HONG KONG MONETARY AUTHORITY

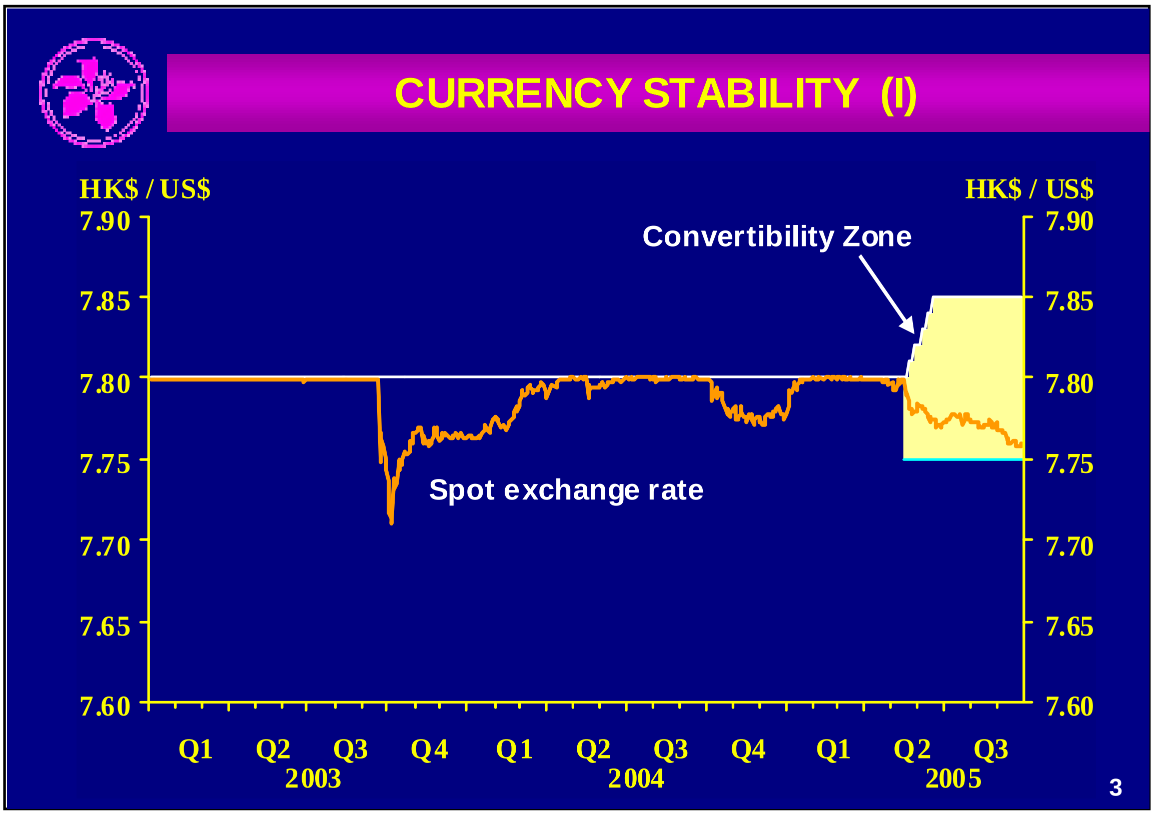
Briefing to the Legislative Council Panel on Financial Affairs

7 November 2005

DISCUSSION TOPICS

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

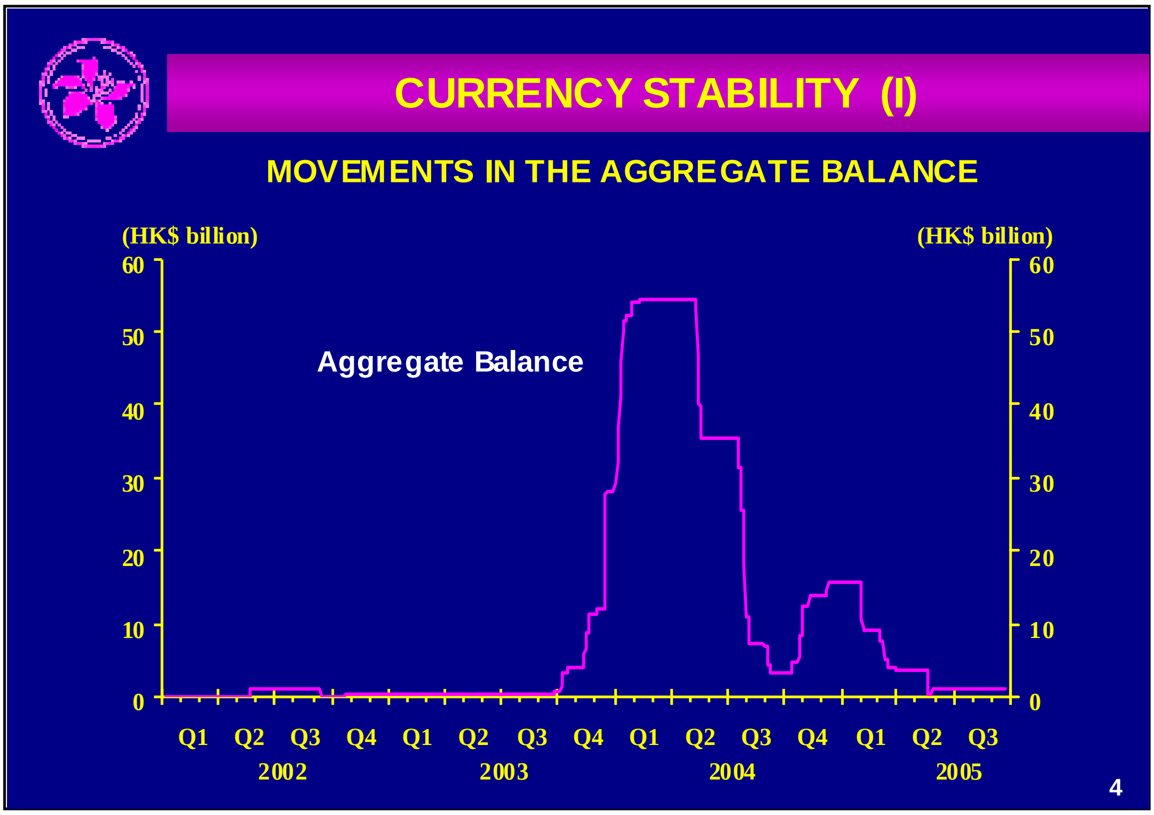
2



- The effects of the repeated episodes of capital inflow and pressure for the Hong Kong dollar to strengthen, which started in 2003 Q3, lingered as market attention on the renminbi grew. The Hong Kong dollar exchange rate remains stable, Hong Kong dollar interest rates remain at low levels and monetary conditions continue to be benign.

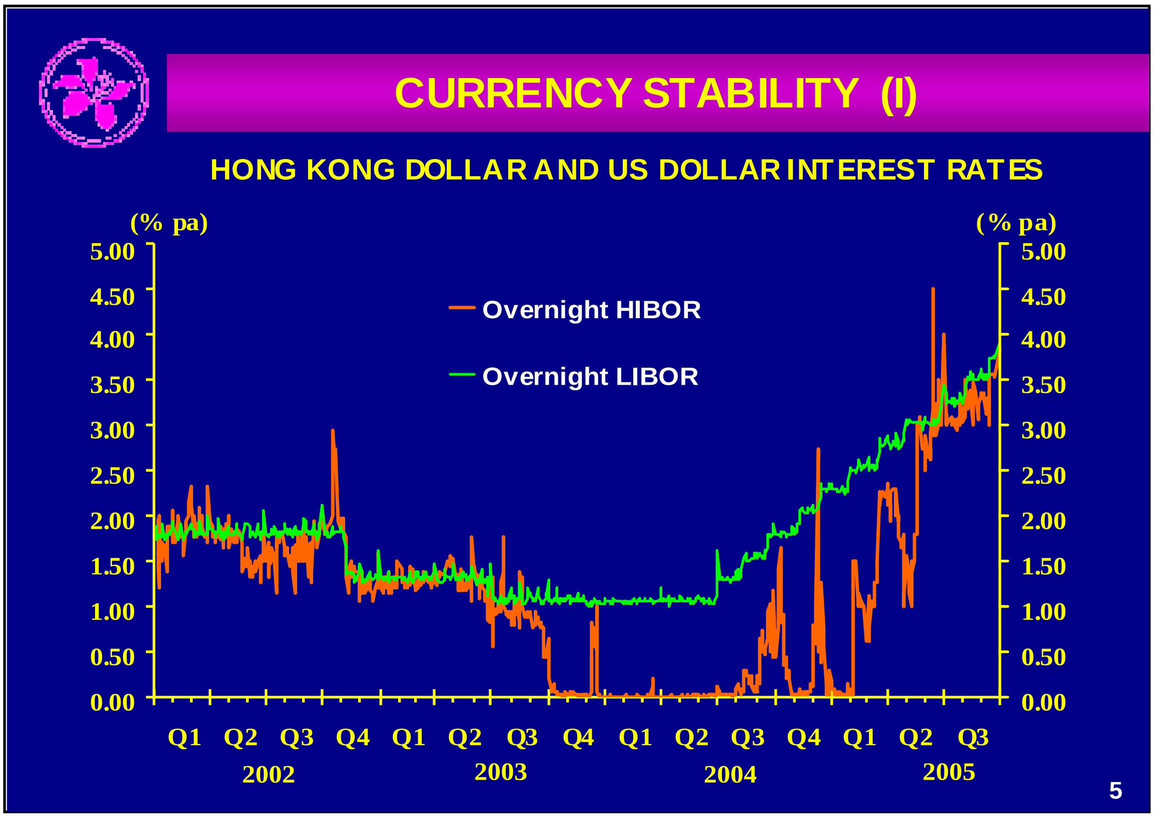
- To better anchor exchange rate expectations on the strong side, the HKMA introduced three refinements to the Linked Exchange Rate system on 18 May 2005. Financial markets reacted favourably to the refinements, with Hong Kong dollar interbank interest rates rising to track their US dollar counterparts more closely and the discount in the Hong Kong dollar forward market falling. Thereafter, the Hong Kong dollar exchange rate strengthened, reflecting increased demand for Hong Kong dollars associated with equity IPOs and market speculation about renminbi revaluation.

- On 21 July 2005, the People's Bank of China announced the reform of the renminbi exchange rate regime by moving to a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. The Hong Kong dollar exchange rate reacted calmly to the announcement. Subsequently, the Hong Kong dollar exchange rate strengthened further due to IPO-related demand for Hong Kong dollars.

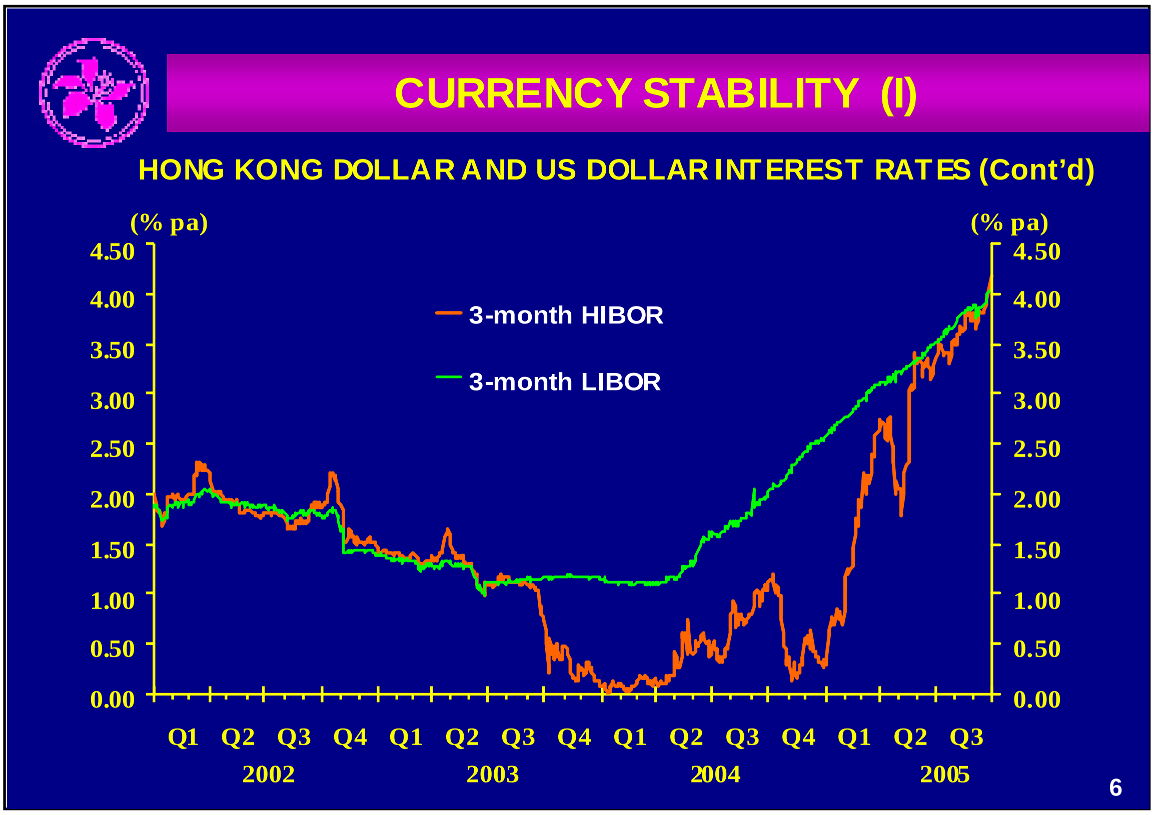


- The weak-side Convertibility Undertaking was triggered immediately after the announcement of the three refinements to the Linked Exchange Rate system, shrinking the Aggregate Balance from HK$3.8 billion to HK$714 million on 20 May. To accommodate increased demand for Hong Kong dollars ahead of a number of equity IPOs, the HKMA sold HK$544 million to banks on 25 May, resulting in an increase in the Aggregate Balance to HK$1.32 billion on 27 May. The Aggregate Balance has remained stable since then.

- The three refinements have been effective in removing the easy monetary conditions in the preceding 18 months and thereafter in keeping the Aggregate Balance and money market conditions stable, despite continued inflows of capital.

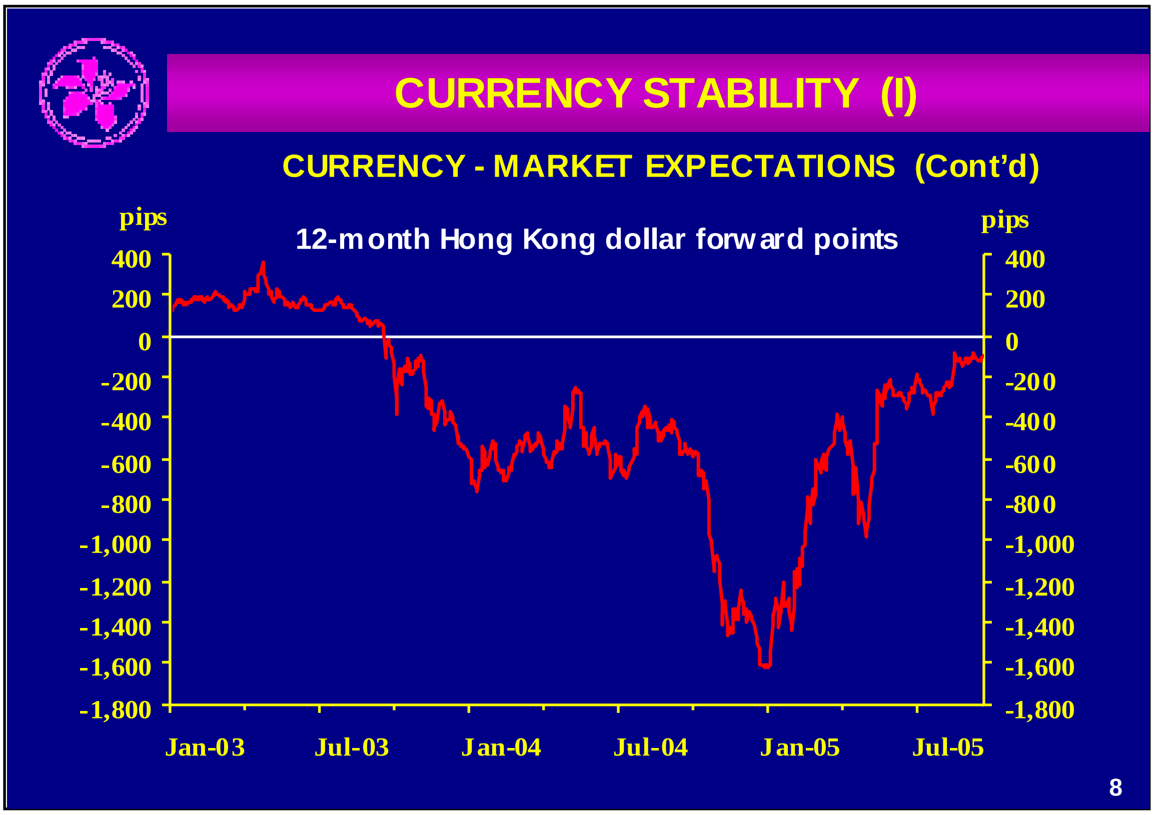


- The significant interest rate gap between the Hong Kong dollar and the US dollar that persisted since 2003 Q4 narrowed notably following the introduction of the three refinements on 21 May, with Hong Kong dollar interbank interest rates tracking more closely the corresponding US dollar rates since then.

