



HONG KONG MONETARY AUTHORITY

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

7 February 2014



DISCUSSION TOPICS

Updates on

- Financial and Economic Environment
- Currency Stability
- Banking Stability
- Financial Infrastructure
- Hong Kong as an International Financial Centre
- Investment Environment and Performance of The Exchange Fund
- Hong Kong Mortgage Corporation



FINANCIAL AND ECONOMIC ENVIRONMENT



GLOBAL ECONOMIC GROWTH FORECASTS

Real GDP Growth

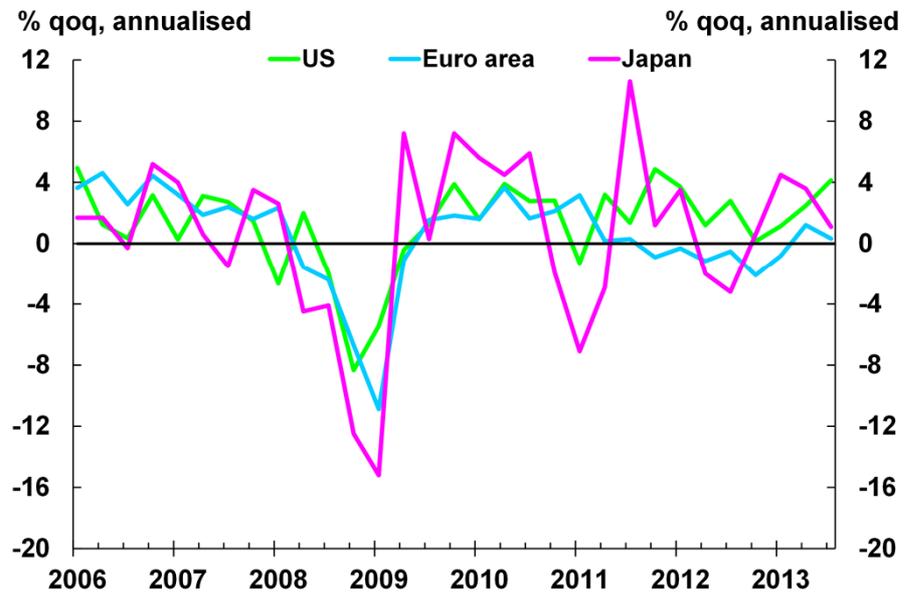
(% year-on-year)

	2013 Forecasts	2014 Forecasts	2015 Forecasts
US	1.9	2.8	3.0
Euro area	-0.4	1.0	1.4
Japan	1.7	1.7	1.2
Asia (ex-Japan)	6.0	6.2	6.3
Mainland China	7.7	7.5	7.4
Hong Kong	3.0	3.5	3.6

Source: January Consensus Forecasts



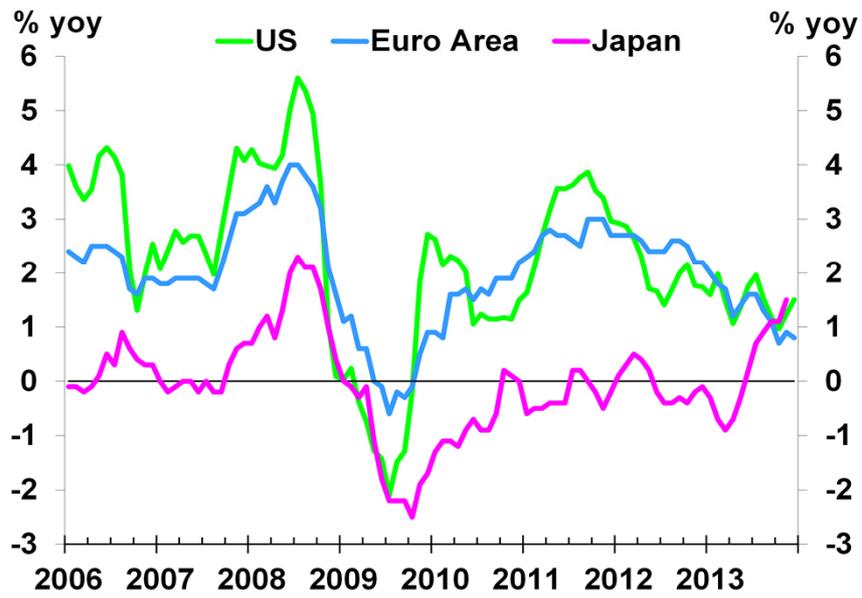
REAL GDP GROWTH IN MAJOR COUNTRIES



Source: Bloomberg



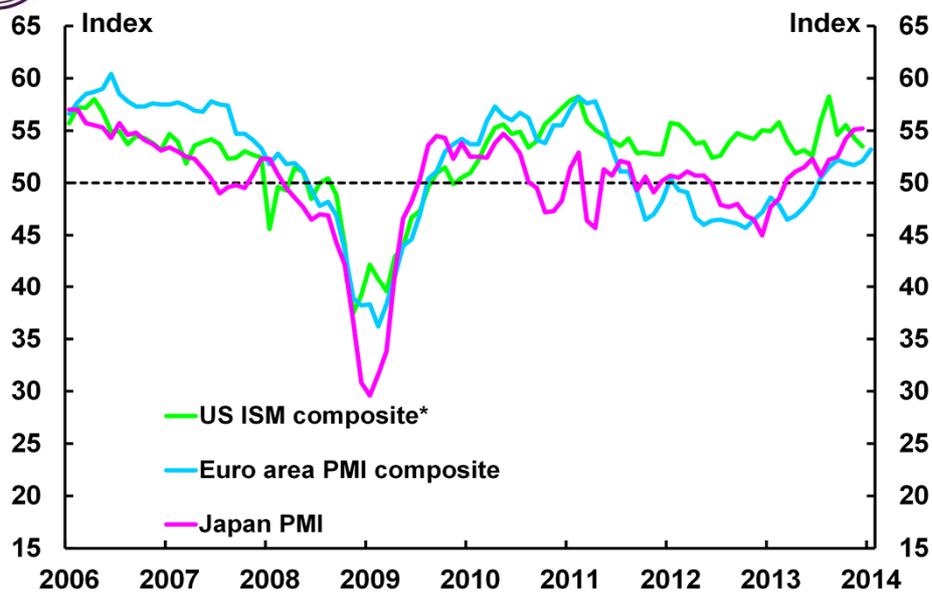
HEADLINE INFLATION IN MAJOR COUNTRIES



Source: Bloomberg and CEIC



PURCHASING MANAGERS' INDEX IN MAJOR ECONOMIES

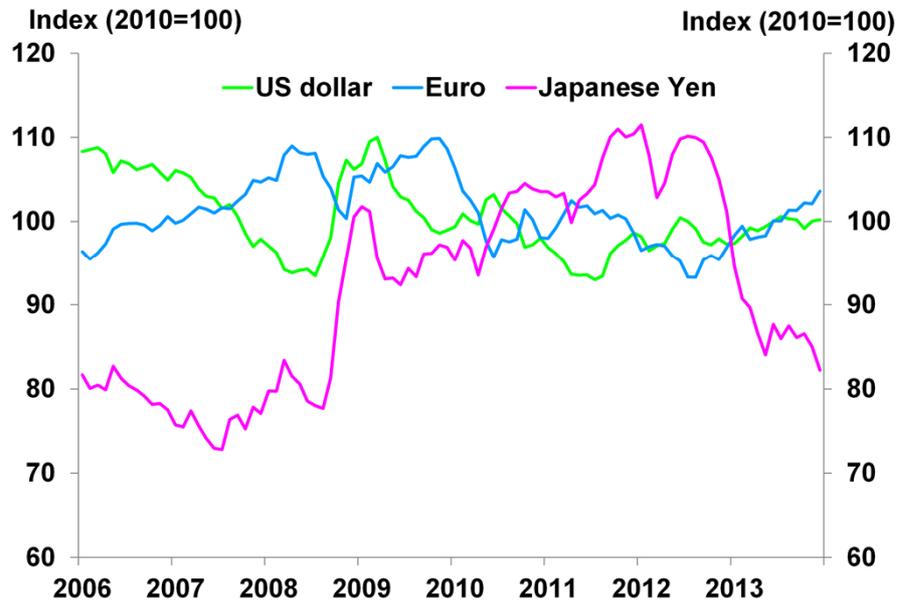


*Weighted average of the ISM manufacturing and non-manufacturing indices

Source: Bloomberg



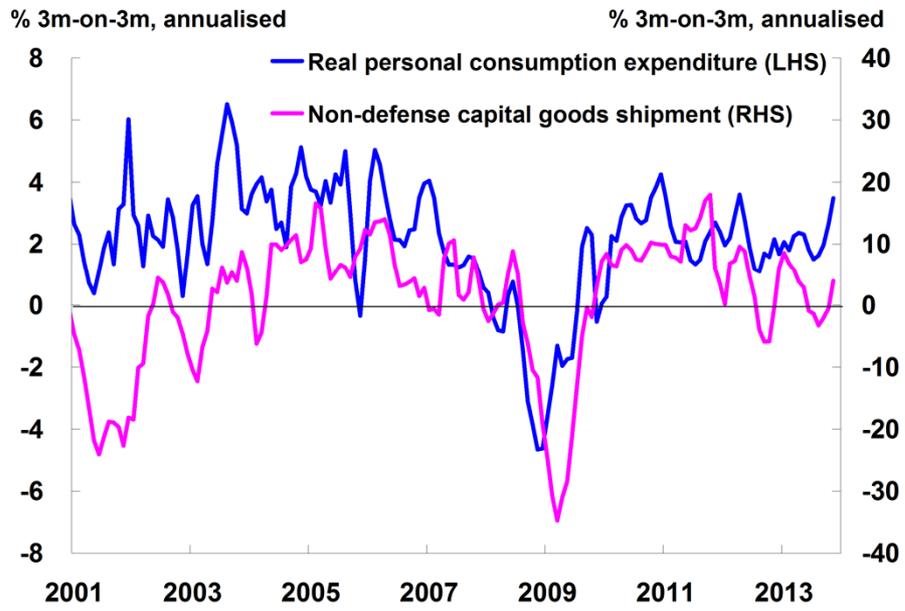
NOMINAL EFFECTIVE EXCHANGE RATE INDEX OF MAJOR CURRENCIES



Source: CEIC



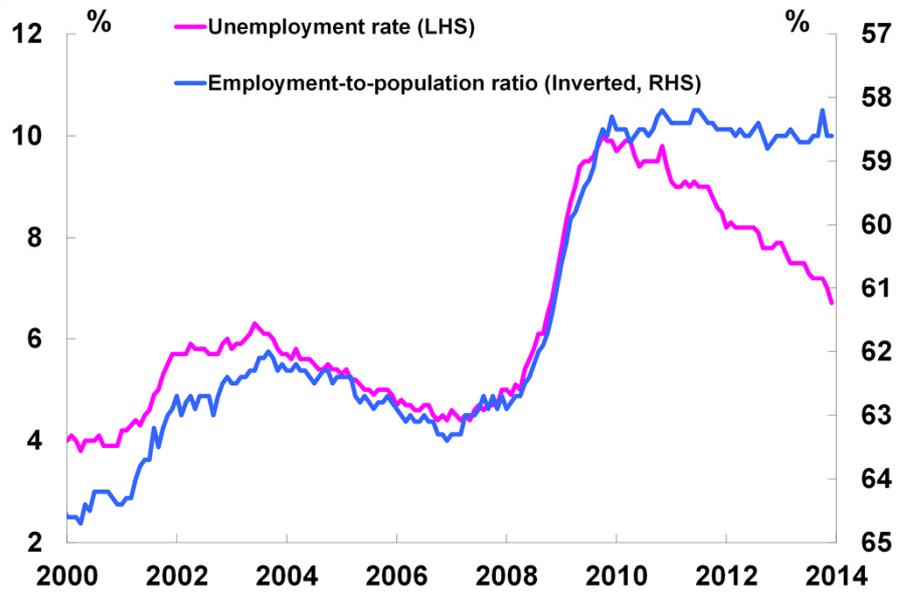
US: CONSUMPTION GROWTH & BUSINESS INVESTMENT ACTIVITY



