Chief Executive's Statement

In 2017, the global economy and financial markets performed much better than expected: the real economy saw steady growth; inflation remained subdued; the three interest rate hikes and the reduction in the balance sheet by the US Federal Reserve during the year did not result in capital outflows from emerging market economies or a strengthening of the US dollar. Amid bullish sentiment, global stock markets, including the three major US stock indices, kept hitting new highs. The MSCI Emerging Markets Index surged by 34%. The Hang Seng Index gained nearly 8,000 points (or 36%) in 2017 and surpassed the 30,000-point level to reach an all-time high in January 2018.

Many investors were filled with optimism, even exuberance, in such a favourable environment. However, this was until early February this year when the latest data showed a higher than expected wage increase in the US, prompting investors to reappraise inflation risks and triggering significant corrections to global stock markets. The Dow Jones Index fell more than 1,000 points in two days during the second week of February, and the Hang Seng Index dropped more than 3,000 points in the same week. The 10-year US Treasury yield surged to as high as 2.95%. The swift reversal of fund flows indicated that the record high market valuation was not built on a solid foundation. It also reminded us of the importance of a sound and robust financial system for Hong Kong to meet the challenges brought by asset market volatility and capital outflows.

Banking system resilience boosted by precautionary measures

As the saying goes, "prevention is better than cure". The HKMA implemented further risk mitigation measures in 2017 to safeguard the stability of Hong Kong's banking and financial systems. In May, we introduced the eighth round of countercyclical measures for banks' mortgage loans and strengthened banks' credit risk management on lending to property developers, with the aim of enhancing the banking system's resilience to shocks arising from any downturn in the property market. With the several rounds of measures, the average loan-to-value ratio of new residential mortgage loans fell to 49% at the end of 2017 from 64% in September 2009, while the average debt servicing ratio also declined to 35% from 41% in August 2010.

In 2017, we established the Resolution Office to implement international standards on the resolution of non-viable financial institutions that are considered "too big to fail". This will help prevent a recurrence of a global financial crisis similar to the one in 2008 where public money was used to save failing financial institutions, and will minimise the impact of their closures on the financial system, the economy and the community at large.

Robust risk management is the cornerstone of steady and sustainable development of the banking sector. The liquidity ratio and capital adequacy ratio of Hong Kong's banking system are well above the applicable statutory requirements and among the highest in the world. This undoubtedly reflects the high resilience of Hong Kong's banking system. Indeed, the banking sector registered strong growth in 2017, with total loans increasing by 16%, while the asset quality also held up well. The classified loan ratio of retail banks fell to 0.54% from 0.72% in 2016, well below the long-term average of 2.2% since 2000. The banking industry's overall return on equity (based on pre-tax operating profits) reached 11.74% in 2017, a very healthy level compared with other international financial centres.

Sound banking the key to long-term financial stability

The 2008 global financial crisis revealed the limitations of relying solely on rules and regulations to restrain the financial industry from pursuing profitability without regard to their primary responsibilities. In light of this, the HKMA has stepped up the promotion of "sound banking" practices in recent years, encouraging banks to develop and pursue good corporate culture and values. In particular, to address the issue of bank staff pursuing short-term profits at the expense of the long-term interests of their customers or banks, we are encouraging banks to put in place appropriate incentive systems that are in line with their corporate culture and values. As part of this campaign, we arranged the inaugural Annual Conference for Independent Non-Executive Directors (INEDs) in March 2017 to highlight the importance of establishing a good banking culture and to empower the INEDs to perform their oversight and monitoring roles more effectively.

With the support of the banking industry, 2017 was a successful year for the HKMA in the advancement of financial inclusion. Six physical bank branches and three mobile branches began operating in remote areas. The Hong Kong Association of Banks worked out an arrangement with EPS and a convenience store chain to launch a pilot scheme allowing the elderly to withdraw cash from the stores in remote areas without the need to make purchases. Hongkong Post is also launching this year a cash withdrawal service for the elderly at seven Post Offices mainly on outlying islands and in the New Territories. Regarding account opening, the HKMA last year set up a webpage and an email account with a dedicated team to follow up public enquiries or complaints relating to the opening of bank accounts. Thanks to the concerted efforts of various stakeholders, there has been a significant improvement in customer experience in opening individual and corporate bank accounts.

