



PEOPLE'S REPUBLIC OF CHINA— HONG KONG SPECIAL ADMINISTRATIVE REGION

June 2021

FINANCIAL SYSTEM STABILITY ASSESSMENT—PRESS RELEASE AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE PEOPLE'S REPUBLIC OF CHINA — HONG KONG SPECIAL ADMINISTRATIVE REGION

In the context of the People's Republic of China—Hong Kong Special Administrative Region's Financial System Stability Assessment, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its May 21, 2021 consideration of the FSSA.
- The **Financial System Stability Assessment** (FSSA) for the People's Republic of China—Hong Kong Special Administrative Region, prepared by a staff team of the IMF for the Executive Board's consideration on May 21, 2021. This report is based on the work of an IMF Financial Sector Assessment Program (FSAP) mission to the People's Republic of China—Hong Kong Special Administrative Region during September 10–24, 2019 and February 24–March 5, 2021. The FSSA report was completed on April 29, 2021.
- A **Statement by the Executive Director** for People's Republic of China—Hong Kong Special Administrative Region.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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Washington, D.C.



IMF Executive Board Concludes Financial System Stability Assessment with Hong Kong SAR

FOR IMMEDIATE RELEASE

Washington, DC – June 8, 2021: The Executive Board of the International Monetary Fund (IMF) concluded the Financial System Stability Assessment¹ with Hong Kong SAR on May 21, 2021.

Sound macroeconomic and prudential policies over the years have provided Hong Kong SAR with important buffers to cope with the current slowdown and future shocks. The banking sector remains well capitalized, profitable, and nonperforming loan ratios remain low. Hong Kong SAR's exchange rate mechanism, the Linked Exchange Rate System (LERS), has continued to support financial stability, and is underpinned by large foreign exchange reserves. In response to the COVID-19 pandemic, the authorities took a multi-pronged approach to support the economy and maintain financial stability.

The FSAP identified the extensive linkages to Mainland China, stretched real estate valuations, and exposure to shifts in global market and domestic risk sentiment, compounded by escalating U.S.-China tensions, as the main macro-financial risks. Stress tests conducted by the FSAP show that the financial system is resilient to severe macro-financial shocks and the banking system is also resilient to liquidity stress, but there are pockets of vulnerabilities in foreign bank branches, investment funds, households, and nonfinancial corporates. Accordingly, the FSAP made recommendations for enhancing oversight over banking groups with both foreign branches and local subsidiaries in Hong Kong SAR, heightening monitoring of liquidity risk for banks operating with multiple group entities, and ensuring that internal risk models to monitor lending to Mainland China are sufficiently forward looking.

The institutional framework for macroprudential policies is functioning well, and the current policy stances on real estate and countercyclical capital buffers (CCyB) are appropriate. Nonetheless, there is further scope for strengthening systemic risk monitoring, improving communication, and bringing non-bank mortgage lending within the regulatory ambit.

Banking supervision and regulation remain strong overall and with respect to cross-border linkages and housing risks, but continued attention and review is needed in regard to competing priorities and the adequacy of supervisory resources. The establishment of the Insurance Authority has greatly strengthened insurance regulation and the supervision of both insurers and intermediaries. The regulatory and supervisory framework for securities trading systems has been strengthened since the 2014 FSAP, as also supervisory coordination with the Mainland.

Crisis management arrangements have been significantly strengthened by the introduction of a comprehensive resolution regime under the Financial Institutions Resolution Ordinance (FIRO) in 2017. Updating some aspects of the depositor protection regime, including the scope of depositor preference, the mandate of the Deposit Protection Board, and reviewing the size of the Deposit Protection Scheme fund would ensure full consistency with the FIRO.

¹ The Financial Sector Assessment Program (FSAP), established in 1999, is a comprehensive and in-depth assessment of a country's financial sector. FSAPs provide input for Article IV consultations and thus enhance Fund surveillance. FSAPs are mandatory for the 47 jurisdictions with systemically important financial sectors and otherwise conducted upon request from member economies. The key findings of an FSAP are summarized in a Financial System Stability Assessment (FSSA).

The FSAP examined the authorities' active role in promoting Fintech and recommended adopting a more proactive cross-sectoral approach as Fintech pervades across activities. The FSAP welcomes the authorities' plan towards climate-related mandatory disclosures, the Common Ground Taxonomy, and risk assessments.

Executive Board Assessment²

Executive Directors broadly agreed with the thrust of the recommendations in the 2021 Financial System Stability Assessment (FSSA). Noting the substantial macro-financial challenges that Hong Kong SAR's economy has faced over the past two years on both the domestic and external fronts, they recognized the resilience of its financial sector, underpinned by sound policies, ample buffers, and strong oversight. Looking ahead, Directors considered that the main macro-financial vulnerabilities relate to stretched real estate valuations and exposure to shifts in global market and domestic risk sentiment. Most Directors also mentioned risks associated with extensive linkages with Mainland China, with a few Directors highlighting also the long-term benefits from such linkages.

Directors welcomed the banking system's resilience to severe macro-financial shocks under the stress tests, but also noted pockets of vulnerability in the corporate, household, and investment fund sectors. To further strengthen resilience, they encouraged monitoring households' debt repayment capacity at a disaggregated level, strengthening data collection, and bringing nonbank mortgage lending within the regulatory framework.

Directors welcomed the strengthening of supervisory and crisis management frameworks since the 2014 FSAP. They agreed that banking supervision and regulation remains strong, but broadly encouraged enhancing oversight and liquidity risk monitoring of banking groups with both local subsidiaries and foreign branches. While noting that Hong Kong SAR's macroprudential policy framework is functioning well and that the current policy stances on real estate and countercyclical capital buffers are appropriate, Directors saw scope for further strengthening systemic risk assessment and communication. Many Directors also supported providing de jure operational independence to the Hong Kong Monetary Authority. Directors generally underscored the importance of continuing to strengthen regulation and preserving the rule of law to maintain a solid foundation for competitiveness as an international financial center.

Directors welcomed the authorities' strategic prioritization of policies to combat the risks of climate change, including through mandatory disclosures, the Common Ground Taxonomy, and risk assessments.

Directors welcomed the authorities' active role in promoting Hong Kong SAR as a fintech hub in Asia, and encouraged continued coordinated efforts among the regulators to guide a proactive and consistent cross-sectoral approach. They encouraged the authorities to continue improving the solid AML/CFT regime.

² At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.IMF.org/external/np/sec/misc/qualifiers.htm>.



PEOPLE'S REPUBLIC OF CHINA— HONG KONG SPECIAL ADMINISTRATIVE REGION

FINANCIAL SYSTEM STABILITY ASSESSMENT

April 29, 2021

KEY ISSUES

Findings: The main macro-financial risks relate to extensive linkages to Mainland China, stretched real estate valuations, and exposure to shifts in global market and domestic risk sentiment, compounded by escalating U.S.-China tensions. Stress tests show that the financial system is resilient to severe macro-financial shocks, but there are pockets of vulnerabilities in foreign bank branches, investment funds, households, and nonfinancial corporates. Hong Kong SAR's financial sector is also exposed to physical and transition risks from climate change.

Recommendations: The macroprudential framework is well structured and the current policy stances on real estate and countercyclical capital buffers are appropriate, but there is room to further strengthen the macroprudential framework by enhancing systemic risk assessment and communication. The micro-prudential oversight of banks, insurance companies, investment funds, and securities markets has been further strengthened since the 2014 FSAP. The FSAP recommends enhancing oversight over banking groups with both foreign branches and local subsidiaries in Hong Kong SAR; heightening monitoring of liquidity risk for banks operating with multiple group entities; bringing nonbank mortgage lending within the regulatory framework; and solidifying the new framework for cross-sectoral resolution and safety nets. A more proactive cross-sectoral approach should be adopted in Fintech as it pervades across activities, and climate risk should become part of the authorities' systemic risk analysis. The FSAP repeats its previous recommendation of providing de jure operational independence to the Monetary Authority.

Approved By
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Prepared By
**Monetary and Capital
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This report is based on the work of the Financial Sector Assessment Program (FSAP) mission that visited Hong Kong Special Administrative Region in September 2019 and a virtual mission in February-March 2021.

- The FSAP team was led by Ananthakrishnan Prasad (MCM) and included Nico Valckx (RES) as Deputy Mission Chief, Mark Adams, Hee Kyong Chon, Cristina Cuervo, Andrea Deghi, Frank Hespeler, Tumer Kapan, Elias Kazarian, Romain Lafarguette, Hui Miao and Alla Myrvoda (all MCM); Fei Han (APD); Stefan W. Schmitz and Ian Tower (External Experts). Elizabeth M. Mahoney, Stephanie Ng, and Manuel Perez-Archila provided research assistance and Kateryna Botsu provided administrative assistance.
- The mission met the Financial Secretary, Secretary for Financial Services and the Treasury, Permanent Secretary for Financial Services and the Treasury (Financial Services), Chief Executive of the Hong Kong Monetary Authority (HKMA), Chief Executive Officer of the Securities and Futures Commission, Chief Executive Officer of the Insurance Authority, Chief Executive of HKEX group, other high ranking public officials, senior representatives of local and foreign banks, insurance companies, and industry associations.
- FSAPs assess the stability of the financial system as a whole and not that of individual institutions. They are intended to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance its resilience to shocks and contagion. Certain categories of risk affecting financial institutions, such as operational or legal risk, or risk related to fraud, are not covered in FSAPs.
- Hong Kong Special Administrative Region is deemed by the Fund to have a systemically important financial sector according to Mandatory Financial Stability Assessments Under the Financial Sector Assessment Program – Update (11/18/2013), and the stability assessment under this FSAP is part of bilateral surveillance under Article IV of the Fund's Articles of Agreement.
- This report was prepared by Ananthakrishnan Prasad and Nico Valckx, with contributions from the members of the FSAP team.

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Glossary

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
ATS	Automated Trading System
BELR	Banking (Exposure Limits) Rules
BIS	Bank for International Settlements
BO	Banking Ordinance
BuDA	Bottom-up Default Analysis
CCyB	Countercyclical Capital Buffers
CET 1	Common Equity Tier 1 Capital
CoAg	Cooperation Agreement
CCPs	Central Counterparties
CFR	Council of Financial Regulators
CMG	Crisis Management Group
CRE	Commercial Real Estate
DPB	Deposit Protection Board
D-SIB	Domestic Systemically Important Bank
ELA	Emergency Liquidity Assistance
FATF	Financial Action Task Force
FIRO	Financial Institutions Resolution Ordinance
FMI	Financial Market Infrastructure
FS	Financial Secretary
FSC	Financial Stability Council
FSAP	Financial Sector Assessment Program
FSI	Financial Soundness Indicators
FSSA	Financial System Stability Assessment
FSTB	Financial Services and the Treasury Bureau
FX	Foreign Exchange
GDP	Gross Domestic Product
G-SIB	Global Systemically Important Bank
HIBOR	Hong Kong Interbank Offered Rate
HKCC	HKFE Clearing Corporation Ltd.
HKD	Hong Kong dollar
HKMA	Hong Kong Monetary Authority
HKSAR	Hong Kong SAR
HONIA	Hong Kong Overnight Index Average
IA	Insurance Authority
IOSCO	International Organization of Securities Commission
IRB	Internal ratings-based
LCR	Liquidity Coverage Ratio
LEERS	Linked Exchange Rate System
LIBOR	London Interbank Offered Rate
LTV	Loan-to-Value

MaPP	Macroprudential Policies
ML/TF	Money Laundering/Terrorist Financing
MOU	Memorandum of Understanding
MPMs	Macroprudential Policy Measures
NDFCs	Non-Deposit Taking Finance Companies
NFC	Non-Financial Corporate
NPL	Non-performing Loan
NSFR	Net Stable Funding Ratio
PFMI	Principles for Financial Market Infrastructures
RAM	Risk Assessment Matrix
RMB	Renminbi
RR	Reserve Requirement
SFC	Securities and Futures Commission
STeM	Stress Testing Matrix
THB	Transport and Housing Bureau
USD	US dollar

EXECUTIVE SUMMARY

Hong Kong SAR is a small and open economy, and a major international financial center with extensive linkages to Mainland China. Over the past two years, Hong Kong SAR experienced unprecedented negative GDP growth, severely impacted by domestic social incidents, US-China tensions, and the global COVID-19 pandemic.

Sound macroeconomic and prudential policies have provided Hong Kong SAR with important buffers to cope with the current slowdown and future shocks. The banking sector remains well capitalized, profitable, and nonperforming loan ratios remain low. Hong Kong SAR's exchange rate mechanism, the Linked Exchange Rate System (LERS), has continued to support financial stability, and is underpinned by large foreign exchange reserves.

The main macro-financial vulnerabilities relate to Hong Kong SAR's extensive linkages to Mainland China, stretched real estate valuations, and exposure to shifts in global market and domestic risk sentiment. Risks to the financial system can manifest from a prolonged COVID-19 pandemic, a further slowdown in Mainland China, a sharp rise in global risk-premia compounded by escalating US-China tensions, and a sharp housing market correction. In a severe scenario, the four risks described above could materialize at the same time and amplify each other's effects.

Stress tests indicate banking system's resilience to severe macro-financial shocks, thanks to the initial high capital buffers and pre-shock profitability. Under a severely adverse solvency stress test scenario combining the above four risk factors, banks' average common equity tier 1 capital (CET 1) ratio decreases by 4.5 percentage points from 15.9 percent in 2019 to 11.5 percent in 2022—remaining well above regulatory requirements. Assessment of concentration risk, based on an assumption of default of the five largest exposures in each bank in the sample, indicates a decline in the average CET1 ratio by close to 6.5 percentage points. The banking system is also resilient to liquidity stress, however, some of the foreign branches are more vulnerable to liquidity shocks, largely due to their higher reliance on unsecured interbank funding and their inability to tap the local deposit base. Non-financial corporate debt-at-risk and default risk could increase significantly under an adverse scenario, particularly in the Mainland China real estate sector. Low- to median-income households' mortgage debt service appears vulnerable to income and interest rate shocks.

To help ensure the continued robustness of the financial system, the FSAP recommends enhancing oversight over banking groups that have both foreign branches and local subsidiaries in Hong Kong SAR; heightening monitoring of liquidity risk at the group and entity level for banks that operate with multiple group entities, and stress testing banks' large exposures separately from their total loan books; ensuring that internal risk models used to determine the capital charge for Mainland China real estate borrowers with low credit ratings are sufficiently forward looking; and monitoring households debt repayment capacity at a disaggregated level.

The institutional framework for macroprudential policies (MaPP) is functioning well, and the current policy stances on real estate and countercyclical capital buffers (CCyB) are

appropriate. Nonetheless, there is scope for strengthening systemic risk monitoring, improving data collection, enhancing communication through a comprehensive and dedicated financial stability report, and bringing non-bank mortgage lending within the regulatory ambit.

The microprudential policy oversight over the financial system is modernized and strong.

Banking supervision and regulation remain strong, both overall and with respect to cross-border linkages and housing risks. The FSAP reiterates the 2014 FSAP's recommendation to provide *de jure* operational independence to the Hong Kong Monetary Authority (HKMA), and to adopt a framework to ensure that its prudential mandate is not compromised by development initiatives. The establishment of the Insurance Authority has greatly strengthened insurance regulation and the supervision of both insurers and intermediaries. In securities markets, the current regulatory and supervisory framework for trading systems has been strengthened since the 2014 FSAP, as well as supervisory coordination with the Mainland.

Crisis management arrangements have been significantly strengthened by the introduction of a comprehensive resolution regime under the Financial Institutions Resolution Ordinance (FIRO) in 2017.

The HKMA and other resolution authorities have also made a strong start at implementing institution-specific resolution plans under the FIRO, although more work is needed. The authorities should update aspects of the depositor protection regime - including the scope of depositor preference, the mandate of the Deposit Protection Board (DPB), and reviewing the size of the DPB Deposit Protection Scheme (DPS) fund and its usability in resolution - to ensure full consistency with the FIRO and underpin deposit confidence.

The FSAP's assessment of the systemically important clearing corporation concluded that while Hong Kong Futures Exchange (HKFE) Clearing Corporation Limited (HKCC) has a sound legal basis and comprehensive risk management framework, the governance structure and the risk management can be further enhanced, an independent review of which has since been commenced by the authorities.

Hong Kong SAR authorities play an active role in promoting Hong Kong SAR as a fintech hub in Asia. Continued coordinated efforts among regulators would guide a more consistent and cross-sectoral approach among others in the areas of harmonizing frameworks for cyber-/IT-related reporting, artificial intelligence and RegTech adoption, and cyber mapping.

Climate change poses financial stability risks in both the short run and the longer run. The FSAP welcomes the authorities' plan towards mandatory disclosures, Common Ground Taxonomy, and risk assessments.

Hong Kong SAR's competitiveness, as a major international financial center has depended on its sound rules and regulations, which have been adapted to international standards and best practices. The Hong Kong SAR authorities should continue to preserve the rule of law and strengthen the high-quality regulatory framework, so that solid foundation for competitiveness in its financial sector is preserved.

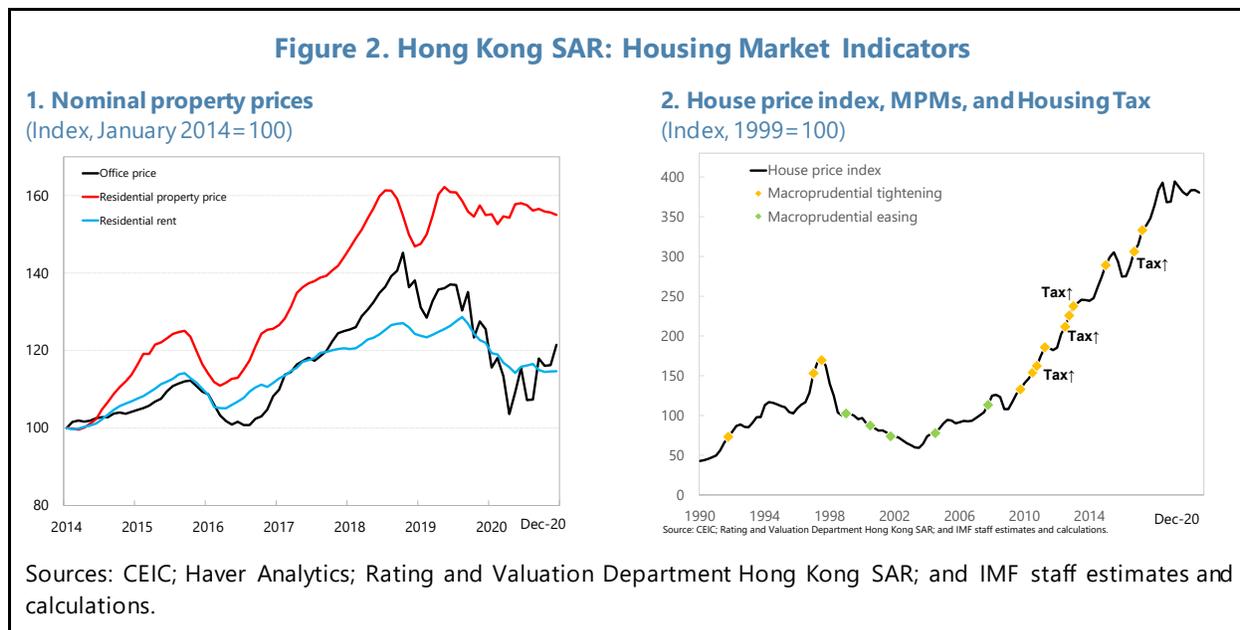
Table 1. Hong Kong SAR: Key Recommendations	
Recommendations	Time
Strengthening Systemic Risk Monitoring	
Continue to monitor Authorized Institutions' concentrated exposures to non-bank Mainland China entities, particularly of banking groups with foreign bank branches and subsidiaries. [HKMA]	C
Reassess the need for amending the regulatory perimeter to monitor NDFCs and leakages to macroprudential policy. [Hong Kong SAR Authorities]	MT
Ensure sufficiently forward-looking internal risk models for capital charge for Mainland China real estate borrowers with low credit ratings. [HKMA]	C
Integrate all bank liquidity stress tests, streamline reporting, and enhance monitoring of liquidity position of foreign branches that appear more vulnerable. [HKMA]	MT
Integrate monitoring and stress testing of investment funds' liquidity in the supervisory framework and increase granularity of data collation. [SFC]	MT
Monitor non-mortgage household debt; ensure consistency of risk guidelines among regulators on investment credit to high-net-worth individuals. [HKMA/SFC]	ST
Macroprudential Policy Framework	
Strengthen the systemic risk monitoring and data collection framework; Continue leveraging analytical expertise of the HKMA/other regulators in CFR/FSC. [FSTB/HKMA/ SFC/IA]	ST
Enhance data collection of intersectoral claims with a focus on claims of the NBFIs to better gauge the importance of intersectoral linkages. [FSTB/HKMA/ SFC/IA]	ST
Financial Sector Supervision	
Update legislation to reflect HKMA's de facto operational independence in the law; in the interim, consider specifying circumstances where Chief Executive may give directions to Monetary Authority. [Government]	MT
Implement group-wide supervision and risk-based capital requirements as planned. [IA]	ST
Assess systemic risk of individual insurers (potential FIRO designation), and cross-sector risks. [IA]	MT
Enhance surveillance and monitoring of OTC trades. [SFC]	MT
Expand enforcement powers over recognized exchange companies and clearing houses, and Part III Automated Trading System providers. [SFC]	MT
Strengthen the current governance of the HKCC by setting up a proper HKCC board, an independent risk management committee, and decentralized key functions. [HKEX]	ST
Crisis Management and Financial Safety Nets	
Update the deposit protection scheme, including expanding the scope of depositor preference, extending the mandate of the DPB to allow it to contribute to resolution costs, and reviewing the size of the DPS fund and flexibility of levies. [FSTB/HKMA]	MT
Fintech and Financial Innovation	
Promote consistency and facilitate information sharing across financial sectors with respect to cyber risk supervision; review and compare incident reporting frameworks across sectors and apply best practices to other sectors. [HKMA/SFC/IA]	ST
Consider undertaking exercise to map network interdependencies. [HKMA/SFC/IA]	MT
Strengthen systematic data collection of entities to enhance monitoring of holdings of virtual assets (VA); monitor VA trading activities continuously; increase investor education. [HKMA/SFC/IA]	ST/C
Note: C - continuous; ST - is 1–3 years; MT - medium-term is 3–5 years.	

BACKGROUND

1. Hong Kong SAR's economic recession deepened in the first half of 2020 amid the COVID-19 outbreak, but is now recovering. In 2019, economic activity weakened due to both external and domestic factors, with GDP contracting by 1.2 percent (Figure 12). GDP continued to decline by another 6.1 percent in 2020, aggravated by the impact of the COVID-19 pandemic. Hong Kong SAR's unemployment rate rose from 3.3 percent at end-2019 to 6.6 percent at end-2020. However, growth has started to recover since the second half of 2020 and an economic rebound in 2021 and 2022 is projected with growth expected to rise to 4.3 percent in 2021 as the authorities took a multi-pronged approach to support the economy and maintain financial stability during the pandemic (Figure 1).

