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## INFORMATION NOTE

### **Responses to the comments made by Professor Charles Goodhart on the research report "The Governance of the Hong Kong Monetary Authority and Comparable Authorities in Hong Kong and Overseas Jurisdictions"**

#### **1. Background**

1.1 The Panel on Financial Affairs (the Panel), at its meeting on 2 June 2003, requested the Research and Library Services Division (RLSD) to respond to the comments made in Professor Charles Goodhart's<sup>1</sup> submission on the research report entitled *the Governance of the Hong Kong Monetary Authority and Comparable Authorities in Hong Kong and Overseas Jurisdictions*<sup>2</sup> (the research report) regarding the research report's accuracy. This information note sets out RLSD's responses to such comments made by Professor Charles Goodhart.

#### **2. Responses to the comments made by Professor Charles Goodhart**

##### Management of foreign exchange reserves

2.1 Professor Charles Goodhart stated that:

*"Although the Treasury owns the reserves in UK [the United Kingdom] and USA [the United States of America], it does not manage them, (108.9 is incorrect on this, as in several other comments on UK and USA). The overall strategy, including decisions to intervene, are set by Government and Treasury, but the actual market operations, the tactics, and day-to-day management are run by the professional FX [foreign exchange] market operators in MA/CB [monetary authority/central bank]..."<sup>3</sup>*

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<sup>1</sup> For details, please see Professor Charles Goodhart's submission entitled *The Governance of the Hong Kong Monetary Authority (HKMA)*, LC Paper No. CB(1) 1788/02-03(06).

<sup>2</sup> The research report entitled *The Governance of the Hong Kong Monetary Authority and Comparable Authorities in Hong Kong and Overseas Jurisdictions* was published by the Research and Library Services Division of the Legislative Council Secretariat on 30 April 2003, RP04/02-03.

<sup>3</sup> Professor Charles Goodhart, *The Governance of the Hong Kong Monetary Authority (HKMA)*, LC Paper No. CB(1) 1788/02-03(06), page 3.

2.2 Paragraph 108.9 of the research report stated that:

*"The management of foreign exchange reserves and the regulation of the banking sector are performed by different authorities in overseas jurisdictions. In the US, the Department of the Treasury is responsible for managing foreign exchange reserves, while the Federal Reserve System (Fed), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC) share the task of regulating the banking sector. In the UK, HM Treasury is entrusted with managing foreign exchange reserves, whereas the Financial Services Authority (FSA) is the regulator of the financial industry..."*

2.3 RLSD would like to point out that the theme of paragraph 108.9 is that the management of foreign exchange reserves and the regulation of the banking sector are performed by different authorities in overseas jurisdictions. RLSD understands that HM Treasury in the UK and the Department of Treasury in the US are responsible for managing their respective foreign exchange reserves at the strategic level and not the operational level. In the UK, the Bank of England (the Bank) acts as HM Treasury's agent for investing the foreign exchange reserves. In the US, the Fed works with the Treasury on investing the country's foreign exchange reserves.

#### Banking supervision

2.4 Professor Charles Goodhart stated that:

*"In most countries this [banking supervision] has been carried out by MA/CB. Recently the blurring of divisions between banks and other financial intermediaries has led many countries to centralise all financial supervision, (n.b. not regulation) in a single institution, (the comment about the FSA wanting to separate prudential supervision and conduct regulation in 108.12 is not at all clear and probably incorrect)..."<sup>4</sup>*

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<sup>4</sup> Professor Charles Goodhart, *The Governance of the Hong Kong Monetary Authority (HKMA)*, LC Paper No. CB(1) 1788/02-03(06), page 4.

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2.5 Paragraph 108.12 of the research report stated that:

*"Prudential supervision and conduct regulation are two different areas of specialization and as such, the US has adopted a multiple-regulator regime under which the Securities Exchange Commission regulates securities activities and the financial regulatory authorities supervise banking activities. In comparison, the UK has opted for a single-regulator regime made possible by the enactment of the Financial Services and Markets Act in 2000, which provides for the establishment of FSA as the single regulator of all financial services. Nonetheless, the FSA is of the view that prudential supervision and conduct regulation are two different areas of specialization that should be conducted by separate bodies."*

2.6 While recognizing the single-regulator regime in the UK, paragraph 108.12 discusses the view of FSA that prudential supervision and conduct regulation refer to two different areas of specialization. The view of FSA can be referred to in the findings of the overseas duty visit of the Legislative Council Panel on Financial Affairs and the Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000, which studied the financial services in the UK and the US in April 2001. In particular, paragraphs 4.5 and 4.6 of the overseas duty visit report entitled *Report on the Financial Systems in the United Kingdom and the United States of America* stated that:

