HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

3 May 2001

DISCUSSION TOPICS

Annual Report 2000

Latest Developments

- Currency
- Banking
- Financial Infrastructure
- Exchange Fund Management

Banking Consumer Issues

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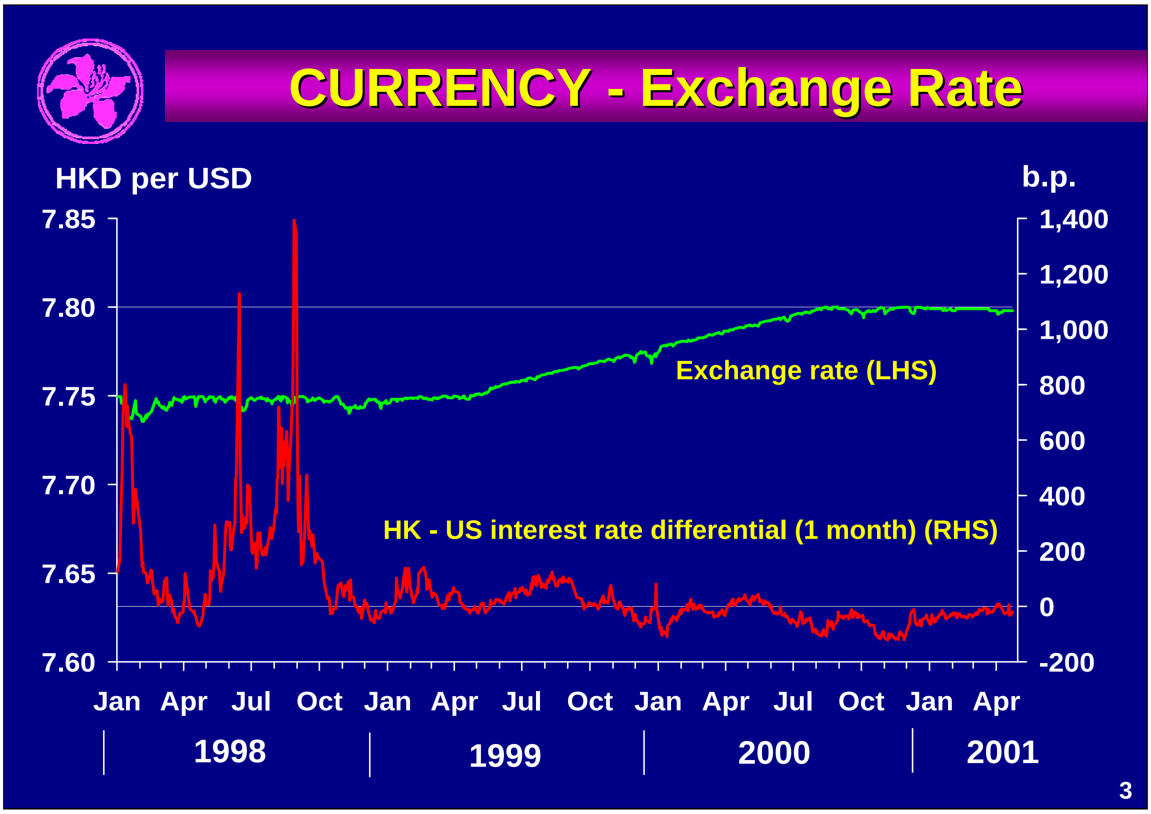
- We have today tabled our Annual Report for 2000. Since Members have been well briefed and kept up to date on the work of the Hong Kong Monetary Authority through similar periodic meetings in the past, we do not intend to go into further details of events in 2000 at this presentation.
- This presentation covers the latest developments in the four main responsibilities of the HKMA:
  - to maintain currency stability, within the framework of the linked exchange rate system;
  - to promote the safety and stability of the banking system;
  - to develop and enhance the financial infrastructure, particularly in relation to payment and settlement arrangements; and
  - to manage the Exchange Fund in a sound and prudent manner.
- We also present the findings of a comparative study recently conducted by the HKMA on how banking consumer protection arrangements in Hong Kong compare with those in two other jurisdictions, namely, UK and Australia.



- The monetary policy objective of the HKMA is to maintain exchange rate stability. The exchange rate continued to be stable during the first four months of 2001.

