



HONG KONG MONETARY AUTHORITY ANNUAL REPORT 2004



HONG KONG MONETARY AUTHORITY
香港金融管理局

THE HONG KONG MONETARY AUTHORITY

Established in April 1993, the Hong Kong Monetary Authority (HKMA) is the government authority in Hong Kong responsible for maintaining monetary and banking stability. The HKMA's policy objectives are

- to maintain currency stability, within the framework of the Linked Exchange Rate system, through sound management of the Exchange Fund, monetary policy operations and other means deemed necessary
- to promote the safety and stability of the banking system through the regulation of banking business and the business of taking deposits, and the supervision of authorized institutions
- to enhance the efficiency, integrity and development of the financial system, particularly payment and settlement arrangements.


The photographs

The theme photographs in this Annual Report show some of the trees commonly found in Hong Kong. Despite its small land area, Hong Kong has some 400 species of trees. Further information on Hong Kong trees can be found in *Tree Lovers' Companion* (Friends of the Country Parks, Hong Kong, 2004) and at <http://resources.ed.gov.hk/trees>.

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The chapter on Banking Stability in this Annual Report is the report on the working of the Banking Ordinance and the activities of the office of the Monetary Authority during 2004 submitted by the Monetary Authority to the Financial Secretary in accordance with Section 9 of the Banking Ordinance.

This Annual Report makes reference to documents and other materials available on the HKMA website www.hkma.gov.hk. These references appear as  >, followed by navigation guidance from the HKMA homepage.

The full text of this Report is available on the HKMA website in interactive form and on PDF files.

A summary version of this Report is also available in *An Introduction of the Hong Kong Monetary Authority* 2005 Edition.

All amounts in this Report are in Hong Kong dollars unless otherwise stated.

HIGHLIGHTS OF 2004



ECONOMIC AND BANKING ENVIRONMENT

Hong Kong's economic recovery gathers momentum in 2004, with strong domestic and external demand. Real GDP grows by 8.1%.

Banks in Hong Kong continue to see growth in profits. But high liquidity and keen competition put pressure on margins.

New \$20, \$50 and \$1,000 Hong Kong banknotes, with advanced security features, are issued in October.



MONETARY STABILITY

The exchange rate of the Hong Kong dollar remains stable during the year amid strong fund flows.



BANKING STABILITY

The HKMA and Hong Kong's banking sector continue to prepare for the implementation of Basel II.

The Deposit Protection Scheme Ordinance is enacted. The Commercial Credit Reference Agency starts operation.



MARKET INFRASTRUCTURE

The Clearing and Settlement Systems Ordinance is enacted and comes into force.

System improvements are made to ease banks' liquidity pressure at times of large fund flows related to IPOs.



INTERNATIONAL FINANCIAL CENTRE

The launch of Asian Bond Fund 2 is announced in December.

Renminbi services are introduced by banks in Hong Kong. Total outstanding renminbi deposits in Hong Kong exceed RMB12 billion yuan by the end of 2004.



RESERVES MANAGEMENT

The Exchange Fund achieves an investment return of 5.7% in 2004.

Hong Kong's foreign currency reserves stand at US\$123.6 billion at the end of 2004.

CHIEF EXECUTIVE'S STATEMENT



broad and sustained recovery

The economic recovery that began in Hong Kong in the second half of 2003 broadened and deepened in 2004. Real Gross Domestic Product grew by 8.1%, more than double the growth in 2003. Exports of goods and services grew at the highest rate in four years, and domestic consumption continued to recover. Asset markets were buoyant during the year, and the steady recovery in the property market helped bring down further the number of residential mortgages in negative equity. The unemployment rate declined from a high of 8.6% in the middle of 2003 to 6.5% in the fourth quarter of the year: this is still high by historical standards, but it should be weighed against the large number of people entering the labour market and the considerable increase in total employment, which reached a record high of 3.3 million in the last quarter of 2004.

Strong global growth, though moderating in the second half of the year, helped fuel Hong Kong's economic recovery. While the demand for goods and services from Hong Kong increased worldwide, particularly in Europe and the Asian region, it is the vitality of the Chinese economy that has continued to be the most important engine of growth in Hong Kong. Growing numbers of visitors to Hong Kong from the Mainland boosted income from tourism. The expansion in Mainland China's external trade continued to reinforce Hong Kong's offshore trade and exports of services. Within Hong Kong, deflation came to an end, although inflation has not yet returned. Interest rates remained low. These favourable conditions, combined with a more optimistic mood in the community and among businesses, have encouraged greater private spending on

unsettled markets

consumption and investment. Economically speaking, Hong Kong had a very good year in 2004: in the absence of any unforeseen crisis, there are good reasons for expecting that the healthy and sustained progress made during the year will continue, although growth may be at a more moderate pace.

In contrast to the largely stable growth in the economy in general, financial markets in 2004 were unsettled. Equity markets throughout the world were volatile. Bond markets retreated on fears of rapid upward adjustments in US interest rates to more “normal” levels. In currency markets, the depreciation of the US dollar against other major currencies, combined with massive fund flows into Hong Kong, had a complex impact on the Hong Kong economy and presented challenges for the HKMA across its various policy areas.

The challenge in reserves management was to achieve the investment objectives of the Exchange Fund in a difficult and volatile environment. Since the Exchange Fund provides the backing for the Monetary Base and safeguards the exchange value of the Hong Kong dollar, these objectives place particular emphasis on capital preservation and high liquidity: they differentiate the Exchange Fund from many ordinary investment funds, which tend to seek maximum investment return. Despite the roller-coaster markets, and the constraints imposed by the investment objectives, the Exchange Fund earned an investment income of \$56.7 billion in 2004, and a rate of return meeting that of the investment benchmark set by the Financial Secretary on the advice of the Exchange Fund Advisory Committee. The share of investment income going to the fiscal reserves placed with the Exchange Fund was \$14.5 billion, which was \$2.2 billion more than the projected amount included in the Government’s budget for the fiscal year.

Hong Kong dollar stability

The decline in the exchange value of the US dollar by a cumulative 4.6% in 2004 contributed, through the Linked Exchange Rate system, to a further decline in the effective exchange value of the Hong Kong dollar – and therefore to Hong Kong’s competitiveness. An improving economy, greatly increased IPO activities, and continued market expectations of a possible revaluation of the renminbi attracted large inflows of funds into Hong Kong. These inflows supported strong liquidity in the banking system, particularly in the first and last quarters. As a result, Hong Kong dollar interest rates continued to be substantially lower than their US dollar counterparts, with differentials widening in the last quarter: short-term Hong Kong dollar interest rates rose by only about 20 basis points during the year, despite the cumulative increase of 125 basis points in the US rates.

The Hong Kong dollar stayed close to its official Linked Rate of 7.8 to the US dollar throughout the year, despite the massive fund flows, persistent speculation about a renminbi revaluation, and the decline in the US dollar. The strengthening episode that began in September 2003 worked itself out in the first four months of 2004 as the HKMA sold Hong Kong dollars in response to requests from banks. During the middle months of the year the dollar closely

tracked the official rate, with repeated triggerings of the Convertibility Undertaking and the purchase of a total of \$51.5 billion worth of Hong Kong dollars by the HKMA. As a result, the Aggregate Balance declined from nearly \$55 billion in February to \$3.2 billion in September, only to begin rising again in October, as the Hong Kong dollar began to strengthen again on fund inflows and renewed renminbi speculation.

The wide variation in the size of the Aggregate Balance during 2004 and the considerable activity on both the strong and weak sides of the Linked Exchange Rate offer a lively illustration of the workings of the Currency Board system, which continues to deliver exchange rate stability for Hong Kong.

**strong and
effective banks**

Despite a continuing squeeze on interest margins, largely as a result of the ample liquidity in the banking system, Hong Kong's banking sector saw an average 20% increase in profitability in 2004. All other main indicators showed improvement, reflecting better economic conditions and increased economic activity. Overall asset quality improved. The classified loan ratio declined. The consolidated capital adequacy ratio of local authorized institutions remained high, at almost 16%, nearly twice the statutory minimum requirement of 8%. Loans to all sectors, particularly business, increased.

Following the full implementation of risk-based supervision in 2003, the HKMA used its supervisory resources in 2004 to focus intensively on areas of business, which, for one reason or another, might give rise to concern. Focused examinations took place of residential mortgage loans, in view of the increased competition, and of risk management and other practices in credit card business. The HKMA continued to improve the supervisory framework for preventing money laundering and terrorist financing, taking into account the latest international developments. Special emphasis was placed on banks' business continuity planning, particularly in the light of the growing dependence on technology of both banks and their customers.

A source of concern during the year was the question of the safety of banking through electronic channels. Prompt actions by the banks, the police and the HKMA early in the year helped lessen the risk of ATM frauds through tampering with machines. Internet banking fraud, however, has become a growing concern in Hong Kong, as in other parts of the world. The HKMA, together with the police and the banks, has placed particular emphasis on tackling this problem both through promoting public awareness of good security practices and through improving security-enhancing technology: by mid-2005 two-factor authentication will be introduced for high-risk Internet transactions by banks in Hong Kong providing Internet services.

The banking sector reform programme, initiated in 1999, entered its final stages in 2004 with the launch of the Commercial Credit Reference Agency in November and the enactment of the Deposit Protection Scheme Ordinance in May. The Hong Kong Deposit Protection Board was established in July, and it

has since then been working on detailed plans for implementing the scheme in the second half of 2006, if prevailing conditions at the time are suitable.

As the reform programme draws to a successful conclusion, another important set of reforms involving the banking sector moves closer. In June the Basel Committee issued its revised framework on capital adequacy standards for banks, or "Basel II" as it is now usually known. Basel II will make capital requirements more risk-sensitive, and will bring banking regulation more into line with the way that banks themselves perceive and manage risk. It will also give banks the incentive to continue to strengthen and improve their own risk management. Good progress was made in 2004 in planning for the implementation of Basel II in Hong Kong. The aim is to switch over to Basel II at the start of 2007, in line with the approach being adopted in other major international financial centres, and of the Basel Committee members themselves. We see value in being among the first in adopting Basel II, not only because of its intrinsic merits, but also because Hong Kong has one of the highest concentrations of banking institutions in the world, with a strong presence of international banking groups.

**developing
Hong Kong as an
international
financial centre**

Being among the first banking centres to implement Basel II will help maintain Hong Kong's position as an international financial centre. Other initiatives taken during the year have also helped bolster this position. Thirty-eight banks in Hong Kong began offering personal renminbi deposit, remittance and exchange services during 2004. Renminbi business grew steadily during the year: at the end of December outstanding renminbi deposits in banks in Hong Kong stood at more than RMB12 billion yuan. Clearly, there is a demand for these facilities in Hong Kong, despite the modest range of services currently available: this is not surprising, given the growing integration between the Hong Kong and Mainland economies, and the considerable surge in tourists from the Mainland during the year. Since the renminbi is not yet a freely convertible currency, future development of renminbi banking business in Hong Kong will by necessity be done in a gradual and cautious way. Discussions are in progress to explore how future development may proceed, taking into account the three strategic directions outlined by the Financial Secretary in August: diversification of renminbi assets and liabilities; denomination and settlement of trade in renminbi; and debt issuance in renminbi.

Hong Kong's position as an international financial centre also benefited in 2004 from progress in the infrastructure for other currencies. Hong Kong dollar and US dollar real time gross settlement links were introduced between Hong Kong and Guangdong province in March, extending the arrangements made between Hong Kong and Shenzhen in 2003. Joint cheque-clearing arrangements for US dollar cheques were introduced between Hong Kong and Shenzhen in July 2004. In December, the Hong Kong dollar entered the Continuous Linked Settlement (CLS) System, a global clearing and settlement system that complements Hong Kong's own multi-currency clearing systems. Entry into the CLS System was made possible by the enactment in July of the Clearing and

Settlement Systems Ordinance, which came into effect in November. The Ordinance gives statutory backing to the Monetary Authority's oversight of important clearing and settlement systems, and legal certainty for settlement finality. In doing this, it will help promote the safety and robustness of Hong Kong's financial infrastructure and the financial stability of Hong Kong.

**regional and
international
co-operation**

Hong Kong's financial stability is dependent not just on the structures and systems that we build within Hong Kong but on the movements of markets throughout the world, and particularly on the health of the regional financial system. Memories of the Asian financial crisis in 1997-8 inevitably fade as the region in general continues to enjoy financial stability and economic growth. But the weaknesses that contributed to this crisis continue to be very much in the minds of Asian central banks, as they work together towards strengthening the regional financial system. Two regional initiatives bore fruit in 2004. The structuring, design and launch of the local currency component of the Asian Bond Fund (ABF2) under the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP) was announced in December. The APEC Initiative on Development of Securitisation and Credit Guarantee Markets came to a successful conclusion in September. Both of these initiatives will help stimulate the development of deep, liquid and mature regional bond markets, which can play an important role when, in times of crisis, the other channels of financial intermediation – the banks and the equity markets – falter or fail.

The HKMA played a leading role in both of these initiatives, and, because of its advantages as an international financial centre, Hong Kong has been chosen as the place of listing for two of the key components of ABF2. The HKMA is also contributing extensively to the work of the Bank for International Settlements (BIS), through its chairmanship of the BIS Asian Consultative Council and Central Bank Governance Steering Group, and in playing a leading role in the drafting process in the review of the Basel Core Principles for Effective Banking Supervision, which began in 2004.

**governance of
the HKMA**

Enabling active participation by Hong Kong in the various international bodies and initiatives was one of the reasons for establishing the HKMA in 1993 as a central banking organisation with a clear identity and mission. Although it is an agency of the Government, the HKMA, following general central banking principles, is separate from the main organs of government in its ability to employ staff on terms different from those of the civil service and in its funding arrangements. These arrangements enable the HKMA to operate with flexibility, in response to rapidly changing conditions, and to maintain a level of resource independence sufficient to enable it to carry out its responsibilities without political influence. This measure of autonomy in the HKMA's operations is balanced by an apparatus of accountability, to the Financial Secretary through the Exchange Fund Advisory Committee (EFAC), and to the community, both directly and through its elected representatives on the Legislative Council.

During 2004 the governance arrangements of the HKMA were strengthened with an expansion of the EFAC sub-committee system. A new Governance Sub-Committee was created, replacing the old Remuneration and Finance Sub-Committee, with the task of monitoring the performance of the HKMA and making recommendations to the Financial Secretary, through EFAC, on the full range of remuneration, human resources, budgetary, administrative and governance issues affecting the HKMA. This Sub-Committee is composed of the non-official, non-banking Members of EFAC. Two new sub-committees – one on investment, the other on financial infrastructure – were formed at the end of 2004 and held their first meetings in early 2005. These two new sub-committees will enable Members to focus more on the technical details of these important areas of the HKMA's work.

The HKMA continued in 2004 to develop its policy of transparency and accessibility. The HKMA's *Half-Yearly Monetary and Financial Stability Report*, first issued in December 2003, has become well established as the main channel of clear and systematic information on the HKMA's view of the main forces acting upon Hong Kong's monetary and financial systems. The HKMA's Information Centre, which opened towards the end of 2003, received nearly 50,000 visitors of all ages and walks of life in 2004. Increasing numbers of people are using our enquiries service and visiting our website. During 2004 the HKMA also mounted an extensive campaign of seminars and visits to inform members of the public about the new \$20, \$50 and \$1,000 banknotes, which went into circulation in October: in all, some 93,000 people were reached during this campaign. At no time has the HKMA been in direct contact with so many people. In helping people better understand Hong Kong's monetary and banking systems, these initiatives have, we believe, helped contribute to Hong Kong's monetary and financial stability. They have also provided further informal channels for keeping ourselves abreast of public views on the policies we pursue.

The work of the HKMA has increased in volume and complexity over the past few years, as new responsibilities and new issues have emerged. Despite this, our staff establishment has remained stable, and our staff strength actually declined in 2004. I take this opportunity to pay tribute to the staff of the HKMA for their hard work and resourcefulness during another busy year. My colleagues and I are also grateful to the Financial Secretary and to Members of EFAC for their continued guidance and support.

A handwritten signature in black ink, appearing to be 'J. Yam', with a long horizontal flourish extending to the right.

Joseph Yam
Chief Executive

ABOUT THE HKMA

The Hong Kong Monetary Authority is Hong Kong's central banking institution. The HKMA has four main functions: maintaining the stability of the Hong Kong dollar; promoting the safety of Hong Kong's banking system; managing Hong Kong's official reserves; and maintaining and developing Hong Kong's financial infrastructure.

THE HKMA'S LEGAL MANDATE

The HKMA was established on 1 April 1993 by merging the Office of the Exchange Fund with the Office of the Commissioner of Banking. To enable the establishment of the HKMA, the Legislative Council passed amendments to the Exchange Fund Ordinance in 1992 empowering the Financial Secretary to appoint a Monetary Authority.

The powers, functions and responsibilities of the Monetary Authority are set out in the Exchange Fund Ordinance, the Banking Ordinance, the Deposit Protection Scheme Ordinance, the Clearing and Settlement Systems Ordinance and other relevant Ordinances. The division of functions and responsibilities in monetary and financial affairs between the Financial Secretary and the Monetary Authority is set out in an Exchange of Letters between the two dated 25 June 2003. This Exchange of Letters also discloses the delegations made by the Financial Secretary to the Monetary Authority under these Ordinances. The letters are public documents: copies of them may be found on the HKMA website.

The Exchange Fund Ordinance establishes the Exchange Fund under the control of the Financial Secretary. According to the Ordinance, the Fund shall be used primarily for affecting the exchange value of the Hong Kong dollar. It may also be used for maintaining the stability and integrity of the monetary and financial systems of Hong Kong, with a view to maintaining Hong Kong as an international financial centre.

The Monetary Authority is appointed under the Exchange Fund Ordinance to assist the Financial Secretary in performing his functions under the Exchange Fund Ordinance and to perform such other functions as are assigned by other Ordinances or by the Financial Secretary. The office of the Monetary Authority is known as the HKMA, and the Monetary Authority as the Chief Executive of the HKMA.

The Banking Ordinance provides the Monetary Authority with the responsibility and powers for regulating and supervising banking business and the business of taking deposits. Under the Ordinance, the Monetary Authority is responsible, among other things, for the authorization of licensed banks, restricted licence banks, and deposit-taking institutions in Hong Kong.

The Clearing and Settlement Systems Ordinance provides a statutory regime for the Monetary Authority to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong or to the functioning of Hong Kong as an international financial centre.

Under the Deposit Protection Scheme Ordinance the Monetary Authority is charged with implementing the decisions of the Hong Kong Deposit Protection Board, and among other things, deciding whether compensation should be paid to the depositors of a failed scheme bank pursuant to the Ordinance.



THE HKMA AND THE HONG KONG SAR GOVERNMENT

The HKMA is an integral part of the Hong Kong SAR Government, but is able to employ staff on terms different from those of the civil service in order to attract personnel of the right experience and expertise. The Chief Executive of the HKMA remains a public officer, as do his staff. In its day-to-day work the HKMA operates with a high degree of autonomy within the relevant statutory powers conferred upon, or delegated to, the Monetary Authority.

The Financial Secretary is responsible for determining the monetary policy objective and the structure of the monetary system of Hong Kong: a letter from the Financial Secretary to the Monetary Authority dated 25 June 2003 specifies that these should be currency stability defined as a stable exchange value at around HK\$7.80 to one US dollar maintained by Currency Board arrangements. The Monetary Authority is on his own responsible for achieving the monetary policy objective, including determining the strategy, instruments and operational means for doing so. He is also responsible for maintaining the stability and integrity of the monetary system of Hong Kong.

The Financial Secretary, assisted by the Secretary for Financial Services and the Treasury, has responsibility for policies for maintaining the stability and integrity of Hong Kong's financial system and the status of Hong

Kong as an international financial centre. In support of these policies, the Monetary Authority is responsible, among other things, for

- promoting the general stability and effective working of the banking system
- promoting the development of the debt market, in co-operation with other relevant bodies
- matters relating to the issuance and circulation of legal tender notes and coins
- promoting the safety and efficiency of the financial infrastructure through the development of payment, clearing and settlement systems and, where appropriate, the operation of these systems
- seeking to promote, in co-operation with other relevant bodies, confidence in Hong Kong's monetary and financial systems, and appropriate market development initiatives to help strengthen the international competitiveness of Hong Kong's financial services.

The Exchange Fund is under the control of the Financial Secretary. The Monetary Authority, under delegation from the Financial Secretary, is responsible to the Financial Secretary for the use of the Exchange Fund, and for the investment management of the Fund.



> [About the HKMA](#) > [The HKMA](#) > [Who we are](#)

ACCOUNTABILITY AND TRANSPARENCY

The autonomy given to the HKMA in its day-to-day operations, and in the methods it uses to pursue policy objectives determined by the Government, is complemented by a high degree of accountability and transparency.

The HKMA serves Hong Kong by promoting monetary and banking stability, by managing the official reserves effectively, and by developing and overseeing a robust and diverse financial infrastructure. These processes help to strengthen Hong Kong's role as an international financial centre and to foster Hong Kong's economic well-being. The HKMA must have the confidence of the community if it is to perform its duties well. The HKMA therefore takes seriously the duty of explaining its policies and work to the general public and makes every effort to address any concerns within the community relevant to the HKMA's responsibilities.

The HKMA is accountable to the people of Hong Kong through the Financial Secretary, who appoints the Monetary Authority, and through the laws passed by the Legislative Council that set out the Monetary Authority's powers and responsibilities. The HKMA also recognises a broader responsibility to promote a better understanding of its roles and objectives and to keep itself informed of community concerns. In its day-to-day operations and in its wider contacts with the community, the HKMA pursues a policy of transparency and accessibility. This policy has two main objectives:

- to keep the financial industry and the public as fully informed about the work of the HKMA as possible, subject to considerations of market sensitivity, commercial confidentiality and statutory restrictions on disclosure of confidential information
- to ensure that the HKMA is in touch with, and responsive to, the community it serves.

The HKMA seeks to follow international best practices in its transparency arrangements. It maintains extensive relations with the mass media and produces a range of regular and special publications in both English and Chinese. The HKMA's bilingual website (www.hkma.gov.hk) carries all HKMA publications, press releases, speeches and presentations, in addition to special sections on research, statistics, consumer information and other topics. The HKMA maintains an Information Centre at its offices, consisting of a library and an exhibition area, which is open to the public six days a week. The HKMA also organises an annual public education programme, which seeks to inform the public, and in particular students, about the work of the HKMA through seminars and guided tours at the Information Centre. The HKMA's weekly *Viewpoint* column, carried on the HKMA website and in several Hong Kong newspapers, informs the public about aspects of the HKMA's work. Further information on the HKMA's media work, publications and public education programmes is contained in the Chapter on Professional and Corporate Services.

 > Viewpoint

 > HKMA Information Centre

Over the years the HKMA has progressively increased the detail and frequency of its disclosure of information on the Exchange Fund and Currency Board Accounts. Since 1999 the HKMA has participated in the International Monetary Fund's Special Data Dissemination Standard project for central banks. The HKMA publishes records of meetings of the Exchange Fund Advisory Committee Currency Board Sub-Committee, along with the monthly reports on Currency Board operations. The supervisory policies and guidelines on banking have been published on the website since 1996.

 > [Information Centre > Press Releases > Exchange Fund](#)

 > [Policy Areas > Supervisory Policy Manual](#)

The relations between the HKMA and the Legislative Council play an important part in the process of accountability and transparency. There is a formal commitment from the Chief Executive of the HKMA to appear before the Legislative Council 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. In addition, staff from 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.

 > [Information Centre > Legislative Council Issues](#)

ADVISORY AND OTHER COMMITTEES

Exchange Fund Advisory Committee

In his control of the Exchange Fund, the Financial Secretary is advised by the Exchange Fund Advisory Committee (EFAC). EFAC is established under Section 3(1) of the Exchange Fund Ordinance, which requires the Financial Secretary to consult the Committee in his exercise of control of the Exchange Fund. The Financial Secretary is ex officio Chairman of EFAC. Other members, including the Monetary Authority, are appointed in a personal capacity by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong SAR. Members of EFAC are appointed for the expertise and experience that they can bring to the committee. Such expertise and experience includes knowledge of monetary, financial and economic affairs and of investment issues, as well as of accounting, management, business and legal matters.

EFAC advises the Financial Secretary on investment policies and strategies for the Fund and on projects, such as the development of financial infrastructure, that are charged to the Fund. Since the operating and staff costs of the HKMA are also chargeable to the Exchange Fund, EFAC advises the Financial Secretary on the HKMA's annual administration budget and on the terms and conditions of service of HKMA staff. EFAC meets regularly and on other occasions when particular advice is being sought.

EFAC is assisted in its work by five sub-committees, which monitor specific areas of the HKMA's work and report and make recommendations to the Financial Secretary through EFAC.

The *Governance Sub-Committee* monitors the performance of the HKMA and makes recommendations on remuneration and human resources policies, and on budgetary, administrative and governance issues.

The *Audit Sub-Committee* reviews and reports on the HKMA's financial reporting process and the adequacy and effectiveness of the internal control systems of the HKMA. The Sub-Committee reviews the HKMA's financial statements, and the composition and accounting principles adopted in such statements. It also examines and reviews with both the external and internal auditors the scope and results of their audits.

The *Currency Board Sub-Committee* monitors and reports on the Currency Board arrangements that underpin Hong Kong's Linked Exchange Rate system. It is responsible, among other things, for ensuring that Currency Board operations are in accordance with established policy, recommending improvements to the Currency Board system, and ensuring a high degree of transparency in the operation of the system. Records of the Sub-Committee's meetings and the reports on Currency Board operations submitted monthly to the Sub-Committee are published.

The *Investment Sub-Committee* monitors the HKMA's investment management work and makes recommendations on the investment policy and strategy of the Exchange Fund and on risk management and other related matters.

The *Financial Infrastructure Sub-Committee* monitors the work of the HKMA in relation to the development and operation of the financial infrastructure in Hong Kong and makes recommendations on measures and initiatives relating to the HKMA's responsibilities for promoting the safety, efficiency and development of Hong Kong's financial infrastructure.

The Banking Advisory Committee

The Banking Advisory Committee is established under Section 4(1) of the Banking Ordinance to advise the Chief Executive of the Hong Kong SAR on matters relating to the Banking Ordinance, in particular matters relating to banks and the carrying on of banking business. The Committee consists of the Financial Secretary, who is the Chairman, the Monetary Authority, and other persons appointed by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong SAR.



The Deposit-Taking Companies Advisory Committee

The Deposit-Taking Companies Advisory Committee is established under Section 5(1) of the Banking Ordinance to advise the Chief Executive of the Hong Kong SAR on matters relating to the Banking Ordinance, in particular matters relating to deposit taking companies and restricted licence banks and the carrying on of a business of taking deposits by them. The Committee consists of the Financial Secretary, who is the Chairman, the Monetary Authority, and other persons appointed by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong SAR.

Chief Executive's Committee

The Chief Executive's Committee is chaired by the Chief Executive of the HKMA and consists of the Deputy Chief Executives and the Executive Directors of the HKMA. The Committee meets weekly to report to the Chief Executive on the progress of major tasks being undertaken by the various departments of the HKMA and to advise him on policy matters relating to the operations of the HKMA.

The membership lists of the various Committees and Sub-Committees are given on pages 16 to 26. Brief biographies and the Code of Conduct for EFAC Members may be found on the HKMA website. A Register of Members' Interests, which contains the declarations of interests by Members of EFAC, is available for public inspection during office hours (9:00 a.m. to 5:00 p.m. Monday to Friday and 9:00 a.m. to 12 noon Saturday) at the HKMA Offices, 55th Floor, Two International Finance Centre, 8 Finance Street, Central, Hong Kong.



> About the HKMA > The HKMA > Advisory Committees



> About the HKMA > The HKMA > The Chief Executive's Committee

ADVISORY COMMITTEES

THE EXCHANGE FUND ADVISORY COMMITTEE

Chairman

The Hon. Henry Tang Ying Yen, GBS, JP
The Financial Secretary

Members

Mr Joseph Yam, GBS, JP
The Monetary Authority

Dr The Hon. David Li Kwok Po, LLD, GBS, JP
Chairman and Chief Executive
The Bank of East Asia Limited

Mr Marvin Cheung Kin Tung, DBA Hon., SBS, JP

Mr David Eldon, GBS, JP
Chairman
The Hongkong and Shanghai Banking Corporation Limited

Professor Richard Y C Wong, SBS, JP
Deputy Vice-Chancellor
The University of Hong Kong

Mr Christopher Cheng Wai Chee, GBS, JP
Chairman
USI Holdings Limited

Mr Victor Lo Chung Wing, GBS, JP
Chairman and Chief Executive
Gold Peak Industries (Holdings) Limited



Mr Thomas Kwok

Mr Henry Fan

Mr He Guangbei

Mr Victor Lo

Professor Richard Wong

Mr Marvin Cheung

Mr Joseph Yam

Dr Patrick Wang Shui Chung, JP

Chairman and Chief Executive Officer
Johnson Electric Holdings Limited

Mr He Guangbei

Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited

Professor K C Chan

Dean of Business and Management
Hong Kong University of Science and Technology
(from 1 May 2004)

Mr Henry Fan Hung-ling, SBS, JP

Managing Director
CITIC Pacific Limited
(from 1 May 2004)

Mr Simon Ip Sik-on, JP

(from 1 May 2004)

Mr Thomas Kwok Ping-kwong, JP

Vice-Chairman and Managing Director
Sun Hung Kai Properties Limited
(from 1 May 2004)

Mr Peter Sullivan

Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited
(from 7 December 2004)

Dr James Z M Kung, GBS

Chairman
Chekiang First Bank Limited
(until 30 April 2004)

Mr Robert C Tang, SC, JP

Barrister-at-Law
(until 22 March 2004)

Mr E Mervyn Davies

Group Chief Executive
Standard Chartered PLC
(until 31 January 2004)

Mr Peter Wong Tung-shun, JP

Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited
(from 1 February to 18 November 2004)

Secretary**Mr Christopher Munn**

Mr Henry Tang

Dr David Li

Mr David Eldon

Mr Christopher Cheng

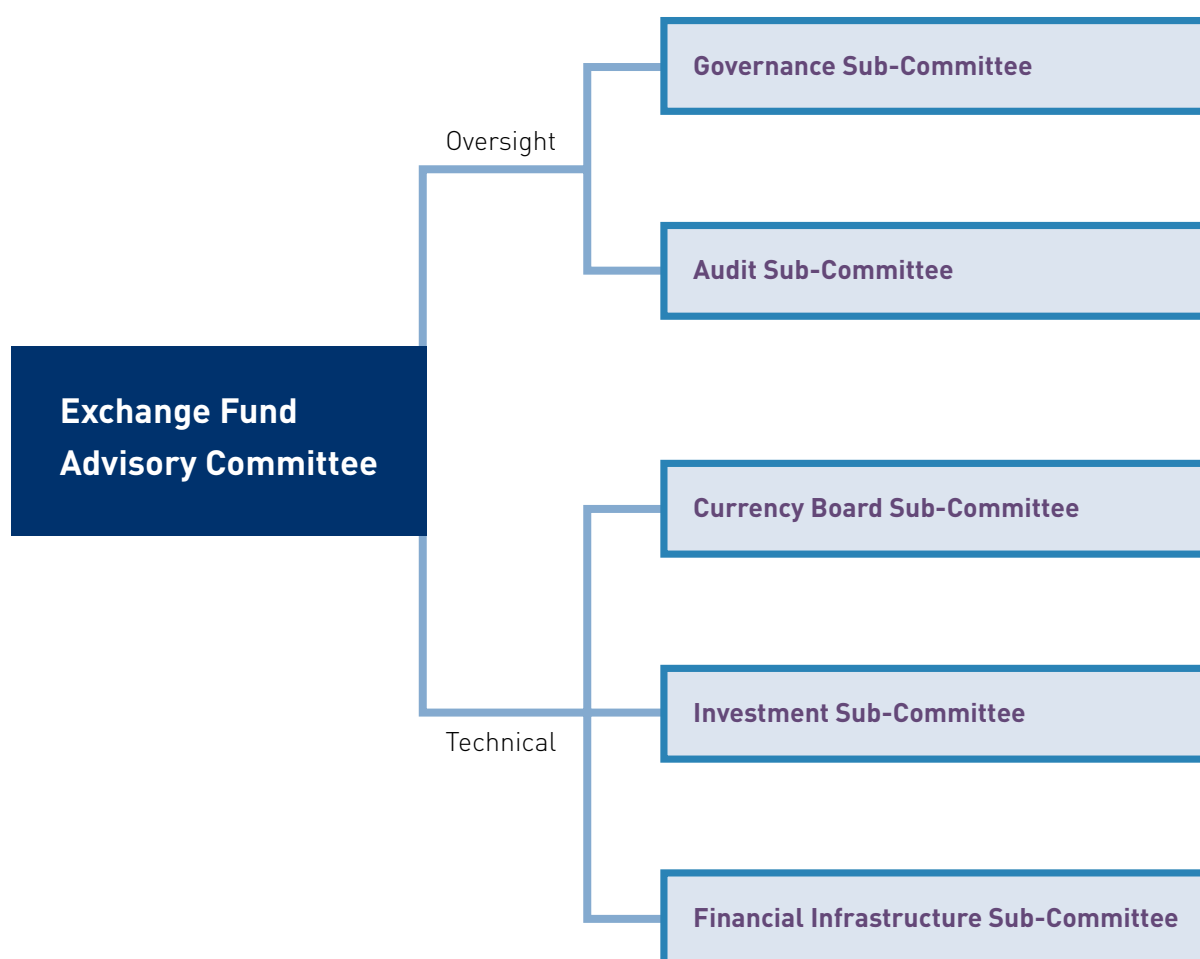
Dr Patrick Wang

Professor K C Chan

Mr Simon Ip

Mr Peter Sullivan

EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE STRUCTURE



THE EXCHANGE FUND ADVISORY COMMITTEE GOVERNANCE SUB-COMMITTEE

Chairman

Mr Marvin Cheung Kin Tung, DBA Hon., SBS, JP

Members

Professor Richard Y C Wong, SBS, JP

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Dr Patrick Wang Shui Chung, JP

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Johnson Electric Holdings Limited

Professor K C Chan

Dean of Business and Management
Hong Kong University of Science and Technology
(from 1 May 2004)

Mr Henry Fan Hung-ling, SBS, JP

Managing Director
CITIC Pacific Limited
(from 1 May 2004)

Mr Simon Ip Sik-on, JP

(from 1 May 2004)

Mr Thomas Kwok Ping-kwong, JP

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Sun Hung Kai Properties Limited
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(until 22 March 2004)

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(from 7 December 2004)

Mr E Mervyn Davies

Group Chief Executive
Standard Chartered PLC
(until 31 January 2004)

Mr Peter Wong Tung-shun, JP

Executive Director and Chief Executive Officer
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Hong Kong Monetary Authority

Mr Peter Pang, JP
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Group Chief Economist
INVESCO Asset Management Limited

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Department of Economics
Hong Kong Baptist University

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Vice Chairman and Chief Executive
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Dean of Business and Management
Hong Kong University of Science and Technology

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Ex Officio Member

Mr Joseph Yam, GBS, JP
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Secretary for Financial Services and the Treasury

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Executive Director
The Hongkong and Shanghai Banking Corporation Limited
Representing The Hongkong and Shanghai Banking Corporation Limited

Mr Peter Sullivan
Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited
Representing Standard Chartered Bank (Hong Kong) Limited
(from 19 November 2004)

Mrs Mignonne Cheng
Head of North and East Asia
BNP Paribas
(from 18 May 2004)

Mrs Chan Hui Dor Lam Doreen
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Mrs Angelina P L Lee, JP
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Woo, Kwan, Lee & Lo
Solicitors and Notaries

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Chairman and Chief Executive
The Bank of East Asia Limited

Mr Tatsuo Tanaka
Managing Director and Chief Executive Officer for China
The Bank of Tokyo-Mitsubishi, Ltd

Mr Samuel N Tsien
President and Chief Executive Officer
Bank of America (Asia) Limited

Mr David S Y Wong, JP
Chairman
Dah Sing Bank Limited

Ms Maria Xuereb
Financial Services Partner
Deloitte Touche Tohmatsu

Mr Peter Wong Tung-shun, JP
Executive Director and Chief Executive Officer
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Representing Standard Chartered Bank (Hong Kong) Limited
(until 18 November 2004)

Mr Didier Balme
Head of North and East Asia
BNP Paribas
(until 27 March 2004)

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Ms Carman Chiu

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The Monetary Authority

Members

The Hon. Frederick Ma Si Hang, JP
Secretary for Financial Services and the Treasury

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Securities and Futures Commission
Representing The Securities and Futures Commission

Mrs Pamela Chan Wong Shui, BBS, JP
Chief Executive
Consumer Council
Representing The Consumer Council

Mr Clifford Forster
Chairman
Hong Kong Association of Restricted Licence Banks and
Deposit-Taking Companies (The DTC Association)
Representing The DTC Association

Mr Mervyn Jacob
Partner
Financial Services Division
PricewaterhouseCoopers
(from 5 November 2004)

Mr Andrew Kuo
Managing Director
JP Morgan Securities (Asia Pacific) Limited

Dr Eric K C Li, GBS, JP
Senior Partner
Li, Tang, Chen & Co
Certified Public Accountants (Practising)

Mr Geoffrey J Mansfield
Managing Director
PrimeCredit Limited

Mr Mok Wai-kin
Director
Hang Seng Finance Limited

Mr Poon Kwok Yuen
President and Chief Executive Officer
ALG Finance (Hong Kong) Limited

Mr Tan Yoke Kong
General Manager
JCG Finance Company, Limited

Mr Frank J Wang
Director and Deputy Chief Executive
Wing Hang Finance Company Limited

Mr Mohan Kohli
Partner
Financial Services Division
PricewaterhouseCoopers
(until 30 June 2004)

Secretary

Ms Carman Chiu

CHIEF EXECUTIVE'S COMMITTEE



CHIEF EXECUTIVE

Joseph Yam, GBS, JP

Joseph Yam has served as Chief Executive of the HKMA since its establishment in April 1993. Mr Yam began his civil service career in Hong Kong as a Statistician in 1971, and became an Economist in 1976. His involvement in monetary affairs in Hong Kong started when he was appointed as Principal Assistant Secretary for Monetary Affairs in 1982. He helped put together Hong Kong's Linked Exchange Rate system in 1983. He was subsequently appointed Deputy Secretary for Monetary Affairs in 1985 and Director of the Office of the Exchange Fund in 1991.



DEPUTY CHIEF EXECUTIVE

Norman Chan, SBS, JP

Norman Chan has responsibility for reserves management and international finance. Mr Chan joined the Hong Kong Government as an Administrative Officer in 1976. In 1991 he was appointed Deputy Director (Monetary Management) of the Office of the Exchange Fund. He became an Executive Director of the HKMA when it was established in 1993 and was made a Deputy Chief Executive in 1996.



DEPUTY CHIEF EXECUTIVE

William Ryback, JP

William Ryback is in charge of the full range of banking policy, development and supervision issues. Prior to joining the HKMA in 2003, Mr Ryback was Senior Associate Director of the Division of Bank Supervision at the Board of Governors of the Federal Reserve System in Washington, D.C.. He was also Chairman of the Board of Directors of the Association of Bank Supervisors of the Americas. He was the Board of Governors representative on the Basel Committee on Banking Supervision from 1986 to 1994.



DEPUTY CHIEF EXECUTIVE

Peter Pang, JP

Peter Pang is responsible for monetary management, financial infrastructure and research. Mr Pang joined the HKMA as Executive Director (Banking Policy) in 1994 and was appointed Executive Director (Monetary Policy and Markets) in 1996. He was the Chief Executive Officer of the Hong Kong Mortgage Corporation from 1997 to 2004. He was appointed to his present position in July 2004. Mr Pang joined the civil service as an Administrative Officer in 1979 and served as Assistant Director General of Trade and Assistant Commissioner of Banking before joining the HKMA.

**GENERAL COUNSEL****Stefan Gannon, JP**

Stefan Gannon has been General Counsel of the HKMA since its establishment in 1993. A barrister, Mr Gannon was the Legal Adviser to the Monetary Affairs Branch of the Hong Kong Government from 1987 to 1993.

**EXECUTIVE DIRECTOR
(BANKING SUPERVISION)****Y K Choi, JP**

Y K Choi is responsible for banking supervision. He joined the Office of the Commissioner of Banking in 1974 and became Assistant Commissioner of Banking in 1990 after a one-year secondment to the Bank of England. In the same year, he was seconded to the Office of the Exchange Fund responsible for monetary policies and was appointed Head (Banking Policy) at the HKMA in 1993. He became Head (Administration) in 1994 and was appointed to his present position in 1995.

**EXECUTIVE DIRECTOR
(CORPORATE SERVICES)****Raymond Li, JP**

Raymond Li is responsible for matters relating to corporate development, human resources, administration, finance and information technology. Mr Li joined the Hong Kong Government as an Administrative Officer in 1982 and became Principal Assistant Secretary (Monetary Affairs) in 1990. He was appointed Head (Banking Development) at the HKMA in 1993 and took up the post of Head (Administration) in 1995. He was promoted to Executive Director (Banking Policy) in 1996. Before being appointed to his present position in July 2004, he was Executive Director (Banking Development).

**EXECUTIVE DIRECTOR
(RESERVES MANAGEMENT)****Amy Yip, BBS, JP**

Amy Yip is responsible for the investment management of the Exchange Fund. Prior to joining the HKMA in 1996, Ms Yip worked at JP Morgan, Rothschild Asset Management and Citibank.

**EXECUTIVE DIRECTOR
(EXTERNAL)****Julia Leung, JP**

Julia Leung is responsible for international affairs relating to multilateral agencies and central bank co-operation, China research and financial market integration, and the HKMA's overseas offices. Ms Leung joined the HKMA in 1994 as Senior Manager in charge of press and publications matters. She was promoted to Division Head in 1996, and was appointed to her present position in April 2000.

**EXECUTIVE DIRECTOR
(BANKING POLICY)****Simon Topping, JP**

Simon Topping is responsible for the development of banking supervisory policies. He joined the HKMA in 1995 as a Division Head in the Banking Supervision Department and was appointed to his present position in September 2000. Prior to joining the HKMA he worked for the Bank of England and the International Monetary Fund.



**EXECUTIVE DIRECTOR
(MONETARY MANAGEMENT
AND INFRASTRUCTURE)**

Eddie Yue, JP

Eddie Yue is responsible for monetary management and financial infrastructure. Mr Yue began his career as an Administrative Officer in the Hong Kong Government in 1986. He joined the HKMA in 1993 as a Senior Manager, and was subsequently promoted to Division Head in 1994. He has worked in a number of divisions, including Monetary Management, External Relations, and Banking Development, and has served as Administrative Assistant to the Chief Executive of the HKMA. Mr Yue was appointed Executive Director (Corporate Services) in June 2001 and to his present position in July 2004.



**EXECUTIVE DIRECTOR
(BANKING DEVELOPMENT)**

Arthur Yuen

Arthur Yuen is responsible for banking sector reform and development and licensing matters. He joined the HKMA in 1996 as Head of Administration and has since taken up different responsibilities including research and liaison on Mainland China economic and market development issues before being appointed as Head of Banking Supervision in 2000. He was appointed to his present position in July 2004. Before joining the HKMA, Mr Yuen worked in the Hong Kong Securities and Futures Commission for two years after having served as an Administrative Officer in the Hong Kong Government for over eight years.



**EXECUTIVE DIRECTOR
(RESEARCH)**

Hans Genberg

Hans Genberg is responsible for research on issues related to monetary policy and financial markets. He is also Director of the Hong Kong Institute for Monetary Research. He has been professor of economics at the Graduate Institute of International Studies in Geneva since 1979, and for a number of years he has been the Head of its Economic Section before joining the HKMA in early 2005. He has also been a visiting scholar at the International Monetary Fund and the World Bank. He has published widely on issues related to monetary and exchange rate policy, and has a keen interest in monetary and financial developments in East Asia.



**CHIEF EXECUTIVE OFFICER
HONG KONG MORTGAGE CORPORATION**

James H Lau Jr, JP

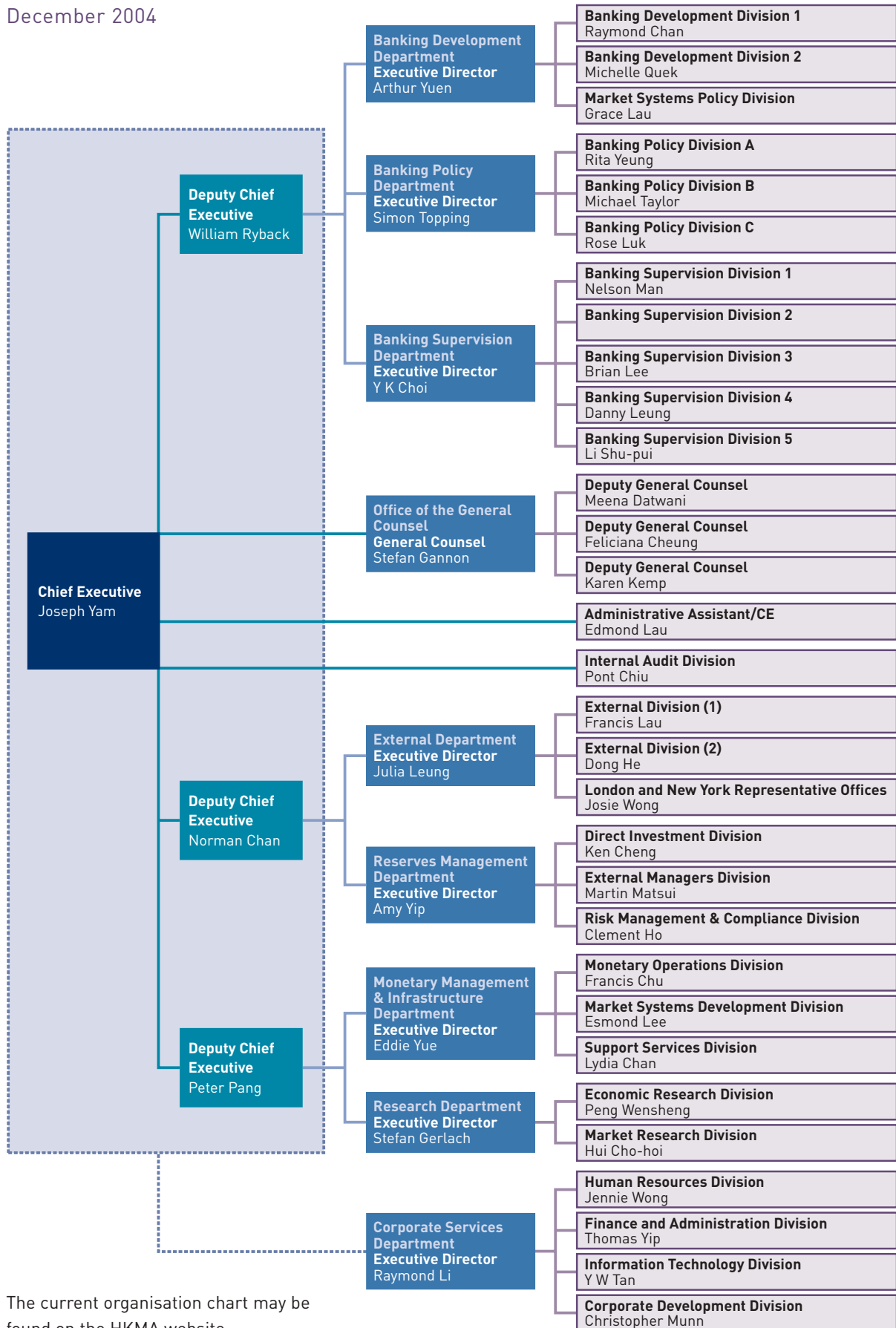
James Lau has been the Chief Executive Officer of the Hong Kong Mortgage Corporation since July 2004. Mr Lau joined the HKMA in 1993 and became Executive Director (External) in 1994 and Executive Director (Monetary Management and Infrastructure) in 2000. Mr Lau joined the Hong Kong Government as an Administrative Officer in 1979. He was Hong Kong's Deputy Permanent Representative to the GATT in Geneva from 1986 to 1990 before joining the Office of the Exchange Fund as Assistant Director (Monetary Management) in 1991.

Stefan Gerlach

Stefan Gerlach was Executive Director (Research) between May 2001 and 31 December 2004. Before joining the HKMA, Mr Gerlach held various positions at the Bank for International Settlements (BIS) since 1992. He returned to the BIS on 1 January 2005.

HKMA ORGANISATION CHART

December 2004



The current organisation chart may be found on the HKMA website.

 > About the HKMA > The HKMA > Organisation Chart



The Chinese banyan, *Ficus microcarpa*, one of Hong Kong's most popular native trees, provides shade and windbreaks for streets and neighbourhoods. Its extensive roots enable it to grow in almost any location.

ECONOMIC AND BANKING ENVIRONMENT

The Hong Kong economy experienced broad-based recovery in 2004 following its rebound in the second half of 2003, reflecting strong domestic and external demand. Benefiting from the thriving economy, the banking sector performed well in 2004, but strong liquidity and increased competition continued to put pressure on profit margins.

THE ECONOMY IN REVIEW

Overview

The recovery in Hong Kong's economy gathered momentum and became more broad-based in 2004, following a strong rebound in the second half of 2003. Real GDP grew by 8.1% in 2004, compared with 3.2% in 2003. Exports of goods and services increased, driven by robust global growth, an expansion in Mainland China's external trade, and a sustained revival in inbound tourism. Domestic demand was supported by rises in asset prices and improved labour market conditions (Table 1). Consumer prices were broadly stable in 2004, following marked declines in previous years. The unemployment rate fell steadily during the year, although it remained high by historical standards.

Monetary conditions continued to be favourable during the year, with low levels of Hong Kong dollar interest rates and a further decrease in the real effective exchange rate. Broad money growth picked

up notably alongside robust economic growth.

Narrow money growth remained strong, owing to the low interest rates and high transaction demand for money arising from buoyant economic and stock market activities.

Strong domestic demand

Private domestic demand increased strongly in 2004, supported by appreciating asset prices, improving labour market conditions, and rising household income. For the year as a whole, private consumption expenditure increased by 6.7% — the highest annual growth rate in 11 years. Private investment spending also picked up sharply, rising by 6.6%, reflecting improved profitability and optimism in the business outlook. Expenditure on machinery, equipment and computer software continued to drive overall investment, while the rate of decline in spending on building and construction slowed in the second half of 2004. By contrast, public investment spending declined by 5.8%, reflecting a fall in construction output under the

TABLE 1 GDP annual growth by expenditure components (%)

	2003					2004				
	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Private consumption expenditure	-2.7	-3.8	0.9	4.4	-0.3	5.4	10.7	5.0	5.7	6.7
Government consumption expenditure	1.0	0.5	0.5	5.5	1.9	5.4	-0.2	-1.4	-1.8	0.5
Gross domestic fixed capital formation	4.2	-5.3	0.0	1.9	0.1	5.5	12.7	2.7	-2.0	4.5
Change in inventories ¹	1.7	0.0	-1.2	0.8	0.3	1.5	2.2	-0.1	-4.2	-0.3
Net exports of goods ¹	-1.0	3.3	2.1	-1.9	0.6	-2.9	-3.5	1.2	7.5	0.9
Net exports of services ¹	4.2	-0.2	2.5	2.5	2.2	3.2	3.9	2.3	1.4	2.6
GDP	4.4	-0.6	3.9	4.8	3.2	7.0	12.1	6.8	7.1	8.1

¹ Percentage point contribution to annual growth of GDP.

Source: Census and Statistics Department.

Public Housing Programme and the winding down of work on railway projects (Chart 1).

Remarkable export performance

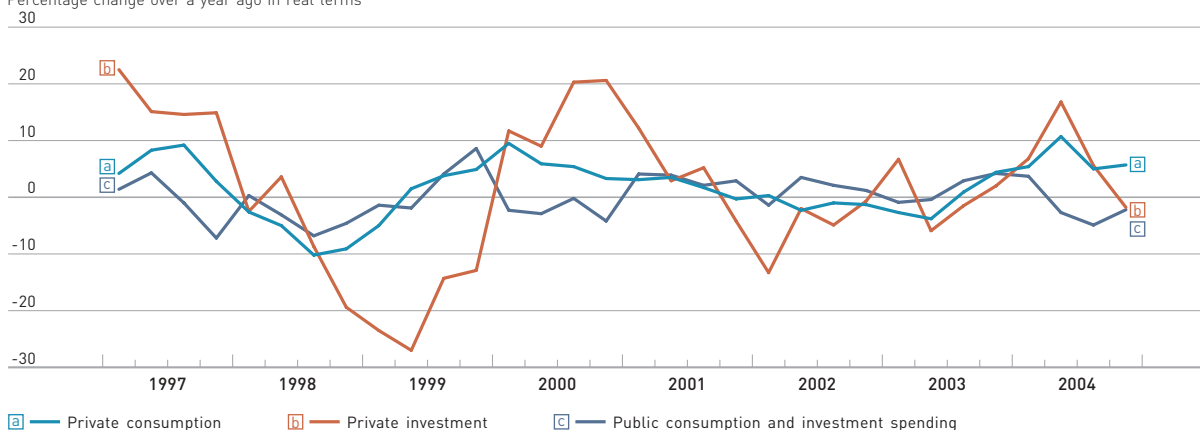
Exports of goods and services increased in 2004, driven by robust global growth, an expansion in Mainland China's external trade, and a revival in inbound tourism. However, the rate of increase in Hong Kong's exports slowed in the second half of the year because of a moderation in growth in Hong Kong's major trading partners. For 2004 as a whole, exports of goods increased by 15.3%. Among major markets, exports to East Asia and the European Union grew strongly, and those to

the United States also recovered (Table 2).

Exports of services rose sharply by 14.9%, led mainly by buoyant trade-related exports of services and an increase in tourism-related earnings, which were helped by a further broadening of the Individual Visit Scheme. The trade surplus widened from 8.2% of GDP in 2003 to 10.9% in 2004, owing to an increase in the surplus in exports of services, which more than offset a rise in the deficit in goods (Chart 2). The latter reflected the recovery in domestic demand. Nevertheless, the goods deficit narrowed markedly in the second half of the year, along with the moderation in domestic demand growth.

CHART 1 Domestic demand

Percentage change over a year ago in real terms



Source: Census and Statistics Department.

TABLE 2 Merchandise exports by major trading partners¹

	Share %	2003					2004				
		Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	44	27	21	16	21	21	16	22	23	17	20
United States	17	7	-5	-7	-3	-3	4	6	4	7	5
European Union	14	16	17	8	8	12	12	19	20	22	18
Japan	5	14	17	11	9	12	10	17	14	16	14
ASEAN5 ² + Korea	8	9	11	7	10	9	24	23	17	13	19
Taiwan	2	25	17	15	32	22	20	25	14	7	16
Others	10	10	6	-2	6	5	10	13	11	12	9
Total	100	18	12	7	11	12	13	18	17	15	16

¹ Figures are percentage changes over a year ago except for major export markets' shares in Hong Kong's total exports.

