CHAPTER 5 : THE FINANCIAL SECTOR#

Summary

- *Hong Kong's financial sector has tided over the global financial crisis well. With its sound fundamentals, the sector witnessed a strong revival starting the second quarter of 2009 amid the gradually improved economic backdrop.*

- *Thanks to the substantial inflow of funds and the normalisation in interbank money market, Hong Kong dollar interbank interest rates remained low throughout 2009. Following the sharp contraction in the early part of the year, lending activities recovered thereafter in tandem with the improvement in both the global and local economies.*

- *Under the linked exchange rate system, the Hong Kong dollar Effective Exchange Rate Indices generally softened alongside the weakening of the US dollar during most part of the year, before showing some signs of stabilisation towards the year end. Meanwhile, the strong demand for Hong Kong dollar assets prompted the HKMA to passively sell Hong Kong dollars against the US dollars to banks, leading to a high level of liquidity in the banking sector.*

- *Benefiting from the brighter economic outlook and abundant liquidity, both stock prices and market turnover posted a sharp rebound as from the second quarter of 2009. Fund raising activities also turned very buoyant, with Hong Kong gaining the leading position as the world's largest centre for IPO fund raising in 2009.*

- *Significant progress has been made during the past year in such areas as expanding the renminbi banking business, broadening the eligible entities for renminbi-denominated bond issuance and exploring opportunities for further financial co-operation with the Mainland. These developments should help enhance Hong Kong's role as a world class financial centre, an offshore renminbi centre outside the Mainland and a premier wealth management centre.*

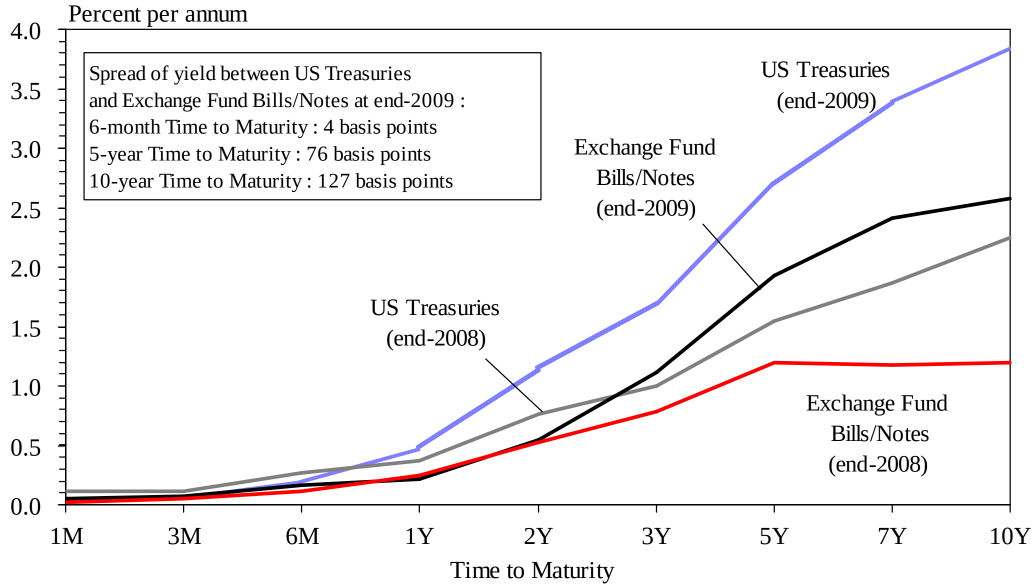
(#) This chapter is jointly prepared by the Hong Kong Monetary Authority (HKMA) and the Economic Analysis Division.

Interest rates and exchange rates

5.1 Short-term interest rates remained benign in 2009. The *Base Rate* under the Discount Window operated by the HKMA stood at 0.5% throughout the year, as the US Federal Funds Target Rate was held unchanged at 0-0.25%[(1)]. Amid continued inflow of funds, the *Hong Kong dollar interbank interest rates* stayed at extremely low levels. Broadly tracking their US dollar counterparts, the overnight HIBOR hovered around 0.1% during most part of the year, while the three-month HIBOR declined from 0.89% at end-2008 to 0.13% at end-2009.

5.2 The spreads between Hong Kong dollar and US dollar interest rates remained negative through the year, though the discount of the three-month HIBOR to the corresponding Euro-dollar deposit rate tightened from 53 basis points at end-2008 to 35 basis points at end-2009. Meanwhile, the *Hong Kong dollar yield curve* steepened notably but continued to stay below the US Treasury yield curve. Reflecting strong demand for high-quality, liquid money-market instruments, the implied yield of 7-day Exchange Fund Bills dipped below zero at times. At the longer-end, the yield of 10-year Exchange Fund Notes went up 139 basis points during the year to 2.58%, but this was still smaller than the increase of 160 basis points for the corresponding US Treasury yield. As a result, their yield spread widened from 106 basis points at end-2008 to 127 basis points at end-2009.