- Interbank interest rates also remained stable in the first four months of 2001. Hong Kong dollar interest rates continued to stay close to the US dollar counterparts, although the external environment has turned less favourable.

CURRENCY - Vulnerabilities

- Risks from globalisation persist
- Economic and financial market adjustments in US
- Uncertain economic outlook in Japan and yen weakness
- Problems in emerging markets
- Structural weakness in other Asian financial systems
- Mainland adjustments to WTO and political situation
- Use of Hong Kong markets for proxy hedge

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- **Risks from globalisation** persist. Globalisation has increased the risks posed by large and sharp capital movements, particularly to small open economies. Financial markets are vulnerable to the contagion effect of problems in other parts of the world, even where the domestic economy has sound fundamentals.

- **US economic growth** slowed to a five-year low of 1% (annualised) in Q4 2000 before rebounding to 2% (annualised) in Q1 2001. There were continuing signs of weakening in the early part of 2001, as evidenced by sharp declines in investment, unfavourable corporate earnings, and weak exports. Nasdaq and S&P 500 were down by 26% and 12% respectively in the first three months, but rebounded somewhat in April following the surprise rate-cut by the Fed.

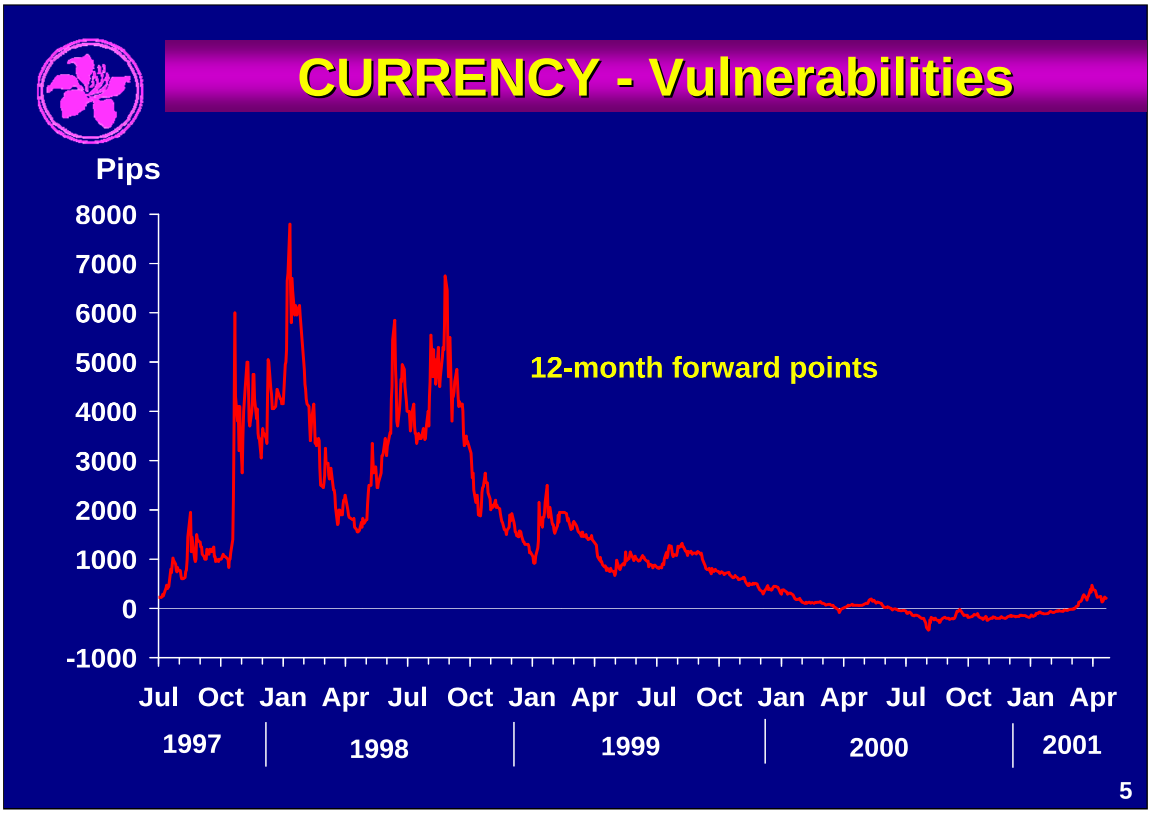
- **Japanese economy** has remained in the doldrums. The latest Tankan survey indicated across-the-board deterioration in business conditions. Deflation has persisted. The yen dipped to a 30-month low of 126.8 against the US dollar at one time in April. The region remains susceptible to the risk of competitive depreciation in the event of a sharp weakening of the Japanese yen.

