

## CHAPTER 4 : THE FINANCIAL SECTOR<sup>#</sup>

### *Summary*

- *Interest rates generally stayed low in the first half of 2010. Yet Hong Kong dollar interbank interest rates of longer tenors edged up towards the end of the period, due to upward movements in the US dollar counterparts and strong funding demand associated with local equity fund raising activities.*
- *After trading within a narrow range in the first four months of 2010, the spot exchange rate of the Hong Kong dollar weakened slightly against the US dollar in May and June upon concerns about possible outflow of funds in face of the European debt problems. Meanwhile, the Hong Kong dollar Effective Exchange Rate Indices appreciated further, in parallel with the strengthening of the US dollar.*
- *On the back of the entrenched economic recovery, domestic loans to most economic sectors recorded sharp gains during the first half of 2010. Yet the stock market underwent some consolidation due to uncertainties about the global situation. Fund raising activities turned quieter in the early months, but have revived sharply since late June.*
- *In the first half of 2010, significant progress has been achieved in such areas as expanding renminbi banking business in Hong Kong and improving market access to the Mainland's banking and securities services sectors.*

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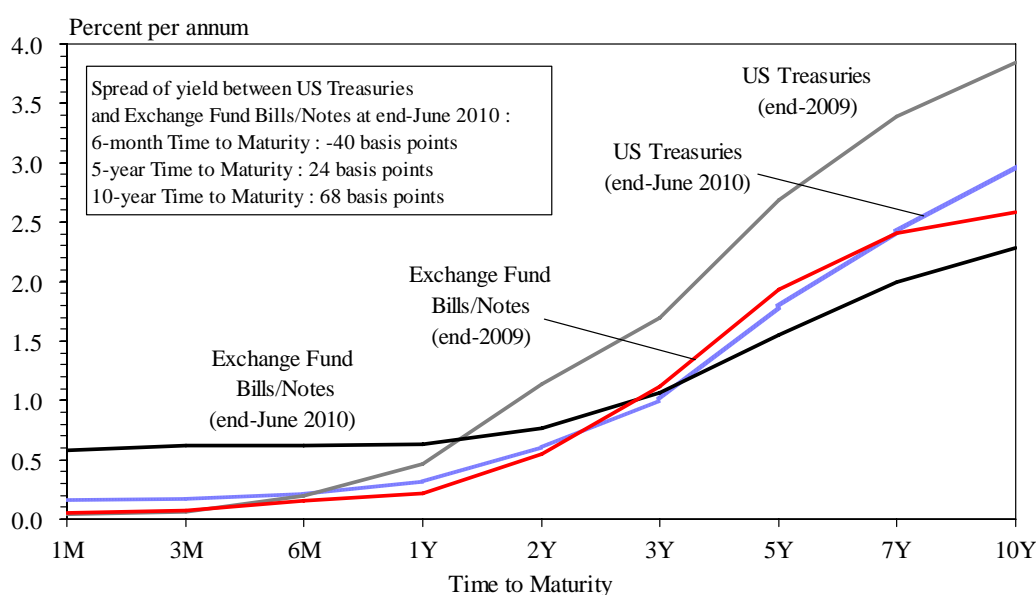
(#) *This chapter is jointly prepared by the Hong Kong Monetary Authority (HKMA) and the Economic Analysis Division.*

## Interest rates and exchange rates

4.1 Against the background of an accommodative monetary policy in the United States, interest rates generally stayed low in Hong Kong during the first half of 2010. With the US Federal Funds rate staying at 0-0.25%<sup>(1)</sup>, the *Base Rate* under the Discount Window operated by the HKMA remained unchanged at 0.5% during the first half of 2010. Meanwhile, *Hong Kong dollar interbank interest rates* especially those of longer tenors edged up towards the end of the period, due to the upward movements in the US dollar counterparts and strong funding demand associated with the equity fund raising activities in late June. The three-month HIBOR rose from 0.13% at end-2009 to 0.58% at end-June 2010, though the overnight HIBOR stayed close to zero.

