

CHAPTER 5 : THE FINANCIAL SECTOR[#]

Summary

- *The low interest rate environment in Hong Kong continued throughout 2010 amid the ongoing accommodative monetary policy in the United States. Interest rates on both wholesale and retail fronts continued to stay at historically low levels.*
- *The Hong Kong dollar spot exchange rate moved within a narrow range of 7.749 to 7.805 per US dollar in 2010. Meanwhile, the Hong Kong dollar Effective Exchange Rate Indices declined alongside the weakening of the US dollar against most major currencies.*
- *Supported by the entrenched economic recovery and buoyant equity fund raising activities, the monetary aggregates expanded further in 2010. Lending to all major economic sectors grew at a brisk pace.*
- *Following the consolidation in the first eight months of 2010, the local stock market picked up visibly starting September, underpinned by the strong growth in the emerging economies especially in the Mainland and a second round of quantitative easing measures in the major economies. Fund raising activities staged a strong performance in 2010, with the equity capital raised from Initial Public Offerings reaching a record high.*
- *In 2010, the financial services industry made notable headways on various fronts. There were a series of policy breakthroughs regarding renminbi business in Hong Kong. Significant progress was also made in investor and deposit protection, market regulation and cross-boundary co-operation.*

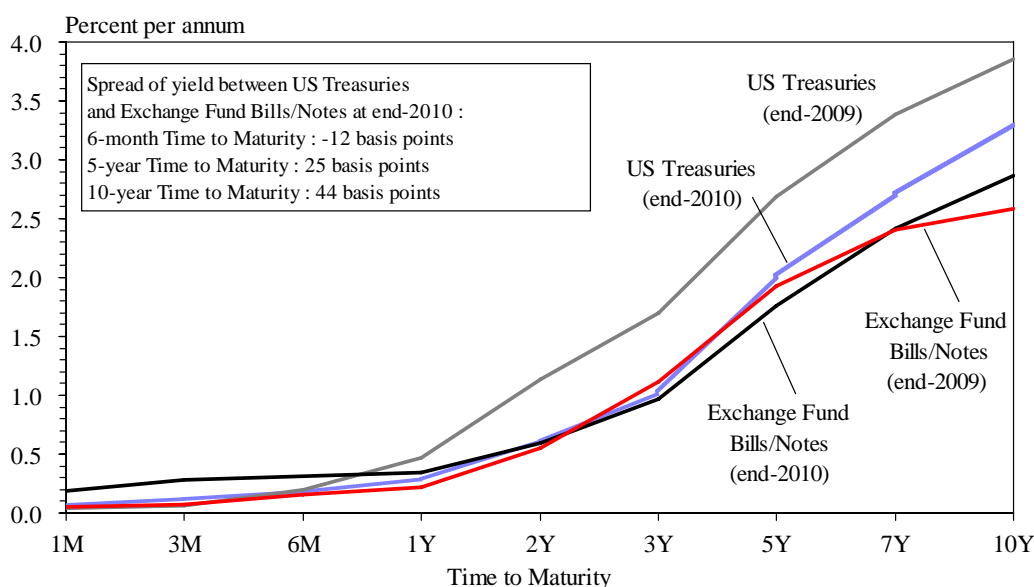
(#) *This chapter is jointly prepared by the Hong Kong Monetary Authority (HKMA) and the Economic Analysis Division.*

Interest rates and exchange rates

5.1 The low interest rate environment in Hong Kong continued throughout 2010 amid the ongoing accommodative monetary policy in the United States. With the US Federal Funds Target Rate staying at 0-0.25%, the *Base Rate* under the Discount Window operated by the HKMA was unchanged at 0.5%⁽¹⁾. The *Hong Kong dollar interbank interest rates* were broadly stable during the year except for a brief uptick in June. Between end-2009 and end-2010, the overnight HIBOR ended up unchanged at 0.13% while the three-month HIBOR edged up from 0.13% to 0.33%.

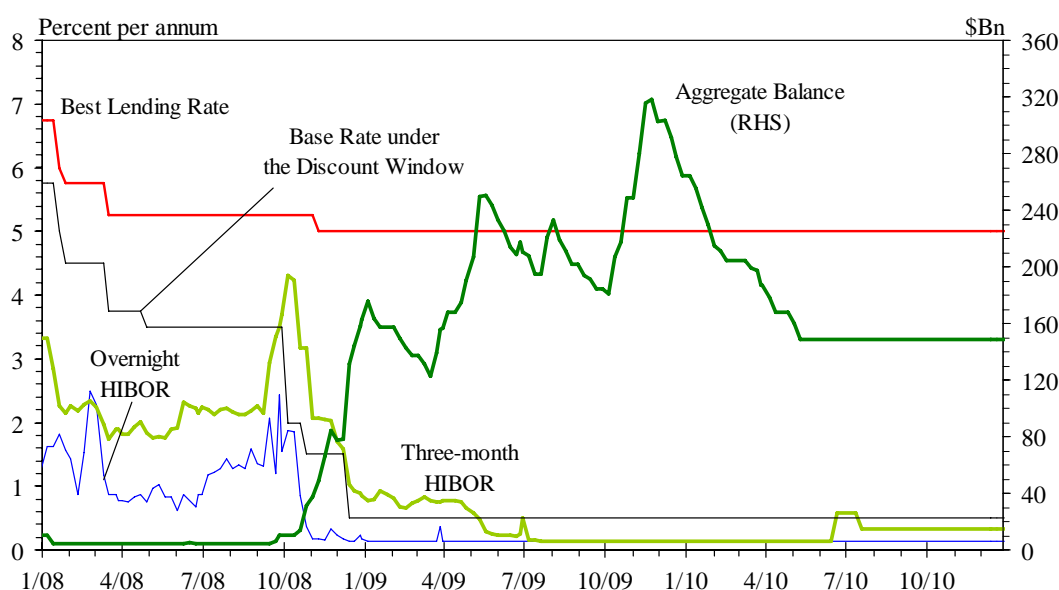
5.2 Hong Kong dollar interest rates continued to stay below their US dollar counterparts, but the negative spreads gradually narrowed in the second half, with the discount of the three-month HIBOR to the corresponding Euro-dollar deposit rate dwindling from 20 basis points at end-2009 to seven basis points at end-2010. Meanwhile, *Hong Kong dollar yields* rose at both the short-end and the long-end, while the *US dollar yield curve* flattened noticeably. As a result, the yield spread between 6-month US Treasury and 6-month Exchange Funds Bills turned from a premium of four basis points at end-2009 to a discount of 12 basis points at end-2010, while the premium between 10-year US Treasury and 10-year Exchange Fund Notes shrank sharply from 127 basis points to 44 basis points.

