CHAPTER 4 : THE FINANCIAL SECTOR[#]

Summary

- *The low interest rate environment in Hong Kong continued in the first quarter of 2014 amid the ongoing accommodative monetary policy in the United States.*

- *The Hong Kong dollar spot exchange rate remained generally stable against the US dollar during the quarter. Meanwhile, the Hong Kong dollar Nominal and Real Effective Exchange Rate Indices rose alongside the strengthening of the US dollar.*

- *The monetary aggregates recorded modest growth in the first quarter. Yet, total loans and advances expanded at an accelerated pace, mainly driven by strong growth in foreign currency loans.*

- *The local stock market underwent some correction in the first quarter, due in part to concerns over possible capital outflow from the emerging markets amid the US Federal Reserve's asset purchase tapering. Market sentiment was also affected by signs of economic slowdown in the Mainland. The Hang Seng Index fell by 5.0% from end-2013 to 22 151 at end-March 2014. Trading activities picked up further, while fund raising activities showed wide fluctuations from quarter to quarter.*

- *In early April, the China Securities Regulatory Commission and the Securities and Futures Commission have jointly approved, in principle, the Shanghai-Hong Kong Stock Connect, a pilot programme for establishing stock market trading links between Shanghai and Hong Kong. The programme will strengthen the strategic co-operation and interaction between the two markets and further increase the liquidity of the offshore RMB market in Hong Kong. It would also reinforce Hong Kong's position as an international financial centre and offshore RMB business centre.*

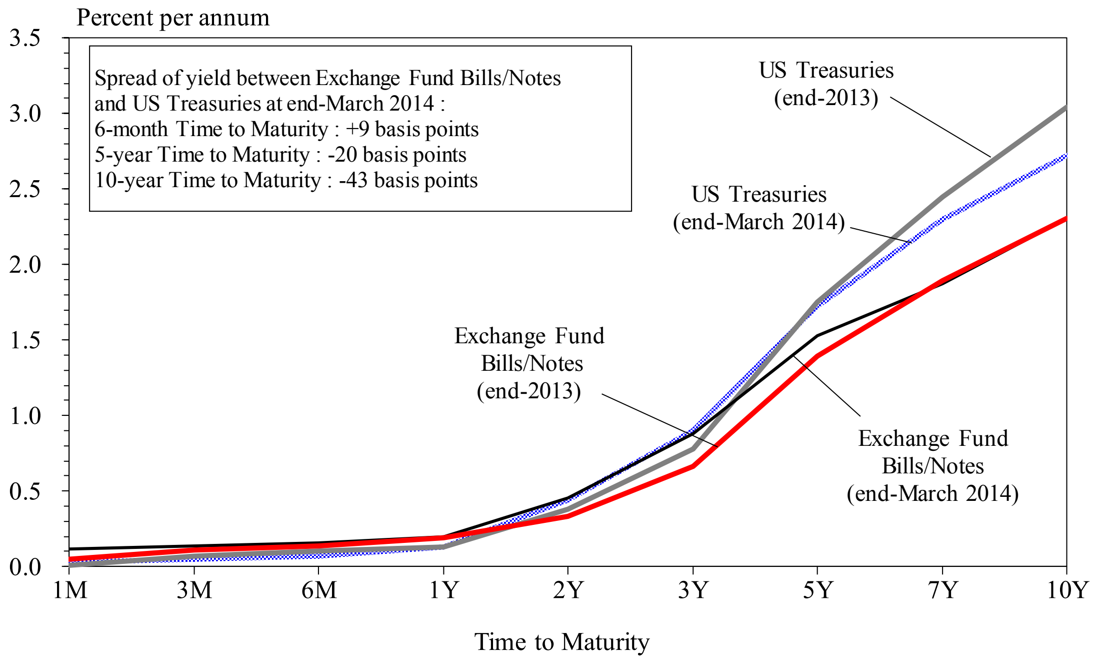
(#) This chapter is jointly prepared by the Hong Kong Monetary Authority (HKMA) and the Economic Analysis Division.

Interest rates and exchange rates

4.1 The low interest rate environment in Hong Kong continued in the first quarter of 2014 amid the ongoing accommodative monetary policy in the United States. With the Federal Funds Target Rate staying at 0-0.25%, the Base Rate under the Discount Window operated by the HKMA held unchanged at 0.5% during the quarter[(1)]. The Hong Kong dollar interbank interest rates also remained low, with the overnight and three-month HIBOR fixings inching down from 0.08% and 0.38% at end-2013 to 0.06% and 0.37% respectively at end-March 2014.

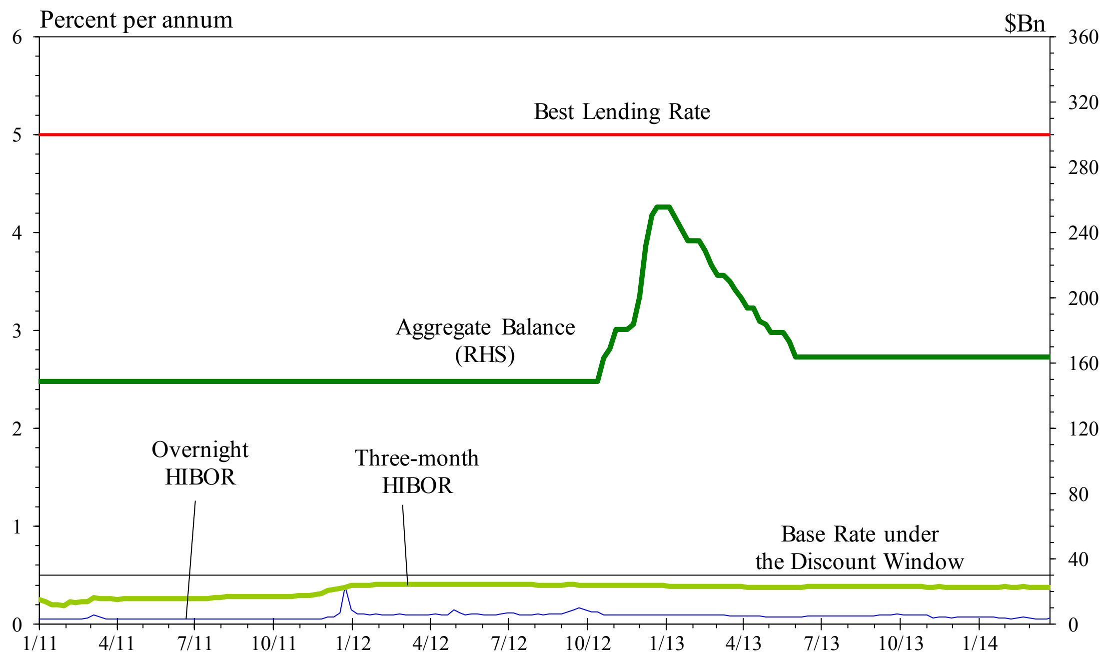
4.2 The *US dollar yield curve* flattened in the first quarter of 2014, with a decline in yields at the longer tenor. Meanwhile, the *Hong Kong dollar yields* showed slight increases at the shorter tenor. As a result, the positive yield spread between 6-month Exchange Fund Bills and 6-month US Treasury Bills edged up from four basis points at end-2013 to nine basis points at end-March 2014, while the negative yield spread between 10-year Exchange Fund Notes and 10-year US Treasury Notes narrowed notably from 74 basis points to 43 basis points.