Figure 1. Hong Kong SAR: Multi-Pronged Approach to Financial Stability and Support the Economy	
Easing cash-flow pressure	Releasing buffers
<ul style="list-style-type: none"> • Provided direct cash transfers to households • Provided relief grants and loans to hard-hit sectors¹ • Introduced Pre-approved Principal Payment Holiday Scheme for eligible small-to-mid-sized enterprises (SME) • Enhanced the SME Financing Guarantee Scheme, including through special loan guarantee for unemployed and self-employed individuals • Encouraged banks to make good use of their lending headroom 	<ul style="list-style-type: none"> • Reduced the Countercyclical Capital Buffer ratio of banks by 1.5 percentage points • Lowered the regulatory reserve requirements on banks by half² • Raised the applicable loan-to-value ratio caps for mortgage loans on non-residential properties by 10 percentage points • Relaxed the eligibility criteria for HKMC-sponsored mortgage insurance program • Strengthened market surveillance and contingency planning • Maintained close dialogues with the industry to understand and address their concerns
Increasing market liquidity	Maintaining market resilience and confidence
<ul style="list-style-type: none"> • Reduced issuance size of Exchange Fund Bills to increase the overall Hong Kong dollar liquidity • Clarified the "Hong Kong Dollar Liquidity Facilities" framework and arranged drills for banks • Introduced the temporary "US Dollar Liquidity Facility" for Hong Kong SAR banks, using funds obtained through the U.S. Federal Reserve's temporary repurchase agreement facility 	<ul style="list-style-type: none"> • Strengthened market surveillance and contingency planning • Maintained close dialogues with the industry to understand and address their concerns
<p>¹ The HKMA clarified that Authorized Institutions should continue to apply the relevant expected credit loss frameworks.</p> <p>² The regulatory reserve requirement (RR) was introduced in 2005 and modified in 2018 during the implementation of the local version of IFSR9 accounting rules, HKFRS9, to build up additional buffers on top of loss provisions, which were increased after the HKFRS9 implementation. Given the notable increases in provisions observed in 2019, HKMA deemed that the need for maintaining a regulatory reserve on top of accounting provisions had diminished and reduced the requirement by 50 percent.</p> <p>Source: HKMA.</p>	

2. Fueled by strong demand and a chronic shortage in housing supply, real residential property prices were nearly 35 percent higher at end-2020 than in early 2014, despite some recent fall in prices in the past two years. The HKMA tightened macroprudential policy measures (MPMs), such as limits on total debt servicing ratios and loan-to-value (LTV) ratios for mortgages, which helped contain banks' exposure to the housing boom (Figure 2). To complement these MPMs, the government increased stamp duties and introduced other taxation measures to contain speculative activity and external demand.¹ The government also adopted supply-side measures to boost housing supply (see the Hong Kong SAR's 2019 Art. IV report for more details). COVID-19 exacerbated pressures in the non-residential property market. Office prices declined by 12 percent between end-2018 and end-2020, largely attributed to the economic slowdown and adoption of work-from-home measures amidst the pandemic. In response to the slipping non-residential property market, in August 2020 the HKMA adjusted the LTV caps for mortgage loans on non-residential properties upward by 10 percentage points.²



3. Despite the deep recession in 2020, corporate and household debt continued to grow, leading to heightened leverage and credit gaps. Bank credit growth slowed to 7 percent (y/y) in the first three quarters of 2020 (1.2 percent in 2020), from a recent peak of 16 percent in 2017, reflecting a combination of moderation in trade finance, domestic loans, and Mainland China-related lending, which accounted for close to 40 percent of total bank lending as of September 2020. Nonfinancial corporate (NFC) debt increased significantly from 202 percent of GDP in 2014 to

¹ Past IMF research showed that without MPMs and tax measures, house prices would have been 12.5 percent higher, and the mortgage credit-GDP ratio 15 percent higher (IMF Country Report 18/17).

² For general cases, the LTV cap was raised from 40 to 50 percent, as per <https://www.hkma.gov.hk/eng/news-and-media/press-releases/2020/08/20200819-5/>.

257 percent in 2020Q3, but debt-at-risk remained low from a historical perspective (Figure 3).³ Household debt increased from 65 percent to 88 percent over the same period.⁴ This led to a widening of the domestic credit-to-GDP gap from close to zero in 2013 to 35 percent in 2020Q3, which may point to rising asset quality risks—although the most recent increases were primarily as a result of lower GDP outturns.

4. Sound macroeconomic conditions and prudential policies have provided Hong Kong SAR with important buffers to cope with the current cyclical slowdown and future shocks.

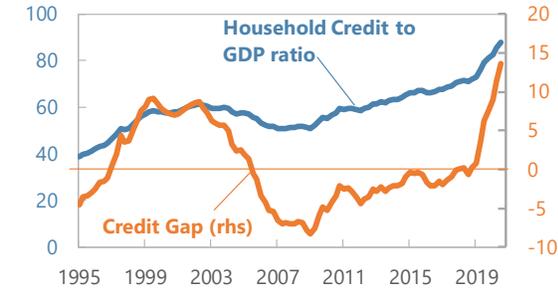
- **External.** FX reserves are around 140 percent of GDP, or 1.8 times the monetary base at end-2020. The net international investment position was around 616 percent of GDP at end-2020, one of the largest in the world.
- **Fiscal.** Adherence to a balanced budget principle (as set out in Art. 107 of the Basic Law), consistent underperformance in expenditures and overperformance in revenues allowed accumulation of fiscal reserves of about 40 percent of GDP in 2019, before falling to about 33 percent of GDP in December 2020 due to countercyclical fiscal policy measures (Table 3).
- **Banking.** The Tier 1 capital ratio of banks stood at 18.3 percent, the liquidity coverage ratio was 157 percent, and the nonperforming loans (NPL) ratio was 0.8 percent in 2020Q3. Return on assets has remained fairly stable since 2013 at around 1 percent but fell to 0.8 percent (annualized) during 2020 Q1-Q3 as a result of the deep recession and slight rise in NPLs (Figure 14 and Table 4).

³ The ratio of non-financial corporate debt-to-GDP may overstate Hong Kong SAR firms' leverage, since it includes many multinational and non-local firms that borrow funds from Hong Kong SAR banks to finance their operations outside Hong Kong SAR.

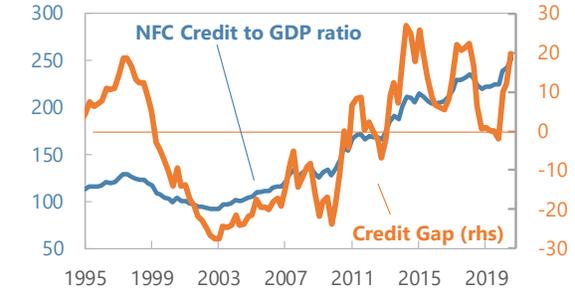
⁴ In addition to borrowing from banks, households have been reliant on lending from non-deposit taking finance companies (NDFC), estimated at about 5 percent of GDP in 2019. Some of this lending appears to be highly risky. Based on June 2019 figures, property developers extended mortgage loans of HKD 41bn with LTV ratios up to 90 percent—equivalent to 3 percent of outstanding residential mortgages of AIs. Other non-deposit taking finance companies and brokers also provided loans to households, secured by financial assets or property.

Figure 3. Hong Kong SAR: Household and Corporate Debt Developments

1. Household debt-to-GDP ratio and gap
(In percent)

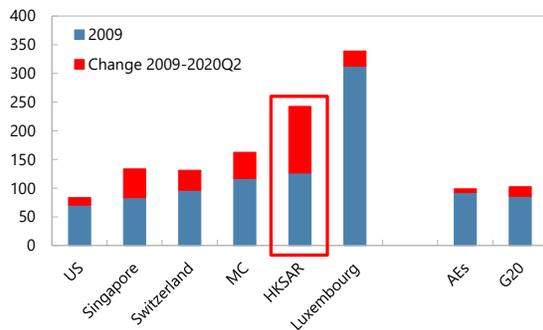


2. Non-financial corporate debt-to-GDP ratio and gap
(In percent)



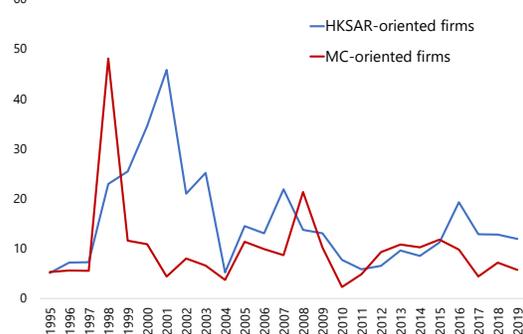
3. Non-Financial corporate debt in selected economies
(In percent of GDP)

Corporate Debt in Selected Economies
(In percent of GDP)



4. Non-financial Corporate Debt-at-Risk
(Share of debt owed by firms with ICR below 1 in percent of total debt)

Non-financial Corporate Debt-at-Risk 1/
(Share of debt owed by firms with ICR below 1 in percent of total debt)



Source: BIS; Bloomberg, L.P.; Hong Kong SAR authorities; Haver Analytics, BIS; IMF staff computations.

Note: Data refers to credit to households and NPISHs (non-profit institutions serving households) from all sectors and to credit to non-financial corporations from all sectors, respectively. Data are at market value and adjusted for breaks. Credit gaps (right-hand scale) are estimated using data from 1988Q4-2020Q3 with a Hodrick-Prescott filter ($\lambda=400,000$).

^{1/} Hong Kong SAR- and Mainland China-oriented firms are identified by the firm's country of risk, a variable defined by Bloomberg based on a number of criteria (including its country of domicile, the primary stock exchange on which it is traded, the location from which the majority of its revenue comes, and its reporting currency).

5. Since its implementation in 1983, the LERS has preserved the HKD fixed parity against the USD in the face of many shocks. Hong Kong SAR authorities have introduced over time several refinements and technical measures to strengthen the functioning of the LERS and smooth the impact of the currency board mechanism on the domestic interest rate. The HKMA excess coverage reserves represent around 80 percent of the monetary base, which provides large buffers to manage liquidity in turbulent times.

- During the worldwide turbulence in money markets in March 2020, the HIBOR-LIBOR spread quickly stabilized after a short period of tension. HKMA swiftly responded to the initial tightening of the USD funding by introducing a temporary USD liquidity facility to Hong Kong

SAR banks by using funds obtained through the U.S. Federal Reserve's temporary repurchase agreement facility (FIMA Repo Facility).

- Since April 2020, large capital inflows in part driven by equity-related demand, including initial public offerings, resulted in an all-time high level of foreign reserves at USD 491 billion in December 2020, representing almost half of HKD M3.

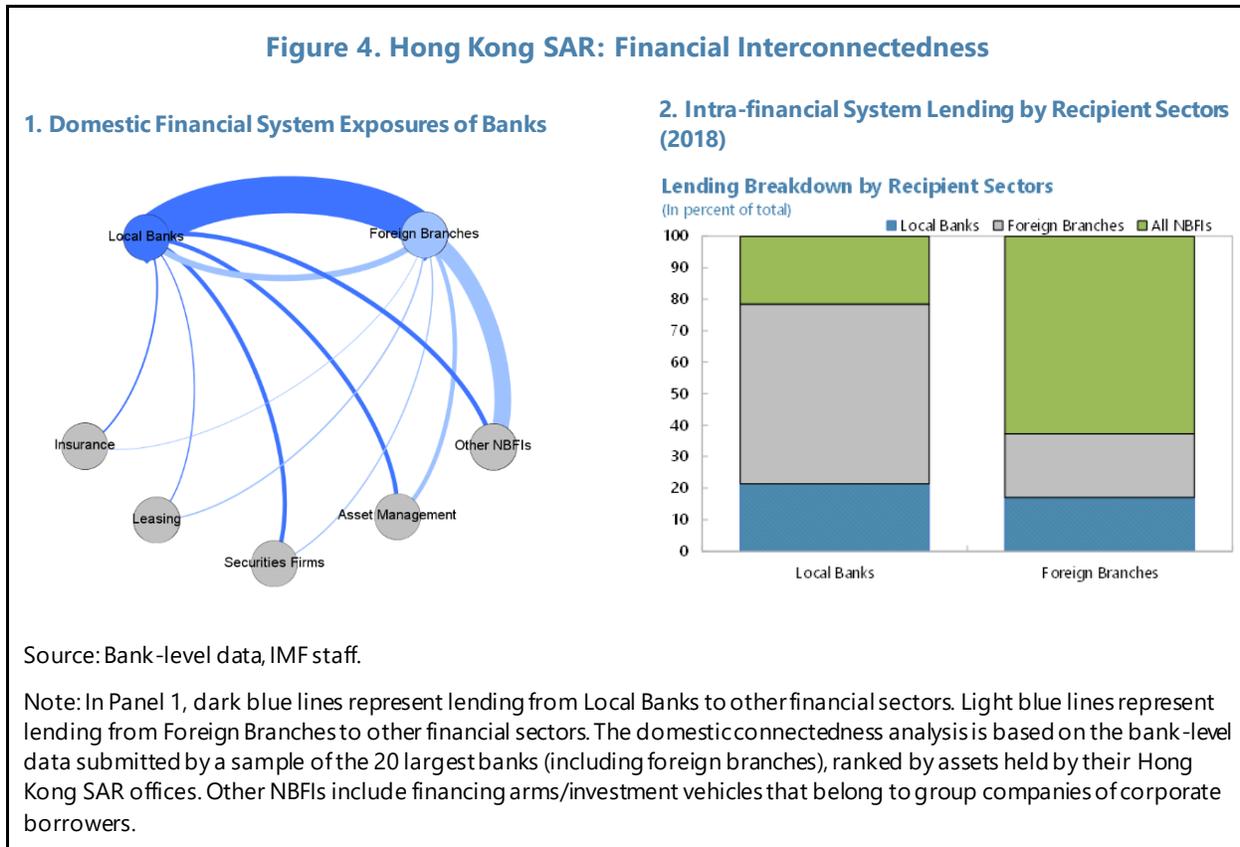
Financial Sector Landscape

6. Hong Kong SAR is a major international financial center with extensive linkages to Mainland China. It has the following key features (Table 2):

- The banking system holds assets of about 950 percent of GDP and is a material contributor to profitability and total assets of several Global Systemically Important Banks (G-SIBs).
- The life insurance sector is amongst the world's largest, particularly by penetration (life premiums to GDP of about 18 percent in 2019) and in per capita terms. The sector's growth has been supported by the popularity of savings products, including sales of policies to Mainland China visitors, although these have declined from recent peaks due to COVID travel restrictions.
- Hong Kong SAR hosts the world's fifth largest stock exchange by market capitalization (USD 6.1 trillion) at end-2020. Mainland China-related companies account for around half of the listed companies in Hong Kong SAR, representing 81 percent of total capitalization. USD-denominated bond issuance in Hong Kong SAR by Mainland China firms accounted for more than 60 percent of Mainland China firms' total offshore issuances in 2020. The Stock and Bond Connect schemes establish mutual market access arrangements between Mainland China and Hong Kong SAR. Average daily turnover in Stock Connect more than doubled in 2020, with Northbound traffic (Hong Kong SAR to Mainland China) going up by 119 percent and Southbound traffic (Mainland China to Hong Kong SAR) going up by 128 percent. Average daily turnover in Bond Connect increased by 82 percent in 2020 on top of a tripling in 2019.
- Assets under management (AUM) amounted to 1,000 percent of GDP in 2019. A major source of funding for the asset and wealth management business is from non-Hong Kong SAR investors (64 percent of AUM in 2019), while assets managed in Hong Kong SAR made up 56 percent of AUM, reflecting the role of Hong Kong SAR as a global wealth management center. A growing part is also Mainland China-related, with 387 licensed corporations and registered institutions established by Mainland China-related groups active in Hong Kong SAR (up by 7 percent from 2018).
- Finally, Hong Kong SAR's FX swap market is the largest in Asia, reflecting its role as an international funding center.

7. The banking system comprises locally incorporated banks (including subsidiaries of international banking groups) and many smaller foreign branches. These two groups have different business models. Local banks have a strong local deposit funding base and engage in

financial intermediation mostly in Hong Kong SAR, but with a significant portion of Mainland China-related loans (about one-third of their loans). Approximately 30 percent of their non-bank lending are to households, with the rest to corporates. Foreign branches rely more on the interbank market to borrow from local banks, and on corporate deposits, and they lend mostly to corporates, many of which are located outside Hong Kong SAR (Figure 4). Foreign branches are not allowed to lend to retail borrowers beyond a minimal limit. About 52 percent of foreign branches' lending are Mainland China-related, compared to around one third for local banks, highlighting the banking system's significant cross-border connections to Mainland China. Despite being smaller, foreign branches account for 60 percent of total cross-border interbank claims.⁵



SYSTEMIC RISK ASSESSMENT

A. Key Vulnerabilities and Risks, Assessment Methods and Scenarios

8. The key macro-financial vulnerabilities relate to Hong Kong SAR's extensive Mainland China linkages (Figure 15), stretched real estate valuations (Figure 16), and exposure to shifts in global market and domestic risk sentiment. These vulnerabilities and the associated risks,

⁵ Foreign branches account for under 39 percent of total assets of Hong Kong SAR office-only balance sheets of all banks.

discussed below, formed the basis of FSAP's risk analyses (Appendix III, Risk Assessment Matrix) and were also identified in the 2019 Art. IV report on Hong Kong SAR.

9. Based on these vulnerabilities, the FSAP identified the following key risks to financial stability:

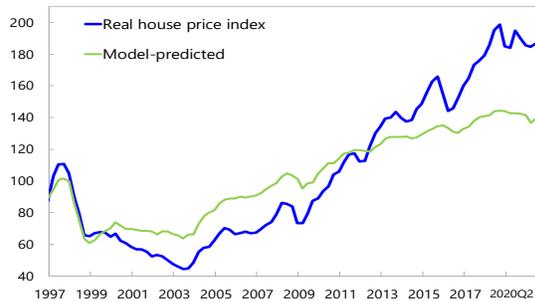
- *A prolonged COVID-19 pandemic* could reduce both domestic and external economic activity and prevent a speedy recovery.
- *Accelerating de-globalization and heightened protectionism accompanied by a further slowdown in Mainland China* could lead to higher uncertainty, reduce trade flows through Hong Kong SAR and lead to a sharp decline in economic activity.
- *A sharp rise in global risk premia compounded by escalating US-China tensions* could tighten financial conditions in Hong Kong SAR and cause a repricing of Hong Kong SAR-specific risks, leading to capital outflows, higher funding cost for borrowers and lower asset values, including property prices.
- *A sharp housing market correction and decline in demand* could lower confidence and residential investment, and constrain new bank lending leading to a larger downturn.

Looking ahead, any renewed social incidents, global economic uncertainties and US-China tensions could continue to pose potential challenges to Hong Kong SAR's standing as an international financial center.⁶ These developments could also trigger a house price correction in Hong Kong SAR (Figure 5), amplifying the downturn through a feedback loop of falling house prices, weaker consumption, higher NPLs, and tightening of banks' lending standards.

⁶ Under the Hong Kong Autonomy Act, 2020, adopted by the U.S. in July 2020, the U.S. can impose sanctions on individuals and entities that it determines as eroding Hong Kong SAR's autonomy as well as secondary sanctions on foreign financial institutions that conduct significant transactions with such parties.

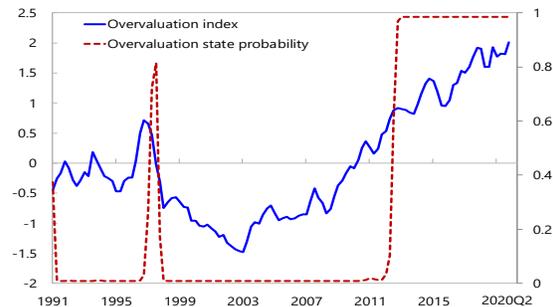
Figure 5. Hong Kong SAR: House Price Valuation and House Price at-Risk

1. Comparison of Real and Model Implied Value of House Prices (Index)



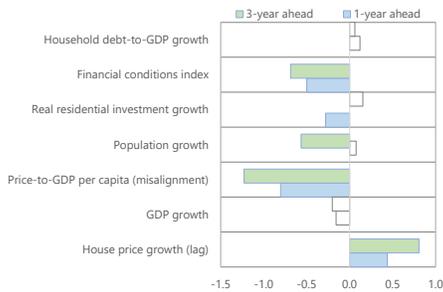
Sources: IMF staff estimates and calculations.

2. Bubble Index and Overvaluation Probability (Z-score, primary axis; probability, secondary axis)



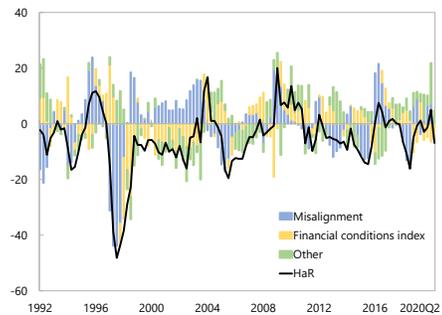
Sources: IMF staff estimates and calculations.

3. Factors affecting House Prices at Risk (10th percentile coefficients)

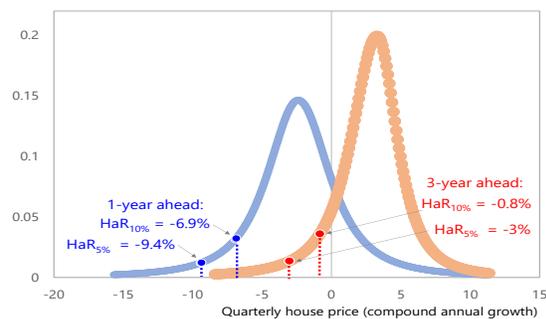


Source: IMF staff estimates and calculations.
1/ Note: Colored bars indicate that the coefficients are statistically significant at the 10 percent level or higher, whereas outlined bars indicate insignificant coefficients.

4. Contribution to 1-Year-Ahead House Price at Risk (In percent)

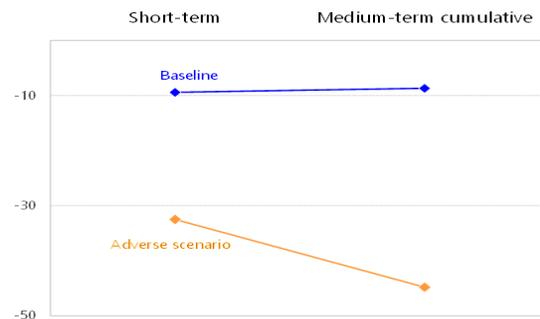


5. Baseline One- and Three-Year-Ahead T-Skew Density Forecasts, 2020Q2 (Probability Density Function, PDF)



Source: IMF staff computations.

6. One-Year and Three-Year-Ahead HaR Baseline and Adverse Scenarios (Percentage change, 5th percentile)



Notes: Panel 1 compares real house prices to the value estimated using an AR(1) model, that captures demand and supply side factors. Panel 2 shows an overvaluation indicator constructed using factor analysis to extract common overvaluation information. Panel 5 shows the conditional probability distributions of one (blue line) and three-year-ahead (orange) house price growth based on a parametric, t-skew density, fitted on quantile regression estimates in the period 2020:Q2. Figures are annualized growth rates. Panel 6 shows the point estimates of

predicted HaR for 2020:Q2 in the short-term (one-year) and the medium-term (3-year ahead) projections at the 5th percentile (compounded growth). The counterfactual (“adverse scenario”) scenario is calibrated as a simultaneous standard deviation shock to the house-prices-to-GDP per capita ratio (misalignment), financial conditions index and credit to household-to-GDP ratio.

10. The FSAP mission conducted stress tests of banks and investment funds, performed corporate and household sectors vulnerabilities analyses, and assessed physical risks from climate change. The bank solvency test covers the 11 largest locally incorporated banks (93 percent of local banks’ assets) using 2019 data, and liquidity tests examine 12 local banks and 11 foreign branches using 2020 Q2 data.⁷ In addition, loan portfolio concentration risk was examined. The solvency dataset precedes the start of the COVID-19 shock and the solvency exercise is conservative as it does not incorporate the potential positive impact of temporary policies aimed at supporting borrowers (e.g., income support to households and SMEs, loan principal payment deferrals), since the support policies are likely to prevent NPLs from increasing to the levels suggested by estimates from historical data up to 2019.

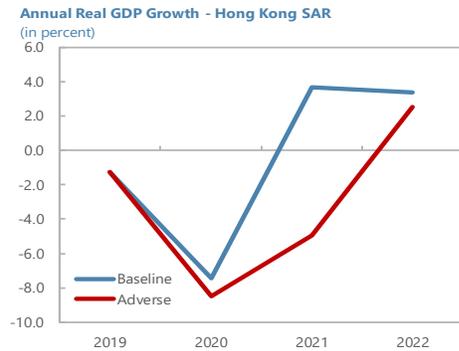
11. For liquidity stress tests, the assessment was based on December 2018 as well as June 2020 data, which allowed comparison over time. For investment funds, the redemption risk profile of the sector was examined (Appendix II, Stress Testing Matrix). Household sector tests assess mortgage repayment capacity by income groups. NFC tests assess the effects of adverse macroeconomic scenarios on their debt-servicing capacity and default risk. The mission also assessed physical risk from climate change. Furthermore, the discontinuation of LIBOR as a reference rate by end-2021 was examined, as it implies transition risk for the Hong Kong SAR banking sector.

12. The macroeconomic scenarios assume different degrees of risks. The GDP path of the adverse scenario incorporates a significant shock as it is more severe than the AFC throughout the simulation period (2020–2022). Unlike the AFC, policy rates are assumed to remain accommodative. However, financial conditions tighten significantly in the adverse scenario as corporate credit spreads rise and asset prices fall, which amplify the effect of the economic slowdown on the banking system (Figure 18). The adequacy of the stress scenario for GDP is corroborated by the Growth-at-Risk (GaR) model (Figure 6).

