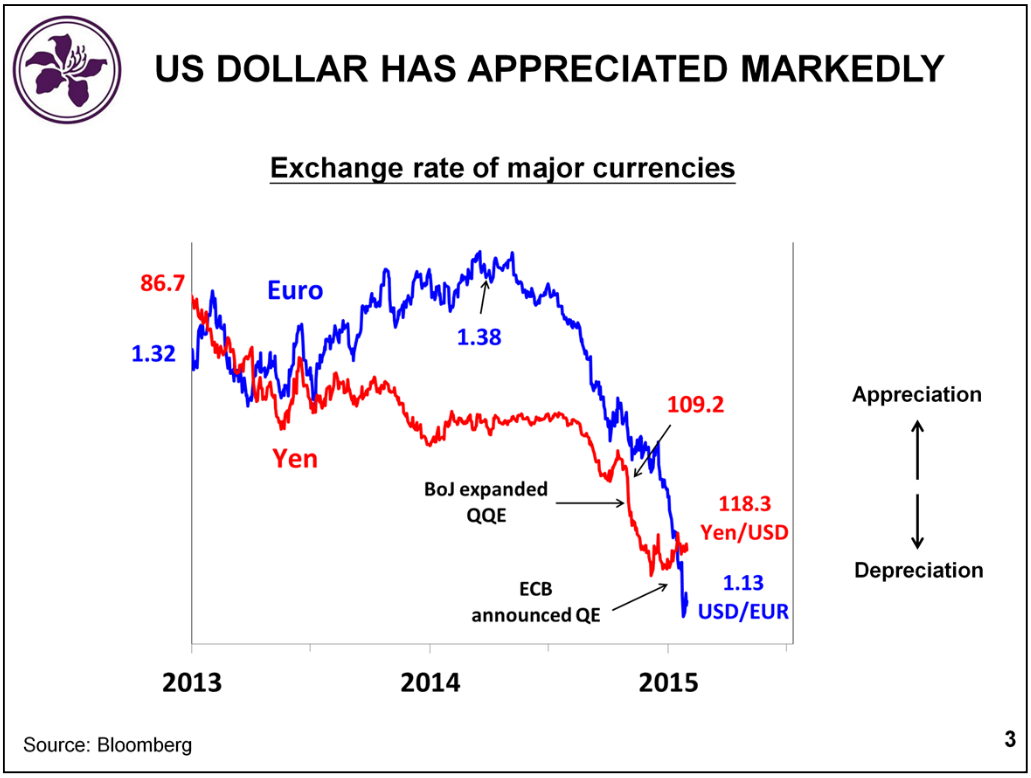
HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

