



HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

1 November 2004



PROGRESS IN KEY FUNCTIONS & RESPONSIBILITIES

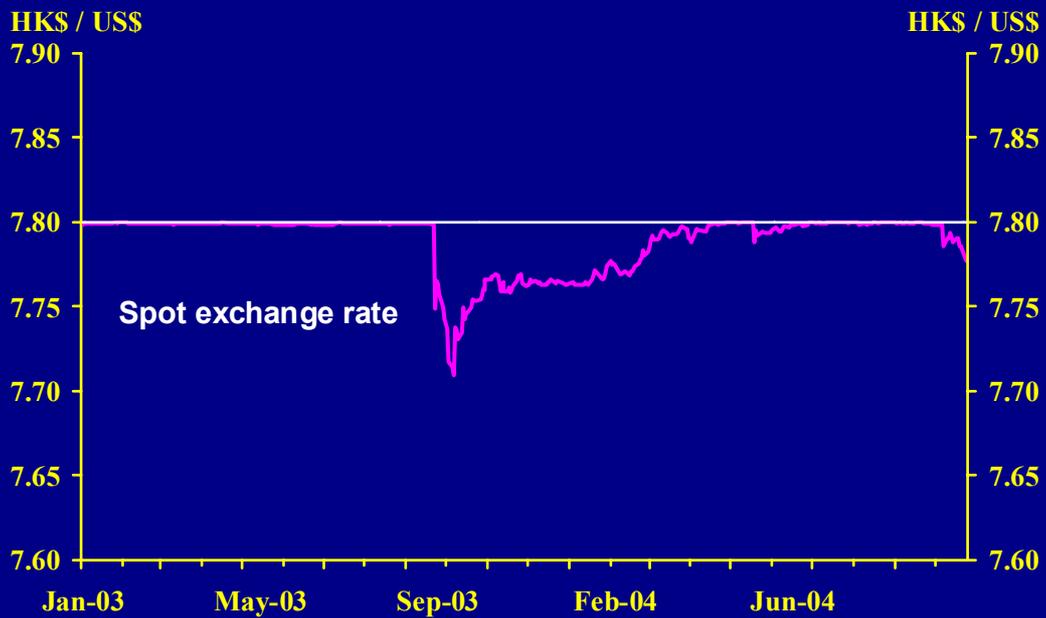
- **Currency Stability**
- **Banking**
- **Financial Infrastructure**
- **Hong Kong as an International Financial Centre**
- **Exchange Fund**

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- This briefing covers the key functions and responsibilities of the HKMA:
 - to maintain currency stability within the framework of the Linked Exchange Rate System;
 - to provide the safety and stability of the banking system;
 - to promote the efficiency, integrity and development of the financial infrastructure, particularly payment and settlement arrangements;
 - to support the maintenance of the status of Hong Kong as an international financial centre; and
 - to manage the Exchange Fund in a sound and prudent manner.



CURRENCY STABILITY (I)

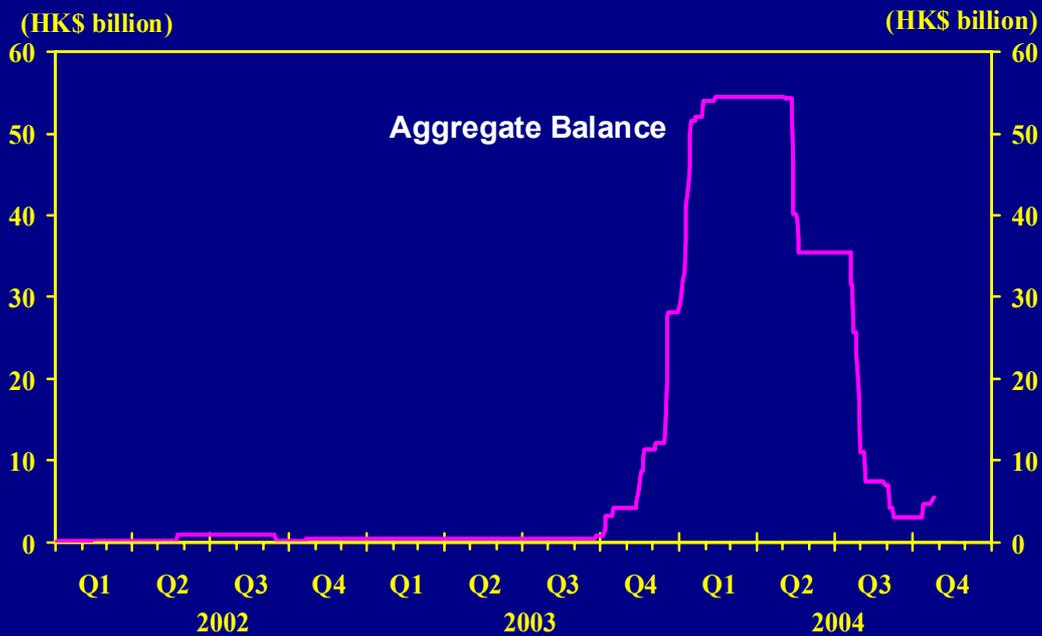


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- The Hong Kong dollar strengthened markedly in the third quarter of 2003. This episode of strengthening has been gradually playing itself out through the normal operations of the Currency Board System.
- Following repeated strong-side operations, the market exchange rate eventually converged to the linked rate in the second quarter of 2004.
- The exchange rate then stayed close to the linked rate, with the Convertibility Undertaking (CU) being triggered occasionally. The triggering of the CU was in part attributable to interest rate arbitrage activities to take advantage of higher US dollar interest rates over Hong Kong dollar counterparts.
- Most recently, the exchange rate strengthened again in mid-October on speculation about the introduction of a more flexible renminbi exchange rate regime.



MOVEMENTS IN THE AGGREGATE BALANCE

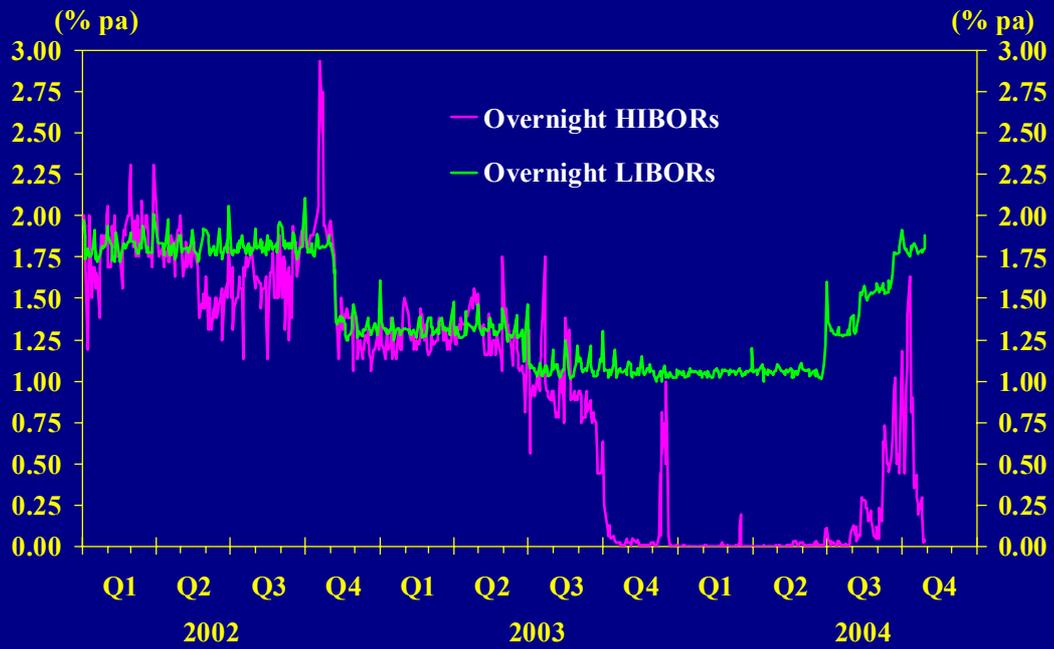


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- As the exchange rate moved back towards 7.8, the CU was triggered frequently between end-April and early September.
- As a result, the Aggregate Balance declined from a peak of over HK\$54 billion to around HK\$3 billion on 8 October.
- As noted earlier, the recent sales of Hong Kong dollars by the HKMA in the face of renewed upward pressure on the Hong Kong dollar led to a rise in the Aggregate Balance to HK\$4.8 billion on 12 October and further to HK\$8.6 billion on 27 October.
- It may take a little more time for the Aggregate Balance to be reduced back to its more normal level (of around HK\$500 million) given the strong economic recovery in Hong Kong and the continued speculation about revaluation of renminbi.

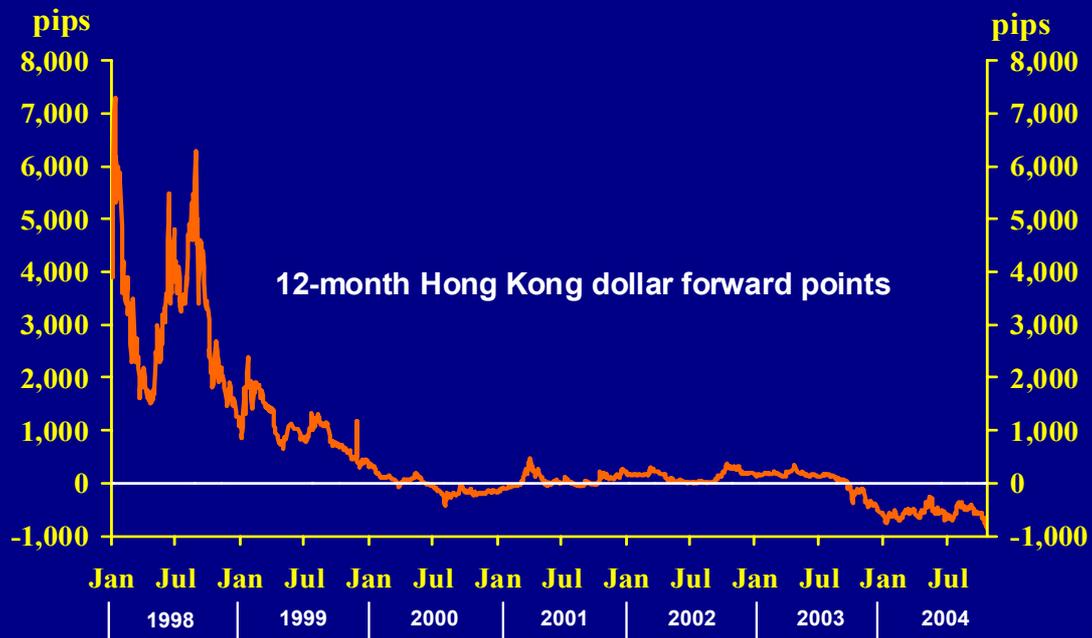


HKD AND USD INTEREST RATES





CURRENCY - MARKET EXPECTATIONS (1)



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- Overall, the market has remained calm by historical standards, although there was a marked shift of expectation from weakness to strength as illustrated by the 12-month forward exchange rate moving from a premium to a discount compared with the spot exchange rate.



