HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

23 May 2011

1. **Assessment of Risk to Hong Kong's Financial Stability**

2. Developments of RMB business in Hong Kong

3. Banking Supervision

4. Investment Return of the Exchange Fund in Q1 2011

GLOBAL ECONOMIC GROWTH FORECASTS

Real GDP Growth

(% year-on-year)

	2009	2010	2011 Forecasts		
			Nov 2010 FAP briefing	March 2011 FAP briefing	**May 2011**
US	-2.6	2.9	2.4	3.2	**2.7**
Euro area	-4.1	1.7	1.4	1.6	**1.7**
Japan	-6.3	4.0	1.2	1.5	**0.0**
Asia (ex-Japan)	5.9	8.9	7.4	7.6	**7.7**

Sources: Consensus Forecasts and CEIC

- Since the March FAP briefing, market's view towards the outlook for the US economy has become less optimistic amid the weak economic performance in the first quarter. Meanwhile, growth forecast for the Euro area is largely unchanged.

- After the earthquake on 11 March, growth in Japan in the current year is expected to decelerate considerably from 1.5% before the catastrophe to zero afterwards. For 2012, the growth forecast is 2.8%. (Note: This figure is based on survey conducted by Consensus Forecasts in early May and has not factored in the impact of a 3.7% quarter-on-quarter annualised contraction of real GDP in the first quarter on the growth forecast for the whole year.)

- While there are still uncertainties over the economic outlook of advanced countries, Asian economies are expected to maintain robust growth momentum. The region is expected to expand by 7.7% this year. Nonetheless, the disruption of supply chains caused by Japan's earthquake and other factors such as rising inflationary pressure may weigh on the region's economic growth.

ASSESSMENT OF THE US ECONOMY: SHORT TERM

- Favourable factors supporting growth in the short term:
- Economic growth slowed considerably in the first quarter (2011Q1: +1.8% vs 2010Q4: +3.1%)
  - Fiscal stimulus measures (US$858 billion stimulus package was approved in Dec 2010)
    - ➢ The effect will gradually diminish over the remainder of 2011
  - Accommodative monetary conditions
    - ➢ QE2 will end in June as scheduled
  - Improved corporate earnings
    - ➢ Productivity growth is expected to slow and could drag on growth in corporate earnings
  - Positive wealth effect arising from a buoyant equity market
    - ➢ 30% gain since August 2010 (resulting in an increase of US$2.9 trillion in market capitalisation)

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- These are the favourable factors supporting US economic growth in the short term as I mentioned in the last FAP briefing.

- Compared with the pace observed at the last briefing, real GDP growth in the US has slowed markedly in the first quarter. The quarter-on-quarter real GDP growth was 1.8% in Q1, which is lower than that forecasted by markets at the beginning of the year and also much slower than the 3.1% recorded in Q4 last year.

- Markets generally perceive that the slowdown was caused mainly by several temporary adverse factors (such as the severe weather conditions and the geo-political events in the Middle East and North African countries that had driven up oil prices). As such, markets generally expect once the drags posed by these adverse factors start to diminish, growth should pick up from the second quarter onwards. Indeed, consensus forecast for the US over 2011 remains at 2.7%, above its trend growth rate of around 2% to 2.5%.

- However, there remains a number of uncertainties clouding the US economic outlook.

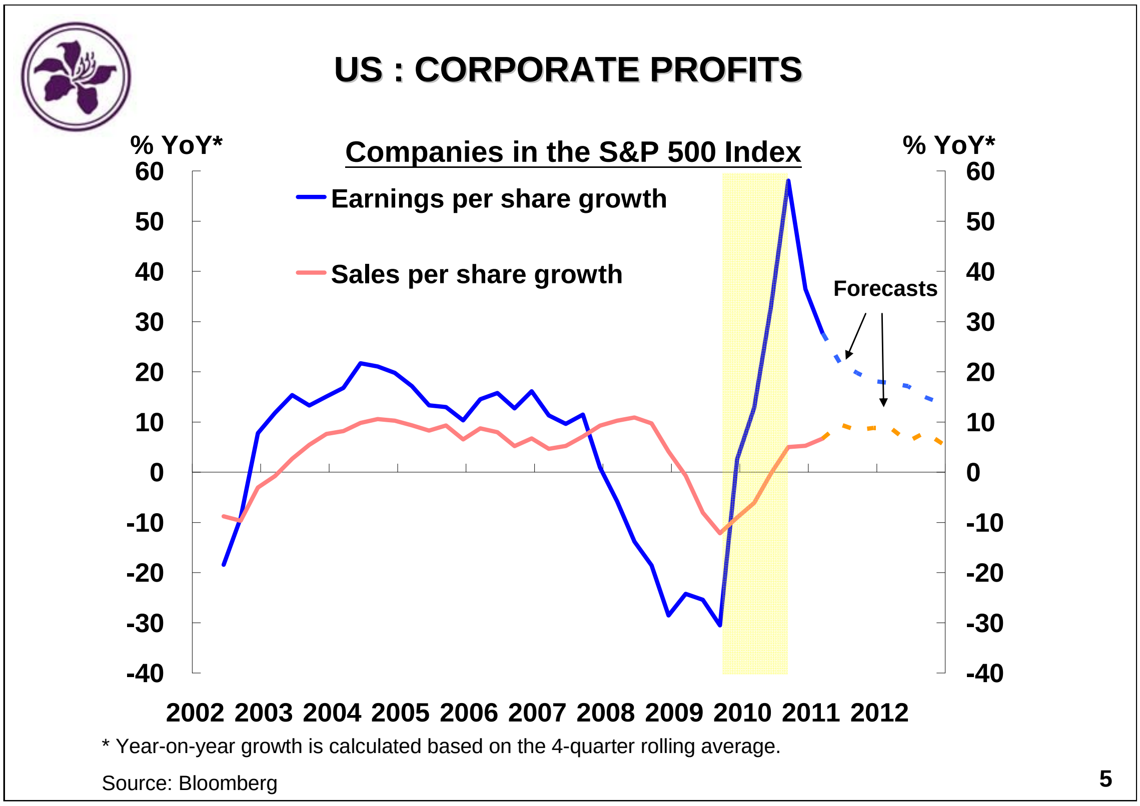
- In addition to the temporary adverse factors, the US economy is set to face many difficult challenges ahead.

