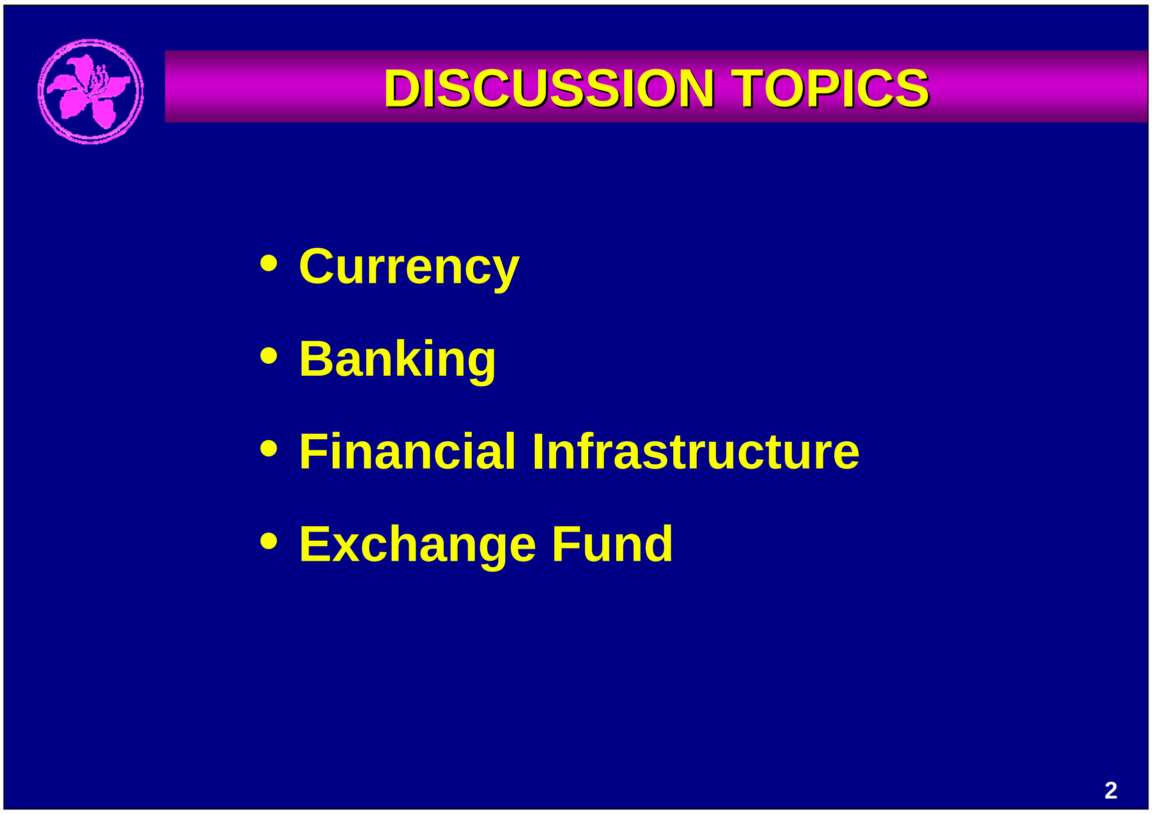
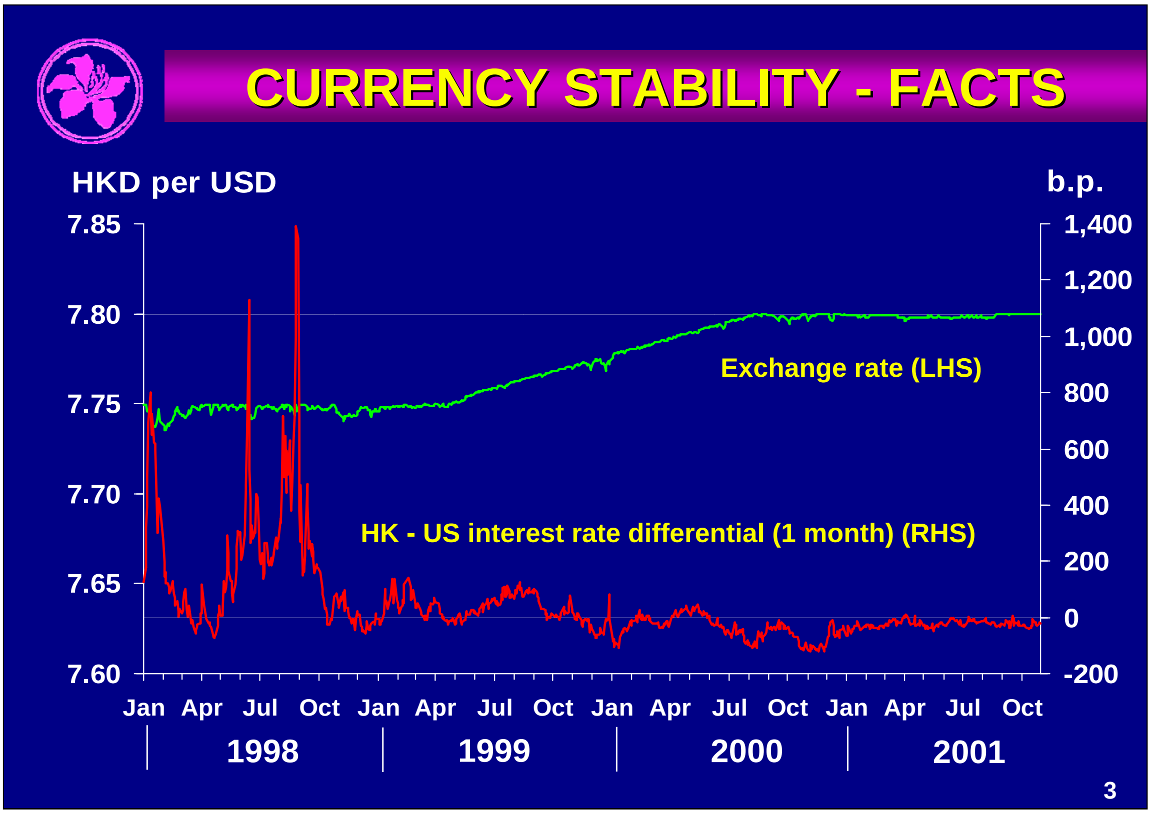
HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