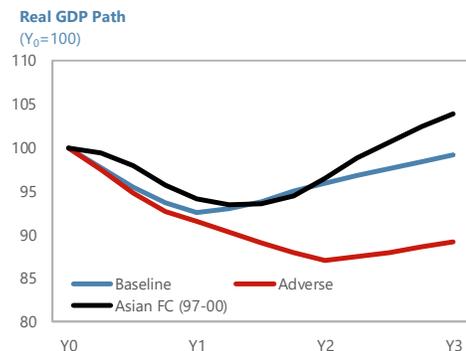
⁷ Confidential bank-level supervisory data was used for these stress tests. For solvency stress tests, granular supervisory data as of 2019Q3 was supplemented with balance sheet data for Q4.

Figure 6. Hong Kong SAR: GDP Growth Scenarios in the Solvency Stress Testing Exercise

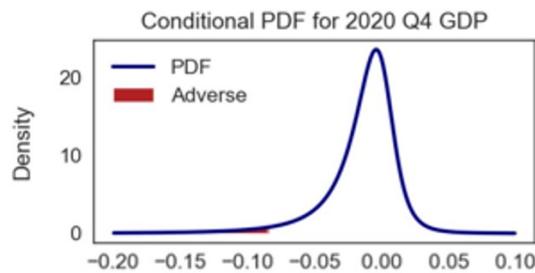
Hong Kong SAR GDP Growth in baseline and adverse scenarios.



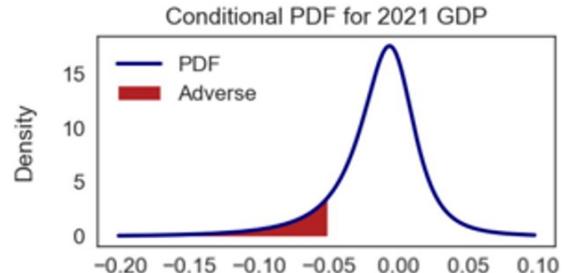
Real GDP Paths under the two scenarios and during the Asian financial crisis.



The adverse scenario GDP growth assumption in 2020 has a 3.8 percent probability in the growth-at-risk model...



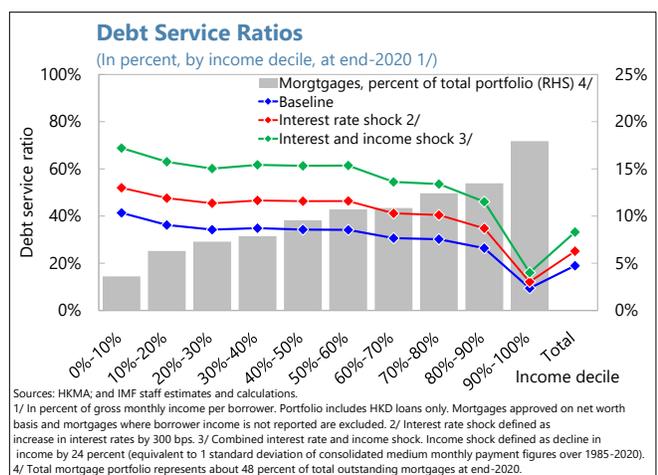
...and the assumed adverse GDP growth for 2021 is a 11.4-percentile tail event based on the model.



Source: IMF staff computations. For details on the methodology of the GaR model, see [IMF WP No. 19/36](#).

B. Household and Corporate Sector Vulnerability Analysis

13. Household debt has grown rapidly and remains manageable overall, but under severely adverse conditions, a large share of households may experience debt distress. Household's bank debt consists of residential mortgage, credit card debt and other investment-related debt, and grew steadily from 51 percent of GDP in 2007 to 88 percent in 2020Q3, above the 72 percent average for advanced economies. If non-bank lending to households (e.g. consumer finance companies, property developers) is included, household debt-to-GDP ratio could be at least 3-5 percentage points higher. Bank for International Settlements (BIS) data shows that the annual increase of household debt-to-GDP ratio is among the highest in advanced



economies. However, the consecutive tightening of macroprudential policies by HKMA has kept the credit quality of household mortgage on sound footing on average. For example, the average LTV ratio and the mortgage debt service-to-income ratio of new mortgages were low, at 57 and 37 percent on average, respectively, as of December 2020. Moreover, the high saving rate and large household assets of Hong Kong SAR residents—as reflected by household net worth-to-liabilities-ratio of 11.2 in 2019, and safe assets-to-liabilities ratio of 2.88—may mitigate the risks of rising household leverage. However, the wealth distribution is likely skewed towards higher-income households. Lower and medium-income households have already high debt service ratios (DSRs) and these would increase significantly under severe stress (combining 300 basis point interest rate hike with an income shock). Hence, careful monitoring of household debt repayment capacity at a disaggregated level is warranted—something that the HKMA has recently started doing.

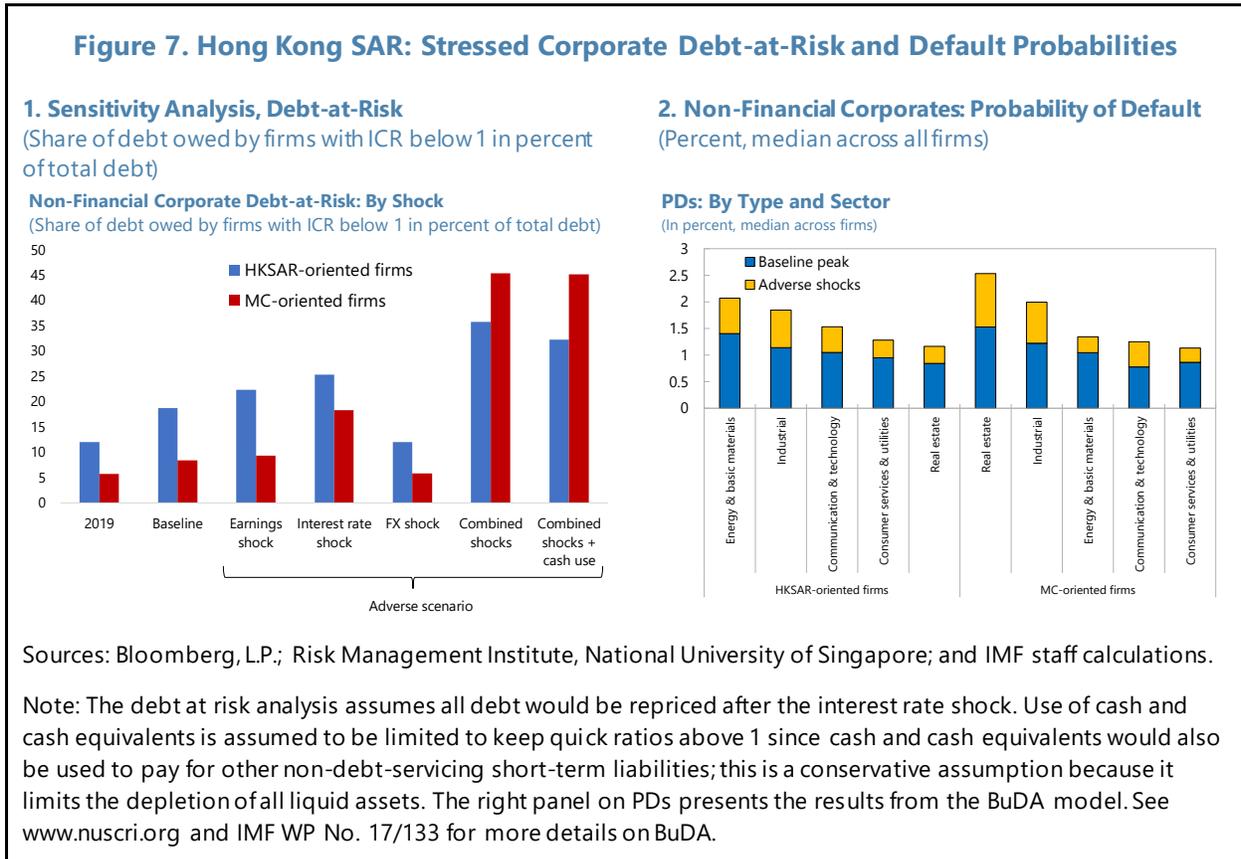
14. Under an adverse scenario, corporate debt-at-risk and default risk could increase significantly, particularly in the Mainland China real estate sector. The FSAP's scenario-based firm-level debt-at-risk analysis⁸ found that: i) the debt-at-risk of Hong Kong SAR- and Mainland China-oriented firms in the adverse scenario would increase to levels beyond their GFC peaks (although still below their AFC peaks), with a more prominent increase in Mainland China-oriented firms, and ii) the debt-at-risk in the Mainland China-oriented real estate sector is particularly vulnerable to the adverse shocks (Figure 7). Results from the bottom-up default analysis (BuDA) confirm that the median probability of default (PD) across all firms could increase significantly in the adverse scenario although still below their AFC peaks (Figure 17), and that PDs of Mainland China-oriented real estate sector are also most vulnerable to the adverse shocks than other sectors (Figure 7), which—given the large bank exposures to the real estate sector—could potentially weigh on banks' balance sheet and lead to stress in banks and other financial institutions.

15. Offshore bond issuances by Mainland China borrowers have increased rapidly which could also pose significant credit risks. About 20 percent of the total amount issued is by Mainland China real estate developers. High-yield issuances are mostly from onshore property developers and denominated in RMB. The potential currency mismatch and refinance risks could lead to spillovers to Hong Kong SAR banks through channels including common exposure, margin finance and market-making obligations.

16. The FSAP recommends to the authorities continue to closely monitor the credit risks facing the potential high-risk Mainland China borrowers and to ensure that the internal risk models used to determine the capital charges for these borrowers, particularly Mainland China real estate borrowers with low credit ratings, are sufficiently forward-looking. The authorities should also

⁸ Debt-at-risk is defined as the share of debt owed by firms with interest coverage ratio (defined as the ratio of earnings before interest and taxes to interest payments) below 1. Given the large presence of MC firms in Hong Kong SAR, the analyses take into account both Hong Kong SAR- and MC-oriented firms listed in Hong Kong SAR, classified according to the firm's risk exposure. The total number of firms is about 2,000, and the total debt of firms domiciled in Hong Kong SAR accounted for nearly 90 percent of Hong Kong SAR's total non-financial corporate debt in 2019 (or about 200 percent of Hong Kong SAR's GDP). The results for pre-2000 should be treated with caution as more than half of the firms do not have available financial data before 2000, which could be because they were only listed after 2000. Firm-level data of 2019 are used in the scenario-based debt-at-risk analysis.

consider incorporating non-financial corporates in the stress testing framework and communicate the key findings in HKMA’s Monetary and Financial Stability Reports.



C. Bank Solvency Stress Test

17. Banks experience mild capital decline under the baseline scenario. The decline is about one percentage point in CET1 ratio during the first year of the simulation period (2020-2022). With the quick return to positive growth in the second year, capital levels stabilize but high NPL levels still weigh on balance sheets. Banks start building up capital buffers in the third year with the continued recovery in the economy. It is important to note that the realized average capital level in the banking system, with a 0.2 percentage points increase in average CET1 ratio from 2019 to 2020, was better than the decline simulated under the baseline scenario in the stress test for 2020. First, the realized 2020 GDP growth (-6.1 percent) turned out to be significantly better than the October WEO-based baseline GDP number assumed in the baseline scenario (-7.5 percent). Additionally, the FSAP’s NPL assumption follows a counterfactual path and assumes there were no support measures (e.g., income support to households and SMEs, loan principal payment deferrals⁹) during 2020 and beyond. Finally, the FSAP took an overall conservative approach to NPL and risk-weighted assets (RWA) modeling under the baseline scenario shocks.

⁹ Payment deferrals apply only to principal, and borrowers are required to continue to make interest payments, which allows banks and regulators to better gauge borrowers’ continued payment ability during the relief period.

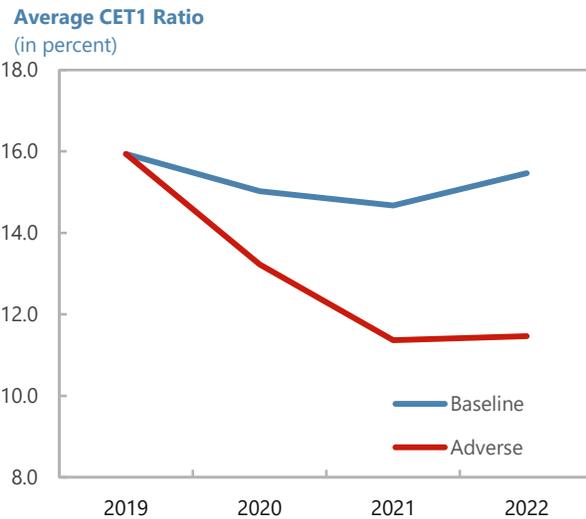
18. ST results indicate that even under the adverse scenario, Hong Kong SAR's banking system appears to be broadly resilient to severe macro-financial shocks, thanks to the initial high capital buffers and pre-shock profitability. The average CET 1 ratio of banks in the sample decreases from 15.9 percent in 2019 to 11.5 percent in 2022 (Figure 8). In the simulation, banks experience significant credit losses and their profitability declines substantially, resulting in significant reductions in their capital levels. Even with those significant declines in capital, all banks remain above the regulatory minimum of 4.5 percent CET1 ratio plus the capital conservation buffer of 2.5 percent. Banks' high initial capital buffers and profitability allow them to withstand significant amount of losses in the adverse scenario. For the IRB banks in the sample, the CET 1 ratio decreases by 4.6 percentage points, from 16.4 percent in 2019 to 11.7 percent in 2022. Banks using standardized credit risk modeling experience smaller declines in their average CET 1 ratio, from 14.4 percent in 2019 to 10.8 percent in 2022, reflecting a smaller increase in their RWA, which contributes to the smaller declines in their capital ratios (Figure 19).

19. The largest drivers of the change in capital ratios in the adverse scenario are loan loss provisions, increase in RWA, and to a lesser extent, decline in net interest margins (interest rate risk) (Figure 8). In line with the simulated deterioration in the economic environment, loan defaults increase substantially, which leads to large loan loss provisions. At the same time, the secured nature of large portions of banks' exposures, moderates the estimated loan losses, even assuming sharp property price declines. The increase in risk weights, which reflects the increase in credit risk going forward, also contributes to the decline in the capital ratios, especially for IRB banks. Standardized banks have more conservative starting risk weights,¹⁰ limiting the estimated decline in capital ratios. The losses from mark-to-market (MTM) decline in the price of securities holdings of banks, leads to more modest declines in capital ratios. Similarly, on the interest risk side, higher funding costs leads to compression of net interest margins, but banks generally have balanced interest rate sensitivities on the asset and liability sides, which limits the overall losses from interest rate shocks.

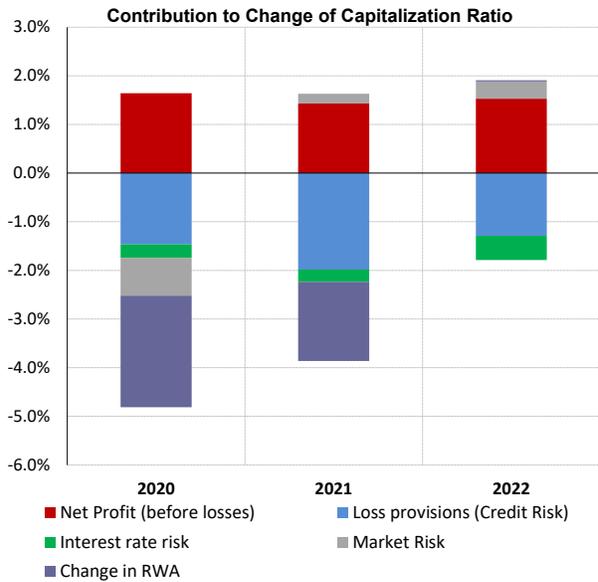
¹⁰ For example, the average risk weights for corporate loan exposures are already above 90 percent.

Figure 8. Hong Kong SAR: Bank Solvency ST Results

CET1 ratio declines by more than 4 percentage points in the adverse scenario...



...with credit losses and increase in RWA being the largest drivers of capital declines.



Source: IMF staff calculations.

D. Bank Loan Portfolio Concentration Risk

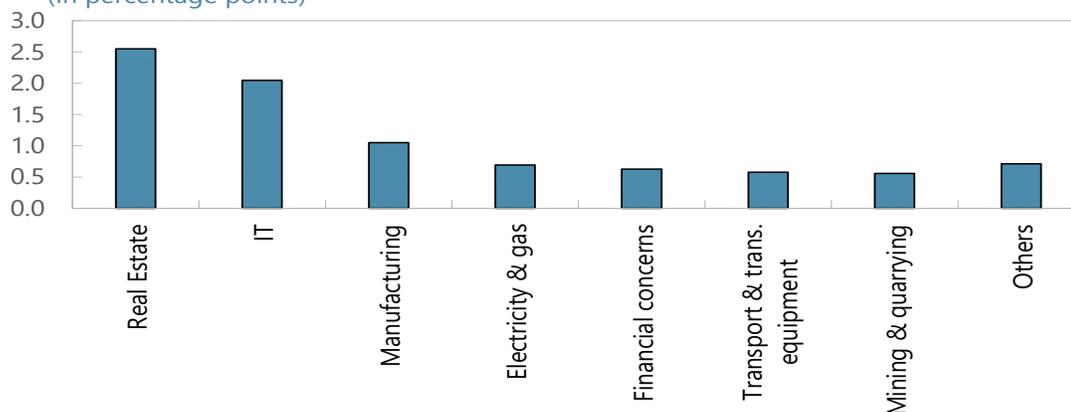
20. The FSAP analysis indicates that potential losses from default of concentrated exposures could be sizeable, especially in the real estate and information technology sectors. Assuming the default of the five largest NFC exposures in each bank, the average CET1 ratio decline would be sizeable, at close to 6.5 percentage points. Under an assumption of default of all real estate-related borrowers that are among the top ten large exposures of each bank, the average CET1 ratio would decline by 2.5 percentage points (Figure 9). The data indicate that large exposures to sectors that are likely to suffer more from the COVID-19 pandemic (transportation, hotels, recreational activities) correspond to a much smaller amount and their defaults would pose minimal losses for the analyzed banks. Hong Kong SAR adopted Basel Committee’s large exposure framework in 2019,¹¹ which went effectively into effect in January 2020 (following a 6-month grace period). This new framework strengthened the requirements on banks’ management of large exposures and enhanced HKMA’s monitoring of these exposures. While the borrowers of the large exposures might have high credit quality, the potential for large losses in a rare default event highlights the importance of monitoring these exposures closely.

¹¹ Banking (Exposure Limits) Rules (BELR). See <https://www.hkma.gov.hk/eng/key-functions/banking/banking-legislation-policies-and-standards-implementation/exposure-limits>

Figure 9. Hong Kong SAR: Credit Concentration Analysis – Sectoral Exposures

Decline in CET1 Ratio: Sectoral Concentration

(In percentage points)

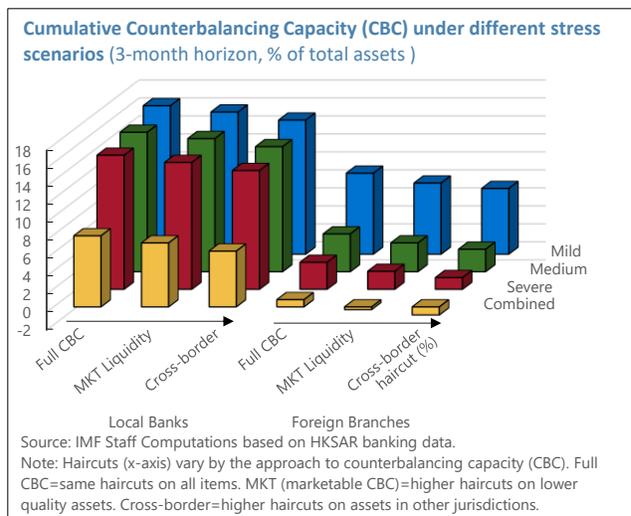


Source: IMF staff calculations.

Notes: The sensitivity analysis assessed both single-name concentration (impact of the default of the five largest NFC borrowers) and sectoral concentration (impact of the default of all borrowers from a specific sector that are among the top ten large exposures). In this analysis, the FSAP team assumed a scenario of zero recovery on the unsecured part of the exposure and full recovery of the value of available collateral.

E. Bank Liquidity Stress Test

21. The banking system is resilient to liquidity stress. The results using 2018 and 2020 as starting points were broadly similar, because the funding structure has remained similar in a global excess liquidity situation since 2016. Cashflow-based stress tests of local and foreign banks' liquidity found that local banks had enough liquid assets to cover stressed cash-outflows (Figure 20). However, liquidity stress-tests have revealed that some of the foreign branches are more vulnerable to liquidity stress, largely due to their higher reliance on unsecured interbank funding and their inability to tap the local deposit base. In managing their USD and CNH liquidity risk, banks rely on well-functioning FX swap markets, which exposes them to some tail risk. Banks' liquidity positions held up well during the pandemic. The authorities pro-



actively communicated that the liquidity buffers are designed to be used under stress; this was complemented by several systemic liquidity measures that supported resilience.¹²

22. The excess reserves of Hong Kong SAR provide significant buffers against systemic liquidity shocks due to capital outflows. Under the most severe FSAP liquidity stress scenario of the FSAP, the excess FX reserves are enough to cover more than two times the liquidity needs of Hong Kong SAR banks. Furthermore, under an assumption of large capital outflows, the current level of HKMA's reserves and LERS mechanism would lead to only limited HKD rate increases and thus not affect adversely the solvency resilience of the banking system. The bank solvency stress test shows that banks can withstand a significant increase in HIBOR-LIBOR spreads that could be necessary to deter substantial capital flows.

F. Interconnectedness and Contagion Analysis

23. The interconnectedness patterns suggest that foreign branches could be a source of significant spillovers to other financial sectors both at home and abroad. The cross-border and domestic intra-financial system lending data suggest that foreign branches source funding from local banks and lend to NBFIs (some of which provide corporate and household loans) and to other banking systems abroad.¹³ These indirect linkages between local banks and other sectors have the potential to create leakages for any regulation that aims to mitigate build-up of risks in the economy. For example, the effectiveness of a capital-based regulation aiming to mitigate risks related to bank lending to certain groups of nonfinancial corporates may be reduced, if a portion of the lending shifts from local banks to foreign branches and ultimately adds to the leverage of the corporate and household sectors. The domestic interconnectedness analysis was based on partial information on the exposures of the banking system on the other sectors. The ideal dataset would have been the who-to-whom exposures across all major sectors of the economy: banking system, NBFIs, NFCs, households, government sector, and the rest of the world. The data gaps in Hong Kong SAR could potentially limit identification of potential stability risks originating from outside the banking system.

G. Strengthening the Banking System

24. The FSAP makes several recommendations to address pockets of vulnerability in the banking system. Stress test results showed that the banking system is resilient to severe shocks. At the same time, the high degree of uncertainty around the scenarios and the future recovery paths, along with uncertainties around loan performance once the temporary support measures are lifted, warrant caution and some policy strengthening to ensure continued robustness of the financial system. First, the FSAP recommends enhancing HKMA's data collection of intersectoral claims across major sectors of the economy (banking, NBFIs, non-financial corporates, households, government,

¹² The FSAP also examined the Hong Kong SAR banking sector's readiness for the discontinuation of LIBOR as a reference rate by end-2021 and found that transition risks appear well-managed.

¹³ As illustrated in Figure 4, local banks also lend to NBFIs, however, their lending is much smaller compared to that of foreign branches.

and the rest of the world) with a focus on claims of the NBFIs, which would allow a better gauge of the importance of intersectoral linkages and to develop an aggregate balance sheet approach in systemic risk assessment. Second, enhanced oversight over banking groups that have both foreign branches and local subsidiaries in Hong Kong SAR would further improve the authorities' ability to monitor and mitigate risks, given their potential for contagion. Third, the FSAP recommends heightened monitoring of liquidity risk both at the group and entity level for banks that operate with multiple group entities in Hong Kong SAR to ensure that banks adhere to internal risk management practices. Fourth, the FSAP recommends that the HKMA periodically stress tests banks' large exposures separately from their total loan books, considering potential cash flows from collateral in case of default of large borrowers.