² ASEAN5 consists of The Philippines, Malaysia, Indonesia, Singapore and Thailand.

Source: Census and Statistics Department.

End of deflation

Consumer prices were broadly stable in 2004, following marked declines in the previous six years. The Composite Consumer Price Index decreased by 0.4% in 2004, with year-on-year changes turning positive in July. However, the rises mainly reflect a low base of comparison because of the Government relief measures implemented in July–November 2003. Adjusted for the effects of these measures and seasonal factors, the index was broadly flat throughout the year. While deflationary pressures eased rapidly and, by some measures, dissipated, there were few signs of a pick-up in inflation.

The broad stability in the index masked divergent movements in its main components. The synchronised recovery in global growth and the revival in domestic economic activity led to increases in the prices of tradable and non-tradable goods and non-housing services. The rental component of the index continued to decline, exerting downward pressure on the aggregate index. The decline in the rental component contrasted with a moderate increase in market rents, as changes in the rental component lagged behind movements in market rents owing to fixed-term rental contracts, typically of one or two years (Chart 3).

CHART 2 Overall trade balance and export growth

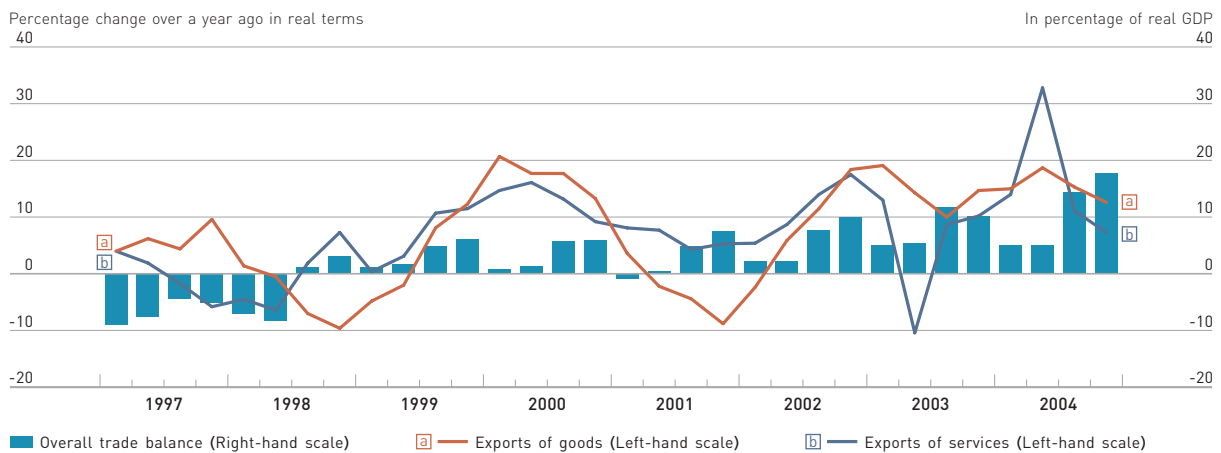
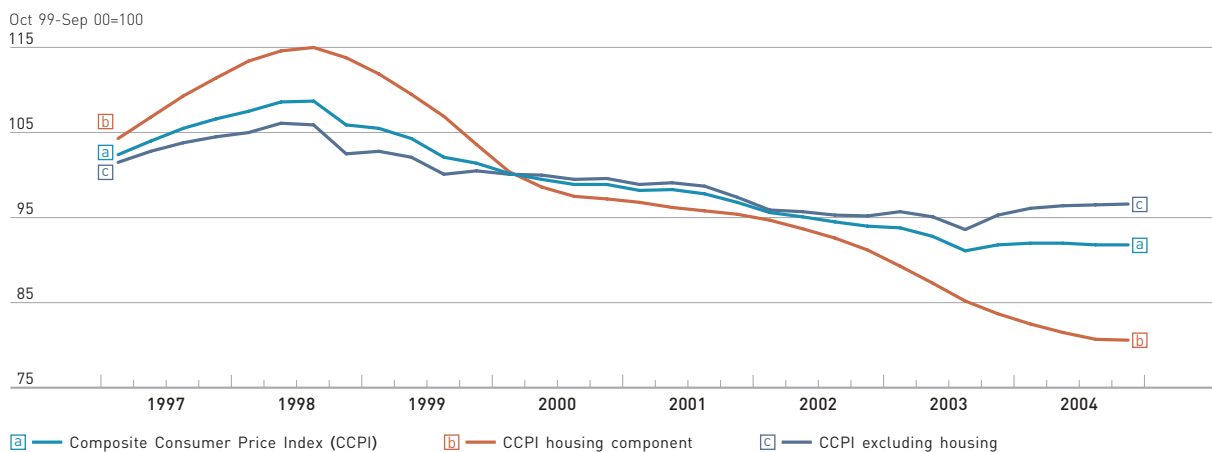


CHART 3 Consumer prices¹



¹ The Composite Consumer Price Index and its sub-indices are adjusted for the effects of special relief measures and seasonal factors.

Source: Census and Statistics Department and staff estimates.

Improved labour market conditions

The recovery resulted in a pick-up in employment, which helped bring down the unemployment rate to 6.5% in the three months ending in December, from a record high of 8.6% in May-July 2003. However, the pace of decline in the unemployment rate slowed in 2004, as increases in employment were partly offset by a rise in the labour force. The working-age population rose, and labour force participation increased as improved employment prospects attracted more people into the job market (Chart 4).

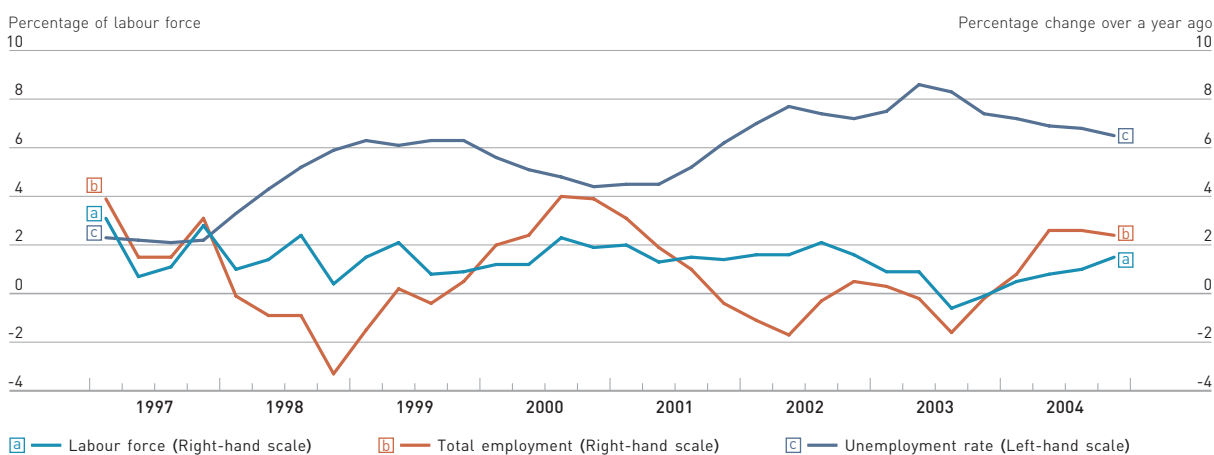
While increased employment led to a rise in household income, labour earnings remained broadly flat, as the relatively high rate of unemployment restrained wage increases. Median household income rose by 1.1% in 2004, following a drop of 7% in the previous year. Average nominal payroll, which includes remuneration, overtime payments, back-pay, and other irregular allowances and bonuses, decreased modestly by 0.7% in the first three quarters of 2004 over a year before, compared with a decline of 1.8% in 2003.

Sustained recovery in asset markets

The recovery in the property market continued in 2004, following the sharp rebound in the second half of 2003. Residential property prices increased by 27% during the year, while prices of commercial properties rose by 62%. Despite the recovery in the property market, the prices of most premises remained 40%–50% below their peaks in 1997. The rise in prices has been associated with increases in transactions, particularly at the high end of the market. The number of Sale and Purchase Agreements increased to a seven-year high in 2004, but was still 40% lower than in 1997.

Local stock prices were more volatile than property prices. After gaining 35% in 2003, the Hang Seng Index continued to rise in early 2004 before falling sharply between March and May on market expectations of an increase in US interest rates and concerns about the impact of monetary tightening in Mainland China. Stock prices rebounded strongly in the second half of 2004, supported by renewed capital inflows and the resulting low interest rates. The Hang Seng Index closed the year at 14,230, 13% higher than that at the end of 2003.

CHART 4 Labour market conditions



MONETARY CONDITIONS

Monetary conditions continued to be favourable in 2004, with low interest rates and a further decline in the effective exchange value of the Hong Kong dollar. With the Aggregate Balance gradually falling from unusually high levels and US dollar interest rates rising, Hong Kong dollar interest rates registered some moderate increases between April and September. Nonetheless, Hong Kong dollar interest rates declined markedly in the fourth quarter on inflows of funds, despite a further rise in US dollar rates. The trade-weighted real effective exchange increase continued to fall in 2004, reflecting a significant US dollar depreciation against other major international currencies and relatively low domestic price inflation.

Strong growth of narrow money and acceleration in broad money growth

Monetary aggregates increased in 2004. Hong Kong dollar narrow money rose by 16.3% during the year, reflecting buoyant stock market activity and the low opportunity cost of holding liquid monetary assets with near-zero short-term deposit rates. Meanwhile, growth of Hong Kong dollar broad money accelerated in the fourth quarter, after registering moderate increases in the first three quarters. Compared with the end of previous year, broad money grew by 4.6% in 2004, largely in line with nominal GDP growth.

Notes and coins

At the end of 2004 the total value of banknotes in circulation was \$146,775 million, an increase of 9.4% from a year ago (Charts 5, 6, 7). The total value of government-issued notes and coins in circulation was \$6,122 million, an increase of 0.9% from a year ago (Charts 8 and 9). By the end of the year, the \$10 note in circulation had reached a value of \$1,131 million, an increase of 8.5% from 2003.

New Hong Kong banknotes

The three note-issuing banks issued the remaining three denominations of the new series of Hong Kong banknotes (\$20, \$50 and \$1,000) in October 2004. The first two denominations (\$100 and \$500) had been put into circulation in December 2003. Additional security features have been incorporated in the new series. These include denomination numerals in optical variable ink, a fluorescent machine readable barcode, a four-millimetre-wide windowed thread and iridescent images. Security features and colour schemes have also been standardised among the banknotes to enable easy recognition by the public.

 > [Consumer Information](#) > [New Hong Kong Banknotes](#)

The HKMA carried out an extensive educational campaign with the aim of promoting public awareness of the designs and security features of the new series banknotes. Activities in the education campaign include

- distribution of more than 770,000 educational leaflets on the new banknotes
- 30 public seminars on the new banknotes, including outreach talks for centres for the elderly and societies for persons with visual impairments
- visits by student ambassadors to around 40,000 retailers in shopping malls, markets and streets throughout Hong Kong.

CHART 5 Banknotes in circulation by note-issuing banks at the end of 2004

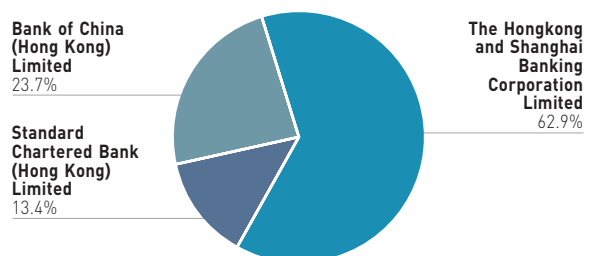


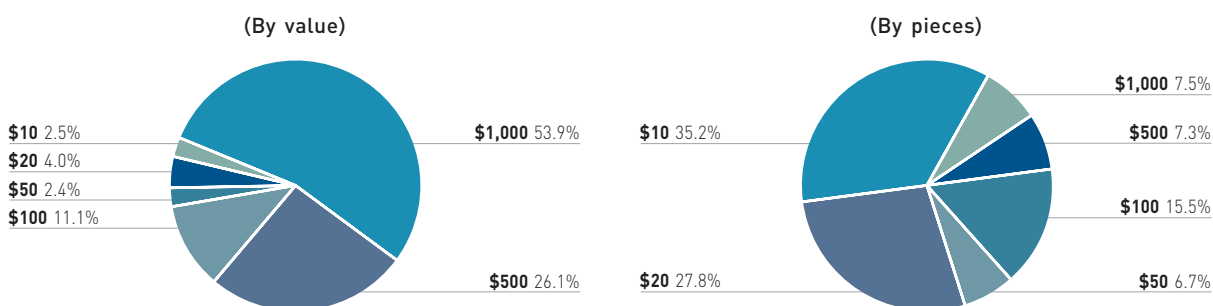
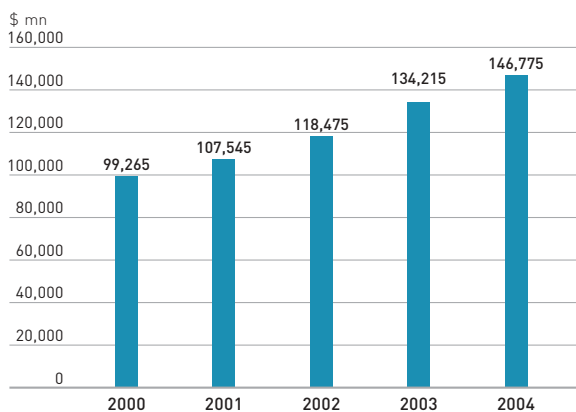
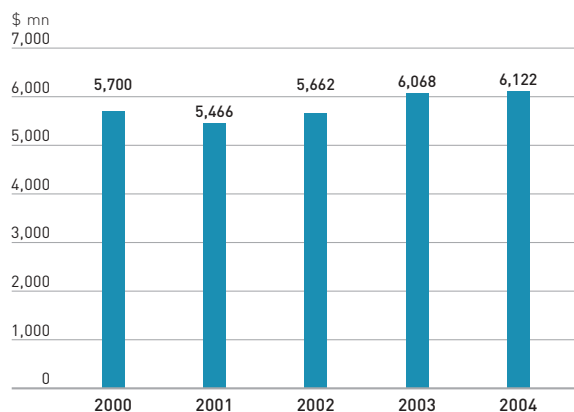
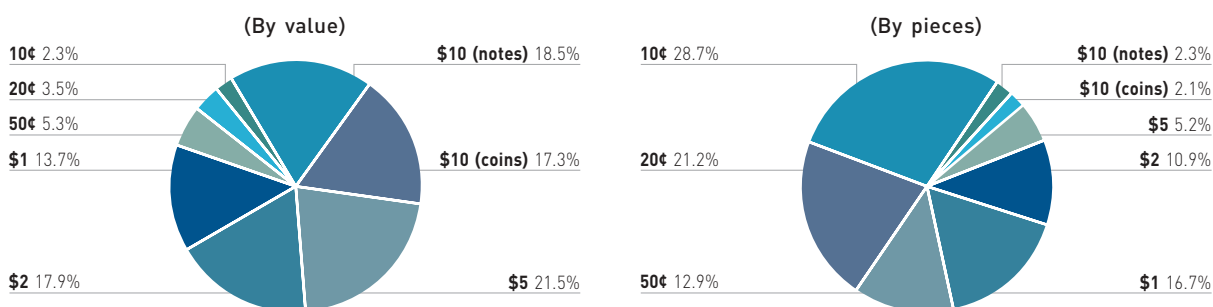
CHART 6 Distribution of banknotes in circulation at the end of 2004

CHART 7 Banknotes in circulation at end of year

CHART 8 Government-issued notes and coins in circulation at end of year¹

¹ Including \$10 notes but excluding coin sets and commemorative gold coins.

CHART 9 Distribution of government-issued notes and coins in circulation at the end of 2004


Coin replacement programme

The programme to withdraw coins bearing the Queen's Head design continued throughout the year. In 2004, 29 million coins were removed from circulation.

 [Consumer Information > Notes and Coins](#)

OUTLOOK FOR THE ECONOMY

Recovery to continue

The economic recovery is expected to continue in 2005, but the pace of expansion is likely to be slower than in 2004. Growth in Hong Kong's exports of goods and services is expected to moderate because of slower global expansion. Nevertheless, the implementation of the Closer Economic Partnership Arrangement (CEPA) with Mainland China, starting from January 2004, and a broadening of the Individual Visit Scheme for Mainland visitors travelling to Hong Kong should support Hong Kong's exports. Growth in domestic demand may also moderate, in part reflecting a slower increase in export earnings. While growth in domestic demand tends to follow growth in export earnings, experience suggests that the two can deviate as a result of asset price movements. Thus, developments in the property market may provide support to domestic demand in the face of slower external demand growth. However, the outlook for the property sector is difficult to assess, as asset prices are forward-looking in nature and they reflect market expectations about future macroeconomic and financial developments.

Inflation to increase and labour market conditions to improve


Consumer prices are expected to rise moderately in 2005, following a small decline in 2004. A positive output gap, rising import prices (in part associated with the weak US dollar), and higher market rentals will exert upward pressure on consumer prices. On the other hand, with the unemployment rate still at a relatively high level, upward pressure on inflation from labour costs is likely to be modest. Other factors that may help contain inflationary pressures include the expected


slower global growth and a gradual deceleration of growth and inflation in Mainland China.

Labour market conditions are expected to continue to improve in 2005. Employment is likely to expand alongside continued recovery in economic activity. But the pace of increase may be moderated in the light of uncertain external developments and expectations of a slower growth. This suggests that the unemployment rate is unlikely to record a sharp decline in 2005.

Uncertainties and risks

The largely positive outlook for the Hong Kong economy is subject to a number of uncertainties and risks arising from both external and domestic developments. The main external uncertainties are the prospects for the US dollar and interest rates, volatility in oil prices, and macroeconomic and financial conditions in Mainland China. Oil prices are likely to remain volatile, given geopolitical uncertainties. There has been renewed focus in the foreign exchange market on the sustainability of the US current account deficit and its implications for the US dollar. An *orderly* decline in the value of the US dollar, to which the Hong Kong dollar is linked, would help improve Hong Kong's competitiveness. A *disorderly* decline, on the other hand, may disrupt global financial markets. US interest rates may rise by more than expected, although the passthrough to Hong Kong dollar interest rates may not be immediate and complete if it is associated with an increased inflow of funds. Higher interest rates could, however, lead to slower growth in the global economy, which in turn would affect Hong Kong. In Mainland China, the risk of a sharp slowdown in growth has receded, but pressure on monetary conditions arising from capital inflows could increase if the US dollar depreciates further against other currencies. Domestically, one concern arises from easy monetary conditions and their potential impact on inflation and property prices.

 [Information Centre > Publications > Half-Yearly Monetary and Financial Stability Report](#)

 [Information Centre > Statistics](#)

PERFORMANCE OF THE BANKING SECTOR

The banking sector performed well in 2004, benefiting from the broad-based economic upturn and closer ties with Mainland China under the Closer Economic Partnership Arrangement.

Reflecting the improvement in the economy, domestic loan growth of 7.2% was recorded in 2004, reversing the contraction in 2003. This helped contribute to strong profit growth, particularly in retail and private banking sector, and enhanced revenue from treasury business. With the unemployment rate falling and property prices rising, asset quality continued to improve.

Banks' profit margins, however, continued to come under pressure. Although 2004 saw rising interest rates in the United States, the rates in Hong Kong remained low, because of the high level of liquidity

in the banking sector. Competition for new business, in particular residential mortgages, has led to margin contraction.

Interest rate trends

Interbank and deposit rates remained low

Given the high level of liquidity in the banking sector, and a strong inflow of funds, the best lending rate in Hong Kong scarcely moved from 5.00%, despite the series of 25-basis-point increases in US interest rates that began in mid-2004. As a result, one-month HIBOR fell to an annual average of 0.25%, compared with 0.92% in 2003, and the one-month time deposit rate more than halved, from 0.07% to 0.03% (Table 3). The spread between the annual average best lending rate and annual average one-month HIBOR widened to 477 basis points compared with 408 basis points in 2003, while that between best lending rate and one-month time deposit rate was almost unchanged.

TABLE 3 Hong Kong dollar interest rate movements (period average figures)

% per annum	Time deposits			HIBOR			Saving deposits	Best lending rate
	1-month	3-month	12-month	1-month	3-month	12-month		
Q4 2003	0.02	0.02	0.05	0.12	0.24	0.92	0.02	5.00
Q1 2004	0.004	0.01	0.03	0.07	0.08	0.44	0.004	5.00
Q2 2004	0.01	0.02	0.15	0.10	0.30	1.17	0.003	5.00
Q3 2004	0.03	0.06	0.43	0.42	0.69	1.53	0.02	5.01
Q4 2004	0.07	0.09	0.44	0.41	0.48	1.09	0.07	5.06
2003	0.07	0.07	0.12	0.92	0.96	1.24	0.03	5.00
2004	0.03	0.04	0.26	0.25	0.39	1.06	0.02	5.02

Profitability trends

Retail banks by and large recorded strong profit growth in 2004, benefiting from the domestic economic upturn and strong growth in external trade. Retail banks' aggregate pre-tax operating profits for their Hong Kong offices increased by 20.3%, compared with an increase of 5.7%^r in 2003 (Chart 10), and after-tax return on average assets rose to 1.38% from 1.18%^r in 2003 (Chart 11).

Improved profitability was primarily attributable to the sharp reduction in bad debt provisions, solid income from treasury operations, and increased level of fees and commissions. In line with the continuing improvement in asset quality, retail banks' overall bad debt charge fell markedly compared with 2003, while their ratio of bad debt charge to average total assets improved to -0.02%, from 0.29% in 2003 (Chart 12) as provisions write-back by some banks more than

offset new bad debt charges. The proportion of retail banks' non-interest income to total income increased to 39.3% from 33.8% in 2003, while the share of income from treasury operations remained constant at approximately 20%.

CHART 11 Retail banks' return on assets (after-tax profit)

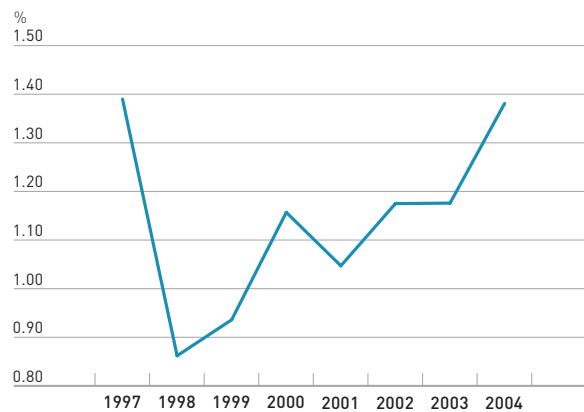


CHART 10 Retail banks' year-on-year growth of operating profit before tax

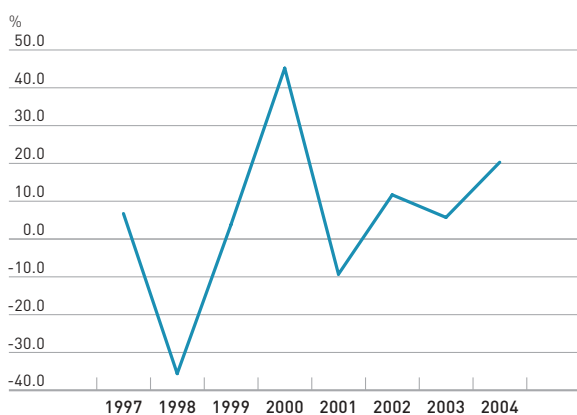
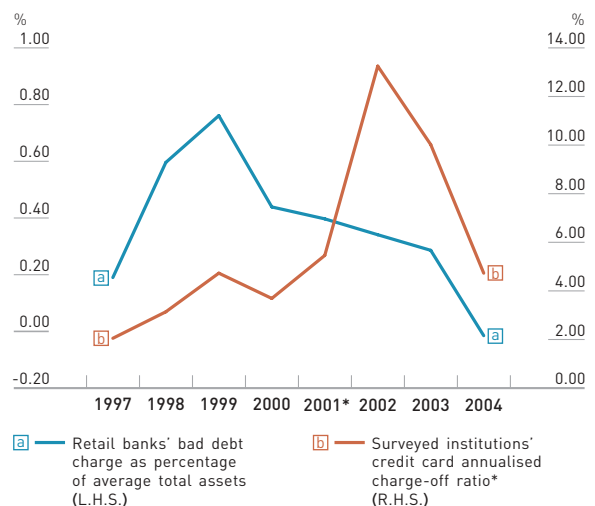


CHART 12 Charge-off ratios



* There is a break in series at December 2001 owing to an increase in the number of surveyed institutions.

^r Figures revised.

The net interest margin of the retail banks contracted to 1.65% from 1.91% in 2003 (Chart 13). The contraction was due to the continued squeeze in lending margins resulting from competition, particularly in residential mortgage lending, and the lower yield on free funds. A decline in net interest income was partially reversed in the fourth quarter as a result of an expansion in interest-bearing assets.

Banks also experienced an increase in their operating costs. Retail banks' cost-to-income ratio rose to 41.6%, from 38.6%^r in 2003, reflecting a general increase in operating costs and other expenses relating to business expansion, especially in Mainland China, as well as system enhancements (Chart 14).

Balance sheet trends

On the back of domestic economic upturn and a strong inflow of funds, the total assets of the banking sector increased by 10.0%, and those of retail banks by 9.1%, with much of the increase occurring in domestic lending, interbank lending, and the holding of debt securities. Retail banks' deposit liabilities increased by 7.4%, the same as in 2003, but the growth was particularly strong in the fourth quarter, reflecting the inflow of funds.

Domestic loan demand grew

Stimulated by the improving domestic economy and strong growth in external trade, retail banks' total lending rose by 8.3% in 2004. Domestic lending increased by 7.2%, compared with the decrease of 1.0% in 2003, much of it for property-related lending

CHART 13 Retail banks' net interest margin

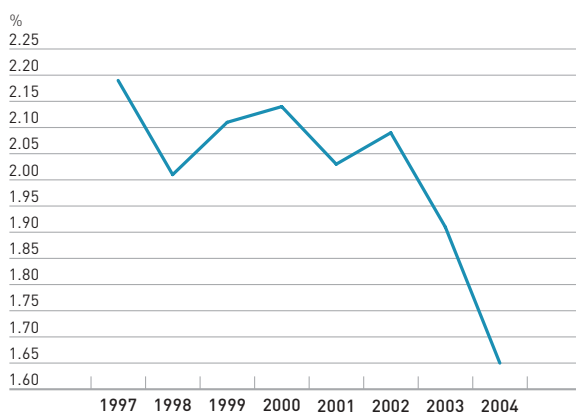
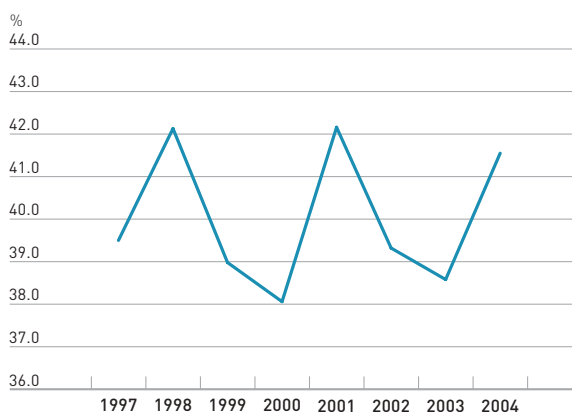


CHART 14 Retail banks' cost-to-income ratio

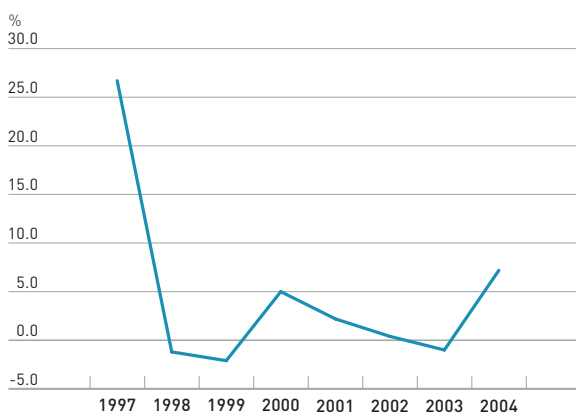


^r Figures revised.

and trade finance (Chart 15). The broad-based economic recovery was reflected in increased lending to almost all major economic sectors.

In line with the rebound in property market activity, property lending rose by 5.7%, compared with a decrease of 2.0% in 2003. The growth was particularly strong in loans for property investment, which recorded a 16.0% increase after having been flat in 2003. Residential mortgage loans increased by 2.9% compared with a decrease of 1.4% in the previous year. Loans for property development fell by 3.8% for the year as a whole, much smaller than the 11.0% decline recorded in 2003, and witnessed an increase in the final quarter. Loans for the purchase of flats under the Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme fell by 11.3% because of the continuing freeze on sales of flats under these schemes.

CHART 15 Retail banks' year-on-year growth of loans to customers inside Hong Kong*



* Defined as loans for use in Hong Kong plus trade-financing loans.

Reflecting the robust growth in external trade, trade finance rose by 17.6% compared with an increase of 11.7% in 2003. Loans to the manufacturing sector and transport and transport equipment sector also rose by 29.6% and 11.1% respectively, having increased by 12.0%^r and 9.6% respectively in 2003. Driven by the inflow of Mainland visitors and growth in private consumption, lending to the wholesale and retail trade sector grew by 11.6% against a decline of 7.7% in 2003. Despite the high level of stock market activity, loans to stockbrokers fell by 30.4%, compared with an increase of 13.4% in 2003. However, loans to non-stockbroking companies and individuals for purchasing shares rose by 11.9% against a decrease of 9.5% in 2003. Lending to the telecommunications sector continued to decrease, although at a slower rate than previously, falling by 20.8%, after a 35.6% fall in 2003.

Led by the revival in consumer confidence, consumer lending, particularly credit card business, expanded in 2004, with much of the increase occurring in the fourth quarter. According to the regular survey of authorized institutions active in credit card business, total credit card receivables rose by 5.2% after a decline of 5.0% in 2003.

Total outstanding exposure to non-bank Chinese entities increased in 2004. This was attributable largely to the increase in exposures to red chip companies and their subsidiaries. Retail banks' exposure increased by 24.3% to \$128.4 billion at the end of 2004 and accounted for 2.7% of their total assets. The exposure of the banking sector also increased to \$178.5 billion (2.4% of total assets).

^r Figures revised.

Level of negotiable debt instruments rose

The holding of negotiable debt instruments (NDIs, excluding negotiable certificate of deposits (NCDs)) by the retail banks continued to grow, but at a slower pace than in the past two years. The increase of 6.7% compared with double-digit increases in both 2002 and 2003. The increase was largely in Exchange Fund papers and corporate debt instruments denominated in Hong Kong dollars. NDIs denominated in Hong Kong dollars grew by 14.0% while foreign currency NDIs rose by 3.1% (Chart 16). A total of 55.3% of NDIs were issued by corporates, 23.5% by governments and

21.2% by banks (Chart 17). Total holdings of NDIs by the retail banks remained steady at 21.3% of their total assets at the end of 2004, compared with 21.8%^r a year before.

In view of the continuing low interest rate environment, demand for NCDs by retail customers continued in 2004, as reflected by the 10.4% increase in outstanding NCDs issued following an increase of 17.3% in 2003. With increased holdings of NCDs by retail customers, the proportion of outstanding NCDs held by retail banks dropped to 31.0% at the end of 2004, compared with 35.0% a year before.

Customer deposits grew

Retail banks' total customer deposits grew by 7.4%, the same rate as in 2003 (Chart 18). The growth was partly associated with the strong inflow of funds, particularly in the fourth quarter.

CHART 16 Negotiable debt instruments held by retail banks (currency breakdown)

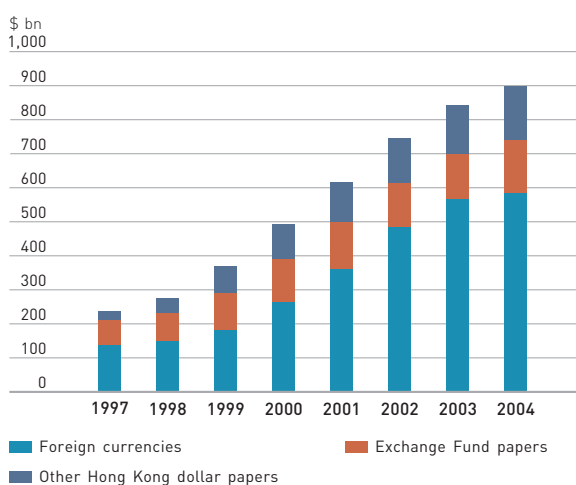


CHART 17 Negotiable debt instruments held by retail banks (counterparty breakdown)

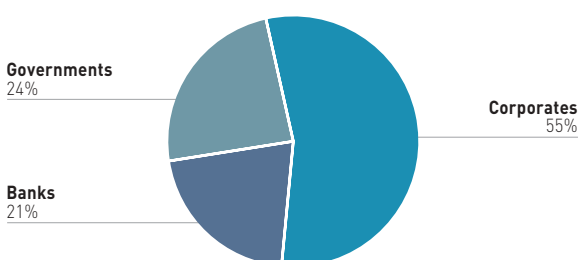
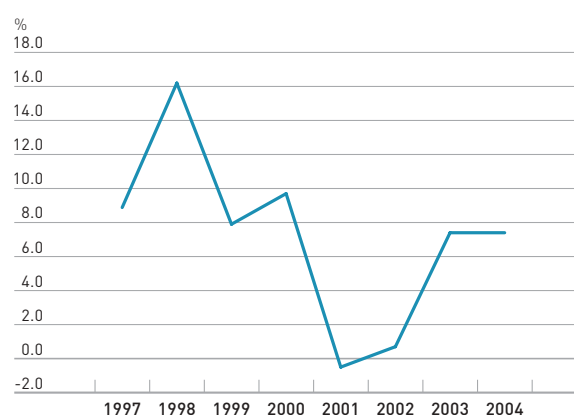


CHART 18 Retail banks' year-on-year growth of total customer deposits



^r Figures revised.

The increase in foreign currency deposits of 11.3% far outpaced the 4.9% increase in Hong Kong dollar deposits (Chart 19), resulting in a slight fall in the proportion of Hong Kong dollar deposits to total deposits to 59.6% compared with 61.0% at the end of 2003. After falling for three consecutive years, time deposits increased slightly by only 1.1% in 2004 against a decrease of 12.3% in 2003. Both savings and demand deposits continued to increase by 11.8% and 22.9% respectively. At the end of 2004, savings and demand deposits together accounted for 53.3% of total deposits, up from 50.4% a year before. The bulk of the increase in savings and demand deposits, however, occurred largely in the fourth quarter.

Retail banks remained highly liquid

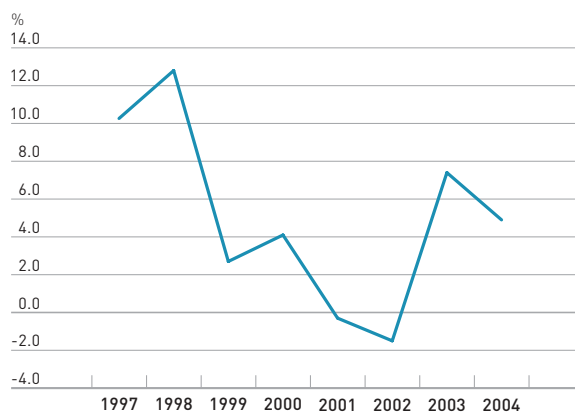
Despite strong loan growth in 2004 retail banks remained highly liquid. Retail banks' loan-to-deposit ratios in all currencies stood at 50.0%, recovering slightly from their all-time low in 2003.

The Hong Kong dollar loan-to-deposit ratio stood at 73.2% against 71.6% at the end of 2003.

Improvement in overall asset quality continued

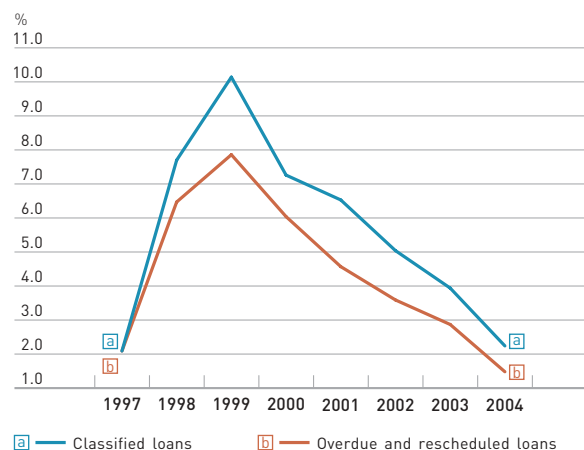
The asset quality of retail banks continued to improve in 2004 reflecting the improved domestic economy, rising property values, improved employment market, and lower level of bankruptcies. All problem loan ratios of the retail banks declined, returning to their pre-Asian financial crisis levels. Loans overdue for more than three months dropped to 1.04% from 2.04%^r at the end of 2003. Coupled with a decrease in the rescheduled loan ratio to 0.45%, the combined ratio of overdue and rescheduled loans improved to 1.48% from 2.87%^r. The classified and non-performing loan ratios also declined to 2.24% and 1.62% from 3.94%^r and 3.17%^r respectively at the end of 2003 (Chart 20).

CHART 19 Retail banks' year-on-year growth of Hong Kong dollar deposits*



* Including swap deposits.

CHART 20 Retail banks' gross classified loans and combined overdue and rescheduled loans as a percentage of total loans



^r Figures revised.

The delinquency ratio for the residential mortgage portfolio reached its lowest level of 0.38% since mid-1998, reflecting an improved labour market and the resultant strengthening of homeowners' repayment ability (Chart 21). The rescheduled loan ratio remained stable at 0.47%, reflecting banks' on-going efforts to restructure loans to borrowers in financial difficulties.

The problem of negative equity also eased with the increase in property prices. The outstanding number of residential mortgage loans in negative equity decreased by 80% from the peak of 106,000 cases to 19,200 cases at the end of 2004.

The overall quality of credit card lending by retail banks also improved, with the credit card charge-off ratio for the year dipping to 4.73%, from 10.02% in 2003 (Chart 12), and the credit card delinquency ratio declining to 0.44% from 0.92%. The improvements were helped in part by the transfer of some rescheduled receivables outside the credit

card portfolio. Taking into account the outstanding rescheduled credit card receivables amounting to \$70 million or 0.1% of total receivables within the card portfolio, the combined delinquency and rescheduled ratio stood at 0.55% at the end of the year.

 > [Information Centre > Press Releases > Residential Mortgage Survey](#)

 > [Information Centre > Press Releases > Credit Card Lending Survey Results](#)

Strong capital ratio

With a faster increase in the capital base than in risk-weighted assets, the capital adequacy ratio of all locally incorporated AIs increased to 15.4% at the end of 2004 from 15.3% at the end of 2003 (Chart 22).

As a result of the increase in paid up capital, the tier one capital ratio increased to 13.7% at the end of 2004, compared with 13.1% at the end of 2003 (Chart 22).

CHART 21 Asset quality of credit card and mortgage lending by surveyed institutions

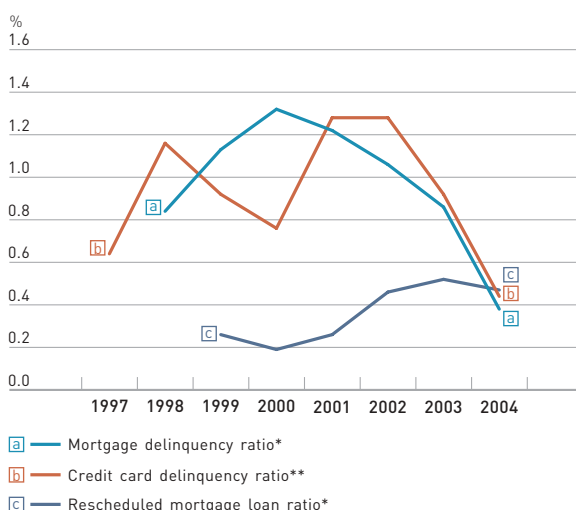
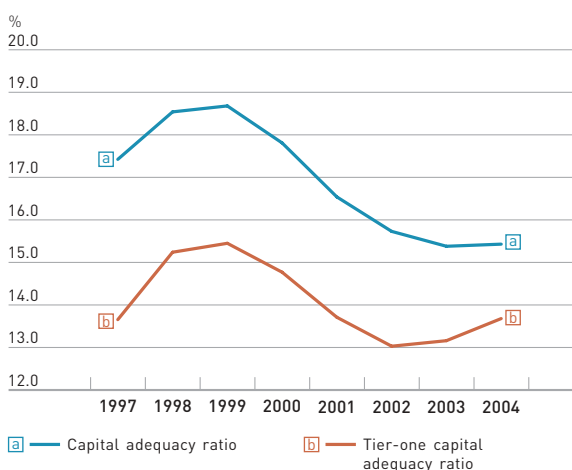


CHART 22 Consolidated capital adequacy ratio of all locally incorporated AIs



PROSPECTS FOR 2005

The robust performance of banks in 2004 reflected in large part the improved economic conditions in Hong Kong. The positive economic prospects have also provided a solid platform for continuing improvement in business outlook. The steady increase in property prices, should it continue, will relieve more homeowners from negative equity problems and strengthen households' balance sheets. Buoyant exports and the revival in consumer spending should continue to underpin domestic economic growth in 2005. The improvement in banks' asset quality should therefore continue.

There are, however, uncertainties in the global economic environment, including the impact of the macroeconomic realignment initiatives in Mainland China, the pace and depth of the economic recovery in the United States, and geopolitical tensions.

The greatest uncertainty in banks' operating environment relates to the future direction of capital flows in Hong Kong. Should recent capital inflows reverse suddenly, the banking system will face a challenge in managing its interest rate risk. On the other hand, if no reversal of capital flows occurs, and the liquidity of the banking system remains high, deploying the large amount of free funds in a competitive environment while maintaining a reasonable profit margin will also be a challenge. Together with rising operating costs, this could put pressure on banks' ability to continue to maintain profitability growth as strong as in 2004. Managing these risks will require banks to keep a tight rein on their operating expenses while exploring new revenue and profit streams through development of new business lines.

In addition, the wider use of fair-value accounting required by the adoption of new international accounting standards in 2005 could result in greater volatility in banks' financial statements globally. It is impossible to predict with certainty the underlying effect on banks' balance sheets and earnings.



The camphor tree, *Cinnamomum camphora*, is often planted as a fung shui tree in village groves, and as a shade tree in parks and gardens. Camphor is obtained from the tree for medicinal and other uses, and the wood of the tree is prized for its insect-repelling properties.

MONETARY STABILITY

The Linked Exchange Rate system operated smoothly in 2004 despite the depreciation of the US dollar, market speculation about revaluation of the renminbi, and interest rate increases in the US.

OBJECTIVES

The primary monetary policy objective of Hong Kong is currency stability, defined as a stable external exchange value of the currency of Hong Kong, in terms of its exchange rate in the foreign exchange market against the US dollar, at around HK\$7.80 to US\$1. The structure of the monetary system is characterised by Currency Board arrangements, requiring the Hong Kong dollar Monetary Base to be at least 100 per cent backed by US dollar reserves held in the Exchange Fund at the fixed exchange rate of HK\$7.80 to US\$1. Any changes in the Monetary Base must be matched by corresponding changes in the US dollar reserves.

The Monetary Base has four components:

- Certificates of Indebtedness, which are used to back the banknotes issued by the three note-issuing banks
- government-issued notes and coins in circulation
- the sum of the balances on the clearing accounts held by banks with the HKMA (known as the Aggregate Balance)
- Exchange Fund Bills and Notes, which are issued by the HKMA on behalf of the Government.

 > [Daily Updates](#) > [Monetary Base](#)

The Hong Kong dollar exchange rate is stabilised around the Linked Rate through an automatic interest rate adjustment mechanism. When the demand for Hong Kong dollars decreases and the market exchange rate weakens to the Convertibility Rate of HK\$7.80 per US dollar, the HKMA stands ready to purchase Hong Kong dollars from banks. The Aggregate Balance (as part of the Monetary Base) will then fall, driving up Hong Kong dollar interest rates. An increase in Hong Kong dollar interest rates against their US dollar counterparts will induce capital inflows, thereby restoring exchange rate stability. Conversely, if the demand for Hong Kong dollars increases and the market exchange rate strengthens, the HKMA may sell Hong Kong dollars to banks for US dollars. The Aggregate Balance will then increase, placing downward pressure on Hong Kong dollar interest rates to restrain inflows.

 > [Policy Areas](#) > [Monetary Stability](#) > [Currency Board System](#)

REVIEW OF 2004

The exchange and money markets were generally stable during the year. As appreciation pressures in late 2003 subsided, the Hong Kong dollar exchange rate gradually depreciated towards the Convertibility Rate of 7.8 during the first four months of 2004 (Chart 1). The return of the exchange rate towards the Convertibility Rate was facilitated by strong-side operations of the Currency Board, under which the HKMA sold a total of \$22.3 billion worth of Hong Kong dollars in response to banks' bids during the first two months of the year. Thereafter, the Hong Kong

dollar exchange rate stayed close to the Convertibility Rate between April and September. The Convertibility Undertaking was repeatedly triggered during this period, with the HKMA purchasing a total of \$51.5 billion worth of Hong Kong dollars. The Hong Kong dollar exchange rate started to strengthen again in October, reaching 7.7703 on 8 December. The renewed strength in the Hong Kong dollar reflected several factors, including weaker sentiment towards the US dollar, upward pressure on the renminbi, and stronger growth in the Hong Kong economy. In response, the HKMA conducted a number of strong-side

operations in the fourth quarter, selling a total of \$12.6 billion of Hong Kong dollars. The Hong Kong dollar exchange rate finally closed at 7.7745 at the end of the year.

Under the Currency Board arrangements, foreign exchange operations by the HKMA lead to corresponding changes in the Aggregate Balance. As appreciation pressure subsided and the Convertibility Undertaking was repeatedly triggered, the Aggregate Balance declined from over \$50 billion in early 2004 to \$3.2 billion in late September (Chart 2). Inflows of funds resumed in

CHART 1 Market exchange rate and Convertibility Rate in 2004

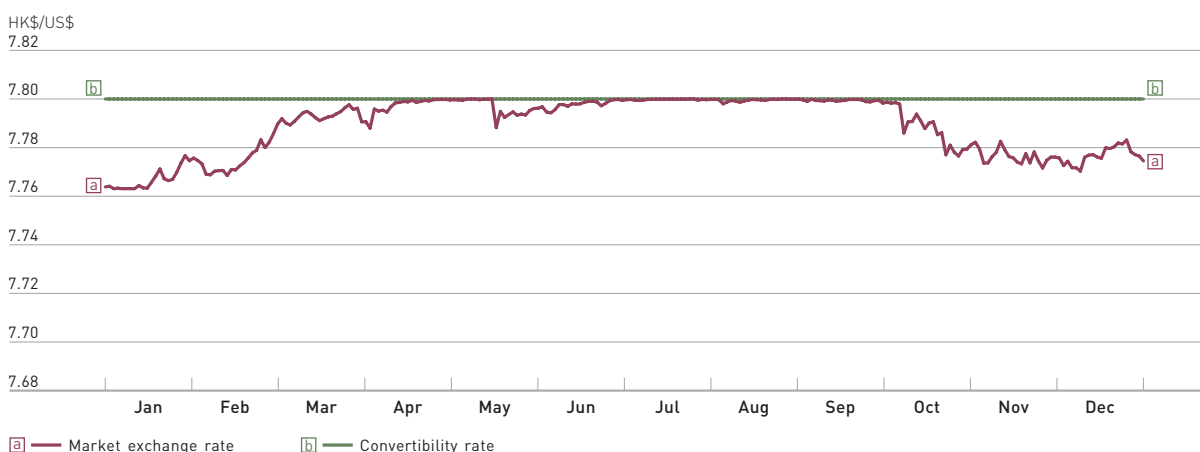


CHART 2 Aggregate Balance in 2004



the fourth quarter. The HKMA conducted a number of strong-side operations. The Aggregate Balance rebounded to close at \$15.8 billion at the end of the year.

The Hong Kong dollar forward discount further widened during the year (Chart 3). The 12-month forward discount fluctuated between 200 and 800 pips during the first nine months of the year, but increased in the fourth quarter to close at 1,650 pips at the end of the year. This reflected weakness

in the US dollar and renewed speculation about the exchange rate policy of the Mainland authorities.

With a cumulative increase of 125 basis points in the US federal funds target rate during the year, Hong Kong dollar interbank interest rates rose between April and September (Chart 4). However, interest rates started to ease in October because of increased liquidity in the face of capital inflows. This led to an increase in the negative spread between Hong Kong dollar interest rates and their

CHART 3 Hong Kong dollar forward points in 2004

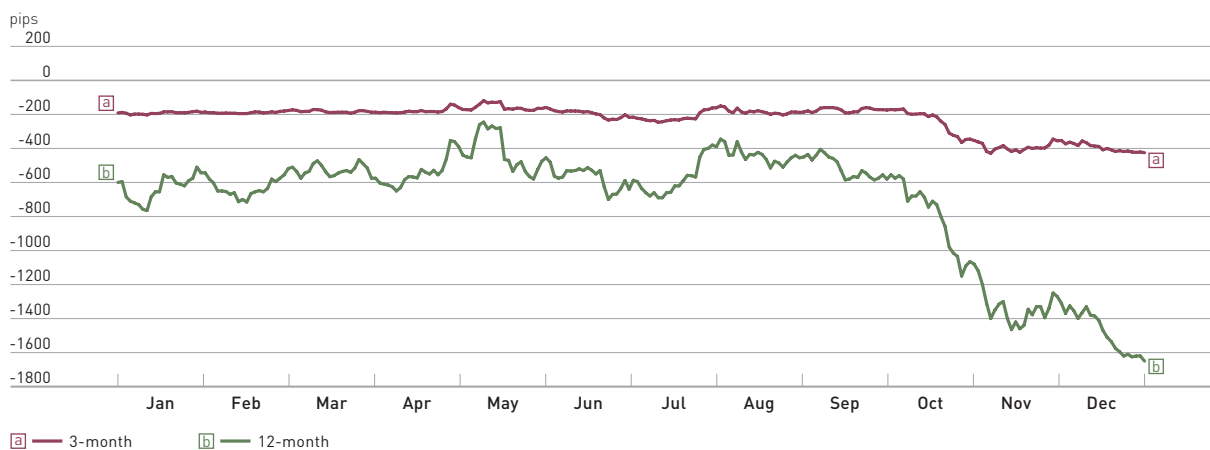
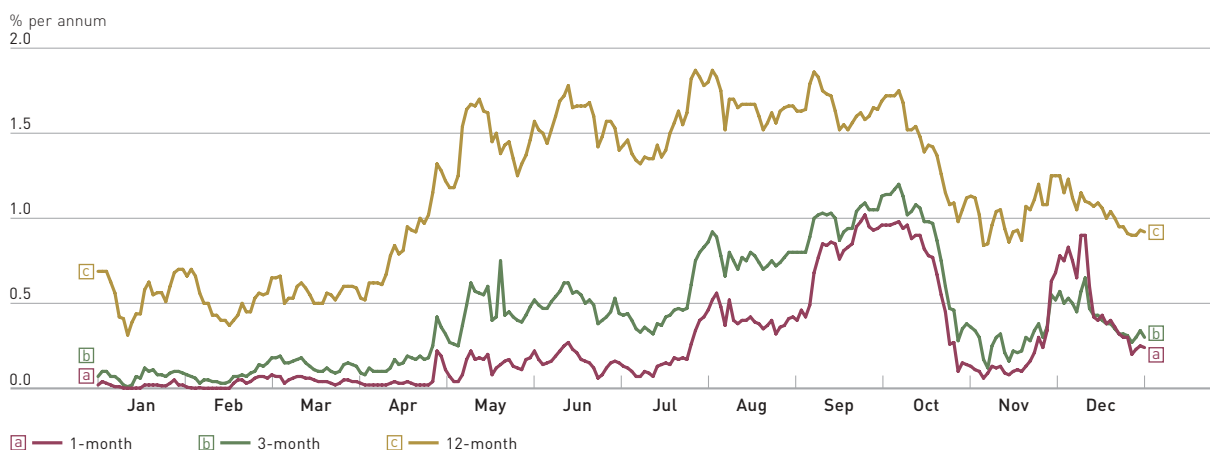


CHART 4 HIBORs in 2004



US dollar counterparts (Chart 5). Short-term interest rates rose for a brief period between mid-November and early December, attributable to liquidity demand associated with a number of equity IPOs. For the year as a whole, short-term interest rates rose only by about 20 basis points, considerably less than the increase of 125 basis points in the US rates.

Interest rate volatility, as measured by the standard deviation of daily changes in the one-month interbank rate, remained low during the

year. The Discount Window functioned smoothly to absorb liquidity shocks, and the overnight interbank interest rate rarely exceeded the Base Rate of the Discount Window.