- These challenges include the gradual dissipation of fiscal stimulus on quarter-on-quarter growth for the second half of the year, following its initial boost to personal consumption in the first quarter.

- As for monetary policy, the Fed’s decision to end QE2 in June as scheduled will increase uncertainties to the outlook for the US economic growth.

- Moreover, growth in US labour productivity rate has recently slowed. The rapid growth observed since 2009 is difficult to sustain, and the slowdown in the labour productivity growth would drag on growth in corporate earnings.

- The S&P 500 Index has already gained about 30% since August last year, resulting in a wealth effect of an increase of US$2.9 trillion in market capitalisation.



- The chart shows that both earnings per share and sales per share of US companies recorded year-on-year declines during the economic downturn. However, both have rebounded since the end of 2009, following the start of the economic recovery.

- We can see from the chart that earnings per share of US companies rose significantly last year. While sales per share had also increased, its growth was much more moderate.

- This mainly reflects the fact that US companies engaged in large-scale cost-cutting exercises by slashing expenditure and laying off employees during the economic downturn. Indeed, close to 7 million jobs have been lost since the onset of the recession that started in late 2007.

- Nevertheless, as businesses cannot keep relying on cutting expenditure and staff to achieve efficiency gain, markets expect the year-on-year growth of earnings per share and sales per share of US companies will slow.

- As mentioned, one of the main reasons for the sharp growth in corporate earnings is the large-scale redundancies of workers made by businesses during the economic downturn.

- The chart shows that the large-scale redundancies has led to rapid growth in labour productivity (i.e. total output per labour hour) once the economy starts recover.

- However, as the recovery continues to take hold and businesses are nearing the end of their cost-cutting exercises, the year-on-year growth in labour productivity rate has started to slow since its peak in the second quarter of last year.

- The slowdown in labour productivity growth implies that on one hand, businesses could soon need to take on additional staff, which will help reduce the unemployment rate. However, on the other hand, slower productivity growth could also pose a drag on corporate profits, which will in turn slow down the recovery process.

ASSESSMENT OF THE US ECONOMY: MEDIUM-TO-LONGER TERM

- A number of risks to economic growth in the medium-to-longer term:
  - Increases in long-term interest rates
    - ➢ No substantial change in the yield curve so far
  - Reduced scope for fiscal policies
    - ➢ S&P downgraded US credit outlook
    - ➢ The US President proposed to cut fiscal deficit by US $4 trillion over the next 12 years but no consensus has been reached yet
  - Household deleveraging yet to be completed
    - ➢ Household savings rate still hovering around 5.7%
  - Continued weakness in the housing market
    - ➢ Negative wealth effect to drag on growth
    - ➢ Reduced geographical mobility of unemployed workers
    - ➢ The situation has not improved

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- These are the risks to US economic growth in the medium-to-longer term as I mentioned in the last FAP briefing.

- No substantial change in the yield curve of US Treasuries has been noted since the last briefing.

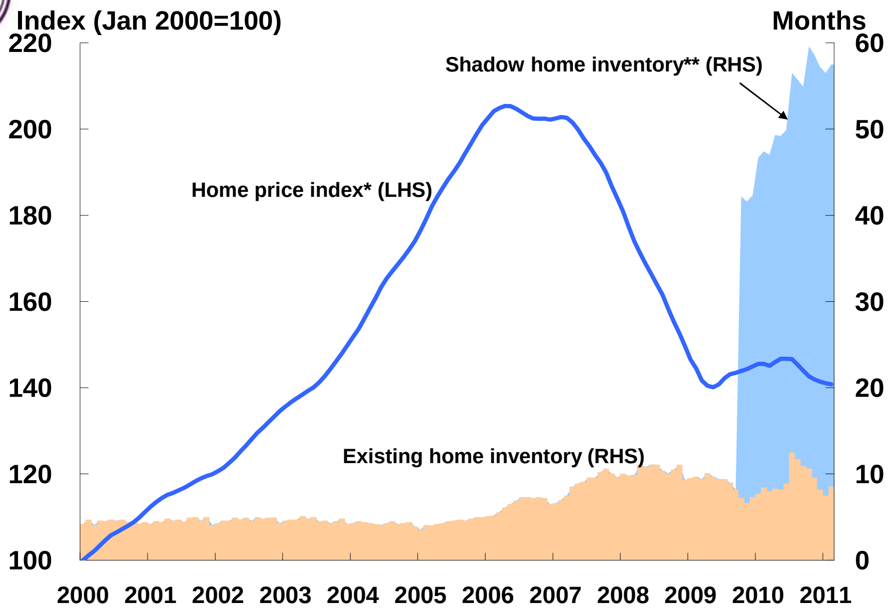
- As for public finances, the credit-rating agency Standard and Poor's downgraded the US credit outlook to negative in April.