5 November 2001

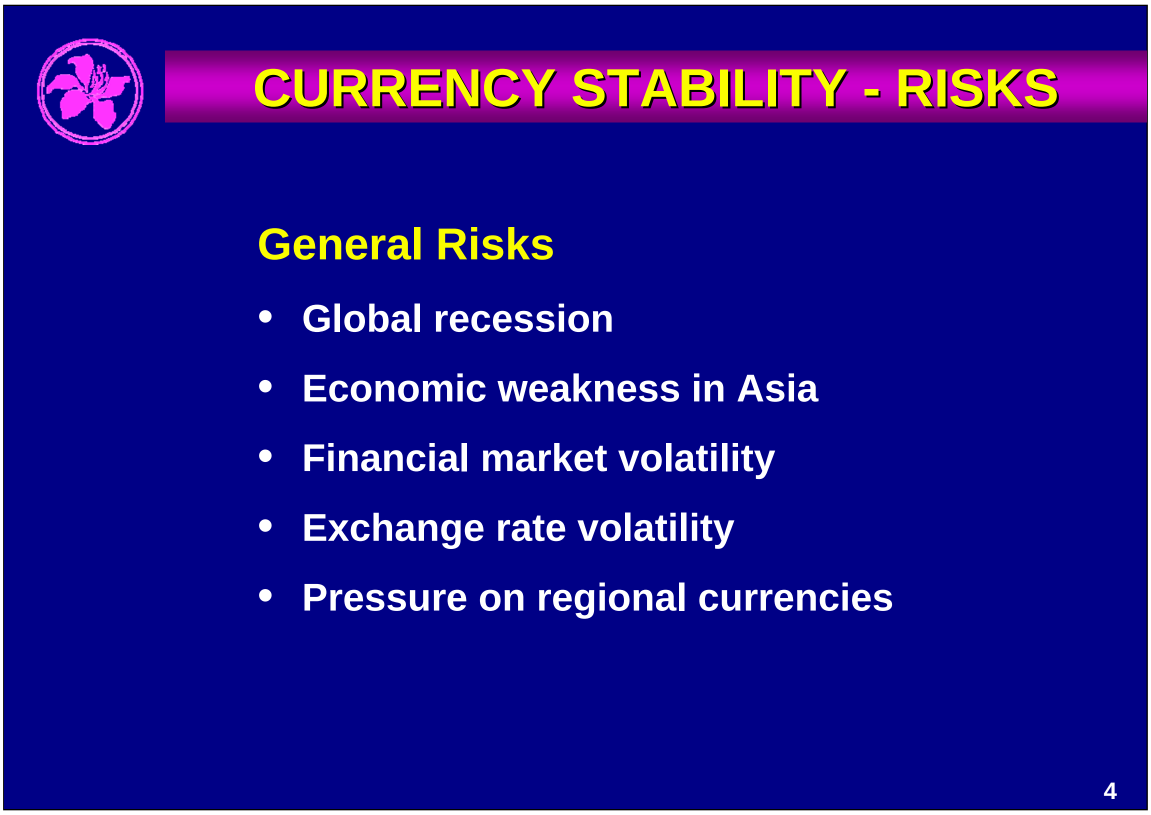


- This presentation covers the four key responsibilities of the HKMA:
  - to maintain currency stability, within the framework of the linked exchange rate system;
  - to promote the safety and stability of the banking system;
  - to enhance the efficiency, integrity and development of the financial infrastructure, particularly payment and settlement arrangements; and
  - to manage the Exchange Fund in a prudent manner.



- The monetary policy objective of the HKMA is to maintain exchange rate stability under the linked exchange rate system. The Hong Kong dollar exchange rate has continued to be stable against the US dollar.

- Although the external environment has turned less favourable, interbank interest rates have remained stable, staying close to their US dollar counterparts.



- **The risk of a global recession** grew further in the wake of the terrorist attacks in the US. The world economy is now exposed to three main risk factors: (1) a further slowdown in the US induced by a deterioration of consumer and business confidence; (2) the effects of US slowdown on the rest of the world through the trade and financial market channels; and (3) the uncertainty brought by protracted war in Afghanistan.

- **Economic weakness in Asia** heightens the vulnerability of the region to the global economic downturn. The region already suffered from an export slump before the attacks in the US. The electronics-heavy exporting economies of Singapore and Taiwan registered record levels of economic contraction. The crisis-hit economies continue to be fraught with weaknesses in their banking and corporate sectors. Japan remains in the doldrums, with shrinking activity, falling exports, rising unemployment, and a weak banking sector.

- **Financial market volatility** can be exacerbated by uncertainties in the global economic outlook. Increased risk aversion among investors has reduced their appetite for financial assets in emerging markets, putting increased strains on these economies.

- Risk of increased **exchange rate volatility** grows. The attacks in the US and its ensuing events create uncertainties in the direction of the US dollar movement. Any increased volatility on capital flows to emerging markets would likewise affect their exchange rates.

- The above risk factors may lead to increased **pressure on regional currencies,** most of which are now under some form of floating exchange rate regime.

CURRENCY STABILITY - RISKS

Hong Kong Specific Risks

- Currency board of Argentina
- Hong Kong markets used for proxy hedge against Asian risks
- RMB exchange rate policy
- Public finances in Hong Kong
- Support for and confidence in the Link