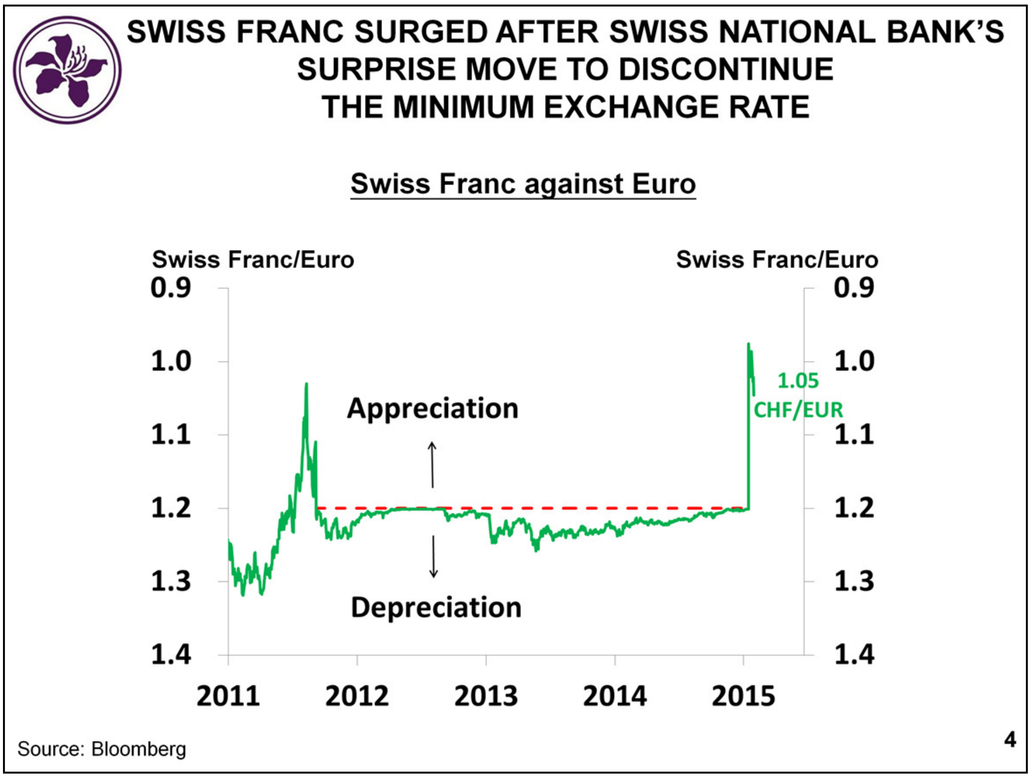
2 February 2015

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



- A major recent risk to global financial stability is the marked appreciation of the US dollar. In view of the continued rise of the US dollar and the upcoming US interest rate normalisation, asset markets in the emerging economies will come under pressure and see potential capital outflows.

- Central banks in Europe, the US and Japan have also taken divergent monetary policy paths. The European Central Bank (ECB) decided on quantitative easing measures at its meeting on January 22 this year. To address deflationary risk, it planned to start buying €60 billion assets each month in March and until September 2016. The Bank of Japan (BoJ) also expanded its QQE programme in October 2014, with target for monetary base growth each year lifted from 60-70 trillion Yen to 80 trillion Yen. The chart shows the sharp fall of the Euro and the Japanese Yen under the divergent policy paths of the central banks concerned. The yen fell from 109.2 to 118.3 against the US dollar (red line), or about 8%, on October 31 last year following the BoJ's expansion of its QQE. Meanwhile, prior to the ECB's announcement of quantitative easing, the Euro dropped about 15.7%, from about 1.38 on 2 April, 2014 to 1.16 against the US dollar (blue line). It has dropped further 2.5% to 1.13 since the announcement.

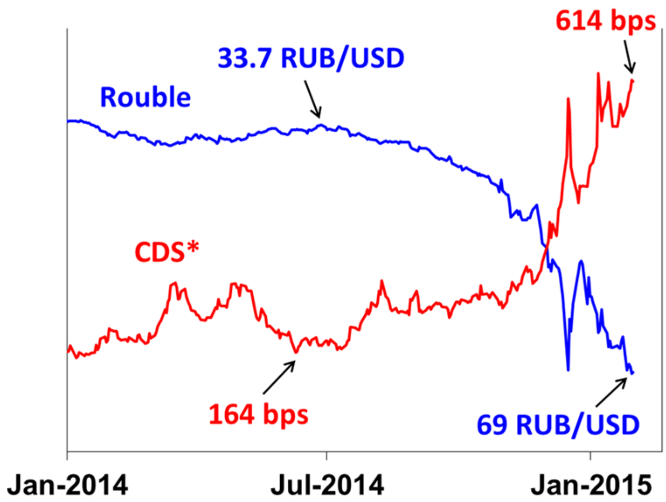


- Prior to the ECB's announcement of QE, the Swiss National Bank took a surprise move on January 15 this year to discontinue the exchange rate floor of 1.2 Swiss francs against the Euro. It also further cut deposit rates from -0.25% to -0.75%. The unexpected move saw the Swiss franc surge 23% against the Euro (green line) on the day of the announcement.

- Markets were concerned that the Swiss franc's sharp rise might hurt Swiss exports and the economy. As a result, the Swiss stock market plunged 15% within two hours, with significant fluctuation also seen in major stock markets in the Euro area.

