

HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council

Panel on Financial Affairs

11 January 2001

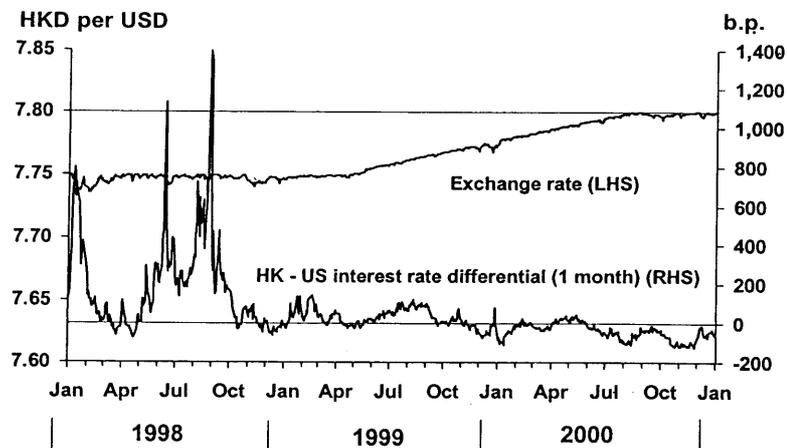
DISCUSSION TOPICS

- **Currency**
- **Banking**
- **Financial Infrastructure**
- **Exchange Fund**
- **HKMA Accountability**

- This presentation covers the four main responsibilities of the Hong Kong Monetary Authority (HKMA):
 - to maintain **currency** stability, within the framework of the linked exchange rate system;
 - to promote the safety and stability of the **banking** system;
 - to develop and enhance the **financial infrastructure**, particularly in relation to payment and settlement arrangements; and
 - to manage the **Exchange Fund** in a sound and prudent manner.
- It also explains the importance placed by the HKMA on enhancing the transparency and accountability of its work, and the efforts made to achieve this.



CURRENCY - Exchange Rate



- The monetary policy objective of the HKMA is to maintain exchange rate stability. The **exchange rate** was remarkably stable during 2000. On 12 August 2000, the two exchange rates of the Convertibility Undertakings for the Certificate of Indebtedness and the Aggregate Balance converged at 7.80.
- Interbank **interest rates** also remained stable in 2000. Following the Asian crisis and the implementation of the seven technical measures in 1998, the Hong Kong dollar interest rate premium came down considerably. At the short end (up to two years' tenor), the Hong Kong dollar interest rates actually fell below the US dollar interest rates, reflecting confidence in the Hong Kong dollar.
- The EFAC Sub-Committee on Currency Board Operations will continue its work to oversee the operation of the currency board arrangements, and, where appropriate, consider measures to further strengthen the monetary system.

CURRENCY - Vulnerabilities

- **US economic outlook**
- **Volatility of major currencies**
- **Financial reform in Asia**
- **Argentina**
- **International financial architecture**

- There continue to be risks and vulnerabilities in the environment, mainly external, that may have an adverse impact on the stability of the Hong Kong dollar:
 - **US economic growth continues to show signs of moderation.** During the third quarter, real GDP (annualised) in the US eased to a four-year low of 2.2%. The US leading indicators, industrial output, retail sales, and new home sales all declined in November. The NAPM index fell almost uninterrupted for one full year. Consumer confidence dropped to a 24-month low in December. While a soft landing remains a more likely scenario, the risk of a hard landing appears to have increased.
 - **Major currencies have remained highly volatile.** After hitting a historical low of 0.8248, the euro has bounced back to 0.96 (16% rise) in recent weeks with the weakness in the US economy. The yen, on the other hand, has weakened from 110 to 116 in the past four weeks as Japan's economic prospect remains uncertain. Currency markets continue to be prone to volatile shifts in sentiment. Given the convergence of growth and interest rates between the US and the euro region, capital flows may reverse to address the imbalance between the US dollar and the euro. There could be unsettling effects on the global financial markets, depending on the magnitude and speed of the adjustment.

