USE OF INTEREST RATE SWAPS IN THE MANAGEMENT OF THE EXCHANGE FUND

The Monetary Authority has been using interest rate swaps (IRS) to hedge the fixed rate liabilities arising from Exchange Fund paper. With the amendment of section 3(2) of the Exchange Fund Ordinance, the use of IRS has been extended to the hedging of fixed rate liabilities arising from Treasury placements and deposits from other statutory bodies.

Use of IRS in connection with Exchange Fund Notes Programme

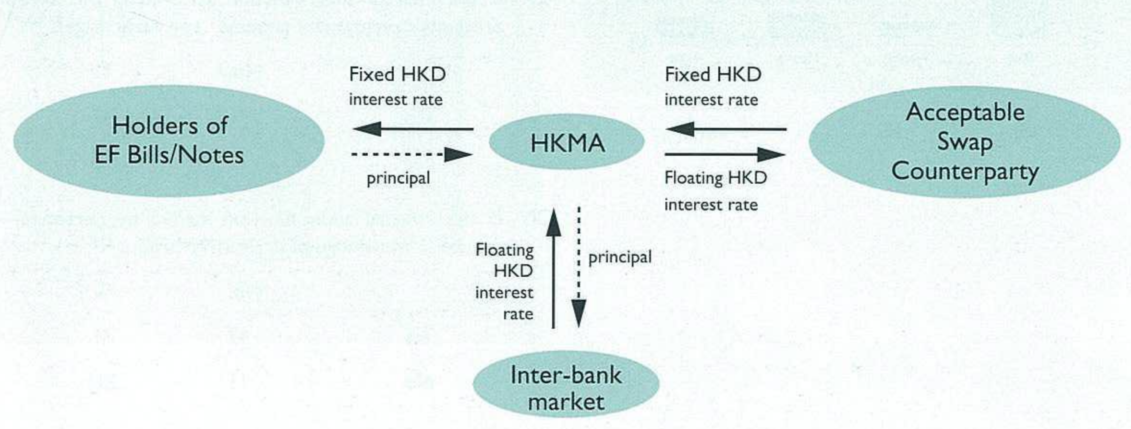
An IRS is a contract in which two parties agree to swap interest payments periodically on a notional principal over a predetermined period of time. Over the past few years, the Monetary Authority has been using IRS to hedge the fixed rate liabilities arising from Exchange Fund (EF) paper with a maturity of one year or over. Unlike the government debt programmes in most other economies, the proceeds of Exchange Fund Bills and Notes are not used to finance government expenditure. They will therefore need to be invested prudently by the Exchange Fund. The use of IRS provides an effective means to facilitate the prudent management of these proceeds. The scheme works as follows:

(a) the Exchange Fund places the proceeds of the EF paper with commercial banks, normally on a 3-month rolling basis, until the corresponding EF paper matures. Alternatively, it may acquire high quality floating rate paper which matches the maturity of the EF paper. In so doing, the Fund receives a floating interest rate.

(b) At the same time, the Exchange Fund enters into an IRS with a counterparty, swapping the floating rate receivables in (a) into fixed rate receivables until the maturity of the EF paper. The interest rate risk arising from the fixed rate interest payment to holders of the EF paper is therefore hedged.

(c) All counterparties in the IRS transactions are reputable banks and hence the credit risks are small.

Compared with placing the proceeds with commercial banks in the form of long-term deposits to match the maturity of the EF paper, the use of IRS has a number of advantages. As far as the principal (i.e. the proceeds of EF paper issues) is concerned, the Exchange Fund is only exposed to short term (say, 3-month) credit and liquidity risk. Secondly, using IRS has a beneficial effect on the development of the IRS market in Hong Kong. Of course, the use of IRS is not the only way to manage the proceeds from the issue of EF paper. Depending on market conditions, the Monetary Authority may use other alternatives, such as switching the proceeds into US dollars for



investment in US dollar fixed income securities, e.g. US Treasuries.

