

Governance of the Hong Kong Monetary Authority

Response to the Research Report of the Legislative Council Secretariat

Introduction

This paper sets out the Hong Kong Monetary Authority's (HKMA) comments on the Research Report on Governance of the HKMA ("the Report") produced by the Legislative Council Secretariat on 12 March 2003. Responses to the questions raised by Members in connection with this Report are at **Annex A**. Further comments on the Report are at **Annex B**.

Scope of Comparison

2. There is general international consensus that, apart from some general principles of good governance for central banks, there is no standard pattern or model for central banking institutions, which come in many shapes and sizes and carry out a variety of different functions. There is no single system that fits all. Each institution has its own unique governance arrangements deriving from historical factors, the characteristics of the market in which it operates, its designated functions and responsibilities, and the political system of the jurisdiction in which it operates. Each institution's governance arrangements have their advantages and disadvantages, and it is important to take into account these broader factors in any attempt to compare different governance arrangements. This is indeed a key conclusion emerging from the ongoing study by the Bank for International Settlements (BIS) of central bank governance arrangements at some 50 central banking institutions around the world.

3. It is therefore inherently difficult to conduct any comparative study on central bank governance. This can be seen by the approach adopted by the Report. The sample of three central banks chosen by the Report is extremely small, particularly in view of the fact that there are well over 100 central banking institutions in the world from which comparison might be drawn. Furthermore, the two main comparators used in the Report – the Bank of England and the US Federal Reserve – present problems because they are different from the HKMA in three crucial respects. First, the HKMA operates a currency board system, while the central banking institutions of the UK and the US pursue monetary policy aimed at securing price stability in a floating exchange rate regime. This has important implications:

- (a) The decision-making mechanisms and the analytic work of the HKMA on the one hand and of the Federal Reserve and the Bank of England on the other will have a very different focus, and consequently may call for different operational and oversight structures.
- (b) Large reserves and their sophisticated management play an important role for a currency board, while a central bank that operates in a floating exchange rate regime can work with considerably smaller reserves. This is a strong argument in favour of locating reserves management at central banking institutions that work as currency boards.
- (c) A strong banking system is essential to a sustainable currency board system. This, together with the fact that the link between banking stability and monetary stability under a currency board system is more direct than under a flexible exchange rate system, provides a further strong argument for locating banking supervision at central banking institutions that operate currency boards.

4. The second set of key differences between Hong Kong and the UK and the US relate to the different sizes of these economies, to their different degrees of openness, and to differences in the nature and relative size of their financial institutions and in the complexity of markets. The central banks in the US and UK deal with highly developed, sophisticated and well-established markets that possess predictable structural and behavioural patterns. The degree of concentration in these markets is so low, and their size is so large, that the probability of systemic and destabilising problems is relatively low. In contrast, the small and open economies, in a globalised market, are exposed to the powerful forces of international finance, which, as we observed in the Asian financial crisis, have the potential to destabilise an entire economy. For this reason, it is often argued that central banking institutions in the small and open economies should be given greater flexibility and more effective authority so that they are in a position to deal with the type of problems they face.

5. The third difference comes in the size and scope of functions of the three comparator institutions. The US Federal Reserve conducts monetary policy, supervises some of the banking industry, and is responsible for maintaining financial stability. In addition to its responsibilities for monetary policy, the Monetary Authority of Singapore is responsible for banking supervision, insurance supervision, and regulation of the securities and futures industry, and it manages some, but not all, of the government's reserves. The Bank of England is responsible for maintaining financial stability, setting interest rates, administering payment and settlement

systems, and issuing banknotes. These differences underline the point that there is no single system that fits all central banking institutions.

6. While the Report notes the functions of the three comparators, it does not appear to take into account differences in functions when assessing the relevance of their governance arrangements to the case of the HKMA. The Report also makes the assumption – or at least gives the impression – that the HKMA’s functions are restricted to reserves management and banking supervision. This is a misconception. Quite apart from its responsibilities for reserves management and banking supervision, and for monetary stability, the HKMA has over the years identified and proactively tackled additional areas of central banking that are crucial to the maintenance of monetary and financial stability. These include the construction of important elements of the financial infrastructure, active involvement in the development of international and regional financial architecture, and the carrying out of research and monitoring essential to our ability to respond to rapidly changing conditions. Even the traditional areas of monetary management, banking supervision and reserves management have seen significant developments and improvements contributing to greater currency stability, a more robust banking system, and higher returns on the Exchange Fund.

7. The HKMA places a high value on international experience and standards as one source of ideas on best practices, and we examine governance arrangements at central banking institutions around the world precisely for this reason. However, in our view, such comparisons require great care, and a good sense of judgement of what is worth considering for Hong Kong’s unique circumstances and what is not. At the same time, comparisons between the HKMA and other local authorities or government departments are questionable, since these various organisations serve different purposes and operate on very different principles.

Principles of central banking: the international consensus

8. While no single pattern of governance can be applied to central banks, the research carried out by the Steering Group on Central Bank Governance (which is currently chaired by the Chief Executive of the HKMA) under the BIS suggests that there is general international consensus on two points. The first is that a central banking institution should have operational and resource independence to enable it to carry out its responsibilities without political influence. The second is that a central banking institution should be transparent in its operations and accountable to the community.

9. Three key issues emerge out of these principles. The first is whether resource independence of a central bank is necessary for operational independence. The second is whether or not the transparency arrangements for the HKMA are adequate for the public scrutiny that is necessary to ensure that checks and balances are effective. The third is whether the arrangements whereby the HKMA is held accountable to the community it serves are effective and appropriate. These three issues are dealt with in the sections that follow.

Resource independence

10. Resource independence is necessary because external control over the availability of resources to the central bank could become a tool for influencing its operations. That is why the majority of central banks have resource independence on top of operational independence. Because of Hong Kong's special circumstances, and in particular Article 113 of the Basic Law, which requires the Exchange Fund to be managed and controlled by the Government, the resource arrangements for the HKMA may differ from those of other central banking institutions. But the current arrangements have, over the past decade, shown that they are effective in allowing sufficient flexibility in resource deployment for the HKMA while ensuring that its operations are free from short-term political influence.