HIGHER RUSSIAN DEFAULT RISK AMID PERSISTENTLY LOW OIL PRICES

Russian rouble exchange rate and credit default swaps



Note: Data shown are 5-year Russian credit default swaps
Source: Bloomberg

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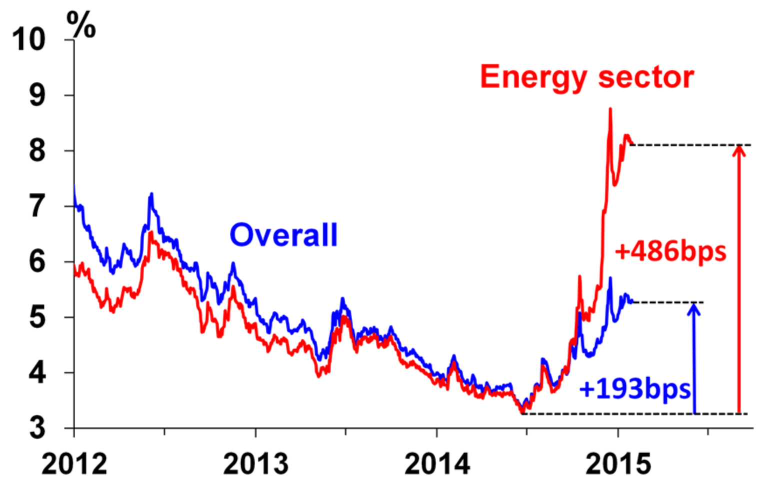
- The market focus is on Russia. It already suffered from weak growth as a result of economic sanctions by the EU and US. Furthermore, it relied heavily on oil exports. Russia's oil exports accounted for 53% of its total exports while public revenue from energy products accounted for 50% of its total revenue in 2013. The oil prices fall added to the plight of the Russian economy.

- The chart shows that amid worries about the impact of oil prices fall on the Russian economy, the rouble plummeted about 51% to 69 against the dollar (blue line) from a high of 33.7 in end-June 2014. As the rouble's fall drove up inflation, the Russian central bank had to raise interest rates substantially to stabilise the currency and contain inflation.

- The Russian sovereign default risk has increased substantially. The chart shows Russia's five-year credit default swaps (red line) shot up by 450 basis points from their low levels in mid-2014.

DEFAULT RISK OF ENERGY-RELATED CORPORATES HAS RISEN SUBSTANTIALLY

US high-yield bond spread



Source: Bloomberg

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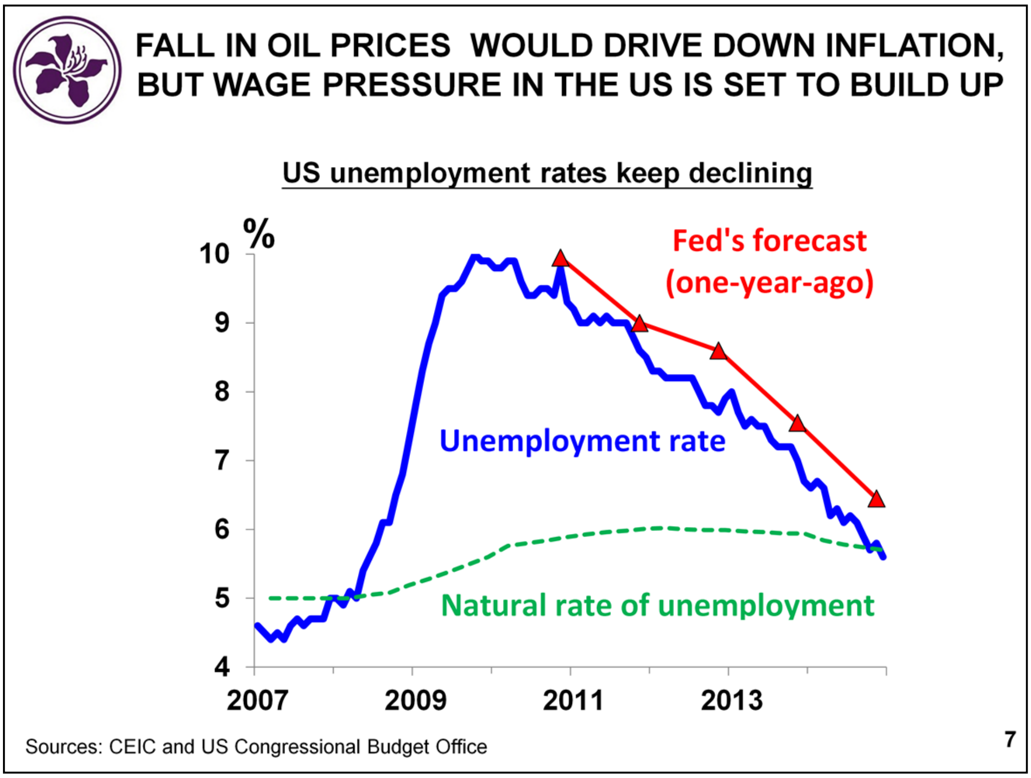
- The chart shows high-yield bond spreads in the US energy sector rose sharply by 486 basis points in the second half of 2014 in tandem with sharp fall in oil prices.

- Recently there are signs that investors have become more cautious about the high-yield bond market, driving up US high-yield bond spreads in general.

