

## CHAPTER 5 : THE FINANCIAL SECTOR<sup>#</sup>

### *Summary*

- *The global financial markets endured a year of turbulence in 2008, especially following the outbreak of the financial tsunami triggered by an array of events including in particular the collapse of Lehman Brothers. The Hong Kong financial markets, being an integral part of the international nexus, were seriously hit.*
- *Hong Kong dollar interbank interest rates rose markedly in September and October on heightened credit and liquidity concerns in the face of the worsening global financial situation. The rates nevertheless eased back subsequently upon the Government's various measures to alleviate the liquidity stress in the banking sector.*
- *The Hong Kong dollar Nominal Effective Exchange Rate Index closely followed the movement in US dollar, strengthening notably in the second half of 2008 after declining in the earlier part of the year. Unwinding of carry trades and possibly some repatriation of funds back to Hong Kong led to strong demand for Hong Kong dollars after mid September, prompting the HKMA to sell Hong Kong dollars against US dollars to banks.*
- *Local stock prices and equity market activities weakened significantly over the course of 2008 alongside the financial turmoil and worsening economic backdrop. Fund raising activities also contracted sharply.*
- *Thanks to our prudent supervision of the financial sector, our financial system has remained relatively stable. Since the outbreak of the global financial tsunami, the relevant authorities have all stepped up their supervisory efforts with a view to ensuring resilience in this turbulent period.*

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(#) **This chapter is jointly prepared by the Hong Kong Monetary Authority (HKMA) and the Economic Analysis Division.**

## Overall situation

5.1 The financial crisis originating in the United States has quickly spread to the global financial markets. Hong Kong as a major international financial centre was seriously hit. Interbank interest rates spiked between mid September and October before easing back upon the efforts of the authorities to provide liquidity to the banking sector. But bank lending to customers remained tight partly due to the banks' increased risk aversion amid the gloomy economic outlook. Alongside the marked drop in asset prices, activities dwindled in respect of a wide spectrum of financial activities including fund raising, share trading and asset management.

5.2 Nevertheless, thanks to our prudent supervision of the financial sector, the local financial system has remained relatively stable with little systemic risk. Since the outbreak of the global financial tsunami, the relevant authorities have all stepped up their supervisory efforts with a view to ensuring resilience and enhancing protection for investors in this turbulent period. Moreover, measures have been introduced to ease the liquidity pressures on the banks, stabilise the banks' deposit base and shore up confidence in the banking system. The Government has also taken initiatives to help the real economy to overcome the current credit crunch, for example, by enhancing the mortgage insurance programme of the Hong Kong Mortgage Corporation and supporting lending to small and medium enterprises.

## Interest rates and exchange rates

5.3 Interest rates trended lower in early 2008. The *Base Rate*<sup>(1)</sup> under the Discount Window operated by the HKMA was adjusted downward from 5.75% to 3.75% between January and March 2008, as the US Federal Funds Target Rate (FFTR) was lowered by a total of 200 basis points to 2.25%. *Hong Kong dollar interbank interest rates* also declined along with their US dollar counterparts. The overnight and three-month HIBORs dropped from 1.88% and 3.31% at end-2007 to 0.78% and 1.90% at end-March 2008 respectively, and then moved within a narrow range in the second quarter and most of the third quarter.

5.4 The interest rate environment took a sharp change when the global financial contagion and confidence crisis entered a new phase after US investment bank Lehman Brothers filed for bankruptcy in mid September. Due to heightened concern about the creditworthiness of counterparties and some stockpiling of liquidity for contingencies, banks globally began to hold back from lending to their counterparts in the unsecured interbank market. HIBORs surged alongside their corresponding US dollar rates, with interest rate volatility heightening and banks demanding more premium for longer-tenor lending. As a result, overnight and three-month HIBORs climbed from 1.58% and 2.19% at end-August respectively to as high as 2.88% for the former on 17 September and 4.30% for the latter on 10 October. To ease the stress in the money market, the authorities have implemented a number of measures since September, including direct liquidity injections, enhanced flexibility in liquidity and capital management, and temporary deposit guarantee (*Box 5.1*).

5.5 Following the introduction of these measures, the interbank credit market generally stabilised and local interbank interest rates moderated across the board. Efforts around the world to provide liquidity to the banking systems and improved market sentiment also helped alleviate the tension in local liquidity situation. At end-2008, the overnight and three-month HIBORs eased back to 0.23% and 0.89% respectively.

## Box 5.1

### Major financial measures undertaken since September 2008

- 18 and 25 Sep, 23 and 27 Oct 2008 A total of \$24.8 billion was injected into the banking system through within-zone foreign exchange operations.  
Purpose : To address the credit crunch in the interbank market and the rising demand for Hong Kong dollar funds.
- 30 Sep 2008 HKMA announced five temporary measures to provide liquidity assistance to licensed banks in Hong Kong upon request, effective from 2 Oct 2008 to 31 Mar 2009:
- First, the eligible securities, for access by individual licensed banks to liquidity assistance through the Discount Window, will be expanded to include US dollar assets of credit quality acceptable to the HKMA.
  - Second, the duration of liquidity assistance provided to individual licensed banks through the Discount Window will be extended, at the request of individual licensed banks and on a case-by-case basis, from overnight money only to maturities of up to three months.
  - Third, the 50% threshold for the use of Exchange Fund paper as collateral for borrowing through the Discount Window at the HKMA Base Rate will be raised to 100%. In other words, the 5% premium (or penalty) over the Base Rate for the use of Exchange Fund paper beyond the 50% threshold, as collateral for borrowing through the Discount Window, will be waived.
  - Fourth, the HKMA will, in response to requests from individual licensed banks and when it considers necessary, conduct foreign exchange swaps (between the US dollar and the Hong Kong dollar) of various durations with licensed banks.
  - Fifth, the HKMA will, in response to requests from individual licensed banks and when it considers necessary, lend term money of up to one month to individual licensed banks against collateral of credit quality acceptable to the HKMA.
- Purpose : To provide term liquidity to licensed banks upon request, against a range of collateral of acceptable quality, through or outside the Discount Window.
- 8 Oct 2008 HKMA announced an adjustment in the methodology for determining the Base Rate, effective from 9 Oct 2008 to 31 Mar 2009.  
Purpose : To lower the cost for banks to obtain liquidity through the Discount Window.

## Box 5.1 (Cont'd)

14 Oct 2008 The Financial Secretary announced two pre-emptive measures to strengthen confidence in Hong Kong's banking system, namely a temporary 100% deposit guarantee and a Contingent Bank Capital Facility. The measures will remain in place until end-2010.

Purpose : To help stabilise banks' deposit base as a source of funding and provide comfort to banks on the availability of additional capital, thereby guarding against systemic failures in the financial sector, enhancing confidence in the local banking system and maintaining banking stability.