Source: CEIC



US: LABOUR MARKET SITUATION



Source: CEIC



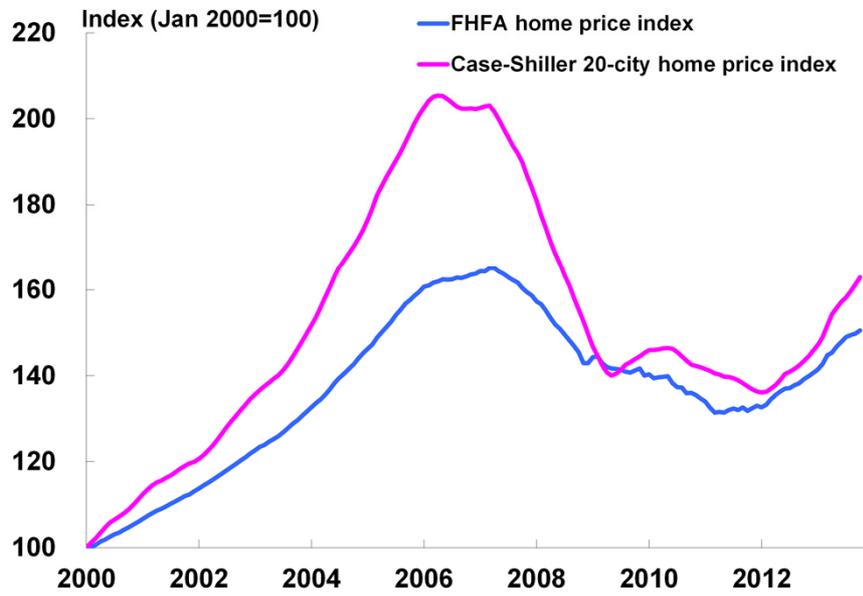
US: LABOUR FORCE PARTICIPATION



Source: CEIC



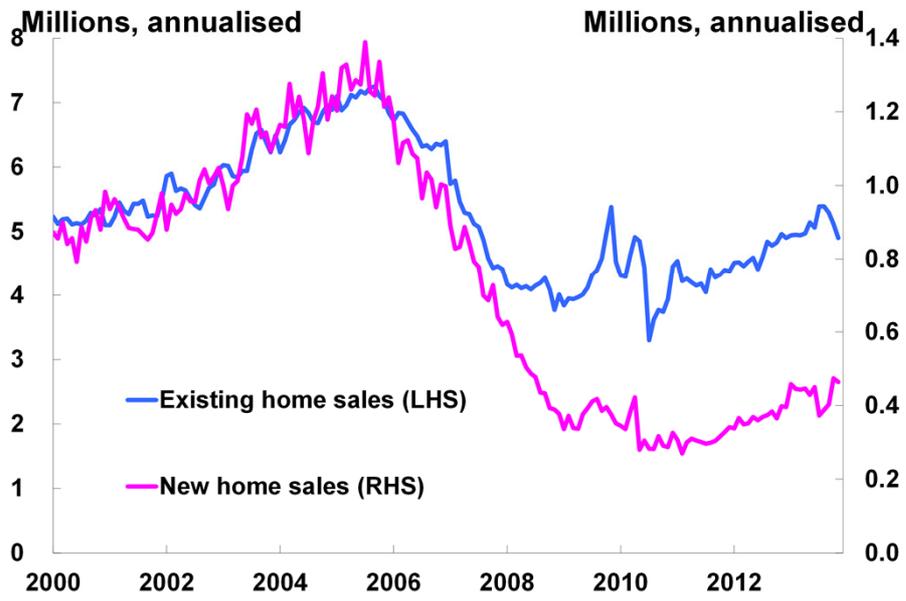
US: HOUSE PRICES



Sources: Standard & Poor's and CEIC



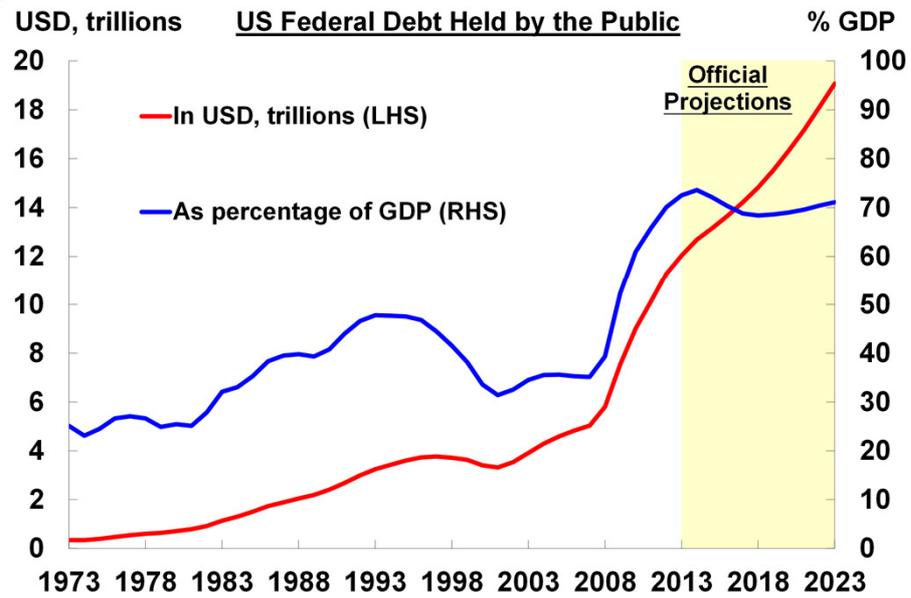
US: HOME SALES



Source: CEIC



US: FEDERAL GOVERNMENT DEBT

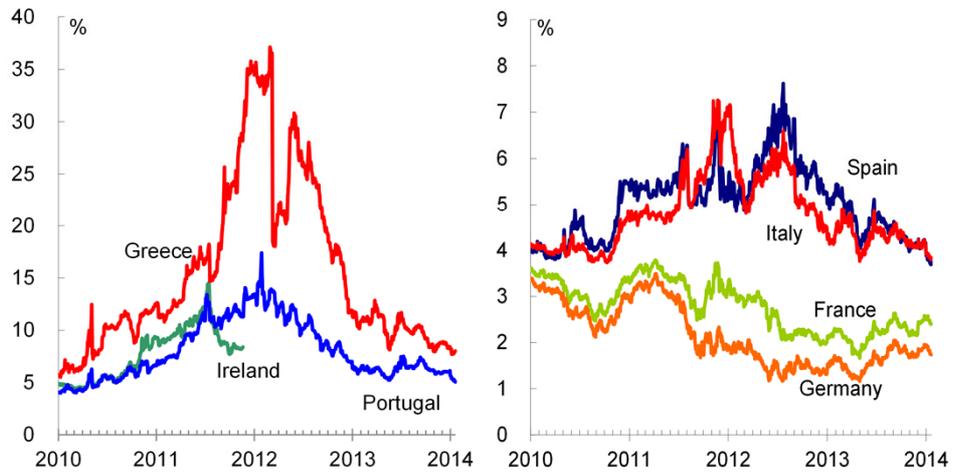


Source: Congressional Budget Office



EUROPE: SOVEREIGN BOND YIELDS

10-year sovereign bond yield

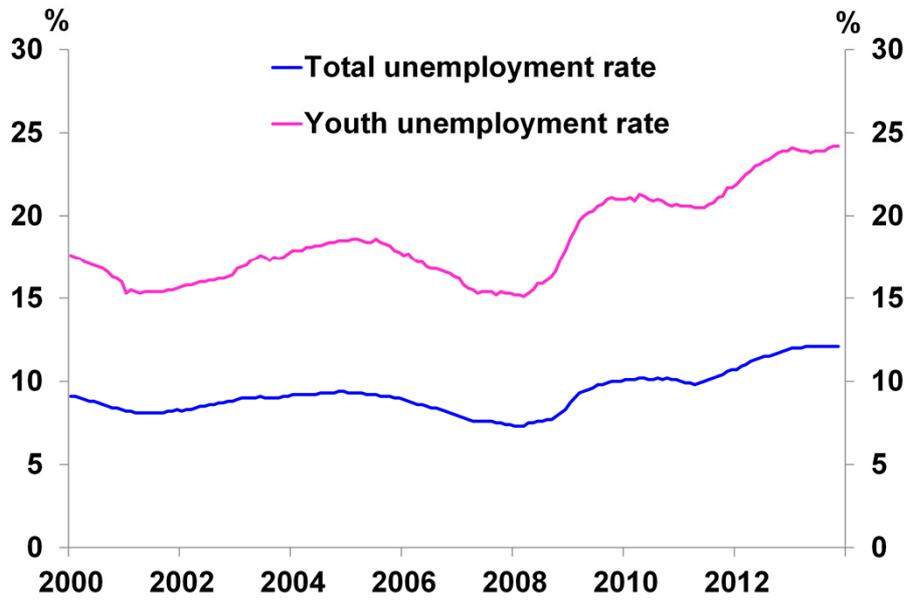


Sources: Bloomberg and EcoWin

Note: EcoWin has stopped publishing Ireland's 10-year bond yield since 22 Nov, 2011



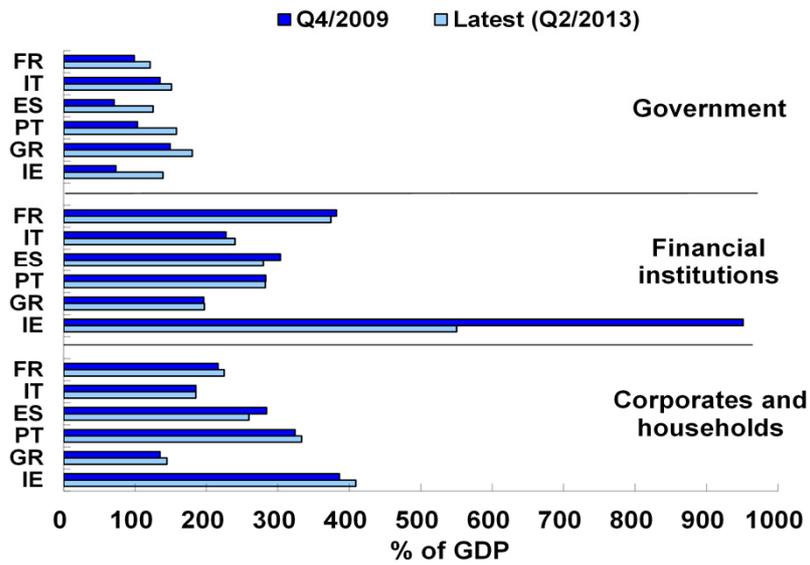
EUROPE: UNEMPLOYMENT RATE



Source: Bloomberg



EUROPE: OVERALL INDEBTEDNESS

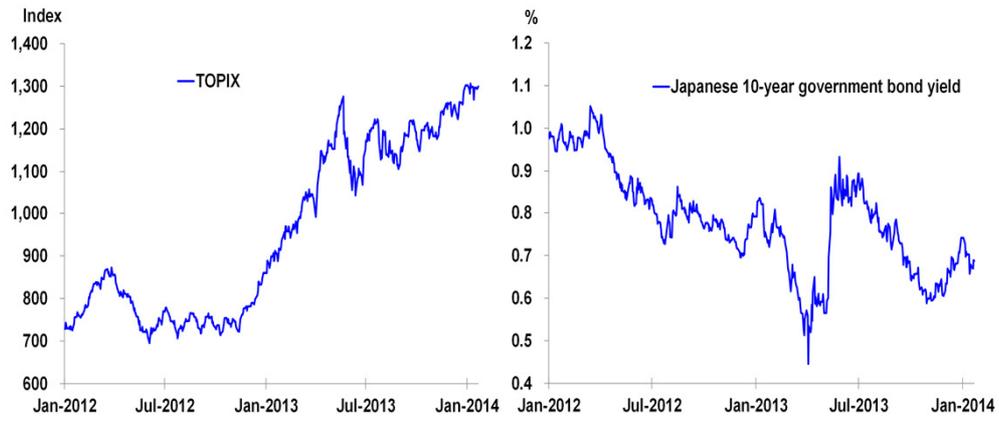


Source: European Central Bank

Note: FR – France, IT – Italy, ES – Spain, PT – Portugal, GR – Greece, IE – Ireland