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- **Argentina,** which is also running a currency board regime, has been under immense pressure. Fears of debt default grew as the cash-strapped government failed to reach agreement on fiscal cuts with opposition dominated provinces. Its stock prices fell sharply and bond spreads widened. It is the view of some people that Argentina's problems stem from an inconsistency between its fiscal deficit and external indebtedness, on the one hand, and its exchange rate regime on the other. While such an inconsistency is not present in our case, we would keep a watchful eye on its developments and the potential implications for our markets. So far, we have not seen any significant contagion effect, reflecting investors' differentiation between markets of different fundamentals.

- There is an increasing risk that **Hong Kong markets may be used as a proxy hedge**. In the absence of capital controls, our liquid financial markets are sometimes used by investors as a proxy hedge for their investment in regional economies, which impose various degrees of controls, or do not have a fully convertible currency or an active forward market (such as Mainland China).

- Market concerns about the **exchange rate policy of the Renminbi**, especially after China's accession to the WTO, may lead to a perception of a greater risk for the Hong Kong dollar.

- Prudence in **public finances in Hong Kong** has been a linchpin of the linked exchange rate system. Amid the cyclical downturn, there are growing demands for increasing government expenditure. Such calls have to be considered carefully, having regard to medium-term fiscal sustainability.

- The **Link** is often blamed for the problems we face during an economic downturn. Our view remains that the Link provides a stable, predictable and well understood monetary system that is well suited to Hong Kong's highly external and flexible economy and to its position as an international financial centre. The Link enables Hong Kong's economy to adjust to external shocks and maintain its competitiveness without the damage and volatility of a sudden currency collapse. It provides Hong Kong with a firm monetary anchor which, among other things, reduces the foreign exchange risk faced by importers, exporters and international investors. The disadvantages of the Link are that it ties Hong Kong to US monetary policy at times when the economic cycles of Hong Kong and the US may not necessarily be moving in tandem (although this is not the case at present), and that it rules out the use of nominal exchange rate movements as a mechanism of adjustment. Nevertheless, the advantages of the Link far outweigh its disadvantages, and there is no better and less risky alternative available to Hong Kong.