11. This measure of resource independence is balanced by checks and controls to ensure that the resources available to the HKMA are sufficient to enable it to carry out its responsibilities but not excessive. The annual administrative budget and the annual pay review for the HKMA are carefully scrutinised by the Remuneration and Finance Sub-Committee of the Exchange Fund Advisory Committee (EFAC) before endorsement by EFAC and approval by the Financial Secretary. The Sub-Committee is made up entirely of the non-official, non-banking members of EFAC. The accounts and operations of the HKMA are subject to continuous scrutiny by the Director of Audit and by the HKMA's Internal Audit Division, which operates independently and reports direct to the Chief Executive of the HKMA. The Audit Sub-Committee of EFAC, which is made up of non-official members, scrutinises the accounts and monitors and makes recommendations on the audits carried out by the Director of Audit and the Internal Audit Division.

12. The HKMA has seen growth in staff from 398 at the end of 1994 to 581 at the end of 2002. This increase is attributable partly to the considerable increase in complexity and volume of the work carried out by the HKMA during a decade of political transition, globalisation, financial crisis and economic difficulty. It is also partly attributable to an expansion of the HKMA's functions to ensure that essential areas of central banking crucial to the maintenance of monetary and financial

stability – such as the building of financial infrastructure, involvement in the development of international and regional financial architecture, and the conduct of monetary and financial research – are covered. For example, in 1993 the number of HKMA staff dedicated to maintaining and developing financial infrastructure amounted to 9. The current number, at the end of a decade in which Hong Kong has seen the development of one of the world's most advanced and sophisticated payment and debt settlement systems, with an international profile, is 18. In 1993 the number of HKMA staff dedicated to monetary and financial research was 9; the present number is 30. In 1993 e-banking had yet to be invented and the securities business of banks was minimal; now we have dedicated regulatory teams of 23 people working on these areas. Further examples could be given.

13. Given the HKMA's broad range of functions and responsibilities and the size and importance of Hong Kong's financial sector, the HKMA's establishment is - and always has been - lean by international standards: indeed a BIS study on the size of central banking institutions, taking into account functions and size of the population served, suggests that the HKMA employs fewer people than the average of all other institutions put together in the survey. This reflects our commitment to the careful stewardship of public resources entrusted to us. Most recently the HKMA has been making heightened efforts to ensure that its staff and other resources are deployed effectively and economically. A total of 31 posts were deleted in 2002. Two senior posts have been frozen so far in 2003, and a further 6 posts will be deleted. Together, these headcount deletions and freezes produce annual savings of HK\$24.3 million, or 6.4% of the current total payroll. The reduction in the HKMA's payroll through pay cuts and headcount adjustments in 2002 and 2003 form part of a co-ordinated effort to reduce expenditure. The total administrative expenses for the HKMA were reduced by 9%, or HK\$65.2 million, in 2002. The administrative budget for 2003 has been reduced by a further 2.1%. The HKMA will continue to make savings where it can. However, at this point, there is reason to be concerned about the institution becoming too lean, since there are essentially no staff contingencies to respond to sudden increases in the demands placed on the HKMA, which, at this time of continuing economic difficulty and global uncertainty, are not to be ruled out.

Transparency arrangements

14. By international standards, the HKMA maintains a high level of transparency in its operations. We believe that transparency is important not just for its own sake, or for the purpose of ensuring accountability, but that it is an essential component of monetary stability, particularly in a system that operates on currency board principles. This is one reason why, over the years, the HKMA has

progressively increased the amount and frequency of disclosure about the operation of the Currency Board system and the accounts of the Exchange Fund, and why we have, through our extensive website and publications, through contacts with the media, through regular briefings to Legislative Council Members and other programmes, made available detailed information on the full range of our work and responsibilities. Our general policy is to disclose full information on all aspects of our work providing that disclosure does not undermine our effectiveness, infringe on commercial confidentiality or personal privacy, or breach statutory restrictions on disclosure of confidential information.

15. The HKMA's strong record on transparency is well known and widely recognised internationally. As a practical arrangement, we benchmark ourselves against the best disclosure practices adopted by other central banks, and, on top of this, we are also responsive to requests for the disclosure of information beyond this general benchmark. For example, in view of the interest expressed in the questions connected with the Report, we are currently working on arrangements for increasing transparency in our remuneration policies. In response to the growing interest in the relationship between monetary issues and the larger economy, we have also recently made available on our website a large proportion of the research memoranda produced by our Research Department.

Accountability arrangements

16. Although accountability arrangements vary considerably from one central bank to another, there are some common themes. An important one is transparency in central bank operations to enable scrutiny by the community. Given the technical nature of central banking, transparency is often supported by careful and detailed explanations of the work of the central bank, targeted at the community directly, or indirectly through the community's representatives and through the media. As explained above, the HKMA has been very forthcoming in this respect. We have, in particular, offered on our own initiative to brief the Legislative Council's Financial Affairs Panel periodically on our work in considerable detail, and we have made special efforts to communicate with, and explain the background of our work to, a wide range of media.

17. Another common theme in promoting accountability is for the functions and responsibilities of the central bank to be clearly defined, so that its performance can be objectively assessed. The functions and responsibilities of the HKMA are clearly and transparently defined in the Exchange Fund Ordinance and the Banking Ordinance, and the policy objectives and work plans pursued by the HKMA are set out in its Annual Report, presentations to the Legislative Council, and other

public documents. The accountability arrangements for the HKMA, together with other governance arrangements, have been set out in a paper on governance of the HKMA sent to the Panel on Financial Affairs and placed on the HKMA website in September 2002. This paper, among other things, sets out the different functions in respect of monetary and financial affairs of the Financial Secretary, the Monetary Authority and the Secretary for Financial Services and the Treasury and the accountability arrangements between the Monetary Authority and the Financial Secretary.

18. One of the objectives of establishing the HKMA as a separate organisation is to help ensure that Hong Kong's monetary and banking policies are conducted with the continuity and professionalism necessary to command the sustained confidence of the people of Hong Kong and the international financial community. We believe that this objective is being largely achieved. The HKMA has helped maintain stability and confidence in Hong Kong's monetary and banking systems during a decade of change and challenge, through political transition, the Asian financial crisis, the collapse of the property bubble, recession, deflation, unemployment, and heightened risk throughout the world. The role and functions of the HKMA are generally understood by the public: there is broad support in the community for our work and international recognition of our achievements. We believe that the existing arrangements have worked well and that they continue to be appropriate to Hong Kong's needs. The priority of the HKMA during this present time of economic difficulty and heightened financial risk is to maintain the stability and efficiency of Hong Kong's monetary and banking systems.

