HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

6 May 2005

DISCUSSION TOPICS

- HKMA Annual Report 2004
- Updates on
  - Currency Stability
  - Banking
  - Financial Infrastructure
  - Hong Kong as an International Financial Centre
  - Exchange Fund

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- The first part of the presentation will cover the key messages from the HKMA Annual Report 2004. Copies of the Report were sent to Members on 19 April.
- This will be followed by an update on the work of the HKMA in its key policy areas.

HKMA ANNUAL REPORT 2004: HIGHLIGHTS (1)

Monetary stability

- monetary stability maintained despite
  - depreciation of the US dollar
  - market speculation about revaluation of renminbi
  - interest rate increases in the US
- the exchange rate remained stable, with a modest strengthening in the fourth quarter to 7.7745 at the end of 2004

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- The Linked Exchange Rate system operated smoothly in 2004 despite the depreciation of the US dollar, market speculation about revaluation of the renminbi, and interest rate increases in the US. The exchange rate remained stable, with a modest strengthening in the fourth quarter to 7.7745 at the end of 2004.

- In response to changes in market conditions, the HKMA conducted a number of operations on both the strong side and the weak side of the Link. The Convertibility Undertaking (CU) was repeatedly triggered during the year. For the year as a whole, the HKMA purchased a net total of $16.6 billion worth of Hong Kong dollars. As a result, the Aggregate Balance declined from $29.5 billion to $15.8 billion during the year.

HKMA ANNUAL REPORT 2004: HIGHLIGHTS (2)

Banking stability

- full implementation of the risk-based supervisory approach
- the HKMA and Hong Kong's banking sector continued to prepare for the implementation of Basel II
- the Hong Kong Deposit Protection Board was formed after the enactment of the Deposit Protection Scheme Ordinance to oversee the project for establishing the Deposit Protection Scheme
- the Commercial Credit Reference Agency was launched

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- Full implementation of risk-based supervisory approach in 2004 enabled the HKMA to use its resources more effectively according to the specific risk areas to which individual authorized institutions are exposed.

- In 2004 the HKMA continued to prepare for the implementation of Basel II and to improve the supervisory framework for preventing money laundering and terrorist financing. Basel II Consultative Group was established to have regular discussion on implementation proposals and the HKMA briefed the Legislative Council Panel on Financial Affairs on the HKMA's plan.

- The Deposit Protection Scheme Ordinance was enacted in May, and the Hong Kong Deposit Protection Board was formed in July to oversee the project for establishing the Deposit Protection Scheme.

- The Commercial Credit Reference Agency was launched in November. The scheme, which in the first stage covers credit data of non-listed companies with an annual turnover not exceeding $50 million, has been operating smoothly since its inception on 1 November 2004.

HKMA ANNUAL REPORT 2004: HIGHLIGHTS (3)

Market infrastructure

- the Clearing and Settlement Systems Ordinance became effective
- system improvements were made to ease banks' liquidity pressure at times of large fund flows related to initial public offerings
- the three note-issuing banks issued the remaining three denominations of the new series of Hong Kong banknotes ($20, $50 and $1,000)
- the Treasury Markets Forum was established

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- In 2004 the new Clearing and Settlement Systems Ordinance came into force to further promote the safety and efficiency of clearing and settlement systems in Hong Kong.
- The CHATS Optimiser, a system mechanism that settles paper cheques and large-value CHATS payment simultaneously and in an offsetting manner, was introduced to the Hong Kong dollar payment system in June 2004. CHATS Optimiser has been widely used by banks. It helped to ease banks' liquidity pressure at times of large fund flows related to initial public offerings.
- The three note-issuing banks issued the remaining three denominations of the new series of Hong Kong banknotes ($20, $50 and $1,000) in October 2004.
- The Treasury Markets Forum was established among industry associations and market professionals in March 2004 to better co-ordinate efforts at raising the professionalism of practitioners and the overall competitiveness of treasury markets in Hong Kong.

HKMA ANNUAL REPORT 2004: HIGHLIGHTS (4)

Hong Kong as an International Financial Centre

- **the launch of Asian Bond Fund 2 was announced**
- **renminbi services were introduced by banks in Hong Kong. Total outstanding renminbi deposits in Hong Kong exceed RMB12 billion yuan by the end of 2004**
- **adopted a more pro-active approach towards Hong Kong's international credit ratings: Standard & Poor's, Fitch Ratings, and Rating and Investment Information all upgraded their outlook on Hong Kong's sovereign rating from negative to stable**

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- The HKMA led several initiatives to develop Hong Kong's role as an international financial centre. These included the launch of renminbi banking business in Hong Kong and the further development of the Asian Bond Fund (ABF2). ABF2 includes a Pan-Asian Bond Index Fund and eight single-market funds. It will be invested in by all 11 EMEAP central banks and will help promote the development of domestic and regional bond markets in Asia.

- Personal renminbi banking services were introduced in Hong Kong in February 2004. By the end of December 2004, the total amount of renminbi deposits outstanding reached RMB12.1 billion yuan.

- The HKMA has been playing a key role in the adoption of a more pro-active approach towards Hong Kong's international credit ratings. Between April and June 2004, Standard & Poor's, Fitch Ratings, and Rating and Investment Information all upgraded their outlook on Hong Kong's sovereign rating from negative to stable.

HKMA ANNUAL REPORT 2004: HIGHLIGHTS (5)

Reserves management

- **the Exchange Fund achieved an investment return of $56.7 billion or 5.7% in 2004 despite considerable volatility in the bond, equity and currency markets**
- **the Fiscal Reserves' share amounted to $14.5 billion, which exceeded the amount budgeted ($12.3 billion) in the fiscal year 2004-05**

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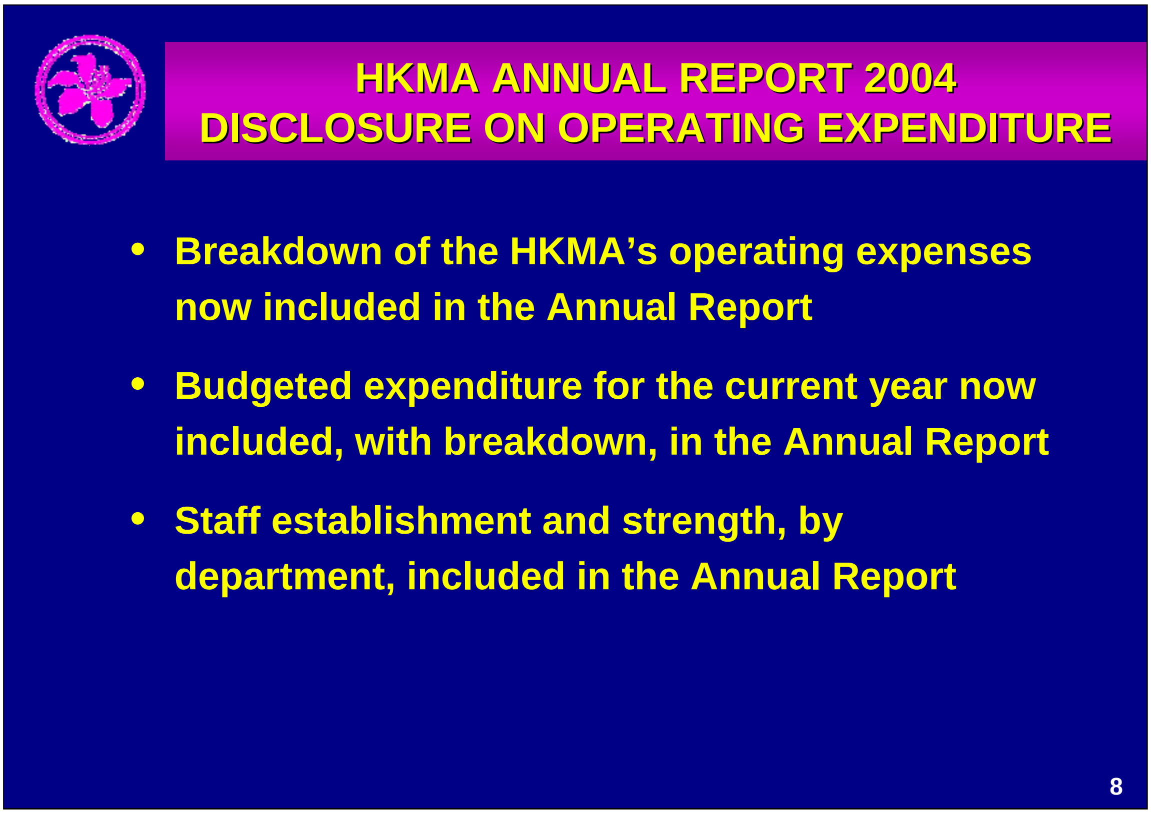
- Despite considerable volatility in the bond, equity and currency markets, the Exchange Fund achieved an investment return of $56.7 billion or 5.7% in 2004, which was in line with the return on its benchmark.

- In 2004 the Exchange Fund recorded income from bonds of $25 billion, $12 billion from Hong Kong equities, $11.2 billion from foreign equities and $8.5 billion from foreign exchange gains.

- Under the sharing arrangement, investment return on the fiscal reserves amounted to $14.5 billion, which exceeded the amount budgeted ($12.3 billion) in the fiscal year 2004-5. In four out of the past seven years in which the sharing arrangement has been in place, the actual investment return on the fiscal reserves exceeded the amount budgeted for.



- The Governance Sub-Committee of EFAC has reviewed the disclosure of information on the HKMA's operating expenditure. The Sub-Committee's recommendations for greater disclosure have been approved by the Financial Secretary on the advice of EFAC. The recommendations take into account the governance arrangements for the HKMA, practices among other central banking institutions, and the practices of private and public-sector organisations in Hong Kong.

- The Sub-Committee's recommendations are:

  (a) inclusion in the Exchange Fund Accounts of a breakdown of the HKMA's operating expenses for the past year (similar to the breakdown provided separately to the Panel last year);

  (b) disclosure in the Annual Report, with a breakdown similar to that for (a), of the budgeted administrative expenditure for the current year; and

  (c) disclose in the Annual Report of the staff establishment and strength of the HKMA by department: this is an enhanced version of the table provided separately to the Panel last year, now includes a breakdown between senior staff and other staff.

- These details will continue to be included in future annual reports. The Governance Sub-Committee will continue to keep disclosure arrangements under review.

ADMINISTRATIVE EXPENDITURE
(2004 AND 2005 BUDGETED)

HK$ million	2004 Budget*	2004 Actual	2005 Budget*
Staff Costs	474		490
- Salaries and other staff costs		421	
- Retirement benefit costs		25	
Premises and equipment expenses			
- Operating lease charges	11	10	5
- Other premises expenses (including utility charges and management fees)	37	33	31
General operating costs			
- Maintenance of office and computer equipment	31	30	27
- Financial information and communication services (including trading, dealing terminals and data link charges)	28	27	30
- External relations (including international meetings)	14	13	15
- Professional and other services (including service fees for operating the interbank payment system)	39	35	26
- Training	5	4	5
- Others	15	10	14
TOTAL	654	608	643

* Includes supplementary budget and relevant provisions in project budgets for the year.

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- Breakdown of budgeted administrative expenditure for the current year now included in the Annual Report (page 132 of the Annual Report). The HKMA will continue to disclose the current year's administrative budget in future Annual Reports.

- Depreciation charge is included in the Accounts but not in the budget.

UPDATE OF PROGRESS IN KEY FUNCTIONS AND RESPONSIBILITIES

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

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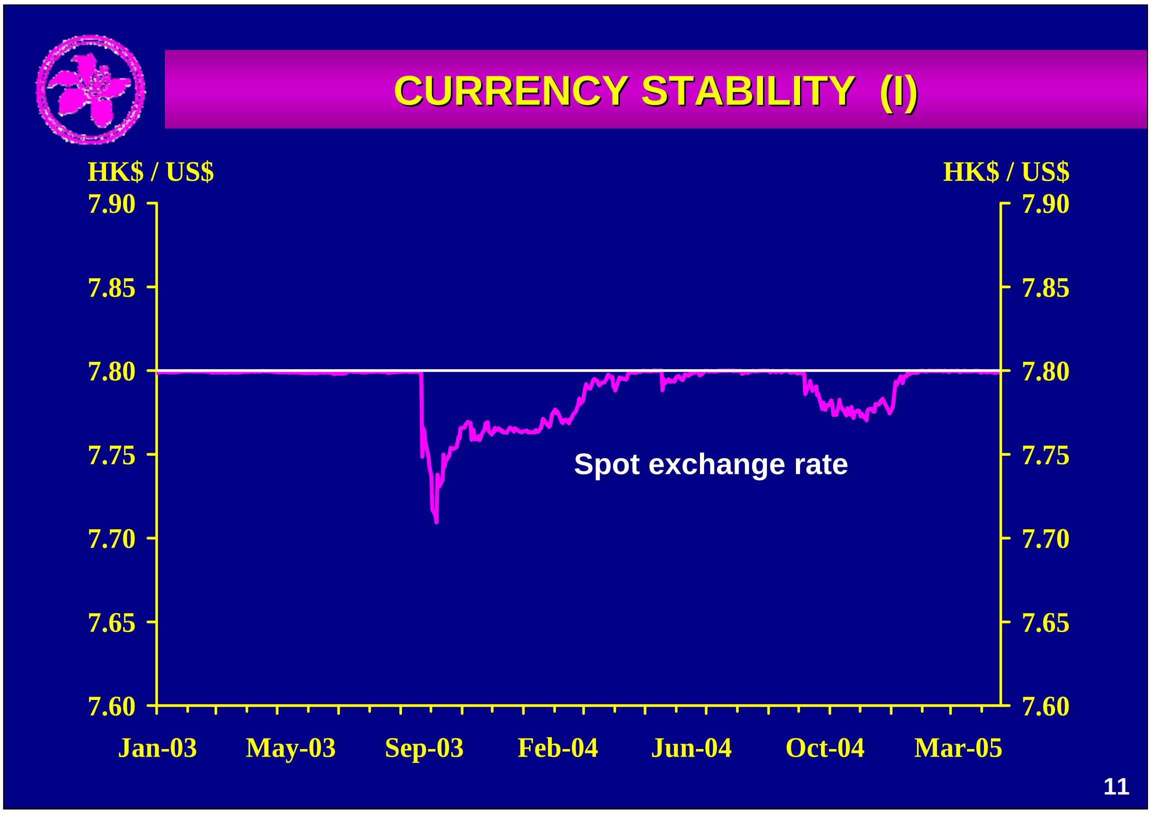
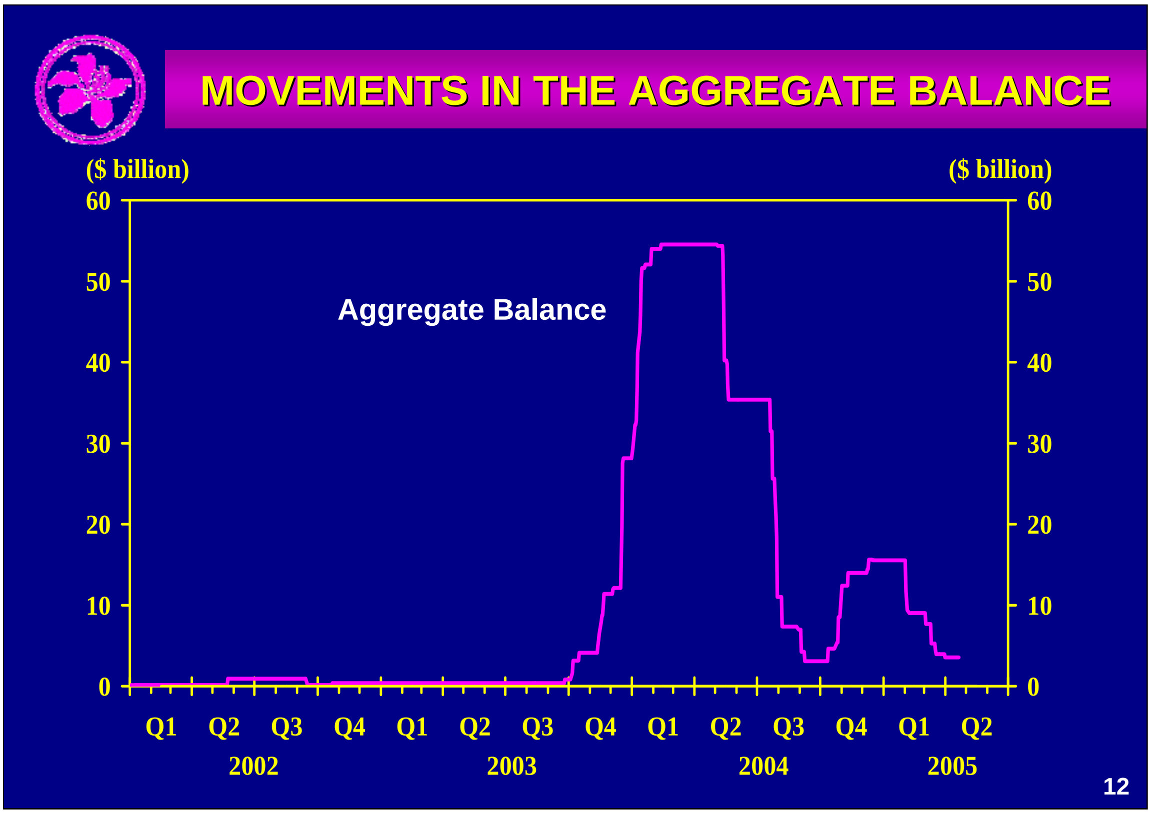