25. To further strengthen HKMA's liquidity reporting and stress testing framework, the FSAP recommends integrating all existing liquidity stress-tests into a single framework and align that with the LCR. In the medium term, the FSAP sees merit in developing alternative funding sources for banks. Since the Hong Kong SAR banking system is currently mostly funded by very short-term deposits, HKMA could take measures, including to develop the repo market, to incentivize banks to diversify funding sources and lengthen and stagger funding tenors.

H. Investment Fund Liquidity Stress Tests

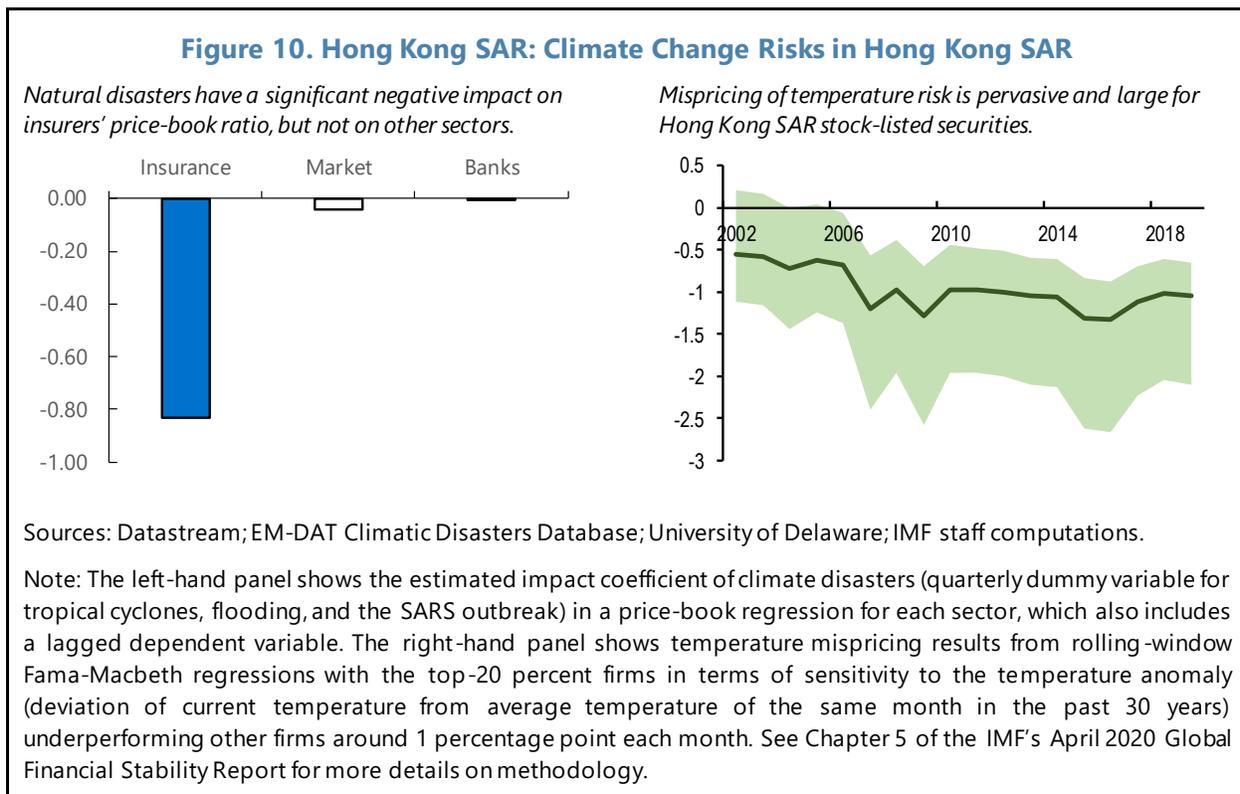
26. The FSAP assessed that large sales by investment funds from large redemption shocks are unlikely to substantially affect asset prices. Investment funds domiciled in Hong Kong SAR, as opposed to those merely marketing their products there, display higher cash buffers and are therefore better protected against extreme redemption shocks. However, the weaker tails of the industry could need to resort to some asset sales with potential spillover effects across the fund industry and beyond. For example, funds with shares denominated in foreign currencies, smaller funds, and fixed-income funds, as well as funds geared towards riskier asset markets appear more prone to liquidity stress. To mitigate such risks the SFC requires fund managers to implement adequate liquidity risk management policies and procedures and to assess the liquidity profile of their funds' liabilities and assets, also through formal liquidity stress tests on a regular basis. The SFC reviews compliance during inspections. While some residual liquidity risks remain under the severe scenario of funds experiencing the worst percentile of their historical outflows, they are unlikely to affect asset prices substantively.

CLIMATE CHANGE RISK ANALYSIS

27. Global climate change poses growth and financial stability risks to Hong Kong SAR's economy and its financial sector in both the short run and the longer run, on account of physical (event risk) and transition effects (adjustments to fight climate risk) (Box 1). Recent studies, e.g., by the Intergovernmental Panel on Climate Change, indicate that climate change may have adverse effects on Hong Kong SAR's GDP growth in the longer term (up to 6.4 percent deviation from the baseline by 2048), due to higher temperatures and a rising sea level, greater health risks, declining tourism, destruction of fixed capital, and lower productivity. Using past climate disaster data, the FSAP found that Hong Kong SAR insurers' stock prices and price/book ratios are

already adversely affected by physical risk (notably storms, floods and landslides), while the effect on Hong Kong SAR bank stock prices is small, as profits and capital buffers are not much affected, although this may reflect mispricing of risk (Figure 10). Indeed, over the period 1998-2019, Hong Kong SAR stocks of companies that are highly sensitive to temperature anomalies earned significantly lower returns, indicating a mispricing of climate risk. In the future, if global efforts to reduce GHG emissions fall short of envisaged benchmarks, climate risk will intensify and the adverse effects on Hong Kong SAR banks, insurers and nonfinancial firms could increase in a nonlinear way, underscoring the importance of monitoring and managing the impact of physical and transition risks on the economy and the financial sector.

28. The authorities' efforts to address climate change risks are welcome. These include implementation of climate-related mandatory financial disclosures by 2025, adopting common taxonomy, and promoting climate-focused scenario analysis through pilot stress testing exercises for banks and insurance companies, and the use of scenario analysis by large asset managers. The FSAP underscores the importance of incorporating climate risk in the systemic risk analysis.



MACROPRUDENTIAL FRAMEWORK AND OVERSIGHT

A. Framework

29. The institutional framework for MaPP is functioning well. MaPP has played a key role in supporting financial stability in Hong Kong SAR, particularly in the context of rising house prices and

strengthening capital buffers in the banking sector. Hong Kong SAR has a sector-based regulatory structure and the responsibilities and tools for safeguarding financial stability are spread across three regulators (the HKMA, SFC, and IA). There are good inter-agency coordination and consultation mechanisms, through the Council of Financial Regulators (CFR) and Financial Stability Committee (FSC), chaired by the Financial Secretary and the Secretary for Financial Services and the Treasury, respectively. Broad coordination between the CFR and government on taxation and housing supply-side policies has also worked well. Data sharing and exchange of information among the three regulators is frequent at various working levels and is formalized by Memoranda of Understanding (MoU).

30. Nonetheless, there is room for improvement to strengthen systemic risk monitoring, improve data collection, enhance communication through a comprehensive and dedicated semi-annual financial stability report, and bring non-bank mortgage lending within the regulatory ambit.

- Because the financial system in Hong Kong SAR is becoming more complex and interconnected, the CFR/FSC secretariat should adopt a more comprehensive and systematic approach to identify and address financial systemic risk by leveraging more on the organizational framework and expertise of the HKMA and other regulators.
- Collecting more comprehensive and granular data on cross-border exposures, for example, non-bank lending to households, and developments in the high yield bond market, will improve systemic risk monitoring.¹⁴
- The communication of MaPP can be further enhanced by publishing periodic risk assessments and summaries of key CFR policy meetings, and dedicated reports on financial systemic risks to enhance the transparency.
- Regular surveillance and data collection from non-bank lenders (e.g., property developers and NDFCs) to households could be suitably strengthened to monitor and stem leakages in macroprudential policies.

B. Policy Stance

31. The FSAP views the current Hong Kong SAR's policy stance on systemic risks from residential and commercial real estate and on CCyB as appropriate and key to ensure banks have sufficient buffers in case of substantial housing market correction or increased household debt defaults. More specifically:

- To contain residential housing market risks and improve housing affordability, the three-pronged approach (para 2) remains appropriate (as also argued in the latest Hong Kong SAR

¹⁴ A separate interconnectedness and contagion analysis has been conducted in the Technical Note on banking sector stress testing.

Art. IV report from 2019). This has helped contain banks' exposure to the housing boom without hampering credit intermediation to the real economy.

- Despite weak economic activity since 2019, the resiliency of house prices and mortgage growth (posing potential financial stability risks in the future) implies that existing residential housing market-related MPMs should be kept unchanged for now, while nonresidential measures can—and have been—appropriately relaxed.¹⁵ However, because risks can migrate into the non-bank financial sector, regular surveillance over this segment would help stem leakages in macroprudential policy.
- As CRE prices have fallen, overvaluation risks decreased, and the HKMA increased LTV caps from 40 to 50 percent in general cases—which the FSAP endorses.
- CCyB was cut twice from 2.5 percent in 2019 to 1 percent in March 2020 to encourage overall bank lending, in order to support the economy.

MICROPRUDENTIAL SUPERVISION

A. Banking Supervision

32. The HKMA's banking supervision and regulation remains strong, both in absolute terms and with respect to the FSAP's focus on cross-border linkages and housing risks. HKMA continues to maintain the high standards of compliance in the 2014 Basel Core Principles assessment, driven by highly experienced supervisory staff. Updating their risk-based supervisory approach helped the HKMA optimize supervisory resources. With respect to the focal areas of this FSAP, the Basel III framework and domestic and cross-border cooperation arrangements are firmly in place and regulation of Hong Kong SAR banks' residential mortgage lending has been strengthened. Specifically:

- On housing risks, the HKMA has raised risk-weight floors on residential mortgage loans and raised risk weights for credit exposures to property developers offering high LTV mortgages, and lending to property developers was the subject of a round of thematic examinations in 2017-2018. NDFCs¹⁶ are regulated under the Money Lenders Ordinance and licensed by the Licensing Court, instead of being regulated by the sectoral financial regulators. While the size of the NDFC industry remains small, the HKMA should continue to monitor whether macroprudential policies

¹⁵ In view of the heightened economic uncertainty, the authorities suspended the discussion at the LegCo about the introduction of vacancy tax targeted at the property sector. The relaxation of eligibility for HKMC mortgage insurance program (e.g. mortgage with LTV up to 90 percent) has attracted more applicants and supported the demand for mortgage. The double *ad valorem* stamp duty imposed on non-residential property transactions was abolished with effect from November 26, 2020.

¹⁶ Borrowers who have comparatively less favorable credit history may be soliciting residential mortgage and consumer loans from NDFCs, but the scale of operations of NDFC is currently modest. Lending by money lenders is estimated to at less than 1 percent of total bank loans.

have spurred household exposures to NDFCs and property developers. Adjusting the regulatory parameters may need to be considered for more timely recognition of risk.

- On cross-border linkages, the HKMA has strengthened home-host coordination and cooperation with home supervisors of international banks and with Mainland China regulators. The HKMA should continue to closely monitor concentrated exposures to non-bank Mainland China entities, especially of banking groups that have both foreign bank branches and subsidiaries in Hong Kong SAR; and the focus should be on the potential for regulatory arbitrage.
- On cross-sector linkages, the HKMA and other domestic sectoral financial regulators cooperate extensively at different levels of seniority and the traditional sectoral regulatory structure in Hong Kong SAR appears to be robust and MOUs are effective. Information sharing mechanisms could be enhanced given the growing linkages among different types of financial institutions and domestic sectoral regulators are encouraged to continue to conduct joint examinations proactively on the cross-sectoral business to promote consistency.

33. The HKMA's regulatory initiatives have kept pace with changes in the banking sector and technological advancements, but there is scope for further refinements. Key priorities include ensuring that regulations support innovation such as Smart Banking initiatives and strengthening the cyber resilience of banks. Since the last FSAP, the HKMA also strengthened its regulatory framework with emphasis on the roles and responsibilities of the Board and independent non-executive directors, for which effective implementation should be the focal point. For instance, the HKMA would need to review cases where individuals hold a large number of director/management positions in financial and non-financial entities, in terms of potential conflicts of interests and time commitment to the role. Exempted exposures from the large exposure rules¹⁷ should be closely monitored, and limited scope onsite examination of the large foreign bank branches that have not had an onsite presence for long intervals is also recommended. In addition, the HKMA's use of independent reviews by external auditors more than doubled from 2017 to 2018. Strengthening the framework for the use of external auditors with a view to managing the associated supervisory objectivity risk is recommended. As the supervisory environment continues to become more challenging, continued attention and review is needed in regard to competing priorities and the adequacy of supervisory resources.

34. This FSAP reiterates the 2014 FSAP's recommendation to provide de jure operational independence to the HKMA (Appendix I) and review checks and balances to ensure that its prudential mandate is not undermined by developmental initiatives. Although the HKMA enjoys de facto operational autonomy, the Banking Ordinance (BO) gives the Chief Executive (CE) of Hong Kong SAR a reserve power to give directions to the Monetary Authority (MA) and the MA shall

¹⁷ The Banking (Exposure Limits) Rules (BELR) in Hong Kong SAR provides more exemptions than detailed in the Basel Large Exposure standards. The HKMA explained that these local exemptions take into account some specific characteristics in Hong Kong SAR (e.g., the IPO process), and they are designed to minimize the risk of potential side effects on financial stability.

comply with any direction given. While such power has never been invoked and any such exercise of the power would be limited to furthering the objectives of the BO, its existence in principle may undermine the HKMA's de jure operational independence. It would be desirable for it to be removed or clarified by specifying the circumstances under which the CE of Hong Kong SAR may give directions to the MA. In addition, on-going vigilance is warranted to ensure that developmental/competitive considerations are not in conflict with the HKMA's prudential mandate. Finally, as a precondition for effective banking supervision, the distinct and unique legal status of Hong Kong SAR should be maintained by upholding transparent rules and its judicial independence as Hong Kong SAR's rule of law is directly related to public confidence in its financial sector.

B. Insurance Supervision

35. The IA's establishment has greatly strengthened insurance regulation. The IA is a dedicated agency, supervising both insurers (since June 2017) and intermediaries (since September 2019), with extended powers, including the resolution authority for relevant insurers, and control over staff salaries and use of its resources. More staff with industry experience (including actuaries) have been recruited. Some provisions of previous legislation that could compromise independence from government have been carried over, and the IA remains dependent on government for certain regulations and budgetary approval. However, the risks are mitigated by clear statutory objectives and close collaboration with the government. The IA needs to sustain an appropriate balance between its policyholder protection and market development objectives, as this promotes a fair, safe, and stable insurance market and contributes to financial stability.

36. Further development of the IA, particularly in supervision, is needed to maximize its effectiveness. The insurance sector has been relatively stable, with only one failure (a specialist motor insurer) over the past ten years, reflecting relatively low risk products (in long-term insurance, mainly participating policies with low guarantees) and effective supervision. The IA has extended regulatory powers over insurance companies as well as insurance intermediaries, and as resolution authority for relevant insurers. Completing the reform of insurance regulation—especially the implementation of full group-wide supervision and risk-based capital requirements, and intermediaries' supervision—will take several years. A priority should be the development and documentation of internal IA processes, including for supervision and enforcement (where not already complete), with appropriate publication of key features. The IA should also further develop its capacity to identify and respond to risks across the insurance sector, such as concerning the vulnerability of many long-term insurers to prolonged low interest rates (as in many other economies), the increased incidence of typhoons, and increased climate change risks more broadly.

C. Securities Markets Supervision

37. Overall, the current regulatory and supervisory framework for trading systems has been strengthened since the previous FSAP in 2014. Requirements for ATS, previously unevenly imposed via licensing conditions, have been consolidated into guidelines and amendments to the code of conduct of intermediaries. Supervision has also been strengthened, with the SFC now carrying out regular on-site inspections of recognized exchanges and clearing houses, in line with

the 2014 FSAP recommendations. Supervision of ATS provision by intermediaries has also been revamped, with a more intrusive and risk-based approach. The SFC has also dedicated great efforts to creating a closer work relationship with the China Securities Regulatory Commission (CSRC), by entering into a number of cooperation agreements, as well as by increasing the frequency of their formal and informal exchanges of information and meetings.

38. The SFC should continue its work to strengthen the regulatory and supervisory framework for trading systems, in particular by expanding SFC's enforcement powers in relation to recognized exchange companies and certain ATS providers, fine-tuning its market surveillance function to ensure it has access to a more comprehensive range of trading data and considering consolidating requirements for recognized exchange companies into the regulatory framework. The SFC should also ensure it continues to strengthen its cooperation with Mainland China as the ties between the two markets are likely to further intensify.

D. Financial Market Infrastructures

39. A detailed assessment of the systemically important HKCC, one of four central counterparties (CCPs) in Hong Kong SAR, against the CPSS-IOSCO principles for financial market infrastructures (PFMI) concluded that HKCC observes the PFMIs and has a sound, coherent and transparent legal basis. The credit and liquidity risks are minimized by having a robust risk management framework, including a rigorous stress testing methodology and access to qualifying liquid resources. Furthermore, the HKCC has clear rules and procedures to handle and manage a participant's default procedures. Moreover, the HKCC has established risk management framework to handle operational risk, including cyber risk, and business continuity management that addresses events posing significant risk of operational disruption.

40. However, the assessment demonstrated the need for further enhancement of the risk management framework and governance structure. The FSAP recommends : (i) establishing an independent risk management committee for HKCC's clearing activities (a review of governance by an independent consultant has since commenced) ; (ii) HKMA oversight over HKCC for liquidity and settlement risks; and (iii) consolidating the three central counterparties (CCPs) for trading¹⁸ into a single CCP, duly considering the cost and benefit and timing, with an appropriate governance structure, an independent board, key functionalities and decision-making process. HKCC could also usefully review the need for strengthening resources to cover the default of the two largest clearing members. Another important recommendation would be for strengthening the secondary site with appropriate staffing arrangements, sufficient resources, capabilities, and functionalities, to allow swaps of operations between the primary and secondary sites during business-as-usual.

¹⁸ The four CCPs are HKCC, Hong Kong Securities Clearing Company Limited (HKSCC) and the SEHK Options Clearing House Limited (SECH), for trading, and the OTC Clearing Hong Kong Limited (OTC Clear) for OTC clearing.

E. Financial Integrity

41. Hong Kong SAR has a solid regime to fight money laundering and terrorist financing (ML/TF) that is delivering good results, and is encouraged to continue to improve its anti-money laundering and combating the financing of terrorism (AML/CTF) regime. The Financial Action Task Force (FATF)'s 2019 Mutual Evaluation Report on Hong Kong SAR's AML/CTF regime found that Hong Kong SAR has a strong legal and institutional framework and the authorities generally have a good understanding of the ML/TF risks they are exposed to, as do the larger financial sector entities. The authorities have been actively prosecuting ML from domestic offenses, and are encouraged to pursue efforts to implement the recommendations of the Mutual Evaluation Report, including enhancing prosecution of the laundering of proceeds from foreign offenses, increasing risk understanding, and strengthening supervision of certain non-financial sectors (such as trust and company service providers and legal and accounting professionals). These actions will be crucial in helping to sustain Hong Kong SAR's reputation as a leading global financial center.¹⁹

FINTECH AND FINANCIAL INNOVATION

42. The authorities play an active role in promoting Hong Kong SAR as a fintech hub in Asia. Hong Kong SAR has a high digital penetration rate like its major regional peers (Figure 11). In 2018, Hong Kong SAR ranked fifth in digitalization of the traditional financial sector and the percentage of fintech users reached 35 percent.²⁰ In 2019, the consumer fintech adoption rate increased to 67 percent.²¹ The number of fintech companies has grown from 230 in 2017 to 600 in 2019. This includes firms specializing in payment and remittances, compliance and regtech, big data and artificial intelligence, blockchain and cryptocurrency, and insurtech. Important milestones since 2016 include the launch of the Faster Payment System; the granting of eight virtual bank and four virtual insurer licenses; the adoption of the open API framework by banks; and the creation of a blockchain-based trade finance platform. Hong Kong SAR is well positioned to develop fintech initiatives from its traditional strengths in financial services.

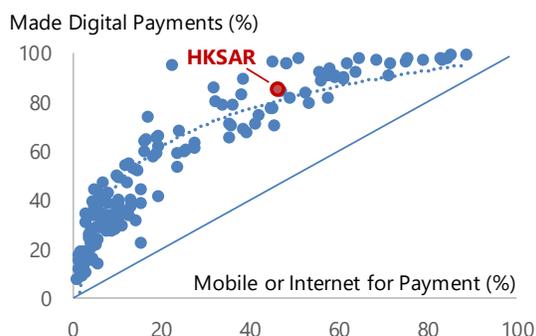
¹⁹ The authorities recently proposed implementing the yet-to-commence "inspection arrangements for companies' register", which may limit public access to certain personal information related to directors of companies (i.e., residential address and full ID number). This could make the verification of ownership and control of legal persons by entities with AML/CFT obligations more difficult, and potentially undermine the effectiveness of AML/CFT measures.

²⁰ Cambridge Judge Business School, 2018 Global Fintech Hub Report, November 2018.

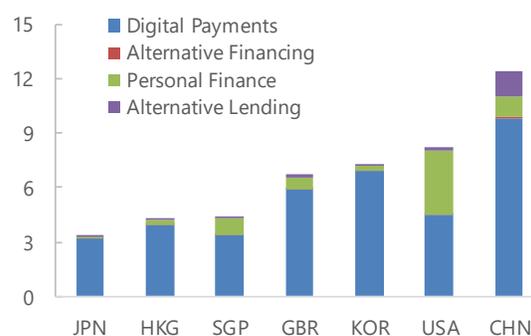
²¹ Ernst & Young, Ernst and Young Global Fintech Adoption Index 2019, June 2019.

Figure 11. Hong Kong SAR: Fintech and Digital Payments in Hong Kong SAR and Major Peers

Usage of digital payments is high in Hong Kong SAR, while mobile and internet use to make/receive payments is average.



Compared to peers, Hong Kong SAR's 2019 transaction value is high for digital payments but not for other fintech means.



Source: Statista; WEO; IMF staff computations; IMF Financial Access Survey.

Notes: Digital payments Made = percentage of respondents, ages 15+, who report using mobile money, a debit or credit card, or a mobile phone to receive a payment through an account in the past 12 months. Mobile or Internet for Payment = percentage of respondents, ages 15+, who report using a mobile phone or the internet to make or receive payments, to make a purchase, or to send or receive money through their financial institution account or through the use of a mobile money service in the past 12 months. In the right-hand chart, fintech transaction value (expressed as a percentage of domestic GDP) includes digital payments, alternative financing (e.g., online crowdfunding), personal finance (e.g., robo-advisors and automated wealth services), and alternative lending (e.g., marketplace lending).

43. The authorities are taking a proactive approach towards fintech trying to balance the need to encourage innovation, competition, and improve financial inclusion, with relevant risk mitigation measures. HKMA has created the Fintech Facilitation Office tasked with spearheading its engagement with the industry and promoting financial innovation. Similar units have been created within the SFC and the IA. All three financial regulators have also established their own sandboxes for incumbents and startup firms to pilot operations in a controlled environment, growing from an aggregated 29 products tested in 2017 to 103 in 2019. The HKMA launched “Smart Banking” initiatives to help the banking sector embrace opportunities created by the convergence of banking and technology, and developed a RegTech promotion roadmap to foster a RegTech ecosystem. In response to industry developments and a changing risk landscape, regulators have introduced and refined range of supervisory requirements, including a voluntary framework for Virtual Asset (VA) trading platforms and guidance for intermediaries dealing with VAs. Virtual banking has steadily gained traction since its inception, stimulating competition in the banking industry. Close supervision of initial operations and comprehensive assessments on virtual banks’ medium- to long-term viability will be critical before additional licenses are granted.