CURRENCY - MARKET EXPECTATIONS (2)



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- The 12-month forward points widened to a discount of 765 pips on 13 January 2004. Since then, the 12-month forward points have once narrowed to about a discount of 200 pips on the back of strengthening of the US dollar but widened to a discount of around 1,000 pips recently on the back of renewed speculation about revaluation of the renminbi.



MONETARY CONDITIONS

- **Currency Board arrangements working effectively.**
- **Interest rate arbitrage has generated some outflows, bringing the Aggregate Balance down to a much lower level.**
- **Interest rates began to climb along with the US rates.**
- **Monetary conditions remain relatively loose.**

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- With the CU being triggered repeatedly between end-April and early September, the Aggregate Balance in the clearing accounts of licensed banks has declined to around HK\$3.2 billion, down sharply from over HK\$54 billion in April-May, though there are signs of renewed Hong Kong dollar buying interest recently.
- The Fed funds target rate in the US has been raised by a total of 75 basis points since end-June. Hong Kong dollar interbank interest rates have all risen accordingly. Nonetheless, Hong Kong dollar interest rates continue to be lower than their US dollar counterparts, although the negative spreads have narrowed somewhat.
- Although interest rates have climbed, monetary conditions remain relatively loose. In particular, the Hong Kong dollar loan-to-deposit ratio is still lower than its long-term average.



CURRENCY STABILITY (II)

External factors

- **Global economic recovery**
- **US monetary tightening**
- **External imbalances of the US**
- **Volatility in currency and equity markets**
- **Political pressure on renminbi exchange rate**
- **Macroeconomic policies of the Mainland**
- **Geopolitical issues**

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- **Global economic recovery:** Global growth slowed during the second quarter of 2004. Growth in the US, Mainland China and Japan moderated, while it was little changed in the euro area. Oil prices have remained high and volatile this year, representing a risk to the global growth outlook.
- **Global interest rates:** US short term interest rates have been raised three times since June and are expected to rise by, at least, a further 25 basis points by the end of the year. Slower growth has reduced the risks of a sharper-than-expected rise in US interest rates.
- **External imbalances:** The US current account deficit recorded a historic high in 2004 Q2, rising to 5.7% of GDP, fuelling concerns about its sustainability.
- **Currency markets:** The US dollar appreciated on a trade-weighted basis by around 2.0% between January and September 2004, as stronger economic data in the first few months of the year outweighed concerns about the current account deficit. But the major currencies have been trading in a wide range during the period (USD/Yen between 103.4 and 114.9 and USD/Euro between 1.176 and 1.293).
- **Political pressure on the renminbi exchange rate:** Political pressure continues on the Mainland authorities to move to a more flexible exchange rate regime, which continues to induce volatility in the Hong Kong dollar.
- **Geopolitical issues:** There are continuing concerns over the situation in Iraq and increasing cross-strait tension.



RENMINBI - MARKET EXPECTATIONS

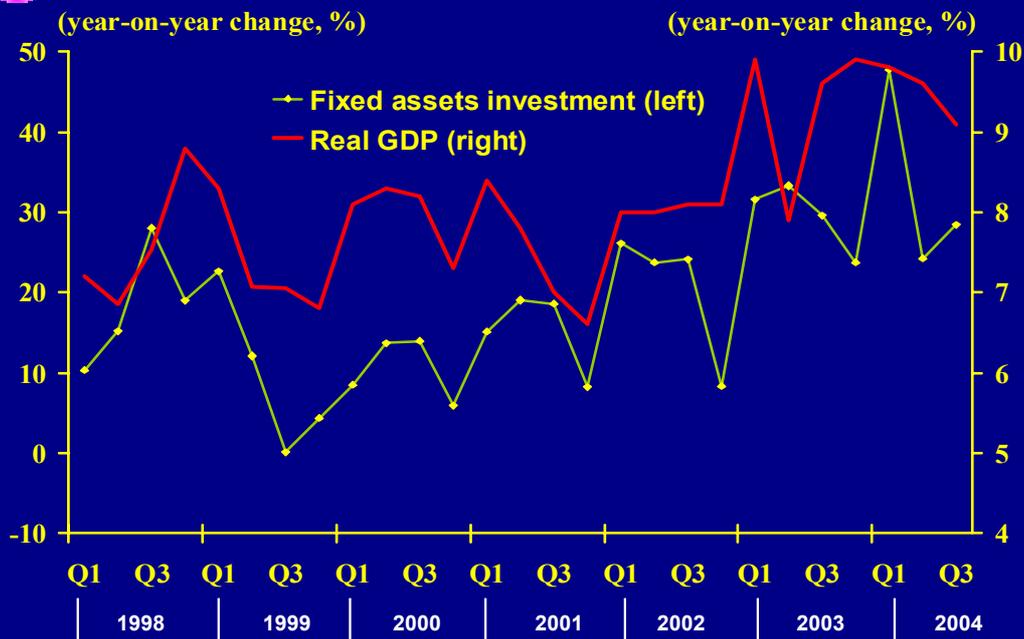


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- Political pressures on revaluation of the renminbi, coupled with the significant trade surplus and fast accumulation of foreign reserves on the Mainland, have brought the 12-month renminbi non-deliverable forward (NDF) points to a discount.
- Between March and early July 2004, the moderation of external political pressure on the Mainland to adopt a more flexible exchange rate regime and concerns about a sharp slowdown in growth helped ease the renminbi revaluation expectations. However, with more recent data suggesting that the economy is probably heading towards a soft landing and renewed pressures on the Mainland authorities, the discount of the 1-year NDF has widened again since late July.



INVESTMENT GROWTH ON THE MAINLAND

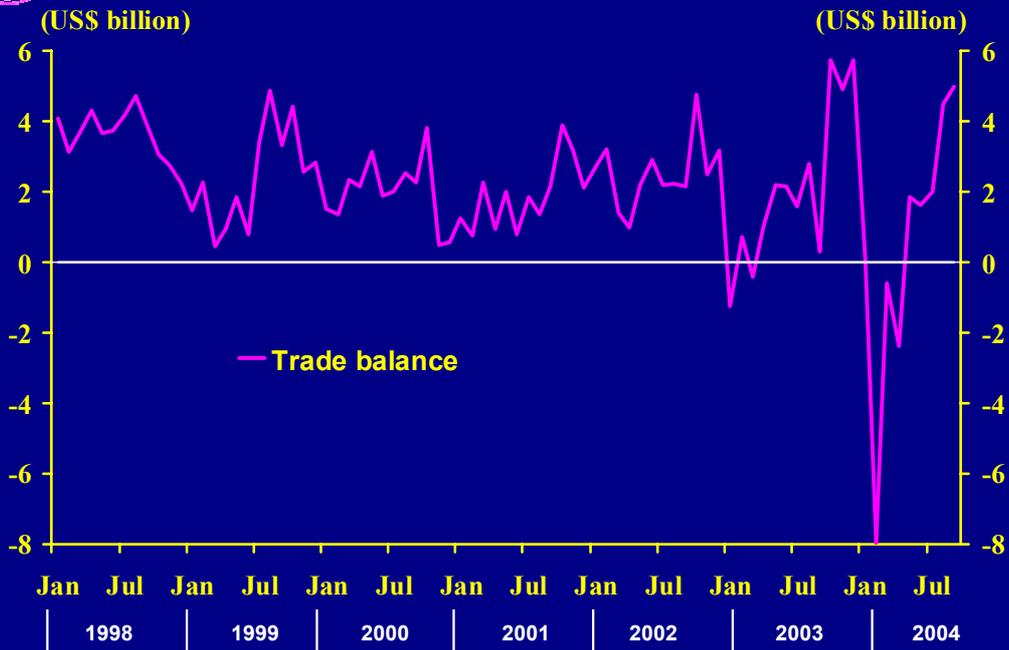


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- The latest data suggest that tightening measures on the Mainland seem to have been effective in achieving a gradual deceleration of economic growth, but demand and inflationary pressures continue to exist.
- Real GDP growth slowed to a year-on-year growth rate of 9.1% in Q3 from 9.8% in Q1 and 9.6% in Q2. In judging how much the economy has been decelerating, one needs to bear in mind that the yoy growth rate for Q2 was likely to have been exaggerated by the low base of comparison in 2003 Q2 when the economy was disrupted by the SARS outbreak. In this light, the latest figure suggests that the deceleration in Q3 was modest, and it is even possible that economic growth has picked up somewhat compared to Q2.
- Growth in fixed asset investment rebounded in Q3 after a sharp slowdown in Q2.
- Newly started projects recorded a marked increase in August, suggesting that growth in investment spending may remain strong in the periods ahead.



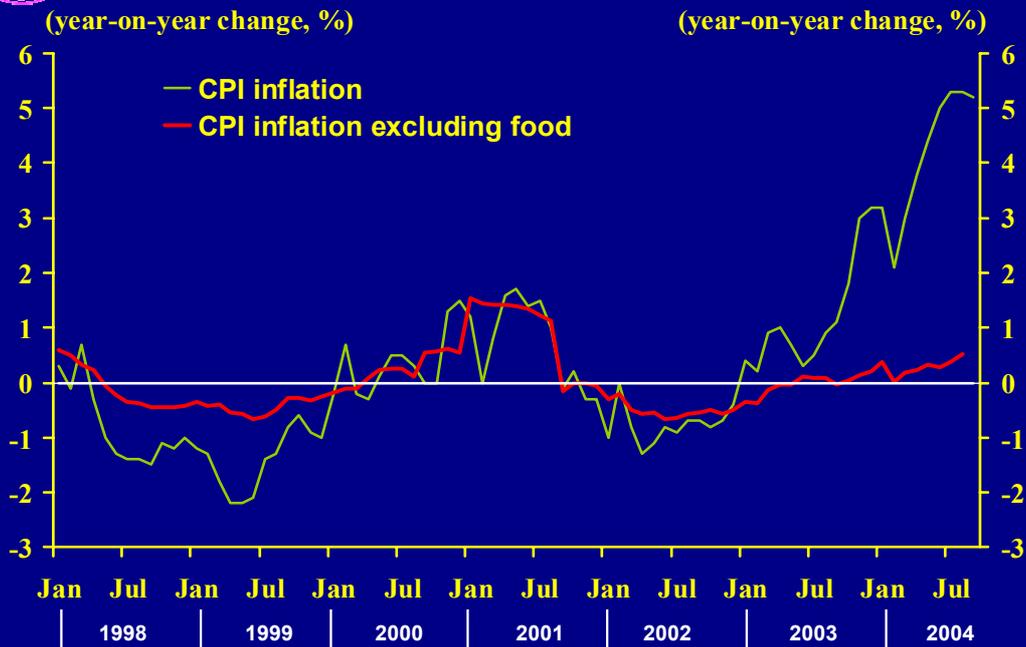
TRADE BALANCE OF THE MAINLAND



- Trade balances returned to surpluses in May-September, as imports of intermediary and capital goods slowed.



