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Legislative Council

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**Report of the Panel on Financial Affairs
for submission to the Legislative Council**

Purpose

This report gives an account of the work of the Panel on Financial Affairs during the Legislative Council session 2002-03. It will be tabled at the meeting of the Council on 9 July 2003 in accordance with Rule 77(14) of the Rules of Procedure of the Council.

The Panel

2. The Panel was formed by a resolution passed by the Council on 8 July 1998 and as amended on 20 December 2000 for the purpose of monitoring and examining Government policies and issues of public concern relating to financial and finance matters. The terms of reference of the Panel are at **Appendix I**.

3. The Panel comprises 18 members, with the Hon Ambrose LAU Hon-chuen and the Hon Henry WU King-cheong elected as Chairman and Deputy Chairman respectively. The membership list of the Panel is at **Appendix II**.

Major work

Hong Kong's economic development

4. Apart from monitoring policies on financial affairs, the Panel continued to provide a forum for all LegCo Members to discuss with the Financial Secretary (FS) on matters relating to macro economic issues. During the session, FS attended four meetings of the Panel to brief Members on Hong Kong's latest economic situation and invite views on ways to re-launch Hong Kong following the outbreak of Severe Acute Respiratory Syndrome (SARS) which seriously hampered Hong Kong's economic development.

Hong Kong's fiscal problem

5. The Panel had two meetings with FS to discuss Hong Kong's fiscal problem and possible measures to resolve it including proposals in budgeting the Government expenditure for the years from 2003-04 to 2006-07. According to FS, the fiscal deficit problem was mainly caused by a period where the Government expenditure had grown faster than the GDP and had been aggravated by sustained deflation. The fiscal deficit which amounted to be over 5% of the GDP in 2002-03 reached a dangerous level, and if not resolved promptly, would adversely affect the overall economy. To tackle the problem, the Administration adopted a three-pronged approach including reviving the economy, cutting government expenditure and raising revenue with the target to restore fiscal balance by 2006-07.

6. Members concurred with FS that reviving the economy was the key to resolving the fiscal deficit problem. Some Members however considered that the Administration had not made sufficient efforts to revive the economy. Instead, Government's strategy was more focused on cutting public expenditure and raising revenue which might create even more pressure on tax payers. In this respect, FS highlighted that the Government's long term strategy was to expedite economic integration with the Mainland to enhance the two-way flows of people, goods, capital, information and services, as well as promoting the development of four high value-added core industries including "financial services, logistics, tourism and producer and professional services". Over \$200 million would be spent to attract foreign investment and promote tourism. Through the recently announced population policy and the capital investment entrant scheme, it was expected that more talents and economic migrants would be brought into Hong Kong. Agreement on the main parts of the Closer Economic Partnership Arrangement between the Mainland and Hong Kong was reached on 30 June 2003 and the Administration had plans to speed up progress of infrastructure projects with co-operation of the Mainland authorities.

7. Regarding the planned reduction in Government's operating expenditure, some Members opined that the progressive reduction from \$220 billion in 2002-03 to \$200 billion in 2006-07 would aggravate the deflation problem. The cuts in the expenditure on education and social services would also have significant implications on the supply of local talents and the quality of services for vulnerable groups. Some Members also questioned if the Administration's commitment to create employment opportunities through the implementation of public works projects would be affected by its new "economic benefit" criterion. In this respect, FS affirmed that there was no plan to cut funds already earmarked for public works projects in the next five years. However, in view of the deficit problem, the Administration would exercise greater vigilance in determining whether and when a public works project should be taken on board having regard to the economic benefits and urgency of the project in meeting community needs.

8. On the other hand, some Members considered that given the pressing deficit problem, the Administration should take decisive steps to cut public expenditure. The fiscal problem already caused concern over Hong Kong's fiscal position and might cause downgrading in its financial ratings and thus adversely affecting Hong Kong's overall economic stability.

9. As regards new revenue measures, Members were advised that the introduction of Goods and Services Tax would be inappropriate under the present economic situation. However, other measures including increasing profits and salaries tax rates, implementing the Boundary Facilities Improvement Tax and soccer betting duty, as well as sale of Government assets were actively pursued to raise Government revenue.

Impact of SARS on Hong Kong's economy

10. Concerning the impact of SARS on Hong Kong's economy, FS pointed out that visitor arrival plunged by over 60% in April 2003 compared with the same period in 2002 and the seasonally adjusted unemployment rate surged to 7.8% for the period of February to April 2003. Hence, the forecast GDP growth rate in real terms was revised downward from the original 3% to 1.5% in May 2003. Members urged the Administration to implement more vigorous measures to help revive Hong Kong's economy. With a view to restoring the confidence of local people and the international community, the Administration should invest more on building infrastructure facilities and assist industries with potentials to develop.