To improve the transparency of the Currency Board Account, specific Exchange Fund assets have been set aside to back the Monetary Base since October 1998. The Backing Ratio, defined as the ratio of Backing Assets to the Monetary Base, rose from 110.06% at the beginning of the year to a high of 112.17% in mid-September (Chart 6). A large part

CHART 5 Hong Kong dollar – US dollar interest rate differentials in 2004

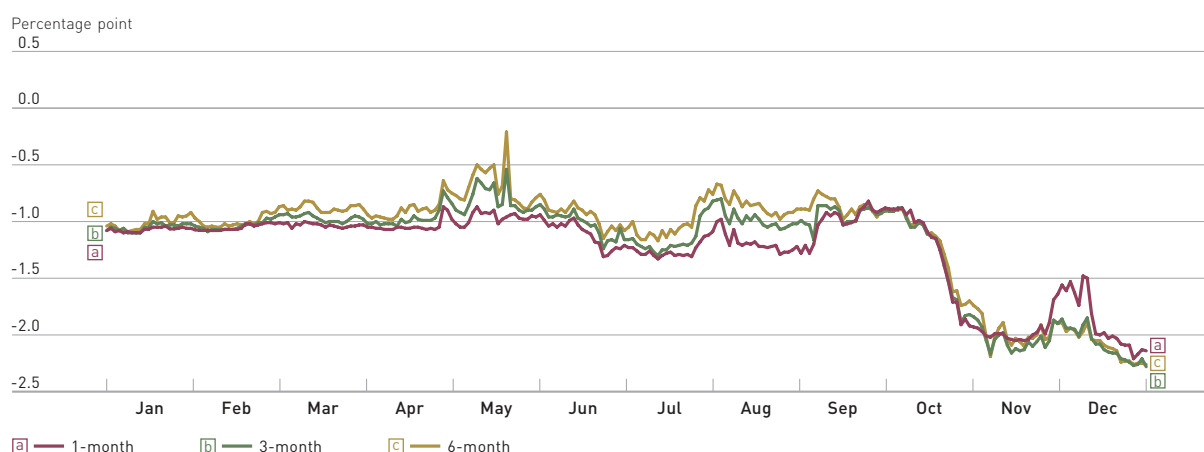
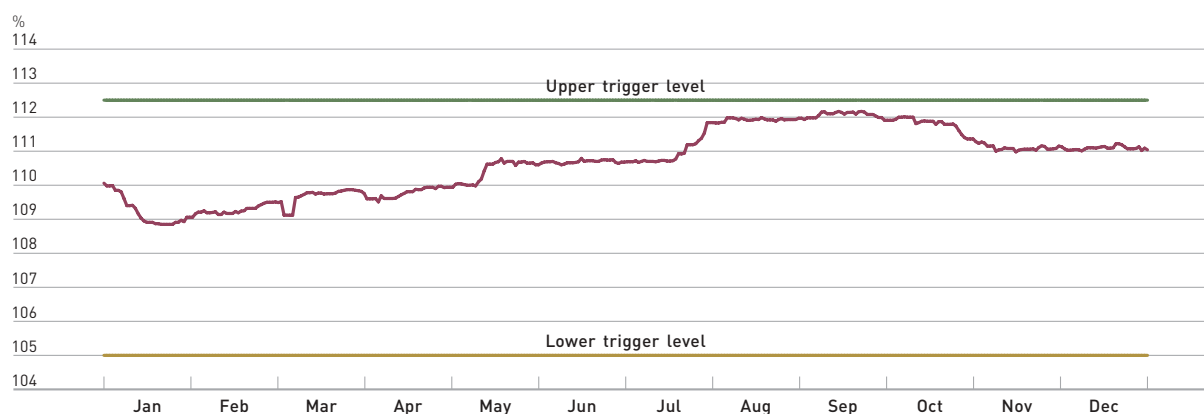


CHART 6 Daily movement of the Backing Ratio in 2004



of the increase was due to the reduction in the Aggregate Balance as a result of the triggering of the Convertibility Undertaking during the period.¹ Thereafter, as the HKMA conducted strong-side operations and the Aggregate Balance expanded in the fourth quarter, the Backing Ratio declined, and closed at 111.04% at the end of the year.

Activities at the HKMA

The EFAC Currency Board Sub-Committee continued to examine issues having a bearing on monetary and financial stability in Hong Kong. These issues included the possible issuance of Exchange Fund papers to reduce the Aggregate Balance, movements in the Backing Ratio, the adequacy of international reserve holdings, macroeconomic conditions in Mainland China, the use of the federal funds futures rate to extract information on market expectation of US monetary policy, and a review of HKMA operations in the foreign exchange market.

 > [Information Centre](#) > [Press Releases](#) > [Monetary Policy](#)

The Hong Kong Institute for Monetary Research, established in August 1999, continued to sponsor research in the fields of monetary policy, banking and finance. In 2004 the Institute hosted 16 full-time and two part-time research fellows. It also published 24 working papers and one occasional paper during the year.

 > [Information Centre](#) > [Research Memoranda](#)

The Institute co-organised with the International Monetary Fund a conference entitled *Managing Procyclicality of the Financial System: Experiences in Asia and Policy Options* on 22 November 2004 with the participation of senior policy makers of the region's central banks, academics, and officials from international financial institutions. In May 2004 the Institute co-organised with the Centre for Central Banking Studies of the Bank of England a one-week workshop on *Advanced Modelling for Monetary Policy in the Asian-Pacific Region*. The Institute organised two workshops on *Research on the Mainland Economy* in July and December. In addition to conferences and workshops, 38 public seminars were organised during the year on a broad range of economic and monetary issues.

 > [About the HKMA](#) > [Links](#) > [HKMA-related Organisations](#) > [Hong Kong Institute for Monetary Research](#)

PLANS FOR 2005 AND BEYOND

The HKMA will continue to study issues affecting the economy in its research programme for the coming year. The EFAC Currency Board Sub-Committee will closely monitor risks and vulnerabilities in the domestic and external environment that may affect Hong Kong's financial stability. The Sub-Committee will keep the technical aspects of the Currency Board arrangements under review and, where appropriate, recommend measures to strengthen them further.

¹ While the Backing Assets decreased by the same magnitude as the Monetary Base, the fractional decrease was smaller in the former because of its larger size, thus increasing the Backing Ratio.



One of the largest of the mangrove trees, the *Heritiera littoralis* (or looking-glass mangrove) can withstand submergence in the sea for several hours a day and yet still grow to the height of a three-storey building. Its strong buttress roots enable it to remain upright in loose soil and strong winds. It is found throughout South-East Asia and among the islands and coastlines of the Indian Ocean and the South Pacific.

BANKING STABILITY

One of the HKMA's main policy objectives is to promote the safety and stability of Hong Kong's banking system through the regulation of banking and deposit-taking business and the supervision of authorized institutions. In 2004 the HKMA continued to prepare for the implementation of Basel II and to improve the supervisory framework for preventing money laundering and terrorist financing. Progress was made in the establishment of a Deposit Protection Scheme. The first phase of the Commercial Credit Reference Agency was successfully launched in Hong Kong. In view of banks' increasing reliance on information technology and the growing popularity of Internet banking services, the HKMA developed further its Internet banking and technology risk management supervisory framework and worked closely with the banking industry to counter Internet banking fraud.

OBJECTIVES

Responsibility for promoting the safety and soundness of Hong Kong's banking system is shared among three departments within the HKMA:

- the *Banking Supervision Department* handles the day-to-day supervision of authorized institutions (AIs)¹
- the *Banking Policy Department* formulates supervisory policies to promote the safety and soundness of the banking sector
- the *Banking Development Department* formulates policies and pursues initiatives to promote the development of the banking industry.

¹ Institutions authorized under the Banking Ordinance to carry on banking business or the business of taking deposits. Authorized institutions are divided into three tiers: licensed banks, restricted licence banks (RLBs) and deposit-taking companies (DTCs).

REVIEW OF 2004

Operational supervision

The full implementation of the risk-based supervisory approach in 2004 enabled the HKMA to deploy its supervisory resources more effectively in accordance with the assessment of the specific risk areas to which individual AIs are exposed. This has enabled the HKMA to reduce the frequency of on-site examinations of AIs that are less risky, and to devote its resources to more intensive examinations of AIs with a higher level of inherent risk. During 2004 the HKMA conducted a total of 247 on-site examinations, which included 78 risk-focused, 11 treasury, and seven securities examinations. The on-site examinations also included 36 focused examinations to assess AIs' compliance with the restrictions on personal renminbi business, which was launched in February 2004. The HKMA carried out 17 focused examinations of residential mortgage loans and 16 focused examinations of credit card operations.

The HKMA also conducted examinations of three Als active in insurance-related activities to check their compliance with the codes of conduct governing the sale of insurance products to their customers. In view of Als' increasing reliance on information technology (IT) and the growing popularity of Internet banking services, the HKMA's specialised examination teams conducted 24 Internet banking and IT-related examinations, of which 17 examinations also covered a review of the Als' business continuity planning.

The implementation of the revised *Supplement to the Guideline on Prevention of Money Laundering* took effect on 31 December 2004. During 2004 the HKMA continued to focus primarily on high-level reviews of Als' controls over preventing money

laundering, and conducted 53 money laundering examinations as part of its routine examinations.

The number of off-site reviews and tripartite meetings conducted in 2004 was slightly lower than in 2003 because the HKMA lengthened the off-site review cycle of Als with smaller and simpler operations and redeployed the resources to handle other ad hoc duties, which included the approval of bank mergers and restructuring, and processing migration applications under the Securities and Futures Ordinance (SFO).

The HKMA continued to maintain regular contact with the boards of directors of locally incorporated Als. HKMA staff met the boards of five banks and one restricted licence bank, and the chairpersons of the audit committees of one bank and one deposit-taking company during 2004. The HKMA and the boards concerned found this arrangement useful in strengthening communication and improving understanding of the state of affairs, financial position and strategic direction of the Als.

The Banking Supervision Review Committee considered nine cases during 2004 relating to the licensing of Als and approval of controllers. In addition, 376 applications to become controllers, directors, chief executives and alternate chief executives of Als were approved. Details of the operational supervisory work performed in 2004 are set out in Table 1.

In 2004 the HKMA used the powers under Section 59(2) of the Banking Ordinance to require one AI to commission external auditors to review internal control issues and report their findings to the HKMA.

TABLE 1 Operational supervision

	2003	2004
1. On-site examinations	247	247
Including those on:		
- treasury	9	11
- securities	18	7
- e-banking	28	24
- review of business continuity plan	20	17
- review of personal renminbi business	-	36
- overseas examinations	9	20
2. Off-site reviews and prudential interviews	216	183
3. Tripartite meetings	77	66
4. Meetings with boards of directors or board-level committees of Als	16	8
5. Approvals of applications to become controllers, directors, chief executives, alternative chief executives of Als	310	376
6. Reports commissioned under Section 59(2) of the Banking Ordinance	5	1
7. Cases considered by the Banking Supervision Review Committee	12	9

During 2004 no AI breached the requirements of the Banking Ordinance relating to the capital adequacy ratio and liquidity ratio. There were two breaches of the requirements relating to large exposures under Section 81 and two breaches of the requirements relating to connected lending under Section 83. All these breaches, which were technical and unintentional in nature, were promptly rectified and did not result in any risk to the interests of depositors or creditors. No use was made of the powers under Section 52 of the Banking Ordinance during the year.

Special examinations

In the second half of 2004 the HKMA conducted a special examination of a bank in relation to the unauthorised distribution of funds by certain of its senior executives. The aim of the special examination was to establish the full details surrounding the incident, assess the effectiveness of the bank's risk management and control systems at the time of the incident and the improvements made since, and determine the lessons learnt. The bank's audit committee and independent non-executive directors also conducted an investigation into the incident: the results confirmed that the funds involved were not assets of the bank, its subsidiaries or any of their customers, but were beneficially owned by the bank's parent company. Throughout the examination, the HKMA maintained close contact with the parent company of the bank and its home authority. At the request of the HKMA, the bank initiated an open, global recruitment process to identify suitable replacements for the positions vacated by various senior executives following the incident. The relevant appointments were announced by the bank before the end of the year.

In the light of this incident the HKMA carried out examinations of several other AIs to assess the effectiveness of their controls of similar accounts maintained by the head offices or parent banks. We identified certain weaknesses in the controls exercised by these AIs and required them to take appropriate remedial measures. Some of these examinations were still in progress at the end of the year.

During the year the HKMA received information from certain overseas and local authorities which suggested potential weaknesses in certain AIs' anti-money laundering procedures. In the light of this information, the HKMA conducted special reviews of the control procedures of some of these AIs and required them to take appropriate improvement measures.

Safeguarding customer assets and information

In October 2004, 83 rented safe deposit boxes at the Mei Foo branch of DBS Bank (Hong Kong) Limited were mistakenly destroyed during branch renovation work. A lesson learnt from the incident is that AIs should never underestimate the need for adequate supervisory oversight and control over outsourced operations. These operations, even though they may seem straight-forward and simple, can pose serious operational and reputation risks to AIs if they are not handled properly.

In the light of the incident, the HKMA issued a circular on 22 December 2004 requiring AIs to adhere to sound internal control principles when undertaking operations that involve customer assets. These should include ensuring sufficient planning for the operations, adequate supervisory oversight and control throughout the whole process, detailed records of customer assets (or items containing customer assets) being handled, and independent verification of the accuracy of these records.

Separately, the HKMA noticed that it was common for Als' marketing or customer service staff to meet customers at open-plan customer service desks or in cubicles where confidential customer information might be collected and retained in hard copy form or electronic form in computers or portable computers. To safeguard the confidentiality of customer information, the HKMA also took the opportunity of the circular to remind Als that they should have adequate data security procedures, such as computer log-on and application-specific access passwords and data encryption technology, to protect against theft and unauthorised access of computer equipment or information in open-plan areas. Als should also have appropriate security measures, such as surveillance cameras and security guards, to monitor any unauthorised access to unattended service desks and meeting rooms.

Asset quality

The asset quality of Als improved markedly alongside the recovery of the economy and the rise in property prices. The number of petitions for bankruptcies continued to fall, from 22,092 in 2003 to 12,489 in 2004. The delinquency ratio for residential mortgage loans improved steadily throughout the year, dropping from 0.86% at the end of 2003 to 0.38% at the end of 2004. The number of residential mortgages in negative equity fell to less than one-fifth of the peak level reached in second quarter of 2003, the lowest level since the start of the survey of mortgages in negative equity in 2001. The quality of credit card portfolios of Als also improved substantially in 2004: the delinquency ratio dropped from 0.92% in 2003 to 0.44% in 2004, the lowest level since the start of the credit card lending survey in 1996. The annualised charge-off ratio also declined from 10.02% in 2003 to 4.73% in 2004.

 > Information Centre > Press Releases > Residential Mortgage Survey

 > Information Centre > Press Releases > Credit Card Lending Survey Results

Focused examinations of residential mortgage loans

In view of the considerable increase in new residential mortgage loans by Als and renewed competition in this business, the HKMA conducted focused on-site examinations of 17 Als that were active in mortgage loans to assess whether they were following prudent lending practices in this business. The examinations reviewed the Als' compliance with the applicable guidelines issued by the HKMA, the adequacy of controls over equitable mortgages, and the extent of use of consumer credit data in assessing residential mortgage applications. The results of these examinations indicated that Als generally had effective risk management procedures for their residential mortgage loan business. However, there were isolated cases of Als breaching the 70% loan-to-value ratio guideline, and weaknesses were noted in the way in which some Als assessed borrowers' repayment ability. Following these examinations, the HKMA issued a circular to Als, drawing their attention to the findings and recommendations of these examinations. In particular, the circular reminded Als to adhere to the 70% guideline.

Focused examinations of credit card business

The HKMA carried out focused examinations of Als that were active in credit card business to review their underwriting criteria, risk management practices and use of consumer credit data in assessing credit card applications. The results of the examinations indicated that the Als had generally put in place effective risk management systems. In the light of the findings of the examinations, the HKMA issued a circular to Als in September 2004 asking them to continue to adhere to the relevant guidelines issued by the HKMA and the Code of Banking Practice, including the need to act responsibly in issuing and marketing credit cards.

Seminar on bankruptcy, mortgage and letter of credit frauds

There were a number of court cases in 2004 relating to bankruptcy, mortgage and letter-of-credit frauds committed against Als. To help Als to have a better understanding of the usual modus operandi of these types of frauds, the HKMA organised a seminar in August and invited speakers from the Department of Justice and Commercial Crime Bureau of the Hong Kong Police Force to advise Als on what they should do to improve their documentation standards and control procedures to guard against these types of frauds, and increase the chance of a successful prosecution if Als became a victim of such frauds.

Taxi loans and public light bus loans

The HKMA continued to monitor the market situation and asset quality of Als' taxi loan portfolios. With the recovery of the economy, the taxi licence value increased considerably in 2004 and was close to the 1997 level towards the end of the year. The operating income of taxi operators also recorded a mild increase in the year. As a result, the overdue and rescheduled loan ratio of the taxi loan portfolio (covering both urban and New Territories taxis) of the institutions surveyed by the HKMA improved significantly to 0.28% at the end of 2004 (2003: 3.18%²).

In 2004 the HKMA completed the review of the Guidance Note on Taxi Financing, which had been in place since December 2000. After consultation with the industry, and taking into account developments in the taxi finance market, the HKMA issued a circular in March 2004 to map out a new set of arrangements for the monitoring of taxi financing, which also covers public light bus

financing business. Under the new arrangements, individual Als are required to put in place their own internal policies for taxi and public light bus financing. The internal policies should set out, at a minimum, the maximum permissible loan-to-value ratio, which should normally not exceed 85%, and the debt servicing ratio, the maximum loan tenor, the limit on the portfolio size, and the cash rebate arrangements. The regular survey on taxi loans was revised to facilitate the HKMA's monitoring of Als' compliance with the new arrangements.

Personal renminbi banking business

Personal renminbi banking business has grown steadily in Hong Kong since its introduction in February 2004 (the chapter, International Financial Centre, has more details on this). Thirty-eight licensed banks in Hong Kong were offering renminbi services to their customers at the end of 2004. During the year the HKMA carried out on-site examinations of the personal renminbi business of 36 Participating Banks. The overall findings indicated a high degree of compliance with the business restrictions set out in the Agreement for Settlement of Personal Renminbi Business in Hong Kong and control effectiveness in the prevention of money laundering among the Participating Banks. Nevertheless, there was room for improvement for some Participating Banks relating to staff training on the various business restrictions, system automation for the processing of transactions, and preparation of more timely and comprehensive management information system reports on breaches of the business restrictions and suspected money-laundering transactions. Participating Banks were required to take appropriate measures to improve their systems.

² Adjusted from 3.30% after including the data of the lending institution added to the survey sample since January 2004.

CEPA

Since taking effect on 1 January 2004, the Closer Economic Partnership Arrangement (CEPA) has provided Hong Kong-incorporated banks with greater market access and flexibility to conduct business in Mainland China. Seven Hong Kong-incorporated banks have benefited from the lowering of the asset size requirement from US\$20 billion to US\$6 billion and have become eligible to establish branch operations on the Mainland. By the end of 2004, five of these banks applied, and four were given approval, to open branches on the Mainland. The relaxation of the criteria for Hong Kong-incorporated banks to conduct renminbi business has also been helpful to these banks' operations on the Mainland. By the end of 2004, two of these banks had already received the approval to conduct such business.

Following the introduction of CEPA II, the Mainland branches of Hong Kong-incorporated banks have since November 2004 been allowed to conduct insurance agent business with the approval of the relevant Mainland authorities. It is expected that this arrangement will help improve business and fee-income opportunities of the Mainland branches of Hong Kong-incorporated banks.

Supervision of Als' securities activities

The HKMA has been working closely with the Securities and Futures Commission (SFC) in the supervision of Als' securities activities. During the year the HKMA and the SFC held five bilateral meetings to discuss matters of common interest under the established mechanism of the Memorandum of Understanding. The HKMA also assisted the SFC in seeking views of the industry associations on the SFC's guidelines on disclosure of fees and charges relating to securities services. To strengthen supervisory co-operation and to ensure a consistent enforcement approach

between the two regulators, reciprocal secondment of staff was arranged during the year. Close liaison with the SFC was also maintained at the operational level to improve understanding about each other's practices. These arrangements have facilitated skill transfer and sharing of experience at various levels in the two organisations.

During the year, 58 incidents with potential grounds for discipline were reviewed by the Event Review Committee (the committee responsible for deciding whether to open cases for disciplinary investigation) and 12 cases were opened for investigation. The Disciplinary Committee (the committee responsible for making recommendations on the exercise of disciplinary powers) considered one case on completion of the investigation during the year. Since no disciplinary grounds could be established, the case was formally closed with no further action considered necessary.

In an effort to improve the workings of the Banking Ordinance, proposed amendments have been incorporated in the Banking (Amendment) Bill 2005 to put beyond doubt the MA's power to publish the relevant facts and findings surrounding cases subject to disciplinary actions under sections 58A and 71C of the Ordinance.

 [HKMA Register of Securities Staff of Authorized Institutions](#)

Supervision of Als' insurance-related and Mandatory Provident Fund activities

Following the signing of a Memorandum of Understanding with the Insurance Authority in late 2003, the first bilateral meeting between the two authorities was held in June 2004 to discuss current and evolving supervisory issues. To facilitate the HKMA's supervision of insurance-related activities, Als were required to submit half-

yearly returns to the HKMA on their insurance-related activities. On-site examinations were also conducted on AIs active in insurance-related business. The objectives of the examinations were to ensure the institutions' compliance with the codes of conduct governing the sale of insurance products issued by the Hong Kong Federation of Insurers and the adequacy of their risk management controls in this regard.

Following the implementation of the SFO, a revised Memorandum of Understanding was signed by the HKMA, the Mandatory Provident Fund Schemes Authority, the SFC and the Insurance Authority in 2004. The four regulators held a meeting in December 2004 to exchange views on regulatory requirements in relation to Mandatory Provident Fund intermediary activities.

Co-operation with overseas supervisors

The HKMA continued to maintain close working relationship with regulators outside Hong Kong. The Bundesanstalt für Finanzdienstleistungsaufsicht of Germany and the HKMA signed a Memorandum of Understanding on 5 January 2004, which established a formal framework for supervisory co-operation and sharing of supervisory information. The HKMA has also been discussing with a number of overseas supervisory authorities the establishment of similar arrangements. During the year, meetings were held in Hong Kong and overseas with regulators from the Mainland, the US, the UK, Australia, Indonesia, Japan, Macau, Singapore, Switzerland, Germany and Taiwan to discuss supervisory issues of common interest.

Initial public offerings

In early 2004 some fraud cases involving the theft of initial public offering (IPO) refund cheques aroused public concern about the security of the

IPO refund process. The HKMA, the SFC, the Hong Kong Police Force and the Federation of Share Registrars responded to the issue immediately and developed a number of measures to guard against similar frauds from happening. Following this, the HKMA issued a circular to all AIs in March 2004 informing them of the new measures. One of the new measures was to print part of the subscriber's identity card number on IPO refund cheques to facilitate checking by banks. The HKMA issued a circular to all AIs in July 2004 drawing their attention to the new arrangements and requiring them to ensure that their staff conduct proper verification of the payee's identity before accepting the deposit of an IPO refund cheque.

In the light of enormous public interest in the IPO of the Link Real Estate Investment Trust by the Housing Authority, the HKMA issued a circular in November 2004 drawing all AIs' attention to the supervisory requirements in relation to the IPO. Throughout the entire IPO process, the HKMA maintained close contact with the receiving banks and the SFC to ensure the smooth operation of the process.

AIs' migration applications under the SFO

Under the transitional arrangements of the SFO, AIs with deemed registration status (deemed RIs) will lose this status if they do not lodge migration applications to become Registered Institutions (RIs) by 31 March 2005. The HKMA wrote to the deemed RIs in October 2004 reminding them of the migration application requirements and deadline. By the end of 2004, 21 of a total of 90 deemed RIs had already migrated to RI status and 42 had submitted applications. The HKMA granted consent to 84 executive officers (responsible for supervising securities activities) of the RIs under the Banking Ordinance within the year.

Banking frauds through electronic channels

In view of the suspected automatic teller machine (ATM) skimming fraud cases reported in 2003, the HKMA recommended a set of precautionary measures to the banking industry and worked with the Hong Kong Police Force to tackle this form of crime. By mid-2004, all ATMs in Hong Kong were protected by appropriate measures, such as anti-skimming devices, closed-circuit television, and more frequent patrols of ATMs during and after office hours. All reported ATM skimming fraud cases were satisfactorily settled in the first quarter of 2004 and no newly reported cases have been received since November 2003. The HKMA worked with the banking industry and the Hong Kong Police Force to set up an ATM Fraud Prevention Task Force in 2004, which developed and launched a consumer education programme (including production of radio segments and posters) to heighten public awareness of ATM security.

The number of reported fake bank websites surged from eight in 2003 to 34 in 2004. The HKMA issued press statements on cases drawn to its attention to remind the public to be careful. A circular was issued in June 2004, after consultation with the banking industry, requiring AIs to introduce two-factor authentication for high-risk retail Internet banking transactions by June 2005.

Despite these actions, the HKMA received for the first time in September 2004 reports that certain customers of a bank had fallen victim to Internet banking fraud and had suffered financial losses. In

the light of this, the HKMA issued a circular to the banking industry making a number of proposals to improve the security of AIs' Internet banking services, including lowering the maximum limit for unregistered third-party transfers through Internet banking. In addition, the HKMA continued to work with the banking industry and the Hong Kong Police Force to promote customer awareness of Internet banking fraud through a multi-channel consumer education programme. The programme included the issue of educational leaflets, the production of a series of TV episodes and radio segments, and the installation of an interactive educational computer programme about Internet security on the HKMA's website and at its Information Centre.



> Consumer Information > Internet Banking Safety

Supervision of Internet banking and business continuity planning

The level of public use of Internet banking continued to rise in Hong Kong in 2004. At the end of 2004 Hong Kong had around 2.5 million personal Internet banking accounts (a 39% increase from 2003) and 87,000 business or corporate Internet banking accounts (an 89% increase from 2003). In addition, the first 3G mobile banking service was launched in June 2004.

In view of the growing acceptance of Internet banking services and AIs' increasing dependence on the use of technology, the HKMA further developed its Internet banking and technology risk management supervisory framework in 2004. A module of the Supervisory Policy Manual on

Supervision of e-Banking was issued in February 2004, advising AIs to implement a number of security and control measures in relation to Internet banking. In addition, 24 on-site examinations of Internet banking and IT-related controls were conducted during the year: of these, 17 covered business continuity planning. The automated control self-assessment process was extended to 50 AIs. The AIs generally reported that their risk management controls had improved in 2004.

The HKMA continued to share its experience in the supervision of Internet banking and technology risk management with overseas bank regulators through the Electronic Banking Group of the Basel Committee.

Banking reform

During the year the HKMA continued to implement the two remaining policy initiatives contained in the banking sector reform programme: the establishment of a Deposit Protection Scheme and a Commercial Credit Reference Agency (CCRA) in Hong Kong.

(a) Deposit Protection Scheme

Following the enactment of the Deposit Protection Scheme Ordinance in May, the Hong Kong Deposit Protection Board was formed in July to oversee the project for establishing the Deposit Protection Scheme. With the assistance of the HKMA, the Board has developed a detailed project plan to implement the Scheme. In November, the draft of a return to be completed by banks for the assessment of contributions under the

Scheme was issued to the industry for consultation. Work on other preparatory tasks including the development of a payout system and the specification of a set of rules governing the operation of the Scheme also began. To keep the industry informed of the progress of the project and to facilitate the exchange of views between the industry and the Board on issues of common interest, a Consultative Committee on Deposit Protection Scheme was formed in November.

(b) Commercial Credit Reference Agency

On 26 October the Hong Kong Association of Banks, the DTC Association and the HKMA held a joint press conference to announce the launch of the CCRA. The scheme, which in the first stage covers credit data of non-listed companies with an annual turnover not exceeding \$50 million, has been operating smoothly since its inception on 1 November. The CCRA is an important addition to Hong Kong's banking infrastructure. It will help strengthen the credit risk management of AIs, and assist small and medium-sized enterprises with good credit history to secure bank financing.



Executive Director (Banking Development) Arthur Yuen (second from left) joins the industry associations at a press conference to launch the commercial credit reference agency.

With the enactment of the Deposit Protection Scheme Ordinance and the establishment of the CCRA, the

banking sector reform programme announced in 1999 has now been fully completed (Table 2).

TABLE 2 Hong Kong banking sector reform programme

Measures	Details of implementation
Market reform and liberalisation measures:	
<ul style="list-style-type: none"> Deregulate the remaining Interest Rate Rules in two phases, subject to the prevailing financial and economic conditions. 	<p>The first phase (for time deposits with maturity of less than 7 days) was introduced in July 2000.</p> <p>The second phase (for savings and current account deposits) was introduced in July 2001.</p>
<ul style="list-style-type: none"> Relax the one branch policy imposed on foreign banks. 	The policy was completely relaxed in November 2001.
<ul style="list-style-type: none"> Allow access to Real Time Gross Settlement (RTGS) system by restricted licence banks (RLBs). 	Legal arrangements were finalised in May 2000 to allow RLBs to access the RTGS system.
<ul style="list-style-type: none"> Relax the market entry criteria for obtaining a banking licence. 	In May 2002 the asset and deposit size criteria applicable to local bank applicants set at \$4 billion and \$3 billion respectively were extended to foreign bank applicants in place of a US\$16 billion asset size criterion. In addition, the requisite period of operation as an RLB or deposit-taking company (DTC) before upgrading to licensed bank was reduced from ten to three years. The "association with Hong Kong" requirement for locally incorporated RLBs and DTCs was also dispensed with.
<ul style="list-style-type: none"> Consider the need for simplifying the three-tier licensing system into a two-tier system. 	A review was conducted in 2001. Since the relaxation of the market entry criteria would enable more RLBs to upgrade themselves to licensed banks and eventually lead to a natural simplification of the three-tier system, it was considered unnecessary to introduce any changes to the current system.
Safety and soundness enhancement measures:	
<ul style="list-style-type: none"> Conduct a detailed study to enhance deposit protection. 	The study was conducted in 2000. Pursuant to the enactment of the Deposit Protection Scheme Ordinance in May 2004, the HKMA is assisting the Hong Kong Deposit Protection Board to implement the Scheme.
<ul style="list-style-type: none"> Clarify the HKMA's role as lender of last resort. 	A policy statement was issued in June 1999.
<ul style="list-style-type: none"> Improve the financial disclosure framework. 	The framework was improved in 2002 and will be subject to continuous refinement.
<ul style="list-style-type: none"> Develop a more formal risk-based supervisory regime. 	The regime was fully implemented in 2003.
<ul style="list-style-type: none"> Conduct a feasibility study on establishing a credit register for commercial enterprises in Hong Kong. 	The feasibility study conducted in 2000 indicated that it was desirable to establish a CCRA in Hong Kong. The scheme was successfully launched in November 2004.
<ul style="list-style-type: none"> Promote high standards of corporate governance within the banking sector. 	A Guideline on Corporate Governance of Locally Incorporated Authorized Institutions was issued in May 2000 and will be subject to continuous refinement.

Consumer credit data sharing

In the first quarter of 2004 the HKMA conducted a round of special on-site examinations covering 37 AIs active in consumer lending to check if they had established appropriate controls to protect customer data privacy. Later in the year, AIs were asked to conduct a self-assessment of their compliance with SPM-IC6, which sets out the minimum standards that should be observed by AIs in sharing and using consumer credit data. The results of both exercises showed that AIs had generally established effective systems to safeguard customer data privacy, although there was room for improvement in the case of several AIs.

Consumer protection

(a) Code of Banking Practice

The HKMA noted during the year that AIs had included a general exemption of liability clause in their terms and conditions for safe deposit box services. Such clauses mainly attempted to exclude or limit AIs' liability, even in any circumstances where the damage may have been caused by the AIs' own negligence. The HKMA considered these clauses to be unfair and inconsistent with the Code of Banking Practice and required AIs to undertake a comprehensive review of their terms and conditions of banking services. The part of the review covering safe deposit box agreements was completed in November. Taking into account the results of the review, the HKMA issued a circular to AIs, requiring them to make appropriate changes to their safe deposit box agreements by 31 March 2005. In parallel, the Code of Banking Practice Committee, of which the HKMA is a member, amended the Code to make it clear that AIs should have due regard to the Control of Exemption Clauses Ordinance, the Unconscionable Contracts Ordinance and the Supply of Services (Implied Terms) Ordinance in drawing up terms and conditions of banking services. AIs are also required to keep their terms and conditions under review to ensure compliance with the Code.

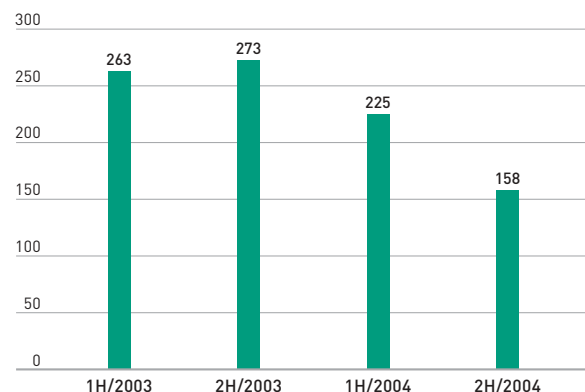
Apart from these changes, the Code of Banking Practice Committee also introduced new provisions into the Code to improve the protection of co-borrowers. At the request of the Committee, the Hong Kong Association of Banks issued a circular advising its members to provide ATM cardholders with a choice of whether their cards should have the function of purchasing cash vouchers through the Easy Payment System.

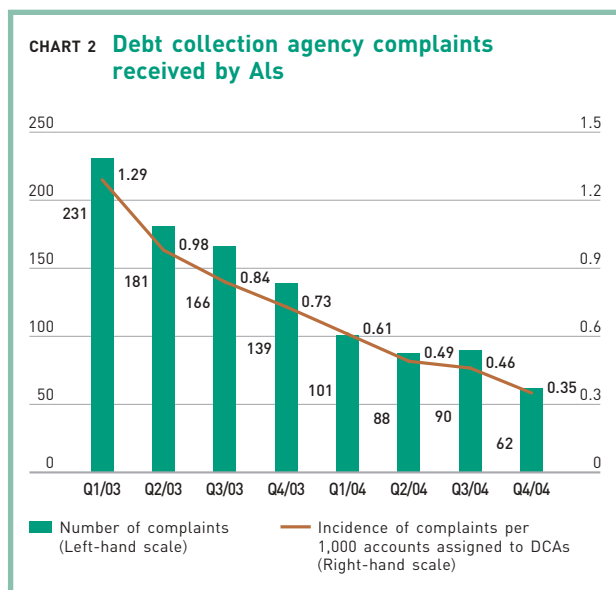
The overall level of compliance with the Code remained high, as reflected by the results of the annual self-assessments conducted by AIs covering the period between June 2003 and May 2004. In the past two years, 99% of AIs reported either full or largely full compliance (that is, fewer than five instances of non-compliance) with the Code. Where non-compliant areas were identified, AIs were required to take prompt action to rectify the situation.

(b) Customer complaints

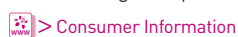
In 2004 the HKMA received a total of 383 complaints, compared with 536 complaints in 2003 (Chart 1). The decrease was attributable mainly to a reduction in the number of complaints relating to the practices of debt

CHART 1 Customer complaints received by the HKMA





collection agencies (DCAs). Commencing in March 2002, the HKMA has required all Als to submit a quarterly return on the number of complaints received against DCAs employed by them. The number of such complaints reported by Als fell further to 341 cases in 2004, from 717 cases in 2003 (Chart 2). The declining number of complaints indicates that Als have generally been more diligent in monitoring the performance of their DCAs.



> Consumer Information

Basel II

In June 2004 the Basel Committee finalised and issued the revised framework on capital adequacy standards for banks (commonly referred to as "Basel II"). Implementation of the revised framework in the member jurisdictions of the Committee is scheduled for the end of 2006 in general, and the end of 2007 for the most advanced approaches. In line with its policy of adhering closely to international supervisory standards, the HKMA will implement the requirements of Basel II in Hong Kong in line with the Basel timetable.

The HKMA has undertaken extensive public consultation in developing the implementation plan for Basel II. A Basel II Consultation Group, which comprises representatives from the HKMA, the banking industry, the accounting profession and other interested groups, has been established to meet regularly to discuss implementation proposals. The Legislative Council Panel on Financial Affairs was also briefed on the HKMA's plans to implement the revised capital framework in Hong Kong. During August and September, the HKMA released for public consultation a detailed package of implementation proposals, which cover, among other things, technical requirements on key areas of Basel II, the implementation process, the exercise of national discretions, and the rule-making approach the HKMA proposes to adopt in putting the revised framework into legislation. The parties consulted endorsed the proposals as a pragmatic means of implementing the revised framework in Hong Kong. The comments received were mostly to seek clarification on a number of technical issues, which the HKMA will take into consideration when finalising rules and requirements under the revised framework.

The HKMA has also maintained close contact with individual banks, particularly those intending to adopt the more advanced approaches for capital measurement, to understand their readiness to meet the revised framework's requirements. Close co-operation among regulators also plays a key role in the smooth implementation of Basel II, especially for banks active in cross-border operations. The HKMA has co-operated with its supervisory counterparts through the exchange of views and experience on relevant practical issues in the implementation process. During the year, the HKMA participated in meetings with supervisors of two large international banks to discuss supervisory co-operation in the implementation of Basel II.

Banking (Amendment) Bill 2005

Basel II involves a more sophisticated approach to the calculation of capital adequacy ratio than the present regime in the Banking Ordinance. This necessitates amendments to the Ordinance to provide for a revised legal framework to incorporate the new requirements. During the year the HKMA collaborated with the Department of Justice and the Financial Services and the Treasury Bureau to produce a draft of the Banking (Amendment) Bill 2005 to implement the Basel II regime.

The draft Bill relates to two main areas. First, in view of the complexity of the calculations under Basel II and the need to keep the capital regime up to date, the Banking Ordinance will be amended to provide for the introduction of a revised capital framework, which will operate in accordance with capital rules promulgated by the Monetary Authority. Secondly, section 60A of the Ordinance will be extended to empower the Monetary Authority to prescribe the information to be disclosed to the general public by AIs.

The draft Bill also covers amendments that limit the liability of a manager of an AI to circumstances where a contravention was caused or contributed to by the manager himself or a person under his control, and other amendments which seek to improve the working of the Ordinance in the light of experience.

Impact of new accounting standards on capital requirements and regulatory reporting

In the course of 2004 the Hong Kong Institute of Certified Public Accountants adopted several new accounting standards modelled on the corresponding International Accounting Standards (IAS). These include Hong Kong Accounting Standards (HKAS): HKAS 32, *Financial Instruments: Disclosure and Presentation*, and HKAS 39 *Financial Instruments: Recognition and Measurement*.

IAS 39, which HKAS 39 closely follows, has been particularly controversial in the banking industry because it significantly extends the use of fair-value accounting. Many bank assets are difficult to value on a fair-value basis. There has also been concern that more extensive use of fair-value accounting will introduce greater volatility into banks' financial statements. Discussions between regulators, the banking industry and the accounting profession are continuing in a number of countries: by having already adopted this standard, Hong Kong has pre-empted the outcome of this process.

The Basel Committee has offered some guidance on the application of the new international accounting standards in calculating capital requirements and in regulatory reporting. The basic principle has been to minimise changes to the existing capital adequacy framework, including the definition of capital, arising from the implementation of the new accounting standards.

In line with the Committee's recommendations, and to avoid a significant increase in banks' reporting burden, the HKMA's aim has been to minimise the impact of the new accounting standards on its capital adequacy framework. However, the implementation date for the new HKAS of 1 January 2005 has provided a relatively short period for assessing the potential impact of the changes, consulting the accounting profession and the banking industry, and providing guidance to AIs.

The HKMA conducted a preliminary assessment of the changes in the second half of 2004 and, on the basis of this, was able to offer guidance on some urgent topics, such as the treatment of provisioning. Nonetheless, to achieve a complete assessment of the implications of the new HKAS, substantial work remains to be done. Further

consultations with the accounting profession and the banking industry will need to continue through the first half of 2005. The HKMA will also continue to monitor international developments, in particular the additional guidance of the Basel Committee.

Financial reporting and disclosure

No revisions were made in 2004 to the financial disclosure guidelines issued by the HKMA. The implementation of the new accounting standards (see major changes in Box) and of Pillar 3 of Basel II may nevertheless entail major changes in the existing financial disclosure regime.

BOX

Major accounting changes

Existing requirements	New requirements
Measurement of financial assets and liabilities	
Most financial assets and liabilities are measured at either historic cost ("book value") or are marked to market. Loans and advances and securities held for investment rather than trading purposes are valued at historic cost. Securities held for trading are marked to market.	HKAS 39 provides scope for institutions to select specific classifications for financial assets (i.e. held for trading, held to maturity, available for sale, loans originated) and financial liabilities. Each classification has different accounting rules for measurement and reporting, including fair value and amortised cost. The available-for-sale classification generally requires fair-value measurement, with unrealised gains and losses included directly in equity and transferred to profit or loss when realised.
Provisioning and interest recognition	
In the absence of any explicit accounting standards, the HKMA drew up guidelines that required banks to make provisions based on likely (expected) losses. Specific provisions are made on an individual-loan basis, while general provisions are made on a portfolio basis. Benchmark provisioning percentages are provided as a reference point.	HKAS 39 adopts an incurred loss approach to impairment. Assets or groups of assets that are individually / collectively identified as having objective evidence of impairment are individually / collectively assessed. Impairment is the difference between the carrying amount and the recoverable amount, which is the present value of the expected future cash flows discounted at the original effective interest rate or the current rate of return for a similar financial asset, as appropriate. No benchmark provisioning percentages are provided.
Interest for classified loans should cease to be accrued or be credited to a suspense account.	Interest income for impaired loans should continue to be recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.
Cash flow hedges	
Derivatives are normally accounted for at notional amount off balance sheet with gains or losses recognised in Profit or Loss.	Under HKAS 39, the effective portion of gains and losses on the hedging instrument of a qualified cash flow hedge should be recognised directly in equity, which would thereafter be recognised in Profit or Loss in the same period or periods during which the hedged instrument affects Profit or Loss. The ineffective portion of gains and losses on the hedging instrument should be recognised in Profit or Loss.
Investment properties and leasehold land	
Revaluation changes of investment properties are accounted for in Investment Property Revaluation Reserve under HKSSAP 13.	Fair value changes of investment properties are accounted for in Profit or Loss under HKAS 40.
Leasehold land is accounted for as an asset item in balance sheet under HKSSAP 14. Revaluation is permitted.	Leasehold land is no longer regarded as an asset item and should be accounted for as prepaid lease payments under HKAS 17. Revaluation is not allowed.

Prevention of money laundering and terrorist financing

In 2004 the HKMA continued its efforts to develop the supervisory framework for the prevention of money laundering and terrorist financing. After industry consultation, the HKMA issued in June 2004 a revised version of the *Supplement to the Guideline on Prevention of Money Laundering*, together with a set of *Interpretative Notes*. The *Supplement* was revised to take account of the revised *Forty Recommendations* issued by the Financial Action Task Force on Money Laundering (FATF) in June 2003. The *Interpretative Notes* were produced in collaboration with the banking industry to provide practical guidance to Als on implementing the requirements of the revised *Supplement* and to explain the risk-based approach to be adopted. Als were expected to review their policies and procedures on the prevention of money laundering and terrorist financing and take necessary actions to comply with the revised requirements before the end of 2004.

Following the release of the revised *Supplement* and the *Interpretative Notes*, the HKMA has started to develop a structured self-assessment framework to facilitate Als' regular assessment of the extent of their compliance with the relevant regulatory requirements. This will also help the HKMA identify risk indicators and further improve supervisory guidance in the longer term.

To promote public awareness of the issues relating to money laundering and terrorist financing, the HKMA and the two industry associations jointly produced an information leaflet entitled *Fighting Crime and Terrorism: How You Can Help*. This

leaflet, which was released in March 2004, explains to customers of Als why they may be required to provide identification documents and how, in line with the latest international practices, this can help prevent money laundering and combat terrorist financing.

During the year the HKMA continued to issue circulars to inform Als of changes to the list of Non-cooperative Countries and Territories and to alert them to the new lists of terrorist suspects published in the Gazette under the relevant local legislation, as well as those designated under the US President's Executive Order.

Review of Core Principles

At its June 2004 meeting, the Basel Committee decided to initiate work to revise the *Basel Core Principles for Effective Banking Supervision* in the light of new regulatory issues and standards, as well as experience with the implementation of the *Core Principles* gained over the years through compliance assessments of various economies by the International Monetary Fund and the World Bank.

Early in the year the Basel Committee appointed experienced supervisors from a number of economies, including Hong Kong, to take part in the preparatory work for the project, including proposing to the Committee on the scope and mandate for the project. These supervisors were later appointed by the Committee to a steering group to co-ordinate and oversee the project. Hong Kong is one of the three economies whose representatives in the steering group are given a leading role in the drafting process.

Development of supervisory policies

A key focus during the year was on the development of detailed supervisory guidance on various important areas under Basel II, some of which were incorporated in the August and September consultation proposals. Supervisory policies in other areas developed during the year included:

Liquidity risk management

This statutory guideline sets out the key elements of effective liquidity risk management, taking into account latest international standards and practices adopted by some international banks, and explains the enhanced approach that the HKMA will adopt towards ensuring the adequacy of Als' liquidity risk management. In addition to restating the need for Als to comply with the statutory liquidity ratio requirements, the revised liquidity regime provides more guidance on the development of an effective liquidity risk management framework; cash flow management and reporting for liquidity management under normal and stressed situations; and contingency planning for dealing with a liquidity crisis. It will replace the guideline issued in 1994 and will take effect in August 2005.

Foreign exchange risk management

This guidance note is aimed at improving the existing supervisory approach on foreign exchange risk and providing more guidance to Als on the key elements of effective foreign exchange risk management. In developing the guidance note, the HKMA has made reference to international standards, the range of practices currently adopted by Als, relevant recommendations made by the IMF during the last FSAP assessment, and the experience of the 1997-98 Asian financial crisis.

The sharing and use of commercial credit data through a commercial credit reference agency

This statutory guideline sets out the minimum standards that the HKMA expects Als to observe in sharing and using commercial credit data through a commercial credit reference agency. It requires Als involved in SME lending to participate in the sharing and use of commercial credit data and to maintain adequate controls to safeguard customer data confidentiality.



> Policy Areas > Supervisory Policy Manual



> Information Centre > Guidelines and Circulars

International co-operation

The HKMA continues to participate in various regional and international forums for banking supervisors, including the Core Principles Liaison Group established by the Basel Committee, the EMEAP Working Group on Banking Supervision, the Offshore Group of Banking Supervisors and the South-East Asia, New Zealand and Australia (SEANZA) Forum of Banking Supervisors. In October 2004, in association with the Financial Stability Institute, the HKMA hosted a seminar on *Problem Bank Resolution* in which 31 participants from 16 supervisory authorities in the SEANZA economies attended.

In April 2004 the HKMA co-operated with the Bank for International Settlements and 51 other economies in the *Triennial Central Bank Survey of*

Foreign Exchange and Derivatives Market Activity.

The results of the survey showed that Hong Kong advanced one place to be the sixth largest foreign exchange market in the world and seventh largest taking into account over-the-counter derivative transactions.



Deputy Chief Executive William Ryback (left) talks with representatives from the SEANZA economies in the Seminar on Problem Bank Resolution.

PLANS FOR 2005 AND BEYOND

Focused examinations

The HKMA plans to conduct a series of focused examinations in 2005 on Als' key business activities, covering residential mortgage loans, trade finance, wealth management and personal renminbi business. The purpose of these examinations is to ensure that Als follow prudent business practices and comply with relevant codes of conduct or business restrictions. Using the findings of these examinations, the HKMA will identify and recommend best practices to Als that are engaging in these activities.

CAMEL rating

In anticipation of the introduction of the Deposit Protection Scheme, the HKMA plans to refine the mechanism and criteria for assessing Als' CAMEL³ rating in 2005. This will include the setting up of a review committee within the HKMA to consider appeals against the rating from Als.

Internet banking and business continuity planning

The HKMA will continue to improve its Internet banking and technology risk management supervisory framework to ensure that it keeps pace with the developments in these areas. In particular, the HKMA plans to increase the number of Als to be subject to the automated control self-assessment process to 55 (50 in 2004), which will cover all retail banks and Als with significant IT operations. The HKMA will also continue its on-site specialist examination programme in 2005.

The HKMA will continue to monitor Internet banking frauds and ensure the implementation of two-factor authentication by relevant Als for high-risk retail Internet banking transactions by June 2005. Through the Electronic Banking Working Group of the Hong Kong Association of Banks, the HKMA will work with the banking industry and the Hong Kong Police Force on suitable education programmes to increase consumer awareness of Internet banking security.

The HKMA will continue to share its experience in supervision of Internet banking and technology risk management with overseas bank regulators both directly and through the Electronic Banking Group of the Basel Committee.

Supervision of Als' securities activities

The HKMA gives high priority to handling deemed Registered Institutions' migration applications under the Securities and Futures Ordinance in 2005. In view of the growth in securities-related business conducted by Als, the HKMA will step up its supervisory efforts for these activities. In particular, the HKMA plans to implement an automated control self-assessment process to cover major Als' securities-related activities.

As part of its continuing efforts to develop the supervisory framework applicable to the securities business of Als, the HKMA will take appropriate measures to cater for the expected growing need for investigation work and the exercise of its disciplinary powers under the Banking Ordinance. Procedural enhancements and, where necessary, legislative changes will be introduced to improve the securities regulatory regime for Als in the light of experience with administering the current regime. The HKMA will continue to maintain a close working relationship with the SFC in accordance with the framework set out in the Memorandum of Understanding signed between the two regulators in order to maintain a consistent enforcement approach.

³ An internationally recognised framework for assessing the Capital adequacy, Asset quality, Management, Earnings and Liquidity of banks.

Improvement of banking sector infrastructure

The HKMA will focus on the establishment of the Deposit Protection Scheme and the further development of the Commercial Credit Reference Agency in 2005.

Deposit Protection Scheme

According to the project plan laid out by the Hong Kong Deposit Protection Board, the Deposit Protection Scheme will be ready for launch in the second half of 2006 if the external environment (such as interest rate levels) prevailing at that time is considered appropriate. Most of the preparatory work, including the development of a payout system and the specification of a set of rules governing the operation of the Scheme, should therefore be substantially completed by the end of 2005. The HKMA will continue to assist the Board to prepare for the launch of the Scheme. The Board and the HKMA will keep the industry abreast of the development of the project through the Consultative Committee on Deposit Protection Scheme.

Commercial Credit Reference Agency

In 2005 the HKMA will, in collaboration with the Industry Working Group on the Commercial Credit Reference Agency, consider methods to expand the coverage of the scheme to include sole proprietorships and partnerships, and evaluate the adequacy of information contained in the Commercial Credit Reference Agency database. The HKMA will also monitor Als' compliance with SPM-IC7, which sets out the minimum standards that should be observed by Als in the sharing and use of commercial credit data.

Consumer credit data sharing

The HKMA will continue to monitor a set of indicators to assess the benefits arising from the sharing of positive consumer credit data, including greater differentiation in interest rates, reduction in default rates and reduced level of indebtedness. With the two-year moratorium on access to credit data for the purpose of credit review coming to an

end in June 2005, the HKMA will also monitor whether Als have made greater use of the consumer credit database in assessing the creditworthiness of their customers.

Consumer protection

The HKMA will continue to promote improvements in the standard of banking practices through active participation in the work of the Code of Banking Practice Committee. We will complete the comprehensive review of Als' terms and conditions to ensure compliance with the Code and the relevant consumer protection legislation. We will also monitor Als' compliance with the Code through the annual self-assessments and the handling of relevant complaints against Als.

Basel II

The draft Banking (Amendment) Bill 2005 was circulated for public consultation in December 2004 and is expected to be introduced in the Legislative Council in the second quarter of 2005. With the legislative process underway, the HKMA, in consultation with the industry, will continue to develop the specific technical and qualitative requirements of the revised capital regime. The proposed requirements will then form the basis of the capital and disclosure rules to be made for the implementation of Basel II. New banking returns for reporting regulatory capital requirements will also be developed and issued for industry consultation in 2005.

The HKMA will start the validation process for Als intending to adopt the Internal Ratings-based Approaches during 2005. Where applicable, this will involve liaising with relevant home supervisors of the Hong Kong operations of international banking groups about the recognition arrangements to avoid unnecessary duplication of work among supervisors.

The HKMA is keen to ensure that, while meeting the international standards required of banks under Basel II, the revised regime is tailored to Hong Kong's needs. We will continue to consult

with the industry regarding relevant rules and guidelines being developed, and monitor closely Als' Basel II implementation progress, particularly in the case of Als intending to adopt the more advanced approaches.

Prevention of money laundering and terrorist financing

The HKMA will continue to monitor the latest international developments in combating money laundering and terrorist financing, and to further improve our supervisory efforts in this area in line with the international standards.

In view of the new requirements stipulated in the revised *Supplement to the Guideline on Prevention of Money Laundering*, the HKMA will conduct on-site examinations on Als' systems of controls over the prevention of money laundering and terrorist financing based on the revised requirements. In addition, the HKMA will carry on with the work of developing a structured self-assessment framework for Als' on-going assessment of their compliance with the relevant requirements. We intend to consult Als on the details of this framework by the end of the first quarter of 2005.

In order to ensure Hong Kong's compliance with the Financial Action Task Force on Money Laundering's revised *Forty Recommendations*, the Government is planning to introduce an omnibus bill that will put the basic obligations relating to customer due diligence and record-keeping into law. The HKMA will work closely with government departments and other financial regulators regarding the drafting of the bill, and will seek comments from the banking industry on the proposed legislation whenever necessary.

Review of Core Principles

The HKMA sees the Basel Committee's updating of the *Core Principles* as very important in maintaining them as a set of widely applied international standards that continue to address current banking supervisory issues. Drawing from its experience in the last Financial Sector

Assessment Programme in 2002, the HKMA will continue to contribute to the process of drafting the relevant updates and assist the Committee in regional consultation.

Development of supervisory policies

Operational risk management

In view of the release of the *Sound Practices for the Management and Supervision of Operational Risk* by the Basel Committee in February 2003 and the increasing importance of operational risk in Als, the HKMA is in the process of developing a new module on operational risk management under the Supervisory Policy Manual. The module will model on the Basel paper and provide additional, detailed guidance to Als on the key elements of a sound operational risk management framework for identifying, assessing, monitoring, and controlling or mitigating operational risks. It will also highlight current practices and approaches of the industry in managing operational risk as a distinct risk similar to credit and market risks. The HKMA intends to release the module for industry consultation in the first quarter of 2005.

Other guidelines

Other guidelines to be developed in 2005 will cover the following areas:

- credit cards
- new share subscriptions and share margin financing
- internal audit, legal and compliance functions.

Accounting and financial disclosure

The HKMA will continue to keep abreast of accounting and disclosure developments. In addition, the HKMA will work, in collaboration with the industry associations and the accounting profession, to understand the impact of the new accounting standards, Pillar 3 of Basel II and the Basel Committee's recommendations on the treatment of various items for capital adequacy purposes on the banking industry.





The *Bauhinia blakeana* (or Hong Kong orchid tree), discovered on Hong Kong Island in the late nineteenth century, is Hong Kong's regional emblem, and its flower appears on Hong Kong's regional flag and on its currency. The flower also forms part of the emblem of the HKMA. Its two-lobed leaf, with its prominent veins, is known in Hong Kong as the "clever leaf" and is often used as a bookmark.

MARKET INFRASTRUCTURE

Promoting a sound financial market infrastructure is one of the main policy objectives of the HKMA. In 2004 the new Clearing and Settlement Systems Ordinance came into force to further promote the safety and efficiency of clearing and settlement systems in Hong Kong. System improvements helped to ease banks' liquidity pressure at times of large fund flows related to IPOs. The Hong Kong dollar was included in the Continuous Linked Settlement System. The HKMA also improved co-ordination with the financial industry through the establishment of the Treasury Markets Forum.

OBJECTIVES

One of the HKMA's key policy objectives is to promote the development of a safe and efficient financial market infrastructure in Hong Kong. This serves two inter-related purposes: to help maintain Hong Kong's financial and monetary stability; and to help maintain Hong Kong's status as an international financial centre. Robust and efficient clearing and settlement systems are important in maintaining the competitiveness of Hong Kong's financial sector. The HKMA pays particular attention to clearing and settlement systems for funds and securities transfers within Hong Kong, and between Hong Kong and the Mainland and financial centres overseas.