20 Oct and The Exchange Fund Bills and Notes Programme was expanded.

24 Nov 2008,

6 Jan 2009

Purpose : To meet the increased demand for Exchange Fund paper by banks for liquidity management purposes and to improve banks' access to the Discount Window and other liquidity facilities introduced by the HKMA, thereby enhancing banks' liquidity management capability.

6 Nov 2008 The measure of lending term money to individual licensed banks against collateral of acceptable credit quality, which was introduced on 30 September 2008, was further refined:

- First, the maximum tenor will be extended from one month to three months.
- Second, the HKMA will take into account the fact that such lending is secured by collateral in setting the applicable interest rate although the rate will continue to be determined with reference to market interest rates.

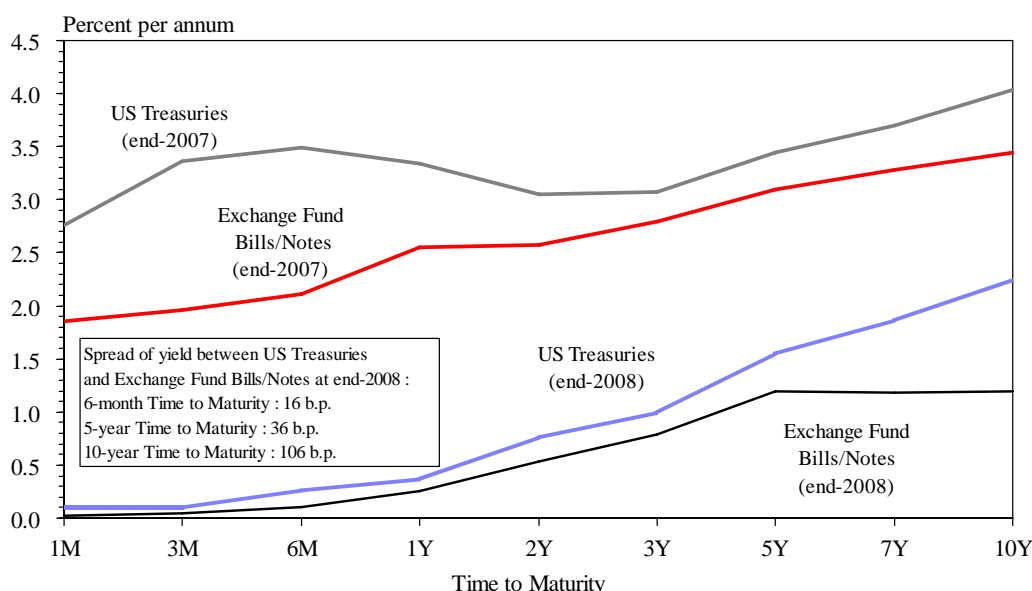
Purpose : To help banks to meet their demand for additional funding towards the year end, ensure adequate liquidity within the banking system and further ease pressures in the interbank market.

20 Jan 2009 The People's Bank of China and the HKMA signed an agreement for a RMB 200 billion (\$227 billion) currency swap facility.

Purpose : To provide short-term liquidity support to the Mainland operations of Hong Kong banks and the Hong Kong operations of Mainland banks in case of need, shoring up Hong Kong's financial stability.

5.6 The differentials between the Hong Kong dollar interbank rates and US dollar interest rates during 2008 were generally negative, with occasional deviations in September and October due to sharp fluctuations in interbank rates. Nevertheless, the discount of the three-month HIBOR over the corresponding Euro-dollar deposit rate narrowed for the year as a whole, from 144 basis points at end-2007 to 53 basis points at end-2008. The *Hong Kong dollar yield curve* shifted downward in 2008, particularly in the second half of the year, in line with general decreases in US Treasury yields. As heightened credit and liquidity concerns led to strong demand for Exchange Fund paper by banks for liquidity management purposes, implied yields for Exchange Fund bills with maturities of three months and below turned negative temporarily in late September and the first half of October.

**Diagram 5.1 : Hong Kong dollar yield curve shifted downward in 2008 alongside the aggressive monetary easing in the US**



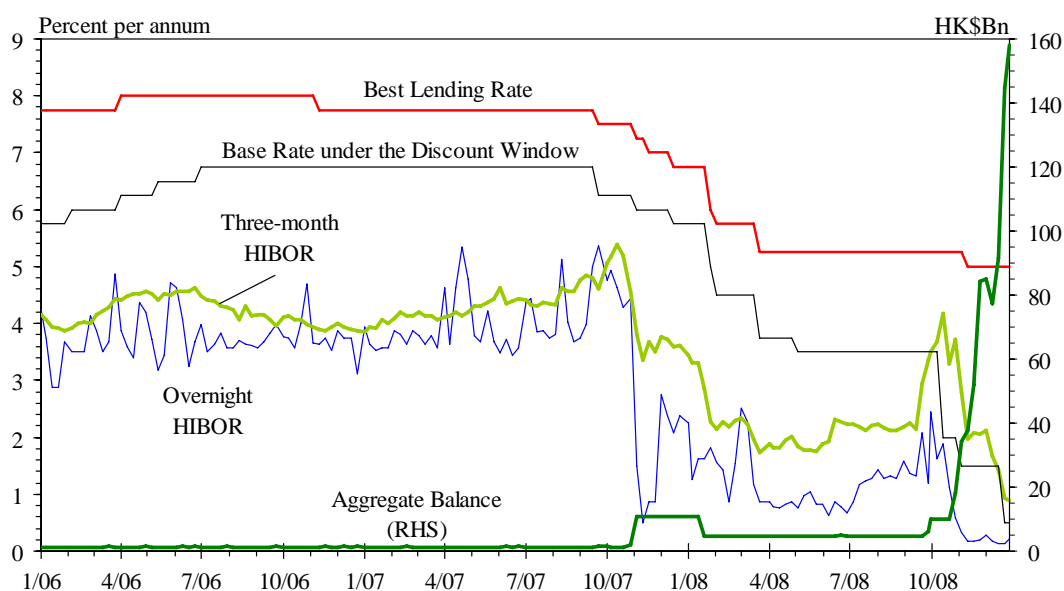
5.7 At the retail level, the two Best Lending Rates (BLRs) were cut from 6.75% and 7.00% at the beginning of the year to 5.25% and 5.50% in late March following the downward movements in US interest rates. While the Base Rate was slashed further from 3.75% to 0.50% between April and December following the cut in US' FFTR from 2.25% to 0-0.25% and the change in formula for determination of the Base Rate in October, the BLRs were lowered only once by 25 basis points in mid November to 5.00% and 5.25%. The average savings deposit interest rate quoted by major banks declined from 1.35% in December 2007 to 0.01% in December 2008. The average one-month time deposit interest rate also fell for the year as a whole, only shooting up briefly between mid September and October when banks

searched for more stable and lower-cost funding following sharp increases in HIBORs. The composite interest rate<sup>(2)</sup>, as an indication of the average cost of funds for banks, also dropped from 2.29% at end-2007 to 0.68% at end-2008, notwithstanding the brief rebound to 1.28% at end-October amid the stress in the money market.

