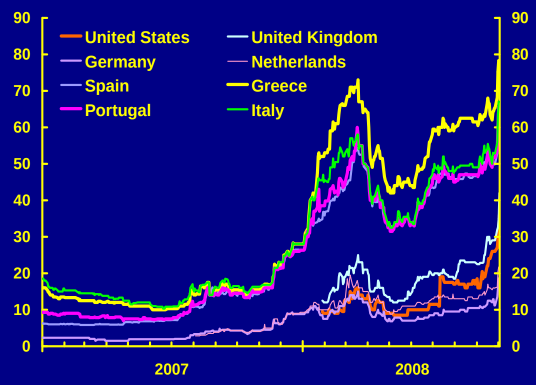
## EFFECTS ON MARKET CONFIDENCE

**Global Financial Stability Map**




Source: IMF GFSR

**Sovereign CDS spreads (bps)**




Source: IMF GFSR, Bloomberg

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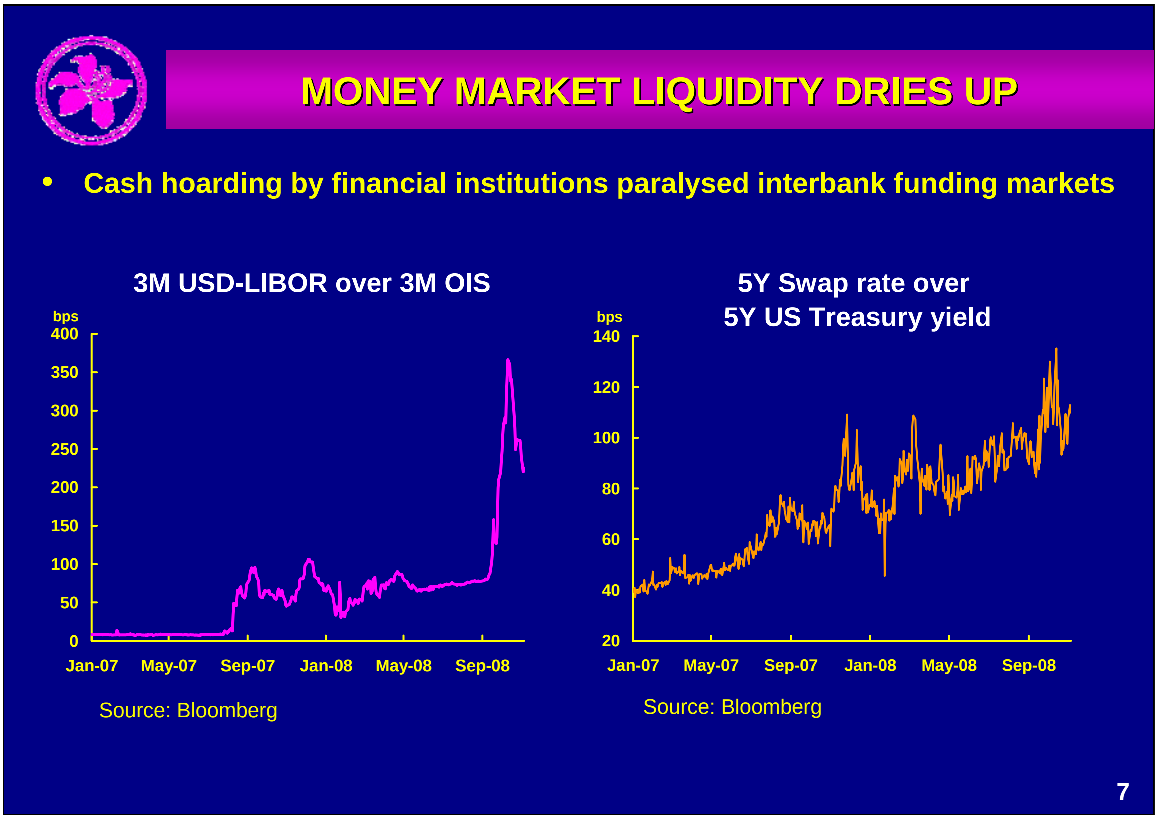
- Sharp deterioration in global financial stability and sovereign CDS spreads:
  - the Global Financial Stability Map constructed by the IMF shows that credit risks, liquidity risks, macroeconomic risks and emerging market risks have all increased now compared to 6 months ago, while risk appetite has decreased and monetary and financial conditions have tightened.
  - The sovereign CDS spreads of developed economies have also widened significantly in the past few months, a sign that investors have become more risk-averse globally.




- Cash hoarding by financial institutions, induced by growing mistrust among counterparties, paralysed interbank funding markets.

- As third-party risk continues to mount, credit markets tighten, as reflected in the elevated LIBOR-Overnight Index Swap spreads and the swap rate over Treasury yields.

## CAPITAL DEPLETION AT FINANCIAL INSTITUTIONS

- **Writedowns are depleting capital rapidly. New capital raised lags behind.**
- **The IMF says banks may need US$675 billion in fresh capital.**

**Writedowns, Credit Losses, and Capital Raised in the US**

| *US$ billions* | Writedowns[1] | Capital Raised[2] | Tier-one Capital[3] |
|---|---|---|---|
| **Americas** | **333.2** | **235.6** | **-** |
| Citigroup Inc. | 60.7 | 71.1 | 106.9 |
| Merrill Lynch & Co. | 52.2 | 29.9 | 27.4 |
| Washington Mutual | 45.2 | 12.1 | 23.9 |
| Wachovia Corporation | 52.8 | 11.0 | 49.5 |
| Bank of America Corp | 21.1 | 20.7 | 101.5 |
| JP Morgan Chase & Co. | 18.2 | 19.7 | 98.8 |
| Morgan Stanley | 15.7 | 14.6 | 37.1 |
| Lehman Brothers Holdings Inc. | 13.8 | 13.9 | 23.2 |
| Wells Fargo & Company | 9.9 | 5.9 | 42.5 |
| National City Corp. | 5.4 | 8.9 | 15.4 |
| Goldman Sachs Group Inc | 4.9 | 10.6 | 43.5 |
| U.S. Bancorp | 1.3 | 0.0 | 18.6 |

1. Include credit losses. Period: Q3 2007 - Current (data as at 30 September 2008)
2. Period: Q3 2007 - Current (data as at 30 September 2008)
3. Based on quarterly SEC filings of the form 10-Q. Period under review is Q2 2008, but the period-end may vary among institutions as accounting periods may differ.

Source: Bloomberg, 10-Q SEC Filings of respective institutions

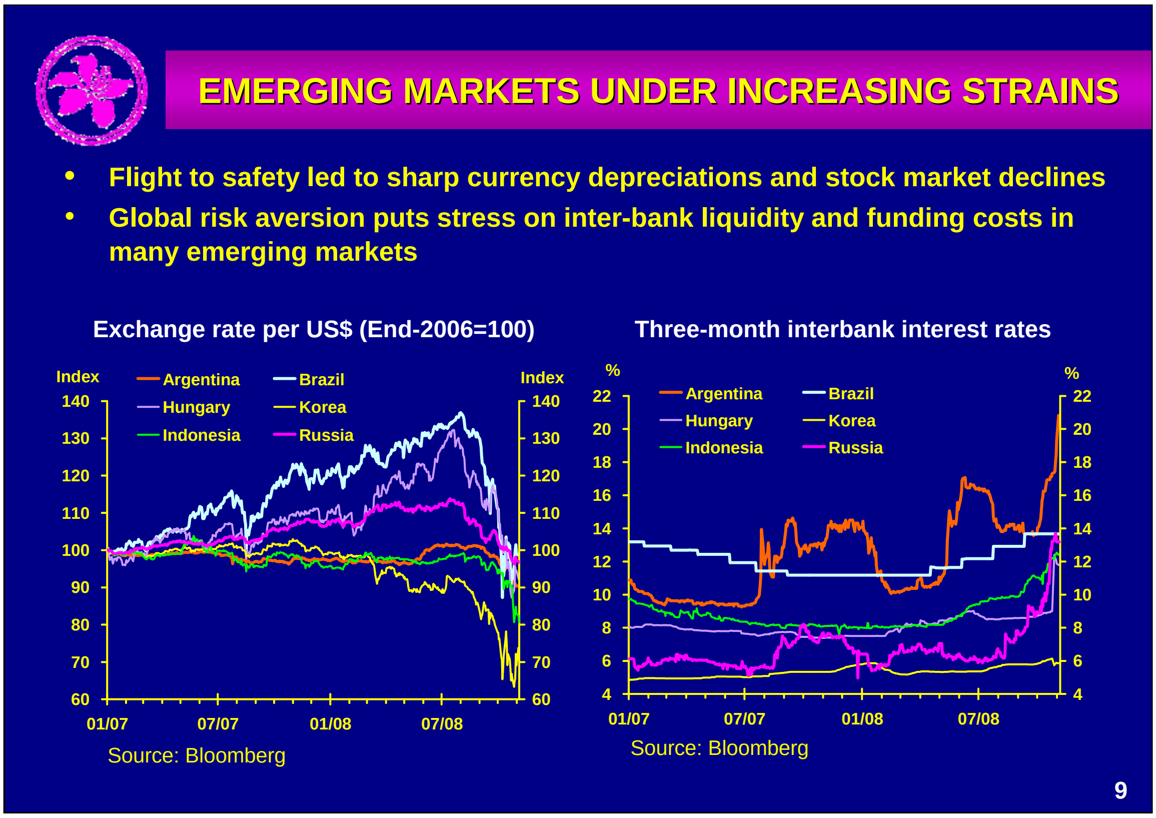


- Financial institutions have suffered writedowns and credit losses amounting to over US$500 billion worldwide since the beginning of the financial market crisis.

- Most of the losses are concentrated in North America (US and Canada) and Europe. Losses in Asia are substantially smaller.

- Writedowns are depleting capital rapidly while new capital raised lags behind. The IMF says that banks may need US$675 billion in fresh capital.

- Future developments will depend heavily on whether or not the TARP and other recapitalisation programmes are able to forestall additional deleveraging and restore conditions conducive to private capital investment in financial insitutions.




- A rise in global risk aversion led to exacerbated volatility and interruptions in capital inflows or capital outflows in some emerging market economies.

- Global risk aversion also put stress on inter-bank liquidity and funding costs in many emerging markets.

- There may also have been increased difficulties of banking systems more reliant on funding in international markets.

- Depositor confidence becomes more fragile in face of failure of major financial institutions and significant losses related to these failures.

## INTERNATIONAL MEASURES TO ADDRESS THE CRISIS

- **Liquidity**
  - **Liquidity injection**
  - **Expansion of central bank facilities**
  - **Coordinated policy rate cuts**
- **Capital replenishment**
  - **Facilitated sales**
  - **Removal of troubled assets**
  - **Capital injection**
  - **Nationalisation**
- **Confidence**
  - **Restrictions on short-selling**
  - **Increase in deposit protection**
  - **Bank debt guarantees**

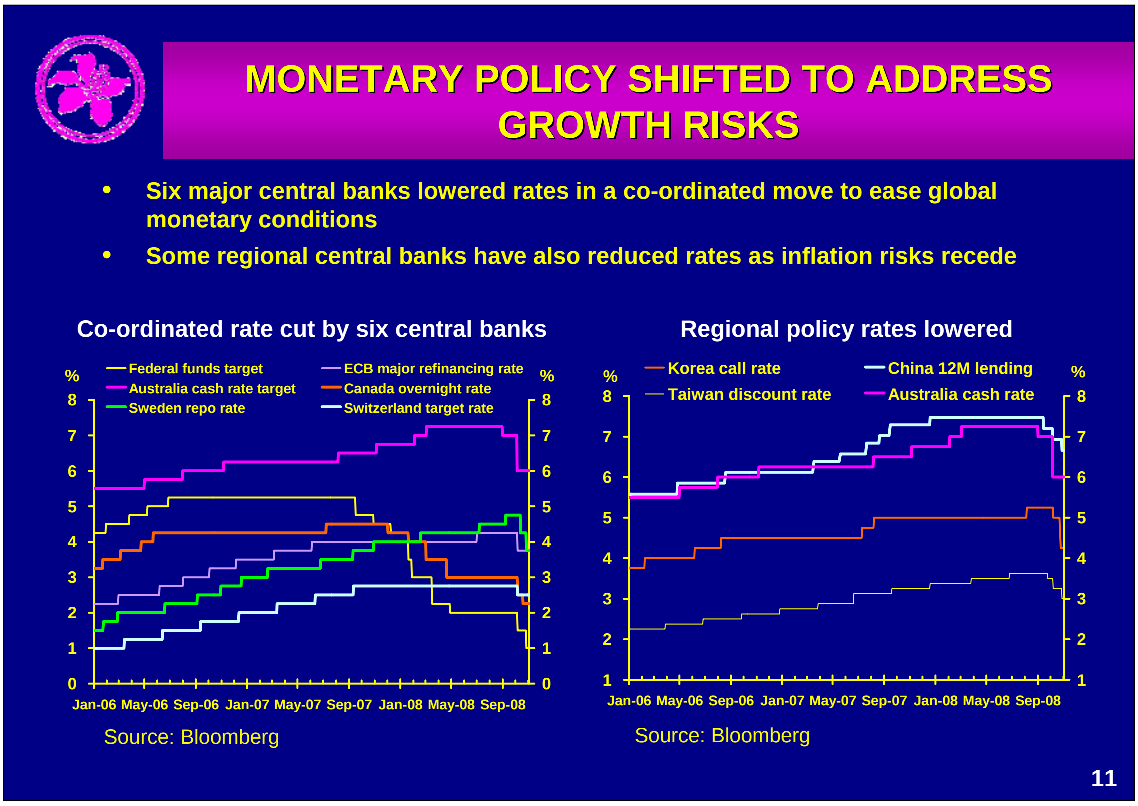


- Before the rebound on 13 Oct, there was a sense of frustration among US and European Finance Ministers and central banks as markets continued to deteriorate despite drastic measures to provide liquidity, help banks to replenish capital and restore market confidence.