- **Problems in emerging markets** continued. For example, Argentina's financial markets have come under stress, due to its huge external debt and fiscal weakness. Hong Kong has so far been little affected, as investors are increasingly able to differentiate the two currency board systems, which rest on very different fundamentals. Financial problems in Turkey have also caused little impact on Hong Kong so far.

- **Structural weaknesses in other Asian financial systems** remain unresolved**.** Bank recapitalisation and corporate debt rescheduling remain slow, especially in Thailand, Indonesia and South Korea. Non-performing loans in these three countries range between 10% and 20% of total bank loans. Banks are still under-capitalised. Meanwhile, about 30-80% of the corporate debt in these countries has yet to be rescheduled. Some regional currencies have shown weaknesses caused mainly by their political problems. So far, we have not seen any contagion effects on other regional financial markets. We shall continue to monitor the situation closely.

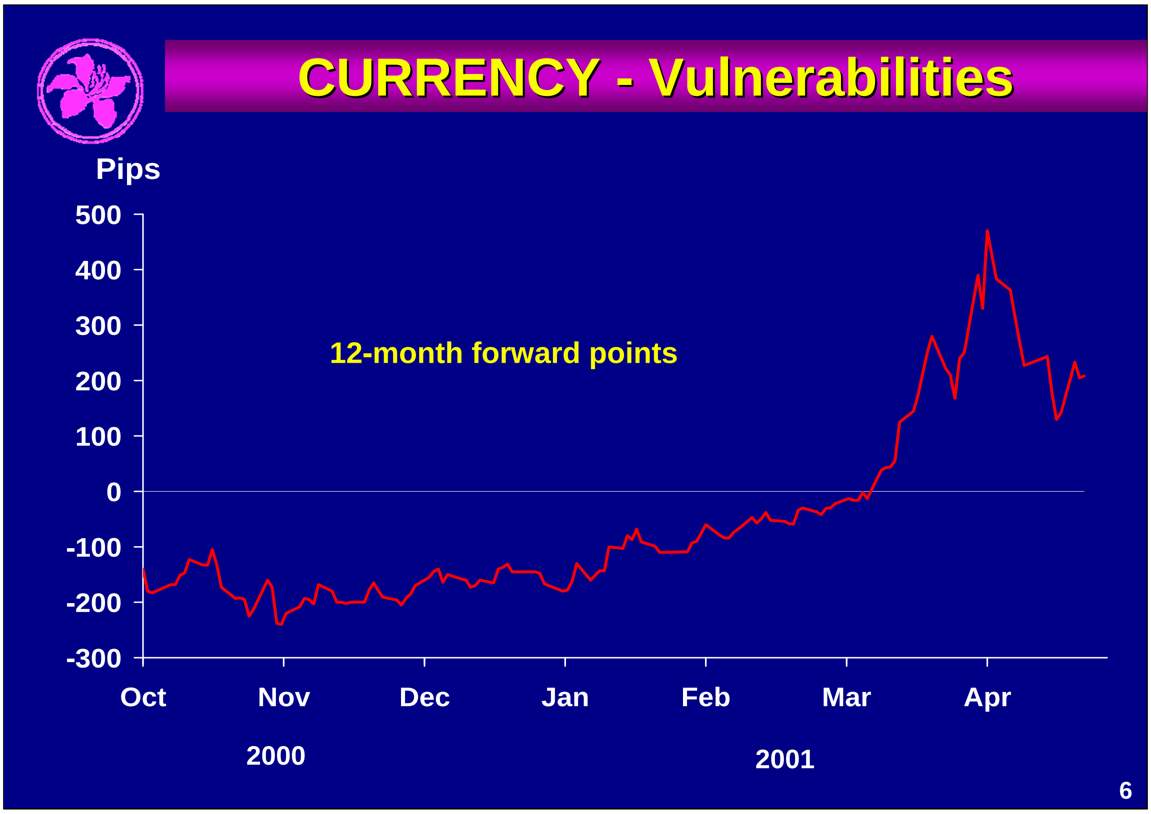
- **Mainland adjustment to WTO and the political situation** may lead to perceptions affecting Hong Kong. With the close linkages between the Hong Kong and mainland economies, market concerns about the possibility of greater flexibility in the renminbi exchange rate (as an adjustment following the WTO accession), or an escalation of Sino-US or cross-Strait tensions, may lead to the perception of a greater risk for the Hong Kong dollar. Nevertheless, we have seen a decoupling of the renminbi and the Hong Kong dollar following the Asian financial turmoil and the strengthening of the currency board arrangements.

