HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

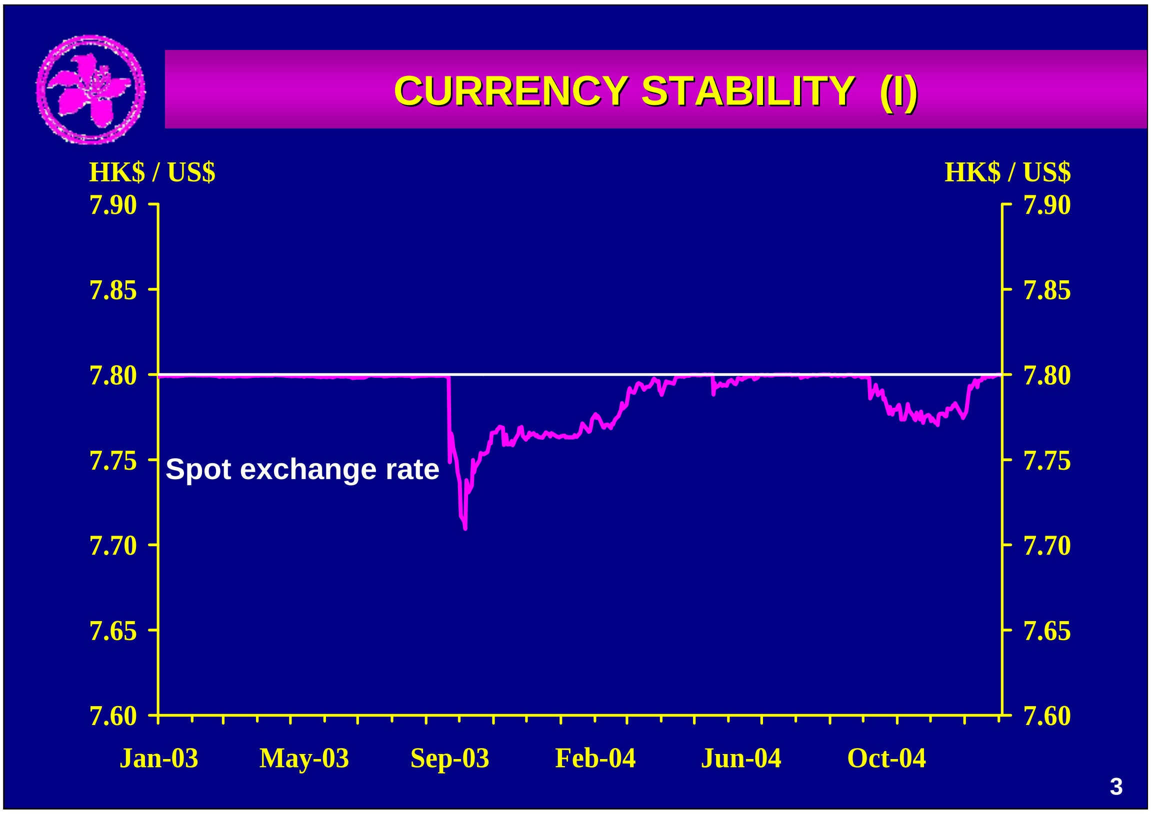
17 February 2005

PROGRESS IN KEY FUNCTIONS & RESPONSIBILITIES

- **Currency Stability**
- **Banking**
- **Financial Infrastructure**
- **Hong Kong as an International Financial Centre**
- **Exchange Fund**

2

- This briefing covers the key functions and responsibilities of the HKMA:
  - to maintain currency stability within the framework of the Linked Exchange Rate system;
  - to maintain the safety and stability of the banking system;
  - to promote the efficiency, integrity and development of the financial infrastructure, particularly payment and settlement arrangements;
  - to support the maintenance of the status of Hong Kong as an international financial centre; and
  - to manage the Exchange Fund in a sound and prudent manner.



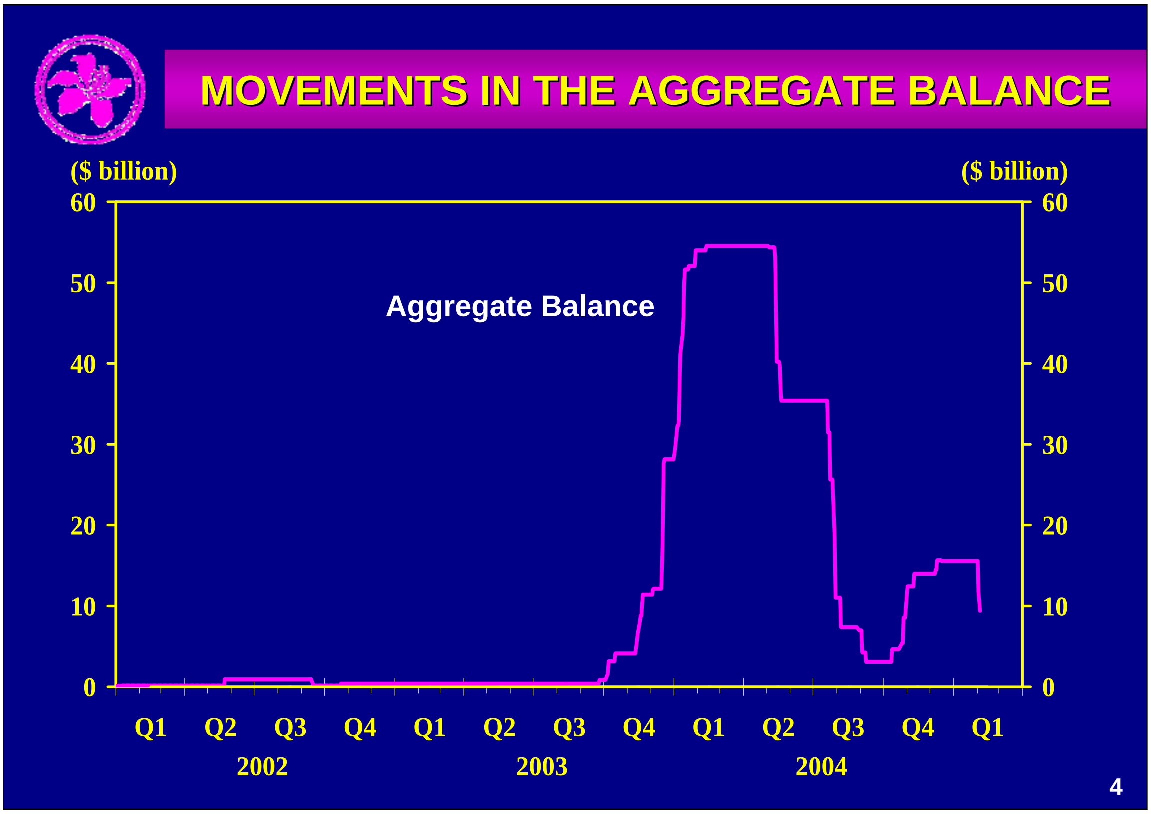
- This episode of capital inflow and pressure for the Hong Kong dollar to strengthen, which started in 2003 Q3, has played itself out through the normal operations of the Currency Board system.

- Following purchases of the US dollar and creation of the Hong Kong dollar by the HKMA, the market exchange rate eventually converged with the Linked Rate in 2004 Q2.

- As capital inflow reversed, the exchange rate stayed close to the Linked Rate in 2004 Q2 and Q3, with the Convertibility Undertaking (CU) being triggered occasionally. The triggering of the CU was in part attributable to interest rate arbitrage activities to take advantage of higher US dollar interest rates over their Hong Kong dollar counterparts.

- There was capital inflow again in mid-October on speculation about the introduction of a more flexible renminbi exchange rate regime. The exchange rate strengthened slightly and the HKMA bought the US dollar again in Q4 in response to offers by banks.

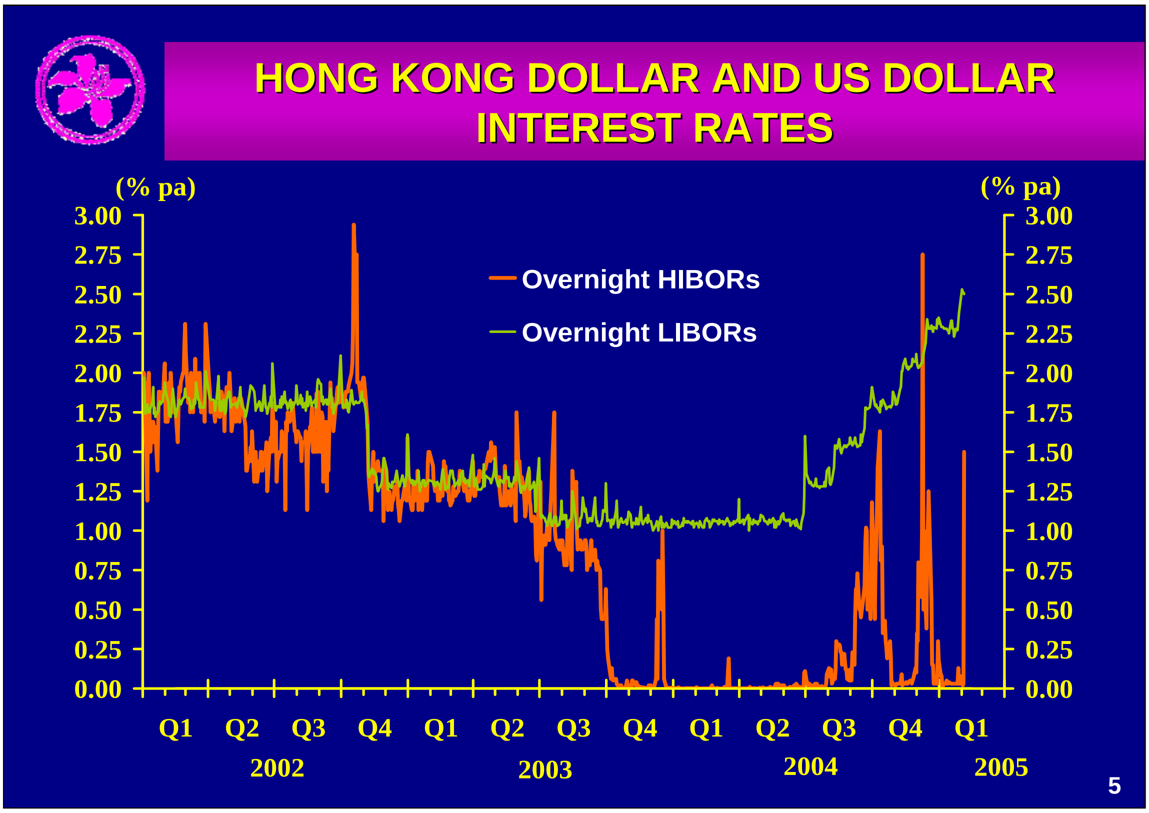
- More recently, with the US dollar appreciating against other major currencies and the widening of the interest rate differential between the US dollar and the Hong Kong dollar, the CU was triggered again in early 2005.



- As the exchange rate moved back towards 7.8, the CU was triggered frequently between the end of April 2004 and early September. As a result, the Aggregate Balance declined from a peak of over $54 billion to around $3 billion on 8 October 2004.

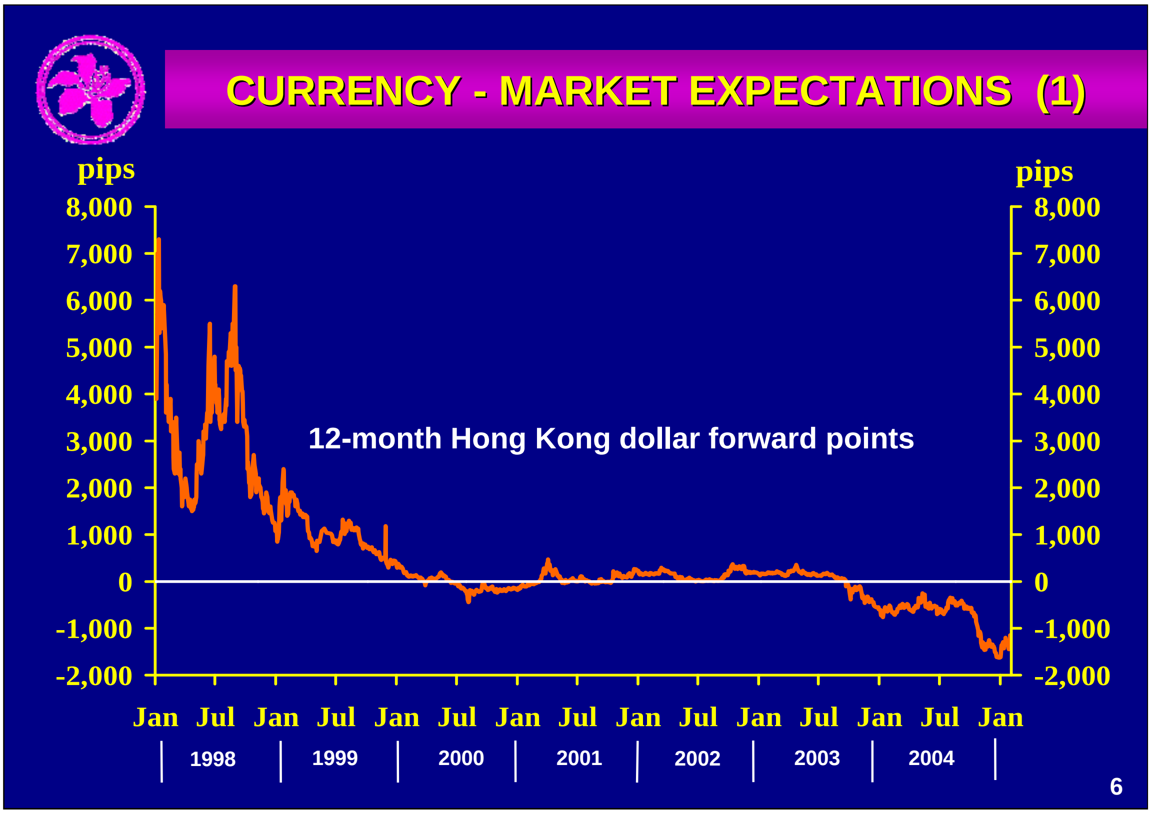
- In Q4, the sales of Hong Kong dollars by the HKMA following renewed upward pressure on the Hong Kong dollar led to a rise in the Aggregate Balance to $15.8 billion on 10 December 2004.