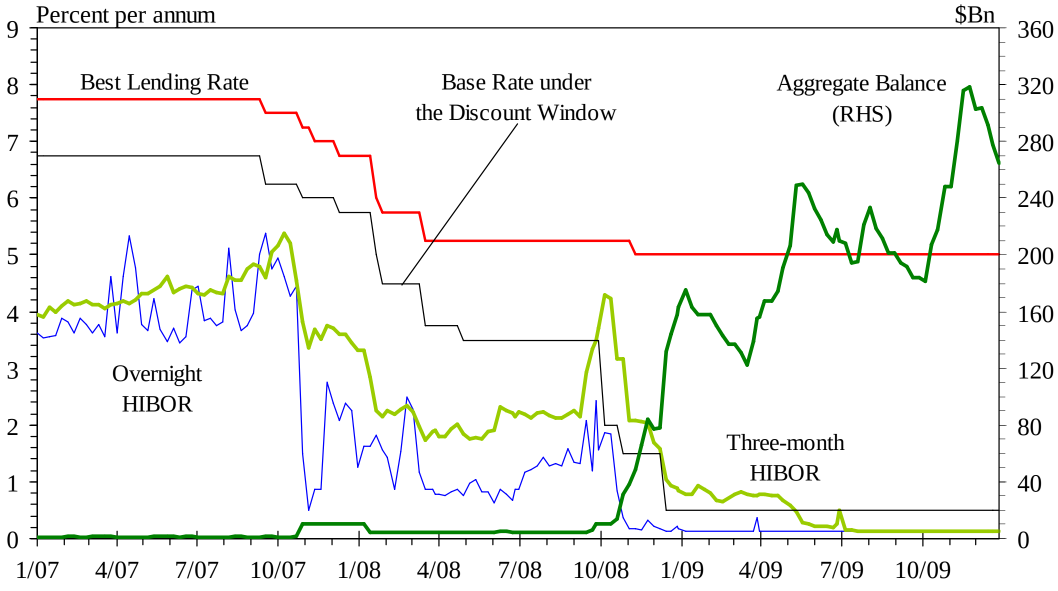
Diagram 5.1 : The Hong Kong dollar yield curve steepened notably, though still by a smaller degree than its US dollar counterpart



5.3 At the retail level, banks kept their Best Lending Rates (BLRs) unchanged at 5.00% and 5.25% during 2009. Deposit interest rates also remained stable at exceptionally low levels, with the average savings deposit rate and one-month time deposit rate quoted by major banks both staying at around 0.01% through the year. The composite interest rate, which indicates the average cost of funds for banks, dropped to 0.11% at end-2009 from 0.68% a year earlier(2). As regards mortgage rates, the proportion of newly approved mortgage loans priced with reference to HIBOR climbed from below one-fifth in December 2008 to a record high of 61.6% in December 2009, as borrowers took advantage of the prevailing low interbank interest rates.

5.4 Partly due to the buoyant stock market, demand for the Hong Kong dollar was strong in 2009. The strong-side Convertibility Undertaking (CU) was repeatedly triggered, prompting the HKMA to passively sell Hong Kong dollars against US dollars to banks. As a result, the Aggregate Balance soared from $158.0 billion at end-2008 to a high of $320.0 billion on 24 November 2009. The Aggregate Balance eventually eased back to $264.6 billion at end-2009, upon HKMA's continued issuance of additional Exchange Fund Bills in the latter part of the year to meet the increased demand by banks for liquidity management purposes.

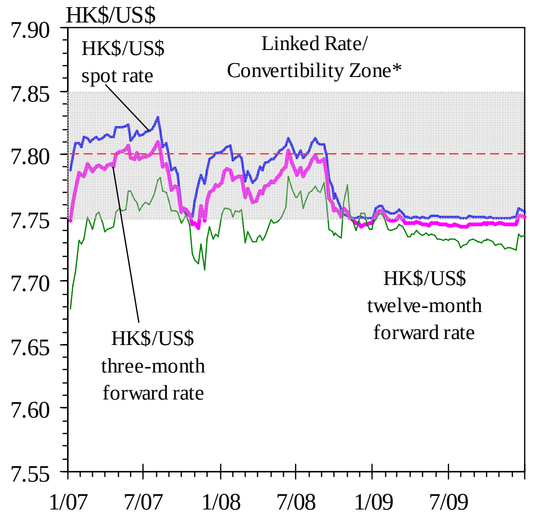
Diagram 5.2 : Hong Kong dollar interbank interest rates remained low throughout the year amid ample liquidity (end for the week)



5.5 As a result of the strong inflow of funds, the Hong Kong dollar spot exchange rate stayed close to 7.75 per US dollar during most of 2009. The discount of the *3-month Hong Kong dollar forward rate* to the spot rate widened slightly from 45 pips (each pip equivalent to HK$0.0001) to 48 pips between end-2008 and end-2009, while the corresponding discount of the *12-month forward rate* expanded by a much larger extent from 95 pips to 193 pips.

