



HONG KONG MONETARY AUTHORITY

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

2 February 2009



DISCUSSION TOPICS

Updates on

- **Financial Market Crisis and Global Recession**
- **Currency Stability**
- **Banking Industry**
- **Financial Infrastructure**
- **Hong Kong as an International Financial Centre**
- **The Investment Environment and Performance of the Exchange Fund**

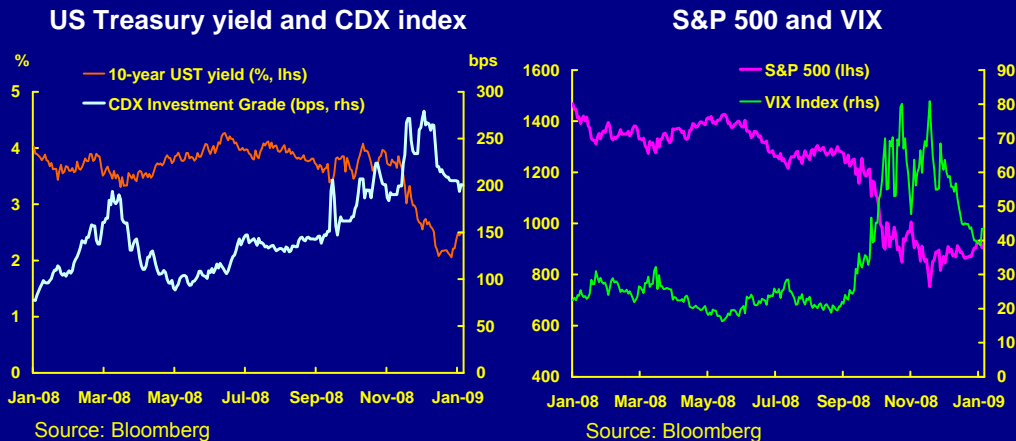


FINANCIAL MARKET CRISIS AND GLOBAL RECESSION



FINANCIAL MARKETS REMAIN STRAINED

- While a financial meltdown has been averted, financial markets remained strained and volatile.



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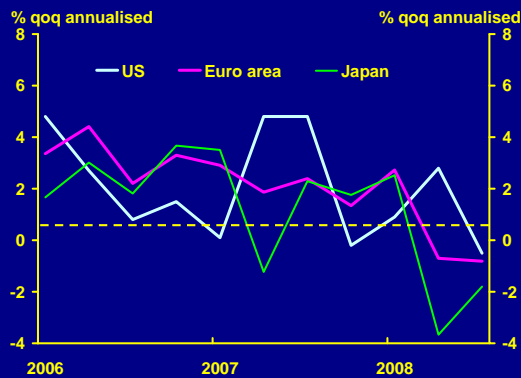
- Financial markets remained strained and market sentiment jittery. US Treasuries continued to be favoured for their safe-haven status, while the CDX indices remained elevated even though they have retreated somewhat from the highs in the fourth quarter of 2008. (A credit default swap index is a benchmark for hedging credit risk or to take a position on a basket of credit entities. The CDX is one such credit default swap index.)
- Equity markets globally declined substantially in the last quarter of 2008 amid extremely high volatility. Volatility continued in the beginning of 2009.



ADVANCED ECONOMIES IN RECESSION

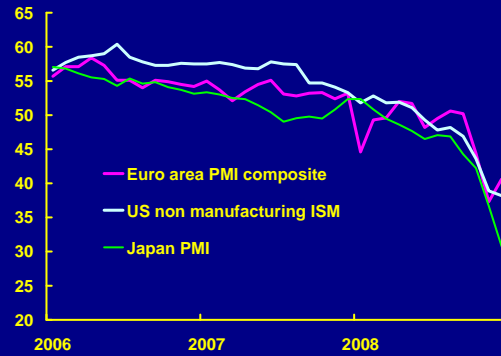
- The financial market crisis evolved into a global economic downturn. Many advanced economies entered sharp recessions.

GDP: US, Euro area, Japan



Source: Bloomberg

PMI: US, Euro area, Japan



Source: Bloomberg

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- The advanced economies of the US, euro area, and Japan all entered sharp recessions. Private sector spending slowed dramatically and consumer and business confidence was severely undermined.
- In the US, the contraction in the business cycle began in December 2007, making this recession already more protracted than the previous two of 2001 and 1990-91.



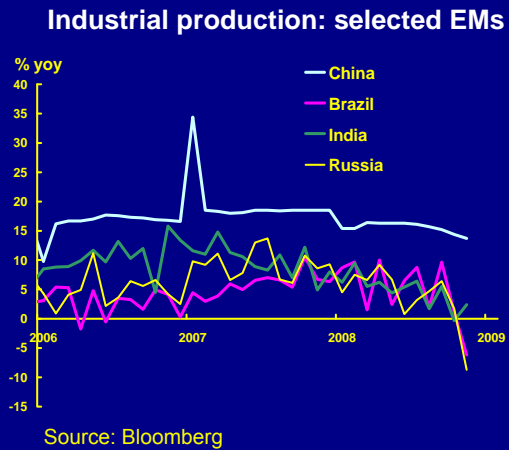
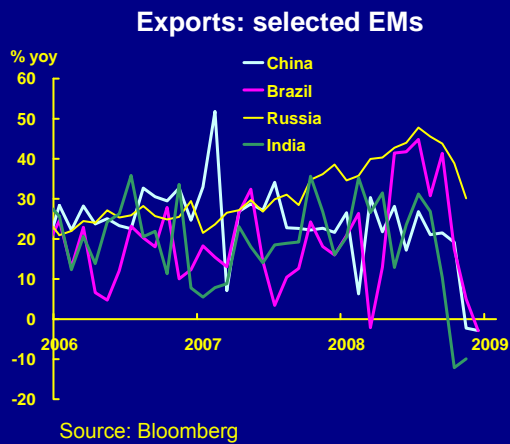
DEFLATION PRESSURES LOOMING

- **Risks of deflation in many advanced economies cannot be dismissed in the scenario of a deep recession**
- **The scope for further interest rate cuts is small**
- **Impact:**
 - **Deflationary trend would lead to rising real interest rates**
 - **Reduce consumption and investment**
 - **Increase the debt burden of borrowers**
 - **Reinforce distress selling, triggering a debt-deflation spiral**



EMERGING MARKETS SLOW SHARPLY

- The emerging markets downturn was marked in the face of slowing exports, a reversal of capital flows, and a loss of confidence.



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- In the face of the global financial crisis and the sharp economic slowdown experienced by the advanced economies, emerging markets are also slowing sharply.
- Many emerging market economies were hit by a reversal of capital inflows, currency depreciations, asset market declines, and a marked slowdown in external demand.



OUTLOOK REMAINS GLOOMY FOR THE GLOBAL ECONOMY

IMF economic forecasts

	2007 (Actual)	2008 (Projections)	2009 (Projections)
GDP Growth			
Advanced economies	2.6	1.4	-0.3
Emerging market and developing countries	8	6.6	5.1
Other advanced economies	4.7	2.9	1.5
G3			
- US	2	1.4	-0.7
- Euro area	2.6	1.2	-0.5
- Japan	2.1	0.5	-0.2
Asia			
- China	11.9	9.7	8.5
- NIEs	5.6	3.9	2.1
- ASEAN-5	6.3	5.4	4.2

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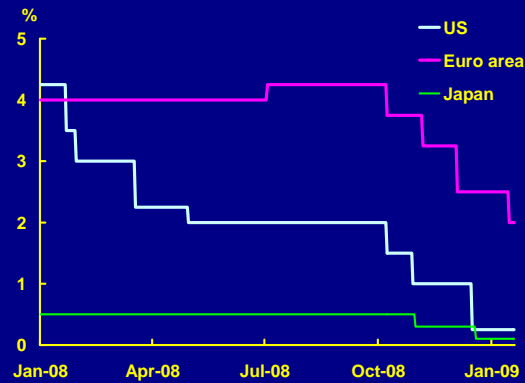
- In their forecast released in November 2008, the IMF forecast a recession in the major advanced economies and significantly slower growth for the region in 2009.



AGGRESSIVE MONETARY EASING TO EASE FINANCIAL CONDITIONS

- Many economies eased monetary policy aggressively to counter growth risks, although the effect of lower interest rates on demand may have been weakened by the disruption in credit markets.

Policy rates: US, euro area, Japan



Source: Bloomberg

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- The US Fed, for instance, lowered its target for the fed funds rate to a range of 0 – 0.25%, the lowest in history. At the same time, the Fed stated its intention to keep its balance sheet at a high level, to engage in quantitative easing to further ease monetary conditions.



FISCAL POLICIES TO SUPPORT GROWTH

- Policymakers have more recently used fiscal stimulus measures to support growth.

