(Translation)

Panel on Financial Affairs of the Legislative Council

Briefing on the work of the HKMA by The Chief Executive of the HKMA on 28 April 2008

<u>Introduction</u>

1. Mr Chairman and Members, in my briefings on the work of the HKMA to the Panel on Financial Affairs over the past year I provided detailed analyses of the financial turmoil triggered by the US sub-prime problems. My aim in doing so was to help market participants to understand the risks involved better and have a greater awareness of the need to manage their risks, in the hope that this would contribute to monetary and financial stability in Hong Kong.

2. The financial turmoil triggered by the US sub-prime problems is not yet over. The credit crunch stemming from it has already done considerable harm to the US economy. But our monetary and financial systems remain intact and are not experiencing any systemic problems during these difficult times. Increased volatility and particularly big adjustments in the stock markets clearly make the market riskier, causing jitters among investors. But volatility and adjustments are things that we expect in financial globalisation, and as I have pointed out before, investors should always manage their risks properly.

<u>Credit crisis</u>

3. After months of hard work on the domestic and international fronts by the monetary authorities, the credit crunch in the US and European markets triggered by the US sub-prime crisis seems to have eased since the beginning of the second quarter. After reaching historical highs in the first quarter due to panic selling, the risk premiums have come down. With the encouragement and help of the regulatory

authorities, financial institutions have made write-offs and provisions, increased transparency in disclosing their problem assets and received additional capital. These decisive moves have helped improve their financial viability and maintain confidence in the credit market.

4. But the situation in the US and European credit markets is still far from normal.

5. First, the US Federal Reserve is still injecting large amounts of liquidity into the money market; has substantially expanded the types and credit ratings of assets accepted for collateralised lending; has lengthened the term of liquidity funding; and is now willing to help non-bank financial institutions, despite the risk of moral hazard of this unprecedented move. All these actions were taken to restore order in the financial markets. In Europe, the Bank of England and the European Central Bank are making similar moves.

6. Secondly, some key areas of the debt market such as securitisation, especially mortgage-backed securities, are still in the doldrums. This affects the functioning of financial intermediation through the debt channel.

7. Thirdly, the banking sector is filled with a sentiment of risk aversion and financial de-leveraging because of fear arising from the sub-prime crisis. Although the costs of credit (interest rates) are already very low after the Federal Reserve has cut them several times, and may continue to do so, the supply of credit through the banking channel is still tight.

8. Fourthly, the credit crunch affects the stock market’s performance and thwarts new listing plans.

9. Fifthly, reduced effectiveness in the various financial intermediation channels will dampen asset prices and hurt the economy. A credit crunch spill-over

to the general economy increases the risk of recession.

10. Sixthly, with clear imbalances in the US housing market, prices are likely to adjust further downwards. Defaults may increase[1] and the quality of mortgage-related assets might worsen, possibly creating more pressure on financial institutions.

11. Given the close relationship between the credit sector and general economy, it will take some time before we can see some overall improvement. Hopefully the probability of sudden and threatening crises should be low. Preliminary consensus has also been reached in the international community on measures to tackle the medium- to long-term structural issues. Many recommendations have been proposed. Among these recommendations, those of the Financial Stability Forum (FSF) are the most comprehensive. Endorsed by the G7, the FSF's recommendations should help strengthen the global financial system and confidence in the financial markets.

12. The FSF's recommendations cover five main areas: 1) strengthening prudential oversight of capital, liquidity and risk management; 2) enhancing transparency and valuation; 3) changes in the role and uses of credit ratings; 4) strengthening the authorities' responsiveness to risks; and 5) robust arrangements for dealing with stress in the financial system.

13. The HKMA, as a member of the FSF, supports these recommendations. I presented our analyses and views on why the credit crisis happened. I have also expressed these views publicly before. I think securitisation is still useful in transferring credit risk. But financial innovation in a free market often creates distortions, the so-called "twisted incentives", such as the lowering of lending

[1] The delinquency ratio (percentage of loans that have been overdue for more than 90 days) of the US mortgage market in the last quarter of 2007 was 3.62%, in which the delinquency ratios of sub-prime mortgages and sub-prime mortgages with adjustable rates were 14.4% and 20% respectively. In Hong Kong, the 90-day delinquency ratio peaked at 1.43% in April 2001.

standards. It created a large number of substandard financial products, which were exported to other parts of the world under the influence of globalisation. Twisted incentives are at the root of global systemic problems as well as substandard financial products.

