Chief Executive's Statement

2013 was a special year for the HKMA: it marked the 30th anniversary of the Linked Exchange Rate system (LERS) and the 20th anniversary of the establishment of the HKMA. These two important milestones are timely reminders of our heavy responsibility in safeguarding the stability of Hong Kong's monetary and financial systems and promoting Hong Kong as an international financial centre.

It was also an eventful year for financial markets around the globe. Although overall market sentiment improved somewhat, market volatilities were unavoidable in the face of lingering uncertainties over economic recovery in the US and other advanced economies, possible exit from quantitative easing by the US Federal Reserve, as well as the timing, magnitude and speed of the exit. In May and June last year, the Fed Chairman's remarks about a possible timeline for tapering triggered a significant sell-off in global equity and bond markets and in emerging market economies. In December 2013, the Fed announced its decision to start tapering from January 2014. The market initially reacted calmly, with the S&P 500 and the Dow Jones indices both closing at record highs on the day of the announcement. At the same time, there were signs of a continued outflow of funds from the emerging markets.

In such a highly uncertain external environment, the HKMA closely monitored market movements and took timely measures to better prepare our banking and financial systems to weather possible shocks. After touching the strong-side Convertibility Undertaking in late 2012 due to a large influx of funds into the Hong Kong dollar, the Hong Kong dollar softened slightly against the US dollar in the first half of 2013. In the second half of the year, the exchange rate turned slightly stronger due to mild inflows. In spite of unpredictable international capital flows and widespread currency fluctuations among emerging market economies, the Hong Kong dollar remained stable throughout the year, again highlighting the fact that the LERS has been an effective cornerstone of Hong Kong's monetary and financial stability since October 1983. When announcing the results of its annual Article IV Consultation for Hong Kong in January 2013, the International Monetary Fund reaffirmed that the LERS remained the best arrangement for Hong Kong. The Government also emphasised its firm commitment to maintaining the LERS.

In order to strengthen our banking system's capacity against the potential impact of US interest rate normalisation on Hong Kong's property and mortgage markets, the HKMA launched its sixth round of countercyclical prudential measures in February 2013. These included raising the interest rate hike assumption for property mortgage loans' approval to 300 basis points and lowering the maximum applicable loan-to-value ratio for non-residential mortgages. As a result of these prudential measures and the Government's demand management tax measures, Hong Kong's property transaction volume dropped significantly in 2013. Property price increases moderated, and the growth in residential mortgage loans slowed from 7.6% in 2012 to 3.9% in 2013. Meanwhile, the aggregate credit growth in the banking sector accelerated from 9.6% in 2012 to 16%. To reduce the risks arising from this rapid credit expansion, the HKMA launched the Stable Funding Requirement in October 2013, requiring banks to ensure stable funding to support the rapid growth of their lending. Credit growth slowed slightly in the fourth quarter of 2013, but picked up sharply again in January 2014. In view of this, in February 2014 the HKMA decided to bring forward the review of banks' credit growth to the end of March to assess their compliance with the Stable Funding Requirement.

In 2013, the HKMA implemented the first phase of Basel III capital standards and related disclosure requirements, in compliance with the new international standards of banking regulatory reforms. To tackle the "too-big-to-fail" problem, we also pushed ahead with the preparatory work for the establishment of an effective resolution regime for financial institutions in Hong Kong, with the launch in early 2014 of the first round of public consultation on the proposed regime. The HKMA also supported and collaborated with stakeholders in setting up the Private Wealth Management Association, which seeks to promote and develop good conduct, integrity and professional competence among practitioners and boost the private wealth management business in Hong Kong. To assist in the protection of financial consumers, the HKMA launched the consumer education programme to promote smart and responsible use of banking products and services. We also engaged the banking sector to develop the Treat Customers Fairly Charter, which was supported and signed up to by 22 Hong Kong retail banks in October. We will continue to work with the signatory banks to implement the principles enshrined in the Charter so that the spirit of fair treatment of customers becomes an integral part of their businesses. In 2013, the HKMA also significantly strengthened its manpower to supervise banks' anti-money laundering work and to enhance bank management's risk awareness and governance culture in this area.

The HKMA's efforts in strengthening Hong Kong's position as an offshore renminbi business centre achieved encouraging results. Both the size and liquidity of our offshore renminbi pool improved significantly in 2013. The amount of renminbi trade settlement handled by banks in Hong Kong increased to RMB3,841 billion, a 46% increase over 2012; total outstanding renminbi customer deposits and certificates of deposit surpassed the important threshold of RMB1 trillion for the first time; and outstanding renminbi bank loans grew to RMB115.6 billion, a 46% jump from 2012, amid sustained growth in renminbi bank loan business. With the increasing use of renminbi in cross-border trade and offshore financial activities, the average daily turnover of Hong Kong's renminbi Real Time Gross Settlement system (RTGS) exceeded RMB500 billion in December 2013, almost double the RMB264.4 billion over the same period in 2012. The HKMA also worked closely with relevant Mainland authorities to pursue a number of policies and improvements to cross-border renminbi businesses, including the broadening of two-way renminbi investment channels, such as expanding the scope of eligible institutions and relaxing the investment restrictions under the Renminbi Qualified Foreign Institutional Investor (RQFII) scheme and allowing cross-border investment using renminbi funds under the Qualified Domestic Institutional Investor (QDII) scheme, as well as streamlining the requirements for cross-border renminbi businesses. We will continue to closely communicate with relevant authorities in the Central People's Government to introduce more policies and initiatives conducive to the sustainable development of Hong Kong's offshore renminbi business.

