CHAPTER 4 : THE FINANCIAL SECTOR[#]

Summary

- *Amid the improved economic conditions and ample liquidity, financial asset prices in Hong Kong rose notably in the recent months, in line with the uptrend in the overseas markets. In parallel, there has been a general expansion in most types of financial sector activities.*

- *Hong Kong dollar interbank interest rates remained low in the third quarter of 2009. The money supply recorded further growth on the back of continued inflow of funds and improved demand for loans locally. Under the strong demand for the Hong Kong dollar, the HKMA was prompted to passively sell Hong Kong dollars against US dollars to banks several times.*

- *Under the linked exchange rate system, the Hong Kong dollar Effective Exchange Rate Indices moved lower during the third quarter, along with the softening of the US dollar.*

- *Local share prices rose further in active trading during the third quarter, propelled by growing optimism about the economic outlook. Fund raising activities showed an accelerated increase, with initial public offerings recovering towards the latter part of the period to level comparable to that before the global financial crisis.*

- *With the issuance of renminbi sovereign bonds in Hong Kong by the Central Government in September, the role of Hong Kong as a renminbi centre outside the Mainland is further strengthened. At the same time, considerable headway was made in cross-boundary co-operation in financial services and increasing the breadth and depth of the local financial sector.*

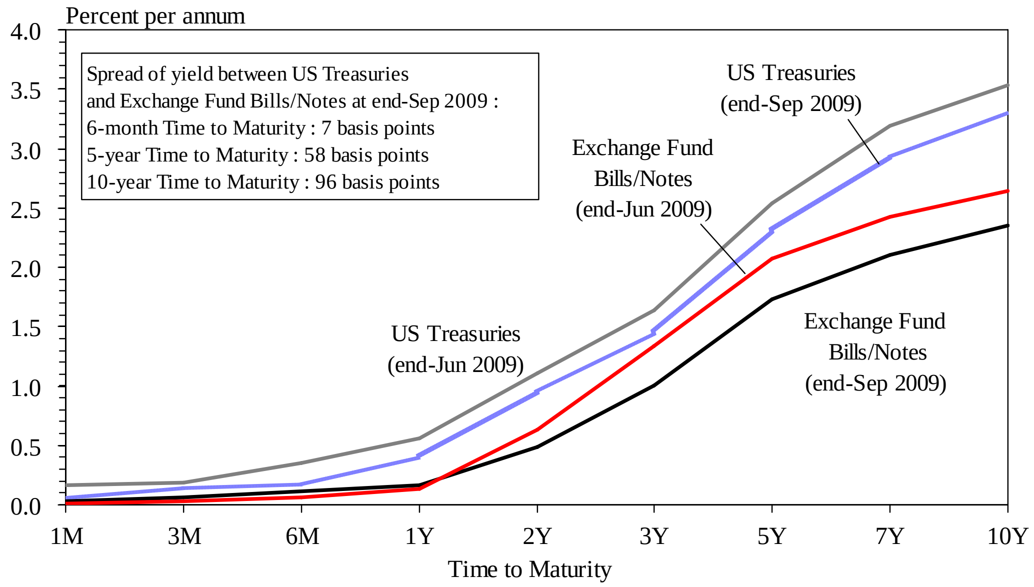
(#) This chapter is jointly prepared by the Hong Kong Monetary Authority (HKMA) and the Economic Analysis Division.

Interest rates and exchange rates

4.1 The *Hong Kong dollar interbank interest rates* remained low throughout the third quarter of 2009. Broadly tracking the movement in their US dollar counterparts, the overnight HIBOR was little changed during the period and stood at 0.13% at end-September 2009, while the three-month HIBOR eased from 0.25% at end-June to 0.13% at end-September. As the US Federal Funds Target Rate was steady at 0-0.25%, the *Base Rate* under the Discount Window operated by the HKMA was unchanged at 0.5% during the quarter(1).

4.2 Hong Kong dollar interest rates remained lower than US dollar interest rates during the third quarter, with the discount of the three-month HIBOR to the corresponding Euro-dollar deposit rate widening from 40 basis points at end-June to 64 basis points at end-September. Meanwhile, the *Hong Kong dollar yield curve* flattened somewhat between end-June and end-September. Alongside decreases in the yields of US Treasuries in August and September, the yields of longer-term Exchange Fund paper declined in the period. On the other hand, the implied yields of one-week and one-month Exchange Fund Bills reverted to positive again after dipping below zero in late June and early July.

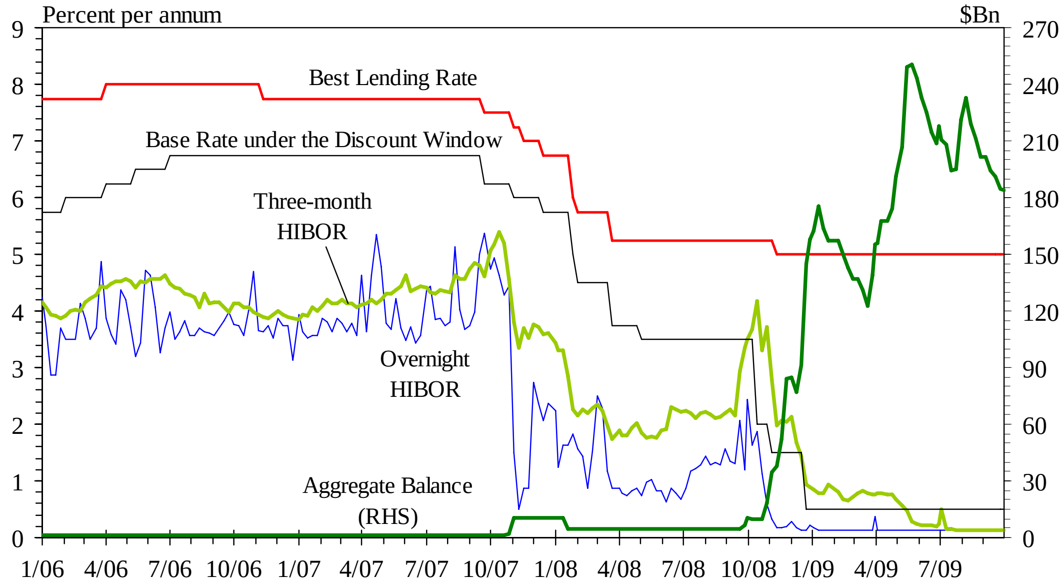
Diagram 4.1 : The Hong Kong dollar longer-term rates declined in the third quarter of 2009 alongside their US dollar counterparts