- Earlier this year, the CU was triggered again as a result of arbitrage activities to take advantage of the increasing interest rate differential between the US dollar and the Hong Kong dollar. As a result, the Aggregate Balance declined to $9.3 billion on 7 February.

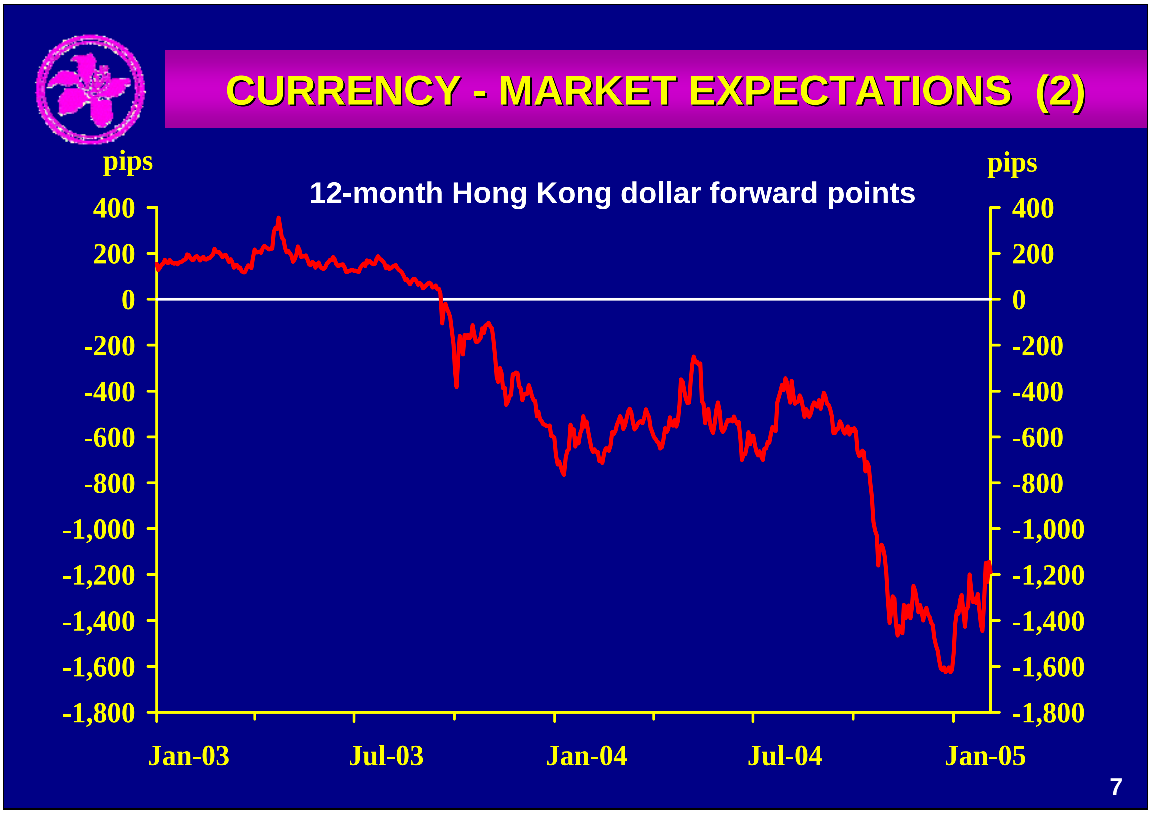


- Overnight Hong Kong dollar interbank interest rates (HIBOR) stayed below their US dollar counterparts during most of the fourth quarter of 2004, particularly the short-term money.

- Overnight HIBOR stayed close to zero between October and mid-November 2004, but rose for a brief period of time between mid-November and mid-December 2004 because of increased liquidity demand associated with equity IPOs. Thereafter, overnight interest rates eased back to near-zero levels towards the end of December 2004.

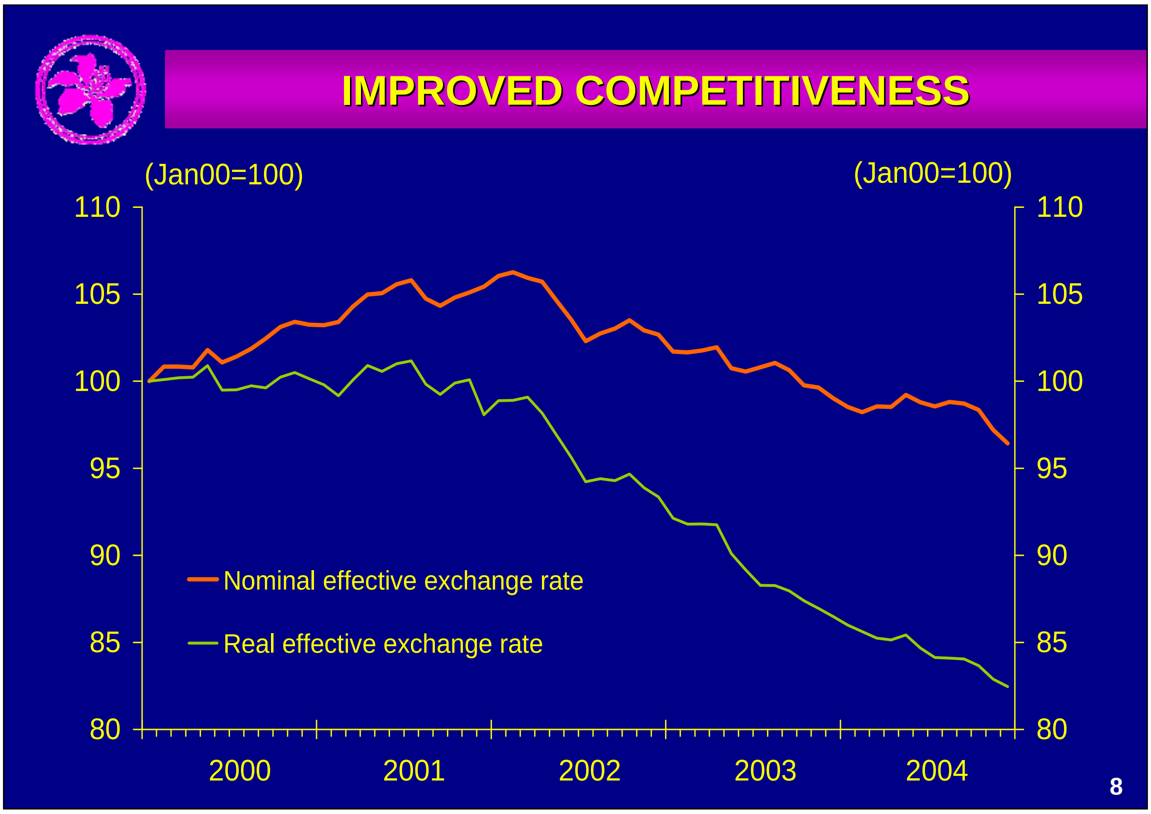


- Overall, the Hong Kong dollar forward market has remained calm by historical standards, although the marked shift of expectation from weakness to strength persisted.



- The 12-month forward points remained in discount throughout 2004. The forward discount widened markedly in Q4, reaching 1,650 pips at the end of 2004 given renewed speculation about revaluation of the renminbi.

- More recently, the 12-month forward discount narrowed to 1,190 pips on 4 February 2005 alongside the rebound of the US dollar against other major currencies.



- Reflecting the US dollar on a weakening trend, the Hong Kong dollar, which is linked to the US dollar, depreciated against most other foreign currencies in recent years. By December 2004, the trade-weighted nominal effective exchange rate declined by almost 10% from February 2002 when the US dollar started to depreciate.

- The trade-weighted real effective exchange rate (REER) declined more significantly, by 17% between February 2002 and December 2004, reflecting lower domestic price inflation. The REER was nearly 30% below its peak in August 1998.

- The decline in the REER has helped improve Hong Kong's external competitiveness, as evidenced by the strong performance in the external trade sector in recent years. Coupled with five quarters (2003 Q4 to 2004 Q4) of very easy monetary conditions, this has in turn contributed significantly to the current robust economic recovery.

MONETARY CONDITIONS

- Currency Board arrangements working effectively.
- Fed funds target rate on an increasing trend, returning to “normal”.
- Capital inflow has prevented the Hong Kong dollar interest rates to keep in line.
- Easy monetary conditions prevailed despite higher US interest rates.
- Catch-up can be quite sharp; overshooting possible.

9

- The IMF, in its 2004 Article IV consultations on the Hong Kong SAR, considered that HKMA’s response to the strong side pressure on the exchange rate has enhanced the resilience of the Linked Exchange Rate system.
- The Fed funds targat rate in the US was raised by five times by a total of 125 basis points in 2004. It was further raised by 25 basis points at the beginning of February 2005. Market generally expects the increasing trend to continue, although it is not clear at what “normal” interest rate level this will stop.
- Capital inflows have, meanwhile, kept Hong Kong dollar interest rates zero-bound, sustaining easy monetary conditions.
- Larger and increasing interest rate differential will eventually reverse capital inflows. The process of Hong Kong dollar interest rates catching up with US dollar interest rates can be quite sharp. There is risk of overshooting as well. Borrowers beware.

CURRENCY STABILITY (II)

External factors

- **The US dollar and external imbalances of the US**
- **US monetary tightening**
- **Volatility in oil prices**
- **Pressure on the renminbi exchange rate**
- **Macroeconomic conditions on the Mainland**

10

- **External imbalances:** The high US current account deficit, approaching 6% of GDP in 2004, is an increasing global concern. This has been translated into volatility in the US dollar around a depreciating trend, and a stronger yen and euro. The risk of a disorderly decline in the US dollar exchange rate (and associated disruption to global financial markets) is judged to be low, but cannot be ruled out.

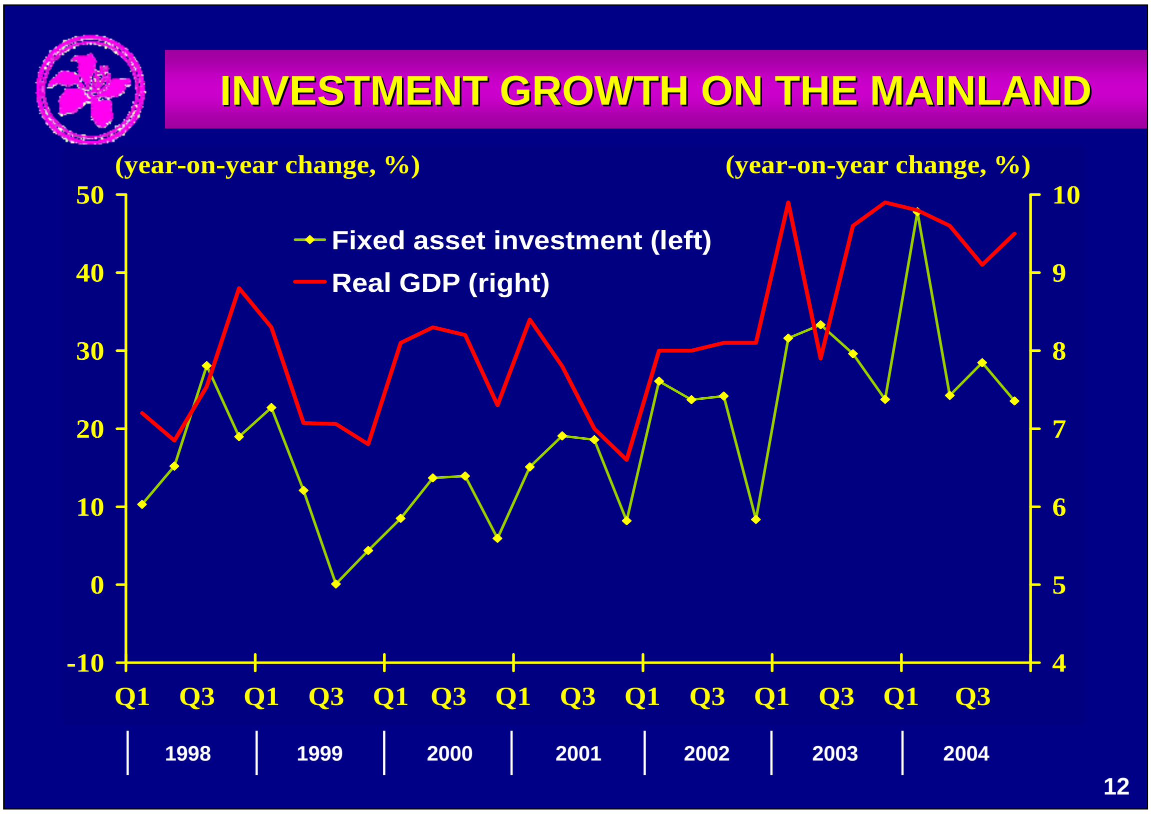
- **Global and regional economy**: Growth in the US and Mainland China was robust in the second half of last year, following a temporary slowdown in the second quarter, which supported continued expansion in non-Japan Asian economies. However, it slowed significantly in Japan and the euro area in the third quarter. The tsunami disaster is expected to have a negative but short-term effect on growth in the affected economies - reflecting the loss of life and destruction of local infrastructure - although with some offset from reconstruction efforts.

- **Interest rates**: The global monetary tightening cycle is well underway, led by the US where short-term interest rates could reach 3.0% by mid-2005 (market expectation).

- **Oil prices:** Oil prices remains volatile, spiking higher last September and October before retreating to end of 2004 25% higher for the year.

- **RMB exchange rate**: There is continuing speculation in financial markets about a change in the renminbi exchange rate regime, which has been associated with strengthened pressure on the Hong Kong dollar exchange rate.

- With more recent data suggesting that the economy is probably heading towards a soft landing, pressures on the Mainland authorities to revalue the renminbi intensifying and the US dollar resuming its decline against major international currencies, the discount of the one-year non-deliverable forward has widened again since late July.