Diagram 5.1 : Hong Kong dollar yield curve rose at both the short-end and the long-end, while the US dollar yield curve flattened noticeably



5.3 Likewise, interest rates on the retail front remained stable at historically low levels. The *Best Lending Rates* (BLR) stayed unchanged at 5.00% or 5.25% throughout the year. The *average savings deposit rate* and one-month *time deposit rate* quoted by major banks also held steady at around 0.01%. In parallel to the movement of the corresponding HIBOR, the one-year time deposit rate edged up in June before reverting to 0.15% towards the end of the year, the same level a year earlier. Yet the *composite interest rate*, which reflects the average cost of funds for banks, crept up from 0.11% at end-2009 to 0.21% at end-2010⁽²⁾. Meanwhile, mortgage borrowers continued to take advantage of the low interest rates offered by loans priced with reference to HIBOR (the rate of which can be as low as one-month HIBOR plus 0.65 percentage point in mid-November), with the share of such loans in newly approved mortgage loans surging from 61.6% in December 2009 to 90.0% in December 2010.

**Diagram 5.2 : Hong Kong dollar interest rates continued to stay low
(end for the week)**

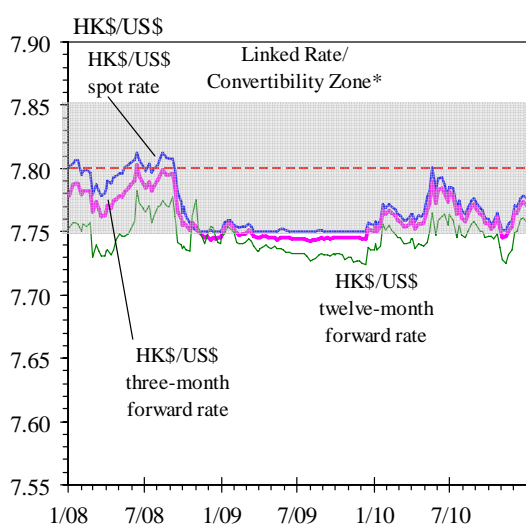


5.4 In 2010, the Hong Kong dollar spot exchange rate moved within a narrow range of 7.749 to 7.805 per US dollar. Notwithstanding a brief weakening around the middle of the year amid possible capital outflows induced by heightened concerns about the European debt crisis, it showed renewed strength thereafter on the back of strong demand associated with the vibrant Initial Public Offerings (IPOs) activities. Between end-2009 and end-2010, the Hong Kong dollar spot exchange rate softened slightly from 7.756 to 7.775. Over the same period, the discount of the *3-month Hong Kong dollar forward rate* widened from 48 pips to 57 pips (each pip equivalent to HK\$0.0001), while the discount of the *12-month Hong Kong dollar forward*

rate narrowed slightly from 193 pips to 191 pips.

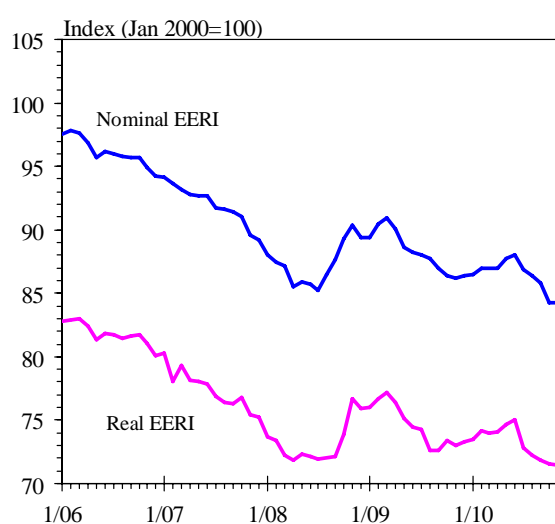
5.5 Under the Linked Exchange Rate system, movements in the Hong Kong dollar exchange rates against other currencies closely followed those of the US dollar. In 2010, the US dollar strengthened against the Euro and the British Pound amid concerns about the European debt problem but weakened further against most other currencies, especially the Australian dollar and the Japanese Yen. As a result, in December 2010 the trade-weighted *Hong Kong dollar Nominal* and *Real Effective Exchange Rate Indices* declined by 2.2% and 2.1% respectively from a year earlier⁽³⁾.

Diagram 5.3 : Hong Kong dollar moved within a narrow range 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 5.4 : Trade-weighted EERIs declined further alongside the weaker US dollar (average for the month)



Money supply and banking sector

5.6 Supported by the ongoing economic recovery and buoyant equity fund raising activities, the monetary aggregates expanded further in 2010. The seasonally adjusted Hong Kong dollar narrow *money supply* (HK\$M1) rose by 8.8% over a year earlier to \$717 billion at end-2010, and the broad money supply (HK\$M3) by 7.6% to \$3,878 billion⁽⁴⁾. Over the period, *total deposits* with authorized institutions (AIs) expanded by 7.5% to \$6,862 billion⁽⁵⁾, among which Hong Kong dollar deposits rose by 7.2% to \$3,617 billion and foreign currency deposits by 7.9% to \$3,245 billion.