4.3 At the retail level, banks continued to keep their Best Lending Rates (BLRs) unchanged at 5.00% and 5.25% throughout the third quarter. Deposit interest rates also remained steady at very benign levels, with the average savings deposit rate and one-month time deposit rate quoted by major banks both staying at around 0.01%. The composite interest rate, which indicates the average cost of funds for banks, edged down to 0.13% at end-September from 0.19% at end-June[(2)]. On the mortgage front, the proportion of newly approved mortgage loans with reference to rates other than the BLR (mostly HIBOR) climbed further to a record high of 54.5% in September, reflecting banks' aggressive stance in the mortgage market and borrowers' increased inclination to take advantage of the prevailing low interbank interest rates.

4.4 Amid buoyant stock market activities, demand for the Hong Kong dollar remained strong during the third quarter. As the strong-side Convertibility Undertaking (CU) was repeatedly triggered between mid-July and early August, the Aggregate Balance rose to a high of $234.2 billion on 4 August 2009, from $217.7 billion at end-June. Despite sporadic triggering of strong-side CU in September, the Aggregate Balance subsequently declined to $184.2 billion at end-September following the additional issuance of Exchange Fund Bills to meet the increased demand by banks for liquidity management purposes.

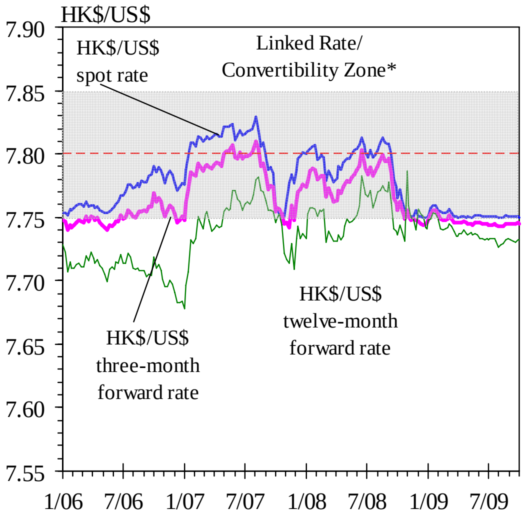
Diagram 4.2 : Hong Kong dollar interbank interest rates remained exceptionally low in the third quarter under abundant liquidity (end for the week)



4.5 Due to strong inflow of funds, the Hong Kong dollar spot exchange rate stayed on the strong side of the link, close to 7.75 per US dollar during the third quarter. Meanwhile, the discounts of the *3-month* and *12-month Hong Kong dollar forward rates* to the spot rates narrowed slightly from 61 and 180 pips (each pip equivalent to HK$0.0001) at end-June to 48 and 179 pips at end-September respectively.

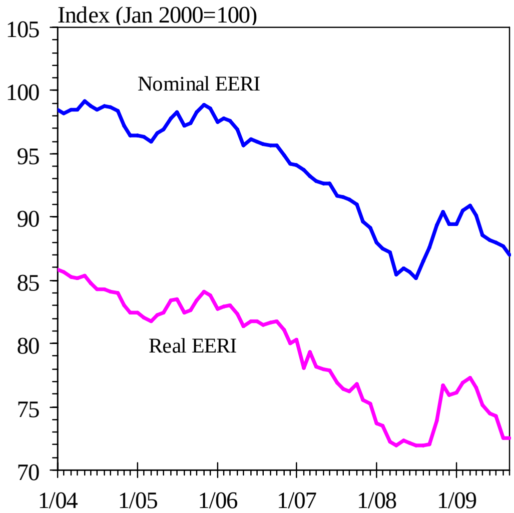
4.6 Under the Linked Exchange Rate system, movements in the Hong Kong dollar exchange rate against other currencies closely followed those in the US dollar. As the US dollar depreciated against other major currencies, the trade-weighted *Hong Kong dollar Nominal* and *Real Effective Exchange Rate Indices* in the third quarter softened by 1.5% and 3.1% respectively from the second quarter[(3)].

Diagram 4.3 : Forward spreads shrank marginally 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.

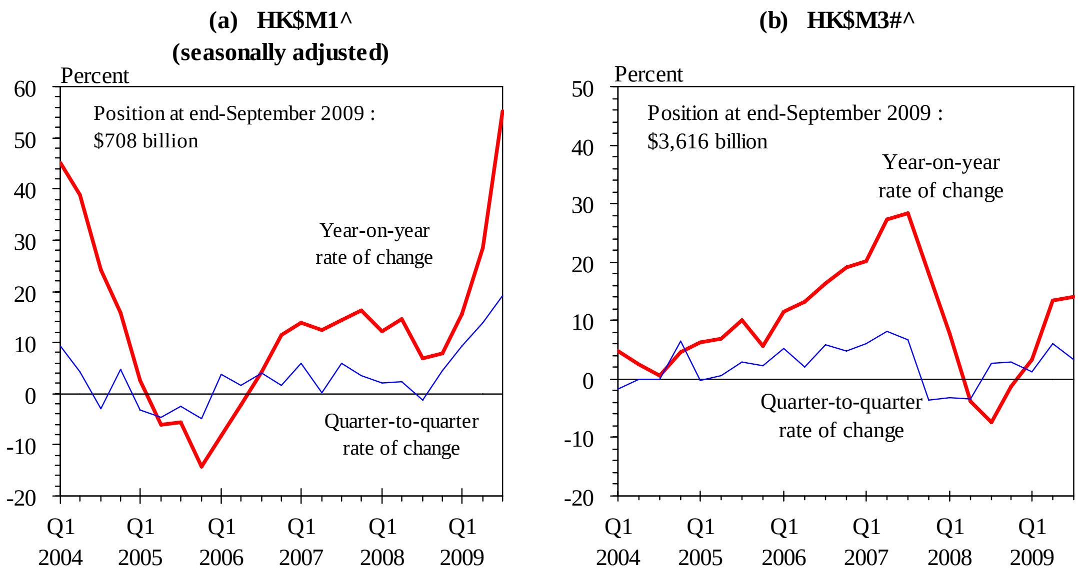
Diagram 4.4 : Trade-weighted EERIs weakened further in the period (average for the month)