14. Fortunately, Hong Kong's banking system does not have sub-prime-related systemic problems. The HKMA and the banking industry have been working well together to ensure that financial institutions continue to adopt prudent lending standards. Occasionally we might see some "innovative" market practices, probably because of severe market competition. But they are isolated cases and have been properly dealt with already. In Hong Kong, the use of securitisation to transfer credit risk is not widespread. And with the lead of the Hong Kong Mortgage Corporation, securitisation business in Hong Kong is prudent and well organised. Securitisation has not created twisted incentives and related systemic problems in the financial markets, and it is unlikely to do so in future.

15. The HKMA started studying the FSF's recommendations as soon as they were released. As far as those that have implications for the HKMA's supervisory regime are concerned, we have established our stance and approach. We also maintain communication with other regulatory bodies through the Financial Stability Committee of the HKSAR Government to help implement the recommendations. We will consult the industry as usual before implementing any recommendations in Hong Kong. Reform is a long process and there are still many issues to be addressed, such as risk management for liquidity and capital adequacy requirements for securitisation. The details of these subjects will be discussed at the working groups of the Basel Committee before any international consensus is reached. The HKMA will continue to contribute to the international forums and committees to ensure that the implementation of any recommendation will suit Hong Kong and help maintain stability in the international financial markets.

16. The financial environment in Hong Kong has become very complex,

directly or indirectly as a result of the credit crunch in the US and Europe. Not only did we see high volatility, but also an easing of monetary conditions because of the weakening of the US dollar and the repeated rate cuts in the US. While exchange rates and interest rates are not the main factors in the inflation now facing us, they do add inflationary pressure on consumer and asset prices. I will now turn to the other areas of work of the HKMA and share with you our views on a number of financial issues. We hope this would help market participants to manage their risks during these difficult times.

Exchange-rate stability

17. The monetary policy objective in Hong Kong has been clearly laid down by the Financial Secretary of the HKSAR Government as maintaining a stable external exchange value of the currency of Hong Kong, at HK$7.80 to US$1 under the Linked Exchange Rate System. After a quarter of a century of operation, the Link is still serving Hong Kong well in this rapidly changing global financial environment. It helps create a stable business environment in our highly externally oriented economy. Occasional problems do occur but they are short-lived and happen only under extraordinary circumstances. For example, US monetary policy may not always be appropriate for our macro-economy. But these difficulties are not good reasons for changing our long-term monetary policy. Also a slowdown or recession in the US will sooner or later affect its trading partners through the trade and other channels. So the misalignment should not last very long.

18. The market has shown strong confidence in the HKSAR Government's commitment to the Link. Despite short-term weakening of the US dollar, strengthening of the renminbi and inflation in the local economy, the Hong Kong dollar has remained stable. In the three months since my last report to the Panel, the Hong Kong dollar has stayed within the Convertibility Zone, requiring no market operations to be conducted by the HKMA. Of course, we will continue to carefully manage market expectation by responding to comments or views on the Link when necessary. We will also continue to offer our analyses of the changes happening in

the global financial markets.

19. The stability of the Hong Kong dollar against the US dollar reflects the balanced supply and demand in the spot market. But this does not mean that all is well. The supply and demand of the Hong Kong dollar in the non-bank sector was affected by the problems mentioned in my presentation. We saw speculative positions taken in the forward market, betting on the rumoured de-linking of the Hong Kong dollar and the resulting appreciation of the currency. The two-year forward discounts have widened from about 800 pips three months ago to about 1,100 pips. But carry trades betting on the maintenance of the Linked Exchange Rate system soon kicked in, offsetting the majority of the speculative positions betting on appreciation and restoring stability in the forward market.

20. The HKMA will remain vigilant and will continue to manage market expectation to maintain stability in the foreign-currency market.

Inflation

21. It is not possible for the HKMA to use monetary policy tools to control inflation under a fixed exchange-rate system. Some people have said that the Link is to blame for the inflationary trend because the weakening of the Hong Kong dollar, alongside the US dollar, makes the import prices more expensive. I have given my views on this on many occasions and shared with the public the findings of our studies on this subject. The exchange rate is not the major factor behind inflation. I would like to make several key points here.

