



HONG KONG MONETARY AUTHORITY

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

2 February 2015



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

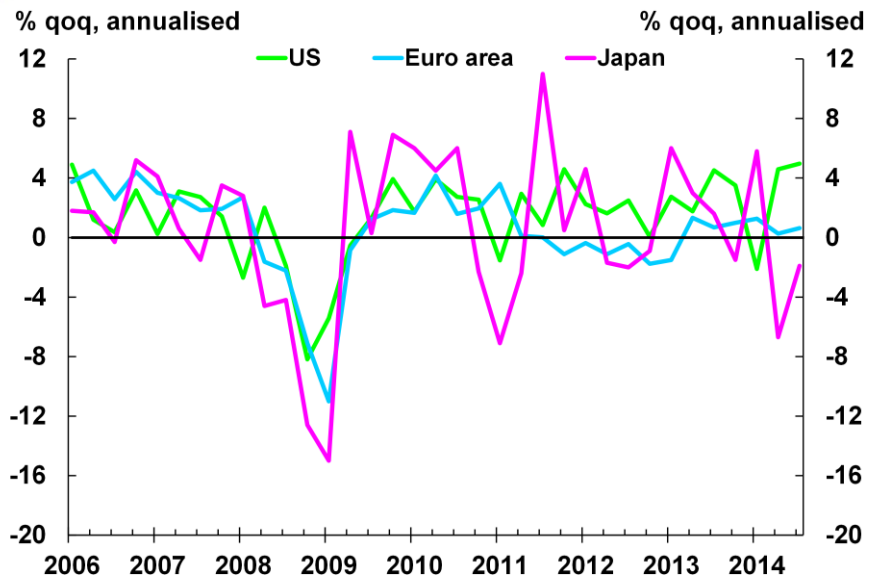
(% year-on-year)

	2014 Estimates	2015 Forecasts	2016 Forecasts
US	2.4	3.2	2.8
Euro area	0.8	1.1	1.6
Japan	0.2	1.2	1.5
Asia (ex-Japan)	6.0	6.0	6.0
Mainland China	7.4	7.0	6.9
Hong Kong	2.2	2.7	2.8

Source: January Consensus Forecasts



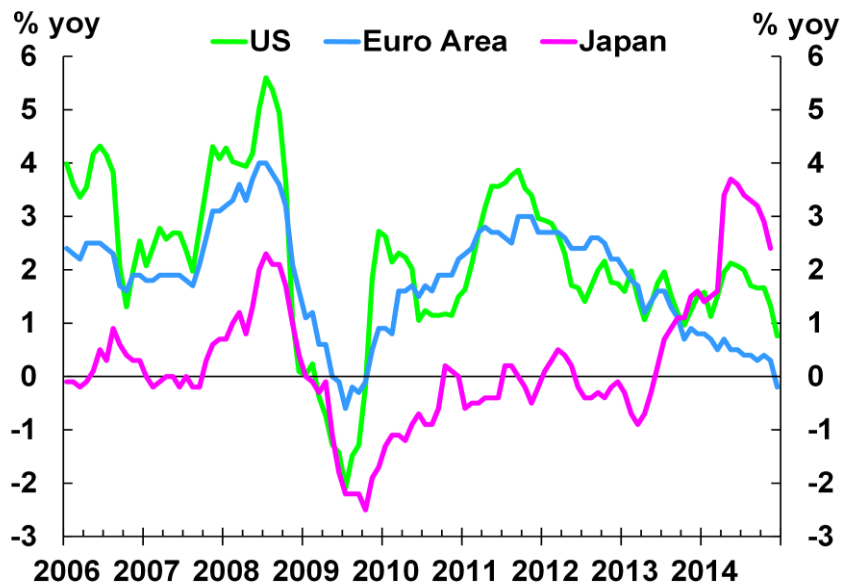
REAL GDP GROWTH IN MAJOR COUNTRIES



Source: Bloomberg



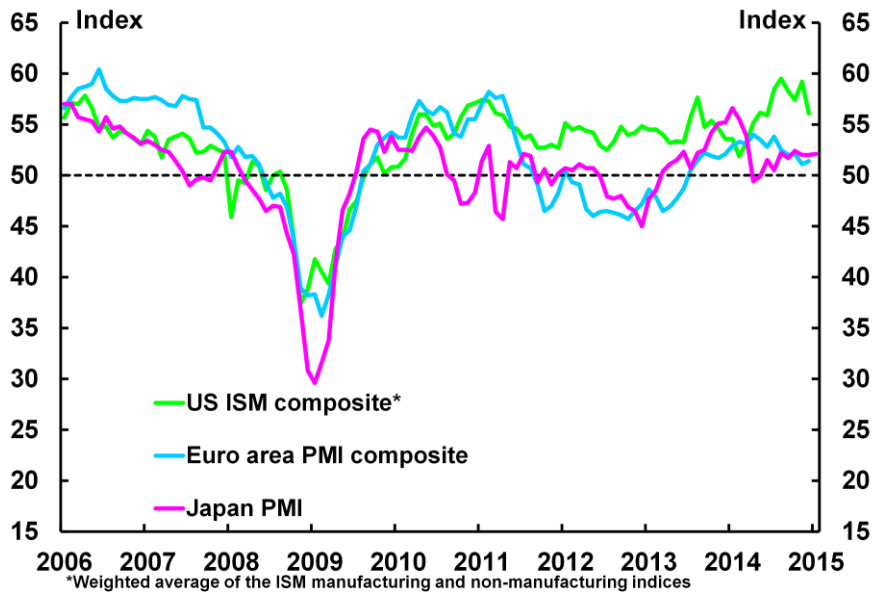
HEADLINE INFLATION IN MAJOR COUNTRIES



Sources: Bloomberg and CEIC



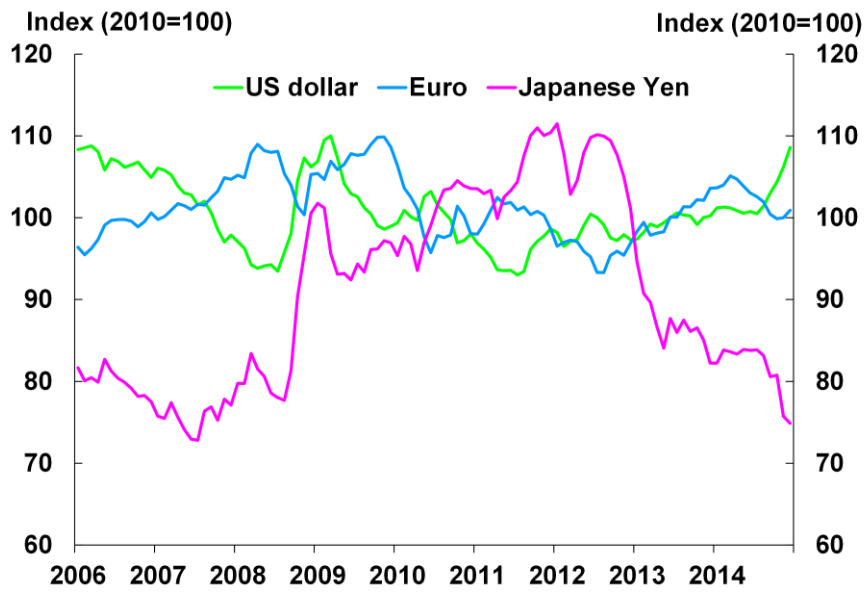
PURCHASING MANAGERS' INDEX IN MAJOR ECONOMIES



Sources: Bloomberg and CEIC



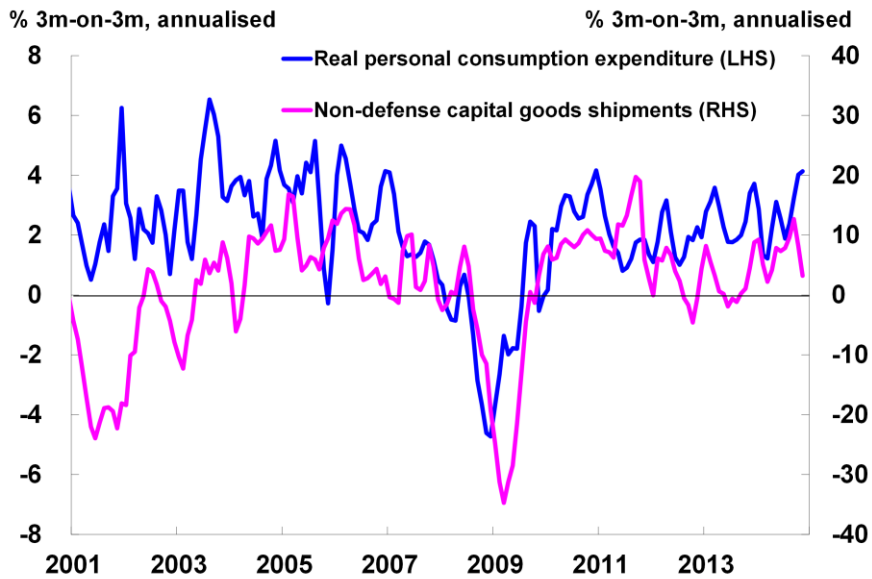
NOMINAL EFFECTIVE EXCHANGE RATE INDEX OF MAJOR CURRENCIES



Source: CEIC



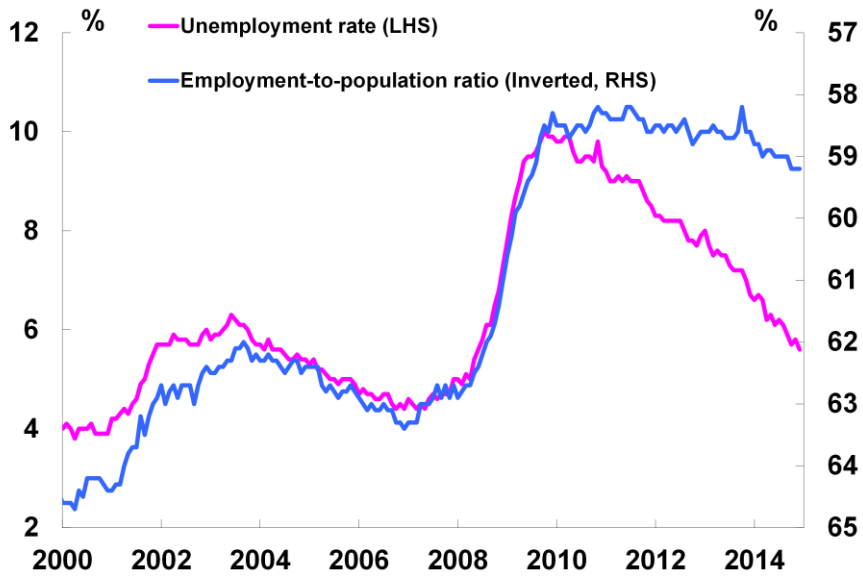
US: CONSUMPTION GROWTH & BUSINESS INVESTMENT ACTIVITY



