

CHAPTER 5 : THE FINANCIAL SECTOR[#]

Summary

- *The low interest rate environment in Hong Kong generally continued through 2011 amid the ongoing accommodative monetary policy in the United States. Yet interest rates at the retail level have gradually crawled up from an extremely low base, with major banks raising the margin for the HIBOR-based mortgage rates several times since March.*
- *The Hong Kong dollar spot exchange rate strengthened slightly against the US dollar, despite the fluctuations in the second half of the year stemming from heightened external uncertainties. Meanwhile, the trade-weighted Hong Kong dollar Effective Exchange Rate Indices declined in the first half, but subsequently recouped some of the lost grounds alongside a rebound in the US dollar.*
- *Loans and advances continued to pose rapid growth in the first half, but the pace decelerated thereafter along with the economic slowdown. Also relevant were the review of risk management in the banking sector announced by the Hong Kong Monetary Authority (HKMA) in April and later the introduction of further prudential measures on mortgage lending in June. Reflecting the brisk growth in loans and the moderate rise in deposits, the Hong Kong dollar loan-to-deposit ratio rose to 85.5% at end-November 2011, the highest since October 2005.*
- *The local stock market mostly moved sideways in the first seven months of the year but suffered a major setback since August in face of heightened risks in the external environment. The Hang Seng Index closed the year at 18 434, representing a decline of 20.0% over a year earlier. Fund raising activities also turned quieter, with a noticeable retreat in the amount of equity funds raised.*

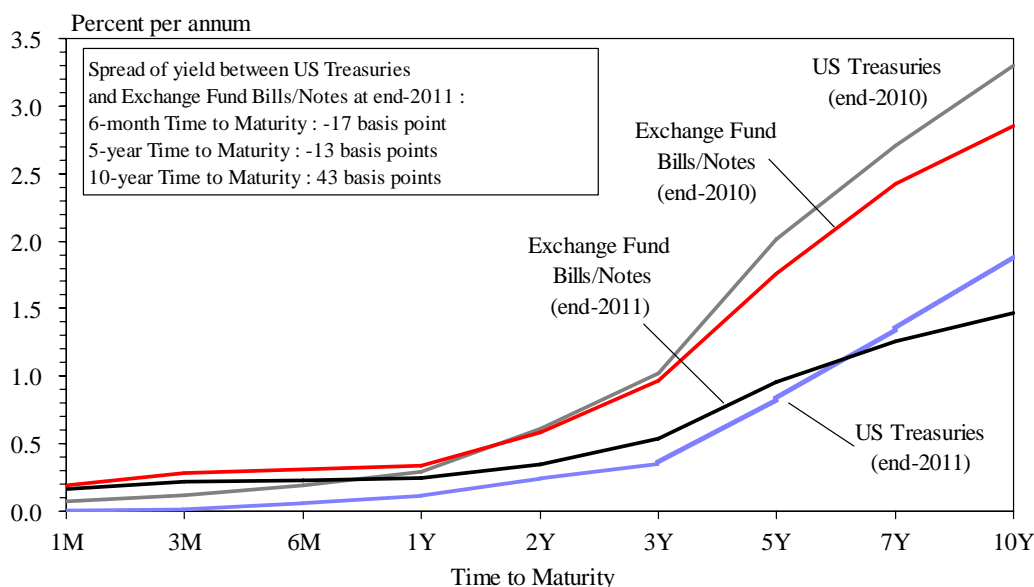
(#) *This chapter is jointly prepared by the Hong Kong Monetary Authority (HKMA) and the Economic Analysis Division.*

Interest rates and exchange rates

5.1 As the United States maintained an accommodative monetary policy, the low interest rate environment in Hong Kong continued through 2011. With the US Federal Funds Target Rate staying at 0-0.25%, the *Base Rate* under the Discount Window operated by the HKMA remained stable at 0.5% during the year⁽¹⁾. Similarly, the *Hong Kong dollar interbank interest rates* remained generally low, with the overnight and three-month HIBORs hovering at 0.13% and 0.33% respectively at end-2011.

5.2 The *US dollar yield curve* flattened noticeably, especially in the second half of 2011, partly due to increasing safe-haven demand for US government bonds in face of the sluggish growth in advanced economies and the deteriorating European debt problems, and partly due to the announcement of the maturity extension program by the Federal Open Market Committee⁽²⁾. The *Hong Kong dollar yield curve* likewise flattened. Reflecting these movements, the negative yield spread between 10-year Exchange Fund Notes and 10-year US Treasury Notes narrowed slightly from 44 basis points at end-2010 to 43 basis points at end-2011 while the positive spread between 6-month Exchange Funds Bills and 6-month US Treasury Bills widened from 12 basis points to 17 basis points.