44. Continued coordination among regulators would guide a more consistent and cross-sectoral approach. Increased reliance on third-party technology service providers and a deeper engagement between fintech companies and financial institutions may necessitate a methodology to recognize interconnectedness and concentration risk in a more comprehensive manner (e.g.

mapping network interdependencies in the financial sector²²). Frameworks for cyber/IT related incident reporting,²³ information sharing, and the implications of artificial intelligence/regtech adoption are examples that would benefit from this more holistic activities-based approach. Continued review of the regulatory perimeter of non-bank fintech companies is also warranted. Authorities are encouraged to continue closely monitoring virtual assets (VAs) including the negotiation of these instruments via trading platforms, as well as financial institutions' exposure to VAs, and to mitigate the risk of misuse by criminals.

CRISIS MANAGEMENT, RESOLUTION, AND SAFETY NETS

45. The framework for crisis management has been strengthened following the 2014 FSAP and is now broadly adequate. The 2017 Financial Institutions Resolution Ordinance (FIRO) created a regime which is clear, comprehensive, and closely aligned with the Financial Stability Board (FSB) Key Attributes of Effective Resolution Regimes, with a particularly strong cross-sectoral coverage. The HKMA's detailed rules and guidance issued under FIRO are also broadly in line with international good practice, despite scope for some enhancements and delays to planned consultations on additional rules during 2020. The framework for emergency liquidity assistance (ELA) in HKD has been updated, and the legal framework also allows for use of the significant Exchange Fund resources for foreign currency lending. The FSAP recommends:

- Enhancing the implementation of the resolution framework in several areas. These include resolution planning for non-DSIBs; close monitoring of Loss-Absorbing Capacity, especially where the HKMA's LAC requirements come into force earlier than group-level TLAC requirements; ex-post resolution levies; adequate resourcing of nonbank resolution authorities (particularly for CCPs); and strengthening cross-border cooperation, information sharing, and simulation exercises, in particular with Mainland China and other resolution authorities in the region.
- Providing greater clarification on governance and risk management of ELA, including on HKMA's approach to viability assessment for banks seeking to access ELA, and testing its ability to accept and value non-standard collateral.
- Updating the deposit protection regime to ensure full consistency with the resolution regime and underpin current high levels of depositor confidence, through expanding the Deposit Protection Board (DPB)'s mandate to allow it to contribute to the costs of a resolution; increasing the DPB's integration into interagency crisis coordination arrangements; expanding deposit preference, and reviewing the relatively low target level of the Deposit Protection Scheme (DPS) fund.

²² For details, please see <https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2019/09/23/Cybersecurity-Risk-Supervision-46238>.

²³ For instance, the current incident reporting timeframes are varied across the financial sector and could be aligned where appropriate.

Box 1. Climate Change Risks for the Hong Kong SAR Financial Sector

Hong Kong SAR's financial sector is exposed to both short-term and long-term climate risks. The former are mostly associated with physical risks pertaining to recurring flooding, typhoons and wildfires, while the latter are mostly related to transition risks for firms and banks due to the transition from a high to a low-carbon economy, although some physical risks may also have a longer term impact.

For now, physical risks appear generally well managed, although Hong Kong SAR stock prices indicate a mispricing of temperature risk. The impact of past climate events on GDP is generally limited and short-lived with no significant impact beyond 1 quarter when regressing sectoral stock price returns on lagged returns and climate events. Only for insurance companies, the impact appears both significant and large (Figure 10, panel 1 in main text). Over the longer term, physical risk could become more intense and widespread, also for banks and asset markets, as the frequency and intensity of climate event risks may increase globally and have a longer-lasting macro impact. In this context, there appears to be a persistent asset pricing anomaly with regard to temperature risk, suggesting that more exposed stocks carry a too low risk premium (Figure 10, panel 2 in main text). This follows from a rolling regression Fama-MacBeth type analysis of equity prices, sorting Hong Kong SAR stocks on their sensitivity to a temperature factor (quarterly data 1990 Q1-2019 Q4, computing the deviation of current from average temperature of the same month in the past 30 years). In a second stage, the top-20 percent firms in terms of sensitivity to the temperature factor appears to underperform other firms by about 1 percentage point each month.

In the longer term, Hong Kong SAR banks may be exposed to climate transition risk stemming from the sectoral composition of their loan and debt securities holdings. Industries with higher GHG emissions will face more significant pressure to make their operations less CO₂-intensive or face higher GHG taxation or activity restrictions when failing to adjust. This could result in lower firm profitability for a prolonged period and potentially higher risk premia for more polluting industries, or higher risk weights on loans or debt holdings, to influence bank lending and investment behavior. Hence, the sectoral makeup of Hong Kong SAR banks' loan and debt securities portfolios could affect their performance and resilience in the longer run.

Hong Kong SAR banks with large exposures to energy and transportation—the most polluting in terms of GHG emissions— are especially vulnerable to climate transition risk. A breakdown of Hong Kong SAR banks' 2018Q4 loans and advances by economic sector for use in Hong Kong SAR and 2017 data on GHG emissions from HK government and Exiobase can give some general insights on their climate transition vulnerabilities. This is complemented by data for the Hong Kong SAR banking sector and sectoral breakdowns of its Mainland China loan portfolios. The building and construction sector (property development and investment) for use in Hong Kong SAR and in Mainland China account for 16 percent and 14 percent of the loan portfolio and total Mainland-related lending, respectively, but the GHG-emission content is relatively low. Domestic and Mainland China exposures to manufacturing, wholesale and retail trade, transportation and agriculture and mining sectors each account for 6 percent or below of the total loan book, and electricity and gas accounts for about 2 percent. However, the latter sector's GHG emission is extremely high compared to other industries, accounting for 65 percent of Hong Kong SAR's total GHG emissions (40,700 kilotonnes CO₂) in 2017.

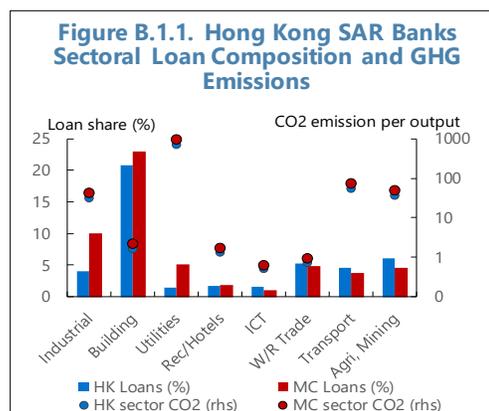
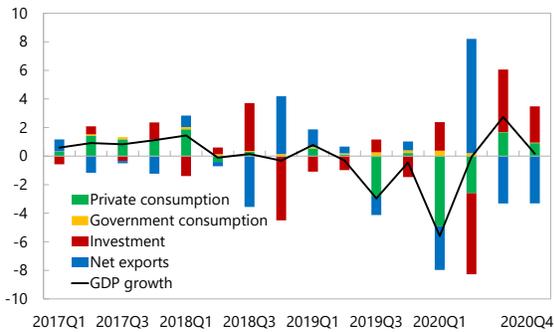


Figure 12. Hong Kong SAR: Macro Fundamentals Remained Weak Amid the Pandemic

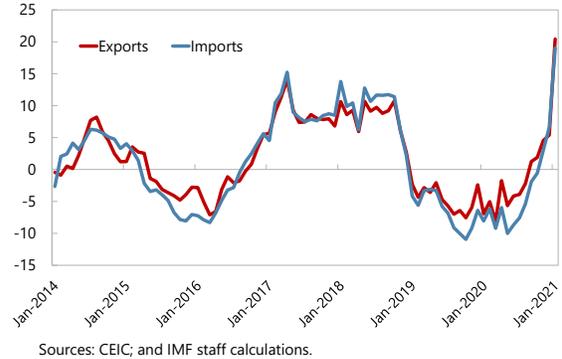
The economic recession deepened amid the pandemic although growth started to recover in 2020Q3.

Real GDP Growth and Contributions
(Percent, quarter-on-quarter SA)



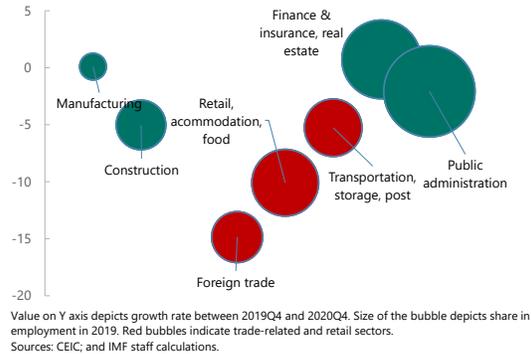
Trade flows remained weak for most of 2020 but have recovered quickly in recent months.

External Merchandise Trade
(Year-on-year growth, 3mma)



Layoffs have intensified amid the pandemic, particularly in trade-related and retail sectors.

Developments in Employment by Sector
(Percent)



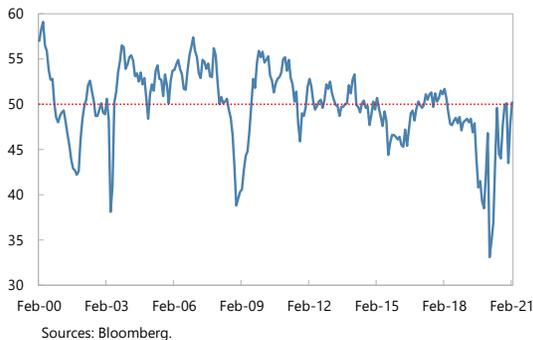
Nearly 100-percent decline in visitor arrivals, from both Mainland China and the rest of the world, exacerbated the decline in retail sales, despite some recent recovery.

Retail Sales and Visitor Arrivals
(Year-on-year growth, percent, 3mma)



Business sentiment worsened sharply during the pandemic but has improved since 2020Q3.

Purchasing Managers Index (SA, 50+ = Expansion)
(Index)



Current account remained in surplus in 2020, but trade flows have declined.

Current Account by Key Component
(Trillions of HKD; percent of GDP)

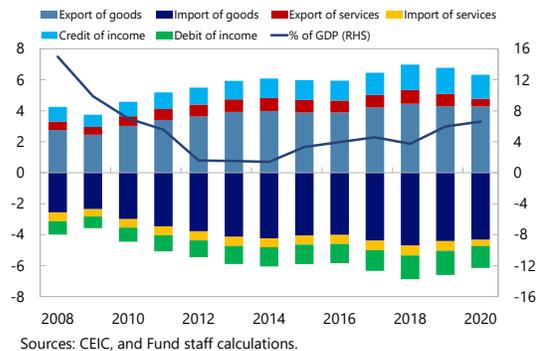
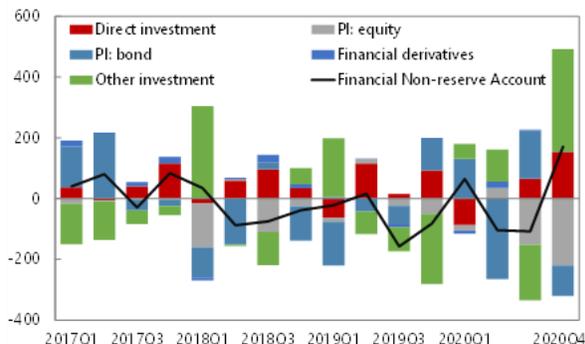


Figure 13. Hong Kong SAR: Domestic Markets Remained Stable During the Covid-19 Crisis

Direct investment and other capital inflows were behind large non-reserve financial flows in 2020...

Financial Non-Reserve Account by Key Component

(Billions of HKD)

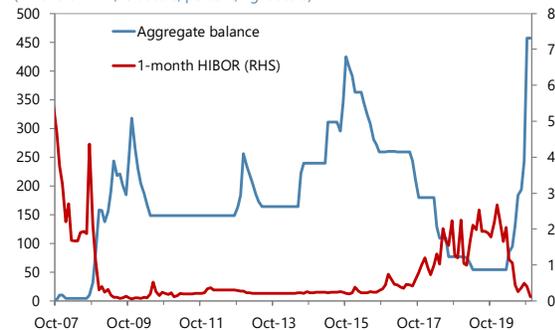


Sources: CEIC and Fund staff calculations.

The aggregate balance expanded, and interbank interest rates fell to near-zero...

Aggregate Balance and Interbank Interest Rate

(Billions of HKD, left scale; percent, right scale)

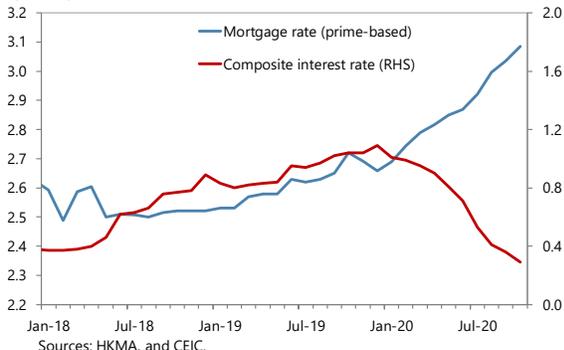


Sources: CEIC.

...and variable mortgage rates followed the narrowing of the LIBOR-HIBOR spread, while funding costs fell...

Mortgage Rate and Composite Interest Rate

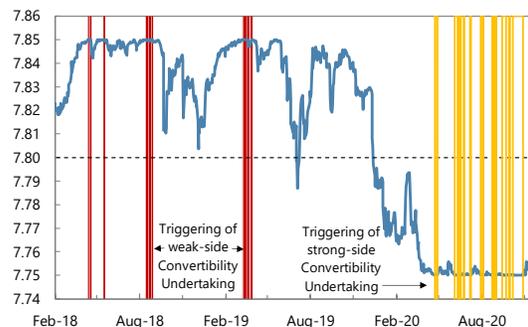
(Percent)



Sources: HKMA, and CEIC.

...which led the HKD going from weak-side Convertibility Undertaking in 2019 to strong-side in 2020.

USD/HKD Spot Exchange Rate

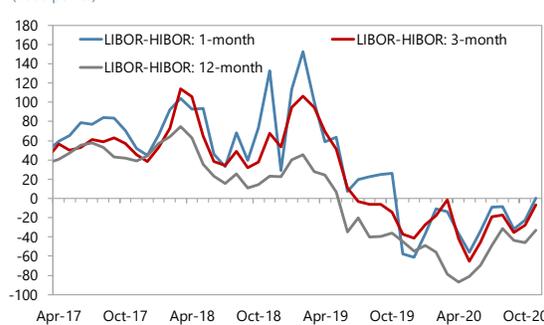


Sources: Bloomberg.

...while narrowing and reversal of the LIBOR-HIBOR spread helped create upward pressure on HKD...

USD-HKD Interest Rate Differentials

(Basis points)

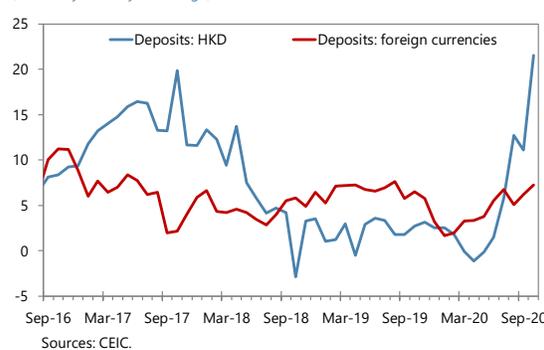


Sources: Bloomberg, CEIC.

...since funding remained ample due to continued growth in customer deposits.

Customer Deposits by Currency

(Percent, year-on-year change)

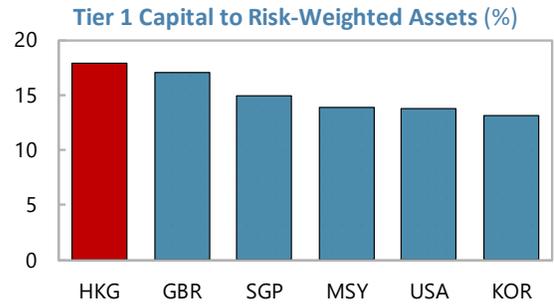
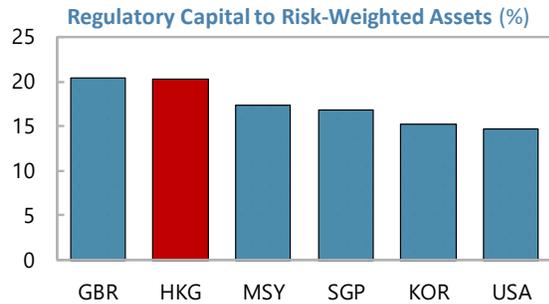


Sources: CEIC.

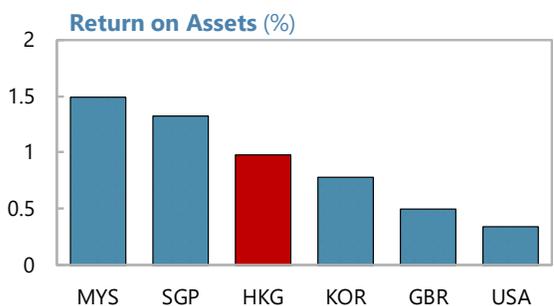
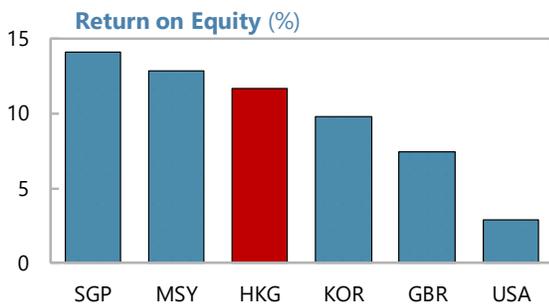
Note: The aggregate balance is defined by the HKMA as the sum of balances in the clearing accounts with the central bank, and is part of the monetary base. The composite interest rate is a measure of average cost of funds of banks.

Figure 14. Hong Kong SAR and Peer Economies: Financial Soundness Indicators (FSIs)
(In percent, 2019 or latest)

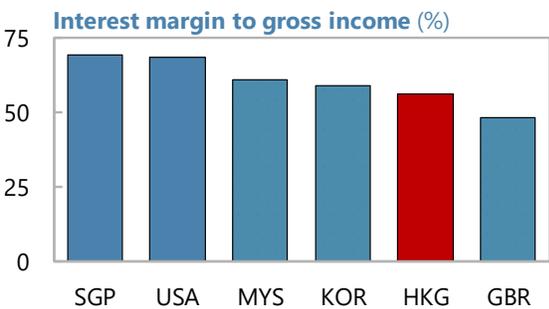
Hong Kong SAR banks have ample capital buffers...



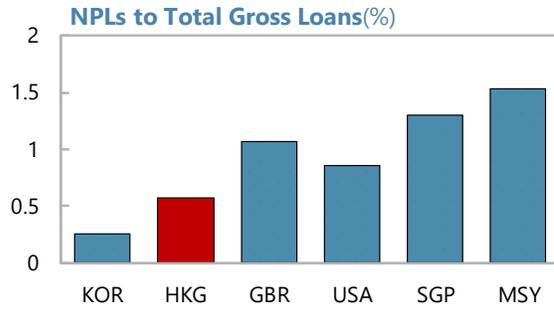
...and appear to be highly profitable...



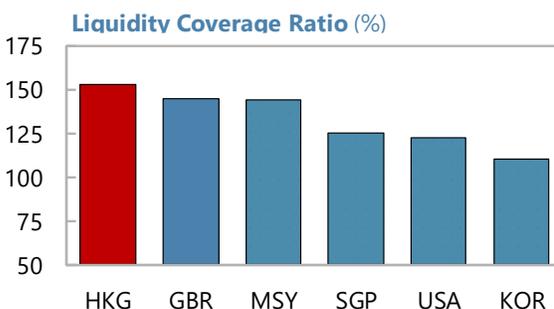
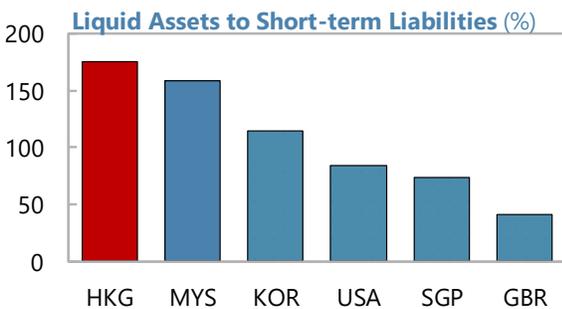
...on account of high interest income...



...and very low loan losses.



Hong Kong SAR banks also stand out in terms of high liquidity.

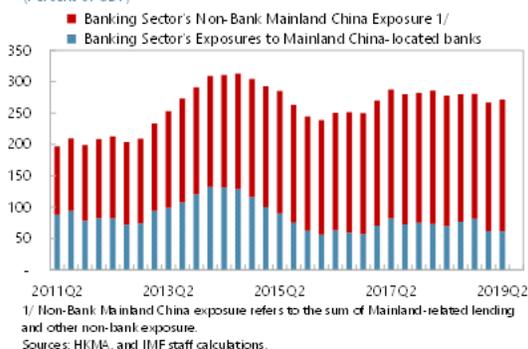


Sources: IMF Financial Soundness Indicators; national authorities' websites; and Haver Analytics.

Figure 15. Hong Kong SAR: Cross-Border Linkages of the Financial System

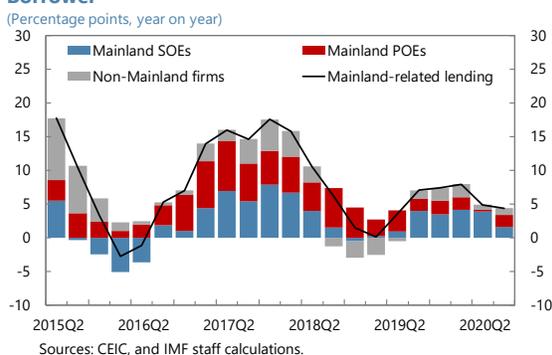
Hong Kong SAR's banking sector is highly exposed to the Mainland...

Banking Sector Exposure to the Mainland
(Percent of GDP)



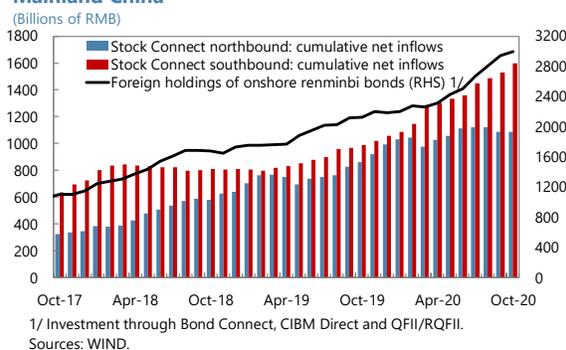
Mainland-related lending slowed more recently due to lower demand amid slowed growth in total credit.

Contribution to Mainland-related Lending by Type of Borrower



Hong Kong SAR's role as a gateway to Mainland China's financial markets has strengthened despite heightened uncertainty.

Cross-border Fund Flows between Hong Kong SAR and Mainland China

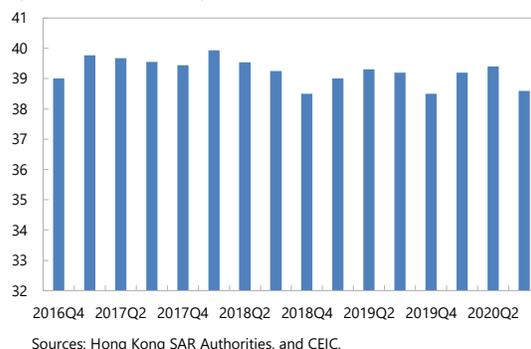


Sources: CEIC; HKEx; Hong Kong SAR C&SD; Hong Kong SAR Authorities; WIND; and IMF staff calculations.

Note: Stock market trading share of Mainland investors is no longer reported in 2019 HKEX Transaction Survey.

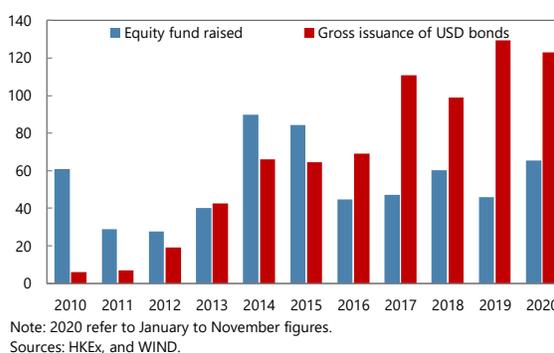
...with close to 40 percent of total loans being Mainland-related.

Banks' Mainland Related Lending
(Percent share of total loans)



Hong Kong SAR remains a major fund-raising platform for Mainland companies through capital markets.

