



HONG KONG MONETARY AUTHORITY

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

2 March 2012



- 1. Assessment of Risk to Hong Kong's Financial Stability**
2. Banking Supervision
3. Hong Kong as an Offshore RMB Centre
4. Investment of the Exchange Fund in 2011
5. Hong Kong Mortgage Corporation



ASSESSMENT OF THE EUROPEAN ECONOMY

Markets' concern over the European debt crisis lessens:

- Leaders of 25 European countries agreed on the Fiscal Compact in December last year and reached consensus on the implementation details in February
 - Market confidence in the fiscal discipline of the eurozone strengthened
- The European Central Bank introduced two rounds of three-year Longer-Term Refinancing Operations on 22 December 2011 and 29 February 2012 respectively to provide 489 billion euros and 529.5 euros of liquidity to the banks
 - Liquidity squeeze in the banking system relieved
 - Italian and Spanish government bond yields fell

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- Leaders of 25 European countries agreed on the Fiscal Compact and the implementation details. The agreement will be signed no later than the end of March 2012 and take effect on 1 January 2013 after being passed by the parliaments of at least 12 of the member states of the eurozone.



ASSESSMENT OF THE EUROPEAN ECONOMY

However, the economic and financial stability in Europe is still faced with considerable downside risks:

- Economic recession in Europe is expected amid fiscal consolidation and deleveraging of banks (consensus forecast: - 0.3%)
- It is not certain that whether Greece can implement the austerity measures as promised
- In addition to implementing austerity measures, other European countries also have to carry out structural reforms to enhance competitiveness

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- Although there are signs of easing of the debt crisis, the economic and financial stability in Europe is still faced with downside risks:
 - Economic recession in Europe is expected amid fiscal consolidation and deleveraging of banks. Market has lowered the growth forecast for Europe in 2012 from 0.4% at the end of last year to -0.3%.
 - In addition to austerity measures, other European countries also have to carry out structural reforms, including improving government efficiency, privatisation of national assets, opening up the service industry to enhance competition and introducing reforms to the collective bargaining mechanism so that wages can better reflect productivity. The governments are encountering tremendous difficulties in implementing these reforms.



ASSESSMENT OF THE US ECONOMY: SIGNS OF IMPROVEMENT IN THE SHORT TERM OUTLOOK

- Growth pace quickened in Q4 2011 and growth rate for the whole year is 1.7%
- According to market forecast, growth rate for the US economy in 2012 is 2.2%
- Recent signs of improvement in the US economy
 - Continued improvement in unemployment (January: 8.3%)
 - Rebound in the equity market (+ 9%)
 - Increase in home sales, with the government introducing more measures to support the housing market
 - Extension of the payroll tax cut and long-term unemployment benefits to the end of 2012
- As the Fed perceives that recovery will be mild, it expects interest rate to stay at the current extremely low level through at least late 2014

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- As for the US economy, driven by stock replenishment, GDP growth accelerated to 3.0% in Q4 following a rise of 1.8% in Q3. Market expects growth for 2012 will improve to 2.2% from 1.7% in 2011.
- Recent performance of the US economy is slightly better than expected:
 - Unemployment continued to improve and fell to 8.3% in January this year from 8.6% in November last year when we had our last FA panel briefing
 - The equity markets have rebounded by 9% since the beginning of this year
 - Monthly existing home sales rose to a year high and existing housing stock fell to the long-term historical average level as a result
 - The US government is considering Fed's suggestion of introducing further measures to support the housing market
 - The US Congress has passed the Middle Class Tax Relief and Job Creation Act of 2012 to extend measures such as payroll tax cut and long-term unemployment benefits. The Act will bring about US\$100 bn of economic stimulus and thereby reducing the need to carry out fiscal consolidation in the near future
- However, the Fed perceives that recovery will be mild and therefore the accommodating monetary policy will continue to be in place. New measures announced by the Fed in its January meeting include extending the time frame for its low interest rate policy from mid-2013 to at least the end of 2014.