Source: CEIC



US: LABOUR MARKET SITUATION



Source: CEIC



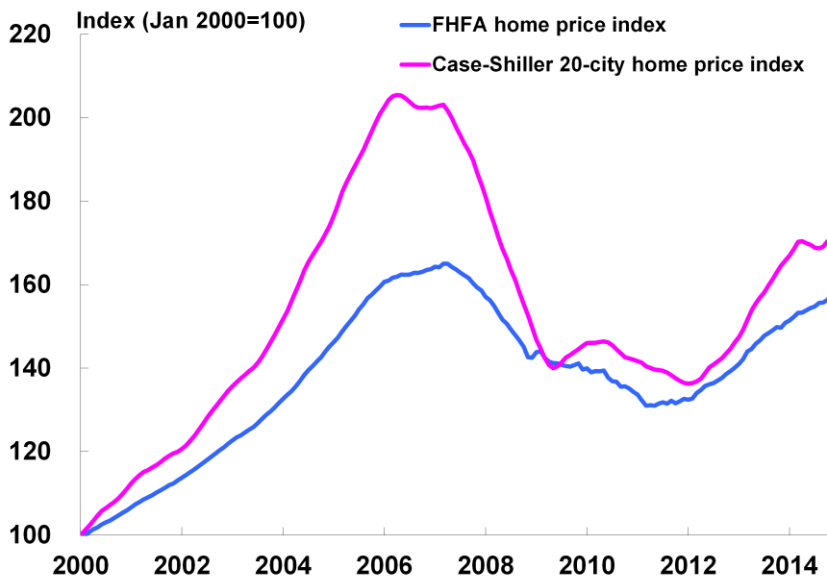
US: LABOUR FORCE PARTICIPATION



Source: CEIC



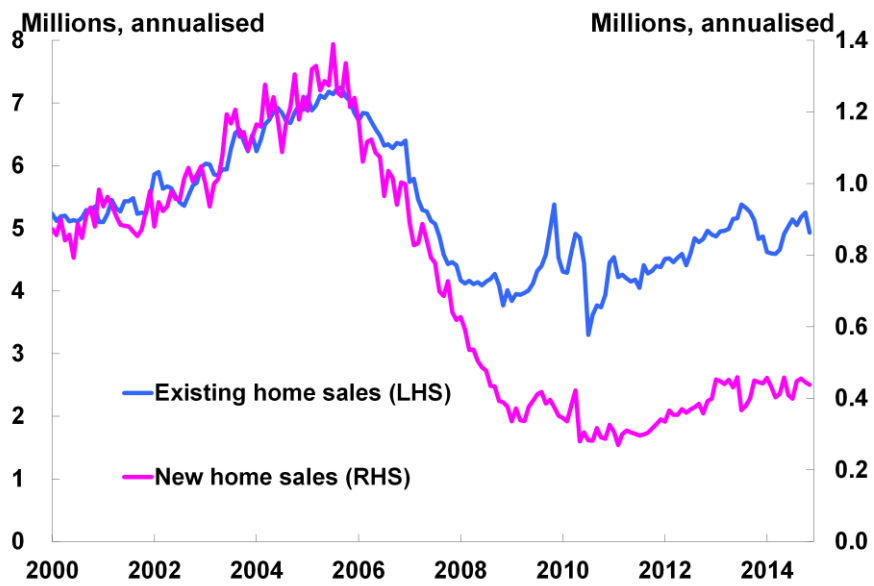
US: HOUSE PRICES



Sources: Standard & Poor's and CEIC



US: HOME SALES

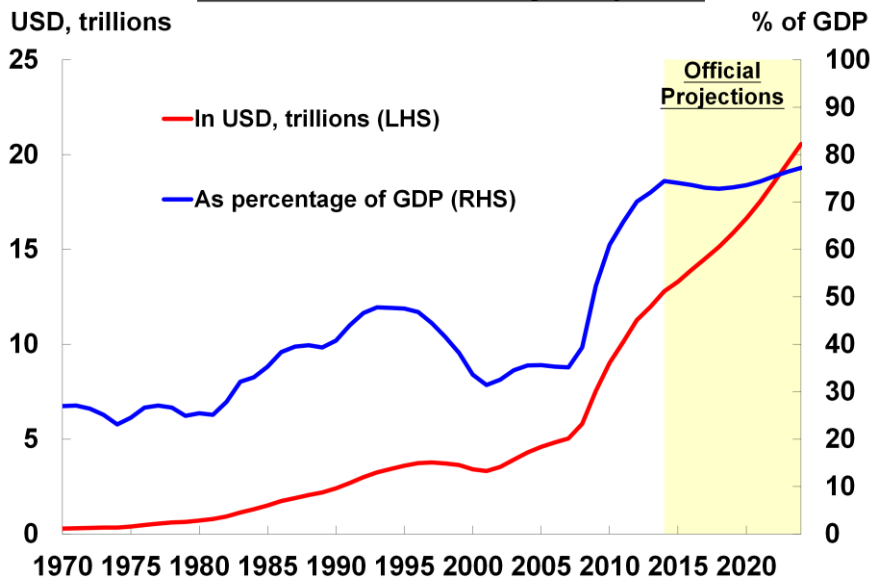


Source: CEIC



US: FEDERAL GOVERNMENT DEBT

US federal debt held by the public

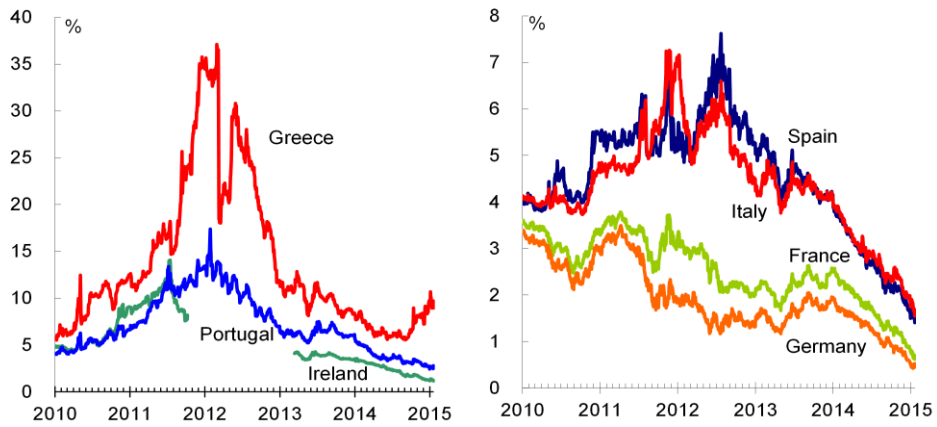


Source: Congressional Budget Office



EURO AREA: SOVEREIGN BOND YIELDS

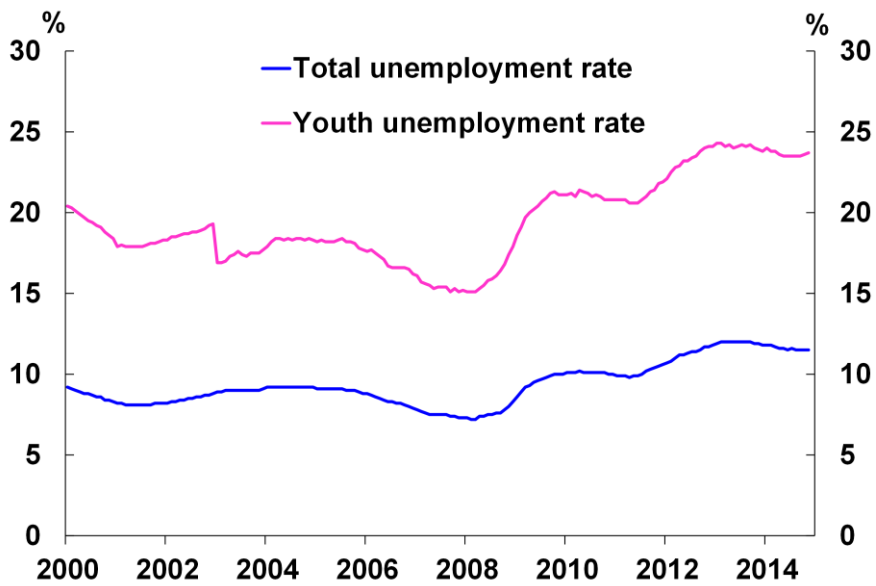
10-year sovereign bond yield



Note: 10-year Irish sovereign bond yield data is not available between 12 Oct 2011 and 14 Mar 2013
Source: Bloomberg



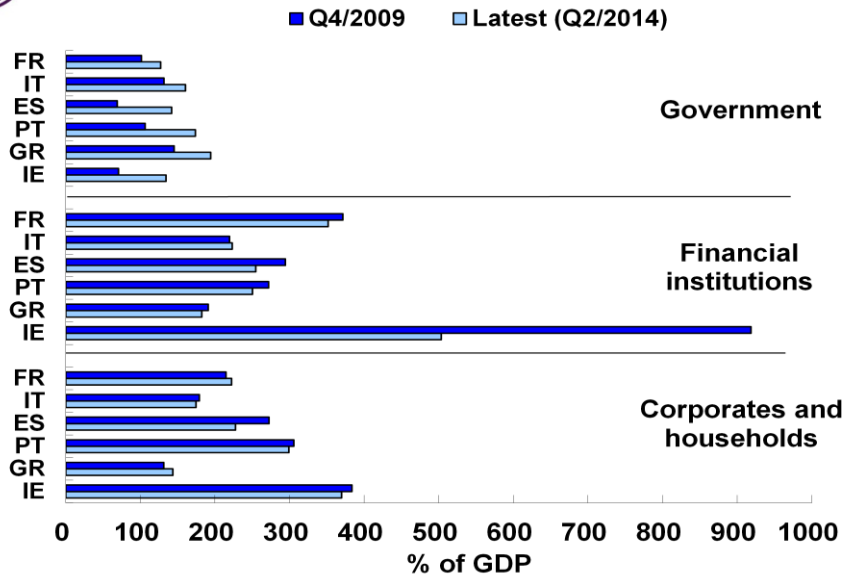
EURO AREA: UNEMPLOYMENT RATE



Source: Bloomberg



EURO AREA: OVERALL INDEBTEDNESS

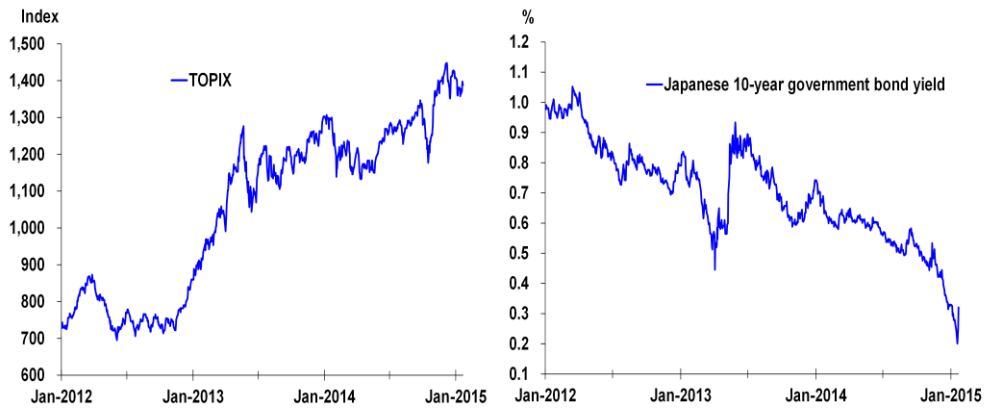


Source: European Central Bank

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



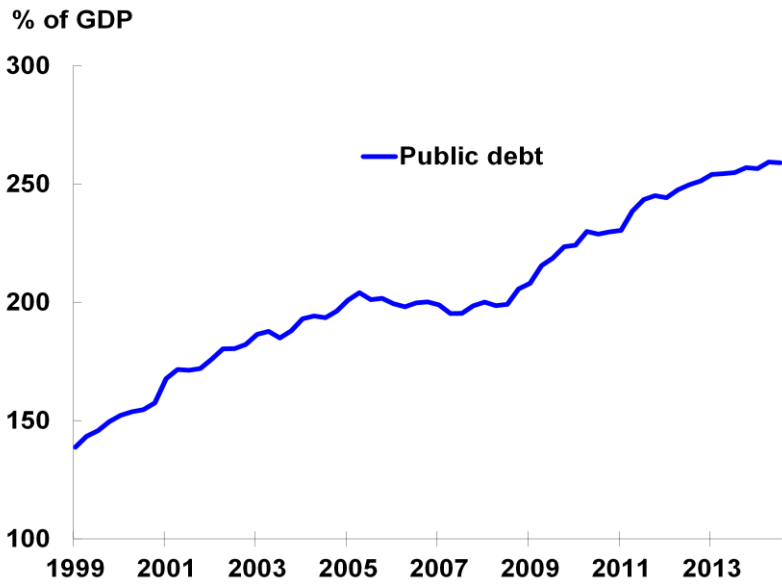
JAPAN: FINANCIAL MARKETS



Source: Bloomberg



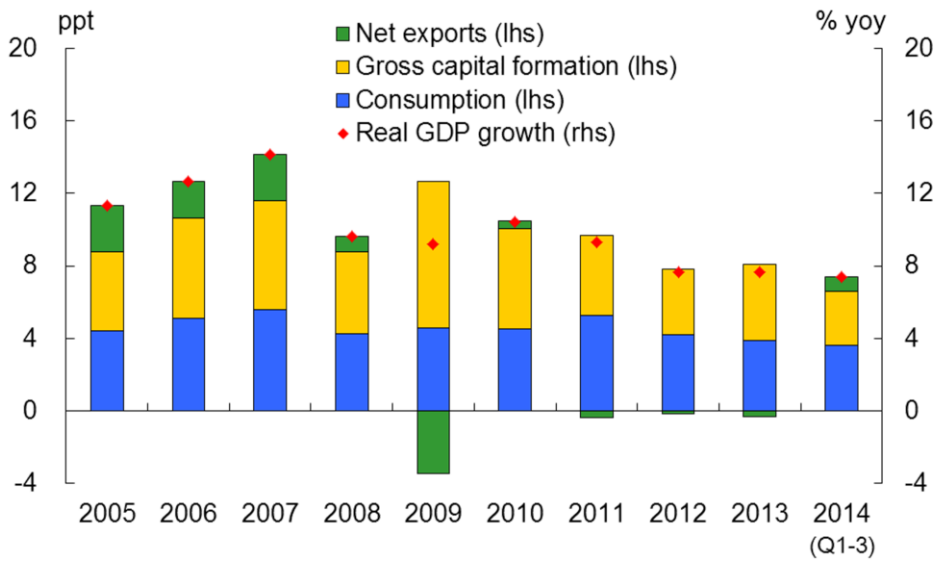
JAPAN: PUBLIC DEBT



Sources: Bank of Japan and CEIC



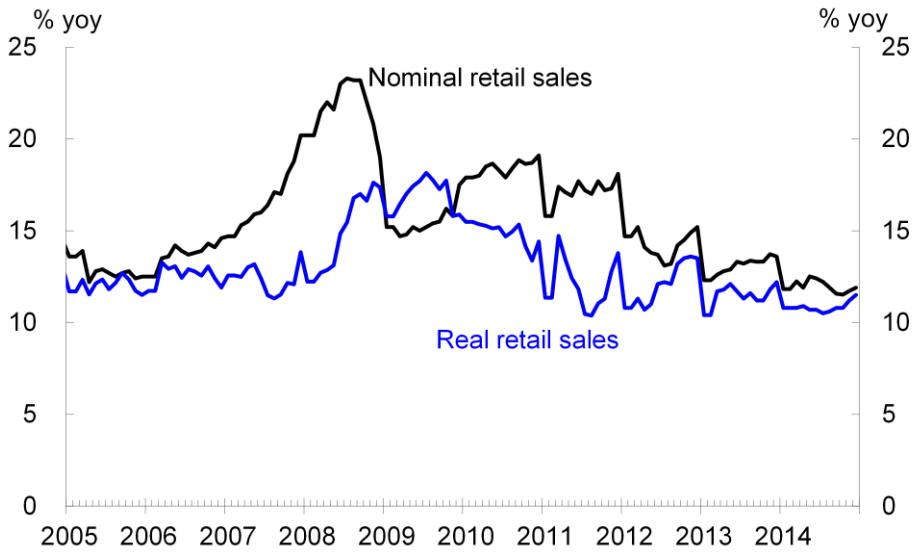
MAINLAND CHINA: REAL GDP GROWTH



Source: CEIC



MAINLAND CHINA: RETAIL SALES

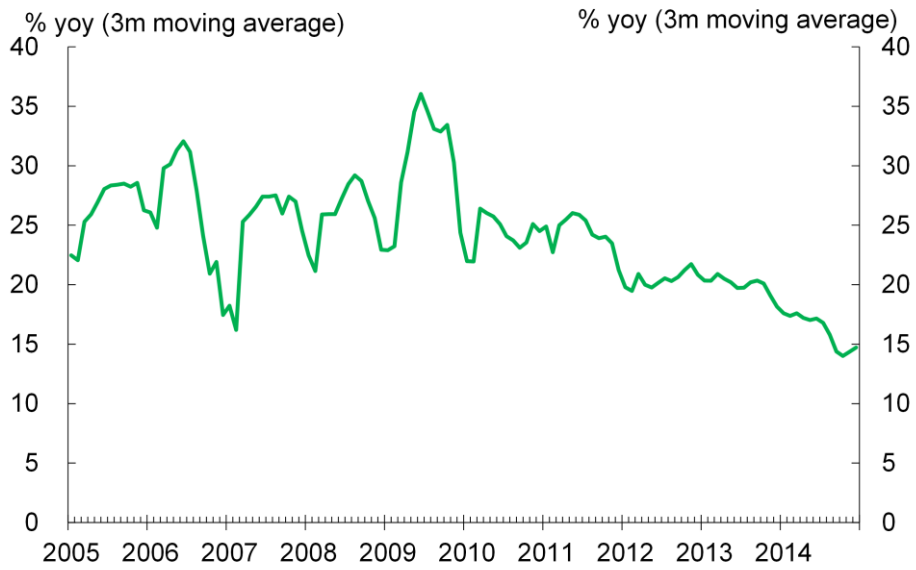


* January and February figures are the average growth rate for the first two months of the year.