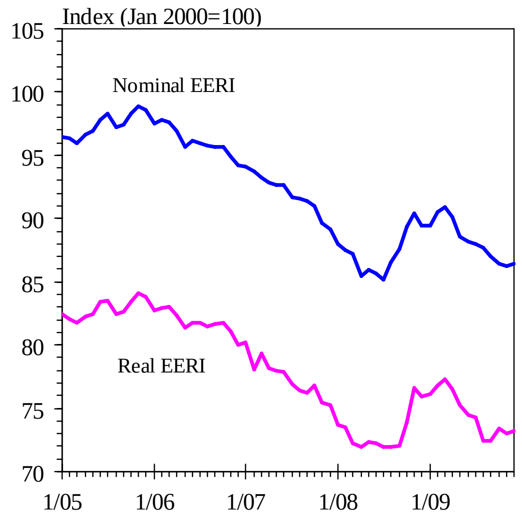
5.6 Under the Linked Exchange Rate system, movements in the Hong Kong dollar exchange rate against other currencies closely followed those of the US dollar. As the US dollar depreciated against other major currencies in the past year, the trade-weighted *Hong Kong dollar Nominal* and *Real Effective Exchange Rate Indices* in December 2009 softened by 3.4% and 3.6% from a year earlier, though the indices have turned more stable towards the end of the year[(3)].

Diagram 5.3 : Forward spreads widened through the year (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.

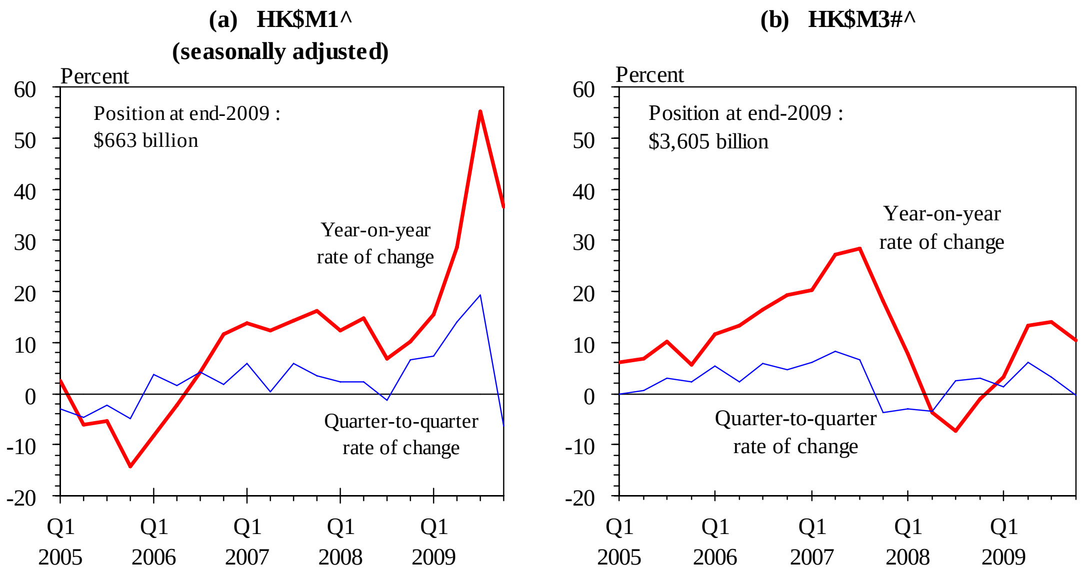
Diagram 5.4 : Trade-weighted EERIs generally weakened alongside the US dollar (average for the month)



Money supply and banking sector

5.7 Hong Kong dollar broad *money supply* (HK$M3) expanded by 10.5% during 2009, having contracted by 1.2% during the preceding year[4]. The seasonally adjusted narrow money supply (HK$M1) posted an even sharper growth of 36.5% during the year, partly because depositors were increasingly willing to hold demand deposits in a low interest rate environment. *Total deposits* with authorised institutions (AIs) also rose during the year, by 5.3% to $6,381 billion at end-2009[5]. Analysed by currency, Hong Kong dollar deposits rose solidly by 11.2% to $3,374 billion while foreign currency deposits edged down by 0.6% to $3,007 billion.

Diagram 5.5 : Money supply expanded solidly during most of the year, supported by continued funds inflow



Notes : (^) Figures refer to the positions at end of quarter.
(#) Adjusted to include foreign currency swap deposits.

5.8 Following the decline in the first four months of 2009, *total loans and advances* trended upward thereafter alongside the gradual recovery in the local economy and a more stable external trading environment. For the year as a whole, total loans outstanding edged up by 0.1% to $3,289 billion at end-2009 (comprising Hong Kong dollar loans of $2,401 billion and foreign currency loans of $887 billion). Among the total, loans for use in Hong Kong bounced back from the earlier lows, though the outstanding balance at end-2009 was still 1.3% lower than a year earlier. Analysed by economic use, residential mortgage loans expanded sturdily, by 7.4% during the year, amid the buoyant housing market and accommodative mortgage interest rates. Loans to stockbrokers jumped by 18.0% albeit with sharp fluctuation over the course of year. On the other hand, trade finance outstanding at end-2009 remained 6.1% lower than a year earlier notwithstanding the rebound as from the second quarter on the back of gradually reviving trade flows. Meanwhile, lending to financial concerns contracted visibly by 31.6% during the year. Due to the concurrent strong expansion in deposit base, the Hong Kong dollar loan-to-deposit ratio fell noticeably from 77.6% to 71.2% during 2009.

