For Information

**Information Note for the**
**Legislative Council Panel on Financial Affairs**

**Responses to Repercussions Arising from the Referendum Result of the United Kingdom's Membership of the European Union**

## PURPOSE

This paper briefs Members of the repercussions arising from the referendum result of the United Kingdom ("UK")'s Membership of the European Union ("EU"), and the follow-up measures and contingency plans of the Government and the regulators.

## BACKGROUND

2. The UK's Referendum on 23 June 2016 voted in favour of leaving the EU ("Brexit"), leading to a spike in volatility and dramatic sell-offs in global risk assets. The full impact of Brexit is still to unfold, as the exit procedure could be complicated and could require multi-year negotiations. There could be a long period of political, economic and market uncertainty for the UK and the EU.

3. The UK needs to formally trigger the exit procedure by invoking Article 50 of the Lisbon Treaty. Thereafter, the UK will remain in the EU for at least two years while the terms of the exit and any subsequent relationships will be negotiated. However, if Brexit leads to prolonged global risk aversion and significant global market volatility, the potential second-round impact on Hong Kong could be more significant. The resultant persistent tightening in global financial conditions would lead to slower economic growth, fall in commodity and asset prices worldwide, as well as renewed strength of the US dollar ("USD"), all of which do not bode well for emerging market economies including Hong Kong. Nevertheless, such downside risk could be in part offset by the potential delay in the US Federal Reserve's monetary policy normalisation and extension of the existing ultra-loose monetary policies in the Eurozone and Japan.

## MARKET REACTION TO BREXIT

4. In Hong Kong, the Hang Seng Index ("HSI") declined 2.9% on 24 June (after the Brexit vote), and stocks with large exposures to the UK in particular recorded more significant losses. Amid easing worries over Brexit and signs of stabilisation in overseas markets, the local market recouped early losses with the HSI rebounding 1.2% (up to 6 July). Performance of major stock markets as of 6 July 2016 is at **Annex**.

5. On 24 June, turnover in the local stock market (Main Board) rose to $99.8 billion versus the daily average of $60.4 billion in the preceding week. During 27 June to 6 July, the average daily turnover eased back to $63.9 billion. The VHSI, a gauge of risk aversion of local investors, also rose from pre-Brexit level of 24.9 on 23 June to 28.2 on 24 June before falling back to 22.9 on 6 July.

6. On the foreign exchange front, most currencies depreciated against USD. In particular, the British Pound ("GBP") has plunged over 10% to a 31-year low, touching USD1.28 per GBP. The Euro ("EUR") also fell sharply, but to a lesser extent. Asian currencies in general fell but did better than other major currencies. In contrast, the Japanese yen ("JPY") appreciated against USD, with the exchange rate once dropping below JPY100 per USD.

7. Tracking the movement in the broad foreign exchange market, the Renminbi ("RMB") also depreciated against USD. The onshore RMB exchange rate ("CNY") depreciated from RMB6.57 per USD to around 6.69, down by about 1.8%. The offshore RMB exchange rate (CNH) also tracked CNY and weakened by 1.7%. Despite the downward pressure on RMB, the offshore RMB market operated in an orderly manner. Meanwhile, there was little impact on the Hong Kong dollar ("HKD"), which remained stable at around HKD7.76 per USD.

## HONG KONG'S FINANCIAL LINKAGES WITH THE UK

8. At present, there are four UK banking groups operating in Hong Kong. In terms of assets, they constitute approximately 30% of market share in the Hong Kong banking sector. As of end March 2016, the Hong Kong banking sector's claims on the UK accounted for 5% of its total assets. As part of its day-to-day supervisory work, the Hong

Kong Monetary Authority ("HKMA") observes that banks in Hong Kong generally do not maintain major open positions on foreign currencies, including GBP. Hong Kong banks' external claims and liabilities vis-à-vis the UK accounted for 9.3% and 9.4% of the respective total positions in March 2016.

9. In the stock market, UK-based intermediaries in Hong Kong accounted for 5.4% of trading activities in the cash market (April 2016). They contributed 5.7% of the trading in the HSI futures and options and 19.1% of the trading in the Hang Seng China Enterprises Index ("HSCEI") futures and options.

10. As of 30 June 2016, there were 92 UK-based intermediaries under the Securities and Futures Commission ("SFC")'s supervision, including 83 licensed corporations and nine registered institutions. As of 31 March 2016, there were 85 SFC-authorised funds that may have significant investment exposure to the UK or are domiciled in the UK.

11. Of the 161 authorised insurers in Hong Kong, 11 insurers were incorporated in the UK while 16 others are controlled by UK interest. These 27 insurers together take up 10.7% and 35.4% of the premium of the non-life and life insurance markets in Hong Kong respectively. According to the latest information available, Hong Kong insurers' aggregate exposure to the UK is immaterial.