INFLATION ON THE MAINLAND

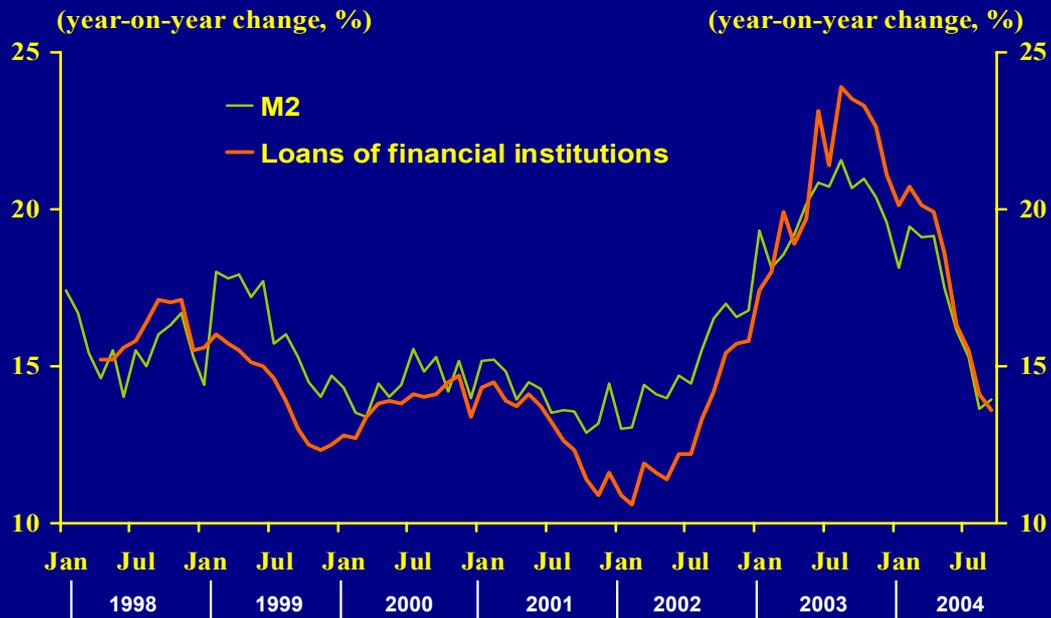


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- Inflationary pressures are visible. Headline CPI inflation has risen above 5% since June, and only moderated slightly in September.
- While rises in food prices remain the most important contributor to the price increases, non-food prices have also increased at faster rates.
- Higher rates of increases in the producer price index (PPI) and investment goods price index, and continued bottlenecks in the energy and transport sectors point to stronger underlying inflationary pressures than suggested by changes in the headline CPI. However, the autumn harvests might start to stabilise food prices, helping ease the upward pressures on the CPI.



MONEY AND CREDIT GROWTH ON THE MAINLAND



- Monetary tightening has led to a marked slowdown in broad money and loan growth in the past few months, raising concerns about the impact on economic activities.
- Overall, even though demand and inflationary pressures continue to exist, the Mainland economy appears to have achieved a measured slowdown. Going forward, appropriate macroeconomic management is crucial to the stability of the economy. If tightening measures remain in place longer than necessary, they might cause a policy-induced hard landing. On the other hand, if tightening measures are withdrawn hastily, pent-up demand pressures might immediately be unleashed, leading to another round of overheating.
- We shall continue to watch developments closely, particularly for any change in exchange rate and monetary policies that could have an impact on monetary stability in Hong Kong. Uncertainty in the macro-economic performance in Mainland China could be translated into volatility in open financial markets outside Mainland China, particularly in Hong Kong, which has been used for hedging risks and exposures on the Mainland.



CURRENCY STABILITY (III)

Domestic factors

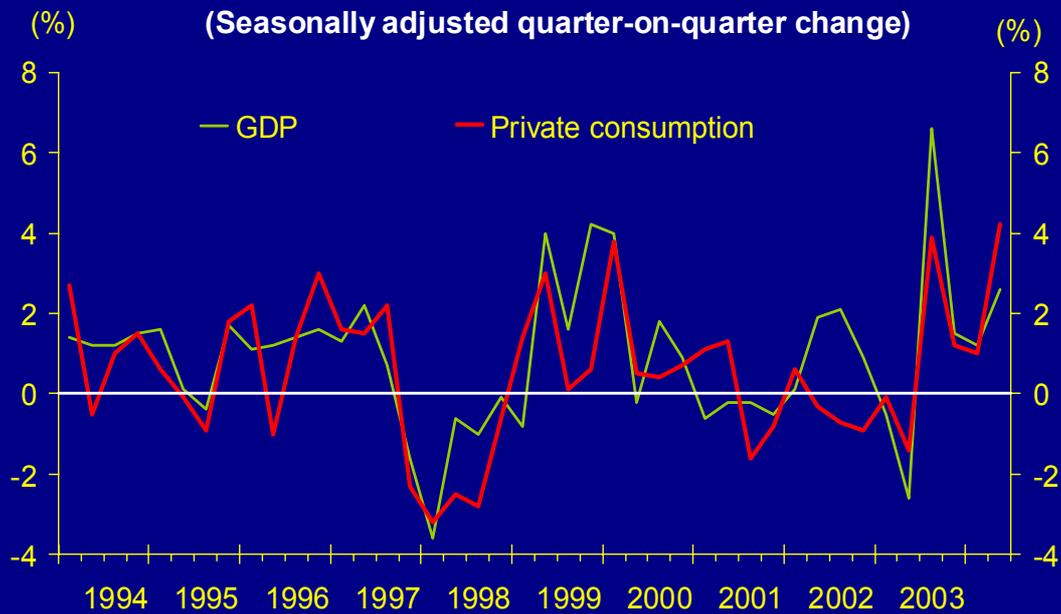
- **Economic recovery**
- **External position**
- **Inflation?**
- **Unemployment**
- **Public finance**

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- **Robust economic recovery:** Real GDP rose further by 2.6% in 2004 Q2 on a seasonally adjusted quarter-on-quarter basis, following a 1.2% growth in 2004 Q1. The government revised upwards its growth projection for 2004 from 6% to 7.5%.
- **Private consumption** grew strongly in 2004 Q2, while growth in external demand remained robust, providing impetus to the overall economic growth.
- **The external position of Hong Kong** remains healthy. Although current account surplus fell significantly from a high level during the first half of the year as a robust recovery in domestic demand drove up imports, the net international investment position remains very strong (at more than two times GDP).
- **The headline Consumer Price Index** recorded its first year-on-year increases in July and August since October 1998. However, they reflected a low base of comparison in 2003 Q3. There are not yet signs of a significant pick-up in inflation.
- The **unemployment rate** eased to 6.8% in the three months to August 2004, from a record high of 8.6% in the April-July 2003 period. The unemployment rate remains high relative to the level before the Asian financial crisis, notwithstanding the recent improvement.
- **Public finances** are still a concern, although there are signs of improvement in recent quarters. Investors are likely to remain watchful of the fiscal position and the policy strategy adopted by the authorities to address the imbalance.



STRONG ECONOMIC RECOVERY

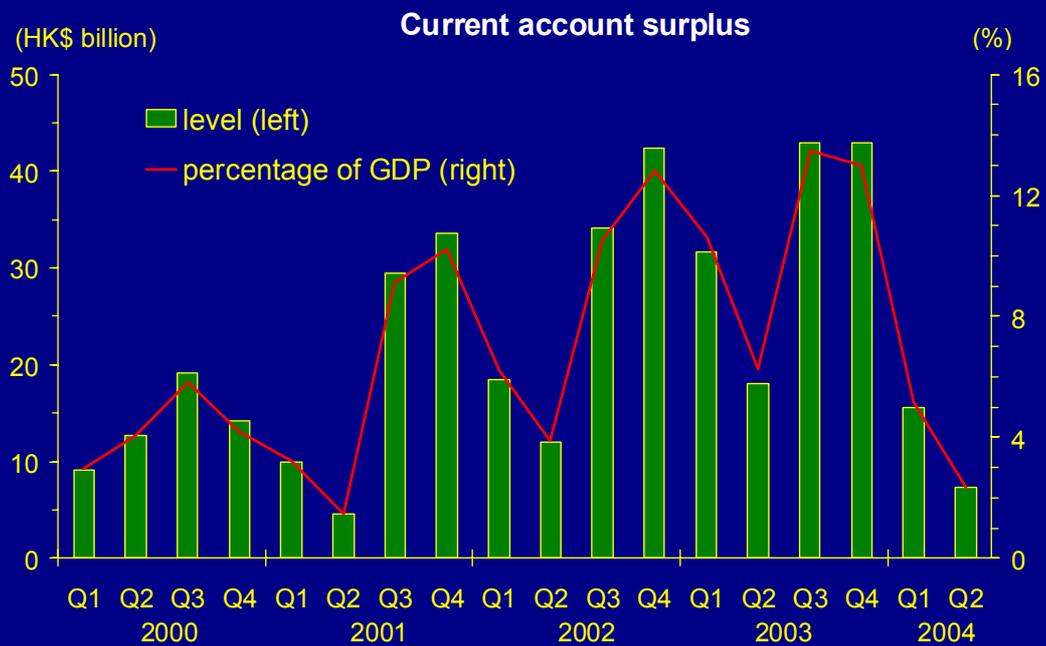


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- The pace of recovery in the Hong Kong economy accelerated in Q2, with real GDP expanding by 2.6% from the previous quarter. On a year-on-year comparison, the economy grew sharply by 12.1%, reflecting in part a low base of comparison in 2003 Q2 when domestic activity was severely disrupted by the SARS outbreak.
- The acceleration in growth was primarily driven by a pick-up in private consumption and investment, while the contribution of net exports of goods and services was small owing to increased imports associated with the strong domestic demand.
- In particular, private consumption expenditure increased by 4.2% in Q2 on a seasonally adjusted basis, the fastest quarter-on-quarter growth in almost 12 years. Investment also rose distinctly, by 13.2% from a year earlier, driven by a continued increase in spending on machinery, equipment, and computer software (seasonally adjusted qoq growth is not available).
- More recent indicators suggest a slowdown in growth in recent months from a relatively high Q2 level. Specifically, merchandise exports grew at a slower month-on-month rate in July-August compared with the average in Q2, while the volume of retail sales declined by 1.2% in July from June. On the other hand, the number of incoming tourists surged to a new record high in August, helped by the expansion of the Individual Visit Scheme in July this year.