- If persistently low level of oil prices results in a widespread default among shale oil production companies, a sell-off in the US high-yield bond market may be triggered, posing systemic financial risk.



- While oil price fall may drive down global inflation in the short-term, its effect in suppressing the inflation in the US might not persist.

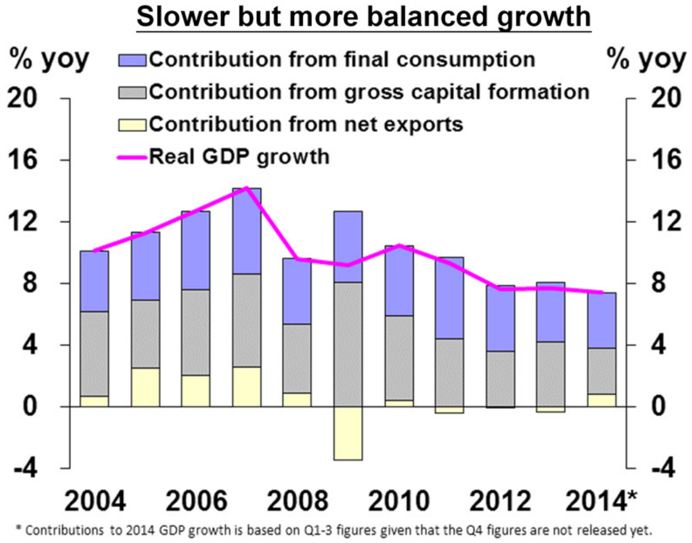
- The US economy and its job market improved markedly. As the chart shows, the unemployment rate (blue line) has persistently fallen by a faster pace than the Fed's forecasts (red dots). In addition, it has even edged close to the natural rate of unemployment. The Congressional Budget Office earlier estimated the natural rate of unemployment at 5.7% (green dotted line) (compared with the Fed's latest estimate of 5.2-5.5%). This reflects a shrinking labour market slack. Previous experience shows as this labour market slack reduces to a certain level, upward pressure on wages will build up, causing inflationary pressures.

- Sharp oil price falls will drive down the US overall inflation rate in the short-run. But as demand in the domestic private sector grows, underlying inflation as reflected in the core inflation rate will continue to face upward pressure. Indeed, prices in the US service sector account for as much as 60% of the overall consumer price index basket, which mainly reflects the domestic demand pressure and that it is more prone to wage rises.

GLOBAL FINANCIAL STABILITY RISK ASSESSMENT

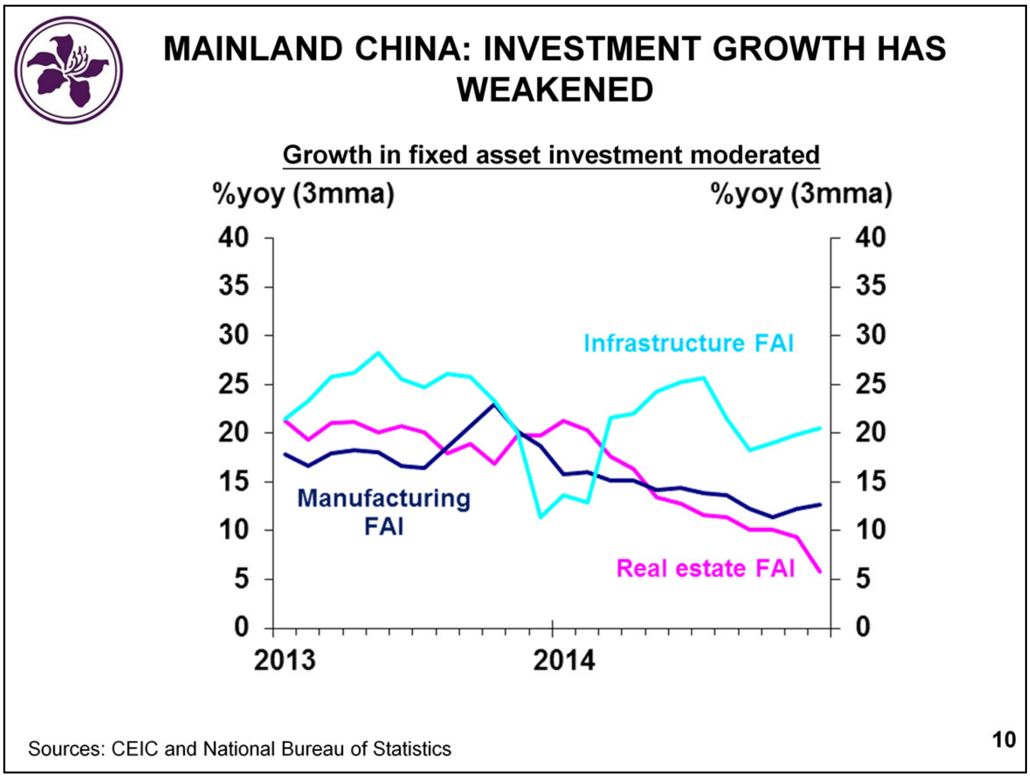
- Timing and pace of US interest rate normalisation have become more uncertain
- US dollar appreciation amid continuous inflows of funds to the US dollar
- Higher volatility in the foreign exchange market
- Economic conditions remain weak in Europe and Japan and effectiveness of their QE policies remains in question
- Emerging Market Economies facing downward pressure on the economies and financial markets, with energy and commodity exporting countries more vulnerable

