

立法會
Legislative Council

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Panel on Financial Affairs

Minutes of meeting
held on Thursday, 17 February 2005 at 9:30 am
in the Chamber of the Legislative Council Building

- Members present** : Hon Bernard CHAN, JP (Chairman)
Hon Ronny TONG Ka-wah, SC (Deputy Chairman)
Hon James TIEN Pei-chun, GBS, JP
Hon Albert HO Chun-yan
Hon LEE Cheuk-yan
Hon CHAN Kam-lam, JP
Hon SIN Chung-kai, JP
Hon Emily LAU Wai-hing, JP
Hon Abraham SHEK Lai-him, JP
Hon Jeffrey LAM Kin-fung, SBS, JP
Hon Andrew LEUNG Kwan-yuen, SBS, JP
Hon WONG Ting-kwong, BBS
Hon CHIM Pui-chung
Hon Albert Jinghan CHENG
Hon TAM Heung-man
- Members absent** : Dr Hon David LI Kwok-po, GBS, JP
Hon James TO Kun-sun

**Public officers
attending**

: Agenda Item IV

Hong Kong Monetary Authority

Mr Joseph YAM, GBS, JP
Chief Executive

Mr Norman CHAN, SBS, JP
Deputy Chief Executive

Mr William RYBACK, JP
Deputy Chief Executive

Mr Peter PANG, JP
Deputy Chief Executive

Agenda Item V

Mr Frederick MA, JP
Secretary for Financial Services and the Treasury

Mr Kevin HO, JP
Permanent Secretary for Financial Services and the
Treasury (Financial Services)

Mrs Clarie LO
Deputy Secretary for Financial Services and the Treasury
(Financial Services)

Clerk in attendance : Miss Salumi CHAN
Chief Council Secretary (1)5

Staff in attendance : Ms Pauline NG
Assistant Secretary General 1

Ms May LEUNG
Legislative Assistant

Agenda Items I to IV

Ms Connie SZETO
Senior Council Secretary (1)4

Agenda Items V and VI

Ms Rosalind MA
Senior Council Secretary (1)8

Action

I. Confirmation of minutes of meetings

(LC Paper No. CB(1)741/04-05 — Minutes of meeting on 6 December 2004

LC Paper No. CB(1)879/04-05 — Minutes of meeting on 3 January 2005)

The minutes of the meetings held on 6 December 2004 and 3 January 2005 were confirmed.

II. Information papers issued since the last meeting

2. Members noted the following information papers issued since the last regular meeting held on 3 January 2005:

- (a) Two consultation papers (LC Paper No. CB(1)670/04-05):
 - (i) Consultation paper on proposed amendments to the Securities and Futures Ordinance to give statutory backing to major listing requirements;
 - (ii) Consultation paper on proposed amendments to the Securities and Futures (Stock Market Listing Rules);
- (b) Papers on “Proposal of granting tax relief to divorced persons paying maintenance to ex-spouses” (LC Paper Nos. CB(1)764/04-05(01) and (02)); and
- (c) Securities and Futures Commission Quarterly Report for October to December 2004 (LC Paper No. CB(1)902/04-05).

III. Date of next meeting and items for discussion

(LC Paper No. CB(1)880/04-05(01) — List of outstanding items for discussion

LC Paper No. CB(1)880/04-05(02) — List of follow-up actions)

3. Members agreed that the followings items be discussed at the next regular meeting of the Panel to be held on 7 March 2005 from 9:30 am to 12:45 pm:

- (a) The Securities and Futures Commission Budget for the Financial Year 2005-06;
- (b) Proposals to enhance the oversight of public interest activities of auditors and establish a Financial Reporting Review Panel; and
- (c) Management of Government investment incomes.

4. On paragraph 3(a) above, members noted that the Securities and Futures Commission (SFC) would submit its budget for the Financial Year 2005-06 for the Panel's information. On paragraph 3(b), members noted that the Administration would brief the Panel on the relevant proposals and that it planned to introduce the relevant bill into the Legislative Council (LegCo) in the second quarter of 2005. As regards paragraph 3(c), members noted that as agreed at the informal meeting held on 7 January 2005, the Administration had been invited to discuss with the Panel in March on the research report on "Management of Government Investment Incomes" prepared by the Research and Library Services Division of the LegCo Secretariat and to provide the required information suggested by members.

IV. Briefing on the work of the Hong Kong Monetary Authority

(LC Paper No. CB(1)880/04-05(03) — Power-point presentation material provided by the Hong Kong Monetary Authority

LC Paper No. CB(1)880/04-05(04) — Letter dated 7 January 2005 from the Clerk to Panel to the Administrative Assistant to Financial Secretary (AA/FS) on "Briefing of the Panel on Hong Kong Monetary Authority's Annual Budget"

LC Paper No. CB(1)880/04-05(05) — Reply dated 17 January 2005 from AA/FS

- LC Paper No. CB(1)880/04-05(06) Letter dated 7 January 2005 from the Clerk to Panel to the Chief Executive of the Hong Kong Monetary Authority (CE/HKMA) on “Return rate of the Exchange Fund”
- LC Paper No. CB(1)880/04-05(07) — Reply dated 4 February 2005 from CE/HKMA
- LC Paper No. CB(1)1950/03-04(01) — List of follow-up actions to be taken by the Administration with the letter dated 30 April 2004 from the Clerk to Panel to CE/HKMA
- LC Paper No. CB(1)1950/03-04(02) — Interim reply dated 24 May 2004 from CE/HKMA
- LC Paper No. CB(1)2303/03-04(01) — Reply dated 30 June 2004 from CE/HKMA
- LC Paper No. CB(1)2387/03-04(03) — Letter dated 6 July 2004 from the Clerk to Panel to CE/HKMA
- LC Paper No. CB(1)2387/03-04(04) — Reply dated 12 July 2004 from CE/HKMA)

Briefing on the work of the Hong Kong Monetary Authority

5. At the invitation of the Chairman, CE/HKMA gave a power-point presentation on HKMA’s key areas of work. CE/HKMA highlighted the following points:

- (a) On currency stability, speculation about the introduction of a more flexible renminbi (RMB) exchange rate regime resulted in capital inflow in mid-October 2004. The exchange rate strengthened slightly and HKMA bought the US dollar again in the fourth quarter of 2004 in response to offers by banks, leading to an increase in the Aggregate Balance (AB) to \$15.8 billion on 10 December 2004. Due to the appreciation of the US dollar against other major currencies and the widening of the interest rate differential between the US dollar and the Hong Kong dollar since early 2005, the AB declined to \$9.3 billion on 7 February 2005.
- (b) Market generally expected the increasing trend in US interest rates to continue. Meanwhile, capital inflows had kept Hong Kong dollar interest rates zero-bound, sustaining easy monetary conditions. Larger

and increasing interest rate differential between the US dollar and the Hong Kong dollar would eventually reverse capital inflows. Borrowers should be aware of the possibility of a sharp catch-up of Hong Kong dollar interest rates with US dollar interest rates and the risk of overshooting.