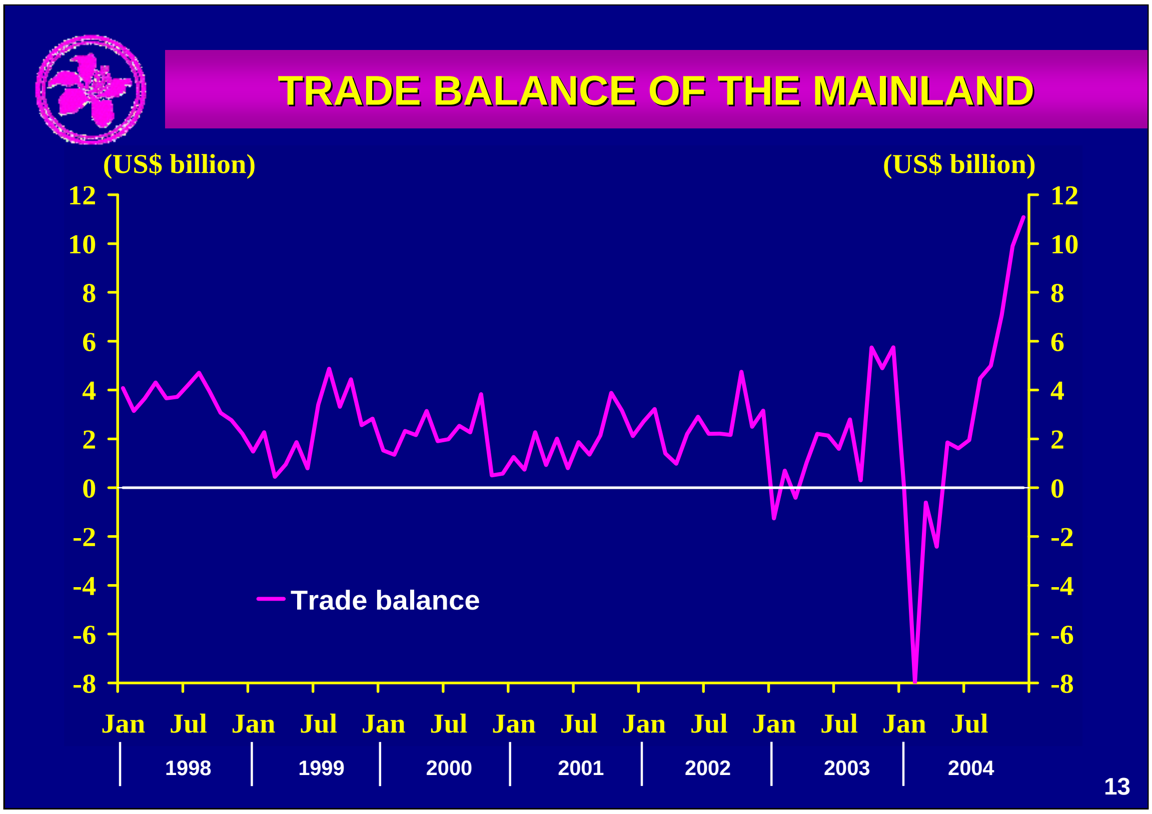


- The latest data suggest that economic growth on the Mainland remained strong in 2004 Q4, with some re-balancing in the economy.

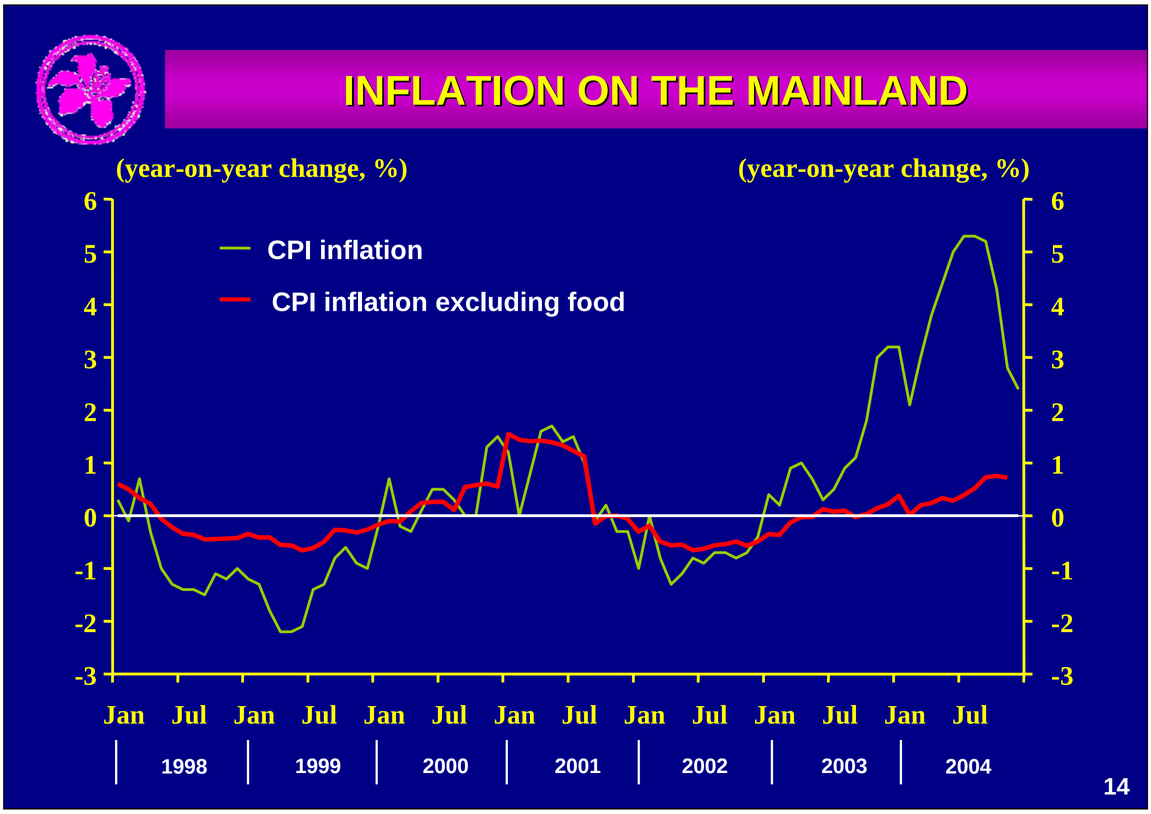
- Based on the year-on-year comparison, real GDP growth accelerated to 9.5% from 9.1% in Q3, although HKMA estimates of quarter-on-quarter changes point to a mild moderation in the momentum.

- The composition of growth continued its gradual shift away from investment to consumption and external trade. In particular, expansion in fixed asset investment decelerated in the last three months of 2004, resulting in a year-on-year rate of 23.6% in Q4, compared to 28.4% in Q3. On the other hand, consumption demand stayed robust.

- Looking ahead, the Mainland economy is expected to grow at a slower, but still relatively rapid pace. With a generally stable external environment, the momentum in export growth could be maintained. Growth in investment could continue to slow, but stay at a robust pace. Structural factors such as urbanisation and rising income will continue to underpin growth in consumption.



- The trade surplus widened to a six-year high of US$32 billion in 2004 as export growth more than offset rising import costs.

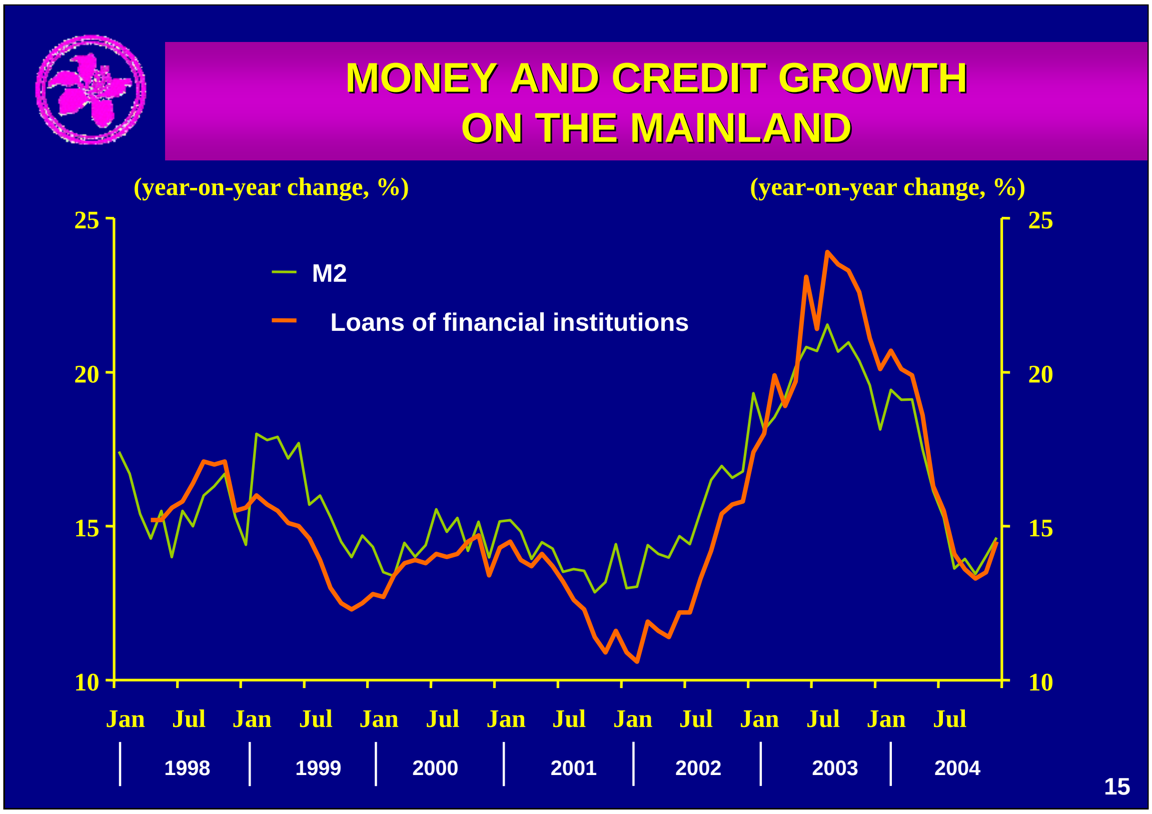


- Inflationary pressures eased significantly towards the end of 2004. Owing to smaller increases in food prices, headline inflation declined for four consecutive months, to 2.4% in December from the peak of 5.3% in August.

- For 2004 as a whole, consumer prices rose by 3.8%.

- Inflationary pressures along the supply chain persisted, but showed some signs of easing. Producer price inflation fell in November-December, while investment goods price inflation decreased to a year-on-year rate of 5.3% at the year-end, from the peak of 9.6% in September.

- Looking ahead, inflation might stabilise in the range of 3-4% in 2005. Increases in food prices might moderate further, but the shortage of utility supply in areas such as water, electricity and fuel could continue to exert upward pressures on prices.



- After slowing noticeably for two consecutive quarters, money-and-loan growth rebounded in 2004 Q4 to around 15% at the year end -- a level described by the central bank as “appropriate” for the economy.

- To signal policy stability, the People’s Bank of China set the target for monetary growth rates for 2005 at 15%.

- Overall, the recent data suggest that the Mainland authorities appear to be successful in guiding the economy onto a path of a gradual deceleration. Nevertheless, we shall continue to watch developments closely, particularly for any change in the exchange rate policy that could have an impact on monetary stability in Hong Kong.

CURRENCY STABILITY (III)

Domestic factors

- Economic recovery
- External position
- Inflation?
- Unemployment
- Public finance

16

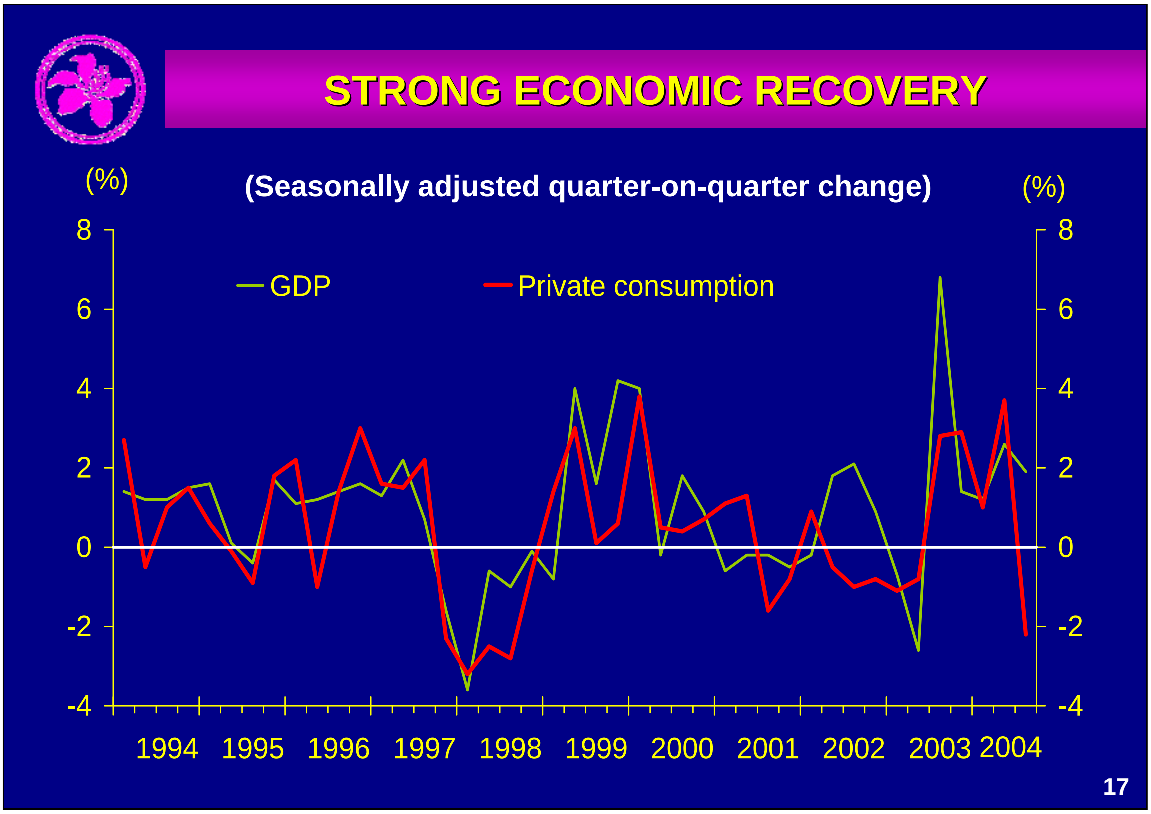
- **Economic recovery remained robust, although the rate of increase moderated slightly.** Real GDP grew by 1.9% in 2004 Q3 from the previous quarter on a seasonally adjusted basis, following an increase of 2.6% in Q2. On a year-on-year comparison, growth slowed to 7.2% from 12.1%, although the latter reflected in part a low base of comparison in 2003 Q2 when domestic activity was severely disrupted by the SARS outbreak.

