



HONG KONG MONETARY AUTHORITY

**Briefing to the Legislative Council
Panel on Financial Affairs**

6 May 2002



DISCUSSION TOPICS

Annual Report 2001

Progress on key responsibilities

- **Currency**
- **Banking**
- **Financial infrastructure**
- **Exchange Fund**

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- The Hong Kong Monetary Authority Annual Report 2001 was released on 30 April. Since Members have been well briefed on the work of the HKMA through previous meetings, we do not intend to go into the details of our work and achievements in 2001. However, we would like to mention briefly our efforts to enhance our transparency and accountability to the community, as noted in the Annual Report, before moving to other discussion topics.
- This presentation will cover 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 sound and prudent manner.



ANNUAL REPORT 2001 TRANSPARENCY & ACCOUNTABILITY

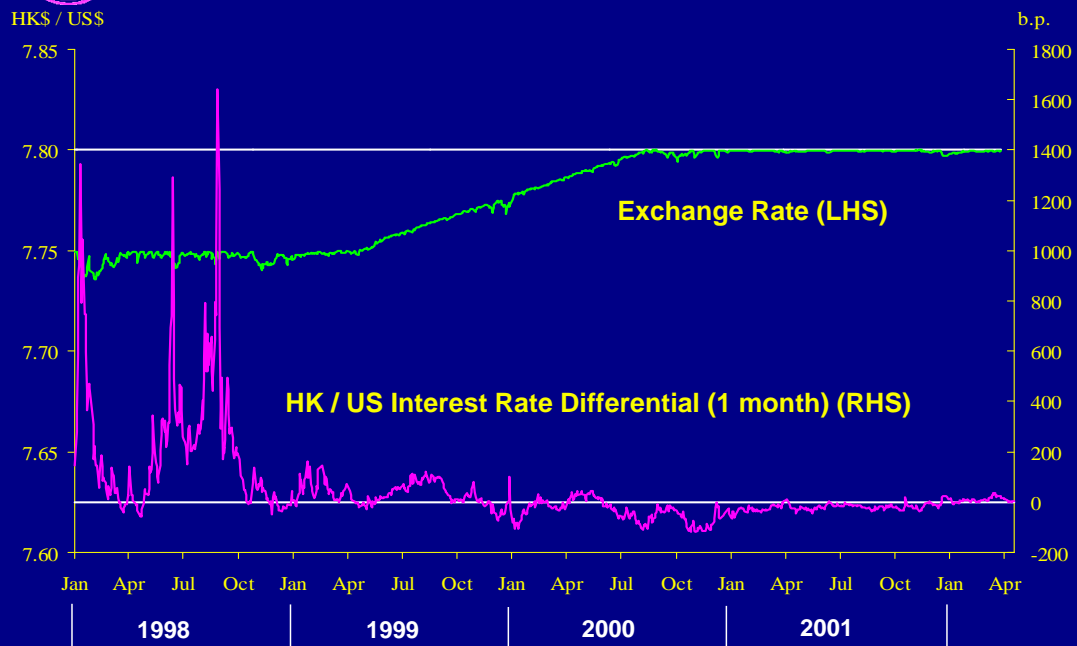
- **Public education -- 2nd summer exhibition, education programmes for schools, etc**
- **Contacts with legislators -- quarterly briefings, attendance at 45 Panel and Bills Committee meetings and less formal meetings with legislators**
- **Contacts with media -- nearly 200 press releases issued, in addition to press conferences and educational briefings**
- **Publications -- statistics, research, banknote security features, monetary and banking terms, etc**
- **HKMA Website -- weekly *Viewpoint*, a new page of Research Memoranda launched in December**

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- The HKMA takes seriously the duty of explaining its policies and work to the general public and strives to address the concerns of the community. During the year we continued to maintain close relations with the media, with community representatives and the community at large, and our educational programmes continued to expand and develop.
- The HKMA held its summer exhibition *Money in Hong Kong 2001* between July and August, attracting over 80,000 visitors.
- We briefed the Legislative Council, through this Panel, on the full range of its policy responsibilities three times a year. Staff from the HKMA attended a total of 45 Legislative Council Panel and Committee meetings on a variety of issues. We also made use of various less formal meetings to exchange views and opinions with Legislative Councillors on a wide range of topical issues.
- We continued to adopt a pro-active approach with the media. A total of 192 press releases were issued; 8 press conferences were held; and four educational briefings were arranged in the year. Our press section handled on average 38 press enquires per day.
- In addition to publications covering monetary, banking and economic issues, we also continued efforts in developing e-publications to provide educational information through access to the Internet.
- The weekly column *Viewpoint* on the HKMA website continued to serve as a valuable channel of comment and information. It was widely carried in local newspapers and on international newswires. In December 2001, a page of HKMA Research Memoranda was launched to disseminate the materials produce by our Research Department.