BALANCE OF PAYMENTS ACCOUNT

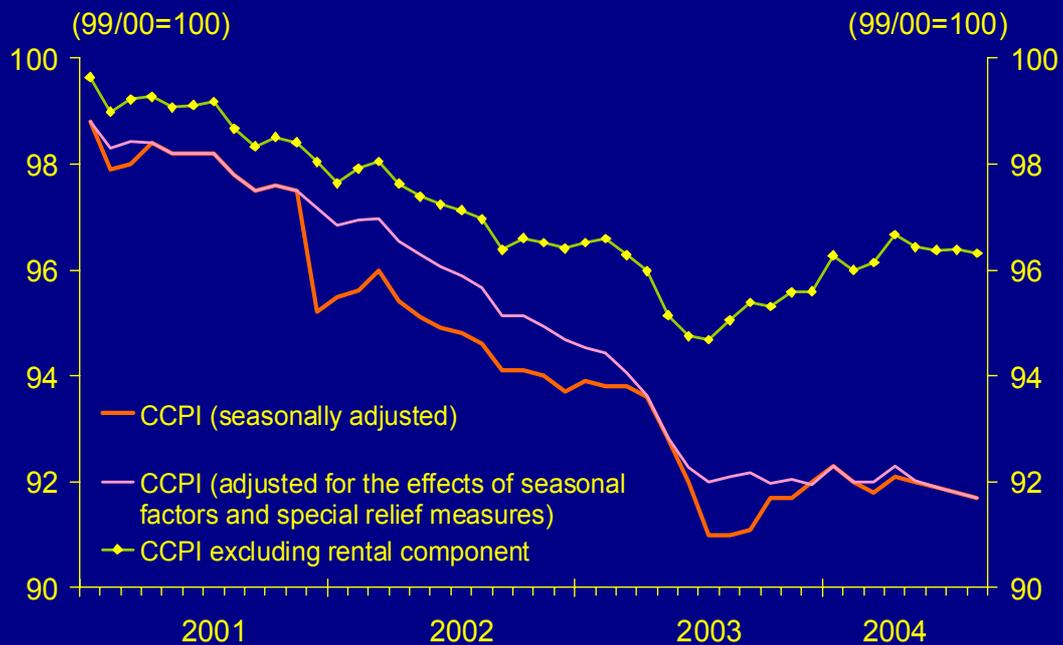


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- Reflecting in part the improved competitiveness, external payment position has been strong.
- In particular, the current account surplus increased to around 13% of GDP in 2003 Q3 and Q4. This reflected a rebound in the tourism-related sectors and sustained growth in exports of goods and trade-related services.
- Current account surplus then declined in the first half of 2004, partly owing to seasonality, and partly attributable to the robust growth in imports arising from the pick-up in local economic activities. Meanwhile, exports of goods and services remained buoyant.
- Nevertheless, the investment income generated by the accumulated net foreign assets (which are close to 250% of GDP) will continue to support the Hong Kong dollar, particularly if these earnings, most likely in foreign currency, are invested in domestic markets alongside the economic upturn.



CONSUMER PRICE MOVEMENTS

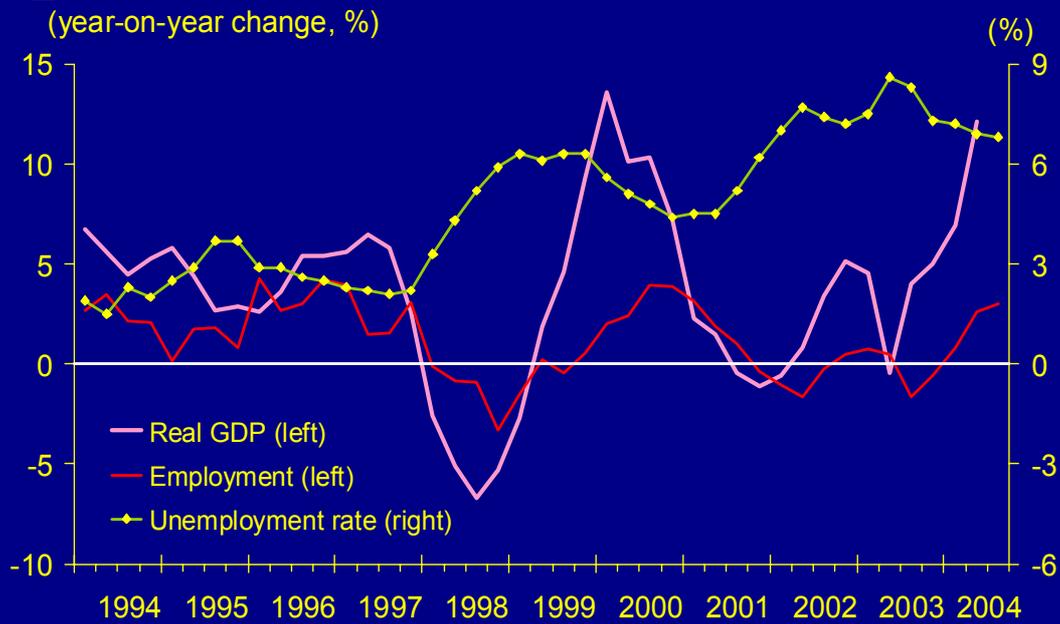


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- The rise in the headline year-on-year inflation rate for two consecutive months since July has led to concerns about a return of inflation to Hong Kong. However, the rise in the headline CCPI in July and August was mainly accounted for by the special relief measures (such as rate concession) granted by the Government in 2003 Q3.
- To better assess underlying price developments, the CCPI is adjusted for the effects of seasonal factors and government relief measures. After removing these effects, the CCPI has been broadly flat since July 2003.
- The rental component accounts for 27% of the consumer price basket, and its movements tend to lag behind market developments, as rental contracts typically have a term of 1-2 years. This makes the overall CCPI a lagging indicator of inflation. After excluding the rental component, the CCPI increased by 2% between July 2003 and April 2004, before declining modestly in recent months.
- On a month-on-month comparison, both the CCPI and the CCPI excluding rental registered small declines in recent months after turning positive earlier in 2004. All these suggest that, while deflationary pressures have eased rapidly and, by some measures, dissipated, there are few signs of a significant pick-up in inflation yet.



LABOUR MARKET

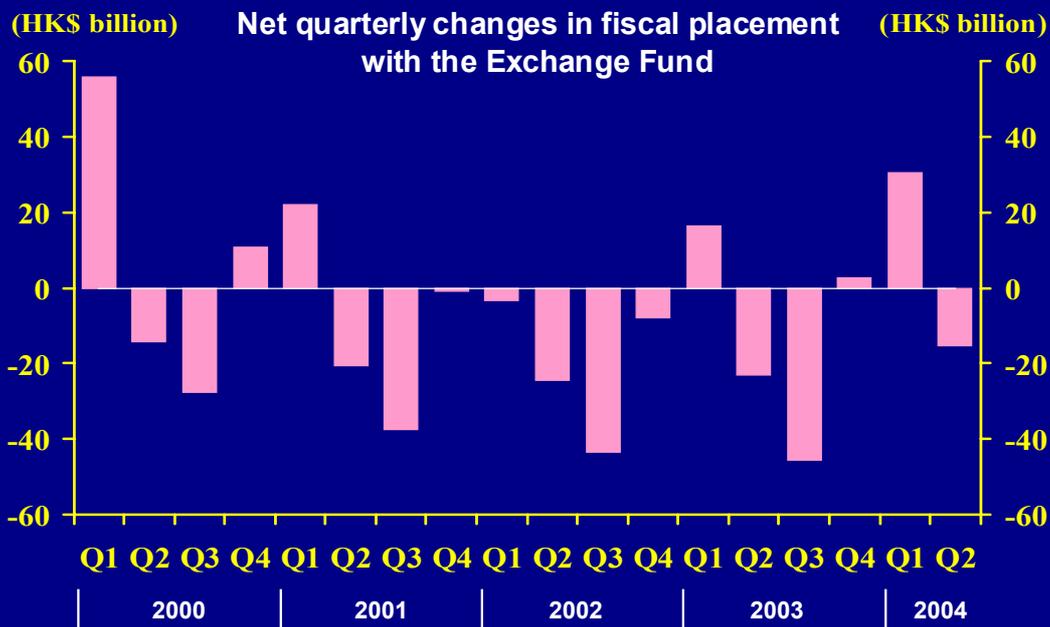


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- Along with the economic recovery, labour market conditions have improved, although the pace of decline in the unemployment rate appears to have moderated in recent months.
- The seasonally-adjusted unemployment rate stood at 6.8% in the three months ending August 2004, compared with a historic high of 8.6% recorded in mid-2003. Most of the improvement took place in the earlier part of 2004. The recent moderation in the decline of the unemployment rate was mainly a result of relatively fast increases in labour force, which largely offset the gain in employment.
- Looking ahead, a sustained recovery of the economy should help reduce the unemployment rate further. In particular, there has been a strong increase in job creation, as new job listings at the free hiring service of the Labour Department increased to about 30,000 in August, registering a record high.



FISCAL DRAWDOWNS



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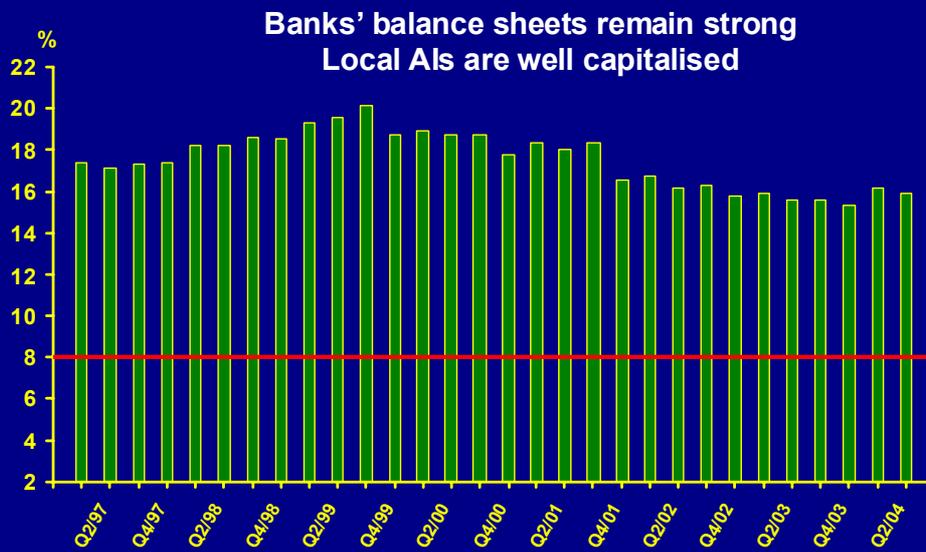
- Along with the economic recovery, the Government's fiscal position has improved.
- There were net placements with the Exchange Fund for two consecutive quarters before a return to a net draw-down in 2004 Q2.
- However, the draw-down in 2004 Q2 was largely a seasonal phenomenon. In fact, the draw-down was lower than that in the same period for the previous three years.
- Detailed figures for quarterly changes in fiscal placements are as follows.

Net Quarterly Change in Fiscal Placement with the Exchange Fund (HK\$ billion)

year \ quarter	Q1	Q2	Q3	Q4
2000	55.9	-14.1	-27.7	10.8
2001	22.1	-20.4	-37.4	-0.7
2002	-3.1	-24.4	-43.5	-8.0
2003	16.4	-22.9	-45.6	2.7
2004	30.7	-15.2		



BANKING SECTOR PERFORMANCE



Period-end figures.