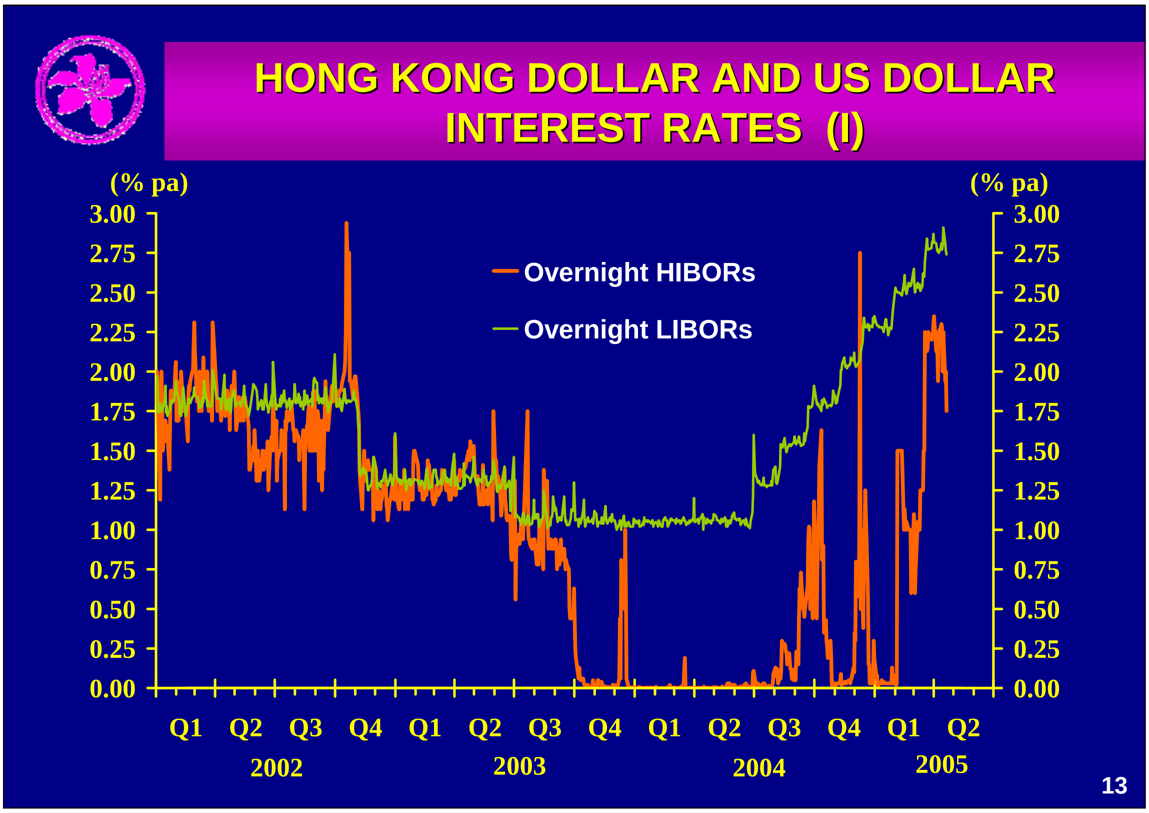
- The effects of the repeated episodes of capital inflow and pressure for the Hong Kong dollar to strengthen, which started in 2003 Q3, linger on as market attention on the RMB grows.

- The Currency Board System functioned reasonably well, with the interest rate differential in time reversing the capital inflow and triggering the weak-side Convertibility Undertaking. The situation has not, however, returned entirely to normal, and relatively easy monetary conditions continue to prevail.



- In 2004 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, market expectation on revaluation of renminbi had moderated and the CU was triggered again as a result of arbitrage activities to take advantage of the interest rate differential between the US dollar and the Hong Kong dollar. As a result, the Aggregate Balance declined to $3.8 billion on 20 April. This is still in multiples of the normal level of less than $1 billion necessary to effect smooth payment and settlement among the banks.

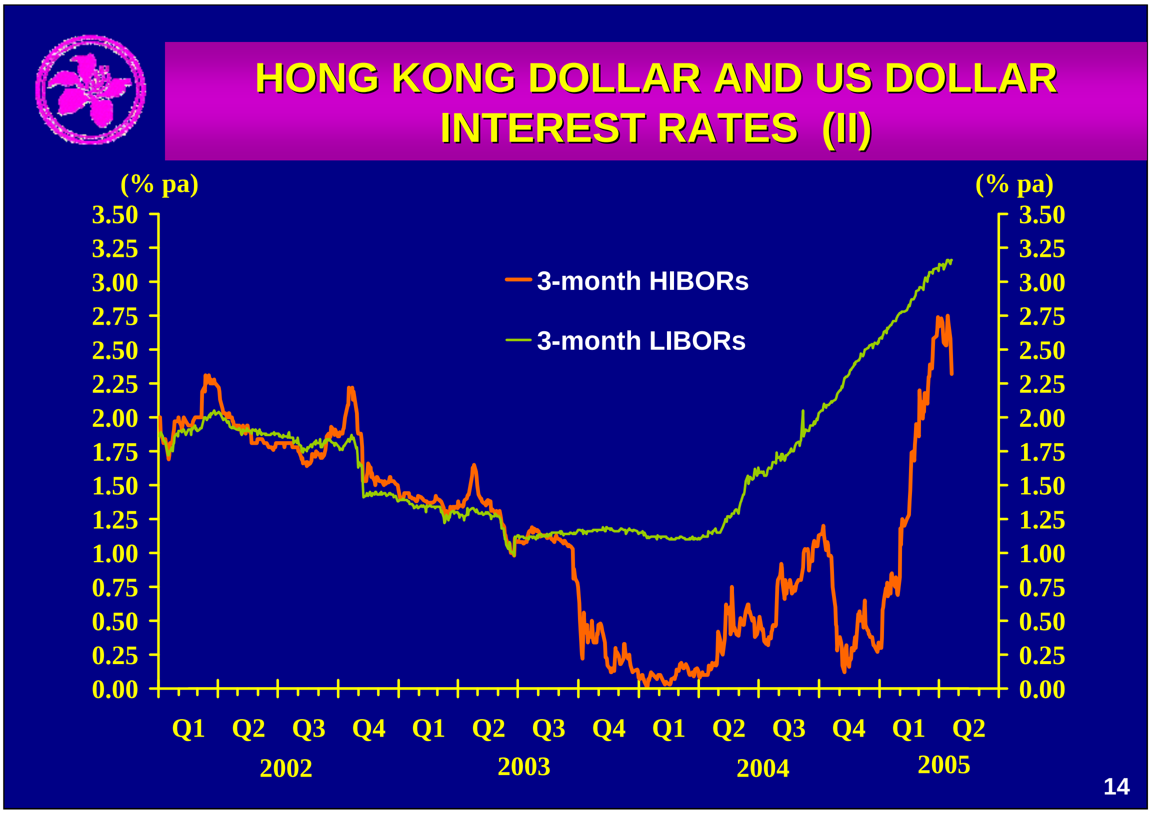


- Hong Kong dollar interbank interest rates (HIBOR) stayed below their US dollar counterparts during most of the fourth quarter of 2004, particularly the short-term money.

- 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.

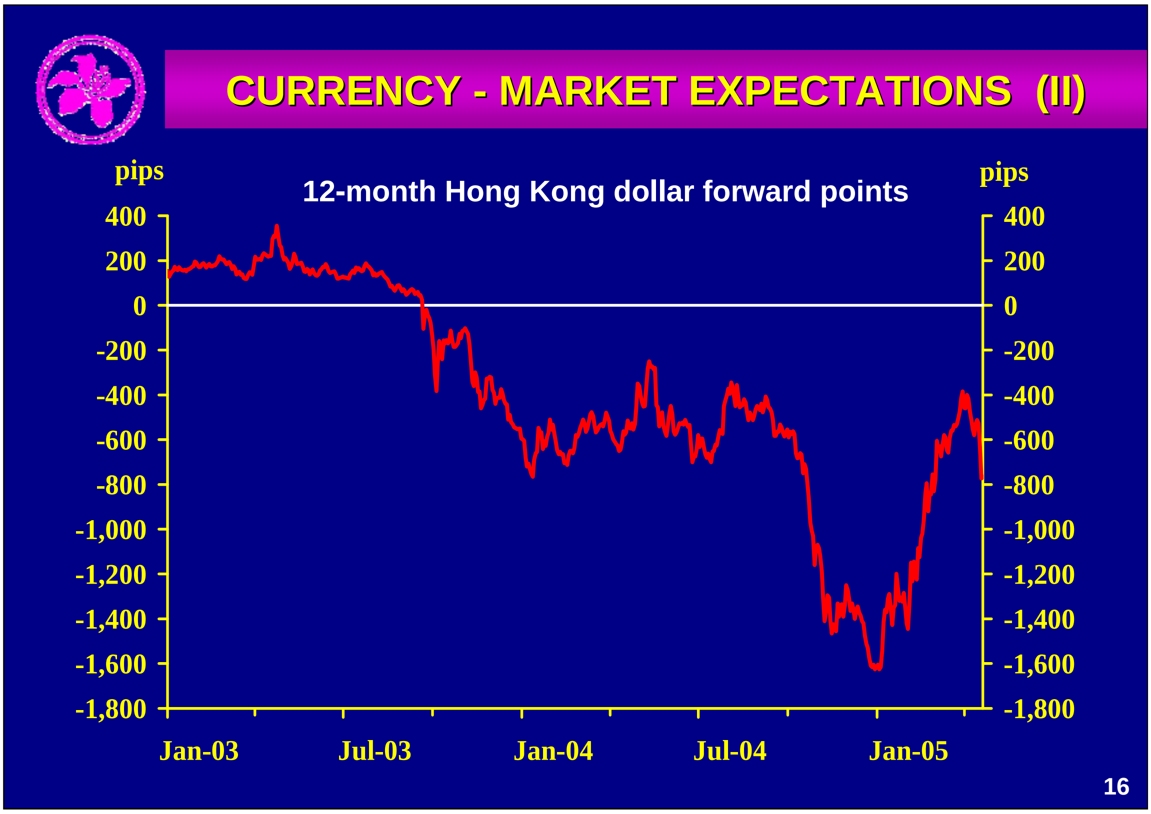
- The CU was then triggered a number of times and the Aggregate Balance contracted accordingly, and interest rates began to climb in early 2005. This has significantly reduced the gap between overnight HIBOR and LIBOR.

- A significant gap, however, still exists as expectation on a change to the RMB exchange rate regime affects market sentiment.



- Other short-term HIBORs also rose, gradually but not quite entirely closing the interest rate differential between Hong Kong dollar and US dollar.

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



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

- During the first few months of 2005, the 12-month forward discount narrowed markedly (to 750 pips on 20 April 2005), in line with the narrowing of the gap between HIBOR and LIBOR.

MONETARY CONDITIONS

- **Currency Board arrangements working effectively.**
- **Fed funds target rate on an increasing trend, returning to "normal".**
- **Capital outflow has led to higher Hong Kong dollar interest rates, although they remain below US rates.**
- **Domestic monetary conditions affected by factors pulling in different directions.**

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- The Fed funds target rate in the US was raised by seven times by a total of 175 basis points between June 2004 and March 2005. Market generally expects the increasing trend to continue, although it is not clear at what "normal" interest rate level this will stop.
- The process of HIBOR catching up with LIBOR has been quite sharp (see page 13 and 14). The higher HIBOR has exerted upward pressure on the prime rates and savings deposit rates of banks.
- Domestic monetary conditions will continue to be affected by two factors pulling in different directions: the trend of higher US interest rates and a possible RMB exchange rate regime change. Volatility is expected and overshooting in interest rate adjustment is possible. Banks need to manage interest rate risks. Borrowers should also beware.