Fintech a game changer for the banking industry

In an era of rapid technological advancement, fintech has been gradually integrated into our daily lives. In this ever changing technological environment, banks must embrace new developments and pursue innovation in their application of fintech. With the new era of Smart Banking, the HKMA launched seven initiatives in September (see page 106 for details) promoting the adoption of fintech in banking to improve the quality of banking products and services for customers. While these initiatives are independent of one another, they are complementary and will be a game changer for the future landscape of payment and banking services in Hong Kong. Customers will not only enjoy more convenient, efficient and secure payment and banking services, they will also have more choices and greater control over their financial transactions. Fintech will be the key to banks' future business success, and moving into the new era of Smart Banking will be a great opportunity for the banks to upgrade and transform themselves.

Chief Executive's Statement

Enormous opportunities created by the Belt and Road and the Bay Area Initiatives

With competition among international financial centres becoming more intense, a diversified financial industry is of paramount importance to Hong Kong. In 2017, the HKMA stepped up its work on enhancing Hong Kong's competitiveness as an international financial centre. Given Hong Kong's unparalleled advantage of "having the Mainland as our hinterland while maintaining an international outlook", the Belt and Road Initiative and the development of the Guangdong-Hong Kong-Macao Bay Area (Bay Area) will offer enormous opportunities for the financial and banking sectors and give new impetus to the economic growth of Hong Kong. The HKMA Infrastructure Financing Facilitation Office, which was established in response to the Belt and Road Initiative, saw the number of its partners grow to around 90 since launch, laying a solid foundation for promoting Hong Kong as a financing hub for infrastructure investments. The issuance of the first Belt and Road bond in Hong Kong by the China Development Bank in 2017 highlighted the pivotal role Hong Kong can play in facilitating the financing of these infrastructure projects.

In addition to infrastructure financing, we are actively involved in the development of Hong Kong as a hub for corporate treasury centres, private equity funds and Asian derivatives businesses, by attracting multinational corporations and major financial institutions to manage their funds, assets and various financial risks in the city. These initiatives will further consolidate and upgrade Hong Kong's financial and related professional services sectors. The HKMA also maintains close dialogue with the relevant authorities responsible for the development of the Bay Area to strengthen collaboration with a view to contributing to the financial development of the area as a world-class city cluster.

Over the years, Hong Kong's financial industry has been developing under the theme of "leveraging Hong Kong's advantages, meeting the country's needs". With the introduction of the Shanghai-Hong Kong Stock Connect in 2014, the Shenzhen-Hong Kong Stock Connect in 2016 and the Northbound Trading of Bond Connect in July last year, the mutual market access between the Mainland and the rest of the world through Hong Kong's financial platform has been expanded from stock markets to bond markets. This underscores Hong Kong's unique role as a financial intermediary in facilitating global investors' access to the Mainland's financial markets. In 2017, Hong Kong maintained its position as the leading global hub for offshore renminbi business. Average daily turnover of the renminbi Real Time Gross Settlement system stood at RMB900 billion. In addition, according to SWIFT statistics, more than 70% of global renminbi payment transactions were handled through Hong Kong during the year. The offshore renminbi market continued to operate smoothly and develop steadily.

Nurturing talent to strengthen the soft power of the banking industry

With the continuing growth of the financial industry, nurturing talent is crucial to its sustainable development. The HKMA attaches great importance to the soft power of the banking industry, and we have been encouraging and supporting ongoing capacity building of banking practitioners. Following the introduction of two modules on anti-money laundering and counter-financing of terrorism and cybersecurity under the Enhanced Competency Framework, we expanded its coverage last year by including retail wealth management and treasury management to enhance the level of core competence of banking practitioners through continuing professional development. The HKMA is also committed to nurturing young talent for the banking industry. In 2017, we launched the Pilot Apprenticeship Programme for Private Wealth Management and the Fintech Career Accelerator Scheme in collaboration with the industry. Given the overwhelming response, the coverage of these programmes will be further expanded in the future.