Recently introduced fiscal stimulus packages

		% of GDP
Australia	A\$10.4 bn	0.9
China ¹	Rmb4 trn	13.9
France	€26 bn	1.3
Germany ¹	€50 bn	2.0
Japan	¥5 trn	1.0
UK	£20 bn	1.4
US ^{1, 2}	\$775 bn	5.4

1. Fiscal spending over two years.

2. To be finalised.

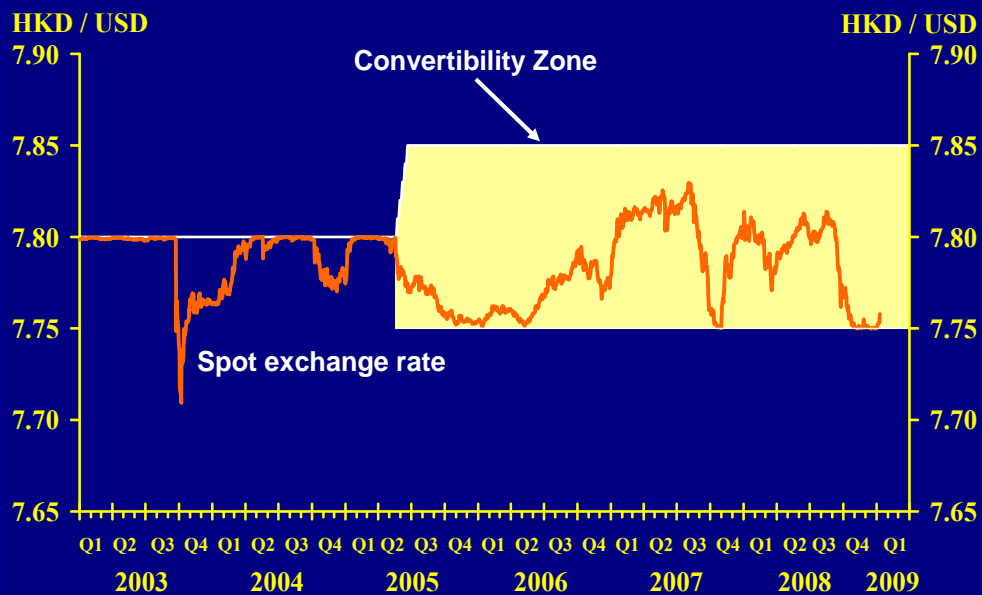
Source: Bloomberg, national authorities' websites



CURRENCY STABILITY



HONG KONG DOLLAR STAYED CLOSE TO 7.75

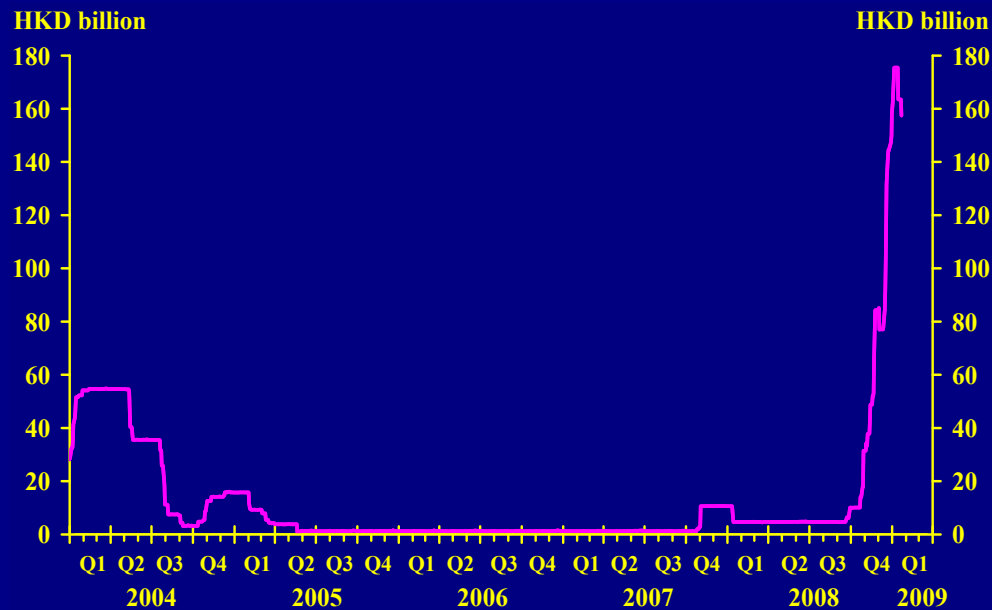


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- The Hong Kong dollar stayed close to the strong-side Convertibility Undertaking level through the year-end. The strong-side Convertibility Undertaking was triggered repeatedly resulting in a substantial increase in the Aggregate Balance.
- At the beginning of the new year, the Hong Kong dollar softened against the US dollar slightly.



AGGREGATE BALANCE SURGED TO NEW HIGHS

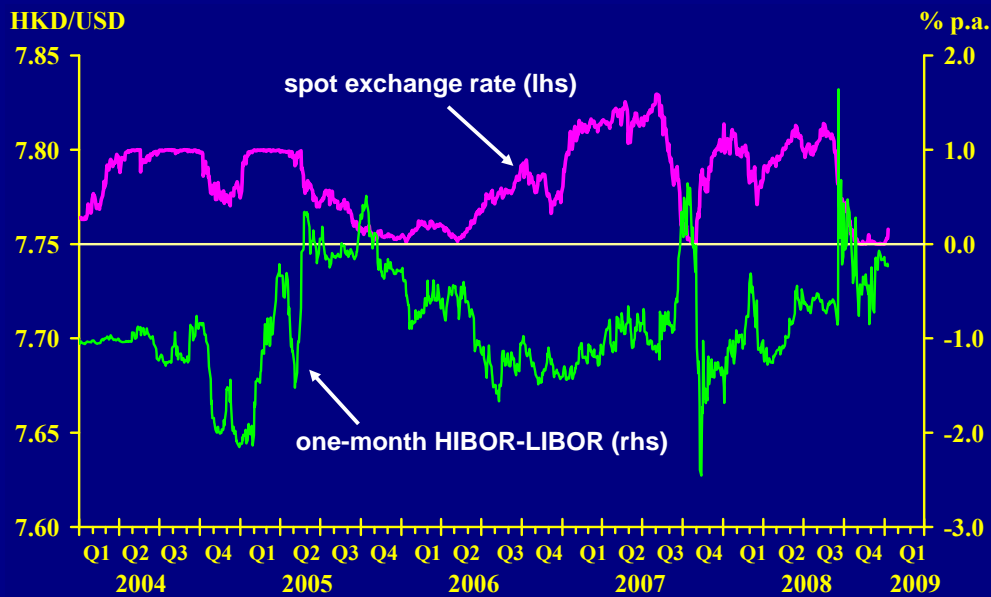


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- Reflecting the triggering of the strong-side CU, the Aggregate Balance increased to HK\$157.4 billion on 21 January 2009.
- The strong inflow into the Hong Kong dollar could be attributable to the following factors:
 - Unwinding of carry trades due to risk aversion by banks and their clients;
 - Repatriation by individuals and corporations given the large net positive international investment position of these entities in Hong Kong. This may be for meeting their funding needs in Hong Kong given the tight credit condition or for other purposes;
 - Demand for Hong Kong dollars to position for better investment opportunities given the relatively benign economic environment in Hong Kong and the Mainland;
 - Possibility of flight to safety given the stable financial system and the introduction of a 100% deposit guarantee in Hong Kong.



NARROWED INTEREST RATE SPREAD

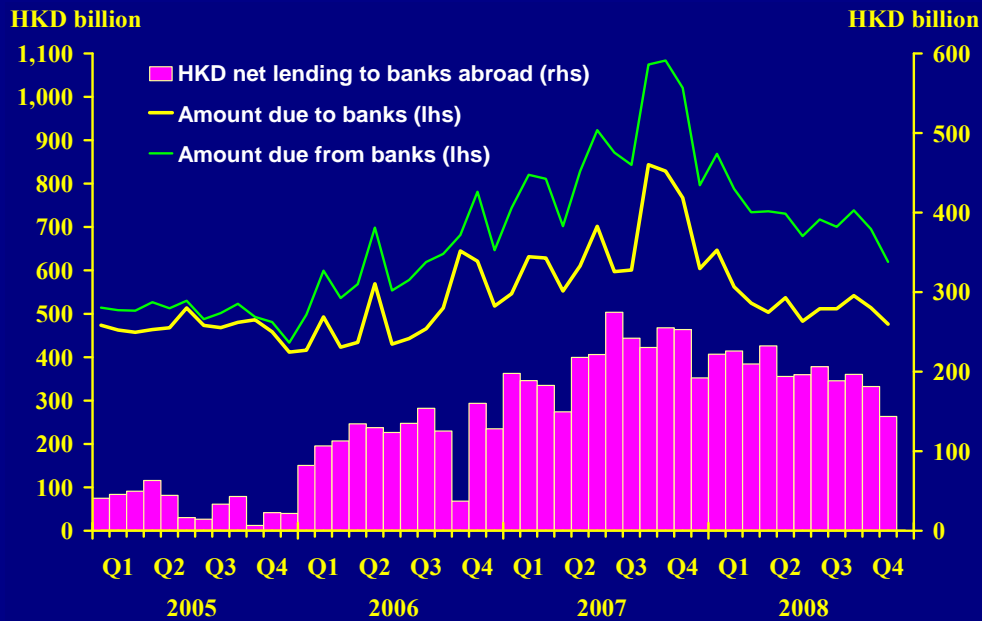


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- The strength of the Hong Kong dollar was due to the unwinding of interest carry trades amid narrowed interest rate differential against the US dollar and risk reduction.
- In particular, the diminished interest rate differential had led to unwinding of previously established interest carry trades on the one hand, and discouraged market players from taking long US dollar and short HK dollar positions on the other. This also put pressure on the HKMA to purchase US dollars against HK dollars when market players' interest in longing the US dollar and shorting the HK dollar diminished.



REDUCED NET LENDING TO BANKS ABROAD



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- The reduction in net lending to banks abroad in the latter part of 2008 may reflect the acceleration of de-leveraging and reduction in credit availability after the collapse of Lehman Brothers. To the extent that borrowers do not have adequate HK dollar liquidity, they may need to sell US dollars to obtain HK dollars to repay loans. Statistics indicate that the net HK dollar lending to banks abroad has declined since April 2008, and the decline seems to have accelerated since October 2008 (after the collapse of Lehman Brothers).