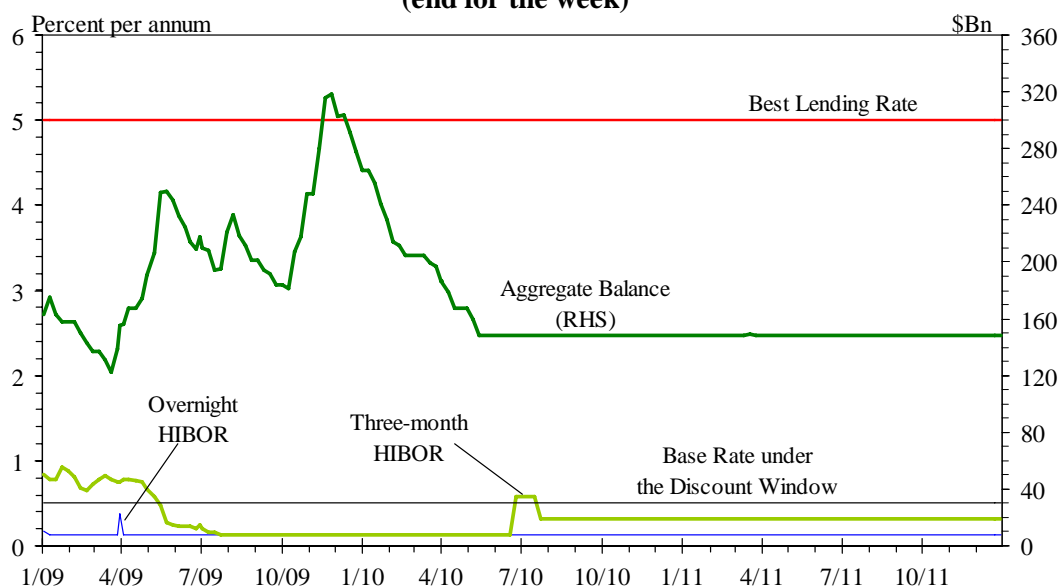
Diagram 5.1 : Both the Hong Kong dollar and US dollar yield curves flattened in 2011



5.3 Interest rates at the retail level also stayed low, but have gradually crawled up from an extremely low base over the course of the year. The *Best*

Lending Rates remained unchanged at 5.00% or 5.25%, but the major banks have raised the interest margins for their mortgage loans several times since March. Specifically, the margin for HIBOR-based mortgage loans has notched up from 0.6-0.9 percentage point in early 2011 to around 2.2-3.0 percentage points at end-2011. While the *average savings deposit rate* and the *one-year time deposit rate* quoted by the major banks (which are for deposits of less than \$100,000) showed little movement and stayed at 0.01% and 0.16% respectively in December 2011, reportedly many banks raised their term deposit rates for new customers in the second half to attract large and longer-term deposits. The *composite interest rate*, which reflects the average cost of funds for banks, hence picked up from 0.21% at end-2010 to 0.48% at end-November 2011, though still a low level by historical standards⁽³⁾.

Diagram 5.2 : Hong Kong dollar interest rates generally stayed low through 2011 (end for the week)

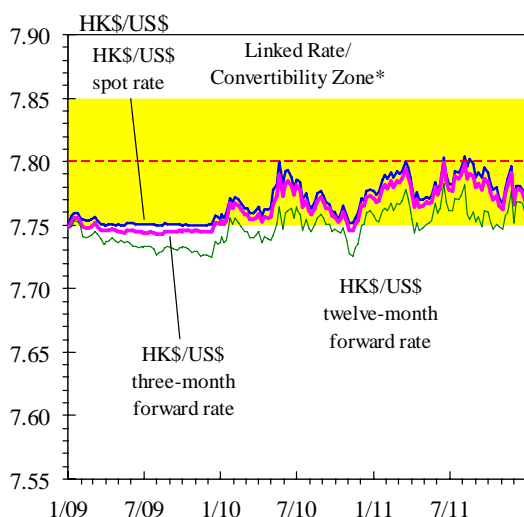


5.4 The Hong Kong dollar spot exchange rate against the US dollar closed at 7.766 at end-2011, slightly stronger than the 7.775 at end-2010. Yet this concealed the fluctuations in the second half of the year stemming from rising external uncertainties, from a low of 7.761 to a high of 7.809. The discounts of the *3-month* and *12-month Hong Kong dollar forward rates* once widened sharply in the second half, before gradually reverting to 31 and 138 pips respectively at end-2011, compared with 57 and 191 pips at end-2010.

5.5 Under the Linked Exchange Rate system, movements in the Hong Kong dollar exchange rate against other currencies closely followed those of the US dollar. The US dollar depreciated further against most major currencies in

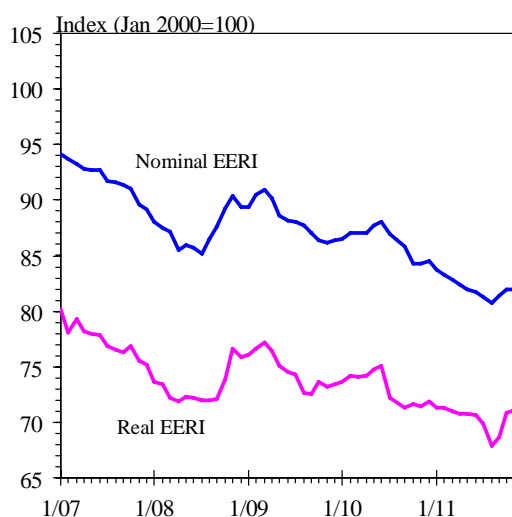
the first half of 2011, but recouped some of the lost grounds in the second half on increasing safe-haven demand for the US dollar. Reflecting these movements, the *trade-weighted Hong Kong dollar Nominal Effective Exchange Rate Index* only declined by 2.5% during 2011, and the real index by 1.0% between December 2010 and November 2011⁽⁴⁾.