- The link to US interest rates is almost certainly helpful at the present point of our economic cycle. Without the link there would be a strong likelihood of Hong Kong interest rates being higher that they are now.

- Accusations that the Link prevents Hong Kong's competitiveness from adjusting are not supported by the evidence. (If the Hong Kong dollar depreciated we would suffer higher import prices etc and it's not clear that the public would be any happier with that than they are with the recent bout of domestic price deflation.

- The 12-month forward points on the Hong Kong dollar provide a barometer of the conditions of the money markets in Hong Kong. The 12-month forward points gradually declined after the subsidence of the Asian financial crisis and the introduction of the technical measures to strengthen the Currency Board system in August 1998. They have, on the whole, stayed close to zero since mid-2000.

- In April, owing to unfavourable external developments, including renewed weakness in regional currencies and escalating Sino-US tensions, the forward discount disappeared and a small premium of around 450 pips emerged.

- In October, worsening conditions in Argentina, and rumours about possible alterations of the Link, have led a rise in the forward point to around 200 pips. This is, however, no higher than the pre-crisis average of 240 pips, and far below the high of nearly 8,000 pips during the Asian financial crisis.

BANKING STABILITY - FACTS

Capital adequacy ratio ^	:	18.0%
Liquidity ratio ^	:	45-55%
Net interest margin ^	:	2.17%
Classified loans ^	:	6.81%
Mortgage delinquency ratio “	:	1.28%
Credit card receivables - delinquency ratio “	:	1.13%
- charge-off ratio ◊	:	4.75%
Growth of total Hong Kong dollar deposits *	:	0.3%
Growth of total domestic lending *	:	- 1.7%

^ *Figure as at end-June 2001*
“ *Figure for September 2001*
◊ *Figure for the September 2001 quarter*
* *Quarterly change between September and June 2001*

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- **Banks in Hong Kong** have been operating under less than desirable conditions: domestic lending continued to shrink and competition on residential mortgage loans and other forms of lending remained intense, leading to a decline in net interest margin. While the asset quality figures still look satisfactory, with the economic slowdown and the rising trend of bankruptcies, the situation is expected to be somewhat adversely affected. Notwithstanding the difficult operating environment, the capital strength of local authorized institutions (AIs) remained strong.

- Reflecting faster growth in risk assets than in capital base, the average consolidated **capital adequacy ratio** of all locally incorporated AIs declined slightly to 18% at end-June from 18.3% at end-March.

- The aggregate average **liquidity ratio** of local banks remains in the 45 -55% range, well above the statutory minimum of 25%.

- Reflecting the fall in net interest income caused by the continued squeeze in lending margins, the annualised **net interest margin** fell to 2.16% in the first half of the year from 2.39% in the same period last year. Nonetheless, it rose in the June quarter to 2.17% from 2.15% in the previous quarter.

- **Asset quality of local banks** continued to be satisfactory as reflected by the following:

