HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

23 May 2016

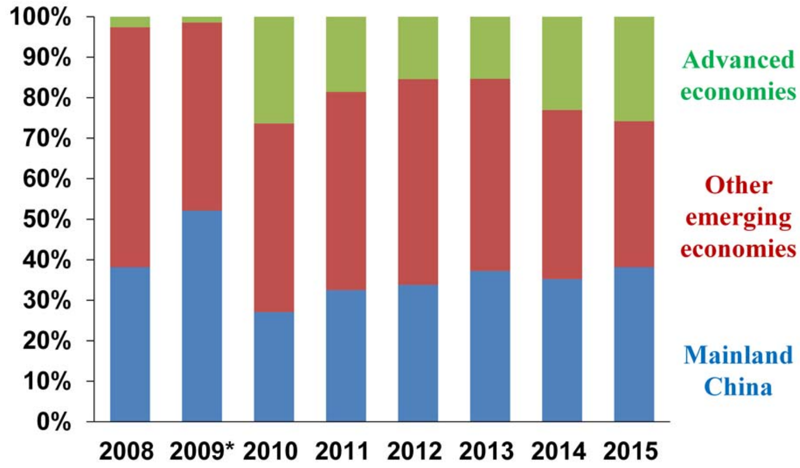
[Translation]

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

MARKET CONCERNS ABOUT GLOBAL FINANCIAL RISKS

- Hard landing of the Mainland economy
- Pace of US interest rate hikes
- Negative interest rate policies in Europe and Japan
- UK's referendum on membership of the European Union

MAINLAND CHINA: REMAINS A KEY IMPETUS TO GLOBAL GROWTH



* Global GDP recorded negative growth in 2009 due to the Global Financial Crisis, so countries or regions with negative growth are excluded from the calculation in that year.

Sources: CEIC, International Monetary Fund and HKMA estimates.

- Despite slower growth, Mainland China remains a key impetus to global economic growth. According to IMF's estimates, Mainland China's contribution to global economic growth was 38% in 2015.

MAINLAND CHINA: DEMAND FOR MAJOR COMMODITIES CONTINUES TO INCREASE

	2015	
(%yoy)	Import volume	Import value
Crude oil	+8.8	-41.2
Iron ore	+2.2	-38.7
Copper ore	+12.3	-11.0
Grain	+24.3	-4.4

Sources: CEIC, China Customs and HKMA estimates.

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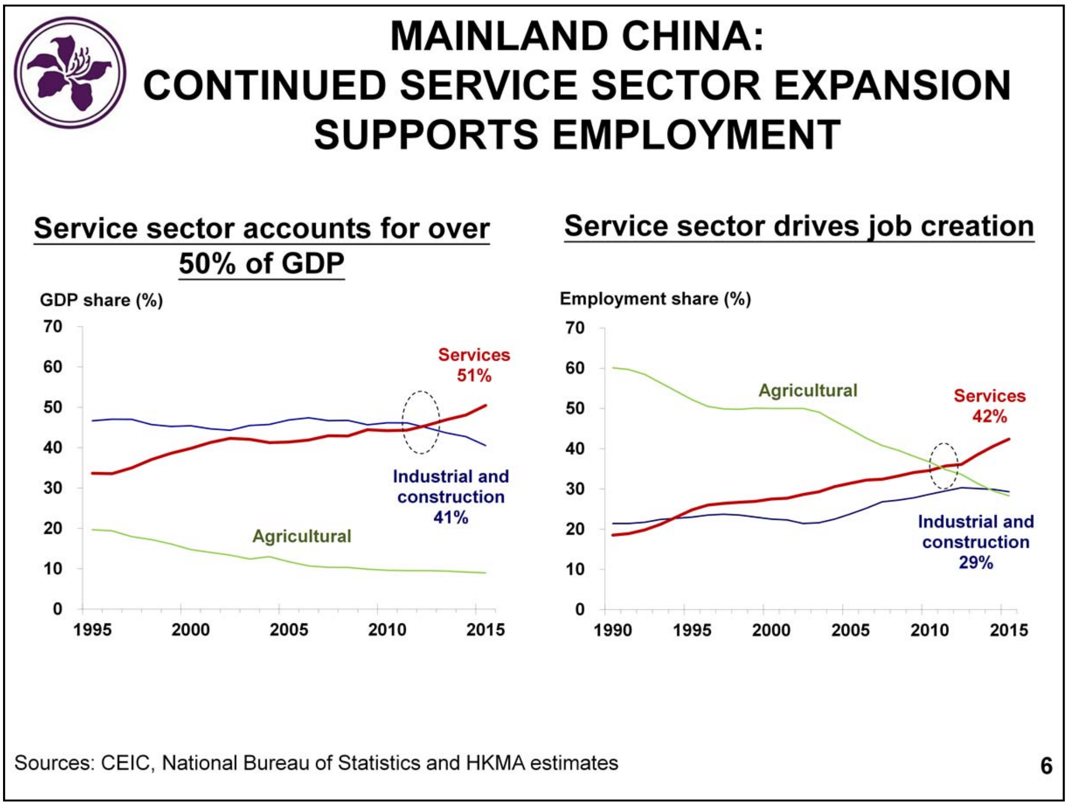
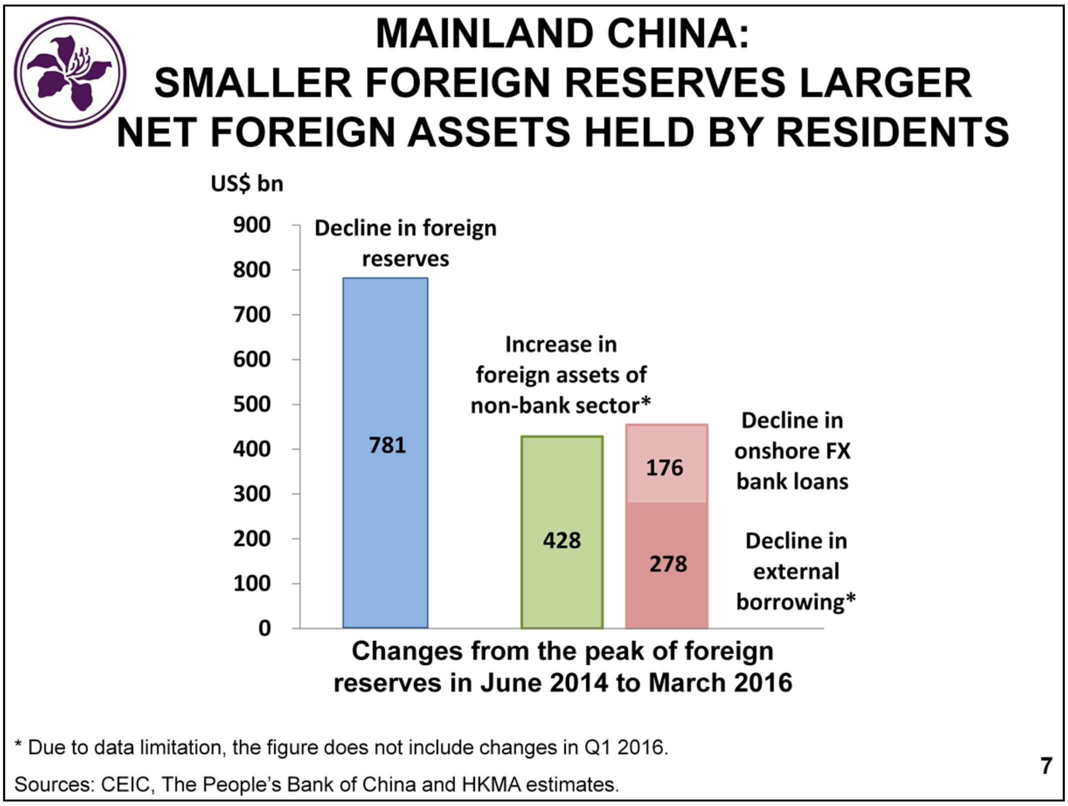
- The Mainland's demand for many primary products, such as fuel and food products, continued to increase.