Money supply and banking sector

4.7 Reflecting the expansion in outstanding Hong Kong dollar loan and continued inflow of funds, Hong Kong dollar *money supply* posted further growth in the third quarter of 2009[(4)]. Seasonally adjusted narrow money supply (HK$M1) jumped by 19.2% in the period after expanding 13.9% in the second quarter, as depositors shifted to more liquid deposits given the extremely low term deposit interest rates. For broad money supply (HK$M3), the amount outstanding rose by another 3.3% in the third quarter, though slowing from the 6.0% growth in the preceding quarter. *Total deposits* with authorised institutions (AIs) also increased, by 2.4% in the third quarter to $6,424 billion[(5)]. Among the total, Hong Kong dollar deposit outstanding grew by 3.4% to $3,392 billion while foreign currency deposits edged up by 1.3% to $3,032 billion.

Diagram 4.5 : Money supply expanded further amid continued inflow of funds



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

4.8 *Total loans and advances* outstanding expanded further during the third quarter, by 2.3% to $3,278 billion at end-September (comprising Hong Kong dollar loans of $2,381 billion and foreign currency loans of $897 billion). Partly reflecting the increased optimism on the local economy, loans for use in Hong Kong edged up by 1.6% during the third quarter. Analysed by economic use, growth in residential mortgage loans accelerated to 3.5% due to the buoyant residential property market and accommodative mortgage interest rates. Trade finance grew further by 2.3% as external trade performance gradually improved. Lending to financial concerns rebounded by 2.1% while loans to stockbrokers dropped notably by 17.2% from the high base of comparison at end-June amid strong initial public offering (IPO)-related activities. Notwithstanding the revived loan demand, the Hong Kong dollar loan-to-deposit ratio declined further from 72.1% at end-June to 70.2% at end-September.

Table 4.1 : Loans and advances

% change during the quarter		All loans and advances for use in Hong Kong — Loans to : 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
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	4.9	15.5	4.6	2.7	1.4	-19.0	4.7	10.1	5.6
	Q3	-2.9	4.5	*	4.4	0.7	8.1	-20.6	2.7	0.6	2.3
	Q4	-16.2	-5.3	-3.3	1.9	-1.4	-5.4	-10.4	-3.5	-6.7	-4.1
2009	Q1	-15.1	-1.5	-5.5	-1.0	-0.3	-14.5	-10.3	-3.8	-2.8	-3.6
	Q2	3.3	-5.8	1.9	-0.5	2.0	-9.0	443.6	1.6	-1.0	1.2
	Q3	2.3	1.9	3.8	-2.3	3.5	2.1	-17.2	1.6	5.6	2.3
Total amount at end-September 2009 ($Bn)		167	139	152	662	685	225	42	2,693	584	3,278
% change over a year earlier		-24.8	-10.5	-3.3	-1.8	3.8	-24.8	261.8	-4.1	-5.2	-4.3

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%

4.9 On 23 October 2009 the HKMA issued a circular to banks in Hong Kong, capping the loan-to-value (LTV) ratios for residential mortgages on properties valued at $20 million or more at 60% (instead of 70% originally) and setting a maximum loan amount of $12 million for properties valued at below $20 million (while leaving the maximum LTV intact at 70%). The circular also reminded banks to be prudent in conducting valuation of properties and in calculating borrowers' debt servicing ratios, with particular consideration to the effect on borrowers' ability to service mortgage payments when interest rates return to more normal levels. These prudential measures are designed in the interest of maintaining banking stability and enhancing banks' risk management on mortgage lending to high-end residential properties.

4.10 Despite the recent global financial crisis, Hong Kong's banking system remained resilient, with the capital positions of the Hong Kong incorporated AIs staying strong. Under the capital adequacy framework promulgated by the Basel Committee on Banking Supervision (commonly referred to as "Basel II"), the capital adequacy ratio (CAR) of these institutions stayed high at an average of 16.5% at end-June. All individual AIs' CARs were above the statutory minimum ratios as required by the HKMA. To address the lessons learnt from the recent global financial crisis, the Basel Committee issued a final package of proposals in July for enhancements of the Basel II capital framework. The HKMA is supportive of the Committee's initiative in this regard and is taking steps to implement the enhanced international standards in consultation with the banking industry.

4.11 Asset quality of the local banking sector remained sound. The ratio of classified loans rose slightly to 1.51% at end-June from 1.47% at end-March, following the relatively more notable deterioration in asset quality earlier on when the global financial turmoil was at its height, but was still low by historical standards. On the other hand, arrears for over three months in credit card repayment edged up only marginally from 0.49% to 0.50%. The delinquency ratio for residential mortgage loans, at 0.05% at end-September, was little changed from end-June.

Table 4.2 : Asset quality of retail banks*

(as % of total loans)

As at end of period		Pass loans	Special mention loans	Classified loans (gross)
2008	Q1	97.72	1.47	0.81
	Q2	97.75	1.38	0.88
	Q3	97.61	1.43	0.96
	Q4	96.55	2.20	1.24
2009	Q1	96.09	2.44	1.47
	Q2	96.14	2.35	1.51

Notes : Due to rounding, figures may not add up to 100.