11. Recognizing the severe difficulties suffered by the general public and the business sectors from the SARS outbreak, the Panel monitored closely the Administration's work in relieving the hardship of the community and re-launching the economy. In this regard, the Panel examined the Administration's economic relief package of \$11.8 billion. On the \$3.5 billion Loan Guarantee Scheme for the four most impacted industries, members welcomed the Administration's policy which had taken on board members' suggestion to extend the use of the loan as working capital for enterprises and to relax the requirement for guarantee from shareholders applying for loans. However, the Administration did not accede to members' request for widening the scope of the scheme to cover other hard-hit sectors due to stringent financial position. As regards members' suggestion that the Government should spend the reserves to relieve the hardship caused by the downturn of the economy and defer implementation of the revenue raising and expenditure cutting proposals in the 2003-04 Budget, FS stressed that the relief package was a one-off measure and the fiscal deficit problem should be addressed without delay.

12. In respect of the \$1 billion re-launch Hong Kong campaign, the Panel generally agreed that it would help to rebuild Hong Kong's international image and restore the confidence of visitors and overseas businesses and to assure people that Hong Kong was a safe place and the economy was moving back to its normal track of development. Members urged the Administration to involve the business sectors and the community in launching the various programmes and to consult the relevant panels on the details.

Hong Kong Monetary Authority

13. During the session, the Panel continued to receive briefings by the Chief Executive of Hong Kong Monetary Authority (CE/HKMA) on three occasions on the work of HKMA in relation to maintaining the stability of the Hong Kong dollar, regulating the banking sector, promoting the development of financial infrastructure, and managing the Exchange Fund (EF).

14. The controversy over the use of \$3.699 billion for purchasing office accommodation for HKMA without seeking the approval of the Finance Committee raised question on how far HKMA's recurrent and capital spending should be funded by the Exchange Fund. The Panel conducted a detailed research on the governance of HKMA with reference to the governance of other government departments and comparable overseas regulatory authorities. The research aimed to provide bases for discussion on HKMA's powers and functions, the arrangements on funding, staff remuneration, and accountability. In view of the importance of the subject, the Panel invited views from HKMA as well as academics and practitioners on the various issues over the governance of HKMA.

15. Whilst appreciating that HKMA's primary duties were covered by the Exchange Fund Ordinance (EFO) and the Banking Ordinance, some members considered that there was room for a review of HKMA's role and the need for putting in place a comprehensive legislation clearly specifying the statutory powers and functions of HKMA. As to whether HKMA should be subject to the normal public funding appropriation mechanism under which LegCo was the approving authority, CE/HKMA stressed that under EFO the operation of HKMA was funded by the EF which was in charge by FS. Hence, HKMA's budget was subject to approval by FS. However, some members opined that HKMA was no different from other government bureaux/departments. They considered that the expenditure of HKMA other than that related to the management of the EF should be subject to the scrutiny of LegCo. As regards the staff remuneration packages, members who expressed a view on the matter generally considered that the present salaries of senior staff of HKMA too high. Noting that reference had been made to the salary levels in the private sector, they urged the Government to review the staff remuneration packages to take into account of those of comparable overseas authorities. Moreover, members

generally opined that there should be greater transparency in HKMA's remuneration policy.

The Penny Stocks Incident and the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure

16. On 25 July 2002, the Hong Kong Exchanges and Clearing Limited (HKEx) published a "Consultation Paper on Amendments to the Listing Rules Relating to Initial Listing and Continuing Listing Criteria and Cancellation of Listing Procedures" for public consultation. As part of the package, the HKEx proposed that where the moving average of the daily volume weighted share price over 30 consecutive trading days of a listed company was less than HK\$0.50, the price of the listed company should be consolidated, failing which, after a series of procedures and possible appeals, delisting might follow. This proposal was widely believed to have triggered the fall of low priced shares on 26 July 2002, i.e. the Penny Stock Incident (the Incident). In view of the wide public concern about the Incident, FS appointed an independent panel of inquiry (Inquiry Panel) to look into the incident. The Inquiry Panel released its report on 10 September 2002.

17. The Panel held five meetings from July to November 2002 to examine the circumstances surrounding the Incident with relevant parties, receive views from organizations from the securities industry and the public, and, upon the publishing of the report of the Inquiry Panel, discuss the findings and recommendations of the report. Members' main concerns were Government's role in the "three-tiered" regulatory framework for the securities market, the regulatory functions of the Securities and Futures Commission (SFC) and HKEx and the working relationship between them, the roles and responsibilities of the key individuals involved in the incident, namely, FS, the Secretary for Financial Services and the Treasury, the Chairman of SFC and the Chief Executive of HKEx.