Sources: CEIC, WIND and HKMA staff estimates



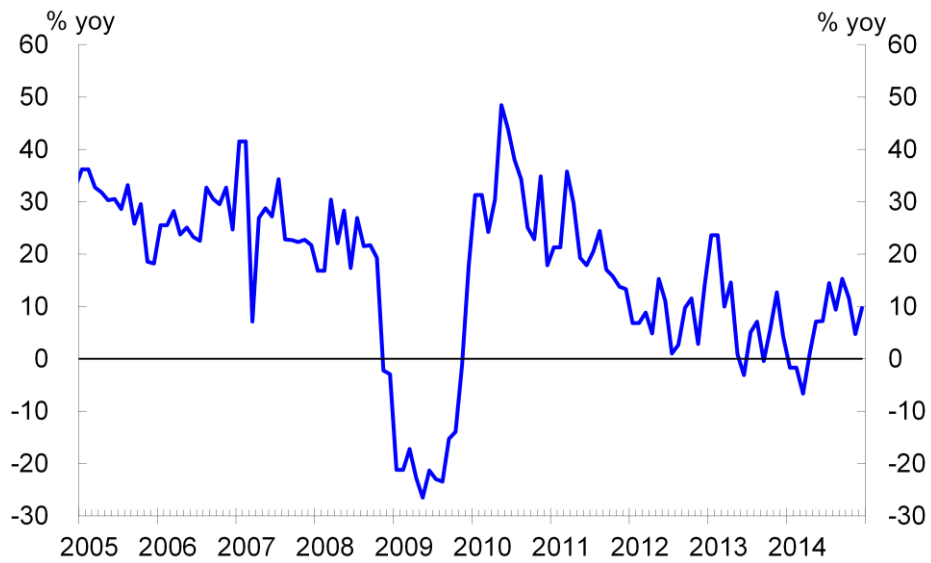
MAINLAND CHINA: FIXED ASSET INVESTMENT



Sources: CEIC and HKMA staff estimates



MAINLAND CHINA: EXPORT GROWTH

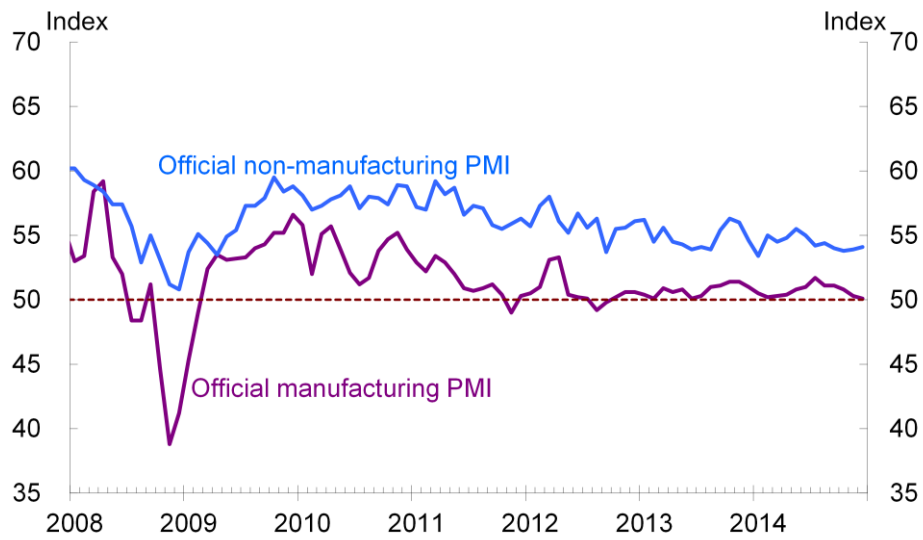


* January and February figures are the average growth rate for the first two months of the year.

Sources: CEIC and HKMA staff estimates



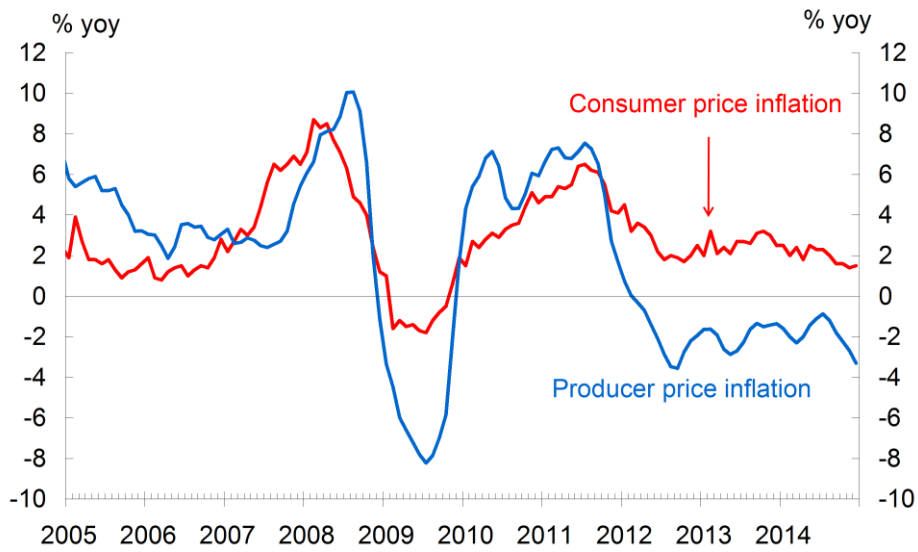
MAINLAND CHINA: PURCHASING MANAGERS' INDEX



Source: CEIC



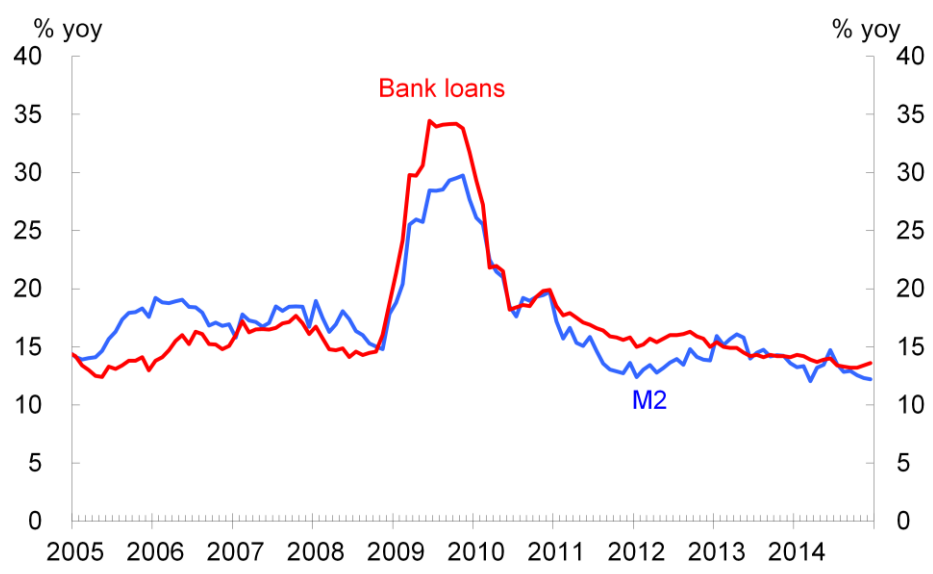
MAINLAND CHINA: INFLATION



Source: CEIC



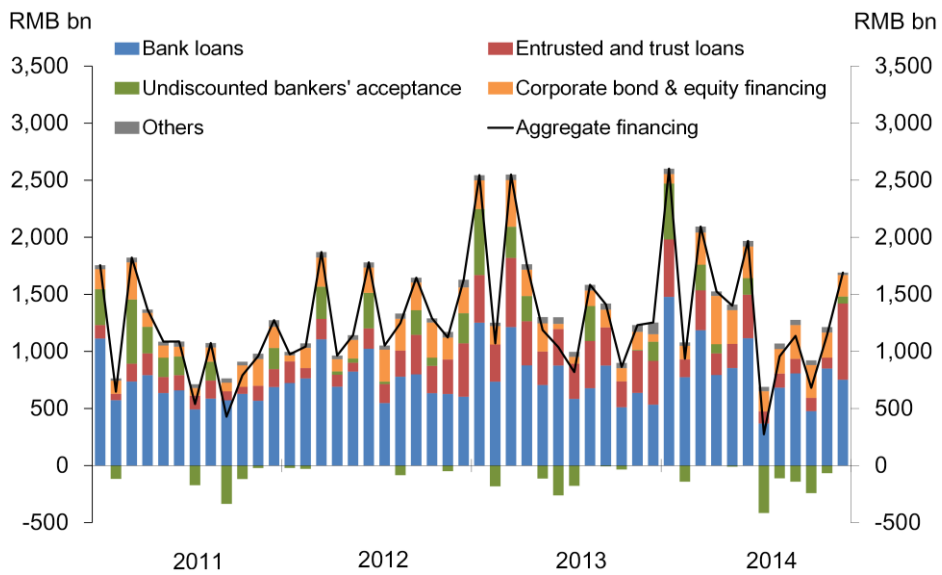
MAINLAND CHINA: MONEY AND LOAN GROWTH



Source: CEIC



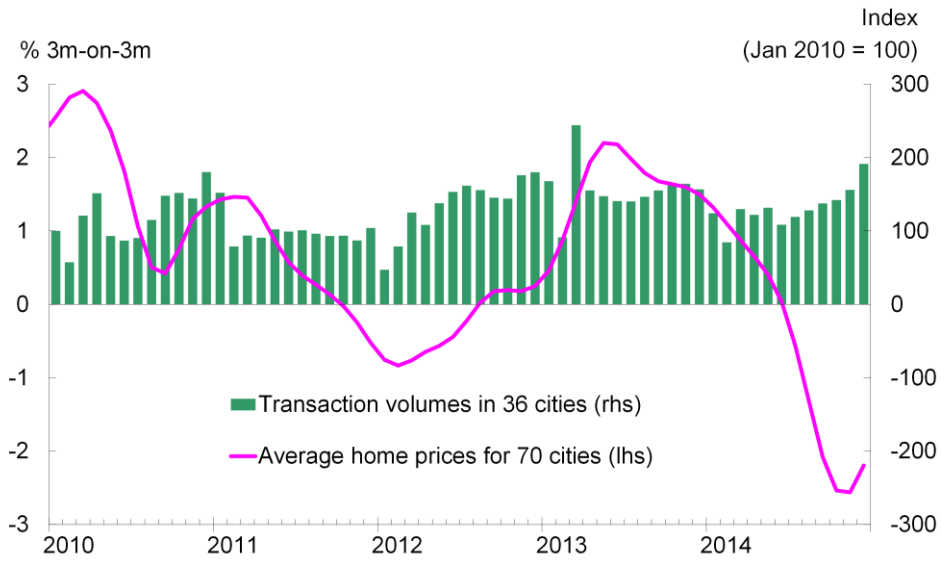
MAINLAND CHINA: AGGREGATE FINANCING



Source: CEIC



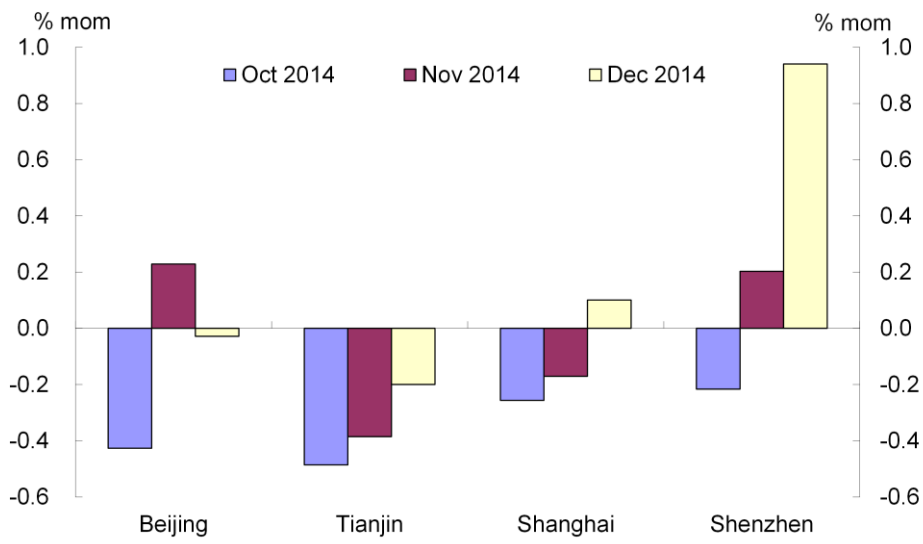
MAINLAND CHINA: PROPERTY PRICE AND TRANSACTION VOLUME