(*) Period-end figures relate to Hong Kong offices and overseas branches. Loans and advances are classified into the following categories: Pass, Special Mention, Substandard, Doubtful and Loss. Loans in the substandard, doubtful and loss categories are collectively known as "classified loans".

4.12 Since February 2004, banks in Hong Kong have been offering renminbi services to customers including deposit-taking, currency exchange and remittance. With the implementation of a pilot scheme in July to allow eligible Mainland enterprises to use renminbi to settle trade transactions with their trade counterparts in selected areas outside the Mainland, the scope of renminbi banking business in Hong Kong has expanded further. Boosted by the renminbi trade settlement pilot scheme and demand induced by the issuance of renminbi-denominated bonds by the Ministry of Finance and Mainland subsidiaries of Hong Kong banks, renminbi deposits outstanding in Hong Kong rose from RMB54.4 billion at end-June to RMB58.2 billion at end-September.

Table 4.3 : Renminbi deposits in Hong Kong

					Interest rates on[a]		
As at end of period		Demand and savings deposits (RMB Mn)	Time deposits (RMB Mn)	Total deposits (RMB Mn)	Savings deposits[b] (%)	Three-month time deposits[b] (%)	Number of authorised institutions engaged in RMB business
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
	Q4	38,119	17,942	56,061	0.46	0.64	39
2009	Q1	35,166	17,944	53,110	0.46	0.64	39
	Q2	35,924	18,457	54,381	0.46	0.64	40
	Q3	40,559	17,616	58,174	0.46	0.66	44
% change over a year earlier		-14.6	-21.5	-16.8	N.A.	N.A.	N.A.

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

(b) Period average figures.

N.A. Not available.

The debt market

4.13 The Hong Kong dollar *debt market* expanded further in the third quarter of 2009, with total gross issuance of Hong Kong dollar debt securities in the period rising considerably by 262.0% over a year earlier. As the HKMA continued to raise the supply of short-dated Exchange Fund paper to meet the demand from banks for liquidity management purposes, issuance of Exchange Fund Bills and Notes increased sharply by 395.9% and accounted for 87.5% of all new debt issuance in the quarter. Consequently, total outstanding balance of Hong Kong dollar debt stood at a record level of $992.5 billion at end-September 2009, up by 38.5% over a year earlier[(6)]. This was equivalent to 27.4% of HK$M3 or 23.0% of Hong Kong dollar-denominated assets of the entire banking sector[(7)].

4.14 With a view to promoting the sustainable development of the local bond market, the Financial Secretary in the 2009-10 Budget announced to implement a Government Bond Programme, under which Government Bonds will be issued in a systematic and consistent manner. The Government Bond Programme is divided into two parts, namely, the Institutional Bond Issuance Programme and the Retail Bond Issuance Programme. The inaugural issue of Government bonds under the Institutional Bond Issuance Programme, a two-year bond with an issue size of $3,500 million, was tendered on 2 September 2009 while the second issue under the Institutional Bond Issuance Programme, a five-year bond with an issue size of $2,000 million, was tendered on 2 November. Both issues were well-received by investors. The HKMA, as the representative of the Government to assist in the implementation of the Programme, will continue to maintain close dialogues with market players and consider measures to encourage primary market participation, promote secondary market liquidity, and broaden investor base. Regarding the Retail Bond Issuance Programme, the Government will take into account the advice of the co-arrangers and prevailing market conditions in determining the timing of issue.

Table 4.4 : New issuance and outstanding value of Hong Kong dollar debt securities ($Bn)

	Exchange Fund paper	Statutory bodies/government-owned corporations	Government	Public sector total	AIs[a]	Local corporations	Non-MDBs overseas borrowers[b]	Private sector total	MDBs[b]	Total
New issuance										
2008 Annual	285.9	24.3	-	310.2	45.2	14.3	51.6	111.2	3.0	424.4
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
Q4	78.6	6.7	-	85.3	6.5	0.6	7.5	14.5	3.0	102.8
2009 Q1	130.7	8.6	-	139.4	5.6	2.8	29.6	38.0	5.8	183.1
Q2	191.1	10.6	-	201.8	15.0*	4.8	21.2	41.0*	6.2	248.9*
Q3	333.8	9.4	3.5	346.7	11.4	5.2	17.6	34.2	0.4	381.4
% change over a year earlier	395.9	171.2	N.A.	389.9	-22.5	28.8	11.4	-1.0	N.A.	262.0
Outstanding (as at end of period)										
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
Q4	157.7	64.6	5.0	227.3	95.1	67.0	313.0	475.1	14.3	716.6
2009 Q1	218.9	63.5	5.0	287.4	86.2	67.7	325.2	479.1	19.3	785.8
Q2	288.4	68.1	5.0	361.5	80.9*	72.0	322.9	475.8*	25.5	862.9*
Q3	413.0	74.4	5.0	492.5	82.6	73.7	319.8	476.1	23.9	992.5
% change over a year earlier	184.9	18.7	0.0	131.6	-20.4	9.1	-0.1	-3.1	93.5	38.5

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

(a) AIs : Authorised institutions.

(b) MDBs : Multilateral Development Banks.

(*) Revised figures.

N.A. Not available.