- Many central banks of developed economies have injected massive amounts of liquidity into their financial systems. Some of them have also expanded their liquidity facilities in terms of amount, terms and types of collateral. Some central banks have also co-ordinated interest rate cuts.

- As the crisis deepened, it became apparent that the capital of financial institutions would need to be replenished and their balance sheets cleaned up for lending to start again. Measures were introduced to facilitate sales and remove troubled assets. Direct capital injections into troubled financial institutions were made and some institutions were even nationalised.

- Some developed economies have imposed restrictions on short-selling of equities, increased deposit protection and introduced bank debt guarantees.




- In the face of deteriorating economic conditions, monetary policy in many advanced and emerging economies shifted to address risks to growth.

- On October 8, six major central banks announced co-ordinated interest rate cuts in efforts to demonstrate their commitment to address the financial market crisis and to ease global monetary conditions.

- Some regional central banks have also lowered their policy rates as inflationary pressures receded along with declining commodity and food prices.

## IMPACT ON FINANCIAL MARKETS IN HONG KONG

- Tighter credit and liquidity conditions in the interbank money market
- Higher term interest rates
- Asset quality of banks affected
- Nervousness among depositors
- Tightened credit supply, affecting funding for SMEs and other customers

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- The continuing strains in the financial systems of developed economies have caused increasing concerns among banks in Hong Kong over the financial health and creditworthiness of counterparties.

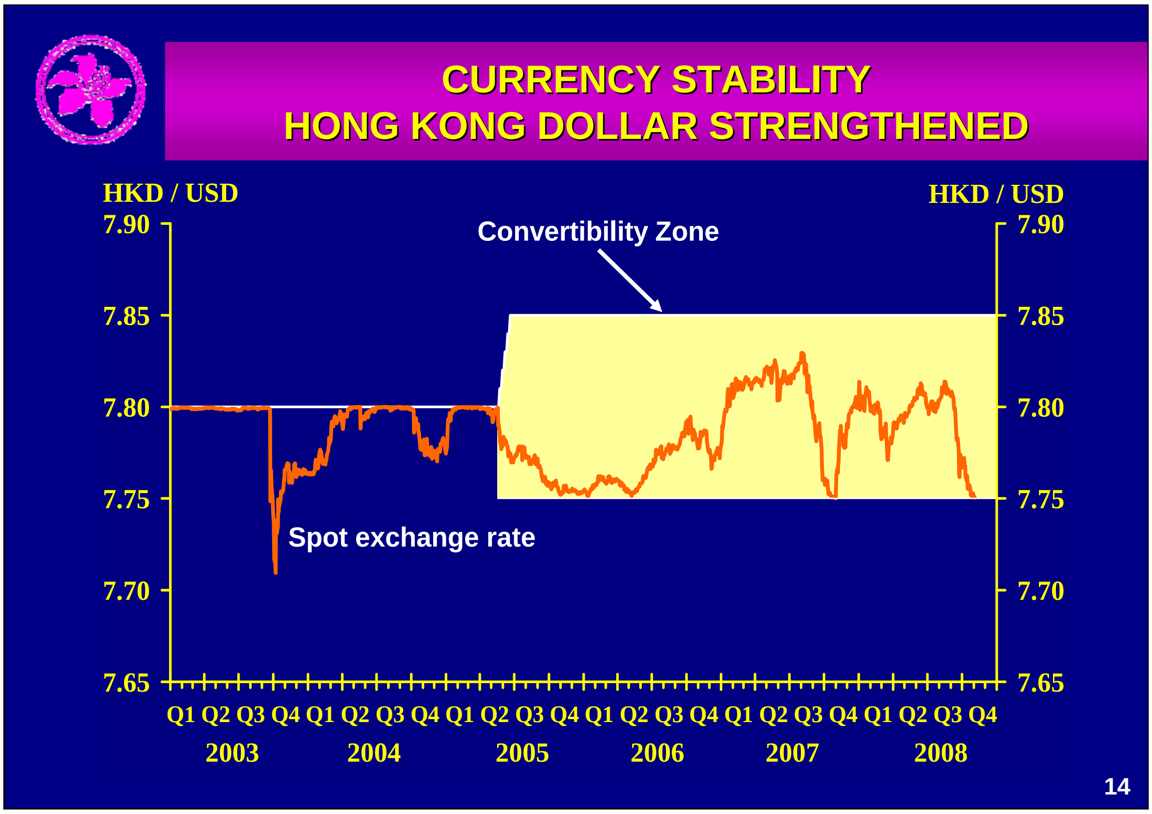
- The incentive to preserve greater liquidity buffers to meet their contingent needs in such a tight credit environment has restrained banks' lending activities in the interbank market. Liquidity for term lending dried up and interest rates went up as a result.

- The tighter credit and liquidity conditions in financial markets worldwide led to a sharp fall in the prices of financial products and activities, adversely affecting banks' asset quality and hence leading to provisions and write-offs.

- Nervousness of depositors led to short-lived rumours questioning the stability of a bank.

- Credit concerns spread to the retail level. There are initial signs that banks have become more prudent in their credit policy towards corporate and individual customers.

# CURRENCY STABILITY




- Despite the increased volatility in global financial markets, the Hong Kong dollar has remained largely stable.

- Having hovered between 7.79 and 7.81 in July and August, the HKD strengthened against the US dollar in September and October. Since 31 October the strong-side Convertibility Undertaking has been triggered a number of times.

- The strengthening was mainly due to the unwinding of long US dollar positions, triggered by growing risk aversion among market participants given higher interest rates, and possible repatriation of funds by domestic corporations.

## MEASURES IMPLEMENTED BY THE HKMA

- Liquidity
  - Within-zone forex operations to inject liquidity into the bank system
  - Five measures to provide liquidity assistance to individual banks
  - Lowering borrowing cost at Discount Window
  - Increase supply of EF paper
  - Two refinements to the liquidity assistance to individual banks

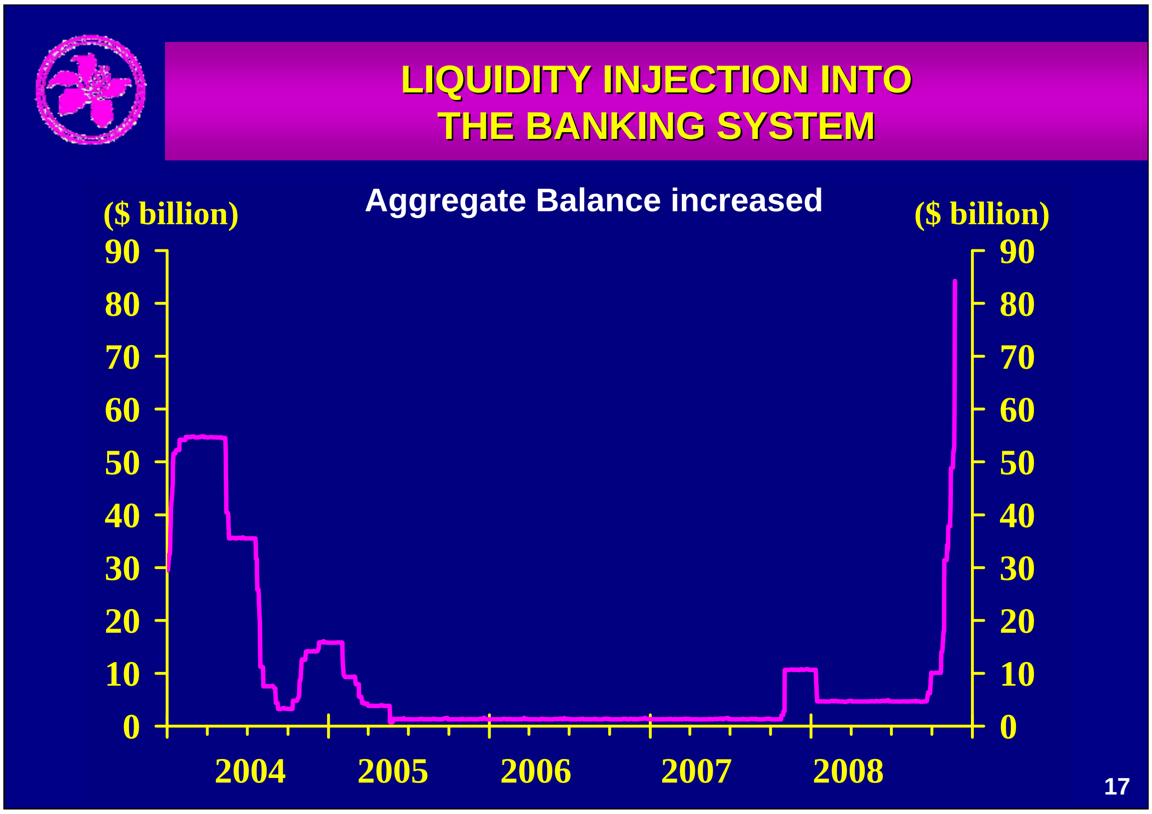
## LIQUIDITY INJECTION INTO THE BANKING SYSTEM

### Within Convertibility-Zone operations

- Five operations conducted between 18 September and 27 October
  - Expanded the Aggregate Balance by HK$24.8 billion
  - Consistent with the Currency Board principles
- As a result of these actions and the triggerings of strong-side Convertibility Undertaking, the Aggregate Balance reached HK$84.3 billion on 24 November



- These within-zone operations were consistent with Currency Board principles, since the expansion of the Monetary Base was fully backed by US dollars.




- Up to 20 November, the HKMA had actively purchased a total of US$3.2 billion within the Convertibility Zone and injected a total of HK$24.8 billion into the banking system. In addition, the HKMA passively purchased a total of US$7.1 billion after the strong-side Convertibility Undertaking was triggered and injected a total of HK$54.8 billion into the banking system. The Aggregate Balance will increase to HK$84.3 billion on 24 November, exceeding the record high of around HK$55.0 billion in 2004 when the market speculated on the strengthening of the Hong Kong dollar on the appreciation of the renminbi.

## LIQUIDITY PROVISION

### Increasing supply of Exchange Fund paper

- **Increase supply of EFBNs**
  - **Offered a total of HK$4 bn of additional Exchange Fund Bills on 28 October and 4 November**
  - **Matching within-zone forex operation on 20 October**
  - **Consistent with Currency Board principles**
- **Benefits**
  - **Meet increased demand for EF paper**
  - **Improve banks' access to the HKMA's liquidity facilities**



- On 20 October, the HKMA announced the issuance of $4 billion of new EF paper in the tenders on 28 October and 4 November.