5.8 In the face of the worsening global financial crisis and the potential risks associated with declining property prices, banks tightened the pricing for new mortgage loans in the last few months of 2008. The proportion of new loans approved at rates more than 2.5% below the BLR fell to 3.3% in December, from usually over 80% prior to October.

5.9 The Aggregate Balance declined from around \$11 billion at the beginning of 2008 to \$5 billion on 14 January 2008, as a result of an additional issue of Exchange Fund paper to meet increased demand for banks' intraday liquidity needs. Between late October and December, the strong-side Convertibility Undertaking (CU) was repeatedly triggered due to strong inflow of funds, prompting the HKMA to passively sell Hong Kong dollars against US dollars to banks. The Aggregate Balance soared to \$158 billion at end-2008, surpassing the previous record high of around \$55 billion in 2004.

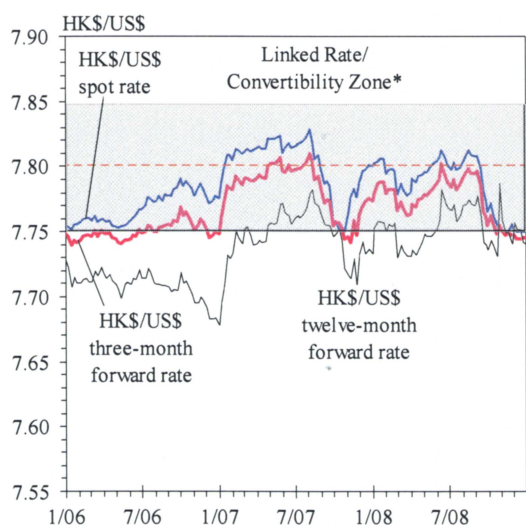
**Diagram 5.2 : Hong Kong dollar interbank interest rates spiked in September and October but eased back towards year-end**  
(end for the week)



5.10 The Hong Kong dollar spot exchange rate against the US dollar traded between 7.762 and 7.816 in the first three quarters of 2008. The exchange rate started to strengthen in September and the strong-side CU was repeatedly triggered between 31 October and 31 December. The strengthening of Hong Kong dollar exchange rate reflected some unwinding of carry trade positions due to tightened credit and heightened risk aversion, and possibly some repatriation of funds by domestic corporations back to Hong Kong. In line with broadly narrowing interest rate spreads, the discounts of *3-month* and *12-month Hong Kong dollar forward rate* over the spot rate shrank from 260 and 660 pips (each pip equivalent to HK\$0.0001) at end-2007 to 45 and 95 pips at end-2008 respectively.

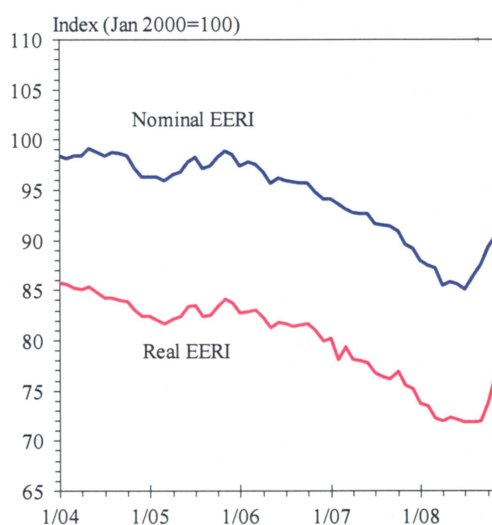
5.11 Under the Linked Exchange Rate system, movements in the exchange rate of the Hong Kong dollar against other currencies closely followed those in the US dollar. The collapse of Lehman Brothers in mid September worsened the global financial turmoil, making the currency market extremely volatile. Between July and November, the US dollar appreciated solidly against most of the major currencies partly due to the expectation of narrower interest rate differentials between the US dollar and other currencies. Increased risk aversion of investors amid the deteriorating global macroeconomic outlook also led to more fund flows to the US dollar. As a result, the trade-weighted *Hong Kong dollar Nominal Effective Exchange Rate Index* rebounded by 4.4% in the second half of 2008, after depreciating by 4.0% alongside a broadly weaker US dollar in the first half. The *Real Effective Exchange Rate Index* also rallied after August<sup>(3)</sup>.

**Diagram 5.3 : Forward spreads shrank as interest rate differentials narrowed (end for the week)**



Note : (\*) The shaded area represents the Convertibility Zone that was introduced in May 2005 as part of the three refinements to the Linked Exchange Rate System.

**Diagram 5.4 : Trade-weighted EERIs rebounded during the second half (average for the month)**



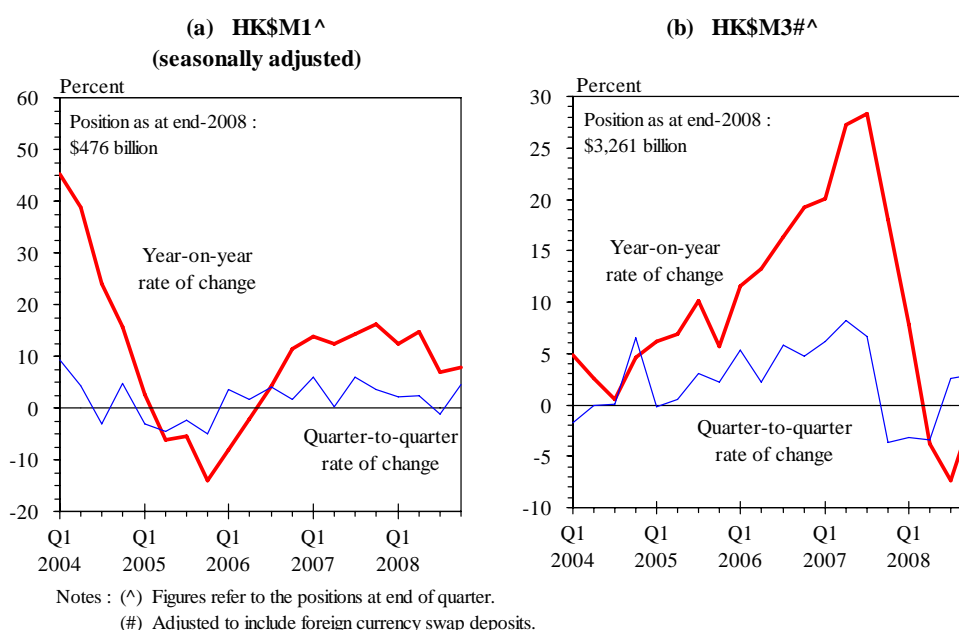


## Money supply and banking sector

5.12 Hong Kong dollar broad *money supply* (HK\$M3) declined during the first eight months of 2008<sup>(4)</sup>. Some depositors' decisions to shift their Hong Kong dollar deposits into foreign currency deposits, including renminbi deposits, put a drag on Hong Kong dollar money supply. Nevertheless, the HK\$M3 expanded markedly between September and December, possibly reflecting some inflow of funds into the Hong Kong dollar. For the year as a whole, the HK\$M3 contracted by 1.2%. The seasonally adjusted Hong Kong dollar narrow money supply (HK\$M1) also recorded a notable increase in the fourth quarter of the year under a low interest rate environment, after a few quarters of moderated growth partly resulting from weaker transaction demand alongside an economic downturn. Compared with a year earlier, the HK\$M1 at end-2008 grew by 8.0%.