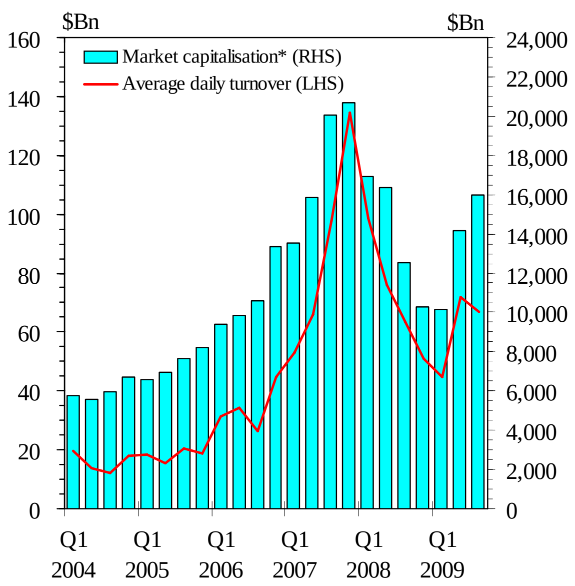
4.15 In September, the Ministry of Finance launched its first issuance of RMB sovereign bonds in Hong Kong totaling RMB6 billion. Two Mainland subsidiaries of Hong Kong banks also issued renminbi bonds that raised RMB6 billion in total during the third quarter. The latest developments represent a significant expansion of RMB bond issuer base in Hong Kong, and have helped enhance the breadth and depth of Hong Kong's bond market.

The stock and derivatives markets

4.16 The *local stock market* gained further strength in the third quarter of 2009. The *Hang Seng Index* (*HSI*) went up by another 14.0% during the quarter to 20 955 at end-September, as investors turned more optimistic about the economic outlook. Compared with the closing low of 11 345 on 9 March, the HSI has soared by 84.7%. This is broadly in line with the gain in other Asian markets, as indicated by the 85.7% jump in the MSCI Asia excluding Japan index over the same period. The *daily turnover* averaged at $66.7 billion in the third quarter, 5.0% higher than a year earlier though 6.9% lower than that recorded in the previous quarter.

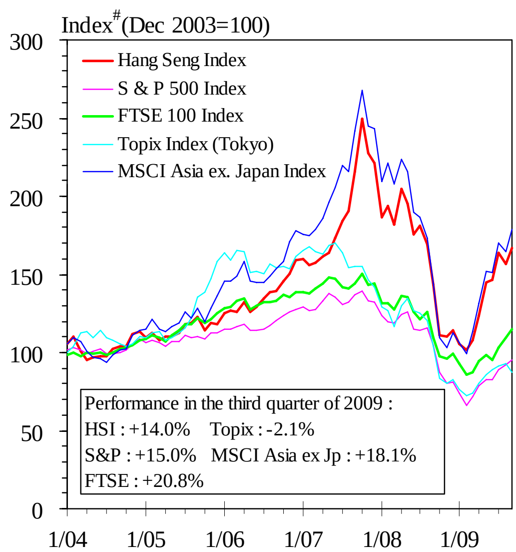
4.17 The *market capitalisation* moved up in tandem, by 12.8% during the third quarter to $16.0 trillion at end-September. The local bourse remained the seventh largest in the world and the third largest in Asia, according to the *World Federation of Exchanges*[(8)]. As to fund raising activities, equity capital raised through new share flotation and post-listing arrangements on the Main Board and the Growth Enterprise Market (GEM) amounted to $147.4 billion in the third quarter, representing a sharp 144.4% jump over the low base a year earlier[(9)]. A resurgence of interest in IPOs was observed in September, when a total of eight new companies were listed on the Main Board and GEM, matching the high level seen in June 2008.

Diagram 4.6 : The local stock market gathered further momentum



Note : (*) Position at end of quarter.

Diagram 4.7 : Most major stock markets continued to trend up



Note : (#) Position at end of month.

4.18 Mainland enterprises continued to play a dominant role in the Hong Kong stock market. At end-September, there were 483 Mainland enterprises (including 153 H-share companies, 96 "Red Chips" companies and 234 private enterprises) listed on the market, accounting for 38% of the total number of listed companies and 57% of the total market capitalisation. In the third quarter, Mainland-related stocks accounted for 72% of equity turnover and 73% of equity capital raised respectively.

4.19 Yet trading in *derivatives market* quieted down somewhat. The average daily trading volume for futures and options contracts in the third quarter fell by 14.2% year-on-year[(10)]. Among these contracts, turnover of HSI futures, H-shares index futures and stock options fell by 11.7%, 18.1% and 23.3% respectively, more than offsetting the 18.9% gain in turnover of HSI options. Similarly, the average daily trading value for securitised derivatives decreased by 7.9% from a year earlier. The decrease was entirely due to a 16.8% drop in trading of derivative warrants, as trading in callable bull/bear contracts increased by 4.5% (***Box 4.1***).

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 ($Mn)	Callable bull/bear contracts ($Mn)	Total securitised derivatives traded ($Mn)^
2008	Annual	89 368	15 723	59 428	225 074	432 126	14,015	4,243	18,258
	Q1	89 686	15 072	61 088	266 199	472 052	26,851	1,395	28,247
	Q2	78 668	13 890	50 653	212 191	388 939	15,715	2,886	18,601
	Q3	95 335	18 381	58 217	220 110	435 527	8,964	6,394	15,359
	Q4	93 607	15 476	67 742	202 782	432 561	4,972	6,183	11,155
2009	Q1	80 094	17 167	54 785	194 279	389 778	5,240	5,856	11,096
	Q2	95 356	21 465	55 346	217 696	449 160	6,770	7,720	14,490
	Q3	84 197	21 857	47 683	168 876	373 514	7,458	6,681	14,139
% change over a year earlier		-11.7	18.9	-18.1	-23.3	-14.2	-16.8	4.5	-7.9

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

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

Box 4.1

The Callable Bull/Bear Contract market in Hong Kong

Callable Bull/Bear Contracts (CBBCs) are a type of structured product that tracks the performance of an underlying asset without requiring investors to pay the asset's full price[1]. In essence, CBBCs allow investors to take a leveraged bullish or bearish view on the underlying asset, with an inbuilt stop-loss mechanism. The CBBC market has grown rapidly since its launch in the Hong Kong Exchanges and Clearing Limited (HKEx)'s securities market on 12 June 2006 and has now become a major activity area.