Diagram 5.5 : Both HK\$M1 and HK\$M3 expanded further in 2010

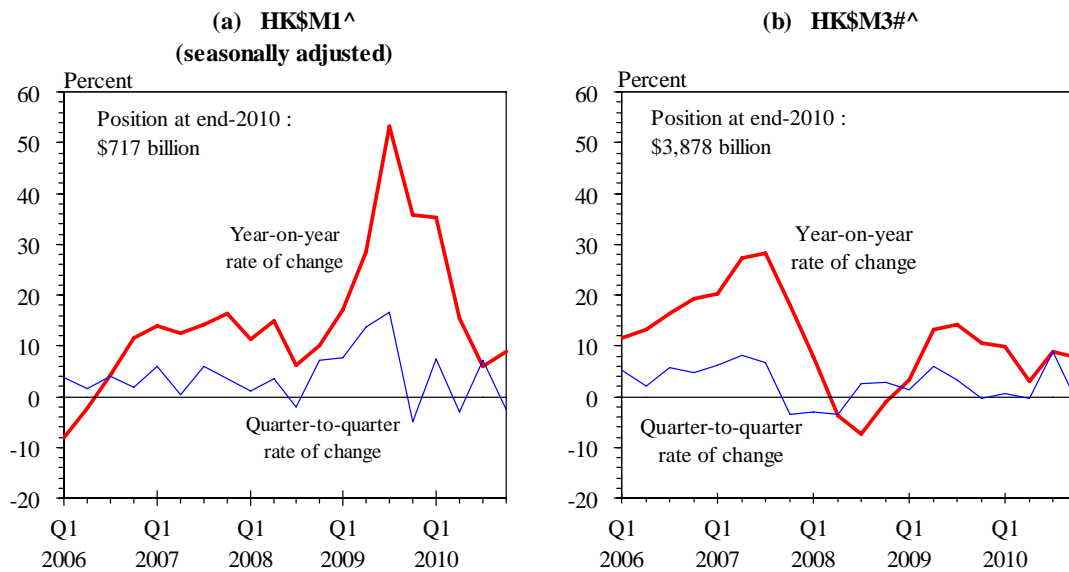


Table 5.1 : Hong Kong dollar money supply and total money supply

| % change during the quarter | | <u>M1</u> | | <u>M2</u> | | <u>M3</u> | |
|---------------------------------|----|-------------------------|--------------|---------------------------|--------------|---------------------------|--------------|
| | | <u>HK\$[^]</u> | <u>Total</u> | <u>HK\$^(a)</u> | <u>Total</u> | <u>HK\$^(a)</u> | <u>Total</u> |
| 2009 | Q1 | 7.7 | 6.9 | 1.3 | -0.5 | 1.3 | -0.6 |
| | Q2 | 13.7 | 10.1 | 6.1 | 4.0 | 6.0 | 4.0 |
| | Q3 | 16.7 | 19.5 | 3.4 | 2.4 | 3.3 | 2.3 |
| | Q4 | -5.0 | -0.7 | -0.3 | -0.5 | -0.3 | -0.6 |
| 2010 | Q1 | 7.4 | 4.7 | 0.4 | -0.1 | 0.5 | * |
| | Q2 | -3.0 | -4.3 | -0.2 | -0.3 | -0.4 | -0.4 |
| | Q3 | 7.1 | 19.1 | 9.0 | 6.2 | 8.9 | 6.2 |
| | Q4 | -2.6 | -5.4 | -1.3 | 2.1 | -1.4 | 2.1 |
| Total amount at end-2010 (\$Bn) | | 717 | 1,017 | 3,867 | 7,136 | 3,878 | 7,156 |
| % change over a year earlier | | 8.8 | 12.8 | 7.8 | 8.1 | 7.6 | 8.0 |

Notes : (^) Seasonally adjusted.

(a) Adjusted to include foreign currency swap deposits.

(*) Change of less than 0.05%.

5.7 After staying virtually flat in 2009, *total loans and advances* jumped by 28.6% over a year earlier to a 13-year high of \$4,227 billion at end-2010 (comprising Hong Kong dollar loans of \$2,824 billion and foreign currency loans of \$1,403 billion). Within the total, loans for use in Hong Kong rebounded by 25.1% to \$3,316 billion, while loans for use outside Hong Kong surged by 42.8% to \$911 billion.

5.8 Supported by the entrenched economic recovery, lending to all major economic sectors expanded at a brisk pace. Trade finance and loans to wholesale and retail trade surged by 56.7% and 52.8% respectively alongside the strong external trade performance. Loans to stockbrokers and financial concerns, and loans for purchase of residential flats also recorded impressive growth, on the back of active equity fund raising activities and a buoyant residential property market. Reflecting the brisk growth in loans against the moderate expansion in deposits, the Hong Kong dollar loan-to-deposit ratio rebounded visibly from 71.2% at end-2009 to 78.1% at end-2010.

Table 5.2 : Loans and advances

| All loans and advances for use in Hong Kong | | | | | | | | | | | |
|---|----|---------------|--------------------|---------------------------------------|--|--|-----------------------|-------------------|---|------|--------------------------|
| | | Loans to : | | | | | | | All loans and advances for use outside Hong Kong ^(c) | | Total loans and advances |
| % 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) | | |
| 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 | -7.7 | 1.4 | 2.9 | 2.0 | -15.7 | -70.8 | -1.6 | 9.2 | 0.3 |
| 2010 | Q1 | 12.2 | 3.4 | 10.2 | 6.8 | 2.5 | 7.1 | 12.3 | 4.8 | 8.3 | 5.5 |
| | Q2 | 19.8 | 10.1 | 15.3 | 5.6 | 2.6 | 13.3 | 87.9 | 7.5 | 14.0 | 8.8 |
| | Q3 | 9.1 | 7.5 | 13.3 | 6.1 | 5.2 | 3.5 | 316.3 | 9.3 | 9.6 | 9.4 |
| | Q4 | 6.8 | 8.7 | 6.1 | 3.8 | 3.0 | 3.0 | -83.1 | 1.6 | 5.6 | 2.5 |
| Total amount at end-2010 (\$Bn) | | 274 | 170 | 236 | 845 | 795 | 246 | 18 | 3,316 | 911 | 4,227 |
| % change over a year earlier | | 56.7 | 33.2 | 52.8 | 24.1 | 13.9 | 29.4 | 48.5 | 25.1 | 42.8 | 28.6 |

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.

5.9 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 16.1% at end-September 2010. All individual AIs' CARs were above the statutory minimum ratios as required by the HKMA.