ASSESSMENT OF THE US ECONOMY: OBSTACLES REMAIN IN THE MEDIUM-TO-LONGER TERM

- Growth in personal income will remain slow
- Household deleveraging is yet to be completed (household debt to income ratio is still at 1.15)
- Shadow inventory (foreclosed homes) remains high, meaning that there are still a lot of homes awaiting disposal
- Tightening of public finance policy has dragged on economic growth

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Structural problems in the US economy will continue to plague its medium-to-longer term outlook :

- **Long-term unemployment in the US** remains serious. 43% of the unemployed workers have been jobless for six months or longer. Meanwhile, 1.1 million people (0.7% of the working force) have left the labour market out of frustration and when these people begin job-hunting again, unemployment rate may be pushed up while wages will be kept from rising.
- As regards **household debt**, debt to income ratio stays at 1.15 while savings rate rebounded slightly to 4% in December from the recent low, reflecting that the process of household deleveraging will go on for some time and household consumption will continue to be affected. *[For reference: Household debt-to-GDP ratio: Q4 2007 = 1.295; Q3 2011 = 1.146]*
- Shadow inventory (foreclosed homes) in **the US housing market** remains high, meaning that there are still a lot of homes awaiting disposal. When a large number of foreclosed homes are put on the market, downward pressure on housing prices will increase.
- Although the Fed has put forward a series of measures, including relaxing the eligibility criteria for the existing home purchase programs and leasing out the foreclosed homes so as to reduce the repayment burden of homeowners and lower the shadow inventory, the effectiveness of such measures remains to be seen.
- As for **public finance**, the Budget Control Act passed by the US Congress last year stipulates that starting from the current fiscal year, the US government will need to reduce its fiscal deficit by US\$2.1 trillion in 10 years' time and automatic across-the-board spending cuts of at least US\$1.2 trillion will have to be made from 2013 onwards. Such across-the-board cuts lack flexibility and will affect economic growth in the medium term.



ASSESSMENT OF THE JAPANESE ECONOMY

- Recovery has been slow in Japan since the earthquake and the economy contracted by 0.9% in 2011
- A strong yen and uncertain economic outlook in the US and Europe will drag on growth. Market expects the Japanese economy to grow by 1.8% in 2012
- The Bank of Japan maintains the zero-interest rate policy and announced that it will further expand the asset purchase program
- Public finance will continue to deteriorate and newly issued government debt is expected to exceed 9% of GDP in the financial year of 2012. Total government debt will be over 200% of GDP. Although it has not led to a confidence crisis in the market, the government is already heavily indebted and the situation is worrisome.

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- Recovery has been slow in Japan since the earthquake and the economy contracted by 0.9% in 2011.
- With the gloomy outlook for the US and European economies and a strong yen, Japan's imports exceeded exports for nine consecutive months, resulting in trade deficit for the whole year, which is the first time in 31 years. According to the January consensus forecast, it is expected that the Japanese economy will grow by 1.8% in 2012.
- Although it has not led to a confidence crisis in the market, the government is already heavily indebted and the situation is worrisome.



ASSESSMENT OF THE MAINLAND ECONOMY

- Dragged by the sluggish external economic conditions, growth in 2012 will slow down and consensus forecast has revised downward the growth forecast for the year to 8.4%
- Inflation this year will come down from last year's 5.4%. According to consensus forecast, inflation rate for 2012 is 3.3%
- Monetary policy will remain prudent and the People's Bank of China (PBoC) has lowered the reserve requirement ratio twice to 20.5% (applicable to large financial institutions)
- Measures to cool down the property market as well as other economic adjustment measures have gradually taken effect, and with relatively more flexibility under the fiscal and monetary policies, the risk of a hard-landing is not significant

