



**HONG KONG MONETARY AUTHORITY**

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

**7 February 2014  
[Translation]**



- 1. Assessment of Risk to Hong Kong's Financial Stability**
2. Development of Financial Infrastructure
3. Banking Supervision
4. Hong Kong as an Offshore Renminbi Centre
5. Investment Performance of the Exchange Fund



**US recovery continues and the Fed has started to taper  
Is it going to be smooth sailing for the global economy?**



## ECONOMIC CONDITIONS IN THE US

- US monetary policy normalisation process has begun
- Signs of US growth momentum
  - Continued fall in the unemployment rate
  - Solid recovery in the housing market
  - Solid growth in consumer spending
  - The Fed forecasts economic growth to pick up and unemployment rate to fall (2014: growth 3%; unemployment rate 6.5%)
- Fiscal deal struck between Republicans and Democrats in December, resulting in a slight public spending cut for the next two years

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- The Fed announced in December last year that it will scale back its monthly bond purchases by US\$10 billion starting January this year.
- Signs of US growth momentum.
  - Unemployment rate continued to fall, reaching 6.7% in December 2013, down 1.2 percentage points from that of last year.
  - Housing prices continued to post year-on-year increases.
  - Consumer spending increased by 3.3% in the fourth quarter.
  - The Fed forecasts economic growth to pick up and unemployment rate to fall steadily. (2014 projections: growth 3%, unemployment rate to reduce to 6.5% at the end of the year)
- Fiscal deal struck between Republicans and Democrats in December, resulting in a slight public spending cut for the next two years.



## CONCERNS FOR THE US ECONOMY

- Business investment remains weak
- Fall in unemployment rate mainly driven by the falling labour force participation rate (to a 35-year low of 62.8%)
- Surge in US equities largely supported by low interest rates, abundant liquidity and share buybacks
- Fiscal consolidation yet to be resolved
- Market interest rates may react greater and faster than the normalisation of monetary policy

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- The labour market appeared to have improved significantly with unemployment rate falling to 6.7% in December last year. However, the fall in unemployment rate was mainly driven by falling labour force participation rate to a 35-year low of 62.8%.



## ASSESSMENT OF THE EURO AREA ECONOMY

### **Latest developments:**

- Economy has stopped contracting and begun to recover slowly
- Ireland and Portugal successfully returned to capital markets with favourable response to their sovereign debt auctions
- Sovereign bond yields in most peripheral countries have fallen to pre-crisis levels

### **Concerns:**

- Unemployment rates remain high with few signs of improvement
- Despite fiscal consolidation across member countries, public debt levels continue to climb in many countries
- Bank credit remains tight as the private and banking sectors remain heavily in debt



## ASSESSMENT OF JAPAN'S ECONOMY

### **Latest developments:**

- Growth accelerated (3% year-on-year in the first 3 quarters of 2013; 1.4% in 2012)
- Inflation rate and inflation expectations have risen substantially as deflation gradually ended (core inflation rate in December 2013: 1.3%; 2012: -0.08%)
- Investor sentiment has improved (Nikkei has risen 33% since the start of 2013)

### **Concerns:**

- Consumption tax hike in April may impact negatively on consumption and investment
- Given the enormous government debt (256% of GDP) with interest payments mounting to 19% of government revenue, rises in interest rates could pose a significant risk to fiscal sustainability
- Wage growth remains slow (real wages are still falling)
- Despite substantial yen depreciation, trade deficit continues to widen
- Abe's "third arrow" of structural reform yet to be implemented



## ASSESSMENT OF MAINLAND CHINA'S ECONOMY

### **Latest developments:**

- The economy continued to expand at a steady pace (2013: 7.7%; 2014: consensus forecast 7.5%)
- The Third Plenum has pledged to deepen reforms and opening-up in a comprehensive way, and let markets play a decisive role in resource allocation, with a view to enhancing the efficiency and sustainability of economic developments
- Policy focus will centre on containing and addressing risks associated with local government debts, as well as strengthening the regulation and supervision of shadow banking activities. Meanwhile, the authorities will continue to guard against key risks such as real estate-related credit risks, industry overcapacity problems, and liquidity risks

### **Concerns:**

- Near-term growth and employment would be held back by the policy objective to resolve the overcapacity problem
- Measures to prevent excessive credit growth and strengthen regulation of shadow banking activities may result in tightening in credit and liquidity conditions
- With the progressive exit from quantitative easing and interest rate normalisation in the US, large-scale capital outflows from emerging market economies could re-emerge and thereby pose negative impacts





