



HONG KONG MONETARY AUTHORITY

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

**5 May 2014
[Translation]**



- 1. Assessment of Risk to Hong Kong's Financial Stability**
2. Development of Financial Market
3. Banking Supervision
4. Investment Performance of the Exchange Fund



ASSESSMENT OF THE US ECONOMY

- The US economy and labour market continue to improve
- The Fed may end its asset purchase programme this autumn
- A great majority of Fed officials expect interest rates to rise in mid-2015
- Whether labour market faces cyclical or structural problems remains to be seen
- Both the extent and pace of rate rises are highly uncertain

3

- Overall economic growth slowed substantially to a mere 0.1% in Q1 (Q4 2013: 2.6%), mainly reflecting adverse weather conditions at the beginning of the year.
- The Fed decided at its April meeting to continue to reduce the scale of its monthly asset purchases by US\$10 billion to US\$45 billion. At the current pace of tapering, it is also expected that the asset purchase programme may end in this autumn.



ASSESSMENT OF THE EURO AREA ECONOMY

- Economic contraction ceases, with slow recovery and persistently low inflation
- Public, private and banking sectors all saddled with high debts
- Yet market sentiment remains sanguine, with decent performance in the equity and bond markets
- European Central Bank is willing to adopt more aggressive measures to tackle low inflation



ASSESSMENT OF JAPAN'S ECONOMY

- Economic recovery continues but wage growth remains weak and current account continues to worsen
- Bank of Japan may introduce a second round of quantitative and qualitative easing (QQE) if the consumption tax hike poses a greater-than-expected drag on the economy
- Some progress with Abe's "third arrow" on structural reforms but the most important part is yet to be agreed on
- Massive public debt still a major risk to Japan's economy



ASSESSMENT OF MAINLAND CHINA'S ECONOMY

- Growth momentum softened, while the Government's economic growth target for 2014 was set at around 7.5%
- Daily trading band of the RMB/USD exchange rate was widened from 1% to 2% in mid-March
- The Government pledged to continue to contain financial risks as well as to strengthen the monitoring of default risks in local government financing platforms, industries with overcapacity and the real estate sector
- Foreign institutions have two different views on Mainland's economic outlook:
 - Many analysts at financial institutions are relatively pessimistic, with greater focus on financial risks associated with local government financing platforms and "shadow banking"
 - Multinational firms with operations in the Mainland are generally more optimistic, and believe that there is still enormous potential in the Mainland market



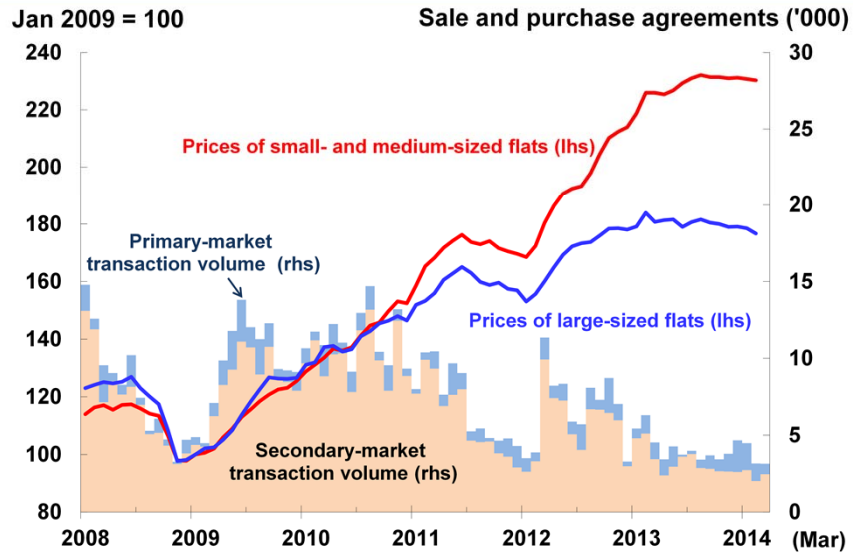
ASSESSMENT OF GLOBAL ECONOMIC AND FINANCIAL STABILITY RISKS

- Market sentiment turning more positive, which may have underestimated potential risks
- The Fed will continue to reduce asset purchases but the timing, extent and pace of rate rises remain uncertain
- The US monetary normalisation process would put pressure on capital flows in emerging markets
- As the rate-hike cycle draws near, risk to interest rates and asset price movements in emerging markets increases