REVIEW OF 2004

Payment Systems

Hong Kong dollar interbank payment system

The Clearing House Automated Transfer System (CHATS) is Hong Kong's Real Time Gross Settlement (RTGS) system, which was introduced in 1996. It provides Hong Kong with a safe and efficient interbank payment system with the following features:

- (a) a single-tier system, in which all licensed banks maintain settlement accounts with the HKMA;
- (b) interbank payments settled real-time on an individual and gross basis using central banking funds across the books of the HKMA;
- (c) intraday liquidity provided through highly automated intraday repo facility using Exchange Fund Bills and Notes;
- (d) a central queuing system for unsettled payment messages, which can only be cancelled, resequenced or amended by the paying banks;
- (e) a capability for developing payment-vs-payment (PvP) links with other payment systems to reduce settlement risk in foreign exchange transactions; and
- (f) a seamless interface with the Central Moneymarkets Unit (the debt securities clearing and settlement system operated by the HKMA) to offer real-time delivery-vs-payment (DvP) and end-of-day DvP functions.

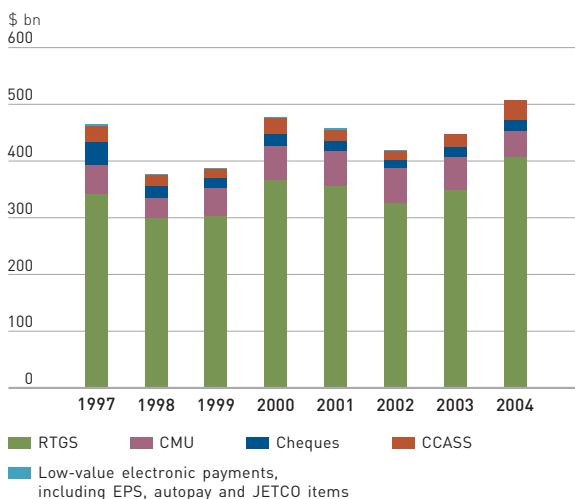
System operations in 2004

The system operator of CHATS is Hong Kong Interbank Clearing Limited (HKICL), a company established in 1995 and equally owned by the HKMA and the Hong Kong Association of Banks. In 2004 HKICL processed a daily average value of \$407 billion in CHATS transactions (14,736 items in volume), and \$17.1 billion in Central Moneymarkets Unit (CMU) secondary market transactions (122 items in volume).

Apart from providing for the settlement of large-value payments, CHATS also handles four daily bulk clearings for the money settlement of stock market transactions (CCASS), cheques, low-value bulk electronic payment items (EPS and autopay), and low-value ATM transfers (JETCO) (Chart 1).

During the year banks made good use of their Exchange Fund Bills and Notes to obtain interest-free intraday liquidity through conducting intraday repo transactions with the HKMA for settlement of interbank payments. On average, \$27 billion worth of intraday repo transactions were carried out daily to facilitate payment flows. This represented about 26% of the \$103 billion Exchange Fund paper held by banks in December 2004.

CHART 1 Hong Kong dollar payment system daily average turnover



System improvements

The HKMA introduced the CHATS Optimiser in June 2004 with a view to easing banks' liquidity pressure, particularly during times of large fund flows associated with initial public offerings (IPOs). Since its introduction, the CHATS Optimiser has been widely used by banks. It enables banks to better manage their liquidity, facilitates the recycling of liquidity to the market, and smoothes payment flows (Box).

In October 2004 the operating time of the RTGS systems in Hong Kong was extended to cover typhoon and rainstorm days. This will align Hong Kong with the international practice of normal operation regardless of adverse weather conditions.

BOX

The CHATS Optimiser

The CHATS Optimiser is a system mechanism that settles paper cheques and large-value CHATS payments simultaneously and in an offsetting manner. Paper cheques are settled daily in a bulk run at a specific time by multilateral netting. When the gross amounts required to settle paper cheque payments are substantial, banks, having known their net cheque settlement positions, can make use of the CHATS Optimiser to make offsetting CHATS payments to their counterparties *during* the bulk settlement run. This improves the funding management efficiency of the banks by alleviating them from the need to sit on substantial amounts to settle the payment obligations at the time of the bulk settlement run.

Foreign currency payment systems in Hong Kong

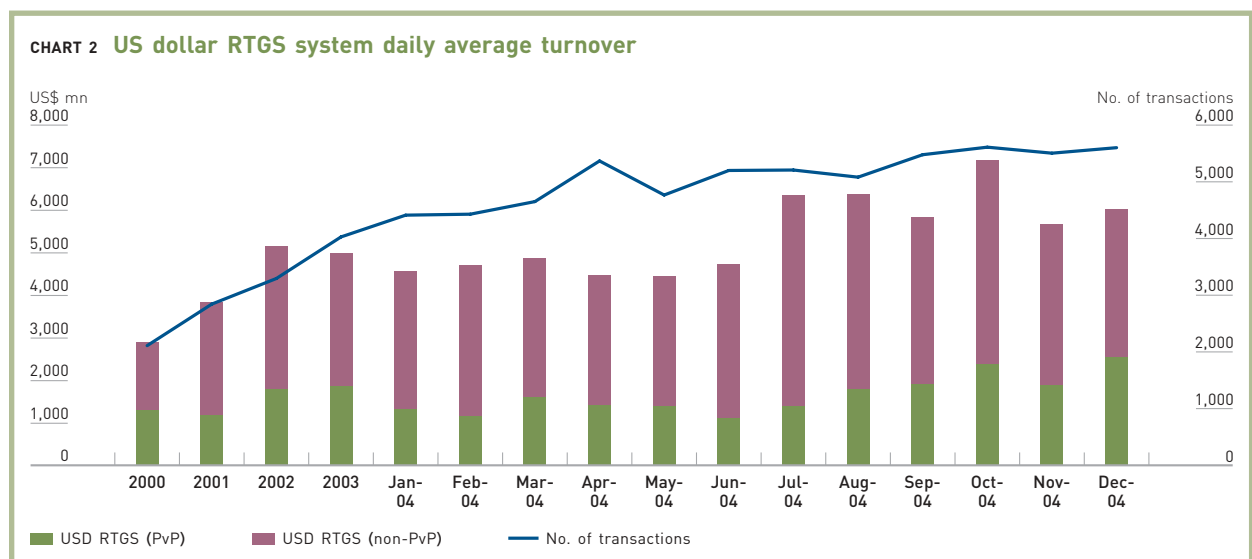
Since their launch in 2000 and 2003 respectively, Hong Kong's US dollar and euro clearing systems have been operating efficiently. Special features of the two systems include

- (a) seamless interface with the Hong Kong dollar clearing system, enabling PvP settlement of Hong Kong dollar/US dollar/euro foreign exchange transactions;
- (b) seamless interface with the CMU to provide settlement of US dollar/euro-denominated debt instruments on a DvP basis;
- (c) elimination of risk arising from settlement of the two legs of a foreign transaction in different time zones;

- (d) lessening of the constraint of bilateral counterparty trading limits with the elimination of risk; and
- (e) improvements in liquidity management since the traded currencies can be recycled immediately.

US dollar clearing system

The settlement institution for the US dollar clearing system is The Hongkong and Shanghai Banking Corporation, with HKICL as system operator. At the end of 2004 there were 68 direct and 164 indirect participants in the system, including 119 indirect participants from outside Hong Kong. In 2004 the system handled an average of 5,033 transactions a day with a total value of over US\$5.51 billion (Chart 2). In 2004 an average of 3,824 US dollar cheques were processed daily, with a total value of over US\$118 million.



Euro clearing system

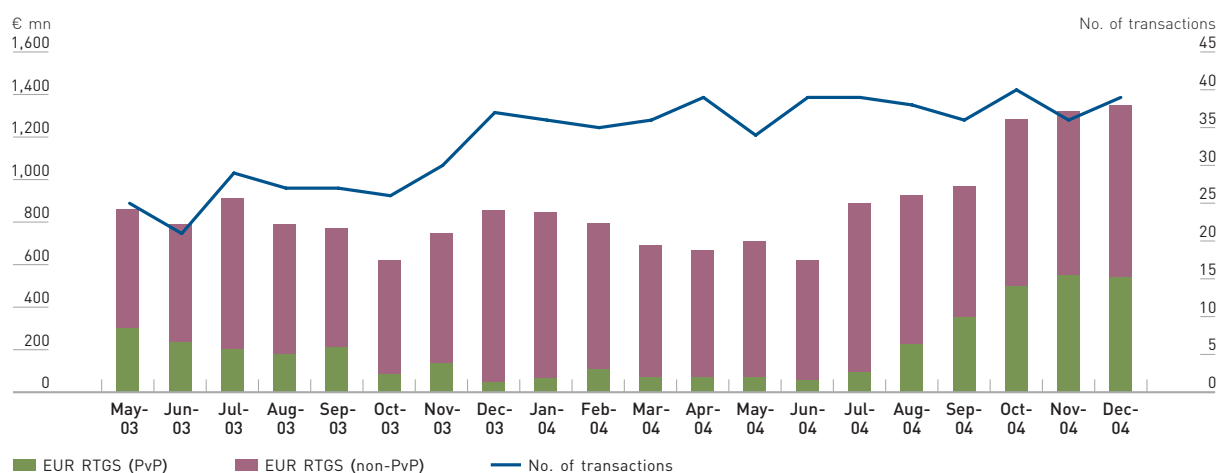
The settlement institution for the euro clearing system is Standard Chartered Bank (Hong Kong) Limited, with HKICL as system operator. At the end of 2004 there were 23 direct and 21 indirect participants in the system, including 11 indirect participants from outside Hong Kong. In 2004 the system handled an average of 37 transactions a day with a total value of over €923 million (Chart 3).

Continuous Linked Settlement

On 6 December 2004 the Hong Kong dollar was included in the Continuous Linked Settlement (CLS) System – a global clearing and settlement system for cross-border foreign exchange transactions. The inclusion enables foreign exchange transactions involving the Hong Kong dollar to be settled through the CLS System on a PvP basis, thus removing the settlement risk in these transactions.

As with the other important clearing and settlement systems in Hong Kong, the finality of settlement for transactions made through the CLS is protected by the laws of Hong Kong, and the CLS is a clearing and settlement system designated under the Clearing and Settlement Systems Ordinance. The participation of the Hong Kong dollar in the CLS System is a further endeavour by the HKMA to eliminate the risk arising from settlement of the two legs of a foreign transaction in different time zones. It provides banks in Hong Kong with an additional channel to settle foreign exchange transactions in a safe and efficient manner. In December 2004 the average daily turnover of CLS-related RTGS turnover in the Hong Kong dollar RTGS system was \$22 billion (including both from banks to CLS account in Hong Kong and vice versa).

CHART 3 Euro RTGS system daily average turnover



Payment linkages with Mainland China

Good progress was made during the year in developing cross-border financial infrastructure between Hong Kong and Mainland China. These payment linkages helped meet the growing needs of cross-border payment flows brought about by increasing economic ties.

The average daily turnover of these linkages (RTGS and cheque, Hong Kong dollar and US dollar) with Guangdong Province and Shenzhen increased to the equivalent of \$850 million in December 2004 (Chart 4).

RTGS system linkages

In March 2004 the HKMA and the Guangzhou branch of the People's Bank of China (PBoC) introduced cross-border system linkages for Hong Kong dollar and US dollar RTGS payments between banks in Hong Kong and Guangdong Province. This arrangement was an extension of similar system linkages between Hong Kong and Shenzhen completed in 2003. With these linkages, payments in Hong Kong dollars and US dollars between banks in Hong Kong and Guangdong Province and Shenzhen can be made in a more efficient and safe manner.

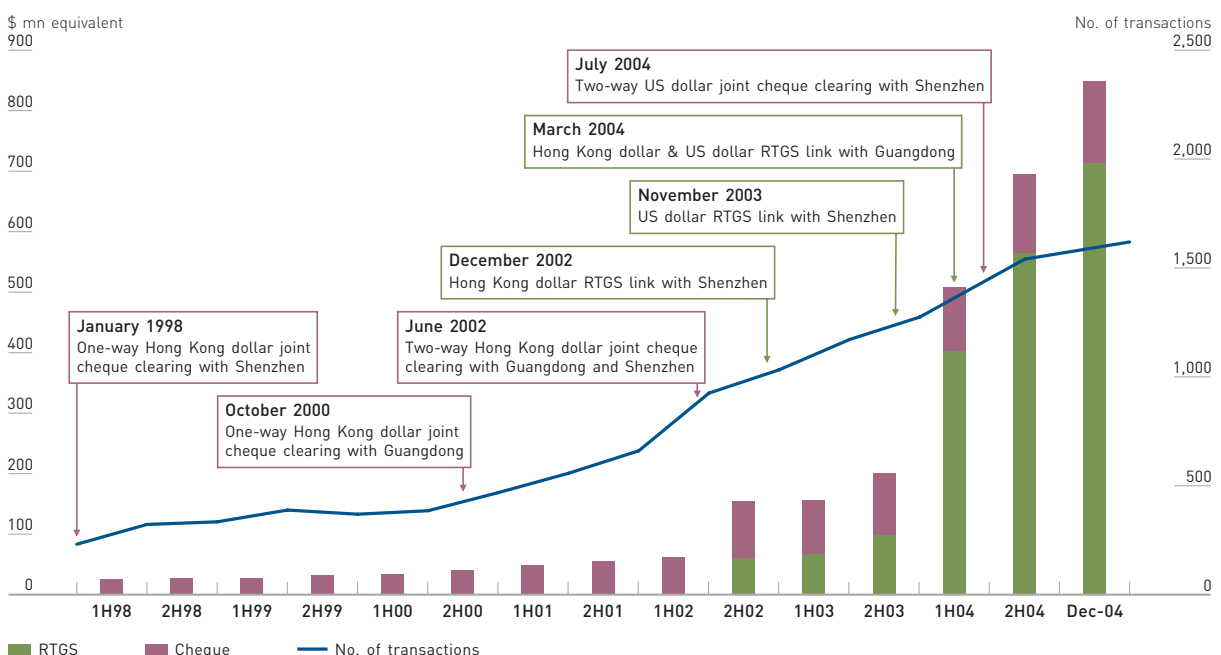
In 2004 the RTGS system linkages with Guangdong Province and Shenzhen handled around 12,000 transactions, with a total value of over \$113 billion equivalent.

Joint cheque clearing

With the co-operation between the HKMA and Shenzhen central sub-branch of PBoC, the existing Hong Kong dollar joint cheque clearing facilities between Shenzhen and Hong Kong were extended in July 2004 to cover US dollar cheques. This shortened the clearing time for US dollar cheques drawn on banks in Hong Kong and presented in Shenzhen, and vice versa. Two-way joint cheque clearing facilities for Hong Kong dollar cheques between Guangdong Province and Shenzhen and Hong Kong have existed since June 2002. The extension to cover US dollar cheques in Shenzhen helped meet growing needs for foreign currency settlement across the border.

In 2004 around 315,000 cheques, with a value of \$27 billion equivalent, were cleared through these joint clearing facilities.

CHART 4 Cross-border payment linkages daily average turnover



Debt settlement systems

CMU linkage with Mainland China

On 28 April 2004 the HKMA signed an agreement with the China Government Securities Depository Trust & Clearing Co. Ltd. (CDC) to establish a direct link between the HKMA's Central Moneymarkets Unit (CMU) and the CDC's Government Securities Book-Entry System (GSBS). This is a one-way link from the GSBS to the CMU enabling CDC Members that are authorised to invest in foreign debt securities to settle and hold Hong Kong and foreign debt securities through the CDC's account with the CMU. This linkage greatly improves access for Mainland investors to debt securities outside the Mainland in a safe and cost-effective manner.

Bank Repo service

In December 2004 the CMU launched a new service, the Bank Repo, for member banks. A Bank Repo transaction is a bilateral deal between two CMU Members. This facilitates borrowing by banks from each other by repoing securities that they accept for such repo activities. The CMU acts as the system administrator, providing a safe and fully automated platform for member banks to undertake these repo transactions in the CMU system. As with other CMU transactions, Bank Repo transactions are also processed on a DvP basis.

CMU system improvement

The CMU implemented a major improvement in December 2004 with the introduction of Central Matching. This is an enhanced mechanism facilitating CMU Members in sending their securities transfer instructions to the CMU. Through this mechanism, members enjoy greater flexibility and operational efficiency since their use of communication channels such as SWIFT, CMU User Terminal and fax for this purpose is no longer dictated by the choice of their counterparties.

 > Policy Areas > Financial Infrastructure > Infrastructure

Oversight of clearing and settlement systems

The Clearing and Settlement Systems Ordinance (CSSO) became effective on 4 November 2004. The Ordinance helps promote the general safety and efficiency of clearing and settlement systems that are material to the monetary or financial stability of Hong Kong or to the functioning of Hong Kong as an international financial centre. As the overseer of designated systems, the Monetary Authority monitors the compliance of designated systems with the safety and efficiency requirements stipulated in the CSSO and induces changes to designated systems where appropriate to bring them into compliance with the requirements.

The Ordinance also provides statutory backing to the finality of settlement for transactions made through systems designated under the Ordinance by protecting the settlement finality from insolvency laws or any other laws. To this end, the Monetary Authority issues certificates of finality to designated systems meeting certain criteria specified in the Ordinance.

To increase the transparency of the designation and oversight functions of the Monetary Authority, an *Explanatory Note on Designation and Issuance of Certificate of Finality* was issued on 4 November 2004. The *Note* sets out the policies and procedures that the Monetary Authority intends to follow in the designation of clearing and settlement systems and the issuance of certificate of finality under the CSSO. In addition, a statutory *Guideline on the Oversight Framework for Designated Systems under the Clearing and Settlement Systems Ordinance* was gazetted on 26 November 2004 after consultation with the industry. The *Guideline* explains the Monetary Authority's interpretation of the oversight requirements and the process that the Monetary Authority intends to follow in the oversight of designated systems.

By the end of 2004, five clearing and settlement systems had been designated pursuant to the CSSO. The systems are the CMU, Hong Kong dollar CHATS, the CLS System, US dollar CHATS and euro CHATS.

An independent Clearing and Settlement Systems Appeals Tribunal was established under the Ordinance to hear appeals by any party aggrieved by a decision of the Monetary Authority on designation and related matters. The Tribunal is chaired by a judge and it consists of a panel of members who are appointed by the Chief Executive of the Hong Kong SAR.

A Process Review Committee, composed of independent members, was established on 1 December 2004 to review processes and procedures adopted by the Monetary Authority in applying standards set under the CSSO to systems in which the HKMA has a legal or beneficial interest.

 > Policy Areas > Financial Infrastructure > Oversight

Debt market development

Gross issuance of Hong Kong dollar debt remained stable in 2004 at \$377 billion, down slightly from the previous year. Issuance by local corporations continued to increase, by 66% to \$9.1 billion in 2004, while issuance by non-Multilateral Development Bank (MDB) overseas borrowers and authorized institutions (AIs) declined. After a 17% increase in 2003, debt issuance by non-MDB overseas borrowers declined by 11% in 2004 to \$76.5 billion, and that by AIs fell by 12% to \$53.6 billion over the same period. Within public-sector debt issuance there was an increase in issuance by statutory bodies and government-owned corporations, as well as the launch of the SAR Government bonds.

The value of outstanding Hong Kong dollar debt rose slightly to \$608 billion at the end of 2004, as the amount of total gross issuance outstripped maturing securities during the year. Despite the

decrease in issuance by non-MDB overseas borrowers in 2004, they remained the largest debtors, accounting for more than one-third of outstanding Hong Kong dollar debt. The amount of outstanding debt issued by AIs continued to fall in 2004, possibly reflecting the ample liquidity in the banking sector and hence little need for external funds.

To promote the development of domestic debt market and to fund infrastructural projects, as well as to provide greater flexibility in managing Government liquidity, the Hong Kong SAR Government launched a landmark \$6 billion toll road securitisation bonds in May and completed a \$20 billion global bond offering in July. Both issues were well received by local and international investors. The retail portions of both offerings were many times oversubscribed, while the international tranche of the Government bond attracted a total of 147 institutional investors.

The retail bond market was deepened further with the Hong Kong Mortgage Corporation's (HKMC) efforts in pioneering the use of plain language, instead of legalistic language, in retail bond prospectuses. The HKMC's issuance of Asia's first retail mortgage-backed securities also helped promote the development of the mortgage-backed securities market.

The HKMA continued to maintain regular contacts with the Government and market participants to promote the development of the Hong Kong debt market. Recommendations were made to the Securities and Futures Commission (SFC) to simplify the procedures for bond issuance and introduce the "dual prospectus" structure, which was later adopted through legislative amendments and SFC guidelines. The HKMA also worked with the Hong Kong Association of Banks and the Hong Kong Capital Markets Association in designing a facility, operated by the CMU, to facilitate the settlement of Hong Kong dollar repo transactions.

 > Policy Areas > Financial Infrastructure > Debt Market Development

Treasury Markets Forum

The Treasury Markets Forum (TMF) was established in March 2004 through reconstituting the previous Foreign Exchange and Money Market Practices Committee. The TMF assumes a broader mandate, focusing not only on foreign exchange and money markets but also on debt and other treasury markets. The objective of the TMF is to achieve better co-ordination and synergy among industry associations and market professionals in raising the professionalism of practitioners and the overall competitiveness of the treasury markets in Hong Kong. The TMF, chaired by Mr Norman Chan, Deputy Chief Executive of the HKMA, has a broad-based representation from various markets, including representatives of the Hong Kong Association of Banks, ACI – The Financial Markets Association of Hong Kong (ACIHK), the Hong Kong Capital Markets Association, the Hong Kong Association of Corporate Treasurers, the DTC Association and the Hong Kong Foreign Exchange and Deposit Brokers' Association.

The TMF has undertaken a number of initiatives during the year to raise the level of professionalism of market practitioners and promote the treasury markets of Hong Kong to the Mainland. The TMF worked with ACIHK to broaden the latter's membership and to develop a set of accreditation and training programmes for market practitioners. The TMF participated in the Hong Kong Financial Services Expo in Shanghai in September 2004 to promote Hong Kong treasury markets. The TMF visited Mainland financial regulators and the China Association of Banks to foster closer links with the Mainland. The TMF and the HKMA jointly organised a seminar on the operation and supervision of treasury markets for Mainland financial regulators in October with an aim to deepen their understanding of the markets in Hong Kong. The TMF also continued to work on a number of market-related issues, such as non-deliverable forward documentation, a review of interest adjustment rate for bulk clearing items, a review of EBS Prime system, and contributions to the CMU regarding the launch of a new facility to facilitate settlement of Hong Kong dollar repo transactions.



The TMF and the HKMA jointly organise a seminar on the operation and supervision of treasury markets for Mainland financial regulators in October 2004.



Exchange Fund Bills and Notes programme

During 2004 the HKMA promoted the liquidity and credibility of the benchmark Hong Kong dollar yield curve by continued re-balancing of the maturity distribution of the Exchange Fund Bills and Notes (EFBN) portfolio, regular review of the performance of market makers, publication of the daily fixings on prices and yields of EFBN, and monitoring of the performance of contributors for the fixings. The HKMA also supported initiatives by market bodies, such as Hong Kong Capital Markets Association, in publicising the EFBN fixings prices through the media.

The one-year pilot scheme to facilitate retail investment in Exchange Fund Notes ended in August 2004. The HKMA reviewed the scheme and introduced certain refinements to improve the features and marketing of the scheme. A total of seven placing banks have been appointed. The scheme will continue to be implemented when market conditions are suitable.

PLANS FOR 2005

Hong Kong's financial infrastructure has made great progress since the Hong Kong dollar RTGS system was introduced in 1996. New systems and linkages have been launched, and continual system refinements have been made to increase payment safety and efficiency. The HKMA is now conducting a comprehensive review of these infrastructural developments with a view to mapping out a coherent strategy and implementation plan to develop a multi-currency multi-dimensional financial infrastructure for Hong Kong.

The review will consider opportunities and challenges, including globalisation of financial markets, increasing integration with Mainland China, the start of the renminbi banking business, and new developments in RTGS and debt securities settlement systems. Our approach is to examine the current usage of systems, to evaluate potential for and impediments to growth, to benchmark with

overseas systems, and to identify projects to meet these challenges. The recommendations of the review will be considered by the EFAC Financial Infrastructure Sub-Committee in the first half of 2005.

The HKMA will continue its efforts in ensuring safe and efficient operations of its payment systems and the CMU, and in upgrading systems functionality and promoting their usage. Following the successful experience of the introduction of the CHATS Optimiser, we shall explore ways to further improve liquidity efficiency and ensure that our systems can cope well with increasing IPO activities. We shall also pursue expansion of the existing payment linkages with Mainland China in order to meet the increasing needs of cross-border payment flows.

Under the Clearing and Settlement Systems Ordinance, the Monetary Authority will perform its role as an overseer of designated systems to promote the safety and efficiency of designated systems. This will involve continuing monitoring of the compliance of designated systems with a focus on areas of high risks and with the aim of detecting problems at an early stage.

The HKMA will review the Exchange Fund Bills and Notes programme with a view to attaining a more balanced maturity profile and improving the liquidity towards the longer end. To deepen the retail bond market development, the retail Exchange Fund Notes programme will be re-launched in 2005, with refinements in marketing and product features to increase its attractiveness. The HKMA will take into account the prevailing market conditions in considering the timing for the retail programme.

The Treasury Markets Forum will continue to work with industry associations in promoting professionalism of market practitioners, market development, and promotion of treasury markets of Hong Kong to the Mainland. In particular, plans are underway to organise seminars for Mainland financial institutions and regulators.



The elephant's ear, *Macaranga tanarius*, is a fast-growing evergreen tree, which can grow to a height of around five metres. It is widely distributed throughout the Asia region and is very common on beaches in Hong Kong, where it provides excellent shade.

INTERNATIONAL FINANCIAL CENTRE

In 2004 the HKMA led several initiatives to develop Hong Kong's role as an international financial centre. These included particularly the launch of renminbi banking business in Hong Kong and the further development of the Asian Bond Fund. Through participation in international financial and central banking forums and dialogues with other international financial institutions, the HKMA contributed to a better understanding in the international financial community of Hong Kong's financial and economic development.

OVERVIEW

The global financial system remained stable in 2004, despite the rise in US interest rates, the rapid increase in crude oil prices and the sharp depreciation of the US dollar. Many Asian markets, in particular China, experienced considerable capital inflows and upward pressure on their currencies, presenting challenges to central banks in the region. The robust economy of Mainland China continued to act as an engine of growth for Asia through expanding intra-regional trade. However, rapid expansion in some sectors of the Mainland economy induced the authorities to introduce macroeconomic adjustment and controls in the second quarter of 2004 to curb overheating in certain sectors and to achieve a soft landing of the economy. Against this background, the HKMA strengthened its communication with Mainland and overseas authorities with the aim of keeping abreast of the latest developments and increasing the international financial community's understanding of Hong Kong's financial and economic developments. Through co-operation with relevant authorities, the HKMA implemented several initiatives to leverage on the greater integration between financial markets on the Mainland and Hong Kong and to promote the development of domestic and regional bond markets.

In the first half of 2004, banks in Hong Kong introduced personal renminbi business, including deposit-taking, exchange, remittances and credit cards, following agreement by the People's Bank of China to provide clearing services for these forms of business. This initiative was the fruit of extensive interaction between the HKMA and the Mainland authorities. The HKMA pursued two regional initiatives during the year. The first was the structuring, design and launch of the local currency component of the Asian Bond Fund (ABF2) under the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP). The second was the successful conclusion of the APEC Initiative on Development of Securitisation and Credit Guarantee Markets, which will provide assistance to APEC member economies interested in promoting asset securitisation.



The HKMA hosts the Second High-Level Policy Dialogue of the APEC Initiative on Development of Securitisation and Credit Guarantee Markets on 22 March 2004.

REVIEW OF 2004

Development of regional bond markets

Through its chairmanship of the EMEAP Working Group on Financial Markets, the HKMA contributed significantly to the design and implementation of the local currency Asian Bond Fund (ABF2) (Box 1). In December 2004 the HKMA, together with the other 10 EMEAP central banks and monetary authorities, announced the launch of ABF2. ABF2 will have an initial size of about US\$2 billion and will be invested in by all 11 EMEAP Members. Implementation will be carried out in two phases: in Phase One, investments will be confined to EMEAP central banks; in Phase Two, the Pan-Asian Bond Index Fund (PAIF) and eight Single-market Funds will be offered to other public and

private-sector investors, through listing where appropriate. It is intended that, subject to approvals by the relevant authorities, two key components of the ABF2 – the PAIF and the Hong Kong fund – will be listed on the Stock Exchange of Hong Kong. Hong Kong was chosen as the initial place of listing for the PAIF on the basis of positive market attributes, efficiency and sophistication.

The HKMA continued to lead the Asia-Pacific Economic Cooperation (APEC) initiative on the Development of Securitisation and Credit Guarantee Markets with Thailand and Korea as co-chairs in 2004. The Initiative, launched in September 2002, was sponsored by the World Bank to assist APEC member economies in identifying market impediments and to devise proposals to remove

BOX 1

Asian Bond Fund 2: A regional initiative aimed at improving financial intermediation efficiency in Asia

The local currency-denominated Asian Bond Fund (ABF2) is an extension of the US dollar-denominated Asian Bond Fund (ABF1) launched in June 2003, with the aim of helping broaden and deepen the domestic and regional bond markets in Asia. ABF2 was announced on 16 December 2004.

ABF2 has a Pan-Asian Bond Index Fund (PAIF) and eight Single-market Funds. The PAIF is a single bond fund investing in sovereign and quasi-sovereign local currency-denominated bonds issued in all EMEAP member economies except Australia, Japan and New Zealand. The eight Single-market Funds will invest in sovereign and quasi-sovereign local currency-denominated bonds issued in the respective markets of the eight EMEAP economies. The PAIF and eight Single-market Funds will be passively managed by private-sector fund managers against a Pan-Asian bond index and relevant domestic bond indices for the eight EMEAP markets. The PAIF and the eight

Single-market Funds will offer new investment opportunities for central banks and other investors.

From a market development perspective, the ABF2 initiative is expected to yield important benefits:

1. Promoting new products: In contrast to the US and Europe, listed bond funds are uncommon in Asia, and the PAIF and the eight Single-market Funds represent a new product of its kind for the respective markets. For instance, the Hong Kong fund would be the first ever fixed-income Exchange-Traded Fund (ETF) to be listed on the Stock Exchange of Hong Kong. The PAIF and eight Single-market Funds are expected to provide a catalytic effect in the development of innovative products in Asia.

2. Improving market infrastructure: In setting up the PAIF and the eight Single-market

them. During the two-year term of the Initiative, two panel visits were made each to Thailand, China and Mexico. The expert panels advised and assisted national authorities in drawing up action plans and taking concrete steps to identify impediments to the development of asset securitisation markets, and to remove them. A policy dialogue attended by senior finance and central bank officials, practitioners and academics in Asia was held in Hong Kong in March 2004 to discuss progress made on the panel visits. While the Initiative was concluded at the September APEC Finance Ministers' Meeting, following the expiry of its two-year term, some follow-up work may continue into 2005 in the light of the strong drive to develop the securitisation and credit guarantee markets in the region.

Regional monetary co-operation and participation in multilateral institutions

The HKMA contributed to policy dialogues in international and regional forums and played an active role in regional monetary co-operation in 2004. The Chief Executive of the HKMA, Mr Joseph Yam, was appointed Chairman of the Bank for International Settlements (BIS) Asian Consultative Council (ACC) for a term of two years beginning in March 2003.¹ Mr. Yam is also the Chairman of the

¹ The Asian Consultative Council (ACC) was established in March 2001 by the BIS to provide a vehicle for communication between the Asian and Pacific members of the BIS and the BIS Board and Management on matters of interest and concern to the Asian central banking community. The ACC currently has 12 members, including central banks and monetary authorities of Australia, China, Hong Kong SAR, India, Indonesia, Japan, Korea, Malaysia, New Zealand, The Philippines, Singapore and Thailand.

Funds, EMEAP and the relevant member central banks have sought to improve market infrastructure through various means. For instance, EMEAP has taken the opportunity to develop, in collaboration with the International Index Company, a set of transparent, replicable and credible bond market indices covering the eight EMEAP markets using a multiple-contributor pricing model, which will be by itself an important piece of market infrastructure for Asia. The indices are based on prices provided by a number of active market makers, and accordingly can better reflect the prevailing market for the underlying bonds. It is envisaged that the indices would be widely adopted by private sector fund managers as benchmark indices for their own fixed income products, and derivatives products would also be structured around these indices.

3. Minimising regulatory hurdles in the relevant

EMEAP markets: The process of developing the PAIF, and the eight Single-market Funds in particular, has helped accelerate tax and regulatory reform at both regional and domestic levels. At the regional level, some

EMEAP economies are currently reviewing or changing their tax and regulatory regimes to facilitate cross-border investment. For instance, Malaysia has opened up its domestic market to issuances by multilateral development banks and multilateral financial institutions, and has exempted non-resident investors from withholding tax on the interest income received from investment in ringgit-denominated debt securities. At the domestic level, some EMEAP economies are actively developing the relevant regulations to facilitate listing of bond funds or fixed income ETF in their respective markets.

In the near term, ABF2 will help raise investor awareness and interest in Asian bonds by providing innovative, low-cost and efficient products in the form of passively managed bond funds. With the continuing efforts in developing better market infrastructure and removing regulatory impediments so initiated, the efficiency of bond market as a channel of financial intermediation will be increased over time, thereby contributing to greater financial stability in the region in the future.

BIS Central Bank Governance Steering Group, which conducts detailed research on central bank governance issues. The HKMA, representing the Hong Kong SAR Government, participated in the review of the use of funds of the Asian Development Fund (ADF), a concessionary lending facility of the Asian Development Bank for the poorest economies in the region, and took part in the negotiation of the Eighth Replenishment of the ADF. In December 2004 the Finance Committee of the Legislative Council approved Hong Kong's contribution of \$149.7 million (or US\$19.19 million) to the Eighth Replenishment. In November the HKMA jointly organised with the International Monetary Fund (IMF) a regional conference in Hong Kong on managing procyclicality of financial systems.

Upgrading of Hong Kong's sovereign credit rating

The HKMA has been playing a pivotal role in the adoption of a more proactive approach towards international credit rating agencies on Hong Kong's credit ratings. Through more effective communication between the international credit rating agencies and the relevant authorities, the HKMA aims at ensuring that the agencies maintain a more balanced view on Hong Kong. Amid improved economic prospects in Hong Kong, these efforts have paid off. Between April and June, Standard & Poor's, Fitch Ratings, and Rating and Investment Information all upgraded the outlook on Hong Kong's sovereign rating from negative to stable.

Financial market integration with the Mainland

The successful launch and smooth running of personal renminbi banking services in Hong Kong in 2004 was one of the results of the close co-operation between Hong Kong and Mainland China (Box 2). The launch of renminbi business provided a new range of services for customers in Hong Kong, helped diversify banking business, and facilitated cross-border spending and economic integration between Hong Kong and the Mainland. The services have been well received, with total outstanding

renminbi deposits at RMB 12.1 billion yuan by the end of December. In addition, the signing of CEPA II (Closer Economic Partnership Arrangement) on 27 October helped expand the business scope of Hong Kong banks on the Mainland. CEPA II allows Mainland branches of Hong Kong banks to act as agents for insurance products after obtaining approval from relevant authorities with effect from 1 November 2004.

To develop its understanding of financial and economic issues on the Mainland, the HKMA continued to engage in research co-operation with Mainland academics and think-tanks. During the year a number of Mainland officials and academics were invited to Hong Kong to exchange views on issues of common interest.

Training

A series of training programmes was designed for officials of the People's Bank of China (PBoC), China Banking Regulatory Commission (CBRC) and other Mainland authorities, both in Hong Kong and on the Mainland, to share HKMA's expertise in the areas of financial stability, banking supervision and accounting management. These included

- three banking supervision courses for senior officials from the CBRC
- four specialised courses for CBRC bank supervisors held in different cities
- two financial stability courses for senior officials from the PBoC
- a bank accounting management course for PBoC accounting officials
- one course for securities regulators of the China Securities Regulatory Commission.

In total, 11 courses, or 2,248.5 days of training, were provided to 833 Mainland officials in 2004.

The HKMA also provided training on request to other external parties. These included one seminar for Mainland commercial banks, and a regional

BOX 2**Renminbi business in Hong Kong**

Following the approval of the State Council in 2003, the People's Bank of China (PBoC) agreed to provide clearing arrangements for personal renminbi business in Hong Kong. The first phase of the renminbi business was launched on 18 January 2004, when shops and ATM machines in Hong Kong began to accept debit and credit cards issued by Mainland banks. The second phase of renminbi business started on 25 February 2004, when banks in Hong Kong began to offer renminbi deposit-taking, currency exchange and remittance services to their customers. The third phase of personal renminbi business, which began on 30 April 2004, allowed banks in Hong Kong to issue renminbi debit and credit cards to Hong Kong residents for use on the Mainland.

The response to the launch of personal renminbi services has been positive. Renminbi deposits have increased gradually since the launch of the business. By the end of December 2004, the total amount of renminbi deposits outstanding reached RMB12.1 billion yuan, with 38 licensed banks

providing this service. There has been a steady increase in the use of renminbi debit and credit cards by Mainland tourists in Hong Kong. By the end of 2004, Mainland tourists spent a total of \$2,152 million using renminbi debit and credit cards in Hong Kong and withdrew a total of \$782 million from ATM machines in Hong Kong. The average size of credit/debit card spending was \$2,989 per transaction, significantly higher than the average transaction size by overseas tourists in Hong Kong.

The HKMA has maintained dialogues with relevant parties to improve the services and to explore further development opportunities for renminbi business in Hong Kong. To this end, the Financial Secretary outlined in August three strategic directions: diversification of renminbi assets and liabilities; denomination and settlement of trade in renminbi; and debt issuance in renminbi. The HKMA will work on specific proposals along these strategic directions.

course on Risk-focused Supervision and Risk Assessment under the APEC financial regulators' training initiative. A total of 65 participants attended the two seminars in 2004.

PLANS FOR 2005 AND BEYOND

Given the new challenges in the global financial markets, the HKMA will continue to monitor closely latest developments and their implications for Hong Kong. We will ensure that the views and concerns of Hong Kong on important issues affecting financial stability are heard in the central banking and international financial forums.

As part of our effort to reinforce Hong Kong's status as a premier international financial centre, the HKMA will work with regional economies to implement current initiatives, such as ABF2, and will continue to support the Hong Kong SAR

Government's proactive strategy in promoting a deeper understanding of Hong Kong's economic and financial strength to the major international credit rating agencies.

Following the launch of personal renminbi banking business in Hong Kong and the full implementation of CEPA I and II, integration between Hong Kong and the Mainland is expected to strengthen further in coming years. The HKMA will continue to maintain close dialogue with Mainland authorities to further promote Hong Kong's role in facilitating fund flows and serving the financial needs of the Mainland. The HKMA will continue to organise training seminars and courses for the staff of Mainland authorities and other external parties in 2005.



> Policy Areas > Monetary Stability > External Relations



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The cotton tree, *Bombax ceiba* (*B. malabaricum*), can grow to 25 metres or more in height. Its magnificent red flowers appear in spring before the new season's leaves, making it one of the most attractive of Hong Kong's roadside trees. The dried flowers are used in herbal preparations to reduce inflammation, and the cotton-like substance in its seed capsules is traditionally used for stuffing pillows and cushions.

RESERVES MANAGEMENT

Despite considerable volatility in the bond, equity and currency markets, the Exchange Fund achieved an investment return of 5.7% in 2004, which was in line with the return on its benchmark.

THE EXCHANGE FUND

The Exchange Fund performs a key role in maintaining the stability of Hong Kong's monetary and financial systems. Since its establishment in 1935, the Exchange Fund has held the backing to the banknotes issued in Hong Kong. In 1976 the backing for coins issued and the bulk of the foreign currency assets held in the Government's General Revenue Account were also transferred to the Fund. On 31 December 2004 the assets of the Fund amounted to \$1,061.9 billion.

The primary objective of the Exchange Fund is to safeguard the exchange value of Hong Kong's currency and to maintain the stability and integrity of the monetary and financial systems of Hong Kong. On 31 December 2004 the foreign currency reserves amounted to US\$123.6 billion. It is also the investment objective of the Fund to maintain the long-term purchasing power of the foreign currency reserves, which represent a store of value for the people of Hong Kong.

The high volatility in financial markets in recent years has highlighted not only the importance of risk management in the investment process but also the need to diversify into new markets and instruments. The management of the reserves by the HKMA is in line with international best practices.

Investment objectives

The Exchange Fund is managed according to the following investment objectives:

- (a) to preserve capital;
- (b) to ensure that the entire Monetary Base at all times will be fully backed by highly liquid short-term US dollar-denominated securities;
- (c) to ensure sufficient liquidity for the purpose of maintaining monetary and financial stability; and
- (d) subject to (a) – (c) above, to achieve an investment return that will preserve the long-term purchasing power of the assets.

An investment benchmark, derived from these objectives, governs the Fund's long-term asset allocation strategy, and represents an optimal use of assets designed to meet the objectives.

The Exchange Fund's investment benchmark is reviewed regularly to ensure that it consistently meets the investment objectives. The latest modifications were made in January 2003. According to the current investment benchmark, 77% of the Exchange Fund is allocated to bonds and 23% to equities and related investments. In terms of currency allocation, 88% is allocated to the US dollar bloc (which includes the Hong Kong dollar) and the remaining 12% to other currencies.

The investment process

The Exchange Fund is managed as two distinct portfolios: the Backing Portfolio and the Investment Portfolio. The Backing Portfolio fully matches the Monetary Base, which, under Hong Kong's Currency Board system, consists of

- Certificates of Indebtedness, which are used to back the banknotes issued by the three note-issuing banks
- government-issued notes and coins in circulation
- the sum of the balances on the clearing accounts held by banks with the HKMA (known as the Aggregate Balance)
- Exchange Fund Bills and Notes, which are issued by the HKMA on behalf of the Government.

The Backing Portfolio holds highly liquid US dollar-denominated securities.

The balance of the Exchange Fund's assets that constitute the Investment Portfolio are primarily invested in OECD bond and equity markets to preserve the value and long-term purchasing power of these assets.

The long-term asset allocation strategy of the Exchange Fund is governed by the investment benchmark, which defines the allocation of investments to different asset classes by country and by sector as well as the overall currency mix for the Fund. To qualify as an approved investment, a new market or financial instrument must meet the minimum credit, security and liquidity requirements of the Exchange Fund.

The Exchange Fund's investment strategy is determined by the Exchange Fund Advisory Committee (EFAC), while the day-to-day management of the Exchange Fund is conducted by the Reserves Management Department of the HKMA. In discharging its responsibilities, the Department operates within the investment guidelines endorsed by EFAC. Through fundamental analysis of different economies and assessments of market development and trends, the HKMA's investment professionals determine the allocations to asset classes by country and by sector as well as the appropriate timing for market entries and exits. To generate more active returns above market returns, these professionals also engage in the selection of specific securities within each market.

Stringent controls and investment guidelines have been established to monitor the risks arising from increasing volatility in the financial markets. In addition, the HKMA conducts detailed performance attribution analyses to make the most effective use of the investment skills of both the internal and the external managers.

Use of external managers

The Exchange Fund employs external fund managers located in 13 international financial centres to manage about one third of its total assets and all of its equity portfolios. The purpose of appointing external managers is to tap the best of the investment expertise available in the market, to capture a diverse mix of investment styles within the global investment field, and to transfer market knowledge and information. In 2004 the Exchange Fund's diversification into different asset classes, management styles, and markets has increased the number and types of specialist managers employed, particularly in the fixed income asset class. Looking ahead to 2005, the Fund intends to continue this diversification.

Externally managed portfolios are subjected to the same stringent controls, investment guidelines and performance attribution analyses as the internally managed portfolios. Assets are custodised with several major global master custodians.

Hong Kong equity portfolios

With effect from January 2003, the management of the Hong Kong equity portfolios was transferred to the HKMA from Exchange Fund Investment Limited. The HKMA manages these portfolios exclusively through external fund managers.

Risk management and compliance

The Risk Management and Compliance Division at the HKMA is responsible for risk control functions. The Division monitors, reports and controls the market, credit, liquidity and operational risks arising from the investment process. It is also responsible for the selection of benchmarks and evaluation of investment performance. Both internally and externally managed portfolios are evaluated against their respective benchmarks, and the Division conducts detailed performance attribution analysis to identify the skills of investment managers to improve effective asset allocation. Risk control tools, such as value-at-risk and scenario stress testing, are used to quantify the market risks in the portfolios under normal and extreme adverse market conditions.

The Risk Management and Compliance Division constantly strengthens and improves its internal diagnostic and analytical capabilities in line with best practices to keep pace with the changes in the investment approach of the Exchange Fund.



> Policy Areas > Monetary Stability > Exchange Fund

PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2004

In 2004 the US Federal Reserve started to tighten after maintaining easy monetary conditions for an extended period. By the end of 2004 the Fed had raised the federal funds target rate from a 45-year low of 1.0% to 2.25%. Short-term interest rates rose in line with the increase in the federal funds target rate but long-term interest rates, such as the yield on the 10-year US Treasury bond barely moved. As inflationary expectations were well contained, the yield on the 10-year US Treasury bond ended the year at 4.22%, which was close to the level of 4.25% at the beginning of the year.

After a promising start in the first quarter of the year, global equity markets declined sharply in the middle of the year but rallied strongly in the fourth quarter on positive earnings. The S&P 500 ended the year 9.0% higher, while the NASDAQ gained 8.6%. The Hong Kong equity market outperformed most other equity markets by rising 13.2% during the year.

For the first part of the year, the US dollar recovered some of the losses in the previous two years. However, mounting concerns about the current account deficit in the US brought on another bout of dollar depreciation in the last months of the year. In 2004 the euro strengthened by 7.8%, while the yen rose by 4.6% against the US dollar. Commodity prices also surged. Gold prices reached a high of US\$457 per ounce before closing the year at US\$438 per ounce. Crude oil prices began the year at US\$32.5 per barrel, and soared to a high of US\$55.6 per barrel before ending the year at US\$43.5 per barrel.

TABLE 1 Market returns

	2004	2003
Currencies		
Appreciation against US dollar		
euro	+7.8%	+20.2%
yen	+4.6%	+10.7%
Bond markets		
JP Morgan US Government Bond (1-3 years) Index	+0.9%	+2.0%
Equity markets		
Standard & Poor's 500 Index	+9.0%	+26.4%
Hang Seng Index	+13.2%	+34.9%

The performance of major bond, equity and currency markets is shown in Table 1.

The Exchange Fund's performance in 2004

The Exchange Fund was positioned defensively in this difficult environment. In 2004 the Exchange Fund recorded income from bonds of \$25 billion, \$12 billion from Hong Kong equities, \$11.2 billion from foreign equities and \$8.5 billion from foreign exchange gains. The total investment income of \$56.7 billion represents an investment return of 5.7%, which is in line with the return of the investment benchmark for the year.



Chief Executive Joseph Yam and Executive Director (Reserves Management) Amy Yip announce the Exchange Fund results for 2004.

TABLE 2 Gross investment return of the Exchange Fund (in Hong Kong dollar terms)¹

	Return on total assets	Return on investment benchmark ²	CPI(A) ³
2004	5.7%	5.7%	+0.4%
2003	10.2%	9.5%	-1.2%
1993 – 2004 cumulative	117.0%	N.A.	24.5%
1993 – 2004 annualised	6.7%	N.A.	1.8%

¹ For the Annual Reports from 2001 to 2003, return on total assets and return on investment benchmark are in US dollar terms.

² Established in January 1999.

³ December year-on-year percentage change in the HK-CPI(A) index. CPI(A) is calculated based on the 1999/2000 base new series.

TABLE 3 Currency mix of the Exchange Fund's assets at 31 December 2004 (including forward transactions)

	HK\$ billion	%
US dollar bloc		
US dollar ¹	835.3	78.7
Hong Kong dollar	92.5	8.7
Non-US dollar bloc	134.1	12.6
Total	1,061.9	100.0

¹ Include US dollar bloc foreign currencies such as Canadian dollar, Australian dollar and New Zealand dollar.

The investment return on the Exchange Fund relative to the investment benchmark and domestic inflation rate for the period from 1993 to 2004 is set out in Table 2. Since 1993 the Exchange Fund has generated a compounded annual return of 6.7%, which compares favourably with the compounded annual inflation rate of 1.8% over the same period. The currency mix of the Fund's assets at 31 December 2004 is set out in Table 3.

Transparency

The Exchange Fund is one of the most transparent among the reserves managed by central banks and monetary authorities. Four press releases on Exchange Fund data are issued by the HKMA each month. Three of these releases disseminate monetary data in accordance with the International Monetary Fund's (IMF) Special Data Dissemination Standard. The International Reserves constitute the official currency reserves of Hong Kong and the analytical accounts of the central bank comprise specifically prescribed balance sheet data. The template on international reserves and foreign currency liquidity provides a comprehensive account of the IMF participant's foreign currency assets and drains on such resources arising from various foreign currency liabilities and commitments. The fourth release, on the Exchange Fund's Abridged Balance Sheet and Currency Board Account, is made in accordance with the HKMA's policy of transparency. This policy of transparency, which was maintained throughout 2004, helps promote public understanding of the Exchange Fund's operating results and financial position.



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THE EXCHANGE FUND

- Report of the Director of Audit to the Financial Secretary
- Exchange Fund – Income and Expenditure Account
- Exchange Fund – Balance Sheet
- Exchange Fund – Statement of Changes in Equity
- Exchange Fund – Cash Flow Statement
- Exchange Fund – Notes on the Accounts

REPORT OF THE DIRECTOR OF AUDIT TO THE FINANCIAL SECRETARY

I have audited the statement of the accounts on pages 94 to 125 which has been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective responsibilities of the Monetary Authority and the Director of Audit

The directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance (Cap. 66) requires the Monetary Authority to sign the statement of the accounts. In preparing the statement of the accounts, the Monetary Authority has to select appropriate accounting policies and to apply them consistently.

It is my responsibility to form an independent opinion, based on my audit, on that statement of the accounts and to report my opinion to you.

Basis of opinion

I certify that I have audited the statement of the accounts referred to above in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance and the Audit Commission auditing standards. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the statement of the accounts. It also includes an assessment of the significant estimates and judgements made by the Monetary Authority in the preparation of the statement of the accounts, and of whether the accounting policies are appropriate to the Exchange Fund's and the Group's circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance as to whether the statement of the accounts is free from material misstatement. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the statement of the accounts. I believe that my audit provides a reasonable basis for my opinion.

Opinion

In my opinion the statement of the accounts gives a true and fair view of the state of affairs of the Exchange Fund and of the Group as at 31 December 2004 and of their surplus and cash flows for the year then ended and has been properly prepared in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance.

Audit Commission
Hong Kong
31 March 2005

(Benjamin Tang)
Director of Audit

EXCHANGE FUND – INCOME AND EXPENDITURE ACCOUNT

for the year ended 31 December 2004

(Expressed in millions of Hong Kong dollars)	Notes	Group 2004	2003	Fund 2004	2003
INCOME					
Interest income					
Interest income on debt securities		21,534	23,253	21,380	23,103
Other interest income		3,064	3,271	2,194	2,410
Total interest income		24,598	26,524	23,574	25,513
Dividend income from listed equity securities		4,556	3,751	4,556	3,751
Dividend income from subsidiaries		-	-	17	140
Net realised and revaluation gains on other investments in securities		19,538	29,384	19,538	29,384
Other net realised and revaluation gains		582	7,977	582	7,960
Net exchange gains		8,469	22,886	8,474	22,900
Bank licence fees		129	130	129	130
Others		353	238	70	49
TOTAL INCOME		58,225	90,890	56,940	89,827
EXPENDITURE					
Interest expense	3(a)	(18,066)	(30,233)	(17,856)	(29,847)
Operating expenses	3(b)	(1,523)	(1,508)	(1,251)	(1,179)
Note and coin expenses	3(c)	(182)	(229)	(182)	(229)
TOTAL EXPENDITURE		(19,771)	(31,970)	(19,289)	(31,255)
SURPLUS BEFORE PREMISES					
REVALUATION AND ASSOCIATE					
Surplus/(Deficit) on revaluation of premises	12(c)	876	(876)	876	(876)
Share of profit of associate		4	10	-	-
SURPLUS BEFORE TAXATION					
Taxation of subsidiaries and share of taxation of associate		39,334	58,054	38,527	57,696
		(110)	(58)	-	-
SURPLUS AFTER TAXATION					
Minority interests		39,224	57,996	38,527	57,696
		(21)	(24)	-	-
SURPLUS FOR THE YEAR					
		39,203	57,972	38,527	57,696

The notes on pages 98 to 125 form part of these accounts.

EXCHANGE FUND – BALANCE SHEET

as at 31 December 2004

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2004	2003	2004	2003
ASSETS					
Cash and money at call		20,759	19,168	20,738	19,143
Placements with banks and other financial institutions	4	48,178	43,823	42,747	41,549
Investment securities	5	300	300	300	300
Other investments in securities	6	977,746	931,737	977,746	931,737
Held-to-maturity securities	7	4,130	3,574	-	-
Mortgage loans		34,938	34,582	-	-
Gold	8	228	217	228	217
Other assets	9	14,510	14,095	13,914	13,503
Investments in subsidiaries	10	-	-	2,145	2,145
Investment in associate	11	23	20	-	-
Fixed assets	12	4,286	3,309	4,036	3,051
TOTAL ASSETS	13	1,105,098	1,050,825	1,061,854	1,011,645
LIABILITIES AND EQUITY					
Certificates of Indebtedness	14	146,775	134,215	146,775	134,215
Government-issued currency notes and coins in circulation	14	6,351	6,297	6,351	6,297
Balance of the banking system	15	15,789	28,277	15,789	28,277
Exchange Fund Bills and Notes	16	125,860	123,520	125,860	123,520
Other debt securities	17	35,495	36,620	-	-
Placements by banks and other financial institutions	18	39,087	44,542	39,087	44,542
Placements by other Hong Kong Special Administrative Region government funds	19	280,091	252,296	280,091	252,296
Placements by Hong Kong statutory bodies		-	164	-	164
Other liabilities	20	29,645	38,284	24,310	37,455
Total liabilities		679,093	664,215	638,263	626,766
Minority interests		167	160	-	-
Accumulated surplus	21	425,644	386,441	423,397	384,870
Premises revaluation reserve	21	194	9	194	9
Total equity		425,838	386,450	423,591	384,879
TOTAL LIABILITIES AND EQUITY		1,105,098	1,050,825	1,061,854	1,011,645

Joseph Yam

Monetary Authority

31 March 2005

The notes on pages 98 to 125 form part of these accounts.