CURRENCY STABILITY (II)

External factors

- Global developments
- Volatility in oil prices
- External imbalances
- US monetary tightening
- Mainland macro adjustment and the RMB
- Geo-political conflicts

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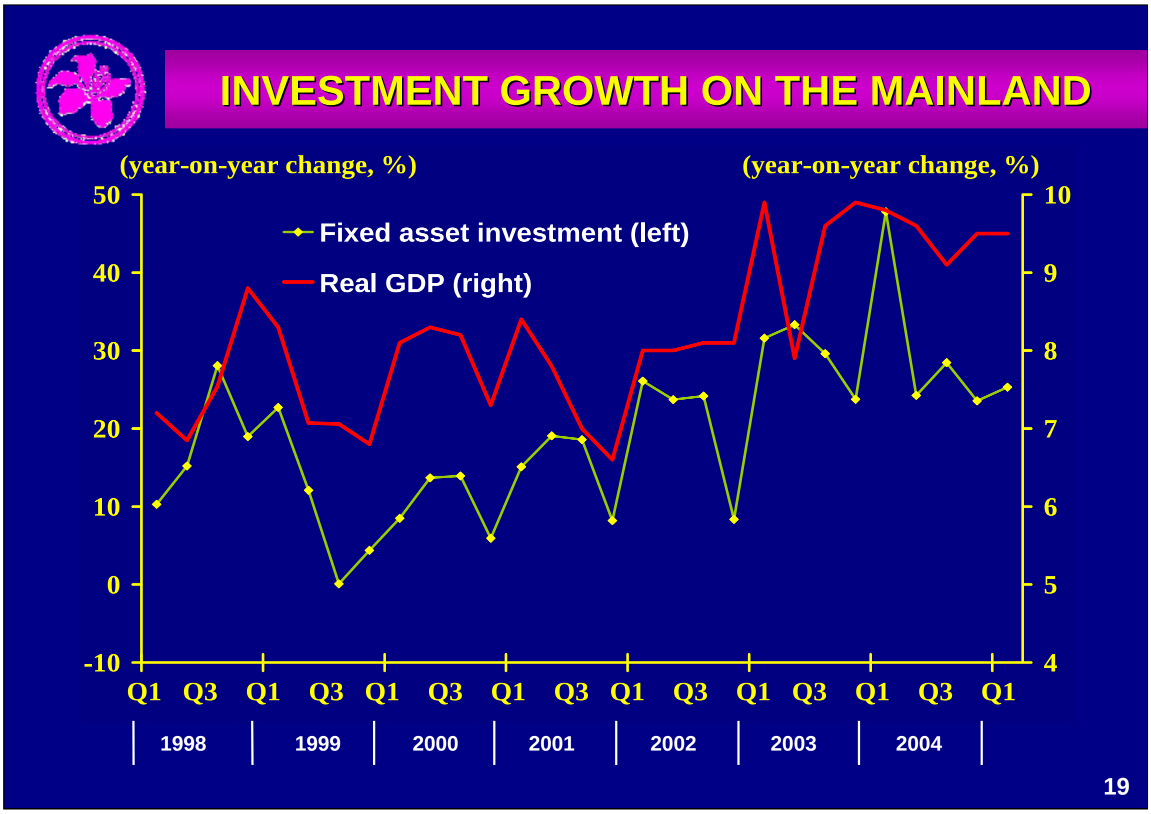
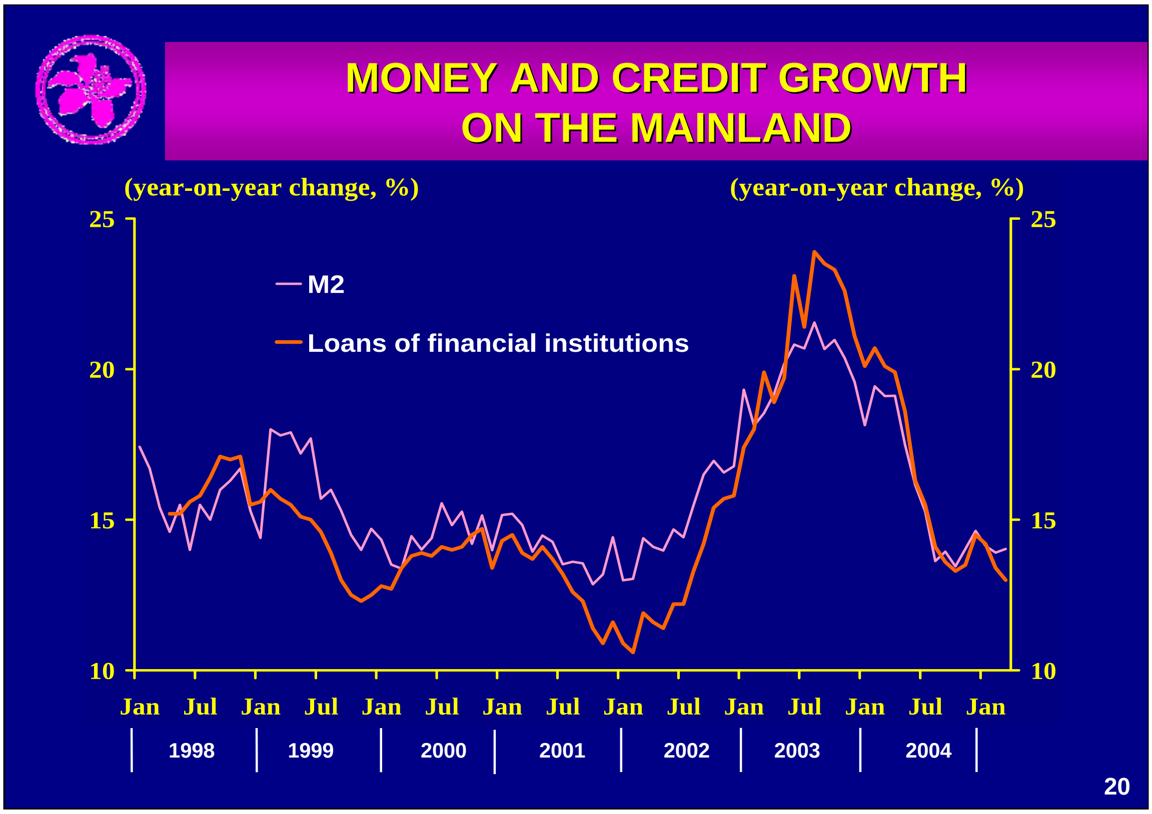
- **Global and regional economy:** The geographical pattern of global growth in the final quarter of 2004 remained unbalanced. Real GDP growth continued to be solid in the US and non-Japan Asia (including Mainland China), but declined in the euro area and was virtually flat in Japan. High-frequency indicators for the euro area and Japan point to a mild recovery at the start of the year.
- **Oil prices:** Oil prices remain volatile. West Texas Intermediate oil prices hit an all-time nominal high of US$57 per barrel at the beginning of April, before falling back towards the middle of this month. Futures contracts suggest that oil prices will remain high at US$56 by the end of this year.
- **External imbalances:** The US current account deficit continued to widen, reaching 6.3% of GDP in the fourth quarter of 2004 (and 5.7% for 2004 as a whole). Despite this, the US dollar has strengthened by 2% since mid-March, supported by higher interest rate differentials between the US, the euro area and Japan. 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.
- **Interest rates:** The FOMC raised the federal funds target rate by 25 basis points to 2.75% in late March, the seventh increase since last June. The accompanying statement mentioned the Committee's rising concern about inflation, increasing market expectations of a more aggressive pace of monetary tightening in the US. Futures contracts indicate that market participants expected interest rates to reach 4% by the end of this year.
- **RMB exchange rate:** Strong economic data for Mainland China in the first two months of the year has renewed fears about overheating pressures and increased speculation in financial markets about a change in the renminbi exchange rate regime. The one-year non-deliverable forward rate fell to 7.93 RMB/USD, implying a 4-5% expected appreciation over the next twelve months.
- **Geo-political conflicts:** unpredictable; considerable tensions here and there.



- The latest data suggest that economic growth on the Mainland remained strong in 2005 Q1, and was broadly based.

- Real GDP growth expanded at a year-on-year rate of 9.5% in Q1, about the pace as in 2004 Q4. Industrial output accelerated to 16.2% year-on-year in 2005 Q1, the highest since 2004 Q2.

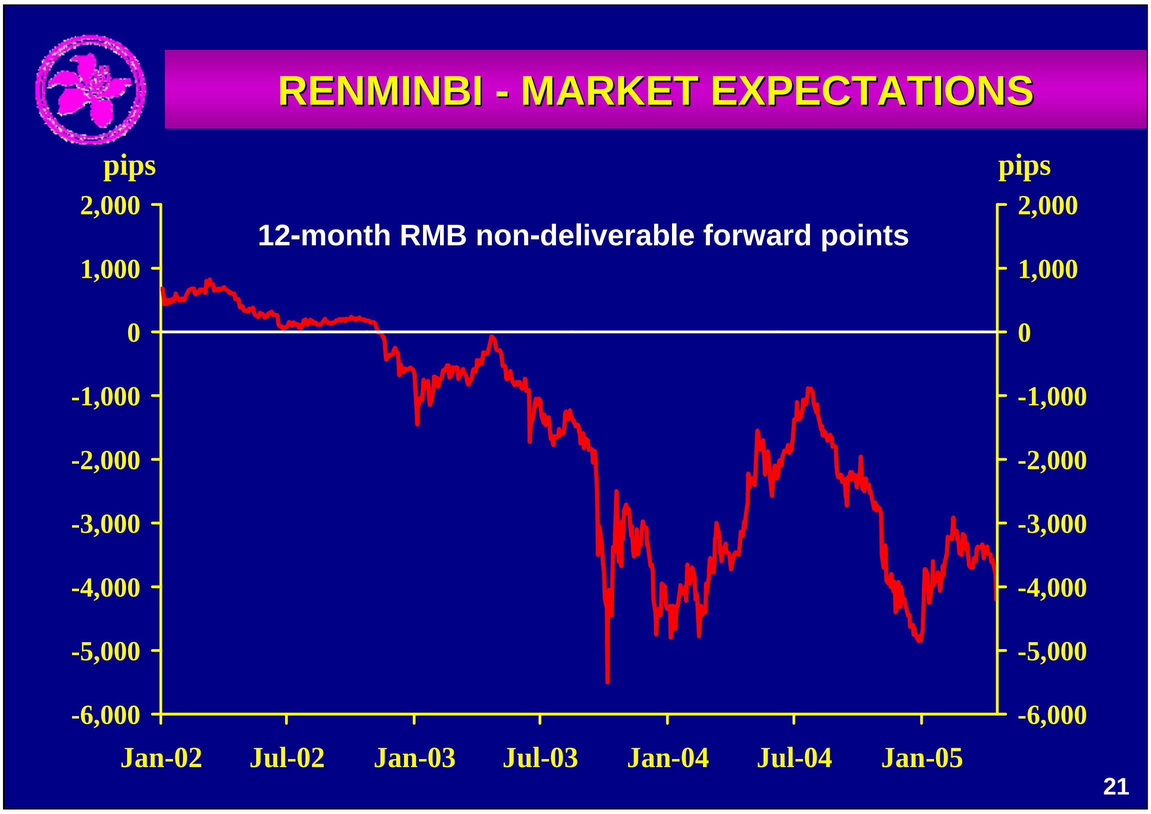
- Growth in fixed asset investment continued to be robust, increasing to 25.3% in 2005 Q1 from 23.6% in 2004 Q4. The rapid growth in fixed asset investment is still a risk to economic stability. Meanwhile, consumption demand has remained robust, and external demand has also expanded markedly.



- On a year-on-year comparison, money and loan growth declined slightly in 2005 Q1. Broad money M2 registered a 14% year-on-year growth, compared to 14.6% in 2004 Q4. Loan growth decelerated to 13% in Q1, the lowest in two years. This shows the credit aggregates are broadly under control.

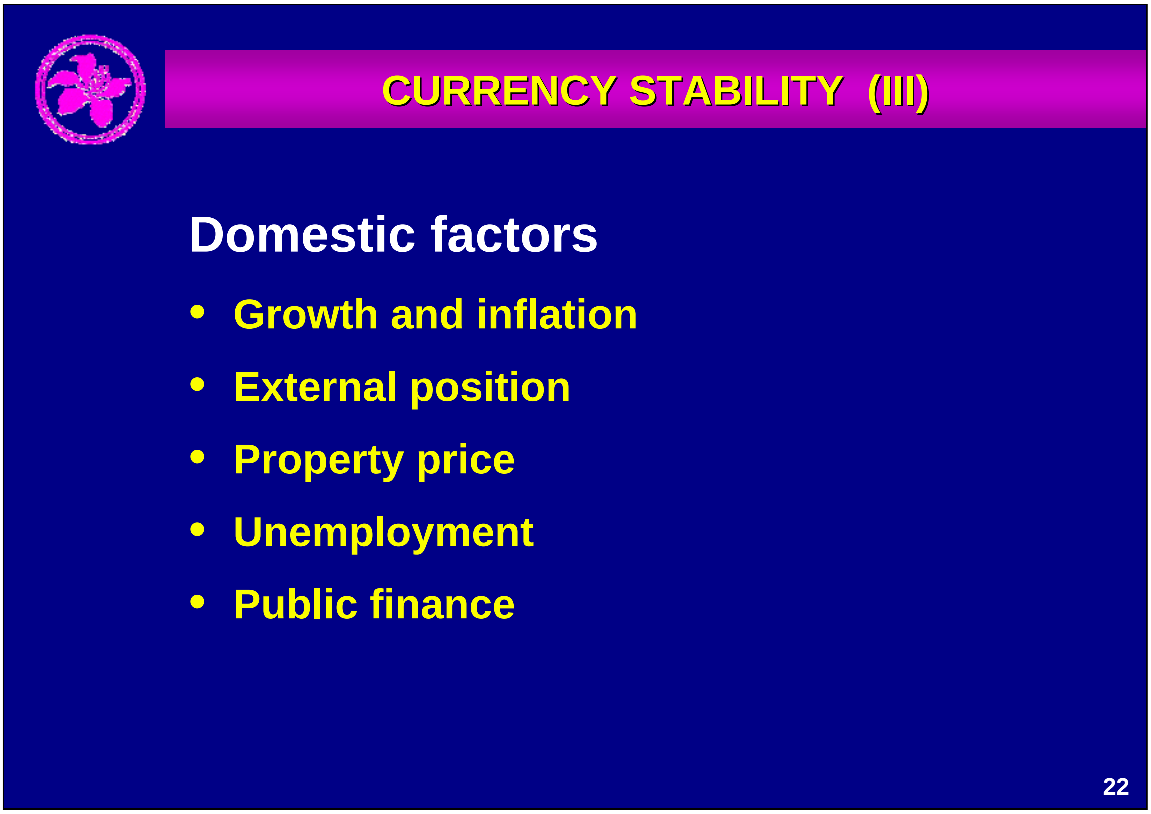
- Rapid credit expansion and fast residential property price appreciation in selected cities prompted the PBoC to raise the required down-payment on house purchases from 20% to 30%, and the effective mortgage rate by 20 basis points in March.

- Overall, the recent data suggest that the Mainland economy continued to grow strongly. Looking ahead, inflation pressures could pick up. Demand pressure could persist, or even intensify. 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.