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- Dragged by the sluggish external economic conditions, growth in 2012 will slow down and consensus forecast has revised downward the growth forecast for the year to 8.4%.
- Inflation this year will come down from last year's 5.4%. According to consensus forecast, inflation rate for 2012 is 3.3%.
- Monetary policy will remain prudent and the People's Bank of China (PBoC) announced to lower the reserve requirement ratio (RRR) on 30 November and 18 February respectively by a total of 1 percentage points. After the downward adjustments, the RRR applicable to large financial institutions is 20.5% and the RRR applicable to medium and small financial institutions is 18.5%.
- Measures to cool down the property market as well as other economic adjustment measures have gradually taken effect, and with relatively more flexibility under the fiscal and monetary policies, the risk of a hard-landing is not significant



EXTERNAL FACTORS AFFECTING HONG KONG'S FINANCIAL ENVIRONMENT

- Risk of the European debt crisis leading to a collapse in the global financial system lessens, but the European economy is beset with difficulties
- Although the US economy will continue to recover, the momentum may be affected as the structural problems are yet to be resolved
- As the growth in Europe, the US and Japan is losing momentum, growth in Asia will slow down as a result
- Uncertainties remain in the external economic and financial environment:
 - Risk of deterioration in the European debt crisis remains
 - The Fed may implement QE3 in the event that recovery in the US slows down or unemployment shows no sign of improvement, which may lead to more inflow of low cost US dollar funds into Hong Kong's financial system
 - There may be sudden changes in the risk appetite of investors. This may result in a resurgence of capital inflow into emerging markets, thereby pushing up inflation and asset prices



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

- The property market has continued to cool down since June last year. Property transaction volume averaged 4,900 per month in the second half of last year, representing a sharp fall of nearly 50% compared with the first half of last year
- Property prices in December last year fell by 5% compared with June
- Results of the residential mortgage survey for January 2012 showed that both the number of newly approved mortgages and the amount involved fell by nearly 70% on average compared with the first half of last year
- Sentiment in the property market improved slightly in February 2012. The HKMA will continue to closely monitor market development and introduce appropriate supervisory measures to maintain banking stability as and when necessary



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

- Bank lending grew by 20.2% in 2011:
 - Rapid growth was recorded in the first half of last year (27.9%) while significant slowdown in the second half of the year (10.9%)
 - Month-on-month growth in January 2012 was 8.5%
- The slowdown in loan growth is expected to continue into 2012:
 - Banks refrain from overly aggressive lending strategy amid uncertain external environment
 - Banks have to prepare for the implementation of Basel III
- As loan demand remains strong and the loan to deposit ratio is at the highest level in recent years, interest rates are under upward pressure.



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

- The macro economic and financial environment is subject to considerable uncertainties, and both downside risks and the risk of asset price bubbles exist in the local economy
- While interest rate in the US may remain at an exceptionally low level in the coming three years, there is still upward pressure on the interest rates in Hong Kong as our deposit rates and lending rates are mainly driven by changes in credit supply and demand
- Even though market sentiment has improved, the public should remain vigilant, manage their interest rate risk prudently and avoid overstretching themselves when applying for loans