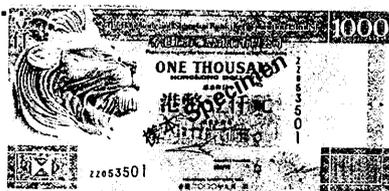
- **The structural reforms in Asia have been progressing slowly.** Some economies have slowed the pace of reform in the wake of economic recovery, while others are hit by political problems which have hindered the reform process. Some regional currencies have shown weaknesses caused mainly by their own particular problems. So far, we have not seen any contagion effects on other regional financial markets. But any prolonged uncertainty in the region could potentially have a knock-on effect on Hong Kong.

- **Argentina, the other sizable economy operating a currency board system, has recently experienced a crisis in public finance and external payment flows,** caused mainly by a weak fiscal position and large external debt. The crisis subsided after the announcement by the IMF of a rescue package on 18 December 2000. Hong Kong has so far been unaffected by the crisis, because trade links between the two economies are limited and partly because financial market participants are increasingly able to differentiate the two currency board systems, which rest on very different fundamentals. We will continue to closely monitor the situation.

- **Reforms to the international financial architecture have not gone very far.** With the memories of the Asian crisis fading, the momentum for reform has slowed. We shall continue to support international efforts in this area and push for early implementation of measures that have been agreed. But small, open economies will remain vulnerable to volatile international capital flows.



CURRENCY - Banknotes



- **New security features to be applied to BoC and SCB \$1,000 banknote**
 - **Longer term review**
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- The **HSBC \$1,000 banknote** with three new security features was introduced on 18 December 2000. So far, the new banknote accounts for about 30% of all HSBC \$1,000 banknotes in circulation.
 - New security features will also be applied to the **\$1,000 banknote of both Bank of China and Standard Chartered Bank**. Design work is already underway.
 - The HKMA is conducting a **longer term review** on the security features and design of the next generation banknotes. The HKMA has already appointed a consultant to give advice on the review.

| BANKING – System Robust | | | |
|---|-------------|--|--------------------------|
| | <u>1998</u> | <u>1999</u> | <u>2000</u> |
| Growth of operating profit before tax (yoy % change) | -32.9% | +15.2% | +45.7% <i>(Q1-Q3)</i> |
| Growth of bad debt charge (yoy % change) | +335.1% | +0.2% <i>(Q1-Q3)</i> | -54.8% |
| Classified loans as % of total loans | 7.33% | 9.81% <i>(peaked at 10.33% in Sep 99)</i> | 7.72% <i>(Sep 00)</i> |
| Capital Adequacy Ratio | 18.5% | 18.7% | 18.7% <i>(Sep 00)</i> |
| Liquidity Ratio | 45.7% | 44.5% | 50.2% <i>(Sep 00)</i> |

- The banking sector has remained robust and healthy.
- Aggregate **profits** of local banks continued to show strong growth as the economy and operating conditions improved in 2000. Pre-tax operating profits grew by 45.7% in the first nine months, a sharp rise compared with the 15.2% in 1999. The strong growth was mainly attributed to a significant drop in bad debt charge and increases in net interest and fee income.
- The **asset quality** of local banks continued to improve slowly. The bad debt charge for local banks fell by 54.8% in the first nine months of 2000. Classified loans (loans classified as substandard, doubtful and loss) declined to 7.72% in September 2000, from the peak of 10.33% recorded in September 1999.
- The asset quality of the **mortgage** portfolio remained good in 2000. The delinquency ratio rose slightly to 1.31% in November 2000, compared with 1.13% at end-1999. But this is still very low and not a major cause of concern.
- Banks remain **well capitalised** and **highly liquid**, as shown by a capital adequacy ratio of 18.7% and a liquidity ratio of 50.2% in September 2000.