Sources: CEIC, WIND and HKMA staff estimates



MAINLAND CHINA: HOUSING PRICE CHANGES IN MAJOR CITIES

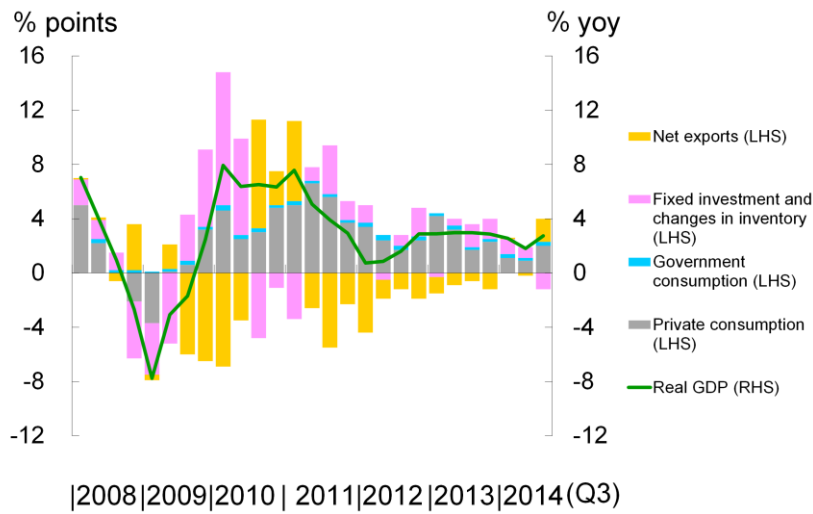


Sources: CEIC, WIND and HKMA staff estimates



HONG KONG: REAL GDP GROWTH

Changes in Real GDP and contributions by major components

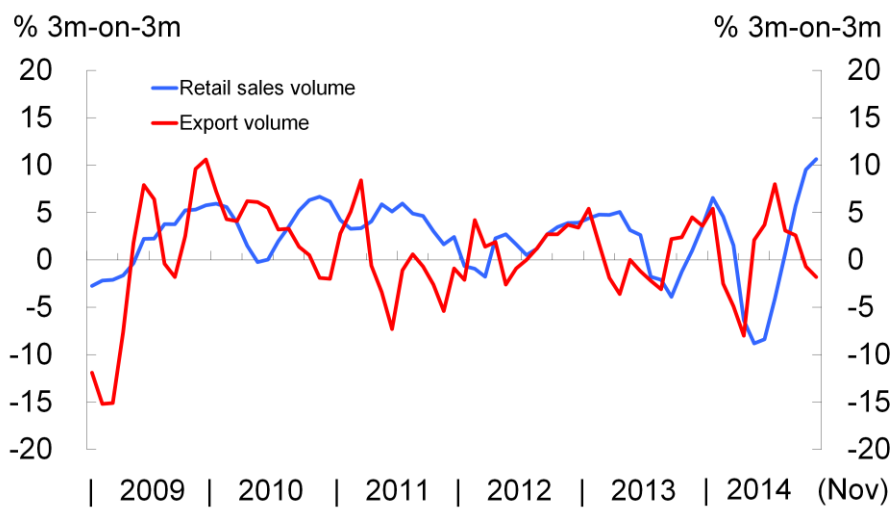


Source: C&SD



HONG KONG: ECONOMIC ACTIVITY

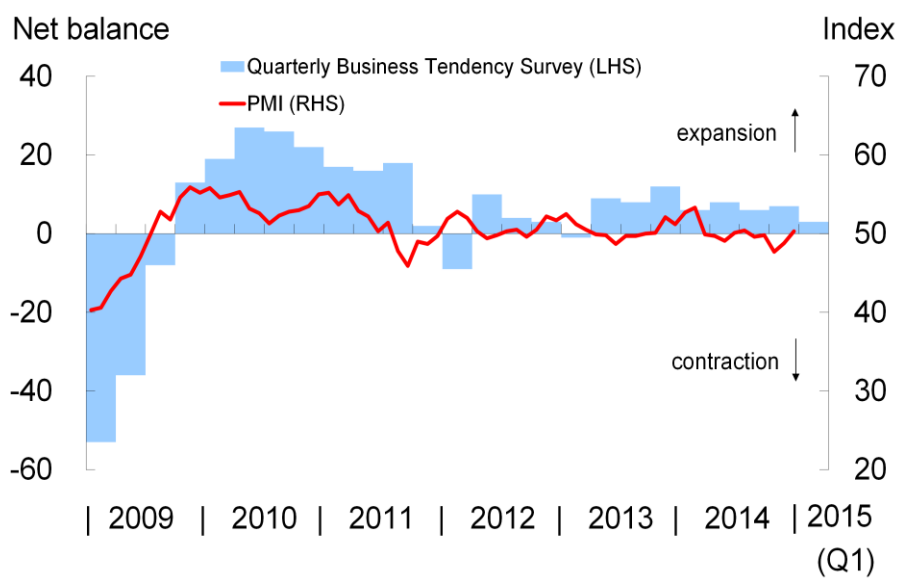
Retail Sales and Exports



Source: C&SD



HONG KONG: BUSINESS OUTLOOK

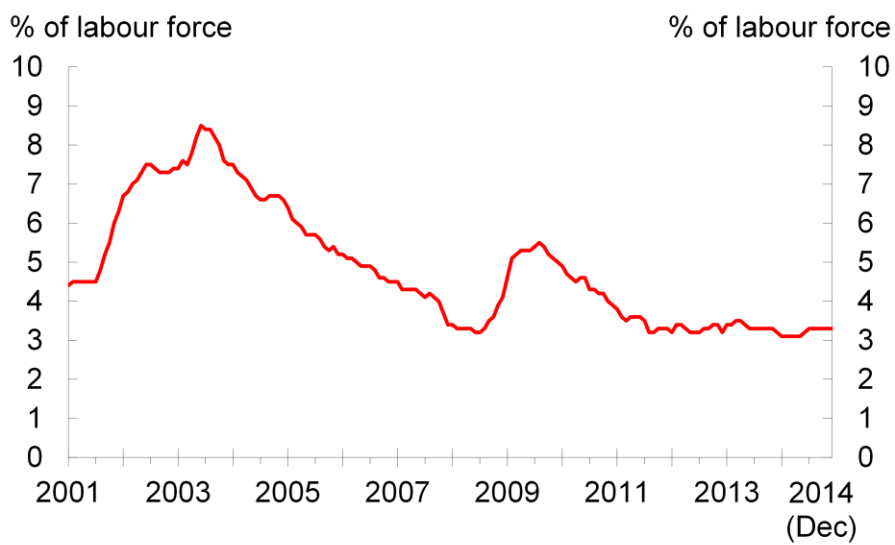


Sources: C&SD and Markit Economics



HONG KONG: LABOUR MARKET

Unemployment rate

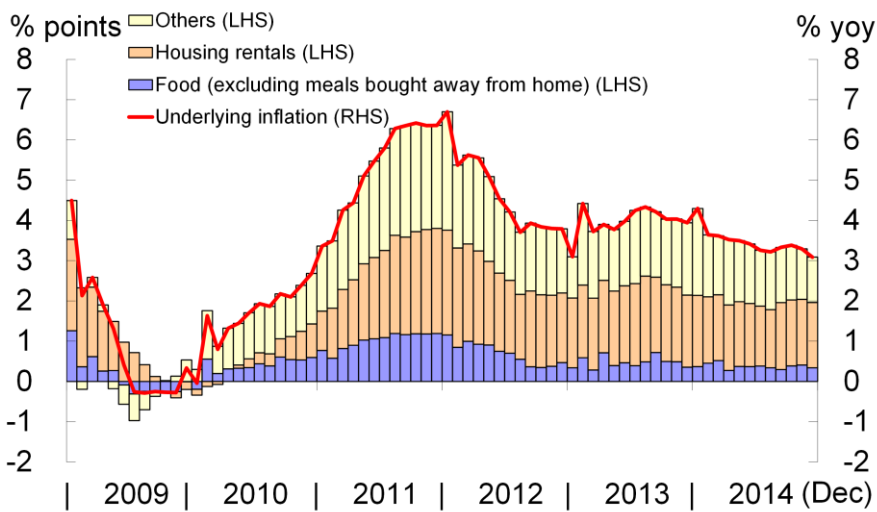


Source: C&SD



HONG KONG: INFLATION

Underlying inflation and contributions of its components

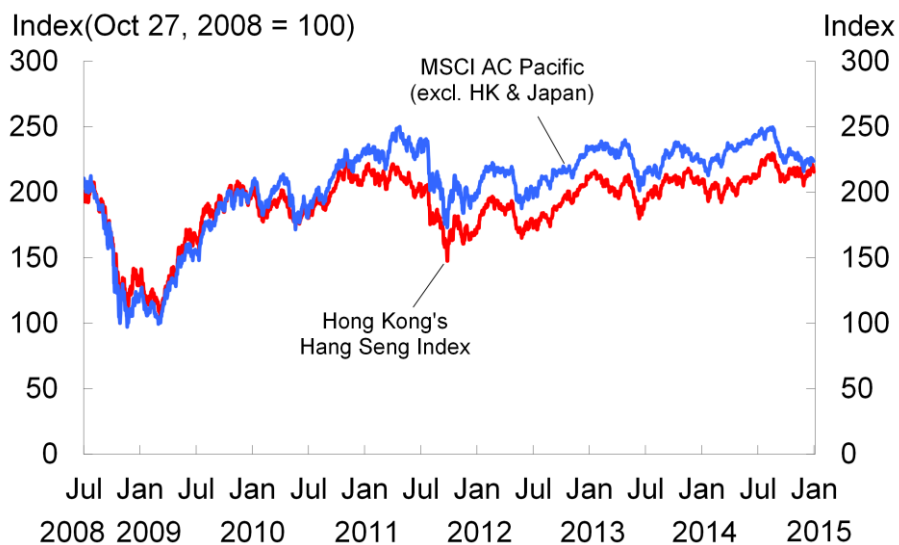


Sources: C&SD and HKMA staff estimates



HONG KONG: EQUITY MARKET

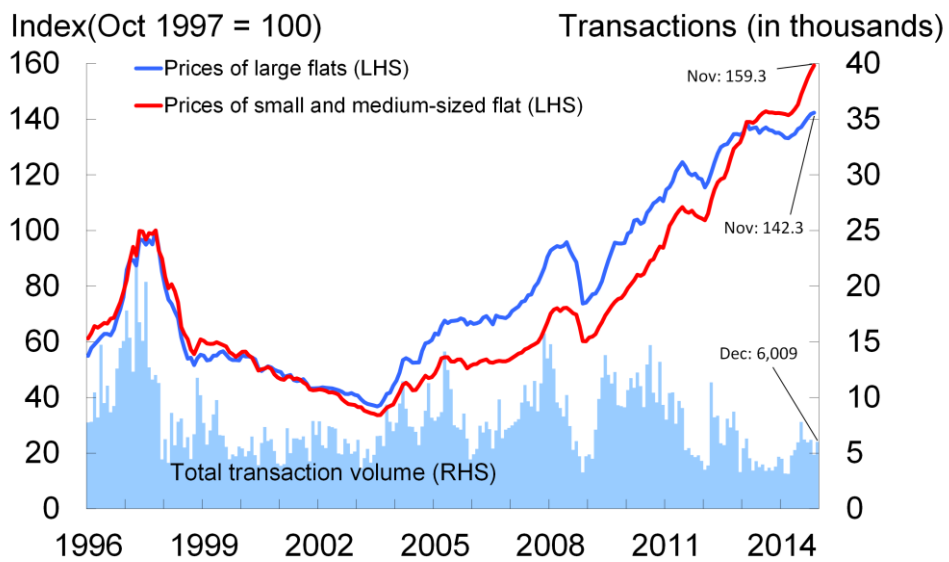
Hong Kong and Asia Pacific equity market performance



Source: Bloomberg



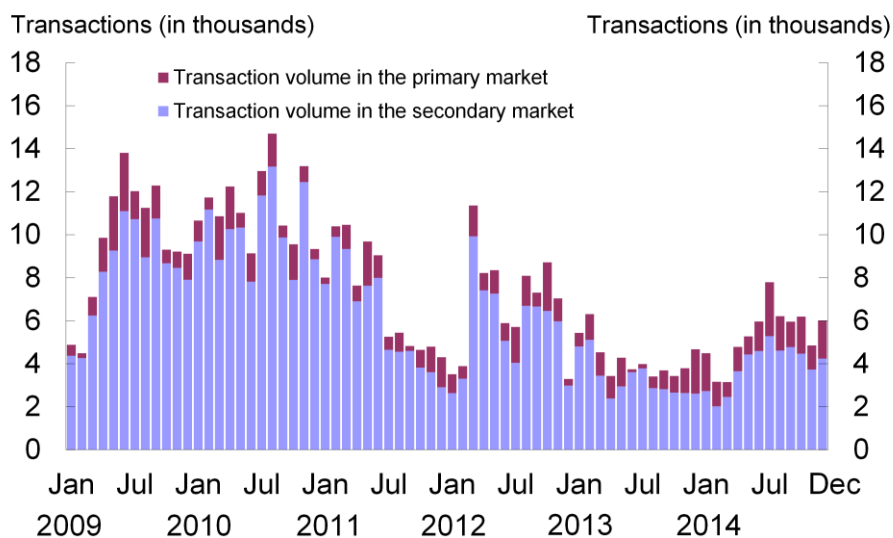
HONG KONG: RESIDENTIAL PROPERTY PRICES AND TRANSACTION VOLUME



Sources: Rating and Valuation Department and The Land Registry



HONG KONG: TRANSACTION VOLUME IN THE PRIMARY AND SECONDARY MARKETS

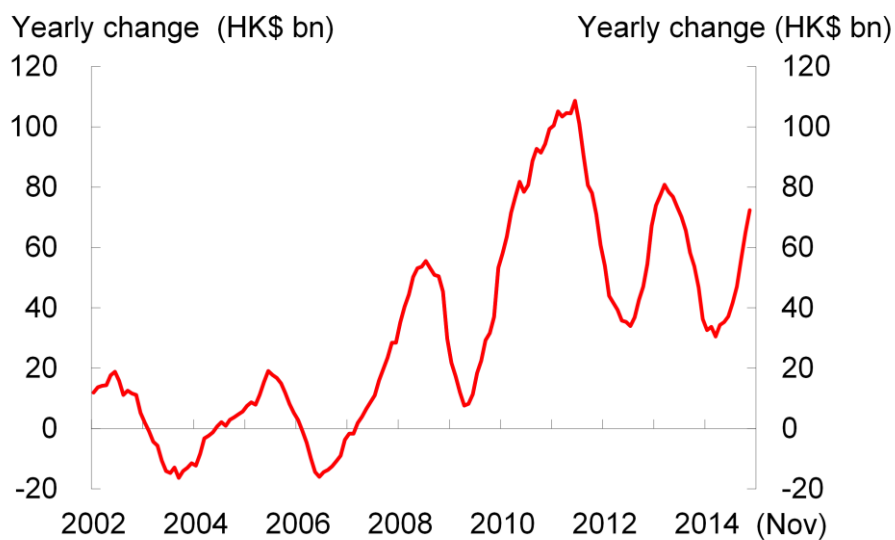


Source: The Land Registry



HONG KONG: OUTSTANDING RESIDENTIAL MORTGAGE LOANS

Changes in outstanding residential mortgage loans



Source: HKMA



HONG KONG: NEW RESIDENTIAL MORTGAGE LOANS

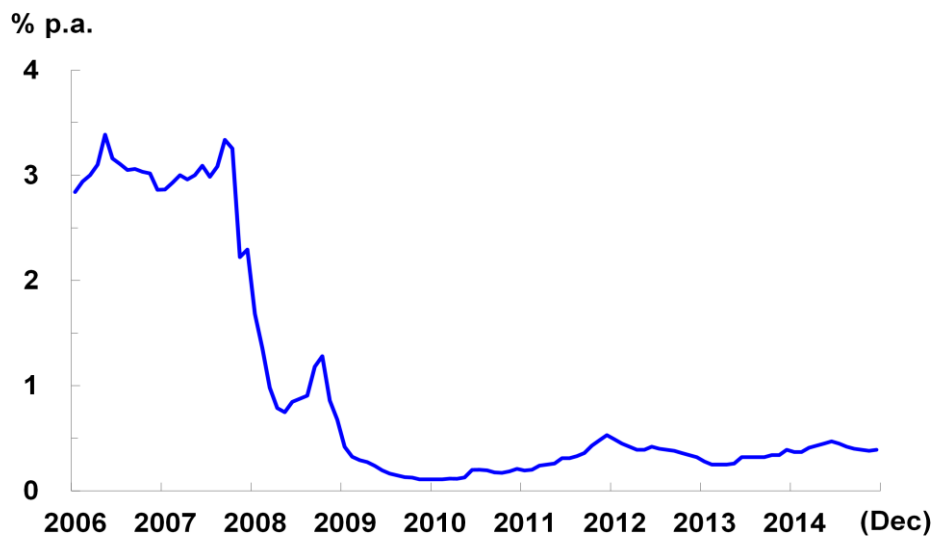
New residential mortgage loans made and approved