5.10 With a view to strengthening the resilience of the global banking system and reducing the probability and severity of banking crises in future, in December the Basel Committee issued the final text of Basel III rules text, setting out the details of the new global regulatory standards on bank capital adequacy and liquidity⁽⁶⁾. To meet the requirement to implement Basel III starting 2013, the HKMA will consider its approach and timeline of implementation of the various measures in consultation with the industry.

5.11 Based on the results of the Quantitative Impact Study on the Basel III consultative proposals conducted by the HKMA, banks in Hong Kong are expected to have little difficulty in meeting the higher capital requirements, given that they are well-capitalised with common equity accounting for a major portion of their capital, and that most of the Basel III regulatory adjustments have been deducted from Tier 1 capital under Hong Kong's existing capital rules.

5.12 Asset quality of the local banking sector continued to improve. The ratio of classified loans to total loans declined further from 1.37% at end-2009 to 0.84% at end-September 2010, and the delinquency ratio for credit card lending from 0.34% to a record low of 0.22%. Likewise, the delinquency ratio for residential mortgage loans edged down from 0.03% at end-2009 to 0.01% at end-2010.

Table 5.3 : 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> (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 | 1.88 | 1.37 |
| 2010 Q1 | 97.08 | 1.72 | 1.20 |
| Q2 | 97.50 | 1.53 | 0.96 |
| Q3 | 97.72 | 1.43 | 0.84 |

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 There were a series of significant policy breakthroughs regarding renminbi business in Hong Kong in 2010. 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. In July, the Settlement Agreement on the Clearing of Renminbi Business (“Clearing Agreement”) was revised. Under the revised Clearing Agreement, there are no longer restrictions on banks in Hong Kong in establishing renminbi accounts for and providing related services to financial institutions, and individuals and corporations are able to conduct renminbi payments and transfers through the banks. Subsequently, the pilot scheme for Renminbi Clearing Bank and other eligible institutions outside the Mainland to invest in the Mainland’s interbank bond market was announced in August, and the HKMA’s eligibility to invest in the Mainland interbank bond market was approved in December. These developments represented significant headways in the development of offshore renminbi business in Hong Kong and could strengthen the territory’s capacity in the provision of renminbi financial intermediation and other services.

5.14 On cross-border trade settlement, in June the Mainland authorities announced an expansion of the renminbi trade settlement scheme to cover trade transactions of 20 Mainland provinces and cities with the rest of the world. In December the Mainland authorities announced to further expand the list of Mainland enterprises eligible for participating in the settlement scheme, substantially boosting the number of eligible enterprises from 365 to 67 359. As a result of the continued expansion of the renminbi trade settlement scheme,

the value of *cross-border renminbi trade settlement* in Hong Kong soared from a meagre RMB1.9 billion in 2009 to RMB369.2 billion in 2010.

5.15 *Total renminbi deposits* in Hong Kong continued to grow significantly, partly due to the increase in renminbi receipts by corporate customers through trade settlement transactions and partly due to the widespread appreciation expectation following 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 in June⁽⁷⁾. The outstanding amount of renminbi deposits jumped from RMB62.7 billion at end-2009 to a historic high of RMB314.9 billion at end-2010. As a result, the share of renminbi deposits to total foreign currency deposits soared from 2.4% to 11.5%.

5.16 Meanwhile, the growing pool of renminbi liquidity has provided an impetus to the development of Hong Kong as an offshore renminbi financing platform. In 2010, a wide spectrum of issuers including local and foreign corporations, Hong Kong branches of foreign banks, international financial institutions and the Ministry of Finance, issued 16 renminbi bonds in Hong Kong, raising a total of RMB36 billion. These issuances were greeted with favourable market responses from both retail and institutional investors.

**Table 5.4 : Renminbi deposits and cross-border renminbi trade settlement
in Hong Kong**

| <u>As at end of period</u> | | Demand and savings <u>deposits</u> (RMB Mn) | Time <u>deposits</u> (RMB Mn) | Total <u>deposits</u> (RMB Mn) | <u>Interest rates on</u> ^(a) | | Number of authorized institutions engaged in RMB <u>business</u> | Amount of cross-border RMB <u>trade settlement</u> ^(c) (RMB Mn) |
|---------------------------------|----|--|-------------------------------------|--------------------------------------|---|--|--|---|
| | | | | | <u>Savings deposits</u> ^(b) (%) | <u>Three-month time deposits</u> ^(b) (%) | | |
| 2009 | Q1 | 35,166 | 17,944 | 53,110 | 0.46 | 0.64 | 39 | N.A. |
| | Q2 | 35,924 | 18,457 | 54,381 | 0.46 | 0.64 | 40 | N.A. |
| | Q3 | 40,559 | 17,616 | 58,174 | 0.46 | 0.66 | 44 | 97 |
| | Q4 | 40,662 | 22,056 | 62,718 | 0.46 | 0.67 | 60 | 1,757 |
| 2010 | Q1 | 44,609 | 26,145 | 70,755 | 0.46 | 0.68 | 73 | 4,163 |
| | Q2 | 52,426 | 37,275 | 89,702 | 0.46 | 0.68 | 77 | 22,974 |
| | Q3 | 71,947 | 77,378 | 149,326 | 0.46 | 0.68 | 92 | 78,856 |
| | Q4 | 117,573 | 197,365 | 314,938 | 0.46 | 0.68 | 111 | 263,238 |
| % change over a year earlier | | 189.1 | 794.8 | 402.2 | N.A. | N.A. | N.A. | N.A. |

- Notes :
- (a) The interest rates are based on a survey conducted by the HKMA.
 - (b) Period average figures.
 - (c) Figures during the period. The RMB cross-border settlement scheme commenced in July 2009 and hence it is not appropriate to compare the figure in the fourth quarter of 2010 against the low base a year earlier.

N.A. Not available.

The debt market

5.17 Driven by the robust growth in public sector debt, the Hong Kong dollar debt market expanded further in 2010. Total gross issuance of Hong Kong dollar debt securities leapt by another 60.7% to \$1,996.0 billion in 2010. Issuance of Exchange Fund Bills and Notes amounted to a hefty \$1,816.8 billion or 91% of the total, due to the increased supply of short-dated Exchange Fund papers to meet the banks' continued demand for liquidity management. Meanwhile, Hong Kong dollar debt issued by AIs, local corporations and overseas borrowers excluding the multilateral development banks edged up by 2.3% to \$149.2 billion. At end-2010, the total outstanding balance of Hong Kong dollar debt rose noticeably by 12.4% over a year earlier to a new high of \$1,248.8 billion⁽⁸⁾, equivalent to 32.2% of HK\$M3 or 26.3% of Hong Kong dollar-denominated assets of the entire banking sector⁽⁹⁾.