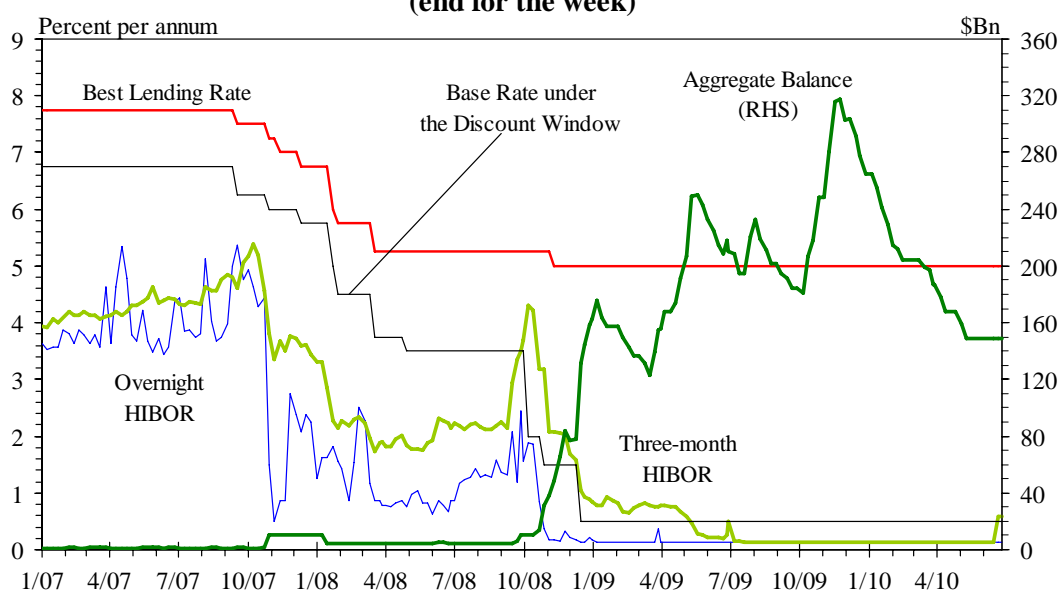
4.2 The spreads between Hong Kong dollar interest rates and US dollar interest rates remained negative. The discount of the three-month HIBOR to the corresponding Euro-dollar deposit rate widened from 20 basis points at end-2009 to 33 basis points at end-June 2010. The *Hong Kong dollar yield curve* flattened during the first half of 2010, reflecting a pick-up in short-dated yields and a fall in long-dated ones. The *US dollar yield curve* flattened even more, as a result of the visible fall in long-dated yields. As a consequence, the yield spread between 10-year US Treasury and 10-year Exchange Fund Notes narrowed from 127 basis points at end-2009 to 68 basis points at end-June 2010, and that between 6-month US Treasury and 6-month Exchange Funds Bills turned from a positive 4 basis points to a negative 40 basis points.

**Diagram 4.1 : Both Hong Kong dollar and US dollar yield curves flattened**



4.3 At the retail level, the *Best Lending Rates* (BLR) were unchanged at 5.00% or 5.25% during the first half of 2010, while the *average savings deposit rate* and one-month *time deposit rate* quoted by major banks likewise held steady at around 0.01%. Yet time deposit rates of longer tenors, such as the six-month and one-year time deposit rates, crawled up towards the end of the second quarter in parallel with the up-tick of HIBOR. These have contributed to a slight increase in the average cost of funds for banks, with the *composite interest rate* rising from a low of 0.11% in December 2009 to 0.20% in June 2010<sup>(2)</sup>. On the mortgage front, loans priced with reference to HIBOR (the rate of which could be as low as one-month HIBOR plus 0.65 percentage point, capped at BLR minus 2.5 percentage points) continued to draw favourable market responses, with the proportion of such loans in newly approved mortgage loans ballooning from 61.6% in December 2009 to 83.9% in June 2010.

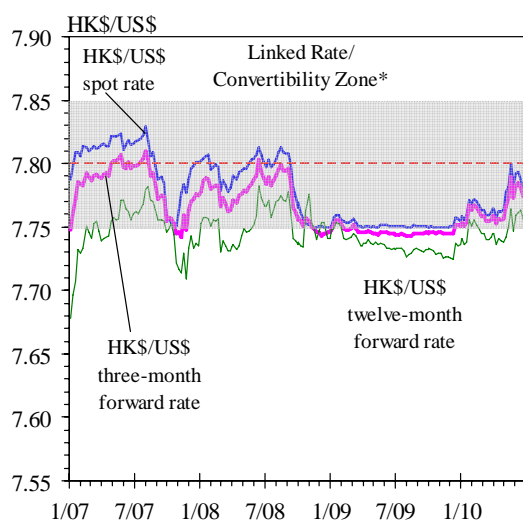
**Diagram 4.2 : Hong Kong dollar interest rates generally stayed low (end for the week)**



4.4 After trading within a narrow range in the first four months of 2010, the Hong Kong dollar spot exchange rate weakened slightly in May and June upon concerns about possible outflow of funds in face of the European debt crisis. The spot exchange rate closed at 7.786 per US dollar at end-June 2010, weakening from 7.756 per US dollar at end-2009. Meanwhile, the discounts of the 3-month and 12-month Hong Kong dollar forward rates closed at 43 and 215 pips (each pip equivalent to HK\$0.0001) respectively at end-June 2010, compared with 48 and 193 pips at end-2009. As a result of the additional issuance of Exchange Fund Bills by the HKMA, the Aggregate Balance declined from \$264.6 billion to \$148.7 billion over the period.