- Driven by price falls in major commodities, the value of Mainland's imports, such as crude oil, iron ore and grains, has dropped in recent years. However, the volume of imports on major commodities continued to rise. Therefore, reduction in import demand from the Mainland is not the main reason behind the major commodity price falls.



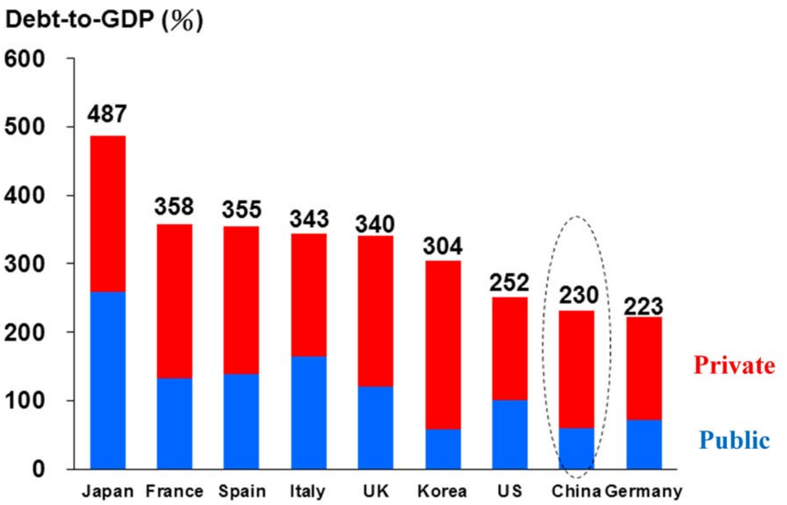
- Continued expansion in the service sector has provided crucial support to the Mainland's economic growth and employment. The sector accounted for over 50% of the Mainland's GDP in 2015.



- The reduction in foreign reserves partly reflects a greater incentive of the Mainland's non-bank private sector in buying foreign exchange, as reflected by an increase in residents' foreign asset holdings. Between June 2014 and March 2016, foreign reserves shrank by about US$780 billion while foreign assets held by the private sector rose almost US$430 billion.

- Meanwhile, there have been additional purchases of foreign exchange by Mainland corporations for servicing external debt as part of their effort to contain exchange rate risk. During the same period, external borrowing by Mainland corporations has reduced by US$280 billion, while onshore foreign currency loans of Mainland banks also fell nearly US$180 billion.

MAINLAND CHINA: OVERALL DEBT RATIO IS NOT HIGH COMPARED WITH ADVANCED ECONOMIES…



2015 figures.

Sources: CEIC, DataStream and HKMA estimates.

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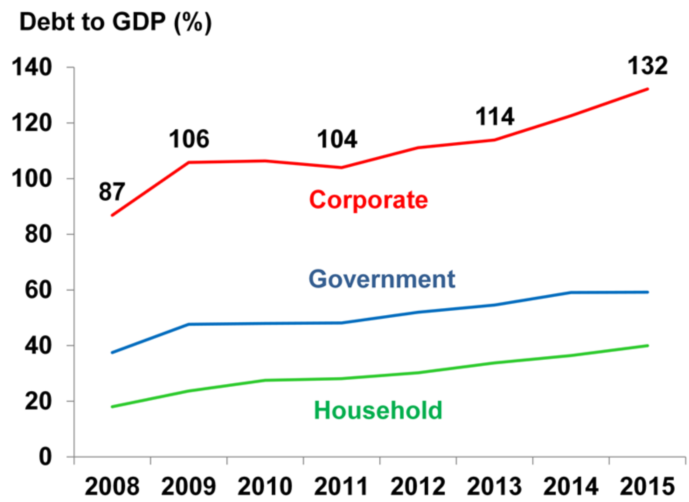
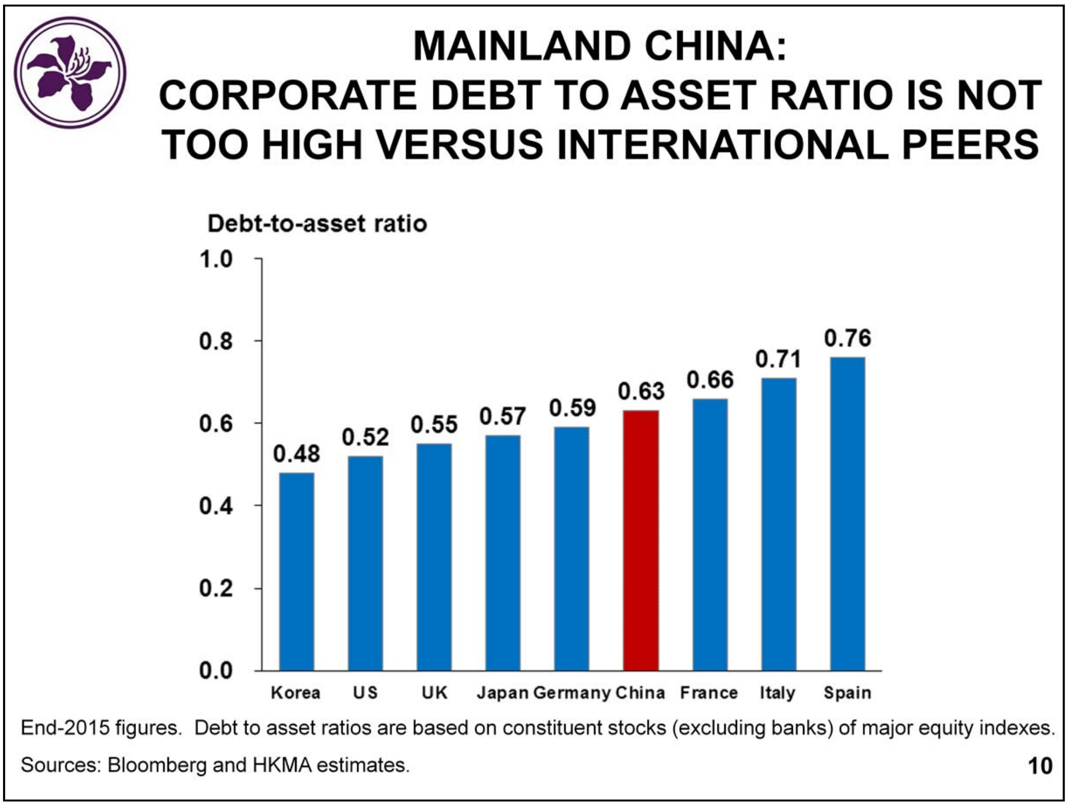
- Despite a relatively fast credit expansion in recent years, the overall debt-to-GDP ratio of the Mainland, at 2.3 times at end-2015, is not high compared with other major economies.