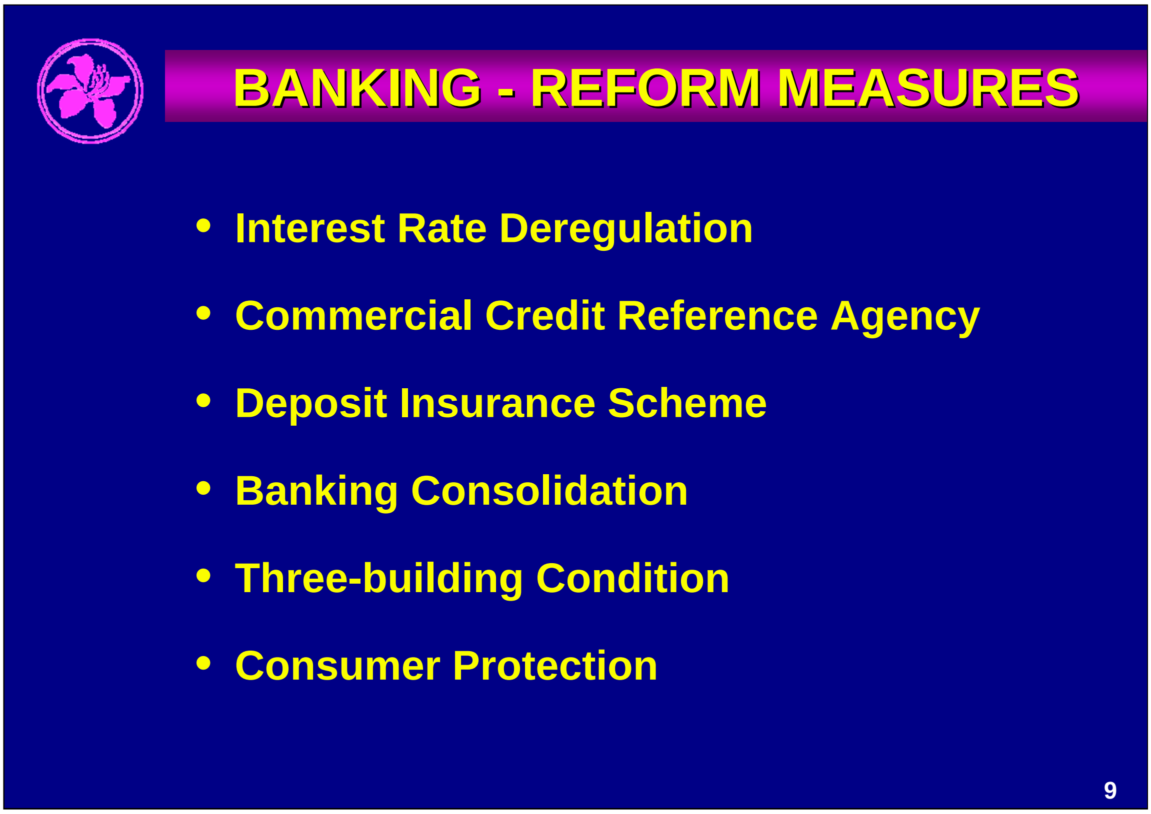
    - **classified loans** as a percentage of total loans fell from 7.12% to 6.81% between March and June 2001;

    - the delinquency ratio of **residential mortgage loans** (measured by residential mortgage loans overdue for more than three months as a percentage of the total mortgage portfolio) remained the same at 1.28% for September 2001, following a decline for four consecutive months from April to August 2001.

- The quality of **credit card receivables** continued to deteriorate. The delinquency ratio (measured as receivables overdue for more than 90 days as a percentage of total receivables) rose to 1.13% at end-September from 1.0% at end-June. The annualised charge-off ratio also rose, to 4.75% in the September quarter from 4.6% in the June quarter.

- **Hong Kong dollar deposits** grew marginally by 0.3% in the September quarter, after growing by 0.2% in the preceding quarter.

- The decline in **domestic lending** accelerated to 1.7% in the September quarter, from a decline of 0.4% in the preceding quarter. The decline was mainly attributable to further drops in loans for financial concerns and property development, which were in line with the developments in the financial and property markets.



- The HKMA is making good progress in banking sector reforms:

  - **Interest Rate Deregulation** - since 3 July 2001 Hong Kong banks have been able to compete for deposits freely on a price basis. While the actual impact of deregulation depends on the prevailing market conditions, the deregulation has the merits of encouraging more innovation in the banking industry and promoting consumer choice. The introduction of combined savings and current accounts and HIBOR-based savings products by some banks is a case in point.

  - **Commercial Credit Reference Agency** - the Working Group is continuing with the detailed design of the scheme to enhance the safety and efficiency of banks' financing of small and medium-sized enterprises in Hong Kong. It has made good progress in drawing up a framework to protect privacy under the scheme. We are still considering whether a voluntary scheme in which banks share credit information through the CCRA rather than a mandatory scheme would better serve the policy objectives. It is expected that a coherent set of recommendations will be ready for public consultation in 2002.

  - **Deposit Insurance Scheme** - the HKMA has issued two discussion papers, one on funding and premium assessment and the other one on reimbursement netting, to the banking industry for comment. After receipt of comments, a set of final proposals on these and other aspects of the scheme will be released for consultation with the industry in the first quarter of 2002.

- **Banking Consolidation** - the pace of consolidation is picking up in Hong Kong. CITIC Ka Wah Bank just announced that it would pay HK$4.2 billion to buy The Hongkong and Chinese Bank. Earlier this year, Development Bank of Singapore acquired Dao Heng Bank. Two Mainland banks, Bank of China and ICBC, also consolidated their Hong Kong operations. The Bank of China move was particularly significant since it has created the second largest banking group incorporated in Hong Kong. The HKMA will not mandate "forced marriages" but will encourage banks to make consolidation a part of their strategic planning.

- **Three-building Condition** - this condition which is applicable to foreign banks licensed since 1978 is due to be removed before the end of 2001. Its removal will help promote Hong Kong's status as an open financial centre.

