

CHAPTER 4 : THE FINANCIAL SECTOR[#]

Summary

- *The global financial crisis exacerbated further in the latter part of the third quarter of 2008, following the fallout of a number of large international financial institutions. Liquidity tightened significantly worldwide, while prices across various asset classes plummeted.*
- *Against such a backdrop, Hong Kong dollar interbank interest rates soared in September due to concerns among licensed banks over the credit worthiness of each other. To address the liquidity situation of the local interbank market, the HKMA, apart from operating within the Convertibility Zone to purchase US dollars with HK dollars, has implemented a range of temporary measures for providing liquidity assistance to licensed banks in Hong Kong.*
- *The Hong Kong dollar strengthened against the US dollar in the latter part of the third quarter, reflecting some unwinding of carry trade positions. Following the greenback's general firming trend vis-à-vis most other currencies, the Hong Kong dollar nominal effective exchange rate index rebounded notably in the third quarter.*
- *The local stock market fell further in the quarter, in parallel with the adverse development in the overseas markets. Trading in stocks continued to shrink, while fund raising activities turned quieter. Nevertheless, trading in a number of derivative products remained buoyant.*
- *In the face of the current exceptionally turbulent time, the Government has put in place necessary measures to help ensure financial market stability. For instance, an enhanced deposit protection scheme and a Contingent Bank Capital Facility have been introduced to instil confidence in the local banking system.*

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

Overall situation

4.1 The global financial markets deteriorated further in the third quarter amidst swelling losses among major financial institutions and investors worldwide. Asset prices demonstrated immense volatility in the past months as the dimmer economic outlook weighed heavily on market sentiment. Liquidity tightened significantly due to the heightened risk aversion of lenders. Against such a backdrop, the Hong Kong market also experienced turbulence, with stock prices falling further and interbank interest rates soaring in September.

4.2 Notwithstanding the global financial crisis, Hong Kong's financial system remained robust. The Government has remained vigilant since the onset of the financial crisis more than a year ago, and the various authorities have exercised their best endeavours to ensure financial stability. Most recently, the Hong Kong Monetary Authority (HKMA) has introduced various measures to ease the interbank credit market conditions and provide assistance to banks. Other regulatory authorities, including the Securities and Futures Commission (SFC) and the Insurance Authority, have also taken further actions to enhance protection for investors and policyholders.

Interest rates and exchange rates

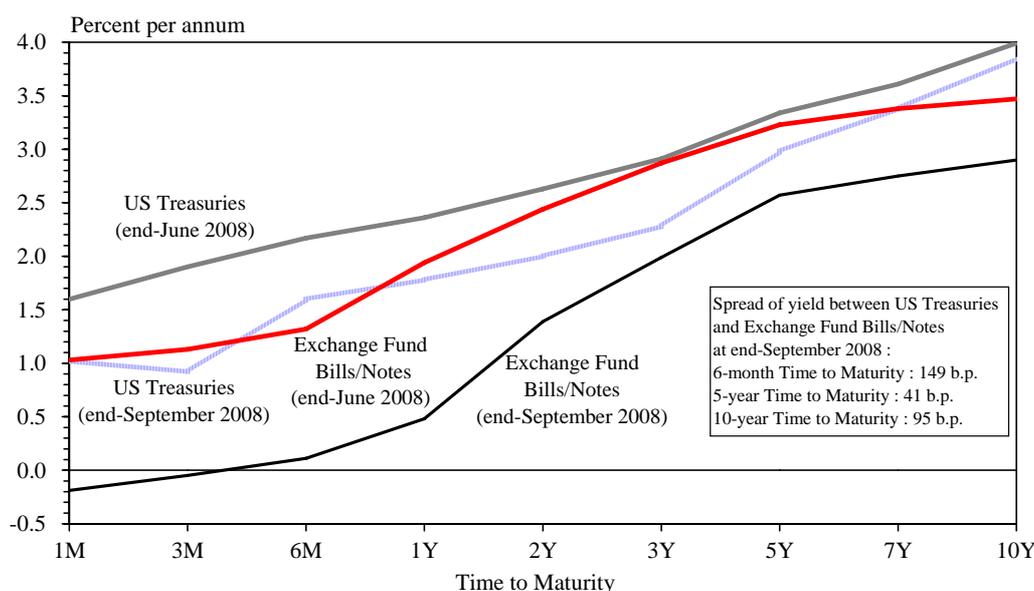
4.3 The *Base Rate* under the Discount Window operated by the HKMA was unchanged at 3.5% in the third quarter of 2008. With effect from 9 October 2008, the formula for determination of the Base Rate was changed by reducing the spread of 150 basis points above the prevailing US Fed Funds Target Rate to 50 basis points. The other leg of the formula relating to the moving averages of the relevant interbank interest rates was removed until the end of March 2009⁽¹⁾. The adjustment in the methodology for the determination of the Base Rate should help stabilise the interbank interest rates and relieve the pressure for banks to lift their best lending rates.