Diagram 5.3 : Hong Kong dollar strengthened slightly against the US dollar, despite some fluctuations during the year (end for the week)



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

Diagram 5.4 : Trade-weighted EERIs declined in the first half but rebounded in the second half (average for the month)*



Note : (*) The real EERI is only available up to Nov-2011.

Money supply and banking sector

5.6 The Hong Kong dollar monetary aggregates maintained solid growth in 2011, though the increase was mostly seen during the first half. The seasonally adjusted Hong Kong dollar narrow *money supply* (HK\$M1) rose by 6.0% over end-2010 to \$760 billion at end-November 2011⁽⁵⁾. The broad money supply (HK\$M3) also expanded by a decelerated 3.8% to \$4,024 billion. Meanwhile, *total deposits* with authorized institutions (AIs) grew by 9.7% to \$7,528 billion, with foreign currency deposits growing at a much faster rate than Hong Kong dollar deposits⁽⁶⁾.

Diagram 5.5 : The monetary aggregates maintained solid growth in the first half of 2011, but the pace decelerated in the second half

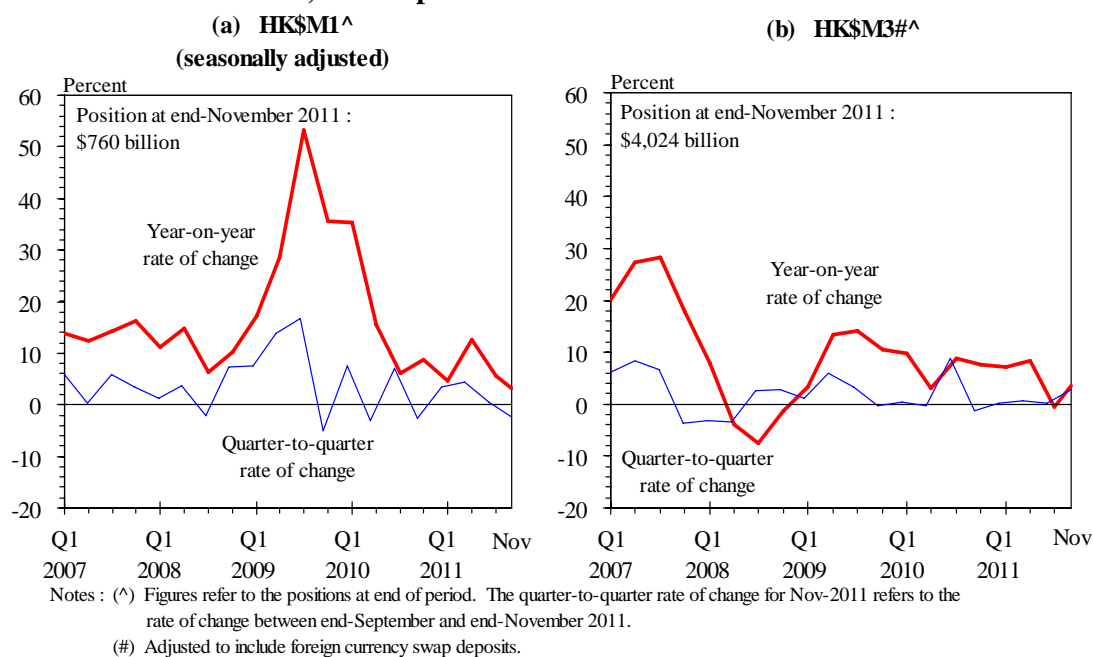


Table 5.1 : Hong Kong dollar money supply and total money supply

		<u>M1</u>		<u>M2</u>		<u>M3</u>	
% change during the quarter		HK\$ [^]	Total	HK\$ ^(a)	Total	HK\$ ^(a)	Total
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
2011	Q1	3.4	2.9	0.1	3.3	0.1	3.4
	Q2	4.3	4.4	0.8	3.4	0.7	3.4
	Q3	0.6	2.3	0.1	1.9	0.1	1.8
	Nov [#]	-2.3	0.2	2.8	2.9	2.8	2.9
Total amount at end-November 2011 (\$Bn)		760	1,122	4,016	7,997	4,024	8,017
% change over end-2010		6.0	10.3	3.9	12.1	3.8	12.0

Notes : (^) Seasonally adjusted.

(a) Adjusted to include foreign currency swap deposits.

(*) Change of less than $\pm 0.05\%$.

(#) % change between end-September and end-November 2011.