- The US President has recently proposed a budget plan for FY2012 which would reduce fiscal deficit by US$4 trillion over the next 12 years. Although the Democrats and the Republicans in Congress are yet to reconcile their differences on the approach and the timetable of fiscal consolidation, they are agreeable on the overall size of the deficit reduction. Fiscal consolidation will poses a drag on economic growth in the medium to long term.

- In addition, the household deleveraging process is yet to be completed and household savings rate is still hovering around 5.7%. (The average savings rate for the past 50 years is 7%.)

- US housing market conditions have not improved. Sales activities remain at very low level and home price index has already fallen for eight consecutive months. The negative wealth effect will continue to drag on US economic growth.

US：HOUSING PRICES AND INVENTORY



* Case-Shiller 20-city home price index

** Standard and Poor's estimates include the total number of homes with mortgage loans more than 90 days delinquent, currently or recently in foreclosure and those that are real estate owned (REO).

Sources: Standard & Poor's and CEIC

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- House prices are still facing considerable downward pressures as a result of the continued lack of demand and excess supply. The Case-Shiller 20 City Home Price Index has already fallen for eight consecutive months while existing home inventory continues to stay at a high level.

- The blue portion of the chart represents the shadow home inventory, which includes homes that have been repossessed and homes that are currently seriously delinquent.

- During the fourth quarter of last year, the shadow home inventory was estimated to have reached around 50 months of supply. Adding that to the existing home inventory for the same quarter, the total number of housing stock would be equivalent to almost 60 months of supply. This means that the problem of excess housing supply could continue to deteriorate in the near term, resulting in possible further fall in housing prices.

- Further fall in house prices may lead to a vicious circle as falling house prices would increase the supply of shadow home inventory, putting further downward pressures on house prices.

- The weak housing market will aggravate the problem of structural unemployment and restrain household consumption, leading to slower economic growth in the US.

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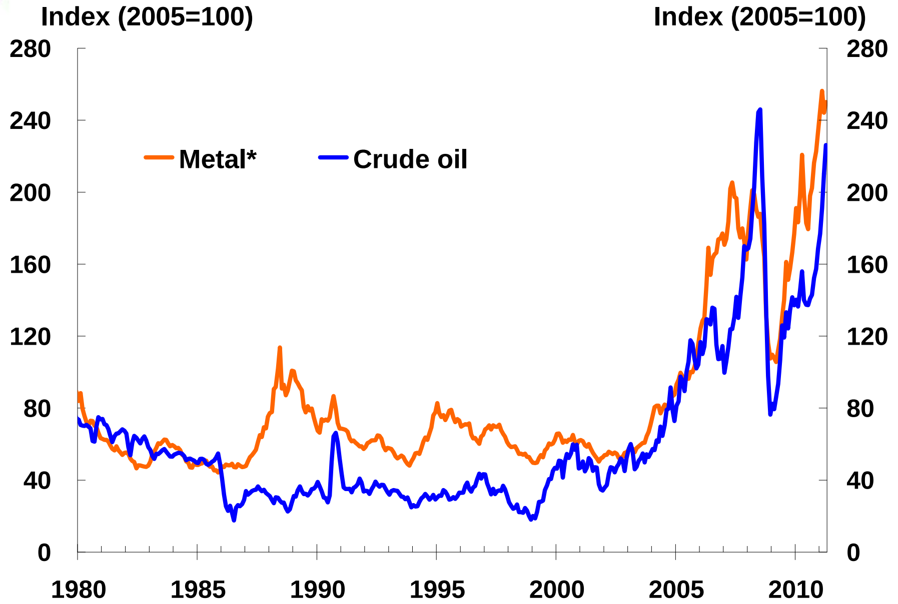
    - ➢ The situation has not improved
  - **Uncertainties over the inflation cycle**

- In addition to the risks to economic growth over the medium-to-longer term as mentioned in the last FAP briefing, there are also uncertainties over the trend of the US inflation cycle.