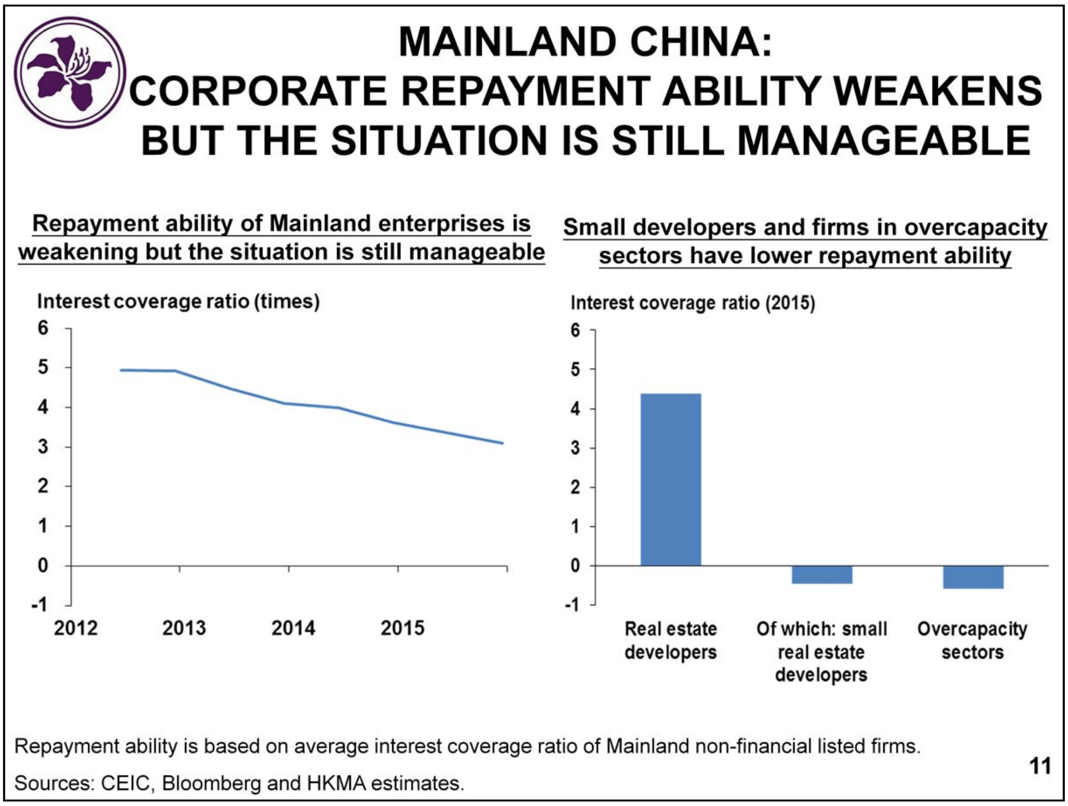
MAINLAND CHINA:
…BUT THE PACE OF CORPORATE DEBT EXPANSION IS A CAUSE FOR CONCERN



Sources: CEIC, The People's Bank of China and HKMA estimates.



- Higher corporate debt levels can be partly attributed to the relatively slow development of equity financing on the Mainland, causing firms to rely heavily on bank loans as a key financing channel. Currently, the debt-to-asset ratio of Mainland listed companies is not too high by international standards, being 63% at end-2015. The level is comparable to other advanced economies.



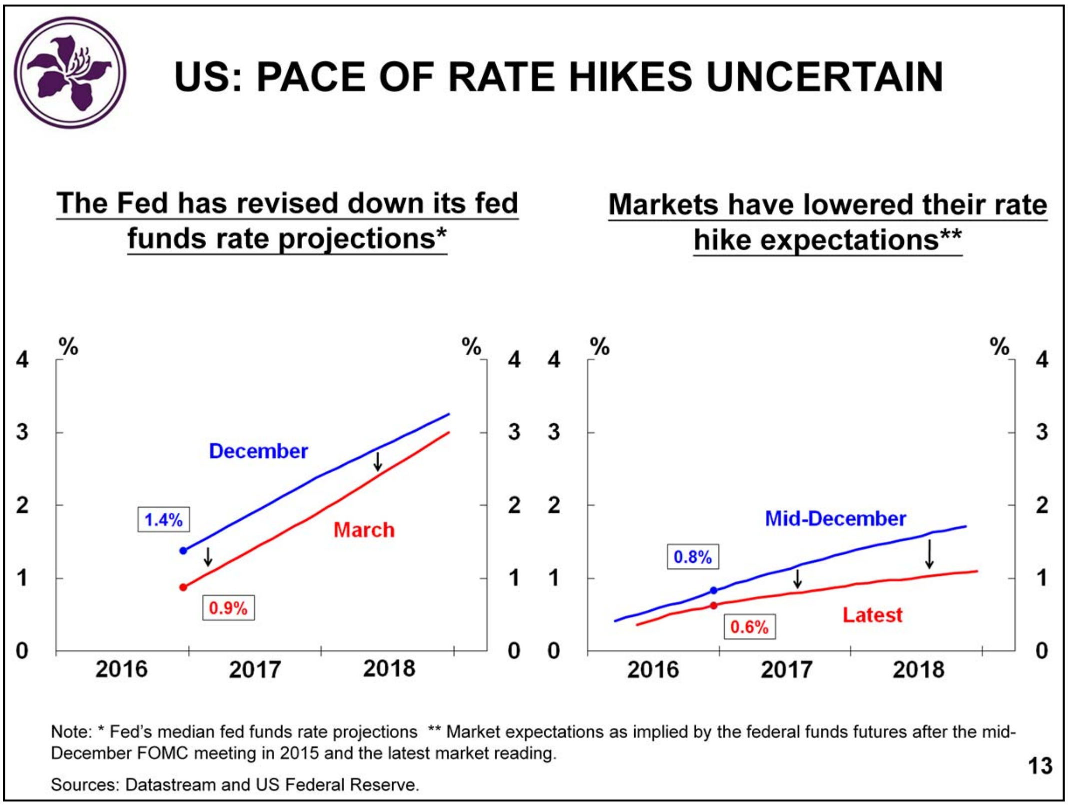
- Due to growing debts and reducing profits, debt servicing ability of Mainland corporations is weakening but the situation is still manageable. Data of listed companies indicate that their interest coverage ratio remained at an average of about three times in 2015.