- **Consumer Protection** - the HKMA is awaiting public responses to our comparative study of banking consumer protection arrangements, including a response from the Legislative Council which is conducting its own study on consumer protection. The revised Code of Banking Practice has been finalized and will shortly be ready for publication. The HKMA will also issue a guideline on complaint handling procedures to AIs in Hong Kong. This guideline will further improve standards of service within the banking industry and increase customer confidence in banks.

BANKING - CURRENT ISSUES

- Terrorist Financing / Money Laundering
- Negative equity
- Bankruptcies
- New Capital Accord
- Banking (Amendment) Bill 2000
- Banking (Amendment) Bill 2001

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- The HKMA has also been actively addressing a number of major supervisory issues:

  - **Terrorist Financing / Money Laundering** - the HKMA pledges full support to the global effort on the combat against terrorism. As a bank regulator, we have issued several circulars to AIs to ask them to be fully alert to the possible existence of terrorist funds. We also take a serious approach towards the prevention of money laundering in the banking sector - AIs are reminded of the statutory obligation under the Organised and Serious Crimes Ordinance to report suspicious accounts to the Joint Financial Intelligence Unit. Hong Kong has a strong reputation in this regard and this is recognised by international bodies including the Financial Action Task Force on Money Laundering. We have also been working with the relevant Government departments on the implementation of the relevant UN sanctions in Hong Kong.

  - **Negative Equity** - the issue will be discussed under a separate agenda item.

- **Bankruptcies** - the HKMA has joined force with the Hong Kong Association of Banks and the Financial Services Bureau, the Official Receiver and the Privacy Commissioner in a high level roundtable discussion to address the rising trend in personal bankruptcy. One of the measures identified is to expand the scope of consumer credit data sharing to include more positive data, with a view to enhancing credit risk assessment by banks. We have also written to AIs to remind them of the need to maintain prudent credit standards and to encourage them to make fuller use of existing credit reference agencies within the limits laid down by the Privacy Commissioner.

- **New Capital Accord** - the Basel Committee on Banking Supervision has proposed major changes to the existing 1998 Capital Accord, which sets out a more risk-sensitive framework for measuring the capital adequacy of banks with the overall objective of promoting soundness and stability in the international banking system. The HKMA has started to consult the banking industry on the necessary steps to be taken to ensure that the scheduled implementation in 2005 can be achieved smoothly and in time. It issued for industry consultation on 3 October 2001 its preliminary proposals on the introduction of the New Accord in Hong Kong and recommendations for banks to enhance their internal rating systems in line with the Basel requirements.

- **Banking (Amendment) Bill 2000 -** the Bills Committee on the Securities and Futures Bill and the related Banking (Amendment) Bill 2000 has completed the final stage of clause-by-clause examination of the Bills.

- **Banking (Amendment) Bill 2001** - The Bill was introduced into the Legislative Council on 4 April 2001. A Bills Committee has been formed to study the various proposals in the Bill.

FINANCIAL INFRASTRUCTURE

Functioning smoothly

- **Hong Kong's payment systems continued to function smoothly in the aftermath of 11 Sept**
- **The event highlights the importance of Hong Kong's US dollar clearing system in the reduction and diversification of risks**
- **We will encourage greater usage of the US dollar clearing system**

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- Our Hong Kong dollar and US dollar payment systems continued to function smoothly following the tragic events in the United States on 11 September.

- The events in the United States have prompted us to look at our own contingency plans, especially for crucial operations, such as our payment and settlement systems. These plans had already been greatly expanded and rigorously tested in advance of the Y2K transition. They cannot specifically address every possible disaster but we are confident that they are robust and flexible enough to enable us to maintain our core operations in all but the most unmanageable situations. We will however be considering with the industry what lessons can be learned from 911 with regard to disaster recovery.

- 11 September has reminded us of the risk of serious disruptions to the global settlement system and has underlined the importance of our US dollar clearing system as a risk management service. Clearly, greater use of the local system for real-time settlement of Hong Kong dollar versus US dollar transactions would bring real benefits in terms of reduction and diversification of risk. We shall be talking to banks to encourage greater usage of the US dollar clearing system.