4.4 Broadly tracking their US dollar counterparts, *Hong Kong dollar interbank interest rates* stayed largely stable in July and August but increased markedly towards the end of September. Following the fallout of some major US financial institutions in the first half of September, global credit and liquidity conditions tightened, subsequently causing concerns among licensed banks in Hong Kong over the credit worthiness of each other. These concerns, coupled with the banks' propensity to preserve liquidity to meet their own contingent needs, led to a general shortage of interbank liquidity and difficulties

for individual licensed banks in obtaining funding in the interbank market. The overnight and three-month HIBORs rose to 2.44% and 3.50% respectively at end-September, compared with 0.88% and 2.15% at end-June.

4.5 Meanwhile, the negative interest rate differentials between the Hong Kong dollar and the US dollar were generally stable from July to mid September but fluctuated sharply afterwards. In particular, the discount of the three-month HIBOR over the corresponding Euro-dollar deposit rate widened from 85 basis points at end-June to 125 basis points at end-September. In line with general decreases in US government bond yields, the *Hong Kong dollar yield curve* shifted downward. As heightened credit and liquidity concern led to strong demand for Exchange Fund paper by banks for liquidity management purposes, the yields with maturities of three months and below declined sharply and turned negative near the end of September.

Diagram 4.1 : Hong Kong dollar yield curve shifted downward in the third quarter alongside its US counterpart

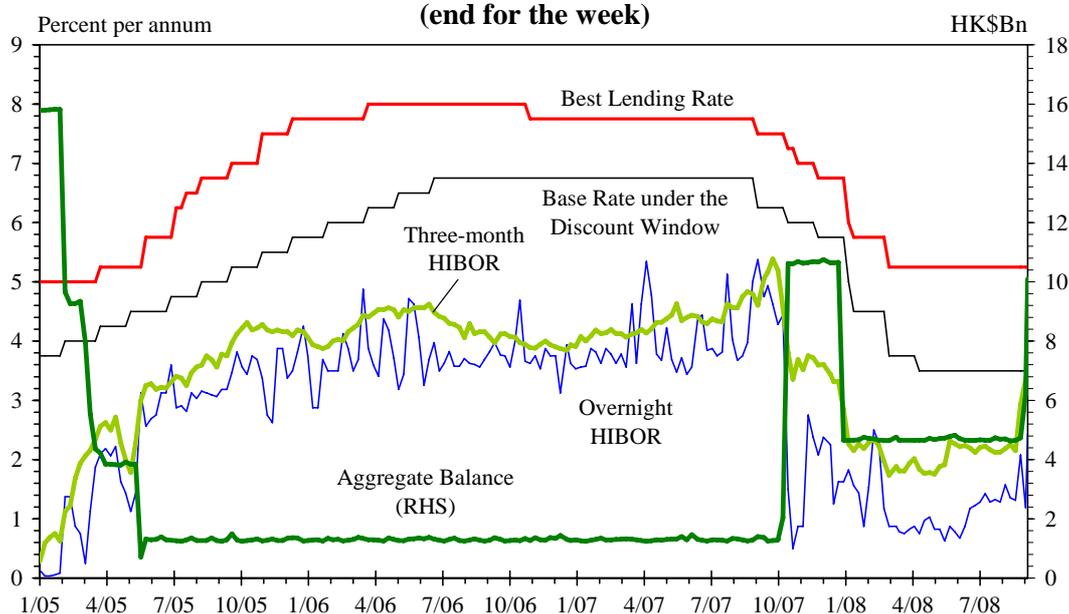


4.6 Amidst heightened concern about credit and liquidity, the HKMA operated within the Convertibility Zone on 18 and 25 September to inject liquidity into the banking system, purchasing US dollars against Hong Kong dollars thereby increasing the Aggregate Balance by \$1.6 billion on 22 September and \$3.9 billion on 29 September. As a result, the Aggregate Balance rose from \$4.7 billion at end-June to \$10.1 billion at end-September. To further address the liquidity situation of the local interbank credit market, the HKMA announced on 30 September five temporary measures for providing liquidity assistance to licensed banks in Hong Kong, with effect from 2 October

for a period of six months (i.e. until the end of March 2009) (*Box 4.1*). These measures, together with other policy actions taken in October, have helped calm the local interbank market and ensured the effective functioning of the banking channel of financial intermediation.

4.7 At the retail level, the two best lending rates were kept on hold at 5.25% and 5.50% respectively during the third quarter. While the average savings deposit interest rate quoted by major banks was unchanged at 0.02%, the average one-month time deposit interest rate rose to 0.63% at end-September, from 0.29% at end-June, as banks searched for more stable and lower-cost funding following the sharp increases in HIBORs. The composite interest rate⁽²⁾, as an indication of the average cost of funds for banks, increased by 33 basis points to 1.18% between end-June and end-September. In the face of tighter interbank liquidity, some banks also raised their mortgage interest rates for new customers. The proportion of newly approved loans priced at more than 2.5% below the best lending rate went down from 86.3% in June to 83.1% in September.