CURRENCY STABILITY

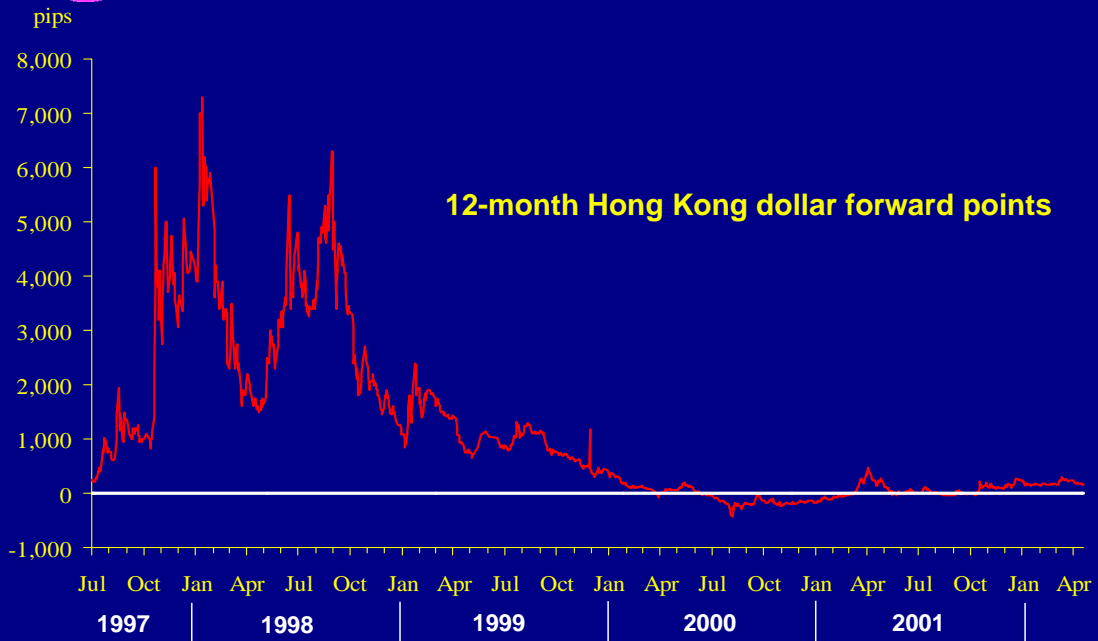


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- Although the external environment and the domestic economic situation had deteriorated for a time, the Hong Kong dollar exchange rate continued to be stable against the US dollar.
- Reflecting strong confidence in the Linked Exchange Rate system, the differential between Hong Kong and US dollar short-term interest rates has stayed close to zero.



CURRENCY - MARKET EXPECTATIONS



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- The 12-month Hong Kong dollar 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 the middle of 2000.



CURRENCY - RISKS & VULNERABILITIES

- **Argentina -- less of a risk factor to Hong Kong**
- **Exchange rates of the yen and RMB -- stable**
- **Public finances in Hong Kong -- credible strategy for deficit reduction**
- **Confidence in the Link -- strong but sensitive to rumours**
- **Hong Kong markets used as proxy hedge against Asian risks -- inevitable due to Hong Kong's role as an international financial centre**

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- The Argentine peso depreciated sharply since the abolition of the currency board arrangements in January. Capital flight has continued. The government recently suspended most banking activity in order to stall deposit withdrawal. Nevertheless, there has been no contagion in Hong Kong, reflecting a rational differentiation of the two economies in financial markets.
- The Japanese yen has been stable lately, although the economy has remained sluggish. As for the RMB, the Mainland authorities, including Premier Zhu Rongji and People's Bank of China Governor Dai Xianglong, have repeatedly said that it would remain stable.
- Prudence in public finance in Hong Kong has been a crucial factor in the success of the Link. While there are concerns about the structural nature of the deficit, the Government has set out a credible medium-term strategy to reduce the deficit. The reaction in financial markets is an encouraging indication that the Government, with the necessary public support, will deliver what is needed.
- Confidence in the Link has been strong, as reflected in the small forward premium on the Hong Kong dollar. While at times unfounded rumours appeared, and led to temporary spikes in the forward points, the effect tended to dissipate soon.
- In the absence of capital controls, our liquid financial markets are popular among investors as a proxy hedge for their investment in regional economies, which impose various degrees of controls, and do not have a fully convertible currency or an active forward market.



CURRENCY - MARKET EXPECTATIONS



- The forward points stayed at below 150 pips in late April, which were lower than the pre-crisis average of 240 pips, and far below the high of nearly 8,000 pips during the Asian financial crisis.
- In the past six months, occasional spikes were seen in the forward points, arising from concerns about public finances in Hong Kong, rumours about the Link, volatility in the Japanese yen, as well as the deepening crisis in Argentina. Nevertheless, the effects were short-lived, reflecting market confidence in the Link.



BANKING SECTOR PERFORMANCE

Capital adequacy ratio¹	: 16.60% (Dec 01)	18.30% (Sep 01)
Liquidity ratio²	: 45.16% (Dec 01)	49.15% (Sep 01)
Net interest margin²	: 2.09% (Q4 annualised)	1.98% (Q3 annualised)
Classified loans²	: 6.37% (Dec 01)	6.36% (Sep 01)
Mortgage delinquency ratio³	: 1.18% (Mar 02)	1.22% (Dec 01)
Credit card - charge-off ratio³	: 8.27% (Q4 annualised)	5.33% (Q3 annualised)
Growth of total HK dollar deposits⁴	: 0.10% (Q4)	0.30% (Q3)
Growth of total domestic lending⁴	: -1.40% (Q4)	-1.70% (Q3)