- (c) Important external factors affecting risks and vulnerabilities of the Hong Kong dollar included the growing US current account deficit, volatility in oil prices, pressure to change RMB exchange rate regime, and the macroeconomic conditions in the Mainland. Recent data seemed to suggest that the Mainland economy was probably heading towards a soft landing with deceleration in expansion in fixed asset investment and easing inflationary pressure. With trade surplus widened to a six-year high of US\$32 billion in 2004, there was intensified international pressure on the revaluation of RMB. Internally, robust economic recovery, strong international investment position, easing unemployment rate, and improvement in fiscal position of the Government had contributed to the strengthening of the Hong Kong dollar.
- (d) On the banking sector performance, banks in Hong Kong had benefited from the economic upturn and recorded good profit growth in 2004. The increasing competitive environment in the banking sector had prompted banks to explore new lines of business for income diversification. This was evidenced in substantial growth in banks' non-interest income, such as fees and commissions from wealth management and trade financing business, and treasury income. In view of the diversification of banks' activities, HKMA had improved its supervision over banks' securities and insurance business and had devoted more efforts to the supervision of banks' risk management.
- (e) On the back of improving economic conditions and asset quality, the bad debt charge declined notably. The extent of negative equity problem had eased along with the rise in property prices. The number of residential mortgage loans in negative equity declined from the peak of around 106 000 cases in June 2003 to some 19 200 cases in December 2004 with a fall in aggregate value from \$165 billion to \$33 billion.
- (f) On specific projects in the banking sector, HKMA had undertaken consultation with the banking industry on the draft Banking (Amendment) Bill 2005 (the Bill) for implementing Basel II for authorized institutions (AIs) in Hong Kong and was considering the comments received. HKMA aimed to introduce the Bill into LegCo in April 2005. On the other hand, the preparatory work for the launch of the Deposit Protection Scheme in the second half of 2006 was in good

progress, and the operation of the Commercial Credit Reference Agency since 1 November 2004 had been smooth so far.

- (g) On the follow-up action for the incident of destruction of rented safe deposit boxes by DBS Bank (Hong Kong) Limited (DBS Bank) happened in October 2004 (the incident), HKMA issued a circular to all AIs in December 2004 requiring them to adopt sound internal control principles to safeguard customer assets. The HKMA also supported the best-practice recommendations on relocation of safe deposit boxes issued by the Hong Kong Association of Banks in November 2004. Moreover, AIs had completed the review of the terms and conditions for safe deposit box service as required by HKMA. For those AIs with exemption of liability clauses in the agreements of safe deposit box service found to be inconsistent with the Code of Banking Practice (the Code), HKMA had required them to rectify the situation by 31 March 2005.
- (h) On the development of market infrastructure, the Clearing and Settlement Systems Ordinance became effective on 4 November 2004. The Hong Kong dollar payment systems responded robustly and efficiently to massive payment flows arising from Initial Public Offer activities taken place recently.
- (i) The development of RMB business in Hong Kong was progressing well. At the end of December 2004, total outstanding RMB deposits in Hong Kong amounted to RMB\$12.128 billion. There had also been a steady increase in the use of RMB debit and credit cards by Mainland tourists in Hong Kong. Further development of RMB business in Hong Kong would follow three strategic directions: to explore the diversification of RMB assets and liabilities of banks in Hong Kong; to explore the use of RMB for the denomination and settlement of current account transactions between the Mainland and Hong Kong; and to explore the feasibility of establishing a RMB debt issuance mechanism in Hong Kong, which would facilitate the repatriation of RMB back to the Mainland.
- (j) On the performance of the Exchange Fund (EF), an investment income of \$56.7 billion was recorded for 2004. After deducting interest and other expenses, the net investment income for 2004 was \$52.1 billion. The share of return for the fiscal reserves placed with EF was \$14.5 billion, which exceeded the amount of \$12.3 billion budgeted in the fiscal year 2004-05. The balance of \$37.6 billion, together with part of a premises revaluation surplus of \$0.9 billion, had been added to EF's accumulated surplus for 2004. The total accumulated surplus of EF reached \$423.4 billion at the end of 2004.

- (k) As regards the outlook for 2005, the investment environment was expected to be uncertain and full of challenges. Returns on bonds were likely to be limited given the market expectation on continued rise in US interest rates. The prospects for equities were uncertain and currency markets would probably continue to be volatile.

(Post-meeting note: Updated pages 27 and 28 of the power-point presentation material tabled at the meeting were issued to Members vide LC Paper No CB(1)933/04-05 on 18 February 2005.)

Discussion

Linked Exchange Rate system and stability of Hong Kong dollar

6. Mr Andrew LEUNG noted that continuous capital inflows had kept Hong Kong dollar interest rates low, sustaining easy monetary conditions. While this had benefited Hong Kong's economic recovery, Mr LEUNG expressed concern about the risk of a bubble economy re-surfacing.

7. CE/HKMA said that it was premature to comment on whether a bubble economy would re-surface in Hong Kong. He pointed out that since the prolonged deflation was arrested in mid 2004, the rise in Composite Consumer Price Index was less than 1% and there were not yet any signs of a significant pick-up in inflation pressures. With increasing economic integration between the Mainland and Hong Kong, Hong Kong's economy had been undergoing a structural adjustment. The loose monetary conditions should be beneficial to Hong Kong during this process. CE/HKMA said that if Hong Kong interest rates followed the trend of increase in US interest rates, reduction in interest rate differential between the US dollar and the Hong Kong dollar would help bring the monetary conditions back to normal. There would then be less risk of a bubble economy re-surfacing.