GLOBAL COMMODITY PRICES AT HIGH LEVEL



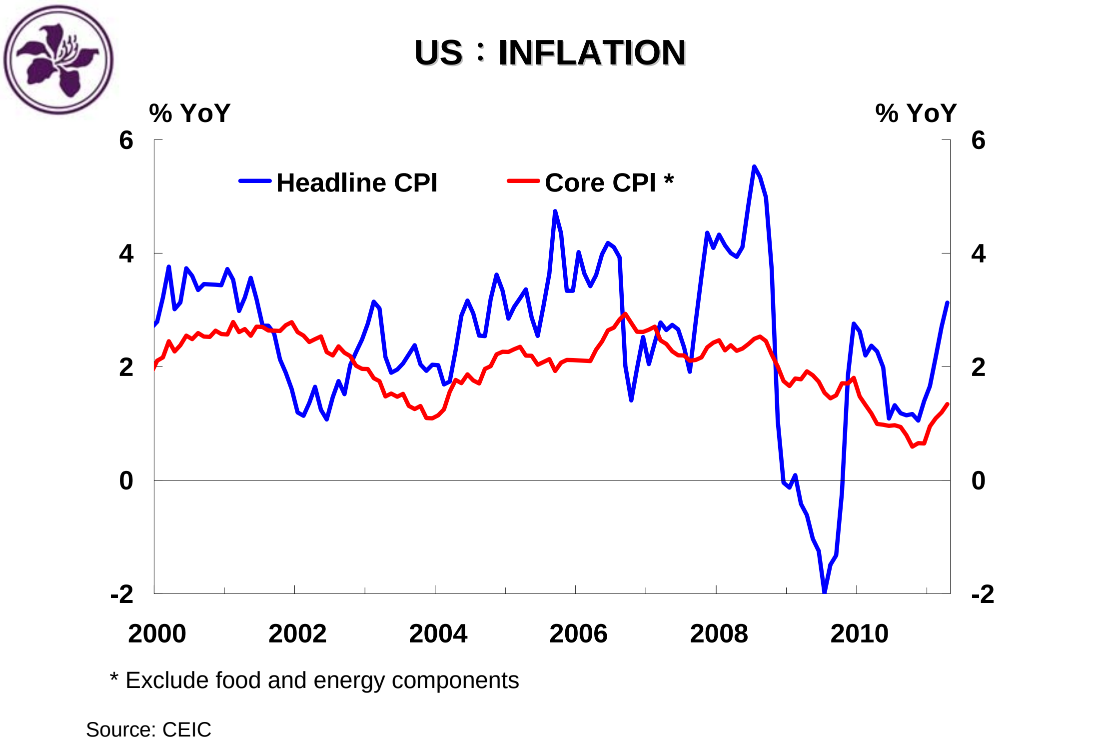
* Include copper, aluminium, iron ore, tin, nickel, zinc, lead, and uranium.

Source: IMF

- Owing to concerns about reduced supply (due to political instability in the Middle East and North Africa region) and strong demand (particularly from the emerging markets), global commodity prices have continued to rise in recent years, adding to inflationary pressure.

- Despite the recent correction in oil prices, Brent crude oil prices are still about 2.5 times higher than its trough in late 2008.

- Metal prices have reached new highs recently, rising by over 130% on average from their trough levels in early 2009.



- The continued surge in commodity prices has resulted in a distinct increase in the US's headline inflation (April: 3.2%). Nevertheless, as the growth momentum in the US is still far from strong and the unemployment rate remains high, core inflation remains benign (April: 1.3%). However, if headline inflation stays high for a prolonged period, there may be more visible pass-through to core inflation.

- Moreover, even though core inflation stays at a moderate level, rises in headline inflation can still have adverse impact on consumption, thereby affecting economic growth.

ASSESSMENT OF THE EUROPEAN ECONOMIES

- Peripheral European economies are still troubled by the sovereign debt problem
  - Portugal formally requested a 78 billion euro bailout
  - Greece failed to meet its budget cut targets, resulting in a higher-than-expected increase in public debt
- Major economies such as Germany and France are expected to see slow but steady growth
- The ECB raised interest rates by 0.25 percentage points in April amid rising inflation

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- Weak European economies are still troubled by sovereign debt problem. Following Greece and Ireland, Portugal also formally requested assistance from the EU and IMF in April. The bailout programme amounts to 78 billion euros.

- Greece fails to meet its budget cut targets, resulting in a higher-than-expected increase in public debt. Markets generally think that Greece will need to undergo debt restructuring, dispose government assets or seek further assistance from the EU or IMF in order to meet its increasing funding needs.

- The spreads of sovereign credit default swaps (CDS) of financially weak countries surged to new highs recently. In particular, the spread of Portugal's 5-year CDS once climbed to a new high before it formally sought assistance. Its current level (as of 19 May) is still more than 150 bps higher than the level at the March briefing. The spread of Greece's CDS also reached its record high in early May amid rumours of debt restructuring. The current spread is more than 350 bps higher than the March level.

- Moreover, the ECB raised interest rates by 0.25 percentage points on 7 April amid rising inflation. This was the first interest rate hike since July 2008. The ECB signalled in early May that it might further raise interest rate after June. According to a survey conducted by Bloomberg, market expects the ECB to raise interest rate by 25 basis points each quarter for 5 straight quarters starting from the third quarter this year, from the present 1.25% to 2.5% in the third quarter next year.