Diagram 4.1 : Both the US dollar yield curve and Hong Kong dollar yield curve flattened



4.3 Interest rates on the retail front also stayed low. The *Best Lending Rates* stayed unchanged at 5.00% or 5.25% in the first quarter. 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) also remained low, at 0.01% and 0.16% respectively. Meanwhile, the *composite interest rate*(2), which indicates the average cost of funds for retail banks, edged up from 0.39% at end-2013 to 0.41% at end-March 2014, still a very low level by historical standards.

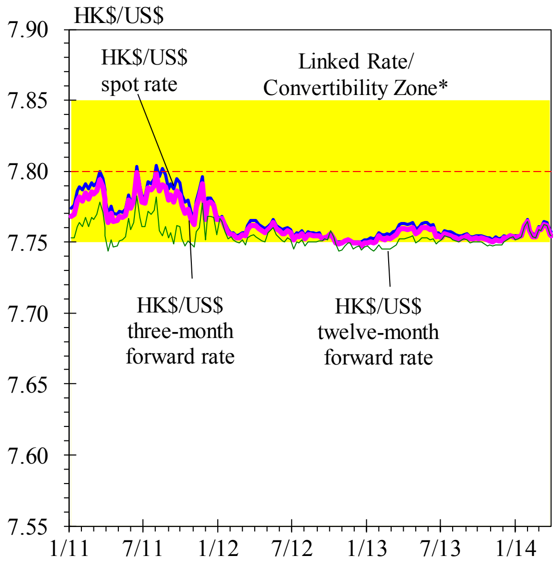
Diagram 4.2 : Hong Kong dollar interest rates remained low
(end for the week)



4.4 The *Hong Kong dollar spot exchange rate* remained generally stable against the US dollar during the quarter, moving within a narrow range between 7.754 and 7.768. It closed at 7.757 at end-March 2014, little changed from 7.754 at end-2013. Meanwhile, the discounts of the *3-month* and *12-month Hong Kong dollar forward rates* to the spot rate widened from 8 and 17 pips (each pip equivalent to HK$0.0001) to 26 and 31 pips respectively.

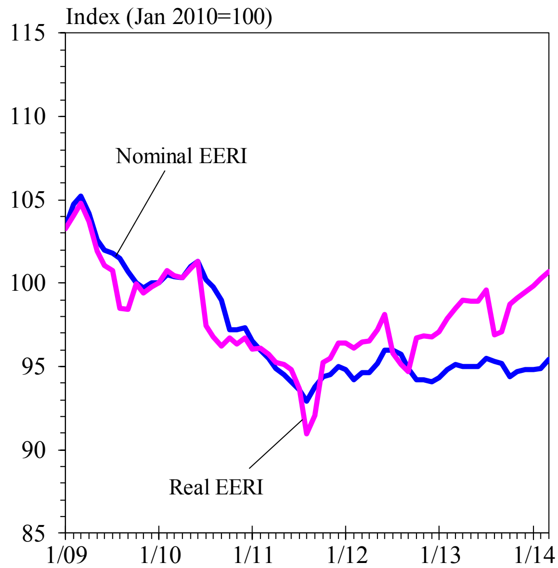
4.5 Under the Linked Exchange Rate system, movements in the Hong Kong dollar exchange rate against other currencies closely followed those of the US dollar. As the US dollar strengthened against the renminbi (RMB) though weakened against most other major currencies, *the Hong Kong dollar Nominal Index* and the *Real Effective Exchange Rate Index*(3) increased by 0.6% and 1.2% respectively during the first quarter.

Diagram 4.3 : Hong Kong dollar remained generally stable 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.