8. Ms Emily LAU noted that while there were signs that the pace of economic recovery in Hong Kong had slowed down recently, the trend of economic growth was expected to continue in the Mainland. Ms LAU enquired about the reasons for the disparity in the pace of economic growth between the Mainland and Hong Kong.

9. In response, CE/HKMA re-iterated that increasing economic integration between the Mainland and Hong Kong had brought about structural adjustment in Hong Kong's economy. While there was disparity in the pace of economic growth between the two economies during the adjustment process, it was believed that after the completion of the process, the pace of economic growth of Hong Kong would catch up with that of the Mainland. CE/HKMA however considered it difficult to predict when the adjustment process would be completed.

10. Given repeated market speculations about the introduction of a more flexible RMB exchange rate regime, Mr Jeffrey LAM enquired about the impact of

appreciation of RMB on Hong Kong's economy and the Linked Exchange Rate (LER) system.

11. CE/HKMA said that the continuous economic development in the Mainland would reinforce the need of introducing a more flexible RMB regime. In the long run, further opening of the Mainland economy would exert pressure on the Mainland authorities to appreciate RMB. Given that Mainland's trade surplus in 2004 was less than 1% of its Gross Domestic Product, the extent of appreciation of RMB, if any, would not be large. CE/HKMA considered it unnecessary for the Hong Kong exchange rate policy to follow that of the Mainland. As regards the impact on Hong Kong's economy, CE/HKMA said that appreciation of RMB would benefit Hong Kong because it would avoid the need for Hong Kong to undertake economic adjustment through lowering of prices, which would bring about deflation. Moreover, appreciation of RMB would increase the competitiveness of Hong Kong products, although an increase in prices of Mainland products might exert an upward pressure on consumer prices in Hong Kong.

12. While pointing out that the business sector supported further development of RMB business in Hong Kong following the three strategic directions mentioned by CE/HKMA, Mr James TIEN expressed concern about whether the development would marginalize the role of Hong Kong dollar. CE/HKMA said that even when the US dollar was strong, Hong Kong dollar had not been marginalized by the US dollar. In fact, it was too early to say whether Hong Kong dollar would be marginalized by RMB because RMB was not yet fully convertible and the Mainland's capital accounts were not yet liberalized. The increasing use of RMB in Hong Kong would unlikely diminish the role of Hong Kong dollar or pose risks to its stability. The abundant reserves held in EF for backing Hong Kong dollar would enhance confidence in the currency.

Profit growth in the banking sector

13. Despite the contraction in retail banks' net interest margin from 1.91% in 2003 to 1.65% in 2004, Mr Andrew LEUNG noticed that banks recorded good profit growth in 2004. He however expressed concern about the impact of continuous contraction in the net interest margin on banks' profit growth.

14. On retail banks' profit growth in 2004, CE/HKMA said that the growth was mainly caused by reduction in bad debt charges and increase in non-interest income. The squeeze in margins of residential mortgage lending and lower yield on free funds due to the increasingly competitive environment in the banking sector had resulted in contraction in banks' net interest margin. CE/HKMA remarked that competition in the residential mortgage lending market had kept interest rates low and benefited property buyers. This was evidenced by the continuous reduction in mortgage lending rate. Indeed, the rate, which was set at the best lending rate plus 1.5% a few years before, had been reduced to the current level at the best lending rate minus 2.7% or more. HKMA was concerned that under the increasingly competitive market

environment, banks might be induced to undertake risky business and conduct their business in a less prudent manner, thus adversely affecting banks' profits and the stability of the banking sector in the long run. CE/HKMA said that there was concern about the risks banks were exposing themselves to in the use of large cash rebates when competing for new residential mortgage business, in particular when the mortgage borrowers had sought additional financing, through mortgage insurance. This would enable borrowers to pay nil or nominal downpayment in the purchase of properties. To this end, HKMA had expressed its concerns to banks and reminded them of the need to monitor the associated risks properly. HKMA had also stepped up its efforts in supervising banks' risk management.

Issues related to the destruction of rented safe deposit boxes by DBS Bank

15. Noting that HKMA had required those AIs with exemption of liability clauses in the agreements of safe deposit box service found to be inconsistent with the Code to rectify the situation by 31 March 2005, Mr Ronny TONG enquired whether the AIs would inform their customers of the changes made to the agreements, including the impact of the changes on customers. He also enquired about the actions to be taken by HKMA against those AIs which failed to rectify the situation by the deadline.

16. CE/HKMA advised that under the Code, AIs were required to ensure that exemption of liability clauses were used appropriately in their contracts with customers and that the clauses were consistent with the relevant provisions of the Control of Exemption Clauses Ordinance (CECO) (Cap. 71). The review of AIs' terms and conditions for safe deposit box service completed in mid November 2004 revealed that 24 AIs had agreements with exemption of liability clauses inconsistent with the Code. HKMA had required the 24 AIs to rectify the situation by 31 March 2005. The AIs concerned were required to inform customers of the changes made to the agreements. CE/HKMA added that non-compliance with the requirement could result in supervisory sanctions against the AIs, which might include suspension of provision of safe deposit box service.

17. Mr Ronny TONG further noted that the Code had been amended to make clear that AIs should have due regard to CECO, the Unconscionable Contracts Ordinance (Cap. 458), and the Supply of Services (Implied Terms) Ordinance (Cap. 457) in drawing up terms and conditions of banking services. Mr TONG considered that HKMA should disclose the details of those exemption of liability clauses in the agreements of banking services which had been found inconsistent with the Code and the amendments made to the Code for rectifying the problem, so as to promote customers' awareness to protect their interests. He further suggested that HKMA should consider requiring AIs to ensure that customers were aware of the content of exemption liability clauses in the agreements and the impact on them before they signed the agreements.

18. In response, CE/HKMA advised that it was the policy of HKMA to encourage AIs to improve their disclosure of information to customers. Moreover, the Code and

HKMA HKMA's guidelines and circulars issued to AIs were open documents accessible by the public. HKMA would consider enhancing disclosure of information in this area. It would also consider strengthening guidelines for AIs to ensure customers' awareness of the exemption of liability clauses in the agreements of banking services.