19. Together with the Administration, the HKMA will keep its governance structure under review and will continue to consider and, where necessary, implement improvements in the light of changing conditions.

Hong Kong Monetary Authority
April 2003

HKMA's response to questions from the Report

I. Powers and functions of the Hong Kong Monetary Authority

(Paragraph 5 of the Executive Summary, Paragraphs 108.5-108.12 of the Report)

- (a) *What was the historical background and rationale for making HKMA responsible for both the management of Hong Kong's foreign exchange reserves and the regulation of banks? In overseas jurisdictions, these two functions are performed by separate authorities. How far is HKMA able to carry out these functions with the professionalism required for the respective functions? In what manner does HKMA keep the operation of these two functions separate? Please also provide the staffing complement in supporting these two functions.*

The HKMA was established in 1993 through the merger of the Office of the Exchange Fund with the Office of the Commissioner of Banking. The decision took into account a number of factors. These included Hong Kong's growing importance as an international financial centre; the important interrelationship between currency stability, safety and stability of the banking system, and efficiency, integrity and development of the financial infrastructure; increased risks of globalisation and volatility of international capital flows to Hong Kong, which is a small, open economy; and rapid economic developments in neighbouring economies. The rationale for establishing the HKMA with responsibilities for bank regulation and other central banking functions (including foreign reserves management) was to help ensure that Hong Kong could respond effectively to the challenges, and that the Government's policies in these areas would be conducted with the continuity and professionalism necessary to command the confidence of the Hong Kong people and the international financial community.

While separation of the management of foreign reserves and the regulation of banks might be suitable for the specific conditions of certain individual economies, it has by no means been demonstrated that it is desirable or suitable in all cases. In fact, many overseas central banks are given responsibilities for both the management of foreign reserves and the regulation of banks simultaneously. These include the central banks in the Czech Republic, France, India, Ireland,

Italy, the Netherlands, Malaysia, New Zealand, Poland, South Africa and Thailand. And in Germany and the US the central bank also plays a very important role in both areas. There are synergies and advantages to be gained from combining these and other central banking functions into a single institution in terms of performing its role as lender of last resort, cross-fertilisation of skills, de-layering of communications and cost savings (e.g. IT systems and support services). This is particularly true for small economies such as Hong Kong, where there is a limited pool of expertise available for these positions.

The management of foreign reserves and regulation of banks are performed by separate departments with the HKMA. The banking departments (i.e. Banking Supervision Department, Banking Development Department and Banking Policy Department) have a total strength of 258 and the Reserves Management Department 47.

- (b) Please provide the reasons for the increase in staff from 289 at end-1993 to around 580 at end-2002, and a breakdown of the changes in staffing complement during this period, as well as the reasons for the increase in staff cost from HK\$191 million in 1994 to HK\$480 million in 2001. What new responsibilities has HKMA undertaken to justify the increase in staff during this period?***

As set out in the Information Note on governance of the HKMA sent to the Panel on Financial Affairs in September 2002, the HKMA is charged with maintaining currency stability, promoting the safety and stability of the banking system, enhancing the efficiency, integrity and development of the financial infrastructure, maintenance of the status of Hong Kong as an international financial centre and reserves management. To carry out these functions and responsibilities, the HKMA has strengthened and restructured a number of departments over the past ten years to meet the increasing complexities, challenges and responsibilities in various work areas. These challenges have made demands on resources in all areas of the HKMA's work and have required a corresponding growth in staff. Examples of expanded scope of work or new tasks taken up by the HKMA since 1993 include:

Monetary stability

Progressive strengthening of the Currency Board system through measures such as refinements to its workings, including the setting up

of the EFAC Sub-Committee on Currency Board Operations. The development of the Exchange Fund Bills and Notes programme. Strengthening of monitoring and research functions during a period of increased global risk and economic difficulty within Hong Kong.

Banking stability

The development and implementation of various banking reforms, such as a deposit protection scheme, interest rate deregulation, liberalisation of the market entry criteria, development of a Code of Banking Practice and the establishment of a commercial credit reference agency. Co-ordinating and monitoring the application of international standards to Hong Kong's banking sector, including the New Capital Accord and a regulatory framework for market and interest rate risks. Adapting supervisory practices to a rapidly changing and increasingly complex banking industry during a time of increased pressure on the banking system, including refinements to the "CAMEL" rating system, the development of risk-based supervision, the introduction of a new loan classification system and a new supervisory regime for liquidity. Improvements to financial disclosure. Development of a supervisory framework for e-banking. Action on issues of concern, such as the Y2K problem, terrorist financing and money laundering, and business continuity plans.

Financial infrastructure

The upgrading of Hong Kong's financial infrastructure through the development of a robust Hong Kong dollar payment and settlement system – Real Time Gross Settlement in 1996, the US dollar and the euro clearing systems. Establishment of the Hong Kong Mortgage Corporation Limited to facilitate development of the secondary mortgage market, and, through its issue of bonds, the market for debt securities. Linking of the Central Moneymarkets Unit with other international central securities depositories such as Euroclear and Clearstream, and through a number of bilateral linkages. Establishment of cross-border cheque clearing facilities for Hong Kong dollar cheques.

Hong Kong as an international financial centre

Active participation in multilateral and regional forums contributing to the reform of the international financial architecture following the Asian financial crisis and during a time of heightened international risk.

Organisation of the World Bank Group / IMF Annual Meetings in Hong Kong in 1997. Facilitating the establishment of the BIS Representative Office for Asia and the Pacific, IMF HKSAR Sub-Office and IFC / IBRD Joint Regional Office in Hong Kong. Promotion of the development of the regional bond market through initiatives such as the Asian Bond Fund and the securitisation and credit guarantee markets.

Reserves management

The growth in size of the actively managed assets under the Exchange Fund following the taking over of Land Fund Office in 1997 and the acquisition of Hong Kong equity portfolio in 1998. Launch of the Tracker Fund through Exchange Fund Investment Limited to facilitate an orderly and gradual disposal of the Hong Kong equity portfolio. Diversification of the investment tools available to the Exchange Fund. Increased risk management control and monitoring measures in the light of increasing market volatility and complexities of investment products.