*"One of the most fundamental principles in considering how different trades are regulated is to distinguish the difference between prudential supervision and conduct regulation. Prudential supervision aims primarily at ensuring that the supervised institutions have adequate capital and liquidity to discharge their liabilities, so as to avoid a systemic crisis. Conduct regulation directs the attention to the day-to-day operations of the institutions and the compliance with the standards imposed in the relevant legislation, codes and guidelines. In the UK, the regulatory functions of the Bank of England over banking institutions were taken over by the new Financial Services Authority (FSA) through the Financial Services and Market Act (FSM Act) passed in 2000. Even the FSA is of the view that prudential supervision and conduct regulation are two different specializations that should best be conducted by separate personnel."*

*In the US, the objective of bank supervision is to maintain the safety and soundness of banks. In our meeting with the Federal Reserve Bank of New York, we observe that there is a general belief that it is more effective for central banks to be responsible for bank supervision. The focus of a bank regulator is on the potential risks to the customers. It has a duty to oversee the level of assets and the standard of management in an institution."*<sup>5</sup>

### The governance of monetary authority/central bank

2.7 Professor Charles Goodhart stated that:

*"In my view the best comparator to the MA/CB in this respect, is not so much the institutions set out in Parts 3-7, but the judiciary..."*<sup>6</sup>

2.8 HKMA has long stated that it is part of the Government. Therefore, it is appropriate to compare the governance of HKMA with that of other government departments and statutory bodies of Hong Kong. In the case of Hong Kong, the judiciary is subject to the same resources allocation mechanism as that for other Government departments, policy bureaux and Government-funded bodies, such as the Legislative Council Commission.

### Control of monetary authority/central bank expenditures

2.9 Professor Charles Goodhart stated that:

*"In the UK the BoE [Bank of England] hands over all seignorage to HMG, and is primarily financed through the interest income arising from deposits placed with it — for just this purpose — by the commercial banks, (incidentally 108.13 (b) is incorrect with respect to BoE)..."*<sup>7</sup>

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<sup>5</sup> Legislative Council Panel on Financial Affairs and the Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000, *Report on the Financial Systems in the United Kingdom and the United States of America*, June 2001, page 34.

<sup>6</sup> Professor Charles Goodhart, *The Governance of the Hong Kong Monetary Authority (HKMA)*, LC Paper No. CB(1) 1788/02-03(06), page 5.

<sup>7</sup> Professor Charles Goodhart, *The Governance of the Hong Kong Monetary Authority (HKMA)*, LC Paper No. CB(1) 1788/02-03(06), page 6.

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2.10 Paragraph 108.13(b) of the research report stated that:

*"[There are five funding mechanisms identified from the authorities covered in this study.] ... (b) receiving an initial capital grant and then operating on a self-financing basis through investment returns generated from the capital grant, and revenues from services provided. Examples are the Mandatory Provident Fund Schemes Authority, the Office of the Telecommunications Authority, the Bank of England ..."*

2.11 It is noteworthy that paragraph 53.1 of the research report described clearly the funding mechanism of the Bank of England, which is:

*"The Bank's [the Bank of England's] activities are funded by its own capital and reserves, which amounted to £1.53 billion, and cash ratio deposits (i.e. non-interest bearing deposits from banks and building societies) of £1.55 billion on 28 February 2002. Under the current arrangement, the Bank is authorized to retain a sum equal to 50% of post-tax profit and pay the remaining 50% to HM Treasury. In Financial Year 2001-02, the Bank recorded a post-tax profit of £84 million<sup>8</sup>; hence, the Bank retained £42 million and paid HM Treasury a sum of £42 million."<sup>9</sup>*

2.12 From paragraph 53.1, it is clear that the funding of the Bank comes from two sources of similar magnitude (at least in Financial Year 2001-02), namely investment return from an initial capital grant and return from cash ratio deposits (revenues from services provided).

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<sup>8</sup> The agreement between HM Treasury and the Bank provides that the entire profit of notes issued is paid over to HM Treasury. For accounting purposes, such profit will not be included in the Bank's financial statements.

<sup>9</sup> The Bank of England, *Annual Report 2002*, pages 49-52.

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## References

1. Professor Goodhart, *The Governance of the Hong Kong Monetary Authority (HKMA)*, LC Paper No. CB(1) 1788/02-03(06).
2. Legislative Council Panel on Financial Affairs and the Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000, *Report on the Financial Systems in the United Kingdom and the United States of America*, June 2001.
3. The Bank of England, *Annual Report 2002*.

## Websites

1. Website of the Bank of England, [www.bankofengland.co.uk](http://www.bankofengland.co.uk).
2. Website of the Federal Reserve Board, [www.federalreserve.gov](http://www.federalreserve.gov).