HKMA 19. Ms Emily LAU requested HKMA to consider disclosing the names of the 24 AIs referred to in paragraph 16 above and to provide a written report to the Panel after 31 March 2005 on the compliance situation of the AIs concerned, as well as the actions taken or to be taken by HKMA on them. CE/HKMA agreed to provide the report to the Panel. He also undertook to consider the request of disclosing the names of the 24 AIs.

(Post-meeting note: The interim reply dated 28 February 2005 from HKMA was circulated to Members vide LC Paper No. CB(1)1026/04-05(01) on 1 March 2005.)

20. Ms Emily LAU was of the view that for the sake of enhancing transparency, DBS Bank should disclose the amount of compensation paid to the customers affected by the incident. CE/HKMA undertook to convey Ms LAU's view to DBS Bank.

(Post-meeting note: The reply dated 28 February 2005 from HKMA was circulated to members vide LC Paper No. CB(1)1026/04-05(01) on 1 March 2005.)

Annual budget of the Hong Kong Monetary Authority

21. Mr SIN Chung-kai stressed that LegCo had a legitimate role to approve Government expenditure and monitor the use of public moneys. Referring to the existing practice under which SFC would present its annual budget to the Panel for members' information before the commencement of each financial year, Mr SIN considered that in order to enhance HKMA's transparency and accountability, its annual budget should be subject to the same arrangement.

22. Ms Emily LAU shared Mr SIN Chung-kai's view. She noted the reply dated 17 January 2005 from the Administrative Assistant to Financial Secretary (AA/FS) advising that the Governance Sub-Committee of the Exchange Fund Advisory Committee (EFAC) was reviewing the question of disclosure of HKMA's administrative expenditure in connection with the publication of HKMA Annual Report 2004, and the Financial Secretary (FS) would invite the Sub-Committee to consider, in the context of the review, members' suggestion for HKMA to brief the Panel on its annual budget. Ms LAU enquired about the progress of the Governance Sub-Committee's review.

23. CE/HKMA replied that the Governance Sub-Committee was reviewing the matter. If the Sub-Committee made a decision that information on the expenses of

HKMA should be disclosed in the context of HKMA's annual report, such information would be incorporated in HKMA Annual Report 2004 to be presented at the Panel meeting in May 2005. As regards members' suggestion for HKMA to brief the Panel on its annual budget, it would be considered by the Sub-Committee in the context of the review.

Protection of interests of banking customers

24. Mr SIN Chung-kai noted that with a view to gauging the views of investors in the formulation of policies and programmes, SFC had set up the Public Shareholders Group, comprising members representing interests of investors. The Mandatory Provident Fund Schemes Authority (MPFA) had also set up various advisory committees comprising members from the labour sector to gauge the latter's views on matters relating to the MPF system. Mr SIN considered that there was room for HKMA to improve its existing structure for gauging the views of banking customers. He enquired whether HKMA would consider establishing an advisory committee to gauge the views of banking customers to enhance protection of their interests.

25. CE/HKMA explained that the legal mandates of HKMA as provided under the Exchange Fund Ordinance (EFO) (Cap. 66) and the Banking Ordinance (BO) (Cap. 155) were to maintain the stability and integrity of the monetary and financial systems of Hong Kong, to regulate banks for enhancing the stability of the banking sector and general protection of depositors. HKMA was not provided with the legal mandate to protect the interests of banking customers. If HKMA was to take up such a new function, it would require amendments to the existing laws. Nonetheless, CE/HKMA advised that HKMA considered it important to protect the interests of banking customers. The banking sector, in collaboration with HKMA, had strengthened the Code to require AIs to give due regard to protecting customers' interests in conducting their business. HKMA had also issued guidelines requiring AIs to put in place effective, transparent and efficient procedures for proper handling of customers' complaints. In addition, HKMA also handled complaints from banking customers where an AI failed to respond to the complainant within a reasonable period of time or when the complainant was dissatisfied with the way the complaint was handled by the AI.

26. Mr SIN Chung-kai considered that HKMA's duty to protect the interest of depositors was related to that of protecting banking customers. He pointed out that the existing Banking Advisory Committee (BAC) and the Deposit-Taking Companies Advisory Committee (DTCAC) formed under BO did not have members representing the interests of banking consumers. Mr SIN re-iterated that the broadening of the existing consultative channels to gauge the views of banking customers would be beneficial to enhancing protection of their interests and identifying areas for improvement in the regulation of the banking sector. In response, CE/HKMA supplemented that there were representatives from the Consumer Council in both BAC and DTCAC and agreed to consider Mr SIN's suggestion further.

27. The Chairman pointed out that due to the current low interest rates environment and intense competition in the banking sector, a lot of banks had diversified their business and had been making intensive promotions on investment plans to customers. The Chairman expressed concern about whether customers were aware of the details and the risks involved in these complicated investment plans. He further enquired whether HKMA would consider reviewing the content of the promotional pamphlets for such investment plans with a view to safeguarding the interest of customers. Noting that MPFA would approve trustees' investment funds schemes, the Chairman considered that HKMA should take a more proactive role in supervising AI's business in this area.

28. CE/HKMA appreciated the Chairman's concern and concurred that AIs had to carry out their business in a prudent manner. He advised that AIs were required under the Code to put in place sound and effective systems for safeguarding interests of their customers and properly managing risks arising from their business operations. If considered necessary, HKMA would issue guidelines and circulars to remind AIs of the risks involved in investment plans and set out the expected practices for conduct of the business.

Convergence of Hong Kong Accounting Standards with the International Accounting Standards

29. Referring to the implementation of the new Hong Kong Accounting Standards (HKASs) which had become effective for accounting periods that began on or after 1 January 2005, Miss Mandy TAM enquired about HKMA's plans to follow-up with banks on the implementation of the new accounting standards.

30. In response, CE/HKMA said that banks incorporated in Hong Kong were required to ensure compliance of their annual accounts with the new HKASs. Given that the new accounting standards, in particular HKAS 39, would result in more extensive use of fair value accounting with changes charged to profit and loss account, HKMA expected that the new accounting standards would introduce greater volatility into banks' financial statements. HKMA would work closely with the industry associations and the accounting profession to assess the impact of the new accounting standards.