MAINLAND CHINA: GROWTH MOMENTUM CONTINUED TO SLOW



Sources: CEIC and National Bureau of Statistics

- Mainland China's economic growth moderated from 7.7% in 2013 to 7.4% in 2014 (2014 Q4: 7.3%). Due to increased uncertainties, the market expects GDP growth to slow to around 7% in 2015. Nevertheless, it is anticipated that growth would become more balanced, in which net exports may play a less significant role as compared to the period before the financial crisis. The contribution of investment and consumption to economic growth will also be more balanced. Downturn in real estate remains the major downside risk to the Mainland economy.



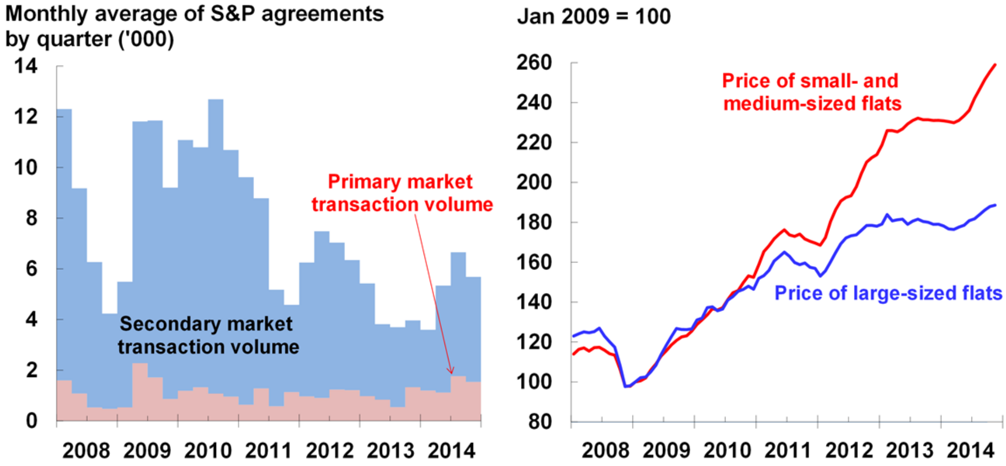
• Growth in fixed asset investment weakened but stabilised slightly at the end of 2014. Real estate investment growth decreased from about 20% in Q4 of 2013 to below 6% in Q4 of 2014.

MAINLAND ECONOMIC GROWTH MODERATED BUT RISK OF A HARD LANDING IS NOT HIGH

- **Mainland authorities rolled out measures to support economic growth**
  - Relaxation of tightening measures on property market
  - Increase in infrastructure investment
  - Lowering interest rates
  - Strengthening liquidity in the banking sector