Table 5.1 : Loans and advances

		All loans and advances for use in Hong Kong									
		Loans to :									
% change during the quarter		Trade finance	Manu-facturing	Whole-sale and retail trade	Building, construction, property development and investment	Purchase of residential property[(a)]	Financial concerns	Stock-brokers	Total[(b)]	All loans and advances for use outside Hong Kong[(c)]	Total loans and advances
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	-16.2	-5.3	-3.3	1.9	-1.4	-5.4	-10.4	-3.5	-6.7	-4.1
2009	Q1	-15.1	-1.5	-5.5	-1.0	-0.3	-14.5	-10.3	-3.8	-2.8	-3.6
	Q2	3.3	-5.8	1.9	-0.5	2.0	-9.0	443.6	1.6	-1.0	1.2
	Q3	2.3	1.9	3.8	-2.3	3.5	2.1	-17.2	1.6	5.6	2.3
	Q4	4.6	-2.5	2.2	3.2	2.0	-13.9	-70.8	-0.7	5.0	0.3
Total amount at end-2009 ($Bn)		175	135	155	683	698	194	12	2,675	614	3,289
% change over a year earlier		-6.1	-7.8	2.2	-0.6	7.4	-31.6	18.0	-1.3	6.7	0.1

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%.

5.9 On 23 October 2009 the HKMA issued a circular to banks in Hong Kong, capping the loan-to-value ratios for residential mortgages on properties valued at $20 million or more at 60% (instead of 70% originally) and setting a maximum loan amount of $12 million for properties valued at below $20 million. The circular also reminded banks to be prudent in conducting valuation of properties and in calculating borrowers' debt servicing ratios, with particular consideration to the effect on borrowers' ability to service mortgage payments when interest rates return to more normal levels. These prudential measures are designed in the interest of maintaining banking stability and enhancing banks' risk management on mortgage lending to high-end residential properties.

5.10 Despite the recent global financial crisis, Hong Kong's banking system remained resilient. Capital positions of the Hong Kong incorporated AIs continued to be strong. Under the capital adequacy framework promulgated by the Basel Committee on Banking Supervision (commonly referred to as "Basel II"), the capital adequacy ratio (CAR) of these institutions stayed high at an average of 16.6% at end-September 2009. All individual AIs' CARs were above the statutory minimum ratios as required by the HKMA.

5.11 To address the issues revealed by the recent global financial crisis, the Basel Committee issued a final package of proposals in July 2009 for enhancements of the Basel II capital framework. The HKMA is supportive of the Committee's initiative and is taking steps to implement the enhanced international standards on 1 January 2011 in accordance with the timetable of the Committee. Moreover, in December 2009 the Committee issued two consultative documents setting out proposals to strengthen global capital and liquidity requirements with the goal of promoting a more resilient international banking system. The Committee will conduct a comprehensive impact assessment of its proposals in the first half of 2010 in order to determine the appropriate calibration of the final set of standards. The finalised standards will be phased in when financial conditions improve and economic recovery is assured, with the aim of implementation by end-2012. As a member of the Basel Committee, the HKMA has participated in the development of the proposed reforms, and supports the underlying objective of the proposed standards. The HKMA will continue to be involved in the process of refining and finalising the proposals at the Committee.

5.12 Asset quality of the local banking sector remained sound. After rising from 1.24% to 1.51% between end-2008 and end-June 2009, the ratio of classified loans eased back to 1.42% at end-September. Arrears for over three months in credit card repayment followed a similar pattern, increasing slightly from 0.34% to 0.50% during the first half of 2009 but moderating to 0.46% at end-September. Meanwhile, the delinquency ratio for residential mortgage loans edged down to 0.03% at end-2009 from 0.05% a year earlier.

Table 5.2 : Asset quality of retail banks*

(as % of total loans)

As at end of period		Pass loans	Special mention loans	Classified loans (gross)
2008	Q1	97.72	1.47	0.81
	Q2	97.75	1.38	0.88
	Q3	97.61	1.43	0.96
	Q4	96.55	2.20	1.24
2009	Q1	96.09	2.44	1.47
	Q2	96.14	2.35	1.51
	Q3	96.47	2.12	1.42

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”.

5.13 Regarding renminbi banking business in Hong Kong, the scope of services has expanded further with the implementation of the pilot scheme in July to allow eligible Mainland enterprises to use renminbi to settle trade transactions with their trade counterparts in selected areas (including ASEAN countries) outside the Mainland. The pilot scheme has been operating smoothly. The establishment of this clearing platform for handling renminbi-related transactions will further strengthen Hong Kong’s status as an international financial centre.