- With 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 widened in the second half of 2004.

- Since early this year, such discount narrowed moderately, probably reflecting weakened expectations for renminbi appreciation. However, the discount appears to be widening again in recent weeks, as there was renewed discussion about a renminbi revaluation in financial markets.



- **Economic recovery remained robust.** Real GDP grew by 7.1% in 2004 Q4 from a year earlier, following an increase of 6.8% in Q3, driven by rises in net exports and private consumption. For 2004 as a whole, real GDP expanded by 8.1%, the highest annual growth since 2000.

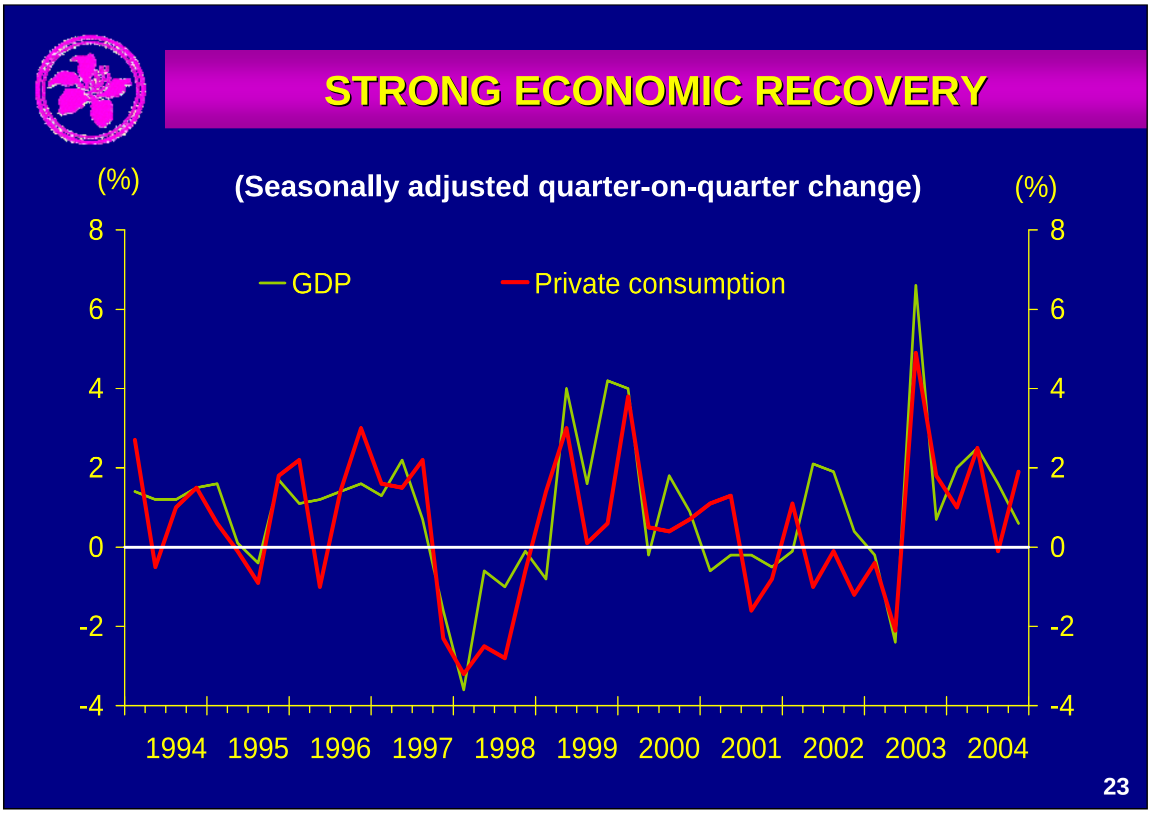
- **The headline Consumer Price Index** rose modestly in recent months. While there are not yet signs of a significant pick-up in inflation pressure, inflation may gather momentum if the current loose monetary conditions persist.

- **The external position of Hong Kong remains healthy.** The current account surplus increased markedly in the second half of 2004, reflecting rises in service account surplus and factor income and 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 about 2.5 times GDP at end-2003).

- **The unemployment rate** eased steadily to 6.1% in the three months to March this year, from a record high of 8.6% in the May-July 2003 period, but remains high relative to the level before the Asian financial crisis.

- **Property prices** have increased significantly from the trough in 2003, contributing to the recovery of the economy through the wealth effect.

- **Public finances:** The fiscal position has improved considerably, helped by the recovery in economic activity. The fiscal deficit for 2004-05 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.

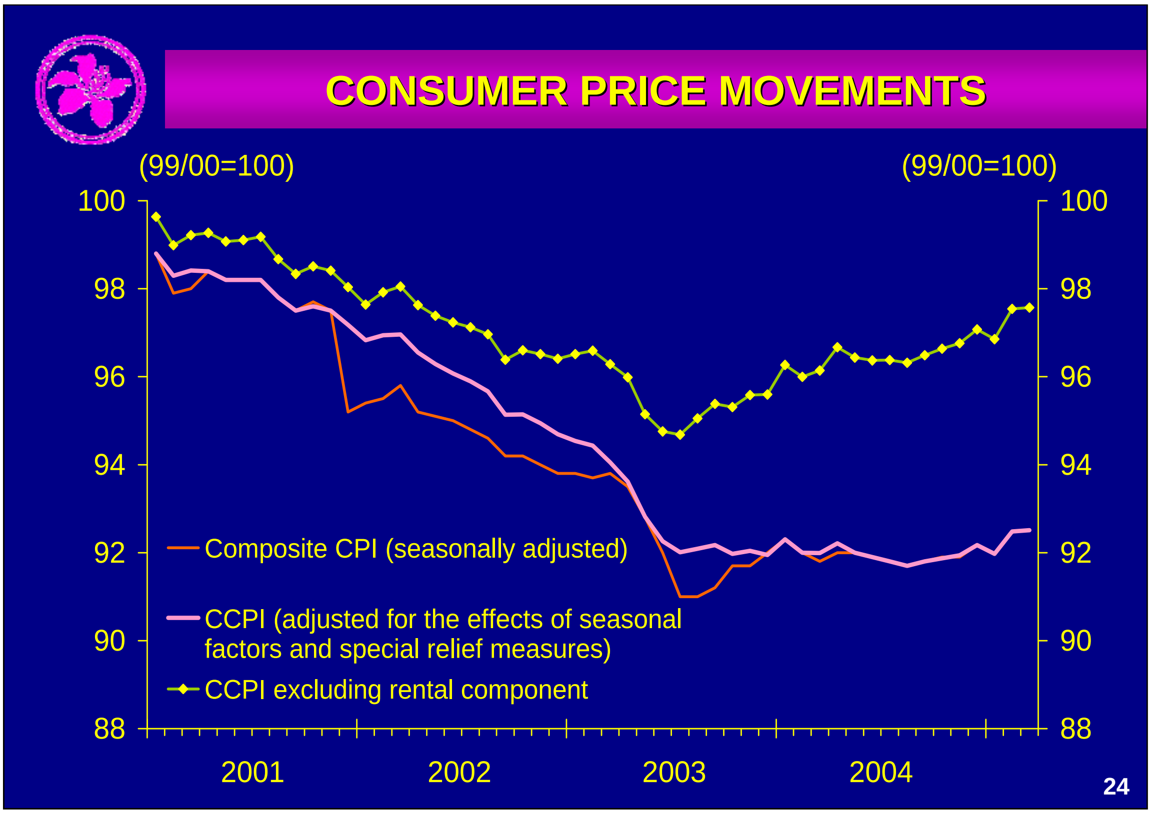


- On a seasonally adjusted quarter-on-quarter basis, real GDP growth slowed to 0.6% in 2004 Q4 from 1.6% in Q3. The slower growth mainly reflects declines in capital goods investment and inventories, which partly offset increases in private consumption and merchandise exports.

- Recent data suggest that growth in 2005 Q1 remained robust, although the rate of increase may have moderated.

  – Monthly data for January and February are distorted by a change in the timing of the Lunar New Year. Thus, statistics for these two months are averaged to minimise the distortions. Taking an average of January and February figures, merchandise exports was just 0.4% higher than in December last year, while retail sales increased by 2.8% during the same period.

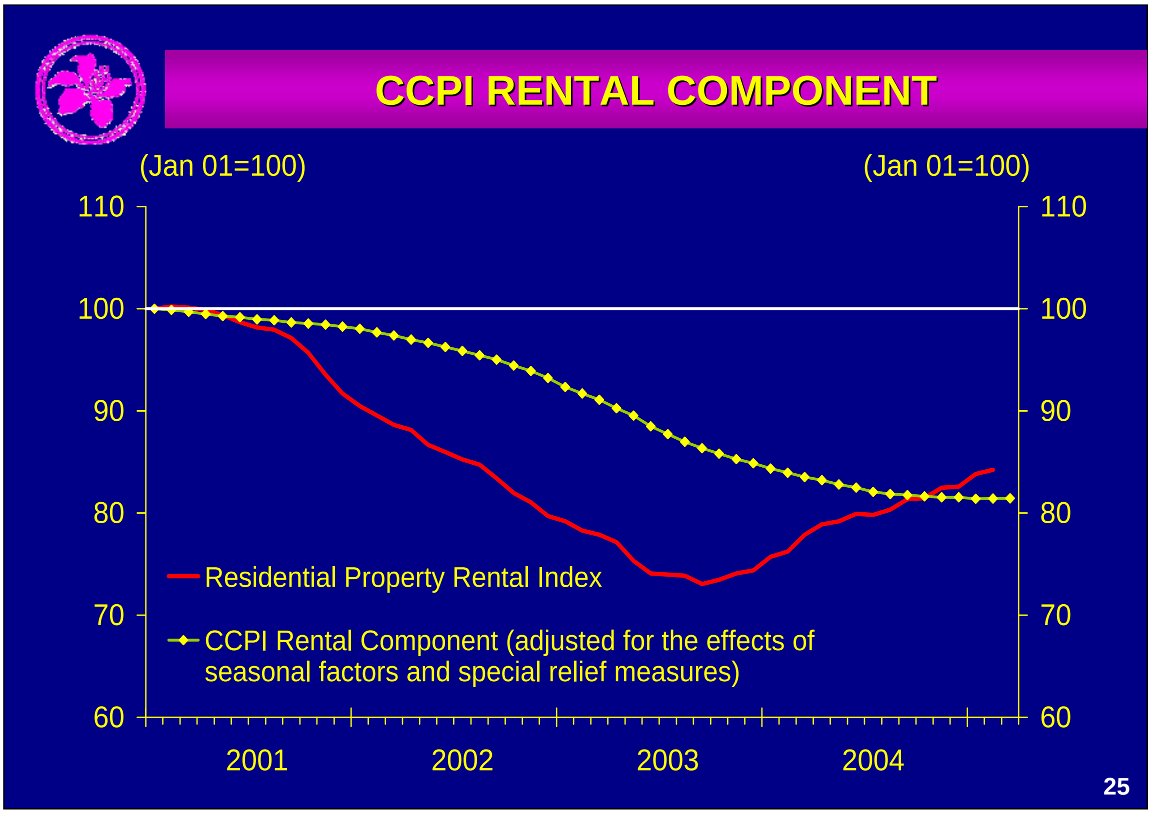
  – The Purchasing Managers' Index points to a slower expansion in overall economic activity than in 2004, although it remained above its neutral level in March (51.5) for the third consecutive month.



- Adjusted for the effects of seasonal factors and government relief measures, the Composite CPI (CCPI) has been broadly stable since the summer of 2003.

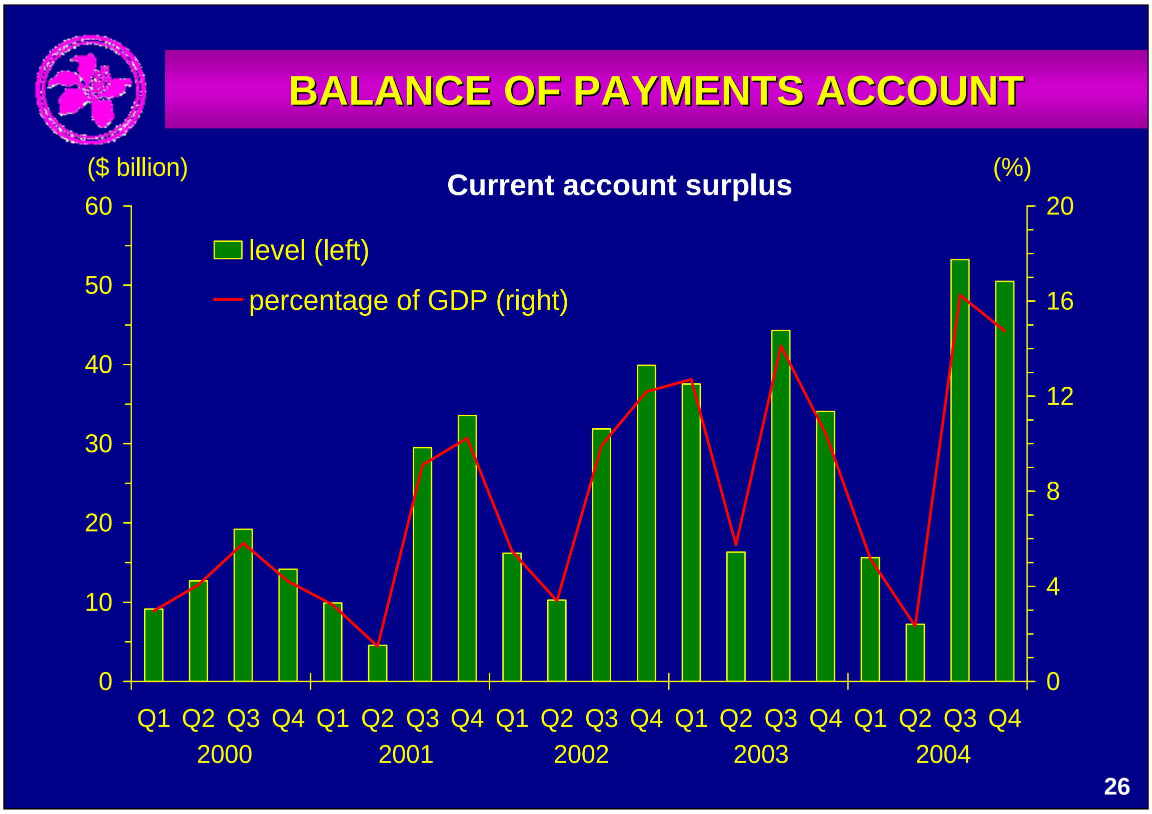
- Nonetheless, the CCPI excluding rental increased modestly in the past few quarters, along with the recovery in economic activity, while the rental component of the index continued to decline.

- Looking ahead, consumer prices are expected to rise moderately on robust economic growth, rising import prices (in part associated with the weak US dollar), and higher market rentals. Nevertheless, the pick-up in inflation is unlikely to be sharp.