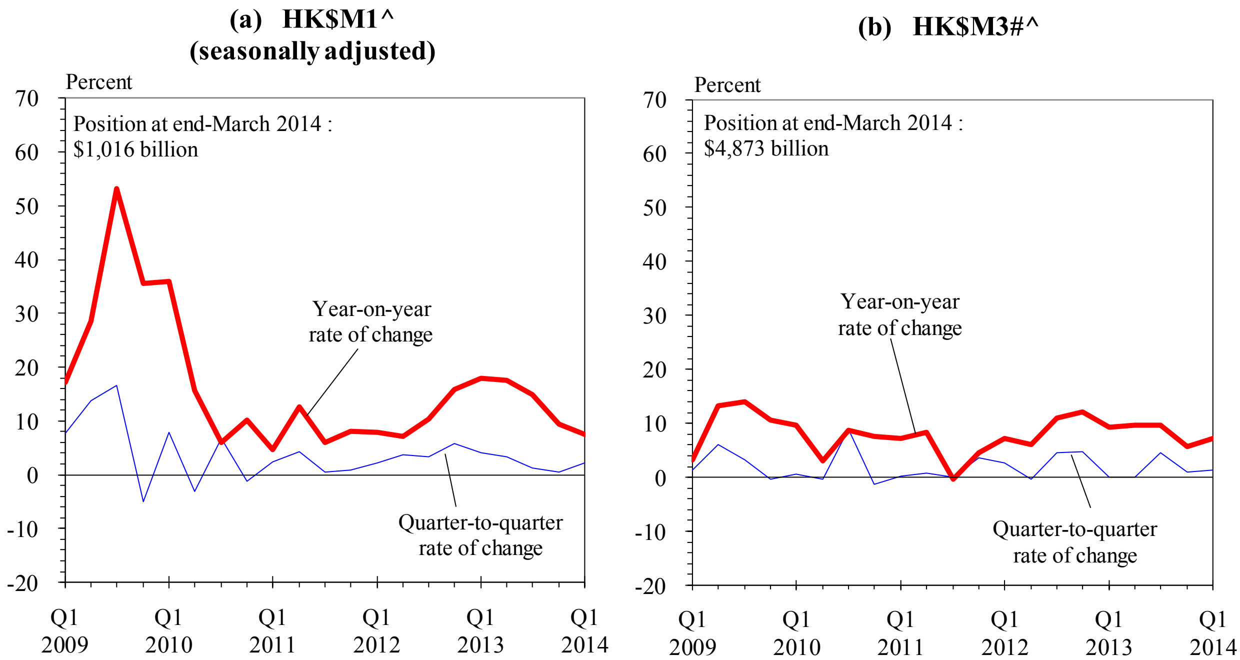
Diagram 4.4 : The trade-weighted nominal and real EERIs increased in the first quarter (average for the month)



Money supply and banking sector

4.6 The monetary aggregates recorded modest growth in the first quarter. The seasonally adjusted Hong Kong dollar narrow *money supply* (HK$M1) grew by 2.2% over end-2013 to $1,016 billion at end-March 2014, and the broad money supply (HK$M3) by 1.4% to $4,873 billion[(4)]. Meanwhile, *total deposits* with authorised institutions (AIs)[(5)] edged up by 0.1% to $9,189 billion, with Hong Kong dollar deposits expanding by 1.2% but foreign currency deposits declining by 0.9%.

Diagram 4.5 : The monetary aggregates recorded modest growth



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

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

% change during the quarter		M1 HK$^	M1 Total	M2 HK$[(a)]	M2 Total	M3 HK$[(a)]	M3 Total
2013	Q1	4.0	1.0	0.1	1.1	0.1	1.1
	Q2	3.3	2.7	0.0	1.9	0.1	1.9
	Q3	1.2	3.9	4.6	5.5	4.6	5.5
	Q4	0.6	1.8	0.9	3.4	0.9	3.4
2014	Q1	2.2	0.8	1.4	0.9	1.4	0.9
Total amount at end-March 2014 ($Bn)		1,016	1,523	4,862	10,146	4,873	10,178
% change over a year earlier		7.4	9.5	7.1	12.1	7.1	12.2

Notes : (^) Seasonally adjusted.

(a) Adjusted to include foreign currency swap deposits.

4.7 Yet, total loans and advances grew by an accelerated 5.7% over end-2013 to $6,825 billion at end-March 2014. Within the total, foreign currency loans and Hong Kong dollar loans rose by 8.0% and 3.9% respectively (***Box 4.1***). Reflecting the respective movements in deposits and loans, the loan-to-deposit ratio for foreign currency picked up from 59.5% at end-2013 to 64.9% at end-March 2014, and that for Hong Kong dollar from 82.1% to 84.3%.

4.8 Loans for use in Hong Kong expanded by a solid 6.5% over end-2013 to $4,825 billion at end-March 2014, and loans for use outside Hong Kong by 3.7% to $2,000 billion. Within the former, loans to most economic sectors showed increases. Trade financing rebounded by a noticeable 12.4%, and loans to manufacturing rose by 7.4%. Loans to wholesale and retail trade went up by 5.5% amid the continued expansion in the local consumption market. Alongside the pick-up in stock market trading activities, loans to financial concerns leapt by 11.6%. By comparison, loans for purchase of residential property and loans to building, construction, property development and investment only rose modestly, by 1.0% and 2.8% respectively, amid the generally quiet property market.

Table 4.2 : Loans and advances

		All loans and advances for use in Hong Kong									
		Loans to :									
% change during the quarter		Trade finance	Manu-facturing	Whole-sale and retail trade	Building, construction, property development and investment	Purchase of residential property[(a)]	Financial concerns	Stock-brokers	Total[(b)]	All loans and advances for use outside Hong Kong[(c)]	Total loans and advances
2013	Q1	19.3	2.5	1.1	-0.7	1.7	3.2	26.2	2.9	3.3	3.0
	Q2	23.9	9.3	8.9	4.2	1.3	3.3	17.2	7.1	4.3	6.3
	Q3	7.8	4.3	6.6	4.3	0.5	3.9	125.7	3.6	8.5	5.0
	Q4	-9.7	0.8	1.6	-0.9	0.3	7.9	-53.1	-0.3	3.9	0.9
2014	Q1	12.4	7.4	5.5	2.8	1.0	11.6	38.2	6.5	3.7	5.7
Total amount at end-March 2014 ($Bn)		618	232	441	1,020	959	365	43	4,825	2,000	6,825
% change over a year earlier		35.5	23.4	24.5	10.8	3.2	29.3	71.3	17.8	21.9	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.

Box 4.1

Mainland-related exposures of the Hong Kong banking sector[1]

Recently, there has been escalated interest in the growth in Mainland-related lending in the Hong Kong banking sector, as such lending has contributed a notable part to the overall loan growth of the banking sector. To better understand the situation and the risk landscape involved, the HKMA published an article titled "Mainland-related exposures" in April 2014[2]. The following paragraphs summarise the key points of the HKMA article.

