HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

4 May 2006

DISCUSSION TOPICS

- HKMA 2005 Annual Report
- Updates on
  - Currency Stability
  - Banking
  - Financial Infrastructure
  - Hong Kong as an International Financial Centre
  - Exchange Fund

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- Copies of the HKMA 2005 Annual Report were distributed to Members on 21 April.

HKMA ANNUAL REPORT 2005 (1)

Monetary stability

- The three refinements introduced in May 2005:
  - normalised monetary conditions in Hong Kong.
  - lessened the likelihood of monetary conditions contributing to inflation and asset bubbles.
  - pre-empted adverse impact of RMB exchange rate reform on Hong Kong in July 2005.
- Exchange rate remained stable within the Convertibility Zone of 7.75 to 7.85.

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- The three refinements to the Linked Exchange Rate system introduced in May 2005 demonstrated the need to be forward looking in monetary management, supported by extensive research and contingency planning.

- The timing in the introduction of the three refinements was most appropriate, being two months ahead of the introduction of exchange rate reform on the Mainland. By anchoring expectation of the Hong Kong dollar appreciating and containing it to within 7.75, the use of the Hong Kong dollar as a proxy for taking a position on the renminbi quickly subsided.

- The removal of too-easy monetary conditions will contribute to the sustainability of the economic recovery.

HKMA ANNUAL REPORT 2005 (2)

Banking stability

- **Highly competitive environment continued to benefit depositors and borrowers, particularly home buyers.**
- **Strong prudential numbers maintained, decent profit growth despite compressed interest margins.**
- **Prevention of money laundering and terrorist financing was a major supervisory priority.**
- **Banking (Amendment) Ordinance 2005 enacted to facilitate Basel II implementation.**
- **Review of sharing of positive consumer credit data showed large benefits for both lenders and consumers.**
- **Good progress in preparatory work for Deposit Protection Scheme.**

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- Performance of retail banks in 2005:
  - Profits: Grew by 8.2% (2004: 20.3% -- post-SARS rebound).
  - Net interest margin: Increased slightly to 1.68% (2004: 1.66%).
  - Domestic lending: Increased by 9.2% (2004: 7.2%).
- Close monitoring of mortgage market where keen competition may have led to imprudent practices.
- A total of 228 on-site examinations were carried out in 2005.
- Banking (Amendment) Ordinance 2005 empowered HKMA to make Capital and Disclosure Rules. First batch of Rules drafted and issued for public comment in December 2005.
- The average indebtedness of bankrupts declined from over 35 times their monthly income in June 2003 to 25 times in August 2005 following the introduction of positive consumer credit data sharing. A large part of the credit card rollover balance was substituted by lower-cost credit such as instalment loans and revolving credit facilities.
- Deposit Protection Board worked hard on operational details of the Deposit Protection Scheme, supported by close consultation with the industry and interested parties.

HKMA ANNUAL REPORT 2005 (3)

Market infrastructure

- A comprehensive review of financial infrastructure was completed in 2005. Proposals of the review are being implemented.
- All designated systems under the Clearing and Settlement Systems Ordinance were found to be in compliance with the safety and efficiency requirements.
- The Exchange Fund Bills and Notes programme was refined to attract more retail investors.
- The Treasury Markets Association was formed.

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- The review confirmed the strategy:
  - to develop multi-currency, real time gross settlement (RTGS), delivery versus payment (DvP) and payment versus payment (PvP) financial infrastructure.
  - to establish international, regional and Mainland linkages to our financial infrastructure.
  - to promote cross-border use of our financial infrastructure.
- Adopted self-regulatory approach for retail payment systems that carry little, if any, systemic risk.
- Treasury Markets Forum pulled market practitioners and fragmented market organisations together within a coherent institutional framework.

HKMA ANNUAL REPORT 2005 (4)

Hong Kong as an IFC

- Renminbi business has expanded. Renminbi deposits exceeded RMB 22 billion yuan at the end of 2005.
- The ABF Pan Asia Bond Index Fund and ABF Hong Kong Bond Index Fund were listed in Hong Kong.
- The HKMA continued to ensure credit rating agencies maintain a more balanced view on Hong Kong. S&P upgraded Hong Kong's foreign currency sovereign credit rating from A+ to AA-.
- More training was provided to officials of Mainland authorities.

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- Expansion in renminbi business:
  - widening the definition of designated merchants who can open renminbi deposit accounts
  - relaxing the limits for exchange and remittance of renminbi by individuals
  - removing the cap on credit limits for renminbi cards issued by participating banks
  - allowing Hong Kong residents to use renminbi cheques in Guangdong Province, facilitated by the launch of the new Renminbi Settlement System in March 2006.
- The ABF Pan Asia Bond Index Fund and ABF Hong Kong Bond Index Fund were well received by investors. The number of outstanding units of the latter has grown by 50% since its listing in July 2005.
- A total of 20 courses, or 4,100 days of training, were provided to 1,130 Mainland officials in 2005.

HKMA ANNUAL REPORT 2005 (5)

Reserves management

- The Exchange Fund earned an investment return of HK$38.2 billion or 3.1% in 2005.
- The rate of investment return exceeded that of the benchmark portfolio by 24 basis points.
- The HKMA continued to out-perform the investment benchmark set by the Exchange Fund Advisory Committee.
- The Fiscal Reserves' share amounted to $10 billion, compared with the budget estimate of $14 billion, made on the basis of historical average rate of investment return.

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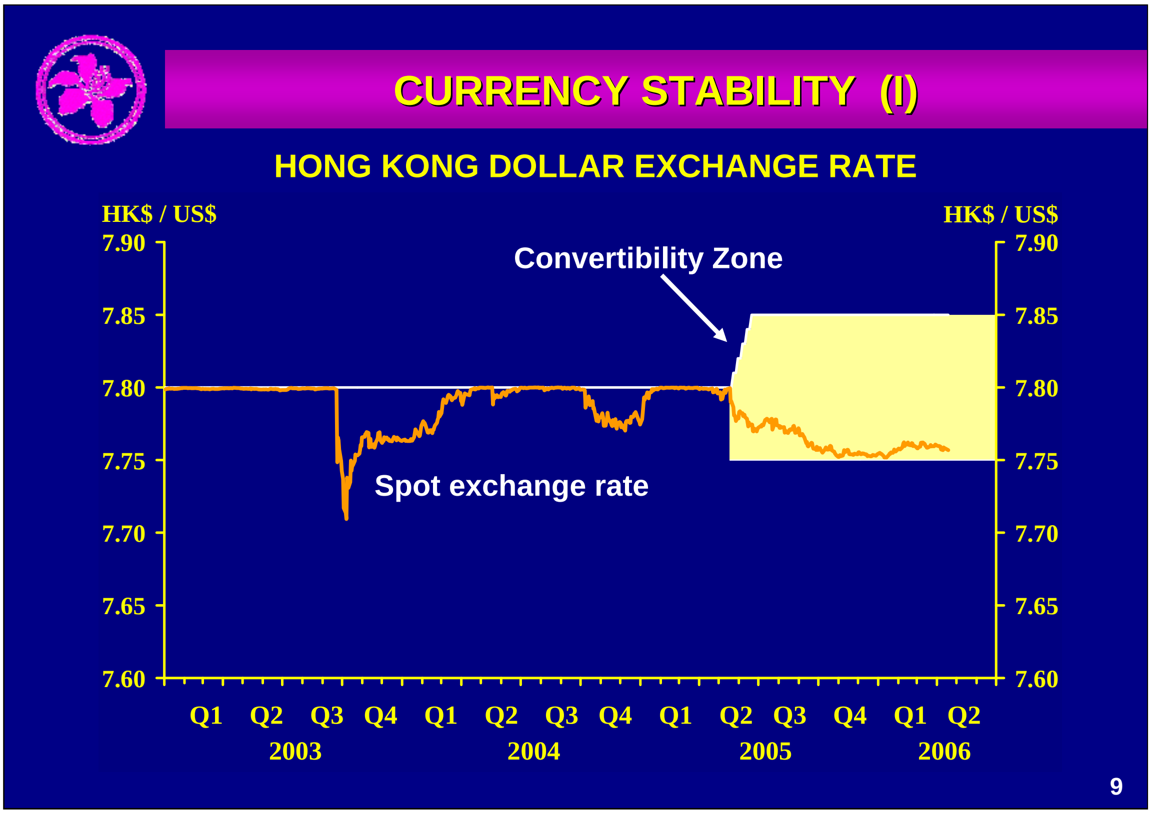
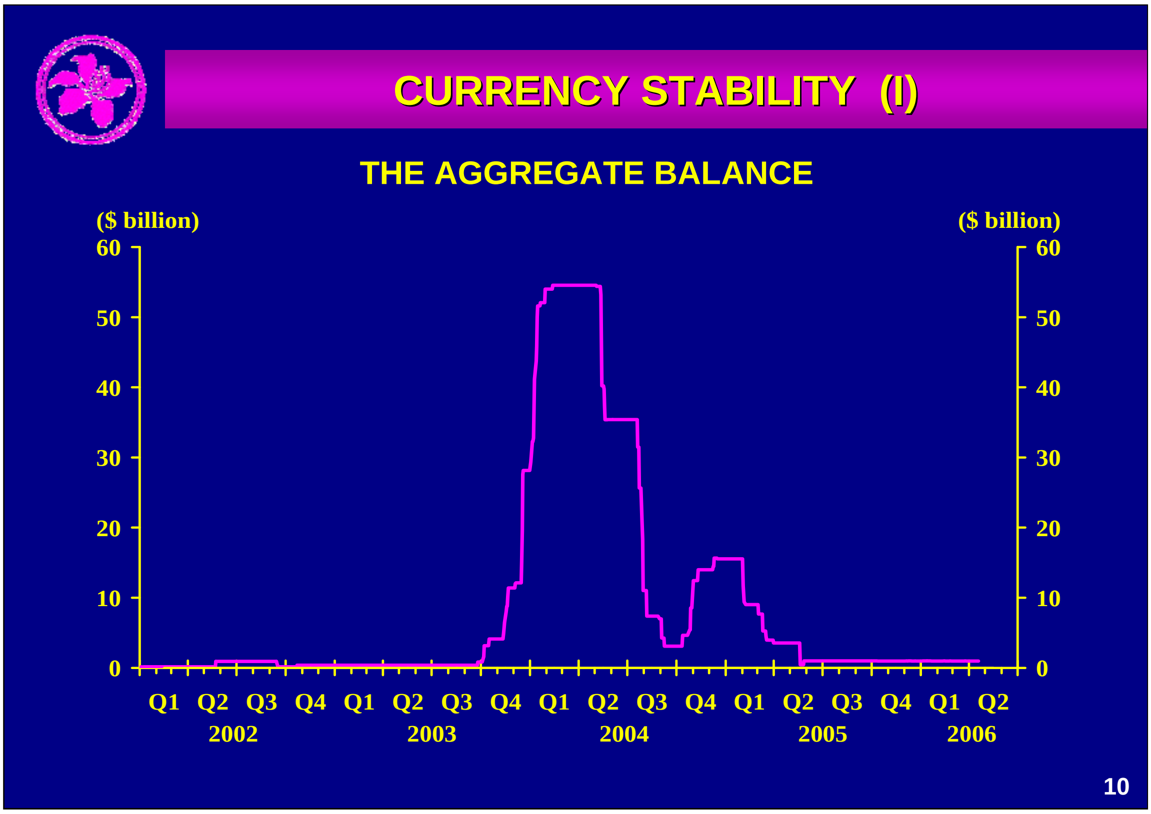
- Components of the investment income of HK$38.2 billion:
  - HK$30.2 billion from bond investment
  - HK$7.0 billion from Hong Kong equities
  - HK$20.5 billion from foreign equities
  - HK$19.5 billion foreign exchange revaluation loss.
- Since 1994, the Exchange Fund has generated a compounded annual return of 6.3%, compared with the compounded annual inflation rate of 1.3% over the same period.
- The investment return of the Exchange Fund has always exceeded, or at least met, the investment benchmark since it was introduced in 1999.
- The out-performance in 2005 amounted to over three years of administrative expenditure of the HKMA.
- The budget estimate of HK$14 billion return on fiscal reserves was a trend number that did not take into account of investment climate of individual years.

- The rest of this presentation will focus on the latest developments in the five areas of responsibility of the HKMA since the last presentation to the Panel on Financial Affairs on 6 February 2006.

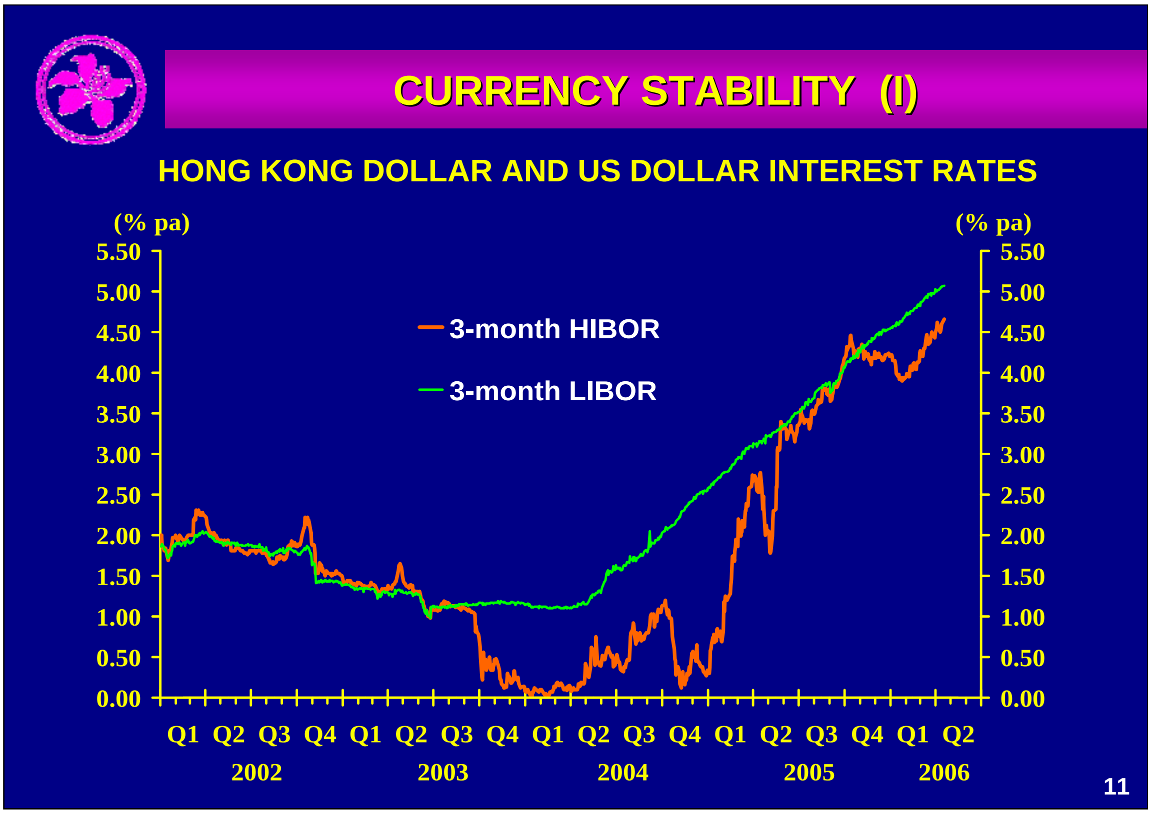


- The Hong Kong dollar exchange rate remained stable within the Convertibility Zone.
- It stayed close to the strong-side Convertibility Undertaking of 7.75 during the past few months, reflecting:
  - market expectation of a strengthening renminbi resulting in a corresponding strengthening of the Hong Kong dollar.
  - equity related demand for Hong Kong dollars, as the stock market performed well, supported by a strong economy and a series of IPOs of H-shares.
- There were no significant signs of currency speculation, or the use of Hong Kong dollar as a proxy instrument for taking a position on the renminbi.
- The threat of a monetary shock remains, as the renminbi exchange rate approaches or breaks through psychological levels, renewing attention on the long term relationship between the renminbi and the Hong Kong dollar.
- The position of the HKSARG on the Linked Exchange Rate system remains clear and firm.



- The Convertibility Undertakings have not been triggered in the past few months. The last occasion when the strong-side Convertibility Undertaking was triggered was in June 2005.

- The Aggregate Balance remained stable at around HK$1.3 billion, reflecting ample liquidity in the interbank market, enough to cope with the occasional surge in demand for funds associated with highly over-subscribed IPOs in the stock market.