Fund Raised by Mainland Firms in Hong Kong SAR
(Billions of USD)



Domestic financial sector also benefits from greater participation of Mainland China investors and companies.

Increasing Investment Activities by Mainland Investors
(Share in percent, left scale; number, right scale)

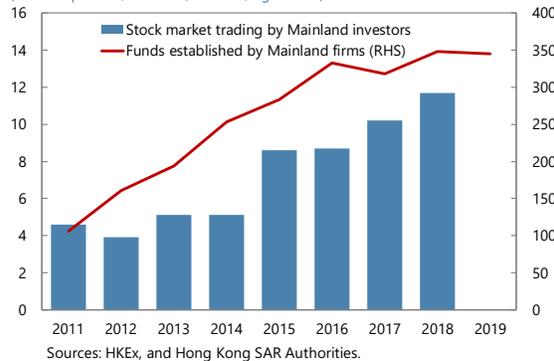
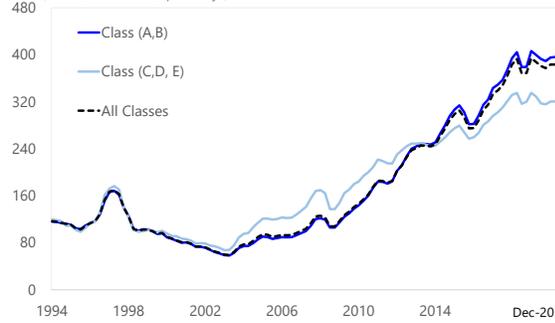


Figure 16. Hong Kong SAR: Housing Sector Developments

Hong Kong SAR nominal house prices increased by more than 55 percent between 2014 and end-2020.

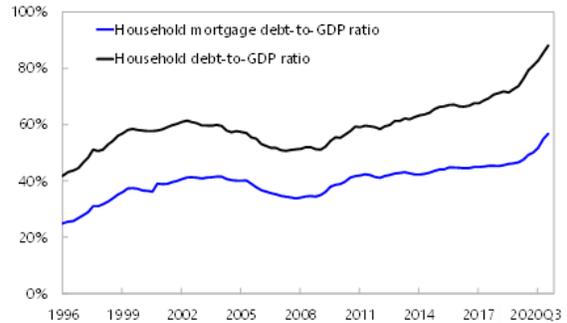
House Price Index: by Class
(Index, 1999=100, quarterly¹)



Source: CEIC and IMF staff estimates and calculations.
¹Simple averages of the specified classes.

Household debt has steadily increased from about 60 percent of GDP in early 2014 to 88 percent of GDP in September 2020.

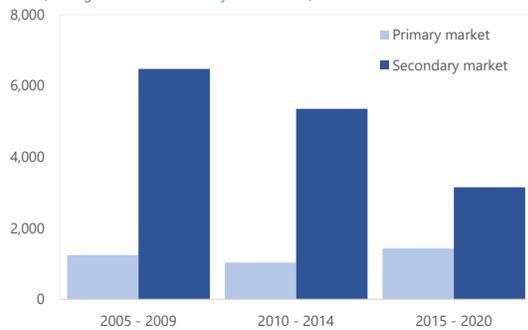
Household Indebtedness Indicators
(In percent of GDP)



Sources: CEIC, Haver Analytics, BIS, and IMF staff estimates and calculations.

Secondary market transactions decreased markedly after the introduction of demand-side management measures.

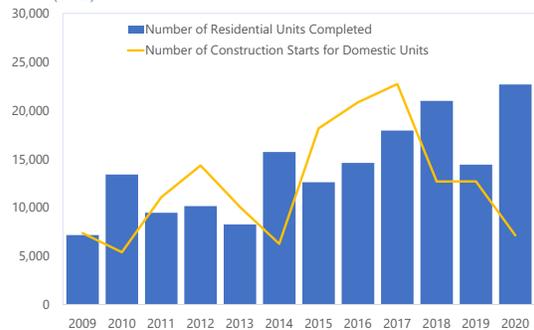
Primary and Secondary Market Transactions
(Average number of monthly transactions)



Source: CEIC, and IMF staff estimates and calculations.

Private housing completions significantly outperformed the previous year, but construction starts fell markedly in 2020.

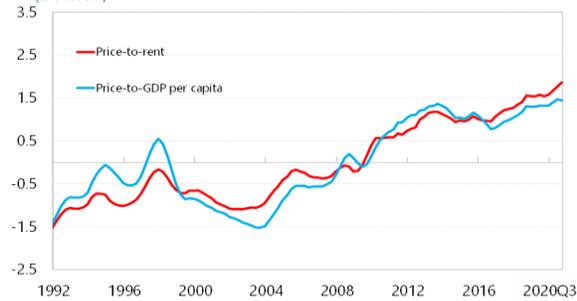
Housing Completions
(Units)



Source: CEIC, and IMF staff estimates and calculations.

While the price-to-GDP per capita and price-to-rent ratios continue to increase, ...

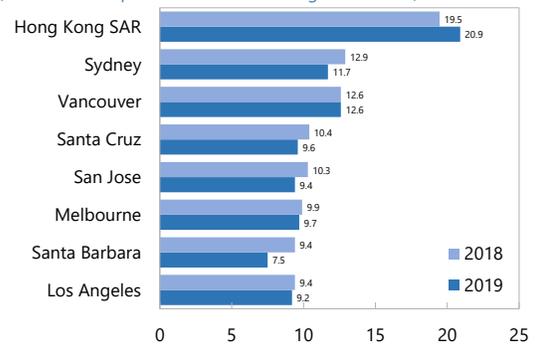
Hong Kong SAR Affordability Measures
(Z-scores¹)



Source: CEIC, Haver Analytics, and IMF staff estimates and calculations.
¹Z-scores of quarterly average prices for A, B, C, D, E classes for Hong Kong SAR, calculated over sample 1990 - June 2020; 4 quarter moving averages. Price-to-GDP in percent of 4 quarter moving sum of GDP.

...housing affordability has deteriorated further since 2018.

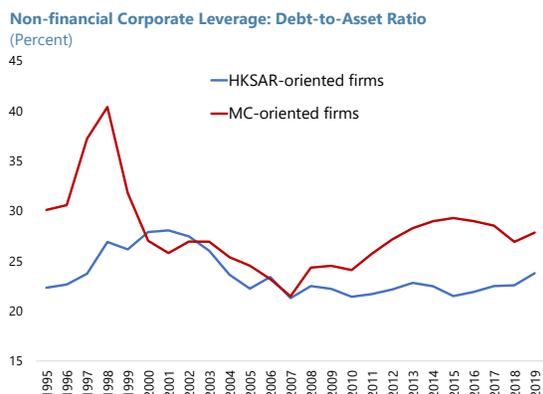
Affordability Indicators: International Housing Markets
(Median house price to median annual gross income)



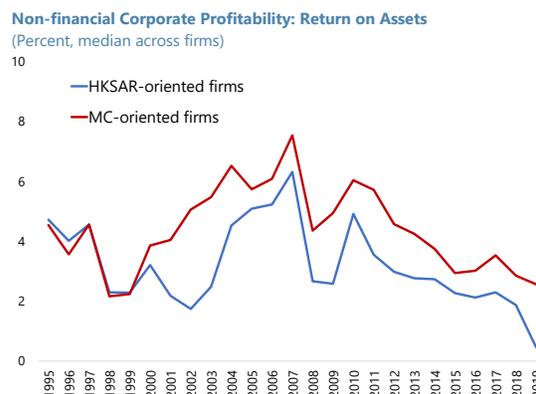
Sources: CEIC; THB; Haver; Demographia; and IMF staff estimates and calculations.

Figure 17. Hong Kong SAR: Non-Financial Corporate Sector Vulnerabilities

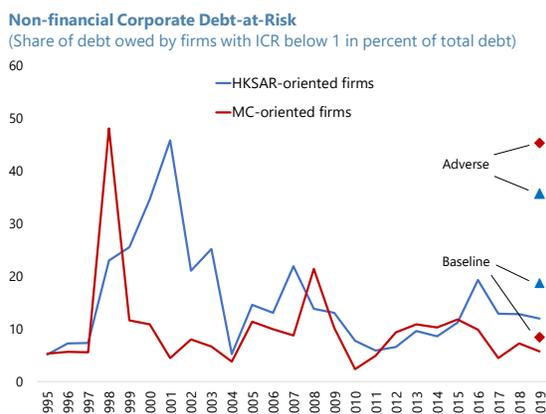
Corporate leverage increased after the GFC, ...



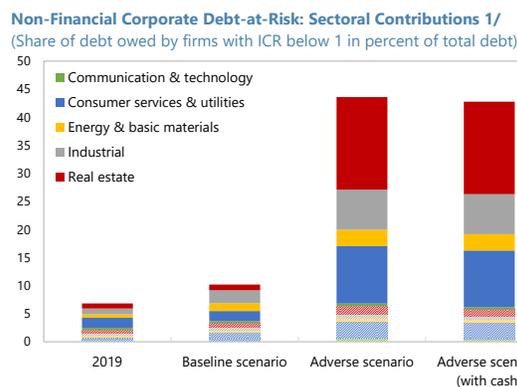
...while profitability declined.



Debt-at-risk would increase significantly in both types of firms in the adverse scenario, ...

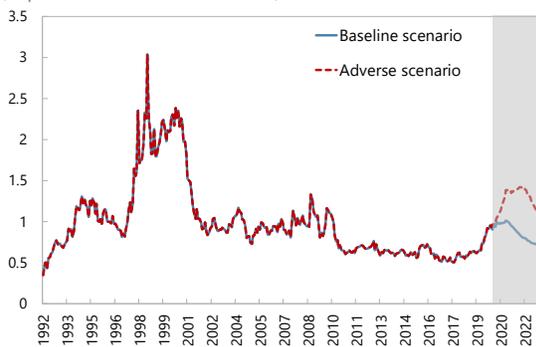


...with particularly high contributions from the Mainland China-oriented real estate sector.



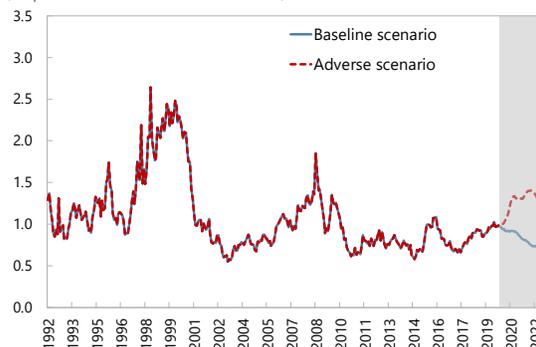
PDs in Hong Kong SAR-oriented firms would increase significantly in the adverse scenario but remain below AFC levels, ...

PDs of HKSAR-oriented Firms
(In percent; Median across firms)



...and PDs in Mainland China-oriented firms would also increase, particularly for those in the real estate sector (see Figure 9).

PDs of MC-Oriented Firms
(In percent; Median across firms)

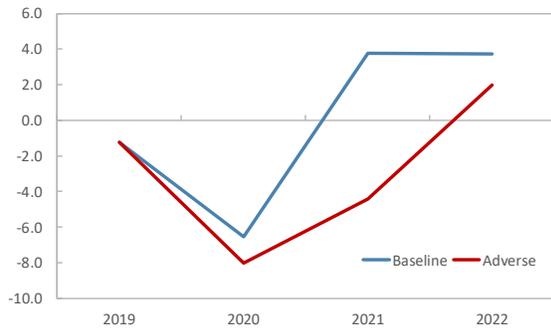


Sources: Bloomberg, L.P.; and IMF staff calculations.

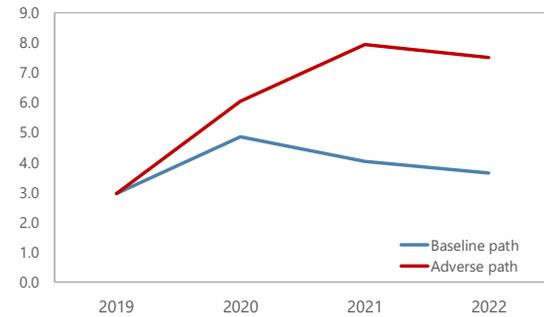
1/ The solid bars and pattern bars represent Mainland China- and Hong Kong SAR-oriented sectors, respectively.

Figure 18. Hong Kong SAR: Solvency Stress-Test Scenarios

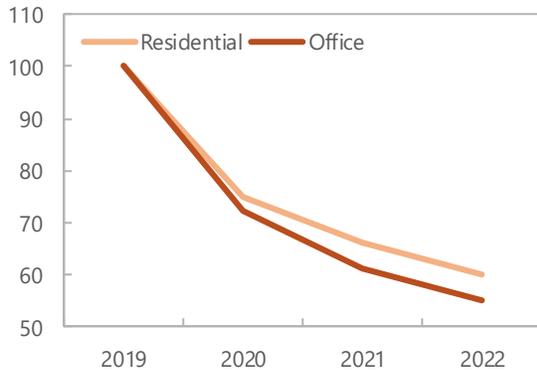
GDP starts recovering in 2021 in the baseline scenario, but falls significantly for two years in the adverse scenario.



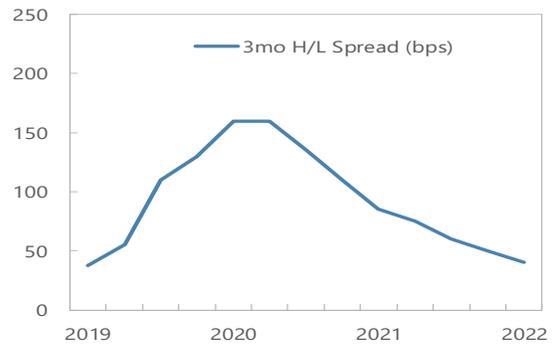
Unemployment increases significantly in the adverse scenario and remains elevated.



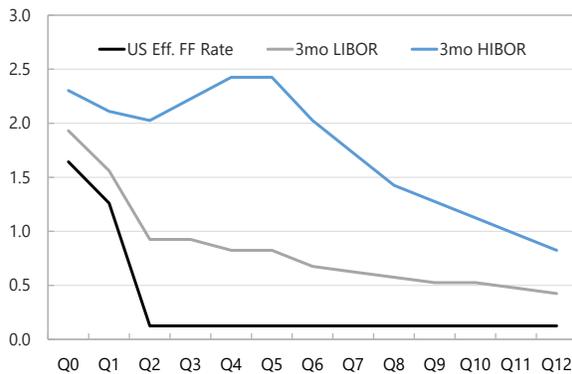
Residential and commercial property prices fall by 40 and 45 percent, respectively, in the adverse scenario.



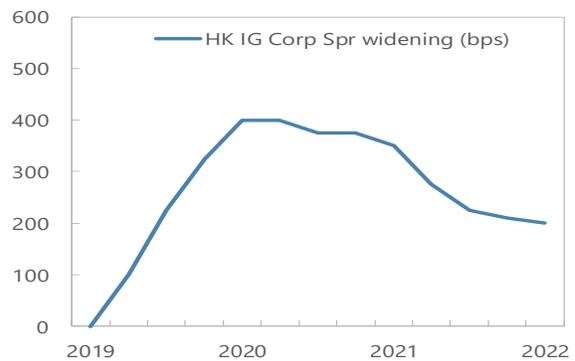
The HIBOR/LIBOR spread widens significantly in the adverse scenario as risk aversion increases.



The spread widening pushes HIBOR up in the first year, and it starts declining in the second year.



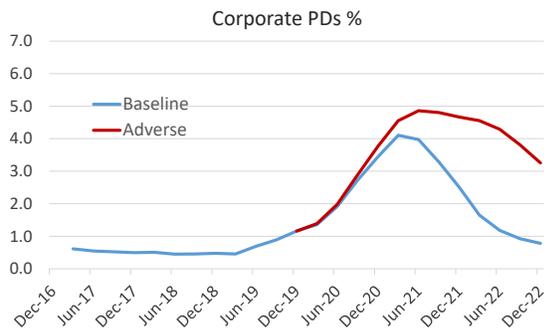
Risk aversion also pushes corporate bond spreads up significantly.



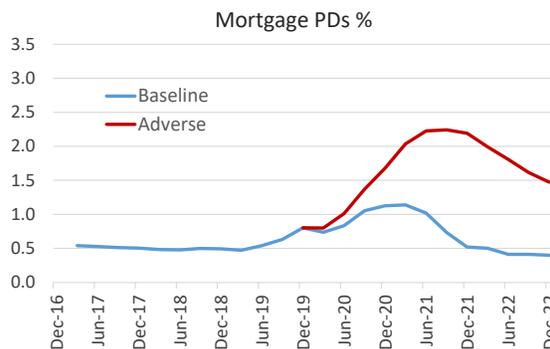
Sources: IMF staff.

Figure 19. Hong Kong SAR: Banking Sector Solvency Stress-Test Results

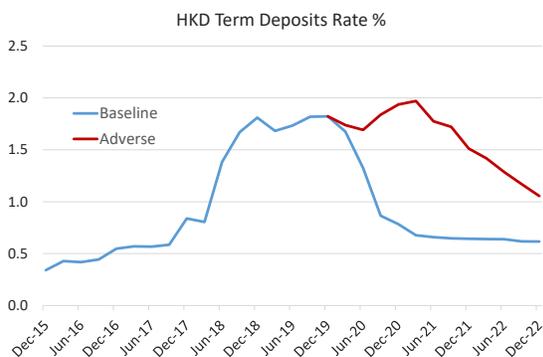
Corporate PD increases substantially,



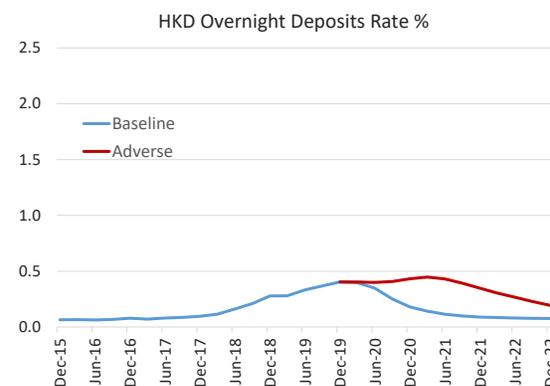
while mortgage PD increase is more muted.



Term deposit rate reflects the interbank stress.

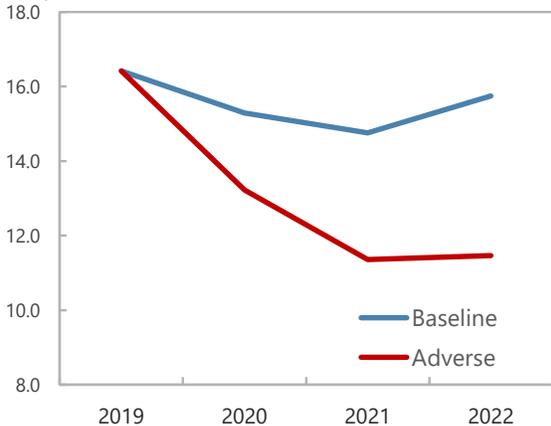


Overnight deposits are less sensitive but follow a similar pattern.



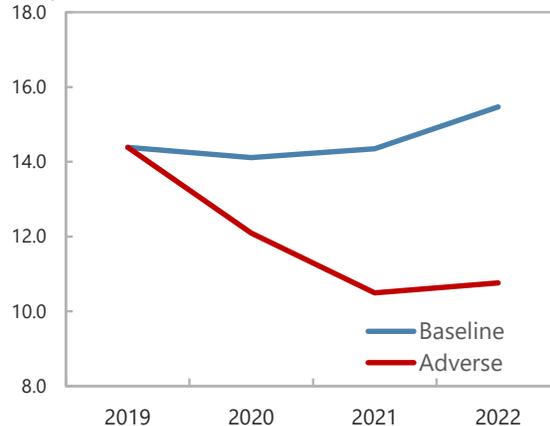
IRB banks experience larger declines in capital ratios due to sensitivity of RWAs.

Average CET1 Ratio - IRB Banks
(in percent)



Standardized banks' capital path follows a similar pattern, but contribution of RWAs is less pronounced.

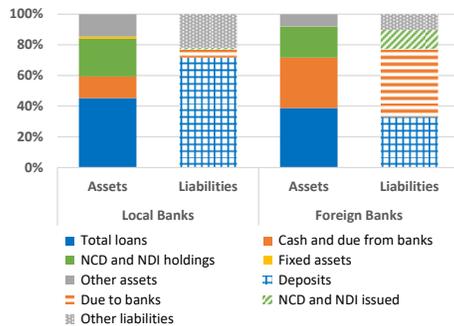
Average CET1 Ratio - STA Banks
(in percent)



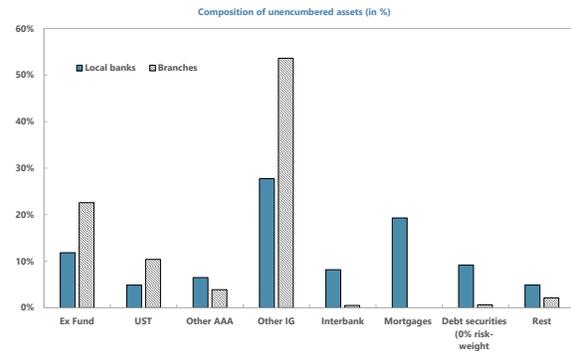
Sources: HKMA and IMF staff computations.

Figure 20. Hong Kong SAR: Bank Business Models and Banking Sector Liquidity

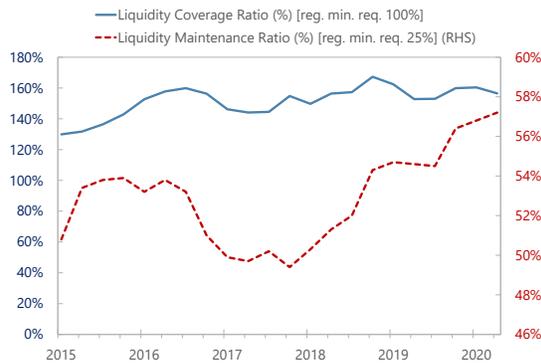
Local banks and foreign branches have very different balance sheets, reflecting different business models...



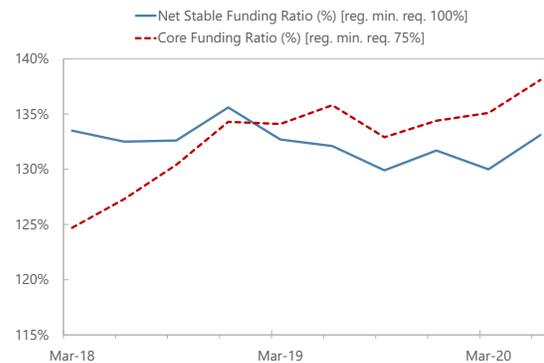
...and their unencumbered asset portfolios differ too.



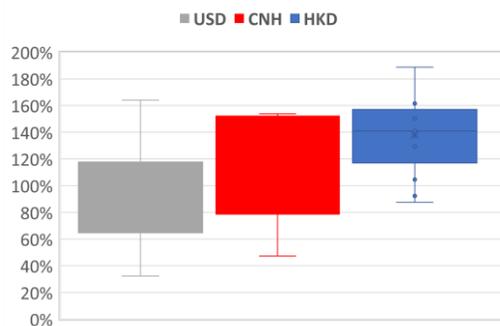
Yet, both actual LCRs and LMRs remain well above regulatory minima...



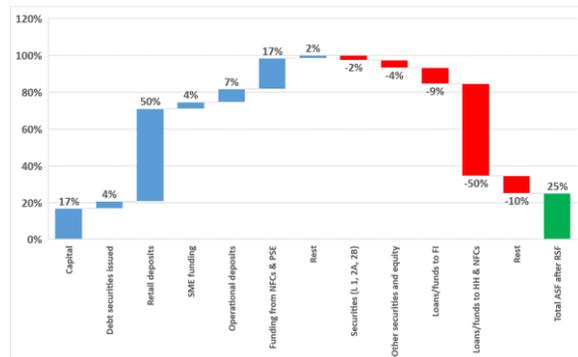
...as do the NSFR and Core Funding Ratios.



Distribution of LCR by currency reveal a large dispersion, especially for USD exposures when inflows are capped.*



NSFR composition for the Hong Kong SAR banking system is mainly driven by retail deposits and retail loans.



Sources: HKMA; Haver Analytics; IMF staff computations.