- While the rental component of the CCPI has continued to record marginal declines in recent months, the rental index increased further, along with the rises in property prices. (The rental index is compiled by the Rating & Valuation Department based on fresh lettings, while the rental component includes both new and existing lettings.)

- Changes in the rental component tend to lag behind movements in market rents owing to fixed-term rental contracts, which are typically two years. As market rents have risen by over 15% since the trough in September 2003, the rental component will likely start to increase towards the latter part of this year. This will exert upward pressure on the CCPI.

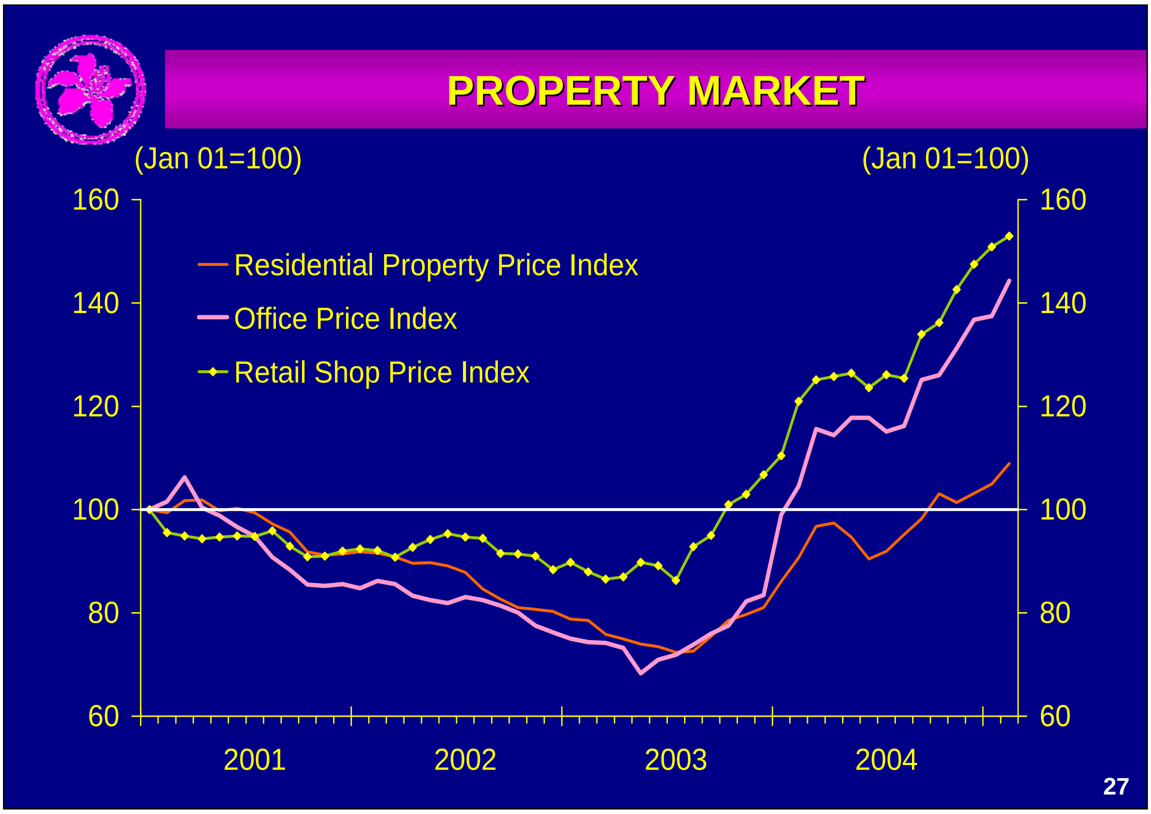


- Reflecting in part sustained improvement in competitiveness, the external payment position has remained strong.

- In particular, the current account continued to register a notable surplus of around 15% of GDP in 2004 Q4, underpinned by strong growth in exports of goods and trade-related services, and sustained growth in the tourism-related sectors. For 2004 as a whole, the current account surplus was equivalent to 9.7% of GDP.

- 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.

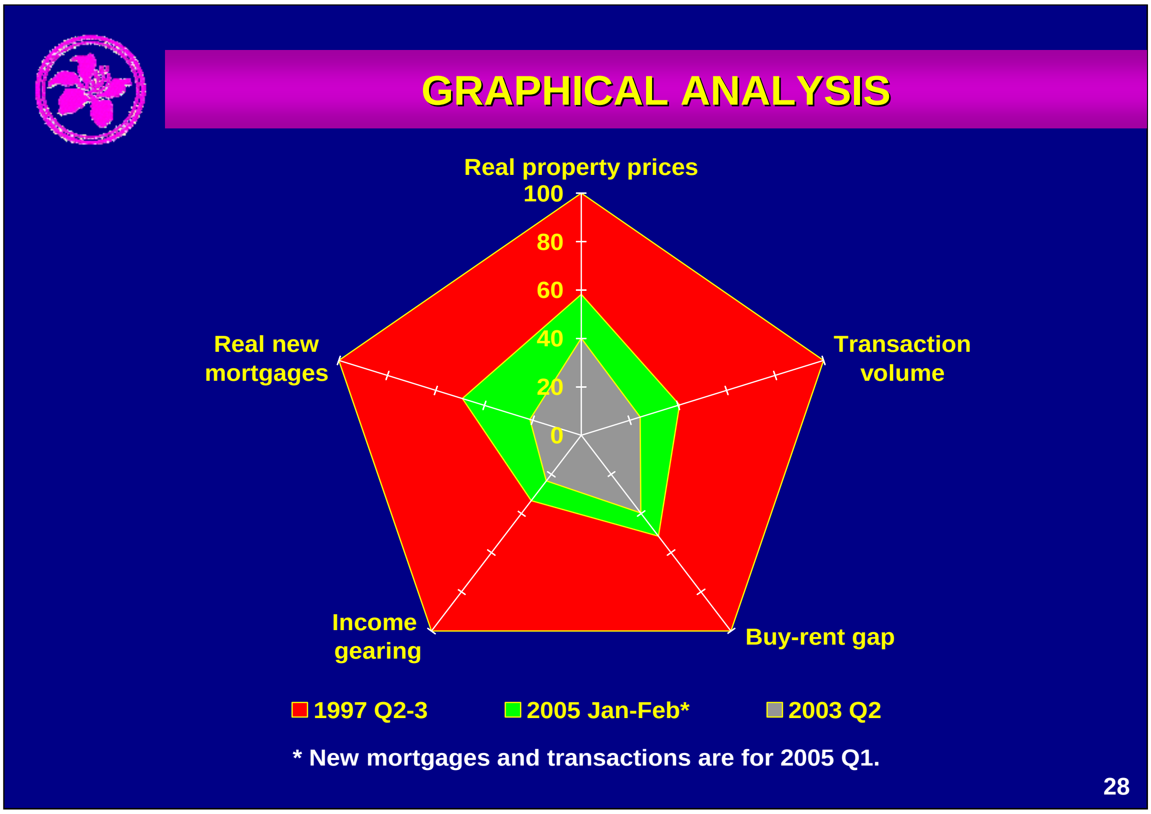
- The investment income generated by the accumulated net foreign assets (which are close to 250% of GDP) will continue to support the Hong Kong dollar, particularly if these earnings, most likely in foreign currency, are invested in domestic markets alongside strong economic growth.



- The recovery in the property market is continuing. By February, residential property prices had increased by 51% from the trough in the summer of 2003. Price increases at the high end of the market have been particularly pronounced, with prices of large flats (saleable area of 160 m^2 or above) rising by 78% during the same period.

- Prices of commercial premises also increased markedly, with those of offices and retail shops rising by 111% and 77% from their trough levels respectively.

- Despite the sharp increase in prices in recent quarters, the risk of a property bubble is not high at present, since the rises in prices have been accompanied by improvement in fundamentals. Housing affordability (in terms of the ratio of household income to mortgage payment) remains at a historically high level.



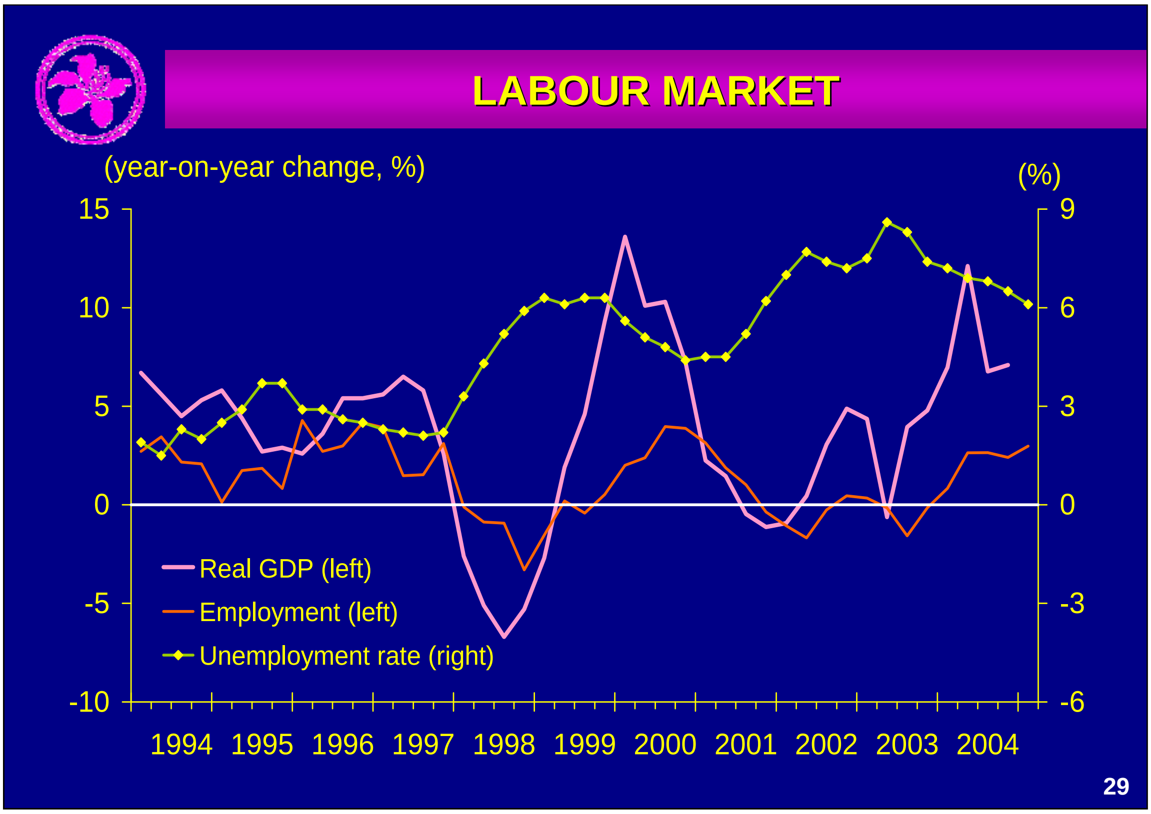
- This graphical analysis summarises the evolution of five key property market indicators: real property prices, property transaction volumes, real new mortgages, the income-gearing ratio (ratio of mortgage payment to household income), and the buy-rent gap (ratio of mortgage payment to rental).

- The values of the five indicators at a particular point of time are presented using a pentagon, with the distance of each corner from its centre representing the magnitude of each indicator. Thus, a larger size of the pentagon suggests a higher risk of overheating in the market.

- By early 2005, the size of the pentagon remained substantially smaller than that for April-September 1997, when market conditions were clearly out of line with the fundamentals. This suggests that the risk of a property bubble remains low at this point of time.

- Nevertheless, there have been signs of an increase in speculative activity. The number of confirmor transactions accounted for 4% of total transactions in recent months, compared with about 1% in 2003 and a high of 8.4% in mid-1997.

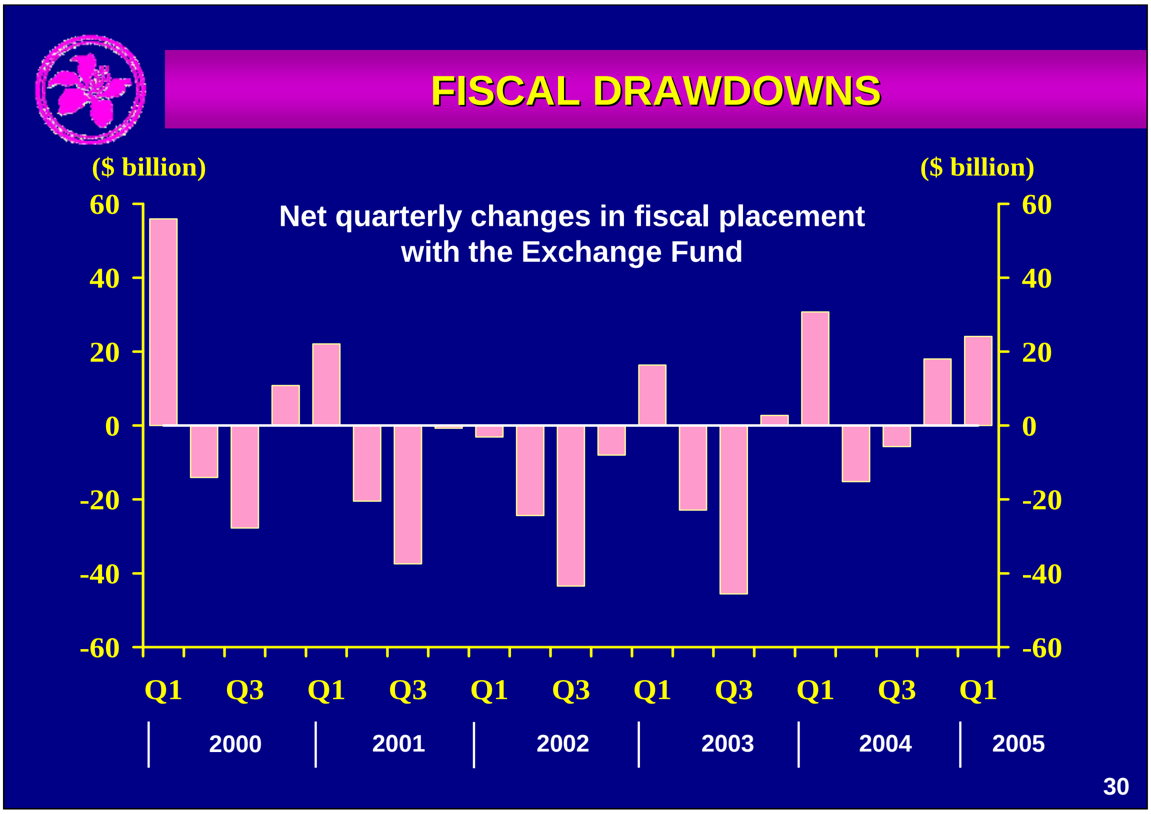
- Furthermore, mortgage rates may rise more sharply than currently expected, if the US interest rates increase further or the negative spreads of Hong Kong dollar interest rates narrow. This would worsen housing affordability and raise the cost of buying a property relative to renting.