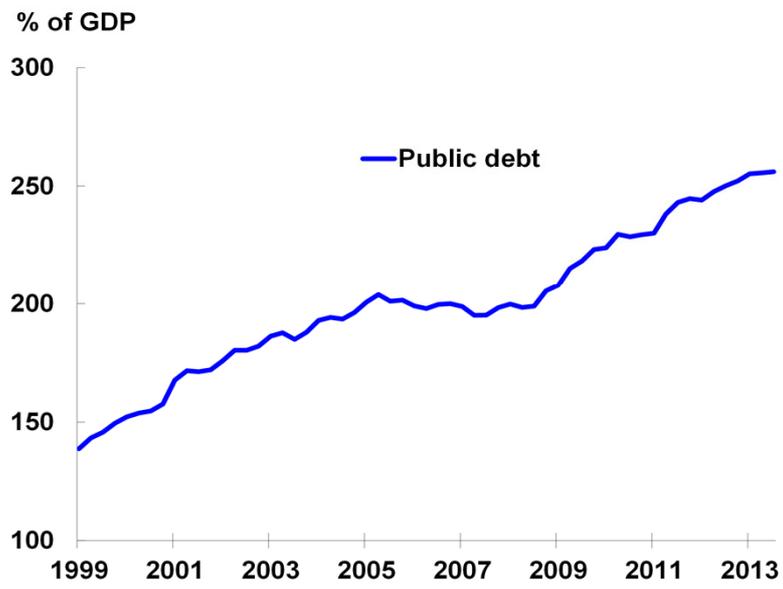
JAPAN: FINANCIAL MARKETS



Source: Bloomberg



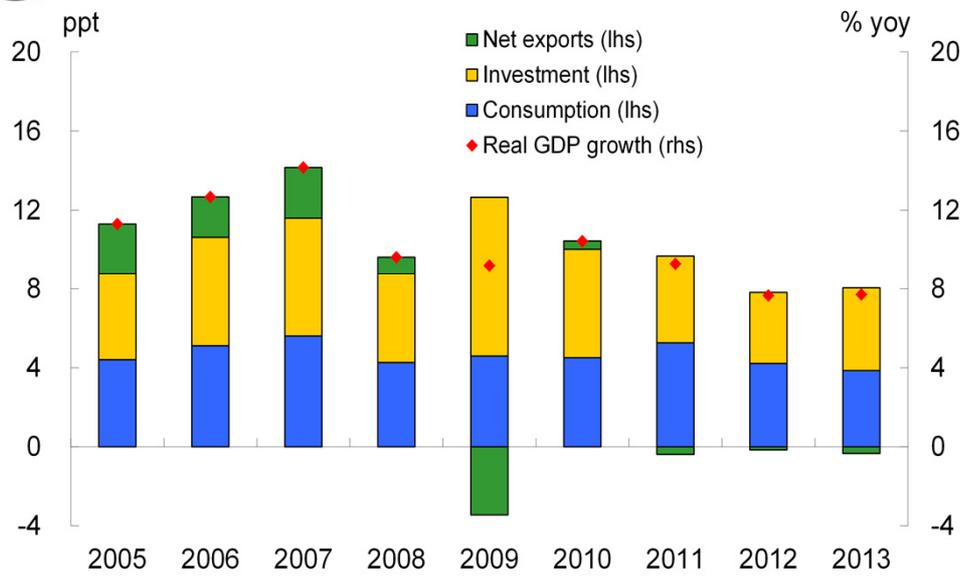
JAPAN: PUBLIC DEBT



Sources: Bank of Japan and CEIC



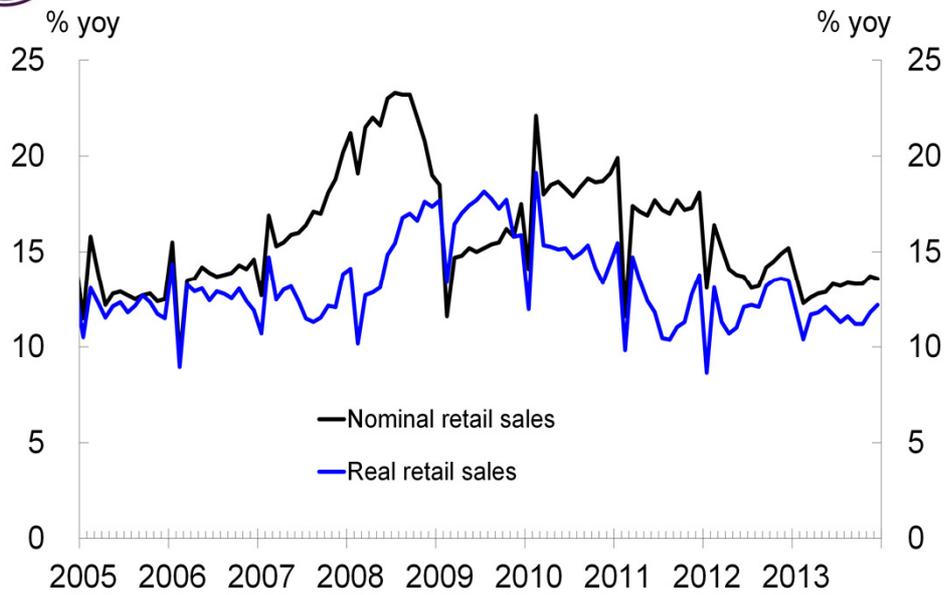
MAINLAND CHINA: REAL GDP GROWTH



Source: CEIC



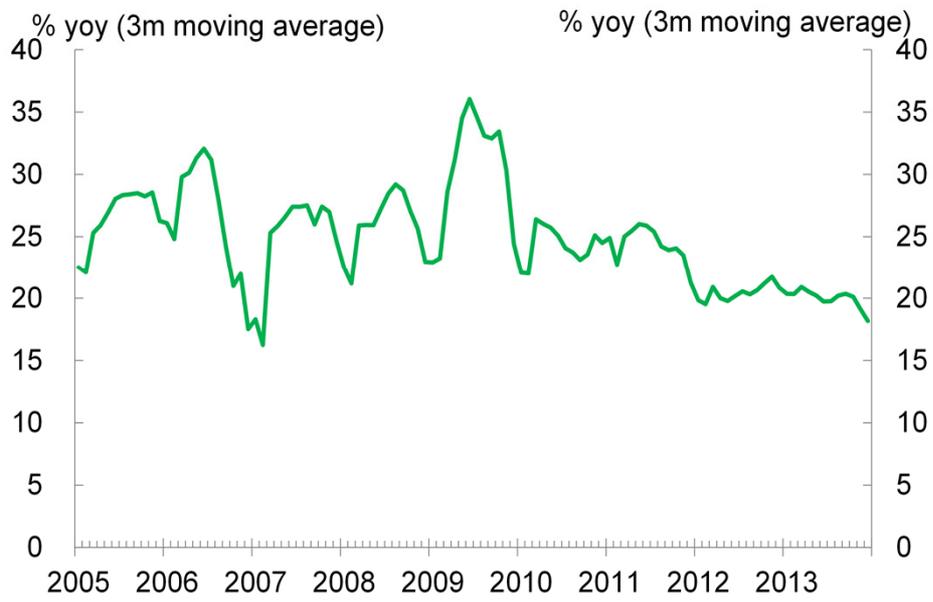
MAINLAND CHINA: RETAIL SALES



Sources: CEIC, WIND and HKMA staff estimates



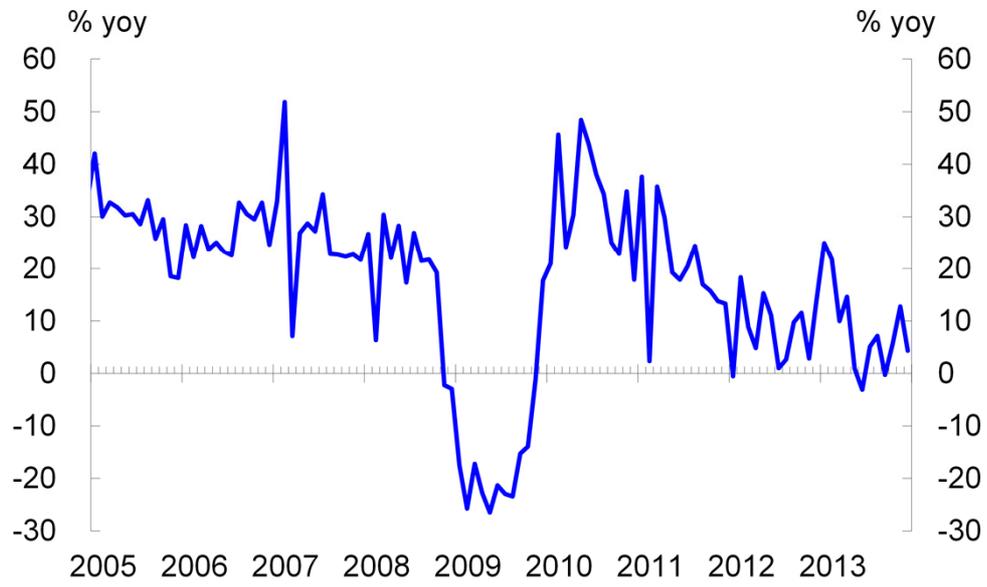
MAINLAND CHINA: FIXED ASSET INVESTMENT



Sources: CEIC and HKMA staff estimates



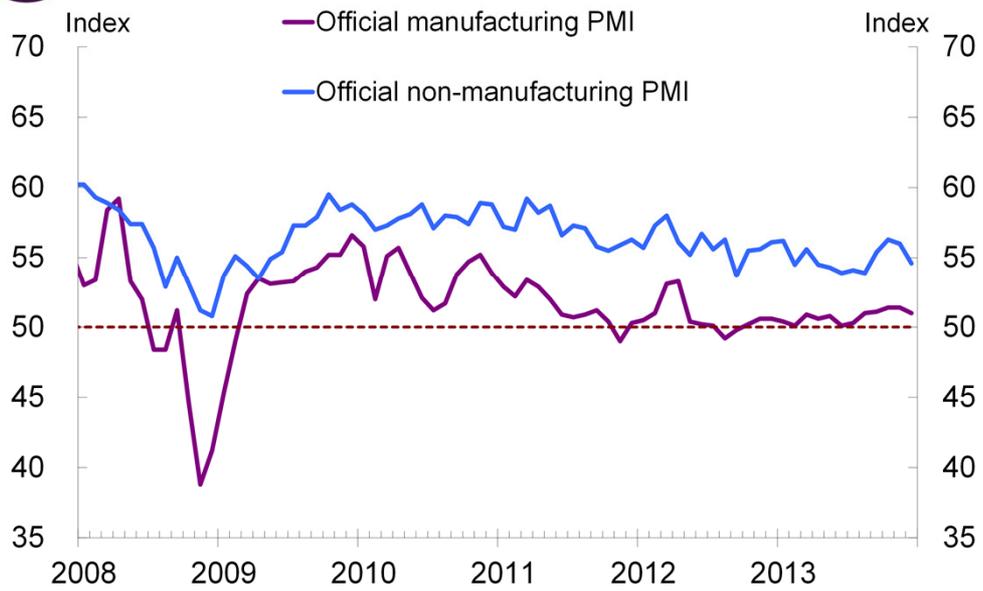
MAINLAND CHINA: EXPORT GROWTH



Sources: CEIC and HKMA staff estimates



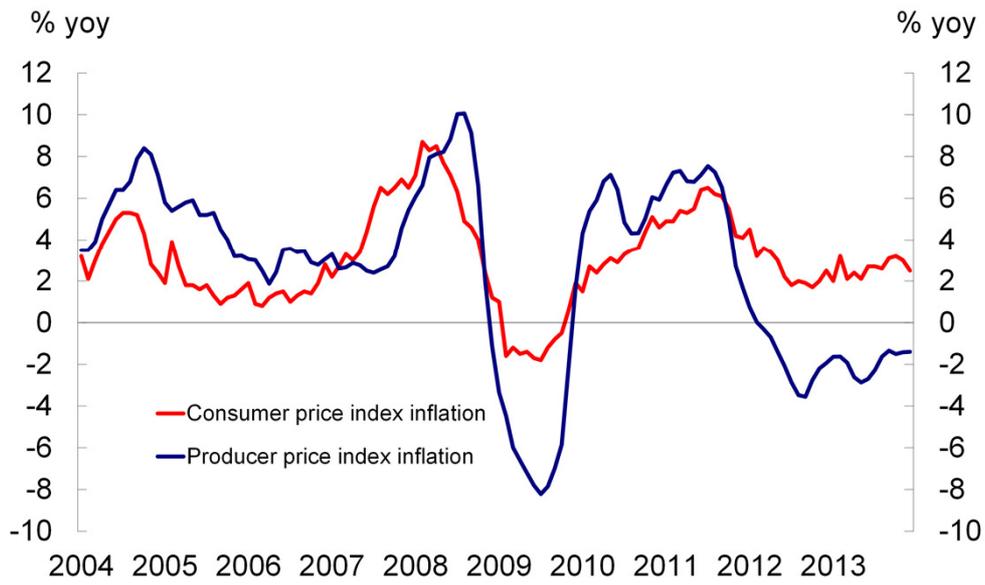
MAINLAND CHINA: PURCHASING MANAGERS' INDEX