- Among the worst-performers are overcapacity sectors and small real estate developers, with their interest coverage ratios turning negative in 2015, suggesting that their profits are not enough to cover interest payments.

- However, overcapacity sectors (including iron and steel, coal, nonferrous metals and cement) account for a small share of total Mainland bank lending, at 2.8% in 2015. The systemic risk is still manageable.

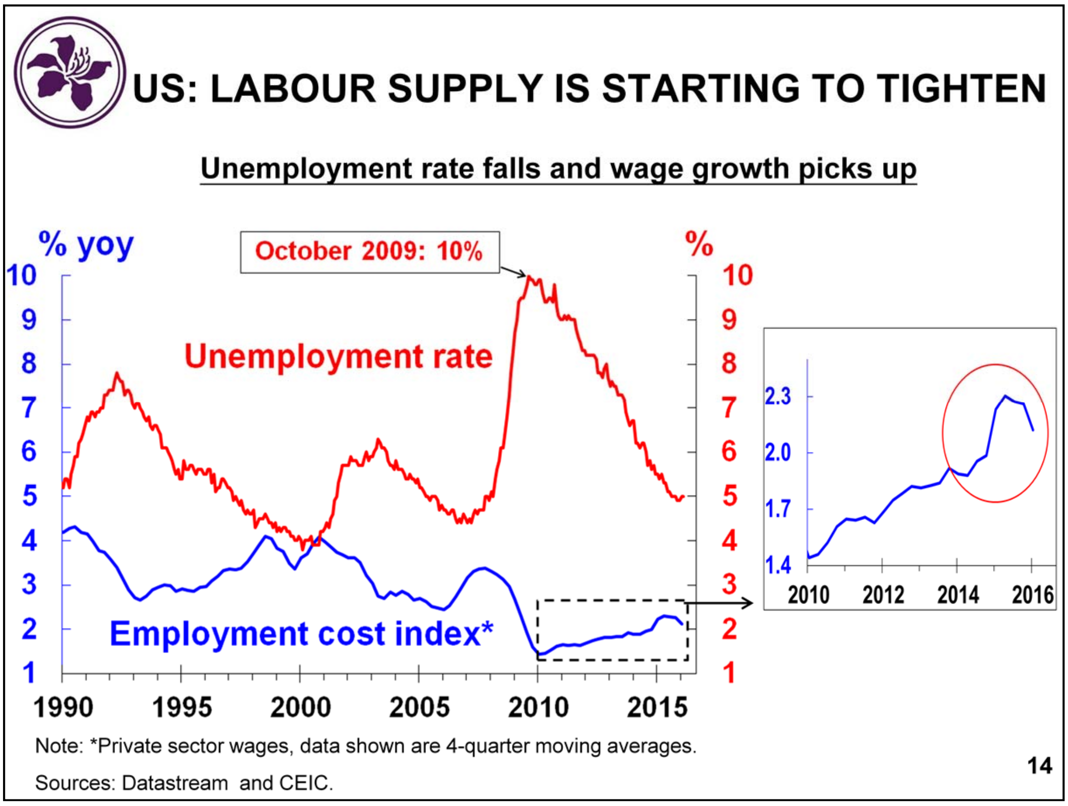
MAINLAND CHINA: HARD LANDING RISK NOT HIGH

- Service sector expansion supports growth and employment, mitigating impact of slowdown in manufacturing sector
- Government and household debt levels are not high; corporate debts grow faster but their risks are still manageable
  - Debt servicing ability of Mainland firms weakens but the situation is still manageable
  - Share of bank lending to overcapacity sectors is not large
  - Banking sector has sufficient cushion to cope with credit loss
- Mainland enterprises have cut back foreign currency liabilities to reduce the risk of currency mismatch
- Mainland economic growth is still decent compared with other major economies; risk of a hard landing has been exaggerated
- Recent rapid increase in property prices in tier-one cities and commodity price gyrations are areas of concern



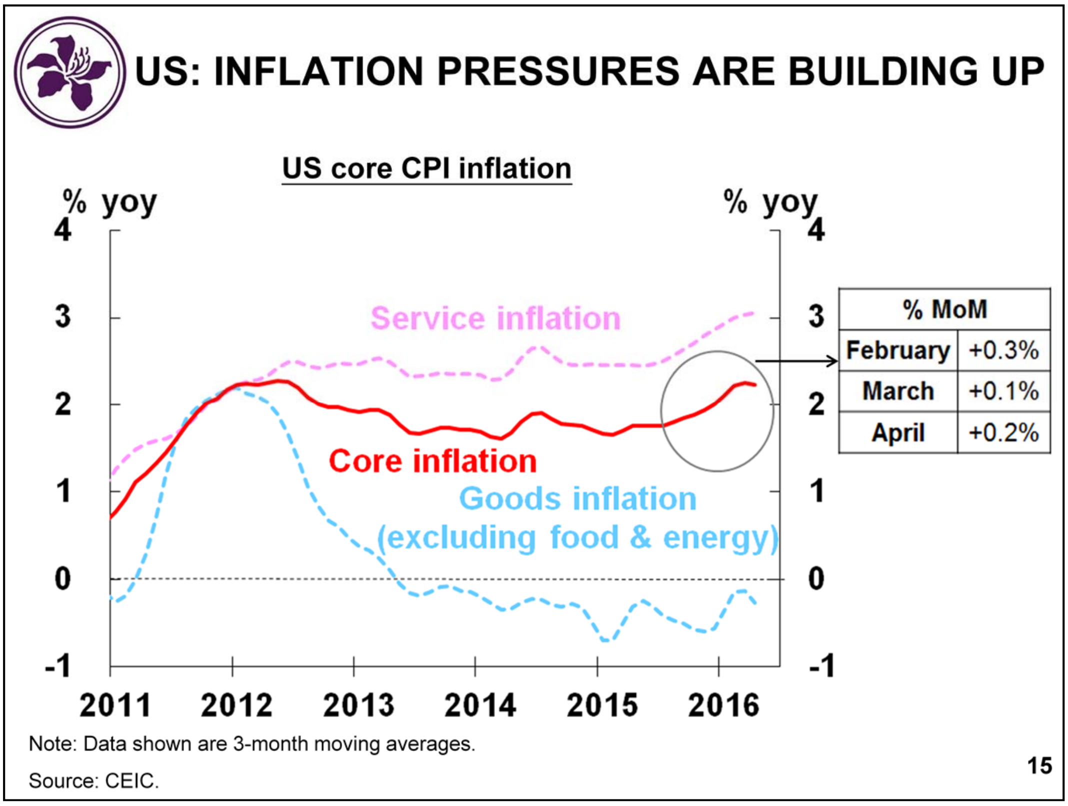
- During its meeting in March 2016, the US Federal Reserve (Fed) expressed concern about the downside risks of global economic and financial developments to the US economy and revised downward its Fed funds rate projections.