5.14 After contracting to RMB53.0 billion at end-April, the amount of renminbi deposits outstanding rebounded to RMB62.7 billion at end-2009, representing a year-on-year increase of 11.9%. Apart from the pilot scheme for renminbi trade settlement, demand associated with the issuance of renminbi-denominated bonds in Hong Kong has also helped bolster interests in renminbi deposits.

Table 5.3 : Renminbi deposits in Hong Kong

As at end of period		Demand and savings deposits (RMB Mn)	Time deposits (RMB Mn)	Total deposits (RMB Mn)	Interest rates on[a] Savings deposits[b] (%)	Interest rates on[a] Three-month time deposits[b] (%)	Number of authorised institutions engaged in RMB business
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
2009	Q1	35,166	17,944	53,110	0.46	0.64	39
	Q2	35,924	18,457	54,381	0.46	0.64	40
	Q3	40,559	17,616	58,174	0.46	0.66	44
	Q4	40,662	22,056	62,718	0.46	0.67	60
% change over a year earlier		6.7	22.9	11.9	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.

The debt market

5.15 The Hong Kong dollar *debt market* expanded considerably in 2009, against the backdrop of increased supply of short-dated Exchange Fund papers by the HKMA to meet the demand by banks for the purposes of liquidity management. Total gross issuance of Hong Kong dollar debt securities surged by 192.7% to $1,242.1 billion in 2009, with issuance of Exchange Fund Bills and Notes accounting for 84.4% of all new debt issuance in the year. Hong Kong dollar debt issued by AIs, local corporations and overseas borrowers excluding the multilateral development banks also rose remarkably by 31.2% to $145.8 billion, reflecting a pick-up in demand for private sector papers. As a result, the total outstanding balance of Hong Kong dollar debt stood at a record level of $1,111.3 billion at end-2009, 55.1% higher than a year earlier(6). This was equivalent to 30.8% of HK$M3 or 25.3% of Hong Kong dollar-denominated assets of the entire banking sector(7).

5.16 With a view to promoting the sustainable development of the local bond market, the Financial Secretary in the 2009-10 Budget announced to implement a Government Bond Programme, under which Government Bonds will be issued in a systematic and consistent manner. The Government Bond Programme is divided into two parts, namely, the Institutional Bond Issuance Programme and the Retail Bond Issuance Programme. The inaugural issue of Government bonds under the Institutional Bond Issuance Programme, a two-year bond with an issue size of $3.5 billion, was tendered on 2 September 2009 while the second issue under the Institutional Bond Issuance Programme, a five-year bond with an issue size of $2.0 billion, was tendered on 2 November. Both issues were well-received by investors. The HKMA, as the representative of the Government to assist in the implementation of the Programme, will continue to maintain close dialogues with market players and consider measures to encourage primary market participation, promote secondary market liquidity, and broaden investor base. Regarding the Retail Bond Issuance Programme, the Government will take into account the advice of the co-arrangers and prevailing market conditions in determining the timing of issue. The Programme is expected to increase the depth, breadth and liquidity of the local bond market, thereby further enhancing Hong Kong’s status as an international financial centre.

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

		Exchange Fund paper	Statutory bodies/government-owned corporations	Government	Public sector total	AIs[a]	Local corporations	Non-MDBs overseas borrowers[b]	Private sector total	MDBs[b]	Total
New issuance											
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	-	132.1
	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
2009	Annual	1,047.7	29.9	5.5	1,083.1	43.9	19.5	82.4	145.8	13.1	1,242.1
	Q1	130.7	8.6	-	139.4	5.6	2.8	29.6	38.0	5.8	183.1
	Q2	191.1	10.6	-	201.8	15.0	4.8	21.2	41.0	6.2	248.9
	Q3	333.8	9.4	3.5	346.7	11.6*	5.2	17.6	34.4*	0.4	381.5*
	Q4	392.1	1.2	2.0	395.2	11.7	6.7	14.1	32.5	0.8	428.5
% change in 2009 Q4 over 2008 Q4		398.9	-82.4	N.A.	363.4	80.1	1,090.2	88.6	123.4	-75.0	316.7
% change in 2009 over 2008		266.5	22.8	N.A.	249.2	-3.0	36.7	59.6	31.2	338.2	192.7
Outstanding (as at end of period)											
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
2009	Q1	218.9	63.5	5.0	287.4	86.2	67.7	325.2	479.1	19.3	785.8
	Q2	288.4	68.1	5.0	361.5	80.9	72.0	322.9	475.8	25.5	862.9
	Q3	413.0	74.4	5.0	492.5	82.8*	73.7	319.8	476.3*	23.9	992.7*
	Q4	534.1	69.7	7.0	610.8	84.7	79.5	312.1	476.2	24.3	1,111.3
% change over a year earlier		238.8	7.9	40.0	168.7	-10.9	18.6	-0.3	0.2	70.8	55.1

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

(a) AIs : Authorised institutions.

(b) MDBs : Multilateral Development Banks.

(*) Revised figures.