- **The external position of Hong Kong remains healthy.** The current account surplus rose significantly in Q3 reflecting rises in service account surplus and factor income as well as a decline in merchandise trade deficit. The latter is mainly due to a moderation in growth in domestic demand. The net international investment position remains very strong (at more than two times GDP).

- **The headline Consumer Price Index** recorded year-on-year increases between July and December 2004. However, the rises mainly reflect a low base of comparison due to the government relief measures (such as the rates concession) implemented in July-November of 2003. There are not yet any signs of a significant pick-up in inflation pressures. However, this may gather momentum if the current loose monetary conditions persist.

- **The unemployment rate** eased to 6.5% in the three months to December 2004, from a record high of 8.6% in the May-July 2003 period, but at remains high relative to the level before the Asian financial crisis.

- **Public finances:** The fiscal position has improved significantly, helped by the recovery in economic activity. In particular, the fiscal deficit for the first eight months of the current financial year narrowed markedly on strong revenue. Nevertheless, investors are likely to remain watchful of the fiscal position and the policy strategy adopted by the Government to address the structural imbalance in the medium term.

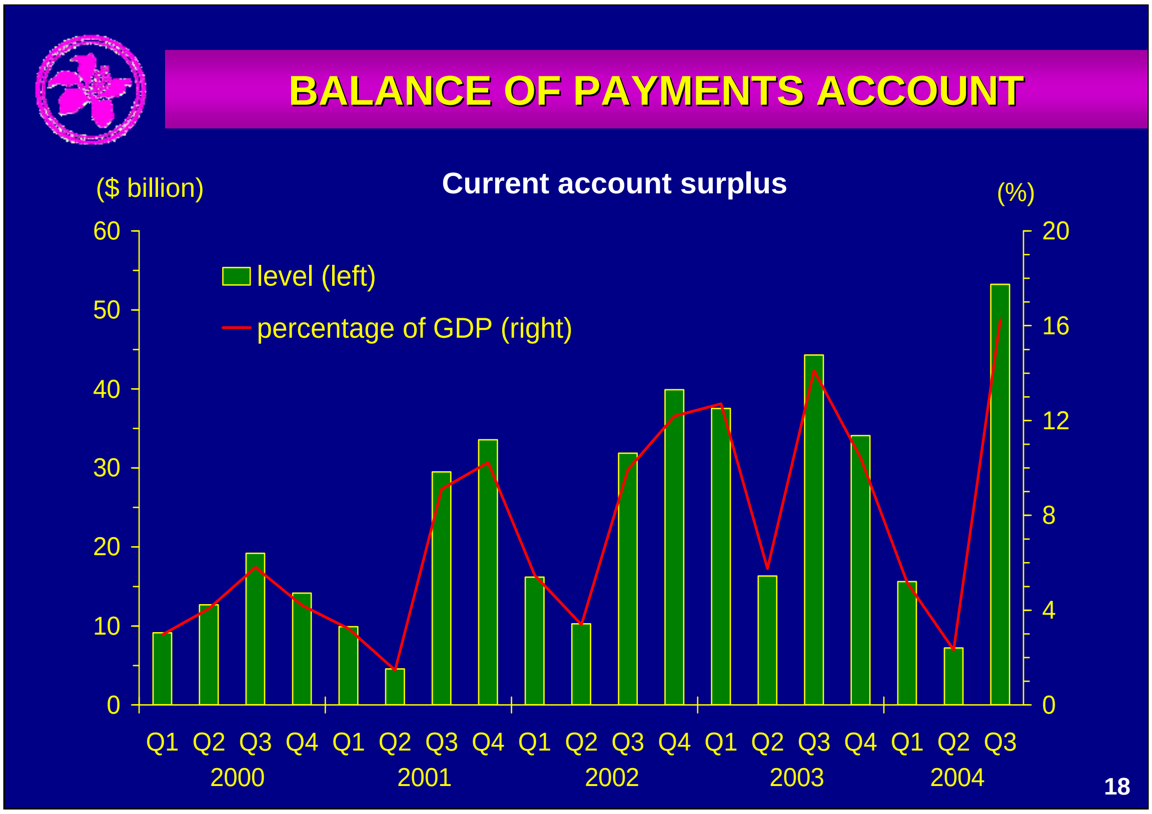


- The main contributor to growth in Q3 was exports of services, particularly tourism-related, which was partly helped by a further expansion of the Individual Visit Scheme in July.

- By contrast, exports of goods declined slightly in Q3 from a high level in Q2, because of slower growth in some of Hong Kong's major trading partners. Domestic demand also fell in Q3, mainly because of a decline in private consumption, following an exceptionally strong increase in Q2.

- Private consumption declined by 2.2% in Q3 on a seasonally adjusted basis. Spending on machinery, equipment, and computer software continued to rise, while the rate of decline in spending on building and construction moderated.

- The latest indicators suggest a further slowdown in growth in Q4. The Purchasing Managers' Index declined to 48.4 in December, slightly below the neutral (no-change) level of 50. However, the slowdown in domestic demand growth is unlikely to be sharp, as rises in asset prices and an improvement in employment should support local consumption and investment.

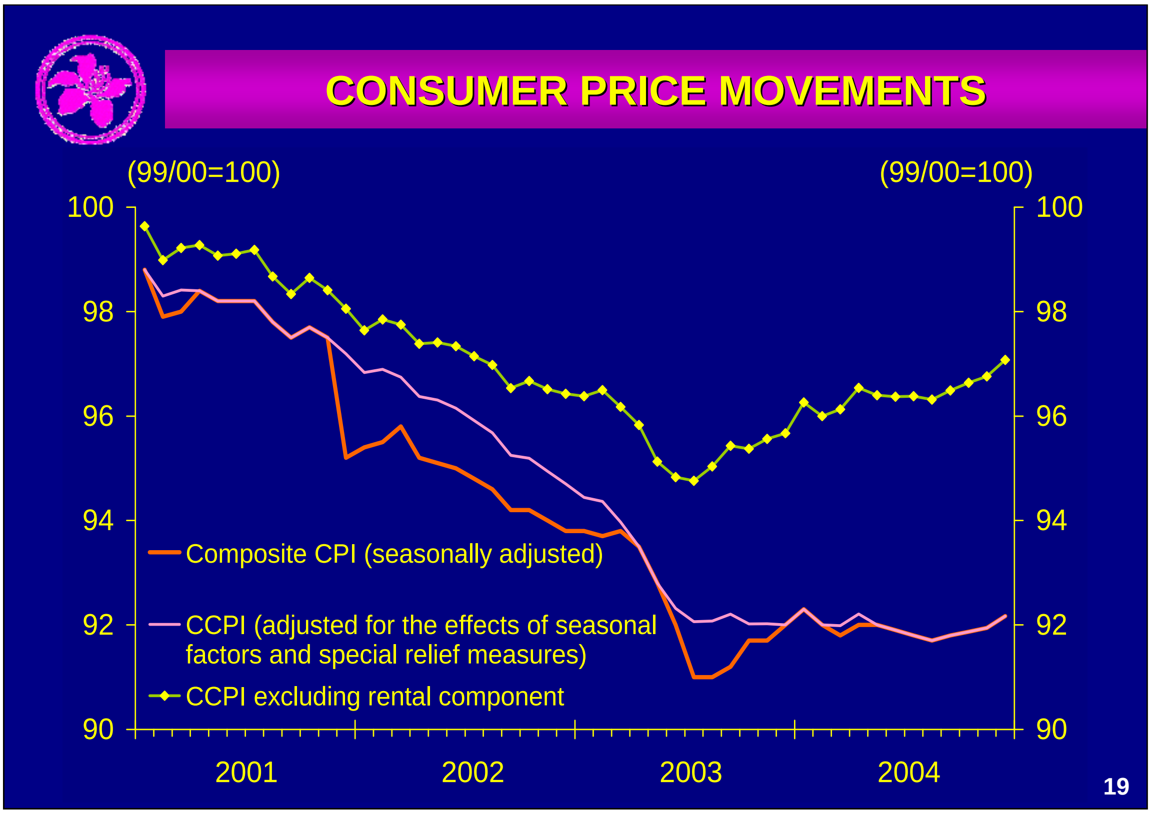


- Reflecting in part further improvement in competitiveness, the external payment position remained strong.

- In particular, the current account surplus increased markedly to around 16% of GDP in 2004 Q3, following moderate increases in the first half of 2004. The sizeable current account surplus in 2004 Q3 reflected strong growth in exports of goods and trade-related services, and sustained growth in the tourism-related sectors.

- The smaller increase in current account surplus in the first half of 2004 was partly due to seasonal factors, and partly attributable to robust growth in imports arising from the pick-up in local economic activity.

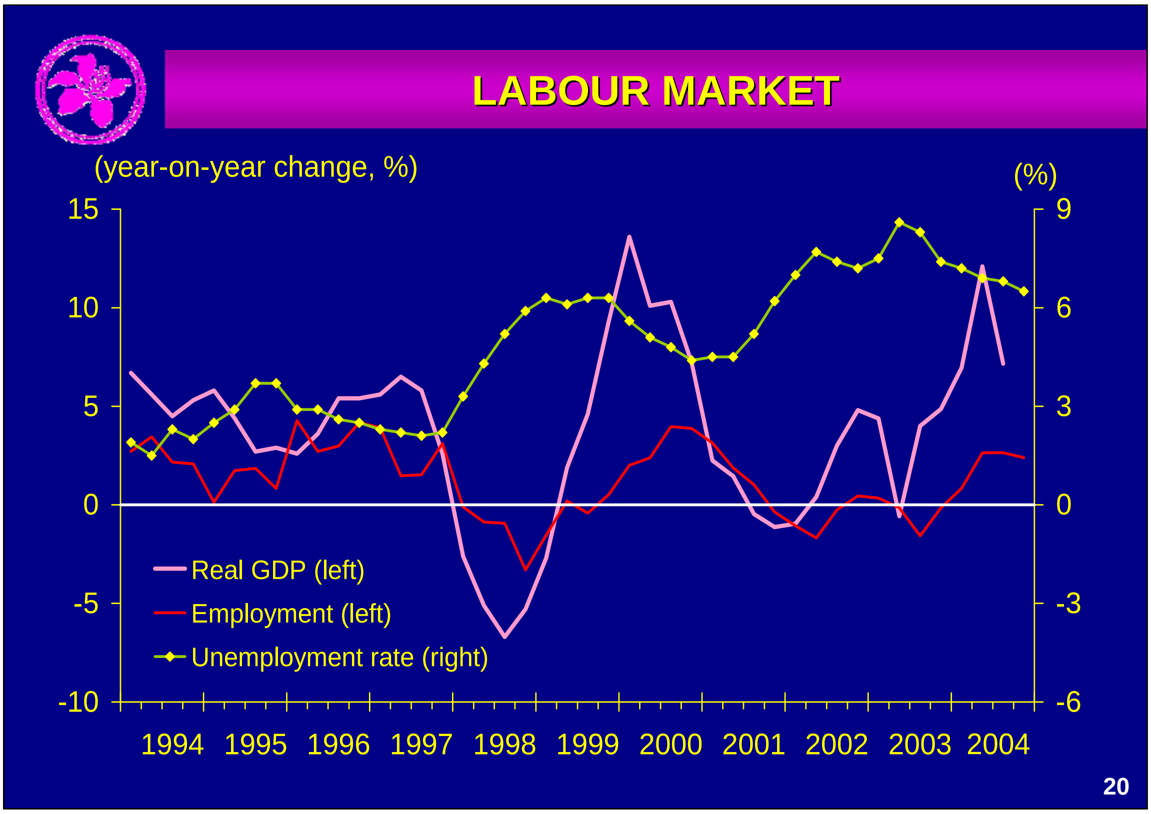
- The investment income generated by the accumulated net foreign assets (which are close to 250% of GDP) will continue to support the Hong Kong dollar, particularly if these earnings, most likely in foreign currency, are invested in domestic markets alongside strong economic growth.



- The increases in the headline year-on-year CPI inflation since July 2004 have led to concerns about a return of inflation to Hong Kong. However, the rises mainly reflect a low base of comparison due to the government relief measures (such as rate concession) implemented in the same period of 2003.

- To better assess underlying price developments, the Composite CPI (CCPI) is adjusted for the effects of seasonal factors and government relief measures. After removing these effects, the CCPI has been broadly flat since the summer of 2003.

- On a month-on-month comparison, both the CCPI and the CCPI excluding rental registered small increases in recent months, after declining in 2004 Q2. All these suggest that, while deflationary pressures have eased rapidly and, by some measures, dissipated, there are few signs yet of a significant pick-up in inflation.

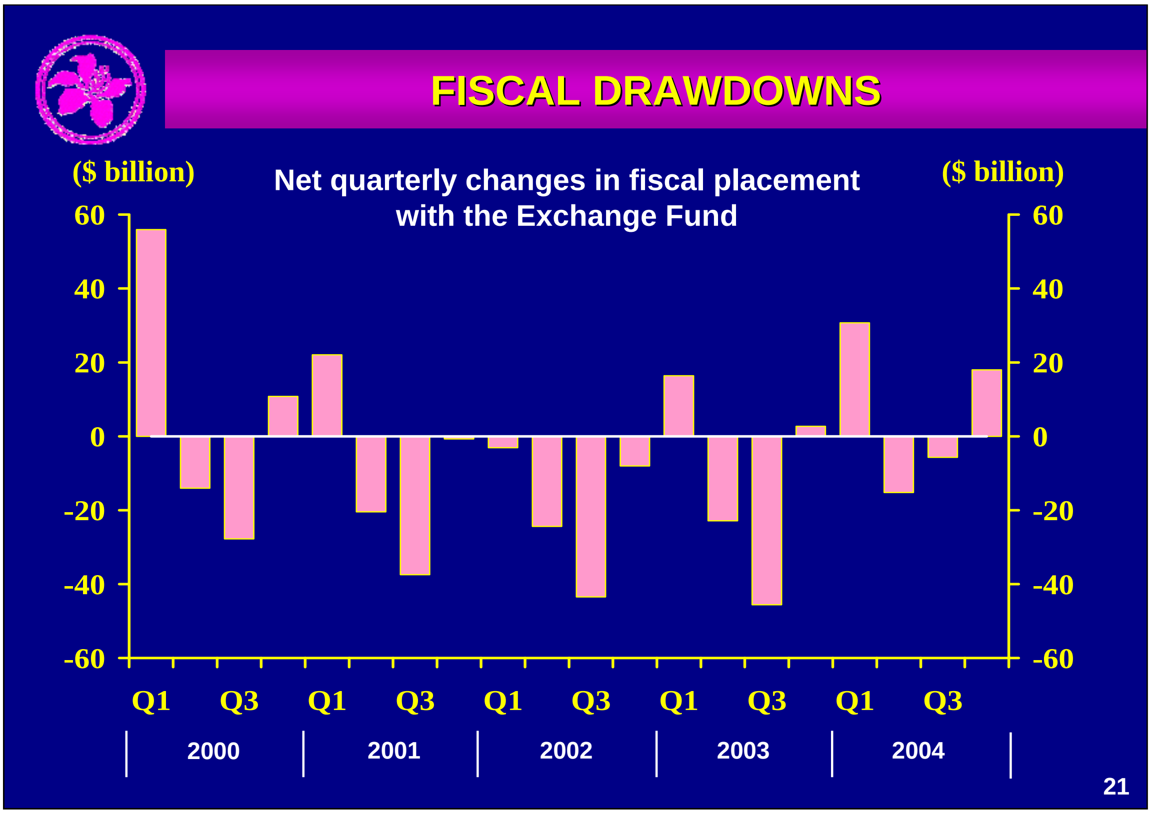


- Along with the economic recovery, labour market conditions have improved. The pace of decline in the unemployment rate appears to have moderated in recent months, due to increases in labour force, which partly offset gains in employment.