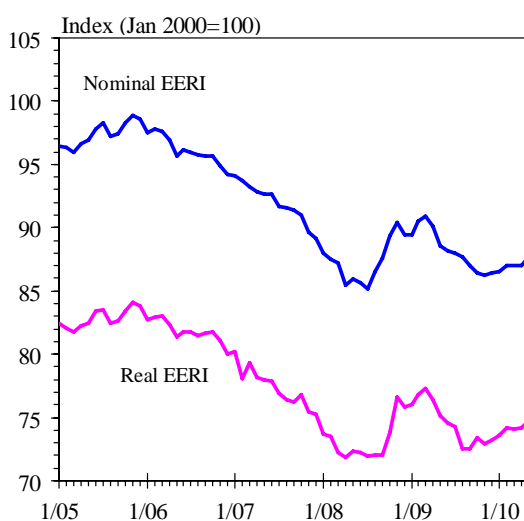
4.5 Under the Linked Exchange Rate system, movements in the Hong Kong dollar exchange rate against other currencies closely followed those of the US dollar. During the first half of 2010, the trade-weighted *Hong Kong dollar Nominal and Real Effective Exchange Rate Indices* rose by 1.9% and 2.6%<sup>(3)</sup>, as the US dollar appreciated against other major currencies, in particular the Euro, amid heightened concerns about the European debt problems.

**Diagram 4.3 : Hong Kong dollar weakened against the US dollar (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.

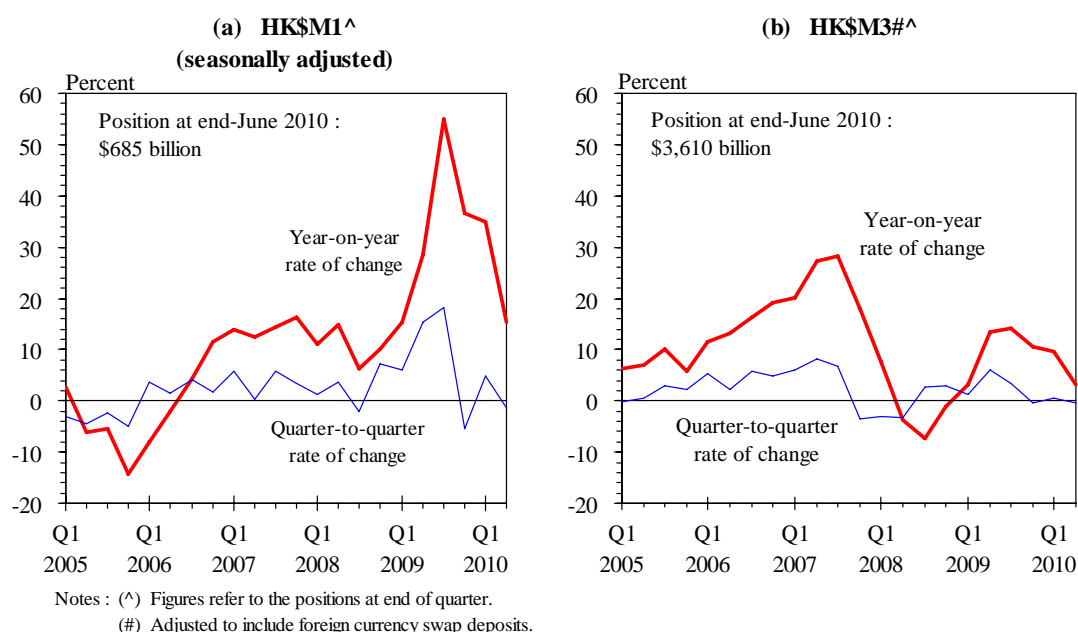
**Diagram 4.4 : Trade-weighted EERIs strengthened further alongside the US dollar (average for the month)**



## Money supply and banking sector

4.6 Hong Kong dollar broad *money supply* (HK\$M3) only edged up by 0.2% from end-2009 to \$3,610 billion at end-June 2010<sup>(4)</sup>. Meanwhile, the seasonally adjusted narrow money supply (HK\$M1) grew by a modest 3.3% to \$685 billion, with the growth occurring entirely during the first quarter. Over the same period, *total deposits* with authorized institutions (AIs) declined slightly by 0.5% to \$6,352 billion<sup>(5)</sup>. Analysed by currency, foreign currency deposits contracted by 0.9% to \$2,981 billion and Hong Kong dollar deposits edged down by 0.1% to \$3,371 billion.