5.7 *Total loans and advances* continued to pose rapid growth in the first seven months of the year amid robust Mainland-related loan demand, but the pace moderated thereafter along with the economic slowdown. Also relevant were the review of better credit and liquidity risks management in the banking sector announced by HKMA in April as well as the introduction of the fourth round of prudential measures on mortgage lending in June. Total loans jumped by 21.0% over end-2010 to \$5,117 billion at end-November 2011 (comprising Hong Kong dollar loans of \$3,175 billion and foreign currency loans of \$1,942 billion), with the gain recorded mainly in the first half. Within the total, loans for use in Hong Kong grew by 15.7% to \$3,775 billion while loans for use outside Hong Kong surged by 39.1% to \$1,343 billion. Given the brisk growth in loans and the moderate rise in deposits, the Hong Kong dollar loan-to-deposit ratio rose visibly from 78.1% at end-2010 to 85.5% at end-November 2011, the highest since October 2005.

5.8 Within loans and advances for use in Hong Kong, lending to most major sectors expanded at a brisk pace in the first half, but generally slowed in the third quarter. Between end-2010 and end-September 2011, loans to wholesale and retail trade and trade financing surged by 40.9% and 30.8% respectively, but growth slowed sharply between June and September in line with the faltering external trade. Loans to building, construction, property development and investment and loans for purchase of residential property also recorded solid growth of 9.8% and 6.7% respectively, but again the pace tapered in the third quarter amid the property market consolidation.

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)		
		2010	Q1	12.2	2.0	9.3	6.0	2.5	6.1	17.1	4.6
	Q2	19.8	9.7	15.2	5.7	2.6	13.0	87.9	7.3	14.4	8.8
	Q3	9.1	8.2	13.8	6.2	5.4	3.8	316.3	9.4	9.3	9.4
	Q4	6.8	5.9	6.4	1.3	3.0	1.2	-83.1	0.4	10.2	2.5
2011	Q1	13.0	7.4	17.0	4.2	2.4	13.2	25.7	7.1	8.6	7.4
	Q2	11.7	5.9	16.6	2.2	3.1	-1.4	9.5	4.4	11.9	6.1
	Q3	3.7	4.4	3.3	3.1	1.1	10.4	-20.1	2.4	10.5	4.4
Total amount at end-September 2011 (\$Bn)		358	193	323	908	850	289	20	3,734	1,296	5,030
% change from end-2010		30.8	18.8	40.9	9.8	6.7	23.2	10.0	14.5	34.3	19.0

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 15.7% at end-September. All individual AIs' CARs were above the statutory minimum ratios as required by the HKMA. In addition, Hong Kong has completed the legislative process for implementation of the enhancements to Basel II introduced by the Basel Committee in July 2009 ("Basel 2.5")⁽⁷⁾. The Banking (Capital) (Amendment) Rules 2011 and the Banking (Disclosure) (Amendment) Rules 2011 have come into effect on 1 January 2012 in line with the Basel Committee's timetable.

5.10 Following the release of the Basel III rules text by the Basel Committee in December 2010, the HKMA issued a circular to all AIs in January 2011 indicating its intention to fully implement Basel III in accordance with the

Basel Committee's timetable, including the transitional arrangements⁽⁸⁾. The HKMA has started the preparatory work, particularly the necessary legislative processes and the policy frameworks for the new liquidity and countercyclical capital buffer requirements. The HKMA has also commenced discussion with individual institutions on their plans to ensure compliance with Basel III, and consulted the industry on its proposed amendments to the Banking Ordinance in October. The Banking (Amendment) Bill was gazetted in December, and subsequently introduced into the Legislative Council. The HKMA anticipates enactment of the Bill in the Legislative Council's 2011-2012 session, followed by the amendments of the Banking (Capital) Rules and the Banking (Disclosure) Rules, for implementation of Basel III in phases at the beginning of 2013.

5.11 Based on the results of the Quantitative Impact Study (QIS) on the Basel III consultative proposals conducted by the HKMA, AIs 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. In order to inform its policy decisions on implementation, the HKMA has commenced another round of QIS to assess the impact of the new Basel III requirements on AIs.

5.12 Asset quality of the local banking sector remained good. The ratio of classified loans to total loans declined from 0.77% at end-2010 to a record-low of 0.60% at end-September 2011, and the delinquency ratio for credit card lending from 0.20% to 0.18%. The delinquency ratio for residential mortgage loans hovered at a low level of around 0.01% through 2011.