5.18 As regards the Government Bond ("GB") Programme, a total of \$18.5 billion worth of GBs were issued under seven tenders in 2010, including \$7 billion 2-year GBs in two tenders, \$4 billion 5-year GBs in two tenders and \$7.5 billion 10-year GBs in three tenders. The tenders received favourable market responses from a diversified range of investors such as banks, investment funds, pension funds and insurance companies. The daily turnover of institutional GBs averaged at \$1.83 billion in the year, equivalent to a turnover ratio of 11.7%⁽¹⁰⁾, and the total outstanding size of institutional GBs was \$24 billion at end-2010.

Table 5.5 : 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 ^(a) | Local corporations | Non-MDBs overseas borrowers ^(b) | Private sector total | MDBs ^(b) | Total |
|--|--------|------------------------|--|-----------------|---------------------------|--------------------|-----------------------|--|----------------------------|---------------------|---------|
| New issuance | | | | | | | | | | | |
| 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 | Annual | 1,816.8 | 11.2 | 18.5 | 1,846.4 | 85.0 | 13.4 | 50.8 | 149.2 | 0.3 | 1,996.0 |
| | 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 |
| | Q3 | 458.7 | 1.2 | 3.5 | 463.4 | 21.4 | 2.8 | 15.7 | 39.8 | - | 503.2 |
| | Q4 | 464.1 | 3.6 | 4.5 | 472.3 | 25.2 | 3.2 | 12.6 | 41.0 | - | 513.3 |
| % change in 2010 Q4 over 2009 Q4 | | 18.4 | 209.2 | 125.0 | 19.5 | 115.2 | -52.6 | -10.5 | 26.1 | N.A. | 19.8 |
| % change in 2010 over 2009 | | 73.4 | -62.5 | 236.4 | 70.5 | 93.7 | -31.5 | -38.3 | 2.3 | -97.6 | 60.7 |
| Outstanding (as at end of period) | | | | | | | | | | | |
| 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 |
| | Q3 | 652.1 | 63.8 | 21.0 | 736.9 | 105.2 | 85.2 | 290.2 | 480.6 | 15.9 | 1,233.4 |
| | Q4 | 653.1 | 63.7 | 25.5 | 742.3 | 122.3 | 84.7 | 284.0 | 491.0 | 15.5 | 1,248.8 |
| % change over a year earlier | | 22.3 | -8.7 | 264.3 | 21.5 | 44.4 | 6.6 | -9.0 | 3.1 | -36.3 | 12.4 |

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

(a) AIs : Authorized institutions.

(b) MDBs : Multilateral Development Banks.

N.A. Not available.

The stock and derivatives markets

5.19 The *local stock market* underwent a consolidation in the first eight months of the year amid worries about the European debt problems and the economic recovery in the United States losing momentum. Yet supported by the strong growth in the emerging economies especially in the Mainland and a second round of quantitative easing measures in the major economies, investor sentiment has picked up visibly since September. The *Hang Seng Index* (HSI) closed the year at 23 035, 5.3% higher than a year earlier. While this represented a more moderate gain than those recorded in most major markets, the HSI has rallied by a cumulative 103% from the recent trough in early 2009. In parallel, *average daily turnover* increased by 10.9% to \$69.1 billion in 2010, with a particularly sharp revival recorded in the fourth quarter.

5.20 After a weak start in the early months of 2010, fund raising activities staged a strong performance in the second half. For the year as a whole, *equity capital raised* through new share floatations and post-listing arrangements on the Main Board and the Growth Enterprise Market (GEM) surged by 33.7% to a historic high of \$858.7 billion. Among the total, a record \$449.5 billion were raised by IPOs of 113 companies including two large-sized financial institutions, representing a 81.1% jump over the preceding year⁽¹¹⁾. This ranked Hong Kong the first in IPO activities among all major exchanges for the second consecutive year. As a result of the rise in stock prices and buoyant fund-raising activities, the *market capitalisation* expanded briskly by 17.9% over a year earlier to \$21.1 trillion at end-2010, though it was still sharply below the peak in late 2007. 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⁽¹²⁾.

Diagram 5.6 : The local stock market has picked up visibly since September 2010

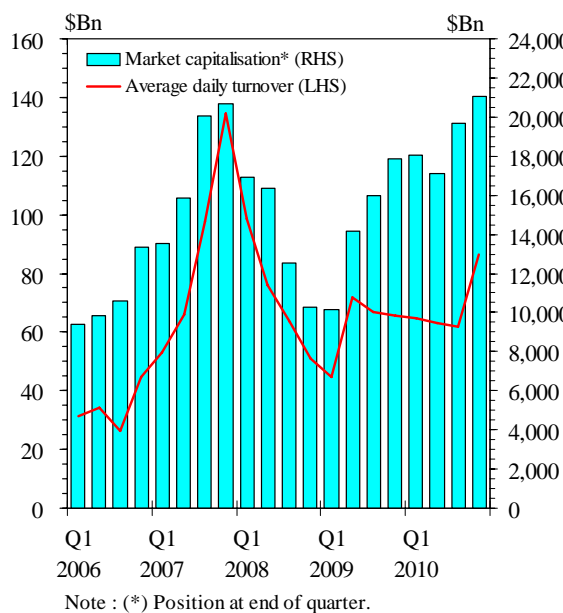
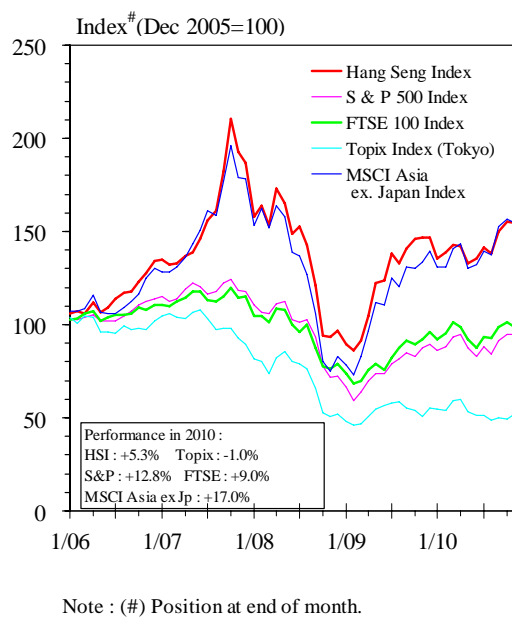