- In order to maintain the current liquidity of the banking system, the HKMA operated with the Convertibility Zone on 20 October by purchasing US dollars against Hong Kong dollars, so that the level of AB will be little affected by issuance of additional paper.

- These operations were consistent with Currency Board principles, since the issuance of additional EF paper was fully backed by foreign exchange reserves.

- The increased supply of EF paper can help address the strong demand for the paper by banks, as manifested in the very low yields of the short-dated EF Bills.

- It also helps improve banks' access to the various liquidity facilities provided by the HKMA as EF paper is one of the eligible collaterals for accessing these facilities.

## LIQUIDITY PROVISION TO INDIVIDUAL BANKS

Five measures to provide liquidity assistance to individuals banks (effective until March 2009)

- Five measures:
  - Expansion of eligible securities for Discount Window borrowing
  - Tenor of repo through Discount Window extended to 3 months
  - Waiving the penalty rate for using over 50% EF paper in accessing the Discount Window
  - Conduct forex swaps with banks if needed
  - Offer term lending against collateral if needed (refined on 6 November to extend maximum tenor and lower the applicable interest rates)
- These backstop liquidity facilities reassure banks about the availability of funds

## LOWERING THE COST OF LIQUIDITY

**Adjusting Base Rate Formula (effective until March 2009)**

- Lowering the borrowing cost of banks at the Discount Window by 100 bps
- Original formula for determination of the Base Rate:
  - the higher of
    - (a) US Fed Funds Target Rate plus 150 bps, or
    - (b) the average of the five-day moving averages of the overnight and one-month HIBORs
- New formula:
  - US Fed Funds Target Rate plus 50 bps

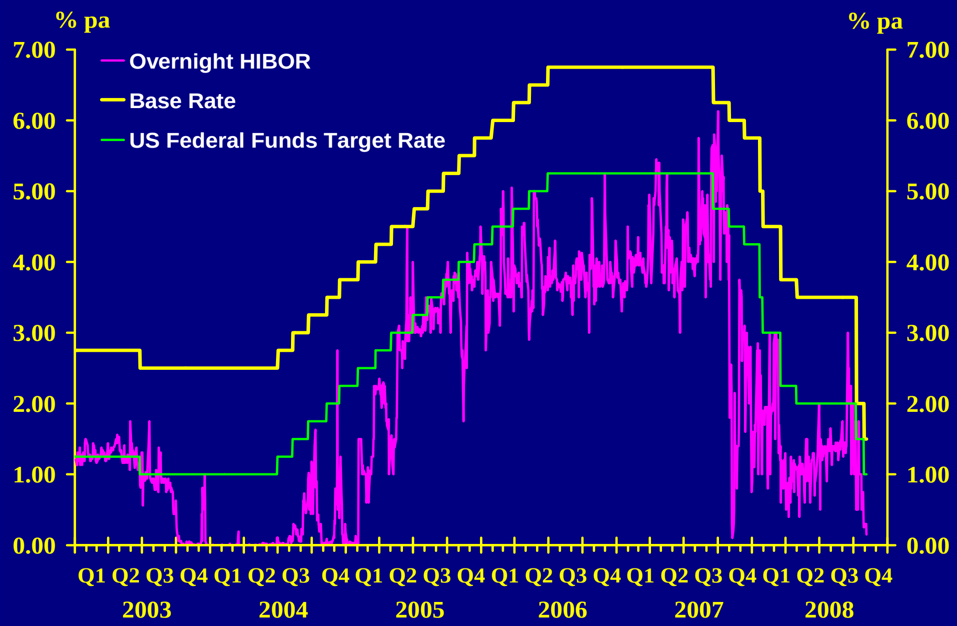


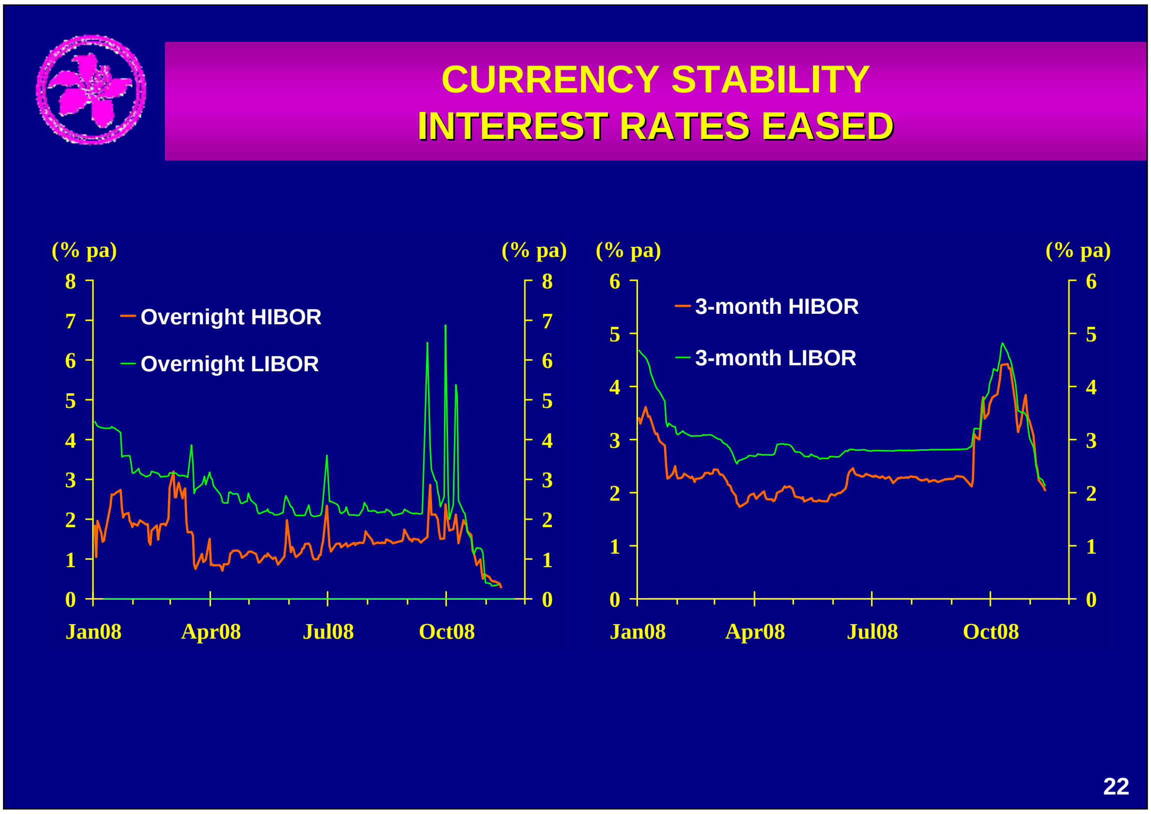
- Previously, the Base Rate was set at either 150 basis points above the prevailing US Federal Funds Target Rate or the average of the five-day moving averages of the overnight and one-month HIBORs, whichever is higher.

- On October 9, the formula for determination of the Base Rate was changed by reducing the spread of 150 basis points above the prevailing US Fed Funds Target Rate to 50 basis points. The other leg relating to the moving averages of the relevant interbank interest rates was removed from the formula until the end of March 2009.

- With all these changes and the recent cut in the US Fed Funds Target Rate, the Base Rate stood at 1.5% on 14 November.

# THE BASE RATE FORMULA ADJUSTED






- As the global financial-market stress increased in late September after the collapse of Lehman Brothers, local interest rates rose abruptly in tandem with US dollar interest rates.

- Overnight HIBOR, having surged to an intraday high of 4% on 18 September, softened continuously to below 1% following a combination of measures taken by the HKMA to provide liquidity assistance to banks and support confidence in the banking system, and a series of coordinated efforts by central banks to ease the global financial-market strains.

## EFFECTIVENESS OF THESE MEASURES

- **Market tension reduced**
- **Confidence in the financial system strengthened**
- **Systemic failures guarded against**
- **A gradual adjustment process worldwide envisaged before normal functioning of the global financial system can be fully resumed**

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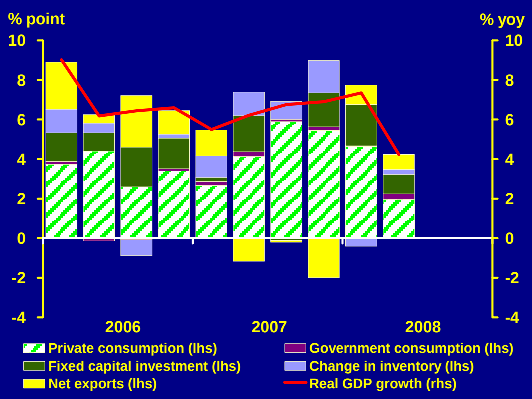
- Funding pressures in the interbank market showed some signs of abating:
  - The overnight rate softened to a more normal level.
  - Term rates eased.
  - Banks are more assured about the availability of funds and capital.
  - Depositors are more assured about the safety of their deposits with all banks in Hong Kong.
- Measures taken so far by the HKMA have helped lessen tension in the interbank market, arrest the loss of confidence in the financial markets, and guard against systemic failures.
- However, the present strains in the financial system are unlikely to be resolved quickly. There will be an adjustment process that will involve realisation of losses in financial institutions worldwide, recapitalisation, restructuring and consolidation among some members of the global financial community, before confidence can be fully restored and hence normal functioning of the global financial system can be resumed.

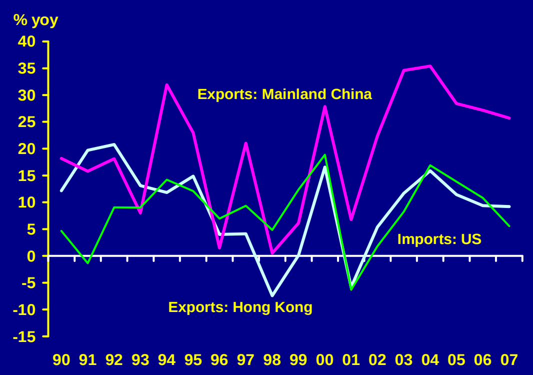
# RISKS TO CURRENCY STABILITY

- Global economic slowdown amid lingering financial market turmoil, posing risk to domestic economic growth and weighing on domestic asset prices
- Potential systemic risk to the global financial system, and associated contagion risk to Hong Kong
- Inflation remains high but is likely to recede
- Risks associated with the Mainland economy

# MODERATION IN ECONOMIC GROWTH

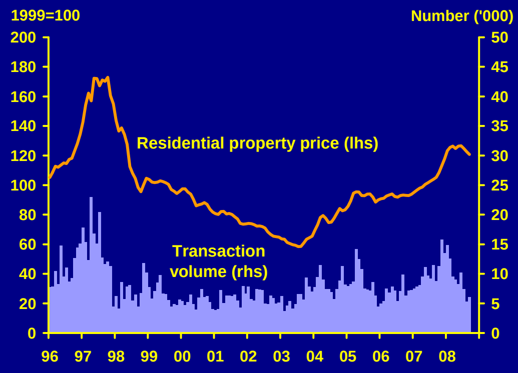
- Real GDP growth slowed notably in Q2 due to weaker private consumption and exports
- A slowdown in the global economy will reduce growth in Hong Kong through the trade channel



# DECLINES IN DOMESTIC ASSET PRICES

- Domestic equity prices declined in tandem with the sharp fall in the global stock markets
- More uncertain economic outlook restrained activity in the property market, affecting house prices and transaction volume

## IMPACT OF TIGHTER GLOBAL FINANCIAL CONDITIONS ON THE DOMESTIC ECONOMY

- **The global credit crunch will raise business borrowing costs, restraining capital investment**
- **Turbulence in the global financial markets will reduce activity in the domestic financial sector**
- **Negative wealth effect stemming from the decline in asset prices will weigh on domestic demand**
- **Deterioration in growth prospects and financial conditions will undermine business confidence**
- **Well-capitalised banking system and stronger corporate balance sheet will help withstand the shocks**



- Tighter global financial conditions will have an impact on real economic activities in Hong Kong.

- First, the global credit crisis has raised corporate borrowing costs, which will restrain capital investment and business expansion.

- Secondly, turbulence in the global financial markets will increase risk aversion of investors and reduce activity in the domestic financial sector.