The annual staff changes since 1993 are given below:

Year ending	Total strength
1993	289
1994	398
1995	448
1996	474
1997	488
1998	511
1999	565*
2000	577
2001	600
2002	581

* All ex-Land Fund Office staff were offered conversion to permanent HKMA terms with effect from 1 July 1999.

Comparison with the staff strength at end-1993 may be misleading since the HKMA was only just established and still building up a full staff complement at the time. The increase in staff cost between 1994

and 2001 was mainly attributable to the growth in the total number of staff required to undertake the expanded range of work and new tasks set out above, and the annual pay adjustments approved by the Financial Secretary on the advice of EFAC, taking into account market pay trend and pay level surveys, and assessments of the performance of the HKMA.

According to a survey conducted by the BIS taking into account the relationship between staff numbers, the range of mandates of the central banking institution and total population size, the HKMA was considered to be employing fewer people than the average of all other surveyed institutions put together.

- (c) ***Regarding the operations of most other authorities studied, their powers and functions were stipulated clearly in legislation. HKMA has expanded its functions since its inception in 1993, but the additional functions were not specifically laid out in the Exchange Fund Ordinance and the Banking Ordinance. Please provide details on all these expanded functions.***

The powers and functions of the Monetary Authority are already stipulated clearly in the Exchange Fund Ordinance and in the Banking Ordinance. In the former, specific provisions have been made for particular activities, e.g. the establishment of settlement accounts of authorized institutions with the Monetary Authority. Other amendments, such as section 3(1A), have been made to the legislation which are expressed in terms of specific strategic objectives. This follows the well established precedent of the type of drafting employed in section 3(1) of the Exchange Fund Ordinance, which has enabled successive Financial Secretaries to make strategic use of the Fund in pursuit of those objectives. In many areas of Government activity, as well as those within the scope of the Exchange Fund Ordinance, it is not possible to identify in advance the specific functions for which resources may need to be deployed to achieve strategic goals in an evolving environment, and particularly where crises have to be addressed at short notice; this type of drafting allows flexibility while ensuring accountability under the law. It should also be pointed out that overseas legislation such as the amended Bank of England Act, the new central bank law of Iceland, and the Maastricht Treaty show a similar tendency to stipulate the strategic goals as opposed to resorting to long descriptive lists of functions.

All functions taken on by the HKMA are fully consistent with its policy objectives and the relevant provisions in these two Ordinances. Details of the expanded functions and new tasks undertaken by the HKMA since 1993 have been shown above.

- (d) *All overseas authorities studied were established by law as statutory bodies, with HKMA as the only exception. Does HKMA consider the existing arrangement more appropriate than introducing a piece of legislation on HKMA to provide for its statutory status; if so, what is the rationale? Would HKMA consider that establishing HKMA as a statutory body and setting out clearly its regulatory framework can better ensure its independence in the implementation of monetary policies, its transparency and accountability to the public?*

The legal status of central banking institutions varies. When amendments were made to the Exchange Fund Ordinance in 1992, the Government stated clearly that, legally, the Monetary Authority would be a person rather than an institution, but that in practice the Monetary Authority would be regarded as an organisation so that an institutional identity would be prominent. The vesting of statutory powers in a person rather than an institution is not uncommon in Hong Kong's legal system. For instance, the Insurance Authority and the Telecommunications Authority are public officers appointed under the Insurance Companies Ordinance and the Telecommunications Ordinance respectively.

The present arrangements for the Monetary Authority are consistent with the Basic Law. They have worked well in ensuring monetary and banking stability in Hong Kong and the achievement of defined objectives of the HKMA. They serve the interests of transparency and accountability in an effective manner and are well understood by the public. There does not appear to be any need for a separate Ordinance to provide for its statutory status.

II. Funding of the Hong Kong Monetary Authority

(Paragraphs 108.13-108.15 and 11.1-12.14 of the Report, footnote 16)

- (a) *What is the scope of activities of HKMA which can be directly financed by the Exchange Fund (EF)?*

The activities of the HKMA which can be directly financed by the Exchange Fund are any of those which serve the strategic objectives of the Ordinance, e.g. section 3(1), section 3(1A), or the specific charging provisions of the Ordinance, e.g. section 3(2), section 4, and section 6.

- (b) *What is the rationale for allowing the operation of an organization which is primarily a Government body reporting directly to the Financial Secretary to be financed entirely by the EF and not to be subject to the resource allocation mechanism applicable to other Government bodies?***

The rationale for taking the HKMA outside the resource allocation mechanism applicable to other Government bodies is the same rationale that lies behind the Exchange Fund itself: the Exchange Fund is a discrete Government Fund that is established to allow the Government to pursue specific strategic objectives, e.g. currency stability, without the delay and disruption to public finances that could otherwise be caused by having to employ the general revenue. Continuity of policy and speed of reaction are key factors in achieving the Exchange Fund Ordinance's statutory goals. The need to persuade the legislature to provide funding from the general revenue would mean advance publicity for all strategic operations. This could (a) result in the publication of market sensitive information; (b) frustrate the effective use of the funds proposed; and (c) exacerbate a crisis, e.g. a bank run, even to the point where systemic damage is done.

The funding of the HKMA is, however, subject to a high degree of control, transparency and accountability: its budget is subject to annual approval by the Financial Secretary on the advice of EFAC and the recommendations of the EFAC Remuneration and Finance Sub-Committee. The EFAC Audit Sub-Committee scrutinises the annual accounts and gives advice and guidance on audit-related issues. The accounts of the Exchange Fund are subject to stringent and continuous auditing by the Director of Audit appointed by the Chief Executive of the HKSAR under section 7 of the Exchange Fund Ordinance. The HKMA Annual Reports are presented to the Legislative Council Panel on Financial Affairs every year. In effect, these arrangements are in line with the general practice among overseas central banks.

- (c) *Why is the expenditure of HKMA not capped like other authorities? Such arrangement fails to ensure that HKMA must operate within its means.***

This is not correct. The budgeted expenditure of the HKMA is subject to annual approval by the Financial Secretary on the advice of EFAC and the recommendations of the EFAC Remuneration and Finance Sub-Committee (and as such is subject to capping). It is also subject to stringent and continuous auditing by the Director of Audit. Moreover, the HKMA has been making coordinated efforts to ensure that its staff and other resources are deployed effectively in an operating environment where efficiencies and cost savings may be gained from automation or revision of workflows. This is an ongoing exercise and the resultant savings are reflected in the budgets of the HKMA.