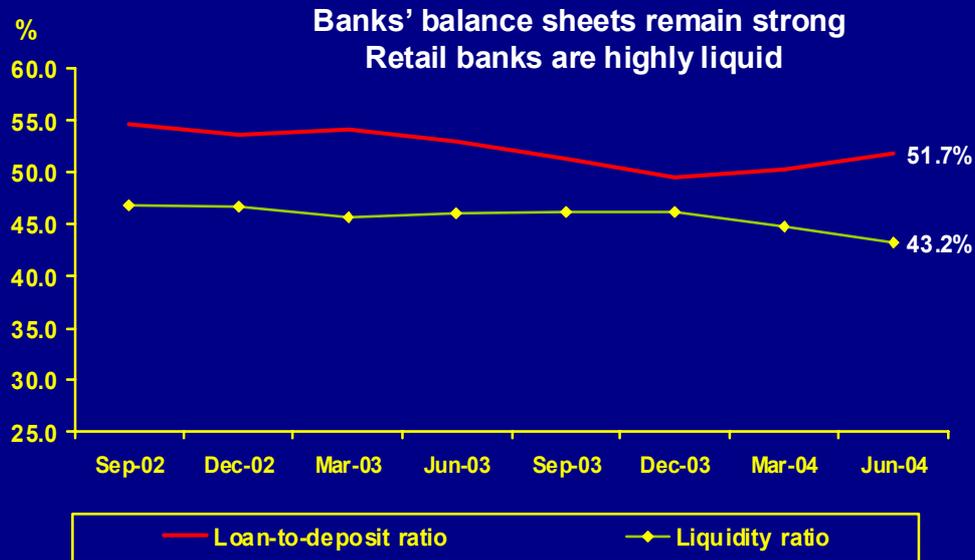
There is a break in series at end-December 2001 owing to a change in the reporting population.

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- Locally incorporated AIs are required to maintain a capital adequacy ratio, which measures the amount of capital that the AI holds in relation to the amount of risk assets that it has, of not less than 8%, being a statutory requirement under the Banking Ordinance and the international minimum standard set by the Basel Committee. At end-June 2004, the average consolidated capital adequacy ratio of all local authorized institutions was almost 16%, well above the statutory and international minimum of 8%.



BANKING SECTOR PERFORMANCE



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- The liquidity of retail banks remained high, as measured by their statutory liquidity ratios and loan-to-deposit ratios.
- In the second quarter of 2004, retail banks' average liquidity ratio was 43.2%, well above the minimum statutory requirement of 25%.
- Although bank lending has risen recently, the banking sector is still very liquid as retail banks' loan-to-deposit ratio in all currencies and in Hong Kong dollar, being 51.7% and 75.3% respectively, remained at very healthy levels.



BANKING SECTOR PERFORMANCE

More robust profit growth of retail banks

	<u>Jun 04</u>	<u>Jun 03</u>
Growth in pre-tax operating profit	+25.7%	+2.3%
Bad debt charge as % of average total asset	-0.02%	0.38%
Cost-income ratio	40.0%	36.8%

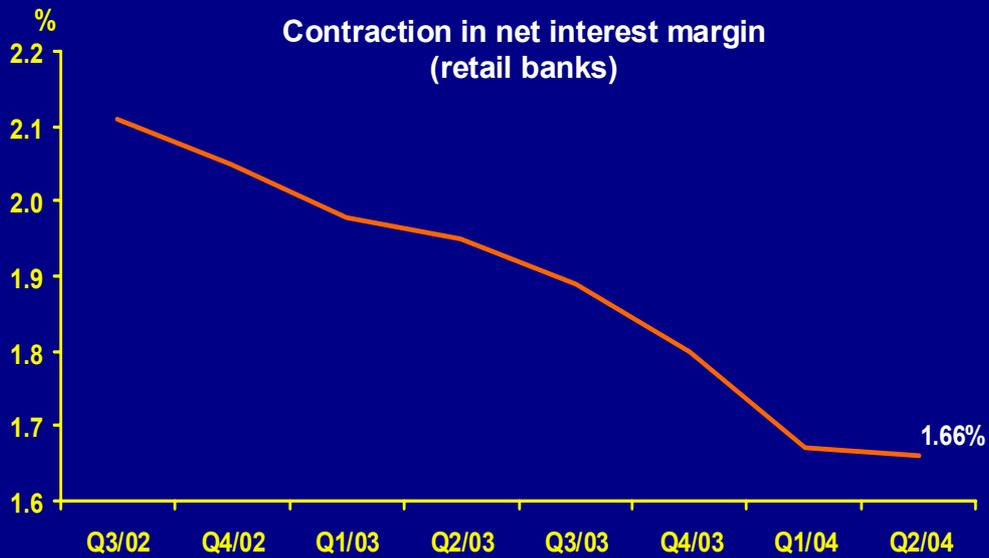
Year-to-date annualised figures

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- Fuelled by the growing momentum in economic recovery, retail banks' aggregate pre-tax operating profit in respect of their Hong Kong offices increased by 25.7% in the first half of 2004, compared with the same period of 2003.
- Despite lower interest income and increase in operating costs, retail banks recorded higher profits in the first half of 2004, attributable mainly to lower bad debt charges, continued gains from treasury operations and higher income from fees and commissions arising mainly from wealth management and trade financing activities.
- On the back of improving economic conditions and asset quality, the bad debt charge declined notably in the first half year compared with a year previously, during which substantial provisions due to SARS were made. Attributable to write-back of provisions experienced by some banks, which more than offset the bad debt charges, retail banks as a whole recorded a net write-back in the first half of 2004. As a result, retail banks' ratio of overall bad debt charge to average total assets improved to -0.02% in the first half of 2004 from 0.38% a year ago.
- Reflecting increases in staff costs and other expenses arising from business expansion, retail banks' cost-income ratio increased to 40% from 36.8% in the first half of 2003.



BANKING SECTOR PERFORMANCE



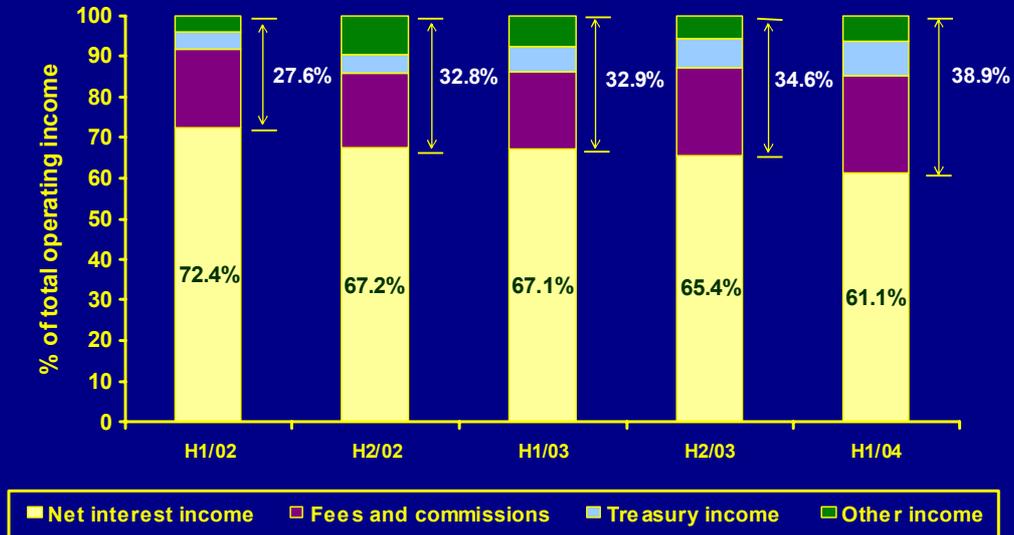
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- As shown in the chart, net interest margin of retail banks has been contracting steadily, reflecting keen competition in the banking sector and sluggish loan demand during the period.



BANKING SECTOR PERFORMANCE

Diversification in source of income (retail banks)

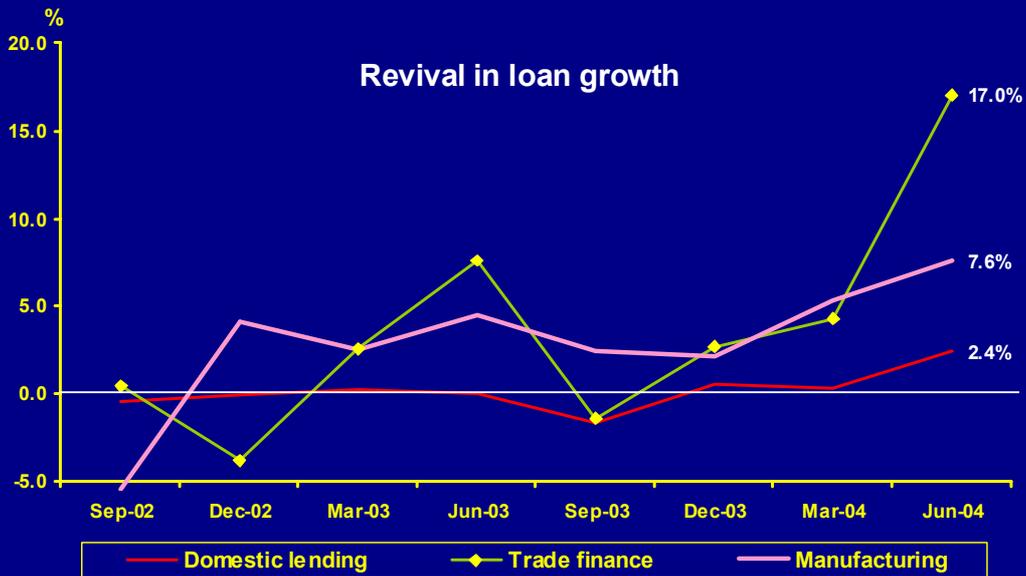


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- Continuing pressure on interest spread has prompted banks to diversify their business and income sources.
- Banks' fee-generating business is growing (e.g. wealth management). As a result, their fees and commission income has increased. Similarly, the proportion of treasury income has also increased, reflecting in part banks' increased holding of negotiable debt instruments in the light of the sluggish loan demand in 2003. Overall, retail banks' non-interest income accounted for 38.9% of total operating income for the first half of 2004, up from 32.9% of the same period last year.
- To address these changes in banks' business profile, the HKMA increased its supervision over banks' securities and insurance businesses including co-operation with other supervisory authorities, collection of prudential data as well as on-site inspections. The HKMA has also put more focus on risk management of banks particularly in the areas of interest rates and market risks as banks increased their holding of negotiable debt instruments.