Diagram 4.2 : Hong Kong dollar interbank interest rates trended higher in the third quarter due to tightened liquidity
(end for the week)



Box 4.1

HKMA's measures to provide liquidity assistance to licensed banks in Hong Kong

The Hong Kong Monetary Authority (HKMA) announced on 30 September five temporary measures for providing liquidity assistance to licensed banks in Hong Kong. With effect from 2 October for a period of six months until the end of March 2009, the HKMA will provide liquidity assistance, on request from licensed banks, through the following five measures:

First, the eligible securities, for access by individual licensed banks to liquidity assistance through the Discount Window, will be expanded to include US dollar assets of credit quality acceptable to the HKMA.

Second, the duration of liquidity assistance provided to individual licensed banks through the Discount Window will be extended, at the request of individual licensed banks and on a case-by-case basis, from overnight money only to maturities of up to three months.

Third, the 50% threshold for the use of Exchange Fund paper as collateral for borrowing through the Discount Window at the HKMA Base Rate will be raised to 100%. In other words, the 5% premium (or penalty) over the Base Rate for the use of Exchange Fund paper beyond the 50% threshold, as collateral for borrowing through the Discount Window, will be waived.

Fourth, the HKMA will, in response to requests from individual licensed banks and when it considers necessary, conduct foreign exchange swaps (between the US dollar and the Hong Kong dollar) of various durations with licensed banks.

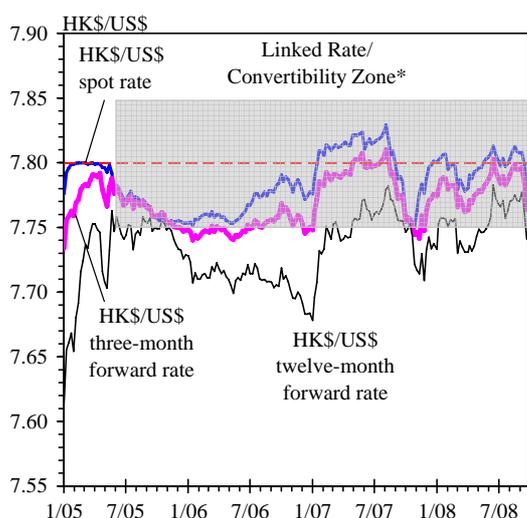
Fifth, the HKMA will, in response to requests from individual licensed banks and when it considers necessary, lend term money of up to one month to individual licensed banks against collateral of credit quality acceptable to the HKMA.

The existing framework for maintaining banking stability – including the prudential supervision of banks and the arrangements for providing liquidity both at the systemic and institutional levels – have ensured that the banking system of Hong Kong is well prepared for turbulent conditions. The five additional measures are intended to reinforce this framework at a time of instability and stress in the world financial system, providing further tools for the HKMA to help ensure the effective functioning of Hong Kong's banking system.

4.8 After moving around the central parity rate of 7.80 between July and mid August, the Hong Kong dollar spot exchange rate against the US dollar strengthened towards the strong side of the Convertibility Zone. This reflected some unwinding of carry trade positions due to tightened HIBORs, and increased funding needs which reportedly caused some banks and financial institutions to use US dollars to obtain Hong Kong dollar funds. The spot exchange rate closed at 7.7655 at end-September, compared with 7.8005 at end-June. Meanwhile, the discounts of 3-month and 12-month Hong Kong dollar forward rate over the spot rate narrowed from 138 and 340 pips (each pip equivalent to HK\$0.0001) at end-June to 100 and 290 pips at end-September respectively.

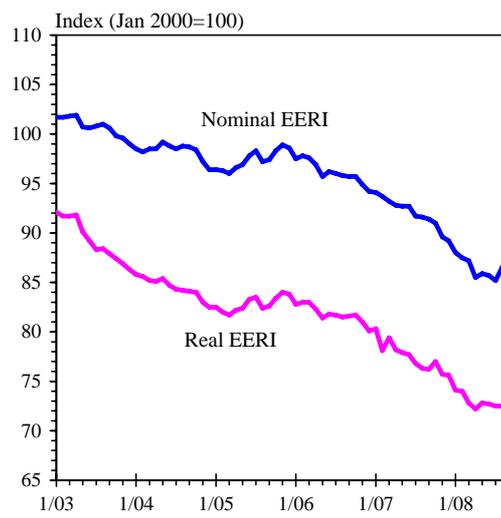
4.9 Under the Linked Exchange Rate system, movements in the exchange rate of the Hong Kong dollar against other currencies closely followed those in the US dollar. During the third quarter, the Hong Kong dollar strengthened against other major currencies alongside a broad-based appreciation of the US dollar. As a result, the trade-weighted Hong Kong dollar Nominal Effective Exchange Rate Index rebounded by 2.2%. On the other hand, the corresponding Real Effective Exchange Rate Index was broadly stable in the period⁽³⁾.