- Financial market expected the actual pace of interest rate hikes to be slower than that projected by the Fed.



- The US unemployment rate has fallen to 5% in April from a high of 10% amid the global financial crisis. The rate is close to the Fed's estimated natural rate of unemployment of about 4.9%.

- As the slackness in the labour market improves, wage growth is on an upward trend. Wage growth in the private sector rose by 2.0% year-on-year in the first quarter of 2016.



- Core inflation has risen to 2.1%. As falls in food and energy prices continue to narrow, the overall inflationary pressure will also increase.

UNCERTAIN PACE OF US RATE HIKES MAY CAUSE SIGNIFICANT MARKET VOLATILITIES

- Fed officials have indicated willingness to tolerate inflation overshoot and hold off on rate hikes. Markets currently expect a slow pace of US interest rate hikes

- But US inflation may rise faster than markets expected

- Markets could become volatile if, by then, the Fed is perceived to be "behind the curve"

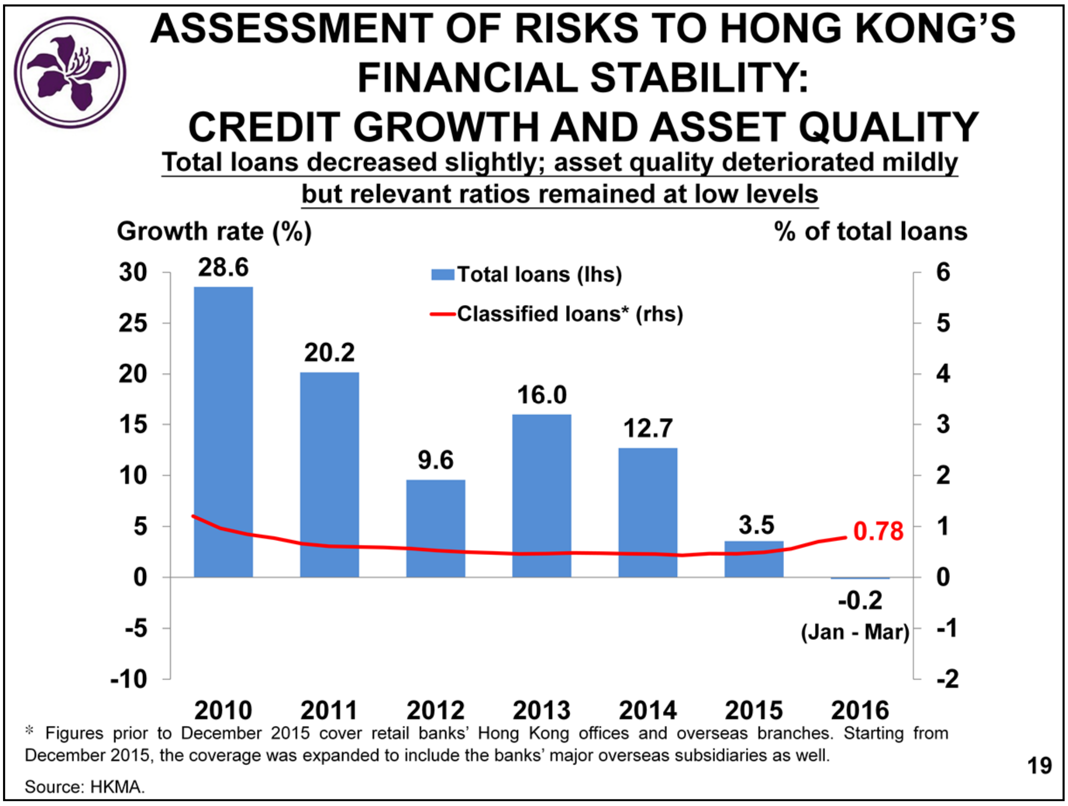
EFFECTIVENESS OF NEGATIVE INTEREST RATE POLICY IN EUROPE AND JAPAN UNCERTAIN

- Economic conditions have not significantly improved as expected since implementation of negative rate policies
  - The euro and the yen have not depreciated conspicuously as some had expected
  - Banks, insurance companies and pension funds are in difficult business environment
  - No significant boost to lending to small- and medium-sized firms
- Markets are sceptical about the effectiveness of QE and negative interest rate policy in Europe and Japan
  - Positive impact smaller than expected while side effects have started to emerge
  - Scope for further negative interest rate cuts is limited

UK REFERENDUM ON EU MEMBERSHIP MAY CAUSE INSTABILITY TO FINANCIAL MARKETS

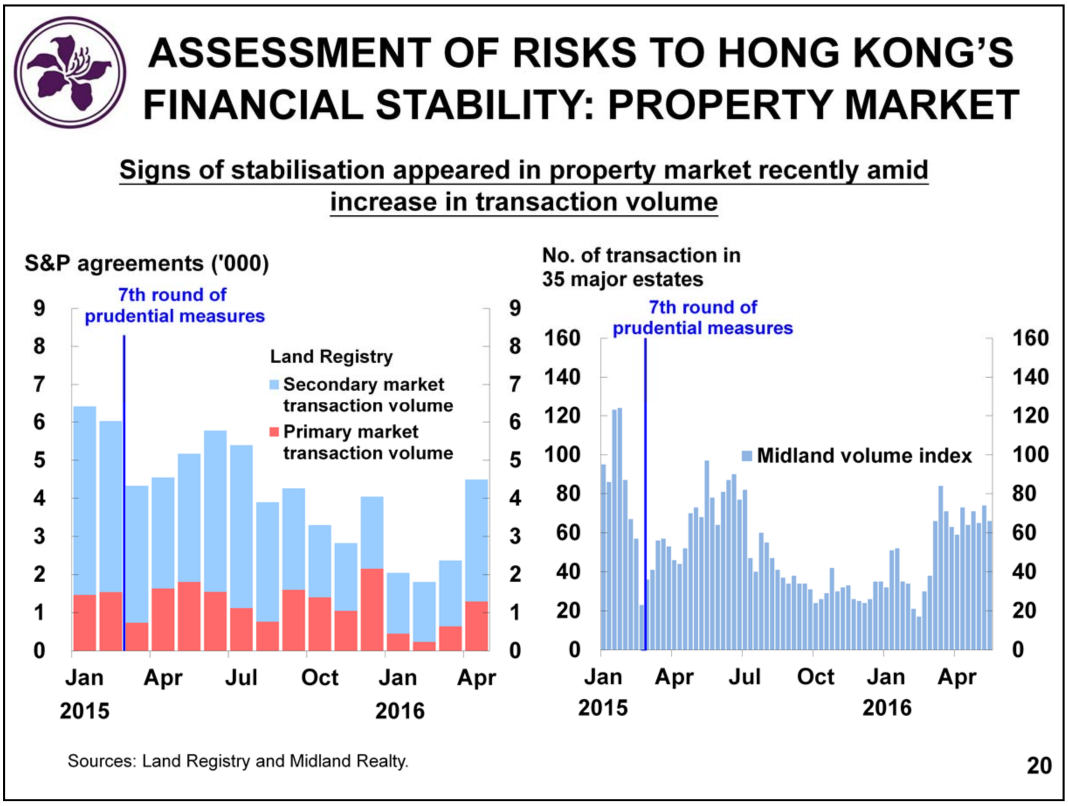
- Various polls in the UK suggest the pro-EU camp does not have a clear lead