HONG KONG HAS SIZEABLE EXTERNAL ASSETS

	Net Total IIP (USD bn)	(% of GDP)
China	1,022	31
Hong Kong	522	252
India	-53	-5
Indonesia	-150	-35
Korea	-155	-16
Malaysia	-18	-10
Philippines	-27	-19
Singapore	223	138
Taiwan	467	122
Thailand	-58	-23

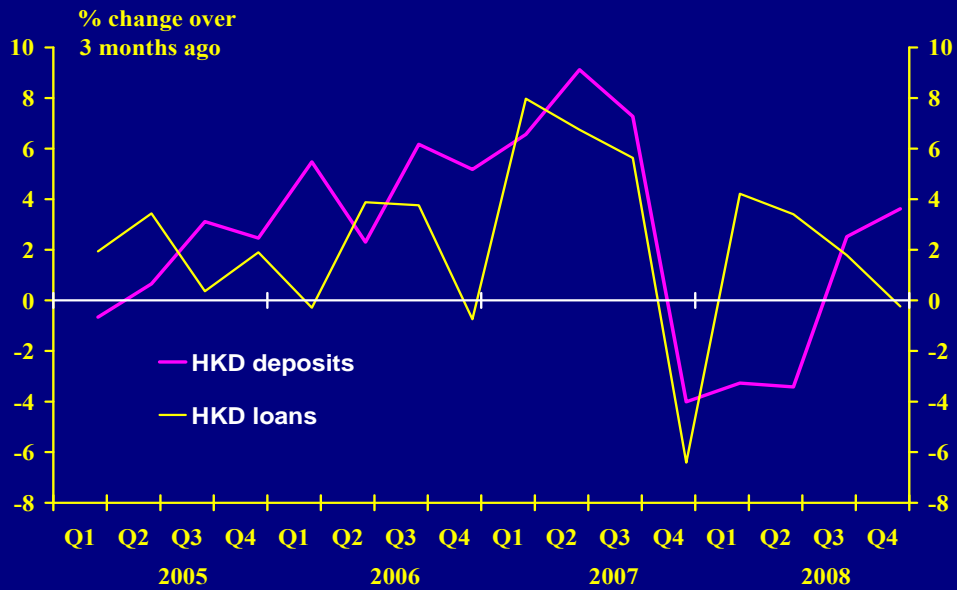
Note: End-2007 figures. Korea and India refer to September and March 2008 figures respectively.

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- International Investment Position (IIP) is a balance sheet showing the stock of external financial assets and liabilities of an economy at a particular time.
- Hong Kong is a net creditor, with net overseas financial assets among the highest in the region.
- Given the large net external assets, it is possible that domestic corporations or residents may repatriate funds from abroad to meet their financing needs in a tightened credit environment.



INCREASE IN HK DOLLAR DEPOSITS



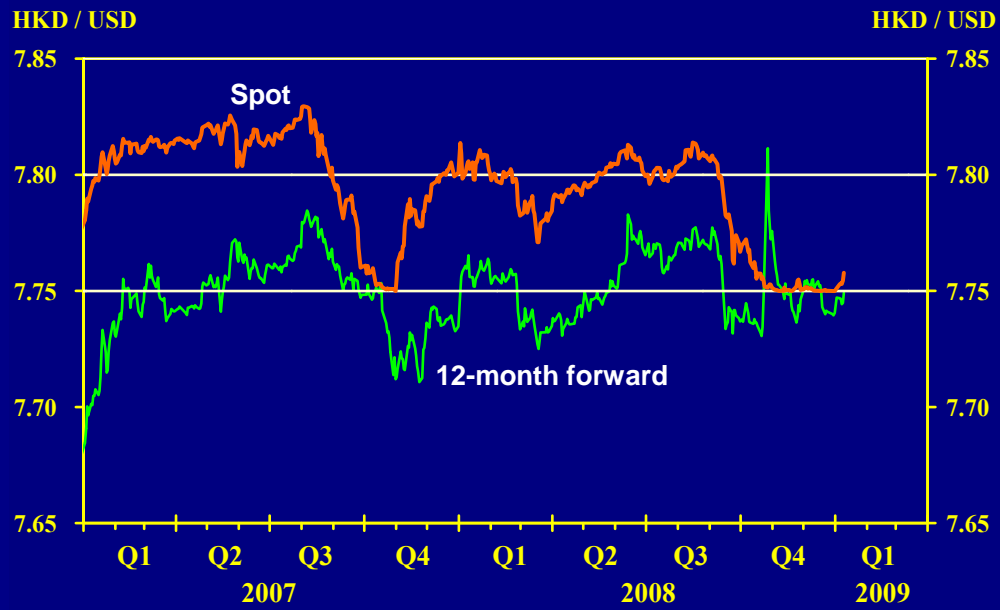
Note: Quarter-end figures. 2008 Q4 refers to end-November number.

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- The recent pick-up in HK dollar deposits and a contraction in HK dollar loans also point to a possible repatriation of funds by the non-bank sector from overseas back to Hong Kong. However, it is not clear what is driving the repatriation. It may be due to a number of factors such as financing local operations, potential equity investments in Hong Kong, home bias, or safe-haven considerations. Indicators compiled by the major equity custodians suggest that there were inflows into the HK dollar.



FORWARD DISCOUNT NARROWED

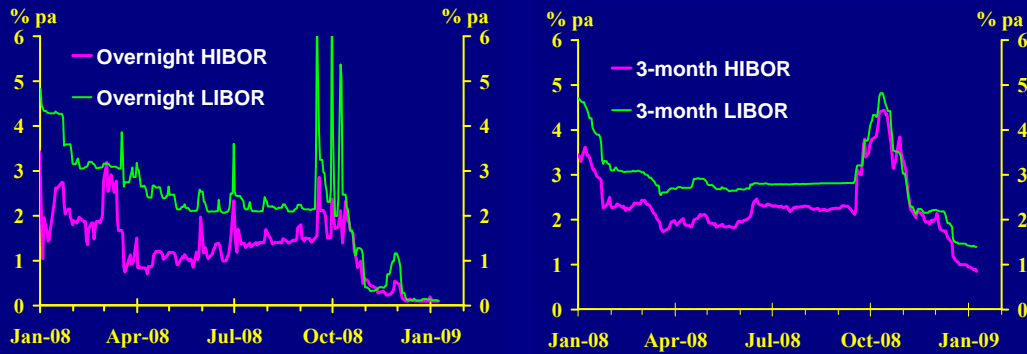


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- The recent strong inflow into the Hong Kong dollar does not seem to be for exchange-rate speculation, in the absence of a widening in the forward discount.



LOCAL INTEREST RATES EASED

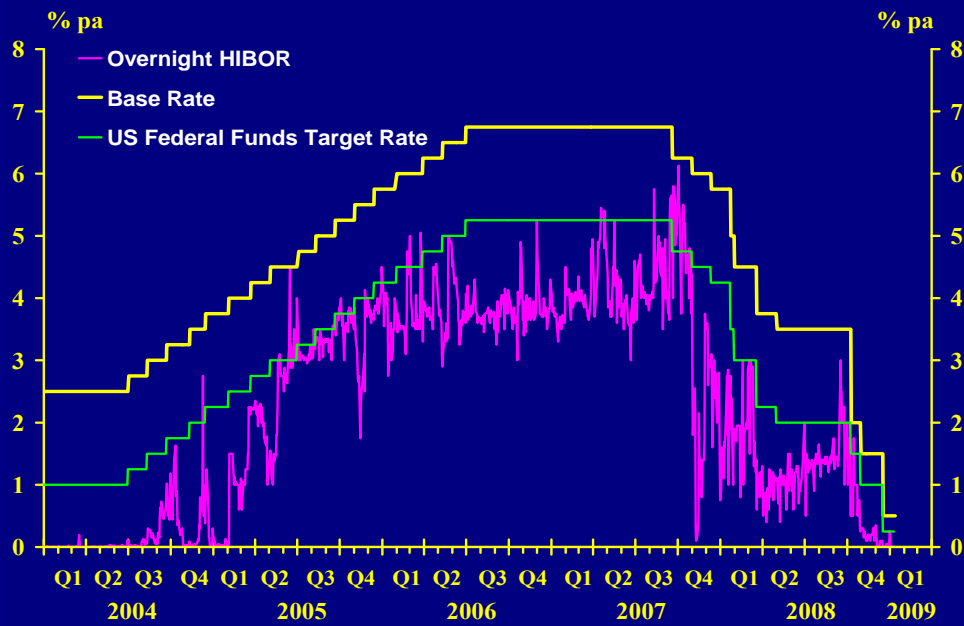


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- Hong Kong dollar interest rates were generally lower, following their US dollar counterparts, as liquidity concerns eased somewhat.
- The large Aggregate Balance helped term rates to ease further, and largely smoothed out the usual tightening in the interbank market around the year-end.
- Overnight HIBOR traded near zero while the 3-month rates declined to below 1% in early January 2009.



THE BASE RATE WAS LOWERED



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- Following the FOMC's decision to establish a target range for the Fed Funds Target Rate at 0 to 0.25% on 16 December, the Base Rate was lowered to 0.5% (lower Band of Fed Funds Target Rate 0%+50 bps) on 17 December 2008.



INCREASED ISSUANCE OF EF PAPER



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- Banks' demand for Exchange Fund paper for liquidity management purpose remained strong, as seen in the very low yield of short-dated Exchange Fund paper.
- To meet the strong demand, a total of HK\$30 billion in additional Exchange Fund Bills has been offered to the market since October 2008.
- The increased issuance of the paper was well received by the market with little reaction in the exchange rate and interest rates.
- Owing to the large Aggregate Balance, the subsequent declines in the Aggregate Balance after the issuance of the paper did not have significant impact on liquidity conditions.