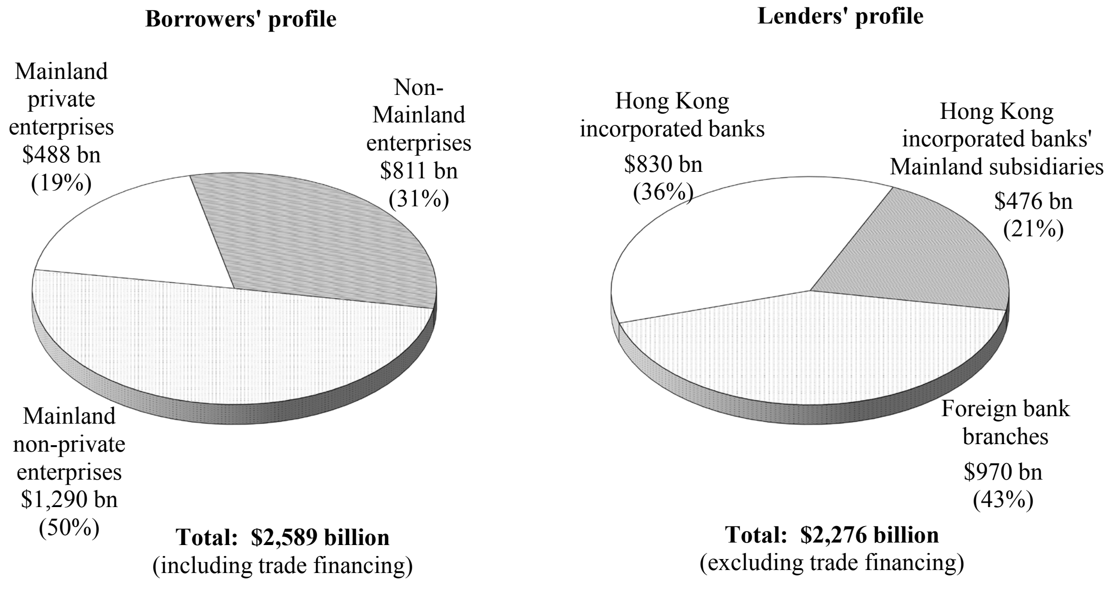
Hong Kong as a regional hub for financial intermediation

Hong Kong is a regional hub for financial intermediation. The role has become more prominent in recent years as a result of Hong Kong's increasing financial and economic integration with the Mainland and the continuous economic growth of the latter. Local and international corporates utilise the Hong Kong platform to raise funds for supporting their business ventures in the Mainland, while Mainland enterprises obtain funds here to finance their business expansion and acquisitions both on the Mainland and in other markets.

Meanwhile, foreign banks including those from Japan, Singapore, Australia and the United States recognise the unique advantage of Hong Kong and have, in recent years, increasingly participated in financial intermediation activities using their Hong Kong branches.

At end-2013, Mainland-related lending of the Hong Kong banking sector amounted to $2,589 billion, comprising $2,276 billion of customer loans and $313 billion of trade financing. Reflecting Hong Kong's status as a regional hub for financial intermediation, both the lenders and borrowers have diversified profiles. Among the borrowers, Mainland non-private enterprises, mostly large state-owned enterprises, accounted for the majority, at 50% of the total Mainland-related lending. Mainland private enterprises took up 19%, while the remaining 31% was borrowed by non-Mainland enterprises, including international corporations and Hong Kong conglomerates. On the lenders side, 43% of Mainland-related lending (excluding trade financing) was made by foreign bank branches. Hong Kong incorporated banks and their Mainland subsidiaries accounted for 36% and 21% respectively (***Chart***).

Chart : Diversified profiles of borrowers and lenders



Note: Figures in brackets denote the share of loans to the corresponding total.

(1) This box article is jointly prepared by the HKMA and the Economic Analysis Division.

(2) For the HKMA article, please see: http://www.hkma.gov.hk/eng/key-information/insight/20140415.shtml.

Box 4.1 (Cont'd)

HKMA's regulatory framework

Given the increasing exposure of the Hong Kong banking sector to Mainland-related lending, it is important to ensure that the risks involved are properly managed. Considering the risk profile of Mainland-related lending and the high degree of heterogeneity in various aspects (e.g. lender type, borrower industry, loan use, credit risk mitigation), from the perspective of a banking supervisor, it is not appropriate to manage the risks of Mainland-related lending using across-the-board hard limits. Therefore, the HKMA's focus is on the robustness of banks' risk management systems, in particular the effectiveness of credit risk and liquidity risk management, and the resilience of banks to possible credit loss in the event of deterioration in loan quality.

Furthermore, the HKMA has stepped up its supervisory efforts in credit risk management since 2010 in light of the significant credit growth. Specifically, these efforts include: (1) regular and thematic onsite examinations of banks' credit underwriting processes; (2) Stable Funding Requirement on banks with high loan growth to ensure adequate long-term funding to support loan growth; and (3) regular supervisory stress-testing to assess banks' resilience to credit shocks.

The HKMA's assessment results show that credit risks of the Hong Kong banking sector, including those of the Mainland-related loans, are properly managed. Also, there is no sign of credit quality deterioration for Mainland-related loans. At end-2013, the classified loan ratio of the banking sector's Mainland-related lending portfolio stood at 0.29%, lower than that of the sector's total lending portfolio at 0.48%.

The HKMA will continue to closely monitor banks' asset quality and ensure that banks are resilient to credit loss throughout the economic cycle by maintaining strong capital positions and, where necessary and appropriate, regulatory reserves. It will also continue to ensure that banks will uphold their credit underwriting standards and prudently manage their liquidity risks.

4.9 The Hong Kong banking sector remains resilient. Hong Kong incorporated AIs were well capitalised, with the total capital adequacy ratio staying high at an average of 15.9% at end-2013. So far no AIs have encountered any difficulty in complying with the statutory minimum ratios required by the HKMA under the Basel III framework(6).