With this in mind, the HKMA continues to enhance the renminbi payment and settlement platform. Since January 2013, and with the support of the People's Bank of China Shenzhen Central Sub-Branch, the clearing houses in Hong Kong and Shenzhen have started a pilot arrangement that links Hong Kong's renminbi RTGS system with the Shenzhen Financial Settlement System. The arrangement extends the operating hours of the cross-border renminbi payment services between Hong Kong and the Mainland from 4:30 p.m. to 10:30 p.m., enabling Hong Kong's renminbi clearing platform to more fully support Mainland and overseas renminbi payments. This is an important initiative to further enhance the operational capabilities of Hong Kong as an offshore renminbi centre. In addition, the HKMA improved the liquidity of Hong Kong's renminbi capital market through enhancements to the renminbi liquidity facility arrangement, which included shortening the required notice period for obtaining one-week renminbi funds under this arrangement from two business days to one, and introducing the provision of one-day funds on a next-day (T+1) basis as well as overnight funds of up to RMB10 billion on a same-day (T+0) basis. The HKMA also sought to strengthen overseas linkages and promote more renminbi business dealings between banks in Hong Kong and the rest of the world to create win-win opportunities. During the year, financial institutions in Hong Kong held their first meetings with counterparts in Australia and Malaysia on co-operation in renminbi business, and the third meeting of the Hong Kong-London Renminbi Forum was held in September.

The development of Islamic finance in Hong Kong, a Government initiative supported by the HKMA, advanced to another stage with the Legislative Council passing in July the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill 2012. The legislation establishes a comparable taxation framework for Islamic bonds vis-à-vis conventional bonds, and we are proactively preparing for the issuance of Islamic bonds under the Government Bond Programme to foster Hong Kong's bond market development. To promote market's awareness, understanding and participation in Islamic finance, we worked closely with overseas central banks, international organisations and local stakeholders in organising a number of Islamic finance seminars and workshops to provide training for market participants. These seminars and workshops were well received. In 2013, we also joined hands with Bank Negara Malaysia to establish a private-sector led Joint Forum that seeks to strengthen co-operation between Hong Kong and Malaysia in the field of Islamic finance. The Forum held its first meeting in December.

In spite of the difficult investment environment in global financial markets in 2013, the Exchange Fund recorded an investment income of HK$81.2 billion. The bond market was exceptionally volatile throughout the year. US bond market reacted strongly in May and June following the Fed's tapering talks, with 10-year US Treasury bond yields once surging more than 100 basis points, leading to a sharp fall in bond prices. The Exchange Fund's Backing Portfolio, which holds top quality and liquid US dollar assets to back the Monetary Base, was inevitably affected by the rising bond yields. These developments resulted in a HK$4.2 billion loss in the Exchange Fund in the first half of 2013. In the second half, the improved market sentiment and the good performance of stock markets in the fourth quarter brought the Exchange Fund an investment income of HK$85.4 billion, recovering its lost ground. Indeed, in the past few years, we have taken defensive measures in the allocation of the Exchange Fund's assets to mitigate the risk to our bond portfolios that may arise from rising interest rates. These measures included increasing the proportion of cash, cash equivalents and bonds denominated in other foreign currencies in the Investment Portfolio. To better manage risk and generate higher medium- to long-term returns, we have, since 2008, been diversifying the Exchange Fund's investments in a prudent and gradual manner into alternative asset classes, such as emerging market bonds and equities, private equity, overseas properties, as well as renminbi bonds and equities. And, we are making good progress. At the end of 2013, the aggregate market value of private equity and real estate investments totalled HK$88.6 billion, recording an annualised internal rate of return of around 15.9% since inception. The outstanding undrawn investment commitments totalled HK$80.2 billion, while the aggregate investments were capped at one-third of the Accumulated Surplus of the Exchange Fund, that is, around HK$212 billion.

Looking ahead, the global financial environment and investor sentiment will be primarily driven by the pace and scale of the Fed's exit from quantitative easing and the corresponding reactions of global interest rates. However, there is still some uncertainty in the speed and sustainability of the US and European recovery. Indeed, the European economy, which is still suffering from high unemployment rates and high levels of public and private debt, is unlikely to see any significant pick-up in the immediate future. In anticipation of the US gradually exiting from quantitative easing and the normalisation of interest rates, we expect that emerging markets and Hong Kong will not be immune from the effects of a continued outflow of funds. In the face of the expected unstable financial and investment environment in 2014, the HKMA will continue to closely monitor market developments to help safeguard monetary stability, and require banks to step up the management of interest rate, liquidity and credit risks. We will also continue to prudently manage the Exchange Fund.

Since its establishment in 1993, the HKMA has all along strived to safeguard Hong Kong's monetary and financial stability, which is the prerequisite for Hong Kong's success in tackling future challenges in an uncertain and unstable global economic and financial environment.

Norman T.L. CHAN
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