FUNCTIONING OF INTERBANK MONEY MARKET

- **Liquidity concerns eased significantly**
- **Utilisation of five measures greatly reduced**
- **Confidence in banking system strengthened**



CURRENCY SWAP WITH PBoC

- **HKD/RMB currency swap agreement signed with PBoC on 20 January 2009**
- **Size : up to RMB 200 bn / HKD 227 bn**
- **In effect for 3 years; extendable upon expiry of agreement**

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- The bilateral swap agreement between the HKMA and the PBoC will enable both sides to meet the contingent short-term liquidity needs of its own banks in the other jurisdiction; meet the payment needs of trade between the two sides, thereby promoting bilateral trade and use of RMB for trade settlement in Hong Kong; and address any other needs as agreed by both sides.
- The size of the swap line is RMB 200 bn / HKD 227 bn. Should there be a need to increase the size in the future, the HKMA may initiate discussion with the PBoC.
- The agreement has taken effect from 20 January 2009 for a period of three years. Upon expiry of the agreement, the HKMA and the PBoC may decide on the need for continuation and review the need for updating of the relevant terms and conditions including the size of the swap agreement.



CURRENCY SWAP WITH PBoC

- **Allow the provision of RMB funding**
 - **To facilitate trade settlement**
 - **To meet potential funding difficulties of Mainland branches/subsidiaries of Hong Kong banks**
- **Signify monetary co-operation between Hong Kong and the Mainland China**
- **Beneficial to financial stability of Hong Kong and promoting Hong Kong's role in regional financial stability**

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- The use of renminbi to settle trade transactions will involve provision of renminbi services by banks. The use of liquidity available under the swap agreement to support the development of this renminbi business can be explored.
- Mainland branches or subsidiaries of Hong Kong banks have short-term funding-difficulties, the swap line will enable the provision of RMB funding to those branches or subsidiaries through the HKMA. This assurance on the funding will assist Hong Kong banks' mainland branches to conduct their lending business. The HKMA will consider RMB funding requests from banks case by case.
- The swap arrangement will not only enhance the financial stability of Hong Kong, but also promote the role played by Hong Kong in regional financial stability as this is consistent with the recommendation of major international bodies such as the FSF to promote greater co-operation in cross-border provision of liquidity.



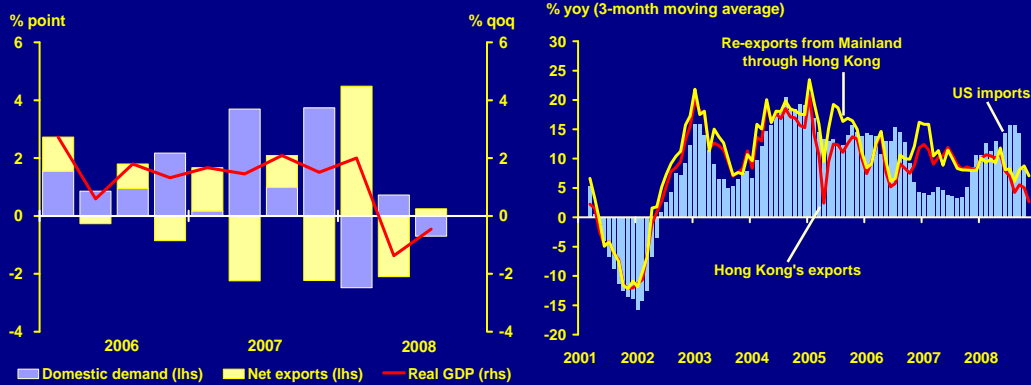
RISKS TO CURRENCY STABILITY

- **Domestic demand and export performance of Hong Kong weakened due to the global economic slowdown, labour market conditions deteriorated**
- **The gloomy economic outlook and tightened credit conditions weighed on domestic asset prices, undermining consumer and business confidence**
- **Risks associated with the Mainland economy**



SIGNIFICANT ECONOMIC DOWNTURN

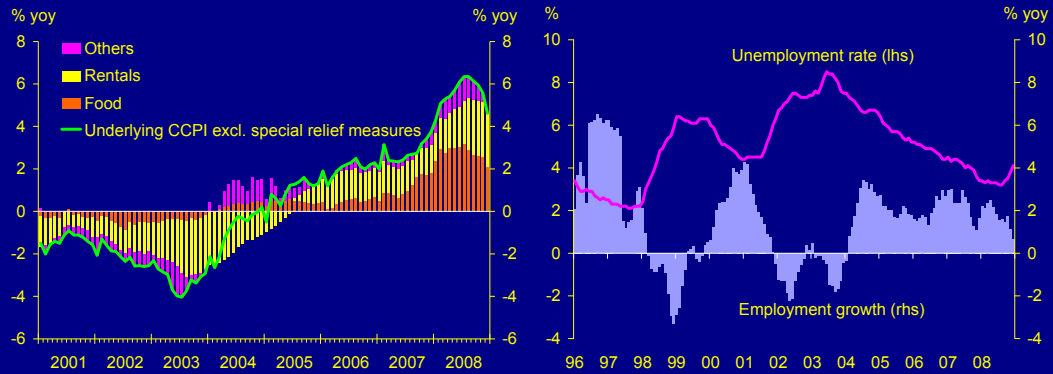
- Real GDP contracted in Q2 and Q3 of 2008, dragged down by weaker domestic demand and exports
- Recessions in the industrialised economies will weigh on domestic economic growth through the trade channel





LOWER INFLATION AND HIGHER UNEMPLOYMENT

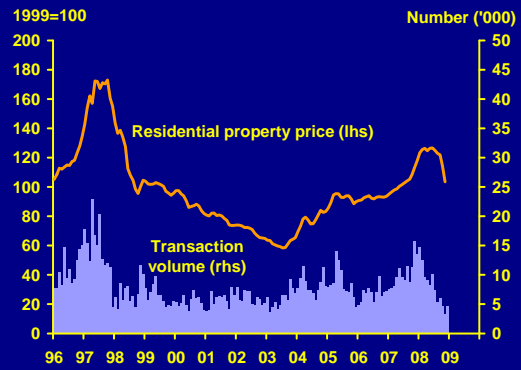
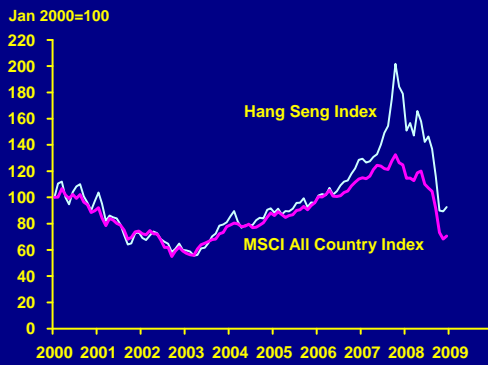
- Underlying CCPI inflation moderated to 4.6% year on year in December 2008, due to smaller increases in food costs and housing rents
- Unemployment rate rose to 4.1% in December 2008, and is likely to edge up further due to sluggish labour demand





DECLINES IN DOMESTIC ASSET PRICES

- Domestic equity prices plummeted by almost 50% in 2008, following the decline in the global stock markets
- House prices and transaction volume trended downward amid weak economic outlook and uncertain job prospects





NEAR-TERM ECONOMIC PROSPECTS

- The Purchasing Managers' index (PMI) has fallen into the contraction zone for six months, pointing to continued weakness in business activities
- Declines in market housing rents and stabilisation in basic food prices will alleviate inflationary pressures





RISKS TO ECONOMIC OUTLOOK

- **Sharper-than-expected recessions in the US and Europe would worsen the trade performance of Hong Kong**
- **Tight credit conditions amid economic contraction may restrain business spending, creating a vicious circle that prolongs the downturn of the domestic economy**
- **More visible slowdown on the Mainland would weigh on the growth prospects in Hong Kong**
- **Nevertheless, Hong Kong has entered this crisis in a position of strength and should be able to weather it relatively well**

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- There are significant risks to the economic outlook for 2009 as the effect of the global financial crisis on the domestic real sector is still unfolding, while the depth and length of recessions in major industrialised economies remain uncertain.
- A sharper-than-expected economic downturn in the US and Europe would worsen trade performance of Hong Kong, given that they are the major final destinations of Hong Kong's exports of goods and services.
- Deterioration in economic conditions may keep credit conditions tight and restrain business spending, creating a vicious circle that may deepen and prolong the economic downturn in Hong Kong.
- Another risk is related to increased uncertainty surrounding the outlook for the Mainland economy. While the Mainland authorities show strong determination to maintain 8-9% real GDP growth for 2009, the effectiveness of the fiscal stimulus package and the accommodative monetary policy in reviving domestic demand is still not clear. Given the closer economic and financial ties between Hong Kong and the Mainland, a more visible slowdown in the Mainland economy would weigh on the growth prospects of the Hong Kong economy.
- Despite the highly uncertain external environment, the domestic economy may weather the current global financial crisis better than during the Asian financial crisis because: (1) there are few signs of significant imbalances in the real sector and domestic asset markets (2) the Asia region, particularly Mainland China, has much stronger economic fundamentals than a decade ago, and policy makers have room for policy manoeuvring; and (3) the ultra loose monetary policy in the US cushions the Hong Kong economy under the Linked Exchange Rate system in the current economic downturn.