Basic features of CBBCs

The following are some key features of the CBBCs listed on HKEx :

- CBBCs are issued either as Bull or Bear contracts with a fixed expiry date;
- They are issued with the condition that during their lifespan they can be called back (i.e. terminated) by the issuers if the price of the underlying asset reaches a level known as the call price (such event is referred to as a mandatory call event, MCE), and investors could suffer losses if the call price is reached before expiry and the CBBC is terminated immediately;
- There are 2 categories of CBBCs - Category N and Category R : Category N CBBCs have no residual value at call (though Category N CBBCs are rare in Hong Kong) while Category R CBBCs have residual value at expiry or at call;
- They have a lifespan of 3 months to 5 years and are settled in cash only; and
- At 13 October 2009, 30 Hong Kong stocks, 3 local indices and 4 overseas stock indices are eligible assets for CBBC issuance.

There are a number of similarities and differences between CBBCs and derivative warrants (DWs), which are another type of securitised derivatives traded on the HKEx :

Both CBBCs and DWs

- are regarded as structured products issued by third parties;
- have maturity not exceeding 5 years;
- are not subjected to stamp duty; and
- will be adjusted for capital changes in the underlying securities.

On the other hand,

- CBBCs can have a shorter minimum maturity (3 months, versus 6 months for DWs);
- price movements of CBBCs tend to track closely the price of the underlying asset while the price of a DW depends on various factors including the volatility of the underlying asset's price and time to maturity;
- DWs do not have the mandatory call feature of CBBCs; and
- DWs have a wider coverage of eligible stocks (177 stocks, at 19 October).

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[1] Products of a similar nature traded in overseas markets are commonly known as contracts for difference or "knock-out"/"stop-loss" certificates.

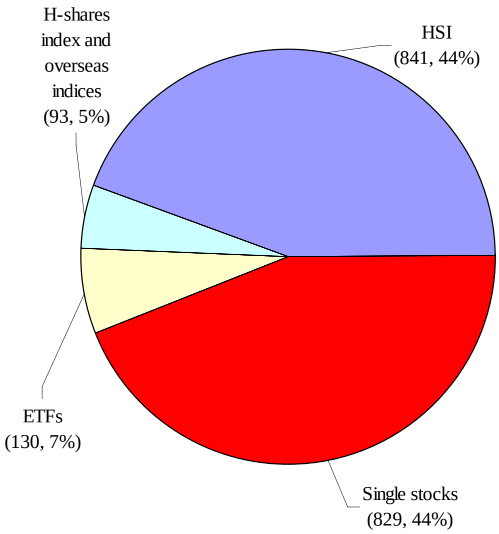
Box 4.1 (Cont'd)

Development of the HKEx CBBC market

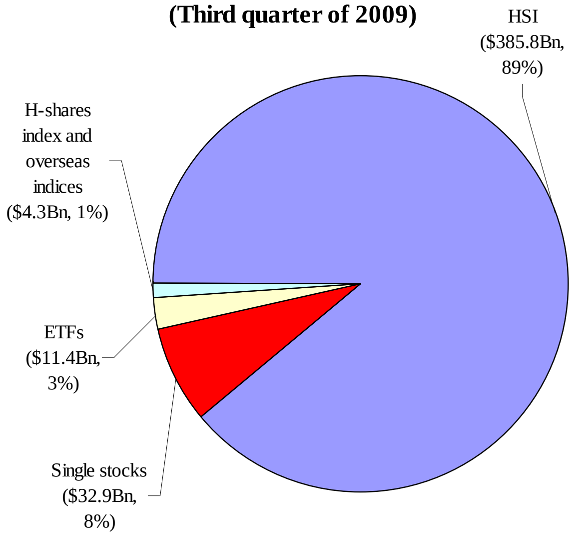
At end-September 2009, 1 893 CBBCs were listed on the HKEx and together they constituted 29.1% of the total number of listed securities. In terms of turnover, CBBCs recorded an average daily turnover of $6.7 billion in the third quarter of 2009, accounting for 10.0% of total value of securities market turnover.

Regarding underlying asset types, Hang Seng Index (HSI) and single stocks were the most popular. At end-September, there were 841 HSI-related CBBCs and 829 single-stock CBBCs listed on the HKEx, accounting for 44.4% and 43.8% respectively of all the listed CBBCs. However, HSI-related issues dominated the trading volume and took up 88.8% of the turnover in CBBCs in the third quarter. Apparently there is room for the HKEx CBBC market to broaden in terms of asset coverage and issuer participation.

Number of CBBCs listed by underlying asset (At end-September 2009)



Total trading value by underlying asset (Third quarter of 2009)



Note : Due to rounding, figures may not add up to 100%.

4.20 Considerable efforts have been directed to enhancing the product offerings and services in the local securities market. On 11 September, the Hong Kong Exchanges and Clearing Limited (HKEx) published a consultation paper on proposals to update Hong Kong's regulatory framework for listed mineral and exploration companies, bringing the framework in line with international best practice and ensuring investors will be provided with information that is both material and reliable. In addition, on 18 September the HKEx launched a consultation on proposals to streamline certain requirements on listed issuers' circulars and listing documents, with the aim of making the contents of these documents more relevant to shareholders and encouraging more timely dispatch of the documents.

4.21 Cross-strait co-operation is an area that offers ample opportunities for the local securities industry. Following the signing of a Side Letter to a Memorandum of Understanding between the Securities and Futures Commission (SFC) and the Taiwan Financial Supervisory Commission in May this year, three Hong Kong exchange traded funds (ETFs) were successfully listed on the Taiwan Stock Exchange, and the first Taiwan ETF was listed on the HKEx in mid-August. In early October, the Taiwan financial regulator added H-shares Index products to its list of overseas futures and options contracts with trading authorisation, thereby giving Taiwan investors access to these investment products.