FINANCIAL INFRASTRUCTURE

Projects

- **Upgrade of CMU into an International Central Securities Depository (ICSD)**
- **Money settlement for CCASS items**
- **Joint cheque clearing with Mainland cities**
- **Development of the retail bond market through Hong Kong Mortgage Corporation debt issues**

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- The CMU is seeking to play a role in Asia more akin to that of an international central securities depository (ICSD). We will extend the existing one-way linkage from Euroclear to CMU to a two-way linkage and to modernise the features of the CMU system. The development of CMU into an ICSD will facilitate cross-border holding and trading in debt securities, and hence will be conducive to the development of a regional debt market in Asia. We expect to complete the two-way linkage with Euroclear and the modernisation of the CMU by end-2002.

- The HKMA chairs a Working Group on Money Settlement for CCASS items to improve the settlement processing of equities and to promote system enhancements to facilitate both institutional and retail Delivery versus Payment (DvP). The Working Group has identified deficiencies in the money settlement arrangement for CCASS items and has proposed a number of recommendations.

- The HKMA is working with the Mainland authorities on extending the existing one-way Hong Kong dollar cheque clearing in Guangdong Province / Shenzhen to a two-way cheque clearing arrangement to cover Hong Kong dollar cheques drawn upon banks in Guangdong / Shenzhen and presented in Hong Kong.

- The current market conditions are ideal for building a critical mass for the retail bond market. With deposit rates at historical low levels and the lack of attractive investment alternatives, retail investors have a strong appetite for bonds, which offer a yield pick-up and a stable return. Against this background, we have been seeking to develop Hong Kong's retail bond market through debt issues by the Hong Kong Mortgage Corporation.

FINANCIAL INFRASTRUCTURE

- Retail Payment Systems Review : results indicate that Hong Kong's retail payment systems function well
- Recommendations on : cash, cheques, credit and debit cards, stored value cards, and e-payment and e-legal tender
- Progressive approach to improve regulatory oversight for stability, efficiency and competitiveness of Hong Kong's retail payment systems

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- The HKMA has completed a review of retail payment systems in Hong Kong. The Review has concluded that the retail payment systems generally function well. They are considered to be efficient and effective, and there exists a wide range of payment instruments. There are no major shortcomings in the retail payment systems that pose a risk to the systemic stability of Hong Kong's financial system or to public confidence.

- To reinforce the efficiency and effectiveness of existing retail payment systems, the Review makes a number of recommendations with respect to different retail payment channels as well as the appropriate regulatory approach for oversight of retail payment services in Hong Kong:

  - **Cash** – the Review notes that a review of the design and security of bank notes is making good progress, paving the way for the launch of a new generation of banknotes.

  - **Cheques** – there is merit in extending the existing joint cheque clearing service in Shenzhen and cities in Guangdong to US dollar cheques issued by banks in Hong Kong.

  - **Credit and debit cards** – the Review sees benefits in the ready availability of credit checking facilities and the sharing of positive credit data of individuals through a credit reference agency. An appropriate framework to foster greater transparency in fee setting for credit and debit cards is also needed.

- **Stored value cards** – the Review concludes that it is appropriate that the operation of stored value cards should continue to be regulated by the HKMA as a licensed deposit-taking company under the Banking Ordinance. There is no current concern over erosion of seignorage because of increased usage of multi-purpose stored value cards, but the Review notes that this topic may require reconsideration at some stage.

- **E-payment and e-legal tender** – the Review sees the benefits in a wider availability of cost-efficient facilities for e-payments to be settled across interbank accounts to facilitate e-trading.

- **Regulatory approach -** the Review suggests a progressive approach to improve regulatory oversight in Hong Kong. The recommendation is to introduce a self-regulatory approach, under which the industry would draw up codes of practices and also monitor compliance with such codes by the trade, while the HKMA would oversee the overall implementation of such approach.

• The recommendations in the Review have been considered and endorsed by the Competition Policy Advisory Group, the Committee on Payment Systems and the Exchange Fund Advisory Committee.

• As a next step, the HKMA will hold discussions with the payment system operators and the participants in the retail payment systems to follow up on the recommendations in the Review.

EXCHANGE FUND BALANCE SHEET

(HK$ million)	31 Dec 2000	31 Mar 2001	30 Sept 2001
ASSETS			
Foreign currency assets	856,680	911,880	901,312
Hong Kong dollar assets	166,683	131,883	90,921
Total Assets	1,023,363	1,043,763	992,233
LIABILITIES AND ACCUMULATED SURPLUS			
Monetary base*	215,140	216,469	231,858
Placements by other Hong Kong Special Administrative Region government funds	417,162	439,228	381,342
Placements by other institutions	45,049	81,853	69,253
Other liabilities	38,913	10,315	13,528
Total Liabilities	716,264	747,865	695,981
Accumulated surplus	307,099	295,898	296,252
Total liabilities and accumulated surplus	1,023,363	1,043,763	992,233

** The monetary base includes interest payable on Exchange Fund Notes and net accounts receivable which are not included here.*

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- The total assets of the Exchange Fund amounted to HK$992.2 bn as at end-September 2001, which was HK$8.2 bn lower than at end-August 2001.