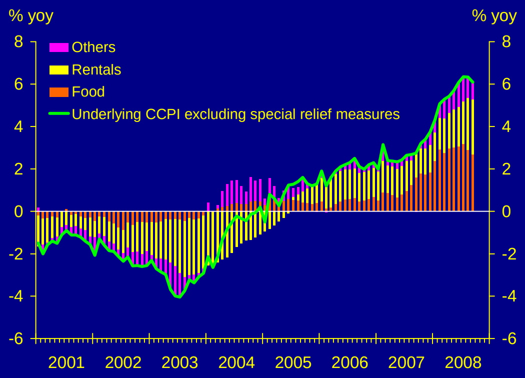
- Thirdly, the negative wealth effect stemming from the decline in domestic equity and asset prices will weigh on domestic demand, which is a key driver of economic growth in recent years.

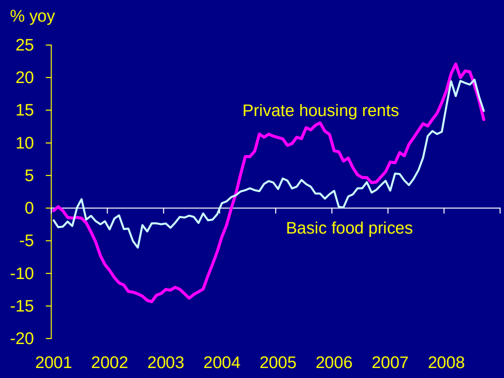
- Finally, deterioration in growth prospects and financial conditions will undermine business confidence, which is negative for employment growth and investment spending.

- That said, the banking system in Hong Kong is well-capitalised, with the average CAR staying high at 14% compared with the international standard of 8%. The balance sheet position of the corporate sector has also strengthened in recent years. These place Hong Kong in a better position to withstand external shocks.

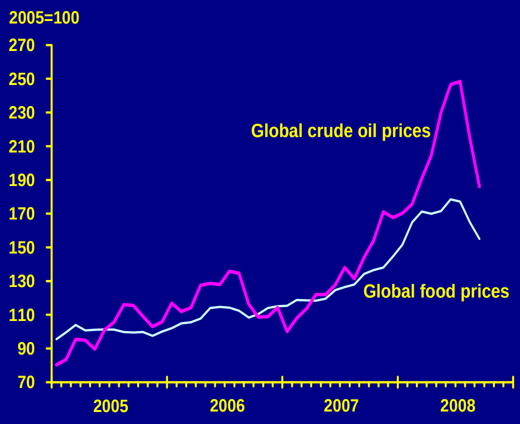
# INFLATION REMAINS ELEVATED, BUT LIKELY TO PEAK SOON

- The underlying CCPI inflation stayed high at 6.1% yoy in September, driven by higher costs of food and rental
- Inflation is likely to peak soon as increases in food prices and housing rents start to moderate



# RETREAT IN GLOBAL OIL AND FOOD PRICES




**CPI inflation in the regional economies**

| | CPI Inflation (% yoy) | |
|---|---|---|
| | Sep-2008 | 2007 |
| Hong Kong[1] | 6.1% | 2.8% |
| NIEs | | |
| Korea | 5.1% | 2.5% |
| Singapore | 6.7% | 2.1% |
| Taiwan | 3.1% | 1.8% |
| ASEAN-4 | | |
| Indonesia | 12.1% | 6.4% |
| Malaysia | 8.2% | 2.0% |
| Philippines | 11.9% | 2.8% |
| Thailand | 6.1% | 2.2% |

1. Netting out the effect of government's relief measures.

## RISKS ASSOCIATED WITH THE MAINLAND ECONOMY

- The Mainland's growth slowed markedly from 10.4% in H1 to 9.0% in Q3. Further declines are likely amid the worsening global environment.
- Inflationary pressures have continued to ease, with headline inflation declining to 4.0% in October, from 7.9% in H1.
- The stock market has remained volatile. The property market weakened significantly, particularly in big cities.
- Mainland authorities have shifted their overall policy stance to "proactive fiscal policy and accommodative monetary policy"
  - Three interest rate cuts and two RRR cuts since September
  - Fiscal stimulus package of RMB 4 trillion announced on 9 Nov
- The slowdown in the Mainland economy and weakening asset markets are likely to affect Hong Kong's economic outlook.



- Real GDP growth eased from 10.4% in H1 to 9.0% in Q3, the lowest since Q2 2003. The slowdown was driven by the softening in domestic demand, and a cut back on production in anticipation of a slowing economy and falling external demand. While the slowdown in Q3 was possibly exaggerated by temporary factors such as factory shut-downs during the Olympics, increasing uncertainties about the strength of the domestic economy and continued deterioration in the external environment point to an unfavourable outlook.

- Headline CPI inflation fell to 4.0% in October from 7.9% in H1, mostly driven by softening food prices. The PPI — an index representing production cost — also eased to 6.6% in October from its peak of 10.1% in August, reflecting the softening in international energy and commodity prices. As the PPI inflation appears to have peaked and aggregate demand growth could slow further, the declining trend in headline inflation is likely to continue in the near term.

- With inflation concerns receding and risks to growth increasing, the Mainland authorities have shifted their overall policy focus from "prevent overheating and prevent inflation" announced early in the year, to "support relatively fast and stable growth". The PBoC has continued to ease monetary policy since September. The benchmark lending rates were cut three times by a total of 81 bps, while that for the deposit rates were cut twice by 54 bps. RRR were also reduced twice by 150 bps for small deposit money banks and once by 50 bps for the other banks. A 10-point fiscal stimulus package of around RMB 4 trillion was also announced on 9 November, reflecting the policy stance of "proactive fiscal policy and accommodative monetary policy".

- The A-share market declined by 63.3% so far in 2008. The property market weakened with sales volume falling more than 50% in Beijing and Shanghai in Q3 from one year ago, while housing prices in Guangzhou and Shenzhen have declined by around 10% for the same period.

- The slowdown in the Mainland economy and weakening asset markets may negatively affect Hong Kong's economic outlook.

## BANKING SYSTEM STABILITY

- **Exchange Fund to provide 100% guarantee for all customer deposits with authorized institutions (effective until the end of 2010)**
- **A precaution. The banking system is robust, but developments in the global financial market could erode the community's confidence**
- **Supervisory scrutiny to minimise moral hazard**



- The banking system in Hong Kong is sound and robust. The probability of a bank failure, and thus insolvency, is very low.

- Despite these strong fundamentals, recent developments in the global financial system, including the increasing risk of serious contagion arising from collapse of Lehman Brothers, rising solvency concerns, and bank failures in other major markets, could erode the community's confidence in the banking system of Hong Kong.

- In the light of these factors, it is both necessary and desirable to take pre-emptive measures to enhance deposit protection at this turbulent time, and put us in a better position to forestall trouble. While helping to avoid a loss of confidence in the financial system, this is also consistent with efforts being taken globally and in our region to reinforce confidence in the banking system and stabilise the financial markets.

- The deposit guarantee may introduce distortions to the banking system, for example by affecting the incentives for prudent management of risks by banks, the competitive environment among banks and the need for depositors to exercise due diligence. This, in turn, may lead to moral hazard. Additional supervisory attention will therefore need to be paid to these various aspects, even though they are temporary.

## DEPOSIT PROTECTION SCHEME

- **The HKMA is assisting the Deposit Protection Board in its review of the coverage of the DPS. The Board is expected to formulate recommendations in Q1 2009**



<u>Deposit Protection</u>

- The HKMA is assisting the Hong Kong Deposit Protection Board (the Board) in its review of the coverage of the Deposit Protection Scheme (DPS).

- The Board is collecting data from Scheme members to analyse the impacts on the cost of the DPS and the number of depositors fully protected if the protection limit is adjusted to higher levels. Based on the findings of its analysis and with reference to the results of the public consultation on the report on review of the HKMA's work on banking stability in respect of the DPS, the Board is expected to be able to formulate concrete proposals on adjusting the protection limit in Q1 2009 for public consultation.

## CONTINGENT CAPITAL FOR BANKS

- **Contingent Bank Capital Facility to provide additional capital to banks if needed (effective until the end of 2010)**
- **A precaution. Capital positions of banks in Hong Kong are among the strongest in the world (14% vs. the minimum of 8%)**

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- Contagion and continuing stress in the financial systems of the developed economies may affect the capital base of banks in Hong Kong. While this risk is currently remote, it is prudent to pre-empt this scenario from developing.

- The capital positions of local banks in Hong Kong are among the strongest in the world. Their Capital Adequacy Ratios, on the basis of Basel II standards, average about 14%, compared with an international minimum requirement of 8%. The banking system in Hong Kong is sound, with a non-performing loan ratio of less than 1% and liquidity ratio of over 40%.

- Setting up a Contingent Bank Capital Facility helps provide comfort to banks on the availability of additional capital when necessary, and thus guard against systemic failures in the financial system.

# BANKING INDUSTRY

## BANKS' LIQUIDITY POSITION AND RISK EXPOSURES IN THE CURRENT ENVIRONMENT

- **Retail banks' average liquidity ratio in Q3 2008 remained high, at 43%**
- **Local banks in general have seen increases in deposits. The trend continued with the announcement of full deposit protection on 14 Oct 08**
- **HKMA is closely monitoring deposit movements and growth of risk assets after full deposit protection**
- **HKMA issued a guideline in Oct 08 on moral hazard issues**



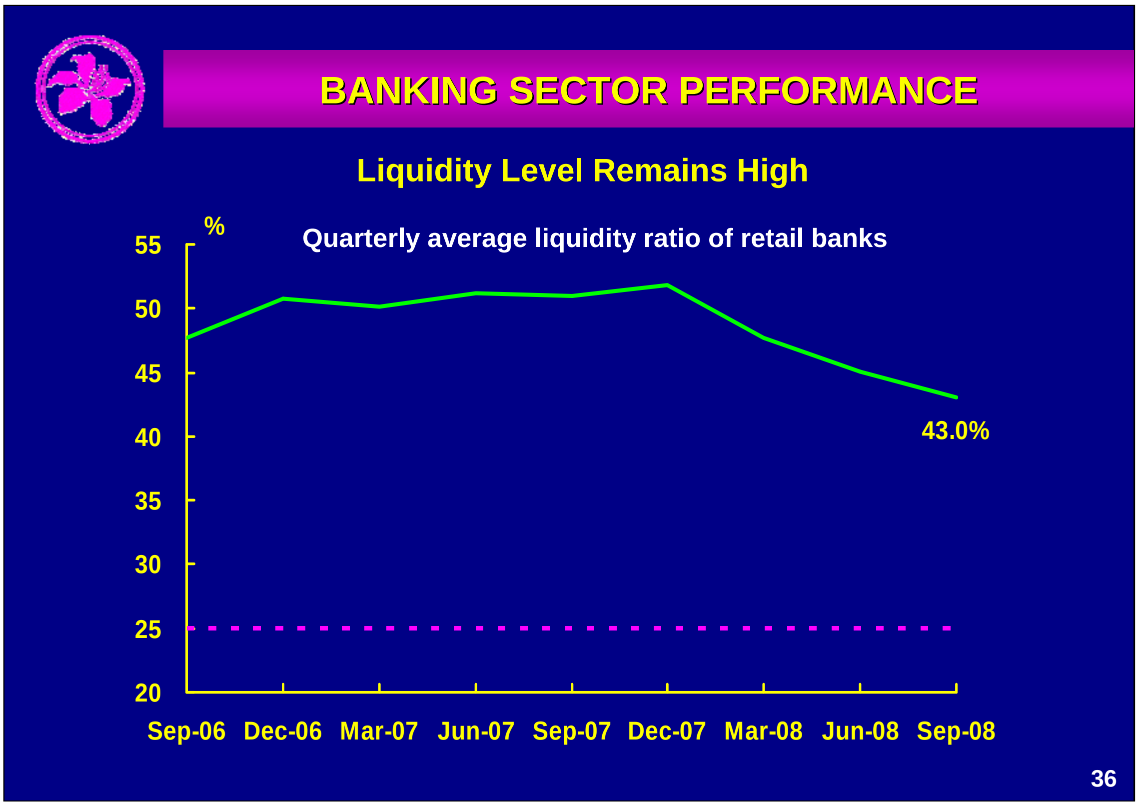
- Banks generally maintained high liquidity ratio in the current environment. Average ratio for retail banks in Q3 2008 was 43%, versus a statutory minimum ratio of 25%.