Diagram 4.3 : Forward spreads narrowed in the third quarter (end for the week)



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

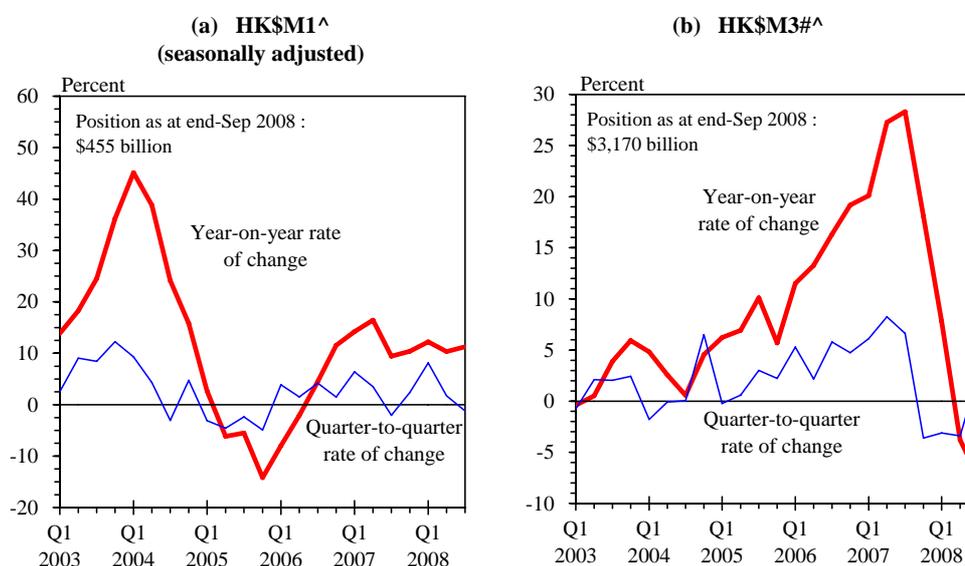
Diagram 4.4 : Trade-weighted nominal EERI rebounded as the US dollar firmed up (average for the month)



Money supply and banking sector

4.10 Growth in Hong Kong dollar narrow money and broad money showed divergent trends during the third quarter of 2008. The seasonally adjusted Hong Kong dollar narrow *money supply* (HK\$M1)⁽⁴⁾ decreased by 1.2% while the corresponding broad money supply (HK\$M3) rose by 2.6%. The decline in HK\$M1 was mainly driven by a contraction in demand deposits, partly reflecting weaker transaction demand alongside an economic slowdown and a reduced turnover in the equity market. Meanwhile, the shift from liquid deposits to time deposits in search of higher returns amidst increased volatility in the asset market has resulted in an increase in HK\$M3. Reversing the declining trends in the previous two quarters, *total deposits* with authorised institutions (AIs)⁽⁵⁾ rose by 2.5% during the third quarter, with both Hong Kong dollar deposits and foreign currency deposits expanding. Total deposits stood at \$5,847 billion at end-September 2008, comprising Hong Kong dollar deposits of \$2,946 billion and foreign currency deposits of \$2,902 billion. Legal tender notes and coins in circulation also posted a notable increase in September as a result of a mini-run on a local bank caused by unfounded rumours.

Diagram 4.5 : Broad money supply increased during the third quarter after declining for three consecutive quarters



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

4.11 Total loan growth decelerated further recently, as domestic and external economic activities continued to weaken. *Total loans and advances* rose by 2.3% during the third quarter, to \$3,426 billion (comprising Hong Kong dollar loans of \$2,396 billion and foreign currency loans of \$1,029 billion) at end-September, slowing from the growth of 7.0% during the first quarter and

5.6% during the second quarter. Growth in loans for use in Hong Kong also decelerated. An analysis of loans for use in Hong Kong by economic sector indicated that most types of loans continued to grow. Nevertheless, loans to trade finance declined by 2.9% during the quarter on the back of shrinking trade flows. Loans to stockbrokers contracted further amidst a slump in the local stock market. The outstanding stock of residential mortgage loans edged up by a meager 0.7% along with a quiet property market. After rising for eight consecutive months since January, the Hong Kong dollar loan-to-deposit ratio declined from a peak of 83.8% at end-August to 81.4% at end-September.

Table 4.1 : Loans and advances

All loans and advances for use in Hong Kong												
		Loans to :										
		Finance		Wholesale and retail trade		Building, construction, property and investment		Purchase of residential property ^(a)		All loans and advances for use outside Hong Kong ^(c)		Total loans and advances
<u>% change during the quarter</u>		<u>visible trade</u>	<u>Manu- facturing</u>	<u>retail trade</u>	<u>and investment</u>	<u>of residential property^(a)</u>	<u>Financial concerns</u>	<u>Stock-brokers</u>	<u>Total^(b)</u>	<u>Hong Kong^(c)</u>	<u>advances</u>	
2007	Q1	-1.0	3.5	1.9	1.0	-0.1	5.9	994.1	7.6	12.4	8.3	
	Q2	12.2	7.4	4.0	6.2	1.2	10.2	35.6	6.4	10.7	7.0	
	Q3	4.2	4.8	1.8	5.7	1.4	6.2	11.8	5.8	10.1	6.4	
	Q4	4.1	1.7	2.8	4.2	2.2	9.5	-86.4	-4.5	7.7	-2.7	
2008	Q1	8.4	16.1	16.6	6.2	2.4	7.2	-4.2	6.3	10.4	7.0	
	Q2	15.2	4.8	15.6	4.7	2.7	1.5	-19.0	4.7	10.0	5.6	
	Q3	-2.9	4.5	*	4.4	0.7	9.5	-20.6	2.7	0.7	2.3	
Total amount at end-September 2008 (\$Bn)		222	154	157	671	660	299	12	2,809	617	3,426	
% change over a year earlier		26.2	29.3	38.5	21.0	8.2	30.4	-91.6	9.1	31.7	12.6	

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.