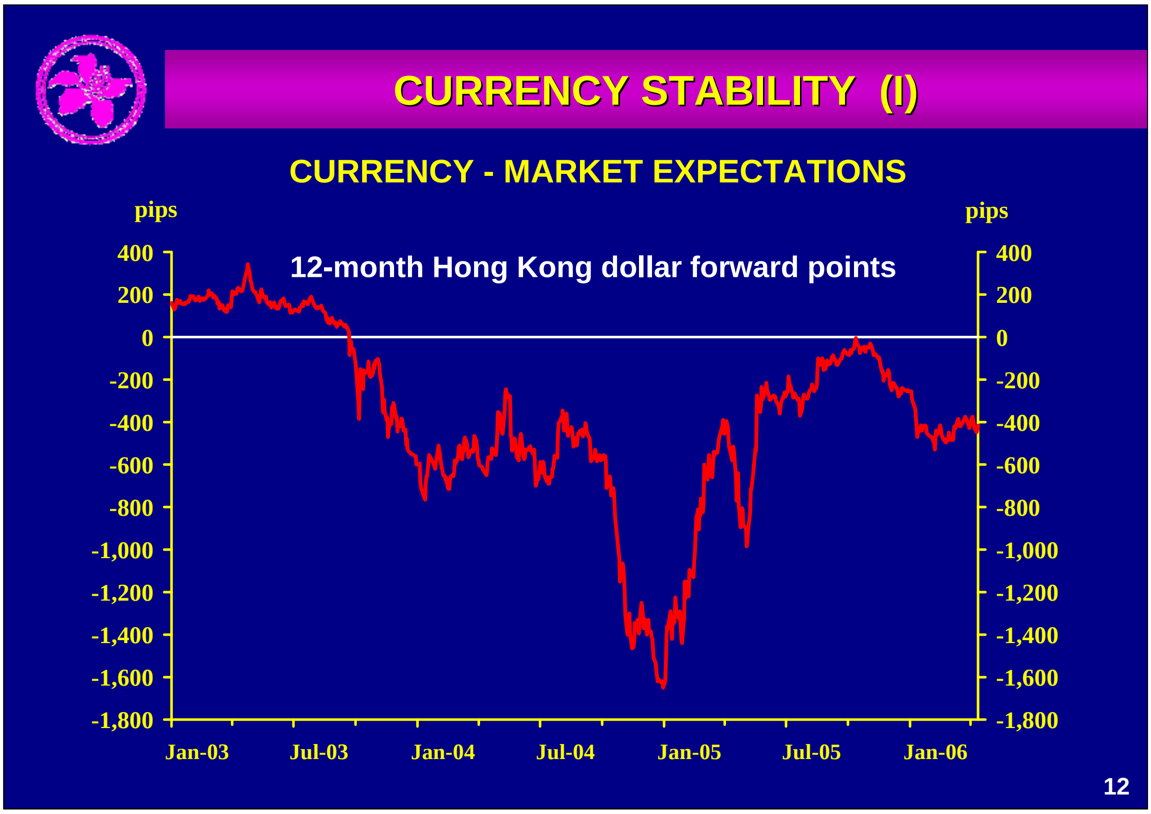


- Hong Kong dollar interbank interest rates continue to track closely the corresponding US dollar rates, although a small discount is observed in recent months.

- The size of the Aggregate Balance, at about HK$1.3 billion, represents more than adequate liquidity under normal circumstances, but is necessary to cater for the occasional surge in demand for funds.

- The small discount of HKD interest rates below corresponding US dollar interest rates has led to some interest arbitrage activities undertaken both by banks and their customers, but not quite enough to weaken the exchange rate to any significant extent.

- Compared with the situation before the introduction of the three refinements, the interest rate discount in recent months, at less than 100 basis points, is much smaller.



- The interest rate discount of Hong Kong dollar against the US dollar is also reflected in the forward exchange rate.

- The discount in the 12-month forward exchange rate widened markedly in recent months and is currently at around 400 pips, indicating willingness on the part of market participants to buy Hong Kong dollars against US dollars in one year's time at around 7.72.

- The fact that the one-year forward exchange rate is stronger than 7.75 reflects market sentiment on the sustainability of the strong-side Convertibility Undertaking at 7.75, but such sentiment is not necessarily rational. The HKSARG remains firmly committed to the maintenance of the Linked Exchange Rate system.

CURRENCY STABILITY (I)

Monetary conditions

- **Firming of US monetary policy largely mirrored in Hong Kong, although there is an abundance of liquidity in the Hong Kong dollar market.**
- **Higher interest rates have exerted some dampening effect on the residential property market, but have not undermined economic recovery in Hong Kong.**
- **US interest rates may have to go up further, but hopefully not a lot, on the back of strong data.**
- **US interest rates reaching a plateau rather than peaking later in the year.**

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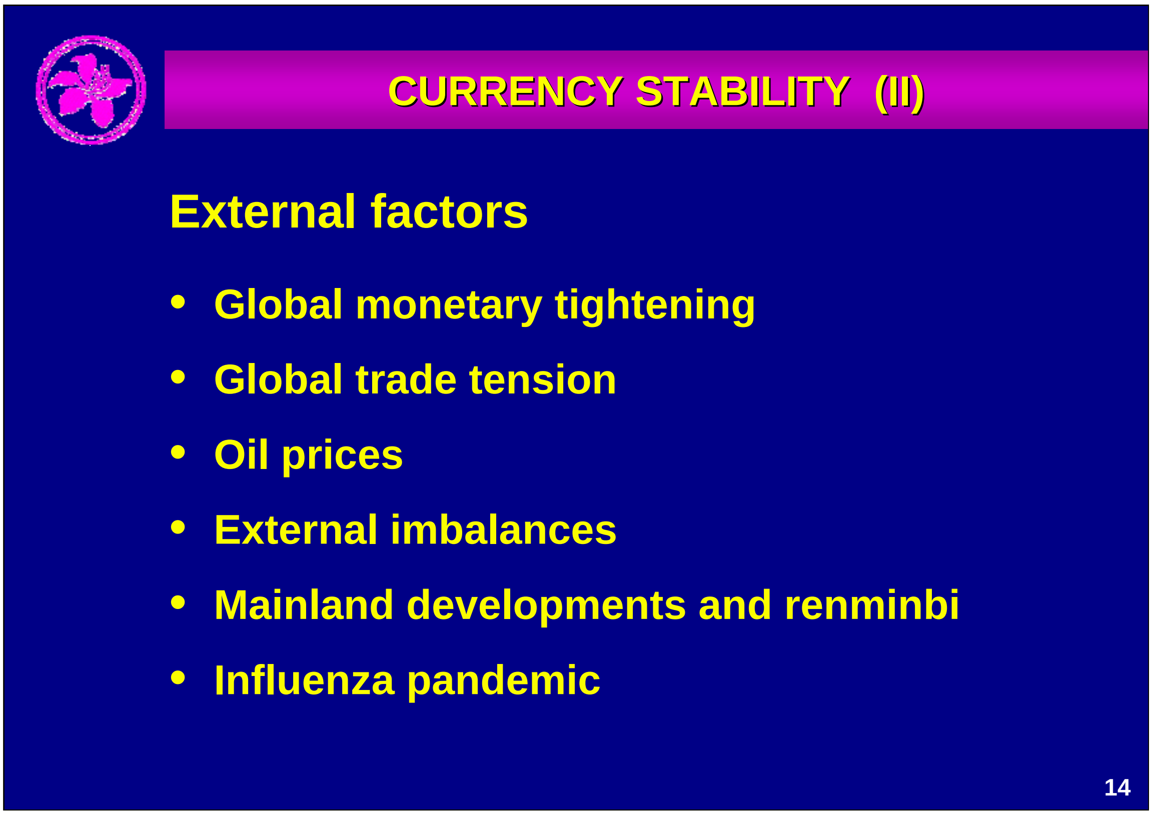
- The US federal funds target rate has been raised 15 times by a total of 375 basis points to 4.75% since June 2004. The market expects the rate to continue to rise to 5% to 5.25% later this year.

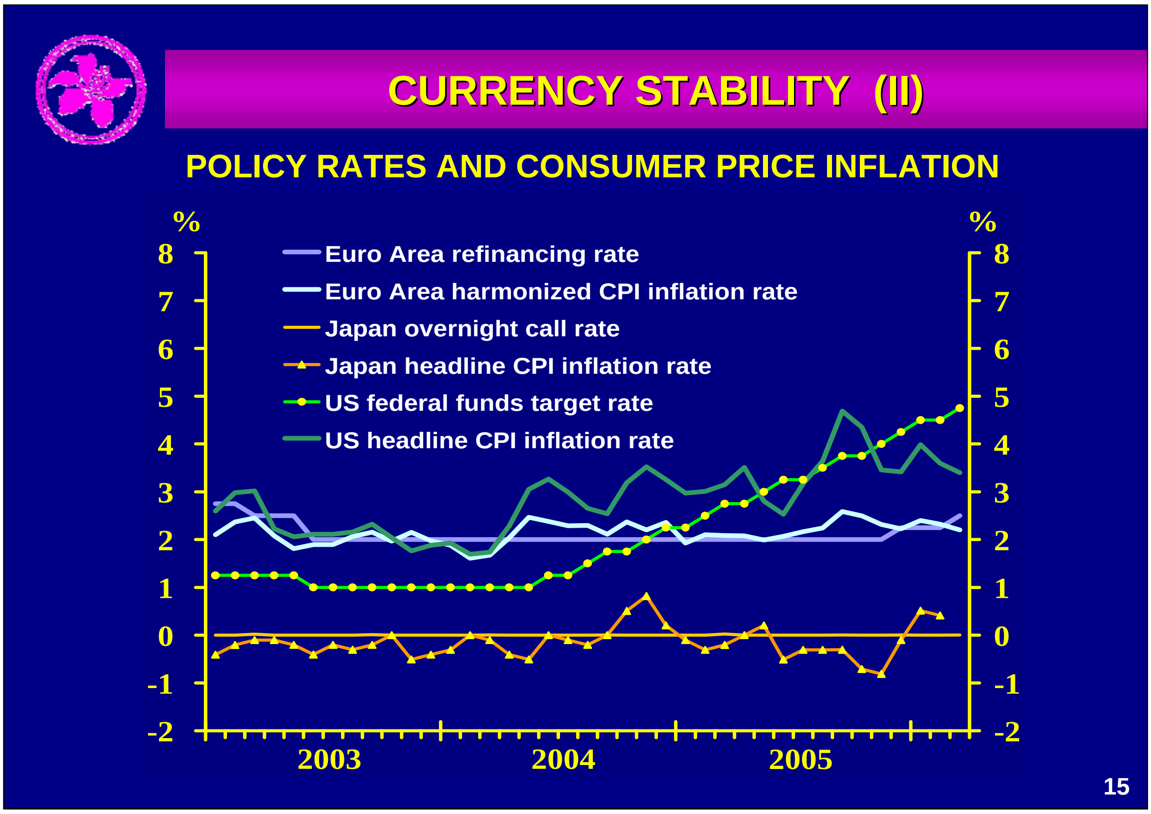
- US interest rate stance generally appropriate for the economic circumstances of Hong Kong.

- The significant catch-up of Hong Kong dollar interest rates with US dollar interest rates has largely been completed, although the process involved some overshooting of the prime rates, due to keen competition with temporarily low cost of funds driving the mortgage rate too far below prime. There is a risk that this process may repeat itself with Hong Kong dollar interbank interest rates recently easing to below corresponding US dollar interest rates.



- As always, there are many external factors that may affect currency stability in Hong Kong. All of these factors are outside the control of Hong Kong.

- Better and more general appreciation of these external factors will help in the risk management of all concerned, thus lessening the adverse impact of unexpected events on Hong Kong, particularly the stability of our currency.



- Financial markets may over-react or be slow to react to the confluence of monetary tightening in major developed economies, as central banks start to get concerned about inflation, although inflationary expectation remains well anchored.

- The US Fed raised its policy rate to 4.75% in March 2006. When the US Fed will end its tightening cycle remains uncertain. While interest rates may be about to reach a plateau, it does not necessarily look like a peak is forming yet. While inflation has remained modest in recent months, there are risks associated with tight labour market conditions and a high capacity utilisation rate.

- Although the European Central Bank and the Bank of Japan lag behind in their tightening cycles, the pace of tightening may accelerate. The Bank of Japan started to remove its quantitative easing policy in March 2006, as core consumer price inflation has stayed above zero since November 2005. The European Central Bank may raise the refinancing rate further should inflationary pressure build up.

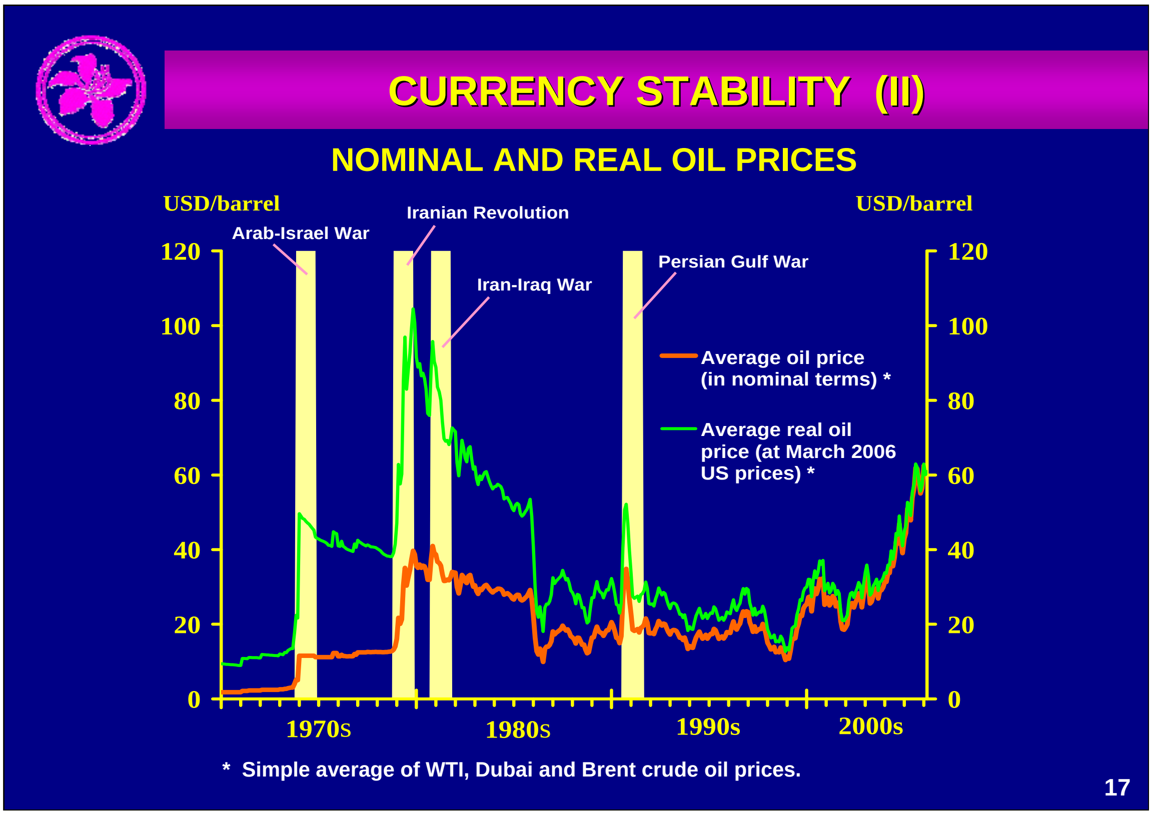
- Global monetary tightening may slow down demand for Hong Kong's exports if it affects growth in our main trading partners. The external position may weaken, although a sharp reversal of the current account surplus seems unlikely. But financial markets tend to telescope future trends into present day activity, possibly triggering outflows of funds.

- Strong growth of Mainland China's exports and an increasing bilateral trade surplus with the US & EU have led to trade disputes and protectionist sentiment against Mainland China.

- The restrictions on the Mainland's textile and clothing exports imposed by the US & EU in 2005 only affected a small percentage of Hong Kong's total exports. However, a risk of broader-based trade sanctions exists.

- In February 2005, US Senators Schumer and Graham introduced a bill to impose a 27.5% tariff on all imports from the Mainland. In March 2006, US Senators Grassley and Baucus introduced a separate bill to propose some new penalties for currency misalignment by trading partners of the US. These include disapproval of Overseas Private Investment Corporation insurance for projects in those countries, disapproval of new loans at the international development banks, opposition to additional voting power in the International Monetary Fund, and retention of non-market economy status for purposes of US anti-dumping laws.

- These bills, if passed, could add significant upward pressure on the renminbi, and volatility to global currency markets. Such volatility may exert pressure on proxy currencies, including the Hong Kong dollar.