- (d) *Will HKMA examine the possibility to separate the accounts of foreign exchange reserves (FER) from those of HKMA as an administrative unit and setting out clearly in legislation the maximum level of reserve for financing its day-to-day operation, or, as an alternative with reference to the practices of other authorities, to fund its day-to-day operation with the investment returns generated from its capital grant only, and stipulate clearly in law that except for the discharge of duties laid down in legislation, such as to maintain the stability of Hong Kong dollars, HKMA shall not deploy FER for its day-to-day operation?*

The funding arrangements for central banking institutions vary, and there is no single funding practice that fits all. For example, in the case of the HKMA, there is no capital grant. The common thread in different funding arrangements of central banking institutions is that there should be adequate and robust control mechanisms to ensure economical use of resources, accountability, and proper auditing. As explained above, the budgeted expenditure of the HKMA is subject to annual approval by the Financial Secretary on the advice of EFAC and the recommendations of the EFAC Remuneration and Finance Sub-Committee. It is also subject to stringent and continuous auditing by the Director of Audit. We believe that there is no need to change the current arrangements, which are working satisfactorily.

- (e) *On the mechanism for approving and controlling the expenditure of HKMA, paragraph 12.12 of the Report pointed out that “according to Legal Adviser, it was clear that the discretion of CE of HKSAR was quite broad as long as he was prepared to take on the responsibilities and political consequences”. In this connection, has HKMA compared the legislation on the expenditure control of other*

authorities to find out whether such discretion, which was “clearly quite broad”, also existed? Are the legitimate purposes for which those authorities may incur expenditure set out more explicitly in the legislation of other jurisdictions? Does HKMA agree that there is a need to introduce legislative amendments to lay down more clearly the legitimate purposes for which expenditure can be incurred so as to avoid controversies arising from the exercise of the discretion by CE?

The HKMA has not conducted any detailed comparison of legislation on the expenditure control of other authorities. Generally speaking, however, a large majority of overseas central banks are in a position to determine their operating expenditure without being constrained by legal provisions or political influence that could – at least in some circumstances – amount to control of the central bank by the purse strings. This resource independence is generally balanced by effective accountability arrangements. Section 6(b) of the Exchange Fund Ordinance restricts the discretion of the Chief Executive of the HKSAR to approving incidental expenditure necessary for the due performance of the duties laid upon the Financial Secretary and EFAC in connection with the operation of the Exchange Fund. The Department of Justice has provided advice on the scope of the use of this section.

(f) Why is the funding required for the services provided by the HKMA (other than the investment function of EF) not subject to the scrutiny of the Legislative Council?

It is important for a central banking institution to be able to formulate its budget free of outside influence – whether of a political or private nature – that might prevent or inhibit it from pursuing the policy objectives set out for it. This is a commonly accepted approach throughout the world. In the large majority of jurisdictions the central banking institution has the power to determine its expenditure budget. In tandem, there typically is a review process (often involving the legislature) in which the performance of the institution is scrutinised, but is not voted upon or otherwise formally approved by the legislature. The financing of the HKMA from the Exchange Fund instead of from the general revenue was effected through an amendment made by the Legislative Council to the Exchange Fund Ordinance in 1993.

- (g) *Can HKMA perform its function in regulating authorized institutions on a self-financing basis? Please provide a statement of account on the actual costs in undertaking this function and the income from bank levies over the last five years.***

The income from bank licence fees has been higher than the costs of the Banking Supervision Department, which carries out the day-to-day regulation of authorized institutions, over the past five years. However, the supervision of authorized institutions also draws on the resources of other Departments within the HKMA, notably the Banking Policy and Banking Development Departments, the costs of which are not fully covered by the income from licence fees. It should be stressed, however, that these two Departments also carry out functions - such as the development of new policies - that are not directly related to day-to-day supervision. The position over the past five years is set out in the table below.

The total income from bank licence fees has fallen over the last five years, reflecting the decline in the number of authorized institutions as a result of the Asian financial crisis and the global trend towards bank mergers.

As far as the HKMA is aware, central banks around the world that are responsible for all or part of banking supervision do not conduct this work on a self-financing basis.

Year	Total cost of Banking Supervision Department (HK\$'000)	Total income from bank licence fees (HK\$'000)
2002	116,238	133,794
2001	133,791	153,886
2000	139,136	151,338
1999	137,362	157,924
1998	133,991	170,361

- (h) *According to paragraph 12.14 of the Report, HKMA has established the Internal Audit Division and the Audit Sub-committee to assist management in controlling risks and monitoring compliance and to give advice and guidance on audit-related issues. What are the statutory status and powers of the Internal Audit Division and the Audit Sub-committee? What penalties and statutory liabilities will***

***the HKMA management subject to for breach of such guidance?
Are similar codes and establishments found in other authorities?
What are the statutory status of such codes and establishments, and
the liabilities of their management when breaching such codes?***

Neither the Internal Audit Division (IAD) nor the EFAC Audit Sub-Committee has any statutory power. The authority of the IAD to audit the operations of the HKMA comes from the Internal Audit Charter approved by the Chief Executive of the HKMA. The IAD operates independently, objectively and separately from other divisions and departments of the HKMA and reports directly to the Chief Executive of the HKMA and the EFAC Audit Sub-Committee, which consists of four non-executive, non-official members of EFAC. Its authority and responsibilities are governed by the Terms of Reference approved by the Financial Secretary on the advice of EFAC. It reviews and reports to EFAC on the financial reporting process and the adequacy and effectiveness of the internal control system of the HKMA.

The IAD reports to the Chief Executive of the HKMA and the Sub-Committee on its findings on internal control mechanisms and, where appropriate, makes recommendations for improvement. Depending on the nature and significance of the control issues, the Chief Executive of the HKMA will determine the most appropriate actions to be taken.

The establishment of an independent internal audit function and the formation of an audit committee are well recognised features of corporate governance in the finance industry and are in line with the guidelines issued by the HKMA, Securities and Futures Commission and Hong Kong Stock Exchange. According to the information available, other authorities managing substantial funds in Hong Kong, such as the Airport Authority, Hospital Authority, Housing Authority and Urban Renewal Authority, have similar establishments and practices. But as far as the HKMA is aware, such establishments have no statutory status and no statutory liabilities will arise from any breach by the management.