EXCHANGE FUND – STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December 2004

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2004	2003	2004	2003
Total equity at 1 January		386,450	328,469	384,879	327,174
Surplus for the year		39,203	57,972	38,527	57,696
Surplus on revaluation of premises	12(c)	185	9	185	9
Total equity at 31 December	21	425,838	386,450	423,591	384,879

EXCHANGE FUND – CASH FLOW STATEMENT

for the year ended 31 December 2004

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2004	2003	2004	2003
Net cash from/(used in) operating activities	23(a)	(984)	54,449	(5,859)	60,037
Cash flows from investing activities					
Purchase of fixed assets		(52)	(2,583)	(25)	(2,544)
Dividends received from subsidiaries		-	-	17	140
Purchase of held-to-maturity securities		(1,762)	(1,561)	-	-
Proceeds from sale or redemption of held-to-maturity securities		1,198	1,407	-	-
Net cash used in investing activities		(616)	(2,737)	(8)	(2,404)
Cash flows from financing activities					
Proceeds from issue of other debt securities		11,408	10,870	-	-
Redemption of other debt securities		(12,524)	(2,870)	-	-
Dividends paid to minority shareholders		(13)	(114)	-	-
Net cash from/(used in) financing activities		(1,129)	7,886	-	-
Net increase/(decrease) in cash and cash equivalents		(2,729)	59,598	(5,867)	57,633
Cash and cash equivalents at 1 January		180,469	120,676	178,170	120,339
Effect of foreign exchange rate changes		1,112	195	1,117	198
Cash and cash equivalents at 31 December	23(b)	178,852	180,469	173,420	178,170

The notes on pages 98 to 125 form part of these accounts.

EXCHANGE FUND – NOTES ON THE ACCOUNTS

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

1. Principal Activities

The Monetary Authority, under delegated authority from the Financial Secretary as Controller of the Exchange Fund (the Fund), manages the Fund in accordance with the provisions of the Exchange Fund Ordinance. The principal activities of the Fund are the safeguarding of the exchange value of the currency of Hong Kong and the maintaining of the stability and integrity of Hong Kong's monetary and financial systems.

The principal activities of the subsidiaries are shown in Note 10.

2. Principal Accounting Policies

(a) Basis of preparation

These accounts have been prepared using the fair value measurement basis, as modified by the use of historical cost for investment securities, held-to-maturity securities, other assets, investments in subsidiaries and associate, fixed assets other than premises, placements by other Hong Kong Special Administrative Region (HKSAR) government funds for which interest is payable at rates determined by reference to the investment income of the Fund and other liabilities, and in accordance with accounting principles generally accepted in Hong Kong, and comply with all applicable Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants. Fair value of a financial instrument represents its market price where there is a published price quotation in an active securities market. Where such a market price is not available, fair value of a financial instrument represents its valuation according to a price matrix of discounted cash flows using applicable interest rates for discounting.

(b) Basis of consolidation

The consolidated accounts of the Group comprise the accounts of the Fund and all its subsidiaries, and also incorporate the Group's interests in an associate on the basis set out in Note 2(c)(iii). All significant intra-group balances and transactions have been eliminated on consolidation.

Minority interests represent the interests of outside shareholders in the operating results and net assets of a subsidiary.

(c) Investments

(i) Investments in securities

Investments in debt and equity securities, except those held as investments in subsidiaries and associate, are accounted for as follows.

Investments in securities are recognised as assets from the date on which the Group is bound by the contract which gives rise to them. They are classified as investment securities, held-to-maturity securities and other investments in securities.

Investment securities

Investment securities are securities which are intended to be held on a continuing basis, and which are held for an identified long term purpose documented at the time of acquisition or change of purpose and are clearly identifiable for the documented purpose. They are carried at cost less provision for any diminution in value which is other than temporary.

Held-to-maturity securities

Held-to-maturity securities are securities which the Group has the expressed intention and ability to hold to maturity. They are carried at amortised cost less provision for any diminution in value.

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

Other investments in securities

Other investments in securities are those which are not classified as investment securities and held-to-maturity securities. They are stated at fair value at the balance sheet date.

Changes in fair value of these investments are recognised in the income and expenditure account in "Net realised and revaluation gains/(losses) on other investments in securities" as they arise.

Gains and losses on sale of these investments are accounted for in the income and expenditure account in "Net realised and revaluation gains/(losses) on other investments in securities" in the period in which the disposal occurs as the difference between the net sales proceeds and the carrying amount of the securities.

(ii) Investments in subsidiaries

Investments in subsidiaries are stated in the Fund's balance sheet at cost less provision for any diminution in value which is other than temporary.

(iii) Investment in associate

Investment in an associate is stated in the Fund's balance sheet at cost less provision for any diminution in value which is other than temporary.

In the Group's consolidated balance sheet, the investment in the associate is stated at the Group's share of its net assets. The Group's consolidated income and expenditure account includes the Group's share of the results of the associate for the year.

(d) Placements with banks and other financial institutions

Placements with banks and other financial institutions are valued in the balance sheet according to a price matrix of discounted cash flows using applicable interest rates for discounting. Changes in value of these placements are included in the income and expenditure account in "Other net realised and revaluation gains/(losses)".

(e) Mortgage loans

Mortgage loans are purchased by The Hong Kong Mortgage Corporation Limited (HKMC), a subsidiary of the Fund, from approved sellers.

(f) Exchange Fund Bills and Notes

Where Exchange Fund Bills and Notes have been issued at a premium or discount, those premiums and discounts are amortised over the period from the date of issue to the date of redemption and are included in the income and expenditure account in "Interest expense".

Exchange Fund Bills and Notes are carried at market value. Revaluation gains and losses are included in the income and expenditure account in "Other net realised and revaluation gains/(losses)".

"Revaluation gains or losses" is the difference between the market value at the end of the year and the market value at the beginning of the year as adjusted for the amortisation of premium or discount for the year. For Bills and Notes issued during the year, "Revaluation gains or losses" is the difference between the market value at the end of the year and the issue price as adjusted for the amortisation of premium or discount for the year.

On redemption of the Exchange Fund Bills and Notes, the resulting gains and losses, being the difference between the redemption amount and the carrying amount, are recognised in the income and expenditure account in "Other net realised and revaluation gains/(losses)" in the period in which the redemption takes place.

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

(g) Other debt securities

Other debt securities are issued by the HKMC for financing the purchase of mortgage loans. Premiums and discounts on issuance of other debt securities are amortised over the period from the date of issue to the date of redemption and are included in the Group's consolidated income and expenditure account in "Interest expense".

Other debt securities are stated in the Group's consolidated balance sheet at fair value. Revaluation gains and losses are included in the Group's consolidated income and expenditure account in "Other net realised and revaluation gains/(losses)". "Revaluation gains or losses" is the difference between the fair value at the end of the year and the fair value at the beginning of the year as adjusted for the amortisation of premium or discount for the year. For other debt securities issued during the year, "Revaluation gains or losses" is the difference between the fair value at the end of the year and the issue price as adjusted for the amortisation of premium or discount for the year.

Gains and losses on redemption of other debt securities, being the difference between the redemption amount and the carrying amount, are included in the Group's consolidated income and expenditure account in "Other net realised and revaluation gains/(losses)" in the period in which the redemption takes place.

(h) Placements by other HKSAR government funds and other placements

Placements by other HKSAR government funds for which interest is payable at market-based rates are valued according to a price matrix of discounted cash flows using applicable interest rates for discounting. Changes in value of these placements are included in the income and expenditure account in "Other net realised and revaluation gains/(losses)". In the balance sheet, these placements are stated at the principal amounts payable at the balance sheet date with the revaluation differences included in "Other liabilities".

Placements by other HKSAR government funds for which interest is payable at rates determined by reference to the investment income of the Fund are stated at the principal amounts payable at the balance sheet date.

Placements by banks, other financial institutions and Hong Kong statutory bodies are valued in the balance sheet according to a price matrix of discounted cash flows using applicable interest rates for discounting. Changes in value of these placements are included in the income and expenditure account in "Other net realised and revaluation gains/(losses)".

(i) Repurchase and resale agreements

Where securities are sold subject to a commitment to repurchase them at a predetermined price, they remain on the balance sheet and a liability is recorded in respect of the consideration received in "Placements by banks and other financial institutions". Conversely, securities purchased under analogous commitments to resell are not recognised on the balance sheet and the consideration paid is recorded in "Placements with banks and other financial institutions". At the balance sheet date consideration received or paid under repurchase and resale agreements is valued according to a price matrix of discounted cash flows using applicable interest rates for discounting. Gains or losses arising from revaluation are included in the income and expenditure account in "Other net realised and revaluation gains/(losses)".

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

(j) Securities lending agreements

Where securities are loaned with the receipt of cash or securities collateral, they remain on the balance sheet. Where cash collateral is received, a liability is recorded in respect of the cash received in "Placements by banks and other financial institutions". At the balance sheet date, this liability is valued according to a price matrix of discounted cash flows using applicable interest rates for discounting. Gains or losses arising from revaluation are included in the income and expenditure account in "Other net realised and revaluation gains/(losses)".

(k) Foreign currency translation

Monetary assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars at the rates of exchange ruling at the balance sheet date. Exchange gains and losses on foreign currency translation are included in the income and expenditure account in "Net exchange gains/(losses)".

Certificates of Indebtedness, government-issued currency notes and coins in circulation, all of which are denominated in Hong Kong dollars but are issued and redeemed in US dollars at the linked exchange rate of US\$1=HK\$7.80, are stated in the accounts at their Hong Kong dollar face value. At the balance sheet date the difference between their Hong Kong dollar face value and the market value of the US dollars required for their redemption is included in "Other assets".

Foreign currency income and expenditure are translated into Hong Kong dollars at the exchange rates prevailing at the transaction dates.

(l) Off-balance sheet financial instruments

Forward foreign exchange contracts are marked to market at the balance sheet date with the resultant revaluation gains and losses being included in the income and expenditure account in "Net exchange gains/(losses)".

Interest rate swap contracts are marked to market at the balance sheet date with the resultant revaluation gains and losses being included in the income and expenditure account in "Other net realised and revaluation gains/(losses)".

Revaluation gains or losses on forward foreign exchange contracts and interest rate swap contracts are included in the balance sheet as "Other assets" or "Other liabilities" as appropriate.

Stock index futures contracts and bond futures contracts are marked to market at the balance sheet date with the unsettled amounts of revaluation gains or losses being included in the balance sheet as "Other assets" or "Other liabilities" as appropriate. The resultant revaluation gains and losses are included in the income and expenditure account in "Other net realised and revaluation gains/(losses)".

(m) Fixed assets

Premises are stated at valuation less accumulated depreciation, except for freehold land which is not depreciated. Valuations are carried out by independent professionally qualified valuers with sufficient regularity to ensure that the carrying amount does not differ materially from the fair value at the balance sheet date. Surpluses arising on revaluation are credited firstly to the income and expenditure account to the extent of any deficits arising on revaluation previously charged to the income and expenditure account in respect of the same premises, and are thereafter taken to the "Premises revaluation reserve". Deficits arising on revaluation are firstly set off against any previous revaluation surpluses included in the "Premises revaluation reserve" in respect of the same premises, and are thereafter taken to the income and expenditure account. Leasehold land is depreciated on a straight-line basis over the unexpired terms of the leases. Buildings are depreciated on a straight-line basis over their estimated useful lives, or the unexpired terms of the leases, whichever the shorter.

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

Other fixed assets, including plant and machinery, furniture, fixtures and equipment, motor vehicles, personal computers and capitalised systems development costs, are stated at cost less accumulated depreciation. These assets are depreciated on a straight-line basis over their respective estimated useful lives of between 2 and 15 years.

Subsequent expenditure relating to a fixed asset that has already been recognised is added to the carrying amount of the asset when it is probable that future economic benefits, in excess of the originally assessed standard of performance of the existing asset, will flow to the Group. All other subsequent expenditure is recognised as an expense in the period in which it is incurred.

Gain or loss arising from the disposal of a fixed asset is determined as the difference between the net disposal proceeds and the carrying amount of the asset and is recognised in the income and expenditure account. On disposal of premises, any related revaluation surplus included in the "Premises revaluation reserve" is transferred directly to "Accumulated surplus".

(n) Revenue recognition

Interest income is recognised on an accrual basis.

Dividend income from listed equity securities is recognised when the share price goes ex-dividend. Dividend income from unlisted equity securities is recognised when the shareholder's right to receive payment is established.

Premiums and discounts relating to other investments in debt securities are dealt with in the income and expenditure account in "Net realised and revaluation gains/(losses) on other investments in securities" in the process of marking to market of such securities at the balance sheet date.

Bank licence fees are fees receivable from Authorized Institutions under the Banking Ordinance and are accounted for in the period when receivable.

Other income includes income from sale of withdrawn coins, Central Moneymarkets Unit fees and other operating income of the subsidiaries. Other income is accounted for in the period when receivable.

(o) Interest expense

Interest expense is recognised on an accrual basis. Discounts and premiums relating to borrowings are amortised on a straight-line basis over the respective remaining lives of the instruments. For a majority portion of the placements by other HKSAR government funds, interest is payable at rates determined by reference to the investment income of the Fund. For the rest of such placements, interest is payable at market-based rates.

(p) Related parties

For the purposes of these accounts, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence. Related parties may be individuals or entities.

(q) Cash and cash equivalents

Cash and cash equivalents are cash and money at call, placements with banks and other financial institutions and short-term highly liquid investments that are readily convertible to known amounts of cash and subject to an insignificant risk of changes in value, having been within three months of maturity when placed or acquired.

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

(r) Staff retirement schemes

The Group operates several defined contribution schemes, including the Mandatory Provident Fund Scheme. Under the schemes, contributions applicable each year are charged to the income and expenditure account. The assets of the staff retirement schemes are held separately from those of the Group.

(s) Operating leases

Leases where substantially all the rewards and risks of ownership remain with the leasing company are accounted for as operating leases. Rental payments under operating leases are charged to the income and expenditure account on a straight-line basis over the period of the relevant leases.

(t) Segment reporting

The activities of the Fund managed by the Hong Kong Monetary Authority (HKMA) comprise four business segments. These are management of funds under the Currency Board Account, management of funds representing the general reserve assets of the Fund, banking supervision and monetary management. As the assets, revenue and overall results of banking supervision, monetary management and the subsidiaries are not significant, their activities are combined with the segment for management of funds representing the general reserve assets of the Fund. Details on this combined segment are disclosed in Note 24 together with the Currency Board Account segment. There is no disclosure of geographic segments as the Group operates predominantly in one location. In line with the normal practice of central banking institutions, further breakdown of the investments by currencies or geographic markets is not disclosed.

(u) Recently issued accounting standards

The Hong Kong Institute of Certified Public Accountants has issued a number of new and revised Hong Kong Financial Reporting Standards and Hong Kong Accounting Standards (new HKFRSs) which are effective for accounting periods beginning on or after 1 January 2005.

The Group has not early adopted these new HKFRSs in the financial statements for the year ended 31 December 2004. The Group has commenced an assessment of the impact of these new HKFRSs.

3. Expenditure

(a) Interest expense

	Group		Fund	
	2004	2003	2004	2003
Interest on placements by other HKSAR government funds				
With interest at market-based rates	25	92	25	92
With interest at rates determined by reference to the investment income of the Fund	14,533	25,700	14,533	25,700
Other interest expense	3,508	4,441	3,298	4,055
TOTAL	18,066	30,233	17,856	29,847

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

(b) Operating expenses

	Group		Fund	
	2004	2003	2004	2003
Staff costs				
Salaries and other staff costs	523	536	421	437
Retirement benefit costs	31	30	25	25
Premises and equipment expenses				
Depreciation charges	135	94	100	62
Operating lease charges	18	66	10	55
Other premises expenses	39	36	33	28
General operating costs				
Maintenance of office and computer equipment	35	26	30	20
Financial information and communication services	31	30	27	26
External relations	15	10	13	9
Professional and other services	43	28	35	22
Training	5	5	4	4
Others	101	168	10	12
Management and custodian fees	547	479	543	479
TOTAL	1,523	1,508	1,251	1,179

The number of senior staff (Executive Directors and above) of the HKMA whose emoluments fell within the following bands were:

HK\$	2004	2003
500,000 or below	-	1
1,000,001 to 1,500,000	1	-
1,500,001 to 2,000,000	1	1
2,000,001 to 2,500,000	1	-
2,500,001 to 3,000,000	-	1
3,000,001 to 3,500,000	5	5
3,500,001 to 4,000,000	2	1
4,000,001 to 4,500,000	1	2
5,000,001 to 5,500,000	1	1
5,500,001 to 6,000,000	1	1
8,500,001 to 9,000,000	1	1
	14	14

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

The aggregate emoluments of senior staff (Executive Directors and above) of the HKMA were as follows:

	2004	2003
Fixed pay	42.9	42.8
Variable pay	7.5	7.4
Other benefits	3.6	2.7
	54.0	52.9

Other benefits shown above include provident funds, medical and life insurance, gratuity and annual leave accrued during the year. There are no other allowances or benefits-in-kind.

- (c) **Note and coin expenses** represent reimbursements to the note-issuing banks in respect of note-issuing expenses and expenses incurred directly by the Fund in issuing government-issued currency notes and coins.

4. Placements with Banks and other Financial Institutions

	Group		Fund	
	2004	2003	2004	2003
Placements with banks and other financial institutions in respect of resale agreements	4,974	4,770	4,974	4,770
Other placements with banks and other financial institutions	43,204	39,053	37,773	36,779
TOTAL	48,178	43,823	42,747	41,549

5. Investment Securities

	Group		Fund	
	2004	2003	2004	2003
Unlisted shares, at cost	300	300	300	300

Investment securities comprise 3,000 shares of the Bank for International Settlements with a nominal value of 5,000 Special Drawing Rights (SDRs) each (25% paid).

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

6. Other Investments in Securities

At fair value	Group		Fund	
	2004	2003	2004	2003
Debt securities				
Treasury bills and commercial papers				
Listed outside Hong Kong	3,119	744	3,119	744
Unlisted	271,847	243,509	271,847	243,509
Certificates of deposit				
Unlisted	12,637	388	12,637	388
Other debt securities				
Listed				
In Hong Kong	1,518	2,630	1,518	2,630
Outside Hong Kong	342,179	369,051	342,179	369,051
Unlisted	140,816	144,744	140,816	144,744
Total debt securities	772,116	761,066	772,116	761,066
Equity securities				
Listed				
In Hong Kong	82,417	71,229	82,417	71,229
Outside Hong Kong	123,213	99,442	123,213	99,442
Total equity securities	205,630	170,671	205,630	170,671
TOTAL	977,746	931,737	977,746	931,737

7. Held-to-Maturity Securities

At amortised cost	Group		Fund	
	2004	2003	2004	2003
Debt securities				
Listed				
In Hong Kong	224	77	-	-
Outside Hong Kong	1,424	1,047	-	-
Unlisted	2,482	2,450	-	-
TOTAL	4,130	3,574	-	-

The market value of the listed held-to-maturity securities was HK\$1,672 million at 31 December 2004 (2003 - HK\$1,148 million).

8. Gold

	Group		Fund	
	2004	2003	2004	2003
Gold, at market value				
66,798 ounces (2003 - 66,916 ounces)	228	217	228	217

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

9. Other Assets

	Group		Fund	
	2004	2003	2004	2003
Staff housing loans	279	324	279	324
Revaluation gains on off-balance sheet items which are marked to market	1,358	1,471	1,358	1,471
Revaluation difference on Certificates of Indebtedness, government-issued currency notes and coins in circulation	536	656	536	656
Prepayments, receivables and other assets	12,337	11,644	11,741	11,052
TOTAL	14,510	14,095	13,914	13,503

10. Investments in Subsidiaries

	Fund	
	2004	2003
Unlisted shares, at cost	2,145	2,145

The following is a list of the subsidiaries as at 31 December 2004 and 2003:

Name of company	Place of incorporation and operation	Principal activities	Issued equity capital	Exchange Fund's interest in equity capital
Hong Kong Note Printing Limited	Hong Kong	Banknotes printing	HK\$255,000,000	55%
The Hong Kong Mortgage Corporation Limited	Hong Kong	Investment in mortgages, mortgage securitisation and guarantee	HK\$2,000,000,000	100%
Exchange Fund Investment Limited	Hong Kong	Dormant	HK\$5,000,000	100%
Hong Kong Institute for Monetary Research	Hong Kong	Research	HK\$2	100%

(a) All subsidiaries are held directly by the Fund.

(b) HKMC has unissued authorised share capital of HK\$1 billion (2003 - HK\$1 billion) which is callable from the Fund.

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

11. Investment in Associate

	Group		Fund	
	2004	2003	2004	2003
Unlisted shares, at cost	-	-	-	-
Share of net assets	23	20	-	-
TOTAL	23	20	-	-

Investment in associate comprises unlisted shares of Hong Kong Interbank Clearing Limited directly held by the Fund at a cost of HK\$5,000 (2003 - HK\$5,000). Details of the associate are as follows:

Name of company	Place of incorporation and operation	Principal activities	Issued equity capital	Exchange Fund's interest in equity capital
Hong Kong Interbank Clearing Limited	Hong Kong	Interbank clearing	HK\$10,000	50%

12. Fixed Assets

(a)

	Group		
	Premises	Other Fixed Assets	Total
Cost or valuation			
At 1 January 2004	2,972	744	3,716
Additions	-	52	52
Elimination of accumulated depreciation on revalued premises	(68)	-	(68)
Surplus on revaluation	1,061	-	1,061
Disposals	(1)	(15)	(16)
At 31 December 2004	3,964	781	4,745
Accumulated depreciation			
At 1 January 2004	1	406	407
Charge for the year	68	67	135
Elimination of accumulated depreciation on revalued premises	(68)	-	(68)
Written back on disposal	-	(15)	(15)
At 31 December 2004	1	458	459
Net book value			
At 31 December 2004	3,963	323	4,286
At 31 December 2003	2,971	338	3,309

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

	Fund		
	Premises	Other Fixed Assets	Total
Cost or valuation			
At 1 January 2004	2,963	385	3,348
Additions	-	25	25
Elimination of accumulated depreciation on revalued premises	(68)	-	(68)
Surplus on revaluation	1,061	-	1,061
Disposals	(1)	(1)	(2)
At 31 December 2004	3,955	409	4,364
Accumulated depreciation			
At 1 January 2004	-	297	297
Charge for the year	68	32	100
Elimination of accumulated depreciation on revalued premises	(68)	-	(68)
Written back on disposal	-	(1)	(1)
At 31 December 2004	-	328	328
Net book value			
At 31 December 2004	3,955	81	4,036
At 31 December 2003	2,963	88	3,051

(b) The net book value of premises comprises:

	Group		Fund	
	2004	2003	2004	2003
Held in Hong Kong				
Medium-term leasehold (between 10 and 50 years)	3,928	2,938	3,920	2,930
Held outside Hong Kong				
Freehold	35	33	35	33
TOTAL	3,963	2,971	3,955	2,963

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

- (c) Premises were revalued by qualified valuers who are members of the Hong Kong Institute of Surveyors employed by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 31 December 2004. The premises of the Fund were valued on open market value basis. The value of the premises of Hong Kong Note Printing Limited situated at Tai Po Industrial Estate was determined by reference to the surrender value laid down under the lease agreement with The Hong Kong Science and Technology Parks Corporation. The surplus on revaluation of premises of HK\$1,061 million (2003 - a deficit of HK\$867 million) is analysed as follows:

	Group		Fund	
	2004	2003	2004	2003
Surplus credited/(Deficit charged) to income and expenditure account	876	(876)	876	(876)
Surplus credited to premises revaluation reserve	185	9	185	9
TOTAL	1,061	(867)	1,061	(867)

- (d) The net book value of premises would have been as follows had they all been stated at cost less accumulated depreciation:

	Group		Fund	
	2004	2003	2004	2003
Net book value at 31 December	3,750	3,838	3,742	3,830

13. Total Assets

	Group		Fund	
	2004	2003	2004	2003
Foreign currency assets	977,229	932,916	969,341	929,625
Hong Kong dollar assets	127,869	117,909	92,513	82,020
TOTAL	1,105,098	1,050,825	1,061,854	1,011,645

The Group holds Hong Kong dollar and foreign currency assets. A large proportion of the Group's foreign currency assets is held in US dollars. Apart from the US dollar assets, the Group also holds assets denominated in fully convertible foreign currencies.

The Group's assets are held in deposit, trustee and safe-keeping accounts with banks, central banks and custodial organisations situated in Hong Kong and other major financial centres.

14. Certificates of Indebtedness, Government-Issued Currency Notes and Coins in Circulation

As backing for the banknote issues, each note-issuing bank is required to hold a non-interest bearing Certificate of Indebtedness issued by the Financial Secretary. Payments for the issuance and redemption of notes against these Certificates are made in US dollars at the fixed exchange rate of US\$1=HK\$7.80. Consistent with the requirement for backing banknote issuance with US dollars, the issuance and the withdrawal of government-issued currency notes and coins are conducted against US dollars at the fixed exchange rate of US\$1=HK\$7.80.

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

15. Balance of the Banking System

Under the interbank payment system based on Real Time Gross Settlement principles, all licensed banks maintain a Hong Kong dollar clearing account with the HKMA for the account of the Fund. The aggregate balance in these accounts represents the total level of liquidity in the interbank market. Under the Convertibility Undertaking, the HKMA undertakes to convert Hong Kong dollars in the clearing accounts maintained by licensed banks with the HKMA into US dollars at the fixed exchange rate of US\$1=HK\$7.80.

16. Exchange Fund Bills and Notes

	Group		Fund	
	2004	2003	2004	2003
Exchange Fund Bills	68,538	68,350	68,538	68,350
Exchange Fund Notes	57,322	55,170	57,322	55,170
TOTAL	125,860	123,520	125,860	123,520

Exchange Fund Bills are issued by the Fund for maturities not exceeding one year. Exchange Fund Notes are issued by the Fund with 2-year, 3-year, 5-year, 7-year and 10-year maturities.

17. Other Debt Securities

	Group		Fund	
	2004	2003	2004	2003
Notes	32,495	33,120	-	-
Transferable loan certificates	3,000	3,500	-	-
TOTAL	35,495	36,620	-	-

18. Placements by Banks and other Financial Institutions

	Group		Fund	
	2004	2003	2004	2003
Placements by banks and other financial institutions in respect of securities lending	-	893	-	893
Other placements by banks and other financial institutions	39,087	43,649	39,087	43,649
TOTAL	39,087	44,542	39,087	44,542

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

19. Placements by other HKSAR Government Funds

	Group		Fund	
	2004	2003	2004	2003
Placements with interest payable at market-based rates				
General Revenue Account	481	362	481	362
Capital Investment Fund	5,138	2,093	5,138	2,093
Loan Fund	1,897	4,976	1,897	4,976
Capital Works Reserve Fund	564	498	564	498
Innovation and Technology Fund	64	68	64	68
Lotteries Fund	213	170	213	170
	8,357	8,167	8,357	8,167
Placements with interest payable at rates determined by reference to the investment income of the Fund				
General Revenue Account	90,488	66,447	90,488	66,447
Land Fund	117,774	140,615	117,774	140,615
Capital Works Reserve Fund	40,551	16,569	40,551	16,569
Civil Service Pension Reserve Fund	14,523	12,376	14,523	12,376
Disaster Relief Fund	19	35	19	35
Innovation and Technology Fund	4,292	4,250	4,292	4,250
Lotteries Fund	4,087	3,837	4,087	3,837
	271,734	244,129	271,734	244,129
TOTAL	280,091	252,296	280,091	252,296

Placements by other HKSAR government funds are not permanently appropriated for the use of the Fund, but are principally repayable on demand when they are required to meet the obligations of the fiscal reserves.

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

20. Other Liabilities

	Group		Fund	
	2004	2003	2004	2003
Interest payable on placements by other HKSAR government funds at rates determined by reference to the investment income of the Fund	14,533	25,700	14,533	25,700
Revaluation losses on off-balance sheet items which are marked to market	2,372	3,724	2,372	3,724
Accrued interest and other liabilities	12,740	8,860	7,405	8,031
TOTAL	29,645	38,284	24,310	37,455

21. Equity

	Group		Fund	
	2004	2003	2004	2003
Accumulated surplus				
At 1 January	386,441	328,469	384,870	327,174
Surplus for the year	39,203	57,972	38,527	57,696
At 31 December	425,644	386,441	423,397	384,870
Premises revaluation reserve				
At 1 January	9	-	9	-
Surplus on revaluation of premises (Note 12(c))	185	9	185	9
At 31 December	194	9	194	9
TOTAL	425,838	386,450	423,591	384,879

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

22. Maturity Profile

	Group						
	2004						
	Repayable on demand	3 months or less	1 year or less but over 3 months	5 years or less but over 1 year	After 5 years	Undated	Total
Assets							
Cash and money at call	20,759	-	-	-	-	-	20,759
Placements with banks and other financial institutions	-	48,159	19	-	-	-	48,178
Investment securities	-	-	-	-	-	300	300
Other investments in securities	-	249,435	83,116	260,001	179,564	205,630	977,746
Held-to-maturity securities	-	1,417	737	1,064	912	-	4,130
Mortgage loans	19	836	2,594	12,379	19,106	4	34,938
Gold	-	-	-	-	-	228	228
	20,778	299,847	86,466	273,444	199,582	206,162	1,086,279
Liabilities							
Certificates of Indebtedness	146,775	-	-	-	-	-	146,775
Government-issued currency notes and coins in circulation	6,351	-	-	-	-	-	6,351
Balance of the banking system	15,789	-	-	-	-	-	15,789
Exchange Fund Bills and Notes	-	51,396	31,217	32,628	10,619	-	125,860
Other debt securities	-	5,027	5,041	21,334	4,093	-	35,495
Placements by banks and other financial institutions	-	39,087	-	-	-	-	39,087
Placements by other HKSAR government funds	274,575	5,516	-	-	-	-	280,091
	443,490	101,026	36,258	53,962	14,712	-	649,448

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

	Group						
	2003						
	Repayable on demand	3 months or less	1 year or less but over 3 months	5 years or less but over 1 year	After 5 years	Undated	Total
Assets							
Cash and money at call	19,168	-	-	-	-	-	19,168
Placements with banks and other financial institutions	-	43,823	-	-	-	-	43,823
Investment securities	-	-	-	-	-	300	300
Other investments in securities	-	247,486	72,986	264,487	176,107	170,671	931,737
Held-to-maturity securities	-	279	860	1,669	766	-	3,574
Mortgage loans	17	1,012	2,608	12,620	18,317	8	34,582
Gold	-	-	-	-	-	217	217
	19,185	292,600	76,454	278,776	195,190	171,196	1,033,401
Liabilities							
Certificates of Indebtedness	134,215	-	-	-	-	-	134,215
Government-issued currency notes and coins in circulation	6,297	-	-	-	-	-	6,297
Balance of the banking system	28,277	-	-	-	-	-	28,277
Exchange Fund Bills and Notes	-	50,569	31,277	33,024	8,650	-	123,520
Other debt securities	-	3,845	5,679	24,635	2,461	-	36,620
Placements by banks and other financial institutions	-	33,271	11,271	-	-	-	44,542
Placements by other HKSAR government funds	246,399	5,897	-	-	-	-	252,296
Placements by Hong Kong statutory bodies	-	164	-	-	-	-	164
	415,188	93,746	48,227	57,659	11,111	-	625,931

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

	Fund						
	2004						
	Repayable on demand	3 months or less	1 year or less but over 3 months	5 years or less but over 1 year	After 5 years	Undated	Total
Assets							
Cash and money at call	20,738	-	-	-	-	-	20,738
Placements with banks and other financial institutions	-	42,747	-	-	-	-	42,747
Investment securities	-	-	-	-	-	300	300
Other investments in securities	-	249,435	83,116	260,001	179,564	205,630	977,746
Gold	-	-	-	-	-	228	228
	20,738	292,182	83,116	260,001	179,564	206,158	1,041,759
Liabilities							
Certificates of Indebtedness	146,775	-	-	-	-	-	146,775
Government-issued currency notes and coins in circulation	6,351	-	-	-	-	-	6,351
Balance of the banking system	15,789	-	-	-	-	-	15,789
Exchange Fund Bills and Notes	-	51,396	31,217	32,628	10,619	-	125,860
Placements by banks and other financial institutions	-	39,087	-	-	-	-	39,087
Placements by other HKSAR government funds	274,575	5,516	-	-	-	-	280,091
	443,490	95,999	31,217	32,628	10,619	-	613,953

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

	Fund						
	2003						
	Repayable on demand	3 months or less	1 year or less but over 3 months	5 years or less but over 1 year	After 5 years	Undated	Total
Assets							
Cash and money at call	19,143	-	-	-	-	-	19,143
Placements with banks and other financial institutions	-	41,549	-	-	-	-	41,549
Investment securities	-	-	-	-	-	300	300
Other investments in securities	-	247,486	72,986	264,487	176,107	170,671	931,737
Gold	-	-	-	-	-	217	217
	19,143	289,035	72,986	264,487	176,107	171,188	992,946
Liabilities							
Certificates of Indebtedness	134,215	-	-	-	-	-	134,215
Government-issued currency notes and coins in circulation	6,297	-	-	-	-	-	6,297
Balance of the banking system	28,277	-	-	-	-	-	28,277
Exchange Fund Bills and Notes	-	50,569	31,277	33,024	8,650	-	123,520
Placements by banks and other financial institutions	-	33,271	11,271	-	-	-	44,542
Placements by other HKSAR government funds	246,399	5,897	-	-	-	-	252,296
Placements by Hong Kong statutory bodies	-	164	-	-	-	-	164
	415,188	89,901	42,548	33,024	8,650	-	589,311

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

23. Notes to the Cash Flow Statement

(a) Reconciliation of surplus before premises revaluation and associate to net cash from/(used in) operating activities

	Group		Fund	
	2004	2003	2004	2003
Surplus before premises revaluation and associate	38,454	58,920	37,651	58,572
Interest income	(24,598)	(26,524)	(23,574)	(25,513)
Interest expense	18,066	30,233	17,856	29,847
Dividend income	(4,556)	(3,751)	(4,573)	(3,891)
Amortisation of premiums and discounts on Exchange Fund Bills and Notes	55	661	55	661
Depreciation	135	94	100	62
Change in placements with banks and other financial institutions	3,995	(3,952)	4,015	(4,015)
Change in other investments in securities	(57,567)	(314)	(57,567)	(314)
Change in mortgage loans	(389)	(6,345)	-	-
Change in gold	(11)	(38)	(11)	(38)
Change in Thailand financing package	-	1,058	-	1,058
Change in other assets	(276)	5,659	(227)	5,713
Change in Certificates of Indebtedness, government-issued currency notes and coins in circulation	12,614	16,146	12,614	16,146
Change in balance of the banking system	(12,488)	27,752	(12,488)	27,752
Change in Exchange Fund Bills and Notes	2,285	(66)	2,285	(66)
Change in placements by banks and other financial institutions	(5,455)	8,272	(5,455)	8,272
Change in placements by other HKSAR government funds	27,795	(49,373)	27,795	(49,373)
Change in placements by Hong Kong statutory bodies	(164)	(4,115)	(164)	(4,115)
Change in other liabilities	2,592	(8,649)	(1,913)	(8,910)
Elimination of exchange differences and other non-cash items	(1,062)	(166)	(1,117)	(198)
Interest received	24,487	27,179	23,435	26,218
Interest paid	(29,328)	(21,689)	(29,088)	(21,338)
Dividend received	4,512	3,507	4,512	3,507
Tax paid	(80)	(50)	-	-
Net cash from/(used in) operating activities	(984)	54,449	(5,859)	60,037

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

(b) Analysis of the balances of cash and cash equivalents

	Group		Fund	
	2004	2003	2004	2003
Cash and money at call	20,759	19,168	20,738	19,143
Placements with banks and other financial institutions	48,158	39,808	42,747	37,534
Treasury bills and commercial papers	97,298	121,105	97,298	121,105
Certificates of deposit	12,637	388	12,637	388
TOTAL	178,852	180,469	173,420	178,170

24. Segment Reporting

The business activities of the Fund managed by the HKMA comprise:

- Management of funds under the Currency Board Account (a)
- Management of funds representing the general reserve assets of the Fund
- Banking supervision
- Monetary management

As the assets, revenue and overall results of the latter two activities and the subsidiaries are not significant, they are combined with the assets, revenue and results of management of funds representing the general reserve assets of the Fund.

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

	Group					
	Currency Board Account		Reserve Management and Other Activities		Total	
	2004	2003	2004	2003	2004	2003
Income	5,549	2,924	52,676	87,966	58,225	90,890
Expenditure						
Interest expense	2,559	3,218	15,507	27,015	18,066	30,233
Other expenses(b)	-	-	1,705	1,737	1,705	1,737
	2,559	3,218	17,212	28,752	19,771	31,970
Surplus/(Deficit) before premises revaluation and associate	2,990	(294)	35,464	59,214	38,454	58,920
Surplus/(Deficit) on revaluation of premises	-	-	876	(876)	876	(876)
Share of profit of associate	-	-	4	10	4	10
Surplus/(Deficit) before taxation and minority interests	2,990	(294)	36,344	58,348	39,334	58,054
Taxation	-	-	(110)	(58)	(110)	(58)
Minority interests	-	-	(21)	(24)	(21)	(24)
Surplus/(Deficit) for the year	2,990	(294)	36,213	58,266	39,203	57,972

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

	Group							
	Currency Board Account		Reserve Management and Other Activities		Re-allocation(c)		Total	
	2004	2003	2004	2003	2004	2003	2004	2003
Assets								
Backing Assets								
Investment in designated US dollar assets	326,823	321,467	-	-	-	-	326,823	321,467
Interest receivable on designated US dollar assets	453	620	-	-	-	-	453	620
Other investments	-	-	759,479	711,954	-	-	759,479	711,954
Other assets	-	-	17,963	16,599	380	185	18,343	16,784
TOTAL ASSETS	327,276	322,087 (A)	777,442	728,553	380	185	1,105,098	1,050,825
Liabilities								
Monetary Base								
Certificates of Indebtedness	146,775	134,215	-	-	-	-	146,775	134,215
Government-issued currency notes and coins in circulation	6,351	6,297	-	-	-	-	6,351	6,297
Balance of the banking system	15,789	28,277	-	-	-	-	15,789	28,277
Exchange Fund Bills and Notes	125,860	123,520	-	-	-	-	125,860	123,520
Interest payable on Exchange Fund Notes	476	548	-	-	-	-	476	548
Net accounts receivable	(380)	(185)(c)	-	-	380	185	-	-
Other debt securities	-	-	35,495	36,620	-	-	35,495	36,620
Placements by banks and other financial institutions	-	-	39,087	44,542	-	-	39,087	44,542
Placements by other HKSAR government funds	-	-	280,091	252,296	-	-	280,091	252,296
Placements by Hong Kong statutory bodies	-	-	-	164	-	-	-	164
Other liabilities	-	-	29,169	37,736	-	-	29,169	37,736
	294,871	292,672 (B)	383,842	371,358	380	185	679,093	664,215
Minority interests	-	-	167	160	-	-	167	160
Accumulated surplus								
Balance brought forward	29,415	29,685	357,026	298,784	-	-	386,441	328,469
Surplus/(Deficit) for the year	2,990	(294)	36,213	58,266	-	-	39,203	57,972
Transfer between Currency Board Account and general reserves(d)	-	24	-	(24)	-	-	-	-
	32,405	29,415	393,239	357,026	-	-	425,644	386,441
Premises revaluation reserve	-	-	194	9	-	-	194	9
TOTAL LIABILITIES AND EQUITY	327,276	322,087	777,442	728,553	380	185	1,105,098	1,050,825
Backing Ratio [(A)/(B)] x 100%	110.99%	110.05%						

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

- (a) Starting from 1 October 1998, specific US dollar assets of the Fund have been designated to back the Monetary Base, which comprises Certificates of Indebtedness, government-issued currency notes and coins in circulation, the balance of the banking system and Exchange Fund Bills and Notes. While specific assets of the Fund have been earmarked for backing the Monetary Base, all the Fund assets have continued to be available for the purpose of supporting the Hong Kong dollar exchange rate under the Linked Exchange Rate system.
- (b) Other expenses have not been allocated to the Currency Board Account as the amounts involved are not material.
- (c) For the purposes of the Currency Board Account, certain assets and liabilities of the Fund's accounts need to be included in the Monetary Base and Backing Assets respectively but as negative amounts. Such presentation is necessary to allow proper computation of the Backing Ratio. As at 31 December 2004, these negative amounts comprised "Other assets" of HK\$380 million (2003 - HK\$185 million) included in the Monetary Base, which consisted of two components:
 - HK\$11 million (2003 - HK\$9 million) representing interests receivable on Hong Kong dollar interest rate swaps used as a means to manage the cost of issuing Exchange Fund Notes; and
 - HK\$369 million (2003 - HK\$176 million) representing receivables pertaining to revaluation gains on Hong Kong dollar interest rate swaps used as a means to manage the cost of issuing Exchange Fund Notes.
- (d) In accordance with an arrangement approved by the Financial Secretary in January 2000, assets can be transferred between the backing and general reserve portfolios when the Backing Ratio reaches either the upper trigger point (112.5%) or the lower trigger point (105%). This arrangement allows transfer of excess assets out of the backing portfolio to maximise their earning potential while ensuring that there are sufficient liquid assets in the backing portfolio.

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

25. Commitments

(a) Capital commitments

Capital expenditure authorised but not provided for in these accounts amounted to:

	Group		Fund	
	2004	2003	2004	2003
Contracted	-	73	-	73
Not contracted	37	63	17	27
TOTAL	37	136	17	100

(b) Loan to the International Monetary Fund

On 27 January 1997, the HKMA participated in the New Arrangements to Borrow (NAB), a standby credit facility to the International Monetary Fund (IMF) for coping with instability in the international monetary system. In respect of this, the HKMA undertakes to lend foreign currencies to the IMF up to HK\$4,104 million equivalent as at 31 December 2004 (2003 - HK\$3,922 million equivalent), in the form of a term loan of five-year maturity bearing prevailing market interest rates. As at 31 December 2004, there was no outstanding balance due from the IMF under the NAB (2003 - Nil).

(c) Lease commitments

Total future minimum lease payments under non-cancellable operating leases at the balance sheet date are analysed as follows:

	Group		Fund	
	2004	2003	2004	2003
Premises				
Not later than one year	3	19	3	8
Later than one year and not later than five years	-	2	-	2
TOTAL	3	21	3	10

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

26. Off-Balance Sheet Items

	Group		Fund	
	2004	2003	2004	2003
Spot and forward foreign exchange contracts				
Outstanding contract amount	152,854	106,736	152,854	106,736
Gross replacement costs	278	159	278	159
Interest rate swap contracts				
Notional principal	83,269	88,149	9,400	10,400
Gross replacement costs	2,274	2,635	1,159	1,290
Stock index futures contracts				
Notional principal	12,421	30,298	12,421	30,298
Gross replacement costs	75	915	75	915
Bond futures contracts				
Notional principal	989	1,005	989	1,005
Gross replacement costs	1	-	1	-

27. Contingent Liabilities

- (a) The Fund has a contingent liability up to 11.25 million SDRs or HK\$136 million equivalent as at 31 December 2004 (2003 - 11.25 million SDRs or HK\$130 million equivalent), in respect of the uncalled portion of its 3,000 shares held in the Bank for International Settlements.
- (b) Under the Mortgage Insurance Programme, the HKMC offers mortgage insurance that covers approved sellers for credit loss up to 25% of the property value of a mortgage loan when the loan amount has exceeded 70% of the property value at origination. The HKMC reinsures the risk exposure with the approved reinsurers. At 31 December 2004, the total risk-in-force assumed by the HKMC was HK\$1.77 billion (2003 - HK\$1.09 billion).
- (c) Under the Guaranteed Mortgage-Backed Pass-Through Securitisation Programme and the Bauhinia Mortgage-Backed Securitisation Programme, the HKMC sells mortgages to two Special Purpose Companies which issue mortgage-backed securities (MBS) to investors. The HKMC provides guarantee on the timely payment of principal and interest in respect of the MBS. At 31 December 2004, the aggregate security principal balance guaranteed by the HKMC under the two programmes was HK\$5.87 billion (2003 - HK\$5.26 billion).

EXCHANGE FUND – NOTES ON THE ACCOUNTS (cont.)

28. Material Related Party Transactions

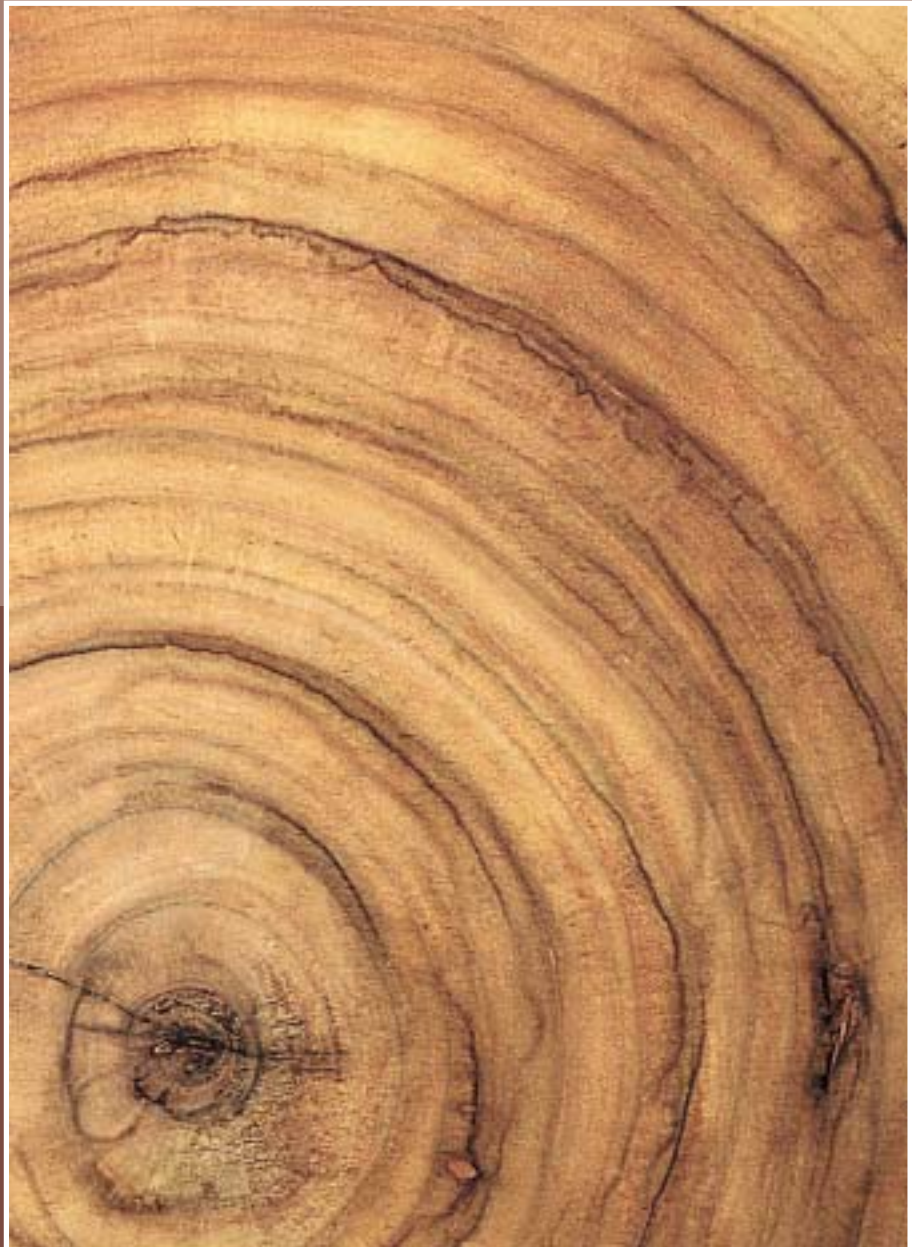
The Fund takes placements from other HKSAR government funds and Hong Kong statutory bodies, as shown on the balance sheet. During the year, interest expenses on placements from other HKSAR government funds amounted to HK\$14,558 million (2003 - HK\$25,792 million) and Nil (2003 - HK\$15 million) for Hong Kong statutory bodies.

Transactions with related parties are conducted at rates determined by the Monetary Authority taking into account the nature of each transaction on a case-by-case basis.

During the year, the HKMC purchased about HK\$10 billion (2003 - HK\$10.5 billion) of mortgage loans from the HKSAR Government.

29. Approval of Accounts

The accounts were approved by the Exchange Fund Advisory Committee on 31 March 2005.



A cross-section of the trunk of the Chinese red pine, *Pinus massoniana*, one of the most common trees in southern China and the only native pine in Hong Kong. The tree can grow to 25 metres, and has been widely used for afforestation.

PROFESSIONAL AND CORPORATE SERVICES

The in-house services provided by the Corporate Services Department, Office of the General Council, and Internal Audit Division provide professional and administrative support to the HKMA in carrying out its policy objectives.

THE HKMA IN THE COMMUNITY

The HKMA saw a considerable increase in its contacts with the general public in 2004. Enquiries to the HKMA and visits to the HKMA website increased by around 25%. The new HKMA Information Centre, which opened in late 2003, received more than 48,000 visitors in 2004. During the summer, HKMA staff and student ambassadors reached around 93,000 members of the public and retailers through seminars and district visits arranged to explain security features on the new Hong Kong banknotes.

The HKMA has a well-established policy of transparency and accessibility, which is realised through a number of channels:

- extensive contacts with the media
- regular and special publications
- a comprehensive and interactive bilingual website

- the HKMA Information Centre
- regular education programmes for students and community groups
- frequent meetings with legislators
- a public enquiry service staffed nine hours a day.

These services are co-ordinated by the Corporate Development Division within the Corporate Services Department. The Division is responsible for providing media, publications and public relations services to the HKMA. It also provides translation and drafting services, and support to the Exchange Fund Advisory Committee and its Sub-Committees.

Media relations

One of the most important channels of communication between the HKMA and the community is the extensive local and international media in Hong Kong. The HKMA maintains close contacts with reporters and editors, handling a daily average of 40 press enquiries.



Student ambassadors explain to retailers the security features of new banknotes.



Six press conferences were held in 2004 and 283 press releases were issued during the year. Special educational briefings were also arranged for reporters and editors on the new Commercial Credit Reference Agency and on the workings of Hong Kong's Currency Board system.

The HKMA continued to be as open and responsive as possible with the media, in accordance with its policy on transparency. Among the measures to increase disclosure in 2004 was the inclusion of statistics on renminbi deposits in Hong Kong in the monthly press releases on monetary statistics, following the launch of renminbi banking business in Hong Kong in early 2004. Transparency in the residential mortgage survey results was improved by including data on fixed-rate mortgages in the monthly press releases.

 > Information Centre > Press Releases

Publications

The HKMA produces a variety of publications to provide information and statistics, and to promote greater understanding of the work of the HKMA.

The *HKMA Annual Report 2003*, published together with its summary report and an interactive website version, won the gold award in the Hong Kong Management Association's Best Annual Reports Award. The Report was commended for its clear and informative presentation and voluntary disclosure of information on corporate governance.



Selected HKMA publications published in 2004.

The *HKMA Quarterly Bulletin* and on-line *Monthly Statistical Bulletin* continued to be a regular source of information on monetary, banking and economic issues. The June and December issues of the *Quarterly Bulletin* include the HKMA's *Half-Yearly Monetary and Financial Stability Report*. This Report analyses in detail recent external and domestic influences on Hong Kong's monetary and financial systems.

During 2004 the HKMA also published information leaflets on Hong Kong's payment systems and on the security features for the new banknotes.

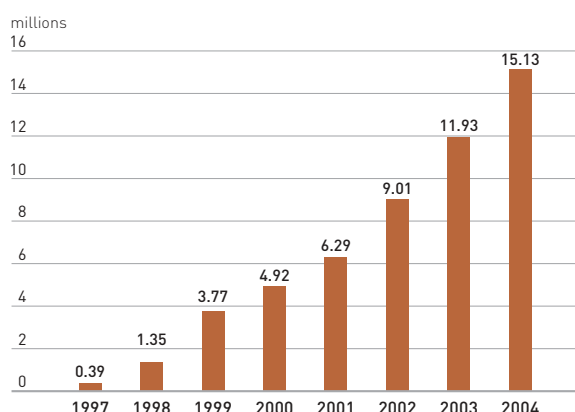
 > Information Centre > Publications

The HKMA on-line

The HKMA website www.hkma.gov.hk is a comprehensive source of news and information on the HKMA conveniently accessible to people throughout the world twenty-four hours a day. All of the main HKMA publications are posted on the website, together with a great deal of additional information. In 2004 website page views exceeded 15 million (Chart 1), a 27% increase over 2003. Around 2,300 subscribers now receive the latest HKMA news through a daily e-mail news service. Sections of the website that were launched or expanded during the year included those on the HKMA Information Centre, new Hong Kong banknotes, the Commercial Credit Reference Agency, and Basel II.

 > What's New > HKMA News Update E-mail Service

CHART 1 Page views of the HKMA website



Public education programme

The HKMA Information Centre, located on the 55/F of Two International Finance Centre, provides the focus for the HKMA's extensive public education programme. The Centre consists of an exhibition area and a library, and is open to the public six days a week.

Using interactive presentations and video montages as well as the more traditional panels and material exhibits, the exhibition area of the Centre presents a survey of the history of money and banking in Hong Kong and the key policy objectives of the HKMA. Topical panels and showcases in the exhibition area were revised and expanded in 2004 to provide information on the new Hong Kong banknotes, renminbi banking business in Hong Kong, and deposit protection.

The library, situated just beyond the exhibition area, contains materials for detailed study of Hong Kong's monetary, banking and financial affairs and of central banking topics elsewhere in the world.

The main elements of the collections are around 22,000 books and journals on monetary, banking, economics, finance and related subjects. The library also houses an electronic register of authorized institutions in Hong Kong, maintained under section 20 of the Banking Ordinance.

Daily guided tours of the Information Centre are organised for visitors and groups. During the year, 48,400 people visited the Centre, either as individual visitors or in guided tours, a total of 476 of which were arranged.

The HKMA continued to organise public education seminars on its work. In 2004, eleven seminars were organised for more than 4,000 students, teachers and members of the public. The Linked Exchange Rate system and the new banknotes were the main themes for the seminars. Since the launch of the education programme in 1998, more than 28,000 students, teachers and members of the public have participated in these seminars.

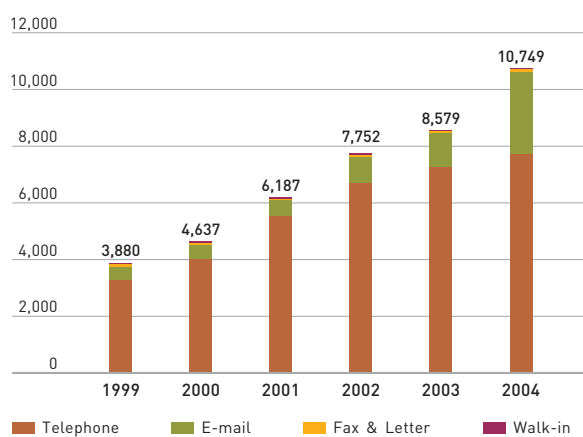
 www.hkma.gov.hk > HKMA Information Centre

Visitors learn about monetary history and security features on new banknotes during guided tours at the HKMA Information Centre.