Fund management and investment funds

4.22 According to SFC's latest Fund Management Activities Survey, the combined assets under management by fund management businesses in Hong Kong amounted to $5,850 billion at end-2008. This was 39.3% lower than the level at end-2007, due to the poor performance across most financial markets during the year. Hedge fund activities of SFC-licensed managers/advisors were likewise affected (***Box 4.2***). Nonetheless, Hong Kong continued to be a premier choice for setting up regional headquarters by international asset management companies. Latest statistics shows that 175 licensed corporations and registered institutions in asset management business have set up their regional headquarters in Hong Kong in 2008, up from 170 in 2007. Managing assets from the Mainland is widely regarded as an important source of new business for the sector.

4.23 Wealth management business continued to revive in the third quarter of 2009, along with the gradual return of investor confidence. Gross retail sales of *mutual funds* jumped by 60.9% over a year earlier to US$4.7 billion in the third quarter(11). Meanwhile, the aggregate net asset value of the approved constituent funds under the *MPF schemes* increased by 12.3% between end-June and end-September 2009, to $292 billion(12). As to retail hedge funds, business showed slight improvement in the third quarter(13).

Box 4.2

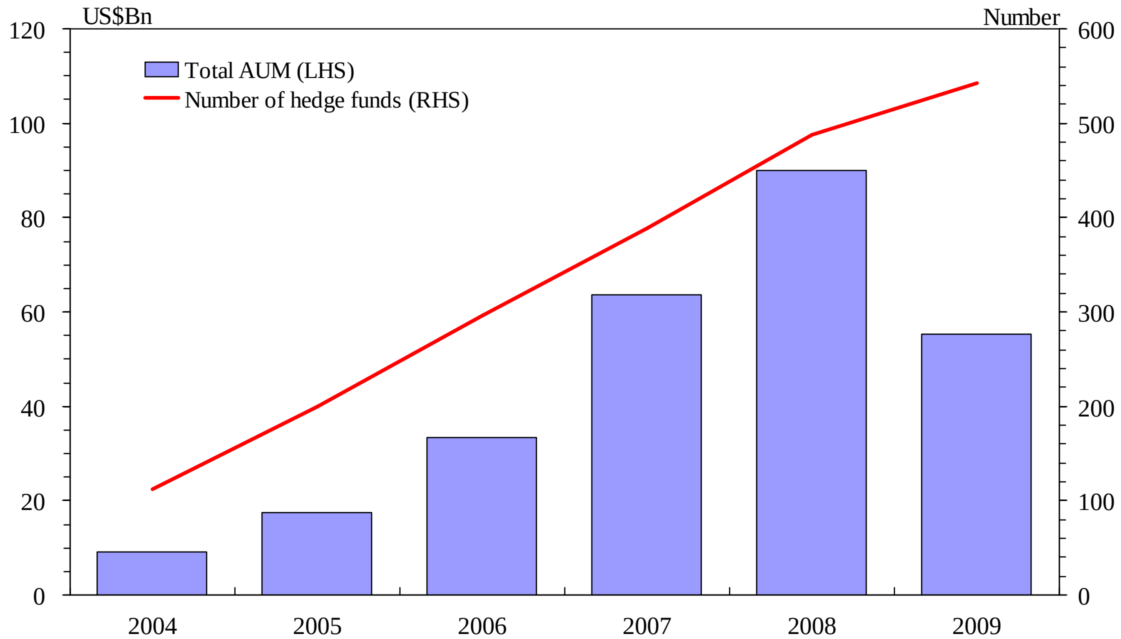
Hedge fund activities of SFC-licensed managers/advisors

In view of the rapid development of the hedge fund industry, the Securities and Futures Commission (SFC) has conducted a fact-finding survey on the industry, taking 31 March 2009 as the reference date[1]. The following are some of the key findings of the survey.

Growth of the local hedge fund industry

Affected by the adverse market conditions, the total assets under management/advisory (AUM) of hedge funds managed in Hong Kong dropped to US$55.3 billion at end-March 2009, 38.6% lower than a year earlier. Yet over a longer-term horizon, significant growth in AUM was observed, by more than five times over the US$9.1 billion at end-March 2004. Moreover, the number of hedge funds managed by SFC-licensed managers has grown to 542 at end-March 2009, almost five times that at end-March 2004.

Total AUM and number of hedge funds*



Note : (*) Both AUM and number of funds are positions at end-March.

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[1] There is no formal definition of hedge funds. For SFC's survey, funds (including managed portfolios) are regarded as hedge funds if they exhibit the following characteristics : (1) use of alternative investment strategies, leverage, use of derivatives for trading purposes, and/or arbitrage techniques; (2) pursuit of absolute returns, rather than measuring investment performance relative to a benchmark; (3) charging of performance-based fees in addition to a management fee based solely on AUM; and/or (4) adoption of investment mandates that give managers more flexibility to shift strategies.

SFC does not directly regulate hedge funds unless they are offered to the public. However, hedge fund managers, like other fund managers, are required to be licensed by the SFC if they carry out asset management or advisory activities in Hong Kong. Once licensed, they are subject to the SFC's ongoing supervision. Also, although the SFC does not regulate private hedge funds directly, all hedge funds using the Hong Kong platform are still subject to the law against fraud, insider dealing and market misconduct.

Box 4.2 (Cont'd)

Features of hedge funds managed in Hong Kong

Hedge funds managed in Hong Kong were mainly Asia Pacific-focused. At end-March 2009, 59.1% of the total AUM was invested in the Asia Pacific markets, with the fund invested in the Hong Kong and Mainland markets accounting for a combined share of 26.7%. Regarding source of investors by location, they were mainly from the Americas (49.1%) and Europe (34.9%). Hong Kong investors, on the other hand, constituted only 1.9% of the investor base. In terms of investor type, funds of funds dominated with a share of 37.6% of the investor base, followed by high-net-worth individuals/family offices (16.6%), financial institutions (14.4%), pensions (11.1%) and endowments/foundations/ charitable organisations (10.3%).