4.10 The HKMA has been implementing the Basel III framework promulgated by the Basel Committee on Banking Supervision in accordance with the transitional timetable set by the Basel Committee, which commenced on 1 January 2013 and is expected to complete on 1 January 2019. Following the first phase of Basel III standards(7) which took effect in 2013, the HKMA is preparing the next phase of implementation of Basel III standards which include capital buffer requirements, the liquidity coverage ratio, as well as disclosure requirements associated with these standards and the leverage ratio. Having considered the comments received in the different rounds of consultations launched in 2013, the HKMA has been developing the implementing rules, including amendments to the Banking (Capital) Rules and the Banking (Disclosure) Rules, and a new set of Banking (Liquidity) Rules, for submission to the Legislative Council in 2014.

4.11 In March 2014 the HKMA launched the industry consultation on the proposals for establishing and implementing a local regulatory and supervising framework for systemically important AIs in Hong Kong, with reference to the Basel Committee's principles. Through the application of a range of prudential and supervisory requirements to these designated AIs, the proposals would help reduce the probability of failure of these AIs, thereby ensuring the resilience of the financial sector of Hong Kong.

4.12 Meanwhile, the HKMA continues to participate in the Basel Committee's implementation monitoring process (IMP) and carry out its local IMP on an expanded sample of AIs to assess both the impact of the Basel III requirements and the implementation progress of AIs, especially on the implementation of the liquidity standards. Based on the local IMP results to date, AIs in Hong Kong are generally not expected to encounter major difficulties in complying with the new liquidity standards, although some AIs may need to adjust their liquidity profiles or liquid asset composition to meet the requirements.

4.13 Asset quality of the local banking sector remains good. The ratio of classified loans to total loans stayed low at 0.48% at end-2013, virtually unchanged from the level at end-September. The delinquency ratio for credit card lending edged down from 0.22% to 0.20% over the same period. The delinquency ratio for residential mortgage loans also stayed at 0.02% at end-March 2014, unchanged from end-2013.

Table 4.3 : Asset quality of retail banks*

(as % of total loans)

As at end of period		Pass loans	Special mention loans	Classified loans (gross)
2012	Q1	98.17	1.27	0.57
	Q2	98.19	1.28	0.52
	Q3	98.19	1.31	0.50
	Q4	98.16	1.36	0.48
2013	Q1	98.32	1.22	0.46
	Q2	98.42	1.11	0.47
	Q3	98.25	1.27	0.48
	Q4	98.33	1.20	0.48

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".

4.14 Offshore RMB business in Hong Kong recorded further growth in the first quarter. *RMB trade settlement handled by banks in Hong Kong* surged by 21.6% over the preceding quarter or 79.2% over a year earlier to RMB1,489 billion. The outstanding *RMB deposits* and *certificates of deposit* rose to RMB1,158 billion at end-March 2014, 9.9% higher than at end-2013. RMB financing activities were also vibrant. On the back of active issuance by international corporates and financial institutions, *RMB bond issuance* in the first quarter surged by 43.4% over the preceding quarter to RMB59 billion. Meanwhile, the *outstanding amount of RMB loans* rose by 4.4% over end-2013 to RMB121 billion at end-March 2014.

Table 4.4 : Renminbi deposits and cross-border renminbi trade settlement in Hong Kong

As at end of period		Demand and savings deposits (RMB Mn)	Time deposits (RMB Mn)	Total deposits (RMB Mn)	Interest rates on[a] Savings deposits[b] (%)	Interest rates on[a] Three-month time deposits[b] (%)	Number of AIs engaged in RMB business	Amount of cross-border RMB trade settlement[c] (RMB Mn)
2013	Q1	144,314	523,744	668,058	0.25	0.52	140	830,955
	Q2	127,512	570,447	697,959	0.25	0.53	140	864,366
	Q3	135,217	594,801	730,018	0.25	0.53	143	921,282
	Q4	151,055	709,417	860,472	0.25	0.53	146	1,224,349
2014	Q1	167,082	777,828	944,910	0.25	0.53	147	1,488,813
% change over the preceding quarter		10.6	9.6	9.8	N.A.	N.A.	N.A.	21.6
% change over a year earlier		15.8	48.5	41.4	N.A.	N.A.	N.A.	79.2

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

(b) Period average figures.

(c) Figures during the period.

N.A. Not available.

The debt market

4.15 The Hong Kong dollar debt market continued to expand in the first quarter of 2014. Total gross issuance of Hong Kong dollar debt securities rose by 0.7% over the preceding quarter or 4.1% over a year earlier to $593.1 billion[8]. Within the total, private sector debt issuance rebounded by a sharp 40.8% over the preceding quarter, with across the board increase in issuance by AIs, local corporations and non-MDBs overseas borrowers. By contrast, public sector debt issuance shrank by 2.5%, as the increase in new debts issued by the Government and statutory bodies/government-owned corporations was more than offset by the decline in Exchange Fund papers issuance. At end-March 2014, the total outstanding balance of Hong Kong dollar debt securities edged up by 0.6% over end-2013 to $1,428.4 billion, equivalent to 29.3% of HK$M3 or 24.5% of Hong Kong dollar-denominated assets of the entire banking sector[9].

4.16 As to the Government Bond (GB) Programme, the Financial Secretary announced in the 2014-15 Budget the proposal to issue another tranche of inflation-linked bond (i.e. iBonds) of up to $10 billion. Meanwhile, a total of $7.5 billion institutional GBs, with tenors ranging from two to ten years, were issued in the first quarter. Separately, the tenth issuance schedule, which covers the six-month period from March to August 2014, was announced in January 2014. As at end-March 2014, the outstanding size of bonds issued under the GB Programme amounted to $94 billion, including ten institutional issues for $64 billion, and three retail issues (iBonds) for $30 billion.

