HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

20 May 2010

1. Macroeconomy / Monetary conditions
2. Assessment of risk on Hong Kong's financial stability
3. Latest developments in the banking sector
4. Investment income of the Exchange Fund in the first quarter of 2010

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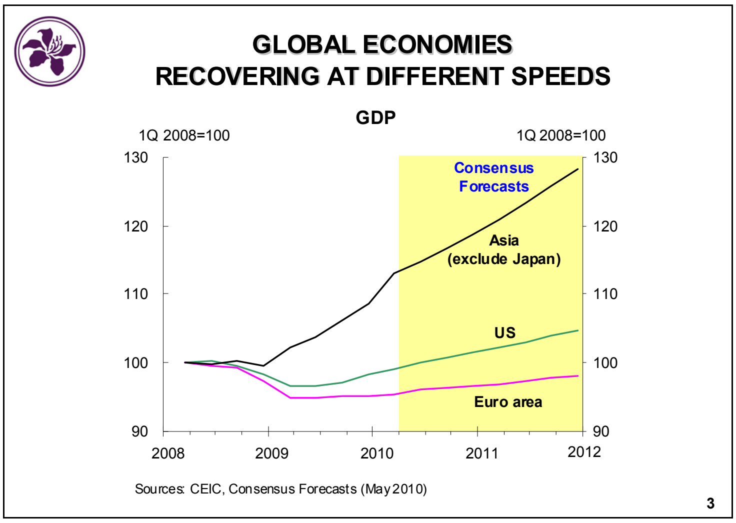
Global economies recovering at different speeds



- While the global economy has emerged from the recession, the pace of recovery varies considerably among regions. In particular, real GDPs in emerging Asia have already exceeded their pre-crisis levels. On the other hand, while the US and the euro area have resumed growth, their total outputs are still lower than the pre-crisis levels.

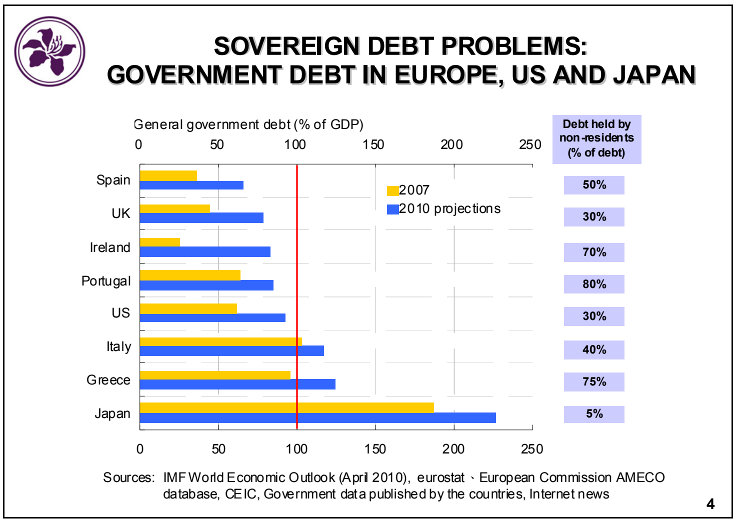
- Market consensus shows that the discrepancies in these three regions may widen further, resulting in a "three-prong" global recovery.

- Growth in Asian economies is expected to continue to be faster than that in the US and the euro area. Domestic demand and intra-regional trade will remain the major drivers of growth.

- The US is also expected to maintain its momentum of recovery. Latest figures show that retail sales have continued to rise and non-farm payrolls have gone up. But the recovery may still be restrained by high unemployment and the fact that the property and credit markets have not fully recovered yet.

- The euro area's economy is relatively weaker. In particular, unemployment continues to deteriorate and banks are even more conservative than their US counterparts in extending loans. Plagued by the sovereign debt problems, some European countries resolved to implement strenuous fiscal consolidation measures. This will dampen economic growth in the euro area, making it the weakest performing region among the three.

Sovereign debt problems: Government debt in Europe, US and Japan



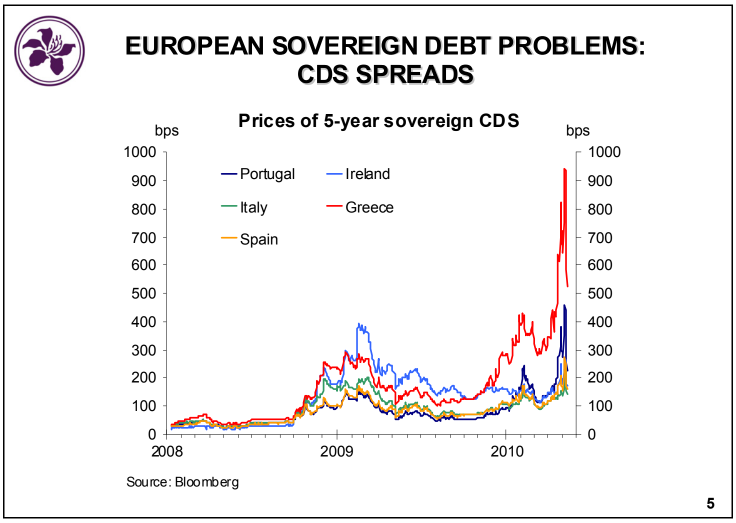
- While the major economies are recovering steadily, there are a number of potential risks facing global economic and financial stability.

- The chart compares the debt burden of a number of euro-zone countries, which have become the focus of attention lately, and the advanced economies of the US, the UK and Japan. These three advanced economies are believed to have accumulated large amounts of debt in the past three years (2007 to 2010). Japan has the largest debt, more than doubling its annual GDP, followed by the US – the world's largest economy – with public debts almost as large as the country's GDP.

- However worrying these figures may be, the chance of the US's and Japan's debt problems escalating into a crisis is still small because only a small portion of their debts is held by non-residents, at about 30% and 5% respectively. The figures compare favourably with those in Greece and other euro-zone members. As the US dollar is still the most common reserve currency around the world and the US government has recently introduced measures to consolidate its fiscal positions, market confidence in the US government debt and the US dollar remains strong.

- In contrast, the sovereign debt problems in the euro area – especially Greece, Ireland, Italy, Portugal and Spain – are more worrying. Not only had these countries borrowed excessively in the past, their fiscal deficits have further increased considerably following the launch of large-scale fiscal stimulus measures in response to the global financial crisis in the past two years. Their debts relatively to GDP have risen so quickly that their repayment ability is questionable.

European sovereign debt problems: CDS spreads



- This chart shows the spreads of sovereign credit default swaps (CDS) of Greece, Ireland, Italy, Portugal and Spain in the past two years. Simply put, the higher the CDS spreads, the more likely the market believes the country concerned would default on its sovereign debts.

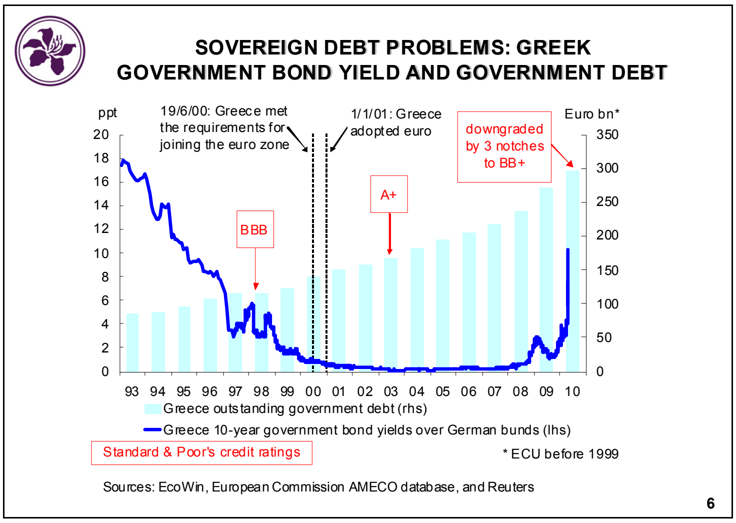
- Reflecting market worries about the sovereign debt problems in these five countries, their CDS spreads surged recently. Greece's sovereign CDS once climbed to nearly 950 basis points, and Portugal's to over 450 basis points. Following the European Union's announcement of plans to contain the sovereign debt crisis, the five countries' CDS spreads dropped markedly, although they are still higher than a month ago.