Source: HKMA



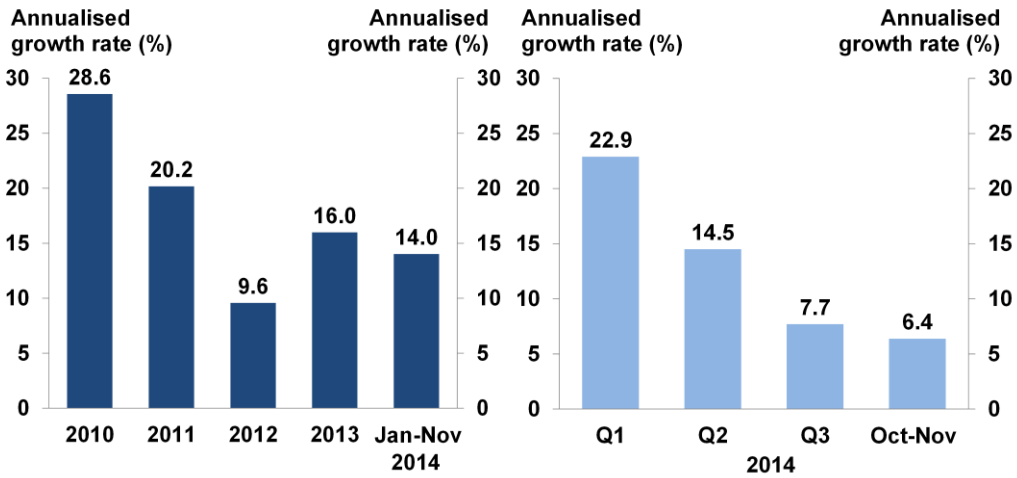
HONG KONG: COMPOSITE INTEREST RATE



Source: HKMA



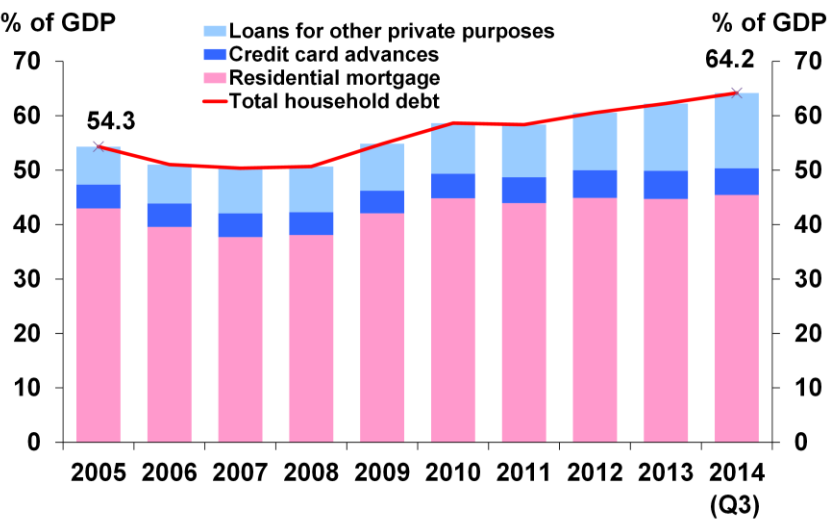
HONG KONG: LOAN GROWTH



Source: HKMA



HONG KONG: HOUSEHOLD DEBT



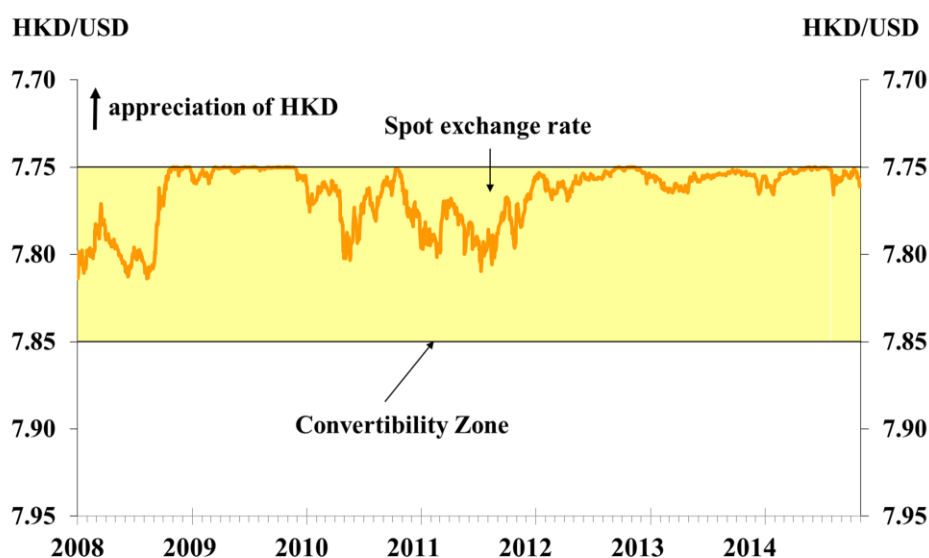
Sources: C&SD and HKMA staff estimates



CURRENCY STABILITY



HONG KONG DOLLAR SPOT EXCHANGE RATE

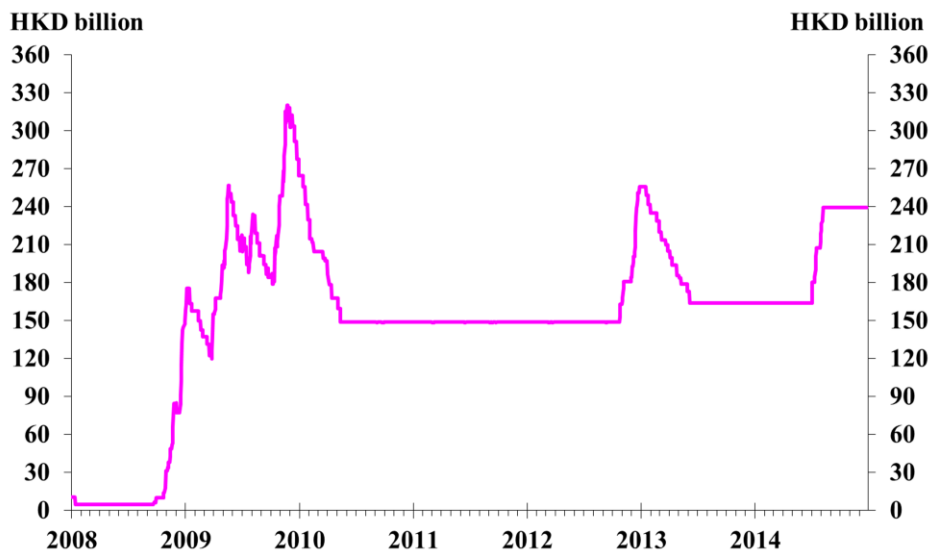


44

- Despite increased volatility in the global financial markets and depreciation pressures in the emerging market currencies, the Hong Kong dollar spot exchange rate remained stable in November and December, trading in the range of 7.7511 to 7.7613.
- The Convertibility Undertaking has not been triggered since 6 August 2014.



AGGREGATE BALANCE

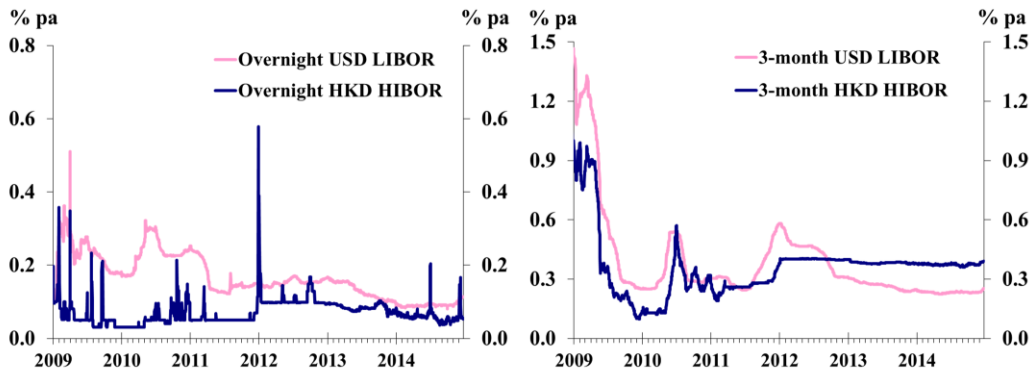


45

- The Aggregate Balance has stayed virtually unchanged at around HK\$239 billion since early August 2014.



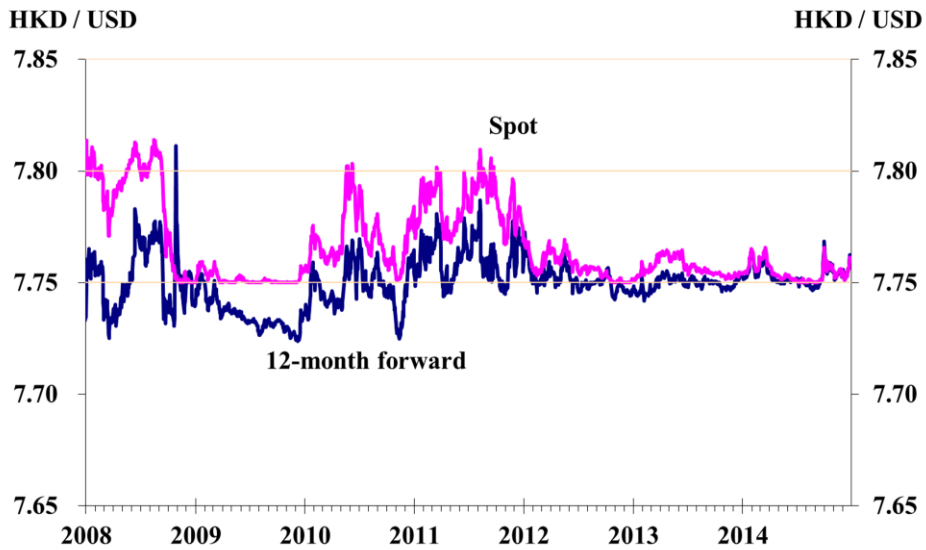
DOMESTIC INTEREST RATES



- In the last two months, the interbank interest rates were broadly steady at low levels amid ample liquidity. The temporary spike in overnight Hong Kong dollar HIBOR in early December reflected an increase in funding demand related to equity fund-raising activities.



HONG KONG DOLLAR FORWARD EXCHANGE RATE



- Hong Kong dollar forward exchange rate tracked closely the movements in the Hong Kong dollar spot rate over the last few months.



COIN COLLECTION PROGRAMME

- Since the launch of the programme in October 2014 until the end of 2014, 50,000 people had used the service. The two “Coin Carts” have collected 46 million coins with total face value of \$41 million.
- The two “Coin Carts” serve the 18 districts all over Hong Kong on a rotating basis, providing service at locations convenient to the public without obstructing the traffic. The HKMA has taken into account suggestions given by the District Councils and the public in choosing suitable service locations.
- This is a 2-year pilot scheme until September 2016. The service schedule is available on HKMA website.

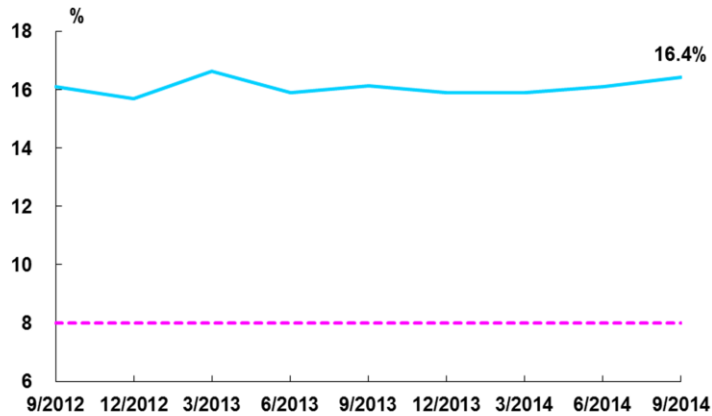


BANKING STABILITY



BANKING SECTOR PERFORMANCE

Locally incorporated Authorized Institutions (AIs)
continued to be well capitalised



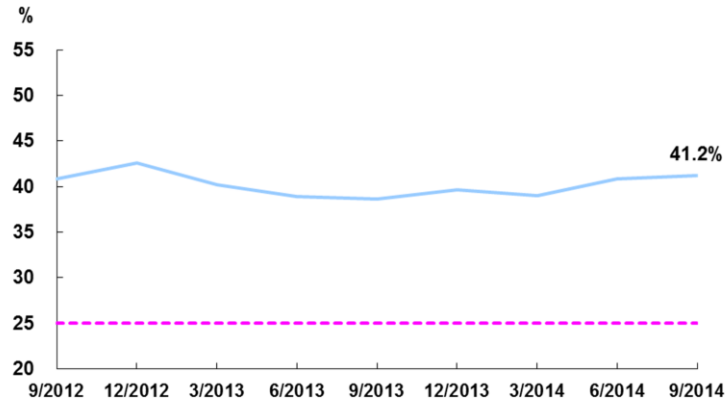
50

- The consolidated capital adequacy ratio (CAR) of locally incorporated AIs increased to 16.4% at end-September 2014 from 16.1% at end-June 2014 because the growth of capital base (+3.2%) outpaced that of risk-weighted amount (+1.0%). The consolidated CAR remained well above the international minimum standard of 8%.



BANKING SECTOR PERFORMANCE

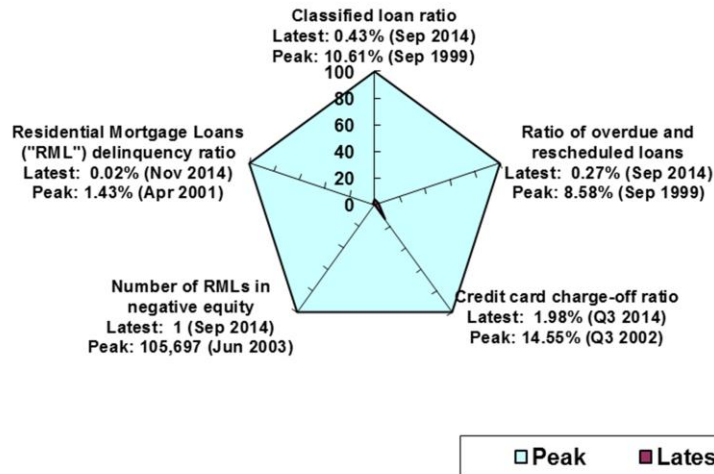
Quarterly average liquidity ratio of retail banks remained well above statutory minimum of 25%





BANKING SECTOR PERFORMANCE

Asset quality remained good compared with historical standards



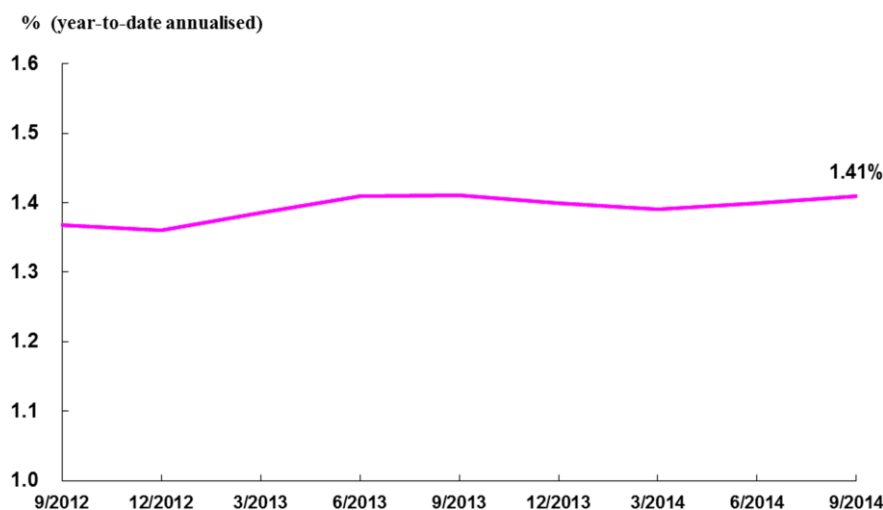
52

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



BANKING SECTOR PERFORMANCE

Net interest margin of retail banks remained stable



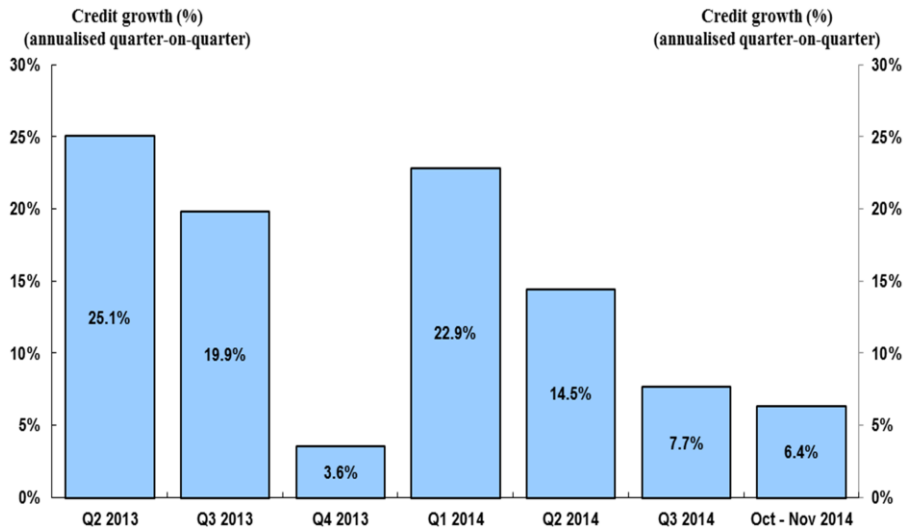
53

- The year-to-date annualised net interest margin (NIM) of retail banks' Hong Kong offices was 1.41% in the first three quarters of 2014, same as the corresponding period last year.
- The aggregate pre-tax operating profit of retail banks' Hong Kong offices in the first three quarters of 2014 increased by 6.4% as compared with the same period last year. The rise was mainly attributable to the robust growth in net interest income (+15.2%), but partly offset by the increase in operating expenses (+10.3%).