Prudent investment strategy achieving a reasonable and stable return over the medium to long term

On the back of strong global economic growth, the Exchange Fund achieved a record high investment income of HK$264 billion last year with gains across the board, including equities, bonds and foreign exchange. The overall investment return was 7.4%. The Investment Portfolio achieved a rate of return of 12.1%, while the Backing Portfolio gained 1.8%. The Long-Term Growth Portfolio (LTGP)'s annualised internal rate of return since its inception in 2009 reached as high as 13.7%. While the investment performance last year was satisfactory, the increasingly complex investment environment requires the HKMA to continue its prudent management of the Exchange Fund. We will remain agile and nimble, monitor market developments closely and deploy defensive measures as and when appropriate. Investments under the LTGP will also be further expanded. As always, the investment principle of "capital preservation first, long-term growth next" within acceptable risk levels will be adhered to when managing the wealth for the people of Hong Kong.

While the global real economy is extending last year's growth momentum, uncertainties and risks still abound in 2018. These include a faster-than-expected pace of US interest rate hikes in case inflation picks up, escalating trade frictions and a deteriorating geopolitical landscape. Should these downside risks materialise, they will have significant and widespread implications for global financial markets, and knock-on effects for Hong Kong's fund flows, asset prices and real economy. It is therefore advisable that we should all manage the risks prudently.

In the coming months, it is likely Hong Kong dollar interest rate movements will remain in the spotlight. The US Federal Reserve has raised interest rates six times since December 2015. With widening spreads between Hong Kong dollar interest rates and their US dollar counterparts, there is a greater incentive for funds to flow from the Hong Kong dollar into the US dollar. The Hong Kong dollar has been under weakening pressure recently and the 7.85 weak-side Convertibility Undertaking (CU) has been triggered. As we have repeatedly stated, when the 7.85 weak-side CU is triggered, the HKMA will act as a "super money changer" by buying Hong Kong dollars and selling US dollars in the market to ensure that the Hong Kong dollar exchange rate will not weaken beyond the 7.85 level. Such operations are normal and in accordance with the design of the Linked Exchange Rate System. This should not cause any concern. Indeed, the Exchange Fund currently holds more than HK$4 trillion worth of assets, of which the Hong Kong dollar Monetary Base amounts to about HK$1.7 trillion, providing a strong buffer in the event of fund outflows. Over the years, the HKMA has put in place various lines of defence to safeguard the stability of the banking and financial systems. From a positive perspective, capital outflows will lead to a gradual increase in Hong Kong dollar interest rates, which will be conducive to the normalisation of the interest rate environment in Hong Kong and hence the sustainable development of the local economy and asset markets. During this process, the HKMA will stay vigilant and make every effort to maintain monetary and banking stability in Hong Kong.

This year marks the 25th anniversary of the establishment of the HKMA. In the past quarter century, the HKMA has been shouldering the important responsibility of maintaining the monetary, banking and financial stability of Hong Kong. While it is no easy task, we strive for continuous improvement and innovation, maintaining systemic stability while enhancing the city's competitiveness as an international financial centre that supports economic development. Over the past 25 years, the HKMA, together with the people of Hong Kong, has weathered several financial crises including the Asian financial crisis in 1997–98, the global financial crisis in 2008 and the European debt crisis in 2011. From these testing times, we have learnt the importance of staying vigilant, pursuing continuous improvement, and taking precautionary measures to prepare for the worst. Hong Kong's status as an international financial centre has not come easily. The HKMA will continue to use its best endeavours to contribute to society and the country.

Norman T.L. Chan
Chief Executive