- There is increasing risk that **Hong Kong markets may be used as a proxy hedge.** In the absence of capital controls, our liquid financial markets are sometimes used by investors as a proxy hedge for their investment in regional economies, which impose various degrees of controls, do not have a fully convertible currency or an active forward market (such as Mainland China).



- The 12-month forward points on the Hong Kong dollar provide a good barometer of the conditions of the money markets in Hong Kong. Following the introduction of the technical measures to strengthen the Currency Board system in August 1998, the 12-month forward points have gradually declined to a negative level since mid-2000.

- In recent months, owing to several unfavourable external developments, including renewed weakness in regional currencies and escalating Sino-US tensions, the forward discount disappeared and a small premium of around 250 pips emerged in April. This was, however, broadly in line with the pre-crisis average of 240 pips, and far below the high of nearly 8,000 pips at the height of the Asian financial crisis.



- This chart shows that the 12-month forward points started to creep up since the beginning of the year owing to various external developments, turned from a discount to a premium in the beginning of March, peaked at around 470 pips in early April before coming back down to around 250 pips now. We shall continue to monitor the market situation closely.

BANKING - Reform Measures

- Commercial Credit Reference Agency
- Interest Rate Deregulation
- Consolidation
- Code of Banking Practice
- Deposit Protection

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- The various banking reform measures are making good progress:
  - The Legislative Council debated the motion to "expedite the establishment of the commercial credit reference agency (CCRA) in Hong Kong" on 27 April. We have taken note of Members' support for the establishment of the CCRA, and of the concerns raised by some Members relating to the mandatory disclosure requirement, personal privacy and competition. The Working Group will take these concerns into account in continuing its work on the details of the scheme.
  - It has been decided that the final phase of interest rate deregulation will take place at the start of July 2001, involving the removal of the remaining interest rate rules on savings and current accounts. We shall monitor closely the effect that this has on interest rates and on banks' deposit base and profitability.
  - In the last few months, we have seen a pick up in the momentum of consolidation. Following the announcement of the Bank of China's restructuring and Bank of East Asia's acquisition of the First Pacific Bank, the DBS Bank has just announced the acquisition of Dao Heng Bank. We shall continue to promote such efforts - not to mandate "forced marriages", but to advocate publicly the idea of consolidation and to put it on the agenda for the consideration of those concerned.

- We are finalising the review of the Code of Banking Practice. The chapter on fees and charges is being finalised after consultation with the industry associations and the Consumer Council. The remaining chapters are now under consultation with the industry associations.

BANKING - Reform Measures

Deposit Protection

- **Approved in principle by ExCo**
- **Preliminary views on design features:**
  - ⇒ **Cover all licensed banks**
  - ⇒ **Mandatory participation**
  - ⇒ **Coverage Cap at HK$100,000**
  - ⇒ **Ex-ante funding preferred**
  - ⇒ **Risk-based premium to be further explored**
  - ⇒ **Separate legal entity**
- **Subject to further study and consultation**

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- On 24 April 2001 the Executive Council approved in principle the proposal to introduce a deposit insurance scheme (DIS) in Hong Kong and requested the HKMA to undertake more detailed work with a view to producing a set of final recommendations on how the scheme should be structured.