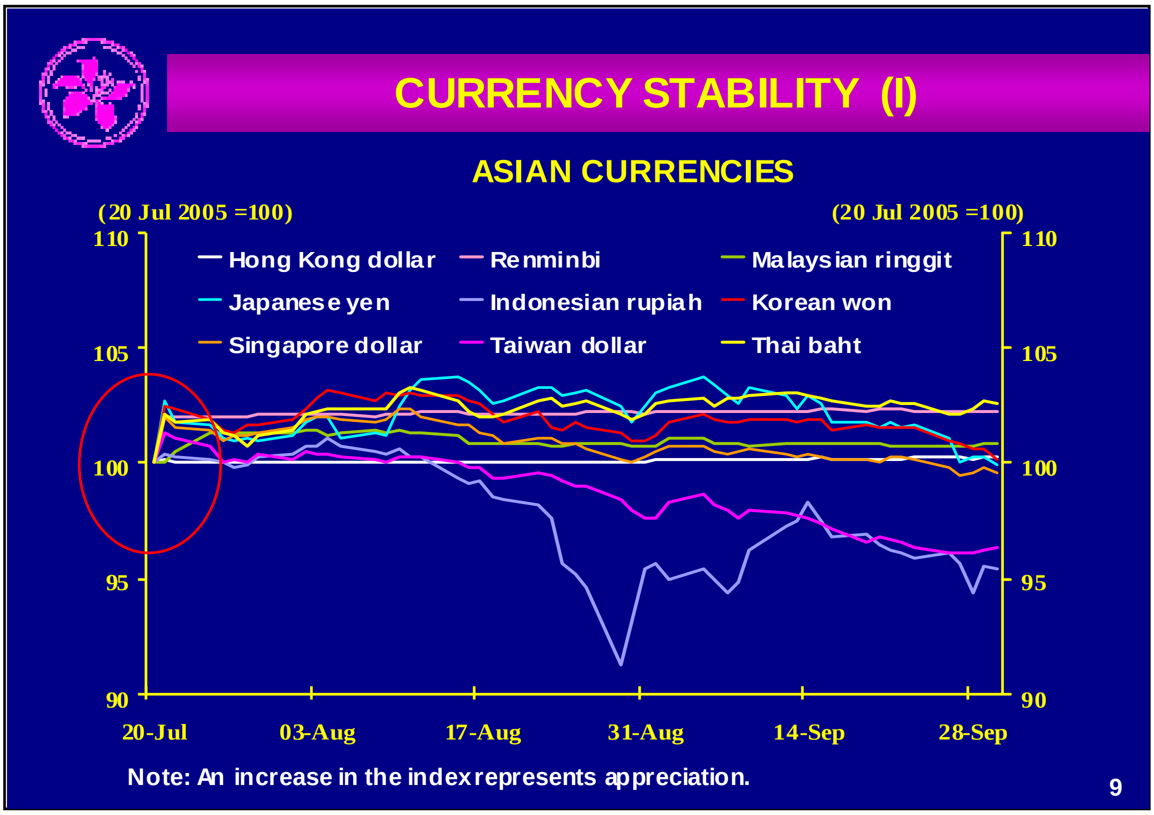


- Other short-term HIBORs also rose significantly, narrowing the interest rate differential between the Hong Kong dollar and the US dollar.

- Market expectation of the Hong Kong dollar strengthening dissipated after the introduction of the three refinements in May 2005, as illustrated by the narrowing of the discount in the one-year forward exchange rate.



- The discount in the one-year forward exchange rate narrowed from around 1,000 pips on the announcement of the three refinements to about 50 pips currently, reflecting enhanced market confidence in the Linked Exchange Rate system after the three refinements.



- While most other Asian currencies appreciated immediately following the announcement of the reform of the renminbi exchange rate regime, the exchange rates of most of them have remained very stable in recent months. Although there are no formal arrangements for maintaining stable exchange rates of these currencies and, unlike the Hong Kong dollar, they do not have a currency anchor, increasing economic integration in the region is consistent with the higher correlation in the exchange rates of Asian currencies.

CURRENCY STABILITY (I)

MONETARY CONDITIONS

- **Currency Board arrangements working effectively to normalise monetary conditions, particularly after the introduction of the three refinements.**
- **Fed funds target rate on an increasing trend.**
- **Domestic monetary conditions affected by factors pulling in different directions.**

10

- The three refinements to the Linked Exchange Rate system have been effective in normalising monetary conditions, with Hong Kong dollar interbank interest rates tracking their US dollar counterparts more closely and the discount in the Hong Kong dollar forward market disappearing.
- At the end of October 2005, the US Fed funds target rate had been raised 11 times by a total of 275 bps to 3.75% since June 2004. Market participants generally expect the increasing trend to continue, although it is not clear at what "normal" level the rate will end up. This has led to upward adjustments on the lending rates and deposit rates of banks in Hong Kong.
- The significant catch-up of HIBORs with LIBORs has been completed, although the anomalous pricing of the mortgage rate against prime and the earlier keen competition for mortgages have led to some overshooting of prime to above the corresponding US level.
- Domestic monetary conditions will continue to be affected by factors pulling in different directions: the trend towards higher US interest rates, inflows associated with large IPOs and market expectations of further renminbi appreciation after the change in the renminbi exchange rate regime. Volatility is expected and it is possible that the interest rate adjustments, will overshoot in either direction, although the three refinements should help alleviate at least some pressure on interest rates. Banks need to manage interest rate risks. Borrowers should also beware.

CURRENCY STABILITY (II)

External factors

- High oil prices
- US monetary tightening
- Unbalanced growth in the global economy
- External imbalances
- Mainland macroeconomic conditions
- Trade disputes
- Possible influenza pandemic

11

- **Oil prices:** Average price of Dubai, Brent and WTI crude has more than tripled since the beginning of 2002. It hit an all-time high of US$66 per barrel on 1 September 2005 and has since remained at about US$60. Futures contracts of WTI crude reflect expectations that oil prices will stay high in the foreseeable future.

- **Interest rates:** The Fed has maintained the stance that policy accommodation will continue at a measured pace. Reflecting this, the financial markets expect the policy rate to reach 4.25% in December 2005. In other major economies, the European Central Bank and the Bank of Japan have put policy on hold while the Bank of England eased policy in August.

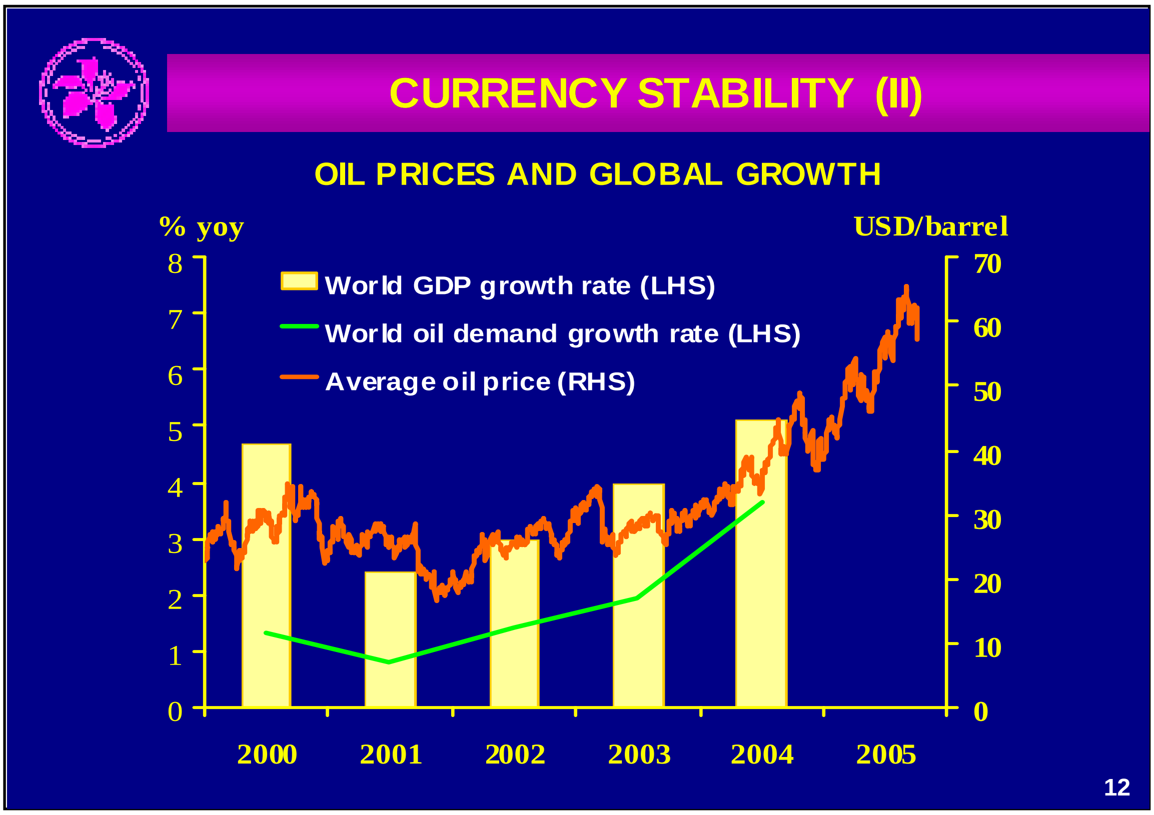
- **Unbalanced growth in the global economy:** Real GDP growth continued to be solid in the US and Asia (including Mainland China and Japan) in 2005 Q2, but slowed in Europe. This unbalanced growth is likely to continue into 2005 H2, as suggested by recent data.

- **External imbalances:** The US current account deficit narrowed marginally to 6.3% of GDP in Q2 from 6.5% in Q1. However, the US dollar has appreciated by 2.8% in effective terms so far this year, supported by widening interest differentials in favour of the US. The risk of a disorderly decline in the US dollar is small, but cannot be ruled out.

- **Mainland macroeconomic conditions:** The Mainland economy remained solid, despite signs of a slight moderation in the periods ahead. The risk of an abrupt deviation from the present growth path is small. However, should there be a further appreciation in the renminbi, renewed capital inflows into Hong Kong could raise inflation risks and possibly fuel asset bubbles.

- **Trade disputes:** A sharp rise in Mainland textile exports has heightened trade tensions between the Mainland and the US and Europe. While the Mainland and EU struck a deal to settle the textile dispute in September, the Sino-US talks have yet to reach an agreement.

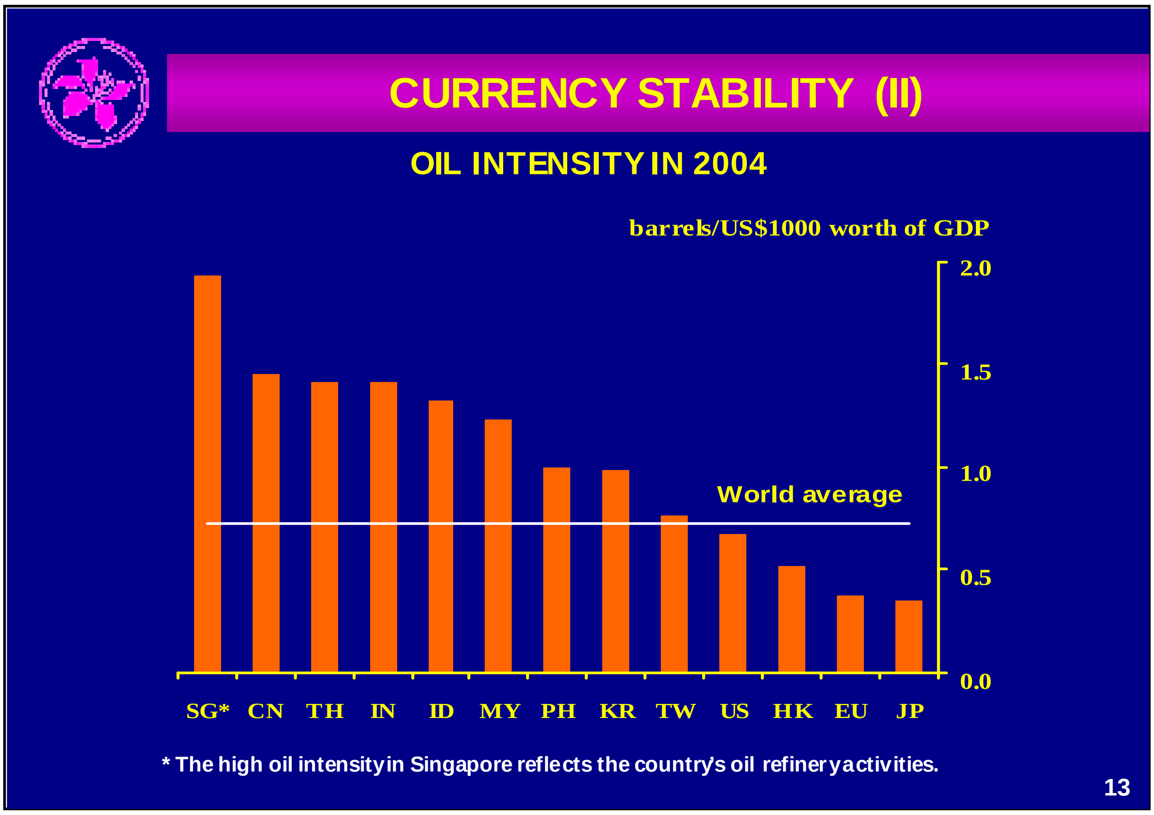
- **Influenza pandemic:** It is uncertain how financial markets might react to an influenza pandemic.



- The average price of Dubai, Brent and WTI crude rose to an all-time high of US$66 per barrel on 1 September before easing to US$57 in early October. As production and refinery capacity approaches the maximum, oil prices will be sensitive to even small changes in demand or supply conditions.

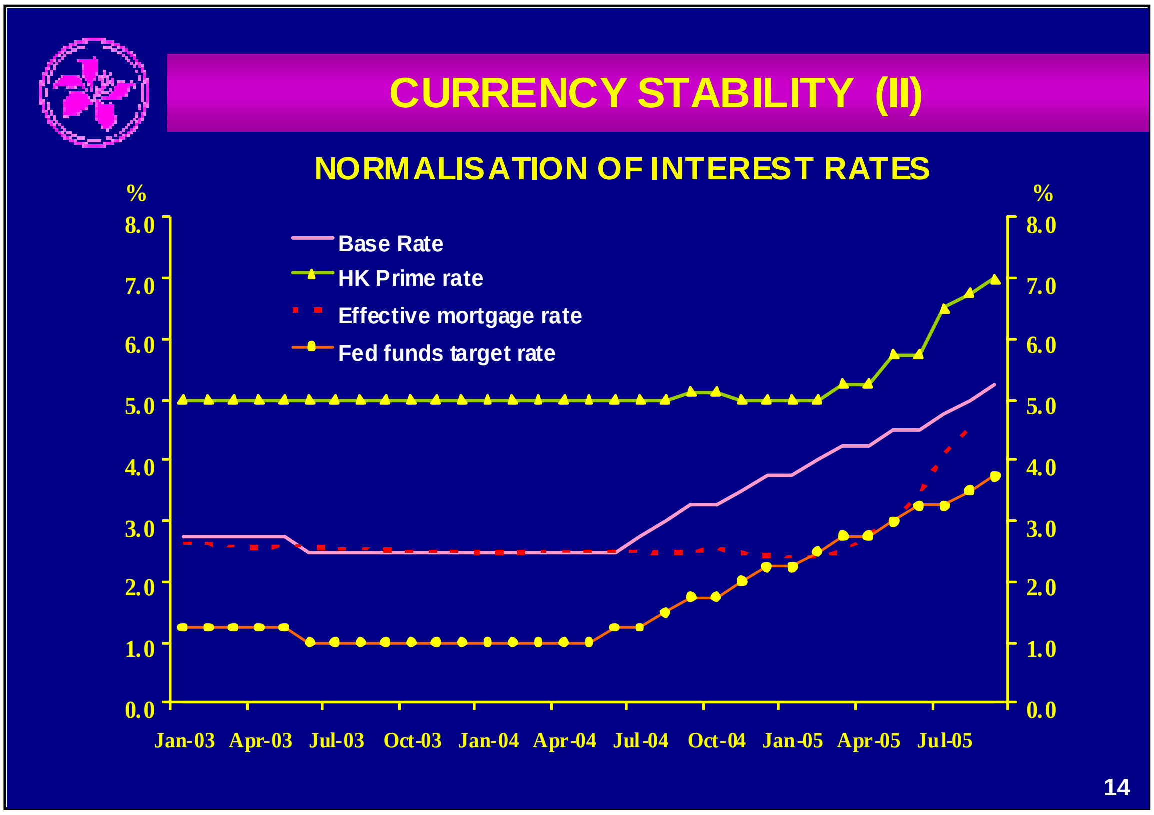
- The rise in oil prices over the past few years has had limited impact on the world economy so far because (a) it was mainly demand-driven; (b) global oil intensity has fallen considerably; (c) oil prices are still well below their historical peaks in real terms; and (d) the pass-through to core inflation - and hence monetary policy response - has been limited.