- Although individual banks had been affected by rumours, local banks on the whole have seen increase in customer deposits during the period. The trend continued with the announcement of full deposit protection on 14 Oct 08.

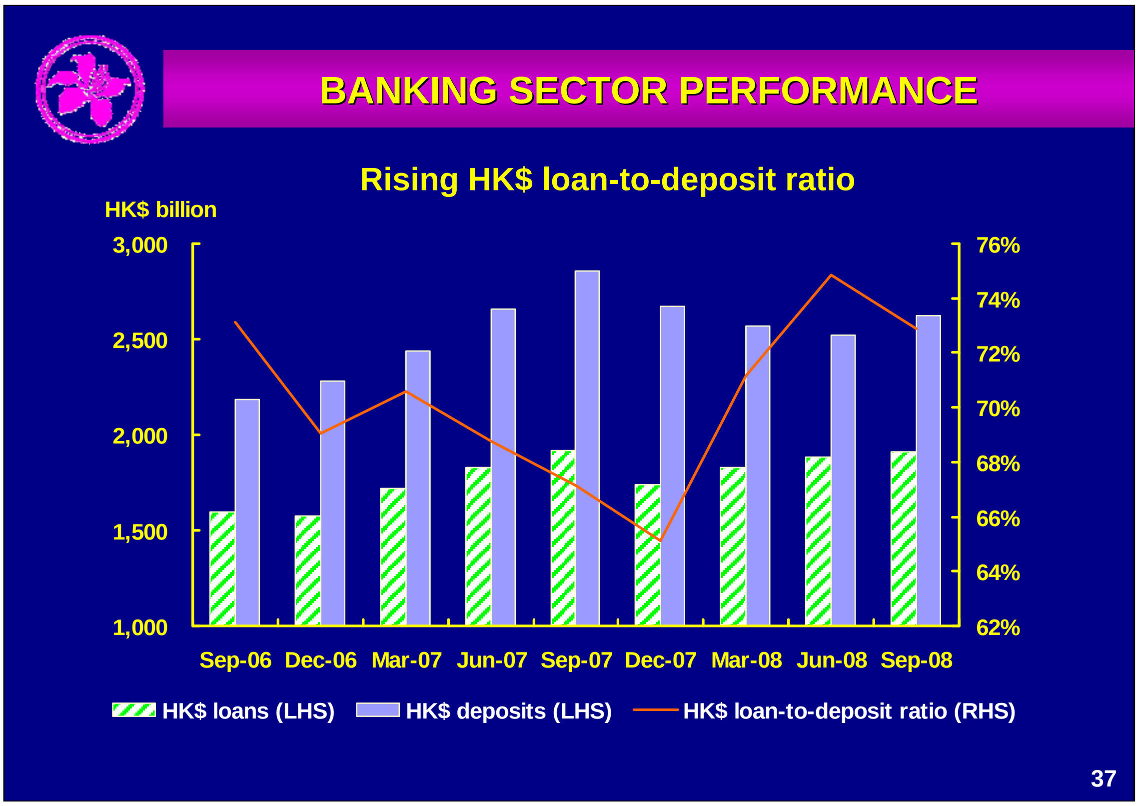
- HKMA has been closely monitoring banks' deposit movements and growth of risk assets and ensure they have sufficient liquid assets to meet obligations.

- A guideline issued under section 7(3) of the Banking Ordinance was gazetted on 24 Oct 08. It sets out how the HKMA proposes to deal with the moral hazard issues arising from the full deposit protection.

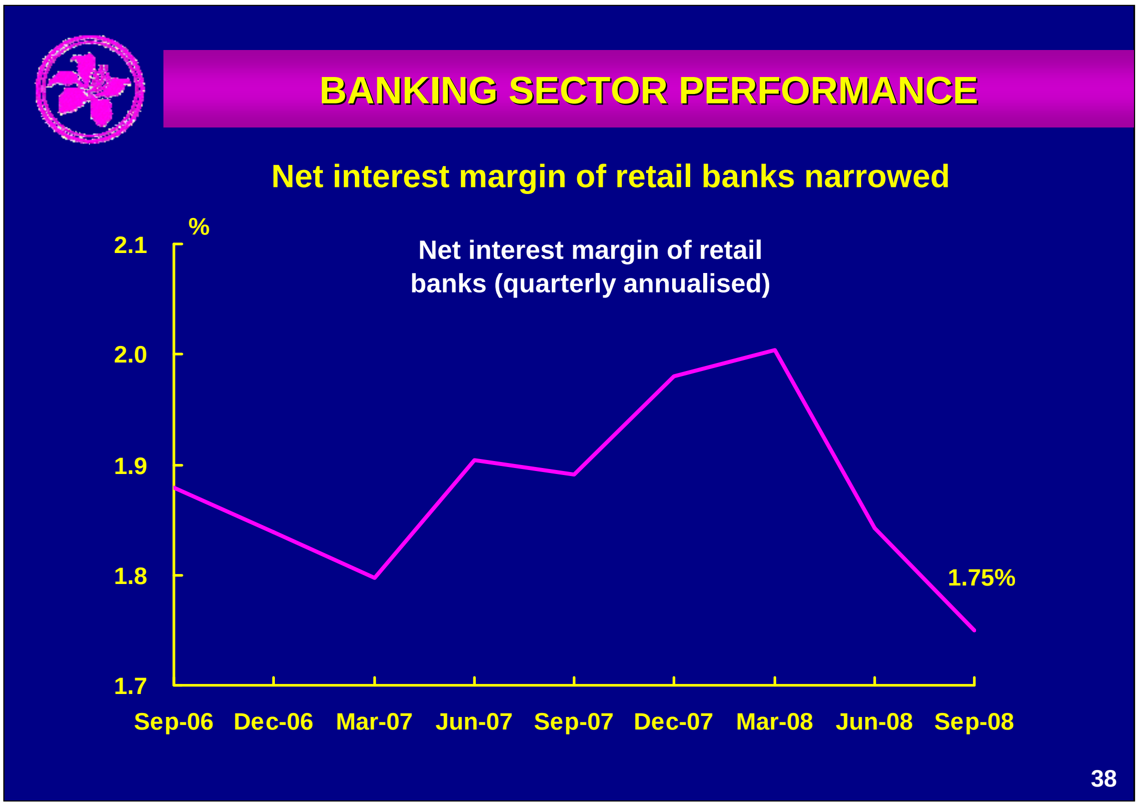
- In particular, institutions are expected not to take on substantially more deposits and risk exposures that are not in line with their conditions and trends before the full deposit protection. Regular statistics will be collected by HKMA to monitor the development.




- The average liquidity ratio of retail banks stood at 43% in Q3 2008, well above the statutory minimum of 25%. In view of the global credit crunch, the HKMA has been monitoring the liquidity positions of retail banks closely.



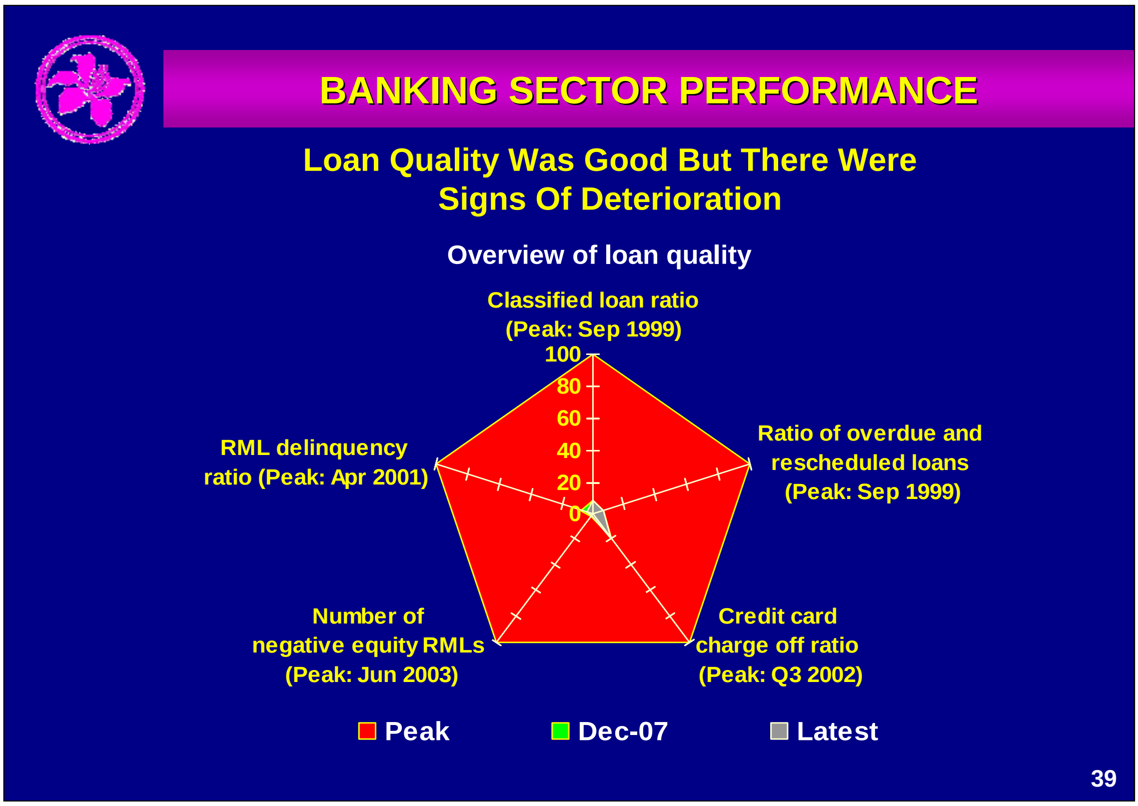

- Total loans of retail banks grew by 14.1% in the first nine months of the year. As the growth of total loans outpaced that of total customer deposits, the loan to deposit ratio rose. The Hong Kong dollar loan to deposit ratio of retail banks rose to 72.9% in September 2008.




- Affected by the global credit turmoil, the aggregate pre-tax operating profit of retail banks' Hong Kong offices declined by 18% in the first nine months of 2008 compared with the same period last year. Net interest margin fell to 1.75% in the third quarter of 2008 compared with 2% in the first quarter and 1.84% in the second quarter.

- Deterioration in the macro environment will present challenges for banks in the year ahead. Banks are expected to incur further impairment charges and investment losses as a result of the global credit crunch which affects the market value of financial assets. Higher operating costs and increased loan loss provisions will also weigh on profitability.

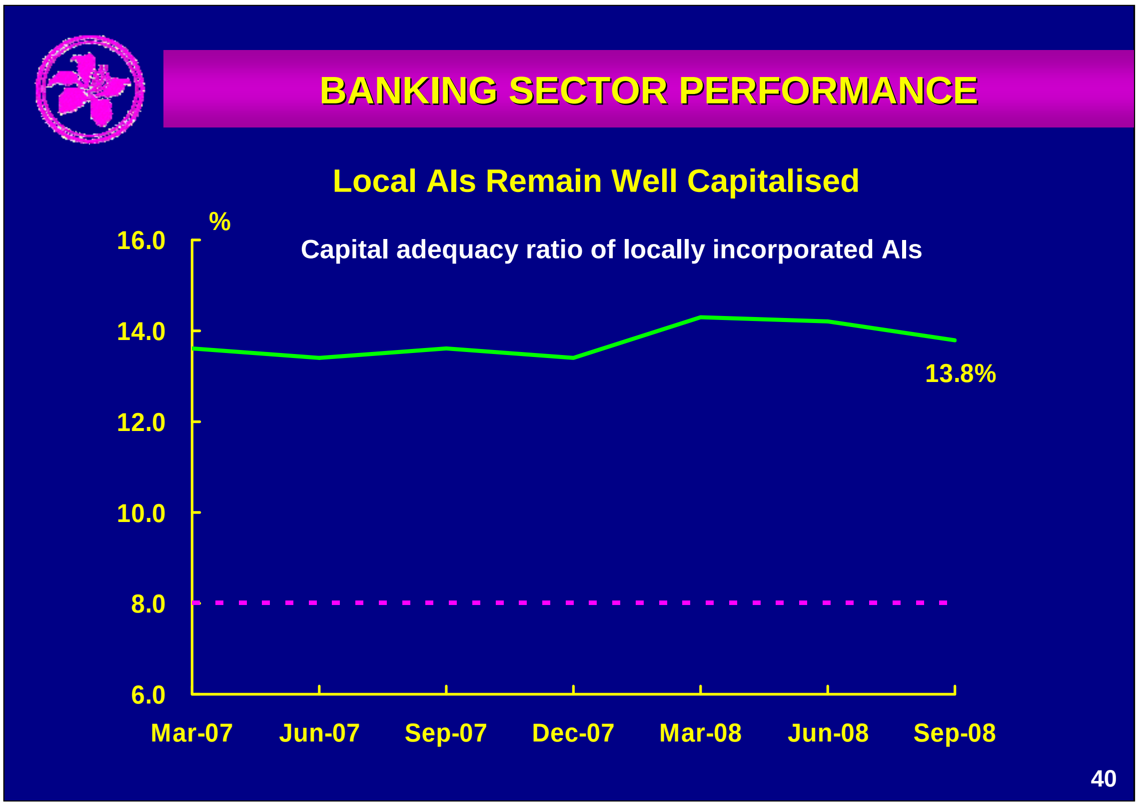
- The HKMA will conduct stress tests to assess the resilience of individual banks, taking into account the latest market developments.