1 *Locally incorporated authorized institutions*

2 *Retail banks*

3 *Surveyed AIs*

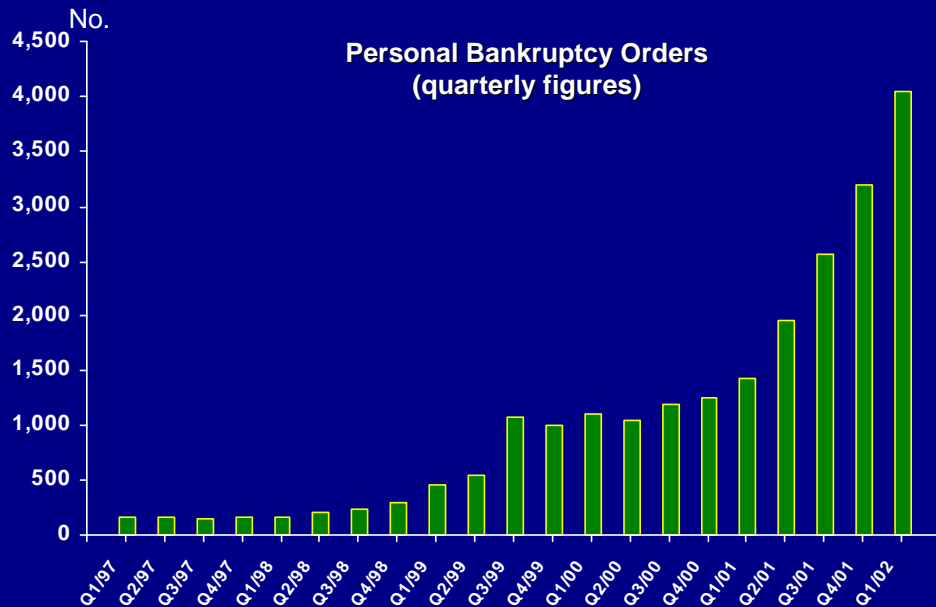
4 *All AIs*

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- The capital and liquidity positions of the banking sector remained strong and well above international minimum standards. The slight decline in the capital adequacy ratio and in the liquidity ratio in the 4th quarter of 2001 reflected in part the effects of changes in the reporting population.
- Owing to the continued squeeze in lending margins, particularly in residential mortgage lending, retail banks' net interest margin contracted to 2.03% in 2001 from 2.14% in 2000. There were, however, fluctuations from quarter to quarter, and indeed the fourth quarter saw an increase in net interest margin.
- The ratio of classified loans remained more or less unchanged at 6.37% at end-December.
- The delinquency ratio of residential mortgage loans further improved from 1.22% in December to 1.18% in March, while the rescheduled loan ratio increased from 0.26% to 0.38% during the same period. The improvement in the delinquency statistics is probably a result of lower interest rates and re-scheduling.
- The quality of credit card receivables deteriorated sharply in the fourth quarter.
- In 2001 customer deposits fell by 3.6%, against an increase of 9.6% in 2000. The contraction was entirely in foreign currency deposits, which fell by 7.8%, while Hong Kong dollar deposits rose marginally by 0.2%.
- The decline in domestic lending moderated to 1.4% in the fourth quarter, compared with a drop of 1.7% in the third quarter.



BANKING - SAFETY & SOUNDNESS PERSONAL BANKRUPTCIES - FACTS

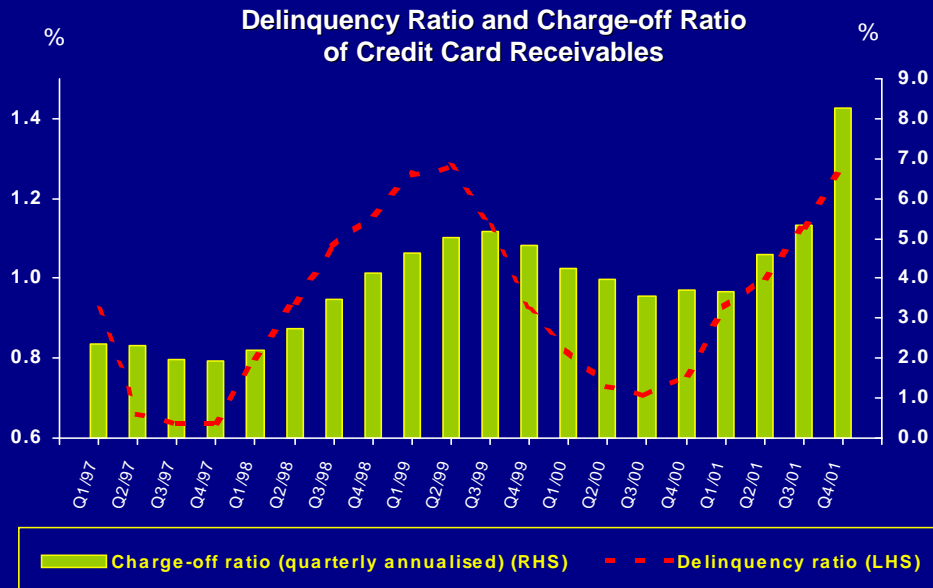


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- The number of personal bankruptcy orders increased ten-fold from 893 in 1998 to 9,151 in 2001. The rising trend continued into the first quarter of this year.
- A particular feature of the Hong Kong situation seems to be the extreme and multiple indebtedness of those who go bankrupt. A recent report by McKinsey and Co. shows that, on average, each bankrupt individual in Hong Kong has borrowed from 12 financial institutions and has incurred total indebtedness which is many times his/her monthly income.