- With major banks, mostly from the advanced economies, being heavily exposed to these five countries, global financial stability would be negatively affected if these countries need to restructure or even default on their debts. Data from the Bank for International Settlements show that total claims of European banks on these five countries amounted to US$2,800 billion and those of American banks reached US$190 billion.

Sovereign debt problems: Greek government bond yields and government debt

- One of the factors leading to the Greek debt crisis is that the credit risk of exposures to Greece had been underestimated by the market in recent years: ineffectiveness in credit-risk pricing had made it possible for Greece to borrow at unreasonably low costs.

- In this chart the dark-blue line shows the yield spreads of Greece's 10-year government bonds over German bunds, and Greece's outstanding government debt is shown by the light-blue bars.



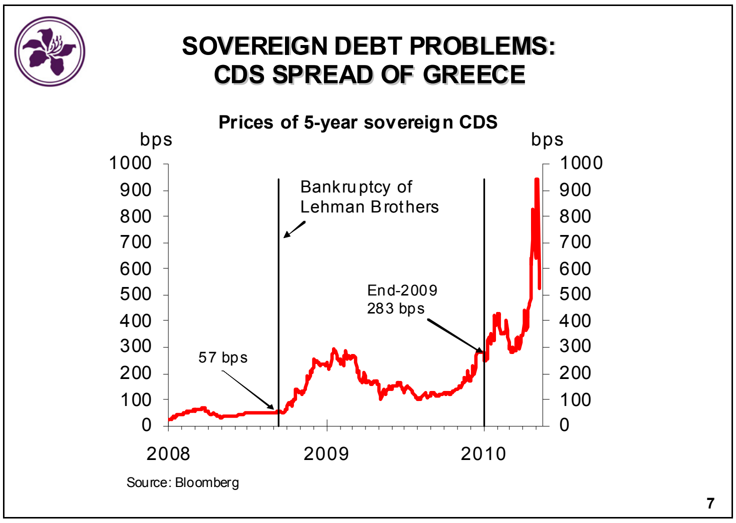
- Before mid-1990s, yields of Greece's government bonds were considerably higher than those of corresponding German bunds, with spreads staying persistently at above 10 percentage points between 1993 and 1995. This reflected higher risk premiums that the market demanded for Greece's government bonds.

- However, in the several years preceding Greece's accession to the euro zone, yields of Greece's government bonds went down markedly. On the one hand, it reflected Greece's strenuous efforts in beefing up its economic fundamentals in order to enter the euro zone, supporting economic growth and curbing inflation. On the other hand, the market expected that Greece would ultimately adopt the euro and therefore lowered the required risk premiums of Greece's government bonds. Upgrades in the credit ratings of Greece's sovereign debt also helped eased market concern about the country's repayment ability.

- Despite improvements in Greece's economic fundamentals, its fiscal deficit kept rising, persistently staying far higher than the EU's limit of 3 per cent of GDP.

- Following Greece's accession to the euro zone, yields of its government bonds gradually converged to those of its European counterparts (convergence play), keeping interest rates persistently low. However, instead of reducing its debts, the Greek government took advantage of the low-interest-rate environment and issued even more debts. Excessive borrowing and persistent increases in government debt sowed the seeds for the current debt crisis. The case of Greece shows the importance of fiscal discipline.

Sovereign debt problems: CDS spreads of Greece



- This chart shows movements of CDS spreads for Greece's sovereign bonds in the past two years. Before the collapse of Lehman Brothers, which triggered the global financial crisis, Greece's CDS spreads were about 50 to 60 basis points. Even in the fourth quarter of 2008 after the eruption of the crisis, the spreads rose to just around 240 basis points. Not until last November when Greece revised the official statistics revealing its fiscal deficit problem then the market began to realise its seriousness. The CDS spread increased sharply from about 280 basis points at the end of 2009 to nearly 1,000 basis points in early May 2010. The spread only returned to around 500 basis points following the announcement of the EU's €750 billion salvage plan, still doubling its pre-crisis levels.

- Obviously Greece's fiscal problem is not something that only came up in the past few months. The unreasonably low CDS spreads before the current crisis showed that the credit risk of Greece bonds had been mispriced for a long time.

EU/IMF measures to avert a sovereign debt crisis in Europe

- To prevent Greece's sovereign debt crisis from spreading to other euro-zone members, the EU announced on 10 May that it would provide up to €750 billion in standby funds and loan guarantees for governments and financial institutions in its member countries. On 9 May, the EU and IMF also agreed to provide Greece with a €110 billion financing package.

EU/IMF MEASURES TO AVERT A SOVEREIGN DEBT CRISIS IN EUROPE

- Loans and guarantees up to €750 billion are provided to the EU members by the EU and the IMF (earlier EU and IMF has agreed to provide Greece with a financing package of €110 billion)
- European Central Bank to buy government and private bonds in the secondary market and provide up to 6-month liquidity to the European banking sector
- Re-open the US dollar liquidity swap facilities between the Federal Reserve and other major central banks
- Other heavily indebted countries have also announced measures to reduce fiscal deficits and government debts

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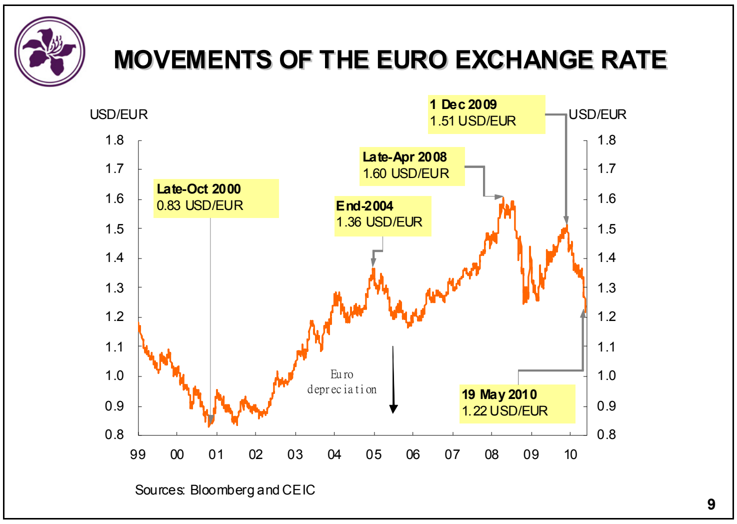
- While these measures were effective in stabilising the market, their effectiveness hinges on the success of Greece and other debt-ridden EU members in slashing deficits and reducing debts. Latest market developments show an easing of worries for Europe's sovereign debt problems, but uncertainties are still looming in the horizon.

- Although the debt crisis broke out in a small country in southern Europe (Greece accounts for only 3% of total GDP of 16 euro zone member countries), regulatory authorities and investors around the world have stayed on full alert. Experience tells us that we can ill afford to overlook the potential contagion effect of a crisis, regardless of its initial magnitude. Using a single currency, what happens in an EU member country can easily affect the others. The authorities must implement decisive and effective responses to the crisis to prevent the crisis from spreading to other member countries and creating big damages.

- In addition to introducing immediate responses to the crisis, the troubled euro zone members must find long-term solutions to mend their public finance positions. Drastic fiscal tightening seems to be the only way to ease market worries about their long-term fiscal health. Other debt-ridden countries including the US and the UK have announced plans to cut their deficits and government debts. However, whether they can restore market confidence depends on whether they have the resolve to implement the deficit-cutting measures fully and properly.