- The asset quality of retail banks remained high by historical standards. However, signs of deterioration are beginning to be seen. The aggregate value of classified loans increased by 11% in the third quarter after rising 14% in the second quarter. Consequently, the classified loan ratio increased to 0.96% in Q3 2008 from 0.88% in Q2 2008. The ratio of overdue and rescheduled loans also rose to 0.55% in Q3 2008 from 0.53% in Q2 2008.

- The quality of retail banks' residential mortgage lending (RML) remained solid, with both the delinquency ratio and the rescheduled ratio declining to 0.05% and 0.14% respectively at the end of September.

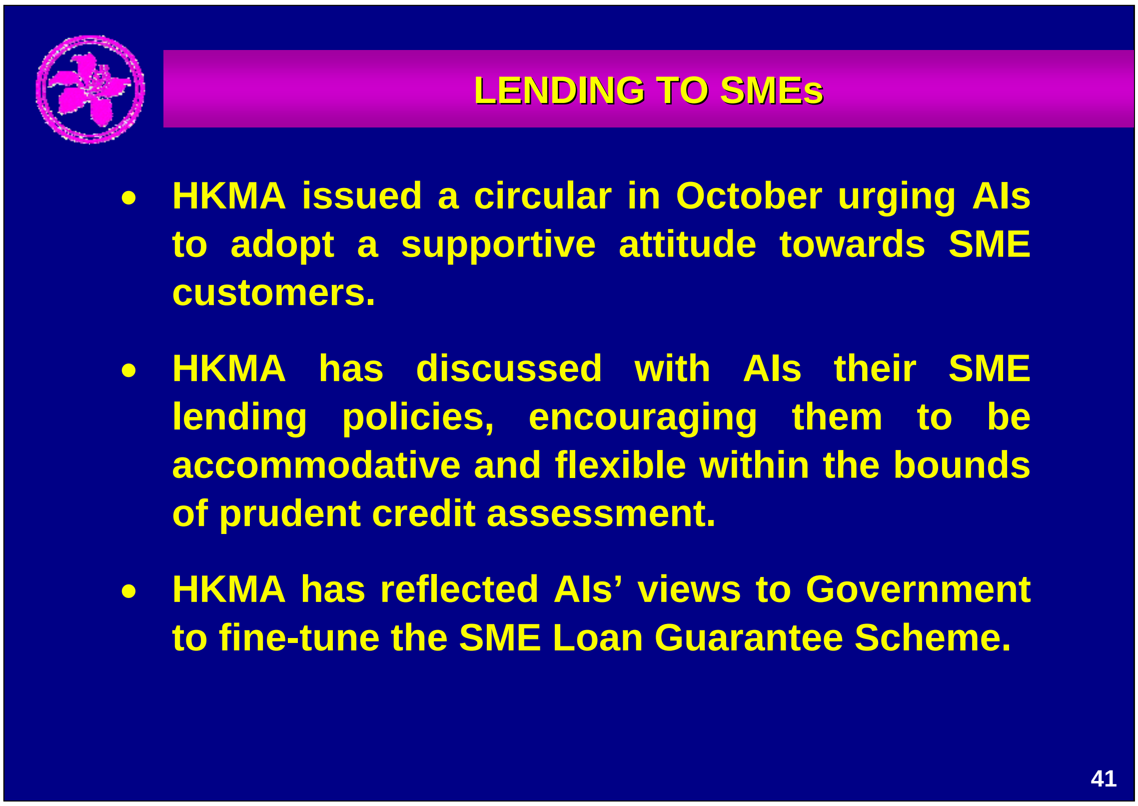
- As the economic environment becomes increasingly challenging, there is a risk that the quality of retail banks' loan portfolios will deteriorate. The HKMA will monitor the developments closely.




- AIs in Hong Kong remain well capitalised under the Basel II standard, which takes into consideration a wider spectrum of credit risks.

- The average consolidated capital adequacy ratio of locally incorporated AIs stood at 13.8% at end-September, compared with 14.2% at end-June. The ratio is well above the international requirement.

- The HKMA has established a Contingent Bank Capital Facility (CBCF) for the purpose of making available additional capital to locally incorporated licensed banks, should this become necessary. The additional capital under the CBCF scheme will be made available to individual banks upon their request but subject to supervisory scrutiny. Each case will need to be examined on its own merits and the form and terms of the CBCF capital will be decided on the basis of the circumstances of each case.



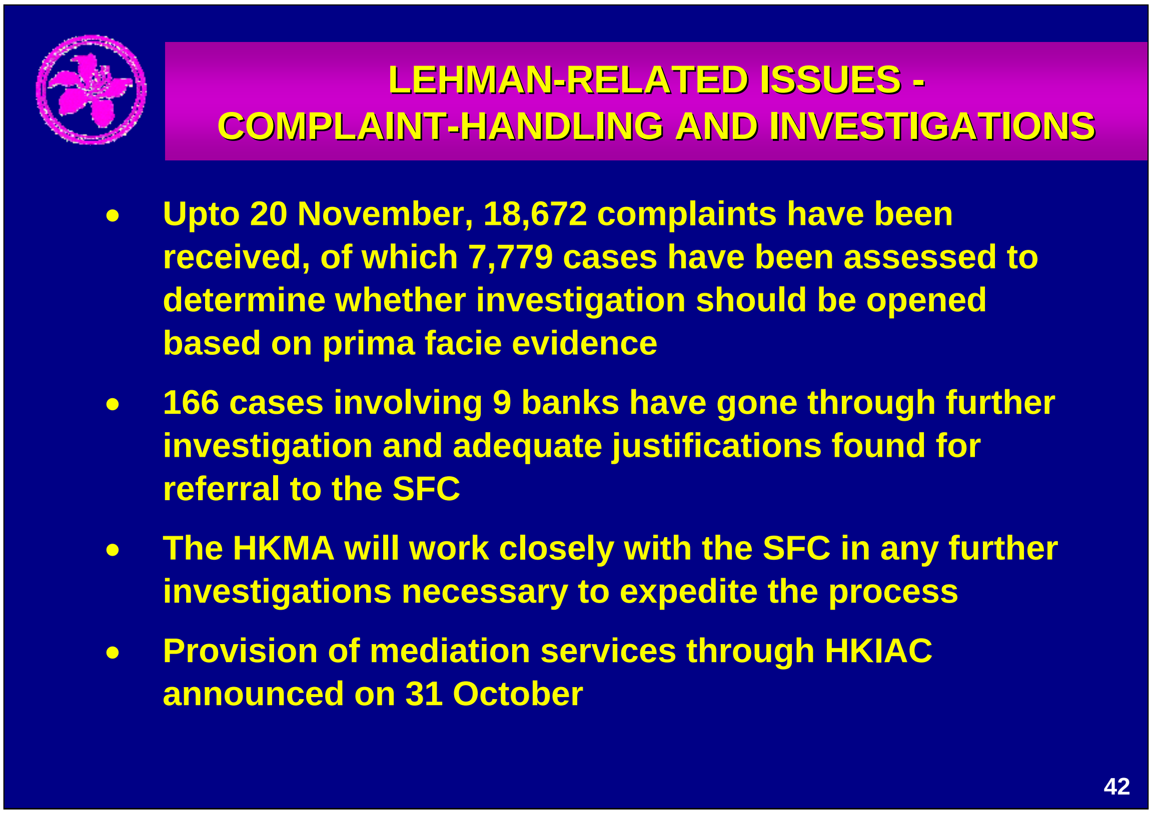

- The provision of credit to SMEs and the terms upon which it is provided are commercial decisions of AIs, but within the bounds of prudent credit assessment, the HKMA has urged AIs to adopt a supportive attitude toward their SME customers.

- The HKMA has issued a circular to this effect and we've followed up with discussions with the banks.

- Banks are confirming that they will assess extensions of credit to SMEs on a case by case basis and will not curtail credit indiscriminately.

- On the extension of the settlement period for credit card transactions, one AI has agreed to shorten the period from 60 days to 14 days and others have confirmed that they will consider other alternatives (such as collateral or guarantees).

- Where the HKMA has heard AIs' views on how the Government's existing SME Loan Guarantee Scheme could be enhanced, we've relayed those views to Government.




- Since the collapse of Lehman Brothers ("LB") in mid-Sep 08, the HKMA has received a large number of complaints alleging against banks mis-selling of LB-related products.
- The HKMA has implemented an expedited process with increased resources deployed to handle the complaints received.
- Key steps in complaint handling
  - Initial processing and establishment of allegations
  - Assessment by Event Review Committee
  - Investigation on opened cases
  - Review of investigation findings by Disciplinary Review Committee (DC)
  - Referral to SFC where sanctioning powers rest with SFC (e.g. sanctions of banks)
  - HKMA continues with post-DC disciplinary proceedings where the MA has the sanctioning powers under BO (e.g. sanctions in connection with relevant individuals, executive officers of banks)
- The provision of mediation and arbitration services through the Hong Kong International Arbitration Centre was announced on 31 October. The HKMA will pay the investors share of the costs in cases referred to the SFC or where a finding is reached against relevant individuals or executive officers of banks by the HKMA or SFC.

## LEHMAN-RELATED INVESTMENT PRODUCTS

- HKMA working closely with Hong Kong Association of Banks and HKSAR Government on the Minibond buy-back proposal
  - appointment of independent financial advisers to ensure fairness of the process
  - ascertaining current value to determine buy-back price for individual series
- Reminded relevant banks
  - to deal with customer complaints promptly and fairly
  - to take initiative to negotiate settlement with vulnerable customers where there is mis-selling on the part of the banks
  - to ensure compliance with all applicable requirements in selling investment products to customers, particularly to the more vulnerable sectors
- Report to FS being prepared

## REVIEW OF THE HKMA'S WORK ON BANKING STABILITY

- **The Consultant's report was published in July for consultation until the end of October.**
- **The report acknowledges the robust condition of Hong Kong's banking sector. The report recommends a number of enhancements to provide an even sounder foundation to cope with the challenges ahead.**
- **The HKMA is studying the comments received, and intends to finalise a policy response to the Consultant's recommendations in the first half of 2009.**



- The Consultant's report was published on 17 July 2008. The consultation period ended on 31 October 2008.
- The report acknowledges the robust condition of Hong Kong's banking sector. The report discusses major trends and issues that are likely to affect Hong Kong's banking sector in the coming years and recommends a number of enhancements to provide an even sounder foundation to cope with the challenges ahead.
- We are now studying the comments received in the consultation. Our plan is to finalise our policy response to the Consultant's recommendations in the first half of 2009.