Source: CEIC



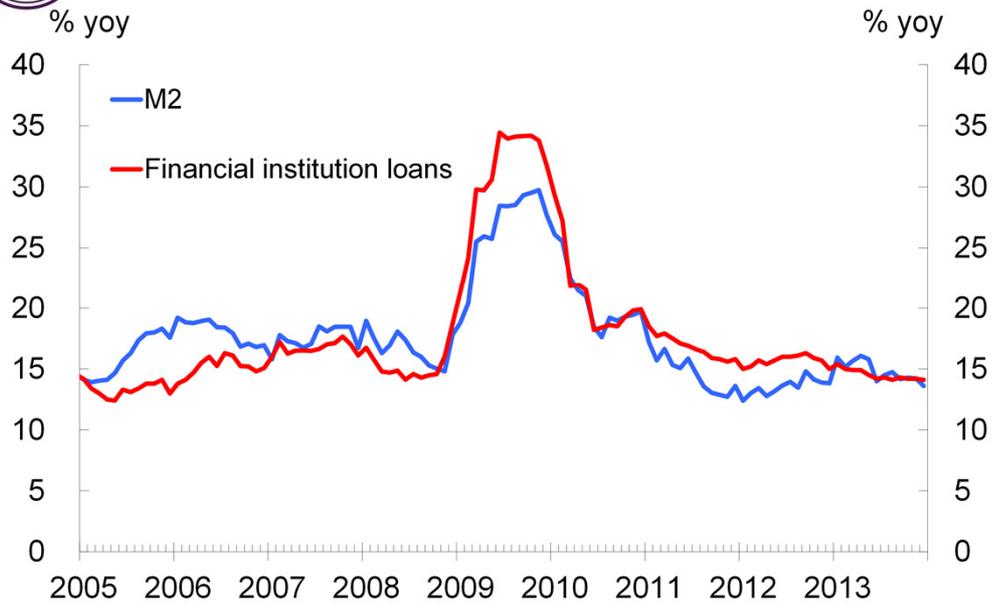
MAINLAND CHINA: INFLATION



Source: CEIC



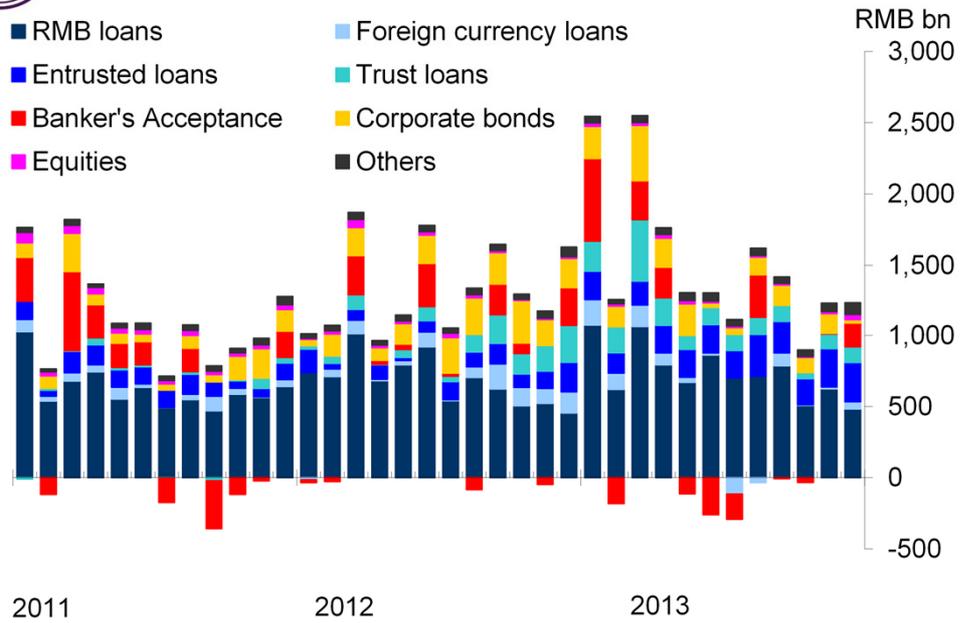
MAINLAND CHINA: MONEY AND LOAN GROWTH



Source: CEIC



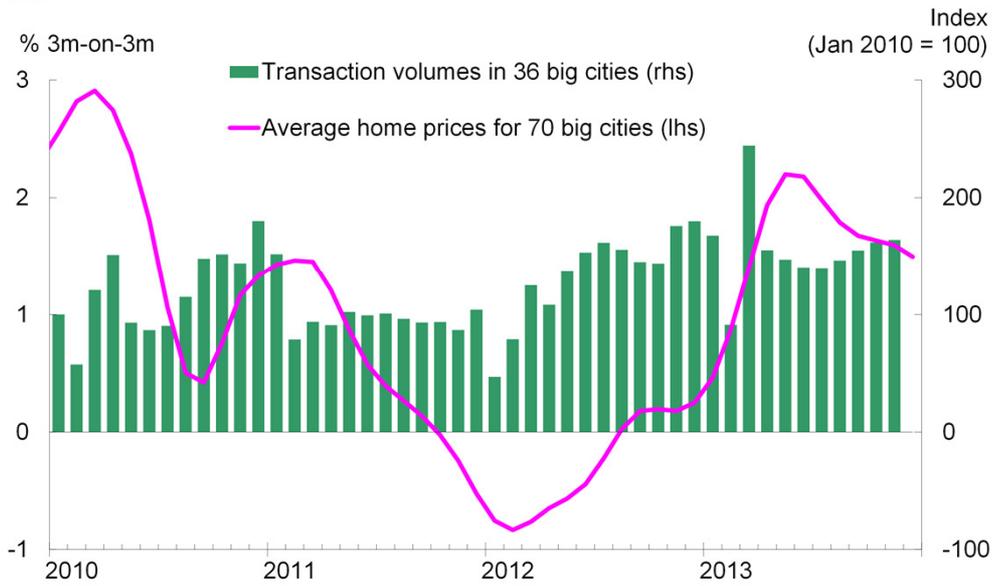
MAINLAND CHINA: TOTAL SOCIAL FINANCING



Source: CEIC



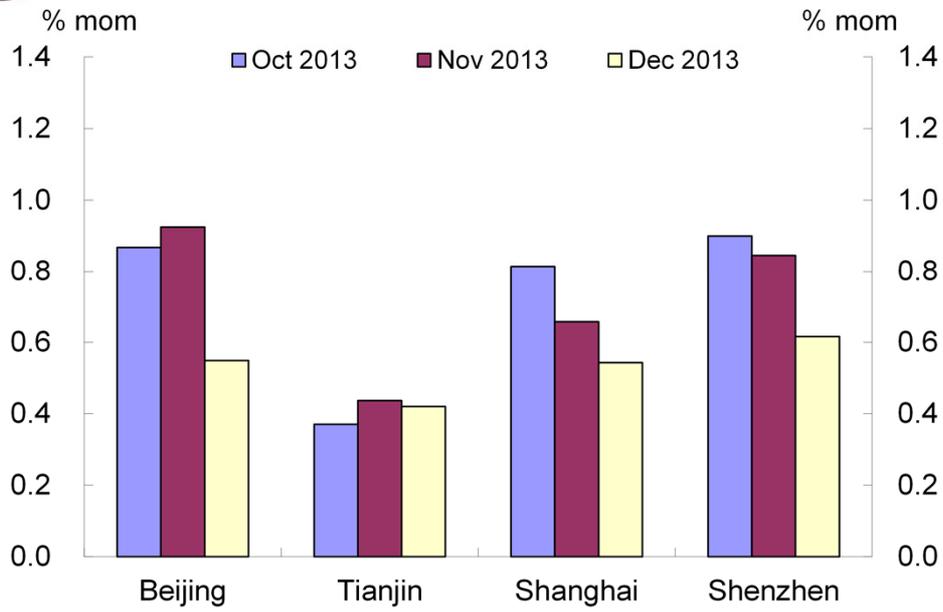
MAINLAND CHINA: PROPERTY TRANSACTION VOLUME AND PRICE CHANGES IN BIG CITIES



Sources: CEIC, WIND and HKMA staff estimates



MAINLAND CHINA: HOUSING PRICE CHANGES IN MAJOR CITIES

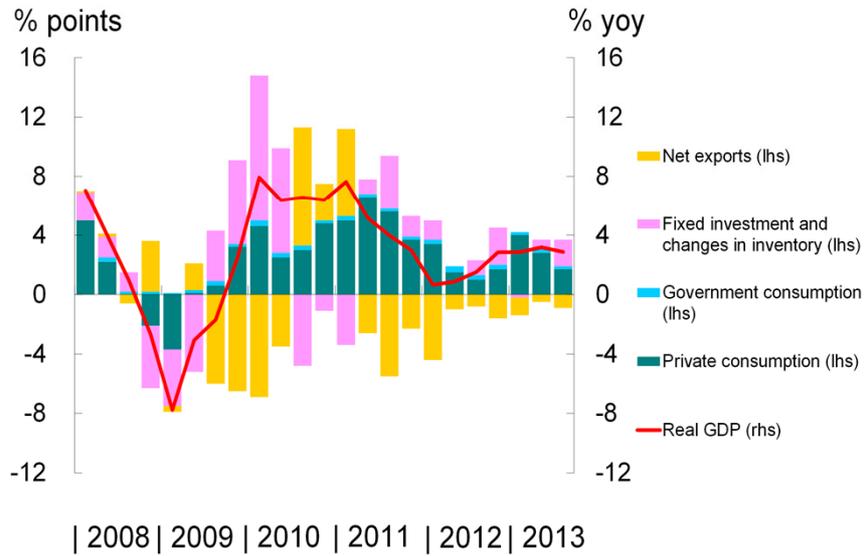


Sources: CEIC, WIND and HKMA staff estimates



HONG KONG: REAL GDP GROWTH

Changes in Real GDP and contributions by major components

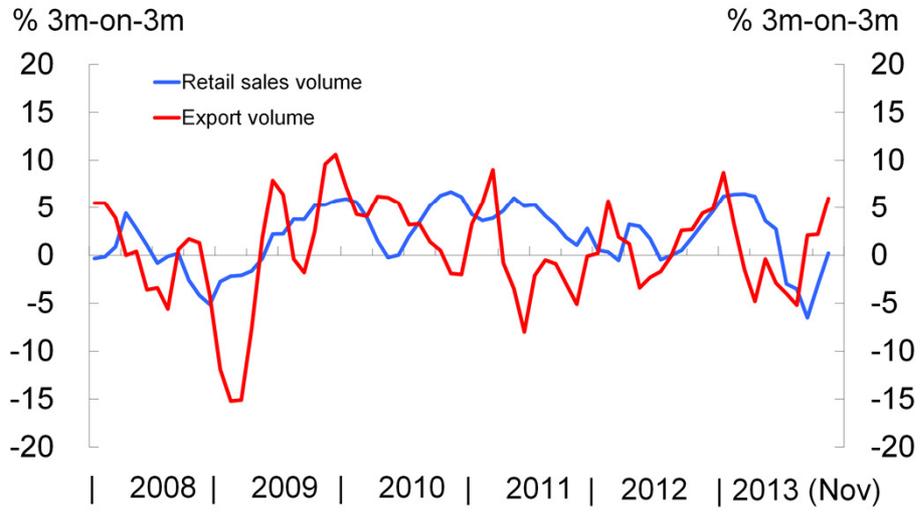


Source: C&SD



HONG KONG: ECONOMIC ACTIVITY

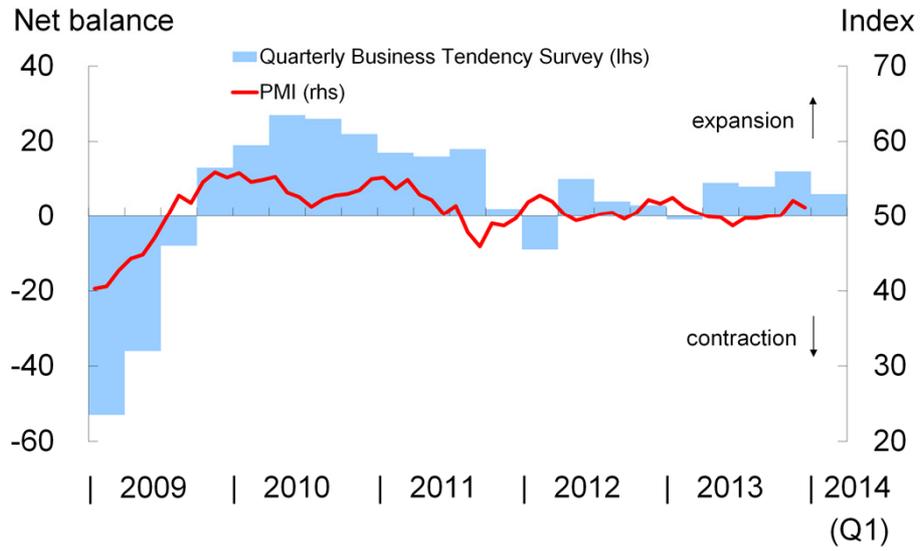
Retail Sales and Exports



Source: C&SD



HONG KONG: BUSINESS OUTLOOK

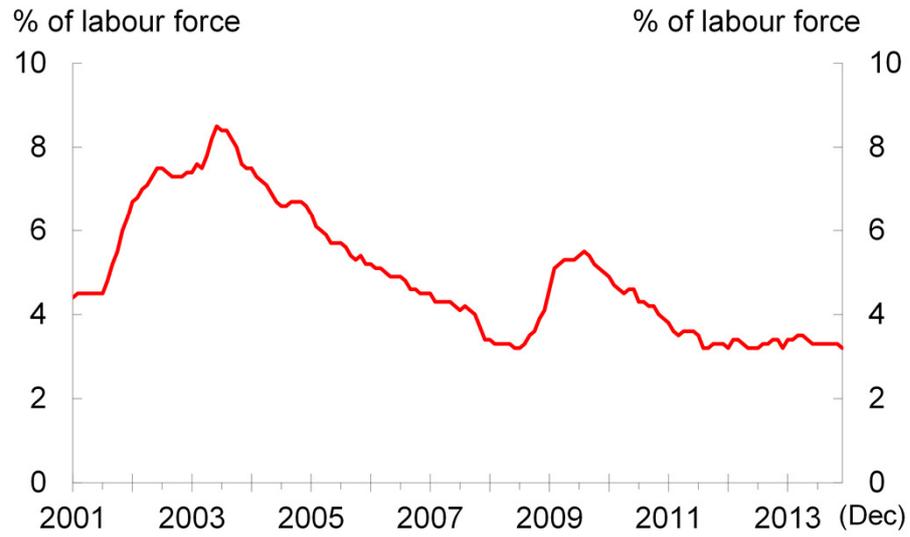


Sources: C&SD and Markit Economics



HONG KONG: LABOUR MARKET

Unemployment rate

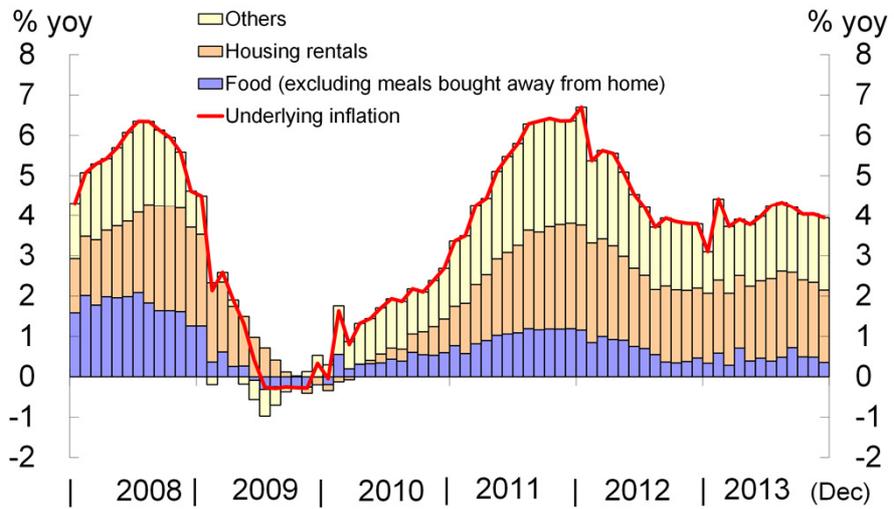


Source: C&SD



HONG KONG: INFLATION

Underlying inflation and contributions of its components

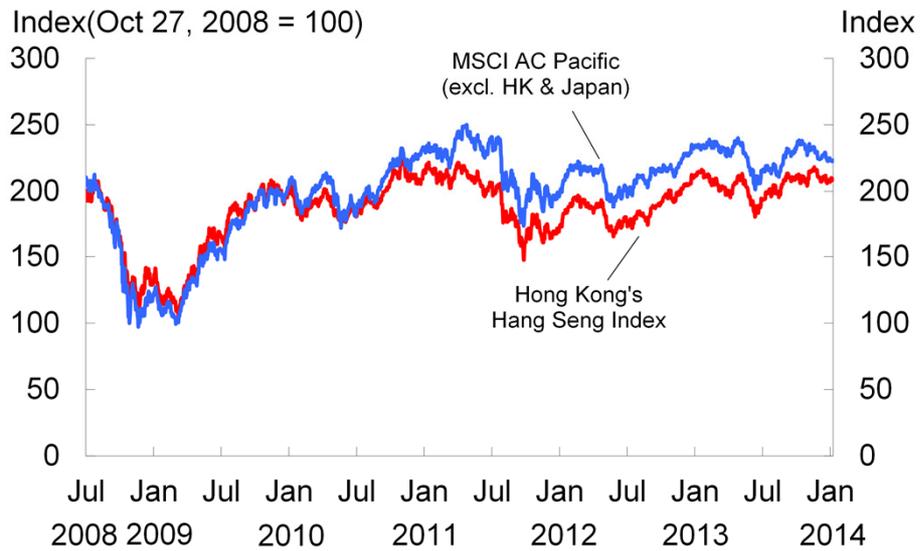


* Underlying inflation: Netting out the effects of all Government's one-off relief measures from headline inflation
Sources: C&SD and HKMA staff estimates



HONG KONG: EQUITY MARKET

Hong Kong and Asia Pacific equity market performance

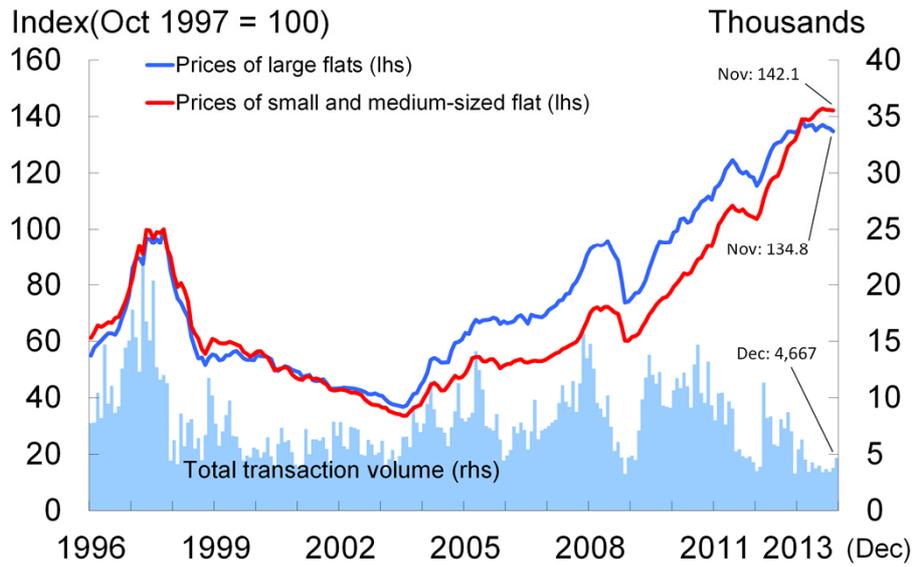


Source: Bloomberg

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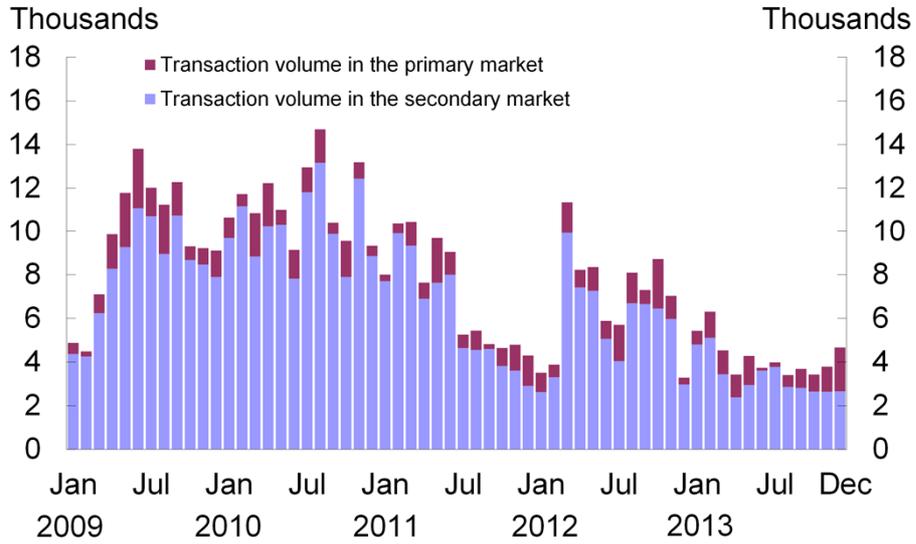
HONG KONG: RESIDENTIAL PROPERTY PRICES AND TRANSACTION VOLUME



Source: Rating and Valuation Department and The Land Registry



HONG KONG: TRANSACTION VOLUME IN THE PRIMARY AND SECONDARY RESIDENTIAL PROPERTY MARKETS

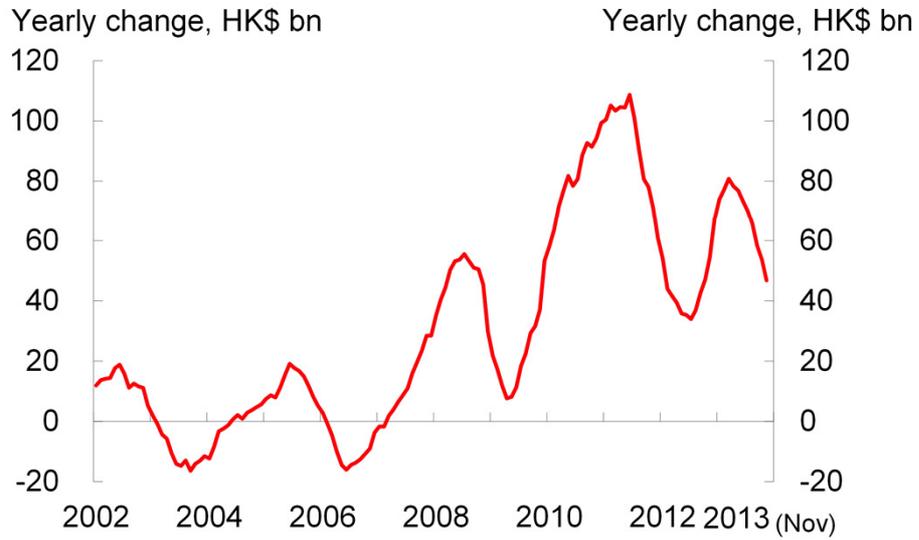


Source: The Land Registry



HONG KONG: OUTSTANDING RESIDENTIAL MORTGAGE LOANS

Changes in outstanding residential mortgage loans

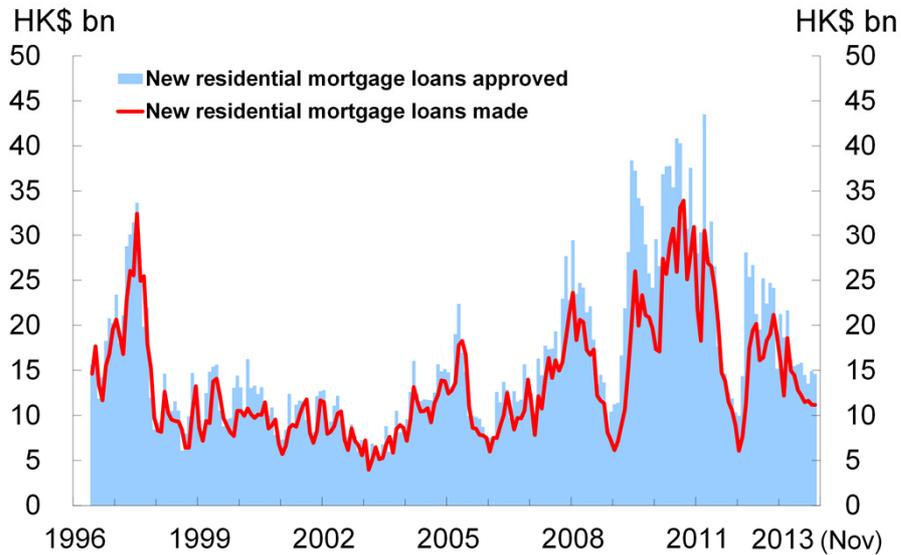


Source: HKMA



HONG KONG: NEW RESIDENTIAL MORTGAGE LOANS

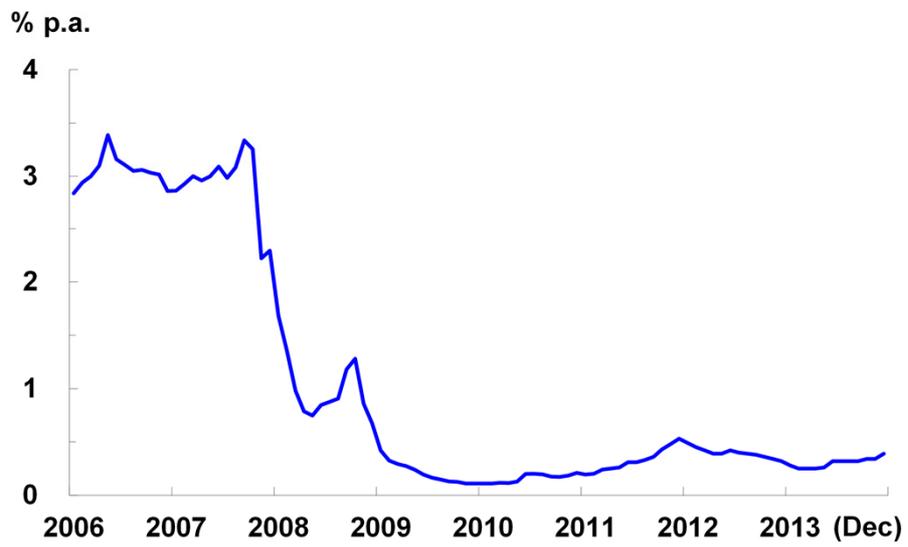
New residential mortgage loans made and approved



* There is a break in data series at December 2000 due to an increase in the number of surveyed institutions
Source: HKMA