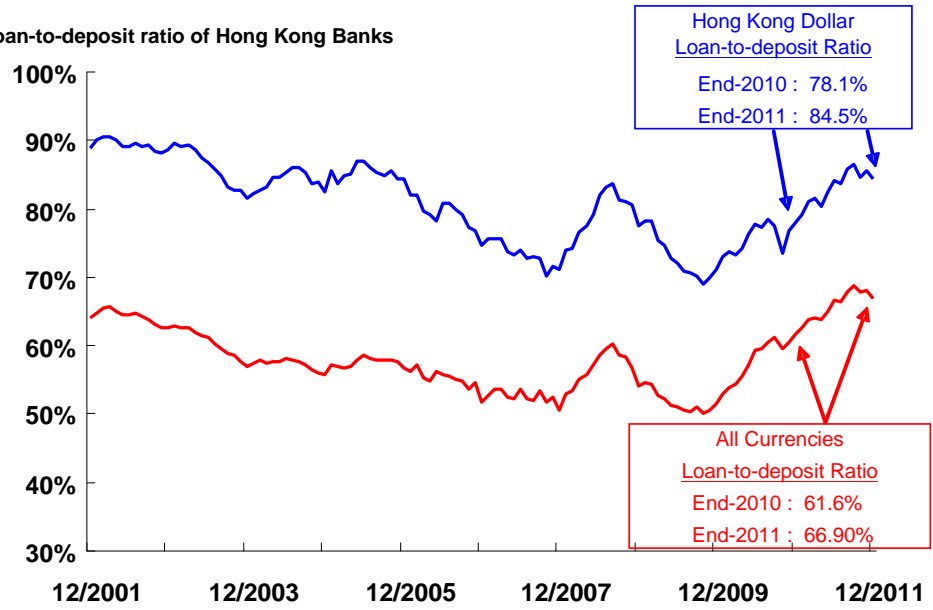


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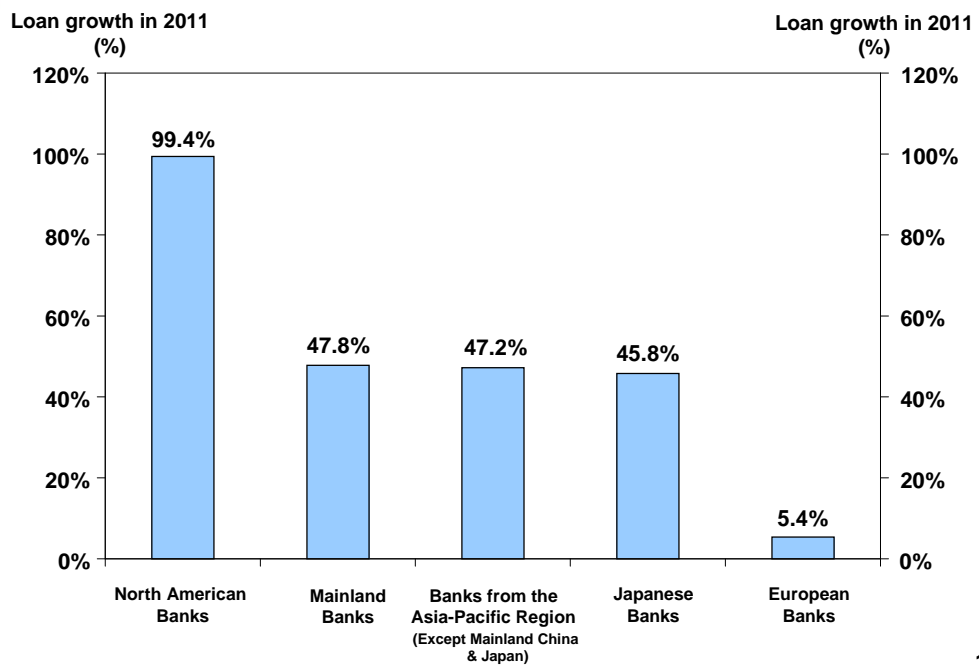
FURTHER RISE IN LOAN-TO-DEPOSIT RATIO

Loan-to-deposit ratio of Hong Kong Banks





CREDIT GROWTH OF FOREIGN BANKS IN HONG KONG





BASEL II ENHANCEMENTS & BASEL III IMPLEMENTATION PROGRESS

- Basel II enhancements
 - Amendment Rules have taken effect from 1 January 2012 in line with the Basel Committee's timeline.

- Basel III
 - Intends to implement Basel III in accordance with the Basel Committee's transition arrangements.
 - Banking (Amendment) Bill 2011 was passed by LegCo on 29 February 2012 after third reading.
 - First consultation package on a series of policy proposals for implementation of Basel III capital and liquidity standards released in January 2012.