Investment of the Exchange Fund

31. Mr James TIEN sought CE/HKMA's view on the impact of global political and economic developments on the strength of the US dollar. Given that a substantial portion of EF assets was held in US dollar and the market expectation of a depreciating trend of US dollar, Mr James TIEN enquired whether the Administration would consider reviewing the investment strategy of EF.

32. CE/HKMA said that both political and economic developments in the international arena would affect the stability of the US dollar. Past experience demonstrated that political tension between the US and other countries had affected the stability of the US dollar, and the high current account deficit in the US (approaching 6% of GDP in 2004) had caused increasing global concern and translated into volatility in the US dollar lately. A weakening US dollar would generally be favourable to the investment performance of EF. CE/HKMA also pointed out that under EFO, EF was under the control of FS and should be used primarily for such purposes as FS thought fit for affecting the exchange value of the currency of Hong Kong and for other purposes incidental thereto. FS might also use EF as he thought fit to maintain the stability and the integrity of the monetary and financial systems of Hong Kong. Moreover, under the monetary policy objective determined by FS, currency stability was defined as a stable external exchange value of Hong Kong dollar in terms of its exchange rate against US dollar at around HK\$7.8 to US\$1. Given the primary purposes of EF and the implementation of the LER system, it was the investment strategy of EF to invest majority of its assets in US dollar investments, including US debt securities and equity securities.

33. Referring to the Administration's plan for privatization of the Airport Authority and listing of the Link Real Estate Investment Trust, Mr CHAN Kam-lam pointed out that such quality public assets should be good investment for EF. He suggested that the investment strategy of EF be reviewed to allow EF to invest in such assets.

34. CE/HKMA advised that the EFAC Sub-Committee on Investment, which comprised experienced market practitioners as members, conducted constant review of the investment strategy of EF. The investment strategy was determined having regard to the nature and the primary purposes of EF provided under EFO. Given the primary purposes of EF were to safeguard the exchange value of Hong Kong dollar and to maintain the stability and integrity of the monetary and financial systems of Hong Kong, the investment strategy of EF, as determined by EFAC, was directed by the objectives of capital preservation, liquidity, full backing of the monetary base and maintaining the long-term purchasing power of the assets. The investment benchmark of EF had allocated 5% of the Fund's assets to the Hong Kong equity market as a long-term investment. Consideration might be given to the issue of whether EF should invest in government assets provided that the investment would not contravene the purposes of EF provided under EFO. CE/HKMA undertook to reflect Mr CHAN

Kam-lam's view to FS.

35. Mr CHAN Kam-lam also expressed concern that the investment income of EF was subject to volatility and uncertainties in the global financial markets. As a result, there might be fluctuation in the share of investment income for the fiscal reserves placed with EF, thus creating difficulty for the Government to project the annual investment return for the fiscal reserves. In order to reduce volatility in the investment return for the fiscal reserves and to provide a more stable revenue source for the Government, Mr CHAN considered that the Administration should consider adopting a five-year average rate of investment return of EF as the rate of return for the fiscal reserves placed with EF. CE/HKMA appreciated the merits of providing a stable revenue source for the Government and agreed to convey the suggestion to FS.

HKMA

36. Miss Mandy TAM enquired whether the Administration would consider changing the existing arrangement under which the fiscal reserves shared the same rate of investment return achieved by the entire EF in a year. In response, CE/HKMA advised that the existing arrangement was introduced in 1998. Over the years, the arrangement had on average generated greater return for the fiscal reserves. It might be inappropriate to revise the rate of return for the fiscal reserves upward as this would result in the investment return of EF subsidizing that of the fiscal reserves.

37. In response to Mr CHIM Pui-chung's enquiry, CE/HKMA confirmed that despite that investment in EF recorded a deficit in the first quarter of 2004 due to volatility in the global financial markets, the investment income for 2004 as a whole reached \$56.7 billion.

Use of the accumulated surplus of the Exchange Fund

38. Noting that the accumulated surplus of EF amounted to \$423.4 billion at the end of 2004, Ms Emily LAU considered that it was high time for the Administration to consider deploying part of the accumulated surplus to meet Government expenditure and to finance new initiatives, such as the programmes for combating poverty. Mr LEE Cheuk-yan shared her view. Whilst appreciating that maintaining a strong financial position of EF would facilitate the work of HKMA in maintaining monetary stability in Hong Kong, Mr LEE was of the view that part of the accumulated surplus of EF should be transferred to the General Revenue for meeting Government expenditure and for the benefit of the public. He was also concerned about the appropriate level of EF to be maintained.

39. In response, CE/HKMA explained that fiscal reserves were placed with EF for investment purpose. On the balance sheet of EF, the fiscal reserves were regarded as liability of EF, while the accumulated surplus was regarded as fund equity of EF. He stressed that the assets in EF were recognized as assets of the Government, which were owned by people of Hong Kong. In his view, it was justified to use these assets for the benefit of the public. CE/HKMA however reiterated that the use of EF was governed by EFO. Apart from the primary purposes of EF mentioned in paragraph 32

above, FS might, after consulting EFAC and with the prior approval of the Chief Executive in Council, transfer from EF to the General Revenue any sum or part of any sum where he was satisfied that such transfer was not likely to affect adversely his ability to fulfil any purpose for which EF was required to be or might be used under EFO.

40. As regards the appropriate level of EF to be maintained, CE/HKMA stressed that it would be extremely difficult, if not impossible, to devise a scientific formula for determining such level. Given the volatility in the global financial market and that Hong Kong was a small and externally oriented economy, a sizable EF was vital for Hong Kong to withstand currency attacks and external shocks. As the Monetary Authority, CE/HKMA considered it necessary to adopt a prudent approach in maintaining the level of EF.

41. Mr LEE Cheuk-yan suggested that the Panel should consider inviting FS to discuss with members on how the accumulated surplus of EF should and would be used. Ms Emily LAU supported Mr LEE's suggestion. The Chairman said that he would convey the suggestion to FS.

(Post-meeting note: The Chairman conveyed the suggestion to FS, and the Clerk to the Panel wrote to AA/FS on 2 March 2005 inviting FS to attend the Panel meeting on 6 May 2005 to discuss with members on the subject.)