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)
2010 Q1	97.08	1.72	1.20
Q2	97.50	1.53	0.96
Q3	97.72	1.43	0.84
Q4	97.95	1.28	0.77
2011 Q1	98.17	1.17	0.66
Q2	98.20	1.19	0.61
Q3	98.21	1.19	0.60

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 Renminbi (RMB) business in Hong Kong expanded further in 2011 on the back of a series of significant policy breakthroughs. In January the People's Bank of China (PBoC) launched a pilot scheme for the settlement of overseas direct investments in renminbi. Then the Central Government stated in the 12th National Five-Year Plan promulgated in March 2011 its support for Hong Kong's development as an offshore renminbi business centre, and subsequently announced a series of supportive measures in August, including the further expansion of the renminbi trade settlement scheme, support for the use of RMB for foreign direct investments in the Mainland, and the introduction of a renminbi Qualified Foreign Institutional Investors scheme for investing in the Mainland's securities markets. Later in November, the PBoC and the HKMA signed a renewed currency swap agreement for a term of another three years, with its size expanding to RMB400 billion/HK\$490 billion. These measures would deepen the development of the offshore renminbi market in Hong Kong and also expand the channels for the flow and circulation of renminbi funds between Hong Kong and the Mainland.

5.14 Reflecting the ongoing expansion in the renminbi trade settlement scheme, the value of *renminbi cross-border trade settlement handled by banks* in Hong Kong soared to RMB1,675.9 billion in the first eleven months of 2011, more than quadrupling the RMB369.2 billion for the entire 2010. Thanks to the rapid increase in corporate RMB deposits, *RMB deposits* in Hong Kong jumped from RMB314.9 billion at end-2010 to RMB627.3 billion at end-November 2011. With a diversified base of investors and issuers, *RMB bond* issuance expanded to RMB99 billion in the first eleven months, more than doubling the total of last year.

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

<u>As at end of period</u>		Demand and savings deposits (RMB Mn)	Time deposits (RMB Mn)	Total deposits (RMB Mn)	<u>Interest rates on^(a)</u>		Number of authorized institutions engaged in RMB business	Amount of cross-border RMB trade settlement ^(c) (RMB Mn)
					Savings deposits ^(b) (%)	Three-month time deposits ^(b) (%)		
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
2011	Q1	137,454	313,965	451,419	0.46	0.66	118	311,279
	Q2	180,346	373,256	553,602	0.30	0.52	128	492,727
	Q3	191,528	430,708	622,236	0.29	0.52	131	525,425
	Nov	186,986	440,317	627,302	0.28	0.52	132	346,452 ^(d)
% change from end-2010		59.0	123.1	99.2	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.

(d) Figures for October and November 2011.

N.A. Not available.

The debt market

5.15 The Hong Kong dollar debt market expanded further in 2011⁽⁹⁾. In the first eleven months, total gross issuance of Hong Kong dollar debt securities expanded by 5.7% over a year earlier to \$1,907 billion. Within the total, debt issued by public sector rose by 4.4% and by private sector by a sharper 20.8%. The total outstanding balance of Hong Kong dollar debt ascended by 1.5% over end-2010 to \$1,264.5 billion at end-November 2011, equivalent to 31.8% of HK\$M3 or 25.1% of Hong Kong dollar-denominated assets of the entire banking sector⁽¹⁰⁾.

5.16 As to the Government Bond (“GB”) Programme, a total worth of \$17.5 billion institutional bonds, with tenors ranging from two to ten years, were issued in 2011. Within the total, two institutional bond tenders were held in the fourth quarter, namely a \$3 billion 3-year re-opening in November and a new \$2.5 billion 5-year GB in December. Daily turnover for the period of January to November 2011 averaged at \$5.73 billion, equivalent to a turnover ratio of 19%⁽¹¹⁾, and the outstanding size of institutional GBs amounted to \$38.0 billion at end-2011. Apart from the institutional bonds, the GB Programme

also consists of a retail part. A \$10 billion 3-year inflation-linked bond, or the iBond, was issued to Hong Kong residents in July 2011. The iBond, being the inaugural retail issue under the GB Programme, was well-received by investors.

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											
2010	Annual	1,816.8	11.2	18.5	1,846.4	103.6	13.4	32.3	149.2	0.3	1,996.0
	Q1	437.4	2.8	6.0	446.2	27.0	4.3	7.3	38.6	-	484.9
	Q2	456.5	3.6	4.5	464.6	19.7	3.2	6.9	29.8	0.3	494.6
	Q3	458.7	1.2	3.5	463.4	28.4	2.8	8.6	39.8	-	503.2
	Q4	464.1	3.6	4.5	472.3	28.4	3.2	9.4	41.0	-	513.3
2011	Jan-Nov	1,694.4	17.5	25.0	1,737.0	128.8	23.7	17.5	170.1	-	1,907.0
	Q1	452.9	4.8	3.5	461.2	32.8	6.1	5.0	43.8	-	505.0
	Q2	459.4	4.4	2.5	466.4	39.9	9.0	5.5	54.3	-	520.7
	Q3	462.0	6.5	16.0	484.5	35.1	3.6	3.2	41.8	-	526.3
	Oct-Nov	320.2	1.8	3.0	324.9	21.0	5.1	3.9	30.0	-	355.0
2011	Jan-Nov	3.5	71.9	56.3	4.4	32.3	90.2	-43.4	20.8	-	5.7
% change over a year earlier											
Outstanding (as at end of period)											
2010	Q1	612.5	64.9	13.0	690.4	199.0	82.6	196.4	478.0	21.1	1,189.5
	Q2	651.4	61.9	17.5	730.8	195.4	84.1	188.6	468.2	18.4	1,217.4
	Q3	652.1	60.8	21.0	733.8	207.3	85.2	187.8	480.3	15.9	1,230.1
	Q4	653.1	60.6	25.5	739.2	218.7	84.9	187.3	490.9	15.5	1,245.7
2011	Q1	653.8	58.6	29.0	741.4	235.6	86.8	187.0	509.4	15.1	1,265.8
	Q2	654.4	52.6	31.5	738.5	244.4	93.0	179.0	516.5	14.7	1,269.7
	Q3	654.8	53.0	44.0	751.8	244.3	94.1	172.8	511.2	14.7	1,277.7
	Nov	655.0	50.3	47.0	752.3	233.9	95.5	168.1	497.5	14.7	1,264.5
% change over end-2010		0.3	-17.0	84.3	1.8	7.0	12.5	-10.3	1.3	-5.2	1.5