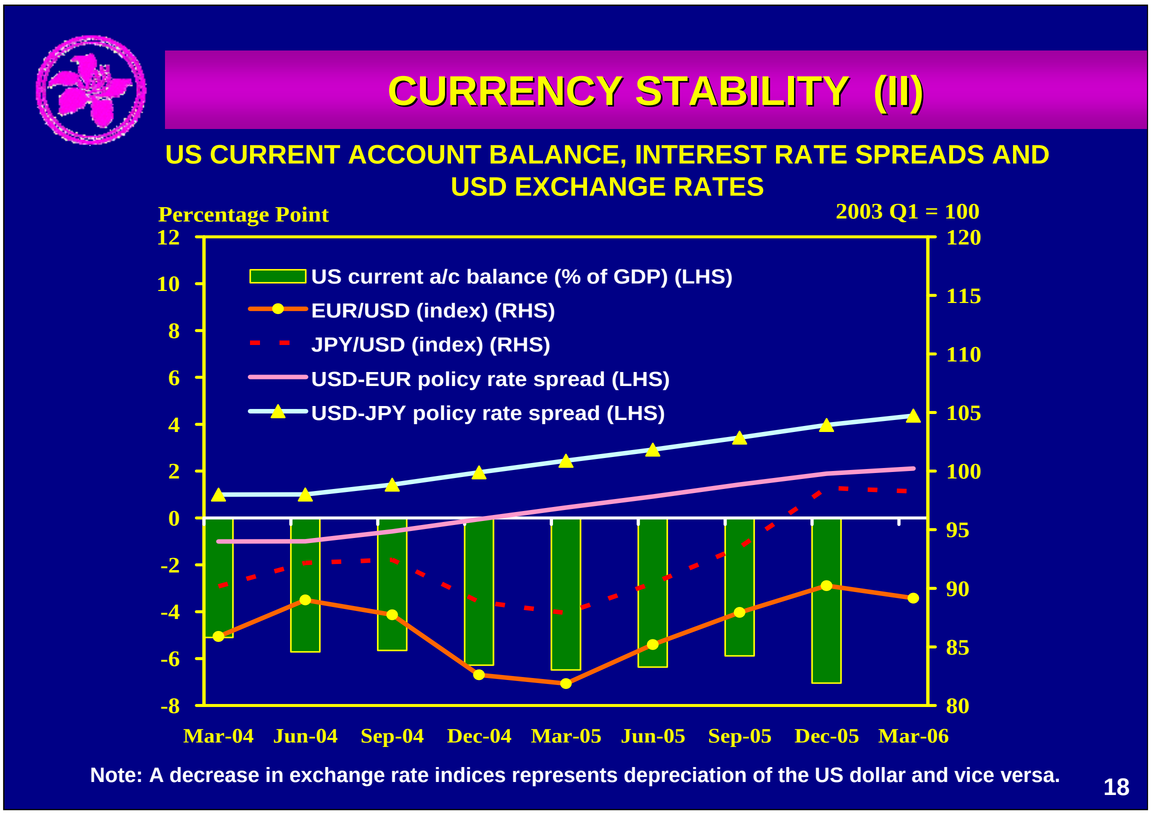


- The price of crude oil (an average of Dubai, Brent and WTI) rose to around US$70 per barrel in mid-April from US$60 at the beginning of 2006, as heightened tensions over Iran's nuclear program and political conflicts in Nigeria may lead to a significant disruption to oil supplies.

- High oil prices so far have had limited impact on the world economy because (a) oil prices are still well below their historical peaks in real terms; (b) global oil intensity has fallen considerably, reflecting increasing energy efficiency in production and a continued shift of the advanced economies away from manufacturing towards service-sector activities; (c) they mainly reflect strong global demand and not supply-side shocks; and (d) the pass-through to core inflation - and hence monetary policy response - has been limited.

- However, further oil price increases might have a more significant impact on global growth. First, as oil production approaches full capacity, any disruption to supply will increase oil price and raise production cost sharply, restraining economic growth. Second, a stronger feeding through to core inflation may trigger more aggressive monetary tightening by major central banks than anticipated. Third, the global trade imbalance could worsen, as higher oil prices inflate the US import bill and oil-exporting countries import more from Asia and Europe (and less from US). Finally, how oil-exporting economies manage their increased foreign reserves may have implications for the funding of the US trade imbalance.

- The direct effect of higher oil prices on Hong Kong is likely to be limited, given the economy's low oil intensity due to its high service orientation. But oil price induced volatility in global financial markets will affect Hong Kong.

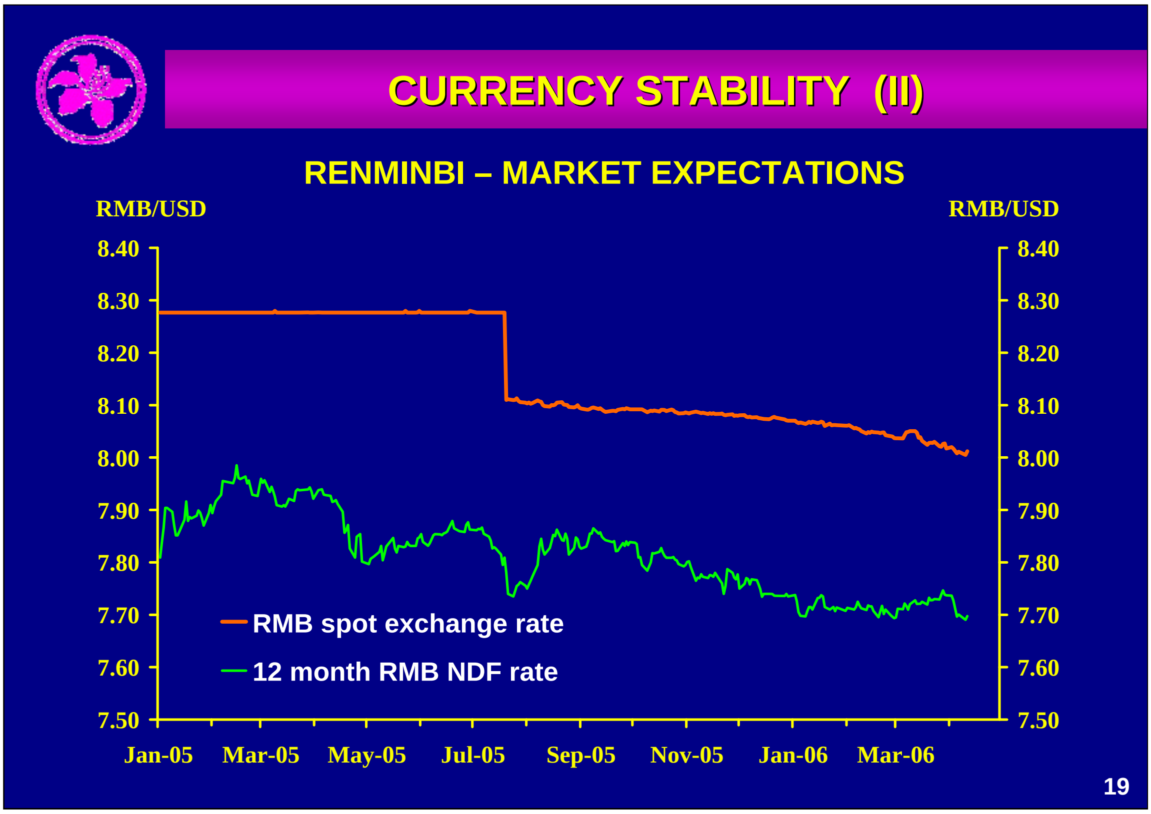


- The US current account deficit has continued to grow, reaching 7.0% of GDP in 2005 Q4. The expanding deficit increases the vulnerability to future shocks and the risk of a disorderly exchange rate adjustment.

- The large current account deficit partly explained the medium-term weakening trend of the US dollar since 2002. Nevertheless, the widening of interest rate differentials in favour of the US gave support to the US dollar in 2005 and attracted capital inflows into the US to finance its large current account deficit. However, it weakened against major currencies in 2006 Q1 on rising expectations of a narrowing of interest rate differentials.

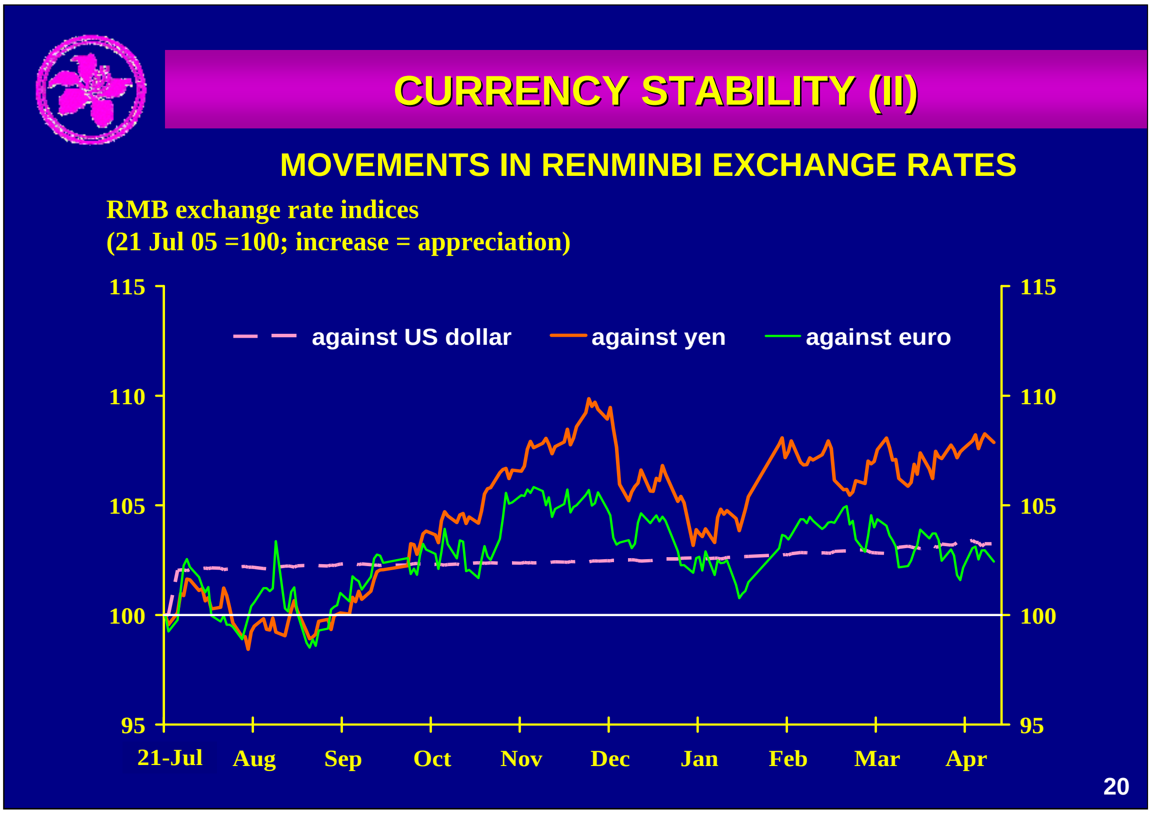
- If US dollar interest rates peak according to market expectations, while interest rates in Europe increase further in response to inflationary concerns, the interest rate differentials in favour of the US may narrow. The US dollar might resume its downward trend. If this leads to a sharp capital outflow from the US and a disorderly adjustment of the US dollar exchange rate, the global financial market will be adversely affected.

- A sharply weaker US dollar will, of course, affect Hong Kong, given the Hong Kong dollar's link with the US dollar.



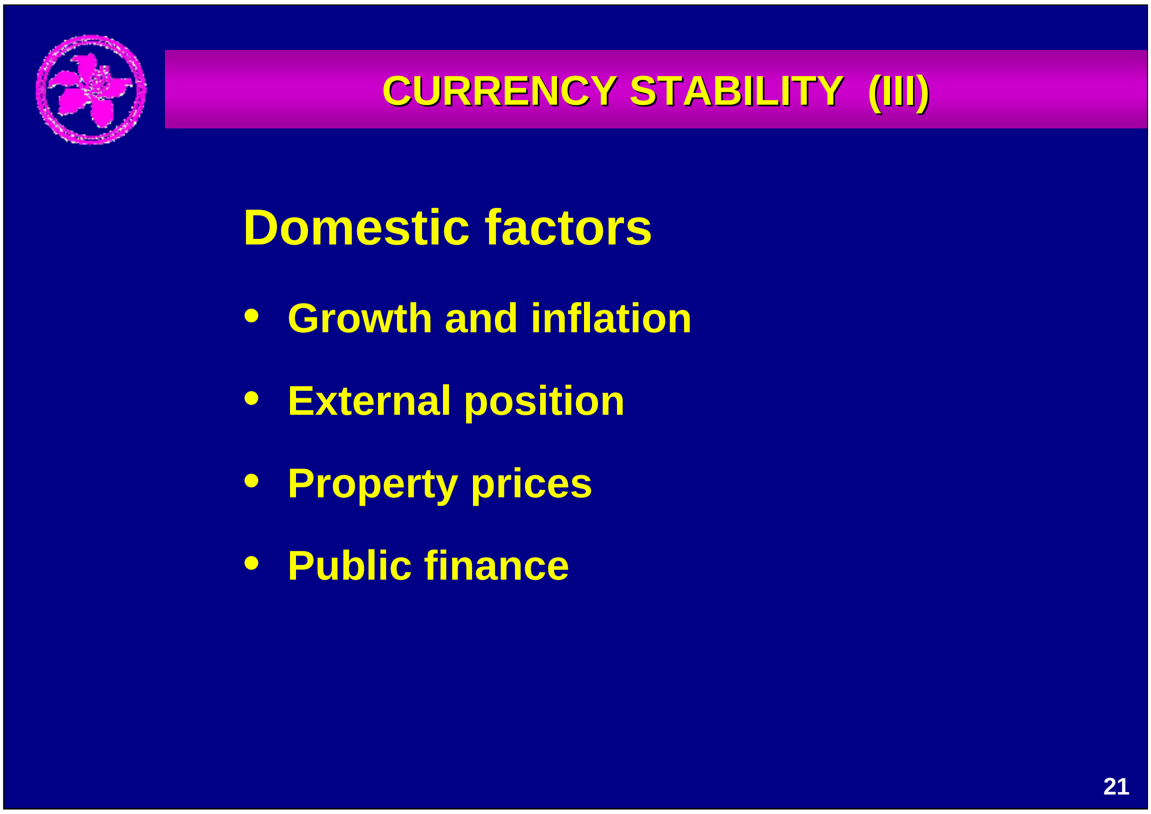
- Speculation about renminbi appreciation has intensified since the later part of 2005, with the 12-month renminbi non-deliverable forward rate gradually strengthening to around 7.70 to one US dollar by mid-April 2006.

- The renminbi exchange rate will continue to be a major factor affecting sentiment on the Hong Kong dollar. It is fortunate that the three refinements introduced in May 2005 to the Linked Exchange Rate system have helped significantly to anchor expectation on the Hong Kong dollar, so that it has fallen out of favour as a proxy for taking a position on the renminbi. But this cannot be taken for granted.



- Since the announcement of the reform in the renminbi exchange rate regime in July 2005, the renminbi has strengthened notably against major currencies, particularly the euro and the yen.

- Further significant appreciation of the RMB may put upward pressure on the Hong Kong dollar, leading to lower Hong Kong dollar interest rates relative to the US rates. Renewed capital inflows into Hong Kong could raise inflation risks and possibly fuel asset bubbles.



- **Domestic economic factors support confidence in the Hong Kong dollar.**

- **Economic growth remained robust.** Real GDP registered its tenth straight quarter of expansion in 2005 Q4, growing by 7.6% from a year earlier, following an increase of 8.3% in Q3, driven by strong domestic and external demand.

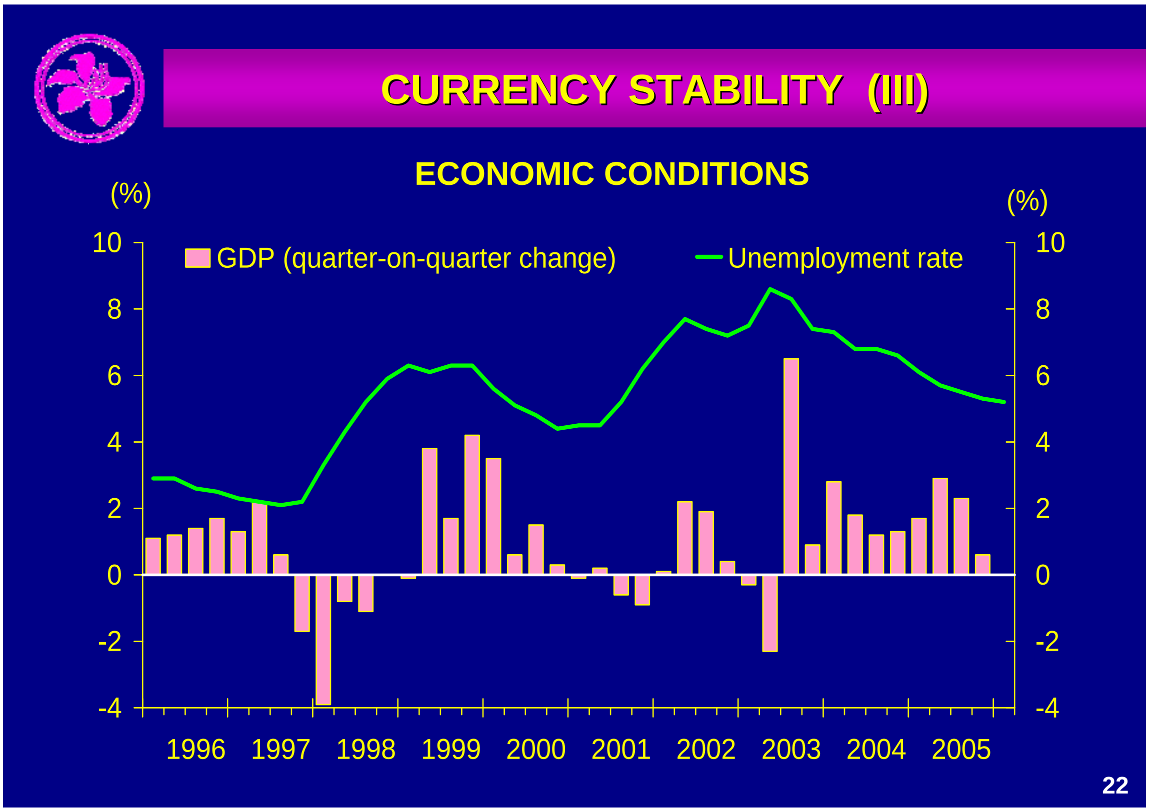
- **The headline Consumer Price Index** edged up steadily in recent months, but the risk of a substantial increase in inflation remains low.