(*) Change of less than 0.05%

4.12 Despite the recent global financial crisis, Hong Kong's banking system remained robust. Under the capital adequacy framework promulgated by the Basel Committee on Banking Supervision for banks (commonly referred to as "Basel II", which was implemented on 1 January 2007), the capital adequacy ratio (CAR) for Hong Kong incorporated AIs remained strong, at an average of 14.2% at end-June. All individual AIs' CARs have been above the statutory minimum ratios as required under the Banking Ordinance. In view of recent market events associated with the US sub-prime mortgage problems, the Basel Committee will offer proposals to further strengthen Basel II. The HKMA is monitoring developments in this regard and will consider their implications for supervisory policies. In late September, circulation of telephone short messages questioning the Bank of East Asia's financial stability resulted in many customers queuing outside the bank's branches to withdraw deposits. The unfounded rumours were quickly cleared and the mini-run on the bank subsided.

4.13 Asset quality of the local banking sector remained good. The ratio of classified loans to total loans of retail banks was at a low level, despite increasing slightly from 0.81% at end-March to 0.88% at end-June. Over the same period, the arrears for over three months in credit card repayment were little changed at 0.32%. The delinquency ratio for residential mortgage loans decreased slightly, from 0.06% at end-June to 0.05% at end-September.

Table 4.2 : 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)
2007	Q1	97.11	1.89	1.00
	Q2	97.37	1.73	0.90
	Q3	97.47	1.64	0.89
	Q4	97.59	1.57	0.85
2008	Q1	97.72	1.47	0.81
	Q2	97.75	1.38	0.88

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 Since February 2004, banks in Hong Kong have been offering renminbi services to customers including deposit taking, currency exchange and remittance. By end-September, a total of 40 licensed banks had been engaged in this line of business. Outstanding renminbi deposits amounted to RMB70.0 billion at end-September, accounting for around 2.7% of total foreign currency deposits in Hong Kong. Further to the three successful issues of renminbi bonds in 2007, there were four more issues between July and September 2008, bringing the total outstanding amount of renminbi bonds issued to RMB22 billion. Partly reflecting bond issuers repatriating funds to the Mainland, renminbi deposits contracted by 9.9% during the third quarter after increasing by 34.8% during the previous quarter. Demand for such deposits also diminished because of higher transaction costs and increased uncertainty about the short-term direction of the renminbi exchange rate. Indeed, the renminbi softened against the Hong Kong dollar during August and September.

Table 4.3 : Renminbi deposits in licensed banks

<u>(As at end of period)</u>		<u>Demand and savings deposits</u> (RMB Mn)	<u>Time deposits</u> (RMB Mn)	<u>Total deposits</u> (RMB Mn)	<u>Interest rates on^(a)</u>		<u>Number of licensed banks engaged in RMB business</u>
					<u>Saving deposits^(b)</u> (%)	<u>Three-month time deposits^(b)</u> (%)	
2007	Q1	13,643	11,595	25,238	0.46	0.65	38
	Q2	17,228	10,391	27,618	0.46	0.65	38
	Q3	18,458	9,045	27,503	0.46	0.65	37
	Q4	22,539	10,861	33,400	0.46	0.65	37
2008	Q1	39,364	18,221	57,585	0.46	0.65	40
	Q2	51,242	26,398	77,640	0.46	0.65	40
	Q3	47,508	22,443	69,951	0.46	0.65	40
% change over a year earlier		157.4	148.1	154.3	N.A.	N.A.	N.A.

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

(b) Period average figures.

N.A. : Not available.

4.15 On 14 October, the government implemented two new temporary measures to support confidence in the local banking system — expanding deposit protection to 100% coverage and establishing a Contingent Bank Capital Facility (CBCF) to provide additional capital to banks if necessary. The temporary 100% deposit protection arrangement should help stabilise banks' deposit bases as a source of funding over the next two years, and the capital facility should help provide comfort to banks on the availability of additional capital, and thus guard against systemic failures in the financial system.

4.16 To help improve banks' access to the Discount Window and other recently-introduced liquidity facilities, the HKMA announced on 20 October issuance of a total of \$4 billion new Exchange Fund Bills in the tenders on 28 October and 4 November. In order to maintain the liquidity of the banking system, the HKMA operated within the Convertibility Zone on 20 and 27 October by purchasing US dollars with Hong Kong dollars, so that the level of the Aggregate Balance will be little affected by the issuance of new paper.

The debt market

4.17 The Hong Kong dollar debt market contracted further in the third quarter of 2008, as the global financial turmoil continued to unfold and its flow-on effects intensified. Total outstanding amount of debt declined to \$716.6 billion at end-September 2008, a reduction of 5.2% from a year ago⁽⁶⁾. The amount was equivalent to 23% of HK\$M3 or 18% of Hong Kong dollar-denominated assets of the entire banking sector⁽⁷⁾. As investors turned cautious and demand for debt instruments fell, fund raising via issuing bonds became difficult. Consequently, domestic debt issuance fell by 20.2% in the third quarter as a whole from the second quarter, with all types of issuers delaying or withdrawing their debt issuance programmes.