- However, there are risks that further oil price increases will have a more significant impact on global growth. <u>First</u>, as oil production approaches full capacity, the effect will be increasingly reminiscent of a supply shock. <u>Second</u>, a stronger feeding through to core inflation may trigger more aggressive monetary tightening by major central banks than currently anticipated. <u>Third</u>, the global trade imbalance could worsen, as higher oil prices inflate the US import bill and oil-exporting countries import more from Asia and Europe (and less from US). <u>Finally</u>, how oil exporting economies manage their increased foreign reserves may have implications for the funding of the US trade imbalance.



- Emerging Asian economies will tend to suffer more in view of their relatively high oil intensity. Those who subsidise oil consumption are facing a dilemma: removing the subsidies will lead to higher inflation and may have social consequences but retaining them will strain their fiscal and external payment positions.

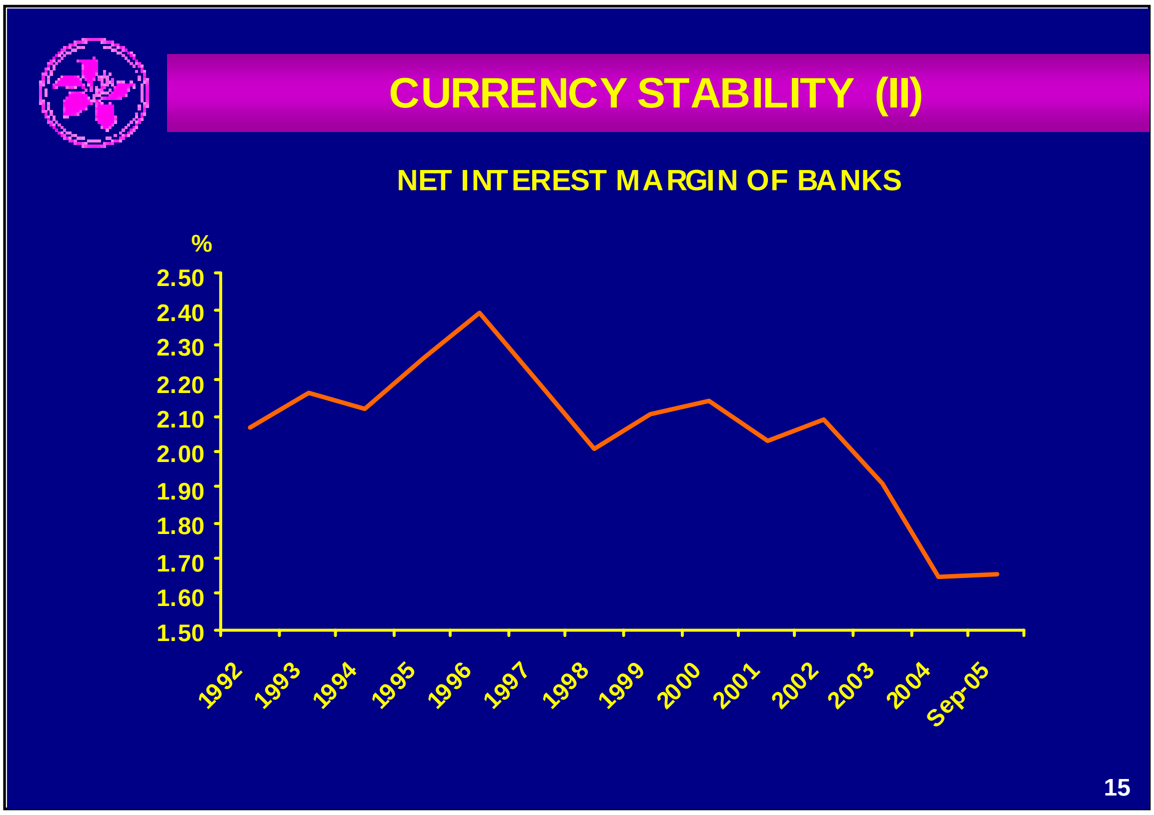
- The direct impact of higher oil prices on the Hong Kong economy will be relatively small, given its high service orientation. However, the indirect impact of higher oil prices resulting in slower global growth, higher inflation and tighter monetary conditions could be significant.



- Hong Kong's Base Rate started to increase along with the Fed funds target rate in mid-2004. Nonetheless, commercial lending rates remained flat until 2005 Q1, as continued capital inflows kept interbank interest rates low.

- With the introduction of the three refinements in May 2005, commercial lending rates offered by banks began to normalise with respect to the Fed funds rate and the Base Rate.

- This suggests that the three refinements have enhanced the effectiveness of the interest rate adjustment mechanism under the Linked Exchange Rate system.


CURRENCY STABILITY (II)
NET INTEREST MARGIN OF BANKS
%
2.50
2.40
2.30
2.20
2.10
2.00
1.90
1.80
1.70
1.60
1.50
1992
1993
1994
1995
1996
1997
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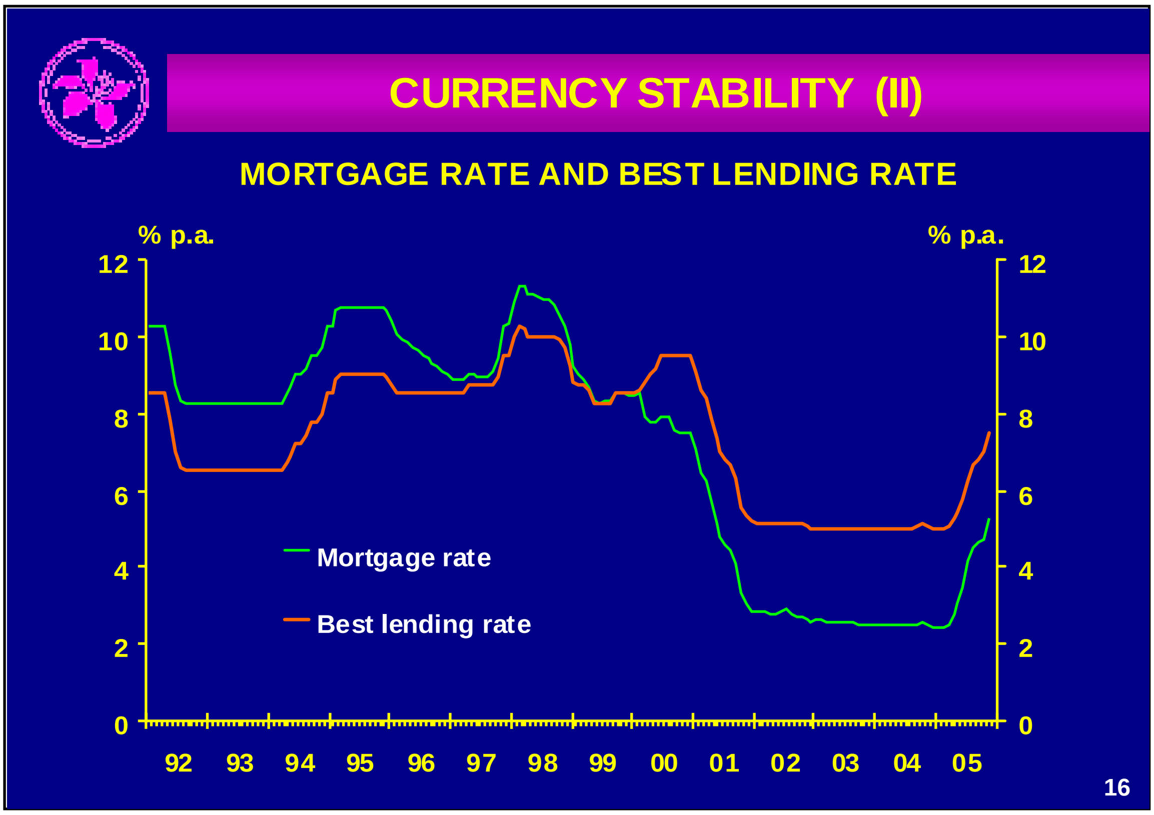
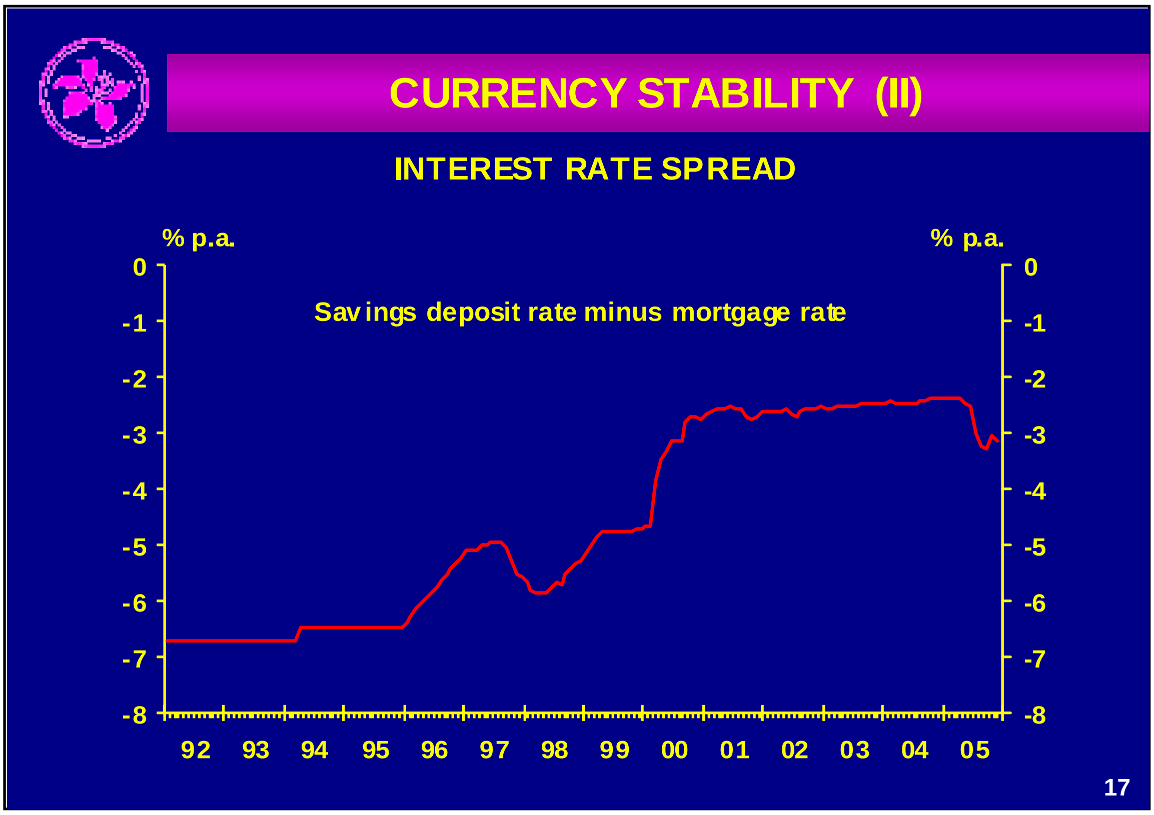
2002
2003
2004
Sep-05
15


CURRENCY STABILITY (II)
MORTGAGE RATE AND BEST LENDING RATE
% p.a.
% p.a.
12
10
8
6
4
2
0
Mortgage rate
Best lending rate
92
93
94
95
96
97
98
99
00
01
02
03
04
05
16


CURRENCY STABILITY (II)
INTEREST RATE SPREAD
% p.a.
% p.a.
Savings deposit rate minus mortgage rate
0
-1
-2
-3
-4
-5
-6
-7
-8
92
93
94
95
96
97
98
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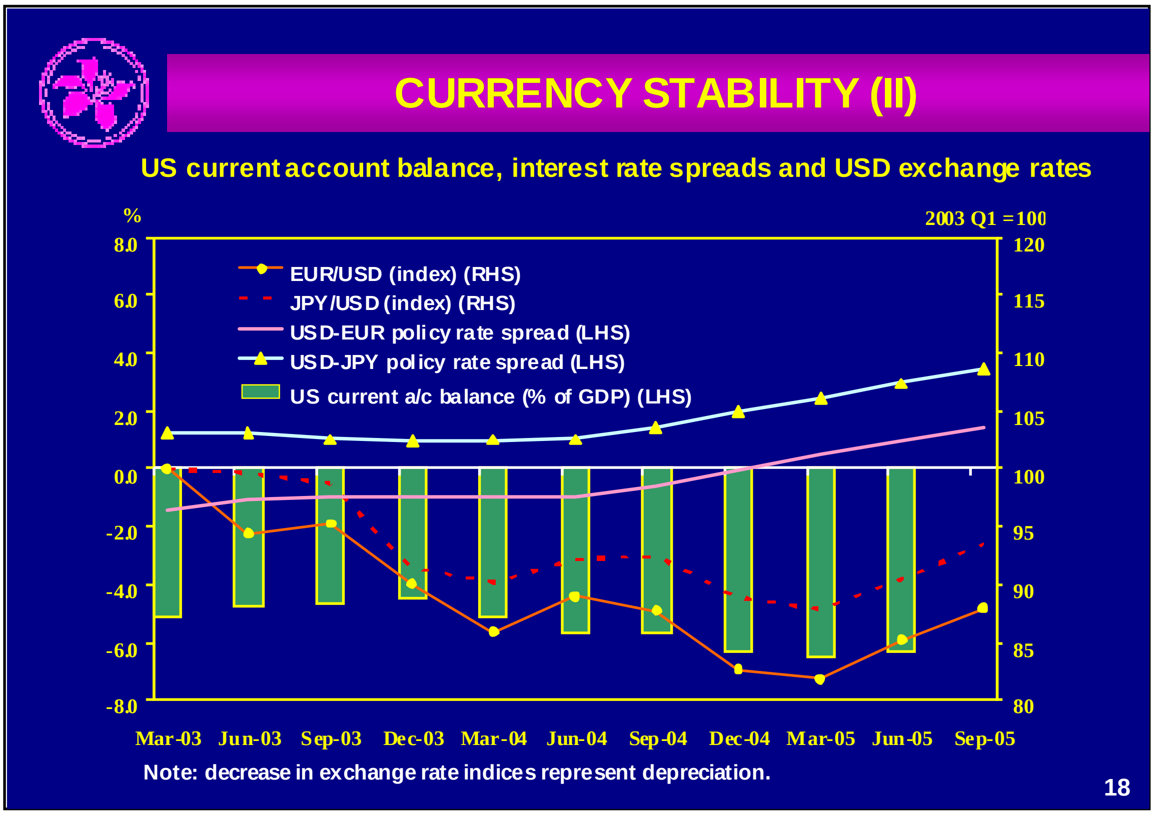
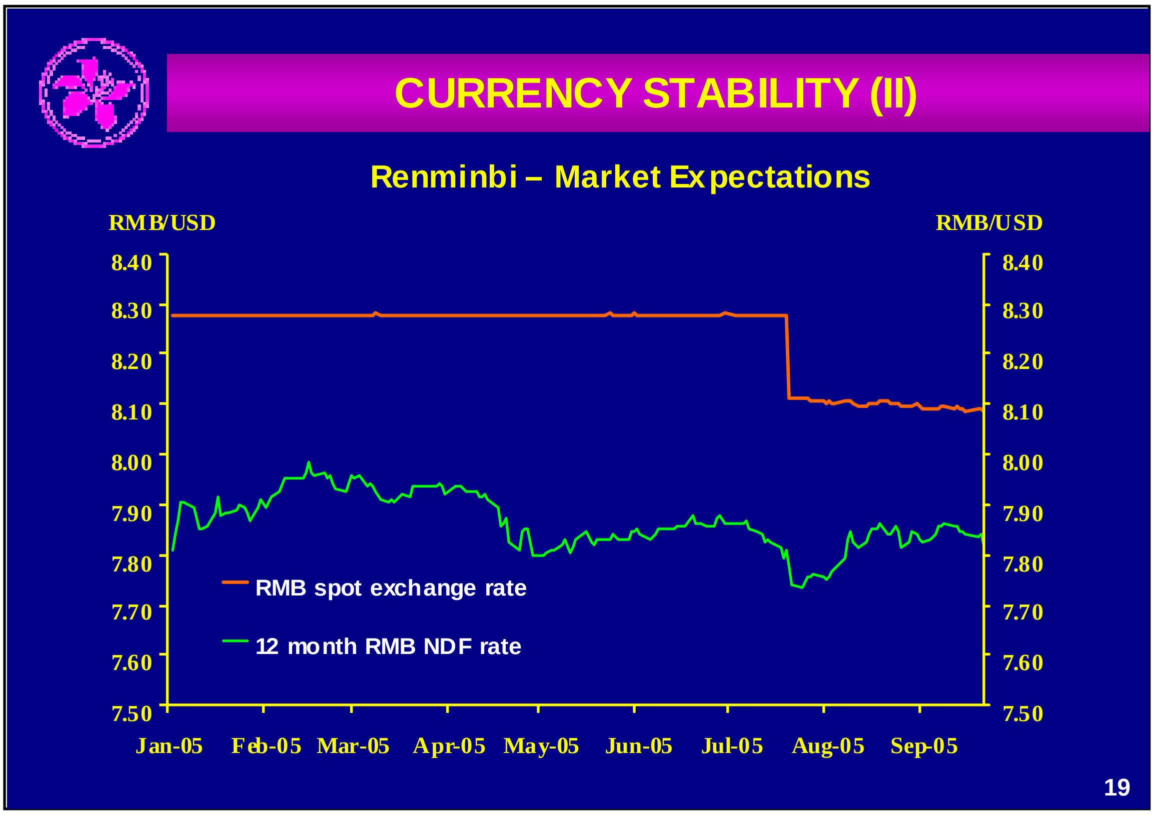


- US current account deficits, measured as a percentage of GDP, have continued to grow in recent years, reaching 6.3% in 2005 Q2, which partly explained the weakening of the US dollar in recent years.