Notes : Figures may not add up to the corresponding totals due to rounding and may be subject to revisions.

(a) AIs : Authorized institutions.

(b) MDBs : Multilateral Development Banks.

N.A. Not available.

The stock and derivatives markets

5.17 The *local stock market* moved sideways in the first seven months of 2011, but suffered a major setback since August in face of heightened risks in the external environment. Concerns over tapering growth in the advanced economies and escalating European debt problems sent shockwaves to the local stock market. Also relevant was the growth moderation in the Mainland economy. The *Hang Seng Index* (HSI) once fell to 16 250 on October 4, the lowest closing since May 2009. While it rebounded to 20 019 on October 28, it subsequently closed at 18 434 at end-2011, 20.0% lower than a year earlier. In parallel, *market capitalisation* of the Hong Kong stock market contracted by 16.8% to \$17.5 trillion, though it remained the seventh largest bourse globally and the third largest in Asia⁽¹²⁾.

5.18 Meanwhile, trading activities were relatively steady during most of 2011, though showing some retreat in the fourth quarter. *Average daily turnover* in the securities market edged up by 0.9% to \$69.7 billion in 2011. Notwithstanding the contraction in the fourth quarter against a high base of comparison, trading of *derivatives products* still witnessed a notable growth for the year as a whole. Average daily trading volume of futures and options expanded by 22.3%⁽¹³⁾, with across-the-board increases for all major products. Trading of HSI options and stock options surged by 26.6% and 22.8% respectively, while trading of H-shares Index futures and HSI futures also recorded substantial growth of 21.9% and 10.9%. Average daily trading value of securitised derivatives products went up by 9.4%, with the surge of 28.8% in callable bull/bear contracts more than offsetting the slight decline of 1.1% in derivative warrants.

Diagram 5.6 : The Hang Seng Index suffered a major setback since August 2011

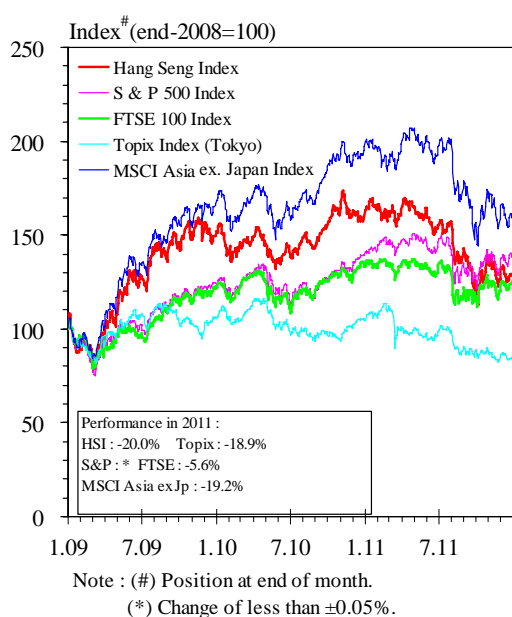


Diagram 5.7 : Market capitalisation contracted but trading activities were relatively steady in 2011

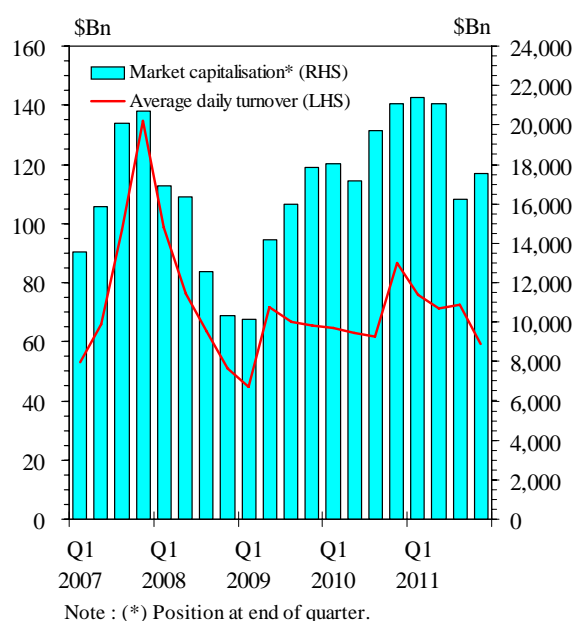


Table 5.6 : Average daily turnover of derivatives products of the Hong Kong market