Table 4.4 : 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											
2007	Annual	223.5	19.4	-	242.9	49.6	18.7	131.9	200.2	1.7	444.8
	Q1	55.0	4.0	-	59.0	12.9	5.4	38.3	56.6	1.5	117.1
	Q2	56.9	6.9	-	63.8	20.2	6.5	40.9	67.6	-	131.4
	Q3	56.1	1.5	-	57.6	6.7	5.7	18.7	31.1	-	88.7
	Q4	55.4	7.0	-	62.5	9.8	1.1	33.9	44.9	0.2	107.6
2008	Q1	62.8	5.5	-	68.2	8.6	1.2	6.1	15.9	-	84.1
	Q2	77.2	8.7	-	85.9	15.4	8.4	22.3	46.2	-	132.0
	Q3	67.3	3.5	-	70.8	14.7	4.1	15.8	34.6	-	105.3
	% change over a year earlier	20.0	131.4	N.A.	22.9	118.1	-28.8	-15.5	11.0	N.A.	18.8
Outstanding (as at end of period)											
2007	Q1	133.0	54.6	7.7	195.3	147.4	54.3	335.7	537.3	16.5	749.1
	Q2	134.4	58.0	7.7	200.1	151.2	58.9	350.9	561.0	14.4	775.5
	Q3	135.6	57.2	7.7	200.5	140.3	62.9	339.3	542.4	13.4	756.3
	Q4	136.6	58.5	7.7	202.8	136.4	60.6	351.3	548.2	13.2	764.2
2008	Q1	143.3	60.3	7.7	211.3	121.4	60.8	320.7	502.9	12.5	726.7
	Q2	144.3	64.5	7.7	216.5	106.5	68.4	318.6	493.5	12.5	722.4
	Q3	145.0	62.7	5.0	212.7	103.8	67.5	320.2	491.6	12.4	716.6
	% change over a year earlier	6.9	9.6	-35.1	6.1	-26.0	7.4	-5.6	-9.4	-7.5	-5.2

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

(a) AIs : Authorised institutions.

(b) MDBs : Multilateral Development Banks.

N.A. : Not available.

The stock and derivatives markets

4.18 The *local stock market* fell further in the third quarter of 2008, in parallel with the plunge observed in the major bourses overseas and in the Mainland. The *Hang Seng Index (HSI)* stood at 18 016 at end-September 2008, 18.5% lower than at end-June. Most of the decline took place in September when the global financial crisis turned more severe. *Daily turnover* shrank further from an average of \$76.1 billion in the second quarter to \$63.6 billion in the third quarter.

4.19 Along with plunging share prices, the *market capitalisation* fell from \$16.4 trillion at end-June to \$12.5 trillion at end-September. Nevertheless, the Hong Kong stock market was ranked as the seventh largest in the world and the third largest in Asia at end-September according to the *World Federation of Exchanges*⁽⁸⁾. Fund raising activities also turned more quiet in the third quarter, with total equity capital raised through new share flotation and post-listing in the Main Board and the GEM totaling only \$53.1 billion⁽⁹⁾.

Diagram 4.6 : The stock market fell further in the third quarter

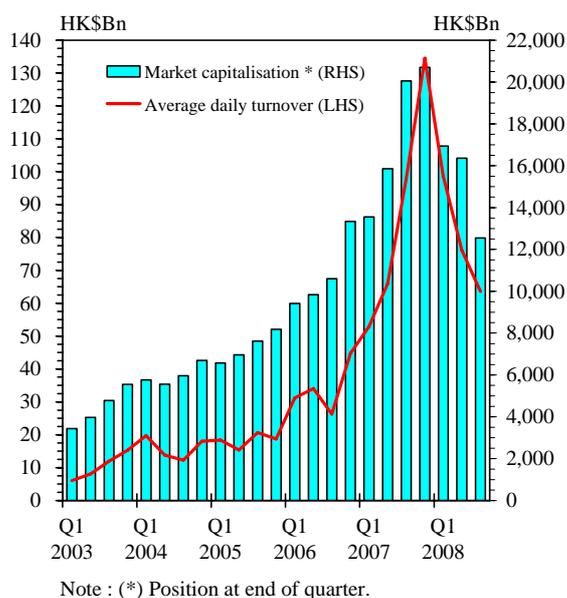
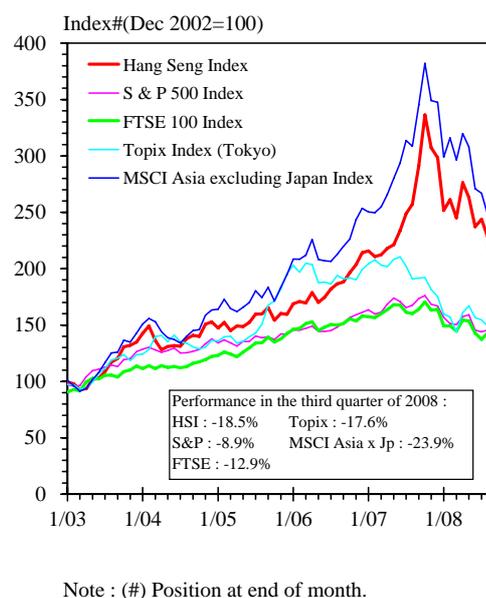