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

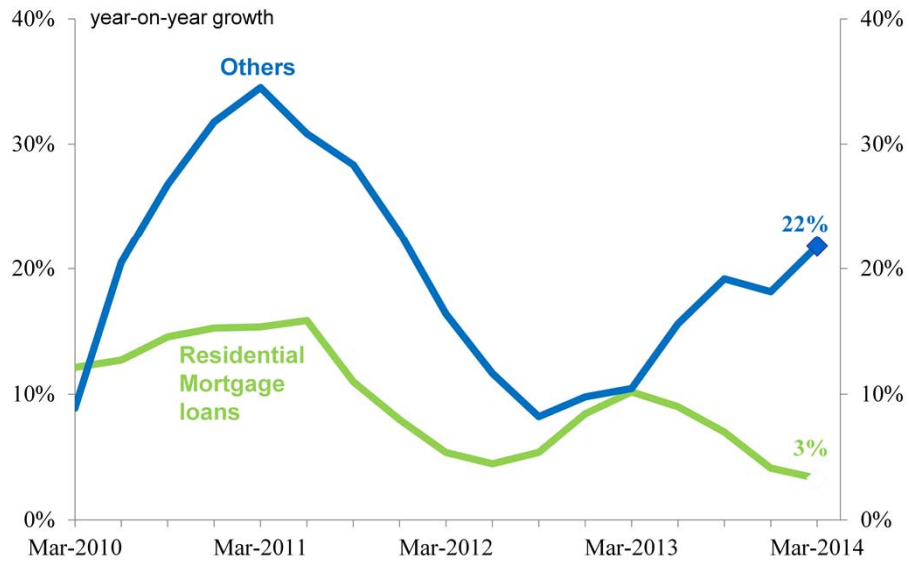
Property market under consolidation, but outlook still uncertain