RISKS ASSOCIATED WITH THE MAINLAND ECONOMY

- **The Mainland economy lost momentum in recent months, with the annualised growth rate softening from 10.4% in H1 to 7.9% in H2 2008.**
- **Inflationary risks receded, with headline inflation declining to 1.2% at the end of 2008, from 7.9% in H1.**
- **The stock market has remained volatile. The property market continued to weaken with prices in big cities falling since February 2008. The prices in December 2008 recorded the first year-on-year decline since July 2005.**
- **Mainland authorities adopted policies to support the economy**
 - **Monetary easing with five interest rate cuts, four RRR cuts and scaled-down open market operations since September 2008**
 - **Fiscal stimulus package of RMB 4 trillion announced on 9 November 2008**
- **A weakening Mainland economy will unavoidably affect Hong Kong's economic prospects. Nonetheless, growth in the Mainland is expected to remain relatively respectable, particularly in view of the proactive policy measures being adopted to stimulate growth.**

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- Real GDP growth eased from 10.4% in H1 to 7.9% in H2 (6.8% in Q4). The slowdown was broad based, reflecting both a softening in domestic demand and falling external demand. In particular, the industrial production growth (real) fell sharply to 5.7% in December from about 16% in H1.
- Headline CPI inflation fell to 1.2% in December 2008 from an average of 7.9% in H1. The annual PPI inflation — an index representing production cost — fell to -1.1% in December 2008 from its peak of 10.1% in August, reflecting marked declines in international energy and commodity prices.
- The A-share market declined by 65.4% in 2008, although it has gained about 9% so far in 2009. Property prices started to decline from February last year, and in December 2008 recorded the first year-on-year decline since July 2005.
- With a sharp slowdown in growth being the key risk at this juncture, the Mainland authorities have proactively used monetary and fiscal policies to support the economy. The PBoC has continued to ease monetary policy since September 2008. The benchmark lending rates have been cut five times by a total of 216 bps, while the deposit rates have been cut four times by a total of 189 bps. RRR have also been reduced four times by a total of 4 percentage points for small deposit money banks and three times by a total of 2 percentage points for other banks, and open market operations have been scaled down. A 10-point fiscal stimulus package of around RMB 4 trillion was announced on 9 November 2008, and implementation is underway.
- Given the close economic and financial linkages, a weak Mainland economy would unavoidably impact on Hong Kong's economic performance. Nonetheless, the Mainland is expected to maintain relatively robust growth, particularly in light of the authorities' proactive policy measures to support the economy.



BANKING INDUSTRY



IMPACT OF GLOBAL FINANCIAL CRISIS ON FINANCIAL PERFORMANCE

- **Local banks' 2008 profitability will be significantly affected**
- **2009 will remain difficult**
- **Banks generally remain well capitalised, while the HKMA will monitor their capital position closely**
- **The HKMA has put in place contingency capital facilities for local banks in case of need**

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- Local banks' 2008 final results will be adversely affected by the global financial crisis to a significant extent. Most banks will see substantial reduction in their profits compared with 2007.
- 2009 will remain difficult. The slowdown of the global economy is likely to affect Hong Kong for a while.
- Nevertheless, local banks generally remain well capitalised. The HKMA will monitor their capital position closely.
- It also stands ready to inject capital into local banks in case of need through the Contingent Bank Capital Facilities.



BANKING SECTOR PERFORMANCE

Net interest margin of retail banks narrowed



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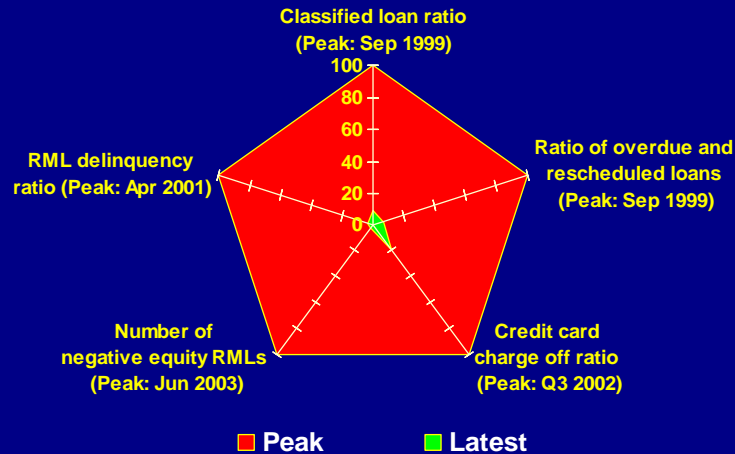
- The aggregate pre-tax operating profit of retail banks' Hong Kong offices declined by 18% in the first nine months of 2008 compared with the same period last year. Net interest margin fell to 1.75% in the third quarter of 2008 compared with 2% in the first quarter and 1.84% in the second quarter.
- Retail banks are expected to incur further impairment charges in relation to their securities investments. Increased loan loss provisions, reduced fees and commissions income and higher operating costs will also weigh on their profitability.



BANKING SECTOR PERFORMANCE

Loan quality was good but signs of deterioration emerged

Overview of loan quality



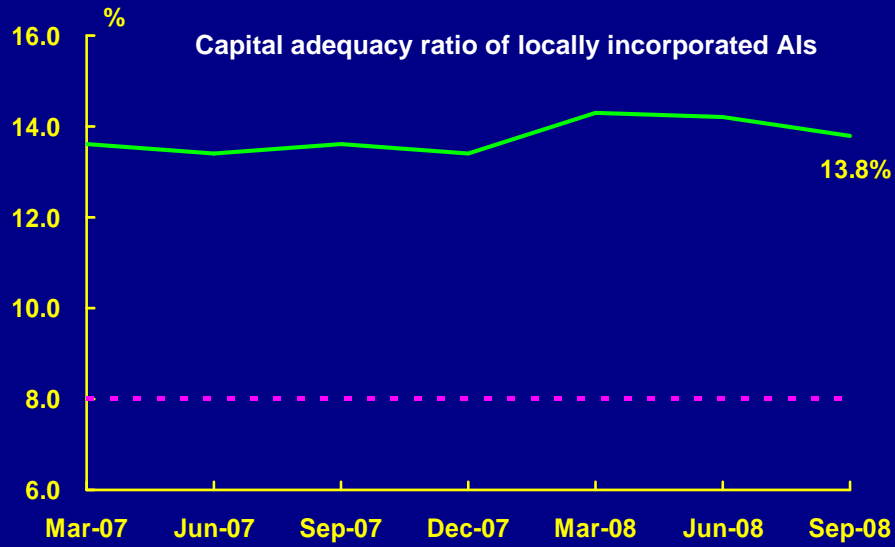
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- The asset quality of retail banks remained high by historical standards, although signs of deterioration are increasingly clear. The aggregate value of classified loans increased by 11% in the third quarter after rising 14% in the second quarter. 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 0.13% respectively at the end of November. However, the number of RMLs in negative equity more than doubled to 2,568 cases in September 2008 from 936 cases in June 2008 as property prices declined during the period.
- The credit card delinquency ratio and quarterly annualized charge-off ratio were 0.31% and 2.74% respectively in the third quarter of 2008, compared with 0.32% and 2.78% in the second quarter.
- The HKMA will monitor closely the quality of retail banks' loan portfolios.



BANKING SECTOR PERFORMANCE

Local AIs remain well capitalised



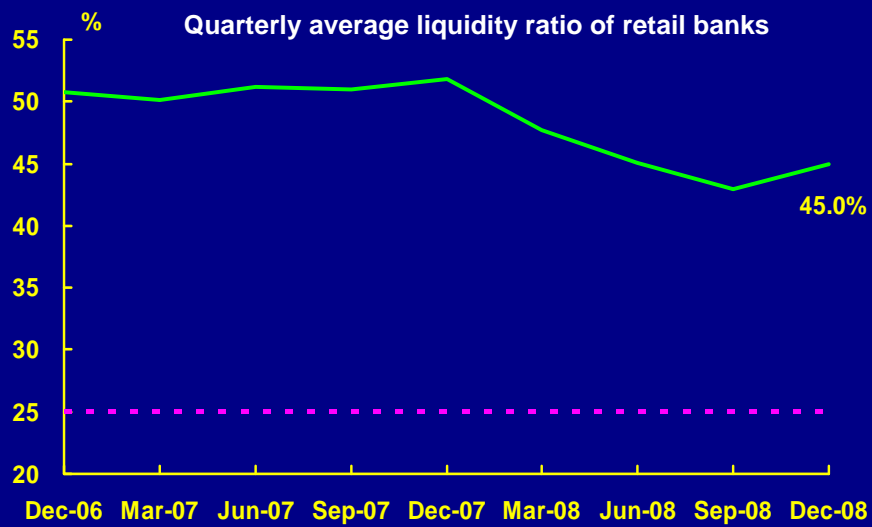
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- The average consolidated capital adequacy ratio of locally incorporated AIs stood at 13.8% at the end of September 2008, compared with 14.2% at the end of June. The ratio is well above the international requirement.



BANKING SECTOR PERFORMANCE

Liquidity level remains high



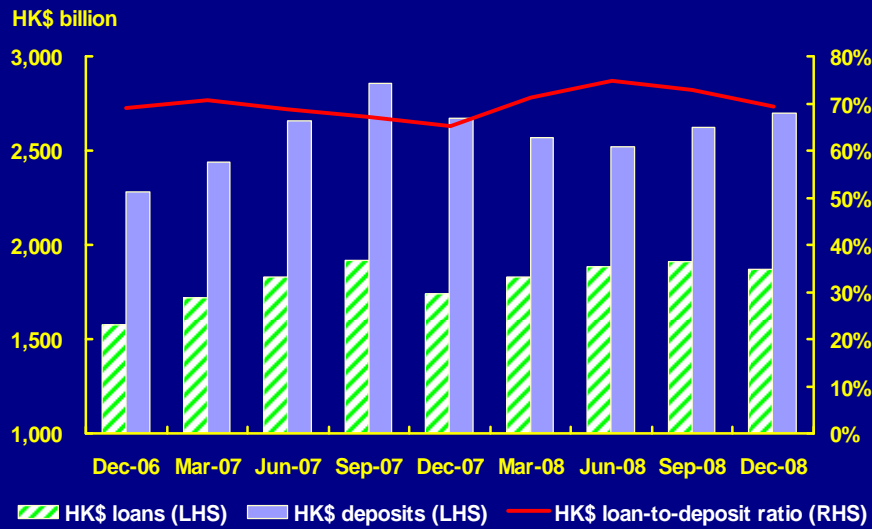
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- The quarterly average liquidity ratio of retail banks remained high at 45.0% in Q4 2008, well above the statutory minimum of 25%.