CREDIT GROWTH

Credit growth continued to moderate



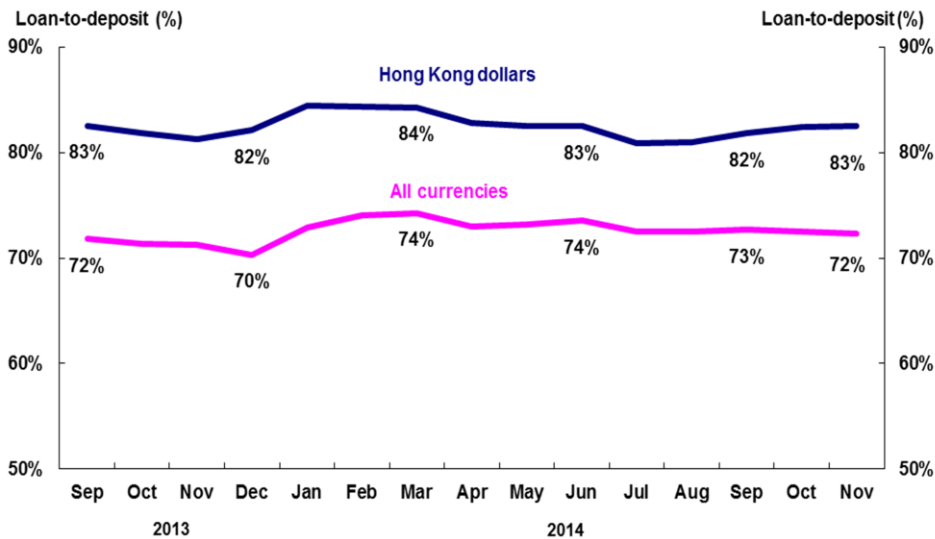
54

- After reaching a high in the first quarter of 2014, the pace of credit growth continued to moderate and registered a 6.4% increase in an annualised term during October and November of 2014.
- The HKMA has been monitoring the operation of the Stable Funding Requirement (SFR) since its launch in October 2013. In October 2014, the HKMA completed a review on the SFR with a view to streamlining its operations and reducing Authorized Institutions' (AIs) reporting work. The review has given due consideration to industry feedback as well as our implementation experience. After collecting views from members of industry associations, a circular was issued to all AIs in November 2014 to implement the refined SFR starting January 2015.
- The HKMA will continue to monitor credit growth of the banking sector.



CREDIT GROWTH

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

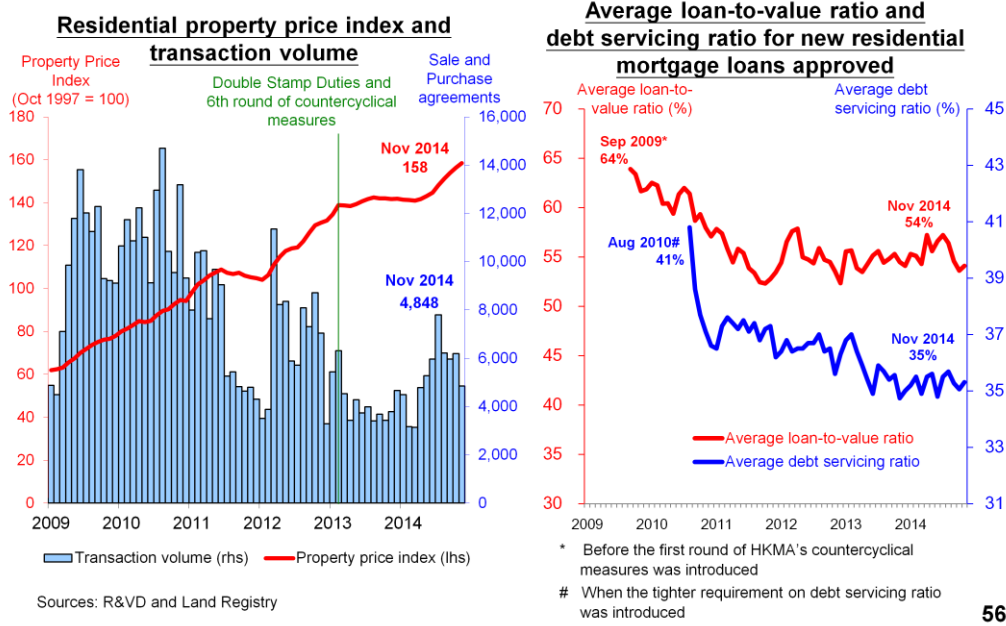


55

- The Hong Kong dollar loan-to-deposit ratio increased slightly to 83% at end-November 2014 from 82% at end-September 2014. The increase was attributable to a rise in Hong Kong dollar loans (+0.6%) coupled with a decrease of Hong Kong dollar deposits (-0.3%).
- By contrast, the all currencies loan-to-deposit ratio declined slightly to 72% at end-November 2014 from 73% at end-September 2014. The decrease was due to a faster pace of increase in total deposits (+1.6%) than that in total loans (+1.1%).
- The HKMA will continue to monitor the movement of loan-to-deposit ratios.



RISK MANAGEMENT OF PROPERTY MORTGAGE LOANS



56

Latest statistics for residential mortgage loans ("RMLs")

	Monthly average in 2012	Monthly average in 2013	July 2014	Aug 2014	Sep 2014	Oct 2014	Nov 2014
Number of sale and purchase agreements	6,778	4,223	7,792	6,212	5,958	6,189	4,848
Number of new RML applications	11,634	8,694	12,728	11,719	11,115	11,698	10,118
Number of new RMLs approved	8,210	5,952	8,995	8,680	8,104	8,494	7,258

Latest statistics for residential property prices

Property price index		Period	Property price index
Rating and Valuation Department (10/1997=100)	Latest position	11/2014	158.5
	Recent Peak	11/2014	158.5
	Peak in 1997	10/1997	100.0
Centaline (6/7/1997=100)	Latest position	28/12/2014	132.5
	Recent Peak	14/12/2014	132.8
	Peak in 1997	19/10/1997	102.9

The HKMA will continue to closely monitor the property and mortgage lending markets. The HKMA will continue to tighten the countercyclical measures if the upward cycle of the property market persists and loosen the measures introduced earlier as appropriate if the downward cycle of the property market is confirmed.



BASEL III IMPLEMENTATION PROGRESS

Effective from 1 January 2015

- Banking (Amendment) Ordinance 2012 (Commencement) Notice 2014
- Banking (Capital) (Amendment) Rules 2014
- Banking (Liquidity) Rules

Tabled before LegCo

- Banking (Disclosure) (Amendment) Rules 2014

57

Legislation

- 3 pieces of subsidiary legislation (viz., Banking (Amendment) Ordinance 2012 Commencement Notice 2014, Banking (Capital) (Amendment) Rules 2014 and Banking (Liquidity) Rules) were enacted by LegCo towards the end of last year to take effect from 1 January 2015. This collection of legislation introduces a series of regulatory capital buffers and the Liquidity Coverage Ratio which together constitute the 2nd phase of Basel III implementation. The MA has also been consulting the industry on the MA's proposed processes and methodology (i) for the setting of the Countercyclical Capital Buffer in Hong Kong and (ii) for assessing which institutions should be designated as domestically systemically important and hence subject to a higher loss absorbency capital buffer.
- To implement the associated public disclosure requirements, a set of Banking (Disclosure) (Amendment) Rules (BDAR) 2014 was tabled at LegCo on 7 January 2015 for negative vetting, with a view to taking effect from 31 March 2015.
- To facilitate consistency and comparability of disclosure, the HKMA is developing standard disclosure templates to support the disclosure requirements in the BDAR 2014. These are expected to be issued for industry consultation within Q1 2015.



CROSS-SECTOR RESOLUTION REGIME FOR FINANCIAL INSTITUTIONS IN HONG KONG

- Second consultation exercise on legislative reform launched on 21 January 2015 for three months
- To meet international standards: Financial Stability Board (FSB)'s "Key Attributes of Effective Resolution Regimes"
- Summarises responses to initial consultation: broad support for reforms
- Provides further details on different aspects of the resolution regime including governance, powers and safeguards
- Aim to introduce a Bill into LegCo by Q4 2015

58

- On 21 January 2015 the FSTB, together with HKMA, Securities and Futures Commission and Insurance Authority, issued a second-stage public consultation paper providing further details on the proposed resolution regime for Financial Institutions in Hong Kong (outcomes from the initial consultation exercise and the authorities' latest thinking on key aspects of the regime will be outlined in the relevant agenda item in the LegCo Financial Affairs Panel (FAP) meeting on 2 March);
- As highlighted to FAP at previous meetings, as part of policy measures designed to reduce the risks posed by systemically important financial institutions (SIFIs), the FSB set new standards for resolution regimes (in its "Key Attributes of Effective Resolution Regimes for Financial Institutions") in late 2011;
- In response to the initial public consultation exercise in 2014, with a view to outlining the reforms needed to meet these standards locally, a total of 33 submissions were received from a wide range of stakeholders. Most respondents indicated that they considered the proposed reforms were important not only to improve the resilience of the local financial system to shocks, but also to allow for coordinated approaches to the orderly resolution of cross-border financial institutions;
- The second consultation paper provides further detail on aspects of the proposed regime including governance arrangements (and the appointment of each of the regulators to act as resolution authorities), resolution powers (in particular, for statutory bail-in) and safeguards (including a "no creditor worse off than in liquidation compensation" mechanism);
- There may be a need for a third, perhaps shorter, consultation exercise in Q2 2015, to allow for consideration of anticipated FSB guidance on specific aspects of the regime (including to accommodate non-bank financial institutions and support cross-border resolution) in future. Otherwise, and subject to the outcome of the consultation exercises, the target remains to introduce a Bill into LegCo in Q4 2015.



INVESTOR AND CONSUMER PROTECTION

- Published in December 2014 results of a mystery shopping programme regarding banks' selling of investment and insurance products
- Issued in December 2014 guidance on expected selling practices for non-linked long term insurance products
- Issued a circular in January 2015 to reiterate important regulatory standards in respect of selling of investment products, including RMB products
- Worked with the industry to review the Code of Banking Practice to offer better protection to financial consumers, with 61 new clauses and 32 revised clauses
- Launched a thematic campaign to enhance the public's understanding of personal loans through radio clips, print media and Internet. Arranged talks for senior secondary school students to promote responsible spending

59

- In December 2014, the HKMA issued a set of guidance on expected practices which banks should adopt in selling of non-linked long term insurance products. The guidance aims at addressing the various areas for improvement in the selling practices identified during the HKMA's supervisory process including on-site examinations and mystery shopping exercise.
- In light of the recent popularity of structured deposits and investment products distributed by banks, the HKMA issued a circular in January 2015 to reiterate some important regulatory standards in respect of selling of investment products, including RMB products. Banks are reminded to have adequate management supervision and monitor their frontline staff on proper selling practices.
- The HKMA has worked with the industry to complete a comprehensive review of the Code of Banking Practice (CoBP). The revised Code is expected to be effective in the first quarter of 2015. Major enhancements include requiring banks' subsidiaries and affiliated companies controlled by banks to observe the CoBP and incorporating the *G20 High-level Principles on Financial Consumer Protection* as general principles for banks to observe when providing products and services to their customers.



EDUCATIONAL ARTICLES ON PERSONAL LOANS



- Beware of the differences between “instalment loans” and “revolving loans”
- Don't assume that there is no borrowing cost for personal loans marketing “zero interest rate” or “full interest waiver”
- Use “Annualised Percentage Rate” to compare the borrowing cost of different personal loan products
- Check early repayment charge and amount of principal already repaid before making early repayment

60

- Educational articles on personal loans were published on newspapers and magazines.



ENHANCEMENTS TO DEPOSIT PROTECTION SCHEME

- Objective: gross payout basis for swifter payouts
- Benefits:
 - to depositors - faster access to compensation
 - to banks - simpler systems
 - to Hong Kong - more effective financial safety net
- 3-month public consultation ended in December 2014: respondents support the enhancement proposals
- Way forward: preparing legislative amendments to implement the proposals

61

- The key proposal is to adopt gross basis for deposit compensation calculation so as to achieve faster payout in case there is a bank failure. Other enhancement proposals include: (1) providing more certainty for determining the “Quantification Date” for more expeditious calculation of accrued interest and conversion of foreign currencies deposits into Hong Kong dollars in a payout and (2) enabling the use of electronic communication channels in addition to paper communication for notifying depositors about details of payout. Implementation of the proposed enhancements can enable the Deposit Protection Scheme (DPS) to pay out in 7 days under most circumstances.
- The three-month public consultation on the proposed enhancements to the DPS jointly launched by the FSTB and the HKMA ended on 12 December 2014.
- All respondents welcomed the proposals because the potential benefit of prompt payout for general depositors, banking stability and Hong Kong’s status as an international financial centre outweigh the costs involved. Key respondents include:
 - the banking industry;
 - statutory body representing consumer interests;
 - legal and accounting professional bodies; and
 - insolvency practitioners.
- A report on the consultation conclusions will be published in Q1 2015. The comments received from the consultation will be incorporated in the legislative amendment bill where appropriate. Aim to introduce the bill within the current LegCo term.



FINANCIAL INFRASTRUCTURE



REGULATORY DEVELOPMENT OF THE OTC DERIVATIVES MARKET

- The Securities and Futures (Amendment) Ordinance 2014 was enacted by the LegCo in Q1 2014. Detailed rules are now under preparation for implementing the regulatory regime for the over-the-counter (OTC) derivatives market in Hong Kong
- Public consultation on the first set of draft rules, which focused on the mandatory reporting and related record keeping obligations, was conducted in Q3 2014. The HKMA and SFC issued the consultation conclusions in Q4 2014. The target is to introduce the proposed rules into LegCo in Q1 2015

63

- As an interim measure before the new legislation comes into effect, the HKMA has mandated the reporting of specified OTC derivative transactions between licensed banks to the trade repository set up by the HKMA with effect from 5 August 2013.
- The regulatory regime for the OTC derivatives market in Hong Kong is expected to take effect around Q1 2015, with the mandatory reporting and related record keeping obligations taking effect first.



REFINEMENT OF GOVERNMENT BOND PROGRAMME AND EXCHANGE FUND BILLS AND NOTES PROGRAMME

Measures:

- Streamline the tenor of securities issued under both programmes, consolidate the HKSAR Government benchmark yield curve; the measure will also increase the issue sizes of relevant bonds to enhance market liquidity.
- Introduce a HK\$10 billion discount window facility for Government Bonds (GBs) to satisfy the need of banks for high-quality liquifiable assets for more flexible bank liquidity management.