It should be noted that, in addition to the Internal Audit arrangements, the HKMA is subject to external auditing by the Director of Audit.

III. Determination of remuneration packages

(Paragraphs 108.16-108.19, 13.1-13.7, 55.3-55.4 and 69.1-69.6 of the Report)

- (a) *Remuneration policies are public information in overseas jurisdictions. Why does HKMA not publish information on its remuneration policy?*
- (b) *What are HKMA's remuneration policies and yardsticks for determining the remuneration of its senior staff?*

Information about the HKMA's remuneration policies is already in the public domain through press releases issued in connection with the annual pay review and answers to questions from the media. The basic remuneration policies are as follows:

- Pay and conditions of service for HKMA staff are entirely separate from civil service pay and conditions. HKMA pay packages are pitched so that they are comparable to, and competitive with, pay for comparable positions in the private sector.
- HKMA pay packages are total cash packages. With the exception of medical benefits (which cease on retirement) and overtime allowance for junior staff, there are no allowances or benefits in addition to basic pay. Instead of pension benefits, the HKMA operates a Provident Fund Scheme.
- HKMA pay packages consist of two elements: Fixed Pay, which is payable monthly, and Variable Pay, which is payable annually according to individual performance, the performance of the HKMA as a whole, and trends in Variable Pay in the private sector.
- Pay for HKMA staff is reviewed annually by the EFAC Remuneration and Finance Sub-Committee, taking into account

the findings of independent consultants on pay trends and pay levels in the private sector, and assessments of the performance of the HKMA.

With the aim of improving transparency, the HKMA is working on arrangements to post a summary of remuneration policies on its website.

By comparison, the practice of a considerable number of central banks is not to make available their remuneration policies in detail, or the salary of any individuals they employ, including the head of the institution. These include the European Central Bank and the central banks in Belgium, Denmark, France, Germany, India, Japan, Malaysia, South Africa, Switzerland and Thailand.

(c) Why is the remuneration of the Chief Executive of HKMA so much higher than the Governor of the Bank of England, Chairman of the Federal Services Authority, UK, and the Chairman of the US Federal Reserve System?

The pay of central bank governor reflects a large number of complex factors, some economic, some political, and some historical, and the characteristics of job markets in different economies vary considerably, reflecting the circumstances of individual markets. It is generally not justified or helpful to compare the levels of remuneration across different central banking institutions.

(d) Is it appropriate for the Exchange Fund Advisory Committee (EFAC) to become the de facto management board of HKMA which also undertakes functions other than that relating to the management of the EF?

The Financial Secretary is required by law to consult EFAC in the exercise of his control of the Exchange Fund. Since this includes consultation with EFAC on the use of the Fund to affect the exchange value of the Hong Kong dollar, on the choice of investment of the Fund, and on the administrative budget and pay of the HKMA (which are charged to the Exchange Fund), the term “de facto management board” has been used to describe EFAC. However, EFAC does not formulate policies in respect of the regulation of banks, which is

governed by the Banking Ordinance. Nor does it oversee the day-to-day work of the HKMA.

- (e) *Is the EFAC the most appropriate party to determine the remuneration of the senior staff of HKMA, given that some of its members are subject to HKMA's regulation?*

The terms and conditions of service of HKMA staff are dealt with in detail by the EFAC Remuneration and Finance Sub-Committee, which consists of six non-official and non-banking members of EFAC. The Financial Secretary, with the advice of EFAC, determines remuneration on the basis of the Sub-Committee's recommendations.

IV. Accountability arrangements of the Hong Kong Monetary Authority

- i. **Appointment of the Chief Executive of the Hong Kong Monetary Authority** (Paragraph 108.21 of the Report)

Why are the selection criteria for the appointment of the Chief Executive of the HKMA not made public? In the UK, the appointment of board members to regulatory bodies is based on the Nolan Principles. In the US, the chief executives of the financial authorities are appointed by the US President and confirmed by the Senate.

Although the Exchange Fund Ordinance does not set out any criteria for the appointment of Monetary Authority, the Financial Secretary is required to act reasonably and bona fide and take all relevant factors into consideration. Relevant factors to be taken into account in appointment would include the appointee's educational qualifications, knowledge and experience, competence, financial soundness, integrity and honesty. We will consider setting out these factors on the HKMA website, in line with the ongoing policy of transparency.

The US practice is somewhat unusual. In a large majority of jurisdictions, the head of the central banking institution is appointed by the head of state / government, and the legislature has no right for approval. The appointment of the Chief Executive of the HKMA by the Financial Secretary is working satisfactorily.

ii. **Reporting requirement**

(Paragraphs 108.22-108.23 of the Report)

Members have noted that financial regulatory authorities of the UK and the US have more comprehensive accountability arrangements with their legislatures, including legal requirement for submission of annual reports and financial statements, self-evaluation of internal management controls, and debate on the work of the regulatory authorities. Has HKMA considered adopting such reporting requirements?

Similar reporting arrangements by the HKMA to the legislature are already in place: there is a formal commitment from the Chief Executive of the HKMA to appear before the Panel on Financial Affairs three times a year to brief Members and to answer questions on the HKMA's work. At one of these briefings, usually in May, the HKMA's Annual Report is presented. The Annual Report incorporates the report on the working of the Banking Ordinance, which is required to be furnished annually under section 9(1) of the Banking Ordinance. Staff of the HKMA attend Legislative Council Panel meetings to explain and discuss particular issues, and Committee meetings to assist Members in their scrutiny of draft legislation. We believe that these arrangements have served the interests of transparency and accountability in an effective way.

iii. **Publication of minutes of meetings**

(Paragraphs 10.9-10.10, 70.4 of the Report)

The minutes of the US Federal Open Market Committee are available to the public. The possible impact of the information on the market is no different from that discussed in the EFAC. Will HKMA consider disclosing the minutes of the EFAC to enhance transparency?

The role of EFAC, which advises on the control of a large public fund, is entirely different from that of the Federal Open Market Committee (FOMC), which is charged with overseeing open market operations, the principal tool of national monetary policy in the US. Although, given the very different monetary policy framework, direct parallels cannot be drawn, the nearest equivalent of the FOMC in Hong Kong is the EFAC Sub-Committee on Currency Board Operations: the records

and regular reports of this Sub-Committee, together with a substantial proportion of the research material that it considers, are already routinely published on the HKMA website and in the HKMA Quarterly Bulletin.