22. First, inflation is a global problem partly caused by the imbalance in the supply and demand of certain food items, especially those affected, directly or indirectly, by the development of bio-fuels. As an externally oriented economy, Hong Kong will not be immune to these developments. In fact, every country in the world is affected, whether they use flexible or fixed exchange-rate systems.

23. Secondly, since Hong Kong is a highly externally oriented economy, the exchange rate pass-through to consumer prices is naturally higher than in economies that are less externally oriented. But our studies show that the pass-through coefficients are lower than we expected. For example, a 10% depreciation of the US dollar against all currencies other than the Hong Kong dollar would cause the inflation rate in Hong Kong to increase by only 0.8 percentage points in the short run and 1.6 percentage points in the medium run. A 10% appreciation of the renminbi against the US dollar would increase Hong Kong's inflation rate by 0.4 percentage points in the short run.

24. Thirdly, the inflation now facing Hong Kong is mainly caused by domestic factors such as higher rents. As the economy continues to grow and unemployment rate is low, domestic demand remains strong, which contributes to the inflation. Unit labour cost began to rise since last year, causing production costs and the inflation rate to rise. I hope productivity can maintain its fast growth so that it could alleviate some inflationary pressures.

25. Fourthly, let's not forget that using monetary tools to control inflation would be costly. The costs include the abandonment of the hard-earned 25 years of exchange-rate stability; higher interest rates that would suppress consumption, increase the burden of servicing mortgages, and increase funding costs for businesses; suppression of overall domestic demand; and fewer employment opportunities. We should all be alert to these.

26. Fifthly, of Hong Kong's two largest trading partners, China and the US, one is stepping up macro-economic adjustments to cool its overheating economy and suppress inflation, while the other is in the middle of a credit crisis and is facing a recession. These developments will reinforce the expectation that the growth in Hong Kong's overall demand will slow, which will hopefully help reduce the inflationary pressures.

Banking Sector

27. Let me now turn to the performance of the banking sector. Risk-based supervision, prudent banking practices, adequate capital and liquidity have contributed to a robust banking sector, enabling it to respond to the credit crunch in the US and Europe triggered by the US sub-prime crisis. However, as the crisis is still unfolding, local banks still have problem assets arising from the crisis to deal with. But we are confident that the crisis has not created any systemic problems to Hong Kong's banking sector, and we believe banks in Hong Kong are capable of dealing with their own problems.

28. The Basel Committee will study the issues concerning banking supervision unveiled by the US sub-prime crisis and explore ways to improve the situation. The HKMA will participate in the discussions on a number of levels. The monetary and financial stability of Hong Kong, as an international financial centre, is not immune to developments in international finance. It is therefore important for the international community to hear our views.

29. First, Basel II, which has been implemented in Hong Kong and some other developed economies, provides a risk-based framework to address the problems now facing us. We should continue to support it and implement it globally.

30. Secondly, Basel II does have its own shortcomings in certain areas and adjustments should be made. For example, consideration should be given to whether capital requirements for structured products and off-balance sheet activities should be increased.

31. Thirdly, credit-risk transfer through securitisation should be encouraged because, in theory, securitisation enables the matching of borrowers' credit risk and investors' risk appetite, making financial intermediation more efficient. But one should be aware of the emergence of "twisted incentives". There is, in the short run at least, a certain degree of conflict between the private interest of financial

intermediaries trying to make as much profit as possible and the public interest of making financial intermediation more efficient. Twisted incentives are at the root of structural problems in the financial system. The erosion of underwriting standards in the US mortgage market is a good example. Regulators must therefore keep pace with financial innovation and have to stand firm if necessary. In Hong Kong, for example, we insist on continuing to implement the 70% loan-to-value ratio to prevent structural problems emerging in the financial system.

32. Fourthly, liquidity-risk management is crucial to the stability of the banking sector on both the institutional and systemic levels, particularly when the sector is facing unexpected internal or external shocks. This has always been one of the priorities in our supervisory work. The HKMA has, from time to time, reviewed the adequacy of banks' liquidity-risk management and their back-up liquidity plans, and the effectiveness of the Lender-of-Last-Resort mechanism. Adding these to the implementation of the Deposit Protection Scheme and regular stress testing, we believe liquidity risk should not be a big problem in Hong Kong. But globalisation has made international financial centres such as Hong Kong particularly vulnerable to the contagious effect of liquidity risk. We should therefore encourage the international community to reach a consensus on approaches to banking supervision.