- **The external position of Hong Kong remains healthy.** The current account surplus increased markedly in 2005 from 2004, reflecting a rise in the service account surplus and a decline in the merchandise trade deficit. The latter reflects strong exports over the year. The net international investment position remains solid (at about 2.6 times GDP at the end of 2004).

- **Property prices** have increased substantially from the trough in 2003 despite some moderation in the past year, contributing to the rebound of private consumption through the wealth effect.

- **Public finances:** The fiscal position has improved considerably, helped by recovery in economic activity. Having been in deficit for seven years, the Government Consolidated Account is estimated to return to a surplus of 0.3% of GDP in FY2005/06. The turnaround mainly reflects higher revenue from salaries and profits taxes and lower operating expenditure.

- These strong fundamentals may stimulate capital inflows, possibly leading to relaxed monetary conditions. We need to be aware of the possibility of inflation and asset price bubbles.

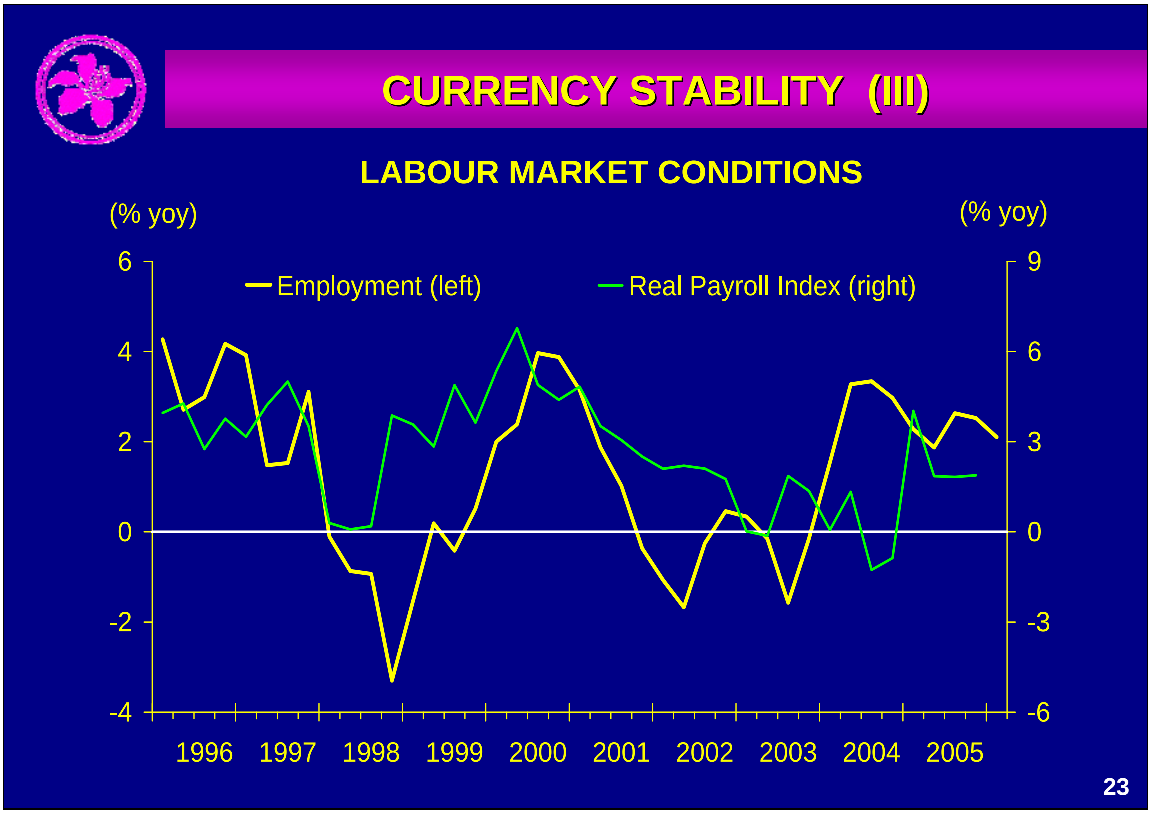


- On a seasonally adjusted quarter-on-quarter basis, GDP grew by 0.6% in real terms in 2005 Q4, following an increase of 2.3% in Q3. The economic expansion was broadly based.

- Despite higher interest rates and a moderation in the property market, private consumption increased by 0.8% from the previous quarter, supported by increased household income and improved labour market conditions.

- Recent data point to an expansion in 2006 Q1. Taking the average of January and February, the value of goods exports increased by 2.6% from the average level in 2005 Q4 (seasonally adjusted). During the same period, the volume of retail sales declined by 0.3% from the average level in Q4 (seasonally adjusted).

- The near-term economic outlook continues to be positive, although the rate of growth is expected to moderate and inflation is likely to increase. The expected slowdown in growth reflects mainly higher interest rates and slower trade growth. The latter is the result of the high base of export growth last year and protectionist measures in the US and EU against the Mainland's exports.

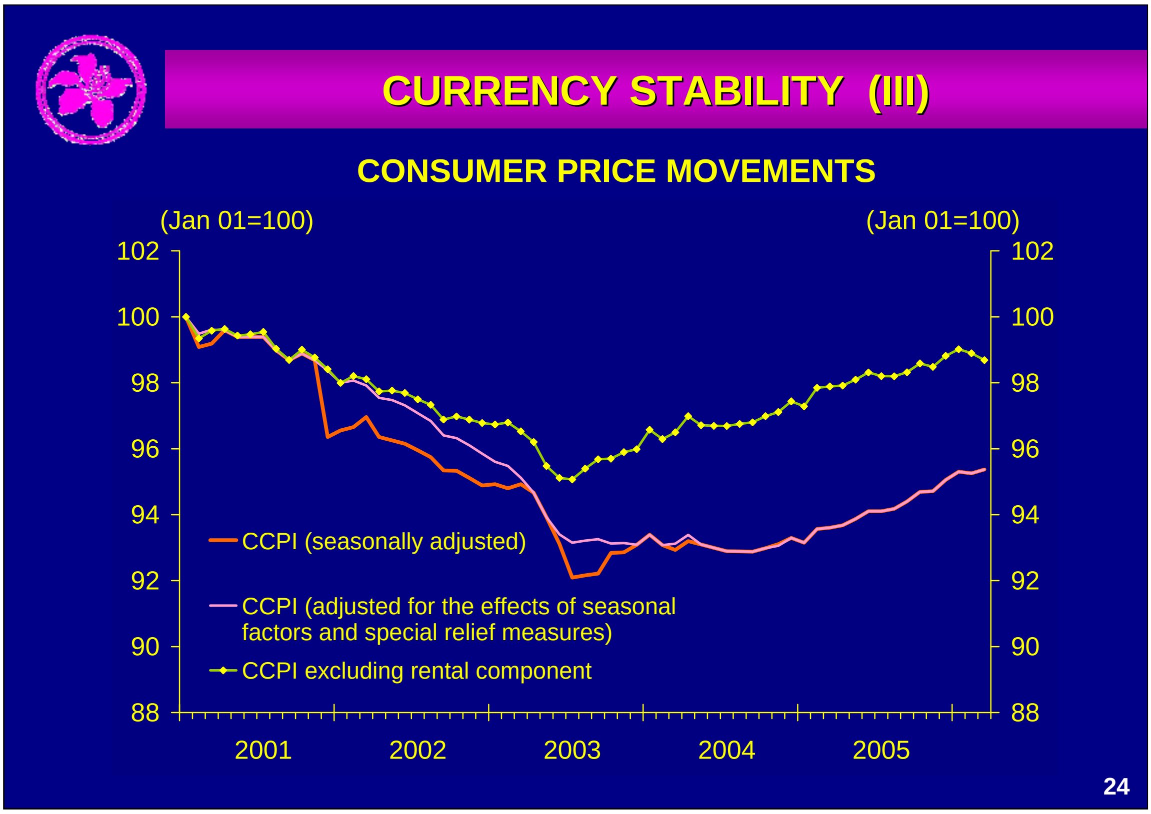


- Along with the economic recovery, labour market conditions continued to improve. The seasonally adjusted unemployment rate declined to 5.2% in the three months ending March 2006, compared with a historic high of 8.6% recorded in mid-2003. During the period, employment increased by 235,900 to 3,425,000.

- A sustained recovery in the economy should help reduce the unemployment rate further. In 2005, the Labour Department received some 426,000 private sector vacancies, surpassing a total of 297,000 in 2004 by 43%.

- Total employment increased by 2.1% in the three months ending in March 2006 from a year earlier.

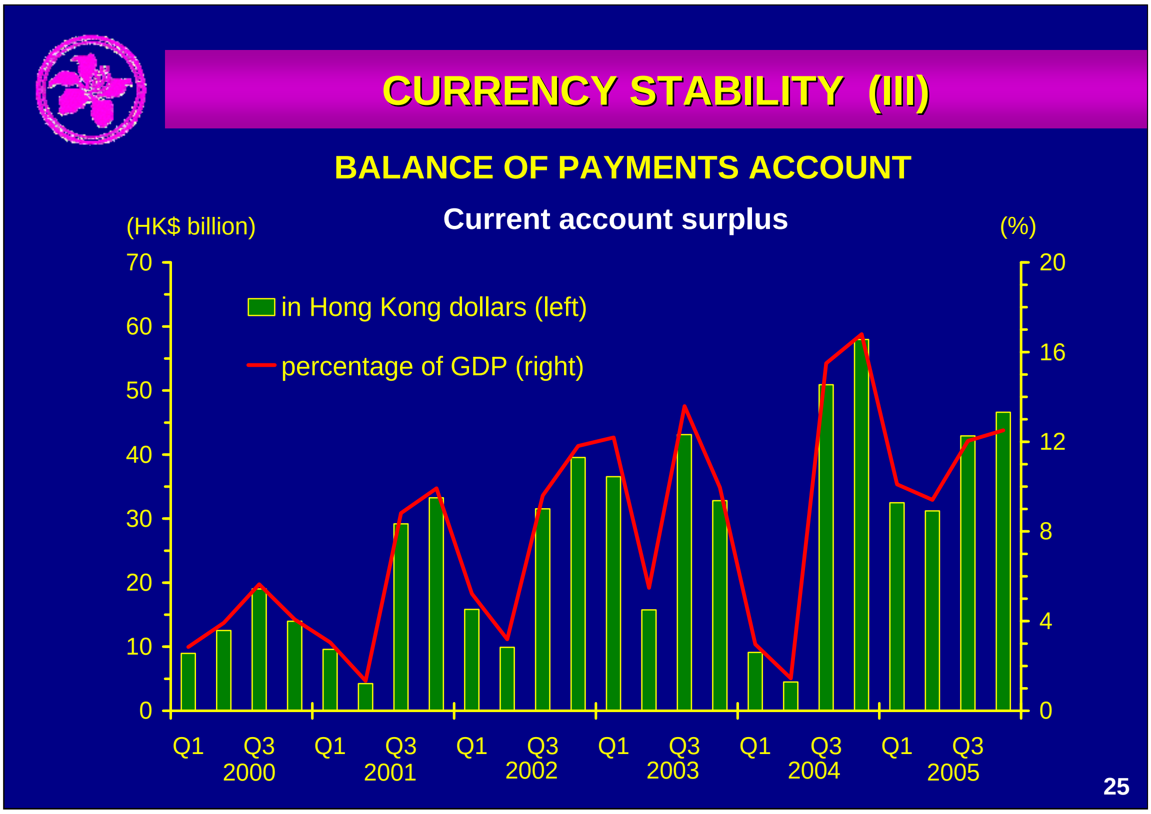
- Increased labour demand has led to a rise in labour earnings. The nominal payroll per worker, which includes remuneration, overtime payments, back-pays, and other irregular allowances and bonuses, increased by 3.5% in 2005 over a year ago. After adjusting for inflation, the real payroll index increased by 2.4% during the same period.



- The headline inflation rate has increased moderately over the past year, but the year-on-year inflation rate remained benign at 1.8% in March 2006, following 2.6% in January and 1.6% in February. The volatile movement of the inflation rate in the first two months reflected the timing of the Chinese New Year holidays, which fell in January this year but February last year. For the first two months as a whole, the Composite CPI (CCPI) rose by 2.1% from a year ago.

- The Composite CPI, excluding rents, has been increasing along with recovery in economic activity. The rental component of the index has picked up more noticeably in recent months due to the feeding through of earlier increases in housing rents.

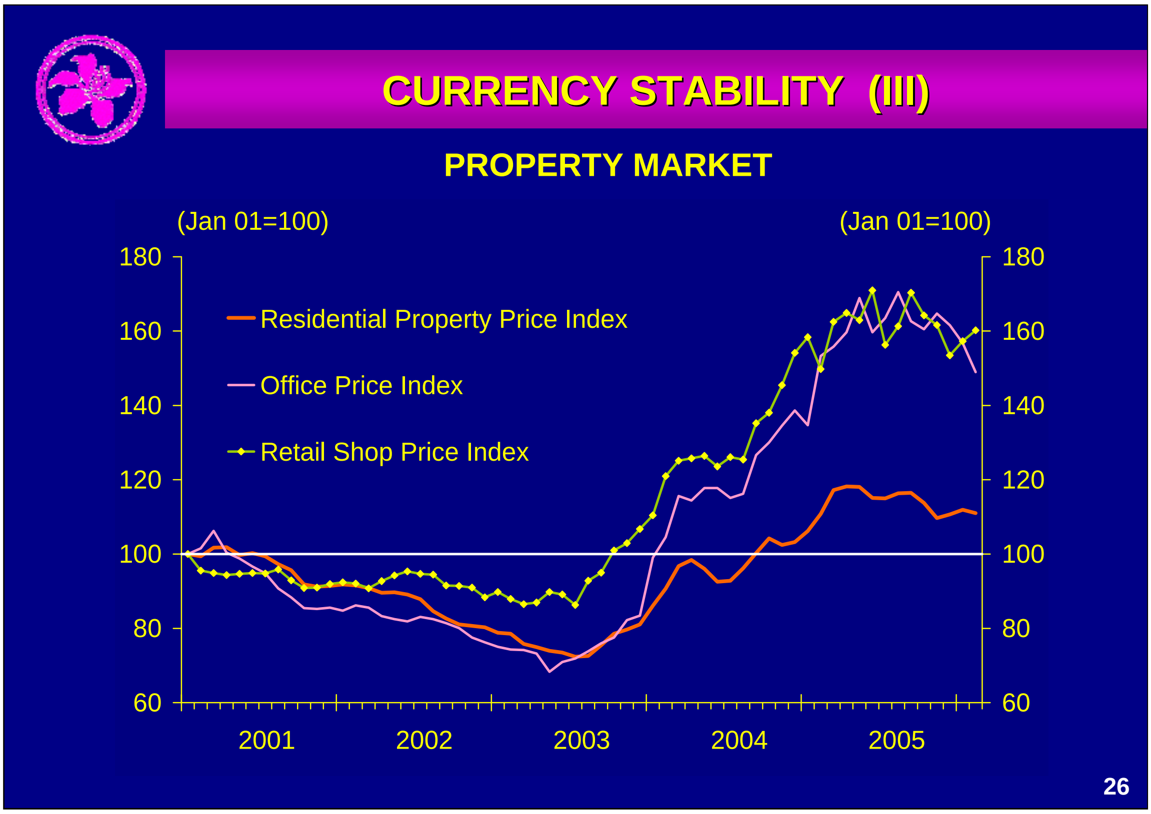
- Consumer prices are expected to rise moderately due to robust economic growth and further pass-through of increases in residential rents to the headline CPI. Nevertheless, the risk of a substantial increase in inflation remains low, given generally low inflation in our major trading partners and the recent increases in interest rates.



- The external position has remained favourable, partly reflecting improvement in our competitiveness.

- The current account continued to register a notable surplus of around 12.5% of GDP in the fourth quarter of 2005, underpinned by solid growth in exports of goods and trade-related services, and strong growth in tourism-related earnings.