Implementation:

- Starting from 2015, stop new issuance of Exchange Fund Notes with tenors of three years and above; and will issue additional Exchange Fund Bills to replace maturing papers of those tenors to maintain the overall size of Exchange Fund papers.
- Starting from 2015, stop new issuance of two-year GBs; and new issuance of GBs will be for tenors of three years and above. The amount of these new issuances will be suitably increased to meet investors' demand for longer term high-quality Hong Kong dollar bonds.
- Starting from 15 December 2014, introduction of a discount facility up to HK\$10 billion overnight liquidity against sale and repurchase of GBs.



PROMOTING ASSET MANAGEMENT BUSINESS

- Working closely with other Government agencies and the private sector 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 will continue to improve our platform and keep up with the latest developments in the asset management industry

65

- Over the past few years, our outreach team held over 880 meetings with over 490 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 on their criteria in choosing an overseas investment hub.
- On platform building, the HKMA conducts reviews of legal, regulatory, tax and other issues to inform policy formulation concerning the development of Hong Kong's asset management industry. The 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, such as the proposed extension of profits tax exemption to offshore private equity funds, the proposed exemption of stamp duty for the transfer of all exchange traded funds shares or units, and the review of the Inland Revenue Ordinance in respect of the taxation regime of corporate treasury activities. On the latter, the Government Task Force, of which the HKMA is a member, is exploring room for optimisation under the Inland Revenue Ordinance so as to create a conducive tax environment for genuine corporate treasury centre activities with a view to enhancing Hong Kong's competitiveness as a regional destination for corporate treasury centres.



CONTINUED DEVELOPMENT AS AN INTERNATIONAL ASSET MANAGEMENT CENTRE

- The combined fund management business in Hong Kong hit a record high of US\$ 2.1 trillion at the end of 2013, a 27% increase over 2012
- Continued increase in the number of licensed corporations and licensed individuals for asset management
- Over 60 of the 100 largest global money managers have offices in Hong Kong
- In terms of private banking, 20 private banks have opened for business in Hong Kong since 2009, bringing the total to 46 banks offering private wealth management services in Hong Kong as of January 2015

66

- According to the Securities and Futures Commission (SFC)'s survey, 72% of the combined fund management business in Hong Kong was sourced from non-Hong Kong investors in 2013, attesting to the fact that Hong Kong is 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 1,012 in September 2014.
- Over 60 of the 100 largest global money managers (ranked by assets under management as of end 2013) have offices in Hong Kong, and about 60 of them are licensed by the SFC.
- Achieved leading positions as an asset management centre in the region. Hong Kong is a leading hub:
 1. Hong Kong is the second largest private equity hub in Asia with over 370 private equity firms as of end 2013.
 2. Over 60% of Qualified Foreign Institutional Investor managers, over 70% Mainland fund management and securities firms with Qualified Domestic Institutional Investor license and over 80% of Renminbi Qualified Foreign Institutional Investor managers have a presence in Hong Kong as of December 2014.
 3. Hong Kong is also the largest hub for Asian hedge funds, with the number of funds increasing from 538 in 2010 to 676 at end September 2012.



DEVELOPMENT OF ISLAMIC FINANCE

- The Government's inaugural sukuk issued under the Government Bond Programme in September 2014 won the Best Islamic Financing Deal Achievement Award from FinanceAsia, the Best Sovereign Bond Award from GlobalCapital Asia / Asiamoney, and the Emerging Asia Deal of the Year Award from Islamic Finance News for 2014
- Will continue to maintain close dialogue with market players, encouraging other public and private sector entities to issue sukuk through Hong Kong's platform, in an effort to promote the further development of sukuk market in Hong Kong



FINANCIAL BENCHMARK REFORM IN HONG KONG

- International bodies such as the International Organization of Securities Commissions (IOSCO) and the Financial Stability Board (FSB) have made recommendations to enhance the transparency and robustness of the major interest rate and foreign exchange (FX) benchmarks that are widely used in the global financial markets
- While the international recommendations do not directly apply to Hong Kong, as an international financial centre, Hong Kong has been proactively reviewing the need and feasibility in reforming our financial benchmarks alongside the international recommendations, having regard to local market conditions
- The HKMA is studying the feasibility in this regard, and will work with relevant industry associations such as the Treasury Markets Association (TMA) to consult stakeholders on any proposed way forward

68

- Financial benchmarks, especially the interest rate (commonly referred to as the “Interbank Offered Rates (IBORs)”) and FX benchmarks, are referred to in many financial contracts. Their robustness is crucial to the well functioning of the financial market. In view of the London Interbank Offered Rate (LIBOR) incident in 2012, various international bodies have made recommendations to enhance the transparency and robustness of those benchmarks that are widely used in the global financial markets.
- In July 2013, the IOSCO promulgated a set of principles, containing an overarching framework of recommended practices for financial benchmarks in general. The FSB also established the Official Sector Steering Group (OSSG) and the Foreign Exchange Benchmark Group (FXBG) to undertake fundamental reviews in, and make recommendations to, those interest rate benchmarks (the three major IBORs, i.e. LIBOR, Euro Interbank Offered Rate (EURIBOR) and Tokyo Interbank Offered Rate (TIBOR)) and FX benchmarks (WM/Reuters 4pm London fix) that are widely used in the global financial markets.
- The main thrust of the international recommendations is that if market conditions permit, financial benchmarks should be calculated based on actual transactions only. In implementing the relevant recommendations, both IOSCO and FSB recognised that there is no one-size-fits-all method. Individual jurisdictions should implement the recommendations in a manner commensurate with the size and risks of the relevant benchmark-setting processes.
- In this connection, the HKMA is collaborating with the TMA to assess the extent to which Hong Kong’s benchmarks (i.e. Hong Kong Interbank Offered Rates (HIBOR), Spot USD/HKD Fixing and Spot USD/CNY(HK) Fixing) could be reformed. Stakeholders will be consulted to ensure that the market’s views are reflected as appropriate.



FINANCIAL INFRASTRUCTURE

- Continue to maintain safety and efficiency of financial infrastructure
- Reporting to the over-the-counter (OTC) derivatives trade repository (TR) of the HKMA has been smooth. The TR will be further developed to meet local reporting requirements and international standards
- Daily average turnover in RMB Real Time Gross Settlement (RTGS) system in December 2014 was at record high of RMB 888 billion

69

Operation of financial infrastructure

- The Hong Kong Dollar, US dollar, Euro and RMB RTGS systems, the Central Moneymarkets Unit (CMU) and the TR for OTC derivatives have been operating smoothly.

OTC derivatives Trade Repository

- Since the reporting function of the TR was launched in July 2013, reporting (by banks) to the TR has been smooth.
- A new phase of the TR system was launched at end-September 2014, mainly to expand product scope to cover the remaining commonly traded interest rate and foreign exchange derivative products in the local market, and to add equity derivative products.
- Preparations are being made to support the commencement in 2015 of the mandatory reporting under the new OTC derivatives market regulatory regime.



LEGISLATIVE FRAMEWORK FOR STORED VALUE FACILITIES AND RETAIL PAYMENT SYSTEMS

- The Clearing and Settlement Systems (Amendment) Bill is scheduled for introduction into the LegCo on 4 February 2015
- The legislative amendments seeks to put in place a legal framework for regulating stored-value facilities (SVF) and retail payment systems (RPS) to ensure adequate protection of users' float maintained with SVF issuers and the security and soundness of the operations of SVF and RPS in Hong Kong
- The FSTB and HKMA have previously consulted the public including industry players and bodies on the key policy proposals in the Bill. The responses are generally supportive. The consultation conclusion was published in October 2014.
- As the new regime provides better legal clarity and a level-playing field, an increasing number of industry players from the Mainland and overseas have approached the HKMA recently to enquire about the new regime, as they look forward to establishing presence in HK to tap the business opportunities of Internet and mobile payment services.

70

The draft Clearing and Settlement Systems (Amendment) Bill includes provisions to:

- implement a licensing regime for SVF covering both device-based and non-device based SVF with a series of licensing criteria including physical presence in Hong Kong; principal business has to be SVF issuing; financial strength; float safeguarding and management; fitness and propriety of ownership and management; anti-money laundering and counter terrorist financing requirements; security and soundness of system and business scheme, etc.;
- implement a designation regime for RPS under which RPS that are important to the public and financial stability of Hong Kong will be so designated by the HKMA and subject to the HKMA's regulation;
- empower the HKMA to exercise necessary supervisory functions on SVF and designated RPS including powers to conduct on-site and off-site supervision; gather information; make regulations; issue guidelines; impose operating rules; and give directions, etc.;
- empower the HKMA to exercise necessary enforcement actions on SVF and RPS including the conduct of investigation;
- with reference to other legislation including the Banking Ordinance, Securities and Futures Ordinance and the Anti-Money Laundering and Counter Terrorists Financing (Financial Institutions) Ordinance, introduce relevant offenses and sanctions for contravention of the the Clearing and Settlement Systems Ordinance (CSSO) including minor sanctions such as caution, warning and reprimand; and
- enhancement to the existing appeal mechanism under the CSSO to enable persons aggrieved by a reviewable decision of the HKMA made under the CSSO to refer the decision to an Appeal Tribunal for review.



E-cheque

- System development has progressed as planned. E-cheque is scheduled for launch in December 2015.
- To give e-cheque the same legal status as paper cheque, the Government has completed the legislative process to amend Schedule 1 of the Electronic Transaction Ordinance (ETO)
- Benefits of e-cheque:
 - can be issued and presented any time, anywhere
 - can be processed more efficiently
 - environmentally friendly
 - carries enhanced security features:
 - digital signature using Public Key Infrastructure (PKI) technology
 - virtual e-cheque book rested in the internet banking system
 - enabling paying bank to check against e-cheque issuance records
- HKMA and Hong Kong Association of Banks (HKAB) will launch consumer education programmes to raise the public awareness of e-cheque in the second half of 2015

71

- The objective of e-cheque is to provide an additional safe and efficient payment instrument for the public to choose. E-cheque is an “end-to-end” electronic payment instrument without the use of paper or the need of physical delivery or presentment throughout the process. It will be issued through the internet banking platform of the paying bank, and presented either through the internet banking platform of the collecting bank or the centralised presentment portal operated by Hong Kong Interbank Clearing Limited (the clearing house in Hong Kong).
- 17 banks have indicated interest to provide e-cheque services to their customers while all banks accepting paper cheque deposit nowadays are required to accept e-cheque deposit once the service is launched.
- To give e-cheque the same legal status as paper cheque, an amendment is being made to Schedule 1 of the Electronic Transactions Ordinance to replace “negotiable instruments” by “negotiable instruments (but excluding cheques that bear the words “not negotiable”)”. The proposed amendment was gazetted on 28 November 2014 and tabled before the Legislative Council for negative vetting on 3 December 2014. Besides, an Information Technology and Broadcasting panel meeting was held on 10 November 2014 and a Subcommittee meeting on Electronic Transactions Ordinance (Amendment of Schedule 1) Order 2014 was held on 2 January 2015 to discuss the legislative amendment and the proposed implementation of e-cheque. The legislative process has been completed, and the amendment order will become effective on 1 April 2015.
- Meanwhile, the system development of both e-cheque clearing platform and centralised presentment portal has progressed as planned. A three-month pilot run is scheduled for launch in December 2015, followed by a commercial launch in March 2016. To enhance the public awareness of e-cheque, the HKMA will collaborate with HKAB to conduct consumer education programmes in the second half of this year.

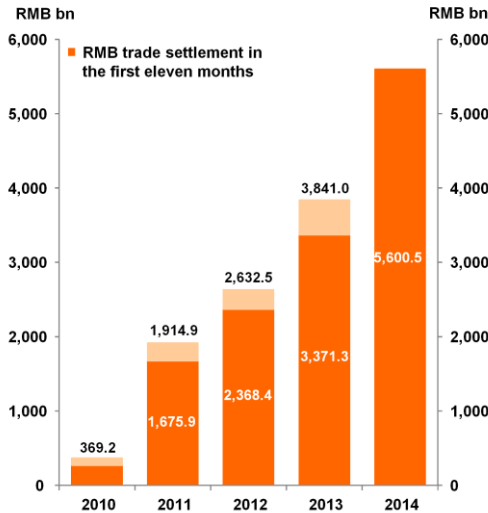


HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

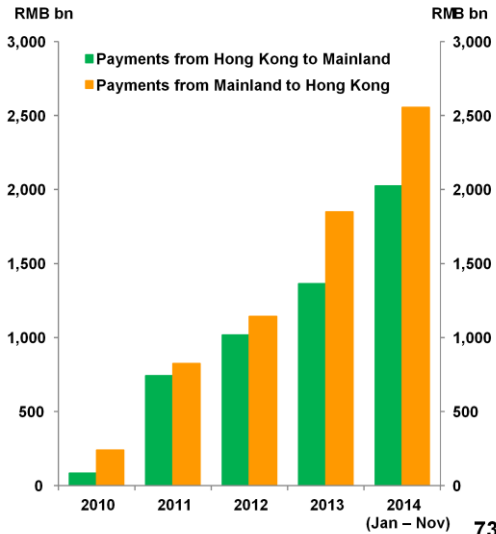


FURTHER EXPANSION OF RMB TRADE SETTLEMENT

**RMB trade settlement
handled by banks in Hong Kong**



**Flows of RMB trade settlement
between Hong Kong and the Mainland**



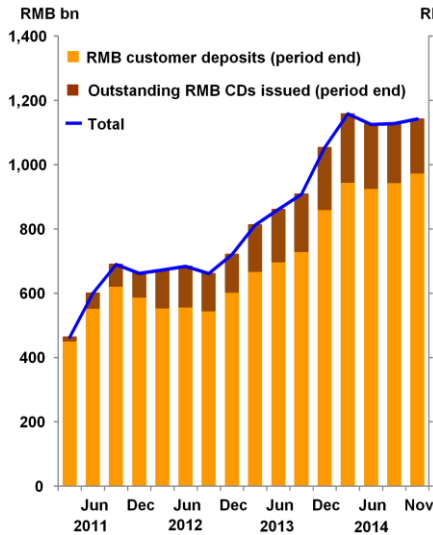
73

- In the first eleven months of 2014, RMB trade settlement handled by banks in Hong Kong amounted to RMB5.6005 trillion, up 66% compared with the same period in 2013. The ratio of payments to and from the Mainland was 1:1.3.