## ANTI-MONEY LAUNDERING AND COUNTER TERRORIST FINANCING

- **The FATF has completed a mutual evaluation of Hong Kong:-**
  - **Hong Kong obtained "Compliant" or "Largely Compliant" ratings in respect of 30 Recommendations.**
  - **The core financial sectors (banking, securities and insurance) fared reasonably well in the evaluation.**
- **The HKMA issued guidance on transaction monitoring in July**



- The Financial Action Task Force on Money Laundering – FATF - completed a mutual evaluation of Hong Kong's anti-money laundering and counter terrorist financing measures. Hong Kong obtained "Compliant" or "Largely Compliant" ratings in respect of 30 Recommendations (out of a total of 49 Recommendations).

- The core financial sectors (i.e. banking, securities and insurance) fared reasonably well in the evaluation. The AML/CFT frameworks of the HKMA, the SFC and the Insurance Authority were assessed to be generally effective.

- The HKMA is studying the mutual evaluation report and will implement those recommendations relating to the banking sector after consulting the industry.

- The HKMA issued a guidance paper on transaction monitoring systems. The guidance aims to assist AIs in developing effective monitoring systems to identify unusual or suspicious activities.

## OVERSIGHT OF THE PAYMENT SYSTEMS

- **Despite the tension in the financial markets, all designated systems remain in compliance with the safety and efficiency requirements under the Clearing and Settlement Systems Ordinance (CSSO).**
- **The clearing and settlement system for Renminbi transactions in Hong Kong was designated and given statutory finality protection under the CSSO on 11 July 2008. This brings all currencies (HKD, USD, EUR, RMB) CHATS under the oversight regime of the CSSO.**
- **The first credit card with Octopus function was introduced in July.**



- Notwithstanding the tension in the financial markets, all the designated systems, i.e. the HKD CHATS, USD CHATS, Euro CHATS, RMB CHATS, the Central Moneymarkets Unit (CMU) and the Continuous Linked Settlement (CLS) system remained in compliance with the safety and efficiency requirements under the Clearing and Settlement Systems Ordinance (CSSO). The HKMA maintained close communication with the New York Fed, the primary overseer of CLS, and other overseeing central banks on potential settlement risks faced by CLS following the collapse of the Lehman Brothers Group in mid-September.

- The clearing and settlement system for settling RMB transactions in Hong Kong has been operating since June 2007. In view of its growing importance, the system was designated and was given a certificate of finality under the CSSO on 11 July 2008. Together with the HKD, USD and Euro CHATS already designated, all currencies CHATS are now under the same set of oversight regime of the CSSO.

- The HKMA has been encouraging Octopus to open up its card issuing business so as to enhance competition in the multi-purpose stored value card market. The first credit card with Octopus function was introduced by Citibank in July.

# FINANCIAL INFRASTRUCTURE

## FINANCIAL MARKET INFRASTRUCTURE (1)

- To develop Hong Kong into a regional payment and settlement hub, enhancing its role and status as an international financial centre
- Strategy for developing market infrastructure
  - Maintain smooth and efficient operation of payment systems
    - Operation remains smooth amid recent stress in the financial markets
  - Enhance the operation of payment and securities settlement systems
    - Extension of RTGS and CMU operating hours
    - Enhancements for Islamic-related transactions and products
    - Migration to SWIFTNet



- Objective: to develop Hong Kong into a regional payment and settlement hub by further strengthening Hong Kong's multi-currency, multi-dimensional payment and settlement platform.

- The operation of Hong Kong's real time gross settlement (RTGS) systems remains robust and smooth amid the recent financial events. The daily turnover of the Hong Kong dollar RTGS system registered a significant increase (38%) in the second half of September when compared with the first half of the month. This highlights the importance of the operational capability and resilience of payment and settlement systems to handle large turnover under critical situations.

- **Extension of RTGS operating hours**: The operating hours of the Hong Kong dollar, US dollar, euro and renminbi RTGS systems in Hong Kong have extended by one hour to close at 6:30pm starting from 3 November 2008 in order to enhance the competitiveness of our payment infrastructure and facilitate banks in Hong Kong to better serve their customers in this region. Lengthened operating hours have also allowed more time for banks to manage their liquidity positions.

- **Enhancements for Islamic-related transactions and products**: (1) a new payment code "68" has been introduced in the Hong Kong dollar, US dollar and euro RTGS systems to enable banks to differentiate its Islamic-related payment transactions (launched on 16 September 2008); (2) US dollar and euro RTGS systems will be enhanced to enable banks to keep Islamic-related funds in non-interest bearing settlement accounts (to be launched on 15 November); (3) the Central Moneymarkets Unit (CMU) will be enhanced to provide custodian, clearing and settlement services for Islamic bonds in Hong Kong (to be launched on 15 November).

- **SWIFTNet**: The existing proprietary platform for the RTGS systems and the CMU will be migrated to an international and open platform to facilitate a greater use of the payment and settlement systems in Hong Kong by overseas financial institutions.

## FINANCIAL MARKET INFRASTRUCTURE (2)

– **Promote links with overseas systems and use of Hong Kong's financial infrastructure**

- **MoU signed with Bank Indonesia in October establishing a payment-versus-payment link between the Indonesian Rupiah RTGS system and Hong Kong's US dollar RTGS system**
- **RTGS links with Mainland China's foreign currency settlement systems**
- **Marketing campaign in Asia and Europe to promote Hong Kong as a payment and settlement hub**
- **Turnover of RTGS systems increased**



- **MoU signed with Bank Indonesia**: On 24 October 2008, Bank Indonesia and the HKMA signed a Memorandum of Understanding for the establishment of a payment-versus-payment (PvP) link between the Indonesian Rupiah RTGS system and the US dollar RTGS system in Hong Kong. The link is planned to be launched by November 2009. The system link builds on the success of the existing model of cross-border PvP links between Hong Kong and Malaysia. It promotes safer and more efficient payment flows, and eliminates foreign exchange settlement risk arising from the delivery of different currencies in different time zones.

- **RTGS links with Mainland China's foreign currency settlement systems**: The HKMA and the People's Bank of China (PBoC) agreed to establish links for the Hong Kong dollar, US dollar and euro RTGS systems in both places. The links would enable banks in Mainland China to use Hong Kong as a channel for foreign currency funding and liquidity management. A seminar, supported by PBoC, the HKMA, and respective settlement institutions in both places, was held in early November in Hong Kong to brief all banks about the upcoming links.

- **Increased turnover of RTGS systems**:

  – Partly as a result of the HKMA's marketing efforts in promoting Hong Kong as a payment and settlement hub, the usage of Hong Kong's US dollar and RMB RTGS systems showed strong growth in the first 10 months of 2008:

    - US dollar RTGS system: daily average of US$10,322 million, 27% increase over the same period in 2007 (US$8,138 million).

    - RMB RTGS system: daily average of RMB664 million yuan, 236% increase over the same period in 2007 (RMB197million yuan).


**Inauguration of ACI Asia in Hong Kong**

- With the support of the HKMA and the TMA, ACI - The Financial Markets Association (ACI) established its first regional office, ACI Asia, in Hong Kong in July 2008. ACI Asia aims to bring treasury market practitioners under one umbrella, establish common professional standards and work closely with the regulators of the region.

**Asia Treasury Markets Summit**

- To help market participants to identify the key themes that will drive the development of Asia's financial markets amid the current challenges, the HKMA and the TMA jointly organised the Asia Treasury Markets Summit in Hong Kong in July 2008. The Summit, which featured a distinguished panel of speakers from the region representing the financial regulators, the IMF, the BIS, leading investment banks and commercial banks, was attended by over 130 market professionals.

# DEVELOPMENT OF ISLAMIC FINANCE (1)

**The HKMA adopts a four-part strategy to assist the Government in developing Islamic finance in Hong Kong:**

**Promote market infrastructure**

- TMA recommendations on Islamic bond market development
- Support the Government's tax review
- Develop regulatory framework for Islamic banking window
- Enhance RTGS infrastructure

**Encourage product development**

- Maintain dialogue with private sector and Government agencies to resolve tax and regulatory issues to facilitate product development

**Build international links**

- Associate membership of the Islamic Financial Services Board
- Organised Islamic finance roadshow in the Middle East in May 2008
- Memorandum of Understanding signed with the Dubai International Financial Centre Authority in May 2008 to foster co-operation

**Promote market knowledge**

- Organised seven professional training workshops this year for Government officials and TMA members

# DEVELOPMENT OF ISLAMIC FINANCE (2)

**Positive market response as evidenced by the introduction of Islamic finance products and services:**

- **Islamic mutual funds were introduced by a local bank in late 2007 and an asset management company in the second half of 2008**
- **An exchangeable sukuk offering China exposure through the Hong Kong platform was launched in March 2008 and well received**
- **An Islamic equity index covering China-related stocks in Hong Kong was launched in May 2008**
- **An Islamic banking window was introduced in Hong Kong by a Malaysian bank in August 2008**

# HONG KONG AS AN INTERNATONAL FINANCIAL CENTRE

## REGIONAL CO-OPERATION STRENGTHENED

- **The HKMA is leading efforts of Asia-Pacific central banks in regional surveillance focusing on the impact of the global financial crisis on regional economies, culminating in the joint statement issued by EMEAP Monetary and Financial Stability Committee on 31 Oct**
- **Chairing EMEAP Working Group on Banking Supervision: monitoring progress of EMEAP economies in implementing Financial Stability Forum's recommendations on enhancing market and institutional resilience**
- **Contributing to regional financial co-operation initiatives and crisis management**



- In the light of the deepening of global financial turmoil, central banks and monetary authorities in the East Asia-Pacific region have further enhanced monitoring and information sharing of the latest financial markets development and the implication for regional economies. EMEAP Monetary and Financial Stability Committee (MFSC) has held a number of teleconferences over the past months. A joint statement of MFSC has been issued on 31 October to show regional commitment to enhance cooperation in terms of greater information sharing and joint monitoring of financial markets development.

- As the Chair of EMEAP Working Group on Banking Supervision, the HKMA has been actively monitoring the progress made in the region in the implementation of recommendations by Financial Stability Forum to enhance market and institutional resilience, and the implications of the implementation to the region.

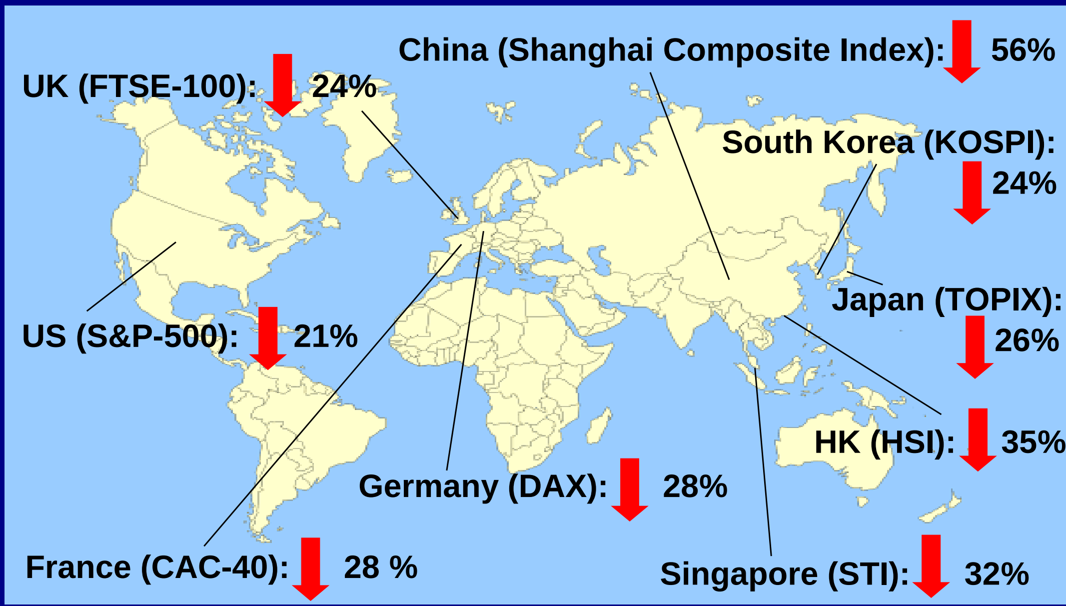
- The HKMA will continue to contribute to regional financial co-operation initiatives and crisis management to promote greater financial stability. The active participation of the HKMA also helps strengthen Hong Kong's status as the leading international financial centre in the region.


- Outstanding amount of renminbi deposits amounted to RMB 70.0 billion yuan at end-September, declining by 9.9% from end-May, after having increased by 132.6% in the first five months of the year. The recent decline reflects the lower expectations of renminbi appreciation and the purchase of renminbi bonds by depositors.