**Diagram 4.5 : Growth momentum of both HK\$M1 and HK\$M3 tapered**



**Table 4.1 : Hong Kong dollar money supply and total money supply**

|                                      |    | <u>M1</u>               |              | <u>M2</u>                 |              | <u>M3</u>                 |              |
|--------------------------------------|----|-------------------------|--------------|---------------------------|--------------|---------------------------|--------------|
| <u>% change during the quarter</u>   |    | <u>HK\$<sup>^</sup></u> | <u>Total</u> | <u>HK\$<sup>(a)</sup></u> | <u>Total</u> | <u>HK\$<sup>(a)</sup></u> | <u>Total</u> |
| 2009                                 | Q1 | 6.1                     | 6.9          | 1.3                       | -0.5         | 1.3                       | -0.6         |
|                                      | Q2 | 15.3                    | 10.1         | 6.1                       | 4.0          | 6.0                       | 4.0          |
|                                      | Q3 | 18.1                    | 19.5         | 3.4                       | 2.4          | 3.3                       | 2.3          |
|                                      | Q4 | -5.5                    | -0.7         | -0.3                      | -0.5         | -0.3                      | -0.6         |
| 2010                                 | Q1 | 4.8                     | 4.7          | 0.4                       | -0.1         | 0.5                       | *            |
|                                      | Q2 | -1.4                    | -4.3         | -0.2                      | -0.3         | -0.4                      | -0.4         |
| Total amount at end-June 2010 (\$Bn) |    | 685                     | 904          | 3,597                     | 6,579        | 3,610                     | 6,600        |
| % change from end-2009               |    | 3.3                     | 0.2          | 0.2                       | -0.4         | 0.2                       | -0.4         |
| % change over a year earlier         |    | 15.3                    | 18.9         | 3.3                       | 1.4          | 3.1                       | 1.3          |

Notes : (^) Seasonally adjusted.

(a) Adjusted to include foreign currency swap deposits.

(\*) Change of less than 0.05%.

4.7 On the back of the entrenched economic recovery, *total loans and advances* grew at a brisk pace in the first half of 2010, particularly in the second quarter. Total loans outstanding expanded by 14.7% over end-2009 to \$3,773 billion at end-June 2010 (comprising Hong Kong dollar loans of \$2,620 billion

and foreign currency loans of \$1,152 billion), the highest level since early 1998. Within the total, loans for use in Hong Kong grew by 12.9% to \$3,020 billion, while loans for use outside Hong Kong recorded an even sharper growth of 22.5% to \$753 billion.

4.8 Domestic loans to most economic sectors went sharply up. Boosted by the equity fund raising activities towards the end of June, loans to stockbrokers at end-June 2010 soared by 111.0% over end-2009. This was followed by notable growth in lending to trade finance, and wholesale and retail trade, of 35.8% and 28.0% respectively. Lending to financial concerns, manufacturing, and building, construction, property development and investment also rose visibly, by 22.0%, 14.6% and 12.3% respectively. As a result of the robust growth in loans against a slight retreat in deposits, the Hong Kong dollar loan-to-deposit ratio rose sharply from 71.2% at end-2009 to 77.7% at end-June 2010.

**Table 4.2 : Loans and advances**

| All loans and advances for use in Hong Kong |    |               |                    |                            |   |   |                    |               |                      |   |                          |
|---|----|---------------|--------------------|----------------------------|---|---|--------------------|---------------|----------------------|---|--------------------------|
| Loans to :                                  |    |               |                    |                            |   |   |                    |               |                      |   |                          |
| % change during the quarter                 |    | Trade finance | Manu-<br>facturing | 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 |
| 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           | -2.6               | 2.0                        | 3.2   | 2.0   | -13.9              | -70.8         | -0.7                 | 5.1   | 0.3                      |
| 2010  | Q1 | 12.8          | 4.9                | 10.6                       | 6.5   | 2.5   | 8.0                | 12.3          | 5.0                  | 7.6   | 5.5                      |
|   | Q2 | 20.3          | 9.3                | 15.7                       | 5.4   | 2.6   | 12.9               | 87.9          | 7.6                  | 13.8  | 8.8                      |
| Total amount at end-June 2010 (\$Bn)        |    | 237           | 155                | 198                        | 767   | 734   | 236                | 26            | 3,020                | 753   | 3,773                    |
| % change from end-2009                      |    | 35.8          | 14.6               | 28.0                       | 12.3  | 5.1   | 22.0               | 111.0         | 12.9                 | 22.5  | 14.7                     |
| % change over a year earlier                |    | 45.4          | 13.8               | 35.4                       | 13.3  | 10.9  | 7.2                | -48.9         | 14.0                 | 35.9  | 17.8                     |

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.

4.9 Hong Kong's banking system remained resilient, with the capital positions of the Hong Kong incorporated AIs staying 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 17% at end-March 2010. Moreover, all individual AIs' CARs were above the statutory minimum ratios as required by the HKMA.

4.10 The Basel Committee issued two consultative documents setting out proposals to strengthen global capital and liquidity standards in December 2009, and subsequently launched a comprehensive impact assessment of its proposals in February 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. As a member of the Basel Committee, the HKMA has been closely involved in the development of the new standards. In line with established policy of adhering to international standards of supervision, the HKMA is also conducting an impact assessment study of the proposals on the local banking sector so as to formulate its implementation plan once the proposals are finalised.

4.11 Asset quality of the local banking sector continued to improve. The ratio of classified loans to total loans declined further to 1.20% at end-March 2010, down for three straight quarters from the recent peak of 1.51% at end-June 2009. Arrears for over three months in credit card repayment followed a similar pattern, declining gradually to 0.32% at end-March 2010 from 0.50% at end-June 2009. Meanwhile, the delinquency ratio for residential mortgage loans, at 0.03% at end-June 2010, was little changed from end-2009.