		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) [^]
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
2011	Annual	94 036	43 452	61 116	302 750	572 274	10,691	7,529	18,220
	Q1	90 884	43 476	52 133	299 477	546 164	13,378	5,921	19,299
	Q2	87 592	43 806	57 151	276 966	531 141	10,786	5,523	16,308
	Q3	104 945	49 166	69 187	348 598	652 827	10,383	8,225	18,608
	Q4	92 210	37 284	65 597	283 945	555 467	8,225	10,340	18,565
% change in 2011 Q4 over 2010 Q4		-0.5	-14.0	27.4	-12.5	-2.7	-41.3	28.6	-15.8
% change in 2011 over 2010		10.9	26.6	21.9	22.8	22.3	-1.1	28.8	9.4

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.

5.19 Fund raising activities quietened down in 2011, especially during the second half, along with the subdued stock market performance. *Total equity capital raised*, including new share floatations and post-listing arrangements on the Main Board and the Growth Enterprise Market (GEM)⁽¹⁴⁾, tumbled by 42.6% to \$488.3 billion in 2011. Within the total, the amount of funds raised through IPOs shrank by 41.8% to \$258.9 billion. Yet Hong Kong still ranked the first globally in terms of funds raised through IPOs for the third straight year.

5.20 Mainland enterprises continued to play a dominant role in the local stock market. At end-2011, a total of 640 Mainland enterprises (including 168 H-share companies, 107 “Red Chips” companies and 365 private enterprises) were listed on the Main Board and GEM, accounting for 43% of the total number of listed companies and 55% of total market capitalisation. Mainland-related stocks also accounted for 66% of equity turnover and 46% of total equity fund raised in the Hong Kong stock exchange in 2011.

5.21 Having considered the views collected from an earlier consultation, in October the Securities and Futures Commission (SFC) announced the revised proposals on short position reporting rules to further consult the public. The SFC considered it more pragmatic to require the industry to report short positions on a net basis, instead of a gross basis, while keeping other earlier proposals unchanged, so as to provide the market with more information on short selling activities without placing undue burden on the industry⁽¹⁵⁾. Subject to the legislative process, the SFC targets to implement the short position reporting requirement by end-March 2012.

5.22 Following an earlier consultation, in December the Hong Kong Exchanges and Clearing Limited announced to proceed with the proposed after-hours futures trading (AHFT). Specifically, HSI futures, H-shares index futures and gold futures would be traded from 5:00 pm to 11:00 pm. In view of the concerns over potential excessive market movements, HKEx will implement a 5% price limit up/down mechanism in the AHFT session. Through extending the trading hours to cover most of the business hours in both Europe and the United States, AHFT would provide investors the opportunities to hedge or adjust their positions in response to the latest market developments. Subject to the legislative amendments and market readiness, HKEx would implement the AHFT in the second half of 2012.

Fund management and investment funds

5.23 The fund management business basically tracked the local stock market during 2011, marked by steady performance in the early part of the year and some moderation later in face of the more volatile global financial markets. Taking the first eleven months together, gross retail sales of *mutual funds* still surged by 34.4% over a year earlier to US\$36.1 billion, but it actually recorded declines in the latter part of the year⁽¹⁶⁾. Aggregate net asset value of the approved constituent funds under the *Mandatory Provident Fund (MPF) schemes* declined by 4.0% from end-2010 to \$351 billion at end-November 2011⁽¹⁷⁾, with most of the decline occurring in the second half conceivably due to correction in the global stock markets. Similarly, the amount of net assets managed by retail hedge funds also retreated⁽¹⁸⁾.

5.24 In the light of operational experience gained and comments received over the past years, in December the MPF Authority announced a public consultation on review of the regulation of withdrawal of MPF benefits, including the mode of payment of MPF benefits on retirement as well as grounds for early withdrawal of MPF benefits. The consultation would last until end-March 2012, and the MPF Authority will consider the way forward after reviewing the views and comments.

Insurance sector

5.25 The *insurance sector* expanded further in the third quarter⁽¹⁹⁾. Driven by both linked and non-linked plans, gross premium income from long-term business registered another robust year-on-year increase of 29.0%. Gross and net premium income from general business also grew, by 12.2% and 10.1% respectively.

Table 5.7 : Insurance business in Hong Kong* (\$Mn)

	General business			Premium for long-term business [^]					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	
2010 Annual	31,361	21,927	2,615	38,673	20,015	92	230	59,010	90,371
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
Q4	6,990	4,690	903	9,181	7,343	18	56	16,598	23,588
2011 Q1	10,263	7,003	482	11,231	5,619	14	69	16,933	27,196
Q2	8,456	5,919	970	15,320	6,281	17	53	21,671	30,127
Q3	8,700	6,051	642	12,846	4,998	16	103	17,963	26,663
% change in 2011Q3 over 2010Q3	12.2	10.1	46.2	32.6	20.3	45.5	58.5	29.0	23.0

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

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

Highlights of market developments

5.26 Having considered the comments and feedback collected in an earlier consultation, in October the HKEx announced the amendments 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, and will be gradually adopted in 2012. These amendments would help maintain a high standard of corporate governance amongst the listed companies in Hong Kong and would protect investors and the integrity of the market for the benefit of Hong Kong's position as an international financial centre.