- The seasonally-adjusted unemployment rate stood at 6.5% in the three months ending in December 2004, compared to a historic high of 8.6% recorded in mid-2003.

- The increase in labour force was due to rises in the working-age population as well as labour force participation, as improved employment prospects attracted more people into the job market.

- Looking ahead, a sustained recovery in the economy should help reduce the unemployment rate further. In particular, the number of private-sector vacancies received by the Labour Department has stayed well above 20,000 since February 2004 (representing about 0.6% of total labour force).



- Alongside the economic recovery, the Government's fiscal position has improved since 2003 Q4.

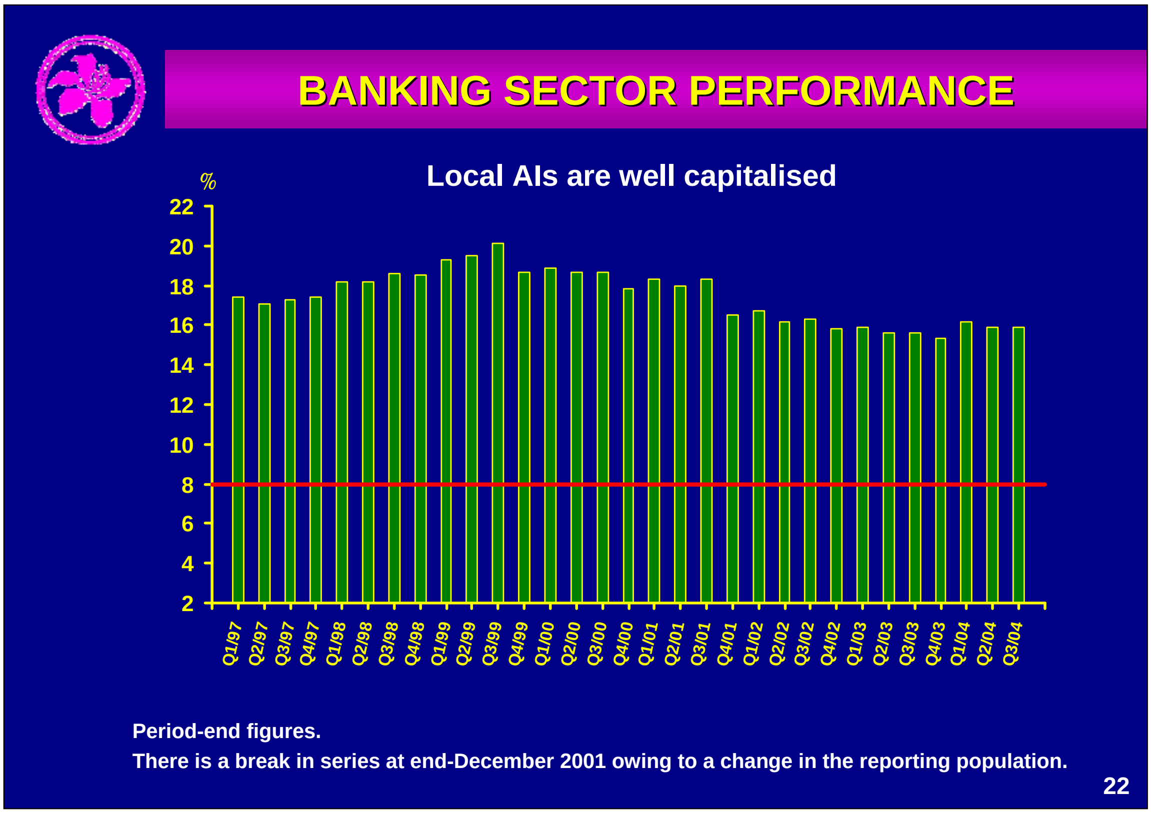
- There was net placement with the Exchange Fund in 2004 Q4 after two consecutive quarters of net draw-downs in Q2 and Q3. The net placement in 2004 Q4 was also much higher than that in the same period in 2003.

- The draw-downs in 2004 Q2 and Q3 were largely seasonal. In fact, the draw-downs were lower than that in the same period for the previous three years.

- Detailed figures for quarterly changes in fiscal placements are as follows.

Net Quarterly Change in Fiscal Placement with the Exchange Fund ($ billion)

year \ quarter	Q1	Q2	Q3	Q4
2000	55.9	-14.1	-27.7	10.8
2001	22.1	-20.4	-37.4	-0.7
2002	-3.1	-24.4	-43.5	-8.0
2003	16.4	-22.9	-45.6	2.7
2004	30.7	-15.2	-5.7	18.0



- Locally incorporated AIs are required to maintain a capital adequacy ratio (a measurement of the capital that an AI holds in relation to the amount of its risk assets) of not less than 8%. This is a statutory requirement under the Banking Ordinance as well as the international minimum standard set by the Basel Committee. At the end of September 2004, the average consolidated capital adequacy ratio of all local authorized institutions was almost 16%, well above the statutory and international minimum.

BANKING SECTOR PERFORMANCE

Robust profit growth
(retail banks)

	2004	2003
Growth in pre-tax operating profit	+20.3%	+5.7%
Bad debt charge as % of average total assets	-0.02%	0.29%
Cost-to-income ratio	41.6%	38.6%
Net interest margin	1.65%	1.91%

23

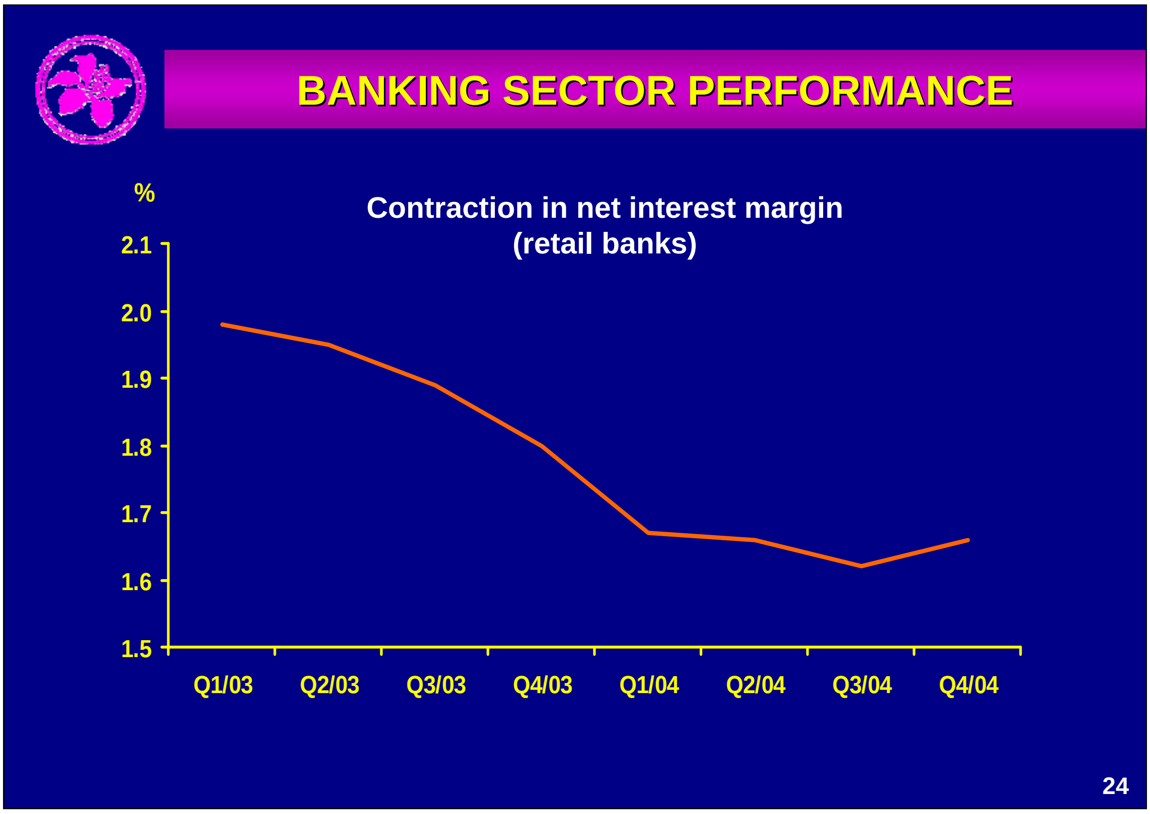
- Benefiting from the economic upturn, banks in Hong Kong recorded good profit growth in 2004. Retail banks' aggregate pre-tax operating profit for their Hong Kong offices increased by 20.3% in 2004, compared with 5.7% in 2003.

- The profit growth was mainly attributable to the reduction in bad debt charges, strong gains from treasury operations and increased fees and commissions received from wealth management and trade financing business. Such increases in income have offset the decline in interest income and rising operating costs.

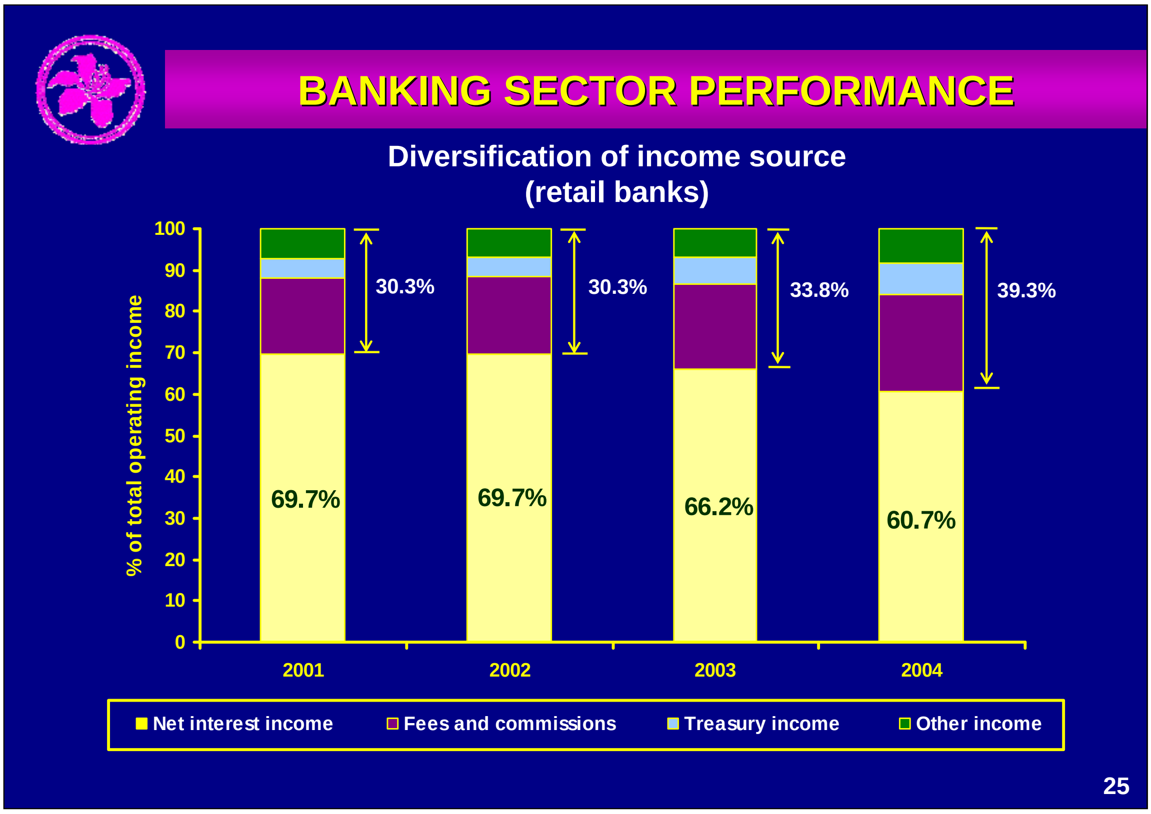
- In line with the on-going improvement in asset quality, the bad debt charge declined notably compared with that of 2003. Retail banks' ratio of bad debt charge to average total assets improved to -0.02% in 2004 from 0.29% a year ago, as provision write backs more than offset new bad debt charges.

- Retail banks' cost-to-income ratio rose to 41.6% in 2004, from 38.6% in 2003, reflecting a general increase in operating costs and other expenses relating to business expansion.

- Owing to the squeeze in margins of residential mortgage lending coupled with the lower yield on free funds, full-year net interest income of retail banks declined in 2004 although an increase was seen in 2004 Q4. Net interest margin contracted to 1.65% in 2004 from 1.91% in 2003.



- Reflecting keen competition and high liquidity in the banking sector, the net interest margin of retail banks contracted steadily in the first three quarters of 2004 (to 1.62% in 2004 Q3) although in 2004 Q4 this was increased to 1.66% owing to the increase in net interest income during the quarter. The average net interest margin for the whole year was 1.65%.