ASSESSMENT OF THE JAPANESE ECONOMY

Impact of earthquake, tsunami and nuclear plant leakages in Japan:

- Short term: Production, tourism, exports and consumption will be affected
- Medium term: Rescue works and rebuilding programmes will stimulate investment and employment, and boost production and imports
- Long term:
  - The Japanese government will need to pay trillions of yen for insurance compensation and post-disaster rebuilding outlays
  - Fiscal burden and public debt will increase (Standard & Poor’s reduced Japan’s long-term credit rating from AA to AA- in January and further downgraded its credit outlook from “stable” to “negative” in April)

- Earthquakes in Japan in March added uncertainties to the Japanese economy.

- Economic figures have begun to reflect the short-term effects. Industrial productions, tourism, exports and local consumption have all suffered.

- In the medium term, rescue works and rebuilding programmes will increase domestic investment, which will in turn stimulate employment, production and imports, contributing to economic growth.

- In the long term, the Japanese government has to shoulder trillions of yen in insurance compensation and post-disaster reconstruction costs, which will add to its burden of public finance and public debt.

- As fiscal conditions deteriorated, Standard & Poor’s reduced Japan’s long-term credit rating from AA to AA- in January and further downgraded its outlook from “stable” to “negative” in April. The Japanese government will face greater challenges in improving its fiscal positions.

FORECASTS OF MAJOR INDICATORS IN MAINLAND CHINA

	2009	2010	2011 forecasts	
			IMF	Consensus
Real GDP growth (%)	9.2	10.3	9.6	9.3
CPI inflation (%)	-0.7	3.3	5.0	4.6

Sources: CEIC, IMF World Economic Outlook (April 2011) and Consensus Forecasts (April 2011).

- The authorities have introduced monetary tightening and macroeconomic regulations to contain inflation and stabilise the property market
- Initiatives are being taken to enhance industrial structure and boost domestic demand

- The prospect of economic growth in Mainland China is positive. Both the IMF and market consensus forecast the Mainland economy will grow by more than 9% in 2011 while inflation could be above 4.5% as inflationary pressures intensify.

- Inflation rate continued to rise, with year-on-year CPI inflation reaching a 32-month high of 5.4% in March and staying at 5.3% in April. The People's Bank of China (PBoC) has used multiple policy instruments to curb inflation. For example, the PBoC has raised the reserve requirement ratio for large and medium sized financial institutions 11 times (including five times in 2011) to 21% since early 2010. It has also raised the benchmark interest rates four times, each by 25 basis points, since October 2010. The one-year benchmark deposit and lending rates are currently 3.25% and 6.31%, respectively.

- Property prices stayed elevated. The authorities have introduced a series of policy measures since December 2009, including tightening mortgage lending and imposing purchase restrictions, to stabilise the property market.

- The authorities are introducing initiatives to promote the development of new industries (e.g. new-generation information technology, energy conservation and environmental protection) and promote the transformation and upgrading of traditional industries to enhance the economy's overall industrial structure. These measures, together with the efforts to fuel the expansion in domestic demand (e.g. speeding up the development of service industries), will contribute to an sustainable development of the Mainland economy.

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

- Short-term speculative activities declined markedly after measures were introduced last November to stabilise the property market.
- Property transactions decreased between mid-November and December and showed signs of a pick-up in January and February 2011 before slowing in March and April. The latest residential mortgage survey shows that new loan approvals and applications fell by more than 30% in April.
- Market developments in May need to be further monitored.
- Overall property prices have surpassed the previous highs in 1997, while the risk of interest rate hikes is much higher than in 1997.
- The HKMA will continue to closely monitor market development and introduce further measures if necessary to safeguard banking stability.

ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: CREDIT GROWTH

- Bank loans grew by HK$940 billion, or 28.6%, in 2010. US dollar and HK dollar loans increased by 68.2% and 17.6% respectively.

- Bank lending continued to grow rapidly in Q1 2011 (at an annualised rate of 29.6%). The HKMA issued a circular on 11 April to require banks to re-assess their loan business and funding plans for the rest of this year.

- The HKMA has completed a preliminary review of the business plans submitted by banks. The plans show that the pace of credit growth would slow in the remainder of 2011.

- The HKMA has been discussing with a number of banks on whether their loan growth and funding plans are too aggressive and whether their loan growth projection should be moderated.

ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: CREDIT GROWTH

- Major focuses of the HKMA's prudential supervision
  - Credit demand will remain strong in the near term
  - Banks must not dilute their prudent underwriting standards, which have been proven effective
  - As loan-to-deposit ratios continue to rise from their previous low levels*, banks should strengthen their liquidity risk management, keep reviewing their funding sources and loan business plans, and make timely adjustments as needed.

- The HKMA will continue to closely monitor banks' loan growth, conduct on-site examinations, and keep closely in touch with banks on their loan business and funding strategies.

* Loan-to-deposit ratio	Dec 2009	Dec 2010	Mar 2011
HK dollar	71.2%	78.1%	81.7%
US dollar	32.3%	53.5%	60.6%

ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: MONETARY OUTLOOK

Factors affecting domestic interest rate movements:

- The end of quantitative easing and the timing of interest rate hikes in the US will affect interest rate cycles and the direction of fund flows in Hong Kong.