BANKING - Reform Measures

- **Depositor Protection**
- **Commercial Credit Reference Agency**
- **Interest Rate Deregulation**
- **Consolidation**
- **Code of Banking Practice**
- **Consumer Issues (?)**

- The HKMA has been introducing a number of banking reform measures aimed at increasing the competitiveness and strengthening the soundness and robustness of the banking system:
 - The public consultation on **depositor protection** will come to an end on 17 January 2001. So far there seems to be general support for the introduction of a deposit insurance scheme, including an expression of support by the LegCo, although some big banks remain opposed to the idea. We shall carefully review all submissions and views collected during the consultation. If it is decided that a deposit insurance scheme should be introduced, we shall work out details of the scheme and conduct further consultations in due course.
 - The public consultation on the proposed establishment of a **Commercial Credit Reference Agency (CCRA)** ended on 15 September 2000. There is general support for a CCRA, although views vary on whether participation should be mandatory or voluntary and on whether it should be publicly or privately owned. The HKMA has established a working group, comprising representatives of the banking industry, the SME sector and the Privacy Commissioner's Office, to consider details of the proposed scheme.

- Subject to the economic and financial environment not being unfavourable, the final phase of **interest rate deregulation** will take place at the start of July 2001, involving the removal of the remaining interest rate rules on savings and current accounts. We will monitor closely the effect that this has on interest rates and on banks' deposit base and profitability.
- With technological advancement and rising competition, it is becoming increasingly hard for small banks to operate in the banking markets. We have therefore been encouraging banks to consider the need for **consolidation**. We are beginning to see results. The Bank of China has announced a restructuring plan which involves the merger of its sister banks into one entity to be incorporated in Hong Kong. The Bank of East Asia has also announced plans to acquire the First Pacific Bank. We will continue with these efforts - not to mandate "forced marriages", but to advocate publicly the idea of consolidation and to put it on the agenda for consideration by those concerned.
- With the completion of interest rate deregulation, the banking environment will become more competitive, but there is also a likelihood that some fees and charges may increase. It has therefore become even more important to ensure that banks operate in a fair and transparent manner. We are in the process of reviewing the **Code of Banking Practice**, which sets out the minimum standards expected of banks in dealing with their customers. The section relating to credit cards has been completed and will be formally issued shortly. The review of the remaining chapters, including those relating to the fees and charges, is well underway.
- It is clear that with a more competitive banking sector, there is an increasing need to address the issue of **protection of banking consumers**. Under the Banking Ordinance, the objective of the HKMA is to provide a measure of protection to depositors and promote the general stability and effective working of the banking system. There is not a clear legal mandate for the HKMA to function as a consumer watchdog and, indeed, such a role may be inconsistent with our role as prudential supervisor. We plan therefore to review the need for a more explicit mandate for the HKMA to deal with consumer issues, and if so, the resource implications.

BANKING - Draft Legislation

- **Banking (Amendment) Bill No. 1**
 - ⇒ **Companion to Securities and Futures Bill**
- **Banking (Amendment) Bill No. 2**
 - ⇒ **Approval of Managers – still in consultation with banking industry**

- The HKMA currently has two legislative initiatives that are being processed:
 - **Banking (Amendment) Bill No. 1** - the Bill has recently been introduced into the LegCo. It proposes a number of changes to the Banking Ordinance relating to the securities business of Authorised Institutions (AI). These changes correspond to the new licensing regime for securities firms being introduced under the Securities and Futures Bill.
 - **Banking (Amendment) Bill No. 2** - the Bill is **still in the course of preparation, including consultation with the banking industry**, and has therefore not yet been introduced into LegCo. It contains a variety of provisions relating to, among other things, advertisements for deposits placed on the Internet, the Monetary Authority's powers of control over AIs' places of business, and the definition of and approval of AIs' senior management. On the latter, the Bill contains provisions that
 - refine the definition of "manager" as a person, other than a director or chief executive of the AI, who is appointed by the AI to be principally responsible for the conduct of the principal business areas of the AI;
 - require the AI to notify the HKMA of appointments; and
 - provide for the HKMA to consider these appointments.