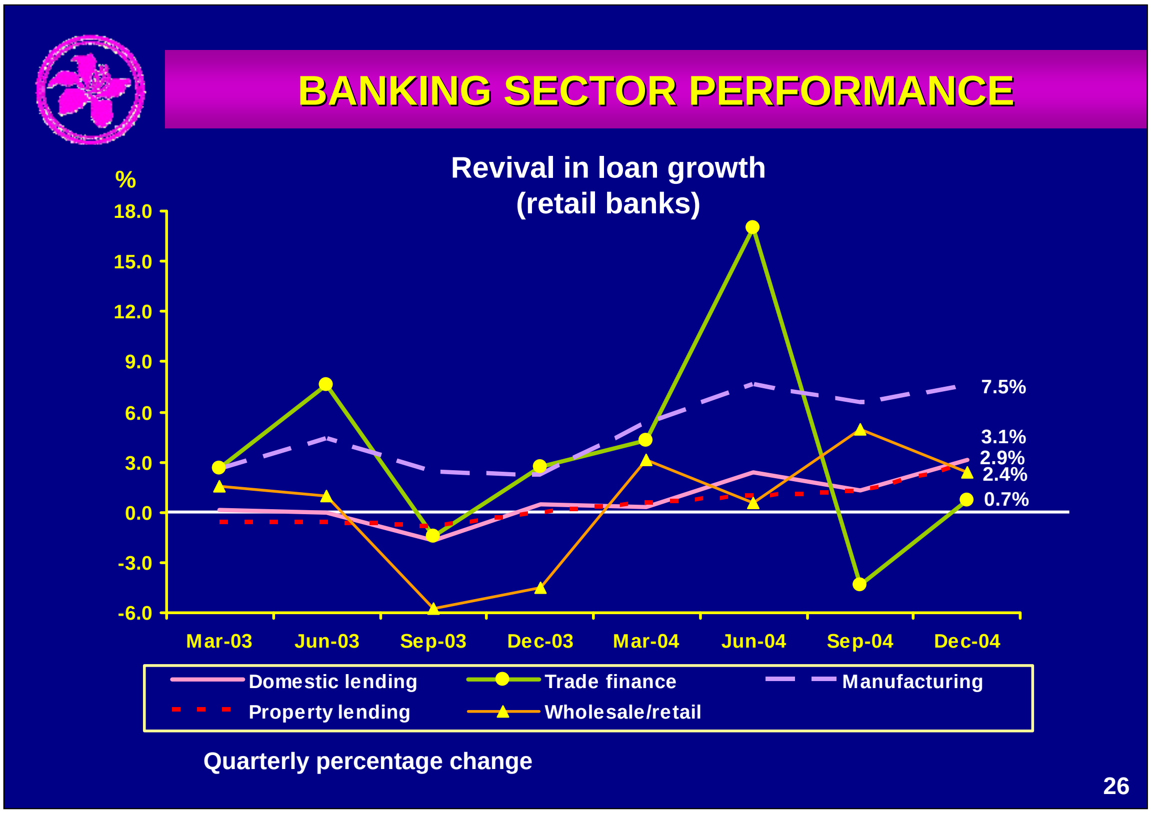


- Increasing pressure on interest spreads in a competitive environment has prompted banks to explore new lines of business for income diversification. Coupled with the decrease in net interest income, the proportion of retail banks' non-interest income to total operating income expanded to 39.3% in 2004 from 33.8% in 2003. The increase in non-interest income was mainly seen in fees & commissions and treasury income.

- Growing fee-based business (e.g. insurance, securities brokerage and private banking) in a low-return environment contributed to the increase in fees and commission income of banks.

- The weighting of treasury income also increased, partly reflected the increased holding of negotiable debt instruments by banks and partly because of the relatively more volatile foreign exchange market in 2004.

- In view of the diversification of banks' activities, the HKMA has improved its supervision over banks' securities and insurance businesses, and has devoted more efforts to the supervision of banks' risk management, particularly in interest rate and market risk management given the increased holdings of negotiable debt instruments by banks.

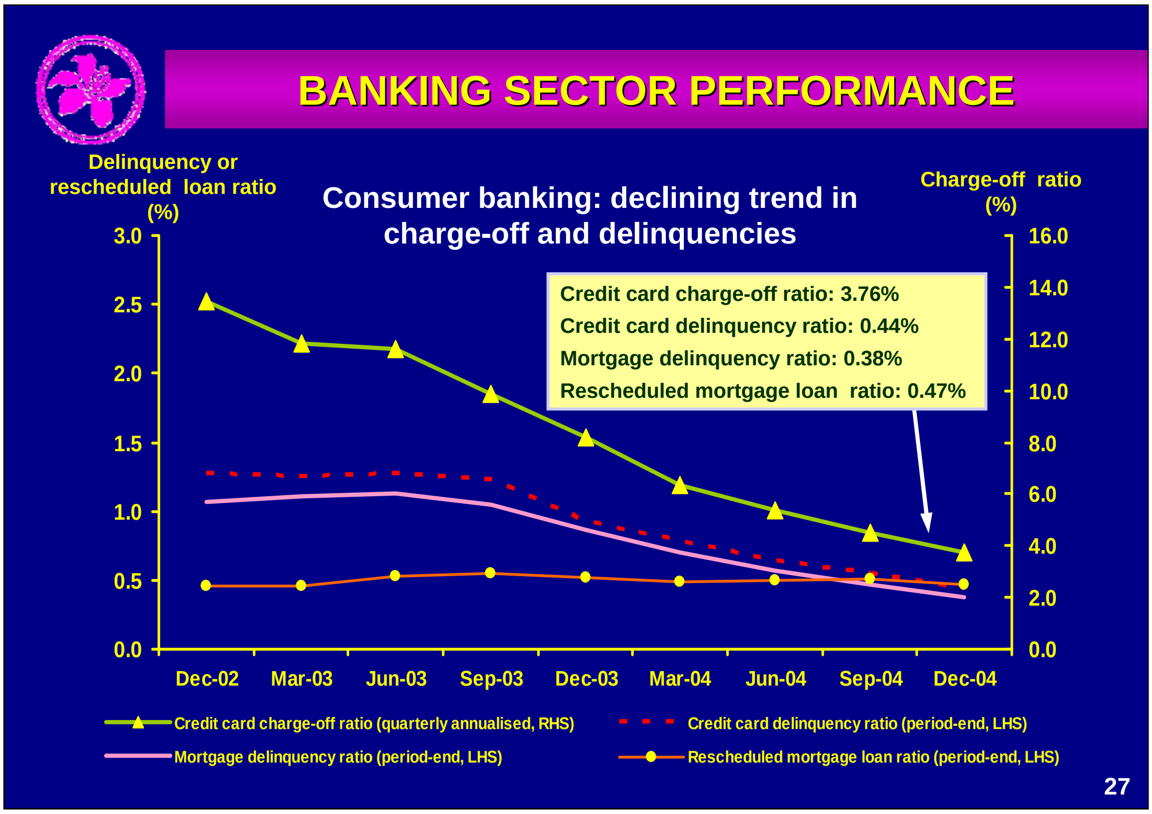


- Underpinned by the improvement in business sentiment and the increase in economic activities, domestic loan demand has picked up since 2003 Q4 (loan growth returned to positive territory as shown in the above chart).

- Total domestic lending advanced by 3.1% in 2004 Q4 from 2004 Q3.

- On the back of flourishing trade flows and the revival of consumer confidence, domestic lending to all major economic sectors increased in 2004. Growth was particularly notable in Q2 as the economic recovery has broadened to a full-fledged upturn in this quarter with external trade growing robustly.

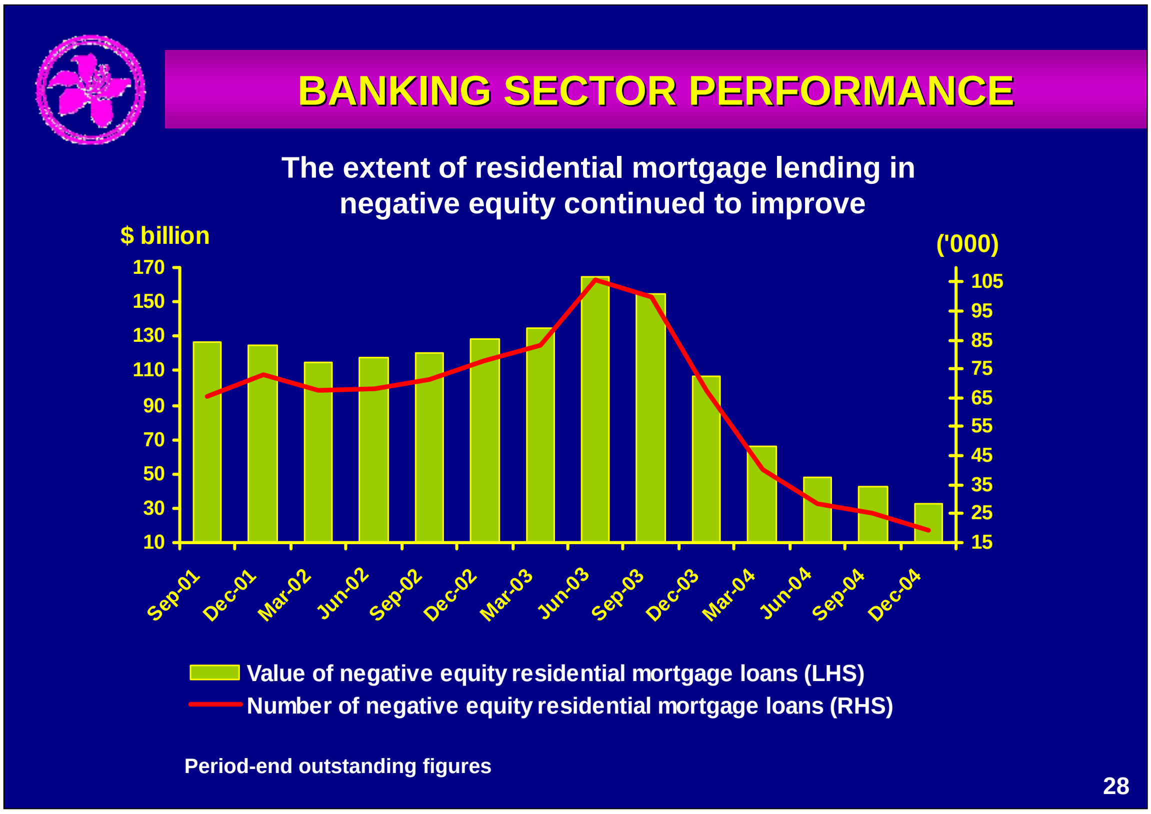
- The sharp decline in trade finance in 2004 Q3 from a strong growth in 2004 Q2 reflected reclassifications initiated by a few banks in the quarter. Compared with the end of 2003, trade finance at end of 2004 rose by 17.6%.



- The improving employment market strengthened borrowers' repayment ability and thus improved the quality of banks' consumer lending.

- The credit card charge-off ratio and delinquency ratio declined to 3.76% and 0.44% at the end of 2004 respectively from the peak of 14.55% and 1.32% at the end of September 2002.

- The residential mortgage delinquency ratio (loans overdue for more than 3 months) fell to a six-year low of 0.38% at the end of 2004 from the peak of 1.43% at the end of April 2001.



- The negative equity problem has eased along with the rise in property prices. The number of residential mortgage loans in negative equity declined from the peak of around 106,000 cases ($165 billion) in June 2003 to some 19,200 cases in December 2004 with an aggregate value of $33 billion.

BANKING SECTOR - 2005 OUTLOOK

- More competitive and challenging environment
- Profitability
  – narrowing interest margins
  – continuous cost pressure
- Moderate increase in loan demand alongside economic growth
- Steady improvement in asset quality
- Banks' balance sheets remain strong & capital level remains high
- Challenges ahead
  – Interest rate and market risks
  – China-related issues
  – Technology issues
  – Volatility in financial statements owing to wider use of fair value accounting
- Sharp return of interest rates to more "normal" levels may present challenges

29

- The banking sector should continue to benefit from the steady improvement in the domestic economy. Alongside the economic pick up since 2004 Q3, domestic loan demand has been steadily increasing. This trend is expected to continue into 2005. The economic upturn has also strengthened borrowers' repayment ability and thus banks' asset quality. But a sharp return of interest rates to more normal levels may have adverse effects.
- However, domestic and global economic expansion may be overshadowed by uncertainties such as the macro-economic adjustment in Mainland China, the pace of increases in US interest rates, and the continuing threat of terrorism. As such, we expect banks to face a more difficult and challenging environment in 2005.
- Competition for new business will remain keen especially if exceptionally high liquidity remains in the banking system. This will further squeeze banks' interest margins. Together with increasing operating costs, banks' profitability will be put under pressure. Whether banks can maintain their profitability will depend on the effectiveness of their cost containment measures and income diversification ability. Plans to expand into Mainland China may also increase the costs of some banks in the short to medium term.
- Backed by strong balance sheets and high capital adequacy, coupled with robust risk management, banks are well placed and sufficiently equipped to embrace the challenges ahead and turn them into opportunities.
- Irrespective of the challenging conditions in banks' operating environment, wider use of fair value accounting following the adoption of the new accounting standards is expected to translate into greater volatility in banks' financial statements.

BANKING SECTOR - WORK PROGRESS (I)

- **International Accounting Standards and Hong Kong Accounting Standards**
  - **Convergence of HKAS with IAS for accounting periods beginning on or after 1 January 2005**
  - **Higher volatility in banks' financial statements due to wider application of fair value accounting**
  - **Review of relevant policy areas in consultation with industry associations and the accounting profession**

30

- The Hong Kong Institute of Certified Public Accountants adopted several new Accounting Standards that are modelled on the corresponding International Accounting Standards (IAS) in 2004. These Accounting Standards become effective for accounting periods that begin on or after 1 January 2005. Banks incorporated in Hong Kong need to ensure their annual accounts are compliant with these new accounting standards.

- As these accounting changes will result in more extensive use of fair value accounting with changes charged to profit and loss account, the HKMA expects the change to introduce greater volatility into banks' financial statements.

- Some aspects of IAS remain controversial, and a debate continues elsewhere in the world, especially Europe, on how best to apply the standards to banks. The Basel Committee is still at an early stage of formulating its guidance on these matters.

- The HKMA has been maintaining close contact with the banking industry and the accounting profession and has conducted a preliminary assessment of the implications of the new accounting standards in the second half of 2004. In some cases, like the treatment of provisioning, the HKMA has offered guidance to the banking sector on our view of how such accounting standards coincide or stand alongside existing prudential standards.

- The HKMA will work closely with the industry associations and the accounting profession to assess the impact of the new accounting standards, Pillar 3 of the New Basel Capital Accord and the Basel Committee's recommendations on international accounting standards.