BANKING - SAFETY AND SOUNDNESS PERSONAL BANKRUPTCIES - FACTS



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- The delinquency ratio is measured by the total amount of credit card receivables overdue for more than 90 days and remaining unpaid at the last day of the reporting month as a percentage of total credit card receivables.
- Charge-off ratio refers to the total amount of credit card receivables written off during a period as a percentage of the total credit card receivables at the end of that period. The charge-off policy may vary among AIs. To facilitate comparison among AIs (especially for those which may provide charge-offs at different intervals during the year), the charge-off ratio is annualised.
- The delinquency ratio provides an early indication of the quality of the credit card portfolio while the charge-off ratio measures the gross credit loss of that portfolio to an AI over a specified period of time.
- The quality of credit card receivables deteriorated sharply in the fourth quarter of 2001.



BANKING - SAFETY & SOUNDNESS PERSONAL BANKRUPTCIES - ACTIONS

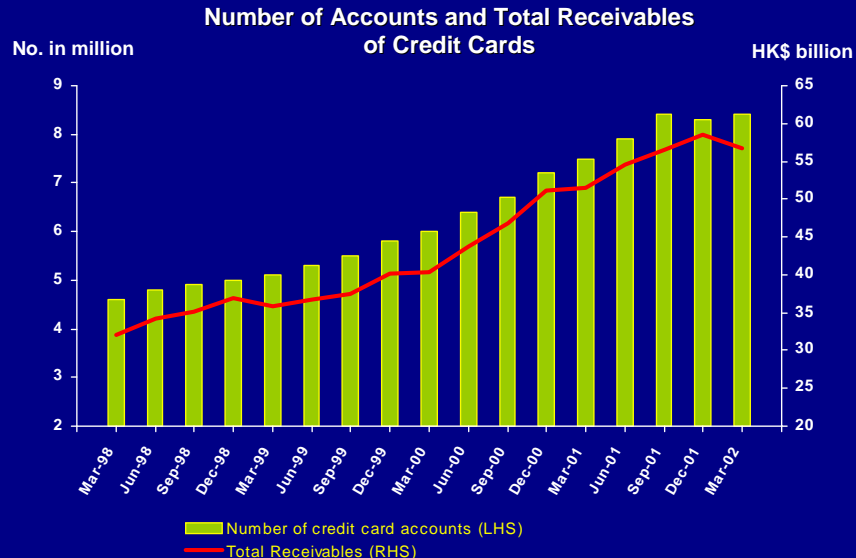
- **Circular issued in February on measures to prevent abuses of the bankruptcy provisions and on best practices for managing credit card operations**
- **Conducting special on-site examinations on AIs which are active credit card issuers**
- **Sharing of positive consumer credit data should help bring real benefits to good borrowers in terms of more favourable pricing and banks in terms of lower bad debts**

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- There are concerns that AIs have not been prudent in the issue of credit cards. Last year, we reviewed and examined the credit card operations of a number of AIs. In the light of our findings, we issued a circular to all AIs in February setting out the measures that AIs could take to prevent abuses of the bankruptcy provisions. The circular also made recommendations on best practices for the management of credit card operations.
- To ascertain whether AIs actively involved in credit card and personal loan businesses are managing such activities prudently, we are conducting special examinations on such activities of the AIs concerned. The examinations focus on: whether AIs have reviewed and revised their card issuing criteria in the light of the rising number of bankruptcies; whether AIs have adopted prudent procedures for assigning credit card limits, and in particular, whether they have reviewed the practice of automatically increasing such limits annually; whether AIs have effective procedures for identifying high risk customers at an early stage; and whether AIs' charge off policies are prudent. So far, we have only identified one case as requiring substantial improvement in its credit assessment and monitoring processes, and remedial actions are being taken.
- The proposal for banks to be allowed to share positive consumer credit data was discussed at this Panel on 9 April. There is considerable support, particularly among banks, for the proposal since the sharing of positive consumer credit data will enable them to conduct better assessments of the creditworthiness of individual borrowers. But concerns have also been expressed about the implications for the data privacy of bank customers.
- We have been in close consultation with the Privacy Commissioner and other relevant parties on this important issue. We continue to welcome views from this Panel.



BANKING - SAFETY AND SOUNDNESS PERSONAL BANKRUPTCIES



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- The above chart shows that growth in the number of credit card accounts and total credit card receivables has flattened out in recent months. This reflects a number of factors, including efforts by banks to tighten up on credit card financing and increased write-offs by the banks.



BANKING - SAFETY & SOUNDNESS NEGATIVE EQUITY - FACTS

Residential Mortgage Loans in Negative Equity

	Dec 2001	Sep 2001
Total number	73,000	65,000
Total outstanding value	\$125 billion	\$127 billion
Percentage priced below Best Lending Rate	56%	51%
Average interest rate charged	0.57% below BLR	0.27% below BLR

Source: HKMA surveys on residential mortgage loans in negative equity

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- The HKMA has conducted two surveys on residential mortgage loans in negative equity with a number of banks active in mortgage financing for the positions as at end-September and end-December 2001. (The figures, however, do not include co-financing loans.) The survey results show that the number of homeowners in negative equity has increased from September to December 2001, given the further decline in property prices during the period. Despite that, the total outstanding amount in negative equity has not risen. The increasing proportion of loans in negative equity being priced at below the Best Lending Rate reflects the fact that the banks have been willing to refinance or restructure loans for homeowners in negative equity.