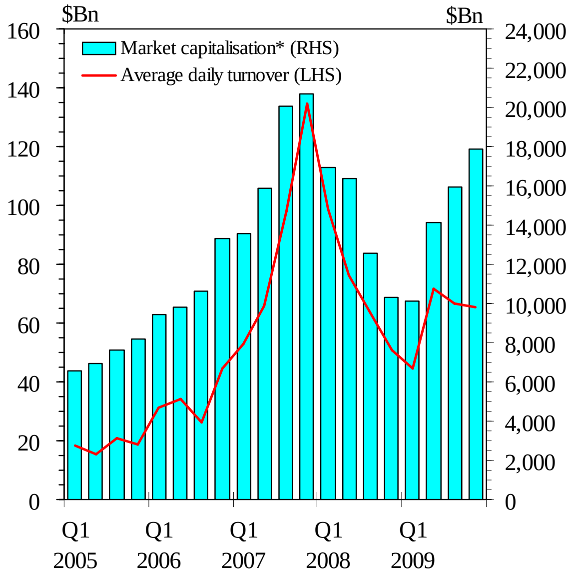
N.A. Not available.

The stock and derivatives markets

5.17 After a weak start in early 2009, the *local stock market* rebounded visibly in the second quarter and remained on a general uptrend through the rest of the year amid the improved economic outlook and abundant liquidity. The *Hang Seng Index* (*HSI*) fell to a closing low of 11 345 on 9 March 2009 under mounting concerns about poor financial results from the listed companies, but then bounced back to close the year at 21 873, representing a jump of 52.0% over a year earlier. This was largely comparable to the performance of other markets in the region, as indicated by the 68.3% gain in the MSCI Asia excluding Japan index. The *daily turnover* averaged at $62.3 billion in 2009. While this was 13.5% lower than in 2008, it represented a notable rebound from the benign levels recorded in late 2008 and early 2009 at the height of the global financial crisis.

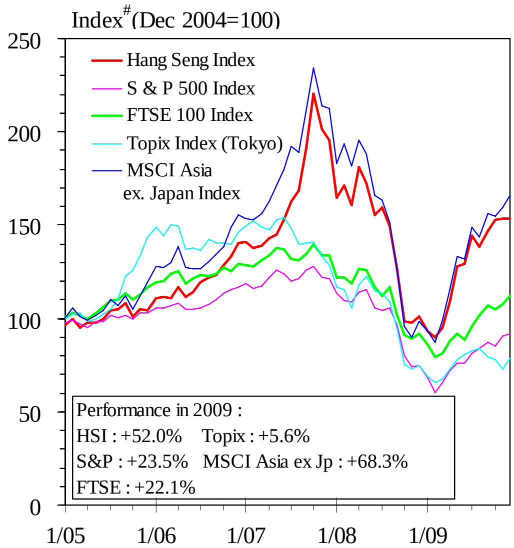
5.18 Alongside the surge in stock prices, the *market capitalisation* also soared, by 73.6% over a year earlier to $17.9 trillion at end-2009. According to the *World Federation of Exchanges*, the local bourse continued to be the seventh largest in the world and the third largest in Asia(8). Supported by revived investor confidence and sanguine business prospects in the region, fund raising activities turned more buoyant in the second half of 2009. Equity capital raised through new share floatations and post-listing arrangements on the Main Board and the Growth Enterprise Market (GEM) jumped by 50.3% to a record $642.1 billion for the year as a whole, though this was partly attributable to an enormous rights issue by a major bank(9). Among the total, funds raised from IPOs surged by 276.2% to $248.2 billion in 2009, putting the Hong Kong stock exchange as the world's largest centre for IPO fund raising in the year.

Diagram 5.6 : Stock prices and trading activities in the local market recovered markedly from earlier lows



Note : (*) Position at end of quarter.

Diagram 5.7 : Market performance in Hong Kong was largely in line with regional peers



Note : (#) Position at end of month.

5.19 Mainland enterprises continued to play a dominant role in the Hong Kong stock market. At end-2009, there were 524 Mainland enterprises (including 156 H-share companies, 97 “Red Chips” companies and 271 private enterprises) listed on the market, accounting for 40% of the total number of listed companies and 58% of the total market capitalisation. In 2009, Mainland-related stocks accounted for 72% of equity turnover in the Hong Kong stock exchange. While their share in total equity capital raised fell to 55% due to an enormous rights issue by a major non-Mainland bank, Mainland enterprises remained the main source of new listings, accounting for 83% of IPO funds raised in the year.

5.20 In line with the decline in overall turnover in the stock market, trading in *derivatives market* also dwindled. The average daily trading volume of futures and options contracts fell by 7.9% in 2009[(10)]. Among these contracts, turnover of HSI futures, stock options and H-shares index futures declined by 6.3%, 14.8% and 15.7% respectively, more than offsetting the 37.9% increase in turnover of HSI options. Meanwhile, the average daily trading value for securitised derivatives shrank by a larger extent of 26.7% in 2009, though it has stabilised since the second quarter. The fall was entirely attributable to the 52.6% plunge in trading of derivative warrants, whereas the transaction value for callable bull/bear contracts actually surged by 58.6%.