Notes: NCD = negotiable certificates of deposit, NDI = Negotiable debt instruments, Exch Fund = Exchange Fund securities, UST = U.S. Treasury securities, Other AAA = other AAA securities, Other IG = other investment-grade securities, Interbank = interbank placements after deductions, RMLs = residential mortgage loans, Other = other non-central bank eligible assets. ASF/RSF = available/required stable funding. Most foreign banking branches are required to comply with requirements of the Liquidity Maintenance Ratio (LMR), and Als of considerable business size are also required to comply with Core Funding Ratio (CFR) requirements, which is a simplified version of the NSFR. * The Net Cash Inflows formula in the LCR caps cash inflows at 75 per cent of cash outflows to ensure that banks do not only rely on inflows but also hold HQLA. Without this cap, the LCRs in CNY and USD are considerably higher since the Net Cash Outflows are considerably lower due to higher expected inflows from FX swaps.

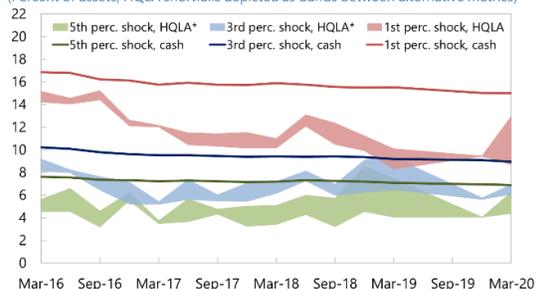
Panel 6 shows total ASF after accounting for ASF (blue bars) and RSF (red bars), which amounts to 25% (green bar), or equivalent to an NSFR of about 133% (a green bar of 0% would be the minimum for an NSFR equaling 100%).

Figure 21. Hong Kong SAR: Main Results of Fund Liquidity Stress Test

Average liquidity shortfalls measured on HQLA/cash basis are substantive for funds authorized in Hong Kong SAR...

Average shortfalls if hit by redemption shock and unable to serve with cash/HQLA

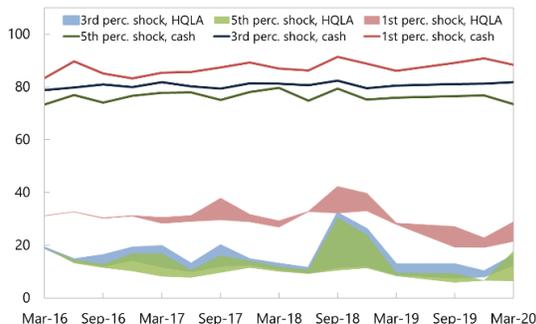
(Percent of assets, HQLA shortfalls depicted as bands between alternative metrics)



The share of funds' assets affected by liquidity shortfalls remained stable and is higher for shortfalls in cash.

Share of assets affected by liquidity shortfalls

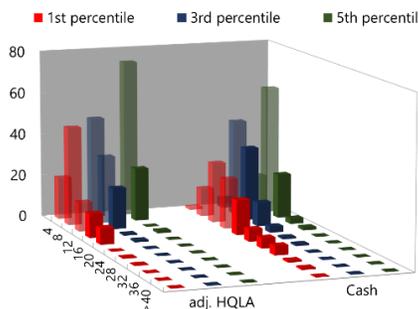
(Percent of assets, values for HQLA shortfalls depicted in bands of alternative metrics)



A tail of assets managed by Hong Kong SAR authorized funds appears particularly responsive to liquidity stress...

Empirical distributions of liquidity shortfalls, 2020: Q1

(Y-axis: percent of affected assets; X-axis: liquidity shortfall in percent of assets)



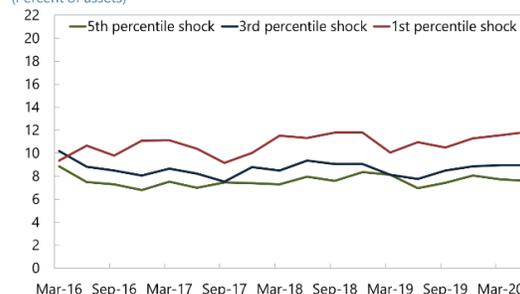
Note: Solid bars contribute to the highest quintiles of shortfalls.

Sources: MorningStar and IMF staff calculations.

...and the liquidity shortfalls measured on cash basis exceed those of their peers domiciled in Hong Kong SAR.

Average shortfalls if hit by redemption shock and unable to serve with cash

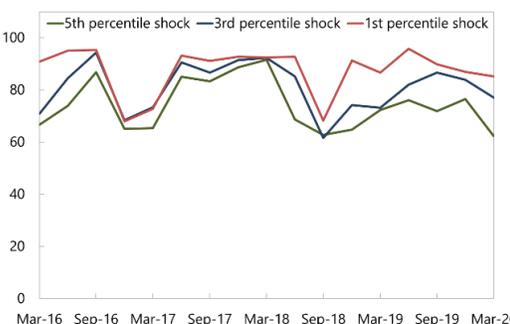
(Percent of assets)



Among funds domiciled in Hong Kong SAR a smaller share of assets is affected.

Share of assets affected by cash liquidity shortfalls

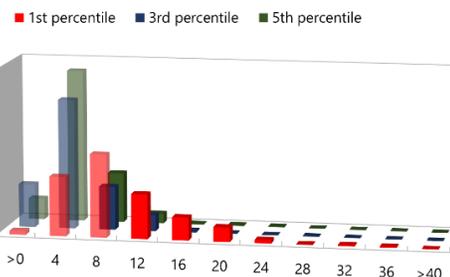
(Percent of assets)



...with a similar pattern holding for funds domiciled in Hong Kong SAR, albeit on a lower shortfall level.

Empirical distributions of cash liquidity shortfalls, 2020: Q1

(Y-axis: percent of affected assets; X-axis: liquidity shortfall in percent of assets)



Note: Solid bars contribute to the highest quintiles of shortfalls.

Notes: Panels 1, 3 and 5 report values for funds authorised in Hong Kong SAR, panels 2, 4 and 6 report values for their domestic peers. Panels 1, 2, 5 and 6 depict funds not being able to meet redemptions. The bands reported in panels 1 and 3 for HQLA are spanned by the alternative estimates obtained by HQLA and AQLA concepts. * =

Values for Q2 and Q3 2019 have been smoothed by interpolating as aggregate data were distorted by a few outliers. HQLA = High Quality Liquid Assets; AQLA = Adjusted High Quality Liquid Assets.

Table 2. Hong Kong SAR: Financial Sector Structure
(2020 Q3 or latest available data)

	Number of institutions	Total assets (HK\$ bn)	Multiples of GDP
Banks	193	26,080	9.5
by place of incorporation:			
Local banks – domestic banks	10	7,037	2.6
Local banks – subsidiaries of foreign banks	46	8,990	3.3
Foreign bank branches	137	10,053	3.7
by business nature:			
Retail banks	34	17,012	6.2
Non-retail banks	159	9,068	3.3
Authorized Insurance Companies (2019)	163	3,872	1.4
Life	49	3,562	1.2
Non-Life	84	166	0.06
Reinsurance	17	144	0.05
Composite	13	(N.A.)	(N.A.)
		Assets under management (HK\$ bn)	
Asset and wealth management business (2019)	-	28,769	10.0
by type of business activities:			
Asset management business	-	17,898	6.2
Fund advisory business	-	1,853	0.6
Private banking and private wealth management business	-	7,774	2.7
SFC-authorized Real Estate Investment Trusts (REITs)	-	289	0.1
Assets held under trusts attributable to non-licensed corporations and non-registered institutions	-	955	0.3

Source: HKMA.

Notes: Figures may not add up to totals due to rounding errors. "Banks" refers to "authorized institutions (AIs)" authorized under the Banking Ordinance to carry on the business of taking deposits. "Domestic banks" refers to AIs incorporated in Hong Kong SAR and are domestically-owned. "Subsidiaries of foreign banks" refers to AIs incorporated in Hong Kong SAR but are foreign-owned. "Foreign bank branches" refer to AIs incorporated outside Hong Kong SAR. Total assets of life insurance companies, non-life insurance companies and reinsurance companies also comprise those of the composite insurance companies. "Private banking and private wealth management business" excludes asset management business provided to private banking and private wealth management clients.

Table 3. Hong Kong SAR: Selected Economic and Financial Indicators, 2017-2026
(Projections based on April 2021 WEO)

	2017	2018	2019	Proj.						
				2020	2021	2022	2023	2024	2025	2026
NATIONAL ACCOUNTS										
Real GDP (percent change)	3.8	2.8	-1.2	-6.1	4.3	3.8	2.8	2.8	2.9	2.9
Private consumption	5.5	5.3	-1.1	-10.1	5.5	4.7	3.5	2.9	2.9	2.9
Government consumption	2.8	4.2	5.1	7.8	3.2	2.3	2.3	2.3	2.5	2.8
Gross fixed capital formation	3.1	1.7	-12.3	-11.5	8.3	4.7	4.2	4.2	4.2	4.2
Inventories (contribution to growth)	0.5	-0.1	-0.6	2.0	-0.6	-0.5	-0.3	-0.2	-0.1	0.0
Net exports (contribution to growth)	-1.3	-1.5	2.3	0.2	-0.6	0.1	-0.2	-0.1	-0.1	-0.1
Output gap (in percent of potential)	0.1	0.1	-2.5	-6.8	-3.0	-1.4	-0.8	-0.5	-0.4	-0.3
Saving and investment (percent of GDP)										
Gross national saving	26.7	25.7	24.8	26.3	25.3	24.4	23.8	23.8	23.9	24.1
Gross domestic investment	22.1	22.0	18.9	19.8	19.8	19.4	19.4	19.6	19.9	20.1
Saving-investment balance	4.6	3.7	6.0	6.5	5.5	5.0	4.5	4.1	4.0	4.0
LABOR MARKET										
Employment (percent change)	0.9	1.2	-0.4	-5.1	1.1	1.5	1.4	0.5	0.5	0.4
Unemployment rate (percent, period average)	3.1	2.8	3.0	5.9	5.3	4.3	3.3	3.2	3.1	3.0
Real wages (percent change)	2.3	1.1	0.2	-0.2	0.3	1.0	1.3	1.3	1.3	1.3
PRICES										
Inflation (percent change)										
Consumer prices	1.5	2.4	2.9	0.3	1.4	1.9	2.4	2.4	2.4	2.4
GDP deflator	2.9	3.7	2.4	0.8	1.1	1.6	2.4	2.5	2.5	2.5
GENERAL GOVERNMENT (percent of GDP)										
Consolidated budget balance	5.6	2.4	-0.6	-10.2	-4.8	-0.1	-0.1	-0.1	-0.1	-0.1
Revenue	23.3	21.2	20.6	20.1	20.7	22.3	22.3	22.2	22.2	22.2
Expenditure	17.7	18.8	21.2	30.3	25.5	22.4	22.3	22.3	22.3	22.3
Fiscal reserves (as of March 31)	41.5	41.3	40.5	33.3	28.1	26.9	25.8	24.5	22.9	21.6
FINANCIAL										
Interest rates (percent, period-average)										
Best lending rate	5.0	5.0	5.1	5.0	...	...	...	...	...	...
Three-month HIBOR	0.9	1.8	2.1	1.1	...	...	...	...	...	...
10-year Treasury bond yield	1.6	2.1	1.5	0.7	...	...	...	...	...	...
EXTERNAL SECTOR										
Merchandise trade (percent change)										
Export value	8.0	7.3	-3.6	-0.2	6.0	4.5	3.6	3.6	3.6	3.6
Import value	8.7	8.4	-6.1	-2.0	6.5	4.8	3.8	3.8	3.8	3.8
Current account balance (percent of GDP) 1/	4.6	3.7	6.0	6.5	5.5	5.0	4.5	4.1	4.0	4.0
Exchange rate										
Market rate (HK\$/US\$, period average)	7.793	7.839	7.836	7.757	...	...	...	...	...	...
Real effective rate (period average, 2010=100)	115.3	113.1	117.6	116.8	...	...	...	...	...	...

Sources: BIS, CEIC; HKSAR Census and Statistics Department; and IMF staff estimates.

1/ Data published using the Balance of Payments Statistics Manual 6 (BPM6) format. BOP data for 2020 and onwards are projections in the April 2021 WEO.

Table 4. Hong Kong SAR: Financial Soundness Indicators, 2014-2020Q3
(In percent)

	2014	2015	2016	2017	2018	2019	2020Q3
Capital Adequacy							
Regulatory Capital to Risk-weighted Assets	16.8	18.3	19.2	19.1	20.3	20.7	20.3
Regulatory Tier 1 Capital to Risk-weighted Assets	13.9	15.3	16.4	16.6	17.9	18.5	18.3
Capital to Assets	9.0	9.5	9.8	9.8	9.5	9.9	9.3
Asset Quality							
Non-Performing Loans Net of Provisions to Capital	1.3	1.9	2.0	1.6	1.4	1.0	1.9
Non-Performing Loans to Total Gross Loans	0.5	0.7	0.9	0.7	0.5	0.6	0.8
Sectoral Distribution of Total Loans: Residents	69.8	69.7	70.3	69.9	69.7	70.0	70.7
Sectoral Distrib of Total Loans: Other Financial Corporations	6.1	6.7	7.6	9.8	9.5	9.4	11.6
Sectoral Distribution of Total Loans: Nonfin Corporations	56.9	55.9	55.7	53.0	52.6	52.1	51.2
Sectoral Distribution of Total Loans: Other Domestic Sectors	6.8	7.1	7.0	7.2	7.6	8.5	7.8
Sectoral Distribution of Total Loans: Nonresidents	30.2	30.3	29.7	30.1	30.3	30.0	29.3
Earnings and Profitability							
Return On Assets	1.0	1.0	1.1	1.0	1.0	1.0	0.8
Return On Equity	13.1	13.2	16.0	12.6	13.1	11.7	9.1
Interest Margin to Gross Income	51.2	46.5	42.6	51.1	56.2	57.1	50.3
Non-Interest Expenses to Gross Income	48.9	48.0	42.8	45.7	44.7	44.8	46.8
Liquidity							
Liquid Assets to Total Assets [Liquid Asset Ratio]	22.3	21.5	21.6	19.6	20.4	21.3	21.2
Liquid Assets to Short Term Liabilities 1/	47.0	164.3	180.8	182.2	187.5	176.1	174.4
Sensitivity to Market Risk							
Net Open Position In Foreign Exchange to Capital	5.3	5.9	4.1	0.5	0.0	-0.2	3.4

Sources: CEIC, Hong Kong SAR authorities, IFS, and IMF staff computations.

1/ composition of liquid assets and short-term liabilities changed in January 2015 after the implementation of a new liquidity regime in accordance with the Basel III framework.

Appendix I. Status of Key Recommendations of 2014 FSAP

Recommendations	Time	Status
Banking Sector		
Eliminate or specify the circumstances triggering the exercise of the legal authority of the Chief Executive of Hong Kong SAR to give directions to the Monetary Authority (MA), and provide for the public disclosure of the reasons for the dismissal of the MA in the Banking Ordinance (BO).	MT	Not implemented
Insurance Sector		
Establish the proposed Independent Insurance Authority (IIA).	MT	Implemented
Update the Insurance Companies Ordinance (ICO) to better reflect current international best practices, including by: (i) extending the fit and proper regime to cover Senior Management and Key Persons in Control Function; (ii) establishing a clear definition of control and pre-determined control levels; (iii) updating risk management requirements; (iv) granting authority to remove or disqualify persons on fit and proper grounds; and (v) requiring insurers to implement contingency plans.	C	Implemented
Amend the ICO to establish a regulatory regime for insurance groups.	ST	Implemented
Amend the ICO to implement a risk-based capital regime.	ST	Underway
Strengthen conduct of business requirements and direct supervision of insurance intermediaries.	ST	Implemented
Securities Market		
Strengthen secondary markets regulation by (i) expanding oversight regime of the HKEX; and (ii) further developing clear and transparent requirements for the recognition of exchanges and the authorization of automated trading services.	ST	Implemented
Strengthen auditors' oversight by (i) enhancing the independence of the auditor oversight body; (ii) strengthening the enforcement framework; and (iii) expanding the scope of oversight to all auditors of companies listed in Hong Kong SAR.	ST	Implemented
Strengthen enforcement by (i) providing the scope for the SFC to take both punitive and remedial actions in cases where breaches of the Code of Conduct do not contravene the law; and (ii) improving the existing coordination arrangements for criminal enforcement.	ST	Implemented
Financial Market Infrastructures		
Develop a clear timetable for each FMI for compliance with the PFMLs.	ST	Implemented
Develop a recovery and resolution plan for each FMI (in line with the resolution regime).	MT	Implemented
Crisis Management and Resolution		
Continue efforts to develop a comprehensive resolution regime, in line with emerging international good practices.	ST	Largely complete
Review the modalities (target size; normal premium level; surcharge premiums for replenishment) for ensuring the deposit protection fund has the appropriate resources to meet its objectives without undue reliance on the Exchange Fund.	MT	Partially complete
Note: Short-term indicates within 18 months; medium-term indicates within 18 months to 3 years.		

Appendix II. Stress Testing Matrix (STeM)

Domain		Assumptions
		Top-down by FSAP Team
Banking Sector: Solvency Stress Test		
1. Institutional Perimeter	Institutions included	<ul style="list-style-type: none"> • Largest 11 locally incorporated banks (ranked by the size of consolidated balance sheets), including five D-SIBs (the sixth D-SIB, Hang Seng Bank, is a majority owned subsidiary of HSBC Ltd and it will be included as part of the consolidated balance sheet of HSBC Ltd, instead of a stand-alone basis).
	Market share	<ul style="list-style-type: none"> • Close to 93 percent of total consolidated assets of all locally incorporated banks.
	Data source and starting date	<ul style="list-style-type: none"> • Data Source: Supervisory and publicly available data. • Baseline date: Balance sheets as of 2019Q3, credit and funding risk historical data up to 2019Q1. <p>The FSAP team started the solvency ST exercise with 2018 bank-level balance sheet data and refreshed the balance sheets to the 2019 data during the course of the work. Due to the extraordinary COVID-19 pandemic circumstances, which imposed additional burdens on the banks, a further update of the balance sheet data to a point in 2020 was deemed impractical. The use of 2019 balance sheet data has limited effect on the solvency assessment due to the fact that there were no significant changes in the average bank capital levels between 2019 and 2020.</p> <ul style="list-style-type: none"> • Scope of Consolidation: Consolidated balance sheets of locally incorporated banks.
2. Methodology	Overall framework	<ul style="list-style-type: none"> • IMF Balance sheet-based approach.
	Satellite models for macro-financial linkages	<ul style="list-style-type: none"> • Satellite models for PDs, LGDs, NPL ratio, and provisioning ratio for credit losses. • Methodology to calculate market losses from holdings of debt instruments (sovereign and other issuers). Haircuts calculated based on modified duration. • Methodology to calculate shocks to bank funding costs. • Non-interest income projected based on nominal GDP growth and expert judgment.
	Stress test horizon	<ul style="list-style-type: none"> • 3-years (2020-2022).
	Assumption	<ul style="list-style-type: none"> • Passive balance sheet assumption: (i) the balance sheet growth is identical to the overall credit growth, which is linked to nominal GDP growth; (ii) the balance sheet composition remains constant throughout the stress test horizon; (iii) banks build capital only through retained earnings; and (iv) maturing capital instruments are not renewed. • Banks can pay dividends only if net income after taxes are positive and if they are adequately capitalized. The dividend payout ratio is assumed to be 50 percent.
3. Type of analyses	Scenario analysis	<ul style="list-style-type: none"> • Scenario-based tests, that assess the impacts on the entire portfolio including the loans and the trading book. • Two macrofinancial scenarios agreed between HKMA and the IMF FSAP team. • The scenarios include domestic macro-financial variables (e.g., GDP, inflation, interest rates, unemployment rate, exchange rate, equity, and property prices), and global variables (US and China GDP, interest rates, and commodity prices). • Baseline scenario based on the October 2020 WEO projections and is informed by the macroeconomic indicators observed since the COVID-19 outbreak started.

Domain		Assumptions
		Top-down by FSAP Team
		<ul style="list-style-type: none"> • The Adverse Scenario is simulated using IMF's Flexible System of Global Models. • The Adverse Scenario reflects macro-financial risks in the RAM. It is driven by a combination of external and domestic shocks amplified by domestic vulnerabilities. The four major drivers of the Adverse Scenario are: <ul style="list-style-type: none"> - Shock 1: Prolonged COVID-19 outbreak, - Shock 2: Heightened protectionism accompanied by a further slowdown in Mainland China, - Shock 3: A sharp rise in risk premia due to an abrupt deterioration in global market sentiment compounded by escalating US-China tensions, - Shock 4: A sharp housing market correction and a decline in demand. • Under the baseline scenario, the Hong Kong SAR economy suffers a large contraction on 2020, but growth turns to positive in 2021, with the annual GDP growth rates of -7.5 percent, 3.7 percent, and 3.4 percent. • Under the adverse scenario, the Hong Kong SAR economy suffers an L-shaped growth path and an L-shaped deep recession, with the annual GDP growth rates of -8.5 percent, -4.9 percent, and 2.5 percent (cumulative GDP contraction of 13 percent over the first two years). This growth path corresponds to a 9-percentage points deviation over the first two years compared to the baseline path, which is equivalent to 1.5 standard deviations of annual growth rates calculated over 1984-2019. • The cumulative price decline reaches 40 percent for residential properties under the adverse scenario. • The 3-month HIBOR-LIBOR spread is simulated to increase to 160 basis points by the end of the first year, well above the 2019Q4 average of 37 basis points. Similarly, the LIBOR-Fed Funds rate spread increases to 70 basis points in 2020Q4 (vs. 29 in 2019Q4). At the same time, U.S. monetary policy will be eased following the COVID-19 shock, with a reduction of 150 basis points in 2020Q1, resulting in a near-zero Fed Funds rate starting in 2020Q2 and remaining at that level throughout the scenario period. This substantial decline will reduce the total increase in the HIBOR rate to 13 basis points. The HIBOR-LIBOR spread is assumed to gradually decline to 85 and 40 basis points in the second and third year of the scenario, respectively.
	Sensitivity analysis	<ul style="list-style-type: none"> • Sensitivity analyses will be conducted to supplement the scenario analysis. • They will evaluate impacts of three different single risk factors on the existing capital buffers: <ul style="list-style-type: none"> - Interest rate risk, - Spread increase for securities portfolios, - Concentration risk.
4. Risks and Buffers	Risks assessed	<ul style="list-style-type: none"> • Credit loss from banks' loan portfolios and bank exposures, including off-balance sheet credit exposures. • Market loss from valuation adjustments of banks' holding of debt securities and existing net open foreign exchange positions. • Losses from bonds and money market instruments (sovereign and other issuers) in the banking and trading books. • Interest rate risk in the banking book, increase in funding costs.