- HK dollar interest rates will also be affected by changes in the supply of Hong Kong dollar deposits and demand for Hong Kong dollar loans in the banking system.

    - HK dollar loans have been growing faster than HK dollar deposits since 2010.
    - While HIBORs remain at low levels, some banks have raised the deposit and lending rates.
    - Credit demand will remain strong in the near term and will continue to put upward pressures on borrowing cost for Hong Kong dollars.

- We must be mindful of and carefully manage the risks of interest rate hikes and avoid over-borrowing.

1. Assessment of Risk to Hong Kong's Financial Stability

2. **Developments of RMB business in Hong Kong**

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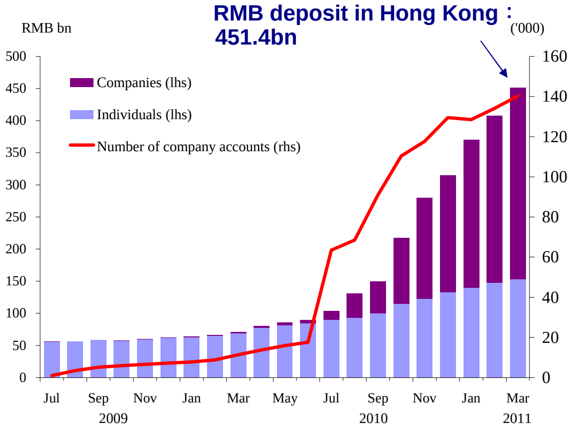
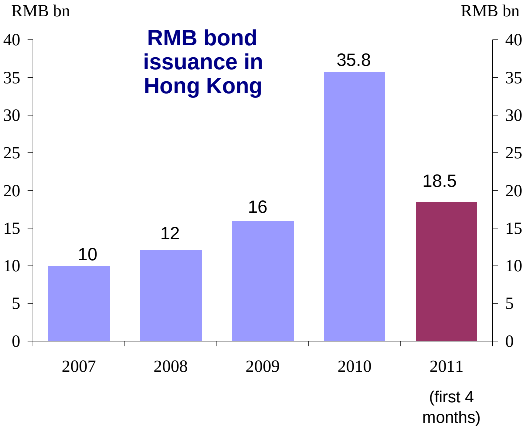
Encouraging developments of Hong Kong's RMB business

Largest RMB liquidity pool outside the Mainland



Note：RMB deposits included deposits from designated merchants.

Largest offshore RMB bond market

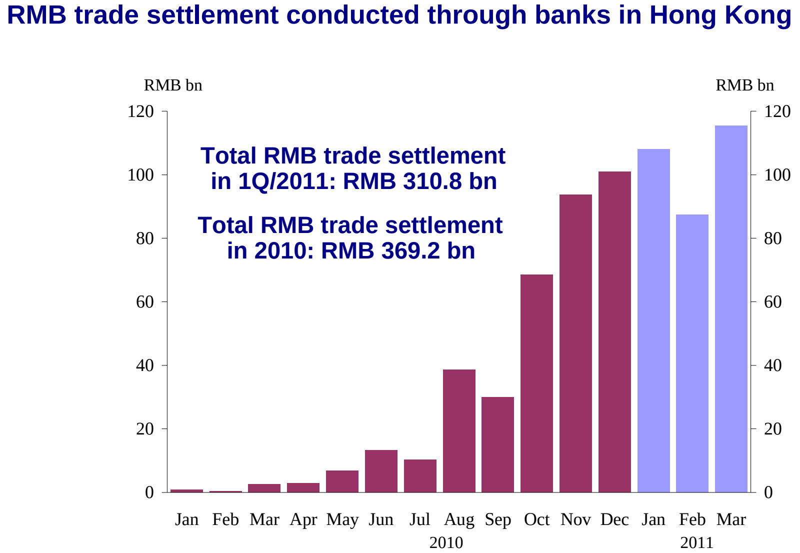


- <u>Hong Kong has the largest RMB liquidity pool outside the Mainland:</u> RMB deposits in Hong Kong increased by RMB136.6 bn during the 1st quarter of 2011, or RMB45.5 bn per month on average.

- <u>Hong Kong has the largest offshore RMB bond market:</u> In the first four months of 2011, there were 20 enterprises and institutions issuing RMB bonds in Hong Kong, involving a total of RMB18.5 bn. It is expected that the RMB bond market in Hong Kong will continue to expand steadily.

- <u>Comprehensive RMB financial infrastructure</u>: The first RMB REIT has been completed in mid-Apr. Hong Kong's RMB platform can support the listing and trading of RMB financial products, paving the way for the launch of more products in the future to meet market demand.

Expanding RMB Trade Settlement Business



- In 1Q 2011, 86% of the Mainland's RMB trade settlement were conducted through banks in Hong Kong, higher than 79% recorded in 2H 2010, suggesting that Hong Kong is the prime platform for RMB trade settlement.