- Taking into account the comments received from the public consultation, the Government's preliminary views on the design features of the DIS are:

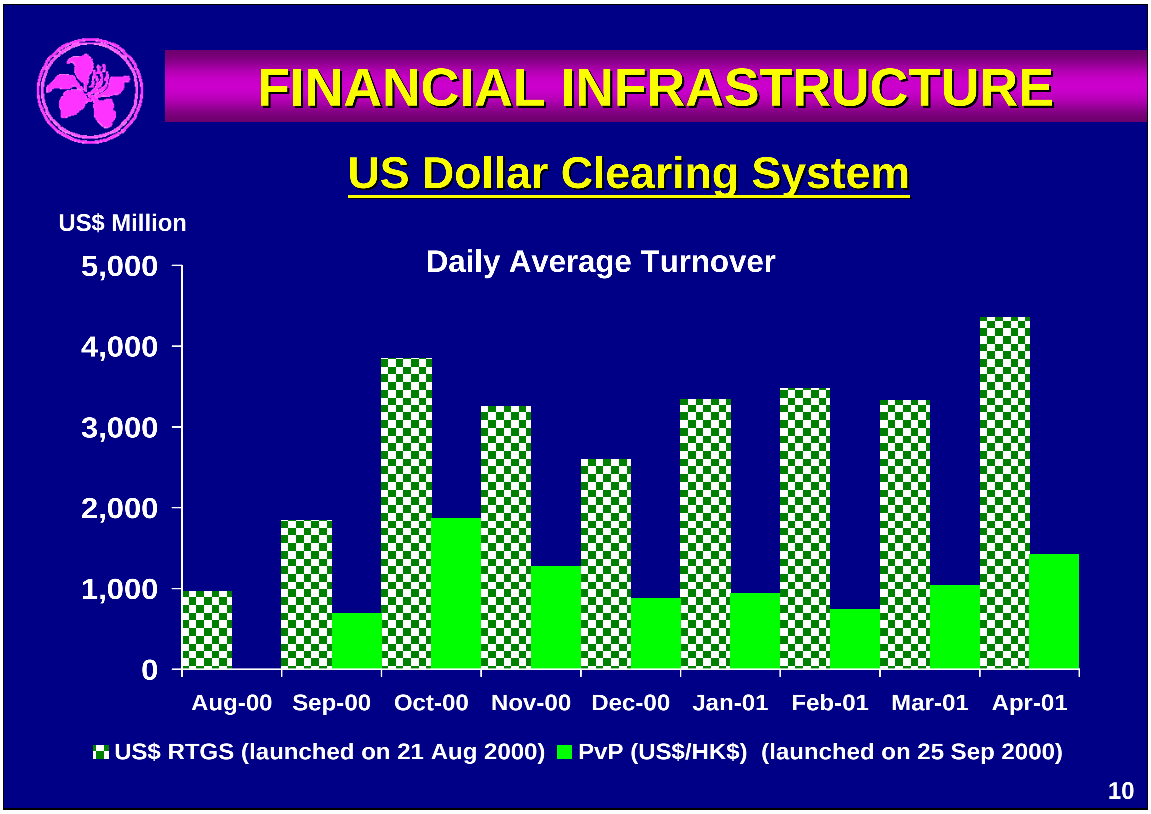
  - all licensed banks would be covered;
  - participation of banks would be mandatory;
  - the coverage cap would be set at HK$100,000 initially in order to curtail moral hazard and keep down the insurance cost;
  - an ex ante funded scheme is preferred;
  - risk-based premium should be further explored; and
  - a separate legal entity would be set up to operate the DIS, but its management structure should be as lean as possible.

- The HKMA will study the specific design features of the DIS and will further consult when more detailed recommendations are developed. It is not expected that any scheme could be implemented before 2002 at the earliest.

- The HKMA currently has two legislative initiatives that are being processed:

  - Banking (Amendment) Bill 2000 - the Bill is being studied by the Bills Committee as a companion to the Securities and Futures Bill. The Bill proposes a number of changes to the Banking Ordinance relating to the securities business of Authorised Institutions (AI).

  - Banking (Amendment) Bill 2001 - The Bill was introduced into the Legislative Council on 4 April. The proposal to approve senior managers has been replaced by an authorization criterion requiring banks to maintain adequate systems to ensure that managers are fit and proper.



- The phased implementation of the US dollar clearing system was completed on 18 December 2000. So far 59 overseas banks have joined the system, in addition to banks in Hong Kong. The system not only allows efficient settlement of US dollar transactions in Hong Kong, but also eliminates settlement risks which could arise when a transaction spreads across different time zones. It is also the first payment-versus-payment foreign exchange transaction system in the world. The system also provides a platform for the issue and trading of equities and bonds denominated in US dollar.

- The daily average turnover has gradually increased since the launch of the first phase in August 2000, reaching about US$5 billion per day now. We are continuing with our promotional efforts to attract further use of the system in the region.