5.13 *Total deposits* with authorised institutions (AIs) grew by 3.2% during 2008<sup>(5)</sup>, sharply lower than the substantial 23.4% expansion in 2007. Total deposits stood at \$6,060 billion at end-2008, comprising Hong Kong dollar deposits of \$3,034 billion and foreign currency deposits of \$3,026 billion. The share of Hong Kong dollar deposits to total deposits declined from 52.4% at end-2007 to 50.1% at end-2008.

**Diagram 5.5 : Broad money supply rebounded in the latter part of 2008**



5.14 *Total loans and advances* rose by 10.9% during 2008, to \$3,284 billion (comprising Hong Kong dollar loans of \$2,355 billion and foreign

currency loans of \$930 billion). However, the quarter-to-quarter growth in loans gradually decelerated over the first three quarters and turned negative in the fourth quarter, against the background of markedly weakened domestic and external economic activities. An analysis of loans for use in Hong Kong by economic sector indicated that many types of loans showed a similar pattern. In line with shrinking trade flows, loans for trade finance registered a particularly sharp fall of 16.1% during the fourth quarter. Amid the setback of the stock market, loans to stockbrokers continued to contract through the year. On the other hand, loans to building, construction, property development and investment managed to grow through the year notwithstanding the downturn of the property market in the second half of the year. The Hong Kong dollar loan-to-deposit ratio rose from 71.0% at end-2007 to a high of 83.8% at end-August 2008 before declining to 77.6% at end-2008.

**Table 5.1 : Loans and advances**

All loans and advances for use in Hong Kong											
		Loans to :									
		Finance		Wholesale and retail trade	Building, construction, property development and investment	Purchase of residential property <sup>(a)</sup>	Financial concerns	Stock-brokers	Total <sup>(b)</sup>	All loans and advances for use outside Hong Kong <sup>(c)</sup>	Total loans and advances
% change during the quarter		visible trade	Manu-facturing	trade	investment	property <sup>(a)</sup>	concerns	brokers	Total <sup>(b)</sup>	Hong Kong <sup>(c)</sup>	advances
2007	Q1	-1.0	3.5	1.9	1.0	-0.1	5.9	994.1	7.6	12.4	8.3
	Q2	12.2	7.4	4.0	6.2	1.2	10.2	35.6	6.4	10.7	7.0
	Q3	4.2	4.8	1.8	5.7	1.4	6.2	11.8	5.8	10.1	6.4
	Q4	4.1	1.7	2.8	4.2	2.2	9.5	-86.4	-4.5	7.7	-2.7
2008	Q1	8.4	16.1	16.6	6.2	2.4	7.2	-4.2	6.3	10.4	7.0
	Q2	15.2	4.9	15.5	4.6	2.7	1.4	-19.0	4.7	10.1	5.6
	Q3	-2.9	4.5	*	4.4	0.7	8.1	-20.6	2.7	0.6	2.3
	Q4	-16.1	-4.8	-3.3	1.9	-1.4	-5.4	-10.4	-3.5	-7.1	-4.1
Total amount at end-2008 (\$Bn)		186	148	152	687	650	283	10	2,711	573	3,284
% change over a year earlier		1.8	21.2	30.3	18.4	4.4	11.1	-44.7	10.3	13.7	10.9

Notes : Some loans have been reclassified. As such, the figures are not strictly comparable with those of previous quarters.

(a) Figures also include loans for the purchase of flats under the Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme, in addition to those for the purchase of private residential flats.

(b) Loans to individual sectors may not add up to all loans and advances for use in Hong Kong, as some sectors are not included.

(c) Also include loans where the place of use is not known.

(\*) Change of less than 0.05%

5.15 With a view to lessening the impact of the credit crunch on potential homebuyers, the Hong Kong Mortgage Corporation implemented an enhancement of the Mortgage Insurance Programme in December by lowering the threshold above which insurance will be made available from the current 70% loan-to-value (LTV) ratio to 60%, subject to a total LTV of 90% and a maximum loan amount of \$8 million. To provide greater support to small and medium enterprises (SMEs) in the midst of the global financial turmoil, the Government has implemented measures in the fourth quarter to facilitate lending to these companies. The existing SME Loan Guarantee Scheme has been enhanced in November, while a \$100 billion Special Loan Guarantee Scheme, under which the Government will provide 70% guarantee for loans granted by the participating lending institutions, was also set up in December.

5.16 Despite the recent global financial crisis, Hong Kong's banking system remained resilient. Under the capital adequacy framework promulgated by the Basel Committee on Banking Supervision for banks (commonly referred to as "Basel II", which was implemented on 1 January 2007), the capital adequacy ratio (CAR) for Hong Kong incorporated AIs remained strong, at an average of 13.8% at end-September 2008. All individual AIs' CARs have been above the statutory minimum ratios as required by the HKMA. To address the lessons learnt from the recent global financial crisis, the Basel Committee will issue for public consultation in 2009 proposals on Basel II enhancements and other guidance to strengthen risk management and controls of banks. The HKMA will monitor closely these proposals and will, where appropriate, incorporate relevant recommendations in its supervisory framework in consultation with the banking industry.

5.17 Asset quality of the local banking sector remained good. The ratio of classified loans to total loans of retail banks was at a low level, albeit increasing from 0.85% at end-2007 to 0.96% at end-September 2008. On the other hand, arrears for over three months in credit card repayment and delinquency ratio for residential mortgage loans declined from 0.35% and 0.11% at end-2007 to 0.34% and 0.05% at end-2008 respectively.

**Table 5.2 : Asset quality of retail banks\***

(as % of total loans)

<u>As at end of period</u>	<u>Pass loans</u>	<u>Special mention loans</u>	<u>Classified loans</u> (gross)
2007 Q1	97.11	1.89	1.00
Q2	97.37	1.73	0.90
Q3	97.47	1.64	0.89
Q4	97.59	1.57	0.85
2008 Q1	97.72	1.47	0.81
Q2	97.75	1.38	0.88
Q3	97.61	1.43	0.96

Notes : Due to rounding, figures may not add up to 100.

(\*) Period-end figures relate to Hong Kong offices and overseas branches. Loans and advances are classified into the following categories: Pass, Special Mention, Substandard, Doubtful and Loss. Loans in the substandard, doubtful and loss categories are collectively known as “classified loans”.