V. Further discussion on proposed amendments to the Securities and Futures Ordinance — the proposal of splitting the post of the Chairman of Securities and Futures Commission into a non-executive chairman post and a chief executive officer post

(LC Paper No. CB(1)880/04-05(08) — Paper provided by the Administration

LC Paper No. CB(1)755/04-05(01) — Letter dated 8 January 2005 from the Principal Assistant Secretary for Financial Services and the Treasury (PAS(FST)) to the Secretary General of the International Organization of Securities Commissions (IOSCO)

LC Paper No. CB(1)755/04-05(02) — Letter dated 12 January 2005 from the Commission Secretary of the Securities Futures Commission to the Secretary General of IOSCO

- LC Paper No. CB(1)755/04-05(03) — Letter dated 12 January 2005 from the Secretary General of IOSCO to PAS(FST)
- LC Paper No. CB(1)880/04-05(09) — Extract from “Objectives and Principles of Securities Regulation” of IOSCO
- LC Paper No. CB(1)881/04-05(01) — Two articles published on the Economist (22 January 2005)
- LC Paper No. IN12/04-05 — Information note on Overseas Securities and Futures Regulators prepared by the Research and Library Services Division of the LegCo Secretariat
- LC Paper No. CB(1)595/04-05(01) — Summary of submissions
- LC Paper No. CB(1)177/04-05(01) — Paper provided by the Administration for discussion at the special meeting on 10 November 2004
- LC Paper No. CB(1)177/04-05(02) — Background brief prepared by the Legislative Council Secretariat
- LC Paper No. CB(1)568/04-05 — Minutes of special meeting on 10 November 2004 (Agenda Item I)
- LC Paper No. CB(1)879/04-05 — Minutes of meeting on 3 January 2005 (Agenda Item V)

Briefing by the Administration

42. At the invitation of the Chairman, the Secretary for Financial Services and the Treasury (SFST) briefed members on the paper provided by the Administration. SFST said that the Securities and Futures Commission (SFC) played a very important role in ensuring and reinforcing Hong Kong’s position as an international financial centre. Hence, the Administration attached great importance to the governance of SFC. The proposal of splitting the post of the Chairman of SFC aimed at enhancing the governance of SFC in order to ensure its effective functioning to meet future challenges and to keep in line with best local and international practice. The proposal had received clear support from a great majority of the organizations and academics invited by the Panel to give views on the proposal, including professional bodies,

academics and a number of associations representing the securities and fund management industry. SFST then highlighted for members' information the following points in relation to the Administration's response to the issues raised during the discussions at previous Panel meetings held on 10 November 2004 and 3 January 2005:

(a) Executive or non-executive chairman

- The future SFC chairman post should be non-executive so that the incumbent could focus on matters relating to the overall directions, policies and strategies of SFC; so that the incumbent could be independent from the executive arm so as to enhance the internal checks and balances; and to avoid overlapping of responsibilities between the chairman and the Chief Executive Officer (CEO).
- The split model was working well in some other financial regulators in Hong Kong, such as the Hong Kong Exchanges and Clearing Limited and the Mandatory Provident Fund Schemes Authority.

(b) Part-time or full time chairman

It was not meaningful to label the non-executive chairman as part-time or full-time. A chairman with commitment would spend as much time as necessary to fulfill his or her roles and responsibilities. There were numerous examples of non-executive chairmen of statutory bodies who devoted a lot of their time and efforts in the spirit of providing a service to the community.

(c) Roles and duties

- The non-executive chairman's role was to lead the board in setting the overall direction, policies and strategies of SFC having regard to local and international developments, and in monitoring the performance of the executive arm in fulfilling the objectives set by the board.
- The CEO should have the executive responsibility on the day-to-day running of SFC.

(d) Appointment and selection criteria

- The non-executive chairman would be appointed by the Chief Executive (CE) in accordance with the present appointment system for public and statutory bodies. Essential qualities of the candidate included integrity; commitment to serve the community; knowledge of the local and international financial markets; vision and leadership; ability to communicate with the public and the relevant stakeholders and to establish a rapport with relevant bodies in other jurisdictions.
- Recruitment of CEO would be conducted through worldwide search. Candidates for the CEO post should possess solid

executive and management ability and experience. He or she should have hands-on experience and knowledge of the financial markets and the regulatory and compliance issues involved.

(e) Remuneration

- In considering the level of remuneration for the non-executive chairman post, a number of factors would be taken into account. The factors included, inter alia, that the chairman post was a service for the community and not an employment with SFC; relativity with the current remuneration of non-executive chairmen of other statutory or public bodies in Hong Kong and relevant regulatory bodies overseas; and relativity with the remuneration of non-executive directors of SFC. The actual level of remuneration would have to be negotiated after the suitable candidate had been identified.
- In drawing up the remuneration package for CEO, the existing principles governing remuneration for senior executives as recommended in the Hay Consultancy Report issued in June 2002 would apply.

(f) Participation in the International Organization for Securities Commissions (IOSCO)

Based on the response from the Secretary General of IOSCO, the appointment of the IOSCO Technical Committee chairman was “a personal appointment based on the recognized experience and authority of the appointee” in providing strong input to the work of the organization.

43. SFST assured members that the selection of the suitable candidate for the non-executive chairman post would be made in a prudent manner, having regard to the essential qualities of the candidate mentioned in paragraph 42(d) above. SFST pointed out that given the merits of the splitting proposal for enhancing the governance of SFC and that the proposal was supported by a number of professional bodies, academics and industry organizations, the Administration saw no reason for delay in taking forward the proposal. In this connection, the Administration planned to introduce the relevant legislative proposal to LegCo in the current legislative session. SFST solicited Members’ support for the proposal.

Discussion

Appointment of the chairman

44. Mr Ronny TONG reiterated his concern expressed at the last meeting about the transparency of the mechanism for appointment of the non-executive chairman. He pointed out that under the existing mechanism, appointments to public bodies were made by CE and were often offered to a small pool of candidates favoured by CE. This arrangement was not conducive to inspiring public confidence in the independence and credibility of the candidates selected. Referring to paragraphs 72 to 74 of the minutes of the last meeting on 3 January 2005, Mr TONG pointed out that the Administration had undertaken to consider his suggestion of enhancing the transparency of the appointment mechanism by setting up an independent nomination/appointment committee comprising members from the industry, academia and the community for the selection of the chairman. He requested the Administration to respond to his suggestion, which was supported by some organizations present at the last meeting. Mr TONG indicated that he would object to the splitting proposal if the Administration retained the existing appointment mechanism without making any improvements to enhance its transparency.