18. Findings of the Inquiry Panel revealed weakness in the communication and delineation of roles and functions of the Government, SFC and HKEx, particularly in relation to the regulation of listing matters. The Panel welcomed the decision of FS in September 2002 to appoint a three-member Expert Group to review the operation of the securities and futures market regulatory structure. The report of the Expert Group was released on 21 March 2003. The most controversial recommendation of the report was the transfer of listing function currently undertaken by HKEx to a new Hong Kong Listing Authority to be established under SFC. In view of the far-reaching impact of the report, the Panel invited the Expert Group to brief members on its recommendations, and discussed with the Administration, SFC and HKEx on the way forward.

19. The Panel noted that there was wide public support for reform on the current regulatory structure governing listing matter and some members called for early implementation of the proposal to transfer listing function to SFC in order to remove the conflict of interests in HKEx which was both a listed company and the primary regulator of companies seeking listing. It was also aware that HKEx did not agree with the proposal. The Panel noted that notwithstanding FS's endorsement of the report right after it was published, the Administration had subsequently decided to conduct a public consultation on the matter. Some members considered that the consultation process should be expedited so that related legislative amendments, if necessary, could be introduced as soon as possible.

Business environment of the stockbroking industry

20. Recognizing the difficulties facing the stockbroking industry, in particular, the small and medium sized (SME) brokers, the Panel held three meetings to discuss with the Administration and the industry associations on ways to assist SME brokers and enhance their competitiveness. The Administration established the Working Group on the Business Environment of the Stockbroking Industry (the Working Group) in January 2003 to examine ways for improving the business environment and enhancing competitiveness of the industry. The Working Group published its report in mid April 2003.

21. Members took note of SME brokers' concern about the negative impact of the abolition of the minimum brokerage commission rates from 1 April 2003 on their business and the need to maintain a level playing field between brokers and banks in the conduct of securities business. SME brokers expressed strong dissatisfaction towards the Administration's refusal to introduce a two-tier commission system. Members also noted the Administration's view that liberalization of the securities brokerage commission regime was global trend and would offer more flexibility to brokers in deciding their pricing strategies. The Administration maintained that it had fully considered the pros and cons of the proposal and took the view that the system would not be conducive to improving the competitiveness of the stockbroking industry. As regards brokers' concern about possible cut-throat price war after the liberalization of the minimum brokerage commission rates, the Panel noted that the problem had not yet materialized.

22. However, some members shared the industry's view that at the midst of the present difficult business environment, the Administration and SFC should consider ways to minimize the compliance burden on SME intermediaries. The Panel welcomed SFC's move to reduce its licensing fees and simplify regulatory requirements. In respect of concern about maintaining a level playing field between banks and brokers, members noted the Administration's assurance that HKMA would adopt SFC regulatory standards and subject banks to the same disciplinary procedures and sanctions as SFC licensed

intermediaries. SFC and HKMA signed a new Memorandum of Understanding to set out their respective regulatory duties.

Corporate governance

23. A number of incidents involving listed companies in particular relating to false financial documents and inaccurate information about the performance of companies aroused public concerns about the procedures for approving listings in Hong Kong and the quality of intermediaries involved.

24. Noting the importance of enhancing corporate governance of companies for maintaining Hong Kong's status as an international financial centre, the Panel met with market practitioners, professionals, academics and regulators to discuss the subject. Members generally supported and urged for expeditious implementation of the Administration's corporate governance action plan announced in January 2003 which included plans to upgrade the Listing Rules and listing process, tighten the regulation of IPO intermediaries, ensure effective implementation of the Securities and Futures Ordinance and early implementation of recommendations of corporate governance review of the Standing Committee on Company Law Reform.

25. Apart from on-going monitoring of company directors and market intermediaries to ensure compliance with regulations and stepping up enforcement against misconduct committed by these parties, members opined that there should be greater transparency in the process of appointment of independent directors and auditors for companies to enhance protection of the interests of small shareholders. To enhance the quality of company directors, members also took note of interested parties' view to strengthen directors' education and provide them with appropriate rewards.

26. As accountants played an important role in safeguarding the integrity of financial reporting, members welcomed the initiative of the Hong Kong Society of Accountants (HKSA) to introduce a private member's bill to amend the Professional Accountants Ordinance for improving its self-regulatory regime. They concurred that legislative proposals to open up HKSA's governance structure and enhance its regulatory processes would meet the public's expectation of improving the independence, transparency and accountability of HKSA.