- The increase in US interest rates relative to those of euro and yen since March 2004 has helped attract capital inflows into the US to finance its large current account deficits.



- The introduction of the change in the renminbi exchange rate regime in July caused only a temporary shift in the 12-month renminbi non-deliverable forward (NDF) rate.

- Afterwards, the NDF rate has returned to the 7.8-7.9 range in early August, suggesting that market expectations on the renminbi exchange rate remained relatively stable notwithstanding the introduction of the new regime.

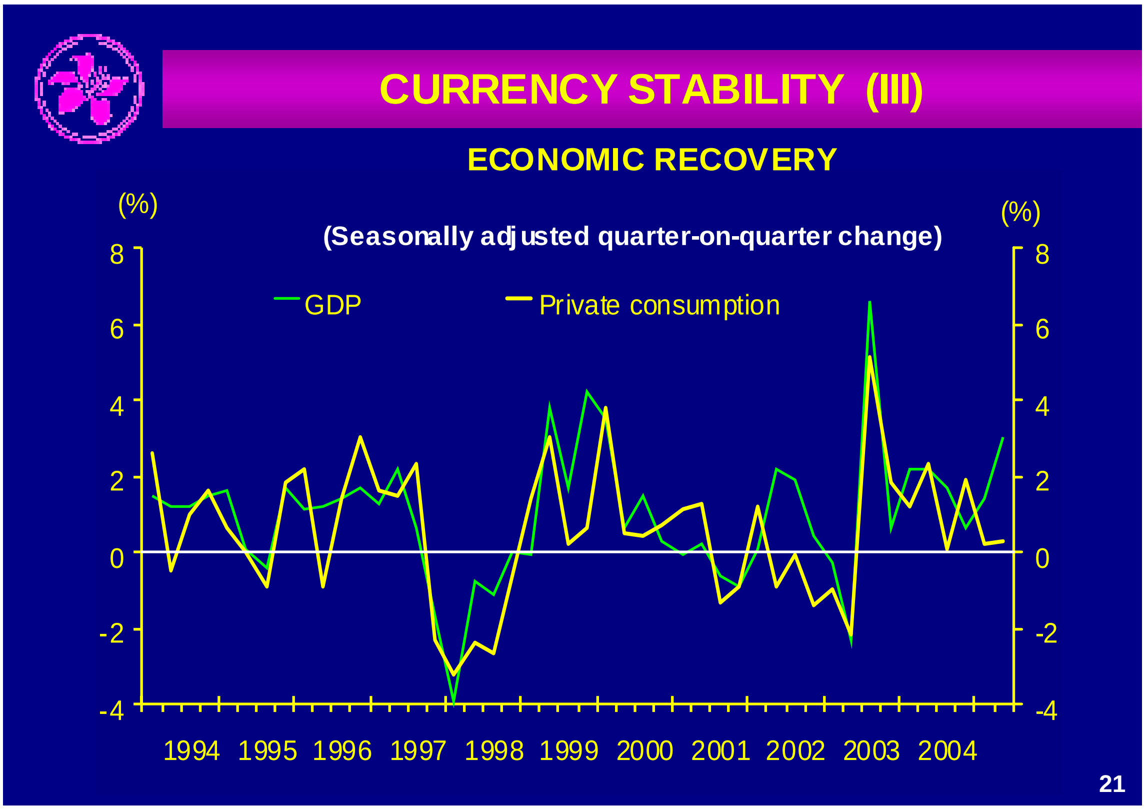
CURRENCY STABILITY (III)

Domestic factors

- Growth and inflation
- External position
- Property prices
- Unemployment
- Public finance

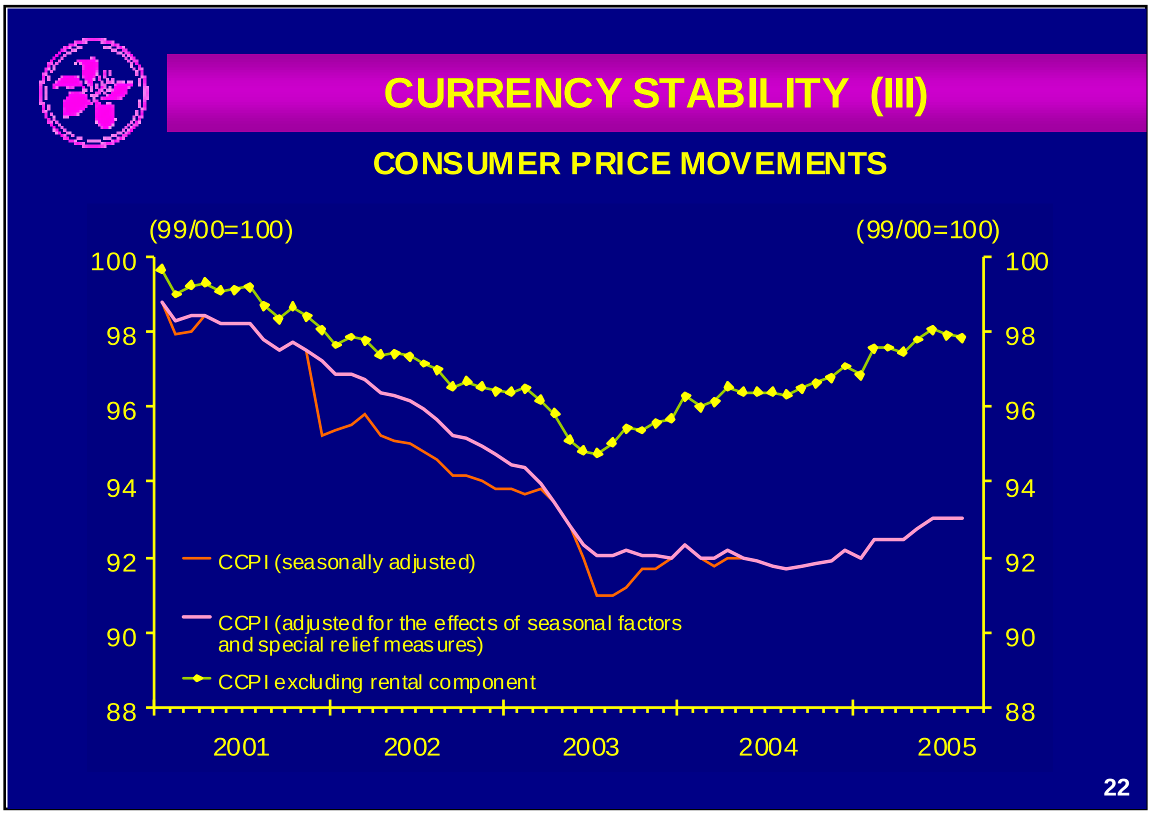
20

- **Economic recovery remained robust.** Real GDP grew by 6.8% in 2005 Q2 from a year earlier, following an increase of 6.2% in Q1, driven by rises in net exports and private sector machinery investment.
- **The headline Consumer Price Index** rose modestly in recent months, but the risk of a sharp increase in inflation remains low.
- **The external position of Hong Kong remains healthy.** The current account surplus increased markedly in the first half of 2005 from the same period of 2004, reflecting a rise in service account surplus and a decline in merchandise trade deficit. The latter reflects strong exports in the first half of the year. The net international investment position remains very strong (at about 2.6 times GDP at the end of 2004).
- **Property prices** have increased sharply from the trough in 2003 despite some moderation in recent months, contributing to the recovery of the economy through the wealth effect.
- **The unemployment rate** eased to 5.5% in the three months ending September this year, from a record high of 8.6% in the May-July 2003 period, but remains high relative to the level before the Asian financial crisis.
- **Public finances:** The fiscal position has improved considerably, helped by recovery in economic activity. The fiscal deficit for 2004/05 narrowed markedly to 0.3% of GDP (after excluding HK$26 billion from sales of government notes and bonds) due to stronger revenue and lower expenditure.



- On a seasonally adjusted quarter-on-quarter basis, GDP grew by 3.0% in real terms in 2005 Q2, compared with 1.4% in Q1. The economic expansion was broadly based.

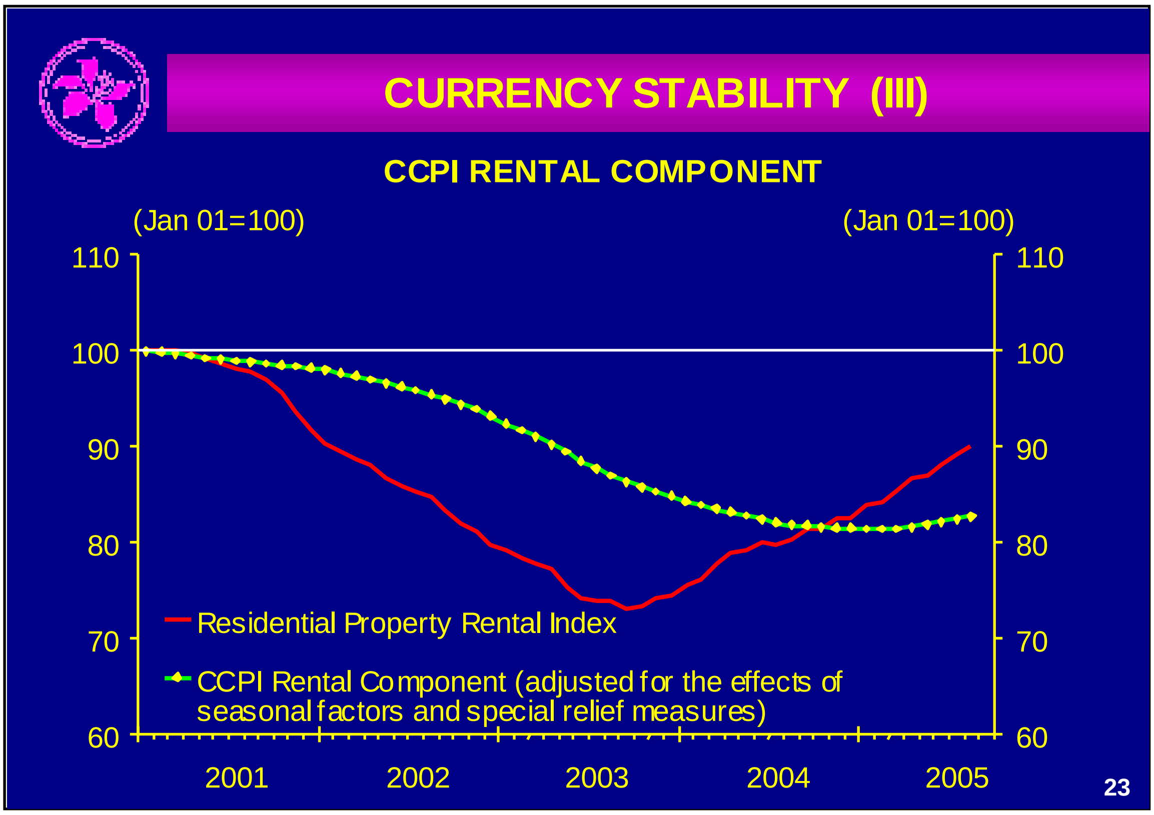
- Recent data suggest that the economy continued to expand in Q3, but the rate of increase may have moderated. Compared with the average in Q2, merchandise exports were virtually unchanged in July-August, while retail sales volume decreased by 0.5% in July (seasonally adjusted).



- Overall inflation rate remained modest.

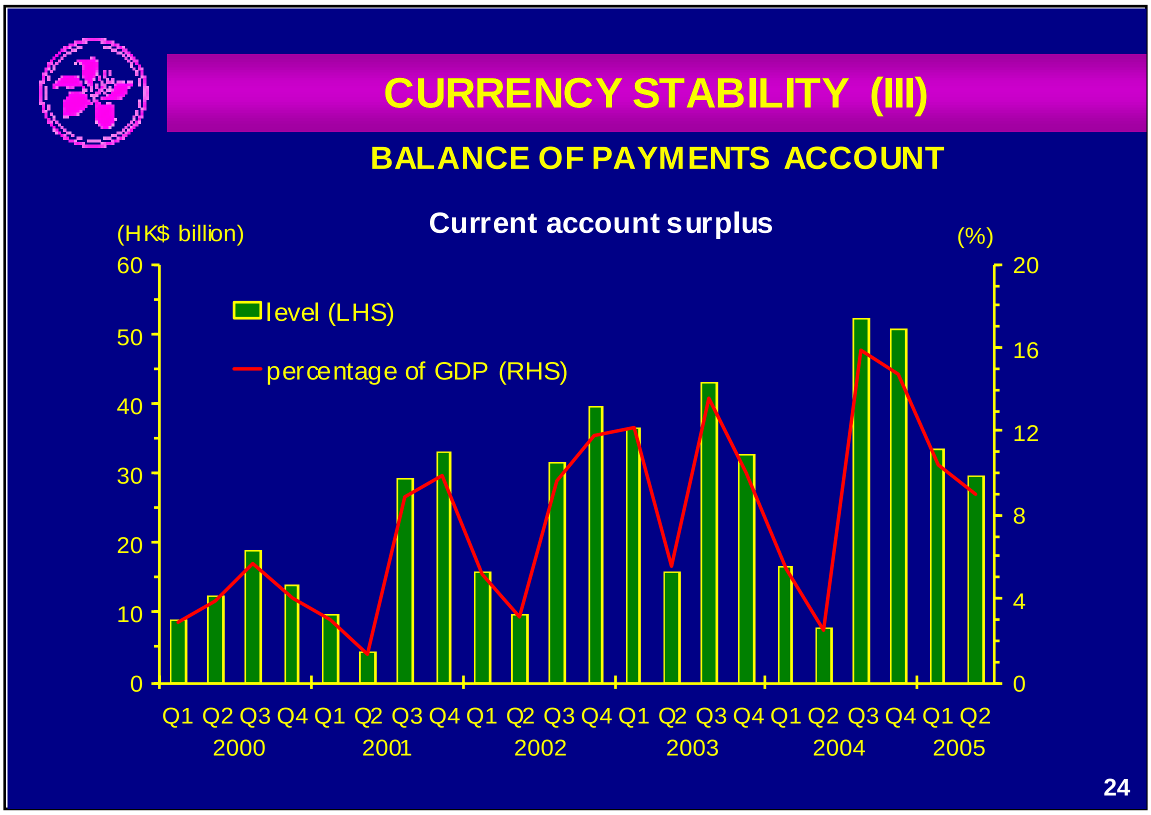
- The CCPI, excluding rents, increased steadily in the past few quarters along with recovery in economic activity, before declining slightly in the last two months. The rental component of the index picked up in recent months due to the pass-through of earlier increases in housing rents.

- Looking ahead, consumer prices are expected to rise moderately due to robust economic growth, rising oil prices, and further pass-through of increases in market rentals to the rental component. Nevertheless, the risk of a sharp increase in inflation is small, given uncertainties in global demand.



- While the residential property rental index rose markedly in the past two years, the rental component of the CCPI has increased only marginally in recent months. (The rental index is compiled by the Rating & Valuation Department based on fresh lettings, while the rental component includes both new and existing lettings.)