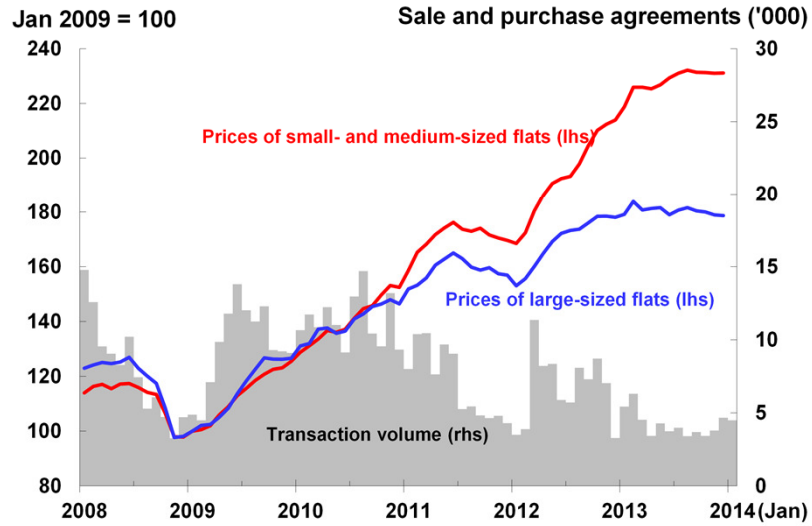
## ASSESSMENT OF RISKS TO GLOBAL FINANCIAL STABILITY: CONCLUSION

- The Fed has started its policy exit and scaled back its asset purchases. Markets initially reacted calmly or even positively before witnessing heightened volatility on worries about capital outflows from emerging market economies
- There are still considerable uncertainties on global monetary and financial conditions
  - Although economic conditions in advanced countries have improved, there are still uncertainties over the strength and sustainability of their recoveries
  - The Fed's policy exit may increase capital outflow pressures from emerging market economies. This may lead to faster than expected rise in market interest rates in these economies, exacerbating asset price corrections



## ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: OUTLOOK FOR PROPERTY MARKET REMAINS UNCERTAIN

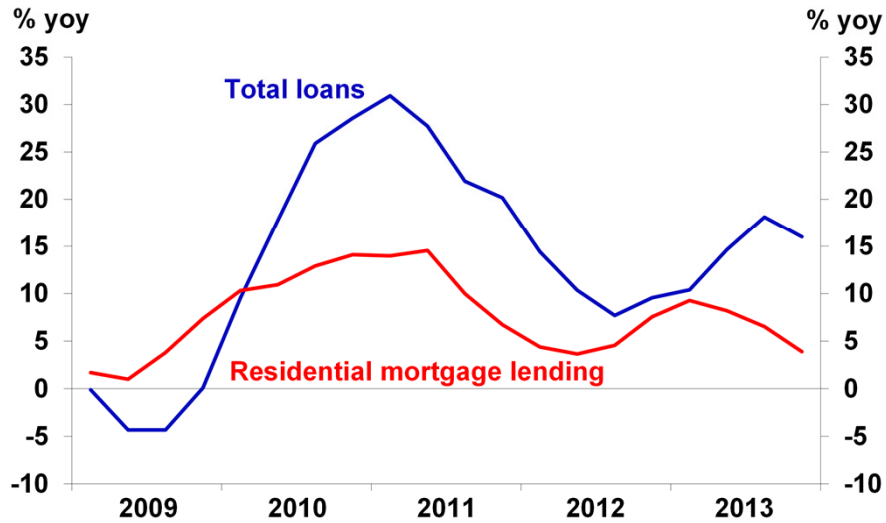
**Property turnover stayed low, while prices decreased slightly**