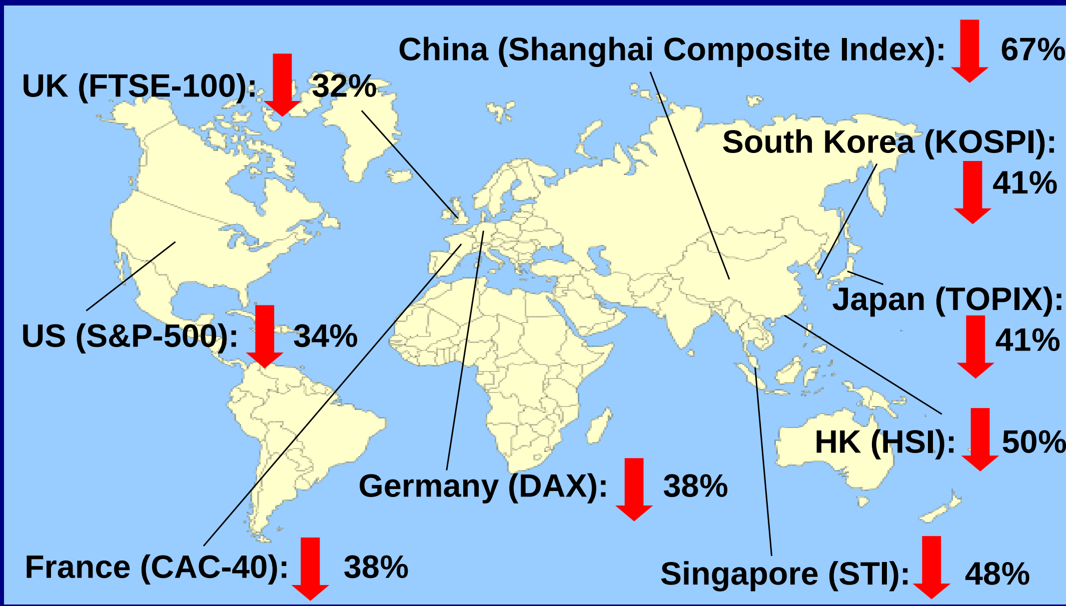
- Between July and September 2008, Bank of Communications, Export-Import Bank of China, China Construction Bank and Bank of China, each issued 3 billion yuan worth of renminbi bonds in Hong Kong, bringing the total amount of renminbi bonds issued so far to 22 billion yuan.

# THE INVESTMENT ENVIRONMENT AND PERFORMANCE OF THE EXCHANGE FUND

# GLOBAL STOCK MARKETS (2008 Q1-Q3)



# GLOBAL STOCK MARKETS (YTD UP TO END-OCT 2008)



# CREDIT MARKETS

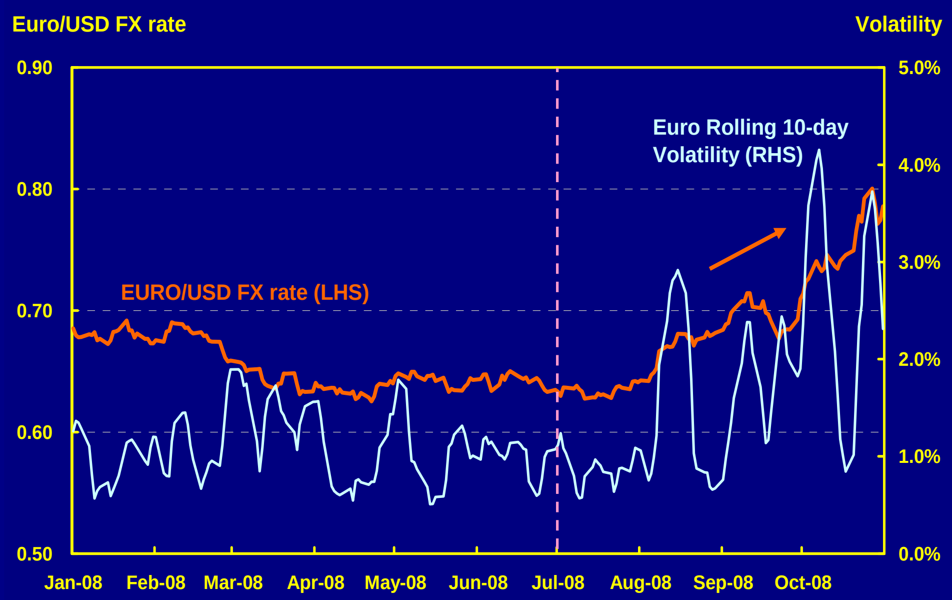
## Corporate Credit Spread *


* Represented by CDX North America 5-year Investment Grade Index

## TED Spread #


\# Spread between 3-mo USD LIBOR and 3-mo US Treasury yield

# CURRENCY MARKET FLUCTUATIONS - SURPRISE SURGE OF US DOLLAR



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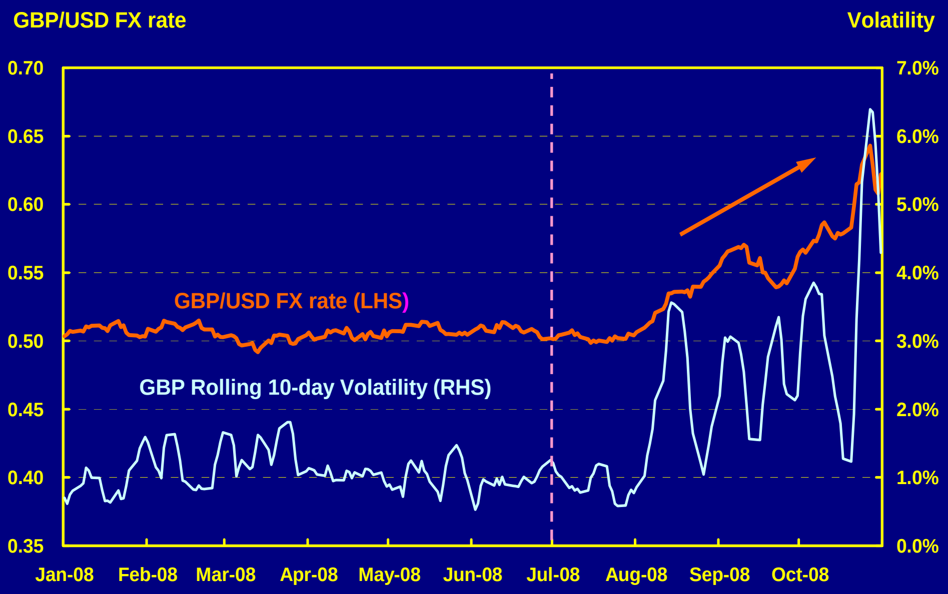

# BOND MARKETS DID NOT RALLY AS STOCKS DECLINED

# INVESTMENT INCOME

| (HK$ billion) | 2008 Jan – Sep* | 2007 Full Year | 2006 Full Year | 2005 Full Year |
|---|---|---|---|---|
| Gain/(Loss) on Hong Kong equities ^ | (56.9) | 55.8 | 35.9 | 7.0 |
| Gain/(Loss) on other equities ^ | (43.2) | 6.7 | 18.7 | 20.5 |
| Exchange gain/(loss) | (13.8) | 18.7 | 17.3 | (19.5) |
| Return from bonds # | 30.6 | 61.0 | 31.9 | 29.8 |
| Investment income / (loss) @ | (83.3) | 142.2 | 103.8 | 37.8 |
| Investment income / (loss) (excluding HK equities) @ | (26.4) | 86.4 | 67.9 | 30.8 |
| Investment return (including HK equities) ## | (5.8%) | 10.1% | 8.8% | 3.5% |
| Investment return (excluding HK equities) ## | (1.9%) | 6.1% | 5.8% | 2.9% |

* figures Unaudited

^ Including dividends

\# Including interest

@ Excluding valuation changes in Strategic Portfolio

\## Investment return = Investment income / Total asset at period end

# CHANGES IN INVESTMENT INCOME, TREASURY'S SHARE AND ACCUMULATED SURPLUS

| (HK$ billion) | 2008 Jan - Sep * | 2008 Q3 | 2008 Q2 | 2008 Q1 | 2007 Full year |
|---|---|---|---|---|---|
| **Investment income / (loss)** | **(83.3)** | **(48.3)** | **(20.4)** | **(14.6)** | **142.2** |
| Other income | 0.2 | 0.1 | 0.0 | 0.1 | 0.2 |
| Interest and other expenses | (5.2) | (1.8) | (1.8) | (1.6) | (10.2) |
| Net investment income / (loss) | (88.3) | (50.0) | (22.2) | (16.1) | 132.2 |
| **Payment to Treasury #** | **(34.9)** | **(11.3)** | **(11.8)** | **(11.8)** | **(27.6)** |
| Valuation change of Strategic Portfolio ^ | (7.7) | (1.2) | (1.0) | (5.5) | 4.7 |
| **Increase / (Decrease) in EF accumulated surplus** | **(130.9)** | **(62.5)** | **(35.0)** | **(33.4)** | **109.3** |

* Unaudited figures

\# The fixed rate of fee payment to Treasury for 2007 (w.e.f. 1 April 2007) and 2008 are 7% and 9.4% respectively.

^ The Strategic Portfolio holds the shares of the HK Exchanges and Clearing Ltd purchased for strategic purpose. Valuation change includes 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* | **N/A** | N/A | (48.3) | (20.4) | (14.6) |

*** Excluding valuation changes in the Strategic Portfolio.**

## ABRIDGED BALANCE SHEET OF THE EXCHANGE FUND

| (HK$ billion) | At 30 Sep 2008 (Unaudited) | At 31 Dec 2007 (Audited) | At 31 Dec 2006 (Audited) |
|---|---|---|---|
| ASSETS | | | |
| Deposits | 117.0 | 132.9 | 62.4 |
| Debt securities | 1,052.6 | 922.9 | 828.4 |
| Hong Kong equities | 115.3 | 184.6 | 122.4 |
| Other equities | 109.0 | 146.0 | 137.4 |
| Other assets | 32.4 | 28.0 | 25.8 |
| Total assets | 1,426.3 | 1,414.4 | 1,176.4 |
| LIABILITIES AND FUND EQUITY | | | |
| Certificates of Indebtedness | 179.9 | 163.4 | 156.9 |
| Government-issued currency notes & coins in circulation | 7.9 | 7.5 | 6.9 |
| Balance of the banking system | 10.1 | 10.6 | 2.0 |
| Exchange Fund Bills and Notes | 150.6 | 141.8 | 129.2 |
| Fiscal Reserves Account | 458.5 | 464.6 | 324.5 |
| Other liabilities | 133.2 | 9.5 | 49.2 |
| Total liabilities | 940.2 | 797.4 | 668.7 |
| Accumulated surplus | 486.1 | 617.0 | 507.7 |
| Total liabilities and fund equity | 1,426.3 | 1,414.4 | 1,176.4 |



- The Accumulated Surplus of the Exchange Fund amounted to HK$486.1 billion on 30 September 2008.

- A reduction in the Accumulated Surplus by HK$130.9 billion for the nine months to 30 September 2008 was due mainly to investment loss (HK$83.3 billion), fee payment to the Fiscal Reserves (HK$34.9 billion), decrease in value of the Strategic Portfolio (HK$7.7 billion) together with interest and other expenses (HK$5.2 billion).

- The Fiscal Reserves placed with the Exchange Fund amounted to HK$458.5 billion on 30 September 2008.

## ROBUST RISK MANAGEMENT

- Conservative asset allocation to meet the Exchange Fund's primary investment objectives
  - Majority in bonds and cash, minority in equities including the passive holding of HK equities
- Prudent credit risk control measures that minimise the Exchange Fund's exposure to 'toxic' assets and ailing financial institutions

## RETURN TO THE TREASURY ON FISCAL RESERVES PLACED WITH THE EXCHANGE FUND

- Based on the investment return of the Exchange Fund in the preceding 6 years
- Determined at the beginning of the year and is not affected by current year's return
- 9.4% for fiscal year 2008/09
- 6-year moving average irons out fluctuations in annual returns to ensure stable return on fiscal reserves