45. Mr Albert CHENG and Mr LEE Cheuk-yan expressed similar concern about the lack of transparency of the existing appointment mechanism. Mr CHENG pointed out that the public had lost confidence in the existing mechanism as CE often made appointments from the small pool of candidates of his choice in the past few years. Pointing out that the non-executive chairman of SFC would have great impact on the image and work of SFC in the local and international markets, Mr LEE considered that the recruitment should be conducted through worldwide search with an open and transparent process. Nevertheless, given that the present governance structure of SFC had been working well, Mr LEE did not see any urgent need for implementing the splitting proposal.

46. Ms Emily LAU considered it essential to put in place a transparent system for the appointment of the chairman of SFC. In this connection, she expressed dissatisfaction that the Administration had not given any direct response to Mr Ronny TONG's suggestion raised at the last meeting, i.e. setting up of a nomination/appointment committee for the selection of the chairman of SFC. Moreover, some other members had also suggested at the last meeting that the Administration should seek LegCo's endorsement on the appointment of the chairman of SFC, with reference to the practice of the United States (US) where the appointment of the five Commissioners (including the chairman) of the Securities and Exchange Commission was made by the US President with the advice and consent of the Senate.

47. Mr CHAN Kam-lam said that given the important role of SFC, the Administration should ensure transparency in the appointment of the non-executive

chairman and adopt stringent selection criteria for identifying a suitable and competent candidate for the post.

48. In response, SFST said that the current appointment system had been working very well and he regretted to note that some Members did not have confidence in the system. He considered those comments unfair to many of the past and serving chairmen and members appointed by the Government to the various statutory and advisory bodies. SFST pointed out that there were numerous examples of chairmen and members of statutory and advisory bodies appointed by the Administration under the present appointment system having devoted a lot of their time and efforts to perform their duties in the spirit of providing a service to the community. SFST assured members that, as he had pointed out during his earlier briefing, the Administration would select the candidate for the non-executive chairman post on merit and in a prudent manner, with a view to identifying a candidate with integrity, commitment to serve the community, and knowledge of the local and international financial markets. He reiterated that the Administration was mindful of the critical role of SFC in maintaining the status of Hong Kong as an international financial centre. The splitting proposal was a move to enhance the governance structure of SFC with a view to facilitating the development of the financial services industry, which was an important pillar of the economy. As regards the suggestion for enhancing the transparency of the appointment mechanism, SFST pointed out that appointments to public bodies were subject to public scrutiny and the Administration welcomed views from the industry and the community on the appointment of the chairman of SFC. The Administration did not consider that there was a need to make changes to the existing appointment system, which had been operating efficiently and effectively in the appointment of public offices in the past years.

Requirements and remuneration of the chairman

49. Mr CHAN Kam-lam expressed concern about the level of remuneration for the non-executive chairman. In his view, the Administration should set a fixed level of remuneration for the post before commencing the appointment exercise so as to enhance the transparency of the appointment and ensure fairness to all potential candidates for the post. In fact, the potential candidates might take into account the level of remuneration in considering the offer. Moreover, offering the same level of remuneration to all candidates would prevent public scepticism about any “transfer of benefits” between the Administration and the selected candidate.

50. In reply, SFST explained that in considering the level of remuneration for the non-executive chairman post, a number of relevant factors as mentioned earlier in his briefing would be taken into consideration. These included: the post was a service for the community and not an employment with SFC; relativity with the current remuneration of non-executive chairmen of other statutory or public bodies in Hong Kong and relevant regulatory bodies overseas; and relativity with the remuneration of non-executive directors of SFC. The Administration considered it appropriate to determine the actual level of remuneration for the non-executive chairman post after

negotiation with the candidate and having regard to the relevant factors. SFST also advised that while the levels of remuneration for the non-executive chairmen of other statutory or public bodies varied to a great extent, the level of remuneration for the non-executive directors of SFC was about \$200,000 per annum.

51. The Chairman pointed out that the levels of basic salaries of the Chairman and CEO of the Financial Services Authority (FSA) of the United Kingdom (UK) were comparable. SFST advised that under the Administration's proposal, the non-executive chairman post was not an employee of SFC and therefore the level of remuneration for the chairman post would be lower than that for the CEO post. Moreover, given the differences in the scope of regulatory work of FSA and SFC, it might not be appropriate to make a direct comparison of the remuneration levels for their chairman posts.

52. Given that SFC was empowered to conduct investigations and take enforcement actions, Ms Emily LAU considered that in order to maintain the credibility of SFC, its chairman should not be directly related to the securities and futures sector regulated by SFC and should be independent from any external influence in his or her work. To ensure the appointment of a candidate who was professional, independent and free from any real or perceived conflict of interests, a reasonable level of remuneration, as in the case of the Chairman of FSA in UK, should be offered to the chairman of SFC.

53. In reply, SFST explained that the non-executive chairman would not be involved in the day-to-day executive responsibilities of SFC. As such, the incumbent would not be involved in the investigation of cases and taking of enforcement actions. Nevertheless, the CEO would inform or consult the non-executive chairman on matters of significance to the SFC, if considered necessary or appropriate to do so. SFST also pointed out that as the regulator of the securities and futures market, SFC had a wide range of functions and powers. Apart from law enforcement, SFC was tasked to strengthen the status of Hong Kong as an international financial centre and promote development of the local market. The non-executive chairman would play an important role of leading SFC in matters relating to the overall directions, policies and strategies of the organization. SFST called upon Members to refrain from making assumptions that suitable and competent candidates could not be identified if only a nominal level of remuneration was offered. On the contrary, previous examples had shown that candidates who were committed to serving the community would take up public offices despite the nominal monetary reward or monetary loss in some cases as they had to devote their time to public services instead of in profit-making business. SFST further pointed out that in order to provide additional safeguard to ensure the independence of the non-executive chairman of SFC, the Administration proposed that during his or her tenure of office, he or she should not:

- (a) be a director of any listed company in Hong Kong; or

- (b) have any material interest in any principal business activity of or be involved in any material business dealing with a listed company, or any person or institution engaged in activities regulated by SFC.