Since EFAC gives advice, among other things, on the investment strategy for the Exchange Fund, its minutes are market-sensitive. Publication of the minutes, whether or not it was subject to a time lag, could provide information to market participants about the behaviour of the Fund that would be detrimental to the Fund's interests. In effect, a high degree of transparency in the management of the Exchange Fund, consistent with considerations of market sensitivity, is already provided in the Annual Report and in the various monthly press releases issued by the HKMA.

iv. Authority for appointing members of the management board

(Paragraph 9 of the Executive Summary, Paragraphs 10.1-10.3, 10.7-10.8, 13.2, 52.5-52.7, 59.4-59.6, 66.6-66.9, 87.3-87.6, 94.2-94.6, 101.2-101.5 of the Report, Table - An overall comparison of the governance of the Hong Kong Monetary Authority with comparable authorities in Hong Kong and overseas jurisdiction.(page 121))

- (a) *How does HKMA define 'management board'?*
- (b) *The management boards of the financial authorities in the UK and US undertake many functions. As for the EFAC, apart from advising the Financial Secretary (paragraph 10.1 of the Report), at present it lacks the statutory powers to determine the remuneration packages for the staff of HKMA (paragraph 13.2 of the Report), to approve the budget of HKMA (Table - authority for approving the budget), to formulate policies in respect of the regulation of banks (paragraph 10.3 of the Report) and to oversee the day-to-day operation of HKMA (paragraph 9 of the Executive Summary). What is the rationale for HKMA to consider the EFAC as the de facto management board of HKMA?*
- (c) *Will the Government consider making reference to the UK and US practices in determining the appointment of members to the EFAC, as well as establishing a board of directors with specific powers to take up a role similar to that of a*

management board, whose composition, appointment and removal arrangement, member qualifications and terms of reference, etc. are prescribed by law?

The HKMA defines “management board” as a body that takes decisions on the management of an organisation. The Financial Secretary is required by law to consult EFAC in the exercise of his control of the Exchange Fund. Since this consultation includes consultation on the administrative budget and pay of the HKMA (which are charged to the Exchange Fund), the term “de facto management board” has traditionally been used to describe EFAC.

The establishment of a formal or statutory management board or board of directors for the HKMA would involve extensive changes to both the existing legislative and institutional frameworks and entail the devolution of powers from the Government, which is not the intention. The present arrangements are working satisfactorily and we see no need for change.

The criteria and procedures for appointment of members to EFAC are already in line with the relevant circulars on appointment of members of advisory and statutory bodies issued by the Government. Relevant areas of expertise include banking, accounting, business, finance and the academic and legal professions, all of which are currently represented in the Committee.

v. **Accountability of management staff**

Has HKMA compared the respective forms of penalties and liabilities for default among board members, chief executives and chief management personnel of overseas authorities, and found out whether statutory codes of practice, etc. have been developed? Has HKMA adopted similar arrangements?

The HKMA has not carried out any comparative study on the respective forms of penalties and liabilities for default among board members, chief executives and chief management personnel of overseas authorities. However, we have come across a number of

overseas central banks that have developed non-statutory codes of practice / staff handbooks for their board members / staff, such as the Bank of England, European Central Bank, and US Federal Reserve System. The HKMA publishes a Staff Handbook, which sets out, among other things, details concerning the conduct and discipline that staff members are expected to observe. The rules and regulations in the Handbook are consistent with those of the Government. Failure to comply with the restrictions or requirements set out in the Staff Handbook may lead to disciplinary action against the staff member concerned. Where the gravity of the breach so warrants the employment of the staff member may be terminated. HKMA staff are also subject to the Prevention of Bribery Ordinance and to reporting requirements and restrictions on their investments.

The HKMA also maintains a Register of Members' Interests, which contains the declarations of interests by members of EFAC and is available for public inspection.

V. Other concerns

Paragraph 108.26 of the Report stated that although HKMA is a government body, it is exempted from many rules, regulations and procedures commonly applicable to a government bureau/department. At the same time, unlike other statutory bodies, HKMA does not have any clearly defined statutory governance structure and checks and balance for its control mechanism. Please give details about the rules, regulations and procedures commonly applicable to a government bureau/department but not to HKMA at present. Is such structure and mode of governance betwixt and between, but different from other authorities; and are there any other authorities whose status is similar to that of HKMA?

We believe that the governance arrangements of the HKMA have served the interests of transparency and accountability in an effective manner and are well understood by the public. The arrangements are clearly set out in the relevant legislation and in various public statements, e.g. the Information Note on governance of the HKMA sent to the Panel on Financial Affairs in September 2002. Since the expenses of the Monetary Authority are paid out of the Exchange Fund and not the general revenue, a number of the Government regulations relating to the general revenue such as procurement rules do not apply to the HKMA. Nevertheless, the HKMA has introduced its own procurement rules that impose the same, if not more stringent,

requirements in respect of procurements from the Exchange Fund. In other words, the HKMA has its own checks and balances, the ultimate being that the budget and all expenses are approved by the Financial Secretary on the advice of EFAC.

The HKMA is more stringent than the Government in its rules on investments by staff and declarations of interests by staff. All HKMA staff are subject to a system of strict requirements for reporting their investments and financial transactions. Under the requirements, designated staff are required not to make certain investments. For example, staff in the banking departments are not allowed to purchase or hold shares or warrants in any authorized institutions or in the holding company of any authorized institutions. All staff are required to declare certain forms of transactions, depending on their job nature or rank.

The employees of the HKMA, as public servants, are all subject to the provisions of the Prevention of Bribery Ordinance. In effect, there are no major Government regulations or procedures that do not apply to the HKMA, whether directly or in equivalent form.

Hong Kong Monetary Authority
April 2003

Further comments by HKMA on the Report

Foreign exchange reserves management and banking regulation (paragraphs 108.7 - 108.10)

As noted in I(a) above, the management of foreign exchange reserves and banking regulation is not in all cases performed by different authorities in overseas jurisdictions (paragraphs 108.7 and 108.9). Central banking institutions come in many shapes and sizes and carry out a variety of different functions. According to a study conducted by the BIS, while the vast majority of central banking institutions in the world have a statutory responsibility for monetary (including foreign reserves) management, a large number of these institutions (about 40%) are also given supervisory objectives.