- Along with the economic recovery, labour market conditions have improved. The seasonally adjusted unemployment rate stood at 6.1% in the three months to March 2005, compared to a historic high of 8.6% recorded in mid-2003.

- The pace of decline in the unemployment rate appears to have moderated in recent quarters, owing to increases in the labour force, which partly offset gains in employment. The increase in the labour force was due to rises both in the working-age population and in labour-force participation, as improved employment prospects attracted more people into the job market.

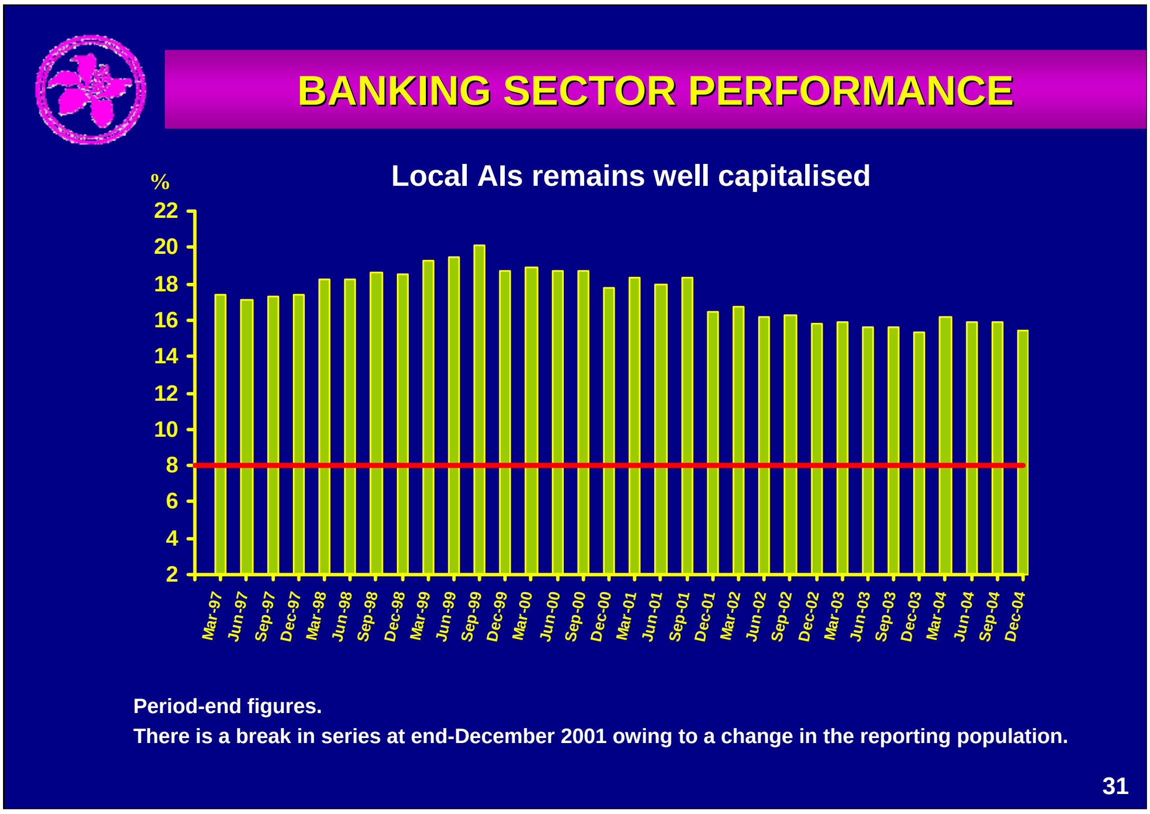
- Looking ahead, a sustained recovery in the economy should help reduce the unemployment rate further. The number of private sector vacancies received by the Labour Department rose to an all-time high of 35,970 in March (representing about 1% of total labour force).



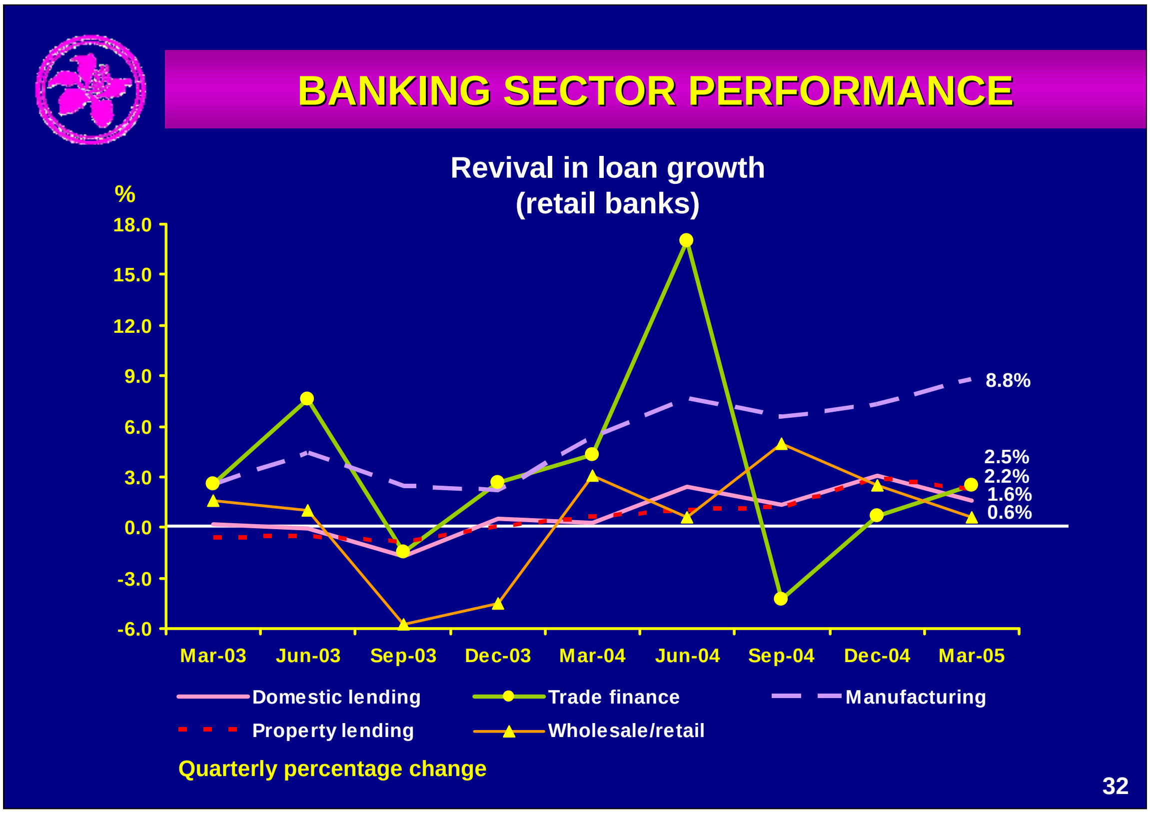
- Alongside the economic recovery, the Government's fiscal position has improved since 2003 Q4.
- There were two consecutive quarters of net placements with the Exchange Fund in 2004 Q4 and 2005 Q1 after two quarters of draw-downs in 2004 Q2 and Q3.
- The draw-downs in 2004 Q2 and Q3 were largely seasonal. In fact, the draw-downs were lower than 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
2005	24.1			



- The banking sector remains well capitalised. At the end of December 2004, the average consolidated capital adequacy ratio of all locally incorporated authorized institutions was almost 16%, well above the statutory and international requirements.

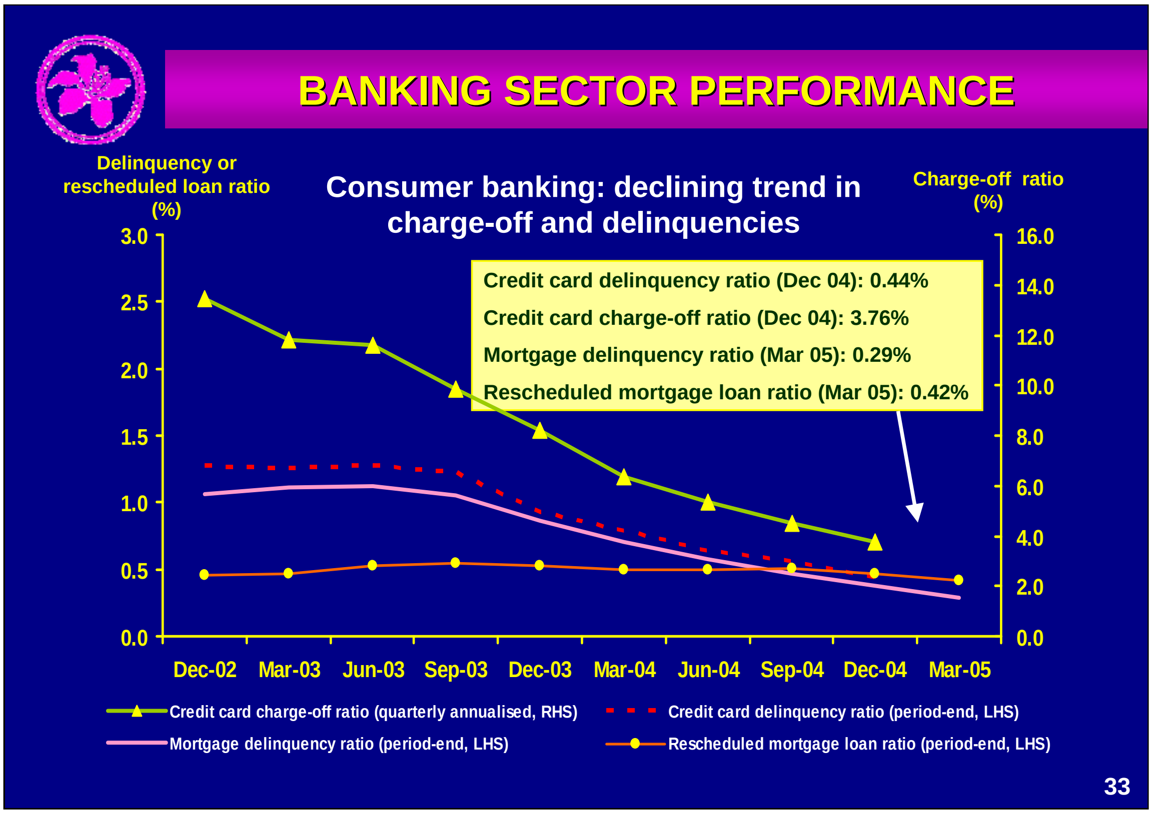


- Positive business sentiment and the upturn in economic activities rendered a strong boost to the demand for domestic loans

- Total domestic lending advanced by another 1.6% in 2005 Q1 from the growth of 3.1% in 2004 Q4.

- The growth of domestic lending to all major economic sectors extended to 2005 Q1. On the back of the robust external trade flows and property market activities, lending to the manufacturing sector and trade finance continued to record a strong growth.

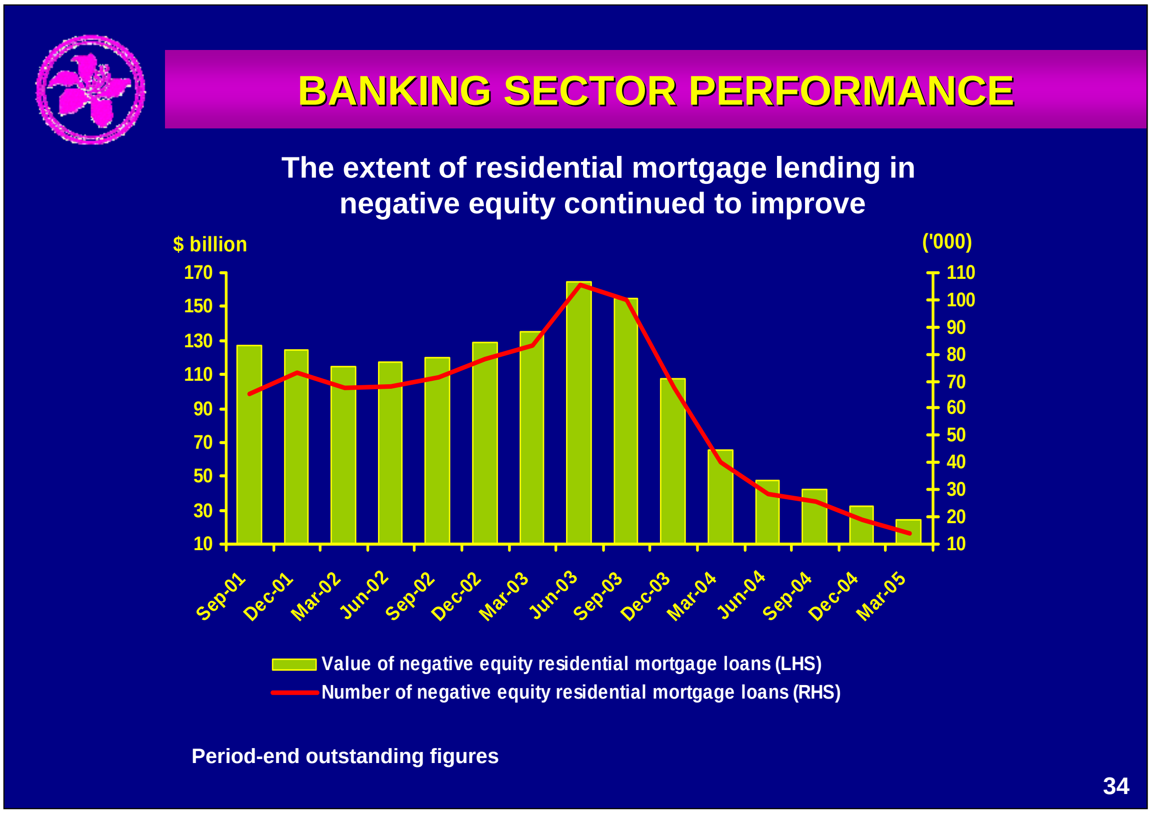
- Note: The sharp decline in trade finance in 2004 Q3 from a strong growth in 2004 Q2 reflected reclassifications initiated by a few banks in the quarter.