Diagram 5.7 : The Hang Seng Index recorded a more moderate gain than most major markets in 2010



5.21 Mainland enterprises continued to play a prominent role in the local stock market. At end-2010, a total of 592 Mainland enterprises (including 163 H-share companies, 102 “Red Chips” companies and 327 private enterprises) were listed on the Main Board and GEM, representing 42% of the total number of listed companies and 57% of total market capitalisation. In 2010, Mainland-related stocks accounted for 68% of equity turnover and 55% of total equity fund raised in the Hong Kong stock exchange.

5.22 After a lacklustre performance in 2009, trading of *derivatives products* rebounded sharply in 2010. The average daily trading volume of futures and options surged by 17.5%, with different types of products continuing to show mixed performance⁽¹³⁾. Trading of HSI options and stock options surged by 58.3% and 28.6% respectively, while trading of HSI futures and H-shares Index futures edged up by 1.3% and 0.1%. The average daily trading value of securitised derivatives jumped by 24.5%. Within the total, trading of derivative warrants soared further by 62.7% while trading of callable bull/bear contracts dwindled by another 13.2% (**Box 5.1**).

Table 5.6 : Average daily turnover of derivatives 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)^ |
|--|--------|-------------------------------|-------------------------------|------------------------------|------------------|--|----------------------------------|--|--|
| 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 | Annual | 84 803 | 34 335 | 50 120 | 246 474 | 467 961 | 10,813 | 5,845 | 16,658 |
| | 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 |
| | Q3 | 78 556 | 31 800 | 46 850 | 216 830 | 420 924 | 10,456 | 5,486 | 15,942 |
| | Q4 | 92 688 | 43 352 | 51 470 | 324 534 | 571 079 | 14,010 | 8,039 | 22,049 |
| % change in 2010 Q4 over 2009 Q4 | | 22.9 | 66.1 | 20.2 | 73.3 | 49.6 | 99.4 | 20.7 | 61.1 |
| % change in 2010 over 2009 | | 1.3 | 58.3 | 0.1 | 28.6 | 17.5 | 62.7 | -13.2 | 24.5 |

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.

5.23 Following the earlier public consultation, in November the Hong Kong Exchanges and Clearing Limited (HKEx) announced that the trading hours of the securities and derivatives markets would be extended in two phases. The opening time of the morning Continuous Trading Sessions (CTS) will be advanced by half an hour and that of the afternoon CTS by one hour starting 7 March 2011. The afternoon CTS will be further advanced by another half an hour starting 5 March 2012⁽¹⁴⁾. Through raising the overlap in its trading hours with that of the Mainland counterparts, the price discovery function of the local bourse for Mainland-related securities will be enhanced.

Box 5.1

Hong Kong's derivatives market in 2009/10

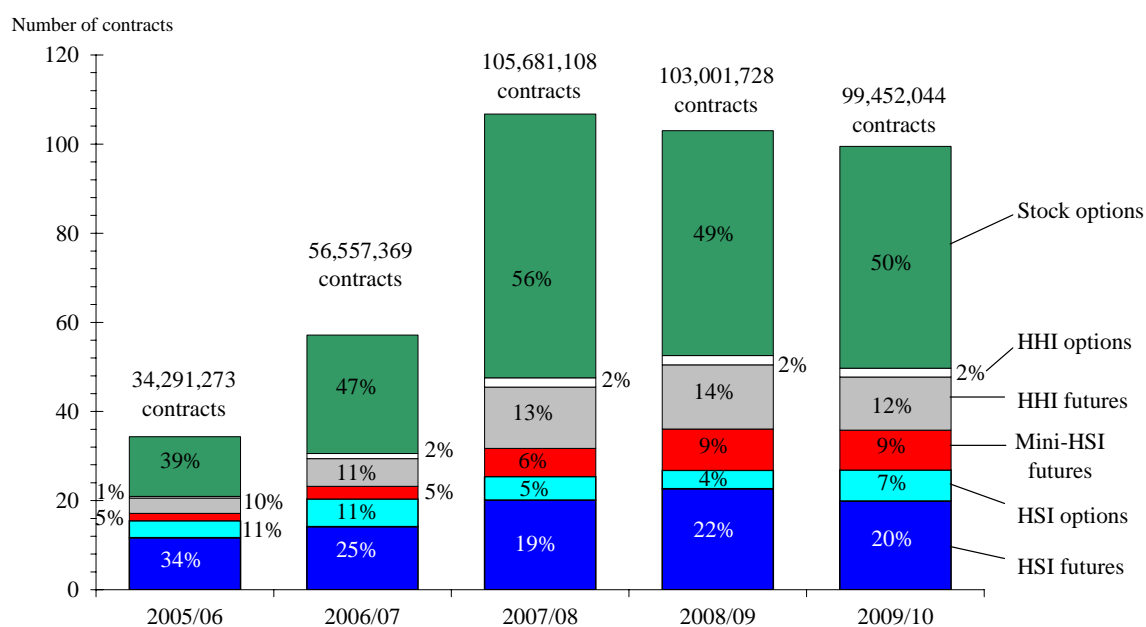
The derivatives market is an indispensable part of Hong Kong's financial market. In order to understand the trading composition in terms of investor type and trading purpose, the Hong Kong Exchanges and Clearing Limited (HKEx) has been conducting an annual survey on the derivatives market since 1994. The latest issue, "The Derivatives Market Transaction Survey 2009/10", covered derivatives transactions for major futures and options products during July 2009 to June 2010 and was published in November 2010⁽¹⁾.