Sources: R&VD and Land Registry



HONG KONG FINANCIAL STABILITY RISK ASSESSMENT: CREDIT EXPANSION

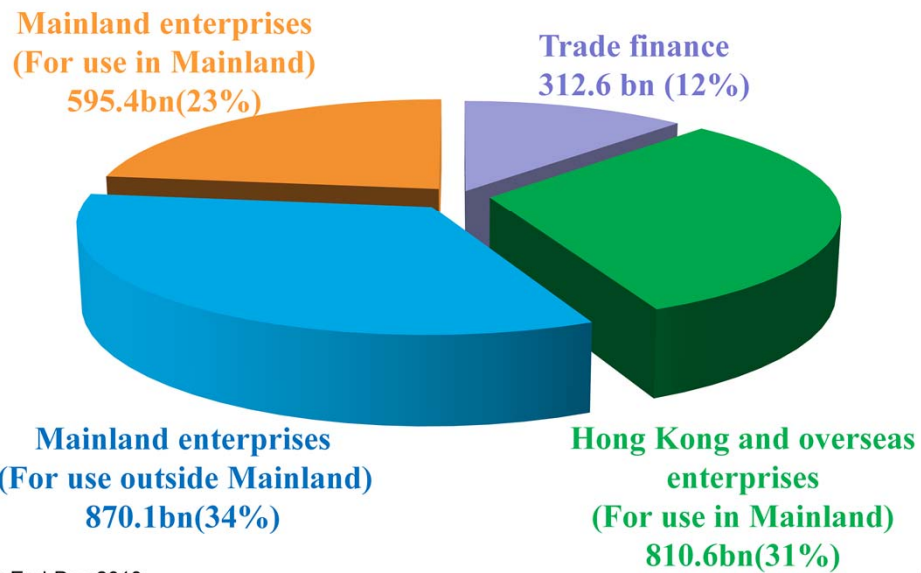


Note : Other loans do not include residential mortgage loans and IPO financing



HONG KONG FINANCIAL STABILITY RISK ASSESSMENT: MAINLAND-RELATED LENDING

Total : 2,588.7bn

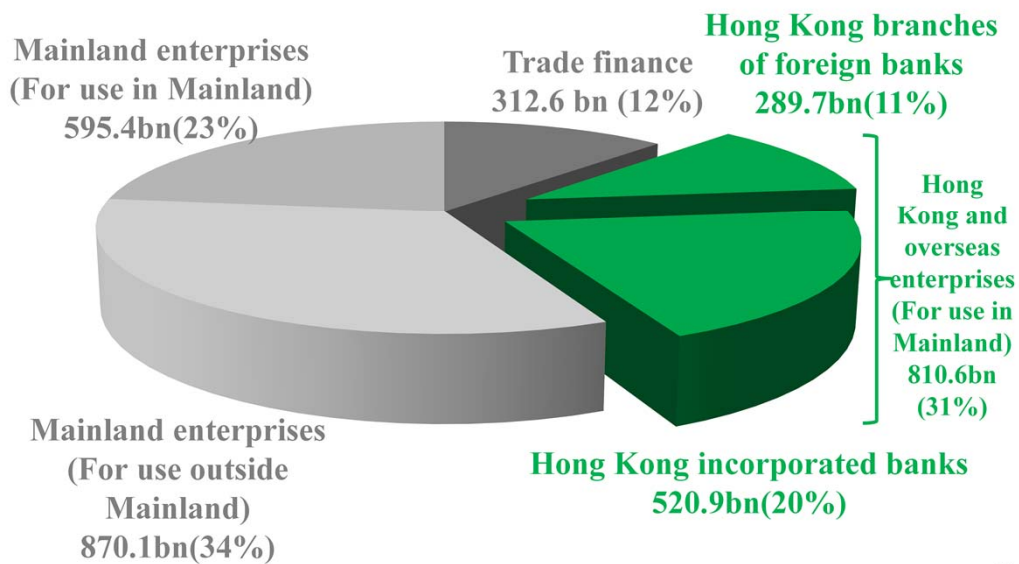


Position : End-Dec 2013



MAINLAND-RELATED LENDING

Total : 2,588.7bn

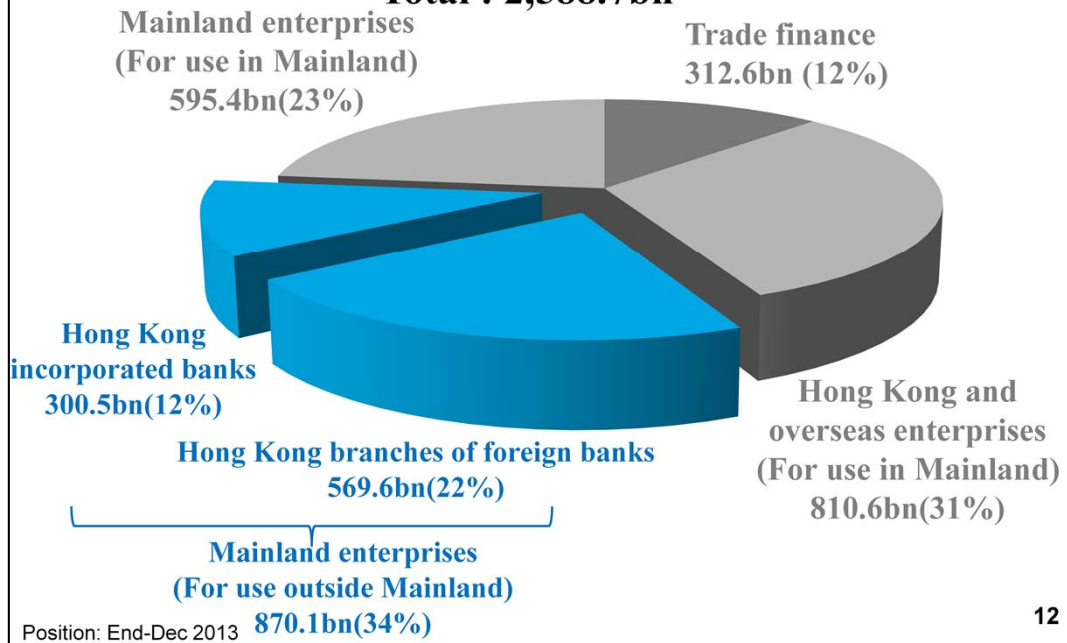


Position : End-Dec 2013



MAINLAND-RELATED LENDING

Total : 2,588.7bn





MAINLAND-RELATED LENDING

Total : 2,588.7bn

Mainland enterprises (For use in Mainland)

595.4bn (23%)

Hong Kong incorporated banks
Hong Kong branches of foreign banks

484.1bn (19%)

111.3bn (4%)

Trade finance
312.6bn (12%)

Mainland enterprises
(For use outside Mainland)
870.1bn (34%)

Hong Kong and overseas enterprises
(For use in Mainland)
810.6bn (31%)

Position : End-Dec 2013

13



RISK MANAGEMENT

- **Areas for attention**
 - Accelerating pace of loan growth since 2010
 - Mainly driven by Mainland-related lending
- **Supervisory principle**
 - Focus on banks' risk management systems
 - ✓ Credit risk management : Ensure prudent credit underwriting standards
 - ✓ Liquidity risk management : Stable Funding Requirement
- **Loan quality remains good: Overall risks manageable**



1. Assessment of Risk to Hong Kong's Financial Stability
- 2. Development of Financial Market**
3. Banking Supervision
4. Investment Performance of the Exchange Fund



DEVELOP HONG KONG AS A CORPORATE TREASURY CENTRE (CTC)

- Financial Secretary has set up a task force to review the taxation of corporate treasury activities under the Inland Revenue Ordinance in order to attract multinational corporations to set up their CTCs in Hong Kong. The task force will come up with concrete proposals in 12 months
- HKMA will liaise with the industry stakeholders and proactively participate in the work of the task force. We will also continue to promote Hong Kong as a destination for CTCs



DEVELOPMENT OF ISLAMIC FINANCE

- The Loans Ordinance has been amended to provide a legal basis for issuance of Islamic bonds (sukuk) under the Government Bond Programme