- Economic and financial crises can spread to other places quickly through financial-intermediation channels. Capital flows can change course overnight. Asset prices can swing up and down. Fickle investor sentiment can spread in no time to all corners of the world through the complex global financial systems, leaving no country immune to its impact. Regulatory authorities and investors should therefore be vigilant. The HKMA will continue to monitor closely the developments of the European debt crisis and to maintain stability in Hong Kong's financial markets.

Movements of the euro exchange rate



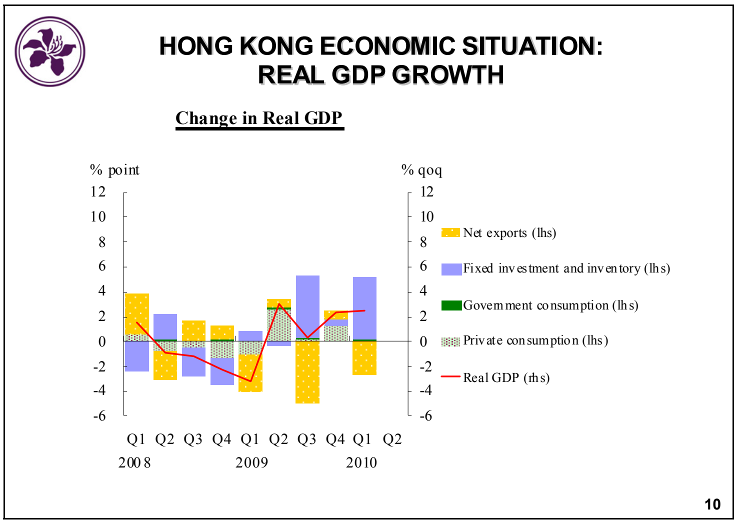
- Coming under pressures since the debt crisis in Greece and several other countries erupted, the euro has depreciated by 19% against the US dollar to level with its 2006 lows in the five months since early December 2009. The market is worried that the euro's volatile movements might create further uncertainties in the current crisis.

- As one of the major currencies around the world, the euro's volatility will certainly be a cause for market concern. But the euro exchange rate has indeed been quite volatile since its inception in 1999, reaching even lower levels than now in some spells. It would therefore not be too surprising if the euro continues to fluctuate or depreciates even further.

- For example, just when the euro hit an all-time low of 0.83 against the US dollar in October 2000, making many people worried whether the depreciation would continue, it started to make a gradual comeback. In the following few years the euro kept on gaining strength, although not without occasional short-term swings.

- The euro's outlook in the near term remained uncertain. Its sharp swings will no doubt heighten investment risks. Investors and regulatory authorities must take heed.

Hong Kong economic situation: Real GDP growth



- Hong Kong stayed on its path of steady recovery. Real GDP rose by 2.4% quarter on quarter in the first quarter of 2010, while its year-on-year growth rate reached 8.2%, the fastest pace in four years.

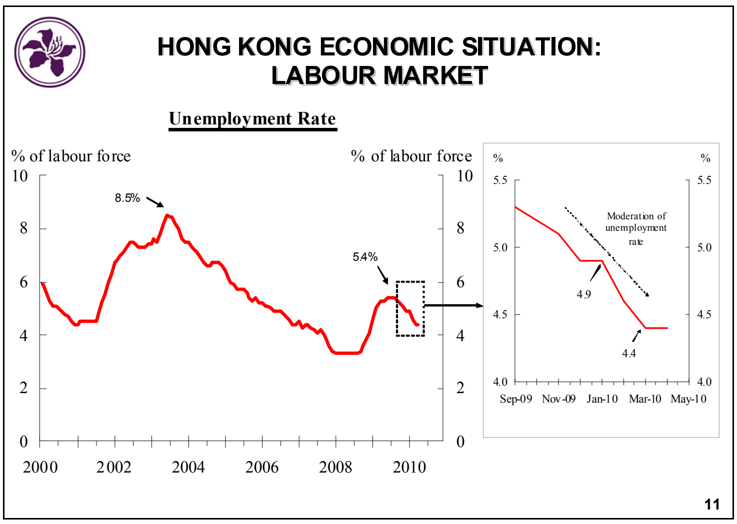
- GDP declined by a total of 7.4% (HK$ 31.7 billion) between the second quarter of 2008 and the first quarter of 2009.

- GDP rose by a total of 8.4% (or HK$33.3 billion) between the second quarter of 2009 and the first quarter of 2010, recovering the previous losses in economic activities.

- Economic growth in the first quarter was mainly driven by a strong rebound in fixed investment (especially acquisition of machinery and equipment, infrastructural spending and inventory growth), reflecting corporations' optimistic views of the economic outlook. Private consumption remained stable. While exports of goods and services continued to grow strongly, imports bounced up at a much faster rate due to strong fixed investment. As a result, net exports shrank and partly offset the increase in fixed investment.

- Recent economic indicators suggest that local economic activities remained vibrant in the second quarter of 2010. The latest Quarterly Business Tendency Survey showed a notable improvement in business sentiment across the board. The Purchasing Managers' Index also stayed above 50, the expansion/contraction cut-off level, for the ninth straight month.

Hong Kong economic situation: Labour market



- Labour market conditions also continued to improve. Unemployment rate declined further to 4.4% in April 2010, down by nearly one percentage point from September 2009.

- Hiring sentiment has gradually improved.

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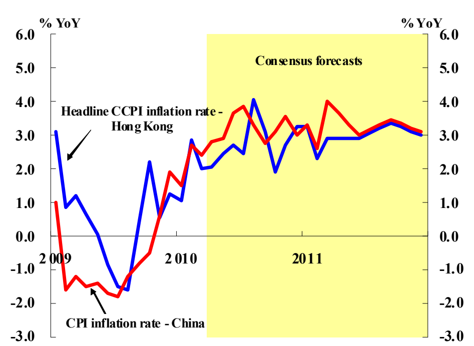
Assessment of risk on Hong Kong's financial stability: Inflation

ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: INFLATION



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- As the economic environment continued to improve, inflationary pressures on the Mainland and in Hong Kong have increased in the past few months but the situation remained benign.

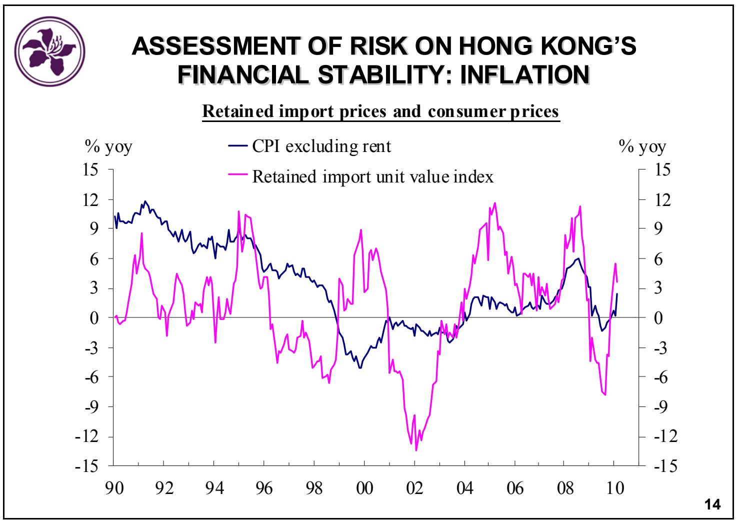
- Nevertheless, inflationary pressures in both places are expected to increase in the rest of 2010 and in 2011.

  – According to the latest market consensus forecast, the year-on-year inflation rate on the Mainland will increase from -0.7% in 2009 to 3.3% in 2010 and 3.4% in 2011.