27. As regards HKSA's proposal for establishing an Independent Investigation Board to deal with alleged accounting, auditing and/or ethical irregularities relating to listed companies, members agreed that this would establish adequate oversight over the conduct and work of accountants and urged the Administration to take forward the proposal as early as possible. While taking note of members' view, in view of the cost implications of the proposal, the Administration would conduct a public consultation in

July/August 2003 before deciding the way forward.

Insurance

28. Due to the increasing difficult operating environment facing the insurance industry and the difficulties encountered by various business sectors in obtaining insurance coverage, the Panel held three meetings during this session to meet with the industry associations and receive views of interested parties on the subject. Most deputations expressed views on issues relating to the two major types of mandatory insurance, namely employees' compensation insurance and motor vehicle third party risk in relation to death and bodily injury. Their main concerns were soaring premiums and refusal by some insurers to underwrite for certain sectors/industries, the lack of transparent mechanisms for determining risk levels and premiums and the escalating trend of damages for compensation awarded by the court on claims.

29. The Panel considered that the Administration should take urgent measures to tackle the problems which affected a wide spectrum of the society. Members noted that the main reason for the rise in insurance premiums was the huge underwriting losses suffered by the insurance industry in recent years. Whilst the Administration attached great importance in enhancing the transparency of the insurance market, it considered inappropriate to intervene with the premium level which should be determined with due regard to risk factors and market forces. The industry opined that the promotion of industrial and road safety would reduce accidents and the compensation to be paid out by the insurers. This would help improve the business environment of the insurance industry.

30. On the proposal to limit the right of an employee or a victim to either statutory compensation or common law damages so as to reduce underwriting losses of insurers and hence addressing the problem of soaring premium, members noted the Administration's view that the proposal would have far reaching implications and not justified as both rights were recognized under the existing legal system.

Other issues

31. The Panel continued to monitor the progress in enhancing consumer protection in the banking sector. Members noted that the assessment on banks' compliance with the revised Code of Banking Practice achieved good results and HKMA issued guideline to banks requiring them to put in place effective, transparent and efficient procedures for proper handling of customers complaints. The Panel was aware that the number of complaints received by HKMA significantly reduced in the second half of 2002. Nonetheless, as banks had been rapidly expanding their business beyond traditional activities to insurance and securities, members urged HKMA to step up supervision on

these activities to safeguard the interests of consumers.

32. During the 2002-03 legislative session, the Panel was briefed on the proposed Employee Compensation Insurer Insolvency Scheme, which was subsequently established in February 2003, and the outcome of the public consultation on the major findings and recommendations of the consultancy study on the review of the role of the Official Receiver's Office. Moreover, the Panel examined various legislative proposals including Bills of Exchange (Amendment) Bill, Deposit Protection Scheme Bill, Clearing and Settlement Systems Bill, Companies (Amendment) Bill 2003, Boundary Facilities Improvement Tax Bill, as well as the private member's bills on Dao Heng Bank Limited (Merger) Bill, and The Bank of East Asia, Limited (Merger of Subsidiaries) Bill.

Council Business Division 1
Legislative Council Secretariat
4 July 2003

**Legislative Council
Panel on Financial Affairs**

Terms of Reference

1. To monitor and examine Government policies and issues of public concern relating to financial and finance matters.
2. To provide a forum for the exchange and dissemination of views on the above policy matters.
3. To receive briefings and to formulate views on any major legislative or financial proposals in respect of the above policy areas prior to their formal introduction to the Council or Finance Committee.
4. To monitor and examine, to the extent it considers necessary, the above policy matters referred to it by a member of the Panel or by the House Committee.
5. To make reports to the Council or to the House Committee as required by the Rules of Procedure.

**Legislative Council
Panel on Financial Affairs**

Membership list

Chairman Hon Ambrose LAU Hon-chuen, GBS, JP

Deputy Chairman Hon Henry WU King-cheong, BBS, JP

Members Hon Kenneth TING Woo-shou, JP
Hon James TIEN Pei-chun, GBS, JP
Hon Albert HO Chun-yan
Hon LEE Cheuk-yan
Dr Hon Eric LI Ka-cheung, GBS, JP
Dr Hon David LI Kwok-po, GBS, JP
Hon NG Leung-sing, JP
Hon James TO Kun-sun
Hon Bernard CHAN, JP
Hon CHAN Kam-lam, JP
Hon SIN Chung-kai
Dr Hon Philip WONG Yu-hong, GBS
Hon Jasper TSANG Yok-sing, GBS, JP
Hon Emily LAU Wai-hing, JP
Hon Abraham SHEK Lai-him, JP
Hon MA Fung-kwok, JP

(Total : 18 members)

Clerk Ms Connie SZETO

Legal Adviser Mr KAU Kin-wah

Date 1 November 2002