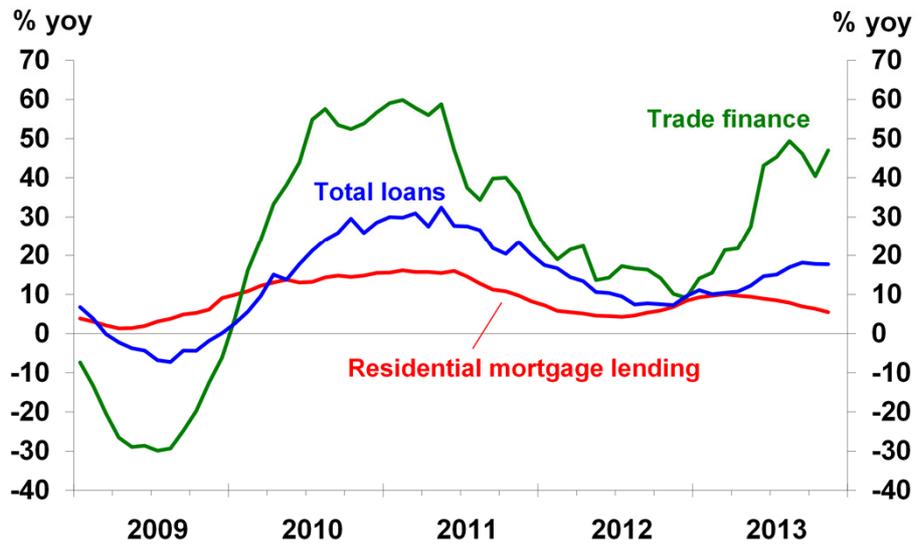
HONG KONG: COMPOSITE INTEREST RATE



Source: HKMA



HONG KONG: LOAN GROWTH



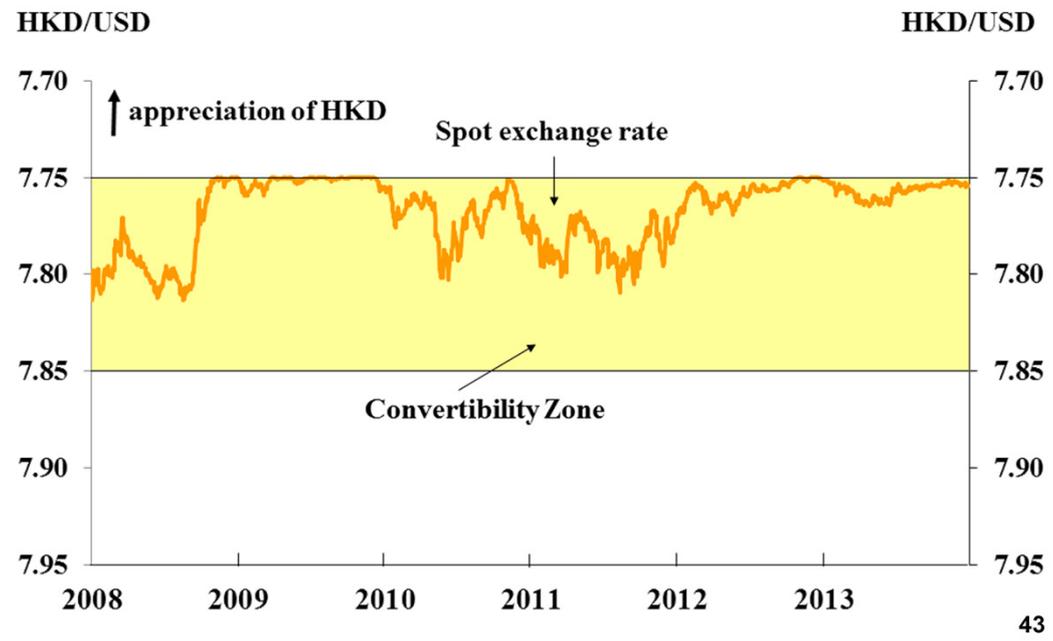
Source: HKMA



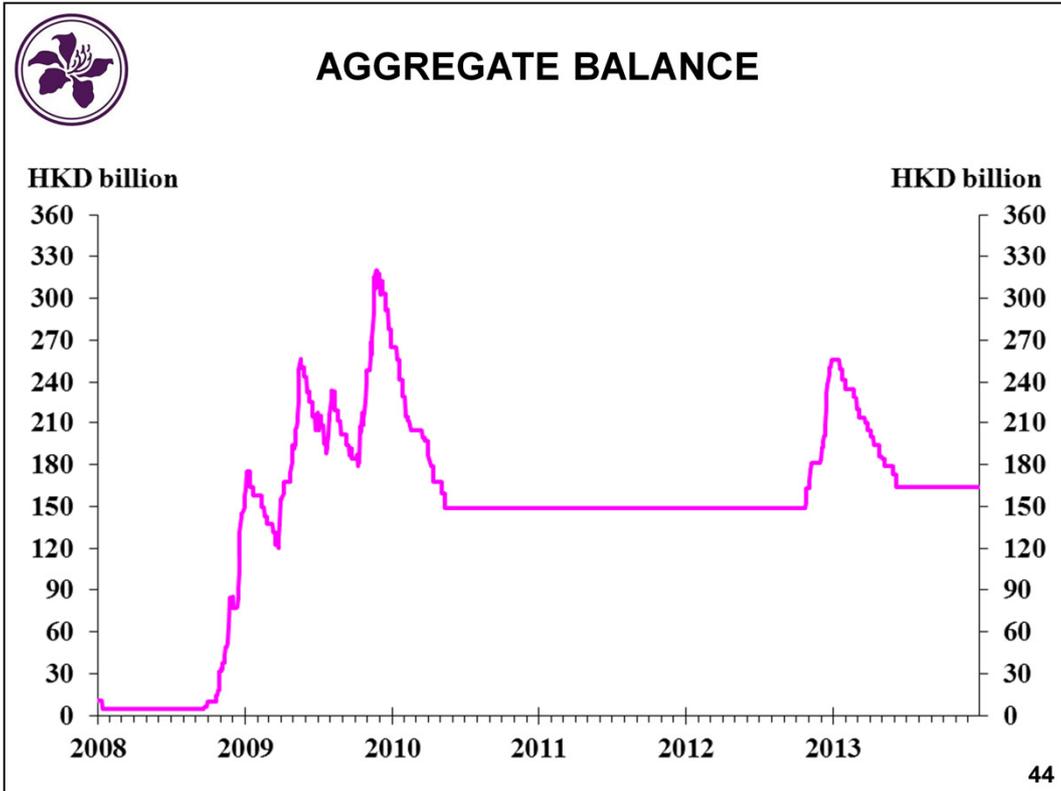
CURRENCY STABILITY



HONG KONG DOLLAR SPOT EXCHANGE RATE



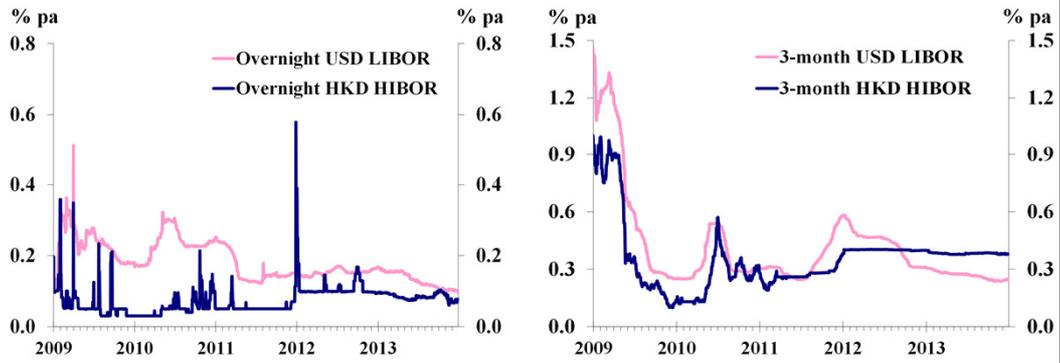
- Global financial markets had been volatile on speculation of the timing and pace of the Fed's tapering, but the HK dollar exchange rate was little affected and remained steady against US dollar.
- There has been no triggering of the strong-side Convertibility Undertaking in 2013.



- The Aggregate Balance has remained steady at around HK\$160 billion since June 2013.



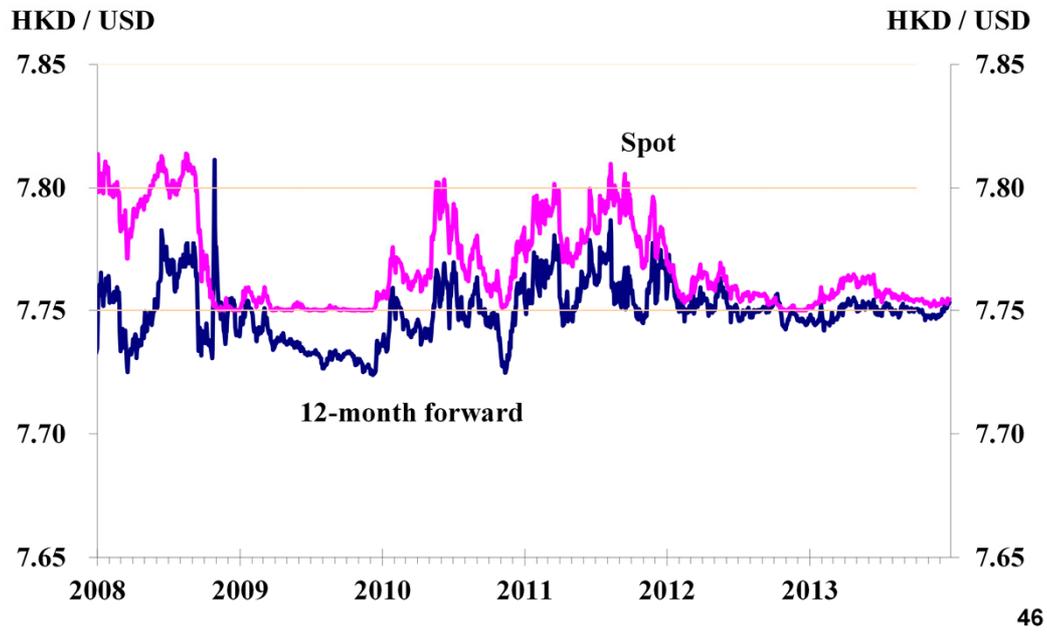
DOMESTIC INTEREST RATES



- Short-term Hong Kong dollar interbank interest rates remained steady.



HONG KONG DOLLAR FORWARD EXCHANGE RATE



- 12-month HKD forward exchange rate was broadly steady.

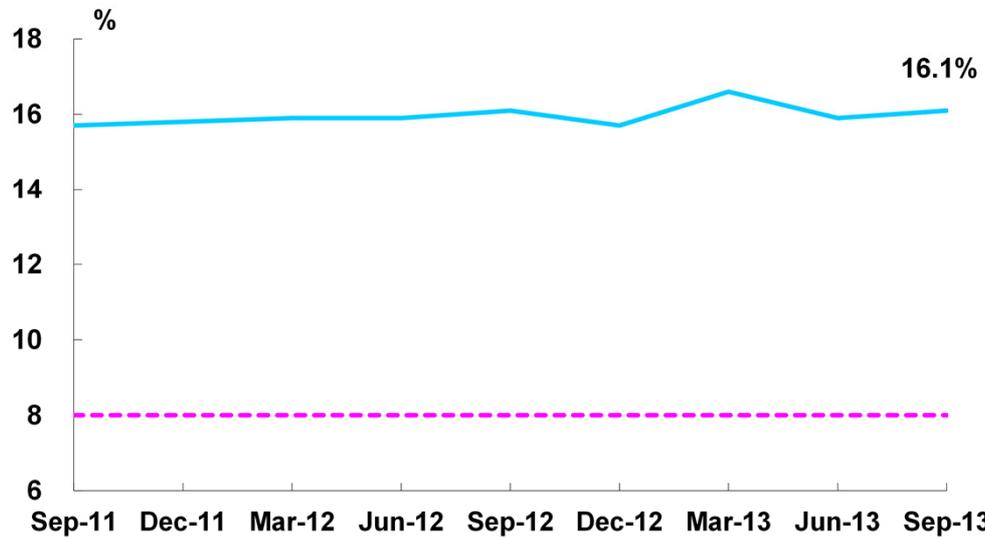


BANKING STABILITY



BANKING SECTOR PERFORMANCE

Locally incorporated AIs continued to be well capitalised



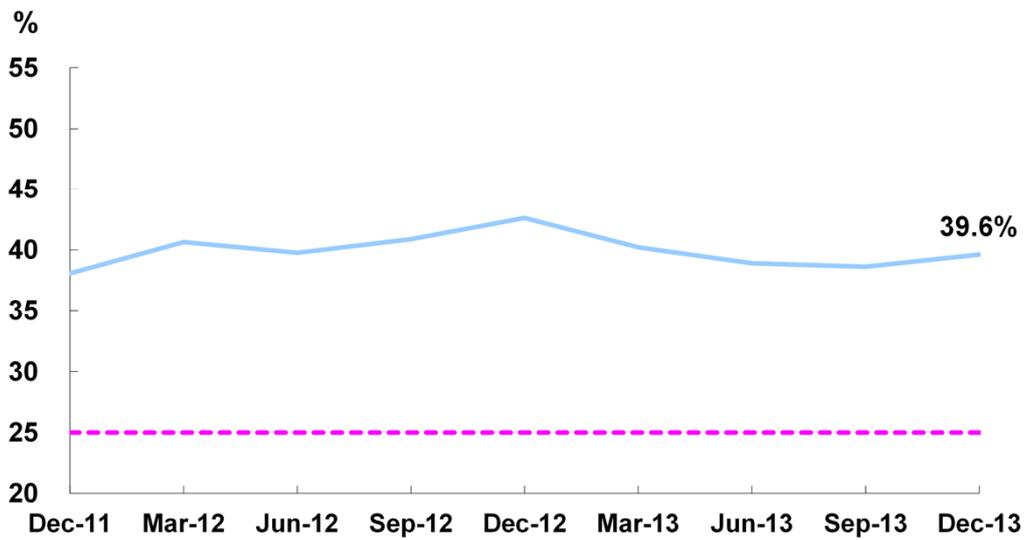
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- The consolidated capital adequacy ratio (CAR) of locally incorporated AIs improved to 16.1% at end-September 2013 from 15.9% at end-June 2013 due to a faster increase in capital base (+4.8%) than the increase in the risk-weighted amount (+3.4%). The consolidated CAR remained well above the international standard of 8%.



BANKING SECTOR PERFORMANCE

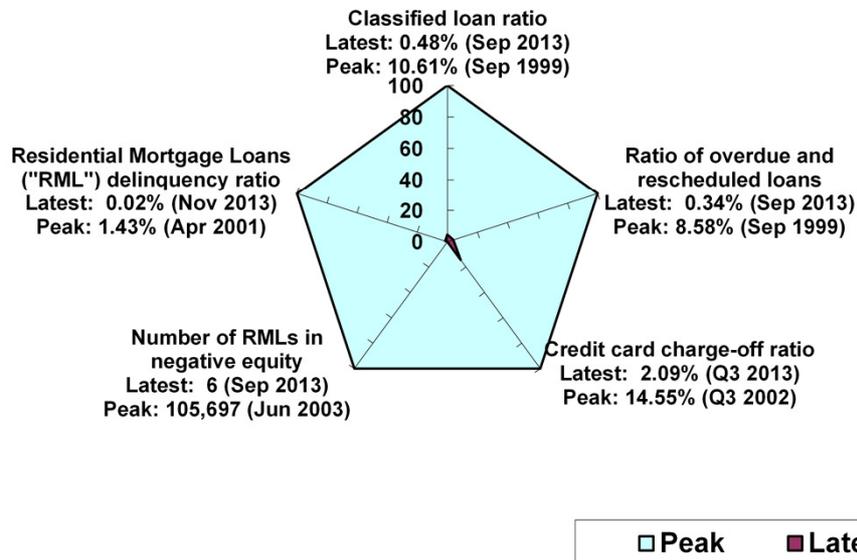
Quarterly average liquidity ratio of retail banks remained well above statutory minimum of 25%





BANKING SECTOR PERFORMANCE

Asset quality remained good compared with historical standards



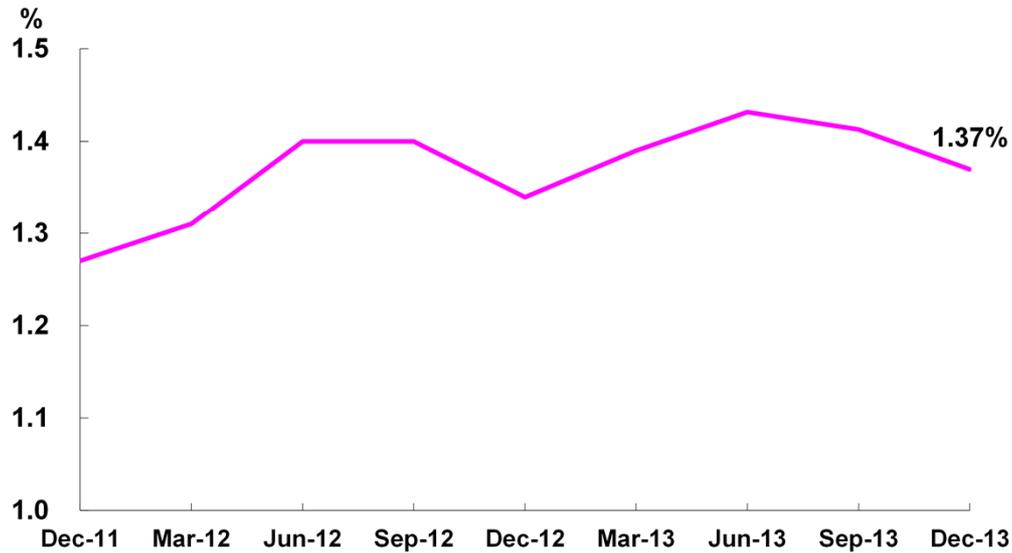
50

- The HKMA will continue to monitor closely the asset quality of retail banks' loan portfolios.



BANKING SECTOR PERFORMANCE

Net interest margin of retail banks



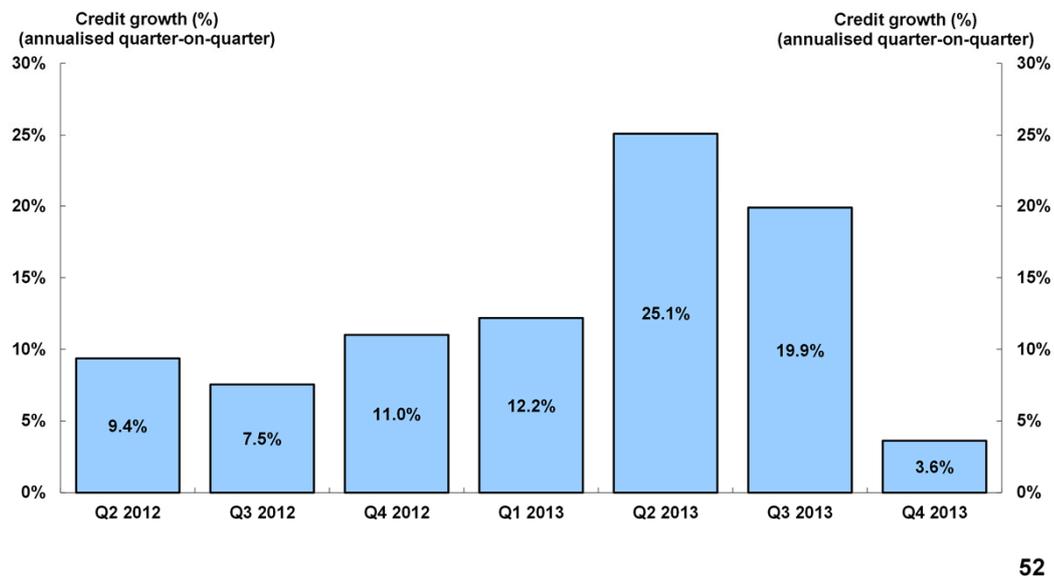
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- The quarter-on-quarter annualised net interest margin (NIM) of retail banks' Hong Kong offices edged down to 1.37% in Q4/2013 from 1.41% in Q3/2013.
- On a yearly basis, the NIM widened to 1.40% in 2013 compared with 1.36% in 2012. The widening of the NIM was due to an 13% increase in net interest income during the year.
- The aggregate pre-tax operating profit of retail banks' Hong Kong offices in 2013 increased by 22.1% compared with a year ago. Moderate increases in both net interest income (+13%) and in non-interest income (+15.2%) contributed to the profit growth.