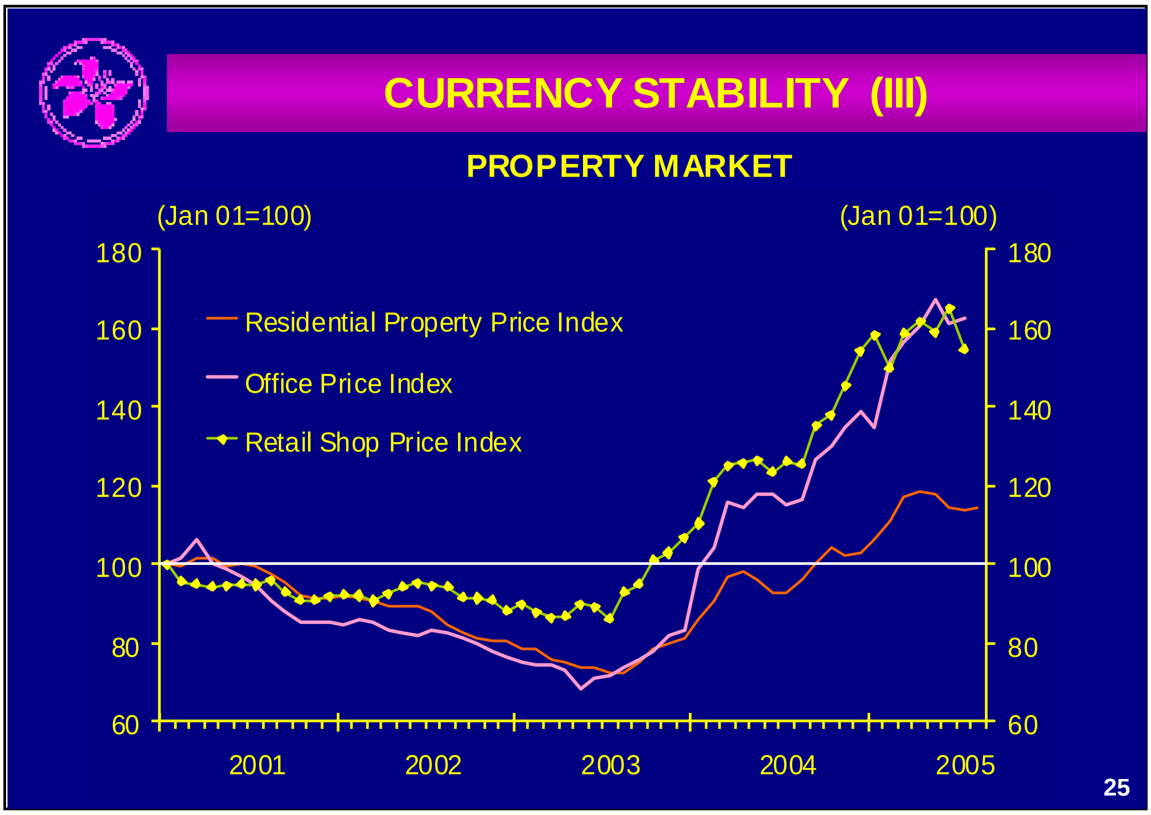
- Changes in the CCPI rental component tend to lag behind movements in market rents owing to fixed-term rental contracts, which are typically for two years. As market rents have risen by over 23% since the trough in September 2003, the rental component started to increase in recent months and continue to rise, exerting upward pressure on the CCPI.



- The external position has remained favourable, partly reflecting improvement in our competitiveness.

- The current account continued to register a notable surplus of around 9% of GDP in the second quarter of 2005, underpinned by solid growth in exports of goods and trade-related services, and strong growth in tourism-related earnings.

- The investment income generated by the accumulated net foreign assets (which are nearly 260% of GDP) will continue to support the Hong Kong dollar, particularly if these earnings, most likely in foreign currency, are invested back into domestic markets.

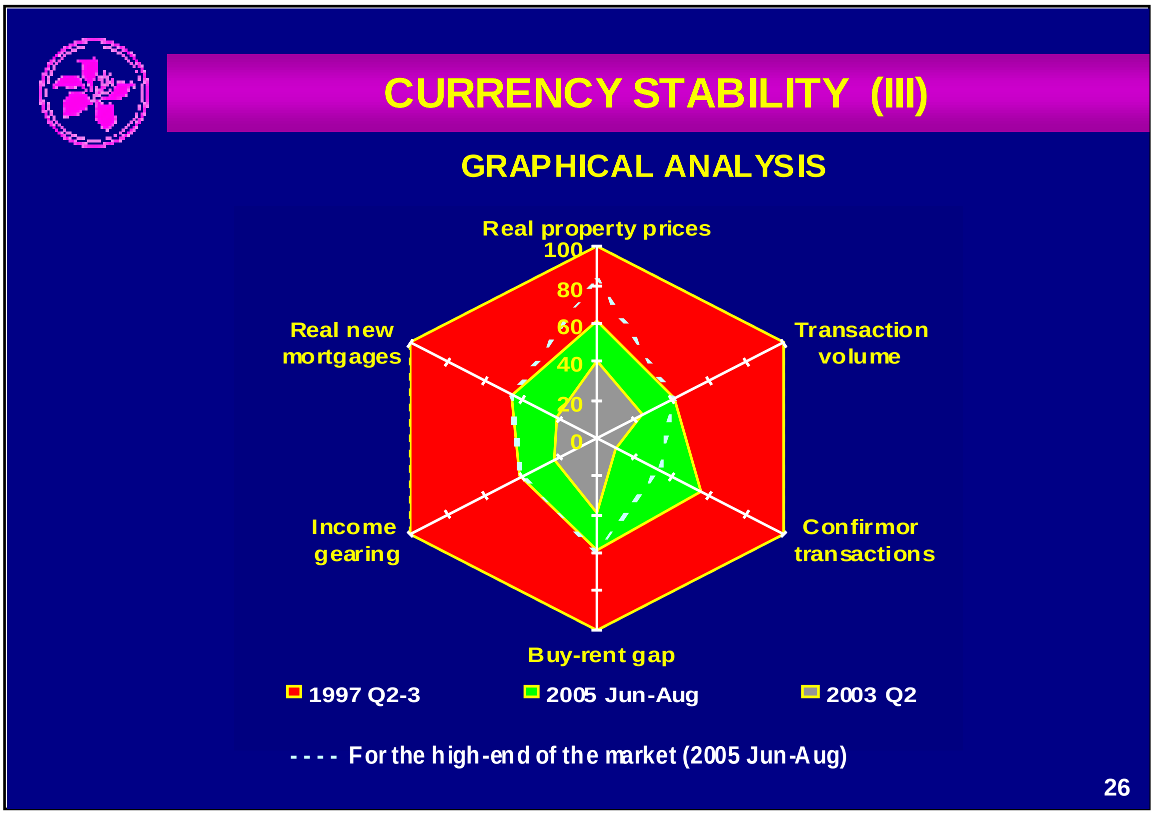


- The interest rate hikes since March this year have dampened property market activities, as indicated by a moderation in prices and transaction volumes in recent months. (Mortgage rates have increased by 225-250 basis points since between March and October 2005.)

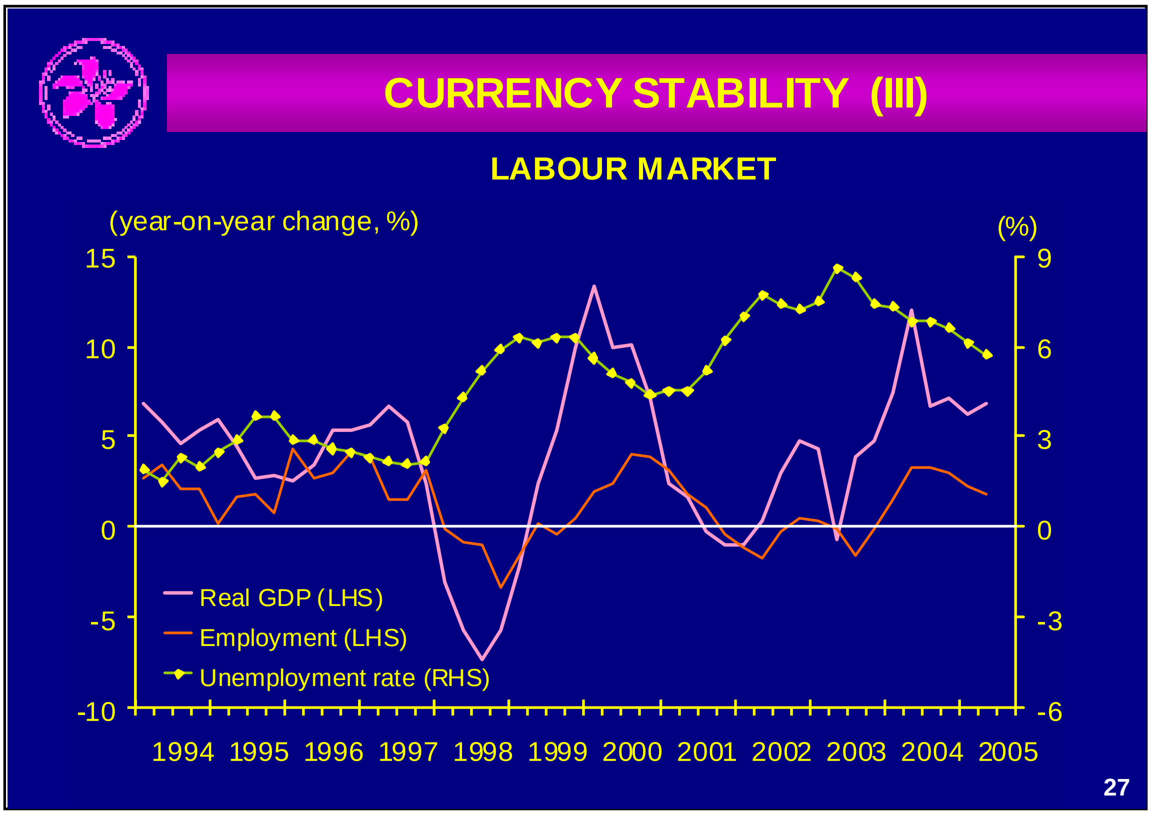
- In particular, residential property prices declined by a total of 3.7% between May and July before stabilising in August. The number of Agreements for Sale and Purchase for residential properties fell markedly by 40% in Q3 compared with Q2.

- Nevertheless, residential property prices have increased on average by 58% from the trough in the summer of 2003. Prices have increased more sharply at the high-end of the market, with prices of large flats (saleable area of 160 m^2 or above) rising by 82% during the same period.

- Prices of commercial premises also increased markedly in the past two years, with those of offices and retail shops rising by 138% and 79% respectively from their lowest levels in mid-2003.

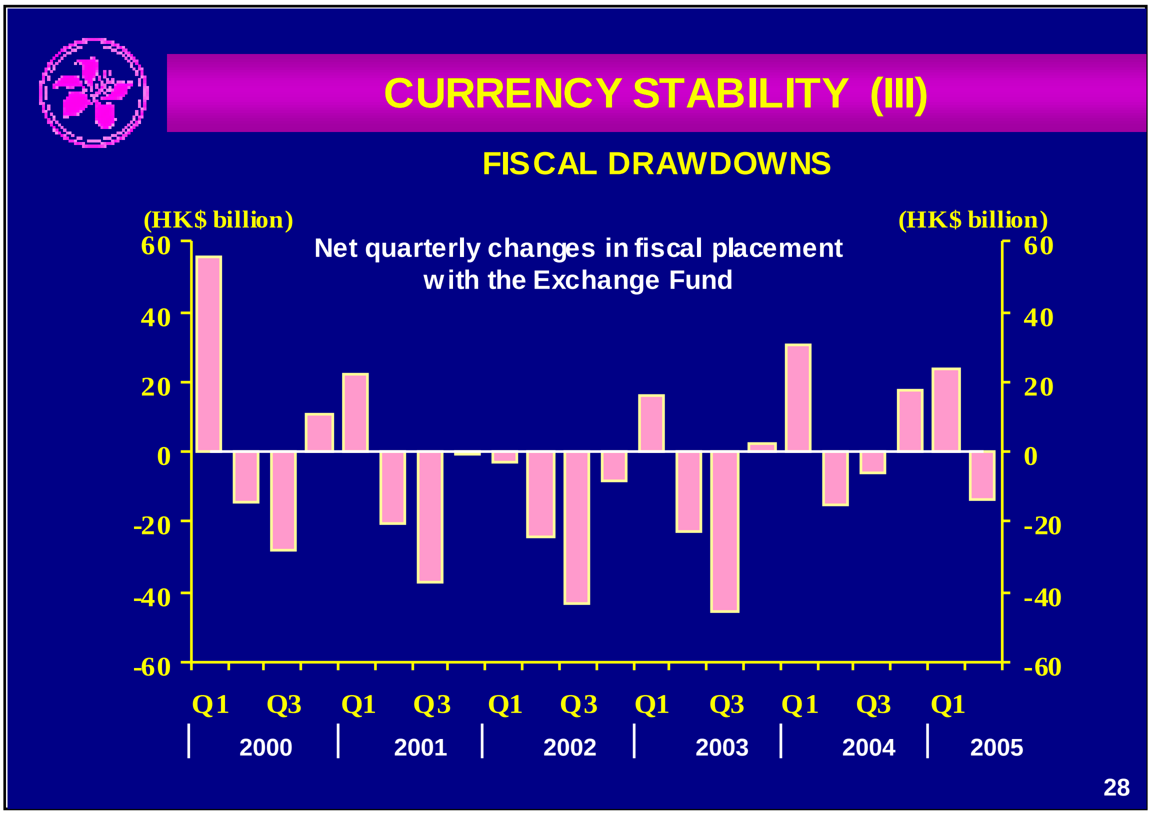


- This graphical analysis summarises the evolution of six key property market indicators: real property prices, property transaction volumes, confirmor transactions, real new mortgages, the income-gearing ratio (ratio of mortgage payment to household income), and the buy-rent gap (ratio of mortgage payment to rental). (Note that 1997 Q2-3 is treated as the base period.)
- The values of the six indicators at a particular time are presented using a hexagon, with the distance of each corner from the centre representing the magnitude of each indicator. Thus, a larger size of the hexagon suggests a higher risk of overheating in the market.
- By August 2005, the size of the hexagon remained smaller than that for April-September 1997, although the income-gearing ratio and buy-rent gap have increased markedly in recent quarters along with rising property prices and mortgage rates, and confirmor transactions also rose sharply.
- The latest situations of prices and confirmor transactions at the high-end of the market are shown by the dotted line in the chart. It shows that prices of large flats have increased more sharply than indicated by the overall price index.
- While a graphical presentation of key real estate indicators suggests that the housing market is still some way off from its previous high in 1997, the risk of a bubble cannot be ruled out. This is because the 1997 peak is an extreme situation when market conditions were clearly out of line with the fundamentals and all the indicators had reached their historical highs.
- Looking ahead, mortgage rates may rise further, if high oil prices lead to a sharp increase in US interest rates. This would worsen housing affordability and raise the cost of buying a property relative to renting.



- Along with the economic recovery, labour market conditions continued to improve. The seasonally adjusted unemployment rate stood at 5.5% in the three months up to the end of September 2005, compared with a historic high of 8.6% recorded in mid-2003. During the period, employment has expanded significantly by 200,900 to 3,390,000.