Total market turnover for the covered derivatives products declined by 3% over the preceding year to 99 million contracts in 2009/10, as the decline in trading of index futures and stock options more than offset the gain in trading of index options. Over the past five years, there was a sharp average growth of 38% per annum, though the latest figure was still 6% below the peak in 2007/08.

Transaction purpose

In 2009/10, hedging was the main purpose of derivatives transactions, for the first time since the survey commenced. It accounted for 45% of the turnover, significantly up from 32% in 2005/06. Pure trading remained an important purpose, though its share of 39% represented a cumulative decline of ten percentage points from 2005/06. Meanwhile, the share of transactions for arbitrage purpose moved within a narrow range of 16% to 21% over the years.

Total market contract turnover and distribution by product (2005/06-2009/10)



Note : Numbers may not add up to 100% due to rounding.

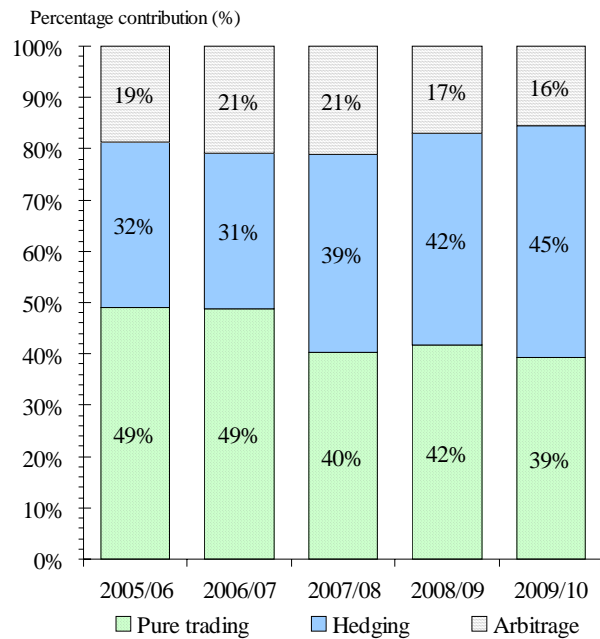
(1) The covered products included Hang Seng Index (HSI) futures, HSI options, Mini-HSI futures, H-shares Index (HHI) futures, HHI options and stock options, which together contributed about 99% of the total turnover volume of the HKEx derivatives market during the period.

Box 5.1 (Cont'd)

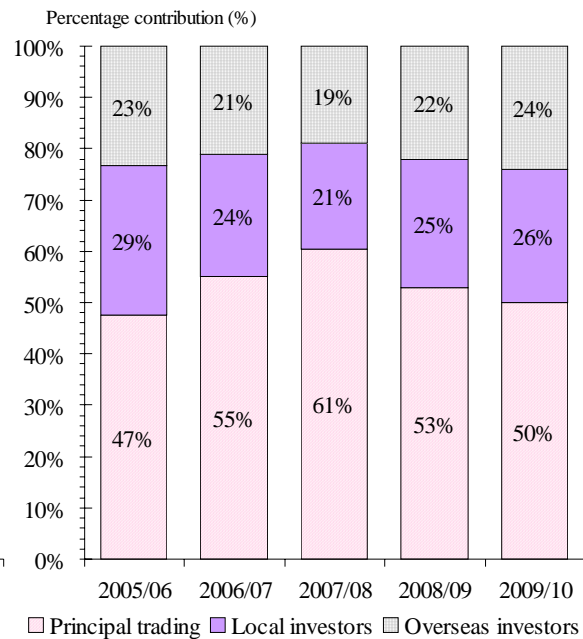
Trading by investor type

Major market participants in the derivatives market included principal trading (comprising market-maker trading and proprietary trading of exchange participants), and local/overseas investors with retail/ institutional background. In 2009/10, principal trading continued to be the largest contributor to derivatives trading, accounting for 50% of the total. Local and overseas investors each accounted for about 25%.

Distribution of trading by transaction purpose



Distribution of trading by investor type



Note : Numbers may not add up to 100% due to rounding.

Fund management and investment funds

5.24 The fund management business continued to put up a solid performance. Gross retail sales of *mutual funds* jumped by 92.3% over the low base in 2009 to US\$28.8 billion in 2010, though it was still much lower than the recent peak in 2007⁽¹⁵⁾. The aggregate net asset value of the approved constituent funds under the *MPF schemes* recorded a distinct expansion of 18.3% over a year earlier to \$365 billion at end-2010⁽¹⁶⁾. Retail hedge funds business also grew sharply during the year⁽¹⁷⁾.

5.25 The Government and the Mandatory Provident Fund Schemes Authority (MPFA) announced a plan to introduce legislation to strengthen the regulatory regime of MPF intermediaries before launching the Employee Choice Arrangement, which will give over two million MPF scheme members a right to transfer the accrued benefits derived from their own mandatory contributions during current employment to an MPF scheme of their choice. The Government and the MPFA are developing legislative proposals in conjunction with financial regulators for consultation and aim to start the legislative process in 2011.

Insurance sector

5.26 In the *insurance sector*, in the third quarter of 2010 gross premium for general business rose by 10.4% over a year earlier, but underwriting profit plunged by 34.5%⁽¹⁸⁾. Meanwhile, gross premium income from long-term business dropped by 3.2%, with both investment-linked plans and non-linked plans showing lacklustre performance.

5.27 The three-month public consultation on the proposed establishment of an independent insurance authority (IIA) ended in October. During the consultation, the public as well as stakeholders in the insurance industry expressed valuable views and comments on the proposed governance structure, organization framework, functions, powers and funding mechanism of the IIA. The Government is analysing the comments and developing detailed proposals to facilitate further discussions with the Legislative Council and the industry. In light of these discussions, the Government will draw up legislative proposals for the establishment of the IIA.