FINANCIAL INFRASTRUCTURE

- **Money Payments** ⇒ **HKD system well established**
⇒ **USD system introduced**
- **Debt Clearing** ⇒ **internationalisation**
- **Equity Clearing** ⇒ **exploring domestic linkages**
- **Retail Payments** ⇒ **internal review**

- The HKMA has spent considerable efforts to develop and enhance the financial infrastructure of Hong Kong, with a view to maintaining the integrity of the financial system and strengthening Hong Kong's position as an international financial centre:
 - **Money payments** - the Hong Kong dollar real-time gross settlement system, introduced in 1996, is now well established and efficiently run. We have replicated that payment system for the US dollar, enabling US dollar transactions to be settled real time in our time zone. It is linked up with the Hong Kong dollar payment system; in September 2000 we executed the first electronic payment versus payment transaction in world financial history between two different currencies. The US dollar payment system was fully implemented on 18 December 2000.
 - **Debt clearing** - over ten years ago we built a fully computerised and paperless debt clearing system as part of our effort to develop the domestic debt market. We have since linked that system to similar debt clearing systems in a number of other jurisdictions to facilitate cross border and cross currency investments in debt markets. We are now developing our debt clearing system further into what we call an ICSD, or international central securities depository, with the aim of pulling debt issues in the region into our system.

- **Equity clearing** - the responsibility for building this part of the financial infrastructure falls on the Hong Kong Exchanges. We have however kept in close touch with them to develop and enhance the domestic linkages between the equities clearing and the money payment systems.

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

EXCHANGE FUND - Balance Sheet end 2000

| | 1999 | 2000 | Change |
|----------------------------|------------------|------------------|---------------|
| | <i>(HK\$ bn)</i> | <i>(HK\$ bn)</i> | <i>(%)</i> |
| Assets | 1,002.8 | 1,020.8 | 1.8 |
| Deposits | 119.0 | 72.8 | (38.8) |
| Debt Securities | 601.0 | 730.1 | 21.5 |
| Hong Kong Equities | 215.3 | 150.7 | (30) |
| Other Equities | 44.1 | 40.4 | (8.4) |
| Other Assets | 23.4 | 26.8 | 14.5 |
| Liabilities | 1,002.8 | 1,020.8 | 1.8 |
| Monetary Base | 234.4 | 215.4 | (8.1) |
| Fiscal Reserves | 392.2 | 417.1 | 6.3 |
| Other Liabilities | 85.3 | 81.2 | (4.8) |
| Accumulated Surplus | 290.9 | 307.1 | 5.6 |

- The total assets of the Exchange Fund grew by 1.8% to HK\$1,020.8 bn at the end of 2000.
- The foreign currency reserve assets of Hong Kong at the end of 2000 stood at US\$107.5 bn. In terms of foreign currency reserves ranking, Hong Kong is now the world's third largest holder of foreign currency reserves, after Japan and Mainland China.

EXCHANGE FUND - 2000 P & L

| | 1999 <i>(HK\$ bn)</i> | 2000 <i>(HK\$ bn)</i> |
|---|--------------------------|--------------------------|
| Gain / (Loss) on HK equities | 90.1 | (11.6) |
| Exchange loss | (9.9) | (11.2) |
| Investment gains on bonds, etc | 23.6 | 67.4 |
| | <hr/> | <hr/> |
| Investment income | 103.8 | 44.6 |
| Other income | 0.2 | 0.2 |
| Interest and expenses | (10.0) | (10.5) |
| | <hr/> | <hr/> |
| Net investment income | 94.0 | 34.3 |
| Treasury's share | (45.4) | (18.1) |
| | <hr/> | <hr/> |
| Increase in EF accumulated surplus | 48.6 | 16.2 |