Interest rate breakdown of residential mortgage loans in negative equity

	Number of cases				Outstanding balance	
	As at 31 Dec 2001		As at 30 Sep 2001		As at 31 Dec 2001	As at 30 Sep 2001
	Number	%	Number	%	HK\$ billion	HK\$ billion
(i) BLR + 2% or above	150	0.2	200	0.3	0.3	0.3
(ii) BLR + 1% to below BLR + 2%	2,250	3.1	3,000	4.6	3.5	5.3
(iii) Above BLR to below BLR + 1%	17,200	23.6	16,800	25.8	29.6	32.5
(iv) BLR	10,300	14.1	10,100	15.6	16.8	17.5
(v) Below BLR to BLR – 1%	12,000	16.4	10,500	16.1	20.4	20.0
(vi) Below BLR – 1%	28,800	39.4	22,600	34.7	51.0	48.5
(vii) Others (e.g. fixed rate)	2,300	3.2	1,800	2.9	3.4	2.9
	73,000	100	65,000	100	125.0	127.0



BANKING - SAFETY & SOUNDNESS NEGATIVE EQUITY - ACTIONS

- **Since October 2001, AIs have been allowed to depart from the 70% LTV ratio in refinancing residential mortgage loans in negative equity**
- **Recommended that AIs set up centralised units to handle enquiries**
- **Schemes to assist homeowners in negative equity**

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- The HKMA issued a letter to AIs in October 2001 stating that it would not object if AIs, should they judge it commercially desirable, were to depart from the 70% guideline in refinancing residential mortgage loans for homeowners in negative equity.
- We issued another letter to AIs in November 2001 recommending the establishment of centralised units to handle enquiries. Some banks have since offered more relief measures to mortgagors, e.g. adjustment of the mortgage terms, lowering of the mortgage rate.
- We are currently conducting another survey to update information on residential mortgage loans in negative equity for the position of end-March. With effect from June, the information requested will form part of the regular survey on residential mortgages.
- The Hong Kong Mortgage Corporation is considering a proposal to allow homeowners to refinance their mortgages by borrowing up to 140% of the value of their property. A number of schemes for assisting homeowners in negative equity to refinance have also been mooted in the market. The HKMA is considering these proposed schemes from a policy and legal viewpoint.



BANKING REFORMS & CONSUMER ISSUES

- **Deposit insurance scheme**
 - 2nd public consultation paper issued
 - draft legislation ready by end-2002
- **Commercial credit reference agency**
 - Working Party to thrash out details of a voluntary participation scheme
- **Banking consumer protection**
 - guideline on complaint handling issued
 - further consideration of way forward

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Deposit insurance scheme

- The second public consultation paper was released on 27 March. The paper deals with detailed technical issues concerning the establishment, mandate, power and operational matters of the DIS. The consultation period will close on 31 May. Comments received during the consultation period will be carefully considered before the HKMA finalises the detailed design features. We will then prepare a bill to put the DIS into effect. It is intended that the bill would be ready by the end of this year.

Commercial credit reference agency

- The HKMA Working Group has completed consideration of how the scheme should be structured and, following consultation with the banking industry associations, has recommended a CCRA scheme targeting at small to medium-sized enterprises based on the voluntary participation by AIs. The industry associations have formed a Working Party to follow up on the implementation of this market-based scheme.

Banking consumer protection

- The HKMA issued a Guideline on Complaint Handling Procedures in February. AIs are expected to meet full compliance as soon as possible, and not later than end-June.
- In February the HKMA informed this Panel of the progress made in relation to consumer protection in the banking sector in the past year. In the light of views expressed by Members, the Administration is reviewing this issue in collaboration with the HKMA. Upon the request of the Panel, the HKMA will report the progress made on the various initiatives taken in this area such as the work of the Code of Banking Practice Committee in its June meeting.



REVIEW OF MARKET ENTRY CRITERIA

Foreign applicants to be a licensed bank

- Replacing the US\$16 billion asset size criterion with the much lower asset and deposit size criteria applicable to local licensed bank applicants (HK\$4 billion and HK\$3 billion respectively)
- Dispensing with the requirement to maintain a local representative office for at least one year

Local applicants to be a licensed bank

- Reducing the requisite period of operation as an RLB or DTC from 10 to 3 years
- Removing the requirement to be “closely associated and identified with Hong Kong”

All applicants to be a licensed bank

- Minimum paid up capital to increase from HK\$150 million to HK\$300 million

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- A review of the existing market entry criteria was completed in December 2001. In view of the ongoing consolidation in the banking sector and the fact that the banking supervisory system has been further strengthened, the HKMA believes that some of the existing market entry criteria can be relaxed without compromising banking stability. The main proposals arising from the review are set out in the above slide.
- The proposed changes, which have been the subject of consultation with the banking industry, are aimed at attracting a broader range of domestic and international institutions to carry on banking business in Hong Kong, which is conducive to maintaining Hong Kong's status as a leading international financial centre.