Diagram 4.7 : Weakness was observed across major stock markets globally



4.20 Mainland enterprises continued to play an important role in the Hong Kong stock market. There were 453 Mainland enterprises (including 151 H-share companies, 93 “Red Chips” companies and 209 private enterprises) listed on the Hong Kong stock market at end-September, accounting for 36% of the total number of listed companies and 55% of the total market capitalisation. In the third quarter, 71% of equity turnover in the market was attributed to Mainland-related stocks. These companies together raised \$33.6 billion, or 63% of the total equity capital raised in the market, in the third quarter.

4.21 Despite the global financial crisis, trading of *derivatives* stayed relatively solid in the third quarter. Supported by the surge of trading in Hang Seng Index futures, the average daily trading volume for futures and options contracts⁽¹⁰⁾ rose by 12.9% in the third quarter over the previous quarter, and was only 0.6% lower than a year earlier. The callable bull/bear contracts market gathered further momentum, with average daily turnover jumping to \$6.39 billion in the third quarter, from \$2.89 billion in the second quarter and

\$0.25 billion a year earlier. By contrast, trading in derivative warrants dropped further in value terms.

Table 4.5 : Average daily turnover of derivative products of the Hong Kong market

		Hang Seng Index futures	Hang Seng Index options	H-shares Index futures	Stock options	Total futures and options traded*	Derivative warrants (\$Mn)
2007	Annual	69 760	30 407	44 091	186 923	357 665	19,081
	Q1	61 184	30 495	31 059	124 662	268 878	10,837
	Q2	62 301	31 774	34 783	137 742	285 315	11,662
	Q3	76 286	37 952	54 210	240 131	438 005	18,810
	Q4	78 803	21 353	55 698	241 918	433 668	34,659
2008	Q1	88 938	14 946	60 579	263 980	468 118	26,851
	Q2	78 023	13 776	50 238	210 452	385 751	15,715
	Q3	95 335	18 381	58 217	220 110	435 527	8,964
	% change over a year earlier	25.0	-51.6	7.4	-8.3	-0.6	-52.3

Note : (*) Turnover figures for individual futures and options do not add up to the total futures and options traded as data for some products are not included in this table.

4.22 The Hong Kong Exchanges and Clearing Limited (HKEx) commenced trading of its first gold Exchange Traded Fund (ETF) on 31 July. Average daily trading volume for the product reached \$33.6 million during 31 July to 30 September, greater than the trading of the same fund in Japan and Singapore combined during the period.

Fund management and investment funds

4.23 Gross retail sales of *mutual funds*⁽¹¹⁾ dwindled by 52.0% from the second quarter of 2008 to US\$2.9 billion in the third quarter. Retail investors largely stayed on the sideline in face of the tremendous volatility in the global financial markets. The aggregate net asset value of the approved constituent funds under the *MPF schemes* shrank from \$250 billion at end-June 2008 to \$224 billion at end-September⁽¹²⁾, due to the losses incurred by most of the funds. Retail hedge funds also experienced a challenging time⁽¹³⁾. To enhance the protection for retail investors, on 3 October 2008 the Securities and Futures Commission issued a circular to require all issuers of retail investment products to review whether risk disclosure and product descriptions are adequate.

Insurance sector

4.24 In the *insurance sector*, gross premium income from new long-term business increased by 17.8% in the second quarter of 2008 over a year earlier⁽¹⁴⁾, though it was 9.6% lower than in the first quarter. Meanwhile, premium for general business rose by 7.5% year-on-year in the second quarter.

4.25 Regarding the recent problems concerning American International Group, Inc. (AIG), the Insurance Authority (IA) has been closely monitoring the development of the matter and has exercised statutory power to require insurance subsidiaries of AIG operating in Hong Kong to seek his prior approval on all transactions involving movement of assets or funds to related entities within the same group. In view of the possible impact of the current financial turmoil on the insurance companies, IA has stepped up monitoring of the financial and solvency position of all authorised insurers in Hong Kong. Where necessary, IA will exercise his statutory power to take appropriate interventionary actions against insurer for the protection of policyholders. IA will also explore with the industry initiatives to enhance protection of policyholders such as strengthening information disclosure and establishing a policyholders' protection fund in the event of insurer insolvency.