BANKING SECTOR - WORK PROGRESS (II)

- **Implementation of Basel II in HK**
  - **On-going, extensive consultation reflects general support of implementation proposals**
  - **Considering comments on proposed amendments to the Banking Ordinance. Banking (Amendment) Bill 2005 to be introduced into LegCo in April 2005**
  - **Continue to develop relevant rules and guidelines and monitor AIs' preparations for the revised capital regime**

31

- The banking industry supports the detailed implementation proposals we released in August / September 2004 as a pragmatic way of implementing Basel II in Hong Kong with effect from 1 January 2007.

- In December 2004, we briefed the Panel, as well as the BAC and the DTCAC on the main provisions and specific details of the Banking (Amendment) Bill 2005 which provides for the introduction of Basel II requirements. We have also undertaken a public consultation of the draft Bill. Comments received are mainly to seek clarification on points of detail, which we will consider and address in conjunction with the Department of Justice and the Financial Services and the Treasury Bureau. We aim to introduce the Bill into LegCo in April 2005.

- The on-going preparatory work on the development of guidelines and rules under Basel II continues. We will undertake further consultations with the industry when necessary. Meanwhile, we will monitor closely AIs Basel II implementation progress, particularly in the case of AIs intending to adopt the more advanced approaches.

BANKING SECTOR - WORK PROGRESS (III)

Safe Deposit Boxes

- **Update on compensation by DBS for the incident**
  - up to 4 February 2005, 76 out of 83 affected cases have been settled
- **Actions taken since the incident**
  - The HKMA issued a circular requiring AIs to adopt sound control to safeguard customer assets
  - The HKAB issued best-practice recommendations on relocation of safe deposit boxes
  - AIs completed the review of the terms and conditions for safe deposit box service. For those exemption of liability clauses found to be inconsistent with the Code of Banking Practice, the AIs concerned are required to rectify the situation by 31 March 2005
  - The industry strengthened the Code of Banking Practice to make it clear that AIs should keep terms and conditions under review to ensure compliance with relevant consumer protection legislation

32

- The HKMA issued a circular to all AIs on 22 December 2004 requiring them to adhere to sound internal control principles when undertaking operations that involve customer assets. This should include ensuring sufficient planning for the operations, adequate supervisory oversight and control throughout the whole process, detailed records of customers assets (or items containing customers assets), and independent verification of the accuracy of these records.

- The Hong Kong Association of Banks issued a circular in November 2004 enclosing a set of best-practice recommendations on the relocation of safe deposit boxes. The HKMA supports the Association's recommendations and expects AIs that provide safe deposit box service to follow the recommendations.

- AIs also completed the review of the terms and conditions for safe deposit box services as required by the HKMA. Taking into account the results of the review, the HKMA issued a circular on 17 December 2004 to provide guidance to AIs on the use of exemption clauses. AIs are required to make appropriate changes to their safe deposit agreements by 31 March 2005.

- In parallel, the industry has amended the Code of Banking Practice to make it clear that AIs should have due regard to the Control of Exemption Clauses Ordinance, the Unconscionable Contracts Ordinance and the Supply of Services (Implied Terms) Ordinance in drawing up terms and conditions of banking services. They should also keep their terms and conditions under constant review.

BANKING SECTOR - WORK PROGRESS (IV)

- **Deposit Protection Scheme (DPS)**
  - Hong Kong Deposit Protection Board has commenced work on the key preparatory tasks
  - Continue to assist the Board with a view to commencing the scheme in 2006 H2
- **Commercial Credit Reference Agency (CCRA)**
  - Operation is smooth so far
  - Study how sole proprietorships and partnerships can be included in the CCRA database
- **Consumer issues**
  - Complete the review of the terms and conditions for other banking services
  - Continue to enhance consumer protection through development of the Code of Banking Practice and monitoring compliance with it
  - Monitor AIs' implementation of the arrangement to provide customers a choice whether to have the function of purchasing cash vouchers using their ATM cards

33

- Following its formation in July 2004, the Hong Kong Deposit Protection Board has commenced work on a number of key preparatory tasks, including the preparation of a yearly return for assessment of contributions and development of the Board's payout policies and procedures. Rules governing the detailed operation of the scheme are also being developed. To keep the industry informed of the progress of the project and to facilitate the exchange of views between the industry and the Board, a consultative committee on DPS was formed in November 2004. The HKMA will continue to assist the Board to prepare for the launch of the DPS in the second half of 2006.

- The CCRA was successfully launched on 1 November 2004. The operation has been smooth so far. Going forward, we will discuss with the industry on the further development of the CCRA, particularly on how sole proprietorships and partnerships can be included to improve the data coverage of the database.

- The HKMA will complete the comprehensive review of the terms and conditions for other banking services to ensure compliance with the Code of Banking Practice. We will provide the results of the review to Members once available. We will continue to monitor AIs' compliance with the Code through annual self-assessment by AIs and handling customer complaints about banking services.

- The HKMA notes that some fraudsters used stolen ATM cards to purchase cash vouchers at Hong Kong Jockey Club outlets through the EPS system. In some cases, this has resulted in a fairly large amount of loss to those customers who have lost their cards and Personal Identification Numbers at the same time. The HKMA has requested the Code of Banking Practice Committee to study this matter. In December, the Hong Kong Association of Banks, at the recommendation of the Committee, issued a circular recommending its members to give customers a choice as to whether their cards should have the function of purchasing cash vouchers. We are following up AIs' implementation of this recommendation.

MARKET INFRASTRUCTURE

- **Commencement of the Clearing and Settlement Systems Ordinance in November 2004**
  - **Two detailed documents issued to explain the designation and oversight functions**
  - **Designation of five clearing and settlement systems**
- **Smooth entry of the Hong Kong dollar into the CLS system in December 2004**
- **Smooth payment flows during major IPO activities, including the IPO of the Link REIT**

34

- The Clearing and Settlement Systems Ordinance became effective on 4 November. Apart from Hong Kong dollar CHATS and CMU which are deemed to have been designated, three more systems including the US Dollar CHATS, euro CHATS and the CLS System were designated. Each of the five designated systems was issued a certificate of finality to provide statutory protection to the settlement finality for transactions effected through these systems.

- To improve our operational transparency, two elaborate documents, namely, the *Explanatory Note on Designation and Issuance of Certificate of Finality* and the *Guideline on the Oversight Framework for Designated Systems under the Clearing and Settlement Systems Ordinance* were compiled in consultation with the industry and issued for public information.

- The Hong Kong dollar became an eligible currency in the CLS system in December 2004, after all operational and legal preparations were duly made. The CLS system is a global clearing and settlement system for cross-border foreign exchange transactions, and there are currently 15 currencies eligible for settlement in the system. The entry of the Hong Kong dollar into the CLS system has reinforced the status of Hong Kong as an international financial centre.

- The Hong Kong payment systems responded robustly and efficiently to massive payment flows arising from IPO activities. The Hong Kong dollar RTGS system processed as much as $280 billion interbank funds flow associated with the subscription monies for the Link REIT IPO in a smooth and orderly manner. The introduction of a new device called the CHATS Optimiser, which provides for the simultaneous settlement of paper cheques and large value CHATS payment in an offsetting manner, has helped the effective and efficient recycling of interbank funds.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

Asian Bond Fund 2 (ABF2)

- The HKMA, together with the other 10 EMEAP central banks and monetary authorities, announced the launch of ABF2 in December 2004.
- All 11 EMEAP Members will invest in ABF2, with an initial size of US$2 billion in total.
- Implementation:
  - Phase 1: Confined to EMEAP central banks.
  - Phase 2: To be offered to other public and private sector investors, through listing where appropriate.
- Two important components of ABF2, namely the Pan-Asian Bond Index Fund and Hong Kong Bond Fund, will be listed on the Hong Kong Stock Exchange.

35

- As the Chairman of the EMEAP Working Group on Financial Markets, the HKMA has been driving the design and implementation of the ABF2.
- The ABF2 comprises two components:
  - **Pan-Asian Bond Index Fund (PAIF):** a single bond fund investing in sovereign and quasi-sovereign local currency-denominated bonds issued in the eight EMEAP markets.
  - **Fund of Bond Funds (FoBF)** is made up of eight Sub-Funds, each of which will invest in sovereign and quasi-sovereign local currency-denominated bonds issued in the respective markets of the eight EMEAP economies.
- All ABF2 funds will be passively managed by private sector fund managers against a set of newly-developed bond indices.
- EMEAP has chosen Hong Kong as the initial place of listing for the PAIF on the basis of market attributes, efficiency and sophistication, taking into account such factors as stock market turnover, transaction costs, potential demand for EMEAP currency bonds as well as the legal and regulatory framework of the relevant markets.
- ABF2 will play a catalytic role in:

  (i) Promoting new products – The Hong Kong Sub-Fund will be the first ever fixed income exchange traded fund listed on the Hong Kong Stock Exchange;

  (ii) Improving market infrastructure – The family of bond market indices newly-developed for ABF2 will draw on price information supplied by various market participants, thereby having enhanced impartiality and credibility. The indices are important market infrastructure for the eight EMEAP markets concerned and will facilitate market participants to structure new products;

  (iii) Minimising regulatory hurdles – Some EMEAP economies are currently reviewing or changing their tax and regulatory regimes to facilitate cross-border investment. For instance, Malaysia has opened up its domestic market to issuances by Multilateral Development Banks (MDBs) and Multilateral Financial Institutions (MFIs), and exempted non-resident investors from withholding tax on the interest income received from investment in ringgit-denominated debt securities.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

- **Renminbi business in Hong Kong**
  - renminbi deposits was RMB12.128 billion at the end of December
  - use of renminbi bank cards is a boost to Mainland tourists' consumption
  - further development of renminbi business in Hong Kong to follow three strategic directions:
    - (i) diversification of renminbi assets and liabilities of banks in Hong Kong;
    - (ii) denomination and settlement of trade in renminbi; and
    - (iii) a renminbi debt issuance mechansim in Hong Kong

36

- Renminbi business
  - Since 18 January 2004, there has been a steady increase in the use of renminbi debit and credit cards by Mainland tourists in Hong Kong. The cumulative total of credit/debit card spending amounted to $2.1 billion on 25 December 2004, or $2,991 per transaction.
  - 38 banks have engaged in personal renminbi deposit, remittance and exchange services since 25 February 2004. Total outstanding renminbi deposits was RMB12.128 billion at the end of December.
  - The launch of renminbi services provides a new range of services for customers in Hong Kong, helps diversify banking business, and facilitates cross-border spending and economic integration between Hong Kong and the Mainland.
  - Further development of renminbi business in Hong Kong would follow three strategic directions:
    - (i) to explore the diversification of renminbi assets and liabilities of banks in Hong Kong;
    - (ii) to explore the use of renminbi for the denomination and settlement of current account transactions such as trade between the Mainland and Hong Kong, and to facilitate this by providing relevant renminbi banking services in Hong Kong; and
    - (iii) to explore the feasibility of establishing a renminbi debt issuance mechanism in Hong Kong, which would facilitate the repatriation of renminbi back to the Mainland.

INVESTMENT OBJECTIVES OF THE EXCHANGE FUND

Investment objectives of the Exchange Fund are:

(1) to preserve capital;

(2) to ensure that the entire Monetary Base at all times will be fully backed by highly liquid short-term US dollar denominated securities;

(3) to ensure sufficient liquidity for the purpose of maintaining monetary and financial stability; and

(4) subject to (1) – (3) above, to achieve an investment return that will preserve the long-term purchasing power of the assets.

37

- It is important to remember that the Exchange Fund is not an ordinary investment fund. The investment strategy must be determined having regard to the nature and the primary objective of the Fund under the Exchange Fund Ordinance.

- The primary objective of the Exchange Fund is to safeguard the exchange value of the Hong Kong currency and to maintain the stability and integrity of the monetary and financial systems.

- The high volatility in the financial markets in recent years has highlighted the importance of prudent investment management.

- The investment strategy of the Exchange Fund, as determined by the Exchange Fund Advisory Committee, is therefore directed by the objectives of capital preservation, liquidity, full backing of the Monetary Base and maintaining the long-term purchasing power of the assets.

FINANCIAL MARKETS IN 2004

- **Overall performance volatile:**
  - **Q1 strong**
  - **Q2 sharp decline**
  - **Q3 moderate**
  - **Q4 strong rally**

38

- The investment environment in 2004 was very volatile. The strong recovery in the performance of the Exchange Fund in the second half of the year contrasted markedly with a difficult first half, particularly in the second quarter.