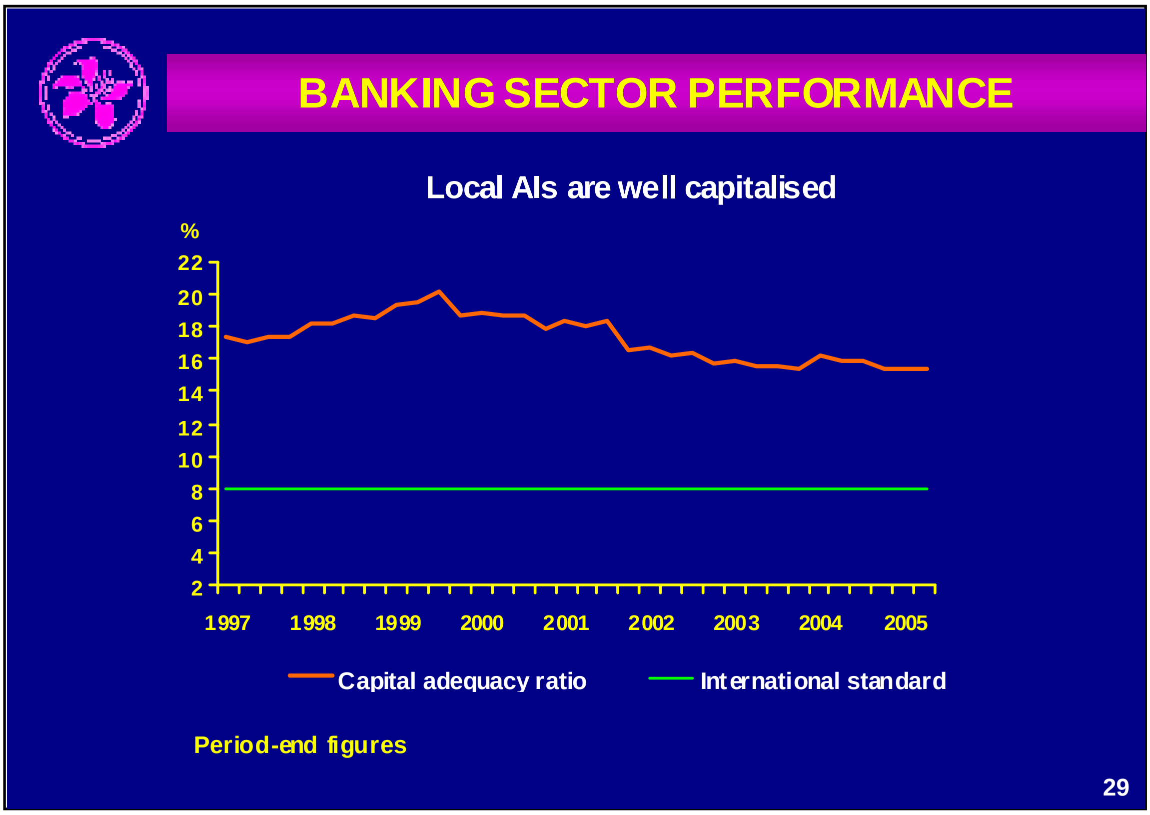
- Looking ahead, a sustained recovery in the economy should help reduce the unemployment rate further. The number of private-sector vacancies received by the Labour Department rose to a record high of 1,900 per working day on average in September. In the first nine months of this year, the Labour Department received 318,596 private sector vacancies, surpassing the full-year figure of 297,186 in 2004 by 7.2%.



- Alongside the economic recovery, the Government's fiscal position has improved since 2003 Q4.
- There were two consecutive quarters of net placements with the Exchange Fund in 2004 Q4 and 2005 Q1, followed by a net draw-down in 2005 Q2.
- The draw-down in 2005 Q2 was largely seasonal. In fact, the draw-down was lower than that in the same period of the previous five years.
- Detailed figures for quarterly changes in fiscal placements are as follows.

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

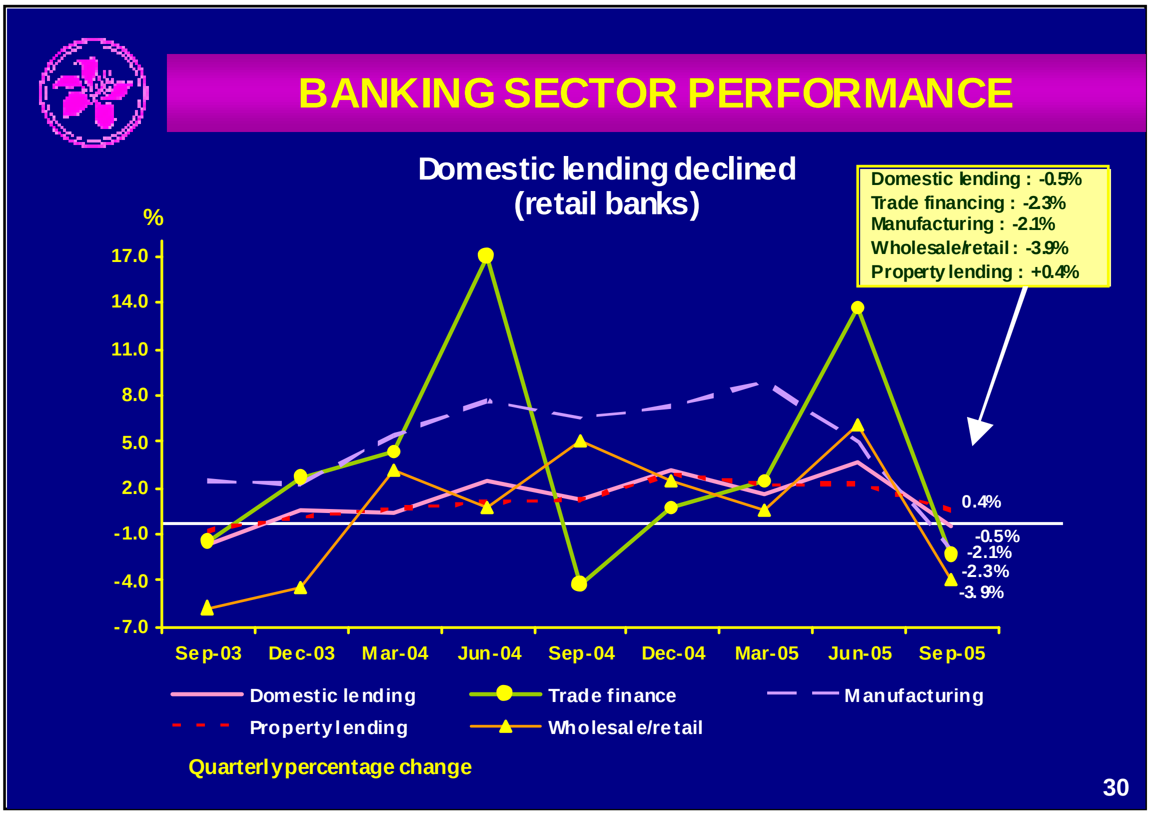
year \ quarter	Q1	Q2	Q3	Q4
2000	55.9	-14.1	-27.7	10.8
2001	22.1	-20.4	-37.4	-0.7
2002	-3.1	-24.4	-43.5	-8.0
2003	16.4	-22.9	-45.6	2.7
2004	30.7	-15.2	-5.7	18.0
2005	24.1	-13.9		



- The banking sector remains well-capitalised. At the end of June 2005, the average consolidated capital adequacy ratio (CAR) of all locally incorporated authorized institutions was over 15%, well above the statutory requirement and international standard 8%.

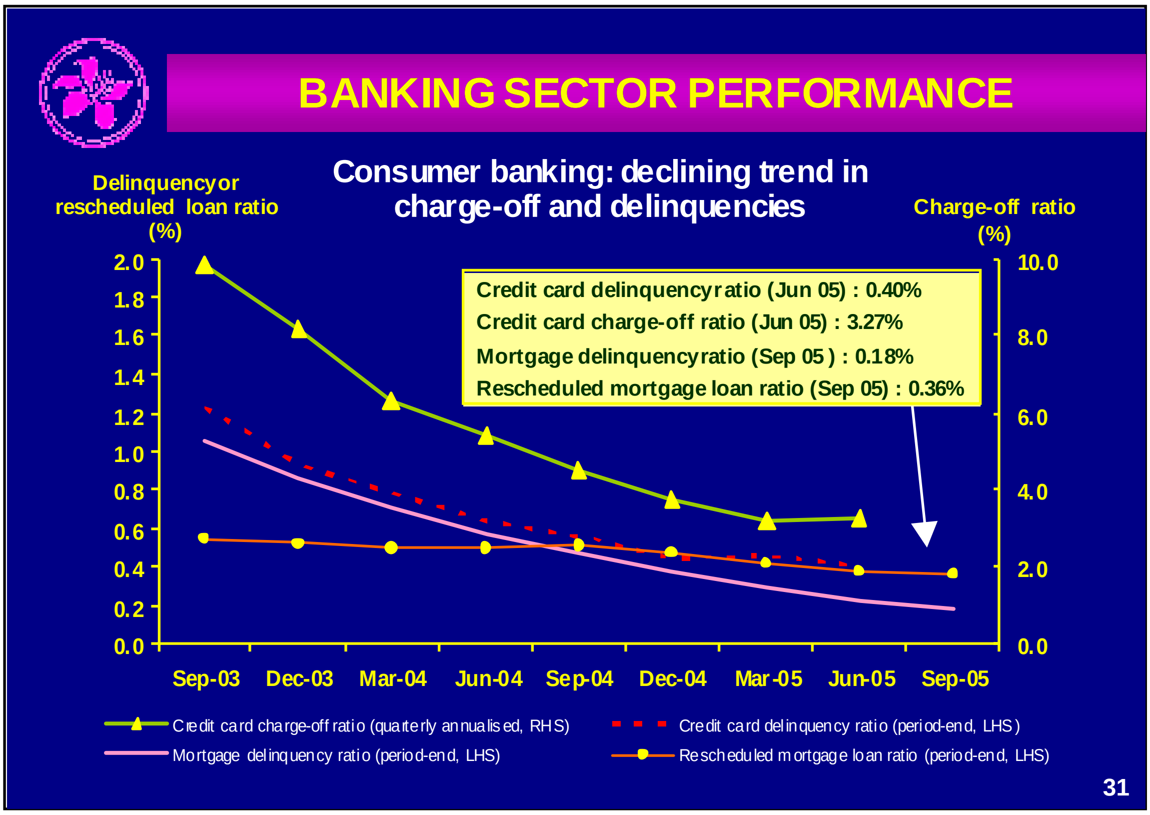
- The decline recorded in December 2001 was due mainly to bank consolidation. The capital adequacy level of the banking sector remained high.

- The slight decrease in the CARs recorded in the first two quarters of 2005 could be explained by the faster growth of risk-weighted assets of local authorized institutions than their capital base. The increase in risk-weighted assets was a result of the increased bank lending in tandem with the growing domestic economy.



- Total domestic lending declined by 0.5% in 2005 Q3 from growth of 3.7% in 2005 Q2. The decline in domestic loans was observed in all major economic sectors except those to the property sector.

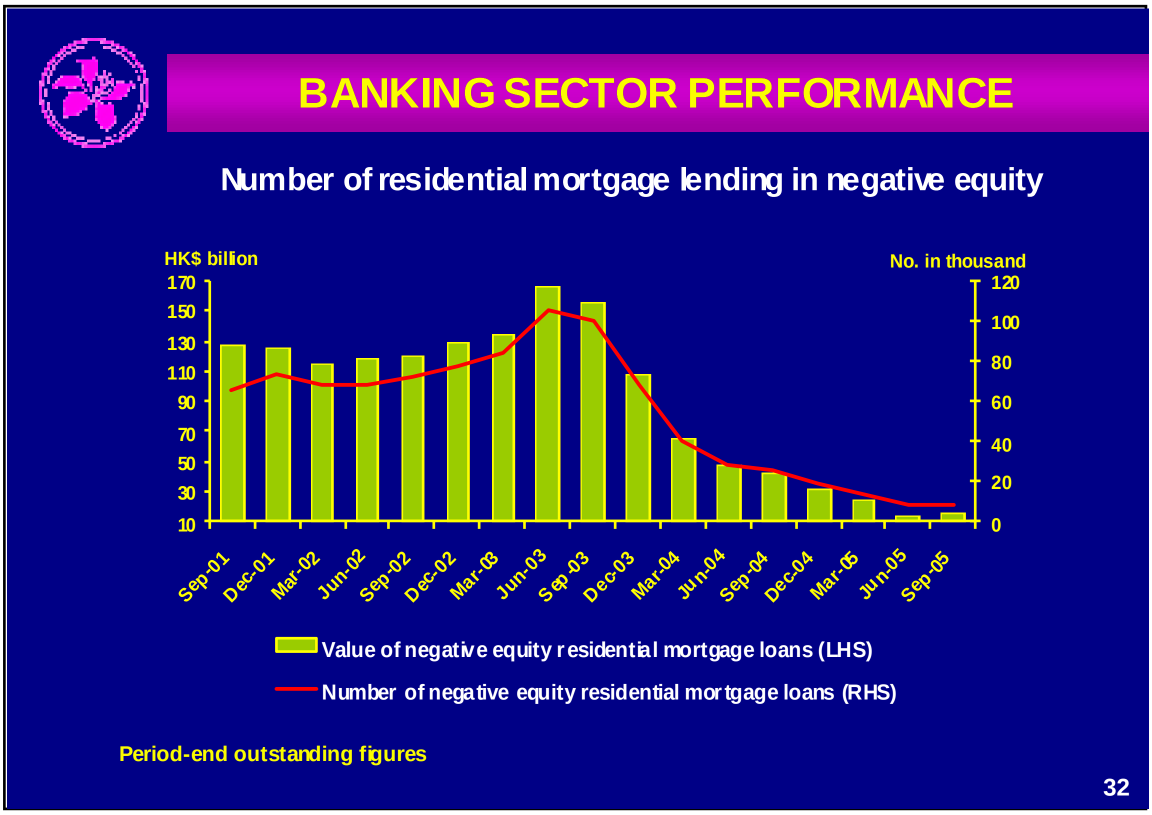
- Note: the sharp decline in trade finance in 2004 Q3 from a strong growth in 2004 Q2 reflected reclassifications initiated by a few banks in the quarter.



- The quality of banks' consumer portfolio improved again so far in 2005 largely based on the strengthening of borrowers' repayment ability alongside the improvement in the labour market.

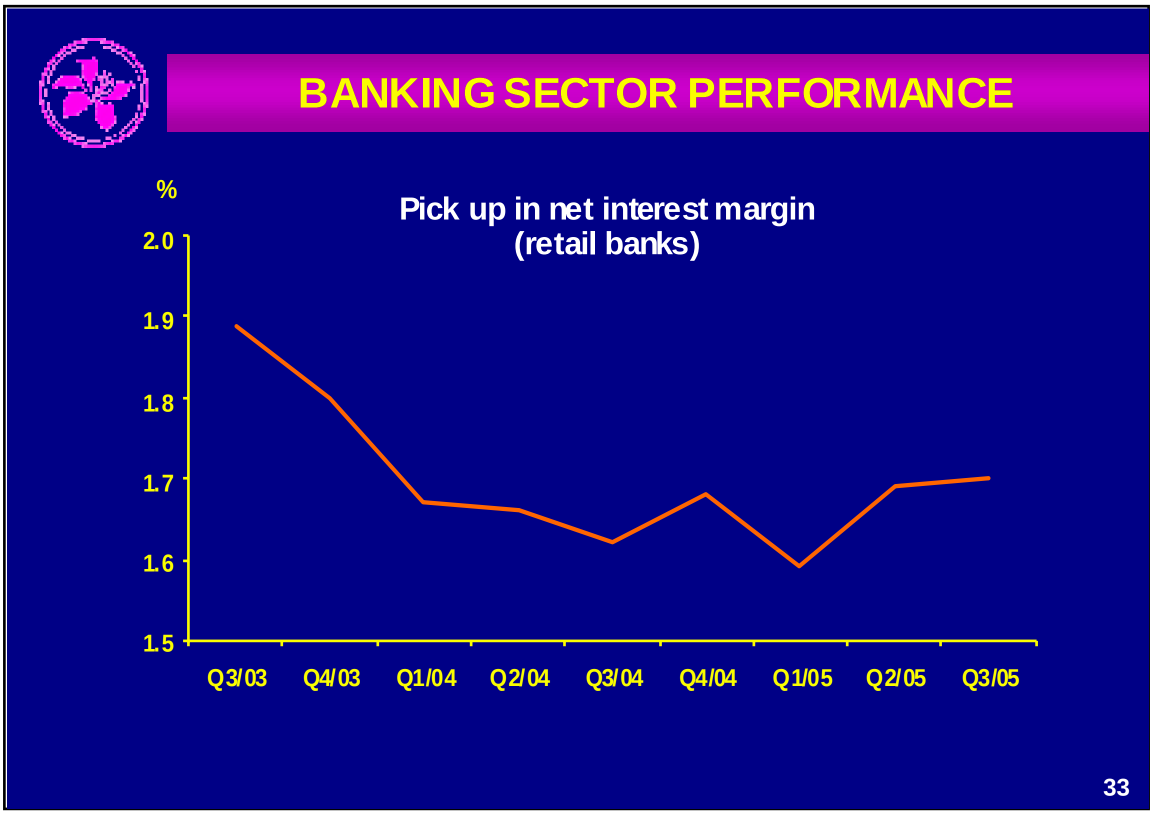
- The residential mortgage delinquency ratio (loans overdue for more than 3 months as a percentage of total mortgage loans) fell to a six-year low of 0.18% at the end of September 2005.

- The credit card annualised charge-off ratio and delinquency ratio declined to 3.27% and 0.40% respectively at the end of June 2005 from peaks of 14.55% and 1.32% at the end of September 2002.