Sources: R&VD and Land Registry



## ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: BANKS' CREDIT GROWTH REMAINS TOO FAST



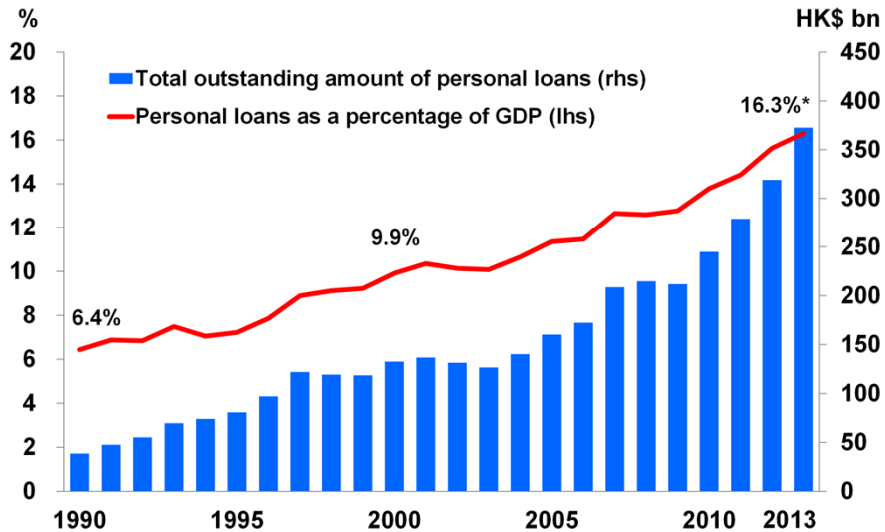
Source: HKMA

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- While the growth of residential mortgages has moderated to 3.9% in 2013, total loans still recorded a 16% growth, indicating rapid growth in other types of loans (18.4%).
- In light of this, the HKMA introduced the Stable Funding Requirement in October 2013 to strengthen banks' liquidity risk management.



## ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: GROWTH IN PERSONAL LENDING REMAINS TOO FAST



Note: \* the level of personal loans as a percentage of GDP is based on the position as at end-September 2013

Sources: HKMA and C&SD

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- The HKMA noticed the intensified competition in personal lending business. In view of this, the HKMA has issued a circular to banks on 14 January 2014, requiring them to review their existing policies in order to strengthen risk management in the following areas:
  - Debt servicing ratio
  - Loan tenor
  - Internal portfolio limit for personal loans
  - Internal stress tests on personal loans portfolios for interest rate hikes



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## Counterfeit HK\$1,000 notes

- First surfacing of 2003 series Bank of China (Hong Kong) and HSBC HK\$1,000 counterfeit notes on 23 December 2013, with a total seizure of 258 pieces as at 4 February 2014.
- Though with a fair degree of resemblance to the genuine notes, the counterfeits can be quite easily identified by the public and retailers with care. In particular, they should pay attention to:
  - fluorescent barcode
  - metallic thread



## Identifying HK\$1,000 counterfeits

### Fluorescent barcode as viewed under ultraviolet light

#### Genuine note

The yellowish fluorescent barcode is bright and clear



#### Counterfeit note

Barcode image looks dull and unclear



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- The yellowish fluorescent barcode on the genuine note is bright and clear when viewed under ultraviolet light, whereas that of the counterfeit note looks dull and unclear.



## Identifying HK\$1,000 counterfeits

### Metallic thread

#### Genuine note

Visibly uneven paper fibre edges in the holographic windowed thread



#### Counterfeit note

Relatively even edges in the holographic windowed thread



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- Some uneven paper fibres can be seen at the edges of the holographic windowed metallic thread on the genuine note. In contrast, the edges of the metallic thread on the counterfeit note look much more even.





## Counterfeit HK\$1,000 notes

- Counterfeit rate in Hong Kong is much lower than that of many countries; the public should feel assured in using banknotes dispensed over bank counters or via ATMs as they are all duly verified as genuine
- HKMA and banks will speed up withdrawal of 2003 series HK\$1,000 notes from circulation; which will be replaced by new 2010 series incorporated with even more robust security features
- HKMA has organised 33 seminars since the first surfacing of the counterfeits; instrumental in enhancing knowledge and skills of over 7,000 frontline employees from banks, retail businesses and public services in identifying counterfeits
- The public may refer to the counterfeit identification tips and a recording of the seminar on HKMA website. They may also contact HKMA, banks or the Police for further assistance



## DEVELOPMENT OF ISLAMIC FINANCE

- Supporting the Government in amending the Loans Ordinance to enable the issuance of Islamic bonds (sukuk) under the Government Bond Programme to promote further development of sukuk market in Hong Kong
- The first meeting of the Joint Forum on Islamic Finance between Hong Kong and Malaysia was held in Hong Kong on 3 December 2013. Participants from the private sector supported the following initiatives:
  - Identifying and encouraging potential fund raisers to issue sukuk and actively studying the launch of Islamic funds
  - A seminar on Islamic finance to be jointly organised in Hong Kong by the HKMA and the Malaysia central bank in the first half of 2014 to promote awareness of Islamic finance in the local market



## 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 to enable multiple payment services on a single NFC-enabled mobile phone, service continuity despite switching mobile network operators and changing phones, and a high-level of security. The guideline was 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 are being considered where appropriate, taking into account comments received from the public consultation
- Preparatory work for the drafting of the Bill is at an advanced stage. Targeting to introduce the Bill into LegCo in second half of 2014



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## **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



## BASEL III IMPLEMENTATION PROGRESS

### Capital standards

- 2<sup>nd</sup> 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

- 2<sup>nd</sup> 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 2<sup>nd</sup> 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.