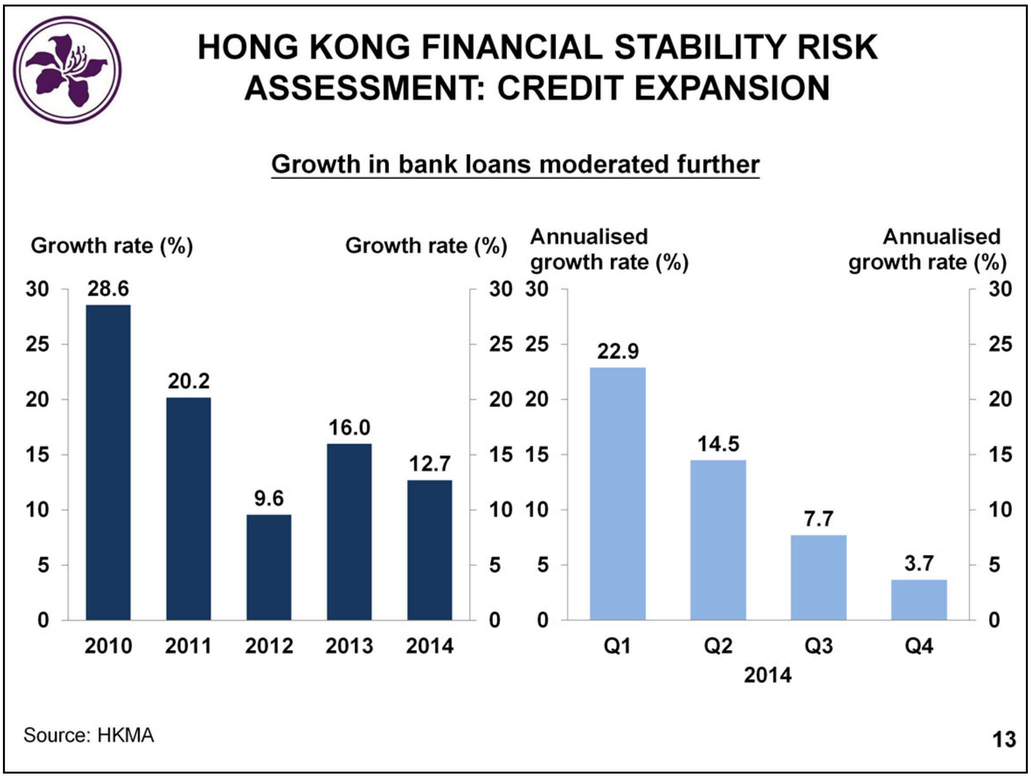
HONG KONG FINANCIAL STABILITY RISK ASSESSMENT: PROPERTY MARKET

Further observation is needed to determine whether the up-cycle of the property market will continue



Sources: Rating and Valuation Department and Land Registry

- Property trading has become active since Q2 2014, with an average monthly turnover of 5,891 units between Q2 and Q4, an increase of almost 40% compared with 2013 (4,223 units). However, the transaction volume was still lower than that of the boom between 2010 and 2012. Primary market transactions were particularly active, acting as the main driver behind the overall turnover growth in 2014. Transaction volume in the primary market reached a monthly average of 1,405 units, up 53% from 2013. It accounted for 26% of total transaction volume, a high since 2004.
- Property prices bucked their falling trend and resume the upward trend since March 2014. In terms of unit size, prices of small- and medium-sized flats rose faster. Whether the property uptrend will continue remains to be seen. Future market direction depends on a host of factors, including interest rate movements, economic growth prospect and housing supply. In particular, uncertainties over the pace and timing of interest rate hikes have increased. It should also be noted that rate hikes will not be one-off. Instead, there may be multiple rate hikes in the future cycle. The impact on the property market remains uncertain .
- The HKMA will continue to monitor closely the development of the property market and adopt appropriate counter-cyclical measures as and when necessary.



- Mainly due to a slowdown in loan demand, coupled with banks' strengthened risk management, recent loan growth continued to moderate.

- In 2014, growth in overall bank loans was 12.7%, slower than 16.0% in 2013. Annualised growth rate fell from 7.7% in Q3 to 3.7% in Q4.

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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

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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 and took effect from 1 January 2015. The legislations introduce a series of regulatory capital buffers and the Liquidity Coverage Ratio which together constitute the 2nd phase of Basel III implementation.

- 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.

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's "Key Attributes of Effective Resolution Regimes"
- Summarises responses to first round 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

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

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COIN COLLECTION PROGRAMME

Up to end-January:

- No. of people served: 63,000
- 57 million pieces (70% cent coins) collected, 900 pieces per person on average
- Total value: $53 million, $850 per person on average
- Waiting time: less than 10 minutes on average

RETAIL PAYMENT DEVELOPMENT

Clearing and Settlement Systems (Amendment) Bill

- To ensure adequate protection of users' float maintained with stored-value facilities (SVF) issuers, and the security and soundness of the operations of SVF and retail payment systems (RPS)
- To introduce into the LegCo on 4 February 2015

E-cheque

- Benefits of e-cheque:
  - can be processed more efficiently, and can be issued and presented any time, anywhere
  - environmentally friendly with enhanced security features
- 3-month pilot run starting December 2015