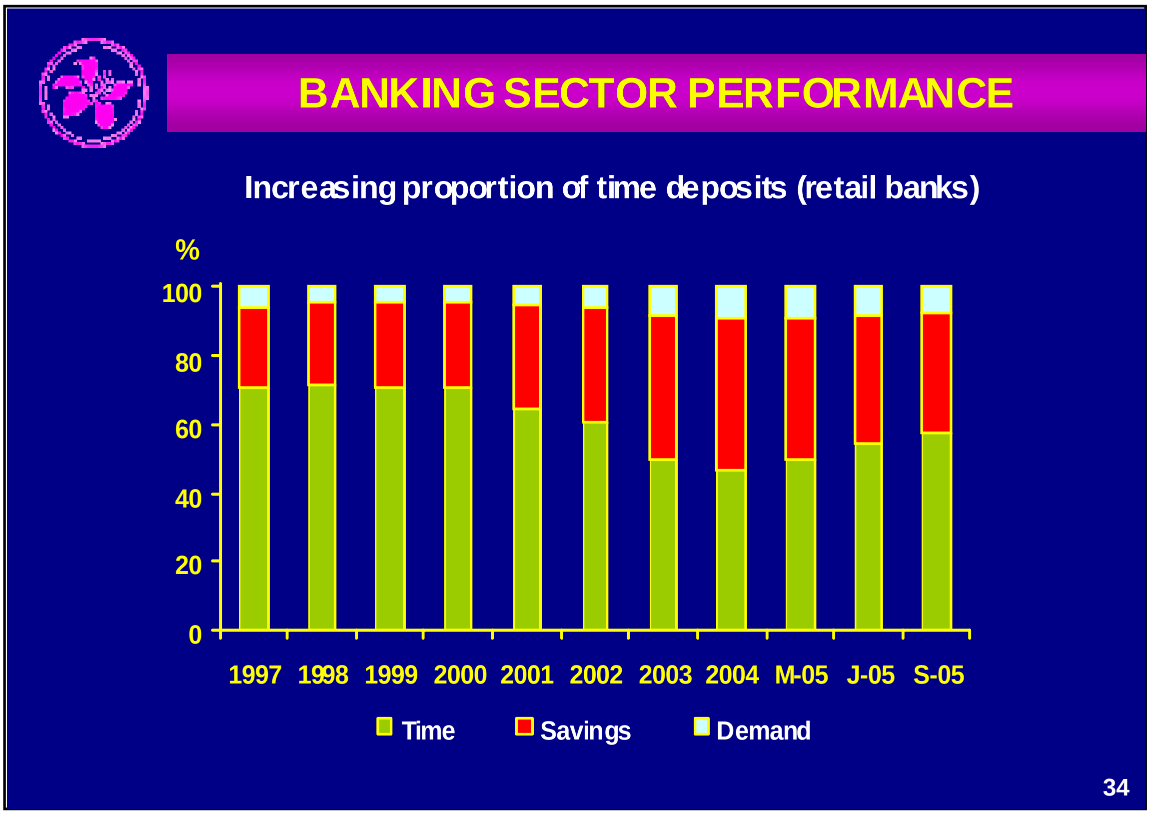


- The number of residential mortgages in negative equity increased slightly by about 300 cases to some 9,000 cases with an aggregate value of HK$16 billion, at the end of September 2005. Despite the increase, the problem of negative equity has eased substantially by 91% from the peak of about 106,000 cases at the end of June 2003.

- The level of residential mortgages in negative equity has improved to a point where it is no longer a concern for banking system stability. We nevertheless understand the anxiety of property buyers for whom this is still a problem.



- The net interest margin of retail banks stayed at historically modest levels, although there was some pick up in the second and third quarters. The recent rise in interest rates has not had a significant impact on the net interest margin of the banking system.



- There was a long-term shift in the structure of customer deposits through to the end of 2004. Time deposits represented around 47% of total deposits by the end of 2004. In 1997, time deposits represented over 70% of the total.

- The trend was caused mainly by the decline in interest rates for time deposits.

- The situation has reversed since 2005 Q1 since interest rates are rising. Depositors have shifted their money from demand and savings deposits to time deposits in search of higher returns.

- The proportion of time deposits expanded from 47% at the end of 2004 to 57% at the end of September 2005.

- This trend has increased banks' long-term funding costs but savers are able to earn higher interest returns.

BANKING SECTOR - WORK PROGRESS (I)

- **Implementation of Basel II in Hong Kong**
  - Banking (Amendment) Ordinance 2005 enacted on 6 July, providing the legislative framework for the implementation of Basel II in Hong Kong
  - Development of revised capital standards making good progress; so far four packages of proposals have been released for consultation
  - Consultation on other outstanding proposals, including the approach to Internal Ratings-based validation, the supervisory review process and disclosure requirements, targeted to finish around end of the year

35

- Following extensive consultation, the Banking (Amendment) Ordinance 2005 was enacted on 6 July. Among other things, the Ordinance provides the Monetary Authority with the power to make rules specifying the way the capital adequacy ratio (CAR) of an AI should be determined (Capital Rules) and the information to be disclosed (Disclosure Rules) under the revised capital adequacy framework.

- Development of capital standards according to Basel II is fairly advanced. Four packages of proposals have so far been released for consultation, covering various implementation issues and weighting framework at the core of Basel II.

- Outstanding proposals will be released shortly for consultation. Major areas include:

  – Validation of Internal Ratings-based systems; the HKMA will issue a guidance note on its proposed approach.

  – Supervisory review process (Pillar 2); the HKMA will issue a paper on the comprehensive process used to monitor and ensure the capital adequacy of individual AIs, taking into account banking risks not captured under Pillar 1 and AIs' internal capital adequacy assessment process.

  – Market discipline (Pillar 3); we will consult the industry on what additional disclosures should be introduced based on Basel II requirements and local characteristics.

BANKING SECTOR - WORK PROGRESS (II)

- **Implementation of Basel II in Hong Kong (cont'd)**
  - **Capital Rules and Disclosure Rules are being drafted. They will be released for consultation by stages, given the length and complexity of the revised framework**
  - **Aim to table the core part of the Rules in LegCo by the end of June 2006, a demanding timetable which will require a substantial commitment of resources by the HKMA, the Government and the banking industry**
  - **Continue to monitor AIs' preparation and contact with overseas regulators to streamline cross-border application of Basel II to banking groups operating internationally**

36

- Proposals on the revised capital standards issued earlier are being translated into Capital Rules and Disclosure Rules, which are subsidiary legislation. These Rules are very lengthy and complex, and will be released in batches during the first round of consultation. There will be two rounds of consultation before the Rules are finalised.

- To get ready at least the core part of the Rules for tabling before LegCo by end-June 2006 (in order for the revised capital framework to take effect from 2007), i.e. less than 12 months since the establishment of the legislative framework for the implementation of Basel II, is a demanding timetable. The process requires a substantial commitment of resources from the HKMA, the Government and the banking industry.

- The HKMA will continue to monitor AIs' preparations for adopting the Basel II standards, particularly those opting for the more advanced approaches. To facilitate adoption of Basel II by internationally-active banking groups, the HKMA has actively engaged the relevant overseas home and host regulators in bi-lateral and in some cases multi-lateral meetings in a bid to minimise duplication of efforts and potential differences / inconsistencies in cross-border application of the revised standards. We also work closely with various working groups of the Basle committee set up to foster better communications between supervisors and initiatives designed to strengthen the supervisory process.

BANKING SECTOR - WORK PROGRESS (III)

- **Prevention of money laundering**
  - **Assessing compliance with anti-money laundering (AML) standards through on-site examinations and introduction of self-assessment framework**
  - **Increasing effectiveness of on-site examinations by improving examination procedures and strengthening AML expertise**
  - **Monitoring the latest international AML developments and incorporating changes in supervisory framework where appropriate**
  - **The Banco Delta Asia incident has highlighted the increasing attention of the international financial community to this subject**

37

- Following the issue of a revised supplementary guideline on the prevention of money laundering in June 2004 that has fully incorporated international anti-money laundering (AML) standards, the HKMA introduced a structured self-assessment framework in June 2005 to strengthen further the monitoring of AML compliance within the banking industry. AIs were required to submit their self-assessment report to the HKMA for review by the end of September 2005. After reviewing the self-assessment results, the HKMA will inform the banking industry of the general findings and identify any particular compliance issues that may warrant closer attention by the industry.

- The HKMA is revising the examination manual to take into account the latest AML requirements and to incorporate a risk-based approach to conducting examinations. There is also a plan to recruit a consultant to train and strengthen the expertise of examiners in this area.

- The HKMA will also follow the Financial Action Task Force (FATF) timetable for implementing Special Recommendation VII (SR VII) on wire transfers by December 2006. The HKMA will be consulting the banking industry on the implementation of SR VII in the next few months.

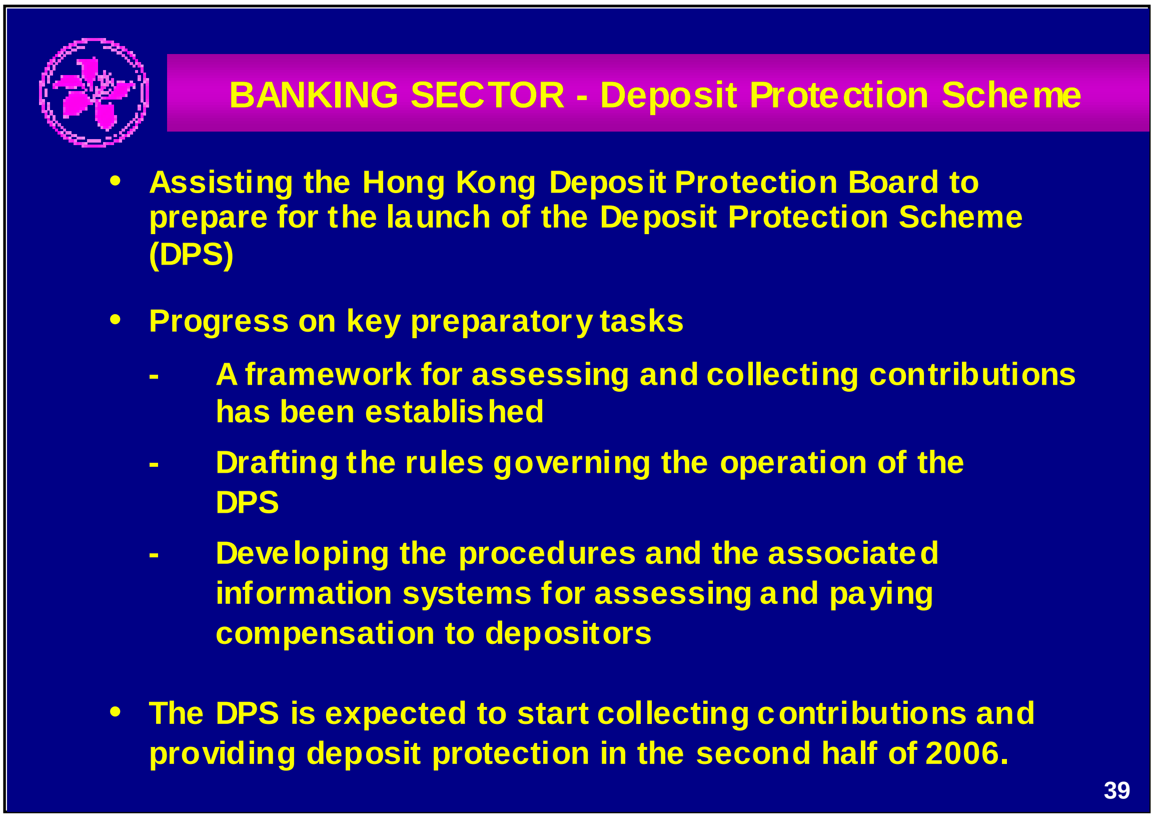
- The incident of Banco Delta Asia S.A.R.L., which was designated by the U.S. Department of the Treasury on 15 September as a "primary money laundering concern" under Section 311 of the USA PATRIOT Act, has highlighted the increasing attention of the international financial community to the subject of money laundering.

BANKING SECTOR - TWO-FACTOR AUTHENTICATION

- **Implementation progress:**
  - All 20 AIs offering high-risk internet banking transactions have adopted two-factor authentication
  - around 250,000 retail customers registered for two-factor authentication in June 2005
- **For visually-impaired customers:**
  - banks are in discussions with representatives of visually-impaired customers
  - exploring solutions, e.g. security token with voice output, one-time password delivered through dedicated phone-banking hotline

38

- Progress of two-factor authentication:
  - The implementation of two-factor authentication is progressing satisfactorily. All 20 AIs, which offer high-risk retail Internet banking transactions, have adopted two-factor authentication.
  - In general, AIs adopt a phased approach. Customers, who have previously engaged in high-risk retail Internet banking transactions, are given priority to register for two-factor authentication. By end of June 2005, around 250,000 customers have registered for the service.
- Two-factor authentication for visually-impaired customers:
  - Some existing solutions (i.e. security token and SMS-based one-time password) currently cannot cater for the need of visually-impaired customers. The banks concerned are discussing appropriate solutions with representatives of visually-impaired customers.
  - A number of solutions are possible, including:
    - (i) security token with voice output (with speaker and/or ear plug); and
    - (ii) one-time password delivered through a dedicated phone-banking hotline.
  - The HKMA will continue to monitor progress.



- The HKMA continues to provide appropriate assistance to the Hong Kong Deposit Protection Board for preparations for the launch of the DPS. Good progress has been made by the Board since its formation in July 2004.

- If everything goes smoothly it is expected that the DPS will start collecting contributions and providing deposit protection in the second half of 2006.

MARKET INFRASTRUCTURE (I)

- **Review by the Financial Infrastructure Sub-Committee of EFAC of financial infrastructure development**
  - development strategy: safe and efficient financial infrastructure based on a multi-currency, multi-dimensional platform
  - main review areas include Mainland-related financial infrastructure, payment systems and debt settlement systems
  - review completed in mid-2005
  - recommendations include project development (for enhancing system capabilities) and business development (for expanding existing infrastructure network and usage)
  - implementation of these recommendations started in the second half of 2005

40

- Development of a safe and efficient financial infrastructure platform is key to the maintenance of Hong Kong as an international financial centre. Hong Kong currently has a very advanced financial infrastructure, which meets the best international standards. In the light of the opportunities presented by developments on the Mainland, new financial products and new technology, the Financial Infrastructure Sub-Committee of the Exchange Fund Advisory Committee has conducted a review to take stock of where we are and map out a strategy to guide future development.
- The review covered the Mainland-related financial infrastructure, payment systems and the debt securities settlement system and was completed in mid-2005.
- Having considered the major opportunities and challenges that Hong Kong is expected to face in the coming years, we consider that the strategy should be to develop a safe and efficient financial infrastructure based on a multi-currency, multi-dimensional platform.
- Recommendations arising from the review cover <u>project development</u> and <u>business development</u>.
  - In respect of <u>project development</u>, we have identified financial infrastructure projects to bring our payment systems up to new international standards; facilitate debt market development; and support financial intermediation between the Mainland and the rest of the world.
  - In respect of <u>business development</u>, we will expand the existing network of financial infrastructure by developing new linkages and expanding the usage of our systems.
- The implementation of these recommendations started in the second half of 2005 and is making progress.

MARKET INFRASTRUCTURE (2)

- **Oversight of the clearing and settlement systems**
  - off-site reviews and on-site examinations of system operators and settlement institutions of designated systems
  - provide secretarial support to the Process Review Committee (PRC), an independent body to ensure that MA has applied the same oversight standards to MA and non-MA-related designated systems
  - encourage credit and debit card industries to conduct self assessment of their security controls and strengthen their security system where necessary in the light of the CardSystems Incident in June

41

- The Clearing and Settlement Systems Ordinance became effective on 4 November 2004. There are five designated systems: HKD CHATS, CMU, USD CHATS, euro CHATS and the CLS System. Each of the five designated systems was issued a certificate of finality to provide statutory protection to the settlement finality for transactions effected through these systems.

- To promote the general safety and efficiency of the designated systems, the HKMA carries out oversight activities through one or more of the following: off-site review of regulatory returns, on-site examinations of high risk areas, external audit report, meeting with the management and international co-operative oversight.

- A Process Review Committee, composed of independent members, was established in December 2004 to review processes and procedures adopted by the MA in making decisions relating to or affecting the designated systems in which the MA has a legal or beneficial interest, as compared to other systems. An annual report on the work of the Committee will be prepared to FS by end-2005.

- In the wake of the outbreak of the CardSystems security breach in late June, the HKMA promptly requested all credit card issuing AIs to assess the impact of the incident on HK cardholders and to take prompt actions to safeguard the interests of card holders. Credit card and debit card companies and card issuing banks in Hong Kong were also requested to conduct self-assessment of their security control system and strengthen it where necessary. The replies we received confirmed that it is unlikely that similar incidents will occur in Hong Kong. The HKMA explained the incident and the follow-up actions to the Financial Affairs Panel of LegCo on 4 July 2005.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE (I)

Renminbi business in Hong Kong

- Outstanding renminbi deposits reached RMB 22.6 billion yuan at the end of September 2005
- In October 2005, State Council agreed in principle that the People's Bank of China should provide clearing arrangements for expanded renminbi business
- Continuing discussions with Mainland authorities on using renminbi to settle cross-border trade and issuance of renminbi bonds in Hong Kong

42

- At the end of September, 38 banks were engaging in renminbi business in Hong Kong and the total outstanding renminbi deposits reached RMB22.6 billion yuan. The cumulative value of transactions by Mainland visitors using renminbi cards to spend and make cash withdrawals in Hong Kong since the start of renminbi card business exceeds HK$7.1 billion. Debit- and credit-card spending by Mainland tourists was HK$2,838 per transaction on average.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE (II)

Expanded scope of renminbi business in Hong Kong:

(i) Designated merchants can open renminbi deposit accounts and exchange the deposits into Hong Kong dollars; definition of "designated merchants" has been widened to include merchants engaging in transportation, communication, medical and education services;

(ii) Hong Kong residents can open renminbi cheque accounts and issue renminbi cheques for consumer spending in Guangdong Province subject to a daily limit of RMB80,000 yuan;

(iii) Daily limits for conversion of renminbi cash by individuals is increased from RMB6,000 yuan to RMB20,000 yuan, and that for renminbi remittance is increased from RMB50,000 yuan to RMB80,000 yuan;

(iv) Cap of RMB100,000 yuan on credit limit of renminbi credit cards issued by Hong Kong banks removed.