- In 1Q 2011, the Mainland's external trade settled in RMB accounted for 7% of its total external trade, much higher than 4% recorded in 2H 2010.

Further Development of Hong Kong's Offshore RMB Business

- **China's 12th Five-Year Plan supports development of Hong Kong as an offshore RMB business centre**
- To actively develop and reinforce Hong Kong's status as the offshore RMB centre **in an orderly and controllable manner** and promote the use of RMB in cross-border trading and investment activities
- **An established and expanding RMB clearing and settlement network with global coverage**
  - At end-Mar 2011, there were 154 branches and subsidiaries of foreign banks, as well as overseas branches of Mainland banks directly participating in Hong Kong's RMB clearing platform
- **Further overseas roadshows to be conducted**

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- China's 12th Five-Year Plan supports development of Hong Kong as an offshore RMB business centre. As Hong Kong's offshore RMB centre has taken shape, we have to foster further growth in RMB business in an orderly and controllable manner and promote the use of RMB in cross-border trading and investment activities.

- At end-Mar 2011, there were 170 banks participating directly in Hong Kong's RMB clearing platform. Among the participating banks, there were 154 branches and subsidiaries of foreign banks, as well as overseas branches of Mainland banks. Hong Kong's RMB platform has developed into a global network, and will continue to expand its reach.

- HKMA has started to conduct overseas roadshows for the promotion of RMB business in Hong Kong since Mar 2011. HKMA also participates in seminars on RMB business organised by other central banks in order to promote Hong Kong's one-stop RMB financial services to banks and companies from overseas (particularly from Asia).

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SHARING OF MORTGAGE DATA FOR CREDIT ASSESSMENT

- On 21 March 2011, the Office of the Privacy Commissioner for Personal Data ("PCO") released its report on the public consultation on the sharing of mortgage data for credit assessment, concluding that the banking industry's proposal for positive mortgage data sharing ("PMDS") would lead to responsible borrowing and lending

- The Code of Practice on Consumer Credit Data was revised on 1 April 2011 to allow for the implementation of PMDS

- The industry has been taking steps to implement PMDS in respect of pre-existing mortgage data and new mortgage loans

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- The Office of the Privacy Commissioner for Personal Data (PCO)'s Consultation Report on the Sharing of Mortgage Data for Credit Assessment concluded that it is appropriate to revise the Code of Practice on Consumer Credit Data (the Code) to allow for the sharing of positive mortgage data.

- The sharing of positive mortgage data through a credit database can help banks verify the information provided by applicants in respect of mortgage loans they already have, thus deterring mortgage applicants from providing false information to authorized institutions (AIs) during the mortgage loan application process. This will strengthen AIs' credit risk assessment, which is crucial to banking and financial stability in Hong Kong.

- The industry has been taking steps to implement PMDS
  - *Pre-existing mortgage data:* AIs have been sending letters to their existing mortgage customers (i.e. borrowers, mortgagors or guarantors) to seek their prescribed consent for the uploading of their pre-existing mortgage data to the credit reference agency (CRA).

  - *New mortgage loan applications:* Applicants for new mortgage loans will be requested to sign a consent form for sharing data of their pre-existing mortgages as well as for uploading of data on their applied mortgage after completion of the loan drawdown. Where a mortgage applicant chooses not to give his/her consent, the AI will still continue to process the mortgage loan application by obtaining additional relevant information from the applicant to assess the applicant's repayment ability. The AI will then decide whether it has sufficient information to conduct the credit assessment of the customer and whether additional measures are required to mitigate the potential credit risk involved.

BASEL III

- Basel III will be phased in from 1 January 2013
  - More stringent capital requirements and higher minimum requirement for common equity (1.1.2013)
  - New liquidity standards: Liquidity Coverage Ratio and Net Stable Funding Ratio (1.1 2015 / 1.1.2018)
  - Capital conservation / countercyclical capital buffer (1.1. 2016)
  - Capital to assets leverage ratio (1.1.2018)
- Banks are expected to be able to meet the new requirements
- Legislative amendments will begin in this year: a briefing to the LegCo Financial Affairs Panel is scheduled for 9 June
- HKMA plans to table the Banking (Amendment) Bill 2011 before LegCo in December 2011

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- Basel III, which will require banks to hold better quality and higher levels of capital and liquidity so as to strengthen the banking sector's resilience to financial and economic stress, will be phased in from 1 January 2013 to 1 January 2019. The HKMA has already written to AIs indicating its intention to adopt Basel III in full following the BCBS's timetable, including the transition arrangements.

- Banks in Hong Kong are generally well-placed to meet the new capital standards, given that they are well-capitalised and place more reliance on common equity to meet regulatory capital requirements.

- While some banks may need to adjust their liquidity profiles to satisfy the relevant requirements in the new liquidity standards, we do not expect any major problems for banks in Hong Kong to comply with the standards.

- To enable the implementation of Basel III in Hong Kong, the HKMA proposes to amend the Banking Ordinance (BO) so that the MA is empowered to
  - make Rules, to give effect to banking supervisory standards relating to capital and liquidity issued by the Basel Committee from time to time (to replace the existing capital and liquidity ratios set out in the BO); and
  - issue codes of practice to provide guidance in respect any of the provisions of the rules.