4.17 To promote the liquidity of the institutional bond market, in 2013 the HKMA devised two liquidity enhancement measures, namely the bond swap facility and the switch tender. The bond swap facility allows Primary Dealers to temporarily swap their institutional GB holdings with the Government, and was launched on 17 February 2014. As to the switch tender, it allows the Government to initiate a tender for Primary Dealers to bid for the permanent switching from one GB to another GB under a competitive tender environment. The first switch tender will be held in mid-May 2014. These measures will enhance the effectiveness of market-making activities and liquidity management on the part of the Primary Dealers, and facilitate end-investors to trade more efficiently in the market.

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

	Exchange Fund paper	Statutory bodies/government-owned corporations	Govern-ment	Public sector total	AIs	Local corporations	Non-MDBs Overseas borrowers(^)	Private Sector total	MDBs(^)	Total
New Issuance										
2013 Annual	2,123.4	10.7	30.0	2164.1	143.0	25.6	23.1	191.7	0.9	2,356.8
Q1	508.9	3.5	7.0	519.4	32.5	11.6	6.1	50.3	-	569.7
Q2	537.6	5.0	13.0	555.6	39.5	2.2	7.5	49.2	-	604.7
Q3	532.0	1.1	7.0	540.1	43.2	6.6	2.4	52.2	0.9	593.2
Q4	545.0	1.1	3.0	549.1	27.8	5.2	7.1	40.0	-	589.1
2014 Q1	525.4	2.5	7.5	535.4	33.3	9.8	13.3	56.4	1.3	593.1
% change in 2014 Q1 over 2013 Q1	3.2	-28.6	7.1	3.1	2.4	-15.8	117.6	12.2	-	4.1
% change in 2014 Q1 over 2013 Q4	-3.6	120.4	150.0	-2.5	19.8	89.1	88.3	40.8	-	0.7
Outstanding (as at end of period)										
2013 Q1	708.6	45.7	72.0	826.4	249.7	123.0	145.8	518.5	10.2	1,355.1
Q2	750.1	43.2	85.0	878.3	250.9	117.0	149.0	516.9	9.9	1,405.0
Q3	750.6	40.1	88.5	879.2	248.1	122.9	148.1	519.2	10.4	1,408.7
Q4	751.2	39.8	91.5	882.5	250.1	127.9	148.7	526.7	10.2	1,419.4
2014 Q1	751.5	40.1	95.5	887.1	249.0	130.4	150.9	530.3	11.1	1,428.4
% change over a year earlier	6.0	-12.4	32.6	7.3	-0.3	6.0	3.5	2.3	8.7	5.4
% change over the preceding quarter	0.0	0.7	4.4	0.5	-0.4	1.9	1.5	0.7	8.2	0.6

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

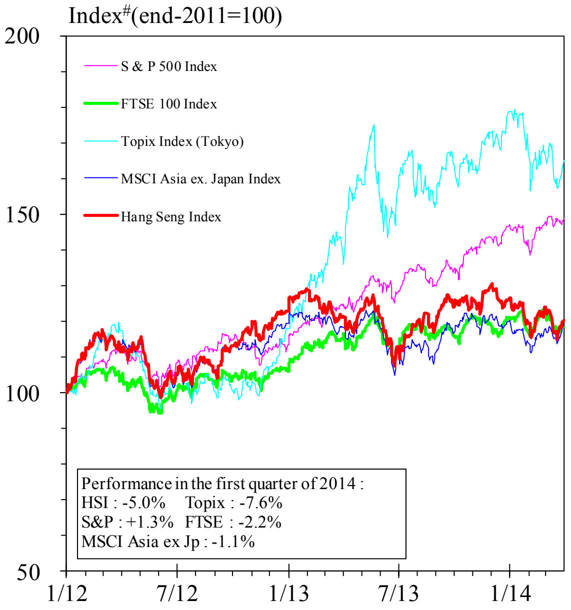
(^) MDBs : Multilateral Development Banks.

The stock and derivatives markets

4.18 The *local stock market* underwent some correction in the first quarter of 2014, due in part to concerns over possible capital outflow from the emerging markets amid the US Federal Reserve's asset purchase tapering. Market sentiment was also affected by signs of economic slowdown in the Mainland. The Hang Seng Index (HSI) fell from a high of 23 340 on 2 January to 21 182 on 20 March. Though recouping part of the loss later, HSI still declined by 5.0% from end-2013 to 22 151 at end-March 2014. In parallel, *market capitalisation* of the Hong Kong stock market shrank by 4.1% to $23.1 trillion. According to the World Federation of Exchanges, the local stock market was the fifth largest stock exchange in the world and the second largest in Asia(10).

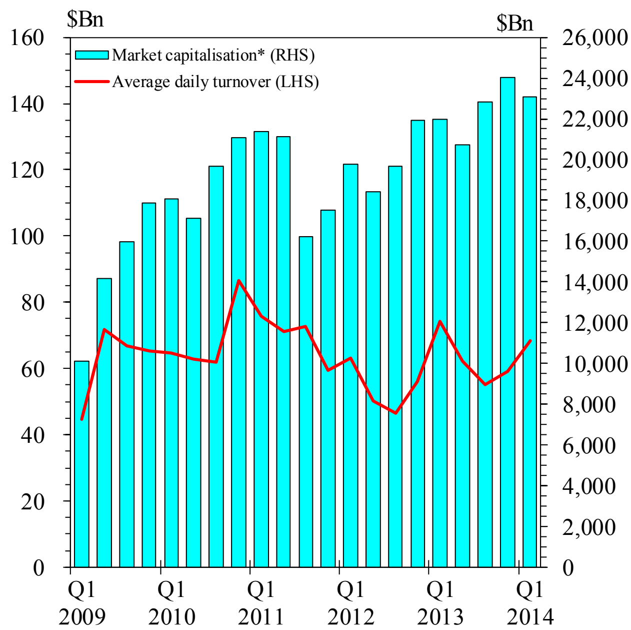
4.19 Meanwhile, trading activities continued to pick up. *Average daily turnover* in the securities market jumped by 15.7% over the preceding quarter to $68.3 billion in the first quarter, though still 8.1% lower than a year earlier. As to *derivatives products*(11), the average daily trading volume of futures and options rose by 7.8% over the preceding quarter. Analysed by products, trading of stock options, H-shares Index futures, HSI futures and HSI options all increased, by 10.8%, 3.8%, 2.9% and 0.8% respectively. The average daily trading value of securitised derivatives products surged by 22.7% against a low base of comparison in the preceding quarter, with trading of callable bull/bear contracts and derivative warrants rising by 23.0% and 22.4% respectively.