**Table 4.3 : 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><br>(gross) |
|----------------------------|-------------------|------------------------------|------------------------------------|
| 2009 Q1                    | 96.09             | 2.44                         | 1.47                               |
| Q2                         | 96.14             | 2.35                         | 1.51                               |
| Q3                         | 96.47             | 2.12                         | 1.42                               |
| Q4                         | 96.74             | 1.91                         | 1.35                               |
| 2010 Q1                    | 97.08             | 1.72                         | 1.20                               |

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".

4.12 Renminbi banking business in Hong Kong continued to grow steadily. The outstanding amount of renminbi deposits increased from RMB62.7 billion at end-2009 to RMB89.7 billion at end-June 2010. The increased demand for such deposits was due partly to the expanding scope of renminbi banking business in Hong Kong and partly to the expected revaluation gains following the People's Bank of China's decision to proceed further with the reform of the RMB exchange rate regime and to enhance the currency's exchange rate flexibility<sup>(6)</sup>. Yet renminbi deposits accounted for only about 3.5% of total foreign currency deposits in Hong Kong at end-June 2010.

4.13 The scope of renminbi banking business in Hong Kong expanded further in the first half of 2010. Based on the existing policy framework and having regard to the views of the industry, in February the HKMA issued a circular to elucidate the supervisory principles and operational arrangements regarding renminbi business in Hong Kong, with a view to simplifying banks' operational procedures and increasing flexibility. Further in June, the Mainland authorities announced an expansion of the renminbi trade settlement scheme to cover a total of 20 Mainland provinces and cities. Also, the location of the other leg of the cross-border trades is no longer limited to Hong Kong, Macao and ASEAN (i.e. will cover the whole world). In July, the Settlement Agreement on the Clearing of Renminbi Business ("Clearing Agreement") was revised. Under the revised Clearing Agreement, there will no longer be restrictions on banks in Hong Kong in establishing renminbi accounts for and providing related services to financial institutions, and individuals and corporations will be able to conduct renminbi payments and transfers through the banks. These expansions and developments marked a milestone in the development of offshore renminbi business in the territory and could strengthen Hong Kong's capacity in the provision of renminbi financial intermediation activities.

**Table 4.4 : Renminbi deposits in Hong Kong**

| <u>As at end of period</u>   |    | Demand and savings deposits<br>(RMB Mn) | <u>Time deposits</u><br>(RMB Mn) | <u>Total deposits</u><br>(RMB Mn) | <u>Interest rates on</u> <sup>(a)</sup>       |  | Number of authorised institutions engaged in RMB business |
|------------------------------|----|---|----------------------------------|-----------------------------------|---|--|---|
|                              |    |   |                                  |                                   | <u>Savings deposits</u> <sup>(b)</sup><br>(%) | <u>Three-month time deposits</u> <sup>(b)</sup><br>(%) |   |
| 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  |
| 2010                         | Q1 | 44,609                                  | 26,145                           | 70,755                            | 0.46  | 0.68   | 73  |
|                              | Q2 | 52,426                                  | 37,275                           | 89,702                            | 0.46  | 0.68   | 77  |
| % change over a year earlier |    | 45.9                                    | 102.0                            | 65.0                              | 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

4.14 The Hong Kong dollar debt market continued to expand during the first half of 2010, driven by the remarkable growth in public sector debt. Total gross issuance of Hong Kong dollar debt securities in the period grew by 126.7% over a year earlier to \$979.5 billion. Within the total, issuance of Exchange Fund Bills and Notes soared by 177.7% to \$893.9 billion, or 91.3% of all new debt issuance, due to the increased supply of short-dated Exchange Fund papers to meet the strong demand by banks for liquidity management. On the other hand, the issuance of Hong Kong dollar debt by the private sector (comprising AIs, local corporations and overseas borrowers excluding the multilateral development banks) declined by 13.4% to \$68.4 billion. At end-June 2010, the total outstanding balance of Hong Kong dollar debt soared to a record level of \$1,220.8 billion, up by 9.8% from end-2009<sup>(7)</sup>. This was equivalent to 33.8% of HK\$M3 or 26.7% of Hong Kong dollar-denominated assets of the entire banking sector<sup>(8)</sup>.

4.15 Under the Institutional Bond Issuance Programme of the Government Bond Programme, a total of four tenders were completed in the first half of 2010, namely a ten-year bond of an issue size of \$2.5 billion in January, a two-year bond of \$3.5 billion in March, a ten-year re-opening of existing bond of \$3 billion in May, and a five-year re-opening of existing bond of \$1.5 billion in June. These issues were all greeted with favourable responses by investors. At end-June 2010, the total outstanding size of institutional bonds was \$16 billion.