FINANCIAL INFRASTRUCTURE

- **Domestic financial activities**
- **International financial activities**
- **Mainland / Hong Kong financial activities**

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- The HKMA shares the objective of maintaining Hong Kong as an international financial centre. By bringing in more demand for financial services, Hong Kong's economy will benefit and more jobs will be created.
- We believe that the main competitive advantage in being an international financial centre lies in the robustness and efficiency of our financial infrastructure. Financial transactions have no geographical boundaries in a wired world, and will gravitate towards a centre where they can be conducted safely and efficiently. Our latest contribution towards building this competitive advantage is a sophisticated payment system in both Hong Kong and US dollars. We will further build on this advantage through initiatives on three fronts:
 - Domestic financial activities - to link up our domestic debt, equity and payment systems so that straight-through-processing can be achieved in Hong Kong dollar transactions.
 - International financial activities - to provide safe and efficient clearing systems in foreign currency transactions in the Asian time zone and to extend the linkages of our infrastructure with those of others in the region, so that more international financial transactions will be attracted to Hong Kong.
 - Mainland / Hong Kong financial activities - to attract Mainland institutions to make more use of Hong Kong as the platform for conducting their international transactions and to strengthen the linkage of the infrastructure of the Mainland and Hong Kong so that two-way payment and settlement will be made more efficient.



FINANCIAL INFRASTRUCTURE FOR DOMESTIC FINANCIAL ACTIVITIES

- **Bond market development**
 - retail bond issues by Hong Kong Mortgage Corporation
 - proposals to streamline retail bond issuing procedures
- **Integration of payment, clearing and settlement systems**

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Bond market development

- The Hong Kong Mortgage Corporation has had some success in developing the retail bond market in Hong Kong. The retail bond issues in November 2001 and February this year attracted subscriptions of over HK\$651 million and HK\$1,371 million respectively from retail investors. This has added significant impetus to further development of the bond market in Hong Kong. The Airport Authority has introduced a retail bond issue in April. Another issue by the MTR Corporation is in the pipeline.
- The Financial Market Development Task Force convened by the Secretary for Financial Services, and consists of members including the HKMA, is considering various proposals to streamline bond issuing procedures. The SFS has indicated that detailed proposals will be announced in the next few months.

Integration of payment, clearing and settlement systems

- Through the integration of payment, clearing and settlement systems for money, debt securities, equities and their derivatives, the domestic market infrastructure facilitates cross-collateralisation between domestic financial products and enhances liquidity management efficiency.
- The HKMA is following up the recommendations of the Standing Committee on Electronic Financial Infrastructure. It chairs a working group to explore the feasibility of improving the Delivery versus Payment arrangement for share transactions under the Central Clearing and Settlement System (CCASS). We are now working to extend the link with CCASS to enable the Central Moneymarkets Unit (CMU) operated by the HKMA to clear and settle equity transactions.



FINANCIAL INFRASTRUCTURE FOR DOMESTIC FINANCIAL ACTIVITIES

- **Retail payment systems review**
 - **codes of practices on credit cards, debit cards and stored-value cards being drawn up**
 - **implications of further development of e-money being considered**
 - **design and security of Hong Kong's currency under review**

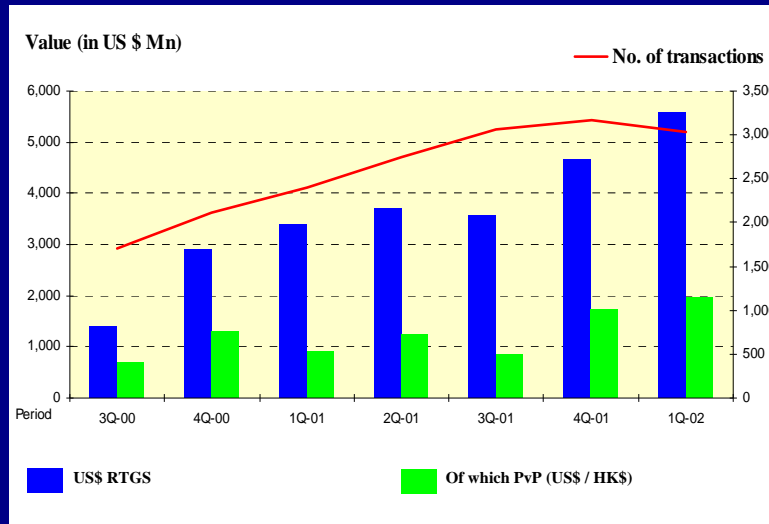
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- Implementation of the retail payment system review recommendations is in progress. Working groups set up by industry participants and under the oversight of the HKMA are preparing codes of practices for credit cards, debit cards and stored-value cards. These codes of practices will cover areas including system reliability and security controls, market access and membership criteria, mechanism for setting fees and charges, and compliance monitoring and enforcement.
- Hong Kong is a pioneer in e-money with extensive usage and deep penetration. The HKMA is now considering the implications of the rapid development of e-money in Hong Kong for a number of important issues, such as regulatory needs, seignorage leakage and competition policy, and how they should be addressed.
- The HKMA is concerned about the surge in the number of counterfeit HK\$10 coins. We have been monitoring the issue and are maintaining close liaison with the police under a well-established mechanism in tackling the issue. To better educate the public on counterfeit HK\$10 coins, the HKMA has issued a leaflet on security features for Hong Kong coins. The HKMA has also written to banks with a set of information showing the security features of the genuine HK\$10 coin, so that inconvenience to the general public can be kept to the minimum.
- The HKMA keeps matters of currency issue under regular review. In this context it has been monitoring and evaluating the coinage situation, in parallel with the specific programme, already announced, for the redesign of the notes of the note-issuing banks, which is progressing well.