Diagram 4.6 : The Hang Seng Index underwent some correction in the first quarter of 2014



Notes : (#) Position at end of month.

Diagram 4.7 : Market capitalisation shrank while trading activities picked up further



Note : (*) Position at end of quarter.

Table 4.6 : 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)^
2013	Annual	80 247	35 252	85 538	249 295	532 905	7,309	5,202	12,510
	Q1	82 570	38 464	77 111	278 115	552 686	10,268	6,032	16,301
	Q2	91 137	43 304	87 653	256 162	563 658	7,150	5,433	12,583
	Q3	78 192	31 109	87 853	217 169	503 305	6,190	5,250	11,441
	Q4	69 587	28 614	89 157	247 867	514 398	5,783	4,138	9,920
2014	Q1	71 607	28 842	92 576	274 757	554 700	7,077	5,090	12,167
% change in 2014 Q1 over 2013 Q1		-13.3	-25.0	20.1	-1.2	0.4	-31.1	-15.6	-25.4
% change in 2014 Q1 over 2013 Q4		2.9	0.8	3.8	10.8	7.8	22.4	23.0	22.7

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

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

4.20 Given the nature of the business, fund raising activities continued to showed wild fluctuation from quarter to quarter. *Total equity capital raised*, comprising new share floatations and post-listing arrangements on the Main Board and the Growth Enterprise Market (GEM)[(12)], plunged by 45.7% from the high base in the preceding quarter to $102.0 billion in the first quarter of 2014, but was sharply higher by 59.8% over a year earlier. Within the total, the amount of funds raised through initial public offerings plummeted by 57.8% from the preceding quarter to $46.0 billion.

4.21 Mainland enterprises continued to play a dominant role in the Hong Kong stock market. At end-March 2014, a total of 817 Mainland enterprises (including 187 H-share companies, 129 “Red Chips” companies and 501 private enterprises) were listed on the Main Board and GEM, accounting for 49% of the total number of listed companies and 56% of total market capitalisation. In the first quarter, Mainland-related stocks accounted for 70% of equity turnover and 60% of total equity fund raised in the Hong Kong stock exchange (HKEx).

4.22 The Securities and Futures Commission (SFC) launched the consultation on the proposals to amend the Code on Real Estate Investment Trusts (REITs) in January. With the aim of introducing greater flexibility in the investment scope of REITs, it is proposed that REITs be allowed to invest in properties under development or engage in property development activities, and invest in financial instruments, subject to relevant restrictions and requirements. The proposals would facilitate the long-term development of the Hong Kong REIT market and enhance Hong Kong's status as an international asset management centre.

4.23 In February, the SFC launched the consultation on the proposal to strengthen regulation of alternative liquidity pools (ALPs). Also known as alternative trading systems and "dark pools", ALPs are electronic systems operated by licensed or registered persons through which the crossing or matching of orders involving listed or exchange traded securities are conducted with no pre-trade transparency. SFC proposed to enhance and standardise the regulatory obligations of ALP operators in such areas as improving disclosure, restricting the access of ALPs to only institution investors, maintaining system adequacy, and introducing additional control and other reporting/record-keeping requirements. The proposals would help strike a balance between market development, and market integrity and investor protection in Hong Kong.

4.24 In early March 2014, the HKEx announced that the first deliverable RMB currency futures in the world would be introduced to after-hours trading on 7 April. Most of the current trading, clearing and risk management measures for HKEx's after-hour futures trading will apply to the RMB currency futures. The wider range of RMB-related products would facilitate the internationalisation of the RMB, thereby enhancing Hong Kong's position as an offshore RMB centre.

4.25 In early April, the China Securities Regulatory Commission and the SFC jointly approved, in principle, the development of Shanghai-Hong Kong Stock Connect, a pilot programme for establishing stock market trading links between Shanghai and Hong Kong. When launched, the programme will allow eligible Mainland investors to trade eligible stocks listed on the HKEx through the Shanghai Stock Exchange (SSE) directly, and allow Hong Kong and overseas investors to trade eligible stocks listed on the SSE through the HKEx directly(13). The programme will strengthen the strategic co-operation and interaction between the two securities markets, catalyse the two-way RMB fund flows between the onshore and offshore markets, and further increase the liquidity of the offshore RMB market in Hong Kong. It would also reinforce Hong Kong's position as an offshore RMB business centre.

Fund management and investment funds

4.26 The fund management business showed some growth in the first quarter. Gross retail sales of *mutual funds* rose by a sharp 40.9% over the preceding quarter or by 3.4% from a year earlier to US$20.6 billion[(14)]. The aggregate net asset value of the approved constituent funds under the *Mandatory Provident Fund (MPF) schemes*[(15)] edged up by 0.4% over end-2013 to $516 billion at end-March 2014. The amount of net assets managed by *retail hedge funds* also recorded a slight increase[(16)].

4.27 In March, the Government launched the consultation on introducing a new open-ended fund company structure to expand Hong Kong's legal infrastructure for investment fund vehicles, so as to provide market participants with more flexibility in establishing and operating funds in Hong Kong. Currently, an open-ended investment fund could be established in the form of a unit trust but not in corporate form. Given the increasing popularity of corporate fund structure, the proposals would help attract more mutual funds and private funds choosing to domicile in Hong Kong, thereby strengthening Hong Kong's position as a premier international asset management centre.

Insurance sector

4.28 The *insurance sector*[(17)] expanded further in 2013, with most underlying business segments recording solid growth. Gross premium income from long-term business jumped by 18.9%. Within the total, premium income from non-investment linked plans went up by 21.0% and that from investment-linked plans by 11.7%. Also, gross and net premium for general business rose by 7.1% and 8.0% respectively.