  – The year-on-year inflation rate in Hong Kong will increase from 0.5% in 2009 to 2.5% in 2010 and 3.1% in 2011.

  – By comparison, the pick-up in the inflation rate is expected to be more visible on the Mainland than in Hong Kong.

Assessment of risk on Hong Kong's financial stability: Inflation



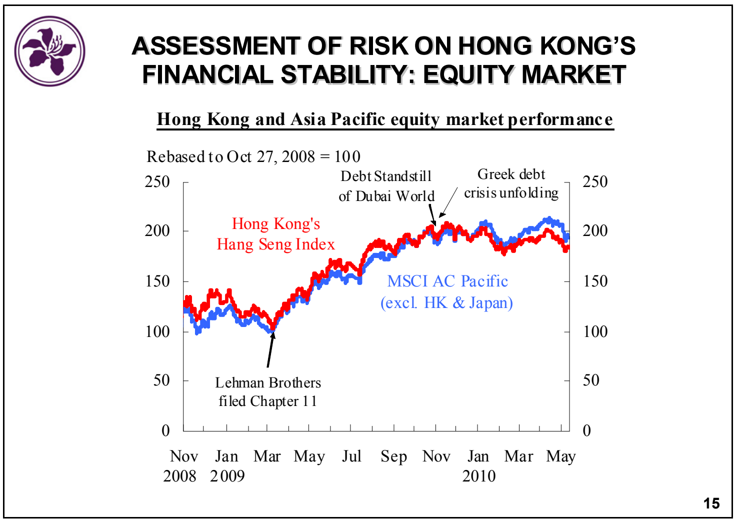
- Recent rumours about renminbi appreciation have triggered concerns that renminbi appreciation could heighten inflationary pressures in Hong Kong, particularly through higher import prices like those of basic foodstuffs. .

- Although Hong Kong is a highly externally oriented economy, data show that in the last 20 years, its CPI inflation rate (excluding rent) and retained import prices were not closely correlated (see chart). Import prices are therefore not the main contributing factor to local inflation.

- Our estimation shows that the direct impact of renminbi appreciation on Hong Kong's inflation is likely to be mild. Retained imports from the Mainland only accounted for about 12% of Hong Kong's total retained imports in 2008, lower than those from the euro area and Japan. Consequently, a 10% appreciation in the renminbi against the Hong Kong dollar would only increase Hong Kong's Composite CPI inflation rate by around 0.5 percentage points. The effect is relatively mild.

- Similarly, if the US dollar depreciates by 10% against a basket of currencies (excluding the Hong Kong dollar), Hong Kong's Composite CPI inflation would increase by 1.6 percentage points in the medium term.

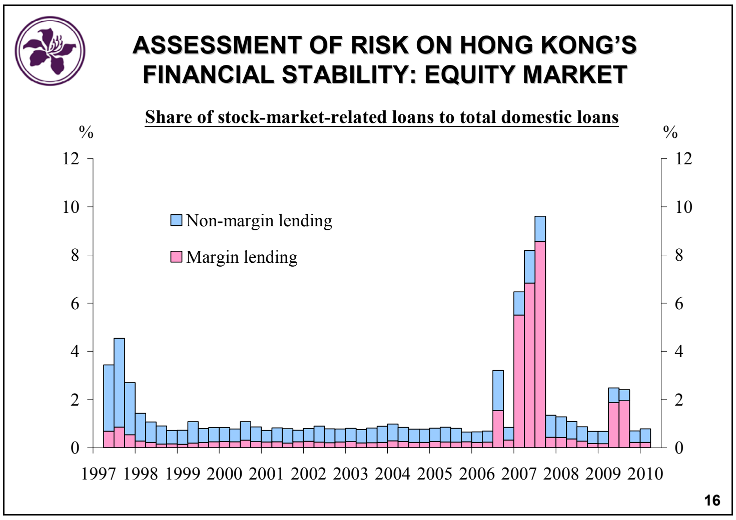
Assessment of risk on Hong Kong's financial stability: Equity market



- The debt standstill of the Dubai World, the Greek debt crisis, and the serious uncertainties about the exit strategies of the central banks have made the equity market more volatile since November last year and investors have become more cautious.

- Hovering between 20,000 and 22,000 during the period, the Hang Seng Index has fallen by 7-8% since the beginning of the year, similar to the trends of other equity markets in the Asia-Pacific region. The MSCI AC Pacific Index (excluding Hong Kong and Japan) declined by 4-5% during the same period.

Assessment of risk on Hong Kong's financial stability: Equity market



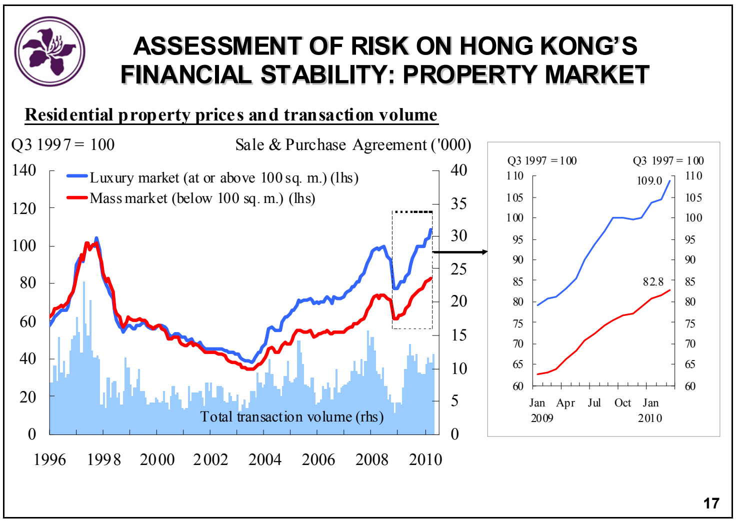
- However, the share of stock-market-related loans in total domestic loans remained low at 0.8% in the first quarter of 2010 (with margin lending accounting for 0.2% and non-margin lending 0.6%), totalling HK$22 billion.

- Experience shows that the share of stock-market-related loans in total domestic loans stayed below 2% for most of the time, although occasional sharp increases did occur due to IPO activities. During the peak in the third quarter of 1997, the ratio was 4.5% (with margin lending accounting for 0.9% and non-margin lending 3.6%) and the stock-market-related loans amounted to about HK$101.5 billion.

- This roughly shows that the leveraged positions by the non-bank private sector have not been excessive in the equity market. Also, risks to the banking system are limited as banking exposure to the stock market has remained low.

Assessment of risk on Hong Kong's financial stability: Property market

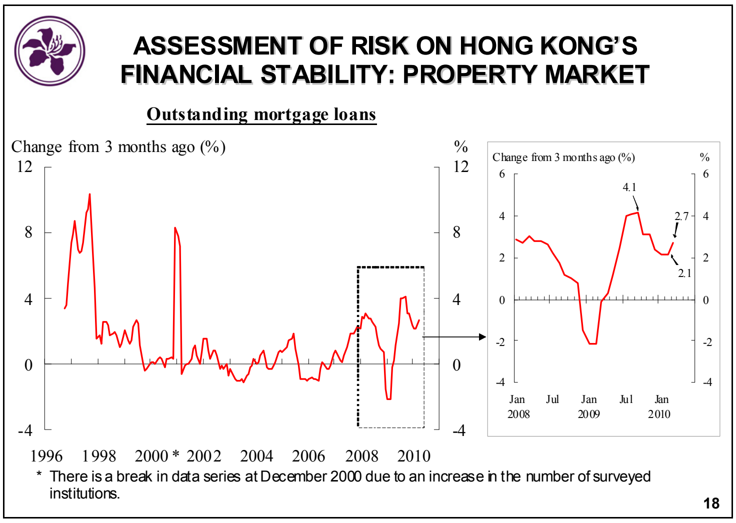
- The property market remained buoyant in the past few months.
  - Property prices rose further by 5.3% in the first quarter this year. The increases in the luxury property prices were particularly strong, already exceeding the peak of 1997 by about 9.0%.
  - Trading was active, with over 10,000 transactions each month during the first four months of this year.