Timing for implementation of the splitting proposal

54. Noting that Mr Andrew SHENG, the incumbent Chairman of SFC, would vacate his office upon the expiry of his current contract in September 2005, Ms Emily LAU was concerned whether there was sufficient time for scrutiny of the relevant legislative proposal for splitting the chairman post. In this connection, she enquired about the transitional arrangement for filling the chairman post if the legislative proposal would not be passed by September 2005.

55. Mr Albert CHENG shared Ms Emily LAU's concern. He also shared the concern expressed by some organizations at the last meeting on 3 January 2005 that whether there was a need for implementing the splitting proposal, which involved a major change to the governance structure of SFC, in haste. Mr CHENG considered that even if the Administration insisted to introduce the relevant legislative proposal into LegCo, the legislative proposal might not be passed before the departure of Mr Andrew SHENG in September 2005.

56. In response, SFST advised that the existing governance structure of SFC would be maintained before the passage of the legislative proposal for the splitting proposal. In case there was a time gap between the departure of the incumbent Chairman and the implementation of the proposal, a suitable candidate would be recruited to fill the chairman post, while making clear to the candidate that the legislative proposal being scrutinized would enable splitting of the post and he or she would become CEO of SFC after the splitting. SFST also pointed out that the Administration was putting forward the splitting proposal for enhancing the governance of SFC in line with the global practice, and was not trying to do it in a hasty manner. As a matter of fact, the Administration had discussed with the Panel on the same proposal at three different meetings including the meeting today. He believed that any time gap between the departure of the incumbent Chairman of SFC and the implementation of the splitting proposal would not bring about problems in the recruitment of a replacement as long as the candidates were fully aware of and accepted the possible changes to the governance structure to be made after the passage of the legislative proposal.

57. Mr Albert CHENG was concerned that the proposed arrangement of recruiting the Chairman of SFC, with a view to re-designating the incumbent as CEO after appointment of the non-executive chairman with the implementation of the splitting proposal, was not desirable. If the CEO and the new chairman could not work well in partnership, fresh recruitment exercises might have to be conducted. SFST assured members that the Administration would endeavour to appoint a competent and credible candidate as the non-executive chairman of SFC. He

believed that the appointee and the CEO could work well in the spirit of partnership and under the common goal of serving the community in their work.

Overall views

58. Mr Abraham SHEK supported the Administration's proposal to split the post of the Chairman of SFC into the non-executive chairman and CEO posts, for enhancing the corporate governance of SFC and hence its work in strengthening the status of Hong Kong as the international financial centre. Mr SHEK pointed out that a majority of members, relevant organizations and academics were concerned about the possibility of appointing a competent and suitable candidate for the non-executive chairman post under the existing appointment mechanism. He opined that while the issue of improving the existing appointment mechanism for advisory and public bodies could be considered by the relevant Panel, it should not be an obstacle for the implementation of the splitting proposal.

59. Mr CHIM Pui-chung said that deputations of the securities and futures industry raised no objection to the splitting proposal in principle. He pointed out that apart from strengthening the status of Hong Kong as the international financial centre, SFC had other important roles to play in providing support to the securities and futures industry, such as providing more development opportunities for local brokers. As to the concern about selection of a suitable candidate for the non-executive chairman post under the existing appointment mechanism, Mr CHIM opined that it was outside the purview of SFST to take follow-up actions for making changes to the appointment mechanism.

60. Mr James TIEN said that given the successful implementation of the split model in other public bodies, such as the Airport Authority and the Mass Transit Railway Corporation Limited, Members of the Liberal Party (LP) considered the Administration's current proposal feasible. As deputations of the securities and futures industry were in support of the splitting proposal, Members of LP would respect their views. Nevertheless, Mr TIEN said that the Administration should address the concern about the appointment of the non-executive chairman and try its best to identify a suitable and credible candidate for the post.

61. Ms Emily LAU expressed great reservations on the splitting proposal. Given that SFC played a very important role in ensuring and reinforcing Hong Kong's position as an international financial centre, any mishandling of the appointment of its chairman would have great adverse impact on Hong Kong and tarnish the reputation and image of SFC. She therefore urged the Administration to reconsider the proposal in detail.

62. Mr SIN Chung-kai stated that Members of the Democratic Party (DP) did not support in principle the splitting proposal. If the relevant legislative proposal was introduced into LegCo, they would not support the proposal.

63. SFST was disappointed that Members of DP did not support the splitting proposal despite the majority support from professional bodies, academics and the industry. He urged members to support the introduction of the proposed legislative amendments so that the Administration could further explain and work out the details of the proposal with LegCo during the scrutiny of the relevant bill.

64. Mr SIN Chung-kai clarified that the implementation details were not the main concern of Members of DP. The reasons why they did not support the splitting proposal were twofold. First, overseas experience did not show that the separation of roles and responsibilities of the chairman and CEO was a global practice commonly adopted by securities and futures regulators. Secondly, there was no major problem identified in the existing governance structure of SFC for the urgent implementation of the splitting proposal. As such, there was no strong justification for making such a significant change to the governance structure of SFC shortly after the commencement of the Securities and Futures Ordinance (Cap. 571) in 2003. In brief, Mr SIN pointed out that while the split model might be suitable for other public bodies, Members of DP did not consider it appropriate to split the Chairman post of SFC at this stage.

Motion proposed by Mr James TIEN

65. Mr James TIEN supported the Administration's proposal and put forward the following motion for the Panel's consideration, a copy of which was tabled at the meeting:

“本事務委員會原則上支持政府修訂《證券及期貨條例》，把證券及期貨事務監察委員會(證監會)主席職位分拆為非執行主席及行政總裁兩個職位，以改善證監會的管治架構。”

(English translation)

“That this Panel supports in principle the Administration's proposal to amend the Securities and Futures Ordinance to split the post of the Chairman of SFC into a non-executive chairman post and a chief executive officer post with a view to enhancing the governance structure of SFC.”

66. The Chairman considered that the proposed motion was directly related to the agenda item under discussion and it was appropriate for the Panel to deal with the motion. With the agreement of the members present to proceed with the motion, the Chairman put the motion to vote. Of the 15 members present, nine voted for and six voted against the motion. The Chairman declared the motion passed.

VI. Any other business

67. There being no other business, the meeting ended at 12:40 pm.

Council Business Division 1
Legislative Council Secretariat
1 April 2005