**Table 4.5 : New issuance and outstanding value of Hong Kong dollar debt securities (\$Bn)**

|  |                                    | Exchange<br>Fund paper | Statutory<br>bodies/govern<br>ment-owned<br>corporations | Govern-<br>ment | Public<br>sector<br>total | AIs <sup>(a)</sup> | Local<br>corporations | Non-MDBs<br>overseas<br>borrowers <sup>(b)</sup> | Private<br>sector<br>total | MDBs <sup>(b)</sup> | Total   |
|--|------------------------------------|------------------------|--|-----------------|---------------------------|--------------------|-----------------------|--|----------------------------|---------------------|---------|
| <b>New issuance</b>                      |                                    |                        |  |                 |                           |                    |                       |  |                            |                     |         |
| 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   |
| 2010                                     | Q1                                 | 437.4                  | 2.8  | 6.0             | 446.2                     | 20.5               | 4.3                   | 13.8   | 38.6                       | -                   | 484.9   |
|  | Q2                                 | 456.5                  | 3.6  | 4.5             | 464.6                     | 17.9               | 3.2                   | 8.7  | 29.8                       | 0.3                 | 494.6   |
|  | During the first<br>half of 2010   | 893.9                  | 6.3  | 10.5            | 910.8                     | 38.5               | 7.5                   | 22.5   | 68.4                       | 0.3                 | 979.5   |
|  | % change<br>over a year<br>earlier | 177.7                  | -67.1  | N.A.            | 167.0                     | 86.7               | -2.2                  | -55.7  | -13.4                      | -97.4               | 126.7   |
| <b>Outstanding (as at end of period)</b> |                                    |                        |  |                 |                           |                    |                       |  |                            |                     |         |
| 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 |
| 2010                                     | Q1                                 | 612.5                  | 68.0   | 13.0            | 693.5                     | 90.7               | 82.6                  | 304.9  | 478.2                      | 21.1                | 1,192.8 |
|  | Q2                                 | 651.4                  | 65.0   | 17.5            | 733.9                     | 94.0               | 84.1                  | 290.3  | 468.4                      | 18.4                | 1,220.8 |
|  | % change from<br>end-2009          | 22.0                   | -6.8   | 150.0           | 20.2                      | 11.0               | 5.9                   | -7.0   | -1.6                       | -24.4               | 9.8     |
|  | % change<br>over a year<br>earlier | 125.8                  | -4.5   | 250.0           | 103.0                     | 16.1               | 16.9                  | -10.1  | -1.6                       | -27.8               | 41.5    |

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

(a) AIs : Authorised institutions.

(b) MDBs : Multilateral Development Banks.

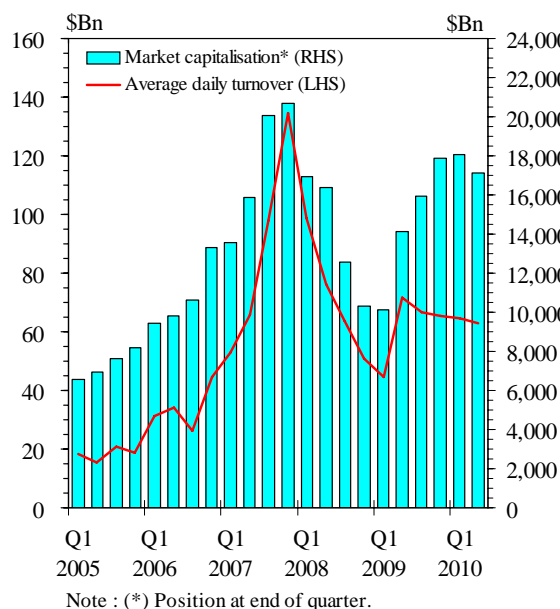
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## The stock and derivatives markets

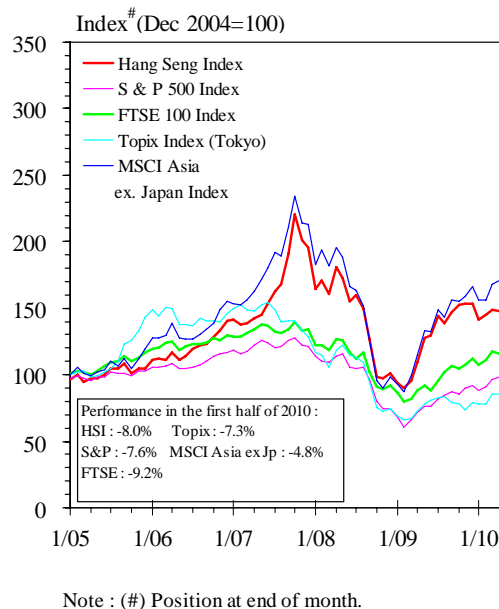
4.16 The *local stock market* showed some consolidation in the first half of 2010, as concerns about the European debt problems and possible exit of expansionary monetary policy in the major economies led to cautious market sentiment. The *Hang Seng Index* (HSI) fell by 8.0% from end-2009 to close at 20 129 at end-June 2010, with noticeable fluctuations from time to time alongside similar gyrations in other major stock markets. Trading activities turned quieter in tandem, with the *average daily turnover* declining by 3.4% from the second half of 2009 to \$63.8 billion in the first half of 2010, albeit rising by 9.5% over the low base a year earlier.