- The new standards are, inevitably, technical in nature and are likely to require refinement over time as business practices and markets evolve. The use of Rules (which will be subsidiary legislation and subject to negative vetting by the Legislative Council) supplemented by codes of practice should provide a practical means to handle, within the legislative framework, the complex calculation methodologies and the need for flexibility to effect changes relatively quickly in response to changing circumstances. Consultation and appeal mechanisms will be built in to provide further checks and balances.

- The HKMA expects to submit a Banking (Amendment) Bill, for the purposes of implementing Basel III, in December 2011, after industry consultation. This timeline should allow sufficient time for development of, and consultation on, the Rules before the first phase of the new requirements (i.e. the new minimum capital requirements) comes into effect on 1 January 2013.

INTERNATIONAL DISCUSSIONS ON REGULATORY REFORM

- Systematically Important Financial Institutions (SIFIs)
  - Resolution Regime
  - relevant regulatory measures to be submitted to G20 at its Summit in November 2011
- Financial Stability Board (FSB)
  - The HKMA attended the Plenary Meeting of the FSB on 5 April. The meeting discussed risks and vulnerabilities affecting global financial stability, and reviewed the progress of major regulatory reform initiatives.
  - The FSB recently commenced two peer reviews. The HKMA chairs the peer review of deposit insurance systems and participates in another review team on compensation practices.

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<u>SIFIs</u>

- In addition to Basel III, the current emphasis of the developments in international regulatory standards is on "how to minimise the probability and consequences of the failure of SIFIs". Whether financial institutions are systematically important depends on their size, interconnectedness and/or lack of substitutability. As the failure of SIFIs is a potential threat to the stability of financial system, the FSB is considering measures to reduce the risks associated with SIFIs including more intensive and effective supervision (with better coordination among home and host supervisors), capital surcharges and recovery and resolution plans.

- Recovery and resolution regime is a set of effective measures to contain the damage potentially caused by a SIFI's failure and provide the authorities with tools to resolve the firm in a manner that ensures the continued performance of essential financial functions and uninterrupted access of depositors to their funds, without exposing taxpayers to the risk of loss.

<u>Financial Stability Board</u>

- The HKMA continued to participate actively in meetings and activities of the FSB Plenary and Standing Committees. At the April Plenary meeting, members reviewed macroeconomic and financial market developments of consequence to global financial stability. Members also discussed various proposals to continue to reform the financial system. One of the major areas is to tackle the "too-big-to-fail" problem posed by SIFIs. The FSB is currently developing a framework that will, among other things, set higher loss-absorbency requirements for global SIFIs, enhance supervisory intensity, and develop effective resolution regime to enable the orderly resolution of these institutions. A number of global SIFIs have operations in Hong Kong and the development of an effective SIFI regulatory framework is of vital importance to Hong Kong's financial stability. The HKMA has been participating actively in the relevant international discussions to ensure that our views are heard. Another key area of work under the FSB is the reform of the OTC derivatives market.

- As part of its efforts to encourage consistent implementation of international standards across its membership, the FSB conducts peer reviews regularly. The HKMA chairs the recently set up peer review of deposit insurance systems and participates in another review team on compensation practices.

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INVESTMENT INCOME

(HK$ billion)	2011 Q1*	2010 Full Year	2009 Full Year	2008 Full Year
Hong Kong equities^@	3.5	11.6	48.9	(77.9)
Other equities^	8.9	27.1	48.8	(73.1)
Foreign exchange	14.5	(3.1)	9.8	(12.4)
Other investments&	0.2	1.7	0.8	-
Bonds#	(2.9)	42.1	(0.6)	88.4
Investment income/(loss)@&	24.2	79.4	107.7	(75.0)

* Unaudited figures
^ Including dividends
# Including interest
@ Excluding valuation changes in Strategic Portfolio
& Including valuation changes of investment held by EF's investment holding subsidiaries

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

(HK$ billion)	2011 Q1*	2010 Full year	2010 Q4	2010 Q3	2010 Q2	2010 Q1
Investment income/(loss)	24.2	79.4	5.9	74.5	(12.1)	11.1
Other income	-	0.2	-	0.1	0.1	-
Interest and other expenses	(1.2)	(4.8)	(1.2)	(1.2)	(1.5)	(0.9)
Net investment income/(loss)	23.0	74.8	4.7	73.4	(13.5)	10.2
Payment to Fiscal Reserves#	(9.2)	(33.8)	(8.6)	(8.3)	(8.4)	(8.5)
Payment to HKSAR government funds and statutory bodies#	(1.1)	(3.9)	(1.1)	(1.1)	(0.9)	(0.8)
Valuation change of Strategic Portfolio less investment held by EF's investment holding subsidiaries^	(0.7)	0.9	1.0	1.2	(0.4)	(0.9)
Increase/(Decrease) in EF Accumulated Surplus	12.0	38.0	(4.0)	65.2	(23.2)	-

* *Unaudited figures*

\# *The fixed rate of fee payment is 6.0% for 2011 and 6.3% for 2010*

^ Including dividends