Domain		Assumptions
		Top-down by FSAP Team
	Buffers	<ul style="list-style-type: none"> Existing capital buffers. Internal capital generation from net income after taxes. No new capital injection.
5. Regulatory Standards	Regulatory Standards	<ul style="list-style-type: none"> National regulatory framework: Basel III approach.
6. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> System-wide capital shortfalls from macroprudential perspectives. Number of banks and percentage of banking system assets in the system that fall below the capital hurdle. Impact of different result drivers, including profit components, losses due to realization of different risk factors. Hurdle rates <ul style="list-style-type: none"> Baseline scenario: the sum of regulatory minimum (CET1, Tier1, and total capital), D-SIB surcharge, capital conservation buffer, and countercyclical capital buffer. Adverse scenarios: the Basel III regulatory minimum.
Banking Sector: Liquidity Stress Test		
1. Institutional Perimeter	Institutions included	<ul style="list-style-type: none"> 23 banks: 12 local banks (including all six D-SIBs) and 11 foreign branches.
	Market share	<ul style="list-style-type: none"> The sample covers about 96 percent of total assets on a solo basis (that is, positions of banks' Hong Kong SAR offices plus their overseas branches).
	Data and Starting position	<ul style="list-style-type: none"> Baseline date: June 30th, 2020 Data Source: Supervisory and publicly-available data. Cash flow data and unencumbered asset data (HKMA reporting template MA(BS)23)
2. Methodology	Overall framework	<ul style="list-style-type: none"> Cash-flow cum counterbalancing capacity-based liquidity stress test Basel III-LCR ratio and HK LMR ratio. Analyses to be carried out separately for HKD, USD, and CNH, based on availability of granular data for various tests.
3. Type of analyses	Scenario analysis	<ul style="list-style-type: none"> 36 embedded scenarios: 4 degrees of severity, 3 different approaches to the counterbalancing capacity over 3 different time horizons. This approach employs multiple embedded scenarios of increasing severity covering several horizons (7 days, 1 month, and 3 months) with varying assumptions regarding shocks to cash inflows and outflows and haircuts on liquidity buffers. The most severe scenario includes historically relatively high outflow rates (e.g. 10 percent for less stable retail deposits, 40 percent for non-operational NFC deposits, and 100 percent for FI deposits) combined with haircuts of up to 25 percent for other investment-grade securities held locally and 30 percent for those held overseas. The scenarios differ from the actual effects of the pandemic on liquidity risk, because the latter led to substantial inflows of deposits rather than outflows and public support for non-financial corporates as well as monetary policy accommodation contributed to avoiding substantial decreases of the liquidity values of assets in the counterbalancing capacity. One of the scenarios includes an assessment of the impact of a disruption of the derivatives markets (e.g., FX swaps) on USD liquidity. The calibration of shock scenarios was based on historical evidence. The analysis of the USD LCR found that banks rely on inflows in USD (i.e. from FX swaps) to match high outflows (also FX swaps) and on the well-functioning

Domain		Assumptions
		Top-down by FSAP Team
		of the underlying markets.
4. Risks and Buffers	Risks	<ul style="list-style-type: none"> • Cash-flow based LST: Retail and wholesale deposit run-off, (partial) closure of funding markets, reduction of liquidity / price declines of asset • LCR/LMR: reclassification risk
	Buffers	<ul style="list-style-type: none"> • Cash-flow based LST: Capacity of banks to generate liquidity from assets under stress (counterbalancing capacity) and central bank facilities • LCR/LMR: Regulatory buffers
5. Regulatory Standards	Regulatory Standards	<ul style="list-style-type: none"> • National regulatory framework: The LCR and NFSR (hurdle of 100 percent for both) for larger (mostly) local banks in the sample, and the LMR (hurdle of 25 percent) and the CFR (hurdle of 75 percent) for the smaller banks (largely foreign banks) in the sample. • The LCR and the LMR are subject to so-called reclassification tests which test their sensitivity with respect to the reclassification of liabilities/assets between various regulatory positions which would entail higher run-off rates and lower regulatory ratios. • The hurdle for the cashflow-based test is zero HK dollars.
6. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> • System-wide LCR and LMR under the reclassification scenarios • System-wide liquid cumulated counterbalancing capacity (CCBC in % of total assets), the number of banks with a CCBC below zero, and their CCBC (in % of TA) under the cashflow-based stress scenarios.
Investment Fund Sector: Liquidity Stress Scenario		
1. Institutional Perimeter	Entities included	<ul style="list-style-type: none"> • 3097 mutual investment funds marketing fund shares in Hong Kong SAR (as of June 2020 with assets of \$1.5 trillion or 95 percent of the assets of funds authorized in Hong Kong SAR) and 512 funds registered in Hong Kong SAR (as of June 2020 with assets of USD73 billion or 47 percent of the assets of funds authorized in Hong Kong SAR) at some time between 2000 and 2020. The mutual fund sector in Hong Kong SAR constitutes only a part of the broader asset management industry represented in Table 1 in text, which includes beyond mutual funds also discretionary mandates, hedge funds and other types of service providers.
	Data	<ul style="list-style-type: none"> • Data is sourced from Morningstar, comprising monthly data on net flows, fund size, portfolio composition and shares of rating grades in debt portfolio.
	Time Horizon	<ul style="list-style-type: none"> • The data horizon is January 2000 to March 2020, allowing an effective analysis from January 2006 to March 2020; results are reported for end of Q1 2020 (Q4 2019 for the domestic industry).
2. Methodology	Overall framework	<ul style="list-style-type: none"> • Liquidity stress scenario: computing liquidity needs as gaps between entity specific redemption scenarios and liquidity buffers • Price impact analysis: Amihud ratio-based price sensitivity analysis for broad asset classes based on aggregate sales needs of the respective investment fund sectors
	Scenarios	<ul style="list-style-type: none"> • Fund specific redemption shock scenarios of equivalent to the worst (respectively, third and fifth worst) percentile of net flows ever experienced
3. Risks and Buffers	Risks	<ul style="list-style-type: none"> • Redemption risks; Asset liquidation risks; Price impact risks
	Buffers:	<ul style="list-style-type: none"> • Narrow liquidity buffers: cash and cash equivalents • Broad liquidity buffer: HQLA liquidity buffers
4. Reporting	Output	<ul style="list-style-type: none"> • Average and aggregate liquidity shortfalls of industry

Domain		Assumptions
		Top-down by FSAP Team
Format for Results	presentation	<ul style="list-style-type: none"> • Respective maximum sales needs in broad asset classes • Price impact: Price impact table • Identification of share of particular vulnerable funds
Financial System: Interconnectedness Analysis		
1. Institutional Perimeter	Institutions Included	<ul style="list-style-type: none"> • Interbank network: Largest 20 banks ranked according to their HK office basis assets (9 locally incorporated banks and 11 foreign branches). • Intra-financial sector network: Banks and major nonbank financial sectors. • Cross-border bank network: the banking systems of all major counterparty economies.
	Data and Starting position	<ul style="list-style-type: none"> • Data source: Supervisory data, market data, and BIS international banking statistics. • Starting position: 2019 year-end data. • Data granularity: <ul style="list-style-type: none"> – Interbank and common exposure: institution-level. – Intra-financial sector: major financial sub-sectors. – Cross-border: banking system and institution-level.
2. Methodology	Overall framework	<ul style="list-style-type: none"> • Interbank: Balance sheet-based interbank model by Espinosa-Vega and Solé (2010). • Common exposure: balance sheet approach. • Cross-border network: Espinosa-Vega and Solé (2010). • Market price-based spillover model by Diebold and Yilmaz (2014).
3. Risks and Buffers	Risks	<ul style="list-style-type: none"> • Credit and funding losses related to interbank exposures, intra-financial exposures, and cross-border banking exposures. • Default of large common borrowers in the banking system.
	Buffers	<ul style="list-style-type: none"> • Interbank network: banks' own capital and liquidity buffers. • Cross-border bank network: capital buffers of the banking system.
4. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> • Interbank network: a network chart, index of vulnerabilities. • Common exposure: system-wide capital shortfalls. • Cross-border network: index of vulnerabilities and contagion, and spillover charts. • Evolution and direction of spillovers.

Appendix III. Risk Assessment Matrix

Source of Risk	Transmission Channels	Likelihood	Impact
Global Risks			
Unexpected shift in the Covid-19 pandemic	Prolonged pandemic: The disease proves harder to eradicate (e.g., due to new virus strains, short effectiveness of vaccines, or widespread unwillingness to take them), requiring costly containment efforts and prompting persistent behavioral changes rendering many activities unviable.	Medium	Medium
Accelerating de-globalization	Despite renewed efforts to reach multilateral solutions to existing tensions, geopolitical competition leads to further fragmentation. Reshoring and less trade reduce potential growth.	Medium	High
A sharp rise in global risk premia exposes financial and fiscal vulnerabilities	A reassessment of market fundamentals (e.g., in response to adverse Covid-19 developments) triggers a widespread risk-off event. Risk asset prices fall sharply and volatility spikes, leading to significant losses in major non-bank financial institutions. Higher risk premia generate financing difficulties for leveraged firms (including those operating in unviable activities) and households, and a wave of bankruptcies erode banks' capital buffers.	Medium	High
Domestic Risks			
A further slowdown in Mainland China	A further slowdown in Mainland China would reduce trade flows and lead to a sharp decline in economic activity in Hong Kong SAR. Lower trade volumes would reduce corporate profits and investment, raise unemployment, and weaken consumption. Trade, logistics, tourism, and retail sectors would be affected most adversely. Banks would likely face higher losses on their loans to Mainland China-related and other corporate borrowers, as well as on their broader credit portfolio due to the overall decline in economic activity.	Medium	High
A sharp housing market correction and decline in demand	A sharp decline in house prices would lower confidence, weaken housing demand, lower residential investment, and constrain new bank lending as many loans are secured by property, leading to a larger downturn.	Medium	High
<p>Notes: This table shows the shocks that will be used for the analysis of resilience of financial institutions. The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly and amplify each other's effects.</p>			

**Statement by Mr. Jin , Executive Director
and Mr. Law on the People's Republic of China - Hong Kong Special Administrative
Region**

May 21, 2021

On behalf of the Hong Kong SAR authorities, we thank staff for their comprehensive Financial System Stability Assessment (FSSA) report. Our authorities appreciate the very constructive policy and technical discussions, and broadly agree with staff's appraisal.

The Hong Kong SAR economy faced challenges on both external and domestic fronts in the past two years when the FSAP exercise took place, but the financial sector has demonstrated remarkable resilience and stability in this real-life stress test. Staff's assessment and policy recommendations would help the authorities further improve the resilience of the financial system.

Latest economic developments and outlook

Hong Kong SAR entered the COVID-19 crisis with a healthy economy, a solid fiscal position, and a sound financial system. Despite being an international travel hub, Hong Kong SAR has managed to contain the number of COVID-19 cases without resorting to strict lockdowns. A risk-based and robust response strategy consisting of border control, extensive testing, rigorous contact tracing, prompt isolation of confirmed cases, as well as transparent disclosure of COVID-related information, contributed substantially to the control right from the beginning when the first confirmed case was detected in January 2020. The awareness of public hygiene and the practice of personal protective behaviors by the population have played an equally important role. Infection cases are now down 99 percent from peak; in the past 14 days, a total of seven local cases are reported, of which only one has an unknown infection source. As the outbreak is under control and vaccination has begun, social-distancing rules have been gradually scaled back and the authorities have been in discussion with selected jurisdictions on travel bubble arrangements. Nevertheless, the inoculation rate remains relatively slow and the threat of new variants of the virus is under close monitoring. Going forward, the authorities' top priority remains to contain the pandemic and to raise vaccination rates so that businesses and the public can be back to their daily routines.

Despite the relatively successful control of the pandemic situation, the economy was severely hit like elsewhere in the world. To mitigate the economic fallout, the authorities set up the Anti-epidemic Fund (AEF) to provide relief for industries and members of the public hit hard by the epidemic. The relief measures, including those launched under the AEF, involve a total of over HK\$300 billion (around US\$39 billion), equivalent to about 10-11 percent of GDP. The authorities also announced additional countercyclical fiscal measures in the 2021-22 Budget to revive the economy, including consumption vouchers as well as loans for unemployed individuals and small and medium-sized enterprises.

On the back of contraction of 1.2 percent and 6.1 percent in 2019 and 2020 respectively, Hong Kong SAR's GDP expanded by 7.9 percent year-on-year in the first quarter of 2021, substantially beating market expectations and ending the streak of contraction in the preceding six quarters. The authorities project real GDP growth to be in the range of 3.5-5.5 percent for 2021 as economic activities are expected to normalize. However, the strength and pace of recovery is subject to a host of uncertainties, especially those surrounding the pandemic situation as well as vaccine rollout and efficacy. Externally, the economy in Mainland China is anticipated to strengthen further and render support to Hong Kong SAR's export of goods and services, but the pace of recovery in other major economies will hinge on the success of their mass vaccination campaigns.

Hong Kong SAR as an international financial center

Amid the external and domestic challenges in the past two years, Hong Kong SAR continues to play an important role as an international financial center, as it provides an all-encompassing and high-quality financial platform for investors, financiers, asset managers, funds and financial institutions from all over the world. Hong Kong SAR's capital markets continue to perform in a resilient and robust manner. Indeed, the highly efficient and properly functioning financial system in Hong Kong SAR played a significant role in maintaining regional financial stability during the volatile market conditions in March and April 2020.

Hong Kong SAR's stock exchange remains a top spot for initial public offerings (IPOs). Over the past decade, Hong Kong SAR has become the most common location to arrange Asian international bonds, capturing 34 percent (or US\$196 billion) of Asian international bonds in 2020. Since the 2014 FSAP, Hong Kong SAR has further strengthened its unique role in serving as the gateway between Mainland China and the international financial markets and investors. The Stock Connect and North-bound Bond Connect programs, first launched in 2014 and 2017 respectively, allow international investors to trade eligible securities in Mainland China through Hong Kong SAR. Currently, around 70 percent of all China A-shares¹ held by international investors are booked or traded through Hong Kong SAR. Average daily turnover of the Bond Connect tripled in 2019 and then almost doubled

¹ Stocks of Mainland China-based companies that trade on the two Chinese stock exchanges, i.e., the Shanghai Stock Exchange and the Shenzhen Stock Exchange.

again in 2020, as international investors raise their renminbi allocation with the attractive yield pick-up and diversification benefit.

Hong Kong SAR is the largest international asset management hub in Asia. The number of asset managers in Hong Kong SAR increased by 3.9 percent year-on-year to 1,878 as at end-2020, and the size of assets under management continues to grow strongly. It is also the largest international private wealth management and hedge fund center in Asia, and the second largest private equity (PE) center (after Mainland China) in Asia. Preparations for the cross-boundary Wealth Management Connect with Mainland China and the South-bound Bond Connect is also underway and is expected to be launched later this year, opening up new avenues for capital flows between the onshore and offshore markets.

Risk assessment and stress testing

Sound macroeconomic conditions and prudential policies have provided Hong Kong SAR with important buffers to cope with the current cyclical slowdown and future shocks. Foreign exchange reserves and fiscal reserves stood at 140 percent and 32 percent as of end-2020. We welcome the staff assessment that confirmed once again the resilience of the Linked Exchange Rate System (LERS), which has been the anchor of Hong Kong SAR's monetary and financial stability. Despite challenges in the domestic and external environment over the past two years, the LERS has continued to function smoothly. Given the net capital inflow, the Hong Kong dollar (HKD) exchange rate remained in the strong half of the convertibility zone since 2020. The HKD market has been very stable and functioning orderly in accordance with the design of the Currency Board.

The banking system remains well capitalized and the liquidity position remains robust. The total capital adequacy ratio of local banks stood at 20.7 percent at end-2020, well above the international minimum requirement of 8 percent. The liquidity coverage ratio stood at 155.1 percent, again well above the statutory minimum requirement of 100 percent. The FSAP's stress test results indicated that even under the adverse scenario, Hong Kong SAR's banking system is broadly resilient to withstand severe macro-financial shocks and to liquidity stress. In relation to the concern about the banking sector's exposure to Mainland China, the non-performing loan ratio of Mainland China-related loans remains low at around 0.96 percent at end-2020, which is comparable to the 0.9 percent of the banking system as a whole. The authorities have been closely monitoring the banking sector's Mainland-related lending and strong credit underwriting requirements have been in place.

The property market remains stable in the last few months. The authorities consider that the three-pronged approach—comprising macroprudential measures, demand-side management measures, and increase in housing supply—remains appropriate in containing housing market risks. The authorities remain committed to increasing land and housing supply to address the supply-demand imbalance. Continuous efforts are being made to increase both public and private housing. For example, the authorities have announced a number of short- and

medium-term support measures, such as increasing the supply of subsidized housing, making more flats available for sale under the subsidized home ownership schemes, and promoting the development of transitional housing.

Household debt increased to 90.2 percent of GDP in the fourth quarter of 2020 from 80.4 percent a year earlier, primarily due to the economic contraction from 2019 to 2020. Even though the pace of household debt growth moderated to 5.5 percent in 2020 (compared with 12.8 percent in 2019), the fall in GDP in 2019 and 2020 continued to push up the household debt ratio by almost 10 percentage points. Currently, residential mortgage loans, which represent 68 percent of household debt, have been on an upward trend amid strong housing demand. Nevertheless, with countercyclical measures in place, residential mortgage loans have grown at a much slower pace than property prices. Since 2009, residential mortgage loans have grown by 1.6 times, compared to the 2.5 times increase in property prices. It is also important to examine the households' balance sheets in addition to the debt level. Overall, Hong Kong SAR's households are financially sound, as reflected in the high safe assets-to-liabilities ratio² (2.88 times). The household net worth-to-liabilities ratio, at 11.2 times, is also amongst the highest in major economies.

A rising trend in corporate leverage was observed in Hong Kong SAR amid the low interest rate environment. The weighted average debt-to-equity ratio rose from 45.3 percent in 2008 to 61.6 percent in 2019, while nonfinancial corporate (NFC) debt increased from 202 percent of GDP in 2014 to 257 percent in the third quarter of 2020. However, caution should be exercised when interpreting the ratios as they tend to overstate the corporate leverage in Hong Kong SAR. The increase in investment activities was a significant driver behind the rising leverage of such firms, as the low interest rate environment reduced external financing costs. Furthermore, many multinational and non-local corporates borrow funds from Hong Kong SAR to finance their overseas operations, but their economic activities and thus incomes are not fully reflected in Hong Kong SAR's GDP, leading to an inflated NFC debt-to-GDP ratio. The authorities will continue to closely monitor the corporate debt issue and its implications on financial stability.

Macroprudential policy framework, oversight, and stance

We welcome staff's assessment that the institutional framework for macroprudential policies (MaPP) is functioning well. The existing high-level and cross-sectoral setup of the Council of Financial Regulators (CFR) and the Financial Stability Committee (FSC), with direct oversight by the Financial Secretary, allows the authorities to draw on the research expertise and resources of all financial regulators and relevant government agencies to inform their discussion. Bilateral memoranda of understanding are in place and diligently implemented

² The ratio is compiled using a macro approach, in which estimates of households' assets are compiled by multiplying the aggregate value of assets by the percentage share of household ownership. For the liabilities of households (mainly mortgage and personal loans), estimates are obtained from banking statistics by the HKMA, supplemented by estimates of credit extended by non-banks obtained through surveys.

among the financial regulators to enhance collaboration and information-sharing among those agencies. The authorities will explore room to further enhance the monitoring of financial systemic risks and to consider measures to enhance the regulatory regime when necessary.

We welcome the endorsement by staff on the authorities' policy stance on systemic risks from residential and commercial real estate. The eight rounds of countercyclical macroprudential measures on property mortgage loans introduced by the Hong Kong Monetary Authority (HKMA) since 2009 have enhanced banks' resilience to risks associated with the property market. As prices of commercial real estate have fallen and overvaluation risks decreased, the HKMA adjusted the loan-to-value caps for mortgage loans on non-residential properties upward by 10 percentage points in August 2020. The level of private residential property prices, however, remains elevated and the authorities do not intend to relax or withdraw any demand-side management measures at this time. The authorities will remain vigilant and closely monitor the property market developments, and act in a timely manner when needed to help ensure the healthy development of the property market and to safeguard broader economic and financial stability. Adjustments to the current stance would only be made having regard to the evolving property market cycle and financial stability risks.

Microprudential oversight

Staff assessed that Hong Kong SAR's microprudential oversight is modernized and strong. Hong Kong SAR has implemented regulatory and supervisory regimes generally in line with international standards and, as a result, financial institutions are well capitalized and have good risk management framework. For the banking sector, the Basel III framework and domestic and cross-border cooperation arrangements are firmly in place. The HKMA collects and monitors a substantial volume of data on major borrowers of the banking sector, including Mainland-related exposures, and the capability will be further augmented through the Granular Data Reporting initiative.³ The HKMA has also been monitoring and analyzing banks' large exposures, and has introduced detailed supervisory guidance governing banks' large exposures and risk concentrations in December 2019. Foreign bank branches are subject to largely the same supervisory standards as locally incorporated subsidiaries.

For the insurance sector, the establishment of the independent Insurance Authority (IA) in 2015, following a recommendation of the 2014 FSAP, has greatly strengthened insurance regulation in Hong Kong SAR. The IA has extended regulatory powers over insurance companies as well as insurance intermediaries, and as resolution authority for relevant insurers. The IA continues to further develop its capacity to maximize its effectiveness. For the securities sector, the Securities and Futures Commission (SFC) is consulting the public

³ The initiative seeks to collect transactional level data from banks, instead of template based aggregate data in the past. This enables the authorities to discover insights and trends in a timely manner and conduct advanced analyses through slicing and dicing the data collected.

on a proposal to introduce an over-the-counter (OTC) securities transactions reporting regime for shares listed on the stock market operated by the Hong Kong Exchanges and Clearing Limited (HKEX) with a view to enhancing the surveillance of OTC trades by non-exchange members.

Staff has assessed that the HKFE Clearing Corporation Limited (HKCC) observes the Principles for Financial Market Infrastructures (PFMI) and has a sound, coherent and transparent legal basis. The HKCC has a Board of Directors and there are multiple lines of defenses within the HKCC to guard against conflict of interests and ensure sound risk management. We acknowledge staff's recommendation to decentralize key functions, but we wish to point out that a decentralized approach had once been adopted in the past and proved deficient for local circumstances. The HKEX, the parent company of HKCC, has recently completed a comprehensive independent review on its risk governance, and the recommendations will strengthen the HKEX's overall risk functions and the board oversight. Changes to the HKCC's governance structure should only be considered after the full implementation of the recommendations.

Hong Kong SAR has a robust regime to combat money laundering and terrorist financing (ML/TF). In the latest round of mutual evaluation conducted by the Financial Action Task Force (FATF), Hong Kong is commended for having a strong legal foundation and effective system for combating ML/TF, which is particularly effective in the areas of risk identification, law enforcement, asset recovery, counter terrorist financing, and international cooperation. Hong Kong SAR will continue to enhance its regime such as through implementation of the recommendations tendered by the FATF in the mutual evaluation.

Crisis management and financial safety net

We welcome staff's assessment that the framework for crisis management, which has been strengthened following the 2014 FSAP, is now broadly adequate. The Financial Institutions (Resolution) Ordinance (FIRO), which came into effect in 2017, establishes the legal basis for a cross-sectoral resolution regime in Hong Kong SAR and is designed to be compliant with the international resolution standards. While we acknowledge staff's recommendation to extend the mandate of the Hong Kong Deposit Protection Board to allow it to contribute to resolution costs, we would like to point out that the Deposit Protection Scheme is not part of the resolution regime and its primary focus is on protection of depositors. Our authorities would consider the need to conduct a separate review on the scope of deposit protection in due course.

Fintech and financial innovation

In recent years, the authorities and other stakeholders have been ramping up efforts to facilitate development of fintech in Hong Kong. A host of measures were pursued to facilitate the development of the local fintech ecosystem. For instance, seven "Smart Banking" initiatives were announced in September 2017, including open application

programming interface (API) for banks, a faster payment system and common QR code standard for retail payments, trade finance initiatives, and virtual banking. Most of these initiatives have been implemented by now. The authorities also maintain close contact with the industry and regulators in other jurisdictions to ensure the robustness of the regulatory regime. The authorities are also working closely with the BIS Innovation Hub (BISIH) Hong Kong Centre, one of the first hub centers set up by BISIH in 2019, to study the application of central bank digital currency in cross-border payments.

As with most innovations, fintech presents both risks and opportunities. Our authorities put great efforts in striking a right balance between providing appropriate flexibility for innovations and ensuring that customer interests are properly safeguarded. The authorities adopt a risk-based and technology-neutral approach in its supervision. A robust regulatory regime with sandboxes and initiatives will help pioneer fintech development in emerging areas. The authorities will continue to update the regulatory and supervisory framework to balance facilitating financial innovations against monitoring and assessing implied financial stability risks such as cybersecurity risks, liquidity risks, and concentration risk due to network effects.

Climate change

We welcome staff's acknowledgement of the comprehensive efforts being undertaken by the authorities to address climate change risks. The authorities are keenly aware that a global collective effort is required to combat climate change, and that the financial sector will play a crucial role in developing green and sustainable finance. The authorities will take forward the strategic plan announced in December 2020 for developing green and sustainable finance, and leverage Hong Kong SAR's role as an international financial center to mobilize capital towards sustainable projects in Asia. Building on the success of the issuance of the first batches of government green bonds, our authorities plan to issue green bonds regularly and will double the size of the Government Green Bond Programme to HK\$200 billion (around US\$25.6 billion) to allow for further issuance of green bonds within the next five years to support the Government's green projects and initiatives, in line with the Hong Kong SAR's target to achieve carbon neutrality before 2050. In November 2020, the HKMA entered into a partnership agreement with the International Finance Corporation (IFC) to become its first partner in the new Alliance for Green Commercial Banks to support financial institutions on their journey to become leading green banks. Under the Alliance, the HKMA will serve as the hub for green finance among commercial banks in Asia.