43

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE (II)

Asian Bond Fund 2 (ABF2)

- **11 EMEAP central banks and monetary authorities, including the HKMA, have invested a total of US$2 billion in ABF2.**
- **ABF2 consists of the ABF Pan Asia Bond Index Fund (PAIF) and 8 Single-market Funds. So far, the PAIF and 3 Single-market Funds in Hong Kong, Malaysia and Singapore have been listed. The other funds will be launched in the next few months.**
- **The ABF Hong Kong Bond Index Fund and the PAIF were listed in Hong Kong in June and July respectively, with asset size having grown by 42% and 12% since launch.**
- **The passively managed bond index funds of ABF2 represent a new asset class in Asia, providing efficient and low-cost vehicles for investing in local currency-denominated bonds in the region.**

44

- As the Chairman of the EMEAP Working Group on Financial Markets, the HKMA has been driving the design and implementation of the ABF2.
- PAIF is a single bond fund investing in sovereign and quasi-sovereign local currency-denominated bonds issued in the 8 EMEAP markets (China, HK, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand) The Single-market Funds will each invest in sovereign and quasi-sovereign local currency-denominated bonds issued in the respective 8 EMEAP markets.
- ABF2 plays a catalytic role in:

  (i) Promoting new products – The ABF HK Bond Index Fund is the first ever bond exchange-traded fund (ETF) in Asia and the PAIF is the first listed bond fund to invest in 8 bond markets in Asia. Both funds have low management fees (16 bps p.a. for PAIF and 15 bps p.a. for HK Fund) and low entry thresholds (minimum board lot: about US$1,000 for PAIF and HK$10,000 for HK Fund). Together with the pricing transparency of their exchange-traded units, the two funds facilitate retail participation in Asian bond markets.

  (ii) Improving market infrastructure – The iBoxx ABF family of indices, the benchmark indices for ABF2, are important financial market infrastructure for the 8 EMEAP markets concerned and will facilitate market participants to structure new products;

  (iii) Minimising regulatory hurdles – Some EMEAP economies are reforming their tax and regulatory regimes to facilitate cross-border investment. For instance, the PAIF is the first foreign institutional investor granted access to China's interbank bond market and Malaysia and Thailand have provided withholding tax exemptions to non-resident investors.

- **Key market data for ABF HK Bond Index Fund and PAIF:**

(As of 26 October)	**HK Fund**	**PAIF**
Fund size	HK$2.0 bn (US$259 mn)	US$1.1 bn
Growth of fund size since inception	+42%	+12%
Average daily turnover since inception	HK$7.9 mn (US$1.0 mn)	US$0.12 mn

EXCHANGE FUND PERFORMANCE

(HK$ billion)	2005[2] Q3	2005[2] Q2	2005[2] Q1	2004[1] Full year
Gain / (Loss) on Hong Kong equities*	8.1	5.1	(3.5)	12.0
Gain / (Loss) on other equities*	10.1	3.4	(0.9)	11.2
Exchange gain / (loss)	(2.4)	(10.7)	(3.0)	8.5
Total return from bonds, etc	3.2	15.8	5.3	25.0
Investment income	19.0	13.6	(2.1)	56.7

* Including dividends

[1] *Audited figures;* [2] *Unaudited figures*

45

- As evident from recent sharp movements in global markets, continued high energy prices and increasing inflationary expectations are disruptive to bond, equity and currency markets. Markets have been very volatile.

EXCHANGE FUND
TREASURY'S SHARE OF INVESTMENT INCOME

(HK$ billion)	2005 Q3	2005 Q2	2005 Q1	2004 Full Year*
Investment income / (loss)	19.0	13.6	(2.1)	56.7
Other income	0.0	0.1	0.0	0.2
Interest, other costs and adjustments	(2.2)	(2.4)	(1.3)	(4.8)
Net investment income / (loss)	16.8	11.3	(3.4)	52.1
Treasury's share	(4.9)	(3.5)	0.7	(14.5)
Revaluation gain on premises affecting accumulated surplus	0.0	0.0	0.0	0.9
Increase / (Decrease) in EF accumulated surplus	11.9	7.8	(2.7)	38.5

* Audited figures

46

- The investment strategy of the Exchange Fund is directed by the objectives of capital preservation, liquidity, full backing of the 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. 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 yearly return of the Exchange Fund and to predict whether the return in any one year will meet the target set by the Treasury.

YEARLY TREASURY SHARE OF THE EXCHANGE FUND INVESTMENT INCOME VS. TREASURY INCOME FORECAST

Year	Actual Treasury Share (note 2)	Treasury Income Forecast (notes 3 & 4)
2005	7.7 (note1)	14.1
2004	14.5	12.3
2003	25.7	12.1
2002	15.6	13.8
2001	1.6	12.5
2000	18.1	31.6
1999	45.4	22.2
1998	26.0	26.7

Note 1: Year-to-date up to the end of September 2005.

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

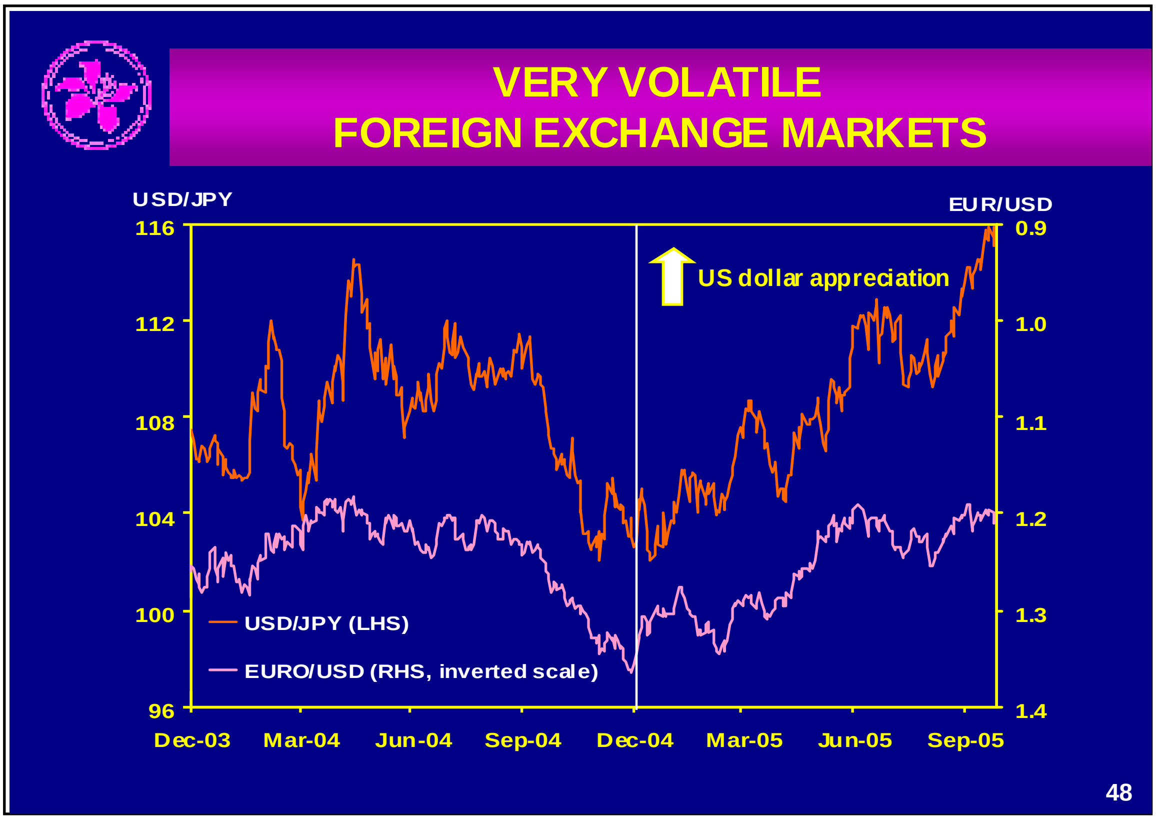
Note 3: Based on HK Government's fiscal year from April to March of the following year.

Note 4: The figures have been published since 2002. Figures before then are HKMA estimates.

47

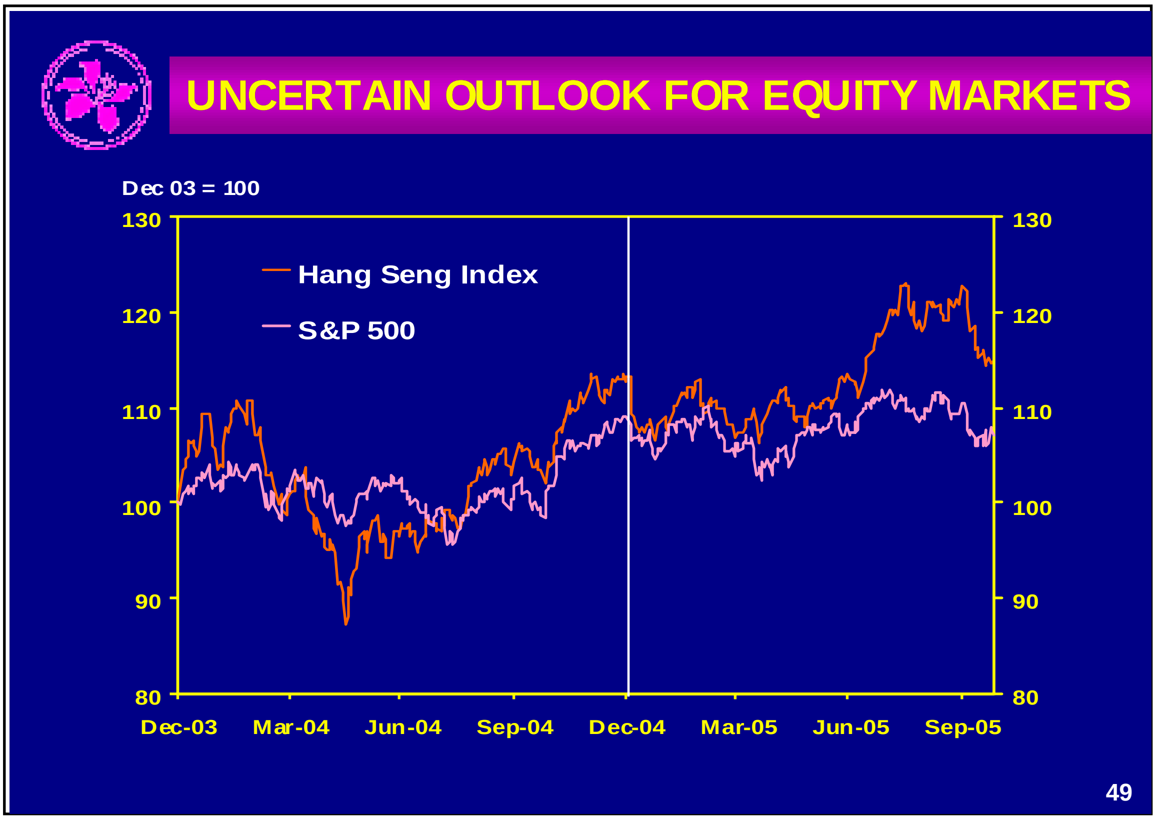
- The Treasury's share of the Exchange Fund investment income fluctuated from year to year, ranging from a low of HK$1.6 billion in 2001 to a high of HK$45.4 billion in 1999.

- Sharing arrangements make investment return on fiscal reserves volatile and unpredictable.



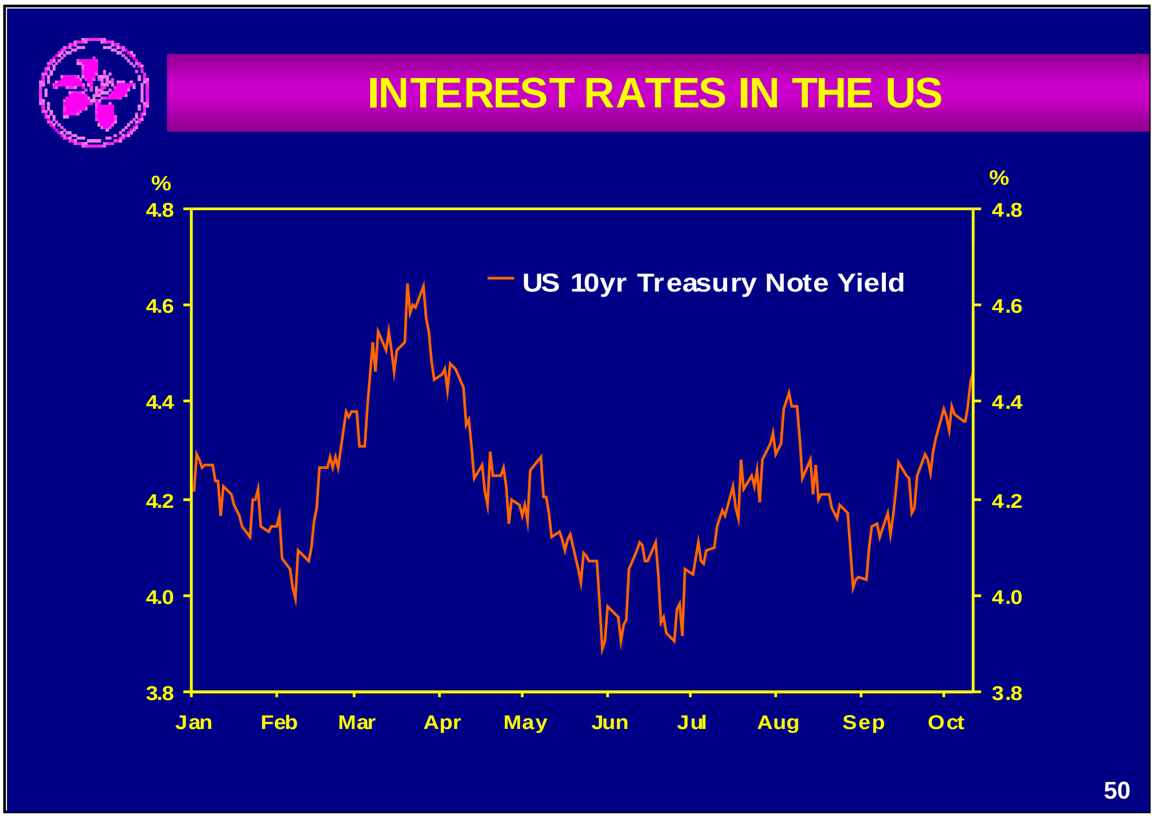
- In 2004, the euro and yen appreciated by 7.8% and 4.6% respectively against the US dollar. Concern over the twin deficits in the US depressed the value of the US dollar.

- In 2005, expectations of continued increases in US interest rates provided some support to the US dollar. As a result, the US dollar has appreciated by 11.6% and 12.5% against the euro and yen respectively since the end of last year. However, imbalances in the global financial system have worsened. The uncertain outlook for growth in view of high energy prices and the increasing size of the imbalances suggests that the US dollar will seesaw through the rest of the year.



- In 2004, the Hang Seng Index and the S&P 500 rose by 13.2% and 9.0% respectively.

- Since the beginning of 2005, the US equity market has been negatively affected by high energy prices and concerns over the sustainability of earning prospects and growth in the US. The sombre mood of the US equity market has spilled over to other markets, including Hong Kong which has become wary of possible declining exports to the US. Up to 27 October, the S&P 500 fell by 2.7% while the Hang Seng Index retreated somewhat but still managed to gain 1.1% compared to end-2004.



- The US Fed is expected to continue to tighten monetary policy at a measured pace throughout 2005.

- Expectations of higher interest rates, concerns over sustainable growth and high oil prices have translated into high volatility in interest rates. The line shows the US 10-year Treasury note yield. The variations in the line also indicate the sensitivity of the market to changes in the expectations of inflation. The uncertainty surrounding future Fed action increases as the Fed funds target rate edges towards more neutral ground.

- We expect the uncertain outlook in currency, equity and bond markets to continue.