5.18 In late September, circulation of telephone short messages questioning a local bank’s financial stability resulted in many customers queuing outside the bank’s branches to withdraw deposits. The unfounded rumours were cleared and the mini-run on the bank quickly subsided. The temporary 100% deposit protection arrangement and a new capital facility for banks, introduced on 14 October, helped instil further confidence in the local banking system.

5.19 Since February 2004, banks in Hong Kong have been offering renminbi services to customers including deposit taking, currency exchange and remittance. At end-2008, a total of 39 licensed banks engaged in this line of business, and outstanding renminbi deposits amounted to RMB56.1 billion, accounting for around 2.1% of total foreign currency deposits in Hong Kong. Between end-2007 and end-May 2008, renminbi deposits in Hong Kong surged by 133%, due to low interest rates in Hong Kong dollar deposits, expected valuation gain arising from the renminbi’s appreciating trend and investors seeking alternatives amid the local stock market correction. However, having stayed steady in June and July, renminbi deposits contracted by 27% during the last five months of 2008, partly reflecting bond issuers repatriating the proceeds to the Mainland. Increased uncertainty about the short-term direction of the renminbi exchange rate and higher transaction cost also reduced the demand for such deposits.

**Table 5.3 : Renminbi deposits in licensed banks**

<u>As at end of period</u>		<u>Interest rates on<sup>(a)</sup></u>					Number of licensed banks engaged in <u>RMB business</u>
		<u>Demand and savings deposits</u> (RMB Mn)	<u>Time deposits</u> (RMB Mn)	<u>Total deposits</u> (RMB Mn)	<u>Savings deposits<sup>(b)</sup></u> (%)	<u>Three-month time deposits<sup>(b)</sup></u> (%)	
2007	Q1	13,643	11,595	25,238	0.46	0.65	38
	Q2	17,228	10,391	27,618	0.46	0.65	38
	Q3	18,458	9,045	27,503	0.46	0.65	37
	Q4	22,539	10,861	33,400	0.46	0.65	37
2008	Q1	39,364	18,221	57,585	0.46	0.65	40
	Q2	51,242	26,398	77,640	0.46	0.65	40
	Q3	47,508	22,443	69,951	0.46	0.65	40
	Q4	38,119	17,942	56,061	0.46	0.64	39
% change over a year earlier		69.1	65.2	67.8	N.A.	N.A.	N.A.

Notes : (a) The interest rates are based on a survey conducted by the HKMA.

(b) Period average figures.

N.A. : Not available.

5.20 There has been substantial progress in enhancing financial co-operation between Hong Kong and the Mainland in 2008. Renminbi business in Hong Kong continued to develop steadily, including the issuance of renminbi bonds by Mainland financial institutions. Further to the three successful issues in 2007, there were four more renminbi bond issues in 2008, bringing the total amount of outstanding renminbi bonds in Hong Kong to RMB22 billion. In December 2008, the Central People's Government announced a further expansion of renminbi business in Hong Kong to allow eligible Mainland and Hong Kong enterprises to use renminbi to settle trade transactions. In servicing such activities, the capabilities of Hong Kong's financial system in handling renminbi-denominated transactions will be strengthened, thereby enhancing the status of Hong Kong as an international financial centre.

## The debt market

5.21 The *Hong Kong dollar debt market* contracted in 2008 due to stringent credit conditions and a fall in demand for debt securities as the global financial crisis deepened. Total outstanding amount of debt stood at \$716.6 billion at end-2008, representing a reduction of 6.2% from a year ago, with the size of private sector debt outstanding declining by 13.3% year-on-year<sup>(6)</sup>. The amount was equivalent to 22% of HK\$M3 or 18% of Hong Kong dollar-denominated assets of the entire banking sector<sup>(7)</sup>. Around 68% of the outstanding debts were accounted for by the private sector and Multilateral Development Banks, and the remaining by the public sector, including the Exchange Fund paper and debt securities issued by the Government and statutory bodies. Gross issuance of Hong Kong dollar debt securities in 2008 declined to \$424.4 billion, down by 4.6% from 2007. In particular, issuance by private sector plunged 44.5%, as fund raising via issuing bonds became increasingly difficult amid a re-appraisal of credit risks.

5.22 In a bid to strengthen Hong Kong's role as an international financial centre, the Government has continued to make efforts to promote the domestic debt market through facilitating the introduction of new instruments and enhancing market liquidity. In May 2008, the HKMA signed a Memorandum of Understanding with the Dubai International Financial Centre Authority to foster co-operation in developing the market for Sharia-compliant financial products in both jurisdictions.

5.23 In July 2008, Standard & Poor's raised the long-term issuer credit rating on Hong Kong from AA to AA+, citing "a further improvement in the credit strength of the Chinese central government" and Hong Kong's continued fiscal health as the main reasons behind the rating action<sup>(8)</sup>. The upgrade reflects Hong Kong's strong economic fundamentals and should help to lower the borrowing costs for Hong Kong corporations.

**Table 5.4 : New issuance and outstanding value of Hong Kong dollar debt securities (\$Bn)**

		Exchange Fund paper	Statutory bodies/govern ment-owned corporations	Govern- ment	Public sector total	AIs <sup>(a)</sup>	Local corporations	Non-MDBs overseas borrowers <sup>(b)</sup>	Private sector total	MDBs <sup>(b)</sup>	Total
<b>New issuance</b>											
2007	Annual	223.5	19.4	-	242.9	49.6	18.7	131.9	200.2	1.7	444.8
	Q1	55.0	4.0	-	59.0	12.9	5.4	38.3	56.6	1.5	117.1
	Q2	56.9	6.9	-	63.8	20.2	6.5	40.9	67.6	-	131.4
	Q3	56.1	1.5	-	57.6	6.7	5.7	18.7	31.1	-	88.7
	Q4	55.4	7.0	-	62.5	9.8	1.1	33.9	44.9	0.2	107.6
2008	Annual	285.9	24.3	-	310.2	45.2	14.3	51.6	111.2	3.0	424.4
	Q1	62.8	5.5	-	68.2	8.6	1.2	6.1	15.9	-	84.1
	Q2	77.2	8.7	-	85.9	15.4	8.4	22.3	46.2	-	132.0
	Q3	67.3	3.5	-	70.8	14.7	4.1	15.8	34.6	-	105.3
	Q4	78.6	6.7	-	85.3	6.5	0.6	7.5	14.5	3.0	102.8
	% change in 2008 Q4 over 2007 Q4	41.9	-4.3	N.A.	36.5	-33.7	-45.5	-77.9	-67.7	1,400.0	-4.5
	% change in 2008 over 2007	27.9	25.5	N.A.	27.7	-8.9	-23.5	-60.8	-44.5	76.5	-4.6
<b>Outstanding (as at end of period)</b>											
2007	Q1	133.0	54.6	7.7	195.3	147.4	54.3	335.7	537.3	16.5	749.1
	Q2	134.4	58.0	7.7	200.1	151.2	58.9	350.9	561.0	14.4	775.5
	Q3	135.6	57.2	7.7	200.5	140.3	62.9	339.3	542.4	13.4	756.3
	Q4	136.6	58.5	7.7	202.8	136.4	60.6	351.3	548.2	13.2	764.2
2008	Q1	143.3	60.3	7.7	211.3	121.4	60.8	320.7	502.9	12.5	726.7
	Q2	144.3	64.5	7.7	216.5	106.5	68.4	318.6	493.5	12.5	722.4
	Q3	145.0	62.7	5.0	212.7	103.8	67.5	320.2	491.6	12.4	716.6
	Q4	157.7	64.6	5.0	227.3	95.1	67.0	313.0	475.1	14.3	716.6
	% change over a year earlier	15.4	10.5	-35.1	12.1	-30.3	10.5	-10.9	-13.3	8.3	-6.2

Notes : Figures may not add up to the corresponding totals due to rounding.