EXCHANGE FUND PERFORMANCE

(HK$ billion)	2000 Full year	2001 Jan-Mar	2001 Apr-Sep	2001 Jan-Sep
Gain / (Loss) on HK equities*	(7.3)	(20.4)	(19.6)	(40.0)
Exchange gain / (loss)	(11.2)	(11.8)	5.4	(6.4)
Total return on bonds, etc	63.6	17.6	22.6	40.2
Investment income	45.1	(14.6)	8.4	(6.2)
Other income	0.2	0.1	0.1	0.2
Interest and expenses	(11.0)	(2.8)	(5.1)	(7.9)
Net investment income	34.3	(17.3)	3.4	(13.9)
Treasury's share	(18.1)	6.1	(3.0)	3.1
Increase / (decrease) in EF accumulated surplus	16.2	(11.2)	0.4	(10.8)

** including dividends*

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- The very difficult investment environment in the first three months of the year continued through the summer into the fall. The Hang Seng Index continued its downward spiral to bring about a loss of about HK$40 bn in the Hong Kong equity portfolio (a loss of HK$20.4 bn in Q1 2001 followed by a further loss of HK$19.6 bn in Q2 and Q3 2001).

- In Q2 and Q3 2001, the euro and the yen recovered somewhat against the US dollar, and hence the Hong Kong dollar - the accounting currency of the Exchange Fund. The exchange gain of HK$5.4 bn for the period reduced the total foreign exchange loss to HK$6.4 bn from HK$11.8 bn at the end of Q1 2001.

- Our bond portfolios performed well under the combined impact of a weak US economy and the September 11 event. Revaluation and interest income from bonds amounted to about HK$40.2 bn (total return of HK$17.6 bn in Q1 2001 and a further gain of HK$22.6 bn in Q2 and Q3 2001).

- Adding the other income and deducting the usual interest expense and other expenses, the net investment loss in the first nine months of 2001 amounted to HK$13.9 bn (a loss of HK$17.3 bn in Q1 2001 and a gain of HK$3.4 bn for Q2 and Q3 2001).

- The fiscal reserves share of this net investment loss on the basis of the sharing arrangement effective from April 1998 was HK$3.1 bn for the nine months of 2001 (a loss of HK$6.1 bn for Q1 2001 and a gain of HK$3.0 bn for Q2 and Q3 2001).

- Return sharing arrangement with Treasuryˆ:

Calendar Year	
1998*	HK$25,996 mn
1999	HK$45,407 mn
2000	HK$18,052 mn
2001 (to end-September)	(HK$3,112 mn)

ˆ *The Treasury decides when the return to Treasury should be settled.*
* *The return sharing arrangement started on 1 April 1998.*

- It is too early to assess the impact of the September 11 event on the US and global economy. The financial markets are expected to remain volatile and the investment climate for the balance of the year and going into early 2002 will be uncertain. It is therefore too early to tell how the Exchange Fund will perform for the full year 2002.

EXCHANGE FUND - HK Equity Portfolio

		(HK$ billion)
Investment in August 1998		118.1
Income from Disposal and Dividends (end-Sep 2001)		138.4
Size of remaining portfolio (end-Sep 2001)		74.2
Disposal	24.6	
Long Term Investment *	49.6	

* *Including HK equities transferred from the Land Fund in 1998 (valued at HK$9 billion in 1998)*

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- We have already fully recouped the investment of HK$118.1 billion in August 1998.

- Through the offer of the Tracker Fund and the subsequent well established mechanism of the Tap Facility, we have managed to dispose of a substantial portion of Hong Kong stocks without any noticeable effect on the market. Up to end-Sept 2001, the total (net) income from disposal and dividends amounted to HK$138.4 billion.

- At the end of September 2001, we still had HK$74.2 billion in Hong Kong stocks. This included the Hong Kong equities transferred from the Land Fund in 1998, which was valued at HK$9 billion at the time of transfer.

- Of the remaining Hong Kong equity portfolio, we intend to keep 5% of the size of the Exchange Fund (i.e. HK$49.6 billion as at end-September 2001), in accordance with the investment guideline of the Exchange Fund. Exchange Fund Investment Limited will continue to manage the disposal of the excess in an orderly way with minimum disruption to the market, just as it has done with the disposal so far.

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