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Hong Kong as offshore RMB business centre expanding rapidly

(RMB billion)	<u>2010</u>	<u>2011</u>	<u>Growth</u>
1 RMB trade settlement handled by banks in Hong Kong	369.2	1,914.9	+419%
2 RMB deposits in Hong Kong (at year-end)	314.9	588.5	+87%
3 Outstanding RMB certificates of deposits (CDs) issued in Hong Kong (at year-end)	5.7	72.0	+1,163%
4 RMB bond issuance in Hong Kong	35.8	107.9	+201%
5 Outstanding RMB loans (at year-end)	1.8	30.8	+1,611%

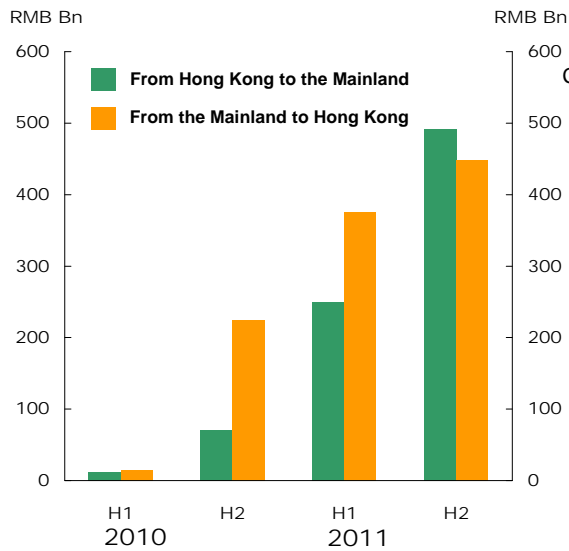
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- Hong Kong is the prime platform for offshore RMB trade settlement. RMB trade settlement conducted through banks in Hong Kong amounted to RMB1,914.9 billion yuan in 2011. During the year, Mainland's trade settled in RMB amounted to RMB2,081.3 billion yuan.
- In 2011, issuance of RMB bonds in Hong Kong totalled RMB107.9 billion yuan, three times of the RMB35.8 billion yuan issued in the entire year of 2010. Meanwhile, the range of issuers continued to diversify.
- In addition, the outstanding amount of RMB loans extended by banks in Hong Kong increased from less than RMB2 billion yuan at the beginning of 2011 to some RMB30 billion yuan in end-December 2011.



Development of Hong Kong as RMB trade settlement and bond issuance centre deepens

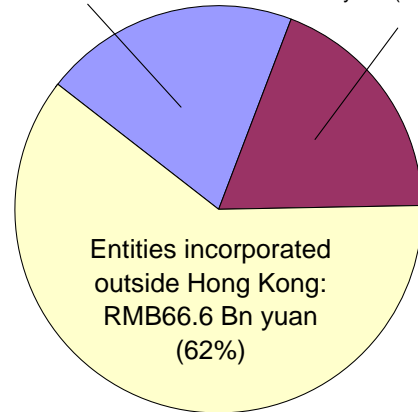
Flow of trade settlement payments becoming more balanced



More diversified range of RMB bond issuers

RMB bonds issued in Hong Kong in 2011 (By type of issuers)

Companies incorporated in Hong Kong:
RMB21.3 Bn yuan (20%)
Ministry of Finance:
RMB20 Bn yuan (18%)





Hong Kong's growing role in supporting RMB business worldwide

	<u>2010</u>	<u>2011</u>	<u>Change</u>
1 No. of participating banks of Hong Kong's RMB clearing platform	153	187	+22%
Of which:	132	165	+25%
Branches and subsidiaries of overseas banks and overseas presence of Mainland banks			
2 No. of RMB correspondent accounts set up by overseas banks at Hong Kong banks	187	968	+418%
3 Amount due to overseas banks (RMB billion at year-end)	19.6	116.4	+494%
4 Amount due from overseas banks (RMB billion at year-end)	10.9	121.7	+1,017%

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- Currently, there are 187 banks participating in Hong Kong's RMB clearing platform, of which 165 are branches and subsidiaries of overseas banks and overseas presence of Mainland banks. This represents a RMB payment and settlement network covering more than 30 countries in 6 continents.
- Meanwhile, RMB banking activities between Hong Kong and overseas banks have also been growing. The amount due to overseas banks by Hong Kong banks increased from 19.6 billion yuan at the beginning of 2011 to some RMB116 billion yuan at end-2011. While the amount due from overseas banks by Hong Kong banks increased from RMB10.9 billion yuan to RMB121.7 billion yuan at end-2011.



