



HONG KONG MONETARY AUTHORITY

**Management Costs for the Investment
of the Exchange Fund**

**Presentation to the Legislative Council
Panel on Financial Affairs**

4 May 2006



Exchange Fund Accounts 2005: Note 4(c)

(c) Operating expenses

	Group		Fund	
	2005	2004 (restated)	2005	2004 (restated)
Staff costs				
Salaries and other staff costs	554	523	449	421
Retirement benefit costs	31	31	25	25
Premises and equipment expenses				
Depreciation and amortisation	147	155	116	120
Rental expense under operating leases	5	18	4	10
Other premises expenses	37	39	31	33
General operating costs				
Maintenance of office and computer equipment	33	35	27	30
Financial information and communication services	33	31	28	27
External relations	13	15	12	13
Professional and other services	31	43	23	35
Training	5	5	4	4
Others	3	12	13	10
Investment management and custodian fees	734	547	731	543
TOTAL	1,626	1,454	1,463	1,271



Breakdown of Investment Management and Custodian fees 2005

	<u>HK\$mn</u>
Investment management and custodian fees :	731
Trading expenses :	-130
Withholding tax :	-99
Others* :	-13

Actual management and custodian fees :	489

* Includes trading expenses for futures, CMU expenses, consultancy fees for rating agencies, market expenses for retail EFBN.



Cost of external fund managers and custodians of the Exchange Fund 1997 – 2005

	Number of portfolios	Management and custodian fees (HK\$ million)
1997	21	140
1998	18	170
1999	29	178
2000	50	235
2001	54	272
2002	67	341
2003	73	421
2004	75	449
2005	78	489



Reasons for the increase in costs 1997-2005

- **Growth of the Exchange Fund**
- **Increased complexity of the Fund**
- **Greater attention to risk management**



Growth of the Exchange Fund

	<u>1997</u>	<u>2005</u>
Total Fund :	HK\$636bn	HK\$1,066bn (+68%)
Accumulated Surplus :	HK\$190bn	HK\$443bn (+133%)

Land Fund (HK\$211.4bn) added in 1998



Increased complexity

- 1998 market intervention: Hong Kong equities added to Fund
- Addition of Land Fund in 1998
- More equities and other instruments :

Investment benchmark

	1997	2005
Bonds	90%	77%
Equities & other	10%	23%

- Equities cost more to manage than fixed-income assets and must be managed externally

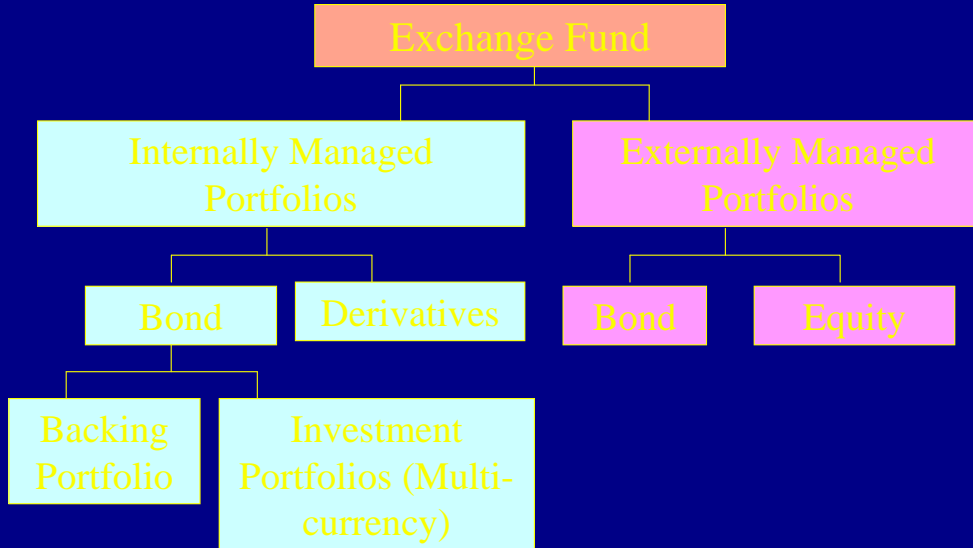


Greater attention to risk management

- **Asian financial crisis**
- **Growing emphasis on risk management generally**
- **Greater diversification and restructuring of portfolios**
 - more specialised portfolios
 - reduced concentration risks
- **Additional reporting requirements**