Table 4.6 : Insurance business in Hong Kong* (\$Mn)

		<u>General business :</u>				<u>Premium for long-term business[^] :</u>				
		<u>Gross premium</u>	<u>Net premium</u>	<u>Underwriting profit</u>	<u>Individual life and annuity (non-linked)</u>	<u>Individual life and annuity (linked)</u>	<u>Other individual business</u>	<u>Non-retirement scheme business</u>	<u>All long-term business</u>	<u>Gross premium from long-term business and general business</u>
2007	Annual	24,057	17,008	2,301	20,314	60,040	261	162	80,777	104,834
	Q1	6,792	4,904	441	5,982	10,122	62	45	16,211	23,003
	Q2	6,156	4,451	598	3,307	13,189	62	50	16,608	22,764
	Q3	5,861	4,122	744	5,028	16,445	76	40	21,589	27,450
	Q4	5,248	3,531	518	5,997	20,284	61	27	26,369	31,617
2008	Q1	7,640	5,478	638	8,212	13,308	64	49	21,633	29,273
	Q2	6,618	4,773	188	6,089	13,345	67	58	19,559	26,177
	% change over a year earlier	7.5	7.2	-68.6	84.1	1.2	8.1	16.0	17.8	15.0

Notes : (*) Figures are based on provisional statistics of the Hong Kong insurance industry.
 (^) Figures refer to new businesses only. Retirement scheme businesses are excluded.

Notes :

- (1) Prior to 9 October 2008, the Base Rate was set at either 150 basis points above the prevailing US Fed Funds Target Rate (FFTR) or the average of the five-day moving averages of the overnight and one-month HIBORs, whichever was higher. With effect from 9 October, this formula for determination of the Base Rate has been changed by reducing the spread of 150 basis points above the prevailing FFTR to 50 basis points.
- (2) In December 2005, the HKMA published a new data series on composite interest rate, reflecting movement in various deposit rates, interbank and other interest rates to closely track the average cost of funds for banks. The published data enable the banks to keep track of changes in funding cost and thus help improve interest rate risk management in the banking sector.
- (3) The trade-weighted Nominal Effective Exchange Rate Index (EERI) is an indicator of the overall exchange value of the Hong Kong dollar against a fixed basket of other currencies. Specifically, it is a weighted average of the exchange rates of the Hong Kong dollar against some 14 currencies of its major trading partners, with the weights adopted being the respective shares of these trading partners in the total value of merchandise trade for Hong Kong during 1999 and 2000.

The Real EERI of the Hong Kong dollar is obtained by adjusting the Nominal EERI for relative movements in the seasonally adjusted consumer price indices of the respective trading partners.

- (4) The various definitions of the money supply are as follows:

M1 : Notes and coins with the public, plus customers' demand deposits with licensed banks.

M2 : M1 plus customers' savings and time deposits with licensed banks, plus negotiable certificates of deposit (NCDs) issued by licensed banks, held outside the monetary sector as well as short-term Exchange Fund placements of less than one month.

M3 : M2 plus customers' deposits with restricted licence banks and deposit-taking companies, plus NCDs issued by such institutions and held outside the monetary sector.

Among the various monetary aggregates, more apparent seasonal patterns are found in HK\$M1, currency held by the public, and demand deposits.

- (5) Authorised institutions include licensed banks, restricted licence banks and deposit-taking companies. At end-September 2008, there were 146 licensed banks, 28 restricted licence banks and 29 deposit-taking companies in Hong Kong. Altogether, 203 authorised institutions (excluding representative offices) from 31 countries and territories (including Hong Kong) had a presence in Hong Kong.
- (6) The figures for private sector debt may not represent a full coverage of all the Hong Kong dollar debt paper issued.

- (7) Assets of the banking sector include notes and coins, amount due from authorised institutions in Hong Kong as well as from banks abroad, loans and advances to customers, negotiable certificates of deposits (NCDs) held, negotiable debt instruments other than NCDs held, and other assets. Certificates of indebtedness issued by Exchange Fund and the counterpart bank notes issued are nevertheless excluded.
- (8) The ranking is made by the World Federation of Exchanges, a global trade association for the stock exchange industry. Its membership comprises 56 securities exchanges (as of 11 October 2008), covering almost all globally recognised stock exchanges.
- (9) At end-September 2008, there were 1 078 and 181 companies listed on the Main Board and GEM respectively.
- (10) At end-September 2008, there were 50 classes of stock options contracts and 43 classes of stock futures contracts.
- (11) These figures are obtained from the Sales and Redemptions Survey conducted by the Hong Kong Investment Funds Association on their members, and covered only the active authorised funds that have responded to the survey. To provide a more accurate picture of the retail fund market in Hong Kong, the survey has been revamped, with effect from 2005, such that it would cover only retail transactions (including switching) and exclude institutional transactions. At end-September 2008, there were 1 348 authorised funds, according to the survey.
- (12) There were 19 approved trustees at end-September 2008. On MPF products, 34 master trust schemes, two industry schemes and two employer sponsored schemes, comprising altogether 340 constituent funds, were approved by the Mandatory Provident Fund Schemes Authority. A total of 238 000 employers, 2.16 million employees and 267 000 self-employed persons have participated in MPF schemes.
- (13) There were 14 retail hedge funds authorised by the Securities and Futures Commission (SFC). The net asset size of SFC-authorised hedge funds amounted to US\$1.72 billion at end-September 2008, down by 0.1% from end-2007. The net asset size at end-September 2008 was approximately 10 times of that as at end-2002, the year when the hedge funds guidelines were first issued.
- (14) As at end-September 2008, there were 174 authorised insurers in Hong Kong. Within this total, 46 were engaged in long-term insurance business, 109 in general insurance business, and 19 in composite insurance business. These authorised insurers come from 24 countries and territories (including Hong Kong).