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2 May 2006

Clerk to the Legislative Council Panel on Financial Affairs
Legislative Council Building
8 Jackson Road
Central
Hong Kong
(Attn: Ms. Salumi Chan)

Dear Ms Chan,

I refer to your letter dated 24 April 2006 enclosing a letter from the Hon. SIN Chung-kai with an attached list of questions. We intend, with the Chairman's permission, to brief Members in detail on this subject under agenda item (V) at the Financial Affairs Panel meeting on 4 May 2006. This letter serves as a preliminary response to the issues raised.

The questions relate principally to the operating costs of the Exchange Fund and in particular the employment of external fund managers.

There are a number of reasons for the increase in the operating costs of the Fund since 1997.

(a) The Fund has grown substantially from about $636 billion in 1997 to $1,066 billion at the end of 2005, including growth in the Accumulated Surplus (the total net profit earned by the Fund) from $190 billion in 1997 to $443 billion in 2005. Apart from year-on-year investment income and other growth in the Fund, the assets of the former Land Fund, totalling some $211.4 billion, were merged into the Exchange Fund on 31 October 1998, increasing both the size and complexity of the Fund.

(b) There has been an increase in the proportion of the Fund invested in equities. The management of equities portfolios is more complex and intensive than that of fixed-income assets, requiring specialised knowledge of individual markets or specific sectors. All of the equity portfolios of the Exchange Fund are managed by external fund managers.

(c) The intervention in the stock market in 1998 led to part of the Exchange Fund's being invested in Hong Kong equities. These assets were initially managed by Exchange Fund Investment Ltd, which also organised the safe disposal of those stocks through the Tracker Fund. The remaining stocks were subsequently transferred to the Exchange Fund.

(d) The Asian financial crisis of 1997-98 underlined the need to manage risks arising from the increasing globalisation of markets which, in part because of advances in information technology, have become more volatile. The HKMA devotes considerable effort to risk management in the financial system of Hong Kong (not least in its own operations). Investment management is obviously one area where risk management is of great importance. Specific measures taken include:

- restructuring multi-currency portfolios, within which fund managers previously operated in many international financial markets, into specialised single-market portfolios to benefit from external managers' detailed and specific knowledge

- increasing the numbers of external managers to reduce concentration and exposure to risks associated with individual institutions. Limits have also been set on the amounts to be placed with external managers, both in absolute terms and as a proportion of the funds under management by that manager, so that no individual manager becomes overly dependent on the Exchange Fund

- introducing stricter reporting and monitoring requirements for external managers to ensure compliance with the established guidelines

- making greater use of custodians to monitor compliance by external fund managers with the guidelines.

These and other risk-management measures approved by the Financial Secretary after consulting the Exchange Fund Advisory Committee (EFAC), have contributed to the Exchange Fund's maintaining its record of outperforming the benchmark portfolio without any mishap arising from investment management that might have adversely affected the financial interests of the Fund. The measures described above obviously involve some additional cost in terms of higher fees charged by external managers and custodians. Spreading the allocation of assets among more managers to reduce concentration also limits the volume discounts that can be obtained. Given the importance of the Exchange Fund to maintaining monetary and financial stability in Hong Kong, we believe that these additional costs, which are not large as a proportion of managing a fund of this size and complexity, are justified and necessary.

A further reason for the apparent increase in the operating costs of the Exchange Fund is that, because of the new accounting standards adopted last year, the figures for 2005 are not directly comparable with those for earlier years, which were prepared under the old standards. We shall be explaining this point in greater detail at the briefing on 4 May.

The reasons for appointing external managers to manage the assets of the Exchange Fund are:

(a) to allow the Fund to be invested flexibly in a variety of specialised assets in a number of international financial centres;
(b) to tap the best investment expertise available in the market;
(c) to capture a diverse mix of investment styles and transferring knowledge and information about the market to in-house professionals; and
(d) to avoid conflict of interest and market sensitivity arising from the HKMA's roles as regulator and as controller of the Exchange Fund's assets.

Without the use of external fund managers, it would be necessary for the HKMA to expand considerably its in-house resources for investment of the Exchange Fund. This would greatly reduce the HKMA's flexibility in international markets without guaranteeing that the same levels of expertise could be attained.

External fund managers are appointed through a rigorous, competitive tendering process, involving an initial screening to identify the best performers in different asset classes, a comprehensive request-for-proposals process, and due-diligence visits by HKMA staff to confirm the information provided. Selection criteria include the institution's expertise in the specific asset class or market, track record and proposed fee level and structure. Appointments are approved after consultation with EFAC and its Investment Sub-Committee (ISC). The cost of appointing external fund managers by the Exchange Fund compares favourably with the fees charged by private-sector managers for managing institutional funds with a comparable mix of equities and fixed-income assets. The performance of external fund managers is carefully monitored and regular reports are made to ISC and EFAC. Where the performance of external managers falls below expectations, the HKMA may terminate their appointments at short notice.

The HKMA will give a detailed presentation to the Panel on these and other points at the meeting on 4 May 2006.

Your sincerely,

A. Ching.

(Andy Ching)
for Chief Executive
Hong Kong Monetary Authority