BANKING SECTOR PERFORMANCE

Hong-Kong-dollar loan-to-deposit ratio declined



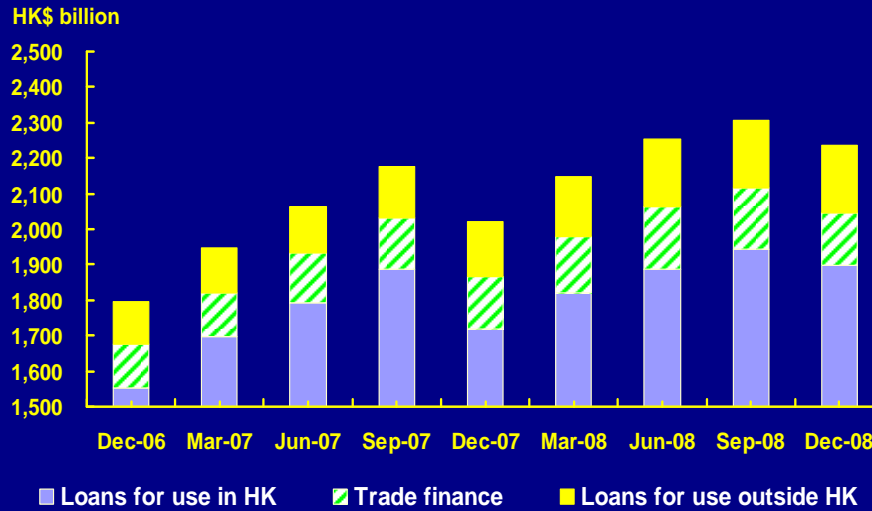
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- The Hong-Kong-dollar loan-to-deposit ratio of retail banks declined. The ratio stood at 69.4% at the end of December 2008, compared with 72.9% at the end of September.



BANKING SECTOR PERFORMANCE

Total loans of retail banks declined



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- Total loans of retail banks dropped by 3.1% in Q4 2008. Whereas loans for use in Hong Kong declined by 2.3% during the period, trade finance related lending dropped more significantly by 14.8%, presumably because of slowing trade activities.



LENDING TO SMEs

- **The HKMA has continued to encourage AIs to be supportive of their SME customers, and reminded them of the need to follow the “Hong Kong Approach to Corporate Difficulties” (circular issued in November 2008)**
- **Many AIs have reiterated their support for SMEs with some establishing “SME lending funds” to support the sector. The banking industry also responded positively to the Government’s newly introduced Special Loan Guarantee Scheme**

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- The HKMA has continued to encourage AIs to be supportive of their SME customers. The HKMA issued a circular letter to all AIs on 19 November 2008 to remind them of the need to follow the “Hong Kong Approach to Corporate Difficulties” in handling customers experiencing financial problems.
- Many AIs have reiterated their support for SMEs. Some AIs have established “SME lending funds” to support the SME sector. In addition, the banking industry has responded positively to the Government’s newly introduced Special Loan Guarantee Scheme. Since the launch of the Scheme in mid-December 2008, a total of 34 AIs have joined the Scheme. A number of them have launched publicity campaigns to promote their loan services covered by the Scheme.



LEHMAN-RELATED ISSUES - COMPLAINT-HANDLING AND INVESTIGATIONS

- Up to 22 January, 19,994 complaints have been received, of which 19,601 cases have gone through preliminary assessment
- The HKMA opened investigations on 4,876 complaints
- In 280 cases involving 15 banks adequate justifications were found for referral to the SFC to determine whether there has been a failure at the bank level
- The HKMA will continue its investigations into individual cases to establish whether there has been a failure by the relevant individuals concerned
- The HKMA is engaging additional contract staff to assist in the investigation of complaints
- The HKMA will work closely with the SFC in any further investigations to expedite the process

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- Since the collapse of Lehman Brothers (“LB”) in mid-September 2008, the HKMA has received large numbers of complaints alleging against banks’ mis-selling of LB-related products.



REPORT ON COMPLAINTS ABOUT SALE OF LEHMAN-RELATED INVESTMENT PRODUCTS

- **On 31 December 2008 the HKMA submitted a report to the Financial Secretary on its observations on lessons learned and issues identified during the process of investigating the complaints about the sale of Lehman-related investment products**
- **The HKMA will play an active role in assisting the Government to review the present regulatory framework for protection of retail investors**

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- The Financial Secretary asked the HKMA and the SFC to submit a report to him by the end of 2008 on their observations on lessons learned and issues identified during the process of investigating the complaints about the sale of Lehman-related investment products.
- On 31 December 2008, the HKMA submitted its report to the Financial Secretary, with recommendations on how the existing regulatory regime and investor protection framework may be strengthened.
- The report will be used by the Government in undertaking a comprehensive review of the present regulatory framework governing the sale of investment products to retail investors. The HKMA will play an active role in assisting the Government in undertaking the review.



REPORT ON COMPLAINTS ABOUT SALE OF LEHMAN-RELATED INVESTMENT PRODUCTS

- Letter issued to AIs on 9 January 2009 urging them to study the report carefully, particularly recommendations aimed at strengthening the existing regulatory regime and investor protection framework
- AIs engaged in the selling of securities and investment products are required to implement some of the recommendations seeking to strengthen the selling process either immediately or within the first quarter
- To formulate a plan to implement separation of deposit and investment services by end of March for discussion with the HKMA

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- Following publication of the HKMA report by the Government, the HKMA issued a letter to AIs urging them to study the report carefully.
- Recommendations aimed at strengthening the existing regulatory regime for selling structured investment products and the investor protection framework should preferably be implemented as soon as possible.
- Recommendations such as “health warning” statements on structured products should be implemented immediately while others on enhanced audit trail (e.g. audio recording) and “mystery shopper” programmes should be implemented no later than the end of March.
- For recommendations involving more structural change, such as segregation of retail securities business from the traditional deposit-taking activities, AIs should formulate a plan for implementation by the end of March for discussion with the HKMA.



REVIEW OF THE HKMA'S WORK ON BANKING STABILITY

- **The HKMA is considering the consultant's recommendations and the comments received from the public consultation**
- **The HKMA aims to produce policy responses to the Consultant's recommendations in the first half of 2009**



SUPERVISORY POLICY INITIATIVES

- **Aim to implement recommendations of the Financial Stability Forum, G20, Basel Committee on Banking Supervision and other international bodies to address lessons learned from the global financial crisis**
- **Major policy initiatives in 2009 and beyond include:**
 - **enhancement of capital adequacy and disclosure framework as well as supervisory oversight of capital adequacy**
 - **revision of supervisory framework for liquidity risk**
 - **development of supervisory guidance to enhance AIs' risk management standards (e.g. management of firm-wide risks, securitisation and off-balance sheet exposures, counterparty credit risk, stress-testing, valuation etc.)**

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Implementation of international bodies' recommendations

- The HKMA's major supervisory policy initiatives in 2009 and beyond will be driven to a significant extent by international responses to the current global financial crisis by the Financial Stability Forum (FSF), G20, Basel Committee on Banking Supervision and other international bodies for enhancing the resilience of financial markets and institutions.
- While the financial crisis has not posed any systemic risk to the Hong Kong banking sector, there is no room for complacency and the HKMA will endeavour to follow international best practices which contribute to the resilience of the banking system.
- As a member of the FSF and various Basel sub-groups, the HKMA will continue to contribute to the work being undertaken by these international bodies in response to the current crisis.

Major policy initiatives in 2009 and beyond

- The HKMA will aim at implementing recommendations in the following areas, having regard to the guidance of the Basel Committee and local circumstances:
 - Strengthen the capital adequacy and disclosure framework through amendment of the Banking (Capital) Rules and Banking (Disclosure) Rules;
 - Enhance the supervisory review process to ensure that AIs' risk management, capital buffers and credit loss estimates are forward-looking and take account of uncertainties associated with models, valuations and business cycle risks;
 - Revise the supervisory framework for liquidity risk in line with the *Principles for Sound Liquidity Risk Management and Supervision* issued by the Basel Committee in September 2008;
 - Develop supervisory guidance to enhance AIs' risk management practices, particularly in areas such as the management of counterparty credit risk, firm-wide risks, and the risks associated with securitization and off-balance sheet exposures, stress-testing, and governance and controls over valuation processes.
- The Basel Committee issued for public consultation in January 2009 proposals on Basel II enhancements and other risk-management guidance. The HKMA will study these proposals and will incorporate relevant recommendations in its supervisory framework where appropriate.



REVISED CODE OF BANKING PRACTICE

- **Completed a comprehensive review of the Code of Banking Practice in 2008**
- **The objectives of the review were to improve the existing provisions of the Code and to keep it up to date with recent developments in the banking sector**
- **Revised Code became effective on 2 January 2009**

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- The Code of Banking Practice Committee convened by the Hong Kong Association of Banks (HKAB) and on which the HKMA and the DTC Association are represented completed a comprehensive review of the Code of Banking Practice in 2008.
- The revised Code became effective on 2 January 2009. AIs are expected to take steps to comply with the revised provisions as quickly as possible and achieve full compliance not later than 6 months from the effective date. A further 6 months is allowed for compliance with those revised provisions which require system changes.