Actively promoting Hong Kong as offshore RMB business centre

- It is expected that offshore RMB business in Hong Kong, and particularly RMB financing activities and introduction of RMB financial and wealth management products, will grow substantially as channels for cross-border circulation of funds continue to broaden
- HKMA's proactive promotion work
 - **2011:** Conducted roadshows in Australia, Russia, UK and Spain
 - **2012:** Plans to visit South America and other places with close trade and investment links with China
- Hong Kong-London Forum
 - Joint private-sector forum, facilitated by HKMA and the UK Treasury
 - To foster cooperation between Hong Kong and London, focusing on clearing and settlement systems, market liquidity and the development of RMB financial products

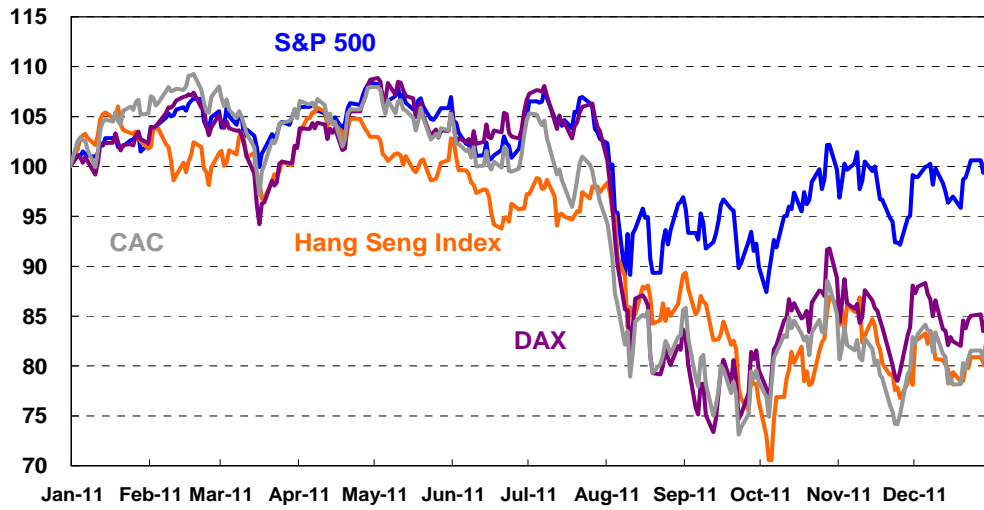


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EQUITY MARKETS EXTREMELY VOLATILE

Normalized Index Level (2010 year-end = 100)





INVESTMENT INCOME

(HK\$ billion)	2011					2010	2009	2008	2007
	I← Full year *	Q4	Q3	Q2	Q1 →I	Full year	Full year	Full year	Full year
Bonds#	71.9	11.2	46.2	17.4	(2.9)	42.1	(0.6)	88.4	61.0
Hong Kong equities^®	(24.2)	5.5	(28.7)	(4.5)	3.5	11.6	48.9	(77.9)	55.8
Other equities^	(12.2)	15.8	(37.5)	0.6	8.9	27.1	48.8	(73.1)	6.7
Foreign exchange	(9.1)	(11.2)	(20.1)	7.7	14.5	(3.1)	9.8	(12.4)	18.7
Other investments&	0.3	0.4	(1.3)	0.4	0.8	1.7	0.8	-	-
Investment income/(loss)^®&	26.7	21.7	(41.4)	21.6	24.8	79.4	107.7	(75.0)	142.2

* Unaudited figures

^ Including dividends

Including interest

® Excluding valuation changes in Strategic Portfolio (a loss of HK\$3.0 billion in 2011)

& Including valuation changes of investment held by EF's investment holding subsidiaries