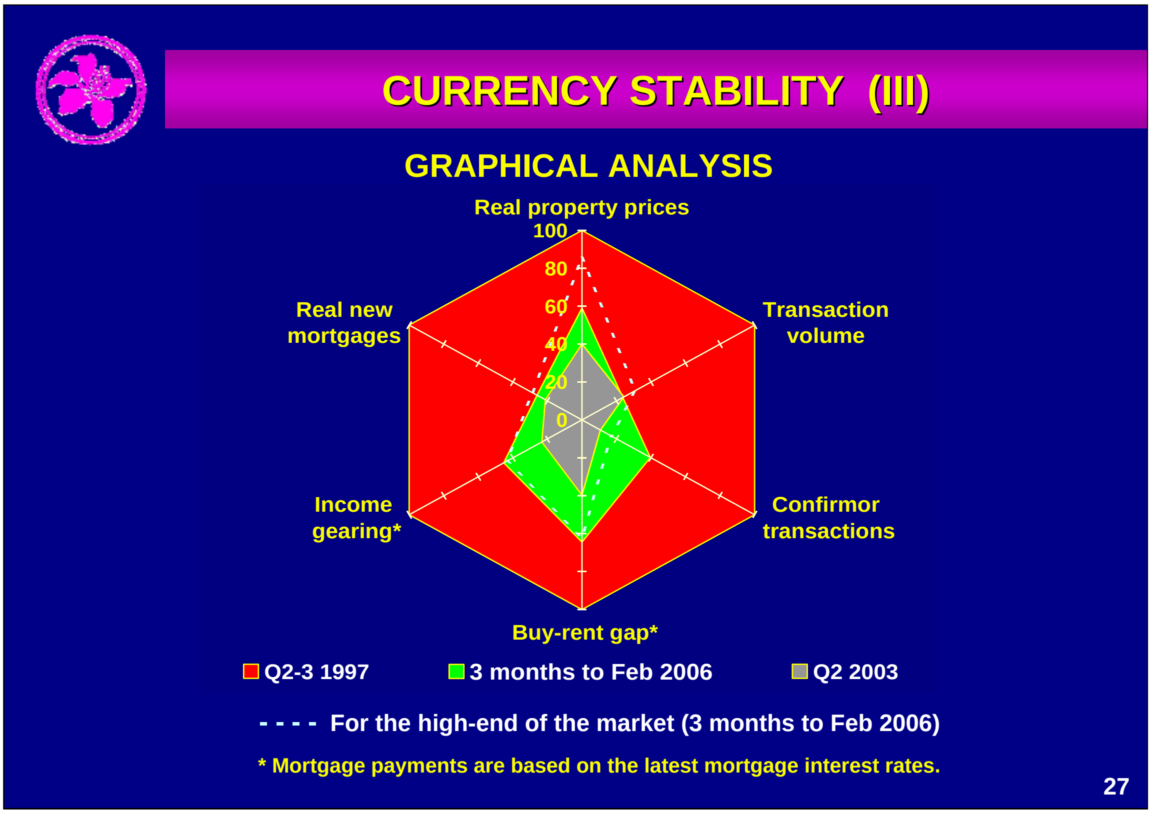
- The investment income generated by the accumulated net foreign assets (nearly 260% of GDP) will continue to support the Hong Kong dollar, particularly if these earnings, most likely in foreign currency, are invested back into domestic markets.



- The cumulative effect of a series of interest rate hikes has curbed residential property market activities and enhanced the sustainability of the underlying improving trend.

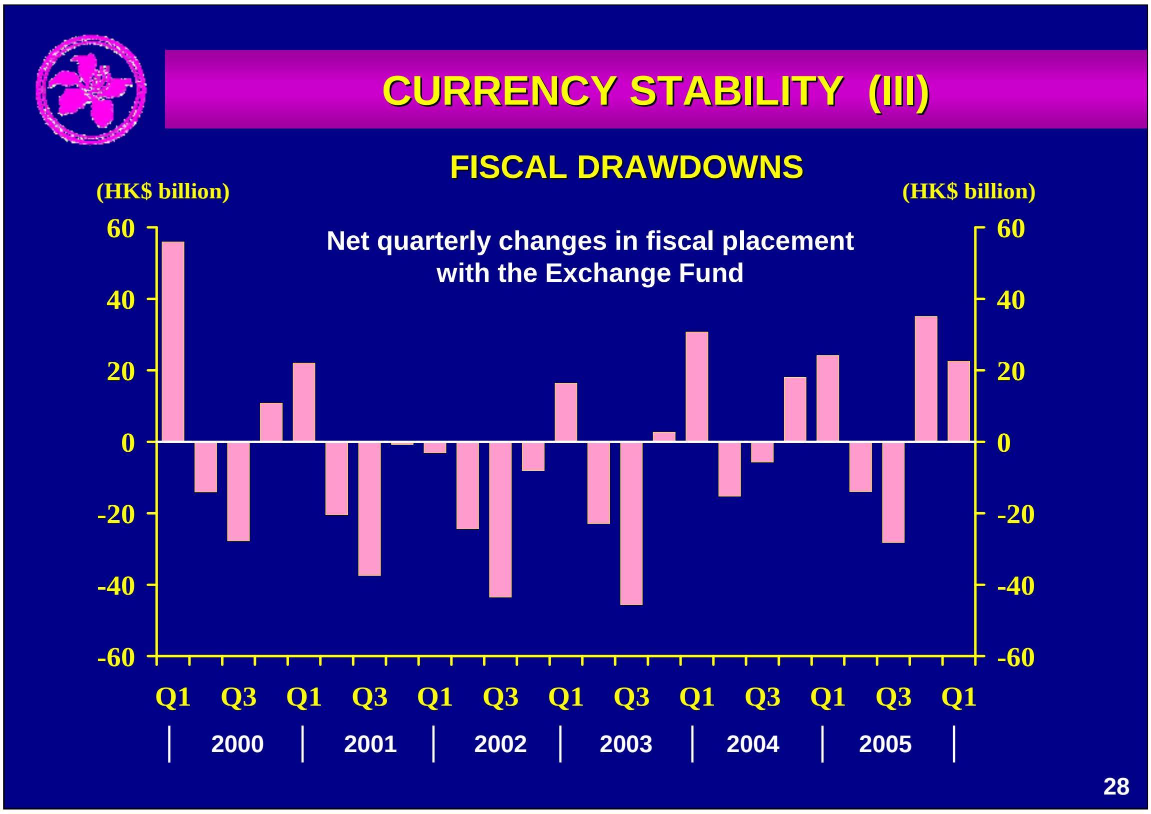
- By February 2006, residential property prices have increased on average by 53% from the trough in the summer of 2003. Prices have increased more sharply at the high-end of the market, with prices of large flats (saleable area of 160 sq m or above) rising by 91% during the same period.

- Prices of commercial premises also increased markedly in the past two years, with those of offices and retail shops rising by 118% and 86% respectively from their lowest levels in mid-2003.



- This graphical analysis summarises the evolution of six key property market indicators: real property prices, property transaction volumes, confirmor transactions, 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). (1997 Q2-3 is treated as the base period.)

- By February 2006, the size of the hexagon remained smaller than that for April-September 1997, although the income-gearing ratio and the buy-rent gap have increased markedly from the trough in 2003, due to higher property prices and mortgage interest rates. The prices of large flats have increased more sharply than indicated by the overall price index.

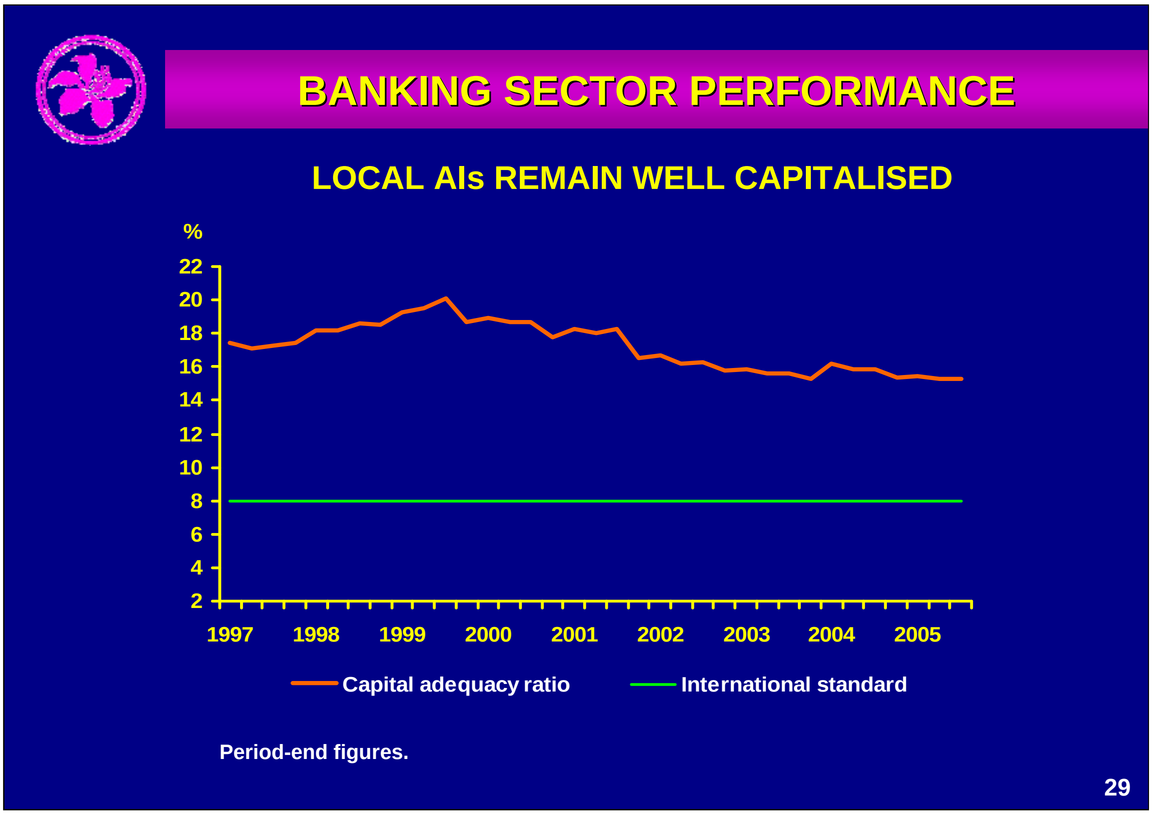


- Reflecting seasonal factors, net placements with the Exchange Fund are usually in surplus in Q4 and Q1, followed by net draw-downs in Q2 and Q3. Latest figures show that net placements with the Exchange Fund returned to surpluses in 2005 Q4 and 2006 Q1.

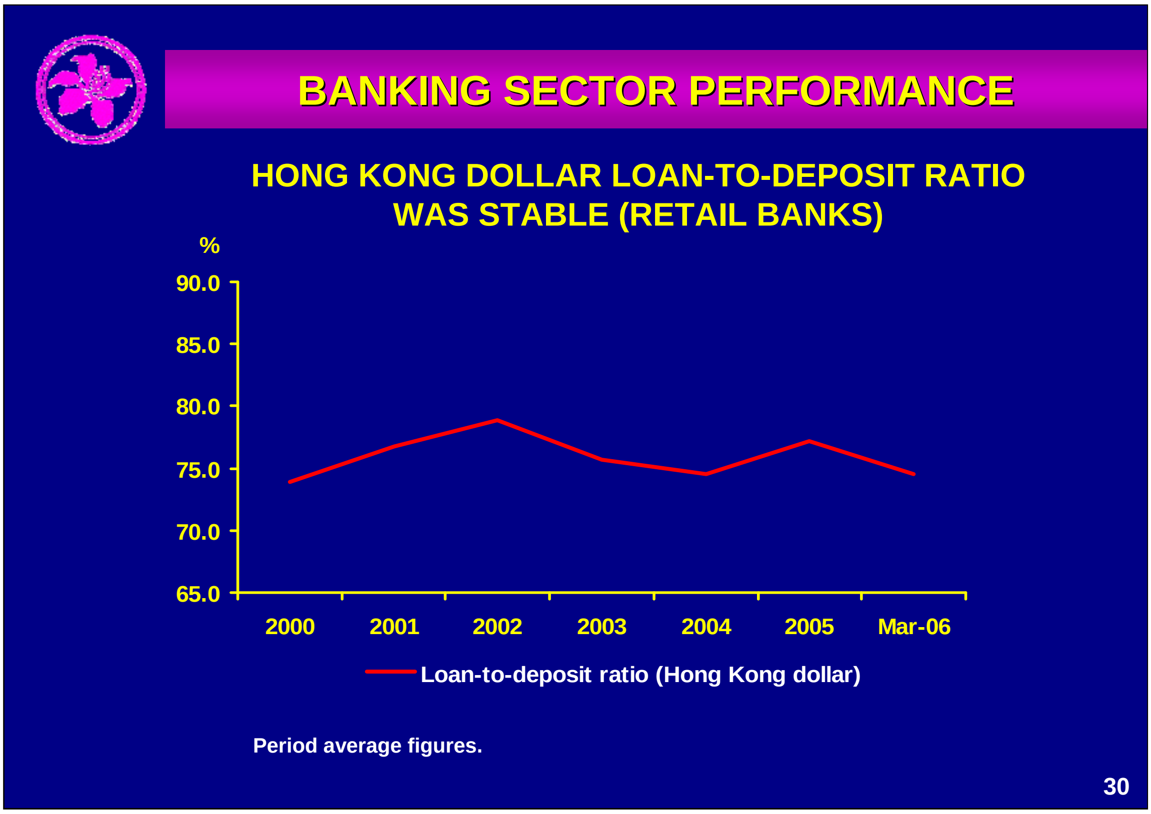
- The draw-downs in 2005 Q2 and 2005 Q3 were largely seasonal. The draw-down in 2005 Q3 was larger than a year ago because the 2004 figure was distorted by bond issuance by the Government.

Net Quarterly Change in Fiscal Placement with the Exchange Fund
(HK$ 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	-13.9	-28.2	35.0
2006	22.6			

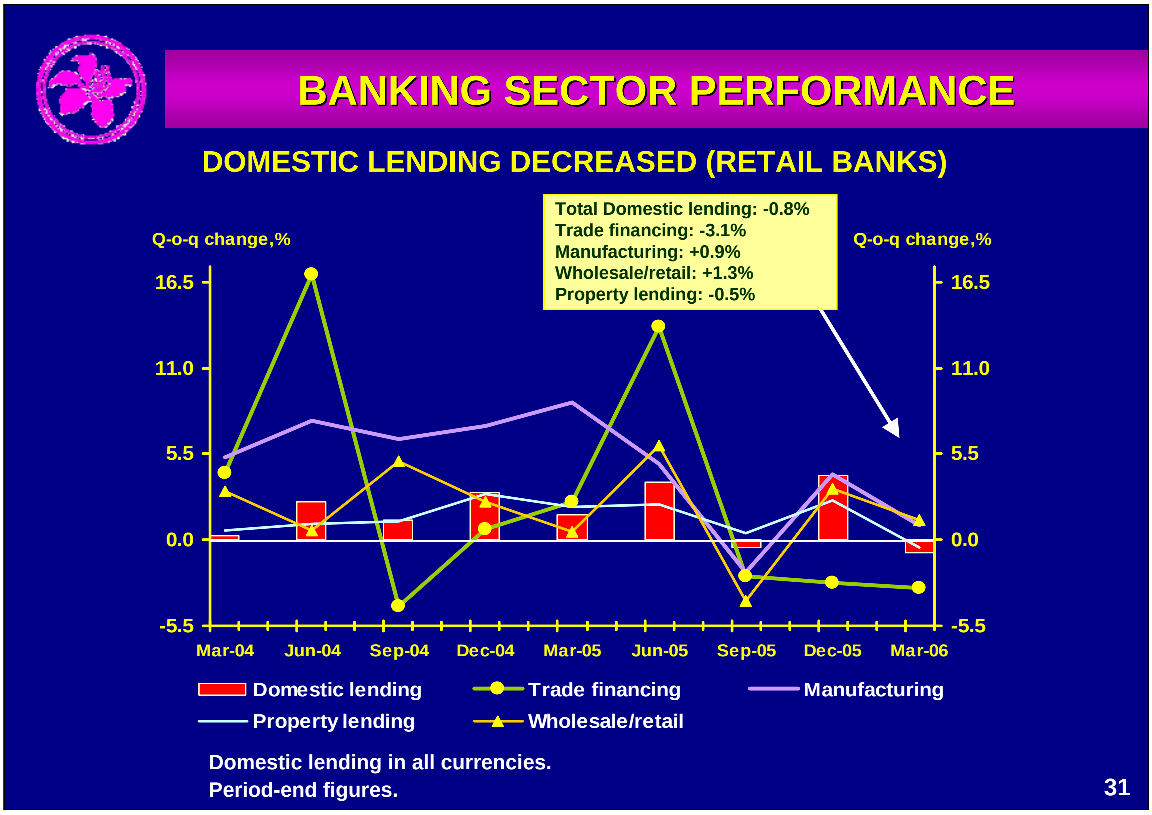


- The banking sector remained well-capitalised. At the end of December 2005, the average consolidated capital adequacy ratio of all locally incorporated authorized institutions was about 15%, well above the statutory requirement and international standard (8%).