MARKET INFRASTRUCTURE

Oversight of the clearing and settlement systems

- **All local designated systems remain in compliance with the safety and efficiency requirements of the Clearing and Settlement Systems Ordinance**
- **Continued support to the Process Review Committee in preparing the fourth Annual Report to the Financial Secretary**

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- The HKMA oversees five local designated systems, including the Hong Kong-dollar Clearing House Automated Transfer System (CHATS), US dollar CHATS, Euro CHATS, RMB CHATS and the Central Moneymarkets Unit through on-site examination, off-site reviews and continuous monitoring. Recently, the HKMA performed annual assessment on these systems and concluded that all the five systems are in compliance with the safety and efficiency requirements under the Clearing and Settlement Systems Ordinance.
- The Process Review Committee is an independent committee to review the process and procedures adopted by the HKMA in overseeing designated systems. The fourth annual report on the work of the Committee will be submitted to the Financial Secretary in due course.



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**

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- 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 raised. Based on the findings and 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.



FINANCIAL INFRASTRUCTURE



FINANCIAL MARKET INFRASTRUCTURE

- **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**
 - **Improve the functions and capabilities of payment and securities settlement systems**
 - **CMU enhancement in support of temporary measures to provide liquidity assistance to banks**
 - **Expedited e-IPO refund process**
 - **Migration to SWIFTNet**

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- 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.
- **CMU enhancement in support of temporary measures to provide liquidity assistance to banks** : CMU to facilitate banks in Hong Kong to
 - use securities other than EFBNs for Discount Window
 - obtain funding through the Discount Window with tenors lengthened up to three months
 - use foreign securities to obtain same-day funding from the HKMA
- **Expedited e-IPO refund process**: Starting from 15 December 2008, the schedule of e-IPO refund process is brought forward by one day to expedite the recycling of market liquidity during IPO periods.
- **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

- **Promote links with overseas systems and use of Hong Kong's financial infrastructure**
 - **Payment-versus-payment link between Hong Kong's US dollar RTGS system and the Indonesian Rupiah RTGS system**
 - **RTGS links with Mainland China's foreign currency settlement systems**
 - **Promotion of Hong Kong's payment services and role as a payment and settlement hub**
 - **Increased turnover of RTGS systems**

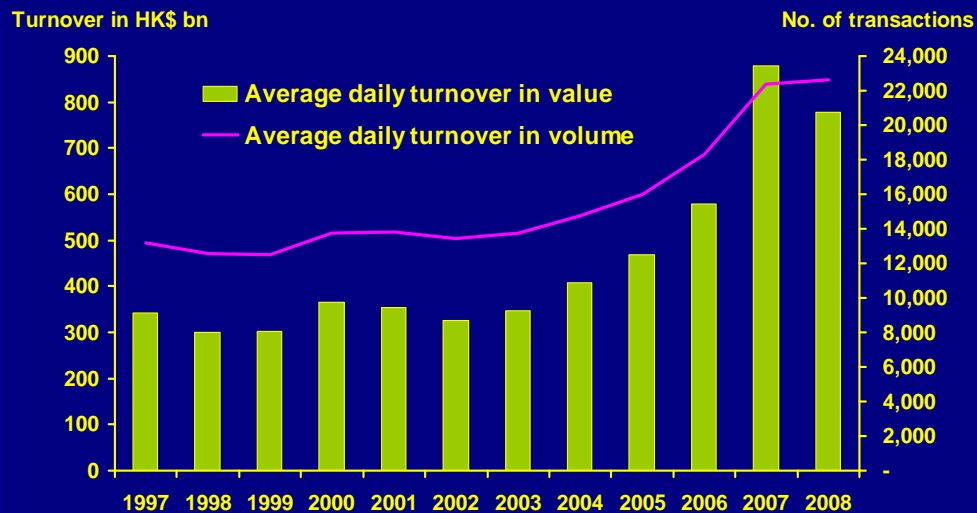
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- **Payment-versus-payment (PvP) link with Bank Indonesia:** Establishment of a PvP link between the US dollar RTGS system in Hong Kong and the Indonesian Rupiah RTGS system is in progress. The link, planned to be launched in early 2010, builds on the success of the existing 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 agreed to establish cross-border links between Hong Kong's RTGS systems and the Mainland's domestic foreign currency RTGS systems. The links, scheduled to start operations in March 2009, aim to increase the settlement efficiency of multi-currency payments between Hong Kong and most parts of China.
- **Increased turnover of RTGS systems:**
 - Partly as a result of the HKMA's marketing efforts in promoting Hong Kong's payment services and role as a payment and settlement hub, the usage of Hong Kong's US dollar and RMB RTGS systems showed strong growth in 2008:
 - ◆ US dollar RTGS system: daily average of US\$10 billion, 19% increase over 2007.
 - ◆ RMB RTGS system: daily average of RMB610 million, 189% increase over 2007.



HONG KONG DOLLAR RTGS TURNOVER

Hong Kong dollar RTGS system



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- Alongside the dampened economic momentum, the average daily turnover of the Hong Kong dollar real time gross settlement (RTGS) system decreased by 12% from a record high of \$879 billion in 2007 to \$777 billion in 2008.
- Despite the financial events in the last quarter of 2008, the operation of the RTGS system remained robust and smooth.



DEVELOPMENT OF ISLAMIC FINANCE

HKMA's Four-part Strategy

Promote market infrastructure

- Assist the Government in its tax review to provide a level playing field for Islamic finance transactions.

Encourage product development

- Launch of the second Islamic banking window in Hong Kong in November 2008
- First Islamic syndicated loan facility arranged in Hong Kong in December 2008

Build international profile

- Participation in an inaugural Hong Kong Islamic finance forum on 25 November 2008

Promote market awareness

- A feature article in HKMA Dec 2008 Quarterly Bulletin to explain HKMA's current supervisory approach to Islamic finance in Hong Kong



HONG KONG AS AN INTERNATIONAL FNANCIAL CENTRE



RENMINBI BUSINESS

- **In December 2008, the Central Government announced a further expansion of renminbi business in Hong Kong, allowing eligible Mainland and Hong Kong enterprises to use renminbi to settle trade transactions.**
- **The HKMA will work closely with the PBoC to facilitate timely completion of technical preparations for an early launch of the arrangement.**

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- The use of renminbi by Mainland and Hong Kong enterprises to settle trade transactions is an experiment that will promote the use of the renminbi outside Mainland China. In servicing such activities, the capabilities of Hong Kong's financial system in handling renminbi-denominated transactions will be strengthened, thereby enhancing the status of Hong Kong as an international financial centre.
- The scope of Hong Kong banks' renminbi services will be expanded, which will create new business opportunities. For importers and exporters, there will be more flexibility to better deal with risks arising from the movements in the renminbi exchange rate, facilitating Mainland trade with or through Hong Kong.
- The outstanding amount of renminbi deposits was RMB 61.9 billion at the end of November 2008, declining by 20.2% from the end of June 2008.



INCREASING REGIONAL CO-OPERATION

- **Monitoring of regional monetary and financial stability: pivotal role in strengthened surveillance efforts of Asia-Pacific central banks amid the global financial crisis**
- **Banking stability: chairing EMEAP Working Group on Banking Supervision and organising a High-Level Meeting jointly with the Financial Stability Institute of Bank for International Settlements to exchange views on the role of banking sector and banking supervision in financial stability**
- **Financial co-operation initiatives: Plenary and regional meetings of Financial Stability Forum (FSF) were held in December in Hong Kong to discuss efforts to contain the global financial crisis and to build a stronger financial system, FSF membership expansion, and the work underway in fulfilling the G20 Action Plan**

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- The HKMA has played a pivotal role in the monitoring by Asia-Pacific central banks of regional monetary and financial stability amid the global financial crisis. The HKMA has coordinated surveillance inputs and prepared macro-monitoring reports for biannual EMEAP Monetary and Financial Stability Committee (MFSC) Meetings and ad hoc MFSC Teleconferences since the establishment of the MFSC in 2007. Phase II of the MFSC Chart Pack, a comprehensive set of economic and financial indicators consolidated by the HKMA, has been launched to support MFSC's regional surveillance. The HKMA has also led the development of a new multi-regional economic model to further enhance MFSC's macro surveillance framework.
- As Chair of EMEAP Working Group on Banking Supervision, the HKMA organised jointly with the Financial Stability Institute of the Bank for International Settlements a High-Level Meeting on the Role of Banking and Banking Supervision in Financial Stability in November 2008. Two sessions of the High-Level Meeting were dedicated for discussion and information sharing among central banks and supervisory authorities in the EMEAP region only.
- The FSF has come to the centre of attention in the light of the global financial crisis. The FSF held its plenary and regional meetings in Hong Kong in December. Topics included efforts to contain the global financial crisis, ways to build a stronger financial system, FSF membership expansion and fulfilling the G20 Action Plan. The Action Plan was laid out in the G20 Declaration of the Summit on Financial Markets and the World Economy. Most of the immediate actions in the Action Plan to be taken by national and regional authorities have already been taken in Hong Kong.