4.17 As a result of the consolidation, the *market capitalisation* shrank by 4.2% from end-2009 to \$17.1 trillion at end-June 2010. Yet according to the *World Federation of Exchanges*, the local bourse rose to the sixth largest in the world and second largest in Asia due to the even larger falls in other markets<sup>(9)</sup>. Fund raising activities were relatively quiet in early 2010, but have rebounded sharply since late June. Reflecting the subdued activities in the earlier months, *equity capital* raised through new share floatations and post-listing arrangements on the Main Board and the Growth Enterprise Market (GEM) fell to \$160.6 billion in the first half of 2010 taken together, down by 62.2% from the relatively high base in the second half of 2009 or 26.2% from a year earlier. Within the total, funds raised from initial public offerings plummeted by 78.2% from the second half of 2009, but rose by 185.1% over the low base a year earlier<sup>(10)</sup>.

**Diagram 4.6 : The local stock market consolidated in the first half of 2010**



**Diagram 4.7 : The Hong Kong and major overseas stock markets showed comparable performance**



4.18 Mainland enterprises continued to play a prominent role in the local stock market. At end-June 2010, a total of 540 Mainland enterprises (including 156 H-share companies, 97 “Red Chips” companies and 287 private enterprises) were listed on the Main Board and GEM, representing 40% of the total number of listed companies and 59% of the total market capitalisation. In the first half of 2010, Mainland-related stocks accounted for 69% of equity turnover and 48% of total equity fund raised in the Hong Kong stock exchange.

4.19 In contrast to the setback in overall trading activities, trading of *derivatives* products picked up. The average daily trading volume of futures and options in the first half of 2010 rose sharply by 16.3% over the second half of 2009 or 4.6% over a year earlier<sup>(11)</sup>. The different types of product showed mixed performance though. While trading of HSI options rose by a sharp 60.2% and that of stock options by a moderate 7.5% over a year earlier, trading of HSI futures and H-shares Index futures fell by 4.3% and 7.1% respectively. As to securitised derivatives, the average daily trading value in the first half of 2010 rose by 1.9% from the second half of 2009 or a more visible 10.8% over a year earlier. Within the total, trading of derivative warrants soared by 54.9% over a year earlier, more than offsetting the 28.3% plunge in trading of callable bull/bear contracts.

**Table 4.6 : Average daily turnover of derivatives products  
of the Hong Kong market**

|      |  | Hang Seng<br>Index<br><u>futures</u> | Hang Seng<br>Index<br><u>options</u> | H-shares<br>Index<br><u>futures</u> | Stock<br><u>options</u> | Total<br>futures and<br>options<br><u>traded</u> <sup>*</sup> | Derivative<br>warrants<br>(\$Mn) | Callable<br>bull/bear<br>contracts<br>(\$Mn) | Total<br>securitised<br>derivatives<br>traded<br>(\$Mn) <sup>^</sup> |
|------|--|--------------------------------------|--------------------------------------|-------------------------------------|-------------------------|---|----------------------------------|--|--|
| 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   |
| 2010 | Q1                                     | 84 138                               | 29 731                               | 48 617                              | 205 581                 | 417 305   | 9,646                            | 4,757  | 14,402   |
|      | Q2                                     | 83 863                               | 32 252                               | 53 719                              | 237 708                 | 461 361   | 8,972                            | 4,994  | 13,966   |
|      | % change in<br>2010 H1 over<br>2009 H1 | -4.3                                 | 60.2                                 | -7.1                                | 7.5                     | 4.6   | 54.9                             | -28.3  | 10.8   |
|      | % change in<br>2010 H1 over<br>2009 H2 | 5.2                                  | 29.4                                 | 12.9                                | 24.5                    | 16.3  | 28.5                             | -26.9  | 1.9  |

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.

## Fund management and investment funds

4.20 Fund management business remained generally solid in the first half of 2010. Gross retail sales of *mutual funds* surged by 147.5% over the low base a year earlier or 28.6% over the second half of 2009 to US\$12.7 billion in the first half of 2010<sup>(12)</sup>. Retail hedge funds business also posted a decent performance so far this year<sup>(13)</sup>. The aggregate net asset value of the approved constituent funds under the *MPF schemes*, at \$308 billion at end-June 2010, stayed virtually unchanged from end-2009<sup>(14)</sup>.

4.21 The Securities and Futures (Levy) (Amendment) Order 2010, which provides for a 25% reduction of the levy payable in respect of trading in securities, futures or options contracts, was passed in May and will take effect on 1 October 2010. The levy reduction will help reduce the transaction cost borne by investors and is thus conducive to the development of the securities and futures markets.

## Insurance sector

4.22 The *insurance sector* continued to recover from the global financial crisis. Gross premium income from long-term business in the first quarter of 2010 jumped by 50.0% from the low base a year earlier<sup>(15)</sup>. Within the total, premium income from non-linked plans showed a solid 40.3% gain. On the other hand, while premium income from investment-linked plans surged by 82.1%, it was still far below the pre-crisis level in early 2008. For general business, gross premium in the first quarter rose by 16.2% over a year earlier but underwriting profit went down by 19.5%.