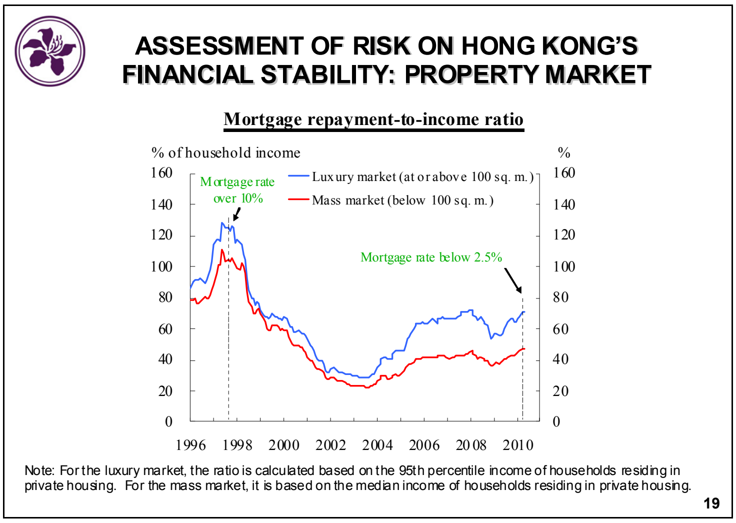
- However, with the series of cooling measures introduced by the Government, market sources indicated that both the transaction prices and volume have moderated recently.

Assessment of risk on Hong Kong's financial stability: Property market

- Driven by active trading and the upward trend in property prices, mortgage lending continued to rise.
- Total outstanding mortgage loans amounted to HK$658.3 billion in March 2010, 2.7% higher than three months ago and 12.2% higher than last year, the fastest pace of increase since 1997.
- New mortgages approved remained stable in the first quarter, increasing slightly by 0.2% quarter on quarter.



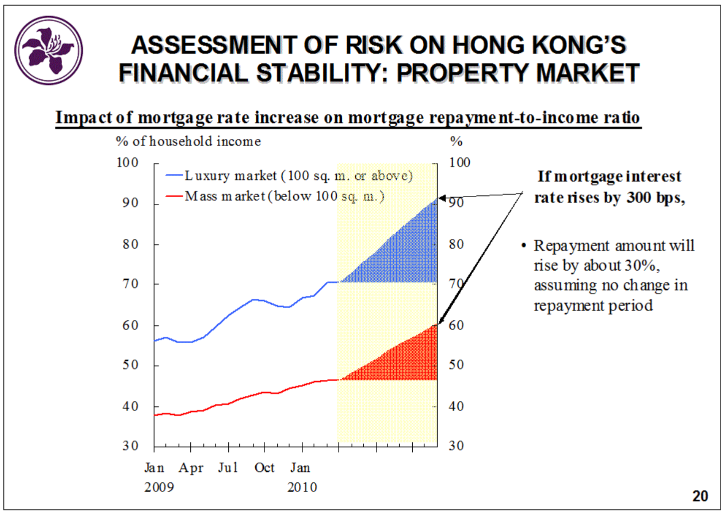
Assessment of risk on Hong Kong's financial stability: Property market



- The surge in property prices has weighed down on housing affordability. Based on the current average property price in the mass market, the monthly mortgage payment for a new flat could account for 47% of the median household income, compared with about 40% a year ago.

- Based on the current average price of luxury properties, the monthly mortgage payment for a new flat could account for 70% of the 95th percentile of domestic monthly household income, much higher than 55% recorded a year ago.

Assessment of risk on Hong Kong's financial stability: Property market



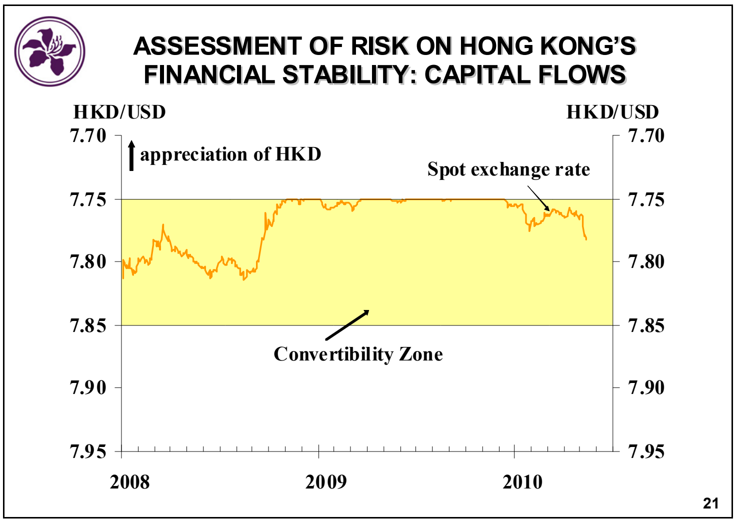
- We have conducted an internal analysis of the impact of interest rate movements on repayment ability.

- A 300-basis-point increase in the mortgage interest rate from the prevailing level will raise the amount of monthly mortgage payment by about 30% if there is no change in the repayment period.

- As a result, mortgagors' repayment ability will deteriorate sharply. The ratio of monthly repayment to monthly income for properties in the mass market will increase from 47% to 61% and that of luxury market will increase from 71% to 92%.

Assessment of risk on Hong Kong's financial stability: Capital flows

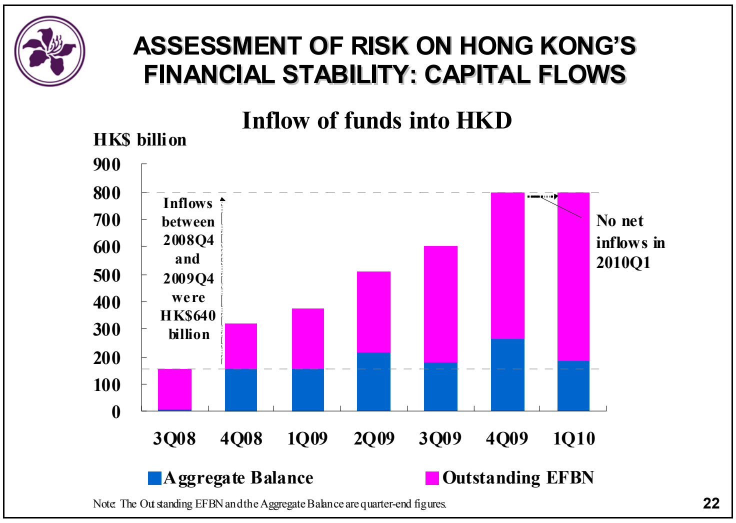
- Because of consolidation in the equity market since early 2010, the scale of capital flows into Hong Kong was not as large as those seen last year. The Hong Kong-dollar exchange rate against the US dollar weakened slightly and the Strong-Side Convertibility Undertaking was not triggered.



- As the sovereign debt crisis worsened, investors have become more risk averse since May, resulting in declines in the major equity markets. The Hong Kong dollar exchange rate weakened alongside other Asian currencies.

Assessment of risk on Hong Kong's financial stability: Capital flows

- The Strong-Side Convertibility Undertaking has not been triggered since January 2010 because there have not been new net inflows of funds into the Hong Kong dollar. The Aggregate Balance declined as a result of the continued issuance of Exchange Fund Bills by the HKMA to meet market demand.