Table 5.7 : 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 |
| 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 |
| | Q2 | 7,385 | 5,279 | 714 | 11,074 | 4,515 | 30 | 55 | 15,674 | 23,059 |
| | Q3 | 7,756 | 5,498 | 439 | 9,689 | 4,155 | 11 | 65 | 13,920 | 21,676 |
| % change over a year earlier | | 10.4 | 7.3 | -34.5 | 0.3 | -9.3 | -84.7 | -11.0 | -3.2 | 1.2 |

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

5.28 In 2010, the financial services industry of Hong Kong made further headways on various fronts including investor and deposit protection, market regulation and cross-boundary co-operation. On deposit protection, in June the Legislative Council passed the Deposit Protection Scheme (Amendment) Bill 2010, which raised the protection limit from \$100,000 to \$500,000 with effect from 1 January 2011 (i.e. after the expiry of the full deposit guarantee at end-2010). 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. The scheme's coverage was also expanded to include deposits pledged as security for banking services.

5.29 In response to the G20's recommendations to improve the regulation of the over-the-counter (OTC) derivatives markets, in December the HKEx and HKMA announced to respectively set up a Central Counterparty (CCP) and a Trade Repository (TR) by end-2012. The CCP will render a stable and efficient central clearing house for OTC derivatives transactions with a view to reducing counterparty risk, while the TR, through maintaining an electronic database of records of such transactions, will provide valuable information for

regulatory authorities to carry out surveillance responsibilities. At the initial stage, the reporting and clearing requirement will apply to interest rate swaps and non-deliverable forwards, and may be later extended to other derivatives asset classes having regard to prevailing local and overseas market developments.

5.30 Having considered the views and comments solicited during the earlier public consultation, in December the Government announced the plan to establish an Investor Education Council (IEC) and a Financial Dispute Resolution Centre (FDRC) in order to enhance investor protection⁽¹⁹⁾. The IEC will devise and take forward the holistic strategy for improving general financial literacy, and therefore the public's ability in managing finance and making informed financial decisions. On the other hand, the FDRC will be responsible for managing an independent and impartial dispute resolution scheme, thus offering a speedy and affordable way to handle monetary disputes between individual consumers and financial institutions.

5.31 In December the HKEx published a consultation paper on the proposed changes to the Code on Corporate Governance Practices and certain Listing Rules relating to corporate governance. The proposed amendments target at such important aspects as communications with shareholders, quality of directors and company secretaries, independent non-executive directors' involvement in the board committees of listed companies and the chairman's role in corporate governance. These proposals are in line with international best practices and are expected to promote the development of higher corporate governance standards amongst the listed companies in Hong Kong.

5.32 As regards cross-boundary co-operation of financial services industry, market access to the Mainland for the banking and securities services sector of Hong Kong has been enhanced since 1 January 2011 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.

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) Authorized institutions (AIs) include licensed banks, restricted licence banks and deposit-taking companies. At end-2010, there were 146 licensed banks, 21 restricted licence banks and 26 deposit-taking companies in Hong Kong. Altogether, 193 AIs (excluding representative offices) from 30 countries and territories (including Hong Kong) had a presence in Hong Kong.

- (6) The Basel III will tighten the definition of capital and increase the minimum common equity requirement from 2% to 4.5% of risk-weighted assets and the Tier 1 capital from 4% to 6%. In addition, banks will be required to hold a capital conservation buffer of 2.5%, bringing the total common equity requirements to 7%. This reinforces the higher capital requirements for trading, derivatives and securitisation activities to be introduced by Basel Committee members including Hong Kong at the end of 2011. The Basel III will also introduce liquidity standards covering a liquidity coverage ratio (i.e. the ratio of high-quality liquid assets to total net cash outflows over the next 30 calendar days) of at least 100% and a net stable funding ratio (i.e. the ratio of available to required amount of stable funding) of above 100%.
- (7) 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.
- (8) The figures for private sector debt may not represent a full coverage of all the Hong Kong dollar debt paper issued.
- (9) Assets of the banking sector include notes and coins, amount due from Authorized 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.
- (10) Turnover ratio is defined as the average daily turnover of bonds divided by the average amount of bonds outstanding.
- (11) At end-2010, there were 1 244 and 169 companies listed on the Main Board and GEM respectively.
- (12) 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 16 February 2011), covering almost all globally recognised stock exchanges.
- (13) At end-2010, there were 57 classes of stock options contracts and 38 classes of stock futures contracts.

- (14) The current and the extended morning and afternoon Continuous Trading Sessions (CTS) of the local securities and derivatives markets are as follows :

| | Securities market and stock futures/ <u>options markets</u> | Index futures/ <u>options markets</u> |
|------------------------------------|---|--|
| Morning CTS | | |
| Current | 10:00-12:30 | 09:45-12:30 |
| Phase1 (effective 7 March 2011) | 09:30-12:00 | 09:15-12:00 |
| Phase2 (effective 5 March 2012) | 09:30-12:00 | 09:15-12:00 |
| Afternoon CTS | | |
| Current | 14:30-16:00 | 14:30-16:15 |
| Phase1 (effective 7 March 2011) | 13:30-16:00 | 13:30:16:15 |
| Phase2 (effective 5 March 2012) | 13:00-16:00 | 13:00:16:15 |

In additional to CTS, the securities and index futures/options markets each have an auction session of half an hour before the morning CTS. Also, the index futures/options markets have an auction session of half an hour before the afternoon CTS.

- (15) 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 authorized funds that have responded to the survey. At end-2010, the survey covered a total of 1 319 active authorized funds.
- (16) At end-2010, there were 19 approved trustees. On MPF products, 38 master trust schemes, two industry schemes and one employer sponsored scheme, comprising altogether 421 constituent funds, were approved by the Mandatory Provident Fund Schemes Authority. A total of 244 000 employers, 2.26 million employees and 260 000 self-employed persons have participated in MPF schemes.
- (17) At end-2010, there were 10 SFC-authorized retail hedge funds with combined net asset size of US\$952 million. The amount of net assets under management was 40.2% higher than the end-2009 level and more than five times of that at end-2002, the year when the hedge funds guidelines were first issued.
- (18) At end-2010, there were 168 authorized insurers in Hong Kong. Within this total, 46 were engaged in long-term insurance business, 103 in general insurance business, and 19 in composite insurance business. These authorized insurers come from 22 countries and territories (including Hong Kong).
- (19) The Government aims at setting up the FDRC by mid-2012. The IEC will be set up as soon as the Legislative Council approves the relevant amendments to the Securities and Futures Ordinance, which will be introduced in May/June 2011.