CREDIT GROWTH

Credit growth eased after high growth in Q2 and Q3 of 2013



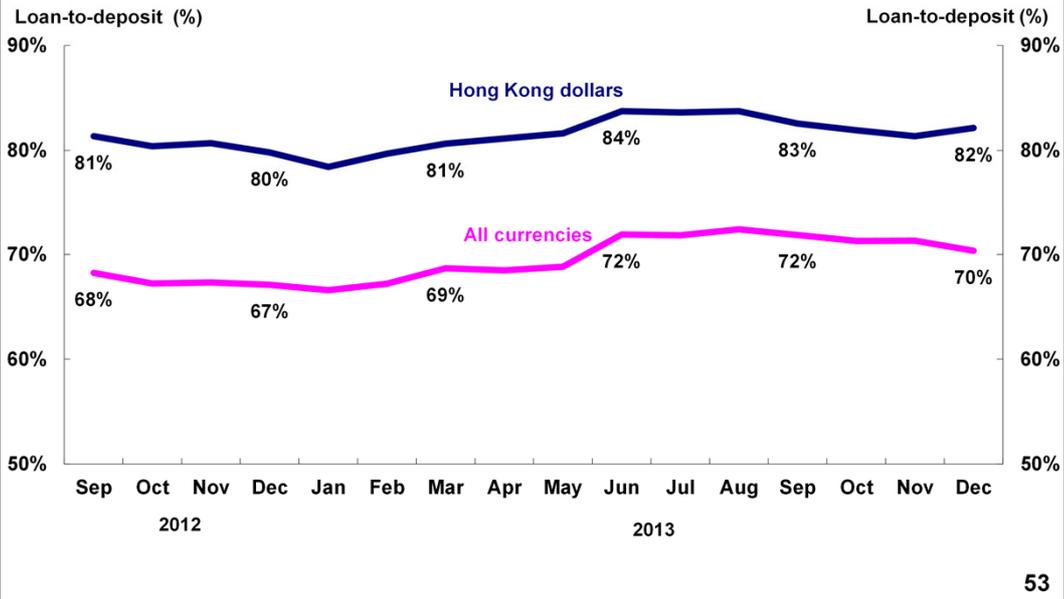
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- In light of the high loan growth during the first three quarters of 2013 and possible volatility in the global markets, the HKMA wrote in October to inform certain banks with faster credit growth of the Stable Funding Requirement to be implemented in 2014, which is a continuation of the tenor matching requirement introduced in 2011 to further enhance banks' liquidity risk management. In the fourth quarter of 2013, credit growth slowed down to 3.6% on an annualised basis.
- The HKMA will continue to monitor credit growth of the banking sector.



CREDIT GROWTH

Loan-to-deposit ratios of banks in Hong Kong slightly reduced

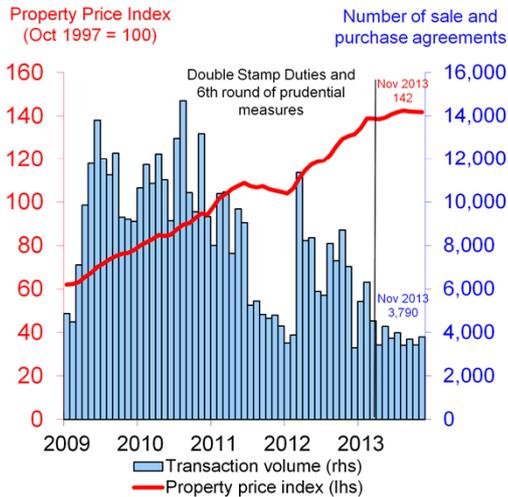


- Owing to a faster increase in Hong Kong dollar deposit (+0.8%) than the increase in Hong Kong dollar loan (+0.3%), Hong Kong dollar loan-to-deposit ratio edged down to 82% at end-December 2013 from 83% at end-September 2013.
- The HKMA will continue to monitor movement of the loan-to-deposit ratio.



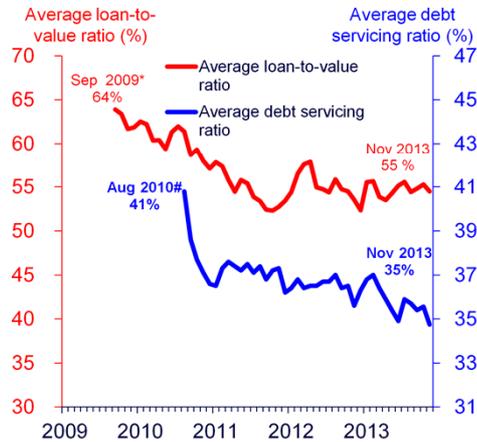
RISK MANAGEMENT OF PROPERTY MORTGAGE LOANS

Residential property price index and transaction volume



Sources: R&VD and Land Registry

Average loan-to-value ratio and debt servicing ratio for new residential mortgage loans approved



* Before the first round of HKMA's prudential measures was introduced

When the tighter requirement on debt servicing ratio was introduced

Latest statistics for residential mortgage loans ("RMLs")

	Monthly average in 2011	Monthly average in 2012	8/2013	9/2013	10/2013	11/2013
Number of sale and purchase agreements	7,039	6,778	3,407	3,686	3,426	3,790
Number of new RML applications	12,644	11,634	8,043	7,526	8,587	7,567
Number of new RMLs approved	9,224	8,210	5,399	4,904	5,535	5,241

Latest statistics for residential property prices

Property price index		Period	Property price index
R&VD (10/1997=100)	Latest position	11/2013	141.7
	Recent Peak	8/2013	142.5
	Peak in 1997	10/1997	100.0
Centaline (6/7/1997=100)	Latest position	12/1/2014	117.7
	Recent Peak	8/9/2013	121.9
	Peak in 1997	19/10/1997	102.9

The HKMA will continue to closely monitor mortgage market developments and introduce appropriate measures as and when necessary to safeguard banking stability.



ENHANCING RISK MANAGEMENT OF PERSONAL LOANS

- The level of household indebtedness has been rising to an extent that surpassed the level during the Asian Financial Crisis
- Personal loan is one of the key drivers behind the rising trend of household indebtedness
- The HKMA has required AIs to adopt prudent underwriting practices:
 - Set binding debt servicing ratio limit
 - Refrain from offering personal loans with long tenors
 - Establish granular internal portfolio limits
 - Conduct stress tests on personal loans portfolios

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- The ratio of household indebtedness to GDP has increased from 50.4% in December 2007 before the global financial crisis to 61.2% in September 2013, surpassing the levels recorded during the 1997/98 Asian financial crisis: the ratio rose from 48.3% in December 1997 to 59.6% in December 2002.
- The size of loans and advances granted for other private purposes had grown from HKD208.7 billion in December 2007 to HKD343.1 billion in September 2013.
- AIs should adopt the following prudential measures for personal loans:
 - Debt servicing ratio (DSR)
 - DSR limits should be binding
 - DSR limits should be granular (longer tenor loans subject to lower DSR limits)
 - DSR calculation should include repayments of both secured and unsecured loans
 - Loan tenor
 - Tenors should be consistent with loan purposes
 - AIs should generally refrain from offering long tenor loans, subject to justifiable exceptions
 - Portfolio-based limit structure
 - AIs should set overall internal portfolio limit
 - AIs should set internal portfolio sub-limits for higher risk loans (e.g. long tenor loans, high DSR loans, etc) with proper justifications
 - Internal stress testing
 - AIs should conduct internal stress tests on their personal loan portfolios, assuming a 300 basis point increase in personal loans' interest rate and taking appropriate actions if called for by the stress test results



BASEL III IMPLEMENTATION PROGRESS

Capital standards

- 2nd phase
 - Capital buffers
 - Higher loss absorbency for global systemically important banks / domestic systemically important banks

Liquidity standards

- Liquidity Coverage Ratio

Legislative changes (in 2014) to:

- Banking (Capital) Rules
- Banking (Disclosure) Rules
- Banking (Liquidity) Rules

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Capital standards

- 2nd phase implementation:
 - Capital buffers: The second phase of implementation of the Basel III capital standards covers 3 complementary types of capital buffer. Whilst banks are in the “buffer zone” they are subject to restrictions on the distributions they can make, in order to rebuild capital. There is a capital conservation buffer which will be phased in to reach a level of common equity tier 1 capital equal to 2.5% of a bank’s risk weighted assets. There is a countercyclical capital buffer designed to be switched on when there is excessive credit growth with systemic implications and switched off when the credit cycle turns down (to facilitate continued lending into the downturn). The HKMA is currently consulting the banking industry on the operation of the countercyclical buffer in Hong Kong. Finally, banks that are designated as systemically important will need to hold a further buffer of common equity (a higher loss absorbency requirement) to enhance their resilience in view of the systemic risk they pose. The HKMA is shortly going to consult the industry on a framework for the identification of DSIBs in Hong Kong. The Basel Committee has produced an assessment methodology for GSIBs.

Liquidity standards

- The HKMA has since 2012 undertaken a series of industry consultations on the implementation of the Basel III liquidity standards (viz. the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio) in Hong Kong. The last consultation in July of 2013, which reflected revisions to the LCR made by the Basel Committee in early 2013 and the industry comments from the previous consultations, closed in September 2013. Having considered the comments received, the HKMA refined and communicated its policy proposals to the industry in December 2013.

Legislative changes (in 2014) to:

- Banking (Capital) Rules:

The 2nd phase Basel III standards are scheduled to take effect from Jan 2016 but the legal framework is required to be in place one year before (i.e. from Jan 2015). Preparation for amending the Banking (Capital) Rules is therefore underway.
- Banking (Disclosure) Rules:

Under the Basel Committee’s transition timetable, banks are required to make disclosures in relation to the Basel III leverage ratio from 1 January 2015 (although the ratio is not scheduled to become a binding standard until 2018). The HKMA is undertaking preparatory work for the purpose of amending the Banking (Disclosure) Rules during 2014 to incorporate the relevant leverage ratio disclosure requirements as well as the required disclosures associated with the capital buffers and the liquidity standards.
- Banking (Liquidity) Rules:

The HKMA will develop a set of Banking (Liquidity) Rules in 2014 to introduce the LCR and a modified version of the existing Liquidity Ratio (MLR). The Rules are expected to be submitted to LegCo in the fall of this year to ensure timely implementation of the LCR and the MLR from 1 January 2015.



CROSS-SECTOR RESOLUTION REGIME FOR HONG KONG

- Legislative reform to meet international standards: Financial Stability Board (FSB)'s "Key Attributes of Effective Resolution Regimes"
- Fill gaps in HK regulators' existing toolkits to support resolution of failing financial institutions
- Three-month public consultation started on 7 January 2014
- Second consultation exercise later in 2014, with a view to implementation by FSB's end-2015 deadline

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- As highlighted to the FAP in November 2013, as part of policy measures designed to reduce the risks posed by systemically important financial institutions (SIFIs), the FSB set new standards for resolution (in its "Key Attributes of Effective Resolution Regimes for Financial Institutions") in late 2011.
- The authorities (in self-assessments) and the FSB (in a peer review) identified a series of gaps in the existing toolkits available to the Hong Kong regulators when compared with these new standards. Legislative reform is necessary to fill these gaps and provide for an effective resolution regime such that in the event that any SIFI were to reach a point of non-viability in the future, the authorities will be in a position to deal with it effectively in a manner that protects both financial stability and public funds.
- FSTB, together with HKMA, SFC and the OCI, issued an initial public consultation paper setting out the authorities' initial thinking and proposals, on 7 January 2014 for a three-month consultation (ending on 6 April 2014).
- To meet the FSB's end-2015 deadline for implementation of the Key Attributes by all member jurisdictions, and to ensure that Hong Kong does not fall behind other key financial centres, it is proposed that a second public consultation exercise take place later in 2014, with a view to introducing a draft Bill into LegCo by early-2015.



INVESTOR AND CONSUMER PROTECTION

- Developing an enhanced competency framework for private wealth management practitioners
- Issued a circular to give guidance in respect of cross-border business activities
- Continued to participate in the work of the Organisation for Economic Co-operation and Development Task Force on Financial Consumer Protection in developing effective approaches to support the implementation of the G20 High-Level Principles on Financial Consumer Protection
- Worked with the industry to introduce the Treat Customers Fairly Charter, in support of which all retail banks have abolished dormant account fee, and will adopt various arrangements to help low-income customers in relation to low-balance fee

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- With a view to raising the competence and ethics of industry practitioners and to developing and maintaining a pool of professional talents for the private wealth management (PWM) industry in Hong Kong, the HKMA has been providing advice and assistance to the industry and the local professional bodies to develop an enhanced competency framework (ECF) covering the requisite level of competence and on-going professional development of PWM practitioners. Industry consultation on the detailed proposal was completed in December 2013, with general support from the respondents for the ECF. Industry comments are being considered before finalising the ECF. Meanwhile, preparatory work in relation to the provision and accreditation of relevant training programmes is underway.
- Given the potential regulatory risk that may arise from cross-border business activities of AIs, the HKMA issued a circular in December 2013 to remind AIs to put in place appropriate procedures and internal controls to ensure compliance with applicable legal and regulatory requirements, including procuring proper legal or professional advice, providing clear guidance to staff and agents, and monitoring their cross-border activities.
- The HKMA is a member of the Task Force on Financial Consumer Protection of the Organisation for Economic Co-operation and Development (OECD) (the Task Force) and has been participating actively in the development of the G20 High-level Principles on Financial Consumer Protection. Following the publication of the Principles in October 2011, the Task Force has been developing effective approaches to support the implementation of the Principles. The Task Force's summary report on effective approaches to support the implementation of the three priority principles (namely, "Disclosure and Transparency", "Responsible Business Conduct of Financial Services Providers and Authorised Agents", and "Complaints Handling and Redress") was endorsed in the G20 Summit held in September 2013. The Task Force is now developing the effective approaches to support the implementation of the remaining 7 principles. The HKMA will continue to contribute to the work of the Task Force.
- The HKMA has worked with the industry to introduce a Treat Customers Fairly Charter, as a catalyst for fostering a stronger risk culture towards fair treatment of customers at all levels of the bank and at all stages of their relationship with customers. All the 22 retail banks in Hong Kong have signed up to the Charter on 28 October 2013, pledging to support and implement the principles. The HKMA is consulting the industry associations on the generic examples of measures to support implementation of the Charter principles.
- To promote the principles of the Charter, the HKMA has discussed with the banks on the possible abolition of dormant account fees, waiver of low-balance fees for vulnerable groups and measures to help low-income customers. In response, all retail banks which previously charged dormant account fee have abolished such fee. As for banks which charge low-balance fee, they will adopt various arrangements to help low-income customers, including treating them as vulnerable customers in waiving low-balance fee, or providing them with unlimited or limited free access to branch counter services in relation to their use of basic bank accounts which do not have minimum balance requirement.



CONSUMER EDUCATION

- Consumer education programme launched in Q4 2013 to help the public to be “smart and responsible” in the use of banking services, e.g. ATMs, internet banking through computers and smartphones and spending with credit cards

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- The HKMA's consumer education programme aims to promote smart and responsible use of different banking services, e.g. self-banking services and credit cards (through various channels), including broadcasting smart tips on radio stations, placing feature articles and illustrations on newspapers and magazines, arranging seminars to senior secondary school students and uploading relevant materials on the HKMA website.
- Apart from the above, we are also consulting various stakeholders (such as Hong Kong Association of Banks, Consumer Council, Investor Education Centre, Education Bureau and the Police) to develop new themes for 2014/15.



DEPOSIT PROTECTION

- Conducted rehearsal in December 2013 to test contingency plan for handling payout. Results were satisfactory
- Maintained high public awareness in Q4 2013 through series of advertising campaigns through various media channels
- Reviewing the annual returns of relevant deposits submitted by Deposit Protection Scheme member banks and preparing for contribution collection

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- In Q4 2013, a rehearsal exercise was conducted to extensively test the contingency plan for handling different banking crisis scenarios and their respective payout arrangements. The results of the rehearsal demonstrated that the payout process was managed in an efficient and effective manner. Areas for further improving the payout procedures and payout system were identified and will be rectified.
- The second-burst of advertising campaign was completed by December 2013, with a newly produced series of 1-minute infotainments broadcasted on TV. The campaign maintained public awareness of the Deposit Protection Scheme at a high level. As revealed in a survey, 77% of the interviewees aware of the Scheme.
- All Scheme members submitted their annual returns of relevant deposits on schedule. The returns are now being reviewed for accuracy and deposit data in the return will be used for assessment of amount of contribution payable by member banks.