## **INCIDENTS OF ERRONEOUS DEDUCTION OF TRANSPORT FARE FROM OCTOPUS CARDS**

- Recently there were three incidents of erroneous deduction of transport fare from Octopus Cards; one was caused by the upgrading of a bus company's card reader software by Octopus Cards Ltd (OCL). OCL has subsequently rectified all the reader software involved and is reviewing the related procedures
- The HKMA is very concerned about the above incident and has reminded OCL to make its best endeavors to minimise the occurrence of operational incidents and their impact on customers
- The other two incidents were caused by a public transport operator and did not involve any malfunctioning of the Octopus Cards system



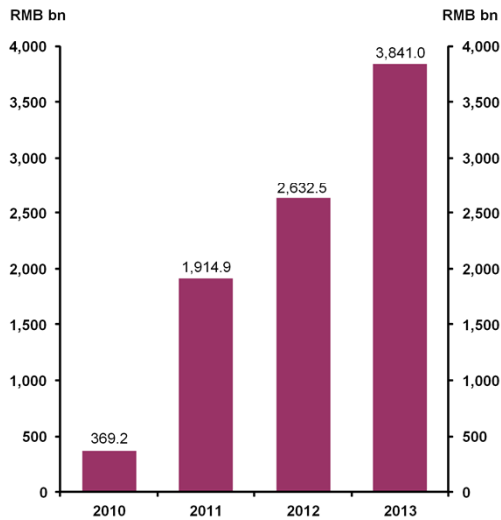


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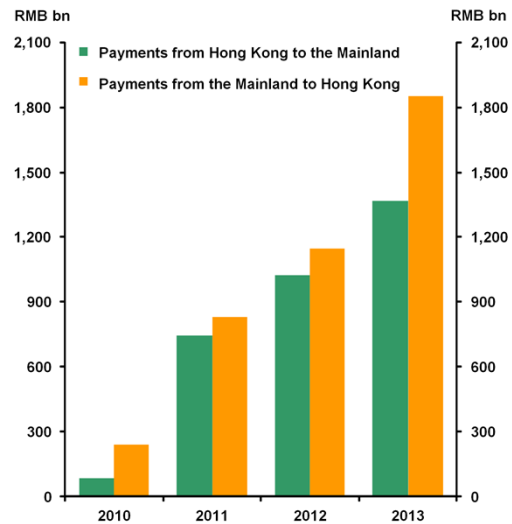


## CONTINUED EXPANSION IN RMB TRADE SETTLEMENT

RMB trade settlement handled by banks in Hong Kong



Flows of RMB trade settlement between Hong Kong and the Mainland

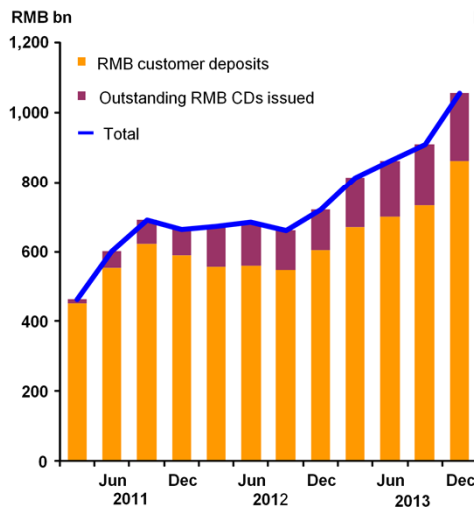


- In 2013, RMB trade settlement handled by banks in Hong Kong amounted to RMB3,841.0 billion, a 46% growth compared with 2012.