- Despite the very difficult investment environment, the Exchange Fund recorded a modest profit for 2000.
- With a net fall recorded in the Hang Seng Index for 2000, there was a loss of HK\$11.6 bn on the Hong Kong equity portfolio.
- Notwithstanding the late rally at the end of 2000, the exchange rate of the euro against the US dollar, and hence against the Hong Kong dollar - the accounting currency of the Exchange Fund - experienced a net depreciation of 8% for 2000. The yen also weakened significantly during the year. The exchange loss, mainly in the euro and the yen, amounted to HK\$11.2 bn for 2000.
- We have done well in the bond market, strategically positioning ourselves, along the yield curve of US Treasuries, to limit the adverse effect of the interest rate hikes in the first half of the year and to benefit from the favourable conditions in the second half. We also benefited from the buy-back of US Treasuries by the US government as its budget ran into surplus, and this buoyed bond prices. The interest income and investment gains amounted to HK\$67.4 bn. This more than offset the book loss incurred in Hong Kong equities and the exchange loss to produce an overall investment income of HK\$44.6 bn.
- Adding the other income and deducting the usual interest expenses (as quite a large part of the assets of the Exchange Fund represents borrowed money) and other expenses which amounted to HK\$10.5 bn, the net investment income amounted to HK\$34.3 bn.

- The fiscal reserves share in this net investment income, and in its volatility, on the basis of sharing arrangements effective from April 1998. Out of this HK\$34.3 bn, HK\$18.1 accrues to the fiscal reserves, leaving HK\$16.2 bn to be added to the accumulated surplus of the Exchange Fund.
- But it is still far too early to tell what the investment income for the fiscal reserves, and its implications for the budget, for the financial year 2000-2001 might be. There are still three more months to go, and in present day financial markets, a lot can change in three months.

| | |
|--|--|
| EXCHANGE FUND - HK Equity Portfolio | |
|--|--|

| | <i>(HK\$ bn)</i> |
|--|------------------|
| Investment in August 1998 | 118.1 |
| Income from Disposal and Dividends | 101.6 |
| | <hr/> |
| Shortfall on original outlay | 16.5 |
| Valuation of Remaining Portfolio (end 2000) * | 150.7 |

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

- The Hong Kong equity portfolio continues to remain substantial relative to the size of the Exchange Fund as a whole. We invested HK\$118.1 bn in August 1998. Through the offer of the Tracker Fund and the subsequent well established mechanism of the Tap Facility, we managed to dispose of a substantial portion of Hong Kong stocks without any noticeable effect on the market. With a total income of HK\$101.6 bn from disposal and dividends, we now have a shortfall of only HK\$16.5 bn on the original outlay.
- At the end of 2000, we still had HK\$150.7 bn in Hong Kong stocks. This included the Hong Kong equities transferred from the Land Fund in 1998, which was valued at HK\$9 bn at the time of transfer.
- Of the remaining Hong Kong equity portfolio, we intend to keep only around HK\$50 bn, in accordance with the investment guideline of the Exchange Fund. The Exchange Fund Investment Limited will continue to manage the disposal of the excess in an orderly way with minimal disruption to the market, just as it has done with the disposal so far.

HKMA ACCOUNTABILITY

- **Open and transparent**
- **Comprehensive publications**
- **Detailed briefings**
- **Community outreach**

- The HKMA believes strongly that confidence in our policies rests on openness and transparency in what we do.
- The HKMA continued in 2000 to develop and expand its educational programmes and its contacts with the community. We improved and relaunched our website, produced a video introduction to the HKMA, and issued a number of new or revised publications, including an education pack designed for students.
- In the past year, we continued to make special efforts to brief legislators, district councillors and other community representatives on our work, both through formal presentations and discussions and through informal meetings and visits. We look forward to continuing our productive and helpful contacts with Legislative Councillors and other community leaders.
- In 2000, a major exhibition, 'Money in Hong Kong' toured three large shopping centres during the summer and attracted more than 70,000 visitors. The exhibition was accompanied by interactive programmes, presentations on banknote security features and the history of money, and a radio quiz. Our school education programme also covered around 4,500 secondary school students and their teachers.

- In 2001 we shall continue with these various projects and seek to foster greater interest and confidence in our work. Building on the success of last year's project, we plan to stage another major exhibition in the summer. In view of the growing use of our website, we also intend to focus on developing web-based publications.