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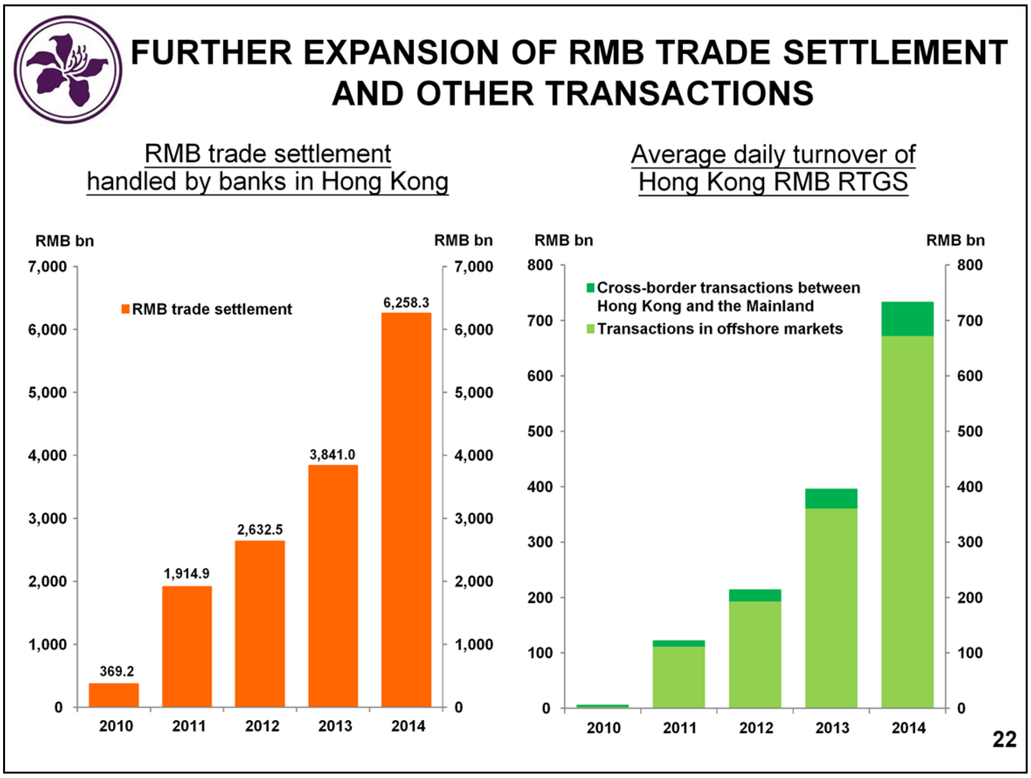
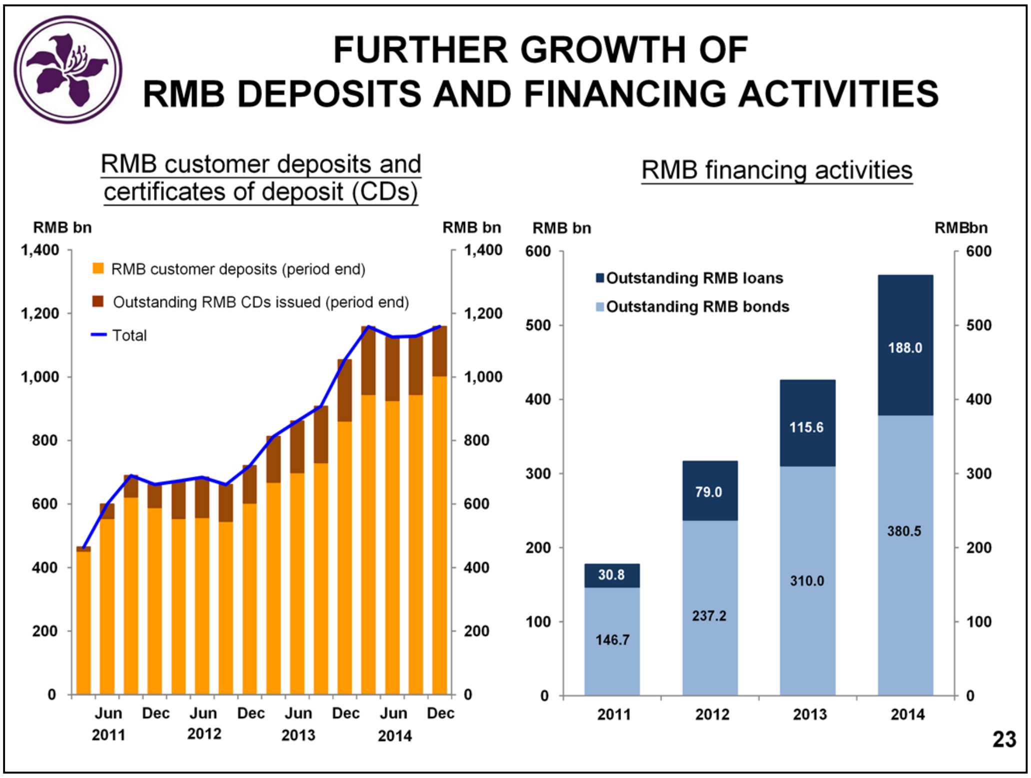