- Should the UK choose to leave the European Union
  - There would be near-term shockwaves to financial markets in the UK and in Europe
  - It is difficult to predict the medium to longer term impact as it hinges on the outcome of negotiation between the UK and the EU on the new economic, trade and financial relations

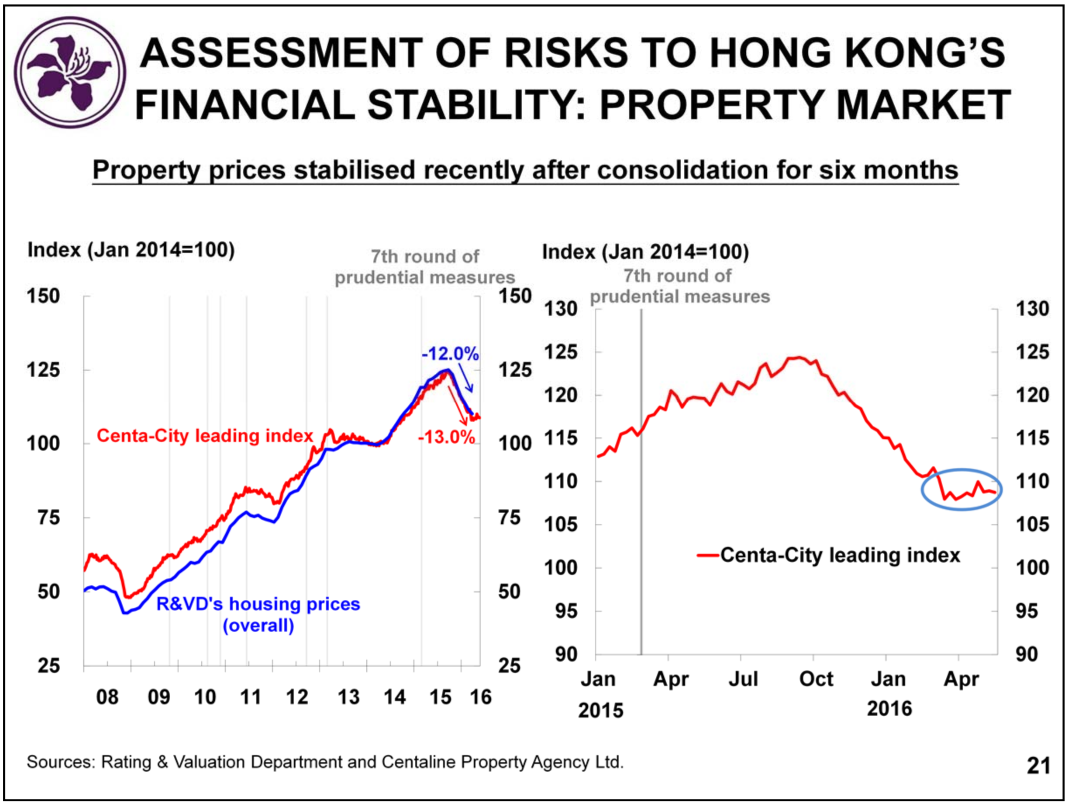


- Clouded by economic uncertainties and reduced cross-border borrowing by Mainland enterprises, total loans of Hong Kong banks fell slightly by 0.2% quarter-on-quarter.

- The asset quality of retail banks deteriorated slightly, but the relevant ratios remained at low levels.



- Data from the Land Registry indicates that the overall average monthly turnover fell nearly 40% in Q1 2016 when compared with that of Q4 2015. But the turnover has rebounded markedly in April.



- The Centa-City leading index has showed signs of stabilisation since mid-March.

ASSESSMENT OF RISKS TO HONG KONG'S FINANCIAL STABILITY: CONCLUSION

- Sentiment has been stabilising after the market turbulence at the start of the year, but external environment remains uncertain amid weak global growth
- Hong Kong economy slows further, with some sectors facing larger downside pressures
- Property transactions picked up since mid-March, while housing prices showed signs of stabilisation
- HKMA needs to observe property market development for a longer period before it can be certain that the property market has entered a downcycle

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BANKING (CAPITAL) (AMENDMENT) RULES 2016

- Amendments to implement three Basel Committee capital standards:
  - New Standardised Approach to counterparty credit risk (SA-CCR)
  - Final risk-weighting framework for exposures to central counterparties (CCPs)
  - New risk-weighting framework for equity investment in funds
- Amendments to be submitted to the LegCo in the last quarter of this year
- Target implementation: 1 January 2017

BANKING (DISCLOSURE) (AMENDMENT) RULES 2016

- Amendments to implement Basel Committee disclosure standards:
  - Standalone report for regulatory disclosures
  - Standard templates and tables
  - Quarterly disclosures
- Amendments to be submitted to the LegCo in the last quarter of this year
- Target implementation: financial year ending 31 December 2016

ESTABLISHING A CROSS-SECTOR RESOLUTION REGIME FOR FINANCIAL INSTITUTIONS IN HONG KONG

- To meet international standards: Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions"

- Imperative to achieve compliance with international standards as soon as possible to deter overseas financial institutions from seeking to reduce operations in Hong Kong to improve resolvability

- Financial Institutions (Resolution) Bill introduced into the LegCo in December 2015 - Bills Committee scrutiny underway

OPENING OF BANK ACCOUNTS

- **Statutory guidelines and regulatory requirements**
  - Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance
  - Risk-based principle
- **Foreign Account Tax Compliance Act of the United States**
  - Global efforts on tax transparency
  - Role of banks
  - Enhancing communication with customers
- **Opening of bank accounts for trustees in bankruptcies**
  - Section 91 of the Bankruptcy Ordinance
  - Facilitation of bankruptcy process by banks

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Statutory guideline and regulatory requirements

- Before opening an account with a customer, banks are required to comply with the relevant legal and regulatory requirements, which include the statutory customer due diligence (CDD) requirements stipulated in the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (AMLO). To ensure compliance, each bank develops its own account opening procedures and requirements, taking into account its own risk appetite and the requirements of its headquarters or Group where applicable.