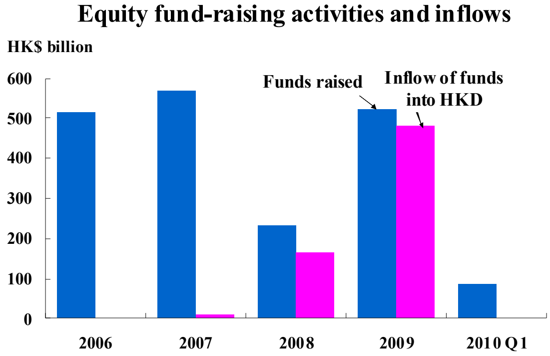


Assessment of risk on Hong Kong's financial stability: Capital flows

- There were no large-scale inflows of funds similar to those seen last year probably because fund-raising activities in the equity market slowed down in the first quarter.

- However, we understand that a number of Mainland banks are planning to raise funds either through large-scale rights issues or IPOs. These fund-raising activities might attract inflows of funds into the Hong Kong dollar. Nevertheless, the Hong Kong dollar exchange rate may or may not be affected depending on how quickly these Mainland banks exchange the proceeds into the renminbi or other currencies.

ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: CAPITAL FLOWS



Note (1): Equities funds raised include IPO, right issues, placings, open offers, consideration issues, warrants exercised and share option scheme.
Note (2): 2008-2009 figures differ from those provided by the HKEx as the activities which did not involve HKD flows have been excluded.

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CONCLUSION (1)

- The low-interest-rate environment and monetary easing in the US and the euro area will persist for some time.
- Funds that flowed into the Hong Kong dollar during late-2008 and 2009 have not left Hong Kong. More funds might flow into the Hong Kong dollar if fund-raising activities in the equity market become more active again in the second half of the year.
- Given the exceptionally low interest rate, abundant liquidity and positive economic conditions, the risk of an asset bubble (especially in the property market) forming in Hong Kong has not lessened.

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Conclusion (2)

Uncertainties surrounding the external factors that affect capital flows and interest rate movements in Hong Kong:

- Capital flows and interest rate movements are not only affected by the pace of increases in US interest rates. Market factors such as the deterioration in the sovereign debt problem in the euro area will also lead to increases in the interest rates and fluctuations in the exchange rates. In addition, signs of overheating in the Mainland economy have become more apparent. In response to high growth rate, surging property prices and inflationary pressures, the Mainland government has introduced a series of measures to adjust the macroeconomy and the property market. Whether the Mainland economy would experience a hard-landing depends on whether these adjustment measures on the Mainland can achieve the desired cooling effects. Capital flows will also be affected. Investors should therefore exercise caution.

CONCLUSION (2)

- The HKMA has taken supervisory measures requiring banks to manage their credit risk properly. The loan-to-value ratio for residential mortgages on properties valued at $20 million or more has been lowered to 60% (At the same time, the Government has taken steps to reduce the risk of a bubble forming in the property market through managing the supply of land and introducing other measures).
- Home-buyers should be alert to the risk of over-stretching themselves in applying for mortgages. Otherwise, they might face difficulties in repaying the loans when interest rates rise to a normal level.
- Investors should exercise caution as external factors affecting capital flows and interest rate movements in Hong Kong are clouded with uncertainties.

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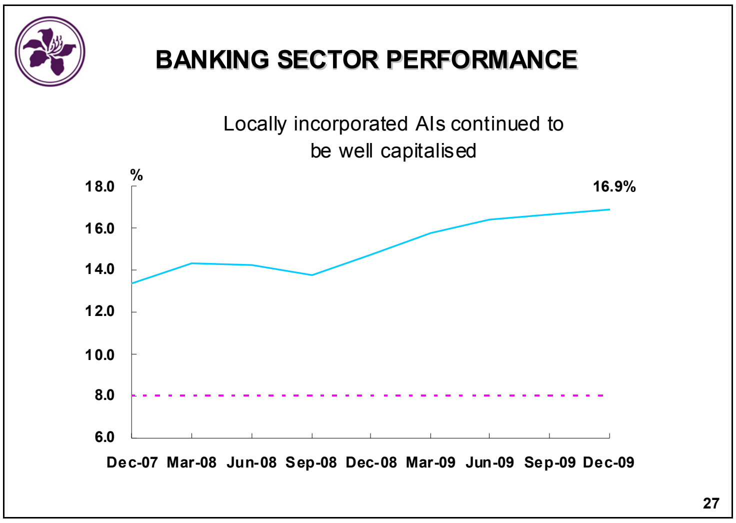
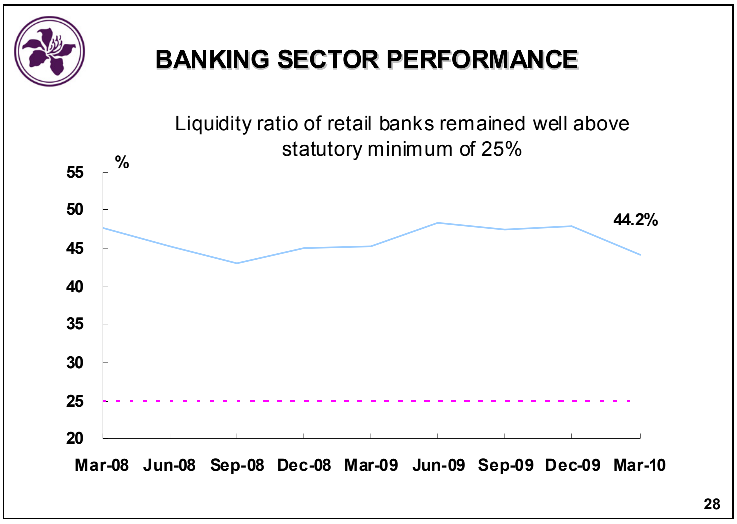
Banking sector performance

- The consolidated capital adequacy ratio of locally incorporated AIs rose to 16.9% at the end of December 2009, compared with 16.7% at the end of September 2009 and 14.7% at the end of December 2008. The ratio is not only well above the international standard of 8%, but is also notably higher than pre-crisis levels, reflecting banks' continuing focus on capital preservation.

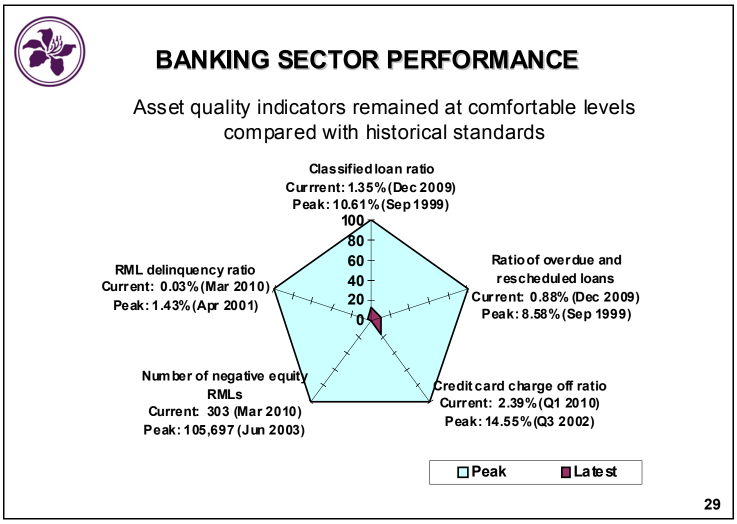




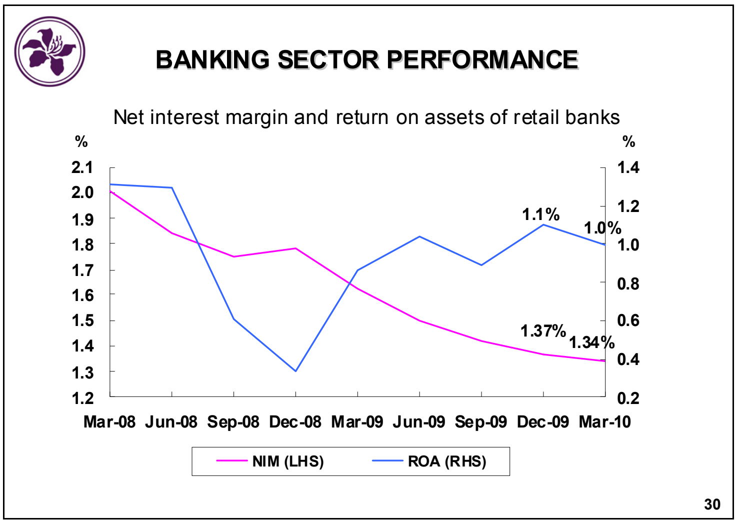
Banking sector performance

- Asset quality remains sound. Indeed the RML delinquency ratio and number of RMLs in negative equity in March were at record lows.