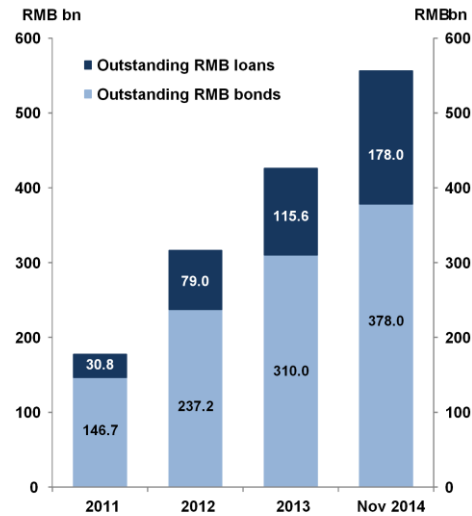


FURTHER GROWTH OF RMB DEPOSITS AND FINANCING ACTIVITIES

RMB customer deposits and certificates of deposit (CDs)



RMB financing activities



74

- At end November 2014, RMB customer deposits and outstanding RMB certificates of deposit amounted to RMB974.1 billion and RMB167.8 billion respectively, totaling RMB1.142 trillion, a 8% growth from RMB1.053 trillion at the end of 2013. The daily RMB conversion limit for Hong Kong residents has been removed since 17 November 2014. Under the new arrangement, banks square their positions arising from RMB conversions conducted with Hong Kong residents in the offshore market. Accordingly, the previous conversion and other relevant restrictions are no longer applicable. The removal of conversion limit has made it more convenient for Hong Kong residents to participate in RMB financial transactions and is conducive to offshore RMB business development.
- The RMB dim sum bond market was active in the first eleven months of 2014, with issuance totalling RMB188.9 billion, 62% more than the total amount of RMB116.6 billion in 2013. Outstanding dim sum bonds amounted to some RMB378.0 billion at end November 2014, up 22% from end 2013.
- RMB bank lending continued to grow, with outstanding amount of RMB loans increasing to RMB178.0 billion at end November 2014, a growth of 54% from the end of 2013.



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

	Nov 2014	2013	2012	2011
1 No. of participating banks of Hong Kong's RMB clearing platform	224	216	204	187
Of which:	199	191	181	165
Branches and subsidiaries of overseas banks and overseas presence of Mainland banks				
2 Amount due to overseas banks (RMB billion)	141.3	166.0	99.1	116.4
3 Amount due from overseas banks (RMB billion)	196.1	164.5	117.1	121.7
4 Turnover in Hong Kong's RMB RTGS system (Daily average during the period; RMB billion)	838.5	395.4	213.7	121.4

75

- Hong Kong's RMB business links with other parts of the world continue to grow. Collaboration on RMB business between Hong Kong and other markets has also been further broadened. The fourth meeting of the Hong Kong – London RMB Forum, facilitated by the HKMA and UK Treasury, was convened in London on 12-13 November 2014. The HKMA also organised a seminar on RMB business as part of the "Asian Financial Forum" on 20 January 2015.
- In the year ahead, the HKMA will continue its RMB business promotion efforts, including through supporting private sector collaboration between Hong Kong and other markets.



INVESTMENT ENVIRONMENT AND PERFORMANCE OF THE EXCHANGE FUND

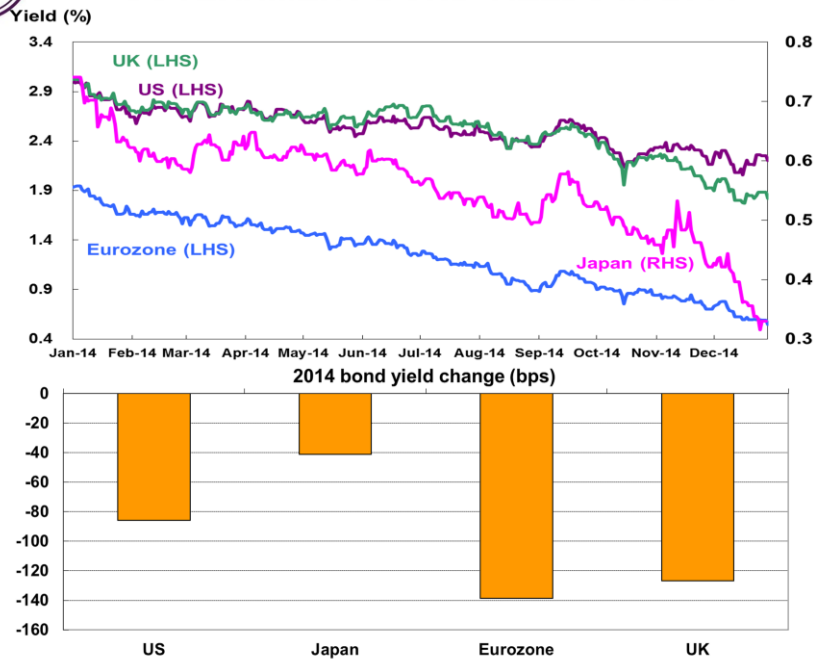


INVESTMENT ENVIRONMENT IN 2014

- **Interest rates:** Major European government bond yields fell sharply in 2014 on the back of weak economic momentum and lingering disinflationary pressure in Europe, as well as the European Central Bank's (ECB) aggressive easing. Longer term US Treasury and JGB bond yields fell in tandem
- **Equity markets:** Most major developed stock markets recorded gains in 2014, with S&P500 outperforming other major markets as supported by the improving economic fundamentals in the US and the Federal Reserve's accommodative stance
- **Exchange rates:** The Euro weakened against the US dollar in the second half of 2014, as a result of the loss in economic momentum in Europe and the ECB's monetary policy accommodation. The Yen also weakened against the dollar in late 2014 following the sluggish economic recovery in Japan after the sales tax hike in April and the Bank of Japan's additional monetary easing



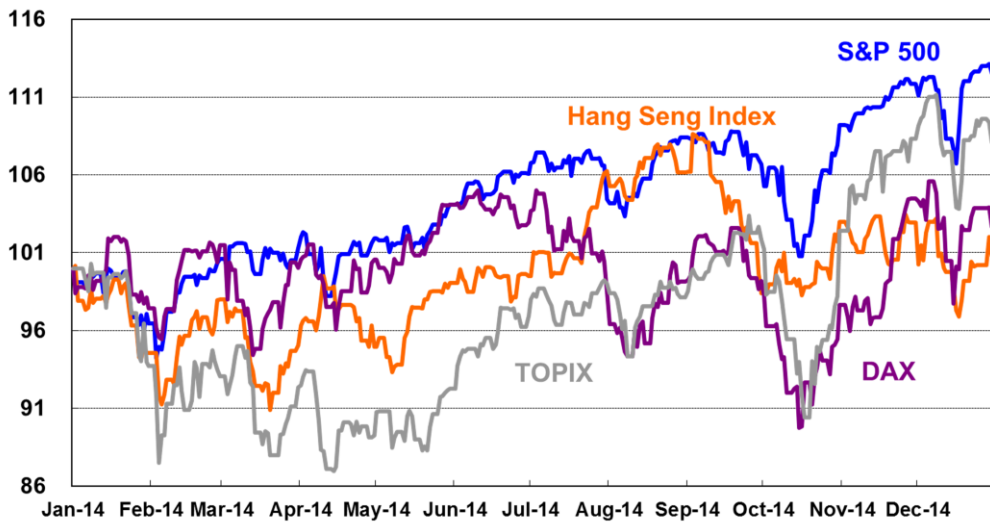
CHANGES IN 10-YEAR GOVERNMENT BOND YIELDS IN 2014





EQUITY MARKETS IN 2014

Normalized Index Level (2013 year-end = 100)

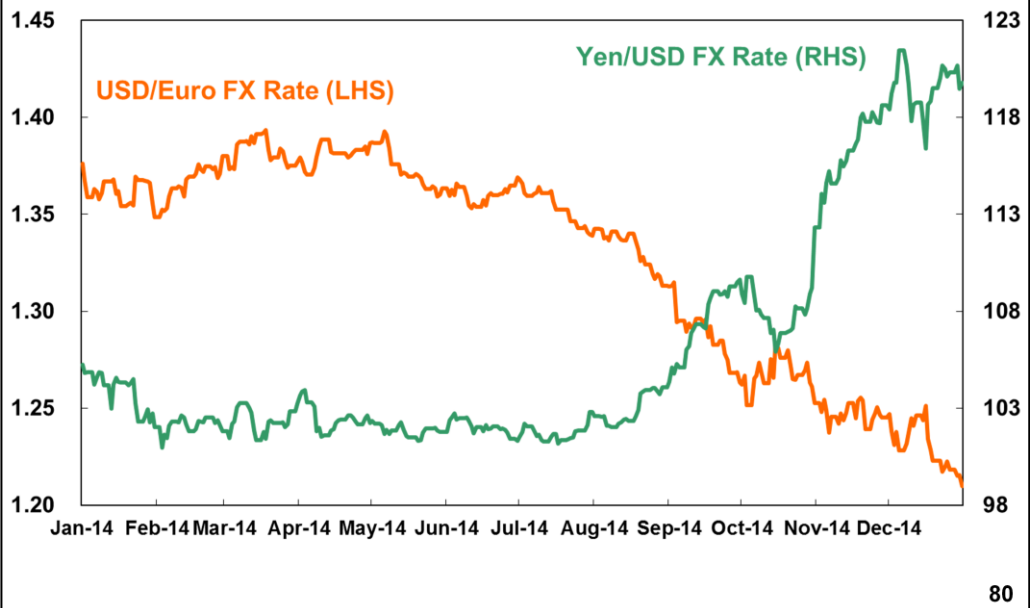




CURRENCY MARKETS IN 2014

USD/Euro FX Rate

Yen/USD FX Rate





INVESTMENT INCOME

	I ← 2014 → I					2013	2012	2011	2010
(HK\$ billion)	Full year *	Q4*	Q3 *	Q2 *	Q1 *	Full year	Full year	Full year	Full year
Hong Kong equities@	6.5	4.8	(0.2)	8.7	(6.8)	10.1	30.7	(24.2)	11.6
Other equities	33.7	11.3	2.8	16.0	3.6	71.8	42.8	(12.2)	27.1
Bonds	47.3	13.6	7.1	13.4	13.2	(19.1)	33.1	71.9	42.1
Other investments&	8.8	-	0.9	5.9	2.0	16.8	6.4	0.7	1.7
Foreign exchange	<u>(52.7)</u>	<u>(24.7)</u>	<u>(28.4)</u>	<u>(0.7)</u>	<u>1.1</u>	<u>1.6</u>	<u>(1.4)</u>	<u>(9.1)</u>	<u>(3.1)</u>
Investment income/(loss)@&	43.6	5.0	(17.8)	43.3	13.1	81.2	111.6	27.1	79.4

* 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 above figures represent valuation changes up to the end of September 2014. Valuations of these investments from October to December are not yet available.)



INCOME AND EXPENDITURE

(HK\$ billion)	2014					2013
	Full year*	Q4*	Q3 *	Q2 *	Q1 *	Full year
Investment income/(loss)	43.6	5.0	(17.8)	43.3	13.1	81.2
Other income	0.2	-	0.1	0.1	-	0.2
Interest and other expenses	<u>(5.2)</u>	<u>(1.1)</u>	<u>(1.3)</u>	<u>(1.7)</u>	<u>(1.1)</u>	<u>(4.9)</u>
Net income/(loss)	38.6	3.9	(19.0)	41.7	12.0	76.5
Fee paid/payable to Fiscal Reserves #	(27.5)	(6.9)	(6.7)	(6.8)	(7.1)	(36.8)
Payment to HKSAR government funds and statutory bodies #	(8.6)	(2.2)	(2.3)	(2.2)	(1.9)	(9.3)

* Unaudited figures

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



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@&	81.2	30.7	54.7	(23.3)	19.1
2014* @&	43.6	5.0	(17.8)	43.3	13.1

@ 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 2014 (unaudited)	At 31 Dec 2013	Change
ASSETS			
Deposits	315.7	292.8	22.9
Debt securities	2,148.0	2,080.0	68.0
Hong Kong equities	156.8	152.9	3.9
Other equities	418.5	370.6	47.9
Other assets [#]	113.1	136.5	(23.4)
Total assets	3,152.1	3,032.8	119.3
	=====	=====	=====
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness	340.2	327.4	12.8
Government-issued currency notes & coins in circulation	11.0	10.6	0.4
Balance of the banking system	239.2	164.1	75.1
Exchange Fund Bills and Notes issued	752.5	782.6	(30.1)
Placements by banks and other financial institutions	64.0	50.7	13.3
Placements by Fiscal Reserves	788.7	773.9	14.8
Placements by HKSAR government funds and statutory bodies	261.1	214.9	46.2
Other liabilities	59.9	71.1	(11.2)
Total liabilities	2,516.6	2,395.3	121.3
Accumulated Surplus	635.5	637.5	(2.0)
Total liabilities and fund equity	3,152.1	3,032.8	119.3
	=====	=====	=====

[#] Including investment injection to EF's investment holding subsidiaries at a carrying amount of HK\$82.6 billion (HK\$66.4 billion at 31 Dec 2013)



HONG KONG MORTGAGE CORPORATION



MORTGAGE INSURANCE PROGRAMME (MIP)

- Since the launch in March 1999, the MIP has helped over 112,000 families to attain home ownership
- In the year 2014, the total drawdown amount under the MIP was HK\$16.0 billion and the average loan size was HK\$3.2 million
- About 91% of drawn down loans were for secondary market properties



REVERSE MORTGAGE PROGRAMME

- By end of December 2014, 742 applications have been received:
 - Average age of borrowers: 69 years old
 - Average monthly payout: HK\$14,300
 - Payment terms: 10-year (31%), 15-year (16%), 20-year (14%), life (39%)
 - Average property value: HK\$4.7 million
 - Average property age: 30 years

87

- The HKMC has implemented revision in relation to the refinancing of reverse mortgage loan under the Reverse Mortgage Programme with effect from 1 May 2014.



SME FINANCING GUARANTEE SCHEME (SFGS)

- In view of the uncertain external economic environment, the Financial Secretary announced in the 2014-15 Budget Speech to further extend the application period for the 80% guarantee product for one year until the end of February 2015.
- In September 2014, rolled out a series of refinements to further streamline the operation of the Scheme and meet the increasing demand for refinancing of facilities upon the expiry of the 5-year guarantee period of the Government's Special Loan Guarantee Scheme in 2014 and 2015.
- The 80% loan guarantee product has been well received by the market. As at end-December 2014, 9,660 applications were approved, involving a total loan amount of HK\$39.7 billion. Key data of the approved applications are as follows:

Average guarantee period	4.7 years	Average loan size	HK\$4.11 million
Proportion of application from manufacturing and non-manufacturing industries	25% and 75% (in terms of applications approved)	Average loan interest rate and average guarantee fee rate	4.83% p.a. 0.54% p.a.
Enterprises with less than 50 employees	91%	Benefitted enterprises and the related no. of employees	6,304 enterprises and 161,770 employees

88

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

Manufacturing sector – 25.1%

- Textiles and clothing 5.0%
- Electronics 2.3%
- Plastics 2.0%
- Printing and publishing 1.8%

Non-manufacturing sector – 74.9%

- Trading 46.0%
- Wholesales and retail 8.4%
- Engineering 2.7%
- Construction 2.7%



MICROFINANCE SCHEME

- Launched in June 2012 for a trial period of 3 years with a tentative maximum aggregate loan amount of HK\$100 million
- As at end of December 2014, the Scheme received 294 formal loan applications. Out of the vetted applications, 143 have been approved with the total loan amount of HK\$36.67 million. The approval rate is around 52%
- For the approved applications, the average loan size was about HK\$260,000 and the average loan tenor was 4.5 years

89

- Industry types for the approved start-up loans and self-employment loans (but excluding 2 self-enhancement loans):
 - Servicing 48 cases (34%)
 - Retailing 60 cases (43%)
 - Wholesales 17 cases (12%)
 - Manufacturing 7 cases (5%)
 - IT related 8 cases (6%)
 - Others 1 case (1%)
- * Component percentages in the table above may not add up to 100% due to rounding.