FINANCIAL INFRASTRUCTURE



REFORMING OTC DERIVATIVES MARKET

G20 Commitments

- All standardised OTC derivative contracts should be traded on exchanges/electronic trading platforms and cleared through central counterparties
- OTC derivative contracts should be reported to trade repositories

Implementation

• **Regulation:**

- Introduced the Securities and Futures (Amendment) Bill 2013 into the Legislative Council in July 2013 to implement the clearing and reporting requirements
- Interim Reporting Requirements :
 - As an interim measure before the new legislation comes into effect, the HKMA issued a circular letter in end-June 2013 to require the reporting of specified OTC derivative transactions between licensed banks to the trade repository developed by the HKMA. The interim reporting requirements took effect from 5 August 2013

• **Central Counterparty:**

- HKEx has developed a local central counterparty for OTC derivatives, which commenced operation in Q4 2013

• **Trade Repository:**

- The HKMA launched the trade repository (TR) for OTC derivatives as scheduled. The TR serves the dual functions of facilitating central clearing at the central counterparty of the HKEx and supporting implementation of mandatory TR reporting in Hong Kong

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- Following the public consultation on the proposed regulatory regime for the OTC derivatives market in October 2011, the HKMA and SFC published the consultation conclusions to respond to the comments received from the consultation and issued a supplemental consultation paper on the proposed scope of new/expanded regulated activities and the oversight of systemically important participants in July 2012. In September 2013, the HKMA and SFC jointly published the supplemental consultation conclusions.
- The detailed requirements of the new regulatory regime will be set out in the subsidiary legislation in the form of rules. The HKMA and SFC aim to conduct a public consultation on the draft subsidiary legislation in Q1 2014.
- The Financial Stability Board has requested its member jurisdictions to provide confirmation by July 2013 that legislation and regulation have been in place to require reporting of OTC derivative transactions to trade repositories. In this connection, as an interim measure before the new legislation comes into effect, the HKMA issued a circular letter on 28 June 2013, which require the reporting of specified OTC derivative transactions (i.e. interest rate swaps and non-deliverable forwards) between licensed banks to the trade repository developed by the HKMA. The interim reporting requirements took effect from 5 August 2013, and certain transitional arrangements are in place to allow for a smooth transition.
- The local TR was launched in two stages – the first stage was launched in December 2012 to support central clearing; the second stage was launched in July 2013 to support mandatory reporting.



GOVERNMENT BOND PROGRAMME

Institutional Bond Issuance Programme:

- 15 issues totalling HK\$77.5 billion were issued as at end 2013
- A yield curve from two years to ten years is established to form the basis for other issuers to price their issues

Liquidity enhancement measures for institutional bonds :

- The Government briefed the Panel on Financial Affairs that HKMA would introduce two measures, namely, switch tender and bond swap facility, for improving the liquidity of the institutional bonds
- Aim to improve liquidity by bridging any supply-demand mismatch

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- The primary objective of the Government Bond Programme (GBP) is to promote the further and sustainable development of Hong Kong's bond market through systematic issuance of government bonds. It can also help promote financial stability by making our debt market an effective channel of financial intermediation, complementing the equity markets and the banking sector.
- The GBP is a long-term programme comprising an Institutional Bond Issuance Programme and a Retail Bond Issuance Programme. As at end 2013, the total outstanding issuance amount was HK\$90 billion, including ten issues of institutional bonds totalling HK\$60 billion and three issues of retail bonds (i.e. the iBonds) totalling HK\$30 billion.
- HKMA considered relevant measures to improve the liquidity of the institutional bonds. Two measures, namely, switch tender and bond swap facility, will be introduced in 2014. These measures will help increase the supply of government bonds in greater demand and reduce the supply of those with less market appetite, with a view to bridging any lasting or temporary supply-demand mismatch among individual bond issuances.
- It is expected that market players will welcome the measures, as these will enhance the effectiveness of market-making activities and liquidity management on the part of the Primary Dealers, and encourage end-investors to trade more actively in the market.



PROMOTING ASSET MANAGEMENT BUSINESS

- Working closely with other Government agencies and the private sector to explore ways to strengthen the competitiveness of Hong Kong's asset management industry and reinforce Hong Kong's position as a leading asset management centre
- Stepping up marketing efforts to proactively promote Hong Kong's financial platform to overseas and Mainland asset owners and asset managers
- Building on the feedback from our regular dialogues with industry players, we continue to improve our platform and keep pace with the latest developments in the asset management industry

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- With the promising growth prospects of the Asian region, there has been increasing interest for overseas asset managers to expand into Asia. To capitalise on this trend and attract more asset managers into Hong Kong, the HKMA is working in conjunction with other Government agencies and market players to promote Hong Kong's asset management business, thereby reinforcing Hong Kong's role as a premier international financial centre.
- Over the past two and a half years our outreach team held over 650 meetings with 420 financial institutions to showcase the unique competitive advantages of Hong Kong as a financial centre.
- Our outreach campaign has had very encouraging results, with some notable asset owners and asset managers choosing to set up their Asia headquarters in Hong Kong. Being an asset owner ourselves, the HKMA has a unique advantage in relating to other asset owners' criteria in choosing an overseas investment hub. For example, we were able to persuade a very large North American pension fund to set foot in Hong Kong last year, by laying out the many competitive advantages of Hong Kong openly and clearly so their board of directors was convinced that Hong Kong is the right place to be.
- Another example is a top UK asset management firm, and they chose Hong Kong because our team hand held them from beginning to end in their setting up a base here, giving them valuable advice drawing on our vast pool of knowledge and experience from meeting hundreds of asset managers.
- The HKMA's help and support are also well appreciated by Mainland asset managers. For example, a prominent Mainland fund management company thanked us for our suggestions that helped them better understand the preparation they need to apply for a license, minimising the amendments and clarifications that were needed later in the process. They have recently obtained SFC license and set up a subsidiary in Hong Kong. Going forward, HKMA will continue to leverage on our unique role as a regulator and institutional investor to promote the development of Hong Kong's asset management business.
- On platform building, HKMA conducts reviews of legal, regulatory, tax and other issues to inform policy formulation concerning the development of Hong Kong's asset management industry. HKMA also provides necessary support to the Financial Services and the Treasury Bureau and other agencies in taking forward new initiatives announced by the Financial Secretary in the 2013-14 Budget, such as the proposed extension of profits tax exemption to offshore private equity funds.



CONTINUED DEVELOPMENT AS AN INTERNATIONAL ASSET MANAGEMENT CENTRE

- The combined fund management business in Hong Kong hit a record high of US\$ 1.6 trillion in 2012, a 39% increase over 2011
- Continued increase in the number of licensed corporations and licensed individuals for asset management
- Around 80 of the 100 largest global money managers have offices in Hong Kong
- In terms of private banking, 15 private banks have opened for business since 2009, bringing the total to 45 banks offering wealth management services in Hong Kong today

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- According to the SFC survey, 65% of the combined fund management business in Hong Kong was sourced from non-Hong Kong investors in 2012, attesting to the fact that Hong Kong is still a preferred location for asset management business in the region.
- The number of licensed corporations for asset management has increased from 680 in 2008 to 928 in September 2013.
- The number of licensed individuals for asset management has also increased from 4,893 in 2008 to 7,058 in September 2013.
- Around 80 of the 100 largest global money managers have offices in Hong Kong, and over 60 of them are licensed by the SFC.
- Achieved leadership positions as an asset management centre in the region. Hong Kong is a leading hub for:
 1. Hong Kong is the second largest private equity hub in Asia with over 370 private equity firms as of end 2013.
 2. Hong Kong is Asia's third most active Exchange-Traded Funds (ETF) market with annual turnover US\$116.4 billion in 2013.
 3. Over 60% of Qualified Foreign Institutional Investor and Qualified Domestic Institutional Investor managers and all Renminbi Qualified Foreign Institutional Investor managers have a presence in Hong Kong as of November 2013.
 4. Hong Kong is also the largest hub for Asian hedge funds, with the number of funds increasing from 538 in 2010 to 676 as of 30 September 2012.



DEVELOPMENT OF ISLAMIC FINANCE

- Supporting the Government in conducting a legislative exercise to amend the Loans Ordinance to enable the issuance of Islamic bonds (sukuk) under the Government Bond Programme to promote the further development of sukuk market in Hong Kong
- Facilitated the first meeting of the private sector led Joint Forum on Islamic Finance between Hong Kong and Malaysia held in Hong Kong on 3 December 2013. During the meeting, market players from both places exchanged views on current developments of Islamic finance and measures to advance the development of Hong Kong's Islamic financial market, particularly the sukuk market and the Islamic fund management industry



FINANCIAL INFRASTRUCTURE

- Continue to maintain safety and efficiency of financial infrastructure
- Banks started to report over-the-counter derivatives trades to the trade repository of the HKMA in August 2013

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Operation of financial infrastructure

- The HKD, USD, EUR and RMB Real Time Gross Settlement (RTGS) systems, the Central Moneymarkets Unit (CMU) and the Trade Repository (TR) for over-the-counter (OTC) derivatives transactions have been operating smoothly.

Trade Repository

- Launched the reporting function of the TR in July 2013 to support the implementation of the interim reporting requirements in August 2013.



RETAIL PAYMENT INITIATIVES

Electronic Bill Presentment and Payment (EBPP) service

- The EBPP service platform was launched on 11 December 2013
- The scope of services includes Business-to-Customer (B-2-C) and Business-to-Business (B-2-B) e-billing and e-payments, cross-border e-billing and e-payments, and e-donation and presentment of e-receipt

NFC mobile payment service

- The HKMA worked closely with an industry working group under the Hong Kong Association of Banks (HKAB) on a set of common standards and guidelines issued by HKAB on 25 November 2013 for banks to follow

Legislative framework for stored value facilities and retail payment systems

- Policy adjustments for incorporation in the draft Bill is being considered, taking into account comments received from the public consultation where appropriate
- Preparatory work for the drafting of the Bill is at an advanced stage. Targeting to introduce to LegCo in second half of 2014

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Electronic Bill Presentment and Payment (EBPP) service

- The EBPP is a consolidated platform for the straight-through processing of electronic bill ('e-bill') presentments and payments. Users only need to go to one place – their internet banking accounts – to receive, view, manage and schedule payments for various e-bills issued by merchants. Through this multi-currency platform, e-payments can be made in Hong Kong dollar, renminbi and US dollar.
- 23 banks which cover 99% of internet banking accounts have agreed to take part in the EBPP service, with 18 of them ready to start the service immediately.

NFC mobile payment service

- The standards and guidelines cover three aspects, including interoperability requirements between devices and systems, operation guidelines of NFC mobile payment services, and security requirements.
- The HKMA supports a market-driven approach for shared infrastructure development as it suits the Hong Kong market. A shared infrastructure, developed by a card association, has been completed to support multiple banks.
- 5 banks and 1 stored value card operator have launched different types of NFC mobile payment services. We anticipate that more banks will launch the service.

Legislative framework for stored value facilities and retail payment systems

- The proposed legislation seeks to empower the HKMA to exercise supervisory and enforcement functions on stored value facilities (SVF) and oversight function on designated retail payment systems (RPS), with a view to ensuring adequate consumer protection, safety and soundness of such facilities and systems in Hong Kong.
- Following the formal industry consultation with over 30 industry participants in end-January 2013, the HKMA and FSTB jointly conducted a 3-month public consultation on the proposed regulation between 22 May 2013 and 22 Aug 2013. Feedbacks received indicated general support to the regulatory proposals.
- We are analysing the comments and considering appropriate policy adjustments, if necessary, taking into account the comments received. Preparatory work for the drafting of the Bill is at an advance stage. We aim to introduce the Bill to LegCo in the second half of 2014.

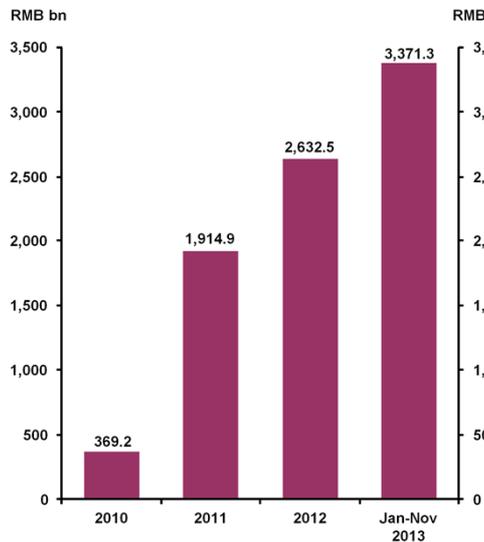


HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

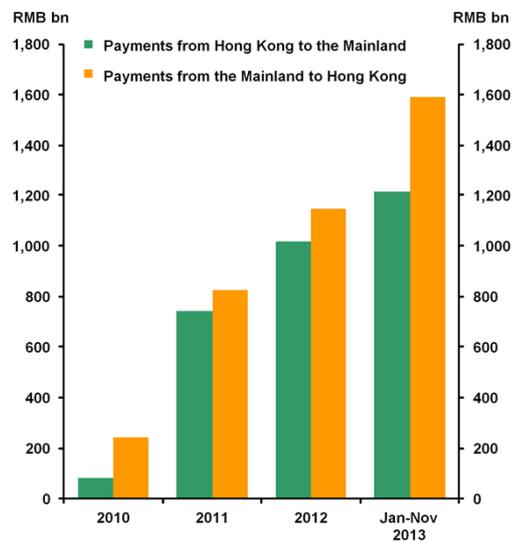


CONTINUED EXPANSION IN RMB TRADE SETTLEMENT

RMB trade settlement handled by banks in Hong Kong



Flows of RMB trade settlement between Hong Kong and the Mainland

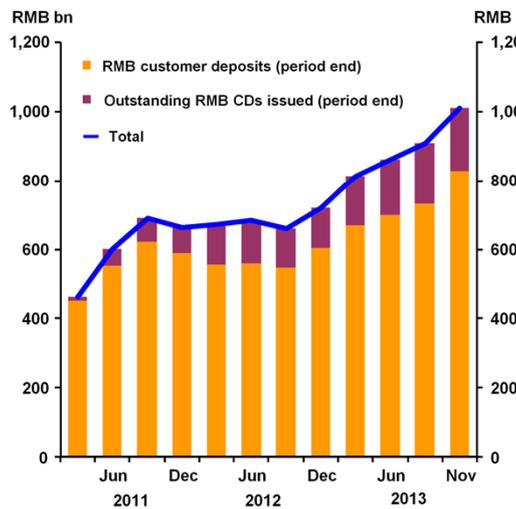


- In the first eleven months of 2013, RMB trade settlement handled by banks in Hong Kong amounted to RMB3,371.3 billion, a 40% growth compared with the same period in 2012. The ratio of payments to and from the Mainland was 1:1.3.

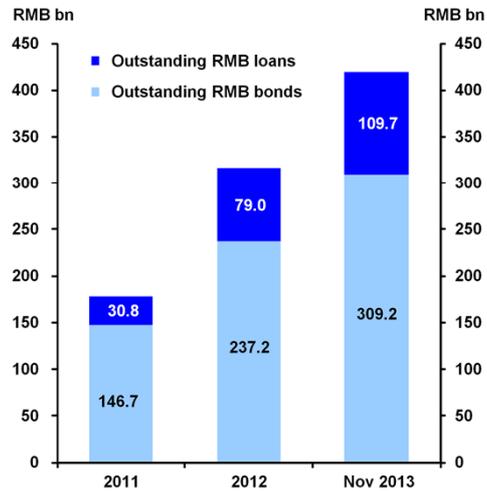


STEADY DEVELOPMENT OF RMB FINANCING MARKET

RMB customer deposits and certificates of deposit (CDs)



RMB financing activities



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- At end November 2013, RMB customer deposits and outstanding RMB certificates of deposits amounted to RMB827.0 billion and RMB181.5 billion respectively, totaling RMB1,008.5 billion, a 40% growth from RMB720.2 billion at the end of 2012.
- Meanwhile, over 90,000 accounts were opened by non-resident personal customers, with deposits exceeding RMB17 billion.
- The RMB dim sum bond market was active in the fourth quarter of 2013. Issuance in the quarter amounted to RMB40.7 billion, including RMB10 billion of sovereign bonds issued by the Ministry of Finance of the Central Government. Issuance totalled RMB116 billion in 2013, similar to RMB112.2 billion in 2012. Outstanding dim sum bonds amounted to some RMB310 billion at end 2013, a growth of 30% from end 2012.
- RMB bank lending continued to grow, with outstanding amount of RMB loans increasing to RMB109.7 billion at end November 2013, a growth of some 40% from the end of 2012.



STRENGTHENING OF HONG KONG'S RMB BUSINESS LINKS WITH OTHER PARTS OF THE WORLD

	Nov 2013	2012	2011
1 No. of participating banks of Hong Kong's RMB clearing platform	212	204	187
Of which:			
Branches and subsidiaries of overseas banks and overseas presence of Mainland banks	187	181	165
2 Amount due to overseas banks (RMB billion)	149.0	99.1	116.4
3 Amount due from overseas banks (RMB billion)	179.8	117.1	121.7
4 Turnover in Hong Kong's RMB RTGS system (Daily average during the period; RMB billion)	440.8	213.7	121.4

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- In 2013, the HKMA made continued efforts to promote the use of the RMB business platform in Hong Kong, including organising and participating in events in Hong Kong and overseas, and facilitating private sector-led collaborative initiatives with other markets (eg. London, Australia etc). These have helped to strengthen Hong Kong's RMB business links with other parts of the world and enhance Hong Kong's role as the premier offshore RMB business centre.
- The HKMA and Bank Negara Malaysia agreed to initiate the Hong Kong – Malaysia Private Sector Dialogue on Offshore Renminbi Business in August 2013. The Dialogue convened its first meeting in December last year, which was attended by senior representatives from 10 Hong Kong and Malaysian banks. The Dialogue participants agreed to enhance collaboration to strengthen efforts in raising awareness among corporates about the use of RMB in trade and investments, expand business relationships between banks in Hong Kong and Malaysia, and develop offshore RMB products and services and offshore RMB sukuk market.