- Likely to be the world's first Islamic bond issued by an AAA rated Government
- Working closely with the Government in formulating a detailed plan for the inaugural Government sukuk. The preliminary plan is as follows:

Issuance size	: US\$500 million – US\$1 billion
Tenor	: 5 years or below
Target investors	: International institutional investors
Sukuk structure	: Lease (underlying assets : Government-owned properties in commercial premises)
Listing	: Seek listing status in Hong Kong and major Islamic financial centres



1. Assessment of Risk to Hong Kong's Financial Stability
2. Development of Financial Market
- 3. Banking Supervision**
4. Investment Performance of the Exchange Fund



INTERNATIONAL STANDARDS TO DEAL WITH “TOO-BIG-TO-FAIL” FINANCIAL INSTITUTIONS

- 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 closed on 6 April 2014; 33 submissions received
- Proactive stakeholder engagement during consultation period
- Second consultation exercise later in 2014, with a view to implementation by FSB’s end-2015 deadline

19

- As highlighted to the FAP in February 2014, 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 Hong Kong authorities (in self-assessments) and the FSB (in a peer review) identified a series of gaps in the existing toolkits available to the 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 in Hong Kong 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 a first-stage public consultation paper setting out the authorities’ initial thinking and proposals in early January. The three-month consultation, which ended on 6 April 2014, resulted in the receipt of 33 submissions from a wide range of stakeholders which are being carefully reviewed.
- The Government and financial regulators have proactively engaged with stakeholders during the consultation period. The HKMA, SFC and OCI have met with stakeholders from the sectors under their respective purviews while the FSTB led a number of sessions with some LegCo FAP members and certain professional associations to discuss the proposals in more detail.
- 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 addressing the more complex aspects of the proposals take place later in 2014, with a view to introducing a Bill into the LegCo by early-2015.