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

(HK\$ billion)	← 2011 →					2010
	Full year (unaudited)	Q4	Q3	Q2	Q1	Full year
Investment income/(loss)	26.7	21.7	(41.4)	21.6	24.8	79.4
Other income	0.2	-	0.1	0.1	-	0.2
Interest and other expenses	<u>(4.6)</u>	<u>(0.8)</u>	<u>(1.0)</u>	<u>(1.6)</u>	<u>(1.2)</u>	<u>(4.8)</u>
Net investment income/(loss)	22.3	20.9	(42.3)	20.1	23.6	74.8
Payment to Fiscal Reserves #	(37.0)	(9.5)	(9.2)	(9.1)	(9.2)	(33.8)
Payment to HKSAR government funds and statutory bodies #	(5.6)	(1.7)	(1.5)	(1.3)	(1.1)	(3.9)
Valuation change of Strategic Portfolio less valuation change of investment held by EF's investment holding subsidiaries^	<u>(3.3)</u>	<u>0.2</u>	<u>(1.7)</u>	<u>(0.5)</u>	<u>(1.3)</u>	<u>0.9</u>
Increase/(Decrease) in EF Accumulated Surplus	(23.6)	9.9	(54.7)	9.2	12.0	38.0

The fixed rate of fee payment is 6.0% for 2011 and 6.3% for 2010.

^ Including dividends



Investment Diversification

- Investment expands into emerging market bonds and equities, private equity, real estate, and Renminbi assets
- Risk-return consideration
 - Higher long-term asset returns but lower liquidity and higher return variability
 - Better portfolio risk management given the lower return correlation with conventional assets
- Approach to portfolio construction
 - Adopt an incremental and prudent approach
 - Deploy both internal and external managers
- Private equity and real estate investment
 - Investments are held through five investment subsidiaries
 - Real estate investment targets at quality rental properties in prime locations in US and Europe
 - Private equity covers a wide spectrum of sectors



Investment diversification

- Renminbi assets - an investment size of around HK\$20 billion through
 - Qualified Foreign Institutional Investor (QFII) scheme
 - Quota of US\$300 million
 - Permissible investments: exchange-traded securities in the Mainland
 - Quota fully invested by end-2011
 - Participation in China Interbank Bond Market (CIBM)
 - Quota of RMB15 billion
 - Permissible investments: debt securities traded in the Mainland's interbank bond market
 - Quota fully invested by end-2011
 - HKMA will continue to liaise with Mainland authorities to expand our RMB investment in the Mainland



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Reverse Mortgage Programme

- Good response in the market since the launch on 11 July 2011
- By 31 January 2012, 188 applications have been approved, with total property value totalling around HK\$700 million
 - Average age of borrowers: 71 years old
 - Payment terms: 10-year (32%), 15-year (21%), 20-year (13%), life (34%)
 - Average property value: HK\$3.7 million
 - Average monthly payout: HK\$13,500
 - Average property age: 31 years



SME Financing Guarantee Scheme (“SFGS”)

- Since the launch on 1 January 2011, as at end-January 2012:
 - 246 applications approved
 - total loan amount is about HK\$840 million
 - the average loan interest rate is 5.2%
 - the average guarantee fee is 1.5% p.a.
- A special concessionary measure expected to be launched in mid-2012 with a 9-month application period
 - guarantee ratio of 80% for which the Government will provide a total guarantee commitment of HK\$100 billion
 - guarantee fee substantially reduced, 70% lesser than the existing guarantee fee for loans with 70% guarantee ratio



Microfinance Pilot Scheme

- A three-year microfinance pilot scheme with a tentative aggregate amount of HK\$100 million expected to be launched in mid-2012
- The maximum loan tenor will be five years and there will be three categories of target borrowers:
 - business starters (maximum loan amount of HK\$300,000)
 - self-employed persons (maximum loan amount of HK\$200,000)
 - people who wish to receive training, enhance their skills or obtain professional qualifications for self-improvement (maximum loan amount of HK\$100,000)
- The HKMC is discussing with banks, voluntary agencies and other stakeholders to work out the details such as the interest rate level, application and approval procedures, and ancillary services, etc.