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

		Hang Seng Index futures	Hang Seng Index options	H-shares Index futures	Stock options	Total futures and options traded*	Derivative warrants ($Mn)	Callable bull/bear contracts ($Mn)	Total securitised derivatives traded ($Mn)^
2008	Annual	89 368	15 723	59 428	225 074	432 126	14,015	4,243	18,258
	Q1	89 686	15 072	61 088	266 199	472 052	26,851	1,395	28,247
	Q2	78 668	13 890	50 653	212 191	388 939	15,715	2,886	18,601
	Q3	95 335	18 381	58 217	220 110	435 527	8,964	6,394	15,359
	Q4	93 607	15 476	67 742	202 782	432 561	4,972	6,183	11,155
2009	Annual	83 750	21 686	50 077	191 676	398 134	6,646	6,731	13,377
	Q1	80 094	17 167	54 785	194 279	389 778	5,240	5,856	11,096
	Q2	95 356	21 465	55 346	217 696	449 160	6,770	7,720	14,490
	Q3	84 197	21 857	47 683	168 876	373 514	7,458	6,681	14,139
	Q4	75 403	26 100	42 828	187 277	381 632	7,027	6,660	13,687
% change in 2009 Q4 over 2008 Q4		-19.4	68.7	-36.8	-7.6	-11.8	41.3	7.7	22.7
% change in 2009 over 2008		-6.3	37.9	-15.7	-14.8	-7.9	-52.6	58.6	-26.7

Notes : (*) Turnover figures for individual futures and options are in number of contracts, and may not add up to the total futures and options traded as some products are not included.

(^) Comprising derivative warrants and callable bull/bear contracts.

5.21 The product offerings in the Exchange Traded Fund (ETF) market continued to expand. In May 2009 the Securities and Futures Commission (SFC) and the Taiwan Financial Supervisory Commission signed a Side Letter to a bilateral Memorandum of Understanding to facilitate cross listing of ETFs in the two markets, and subsequently in August the first Taiwan ETF was listed on the Hong Kong stock exchange. In November, four Mainland A-share industry sector ETFs commenced trading on the local bourse, making Hong Kong the first exchange with Mainland A-share industry sector ETFs.

5.22 In December, the SFC, jointly with Hong Kong Exchanges and Clearing Limited and the Federation of Share Registrars, issued a consultation paper on the proposed operational model for implementing a scripless securities market in Hong Kong. The paper puts forward an operational model in building market rapport in pressing ahead an important initiative to modernise our financial infrastructure, enhance corporate governance and investor protection as well as align with international trends.

Fund management and investment funds

5.23 Fund management and investment fund business have staged a steady recovery since the second quarter of 2009 amid the more upbeat investor sentiment. Although the gross retail sales of *mutual funds* fell by 16.5% to US$15.0 billion for 2009 as a whole, it has gradually trended up over the year[(11)]. Meanwhile, the aggregate net asset value of the approved constituent funds under the *MPF schemes* rose to $309 billion at end-2009, 47.4% higher than a year earlier[(12)]. Retail hedge funds business also picked up after a weak start in the early part of the year[(13)].

Insurance sector

5.24 Gross premium income from long-term business for the *insurance sector* reverted to a year-on-year increase of 10.5% in the third quarter of 2009[(14)]. Specifically, premium for non-linked insurance plans surged by 62.7%. While premium for investment-linked products continued to decline by 34.1% on a year-on-year basis, there has been significant improvement when compared with the low levels in late 2008 and early 2009. Regarding general business, gross premium in the period increased by 5.2% over a year earlier.

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

	General business			Premium for long-term business^					
	Gross premium	Net premium	Underwriting profit	Individual life and annuity (non-linked)	Individual life and annuity (linked)	Other individual business	Non-retirement scheme group business	All long-term business	Gross premium from long-term business and general business
2008 Annual	27,019	19,158	1,510	24,054	36,107	256	218	60,635	87,654
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
Q4	6,085	4,184	696	3,816	2,505	62	38	6,421	12,506
2009 Q1	7,940	5,647	694	6,223	2,198	54	69	8,544	16,484
Q2	6,568	4,853	600	7,040	3,827	69	37	10,973	17,541
Q3	7,026	5,122	670	9,658	4,582	72	73	14,385	21,411
% change over a year earlier	5.2	8.4	N.A.	62.7	-34.1	14.3	0.0	10.5	8.7

Notes : (*) Figures are based on provisional statistics of the Hong Kong insurance industry.

(^) Figures refer to new business only. Retirement scheme business is excluded.

N.A. Not available.

Some highlights of market developments

5.25 To further strengthen investors' confidence in the local financial markets, the Government has reviewed the regulatory framework for the financial sector following the outbreak of the global financial crisis. The various regulatory authorities, including the HKMA and SFC, have come up with a number of recommendations, some of which like improving the way investment products are sold, enhancing the business conduct of intermediaries and enhancing investor education have already been implemented.