FINANCIAL INFRASTRUCTURE FOR INTERNATIONAL FINANCIAL ACTIVITIES

US Dollar RTGS Turnover (daily average)



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- Since its full implementation in December 2000, the US dollar clearing system has operated smoothly and has received wide acclaim. Business volume has been steadily increasing - by December 2001 the system handled on average 3,100 transactions daily with a total value of over US\$5 billion.
- The average daily turnover in the US dollar RTGS system in March this year was at a record high of US\$6.3 billion.



FINANCIAL INFRASTRUCTURE FOR INTERNATIONAL FINANCIAL ACTIVITIES

- **Proposal to develop euro and yen RTGS clearing systems**
- **International linkages of payment systems**
- **International linkages of debt clearing systems**
 - **linkage to Euroclear**
 - **clearing of US Treasuries in Hong Kong**

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Proposal to develop euro and yen RTGS systems

- Following the success of the US dollar clearing system, the HKMA has been considering the introduction of euro and yen clearing systems in Hong Kong. These would enable Asian investors to settle all G3 currencies in the Asian time zone on a real-time basis. The euro and yen clearing systems will also facilitate the tapping of international liquidity by financial institutions in Hong Kong and enhance Hong Kong's role as a regional clearer of foreign currency settlement activity. Preparatory work on the euro and yen clearing systems is now underway.

International linkages of payment systems

- To date, more than 80 banks outside Hong Kong have joined our US dollar RTGS system as indirect participants. We are also discussing with Bank of Thailand a possible linkage between the Thai baht payment system and the US dollar RTGS payment system in Hong Kong.

International linkages of debt clearing systems

- The development work relating to the linkage with Euroclear is making good progress. The linkage is expected to go live before the end of this year.
- In consultation with the Federal Reserve Bank of New York, the HKMA is setting up a clearing facility for US Treasuries in Hong Kong with a view to enabling the CMU to serve as the settlement institution for US Treasuries in Hong Kong. We aim to implement this new service by around the end of this year.



FINANCIAL INFRASTRUCTURE FOR MAINLAND / HONG KONG FINANCIAL ACTIVITIES

- **Greater mobility of capital flows between Mainland and Hong Kong will benefit the two economies in terms of higher growth and more jobs**
- **At present, Hong Kong's capital can move "north" without restrictions, but not vice versa**
- **GDP of Mainland in 2001: US\$1,159 billion. GDP of Hong Kong in 2001: US\$162 billion. → A ratio of 7:1**
- **Mainland's direct investment in Hong Kong in 2000: US\$14 billion. Hong Kong's direct investment in Mainland in 2000: US\$46 billion. → A ratio of 1:3**

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- To maintain our status as an international financial centre, Hong Kong must increasingly take into account the needs of finance in the Mainland. Years of positive economic growth in the Mainland have produced an accumulation of wealth and capital. China's accession to the World Trade Organisation opens up many possibilities for future. Hong Kong is the Mainland's natural international financial centre.
- At present, Hong Kong people can freely invest in the Mainland without restrictions, but not vice versa. According to Hong Kong's statistics, Hong Kong's direct investment in the Mainland amounted to US\$46 billion in 2000 (this was partly due to some large-scale acquisition activities in the Mainland carried out by Mainland enterprises in the Hong Kong stock market). This accounted for 78% of Hong Kong total outward direct investment in that year. In the opposite direction, the Mainland's direct investment in Hong Kong amounted to just US\$14 billion in 2000. This represented 23% of Hong Kong's total inward direct investment in that year.
- Lessening the degree of asymmetric mobility of capital across the border will help promote growth and jobs in the two economies. The challenge is how to achieve this without hasty financial liberalisation that may undermine monetary and financial stability in the Mainland.



CHANNELS TO FACILITATE MAINLAND / HONG KONG CAPITAL FLOWS

- **Closer Economic Partnership Arrangement**
- **RMB deposit-taking in Hong Kong**
- **Qualified Domestic Institutional Investors (QDII)**
- **Joint cheque clearing between Guangdong and Hong Kong**
- **Linkages in debt clearing systems**
- **Linkages in payment systems**

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- Within the framework of “one country, two systems” the Hong Kong Government authorities, including the HKMA, have been in practical and detailed discussions with the Mainland authorities on how best Hong Kong can assist and participate in the Mainland’s financial development. Some discussions relate to ways to address the asymmetric mobility of capital between the two economies. These discussions will take time, given the Mainland’s concerns that hasty financial liberalisation may undermine monetary and financial stability in the Mainland, but we hope that the outcomes would be to the benefits of the two economies.
- Regarding the HKMA initiatives to build linkages with the Mainland’s financial systems, we have made good progress on various fronts:
 - The Memorandum of Understanding for the two-way joint Hong Kong dollar cheque clearing has been signed between the HKMA and People’s Bank of China Guangzhou. The link will speed up the processing of Hong Kong dollar cheques drawn upon banks in Guangdong (including Shenzhen) and presented in Hong Kong. The link is expected to be launched in June.
 - In January agreement in principle was reached to establish a link between the CMU and the Mainland’s Government Securities Book-entry System. This link will enable Mainland financial institutions authorized to deal in foreign exchange transactions to hold and settle debt securities in Hong Kong.
 - We are in discussion with the People’s Bank of China about a Hong Kong dollar RTGS settlement arrangement to facilitate RTGS payments between Hong Kong and Shenzhen.