- The CDD requirements stipulated in the AMLO are risk-based, which is an internationally recognised concept that different customers, transactions or services will each present different risks, and CDD measures applied by banks should be commensurate with the risk identified, i.e. on a risk-sensitive basis. The HKMA has issued statutory guideline under the AMLO to provide practical guidance to assist banks on how to meet these requirements. At the same time, the HKMA requires that the account opening process of banks should be transparent, and in this respect, all retail banks have put the basic information about account opening procedures and documentation requirement in their websites and sought to provide sufficient training to frontline staff to ensure enhanced communication with customers.

Foreign Account Tax Compliance Act (FATCA)

- As part of the HKSARG's commitment in global efforts in enhancing tax transparency and combatting tax evasion, the banking industry in Hong Kong is facilitating the implementation of requirements under the FATCA. This is in line with efforts adopted in other jurisdictions.

- FATCA is a United States (US) legislation that aims at combatting tax evasion by US persons holding accounts and other financial assets outside the US. In brief, under FATCA, foreign financial institutions including banks are required to collect additional information or documentation from customers to ascertain their non-US or US tax status. For instance, when individuals (regardless of whether they are US citizens/residents or not) open new bank accounts, banks may request customers to complete specific US tax forms or bespoke self-certification forms, and other supporting documentation as required.

- In view of such new developments which also affect bank customers, in October 2015, the HKMA issued guidance to the industry on improving customer communication, and reminded banks of the importance of clearly informing their customers about the purpose of signing forms/declaration in relation to FATCA.

- To understand retail banks' implementation progress after receiving the HKMA's guidance of October 2015, the HKMA has conducted a survey of retail banks' actual practices. We see room for improvement in the FATCA Fact Sheet which was developed by HKAB for its member banks' reference in tailoring their customer communications on FATCA. The HKMA is now working with HKAB in enhancing the FATCA Fact Sheet so as to better address the commonly asked questions by bank customers on what are required on them under FATCA in light of the recent experience. While appreciating that banks are not professional tax advisors, the HKMA encourages banks to work with customers and prospective customers to seek to minimise the reporting burden and especially for those customers who confirm themselves as non-US persons and non-US taxpayers.

<u>Opening of bank accounts for trustees in bankruptcies</u>

- We understand from the Official Receiver's Office that under section 91 of the Bankruptcy Ordinance, every trustee in a bankruptcy shall open an account in the name of the bankrupt's estate at the same bank where the Official Receiver maintains an account ("OR banks") and shall pay to the credit of such account all sums which may from time to time be received by him as trustee. Currently, the Official Receiver maintains bankruptcy accounts with five banks.

- Where a trustee is not able to open such a bank account, this would make it impossible for the administration of the bankruptcy estate concerned. It is thus the expectation of the HKMA that OR banks are supportive of bona fide activities of such trustees and accommodate their legitimate applications for opening of accounts for the bankrupts' estates. We have recently reminded the OR banks concerned about our expectation. Trustees may open accounts at any of the OR banks in accordance with section 91 of the Bankruptcy Ordinance.

UNAUTHORISED ONLINE SHARE TRADING TRANSACTIONS

- On 20 April, the HKMA issued an "E-banking Alert" to alert the public to guard against unauthorised online share trading transactions
- Simple precautionary measures adopted by the public can help avoid such fraud cases
- Unless a customer acts fraudulently or with gross negligence, he should not be responsible for any direct loss suffered by him as a result of unauthorised transactions conducted through his accounts

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- In early April, banks identified 8 cases of unauthorised online share trading transactions involving a total amount of HK$6.86 million. The HKMA forthwith issued email to banks to alert them again to this type of frauds and ask them to step up security surveillance. On 20 April, the HKMA issued an "E-banking Alert" to alert the public to guard against unauthorised online share trading transactions.

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REGULATORY FRAMEWORK FOR STORED VALUE FACILITIES AND RETAIL PAYMENT SYSTEMS - PROGRESS UPDATE

- Following the enactment of the Payment Systems and Stored Value Facilities Ordinance in November 2015, the HKMA issued two sets of guidance documents on the Stored Value Facilities (SVF) licensing regime and related key regulatory requirements
- The HKMA has been in close dialogue with more than 20 prospective SVF applicants, and expects to issue the first batch of SVF licences in Q3 2016
- The HKMA will commence work to determine if any existing Retail Payment Systems (RPS) should be designated. It is expected that an explanatory note on the HKMA's policies and procedures on RPS designation will be issued in H1 2016
- A media briefing on the SVF regime was held on 5 April 2016. The HKMA will continue its public education programme to enhance public understanding of the new SVF and RPS regulatory regime and the use of retail payment products and services

THE ROLE OF FINTECH FACILITATION OFFICE

1. **Clustering and outreaching platform**
   - To organise industry liaison events for fintech industry players and interested parties to exchange ideas and share information and insights about market development
2. **Interface between the industry and the HKMA**
   - To help fintech stakeholders better understand the regulatory landscape for the banking and payment services in Hong Kong and respond to industry enquiries
3. **Research and application (R&A) initiator**
   - *"Cybersecurity Fortification Initiative"*: cyber risk and preparedness assessment, training programme and information sharing platform
   - Other projects (e.g. research on blockchain technology)

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DEVELOPMENT OF HONG KONG OFFSHORE RMB BUSINESS

- Offshore RMB exchange rate and interest rates have stabilised in recent months
- Some investors remain cautious about RMB outlook. Offshore RMB business has generally slowed down. Q1 2016 saw RMB liquidity pool in Hong Kong contract comparing to a quarter earlier but the offshore RMB market in Hong Kong continues to operate in an orderly manner
- Mainland authorities' commitment to RMB internationalisation and opening up of the capital account, as well as the "Belt and Road" strategy, will inject impetus to the development of offshore RMB business

DEVELOPING HONG KONG INTO A HUB FOR CORPORATE TREASURY CENTRES AND THE CENTRE FOR INFRASTRUCTURE FINANCING

Corporate Treasury Centres

- The Inland Revenue (Amendment) (No. 4) Bill 2015 was introduced into LegCo to (i) allow, under specified conditions, interest deductions under profits tax for Corporate Treasury Centres (CTCs) and (ii) reduce profits tax for specified treasury activities by 50%
- The amendment will enhance the competitiveness of Hong Kong as an international financial centre and help develop Hong Kong into a regional hub for CTCs