5.26 In 2009, the range of issuers for renminbi-denominated bonds was extended from Mainland financial institutions to include the Mainland subsidiaries of Hong Kong banks. Also, the Ministry of Finance of the Central Government issued renminbi bonds in Hong Kong for the first time during the year. This was also the first renminbi sovereign bond issuance outside the Mainland.

5.27 With effect from 1 October 2009, Hong Kong banks, through their branches or wholly owned subsidiaries in the Mainland, can apply for establishing "cross-location" sub-branches within the Guangdong Province with reference to the relevant rules in the Mainland under Supplement VI to CEPA signed in May 2009. This measure exempts Hong Kong banks operating in the Guangdong Province from the Mainland's general requirement that a bank having a branch in one city can open sub-branches in the same city only. This will lower the costs for Hong Kong banks to expand their networks in Guangdong as the minimum operating capital requirement for sub-branches is substantially lower than that for branches.

5.28 In November, the SFC and the Securities Commission of Malaysia signed the Declaration on Mutual Co-operation on Development of Islamic Capital Market and Islamic Collective Investment Schemes, which provides for the mutual recognition of Islamic collective investment schemes (CISs) between the two jurisdictions. The Declaration also promotes sharing of information on Islamic CISs between the two authorities, as well as the exchange of regulatory experience relating to Shariah principles governing these schemes. These co-operation measures will help foster the further development of Islamic fund management in Hong Kong and facilitate the cross-border offering of these schemes to investors in the two markets.

5.29 Notable headways have been made in strengthening the links between the financial sectors of the Mainland and Hong Kong. In November, the Expert Group on Hong Kong/Guangdong Financial Co-operation held its first meeting to exchange views on the strengthening of co-operation in areas including the securities, banking, renminbi and insurance businesses. The two sides also discussed proposals for more policies and measures that would be mutually beneficial to the development of financial industries in Hong Kong and Guangdong, by leveraging on CEPA, the model of early and pilot implementation and other channels.

5.30 In January 2010, the Financial Services and the Treasury Bureau and the Shanghai Municipal Government Financial Services Office signed the Memorandum of Understanding Concerning Advancing Hong Kong-Shanghai Financial Co-operation (MOU). According to the MOU, the two cities would strengthen financial co-operation under the framework of the Hong Kong/Shanghai Economic and Trade Co-operation Conference and with the advice and support of national financial authorities. In addition, the MOU set out priority areas for co-operation between the two places, including the development of financial markets, mutual establishment of financial institutions and training and exchange of financial talent.

5.31 As regards co-operation in the Asia-Pacific region, in December 2009 the HKMA together with the Finance Ministers and Central Bank Governors of the Central Government, ASEAN Member States, Japan and Korea signed the Chiang Mai Initiative Multilateralisation (CMIM) Agreement. The CMIM, with a total size of US$120 billion, will supplement the existing international financial arrangements and provide financial support through currency swap transactions to the CMIM participants facing balance-of-payments and short-term liquidity difficulties. The initiative should help maintain economic and financial stability within the region.

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. Between 9 October 2008 and 31 March 2009, this formula for determination of the Base Rate was temporarily 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. After a review of the appropriateness of the new Base Rate formula, the narrower 50 basis point spread over the FFTR was retained while the HIBOR leg was re-instated in the calculation of the Base Rate after 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 (AIs) include licensed banks, restricted licence banks and deposit-taking companies. At end-2009, there were 145 licensed banks, 26 restricted licence banks and 28 deposit-taking companies in Hong Kong. Altogether, 199 AIs (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 deposit (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 ranking is made by the World Federation of Exchanges, a global trade association for the securities exchange industry. Its membership comprises 52 securities exchanges (as of 25 January 2010), covering almost all globally recognised stock exchanges.

(9) At end-2009, there were 1 145 and 174 companies listed on the Main Board and GEM respectively.

(10) At end-2009, there were 51 classes of stock options contracts and 38 classes of stock futures contracts.

(11) These figures are obtained from the Sales and Redemptions Survey conducted by the Hong Kong Investment Funds Association on their members, and cover only the active authorised funds that have responded to the survey. At end-2009, the survey covered a total of 1 255 active authorised funds.

(12) At end-2009, there were 19 approved trustees. On MPF products, 35 master trust schemes, two industry schemes and one employer sponsored scheme, comprising altogether 369 constituent funds, were approved by the Mandatory Provident Fund Schemes Authority. A total of 238 000 employers, 2.21 million employees and 263 000 self-employed persons have participated in MPF schemes.

(13) At end-2009, there were 12 SFC-authorised retail hedge funds with combined net asset size of US$679 million. The amount of net assets under management was 11.8% lower than the end-2008 level, but it was 4.8% higher than the figure at end-March 2009 and more than four times of that at end-2002, the year when the hedge funds guidelines were first issued.

(14) At end-2009, there were 171 authorised insurers in Hong Kong. Within this total, 46 were engaged in long-term insurance business, 106 in general insurance business, and 19 in composite insurance business. These authorised insurers come from 22 countries and territories (including Hong Kong).