Table 4.7 : 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
2012 Annual	39,312	27,008	2,215	60,339	17,122	104	279	77,844	117,156
Q1	10,924	7,608	853	15,056	3,961	16	79	19,112	30,036
Q2	9,328	6,593	735	14,697	3,924	28	50	18,699	28,027
Q3	10,264	6,930	464	15,351	3,998	26	115	19,490	29,754
Q4	8,796	5,877	163	15,235	5,239	34	35	20,543	29,339
2013 Annual	42,120	29,179	3,038	73,015	19,132	156	285	92,588	134,708
Q1	12,359	8,759	657	17,527	4,919	36	53	22,535	34,894
Q2	10,428	7,446	864	17,570	5,597	40	61	23,268	33,696
Q3	10,512	7,314	671	18,910	3,831	40	50	22,831	33,343
Q4	8,821	5,660	846	19,008	4,785	40	121	23,954	32,775
% change in 2013 Q4 over 2012 Q4	0.3	-3.7	419.0	24.8	-8.7	17.6	245.7	16.6	11.7
% change in 2013 over 2012	7.1	8.0	37.2	21.0	11.7	50.0	2.2	18.9	15.0

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

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

4.29 The Inland Revenue (Amendment) (No.3) Bill 2013, which would provide tax concession for captive insurers with effect from the year of assessment 2013/14 onwards, was passed by the Legislative Council in March 2014. With a view to attracting more enterprises to establish their captive insurers in Hong Kong for underwriting risks of companies within the same group to which they belong, the profits tax on offshore risks insurance business of captive insurers would be reduced by 50%. This would help form a cluster of captive insurers, thereby reinforcing Hong Kong's status as a regional insurance hub, while at the same time making Hong Kong's risk management services more diversified and promoting the development of other professional services including reinsurance, legal and actuarial services in Hong Kong.

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 15 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 2009 and 2010.

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) AIs include licensed banks, restricted licence banks and deposit-taking companies. At end-March 2014, there were 158 licensed banks, 21 restricted licence banks and 23 deposit-taking companies in Hong Kong. Altogether, 202 AIs (excluding representative offices) from 31 countries and territories (including Hong Kong) had a presence in Hong Kong.

(6) Basel III was introduced by the Basel Committee in December 2010 (and subsequently revised in June 2011) to strengthen the resilience of banks and banking systems in the light of lessons drawn from the global financial crisis. It 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% (with the total capital ratio remaining at 8%); 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% (or higher at national discretion) at times of excessive credit growth, both to be met by common equity. It introduces a supplementary leverage ratio as a backstop to risk-weighted capital measures and enhances the transparency of the capital base. In addition, Basel III introduces two liquidity standards i.e. the Liquidity Coverage Ratio (LCR) to promote short term liquidity resilience and the Net Stable Funding Ratio (NSFR) to encourage more stable funding structures. The LCR is scheduled to take effect from 1 January 2015, starting with a minimum required level of 60% which is to be stepped up by 10 percentage points annually until achieving 100% by 1 January 2019. The NSFR is scheduled to take effect from 1 January 2018.

(7) The first phase of Basel III standards, which covers revised minimum capital requirements calculated based on a stricter definition of capital base and a wider risk coverage, took effect in Hong Kong with the amendments to the Banking (Capital) Rules (by way of the Banking (Capital) (Amendment) Rules 2012) coming into operation since 1 January 2013. To implement the Basel Committee's disclosure requirements associated with these standards, amendments were introduced in the Banking (Disclosure) Rules (by way of the Banking (Disclosure) (Amendment) Rules 2013) which took effect from 30 June 2013.

(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 AIs 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) The ranking is made by the World Federation of Exchanges, a global trade association for the securities exchange industry. Its membership comprises 60 securities exchanges, covering almost all globally recognised stock exchanges.

(11) At end-March 2014, there were 74 classes of stock options contracts and 41 classes of stock futures contracts.

(12) At end-March 2014, there were 1 471 and 195 companies listed on the Main Board and GEM respectively.

(13) As to the operating details of Shanghai-Hong Kong Stock Connect, initially all Mainland institutional investors and eligible individual investors (i.e. individuals who hold an aggregate balance of not less than RMB500,000 in their securities and cash accounts) will be accepted to trade eligible stocks listed on the HKEx through SSE directly. Meanwhile, all Hong Kong and overseas institutional and individual investors will be accepted to trade eligible stocks listed on the SSE through the HKEx directly. Being a pilot programme, the Shanghai-Hong Kong Stock Connect will be implemented in a progressive and risk-controllable manner, and cross-border investment will be subject to quotas. The buying of the eligible HKEx securities by Mainland investors will be capped at an aggregate net quota of RMB250 billion and a

daily net quota of RMB10.5 billion. The buying of the eligible SSE securities by Hong Kong and overseas investors will be capped at an aggregate net quota of RMB300 billion and a daily net quota of RMB13 billion. These quotas will be subject to consideration of any appropriate adjustment in accordance with the actual operational circumstances.

(14) 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-March 2014, the survey covered a total of 1 182 active authorised funds.

(15) At end-March 2014, there were 19 approved trustees. On MPF products, 38 master trust schemes, two industry schemes and one employer sponsored scheme, comprising altogether 477 constituent funds, were approved by the Mandatory Provident Fund Schemes Authority. A total of 266 000 employers, 2.49 million employees and 212 000 self-employed persons have participated in MPF schemes.

(16) At end-March 2014, there were three SFC-authorised retail hedge funds with combined net asset size of US$259 million. The amount of net assets under management edged up by 0.8% from the end-2013 level, and represented an increase of 1.5 times of that at end-2002, the year when the hedge funds guidelines were first issued.

(17) At end-March 2014, there were 158 authorised insurers in Hong Kong. Within this total, 44 were engaged in long-term insurance business, 95 in general insurance business, and 19 in composite insurance business. These authorised insurers come from 22 countries and territories (including Hong Kong).