BANKING SECTOR PERFORMANCE



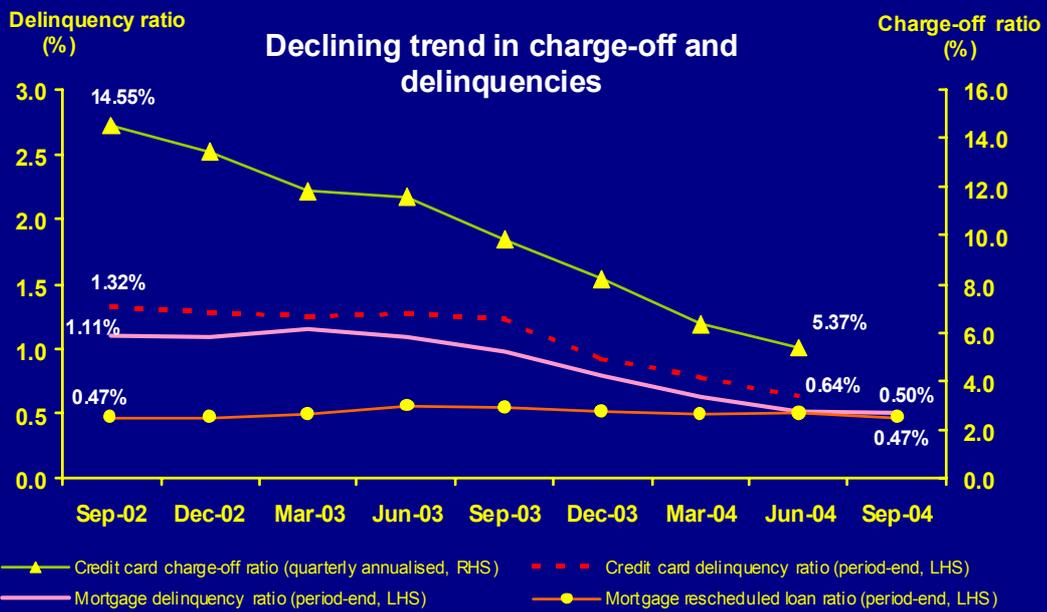
Quarterly percentage change

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- The latest data suggest that the economic recovery is broadening, in that bank lending has started growing more strongly - by 2.4% in the second quarter. (This is not a year-on-year growth rate. Loans to customers in Hong Kong at the end of June were 2.4% higher than at the end of March.)
- Growth is now not just in consumer lending, but also in trade financing (up 17% in the second quarter) and corporate lending; lending to the manufacturing sector increased by 7.6% in the second quarter. This is encouraging. A recovery that is broader-based could be more sustainable.



BANKING SECTOR PERFORMANCE



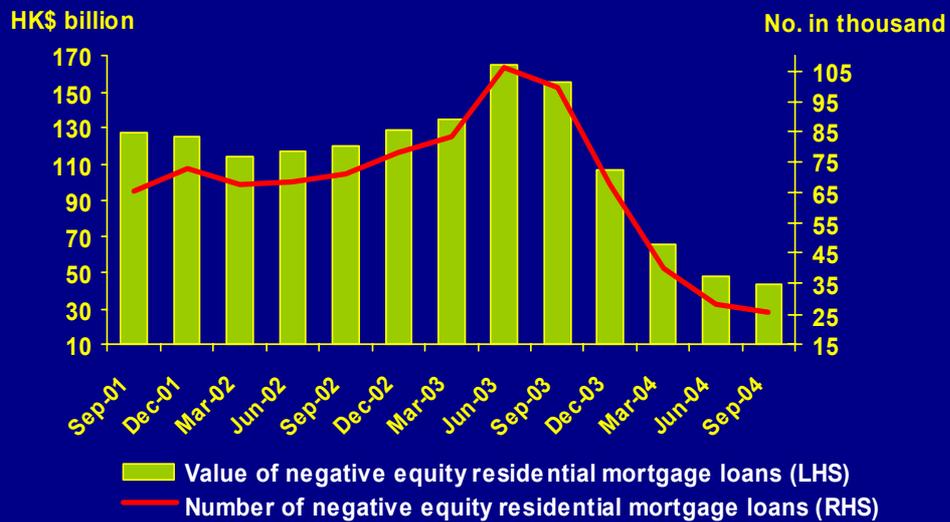
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- Delinquency ratio of mortgage lending refers to the ratio of mortgage loans overdue for more than 3 months to total outstanding loans.
 - Quality of consumer lending also improved, mainly driven by the continued fall in unemployment and bankruptcies and recovery of property values.
 - Credit card charge-off gradually declined to 5.37% from the peak of 14.55% and delinquency ratio down to 0.64% at end-June 2004 from the peak of 1.32% at end-September 2002. The improvement in the quality of the credit card portfolio was also helped in part by banks' on-going debt rescheduling arrangements.
 - The mortgage delinquency ratio fell to a 5-year low of 0.47% at the end of September 2004 from the peak of 1.4% at end-April 2001.



BANKING SECTOR PERFORMANCE

The extent of residential mortgage lending in negative equity continued to improve



Period-end outstanding figures

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- The extent of negative equity problem eased along with the rise in property prices. The number of residential mortgage loans in negative equity reduced from the peak of around 106,000 cases (HK\$165 billion) in June 2003 to around 25,400 cases in September 2004 with an aggregate value of HK\$43 billion. Compared with a year ago, the number of residential mortgage loans in negative equity has reduced by 75%.



DBS BANK (HONG KONG) LIMITED DESTRUCTION OF RENTED SAFE DEPOSIT BOXES (1)

The HKMA's Views and Actions

- **The HKMA took a serious view of this incident and required the bank to**
 - promptly notify affected customers
 - handle compensation in a prompt, fair and reasonable manner
 - conduct a thorough investigation into the incident
 - take immediate actions to strengthen controls relating to destruction of safe deposit boxes
 - review exemption of liability clauses used in its contracts

- **Three major issues arising from the incident need to be addressed**
 - compensation to affected customers
 - exemption of liability clauses
 - operation of safe deposit boxes



DBS BANK (HONG KONG) LIMITED DESTRUCTION OF RENTED SAFE DEPOSIT BOXES (2)

Compensation

- **Code of Banking Practice (provides general principles)**
 - **Als should establish effective procedures for handling customer complaints in a fair and speedy manner**
- **The HKMA's Guidance Note on Complaint Handling Procedures**
 - **where a complaint is upheld and redress is appropriate, an AI should aim to provide the complainant with fair compensation for any acts or omissions for which it was responsible**
- **Up to 29 October, out of the 83 customers affected**
 - **55 cases have been fully settled**
 - **26 customers have accepted \$150,000 for full settlement**
 - **29 customers have filed their claims which have been settled by the bank**
 - **Of the remaining 28 unsettled cases**
 - **7 customers have submitted claims which are being considered by the bank**
 - **21 customers are either in process of preparing their claims with the bank or considering their cases. The bank is liaising with these customers and providing assistance to them**

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- Paragraph 13 of the Code of Banking Practice provides that Als should handle customer complaints in a fair and speedy manner. In particular, Als' complaint handling procedures should provide for the speedy resolution of disputes in a fair and equitable manner.
- Section 2.5.1 of the HKMA's Guidance Note on Complaint Handling Procedures stipulates that Als' internal complaint handling procedures should provide for adequate responses to address the matters of complaint and where a complaint is upheld, to offer appropriate redress. Further, where an authorized institution decides that redress is appropriate, it should aim to provide the complainant with fair compensation for any acts or omissions of which it was responsible.
- The HKMA expects the bank to handle compensation to customers in a prompt and fair manner and will continue to monitor its progress.



DBS BANK (HONG KONG) LIMITED DESTRUCTION OF RENTED SAFE DEPOSIT BOXES (3)

Exemption of liability clauses

- **Safe deposit box agreements generally include an exemption of liability clause. Some clauses purport to exclude a bank's liability even in the case of loss or damage caused by negligence of the bank.**
- **Code of Banking Practice effectively requires these clauses to be consistent with the Control of Exemption Clauses Ordinance which contains a "reasonableness" element.**
- **The HKMA requested AIs to undertake a comprehensive review of terms and conditions for banking services**
 - relating to safe deposit box service: by 15 November 2004
 - relating to other banking services: by 15 January 2005
- **Exploring with the Code of Banking Practice Committee on how to improve AIs' use of exemption clauses.**

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• Exemption of liability clauses:

- The DBS Bank (Hong Kong) incident highlighted that banks providing safe deposit box service generally include an exemption of liability clause in their contract with customers.
- Some of these exemption clauses purport to exclude or restrict to a nominal amount an institution's liability even in the case of loss or damage caused by the negligence of the institution or its staff.

• Possible inconsistency with the statute and the Code:

- Although, in this particular incident, DBS Bank (Hong Kong) does not rely on the exemption clause in determining compensation to the affected customers, we believe that there is room for improvement in relation to the use of exemption clauses in banks' contracts with customers.
- Under the Control of Exemption Clauses Ordinance, a party to a contract cannot by reference to any contract term exclude or restrict his liability for negligence except in so far as the term or notice satisfies the requirement of reasonableness (re section 7(2) of that Ordinance).
- Section 5.5 of the Code of Banking Practice states that, in drawing up their terms and conditions for banking services, institutions should have due regard to applicable laws in Hong Kong, especially consumer protection legislation, which should include the Control of Exemption Clauses Ordinance.
- Exemption clauses that purport to exclude or restrict to a nominal amount an institution's liability even in the case of loss or damage caused by the negligence of the institution or its staff appear to be inconsistent with the Code.

• Action taken and way forward:

- In view of the above, we have requested all authorized institutions to undertake a comprehensive review of their terms and conditions for banking services to see if they are consistent with the Code and to consider whether any amendments to such terms and conditions are necessary.
- Authorized institutions are required to submit the full report in three months whereas the part in relation to safe deposit box service in one month. The HKMA will then review institutions' findings and follow up with individual institutions to ensure that any necessary amendments to their terms and conditions are implemented.
- While we are awaiting the results of institutions' reviews, we are also exploring with the Code of Banking Practice Committee on how the current practice in relation to institutions' use of exemption clauses can be improved under the context of the Code.



DBS BANK (HONG KONG) LIMITED DESTRUCTION OF RENTED SAFE DEPOSIT BOXES (4)

Operations of Safe Deposit Boxes

- **Simple operations but could have high potential customer impact. A typical case reflecting the importance of operational risks of banks.**
- **Banks expected to follow sound internal control principles in removing or destroying safe deposit boxes, such as**
 - **adequate oversight during removal or destruction operations**
 - **detailed records of safe deposit boxes to be removed**
 - **independent verification of such records and the boxes to be removed/destroyed during the process**
- **The HKMA will study the bank's investigation report and consider what lessons to be shared with banks providing safe deposit box service.**

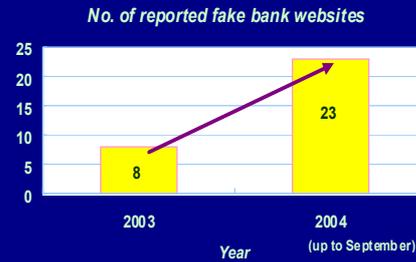
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- Section 6.1.2 of the HKMA's Statutory Guideline on General Risk Management Controls contains a requirement for authorized institutions to have a properly structured internal control system that should help minimise the operating risk of loss from irregularities, fraud and error.
- Section 6.1.3 of the Guideline requires that an authorized institution's internal control system should cover controls relating to major functional areas, including retail banking, which should cover safe deposit box service.
- The HKMA will consider the bank's internal investigation report in due course and consider whether there are any lessons that should be shared with other banks providing safe deposit box service.