Seminars to introduce to the general public the design and security features of the new banknotes.



CHART 2 Total number of public enquiries

Public enquiries service

The number of enquiries from members of the public to the HKMA reached a record high in 2004. The HKMA received a total of 10,749 public enquiries during the year (Chart 2). These enquiries, which were received mainly by telephone, mostly consisted of requests for statistical information or information on consumer banking, monetary and other HKMA-related issues from researchers, industry professionals, students and the general public. They also included complaints and suggestions. The HKMA is committed to delivering a speedy and informed response to all enquirers.

The number of enquiries in 2004 increased by 25% over the previous year, and the number of enquiries by e-mail more than doubled. One reason for the increase in enquiries was the readiness of members of the public to report suspected fraudulent bank e-mails and websites. In many cases this helped the HKMA, the police and the banks affected to take speedy action to warn the general public. Over 1,500 enquiries and reports on suspected fraudulent bank e-mails and websites were received by the HKMA during the year.

 [Contact us](#)

HUMAN RESOURCES

The Human Resources Division provides the human resources support to facilitate the HKMA in meeting its policy objectives and day-to-day operations.

Organisational changes

A new Market Systems Policy Division was established, initially under the Monetary Management and Infrastructure Department, in February 2004 with responsibility for policy and activities relating to the designation and oversight of clearing and settlement systems either in Hong Kong or involving Hong Kong dollar-denominated transactions. With the creation of the new division, the Market Systems Division in the Department was renamed Market Systems Development Division.

The three banking departments were reorganised in November 2004, following the completion of an internal review, which analysed the major trends to be faced by the banking industry over the coming years and their impact on the work focus. The reorganisation involved adjustments in the responsibilities of different teams. In particular, each of the five divisions in the Banking Supervision Department will in future focus on specific aspects of supervisory work.

Two transfers of responsibilities took place between departments towards December 2004:

- the Monetary Management and Infrastructure Department took over from the Banking Development Department the currency operations of the Support Services Division; and
- the Market Systems Policy Division, which was established under the Monetary Management and Infrastructure Department in February 2004, was transferred to the Banking Development Department.

 [About the HKMA > The HKMA > Organisation Chart](#)

Staffing

The post of Deputy Chief Executive (Development), which had been vacant since January 2003 was filled by Mr Peter Pang in July 2004, and the responsibilities for monetary management, financial infrastructure and research, which had been temporarily undertaken by the Deputy Chief Executive (Monetary), were transferred back to the schedule of Deputy Chief Executive (Development).

The overall establishment of the HKMA for 2004 remained at 604, despite the expansion in scope and increase in complexity of various activities undertaken by the HKMA. The human resources required for the new activities were met by internal redeployment or regrading of posts.

Table 1 shows a breakdown of the establishment and strength in various departments at the end of 2004.

Remuneration of senior executives

The remuneration packages of the senior executives in 2004 are shown in Table 2.

TABLE 1 Establishment and strength of the HKMA

Department	Functions	2004			
		Senior staff		Others	
		Establishment	Strength	Establishment	Strength
Chief Executive's and Deputy Chief Executives' Offices	Top management of the HKMA.	4	4	6	6
Banking Development	To formulate policies for the development of the banking industry, and to facilitate settlement for transactions executed by the HKMA for the Exchange Fund.	1	1	65	65
Banking Policy	To formulate supervisory policies for promoting the safety and soundness of the banking sector.	1	1	38	38
Banking Supervision	To supervise day-to-day operations of authorized institutions.	1	1	155	137
Office of the General Counsel	To provide in-house legal support and advice.	1	1	15	15
External	To help develop and promote Hong Kong as an international financial centre and to foster regional monetary co-operation through active participation in the international central banking and financial community.	1	1	47	46
Monetary Management & Infrastructure	To maintain currency stability through monitoring of market operations and development issues and developing financial market infrastructure, and to ensure adequate supply of banknotes and coins.	1	1	38	38
Research	To conduct research and analysis on economic and international financial market development, both in Hong Kong and in other economies.	1	1	31	30
Reserves Management	To manage reserves to achieve investment returns in line with established guidelines and to enhance the quality of return by diversifying into different investment markets and asset types.	1	1	46	44
Corporate Services	To provide support services in the form of administrative, finance, HR, IT, and secretariat services, and to handle media and community relations.	2*	1	142	136
Internal Audit	To provide audit services through assisting the management in controlling risks, monitoring compliance, and improving the efficiency of internal control systems and procedures.	0	0	7	7
Total		14	13	590	562

* Senior staff" refers to staff at the Executive Director level and above.

* Inclusive of a frozen Executive Director post

TABLE 2 Remuneration packages of HKMA senior executives in 2004

\$'000	Chief Executive	Deputy Chief Executive (average)	Executive Director (average)
Number of staff	1	3	10
Fixed pay	6,493	4,102	2,832
Variable pay	1,918	822	394
Other benefits	488	488	204

Note:
Other benefits include provident funds, gratuity, medical and life insurance and annual leave accrued during the year. The provision of these benefits varies among senior staff depending on individual terms of service.

Training and development

The HKMA continued to arrange training programmes to meet organisational and career development needs. During the year, HKMA staff were provided with a total of 3,208 training days. These included 1,311 days of horizontal training in general skills common to staff of the same rank, and 1,897 days of vertical training in job-specific skills and knowledge. Each staff member received on average 5.57 days of training.

Horizontal training covered regular in-house programmes on personal effectiveness, languages and communications, leadership and computer applications to improve the core competencies of staff at different levels. Others included a crisis management workshop and team building workshops. A central banking course was conducted in July for new appointees.

For vertical training, staff attended a range of courses offered by other central banks, multilateral organisations and other institutions to deepen their skills and knowledge and broaden their international exposure. In-house programmes were also arranged for banking staff: apart from programmes on general supervisory issues conducted in-house, guest speakers from relevant industries were enlisted to speak on specialised areas. Experts from the Federal

Reserve System also conducted workshops at the HKMA to help banking supervisors improve their skills in conducting meetings with authorized institutions.

FINANCE AND ADMINISTRATION

The Finance and Administration Division aims at achieving an efficient allocation of resources within the HKMA. The administrative expenditure in 2004 and the budgeted expenditure for 2005 are shown in Table 3.

TABLE 3 Administrative expenditure (2004 and 2005 budgeted)

\$ mn	2004 Budget*	2004 Actual	2005 Budget*
Staff costs	474		490
– Salaries and other staff costs		421	
– Retirement benefit costs		25	
Premises and equipment expenses			
– Operating lease charges	11	10	5
– Other premises expenses (including utility charges and management fees)	37	33	31
General operating costs			
– Maintenance of office and computer equipment	31	30	27
– Financial information and communication services (including trading, dealing terminals and data link charges)	28	27	30
– External relations (including international meetings)	14	13	15
– Professional and other services (including service fees for operating the interbank payment system)	39	35	26
– Training	5	4	5
– Others	15	10	14
TOTAL	654	608	643

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

In 2004 the Division continued to streamline the workflow, and implemented electronic receipt and electronic inventory systems to improve operational efficiency.

TABLE 4 A more environmentally friendly office

Item	Unit	2003 usage	2004 usage	Percentage change 2003 to 2004
Paper cup	No.	42,000	36,000	-14.3%
Christmas card	No.	2,600	0	-
Electricity consumption at Main Office in Central	kWh	2,305,140	2,131,016	-7.6%
Chilled water consumption at Main Office in Central	kWh	1,444,940	925,460	-36.0%

Since the introduction of the HKMA's Environmental Policy in late 2001, a number of green-office measures have been implemented and colleagues' awareness of environmental issues has increased. More energy-efficient lighting and air-conditioning in the new offices, and the decision to dispense with printed Christmas cards helped save resources in 2004 (Table 4).

The HKMA continued to support and encourage recycling in 2004, through such measures as collecting waste paper for recycling and donating computer equipment to charitable organisations.

Regular campaigns were held to collect unwanted clothes, toys and other reusable items from colleagues for donation to people in need.

During the year, the HKMA participated in various community events and fund-raising activities. These included several charity races, such as the Hong Kong Marathon and the Green Power Hike in February, and the Run-up Two IFC in November 2004. Fifty-eight colleagues took part in the Hong Kong Red Cross blood donation day in August. Staff also participated in other fund-raising activities such as Community Chest's Skip Lunch Day, Green Day and Dress Casual Day.

In May the HKMA Volunteer Team visited pupils in Liannan, a mountain district in Guangdong province inhabited by the minority Yao people. Various activities were held to appeal for donations, in cash and in kind, to help students in Liannan to continue their education. The HKMA Volunteers also organised an outing for clients of a sheltered workshop and hostel in May 2004.

The HKMA bought suitable office supplies from a workshop staffed by people with physical disabilities. The electronic Christmas card of the HKMA was designed by a charitable organisation for the visually impaired.



An HKMA Corporate Team participates in the Run-up Two IFC Charity Race.



An HKMA Volunteer Team visits the school children in Liannan, a hilly area in Guangdong.

INFORMATION TECHNOLOGY

The Information Technology Division provides reliable and efficient IT services to all business units in the HKMA. During 2004 the Division continued its efforts to strengthen the HKMA's IT systems and infrastructure.

Business continuity plan

After the relocation of the HKMA office to Two International Finance Centre, a full review of the business continuity plan (BCP) was initiated in February, taking into account lessons learnt from various incidents, including the events of 11 September 2001 and the SARS (severe acute respiratory syndrome) epidemic in 2003. The review was carried out at both the divisional and organisation level, examining all of the critical business impacts of different BCP scenarios, IT system recovery and administrative support. The review also scrutinised the decision-making process, activation procedures, seating arrangements, and return-to-normal procedures. Following revisions to the updated BCP procedures, a drill was held successfully on 20 November 2004.

OFFICE OF THE GENERAL COUNSEL

The Office of the General Counsel (OGC) advises the HKMA on the legal aspects of all of the HKMA's activities. The OGC's lawyers are involved at an early stage in the planning and implementation of the HKMA's projects, initiatives and operations.

In addition to its general operational workload, the OGC was involved in a number of projects in 2004, including the implementation of the Clearing and Settlement Systems Ordinance and the Deposit Protection Scheme Ordinance, the preparation of the Banking (Amendment) Bill 2005 to implement

the revised Basel II capital accord in Hong Kong, the launching of the Asian Bond Fund 2, and the admission of the Hong Kong dollar into the Continuous Linked Settlement System. The OGC also advised on a number of other projects, including a review of the penal provisions of the Banking Ordinance, the conduct of personal renminbi business in Hong Kong and several bank mergers and bank restructurings. The OGC continued to advise on the supervision of securities business conducted by authorized institutions under the Banking Ordinance and the Securities and Futures Ordinance.

During the year, lawyers of the OGC participated in meetings and conferences for central bankers and their legal advisors to keep abreast of topical developments in important international financial centres. These conferences covered issues such as money laundering, electronic financial infrastructure and central bank governance. OGC lawyers also took part in a series of teleconferences with their counterparts from central banks and international legal think-tanks to clarify and resolve topics of current concern. Presentations were made by lawyers of the OGC at professional seminars and universities (both local and overseas) on subjects ranging from corporate governance issues for banks, banking supervision, anti-money laundering measures and prevention of terrorist financing.

INTERNAL AUDIT

The Internal Audit Division was established in 1995 to assist management in controlling risks, monitoring compliance and improving the efficiency and effectiveness of control systems and procedures within the HKMA. The role, mission and authority of the Division are defined in the Internal Audit Charter granted by the Chief Executive of the HKMA. The Charter is available at the HKMA website.

Audit work performed in 2004

Reporting directly to the Chief Executive of the HKMA and the EFAC Audit Sub-Committee, the Division continued to operate independently throughout the year. The internal audit assignments carried out by the Division covered the HKMA's key functions, which included monetary operations, reserves management, settlement operations, finance and administration, and the security arrangements of various IT systems. In addition, the Division advised on IT system development projects and performed ad hoc reviews at the request of senior management. Working jointly with a professional accounting firm, the Division also conducted a value-for-money audit to assess the economy, efficiency and effectiveness of the use of resources within the organisation. The results of the audits conducted in 2004 were satisfactory. Recommendations for improvement put forward by the Division were well received and implemented by auditees.

With the input from line management, the Division completed the organisation-wide implementation of Risk Assessment Methodology in early 2004. This exercise systematically identified and assessed the risks and corresponding controls in the operations of individual business units. The results of the risk assessments enabled management to ensure that resource allocation and controls in operations are commensurate with the underlying risks. The Internal Audit Division was also able to map the risk profiles of individual business units against the audit requirements to ensure that all the significant risks will be adequately and systematically covered by its audit work.

The Internal Audit Division attaches great importance to keeping abreast of the developments in the internal auditing profession and of the practices adopted by other central banks. During the year, the Division staff attended various international conferences on internal audit of central banks and monetary authorities, and met with the internal auditors of other regulatory authorities and financial institutions to exchange views and share experience on risk management and internal audit approaches. Training courses and seminars on risk management, audit techniques, management and language skills were arranged for the professional staff of the Division to facilitate the performance of audits and career development.



> About the HKMA > Internal Audit

CALENDAR OF EVENTS 2004

FEBRUARY

25 Banks in Hong Kong introduce personal renminbi deposit, exchange and remittance services.

APRIL

28 The HKMA signs an agreement with the China Government Depository Trust & Clearing Co. Ltd (CDC) to establish a direct link between the HKMA's Central Moneymarkets Unit and CDC's Government Securities Book-Entry System. The aim is to foster cross-border debt securities settlement between Mainland China and Hong Kong.

MAY

5 The Deposit Protection Scheme Ordinance is passed by the Legislative Council. The Ordinance provides for the establishment of a deposit protection scheme (DPS) in Hong Kong with the aim of enhancing deposit

protection in Hong Kong and contributing to the stability of the financial system. The DPS, to be managed by an independent Deposit Protection Board, is expected to start providing deposit protection in 2006.

JUNE

8 The HKMA issues a revised Supplement to the Guideline on Prevention of Money Laundering and a set of Interpretative Notes. The Supplement sets out the latest "Know-Your-Customer" principles. It covers the account opening process for various types of new customers and the on-going monitoring process for existing customers. It also incorporates the latest requirements relating to terrorist financing.

30 The HKMA announces that the Chief Executive of the Hong Kong SAR has appointed the Chairman and Members of the Hong Kong Deposit Protection Board. The Board is chaired by Professor Andrew Chan Chi-fai (Chairman and Member) and has six other Members (including two ex officio Members — the Monetary Authority and Secretary for Financial Services and the Treasury).

JULY

1 Mr Peter Pang is appointed Deputy Chief Executive of the HKMA. The post had been vacant since January 2003.

2 The Legislative Council passes the Clearing and Settlement Systems Ordinance. The Ordinance establishes a statutory regime for the Monetary Authority to designate and oversee clearing and settlement systems which are material to the monetary or financial stability of Hong Kong or to the functioning of Hong Kong as an international financial centre.

SEPTEMBER

28 The Bank for International Settlements triennial survey on the turnover of foreign exchange and derivatives shows that Hong Kong advanced one place from the 2001 survey to rank sixth in the global foreign exchange market, and seventh in the global foreign exchange and OTC derivatives market.

30 The HKMA issues a circular to all authorized institutions stressing the importance of putting in place appropriate precautionary measures to guard against fraud relating to fake bank websites and e-mails.

OCTOBER

11 \$20, \$50 and \$1,000 denominations in the new series of Hong Kong banknotes go into circulation.

NOVEMBER

1 Hong Kong's new Commercial Credit Reference Agency is launched.

4 The Clearing and Settlement Systems Ordinance comes into effect.

16 An International Monetary Fund Staff Mission to Hong Kong expresses support for the Linked Exchange Rate system and considers that the HKMA's response to strong-side pressures on the Hong Kong dollar has enhanced the resilience of the Linked Exchange Rate system.

DECEMBER

6 The HKMA announces that the Hong Kong dollar has been included in the Continuous Linked Settlement (CLS) System, a global clearing and settlement system for cross-border foreign exchange transactions operated by CLS Bank International (CLS Bank). The inclusion of the Hong Kong dollar into the CLS System enables foreign exchange transactions involving the Hong Kong dollar to be settled through the CLS System on a payment-versus-payment basis, thus removing the settlement risk in these transactions.

16 The Executives' Meeting of East Asia and Pacific Central Banks (EMEAP) Group announces the launch of the Asian Bond Fund 2 (ABF2). All 11 members of the Group, including Hong Kong, will invest in the ABF2. The ABF2, which will have an initial size of around US\$2 billion, will invest in domestic currency bonds issued by sovereign and quasi-sovereign issuers in all EMEAP economies except Australia, Japan and New Zealand.

ANNEX AND TABLES

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ANNEX: AUTHORIZED INSTITUTIONS AND LOCAL REPRESENTATIVE OFFICES AT 31.12.2004

Licensed Banks

Incorporated in Hong Kong

Asia Commercial Bank Limited
Bank of America (Asia) Limited
Bank of China (Hong Kong) Limited
Bank of East Asia, Limited (The)
Chiyu Banking Corporation Limited
CITIBANK (HONG KONG) LIMITED #
CITIC Ka Wah Bank Limited
Dah Sing Bank Limited
DBS BANK (HONG KONG) LIMITED
Hang Seng Bank, Limited

Hongkong & Shanghai Banking
Corporation Limited (The)
Industrial and Commercial Bank of
China (Asia) Limited
International Bank of Asia Limited
JIAN SING BANK LIMITED
Liu Chong Hing Bank Limited
MEVAS Bank Limited
Nanyang Commercial Bank, Limited
Shanghai Commercial Bank Limited

Standard Bank Asia Limited
Standard Chartered Bank
(Hong Kong) Limited #
Tai Sang Bank Limited
Tai Yau Bank, Limited
WING HANG BANK, LIMITED
Wing Lung Bank Limited

Deletion in 2004

Chekiang First Bank Limited

Incorporated outside Hong Kong

ABN AMRO Bank N.V.
Agricultural Bank of China
American Express Bank Limited
Australia & New Zealand Banking
Group Limited
Baden-Württembergische Bank
Aktiengesellschaft
BANCA DI ROMA, SOCIETA' PER
AZIONI
Banca Intesa S.p.A.
also known as:
Intesa S.p.A.
Banca Monte dei Paschi di Siena S.p.A.
Banca Nazionale del Lavoro S.p.A.
Banco Bilbao Vizcaya Argentaria S.A.
Bangkok Bank Public Company
Limited
Bank Melli Iran
Bank of America, National Association
Bank of China Limited
(formerly known as Bank of China)
Bank of Communications
Bank of India
Bank of Montreal
Bank of New York (The)
Bank of Nova Scotia (The)
BANK OF TAIWAN

Bank of Tokyo-Mitsubishi, Ltd. (The)
Bank SinoPac
Barclays Bank plc
Bayerische Hypo-und Vereinsbank
Aktiengesellschaft
Bayerische Landesbank
BELGIAN BANK
(formerly known as FORTIS BANK
ASIA HK)
BNP PARIBAS
BNP PARIBAS PRIVATE BANK
Canadian Imperial Bank of Commerce
CALYON
(formerly known as Credit Agricole
Indosuez)
CATHAY UNITED BANK COMPANY,
LIMITED
Chang Hwa Commercial Bank Ltd.
Chiba Bank, Ltd. (The)
China Construction Bank
China Merchants Bank Co., Ltd.
Chinatrust Commercial Bank, Ltd.
Chugoku Bank, Ltd. (The)
Citibank, N.A.
Commerzbank AG
Commonwealth Bank of Australia

Coöperatieve Centrale
Raiffeisen-Boerenleenbank B.A.
Coutts Bank von Ernst AG
also known as:
Coutts Bank von Ernst SA
Coutts Bank von Ernst Ltd
(formerly known as Coutts Bank
(Schweiz) AG)
Credit Lyonnais
Credit Suisse
DBS BANK LTD.
Deutsche Bank Aktiengesellschaft
DZ BANK AG Deutsche
Zentral-Genossenschaftsbank,
Frankfurt am Main
E.Sun Commercial Bank, Ltd.
EFG Private Bank SA
Equitable PCI Bank, Inc.
Erste Bank der oesterreichischen
Sparkassen AG
First Commercial Bank, Ltd
Fleet National Bank
Fortis Bank
Governor and Company of the Bank
of Scotland (The)
Hachijuni Bank, Ltd. (The)
HANA BANK

Addition in 2004

ANNEX: AUTHORIZED INSTITUTIONS AND LOCAL REPRESENTATIVE OFFICES AT 31.12.2004 (cont.)

HONG LEONG BANK BERHAD #	Mitsubishi Trust and Banking Corporation (The)	Svenska Handelsbanken AB (publ)
HSBC BANK INTERNATIONAL LIMITED	Mizuho Corporate Bank, Ltd.	TAIPEIBANK Co., Ltd.
HSBC Bank plc	Natexis Banques Populaires	TAISHIN INTERNATIONAL BANK CO., LTD
HSBC Bank USA	National Australia Bank Limited	Taiwan Business Bank
HSBC Private Bank (Suisse) SA (formerly known as HSBC Republic Bank (Suisse) SA)	National Bank of Pakistan	Toronto-Dominion Bank (The)
HSH Nordbank AG	Oversea-Chinese Banking Corporation Limited	UBS AG
Hua Nan Commercial Bank, Ltd.	Philippine National Bank	also known as:
Indian Overseas Bank	PT. Bank Negara Indonesia (Persero) Tbk.	UBS SA
Industrial and Commercial Bank of China (The)	Public Bank Berhad	UBS Ltd
INTERNATIONAL BANK OF TAIPEI	Royal Bank of Canada	UCO Bank
INTERNATIONAL COMMERCIAL BANK OF CHINA CO., LTD. (THE)	Royal Bank of Scotland public limited company (The)	UFJ Bank Limited
ING Bank N.V.	SANPAOLO IMI S.p.A.	UniCredito Italiano Societa' per Azioni
Iyo Bank, Ltd. (The)	Shiga Bank, Ltd. (The)	UNITED COMMERCIAL BANK
JPMorgan Chase Bank, National Association (formerly known as JPMORGAN CHASE BANK)	Shinkin Central Bank	United Overseas Bank Ltd.
KBC Bank N.V.	Shizuoka Bank, Ltd. (The)	Wells Fargo Bank, National Association
Korea Exchange Bank	Societe Generale	WestLB AG
Malayan Banking Berhad	Standard Chartered Bank	Westpac Banking Corporation
	State Bank of India	Woori Bank
	State Street Bank and Trust Company	
	Sumitomo Mitsui Banking Corporation	

Deletion in 2004

Bank One, National Association
Dresdner Bank AG
Yamaguchi Bank, Ltd. (The)

Addition in 2004

ANNEX: AUTHORIZED INSTITUTIONS AND LOCAL REPRESENTATIVE OFFICES AT 31.12.2004 (cont.)

Restricted Licence Banks

Incorporated in Hong Kong

ABSA BANK (ASIA) LIMITED
AIG Finance (Hong Kong) Limited
ALLIED BANKING CORPORATION
(HONG KONG) LIMITED
Banc of America Securities Asia
Limited
(formerly known as BA Asia Limited)
Bank of Baroda (Hong Kong) Limited
BOCI Capital Limited
Canadian Eastern Finance Limited
Citicorp Commercial Finance (H.K.)
Limited
Citicorp International Limited
GE Capital (Hong Kong) Limited

Hang Seng Finance Limited
Indover bank (Asia) Limited
Industrial and Commercial
International Capital Limited
J. P. MORGAN SECURITIES (ASIA
PACIFIC) LIMITED
KDB Asia Limited
KOOKMIN BANK HONG KONG
LIMITED
(formerly known as Kookmin
Finance Hong Kong Limited)
Mitsubishi Securities (HK), Limited
MIZUHO CORPORATE ASIA (HK)
LIMITED

N.M. Rothschild & Sons (Hong Kong)
Limited
ORIX Asia Limited
Pacific Finance (Hong Kong) Limited
SCOTIABANK (HONG KONG)
LIMITED
Shinhan Finance Limited
Societe Generale Asia Limited
UBAF (Hong Kong) Limited

Deletion in 2004

Manhattan Card Company Limited

Incorporated outside Hong Kong

Bank of Ayudhya Public Company
Limited
Bank of Bermuda, Limited (The)
Bumiputra-Commerce Bank Berhad
Dexia Banque Internationale à
Luxembourg
HYPO REAL ESTATE BANK
INTERNATIONAL #
(not yet opened)
Industrial Bank of Korea
Lloyds TSB Bank Plc
Mashreq Bank - Public Shareholding
Company
also known as:
Mashreqbank psc

NEDBANK LIMITED
PT. BANK MANDIRI (PERSERO) Tbk
(formerly known as PT. Bank
Mandiri (Persero))
Siam Commercial Bank Public
Company Limited (The)
Thanakharn Kasikorn Thai Chamkat
(Mahachon)
also known as:
KASIKORNBANK PUBLIC
COMPANY LIMITED

Thai Military Bank Public Company
Limited
Union Bank of California, National
Association
Wachovia Bank, National Association

Deletion in 2004

Citibank International
CITIBANK KOREA INC.
(formerly known as KorAm Bank)

Addition in 2004

ANNEX: AUTHORIZED INSTITUTIONS AND LOCAL REPRESENTATIVE OFFICES AT 31.12.2004 (cont.)

Deposit-taking Companies

Incorporated in Hong Kong

Argo Enterprises Company Limited	Hachijuni Asia Limited	Orient First Capital Limited
BCOM Finance (Hong Kong) Limited	HBZ Finance Limited	PrimeCredit Limited
BII Finance Company Limited	Henderson International Finance Limited	Shacom Finance Limited
BPI International Finance Limited	HKCB Finance Limited	Sumitomo Trust Finance (H.K.) Limited (The)
C.F. Finance Company Limited	Hung Kai Finance Company Limited	Vietnam Finance Company Limited
Chau's Brothers Finance Company Limited	IBA Credit Limited	Wing Hang Finance Company Limited
Chohung Finance Limited	Inchroy Credit Corporation Limited	Wing Lung Finance Limited
Commonwealth Finance Corporation Limited	Indo Hong Kong International Finance Limited	
Corporate Finance (D.T.C.) Limited	JCG Finance Company, Limited	
Delta Asia Credit Limited	KEXIM ASIA LIMITED #	
Edward Wong Credit Limited	Korea First Finance Limited	
First Metro International Investment Company Limited	Liu Chong Hing Finance Limited	
Gunma Finance (Hong Kong) Limited	Michinoku Finance (Hong Kong) Limited	
Habib Finance International Limited	OCTOPUS CARDS LIMITED	

Deletion in 2004

BCA Finance Limited
Hang Seng Credit Ltd.
Ka Wah International Merchant Finance Limited
Kincheng-Tokyo Finance Company Limited
Mashreq Asia Limited

Incorporated outside Hong Kong

NIL

Local Representative Offices

AlG Private Bank Ltd.	Banca Popolare di Ancona Società per azioni	Banco Popolare di Verona e Novara S.c.r.l.
ANTWERPSE DIAMANTBANK NV also known as: ANTWERP DIAMOND BANK NV	Banca Popolare di Bergamo S.p.A.	Banco Popular Español, S.A.
Arab Bank plc	Banca Popolare di Novara – Società per Azioni	Banco Santander Central Hispano, S.A.
Banca Antoniana-Popolare Veneta S.C.A R.L.	Banca Popolare di Sondrio Soc. Coop. a r.l.	Bank für Arbeit und Wirtschaft Aktiengesellschaft
Banca del Gottardo	Banca Popolare di Vicenza Soc. Coop. a r.l.	Bank Leumi Le-Israel B.M.
Banca Popolare dell'Emilia Romagna Soc. Coop. a r.l.	Banco do Brasil S.A.	Bank of Fukuoka, Ltd. (The)
		Bank of Kyoto, Ltd. (The)

Addition in 2004

ANNEX: AUTHORIZED INSTITUTIONS AND LOCAL REPRESENTATIVE OFFICES AT 31.12.2004 (cont.)

Bank of New York – Inter Maritime Bank, Geneva	GUANGDONG DEVELOPMENT BANK CO., LTD.	Resona Bank, Limited
Bank of Yokohama, Ltd. (The)	Habib Bank A.G. Zurich	Rothschild Bank AG
Banque Cantonale Vaudoise	HSBC Bank Australia Limited	Schroder & Co Bank AG
Banque Privee Edmond de Rothschild S.A.	HSBC Bank Canada	also known as:
BSI Ltd.	HSBC Guyerzeller Bank AG	Schroder & Co Banque SA
CARIPRATO – Cassa di Risparmio di Prato S.p.A.	HSBC Trinkaus & Burkhardt (International) S.A.	Schroder & Co Banca SA
Cathay Bank	Investec Bank Limited	Schroder & Co Bank Ltd
China Development Bank	Japan Bank for International Cooperation	Schroder & Co Banco SA
China Everbright Bank Co., Ltd	Juroku Bank, Ltd. (The)	Shanghai Pudong Development Bank Co., Ltd.
CHINA MINSHENG BANKING CORPORATION LIMITED #	Kagoshima Bank Ltd. (The)	Shenzhen Development Bank Co., Ltd.
Chinese Bank (The)	Korea Development Bank (The)	Shoko Chukin Bank (The)
CITIC Group	Kredietbank S.A. Luxembourgise	Standard Bank of South Africa Ltd. (The)
(formerly known as China International Trust and Investment Corporation)	Land Bank of Taiwan	STANDARD CHARTERED (JERSEY) LIMITED
Clariden Bank	LGT Bank in Liechtenstein AG	(formerly known as STANDARD CHARTERED GRINDLAYS (OFFSHORE) LTD)
Clearstream Banking	also known as:	Taiwan Cooperative Bank
Credit Industriel et Commercial	LGT Bank in Liechtenstein Ltd.	UFJ Bank (Schweiz) AG
Credito Bergamasco S.p.A.	LGT Banque de Liechtenstein S.A.	also known as:
D.A.H. Hambros Bank (Channel Islands) Limited	LGT Banca di Liechtenstein S.A.	UFJ Bank (Switzerland) Ltd.
DePfa Investment Bank Limited	LLOYDS TSB OFFSHORE LIMITED	UFJ Banque (Suisse) SA
DVB Bank N.V.	(formerly known as LLOYDS TSB OFFSHORE TREASURY LIMITED)	UFJ Banca (Svizzera) SA
(formerly known as NEDSHIP BANK N.V.)	Merrill Lynch Bank (Suisse) S.A.	Union Bank of Taiwan
EFG PRIVATE BANK LIMITED #	Merrill Lynch International Bank Limited	Veneto Banca S.c.a.r.l.
(opened on 1 Jan 2005)	Metropolitan Bank and Trust Company	Yamaguchi Bank, Ltd. (The) #
Euroclear Bank	Nanto Bank, Ltd. (The)	Yamanashi Chuo Bank, Ltd.
Far Eastern International Bank	National Bank of Canada	
Fiduciary Trust Company International	Nishi-Nippon Bank, Ltd. (The)	Deletion in 2004
Fuhwa Commercial Bank Co., Ltd.	Norinchukin Bank (The)	Banco Atlantico S.A.
GERRARD PRIVATE BANK (JERSEY) LIMITED	Ogaki Kyoritsu Bank, Ltd. (The)	BRADFORD & BINGLEY INTERNATIONAL LIMITED
	Oita Bank, Ltd. (The)	Comerica Bank
	P.T. Bank Central Asia	Export-Import Bank of Korea (The)
	P.T. Bank Rakyat Indonesia (Persero)	F. van Lanschot Bankiers N.V.
	Raiffeisen Zentralbank Osterreich AG	

Addition in 2004

TABLE A: MAJOR ECONOMIC INDICATORS

	2000	2001	2002	2003	2004
I. Gross Domestic Product					
Real GDP growth (%)	10.2	0.5	1.9	3.2	8.1 ^(a)
Nominal GDP growth (%)	3.4	-1.4	-1.7	-2.2	5.1 ^(a)
Real growth of major expenditure components of GDP (%)					
– Private consumption expenditure	5.9	2.0	-1.1	-0.3	6.7 ^(a)
– Government consumption expenditure	2.0	6.1	2.5	1.9	0.5 ^(a)
– Gross domestic fixed capital formation of which	11.0	2.6	-4.5	0.1	4.5 ^(a)
– Building and construction	-7.6	-1.1	-1.1	-7.0	-10.3 ^(a)
– Machinery, equipment and computer software	27.0	6.2	-7.6	6.5	12.2 ^(a)
– Exports	16.6	-1.8	9.2	12.7	15.2 ^(a)
– Imports	16.8	-1.5	7.5	11.3	13.8 ^(a)
GDP at current market prices (US\$ billion)	165.4	162.8	160.0	156.7	164.6 ^(a)
Per capita GDP at current market prices (US\$)	24,811	24,213	23,577	23,030	23,917 ^(a)
II. External Trade (HK\$ billion)					
Merchandise trade ^(b)					
– Domestic exports of goods	181.0	153.5	131.1	122.1	126.4 ^(a)
– Re-exports of goods	1,391.7	1,327.5	1,431.0	1,627.0	1,900.6 ^(a)
– Total imports of goods	1,636.7	1,549.2	1,601.5	1,794.1	2,099.5 ^(a)
– Merchandise trade balance	-64.0	-68.2	-39.4	-45.0	-72.5 ^(a)
Services trade					
– Exports of services	301.8	307.7	335.4	347.4	407.6 ^(a)
– Imports of services	191.5	192.5	199.7	196.1	225.0 ^(a)
– Services trade balance	110.3	115.2	135.7	151.4	182.6 ^(a)
III. Fiscal Expenditure and Revenue (HK\$ million, fiscal year)					
Total government expenditure	232,893	238,890	239,177	247,466	249,741 ^(a)
Total government revenue	225,060	175,559	177,489	207,338	261,694 ^(a)
Consolidated surplus/deficit	-7,833	-63,331	-61,688	-40,128	11,953 ^(a)
Reserve balance as at end of fiscal year ^(c)	430,278	372,503	311,402	275,343	287,296 ^(a)
IV. Prices (annual change, %)					
Consumer Price Index (A)	-3.0	-1.7	-3.2	-2.1	0.0
Composite Consumer Price Index	-3.8	-1.6	-3.0	-2.6	-0.4
Trade Unit Value Indices					
– Domestic exports	-1.0	-4.7	-3.3	0.2	1.5
– Re-exports	-0.1	-2.0	-2.7	-1.5	1.1
– Imports	0.8	-3.1	-3.9	-0.4	2.9
Property Price Indices					
– Residential flats	-10	-12	-11	-12	27 ^(a)
– Office premises	-10	-12	-13	-9	57 ^(a)
– Retail premises	-6	-7	-2	1	39 ^(a)
– Flatted factory premises	-9	-10	-9	-4	22 ^(a)

TABLE A: MAJOR ECONOMIC INDICATORS (cont.)

	2000	2001	2002	2003	2004
V. Labour					
Labour force (annual change, %)	1.6	1.6	1.8	0.3	0.9
Employment (annual change, %)	3.1	1.4	-0.6	-0.4	2.1
Unemployment rate (annual average, %)	4.9	5.1	7.3	7.9	6.8
Underemployment rate (annual average, %)	2.8	2.5	3.0	3.5	3.3
Employment ('000)	3,207	3,252	3,232	3,219	3,288
of which					
– Manufacturing	334	326	290	272	232
– Financing, insurance, real estate and business services	453	478	474	470	480
– Wholesale, retail and import/export trades, restaurants and hotels	982	981	983	992	1,067
VI. Money Supply (HK\$ billion)					
HK\$ money supply					
– M1	204.0	229.8	259.4	354.8	412.6
– M2 ^(d)	1,988.0	1,998.8	1,984.0	2,107.3	2,208.6
– M3 ^(d)	2,002.4	2,016.6	2,004.2	2,122.9	2,219.5
Total money supply					
– M1	243.8	258.1	295.6	413.4	484.5
– M2	3,649.5	3,550.1	3,518.3	3,813.4	4,166.7
– M3	3,692.8	3,594.1	3,561.9	3,858.0	4,189.5
VII. Interest Rates (end of period, %)					
Three-month interbank rate	5.75	1.88	1.41	0.07	0.28
Savings deposit	4.75	0.15	0.03	0.01	0.01
One-month time deposit	5.03	0.54	0.13	0.01	0.02
Banks' 'Best lending rate'	9.50	5.13	5.00	5.00	5.00
VIII. Exchange Rates (end of period)					
HK\$/US\$	7.796	7.797	7.798	7.763	7.774
Trade-weighted Effective Exchange Rate Index (Jan 2000=100)	102.9	105.9	102.0	98.8	96.0
IX. Foreign Currency Reserve Assets (US\$ billion) ^(e)	107.6	111.2	111.9	118.4	123.6
X. Stock Market (end of period figures)					
Hang Seng Index	15,096	11,397	9,321	12,576	14,230
Average price/earning ratio	12.8	12.2	14.9	19.0	18.7
Market capitalisation (HK\$ billion)	4,795.2	3,885.3	3,559.1	5,477.7	6,629.2

(a) The estimates are preliminary.

(b) Includes non-monetary gold.

(c) Includes changes in provision for loss in investments with the Exchange Fund.

(d) Adjusted to include foreign currency swap deposits.

(e) Excludes unsettled forward transactions but includes gold.

TABLE B: PERFORMANCE RATIOS OF THE BANKING SECTOR ^(a)

	All AIs							
	1997	1998	1999	2000	2001	2002	2003	2004
Asset Quality ^(b)	%	%	%	%	%	%	%	%
As % of total credit exposures ^(c)								
Total outstanding provisions	0.85	1.79	2.32	2.03	1.73	1.40	1.14	0.78
Classified ^(d) exposures:								
Gross	1.08	4.52	5.52	4.34	3.71	2.77	2.25	1.21
Net of specific provisions	0.72	3.29	3.69	2.86	2.47	1.85	1.54	0.80
Net of all provisions	0.22	2.72	3.20	2.31	1.98	1.37	1.10	0.43
Non-performing exposures ^(e)	N.A.	N.A.	3.85	3.18	2.62	1.98	1.66	0.84
As % of total loans								
Total outstanding provisions	1.03	2.17	3.14	2.98	2.82	2.39	1.98	1.42
Classified ^(d) loans:								
Gross	1.23	5.27	7.24	6.08	5.73	4.53	3.74	2.11
Net of specific provisions	0.82	3.79	4.79	3.96	3.75	2.98	2.54	1.39
Net of all provisions	0.20	3.09	4.10	3.11	2.92	2.13	1.76	0.68
Non-performing loans ^(e)	N.A.	N.A.	5.34	4.72	4.37	3.46	2.95	1.56
Overdue > 3 months and rescheduled loans	1.07	4.18	5.72	5.12	4.16	3.41	2.81	1.54
Profitability								
Return on assets (operating profit)	0.69	0.36	0.42	0.84	0.85	0.94	0.93	1.06
Return on assets (post-tax profit)	0.60	0.28	0.39	0.77	0.76	0.81	0.81	0.97
Net interest margin	1.08	1.13	1.34	1.43	1.45	1.52	1.41	1.18
Cost-income ratio	45.9	48.3	44.2	45.5	47.2	46.3	45.8	48.8
Bad debt charge to total assets	0.13	0.45	0.64	0.26	0.23	0.24	0.24	0.01
Liquidity								
Loan to deposit ratio (all currencies)	152.1	110.1	86.5	69.8	64.1	62.6	57.1	55.8
Loan to deposit ^(f) ratio (Hong Kong dollar)	112.3	99.7	90.6	89.3	88.8	88.5	81.5	82.6

Asset Quality

Delinquency ratio of residual mortgage loans

Credit card receivables ^(g)

Delinquency ratio

Charge-off ratio

Profitability

Operating profit to shareholders' funds

Post-tax profit to shareholders' funds

Capital adequacy

Equity to assets ratio ^(b)

Capital adequacy ratio (consolidated)

- (a) Figures relate to Hong Kong office(s) only except where otherwise stated.
- (b) Figures relate to Hong Kong office(s) and for the locally incorporated AIs included therein, also their overseas branches.
- (c) Credit exposures include loans & advances, acceptances & bills of exchange held, investment debt securities issued by others, accrued interest, and commitments and contingent liabilities to or on behalf of non-banks.

- (d) Denotes loans or exposures graded as "substandard", "doubtful" or "loss".
- (e) Denotes loans or exposures on which interest has been placed in suspense or on which interest accrual has ceased.
- (f) Includes swap deposits.
- (g) There is a break in series in 2001 owing to an increase in the number of surveyed institutions.
- N.A. not available

Retail banks

1997	1998	1999	2000	2001	2002	2003	2004
%	%	%	%	%	%	%	%
1.59	2.53	2.68	2.16	1.76	1.41	1.13	0.78
1.63	6.11	6.72	4.70	4.03	3.02	2.32	1.27
1.03	4.48	4.72	3.25	2.85	2.15	1.67	0.90
0.04	3.57	4.04	2.54	2.27	1.61	1.18	0.49
N.A.	N.A.	4.68	3.52	2.92	2.17	1.72	0.85
2.14	3.34	4.25	3.52	3.04	2.49	2.05	1.46
2.09	7.70	10.14	7.26	6.53	5.04	3.94	2.24
1.30	5.57	7.02	4.93	4.51	3.53	2.78	1.58
-0.06	4.35	5.89	3.74	3.48	2.55	1.89	0.78
N.A.	N.A.	7.60	5.87	5.16	3.94	3.17	1.62
2.09	6.47	7.86	6.04	4.57	3.59	2.87	1.48
1.62	0.98	0.98	1.33	1.17	1.35	1.36	1.51
1.39	0.86	0.94	1.16	1.05	1.18	1.18	1.38
2.19	2.01	2.11	2.14	2.03	2.09	1.91	1.65
39.5	42.1	39.0	38.1	42.2	39.3	38.6	41.6
0.19	0.60	0.76	0.44	0.40	0.34	0.29	-0.02
72.3	61.2	55.2	52.6	53.7	53.5	49.5	50.0
83.4	73.8	71.7	73.3	77.2	78.6	71.6	73.2

Surveyed institutions

1997	1998	1999	2000	2001	2002	2003	2004
%	%	%	%	%	%	%	%
N.A.	0.84	1.13	1.32	1.22	1.06	0.86	0.38
0.64	1.16	0.92	0.76	1.28	1.28	0.92	0.44
2.05	3.14	4.92	3.88	5.46	13.25	10.02	4.73

Locally incorporated banks

1997	1998	1999	2000	2001	2002	2003	2004
%	%	%	%	%	%	%	%
17.9	11.0	12.6	17.0	15.4	16.2	16.9	18.6
15.7	9.5	11.6	14.7	14.1	14.0	14.6	17.1
9.9	9.1	8.9	8.6	10.5	10.6	10.5	10.7

All locally incorporated AIs

1997	1998	1999	2000	2001	2002	2003	2004
%	%	%	%	%	%	%	%
17.4	18.5	18.7	17.8	16.5	15.7	15.3	15.4

TABLE C: AUTHORIZED INSTITUTIONS: DOMICILE AND PARENTAGE

	2000	2001	2002	2003	2004
Licensed Banks					
(i) Incorporated in Hong Kong	31	29	26	23	24
(ii) Incorporated outside Hong Kong	123	118	107	111	109
Total	154	147	133	134	133
Restricted Licence Banks					
(i) Subsidiaries of licensed banks:					
(a) incorporated in Hong Kong	2	2	2	1	1
(b) incorporated outside Hong Kong	11	11	12	11	10
(ii) Subsidiaries or branches of foreign banks which are not licensed banks in Hong Kong	29	30	26	24	23
(iii) Bank related	3	3	3	3	3
(iv) Others	3	3	3	3	3
Total	48	49	46	42	40
Deposit-taking Companies					
(i) Subsidiaries of licensed banks:					
(a) incorporated in Hong Kong	16	15	14	9	7
(b) incorporated outside Hong Kong	8	5	4	3	2
(ii) Subsidiaries of foreign banks which are not licensed banks in Hong Kong	23	21	15	15	14
(iii) Bank related	2	2	2	2	2
(iv) Others	12	11	10	10	10
Total	61	54	45	39	35
All Authorized Institutions	263	250	224	215	208
Local Representative Offices	118	111	94	87	85

**TABLE D: AUTHORIZED INSTITUTIONS:
REGION/ECONOMY OF BENEFICIAL OWNERSHIP**

Region/Economy	Licensed Banks					Restricted Licence Banks					Deposit-taking Companies				
	00	01	02	03	04	00	01	02	03	04	00	01	02	03	04
Asia & Pacific															
Hong Kong	16	14	12	13	12	2	2	2	1	1	16	15	14	13	12
Australia	4	4	4	4	4	-	-	-	-	-	-	-	-	-	-
Mainland China	19	19	13	12	13	2	2	2	2	2	3	3	3	3	2
India	4	4	4	4	4	-	-	1	1	1	3	3	2	2	2
Indonesia	2	2	1	1	1	2	2	2	2	2	7	4	2	2	1
Japan	22	20	15	13	12	5	5	4	4	4	8	7	7	5	4
Malaysia	3	1	1	2	3	2	2	2	1	1	2	1	1	1	1
Pakistan	1	1	1	1	1	-	-	-	-	-	2	2	2	2	2
Philippines	2	2	2	2	2	1	1	1	1	1	5	4	3	3	3
Singapore	5	7	6	4	4	1	1	-	-	-	2	3	2	-	-
South Korea	3	3	3	3	3	6	6	5	5	4	2	2	1	1	2
Taiwan	6	7	10	13	14	1	1	2	-	-	-	-	-	-	1
Thailand	1	1	1	1	1	4	4	4	4	4	-	-	-	-	-
Vietnam	-	-	-	-	-	-	-	-	-	-	1	1	1	1	1
Sub-Total	88	85	73	73	74	26	26	25	21	20	51	45	38	33	31
Europe															
Austria	2	2	1	1	1	-	-	-	-	-	-	-	-	-	-
Belgium	4	4	3	3	2	-	-	-	-	-	-	-	-	-	-
Denmark	1	-	-	-	-	-	-	-	-	-	-	-	-	-	-
France	6	5	6	6	6	3	3	3	2	2	1	-	-	-	-
Germany	9	9	9	9	8	1	1	-	-	1	-	-	-	-	-
Italy	7	6	6	6	6	-	-	-	-	-	-	-	-	-	-
Netherlands	3	3	3	3	3	-	-	-	-	-	-	-	-	-	-
Spain	1	1	1	1	1	-	-	-	-	-	-	-	-	-	-
Sweden	2	1	1	1	1	-	-	-	-	-	-	-	-	-	-
Switzerland	3	3	3	3	3	1	1	1	1	1	-	-	-	-	-
United Kingdom	8	10	10	9	10	2	2	2	2	1	-	-	-	-	-
Sub-Total	46	44	43	42	41	7	7	6	5	5	1	-	-	-	-
Middle East															
Bahrain	1	1	1	1	0	-	-	-	-	-	1	1	1	1	0
Iran	1	1	1	1	1	-	-	-	-	-	-	-	-	-	-
U.A.E.	-	-	-	-	-	-	-	-	1	1	1	1	1	1	0
Sub-Total	2	2	2	2	1	-	-	-	1	1	2	2	2	2	0
North America															
Canada	5	5	4	5	5	1	2	2	2	2	-	-	-	-	-
United States	13	10	10	11	11	10	9	9	9	8	5	5	3	3	3
Sub-Total	18	15	14	16	16	11	11	11	11	10	5	5	3	3	3
South Africa	-	1	1	1	1	2	3	2	2	2	1	1	1	-	-
Bermuda	-	-	-	-	-	2	2	2	1	1	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	1	1	1	1	1	1	1
Grand Total	154	147	133	134	133	48	49	46	42	40	61	54	45	39	35

TABLE E: PRESENCE OF WORLD'S LARGEST 500 BANKS IN HONG KONG

Positions at 31.12.2004	Number of Overseas Banks ^(b)					Licensed Banks ^(c)				
	00	01	02	03	04	00	01	02	03	04
World Ranking^(a)										
1-20	20	20	20	20	20	28	28	30	30	33
21-50	26	24	23	23	22	23	23	22	21	19
51-100	33	32	30	32	28	27	26	27	27	23
101-200	49	47	42	44	42	27	25	21	22	22
201-500	58	53	53	51	45	12	12	15	18	17
Sub-total	186	176	168	170	157	117	114	115	118	114
Others	75	73	51	44	52	37	33	18	16	19
Total	261	249	219	214	209	154	147	133	134	133

(a) Top 500 banks/banking groups in the world ranked by total assets less contra items.

Figures are extracted from The Banker, July 2004 issue.

(b) The sum of the number of licensed banks, restricted licence banks, deposit-taking companies and local representative offices is greater than the number of overseas banks with a presence in Hong Kong because of the multiple presence of some overseas banks.

The figures exclude banks incorporated in Hong Kong.

(c) Include subsidiaries of overseas banks, classified in accordance with the world ranking of these overseas banks.

Restricted Licence Banks ^(c)					Deposit-Taking Companies ^(c)					Local Representative Offices				
00	01	02	03	04	00	01	02	03	04	00	01	02	03	04
13	11	12	11	10	7	6	4	3	1	11	8	7	7	7
4	5	3	4	5	-	-	-	-	-	5	8	7	4	4
2	3	4	4	4	3	3	5	2	2	11	11	6	6	5
4	4	2	3	3	9	6	5	5	4	17	17	19	23	22
12	14	13	10	7	6	7	8	7	5	35	30	24	22	20
35	37	34	32	29	25	22	22	17	12	79	74	63	62	58
13	12	12	10	11	36	32	23	22	23	39	37	31	25	27
48	49	46	42	40	61	54	45	39	35	118	111	94	87	85

**TABLE F: BALANCE SHEET:
ALL AUTHORIZED INSTITUTIONS AND RETAIL BANKS****All Authorized Institutions**

(HK\$ bn)

	1997			1998			1999		
	HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total
Assets									
Loans to customers	1,742	2,379	4,122	1,695	1,609	3,304	1,607	1,206	2,813
Inside Hong Kong ^(a)	1,706	525	2,230	1,665	444	2,110	1,584	349	1,933
Outside Hong Kong ^(b)	37	1,854	1,891	30	1,165	1,195	23	857	880
Interbank lending	712	2,368	3,081	578	2,364	2,942	511	2,414	2,925
Inside Hong Kong	517	254	771	411	218	629	359	177	536
Outside Hong Kong	195	2,114	2,310	167	2,146	2,312	152	2,237	2,389
Negotiable certificates of deposit (NCD)	122	50	173	106	38	144	103	35	138
Negotiable debt instruments, other than NCD	187	448	635	204	342	546	261	322	583
Other assets	170	217	387	169	150	318	200	125	326
Total assets	2,934	5,463	8,397	2,752	4,503	7,254	2,682	4,102	6,784
Liabilities									
Deposits from customers ^(c)	1,552	1,159	2,710	1,700	1,300	3,000	1,773	1,477	3,251
Interbank borrowing	811	3,942	4,753	646	2,780	3,426	539	2,191	2,731
Inside Hong Kong	521	251	772	414	208	622	360	168	529
Outside Hong Kong	290	3,691	3,981	232	2,572	2,803	179	2,023	2,202
Negotiable certificates of deposit	172	48	220	163	46	209	164	36	199
Other liabilities	386	328	714	365	254	619	405	198	604
Total liabilities	2,921	5,476	8,397	2,874	4,380	7,254	2,882	3,903	6,784

Retail Banks

(HK\$ bn)

	1997			1998			1999		
	HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total
Assets									
Loans to customers	1,171	260	1,431	1,168	239	1,407	1,166	203	1,369
Inside Hong Kong ^(a)	1,156	213	1,369	1,154	198	1,352	1,154	170	1,323
Outside Hong Kong ^(b)	15	47	62	14	41	55	12	34	46
Interbank lending	553	543	1,096	476	790	1,266	412	877	1,289
Inside Hong Kong	408	86	495	345	120	466	299	101	399
Outside Hong Kong	145	456	601	131	670	801	113	777	890
Negotiable certificates of deposit (NCD)	44	10	54	42	10	52	48	10	58
Negotiable debt instruments, other than NCD	98	137	236	127	149	275	188	180	369
Other assets	134	70	205	133	46	180	168	50	218
Total assets	2,001	1,020	3,021	1,946	1,234	3,180	1,982	1,321	3,303
Liabilities									
Deposits from customers ^(c)	1,404	574	1,978	1,583	716	2,299	1,627	854	2,481
Interbank borrowing	262	294	556	194	232	426	162	187	349
Inside Hong Kong	72	31	103	46	39	85	50	33	82
Outside Hong Kong	190	263	453	148	193	341	112	155	267
Negotiable certificates of deposit	120	19	139	116	21	137	112	14	126
Other liabilities	265	83	348	258	60	318	312	34	346
Total liabilities	2,050	971	3,021	2,151	1,029	3,180	2,212	1,091	3,303

(a) Defined as loans for use in Hong Kong plus trade financing loans.

(b) Includes "others" (i.e. unallocated).

(c) Hong Kong dollar customer deposits include swap deposits.