Hedge funds managers operating in Hong Kong are typically considered boutique funds as far as AUM is concerned. At end-March 2009, 60.7% of the hedge fund managers had an AUM of US$100 million or less, while another 25.7% of managers had AUM of US$100-500 million. Only 6.3% of the hedge fund managers in Hong Kong had more than US$1 billion under management.

On employment, the 209 hedge fund managers covered by the survey reported that a total of 1 967 staff were involved in their hedge fund business in Hong Kong at end-March 2009, 86.8% higher than the 1 053 at end-March 2006. Among the total, 38.7% of their staff was involved in investment management, advisory and research. The proportion of hedge fund managers with more than 20 staff increased from 6.0% to 10.1% during the past three years, in tandem with the expansion of the assets managed during the period.

Insurance sector

4.24 Gross premium income from long-term business for the *insurance sector* contracted sharply by 43.9% in the second quarter of 2009 from a year earlier, though already recovered notably from the troughs seen in late 2008 and early 2009[(14)]. While performance for non-linked insurance plans have improved to a level comparable to that in the pre-crisis period, business for investment-linked products remained subdued. Regarding general business, gross premium in the second quarter declined marginally by 0.8% from a year earlier.

Table 4.6 : 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
2008 Annual	27,019	19,158	1,510	24,054	36,107	256	218	60,635	87,654
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
Q3	6,676	4,723	-12	5,937	6,949	63	73	13,022	19,698
Q4	6,085	4,184	696	3,816	2,505	62	38	6,421	12,506
2009 Q1	7,940	5,647	694	6,223	2,198	54	69	8,544	16,484
Q2	6,568	4,853	600	7,040	3,827	69	37	10,973	17,541
% change over a year earlier	-0.8	1.7	219.1	15.6	-71.3	3.0	-36.2	-43.9	-33.0

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

(^) Figures refer to new businesses only. Retirement scheme businesses are excluded.

4.25 Market confidence is the cornerstone of any sustainable insurance market. In this connection, the Government has proposed the establishment of a Policyholders' Protection Fund (PPF) in collaboration with the insurance industry. An actuarial consultancy study will commence in early 2010 to examine the scope of coverage, levy rates, target fund size, and other detailed arrangements for the proposed PPF.

Some highlights of market developments

4.26 The authorities continued to put much effort in increasing the breadth and depth of the financial markets. In September, the Hong Kong International Airport Precious Metals Depository has commenced operation. The depository would allow storage and physical settlement activities, thus paving the way for the launch of new commodity-related financial products. Also in September, the HKMA signed a Memorandum of Understanding with Bank Negara Malaysia on co-operation in the development of the financial services industry, particularly in the area of Islamic finance.

4.27 Following the global financial crisis, many international organisations and overseas authorities are striving to reform the financial sector, with the aim of forestalling another crisis in the future. Back in Hong Kong, to instil greater investor confidence in the market and its regulatory framework, the Government will consult the public on proposals to establish an Investor Education Council and a Financial Services Ombudsman by the end of 2009.

Notes :

(1) Prior to 9 October 2008, the Base Rate was set at either 150 basis points above the prevailing US Federal Funds Target Rate (FFTR) or the average of the five-day moving averages of the overnight and one-month HIBORs, whichever was higher. Between 9 October 2008 and 31 March 2009, this formula for determination of the Base Rate was temporarily changed by reducing the spread of 150 basis points above the prevailing FFTR to 50 basis points and by removing the other leg relating to the moving averages of the relevant interbank interest rates. After a review of the appropriateness of the new Base Rate formula, the narrower 50 basis point spread over the FFTR was retained while the HIBOR leg was re-instated in the calculation of the Base Rate after 31 March 2009.

(2) In December 2005, the HKMA published a new data series on composite interest rate, reflecting movement in various deposit rates, interbank and other interest rates to closely track the average cost of funds for banks. The published data enable the banks to keep track of changes in funding cost and thus help improve interest rate risk management in the banking sector.

(3) The trade-weighted Nominal Effective Exchange Rate Index (EERI) is an indicator of the overall exchange value of the Hong Kong dollar against a fixed basket of other currencies. Specifically, it is a weighted average of the exchange rates of the Hong Kong dollar against some 14 currencies of its major trading partners, with the weights adopted being the respective shares of these trading partners in the total value of merchandise trade for Hong Kong during 1999 and 2000.

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

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

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

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

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

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

(5) Authorised institutions (AIs) include licensed banks, restricted licence banks and deposit-taking companies. At end-September 2009, there were 146 licensed banks, 26 restricted licence banks and 28 deposit-taking companies in Hong Kong. Altogether, 200 AIs (excluding representative offices) from 30 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 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.

(8) The ranking is made by the World Federation of Exchanges, a global trade association for the stock exchange industry. Its membership comprises 53 securities exchanges (as of 29 October 2009), covering almost all globally recognised stock exchanges.

(9) At end-September 2009, there were 1 114 and 172 companies listed on the Main Board and GEM respectively.

(10) At end-September 2009, there were 51 classes of stock options contracts and 41 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 cover only the active authorised funds that have responded to the survey. At end-September 2009, there were 1 249 authorised funds, according to the survey.

(12) At end-September 2009, there were 19 approved trustees. On MPF products, 35 master trust schemes, two industry schemes and one employer sponsored scheme, comprising altogether 365 constituent funds, were approved by the Mandatory Provident Fund Schemes Authority. A total of 239 000 employers, 2.20 million employees and 265 000 self-employed persons have participated in MPF schemes.

(13) At end-September 2009, there were 13 SFC-authorised retail hedge funds with combined net asset size of US$675 million. The amount of net assets under management represented a 1.4% increase over end-June 2009 though it was still 12.3% lower than the end-2008 level. It was more than four times of that at end-2002, the year when the hedge funds guidelines were first issued.

(14) At end-September 2009, there were 172 authorised insurers in Hong Kong. Within this total, 46 were engaged in long-term insurance business, 107 in general insurance business, and 19 in composite insurance business. These authorised insurers come from 23 countries and territories (including Hong Kong).