(a) AIs : Authorised institutions.

(b) MDBs : Multilateral Development Banks.

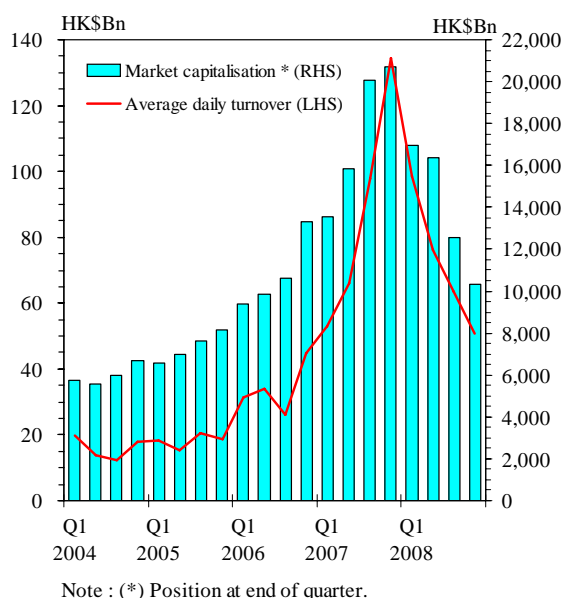
N.A. : Not available.

## The stock and derivatives markets

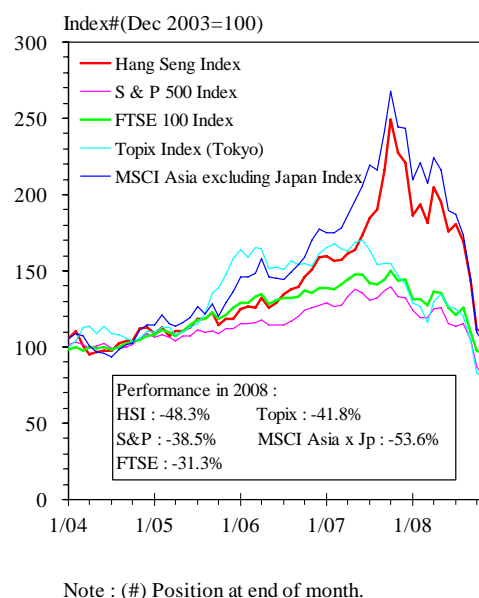
5.24 The *local stock market* suffered a significant setback in 2008, as liquidity tightened and companies' earnings outlook deteriorated owing to the weakening economic environment. The *Hang Seng Index (HSI)* plunged to an intra-day low of 10 676 on 27 October 2008 following the outbreak of the global financial tsunami. Closing the year at 14 387, it was 48.3% lower than a year earlier. As investors became more wary about the market outlook, trading volume contracted sharply over the course of 2008. For the year as a whole, *daily turnover* dropped by 18.2% to an average of \$72.1 billion.

5.25 As a result of plunging share prices, the *market capitalisation* plummeted from \$20.7 trillion at end-2007 to \$10.3 trillion at end-2008. Nevertheless, the Hong Kong stock market remained the seventh largest in the world and the third largest in Asia at end-2008 according to the *World Federation of Exchanges*<sup>(9)</sup>. Fund raising activities also turned much quieter, with *initial public offerings (IPOs)* almost dried up in 2008, especially in the second half. While total equity capital raised through new share flotation and post-listing activities on the Main Board and the GEM fell by a relatively less severe 27.9% to \$403.7 billion in 2008<sup>(10)</sup>, it was boosted by the issue of shares related to a mega merger deal which did not involve fresh funds from investors.

**Diagram 5.6 : The stock market slumped through 2008**



**Diagram 5.7 : All major stock markets tumbled**





5.26 Mainland enterprises continued to play an important role in the Hong Kong stock market. There were 465 Mainland enterprises (including 150 H-share companies, 93 “Red Chips” companies and 222 private enterprises) listed on the Hong Kong stock market at end-2008, accounting for 37% of the total number of listed companies and 60% of the total market capitalisation. In 2008, 71% of equity turnover in the market was attributable to Mainland-related stocks. These companies together raised \$287.0 billion in 2008, accounting for 71% of the total equity capital raised in the market in the period.

5.27 Notwithstanding the downturn of the stock market, trading of most types of *derivatives* was rather active in 2008, with enthusiastic participation from a wide range of investors and traders (**Box 5.2**). The average daily trading volume for futures and options contracts<sup>(11)</sup> expanded by 19.8% for the year as a whole, and remained steady in the second half despite the turbulent financial market conditions. Among the total, trading in Hang Seng Index futures and H-shares index futures recorded particularly impressive growth of 27.1% and 33.7% respectively for 2008 as a whole. On the other hand, trading in securitised derivatives declined by 5.7% in value terms. With trading of callable bull/bear contracts actually surging by about 14 times, the drop was due entirely to the plunge in trading of derivative warrants.

**Table 5.5 : Average daily turnover of derivative products  
of the Hong Kong market**

		Hang Seng Index <u>futures</u>	Hang Seng Index <u>options</u>	H-shares Index <u>futures</u>	Stock <u>options</u>	Total futures and options traded*	Derivative warrants (\$Mn)	Callable bull / bear contracts (\$Mn)	Total securitised derivatives traded (\$Mn)^
2007	Annual	69 760	30 407	44 091	186 923	357 665	19,081	290	19,371
	Q1	61 184	30 495	31 059	124 662	268 878	10,837	79	10,916
	Q2	62 301	31 774	34 783	137 742	285 315	11,662	91	11,754
	Q3	76 286	37 952	54 210	240 131	438 005	18,811	249	19,060
	Q4	78 803	21 353	55 698	241 918	433 668	34,659	733	35,391
2008	Annual	88 639	15 595	58 943	223 236	428 599	14,015	4,243	18,258
	Q1	88 938	14 946	60 579	263 980	468 118	26,851	1,395	28,247
	Q2	78 023	13 776	50 238	210 452	385 751	15,715	2,886	18,601
	Q3	95 335	18 381	58 217	220 110	435 527	8,964	6,394	15,359
	Q4	92 097	15 226	66 649	199 511	425 584	4,972	6,183	11,155
	% change in 2008 Q4 over 2007 Q4	16.9	-28.7	19.7	-17.5	-1.9	-85.7	744.1	-68.5
	% change in 2008 over 2007	27.1	-48.7	33.7	19.4	19.8	-26.5	1,362.3	-5.7

- Notes : (\*) Turnover figures for individual futures and options may not add up to the total futures and options traded, as some products are not included.  
(^) Including derivative warrants and callable bull / bear contracts.