About two-thirds of assets are managed internally





Exchange Fund: management by HKMA Staff

- **HKMA staff involved in the management of the Exchange Fund :**

	1997	2005
Establishment	29	48
Strength	25	47

- **Broadly in line with growth of Exchange Fund**
- **Absorption of Land Fund staff 1998**
- **Strengthening of risk management and compliance**



Cost of managing the Exchange Fund : perspectives

- (1) Cost in relation to Funds under management**
- (2) Cost of managing comparable funds**
- (3) Cost in relation to performance against benchmark**



Perspective (1): Costs in relation to Funds in 2005

Cost of external managers, managing one third of Fund:

0.14% of funds under management

(Management costs for the whole Exchange Fund, including external managers and internal costs:

0.05% of the total Exchange Fund)



Perspective (2): Comparable Funds 2005

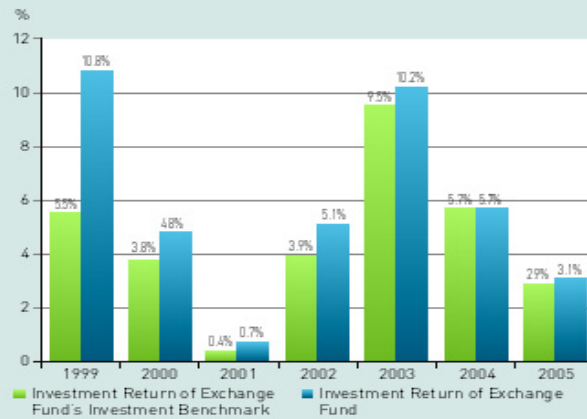
<u>Fund</u>	<u>External management fees</u> (as percentage of funds under management)
Norwegian Government Pension Fund	0.27
Comparable institutional funds available in HK	0.45 – 0.95
Exchange Fund	0.14



Perspective (3): Cost in relation to performance

- **Compounded annual investment return of Exchange Fund 1999-2005 : 5.7%**

Investment return of the Exchange Fund and the Exchange Fund's investment benchmark (1999-2005)





Perspective (3): Cost in relation to performance

Annual return on Exchange Fund 1999-2005 has exceeded that on the benchmark portfolio:

- **by an average of 1.2% (or \$11.9 bn) between 1999 and 2005**
- **or by around 30 times the average total annual cost of managing the Fund.**



Why appoint external managers?

- to allow the Fund to be invested flexibly in a variety of specialised assets in a number of international financial centre
- to tap the best investment expertise available in the market
- to transfer market knowledge to in-house professionals
- to avoid market sensitivity arising from the HKMA's role as regulator



Appointments of External Managers

- **Rigorous, competitive process**
- **Selection according to track record, expertise, fee structure and fee level**
- **Subject to procurement guidelines**
- **Extensive due diligence**
- **Approved by Financial Secretary on the advice of the Exchange Fund Advisory Committee**



2006 Administrative Budget

Administrative expenditure (2005 and 2006 budgeted)

\$ mn	2005 Budgets*	2005 Actual	2006 Budgets*
Staff costs	492		523
Salaries and other staff costs		449	
Retirement benefit costs		25	
Premises and equipment expenses			
Operating lease charges	5	4	4
Other premises expenses (including utility charges and management fees)	31	31	32
General operating costs			
Maintenance of office and computer equipment	27	27	29
Financial information and communication services (including trading, dealing terminals and data link charges)	30	28	31
External relations (including international meetings)	16	12	18
Professional and other services (including service fees for operating the interbank payment system)	29	23	45
Training	5	4	4
Others	15	13	15
Total	650	616	701

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



2006 Staff costs

(HK\$m)

2005 Budget	2005 Actual	2006 Budget
492	474	523

increase in 2006 reflects:

- 10 new posts at managerial and technical levels for
 - infrastructural development
 - reserves management
 - securities enforcement
 - anti-money laundering
 - Hong Kong-Mainland Links
- 2006 pay review
- savings in 2005 from posts unfilled through turnover



2006 Professional and other services

(HK\$m)

2005 Budget	2005 Actual	2006 Budget
29	23	45

increase in 2006 reflects:

- **infrastructural development projects, including:**
 - migration to SWIFTNet of RTGS systems and CMU
 - CMU improvements
- **consultancy for drafting of Basel II regulations**
- **specialised advice on**
 - anti-money laundering policies
 - industry accounting guidelines