Use of IRS in connection with Treasury placements

In addition to the EF paper, the main interest-bearing liabilities of the Exchange Fund are the Treasury placements and deposits from statutory bodies. The Government has recently decided to place part of its fiscal reserves for longer maturity of up to 3 years. The yields that the Exchange Fund offers to the Treasury are set with reference to the market interest rates prevailing at the time when the placements are made. As these placements are of longer maturity, it is prudent to hedge the Exchange Fund's interest rate risk. A substantial part of these placements has been switched into US dollar assets matching the maturity of the Treasury placements while the remaining part is invested in HK dollar assets, making use of IRS to hedge the interest rate risk as in the case of EF paper.

While the use of IRS in the context of the EF paper programme is permissible pursuant to sections 3(1) and 3(1A) of the Exchange Fund Ordinance, the use of IRS was not permissible under section 3(2) of the Ordinance, which governed the day-to-day investment activities of the Exchange Fund, prior to its amendment in February 1995. The old section 3(2) of the Exchange Fund restricted its investments to Hong Kong currency, foreign exchange, gold, silver and securities approved by the Secretary of State. IRS, a financial derivative product not involving the delivery of underlying securities, was outside the ambit of investment stipulated in section 3(2).

As IRS and many other financial products are useful instruments to hedge against interest rate risk and market risk, it is considered desirable to broaden the scope of permissible investments of the Exchange Fund. Section 3(2) of the Ordinance has therefore been amended, with the enactment of the Exchange Fund (Amendment) Ordinance 1995 on 17 February, to read as follows:

> "The Fund, or any part of it, may be held in Hong Kong currency or in foreign exchange or in gold or silver or may be invested by the Financial Secretary in such securities or other assets as he, after having consulted the Exchange Fund Advisory Committee, considers appropriate; and the Financial Secretary may for the account of the Fund
>
> (a) buy or sell such currency, foreign exchange, gold, silver, securities or assets accordingly; and
>
> (b) after having consulted the Exchange Fund Advisory Committee, enter into any financial arrangement that he considers appropriate for the prudent management of the Fund."

It is important to note that while the investment ambit of the Exchange Fund has been widened, there are two built-in safeguards against the Fund engaging in high risk financial products. First, the financial arrangements referred to in (b) above can only be entered into for the prudent management of the Fund, i.e. for hedging purposes. Secondly, there will be prior consultation with the Exchange Fund Advisory Committee before the Financial Secretary can enter into such arrangements.

Impact of IRS on interbank liquidity and interest rates

When the Treasury withdraws its deposits with commercial banks and moves them across to the Exchange Fund, or when EF paper is issued, the clearing accounts of the banks concerned are debited through the Management Bank. Interbank liquidity will decline in the first instance. But unless the Monetary Authority wishes to vary the level of interbank liquidity for monetary policy reasons, it usually recycles back to the banking system the full amount of the proceeds from Treasury placements or EF paper. However, regardless of whether the full amount or a partial amount is recycled, once that sum is determined, whether the monies are recycled through the placement of short-term deposits with an associated use of IRS or through other avenues makes no difference to the level of interbank liquidity. In other words, the use of IRS per se does not affect the supply of liquidity in the interbank market.

The use of IRS may affect the term structure of interest rates, because swapping floating rate receivables into fixed rate receivables has a similar effect as increasing the supply of longer term fixed-rate funds. This may in turn lead to an easing in the longer term interest rate. But considering that the magnitude of the IRS deals arranged by the HKMA is not large and that these deals are done only occasionally, the impact on interest rates, if any, will be marginal.

Concluding remarks

The use of IRS by the Monetary Authority is solely for hedging purposes. So far, this has been confined to the hedging of fixed rate liabilities arising from the EF paper as well as those arising from Treasury placements and deposits from statutory bodies. As such, the timing of using IRS will be dependent upon the issue schedule of EF paper as well as the placement of longer term deposits by the Treasury and other statutory bodies. The Monetary Authority will continue to make use of IRS as and when appropriate to facilitate the prudent management of the Exchange Fund. It should be noted that the use of IRS by the Exchange Fund would contribute to the development of the IRS market in Hong Kong.

– Prepared by the Monetary Policy and Markets Department