## Box 5.2

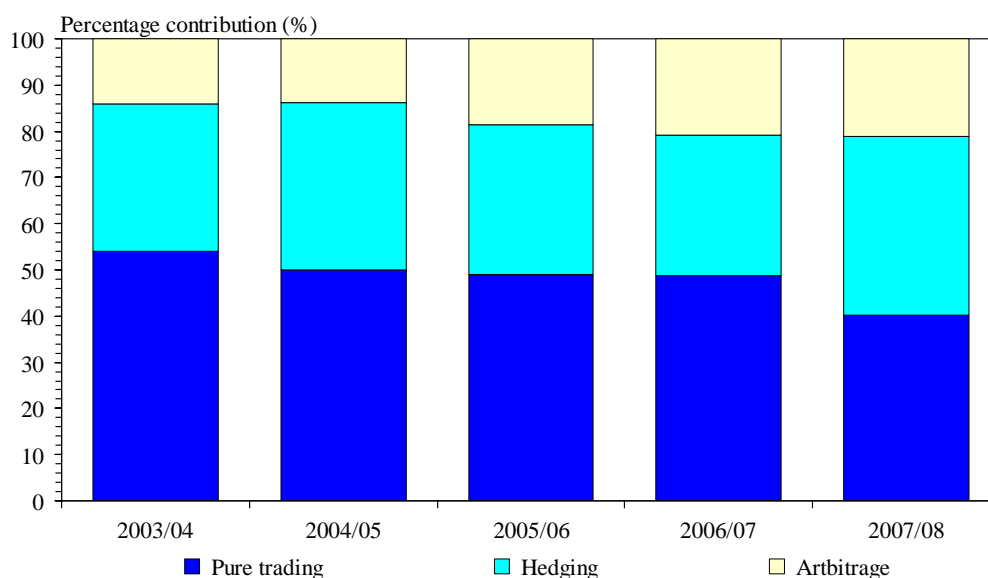
### Futures and options markets in Hong Kong

The Hong Kong Exchanges and Clearing Limited (HKEx) published its Derivatives Market Transaction Survey 2007/08 in November 2008. The main objective of the annual survey is to track trading composition by trading purpose and by investor type in HKEx's futures and options markets. The latest 2007/08 survey covered transactions during July 2007 to June 2008 (refer to as the year 2007/08 below).

#### Pure trading and hedging were the main purposes of transactions

During 2007/08, pure trading and hedging were the two main purposes of futures and options trading, accounting for 40% and 39% respectively of the total turnover. Arbitrage turnover accounted for the remainder, or 21%, of the market turnover in the period. Compared with the 2003/04 survey, the share of transactions for both hedging and arbitrage has increased by about seven percentage points each, while the proportion of pure trading has dropped by 14 percentage points. Moreover, increased share of hedging in transactions was observed in most HKEx's major products – Hang Seng Index (HSI) futures, HSI options and H-shares Index (HHI) futures.

#### Transaction purposes for overall futures and options markets

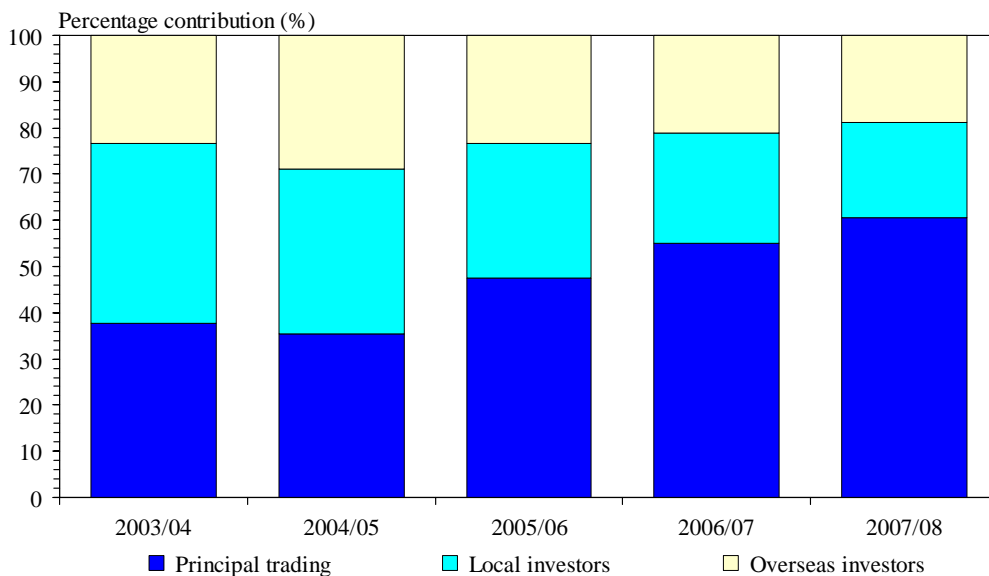


## Box 5.2 (Cont'd)

### Trading by investor type varied across different derivative products

Exchange participants (EPs)' principal trading accounted for 61% of the trading volume for futures and options in 2007/08. However, this was mainly due to the very high share of principal trading in the stock options market, at about 80% consistently (mostly for market making purpose). The split of futures and options turnover among EPs' principal trading, local investors and overseas investors varied significantly across the different products. For instance, overseas institutional investors made up almost half of the trading in HHI futures in 2007/08, whereas about 60% of the trading in mini-HSI futures was attributable to local retail investors.

**Distribution of futures and options trading by investor type**



5.28 With a view to building a more diversified market, the Hong Kong Exchanges and Clearing Limited continued to work towards widening product variety. For instance, the first batch of Market Access Products, which are cash-settled structured products based on non-Hong Kong underlying assets, was introduced in January 2008. Seven new Exchange Traded Funds (ETFs), including the first gold ETF, were listed within the year. In addition, gold futures were re-launched in October.

### **Fund management and investment funds**

5.29 The fund management business has been hard hit by the worsening financial markets. As retail investors' interest was seriously dampened by the poor performance of most unit trust products, gross retail sales of *mutual funds*<sup>(12)</sup> dived by 60.6% to US\$18.0 billion in 2008. The aggregate net asset value of the approved constituent funds under the *MPF schemes* shrank from \$265 billion at end-2007 to \$209 billion at end-2008<sup>(13)</sup>, as investment losses more than offset the new contributions from scheme participants. Retail hedge funds also experienced a challenging time<sup>(14)</sup>.