- Nevertheless, the HKMA will continue to monitor the quality of retail banks' loan portfolios closely because of the economic uncertainties following the global financial crisis.



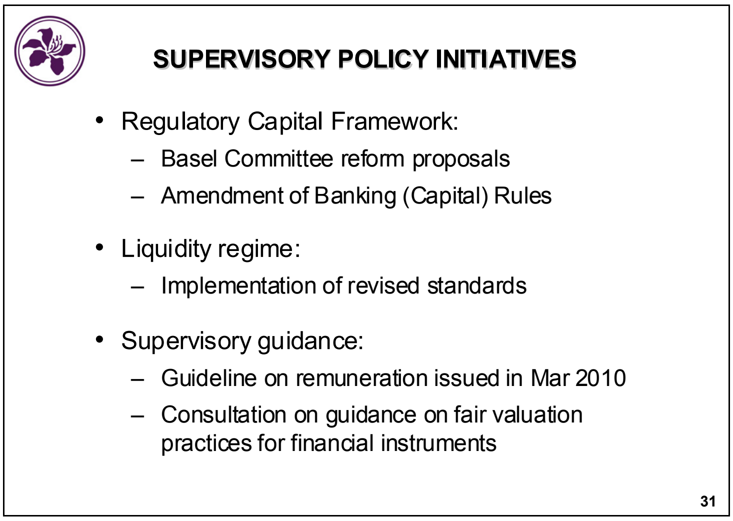
Banking sector performance



- The quarterly annualised net interest margin of retail banks continued to narrow to 1.34% in Q1 2010 from 1.37% in Q4 2009 as interest rates remain at unprecedentedly low levels and banks deploy funds to less risky assets. Intense pricing competition, especially in the residential mortgage market, has also squeezed banks' interest margins.

- Nevertheless, the aggregate pre-tax operating profit of retail banks' Hong Kong offices rose by 13.6% in Q1 2010 compared with the same period in 2009, contributed mainly by improvements in investment and fees income and lower provisioning levels. Return on assets also remained stable recently.

Supervisory policy initiatives



- <u>Regulatory Capital Framework</u>: Basel Committee's consultation on proposals to increase the level, quality and transparency of banks' capital and to produce global liquidity standards closed on 16 April 2010. The HKMA, as a member of the Committee, relayed local issues and concerns raised in discussions with various stakeholders back to the Committee. The Committee's aim is to develop a fully calibrated set of standards by the end of the year, to be phased into implementation by the end of 2012, as financial conditions improve and the economic recovery is assured.

  To assist in this process, a quantitative impact study was launched in February 2010 and is currently still in progress. A number of Hong Kong banks are participating. The HKMA is also conducting a local impact study with a broader sample of banks to better assess the impact of the proposals on the local banking sector.

  In due course, the HKMA will be updating the Banking (Capital) Rules in line with the new international capital standards, once agreed, taking into account local circumstances.

  Meanwhile, the process of amending the Rules to reflect the enhancements already made by the Basel Committee, last July, in respect of the securitization and trading book frameworks continues, with the revised rules currently being drafted for implementation at the beginning of next year. This is in line with the Committee's proposed timeframe.

- <u>Revised liquidity standards</u>: The HKMA has revised its guidance on liquidity risk management standards, to implement the Basel Committee's Principles for Sound Liquidity Risk Management and Supervision. Following initial consultation with a number of banks, the draft guidance will be released shortly for formal industry consultation.

  The Basel Committee's Working Group on Liquidity is conducting a review to gauge the extent to which jurisdictions have implemented the Sound Principles in respect of liquidity risk supervision. The HKMA is participating in this review.

- <u>Remuneration guideline</u>: Following consultation with the industry associations, the HKMA issued the "Guideline on a Sound Remuneration System" in March 2010 to provide AIs with guidance for the development and operation of their remuneration systems in a manner consistent with effective risk management.

- Fair value practices guidance: The HKMA is updating its supervisory guidance on fair valuation practices for financial instruments, in recognition of the importance of fair value measurements for financial reporting, assessment of capital adequacy and internal risk management. The HKMA aims to issue the revised guidance shortly, after taking into account comments received from the industry consultation which closed at the end of April.

Deposit protection

- The Deposit Protection Scheme (Amendment) Bill 2010 for effecting the enhancements to the DPS concluded in the DPS review last year was introduced into the LegCo on 21 April. The HKMA and the Deposit Protection Board (DPB) will render full support to the LegCo in scrutinising the Bill to facilitate an early passage of it.

- Subject to the progress on the legislative process, the enhanced DPS is targeted to take effect at the beginning of 2011, immediately after the expiry of the full deposit guarantee by the end of this year. Preparations are being made by the HKMA and the DPB to get the public and the industry ready for the transition.

DEPOSIT PROTECTION

- The amendment bill for enhancing the Deposit Protection Scheme (DPS) was introduced into LegCo in April
- The enhanced DPS (including the new protection limit of $500,000) expected to be effective immediately after the expiry of the full deposit guarantee
- The HKMA participated in a tripartite working group with the central banks of Malaysia and Singapore to implement a concerted exit strategy for full deposit guarantee by the end of this year by all three jurisdictions as scheduled

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Investor protection

- The HKMA and the SFC will engage a service provider to undertake a mystery shopping exercise covering the sales process of regulated entities in selling unlisted investment products. Preparatory work is underway and the fieldwork is expected to commence around July. A circular will be issued to inform the regulated entities of the launch of the programme.

> **INVESTOR PROTECTION**
>
> - Mystery shopping programme to be implemented in the second half of 2010
> - Assisting the Government on establishing the Investor Education Council and Financial Dispute Resolution Centre
> - Working with SFC on implementation of proposed new measures to enhance investor protection, such as:
>   - investor characterisation process
>   - pre-sale disclosure of commissions and other commercial interests
> - Introducing the Pre-Investment Cooling-Off Period
>
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- The Government's consultation on proposed establishment of an Investor Education Council and a Financial Dispute Resolution Centre ended on 8 May 2010. The HKMA supports the initiatives and will assist the Government with the implementation of the initiatives where appropriate.

- The HKMA has liaised with the SFC on formulating consultation conclusions of the SFC's proposed measures to enhance protection for the investing public, including the adoption of investor characterisation process and pre-sale disclosure of commercial interests (such as commission). Regarding investor characterisation, intermediaries should categorise customers according to their knowledge in derivatives (such as whether they have purchased the products in the past) to help ensure that the investment advices they give and products recommended are suitable for their customers (in particular those who are not familiar with the derivatives products that they want to purchase). The two regulators will work together on the implementation of the new measures.

<u>Pre-Investment Cooling-Off Period</u>

- The HKMA has discussed with the banking industry on introducing the Pre-Investment Cooling-Off Period, a new measure to provide additional investor protection for the elderly and first-time buyers of derivatives products with high asset concentration on the product. This arrangement will allow customers more time to understand the product and consider the appropriateness of the investment. The HKMA will issue a circular about the implementation of this new measure to all authorized institutions today.