- Following the success of the US dollar clearing system, we are now studying the possibility of introducing clearing systems in other foreign currencies.

FINANCIAL INFRASTRUCTURE

Retail Payments

- **Internal review on the provision of retail payment services**
  - ⇒ **Efficiency, pricing, competition, consumer protection, regulatory framework and systemic implications**
- **Making good progress. Expect to be completed shortly.**

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- An internal HKMA Working Group has been set up under the Committee on Payment Systems to conduct a comprehensive review of retail payment services in Hong Kong. The review covers current means of retail payments, the likely future trends given technological developments, the risks associated with different means of payments, and the efficiency, pricing, degree of competition, consumer protection, regulatory framework and systemic implications in the provision of retail payment services.

- The review is making good progress. A review report is being finalised. We expect the review to be completed shortly.

EXCHANGE FUND PERFORMANCE

	1999 (HK$ bn)	2000 (HK$ bn)	2001 Q1 (HK$ bn)	April 2001 (HK$ bn)
Gain/(Loss) on HK equities	90.1	(11.6)	(21.5)	3.9
Exchange gain/(loss)	(9.9)	(11.2)	(11.8)	3.2
Total return on bonds etc	23.6	67.9	18.8	(2.1)
Investment income	103.8	45.1	(14.5)	5.0
Other income	0.2	0.2	0.0	0.0
Interest and expenses	(10.0)	(11.0)	(2.8)	(0.6)
Net investment income	94.0	34.3	(17.3)	4.4
Treasury's share	(45.4)	(18.1)	6.1	(2.0)
Increase/decrease in EF accumulated surplus	48.6	16.2	(11.2)	2.4

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- The investment environment during the first four months of 2001 has been extremely difficult.
- With a net fall recorded in the Hang Seng Index for the first four months of 2001, there was a loss of about HK$17.6 billion on the Hong Kong equity portfolio (a loss of HK$21.5 billion in Q1 2001, and a gain of HK$3.9 billion in April).
- During 2001 the exchange rate of the euro and the yen continued to weaken against the US dollar, and hence against the Hong Kong dollar - the accounting currency of the Exchange Fund. The exchange loss, mainly in the euro and the yen, amounted to about HK$8.6 billion (a loss of HK$11.8 billion in Q1 2001, and a gain of HK$3.2 billion in April).
- We continued to do well in bond markets. The interest income and revaluation on bonds amounted to about HK$16.7 billion (total return of HK$18.8 billion in Q1 2001, and a loss of HK$2.1 billion in April). This has offset some but not all of the book loss incurred in Hong Kong equities and the exchange loss.
- Adding the other income and deducting the usual interest expense and other expenses, the net investment loss in the first four months of 2001 amounted to HK$12.9 billion (a loss of HK$17.3 billion in Q1 2001, and a gain of HK$4.4 billion in April).
- The fiscal reserves share on this net investment loss on the basis of sharing arrangements effective from April 1998. After deducting this amount, the Exchange Fund recorded a decrease in accumulated surplus of about HK$8.8 billion in the first four months of 2001 (a decrease of HK$11.2 billion in Q1 2001 and an increase of HK$2.4 billion in April).
- It is still too early to tell how the Exchange Fund will perform in 2001. The investment climate for the remainder of 2001 is expected to continue to be difficult. However, the recent interest rate cuts in the US should have a positive effect on the bond market, and more generally should help stimulate the US economy.

EXCHANGE FUND - HK Equity Portfolio

		(HK$ bn)
Investment in August 1998		**118.1**
Income from Disposal and Dividends		**126.1**
Size of remaining portfolio (end-April 2001)		**110.9**
Disposal	**60.9**	
Long Term Investment *	**50.0**	

* **Including HK equities transferred from the Land Fund in 1998 (valued at HK$9 bn in 1998)**

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- We have already fully recouped the investment of HK$118.1 billion in August 1998.

- Through the offer of the Tracker Fund and the subsequent well established mechanism of the Tap Facility, we managed to dispose of a substantial portion of Hong Kong stocks without any noticeable effect on the market. Up to end-April 2001, the total income from disposal and dividends amounted to HK$126.1 billion.