### **Insurance sector**

5.30 Gross premium income from new long-term business for the *insurance sector* slumped by 39.7% in the third quarter of 2008 over a year earlier<sup>(15)</sup>, led by the 57.7% plunge in premium from investment-linked plans amid the worsening financial markets. On the other hand, premium from non-linked business increased by 18.1% over a year earlier. Meanwhile, gross premium for general business rose by 13.9% over the same period. However, insurers recorded an underwriting loss in the quarter, mainly due to poor performance in motor vehicle and employment compensation businesses.

5.31 In view of the possible impact of the current financial turmoil on the insurance companies, the Insurance Authority (IA) has stepped up his monitoring of the financial and solvency position of all authorised insurers in Hong Kong. Where necessary, the IA will exercise his statutory power to take appropriate interventionary actions against insurers for the protection of policyholders.

**Table 5.6 : Insurance business in Hong Kong\* (\$Mn)**

		<u>General business :</u>				<u>Premium for long-term business<sup>^</sup> :</u>				
		<u>Gross premium</u>	<u>Net premium</u>	<u>Underwriting profit</u>	<u>Individual life and annuity (non-linked)</u>	<u>Individual life and annuity (linked)</u>	<u>Other individual business</u>	<u>Non-retirement scheme group business</u>	<u>All long-term business</u>	<u>Gross premium from long-term business and general business</u>
2007	Annual	24,057	17,008	2,301	20,314	60,040	261	162	80,777	104,834
	Q1	6,792	4,904	441	5,982	10,122	62	45	16,211	23,003
	Q2	6,156	4,451	598	3,307	13,189	62	50	16,608	22,764
	Q3	5,861	4,122	744	5,028	16,445	76	40	21,589	27,450
	Q4	5,248	3,531	518	5,997	20,284	61	27	26,369	31,617
2008	Q1	7,640	5,478	638	8,212	13,308	64	49	21,633	29,273
	Q2	6,618	4,773	188	6,089	13,345	67	58	19,559	26,177
	Q3	6,676	4,723	-12	5,937	6,949	63	73	13,022	19,698
	% change over a year earlier	13.9	14.6	-101.6	18.1	-57.7	-17.1	82.5	-39.7	-28.2

Notes : (\*) Figures are based on provisional statistics of the Hong Kong insurance industry.  
 (^) Figures refer to new businesses only. Retirement scheme businesses are excluded.

## Notes :

- (1) Prior to 9 October 2008, the Base Rate was set at either 150 basis points above the prevailing US Federal Funds Target Rate (FFTR) or the average of the five-day moving averages of the overnight and one-month HIBORs, whichever was higher. With effect from 9 October, this formula for determination of the Base Rate has been changed by reducing the spread of 150 basis points above the prevailing FFTR to 50 basis points and by removing the other leg relating to the moving averages of the relevant interbank interest rates. These changes will be reviewed by 31 March 2009.
- (2) In December 2005, the HKMA published a new data series on composite interest rate, reflecting movement in various deposit rates, interbank and other interest rates to closely track the average cost of funds for banks. The published data enable the banks to keep track of changes in funding cost and thus help improve interest rate risk management in the banking sector.
- (3) The trade-weighted Nominal Effective Exchange Rate Index (EERI) is an indicator of the overall exchange value of the Hong Kong dollar against a fixed basket of other currencies. Specifically, it is a weighted average of the exchange rates of the Hong Kong dollar against some 14 currencies of its major trading partners, with the weights adopted being the respective shares of these trading partners in the total value of merchandise trade for Hong Kong during 1999 and 2000.

The Real EERI of the Hong Kong dollar is obtained by adjusting the Nominal EERI for relative movements in the seasonally adjusted consumer price indices of the respective trading partners.

- (4) The various definitions of the money supply are as follows:

M1 : Notes and coins with the public, plus customers' demand deposits with licensed banks.

M2 : M1 plus customers' savings and time deposits with licensed banks, plus negotiable certificates of deposit (NCDs) issued by licensed banks, held outside the monetary sector as well as short-term Exchange Fund placements of less than one month.

M3 : M2 plus customers' deposits with restricted licence banks and deposit-taking companies, plus NCDs issued by such institutions and held outside the monetary sector.

Among the various monetary aggregates, more apparent seasonal patterns are found in HK\$M1, currency held by the public, and demand deposits.

- (5) Authorised institutions include licensed banks, restricted licence banks and deposit-taking companies. At end-2008, there were 145 licensed banks, 27 restricted licence banks and 28 deposit-taking companies in Hong Kong. Altogether, 200 authorised institutions (excluding representative offices) from 30 countries and territories (including Hong Kong) had a presence in Hong Kong.
- (6) The figures for private sector debt may not represent a full coverage of all the Hong Kong dollar debt paper issued.

- (7) Assets of the banking sector include notes and coins, amount due from authorised institutions in Hong Kong as well as from banks abroad, loans and advances to customers, negotiable certificates of deposits (NCDs) held, negotiable debt instruments other than NCDs held, and other assets. Certificates of indebtedness issued by Exchange Fund and the counterpart bank notes issued are nevertheless excluded.
- (8) The agency also raised China's long-term sovereign credit rating from A to A+, and its short-term credit rating from A-1 to A-1+.
- (9) The ranking is made by the World Federation of Exchanges, a global trade association for the stock exchange industry. Its membership comprises 50 securities exchanges (as of 28 January 2009), covering almost all globally recognised stock exchanges.
- (10) At end-2008, there were 1 087 and 174 companies listed on the Main Board and GEM respectively.
- (11) At end-2008, there were 49 classes of stock options contracts and 42 classes of stock futures contracts.
- (12) These figures are obtained from the Sales and Redemptions Survey conducted by the Hong Kong Investment Funds Association on their members, and covered only the active authorised funds that have responded to the survey. To provide a more accurate picture of the retail fund market in Hong Kong, the survey has been revamped, with effect from 2005, such that it would cover only retail transactions (including switching) and exclude institutional transactions. At end-2008, there were 1 287 authorised funds, according to the survey.
- (13) There were 19 approved trustees at end-2008. On MPF products, 34 master trust schemes, two industry schemes and two employer sponsored schemes, comprising altogether 340 constituent funds, were approved by the Mandatory Provident Fund Schemes Authority. A total of 238 000 employers, 2.18 million employees and 267 000 self-employed persons have participated in MPF schemes.
- (14) There were 14 SFC-authorised retail hedge funds with combined net asset size of US\$770 million at end-2008. This amount of net assets under management represented a 55.5% decrease from end-2007 level, but was around 5 times of that at end-2002, the year when the hedge funds guidelines were first issued.
- (15) At end-2008, there were 175 authorised insurers in Hong Kong. Within this total, 46 were engaged in long-term insurance business, 110 in general insurance business, and 19 in composite insurance business. These authorised insurers come from 23 countries and territories (including Hong Kong).