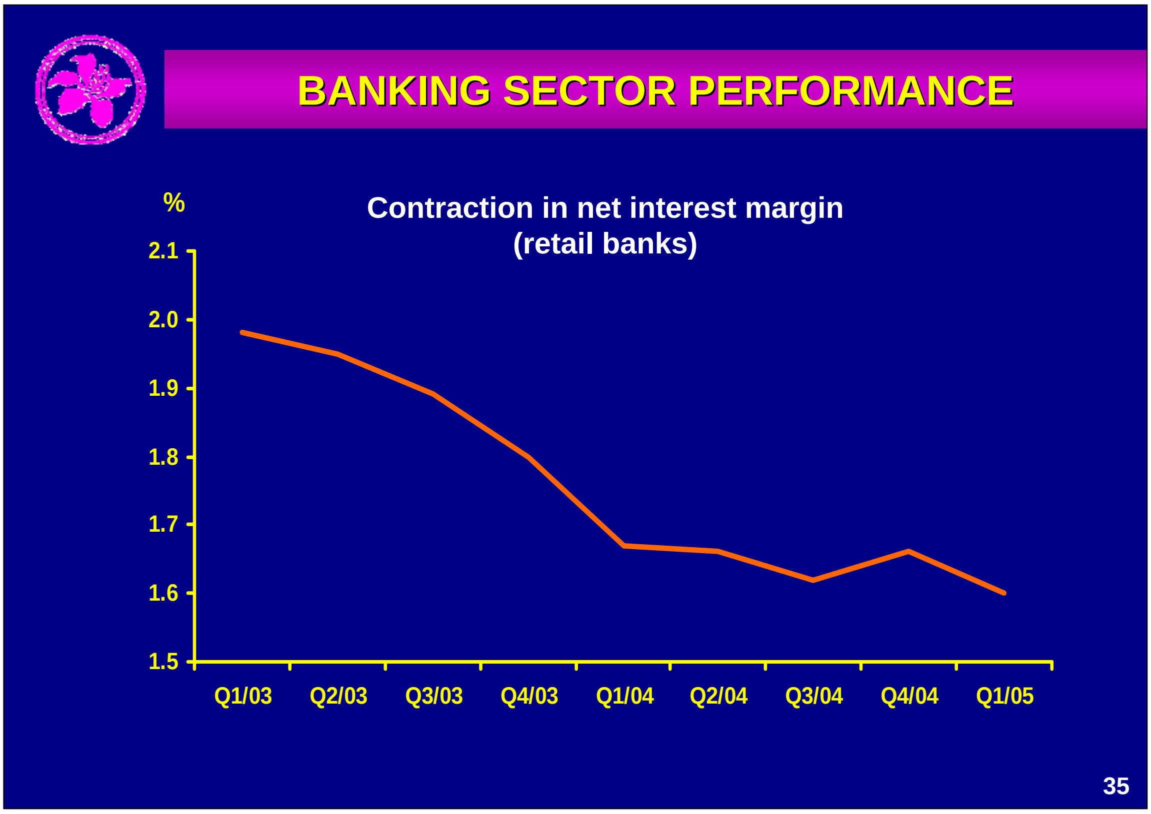
- The quality of banks' consumer lending improved further in 2005 Q1 owing to the strengthening of borrowers' repayment ability alongside the improvement in the employment market.

- The residential mortgage delinquency ratio (loans overdue for more than 3 months as a percentage of total mortgage loans) fell to a six-year low of 0.29% at the end of March 2005 from 0.38% at the end of 2004.

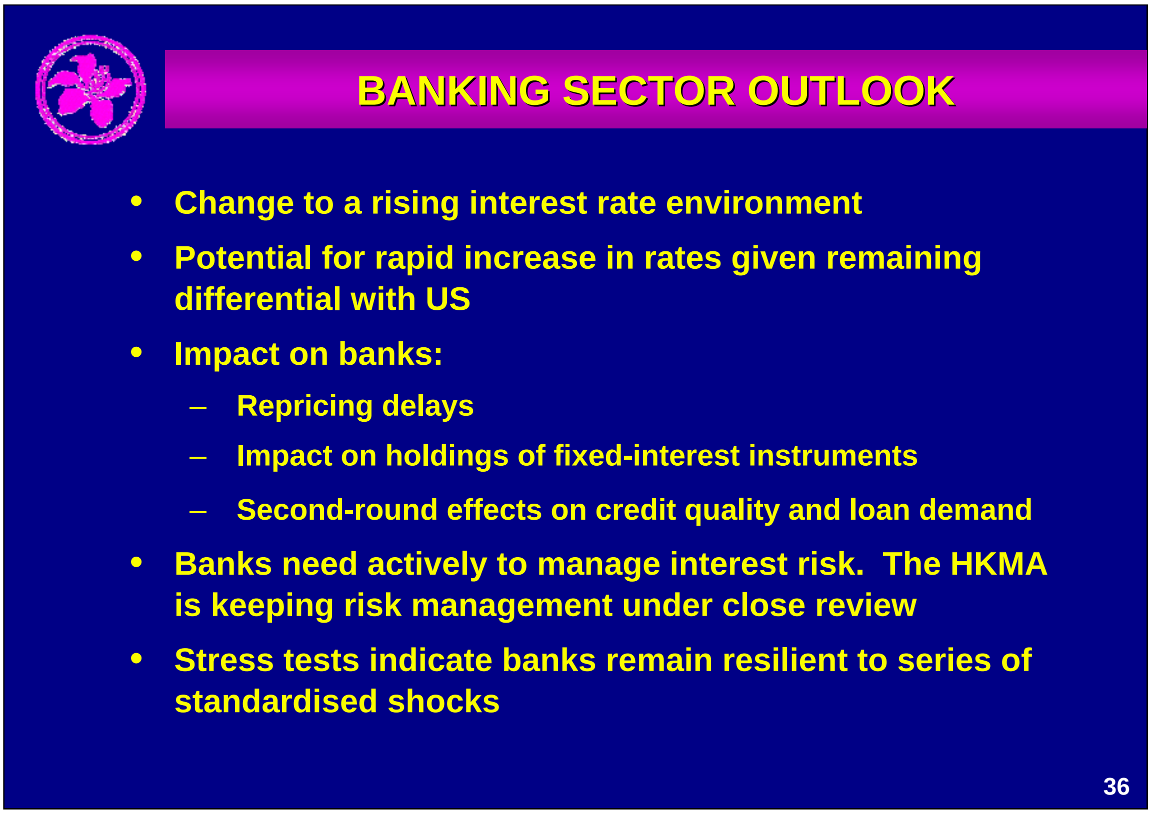
- The credit card charge-off ratio and delinquency ratio declined to 3.76% and 0.44% at the end of 2004 respectively from the peak of 14.55% and 1.32% at the end of September 2002.



- The negative equity problem has eased along with the steady increase in property prices. The number of residential mortgage loans in negative equity declined to some 14,000 cases with an aggregate value of $24 billion from 19,200 cases ($33 billion) at the end of 2004. Compared with the peak of around 106,000 cases ($165 billion) in June 2003, the decline was about 87%.



- Despite further expansion in interest bearing assets as a result of continuous loan growth, the net interest margin of retail banks declined to 1.60% in 2005 Q1, compared with 1.66% in 2004 Q4 and the 2004 full-year ratio of 1.65% owing to the increase in funding costs.



- Hong Kong has entered into an interest rate upcycle since March. There is potential for further rapid increases in rates owing to the remaining interest gap with US interest rates, and likely increases in US interest rates in the short term.

- The increase in interest rates will adversely affect banks' earnings if there are delays in repricing of assets (mainly loans) to catch up with the rapid increase in funding costs.

- Interest rate increases will have an adverse impact on the value of banks' holding of fixed interest instruments.

- Interest rate rises add debt repayment burden to borrowers and thus adversely affect banks' asset quality although the extent of this impact may be offset by the improving economy and employment situation. A rising interest rate will also dampen demand for loans.

- Despite these impacts, the banking sector remains strong. Banks have actively managed their interest rate and market risks, and the HKMA has closely monitored banks' risk management.

- The HKMA's internal stress-test results also revealed that the banking system remains resilient to series of standardised interest rate shocks.

BANKING SECTOR - WORK PROGRESS (I)

- **Residential mortgage lending (RML)**
  - on 28 February 2005 the HKMA issued on a circular on cash rebates
    - reminding authorized institutions of the need to monitor carefully the risks associated with residential mortgages
    - limiting the level of cash rebates to no more than 1% of the loan amount
  - on-site examinations on residential mortgages being conducted

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A new circular on cash rebates

- In the light of the use of large cash rebates by AIs earlier this year to compete for new residential mortgage lending business, the HKMA issued a circular to all AIs on 28 February 2005 reminding them of the need to monitor carefully the risks associated with RML and setting out the treatment of cash rebates and interest/repayment holidays within the context of the 70% loan-to-value ratio guideline (the 70% guideline).
- The circular has effectively capped the level of cash rebate to no more than 1% of the mortgage loan amount. Since then, AIs have reduced the level of cash rebates (generally within the range of 0.3% to 0.8% of the loan amount). Some AIs have even ceased to offer cash rebates.

On-site examinations on RML

- The HKMA has also started a round of on-site examinations on RML business of individual AIs (26 AIs) to review their compliance with the 70% guideline, and assess the quality of banks' credit underwriting standards and risk management arrangements for such business.

BANKING SECTOR - WORK PROGRESS (II)

- **Implementation of Basel II in HK**
  - continue to develop relevant rules and guidelines in consultation with the industry and monitor AIs' preparations for the revised capital regime
  - the Banking (Amendment) Bill 2005 tabled on 6 April being considered by a Bills Committee
  - early passage of the Bill is essential to ensure implementation according to international timetable

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- The on-going preparatory work on the development of rules and guidelines under Basel II continues. We have released in 3 batches detailed proposals on our approach and revised capital standards for implementing Basel II in Hong Kong from 1 Jan 2007. The proposals, which industry has generally endorsed as pragmatic and appropriate, will form the basis for the preparation of the rules and guidelines. We will also monitor closely AIs' Basel II implementation progress, particularly in the case of AIs intending to adopt the more advanced approaches.

- The process for the introduction of Basel II requirements into the legislative framework is progressing. After going through the consultation process in late 2004 / early 2005, the Banking (Amendment) Bill 2005 was gazetted on 4 March and subsequently tabled in LegCo on 6 April. A Bills Committee has been set up to consider the Bill.

- There is a clear necessity for an early passage of the Bill which provides legal backing and therefore practical certainty for Capital and Disclosure Rules to be drafted for the implementation of the Basel II requirements. The timing for the drafting process will be extremely tight given the lengthy and complex standards that need to be translated into Rules. Any delay in the legislative process will affect the targeted implementation date, and the position of Hong Kong as an international financial centre that prides itself on its commitment to always follow closely international supervisory standards.

BANKING SECTOR - EXEMPTION OF LIABILITY CLAUSES (ELCs)

- **Safe Deposit Box (SDB) Services**
  - DBSHK Incident: 78 out of 83 cases settled
  - guidance provided to AIs on the use of ELCs in SDB agreements:
    - ELCs should be reasonable
    - ELCs should be drawn to customers' attention
    - Customers should be advised to take out insurance as appropriate
  - by the end of April, all relevant AIs will have amended their ELCs
  - 2 AIs decided to terminate their SDB services
- **Other Personal Banking Services**
  - reviewing the reports submitted by AIs
  - will publish the results of the review once they are available

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- Regarding the DBSHK Incident, 78 out of 83 cases have been settled. We have conveyed Members' request to the bank to disclose the amount of compensation paid to affected customers. The bank considers that, since there are still a few unsettled cases and negotiations with these customers are ongoing, it is not appropriate to disclose this information at present. If the bank is able, at some future date, to disclose the required information without jeopardising its legal position, the bank will consider making an appropriate, non-customer-specific disclosure.

- As reported to Members previously, AIs have completed the review of their SDB agreements. Of the 27 AIs providing SDB services, 24 AIs were required to amend their SDB agreements to comply with the Code of Banking Practice. The HKMA has also issued guidance to AIs on the use of exemption clauses in their terms and conditions for SDB services. In formulating such guidance, the HKMA has to strike a reasonable balance between protecting consumer rights and upholding AIs' legitimate interest in managing their business risk. The overriding principle is that AIs should ensure that the use of such clauses is reasonable. The HKMA also considers it important for AIs to make exemption clauses highly transparent to customers, and has therefore required AIs to draw to customers' attention any exemption clauses incorporated in the terms and conditions. As a further protection, AIs are required to advise their customers to take out insurance as and when appropriate in the use of SDB services.

- The HKMA has earlier informed Members of the compliance position of the 24 AIs which are required to amend their SDB agreements. By the end of April, 22 out of the 24 AIs will have amended their ELCs such that they will not seek to exclude or restrict their liability in cases where the damage is caused by the AIs' own negligence. The remaining two AIs have decided to terminate their SDB services shortly and therefore no changes to their terms and conditions in this regard are considered necessary. Since these two AIs are wholesale banks, the number of customers affected is small (less than 150).

- In relation to the review of the terms and conditions of other personal banking services, we have received reports from 173 AIs which offer banking services to personal customers. We are now consolidating the results of the exercise and will share them with Members and the industry once they are available.

BANKING SECTOR - INTERNET BANKING FRAUD

- **Update since February 2005:**
  - 5 more reports of fake bank websites received
  - no further financial loss by customers was involved
- **Progress of two-factor authentication implementation:**
  - implementation by the end of June is on schedule
  - common methods adopted: digital certificate, SMS-based one-time password (OTP) and security token-based OTP
  - launch of consumer education programme in May 2005 to promote public awareness of two-factor authentication

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- Update since February 2005:
  - The number of fake bank websites received by the HKMA since February 2005 have increased by 5 to 50. (The first reported case on fake bank website was received by the HKMA in June 2003.)
  - No further customers suffered financial loss in relation to fake bank websites or e-mails. To date the total financial loss arising from such fraud remains at around HK$1.4 million involving 26 customers of a bank.

- Two-factor authentication implementation:
  - To further strengthen the security controls, the HKMA issued a circular in June 2004 to require AIs offering **high-risk retail Internet banking transactions (such as fund transfers to non-designated accounts)** to implement two-factor authentication by June 2005.
  - The implementation of two-factor authentication is progressing satisfactorily. It is expected that all relevant AIs will complete the implementation by June 2005.
  - Different banks may offer different types of second factor authentication methods. Three common methods being adopted by banks are digital certificate, Short Message Service (SMS)-based one-time password (OTP), and security token-based OTP.
  - With a view to promoting the consumer awareness on two-factor authentication, the HKMA is working with the banking industry and the Police to launch a consumer education programme (including a press conference, an educational leaflet, a computer interactive programme, TV episodes and radio segments) in late May 2005.

- Development of a safe and efficient financial infrastructure platform is key to the maintenance of Hong Kong as an international financial centre. Hong Kong currently has one of the most advanced financial infrastructure which meets the best international standards. Notwithstanding this, in the light of the new opportunities presented by the Mainland developments and the changing financial landscape and technology standards, the Financial Infrastructure Sub-Committee of the Exchange Fund Advisory Committee has started a review to take stock of where we are and map out a strategy to guide future development.

- Having considered the major opportunities and challenges that Hong Kong is expected to face in the coming years, we consider that the overall strategy should aim at developing a safe and efficient financial infrastructure for Hong Kong based on a multi-currency, multi-dimensional platform.