Infrastructure Financing Facilitation Office

- The HKMA is setting up the Infrastructure Financing Facilitation Office (IFFO), which is aimed to be launched officially in the summer

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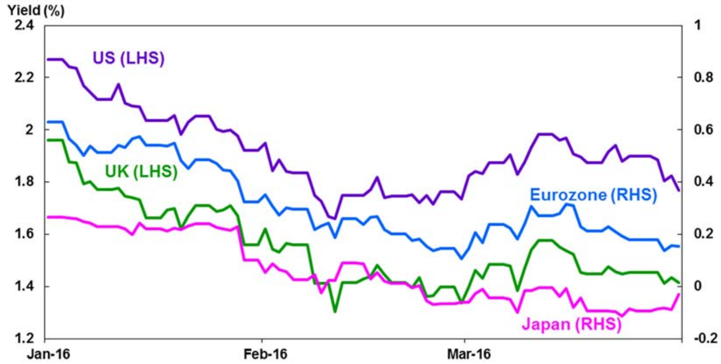
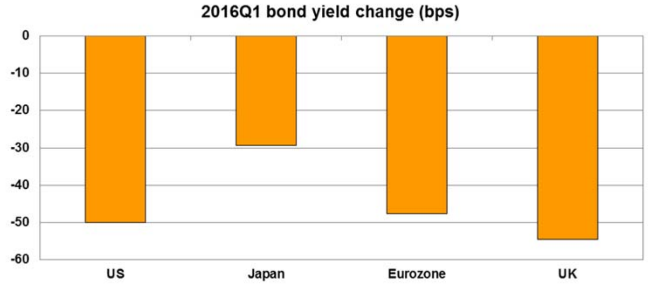
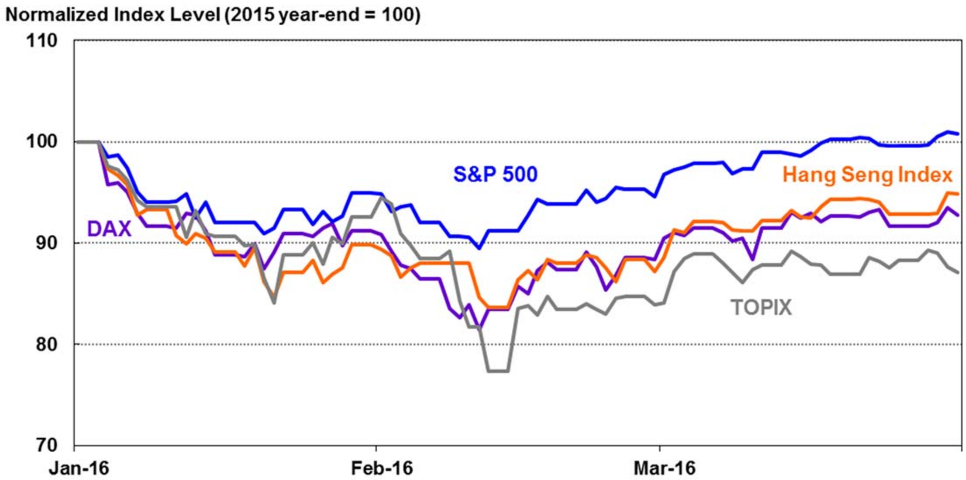
CHANGES IN 10-YEAR GOVERNMENT BOND YIELDS IN Q1 2016

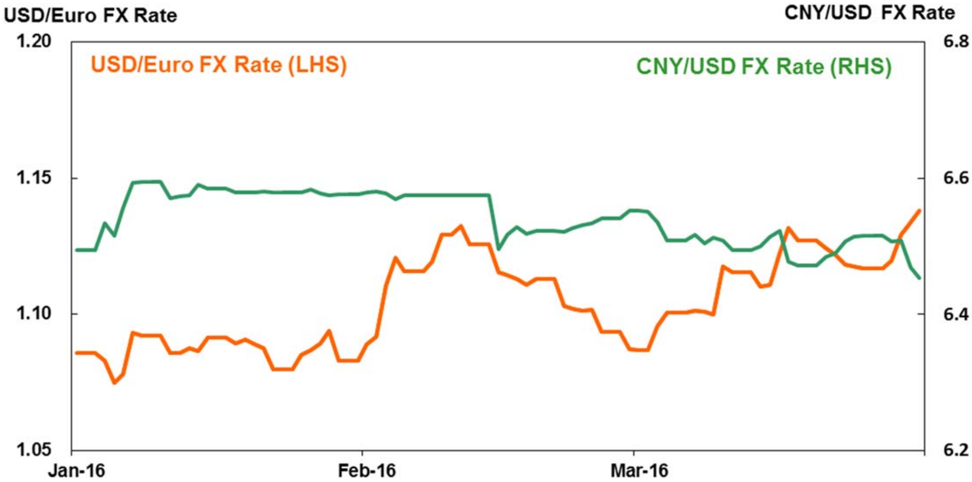




EQUITY MARKETS IN Q1 2016



CURRENCY MARKETS IN Q1 2016



INVESTMENT INCOME

(HK$ billion)	2016 (unaudited) Q1	2015 Full Year	2014 Full Year
Hong Kong equities*	**(6.2)**	**(5.0)**	**6.5**
Other equities	**(9.9)**	**7.1**	**33.7**
Bonds	**25.0**	**15.9**	**47.3**
Other investments@	**-**	**11.1**	**9.9**
Foreign exchange#	**15.2**	**(44.9)**	**(52.7)**
Investment income/(loss)	**24.1**	**(15.8)**	**44.7**

* Excluding valuation change of the Strategic Portfolio

@ Including valuation changes of private equity and real estate investments held under the Long-Term Growth Portfolio (LTGP). The valuation figures for the first quarter of 2016 are not yet available.

\# This is primarily the effect of translating non-US dollar foreign currency assets into Hong Kong dollar after deducting the portion for currency hedging

INCOME AND EXPENDITURE

(HK$ billion)	2016 (unaudited) Q1	2015 Full Year	2014 Full Year
Investment income/(loss)	**24.1**	**(15.8)**	**44.7**
Other income	0.0	0.2	0.2
Interest and other expenses	(1.2)	(4.8)	(5.2)
Net income/(loss)	22.9	(20.4)	39.7
Fee payment to Fiscal Reserves*#	(6.0)	(46.7)	(27.5)
Fee payment to HKSAR government funds and statutory bodies*	(2.3)	(14.7)	(8.6)

* The annual fixed rate is 3.3% for 2016, 5.5% for 2015 and 3.6% for 2014.

\# This does not include the 2016 fee payment to the Future Fund because such amount will only be calculated when the figures on the LTGP annual performance for 2016 are available.