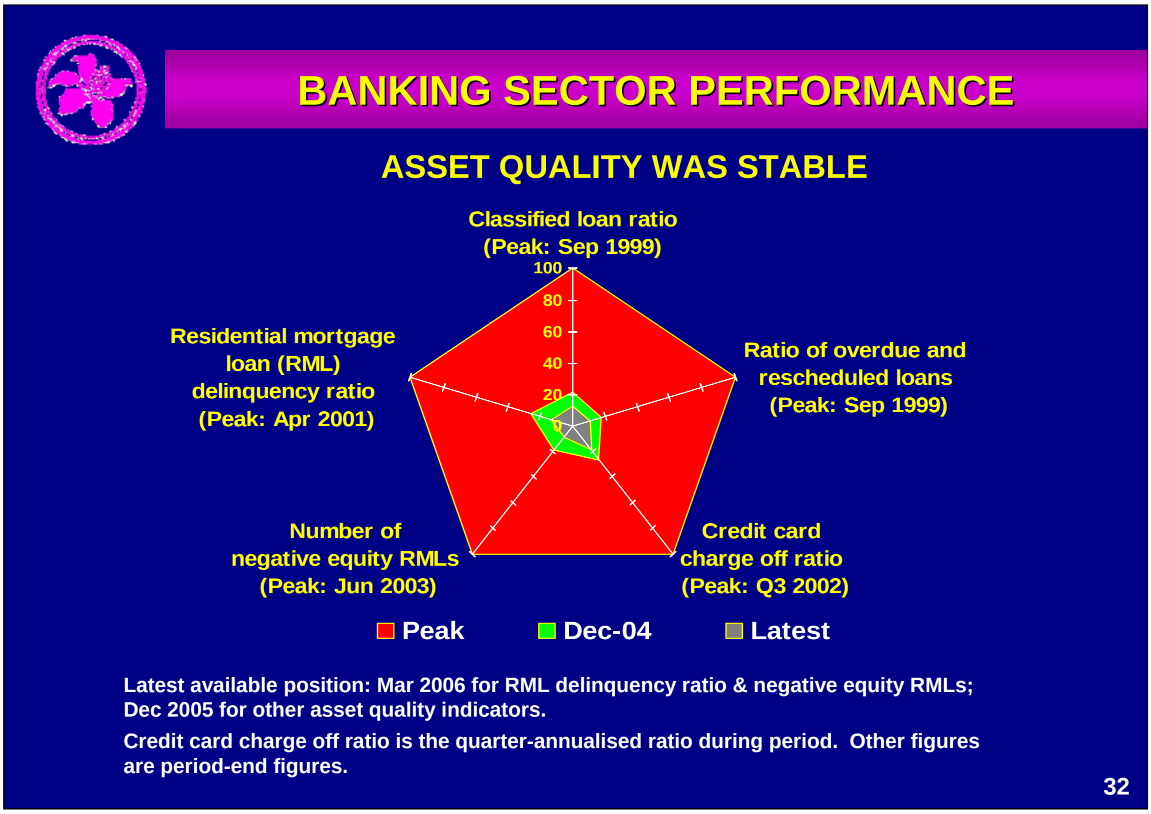


- The loan-to-deposit ratio of retail banks has remained stable in recent years, moving within the range of 75% to 80%, reflecting ample liquidity in the banking sector.

- The ratio for 2006 Q1 is 75%, compared with 77% in 2005. The decrease reflects the dampening effect of the rising interest rates on loan demand and the faster growth in customer deposits.



- Total domestic lending declined by 0.8% in 2006 Q1.
- The decline in trade financing and property lending was more than offset the slight increase in loans for the manufacturing, wholesale and retail sectors. The decrease in credit demand was partly due to increasing borrowing cost.
- 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.

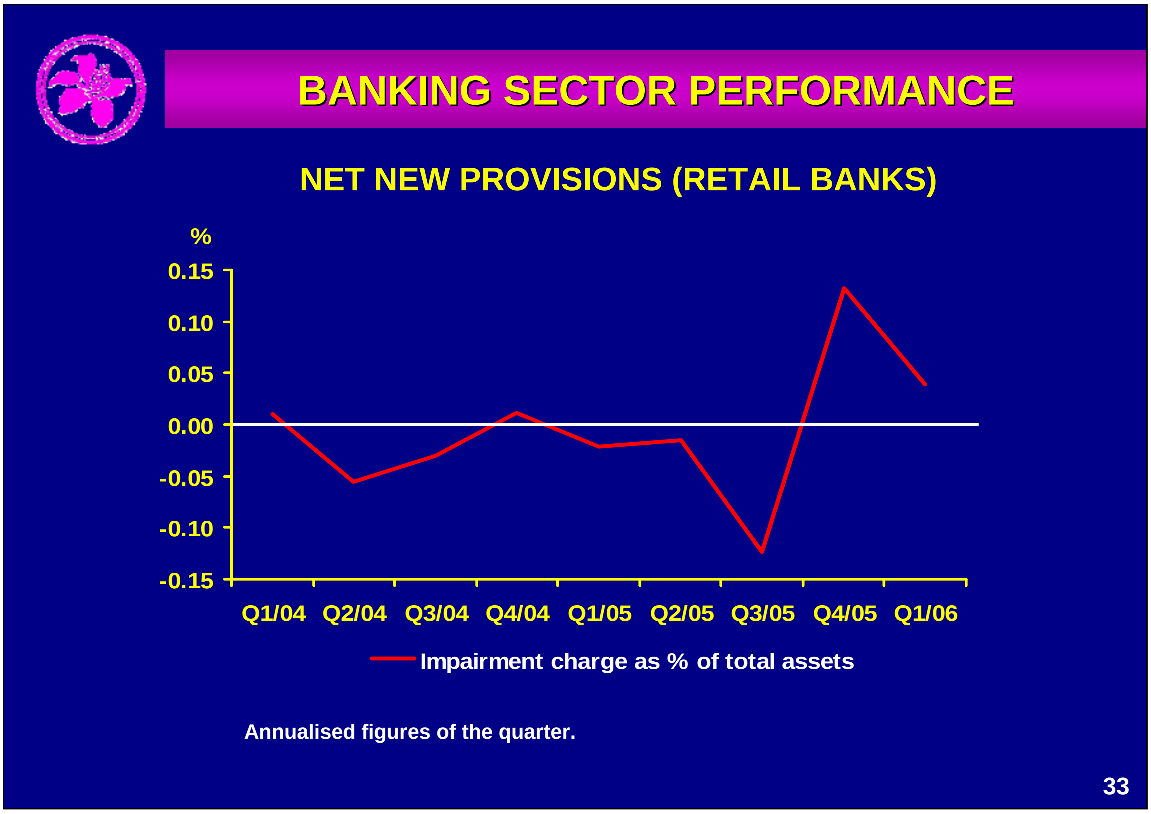


- The latest position of all five asset quality indicators is about 15% of their worst positions in recent years.

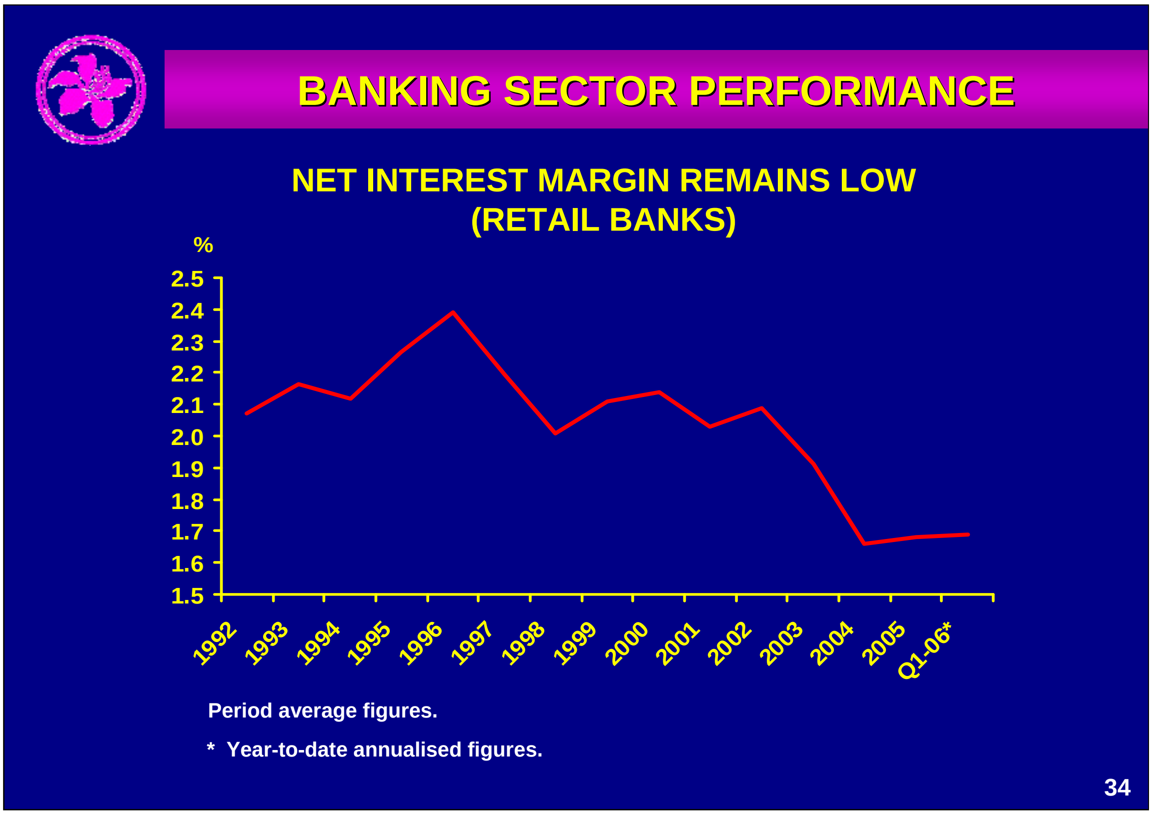
- The quality of residential mortgages was stable. At the end of March 2006, the mortgage delinquency ratio was 0.19%, unchanged from the position at the end of December 2005. The rescheduled mortgage ratio fell to 0.34% from 0.35% at end 2005.

- The delinquency ratio of credit cards improved from 0.39% at the end of 2005 Q3 to 0.37% at the end of 2005 Q4. The annualised charge-off ratio improved to 2.72% in 2005 Q4 from 2.95% a quarter earlier.

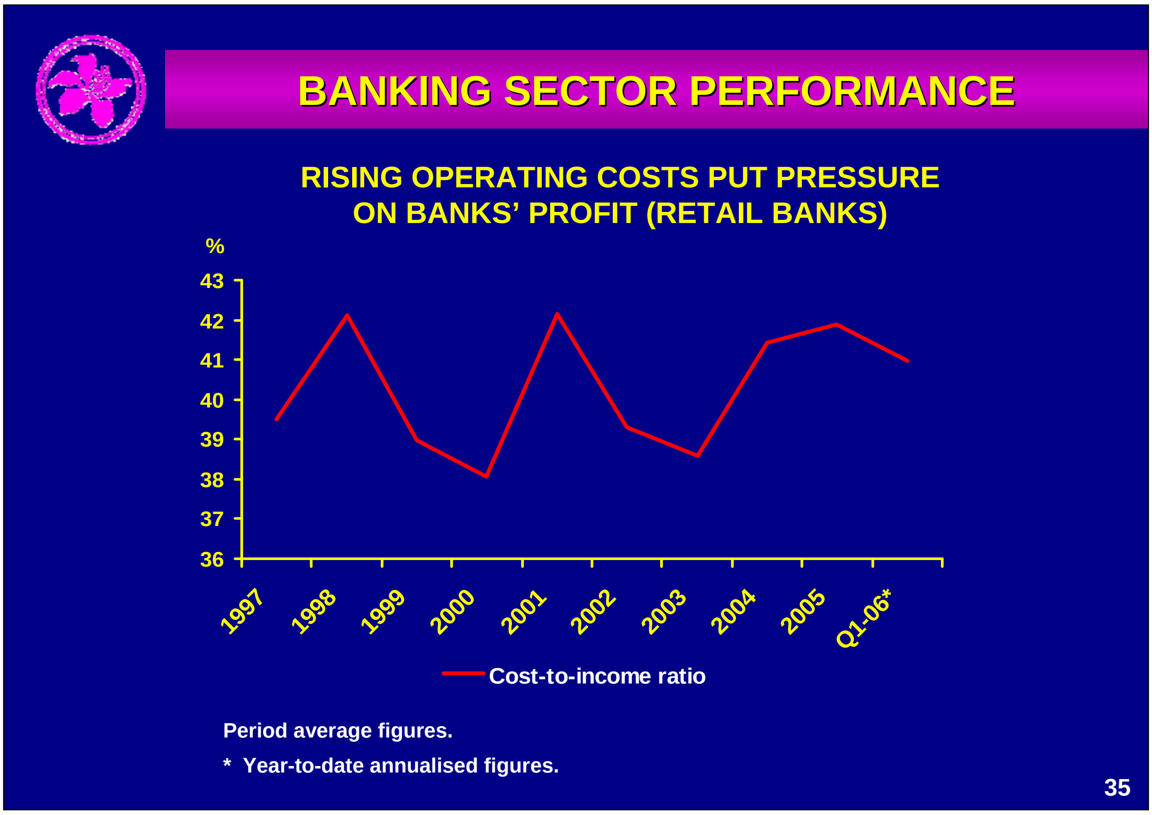
- Despite the improvement in loan performance indicators, there are early warning signals of deterioration in loan quality. Half of the retail banks recorded more “special mention” loans in 2005 Q4 compared with a quarter earlier. Consumer loans also demonstrated early signs of deterioration in quality with the absolute values of credit card charge-offs and delinquencies at the end of 2005 Q4 moving up compared with a quarter earlier. This trend was masked in the performance indicators for credit cards as outstanding receivables grew by almost 15% over the quarter.



- After recording net provision write-backs in 2004 and in most of 2005, banks have recently begun to make new provisions, indicated by the increase in the ratio of impairment charge to total assets from -0.12% in 2005 Q3 (indicating a net write back) to 0.13% in 2005 Q4 (indicating net new provisions). Further provisions have been made in 2006 Q1 but the amount reduced to 0.04% of total assets. The need to make new provisions will affect banks' profits, and it reflects the decline in asset quality.

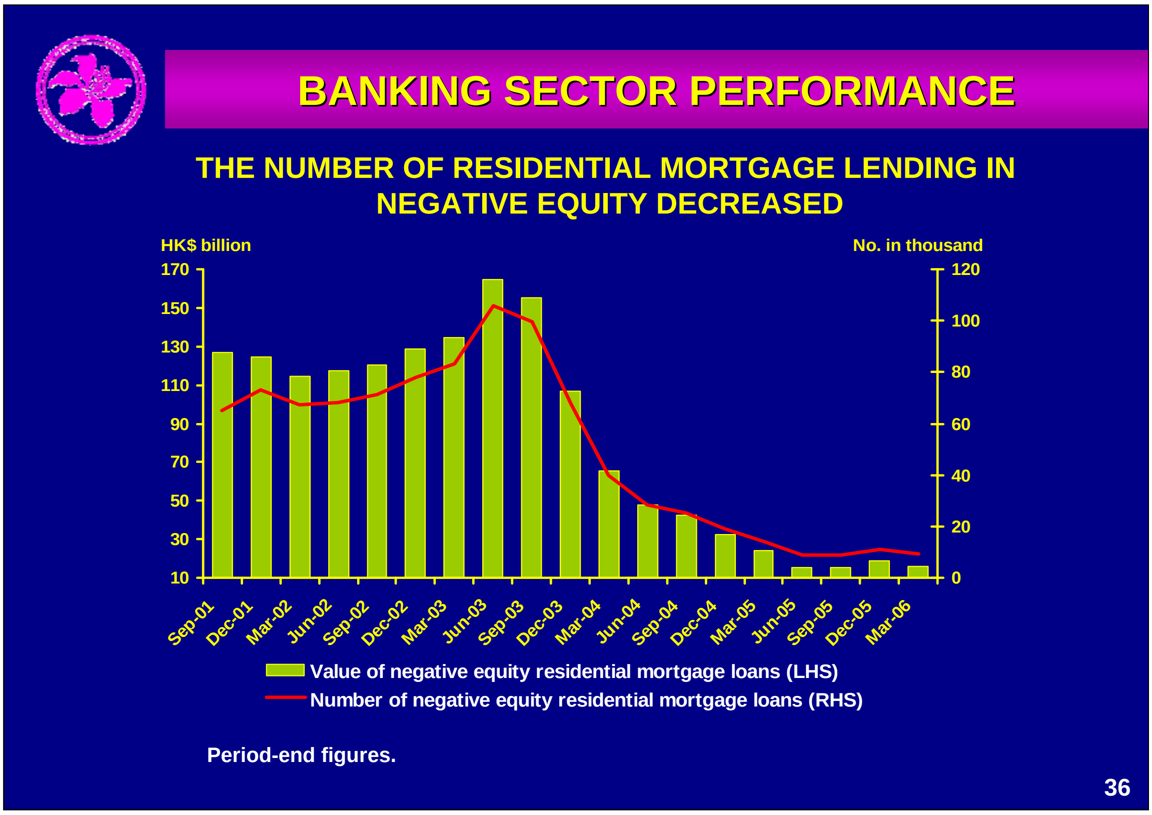


- The annualised net interest margin of retail banks edged up slightly to 1.69% in 2006 Q1 from the full year average of 1.68% in 2005, but remained low by historical standards. Low net interest margin reflects increased funding cost and the narrowed loan spread in a highly competitive environment.