2000			2001			2002			2003			2004		
HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total
1,652	809	2,461	1,648	537	2,185	1,616	461	2,076	1,573	462	2,035	1,667	489	2,156
1,626	339	1,965	1,626	252	1,879	1,591	243	1,834	1,542	267	1,809	1,631	291	1,922
26	470	496	21	285	306	25	218	243	31	195	226	36	198	233
533	2,469	3,002	397	2,231	2,628	332	1,983	2,315	438	2,175	2,614	447	2,577	3,024
380	171	551	287	182	468	236	159	395	295	177	472	291	184	475
153	2,297	2,450	111	2,049	2,160	96	1,823	1,919	144	1,998	2,142	156	2,392	2,548
98	37	135	87	40	128	90	44	134	86	58	144	74	48	121
329	427	756	355	553	908	395	715	1,109	397	800	1,197	459	870	1,328
202	106	307	231	74	306	255	110	365	289	212	501	296	212	508
2,814	3,847	6,661	2,718	3,436	6,154	2,687	3,312	5,999	2,783	3,708	6,491	2,942	4,195	7,137
1,851	1,677	3,528	1,855	1,552	3,407	1,825	1,493	3,318	1,931	1,636	3,567	2,018	1,848	3,866
601	1,694	2,295	454	1,474	1,929	384	1,404	1,788	428	1,489	1,918	437	1,711	2,148
380	163	543	290	180	470	236	157	394	285	185	470	294	203	497
221	1,530	1,752	164	1,295	1,459	147	1,246	1,394	143	1,305	1,448	143	1,508	1,651
151	26	178	135	37	172	138	73	211	132	110	242	124	132	256
447	213	661	473	173	646	509	173	683	495	268	764	610	256	867
3,051	3,610	6,661	2,917	3,237	6,154	2,856	3,143	5,999	2,987	3,504	6,491	3,190	3,947	7,137
2000			2001			2002			2003			2004		
HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total
1,242	189	1,431	1,304	150	1,454	1,307	151	1,459	1,278	172	1,450	1,371	200	1,571
1,227	163	1,390	1,292	128	1,420	1,296	130	1,426	1,266	146	1,412	1,354	159	1,513
14	26	41	12	22	33	11	22	33	12	26	39	17	41	58
446	987	1,433	307	881	1,188	245	765	1,010	330	836	1,166	302	1,022	1,324
325	107	432	239	109	348	190	107	297	247	110	358	235	117	352
121	881	1,002	68	772	840	56	658	713	83	726	809	67	905	972
57	20	77	56	18	74	61	21	82	58	38	96	55	28	83
232	262	494	256	360	616	259	484	744	278	565	843	317	583	900
162	40	202	183	38	221	208	61	269	233	78	312	243	99	342
2,139	1,498	3,637	2,106	1,447	3,553	2,081	1,483	3,564	2,178	1,689	3,867	2,288	1,932	4,219
1,693	1,029	2,722	1,688	1,020	2,708	1,663	1,063	2,726	1,786	1,141	2,927	1,874	1,270	3,144
204	221	425	122	207	329	78	213	291	90	265	354	87	295	382
57	29	86	39	20	58	24	31	55	31	26	58	36	30	66
147	192	339	83	188	271	54	182	236	58	238	296	51	265	316
105	13	118	85	28	113	86	52	138	82	80	162	80	99	179
327	45	372	359	44	402	365	44	409	361	63	424	436	79	515
2,330	1,308	3,637	2,254	1,299	3,553	2,193	1,372	3,564	2,319	1,548	3,867	2,476	1,744	4,219

TABLE G: MAJOR BALANCE SHEET ITEMS BY REGION/ECONOMY OF BENEFICIAL OWNERSHIP OF AUTHORIZED INSTITUTIONS

(HK\$ bn)		Mainland China	Japan	US	Europe	Others	Total
Total Assets	2003	1,079	624	552	1,565	2,671	6,491
	2004	1,146	576	650	1,876	2,888	7,137
Deposits from Customers	2003	784	177	238	489	1,879	3,567
	2004	836	178	291	541	2,019	3,866
Loans to Customers	2003	453	152	118	378	934	2,035
	2004	478	131	124	402	1,020	2,156
Loans to Customers Inside Hong Kong^(a)	2003	427	81	109	295	897	1,809
	2004	446	84	116	310	967	1,922
Loans to Customers Outside Hong Kong^(b)	2003	26	71	8	83	37	226
	2004	32	47	8	93	53	233

(a) Defined as loans for use in Hong Kong plus trade financing loans.

(b) Includes "others" (i.e. unallocated).

TABLE H: FLOW OF FUNDS FOR ALL AUTHORIZED INSTITUTIONS AND RETAIL BANKS**All Authorized Institutions**

(HK\$ bn) Increase/(Decrease) in	2003			2004		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Assets						
Loans to customers	(43)	1	(41)	94	27	121
Inside Hong Kong ^(a)	(49)	24	(25)	89	25	114
Outside Hong Kong ^(b)	6	(22)	(16)	4	2	7
Interbank lending	106	193	299	9	401	410
Inside Hong Kong	59	18	76	(4)	7	4
Outside Hong Kong	48	175	223	12	394	406
All other assets	32	201	234	56	59	116
Total assets	96	395	492	159	488	646
Liabilities						
Deposits from customers ^(c)	106	144	249	87	212	299
Interbank borrowing	44	86	130	9	221	230
Inside Hong Kong	49	28	76	9	18	27
Outside Hong Kong	(4)	58	54	0	203	204
All other liabilities	(20)	132	112	107	10	117
Total liabilities	130	362	492	203	443	646
Net interbank borrowing/(lending)	(62)	(107)	(169)	0	(180)	(180)
Net customer lending/(borrowing)	(148)	(142)	(291)	6	(185)	(178)

Retail Banks

(HK\$ bn) Increase/(Decrease) in	2003			2004		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Assets						
Loans to customers	(29)	20	(8)	93	28	120
Inside Hong Kong ^(a)	(30)	16	(14)	88	13	101
Outside Hong Kong ^(b)	2	4	6	5	15	19
Interbank lending	85	71	156	(28)	185	157
Inside Hong Kong	58	3	60	(13)	7	(6)
Outside Hong Kong	27	68	96	(15)	178	163
All other assets	40	115	155	45	29	74
Total assets	96	207	303	110	242	352
Liabilities						
Deposits from customers ^(c)	123	78	201	88	129	217
Interbank borrowing	11	52	63	(3)	31	28
Inside Hong Kong	7	(4)	3	4	4	8
Outside Hong Kong	4	56	60	(7)	27	20
All other liabilities	(8)	47	39	72	35	108
Total liabilities	126	177	303	157	195	352
Net interbank borrowing/(lending)	(74)	(19)	(93)	25	(155)	(130)
Net customer lending/(borrowing)	(152)	(58)	(210)	5	(101)	(96)

(a) Defined as loans for use in Hong Kong plus trade financing loans.

(b) Includes "others" (i.e. unallocated).

(c) Hong Kong dollar customer deposits include swap deposits.

TABLE I: LOANS TO AND DEPOSITS FROM CUSTOMERS BY CATEGORY OF AUTHORIZED INSTITUTIONS

(HK\$ bn)	Loans to Customers				Deposits from Customers ^(a)			
	HK\$	F/CY	Total	%	HK\$	F/CY	Total	%
1997								
Licensed banks	1,557	2,319	3,876	94	1,536	1,108	2,644	98
Restricted licence banks	127	37	163	4	9	43	52	2
Deposit-taking companies	59	24	82	2	6	8	15	1
Total	1,742	2,379	4,122	100	1,552	1,159	2,710	100
1998								
Licensed banks	1,522	1,565	3,087	93	1,689	1,265	2,954	98
Restricted licence banks	121	29	150	5	6	31	36	1
Deposit-taking companies	52	15	67	2	5	5	10	-
Total	1,695	1,609	3,304	100	1,700	1,300	3,000	100
1999								
Licensed banks	1,456	1,178	2,633	94	1,763	1,447	3,210	99
Restricted licence banks	108	23	130	5	6	29	35	1
Deposit-taking companies	44	5	49	2	4	2	6	-
Total	1,607	1,206	2,813	100	1,773	1,477	3,251	100
2000								
Licensed banks	1,502	788	2,291	93	1,839	1,652	3,491	99
Restricted licence banks	108	18	126	5	9	22	31	1
Deposit-taking companies	41	3	44	2	3	2	6	-
Total	1,652	809	2,461	100	1,851	1,677	3,528	100
2001								
Licensed banks	1,507	521	2,028	93	1,838	1,528	3,367	99
Restricted licence banks	108	15	122	6	12	21	33	1
Deposit-taking companies	32	2	35	2	4	2	6	-
Total	1,648	537	2,185	100	1,855	1,552	3,407	100
2002								
Licensed banks	1,491	446	1,937	93	1,806	1,470	3,276	99
Restricted licence banks	99	13	112	5	15	21	36	1
Deposit-taking companies	26	2	27	1	4	2	6	-
Total	1,616	461	2,076	100	1,825	1,493	3,318	100
2003								
Licensed banks	1,465	448	1,913	94	1,916	1,608	3,524	99
Restricted licence banks	85	12	97	5	12	27	38	1
Deposit-taking companies	24	1	25	1	3	2	5	-
Total	1,573	462	2,035	100	1,931	1,636	3,567	100
2004								
Licensed banks	1,581	475	2,057	95	2,007	1,839	3,846	99
Restricted licence banks	67	12	79	4	8	7	15	-
Deposit-taking companies	19	2	20	1	3	2	5	-
Total	1,667	489	2,156	100	2,018	1,848	3,866	100

(a) Hong Kong dollar customer deposits include swap deposits.

A "-" sign denotes a figure of less than 0.5. Figures may not add up to total due to rounding.

TABLE J: LOANS TO CUSTOMERS INSIDE HONG KONG BY ECONOMIC SECTOR**All Authorized Institutions**

(HK\$ bn)	1997		1998		1999		2000		2001		2002		2003		2004	
Sector	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%
Hong Kong's visible trade	193	9	149	7	114	6	104	5	89	5	91	5	100	6	130	7
Manufacturing	111	5	95	4	80	4	74	4	71	4	71	4	80	4	99	5
Transport & transport equipment	96	4	106	5	103	5	105	5	102	5	104	6	110	6	121	6
Building, construction & property development and investment	440	20	416	20	384	20	398	20	389	21	379	21	360	20	386	20
Wholesale and retail trade	206	9	180	9	144	7	120	6	101	5	100	5	94	5	99	5
Financial concerns (other than authorized institutions)	260	12	234	11	189	10	170	9	142	8	125	7	147	8	168	9
Individuals:																
to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	60	3	74	4	76	4	91	5	107	6	99	5	87	5	77	4
to purchase other residential property	480	22	515	24	532	28	536	27	540	29	542	30	529	29	534	28
other purposes	154	7	143	7	138	7	148	8	150	8	143	8	137	8	149	8
Others	230	10	196	9	173	9	220	11	188	10	178	10	164	9	158	8
Total^(a)	2,230	100	2,110	100	1,933	100	1,965	100	1,879	100	1,834	100	1,809	100	1,922	100

Retail Banks

(HK\$ bn)	1997		1998		1999		2000		2001		2002		2003		2004	
Sector	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%
Hong Kong's visible trade	128	9	107	8	85	6	78	6	69	5	72	5	80	6	103	7
Manufacturing	61	4	55	4	49	4	47	3	46	3	47	3	53	4	65	4
Transport & transport equipment	33	2	42	3	43	3	48	3	58	4	63	4	68	5	76	5
Building, construction & property development and investment	289	21	276	20	272	21	294	21	307	22	311	22	301	21	331	22
Wholesale and retail trade	110	8	103	8	87	7	76	5	68	5	70	5	65	5	67	4
Financial concerns (other than authorized institutions)	69	5	71	5	72	5	63	5	63	4	56	4	65	5	65	4
Individuals:																
to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	37	3	44	3	45	3	56	4	69	5	65	5	57	4	51	3
to purchase other residential property	385	28	431	32	458	35	482	35	497	35	508	36	501	35	515	34
other purposes	112	8	105	8	105	8	114	8	116	8	111	8	104	7	126	8
Others	144	11	119	9	106	8	132	9	126	9	122	9	117	8	113	7
Total^(a)	1,369	100	1,352	100	1,323	100	1,390	100	1,420	100	1,426	100	1,412	100	1,513	100

(a) Defined as loans for use in Hong Kong plus trade financing loans.

TABLE K: DEPOSITS FROM CUSTOMERS

(HK\$ bn)	All AIs				Retail banks			
	Demand	Savings	Time	Total	Demand	Savings	Time	Total
Hong Kong Dollar ^(a)								
1997	108	336	1,108	1,552	97	329	978	1,404
1998	97	414	1,188	1,700	88	408	1,087	1,583
1999	106	452	1,216	1,773	97	445	1,085	1,627
2000	112	493	1,246	1,851	101	486	1,106	1,693
2001	128	614	1,113	1,855	117	608	963	1,688
2002	146	674	1,004	1,825	134	668	861	1,663
2003	227	936	768	1,931	203	927	656	1,786
2004	272	1,033	713	2,018	250	1,023	601	1,874
Foreign Currency								
1997	20	155	984	1,159	15	136	424	574
1998	19	169	1,112	1,300	14	149	553	716
1999	20	192	1,266	1,477	15	168	671	854
2000	40	203	1,433	1,677	20	181	828	1,029
2001	28	238	1,286	1,552	20	214	786	1,020
2002	36	272	1,184	1,493	24	245	794	1,063
2003	59	341	1,236	1,636	38	307	796	1,141
2004	72	399	1,378	1,848	47	357	866	1,270
Total								
1997	128	491	2,092	2,710	112	465	1,401	1,978
1998	116	583	2,300	3,000	102	557	1,640	2,299
1999	126	644	2,481	3,251	111	613	1,756	2,481
2000	152	696	2,680	3,528	121	667	1,934	2,722
2001	156	851	2,399	3,407	137	822	1,749	2,708
2002	182	946	2,189	3,318	158	913	1,656	2,726
2003	286	1,278	2,004	3,567	241	1,234	1,452	2,927
2004	344	1,432	2,090	3,866	297	1,379	1,468	3,144

(a) Hong Kong dollar customer deposits include swap deposits.

TABLE L: GEOGRAPHICAL BREAKDOWN OF NET EXTERNAL CLAIMS/ (LIABILITIES) OF ALL AUTHORIZED INSTITUTIONS

(HK\$ bn) Region/Economy	2003			2004		
	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)
Asia & Pacific	411	(38)	373	573	(122)	451
Singapore	163	(38)	125	276	(48)	228
Japan	134	78	212	185	35	220
Australia	166	24	190	179	26	204
India	6	7	13	9	8	17
South Korea	24	16	40	(3)	20	17
New Zealand	14	3	17	12	1	13
Malaysia	13	8	21	(3)	14	11
Republic of Kazakhstan	0	0	0	0	0	1
Pakistan	(2)	0	(2)	0	0	0
Vietnam	(2)	(1)	(2)	0	(1)	(1)
Sri Lanka	0	0	0	(1)	0	(1)
Vanuatu	(1)	(1)	(2)	0	(1)	(1)
Western Samoa	0	0	0	0	(2)	(2)
Brunei	(1)	0	(1)	(3)	0	(3)
Indonesia	(4)	(3)	(7)	(3)	(3)	(5)
Philippines	(2)	(5)	(7)	(2)	(7)	(9)
Thailand	(5)	1	(4)	(12)	(1)	(13)
Taiwan	17	(42)	(25)	26	(57)	(31)
Macau SAR	(41)	(6)	(48)	(42)	(9)	(51)
Mainland China	(70)	(77)	(147)	(44)	(97)	(140)
Others	0	(1)	(2)	0	(1)	(1)
North America	141	125	266	121	131	252
United States	110	108	218	91	122	213
Canada	31	17	48	30	9	39
Caribbean	(10)	(57)	(67)	11	(39)	(27)
Bermuda	0	2	2	0	4	4
Panama	0	0	0	0	0	1
Netherlands Antilles	1	(6)	(5)	1	(6)	(5)
Bahamas	(2)	(3)	(6)	(8)	(6)	(14)
Cayman Islands	(9)	(46)	(55)	19	(38)	(19)
Others	0	(3)	(4)	0	7	6
Africa	0	(1)	(1)	(3)	(1)	(5)
South Africa	0	1	0	0	0	0
Liberia	0	(1)	(1)	0	(1)	(1)
Mauritius	1	0	0	(3)	(1)	(4)
Others	0	0	0	0	0	0

TABLE L: GEOGRAPHICAL BREAKDOWN OF NET EXTERNAL CLAIMS/ (LIABILITIES) OF ALL AUTHORIZED INSTITUTIONS (cont.)

(HK\$ bn) Region/Economy	2003			2004		
	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)
Latin America	1	(1)	(1)	2	(1)	0
Chile	0	1	1	0	1	1
Brazil	0	(1)	0	1	0	1
Venezuela	0	(1)	(1)	0	(1)	(1)
Others	0	0	0	0	0	0
Eastern Europe	(1)	1	(1)	1	0	1
Western Europe	668	65	733	790	43	833
United Kingdom	310	17	327	347	1	348
France	56	17	73	132	13	145
Netherlands	79	14	94	66	13	78
Belgium	24	2	26	39	1	40
Italy	25	6	31	32	7	40
Switzerland	38	(2)	36	39	(2)	36
Germany	46	3	49	24	4	29
Sweden	21	3	24	25	3	28
Norway	14	1	15	16	2	18
Luxembourg	10	0	10	17	0	17
Denmark	9	0	10	13	0	13
Austria	12	1	12	11	0	11
Republic of Ireland	14	1	15	11	1	11
Spain	4	1	5	9	0	9
Finland	6	0	6	5	0	5
Portugal	1	0	1	2	0	2
Iceland	1	0	1	2	0	2
Guernsey	0	0	0	(1)	2	1
Greece	(1)	1	0	(1)	1	1
Jersey	0	0	0	0	(1)	(1)
Others	(2)	(1)	(3)	1	(1)	0
Middle East	(2)	0	(2)	9	1	10
Bahrain	2	0	2	10	0	10
United Arab Emirates	(2)	0	(2)	1	1	1
Israel	(1)	0	(1)	0	0	0
Egypt	(1)	0	(1)	0	0	0
Iran	0	0	0	(1)	0	(1)
Others	0	0	0	0	0	0
Others^(a)	0	44	44	36	0	36
Overall Total	1,207	138	1,345	1,539	12	1,551

(a) "Others" include economies not listed in the above and position in relation to international organisations.

ABBREVIATIONS USED IN THIS REPORT

ABF	– Asian Bond Fund	GSBS	– CDC's Government Securities Book-Entry System
ABF1	– US dollar-denominated Asian Bond Fund	HIBOR	– Hong Kong Interbank Offer Rate
ABF2	– Local currency-denominated Asian Bond Fund	HK	– Hong Kong
ACC	– BIS Asian Consultative Council	HKAS	– Hong Kong Accounting Standard
ACIHK	– The Hong Kong Association of Banks – The Financial Markets Association of Hong Kong	HKICL	– Hong Kong Interbank Clearing Limited
ADF	– Asian Development Fund	HKMA	– Hong Kong Monetary Authority
AI	– Authorized institution	HKMC	– Hong Kong Mortgage Corporation
APEC	– Asia-Pacific Economic Co-operation	HKSAR	– Hong Kong Special Administrative Region
ASEAN5	– The Philippines, Malaysia, Indonesia, Singapore and Thailand	HKSSAP	– Hong Kong Statement of Standard Accounting Practice
ATM	– Automated teller machine	IAS	– International Accounting Standards
BCP	– Business continuity plan	IMF	– International Monetary Fund
BIS	– Bank for International Settlements	IPO	– Initial public offering
bn	– billion	IT	– Information technology
CAMEL	– Capital adequacy, Asset quality, Management, Earnings and Liquidity of banks	JETCO	– Joint Electronic Teller Company Limited
CBRC	– China Banking Regulatory Commission	MBS	– Mortgage-Backed Securities
CCASS	– Central Clearing and Settlement System	MDB	– Multilateral Development Bank
CCPI	– Composite Consumer Price Index	mn	– million
CCRA	– Commercial Credit Reference Agency	N.A.	– not applicable
CDC	– China Government Securities Depository Trust & Clearing Co. Ltd.	NAB	– New Arrangements to Borrow
CEPA	– Closer Economic Partnership Arrangement	NASDAQ	– National Association of Securities Dealers Automated Quotations system
CHATS	– Clearing House Automated Transfer System	NCD	– Negotiable certificate of deposit
CLS	– Continuous Linked Settlement	NDI	– Negotiable debt instrument
CMU	– Central Moneymarkets Unit	OECD	– Organisation for Economic Co-operation and Development
CPI	– Consumer Price Index	OGC	– The Office of the General Counsel
CSSO	– Clearing and Settlement Systems Ordinance	OTC	– Over the counter
DCA	– Debt collection agency	PAIF	– Pan-Asian Bond Index Fund
DPS	– Deposit Protection Scheme	PBoC	– People's Bank of China
DTC	– Deposit-taking Company	PvP	– Payment-versus-Payment
DvP	– Delivery-versus-Payment	RI	– Registered Institutions
e-banking	– Electronic banking	RLB	– Restricted Licence Bank
EFAC	– Exchange Fund Advisory Committee	RMB	– Renminbi
EFBN	– Exchange Fund Bills and Notes	RTGS	– Real Time Gross Settlement
ETF	– Exchange-Traded Fund	S&P 500	– Standard & Poor's 500
EMEAP	– Executives' Meeting of East Asia and Pacific Central Banks	SAR	– Special Administrative Region
EPS	– Easy Pay System	SDR	– Special Drawing Right
FATF	– Financial Action Task Force on Money Laundering	SEANZA	– Central Banking Group of South East Asia, New Zealand and Australia
FoBF	– Fund of Bond Funds	SFC	– Securities and Futures Commission
FSAP	– Financial Sector Assessment Programme	SFO	– Securities and Futures Ordinance
GDP	– Gross Domestic Product (in real terms unless otherwise stated)	SME	– Small and medium-sized enterprise
		SPM	– Supervisory Policy Manual
		SWIFT	– Society for Worldwide Interbank Financial Telecommunication
		TMF	– Treasury Markets Forum
		US	– United States of America

REFERENCE RESOURCES

The *HKMA Annual Report* is published in April or May each year. A number of other HKMA publications provide explanatory and background information on the HKMA's policies and functions. These include

HKMA Quarterly Bulletin

(published in March, June, September and December each year)

HKMA Monthly Statistical Bulletin (on-line publication)

(published in two batches on the third and sixth business days of each month)

Guide to Hong Kong Monetary and Banking Terms (Second Edition)

HKMA Background Brief No. 1 – Hong Kong's Linked Exchange Rate System

HKMA Background Brief No. 2 – Banking Supervision in Hong Kong

Money and Banking in Hong Kong: A Historical Timeline

Money in Hong Kong: A Brief Introduction

Educational leaflets on various topics including notes and coins and banking issues

HKMA publications may be purchased or obtained from the **HKMA Information Centre**, 55th Floor, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. The HKMA Information Centre consists of an Exhibition Area and a Library. The Centre introduces the work of the HKMA and houses books, journals and other texts on central banking and related subjects. The Centre is open to the public six days a week.

 > [The HKMA Information Centre](#)

Most HKMA publications are also available for download free of charge from the HKMA website (www.hkma.gov.hk). A mail order form for the purchase of print publications can be found on the website.

 > [Information Centre > Publications](#)

The main texts of the regular briefings by the HKMA to the Legislative Council Panel on Financial Affairs are available online.

 > [Information Centre > Legislative Council Issues](#)

The HKMA website contains detailed and extensive information on the whole range of the HKMA's work. This information includes press releases, statistics, speeches, guidelines and circulars, research memoranda, and features on topical issues.

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AN INTRODUCTION TO THE
HONG KONG MONETARY AUTHORITY
2005 EDITION



Incorporating the Summary Version of the HKMA Annual Report 2004



HONG KONG MONETARY AUTHORITY
香港金融管理局

THE HONG KONG MONETARY AUTHORITY

Established in April 1993, the Hong Kong Monetary Authority (HKMA) is the government authority in Hong Kong responsible for maintaining monetary and banking stability. The HKMA's policy objectives are

- to maintain currency stability, within the framework of the Linked Exchange Rate system, through sound management of the Exchange Fund, monetary policy operations and other means deemed necessary
- to promote the safety and stability of the banking system through the regulation of banking business and the business of taking deposits, and the supervision of authorized institutions
- to enhance the efficiency, integrity and development of the financial system, particularly payment and settlement arrangements.

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The first part of this booklet introduces the work and policies of the HKMA. The second part contains a summary of the HKMA's Annual Report for 2004. The full Annual Report is available on the HKMA website both in interactive form and on PDF files. Hard copies may also be purchased from the HKMA: see Reference Resources on page 47 for details.

This booklet makes reference to documents and other materials available on the HKMA website www.hkma.gov.hk. These references appear as  >, followed by navigation guidance from the HKMA homepage.

All amounts in this booklet are in Hong Kong dollars unless otherwise stated.

ABOUT THE HKMA

The Hong Kong Monetary Authority is Hong Kong's central banking institution. The HKMA has four main functions: maintaining the stability of the Hong Kong dollar; promoting the safety of Hong Kong's banking system; managing Hong Kong's official reserves; and maintaining and developing Hong Kong's financial infrastructure.

The HKMA'S legal mandate

The HKMA was established on 1 April 1993 by merging the Office of the Exchange Fund with the Office of the Commissioner of Banking. To enable the establishment of the HKMA, the Legislative Council passed amendments to the Exchange Fund Ordinance in 1992 empowering the Financial Secretary to appoint a Monetary Authority.

The powers, functions and responsibilities of the Monetary Authority are set out in the Exchange Fund Ordinance, the Banking Ordinance, the Deposit Protection Scheme Ordinance, the Clearing and Settlement Systems Ordinance and other relevant Ordinances. The division of functions and responsibilities in monetary and financial affairs between the Financial Secretary and the Monetary Authority is set out in an Exchange of Letters between the two dated 25 June 2003. This Exchange of Letters also discloses the delegations made by the Financial Secretary to the Monetary Authority under these Ordinances. The letters are public documents: copies of them may be found on the HKMA website.

The Exchange Fund Ordinance establishes the Exchange Fund under the control of the Financial Secretary. According to the

Ordinance, the Fund shall be used primarily for affecting the exchange value of the Hong Kong dollar. It may also be used for maintaining the stability and integrity of the monetary and financial systems of Hong Kong, with a view to maintaining Hong Kong as an international financial centre.

The Monetary Authority is appointed under the Exchange Fund Ordinance to assist the Financial Secretary in performing his functions under the Exchange Fund Ordinance and to perform such other functions as are assigned by other Ordinances or by the Financial Secretary. The office of the Monetary Authority is known as the HKMA, and the Monetary Authority as the Chief Executive of the HKMA.

The Banking Ordinance provides the Monetary Authority with the responsibility and powers for regulating and supervising banking business and the business of taking deposits. Under the Ordinance, the Monetary Authority is responsible, among other things, for the authorization of licensed banks, restricted licence banks, and deposit-taking institutions in Hong Kong.

The Clearing and Settlement Systems Ordinance provides a statutory regime for the Monetary Authority to designate and oversee clearing and settlement systems that are material to the monetary or financial stability

of Hong Kong or to the functioning of Hong Kong as an international financial centre.

Under the Deposit Protection Scheme Ordinance the Monetary Authority is charged with implementing the decisions of the Hong Kong Deposit Protection Board, and among other things, deciding whether compensation should be paid to the depositors of a failed scheme bank pursuant to the Ordinance.

 > [About the HKMA](#) > [The HKMA](#) > [Who we are](#)

The HKMA and the Hong Kong SAR Government

The HKMA is an integral part of the Hong Kong SAR Government, but is able to employ staff on terms different from those of the civil service in order to attract personnel of the right experience and expertise. The Chief Executive of the HKMA remains a public officer, as do his staff. In its day-to-day work the HKMA operates with a high degree of autonomy within the relevant statutory powers conferred upon, or delegated to, the Monetary Authority.

The Financial Secretary is responsible for determining the monetary policy objective and the structure of the monetary system of Hong Kong: a letter from the Financial Secretary to the Monetary Authority dated 25 June 2003 specifies that these should be currency stability defined as a stable exchange value at around HK\$7.80 to one US dollar maintained by Currency Board arrangements. The Monetary Authority is on his own responsible for achieving the monetary policy objective, including determining the strategy, instruments and operational means for doing so. He is also responsible for maintaining the stability and integrity of the monetary system of Hong Kong.

The Financial Secretary, assisted by the Secretary for Financial Services and the Treasury, has responsibility for policies for maintaining the stability and integrity of Hong Kong's financial system and the status of Hong Kong as an international financial centre. In support of these policies, the Monetary Authority is responsible, among other things, for

- promoting the general stability and effective working of the banking system
- promoting the development of the debt market, in co-operation with other relevant bodies
- matters relating to the issuance and circulation of legal tender notes and coins
- promoting the safety and efficiency of the financial infrastructure through the development of payment, clearing and settlement systems and, where appropriate, the operation of these systems
- seeking to promote, in co-operation with other relevant bodies, confidence in Hong Kong's monetary and financial systems, and appropriate market development initiatives to help strengthen the international competitiveness of Hong Kong's financial services.

The Exchange Fund is under the control of the Financial Secretary. The Monetary Authority, under delegation from the Financial Secretary, is responsible to the Financial Secretary for the use of the Exchange Fund, and for the investment management of the Fund.

 > [About the HKMA](#) > [The HKMA](#) > [Who we are](#)

Accountability and transparency

The autonomy given to the HKMA in its day-to-day operations, and in the methods it uses to pursue policy objectives determined by the Government, is complemented by a high degree of accountability and transparency.

The HKMA serves Hong Kong by promoting monetary and banking stability, by managing the official reserves effectively, and by developing and overseeing a robust and diverse financial infrastructure. These processes help to strengthen Hong Kong's role as an international financial centre and to foster Hong Kong's economic well-being. The HKMA must have the confidence of the community if it is to perform its duties well. The HKMA therefore takes seriously the duty of explaining its policies and work to the general public and makes every effort to address any concerns within the community relevant to the HKMA's responsibilities.

The HKMA is accountable to the people of Hong Kong through the Financial Secretary, who appoints the Monetary Authority, and through the laws passed by the Legislative Council that set out the Monetary Authority's powers and responsibilities. The HKMA also recognises a broader responsibility to promote a better understanding of its roles and objectives and to keep itself informed of community concerns. In its day-to-day operations and in its wider contacts with the community, the HKMA pursues a policy of transparency and accessibility. This policy has two main objectives:

- to keep the financial industry and the public as fully informed about the work of the HKMA as possible, subject to considerations of market sensitivity, commercial confidentiality and statutory restrictions on disclosure of confidential information
- to ensure that the HKMA is in touch with, and responsive to, the community it serves.

The HKMA seeks to follow international best practices in its transparency arrangements. It maintains extensive relations with the mass media and produces a range of regular and special publications in both English and Chinese. The HKMA's bilingual website (www.hkma.gov.hk) carries all HKMA publications, press releases, speeches and presentations, in addition to special sections on research, statistics, consumer information and other topics. The HKMA maintains an Information Centre at its offices, consisting of a library and an exhibition area, which is open to the public six days a week. The HKMA also organises an annual public education programme, which seeks to inform the public, and in particular students, about the work of the HKMA through seminars and guided tours at the Information Centre. The HKMA's weekly *Viewpoint* column, carried on the HKMA website and in several Hong Kong newspapers, informs the public about aspects of the HKMA's work. Further information on the HKMA's media work, publications and public education programmes is contained in the Chapter on Professional and Corporate Services in the full Annual Report.

 > Viewpoint

 > HKMA Information Centre

Over the years the HKMA has progressively increased the detail and frequency of its disclosure of information on the Exchange Fund and Currency Board Accounts. Since 1999 the HKMA has participated in the International Monetary Fund's Special Data Dissemination Standard project for central banks. The HKMA publishes records of meetings of the Exchange Fund Advisory Committee Currency Board Sub-Committee, along with the monthly reports on Currency Board operations. The supervisory policies and guidelines on banking have been published on the website since 1996.

 > [Information Centre > Press Releases > Exchange Fund](#)

 > [Policy Areas > Supervisory Policy Manual](#)

The relations between the HKMA and the Legislative Council play an important part in the process of accountability and transparency. There is a formal commitment from the Chief Executive of the HKMA to appear before the Legislative Council 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. In addition, staff from 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.

 > [Information Centre > Legislative Council Issues](#)

Advisory and other committees

Exchange Fund Advisory Committee

In his control of the Exchange Fund, the Financial Secretary is advised by the Exchange Fund Advisory Committee (EFAC). EFAC is established under Section 3(1) of the Exchange Fund Ordinance, which requires the Financial Secretary to consult the Committee in his exercise of control of the Exchange Fund. The Financial Secretary is ex officio Chairman of EFAC. Other members, including the Monetary Authority, are appointed in a personal capacity by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong SAR. Members of EFAC are appointed for the expertise and experience that they can bring to the committee. Such expertise and experience includes knowledge of monetary, financial and economic affairs and of investment issues, as well as of accounting, management, business and legal matters.

EFAC advises the Financial Secretary on investment policies and strategies for the Fund and on projects, such as the development of financial infrastructure, that are charged to the Fund. Since the operating and staff costs of the HKMA are also chargeable to the Exchange Fund, EFAC advises the Financial Secretary on the HKMA's annual administration budget and on the terms and conditions of service of HKMA staff. EFAC meets regularly and on other occasions when particular advice is being sought.

Membership (1 April 2005)

Chairman

The Hon. Henry Tang Ying Yen, GBS, JP
The Financial Secretary

Members

Mr Joseph Yam, GBS, JP
The Monetary Authority

Dr The Hon. David Li Kwok Po, LLD, GBS, JP
Chairman and Chief Executive
The Bank of East Asia Limited

Mr Marvin Cheung Kin Tung, DBA Hon., SBS, JP

Mr David Eldon, GBS, JP
Chairman
The Hongkong and Shanghai Banking Corporation Limited

Professor Richard Y C Wong, SBS, JP
Deputy Vice-Chancellor
The University of Hong Kong

Mr Christopher Cheng Wai Chee, GBS, JP
Chairman
USI Holdings Limited

Mr Victor Lo Chung Wing, GBS, JP
Chairman and Chief Executive
Gold Peak Industries (Holdings) Limited

Dr Patrick Wang Shui Chung, JP
Chairman and Chief Executive Officer
Johnson Electric Holdings Limited

Mr He Guangbei
Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited

Professor K C Chan
Dean of Business and Management
Hong Kong University of Science and Technology

Mr Henry Fan Hung-ling, SBS, JP
Managing Director
CITIC Pacific Limited

Mr Simon Ip Sik-on, JP

Mr Thomas Kwok Ping-kwong, JP
Vice-Chairman and Managing Director
Sun Hung Kai Properties Limited

Mr Peter Sullivan
Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited

Secretary

Mr Christopher Munn

EFAC is assisted in its work by five sub-committees, which monitor specific areas of the HKMA's work and report and make recommendations to the Financial Secretary through EFAC.

The **Governance Sub-Committee** monitors the performance of the HKMA and makes recommendations on remuneration and human resources policies, and on budgetary, administrative and governance issues.

Membership (1 April 2005)

Chairman

Mr Marvin Cheung Kin Tung, DBA Hon., SBS, JP

Members

Professor Richard Y C Wong, SBS, JP
Deputy Vice-Chancellor
The University of Hong Kong

Mr Christopher Cheng Wai Chee, GBS, JP
Chairman
USI Holdings Limited

Mr Victor Lo Chung Wing, GBS, JP
Chairman and Chief Executive
Gold Peak Industries (Holdings) Limited

Dr Patrick Wang Shui Chung, JP
Chairman and Chief Executive Officer
Johnson Electric Holdings Limited

Professor K C Chan
Dean of Business and Management
Hong Kong University of Science and Technology

Mr Henry Fan Hung-ling, SBS, JP
Managing Director
CITIC Pacific Limited

Mr Simon Ip Sik-on, JP

Mr Thomas Kwok Ping-kwong, JP
Vice-Chairman and Managing Director
Sun Hung Kai Properties Limited

Secretary

Mr Christopher Munn

The **Audit Sub-Committee** reviews and reports on the HKMA's financial reporting process and the adequacy and effectiveness of the internal control systems of the HKMA. The Sub-Committee reviews the HKMA's financial statements, and the composition and accounting principles adopted in such statements. It also examines and reviews with both the external and internal auditors the scope and results of their audits.

Membership (1 April 2005)

Chairman

Mr Marvin Cheung Kin Tung, DBA Hon., SBS, JP

Members

Mr David Eldon, GBS, JP

Chairman

The Hongkong and Shanghai Banking Corporation Limited

Mr He Guangbei

Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited

Mr Peter Sullivan

Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited

Dr The Hon. David Li Kwok Po, LLD, GBS, JP

Chairman and Chief Executive
The Bank of East Asia Limited

Secretary

Mr Christopher Munn

The **Currency Board Sub-Committee** monitors and reports on the Currency Board arrangements that underpin Hong Kong's Linked Exchange Rate system. It is responsible, among other things, for ensuring that Currency Board operations are in accordance with established policy, recommending improvements to the Currency Board system, and ensuring a high degree of transparency in

the operation of the system. Records of the Sub-Committee's meetings and the reports on Currency Board operations submitted monthly to the Sub-Committee are published.



[Information Centre](#) > [Press Releases](#) > [Monetary Policy](#)

Membership (1 April 2005)

Chairman

Mr Joseph Yam, GBS, JP

The Monetary Authority

Members

Mr Norman Chan, SBS, JP

Deputy Chief Executive

Hong Kong Monetary Authority

Mr William Ryback, JP

Deputy Chief Executive

Hong Kong Monetary Authority

Mr Peter Pang, JP

Deputy Chief Executive

Hong Kong Monetary Authority

Dr The Hon. David Li Kwok Po, LLD, GBS, JP

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Professor Richard Y C Wong, SBS, JP

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The University of Hong Kong

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Group Chief Economist

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Professor K C Chan

Dean of Business and Management

Hong Kong University of Science and Technology

Mr He Guangbei

Chairman

The Hong Kong Association of Banks

Secretary

Mr Christopher Munn

The **Investment Sub-Committee** monitors the HKMA's investment management work and makes recommendations on the investment policy and strategy of the Exchange Fund and on risk management and other related matters.

Membership (1 April 2005)

Chairman

Mr Joseph Yam, GBS, JP
The Monetary Authority

Members

Mr Norman Chan, SBS, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr David Eldon, GBS, JP
Chairman
The Hongkong and Shanghai Banking Corporation Limited

Mr Christopher Cheng Wai Chee, GBS, JP
Chairman
USI Holdings Limited

Mr He Guangbei
Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited

Professor K C Chan
Dean of Business and Management
Hong Kong University of Science and Technology

Mr Henry Fan Hung-ling, SBS, JP
Managing Director
CITIC Pacific Limited

Mr Peter Sullivan
Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited

Secretary

Mr Christopher Munn

The **Financial Infrastructure Sub-Committee** monitors the work of the HKMA in relation to the development and operation of the financial infrastructure in Hong Kong and makes recommendations on measures and initiatives relating to the HKMA's responsibilities for promoting the safety, efficiency and development of Hong Kong's financial infrastructure.

Membership (1 April 2005)

Chairman

Mr Joseph Yam, GBS, JP
The Monetary Authority

Members

Mr Norman Chan, SBS, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr Peter Pang, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Dr The Hon. David Li Kwok Po, LLD, GBS, JP
Chairman and Chief Executive
The Bank of East Asia Limited

Mr David Eldon, GBS, JP
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Mr Henry Fan Hung-ling, SBS, JP
Managing Director
CITIC Pacific Limited

Mr Peter Sullivan
Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited

Secretary

Mr Christopher Munn

The Banking Advisory Committee

The Banking Advisory Committee is established under Section 4(1) of the Banking Ordinance to advise the Chief Executive of the Hong Kong SAR on matters relating to the Banking Ordinance, in particular matters relating to banks and the carrying on of banking business. The Committee consists of the Financial Secretary, who is the Chairman, the Monetary Authority, and other persons appointed by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong SAR.

Membership (1 April 2005)

Chairman

The Hon. Henry Tang Ying Yen, GBS, JP
The Financial Secretary

Ex Officio Member

Mr Joseph Yam, GBS, JP
The Monetary Authority

Members

The Hon. Frederick Ma Si Hang, JP
Secretary for Financial Services and the Treasury

Mr He Guangbei
Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited
Representing Bank of China (Hong Kong) Limited

Mr Peter Wong Tung-shun, JP
Executive Director
The Hongkong and Shanghai Banking Corporation Limited
Representing The Hongkong and Shanghai Banking Corporation Limited

Mr Peter Sullivan
Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited
Representing Standard Chartered Bank (Hong Kong) Limited

Mrs Mignonne Cheng
Head of North and East Asia
BNP Paribas

Mrs Chan Hui Dor Lam Doreen

President and Chief Executive Officer
Citic Ka Wah Bank Limited

Mrs Angelina P L Lee, JP

Partner
Woo, Kwan, Lee & Lo
Solicitors and Notaries

Dr The Hon. David Li Kwok Po, LLD, GBS, JP

Chairman and Chief Executive
The Bank of East Asia Limited

Mr Tatsuo Tanaka

Managing Director and Chief Executive Officer for China
The Bank of Tokyo-Mitsubishi, Ltd

Mr Samuel N Tsien

President and Chief Executive Officer
Bank of America (Asia) Limited

Mr David S Y Wong, JP

Chairman
Dah Sing Bank Limited

Ms Maria Xuereb

Financial Services Partner
Deloitte Touche Tohmatsu

Secretary

Ms Ida Liu

The Deposit-Taking Companies Advisory Committee

The Deposit-Taking Companies Advisory Committee is established under Section 5(1) of the Banking Ordinance to advise the Chief Executive of the Hong Kong SAR on matters relating to the Banking Ordinance, in particular matters relating to deposit taking companies and restricted licence banks and the carrying on of a business of taking deposits by them. The Committee consists of the Financial Secretary, who is the Chairman, the Monetary Authority, and other persons appointed by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong SAR.

Membership (1 April 2005)

Chairman

The Hon. Henry Tang Ying Yen, GBS, JP
The Financial Secretary

Ex Officio Member

Mr Joseph Yam, GBS, JP
The Monetary Authority

Members

The Hon. Frederick Ma Si Hang, JP
Secretary for Financial Services and the Treasury

Mr Andrew Sheng, SBS, JP
Chairman
Securities and Futures Commission
Representing The Securities and Futures Commission

Mrs Pamela Chan Wong Shui, BBS, JP
Chief Executive
Consumer Council
Representing The Consumer Council

Mr Clifford Forster
Chairman
Hong Kong Association of Restricted Licence Banks and
Deposit-Taking Companies (The DTC Association)
Representing The DTC Association

Mr Mervyn Jacob
Partner
Financial Services Division
PricewaterhouseCoopers

Mr Andrew Kuo
Managing Director
JP Morgan Securities (Asia Pacific) Limited

Dr Eric K C Li, GBS, JP
Senior Partner
Li, Tang, Chen & Co
Certified Public Accountants (Practising)

Mr Geoffrey J Mansfield
Managing Director
PrimeCredit Limited

Mr Mok Wai-kin
Director
Hang Seng Finance Limited

Mr Poon Kwok Yuen
President and Chief Executive Officer
AIG Finance (Hong Kong) Limited

Mr Tan Yoke Kong
General Manager
JCG Finance Company, Limited

Mr Frank J Wang
Director and Deputy Chief Executive
Wing Hang Finance Company Limited

Secretary

Ms Ida Liu

Chief Executive's Committee

The Chief Executive's Committee is chaired by the Chief Executive of the HKMA and consists of the Deputy Chief Executives and the Executive Directors of the HKMA. The Committee meets weekly to report to the Chief Executive on the progress of major tasks being undertaken by the various departments of the HKMA and to advise him on policy matters relating to the operations of the HKMA.

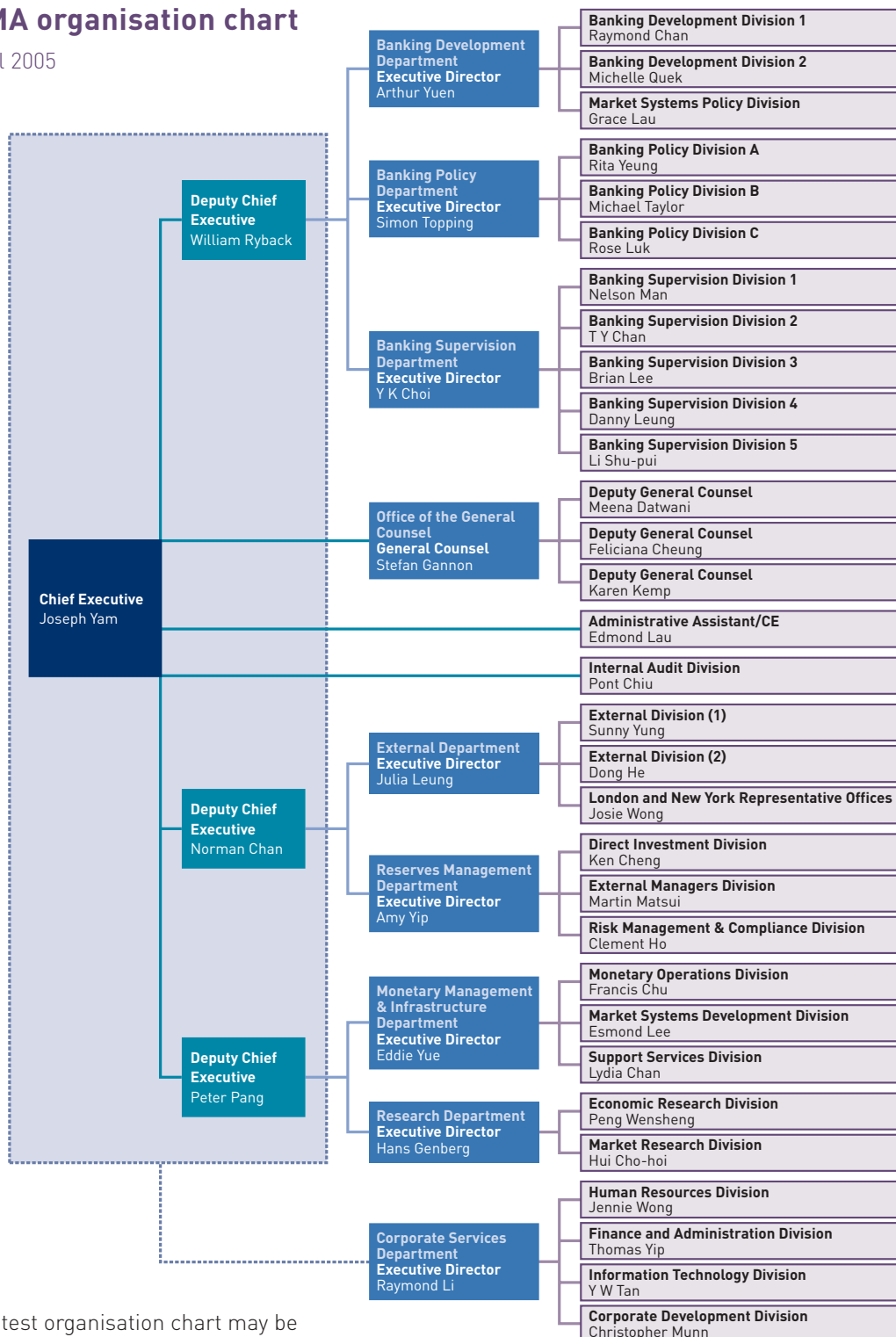
The membership lists of the various Committees and Sub-Committees, brief biographies, and the Code of Conduct for EFAC Members may be found on the HKMA website. A Register of Members' Interests, which contains the declarations of interests by Members of EFAC, is available for public inspection during office hours (9:00 a.m. to 5:00 p.m. Monday to Friday and 9:00 a.m. to 12 noon Saturday) at the HKMA Offices, 55th Floor, Two International Finance Centre, 8 Finance Street, Central, Hong Kong.

 > [About the HKMA](#) > [The HKMA](#) > [Advisory Committees](#)

 > [About the HKMA](#) > [The HKMA](#) > [The Chief Executive's Committee](#)

HKMA organisation chart

1 April 2005



The latest organisation chart may be found on the HKMA website.

 > About the HKMA > The HKMA > Organisation Chart

MAINTAINING MONETARY STABILITY

The Linked Exchange Rate system

The monetary policy objective of Hong Kong is currency stability. This is defined as a stable external exchange value of the Hong Kong dollar in terms of its exchange rate against the US dollar at around HK\$7.80 to one US dollar. The monetary policy objective is achieved through the Linked Exchange Rate system, which has been implemented since 17 October 1983. The Linked Exchange Rate system plays an important part in supporting Hong Kong's role as a trading, service and financial centre.

The Currency Board system

Exchange rate stability in Hong Kong is achieved through a Currency Board system. The Monetary Base is consequently fully backed by foreign currency reserves at the fixed exchange rate of HK\$7.80 to US\$1. Under the Currency Board system, any change in the Monetary Base must be fully matched by corresponding changes in foreign currency reserves.

Hong Kong's Monetary Base consists of four components:

- Certificates of Indebtedness, which back the banknotes issued by the three note-issuing banks
- government-issued currency notes and coins in circulation
- the sum of the balances on the clearing accounts maintained by banks with the HKMA (known as the Aggregate Balance)
- Exchange Fund Bills and Notes, which are issued by the HKMA to facilitate liquidity management by banks.

Under the Currency Board system, the stability of the Hong Kong dollar exchange rate is maintained through an interest rate adjustment mechanism.

In recent years the Currency Board system has been strengthened to make it more transparent and resilient to external shocks. In particular, the HKMA has provided a clear undertaking to all banks to convert their Hong Kong dollar clearing balances into US dollars at the convertibility rate of HK\$7.80.



[Policy Areas > Monetary Stability > Currency Board System](#)

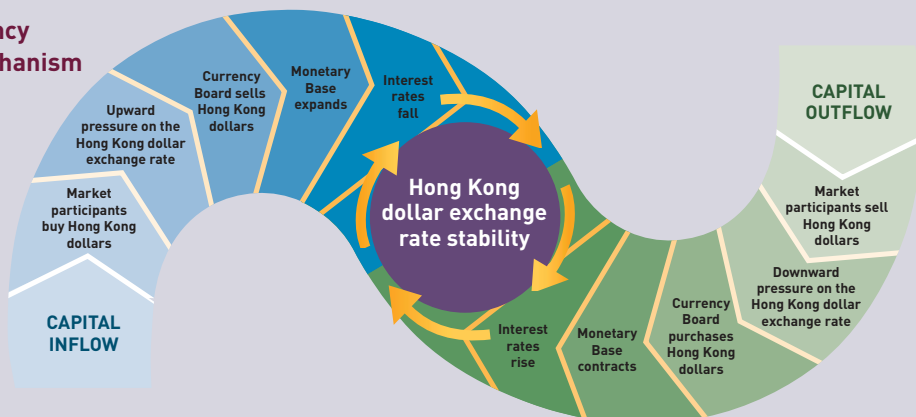


Further reading:

[HKMA Background Brief No.1 – Hong Kong's Linked Exchange Rate System](#)

[HKMA Annual Report 2004: Monetary Stability chapter](#)

The Currency Board mechanism



PROMOTING BANKING SAFETY



The principal function of the HKMA as banking supervisor is to promote the general stability and effective working of the banking system in Hong Kong. The HKMA seeks to ensure that banks and deposit-taking companies in Hong Kong operate in an effective, responsible, honest and business-like manner to provide a measure of protection to depositors. The HKMA derives its powers as banking supervisor from the Banking Ordinance.

The three tiers of banking in Hong Kong

Hong Kong's banks are divided into three tiers of authorized institutions (AIs). The main distinctions lie in the deposit business each tier of institution is allowed to conduct under the Banking Ordinance.

The HKMA is the licensing authority for AIs under the Banking Ordinance. The HKMA's supervisory approach is based on a policy of

continuous supervision. This involves continuous monitoring of AIs through the use of a variety of techniques, including on-site examinations, off-site reviews, prudential meetings, meetings with boards of directors, co-operation with external auditors, and sharing of information with other supervisors. The aim is to try to ensure that any problems affecting AIs are detected and addressed at an early stage.

The HKMA uses a risk-based supervisory approach to ensure that AIs have the necessary risk management systems in place to identify, measure, monitor and control the risks inherent in their operations. This enables the HKMA to be more proactive in taking actions to pre-empt any serious threat to the stability of the banking system.



> Policy Areas > Banking Stability



Further reading:

HKMA Background Brief No.2 – Banking Supervision in Hong Kong
HKMA Annual Report 2004: Banking Stability chapter

Three tiers of authorized institutions	Deposit business permitted
Licensed banks	<ul style="list-style-type: none">• Current accounts, savings deposits and time deposits of any size and maturity
Restricted licence banks	<ul style="list-style-type: none">• Time deposits of HK\$500,000 or more for any maturity• Savings and current accounts are not permitted
Deposit-taking companies	<ul style="list-style-type: none">• Time deposits of HK\$100,000 or more for at least three months• Savings and current accounts are not permitted



MANAGING THE EXCHANGE FUND

The Exchange Fund

Established in 1935, the Exchange Fund is the cornerstone of monetary stability in Hong Kong. Its primary objective is to safeguard the exchange value of the Hong Kong dollar. Hong Kong's foreign currency reserves, held in the Exchange Fund, form the backing for the Linked Exchange Rate system.

The Exchange Fund is managed by the HKMA under powers delegated by the Financial Secretary to the Monetary Authority under the Exchange Fund Ordinance. The Exchange Fund Advisory Committee advises the Financial Secretary, as Controller of the Fund, on the investment policies and strategies for the Fund.

Investment objectives

The investment objectives of the Exchange Fund are

- (a) to preserve capital;
- (b) to ensure that the entire Monetary Base at all times will be fully backed by highly liquid short-term US dollar denominated securities;
- (c) to ensure sufficient liquidity for the purpose of maintaining monetary and financial stability; and
- (d) subject to (a) – (c) above, to achieve an investment return that will preserve the long-term purchasing power of the assets.

Investment process

The Exchange Fund is managed as two main portfolios – the Backing Portfolio and the Investment Portfolio. The Backing Portfolio is used to back the Monetary Base of Hong Kong. The Investment Portfolio is used to preserve the value and long-term purchasing power of assets.

The long-term asset allocation strategy of the Fund is governed by the investment benchmark, which is set by the Exchange Fund Advisory Committee. This defines the allocation of investments to different asset classes by country and by sector as well as the overall currency mix for the Fund.

Use of external managers

The Exchange Fund employs global external managers to manage about one third of its total assets and all of its equity portfolios. The purpose of appointing external managers is to tap the best of the investment expertise available in the market, to capture a diverse mix of investment style within the global investment field, and to transfer market knowledge and information.



> [Policy Areas](#) > [Monetary Stability](#) > [Exchange Fund](#)



Further reading:

[HKMA Annual Report 2004: Reserves Management chapter](#)

DEVELOPING FINANCIAL INFRASTRUCTURE



Policy objective

The HKMA is committed to promoting a safe, efficient and reliable financial market infrastructure to help maintain Hong Kong's status as an international financial centre. The HKMA oversees the operation of important clearing and settlement systems in Hong Kong under the Clearing and Settlement Systems Ordinance. It also assumes a leading role in developing financial market infrastructure to accommodate the evolving needs of Hong Kong. The HKMA pays particular attention to fostering the local and regional debt markets and developing clearing systems to facilitate cross-border transfers of funds and securities. The long-term aim is for Hong Kong to be a leading centre of financial intermediation, where all types of financial transactions, initiated from whatever location or time zone and in whatever currency, whether at the wholesale or retail level, can be executed and settled in real time.

Payment systems in Hong Kong

Since 1996, interbank funds transfers have been settled real-time through the Hong Kong dollar Real Time Gross Settlement (RTGS) system – the Clearing House Automated Transfer System (CHATS). This means that payment is processed continuously and that finality of settlement is instantaneous. The advantages are speed, efficiency and safety.

On an average business day around 407 billion Hong Kong dollars worth of transactions are settled through Hong Kong's RTGS system. Every year, the total turnover through this system amounts to some 102 trillion Hong Kong dollars, which is equivalent to more than 80 times Hong Kong's annual gross domestic product. The system processes the larger transactions between banks arising from the money and capital markets. It also handles smaller retail payment items, such as cheque and autopay transactions.