5.27 In accordance with the commitments of the G20 Leaders, in October the SFC and HKMA issued a joint consultation paper on the proposed regulatory regime for Hong Kong's over-the-counter (OTC) derivatives market to improve the overall transparency and reduce systemic risk in the financial

system. The proposed regime will be set out in the Securities and Futures Ordinance, and will be jointly overseen and regulated by the HKMA and SFC. OTC derivatives transactions will be reported to the trade repository to be set up by the HKMA, and standardised OTC derivatives transactions will be centrally cleared through a designated central counterparty. The reporting requirement and clearing obligation would initially apply only to certain interest rate swaps and non-deliverable forwards, and may be subsequently extended to other product classes after further market consultation. The HKMA and SFC are working towards meeting the G20 implementation deadline of end-2012, subject to the progress of reform in other major markets, due completion of the legislative process and market readiness.

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) On 21 September 2011, the Federal Open Market Committee announced that it would extend the average maturity of its holdings of securities. Specifically, the Committee intends to purchase, by the end of June 2012, \$400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less. This program should put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative. This maturity extension program is also commonly called "Operation Twist".
- (3) 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.
- (4) 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.

(5) 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.

(6) Authorized institutions (AIs) include licensed banks, restricted licence banks and deposit-taking companies. At end-November 2011, there were 151 licensed banks, 20 restricted licence banks and 26 deposit-taking companies in Hong Kong. Altogether, 197 AIs (excluding representative offices) from 31 countries and territories (including Hong Kong) had a presence in Hong Kong.

(7) Basel 2.5 strengthens the risk coverage of Basel II in the light of lessons drawn from the global financial crisis. The main improvements include raising banks' capital requirements for exposures booked in banks' trading books and for securitization exposures, providing supplemental guidance on risk management principles and strengthening disclosure in corresponding areas.

(8) Basel III tightens the definition of regulatory capital and increases 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, it requires banks to hold a Capital Conservation Buffer of 2.5% during good times and a Countercyclical Capital Buffer in the range of 0% to 2.5% at times of excessive credit growth, both to be met by common equity. These reinforce the higher capital requirements for banks' trading, derivatives and securitisation activities introduced by the Basel Committee in July 2009 as enhancements to Basel II, which Basel Committee members including Hong Kong are expected to adopt by the end of 2011. Basel III also introduces two liquidity standards i.e. the Liquidity Coverage Ratio of at least 100% to promote short term liquidity resilience and the Net Stable Funding Ratio of above 100% to encourage more stable funding structures.

(9) The figures for private sector debt may not represent a full coverage of all the Hong Kong dollar debt paper issued.

(10) 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.

- (11) Turnover ratio is defined as the average daily turnover of bonds divided by the average amount of bonds outstanding.
- (12) The ranking is made by the World Federation of Exchanges, a global trade association for the securities exchange industry. Its membership comprises 54 securities exchanges (as of 20 January 2012), covering almost all globally recognised stock exchanges.
- (13) At end-2011, there were 60 classes of stock options contracts and 38 classes of stock futures contracts.
- (14) At end-2011, there were 1 326 and 170 companies listed on the Main Board and GEM respectively.
- (15) Specifically, it is required that a net short position that hits the threshold of 0.02% of the issued share capital of a listed company, or a market value of \$30 million, whichever is lower, has to be reported to the SFC on a weekly basis. In general, the party who beneficially owns the short position will be responsible for the reporting. Only short positions in the constituent stocks of the Hang Seng Index, the Hang Seng China Enterprises Index and other financial stocks specified by the SFC will be subject to reporting. The reporting requirement may be tightened to further enhance transparency and monitoring in contingency situations.
- (16) 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-November 2011, the survey covered a total of 1 220 active authorized funds.
- (17) At end-2011, there were 19 approved trustees. On MPF products, 38 master trust schemes, two industry schemes and one employer sponsored scheme, comprising altogether 445 constituent funds, were approved by the Mandatory Provident Fund Schemes Authority. A total of 252 000 employers, 2.34 million employees and 229 000 self-employed persons have participated in MPF schemes.
- (18) At end-November 2011, there were 6 SFC-authorized retail hedge funds with combined net asset size of US\$759 million. The amount of net assets under management was 20.3% below the end-2010 level, though it was still more than four times of that at end-2002, the year when the hedge funds guidelines were first issued.
- (19) At end-2011, there were 163 authorized insurers in Hong Kong. Within this total, 45 were engaged in long-term insurance business, 98 in general insurance business, and 20 in composite insurance business. These authorized insurers come from 22 countries and territories (including Hong Kong).