BANKING SECTOR - WORK PROGRESS INCREASE IN INTERNET FRAUD

- **Increasing number of fake bank e-mails and websites reported recently in Hong Kong:**
 - **8 cases of fake websites in 2003**
 - **23 cases of fake websites in 2004 (up to September)**
 - **First case reported with financial loss in September 2004**
 - **So far, HK\$1.4 million involving 20 customers of the same bank reported. The Police is still investigating the cases.**
- **Customers should enhance their vigilance: banks or their agents would never ask their customers to provide sensitive personal and account details through emails**



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Increase in Internet Fraud

- There is an increasing trend of reports on fake bank e-mails and websites targeting at bank customers in Hong Kong:
 - The HKMA received 8 reports in 2003 and 23 reports during the first 9 months of 2004 on fake bank websites.
 - Reports on customers suffering financial loss in relation to fake bank websites were first received in September 2004.
 - So far, the HKMA has received reports on a total financial loss of around HK\$1,400,000 involving 20 customers of the same bank. The Police and the bank are still investigating these cases.
- Banks have sent clear advice to customers that they will never ask for sensitive account and personal information through emails.



BANKING SECTOR - WORK PROGRESS INTERNET FRAUD: INITIATIVES

Measures taken since 2003:

- **Consumer education**
 - Co-operated with the banking sector and the Police on a multi-channel consumer education programme
- **Strengthening Internet banking security**
 - Issued a circular in June 2004 recommending AIs to implement two-factor authentication for high-risk retail Internet banking transactions by the middle of 2005
- **Interim measures before mid-2005**
 - AIs are expected to review and enhance their existing security measures, including:
 - improving fraud monitoring and reporting mechanism
 - suspending transfers to unregistered third party accounts or lowering the maximum limit for such transfer
 - speeding up implementation of two-factor authentication



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Initiatives taken by the HKMA

The HKMA has taken the issue of fake bank e-mails and websites seriously. In this connection, the HKMA and the banking sector have taken a number of initiatives. Measures taken since 2003 include:

- Consumer education programme:
 - The Police, the banking sector and the HKMA have been working together to promote customer education, e.g. a multi-channel consumer education programme was launched to promote awareness of Internet banking security in Hong Kong. The programme includes issuance of educational leaflets, production of a series of TV episodes and radio segments, and development of interactive computer programmes.
- Strengthening Internet banking security:
 - The HKMA issued a circular in June 2004 recommending AIs to introduce two-factor authentication for high-risk retail Internet banking transactions before the middle of 2005.
 - Examples of second-factor authentication include digital certificates, one-time passwords generated by a security device and SMS-based one-time passwords.
- Interim measures before mid-2005:
 - Another circular was issued in September 2004 reiterating the importance of precautionary measures against fake bank e-mails and websites. While AIs are expected to accord high priority for implementing two-factor authentication, they are also recommended to review and enhance their existing security measures before two-factor authentication is in place. Among others, AIs should consider:
 - improving their fraud monitoring and reporting mechanism;
 - suspending transfers to unregistered third-party accounts or lowering the maximum limit for such transfer; and
 - speeding up implementation of two-factor authentication where possible.



BANKING SECTOR - WORK PROGRESS ADVICE FOR CUSTOMERS

- **Do not:**
 - Access your Internet banking account through hyperlinks embedded in e-mails, suspicious pop-up windows or Internet search engines.
 - Click on a hyperlink in a suspicious e-mail, open unexpected e-mails with attachments, or visit suspicious websites.

- **Do:**
 - Access your Internet banking account either by typing the website addresses in the address bar of the browser, or by bookmarking the genuine website and using for access.
 - Install personal firewall software and anti-virus software, and regularly download the latest updates available.
 - Change passwords regularly.



BANKING SECTOR - WORK PROGRESS

- **Implementation of Basel II in HK**
 - **FA Panel already briefed on broad concept in July 2004**
 - **preparing for the legal and regulatory frameworks for implementation**
 - **ongoing, extensive market consultation**
 - **will brief FA Panel in more detail in December**

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- In line with our policy of adhering closely to international best practices and standards, we will implement the requirements of Basel II (i.e. the revised capital standards issued by Basel Committee in June 2004) following the Basel timetable: simpler approaches at end-2006 and most advanced approaches by end-2007. We already briefed FA Panel members about this earlier in July.
- Preparatory work for legislating Basel II is in progress. We plan to introduce in early 2005 a Banking Amendment Bill to the LegCo for effecting relevant legislative amendments to the Banking Ordinance.
- A Basel II Consultation Group with representatives from the industry and other interested parties was set up early in the year with three meetings already held so far. These resulted in a detailed consultation package on our implementation proposals and a subsequent addendum to it being released for public consultation in August and September. Interested parties have been invited to send in comments by end-October.
- We have scheduled to brief FA Panel again in December our detailed work progress of implementing Basel II in Hong Kong.



BANKING SECTOR - WORK PROGRESS

- **Deposit Protection Scheme (DPS)**
 - the DPS Ordinance was enacted in May 2004 and the Hong Kong Deposit Protection Board was formed in July 2004
 - will proceed with the development of the relevant rules, policies and procedures, as well as the payout IT systems
 - expect to start providing protection in the second half of 2006
- **Positive data sharing**
 - Increasing signs of the benefits of positive data sharing being realised
 - Als generally have established effective systems for safeguarding the privacy of customer data
- **Commercial credit reference agency (CCRA)**
 - systems tested
 - service to be launched on 1 November 2004
 - will monitor participating Als' compliance with the data protection requirements specified in the HKMA's guideline

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- Following the enactment of the Ordinance and the formation of the Deposit Protection Board, a large amount of preparatory work will need to be completed before deposit protection can be provided. These include the development of the rules for collecting contributions from banks, the policies and procedures for making compensation payments, as well as the related IT systems. As it will take time to complete these tasks and for banks to adapt to the Board's requirements, we expect the Scheme to be launched in the second half of 2006.
- Sharing of positive consumer credit data among banks has been implemented for more than a year (since August 2003). So far, the operation has been smooth. There are increasing signs that the benefits of positive data sharing are being realised. A number of banks have launched tiered interest rate products based on the creditworthiness of individual borrowers. This will benefit borrowers with good credit standing. Banks also inform us that positive data sharing has strengthened their credit risk management systems and has enabled them to offer better terms to customers. Meanwhile, we conducted in early 2004 a special review on the major players in the consumer credit market regarding their compliance with our supervisory guideline. The results show that Als generally have established effective systems for safeguarding the privacy of customers' personal data.
- Following about a year's preparation, the CCRA, which collates credit information of SMEs and makes it available to lending institutions, has successfully been established. Starting from today (i.e. 1 November 2004), Als can access the credit information of SMEs held at the CCRA. We believe that the establishment of the CCRA will strengthen Als' credit risk management and make it easier for SMEs to obtain bank financing. The HKMA will closely monitor the operation of the CCRA and Als' compliance with the data protection requirements specified in our guideline.



MARKET INFRASTRUCTURE

- **Clearing and Settlement Systems Ordinance will commence operation in November 2004 to**
 - **strengthen the HKMA's oversight of important clearing and settlement systems**
 - **provide settlement finality to transactions effected through such systems**
- **Hong Kong dollar is expected to join the Continuous Linked Settlement (CLS) System in December 2004**
- **Implementation of cross-border linkages with Mainland cities:**
 - **Hong Kong dollar and US dollar RTGS linkages between Guangdong and Hong Kong implemented in March 2004;**
 - **US dollar cheque two-way clearing between Shenzhen and Hong Kong implemented in July 2004**

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- The Clearing and Settlement Systems Ordinance was enacted in July 2004 and is expected to commence operation on 4 November 2004, subject to negative vetting by the LegCo. The Ordinance establishes a statutory regime for the Monetary Authority to designate and oversee important clearing and settlement systems and provides settlement finality to the transactions effected through such systems. To prepare for the commencement of the Ordinance, the HKMA has been consulting the industry on the preparation of the oversight framework and relevant guideline and returns.
- The Ordinance facilitates the admission of Hong Kong dollar into the Continuous Linked Settlement (CLS) system in December 2004 by providing settlement finality for transactions effected through CLS and the underlying Hong Kong dollar RTGS system.
- At its inception in October 2002, the CLS System admitted the US dollar, euro, yen, sterling, Swiss Franc, Canadian dollar and Australian dollar as the first wave currencies, and the Danish Krone, Norwegian Krone, Swedish Krona and Singapore dollar as the second wave currencies in October 2003. The CLS System is now settling over 120,000 transactions a day on average with a gross value of about US\$1.3 trillion. The admission of the Hong Kong dollar into the CLS System would help maintain Hong Kong's status as an international financial centre.
- To further facilitate the intermediation of funds across the border between Hong Kong and the Mainland, two new initiatives - the **Hong Kong dollar and US dollar RTGS linkages between Guangdong and Hong Kong, and US dollar cheque two-way clearing between Shenzhen and Hong Kong** - were implemented in March and July 2004 respectively. Under the first initiative, electronic funds transfers denominated in Hong Kong dollar and US dollar can now be made on a real time basis between Guangdong and Hong Kong. An average of HK\$1.4 million and US\$1.7million of funds are settled through these linkages each day. Under the second initiative, the US dollar cheques issued by corporates or individuals in Shenzhen and Hong Kong can now be presented to banks in both areas with funds available on the next business day. An average of about US\$200,000 is cleared through this facility each day.



MARKET INFRASTRUCTURE

New Hong Kong Banknotes

- **New \$100 and \$500 banknotes issued in 2003. Remaining new \$20, \$50 and \$1,000 banknotes put into circulation on 11 October.**
- **The HKMA has launched an extensive publicity programme for new banknotes.**

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- Last year, the three NIBs put into circulation the new series of \$100 and \$500 banknotes with enhanced security features. On 11 October this year, they put the remaining three denominations into circulation.
- Before the new banknotes were put into circulation, the HKMA has co-ordinated with relevant entities to ensure a smooth launch: e.g. to ensure public transport operators have properly calibrated their machines in order to accept the new banknotes. We also launched an extensive public education programme on the new security features and designs of the banknotes. The programme includes:
 - distribution of educational leaflets to some 40,000 retail shops, shopping centre and markets throughout Hong Kong by student ambassadors
 - educational leaflets distributed through public bodies/Government Departments e.g. Hospital Authority, Home Affairs Department, Post Office, etc. So far, about 740,000 leaflets have been distributed
 - seminars organised for retailers and the general public
 - seminars organised for the elderly and the visually impaired
 - a dedicated telephone line with recorded messages set up to provide guidance for people with visual impairments
 - “banknote measurement templates” distributed to several organisations for the visually impaired to assist them in recognising the new banknotes.



HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

- **Renminbi business in Hong Kong**
 - **Renminbi denominated credit cards for Hong Kong residents' uses launched. Renminbi deposits at around RMB7.5 billion by the end of August.**
 - **Use of renminbi bank cards is a boost to Mainland tourists' consumption.**
 - **further development of renminbi business in Hong Kong to follow three strategic directions:**
 - (i) diversification of renminbi assets and liabilities;**
 - (ii) denomination and settlement of trade in renminbi;**
 - (iii) debt issuance in renminbi.**

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- Renminbi business
 - Since 18 January 2004, there has been a steady increase in the use of renminbi debit and credit cards by Mainland tourists in Hong Kong. The cumulative total of credit/debit card spending amounted to over HK\$1.3 billion on 2 October, or HK\$2,897 per transaction.
 - 38 banks have engaged in personal renminbi deposit, remittance and exchange services since 25 February, down from 39 banks at end-July due to the merger of Chekiang First Bank. Total outstanding renminbi deposits was about RMB7.5 billion by end-August.
 - The launch of renminbi services provides a new range of services for customers in Hong Kong, helps diversify banking business, and facilitates cross-border spending and economic integration between Hong Kong and the Mainland.
 - Further development of renminbi business in Hong Kong would follow three strategic directions:
 - (i) to explore the diversification of renminbi assets and liabilities of banks in Hong Kong;
 - (ii) to explore the use of renminbi for the denomination and settlement of current account transactions such as trade between the Mainland and Hong Kong, and to facilitate this by providing relevant renminbi banking services in Hong Kong; and
 - (iii) to explore the feasibility of establishing a renminbi debt issuance mechanism in Hong Kong, which would facilitate the repatriation of renminbi back to the Mainland.



EXCHANGE FUND PERFORMANCE

(HK\$ billion)	2004 ² YTD Sept-end	2003 ¹ Full year	2002 ¹ Full year	2001 ¹ Full year
Gain / (Loss) on HK equities*	5.1	21.2	(11.8)	(27.1)
Gain / (Loss) on other equities*	1.0	26.8	(22.7)	(3.3)
Exchange gain / (loss)	(0.3)	22.9	27.2	(13.0)
Total return from bonds, etc	<u>17.9</u>	<u>18.8</u>	<u>54.3</u>	<u>50.8</u>
Investment income	23.7	89.7	47.0	7.4

* including dividends

1 Audited figures; 2 Unaudited figures

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- Investment income recorded for year-to-date at the end of September 2004 was HK\$23.7 billion. But the rest of the year presents challenges because of an uncertain and difficult investment environment.



EXCHANGE FUND TREASURY'S SHARE OF INVESTMENT INCOME

(HK\$ billion)	2004			2003			
	Q1	H1 Sept-end	YTD	Q1	H1	YTD Sept-end	Full* Year
Investment income/(loss)	16.8	9.6	23.7	6.7	47.8	56.2	89.7
Other income	0.0	0.1	0.1	0.0	0.1	0.1	0.2
Interest and expenses	<u>(1.1)</u>	<u>(2.2)</u>	<u>(3.5)</u>	<u>(1.4)</u>	<u>(2.9)</u>	<u>(4.2)</u>	<u>(6.5)</u>
Net investment income/(loss)	15.7	7.5	20.3	5.3	45.0	52.1	83.4
Treasury's share	<u>(4.5)</u>	<u>(2.4)</u>	<u>(6.0)</u>	<u>(2.1)</u>	<u>(15.1)</u>	<u>(17.1)</u>	<u>(25.7)</u>
Increase/(Decrease) in EF accumulated surplus	11.2	5.1	14.3	3.2	29.9	35.0	57.7

* Audited figures

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- The investment strategy of the Exchange Fund is directed by the objectives of capital preservation, liquidity, full backing of Hong Kong dollar Monetary Base, and maintaining the long-term purchasing power of the assets. The investment return of the Exchange Fund is linked to the returns of allowable asset markets in which the assets are invested. As history shows, the investment returns can vary widely from year to year, depending on the conditions of the financial markets. It is therefore difficult to forecast the year-to-year return of the Exchange Fund and to predict whether the yearly return of any one year may be able to meet the annual target set by the Treasury.
- In April 1998, a new arrangement was introduced to enable the fiscal reserves placed with the Exchange Fund to enjoy the same return achieved by the entire Exchange Fund. The Treasury's share of the Exchange Fund investment income fluctuated from year to year, ranging from a low of HK\$1.6 billion in year 2001 to a high of HK\$45.4 billion in year 1999. However, the return achieved year-to-date at September-end 2004 appears to be short of the target set by the Treasury for fiscal 2004 (HK\$12.3 billion) - the HK Government fiscal year ends on March-end in each year, mismatching the fiscal year of the Exchange Fund which ends at December-end.



YEARLY TREASURY SHARE OF THE EXCHANGE FUND INVESTMENT INCOME VS. TREASURY ESTIMATE (FROM 2002 TO SEPT-2004)

(all figures in HK\$ billion)

Year	2002	2003	2004
Actual ^[note 2] Treasury Share	15.6	25.7	6.0 ^[note 1]
Treasury ^[note 3] Estimate	13.8	12.1	12.3

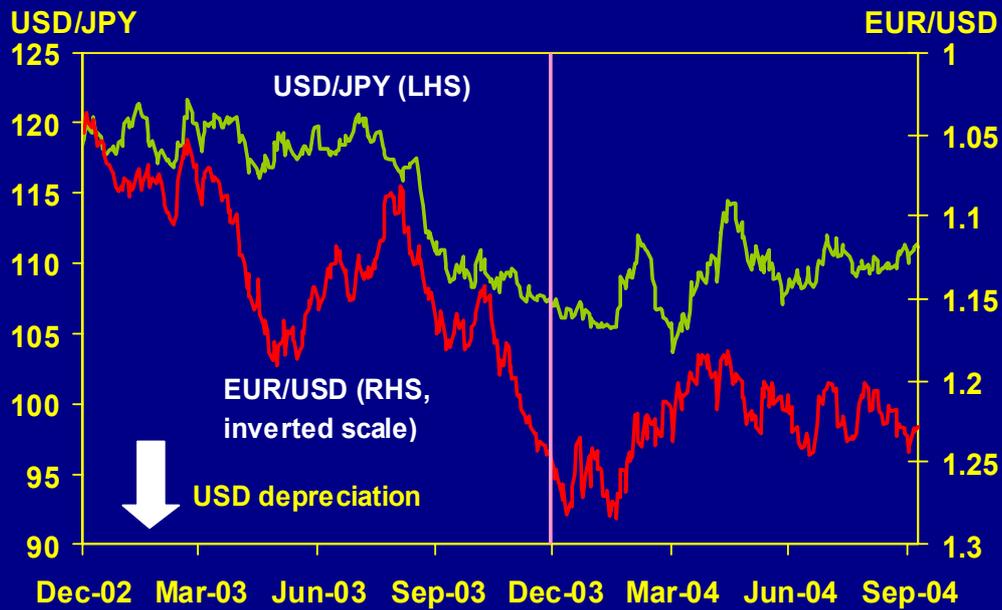
Note 1: year-to-date up to the end of September 2004

Note 2: based on MA's fiscal year from January to December in each calendar year

Note 3: based on HK Government's fiscal year from April to March of the following year



US DOLLAR STRENGTHENING



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- In 2003, the US dollar fell 16.7% against the euro and 9.7% against the yen. As indicated by the chart, the Euro/USD exchange rate was more volatile than the USD/Yen rate. Throughout 2003, the Bank of Japan intervened massively in support of the US dollar and succeeded in dampening both the magnitude and the volatility of the US dollar's depreciation against the yen.
- Since the beginning of 2004, the US dollar has rebounded against the euro and the yen. Strong economic growth in the US suggests that US interest rates may rise faster than Euroland or Japan. Expectation of widening interest rate differentials in favour of the US has so far been supportive of the US dollar.



UNCERTAIN EQUITY MARKETS

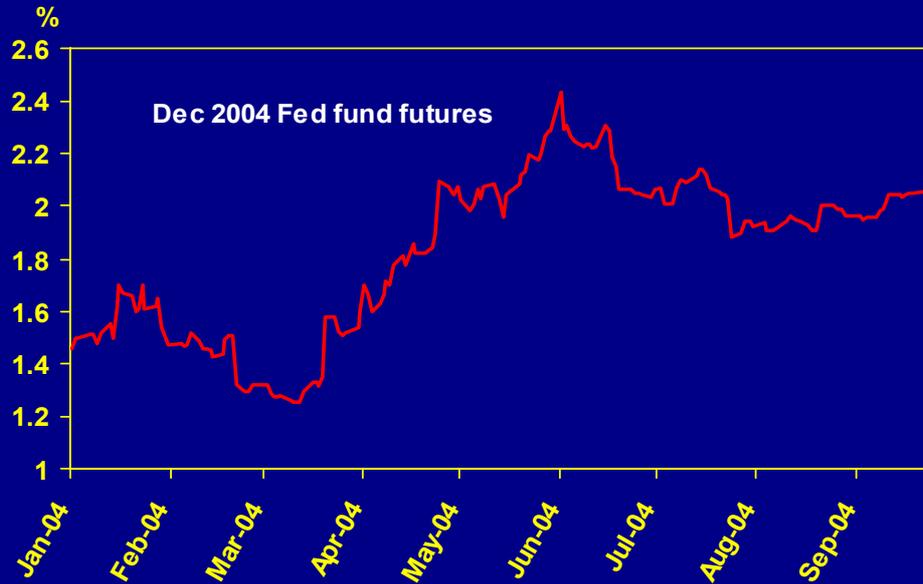


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- In 2003, the Hang Seng Index and the S&P500 rose by 34.9% and 26.4% respectively. The rise in the Hong Kong and the US equity markets began in April/May and the ascent between then and the end of 2003 was fairly uninterrupted. In the second half of 2003, the markets were enthusiastic about economic growth in the US, the Mainland and Hong Kong and projecting expectations for positive corporate earnings in these markets.
- Since the beginning of 2004, the US equity market was clouded initially by uncertainties over the sustainability of the pace of growth in the US, and later upon further confirmation of strong growth, by concerns over interest rate hikes and surging oil prices. The performance of the Hong Kong market year-to-date has been marred by worries initially about an over-heating economy on the Mainland and later by concerns over rising inflation.



VOLATILE BOND YIELDS ALONGSIDE WITH CHANGING INTEREST RATES EXPECTATION



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- Expectations of the timing of the first interest rate hike and the magnitude of the rate hike by the end of 2004 fluctuated widely with releases of economic data in the US.
- The red line tracks the market's expectations of the magnitude of the interest rate hikes by year-end. In January, the markets expected the US Fed to raise rates by 50 bps by end-2004. In March this expectation was reduced to 30 bps and thereafter got to as high as 150 bps just before the first rate hike in June. In the past few weeks, mixed data and concern over surging oil prices have led the market to expect the Fed to raise rates by another 25 bps by year-end after it has already raised its target rate by 75bps since June.
- We expect the extreme volatility in currency, equity and bond markets to continue in the foreseeable future.



HONG KONG MONETARY AUTHORITY

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

1 November 2004

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