12. As of 30 June 2016, out of a total of 462 Mandatory Provident Fund ("MPF") constituent funds ("CFs"), there were 11 European equity funds investing broadly in the European market including the UK, with none of them investing solely in the UK market. As at the valuation day of 30 June 2016, the total exposure of MPF CFs to EUR- and GBP-denominated assets was $37.6 billion (of which $13.9 billion was denominated in GBP), less than 10% of the total assets in the MPF System.

**MEASURES IMPLEMENTED PRIOR TO THE UK'S REFERENDUM**

13. In light of the highly uncertain outcome of the UK's Referendum and its evolvement, HKMA had been closely monitoring the HKD money and currency markets, and stood ready to provide liquidity support to banks if needed. HKMA had also monitored banks' financial positions and risk exposures closely, and conducted regular stress tests to

ensure that banks had sufficient capital and liquidity to withstand significant market shocks.

14. Before the UK's Referendum, SFC discussed with the Hong Kong Exchanges and Clearing Limited ("HKEX") to assess and prepare for the potential impact arising from Brexit. SFC also maintained close contact with HKEX as regards the settlement status of exchange participants. In addition, HKEX has an established mechanism in place to monitor and manage its risk exposure arising from market volatility. In particular, HKEX performs regular assessments including stress tests to ensure that its clearing houses maintain sufficient financial resources to cover the risk exposures to market participants at times of extreme market volatility.

15. SFC also closely monitored the financial conditions of securities brokers and leveraged foreign exchange trading ("LFET") firms by way of performing stress tests to ascertain their ability to respond to market volatility. Enquiries were made to some thinly capitalised securities brokers as identified under SFC's stress tests to obtain an understanding of their financial status and operations, and no major problem was reported by these brokers. Based on SFC's stress test and enquiries, all the LFET firms with significant positions were found to be able to withstand a significant adverse movement in their foreign exchange positions. Most of the active LFET firms advised that they had raised the margin levels for GBP-related contracts, and no major client risks were reported.

16. SFC also maintained close monitoring of the liquidity of SFC-authorised listed and unlisted funds in view of the volatility and uncertainty in local and international markets, and it had been in contact with SFC-authorised listed and unlisted funds as well to remind them to keep track of the trading and liquidity requirements of the funds.

17. The Insurance Authority ("IA") conducts stress tests regularly on all insurers. The results revealed that they were able to sustain adverse scenarios, such as a drop in equity value and movements in interest rates. For life insurers, as their insurance liabilities are mainly long-tail by nature, they are required to regularly submit dynamic solvency testing ("DST")[1] reports on adverse scenarios which include a

[1] Dynamic Solvency Testing is one of the regulatory tools in analysing and projecting the trends of the financial position of an insurance company under a variety of future scenarios relating to changes in interest rates, equity and real estate values, mortality and morbidity rates, business

drop in equities value and movements in interest rates. There is also a legal requirement for currency matching of insurance liabilities with assets. Therefore, some life insurers with currency exposure to GBP have already put in place foreign exchange hedge to reduce the volatility of their balance sheets due to currency movements, while others have carried out scenario tests on their balance sheet, which include possible impacts of Brexit.

18. Notwithstanding the volatile external environment, the local banking and financial systems, the foreign exchange and money markets, and the securities and futures markets have been functioning properly and remain in good order.

19. While the outcome of the Brexit Referendum resulted in increased volatilities in the financial markets, HKMA so far has not seen any material impact on the Hong Kong banking system which remains highly liquid and resilient to market volatilities.

20. The interbank market in Hong Kong also continues to function normally, without any signs of liquidity issues. Unlike that in the 2008 global financial crisis, there have been no signs of systemic seizure in interbank funding market. The HKD interbank interest rates have remained steady as well.

21. Despite higher market volatility after the UK's Referendum voted in favour of Brexit, Hong Kong's stock and derivative markets have been operating in an orderly manner. The total open positions of HSI and HSCEI futures and options remain at a similar level from the previous month, and no significant built up of open positons was noted. Meanwhile, all intra-day margin calls for the futures and options markets are confirmed settled, and the financial resources of the clearing houses of HKEX have remained sufficient to withstand the potential losses under the stress scenarios.

22. Moreover, SFC has not received any reports on liquidity problem in meeting redemption requests or suspension of redemptions by SFC-authorised funds. For SFC-authorised unlisted structured investment products, SFC also has not received any complaints from investors or notifications from issuers/product arrangers regarding any irregularity affecting such unlisted structured investment products.

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growth, etc.

23. In the insurance market, no adverse movements have been observed and the market continues to operate in an orderly manner. At this stage, UK-based insurers are still monitoring the developments of Brexit and the possible impacts on their Hong Kong business. Operations in the MPF sector remain orderly as well. No approved trustees have reported any operational disruptions due to Brexit so far.

## CONTINGENCY PLANNING

24. Regarding Hong Kong's economic ties with the UK and the EU, the EU was Hong Kong's third largest market (after Mainland and the US) for merchandise exports, amounting to $335 billion and accounting for 9.3% of the total in 2015 (with exports to the UK amounting to $55 billion and accounting for 1.5% of the total in 2015). Hong Kong is also an important operational base for both EU and UK companies. As of June 2015, more than 1 100 regional headquarters and regional offices were set up by EU companies in Hong Kong, of which around 350 were from the UK.