- At the end of April 2001, we still had HK$110.9 billion in Hong Kong stocks. This included the Hong Kong equities transferred from the Land Fund in 1998, which was valued at HK$9 billion at the time of transfer.

- Of the remaining Hong Kong equity portfolio, we intend to keep only around HK$50 billion, in accordance with the investment guideline of the Exchange Fund. Exchange Fund Investment Limited will continue to manage the disposal of the excess in an orderly way with minimum disruption to the market, just as it has done with the disposal so far.

BANKING CONSUMER ISSUES

- Increasing focus on how to address banking consumer protection
- HKMA has no explicit role in consumer protection under the Banking Ordinance
- A comparative study of banking consumer protection arrangements completed
- Report on this comparative study sent to Financial Services Bureau and the Legislative Council Financial Affairs Panel
- Welcome advice on the way forward

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- There is increasing focus on how to address the issue of protection of bank customers in an increasingly deregulated and competitive environment, particularly as banks become more involved in the provision of a wider range of products and services to consumers.

- The HKMA only has a general duty to "provide a measure of protection to depositors" under the Banking Ordinance. There is no explicit mandate with respect to customer protection.

- The HKMA has therefore undertaken a comparative study on how banking consumer protection arrangements in Hong Kong compare with those in the UK and Australia to see whether any improvements are needed.

- The study has focused on UK and Australia because these two jurisdictions are both very advanced in their treatment of banking consumer issues, and have a legal system similar to Hong Kong's. The two systems also present a contrasting approach in terms of regulatory structure - single all-embracing regulator in the UK versus the more disaggregated Australian approach. (The US system may be a less appropriate model because of its complexity).

- The issue of banking consumer protection has to be carefully studied and considered by both the Government and the Legislative Council. We have sent a copy of the report of the study to the Financial Services Bureau and to Members.

BANKING CONSUMER ISSUES

HIGHLIGHTS OF FINDINGS OF STUDY (I)

Banking Consumer Protection Arrangements	UK	Australia	HK
a) Regulator assigned statutory responsibility for consumer protection	✓	✓	✓✗
b) Self-regulation by non-statutory Code of Banking Practice	✓	✓	✓
c) Sanctions against non-compliance with the Code	✓	✓✗	✓✗
d) Ombudsman schemes to resolve customer complaints	✓	✓	✗
e) Regulation of banks' fees and charges	✗	✗	✗
f) Specific Government initiatives to promote basic banking services	✓	✗	✗

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- The first area covered by the study involves the comparison of the general arrangements in banking consumer protection in UK, Australia and Hong Kong, and a summary of the comparisons are as follows :

  - **Regulator assigned statutory responsibility for banking consumer protection:**

    UK - formal regulation by Financial Services Authority (FSA).
    Australia - formal regulation by Australian Securities and Investment Commission (ASIC).
    Hong Kong - HKMA has no explicit role in the protection of bank customers. Despite this, it has been heavily involved in the Code of Banking Practice and in handling customer complaints.

  - **Code of Banking Practice:**
    Industry Associations in all three jurisdictions have issued Code of Banking Practice.

  - **Sanctions against non-compliance with the Code:**
    UK - the Banking Code Standards Board set up by the British Bankers' Association (BBA) can "name and shame" institutions that breach the Code.
    Australia - ASIC cannot generally take enforcement action.
    Hong Kong - the MA can exercise moral suasion, but its formal powers are generally not suited to micro issues of customer protection.

- **Ombudsman scheme:**
  UK - the Banking Ombudsman Scheme is an industry-based scheme, but it will soon be subsumed into the Financial Ombudsman Scheme to be set up by the FSA under the Financial Services and Markets Act (FSMA).
  Australia - the Banking Ombudsman Scheme is an industry-based, self-regulatory scheme.
  Hong Kong - there is no such scheme in HK.

- **Regulation of fees and charges:**
  While the scope of consumer protection is wider in the UK and Australia, there is no regulation of fees and charges.

- **Specific Government initiatives to promote basic banking services:**
  UK - Voluntary standards in charges, access and terms (CAT standards) promulgated by the Treasury on basic bank accounts, e.g., no one-off or regular charges for everyday transactions, ability to use cash machines and make automated credit transfers, etc. Initiative to set up a Universal Bank using the Post Office.
  Australia and Hong Kong - no comparable standards exist.