EXCHANGE FUND PERFORMANCE

($ billion)	2004 Full year	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2003 Full year	2002 Full year	2001 Full year	2000 Full year
Gain / (Loss) on Hong Kong equities*	12.0	1.0	(1.4)	5.5	6.9	21.2	(11.8)	(27.1)	(7.3)
Gain / (Loss) on other equities*	11.2	3.2	2.5	(4.7)	10.2	26.8	(22.7)	(3.3)	0.5
Exchange gain / (loss)	8.5	0.6	(2.6)	1.7	8.8	22.9	27.2	(13.0)	(11.2)
Total return from bonds, etc	25.0	12.0	(5.7)	11.6	7.1	18.8	54.3	50.8	63.1
Investment income	56.7	16.8	(7.2)	14.1	33.0	89.7	47.0	7.4	45.1

* including dividends

39

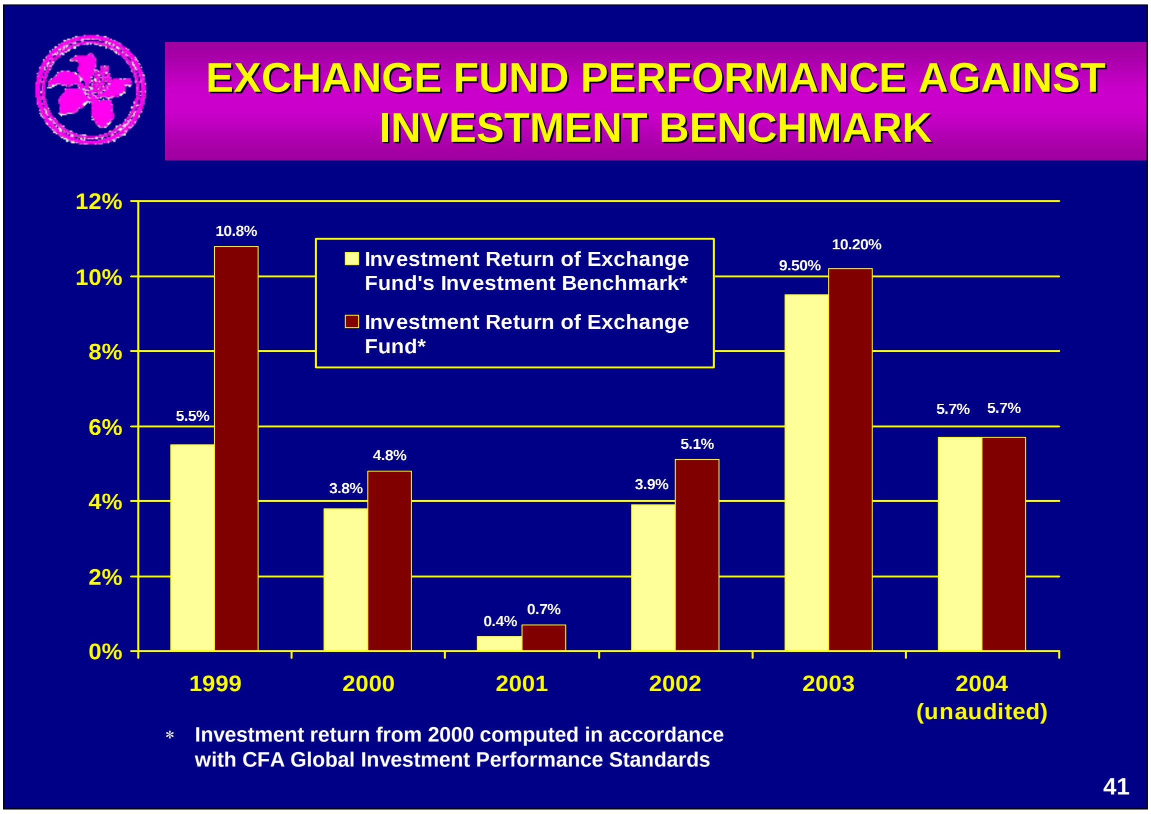
- The Exchange Fund recorded an investment income of $56.7 billion in 2004. The main components of this income were:
  - valuation gain and dividends from the Hong Kong equities portfolio amounting to $12 billion.
  - valuation gain and dividends from other equities amounting to $11.2 billion.
  - an exchange valuation gain of $8.5 billion, mainly as a result of the appreciation of the euro against the US dollar.
  - total return from bonds and other investments of $25 billion.

EXCHANGE FUND
CHANGE IN ACCUMULATED SURPLUS

($ billion)	2004 Full year	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2003 Full year
Investment income	56.7	16.8	(7.2)	14.1	33.0	89.7
Other income	0.2	0.0	0.1	0.0	0.1	0.2
Interest and expenses	(4.8)	(1.1)	(1.1)	(1.3)	(1.3)	(5.6)
Net investment income	52.1	15.7	(8.2)	12.8	31.8	84.3
Treasury's share	(14.5)	(4.5)	2.1	(3.6)	(8.5)	(25.7)
Revaluation gain/(loss) on premises affecting accumulated surplus	0.9	0.0	0.0	0.0	0.9	(0.9)
Increase/(Decrease) in EF accumulated surplus	38.5	11.2	(6.1)	9.2	24.2	57.7

40

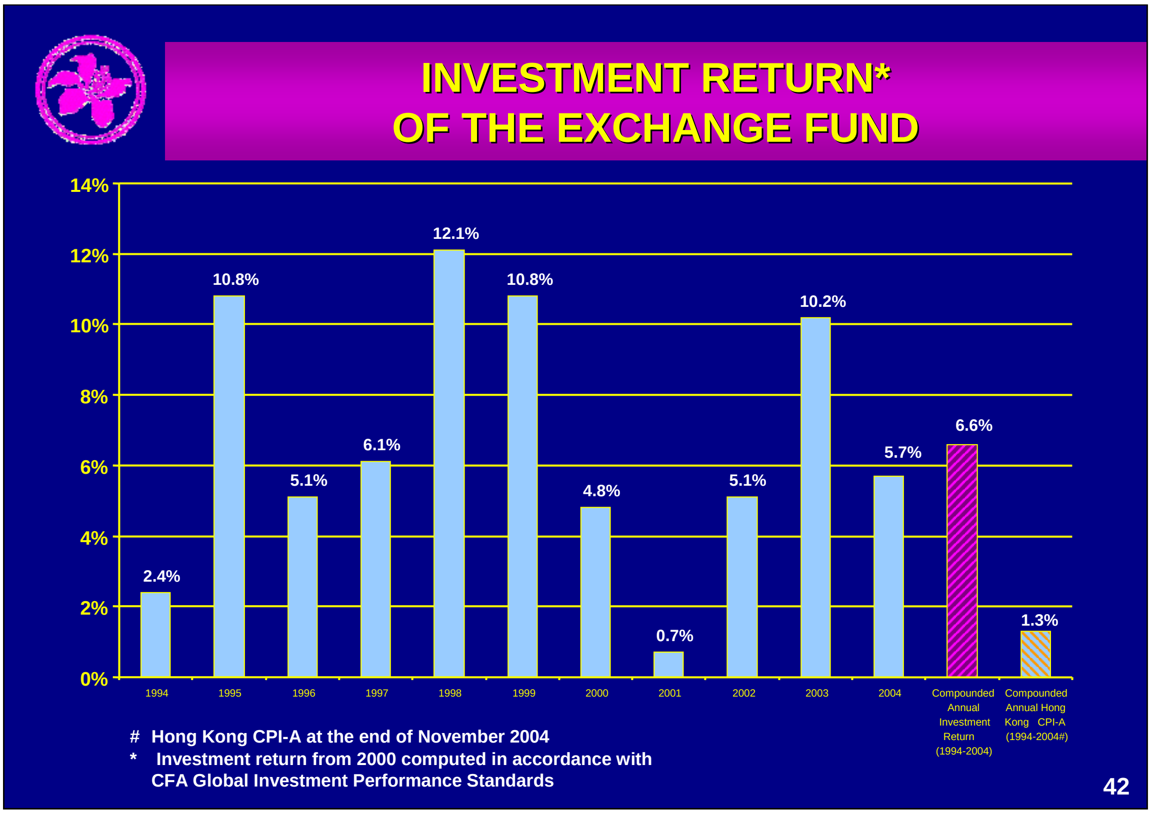
- After deducting interest and other expenses, the net investment income in 2004 was $52.1 billion. Of this, the fiscal reserves' share amounted to $14.5 billion, which exceeded the amount budgeted ($12.3 billion) in the fiscal year 2004/05.
- The balance of $37.6 billion, together with part of a premises revaluation surplus ($0.9 billion), has been added to the Exchange Fund's accumulated surplus for 2004. The accumulated surplus stood at $423.4 billion at the end of the year.



- In 2004, the Exchange Fund achieved an investment return of 5.7%, which met the investment return of the benchmark portfolio determined by the Financial Secretary after consultation with the Exchange Fund Advisory Committee.

- Since 1999, the Exchange Fund has achieved a 6.2% annual return[1], or an annual out-performance of 1.4% above the benchmark's 4.8% annual return[1] for the same period.

[1] Compounded.



- Since 1994, the Exchange Fund has generated an annual return of 6.6%[1] compared with the annual inflation rate of 1.3%[1] over the same period.

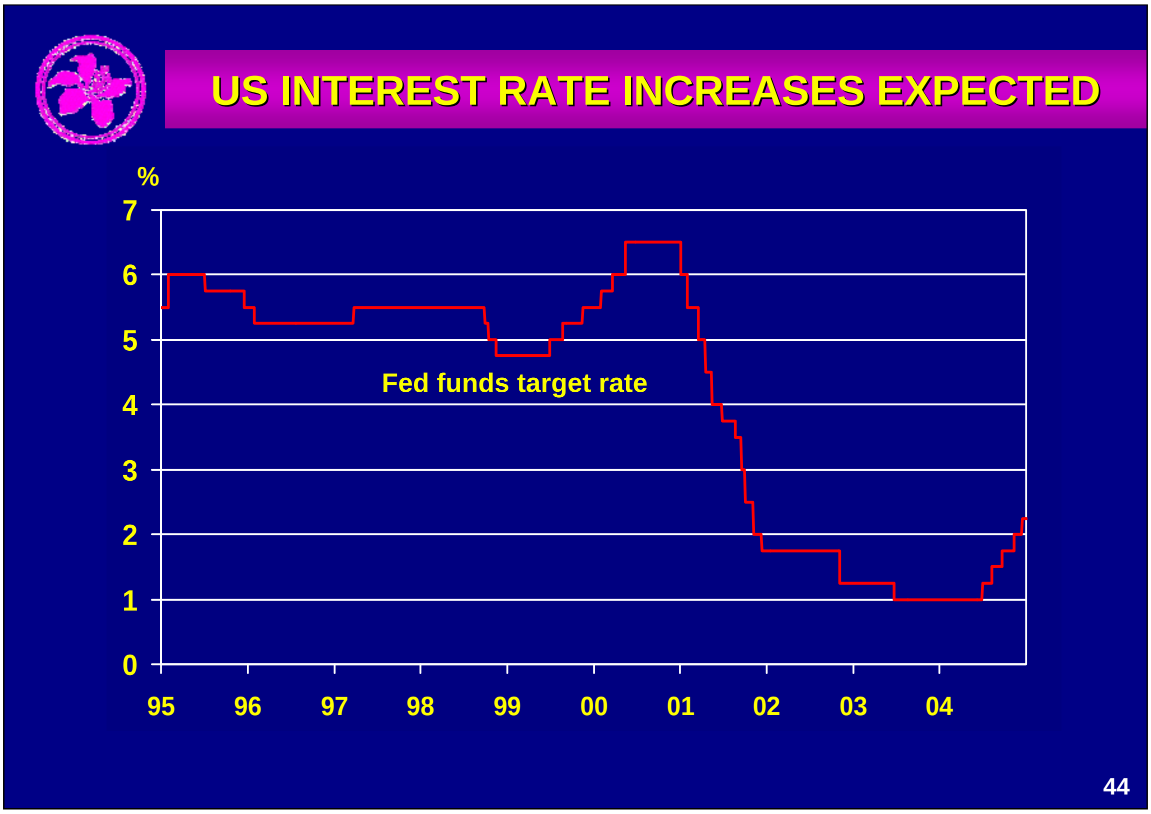
[1] Compounded.

OUTLOOK FOR 2005

- US interest rate increases expected
- Outlook for equities uncertain
- Currencies may be erratic

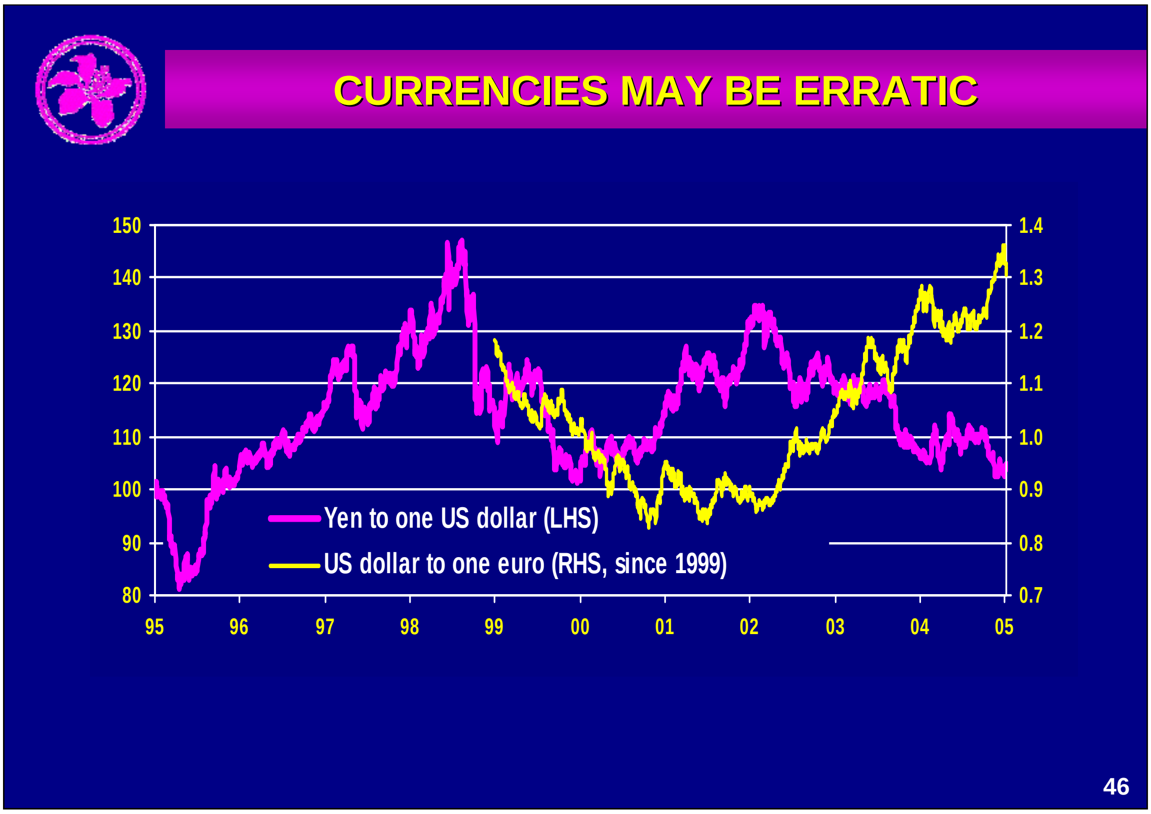
43

- The investment environment in 2005 is uncertain and challenging. The markets have already begun the year in a volatile way.
- Returns on bonds are likely to be limited given the market expectation on continued rise in US interest rates. The prospects for equities are uncertain and currency markets will probably continue to be volatile.


US INTEREST RATE INCREASES EXPECTED
%
7
6
5
4
3
2
1
0
Fed funds target rate
95
96
97
98
99
00
01
02
03
04
44

OUTLOOK FOR EQUITIES UNCERTAIN

45


CURRENCIES MAY BE ERRATIC
150
140
130
120
110
100
90
80
1.4
1.3
1.2
1.1
1.0
0.9
0.8
0.7
95
96
97
98
99
00
01
02
03
04
05
Yen to one US dollar (LHS)
US dollar to one euro (RHS, since 1999)
46

HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

17 February 2005

47