33. Fifthly, we share the views that banks should improve transparency by making forward-looking disclosures and provisions. This will help the market to monitor their performance and understand their financial positions better. But we do realise that the accepted international accounting standards are more backward-looking, emphasising the accuracy of disclosure of a snap-shot position. So making forward-looking provisions in the financial statements may not be practicable. We hope the international accounting community and the Basel Committee can reach a consensus on this and remove this discrepancy as soon as possible. Meanwhile in Hong Kong, we require banks to earmark a forward-looking "regulatory reserve" for known or expected events after the balance-sheet date.

34. The review of the HKMA's work on banking stability by Mr David Carse is progressing well. The report is expected to be completed by the middle of the year. Mr Carse agrees that references should be made to the proposed reform measures put forward by the UK, the US and other international organisations following the sub-prime crisis. The HKMA will formulate a policy response after we have received Mr Carse's report.

35. The banking sector continued to function smoothly in the past three months. One development worth noting is the sharp increase in renminbi deposits and a number of banks offering Mainland renminbi deposit account services to their customers in Hong Kong, as Hong Kong-dollar deposit rates remain low, the renminbi continues to appreciate and the local stock market has not been performing well. The total amount of renminbi deposits in Hong Kong increased by 72% in the first quarter of this year, reaching RMB57.6 billion at the end of March. The amount represents only 1.1% of Hong Kong's total deposits or 2.2% of total Hong Kong-dollar deposits, and therefore will not affect the status of the Hong Kong dollar. According to the Agreement for Settlement of Renminbi Banking Business in Hong Kong, each person is allowed to convert RMB20,000 a day. So Hong Kong residents' demand for renminbi as a medium for storage of wealth will be limited, and it will not affect the Hong Kong dollar exchange rate. All new renminbi deposits, whether they are depositors' own funds or newly exchanged renminbi, received by the participating banks will be placed through the clearing bank with the Shenzhen Branch of the People's Bank of China. These renminbi deposits will not enter the Mainland's financial system directly. In other words, the increase or decrease of renminbi deposits in Hong Kong will not affect the money supply on the Mainland and therefore sterilisation is not needed.

36. Because renminbi deposit rates on the Mainland are higher than both renminbi deposit rates and Hong Kong dollar deposit rates in Hong Kong, and the difference is widening, placing renminbi deposits on the Mainland has become more attractive than holding them in Hong Kong. Some Hong Kong residents have

opened renminbi deposit accounts on the Mainland. Estimating from the amount of renminbi remittances into the Mainland, the total amount of Hong Kong residents' renminbi deposits on the Mainland is not large. Remittance of RMB 1 to 2 billion each month represents only 0.2% of the average monthly total increase in renminbi saving deposits on the Mainland in the past few months. It will not put pressure on monetary management on the Mainland. Development of renminbi business in Hong Kong provides a robust testing ground for the gradual move towards renminbi convertibility for capital-account items. Market information obtained in our free-market environment is a useful reference for financial liberalisation on the Mainland.

37. The HKMA has requested the participating banks to observe the requirements of the Agreement for Settlement of Renminbi Banking Business in conducting renminbi banking business. If they assist their customers to open accounts on the Mainland, they should make sure they observe the laws and regulations in Hong Kong and on the Mainland. They should also make sure their customers understand the limitations and risks of the deposit arrangements, such as the limitation on and the exchange-rate risk of remitting the deposits from the Mainland back to Hong Kong. Banks should not hesitate to seek advice from the authorities on the Mainland about the detailed procedures of their renminbi banking services if needed.

38. The HKMA recently made known its supervisory stance about banks providing or participating in mortgage arrangements with "principal repayment holidays." Our move has attracted some attention. Some people said that as long as the 70% LTV ratio is observed, the HKMA should not get itself involved in the detailed arrangements of mortgage loans given by banks. We do not agree with this view. First, we do not want to see sub-prime mortgages in Hong Kong. We do not want banks to involve themselves in offering sub-prime mortgages even though their exposure would be limited to 70% of the value of the collateral. The sub-prime crisis in the US has proved we are right in insisting on this supervisory policy. In theory,

financial innovation enables risks arising from sub-prime mortgages to be transferred away from the banking system. But the experience in the US has shown that this may not be true. When the financial system is under stress, these risks will inevitably be transferred back to the banking system. Mortgages with "principal repayment holidays" will attract home-buyers who might not be otherwise able to service their debts to apply for mortgage loans. These mortgages will definitely stimulate the property market in the short run, and they will make the market more volatile in the long run. When the market turns south, there will be more defaults, more repossessed properties, and more mortgages in negative equity. The stability of the banking system will be threatened. The HKMA's supervisory stance is not affected by the performance of the property market. The HKMA will not, and should not, comment on the property market.