25. As the UK will negotiate with the EU and other economies on their future economic relationship, the associated uncertainties will persist for a prolonged period, which would have negative impacts on the UK economy, adding hurdles to the fragile recovery of the European economy. Given the already-subpar global economic conditions, the possible knock-on impacts on the European and global economy down the road still cannot be ruled out. If such an adverse scenario occurs, there would be increased ramifications on Hong Kong's economy as well as financial markets through trade and financial channels.

26. The Government and the regulators will stay vigilant under the uncertain external environment and will continue to make use of a number of standing cross-sectoral platforms, such as the Council of Financial Regulators ("CFR") and the Financial Stability Committee ("FSC") to facilitate exchanges of information and views on the latest development in the financial markets, with a view to maintaining financial stability in Hong Kong[2].

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[2] The CFR aims to strengthen the efficiency and effectiveness of regulation and supervision of financial institutions, promote and develop the financial markets, and maintain financial stability in Hong Kong.
The FSC is tasked to monitor on a regular basis the functioning of the financial system of Hong Kong. It deliberates on events, issues and developments with possible cross market and systemic implications, and where appropriate, formulate and coordinate responses.

27. Regulators will also maintain contact with their overseas peers to understand whether there are any potential risks arising from the operational and financial situation of foreign financial institutions.

28. HKMA has been monitoring developments in relation to the UK's Referendum. Before the vote took place, HKMA had asked banks in Hong Kong to assess the potential impact of a Brexit vote on their financial positions, and make appropriate preparations. HKMA will continue to closely monitor the development and assess its implications on the Hong Kong banking system, and will also maintain close dialogue with the banking supervisory authority in the UK regarding the impact of Brexit on those UK banking groups which have significant presence in Hong Kong.

29. As investor sentiment remains fragile given uncertainties over the prolonged Brexit negotiations as well as the economic and financial implications, shrinking risk appetite may lead to capital outflows from regional markets and risky assets, including Hong Kong equities. SFC will continue to monitor the situation and market operation closely. SFC has established a market contingency plan to deal with different market scenarios, and will continue to maintain a close dialogue with market participants to monitor the situation and assess if any precautionary measures should be considered.

30. In addition, SFC will stay alert to the financial situation of securities brokers and LFET firms, the liquidity of SFC-authorised listed and unlisted funds, and the credit standing (including credit ratings and credit default swap levels) of the issuers of unlisted structured investment products.

31. The IA has reviewed the latest solvency positions of insurers and confirmed all their solvency ratios are above the statutory requirement. An additional round of DST has been performed by all life insurers upon IA's instruction with satisfactory results. Moreover, the IA has established close contact and discussion with the UK prudential regulator for coordinated measures to be carried out by both regulators to strengthen supervisory measures after Brexit. The IA will continue to closely monitor the financial position of insurers in Hong Kong.

## CONCLUSION

32. The Government and the regulators will continue to closely monitor the latest development of the global and local financial markets in response to Brexit, and will act swiftly as and when necessary to ensure the proper functioning of our financial markets.

**Financial Services and the Treasury Bureau**
**Hong Kong Monetary Authority**
**Mandatory Provident Fund Schemes Authority**
**Office of the Commissioner of Insurance**
**Securities and Futures Commission**
**July 2016**

**Annex**

# Performance of Major Stock Markets (as of 6 July 2016)

| | | Index (6 July) | % change on 24 June 2016 | Cumulative % change since 23 June 2016 | Year-to-date % change |
|---|---|---|---|---|---|
| **Hong Kong and the Mainland** | | | | | |
| Hong Kong | -HSI | 20,495.29 | -2.9% | -1.8% | -6.5% |
| China | -Shanghai Comp | 3,017.29 | -1.3% | +4.3% | -14.7% |
| **Asia** | | | | | |
| Japan | -Nikkei 225 | 15,378.99 | -7.9% | -5.3% | -19.2% |
| Australia | -AOI | 5,284.71 | -3.1% | -1.4% | -1.1% |
| Taiwan | -TWSE | 8,575.75 | -2.3% | -1.2% | +2.9% |
| Korea | -KOSPI | 1,953.12 | -3.1% | -1.7% | -0.4% |
| **US** | | | | | |
| US | -Dow | 17,918.62 | -3.4% | -0.5% | +2.8% |
| | -Nasdaq | 4,859.16 | -4.1% | -1.0% | -3.0% |
| | -S&P | 2,099.73 | -3.6% | -0.6% | +2.7% |
| **Europe** | | | | | |
| UK | -FTSE100 | 6,463.59 | -3.1% | +2.0% | +3.5% |
| Germany | -DAX | 9,373.26 | -6.8% | -8.6% | -12.8% |
| France | -CAC | 4,085.30 | -8.0% | -8.5% | -11.9% |