INCREASING REGIONAL AND INTERNATIONAL FINANCIAL CO-OPERATION

Financial Stability Board (FSB)

- HKMA attended the FSB Plenary Meeting on 8 November 2013. Members discussed vulnerabilities affecting the global financial system and progress in various financial regulatory reform areas, including ending the “too-big-to-fail” problem, OTC derivatives market reforms, and strengthening oversight and regulation of shadow banking activities.

Regional Co-operation

- HKMA continued to participate actively in meetings of regional forums including EMEAP (Executives’ Meeting of East Asia-Pacific Central Banks) and ASEAN+3 to review recent economic and financial developments in the region and to exchange views on issues of common interest.



INVESTMENT ENVIRONMENT AND PERFORMANCE OF THE EXCHANGE FUND

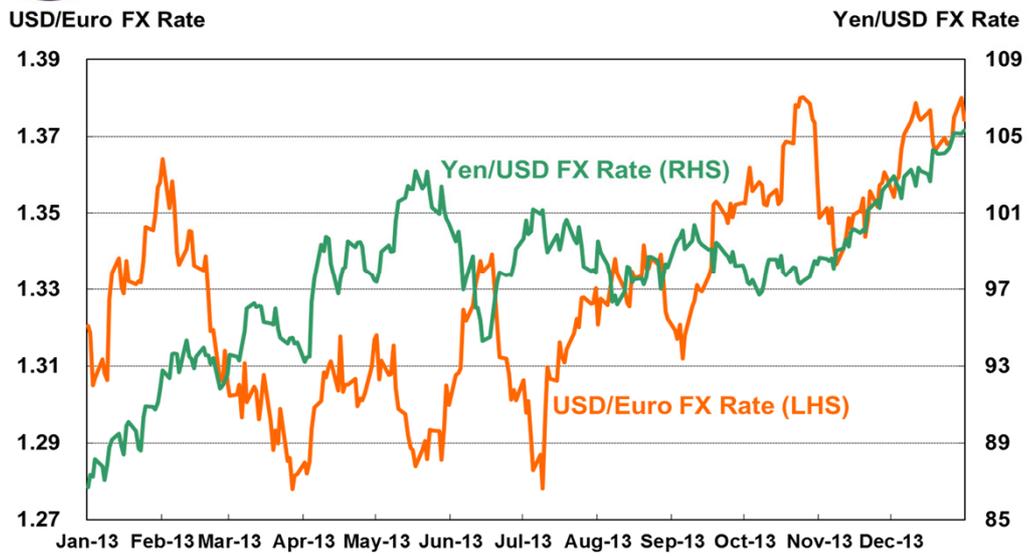


INVESTMENT ENVIRONMENT IN 2013

- **Exchange rates:** The Euro strengthened against the dollar in 2013, as market confidence returned on the back of the recovering European economy and receding debt crisis. The Yen continued to weaken against the dollar, as the market started to price in more easing of monetary policy in Japan
- **Equity markets:** Major stock markets posted strong gains, supported by the risk-favouring sentiment, abundance of liquidity and improving economic fundamentals. Emerging market performance lagged behind that of developed markets
- **Interest rates:** Longer term US Treasury bond yields rose sharply in 2013 on the talk of the Fed's QE tapering measures. European government bond yields rose in tandem, though JGB yields remained sluggish



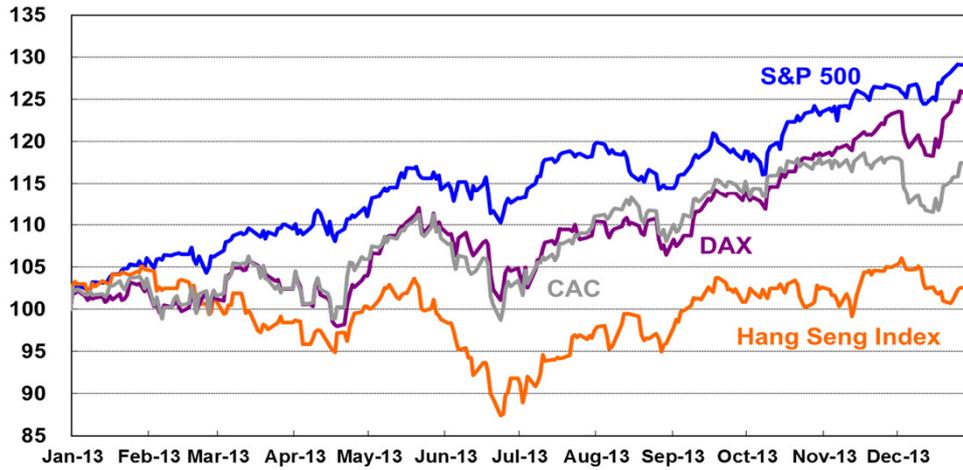
CURRENCY MARKETS IN 2013





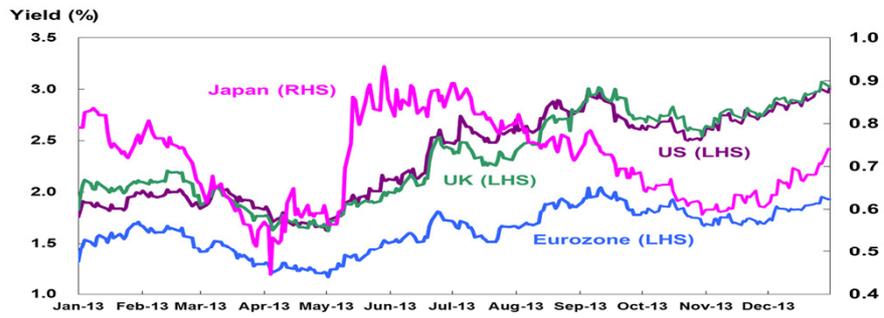
EQUITY MARKETS IN 2013

Normalized Index Level (2012 year-end = 100)

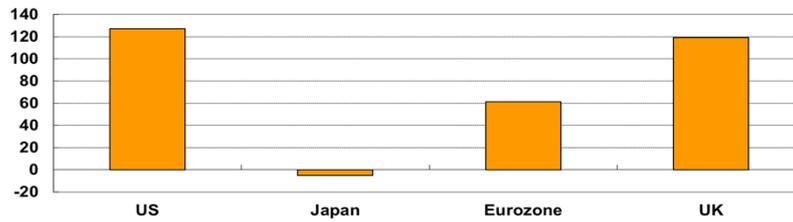




CHANGES IN 10-YEAR GOVERNMENT BOND YIELDS IN 2013



2013 bond yield change (bps)





INVESTMENT INCOME

(HK\$ billion)	2013					2012	2011	2010	2009
	Full year *	Q4 *	Q3 *	Q2 *	Q1 *	Full year	Full year	Full year	Full year
Hong Kong equities[^]@	10.1	3.9	13.7	(6.1)	(1.4)	30.7	(24.2)	11.6	48.9
Other equities[^]	71.6	22.6	17.9	6.2	24.9	42.8	(12.2)	27.1	48.8
Bonds[#]	(19.1)	(4.1)	1.8	(19.6)	2.8	33.1	71.9	42.1	(0.6)
Other investments^{&}	11.7	1.3	5.7	2.1	2.6	6.4	0.7	1.7	0.8
Foreign exchange	<u>1.6</u>	<u>1.7</u>	<u>15.6</u>	<u>(5.9)</u>	<u>(9.8)</u>	<u>(1.4)</u>	<u>(9.1)</u>	<u>(3.1)</u>	<u>9.8</u>
Investment income/(loss)^{@&}	75.9	25.4	54.7	(23.3)	19.1	111.6	27.1	79.4	107.7

* Unaudited figures

[^] Including dividends

[@] Excluding valuation changes in Strategic Portfolio

[#] Including interest

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

(Investments held by EF's investment holding subsidiaries include private equity and real estate investments. The figure for the latest quarter is preliminary and is subject to change in case there are changes in the valuations of these investments.)



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

(HK\$ billion)	← 2013 →					2012
	Full year *	Q4 *	Q3 *	Q2 *	Q1 *	Full year
Investment income/(loss)	75.9	25.4	54.7	(23.3)	19.1	111.6
Other income	0.2	0.0	0.1	0.1	0.0	0.2
Interest and other expenses	<u>(4.9)</u>	<u>(1.2)</u>	<u>(1.3)</u>	<u>(1.5)</u>	<u>(0.9)</u>	<u>(4.4)</u>
Net income/(loss)	71.2	24.2	53.5	(24.7)	18.2	107.4
Payment to Fiscal Reserves #	(36.8)	(9.0)	(9.0)	(9.5)	(9.3)	(37.8)
Payment to HKSAR government funds and statutory bodies #	(9.3)	(2.6)	(2.5)	(2.1)	(2.1)	(8.0)
Valuation change of Strategic Portfolio less valuation change of investments held by EF's investment holding subsidiaries^	<u>(11.7)</u>	<u>(1.0)</u>	<u>(5.1)</u>	<u>(3.0)</u>	<u>(2.6)</u>	<u>(5.6)</u>
Increase/(Decrease) in EF Accumulated Surplus	13.4	11.6	36.9	(39.3)	4.2	56.0

* Unaudited figures

The fixed rate of fee payment is 5.0% for 2013 and 5.6% for 2012

^ Including dividends



HISTORICAL INVESTMENT INCOME

(HK\$ billion)

Year	Full Year	Q4	Q3	Q2	Q1
2001	7.4	13.6	10.4	(2.0)	(14.6)
2002	47.0	26.3	(2.1)	26.5	(3.7)
2003	89.7	33.5	8.4	41.1	6.7
2004	56.7	33.0	14.1	(7.2)	16.8
2005	37.8	7.3	19.0	13.6	(2.1)
2006	103.8	36.0	37.1	12.5	18.2
2007 [@]	142.2	33.4	61.8	26.3	20.7
2008 [@]	(75.0)	8.3	(48.3)	(20.4)	(14.6)
2009 ^{@&}	107.7	10.6	71.9	58.7	(33.5)
2010 ^{@&}	79.4	5.9	74.5	(12.1)	11.1
2011 ^{@&}	27.1	22.1	(41.4)	21.6	24.8
2012 ^{@&}	111.6	30.3	42.4	(5.6)	44.5
2013 ^{*@&}	75.9	25.4	54.7	(23.3)	19.1

[@] Excluding valuation changes in Strategic Portfolio

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

^{*} Unaudited figures



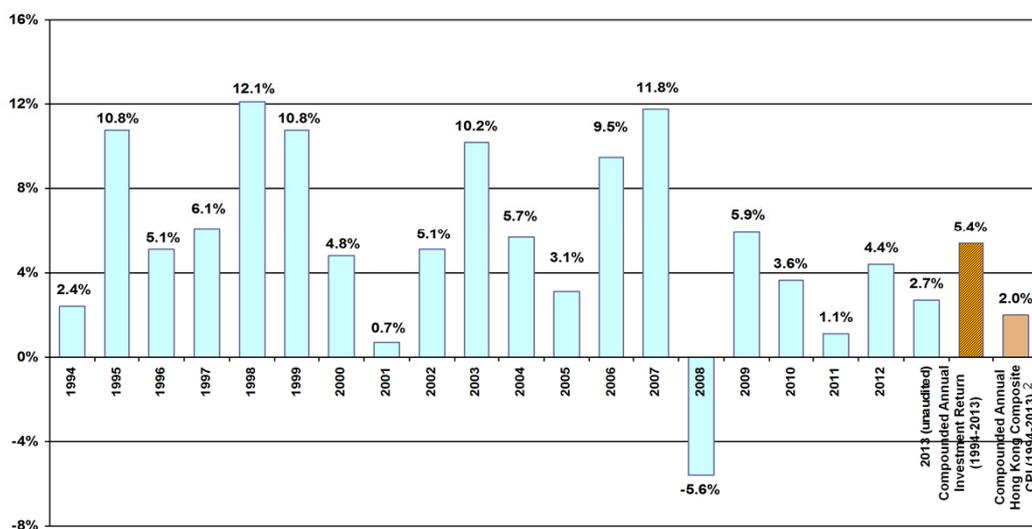
EXCHANGE FUND ABRIDGED BALANCE SHEET

(HK\$ billion)	At 31 Dec 2013 (unaudited)	At 31 Dec 2012	Change
ASSETS			
Deposits	293.0	188.3	104.7
Debt securities	2,079.0	2,048.5	30.5
Hong Kong equities	152.9	148.0	4.9
Other equities	372.3	283.3	89.0
Other assets [#]	<u>132.8</u>	<u>113.0</u>	<u>19.8</u>
Total assets	<u>3,030.0</u> =====	<u>2,781.1</u> =====	<u>248.9</u> =====
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness	327.4	289.8	37.6
Government-issued currency notes & coins in circulation	10.6	9.9	0.7
Balance of the banking system	164.1	255.9	(91.8)
Exchange Fund Bills and Notes issued	782.6	688.5	94.1
Placements by banks and other financial institutions	50.7	0.0	50.7
Placements by Fiscal Reserves	773.9	717.5	56.4
Placements by HKSAR government funds and statutory bodies	214.9	167.9	47.0
Other liabilities	<u>68.5</u>	<u>27.7</u>	<u>40.8</u>
Total liabilities	<u>2,392.7</u>	<u>2,157.2</u>	235.5
Accumulated Surplus	<u>637.3</u>	<u>623.9</u>	<u>13.4</u>
Total liabilities and fund equity	<u>3,030.0</u> =====	<u>2,781.1</u> =====	<u>248.9</u> =====

[#] Including investment injection to EF's investment holding subsidiaries at a carrying amount of HK\$66.4 billion (HK\$53.6 billion at 31 Dec 2012)



INVESTMENT RETURN OF THE EXCHANGE FUND (1994-2013) ¹



¹ Investment return calculation excludes the holdings in the Strategic Portfolio

² Composite CPI is calculated based on the 2009/2010 base series



INVESTMENT DIVERSIFICATION

- To enhance the return of the Exchange Fund in the medium and long term, the HKMA has, since 2008, been diversifying part of the Fund's investment into more asset classes, including emerging market bonds and equities, private equity, real estate, and Mainland renminbi bonds and equities. Emerging market bonds and equities and renminbi assets were transferred to the Investment Portfolio of the Exchange Fund in March 2013.
- Private Equity and Real Estate remain under the Long-Term Growth Portfolio (LTGP). Positions at end-2013 and performance since inception are as follows:

As of end 2013

New Asset Classes	Market Value HK\$ billion	Annualized return since inception till end 2013
Private Equity	64.2	} 15.9% (IRR)
Real Estate	24.4	
Total	88.6	

Note: Outstanding investment commitments at the end of 2013 amounted to HK\$81.3 billion



HONG KONG MORTGAGE CORPORATION



REVERSE MORTGAGE PROGRAMME

- By end-Dec 2013, 538 applications have been received:
 - Average age of borrowers: 69 years old
 - Average monthly payout: HK\$14,100
 - Payment terms: 10-year (33%), 15-year (16%), 20-year (13%), life (38%)
 - Average property value: HK\$4.5 million
 - Average property age: 30 years

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- The HKMC has accepted the use of Enduring Power Attorney and Part II Order under the Reverse Mortgage Programme since 22 November 2013.



SME FINANCING GUARANTEE SCHEME

- The Financial Secretary announced in the 2013-14 Budget Speech the extension of application period of the 80% loan guarantee product for one year up to 28 February 2014
- The 80% loan guarantee product has been well received by the market. As at end-Dec 2013:
 - 8,016 applications were approved, involving total loan amount of HK\$33.9 billion
 - General characteristics of the approved applications are as follows:

Average guarantee period	4.79 years	Average loan size	HK\$4.23 million
Manufacturing and Non-manufacturing industries	27% and 73% (in terms of applications approved)	Average loan interest rate and average guarantee fee rate	4.74% p.a. 0.54% p.a.
Enterprises with less than 50 employees	91%	Benefitted enterprises and the related employees	5,507 enterprises and 144,380 employees

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- Industry types of approved applications for 80% loan guarantee products:

Manufacturing sector –

- Textiles and clothing 5.6%
- Electronics 2.5%
- Plastics 2.0%
- Printing and publishing 1.9%

Non-manufacturing sector –

- Trading 45.0%
- Wholesales and retail 8.4%
- Construction 2.5%
- Engineering 2.4%



MICROFINANCE SCHEME

- Launched in June 2012 for a trial period of 3 years with a tentative aggregate loan amount of HK\$100 million
- 6 banks and 5 non-governmental organisations have joined
- As at end-Dec 2013, the Scheme received 197 formal loan applications. Out of the vetted applications, 106 have been approved with the total loan amount of HK\$28.1 million. The approval rate is around 61%
- For the approved applications, the average loan size was about HK\$270,000 and the average loan tenor was 4 years

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- Industry type for the approved cases
 - Servicing 41 cases (39%)
 - Retailing 41 cases (39%)
 - Wholesales 14 cases (13%)
 - Manufacturing 5 cases (5%)
 - IT related 4 cases (4%)
 - Others 1 case (1%)

* Component percentages in the table above may not add up to 100% due to rounding.