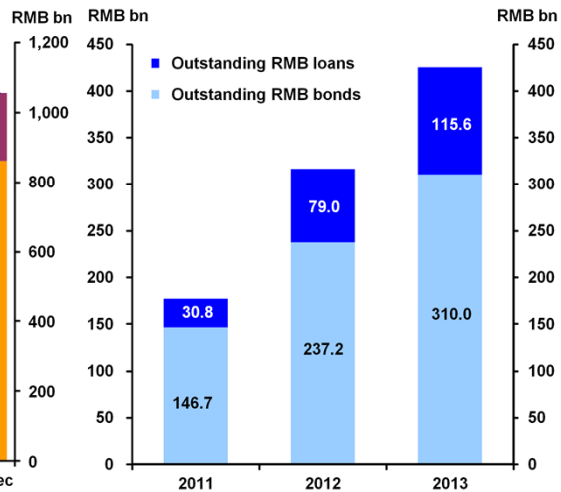


## STEADY DEVELOPMENT OF RMB FINANCING MARKET

RMB customer deposits and certificates of deposit (CDs)



RMB financing activities



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- At the end of 2013, RMB customer deposits and outstanding RMB certificates of deposits together amounted to RMB1,053.0 billion, a 46% growth from RMB720.2 billion at the end of 2012.
- RMB dim sum bond issuance totalled RMB116.6 billion in 2013, similar to RMB112.2 billion in 2012. Outstanding dim sum bonds amounted to some RMB310 billion at the end of 2013, a growth of 30% from the end of 2012.
- RMB bank lending continued to grow, with outstanding amount of RMB loans increasing to RMB115.6 billion at the end of 2013.



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

	2013	2012	2011
1 No. of participating banks of Hong Kong's RMB clearing platform	216	204	187
Of which:			
Branches and subsidiaries of overseas banks and overseas presence of Mainland banks	191	181	165
2 Amount due to overseas banks (RMB billion)	166.0	99.1	116.4
3 Amount due from overseas banks (RMB billion)	164.5	117.1	121.7
4 Turnover in Hong Kong's RMB RTGS system (Daily average during the period; RMB billion)	395.4	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.



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## INVESTMENT INCOME

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

\* Unaudited figures

<sup>^</sup> Including dividends

<sup>@</sup> Excluding valuation changes in Strategic Portfolio

<sup>#</sup> Including interest

<sup>&</sup> 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
<b>Investment income/(loss)</b>	<b>75.9</b>	<b>25.4</b>	<b>54.7</b>	<b>(23.3)</b>	<b>19.1</b>	<b>111.6</b>
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
<b>Payment to Fiscal Reserves #</b>	<b>(36.8)</b>	<b>(9.0)</b>	<b>(9.0)</b>	<b>(9.5)</b>	<b>(9.3)</b>	<b>(37.8)</b>
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>
<b>Increase/(Decrease) in EF Accumulated Surplus</b>	<b>13.4</b>	<b>11.6</b>	<b>36.9</b>	<b>(39.3)</b>	<b>4.2</b>	<b>56.0</b>

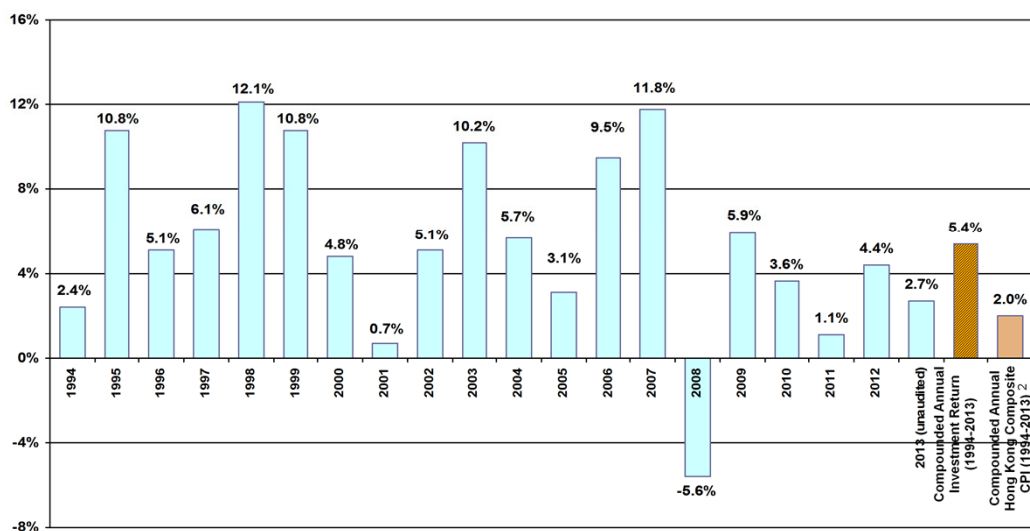
\* Unaudited figures

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

^ Including dividends



## INVESTMENT RETURN OF THE EXCHANGE FUND (1994-2013) <sup>1</sup>



<sup>1</sup> Investment return calculation excludes the holdings in the Strategic Portfolio

<sup>2</sup> 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	
<b>Total</b>	<b>88.6</b>	

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