EXCHANGE FUND ABRIDGED BALANCE SHEET

(HK\$ billion)	31 Dec 01 ¹	31 Mar 02 ²	30 Apr 02 ²
ASSETS			
Deposits	99.2	81.8	81.0
Debt securities	732.7	736.6	745.9
Hong Kong equities	85.9	80.0	77.4
Other equities	35.3	35.4	37.7
Other assets	<u>26.0</u>	<u>45.9</u>	<u>35.9</u>
Total assets	979.1	979.7	977.9
LIABILITIES AND ACCUMULATED SURPLUS			
Certificates of Indebtedness	107.5	116.0	111.8
Coins in circulation	5.7	5.7	5.7
Balance of banking system	0.7	0.8	0.4
Exchange Fund Bills and Notes	118.1	116.1	122.0
Placements by other HKSAR government funds	380.6	377.5	373.7
Other liabilities	<u>63.9</u>	<u>64.7</u>	<u>57.8</u>
Total liabilities	676.5	680.8	671.4
Accumulated surplus	<u>302.6</u>	<u>298.9</u>	<u>306.5</u>
Total liabilities and accumulated surplus	979.1	979.7	977.9

1 Audited figures; 2 Unaudited figures

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- The total assets of the Exchange Fund amounted to HK\$977.9 billion at the end of April 2002 according to preliminary figures, compared with HK\$979.1 billion at the end of December 2001.
- For the first four months of 2002, there was a net drawdown of the fiscal reserves amounting to HK\$6.9 billion.



EXCHANGE FUND PERFORMANCE

(HK\$ billion)	2002 Jan	2002 Feb	2002 Mar	2002 Apr	2002 Jan-Apr
Gain/(Loss) on Hong Kong equities*	(4.1)	(2.8)	4.7	3.2	1.0
Exchange gain/(loss)	(5.2)	0.6	1.7	5.1	2.2
Total return on bonds, etc	<u>2.8</u>	<u>3.3</u>	<u>(4.7)</u>	<u>4.7</u>	<u>6.1</u>
Investment income	(6.5)	1.1	1.7	13.0	9.3
Other income	0.0	0.0	0.0	0.0	0.0
Interest and expenses	<u>(0.5)</u>	<u>(0.5)</u>	<u>(0.6)</u>	<u>(0.6)</u>	<u>(2.2)</u>
Net investment income	(7.0)	0.6	1.1	12.4	7.1
Treasury's share	<u>2.6</u>	<u>(0.4)</u>	<u>(0.6)</u>	<u>(4.8)</u>	<u>(3.2)</u>
Increase/decrease in EF accumulated surplus	(4.4)	0.2	0.5	7.6	3.9
	===	===	===	===	=====

* Including dividends

Note : all are unaudited figures

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- The investment environment continues to be very volatile. For the first four months of 2002, the Exchange Fund recorded a positive investment income of HK\$9.3 billion. The main components of this income were:
 - a profit of HK\$1 billion from the Hong Kong equities portfolio;
 - an exchange gain of HK\$2.2 billion; and
 - a profit of HK\$6.1 billion from bonds and other investments.
- After deducting interest and other costs, and the sharing of investment income with the fiscal reserves placed with the Exchange Fund, the accumulated surplus recorded an increase of HK\$3.9 billion.
- Return to the fiscal reserves placed with the Exchange Fund for the first four months of 2002 amounted to HK\$3.2 billion.
- Quarterly returns to fiscal reserves under the return sharing arrangement, started on 1 April 1998, are as follows:

	(HK\$ billion)				
	1998	1999	2000	2001	2002
Q1	n.a.	5.2	2.6	(6.1)	(1.6)
Q2	4.1	18.0	(4.2)	(1.0)	4.8*
Q3	6.9	(0.5)	7.7	4.0	
Q4	<u>15.0</u>	<u>22.7</u>	<u>12.0</u>	<u>4.7</u>	
	26.0	45.4	18.1	1.6	

* up to end-April 2002 only

It is up to the Treasury to decide when to settle the return to the fiscal reserves placed with the Exchange Fund.



EXCHANGE FUND HONG KONG EQUITY PORTFOLIO

	(HK\$ billion)
Investment in August 1998	118.1
Income from Disposal and Dividends (end-April 2002)	149.8
Size of remaining portfolio (end-April 2002)	77.4
Disposal	28.5
Long Term Investment*	48.9

* Including Hong Kong 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-April 2002, the total net income from disposal and dividends amounted to HK\$149.8 billion.
- Of the remaining Hong Kong equity portfolio, we intend to keep 5% of the size of the Exchange Fund (i.e. HK\$48.9 billion as at end-April 2002), 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.



HONG KONG MONETARY AUTHORITY

**Briefing to the Legislative Council
Panel on Financial Affairs**

6 May 2002

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