The separation of these two functions may not necessarily enhance the response to market contingencies (paragraph 108.10). In particular, as paragraph 108.8 notes, there is significant interaction between exchange rate stability and financial system stability. Putting responsibility for monetary (including foreign reserves) management and banking regulation under one roof therefore brings with it important synergies in terms of responding to a market or banking crisis (e.g. through the speedy provision of lender of last resort assistance). There is no apparent reason why the required professionalism for the management of foreign exchange reserves and the regulation of the banking sector cannot be maintained within one organisation. This enables staff to acquire a broad spectrum of central banking skills through posting rotation, which can facilitate the filling of vacancies and provide back-up for key staff in emergency situations. It also allows for economies of scale through the sharing of administrative and support functions, which would have to be duplicated if reserves management and banking regulation were to be split between separate authorities.

Prudent supervision and conduct regulation (paragraphs 108.11 – 108.12)

There are two distinct issues here. The first is the question of single versus multiple-regulator regimes. Notwithstanding the move by some overseas jurisdictions towards the former, in many other jurisdictions, including the US, banking, securities

and insurance businesses continue to be subject to regulation by separate authorities. It is debatable whether a single regulator offers clear advantages over the multiple approach. While the single regulator should offer economies of scale and help to reduce regulatory gaps and inconsistencies, there is a danger that such a body will become too all-powerful and overly bureaucratic. The costs and administrative burden of putting in place an entirely new organisation should also not be underestimated. The HKMA is therefore not convinced of the case for establishing a single regulator in Hong Kong. In practice, coordination among the various regulators in Hong Kong is achieved both bilaterally and through the Council of Financial Regulators, which was established in 1999 and which includes the heads of all the major financial regulators.

As regards the question of prudential supervision and conduct regulation, we do not consider that a clear-cut distinction or conflict exists between these to the extent that they must be conducted by separate bodies. In the UK both functions are undertaken by the FSA (and we are not therefore sure of the basis of the claim in paragraph 108.12 that the FSA believes that prudential supervision and conduct regulation should be conducted by two different bodies). In practice, whether or not single or multiple regulators are involved, the regulator concerned will normally have to consider both prudential and conduct of business issues in relation to the regulated institutions, particularly since such institutions increasingly offer a broad range of financial services. The way in which institutions such as banks conduct business can affect not only the interests of individual consumers, but also public confidence in the institutions concerned and possibly in the financial system as a whole. Business conduct also has a bearing on the fitness and properness of management, which is a prudential issue. This interaction helps to explain why the HKMA has become increasingly involved in consumer issues over the years, including its sponsorship of the Code of Banking Practice. Moreover, the ultimate threat to the interests of consumers is if an institution fails through lack of capital or liquidity. This reinforces the fact that even those regulators whose most obvious focus is on conduct of business issues must also keep prudential issues very much in mind. The two areas cannot therefore be neatly compartmentalised.

Funding mechanism (paragraphs 108.13-108.15)

The funding mechanism may vary among institutions according to historical factors, designated functions and responsibilities etc, but in common with other well run central banking institutions the HKMA has a considerable number of elements seen as necessary to provide checks and balances on its funding. These include relevant statutory underpinnings, budgetary accountability to the Financial Secretary through EFAC, stringent and continuous auditing by the HKMA Internal Audit Division reporting to the EFAC Audit Sub-Committee and by the Director of Audit, and a high level of financial account transparency to the public and the legislature.

Authority to determine remuneration package (paragraphs 108.16 – 108.18)

The remuneration package for the Chief Executive of the HKMA – and of other senior officials – is determined by the Financial Secretary on the advice of EFAC and on the recommendations of the EFAC Remuneration and Finance Sub-Committee, which consists of all non-executive, non-banking members of EFAC. Through this arrangement, the non-executive, non-banking members of EFAC are in a position to exercise a considerable degree of influence over the determination of remuneration packages for the Chief Executive of the HKMA. As such it can be argued that the current arrangements of the HKMA are akin to those adopted by the Mandatory Provident Fund Authority, the Bank of England, the UK Financial Services Authority and the Monetary Authority of Singapore.

In a considerable number of overseas cases, the central bank's supervisory board or a similar grouping, or the bank's general meeting determines the remuneration package of the head of the institution. In other cases it is often determined by the Minister of Finance or the government. It is rare for the remuneration package of the head of the central bank to be determined by the legislature: in an extensive survey by the BIS this was the practice only in one jurisdiction, where the legislature determines the salary grid for senior positions in government, and the central bank governor is compensated according to the classification of his position within this grid.

Disclosure of remuneration information (paragraph 108.19)

Information about the HKMA's remuneration policies is already in the public domain. However, with the aim of improving transparency, the HKMA is working on arrangements to post a summary of remuneration policies on its website.

Impact of the accountability system for Principal Officials on the governance of the local authorities (paragraphs 108.24 – 108.25)

The accountability arrangements of the central banking institutions in the UK and the US are noted (paragraph 108.25). While any direct comparison would not be entirely appropriate for the reasons stated above, we believe that the accountability arrangements of the HKMA already incorporate the elements of good governance:

- (a) the powers and functions of the Monetary Authority are clearly set out in the Exchange Fund Ordinance and the Banking Ordinance, and summarised in the Information Note on governance of the HKMA sent to the Panel on Financial Affairs in September 2002;
- (b) although the Exchange Fund Ordinance does not set out any criteria for the Monetary Authority's appointment, the Financial Secretary is required to act reasonably and bona fide and take all relevant factors into consideration. Relevant factors to be taken into account in appointment would include the appointee's educational qualifications, knowledge and experience, competence, financial soundness, integrity and honesty. The criteria for appointment of members to EFAC are in line with the relevant circulars on appointment of members of advisory and statutory bodies issued by the Government;
- (c) as explained in III(b) the level of disclosure of remuneration information varies widely across central banking institutions and there is no standard practice in this regard. Information about the HKMA's remuneration policies is already in the public domain. However, with the aim of improving transparency, the HKMA is working on arrangements to post a summary of remuneration policies on its website;

- (d) in effect the accountability arrangements of the HKMA are similar to those of the vast majority of overseas central banks, and have served the interests of transparency and accountability in an effective manner; and
- (e) the relevant ordinances already provide checks and balances in relation to the powers of the Monetary Authority, e.g. various appeal mechanisms are set out in the Banking Ordinance against the decisions of the Monetary Authority.

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