THE INVESTMENT ENVIRONMENT AND PERFORMANCE OF THE EXCHANGE FUND



MARKETS IN 2008

- **Exchange rates:**
 - US dollar strengthened sharply in the second half of 2008 against the euro but weakened against the yen
- **Equity markets:**
 - Major markets experienced one of the worst slumps in history
 - Major indices dropped around 30-50%
- **Interest rates:**
 - Aggressive easing by major central banks
 - Capital seeking a safe haven flooded into sovereign bond markets
 - Government bond yields reached historical lows in the fourth quarter of 2008



INVESTMENT INCOME

(HK\$ billion)	2008					2007	2006	2005	2004
	Full year *	Q4	Q3	Q2	Q1	Full year	Full year	Full year	Full year
Gain/(Loss) on Hong Kong equities [^] @	(77.9)	(21.0)	(24.8)	(2.1)	(30.0)	55.8	35.9	7.0	12.0
Gain/(Loss) on other equities [^]	(73.2)	(30.0)	(17.8)	(3.0)	(22.4)	6.7	18.7	20.5	11.2
Exchange gain/(loss)	(12.4)	1.4	(25.4)	(0.6)	12.2	18.7	17.3	(19.5)	8.5
Return from bonds [#]	<u>88.6</u>	<u>58.0</u>	<u>19.7</u>	<u>(14.7)</u>	<u>25.6</u>	<u>61.0</u>	<u>31.9</u>	<u>29.8</u>	<u>25.0</u>
Investment income/(loss) (including HK equities) [@]	(74.9)	8.4	(48.3)	(20.4)	(14.6)	142.2	103.8	37.8	56.7
Investment income/(loss) (excluding HK equities)	3.0	29.4	(23.5)	(18.3)	15.4	86.4	67.9	30.8	44.7

* Unaudited figures

[^] Including dividends

[#] Including interest

[@] Excluding valuation changes in Strategic Portfolio



CHANGES IN INVESTMENT INCOME, PAYMENT TO TREASURY AND ACCUMULATED SURPLUS

(HK\$ billion)	2008					2007
	Full year *	Q4	Q3	Q2	Q1	Full year
Investment income/(loss)	(74.9)	8.4	(48.3)	(20.4)	(14.6)	142.2
Other income	0.3	0.1	0.1	0.0	0.1	0.2
Interest and other expenses	<u>(6.4)</u>	<u>(1.2)</u>	<u>(1.8)</u>	<u>(1.8)</u>	<u>(1.6)</u>	<u>(10.2)</u>
Net investment income/(loss)	(81.0)	7.3	(50.0)	(22.2)	(16.1)	132.2
Payment to Treasury #	(46.4)	(11.5)	(11.3)	(11.8)	(11.8)	(27.6)
Valuation change of Strategic Portfolio [^]	<u>(8.9)</u>	<u>(1.2)</u>	<u>(1.2)</u>	<u>(1.0)</u>	<u>(5.5)</u>	<u>4.7</u>
Increase/(Decrease) in EF accumulated surplus	(136.3)	(5.4)	(62.5)	(35.0)	(33.4)	109.3

* Unaudited figures

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

[^] Including 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*#	(74.9)	8.4	(48.3)	(20.4)	(14.6)

* Excluding valuation changes in the Strategic Portfolio.

Unaudited figures



HISTORICAL CHANGE IN INVESTMENT INCOME, PAYMENT TO TREASURY AND ACCUMULATED SURPLUS

(HK\$ billion)	2008*	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998
Investment income/(loss)	(74.9)	142.2	103.8	37.8	56.7	89.7	47.0	7.4	45.1	103.8	93.8
Other income	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Interest and other expenses	(6.4)	(10.2)	(10.5)	(7.6)	(4.8)	(5.6)	(7.0)	(10.5)	(11.0)	(10.0)	(16.0)
Net investment income/(loss)	(81.0)	132.2	93.5	30.4	52.1	84.3	40.2	(2.9)	34.3	94.0	78.0
Payment to Treasury	(46.4)	(27.6)	(28.9)	(10.1)	(14.5)	(25.7)	(15.6)	(1.6)	(18.1)	(45.4)	(26.0)
Valuation change of Strategic Portfolio [^]	(8.9)	4.7	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Revaluation gain/(loss) on premises	N/A	N/A	N/A	N/A	0.9	(0.9)	N/A	N/A	N/A	N/A	N/A
Carry to accumulated surplus	(136.3)	109.3	64.6	20.3	38.5	57.7	24.6	(4.5)	16.2	48.6	52.0
Adjustment to accumulated surplus											
Effect of implementation of HKAS 39	N/A	N/A	N/A	(0.6)	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Increase/(Decrease) in EF accumulated surplus	(136.3)	109.3	64.6	19.7	38.5	57.7	24.6	(4.5)	16.2	48.6	52.0

* Unaudited figures

[^] Including dividends



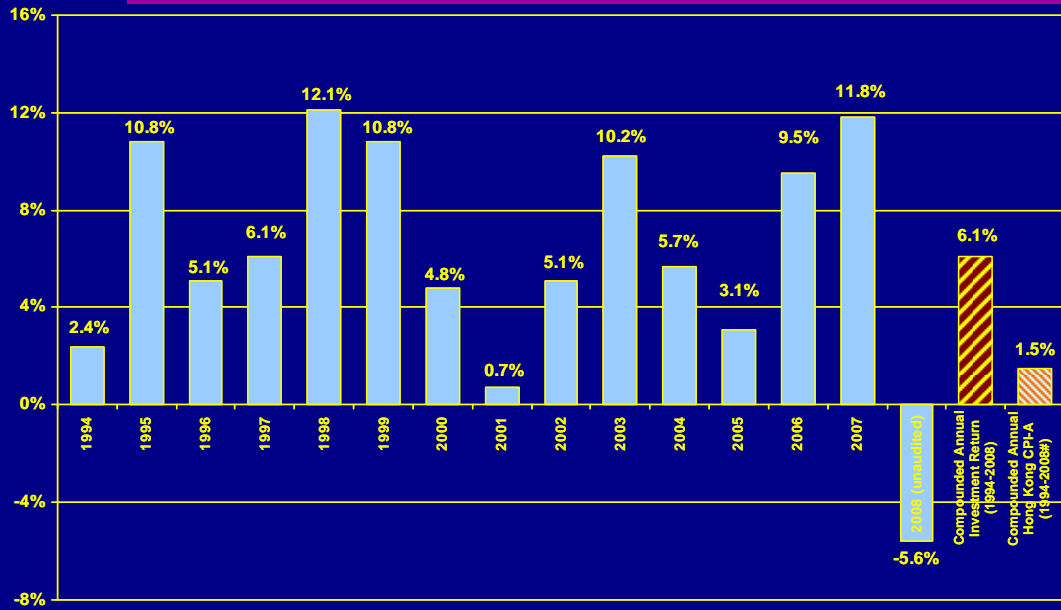
EXCHANGE FUND ABRIDGED BALANCE SHEET

(HK\$ billion)	At 31 Dec 2008 *	At 31 Dec 2007	Change
ASSETS			
Deposits	190.4	132.9	57.5
Debt securities	1,150.8	922.9	227.9
Hong Kong equities	92.9	184.6	(91.7)
Other equities	86.1	146.0	(59.9)
Other assets	<u>37.5</u>	<u>28.0</u>	<u>9.5</u>
Total assets	<u>1,557.7</u>	<u>1,414.4</u>	<u>143.3</u>
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness	176.1	163.4	12.7
Government-issued currency notes & coins in circulation	8.3	7.5	0.8
Balance of the banking system	158.0	10.6	147.4
Exchange Fund Bills and Notes	162.5	141.8	20.7
Fiscal Reserves Account	531.4	464.6	66.8
Other liabilities	<u>40.7</u>	<u>9.5</u>	<u>31.2</u>
Total liabilities	1,077.0	797.4	279.6
Accumulated surplus	<u>480.7</u>	<u>617.0</u>	<u>(136.3)</u>
Total liabilities and fund equity	<u>1,557.7</u>	<u>1,414.4</u>	<u>143.3</u>

* Unaudited figures



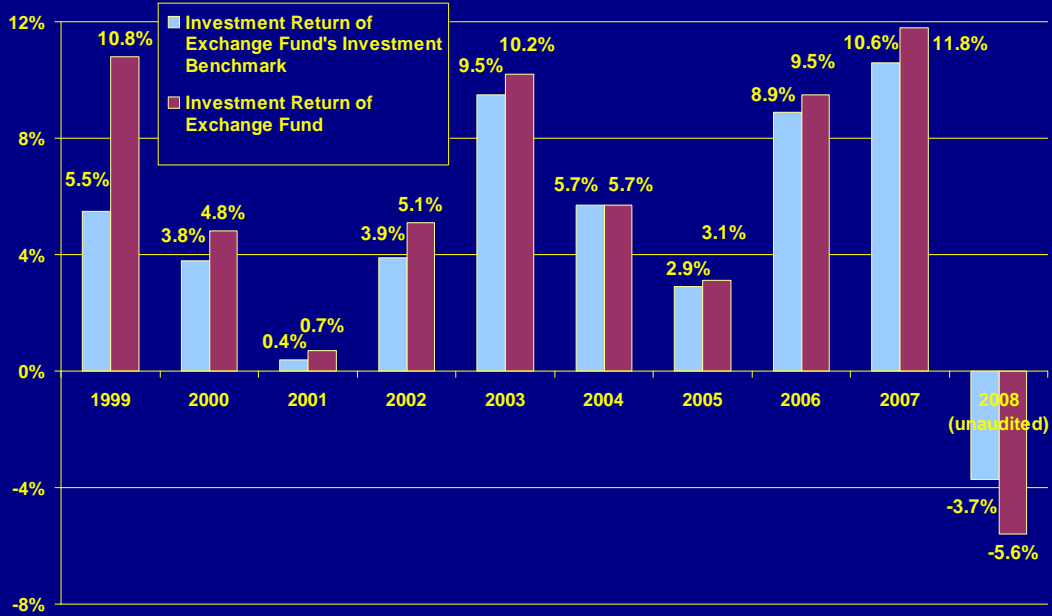
INVESTMENT RETURN OF THE EXCHANGE FUND



Hong Kong CPI-A at end-November 2008



EXCHANGE FUND PERFORMANCE AGAINST INVESTMENT BENCHMARK





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**



PAYMENT TO TREASURY AGAINST ESTIMATE