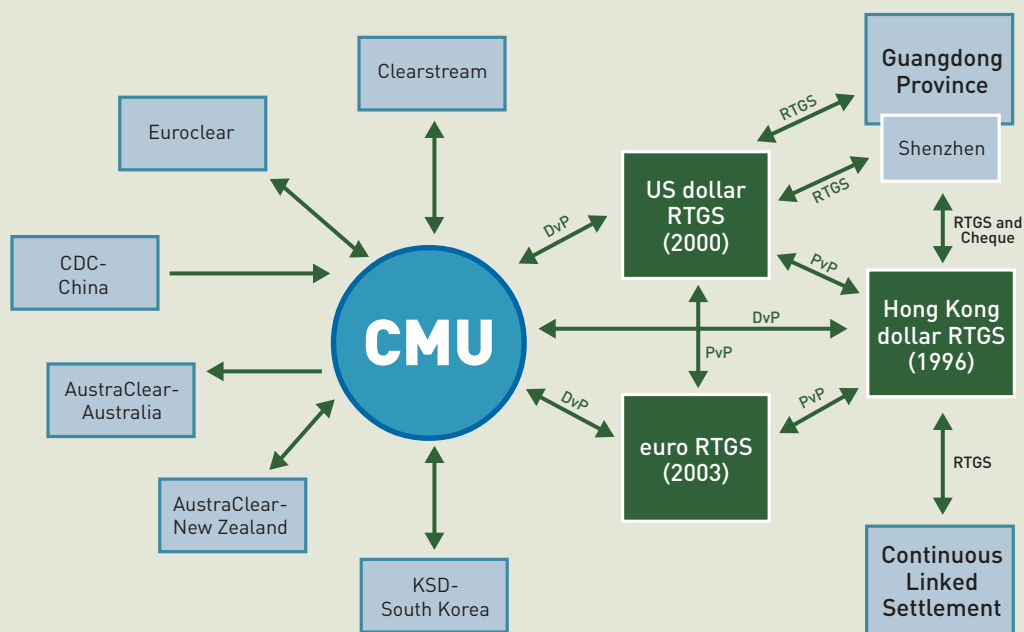
Building on the technology of the Hong Kong dollar RTGS system, the HKMA introduced a US dollar RTGS system in 2000 and a euro RTGS system in 2003.

Central Moneymarkets Unit

The Central Moneymarkets Unit (CMU), operated by the HKMA, provides an efficient clearing, settlement and depository service for both Hong Kong dollar and other international debt securities. Since its establishment in 1990 the CMU has developed external linkages with other regional and international central securities depositories. Through these links, overseas investors can hold and settle securities lodged with the CMU.

Hong Kong's financial infrastructure

(clearing and settlement systems for funds and securities operated, developed or overseen by the HKMA)



Delivery-versus-Payment (DvP): A securities delivery arrangement in which the delivery of securities takes place as soon as payment is made for them and confirmed final and irrevocable.

Payment-versus-Payment (PvP): A mechanism for settling a foreign exchange transaction to ensure that a final transfer of one currency occurs only if the corresponding final transfer of the other currency or currencies also takes place at the same time.



> Policy Areas > Financial Infrastructure



Further reading:
HKMA Annual Report 2004: Market Infrastructure chapter



REVIEW OF 2004

Summary Version of the
HKMA Annual Report 2004

CHIEF EXECUTIVE'S STATEMENT



broad and sustained recovery

The economic recovery that began in Hong Kong in the second half of 2003 broadened and deepened in 2004. Real Gross Domestic Product grew by 8.1%, more than double the growth in 2003. Exports of goods and services grew at the highest rate in four years, and domestic consumption continued to recover. Asset markets were buoyant during the year, and the steady recovery in the property market helped bring down further the number of residential mortgages in negative equity. The unemployment rate declined from a high of 8.6% in the middle of 2003 to 6.5% in the fourth quarter of the year: this is still high by historical standards, but it should be weighed against the large number of people entering the labour market and the considerable increase in total employment, which reached a record high of 3.3 million in the last quarter of 2004.

Strong global growth, though moderating in the second half of the year, helped fuel Hong Kong's economic recovery. While the demand for goods and services from Hong Kong increased worldwide, particularly in Europe and the Asian region, it is the vitality of the Chinese economy that has continued to be the most important engine of growth in Hong

unsettled markets

Kong. Growing numbers of visitors to Hong Kong from the Mainland boosted income from tourism. The expansion in Mainland China's external trade continued to reinforce Hong Kong's offshore trade and exports of services. Within Hong Kong, deflation came to an end, although inflation has not yet returned. Interest rates remained low. These favourable conditions, combined with a more optimistic mood in the community and among businesses, have encouraged greater private spending on consumption and investment. Economically speaking, Hong Kong had a very good year in 2004: in the absence of any unforeseen crisis, there are good reasons for expecting that the healthy and sustained progress made during the year will continue, although growth may be at a more moderate pace.

In contrast to the largely stable growth in the economy in general, financial markets in 2004 were unsettled. Equity markets throughout the world were volatile. Bond markets retreated on fears of rapid upward adjustments in US interest rates to more "normal" levels. In currency markets, the depreciation of the US dollar against other major currencies, combined with massive fund flows into Hong Kong, had a complex impact on the Hong Kong economy and presented challenges for the HKMA across its various policy areas.

The challenge in reserves management was to achieve the investment objectives of the Exchange Fund in a difficult and volatile environment. Since the Exchange Fund provides the backing for the Monetary Base and safeguards the exchange value of the Hong Kong dollar, these objectives place particular emphasis on capital preservation and high liquidity: they differentiate the Exchange Fund from many ordinary investment funds, which tend to seek maximum investment return. Despite the roller-coaster markets, and the constraints imposed by the investment objectives, the Exchange Fund earned an investment income of \$56.7 billion in 2004, and a rate of return meeting that of the investment benchmark set by the Financial Secretary on the advice of the Exchange Fund Advisory Committee. The share of investment income going to the fiscal reserves placed with the Exchange Fund was \$14.5 billion, which was \$2.2 billion more than the projected amount included in the Government's budget for the fiscal year.

Hong Kong dollar stability

The decline in the exchange value of the US dollar by a cumulative 4.6% in 2004 contributed, through the Linked Exchange Rate system, to a further decline in the effective exchange value of the Hong Kong dollar – and therefore to Hong Kong's competitiveness. An improving economy, greatly increased IPO activities, and continued market expectations of a possible revaluation of the renminbi attracted large inflows of funds into Hong Kong. These inflows supported strong liquidity in the banking system, particularly in the first and last quarters. As a result, Hong Kong dollar interest rates continued to be substantially lower than their US dollar counterparts, with differentials widening in the last quarter: short-term Hong Kong dollar interest rates rose by only about 20 basis points during the year, despite the cumulative increase of 125 basis points in the US rates.

The Hong Kong dollar stayed close to its official Linked Rate of 7.8 to the US dollar throughout the year, despite the massive fund flows, persistent speculation about a renminbi revaluation, and the decline in the US dollar. The strengthening episode that began in September 2003 worked itself out in the first four months of 2004 as the HKMA sold Hong Kong dollars in response to requests from banks. During the middle months of the year the dollar closely tracked the official rate, with repeated triggerings of the Convertibility Undertaking and the purchase of a total of \$51.5 billion worth of Hong Kong dollars by the HKMA. As a result, the Aggregate Balance declined from nearly \$55 billion in February to \$3.2 billion in September, only to begin rising again in October, as the Hong Kong dollar began to strengthen again on fund inflows and renewed renminbi speculation.

The wide variation in the size of the Aggregate Balance during 2004 and the considerable activity on both the strong and weak sides of the Linked Exchange Rate offer a lively illustration of the workings of the Currency Board system, which continues to deliver exchange rate stability for Hong Kong.

strong and effective banks

Despite a continuing squeeze on interest margins, largely as a result of the ample liquidity in the banking system, Hong Kong's banking sector saw an average 20% increase in profitability in 2004. All other main indicators showed improvement, reflecting better economic conditions and increased economic activity. Overall asset quality improved. The classified loan ratio declined. The consolidated capital adequacy ratio

of local authorized institutions remained high, at almost 16%, nearly twice the statutory minimum requirement of 8%. Loans to all sectors, particularly business, increased.

Following the full implementation of risk-based supervision in 2003, the HKMA used its supervisory resources in 2004 to focus intensively on areas of business, which, for one reason or another, might give rise to concern. Focused examinations took place of residential mortgage loans, in view of the increased competition, and of risk management and other practices in credit card business. The HKMA continued to improve the supervisory framework for preventing money laundering and terrorist financing, taking into account the latest international developments. Special emphasis was placed on banks' business continuity planning, particularly in the light of the growing dependence on technology of both banks and their customers.

A source of concern during the year was the question of the safety of banking through electronic channels. Prompt actions by the banks, the police and the HKMA early in the year helped lessen the risk of ATM frauds through tampering with machines. Internet banking fraud, however, has become a growing concern in Hong Kong, as in other parts of the world. The HKMA, together with the police and the banks, has placed particular emphasis on tackling this problem both through promoting public awareness of good security practices and through improving security-enhancing technology: by mid-2005 two-factor authentication will be introduced for high-risk Internet transactions by banks in Hong Kong providing Internet services.

The banking sector reform programme, initiated in 1999, entered its final stages in 2004 with the launch of the Commercial Credit Reference Agency in November and the enactment of the Deposit Protection Scheme Ordinance in May. The Hong Kong Deposit Protection Board was established in July, and it has since then been working on detailed plans for implementing the scheme in the second half of 2006, if prevailing conditions at the time are suitable.

As the reform programme draws to a successful conclusion, another important set of reforms involving the banking sector moves closer. In June the Basel Committee issued its revised framework on capital adequacy standards for banks, or "Basel II" as it is now usually known.

**developing Hong
Kong as an
international
financial centre**

Basel II will make capital requirements more risk-sensitive, and will bring banking regulation more into line with the way that banks themselves perceive and manage risk. It will also give banks the incentive to continue to strengthen and improve their own risk management. Good progress was made in 2004 in planning for the implementation of Basel II in Hong Kong. The aim is to switch over to Basel II at the start of 2007, in line with the approach being adopted in other major international financial centres, and of the Basel Committee members themselves. We see value in being among the first in adopting Basel II, not only because of its intrinsic merits, but also because Hong Kong has one of the highest concentrations of banking institutions in the world, with a strong presence of international banking groups.

Being among the first banking centres to implement Basel II will help maintain Hong Kong's position as an international financial centre. Other initiatives taken during the year have also helped bolster this position. Thirty-eight banks in Hong Kong began offering personal renminbi deposit, remittance and exchange services during 2004. Renminbi business grew steadily during the year: at the end of December outstanding renminbi deposits in banks in Hong Kong stood at more than RMB12 billion yuan. Clearly, there is a demand for these facilities in Hong Kong, despite the modest range of services currently available: this is not surprising, given the growing integration between the Hong Kong and Mainland economies, and the considerable surge in tourists from the Mainland during the year. Since the renminbi is not yet a freely convertible currency, future development of renminbi banking business in Hong Kong will by necessity be done in a gradual and cautious way. Discussions are in progress to explore how future development may proceed, taking into account the three strategic directions outlined by the Financial Secretary in August: diversification of renminbi assets and liabilities; denomination and settlement of trade in renminbi; and debt issuance in renminbi.

Hong Kong's position as an international financial centre also benefited in 2004 from progress in the infrastructure for other currencies. Hong Kong dollar and US dollar real time gross settlement links were

introduced between Hong Kong and Guangdong province in March, extending the arrangements made between Hong Kong and Shenzhen in 2003. Joint cheque-clearing arrangements for US dollar cheques were introduced between Hong Kong and Shenzhen in July 2004. In December, the Hong Kong dollar entered the Continuous Linked Settlement (CLS) System, a global clearing and settlement system that complements Hong Kong's own multi-currency clearing systems. Entry into the CLS System was made possible by the enactment in July of the Clearing and Settlement Systems Ordinance, which came into effect in November. The Ordinance gives statutory backing to the Monetary Authority's oversight of important clearing and settlement systems, and legal certainty for settlement finality. In doing this, it will help promote the safety and robustness of Hong Kong's financial infrastructure and the financial stability of Hong Kong.

**regional and
international
co-operation**

Hong Kong's financial stability is dependent not just on the structures and systems that we build within Hong Kong but on the movements of markets throughout the world, and particularly on the health of the regional financial system. Memories of the Asian financial crisis in 1997-8 inevitably fade as the region in general continues to enjoy financial stability and economic growth. But the weaknesses that contributed to this crisis continue to be very much in the minds of Asian central banks, as they work together towards strengthening the regional financial system. Two regional initiatives bore fruit in 2004. The structuring, design and launch of the local currency component of the Asian Bond Fund (ABF2) under the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP) was announced in December. The APEC Initiative on Development of Securitisation and Credit Guarantee Markets came to a successful conclusion in September. Both of these initiatives will help stimulate the development of deep, liquid and mature regional bond markets, which can play an important role when, in times of crisis, the other channels of financial intermediation – the banks and the equity markets – falter or fail.

The HKMA played a leading role in both of these initiatives, and, because of its advantages as an international financial centre, Hong Kong has been chosen as the place of listing for two of the key

**governance of
the HKMA**

components of ABF2. The HKMA is also contributing extensively to the work of the Bank for International Settlements (BIS), through its chairmanship of the BIS Asian Consultative Council and Central Bank Governance Steering Group, and in playing a leading role in the drafting process in the review of the Basel Core Principles for Effective Banking Supervision, which began in 2004.

Enabling active participation by Hong Kong in the various international bodies and initiatives was one of the reasons for establishing the HKMA in 1993 as a central banking organisation with a clear identity and mission. Although it is an agency of the Government, the HKMA, following general central banking principles, is separate from the main organs of government in its ability to employ staff on terms different from those of the civil service and in its funding arrangements. These arrangements enable the HKMA to operate with flexibility, in response to rapidly changing conditions, and to maintain a level of resource independence sufficient to enable it to carry out its responsibilities without political influence. This measure of autonomy in the HKMA's operations is balanced by an apparatus of accountability, to the Financial Secretary through the Exchange Fund Advisory Committee (EFAC), and to the community, both directly and through its elected representatives on the Legislative Council.

During 2004 the governance arrangements of the HKMA were strengthened with an expansion of the EFAC sub-committee system. A new Governance Sub-Committee was created, replacing the old Remuneration and Finance Sub-Committee, with the task of monitoring the performance of the HKMA and making recommendations to the Financial Secretary, through EFAC, on the full range of remuneration, human resources, budgetary, administrative and governance issues affecting the HKMA. This Sub-Committee is composed of the non-official, non-banking Members of EFAC. Two new sub-committees – one on investment, the other on financial infrastructure – were formed at the end of 2004 and held their first meetings in early 2005. These two new sub-committees will enable Members to focus more on the technical details of these important areas of the HKMA's work.

The HKMA continued in 2004 to develop its policy of transparency and accessibility. The HKMA's *Half-Yearly Monetary and Financial Stability Report*, first issued in December 2003, has become well established as the main channel of clear and systematic information on the HKMA's view of the main forces acting upon Hong Kong's monetary and financial systems. The HKMA's Information Centre, which opened towards the end of 2003, received nearly 50,000 visitors of all ages and walks of life in 2004. Increasing numbers of people are using our enquiries service and visiting our website. During 2004 the HKMA also mounted an extensive campaign of seminars and visits to inform members of the public about the new \$20, \$50 and \$1,000 banknotes, which went into circulation in October: in all, some 93,000 people were reached during this campaign. At no time has the HKMA been in direct contact with so many people. In helping people better understand Hong Kong's monetary and banking systems, these initiatives have, we believe, helped contribute to Hong Kong's monetary and financial stability. They have also provided further informal channels for keeping ourselves abreast of public views on the policies we pursue.

The work of the HKMA has increased in volume and complexity over the past few years, as new responsibilities and new issues have emerged. Despite this, our staff establishment has remained stable, and our staff strength actually declined in 2004. I take this opportunity to pay tribute to the staff of the HKMA for their hard work and resourcefulness during another busy year. My colleagues and I are also grateful to the Financial Secretary and to Members of EFAC for their continued guidance and support.

A stylized, handwritten signature in black ink, consisting of a large, flowing 'J' followed by a series of connected loops and a long horizontal stroke.

Joseph Yam
Chief Executive



Ficus microcarpa

THE ECONOMIC AND BANKING ENVIRONMENT IN 2004

Economic performance

The recovery in Hong Kong's economy gathered momentum and became more broad-based in 2004, following a strong rebound in the second half of 2003. Real GDP grew by 8.1%, reflecting a marked pick-up in domestic demand, which was supported by appreciating asset prices, improving labour market conditions and rising household income. Exports of goods and services also increased, driven by robust global growth, an expansion in Mainland China's external trade, and a revival in inbound tourism.

Prospects for 2005

The economic recovery is expected to continue in 2005, but the pace of expansion is likely to be slower than in 2004 because of an expected slowdown in global growth. With the upturn in Hong Kong's economic activity, inflation is likely to pick up moderately, while labour market conditions should continue to improve. The main external uncertainties are the prospects for the US dollar and interest rates, volatility in oil prices, and macroeconomic and financial conditions in Mainland China.

Performance of the banking sector

The banking sector performed well in 2004, benefiting from the broad-based recovery and closer ties with Mainland China under the Closer Economic Partnership Arrangement.

Reflecting the improving economy, domestic loans grew by 7.2% in 2004, reversing the contraction in 2003. This helped contribute to strong profit growth, particularly in the retail and private banking sector, and greater revenue from treasury business. With the unemployment rate falling and property prices rising, asset quality continued to improve.

Banks' profit margins, however, again came under pressure. Although 2004 saw rising interest rates in the United States, the rates in Hong Kong remained low, because of the high level of liquidity in the banking sector. Competition for new business, particularly for residential mortgages, led to a reduction in margins.

Prospects for the banking sector in 2005

Buoyant exports and the revival in consumer spending should continue to underpin domestic economic growth in 2005. These conditions should lead to a further improvement in banks' asset quality. If the steady increase in property prices in 2004 continues, negative equity problems for homeowners will be lessened and households' balance sheets will strengthen.

However, uncertainties persist in the global economic environment, including the impact of macroeconomic realignment initiatives in Mainland China and the pace and depth of the economic recovery in the United States. Domestically, banks are facing risks arising from the uncertain direction of capital flows.

Currency

The three note-issuing banks began circulating the remaining three denominations of the new series Hong Kong banknotes (\$20, \$50 and \$1,000) in October 2004. Additional security features have been incorporated in the new series:

- denomination numerals in optical variable ink
- a fluorescent machine-readable barcode
- a four-millimetre-wide windowed thread
- iridescent images.

Security features and colour schemes have also been standardised among the banknotes to enable easy recognition by the public.



> Consumer Information > Notes and Coins



Student ambassadors explain to retailers the security features of new banknotes.



Hong Kong's economy in 2004

	2003	2004
Economic Growth and Inflation		
Real growth in Gross Domestic Product (%),	3.2	8.1 ^(a)
of which:		
Real growth in private consumption expenditure (%)	-0.3	6.7 ^(a)
Real growth in gross domestic fixed capital formation (%)	0.1	4.5 ^(a)
Real growth in exports (%)	12.7	15.2 ^(a)
Real growth in imports (%)	11.3	13.8 ^(a)
Composite Consumer Price Index (annual change, %)	-2.6	-0.4
Labour Market		
Employment (annual change, %)	-0.4	2.1
Unemployment rate (annual average, %)	7.9	6.8
Money Supply (annual change, %)		
Hong Kong money supply (M1)	36.8	16.3
Hong Kong money supply (M2) ^(b)	6.2	4.8
Hong Kong money supply (M3) ^(b)	5.9	4.6
Interest Rates (end of year, %)		
Savings deposit rate	0.01	0.01
Best lending rate	5.00	5.00
Three-month interbank rate	0.07	0.28
Exchange Rates (end of year)		
Hong Kong dollar/US dollar	7.763	7.774
Trade-weighted effective exchange rate index (Jan 2000=100)	98.8	96.0
Hang Seng Index (end of year)	12,576	14,230

(a) The estimates are preliminary.

(b) Adjusted to include foreign currency swap deposits.

Performance ratios of Hong Kong's banking sector in 2004

	2003 %	2004 %	2003 %	2004 %
	All AIs		Retail banks*	
Profitability ^(a)				
Growth of pre-tax operating profit	N.A.	N.A.	5.72	20.31
Return on assets (operating profit before tax)	0.93	1.06	1.36	1.51
Return on assets (post-tax profit)	0.81	0.97	1.18	1.38
Net interest margin	1.41	1.18	1.91	1.65
Bad debt charge to average total assets	0.24	0.01	0.29	-0.02
Business Profile ^(a)				
Growth in loans to customers	-2.0	5.9	-0.6	8.3
Growth in customer deposits (all currencies)	7.5	8.4	7.4	7.4
Hong Kong dollar loan to deposit ^(b) ratio	81.5	82.6	71.6	73.2
Asset Quality ^(c)				
Classified loans ^(d) as percentage of total loans	3.74	2.11	3.94	2.24
Non-performing loans ^(e) as percentage of total loans	2.95	1.56	3.17	1.62

	All locally incorporated AIs	
Capital Adequacy Ratio (consolidated)	15.3	15.4

Note:

(a) Figures relate to Hong Kong office(s) only.

(b) Includes swap deposits.

(c) Figures relate to Hong Kong office(s) and in the case of local AIs include overseas branches.

(d) Denotes loans graded as "substandard", "doubtful" or "loss".

(e) Denotes loans on which interest has been placed in suspense or on which interest accrual has ceased.

* This comprises all the locally incorporated banks plus a number of the larger foreign banks which are not locally incorporated but whose operations are similar to those of the locally incorporated banks, in that they operate a branch network and are active in retail banking.



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MONETARY CONDITIONS IN 2004

The Linked Exchange Rate system operated smoothly during the year, despite the depreciation of the US dollar, market speculation about revaluation of the renminbi, and significant fund flows in Hong Kong. The exchange rate remained stable, with a modest strengthening in the fourth quarter to 7.7745 at the end of 2004 (Chart 1).

In response to changes in market conditions, the HKMA conducted a number of operations on both the strong side and the weak side of the Link. The Convertibility Undertaking was repeatedly triggered during the year. For the year as a whole, the HKMA purchased a net total of \$16.6 billion worth of Hong Kong dollars. As a result, the Aggregate Balance declined from \$29.5 billion to \$15.8 billion during the year (Chart 2).

With a cumulative increase of 125 basis points in the US federal funds target rate during the year, Hong Kong dollar interbank interest rates rose between April and September. However interest rates started to ease in October because of increased liquidity in the face of capital inflows. This led to an increase in the negative spread between Hong Kong dollar interest rates and their US dollar counterparts (Chart 3).

Activities at the HKMA

The EFAC Currency Board Sub-Committee continued to examine issues affecting monetary and financial stability in Hong Kong. The records of discussion of the meetings of the Sub-Committee and reports on the operations of the Currency Board system are published in the HKMA's *Quarterly Bulletin* and on the HKMA website. Many of the papers the Sub-Committee considers are published in the *Quarterly Bulletin* as research articles or on the HKMA website as research memoranda.

The Hong Kong Institute for Monetary Research published 24 working papers in 2004 and organised numerous workshops and conferences on strategic issues affecting monetary and financial developments in Hong Kong and the region.



> [Information Centre](#) > [Press Releases](#) > [Monetary Policy](#)



> [Information Centre](#) > [Research Memoranda](#)

CHART 1 Market exchange rate and Convertibility Rate**CHART 2 Aggregate Balance****CHART 3 Hong Kong dollar – US dollar interest rate differentials**



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BANKING POLICY AND SUPERVISORY ISSUES IN 2004

Operational supervision

Full implementation of the risk-based supervisory approach in 2004 enabled the HKMA to use its resources more effectively according to the specific risk areas to which individual authorized institutions (AIs) are exposed. The HKMA conducted 247 on-site examinations, including 78 risk-focused, 11 treasury, and seven securities examinations. There were 36 focused examinations to assess AIs' compliance with the restrictions on personal renminbi business, which was launched in February 2004. Details of the operational supervisory work in 2004 are in Table 1.

Supervision of banks

In promoting the safety and soundness of AIs in 2004, the HKMA

- issued a circular in December reminding AIs to adhere to sound internal control principles when undertaking operations involving customer assets
- worked closely with the Securities and Futures Commission in the supervision of AIs' securities activities
- held the first bilateral meeting with the Insurance Authority in June to discuss current and evolving supervisory issues
- signed an Memorandum of Understanding with the Bundesanstalt für Finanzdienstleistungsaufsicht of Germany in

TABLE 1 Operational supervision

	2003	2004
1. On-site examinations	247	247
Including those on:		
- treasury	9	11
- securities	18	7
- e-banking	28	24
- review of business continuity plan	20	17
- review of personal renminbi business	-	36
- overseas examinations	9	20
2. Off-site reviews and prudential interviews	216	183
3. Tripartite meetings	77	66
4. Meetings with boards of directors or board-level committees of AIs	16	8
5. Approvals of applications to become controllers, directors, chief executives, alternative chief executives of AIs	310	376
6. Reports commissioned under Section 59(2) of the Banking Ordinance	5	1
7. Cases considered by the Banking Supervision Review Committee	12	9

January 2004 to establish a formal framework for supervisory co-operation and the sharing of supervisory information

- recommended a set of precautionary measures to prevent ATM skimming fraud cases in Hong Kong

- launched a multi-channel consumer education programme on Internet banking security and issued a Supervisory Policy Manual module on Supervision of e-Banking and conducted 24 on-site examinations of Internet banking and IT-related controls.

Banking reform

Further progress was made on the two remaining policy initiatives in the HKMA's banking sector reform programme:

- the Deposit Protection Scheme Ordinance was enacted in May, and the Hong Kong Deposit Protection Board was formed in July to oversee the project for establishing the Deposit Protection Scheme
- the Commercial Credit Reference Agency was launched in November.

Basel II

Scheduled for implementation on 1 January 2007, the New Basel Capital Accord (or "Basel II") is a more risk-sensitive framework for regulating the capital adequacy of banks. During 2004 the HKMA

- established a Basel II Consultation Group¹ to meet regularly to discuss implementation proposals
- briefed the Legislative Council Panel on Financial Affairs on the HKMA's plans to implement the revised capital framework in Hong Kong

- released detailed proposals for public consultation during August and September 2004
- maintained close contact with individual banks to understand their readiness to meet the revised framework's requirements
- worked with the Department of Justice and the Financial Services and Treasury Bureau in drafting the Banking (Amendment) Bill 2005 to provide for the implementation of the Basel II requirements.

Consumer issues

The HKMA issued a circular requiring all AIs to make appropriate changes to their safe deposit box agreements by 31 March 2005 with a view to improving the use of exemption clauses by AIs. In parallel, the Code of Banking Practice Committee, of which the HKMA is a member, amended the Code to make it clear that AIs should have due regard to the Control of Exemption Clauses Ordinance, Unconscionable Contracts Ordinance and the Supply of Services (Implied Terms) Ordinance in drawing up terms and conditions of banking services. Overall, the level of compliance with the Code remained high, with 99% of AIs reporting either full, or largely full, compliance in the past two years.

¹ The Basel II Consultation Group comprises representatives from the HKMA, the banking industry, the accounting profession and other interested groups.

 > [Information Centre > Press Releases > Banking in Hong Kong](#)

 > [Information Centre > Guidelines and Circulars](#)

 > [Policy Areas > Supervisory Policy Manual](#)

 > [Consumer Information](#)



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MARKET INFRASTRUCTURE IN 2004

Payment systems in Hong Kong

The Hong Kong dollar payment system and the two foreign currency payment systems operated smoothly and efficiently in 2004.

Hong Kong Interbank Clearing Limited processed a daily average value of \$407 billion (14,736 items in volume) Clearing House Automated Transfer System (CHATS) transactions, and \$17.1 billion (122 items in volume) Central Moneymarkets Unit (CMU) secondary market transactions. The system also provided for the smooth settlement of the four daily bulk clearings – the money settlement of stock market transactions (Central Clearing and Settlement System or CCASS), cheques, low-value bulk electronic payment items (EPS and autopay) and low-value ATM transfers (JETCO) (Chart 1).

The CHATS Optimiser, a system mechanism that settles paper cheques and large-value CHATS payments simultaneously and in an offsetting manner, was introduced to the Hong Kong dollar payment system in June 2004. CHATS Optimiser has been widely used by banks. It enables them to better manage their liquidity, facilitates the recycling of liquidity to the market, and smoothes payment flows, in particular at times of large fund flows associated with initial public offerings.

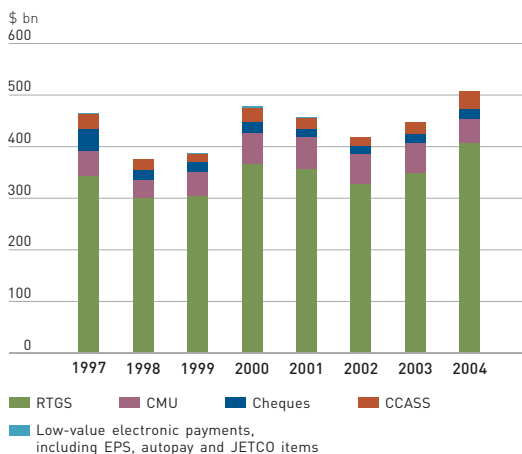
At the end of 2004 there were 68 direct and 164 indirect participants in the US dollar clearing system, including 119 indirect participants from outside Hong Kong. The system handled on average 5,033 transactions a day in 2004 with a total value of over US\$5.51 billion.

At the end of 2004 the euro clearing system had 23 direct and 21 indirect participants, including 11 indirect participants from outside Hong Kong. The system handled an average of 37 transactions a day with a total value of €923 million.



> Policy Areas > Financial Infrastructure > Infrastructure

CHART 1 Hong Kong dollar payment system daily average turnover

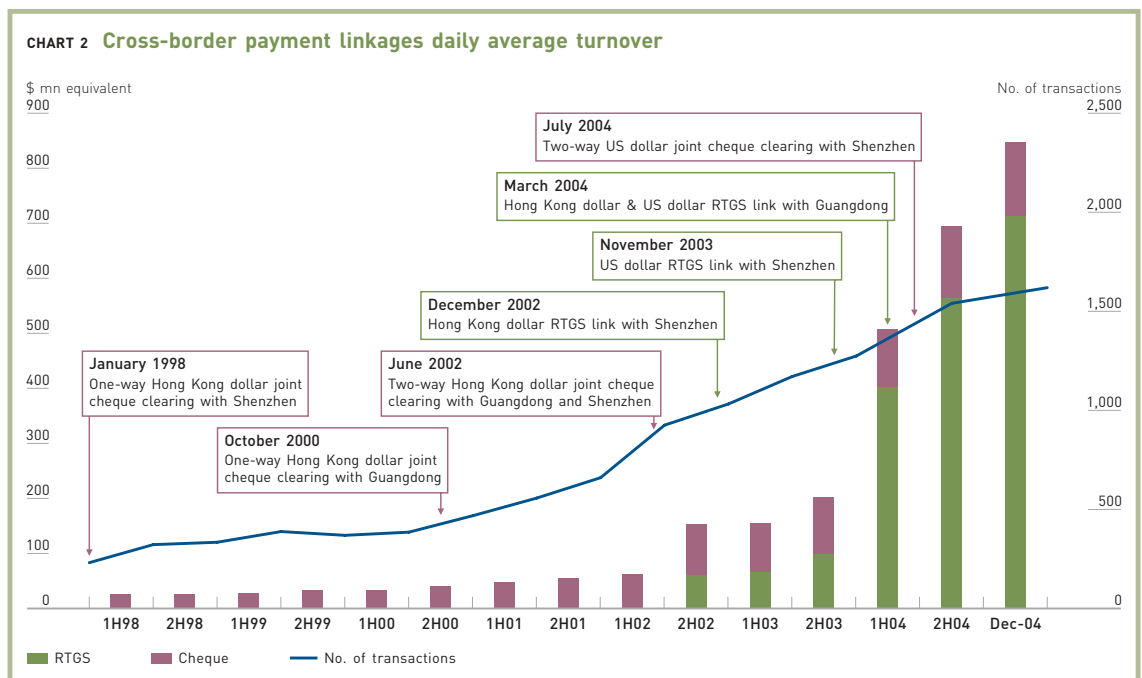


Payment linkages with Mainland China

In 2004 two new links with the Mainland were implemented. In March the HKMA and the Guangzhou branch of the People's Bank of China introduced cross-border system linkages for Hong Kong dollar and US dollar Real Time Gross Settlement (RTGS) payments between banks in Hong Kong and Guangdong

Province. In July the existing Hong Kong dollar joint cheque clearing facilities between Shenzhen and Hong Kong were extended to cover US dollar cheques.

The average daily turnover through all payment linkages with Mainland China increased rapidly to the equivalent of \$850 million in December 2004 (Chart 2).



Oversight of clearing and settlement systems

The Clearing and Settlement Systems Ordinance became effective in November 2004. The Ordinance establishes a statutory regime for the Monetary Authority to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong, or to the functioning of Hong Kong as an international financial centre. It also provides statutory backing to the finality of settlement for transactions made through systems designated under the Ordinance by protecting the settlement finality from insolvency laws or any other laws. The legislation contributes to the transparency of the HKMA's central bank operations.

 > [Policy Areas](#) > [Financial Infrastructure](#) > [Oversight](#)

Debt market development

To promote development of the debt market, the HKMA

- improved the liquidity and credibility of the Hong Kong dollar benchmark yield curve by continually rebalancing the maturity mix of the Exchange Fund Bills and Notes (EFBN) portfolio, and by increasing transparency in the daily fixings of the EFBN
- reviewed the one-year pilot scheme to facilitate retail investment in Exchange Fund Notes

- worked closely with industry associations and the Government on initiatives, such as the simplification of bond issuance procedures and the introduction of “dual prospectus” structure, and the launch of the facility operated by the CMU to facilitate settlement of Hong Kong dollar repo transactions
- deepened retail bond market development with Hong Kong Mortgage Corporation's issue of Asia's first retail mortgage-backed securities.

 > [Policy Areas](#) > [Financial Infrastructure](#) > [Debt Market Development](#)

Treasury Markets Forum

The Treasury Markets Forum (TMF) was established among industry associations and market professionals in March 2004 to better co-ordinate efforts at raising the professionalism of practitioners and the overall competitiveness of treasury markets in Hong Kong. During the year the TMF introduced accreditation and training programmes, participated in the Financial Services Expo in Shanghai, visited Mainland financial regulators, and reviewed market practices, codes and standards.

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INTERNATIONAL FINANCIAL CENTRE

The HKMA and the international financial community

The HKMA continued to strengthen its contacts with the international central banking and financial community in 2004, enabling it to

- promote international understanding of, and confidence in, Hong Kong's monetary and financial systems
- promote the development of regional bond markets
- share information with other central banks about financial developments so as to facilitate the proper oversight of the markets and the prudential supervision of financial institutions
- improve understanding of international economic and financial trends
- strengthen the sharing of technical expertise between the HKMA and major central banks and multilateral institutions
- promote the understanding of other central banks, international financial institutions, and investors on Hong Kong's monetary, financial and economic developments.

Development of regional bond markets

Through its Chairmanship of EMEAP (Executives' Meeting of East Asia and Pacific Central Banks) Working Group on Financial

Markets, the HKMA co-ordinated the important regional initiative of the local currency Asian Bond Fund (ABF2), the launch of which was announced in December. ABF2 includes a Pan-Asian Bond Index Fund (PAIF) and eight single-market funds. It will be invested in by all 11 EMEAP central banks and will help promote the development of domestic and regional bond markets in Asia. During the year, the HKMA continued to lead the Asia-Pacific Economic Co-operation (APEC) initiative on the Development of Securitisation and Credit Guarantee Markets with Thailand and Korea as co-chairs.

Regional monetary co-operation

The HKMA continued to contribute to policy dialogues in international and regional forums and to play a role in regional monetary co-operation in 2004. The Chief Executive of the HKMA, Mr Joseph Yam, chaired the Asian Consultative Council of the Bank for International Settlements in 2004. The HKMA, representing the Hong Kong SAR Government, participated in the review of the use of funds of the Asian Development Fund (ADF), a concessionary lending facility of the Asian Development Bank for the poorest economies in the region, and took part in negotiations on the Eighth Replenishment of the ADF. In December 2004, the Legislative Council's Finance Committee approved Hong Kong's contribution of \$149.7 million (US\$19.19 million) to the Eighth Replenishment.

Upgrading of Hong Kong's sovereign credit ratings

The HKMA has been playing a key role in the adoption of a more pro-active approach towards Hong Kong's international credit ratings. Between April and June, Standard & Poor's, Fitch Ratings, and Rating and Investment Information all upgraded their outlook on Hong Kong's sovereign rating from negative to stable.

Financial market integration with the Mainland

Personal renminbi banking services were introduced in Hong Kong in February 2004. At the end of 2004 outstanding renminbi deposits totalled RMB12.1 billion yuan. The signing of Closer Economic Partnership Arrangement (CEPA II) on 27 October 2004 helped expand the business scope of Hong Kong banks on the Mainland. CEPA II allows Mainland branches of Hong Kong banks to act as agents for insurance products after obtaining approval from relevant authorities with effect from 1 November 2004.

The HKMA continued to engage in research co-operation with Mainland academics and think-tanks to develop its understanding of financial and economic issues in the Mainland. A number of Mainland officials and academics were also invited to Hong Kong to exchange views on issues of common interest. Training programmes were provided to 833 Mainland officials in 2004.



> [Policy Areas](#) > [Monetary Stability](#) > [External Relations](#)



> [Information Centre](#) > [Press Releases](#) > [International Relations](#)



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EXCHANGE FUND PERFORMANCE IN 2004

Financial markets were volatile in 2004 (Table 1). The Exchange Fund recorded income of

- \$25 billion from bonds
- \$12 billion from Hong Kong equities
- \$11.2 billion from foreign equities
- \$8.5 billion from foreign exchange gains.

The investment strategy resulted in an overall income of \$56.7 billion, or a return on investment of 5.7%, which was in line with the benchmark for the year.

The investment return on the Exchange Fund relative to the investment benchmark and domestic inflation rate from 1993 to 2004 is shown in Table 2. The currency mix of the Fund's assets at 31 December 2004 is in Table 3.



> Policy Areas > Monetary Stability > Exchange Fund

> Information Centre > Press Releases > Exchange Fund

TABLE 1 Market returns

	2004	2003
Currencies		
Appreciation against US dollar		
euro	+7.8%	+20.2%
yen	+4.6%	+10.7%
Bond markets		
JP Morgan US Government Bond (1-3 years) Index	+0.9%	+2.0%
Equity markets		
Standard & Poor's 500 Index	+9.0%	+26.4%
Hang Seng Index	+13.2%	+34.9%

TABLE 2 Gross investment return of the Exchange Fund (in Hong Kong dollar terms)¹

	Return on total assets	Return on investment benchmark ²	CPI(A) ³
2004	5.7%	5.7%	+0.4%
2003	10.2%	9.5%	-1.2%
1993 – 2004 cumulative	117.0%	N.A.	24.5%
1993 – 2004 annualised	6.7%	N.A.	1.8%

¹ For the Annual Reports from 2001 to 2003, return on total assets and return on investment benchmark are in US dollar terms.

² Established in January 1999.

³ December year-on-year percentage change in the HK-CPI(A) index. CPI (A) is calculated based on the 1999/2000 base new series.

TABLE 3 Currency mix of the Exchange Fund's assets at 31 December 2004 (including forward transactions)

	HK\$ billion	%
US dollar bloc		
US dollar ¹	835.3	78.7
Hong Kong dollar	92.5	8.7
Non-US dollar bloc	134.1	12.6
Total	1,061.9	100.0

¹ Include US dollar bloc foreign currencies such as Canadian dollar, Australian dollar and New Zealand dollar.

THE EXCHANGE FUND

The financial position of the Exchange Fund and the Group in 2004 is shown below in the Income and Expenditure Account and Balance Sheet, which are extracted from the *HKMA Annual Report 2004*. The audited full statement of accounts of the Exchange Fund for 2004 may be found on pages 92 to 125 of the full Annual Report.

EXCHANGE FUND – INCOME AND EXPENDITURE ACCOUNT

for the year ended 31 December 2004

(Expressed in millions of Hong Kong dollars)	Group		Fund	
	2004	2003	2004	2003
INCOME				
Interest income				
Interest income on debt securities	21,534	23,253	21,380	23,103
Other interest income	3,064	3,271	2,194	2,410
Total interest income	24,598	26,524	23,574	25,513
Dividend income from listed equity securities	4,556	3,751	4,556	3,751
Dividend income from subsidiaries	-	-	17	140
Net realised and revaluation gains on other investments in securities	19,538	29,384	19,538	29,384
Other net realised and revaluation gains	582	7,977	582	7,960
Net exchange gains	8,469	22,886	8,474	22,900
Bank licence fees	129	130	129	130
Others	353	238	70	49
TOTAL INCOME	58,225	90,890	56,940	89,827
EXPENDITURE				
Interest expense	(18,066)	(30,233)	(17,856)	(29,847)
Operating expenses	(1,523)	(1,508)	(1,251)	(1,179)
Note and coin expenses	(182)	(229)	(182)	(229)
TOTAL EXPENDITURE	(19,771)	(31,970)	(19,289)	(31,255)
SURPLUS BEFORE PREMISES REVALUATION AND ASSOCIATE	38,454	58,920	37,651	58,572
Surplus/(Deficit) on revaluation of premises	876	(876)	876	(876)
Share of profit of associate	4	10	-	-
SURPLUS BEFORE TAXATION	39,334	58,054	38,527	57,696
Taxation of subsidiaries and share of taxation of associate	(110)	(58)	-	-
SURPLUS AFTER TAXATION	39,224	57,996	38,527	57,696
Minority interests	(21)	(24)	-	-
SURPLUS FOR THE YEAR	39,203	57,972	38,527	57,696

EXCHANGE FUND – BALANCE SHEET

as at 31 December 2004

(Expressed in millions of Hong Kong dollars)	Group		Fund	
	2004	2003	2004	2003
ASSETS				
Cash and money at call	20,759	19,168	20,738	19,143
Placements with banks and other financial institutions	48,178	43,823	42,747	41,549
Investment securities	300	300	300	300
Other investments in securities	977,746	931,737	977,746	931,737
Held-to-maturity securities	4,130	3,574	-	-
Mortgage loans	34,938	34,582	-	-
Gold	228	217	228	217
Other assets	14,510	14,095	13,914	13,503
Investments in subsidiaries	-	-	2,145	2,145
Investment in associate	23	20	-	-
Fixed assets	4,286	3,309	4,036	3,051
TOTAL ASSETS	1,105,098	1,050,825	1,061,854	1,011,645
LIABILITIES AND EQUITY				
Certificates of Indebtedness	146,775	134,215	146,775	134,215
Government-issued currency notes and coins in circulation	6,351	6,297	6,351	6,297
Balance of the banking system	15,789	28,277	15,789	28,277
Exchange Fund Bills and Notes	125,860	123,520	125,860	123,520
Other debt securities	35,495	36,620	-	-
Placements by banks and other financial institutions	39,087	44,542	39,087	44,542
Placements by other Hong Kong Special Administrative Region government funds	280,091	252,296	280,091	252,296
Placements by Hong Kong statutory bodies	-	164	-	164
Other liabilities	29,645	38,284	24,310	37,455
Total liabilities	679,093	664,215	638,263	626,766
Minority interests	167	160	-	-
Accumulated surplus	425,644	386,441	423,397	384,870
Premises revaluation reserve	194	9	194	9
Total equity	425,838	386,450	423,591	384,879
TOTAL LIABILITIES AND EQUITY	1,105,098	1,050,825	1,061,854	1,011,645

MAJOR EVENTS 1993 - 2004

1993

April 1993

The Hong Kong Monetary Authority is established with responsibility for monetary and banking stability, reserves management, and financial infrastructure.

May 1993

The Government starts to replace the Queen's Head coins with the new bauhinia design.



July 1993

The Government announces the sale of Overseas Trust Bank for HK\$4,457 million. The sale of the bank, taken over in June 1985, marks the end of the Government's efforts to rescue banks in the 1980s.



July 1993

Hong Kong becomes the first city in the world to have a completely digital telephone network.

1994

May 1994

The Bank of China issues its first Hong Kong banknotes.



June 1994

The Government announces a package of measures to dampen property speculation.

August 1994

The Hang Seng China Enterprises Index is launched to serve as an indicator of the overall performance of Hong Kong-listed, state owned enterprises of the People's Republic of China.

September 1994

The first issue of five-year Exchange Fund Notes is launched. The issue helps extend the benchmark yield curve for Hong Kong dollar debt to the five year area.

October 1994

The interest rate cap on time deposits is lifted in phases. This marks the beginning of a relaxation of Interest Rate Rules in Hong Kong.

November 1994

Hong Kong issues its first bimetallic coin – the bauhinia \$10 coin.



1995

January 1995

In the aftermath of the Mexican peso crisis, the Hong Kong dollar comes under selling pressure along with other Asian currencies.

Hong Kong dollar forward exchange rate



May 1995

Hong Kong Interbank Clearing Limited is established to provide interbank clearing functions in Hong Kong.



HONG KONG INTERBANK
CLEARING LIMITED
香港銀行同業結算有限公司

June 1995

The HKMA becomes the licensing authority of three types of authorized institutions, following the enactment of the Banking (Amendment) Ordinance 1995.

July 1995

The Companies Ordinance is amended so that depositors are entitled to receive priority payment in the liquidation of banks.

November 1995

The Government decides to publish the size of Hong Kong's foreign exchange reserves (i.e. foreign currency assets of the Exchange Fund) every quarter instead of every six months.

November 1995

The first issue of seven-year Exchange Fund Notes is launched.

January 1996

The Exchange Fund acquires the De La Rue banknote printing plant in Tai Po, which is renamed "Hong Kong Note Printing Limited".



September 1996

The HKMA is invited to join the Bank for International Settlements, the Swiss-based forum promoting co-operation among central banks.

October 1996

The first issue of ten-year Exchange Fund Notes is launched.

December 1996

Real Time Gross Settlement is launched in Hong Kong, enabling interbank payments to be settled real time.

March 1997



The Hong Kong Mortgage Corporation is established. It will buy mortgage loans for its own portfolio and issue mortgage-backed securities.

July 1997

Hong Kong becomes a Special Administrative Region of the People's Republic of China.



July 1997

The assets of the Land Fund are handed over to Hong Kong SAR Government with a net value of HK\$197 billion. From July 1997 to October 1998 these assets are managed by the HKMA as a separate fund within the fiscal reserves. On 1 November 1998 the assets of the Land Fund are merged with the Exchange Fund and managed as part of the investment portfolio of the Exchange Fund.



July 1997

The *Code of Banking Practice* is issued to improve the transparency and quality of banking services in Hong Kong.

September 1997



The Octopus card appears in Hong Kong. This contact-free stored value card is used for transport fares and retail purchases.



September 1997

World Bank/IMF Annual Meetings are held in Hong Kong. Central bank and finance ministry officials from some 180 countries attend the meetings.

MAJOR EVENTS 1993 - 2004 (cont.)

1998

July 1998

Hong Kong International Airport opens at Chek Lap Kok.



July 1998

The Bank for International Settlements opens its representative office for Asia and the Pacific in Hong Kong.

August 1998

Using HK\$118 billion from the Exchange Fund, the Hong Kong SAR Government launches a stock market operation to frustrate manipulation of the money and stock markets.

September 1998

The HKMA introduces seven technical measures to strengthen the Currency Board arrangements.



October 1998

Exchange Fund Investment Limited is established to manage the portfolio of Hang Seng Index constituent stocks acquired by the Exchange Fund in the market operation of August.

1999

January 1999

The foreign currency assets and the balance sheet data of the Exchange Fund are published monthly, in line with the standard set by the International Monetary Fund.

August 1999

Exchange Fund Notes commence listing on the Hong Kong Stock Exchange.

August 1999

The Hong Kong Institute for Monetary Research is established.



November 1999

The Tracker Fund of Hong Kong is established as a vehicle for gradually disposing of the majority of the stocks acquired by the Exchange Fund in the 1998 market operation.



2000

August 2000

Hong Kong processes its first transaction through the new US dollar clearing system.

October 2000

Hong Kong is selected as President for 2001-2002 of the Financial Action Task Force on Money Laundering, an international body.

December 2000

Hong Kong's Mandatory Provident Fund System comes into full operation after years of preparation.

2001

January 2001

The International Monetary Fund opens a sub-office in Hong Kong.

April 2001

The Government approves in principle the proposal to introduce a deposit protection scheme in Hong Kong.

July 2001

Interest Rate Rules are completely deregulated. Banks are free to set interest rates for all types of deposits.

November 2001

All restrictions on the number of branches of foreign banks are lifted.

December 2001

China enters the World Trade Organisation.

March 2002

The Securities and Futures Ordinance is passed by the Legislative Council. The Ordinance consolidates and modernises 10 existing ordinances into a single piece of legislation to govern financial and investment products, regulate the securities and futures markets, and protect investors.

May 2002

The Government endorses the HKMA's proposals to relax certain market entry criteria for the banking sector.

September 2002

The Government issues new \$10 currency notes.



March to June 2003

Outbreak of Severe Acute Respiratory Syndrome (SARS). 1,755 people in Hong Kong are infected and 299 people die.

April 2003

Hong Kong processes its first transaction through its new euro clearing system.

June 2003

Exchange of letters between the Financial Secretary and the Monetary Authority on functions and responsibilities in monetary and financial affairs.

June 2003

The Mainland and Hong Kong sign the Closer Economic Partnership Arrangement (CEPA).



November 2003

The HKMA moves its offices to permanent premises at Two International Finance Centre.

November 2003

Following approval from the State Council, the People's Bank of China agrees to provide clearing arrangements for banks in Hong Kong to conduct personal renminbi business on a trial basis. The scope of the business to be conducted includes deposit-taking, exchange, remittances and debit and credit cards.

December 2003

The three note-issuing banks issue new \$100 and \$500 notes with additional security features.



February 2004

Over 30 banks in Hong Kong introduce renminbi deposit, exchange, remittance, and debit and credit card services.

May 2004

The Deposit Protection Scheme Ordinance is enacted.

June 2004

The Basel Committee on Banking Supervision issues a revised framework on capital standards.

July 2004

The Clearing and Settlement Systems Ordinance is enacted.

October 2004

The three note-issuing banks issue new \$20, \$50 and \$1000 notes with additional security features.



November 2004

The Commercial Credit Reference Agency is launched.

ABBREVIATIONS

ABF2	– Local currency denominated Asian Bond Fund
ADF	– Asian Development Fund
AI	– Authorized institution
APEC	– Asia-Pacific Economic Co-operation
ATM	– Automated teller machine
BIS	– Bank for International Settlements
bn	– billion
CCASS	– Central Clearing and Settlement System
CDC	– China Government Securities Depository Trust & Clearing Co. Ltd.
CEPA	– Closer Economic Partnership Arrangement
CHATS	– Clearing House Automated Transfer System
CLS	– Continuous Linked Settlement
CMU	– Central Moneymarkets Unit
CPI	– Consumer Price Index
DvP	– Delivery-versus-Payment
EFAC	– Exchange Fund Advisory Committee
EFBN	– Exchange Fund Bills and Notes
EMEAP	– Executives' Meeting of East Asia-Pacific Central Banks
EPS	– Easy Pay System
GDP	– Gross Domestic Product (in real terms unless otherwise stated)
HK	– Hong Kong
HKMA	– Hong Kong Monetary Authority
HKSAR	– Hong Kong Special Administrative Region
IMF	– International Monetary Fund
IPO	– Initial Public Offering
JETCO	– Joint Electronic Teller Company Limited
KSD	– Korea Securities Depository
mn	– million
N.A.	– not applicable
PAIF	– Pan-Asian Bond Index Fund
PvP	– Payment-versus-Payment
RMB	– Renminbi
RTGS	– Real Time Gross Settlement
SAR	– Special Administrative Region
TMF	– Treasury Markets Forum
US	– United States of America

REFERENCE RESOURCES

The *HKMA Annual Report* is published in April or May each year. A number of other HKMA publications provide explanatory and background information on the HKMA's policies and functions. These include

HKMA Quarterly Bulletin

(published in March, June, September and December each year)

HKMA Monthly Statistical Bulletin (on-line publication)

(published in two batches on the third and sixth business days of each month)

Guide to Hong Kong Monetary and Banking Terms (Second Edition)

HKMA Background Brief No. 1 – Hong Kong's Linked Exchange Rate System

HKMA Background Brief No. 2 – Banking Supervision in Hong Kong

Money and Banking in Hong Kong: A Historical Timeline

Money in Hong Kong: A Brief Introduction

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The photographs

The theme photographs in this Annual Report show some of the trees commonly found in Hong Kong. Despite its small land area, Hong Kong has some 400 species of trees. Further information on Hong Kong trees can be found in *Tree Lovers' Companion* (Friends of the Country Parks, Hong Kong, 2004) and at <http://resources.ed.gov.hk/trees>.



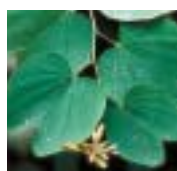
The Chinese banyan, *Ficus microcarpa*, one of Hong Kong's most popular native trees, provides shade and windbreaks for streets and neighbourhoods. Its extensive roots enable it to grow in almost any location.



The camphor tree, *Cinnamomum camphora*, is often planted as a fung shui tree in village groves, and as a shade tree in parks and gardens. Camphor is obtained from the tree for medicinal and other uses, and the wood of the tree is prized for its insect-repelling properties.



One of the largest of the mangrove trees, the *Heritiera littoralis* (or looking-glass mangrove) can withstand submergence in the sea for several hours a day and yet still grow to the height of a three-storey building. Its strong buttress roots enable it to remain upright in loose soil and strong winds. It is found throughout South-East Asia and among the islands and coastlines of the Indian Ocean and the South Pacific.



The *Bauhinia blakeana* (or Hong Kong orchid tree), discovered on Hong Kong Island in the late nineteenth century, is Hong Kong's regional emblem, and its flower appears on Hong Kong's regional flag and on its currency. The flower also forms part of the emblem of the HKMA. Its two-lobed leaf, with its prominent veins, is known in Hong Kong as the "clever leaf" and is often used as a bookmark.



The elephant's ear, *Macaranga tanarius*, is a fast-growing evergreen tree, which can grow to a height of around five metres. It is widely distributed throughout the Asia region and is very common on beaches in Hong Kong, where it provides excellent shade.



The cotton tree, *Bombax ceiba* (*B. malabaricum*), can grow to 25 metres or more in height. Its magnificent red flowers appear in spring before the new season's leaves, making it one of the most attractive of Hong Kong's roadside trees. The dried flowers are used in herbal preparations to reduce inflammation, and the cotton-like substance in its seed capsules is traditionally used for stuffing pillows and cushions.

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