- Cost-to-income ratio decreased from 41.9% in 2005 to 39.8% in 2006 Q1. The decrease is a combined result of the increased revenue in 2006 Q1 and cost containment efforts of banks. Despite the slight decline in the ratio, rising operating costs, particularly in staff expenses, rental expenses and IT development costs, continue to put pressure on banks' profits.

- In response to rising cost pressures, some banks have begun to explore the possibility of relocating more of their support operations to lower-cost centres, such as those on the Mainland.



- After rising for two consecutive quarters, the number of residential mortgages in negative equity decreased to around 9,200 cases with an aggregate value of $16 billion at the end of March 2006, compared with 11,000 cases ($19 billion) a quarter earlier. The decline reflects the recent upward adjustment of property prices. Compared with the peak of around 106,000 cases ($165 billion) in June 2003, the number has declined by around 91%.

BANKING SECTOR PERFORMANCE

Impact of higher interest rates:

- **Net interest margin narrowed**
- **Loan impairment charges increased**
- **Operating costs rose**
- **Loan growth slowed**
- **Early signs of deterioration in loan quality**
- **No. of negative-equity mortgages is sensitive to property price movement**

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- The operating environment of the banking sector is more difficult in 2006 than in the past few years, partly because of rising interest rates.

- High interest rates increase borrowing costs and dampen credit demand.

- While the net interest margin is expected to remain low due to stiff competition, loan impairment allowance is likely to move up further in light of early signs of deterioration in credit quality.

- In a mild inflationary environment, operating costs are on an upward trend. Staff expenses and IT costs for business development are expected to rise.

- The number of residential mortgages in negative equity remains sensitive to property price movements. The problem of negative equity mortgages will deteriorate if property prices decline.

- Small banks that rely on interbank funding and have high operating costs are more affected than large banks that are able to attract low-cost retail deposits and enjoy economies of scale.

- The impact of interest rate rises is expected to extend into the second half of the year in view of the uncertain interest rate outlook. This makes good management of interest rate and market risks very important for banks.

BANKING SECTOR DEVELOPMENT

New Composite Interest Rate mortgage products

- Major retail banks teamed up with the Hong Kong Mortgage Corporation Limited and property developers to offer mortgages with reference to the Composite Interest Rate
- More choice for borrowers and strengthening of banks' interest risk management
- HKMA will continue to publish the Composite Interest Rate monthly

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- Residential mortgages based on the Composite Interest Rate (C) have started to appear in the market. Major retail banks teamed up with the HKMC or mortgage agencies and property developers to offer mortgages with reference to Composite Interest Rate.

- So far, C-based loans are second mortgages, but some banks are exploring the possibility of using it for first mortgages.

- The introduction of C-based mortgages benefits both borrowers and lenders. It offers more choices for borrowers and at the same time help banks to better manage their interest rate risk.

BANKING SECTOR - WORK PROGRESS

Implementation of Basel II

- **Preparations for implementation in January 2007 progressing well**
- **Development of implementation proposals complete**
- **Development of Capital & Disclosure Rules in progress**
- **Detailed brief on the development of the Rules will follow**

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- The Basel II framework will take effect from January 2007 as scheduled. Preparatory work for the implementation is going well.

- With the release of the last batch of implementation proposals in April, the policy setting stage is complete.

- Preliminary consultation on the draft Capital and Disclosure Rules is in progress. The whole set of Rules will be issued for statutory consultation in July before they are introduced to LegCo in October for negative vetting. The Rules are intended to take effect on 1 January 2007.

- My colleagues responsible for banking supervision will give a presentation on the development of Rules in greater details to panel members later in today's session.

BANKING SECTOR - WORK PROGRESS

Anti-money Laundering (AML) and Counter Terrorist Financing (CFT)

- **Analysis of AIs' self-assessment reports completed, with general findings issued to industry**
- **A specialised team started in-depth AML/CFT on-site examinations in early 2006. An AML consultant recently recruited to advise on further enhancement of supervisory framework and examination approach**
- **Establishment of industry user groups (to share AML/CFT experiences/ techniques, identify implementation issues and devise industry best practices) is underway**

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AML self-assessment

- A summary report on the self-assessment exercise has been issued to the banking sector on 15 March. The self-assessment results showed a high level of compliance within the banking sector. The HKMA will continue to work with the banking sector on those common compliance issues identified with a higher priority of concern and to consider areas for refinement of AML/CFT guidelines.

On-site examination programme

- The HKMA deployed a specialised team to conduct in-depth AML/CFT examinations and carry out benchmarking examinations on selected high-risk areas starting from January 2006. An AML consultant with relevant expertise has also been recruited to train and lead the specialised examination team and to give policy advice on how to further enhance the AML/CFT supervisory framework of the HKMA.

Industry user groups

- The HKMA is working with the industry associations on the proposals for setting up industry user groups on selected AML issues. These user groups are expected to provide a forum for AIs to share their AML experiences and techniques with a view to enhancing awareness, identifying implementation issues and coming up with industry guidance and best practices.

BANKING SECTOR - DEPOSIT PROTECTION SCHEME

- **Continue to assist the Hong Kong Deposit Protection Board in preparing for the launch of the DPS**
- **Progress of key preparatory tasks**
  - **Completed drafting the subsidiary legislation governing the operation of the DPS**
  - **Amending Schedules 1 and 4 of the DPS Ordinance to clarify the protection status of structured products**
  - **Tested the payout system for assessing and paying compensation to depositors**
  - **Working on the publicity campaign for the launch of the DPS**

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- The HKMA continues to assist the Hong Kong Deposit Protection Board in preparing for the launch of the DPS.

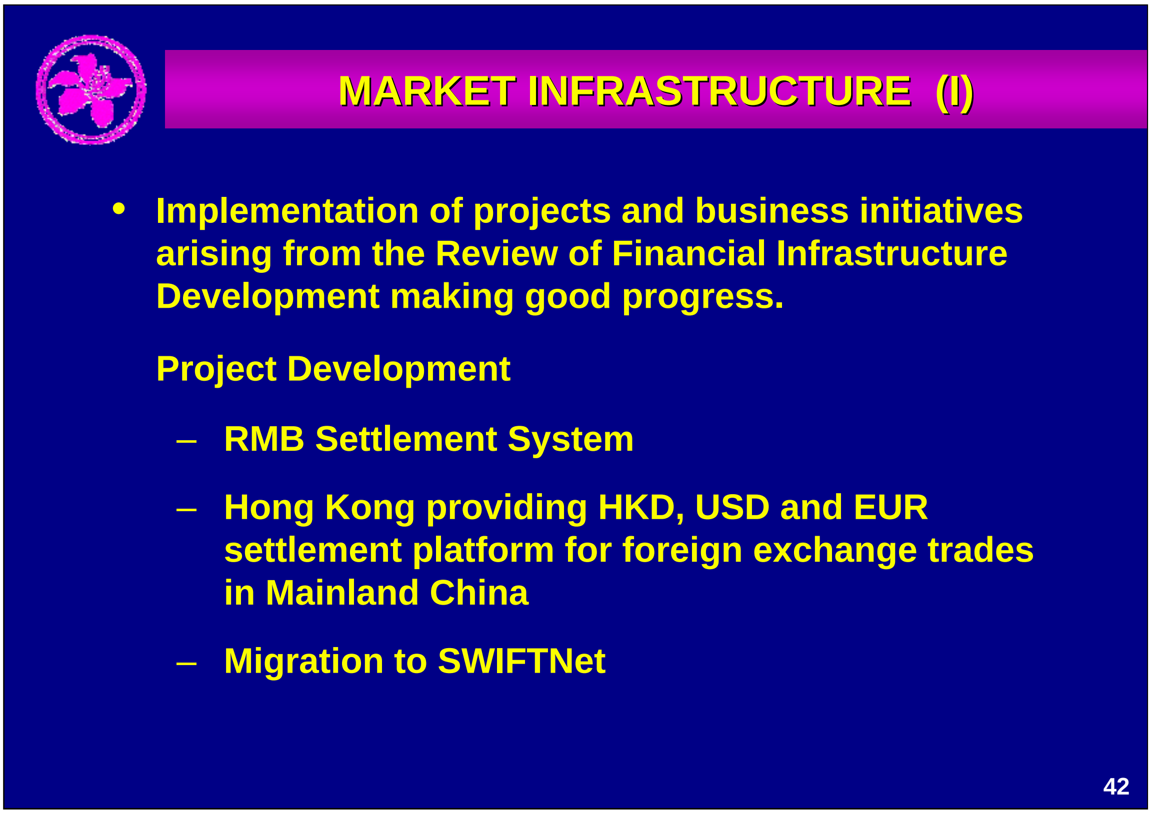
- Good progress has been made since the last briefing to the Panel in February. Specifically: -

  (i) drafting of the subsidiary legislation governing the operation of the DPS has been completed and the subsidiary legislation will be tabled before LegCo for negative vetting very shortly;

  (ii) schedules 1 and 4 of the DPS Ordinance will be amended to clarify the protection status of structured products and the Amendment Notice will be tabled before LegCo for negative vetting;

  (iii) user acceptance test of the payout system for assessing and paying compensation to depositors has been completed; and

  (iv) currently working on a publicity campaign for launching the Scheme in the second half of 2006.

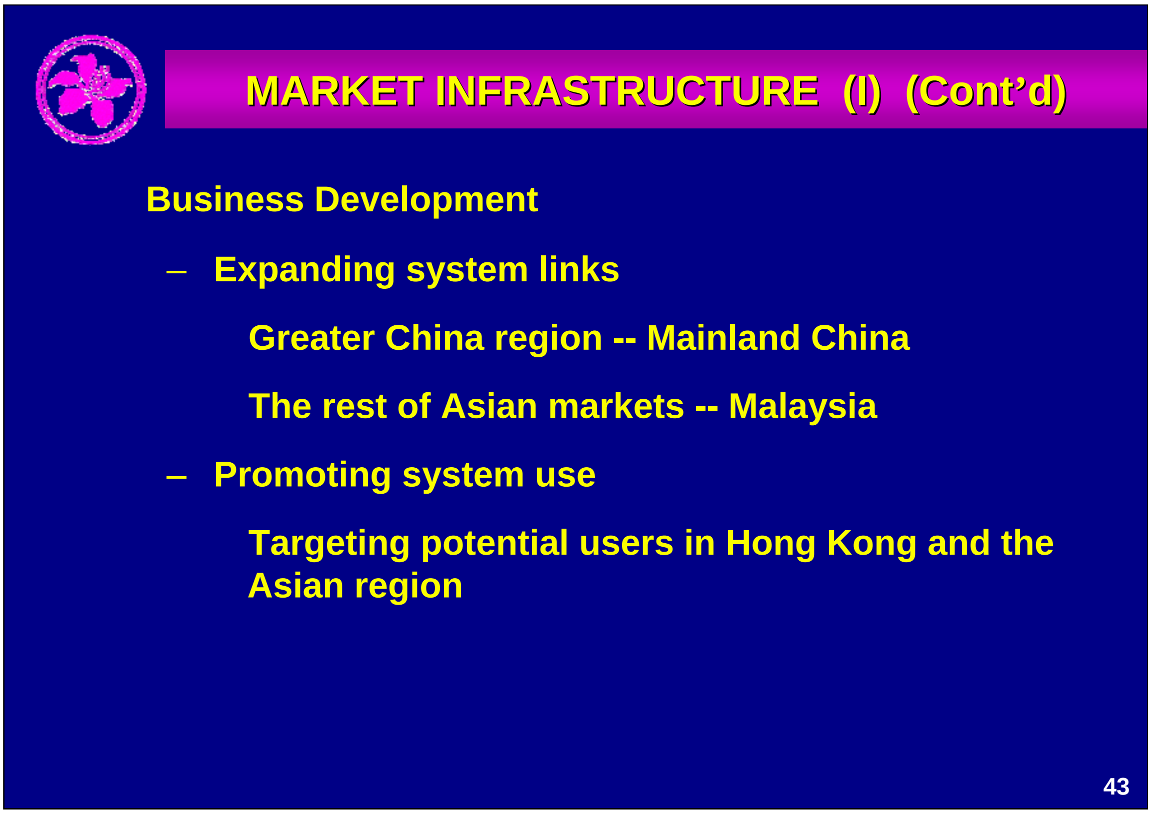


- Implementation of projects and business initiatives arising from the Review of Financial Infrastructure Development conducted last year is making good progress. Project development:

  - RMB Settlement System – launched on 6 March 2006, to cater for the operations of the expanded renminbi business and the new renminbi cheque business announced in Oct 05. Its key functions include a clearing and settlement system for renminbi cheques drawn on banks in HK for consumer spending in Guangdong, an automated system for remittance processing, renminbi bank card payments and renminbi position-squaring and a real-time enquiry service for participants of the system. This provides a safe and efficient platform to support further expansion of renminbi business in Hong Kong.

  - Hong Kong providing HKD, USD and EUR settlement platform for FX trades in Mainland China – made marketing efforts to capture the settlement of the foreign currency leg of FX transactions on the mainland, immediately following their announcement of market reform to allow over-the-counter trade. A user group was formed for the correspondent banks of Mainland's market-makers in HK. In view of potential growth of system usage due to these Mainland-related FX transactions, system enhancements (e.g. liquidity optimiser) will be introduced in our Real Time Gross Settlement (RTGS) systems in April 2006 to facilitate banks' liquidity management.

  - Migration to SWIFTNet – to replace the existing proprietary platform for the RTGS systems and the Central Moneymarkets Unit by an open platform to improve their compatibility with overseas clearing and settlement systems. Proposals from prospective vendors are being reviewed. If project approval is obtained by mid-2006, the migration is expected to take place by 2008 Q1.



- Business development:
  - Expanding system links – to develop HK into a payment and clearing hub for the region, we have been actively exploring opportunities to establish international links for our RTGS systems and the CMU, focusing on the greater China region, followed by the rest of Asian markets.
  - Promoting system use – to promote the use of Hong Kong's foreign currency payment systems and cross-border payment links with Mainland China and CMU services.

MARKET INFRASTRUCTURE (II)

- **Oversight of the clearing and settlement systems**
  - **All local designated systems remain in compliance with the safety and efficiency requirements of the Clearing and Settlement Systems Ordinance**
  - **The Process Review Committee submitted its first annual report to FS. The report concluded that HKMA had followed duly the procedures and was procedurally fair in carrying out its oversight activities across different designated systems**

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- The HKMA exercises on-going oversight on the four local designated systems through off-site reviews and continuous monitoring. All systems are in compliance with safety and efficiency requirements under the Clearing and Settlement Systems Ordinance (SSO).