BANKING CONSUMER ISSUES

HIGHLIGHTS OF FINDINGS OF STUDY (II)

Role of regulator in banking consumer protection	UK	Australia	HK
a) Explicit mandate to protect banking consumers	✓	✓	✓✗
b) Power of regulator to regulate market conduct	✓	✓	✓✗
c) Monitoring compliance with the Code of Banking Practice	✗	✓	✓
d) Responsibility in relation to Ombudsman schemes	✓	✓	✗
e) Setting standards for dispute resolution	✓	✓	✗

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- The second area covered by the study is the role of regulator in banking consumer protection. The main findings are as follows:

  - **Explicit mandate for the regulator on banking consumer protection:**
    UK - the regulatory objectives of the FSA include consumer protection and promoting public understanding of the financial system.
    Australia - ASIC's regulatory objectives include the requirement to "promote the confident and informed participation of consumers in the financial system".
    Hong Kong - One of the functions of the HKMA is to "promote proper standards of conduct and sound and prudent business practices", but this has to be viewed in the light of the principal function, which is related to the more macro issue of maintaining stability of the banking system.

  - **Power to regulate market conduct:**
    UK and Australia - regulators in both jurisdictions are involved in setting standards for conduct of business and rules on complaint handling.
    Hong Kong - the powers available to the HKMA under the Banking Ordinance are not suitable for dealing with bank-customer relationship matters.

  - **Monitoring compliance with the Code of Banking Practice:**
    UK - monitoring by industry body.
    Australia - monitoring by ASIC.
    Hong Kong - monitoring by HKMA.

- **Setting up Ombudsman schemes:**
  UK - FSA required under the FSMA to set up the Financial Ombudsman Scheme.
  Australia - ASIC approves external dispute resolution schemes such as the Banking Ombudsman Scheme.

- **Setting standards for dispute resolution:**
  UK and Australia - relevant standards and rules set by FSA and ASIC respectively.

BANKING CONSUMER ISSUES

HIGHLIGHTS OF FINDINGS OF STUDY (III)

Role of Industry Associations in banking consumer protection	UK	Australia	HK
a) Issue Code of Banking Practice	✓	✓	✓
b) Drafting and conducting review of the Code	✓	✓	✓✗
c) Monitoring compliance with the Code	✓	✗	✗
d) Setting up and funding Banking Ombudsman schemes	✓	✓	✗
e) Consumer education	✓	✓	✗

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- The third area covered by the study is the role of industry Associations in banking consumer protection. The main findings are:

  - **Issue of Code of Banking Practice:**
    Code of Banking Practice is issued by industry bodies in all three jurisdictions.

  - **Drafting and conducting review of the Code:**
    UK and Australia - review of the Code was initiated and led by the industry Associations.
    Hong Kong - review of the Code was initiated and led by the HKMA with participation from industry representatives.

  - **Monitoring compliance with the Code:**
    UK - compliance monitored by the Banking Code Standards Board established by the BBA.
    Australia and Hong Kong - compliance monitored by the regulator.

  - **Setting up and funding Ombudsman schemes:**
    UK and Australia - the Banking Ombudsman Schemes in both jurisdictions are industry-based, self-regulatory schemes. The UK scheme will soon be subsumed into the Financial Ombudsman Scheme under statute, but it will continue to be funded by the industry.

  - **Consumer education:**
    UK and Australia - the industry Associations publish a host of literature related to a range of issues such as safe banking at ATMs, and over the internet, dormant accounts, etc.

- This report aims to collect information on overseas experience and highlight the gaps in the Hong Kong arrangements. There are no policy recommendations yet.

- The HKMA and the Government will now proceed to consider the policy implications. In doing so, the specific issues that need to be addressed include:

  - Should the HKMA be given an explicit statutory responsibility for bank customer protection?
  - What are the pros and cons of the prudential regulator becoming involved in such issues?
  - How should the Code of Banking Practice be monitored and enforced?
  - Is there a case for setting up an Ombudsman scheme in Hong Kong? If so, who should be responsible for this?
  - What should be the role of the industry Associations in relation to protection of banking consumers?

- The HKMA is open-minded on whether it should have a more explicit role on banking consumer protection.

- We welcome advice from Members before we proceed further. After we have studied the policy implications and have a preliminary view on the specific issues raised above, we shall obviously consult further and more widely.

HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

3 May 2001

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