BASEL III IMPLEMENTATION PROGRESS

Legislative changes in Q4 2014

- Banking (Capital) (Amendment) Rules 2014
- Banking (Disclosure) (Amendment) Rules 2014
- Banking (Liquidity) Rules

Consultations

- Countercyclical capital buffer
- Higher loss absorbency for systemically important banks

20

Legislative changes in Q4

- Quick recap – Next phase of Basel III standards will cover:
 - Capital - the two capital buffers (“capital conservation buffer” and “countercyclical capital buffer”) and, in the case of banks identified as “systemically important”, a higher loss absorbency requirement;
 - Liquidity – the liquidity coverage ratio (and for Hong Kong, together with some modifications to the existing liquidity ratio); and
 - Disclosure – disclosures associated with the said capital and liquidity standards as well as those in relation to the leverage ratio.
- According to the Basel implementation timeline, legislation for these standards should be in place by 1 January 2015. We are currently working in conjunction with the FSTB and the DoJ in preparing the implementing rules, which will take the form of:
 - in the case of capital and disclosure standards, amendments to existing Banking (Capital) Rules and Banking (Disclosure) Rules; and
 - in the case of liquidity standards, a new set of Banking (Liquidity) Rules.

Consultations

- Meanwhile, consultations are in progress regarding certain operational aspects of the capital standards:
 - Countercyclical capital buffer – the HKMA is finalising its proposals on the technical mechanics for operating the buffer in view of comments received from the industry during consultation; and
 - Higher loss absorbency (HLA) – the HKMA has recently put out for consultation its policy proposals for a framework to identify systemically important banks in Hong Kong and assess the required level of HLA to be applied to them. The consultation is scheduled to close on 26 May.



1. Assessment of Risk to Hong Kong's Financial Stability
2. Development of Financial Market
3. Banking Supervision
- 4. Investment Performance of the Exchange Fund**



INVESTMENT INCOME

	2014	2013	2012	2011
(HK\$ billion)	Q1*	Full Year	Full Year	Full Year
Hong Kong equities[@]	(6.8)	10.1	30.7	(24.2)
Other equities	3.6	71.8	42.8	(12.2)
Bonds	13.2	(19.1)	33.1	71.9
Other investments^{&}	-	16.8	6.4	0.7
Foreign exchange	<u>1.1</u>	<u>1.6</u>	<u>(1.4)</u>	<u>(9.1)</u>
Investment income^{@&}	11.1	81.2	111.6	27.1

* Unaudited figures

@ Excluding valuation changes in Strategic Portfolio

& Including valuation changes of private equity and real estate investments held by Exchange Fund's investment holding subsidiaries

(The first quarter valuation change is not available pending the receipt of valuation reports of some investments)



INCOME AND EXPENDITURE

(HK\$ billion)	2014	2013				
	Q1*	Full year	Q4	Q3	Q2	Q1
Investment income/(loss)	11.1	81.2	30.7	54.7	(23.3)	19.1
Other income	-	0.2	-	0.1	0.1	-
Interest and other expenses	<u>(1.1)</u>	<u>(4.9)</u>	<u>(1.2)</u>	<u>(1.3)</u>	<u>(1.5)</u>	<u>(0.9)</u>
Net income/(loss)	10.0	76.5	29.5	53.5	(24.7)	18.2
Payment to Fiscal Reserves[#]	(7.1)	(36.8)	(9.0)	(9.0)	(9.5)	(9.3)
Payment to HKSAR government funds and statutory bodies [#]	(1.9)	(9.3)	(2.6)	(2.5)	(2.1)	(2.1)

* Unaudited figures

The fixed rate of fee payment is 3.6% for 2014 and 5.0% for 2013