- An independent Process Review Committee was established in December 2004 to review processes and procedures adopted by the HKMA in applying the standards set under the CSSO to designated systems in which the HKMA has a legal or beneficial interest. The Committee submitted its first Annual Report to the FS. In the report, the Committee concluded that it was not aware of cases where the HKMA had not followed duly the procedures, or had not been procedurally fair in carrying out its oversight activities across different designated systems. The annual report was published on the HKMA's website.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE (I)

5-Pronged Strategy to maintain Hong Kong as an IFC

- Enhance access for Hong Kong financial institutions on the Mainland
- Enhance the mobility of fund raisers, investors and investment funds from the Mainland to Hong Kong
- Enhance the mobility of financial instruments to the Mainland from Hong Kong
- Enhance the capability of Hong Kong’s financial system to handle transactions denominated in renminbi
- Strengthen financial-infrastructure links between the Mainland and Hong Kong

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HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE (II)

Renminbi business in Hong Kong

- Outstanding renminbi deposits: RMB 22.5 billion yuan at the end of March 2006
- With the Renminbi Settlement System in operation from 6 March 2006, Hong Kong individuals can use renminbi cheques for consumer spending in Guangdong province
- Continuing discussions with Mainland authorities on proposals for using renminbi to settle cross-border trade and issuing renminbi bonds in Hong Kong

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- At the end of March 2006, 39 banks were engaging in renminbi business in Hong Kong and the total outstanding renminbi deposits reached RMB 22.5 billion yuan. The cumulative value of transactions by Mainland visitors using renminbi cards to spend and make cash withdrawals in Hong Kong since the start of renminbi card business was over HK$12 billion. Debit- and credit-card spending by Mainland tourists was about HK$2,800 per transaction on average.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE (III)

Asian Bond Fund 2 (ABF2)

- **11 EMEAP central banks and monetary authorities, including the HKMA, have invested a total of US$2 billion in ABF2.**
- **ABF2 consists of the ABF Pan Asia Bond Index Fund (PAIF) and 8 Single-market Funds. So far, the PAIF and 5 Single-market Funds in Hong Kong, Malaysia, Singapore, Philippines and Thailand have been launched. The other ABF2 Funds will be launched by mid-2006.**
- **The ABF Hong Kong Bond Index Fund and the PAIF were listed in Hong Kong in June and July 2005 respectively, with asset size having grown by 50% and 17% since launch.**

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- Key market data for ABF HK Bond Index Fund and PAIF:

(As of 18 April 2006)	**HK Fund**	**PAIF**
Fund size	HK$2.12 bn (US$274 mn)	US$1.16 bn
Growth of fund size since inception	+50%	+17%
Average daily turnover since inception	HK$3.7 mn (US$0.48 mn)	US$0.10 mn

MANAGEMENT OF THE EXCHANGE FUND

- Article 113 of the Basic Law:

"The Exchange Fund of the Hong Kong Special Administrative Region shall be managed and controlled by the government of the Region, primarily for regulating the exchange value of the Hong Kong dollar. "

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MANAGEMENT OF THE EXCHANGE FUND

- Exchange Fund Ordinance (Cap. 66):

“shall be used primarily for … affecting, either directly or indirectly the exchange value of the currency of Hong Kong and for other purposes incidental thereto”

“with a view to maintaining Hong Kong as an international financial centre … maintain the stability and integrity of the monetary and financial systems of Hong Kong”

MANAGEMENT OF THE EXCHANGE FUND

• **Controller:**	**Financial Secretary**
• **Consultation:**	**Exchange Fund Advisory Committee (ex-officio chairman: Financial Secretary)**
• **Execution:**	**HKMA**

MANAGEMENT OF THE EXCHANGE FUND

- The Exchange Fund is unlike ordinary investment funds
- The priority is to fulfil the statutory objectives of the Exchange Fund
- A fine balance between liquidity, risks and return

MANAGEMENT OF THE EXCHANGE FUND

Investment objectives:

- Preservation of capital
- Backing for the Monetary Base
- Providing liquidity to maintain monetary and financial stability
- Preservation of long-term purchasing power

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MANAGEMENT OF THE EXCHANGE FUND

Benchmark portfolio:

• Asset mix	Bonds	77%
	Equities	23%
• Currency mix	US dollar	88%
	Non-US dollar	12%

Risk Management: a number of limitations (credit, concentration, liquidity and other risks)

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MANAGEMENT OF THE EXCHANGE FUND

Evaluation of investment performance

	Return on benchmark portfolios (%)	Actual return (%)	Exceeds benchmark	
			Value HK$ bn	%
1999	5.5	10.8	50.7	5.3
2000	3.8	4.8	9.6	1.0
2001	0.4	0.7	2.9	0.3
2002	3.9	5.1	11.2	1.2
2003	9.5	10.2	6.6	0.7
2004	5.7	5.7	0	0.0
2005	2.9	3.1	2.1	0.2
Average for 7 years	4.5 #	5.7 #	11.9	1.2

Compounded growth rate

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MANAGEMENT OF THE EXCHANGE FUND

Misconception about investment performance	Response
US Treasury bond yield in 2005 was about 4.5%	• Changes in market prices not reflected • Calculated in market prices: investment return of a portfolio comprising 1 to10-year US Treasury bonds in 2005: 1.6% investment return of 10-year US Treasury bonds in 2005: 2.9% • Average return for the Exchange Fund from 1999 to 2005: 5.7%

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MANAGEMENT OF THE EXCHANGE FUND

Misconception about investment performance	Response
Large Hong Kong dollar fixed deposit rates currently about 4%	• Liquidity and credit risks not considered; concentration risk also needs to be managed • Large-amount Hong Kong dollar fixed deposit rates in 2005 averaged about – One-month fixed deposits: 1.47% – Three-month fixed deposits: 1.60% • Before introducing the three refinements in May 2005, Hong Kong dollar deposit rates were close to 0%

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MANAGEMENT OF THE EXCHANGE FUND

Misconception about investment performance	Response
Return on other investment funds in 2005 exceeded 3.1%	• The Exchange Fund is unlike ordinary investment funds • Return on the Exchange Fund often exceeded that of other funds in previous years • The Exchange Fund has never suffered a loss while this is often the case with other funds

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MANAGEMENT OF THE EXCHANGE FUND

Misconception about investment performance	Response
Return for fiscal reserves fails to meet budget estimates	• The estimated return for fiscal reserves is not the right tool for evaluating the Exchange Fund's investment return • Estimates are just broad projections and have not taken into consideration short-term market fluctuations • Other options available for increasing the accuracy of estimates, e.g. charge an annual fixed fee on the Exchange Fund or use an average of the actual returns over a number of years

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MANAGEMENT OF THE EXCHANGE FUND

Misconception about investment performance	Response
Pay for HKMA staff should be linked with investment performance of the Exchange Fund	• The number of employees engaged in investment management of the Exchange Fund accounts for less than 10% of HKMA staff • Investment performance should be judged against return on benchmark portfolios

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MANAGEMENT OF THE EXCHANGE FUND

More aggressive benchmark portfolios

- Cost: higher risks, lower liquidity
- Prerequisites: enough foreign reserves to meet the statutory objectives of the Exchange Fund
- Concensus to be reached on how much is enough

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EXCHANGE FUND PERFORMANCE

(HK$ billion)	2006[2] Q1	2005[1] Full Year	2004[1] Full Year	2003[1] Full Year
Gain / (Loss) on HK equities*	6.7	7.0	12.0	21.2
Gain / (Loss) on other equities*	7.7	20.5	11.2	26.8
Exchange gain / (loss)	3.7	(19.5)	8.5	22.9
Total return from bonds, etc	0.1	29.8	25.0	18.8
Investment income	18.2	37.8	56.7	89.7

* including dividends

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

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- Year-to-date investment income at the end of March 2006 registered a gain of HK$18.2 billion, mainly because of the better performance of global equities market and the marginally weaker US dollar.

- But bond prices decreased due to higher interest rates, offsetting the bulk of interest income from bonds, as the bonds are marked to market.

CHANGE IN ACCUMULATED SURPLUS

(HK$ billion)	2006 Q1	2005 Full Year*	2005 Q4	2005 Q3	2005 Q2	2005 Q1
Investment income / (loss)	18.2	37.8	7.3	19.0	13.6	(2.1)
Other income	0.0	0.2	0.1	0.0	0.1	0.0
Interest and other cost	(2.2)	(7.6)	(2.3)	(2.2)	(1.8)	(1.3)
Net investment income / (loss)	16.0	30.4	5.1	16.8	11.9	(3.4)
Treasury's share	(5.3)	(10.1)	(2.4)	(4.9)	(3.5)	0.7
Carry to accumulated surplus	10.7	20.3	2.7	11.9	8.4	(2.7)
Adjustment to accumulated surplus, effect of implementation of HKAS 39 (1)	0.0	(0.6)	0.0	0.0	0.0	(0.6)
Increase / (Decrease) in EF accumulated surplus	10.7	19.7	2.7	11.9	8.4	(3.3)

Note 1: The effect of changing from using mid-price to using bid-price for valuing securities held, and using ask-price for valuing securities issued.

* *Audited figures*

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- The investment objective of the Exchange Fund is to preserve capital, provide liquidity and full backing of the Hong Kong-dollar Monetary Base, and maintain the long-term purchasing power of the Fund. Given these objectives, it is not appropriate to compare the investment return of the Exchange Fund with that of the typical investment funds. While the Exchange Fund would try to provide a decent return for the HKSARG, meeting the nominal target as set out in FS's budget plan might not always be achievable given the unpredictable nature of the investment environment.

YEARLY TREASURY SHARE OF THE EXCHANGE FUND INVESTMENT INCOME VS. TREASURY INCOME PROJECTION

Year	Actual Treasury Share (note 1)	Treasury Income Forecast (note 2 & 3)
2006	N/A	18.2
2005	10.1	14.1
2004	14.5	12.3
2003	25.7	12.1
2002	15.6	13.8
2001	1.6	12.5
2000	18.1	31.6
1999	45.4	22.2
1998	26.0	26.7

Note 1: Based on HKMA's fiscal year from January to December in each calendar year
Note 2: Based on HK Government's fiscal year from April to March of the following year
Note 3: The figures have been published since 2002. Figures before then are HKMA estimates

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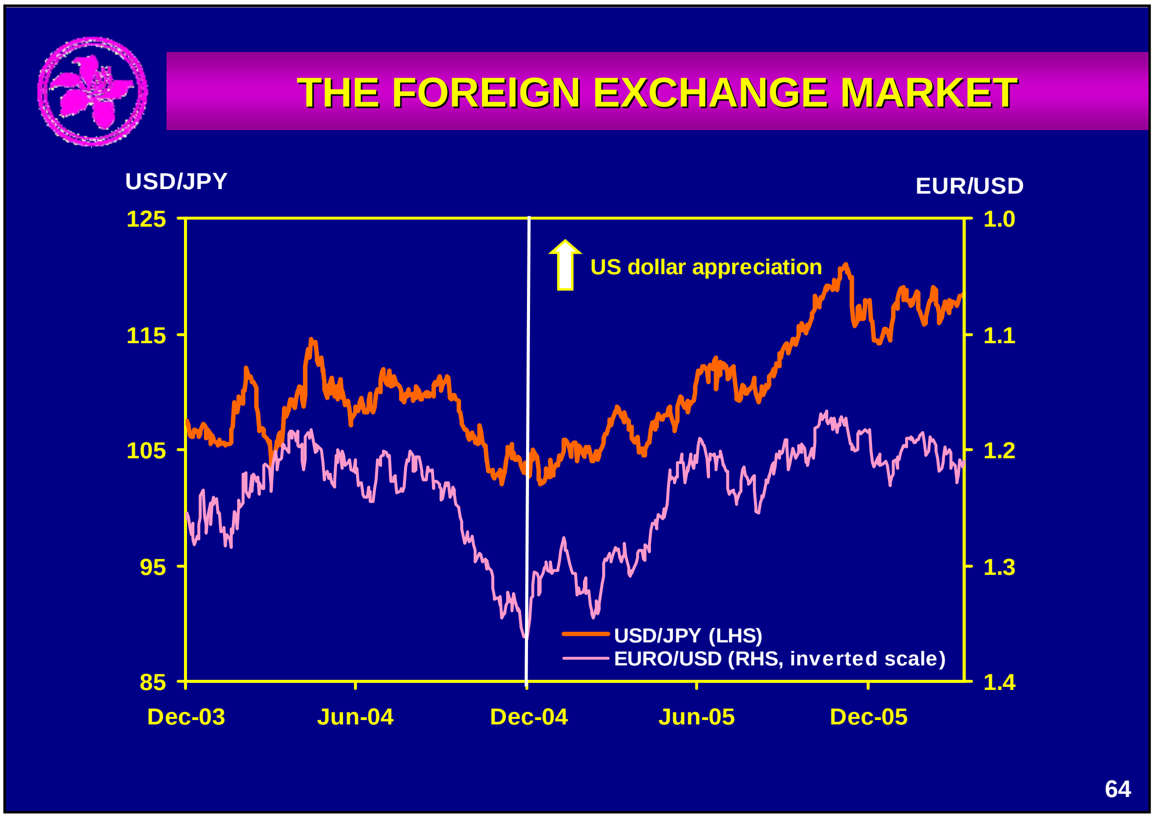
- Historical data shows that the Treasury's share of the Exchange Fund investment income fluctuated from year to year, ranging from a low of HK$1.6 billion in 2001 to a high of HK$45.4 billion in 1999, largely depending on the investment environment.

- On average, the Treasury's share of investment income exceeded the forecast by HK$1.5 billion per year over the past 8 years.

- The sharing arrangement exposes the fiscal reserves to investment returns that are considerably volatile, rendering the budget estimate often inaccurate and actual outturn unpredictable.

- Shortfalls in investment return against budget (in 4 out of 8 years from 1998 to 2005) are regrettably interpreted as under-performance by the HKMA in the investment management of the Exchange Fund.

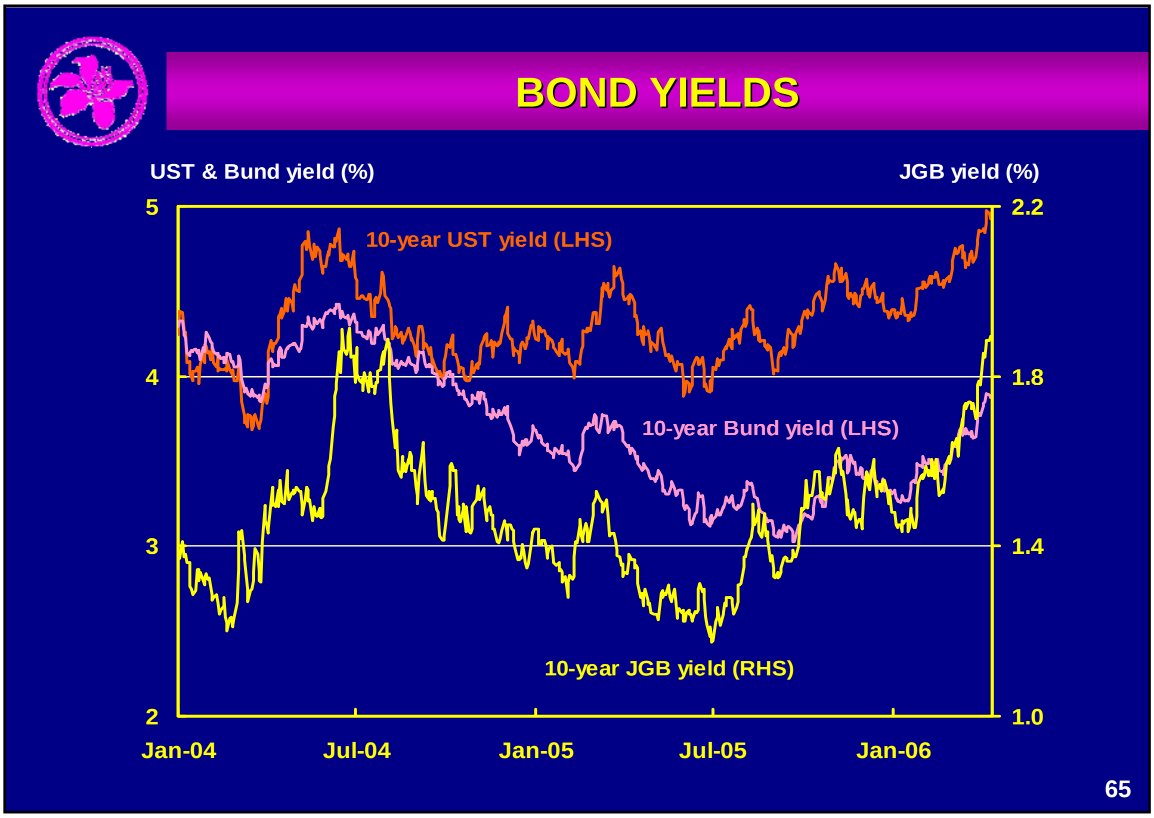
- Investment performance is measured objectively by comparing actual rate of return with the rate of return of a benchmark portfolio. The HKMA's performance in the eight years 1998-2005 has either exceeded or met the investment return of the benchmark portfolio. In 2005, the actual rate of investment return exceeded the benchmark rate of return by 24 basis points. With over HK$1 trillion under management, this means an over performance amounting to HK$2.4 billion, equivalent to over 3 years' administrative expenditure of the HKMA.



- While the twin deficits in the US argue for a weaker US dollar, the wide interest rate gaps provided considerable incentive for holding US dollars instead of the low-yielding currencies, such as the euro and yen.

- The possibility of a disorderly adjustment to the US current account deficit, involving a sharp weakening of the US dollar, remains.

- Difficult to see what might trigger such an adjustment.



- Despite the persistent tightening in US monetary stance, long-term US Treasury yields only edged up recently, possibly reflecting continuing strong demand for US assets by jurisdictions running large current account surpluses and the lack of alternative investments. Economists are warning that inflation can pick up very quickly in the US given the tightness in the labour market and high energy costs. This would affect sentiment in the bond market.

- Alternatively, if US short-term rates stablise on a plateau, the US bond market may benefit.

- Bond yields in euro and yen moved higher in recent months, reflecting monetary tightening in Europe and the end of quantitative easing in Japan. A trend may be forming, affecting bond price outlook in these two markets.

- Overall, bond market unlikely to be a star performer in 2006.

- There were more marked movements in bond yields in the two-year area, with these trading distinctly higher in all three markets.

- While it is generally perceived that the global equities markets should continue to show reasonably good performance in 2006, most analysts are skeptical that the good returns achieved in 2005 can be repeated, given the higher energy costs, continued monetary tightening, and worries about a possible slowdown in US demand.

- Quite sharp volatility was observed in equity markets in recent months, particularly in Hong Kong.