Renminbi business in Hong Kong (1)

- The circular also clarifies the operational arrangements in respect of account opening, remittance and financing for corporate customers. The range of eligible issuers, issue arrangements, and target investors in relation to RMB bonds in Hong Kong are to be determined in accordance with the usual applicable regulations and market conditions in Hong Kong.

RENMINBI BUSINESS IN HONG KONG (1)

- On 11 February, HKMA issued an elucidation of the supervisory principles and operational arrangements regarding RMB business in Hong Kong to simplify the operational procedures and increase the flexibility in developing diversified RMB-denominated financial products in Hong Kong:
  - Mainland authorities and banks are responsible for verifying whether transactions undertaken by the Mainland counterparts are in compliance with the relevant rules and requirements in the Mainland, while Participating AIs in Hong Kong will process the RMB transactions in accordance with the usual banking practices in Hong Kong
  - With regard to the RMB funds that have flowed into Hong Kong, Participating AIs can develop RMB businesses based on the regulatory requirements and market conditions in Hong Kong

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Renminbi business in Hong Kong (2)

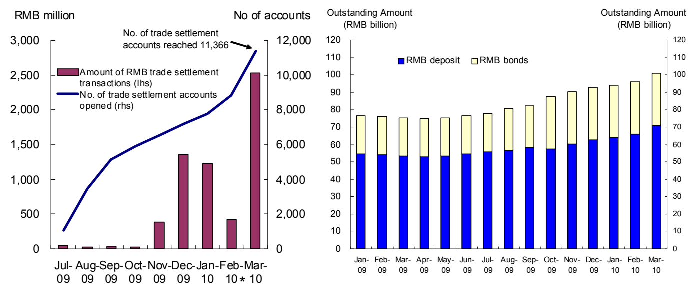
- The number of Hong Kong authorized institutions engaging in RMB trade settlement business increased to 64 at the end of March 2010 from 52 at the end of December 2009.

- The number of overseas banks which had signed the clearing agreement with the Hong Kong Clearing Bank increased from 15 at the end of December 2009 to 30 at the end of March 2010.

RENMINBI BUSINESS IN HONG KONG (2)

RMB trade settlement gained momentum in March 2010

RMB deposits and bonds issuance in Hong Kong increasing steadily



* The Chinese New Year fell in February in 2010, so there were fewer working days than usual in that month.

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- The amount of trade transactions settled in RMB increased markedly to RMB2.5 billion in March 2010, compared with a total amount of RMB1.6 billion for January and February together.

- At the end of March 2010, RMB deposits amounted to RMB70.8 billion. Outstanding RMB bonds amounted to RMB30 billion. About 1.4 million RMB accounts have been opened, of which 11,366 were RMB trade settlement accounts.

1. Macroeconomy / Monetary conditions
2. Assessment of risk on Hong Kong's financial stability
3. Latest developments in the banking sector
4. **Investment income of the Exchange Fund in the first quarter of 2010**

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Investment income

- Investment income of the Exchange Fund for the first quarter amounted to HK$10.8 billion. Main contributors were return from bonds and gains on other equities. The sum of the gains more than offset the losses on Hong Kong equities and the exchange loss.

INVESTMENT INCOME

(HK$ billion)	2010 Q1 *	2009 Full Year	2008 Full Year	2007 Full Year
Gain/(Loss) on Hong Kong equities^@	(3.1)	48.9	(77.9)	55.8
Gain/(Loss) on other equities^	11.2	48.8	(73.1)	6.7
Exchange gain/(loss)	(8.7)	9.8	(12.4)	18.7
Return from bonds#	11.4	(0.6)	88.4	61.0
Investment income/(loss)@	10.8	106.9	(75.0)	142.2

* Unaudited figures
^ Including dividends
# Including interest
@ Excluding valuation changes in Strategic Portfolio

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- Return from bonds – benefiting from the accommodative monetary policies of the major central banks, the US government bond yields moved within a narrow range in the first quarter.

- Gains on foreign equities – investors were cautious at the beginning of the year but their sentiment has turned more positive since February after the US Fed had made clear that the accommodative monetary policy would continue.

- Exchange loss – With economic recovery in the US faster than those in other countries, together with the Greek debt crisis, the US dollar appreciated against other major currencies.

Exchange Fund's investment strategy

- The primary investment objectives of the Exchange Fund are to ensure capital preservation and adequate liquidity to provide backing for the Hong Kong dollar. Subject to the fulfilment of these objectives, the HKMA also aims to preserve the long-term purchasing power of the Fund.

- To this end, the HKMA manages the Fund prudently and pursues, in a cautious manner, opportunities for diversification of investments for better risk management and yield-enhancement purposes.

- The HKMA has been exploring the feasibility of diversifying into other asset classes, including private equity, emerging-market bonds and equities, and investments in Mainland China.

- The HKMA has started investing a small portion of the Fund's assets in yield-enhancement assets and will proceed cautiously and incrementally.

- As with all other investments of the Exchange Fund, investment in yield-enhancement assets is subject to elaborate and rigorous risk management policies and practices and is properly reflected in the financial statements in accordance with the Accounting Standards.

Changes in investment income, payment to the fiscal reserves and Accumulated Surplus

- The investment income of HK$10.8 billion in the first quarter of 2010 offset the Fund's interest and other expenses, the payments to Fiscal Reserves and other government bodies, and the valuation change in the Strategic Portfolio.

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

	2010	2009				
(HK$ billion)	Q1*	Full year	Q4	Q3	Q2	Q1
Investment income/(loss)	10.8	106.9	10.0	71.9	58.5	(33.5)
Other income	**0.0**	**0.2**	**0.0**	**0.0**	**0.2**	**0.0**
Interest and other expenses	**(0.9)**	**(3.8)**	**(1.0)**	**(0.9)**	**(1.2)**	**(0.7)**
Net investment income/(loss)	**9.9**	**103.3**	**9.0**	**71.0**	**57.5**	**(34.2)**
Payment to Fiscal Reserves #	(8.5)	(33.5)	(7.9)	(8.0)	(8.5)	(9.1)
Payment to HKSAR government funds and statutory bodies #	**(0.8)**	**(1.2)**	**(0.6)**	**(0.3)**	**(0.3)**	**0.0**
Valuation change of Strategic Portfolio^	**(0.6)**	**4.4**	**0.0**	**1.3**	**3.2**	**(0.1)**
Increase/(Decrease) in EF Accumulated Surplus	0.0	73.0	0.5	64.0	51.9	(43.4)

* *Unaudited figures*
\# *The fixed rate of fee payment is 6.3% for 2010 and 6.8% for 2009*
^ Including dividends

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- Payments to the Fiscal Reserves and other government bodies for 2010 were based on a rate of 6.3%. The rate is derived from the current fee arrangement with the Government, representing the average annual return of the Exchange Fund's Investment Portfolio in the past six years.

<u>Outlook for the investment environment</u>

- The investment outlook for 2010 continues to be difficult and challenging, with considerable uncertainties surrounding the financial markets. Although the global economies are recovering steadily, the tempos of recovery differ in different countries and the overall tone is still fragile. Moreover, given the differences in the pacing of 'exit strategies' of the major central banks along with volatile capital flows, the risks of considerable fluctuations in exchange rates and asset prices still remain. Because of all these factors, fluctuations in the short-term performance of the Exchange Fund are inevitable. As a result, focus should be placed on the Fund's long-term performance, instead of its short-term results.

- As I mentioned in the press announcement in January this year, 2010 is not a year for aggressive investment given the considerable risks in the financial markets and the distinctive investment objectives of the Exchange Fund. My colleagues in the HKMA and I will continue to manage the investment of the Exchange Fund with great caution and prudence in accordance with the established investment objectives determined by the Exchange Fund Advisory Committee.