- The review will cover the Mainland related financial infrastructure, payment systems and the debt securities settlement system. It is expected to be completed in mid-2005. Implementation of the recommendations arising from the review will start in the second half of 2005.

- 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 promote the general safety and efficiency of the designated systems, the HKMA will carry out ongoing oversight activities through one or more of the followings: off-site review of regulatory returns, on-site examinations of high risk areas, external audit report, meeting with the management and international co-operative oversight.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE (I)

- **Renminbi business in Hong Kong**
  - **outstanding renminbi deposits totalled RMB13.9 billion yuan at the end of February 2005**
  - **use of renminbi bank cards facilitates Mainland tourists' spending in Hong Kong**
  - **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) development of a renminbi debt issuance mechansim in Hong Kong**
  - **to study the establishment of a clearing and settlement platform for renminbi transactions**

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- Renminbi business

  – 38 banks have engaged in personal renminbi deposit, remittance and exchange services since 25 February 2004. Total outstanding renminbi deposits amounted to RMB13.9 billion yuan at the end of February 2005.

  – 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 value of transactions by Mainland visitors using renminbi cards to spend and make cash withdrawals in Hong Kong exceeds $2.9 billion at the end of 2004. The average size of debit and credit card spending by Mainland tourists was $2,989 per transaction.

  – 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 will follow three strategic directions:

    (i) to explore the diversification of renminbi assets and liabilities of banks in Hong Kong;

    (ii) to explore the provision of appropriate renminbi banking services for trade and other current account transactions between Hong Kong and the Mainland; 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.

  – We are studying the establishment of a clearing and settlement platform for renminbi transactions so as to enhance their efficiency and safety.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE (II)

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 – the Pan-Asian Bond Index Fund and Hong Kong Bond Fund – will be listed on the Hong Kong Stock Exchange.**

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- 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 Market-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.

EXCHANGE FUND PERFORMANCE

(HK$ billion)	2005[2] Q1	2004[1] Full Year	2003[1] Full Year	2002[1] Full Year
Gain / (Loss) on HK equities*	(3.5)	12.0	21.2	(11.8)
Gain / (Loss) on other equities*	(0.9)	11.2	26.8	(22.7)
Exchange gain / (loss)	(3.0)	8.5	22.9	27.2
Total return from bonds, etc	5.3	25.0	18.8	54.3
Investment income	(2.1)	56.7	89.7	47.0

* including dividends

[1] *Audited figures;* [2] *Unaudited figures*

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- Year-to-date investment income at end-March 2005 registered a marked-to-market loss of HK$2.1billion because of the fall in the Hong Kong equity market and the strengthening of the US dollar against other currencies.

EXCHANGE FUND
CHANGE IN ACCUMULATED SURPLUS

(HK$ billion)	2005 Q1	2004 Full Year*	2004 Q1	2004 Q2	2004 Q3	2004 Q4
Investment income / (loss)	(2.1)	56.7	16.8	(7.2)	14.1	33.0
Other Income	0.0	0.2	0.0	0.1	0.0	0.1
Interest and expenses	(1.3)	(4.8)	(1.1)	(1.1)	(1.3)	(1.3)
Net investment income / (loss)	(3.4)	52.1	15.7	(8.2)	12.8	31.8
Treasury's share	0.7	(14.5)	(4.5)	2.1	(3.6)	(8.5)
Revaluation gain on premises affecting accumulated surplus	0.0	0.9	0.0	0.0	0.0	0.9
Increase / (Decrease) in EF accumulated surplus	(2.7)	38.5	11.2	(6.1)	9.2	24.2

* Audited figures

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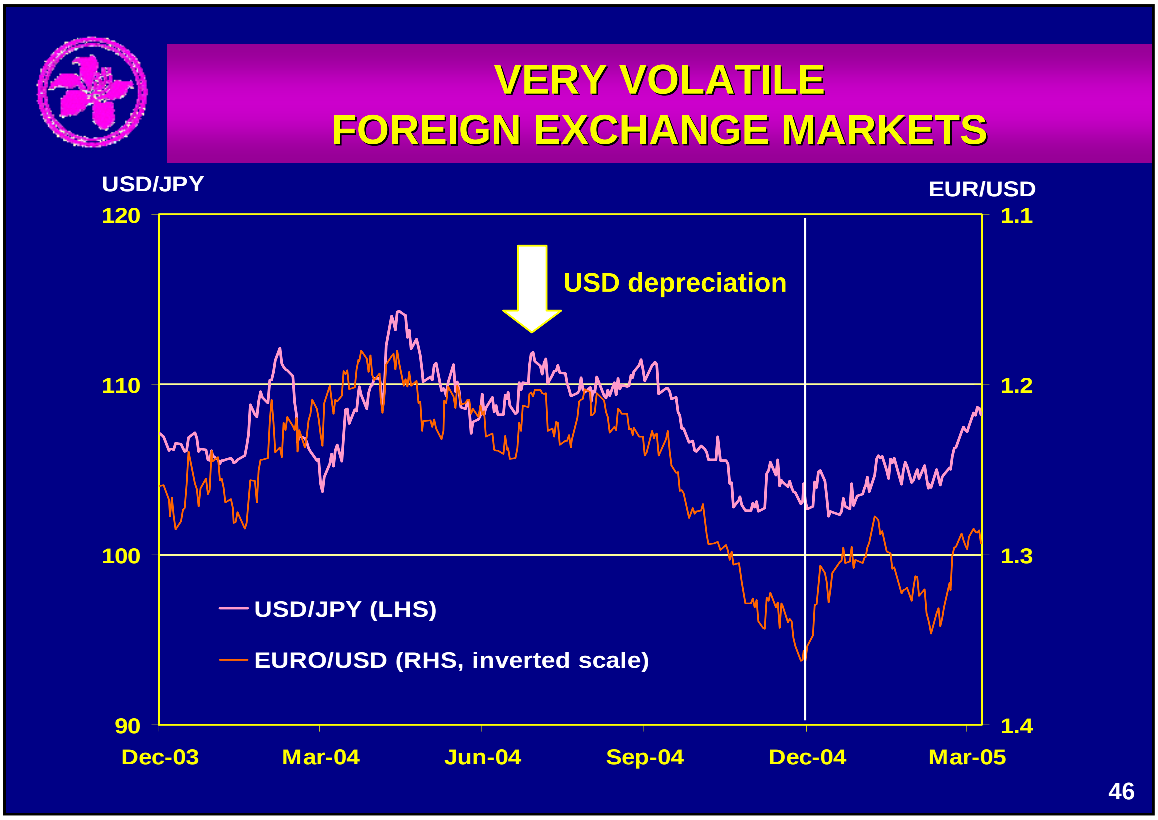
- The investment income of the Exchange Fund is inevitably linked to the performance of the major financial markets.

- In 2005 Q1, investment income suffered from the rebound of the US dollar, the rise in bond yields and the fall in equity markets. We expect the rest of 2005 to be as challenging as the first quarter of the year.

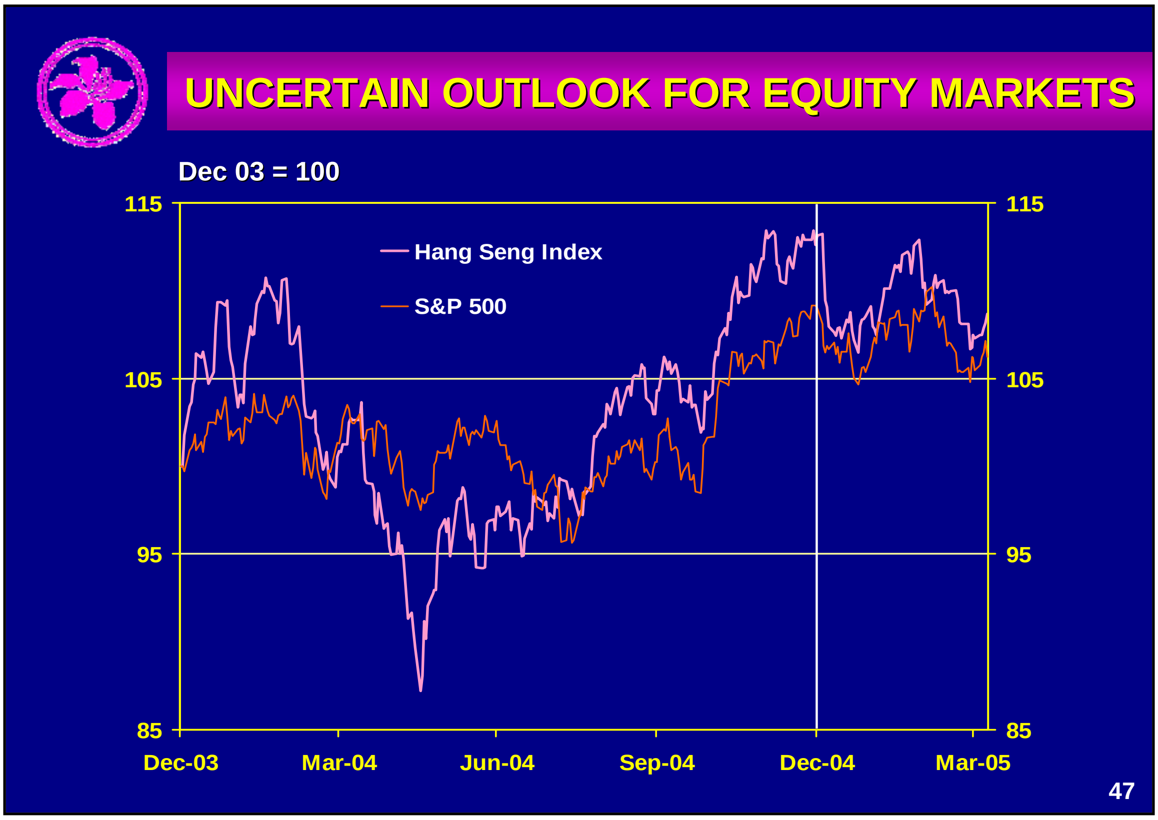
- Short-term investment performance can fluctuate widely. The table above shows investment income quarter by quarter and illustrate how quarterly income varies widely.

- In view of the purpose of the Exchange Fund which requires high liquidity and security, it is more appropriate to view the investment income of the Exchange Fund from a longer-term perspective.



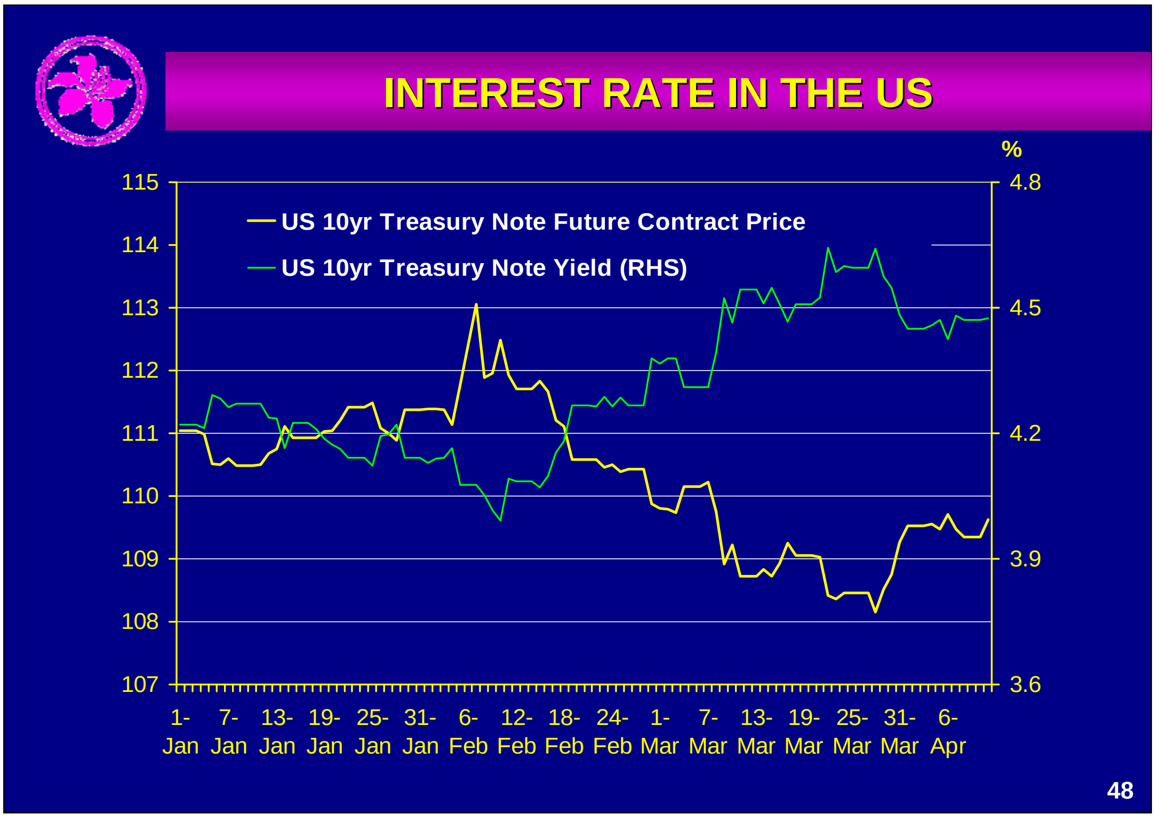
- In 2004, the euro and yen appreciated 7.8% and 4.6% against the US dollar respectively. Concern over twin deficits in the US depressed the value of the US dollar.

- In 2005 expectations for continued increases in US interest rates provided some support to the US dollar. As a result, the US dollar has appreciated 4.1% and 4.7% against the euro and yen respectively since the end of last year. However, imbalances in the global financial system have worsen. The uncertain outlook on growth in view of high energy prices and the increasing size of the imbalances suggest that the US dollar will seesaw through the rest of the year.



- In 2004, the Hang Seng Index and the S&P500 rose by 13.2% and 9.0% respectively.

- Since the beginning of 2005, the US equity market has been negatively affected by high energy prices and concerns over the sustainability of growth in the US. The sombre mood of the US equity market has spilled over to other markets, including Hong Kong which has also become wary of possible declining exports to the US. Up to 18 April, the S&P 500 and the Hang Seng Index have declined by 5.4% and 6.1% compared with the end of 2004.



- The US Fed is expected to continue to tighten monetary policy at a measured pace throughout 2005.

- The rate increase expectation has translated into high volatility in interest rates. The green line shows the US 10-year Treasury note yield while the yellow line represents the price of the US 10yr Treasury note future contract. The wavers in the line indicate the sensitivity of the market to changes in the expectations of inflation. Since June 2004, the US Fed has increased interest rates by 175 basis points from 1% to 2.75%. As the Fed Fund Target rate edges towards more neutral ground, the uncertainty surrounding future Fed action increases.

- We expect the uncertain outlook in currency, equity and bond markets to continue.

Briefing to the Legislative Council Panel on Financial Affairs

6 May 2005