- In 2014, RMB trade settlement handled by banks in Hong Kong amounted to RMB6,258.3 billion, up 63% compared with 2013.

- Turnover in Hong Kong's RMB RTGS system increased further, with daily turnover reaching RMB888.0 billion in December 2014.



- At end 2014, RMB customer deposits and outstanding RMB certificates of deposit amounted to RMB1,003.6 billion and RMB154.7 billion respectively, totaling RMB1,158.3 billion, a 10% growth from RMB1,053 billion at the end of 2013. The daily RMB conversion limit for Hong Kong residents has been removed since 17 November 2014.

- The RMB dim sum bond market was active in 2014, with issuance totalling RMB196.8 billion, 69% more than the total amount of RMB116.6 billion in 2013. Outstanding dim sum bonds amounted to some RMB380.5 billion at end 2014, up 23% from end 2013.

- RMB bank lending continued to grow, with outstanding amount of RMB loans increasing to RMB188.0 billion at end 2014, a growth of 63% from the end of 2013.

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INVESTMENT INCOME

(HK$ billion)	2014 Full year *	2014 Q4*	2014 Q3 *	2014 Q2 *	2014 Q1 *	2013 Full year	2012 Full year	2011 Full year	2010 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	(52.7)	(24.7)	(28.4)	(0.7)	1.1	1.6	(1.4)	(9.1)	(3.1)
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.)

MARKET VALUE OF LONG-TERM GROWTH PORTFOLIO

(AS OF END-2014)

New Asset Classes	Market Value HK$ billion	Annualized return since inception till end 2014
Private Equity	80.5	13.5 % (Internal Rate of Return)
Real Estate	34.7	
Total	**115.2**	

Note: Outstanding investment commitments at the end of 2014 amounted to HK$79.9 billion

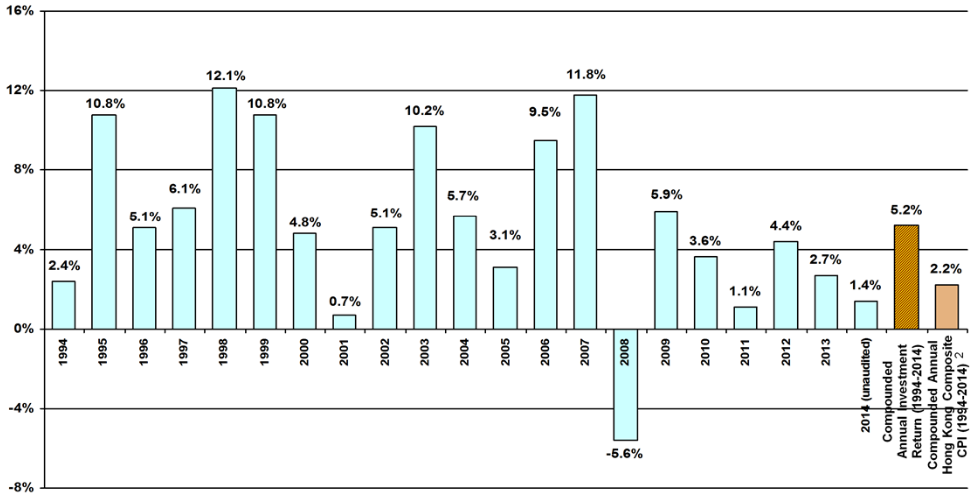
INCOME AND EXPENDITURE

(HK$ billion)	2014 Full year*	Q4*	Q3 *	Q2 *	Q1 *	2013 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	(5.2)	(1.1)	(1.3)	(1.7)	(1.1)	(4.9)
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.

INVESTMENT RETURN OF THE EXCHANGE FUND (1994-2014) [1]



1 Investment return calculation excludes the holdings in the Strategic Portfolio

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