39. The utilisation rate of Internet banking services in Hong Kong has been rising steadily in recent years. The two-factor authentication introduced by the banking sector in 2005 has further improved Internet banking safety. Fraudulent cases decreased sharply after the launch of this facility. To further improve Internet banking safety, the HKMA in the second half of 2007 requested banks to provide SMS notification services for high-risk transactions to their customers to alert them of unauthorised Internet transactions. But we understand from overseas regulators and banks in Hong Kong that the number of fake emails and fraudulent bank websites is on the rise. In some reported cases, the bank customers provided sensitive personal information such as user names, identity numbers or even passwords to third parties, believing the fake bank websites were genuine. I would like to take this opportunity to remind members of the public that they should not provide sensitive information to third parties, either through emails or hyperlinks. Banks should not, and will not, ask their customers to provide sensitive information such as passwords or account details through e-mails or over the telephone. Internet banking users should also install anti-virus and firewall software and use the SMS notification service mentioned above, and check their transaction records frequently.

40. Because of time constraints, I will skip the parts on the HKMA's work in assisting the HKSAR Government to maintain Hong Kong's status as an international financial centre and in developing Hong Kong's financial infrastructure. The *2007 HKMA Annual Report* was published on 18 April and was distributed to all Members of the Legislative Council with the help of the Secretariat on the same day. I am happy to answer any questions on these parts.

<u>Exchange Fund</u>

41. Lastly, I would like to report on the management of the Exchange Fund. When I briefed the Panel in January, I pointed out that the investment environment in 2008 would be difficult and the sharp adjustment in global stock markets at the start of 2008 would affect the investment income of the Exchange Fund this year. After achieving a record investment return of $142.2 billion in 2007, the Exchange Fund recorded an investment loss of $14.6 billion in the first quarter of 2008.

42. The loss mainly came from Hong Kong and overseas equities, amounting to $30.0 billion and $22.4 billion respectively. We are pleased to report that investment incomes from foreign exchange and bonds amounted to $12.2 billion and $25.6 billion respectively, partly offsetting the losses in equities. The loss of $14.6 billion in the first quarter represented less than 1% of the total assets of the Exchange Fund of around $1.5 trillion, proving the conservative investment strategy of the Exchange Fund has helped reduce the impact on the overall performance of the Fund at a time of turbulence.

43. The investment loss recorded by the Exchange Fund in the first quarter will not affect the investment income earned by the fiscal reserves placed in the Exchange Fund. Since April 2007, after the approval of the Financial Secretary, a new fee arrangement has replaced the sharing arrangement between the fiscal reserves and the Exchange Fund. The annual fee paid to the fiscal reserves is a fixed rate calculated as the six-year moving average annual rate of return of the Investment Portfolio of the Exchange Fund. In calculating the fee rate for 2008, the investment

returns for 2002 to 2007 are used. Because 2001, which was a bad year with low investment return, is taken out while 2007, a good year with a high return, is included, the average annual rate of return for the six years from 2002 to 2007 increases to 9.4% and the budgeted fee for 2008 exceeds $40 billion. The actual rate of return of the Investment Portfolio of the Exchange Fund in 2008 will not affect the amount the fiscal reserves will receive. The fee arrangement enables the fiscal reserves placed with the Exchange Fund to achieve a more stable and predictable return.

44. The investment objectives of the Exchange Fund are set based on the statutory purposes of the Fund set in the Exchange Fund Ordinance. To achieve these objectives, a long-term horizon and investment strategy are adopted. So it is not unusual for the Exchange Fund to suffer short-term losses at a time when the financial market is so volatile. This explains why the more short-term sharing arrangement has now been replaced by a longer-term fee arrangement, with reference made to the six-year moving average annual rate of return in determining the amount paid to the fiscal reserves. I hope the investment performance of the Exchange Fund can be judged on a long-term basis. We will, of course, continue to try our best to manage the Exchange Fund according to the strategy approved by the Exchange Fund Advisory Committee.

45. Mr Chairman, this is my report on the work of the HKMA. My three Deputies and I will be happy to answer questions from Members.