4.23 In July 2010, the Government commenced a three-month public consultation on the proposed establishment of an independent insurance authority (IIA). In line with international regulatory practices, the proposed IIA will be financially and operationally independent of the Government. In lieu of the existing self-regulatory system, IIA will supervise the conduct of insurance intermediaries directly through introducing a licensing regime. Replacing the current Office of the Commissioner of Insurance, it would be given the regulatory powers to conduct inspections and investigations, and impose supervisory sanctions against breaches. The proposed set up of the IIA would enable better regulation of insurers and insurance intermediaries, and thus help enhance protection for insurance policyholders.

**Table 4.7 : Insurance business in Hong Kong\* (\$Mn)**

|                                  | General business |             |                     | Premium for long-term business <sup>^</sup> |                                      |                           |                                      |                        | Gross premium from long-term business and general 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 |  |
| 2009 Annual                      | 28,550           | 20,512      | 2,209               | 30,965                                      | 15,066                               | 279                       | 207                                  | 46,517                 | 75,067   |
| 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   |
| Q4                               | 7,016            | 4,890       | 245                 | 8,044                                       | 4,459                                | 84                        | 28                                   | 12,615                 | 19,631   |
| 2010 Q1                          | 9,230            | 6,460       | 559                 | 8,729                                       | 4,002                                | 33                        | 54                                   | 12,818                 | 22,048   |
| % change in 2010 Q1 over 2009 Q1 | 16.2             | 14.4        | -19.5               | 40.3  | 82.1                                 | -38.9                     | -21.7                                | 50.0                   | 33.8   |

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

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

## **Some highlights of market developments**

4.24 With effect from 1 January 2011, market access to the Mainland for the banking and securities services sector of Hong Kong will be further enhanced under Supplement VII to CEPA signed in May 2010. For banking services, Hong Kong banks that have maintained representative offices in the Mainland for more than one year can apply for setting up a wholly foreign-funded bank or a foreign bank branch, and their operating institutions in the Mainland can apply for conducting renminbi business if they have been operating for more than two years and profitable for one year. In addition, foreign banking institutions established in the Mainland by Hong Kong banks can set up specialised institutions to provide financial services to small enterprises. For securities services, open-end index-tracking exchange traded funds constituted by Hong Kong listed stocks will be launched in the Mainland at an appropriate time.

4.25 The Legislative Council passed the Deposit Protection Scheme (Amendment) Bill 2010 in June. Under the enhanced Deposit Protection Scheme (DPS), which will take effect after the expiry of the full deposit guarantee at end-2010, the protection limit would be raised from \$100,000 to \$500,000. The higher limit would fully cover about 90% of depositors, on par with the higher end of international standards in terms of percentage of depositors fully covered. In addition, the scheme's coverage would also be expanded to include secured deposits.

### **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-June 2010, there were 146 licensed banks, 24 restricted licence banks and 27 deposit-taking companies in Hong Kong. Altogether, 197 AIs (excluding representative offices) from 30 countries and territories (including Hong Kong) had a presence in Hong Kong.
- (6) On 19 June 2010, the People's Bank of China announced the decision to proceed further with reform of the RMB exchange rate regime and to enhance the RMB exchange rate flexibility. In further proceeding with reform of the RMB exchange rate regime, continued emphasis would be put on reflecting market supply and demand with reference to a basket of currencies. The daily exchange rate floating bands, at 0.5%, remains the same as previously announced in the inter-bank foreign exchange market.
- (7) The figures for private sector debt may not represent a full coverage of all the Hong Kong dollar debt paper issued.
- (8) 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.
- (9) 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 6 August 2010), covering almost all globally recognised stock exchanges.

- (10) At end-June 2010, there were 1 170 and 174 companies listed on the Main Board and GEM respectively.
- (11) At end-June 2010, there were 51 classes of stock options contracts and 38 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 cover only the active authorised funds that have responded to the survey. At end-June 2010, the survey covered a total of 1 136 active authorised funds.
- (13) At end-June 2010, there were 11 SFC-authorised retail hedge funds with combined net asset size of US\$731 million. The amount of net assets under management was 7.7% higher than the end-2009 level and more than four times of that at end-2002, the year when the hedge funds guidelines were first issued.
- (14) At end-June 2010, there were 19 approved trustees. On MPF products, 36 master trust schemes, two industry schemes and one employer sponsored scheme, comprising altogether 376 constituent funds, were approved by the Mandatory Provident Fund Schemes Authority. A total of 238 000 employers, 2.20 million employees and 262 000 self-employed persons have participated in MPF schemes.
- (15) At end-June 2010, there were 170 authorised insurers in Hong Kong. Within this total, 46 were engaged in long-term insurance business, 105 in general insurance business, and 19 in composite insurance business. These authorised insurers come from 22 countries and territories (including Hong Kong).